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June 21, 2016

Letter to all Interested Stakeholders

Commission Investigation into Potential Improvements to its Water Policies
(Docket No.: W-00000C-16-0151)

Dear Interested Stakeholder:

Included in this mailing are the Discussion of Policy Recommendations for the Water and Wastewater Industries, as well as Attachment 1: Questions and Proposals for the Short Form Water Rate Application. These documents have been prepared for the Special Open Meeting Water Workshop being held at the Commission on June 24th, 2016 and can also be found in Docket, or on the Commission website via the docket link.

Sincerely,

A handwritten signature in black ink, appearing to read "DLittle".

Doug Little
Chairman

Arizona Corporation Commission
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JUN 21 2016

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Discussion of Policy Recommendations for the Water and Wastewater Industries

by Chairman Doug Little

Prepared for the Special Open Meeting on June 24th, 2016

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10 I. Introduction

11 The private water utility industry in Arizona is highly fragmented and problematic. This Commission
 12 has seen first-hand the extent to which small water utilities sometimes struggle both financially and
 13 operationally. The struggles of these companies can have direct impacts on the service they provide
 14 to their customers. Consolidating the small systems through purchases by larger systems has long
 15 been proposed as a solution to the problems associated with small systems and this Commission has
 16 endorsed consolidation through purchase at various times over the past decades. We recognize
 17 that consolidation can be an effective method of solving problems associated with small systems
 18 and propose several policies here to encourage consolidation directly. However, we also recognize
 19 that consolidation cannot solve all problems; some small systems may never be consolidated due to
 20 practical reasons and some small systems are perfectly capable of providing quality service without
 21 consolidation. Therefore, we are also proposing policies here aimed at alleviating the unnecessary
 22 regulatory burdens that small companies face when dealing with the Commission. The aim here is
 23 to allow the smaller companies and Commission Staff to get through rate cases with a focus on
 24 efficiently establishing just and reasonable rates and to deemphasize aspects of the rate case
 25 process that stray from that core mission.

26 Allowing for more efficient rate cases and encouraging consolidation will have direct and tangible
 27 benefits for small water utility customers. When small utilities do not file rate cases for extremely
 28 long periods of time they will almost inevitably end up in a situation where their expenses and
 29 capital needs are difficult or impossible to meet. This results in service quality problems that impact
 30 customers directly. And when companies in this situation eventually do file rate cases, the cases are
 31 more complex (due to e.g., the long period of time the rate base audit will cover and due to the
 32 assessment of engineering improvements that have to be made) and the rate increase that
 33 ultimately comes out of the case will be larger resulting in “rate shock” to the customers. A
 34 situation where companies come in for smaller rate increases more frequently would result in
 35 healthier companies, safer and more reliable water and less agitated customers. We do recommend
 36 that small utilities file rate cases (or at least seriously examine whether a rate case filing is
 37 necessary) at least every 5 to 7 years. However, requiring them to do so would not be good policy.
 38 Rather, we should create an environment where utilities will do so voluntarily.

1 Similarly, troubled small water systems that are acquired by larger entities will have access to the
2 capital and expertise necessary to make tangible improvements in service quality. And if rate-
3 consolidation is adopted the rate impact of necessary capital improvements to small systems may
4 be significantly less than it would be otherwise.

5 While the focus and impetus of this Policy Statement is on smaller utilities, we also recognize that
6 the regulatory burden on larger water utilities can be significant and costly (and those costs
7 ultimately are passed onto customers.) Therefore we propose here policies that will streamline the
8 rate case process for larger companies as well.

9 The proposals and issues discussed here are not new. This Commission has recognized and
10 discussed these issues since (at least) 1998 when the Commission's Water Task Force¹ was formed
11 to develop recommendations dealing with essentially the same issues discussed herein. Over the
12 intervening years these issues have come up repeatedly in rate cases and other dockets. We believe
13 it is time to provide clarity to the Commission Staff and to Arizona's water utility industry on the
14 Commission's stance on the issues discussed below. Processing water utility rate cases is one of the
15 core missions of this Commission and as such it is appropriate that the Commission provide clarity
16 on these issues.

17 II. Small Water Company Rate Case Issues

18 The rate case process is potentially difficult and intimidating for small water utilities. Small utilities
19 do not typically have professional regulatory accountants or rate experts on staff to prepare and file
20 such cases, deal with discovery, work with Staff and bring the case to conclusion. When small
21 utilities are unable to prepare a rate case or complete the rate case process, their rates will become
22 out-of-date due to inflation and other factors, affecting their financial viability as well as their ability
23 to fund necessary maintenance and capital improvements. This can lead to service quality issues
24 and to rate shock for customers when rates are finally increased.

25 The Arizona Administrative Code as it pertains to rate cases² allows smaller companies to file fewer
26 schedules than larger companies. The Commission also provides a "short form" rate application for
27 small water utilities.³ Further, our rate case time-clock rule⁴ requires a faster process for smaller
28 companies. We recently updated the utility classifications, which is another measure that should
29 help smaller companies.⁵ We also worked with the Legislature to amend A.R.S. § 40-250 to remove
30 the hearing requirement for utilities with intrastate gross operating revenues of less than one
31 million dollars.⁶ In spite of these efforts to reduce the regulatory burden on small water utilities,
32 many small company rate cases can, when issues are contested, become lengthy and extend well
33 beyond specified processing timelines.

¹ W-00000C-98-0153

² A.A.C. R14-2-103.

³ <http://www.azcc.gov/Divisions/Utilities/forms/2016WaterRateApplicationUnder1M-draft.pdf>

⁴ A.A.C. R14-2-103(B)(11).

⁵ See Notice of Final Rulemaking at 20 Arizona Administrative Register 3439 to 3445.

⁶ See A.R.S. 40-250. This was amended in 2015 by S.B. 1098. Previously, utilities with revenues under \$250,000 were exempt.

1 Listed below are specific policies we adopt to lessen the regulatory burden on small water utilities
2 while continuing to ensure customers are protected.

3 **1. Encourage use of the Class Spokesperson Procedure:** We encourage public participation in rate
4 cases, and recognize that value and perspectives that intervenors bring to rate cases. However,
5 participation by multiple intervenors in a small utility rate case can increase the expense of the case
6 substantially. Accordingly, we encourage the Hearing Division to use the class spokesman procedure
7 in A.A.C. R14-3-105(C) in appropriate cases to ensure that intervenors do not unduly prolong the
8 process. Employing this procedure can also lessen the expense on the intervenors themselves since
9 it will reduce the amount of filings they will have to make and will allow them to pool their
10 resources. In addition, as with all discovery, intervenor discovery should not be unreasonable or
11 disproportionate to the amounts at stake.

12 **2. Allow for Emergency Surcharges:** A Class C, D, or E water or wastewater utility that faces a
13 water supply emergency (such as a failed well, pump, or tank) may request an emergency surcharge.
14 The emergency surcharge procedure will comply with all legal requirements for an “emergency rate
15 case”. The emergency surcharge shall be based on the estimated costs of repairs or replacement
16 plant. The emergency surcharge may be based on a ten-year amortization based on the interest
17 rate for any loan anticipated to fund the repairs or replacement plant, or on the cost of debt
18 approved in the most recent “Class A” water utility rate case. A reasonable deadline for expiration
19 of the surcharge should the utility not file a rate case may be established. Since the legal
20 requirements for “emergency rate cases” are not contained in statute or the Administrative Code
21 but rather are contained in various court cases and at least one Attorney General’s opinion, Staff will
22 provide a draft write up on the process for applying for an emergency surcharge to the Commission
23 by **August 11, 2016**. The write up will be placed on the Utility Division’s web page when finalized by
24 the Commission.

25 **3. Allow for Purchased power and Water Adjustors for Small Utilities:** We have sometimes
26 approved purchased power adjustors and purchased water adjustors for larger water companies.
27 We will consider requests for such adjustors from smaller utilities as well—there should be no
28 minimum utility size required for adjustor mechanisms. Staff is directed to update the Short Form
29 Rate Application to include schedules necessary for calculating purchased power and water
30 adjustors. The revised Short Form rate application will be available for Commission review by **August**
31 **11, 2016**.

32 **4. Allow for System improvement Funds:** In rate cases for Class D or E water or wastewater
33 utilities, we will consider establishing a fixed surcharge to fund a “system improvement” fund
34 and/or an “emergency repair and replacement” fund. Normally, the revenue allowed to cover
35 depreciation expense serves the purpose of allowing for plant replacements. However, many small
36 utilities find themselves in a situation where depreciation expense is (and has been) insufficient to
37 cover needed improvements. Requests for these surcharges will be considered on a case-by-case
38 basis. Surcharges will be capped, and funds from each surcharge must be strictly tracked and spent
39 only for the specified purposes. We may require surcharge funds be deposited into separate,
40 segregated bank accounts. Any such surcharges will continue until the utility’s next rate case. The
41 surcharge amount will not change between rate cases. Staff is directed to update the Short Form

1 Rate Application to include schedules necessary for calculating system improvement surcharges. The
2 revised Short Form rate application will be available for Commission review by **August 11, 2016**.

3 **5. Insure Staff Reports Are Sufficiently Informative:** In order to allow the Commission to fully
4 evaluate the recommendations of Staff in small water utility rate cases the following information
5 will be included in all future Staff Reports (or testimony if applicable) on Class C,D, and E water rate
6 cases:

7 a. A Cash Flow Schedule that clearly shows Staff's calculation of Free Cash Flow. For small
8 companies Free Cash Flow is an extremely important statistic and is sometimes used as the basis for
9 ratemaking. Therefore, it is very important that the Commission, the ALJ and the Company
10 understand Staff's calculation of free cash flow. Staff currently reports a Free Cash Flow number
11 (without a schedule showing how it is developed) so this requirement does not require any new
12 calculations.

13 b. A schedule that clearly shows how much revenue (in absolute and percentage terms) is
14 generated by the basic service charge and each of the commodity tiers for the Company's present
15 rates, the Company's proposed rates and Staff's proposed rates. As discussed below, rate design is
16 an essential part of the ratemaking process. It is essential that there be transparency with respect
17 to the implications of whatever rate design is being recommended.

18 c. A statement that clearly explains what method Staff used to generate the revenue
19 requirement (Rate Base Rate of Return, Operating Margin, or Cash Flow) and explains why the
20 method used is preferable to the other potential methods.

21 **6. Establish Standard of Materiality:** Audits performed by Staff on small water companies should
22 focus on issues likely to materially impact rates. Accounting issues that have minimal impact on
23 rates need not be addressed in small water utility rate cases. Staff will establish standards of
24 materiality that take into account rate impacts. Staff will not request invoices or other information
25 from companies if the amount in question is too small to have a material impact on rates and/or if
26 the information is not directly relevant to rate setting. The standard of materiality will be submitted
27 for Commission review by **August 11, 2016**. The current standard of materiality Staff uses (FRA Staff
28 Issue Discussion Memorandum Materiality, January 2014) has a high level discussion of what types
29 of *adjustments* are appropriate but does not discuss what types of *data requests* are appropriate.

30 **7. Allow for Collection of Lost Revenue:** We recognize that small water companies may be reluctant
31 to respond to Staff's recommendations or engage in debate with Staff, either because of ignorance of
32 the process, fear of a bad result and/or fear of a delayed process. Staff reports should clearly and
33 prominently state that they are recommendations only and that the applicant has a right to respond.
34 In order to alleviate the potential reluctance of small water companies to fully participate in the rate
35 case process due to fear of delay, if a class C, D or E rate case is not completed in the timeframe
36 specified by the Arizona Administrative Code, when new rates ultimately are approved a surcharge
37 mechanism may be established that collects the "lost revenue" associated with missing the deadline.
38 The lost revenue will be calculated as the revenue that would have been collected under the approved
39 rates had they been effective on the day the time-clock specified in the Arizona Administrative Code
40 expires up to the date the new approved rates actually are effective. If the cause of the delay can

1 clearly be linked to the Company's actions the Commission may choose not to impose the above
2 surcharge.

3 **8. Establish a process for the Small Water Systems Fund:** The Commission has been authorized to
4 provide recommendations for the approval of grants from the Small Water System Fund for some
5 time.⁷ In spite of this authorization, the SWSF has not had a source of funding for some years until
6 recent legislation provided \$500,000. We believe a simple process that insures the fund is used for
7 real emergencies at utilities that legitimately cannot afford repairs while at the same time does not
8 impose unnecessary red tape on the struggling utility is advantageous. As such, we adopt a modified
9 version of the process outlined by Staff in the Staff Report docketed September 8, 2015 in Docket W-
10 00000C-15-0250. In that Staff Report, Staff described the following process:

- 11 • The ACC Utilities Director receives the request for funding.
- 12 • The request is evaluated by the ACC Utilities Division Staff, including determination of the
13 status of existing infrastructure, reasonableness of estimated cost to remedy, and
14 financial circumstances of the requesting company in order to correct or avoid an
15 interruption of service.
- 16 • If approval is recommended, a letter to WIFA is prepared and discussed with
17 Commissioners in an ACC Staff Meeting. If approved by the Commission, the letter is
18 signed by the Chairman and sent to WIFA. The Commission may also order that the
19 Company file a financial improvement plan (with a reasonable deadline in light of the
20 emergency situation.) If approval is not recommended, the reason why will be discussed
21 at a Commission Staff meeting.
- 22 • According to WIFA, once the ACC recommendation is received by WIFA (as required by
23 statute), the water company is asked to submit a grant application that is reviewed by
24 WIFA Staff and a Resolution is prepared. Commission Staff will assist the Company with
25 the grant application if necessary. The Resolution is then submitted to the WIFA Board
26 (or the WIFA Board's designee.)
- 27 • During this process, WIFA staff reviews the detailed invoices and conducts a site visit prior
28 to the final disbursement of funds.
- 29 • Any subsequent review of funds utilized by the Interim manager for infrastructure needs
30 would be made through the next emergency or permanent rate case proceeding.
- 31 • Any funds disbursed are to be sent directly to the vendors who supplied material or labor
32 for the emergency repair or improvement, not to the utility itself.
- 33 • The Utilities Division will keep records sufficient to comply with the reporting
34 requirements of House Bill 2695 Sec. 150(C). That section requires financial reporting on
35 the fund by August 1, 2017 but we direct Staff to keep records on the funds disbursements
36 continuously so that the disposition of the fund can be ascertained at any time.

37 **9. Revise Short Form Application:** The short form rate application available on the
38 Commission's web page is in need of revision. Some of the information it asks for is unnecessary
39 and it does not ask for some necessary information that is routinely acquired through data
40 requests. Staff will update the short form rate application and circulate an updated application

⁷ ARS 49-355

1 to the Commission by **August 11, 2016**. Specific comments and questions regarding the short
2 form are contained in Attachment 1 to this document.

3 III. Rate Design Challenges

4 Arizona is an arid state. Both our urban and rural areas must grapple with scarce water supplies.
5 This has always been true but the current multiyear drought has highlighted the importance of
6 conserving our most important natural resource. Arizona's record in dealing with its water challenges is
7 exemplary, the building of the Central Arizona Project and the passage of the Arizona Groundwater
8 Management Act show real commitment to addressing the challenges of living in an arid environment.

9 This Commission too has worked towards the goal of water conservation. By embracing three-
10 tiered increasing block rate structures this Commission has shown a willingness to consider water
11 conservation as one of the principle components of rate design. The Commission's embrace of water
12 conservation via three tiered increasing block rate structures was a divergence from traditional rate
13 making with its focus on revenue recovery.⁸ While we continue to believe that there is value in
14 promoting conservation through three tiered rates, we also recognize that they have been problematic.
15 The problem with increasing block rates is that they have actually worked. We have seen that in
16 response to being presented with three tiered rates customers have decreased their usage. In some
17 cases they have decreased their usage significantly. This has resulted in many instances where
18 companies have been unable to attain their Commission authorized revenue requirement.

19 The Commission has recognized this problem with respect to large water utilities and has
20 allowed for "conservation adjustments" to the revenue requirement to address it.⁹ We continue to
21 support conservation adjustments for large water utilities but we aware that the revenue erosion
22 caused by conservation can be far more harmful to small utilities. The revenue requirement of a small
23 utility may be especially dependent on revenue generated from a small number of high gallon
24 consumers and thus all it would take is one or two of the high consumption consumers conserving to
25 make attaining the authorized revenue requirement impossible. We believe there is some value in
26 allowing small water utilities to utilize a conservation adjustment as well.

27 All utilities should have a reasonable opportunity to achieve their authorized revenue
28 requirements. To that end, rate designs should be implemented on a transparent and consistent basis
29 across all utilities. This has been a problem in the past. In fact, three tiered rates have largely been
30 implemented on an *ad hoc* basis and has lacked consistency and transparency.

31 Another concern with three tiered rates is the rate shock they may impose on high use
32 customers. It may be assumed that high use customers are all high income customers but that is not
33 necessarily the case. High use customers may have high incomes and large pools, water features,
34 extensive landscaping and/or livestock. But they may also be moderate or low income people with large
35 families living together in one residence. Excessive top tier rates could be detrimental to such
36 customers. So we should not be callous in our assessment of appropriate rate design.

37 Water rate design must balance the three (competing) objectives of promoting conservation,
38 customer fairness, promoting conservation and allowing a meaningful opportunity for the utility to
39 recover its authorized revenue. We recognize that balancing these objectives has not been easy. The

⁸ The closest Bonbright et. al.'s discussion of rate design comes to addressing conservation is a passing mention of externalities, *Principles of Public Utility Rates*, Second Edition, at Chapter 16: Criteria for a Sound Rate Structure

⁹ See Decision 74081 (Arizona Water's 2012 rate case) for example.

1 Staff, the utilities and various interveners have struggled with how to appropriately balance these
2 issues. Based on the experience gained to date we offer the below policy direction that is intended to
3 alleviate the problems discussed above and to alleviate costly debate on these issues during rate cases.

4 **1. General Statement of Rate Design Policy:** It is the policy of this Commission that water rate
5 design should:

- 6 1. Encourage the conservation of water.
- 7 2. Take customer impacts into account.
- 8 3. Provide a meaningful opportunity for recovery of authorized revenue.

9 In order to appropriately balance these three general policies the Commission provides the following
10 direction:

- 11 1. The default water utility rate design will be a three-tier increasing block rate design with
12 a non-discretionary usage tier (Rate Tier 1) applicable only to residential customers.
13 Additional rate tiers and other rate design elements may be appropriate where
14 appropriate analysis and justification is provided.
- 15 2. Large commercial or industrial customers, large master-metered customers or large
16 standpipe customers should be considered separately from the general rate design for
17 typical residential and other commercial users.
- 18 3. Significant changes in rate design for a single water utility may require several rate
19 cycles before applicable targets are reached. Gradualism should guide these transitions
20 in order to reduce disproportionate customer-specific impacts, as well as assuring the
21 utility's revenue recovery.
- 22 4. Case specific departures from standard rate design requirements and revenue targets
23 should be given full consideration when they are supported with factual information
24 and explanations.

25 **2. Statement on Conservation Adjustments:** Because adopting inverted block tiered rates is
26 intended to lead to reduced water use by customers, it is likely to lead to under recovery of revenue.
27 For this reason we endorse the use of Conservation Adjustments to revenue requirements. Larger
28 utilities are capable of presenting a case justifying a particular adjustment. We endorse the use of these
29 adjustments for large utilities. Smaller utilities typically lack the expertise necessary to provide the same
30 level of analysis of usage that a larger utility would. However, we believe small utilities should be able
31 to avail themselves of Conservation Adjustments. We direct Staff to adopt a formulaic method that will
32 allow small utilities who are eligible to use the Short Form rate application to calculate a Conservation
33 Adjustment. This formulaic method will be available for Commission review by **August 11, 2016**. Staff
34 can work with the WUAA and/or other members of the industry in developing this method. Upon
35 acceptance by the Commission, this formulaic method for calculating a Conservation Adjustment will be
36 included in the Short Form rate application available on the Commission's website.

37 **3. Specific Policy on Implementation of Three Tiered Inclining Block Rates:** In order to
38 provide clarity and consistency to all rate case participants we provide the following simple rules for
39 how Three Tiered Inclining Block rates should be structured:

- 40 1. The Basic Service Charge and the 1st tier of the volumetric rates taken together will generate *at*
41 *least* 50% of the total revenue requirement.

1 2. The third or top tier will be designed to generate *no more than* 20% of the total revenue
2 requirement.

3 These rules allow for flexibility while ensuring that rate designs do not unreasonably skew revenue
4 recovery to the higher tiers. Deviation from the above simple rule for application of three tiered rates
5 should be considered when factual circumstances merit it.

7 IV. Cost of Capital Reform and Income Issues

8 In rate cases for larger water utilities, determining the appropriate Cost of Capital to use in utility rate
9 setting is often a contentious and expensive process. Outside experts on the subject are often
10 employed at considerable expense by the utilities and the interveners. Considerable Staff time and
11 resources can go towards developing Cost of Capital testimony. The recommendations of these experts
12 rarely change considerably from one case to the next. The arcane nature of this expert testimony raises
13 the question of how much value it actually provides to the Commission in its decision making. This
14 expert testimony consists of taking data from a proxy group of companies (large publicly traded utilities)
15 and running that data combined with various other assumptions through several different financial
16 models. It seems that a more efficient way to deal with the issue would be desirable.

17 Small water utility rate cases have a different problem with respect to Cost of Capital: their low rate
18 bases often mean that the rate base rate of return method cannot be (or at least should not be) used to
19 determine the revenue requirement because it would not result in just and reasonable rates. In these
20 cases the Commission has employed an operating margin based method or a free cash flow based
21 method. However, there is no clear policy regarding which of the three methods is most appropriate or
22 regarding what circumstances would lead us to favor one of the methods over the others. With respect
23 to the operating margin and free cash flow methods, there is also no clear policy regarding what level of
24 operating margin or free cash flow is appropriate.

25 When a company has zero or negative rate base then obviously the rate base rate of return method
26 cannot be used to set rates. In these cases rates must be set based on a targeted operating margin or
27 free cash flow. But which is more appropriate: operating margin or free cash flow? And what level of
28 operating margin or free cash flow is an appropriate target? Providing guidance on these questions will
29 help the Staff and the regulated companies as they develop and review rate case applications.

30 In the past Staff has stated on the record that small companies with negative rate base should only be
31 afforded a "nominal" amount of free cash flow.¹⁰ We reject this notion and note that negative rate base
32 is most often the result of financing decisions made decades ago. Typically, negative rate base results
33 from the use of AIAC to fund plant one or two decades in the past. We note that the use of AIAC has
34 been endorsed by both the Staff and the Commission. We believe it is not appropriate to financially
35 hobble companies in perpetuity because ten or twenty years ago a choice was made to avail themselves
36 of a financing method that the Staff and Commission have endorsed.

37 To address the problems discussed above we endorse the following statements of policy and provide
38 direction to Staff:

¹⁰ See Docket No. W-02031A-10-0168, Transcript of 10/19/2011 Hearing, Volume II Page 252, line 15

1 **1. Increased risk faced by small water companies:** Class D, and E water or wastewater utilities
2 face significantly increased business risk as compared to larger water and wastewater utilities. These
3 firms are simply not able to raise capital on the same terms as the much larger companies included in
4 the proxy groups for determining cost of equity. Additionally, they have very little ability to diversify
5 their business risks (e.g., losing just one large customer can have significant revenue impacts, or a single
6 necessary repair can raise expenses enough to eliminate a small company's income.) We believe this
7 increased risk faced by small companies should be considered in the ratemaking process. It is the policy
8 of this Commission to recognize this increased business risk.

9 Below we establish a process to review the ROE processes in California and Florida for possible adoption
10 in Arizona. We direct that this process should include investigation of business risk for small utilities
11 including consideration of establishing minimum operating margins and the use of ROE adders for Class
12 D and E water utilities.

13 **2. Establishing revenue requirements for Class D and E water companies:** In order to maintain
14 quality and safe water service and remain financially healthy water utilities must maintain minimum
15 operating margins. For cases where the use of standard rate base rate of return methods will not result
16 in just and reasonable rates, a process should be established to develop a minimum operating margin
17 standard (either based on the methods used in Florida or California or a new method may be adopted)
18 for class D and E water utilities.

19 The minimum operating margin will be used to develop revenue requirements (and the return on rate
20 base when applicable.)

21 **3. Examination of Florida and California Commissions' small water utility policies:** Both Florida
22 and California have large numbers of small water utilities and have historically had similar problems with
23 those small utilities as has Arizona. The Florida Public Service Commission and California Public Utilities
24 Commission have instituted policies aimed at alleviating the regulatory burden on small water utilities
25 and rationalizing the ratemaking process for small water utilities. Commission selected personnel, in
26 collaboration with other interested parties, will examine the policies of the Florida and California
27 Commissions pertaining to small water utilities and will provide a report along with recommendations
28 for policy changes.

29 **4. Examination of Florida and California Commissions' Generic ROE Policy:** It is our
30 understanding that the Florida and California Commissions both employ a standardized or generic ROE
31 policy. Commission selected personnel, in collaboration with other interested parties, will examine the
32 policies of the Florida and California Commissions pertaining to standardized ROEs for use in rate cases
33 and will provide a report along with recommendations for policy changes.

34 We believe that the above reports regarding policies of the Florida and California Commission's should
35 be completed within 90 days. Parties will have an opportunity to comment.

36 V. Water Utility Acquisition Process

37 We wish to encourage the consolidation of small water utilities through acquisition because this can
38 result in real benefits to small utilities' customers. Many small utilities lack the financial resources or
39 access to capital needed for capital replacements. Allowing such companies to be consolidated into
40 larger companies or combined with other systems of smaller companies can solve such problems.

1 Because of this we do not believe unnecessary regulatory burdens should be imposed on utilities
2 seeking to purchase smaller water systems. To alleviate the regulatory burden that currently exists for
3 utilities seeking to purchase smaller systems we institute the following policy:

4 In instances where a Class A, B, or C water utility that is in good standing with the Commission, ADEQ
5 and ADWR seeks to purchase a class D or E water utility and absent extraordinary circumstances, when
6 the acquiring utility requests a waiver under A.A.C. R14-2-806 of A.A.C. R14-2-803 for such a transaction,
7 the Commission will allow the waiver to take effect by operation of law under A.A.C. R14-2-806(C). The
8 waiver application must comply with A.A.C. R14-2-806(B) but need not include the information specified
9 in A.A.C. R14-2-803(A).

10 We direct the Commission staff to commence a rulemaking to consider the following amendment to
11 A.A.C. R14-2-803: "D. A notice of intent under this section is not required when the reorganization of
12 an existing Arizona water or wastewater public utility holding company is due to the purchase of the
13 shares (or merger of) a Class D, or E water or wastewater utility".

14 VI. Policies Regarding Consolidation of Small Water Utilities

15 It has essentially become a truism in Arizona that consolidation of small water utilities is desirable.
16 While we do not believe that consolidation is a panacea, there can be no doubt that in some
17 circumstances consolidating small systems into larger entities will have real benefits for customers.
18 Consolidating systems can allow for greater and less expensive access to capital, more professional
19 management, an ability to diversify against business risks and flexibility with rate design. The
20 Commission Staff, RUCO and other customer advocates, industry representatives and the Commission
21 itself have all stated that consolidation in the water industry is desirable. As such, we believe providing
22 explicit policy guidance is appropriate. Therefore, we adopt the following statements of policy:

23 **1. Policy Regarding Rate Consolidation for Small Jointly Owned Water Utilities:**¹¹ Small utilities in
24 rural areas have largely been treated as stand-alone entities by the Commission for ratemaking
25 purposes. However, we believe it is beneficial to allow jointly owned class D and E water utilities to
26 adopt a single rate design and/or to merge into a single entity. This policy applies to both Class D and E
27 water utilities that have been purchased by a larger water utility as well as to Class D and E water
28 utilities that are jointly owned by some other entity. Traditionally, a strict interpretation of the "cost
29 causer pays" principle has inhibited small water systems that do not share common facilities from
30 consolidating their rates. We believe that the practical benefits that can accrue from allowing rate
31 consolidation far outweigh the benefits of strict adherence to this abstract theoretical principle.

32 Generally speaking, the Commission will favor proposals (brought forward in rate cases) to consolidate
33 the rates of jointly owned Class D and E water utilities. We direct Staff to evaluate the merits of such
34 proposals based on their practical benefits and not to reject them based solely on theoretical
35 considerations. If specific *factual* circumstances exist that draw the benefits of rate consolidation into
36 question then, of course, those circumstances should be fully considered.

¹¹ This policy applies only to Class D and E water utilities in rural areas. The Commission has a long history of dealing with the problems that often arise from Class D and E water utilities in rural areas. This policy statement has no bearing whatsoever on the appropriateness or inappropriateness of rate consolidation for larger and/or more urban utilities.

1 **2. Policy Regarding Direct Incentives for Acquisitions:** Allowing for some form of acquisition
2 premium associated with the purchase of small non-viable water utilities is a concept that has long been
3 discussed favorably in Arizona but that has seen little (if any) actual adoption. We support the notion
4 that the purchase of non-viable Class D and E water utilities should be encouraged through incentives.
5 Therefore we endorse the following statement of Policy:

6 To encourage the consolidation of small water utilities, it is the policy of the Commission that
7 acquisition premiums should be allowed for acquisitions of private water systems subject to the
8 following conditions:

- 9 1. The purchase price is fair and reasonable and conducted through arms' length
10 negotiations;
- 11 2. If appropriate, the acquirer's rates may be applied to the acquired system;
- 12 3. The acquisition premium must be associated with improvements, which can be
13 qualitative or quantitative or both (this provision ensures that only companies in need of
14 improvements will be able eligible for acquisition premiums); and
- 15 4. The premium must be reviewed and approved in a rate case.

16 It is the policy of the Commission that the acquisition premium be determined in accordance
17 with the following principles (in addition to those above):

- 18 1. The premium shall not exceed twenty percent of the original cost rate base at the time
19 of the acquisition.
- 20 2. One or more of the following may be used to provide recovery of the acquisition
21 premium:
 - 22 a. A premium on the return on equity.
 - 23 b. An acquisition adjustment (credit or debit adjustments to rate base
24 for purchase price discounts or premiums, respectively, may be
25 used).
 - 26 c. A deferral of the cost of improvements the acquirer undertakes.
 - 27 d. A surcharge for the recovery of the cost of improvements the
28 acquirer undertakes.
- 29 3. If the improvements that are required to improve service quality would result in rates that
30 are deemed too high to be absorbed by ratepayers at one time, rate recovery of the
31 improvement costs may be recovered in phases. There may be a one-time treatment of the
32 improvement costs in the initial rate case but a phasing in of the acquisition improvements
33 and associated carrying costs may be allowed over a finite period.

34 **3. The Pennsylvania Model and Other Issues:** Above we stated our clear endorsement of the
35 use of acquisition incentives for small water utilities in need of improvement. The above policy
36 statement applies only to the acquisition of small systems in need of improvement. The industry
37 representatives before us have advocated adoption of the acquisition policies used in Pennsylvania

1 which include incentives for purchase of both viable and non-viable systems. We are reluctant to import
2 lock stock and barrel policy statements, rules and/or statutes from other states. We are also reluctant
3 to endorse incentives for the purchase of viable systems. However, we are interested in examining the
4 Pennsylvania model and whether including aspects of it within the above policy statement will provide
5 benefits to customers. We will schedule a Special Open Meeting in August and/or September to discuss
6 this issue further and to discuss any other issues contained in this statement (or in brought forward by
7 parties or Commissioners) that were not fully addressed at the June 24th Special Open Meeting.

8

9

Attachment 1

Questions and Proposals for the Short Form Water Rate Application

Page 1 Water Rate Application Checklist

1. Item 1. indicates 13 copies are necessary but we understand that Docket Control actually requires 15 copies. Also, at the June 14th Staff Meeting we decided to reduce the number of copies needed. The application should be updated to reflect the actual number of copies required.
2. Items #3 and # 10 ask for the same things, ADEQ MAP invoices.
3. Item #4 is not included in the packet that applicants are required to file three copies of. We understand that some utilities are asked to file three copies of this information. The application should state that 3 copies of #4 are necessary if that is the case. It is unclear why three copies of expense invoices are necessary (items #5 to #11) but only one copy of plant invoice (item #4) is OK.
4. Why are three copies of the items included in #5-#11 necessary. Staff should determine if one copy is sufficient and whether this information can be provided electronically.
5. Item #5 requires employee names to be provided with their salaries. Is this a privacy issue?
6. Item #7 appears to be burdensome. This item requests all power invoices even though some of these can be as low as \$25. Would a GL transaction list and a selection of large invoices from each account be sufficient?
7. Item #8 appears to be burdensome. It requires that all repair invoices be filed regardless of how small they are. Repair invoices can be as low as \$5 for parts purchased from a hardware store. Should there be some consideration of materiality here?

Page 2

Here the utilities are required to mail out notice on the *same* day as the rate case is docketed. For a utility with a small staff this can be a burden. Would requiring notice to be sent within a few days of the application being filed work just as well?

Page 8

The instructions on Page 8 will need to be updated to include whatever rate design policies are adopted as part of the ongoing docket.

Pages 10 and 11

Should the standard rates that Staff recommends for the service charges and service line and meter installation charges be included here?

Pages 14

It may be appropriate to add a column for annual depreciation to the Plant Additions and Retirements by Year Schedule. The annual depreciation is usually asked for through data requests so why not just ask for it up front in the application?

Page 20

The income statement schedule doesn't provide a way to show pro forma adjustments and it doesn't include a column for income at proposed rates. Should these be included?

Page 21

Income taxes for LLCs: an example of how this works would be helpful.

Page 22

The Depreciation Expense Form doesn't include a way to calculate depreciation expense at proposed rates. That is, there is no true up for the half year convention for plant added in the test year.

Page 27

Splitting out LXA AIAC and Meter deposit AIAC will make things simpler in the long run. When they are tracked and reported jointly as required here it can lead to confusion and data requests (especially if there is a lot of both types of AIAC.) It may be worthwhile to have the two types of AIAC reported separately on this schedule.

Page 28

This CIAC schedule doesn't include CIAC Amortization. But the amortization is asked for through data requests. Why not include it in the application?

Pages 30 to 34

The quarterly breakout of the bill count is unnecessary and creates more work for little if any benefit. The quarterly break out seems to be a vestige from when bill counts were done manually. Today, even the smallest utilities keep their billing records electronically. It should be made clear that the quarterly break out is optional and necessary only for utilities that do not have electronic billing systems and/or for use by utilities that are having trouble getting their bill count to tie out to revenue.

Short Form for Wastewater:

Should there be a short form application for wastewater? Currently some wastewater utilities use a modified version of the water short form that they create themselves. Should we continue that practice or should we create a formal short form for wastewater?