

ARIZONA COURT OF APPEALS

DIVISION ONE

RESIDENTIAL UTILITY
CONSUMER OFFICE, an agency of
the State of Arizona,

Appellant,

v.

THE ARIZONA CORPORATION
COMMISSION,

Appellee.

ARIZONA WATER COMPANY,

Intervenor.

Court of Appeals
Division One
No. 1 CA-CC 13-0002
1 CA-CC 14-0001
(consolidated)

Arizona Corporation Commission
Nos. W-01445A-11-0310
W-01445A-12-0348

APPELLANT'S OPENING BRIEF

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STATEMENT OF THE CASE

These consolidated appeals seek review of two Decisions of the Arizona Corporation Commission (“Commission”) adopting a rate making device to engage in single-issue ratemaking that has been prohibited by the Arizona courts. The Decisions permit the utility to raise rates between full rate cases, sidestepping the requirement imposed on the Commission by the Arizona Constitution to adjust rates only after undertaking an all-encompassing process of determining (and meaningfully using in the rate making process) the “fair value” of the utility’s property. The “fair value” requirement is an important consumer protection that Arizona courts have long respected. In the Decisions appealed here, the Commission adopted System Improvement Benefits (“SIB”) mechanisms as part of the rate structure of Arizona Water Company’s (“AWC” or the “Company”) rates for its Northern and Eastern Groups. However, the Commission indicated that it intends to use the SIB mechanism adopted in the Decisions as a model for other utilities. Thus, left unchecked here, the Commission will continue on a path to undermine the important consumer safeguard required by the Constitution.

In August 2011, AWC filed with the Commission an application for a determination of fair value and adjustments to rates for its Eastern Group (Commission Docket No. W-01445A-11-0310) (the “Eastern Group rate case”). In

the Eastern Group rate case application, AWC had proposed a Distribution System Improvements Charge (“DSIC”).

On August 1, 2012, AWC filed with the Commission an application for a determination of fair value and adjustments to rates for its Northern Group (Commission Docket No. W-01445A-12-0348) (the “Northern Group rate case”). AWC had also proposed a DSIC mechanism in the Northern Group rate case application.

The Commission held a hearing on the Eastern Group rate case (the “Phase 1 Proceeding”). In February 2013 the Commission adopted Decision No. 73736 in the Eastern Group rate case (the “Phase 1 Decision”), granting AWC a rate increase for its Eastern Group systems, declining to adopt AWC’s proposed DSIC, but keeping the docket open “to allow the parties the opportunity to enter into discussions regarding AWC’s DSIC proposal and other DSIC-like proposals.” In April 2013, all of the parties to the Eastern Group rate case, except RUCO, entered a settlement agreement in the Eastern Group rate case (the “Eastern Group Settlement Agreement”), proposing adoption of a type of DSIC the settling parties labelled a System Improvement Benefits (“SIB”) mechanism. The Commission held a hearing on the Eastern Group Settlement Agreement (the “Phase 2 Proceeding”), at which RUCO presented evidence and legal argument in opposition to the Eastern Group Settlement Agreement.

In April 2013, a settlement agreement signed by all of the parties to the Northern Group rate case, except RUCO, was filed in the Northern Group rate case (the “Northern Group Settlement Agreement”). The Northern Group Settlement Agreement relied on the outcome of the Eastern Group rate case for resolution of the DSIC-type mechanism issue. RUCO filed with the Commission a motion to incorporate the record from the Eastern Group rate case into the record in the Northern Group rate case, which motion was granted.

On June 27, 2013, the Commission adopted Decision No. 73938 in the Eastern Group rate case, approving the Eastern Group Settlement Agreement (the “Phase 2 Decision”). RUCO filed an Application for Rehearing of the Phase 2 Decision. The Commission granted that Application for Rehearing of the Phase 2 Decision, and held a hearing on the matter in November 2013 (the “Rehearing”).

On September 23, 2013 the Commission adopted Decision No. 74081 in the Northern Group rate case (the “Northern Group Decision”), which adopted a SIB mechanism similar to what had been approved in the Phase 2 Decision and further ordered that the SIB mechanism would be subject to any additional modifications that may be made by the Commission in the Rehearing. On October 11, 2013, RUCO filed an Application for Rehearing of the Northern Group Decision. Pursuant to A.R.S. § 40-253(A), RUCO’s Application for Rehearing was denied by operation of law. On November 27, 2013, RUCO filed with this Court a Notice of

Appeal from Decision No. 74081. The matter was assigned Case No. CC-13-0002 (the “Northern Group Appeal”).

Because the ultimate resolution of the Northern Group rate case was dependent on the resolution of the then-still-pending rehearing of the Eastern Group rate case, and because the record from the Eastern Group rate case was incorporated into the Northern Group rate case, RUCO and the Commission filed in the Northern Group Appeal a Stipulated Motion to Stay Direct Appeal, which this Court granted by an Order filed January 15, 2014.

On April 22, 2014, the Commission entered Decision No. 74463 in the Eastern Group rate case (the “Rehearing Decision”), affirming the Phase 2 Decision. On April 25, 2014, RUCO filed with this Court a Notice of Appeal from the Phase 2 Decision, as affirmed by the Rehearing Decision. The matter was assigned Case No. CC-14-0001 (the “Eastern Group Appeal”). Pursuant to a stipulation of the parties, this Court on May 27, 2014 consolidated the Northern Group Appeal and the Eastern Group Appeal.

The appeals are from Arizona Corporation Commission decisions “relating to rate making...pursuant to § ...40-250...” See A.R.S. § 40-254.01(A). Therefore, this Court has jurisdiction over the consolidated appeals. *Id.*

STATEMENT OF FACTS

In the Phase 1 Proceeding, AWC proposed implementation of a DSIC mechanism, a ratemaking tool to allow the utility to recover, between rate cases, the capital costs of certain improvement projects to its distribution system to replace its aging infrastructure. Index of Record Commission Docket No. W-01445A-11-0310 (“IOR”)¹ Tab A-67 at 84, Tab C-9 at 12. AWC presented the infrastructure replacement as necessary to enable it to come into compliance with a Commission directive to reduce its water loss to an acceptable level. IOR C-33 at 79-80. RUCO opposed the DSIC because the proposed infrastructure replacement projects were routine in nature and appropriately recovered through a general rate case, the DSIC mechanism was one-sided in that it worked to the advantage of only the shareholders, and AWC had not shown that the DSIC was essential for the provision of safe and reliable water service. IOR Tab A-67 at 97. In addition, RUCO questioned the legality of the DSIC. IOR Tab A-67 at 97. The Commission’s Utilities Division Staff (“Staff”) also opposed the DSIC, for reasons similar to RUCO. IOR Tab A-67 at 99. In addition, Staff was concerned that the

¹ Unless otherwise noted, all references to the IOR shall be to the record of the Eastern Group rate case, Commission Docket No. W-01445A-11-0310. The entire record of the Phase 2 Proceeding, and the portions of the Phase 1 Proceeding pertaining to the DSIC, were incorporated into the record of the Northern Group rate case. IOR Commission Docket No. W-01445A-12-0348 (“Northern Group IOR”) Tab A-75 at 6.

DSIC's recovery of capital improvement costs between regular rate cases results in less scrutiny of plant investments both as to prudence and the degree to which the plant was used and useful. IOR Tab A-67 at 100. Staff believed that the DSIC was an "adjustor mechanism," the use of which should be limited to "extraordinary circumstances," and that AWC's proposed use of the DSIC for its routine expenditures is therefore unjustified. IOR Tab C-65 at 35. Staff testified that AWC's Eastern Group infrastructure replacement needs, even assuming AWC's \$67 million cost estimate, was not extraordinary. IOR Tab B-8 at 1332-33.

In the Phase 1 Proceeding, AWC proposed an authorized return on equity ("ROE") of 12.5 percent. IOR Tab A-67 at 45. RUCO and Staff each proposed an authorized ROE of 9.4 percent. IOR Tab A-67 at 54, 58. The Commission had recently approved an ROE for AWC's Western Group of 10.0 percent without a DSIC. IOR Tab A-67 at 61.

The Commission's Administrative Law Judge ("ALJ") recommended denial of the DSIC because AWC had not established that its current situation was exceptional, the DSIC could reward utilities for failing to maintain their systems reliably, and the regular rate making process was in place because of the monopolistic nature of the utility service. IOR Tab A-56 at 104-106. The ALJ was also concerned that the Company had been paying out yearly dividends, and could have used those funds to pay for at least part of the infrastructure it claimed

was necessary. IOR Tab A-56 at 104-106. However, the ALJ recommended that, due to the age of some of the Company's Eastern Group systems resulting in an increased need for infrastructure replacements, a "somewhat higher" ROE than the 10 percent that the Commission had recently awarded in the Company's Western Group case was necessary: IOR Tab A-56 at 61. Therefore the ALJ recommended an authorized ROE of 10.55 percent. IOR Tab A-56 at 61.

The Commission granted AWC a rate increase for its Eastern Group systems, but modified its ALJ's recommendation regarding the DSIC, indicating that it was "supportive of the DSIC type mechanism," and left the Docket open to allow the parties to further discuss the proposal and others like it that Staff might wish to introduce. IOR Tab A-67 at 104. The Commission, however, did not modify the ALJ's recommended ROE of 10.55 percent. IOR Tab A-67 at 61.

A number of other utilities then sought to intervene in the Eastern Group rate case, recognizing that any resulting DSIC-type mechanism that might be approved for AWC would create a model or template for other Arizona utilities. IOR Tabs A-63, -64, -65, and -66; Tab C-78 at 8; Tab C-81 at 2; Tab C-82 at 2; Tab C-85 at 2; Tab B-15 at 7, 111.

AWC, Staff and several other parties, excluding RUCO, subsequently filed the Eastern Group Settlement Agreement, proposing the adoption of a type of DSIC mechanism, which the parties to the settlement named a SIB mechanism, to

provide for the recovery between rate cases of the capital costs (depreciation expense and pre-tax return on investment) associated with a wide variety of distribution system improvements which have been placed into service and where costs have not been included in the rates established by the Phase 1 Decision. IOR Tab C-77 at 4, Tab C-78 at 8, Tab C-80 at 10. The SIB will reduce “regulatory lag” (the time it takes for a utility to begin recovering the costs of plant additions through new rates) in favor of AWC, because the Company will not have to wait until its next full rate case before it begins recovery of its investment in replacement plant. IOR Tab C-91 at 10-11; Tab C-97 at 5-6. However, any actual cost savings, such as lower operating and maintenance expense, attributable to the replacement plant will not be captured by the SIB. IOR Tab C-91 at 10-11. Rather, the SIB adjusts rates without evaluation of all the rate case elements normally examined in a rate case proceeding. Tab B-12 at 258.

RUCO objected to the SIB for reasons similar to those it had objected to the DSIC. IOR Tab C-91 at 10-18. In addition, RUCO objected that the scope of projects that could be recovered through the SIB was far broader than only those to address water loss concerns. IOR Tab C-90 at 3, Tab B-12 at 383, Tab C-77 at Sections 6.3.2 and 6.3.3. As described by Staff, the plant that can be recovered through the SIB includes all plant in the six accounts identified in Section 6.4 of the Eastern Group Settlement Agreement that was not included in the rates

resulting from the Phase 1 Decision. IOR Tab B-12 at 331. Those six accounts represent approximately seventy percent of the plant in service. IOR Tab A-1, Schedule C-2 Appendix, pgs 32, 33, 35 and 36. Finally, RUCO opposed adoption of the SIB without a downward adjustment to the ROE approved in the Phase 1 Decision. The downward adjustment to ROE was necessary to reflect the adoption of a mechanism (the SIB mechanism) that would decrease AWC's financial risk. IOR Tab C-90 at 4. RUCO asserted, and several other parties agreed, that pursuant to the Commission's limiting of the scope of the Phase 2 Proceedings when it adopted the Phase 1 Decision, RUCO was foreclosed in the Phase 2 Proceedings from seeking an adjustment to the Company's approved ROE. IOR Tab A-128 at 55.

The Commission held the Phase 2 Proceeding on the Eastern Group Settlement Agreement and the SIB. The Commission's Administrative Law Judge recommended approval of the Eastern Group Settlement Agreement, but recognized that the Commission's Phase 1 Decision had explicitly granted a higher ROE to AWC to address the infrastructure replacement needs expressed by the Company. IOR Tab A-117 at 55. The ALJ therefore proposed that the ROE authorized in the Phase 1 Decision be adjusted downward "to reflect [the] commonality of purpose" between the higher ROE awarded previously, and the SIB mechanism. IOR Tab A-117 at 55. The ALJ recommended a ROE of 10.0

percent, as the Commission had recently approved for AWC's Western Group which did not involve the approval of a DSIC or SIB. IOR Tab A-117 at 55.

The Commission accepted its ALJ's recommendation to approve the SIB and the Eastern Division Settlement Agreement, but rejected the recommendation to decrease the Company's ROE to 10.0 percent. IOR Tabs A-124; B-15 at 112; and A-128 at 55. Initially, Commissioners Brenda Burns, Susan Bitter Smith and Bob Burns expressed opposition to an amendment that would instead maintain the originally-approved ROE of 10.55 percent. IOR Tab B-15 at 56, 60, 61. Upon seeing that the ALJ's recommendation to decrease the ROE might pass, counsel for AWC proposed that the Commission not adopt any further decision in the Eastern Group case, leaving in place the rates (and ROE) adopted in the Phase 1 Decision, without either the DSIC or the SIB. IOR Tab B-15 at 63-64, 102. AWC's indicated it would withdraw from the Eastern Group Settlement Agreement if the 10.55 percent ROE was not maintained. IOR Tab B-15 at 63, 102. However, Commissioner Bitter Smith rejected the Company's offer to defer adoption of the SIB into the upcoming rate case for AWC's Northern Group, essentially insisting that the Commission adopt a SIB mechanism that very day. IOR Tab B-15 at 91, at 105 ("I do not want to walk out of this room without a SIB"), at 111 ("I do not want to walk away from this template mechanism"). Commissioner Bitter Smith ultimately voted for the amendment to increase the ROE to 10.55 percent, and the

amendment passed by a vote of 3-2. IOR Tab B-15 at 111, 112. The Commission then adopted the Phase 2 Decision by a vote of 4-1, approving the SIB and a 10.55 percent ROE. IOR Tab A-128. Commissioner Brenda Burns filed a written dissent, noting that “[t]he AWC ratepayers should not be asked to pay for an elevated ROE while also being the test case for a newly approved SIB.” IOR Tab A-128, final 2 unnumbered pages.

RUCO filed its Application for Rehearing of the Phase 2 Decision on two grounds – that the Commission was requiring ratepayers to pay twice for the need to invest in SIB-related infrastructure, and that the SIB was illegal. IOR Tab A-129 The Commission granted RUCO’s application. IOR Tab A-138. The Commission held the Rehearing, at which RUCO offered additional expert testimony that AWC’s cost of equity with the SIB should be in the range of 8.5 percent to 10 percent, with a mid-point estimate of 9.25 percent. IOR Tab C-99 at 14-15. By comparison, average authorized returns on equity for water utilities in other states over the prior four years had been trending downward, and with the prior two years the trend has been below 10 percent. IOR Tab C-99 at 16 and at Exh. DCP-7. In Arizona, 18 of 20 of the recently authorized returns on equity for water utilities were 10 percent or less. IOR Tab C-99 at Exh. DCP-9.

The Commission’s ALJ issued a recommendation to maintain the SIB mechanism, but to adjust the ROE down to 10.0 percent to reflect the more recent

cost of capital determinations, for consistency with ROEs approved in recent cases for the Company's Northern and Western Groups, and due to the duplicative purpose of the SIB and the increased ROE in the Phase 1 Decision. IOR Tab A-177 at 42-44, and at Finding of Fact 19 (pg. 47). The Commission again rejected its ALJ's recommendation for a lower ROE, and adopted an amendment to restore the ROE to 10.55 percent. IOR Tab A-182, Tab A-183 at 42-43. The Commission concluded that the "new data" regarding recent ROEs was "too far outside the 2010 test year," and that when setting the Company's ROE, the SIB should not be considered as a factor that reduces the Company's risk. IOR Tab A-183 at 42. The Commission also stated that it was rejecting the proposal to decrease the ROE out of a "concern" that a decrease to the 10.55 percent ROE of the Eastern Group Settlement "might jeopardize the Settlement Agreement concerning the Company's much needed SIB." IOR Tab A-183 at 42-43. The Commission's Rehearing Decision was adopted by a 3-2 majority; Commissioner Robert Burns filed a written dissent, noting "I believe that RUCO met its burden that in light of the SIB, as well as facts specific to this case, modifying the ROE downward is the only reasonable course of action. Permitting the Company to receive both a SIB and an elevated ROE is not in the best interest of the ratepayers." IOR Tab A-183 at 46, final unnumbered page.

ISSUES PRESENTED FOR REVIEW

1. Whether the Arizona Constitution prohibits the Commission implementing the SIB mechanism to allow a utility's rates to adjust between rate cases.
2. Whether the Commission's failure to decrease the authorized return on equity when it adopted the SIB mechanism was arbitrary and unreasonable.

ARGUMENT

I. STANDARD OF REVIEW

The applicable standard of review, as set forth in A.R.S. § 40-254.01(E), requires a “clear and satisfactory showing that the [Commission’s] order is unlawful or unreasonable.” This standard has been interpreted to require a clear and convincing showing. *Residential Utility Consumer Office v. Ariz. Corp. Comm’n*, 199 Ariz. 588, 591 ¶ 9, 20 P.3d 1169, 1172 (App. 2001); *Consolidated Water Utilities Ltd. v. Ariz. Corp. Comm’n*, 178 Ariz. 478, 481, 875 P.2d 137, 140 (App. 1993). The court may disturb the Commission’s decision if it is not reasonably supported by the evidence, is arbitrary, or is otherwise unlawful. *See, Tucson Elec. Power Co. v. Ariz. Corp. Comm’n*, 132 Ariz. 240, 243, 645, P.2d 231, 234 (1982). Questions of law are reviewed *de novo* by the court. *Ariz. Water Co. v. Ariz. Corp. Comm’n*, 217 Ariz. 652, 656 ¶ 10, 177 P.3d 1224, 1228 (App. 2008).

II. THE SIB MECHANISM IS AN IMPERMISSIBLE ATTEMPT TO ADJUST RATES OUTSIDE OF A FULL RATE CASE.

- A. Full rate cases are generally required to avoid the potential abuses of piecemeal ratemaking.

Although the Commission alone has authority to prescribe rates for public service companies, it does not possess unfettered discretion when setting such rates. Rather, the Commission's rate-making authority is subject to the "just and reasonable" clauses of A.R.S. Const. Art. XV, § 3 of the Arizona Constitution. *Residential Utility Consumer Office*, 199 Ariz. at 591 ¶ 11, 20 P.3d at 1172. In addition, Arizona's Constitution obligates the Commission to determine the fair value of a utility's property and use such finding as a rate base for the purpose of calculating what are just and reasonable rates. A.R.S. Const. Art. XV, § 14; *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956) ("While our constitution does not establish a formula for arriving at fair value, it does require such value to be found and used as the base in fixing rates. *The reasonableness and justness of the rates must be related to this finding of fair value.*") (emphasis added); *Residential Utility Consumer Office*, 199 Ariz. at 588 ¶ 11, 20 P.3d at 1172. These provisions of Arizona's Constitution should be liberally construed to carry out the purposes for which they were adopted. *See, Laos v. Arnold*, 141 Ariz. 46, 685 P.2d 111 (1984). The purpose of the Commission, and the constitutional requirements regarding how it functions, is to protect consumers from abuse and overreaching by public service corporations.

Ariz. Corp. Comm'n v. State ex rel. Woods, 171 Ariz. 286, 295, 830 P.2d 807, 816 (1992).

It is with sound reason that the constitution thus limits the Commission's latitude to set rates apart from a rate case that permits the examination of all costs and revenues. The court in *Scates v. Ariz. Corp. Comm'n* acknowledged that such "piecemeal" ratemaking is "fraught with potential abuse...[and] serve[s] both as an incentive for utilities to seek rate increase each time cost in a particular area rises, and as a disincentive for achieving countervailing economies in the same or other areas of their operations." 118 Ariz. 531, 534, 587 P.2d 612, 615 (App. 1978).

The court in *Scates* invalidated the piecemeal ratemaking in that case because "the Commission was without authority to increase the rate without any consideration of the overall impact of that rate increase upon the [company's rate of return], and without, as specifically required by our law, a determination of [the company's] rate base." *Scates*, 118 Ariz. at 537, 578 P.2d at 618.

To satisfy its constitutional obligations, the Commission's rules require that a utility's application to increase its rates and charges must provide certain financial and statistical information. A.A.C. R14-2-103. The SIB results in piecemeal rate making, however, as it allows rates to adjust without looking at all the elements that impact rates that the Commission would normally examine in a rate case. IOR Tab B-12 at 258. For instance, the SIB does not look at any of the

expenses associated with the SIB plant costs other than depreciation expense. IOR Tab C-91 at 10; Tab C-96 at 8. There will be no calculation of savings and other efficiencies associated with the SIB plant and improvements which would reduce the overall rate increase for ratepayers.² This is the danger inherent in such piecemeal ratemaking.

- B. There are two exceptions to the requirement that rates be adjusted only in a full rate case, but the SIB does not qualify under either exception.

Arizona's court have recognized two exceptions to the general requirement that rates be adjusted only after examination of all revenue and expenses: 1) interim rates, or 2) rates modified pursuant to an "automatic adjustment clause." *Residential Utility Consumer Office*, 199 Ariz. at 588, ¶ 11, 20 P.3d at 1172; *Scates*, 118 Ariz. at 534-35, 578 P.2d at 615-16. Conversely to the rule that constitutional requirements should be construed broadly, exceptions to such requirements should be narrowly construed. *See, Spokane & I.E.R. Co. v. U.S.*, 241 U.S. 344, 350, 36 S.Ct. 668, 671 (1916) (an "elementary rule" that exceptions from a general policy embodied in the law should be strictly construed); *see also, Fidelity Sec. Life Ins. Co. v State Dept. of Insur.*, 191 Ariz. 222, 224-25 ¶ 7, 954 P.2d 580, 582-83 (1999). Neither the interim rate nor the automatic adjustor

²The SIB includes an efficiency credit to address the savings which is 5%, which is insignificant and not representative of the actual savings. IOR Tab C-96 at 8, 13.

mechanism exception can be applied to the SIB, a device which permits AWC to seek an increase in rates between full rate cases.

Interim rate are only appropriate if the Commission finds that an emergency (i.e. a sudden change that brings hardship to a company) exists, a bond is posted by the utility to guaranty a refund to customers if interim rates are later determined to have been set too high, and the Commission undertakes to determine final rates after a valuation of the company's property. *Residential Utility Consumer Office*, 199 Ariz. at 591 ¶ 12, 20 P.3 at 1172 (citing *Scates*, 118 Ariz. at 535, 578 P.2d at 616), and at 592 ¶ 17, 20 P.3d at 1173. AWC never asserted that an emergency exists, there is no evidence in the record of such an emergency, and the Commission made no finding of an emergency in the Phase 1, Phase 2 or Rehearing Decisions. Nor has the Company claimed, or the Commission found, that permanent rate relief would be untimely. The fact that the SIB mechanism requires the Company to file a rate case application no later than 2016 does not imbue the Phase 2 Decision and the Rehearing Decision with the essential characteristics of an interim rate so as to fall within this exception to the requirement to find fair value. The SIB mechanism is not a device that results in interim rates.

The second exception to the requirements of *Scates* permits the Commission to change rates by means of an automatic adjustment clause. *Scates*, 118 Ariz. at

535, 578 P.2d at 616. “The automatic adjustment clause is a device to permit rates to adjust automatically, either up or down, in relation to fluctuations in certain, narrowly defined, operating expenses.” *Id.* Automatic adjustor mechanisms must be established in a proceeding that finds the utility’s fair value rate base, to insure that the utility’s rate of return does not change as a result of the implementation of the mechanism. *Residential Utility Consumer Office*, 199 Ariz. at 592-93 ¶ 19, 20 P.3d at 1173-74; *Scates*, 118 Ariz. at 535, 578 P.2d at 616. Permissible adjustor mechanism allow rates to adjust for variations in “certain [and] narrowly defined *operating expenses*.” *Id.* (emphasis added). An automatic adjustment mechanism allows the utility to recoup increases in specifically identified costs from customers; conversely, decreases in the same specifically identified costs are also passed on to customers through the same automatic adjustment mechanism - both without disturbing the utility’s profit. *Residential Utility Consumer Office*, 199 Ariz. at 591-92 ¶ 13, 20 P.3d at 1172-73.

The Commission repeatedly characterized the SIB mechanism as an adjustor mechanism when it adopted it. IOR Tab A-128 at 52, lines 2-4 (“[t]he SIB mechanism...is an adjustment mechanism established within a rate case as a part of a company’s rate structure”); at 52, fn. 39; at 59 at Conclusion of Law No. 4. However, the Commission overtly acknowledges that the SIB recovers capital costs of plant investments, rather than an operating expense such as fuel. IOR Tab

A-128 at 52, 53, and fn 39. Arizona courts have never permitted the Commission, whether through an adjustor mechanism or otherwise, to increase rates between full rate cases to accelerate the recovery of a utility's *capital investments*. Moreover, the SIB mechanism only permits rates to adjust upward, but never down. IOR Tab C-91 at 11. The Commission is not permitted to approve an upward-only automatic adjustor mechanism to recover capital investments between rate cases. Rather than recovering the costs of infrastructure replacements through an adjustor mechanism, AWC's investments in replacement plant should be recovered through the standard rate adjustment process of a rate case.

In *Residential Utility Consumer Office*, this Court recognized the potentially abusive situation when the Commission engages in an overly-expansive interpretation of the automatic adjustor exception. The court rejected the Commission's attempt to *sua sponte* declare that an automatic adjustment mechanism would be implemented outside of a full rate case considering the fair value of the utility's rate base. *Residential Utility Consumer Office*, 199 Ariz. at 593, ¶¶20-21, 20 P.3d at 1174. Here, the Commission is attempting to pigeon-hole recovery of increased capital expenditures into a mechanism that is permitted to allow recovery of increases (and corresponding decreases) in operating expenses. The court should not permit such an unprecedented expansion of the automatic adjustor mechanism exception to the traditional ratemaking process, particularly in

light of the canon that exceptions to constitutional provisions should be narrowly construed.

- C. Arizona courts have not adopted a “third exception,” and even if they had, the SIB does not qualify under it.

The Commission believes that this Court has adopted a “third exception” to the requirement that rates only be adjusted pursuant to a full rate case. IOR Tab A-128 at 44. In the Phase 2 Decision the Commission asserted that in *Scates* this Court recognized that in exceptional circumstances the Commission may adjust rates outside of a full rate case in which a utility has provided the financial information required by the Commission’s filing requirements rules. IOR Tab A-128 at 44. The text of *Scates* set forth by the Commission, however, reveals that the court’s statement was merely *dicta*. The *Scates* court stated the following:

We do not need to decide in this case whether as a matter of law there must be de novo compliance with all provisions of the order³ in connection with every increase in rates....**There may well be** exceptional situations in which the Commission may authorize partial rate increases without requiring entirely new submissions. **We do not decide in this case**, for example, whether the Commission could have referred to previous submissions with some updating or whether it could have accepted summary financial information.

Scates, 118 Ariz. at 537, 578 P.2d at 618 (emphasis added, footnote added).

Similarly, the Arizona Supreme Court has not authoritatively held that the

³ The court’s reference to “the order” is to the Commission’s general order R14-2-128, the predecessor to A.A.C. R14-2-103.

Commission can increase rates based on summary filings that supplement previous filings that comply with the requirements of A.A.C. R14-2-103. In the Phase 2 Decision, the Commission cites *Ariz. Community Action Assoc. v. Ariz. Corp. Comm'n*, 123 Ariz. 228, 230, 599 P.2d 184, 186 (1979), as support for its adoption of the SIB. IOR Tab A-128 at 42, 53. In *Ariz. Community Action Assoc.*, the Commission had determined a utility's fair value rate base and established a "Step I" rate increase in August 1977, and permitted the utility to make "Step II" and "Step III" rate increases in 1978 and 1979 if certain future conditions were satisfied. 123 Ariz. at 229, 599 P.2d at 185. The Arizona Supreme Court struck down the Commission's adoption of the mechanism to allow the "Step II" and "Step III" increases. Though it was not necessary to do so, the court did confirm that the Commission could include in its determination of fair value rate base the already-expended costs of plant that was not yet in service, but was expected to be placed in service within a fixed period of time thereafter (known as "construction work in progress"). 123 Ariz. at 230, 599 P.2d at 186 (1979). The court went on to state that the adjustments to the Commission's fair value determination that would occur when the "Step II" adjustment was made were adequate to maintain reasonable compliance with the constitutional requirements if used only for a limited period of time. *Id.* at

231, 599 P.2d at 187. However, the statement was *obiter dictum*, as it was unnecessary to the decision in the case, and is therefore not precedential. *See, Phelps Dodge Corp. v. Ariz. Dept. of Water Resources*, 211 Ariz. 146, 152 ¶ 22 fn 9, 118 P.3d 1110, 1116 (App. 2005). No Arizona appellate court has authoritatively held that a “third exception” exists.

Even if such a “third exception” existed, however, the SIB would not qualify under it. In *Scates*, this Court suggested that if such an exception existed, it would apply in “exceptional situations.” *Scates*, 118 Ariz. at 537, 578 P.2d at 618. In the Phase 1 proceedings, Staff repeatedly indicated that AWC’s need to replace infrastructure was not an exceptional circumstance, even assuming a \$67 million cost estimate. IOR Tab C-65 at 35, Tab B-8 at 1332-33, Tab A-51 at 27-28, Tab A-55 at 14-16. The Commission made no finding in its Phase 1 Decision that an extraordinary circumstance existed. It is undisputed that the plant to be recovered through the SIB is routine plant. IOR Tab B-3 at 81-82; Tab C-65 at 35; Tab C-91 at 16. There is no reason why this routine, normal plant could not be recovered in the context of a full rate case where all the ratepayer safeguards are in place. Further, the Company had been paying out substantial yearly dividends prior to the filing of its rate case. IOR Tab B-3 at 154-155; Tab C-66 at 16-17. The

Commission's ALJ correctly noted that the Company could have used some of its revenues to address its infrastructure issues. IOR Tab A-56 at 105.

In the Phase 2 Decision, the Commission, in a footnote, characterizes the significant capital investment which will be required from AWC as an "exceptional circumstance" justifying adoption of the SIB. IOR Tab A-128 at 52, fn 39. However, in the Phase 1 hearing, Staff acknowledged that nothing about the Company's expenditures changed between the Phase 1 Proceeding and the Phase 2 Proceeding to create an extraordinary circumstance. IOR Tab B-12 at 301. Rather, Staff testified that an extraordinary circumstance existed because the Commission itself had directed the parties to further discuss the DSIC. IOR Tab B-12 at 301. The Commission's own statement that the parties should further discuss the DSIC cannot create an "extraordinary circumstance" sufficient to justify the use of such a rate adjustment mechanism. This Court has previously rejected such an "*ipse dixit* approach" by the Commission to finding extraordinary circumstances to circumvent the constitutional mandate that rates be established in the context of a full rate case. *See, Residential Utility Consumer Office*, 199 Ariz. at 593 ¶21, 20 P.3d at 1174.

Further, the court in *Ariz. Community Action Assoc.* suggested that the "limited period of time" for which the Step II rate case could be in effect

was factor supporting its *dicta* statement that the Commission's actions reasonably complied with the constitution's fair value requirement. 123 Ariz. at 231, 599 P.2d at 186. In that instance, the Step II rate increase, if it had been permitted by the court, would have been in effect for no more than two years.⁴ *Id.* The SIB, however, would permit rates based on the SIB application to be in place for up to 5 years, a far longer period. IOR Tab A-128 at 58, Finding of Fact No. 21. The SIB would therefore fail to meet both the "extraordinary circumstances" and "limited period of time" requirements of any "third exception" to the requirement that rates be established pursuant to a finding of fair value made in a full rate case.

III. THE COMMISSION'S FAILURE TO DECREASE THE PREVIOUSLY APPROVED RETURN ON EQUITY WHEN THE COMMISSION ADOPTED THE SIB MECHANISM WAS ARBITRARY AND UNREASONABLE.

Action which is unreasoned, without consideration, or in disregard of facts and circumstances is considered arbitrary. *Petras v. Ariz. State Liquor Bd.*, 129 Ariz. 449, 452, 631 P2d 1107, 1110 (App. 1981). There is perhaps nothing more

⁴ The Commission had adopted the "Step I" rate increase on August 1, 1997, and permitted Step II and Step III increases in 1978 and 1979. The Commission also required the utility file a full rate case application based on a test year ending December 31, 1978, which would have resulted in new rates effective in 1979 or 1980. Thus, any rate increase in Step II would have only been in effect for approximately 2 years.

unreasonable and unfair in rate making that charging the rate payer twice for the same thing.

A. The SIB and 10.55 ROE were intended to serve the same purpose.

In the Phase 1 Decision denying the DSIC, the Commission indisputably awarded AWC an increased ROE of 10.55 percent in recognition of the Company's infrastructure replacement needs. IOR Tab A-67 at 61, lines 9-17. The SIB will reduce regulatory lag in favor of AWC, because the Company will not have to wait until its next full rate case before it begins recovery of its investment in replacement plant. IOR Tab C-91 at 10, 11; Tab C-97 at 5-6. As a result, the SIB reduces AWC's risk. Tab C-97 at 6; Tab C-98 at 3-5.

The ALJ on two occasions recommended that the Commission decrease AWC's ROE to 10.0 percent because there was a duplicative purpose between the elevated ROE and the SIB. IOR Tab A-117 at 55; Tab A-177 at 42-44. Even Staff indicated that it signed the Eastern Division Settlement Agreement, which included the 10.55 ROE, because it believed the Commission wanted to award a higher ROE regardless of whether a SIB was authorized or not, and that Staff could live with either a 10.55 percent or a 10.0 percent ROE. IOR Tab B-15 at 84, Tab B-17 at 254. Further, the Commission itself acknowledged there is a duplication of purpose with the elevated ROE and the SIB. In the Phase 1 Decision, the Commission stated it was awarding a higher ROE (as compared to the 10.0 percent

ROE it had recently awarded in AWC's Western Group case), to address the Company's infrastructure needs. IOR Tab A-67 at 61. In the Phase 2 Decision, the Commission approved a SIB, also to address the Company's infrastructure needs. IOR Tab A-128 at 57 (Finding of Fact No. 16). There is no question that in the Phase 1 and Phase 2 Decisions, the Commission's own words acknowledge that the increased ROE and the SIB address the same thing. Even the Commission Staff's Director explained to the Commission at the time it was considering the Phase 2 Decision that the Phase 1 Decision had increased the ROE because there was no SIB or DSIC adopted at that time. IOR Tab B-15 at 84. The Commission's adoption of two devices (an increased ROE, and the SIB) to compensate the Company for the fact that it will make substantial investment in distribution plant between rate cases is arbitrary and unreasonable.

B. The Commission is not free to reject the rehearing evidence of more recent and lower ROEs.

In the Rehearing, RUCO testified that ROE awards have been declining since the Phase 1 and Phase 2 Decisions; the Commission, however, disregarded that data as "too far outside the 2010 test year." IOR Tab A-183 at 42. But the cost of capital (of which ROE is a component) is a forward-looking concept, not a historic concept as is the test year from which rate base and operating expenses are determined. IOR Tab C-100 at 10 (RUCO witness Parcell); Tab C-5 at 10 (AWC

witness Ahearn); Tab C-67 at 7 (Staff witness Cassidy).⁵ The return to be earned will be earned in the future, after the Commission has concluded its rate-setting process. The Commission therefore must consider evidence of shareholder's ROE expectations which are more recent than those on which the Commission based its determination of ROE in the Phase 1 Decision. The Commission's rejection of testimony to establish an approved ROE on the basis that the data is temporally too far away from the time period of the data used to establish the utility's rate base was arbitrary and unreasonable, and flies in the face of the Commission's obligation to establish rates that will permit the utility an opportunity to earn a fair return on its investment during the period the rates are in effect.

Further, the Commission's refusal to consider a decrease in ROE out of a "concern" that an adjustment to the 10.55 percent ROE might jeopardize the Settlement Agreement and its proposed SIB is arbitrary and unreasonable. IOR Tab A-183 at 42-43. The Company had previously indicated to the Commission that it would be agreeable to the Commission leaving in place the 10.55 percent ROE, without an approved DSIC or SIB. IOR Tab B-15 at 63-64, 102. Even where the Company had indicated it would be satisfied with the higher ROE and

⁵ This is unlike the Commission's obligation to determine a utility's fair value rate base, which must be based on a value of property at the time of the Commission's inquiry. *See, Simms*, 80 Ariz. at 151, 294 P.2d at 382.

not the SIB, the Commission insisted on giving it both. The Commission apparently came to the table at the Rehearing with the mindset that adoption of the SIB as proposed by the Settlement Agreement was a *fait accompli* that must be preserved at all costs, even the cost of disregarding the un rebutted evidence that the national trend since the Commission's Phase 1 Decision was for decreasing ROEs below 10.0%, and in Arizona the trend has been ROEs for companies with SIB-type mechanisms that have been lower than 10.55 percent. The Commission's headstrong insistence on approving both the increased ROE and the SIB was not based on reasoned judgment and substantial evidence in the record, but on a subjective determination that a SIB must be approved in the Eastern Group rate case. Such arbitrary action cannot be affirmed.

CONCLUSION

The Arizona Constitution requires the Commission find the fair value of a utility's plant in a full rate case at the time it adjusts the utility's rates. While there are two exceptions recognized by the courts (for interim rates and automatic adjustor mechanisms), the SIB does not qualify for either exception, and Arizona's courts have not created a "third exception" to the fair value requirement. Thus, the SIB, which permits upward adjustments to AWC's rates between full rate cases does not comply with the constitutional requirements to which the Commission is

bound. Thus, the Commission's Phase 2 Decision, as modified by the Rehearing Decision, should be vacated.

In addition, the Commission acted arbitrarily and unreasonably when it decided that ratepayers should pay twice for the same thing.. Therefore, if the Phase 2 Decision, as modified by the Rehearing Decision, is not vacated, the court should reverse in part and remand to the Commission with instructions to decrease the ROE to no more than 10 percent.

Respectfully submitted this 7th day of August, 2014.

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