

1 **TESTIMONY OF JAY L. SHAPIRO**

2 **June 30, 2011**

3 **Q. SO WHO ARE YOU AND WHY ARE YOU HERE?**

4 A. I am Jay L. Shapiro, an attorney with Fennemore Craig. I am here today to try to
5 answer a question posed by my friend and colleague Paul Walker: Does water
6 service from a private water company cost more than water service from a
7 municipality?

8 **Q. WHAT MAKES YOU KNOWLEDGEABLE ABOUT RATEMAKING?**

9 A. I have spent over 20 years working on ratemaking cases for water companies
10 regulated by the Arizona Corporation Commission, which is authorized to set rates
11 for public utilities. I participated in my first water utility rate case in 1992, when I
12 watched a hearing before the ACC devolve into a fight over the water company's
13 decision to provide its customers with calendars and to purchase flowers for the
14 recently-widowed company receptionist. I knew then that this was my bailiwick.
15 I've since participated as legal counsel in nearly 50 ACC rate cases for water and
16 sewer utilities regulated by the ACC.

17 **Q. WHAT ASPECT OF RATEMAKING ARE YOU ADDRESSING IN THIS**
18 **TESTIMONY?**

19 A. The topic today involves the contrast between financing and ratemaking for
20 municipal water and wastewater providers, such as cities and special districts, and
21 private water companies, which are regulated by the ACC.

22 **Q. LET'S ADDRESS MR. WALKER'S QUESTION: DOES WATER SERVICE**
23 **FROM A PRIVATE WATER COMPANY COST MORE THAN WATER**
24 **SERVICE FROM A MUNICIPALITY?**

25 A. There are significant differences between municipal and private water systems.
26 These differences affect the cost of providing service and therefore affect the rates

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that must be charged. For example, private utilities act as tax collectors for various federal, state and local governmental bodies. Private utilities pay federal and state income taxes, property taxes, sales taxes, and other types of governmental assessments, such as franchise fees. These costs are passed on to customers as a cost of service. Municipal water providers are generally exempt from taxation. Private utilities also recover depreciation as a cost of providing service – the wear and tear on their utility plant used to provide service. Municipalities don’t recover depreciation per se, but instead often recover an amount that is used to fund future capital projects. In addition, municipalities can raise low-cost capital through tax-exempt bonds and similar financing mechanisms, which are generally not available to private water companies. Private water companies rely on conventional debt as well as equity to finance capital project, which have a higher cost.

Q. DOES THE MANNER IN WHICH PRIVATE WATER COMPANIES ARE REGULATED AFFECT THEIR COST OF SERVICE?

A. There are several aspects of ratemaking for private utilities that add to the cost of water service. One factor is the legal constraint on Arizona water utilities that limits their ability to obtain rate relief outside of general rate cases. The Arizona Constitution, as interpreted in recent court decisions, limits the ability of Arizona utilities to utilize adjustment mechanisms, advice letter filings and other streamlined procedures to obtain recovery of costs outside a general rate case.

Another factor is the particular process and requirements that are used by the ACC to set rates. For example, the ACC requires the use of historic test years with limitations on the amount of out-of-period adjustments that can be considered in setting rates. This approach means that when new rates are set, they are usually based on information that is several years old. And the ACC rarely allows private

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water companies to implement surcharges and adjustment mechanisms when they are sought during a rate case.

Moreover, the ACC’s ratemaking process is lengthy and conflict-oriented. Ratemaking for private utilities is costly, and that cost is added to the cost of service in direct ways, like rate case expense, and indirect ways, like increased cost of capital.

Q. HOW DOES USE OF THE HISTORIC TEST YEAR MAKE RATEMAKING MORE EXPENSIVE?

A. It makes investment lumpy, which leads to larger requested increases every few years. For instance, if a utility needs to build a new treatment plant and the cost is \$25 million, the utility has to finance and build the plant, and then ask the ACC for permission to recover the costs related to the plant in rates. There is no opportunity to phase in the costs of the project, in contrast to municipalities. This adds to the contested nature of rate cases. Put simply, there is a lot more at stake when the proposed increase in rates is 80% rather than 10% annually over a period of several years.

Q. WHAT DO YOU SUGGEST BE DONE DIFFERENTLY?

A. The key, I believe, is greater regulatory flexibility. First, the ACC needs to develop a means of addressing the challenge of financing larger-scale projects. One approach would be to recognize construction work in progress or “CWIP” in rate base, especially on larger projects. Other states, such as California, use future test years or partially-projected test years to better reflect future costs and to match plant, expenses and revenues on a going-forward basis. The ACC could follow the lead of these jurisdictions and use an approach that is forward-looking rather than historical.

1 For more routine plant investment, such as replacement of main and service
2 lines, the ACC could approve plant funding mechanisms, such as distribution
3 system improvement charges, which would fund planned replacement of
4 infrastructure over longer periods of time, thereby reducing the “shock” impact on
5 rates and ensuring that mains and lines are not operated under a “bailing wire and
6 hope” policy. Rate increases also can be phased in to coincide with the completion
7 of plant.

8 **Q. DO THESE FLEXIBLE FUNDING MECHANISMS ADDRESS EXPENSES**
9 **TOO?**

10 A. Absolutely. Automatic adjustment mechanisms allow private water companies to
11 adjust their rates, through a surcharge or similar mechanism, in response to changes
12 in the rates for critical operating expenses, such as purchased water, purchased
13 power, chemicals and fuel. These expenses are variable and outside the company’s
14 control. They also make up a significant portion of most water companies’
15 operating expenses. Relatively modest increases in the rates for power and water,
16 for example, can have a serious impact on a water company’s earnings and ability
17 to finance necessary capital improvements. At the same time, if expenses covered
18 by an adjustment mechanism decrease, the decrease can be passed on to customers
19 through a credit.

20 **Q. HAVE WATER AND SEWER UTILITIES IN ARIZONA SOUGHT**
21 **APPROVAL OF THESE TYPES OF MECHANISMS FROM THE ACC?**

22 A. Yes. Ironically, in the late 1970s and 1980s, the ACC approved purchased power
23 and water mechanisms for several water companies. Beginning in the 2000s,
24 however, the ACC began to eliminate these mechanisms from water companies’
25 tariffs. In several recent rate cases, for example, Arizona Water Company’s
26 adjustment mechanisms, which were originally approved in the early 1980s, were

1 eliminated over the company's objection. Other water companies, such as
2 Chaparral City Water Company, requested, but were denied approval to implement
3 automatic adjustment mechanisms for purchased water and power. Arizona
4 American Water Company has sought and been denied a distribution system
5 improvement charge, but it has another request for one pending right now.

6 As far as capital projects go, I am not aware of any utility that has received
7 approval of CWIP in the last 10 years. Plant must be completed and placed in
8 service by the end of the historic test year, or at least a reasonable time after the test
9 year. In addition, one of the more contentious issues in many recent rate cases is
10 whether a particular project has "excess" capacity, meaning that the plant cannot be
11 oversized, even where substantial economies of scale can be achieved. This
12 approach encourages water companies to think short-term, and design and build
13 plant based on whether it will be recognized for ratemaking purposes.
14 Municipalities, in contrast, are able to develop and implant long-range plans for
15 capital improvements, reducing financing and construction costs and, ultimately,
16 lowering rates for service.

17 **Q. HAVE THERE BEEN ANY RECENT SUCCESSES?**

18 A. There have been a couple of limited successes. Arizona Water Company was able
19 to obtain approval of a mechanism to recover certain costs related to installing
20 treatment for arsenic to comply with the new drinking water standard established
21 by the EPA. Arizona-American Water Company obtained approval of a similar
22 cost mechanism using the Arizona Water approach as a model. The ACRM
23 allowed these utilities to recover some of the cost of arsenic treatment without the
24 immediate burden of waiting for new rates to be approved. More recently, Liberty
25 Water obtained approval to recover on unique capital improvement costs to be
26 incurred while it returns to formalize inclusion of those costs in rate base.

1 **Q. WHY HASN'T THE ACC REGULARLY APPROVED THESE TYPES OF**
2 **FLEXIBLE RATEMAKING MECHANISMS?**

3 A. The ACC has approved them, but only for large energy providers like Southwest
4 Gas, Arizona Public Service Company and Tucson Electric Power. These large
5 utilities have various surcharges and adjustment mechanisms in their tariffs. But
6 private water and wastewater utilities have been denied these mechanisms for a
7 variety of reasons that include lack of sufficient volatility in expenses, violation of
8 the “matching principle,” “piecemeal ratemaking,” and customer fairness.

9 **Q. HOW WOULD APPROVAL OF ADJUSTMENT MECHANISMS IMPACT**
10 **RATEMAKING PROCEEDINGS?**

11 A. They would have several positive impacts. First, they would smooth out increases
12 in rates due to capital investment in plant and increases in expenses. Rates would
13 adjust annually in small increments. Second, water utilities could go longer
14 without the need to file a general rate case. Third, when a general rate case is filed,
15 the required increase will often be less than would be the case without adjustment
16 mechanisms. This, in turn, should lead to less contested rate proceedings.

17 **Q. ARE YOU SUGGESTING APPROVAL OF THESE FLEXIBLE**
18 **RATEMAKING TOOLS WOULD ELIMINATE LITIGATION IN**
19 **RATEMAKING?**

20 A. No, that’s not likely. Presently, when a water utility files for new rates it faces at
21 least two state agencies likely to recommend different rates and treatments. Public
22 interest and community groups like HOAs also intervene, as do business
23 customers. As a result, the utility ends up fighting for every dollar of new revenue
24 that is actually approved. This litigation process plays itself out over 12 to 18
25 months with massive filings and lengthy hearings before culminating in a vote by
26 the ACC at a public meeting where anything can happen. Flexible ratemaking

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mechanisms are needed but they are only one part of the solution. Another part of the solution would be to adopt procedures to streamline and simplify rate cases. One possibility would be to have some type of alternative dispute resolution process, such as mediation or mandatory settlement conferences, to eliminate contested issues.

Q. SO WHAT YOU ARE SAYING IS THE UTILITIES AND THEIR LAWYERS, SUCH AS YOURSELF, MAKE THE PROCESS LITIGIOUS?

A. No, I fight for my client’s revenues because they are entitled to them and this is the only process available. Like me, our clients are advocating changes intended to reduce the cost, in time, money and other resources, of ratemaking for private water utilities in Arizona. If we’re right, lawyers like me would make less money doing rate cases at the ACC.

Q. BUT WON’T THESE FLEXIBLE REGULATORY MECHANISMS AND LESS CONTESTED RATE CASES MAKE IT MORE LIKELY UTILITIES WILL OVERCHARGE THEIR CUSTOMERS?

A. We are not advocating zero regulation, or even less regulation of water and sewer companies. It is about more efficient regulation. Utilities would obtain smaller revenue increases in less contested rate cases. This would allow rate cases to be decided more quickly, and reduce rate case expense. It also would free up the ACC’s limited resources to more efficiently regulate. And more efficient regulation would make it easier for utilities to actually earn their authorized return, making the business more attractive to investors.

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Q. AND THAT REALLY IS YOUR PERSPECTIVE – THE INVESTOR’S PERSPECTIVE. WHAT YOU PROPOSE IS NOT NECESSARILY GOOD FOR RATEPAYERS, RIGHT?

A. I disagree. Ratepayers benefit from less costly rate proceedings because there will be less rate case expense included in rates. But more importantly, ratepayers and utilities benefit from the type of certainty that a more efficient ratemaking promises. Regulators would also benefit. If a water and sewer utility with 30,000 customers were allowed to collect a distribution system improvement charge to fund plant replacement, collect a hook-up fee from new customers to fund growth, and implement adjustment mechanisms that allow recovery of increases in key expenses such as power, then when the utility files a general rate case, the rate case would be simpler and less controversial. And the increases sought would be smaller and a lot more palatable for consumers and their elected representatives.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes, but I am available to be rigorously cross-examined.