Go to Table of Contents

SUPREME COURT
STATE OF ARIZONA

RESIDENTIAL UTILITY CONSUMER OFFICE, an agency of the State of Arizona, Respondent, vs. THE ARIZONA CORPORATION COMMISSION, Petitioner, and ARIZONA WATER COMPANY, Petitioner-Intervenor.	No. CV-15-0281-PR Arizona Court of Appeals No. CA-CC-13-0002 No. CA-CC-14-0001 Corporation Commission No. W-01445A-11-0310 No. W-01445A-12-0348

BRIEF OF AMICUS CURIAE ARIZONA INVESTMENT COUNCIL ON BEHALF OF PETITIONER ARIZONA CORPORATION COMMISSION (FILED WITH THE PARTIES' CONSENT)

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Click on the headings below to go to the corresponding page

TABLE OF CONTENTS

Page

Go to Table of Contents

TABLE OF AUTHORITIES

Page

CASES

CONSTITUTION

TREATISES

Go to Table of Contents

INTRODUCTION[1]

Across the country, state regulatory commissions are presiding over some of the most important investments in the history of the electric industry, during what is generally recognized to be a period of marked transition. The same holds true for gas and water utilities, which are challenged to finance hefty capital expenditures in the face of declining commodity sales. To fund their investments, the investor-owned gas, water, and electric utilities in Arizona and across the country will turn to the debt and equity markets, competing against one another for the limited pool of capital dollars available to utilities to fund their respective infrastructure needs. Capital markets favor and give the lowest financing rates to those that are the most creditworthy and promise the greatest return on equity – an analysis that, in the utility world, is intimately connected to the utility's regulatory environment.

Arizona's utility regulatory regime has historically been viewed as less constructive relative to other jurisdictions. In large part, this is because Arizona sets rates based on a "historical test year," which, when

[1] This Brief is being filed with the parties' consent.

coupled with a rate case process that can take in excess of 12 months to two years, often results in rates that fail to reflect the actual conditions experienced by the utility at the time new rates finally take effect. This impact is what is known as "regulatory lag." When a utility's capital expenditures are high – as they promise to be for regulated utilities in the upcoming years – the effects of regulatory lag are particularly damaging, preventing the utility from earning its allowed rate of return. This, in turn, results in credit rating downgrades and an increasing cost of capital, which ultimately raises the cost of utility service to Arizona customers.

Recognizing the negative consequences of relying strictly on the prolonged rate case process, the Arizona Corporation Commission ("ACC") has become increasingly receptive to rate mechanisms that allow utilities – under carefully monitored conditions - to adjust rates in between rate cases. Such mechanisms include not only the System Improvement Benefits charge ("SIB") at issue in this proceeding, but others that have been granted to virtually every type of utility in Arizona: electric, gas, water, investor-owned, and cooperative. The legality of these mechanisms is carefully vetted by the ACC legal staff,

which takes a highly conservative approach to assure that rates are "just and reasonable" and fully compliant with existing legal precedent.

The Court of Appeals' decision, by disregarding much of this Court's prior analyses as dictum, far too narrowly construes existing precedent as to the meaning of "fair value" and the limitations placed on the ACC's ability to approve rate mechanisms that allow rates remain "just and reasonable" in between rate cases. In so doing, the opinion raises significant concerns regarding Arizona's regulatory environment—concerns that could have a devastating impact on the investment community's perception of Arizona regulation, thereby making capital more expensive and less available to Arizona's utilities.

The provision of reliable, cost-effective utility service is an issue of statewide importance that is undermined by the Court of Appeals' opinion. This Court should accept review and overturn the narrow construction of how the "fair value" requirement of Article 15, Section 14 limits the ACC's rate setting abilities.

Go to Table of Contents

INTERESTS OF AMICUS CURIAE

AIC offers this brief in support of granting the petition for review so that this Court may clarify that "fair value" under the Arizona Constitution is flexible enough to adapt to accommodate the concerns of utilities, utility investors, and consumers. AIC is an organization with nearly 6,000 members, including Arizona utility service providers and individuals who hold stock or debt investments in utilities. Part of AIC's purpose is to promote policies that encourage utility investment and infrastructure development in Arizona, and to represent the interests of debt and equity investors in Arizona utilities.

AIC and its members have a substantial interest in this proceeding because the overly-restrictive interpretation of "fair value" espoused by the Court of Appeals unreasonably deprives the Commission of the ability to adopt rate mechanisms that best serve public policy.

ARGUMENT

I. The Petition Raises Issues of Statewide Importance

The issues raised in the petition go to the heart of the ACC's constitutional duty to "prescribe just and reasonable classifications to be

used[,] and just and reasonable rates and charges to be made and collected, by public service corporations within the state." Ariz. Const. art. 15, § 3; *see also* Ariz. Const. art. 15, § 14 (requiring the ACC to "ascertain the fair value" of property "to aid it in the proper discharge of its duties"). *See, e.g., Ariz. Corp. Comm'n v. State ex rel. Woods*, 171 Ariz. 286, 288, 830 P.2d 807, 809 (1992) (holding, in the affiliate transaction context, that the ACC's regulatory authority is "of great importance to the people of this state.") This Court should grant the ACC's petition for review to address the uncertainty that the lower court's opinion raised with respect to the ACC's authority to set just and reasonable rates.

II. Public Policy Supports Rate Mechanisms that Promote Regulatory Certainty and Minimize Regulatory Lag.

The Court of Appeals severely limited the ACC's ability to approve rate adjustments in between rate cases by creating an overly narrow definition of both "fair value" and the procedure necessary to establish it without understanding or accounting for the full consequences of the Court's decision. *See State ex rel. Woods*, 171 Ariz. at 296, 830 P.2d at 817 ("[C]urrent events in this state and others prove the

wisdom and necessity of a broader view of what is involved in ratemaking."). Recognizing the negative consequences of relying strictly on the rate case process to adjust rates in a historical test year jurisdiction, the ACC has adopted several rate adjustment mechanisms that allow its regulated utilities the opportunity to earn their authorized rates of return in between full rate cases. The Court of Appeals' decision would undo this constructive regulatory treatment. From an investor perspective, the decision thus creates uncertainty and results in a regulatory regime in which utility rates will fail to reflect the actual financial conditions experienced during the rate effective period – a result that may impair the creditworthiness of Arizona's utilities to the long-term detriment of Arizona consumers.

A utility's regulatory environment is one of the most significant considerations impacting a utility's credit rating and its ability to raise capital. *See* McGraw Hill Financial S&P Capital IQ, *Assessing U.S. Investor-Owned Utility Regulatory Environments ("Utility Regulatory Environments")*(May 18, 2015). As the most prominent credit rating agency, Standard & Poor's ("S&P"), explains, "[f]or a regulated utility company, the regulatory regime in which it operates will influence its

performance in profound ways. As such, [the assessment of the regulatory environment] is one of the most important factors in our credit rating analysis of regulated utilities." *See* McGraw Hill Financial S&P Capital IQ, *How Regulatory Advantage Scores Can Affect Ratings on Regulated Utilities* ("*Regulatory Advantage*")(May 18, 2015). And an assessment of a single state's regulatory environment is not taken in isolation. Rather, the rating agency "considers the overall regime and compare[s] it with other jurisdictions globally, and this broader assessment is what ultimately influences our ratings opinions." *Id.*

Two aspects of a utility's regulatory environment are particularly important: regulatory stability, encompassing a transparent, predictable, and consistent approach to regulating utilities; and a utility's ability to timely recover costs. *See Utility Regulatory Environments* at 1-2. A public utility commission's treatment of capital spending is critical, especially when capital investments are expected to be high and ongoing, as they are for all of Arizona's investor-owned utilities. Consider the following excerpt from S&P's credit rating guidance:

> When applicable, a jurisdiction's willingness to support large capital projects with cash during construction is an important aspect of our analysis. . . Very supportive jurisdictions offer a separate recovery mechanism for all capital spending, a mandated current cash return during construction, and a bonus return for some or all capital projects. We deem a jurisdiction weaker if there are separate mechanisms for only certain kinds of spending and the cash return and higher return are subject to the regulator's discretion. We view jurisdictions that don't allow separate recovery or a current return as being lower on the scale. We assess a jurisdiction as weaker still when it doesn't have independent rate mechanisms for capital projects, and we view it as most risky when full recovery occurs only after a utility's assets become operational.

See Utility Regulatory Environments at 4.

Were the lower court's narrow construction of the fair value requirement to be upheld, the only method of recovering capital certain to withstand its unreasonably proscriptive requirements for "fair value" scrutiny would be in a rate case, after the utility plant has been placed in service. From the investor perspective, Arizona's capital recovery program would thus move from about average in terms of constructiveness to the "most risky," which may negatively impact Arizona utilities' ability to secure capital at reasonable costs.

The practical implications of a large capital program in a historical test year jurisdiction can be dire, absent the ability to update rates to reflect real costs between rate cases. Assume, for example, that a power company is required to install environmental upgrades at its coal facilities at a cost of $50 million each year over a period of four years, beginning in 2016. Assume also that the environmental plant becomes operational the year it is installed. To recover its costs, the company would have to file a rate case, using 2016 as a test year. The rate case schedules, which require voluminous amounts of financial data, need to be based upon the company's verified accounting records, which takes several months to complete. That 2016 test year rate case would therefore not likely be filed until the middle of 2017. And the rate case process itself can take anywhere from 12-24 months, depending on the size of the utility and the issues involved. Best case scenario, the rate case concludes in one year and the new rates reflecting the 2016 environmental capital spend take effect mid-year 2018 – almost two years *after* the plant went into service.

But what those rates do *not* reflect are the $100 million of additional capital upgrades that have been made in 2017 and 2018,

during the pendency of the rate case. The rates set in 2018 are outdated the very moment they are put into effect. And while the utility may turn around and file yet another rate case, the same phenomenon will occur. No amount of operational efficiency or cost management can make up for rates set on a rate base that is $100 million short. From an investor perspective, the consequence of relying solely on the historical test year rate-making process is a utility that will never be given an ability to recover its costs and earn a timely return – a view that can significantly impair the evaluated creditworthiness of Arizona utilities.

Arizona's regulatory environment must continue to be productive if our utilities are to compete successfully for the limited amount of available capital investment funds and secure them at cost-effective rates. Edison Electric Institute estimates that, in 2016, the electric industry alone is expected to make $90.6 billion in capital investments. *See* Edison Electric Institute, *EEI Industry Capital Expenditures* (last visited December 10, 2015). Arizona utilities' ability to compete for these dollars will be crippled if they are viewed as a credit risk relative to utilities in other jurisdictions. And the capital they do secure will be more expensive, adjusted upward to account for the higher risk profile.

Higher capital costs mean higher utility rates for customers – an end that serves no one well.

For these reasons, public policy very much supports a regulatory environment that fosters regulatory stability and mitigates the financial consequences of regulatory lag. Tailored rate adjustment mechanisms like the SIB are imperative if Arizona's utilities are to continue to provide reliable, cost-effective service during what all agree will be a time of stunning capital investments. The Court of Appeals' decision overlooks these important real-world implications, and should be overturned.

III. Arizona Law Supports Rate Mechanisms that Adjust Utility Rates Between Rate Cases.

The Court of Appeals held that, to comply with Article 15, Section 14 of the Arizona Constitution, the SIB rate mechanism must be based on "the functional equivalent of a fair value determination." *Residential Util. Consumer Office v. Ariz. Corp. Comm'n*, 238 Ariz. 8, 17 ¶ 47 (App. 2015) . But it then essentially held that "the functional equivalent of a fair value determination" can occur in nothing short of a rate case, with only two limited exceptions (interim rates and adjustment mechanisms

that recover narrowly defined operating expenses). *See id.* at 16-17 ¶¶ 40-042.

That view too narrowly construes the legal precedent upon which the ACC, utilities and other stakeholders have relied for decades in devising rate solutions to the investment challenges facing Arizona's regulated utilities. *See, e.g., Ariz. Cmty. Action Ass'n v. Ariz. Corp. Comm.*, 123 Ariz. 228, 230 (1979) (authorizing "step increase" rate adjustments between rate cases to promote "stability in the rate structure within the bounds of fairness and equity rather than a constant series of rate hearings"); *Ariz. Corp. Comm. v. Ariz. Pub. Serv. Co.*, 113 Ariz. 368, 371 (1976) (finding it "obvious" that the Commission may include post-historic test year costs in rate base); *Mountain States Tel. & Tel. Co. v. Ariz. Corp. Comm.*, 137 Ariz. 566 (Ct. App. 1983) (noting that the Commission may determine fair value using "something less than a full or permanent rate hearing of the most complex type"); *U.S. West Commc'ns, Inc. v. Ariz. Corp. Comm.*, 201 Ariz. 242, 246 (2001) ("Neither Section 3 nor Section 14 of the constitution require the corporation commission to use fair value as the exclusive 'rate basis.'").

The ACC is required to set rates that are "just and reasonable," Ariz. Const. art. 15, Sec. 3, and that provide utilities with an opportunity to earn a reasonable rate of return, *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 153 (1956) . The combination of the historical test year, regulatory lag in excess of 12-24 months, and an intensive multi-year capital investment program results in utility rates that deprive utilities of the ability to earn their authorized rates of return on the rate effective date. Such rates are confiscatory and therefore unjust and unreasonable as a matter of law. *See, e.g., Ariz. Corp. Comm'n v. Mountain States Tel. & Tel. Co.*, 71 Ariz. 404 (1951) (recognizing that rates collecting insufficient revenue are unjust, unreasonable, and confiscatory in violation of the due process clause of the Arizona and U.S. Constitutions).

As the United State Supreme Court has explained,

> [T]he fixing of 'just and reasonable rates' involves a balancing of the investor and the consumer interests . . . From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock . . . By that standard, the return to the equity owner should be commensurate with returns on the investment in other enterprises having corresponding risks. That return, moreover should be sufficient to assure confidence in the

> financial integrity of the enterprise, so as to maintain its credit and to attract capital.

Fed. Power Comm'n v. Hope Natural Gas Co. City of Cleveland, 320 U.S. 591, 603 (1944)

Mechanisms like the SIB that reflect capital additions in between rate cases undergo a fair value rate base analysis and restore the utility's opportunity to earn its authorized rate of return. Under such circumstances, such mechanisms are not only legally permissible, they are mandatory.

CONCLUSION

For the reasons outlined above, AIC respectfully requests this Court to grant the ACC's petition for review.

RESPECTFULLY SUBMITTED this 14th day of December, 2015.

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