21

0000001152

ORIGINAL

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

MARC SPITZER, Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
MIKE GLEASON
KRISTIN K. MAYES

Arizona Corporation Commission
DOCKETED
MAR 1 9 2004
DOCKETED BY

IN THE MATTER OF THE APPLICATION OF ARIZONA WATER COMPANY, AN ARIZONA CORPORATION, FOR ADJUSTMENTS TO ITS RATES AND CHARGES FOR UTILITY SERVICE FURNISHED BY ITS EASTERN GROUP AND FOR CERTAIN RELATED APPROVALS.

DOCKET NO. W-01445A-02-0619

DECISION NO. 66849

OPINION AND ORDER

DATES OF HEARING:	March 31, 2003 and September 17, 2003 (pre-hearings), September 22, 23, 24, 25 and 26, 2003, December 8, 2003 (oral argument)
PLACE OF HEARING:	Phoenix, Arizona
ADMINISTRATIVE LAW JUDGE:	Dwight D. Nodes
IN ATTENDANCE:	Mike Gleason, Commissioner
APPEARANCES:	Mr. Jay Shapiro and Mr. Norman James, FENNEMORE CRAIG, on behalf of Arizona Water Company;
	Mr. Daniel Pozefsky on behalf of the Residential Utility Consumer Office;
	Ms. Kay Bigelow, City Attorney, on behalf of the City of Casa Grande;
	Mr. Robert Skiba, in propria persona; and
	Mr. Timothy J. Sabo and Mr. Gary Horton, Staff Attorneys, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

Arizona Corporation Commission
DOCKETED
MAR 1 9 2004
DOCKETED BY

BY THE COMMISSION:

I. INTRODUCTION

On August 14, 2002, Arizona Water Company ("Arizona Water," "Company" or Applicant") filed an application with the Arizona Corporation Commission ("Commission") for a rate increase for the Company's Eastern Group systems. Arizona Water supplies water to approximately 60,000 customers in eight Arizona counties under 18 separate water systems. The rate application filed in this docket involves only the Company's Eastern Group, which serves approximately 29,000 customers in the Apache Junction, Bisbee, Miami, Oracle, San Manuel, Sierra Vista, Superior, and Winkelman systems.

Arizona Water's current rates and charges for the Eastern Group were authorized in Decision No. 58120 (December 23, 1992), and became effective January 1, 1993. The service charges were later modified in Decision No. 60512 (December 3, 1997). The Company's purchased power adjustor mechanisms ("PPAMs") were changed in Decision No. 58293 (May 19, 1993) and Decision No. 62755 (July 25, 2000). The Monitoring Assistance Program ("MAP") surcharge was established in Decision No. 62141 (December 14, 1999).

The Commission's Utilities Division Staff ("Staff") filed a letter of insufficiency on September 13, 2002. Following supplementation by Arizona Water, the application was found sufficient on October 11, 2002. On October 23, 2002, a Rate Case Procedural Order was issued setting this matter for hearing on June 23, 2003.

On February 27, 2003, Staff filed a Motion to Continue all Procedural Deadlines, Continue Hearing, and for Tolling of the Rate Case Time Clock. Staff sought additional time to permit an analysis of the Company's request for inclusion of post-test year plant for the 12 months following the end of the December 31, 2001 test year. During oral argument on the Motion, Arizona Water indicated that it would agree to the extension of time to allow analysis of post-test year plant if the only alternative was to forego consideration of such plant additions. A Second Rate Case Procedural Order was issued on March 14, 2003 setting a revised hearing date of September 22, 2003. Accordingly, the time clock for a final Commission decision was extended.

Intervention was granted to the Residential Utility Consumer Office ("RUCO"), Superstition Mountain, LLC, and Mr. Robert Skiba. Arizona Water, Staff, RUCO, and Mr. Skiba filed testimony supporting their respective positions in this proceeding. By agreement, Mr. Skiba's testimony was entered into the public comment section of the docket. Public comment hearings were conducted by Commissioners on August 18, 2003 in San Manuel, on August 19, 2003 in Bisbee, and on August 28, 2003 in Apache Junction. Evidentiary hearings were conducted in Phoenix on September 22, 23, 24, 25, and 26, 2003. Closing briefs were filed on October 31, 2003 and reply briefs were filed on

November 10, 2003. An oral argument was held on December 8, 2003.

A. Rate Application

According to the Company's revised schedules, in the test year ended December 31, 2001, Arizona Water's Eastern Group had adjusted operating income of $1,969,034 on an adjusted original cost rate base of $39,123,198, a 5.03 percent rate of return. Arizona Water requests a revenue increase of $4,303,552, for an 11.00 percent rate of return on its proposed original cost rate base of $39,123,198. The Company's request would increase revenue by approximately 26.01 percent for the Eastern Group.

II. RATE BASE

A. Plant in Service and Post-Test Year Plant Additions

Arizona Water proposes a revised Eastern Group fair value rate base of $39,123,198 (Ex. A-13, at SLH-RJ2, p.1; Ex. A-19). The Company's rate base proposal includes recommended gross and net plant in service of $84,722,378 and $66,477,550, respectively, for the Eastern Group (Ex. A-19). Although the amount of gross plant in service is no longer in dispute between the Company and Staff (Tr. 982-983), there continues to be disagreement regarding net plant in service due to Staff's proposed adjustments to accumulated depreciation. There is also disagreement between Arizona Water and RUCO due to RUCO's position that actual cost information should be used for considering post-test year plant in service additions.

As indicated above, the hearing and time clock in this proceeding were extended to enable Staff and RUCO the opportunity to analyze Arizona Water's post-test year plant additions. Based on Commission precedent, including Arizona Water's Northern Group rate case (Decision No. 64282), Staff agrees that post-test year plant additions for up to one year may be included in rate base. The Company seeks $3,349,416 for post-test year plant to be included in this proceeding, based on plant that was in service prior to December 31, 2002 (Tr. 736-740; 983).

RUCO recognizes that the Commission has in the past allowed post-test year plant to be included and recommends that, if the Commission follows that precedent in this case, it should also consider the actual matching of post-test year expenses, revenues, and rate base elements including plant additions financed by contributions in aid of construction ("CIAC") and advances in aid of construction ("AIAC") (Tr. 724-725). RUCO points out that this proceeding is unique in that the extension of the hearing date granted by the Commission allowed RUCO time to obtain and analyze the Company's "actual" 2002 operating results (RUCO Ex. 3, at 16). Thus, unlike most rate cases where pro forma adjustments must be made, RUCO contends that the actual known and measurable information should be used.

Arizona Water argues that RUCO's proposal would result in a "projected" test year. According to the Company, RUCO's recommendation is simply an attack on the Commission's policy of including post-test year plant as long as the plant is revenue neutral (*i.e.*, intended to provide service to customers existing at the end of the test year) and the plant is completed and placed in service a reasonable time before the hearing so that the plant can be inspected and audited. *See, e.g.*, *Bella Vista Water Co.*, Decision No. 65350 (November 1, 2002); *Paradise Valley Water Co.*, Decision No. 61831 (July 20, 1999); *Far West Water Co.*, Decision No. 60437 (September 29, 1997). The Commission also granted inclusion of 12 months of post-test year plant in Arizona Water's most recent rate case involving the Company's Northern Group systems. Decision No. 64282 (December 28, 2001), at 2-5.

The Commission's rules require that the test year selected by a rate applicant for determining rate base, operating income, and rate of return to be "the most recent practical date available prior to the filing." A.A.C. R-14-2-103(A)(3)(p). However, the Commission has in the past allowed consideration of known and measurable post-test year data, generally for no more than 12 months after the end of the test year. Decision No. 64282, at 5. Although RUCO contends that adoption of the Company's position would result in a mismatch (because it claims post-test year plant was financed with CIAC), Company witness Hubbard testified that RUCO's contention is inaccurate (Ex. A-13, at 18-19). According to Ms. Hubbard, Arizona Water did not include any post-test year additions that constitute CIAC or AIAC and, therefore, it would be improper to accept RUCO's attempt to manipulate the Company's rate base by including post-test year CIAC, AIAC, accumulated depreciation, and deferred taxes, because those items are not related to Arizona Water's post-test year plant additions (Id.; Ex. SLH-RJ6). Ms. Hubbard testified that this information was provided to RUCO through a data request response prior to the beginning of the hearing (Id.).

We agree with Arizona Water that the evidence does not support RUCO's contention that post-test year plant was financed by CIAC or AIAC. RUCO's witness conceded that the so-called "matching principle" proposal in this case is similar to the approach advocated by RUCO in the Company's Northern Group case, which was rejected by the Commission (Tr. 748-749). In this proceeding, Arizona Water and Staff recommend using the formula adopted by the Commission in prior cases whereby the historical test year is adjusted by pro forma annualization and normalization adjustments for known and measurable changes subsequent to the test year. Contrary to RUCO's claims, we do not believe adoption of this method would result in a mismatch because the post-test year plant additions are revenue neutral (i.e., not funded by CIAC or AIAC). Rather, the pro forma adjustments related to post-test year plant additions, including appropriate adjustments for accumulated depreciation (see discussion below) and depreciation expense, will recognize the post-test year plant as if it were in service as of the end of the test year. Consistent with our treatment of post-test year plant in prior cases, including Arizona Water's most recent Northern Group proceeding, we decline to accept RUCO's arguments in this case.

1. Accumulated Depreciation

In calculating accumulated depreciation, Arizona Water uses the "half-year convention" of depreciation. Under this convention, plant additions during the year are assumed to be made on June 30 or July 1, resulting in a half-year's depreciation in the first year and a half-year's depreciation in the year the plant is retired (Ex. A-11, at 10). This convention was approved in the Company's last rate case for the Eastern Group systems (Decision No. 58120, at 5-6). In this case, Arizona Water followed the half-year convention on its books but seeks recovery of a full 12 months of depreciation for ratemaking purposes. The Company claims that this pro forma adjustment ensures proper matching of the amount added to the accumulated depreciation balance and the amount of depreciation expense to be recovered in rates (Ex. A-11, at 31-32). Arizona Water argues that its pro forma depreciation adjustments properly recognize the known and measurable change in test year operating expense levels that will result from additional depreciation on plant not previously included in test year depreciation expense. As a result, the Company contends that its pro forma depreciation expense adjustments and corresponding adjustments to the accumulated depreciation are identical.

According to Company witness Sheryl Hubbard, Arizona Water's pro forma adjustment to plant in service for non-revenue producing post-test year plant is merely an attempt to enable the Company an opportunity to earn a fair rate of return on investments to serve test year-end customers (Ex. A-12, at 6). Ms. Hubbard stated that if an additional year of depreciation is used to reduce the Company's rate base, its ability to earn a return on the post-test year additions is diminished (Id.).

Staff's recommendation is that the level of accumulated depreciation should be updated to the end of 2002 to reflect the addition of post-test year plant. Staff witness Ron Ludders testified that because rate base is determined at a given point in time, related accounts including depreciation should be treated in a comparable manner (Tr. 985-987). He indicated that failure to match the plant and accumulated depreciation dates will result in an overstatement of plant in service. He claims that the Company's recommendation violates its half-year convention.

Consistent with our decision in Arizona Water's Northern Group case (Decision No. 64282), we agree with Staff that it is appropriate to reflect an additional year in the depreciated accumulation balance because the Company included an additional year of plant beyond the test year (Tr. 985-986). As we stated in Decision No. 64282, "it is necessary to reconcile the accumulated depreciation with the same cut-off date as was used for the post-test year plant" (*Id.* at 6). We agree with Staff that Arizona Water's proposal would create a mismatch by measuring rate base and accumulated depreciation at different points in time. Absent reconciliation between accumulated depreciation and test year plant, the Company's shareholders will realize a windfall at the expense of ratepayers. We will therefore adopt Staff's accumulated depreciation recommendation.

2. Working Capital

Arizona Water is seeking a total working capital allowance of $923,871 for its Eastern Group consisting of cash working capital, materials and supplies inventory, required bank balances, and prepayments and special deposits (Ex. A-14). Only the cash working capital component is disputed in this proceeding. The Company points out that the cash working capital component is generally determined by one of three methods: 1) a lead/lag study measuring the amount of time before expenses must be paid compared with the amount of time before revenues are received; 2) the formula method based on one-eighth of a company's annual operating and maintenance expenses; or

3) a balance sheet method which represents the difference between a utility company's current assets and liabilities.

As we stated in the Company's Northern Group case, the lead/lag methodology is generally more accurate than the formula method and is the appropriate method for a utility the size of Arizona Water (Decision No. 64282, at 7). In this proceeding, the parties do not dispute that lead/lag is the appropriate method to be used for determining cash working capital. There remains a dispute between the Company and Staff regarding the proper number of lag days to be used for calculating the property tax component of the working capital allowance. Arizona Water and RUCO also disagree regarding calculation of the income tax component of working capital. These disputed issues are addressed below.

a. Property Tax Component

The lead/lag method utilized by all parties in this case requires a calculation of the lead days or lag days that exist between the time an expense is due and paid (Ex. A-12, at 9; Ex. A-13, at 7). The dispute between Arizona Water and Staff relates to the appropriate number of lag days used to determine the property tax component of the working capital allowance. Arizona Water proposes using an average of 212 lag days[1], while Staff contends that a lag period of 532 days is appropriate (Tr. 497, 1011, 1022).

The lag day dispute centers on the interpretation of when the Company's property taxes are assessed. Ms. Hubbard explained that although the Arizona Department of Revenue ("ADOR") prepares a notice of valuation one year prior to any given tax year, the actual assessment of property taxes occurs during the tax year through issuance of county tax bills (Tr. 396; Ex. A-21; Ex. A-13, at SLH-RJ7). The Company argues that the notice of valuation from ADOR represents a preliminary indication of the value of property subject to taxation, but does not establish an amount of the Company's tax liability. Arizona Water claims that ADOR never assesses property tax liability but, instead, simply values the utility's property, and that valuation remains subject to challenge. Ms. Hubbard stated that the first property tax payment is due in October of the tax year and the second

[1] RUCO also proposes using 212 lag days.

payment is due in March of the following year (Ex. A-13, at 7-8). Thus, the Company contends that the average of 212 lag days should be utilized for determining the property tax component of working capital (Ex. A-21).

In support of its 532 lag day recommendation, Staff claims that the appropriate starting point is the time that Arizona Water receives its valuation notice from ADOR, rather than the date that the Company receives its property tax bill. According to Staff witness Ludders, Arizona Water accrues property taxes on its books once it receives the valuation notice from ADOR. Staff asserts that although the amount of tax due is not listed on the valuation notice, the property tax liability can be calculated from the valuation notice. Mr. Ludders analogizes the valuation liability to a credit card debt that exists once an item is charged, although payments of the charges are not due at that time (Tr. 1012). Mr. Ludders conceded that the Commission used a 212 day lag period in the Northern Group case, but he claims that the Commission likely did not understand that the current ADOR valuation methodology was already in effect at that time (Tr. 1025-1026). Mr. Ludders also testified that Staff's understanding of the ADOR valuation methodology has improved based on conversations with ADOR since the Northern Group case was decided (Id. at 1104).

We agree with the Company and RUCO that 212 days is the appropriate lag period for calculating the property tax component for cash working capital. There has not been any substantive change in the valuation or assessment methodology by state or county entities since the Northern Group proceeding where we adopted 212 lag days for this issue. As the Company points out, the valuation notice from ADOR is useful only for determining a value of the property for which property taxes are to be assessed. That valuation does not, however, obligate the Company to pay any specific amount at that time; nor does the valuation even indicate how much is due since that determination is made subsequently by the individual county in which the property is located. We therefore adopt 212 lag days for calculating the property tax component of working capital.

b. Income Tax Lag Days

Arizona Water records its federal and state income tax liability on a monthly basis, although the Company pays 90 percent of that income tax liability on a quarterly basis (Ex. A-13, at 20). RUCO claims that the Company incorrectly used an income tax lag of 2.52 days rather than 61.95

days. RUCO witness Coley stated that, because the Internal Revenue Service requires quarterly payment of taxes rather than monthly, the Company's monthly payment calculation should be increased to reflect a longer lag period (RUCO Ex. 5, at 26-27).

Company witness Hubbard disputes RUCO's argument. She contends that the lead/lag methodology requires a calculation of the lead days or lag days that exist between the time an expense is recorded and the payment of such expenses. Ms. Hubbard claims that the Company's calculation of the lag associated with the payment of federal income taxes recognizes the lag reflected by quarterly payment of 90 percent of the liability, as well as the lag associated with the payment of the remaining ten percent of the liability made in March of the subsequent year. According to Ms. Hubbard, RUCO's calculation of 61.95 days is based on the incorrect assumption that payments are made annually.

Based on Company witness Hubbard's testimony, we will adopt 2.52 lag days for determining the income tax component of cash working capital. As Ms. Hubbard explained, it appears that RUCO's calculation relies on the erroneous assumption that income tax payments are made on an annual basis. Since the Company records the tax liability on a monthly basis, but pays 90 percent of the liability on a quarterly basis, we will adopt Arizona Water's calculation of 2.52 lag days.

B. Deferred CAP M&I Capital Charges

In this proceeding, Arizona Water seeks to reduce significantly the currently authorized amortization period, from 44 years to 3 years, for recovery of Central Arizona Project ("CAP") Municipal and Industrial ("M&I") capital charges. Ms. Hubbard testified that pursuant to the Company's 1985 contract with the United States Bureau of Reclamation and the Central Arizona Water Conservation District ("CAWCD"), Arizona Water purchases CAP water for use in its Apache Junction system (Ex. A-11, at 10). At the time of the Company's last rate case involving the Eastern Group systems (Decision No. 58120), Arizona Water was taking only limited deliveries of CAP water for delivery to potable water customers in Apache Junction. In that Decision, the Commission authorized Arizona Water to defer its pre-1991 CAP M&I capital charges over a 44-year period (Tr. 448-449). Since that time, the Company began taking increased deliveries of CAP water for both potable and non-potable uses, and the CAP M&I charges have continued to be deferred for future recovery in a rate case. In this case, the Company seeks recovery of $691,522 in rate base for the deferred CAP M&I capital charges (Ex. A-13, at Ex. SLH-RJ2, p. 1 of 9)[2].

The disputed issue raised by both Staff and RUCO is the Company's request to recover the CAP M&I charges based on a 3-year amortization period, rather than the currently authorized 44-year period. The Company's 3-year amortization proposal is based on the expected interval between this proceeding and the next rate case involving the Apache Junction system (Ex. A-11, at 12). RUCO recommends a 10-year amortization period based on the period of time over which Arizona Water has been deferring CAP M&I charges since the last rate case (RUCO Ex. 3, at 27). Staff recommends a 32-year amortization period based on the remaining life of the CAP contract (Tr. 1033). According to Staff witness Ludders, the 32-year remaining life amortization is appropriate because it is consistent with Generally Accepted Accounting Principles ("GAAP"), because the CAP contract provides a future benefit to the Company and it is based on the currently authorized amortization period (Id. at 1033-1034).

We believe that RUCO's recommendation of a 10-year amortization period provides a reasonable resolution of this issue. As the Company points out, at the time the prior 44-year amortization period was approved, many providers, including Arizona Water, had not yet begun to take significant amounts of CAP water and no consistent policy on recovery had been developed by the Commission. However, the Company is now using its CAP allocation and it is reasonable to allow amortization over the same period in which the costs were incurred. This approach is consistent with our decision several years ago in Citizens Utilities Company's (now Arizona-American Water Company's) Sun City and Sun City West districts, wherein the Commission adopted Staff's recommendation to approve a 5-year amortization period based on the period of time over which the CAP M&I capital costs were deferred. Decision No. 62293 (February 1, 2000), at 8.

C. <u>Summary of Rate Base Adjustments</u>

Based on the foregoing discussion, we adopt an adjusted OCRB for the Eastern Group of $35,944,611, as shown on the attached Exhibit A. Arizona Water agreed to use the OCRB as the Fair

---

[2] This amount includes $645,207 for amounts deferred since the last rate case and $46,315 for CAP M&I capital charges associated with the unamortized balance of deferred charges authorized in Decision No. 58120 (Tr. 422-423). CAP M&I charges incurred on a going-forward basis would be recovered as operating expenses (Ex. A-11, at 15-16).

Value Rate Base for purposes of this proceeding. We therefore adopt $35,944,611 as the Fair Value Rate Base for Arizona Water's Eastern Group.

III. OPERATING INCOME

The test period in this proceeding is the 12 months ended December 31, 2001. Arizona Water, Staff, and RUCO have analyzed the Company's accounts for the test year and have recommended adjustments to the actual operating results. RUCO argues that the Commission should not use the Company's proposed post-test year adjustments for either rate base, as discussed above, or for determining operating income expense issues. Rather, RUCO recommends using the actual expense levels for 2002, consistent with its argument regarding inclusion of actual data for post-test year plant (RUCO Ex. 5, at 27). RUCO points out that the Company was the source of the actual 2002 expense information (Tr. 415).

Ms. Hubbard contends that using 2002 unadjusted actual data "is inappropriate because there are (sic) no normalizing analysis performed on the numbers, no annualizing expense levels performed on those expense levels. No analysis of whether, like, an expense has been recorded in a wrong account." (Tr. 414-415). She also testified that RUCO's recommended expense levels are based on a different level of customers than were taking service at the end of the test year. Ms. Hubbard's final justification for rejecting RUCO's proposal is that the data given to RUCO has not been analyzed by the parties with the same level of detail that typically would occur in the context of a rate case filing (Id. at 415-416).

Although we agree with RUCO that rates should reflect the most accurate information possible, for the reasons stated previously we believe the methodology advocated by the Company and Staff properly reconciles post-test year plant with test year revenues and expenses. Pursuant to the Commission's rules, Arizona Water is required to base its filing on an historical test year rather than a projected test year. It is therefore appropriate to recognize test year operating expense and revenue levels, subject to pro forma adjustments to recognize known and measurable changes to the test year levels (*See*, A.A.C. R14-2-103A.3.i.). Although the data used by RUCO to support its position was supplied by the Company through discovery requests, that information has not been audited by Staff and the other parties with the level of scrutiny that is employed in the analysis of a rate case filing. Thus, it would be inappropriate to use the raw data advocated by RUCO as the basis for setting rates in this proceeding. Accordingly, we will adopt the methodology proposed by the Company and Staff for purposes of establishing revenues and expenses.

Adjustments made by the Company that have not been challenged by the other parties will not be discussed. The following contested issues remain to be resolved.

A. <u>Revenue Annualization</u>

There is no dispute that pro forma adjustments to actual test year revenues and expenses are necessary to account for additional customers added during the course of the test year (Ex. A-11, at 24-25). According to Ms. Hubbard, the test year average number of Eastern Group customers was 28,636, while the end of test year customer count totaled 29,236 (Id.). Arizona Water determined the average revenue per customer using only the 5/8-inch metered customers because that class of customers comprised 98 percent of all customer growth during the test year (Ex. A-12, at 16).

Staff claims that the Company's proposed revenue annualization results in a mismatch because it measures expenses by using total expenses and measures revenue by looking only at 5/8 inch residential customers (Ex. S-44, at 9-10). Although the Company corrected this mismatch error by also calculating expenses related only to 5/8-inch customers (Ex. A-13, at 11), Staff contends that the Company's allocation of expenses was not based on a cost of service study and should therefore be disregarded (Tr. 450, 1056-1058). Mr. Ludders testified that Staff's revenue annualization proposal should be accepted because it does not result in a mismatch of revenue and expense allocations (Id. at 1056-1058).

We believe Arizona Water's revenue annualization proposal results in the most accurate reflection of revenue growth for the Eastern Group. Although Staff argues that a cost of service study is required to properly match revenues and expenses, the Commission has in the past accepted revenue annualization without such a study (*See, e.g.*, Decision No. 64282, at 10). We agree with Arizona Water that Staff's recommendation, which averages revenue increases to all customer classes, results in an overstatement of revenue because it does not recognize that the vast majority of growth occurred in the 5/8-inch residential class. We therefore adopt Arizona Water's revenue annualization recommendation.

B. Purchased Power and Purchased Water Adjustment Mechanisms

The Commission approved purchased power and water adjustment mechanisms in the last rate case for Arizona Water's Eastern Group (Ex. A-11, at 22). The Company currently purchases electric power from several different providers for pumping in the Eastern Group systems, and recovers those costs pursuant to a Purchased Power Adjustment Mechanism ("PPAM") (Ex. A-12, at 17). Arizona Water also has in place for the San Manuel and Superior systems a Purchased Water Adjustment Mechanism ("PWAM") under which the Company passes through purchased water costs to customers in those systems (Tr. 453). Ms. Hubbard testified that the adjustment mechanisms allow the Company to recover operating expenses that are outside of its control, and that the PPAM and PWAM protect both ratepayers and shareholders because they are revenue neutral to the Company (Ex. A-13, at 12).

RUCO does not oppose continuation of these adjustment mechanisms. However, Staff recommends that both the PPAM and PWAM should be discontinued[3]. With respect to the PPAM, Staff witness Ludders testified that Arizona Water is the only water utility that still uses a PPAM and that such adjustors should be used only "where power costs are by far the largest single cost item and are highly volatile" (Ex. S-46, at 7; Tr. 1060). The PWAM applies only to the San Manuel and Superior systems. Mr. Ludders stated that purchased water for the Superior system is less than one-half of one percent of operating revenues (Tr. 1061). The San Manuel system has no wells and purchases all of its water from the BHP Copper Company ("BHP") (Id. at 1062). Although Arizona Water has discussed buying the BHP wells, the Company has not discussed such a purchase with BHP recently (Tr. 84-87).

We agree with Staff that PPAM and PWAM adjustment mechanisms should be discontinued. Although Arizona Water argues that such mechanisms benefit both the Company and ratepayers by passing on increased costs and savings, adjustment mechanisms may also provide a disincentive for the Company to obtain the lowest possible cost commodity because the costs are simply passed through to ratepayers. Moreover, the record does not suggest that purchased power costs are a

---

[3] Arizona Water also seeks approval of a Monitoring Assistance Program ("MAP") adjustor and an Arsenic Cost Recovery Mechanism ("ACRM") adjustor (See ACRM discussion below). Staff does not oppose approval of the MAP and ACRM adjustment mechanisms.

significant portion of the Company's expenses, or that electricity costs are particularly volatile. With respect to purchased water expenses, the Superior system purchases only a small portion of its water supply[4]and there is no evidence that the San Manuel system is expected to incur any significant increases or decreases in purchased water costs in the near future. Therefore, Arizona Water's purchased power and purchased water adjustment mechanisms should be discontinued.

C. <u>Rate Case Expense</u>

Arizona Water requests recovery of $329,550 for rate case expenses that the Company claims are based on actual expenses it is incurring related to this proceeding (Tr. 513; Ex. A-18). Although the total amount is partially estimated, the Company contends that it has incurred actual rate case expenses of more than $276,000 through November 7, 2003 (See Updated Data Response REL 25-2, Attached to Arizona Water's Reply Brief). The largest expenditures to date are for outside legal counsel ($182,808), an outside consultant to perform a cost of capital study ($68,000), and payroll overheads ($23,875) (Id.). In support of its proposal, Arizona Water contends that rate cases are much more complex than they were in prior years and that the Company's in-house counsel has many other duties that do not permit him to litigate rate cases (Tr. 305).

Staff argues that Arizona Water's rate case expense is exorbitant and should be reduced. Staff points out that the estimated rate case expense has increased steadily over the course of this case and that rate case expense in the Company's 1990 rate case was only $52,053 (Tr. 1048). Staff claims that Arizona Water has failed to justify its heavy use of outside attorneys and consultants, compared to the prior case where those functions were performed by in-house personnel. Staff also notes that rate case expense for the Northern Group case was only $217,000 (Tr. 463).

RUCO argues on brief that it did not oppose the Company's original rate case expense estimate of $257,550, but now opposes the increased estimate of costs. RUCO opposes allowing the Company to continue to update its rate case expenses because it believes such a policy would encourage abuse and saddle ratepayers with unreasonable expenditures.

Although we do not believe it is unreasonable for Arizona Water to retain outside counsel or

[4] The Superior system is expected to be physically interconnected to the Apache Junction system within two years.

consultants to prepare and litigate its rate case filings, at some point the costs associated with retaining those services must be mitigated. Staff points out that the Company's 1990 rate case for all of its systems was prepared exclusively by in-house personnel at a cost of just over $50,000. Although that case was considered a number of years ago, the current estimate of more than $329,000 far exceeds the prior amount. A more analogous case is the recent Northern Group proceeding in which the Commission approved rate case expense in the amount of $217,000 (Decision No. 64282, at 16). As a justification of the higher costs in this case, the Company claims that the instant proceeding involves eight separate systems, while the Northern Group case addressed only five systems. However, the number of systems does not justify the magnitude of increased expenses sought by Arizona Water. Moreover, the extension of the hearing date and concomitant increase in Arizona Water's rate case expenses, were due to the Company's decision to request inclusion of post-test year plant.

Based on our review of the complexity of this proceeding, the number of systems involved in the Eastern Group rate request, and a comparison of other cases, we believe that rate case expense in the amount of $250,000 is reasonable for this proceeding. Consistent with the Northern Group case, rate case expense will be amortized over three years.

D. <u>CIAC Amortization</u>

Staff recommends that Arizona Water's CIAC amortization should be calculated consistent with the Company's 1990 rate case and the Northern Group rate case. Mr. Ludders testified that Staff calculates the composite depreciation rate by dividing each depreciation expense by its depreciable plant. For CIAC, Staff's calculation resulted in an amortization rate of 2.34 percent (Ex. S-46, at 11).

Arizona Water argues that Staff miscalculated the CIAC amortization rate because it calculated a composite depreciation rate, which is inconsistent with the individual component depreciation rates that the Company will be required to use on a going-forward basis. The Company claims that neither Decision No. 58120 nor Decision No. 64282 discusses the methodology to be used in determining the CIAC amortization rate. However, in the Northern Group case, the Commission directed the Company to implement component depreciation rates in its next rate application (Decision No. 64282, at 11-12). Arizona Water asserts that a composite rate for contributed plant should be based on the annual depreciation associated with the individual plant accounts that include contributed plant, in order to match the CIAC amortization rate to the depreciation rates for those specific plant accounts (Ex. A-12, at 27).

We agree with Arizona Water that consistency with the move to individual component depreciation rates requires consideration of the individual plant accounts that include contributed plant (*i.e.*, transmission and distribution mains, fire sprinkler caps, services, meters, and hydrants). Based on consideration of the depreciation rates these individual plant accounts results in an Eastern Group composite CIAC amortization rate of 2.00 percent (Ex. A-12, at 27; Ex. S-55). The Company's recommendation for CIAC amortization shall be adopted.

E. <u>Statement of Operating Income</u>

In accordance with the foregoing discussion, Arizona Water's Eastern Group adjusted test year operating income is $2,168,324. The adjusted test year operating income by system and Eastern Group total is shown on the attached Exhibit B.

IV. <u>RATE OF RETURN</u>

Cost of capital analyses were presented in this case by Arizona Water, Staff, and RUCO for purposes of determining a fair value rate of return in this proceeding. Arizona Water's witness, Dr. Thomas Zepp, determined an overall cost of capital of 11.0 percent. As a result of the analysis of Staff witness Joel Reiker, Staff concluded that an overall rate of return of 8.6 percent is reasonable. RUCO presented testimony by William Rigsby who advocated an overall cost of capital of 8.68 percent.

A. <u>Capital Structure and Cost of Debt</u>

1. Capital Structure

There is virtually no disagreement between the parties concerning Arizona Water's capital structure. The Company, Staff, and RUCO agree that Arizona Water's capital structure as of December 31, 2001 should be used (Ex. A-17, at 9; Ex. S-38, at 3-4; RUCO Ex. 4, at 37-38). That capital structure is comprised of 5.62 percent short-term debt, 28.24 percent long-term debt, and 66.14 percent common equity (Id.).

2. Long-Term Debt

The parties also agree that Arizona Water's cost of long-term debt should be set at 8.46 percent. Accordingly, the long-term debt rate shall be set at 8.46 percent (Id.).

3. Short-Term Debt

Although the parties are in agreement on the capital structure and long-term debt, they disagree regarding Arizona Water's short-term debt rate. The Company borrows short-term funds under an agreement with Bank of America at prime minus .25 percent. As of January 1, 2003, the bank reference rate was 4.25 percent. Therefore, Staff contends that the short-term rate should be set at 4.00 percent to reflect actual short-term loan agreements between Arizona Water and Bank of America (Ex. S-38, at 3-5). RUCO witness William Rigsby agrees with Staff's recommendation to set the short-term debt rate at 4.00 percent (RUCO Ex. 4, at 36-37).

Arizona Water argues that the short-term debt rate should be set at 5.548 percent based on a 24-month average from January 2001 through December 2002. The Company contends that short-term debt costs are variable and the debt rate set in this proceeding should reflect the volatile nature of those rates (Ex. A-17, at 8-9).

We agree with Staff and RUCO that the short-term debt rate should be set to reflect the current agreement between Arizona Water and Bank of America. Since that agreement results in a short-term debt rate of 4.00 percent, as of January 1, 2003, we will adopt that rate for purposes of determining Arizona Water's cost of capital in this case.

B. Cost of Equity

Although the cost of debt and preferred stock can be determined from fixed cost rates, the cost assigned to the equity component of the capital structure can only be estimated. The cost of equity recommendations advocated by the parties are 12.4 percent by Arizona Water, 9.0 percent by Staff, and 9.18 percent by RUCO.

In determining its recommended cost rate for common equity, the Company's cost of capital consultant, Dr. Zepp, used the discounted cash flow ("DCF") model, several risk premium models, and the capital asset pricing model ("CAPM") to estimate benchmark equity cost with data for publicly traded water and gas utilities. Arizona Water also presented testimony from Walter Meek, the President of the Arizona Utility Investors Association ("AUIA"). Mr. Meek did not perform an independent cost of capital analysis, but testified that, in his opinion, Staff's recommendation ignores the realities of investor expectations (Ex. A-8, at 2-4). Finally, Company witness Ralph Kennedy testified regarding risks that are unique to Arizona Water that affect its cost of capital requirement. Mr. Kennedy discussed the difficulties experienced by Arizona Water in 2001 in placing its Series K bonds, federal arsenic removal requirements facing the Company, and the inability of the Company to obtain long-term financing on terms that are comparable to publicly traded companies with Baa or higher credit ratings (Ex. A-15, at 25-27).

Dr. Zepp found the current equity cost for his benchmark utilities to be in the range of 10.6 percent to 10.8 percent, based on his application of the DCF model and an average of two forward-looking measures. His analysis included a "restatement" of Mr. Reiker's DCF estimates based on the constant growth model. Dr. Zepp testified that Staff's DCF analysis is flawed because it uses dividends per share ("DPS") which, according Dr. Zepp, is the worst measure of average future growth when earnings per share ("EPS") are growing more rapidly (Ex. A-5, at 53-56). The Company's restatement of Staff's DCF was conducted by including a second stage that Dr. Zepp claims reflects investors' expectations that future growth will be higher than current DPS when DPS are growing at a slower rate than EPS (Id. at 57-59). Based on this restatement of Staff's multi-stage DCF model, the equity cost for the sample companies was calculated to be 10.1 percent (Id. at 59, Tables 6 and 7). Dr. Zepp also performed a restatement of RUCO witness Rigsby's DCF analysis. The Company's restatement of RUCO's analysis resulted in a cost of equity for the benchmark water companies in the range of 9.6 to 11.1 percent (Id. at 61-63).

Dr. Zepp performed three different risk premium analyses with cost of equity results in a range of 10.3 to 11.2 percent. According to Dr. Zepp, the CAPM analyses conducted by Staff and RUCO failed to include separate risk premium estimates. Dr. Zepp favors a "zero-beta" CAPM model which produces results showing that low beta stocks like water utilities require higher returns (Ex. A-5, at 44-49). Dr. Zepp performed a restatement of the CAPM analyses of both Staff and RUCO using forecasted values for long-term Treasury bonds. Based on his recalculation, Dr. Zepp found the cost of equity for the benchmark companies to be in the range of 9.8 to 11.3 percent (Id. at

50-52).

Aside from the technical analysis of the Staff and RUCO recommendations, Arizona Water claims that those analyses are inconsistent with recent authorized returns on common equity, realized returns on common equity, and *Value Line* forecasted returns on equity. Dr. Zepp prepared a rebuttal schedule containing the authorized, realized, and forecasted returns based on Staff's sample group of publicly traded water utilities, except for two companies Dr. Zepp claims were acquisition targets based on their rapid stock price increases. His table shows average authorized returns from 2001 through 2003 of 10.69 percent, realized returns of 10.48 percent, and forecasted returns of 10.83 percent (Ex. A-5, Rebuttal Table 1). Arizona Water argues that these results show that the Staff and RUCO cost of equity estimates of 9.2 percent and 9.18 percent, respectively, are not consistent with investor expectations. The Company contends that the results produced by Dr. Zepp's models reflect more accurately the actual and forecasted cost of equity performances for comparably situated water companies.

Dr. Zepp also testified that, in order to establish a fair rate of return for Arizona Water, 100 to 150 basis points must be added to the Company's cost of equity estimates to account for the additional risk associated with investing in Arizona Water (Ex. A-4, at 13-23; Ex. A-5, at 24-42). Arizona Water asserts that an additional risk premium is required to compensate the Company for its small size and due to its claim that the rate-setting system in Arizona, which employs an historical test year, makes it difficult to match expected revenues with expected plant investment. The Company also contends that investment risk is heightened by the capital and operating costs it is expected to incur due to arsenic treatment requirements. Arizona Water argues that, in accordance with the fair and adequate rate of return requirements under decisions such as *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, (1944); *Bluefield Waterworks & Improvement Co. v. Public Serv. Comm'n of West Virginia*, 262 U.S. 679 (1923); and *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989), the Commission must recognize that the cost of equity recommendations put forth by Staff and RUCO would fail to adequately compensate the Company with a reasonable rate of return on its investment.

Staff performed both DCF and CAPM analyses in arriving at its 9.0 percent cost of equity recommendation. Mr. Reiker stated that, because Arizona Water's stock is not publicly traded, six publicly traded water companies and 10 gas companies were used as proxies (Ex. S-38, at 9). In his analysis, Mr. Reiker applied the DCF constant growth and non-constant, or multi-stage, growth models to the sample companies (Id. at 11). Mr. Reiker explained that the DCF method is based on the theory that the market price of a stock is equal to the present value of all future dividends. In applying the DCF model, the following three variables are required: 1) the expected annual dividend; 2) the current stock price; and 3) the expected infinite annual growth rate of dividends (Id.).

With respect to establishing the stock price component, Staff used a spot price because it contends the spot price reflects investor expectations of future returns and is the best indicator of those expectations (Id. at 12). Staff cites a recent Commission Decision in *Black Mountain Gas Co.*, Decision No. 64727 (April 17, 2002) to support its proposal that the Commission should adopt spot price as the basis for determining cost of equity.

In its growth variable analysis, Staff examined historical and projected growth in dividends per share, growth in earnings per share, and intrinsic growth. For the proxy companies, Staff's analysis produced average historical growth of 2.5 percent; projected growth over the next five years of 2.0 percent; historical earnings per share of 3.2 percent; and an intrinsic growth rate of 7.8 percent (Id. at 12-13, Scheds. JMR-2, JMR-3). Staff's analysis produced an equity cost estimate under the constant-growth DCF model of 8.5 percent (Id. at 19). The multi-stage DCF model considers investor expectations for near-term growth (Stage 1) and long-term constant growth (Stage 2). The cost of equity result of Staff's multi-stage DCF analysis is 9.6 percent (Id. at 20, Sched. JMR-6).

Mr. Reiker testified that the CAPM model provides a measure of the expected return on an investment. The CAPM requires the input of variables to determine an estimate of a company's equity cost. The variables that are input into the model are the risk-free rate, the expected return on the market, the risk variable (or "beta"), and the expected market risk premium (Ex. S-38, at 21-22). Staff's risk-free rate estimate is based on the average of intermediate-term U.S. Treasury securities spot rates, and the beta was derived from the average of the *Value Line* betas for the six proxy water utilities. The average beta for the six proxy companies is .59 (Id. at Sched. JMR-5). Mr. Reiker stated that the expected market risk premium represents the additional return an investor expects for investing in an average or higher risk security over the expected return on a risk-free security. Staff's historical market risk premium analysis produced a rate of 7.4 percent, while its current market risk premium analysis resulted in a rate of 13.1 percent (Id. at 23-24). Staff's CAPM analysis results in an equity cost estimate for Arizona Water of 9.4 percent (Id. at Sched. JMR-7).

Staff's overall cost of equity recommendation was determined by averaging the results of its constant growth and multi-stage DCF analysis, which produces a result of 9.0 percent. Next, Staff averaged the results of its historical and current market risk premium CAPM analysis, with a result of 9.4 percent. The DCF and CAPM results were then averaged to produce a final estimate of 9.2 percent (Id. at 25, Table 7). However, Staff also took into account the fact that Arizona Water's capital structure consists of approximately 70 percent equity, which Staff believes represents lower financial risk compared to its proxy water companies which had an average common equity component of just under 50 percent (Id. at Sched. JMR-1).

Staff also averaged the DCF and CAPM results for the proxy gas companies, which resulted in an equity cost estimate of 10.3 percent for those companies. Staff claims that the sample gas companies are more risky than the sample water companies, as evidenced by average betas of .59 and .69 for the water and gas companies, respectively. Staff claims that, because the equity cost for the sample gas companies is approximately 100 basis points higher than the water companies, a downward adjustment must be made to reflect the cost of equity for a water company such as Arizona Water. Therefore, Staff adjusted the results of its DCF and CAPM analyses downward from 9.2 percent to 9.0 percent.

RUCO witness Rigsby recommends a rate of return of 8.68 percent based on a cost of common equity calculation of 9.18 percent (RUCO Ex. 4, at 22). Mr. Rigsby's cost of equity recommendation was determined based on a DCF analysis that produced the 9.18 percent result for Arizona Water (Id.). Mr. Rigsby also performed a CAPM analysis which produced results ranging from 6.79 percent to 8.06 percent (Id. at 27). RUCO claims that Mr. Rigsby's analysis properly considers the current environment of low inflation and low interest rates in which Arizona Water is operating. Mr. Rigsby also contends that his recommendation takes into account the fact that the Company's capital structure is heavily weighted with equity, compared to the group of proxy companies used in RUCO's analyses, thus reducing the risk associated with investing in Arizona Water (Id. at 32-39). RUCO argues that the Company's cost of capital recommendation fails to recognize Arizona Water's lower risk. RUCO requests that its proposed cost of capital recommendation be adopted for purposes of setting rates in this proceeding.

We agree that Staff's analysis represents a fair and reasonable estimate of Arizona Water's cost of equity for purposes of this proceeding. As described above, Staff calculated an estimated equity cost of 9.2 percent by taking an average of two DCF models (constant growth and multi-stage) and the CAPM model. Although Arizona Water's witnesses are critical of Staff's analysis, we believe the Company's recommendation has several flaws.

First, Arizona Water's infinite growth DCF model averaged the near-term growth forecast for the entire water utility industry rather than an average of near-term growth forecasts. As Mr. Reiker pointed out, including the entire industry creates a mismatch between the expected dividend growth rate and the expected dividend yield, thereby producing a less accurate cost of equity estimation (Ex. S-38, at 38). We also agree with Staff's witness that the Company's exclusive reliance on analyst forecasts erroneously assumes that investors rely only on near-term earnings and sustainable growth without considering past earnings. Reliance solely on analyst projections tends to result in inflated growth projections without considering DPS and past EPS growth, information that even Dr. Zepp has acknowledged should be considered in determining estimated growth (Id. at 44-45). We believe that Staff's multiple component DCF analysis properly recognizes that investors expect both non-constant short-term growth as well as long-term constant growth.

With respect to the competing "risk premium" analyses, we believe Staff's CAPM model properly takes into account risk for purposes of estimating equity costs. Mr. Reiker stated that Arizona Water's reliance on forecasted Baa bond rates is less reliable because such bond forecasts have historically been inaccurate. Thus, according to Staff, the accuracy of the Company's risk premium analysis is suspect. We agree with Staff that assessing the risk premium based on corporate bond yields is inappropriate because the default risk for corporate bonds can change significantly over time (Ex. S-38, at 46-49). We believe Staff's CAPM analysis, which includes a risk variable, is a reasonable means of estimating Arizona Water's cost of equity in this case and is preferable to the

Company's proposed risk premium recommendation.

However, we part company with Staff's recommendation with respect to the necessity for a downward adjustment to cost of equity. As described above, Staff and RUCO argue that Arizona Water is less risky than the group of sample companies that were used for purposes of determining their cost of capital recommendations. As a result, Staff argues that the product of its average of the DCF and CAPM models (9.2 percent) should be reduced to 9.0 percent to recognize the lesser risk associated with investing in Arizona Water. On the other hand, the Company proposes an upward adjustment of 100 to 150 basis points to recognize what it asserts are increased risks. As indicated above, the risk factors alleged by the Company include its relatively small size compared to the proxy companies, the use of an historical test year in Arizona, difficulty placing its bonds, and federal arsenic removal requirements.

Based on our review of the entirety of the record, we do not believe that the risk factors described by Staff, RUCO, and the Company support a finding that a risk adjustment, either upward or downward, is necessary in this proceeding. The Company's approximately 70 percent equity position, as well as the lower betas of the sample water companies compared to the sample gas companies, may justify consideration of an adjustment. However, even if Arizona Water is slightly less risky than the proxy companies as a whole, we do not agree that Staff's proposed downward adjustment is appropriate. Nor do we believe that an upward adjustment is required. Although the Company cited its difficulty in placing its corporate bonds in 2001, $15 million of general mortgage bonds were ultimately issued. Regarding Arizona Water's size, Staff points out that the Commission has in the past rejected such arguments, and at least one study supports rejection of allowing a risk premium based on a company's smaller size (Ex. S-38, at 59-64). Concerning the Company's historical test year argument, there is no precedent for recognizing a risk adjustment because the law requires an historical test year. Indeed, we have allowed Arizona Water in this case to include post-test year plant in rate base for a full 12 months following the test year. Moreover, it is the Company that controls the timing of its rate application and the test year. Finally, the risks associated with arsenic treatment costs have been mitigated by the Commission's approval in both the Northern Group case (See ACRM discussion below), and in this proceeding, of an arsenic cost recovery mechanism that enables the Company to seek expedited approval of capital costs and a significant portion of operating costs associated with arsenic treatment for its affected systems. Given all of these factors, we will not adopt any specific risk adjustments to the 9.2 percent cost of equity determined by Staff's analysis.

C. Cost of Capital Summary

	Percentage	Cost	Weighted Cost
Short-Term Debt	5.6%	4.0%	0.22%
Long-Term Debt	28.2%	8.46%	2.39%
Common Equity	66.2%	9.2%	6.09%
Cost of Capital			8.7%

V. AUTHORIZED INCREASE

Multiplying the Eastern Group's fair value rate base by the fair value rate of return produces a required operating income of $3,127,181 on a total company basis. This is $958,854 more than the adjusted test year income under existing rates. The required increase in gross annual revenues for the Eastern Group is $1,564,803, or 10.68 percent, as shown on the attached Exhibit C.

VI. RATE DESIGN

A. Staff's Proposed Inverted Tier Rate Design

Under Arizona Water's current rate structure customer classes and the monthly minimum charges are determined by meter size. The monthly minimum for all customer classes includes 1,000 gallons with a single commodity rate applied to all usage. Under the Company's proposed rate design, the 1,000 gallons of "free" water in the monthly minimum was eliminated and each of the eight systems' existing meter multiples[5] were moved half way toward the actual meter multiples (Ex. A-16, at 15-16). Arizona Water points out that its proposed rate design in this proceeding follows the same principles as the design that was approved in Decision No. 64282 for the Company's Northern Group.

[5] "Meter multiples" is a rate design concept whereby the monthly minimum charge for each meter size is established by first establishing the appropriate charge for the smallest meter size and multiplying that minimum charge by a factor appropriate for each larger meter size (*See, e.g.*, Decision No. 64282, at 23).

Staff's proposed rate design consists of inverted tier rate blocks whereby the commodity rate would increase through three tiers of rates as usage increases. Staff's rate blocks are structured so that the first tier (0 to 3,000 gallons) is priced 20 percent less than the second tier (3,001 to 50,000 gallons) and the third tier (over 50,000 gallons) is priced 20 percent higher than the second block (Ex. S-40, at 2-9). Staff claims that its proposed 20 percent first tier "discount" rate structure provides a "lifeline" concept that allows for a minimum volume of water usage for basic needs (Tr. 934-935, 941). Staff believes the 20 percent third tier "premium" rate will send a price signal to heavy users to reflect the extra costs they impose on the system (Tr. 896). Staff witness John Thornton testified that Staff's rate design is based on a marginal pricing concept that provides "a more efficient rate structure that results in conservation of resources in the provision of water" (Id. at 883). Staff concedes that the third block would subsidize the other blocks on an embedded cost basis, although Staff has not quantified that subsidy (Id. at 884). According to Staff, a number of other water companies in the state use inverted block rates, including Arizona-American Water Company. Staff argues on brief that its rate design will send a price signal that is likely to result in conservation in the long run. However, Mr. Thornton admitted on cross-examination that any conservation price signals would apply only to usage over 50,000 gallons per month, thereby eliminating any conservation goals directed to smaller customers, including residential customers (Tr. 939).

Arizona Water argues that Staff's rate design recommendation deviates from basic cost of service principles and ignores the rate design approved in the last rate case for the Eastern Group customers (Decision No. 58120) and in the Company's Northern Group case (Decision No. 64282). The Company contends that Staff's proposal does not encourage conservation and in fact creates subsidies for usage in the first tier without sending any appropriate price signals. Arizona Water asserts that Staff's proposed rate design is not based on a cost of service study and that it would shift recovery of a substantial portion of the revenue requirement from the monthly minimum to the commodity rate with no supporting evidence. The Company also contends that Staff's so-called "lifeline" rate is inconsistent with lifeline rates described in publications of the American Water Works Association which limit such rates to: low income residential customers; where a significant portion of customers in the area are unable to afford water service; and where water conservation is not a concern (because discounted rates may actually cause increased water usage) (Ex. A-28, at 10-13). Arizona Water argues that Staff's rate design is inequitable and will promote economic inefficiencies.

We agree with Arizona Water that the justification provided by Staff does not support its recommended rate structure in this proceeding. Staff points out that inverted tier rate designs have been adopted in a number of prior cases as a means of encouraging customers to conserve water. Although we agree with Staff that conservation of water is a desirable goal, its own witness testified that no conservation price signals would be received by customers until usage reached more than 50,000 gallons. As a result, Staff's recommendation in this case is clearly distinguishable from the type of inverted block structures approved by the Commission in other cases.

Staff's proposed rate design is also inconsistent with the type of block structures in place in a number of cities in Arizona, as evidenced by a number of exhibits introduced by Staff at the hearing (Exs. S-5, S-6, S-7, S-8, and S-9). These rate schedules show that the rates in effect for the cities of Phoenix, Tucson, Scottsdale, Mesa, and in the Sun City area do not follow the type of design advocated by Staff in this proceeding but, rather, indicate that the rates include increasing minimum rates based on larger meter sizes or have second tier blocks that are substantially different than those recommended by Staff (*e.g.*, 8,000 gallons for Sun City, 12,000 gallons for Mesa, and 15,000 gallons for Tucson Residential). Thus, average residential customers in those areas may be incented to reduce consumption by being presented with price signals that provide more attainable targets. We do not believe that Staff's proposal fits within the type of rate design structures that have been adopted by the Commission in prior cases or in the other jurisdictions cited by Staff. Accordingly, we decline to adopt Staff's proposed inverted tier rate design in this proceeding.

Although we are rejecting Staff's proposed rate design, we believe that an alternative inverted tier rate structure is a valid tool for promoting conservation by sending appropriate price signals to heavier users. Similar inverted block structures have been approved in a number of prior cases and we believe it is reasonable to adopt such a rate design in this proceeding. Therefore, we adopt the following inverted tier rate structure for Arizona Water's Eastern Group: first tier – 0 to 10,000 gallons per month; second tier – 10,001 to 25,000 gallons per month; third tier – over 25, 001 gallons per month.

B. Consolidation of Apache Junction and Superior Systems

Arizona Water is requesting that the Eastern Group's Apache Junction and Superior systems be consolidated in this proceeding for rate making and accounting purposes. Under the Company's proposal, uniform monthly minimum charges would be established for both systems in this proceeding, with each system retaining its own commodity rate. In the next rate proceeding, full consolidation of the systems would occur (Ex. A-15, at 11-12).

Company witness Kennedy explained that the Apache Junction and Superior systems are facing substantial rate increases due to the costs associated with arsenic removal. For the Apache Junction system, capital costs alone are expected to reach \$8.8 million, which represents approximately 36 percent of that system's adjusted original cost rate base. The impact of arsenic removal is even more severe for the Superior system, with estimated capital costs of \$1.7 million, or 63 percent of the system's rate base. Both systems would also incur significant additional costs related to arsenic removal operating costs (Id.).

Because the Superior system (1,288 customers) is significantly smaller than the Apache Junction system (16,093 customers), and the Superior system's current rates (\$18.13 residential minimum charge and \$4.06 per 1,000 gallons) are much higher than the Apache Junction rates (\$12.43 residential minimum and \$2.569 per 1,000 gallons), Arizona Water argues that absent consolidation, the differences in rates between the two systems will become even more pronounced as a result of this proceeding. Mr. Kennedy testified that without consolidation of the Superior and Apache Junction rates in this case, future consolidation will be more difficult, especially when the impact of arsenic treatment is added to rates (Ex. A-17, at 7; and RJK-RJ5). The Company points out that the Superior and Apache Junction systems are expected to be interconnected within two years, which distinguishes the proposal in this case from prior proceedings in which the Commission has declined to approve consolidation proposals. Under the Company's proposed revenue requirements, without consolidation the Apache Junction system rates would increase by more than 16 percent, while the Superior system revenue requirement would increase by more than 70 percent, even without adding arsenic removal costs (Id.).

RUCO and Staff oppose consolidation of the Superior and Apache Junction systems based on the premise that individual system rates should reflect their specific system costs (RUCO Ex. R-3, at 43-46; RUCO Ex. R-2, at 21-24; Ex. S-44, at 34; Ex. S-51, at 11-12; Tr. 525-530). Staff and RUCO argue that until physical interconnection of the systems is completed, allowing consolidation would result in subsidization of Superior system customers by Apache Junction customers. Staff and RUCO cite to prior decisions in which the Commission has recognized the concept that system rates should reflect individual system costs (Decision No. 58120, at 33-34; Decision No. 64282, at 20-21; Decision No. 66400, at 11-13).

We agree with Arizona Water that the Superior and Apache Junction systems should be consolidated for purposes of rate making and accounting under the Company's proposed two-step consolidation process. Although Staff and RUCO point out that the Company's Northern Group consolidation recommendation was recently denied, the request in this proceeding is distinguishable. First, unlike the situation in the Northern Group case, the Superior and Apache Junction systems are already contiguous (Ex. A-9, at 10). Further, the backbone transmission facilities needed to serve a development approximately four miles from the Superior system well fields are already under construction, and full interconnection with Superior will be completed in less than two years (Ex. A-10, at 4-5; Ex. A-17, at 7). Thus, the interconnection of systems is not speculative but is imminent.

Given these differences from the Northern Group proceeding, we believe it is appropriate to allow the first step of consolidation at this time in order to recognize the interconnection of the systems and to minimize the "rate shock" that may otherwise be experienced by customers in the Superior system. Consolidation is even more critical to offset the significant rate increases that will be experienced once arsenic treatment costs are imposed on Arizona Water's customers. According to Mr. Kennedy, arsenic treatment capital costs are estimated to be approximately $573 per customer in the Apache Junction system and $1,309 per customer in the Superior system (Ex. A-17, at 7). Absent consolidation, this impact will be exacerbated by the depressed economic conditions in the Superior area where customer growth has actually declined in recent years (Id. at 6).

With respect to Staff and RUCO's arguments that consolidation will result in inter-system subsidies, we note that consolidation of individual Arizona Water systems is not without precedent.

In fact, Arizona Water has in the past been permitted to consolidate a number of systems that are not physically interconnected (*e.g.*, River Valley and Rimrock, Arizona City and Casa Grande, Forest Towne and Overgaard, Valley Vista and Sedona, and Tierra Grande and Casa Grande) (Ex. A-17, at 5). In this proceeding, the fact that interconnection of the Superior and Apache Junction systems will be completed within two years, the further widening of the base rate disparity between the systems absent consolidation, and the significant additional rate impact in the near future associated with arsenic removal costs, justifies implementing the first step of consolidation in this proceeding as proposed by Arizona Water. Accordingly, the Company's rate consolidation recommendation is adopted.

VII. OTHER ISSUES

A. Staff's Proposed Water Loss Plan

Staff proposed that Arizona Water be required to audit its water losses for systems in the Eastern Group with greater than 10 percent water loss, and file a plan for reducing such losses where it is feasible to do so (Ex. S-52, at 4-6). Staff contends that its proposal is not burdensome because the Company already produces internal water loss reports that could be used as a starting point for the reporting requirements recommended by Staff (Tr. 90-91).

Arizona Water claims that Staff has not established that the Company has a water loss problem because Staff's loss calculations are based on "unsold" water rather than "lost" water (Tr. 324, 1128-1129; Ex. A-2, at 24). According to the Company, unsold water is the difference between water produced and received, and water sold to customers. Unsold water includes water used for a number of purposes including for operational and maintenance needs, as well as overflowing water storage tanks, flushing water distribution systems, and fire suppression (Ex. A-2, at 24-25). By contrast, lost water represents quantities that the Company cannot account for (Tr. 324). Arizona Water opposes Staff's recommendation because of the Company's claim that Staff has not identified any harm to ratepayers that needs to be remedied, and because the Company believes Staff's reporting requirements constitute unnecessary micro-management of the Company's operations.

We do not believe that Staff's proposed audit and reporting requirements will impose an undue burden on Arizona Water's operations. Although the Company challenges Staff's definition of system water losses, whether the water is "unsold" or "unaccounted for" should not be the deciding factor in assessing the need for monitoring of water that is pumped but not ultimately paid for by the Company's customers. Staff's recommendation does not require any specific remedy for unaccounted for water but, instead, simply requires the Company to report systems that exceed the 10 percent loss limit and to propose cost-effective solutions for reducing such losses. We believe Staff's recommendation will enable Staff to monitor Arizona Water's unaccounted for water while allowing the Company sufficient flexibility to resolve water loss situations that require a remedy. Staff's recommendation is therefore adopted.

B. <u>NP-260 Tariff</u>

Arizona Water has a NP-260 Non-Potable Central Arizona Project Water Tariff ("NP-260 Tariff") that is designed to pass through to non-potable customers all costs associated with providing non-potable water service plus amounts for administration. Company witness Kennedy testified that the NP-260 Tariff is designed to be as income neutral as possible while avoiding passing costs onto potable customers (Ex. A-16, at 28).

Staff recommends that Arizona Water amend its NP-260 Tariff as follows: eliminate the fixed meter charge; eliminate the depreciation charge; indemnify customers from maintenance, repair or replacement charges when the damage to CAP facilities is the result of the Company's error; require the customer to be responsible for repair or replacement of the meter; and include fixed-dollar administrative charges representative of the Company's actual costs (Ex. S-51, at 16-17). Staff claims that these changes are necessary to address problems that were identified in a formal complaint filed in *SLV Properties v. Arizona Water Co.*, Decision No. 65755 (March 20, 2003).

Arizona Water contends that the Decision cited by Staff does not support the proposed recommendation. According to the Company, the NP-260 Tariff maintenance fees and related charges were found reasonable in Decision No. 65755 and there is no reason to change the tariff in this case.

We agree with Staff's recommended changes to the NP-260 Tariff. In Decision No. 65755, we directed Staff to "review the NP-260 Tariff" in the instant proceeding and "recommend changes or revisions as required." The Company does not dispute that the depreciation charge should be eliminated from the tariff. However, as Mr. Hammon indicates, there is no valid basis to find that the current fixed monthly meter charge of more than $363 is relevant to the fixed costs of the CAP delivery system (Ex. S-51, at 15). The CAP fixed costs are already recovered through the CAWCD capital charges which are passed on to customers with a percentage fee for administration collected by Arizona Water. We also agree that the NP-260 Tariff does not adequately define customer rights, especially for unusual maintenance situations (*e.g.*, lightning strikes). Under the current tariff, Arizona Water has no real incentive to protect the equipment that is owned and controlled by the Company, but for which the customer bears maintenance responsibility (Id. at 16). We find that Staff's proposed changes to the NP-260 Tariff are reasonable and shall be adopted.

C. <u>Arsenic Treatment Cost Recovery Mechanism</u>

Arizona Water is requesting approval in this proceeding of an arsenic cost recovery mechanism ("ACRM") that would allow the Company to recover arsenic treatment capital costs and certain "recoverable" operation and maintenance ("O&M") costs. The Company's proposal is based on the ACRM approved recently for Arizona Water's Northern Group in Decision No. 66400. Arizona Water projects arsenic treatment capital costs for the Eastern Group will exceed $12 million and that annual O&M costs for the affected Eastern Group systems (Apache Junction, Superior, and San Manuel) will cost more than $2.6 million (Ex. A-1, at 9; Ex. A-15, at 7-8).

Neither Staff nor RUCO filed testimony opposing the Company's ACRM recommendation. Given the lack of opposition to the proposed ACRM, and considering that the Company's proposal is based on the recently approved ACRM for the Northern Group, we will approve the ACRM recommendation for the Eastern Group in this proceeding.

D. <u>Curtailment Tariff and Water Conservation Notice</u>

Staff recommended that Arizona Water be directed to file a curtailment tariff consistent with prior Commission decisions requiring such tariffs. At the hearing, the Company agreed to file such a tariff (Tr. 82-83). Accordingly, Arizona Water is directed to file a curtailment tariff in a form approved by Staff at the time it files its tariffs in compliance with this Decision.

We also believe it is appropriate and necessary to require Arizona Water Company to implement a water conservation initiative for customers affected by this Application. Within 30 days of the effective date of this Decision, Arizona Water Company shall develop and submit to Staff a notice concerning water conservation information, including methods and guidelines that customers may use to lower water usage. Within 30 days of approval by Staff, Arizona Water Company shall send to all customers affected by this Application, by bill insert or separate mailing, a copy of the approved notice.

E. Pinal Creek Group Settlement

In 1998, Arizona Water negotiated a settlement with members of the Pinal Creek Group ("PCG Settlement"), a group of mining interests with copper mining operations in the vicinity of the Company's Miami system (Ex. A-16, at 7-8).

Arizona Water's Miami system is located in Gila County and serves approximately 3,000 customers. According to the Company's witnesses, the capacity of wells in the Miami system has been extremely variable due to the prevailing hydrology of the area. The Company claims that production from area wells has been consistently declining over time and customers have been subjected to temporary shortages and conservation restrictions (Ex. A-2, at 5-7).

In 1997, while it was investigating additional water supply options in the Miami area, Arizona Water discovered that the Arizona Department of Environmental Quality ("ADEQ") and the United States Environmental Protection Agency ("EPA") were about to enter into a consent order with the PCG concerning alleged contamination of groundwater in the Miami area by the members of the PCG (Ex. A-2, at 7). Because the proposed consent order did not address the potential effects on Arizona Water and its customers, the Company took action to insert itself into the action before the consent order between ADEQ and the PCG was finalized. Mr. Garfield testified that Arizona Water's participation in the proceeding was not welcomed by either ADEQ or the PCG, and only through the Company's persistence was it able to secure its primary goal of a guaranteed source of replacement water for the Miami system. (Id.; Tr. 135-136).

The consent order between the PCG, ADEQ, and EPA requires the PCG to pay fines to both ADEQ and EPA, and to take responsibility for cleanup in the area at an estimated cost of $100 million (RUCO Ex. 3, at 29). In its separate settlement with the PCG, Arizona Water agreed to a cash settlement of $1.4 million paid over a three-year period. This cash compensation under the settlement was recorded as Miscellaneous Non-Operating Income, whereby none of the proceeds were allocated to ratepayers (Id. at 29-30). In addition, the PCG Settlement provides that the Company is to receive replacement water from various PCG wells (through an interconnection linking the PCG system with Arizona Water's Miami system). Under the agreement, the Company began receiving 100 gallons of water per minute ("gpm") in 1998, increasing by 100 gpm up to 600 gpm in October 2003. After that time, PCG is required to continue to provide an aggregate volume of capacity of 600 gpm until the settlement agreement expires in 2028 (Id.).

Staff argues that the Company's Miami ratepayers are entitled to the entirety of the PCG Settlement proceeds. Staff claims that the benefits from the settlement were in exchange for the release of past damages and the Company retains the ability to seek future damages. Staff asserts that Arizona Water has not retired any wells in the Miami system for more than 20 years and ratepayers have paid for those wells through rates during that same time period (Tr. 543-558). Staff further contends that as the holder of a CC&N in the Miami area, it is the Company's duty to secure adequate sources of water for its customers. Staff claims that the Company is adequately compensated by having rates in effect that allow it to earn a reasonable return on its investment and there is no basis for allowing additional compensation through entitlement to the settlement proceeds. Staff also contends that the Company improperly accounted for the proceeds as miscellaneous income instead of as a deferred regulatory liability pursuant to the NARUC Uniform System of Accounts ("USOA") (Tr. 1083-1092). Staff claims that its recommendation corrects the improper accounting treatment by reducing rate base by the amount of the payment, and amortizing the reduction over the remaining life of the PCG Settlement (Ex. S-45, at 52).

RUCO similarly argues that the proceeds of the PCG Settlement were a windfall to Arizona Water's shareholders. RUCO refutes the Company's assertion that the replacement water alone represents sufficient compensation for ratepayers. According to RUCO, the replacement water is nothing more than that to which customers are entitled because it is the Company's obligation to provide its customers with safe drinking water in exchange for being granted an exclusive franchise to serve that area. RUCO recommends that the settlement proceeds should be shared equally between ratepayers and shareholders. RUCO believes that requiring an equal allocation strikes a balance between encouraging the Company to pursue legitimate legal recourse, while at the same time preventing the Company from obtaining an unjustified windfall.

Arizona Water disputes Staff's contention that it improperly accounted for the settlement proceeds pursuant to the NARUC USOA. The Company contends that the settlement proceeds were properly included in Account 421-NonUtility Income, and Staff has presented no evidence to the contrary. Arizona Water also argues that both Staff and RUCO have ignored the substantial benefits associated with more reliable and less expensive water supplies that are conferred on customers as a result of the PCG Settlement. The Company points out that the PCG replacement water provides a reliable source of water in an area where lack of water has become a serious issue. Mr. Kennedy estimated that the present value of the replacement water provision in the settlement is between \$5.48 and \$7.97 million (Ex. A-16, at 5).

Arizona Water cites as precedent for its recommendation Decision No. 58497 (January 14, 1994) involving Tucson Electric Power Company ("TEP"). The Company contends that the Commission allowed TEP to retain the \$40 million cash portion of a settlement agreement due to another provision of the settlement that required TEP to share benefits of a 10 year power sharing agreement (Decision No. 58497, at 59-60). Arizona Water argues that, similar to the TEP Decision, the Commission should consider the overall benefits provided by the PCG Settlement rather than focusing solely on the monetary payment of the settlement.

We agree with RUCO's recommendation that the monetary proceeds of the PCG Settlement should be shared equally between shareholders and ratepayers. RUCO and Staff argue convincingly that Arizona Water, as holder of the exclusive franchise to provide water service in the Miami area, has an ongoing obligation to obtain and provide adequate and safe water for customers in the service area. The fact that Arizona Water pursued a legal remedy to assure that its water supply would be protected does not necessarily entitle the Company to retain for the exclusive benefit of its shareholders the monetary proceeds from the legal settlement. Although we recognize that the replacement water provision of the PCG Settlement provides ratepayers with the benefit of future quantities of water, the Company also benefits from securing an assured supply of water, effectively eliminating the risk associated with obtaining additional supplies in the area for a number of years.

We believe that the TEP case cited by Arizona Water supports this conclusion. In Decision No. 58497, the Commission allowed TEP to retain for shareholders a $40 million payment TEP obtained from Southern California Edison Company ("SCE") as part of a legal settlement involving a failed merger. However, it was noted in that Decision that TEP's shareholders had incurred more than $12 million in legal expenses pursuing the litigation against SCE. In addition, TEP was required to apply the proceeds towards a reduction in its debt service. In this proceeding, there are no similar conditions placed on how Arizona Water's share of the settlement proceeds must be applied. Further, as discussed below, we are allowing Arizona Water to include in rate base more than $308,000 in legal expenses associated with the PCG litigation (see discussion below). Considering the PCG Settlement in its entirety, we find that splitting the cash proceeds of the agreement equally provides a reasonable balance between the rights and obligations of shareholders and ratepayers and will provide the Company with a sufficient incentive to pursue future litigation or settlement of claims that the Company and its customers may be entitled to receive.

1. PCG Legal Expenses

Staff claims that the Company receives further compensation from the PCG Settlement through the inclusion of capitalized legal fees in rate base (Tr. 1099). RUCO argues on brief that the $308,005 booked by the Company as legal expenses associated with the PCG Settlement should be removed from plant accounts, reclassified as a separate addition to rate base, and amortized over the life of the agreement (RUCO Brief, at 7-9). RUCO claims that, absent its proposed adjustment, Arizona Water will earn a perpetual return in operating income from inclusion of these legal costs.

Arizona Water asserts that there is no evidence in the record to support RUCO's recommendation which was raised for the first time in RUCO's brief. The Company claims that the only record evidence is that the legal costs were incurred to protect its rights to a specified quantity of water, an asset with an unlimited life that is not subject to depreciation (Company Reply Brief, at 41-42).

We agree with Arizona Water that there is insufficient evidence in the record of this case to support RUCO's proposed treatment of the PCG Settlement legal costs. RUCO's recommendation was presented for the first time in its initial brief, thereby precluding an opportunity for cross-examination or rebuttal of the proposed alternative treatment. Although we are denying RUCO's recommendation, we believe this issue should be reviewed in the Company's next rate proceeding to allow a full analysis of whether it is appropriate to allow recovery in rate base of legal expenses associated with pursuit of litigation and settlement of legal claims.

2. Miami Purchased Power Expense

Staff witness Hammon testified that because the PCG Settlement provides Arizona Water with up to 600 gpm of replacement water, the Company's purchased power required to pump water in the Miami system has been reduced (Ex. S-52, at 17-18). Accordingly, Staff reduced the Company's purchased power expense in its recommendation regarding allowable expenses (Id.).

Arizona Water contends that Staff's recommendation is based on speculation regarding the amount of the Company's future purchased power expenses (Tr. 1134-1135). The Company argues that speculative expense reductions are not a sufficient basis for adopting Staff's recommendation.

We agree with the Company that Staff's proposal is based on estimates of future reductions in purchased power. Although Mr. Garfield admitted that Arizona Water did not yet own the PCG wells in question, he testified that PCG may exercise its option under the agreement to convey the wells to the Company (Tr. 252-259). Given the current uncertainty regarding this issue, and the speculative nature of Staff's recommendation, we do not believe it is appropriate to reduce Arizona Water's Miami purchased power expenses in this proceeding.

3. Confidentiality of PCG Settlement

The PCG Settlement contains a confidentiality provision that prohibits Arizona Water from disclosing the terms of the agreement (Ex. S-10). The allegedly confidential information was provided to the Administrative Law Judge and Commissioners. The information was also provided to most of the other parties pursuant to protective agreements. Portions of the hearing were conducted on a closed record and transcripts, exhibits, testimony, and briefs addressing the confidential PCG Settlement issues have, up to this point in time, been maintained under seal.

On December 17, 2003, a Procedural Order was issued ruling that Arizona Water's request for confidentiality of the PCG Settlement should be denied. As stated in the December 17, 2003 Procedural Order, A.R.S. §39-121 provides that "Public records and other matters in the custody of any officer shall be open to inspection by any person at all times during office hours." Although there is a strong presumption in favor of disclosure, the right to inspection of public documents is not unlimited. Access to public records may be denied or restricted where "the interests of privacy, confidentiality, or the best interest of the state in carrying out its legitimate activities outweigh the general policy of open access." *Carlson v. Pima County*, 141 Ariz. 487, at 491, 687 P.2d 1242 (1984). The purpose of public records laws is to allow citizens 'to be informed about what their government is up to.' *Scottsdale Unified School District v. KPNX Broadcasting Co.*, 191 Ariz. 297, 302-303, 955 P.2d 534, 539-540 (1998) (quoting *United States Dep't. of Justice v. Reporters Comm. For Freedom of the Press*, 489 U.S. 749,773, 109 S.Ct. 1468 (1989). See, also, *A.H. Belo Corp. v. Mesa Police Dept.*, 202 Ariz. 184, 42 P.2d 615 (Ariz. Ct. of Appeals 2002).

Arizona Water and BHP Copper[6] contend that disclosure of the terms of the PCG Settlement could have a chilling effect on future settlements between utility companies and third-party litigants. However, the public interest in disclosure outweighs the potential effect on future settlements. This public interest exists in the form of the public's right to know the underlying basis for how the rates set by the Commission were established. In this case, our decision that the settlement proceeds should be shared equally between shareholders and ratepayers has an effect on the revenue requirement for the Miami system. Thus, public disclosure of the amount of the settlement is necessary to enable the public to assess how the revenue requirement was determined.

In addition, we do not believe it is good public policy to retain confidentiality of the terms of a settlement agreement entered into by a regulated utility and a third party simply because disclosure may expose the third party to some future liability for its actions. Although most of the cases on public records address disclosure requirements for records and information maintained by government agencies, the same principles apply equally in situations where, as in this case, the Commission reviewed the terms of the PCG Settlement as part of its ratemaking authority under Article XV of the Arizona Constitution. We find that the presumption in favor of access to public records outweighs the privacy interests expressed by Arizona Water and the PCG Group.

---

[6] BHP Copper is one of the members of the PCG Group. Counsel for BHP Copper appeared at the December 8, 2003 oral argument in support of maintaining confidentiality of the terms of the settlement agreement.

* * * * * * * * * *

Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

FINDINGS OF FACT

1. Arizona Water is an Arizona corporation engaged in the business of providing water utility service to the public in portions of Arizona pursuant to authority granted by the Commission.

2. On August 14, 2002, Arizona Water filed with the Commission an application for a permanent increase in water rates for its Eastern Group, consisting of the Company's Apache Junction, Bisbee, Miami, Oracle, San Manuel, Sierra Vista, Superior, and Winkelman systems.

3. By Procedural Order issued October 23, 2002, a hearing was scheduled for June 23, 2003.

4. A Second Rate Case Procedural Order was issued March 14, 2003, granting Staff's Motion to Continue and setting a new hearing date of September 22, 2003. The March 14, 2003 Procedural Order also extended the time clock for a final Commission decision.

5. Intervention was granted to RUCO, the City of Casa Grande, Superstition Mountain, LLC, and Mr. Robert Skiba.

6. Pre-hearing conferences were conducted on March 31, 2003 and September 17, 2003. Public comment hearings were conducted on August 18, 2003 in San Manuel, on August 19, 2003 in Bisbee, and on August 28, 2003 in Apache Junction. The evidentiary hearing commenced on September 22, 2003 and concluded on September 26, 2003.

7. Initial closing briefs were filed on October 31, 2003 and reply briefs were filed on November 10, 2003. An oral argument was conducted on December 8, 2003.

8. Based on the adjusted test year data, as determined herein, the operating income under existing rates for the Eastern Group is $2,168,327.

9. Based on the adjusted test year data, as determined herein, the fair value rate base for the Eastern Group is $35,944,611.

10. A fair and reasonable rate of return on fair value rate base is 8.7 percent.

11. The revenue increase proposed by Arizona Water would produce an excessive return

on fair value rate base.

12. The authorized increase in gross annual revenues for the Eastern Group is $1,564,803.

13. Staff's proposed inverted tier rate structure does not support our conservation goals for usage under 50,000 gallons.

14. The rate design adopted herein will promote conservation and send appropriate price signals to all consumers.

15. As discussed herein, Arizona Water's Eastern Group Purchased Power and Purchased Water Adjustment Mechanisms should be discontinued.

16. Arizona Water's proposal to consolidate the Superior and Apache Junction systems, through the two-step process described herein, is reasonable and shall be adopted.

17. Staff's proposed water loss audit and reporting plan is reasonable and shall be adopted.

18. Staff's proposed changes to Arizona Water's NP-260 Tariff are reasonable and shall be adopted.

19. Arizona Water's proposed Arsenic Cost Recovery Mechanism for the Eastern Group, which is based on the Commission's approval of the Northern Group ACRM in Decision No. 66400, is reasonable and shall be approved.

20. Staff's proposed Curtailment Tariff requirement for Arizona Water is reasonable and shall be approved.

21. The treatment of the Pinal Creek Group Settlement discussed herein is reasonable and shall be adopted.

22. For the Apache Junction system, the rates set herein produce a decrease in annual revenues of 3.29 percent which results in a decrease of 6.5 percent for the average usage 5/8 x ¾ inch meter customer and a decrease of 3.0 percent for the median usage 5/8 x ¾ inch customer.

23. For the Bisbee system, the rates set herein produce an increase in annual revenues of 32.10 percent which results in average and median increases for 5/8 x ¾ inch meter customers of approximately 22.8 percent and 26.5 percent, respectively.

24. For the Miami system, the rates set herein produce an increase in annual revenues of

24.24 percent which results in average and median increases for 5/8 x ¾ inch meter customers of approximately 13.9 percent and 17.7 percent, respectively.

25. For the Oracle system, the rates set herein produce an increase in annual revenues of 13.04 percent which results in average and median increases for 5/8 x ¾ inch meter customers of approximately 13.0 percent and 17.3 percent, respectively.

26. For the San Manuel system, the rates adopted herein reflect elimination of the purchased water adjustment mechanism and will result in average and median increases for 5/8 x ¾ inch meter customers of approximately 23.8 percent and 26.9 percent, respectively.

27. For the Sierra Vista system, the rates set herein produce an increase in annual revenues of 27.82 percent which results in average and median increases for 5/8 x ¾ inch meter customers of approximately 17.8 percent and 20.4 percent, respectively.

28. For the Superior system, the rates set herein produce an increase in annual revenues of 50.60 percent which results in the average usage 5/8 x ¾ inch meter customer experiencing a decrease of approximately 33.8 percent and the median usage 5/8 x ¾ inch customer experiencing a decrease of approximately 31.8 percent. The decreases for these average and median usage customers are due primarily to consolidation of the Superior and Apache Junction systems, as described herein.

29. For the Winkelman system, the rates set herein produce an increase in annual revenues of 24.16 percent which results in average and median increases for 5/8 x ¾ inch meter customers of approximately 1.4 percent and 2.5 percent, respectively.

30. The rates and charges for each system, as attached hereto in the attached Exhibit D and incorporated by reference herein, are reasonable.

CONCLUSIONS OF LAW

1. Arizona Water is a public service corporation within the meaning of Article XV of the Arizona Constitution and A.R.S. §§40-250 and 40-251.

2. The Commission has jurisdiction over the Company and of the subject matter of the Application.

3. Notice of the Application was provided in the manner prescribed by law.

4. The rates and charges for each system, as attached hereto in Exhibit D and incorporated by reference herein, are reasonable and shall be approved.

ORDER

IT IS THEREFORE ORDERED that Arizona Water Company is hereby directed to file with the Commission on or before March 31, 2004 revised schedules of rates and charges consistent with Exhibit D and the discussion herein.

IT IS FURTHER ORDERED that the revised schedules of rates and charges shall be effective for all service rendered on and after March 10, 2004.

IT IS FURTHER ORDERED that Arizona Water Company shall notify its affected customers of the revised schedules of rates and charges authorized herein by means of an insert in its next regularly scheduled billing, in a form approved by Staff.

IT IS FURTHER ORDERED that Arizona Water Company shall implement the approved Arsenic Cost Recovery Mechanism for the Eastern Group in accordance with the discussion herein and consistent with the ACRM approved in Decision No. 66400 for Arizona Water's Northern Group.

IT IS FURTHER ORDERED that Arizona Water Company's Eastern Group Purchased Power and Purchased Water Adjustment Mechanisms should be discontinued.

IT IS FURTHER ORDERED that Arizona Water Company shall implement the Water Loss Plan proposed by Staff, as discussed herein, within 120 days of the effective date of this Decision.

IT IS FURTHER ORDERED that Arizona Water Company shall submit an amended NP-260 Tariff, in the form prescribed by Staff and approved herein, by no later than March 31, 2004.

IT IS FURTHER ORDERED that Arizona Water Company shall develop and submit for the approval of Staff a water conservation initiative within 30 days of the effective date of this Decision. Arizona Water Company shall disseminate the notice to all customers affected by this Application, as discussed herein, within 30 days of approval by Staff.

IT IS FURTHER ORDERED that Arizona Water Company shall file a rate case application for its Eastern Group no later than September 30, 2007.

. . .

IT IS FURTHER ORDERED that Arizona Water Company shall submit a Curtailment Tariff in the form prescribed by Staff and approved herein, by no later than March 31, 2004.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN	COMMISSIONER	COMMISSIONER
COMMISSIONER	COMMISSIONER	

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Secretary of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this 19th day of March, 2004.

BRIAN C. McNEIL
EXECUTIVE SECRETARY

DISSENT

DISSENT

DDN:mlj

SERVICE LIST FOR: ARIZONA WATER COMPANY

DOCKET NO.: W-01445A-02-0619

Robert W. Geake
Vice President and General Counsel
ARIZONA WATER COMPANY
P.O. Box 29006
Phoenix, AZ 85038-9006

Norman D. James
Jay L. Shapiro
FENNEMORE CRAIG
3003 N. Central Avenue, Ste. 2600
Phoenix, AZ 85012
Attorneys for Arizona Water Company

Kay Bigelow
CASA GRANDE CITY ATTORNEY'S OFFICE
510 East Florence Blvd.
Casa Grande, AZ 85222

Scott S. Wakefield, Chief Counsel
RUCO
1110 W. Washington, Ste. 220
Phoenix, Arizona 85012

Robert Skiba
P.O. Box 1057
Oracle, AZ 85623

Thomas H. Campbell
Michael T. Hallam
LEWIS AND ROCA, LLP
40 N. Central Avenue
Phoenix, AZ 85004
Attorneys for Superstition Mountain, LLC

Philip A. Edlund, Vice President
Superstition Mountain, LLC
8777 N. Gainey Center Drive, Ste. 205
Scottsdale, AZ 85258

Christopher Kempley, Chief Counsel
Legal Division
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, AZ 85007

Ernest Johnson, Director
Utilities Division
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, AZ 85007

Arizona Water Company
Docket No. W-01445A-02-0619
Test Year Ended December 31, 2001

EXHIBIT A
RATE BASE

LINE NO.	DESCRIPTION	Apache Junction	Bisbee	Miami	Oracle	San Manuel	Sierra Vista	Superior	Winkelman	Eastern Group
1	Company Proposed Rate Base - Rejoinder	$ 21,722,321	$ 3,878,994	$ 4,507,618	$ 2,706,211	$ 759,504	$ 2,512,878	$ 2,646,023	$ 269,330	$ 39,002,879
	ALJ Adjustment	$ 67,011	$ 11,966	$ 13,905	$ 8,348	$ 2,343	$ 7,752	$ 8,163	$ 831	$ 120,319
	ALJ Proposed Rate Base	$ 21,789,332	$ 3,890,960	$ 4,521,523	$ 2,714,559	$ 761,847	$ 2,520,630	$ 2,654,186	$ 270,161	$ 39,123,198
	Adjustments to Accumulated Depreciation	$ (1,319,494)	$ (121,028)	$ (24,822)	$ (99,812)	$ 24,889	$ (92,123)	$ (77,188)	$ 7,566	$ (1,702,012)
2	Adj. to Regulatory Asset/Deferred Credit	$ -	$ -	$ (700,000)	$ -	$ -	$ -	$ -	$ -	$ (700,000)
4	Adjustments to Working Capital	$ (485,547)	$ (46,080)	$ (78,337)	$ (44,919)	$ (17,694)	$ (32,574)	$ (23,813)	$ (6,459)	$ (735,423)
5	Adjustments to CIAC Amortization	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
	Adjustments to CAP Amortization	$ (69,152)								$ (69,152)
7	Adj. to Regulatory Liability/Deferred Credit	$ -		$ 28,000						$ 28,000
8	Phx Office/Metrer Shop Adjustments	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
9	Authorized Rate Base	$ 19,915,139	$ 3,723,852	$ 3,746,364	$ 2,569,828	$ 769,042	$ 2,395,933	$ 2,553,185	$ 271,268	$ 35,944,611

DOCKET NO. W-01445A-02-0619

DECISION NO. 66849

ARIZONA WATER COMPANY
DOCKET NO. W-01445A-02-0619
TEST YEAR ENDED DECEMBER 31, 2001

	Apache Junction	Superior	Bisbee	Miami	Oracle	San Manuel	Sierra Vista	Winkelman
Service Charges:								
Establishment	$ 16.00	$ 16.00	$ 16.00	$ 16.00	$ 16.00	$ 16.00	$ 16.00	$ 16.00
Guarantee Deposit	(c)	(c)	(c)	(c)	(c)	(c)	(c)	(c)
Reconnection for Delinquency (per disconnection)	$ 16.00	$ 16.00	$ 16.00	$ 16.00	$ 16.00	$ 16.00	$ 16.00	$ 16.00
Re-establishement	(d)	(d)	(d)	(d)	(d)	(d)	(d)	(d)
Service Call Out (After Regular Working Hours Only)	$ 35.00	$ 35.00	$ 35.00	$ 35.00	$ 35.00	$ 35.00	$ 35.00	$ 35.00
Returned Check Charge	$ 25.00	$ 25.00	$ 25.00	$ 25.00	$ 25.00	$ 25.00	$ 25.00	$ 25.00
Meter Re-read (After Regular Working Hours Only)	$ 35.00	$ 35.00	$ 35.00	$ 35.00	$ 35.00	$ 35.00	$ 35.00	$ 35.00
Meter Test	$ 50.00	$ 50.00	$ 50.00	$ 50.00	$ 50.00	$ 50.00	$ 50.00	$ 50.00
Late Charge	(e)	(e)	(e)	(e)	(e)	(e)	(e)	(e)

(c) Per Commission Rule A.A.C. R14-2-403B
(d) Eight (8) times the customer's monthly minimum charge, or payment of the minimums since disconnection, whichever is less.
N/A No current tariff.
(e) 1.5 percent after 15 days

Arizona Water Company
Docket No. W-01445A-02-0619
Test Year Ended December 31, 2001

EXHIBIT B
OPERATING STATEMENT

LINE NO.	DESCRIPTION	Apache Junction	Bisbee	Miami	Oracle	San Manuel	Sierra Vista	Superior	Winkelman	Eastern Group
1	Company Test Year Operating Income	$ 1,862,934	$ 31,709	$ 59,991	$ 167,200	$ (186,409)	$ 31,077	$ (6,904)	$ 9,436	$ 1,969,034
2	Adjustments to Revenue	$ -	$ (347)	$ -	$ -	$ -	$ -	$ -	$ -	$ (347)
3	Adjustment to Purchased Water	$ 5,747	$ -	$ -	$ 916	$ (7,875)	$ -	$ -	$ -	$ (1,212)
4	Adjustment to Purchased Power	$ 6,251	$ 3,783	$ 40,123	$ -	$ 1,024	$ 2,544	$ -	$ 122	$ 53,847
5	Adjustments to Water Treatment Expense	$ (5,320)	$ 6,143	$ 62,992	$ (9,014)	$ 9,269	$ 5,031	$ 8,847	$ (242)	$ 77,706
6	Adjustment to Transmission/Distrib. Exp.	$ 19,050	$ 4,261	$ 3,788	$ 1,724	$ 1,981	$ (4)	$ 1,639	$ 237	$ 32,676
7	Adj. to Customer Account Expense	$ (225)	$ 3	$ 1	$ (5)	$ 1	$ (4)	$ 4	$ 2	$ (223)
8	Adj. to Administrative /General Expense	$ 8,976	$ 1,996	$ 2,030	$ 977	$ 830	$ 1,372	$ 943	$ 116	$ 17,240
9	Adj. to Depreciation/Amortization	$ 337,635	$ 5,632	$ 42,131	$ 1,954	$ 12,874	$ 2,256	$ 2,100	$ 219	$ 404,801
10	Adjustment to Property Tax	$ (57,538)	$ 5,704	$ (3,010)	$ (953)	$ (6,957)	$ 5,240	$ (11,647)	$ (1,402)	$ (70,563)
11	Adj. to Federal/State Income tax	$ (280,267)	$ 14,509	$ (98,493)	$ (5,347)	$ 16,847	$ 8,133	$ 10,404	$ 597	$ (333,617)
8	ROO Test Year Adj. Operating Income	$ 1,897,243	$ 73,393	$ 109,553	$ 157,452	$ (158,415)	$ 55,645	$ 5,386	$ 9,085	$ 2,149,342

Arizona Water Company
Docket No. W-01445A-02-0619
Test Year Ended December 31, 2001

EXHIBIT C
REVENUE REQUIREMENT

LINE NO.	DESCRIPTION	Apache Junction	Bisbee	Miami	Oracle	San Manuel	Sierra Vista	Superior	Winkelman	Eastern Group
1	Adjusted Rate Base	$ 19,915,139	$ 3,723,852	$ 3,746,364	$ 2,569,828	$ 769,042	$ 2,395,933	$ 2,553,185	$ 271,268	$ 35,944,611
2	Adjusted Operating Income (Loss)	$ 1,897,243	$ 73,393	$ 109,553	$ 157,452	$ (158,414)	$ 55,645	$ 5,386	$ 9,086	$ 2,149,344
3	Current Rate of Return (L2 / L1)	9.53%	1.97%	2.26%	6.13%	-20.60%	2.32%	0.21%	3.35%	5.98%
4	Required Rate of Return	8.7000%	8.7000%	8.7000%	8.7000%	8.7000%	8.7000%	8.7000%	8.7000%	8.7000%
5	Required Operating Income (L4 * L1)	$ 1,732,617	$ 323,975	$ 325,934	$ 223,575	$ 66,907	$ 208,446	$ 222,127	$ 23,600	$ 3,127,181
6	Operating Income Deficiency (L5 - L2)	$ (164,626)	$ 250,582	$ 216,381	$ 66,123	$ 225,321	$ 152,801	$ 216,741	$ 14,515	$ 977,837
7	Gross Revenue Conversion Factor	1.63195	1.63195	1.63195	1.63195	1.63195	1.63195	1.63195	1.63195	1.63195
8	Increase In Gross Revenue (L7 * L6)	$ (268,661)	$ 408,938	$ 353,123	$ 107,910	$ 367,712	$ 249,365	$ 353,710	$ 23,687	$ 1,595,782
9	Adjusted Test Year Revenue	$ 8,943,927	$ 1,256,603	$ 1,456,939	$ 827,577	$ 474,250	$ 896,485	$ 698,968	$ 98,022	$ 14,652,771
10	Proposed Annual Revenue (L8 + L9) Note A	$ 8,675,266	$ 1,665,541	$ 1,810,062	$ 935,487	$ 841,962	$ 1,145,850	$ 1,052,678	$ 121,709	$ 16,248,553
11	Require Increase in Revenue (%) (L8/L9)	-3.00%	32.54%	24.24%	13.04%	77.54%	27.82%	50.60%	24.16%	10.89%

ARIZONA WATER COMPANY
DOCKET NO. W-01445A-02-0619
TEST YEAR ENDED DECEMBER 31, 2001

EXHIBIT D
RATE DESIGN

	Apache Junction	Superior	Bisbee	Miami	Oracle	San Manuel	Sierra Vista	Winkelman
Monthly Usage Charge:								
5/8" x 3/4" Meter	$ 12.54	$ 12.54	$ 16.32	$ 15.44	$ 19.31	$ 19.94	$ 15.40	$ 12.95
1" Meter	$ 34.30	$ 34.30	$ 43.78	$ 38.87	$ 40.62	$ 42.51	$ 32.71	$ 38.15
2" Meter	$ 120.20	$ 120.20	$ 141.06	$ 129.86	$ 166.69	$ 234.67	$ 125.47	$ 81.75
3" Meter	$ 236.03	$ 236.03	$ 267.25	$ 248.35	$ 220.51	$ 358.76	$ 284.04	$ 241.28
4" Meter	$ 480.25	$ 480.25	$ 477.98	$ 497.76	$ 286.45	$ 453.35	$ 398.10	$ 451.22
6" Meter	$ 774.01	$ 774.01	$ 662.53	$ 875.26	$ 341.11	$ 538.19	$ 604.72	$ 616.16
8" Meter	$ 926.15	$ 926.15	$ 891.27	$ 1,163.12	$ 625.36	$ 854.56	$ 725.66	$ 764.18
10" Meter	$ 1,157.69	$ 1,157.69	$ 1,200.36	$ 1,305.25	$ 837.19	$ 1,228.50	$ 907.08	$ 935.02
Gallons Included In Minimum Charge:								
5/8" x 3/4" Meter	0	0	0	0	0	0	0	0
1" Meter	0	0	0	0	0	0	0	0
2" Meter	0	0	0	0	0	0	0	0
3" Meter	0	0	0	0	0	0	0	0
4" Meter	0	0	0	0	0	0	0	0
6" Meter	0	0	0	0	0	0	0	0
8" Meter	0	0	0	0	0	0	0	0
10" Meter	0	0	0	0	0	0	0	0
Fire Hydrants Used For Construction Water	0	0	0	0	0	0	0	0
Commodity Rates :								
Per 1,000 Gallons (In Excess of Minimum)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Per 1,000 Gallons for 0 to 10,000 Gallons	$ 1.9688	$ 2.2000	$ 2.5940	$ 3.1400	$ 4.9850	$ 1.7040	$ 1.6120	$ 1.1360
Per 1,000 Gallons for 10,001 to 25,000 Gallons	$ 2.4610	$ 2.7500	$ 3.2420	$ 3.9250	$ 6.2310	$ 2.1300	$ 2.0150	$ 1.4200
Per 1,000 Gallons for Gallons in Excess of 25,000	$ 2.9532	$ 3.3000	$ 3.8900	$ 4.7100	$ 7.4770	$ 2.5560	$ 2.4180	$ 1.7040
Service Line and Meter Installation Charge:								
5/8" x 3/4" Meter	(a)	(a)	(a)	(a)	(a)	(a)	(a)	(a)
1" Meter	(a)	(a)	(a)	(a)	(a)	(a)	(a)	(a)
2" Meter	(b)	(b)	(b)	(b)	(b)	(b)	(b)	(b)
3" Meter	(b)	(b)	(b)	(b)	(b)	(b)	(b)	(b)
4" Meter	(b)	(b)	(b)	(b)	(b)	(b)	(b)	(b)
6" Meter	(b)	(b)	(b)	(b)	(b)	(b)	(b)	(b)

(a) No charge for 5/8" and 1" if on existing pipelines. Full cost for 5/8" and 1" if if on new pipelines.
(b) Full cost for 2"and larger if on existing or new pipelines.

DOCKET NO. W-01445A-02-0619