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FENNEMORE CRAIG
A Professional Corporation
Norman D. James (No. 006901)
Jay L. Shapiro (No. 014650)
3003 North Central Avenue
Suite 2600
Phoenix, Arizona 85012-2913
Telephone: (602) 916-5000

Attorneys for Arizona-American Water Company

Arizona Corporation Commission
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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS SUN CITY WEST WATER AND WASTEWATER DISTRICTS.	**DOCKET NOS. WS-01303A-02-0867** **WS-01303A-02-0868** **W-01303A-02-0869** **WS-01303A-02-0870** **W-01303A-02-0908** **(CONSOLIDATED)**
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS SUN CITY WATER AND WASTEWATER DISTRICTS.	**ARIZONA-AMERICAN WATER COMPANY'S EXCEPTIONS TO RECOMMENDED OPINION AND ORDER**
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS MOHAVE WATER AND HAVASU WATER DISTRICTS.	

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IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS TUBAC WATER DISTRICT.

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Arizona-American Water Company ("Arizona-American or "the Company") submits its exceptions to the Recommended Opinion and Order ("RO") issued by the Administrative Law Judge ("the ALJ") on April 26, 2004.

I. OVERVIEW AND SUMMARY OF THE ISSUES PRESENTED.

Arizona-American has applied for a determination of the fair value of its utility plant and property and for increases in its rates and charges for utility service. The Company's applications cover 10 water and wastewater districts, and seek rate adjustments based on the fair value rate bases and operating results in those districts utilizing a 12-month test period ending December 31, 2001, with appropriate pro forma adjustments to annualize and normalize rate base, revenues and expenses on a going-forward basis. These districts were previously owned and operated by Citizens Communications Company ("Citizens"), and were acquired by Arizona-American on January 15, 2002.[1]

None of the districts has received any recent rate increases. Citizens' Agua Fria Water Division, Sun City Water Company, Sun City Sewer Company, Sun City West Utilities Company and Tubac Valley Water Company's last rate orders were issued in May 1997 based on test years ending March 31, 1995. Decision No. 60172 (May 7, 1997).[2] Citizens' Mohave Water Division last received rate increases in February 1990, based on a test year ending March 31, 1988. Decision No. 56806 (Feb. 1, 1990). Havasu Water Company last received rate increases in February 1992, based on a test year ending

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[1] A small wastewater district located in Mohave County, formerly known as Sorenson Utility Company, was also acquired by Arizona-American. This wastewater district is not involved in the rate applications, nor is the Paradise Valley water district, which has been owned and operated by Arizona-American since the late 1960s. Both of these districts received rate increases within the past five years.

[2] In this decision, Sun City Water Company and Sun City West Utilities' rates for water service were actually reduced.

December 31, 1990. Decision No. 57743 (Feb. 21, 1992).[3]

The Company has requested adjustments to its rates and charges for service that would produce an overall increase in revenue of approximately $8.2 million, as shown on page 6 of the RO, which would provide a rate of return of 7.5% on the fair value of the Company's utility plant and property devoted to public service. Under the RO, the Company's rates would be adjusted to produce a total increase in revenue of approximately $1.3 million, with rates of return on the Company's fair value rate bases ranging from 4.32% to 6.43%, depending the particular district. RO at 33-35. By contrast, the current yield on a long-term Treasury note is about 5.5%, while the yield on an investment grade corporate bond is about 6.8%.

Arizona-American respectfully submits that the following recommendations in the RO are arbitrary, contrary to law, and unsupported by the evidence in the record:

1. **Rate base issues.** The RO would violate the "fair value" standard, contained in Article 15, section 14 of the Arizona Constitution in two different respects. First, in developing the Company's fair value rate base for each district, the RO simply averaged the original cost rate base ("OCRB") and the reconstruction cost new ("RCND") rate base because this method is "traditional," and disregarded the Company's evidence showing that the RCND rate bases are conservative and substantially understate the current value of the Company's utility plant and property. *See* RO at 14-16. Second, and even more critically, the Company's fair value rate bases are ***not*** used to determine the Company's authorized level of operating income. Instead, operating income is determined by multiplying the rate of return by the OCRB. *See* RO at 31-32. This "backing-in" method produces fluctuating rates of return on fair value, as noted above, which are below

[3] In addition, Arizona-American was required to file for rate review for the Anthem water and wastewater districts by 2004 or, if earlier, when the number of equivalent residential units in Anthem reached 3,500. Decision No. 60975 (June 19, 1998).

the current cost of investment grade bonds and, in some instances, below current yields on Treasury instruments. This method is unlawful and violates the Arizona constitution.

2. **Rate of Return.** The RO adopts the rate of return, 6.5%, recommended by the Utilities Division ("Staff"), which is based on the Company's embedded cost of debt and a return on common equity of only 9.0%. In adopting Staff's recommendation, the RO arbitrarily rejects the cost of equity estimates of the Company's expert, as well evidence of the actual and authorized returns on equity of the publicly traded water utilities used by Staff. The RO fails to consider recent increases in interest rates, while rejecting the Company's Risk Premium and Capital Asset Pricing Model ("CAPM") estimates because they rely on interest rate projections. RO at 29-30. As discussed below, however, the forecasted interest rates used by the Company's expert in his cost of equity estimates are actually *lower* than current interest rates.[4] Moreover, the RO ignores evidence of actual and authorized earnings because this sort of real world information has been "replaced" by "corporate finance models." RO at 29. Based on current interest rates and actual equity returns, and taking into account the amount of debt in the Company's capital structure, Arizona-American is entitled to an authorized return on equity substantially greater than 9.0%.

3. **Rate Case Expense.** The RO would allow the Company to recover $418,941 in rate case expense, despite the fact that its actual rate case expense will exceed $1 million. The primary basis for this recommendation is the Residential Utility Consumer Office's ("RUCO") contention that the Company used an inappropriate test year. RO at 20. The reality is that the Company's rate case expense is significant because of the size and complexity of this proceeding, which involves 10 different water and

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[4] As discussed below, Staff used an average of the yields on 5, 7 and 10-year Treasury notes in its CAPM model. Since Staff's original CAPM estimates were made, the average yield on those instruments has increased by over 100 basis points (1.0%).

wastewater districts, each of which has its own rate base, income statement and rate schedule. Only one significant issue was affected by the Company's use of a 2001 test year. Moreover, a delay in filing would have made it even more difficult to obtain plant records and other historic data from Citizens, resulting in further complications and, ultimately, more expense. Finally, as discussed below, the amount of rate case expense requested by the Company, $715,000 (amortized over three years), is reasonable when compared to other Citizens and Arizona-American rate proceedings.

4. <u>Other Issues</u>. The RO also denies Arizona-American's request to implement a mechanism to recover payments to the City of Tolleson under the Company's contract for wastewater treatment services with that city. RO at 42-45. Under an amendment made in April 2003 (Ex. S-1), Arizona-American is required to pay to Tolleson an increased monthly fee under "Rate Component Three" to fund the replacement and contingencies reserve. In addition, under the new "Rate Component Four," the Company must pay a pro rata portion of the cost of constructing major capital improvements to Tolleson's treatment plant, to which wastewater flows from the Sun City wastewater district are delivered for treatment. Payments under Rate Component Four will total approximately $10 million during the 2004 to 2008 time period or about $2 million annually. RO at 42.[5] Although there is no dispute that this contractual arrangement is reasonable, prudent and beneficial to Sun City customers (*see, e.g.,* Tr. at 1154-56), Staff and RUCO contend that these payments are not sufficiently "known and measurable." The ALJ has accepted that argument and recommends denial of the Company's cost recovery mechanism. RO at 45. Although the Company disagrees with this recommendation, to reduce the areas of disagreement, the Company will accept the

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[5] By way of comparison, under the RO, the Sun City wastewater district's total operating income would be $560,000 per year, which is approximately 25% of the average annual payments the Company will make to Tolleson under Rate Component Four.

ALJ's recommendation, and will capitalize its increased payments under Rate Component Three and its payments under new Rate Component Four and include those payments in rate base in its next general rate case for the Sun City wastewater district.

II. THE RECOMMENDED ORDER VIOLATES THE "FAIR VALUE" STANDARD MANDATED BY THE ARIZONA CONSTITUTION BY IGNORING EVIDENCE OF CURRENT VALUE AND RELYING EXCLUSIVELY ON ORIGINAL COST TO SET RATES AND CHARGES FOR UTILITY SERVICE.

A. Overview of the "Fair Value" Standard.

In Arizona, utility rates must be established on the basis of the "fair value" of the utility's property. Ariz. Const. art. 15, § 14. For example, in the seminal decision *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956), the Arizona Supreme Court stated:

> It is clear, therefore, that under our constitution as interpreted by this court, *the Commission is required to find the fair value of the company's property and use such finding as a rate base* for the purpose of calculating what are just and reasonable rates. . . . While our constitution does not establish a formula for arriving at fair value, *it does require such value to be found and used as the base in fixing rates. The reasonableness and justness of the rates must be related to this finding of fair value.* [Emphasis supplied.]

More recently, the Court confirmed that in a monopoly setting, fair value is the exclusive rate base on which a utility's rates are established. *US West Communications, Inc. v. Ariz. Corp. Comm'n,* 201 Ariz. 242, 244-46, ¶¶ 13-19, 34 P.3d 351, 354-55 (2001) (summarizing Arizona court decisions requiring the use of fair value to set rates).

Under the fair value method, rates are set "according to the actual present value of the assets employed in the public service." *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 308 (1989). "Fair value means the value of properties at the time of inquiry," and not simply their historic cost. *Simms*, 80 Ariz. at 151, 294 P.2d at 382.

> [The] fair value standard mimics the operation of the

> competitive market. To the extent the utilities' investments in plants are good ones (because the benefits exceed their costs) they are rewarded with an opportunity to earn an "above cost" return, that is, a fair return on the current "market value" of the plant. To the extent the utilities' investments turn out to be bad ones (such as plants that are canceled and so never used and useful to the public), the utilities suffer because the investments have no fair value and so justify no return.

Duquesne Light, 488 U.S. at 308-09. *See also Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of West Va.*, 262 U.S. 679, 690 (1923) ("If the property, which legally enters into the consideration of the question of rates, has increased in value since it was acquired, the company is entitled to the benefit of such increase."); *City of Tucson v. Citizens Utilities Water Co*, 17 Ariz.App. 477, 480, 498 P.2d 551, 554 (1972) ("The Court reiterated [in *Simms*] that fair value meant 'value of properties at the time of inquiry' . . . which figure will necessarily reflect the current cost of construction.").

B. The Use of the Average of the Company's OCRB and RCND Rate Bases is Unlawful and Ignores the Evidence Presented.

Arizona-American presented evidence establishing both an original cost rate base ("OCRB") and a reconstruction cost new less depreciation ("RCND") rate base for each district in accordance with the Commission's rule defining the requirements for an application seeking rate adjustments. A.A.C. R14-2-103(B)(1) and Schedules B-1 through and B-4. There were certain minor disagreements relating to total plant in service and accumulated depreciation, as described on pages 7 through 9 of the RO, which result in the adoption of an adjusted OCRB for all 10 districts totaling approximately $90.9 million. RO at 10. These adjustments are carried over to the RCND rate bases, which, as adjusted, total approximately $134.4 million. RO at 11.

The Company maintains that its RCND rate bases should be used as its "fair value" rate base ("FVRB") because the RCND rate bases provide the best estimate of the current value of the Company's utility plant and property. In addition to offering reproduction

cost new ("RCN") plant-in-service studies for each district, which were accepted by Staff (and not challenged by any other party), the Company also pointed to the recent purchase price paid by Arizona-American in acquiring Citizens' water and wastewater assets as evidence that the fair value of those assets substantially exceeds their original cost. Staff, in contrast, proposed a FVRB based on the average of the OCRB and the RCND rate base for each district because this what the Commission has "traditionally" done.[6] The RO adopts Staff's position and rejects the Company's position on several different grounds, which are contrary to law and to the evidence presented.

First, the ALJ equated the use of the Company's RCND rate base as the FVRB with the recovery of an "acquisition adjustment." RO at 14-15. There is no evidence that the Company's RCND rate base includes any acquisition adjustment.[7] As shown in the Company's schedules, there is simply no adjustment to any of those rate bases as a result of the acquisition of Citizens' utility plant. *See* Ex. A-24, Rejoinder Schedules B-1 (rate base summary) and B-3 (adjustments to RCRB). *See also* Tr. at 105 ("The [RCRB] does not include an acquisition adjustment . . . . It is the company's estimate of the current value of its utility property.") and 123 (same).

Nevertheless, the ALJ concluded that the RCND rate bases contain an acquisition adjustment. RO at 15. However, if Citizens had not sold its water and wastewater assets

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[6] RUCO and Youngtown ignored the Company's RCND rate bases and, instead, advocated the use of the Company's OCRB to set rates.

[7] The acquisition adjustment that has been discussed by the parties in this case results from Arizona-American's acquisition of the Citizens' water and wastewater systems, the purchase price of which was approximately $276,500,000. Ex. A-64 at 10. Under the Uniform System of Accounts, Arizona-American was required to record the difference between (1) the cost (i.e., purchase price) of Citizens' water and wastewater systems and (2) the original cost of Citizens' utility plant and property, less any amounts credited at the time of the acquisition to accumulated depreciation, accumulated amortization and contributions in aid of construction with respect to such property. *See* Ex. A-86 (Uniform System of Accounts, Balance Sheet Account No. 114).

and, instead, had applied for rate adjustments, Citizens' RCND rate bases ***would be exactly the same*** as the Company's RCND rate bases, as testified to by Youngtown's witness, Mr. Burton, during the hearing. Mr. Burton was asked whether it would have been permissible for Citizens to have submitted RCN studies and to have requested a return on an RCND rate base, assuming that no sale had occurred. Mr. Burton agreed that Citizens would have had the right to do so. Tr. at 1279-81. It is inappropriate to prohibit Arizona-American from seeking a return on an RCND rate base simply because there has been a change in ownership, when the prior owner of the districts would have the right to request the same rate-making methodology under the Arizona Constitution.

The discussion found on pages 14 and 15 of the RO also confuses the concepts of "cost" and "value." For example, the RO states that the "OCRB methodology is based on current, verifiable and reasonable adjustments to a verifiable, objective record of the *value* of assets . . . ." RO at 14-15 (emphasis supplied). However, an "original cost" rate base reflects the *historic cost* to construct the assets, rather than the assets' *current value*. While the historic cost to construct an asset may be "verifiable" and "objective," that cost may have little relation to the asset's value today, which is the crux of the fair value methodology. *E.g.*, *Duquesne Light*, 488 U.S. at 308-09; *Bluefield Waterworks*, 262 U.S. at 690; *US West*, 201 Ariz. 245-56, ¶¶ 13-18, 34 P.3d 354-55.

For these reasons, the conclusion that the Company has failed to present a "legitimate basis" for using its RCND rate base as its FVRB is not supported by substantial evidence. Because the principal goal of the fair value method of rate-making is to set rates on the basis of the current value of the property devoted to public service, as opposed to that property's historic cost, averaging the utility's RCRB with its OCRB without a legitimate reason to do so would violate that Arizona Constitution.

> It is well established that values of utility properties fluctuate, and that owners must bear the decline and are entitled to the

> increase. The decision of this court in *Smyth v. Ames* . . . declares that to ascertain value 'the present as compared with the original cost of construction' are, among other things, matters for consideration. But this does not mean that the original cost or the present cost or some figure arbitrarily chosen between these two is to be taken as the measure. The weight to be given to such cost figures and other items or classes of evidence is to be determined in the light of the facts of the case in hand.

McCardle v. Indianapolis Water Co., 272 U.S. 400, 410 (1926) (quoting *Smyth v. Ames*, 169 U.S. 466, 547 (1898)).

In this case, Arizona-American presented RCND rate bases for each district and evidence of a recent arms-length transaction involving two independent and sophisticated parties. The evidence shows that the current value of the Company's utility plant exceeds its RCND rate bases and, therefore, that the use of its RCND rate bases as the FVRB is conservative. Conversely, there is no evidence supporting the use of the average of the Company's OCRB and RCND rate bases, other than it is "traditional." Therefore, the Company's RCND rate bases should be used as its FVRB.

C. The ALJ Has Failed to Use the Company's "Fair Value" Rate Base to Set Rates, in Violation of the Arizona Constitution.

The RO adopts Staff's recommended rate of return, 6.5%. RO at 31. However, that rate of return is ***not*** applied to the FVRB for each water and wastewater district. Instead, the ALJ has adopted the so-called "backing-in" method advocated by Staff, RUCO and Youngtown. Under this method, the utility's OCRB and rate of return are first determined. Next, the OCRB is multiplied by the rate of return to determine the utility's operating income. Third, the utility's operating income is divided by its FVRB, to compute what is euphemistically called the "fair value rate of return." Finally, the "fair value rate of return" is multiplied by the FVRB to produce the authorized operating income. The last two steps are meaningless – the utility's operating income is actually

based on its OCRB.

For example, assume that a hypothetical utility's OCRB is $1 million, its rate of return on rate base is 9.0%, and its FVRB is $1.5 million. The utility's operating income would be determined, as follows:

Step One – Determine Operating Income

OCRB	1,000,000
Rate of Return	x 9%
Operating Income	**$ 90,000**

Step Two – Compute "Fair Value Rate of Return"

Operating Income	90,000
FVRB	÷ 1,500,000
"Fair Value Rate of Return"	**6%**

Step Three – Re-Compute Operating Income

FVRB	1,500,000
"Fair Value Rate of Return"	x 6%
Operating Income	**$ 90,000**

Thus, the utility's operating income will always be based on its OCRB as opposed to the fair value of its utility plant. For example, if the hypothetical utility's FVRB were $1.2 million instead of $1.5 million, the required operating income, $90,000, would be divided by $1.2 million to produce a "fair value return" equal to 7.5%. If the utility's FVRB were instead $900,000, the "fair value rate of return" would be set at 10%. In each case, the utility's authorized operating income, $90,000, remains unchanged. Consequently, this method renders the fair value of the Company's utility plant meaningless, as well as the Commission's own requirement that a utility submit an RCND rate base. A.A.C. R14-2-

103(B)(1) and Rate Base Schedules B-1, B-3 and B-4.

In this case, each water and wastewater district's OCRB is multiplied by 6.5%, Staff's recommended rate of return, to determine the district's authorized operating income. The district's operating income is then divided by the district's FVRB to produce the "fair value rate of return." The result is that each district has a ***different*** rate of return on its FVRB, and that return is ***less*** than the recommended rate of return, 6.5%:

District	Rate of Return on Rate Base
Sun City Water	4.32%
Sun City Wastewater	4.37%
Tubac Water	5.12%
Havasu Water	5.44%
Mohave Water	5.46%
Sun City West Wastewater	5.48%
Sun City West Water	5.70%
Agua Fria Water	6.20%
Anthem Water	6.38%
Anthem/Agua Fria Wastewater	6.43%
Recommended Return	6.5%

RO at 33-35. The use of these fluctuating rates of return ensures that the Company's authorized operating income is equal to the operating income produced by using each district's OCRB as its rate base. The recommended rate of return is ***never*** applied to the fair value of the Company's utility plant and property.

The rationale for using this anomalous approach is found on page 32 of the RO. Again, the ALJ simply adopted Staff's argument that this approach "is the approach the Commission has traditionally used." None of the court decisions discussed on page 32

actually approves this method. The only decision that actually describes the two-step "backing-in" process is *Litchfield Park Serv. Co. v. Ariz. Corp. Comm'n*, 178 Ariz. 431, 434-35, 874 P.2d 988, 991-92 (App. 1994). The description in that case, however, is *dicta*, i.e., general background that has nothing to do with the actual issues presented for review.

The RO states that in *Sun City Water Co. v. Ariz. Corp. Comm'n*, 113 Ariz. 464, 465, 556 P.2d 1126, 1127 (1976), the Arizona Supreme Court affirmed a Commission decision, stating that "cost of capital estimates must be restated if they are applied to a fair value rate base." RO at 32. This misstates the holding of that decision in several respects. First, the Court did not discuss the underlying Commission decision. Instead, the issue was the scope of the Court of Appeals' review of the trial court's decision. *Id.* at 475, 556 P.2d at 1127. Second, none of the issues on appeal concerned the Commission's use of "backing-in" method. Instead, the issues on appeal were the sufficiency of the rate of return, whether the rates would produce the rate of return, and whether the trial court erred in remanding the Commission's decision for a new determination of rates. *Id.* Third, in reversing the Court of Appeals, the Supreme Court simply concluded that the trial court's judgment was supported by "reasonable evidence." *Id.* Consequently, this decision does not address, let alone support the lawfulness of the "backing-in" method.[8]

The remaining decisions cited on page 32 of the RO support the Company's position. For example, in *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (App. 1978), the court explained:

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[8] Putting aside the plain language of the Court's decision, which never mentions how the rate of return is applied to the utility's rate base, the court of appeals' subsequent decision in *Ariz. Corp. Comm'n v. Citizens Utilities Co.*, 120 Ariz. 184, 584 P.2d 1175 (App. 1978) (review denied), makes it clear that *Sun City Water* is irrelevant. In *Citizens Utilities*, the court explained that its decision in *Sun City Water* was vacated because "there existed reasonable evidence before the trial court regarding the Commission's rate of return." *Id.* at 188, 584 P.2d at 1179.

> The general theory of utility regulation is that the total revenue, including income from rates and charges, should be sufficient to meet a utility's operating costs and to give the utility and its stockholders a reasonable rate of return on the utility's investment. . . . To achieve this, ***the Commission must first determine the "fair value" of a utility's property and use this fair value as the utility's rate base***. . . . The Commission then must determine what the rate of return should be, and then apply that figure to the rate base in order to establish just and reasonable tariffs. [Emphasis supplied; citations omitted.]

The *Scates* court relied on *Simms*, quoted above, and *Ariz. Corp. Comm'n v. Arizona Public Serv. Co.*, 113 Ariz. 368, 555 P.2d 326 (1976) ("*APS*"). In *APS*, the Arizona Supreme Court stated:

> Article 15, section 14, [of the Arizona Constitution] requires the Commission to ascertain the fair value of the property within the state, of every public service doing business therein. Under the constitution as interpreted by this court, ***the Commission is required to find the fair value of the company's property and use such finding as a rate base*** for the purpose of determining what are just and reasonable rates.

113 Ariz. at 370, 555 P.2d at 328 (emphasis supplied; citing *Simms*).[9]

The requirement that the Commission apply the rate of return to the utility's FVRB was emphasized earlier this year in *Phelps Dodge Corp. v. Ariz. Electric Power Coop.*, 207 Ariz. 95, 83 P.2d 573 (App. 2004), in which the court stated:

> In monopolistic markets, "fair value has been the factor by which a reasonable rate of return was multiplied to yield, with the addition of operating expenses, the total revenue that a corporation could earn." . . . Although *US West II* held that this rate-of-return method for rate setting may be inappropriate in a competitive environment, it affirmed the supreme court's long-standing view that this method is properly employed in traditional, non-competitive markets.

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[9] Similarly, in *City of Tucson*, also cited on page 32 of the RO, the court followed *Simms* in holding that the Commission's FVRB was not supported by substantial evidence. 17 Ariz.App. at 480-81, 498 P.2d at 554-55. Again, this decision supports the Company.

207 Ariz. at __, ¶ 21, n.8, 83 P.3d at 583, n.8 (quoting *US West*, 201 Ariz. at 245, ¶ 19, 34 P.3d at 355). The discussion in the RO conflicts with both *Phelps Dodge* and *US West*.

Moreover, the Arizona Supreme Court addressed the "backing in" method employed in the RO, and stated that it is "illegal":

> The company contends *the commission . . . first determined what the company should be allowed to earn* in order to maintain a sound financial position, attract necessary additions to capital and pay a fair return on common equity; *and second, having thus established the amount the company should be allowed to earn for such purposes, it proceeded to adjust the rate of return to any rate base.* If this be true, it would be an illegal method of establishing a rate base. The standard for establishing a rate base must be the fair value of the property and not what the commission might believe was a fair rate of return on common equity.

Simms, 80 Ariz. at 155, 294 P.2d at 385 (emphasis supplied). More recently, in *Citizens Utilities*, the Arizona Court of Appeals stated that the use of a "fluctuating" rate of return is unlawful:

> Under our constitution, a utility is entitled to a fair rate of return on the fair value of its properties, "no more and no less." . . . Dr. Langum [the Staff cost of capital witness] violated this principle by pegging his opinion as to rate of return to the finding of fair value. *This results in a fluctuating rate of return. Thus, under Dr. Langum's theory, it makes no difference whether the Commission used original cost or reproduction cost as the base, the amount of dollars in the Company's coffers is basically the same.*

120 Ariz. at 190, n. 5, 584 P.2d at 1181, n. 5 (emphasis supplied; quoting *Ariz. Corp. Comm'n v. Arizona Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415(1959)).

In short, none of the decisions cited in the RO provides that the Commission may lawfully back into the rate of return on FVRB by applying the rate of return to the OCRB to determine the utility's operating income. Instead, they provide that the fair value of the utility's plant and property must be used as its rate base, and that the rate of return must be applied to that rate base. The Commissioners must reject this illegal approach and set Arizona-American's rates based on the fair value of its utility plant and property.

III. THE RECOMMENDED RATE OF RETURN, 6.5%, IS UNREASONABLY LOW AND, IF ADOPTED, WOULD FAIL TO PROVIDE ARIZONA-AMERICAN A REASONABLE RETURN ON COMMON EQUITY CAPITAL.

A. Overview of the Parties' Positions.

The RO adopts Staff's recommended rate of return, 6.5%, based on Staff's capital structure, Staff's cost of long-term debt, and Staff's cost of common equity capital. This rate of return is *less* than the current interest rate on investment grade bonds.

10-Year Treasury Bond	4.85%
20-Year Treasury Bond	5.61%
Moody's Aaa Industrial Bonds	6.18%
Moody's Baa Industrial Bonds	6.87%

Federal Reserve Statistical Release H.15 (May 13, 2004). Although there was some disagreement about the Company's capital structure and its cost of debt, as a practical matter, resolving these disagreements in favor of Staff does not have a material impact on the Company's revenue requirement. The primary area of disagreement is the authorized return on equity.

Arizona-American requested a return on equity of 11.5%. RUCO originally recommended a 9.11% return on equity, but increased its recommendation to 9.61% in its surrebuttal filing. Ex. R-5 at 4; Ex. R-6 at 10. Staff originally recommended a 9.7% return on equity, but reduced its recommendation to 9.0% in its surrebuttal filing. Ex. S-45 at 25; Ex. S-46 at 2. All of the parties agreed that it is appropriate to increase the Company's return on equity by 50 basis points to account for the fact that Arizona-American has more debt in its capital structure than the sample group of publicly-traded utilities used in the witnesses' analyses. RO at 23.

The RO adopts Staff's 9.0% recommendation. In doing so, the ALJ (1) rejected the

equity cost estimates provided by the Company's expert, Dr. Thomas M. Zepp, and accepted Staff's estimates, and (2) ignored the evidence presented by the Company regarding the returns on equity that the comparable utilities are actually earning. *See, e.g.*, Ex. A-49 at 3-4 and Rebuttal Table 1. The ALJ concluded, without authority, that the comparable earnings method "has been replaced by market based corporate finance models." RO at 29.

B. The Legal Standard Applicable to Setting a Utility's Rate of Return.

Over the past 100 years, the United States Supreme Court, as well as various federal and state courts (including Arizona), have held that a regulated utility is entitled to earn a return on equity "commensurate with returns on investments in other enterprises having corresponding risks." *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944). One of the most commonly cited statements of the applicable legal standard is found in *Bluefield Waterworks*:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same part of the country on investments and other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to ensure confidence in the financial soundness of the utility and should be adequate under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.

262 U.S. at 692-93. The criteria set forth in *Bluefield Waterworks* remain applicable today. *See, e.g., Duquesne Light*, 488 U.S. at 314-15 (citing *Bluefield Waterworks*, 262 U.S. at 692-93)); *Sun City Water*, 26 Ariz. App. 304, 306, 547 P.2d 1104, 1109 (quoting *Bluefield Waterworks*), *vacated on other grounds* 113 Ariz. 464, 556 P.2d 1126 (1976); W. Whittaker, "The Discounted Cash Flow Methodology: Its Use In Estimating A

Utility's Cost of Equity," 12 *Energy Law Journal* 265 (1991) ("Under the *Bluefield-Hope* standard, the equity return must enable the utility to (1) attract additional capital on reasonable terms (the capital attraction standard); and (2) realize a return on equity commensurate with the returns earned by enterprises with comparable risks (the comparable earnings standard).").

C. The ALJ's Rejection of the Company's Evidence on Cost of Equity, Including the Actual Earnings of the Comparable Utilities, is Arbitrary and Unreasonable.

It would seem axiomatic that in analyzing the returns on equity earned by a group of publicly traded companies under the comparable earnings standard, the starting point is what those companies are actually earning. In fact, that is what this Commission has traditionally done. For example, in *Litchfield Park*, the Commission Staff used comparable earnings, along with the Discounted Cash Flow ("DCF") model and an analysis of firm-specific risks, to develop its recommended rate of return. 178 Ariz. at 436-37, 874 P.2d at 993-94. *See also Citizens Utilities*, 120 Ariz. at 190-91, 584 P.2d at 1181-82 (describing comparative earnings methodology used by Staff's witness); *Sun City Water Co. v. Ariz. Corp. Comm'n*, 26 Ariz. App. at 309-10, 547 P.2d at 1109-10 (the Commission "must appraise the equity earnings of other utilities and non-regulated companies and use this appraisal in setting the allowed rate of return on the equity component in the cost of capital").

Staff's proxy group have earned the following returns on equity:

	2000	2001	2002	2003
American States	9.3%	10.1%	9.5%	5.6%
California Water	10.1%	7.2%	9.5%	7.9%
Philadelphia Suburban[10]	11.7%	12.4%	12.7%	12.3%

[10] Earlier this year, Philadelphia Suburban Corporation's name was changed to Aqua America. (footnote continued on next page)

Connecticut Water	12.1%	12.1%	10.9%	11.2%
Middlesex Water	7.1%	9.1%	9.6%	8.2%
SJW Corp.	7.4%	9.4%	9.3%	9.8%
Average Actual ROE	9.6%	10.1%	10.3%	9.2%

Ex. A-83; *C.A. Turner Utility Reports*, May, 2004 (copy attached at Tab A). The water utilities currently reporting the lowest equity returns, American States Water and California Water Service, received substantial rate increases during the past nine months, which will result in increased earnings. *See In the Matter of the Application of Southern California Water Company*, Decision No. 0403039 (March 16, 2004) 62-73.[11] The California Public Utilities Commission ("CPUC") granted American States rate increases of $8 million in the year 2003 as well as additional increases of $1.9 million in 2004 and $2.8 million in 2005. The CPUC granted California Water Service rate increases of $12.8 million in 2003, and additional increases of $2.2 million in 2004 and in 2005. In approving these increases, American States was authorized a 9.9% return on equity, while California Water Service was authorized a 9.7% return on equity. In other recent rate decisions issued by the CPUC, Suburban Water Systems was authorized a 9.84% return on equity for 2003-2005, and California-American Water Company was authorized a 10.25% return on equity for the same period. *Id.* at 73, n. 44.[12]

(footnote continued from previous page)

To be consistent with the record, the Company will continue to refer to that water utility as Philadelphia Suburban.

[11] Southern California Water Company is American States' primary utility subsidiary. *See* Ex. A-83.

[12] While criticizing the comparable earnings method, RUCO ultimately acknowledged that recent authorized equity returns are relevant by citing in its post-hearing reply brief a decision issued in January 2004 by the West Virginia Public Utilities Commission, in which a 7.0% return on equity was authorized for West Virginia-American Water. RO at 28. That decision, which is on appeal, (footnote continued on next page)

The foregoing equity returns are significantly higher than the results produced by the versions of the finance models used by Staff and RUCO:

Staff Cost of Equity Estimates	
DCF (Constant Growth)	8.4%
DCF (Multi-Stage)	9.6%
CAPM (Historic Risk Premium)	8.0%
CAPM (Current Risk Premium)	8.1%
Staff Average ROE	8.5%

RUCO Cost of Equity Estimates	
DCF (Constant Growth)	9.11%
CAPM (Geometric Mean)	6.79%
CAPM (Arithmetic Mean)	8.06%
RUCO Average ROE	7.99%

Ex. S-46, Schedule JMR-S7; Ex. R-5, Schedules WAR-3 and WAR-8.[13]

Obviously, something is wrong with the finance models used by Staff and RUCO when those models consistently produce returns below the returns the sample group of water utilities is actually earning and is authorized to earn. Neither Staff nor RUCO's cost of capital witness offered any credible explanation for this result. In fact, during the

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(footnote continued from previous page)

is an outlier. As shown in the schedule attached at Tab B, since 2002, the equity returns authorized for other American Water Works utility subsidiaries by other public utility commissions have averaged 10.17%.

[13] To RUCO's credit, its final recommendation, 9.61%, is based on its DCF model estimate (9.11% plus 50 basis points for leverage). RUCO appropriately disregarded the obviously low results produced by the CAPM. *See* Ex. R-5 at 7. Staff, in contrast, simply averaged the results of its CAPM to lower the rate of return.

pendency of this rate proceeding, Staff's recommended cost of equity dropped from 9.7% to 9.0% within a period of less than 60 days. *Compare* Ex. S-45 at 25 (filed Sept. 5, 2003) *with* S-46 at 2 (filed Oct. 31, 2003). This drop in Staff's recommended equity return is especially puzzling in a period in which interest rates were increasing from historic lows. Ex. A-50 at 14, 23-26 and Rejoinder Table 6. This casts additional doubt on the validity of Staff's methods.

It is also telling that the results produced by Staff's finance models are less than recent returns authorized by the CPUC for American States, California Water Service and California-American Water. California uses projected test years and various forward-looking regulatory mechanisms that reduce business and regulatory risk, such as balancing accounts for purchased water and purchased power and memorandum accounts for significant expenses and capital costs, and allows construction work in progress to be included in rate base. For this reason, authorized returns in California have generally been *lower* than authorized returns in Arizona, which uses an historic test year and generally does not allow the recovery of expenses outside of a general rate case. *See, e.g., In the Matter of the Application of Arizona Water Company*, Decision No. 66849 (March 22, 2004) at 13-14 (adopting Staff's recommendation that the utility's purchased water and purchased power adjustment mechanisms be discontinued). In short, even though Arizona uses an historic test year and disfavors forward-looking cost recovery techniques, recent returns on equity approved by this Commission are less than the returns approved in California and other jurisdictions that employ more progressive regulatory techniques.[14]

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[14] Arizona Water, for example, was authorized a return on equity of 9.2% in Decision No. 66849 last March as compared to the 9.9% return authorized that same month for Southern California Water Company. Arizona Water's capital structure contains only 32% debt, while Arizona-American's capital structure contains 60% debt. Using Staff's recommended equity return for Arizona Water and adding 50 basis points for Arizona-American's leverage produces a return on equity of 9.7% in this case, which is still below the returns authorized in California.

In contrast, the versions of the finance models used by Arizona-American's expert, Dr. Thomas Zepp, do produce results consistent with actual and authorized returns on equity. Dr. Zepp's updated estimates, presented in his Rebuttal Testimony, are:

Dr. Zepp Cost of Equity Estimates	
DCF (Water Companies)	10.5%
Risk Premium (Past Water Utilities' ROEs)	11.0 – 11.2%
Risk Premium (Natural Gas Utilities' ROEs)	10.4 – 10.7%
Risk Premium (Moody's Gas Stock Index)	10.3 – 10.9%
Average	10.5 – 10.8%

Ex. A-49 at 5-6 and Update Table 24. The average of Dr. Zepp's estimates, 10.5% to 10.8%, are consistent with actual and authorized returns for Staff's water utility sample group, set forth above.[15]

Dr. Zepp also restated the equity cost estimates made by Staff and RUCO, using the same finance models but with more reasonable assumptions. The cost of equity produced by these restatements is, again, consistent with the actual returns:

	Equity Costs For Water Utility Sample	Equity Cost for Arizona-American
DCF Estimates		
Staff	9.8% to 10.1%	10.3% to 10.6%
RUCO	10.1% to 10.9%	10.6% to 11.4%
CAPM Estimates		
Staff	9.9% to 10.1%	10.4% to 10.6%
RUCO	9.8%	10.3%

[15] These equity cost estimates do not include the additional 50 basis points that, as discussed above, the Company, Staff and RUCO have agreed should be added to reflect the additional debt in the Company's capital structure.

Estimated Equity Cost Range for Arizona-American	10.3% to 11.4%

Ex. A-50 at 10-14 and Rejoinder Table 14.

Finally, as noted above, during the pendency of this case, interest rates have continued to increase. Despite acknowledging that at the time his direct testimony was prepared interest rates were at their lowest level since the 1950s (Ex. S-45 at 5), the Staff witness strongly criticized Dr. Zepp for using forecasted interest rates in implementing the Risk Premium and CAPM models, both of which rely heavily on interest rates. *E.g.*, Ex. S-46 at 17 ("the Commission should not rely on a forecasted interest rate that was likely predicted with no more accuracy than that of a coin toss"). It turns out, however, that the interest rate forecasts used by Dr. Zepp are somewhat conservative:

	Reiker Direct May 6, 2003	Reiker Surrebuttal Sept. 25, 2003	Forecasted Interest Rates Used by Zepp	Current Interest Rates May 13, 2004
5-Year Treasury Note	2.74%	3.05%	3.7%	4.01%
7-Year Treasury Note	3.38%	3.59%	N/A	4.46%
10-Year Treasury Note	3.80%	4.12%	4.6%	4.85%
Average	3.3%	3.6%	4.2%	4.4%

Ex. S-45 at 23 n. 11; Ex. A-50 at 24-26 and Rejoinder Table 6; Federal Reserve Statistical Release H.15 (May 13, 2004). The ALJ nevertheless accepted Staff's argument that Dr. Zepp's use of forecasted interest rates is suspect, and rejected his Risk Premium estimates in favor of Staff's outdated "spot" interest rates, which do not reflect current capital costs. RO at 29-30.

In short, there is no disagreement that the methods used by the cost of capital witnesses for the Company, Staff and RUCO – the DCF model, the Risk Premium model,

and the CAPM model – are all recognized methods of estimating the cost of equity. *E.g.*, Roger A. Morin, *Regulatory Finance: Utilities Cost of Capital* 28 (1994) ("There are four generic methodologies available to measure the cost of equity: DCF, Risk Premium, and CAPM, which are market-oriented, and Comparable Earnings, which is accounting oriented."). *See also* Charles F. Phillips, Jr., *The Regulation of Public Utilities*, 394-99 (discussion of approaches commonly used to estimate the cost of equity). There is considerable disagreement, however, regarding how these methodologies should be employed. Regardless of the method used, however, it should produce results that are consistent with reality. Here, the ALJ has rejected the Company's cost of equity estimates, and concluded that "the methodology and variables used by Staff," such as Staff's September 25, 2003 spot interest rates in the table above, are "reliable and reasonable." RO at 31. The data presented by the Company on the actual returns of the water utilities used as proxies for Arizona-American, which conflict with the results of Staff's models, is summarily rejected. This is arbitrary and unreasonable, and results in an overall rate of return that is less than the current yield on an investment grade bond.

IV. THE AMOUNT OF RATE CASE EXPENSE RECOMMENDED IN THE RO IS UNREASONABLE.

This has been a lengthy, complicated and difficult rate proceeding, and Arizona-American has been required to devote extensive resources in its prosecution. At the end of some 18 months, there will have been five applications concerning 115,000 customers, 10 parties, hundreds of data requests, five rounds of prefiled testimony, 9 days of hearings, over 100 hundred marked exhibits, over 1,000 pages of hearing transcripts, two rounds of post-hearing briefs, written exceptions and an Open Meeting before the Commissioners. *See* Tr at 799-802. As a consequence, the Company's witnesses testified that as of November 2003 (i.e., prior to the hearing) its total rate case expense for this proceeding exceeded $1 million, and that total rate case expense would likely be between $1.3 million

and $1.4 million. RO at 18. Nevertheless, the Company requested recovery of only $715,000 in rate case expense, amortized over three years. RO at 18. As explained by Company witness David Stephenson, Arizona-American recognizes that some of its rate case expense needs to be absorbed by the Company. Tr. at 488.

Staff supported the Company's requested recovery of rate case expense and included an amortized portion of the $715,000 in its recommendations. Exs. S-15 through S-24. However, RUCO opposed the Company's request.[16] RUCO recommended that the Company be allowed to recover $418,941 in rate case expense, which amount is based on the amount that Citizens was allowed to recover in its last rate proceeding in 1997 covering only the Maricopa County systems, adjusted for inflation.

The RO adopts RUCO's recommended rate case expense, concluding that "the Company chose the test year" and that "ratepayers should not be made to bear the burden of the Company's choices to incur unreasonable increase in expenses." RO at 20. It is unclear what increased expenses the RO refers to, and there is no evidence that the choice of test year had a material impact on the level of rate case expense incurred or sought by the Company. Moreover, in adopting RUCO's position, the ALJ again largely ignored the evidence presented by the Company.

First, the ALJ's conclusion that the selection of 2001 as the test year supports lower rate case expense recovery is erroneous. Although RUCO made that argument, claiming that use of a 2001 test year resulted in a substantial amount of additional and unnecessary rate case expense, it failed to produce evidence to support its claim. The evidence before the Commission irrefutably shows that the bulk of the activities

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[16] The RO states that "only the Company disputed RUCO's proposal" concerning rate case expense, which is misleading. RO at 19. In fact, no other party supported RUCO's punitive amount of rate case expense, and no other party used RUCO's amount of rate case expense in its recommendations. Instead, the other parties used the Company's requested expense amount.

associated with the rate case would have been precisely the same if the Company had delayed its filing. *E.g.,* Tr. at 136-38, 1532-44; Ex. A-102. The most labor-intensive aspect of this case related to the development of plant-in-service and rate base schedules, in accordance with A.A.C. R14-2-103, the Commission's rule governing applications for rate increases. Nearly 80% of the data requests served on the Company pertain to plant-in-service issues. The use of a later test year would not have simplified or eliminated issues relating to plant. Instead, those issues would have been exacerbated by further delay because, as the RO states on page 18, plant records and other historic data were held by another company, Citizens, which no longer existed and no longer had any employees. Tr. at 1537-38, 1540-41. Obviously, it would have been more difficult to access and utilize those records if the Company had, for example, filed its rate applications in 2003, utilizing 2002 as the test year.

The only issue that resulted from the selection of a 2001 test year was the dispute over the Company's proposed pro forma adjustment to remove Citizens' test year overheads and salaries and bring in the Company's overheads and salaries, an adjustment supported by RUCO and adopted in the RO. *See* RO at 16-18. However, the amount of additional expense associated with that adjustment is only a small part of the total rate case expense that the Company will incur. *See* Ex. A-102. Ultimately, the amount of rate case expense is a product of the size and complexity of the applications, which would not have been reduced by simply choosing a different test year.

Second, RUCO's recommended rate case expense of $418,941 is unreasonable when compared to other rate proceedings. Citizens' 1995 rate proceeding, the basis for RUCO's recommendation, involved fewer districts, and fewer customers. Tr. at 812. In addition, Citizens employed specific individuals that were assigned the task of prosecuting rate applications, and those expenses were included in the management fees charged to the districts and recovered in rates. Ex. A-74 at 23-24. This is not the case for Arizona-

American, something RUCO ignored in its analysis. In fact, the only factor RUCO considered in utilizing the 1995 proceeding was the inflation rate. Tr. at 812. This is simplistic at best.

By contrast, in Citizens' 1990 rate proceeding for its Mohave water and wastewater districts, the Commission authorized rate case expense of $165,000. *See* Ex. S-4, Decision No. 56806 (February 1, 1990) at 10-11. Had RUCO used that prior Citizens' rate case, and made adjustments for inflation and for the greater number of districts involved in this case (10 districts versus two districts and five applications versus one application), the amount of rate case expense would be far greater than the amount the Company is now requesting. Tr. at 1598. Simply multiplying rate case expense of $165,000, authorized for only two districts, by five results in rate expense of $825,000 – with no adjustment for inflation.

The same is true if the Company's 1996 rate application for the Paradise Valley water district (formerly Paradise Valley Water Company) is used as a comparison. In that case, the Company filed a single application involving one water system with approximately 4,400 customers. Decision No. 60226 (May 27, 1997). The issue of rate case expense was contested, with the Company seeking and the Commission approving $62,200 in rate case expense amortized over two years. *Id.* at 12-13. Adjusting that expense amount for the larger number of districts (10 districts versus one district in that case), and taking into account inflation since 1996 when the application was filed, further illustrates that the amount of rate case expense requested by the Company is reasonable.

Finally, in this proceeding, the Town of Youngtown, which intervened to address a narrow range of issues affecting only the Sun City water and wastewater districts, incurred approximately $70,000 on consultants' fees alone. If legal fees are also included, Youngtown's expenses will be approximately equal to $100,000. Tr. at 1255-57. Certainly, it should come as no surprise that Arizona-American's rate case expense would

be at least seven times the amount Youngtown incurred in connection with its intervention, which related to only two districts and a limited number of issues.

Despite this compelling evidence, the RO would adopt RUCO's argument with little discussion or analysis. The RO implies that the Company failed to "mitigate the costs" associated with retaining outside counsel and consultants to present the Company's case. RO at 20. Again, there is no evidence to support this conclusion. Moreover, to the extent it were true, it is obvious that the Company has mitigated its costs by requesting $715,000 as opposed to its actual rate case expense, which exceeds $1 million. In short, the ALJ's decision to recommend rate case expense in the amount of $418,941, roughly one-third of the amount the Company will actually incur, or approximately $40,000 per district, is contrary to the overwhelming weight of evidence and unreasonable given the size and complexity of this proceeding. Therefore, the Company's requested amount of rate case expense should be approved.

RESPECTFULLY SUBMITTED this 17th day of May, 2004.

FENNEMORE CRAIG

By Norman D. James

Norman D. James
Jay L. Shapiro
Attorneys for Arizona-American Water Company

ORIGINAL and 21 copies of the foregoing were delivered this 17th day of May, 2004, to:

Docket Control
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

COPY of the foregoing was delivered this 17th day of May, 2004 to:

Chairman Marc Spitzer
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Commissioner William Mundell
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Commissioner Mike Gleason
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Commissioner Jeff Hatch-Miller
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Commissioner Kristin Mayes
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Paul Walker, Aide to Chairman Spitzer
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Adam Stafford, Aide to Commissioner Mundell
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Jodi Jerich, Esq., Aide to Commissioner Gleason
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Dean Miller, Aide to Commissioner Hatch-Miller
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Jerry Hays, II, Aide to Commissioner Mayes

Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Teena Wolfe, Esq.
Administrative Law Judge
Arizona Corporation Commission
1200 West Washington
Phoenix, AZ

Timothy Sabo, Esq.
Gary Horton, Esq.
Legal Division
Arizona Corporation Commission
1200 West Washington
Phoenix, AZ

Ernest G. Johnson, Director
Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, AZ

And a copy mailed this 17
day of May, 2004 to:

Daniel Pozefsky, Esq.
Residential Utilities Consumer Office
1110 W. Washington, Suite 220
Phoenix, AZ 85007
Attorney for Intervenor Residential Utility
Consumer Office

William P. Sullivan, Esq.
Larry K. Udall, Esq.
Martinez & Curtis
2712 N. 7th St.
Phoenix, AZ 85006
Attorneys for Intervenor Town of Youngtown

Walter Meek
Arizona Utility Investors Association
2100 N. Central Ave.
Phoenix, AZ 85004
Pro Se

Frank J. Grimmelmann
42441 N. Cross Timbers Court
Anthem, AZ 85086
Pro Se

Raymond E. Dare
Sun City Taxpayers' Association
12630 N. 103rd Ave., Suite 144
Sun City, AZ 85351-3476
Pro Se

Carlton G. Young
3203 W. Steinbeck Dr.
Anthem, AZ 85086
Pro Se

John Buric, Esq.
Warner Angle Hallam Jackson & Formanek
3550 N. Central Ave., Suite 1500
Phoenix, AZ 85012
Attorneys for Intervenor Fiesta RV Resort

Kenneth C. Sundlof, Jr., Esq.
Jennings, Strouss & Salmon
The Collier Center, 11th Floor
201 E. Washington St.
Phoenix, AZ 85004-2385
Attorneys for Intervenor Sun Health Corporation

By Mary House

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A

ARIZONA-AMERCIAN WATER COMPANY

Requested and Approved Returns on Equity
In Recent Rate Cases of Affiliates

Name of Affiliate	Effective Date of Order	Requested ROE	Approved ROE
California-American (Monterey)	Feb. 23, 2003	10.68%	10.26%
ETown Water Company (N.J.)	Feb. 18, 2004	11.25%	9.75%
Hawaii-American Water Company	Apr. 22, 2004	10.90%	10.60%
Illinois-American Water Company	Aug. 12, 2003	11.02%	10.27%
Indiana-American Water Company	Nov. 6, 2002	11.50%	10.50%
Iowa-American Water Company	Feb. 21, 2002	11.33%	10.45%
Missouri-American Water Company	April 16, 2004	11.00%	10.00%
New Jersey-American Water Company	Feb. 18, 2004	11.25%	9.75%
New Mexico-American Water Company	Dec. 12, 2003	11.15%	10.08%
Ohio-American Water Company	Feb. 7, 2002	11.75%	10.30%
Pennsylvania-American Water Company	Jan. 16, 2004	12.00%	10.60%
Tennessee-American Water Company	Aug. 7, 2003	11.00%	9.90%
Virginia-American Water Company	Nov 23, 2003	10.75%	9.80%
Average ROE Approved			**10.17%**
West Virginia-American Water Company	Jan. 2, 2004	11.00%	7.00%

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WATER COMPANIES

COMPANY	LATEST 12 MONTHS EARNINGS AVAILABLE	PER SHARE EARNINGS	PER SHARE CURRENT ANNUAL DIVIDEND	DATA (S) BOOK VALUE (1)	DATA (S) STOCK PRICE 4/22	DATA (S) COMMON SHARES O/S MILL	PERCENT (2) DIV PAYOUT	PERCENT (2) DIV YIELD	PERCENT (2) MKT/ BOOK	DIV/ BOOK (2)	PRICE EARN MULT
American States Water Co. (NYSE-AWR)	12/03	0.78	0.88	13.98	24.29	15.2	113	3.6	174	6.3	31.1
Aqua America, Inc. (NYSE-WTR)	12/03	0.79	0.48	7.13	21.00	92.4	61	2.3	294	6.7	26.5
Artesian Resources Corp. (NDQ-ARTNA)	12/03	0.97	0.81	13.53	27.90	3.9	84	2.9	206	6.0	28.8
California Water Service Group (NYSE-CWT)	12/03	1.23	1.13	14.44	29.75	16.9	91	3.8	206	7.8	24.1
Connecticut Water Service, Inc. (NDQ-CTWS)	12/03	1.15	0.83	10.47	27.74	8.0	72	3.0	265	7.9	24.1
Middlesex Water Company (NDQ-MSEX)	12/03	0.61	0.66	7.54	21.20	10.6	108	3.1	281	8.8	34.8
Pennichuck Corporation (NDQ-PNNW)	12/03	0.52	0.86	12.59	26.65	2.4	165	3.2	212	6.8	51.3
SJW Corporation (ASE-SJW)	12/03	1.71	1.02	18.21	37.09	9.1	60	2.8	204	5.6	21.6
Southwest Water Company (NDQ-SWWC)	12/03	0.49	0.19	5.43	13.73	14.7	39	1.4	253	3.5	28.0
York Water Company (NDQ-YORW)	12/03	0.70	0.58	6.08	20.38	6.4	83	2.8	335	9.5	29.1
AVERAGE							88	2.9	243	6.9	29.9

WATER COMPANIES

COMPANY	OPER REV $ MILL (1)	% WAT REV	NET PLANT $ MILL	NET PLANT PER $ REV (1)	S&P BOND RATING	MOODY'S BOND RATING	COMMON EQUITY RATIO (3)	% RETURN ON BOOK VALUE COMMON EQUITY (4)	% RETURN ON BOOK VALUE TOTAL CAPITAL	REGULATION ALLOWED ROE	REGULATION ORDER DATE
American States Water Co. (NYSE-AWR)	212.7	88	538.0	2.53	A+	A2	43	5.6	6.0	10.00	4Q/99
Aqua America, Inc. (NYSE-WTR)	367.2	92	1,620.8	4.41	AA-	NR	44	12.3	8.4	10.15	-
Artesian Resources Corp. (NDQ-ARTNA)	36.3	97	157.5	4.34	NR	NR	37	7.4	6.7	10.50	04/03
California Water Service Group (NYSE-CWT)	277.1	97	669.0	2.41	NR	A2	46	8.7	7.5	9.70	-
Connecticut Water Service, Inc. (NDQ-CTWS)	51.1	92	194.6	3.81	A	NR	52	11.2	8.9	12.70	-
Middlesex Water Company (NDQ-MSEX)	64.1	87	210.8	3.29	A+	NR	41	8.2	6.2	10.38	-
Pennichuck Corporation (NDQ-PNNW)	21.4	87	63.8	2.98	NR	NR	51	4.1	5.5	10.33	-
SJW Corporation (ASE-SJW)	149.7	98	267.6	1.79	NR	NR	54	9.8	8.1	9.95	04/01
Southwest Water Company (NDQ-SWWC)	173.0	33	138.0	0.80	NR	NR	51	10.2	7.8	9.84	05/03
York Water Company (NDQ-YORW)	20.9	87	103.0	4.93	NR	NR	50	11.7	9.5	-	06/03
AVERAGE							47	8.9	7.5	10.39	