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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 WEST WATER AND WASTEWATER DISTRICTS.

Docket No: WS-01303A-02-0867

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.

Docket No: WS-01303A-02-0868

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 MOHAVE WATER DISTRICT AND ITS HAVASU WATER DISTRICT.

Docket No: W-01303A-02-0869

**RUCO'S INITIAL  
CLOSING BRIEF**

Arizona Corporation Commission  
**DOCKETED**

FEB 04 2004

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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 AGUA FRIA WATER DISTRICT AND ITS ANTHEM / AGUA FRIA WASTEWATER DISTRICT.

Docket No. WS-01303A-02-0870

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 TUBAC WATER DISTRICT.

Docket No. W-01303A-02-0908

**RUCO'S INITIAL CLOSING BRIEF**

**INTRODUCTION**

The Residential Utility Consumer Office ("RUCO") submits the following points in support of its position in the Arizona-American Water Company ("Company or Arizona-American") rate application. RUCO recommends that the Arizona Corporation Commission ("Commission") reject the Company's proposed revenue requirement based solely on a Reconstruction Cost New Depreciated ("RCND") rate base and adhere to the original cost standard traditionally used by the Commission when setting rates and proposed by RUCO and Staff in this case. RUCO further requests that the Commission adopt RUCO's recommended adjustments to operating income, in particular, rate case expense and property taxes. Finally, RUCO recommends the Commission adopt its recommended cost of capital and rate design.

1 **REVENUE REQUIREMENT**

2 The Company proposes a RCND rate base as the sole measure of rate base  
3 quantifying its proposed revenue requirement. RUCO-7 at 8.<sup>1</sup> An RCND rate base  
4 restates the Company's original cost of its assets and liabilities to represent the "current"  
5 cost of those assets and liabilities. Id. at 8. By comparison, an original cost rate base  
6 ("OCRB") values the Company's assets and liabilities based on their original costs. In an  
7 inflationary environment, the RCND rate base will be greater than an OCRB rate base  
8 since it adjusts the costs for inflation. Id. The RCND rate base will also result in an  
9 increase in the Company's revenue requirement merely as a consequence of the  
10 restatement. Id.

11 RUCO does not take issue with the Company's use of RCND as an element in  
12 measuring a fair value rate base ("FVRB") or the figure the Company computed as the  
13 RCND rate base. In fact, RUCO agrees with the Company that the Commission is  
14 required to make a finding of fair value, and consideration of the RCND rate base is  
15 proper. RUCO-8, at 2, Trans., Vol.V at 721. See *Arizona Corporation Commission v.*  
16 *Arizona Water Company*, 85 Az. 198, 202, 335 P.2d 412, 414 (1959)(Where there is  
17 evidence of both original cost less depreciation and reconstruction cost new less  
18 depreciation, the Commission must consider both when determining fair value). However,  
19 the Companies revenue requirement is calculated by multiplying the Company's FVRB by  
20 the Company's cost of capital. See *Scates v. Arizona Corporation Commission*, 118 Az.

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<sup>1</sup> For ease of reference, trial exhibits will be identified similar to their identification in the Transcript of Proceedings. The transcript volume number will identify references to the Transcript.

1 531, 534, 578 P. 2d 612, 615 (Ariz. App. 1978). Therefore, when determining the  
2 appropriate revenue requirement, the Commission needs to consider both the FVRB and  
3 the cost of capital. In this case, both the Company's proposed FVRB and cost of capital  
4 factor in inflation, resulting in an overstated revenue requirement.

5 Historically, the Commission averages a Company's OCRB and its RCND to  
6 determine the Company's FVRB. RUCO-8 at 4-5, Exhibit MDC-A, S-2, S-4, S-5, S-6,  
7 Trans., Vol. II at pp. 183-191. The Commission then computes a rate of return to apply to  
8 the FVRB based on the average of the OCRB and the RCND. Here, the Company  
9 proposes the Commission deviate from its historical approach and apply a rate of return  
10 based exclusively on an OCRB to a RCND rate base. Id. at 9.

11 The Company's proposed original cost of capital, like its proposed RCND rate base,  
12 factors inflation into its computation<sup>2</sup>. RUCO-7 at 9. The Company's original cost of  
13 capital factors inflation in both the cost of debt analysis and the cost of equity analysis. Id.  
14 Thus, the Company's proposed revenue requirement factors inflation in twice, which  
15 explains the substantial difference between the Companies and Staff and RUCO's revenue  
16 requirement. RUCO-7 at 9-10. The Company's proposal should be rejected because it  
17 factors inflation in twice, thereby overstating the Company's proposed revenue  
18 requirement.

19 The Company suggests that a comparison of the OCRB rate base to the RCND rate  
20 base, at least for some its Divisions<sup>3</sup>, indicates that, in fact, the OCRB rate base is greater

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<sup>2</sup> The original cost rate base, as RUCO recommends, does not consider inflation. Applying an original cost of capital to an original cost rate base results in a proper matching. RUCO - 7 at 9.

<sup>3</sup> See Direct Testimony of Thomas Bourassa, Schedule B-1 for the following divisions: Sun City West Water (A-8), Sun City West Wastewater (A-9), Aqua Fria Water (A-13), Aqua Fria Wastewater (A-14), Anthem Water (A-12), Havasu Water (A-11), and Mohave Water (A-10).

1 than the RCND rate base. For example, the Company's rate base schedule for its Aqua  
2 Fria Water Division shows an OCRB rate base of \$29,855,785. A-13, Schedule B-1. The  
3 RCND rate base listed in the same schedule is \$19,019,699. Id. Accordingly, for those  
4 Divisions, which by comparison, have a greater OCRB than RCND rate base, the  
5 Company's schedules leave the impression that the RCND rate base, if anything, is  
6 understated. This impression is misleading - the OCRB rate base figures listed in these  
7 schedules are overstated. Moreover, the OCRB rate base figures listed in Mr. Bourassa's  
8 B-1 schedules for the remainder of the Divisions<sup>4</sup> are also overstated.

9 The OCRB rate base figures are overstated because the Company has wrongly  
10 included an acquisition adjustment in its OCRB rate base calculations. (See B-1  
11 schedules for A-6 – A-15). The acquisition adjustment represents the \$71,637,084<sup>5</sup> in  
12 excess of net book value that the Company paid Citizens Utilities Company ("Citizens") for  
13 the various water and wastewater properties that are at issue in this case. Decision No.  
14 63584 docketed April 24, 2001, Direct Testimony of Donald Stephenson, Exhibit 1. In  
15 Decision No. 63584, the Commission approved a settlement agreement between the  
16 Company and Staff wherein the Company agreed to Staff's recommendations if adopted  
17 by the Commission. Decision No. 63584 at 15. The Commission adopted Staff's  
18 recommendation which provided that the Company could not recover the acquisition  
19 premium in a future rate case unless the Company could substantiate the net benefits. Id.  
20 In this case, filed approximately one and a half years after that Decision, the Company has

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23 <sup>4</sup> See Direct Testimony of Thomas Bourassa, Schedule B-1: Sun City Water (A-6), Sun City Wastewater (A-  
7), and Tubac Valley Water (A-15).

24 <sup>5</sup> The Company allocated the acquisition adjustment for each Division based on gross plant. Transcript, Vol. II at 132.

1 not even attempted to substantiate the net benefits—yet it has included the acquisition  
2 premium in its ratemaking schedules.

3 According to the Company, the acquisition adjustment was included in the OCRB  
4 rate base for accounting purposes<sup>6</sup>. A-74, at 10, Transcript, Volume III at 371. However,  
5 the schedules submitted by the Company in support of its application were submitted for  
6 ratemaking purposes, not accounting purposes. For ratemaking<sup>7</sup> purposes, even the  
7 Company concedes the acquisition adjustment should not be recorded on its books. A-74  
8 at 10. Including the acquisition adjustment in the OCRB rate base only leaves the  
9 mistaken impression that the OCRB rate base is \$71,637,084 greater than it should be,  
10 which, in turn, makes the RCND rate base appear more reasonable. The Commission  
11 should exclude from consideration the acquisition adjustment when comparing the RCND  
12 rate base to the OCRB rate base<sup>8</sup>.

13 In sum, the Company's proposal to apply a rate of return based on an original cost  
14 rate base to a RCND rate base, would, if approved, be inconsistent with this Commission's  
15 traditional ratemaking formula. It would also set a dangerous precedent by providing  
16 utilities filing future rate applications a strong incentive to restate their rate base and capital  
17 costs in order to maximize their revenue requirement. Moreover, the Company has failed  
18 to show a reason why this Commission should depart from its traditional ratemaking  
19 formula and adopt a formula which will invariably result in an overstated revenue

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21 <sup>6</sup> Interestingly, the Company's witness on this subject, David P. Stephenson, is familiar with the accounting  
22 treatment as it relates to the OCRB rate base, but has "no idea" of whether accounting principles apply to the  
RCND rate base. Transcript, Vol. III at 371.

23 <sup>7</sup> Mr. Stephenson actually uses the term "valuation" which RUCO equates with ratemaking in the context it  
was used.

24 <sup>8</sup> Counsel for RUCO, argued in his opening statement that the Company should not "have its cake and eat it  
too". Counsel's reference addressed this very point—that for comparison purposes the Company should not  
be able to include the acquisition adjustment in the OCRB rate base while also being allowed to defer its  
obligation to substantiate the net benefits resulting from the transfer.

1 requirement. The Commission should reject the Company's proposed revenue  
2 requirement.

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4 **RATECASE EXPENSE**

5 The Company has requested \$715,000 in rate case expense. A-74 at 23. The  
6 Company further requests that its rate case expense be amortized over three years. Id.  
7 The Company based its rate case expense on its estimated completed cost at the time it  
8 filed its application. RUCO-7 at 25. At the time of the hearing, the Company claims to  
9 have incurred over one million dollars, but is only seeking the amount it originally  
10 requested. Trans, Vol. IX at 1593. RUCO believes that the Company's request is  
11 unreasonable and recommends that the level of rate case expense be reduced to  
12 \$418,941. RUCO-7 at 26. For the following reasons, the Company failed to mitigate its  
13 rate case expense and the Commission should adopt RUCO's proposed rate case  
14 expense.

15 As with any expense the Company seeks to recover from ratepayers, the Company  
16 is responsible for maintaining control over that expense and avoiding excess costs which  
17 contribute to that expense. At the point where the proposed expense exceeds what is  
18 reasonable under the circumstances, it should be the shareholders, and not the  
19 ratepayers, who become responsible for the excess expense. Otherwise, Companies  
20 could act without restraint, and have no incentive to act diligently when incurring expense.  
21 The Commission should not encourage such an open checkbook policy.

22 By the Company's own admission, its proposed rate case expense is a "... fairly  
23 large request on an overall basis." Trans., Vol. IX at 1594. The Company justifies its large  
24 proposal on the amount of time that it had to spend and the large number of issues it had

1 to consider in reconciling plant and working with the revenue issue to reconcile revenues.  
2 Id. According to the Company, it had little choice in the number of hours attorneys and  
3 outside consultants were required to spend. A-75 at 5. The number of issues and the  
4 actions of the other parties, argues the Company, drove those high costs. Id. The  
5 Company further argues that the number of districts involved (ten) as well as the number  
6 of customers contributes to its large rate case expense. For example, the Company  
7 claims that the two customer notices required for the filing of the rate application and the  
8 approval of rates will result in rate case expense of as much as \$80,000.

9 The excessive rate case expense incurred by the Company, however, was the  
10 result of its misguided and unorthodox approach to this rate case. The Company chose as  
11 its test year the period ending December 31, 2001. Direct Testimony of David Stephenson  
12 at 6. The Company's purchase of Citizen's assets formally closed on January 15, 2002.  
13 Id. Hence, another company, Citizens, that no longer existed and no longer had any  
14 employees, held all of the data that the Company used in determining the historical test  
15 year. Trans., Vol. V at 782. The Company now had the added burden of obtaining the  
16 data from Citizens and then verifying it for accuracy. The Company also requested  
17 numerous proforma adjustments which, because of the transfer, would require an audit of  
18 not just the Company, but of Citizens, to reconcile the data. Typically, reconciliation of  
19 proforma adjustments only requires an audit of one company. Id. at 783. Whereas, had  
20 the Company waited a couple of years after the transfer to file its rate case as utilities  
21 normally do, it would have established a baseline ordinary level of operating expenses and  
22 revenues. Trans., Vol. V at 783. It could have then used a historical test year based on its  
23 own operations, thereby reducing the amount of work required by two audits.

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1 Next, the Company has spent an exorbitant amount of time and resources trying to  
2 convince this Commission to deviate from a formula it has utilized to determine revenue  
3 requirement for as long as the Commission has been hearing rate cases. While RUCO is  
4 not suggesting that the Company should be denied the right to present this argument,  
5 RUCO is suggesting that the ratepayers should not be charged for the monumental effort  
6 and resources necessary to present the Company's argument. The Company willingly  
7 admits that it had little choice in the amount of time its outside professionals spent on this  
8 case. A-75 at 5. It should be the Company, and not its experts, who control the  
9 Company's rate case expense. The rate case expense incurred by this Company in this  
10 case, standing alone, can serve as the basis for a rate application.

11 Moreover, for the reasons stated in the revenue requirement section of this Brief,  
12 the Company's revenue requirement argument lacks merit and not surprisingly, results in a  
13 revenue requirement substantially higher than that recommended by Staff and RUCO.  
14 The Commission should reject the Company's proposed rate case expense.

15 RUCO considered what would be a fair amount of rate case expense under the  
16 circumstances. RUCO considered the Arizona Water case presently pending before the  
17 Commission. Docket No. W-01445A-02-0619. In Arizona Water, the utility filed for a rate  
18 increase for utility services furnished by its Eastern Division, consisting of eight separate  
19 Divisions. RUCO noted that in Arizona Water, the utility originally requested \$257,550 in  
20 rate case expense—approximately 40% of what Arizona American is asking in the subject  
21 case. The utility subsequently modified its initial request to \$329,550. The Administrative  
22 Law Judge issued his Recommended Opinion and Order ("ROO") on January 2, 2004 and

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1 recommended the Company be allowed \$250,000<sup>9</sup> for rate case expense. The ALJ  
2 compared that case to the Company's Northern Division case<sup>10</sup> and noted that, at some  
3 point, Arizona Water must mitigate the costs associated with preparing and litigating its  
4 rate case filings.

5 Similarly, RUCO compared the rate case expense awarded to Citizens in its last  
6 rate case (\$366,231, Decision No. 60172, docketed May 7, 1997 at 31). RUCO's  
7 recommendation was calculated by adjusting Citizens' prior rate case expense by the  
8 change to the Consumer Price Index to reflect current prices. RUCO-7 at 26. The result,  
9 while still significantly higher than the amounts the Commission has historically awarded  
10 water companies, is reasonable under the circumstances of this case. The Commission  
11 should adopt RUCO's recommended rate case expense.

12

### 13 **COST OF CAPITAL**

14 RUCO believes the Commission should adopt RUCO's recommended rate of return  
15 of 6.77 percent, which is the weighted cost of RUCO's recommended costs of debt and  
16 equity capital. R-6 at 10.

17 RUCO believes that the 9.61 percent cost of common equity is appropriate given  
18 the current environment of low inflation and low interest rates that Arizona is operating in.  
19 Id. at 14. RUCO further believes that the 9.61 percent cost of common equity estimated by  
20 RUCO witness William A. Rigsby is very reasonable when the Company's debt heavy  
21 capital structure is taken into consideration and when Mr. Rigsby's discounted cash flow

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23 <sup>9</sup> See Recommended Opinion and Order, Docket No. W-01445-02-0619, docketed January 2, 2004, at  
24 pages 14-15. That matter has yet to be scheduled for Open Meeting.

<sup>10</sup> Where the Commission approved rate case expense of \$217,000. ROO at 15, Decision No. 64282.

1 growth rate estimates are compared with the growth estimates of other independent  
2 analysts. R-5 at 38, 40, Schedule WAR-10.

3

4 **PROPERTY TAXES**

5 RUCO's recommended property tax expense calculation was based on the Arizona  
6 Department of Revenue's ("ADOR") property tax formula. R-2 at 2. The property tax  
7 formula, as prescribed in ADOR's memo to the Company dated January 3, 2001, values  
8 the Company, for property tax purposes, by multiplying the average of the three previous  
9 years of reported gross revenues of the company by a factor of two (2). Id., Exhibit 1.

10 The Company has misinterpreted the clear meaning of the ADOR directive to  
11 require it to use for valuation purposes the adjusted test-year (2002) twice and its  
12 proposed level of revenues for 2004 once. Id. RUCO, for valuation purposes, has  
13 properly included the test year (2001) and the prior two years (1999, 2000) as directed by  
14 ADOR. The Commission should adopt RUCO's recommended property tax expense as it  
15 complies with the ADOR directive.

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17 **MISCELLANEOUS ISSUES**

18 Payroll Expense Capitalization Rate – RUCO recommends that the Commission adopt a  
19 Company wide capitalization rate and not the 2002 capitalization factors for each system  
20 proposed by the Company. RUCO-8 at 8. RUCO's recommendation considers the  
21 desirability of setting rates to reflect an average capitalization factor in order to capture the  
22 year-to-year ebb and flow of construction projects. Id. at 9.

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1 Tolleson Agreement – Pursuant to Commission Decision No. 66387, the Company has  
2 authority to accrue plant improvement costs and recover these costs once the  
3 expenditures have been made and the plant is in service. Therefore, RUCO disagrees  
4 that an adjustor mechanism is appropriate to recover these costs. Id. at 14-15.

5  
6 Additional Corporate Overhead - RUCO recommends that the Commission adopt its  
7 calculation of projected corporate overhead expense of \$4,216,091. R-3, Schedule RLM-  
8 14, R-4 at 9.

9  
10 AIAC & CIAC – RUCO recommends that the Commission adopt its adjustment to correct  
11 an error in the Company's test year AIAC balance. R-1 at 10.

12  
13 Rate Design – RUCO recommended a rate design that has maintained the same  
14 relationships between meter sizes, allocations between minimums and commodity rates,  
15 and tier systems as with the current system. The Company did not offer a cost of study,  
16 thus, there is no database to support widespread changes to the existing structure.  
17 RUCO-7 at 31. RUCO, however, remains open to other possible rate designs provided  
18 that, in the end, there is an equitable distribution of rates to each respective class.

19  
20 **CONCLUSION**

21 RUCO recommends the Commission reject the Company's proposed revenue  
22 requirement and adopt RUCO's proposed revenue requirement based on the  
23 Commission's historical use of an OCRB rate base. RUCO further recommends the  
24 Commission adopt its proposed rate case expense, property tax expense and other

1 proposed adjustments to operating income. RUCO's proposed cost of capital and rate  
2 design are also fair and reasonable and should be adopted by the Commission. Finally,  
3 the Commission should adopt RUCO's proposed payroll expense capitalization rate and  
4 RUCO's position that an adjustor mechanism is not necessary to recover the accrued plant  
5 improvement costs under the Company's agreement with Tolleson.

6  
7 RESPECTFULLY SUBMITTED this 4<sup>th</sup> day of February, 2004.

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10 Daniel W. Pozefsky  
11 Attorney

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