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BEFORE THE ARIZONA CORPORATION COMMISSION

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| IN THE MATTER OF THE APPLICATION OF CHAPARRAL CITY 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 FOR UTILITY SERVICE BASED THEREON. | Docket No. W-02113A-04-0616 |

**RUCO'S INITIAL CLOSING BRIEF**

## INTRODUCTION

The Residential Utility Consumer Office ("RUCO") submits the following points in support of its position in the Chaparral City Water Company's ("Company or Chaparral") rate application. RUCO recommends that the Arizona Corporation Commission ("Commission") reject the Company's proposed revenue requirement based on the application of an Original Cost Rate of Return ("OCROR") to a Fair Value Rate Base ("FVRB"), and instead adhere to the traditional method used by the Commission when setting rates and as proposed by RUCO and Staff in this case. RUCO further requests that the Commission adopt its recommendations regarding the following:

1) Rate Base – RUCO recommends the Commission exclude from rate base the extension of the Fountain Hills Boulevard Main ("Main") and reclassify test-year hook-up fees as Contributions In Aid Of Construction ("CIAC").

2) Operating Income – RUCO recommends the Commission adopt its test-year depreciation expense adjustment based on RUCO's recommended total plant value and RUCO's proposed depreciation rates. RUCO also recommends the Commission adopt its adjustment to property tax expense based on the formula used by the Arizona Department of Revenue ("ADOR").

3) Purchased Water and Purchase Power Adjustment Mechanisms – RUCO recommends that the Commission deny the Company's request for automatic adjustors for purchased water and purchased power.

4) Rate Design - RUCO recommends the Commission adopt its proposed three-tier inverted block structure.

5) Cost of Capital – RUCO recommends the Commission adopt its 7.66% weighted average cost of capital.

Finally, RUCO recommends the Commission adopt its positions on several miscellaneous issues described more fully below.

**REQUIRED OPERATING INCOME METHODOLOGY**

The Company proposes applying an OCROR to an FVRB to derive its operating income. A-6 at 3.[1] The Company's recommendation of applying an OCROR to an FVRB

[1] For ease of reference, trial exhibits will be identified similar to their identification in the Transcript of Proceedings. The Transcript page number will identify references to the Transcript.

accounts for inflation more than once resulting in an overstatement of required operating income. Id. at 8. The Commission has historically applied a Fair Value Rate of Return ("FVROR") to an FVRB which provides for an appropriate accounting of inflation. R-6 at 3. The Commission should reject the Company's flawed method of calculating required operating income.

The Company claims that Staff's and RUCO's revenue requirements are based solely on OCRB. According to the Company, by determining the revenue requirement in this way, Staff and RUCO have rendered meaningless the Constitutional requirement that the Commission determine the fair value of the Company's plant. A-5 at 3. The Company's argument lacks merit.

The Commission determines a company's operating income by multiplying its rate base by its cost of capital. In determining the Company's ratebase the Constitution requires the Commission to make a finding of fair value. Such a finding requires consideration, where evidence has been presented, of both the Reconstruction Cost New Less Depreciation ("RCND") ratebase and the OCRB. See Arizona *Corporation Commission v. Arizona Water Company*, 85 Az. 198, 202, 335 P.2d 412, 414 (1959)(Where there is evidence of both original cost less depreciation and reconstruction cost new less depreciation, the Commission must consider both when determining fair value). Historically, and consistent with both the Arizona Constitution and the *Arizona Water Company* case, the Commission averages a Company's OCRB and its RCND rate base to determine the Company's FVRB. R-6 at 3. The Commission then computes an FVROR to apply to the FVRB.

In the Company's application, the Company proposes the Commission deviate from its historical approach of applying an FVROR to an FVRB and instead apply an OCROR to an FVRB rate base. A-6 at 3. Staff correctly concludes that: "Windfall gains (losses) would result whenever the FVRB is greater (less) than the OCRB if the Commission multiplied the ROR [OCROR] by the FVRB to determine earnings." S-3 at 33. By simply making this one minor modification to the formula historically used by the Commission, the Company has overstated its required operating income by approximately $443,000. Transcript at 493. The Commission should reject the Company's recommended methodology for determining operating income.

In sum, the Company's proposal to apply an OCROR to an FVRB would, if approved, deviate from the traditional ratemaking formula approved by the Commission and result in an overstated revenue requirement. The Commission should reject the Company's proposal to compute required operating income.

**RATE BASE**

**1) POST-TEST YEAR PLANT**

The Company has requested the inclusion of two specific post-test year plant projects. RUCO has opposed the inclusion of one of those projects – the Fountain Hills Blvd. Main Project ("Main"). The Company is requesting inclusion in ratebase of $940,979 on the basis that the Main improves service and provides greater operational efficiencies. A-1 at 9.

RUCO does not dispute that the Main provides better service or provides greater efficiency. The Company misses the point. RUCO opposes the Main because the Company fails to account for savings which result from the Main. The Matching Principle is a basic tenet of ratemaking, and requires that ratebase be matched with the revenues and expenses of the same time period. Post-test year plant inherently violates the Matching Principle because of the inability to match the post-test year plant with the test year revenues and expenses. S-6 at 8. Therefore, in only very "special and unusual cases" should the Commission recognize post-test year plant. Id.

In analyzing the costs associated with post-test year plant, the Matching Principle requires that the post-test year savings also be recognized. In this case, despite both the Company's[2] and Staff's conclusions to the contrary, the evidence is clear that the Main has resulted in savings to the Company. Prior to the Main being built, water was pushed from the Company's treatment plant through a system of "capillary" mains to reach the Company's service area. Transcript at 37. The purpose of the Main was to transfer water through one large diameter main rather than relying on a series of smaller diameter mains. Id. In Fountain Hills, the service area consists of three separate pressure zones, known as Zone 1, Zone 2 and Zone 3. Id. at 36. Prior to the building of the Main water was pumped from the treatment plant to Zone 2 where it was then gravity fed back to Zone 1 customers[3]. R-9 at 2-3. After the Main was built water was and still is gravity fed directly to customers in Zone 1. By eliminating the need to pump water to Zone 2 to service its Zone 1 customers, the Company saves on pumping costs. Id., Attachment 5.02 (C), Feasibility Study at 13 and 15. The Commission should offset the operating expenses by the savings[4].

Yet, despite the overwhelming evidence to the contrary, Staff denies there are savings, and the Company does not know whether there are savings. RUCO has shown, through the feasibility study presented to RUCO by the Company, and prepared for the Company in analyzing the cost/benefits of the Main, that the Main results in savings. Id. Moreover, neither the Company's nor Staff's position makes sense. The fact that the Company no longer has to pump water to Zone 2 to service its Zone 1 customers not only is more efficient, but is less

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[2] The Company does not know if the Main produces savings. Transcript at 40.
[3] Incredibly, despite the Company's explanation of how water was delivered to Zone 1 customers before the Main was built, Staff maintains that there were no pumping costs involved prior to the Main being built. Transcript at 636-638. Staff's determination that there were no savings resulting from the Main appears to be based on it's engineer's conclusion that there were no pumping costs prior to the Main being built. See Transcript at 664-669.

costly. In this case, efficiency equates to savings. The Commission should not allow the Main costs without quantifying the savings.

### 2) RECLASSSIFICATION OF HOOK-UP FEES

RUCO supports the Company's adjustment to remove hook-up fees from operating revenue and treat the hook-up fees as Contributions in Aid of Construction ("CIAC"). RUCO does not support the Company's failure to include the hook-up fees in the test-year CIAC balance. RUCO recommends the Commission approve an adjustment to include the hook-up fees in the test-year CIAC balance.

The argument on this issue merits no further analysis beyond the simple fact that it is **ratepayers** who pay the hook-up fees and it is the ratepayers who should get recognition for paying the hook-up fees. The Company, however, wants to remove the hook-up fees from the test year revenues and make no corresponding adjustment to CIAC to recognize that the customers are financing a portion of the plant. The result of this omission is to allow the Company's shareholders to earn a return on $222,000 of plant that customers financed.

The Company argues that increasing the CIAC balance by the amount collected in the test-year constitutes *retroactive* ratemaking. A-5 at 22. The Company believes that increasing the test year CIAC balance by the amount of the hook up fees is equivalent to recalculating and restating accumulated depreciation by using proposed new depreciation rates. Id.

The Company's argument has no merit and is a weak attempt to mask the obvious result. By simply removing the hook-up fees from revenue and failing to reclassify the revenues, the Company's proposal improperly inflates the rate base on a going forward basis

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[4] Since the Company is requesting inclusion of this post-test year plant, the burden is on the Company to

and imbeds higher rates. R-6 at 7. The Commission should reclassify the test year hook-up fees in CIAC, thereby ensuring that ratepayers are credited with monies they have contributed to the Company.

## OPERATING INCOME

### 1) DEPRECIATION EXPENSE ADJUSTMENT

The issue here comes down to what are appropriate depreciation rates. The Company calculated its depreciation expense based on rates it claims are typically recommended by Commission Staff. R-5 at 16. The Company considered as "typical" the depreciation rates recently approved by the Commission in the Rio Rico rate case. R-6 at 8. Rio Rico's depreciation rates are not "typical" but are among the highest rates the Commission has recently approved. Id. at 9. The Commission should adopt depreciation rates that are truly typical of what the Commission has approved in recent rate case filings.

Ideally, the Company could have submitted a depreciation study which would have provided a definitive set of depreciation rates. A depreciation study would have allowed the parties to conduct an analysis based on company specific information. In lieu of such an analysis it is appropriate to compare recently approved depreciation rates derived from both plant-category specific rates and also flat rates. R-6 at 9.

A comparison of recently approved depreciation rates in the Arizona-American Water Company case to the Rio Rico rates illustrates the atypical, high rates being recommended by the Company. In Arizona-American, as the Company highlights in its analysis, the composite rates for each of the water districts are; Sun City West – 2.86%, Sun City – 2.80%, Anthem – 2.45%, Aqua Fria – 2.67%, Mohave – 3.99%, Tubac – 2.56%. A-5 at 25. By comparison, the composite rate for Rio Rico is approximately 3.00% and the Company's composite rate is

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establish the plant value, taking into account both the cost and the savings.

3.35%. Id. Clearly, the Rio Rico rate is not "typical" of the other rates. The Commission should not approve the Company's proposed depreciation expense adjustments.

The Company dismisses this comparison noting that some of the rates compared by RUCO are composite rates and are not account specific. Id. The Company's argument lacks merit. It is not uncommon for companies to apply for composite rates. Transcript at 496 and 497. Moreover, the rates being compared are composite rates to composite rates and therefore provide an apples-to-apples comparison. For comparison purposes, it does not matter whether depreciation rates are account specific or composites. The effect, however, on the revenue requirement is significant – in this case using the rates proposed by RUCO reduced the Company's proposed depreciation expense by $312,186, which is still $193,973 more than the Company's actual test-year depreciation expense. R-5 at 17. The Commission should adopt RUCO's recommended depreciation expense adjustments.

**2) PROPERTY TAXES**

RUCO's recommended property tax expense calculation was based on the Arizona Department of Revenue's ("ADOR") property tax formula. Id. at 18. The property tax formula, as prescribed in ADOR's memo to the Company dated January 3, 2001, values water utilities, for property tax purposes, by multiplying the average of the water utility's three previous years of reported gross revenues by a factor of two. Id.

The Company has disregarded the revenues required under the ADOR directive and substituted in its place the adjusted test-year revenues twice and its proposed level of revenues once ("Company methodology"). Id. RUCO, for valuation purposes, has included the test year (2003) and the prior two years (2001, 2002) as directed by ADOR ("ADOR methodology"). Since the ADOR issued its memo, enough time has passed so that actual property tax figures for 2004 are available and the Commission can compare those figures to the estimated figures derived using the Company's and the ADOR methodologies. In this case, utilizing a 2003 test-year, the actual 2004 property taxes were $280,537. R-2. Using the ADOR methodology, the estimated 2004 property tax assessment is $280,835, a difference from the actual expense of $298. Id. Applying the Company's methodology results in an estimate of $308,326, a difference of $27,789 from the actual expense. Id. In light of this evidence that RUCO's method more closely approximates the Company's actual post-test year property tax bill, the Commission should adopt that approach and recognize the ADOR methodology as the best measure of estimated property tax expense.

The Company argues that the use of the revenues required under the ADOR methodology does not take into consideration the increased revenues that will be approved by the Commission in this proceeding. A-5 at 27. However, in recent rate cases where actual property tax expenses have been known, the use of the ADOR methodology provides an accurate depiction of the actual expenses. Transcript at 612. In this case, had the Commission previously approved the Company's methodology, property taxes for 2004 would have been overstated by $27,789 which would have allowed the Company to over earn for several years until the tax was actually paid. Id. at 612 – 613.

The reason why the ADOR formula is a more accurate measure is also obvious. Contrary to what the Company perceives as the flaw in the ADOR methodology, the ADOR methodology does take into consideration future rate increases. The ADOR formula inherently projects an increase in the operating revenues by doubling the three-year historical average of operating revenues. R-6 at 10. The Company's methodology doubles adjusted and projected revenues, which overstates the tax expense. Transcript at 612. The Commission should adopt the ADOR methodology.

**PURCHASED WATER AND PURCHASE POWER ADJUSTMENT MECHANISMS**

**1) THE CIRCMSTANCES IN THIS CASE DO NOT SUPPORT APPROVAL OF PURCHASED WATER AND PURCHASE POWER ADJUSTOR MECHANISMS**

RUCO recommends that the Commission deny the Company's request for automatic adjustors for purchased water and purchased power expenses. The law on this issue has been the subject of much debate in Arizona, but even under the best of circumstances, the evidence does not support the Company's request. The Commission should deny the Company's request for a purchased water ("PWAM") and purchase power adjustor mechanism ("PPAM").

In only limited circumstances may the Commission establish rates without simultaneously determining the effect of changed rates on a utility's rate of return. One of those circumstances is when the Commission has established an automatic adjustor mechanism. *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 535, 578 P.2d 612, 616; *Residential Util. Consumer Office v. Arizona Corp. Comm'n ("Rio Verde")*, 199 Ariz. 588, 591 ¶ 11, 20 P.3d 1169, 1172. An automatic adjustor mechanism permits rates to adjust up or down "in relation to fluctuations in certain, narrowly defined, operating expenses." *Scates* at 535, 616. An automatic adjustor permits a utility's rate of return to remain relatively constant despite fluctuations in the relevant cost. An automatic adjustor clause can only be implemented as part of a full rate hearing. *Rio Verde* at 592 ¶ 19, 1173, *citing Scates* at 535, 616.

The Commission has also defined adjustment mechanisms as applying to expenses that routinely fluctuate widely. In a prior decision in which it eliminated APS' fuel and power adjustor, the Commission stated:

> The principal justification for a fuel adjustor is volatility in fuel prices. A fuel adjustor allows the Commission to approve changes in rates for a utility in response to volatile changes in fuel or purchased power prices without having to conduct a rate case. (Decision No. 56450, page 6, April 13, 1989).

The Commission went on to discuss the undesirability of such adjustors because they can cause piecemeal regulation that is inefficient and undesirable. *Id.* at 8. *See also Scates* at 534, 615.

In the subject case, the circumstances do not warrant a PPAM or a PWAM. In neither case, do the expenses fluctuate widely nor are there volatile changes. Staff projected the Company's purchased water expense for 2006, 2007 and 2008. S-7 at 21, Moe Exhibit 5. For 2006, Staff projected that purchased water expense would increase by $31,766; 2007, Staff projected purchased water expenses would decrease by $8,158; and for 2008 Staff projected the purchased water expenses would increase by $28,547. Id. By comparison to the Company's total operating expense, purchased water expense is not material enough to warrant a PWAM. Transcript at 760. RUCO also projected the purchased water cost until the end of 2007 and reached the same conclusion. R-5 at 35, Schedule RLM-21. The Commission should reject the Company's request for a PWAM.

There is even less of a need for PPAM. Historically, the large electrical utilities that supply the Company its power, such as APS and SRP tend to maintain stable rates. Id. at 36. These utilities are inclined to reduce volatility by planning rate changes through gradual incremental steps. Id. SRP just completed a rate review and calculated the Company's rate increase for 2004. These known and measurable pro-forma adjustments have already been recognized in test year purchased power expenses, thereby reducing the probability of another rate increase any time before the Company files its next rate case in three years. Id. In addition, the Commission recently decided the APS rate case. In that case, the Commission approved an adjustor mechanism subject to a cap, assuring that rates will not fluctuate widely until at least the next rate case. Id. at 37. The Commission should reject the Company's request for a PWAM.

## 2) THE COMMISSION IS NOT BOUND BY THE LEGISLATURE'S STATEMENT OF POLICY IN ARS §40-370

The Company is requesting that the adjuster mechanisms be approved based on the Company's interpretation of the Legislature's policy, as referenced in ARS §40-370, of allowing recovery of changes in purchased power and purchased water expenses without the need to file a complete rate case. A-6 at 25, 26. The Company's reliance on the statute as a statement of public policy is misplaced based on the well-recognized and established law regarding the separation of powers between the Commission and the Legislature. The statute itself is also inapplicable as the Company is making its request in the context of a rate case. The Commission should deny the Company's request for a PWAM and PPAM.

ARS § 40-370, adopted in 1997, states that the Commission shall authorize surcharges for water to recover increases and decreases in "specific, readily identifiable costs that are subject to the control of another person," including the purchase of electricity, water from another utility, and taxes. ARS § 40-370(A). The statute permits the surcharge to become effective apart from a rate case, based on a filing by a utility with the Commission and notice to the customers. ARS § 40-370(B)-(D). If the Commission does not act on the request for the surcharge within 120 days, the surcharge is to be deemed effective without further Commission action. ARS § 40-370(D).

In 1999, Rio Verde Utilities filed an application under ARS § 40-370 to implement a surcharge to recover increases in the cost of water purchased from the Central Arizona Project. The Commission approved the surcharge application in Decision No. 62037. RUCO appealed Decision No. 62037, and the Arizona Court of Appeals set aside Decision No. 62037 as exceeding the Commission's authority. See *RUCO v. Ariz. Corp. Comm'n.*, 199 Ariz. 588, 20 P.3d 1169 (App. 2001). The Court concluded that the Commission lacked the inherent Constitutional authority to adopt the requested surcharge outside of a rate proceeding in which it finds the fair value of a utility's property. While the ruling was based on the scope of the Commission's plenary power under the Constitution, and not on the constitutionality of ARS § 40-370 specifically, it is instructive as to the effectiveness of ARS § 40-370, for the legislature cannot by statute empower the Commission to do what the Constitution prohibits. See *Kilpatrick v. Superior Court*, 105 Ariz. 413, 416, 466 P.2d. 18, 421 (1970).

The purchased water and purchased power costs the Company is requesting recovery on are the type of costs contemplated by ARS § 40-370. However, ARS § 40-370 is not directly applicable to this matter, because the Company's request is part of a rate case, rather than a separate action as contemplated by the statute.

Instead, the Company relies on the statute indirectly. A-6 at 26. The Company suggests that the Legislature adopted a policy that water utilities should recover changes in purchased water and purchased power costs directly, without needing to file a complete rate case, and that the Commission should follow that legislative policy. Id. However, the statute's effectiveness as a statement of public policy is doubtful, based on the well-established law regarding the separation of powers between the Commission and the Legislature.

The Arizona Constitution grants "full power" to establish rates for public service companies to the Commission. Article XV, §3. Just two years after statehood, the Arizona Supreme Court ruled that, based on Article XV, §3, the Commission's authority over public service companies rates is "exclusive and supreme." *State v. Tucson Gas*, 15 Ariz. 294, 299, 138 P. 781, 783 (1914).

The statute purports to tell the Commission what it "shall" do regarding utility rates to recover certain operating costs. ARS § 40-370(A). However, the Legislature is not permitted to dictate to the Commission how it must fulfill its constitutional duties. *Ethington v. Wright*, 66 Ariz. 382, 395, 189 P 2d 209, 218 (1948). Therefore, the Legislature's statement of policy in ARS § 40-370 is an impermissible usurpation of the Commission's constitutional authority, and is not binding on the Commission.

While the Commission is not bound to follow a legislative statement about how a utility can recover its increased costs, it is obligated to comply with the Arizona Constitution's requirement on the subject. As explained at length above, the proposed adjustor mechanisms in this case do not meet the constitutional fair value requirement or qualify as an adjustor mechanism under *Scates*. The Commission should deny the Company's request for a PPAM and PWAM.

**RATE DESIGN**

RUCO's recommended rate design implements a three tier inverted block rate structure. R-5 at 32. RUCO's rate design implements two break over points, the first approximates present average use of 8,000 gallons. Id. The second break-over point at 73,000 gallons was calculated as the average of the Company's proposed graduated break-over points. Id. Water is a precious commodity, and customers should have to pay more if they use more. Arguably, any potential for conservation would be better motivated with a higher, rather than a lower rate for above average use. RUCO's proposed rate design does not discriminate between class or meter size. It is a fair rate design because, stated simply, each customer pays the same commodity rate for the same level of usage. Transcript at 594.

**COST OF CAPITAL**

RUCO believes the Commission should adopt RUCO's recommended rate of return of 7.66 percent, which is the weighted cost of RUCO's recommended costs of debt and equity capital. R-4 at 5.

RUCO believes that the 9.45 percent cost of common equity is appropriate given the current environment of low inflation and low interest rates that the Company is operating in. R-3 at 40, 41. RUCO further believes that the 9.45 percent cost of common equity estimated by RUCO witness William A. Rigsby is very reasonable when the Company's capital structure of 59 percent equity and 41 percent debt is compared with the capital structures of other publicly traded water providers which averaged 56 percent equity and 44 percent debt. R-3 at 40-41. Despite the fact that Chaparral's capital structure is slightly higher in equity than the average capital structure of the water providers included in his analysis, Mr. Rigsby has made no downward adjustment to the results that he obtained from his DCF model. R-3 at 28, 29. Furthermore, Mr. Rigsby's discounted cash flow growth rate estimates exceed the estimates of independent securities analysts by forty-nine to sixty basis points. Id at 40-44. Finally, Mr. Rigsby's recommended 9.45 percent cost of common equity estimate is extremely close to the 9.5 percent return on common equity that Value Line Investment Survey has projected for Chaparral's parent company, American States Water Company, for the 2005 operating period. R-3 at 41.

**MISCELLANEOUS ISSUES**

Salaries, Wages and Payroll Tax Expense – RUCO recommends that the Commission include all the test-year labor costs and annualize the expense by calculating the appropriate 2004 wage increase. R-6 at 14. This revision reduces the proposed expense by $69,961. Id.

Employee Beverages and Barbeque Costs – RUCO recommends these costs be removed as the benefit inures to the shareholders and not the ratepayers. Id.

Legal Fees – The legal expenses associated with the sale of the water utility from its prior owner, MCO Properties, to Chaparral Water Company were unique, not typical, or recurring. RUCO recommends the removal of these expenses.

Reservoir Inspection Costs – RUCO recommends that the costs associated with the first time inspection and cleaning of its tanks in 2003 be removed. Id. These costs were already recovered through the 2003 operating revenues and the next inspection has not been scheduled. Id at 16-17.

Plant Damage – RUCO recommends that the test-year cost of repair of damage incurred 20 years ago should be removed as it is a rare event, atypical and not recurring. Id. at 17.

**CONCLUSION**

RUCO recommends the Commission reject the Company's proposed revenue requirement and adopt RUCO's proposed methodology of determining required operating income based on the Commission's historical application of an FVRB to an OCROR. RUCO also recommends the Commission exclude from rate base the costs associated with the extension of the Main, and adopt RUCO's property tax expense and other proposed adjustments to operating income. RUCO further requests the Commission deny the

Company's request for a PPAM and PWAM. RUCO's proposed rate design and cost of capital are fair and reasonable and should be adopted by the Commission. Finally, the Commission should adopt RUCO's recommendations regarding the miscellaneous issues described above.

RESPECTFULLY SUBMITTED this 6th day of July, 2005.

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