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Arizona Corporation Commission  
**DOCKETED**

JUN 15 2005

DOCKETED BY *KJ*

**BEFORE THE ARIZONA CORPORATION COMMISSION**

12 IN THE MATTER OF THE  
13 APPLICATION OF ARIZONA WATER  
14 COMPANY, AN ARIZONA  
15 CORPORATION, FOR ADJUSTMENTS  
16 TO ITS RATES AND CHARGES FOR  
17 UTILITY SERVICE FURNISHED BY  
18 ITS WESTERN GROUP AND FOR  
19 CERTAIN RELATED APPROVALS.

Docket No. W-01445A-04-0650

**NOTICE OF FILING  
SUMMARY OF WITNESSES'  
PRE-FILED TESTIMONY**

17 Arizona Water Company, an Arizona corporation ("Arizona Water" or  
18 "Company"), hereby files the summaries of the pre-filed testimony of the following  
19 witnesses:

- 20 1. William M. Garfield
- 21 2. Richard W. Henderson
- 22 3. Michael J. Whitehead
- 23 4. Ralph J. Kennedy
- 24 5. Sheryl L. Hubbard
- 25 6. Thomas M. Zepp
- 26

AZ CORP COMMISSION  
DOCUMENT CONTROL

2005 JUN 15 P 4: 47

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1 The pre-filed direct, rebuttal, and/or rejoinder testimonies of each of these witnesses  
2 supports Arizona Water's application for adjustments to its rates and charges for water  
3 utility service provided.

4 During the test year used in this proceeding, the twelve-month period ending  
5 December 31, 2003, Arizona Water served approximately 20,266 water utility customers  
6 in its Western Group, which currently includes five water systems. The Company's  
7 present rates and charges for utility service for the Western Group were approved by the  
8 Commission in Decision No. 58120 (December 23, 1992), and became effective on  
9 January 1, 1993. Revenues from the Company's utility operations are now inadequate to  
10 provide a reasonable rate of return. Attached to Ms. Hubbard's witness summary are  
11 summaries of Parties' Schedule A-1, titled "Computation of Increase in Gross Revenue  
12 Requirements," which show a comparison of the proposed increase in gross revenue  
13 recommended by the Company, Staff, and RUCO for each Western Group system.

14

15 DATED this 15th day of June, 2005.

16

FENNE MORE CRAIG, P.C.

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By

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1 An original and 13 copies of the  
2 foregoing filed this 15th day of  
June, 2005 with:

3 Docket Control  
4 Arizona Corporation Commission  
5 1200 West Washington  
6 Phoenix, AZ 85007

7 A copy of the foregoing hand-delivered  
8 this 15th day of June, 2005 to:

9 Chairman Jeff Hatch-Miller  
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19 A copy of the foregoing via U.S. mail  
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15 By: Mary A. House

16 PHX/JSHAPIRO/1671873.1/12001.189

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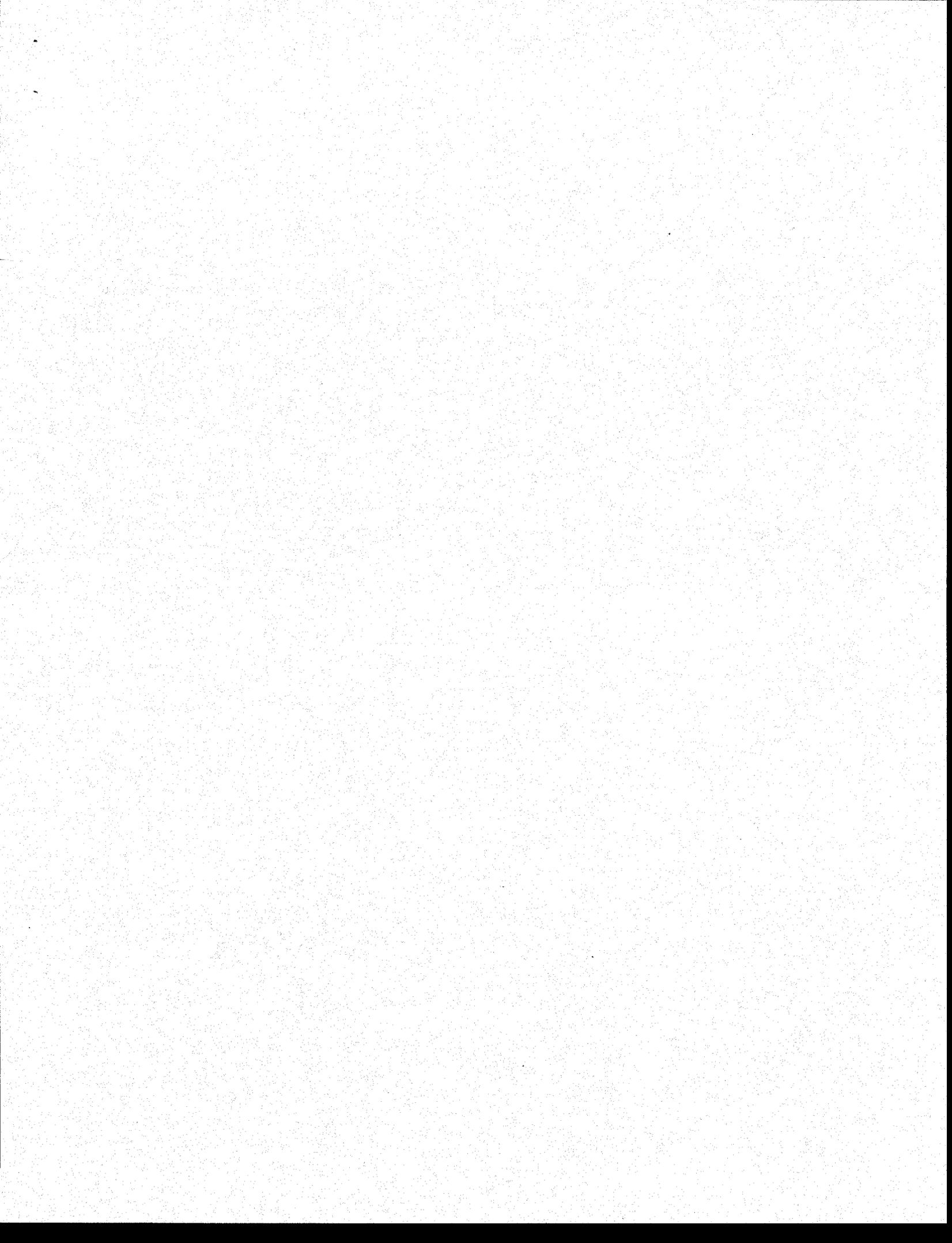
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# ARIZONA WATER COMPANY

Docket No. W-01445A-04-0650

## Summary of Testimony of William M. Garfield

Mr. Garfield is the President of Arizona Water Company ("the Company"). Mr. Garfield holds a bachelor of science degree (with honors) in Thermal and Environmental Engineering from Southern Illinois University, and has taken post-graduate course work at Arizona State University in Civil Engineering, including hydrology, water and wastewater treatment, and statistics. He is a member of the Tau Beta Pi (a national honorary engineering society), the American Water Works Association, serving on that association's Water Meter Standards Committee, and the Arizona Water and Pollution Control Association. Mr. Garfield also serves on the Board of Directors of the Water Infrastructure Finance Authority of Arizona, and is currently the Chairman of the Water Management Subcommittee of the Pinal Active Management Area Groundwater User Advisory Council. Mr. Garfield has been employed by the Company since 1984.

Mr. Garfield prepared direct, rebuttal and rejoinder testimony on behalf of the Company in this case. His pre-filed testimony addresses the topics of the Company's Central Arizona Project ("CAP") water subcontracts and the Company's planning for and use of CAP water; the Company's arsenic treatment program to comply with the new Maximum Contaminant Level ("MCL") for arsenic; the recovery of costs incurred by the Company in defending against the City of Casa Grande's ("the City") unsuccessful attempt to condemn a portion of the Company's Casa Grande system and the Company's lawsuit against the City related to the City's sale of effluent to customers within the Company's service territory; and certain significant business risks faced by the Company based on its unique circumstances.

### **1. CAP Water Use and Planning.**

In his testimony, Mr. Garfield explains that the Company holds CAP subcontracts with the Central Arizona Water Conservation District ("CAWCD") for allocations of CAP water for White Tank (968 acre-feet per year), Coolidge (2,000 acre-feet per year) and Casa Grande (8,884 acre-feet per year). At present, the Company delivers approximately 2,300 acre-feet of CAP water annually to industrial and commercial customers in the Company's Casa Grande service area. No CAP water is currently being used in the White Tank and Coolidge service areas. Mr. Garfield explains that the Company has been actively working toward full utilization of its CAP allocations. With respect to the White Tank system, located in the western portion of the Phoenix area, the Company has been in negotiations with Arizona-American Water Company ("AAWC") to obtain the right to utilize a portion of a regional CAP water treatment plant AAWC is planning to construct, which will enable the Company to use its entire White Tank CAP allocation to serve its customers. With respect to the Casa Grande and Coolidge CAP allocations, the Company began planning a regional CAP water treatment plant located near Coolidge several years ago. The Company has already purchased a treatment plant site, and is proceeding with the engineering design of the new plant, as discussed in more detail in the pre-filed testimony of Mr. Whitehead.

Mr. Garfield also provides an historic overview on the CAP in order to place the Company's request to recover deferred CAP charges in perspective, which testimony is unchallenged. In addition, he discusses the Staff's CAP Cost Recovery Policy, which was developed through the Commission's Water Task Force during the 1998-1999 time period. Mr. Garfield (as well as Mr. Kennedy) participated in the Water Task Force, which developed a policy that would allow Arizona water utilities to retain their CAP subcontracts and phase in the use of CAP water over a number of years. In his rebuttal testimony, Mr. Garfield also provides as exhibits a copy of Decision No. 62993 (Nov. 3, 2000), by which the Commission approved the recommendations of Staff based on the Water Task Force Report, and the Memorandum, dated June 29, 2001, by which Staff provided the CAP Cost Recovery Policy (attachment D) to the Commissioners.<sup>1</sup> Under this policy, the use of CAP water is *not* required in order to begin recovering CAP costs.

In response to recommendations made by Staff and RUCO, under which the Company would be prohibited from beginning to recover deferred and on-going CAP costs, Mr. Garfield explains the benefits that have been provided by the Company's CAP allocations. Under the Groundwater Code, water providers with CAP allocations were deemed to have an assured water supply until August 1995, which allowed subdivisions in Casa Grande, Coolidge and White Tank to be platted and developed. In addition, commercial and industrial customers, including the Reliant Energy (now Salt River Project) Desert Basin Power Plant and the Francisco Grande Golf Course, have been receiving untreated CAP water in lieu of using groundwater, helping to preserve groundwater for future use. These sales of untreated CAP water have also generated revenue to pay CAP costs, reducing the need to recover those costs from other customers in the future. Finally, Mr. Garfield explains that because CAP water is intended to provide long-term renewable supplies and to reduce non-irrigation uses of water in the Pinal Active Management Area, both current and future customers should bear the costs associated with maintaining the Company's CAP allocations. Denying cost recovery in this proceeding would conflict with public policy and result in increases in deferred CAP costs, causing the recovery of those costs to become a larger, more difficult problem to deal with in the future.

## **2. The Company's Arsenic Treatment Program.**

Mr. Garfield explains that the EPA's adoption of a far more stringent MCL for arsenic, which will become effective in January 2006, will have a significant impact on the Company. In the Western Group, arsenic treatment facilities will be required for the Casa Grande, White Tank and Stanfield water systems. Mr. Garfield explains that on a company-wide basis, the capital costs to comply with the new arsenic MCL is estimated at \$30 million, which will have a dramatic financial impact on the Company. He also explains that in addition to investment in new plant, the new arsenic MCL will have major impacts on the Company's water system operations, including increased employee training, hiring additional qualified employees to operate and maintain treatment facilities, and possible reductions in the availability of water supplies. Mr. Garfield notes that the additional capital costs and operating expenses associated with arsenic treatment are *not* included in this application.

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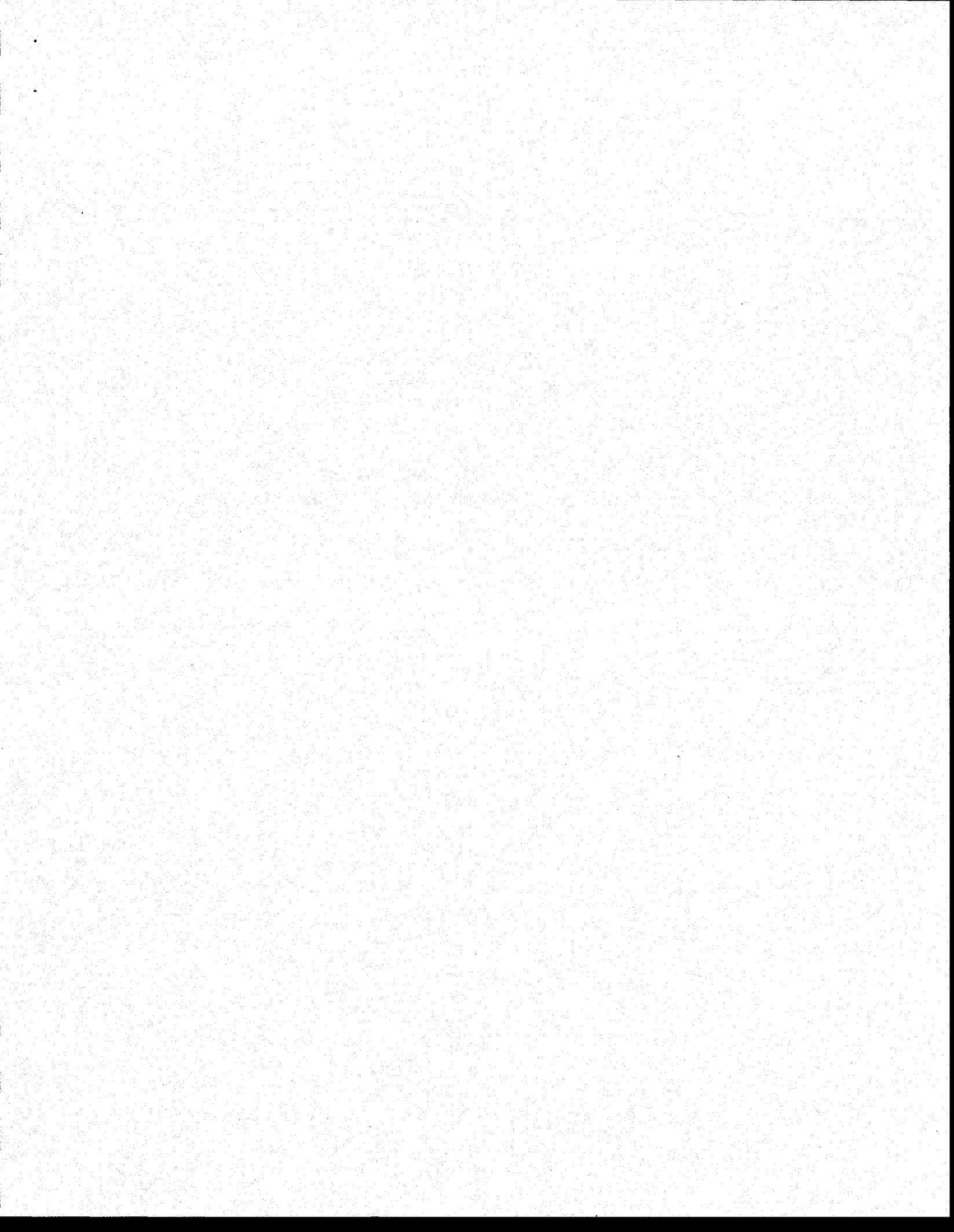
<sup>1</sup> All of these materials are available on the Commission's website.

Mr. Garfield also addresses certain pre-filed testimony of the City relating to the timing of the construction of CAP water treatment plants and facilities necessary to treat for arsenic. He explains that it is neither possible nor practical for the Company to accelerate its construction of CAP water treatment plants as a substitute for arsenic treatment facilities. The Company's CAP allocation for its Casa Grande service area does not meet the full water demands of those customers. Even if the Company's regional CAP water treatment plant were operational today, the Company would still need to rely on its existing groundwater supplies for peaking purposes and during times when the CAP delivery system is out of service for repairs. Finally, Mr. Garfield explains that there is insufficient time to properly plan, design and construct a CAP water treatment plant to comply with the new arsenic MCL, which will go into effect shortly after this case is concluded.

### **3. Recovery of Litigation Expenses.**

The Company is requesting recovery of expenses that it incurred in connection with two lawsuits, both of which involved the City. In his pre-filed testimony, Mr. Garfield discusses both of those lawsuits. The first lawsuit was the result of the City's unlawful attempt to condemn a portion of the Company's Casa Grande system, which would have severed the Company's remaining water system into several pieces without adequate water production or storage capacity. Mr. Garfield explains that the fees and expenses incurred by the Company in successfully defending against the City's action were legitimate business expenses, and were necessary to protect the Company's rights under its certificate of convenience and necessity ("CC&N"). He also explains that Casa Grande customers benefited in several ways from the Company's defense of the City's lawsuit, including preventing adverse impacts on the Company's remaining Casa Grande customers, the Company's retention of its CAP subcontract (which the City sought to acquire), and avoiding higher water rates and diminished service to Casa Grande customers had the City been successful. Mr. Garfield also notes that the City's voters (the Company's customers) had already rejected a previous attempt by the City to enter the water utility business, which the City chose to ignore.

The second lawsuit was filed by the Company in order to prevent the City from providing competing water service within the Company's CC&N. That lawsuit was prompted by the City's decision to offer treated effluent to several of the Company's non-potable customers, including the Desert Basin Power Plant, to which the Company provides untreated CAP water. Mr. Garfield explains that in offering this competing utility service, the Company and its customers were harmed. Revenue from the sale of untreated CAP water was reduced, adversely impacting the Company's ability to pay CAP costs and thereby reduce the amount of deferred CAP costs. Mr. Garfield maintains that the fees and expenses incurred by the Company in prosecuting this lawsuit constitute legitimate and necessary business expenses, and therefore should be recovered in rates.



## **ARIZONA WATER COMPANY**

**Docket No. W-01445A-04-0650**

### **Summary of Testimony of Richard W. Henderson**

Mr. Henderson is employed by Arizona Water Company ("Arizona Water" or the "Company") as Vice President of Operations. Mr. Henderson received a Bachelor of Science degree from Arizona State University in General Business Administration. He is a member of the American Water Works Association and the Arizona Water and Pollution Control Association. He has been employed by Arizona Water since 1990.

Mr. Henderson prepared only direct testimony in support of the Company's application for rate increases. Mr. Henderson's pre-filed testimony focuses on the Company's tank maintenance accrual accounts, operating and maintenance costs for chlorination, and water sampling. No party challenged Mr. Henderson's direct testimony, which is further summarized below.

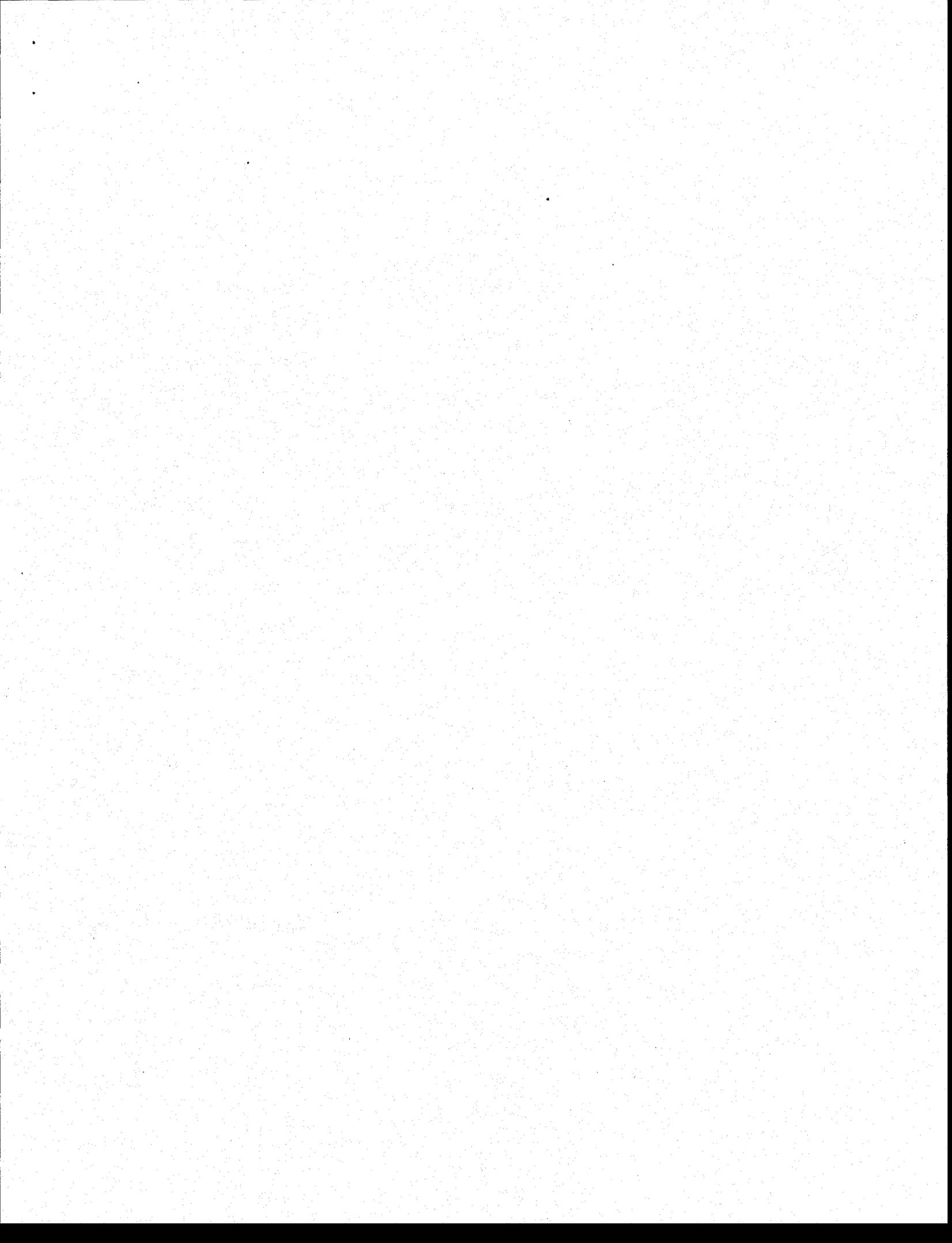
Under the Company's tank maintenance program, water storage tanks are inspected and cleaned on a routine basis. Interiors are recoated every 14 years and the exteriors are painted every 7 years. Without this program, water storage tanks would deteriorate more rapidly, shortening the useful life of each tank. Since the last general rate case, inspection costs, the cost of the product and labor costs have all increased. With the higher volume of solids and less solvents in coatings used today to reduce airborne emissions, the coatings are more difficult to apply, resulting in increased labor and equipment costs.

State and federal safe drinking water standards require public water distribution systems to maintain a bacteria free water supply. To meet these requirements, the Company disinfects its water supply with chlorine and maintains a free chlorine residual. The cost of operating and maintaining the liquid and tablet chlorination equipment has increased considerably since the last general rate case. In addition, there are now more chlorination units in operation in the Company's water systems as a result of water system growth and the addition of pumping facilities. As additional sources of supply are added in each system, chlorination units will be installed and maintenance costs will increase.

ADEQ's adoption of the Safe Drinking Water Act in Arizona's Safe Drinking Water Rules resulted in significantly increased numbers and type of contaminants that must be monitored. Additional testing will also be required in those systems with more than 10 parts per billion of arsenic when the new MCL takes effect in early 2006. Microbiological particulate analysis testing for water supplies located near surface waters or ephemeral washes is also required by ADEQ under recently adopted amendments to the Safe Drinking Water Act. The average cost of these tests is \$325.00 per test and multiple tests are necessary for wells that fall under this regulation. As a result of regulatory changes, monitoring costs overall have increased significantly and will continue to increase.

ADEQ created the Monitoring Assistance Program (MAP) in 1998 to perform water quality monitoring and reporting for most water systems. The MAP monitors for the majority of contaminants, but system operators must monitor some contaminants that are not covered under the program. Participation in the MAP is mandatory for systems serving a population of 10,000 people or less; and voluntary for systems serving a population over 10,000 people. ADEQ assesses the Company for annual charges on a per meter basis for all Western Group water systems in the MAP. Because the Company is able to monitor its systems at a lower cost than ADEQ, the Company has chosen not to participate in the MAP for water systems serving a population over 10,000 people, such as Casa Grande. All other systems in the Western Group, except Ajo Heights, participate in the MAP. As a consecutive public water system, defined in the ADEQ Safe Drinking Water rules (R18-4-101) as a public water system that obtains all of its water from another public water system that is regulated by the department, Ajo Heights is not required to participate in the monitoring assistance program. The Company's water sampling costs are greater through participation in the MAP than they were prior to mandatory participation in the MAP.

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# ARIZONA WATER COMPANY

Docket No. W-01445A-04-0650

## Summary of Michael J. Whitehead Testimony

Mr. Whitehead is a Certified Professional Engineer and Arizona Water Company's Vice President-Engineering. Mr. Whitehead has been with Arizona Water Company since 1980. Mr. Whitehead prepared direct and rebuttal testimony focused primarily on three issues: (1) Company funded plant construction between 1990 and 2003 in the Western Group; (2) the construction of arsenic treatment facilities; and (3) the Company's plans for construction of a regional CAP water treatment plant.

### **1. Company Funded Plant Construction.**

Mr. Whitehead provides a discussion of the Company's plant additions and improvements between 1990 and 2003. Mr. Whitehead outlines the Company's construction budgeting process, which includes annual planning directed at improving or maintaining the infrastructure needed to serve existing customers. Before final construction budgets are prepared for a given year and presented to the Company's Board of Directors, the Company's engineering and operations departments, along with senior management, meet to review and discuss each proposed construction project.

In Mr. Whitehead's direct testimony he provides a chart identifying the cost of plant additions from 1990 through 2003. As Mr. Whitehead testifies, these construction projects were necessary in order to maintain infrastructure, resolve operational problems, comply with regulatory requirements and maintain or improve water service to customers. Mr. Whitehead provides examples of significant projects including the construction of three new wells in the Casa Grande system, and a new 1,000,000 gallon reservoir, a new well, and approximately 4.5 miles of 6 inch through 12 inch pipe in the White Tank system.

### **2. Facilities for Arsenic Treatment**

Mr. Whitehead also provides specific testimony regarding the Company's proposed plant additions related to arsenic treatment to comply with the new MCL for arsenic under the Safe Drinking Water Act. Mr. Whitehead explains that three of the Company's systems in the Western Group (Casa Grande, Stanfield and White Tank) will be impacted by the new arsenic standard and that the Company will have to construct arsenic treatment facilities for such systems. Mr. Whitehead's testimony includes estimated construction budgets for such systems, including an estimated budget for its Casa Grande system of approximately \$5,000,000 in 2004 and \$7,000,000 in 2005, solely for arsenic treatment.

### **3. Plans for Design and Construction of Regional CAP Water Treatment Plant**

Mr. Whitehead also provides testimony supporting the Company's plans for design and construction of a regional facility to treat CAP water. The Company started planning a regional CAP water treatment facility in central Pinal County several years ago. First, the Company

identified the preferred location and purchased approximately 68 acres of land southeast of Coolidge, roughly a half-mile west of the CAP canal. The Company has also submitted its application to the Arizona State Land Department ("State Land") for right-of-way access necessary for construction of a 48-inch diameter pipeline that will be used to deliver water from the CAP canal to the treatment facility. The initial design of the booster pump station necessary to pump water from the CAP canal and pressurize the pipeline for delivery to the Plant is also complete. Next, plans will be submitted to the Central Arizona Water Conservation District ("CAWCD"), the operator of the CAP, for review and comment.

As Mr. Whitehead further discussed, the Company considers this CAP water treatment plant to be a regional plant because it will be treating both the Company's Casa Grande and Coolidge CAP allocations among other available groundwater and surface water supplies. The Company's Casa Grande and Coolidge CAP allocations totaling 10,884 acre feet, could serve approximately 24,000 residential customers based on an average use of 0.45 acre feet per customer per year. The plant though, as planned, also has the potential to treat water supplies for other water providers, such as the City of Eloy and the City of Florence, or, as necessary, to allow the Company to secure additional other non-Indian agricultural priority CAP water and to lease Indian CAP supplies. Also, much of the Company's Casa Grande and Coolidge areas include lands within the San Carlos Irrigation and Drainage District, which District has rights to Gila River surface water supplies. These additional supplies have the potential to serve well above 24,000 residential customers, as such supplies are identified and under contract to the Company.

The approaches taken by the Company with the Plant, i.e., its approach to phasing, modular expansion capability, adaptable treatment technologies and treatment trains, ability to treat multiple sources of supply, among others, not only provide the flexibility needed to meet ever-changing state and federal regulations but it also provides the flexibility to meet the projected demands of the Company's customers. For example, the initial capacity would be 10 million gallons per day ("MGD"), which capacity could be expanded later to as much as 40 MGD.

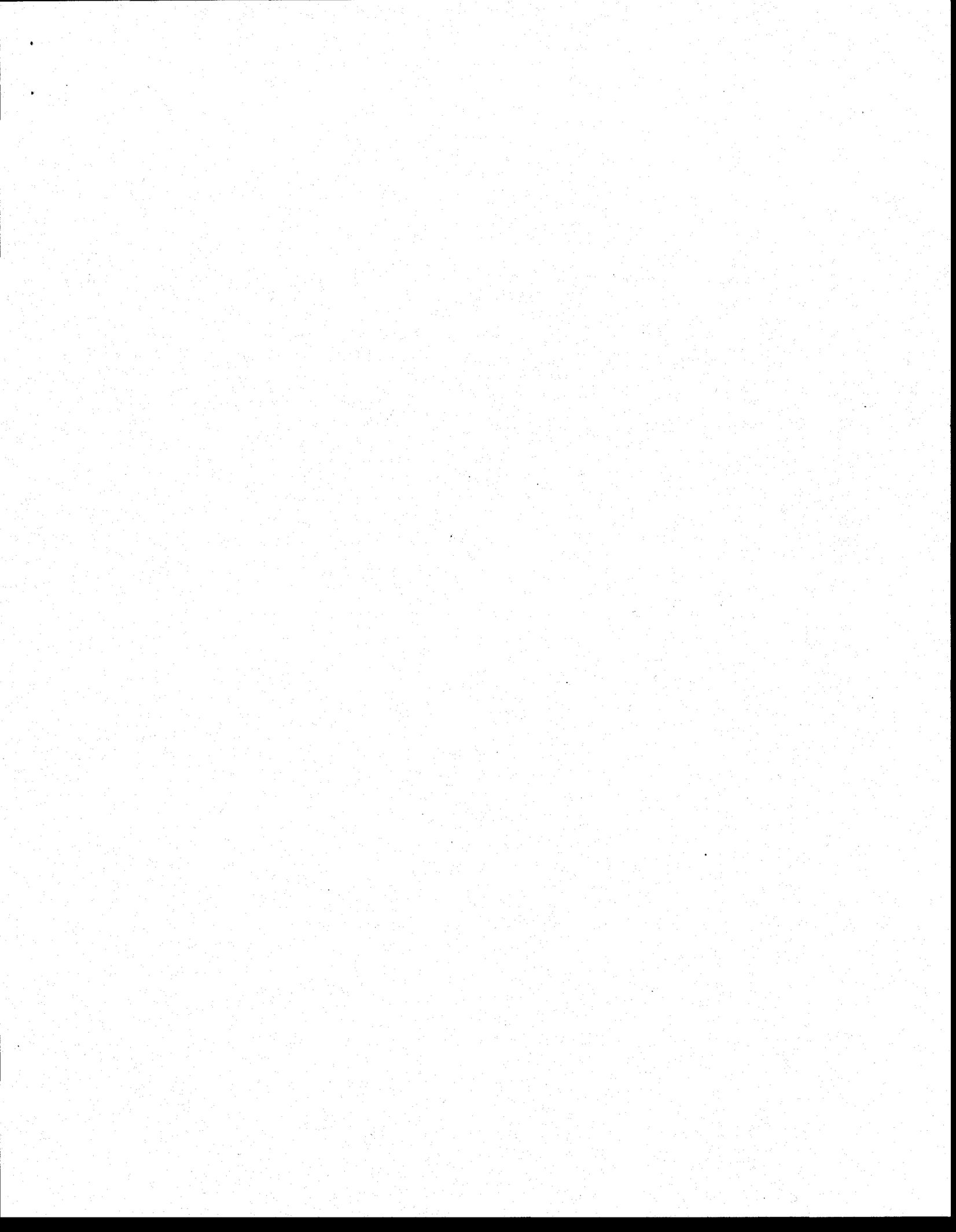
Ultimately, state and federal regulations will govern the treatment processes. Typically, surface water treatment plants involve pre-treatment and post treatment processes, flocculation, coagulation, and some form of filtration method. Conventional surface water treatment plants could use a single, dual or multi-media filter material, such as sand, anthracite and garnet. Because of the potential for generating disinfection byproducts, advanced treatment methods, such as microfiltration, ultrafiltration or another form of membrane treatment could be used. Additional waste can be generated using one of these advanced methods and thus, waste disposal may become a more important factor. The use of activated carbon has also been used more extensively in recent years for removal of organic materials and to prevent taste and odor problems.

The Company's plant will consist of a number of components including raw water pumps, raw water intake structures and delivery lines, pretreatment, pre-disinfection, chemical feed, rapid mix, flocculation, sedimentation, clarification, pH adjustment, filter vessels and/or membrane systems, post treatment chlorination, and taste and odor control. The plant will consist of concrete structures, water storage vessels, backwash tanks, pumping equipment,

chemical feed equipment, flow meters, rate of flow controllers, valves, emergency standby power equipment, laboratory equipment, safety and first aid equipment, supervisory control and data acquisition system ("SCADA"), and other miscellaneous treatment plant equipment.

The Company's current plan for construction has the pipeline being installed on a schedule consistent with the Company's master planning for this area, including the progress of development of master planned communities along the western boundary of Coolidge. The Company anticipates accepting bids for treatment plant design in 2007 and awarding a design contract in 2008. Bidding for the construction of the first phase of the Plant would commence in early 2009. Following bid review and the awarding of a construction contract for the Plant, work would commence late 2009 with a planned 2012 completion date. This should lead to treated CAP water being delivered to Coolidge in 2012, followed by deliveries to Casa Grande commencing in 2014. The initial estimated cost to design and construct the first phase of the treatment facility is approximately \$20 million. The Company's estimated costs for the booster pumps and transmission pipeline are \$300,000 and \$600,000, respectively. Once complete, it is expected that the plant could serve the Company's customers for up to 75 years.

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## ARIZONA WATER COMPANY

Docket No. W-01445A-04-0650

### Summary of Testimony of Ralph J. Kennedy

Mr. Kennedy is Vice President and Treasurer of Arizona Water Company ("the Company"). He received a Masters in Business Administration from the University of Chicago and a Bachelor of Science degree from the University of Illinois. He is a Certified Public Accountant in Arizona and Illinois, and is a member of both the Arizona Society of Certified Public Accountants and the American Institute of Certified Public Accountants. Mr. Kennedy has been employed by the Company since 1987. His previous regulatory experience includes serving as the Chief of the Accounting and Rates Section of the Commission from 1985 through 1986, and as the Manager of Accounts and Finance for the Illinois Commerce Commission from 1974 to 1978. He has also worked as a management consultant, as Assistant to the Illinois Director of Revenue, and as an independent trader on the Chicago Board Options Exchange.

In this case, Mr. Kennedy prepared direct, rebuttal and rejoinder testimony on behalf of the Company. The primary topics covered by Mr. Kennedy's pre-filed testimony include post test year plant and the Company's request to implement an arsenic cost recovery mechanism ("ACRM") modeled after the ACRM previously approved for the Company's Northern and Eastern Groups; modification of the depreciation methodology employed by the Western Group systems to implement component depreciation rates that are the same as the depreciation rates approved for the Company's Eastern Group in Decision No. 66849 (March 19, 2004); retention of the Company's purchased power and purchased water adjustment mechanisms for the Western Group systems; the Company's capital structure and weighted cost of capital; the design of rates for the Company's Western Group systems; and a general overview and background on the rate application and circumstances that have led to its filing. It should be noted that the Company's request to implement the ACRM and the modification of the Company's depreciation methodology to implement rates by individual plant accounts are not in dispute.

#### **1. Background Concerning the Company's Rate Application and the ACRM.**

In his direct testimony, Mr. Kennedy discusses the circumstances leading to the filing of the instant application for rate adjustments, which is based on operating results and investment in the Western Group water systems (Casa Grande, Stanfield, White Tank, Ajo Heights and Coolidge) for the adjusted test year 2003. As of December 31, 2003, the Western Group served a total of 20,266 customers, of which nearly 74% are in the Casa Grande service area. The current water rates were approved in Decision No. 58120 (Dec. 23, 1992) based on operating results and investment for the adjusted test year of 1990.

Mr. Kennedy states that there have been numerous changes in the economy as well as the Company's operations since 1990. Although annual inflation rates have been moderate, inflation has increased more than 38% from 1990 through May 2004, and by the time the rates authorized in this proceeding become effective in late 2005, the Consumer Price Index will have increased well over 40%. Since 1990, the Company has continued to invest in plant and facilities needed to furnish service, and its net investment in plant has increased by some \$9 million or nearly 67%

since 1990. The Company's investment in plant and other facilities has resulted in increased depreciation expense, which has more than doubled over the 1990-2003 period. Moreover, the general costs of doing business, including salaries, supplies, various types of insurance, various taxes, as well as purchased power and water costs have increased significantly. In addition, regulatory changes, such as requirements imposed under the Safe Drinking Water Act, have led to increased operating expenses.

In this case, the Company is not requesting the inclusion in rate base of any non-revenue producing plant placed in service following the end of the test year, despite the fact that the Company continues to invest in new plant and facilities necessary to ensure safe and reliable water service. Mr. Kennedy discusses the importance of allowing the inclusion of post test year plant in rate base in order to reduce the impact of regulatory lag under Arizona's rate-setting system, which utilizes an historic test year. He notes that over 70% of the Western Group's 2004 construction budget consists of required arsenic treatment facilities. He also explains that the Company is requesting approval of an ACRM modeled after the mechanisms previously approved by the Commission for the recovery of costs associated with arsenic treatment for the Northern and Eastern Group systems. Mr. Kennedy emphasizes the additional risk that results from the Company's substantial budget and financing associated with the construction of arsenic treatment facilities and related operating expenses, which impacts the cost of capital.

## **2. Purchased Power and Purchased Water Adjustment Mechanisms.**

Mr. Kennedy addresses the existing purchased power and purchased water adjustment mechanisms for the Western Group systems. He explains that the Ajo system, which purchases all of its water from the Ajo Improvement Company, currently has an authorized purchased water adjustment mechanism ("PWAM"), and that a purchased power adjustment mechanism ("PPAM") is authorized for each Western Group system. Mr. Kennedy notes that since the effective date of the Company's last rate order through 2003, the Western Group systems' customers received an overall net rate reduction totaling about \$176,000 as a result of those adjustment mechanisms. He also explains that in the Company's Northern Group rate case, Decision No. 64282, the existing PPAM was affirmed. However, in the Eastern Group rate case, Decision No. 66849, the Staff recommended that the PPAM and PWAM be discontinued for those systems. In this case, Staff (as well as RUCO and the City) have recommended discontinuance of the existing PPAM and PWAM.

In his pre-filed testimony, Mr. Kennedy explains why the recommendations of the other parties conflict with public policy and previous Commission decisions. In the Company's 1992 rate decision, the Commission found that the Company's adjustment mechanisms "send[] a more appropriate price signal to users and receive[] greater customer acceptance than less frequent, but far larger rate increases, as well as allowing decreases in power and water costs to be passed on to customers." Decision No. 58120 at 30. Mr. Kennedy also explains that there is a specific state law, A.R.S. § 40-370, encouraging adjustment mechanisms that allow water utilities to recover increases in specific operating costs beyond their control, including the cost of purchasing electricity and water. The Company has no control over rates for power provided by Arizona Public Service Company (the Company's primary power supplier) and co-op suppliers, whose rates and charges for service are adjusted by the Commission. Similarly, the Company has no control over rates charged by the Ajo Improvement Company, the sole supplier of water

for the Company's Ajo system, or the cost of CAP water, which is set annually by the Central Arizona Water Conservation District.

In response to arguments made by the Staff witness regarding the significance of purchased power and purchased water costs, Mr. Kennedy explains that the most relevant comparison is between the cost of purchased power or purchased water and a system's total operating income, which are the funds remaining after expenses, depreciation and taxes for debt service and other capital requirements. Mr. Kennedy provides a table on page 5 of his rebuttal testimony containing that comparison:

<u>System</u>	<u>Purchased Power as a Percentage of Operating Income</u>	<u>Purchased Water as a Percentage of Operating Income</u>
Ajo	8.58%	467.24%
Casa Grande	68.66%	42.20%
Stanfield	67.27%	0.00%
White Tank	64.56%	30.78%
Coolidge	96.69%	55.59%

In his rejoinder testimony, Mr. Kennedy points out that in 2004, the Commission authorized rate increases for the Ajo Improvement Company, which resulted in an annual increase in the Ajo system's purchased water cost of \$34,773. Without the PWAM, the Company would have had to prepare an emergency rate filing, incur substantial legal expenses (which would have been passed on as rate case expense), and suffered a delay in collecting the necessary revenue increase.

### **3. Capital Structure and Weighted Average Cost of Capital.**

Mr. Kennedy also addresses the Company's capital structure and its proposed weighted cost of capital, which is 10.5%, and sponsors the Company's D Schedules. At the end of the 2003 test year, the Company (on a company-wide basis) had long-term debt totaling \$22.2 million, at an average embedded cost of 8.43%. Mr. Kennedy explains that the amount of debt in the Company's capital structure will increase substantially, as arsenic treatment facilities and other plant are added to comply with the new arsenic MCL by January 2006. The Company expects to issue a new series of long-term bonds by the end of 2005. Consequently, the decision in this case will impact the Company's ability to finance the arsenic treatment facilities as well as the cost of new debt.

In response to the 9.1% return on equity recommended by Staff, Mr. Kennedy points out that in the Company's Eastern Group rate case, Staff's basic cost of equity, using its six "proxy" publicly traded water utilities, was 9.2%, which was adopted by the Commission. In this case, in contrast, Staff's recommended rate of return is 9.1%, even though interest rates have increased since mid-2003, when Staff's cost of equity estimates were made in the Eastern Group rate case.

Mr. Kennedy also discusses the fact that investors do care about specific company risk, and use a variety of sources to conduct research on the risks and returns of individual companies before investing in a particular stock. He expresses agreement with specific risks identified by Dr. Zepp in recommending an adjustment of at least 50 basis points for the Company. Those company-specific risks include the use of an historical test year, with limited out-of-period adjustments; elimination of the PPAM and PWAM for the Company's Eastern Group systems; limited ability to recover costs associated with arsenic treatment outside a general rate case; and risks resulting from use of an inverted three-tiered commodity rate structure, without any consideration of the impact on customers' water use and the Company's revenues.

#### **4. Rate Design.**

Mr. Kennedy addresses the issue of rate design and sponsors the Company's H Schedules. The Western Group systems have a very simple rate design that is easy for customers to understand and for the Company to administer, and produces predictable revenues. The Company's monthly minimum charge is based solely on meter size, and there is a single, uniform commodity rate for all gallons sold. In this case, the Company is proposing to maintain that rate design, with the exception of eliminating the 1,000 gallons of water included in the existing monthly minimum charge.

In response to Staff's proposed inverted three-tier commodity rate design, Mr. Kennedy identifies a number of serious shortcomings, including:

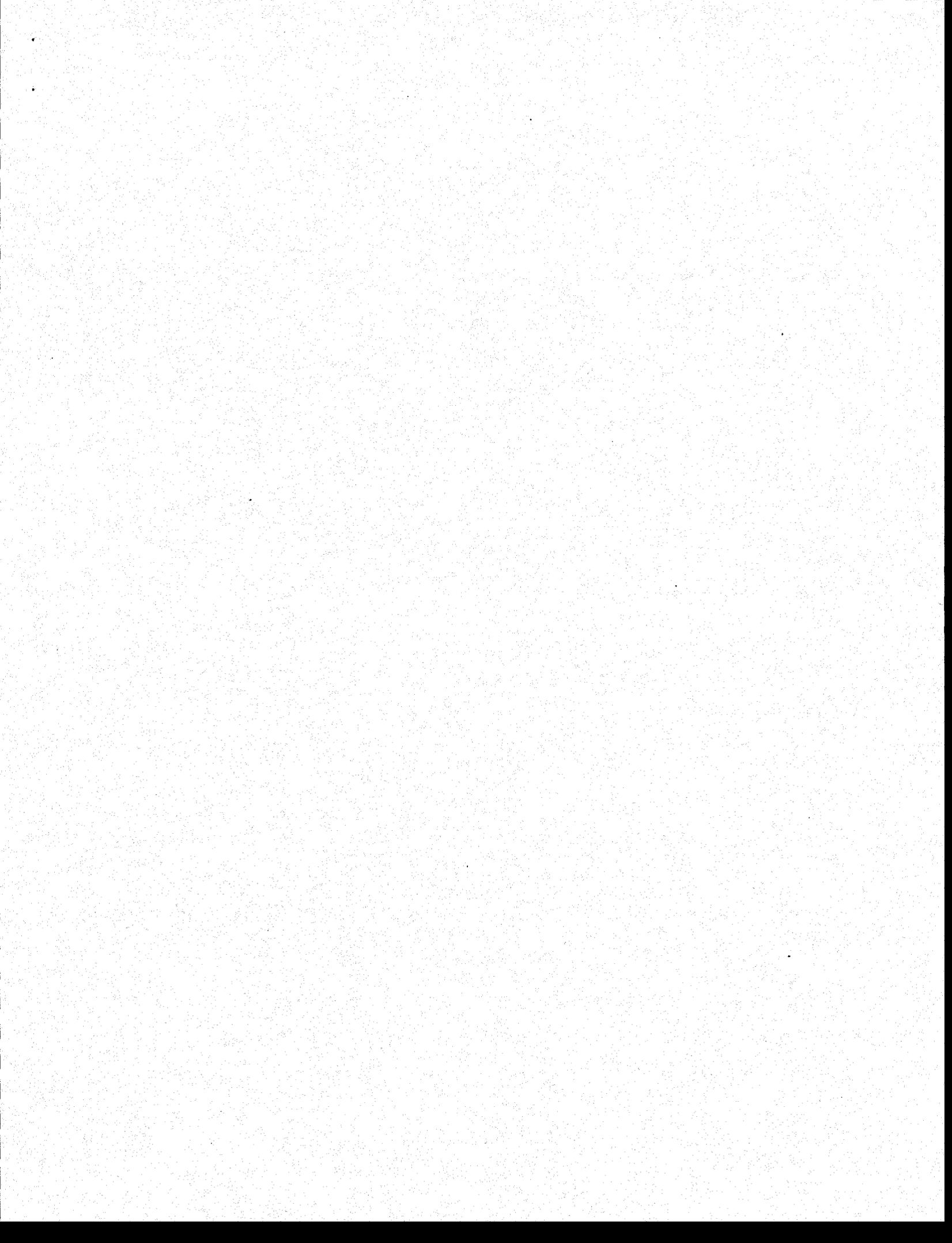
- Staff's failure to recognize and adjust rates for price elasticity.
- Staff's failure to provide any protection to the Company for the increased revenue volatility that results from Staff's tiered commodity rate design.
- Staff's failure to justify the subsidy produced by pricing the first block of water for the 5/8 x 3/4-inch meter size well below the existing commodity rate.
- In inequitable rates for larger meter sizes.

Mr. Kennedy notes that Staff failed to perform any studies or analysis to support its rate design. Staff has acknowledged, in response to Company data requests, that it does not know how its rate design will impact customer water use.

Mr. Kennedy cited materials from several authoritative sources, including the National Regulatory Research Institute ("NRRI") and the American Water Works Association ("AWWA"), explaining the need to carefully evaluate and adjust for price elasticity in implementing inverted tier rates. He also quoted from a report prepared by the Governor's Drought Task Force in June 2004, reviewing research on the elasticity of residential and industrial water demand in response to price changes. Although Mr. Kennedy provided this report to Staff in November 2004, Staff chose to ignore it. Mr. Kennedy points out that the Commissioner's stated objective for inverted tier rates is reduce water consumption. If customers' water use patterns are not influenced by inverted rates, as Staff apparently believes, then there is no legitimate reason to use them.

Mr. Kennedy also addresses RUCO's proposed rate design, which is even more seriously flawed than Staff's proposal. In contrast to Staff, RUCO proposes the *same* commodity rate blocks for all meter sizes, discriminating against customers on larger meters. In his rejoinder testimony, Mr. Kennedy presents a table showing the percentage of use in RUCO's second or upper commodity block. Under RUCO's rate design, over 97% of usage by customers on meters larger than 1-inch would fall in the upper commodity rate block, while 40% of usage by customers on 5/8 x 3/4-inch meters would fall in the lower commodity rate block. Like Staff, RUCO has proposed this rate design without any study or analysis, and has ignored its impact on the Company's ability to collect sufficient revenues to earn its authorized rate of return.

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## ARIZONA WATER COMPANY

Docket No. W-01445A-04-0650

### Summary of Testimony of Sheryl Hubbard

Ms. Hubbard is employed by Arizona Water Company ("Arizona Water" or "Company") as Manager of Rates and Regulatory Accounting. Ms. Hubbard holds a B.A. from Michigan State University and is a Certified Public Accountant. Ms. Hubbard has 26 years of public utility accounting and regulation experience, including Audit Manager with the Michigan Public Service Commission and Chief of the Accounting and Rates section of the Arizona Corporation Commission. She has testified in numerous proceedings involving utility rates and other regulatory matters, including the Company's recent Eastern Group rate proceeding.

Ms. Hubbard prepared direct, rebuttal and rejoinder testimony in support of the Company's request for rate increases for its Western Group systems. Ms. Hubbard's pre-filed testimony addresses a variety of rate base and income statement issues, including testimony on behalf of Arizona Water on a number of issues in dispute with Staff, RUCO and/or the City of Case Grande such as plant in service, accumulated depreciation, working capital allowance, deferred Central Arizona Project charges, purchased power and rate case expense, along with issues related to the selection of a test year and the propriety of pro forma adjustments to test year data.

In addition, Ms. Hubbard introduces and explains the majority of the standard schedules required under the Commission's regulations, including the A, B, C, E and F Schedules for the Company's Western Group. These schedules provide evidence of the Company's original cost rate base, actual and adjusted net operating income, operating income deficiency and required revenue increase for the five operating systems in the Western Group. Ms. Hubbard also explains each of the pro forma adjustments made to the Company's recorded test year accounts to make the Company's test year plant, revenues and expenses representative of the period during which new rates will be in effect, as authorized under A.A.C. R14-2-103. Copies of the summary schedules filed with the Company's rejoinder testimony are reproduced and attached to the Company's filing of Summaries of Testimonies.

A summary of the significant issues in dispute that Ms. Hubbard addresses in her prefiled testimony follows.

#### 1. RATE BASE ISSUES

##### a. **Working Capital Allowance**

Ms. Hubbard addresses the Company's working capital allowance in her testimony, including the errors in the manner in which Staff and RUCO have calculated the Company's working capital allowance. Specifically, the dispute centers on the choice of lag days associated with state and federal income taxes. As Ms. Hubbard explains, in the Company's Eastern Group rate proceeding (Decision No. 66849 (March 19, 2004) at 9), the Commission discussed the

calculation of the federal income tax lag days and adopted the Company's calculation of 2.52 lag days for federal income taxes and 27.05 for state income taxes. Nevertheless, in this case, RUCO continues to offer the same recommendation for federal income tax lag days of 61.95 that the Commission rejected in the last two rate cases for Arizona Water. Similarly, Staff recommends a lead/lag factor for federal and state income taxes of 37 days. Like RUCO's calculation, this has the effect of lowering the working capital allowance and the revenue requirement. However, Ms. Hubbard explains that Staff's calculation of the 37-day lag factor for federal and state income taxes is based upon the mistaken assumption that the service period for the tax liability paid quarterly is the twelve months of the tax year. Accordingly, Staff's analysis uses a mid-point for the service period of July 1. Conversely, the Company uses a service period that reflects the period that gives rise to the tax liability, i.e., the months in which the revenues are earned. The quarterly tax payment is related to the income earned monthly during the respective quarters. Therefore, the service period is more appropriately the mid-point of the month, which translates into the lag factors of 2.52 for federal income taxes and 27.05 for state income taxes, as the Commission previously recognized in the Company's Northern and Eastern Group cases.

**b. Accumulated Depreciation**

RUCO proposes to eliminate the adjustment to the accumulated depreciation balance that the Company made to annualize the depreciation expense on the year-end plant in service. As Ms. Hubbard testifies, based on her substantial experience, the Commission has consistently adopted the second adjustment when the first is made. See Decision No. 64282 at 6; Decision No. 66849 at 6.

Another adjustment that RUCO proposes to the accumulated depreciation balance results from its recalculation of the annual depreciation expense and plant retirements for the period since the 1990 test year used in the Company's last rate case. As Ms. Hubbard explains, RUCO made a number of errors in its recalculation. RUCO failed to account for the fact that the accumulated depreciation balance is impacted by more than just the annual depreciation expense and plant retirements. The Company was authorized by the Commission to record a reserve deficiency adjustment to its accumulated depreciation accounts for all of its Western Group systems for all of the years included in RUCO's recalculation efforts. Decision No. 38733 (December 2, 1966) at 1.

The cost of removal/salvage was also ignored by RUCO in calculating a proposed adjustment to the Accumulated Depreciation balances of the Western Group systems. Again, as Ms. Hubbard explained, RUCO failed to include the reserve deficiency adjustment and the adjustments for cost of removal/salvage in its recalculations, resulting in an erroneous adjustment to the Company's test year Accumulated Depreciation balance.

For Company systems that lease office facilities, RUCO used the composite depreciation rate instead of the proper leasehold amortization rate. In addition, RUCO erroneously adjusted the accumulated depreciation balance by the retirement of non-depreciable plant. Accordingly, no adjustment is necessary to the accumulated depreciation balance because the adjustment proposed by RUCO arises only because of errors in RUCO's calculations.

c. **Deferred CAP Charges**

Ms. Hubbard also testifies about the appropriate treatment of deferred Central Arizona Project ("CAP") charges, including deferred CAP M&I capital charges for the Western Group that the Commission authorized the Company to accrue in the last rate decision. In this case, the Company initially proposed to include the test year end balance of deferred M&I charges in rate base and amortize the deferred charges over a period of time equivalent to the time period that the deferred charges have been accumulated. In the case of the Casa Grande, White Tank and Coolidge systems, the Company estimates this period of time to be approximately ten years (1993 to 2003). The Company proposed that the M&I deferral be amortized to expense over a ten-year amortization period. The balance of the deferred M&I charges as of December 31, 2003 is \$3,525,803 for Casa Grande, \$506,268 for White Tanks, and \$1,046,011 for Coolidge resulting in annual amortizations amounts of \$352,580, \$50,627, and \$104,601, respectively. This was similar to the approach the Commission took in the Company's recent Eastern Group proceeding with respect to the Apache Junction system. Decision No. 66849, (March 19, 2004) at 10.

As Ms. Hubbard testifies, the Company's initial proposal is consistent with the policy on CAP cost recovery found on the Commission's website. In that policy, Staff has identified four criteria that a water company must address and provide evidence to demonstrate compliance when requesting CAP cost recovery. First, the water company must demonstrate that the CAP allocation is needed to properly serve its customers. The second requirement is that the CAP allocation will be needed by 2025. The third requirement is that a reasonable amount of the CAP allocation will actually be used by 2025. The fourth requirement is that the water company will be using all of its CAP allocation by 2034.

Later, in her rebuttal testimony, Ms. Hubbard testified that both Staff and RUCO completely ignored the CAP Cost Recovery Policy found on the Commission's website. Instead, both parties relied primarily on Commission decisions issued prior to the adoption of the CAP Cost Recovery Policy to support their recommended disallowance of all deferred and current CAP M&I capital charges. In response, the Ms. Hubbard again explained how the Company's proposal met all four criteria:

i. CAP Allocation Is Needed to Properly Serve Customers

Use of the CAP allocation to provide non-potable water reduces the Company's demand for groundwater (as required by the Groundwater Code), while still providing the required level of water service to the Company's customers. In addition, CAP water is needed to ensure an adequate long-term water supply. Planning for a regional CAP water treatment plant to provide potable water service in the Company's Casa Grande and Coolidge systems has been underway for several years.

In the White Tank system, customers have increased 106 percent (from 617 to 1270) since the Company's last rate case. To accommodate this growth in water demand, the Company is in the process of contracting for the treatment of

its CAP allocation to provide potable water to customers in the White Tank system, as further detailed in the rebuttal testimony of Mr. Garfield.

In the Coolidge system, the Company is presently proceeding with preliminary engineering design work and right-of-way acquisition and permitting for a CAP water treatment plant for use by the Coolidge and Casa Grande systems, as well as other future interconnected systems. These engineering and permitting efforts are discussed in more detail in the rebuttal testimony of Mr. Whitehead. Finally, the Company is already making non-potable CAP water available to serve golf courses and industrial customers under its NP-260 tariff, thereby reducing groundwater pumping and preserving groundwater supplies.

ii. CAP Allocation Is Needed By 2025.

In Casa Grande, a significant portion of the CAP allocation is currently being used (approximately 2,300 acre-feet of the Company's allocation were used during 2004). The Company anticipates continued increases in non-potable CAP water usage in Casa Grande and upon completion of a treatment plant, CAP water will also be used for potable purposes. Accordingly, the Company expects that the full CAP allocation will be needed at the time a CAP water treatment plant is completed, currently anticipated by 2012, many years before the deadline in the CAP Cost Recovery Policy.

In White Tank, the CAP allocation will be used to reduce the Company's dependence on groundwater and meet increasing water system demands. Although the CAP allocation is currently needed, a CAP water treatment plant is not presently available. Upon completion of a joint CAP water treatment plant with Arizona-American Water Company ("AAWC"), this condition will be fully satisfied. In addition to this potable use of treated CAP water, the Company expects demand for non-potable CAP water in the White Tank system to develop as non-potable uses and needs for such water develop similar to customers currently using non-potable CAP water in other Company systems.

In Coolidge, as in White Tank, the CAP allocation will be used to reduce the Company's dependence on groundwater and to meet increasing demand. The Company is currently proceeding with preliminary engineering and right-of-way acquisitions and permitting for a CAP water treatment plant to provide treated CAP water to customers of the Casa Grande and Coolidge water systems as well as other systems interconnected with such systems. The current timetable for completion of a Casa Grande CAP water treatment plant is 2012, but demand for non-potable CAP water is expected to increase from current levels in both Coolidge and Casa Grande.

iii. Reasonable Amount of Allocation Will Be Used by 2025

The Company intends to reduce its reliance on groundwater by encouraging customers to use non-potable supplies where possible, constructing a

regional CAP water treatment plant, and participating in a joint CAP water treatment plant with AAWC. The Company's present goal and current plans for using the CAP allocations for Casa Grande, White Tank, and Coolidge satisfy the criteria that a reasonable amount of the CAP allocation will be used by 2025.

iv. All of CAP Allocation Used by 2034

The Company is in the process of developing capabilities for CAP water treatment plants to fully utilize its CAP allocations for Casa Grande, White Tank, and Coolidge—by 2008 in White Tank and by 2012 for Casa Grande and Coolidge—well before 2034. Consistent with the Company's current goals and operating expectations, the Commission's criteria as set forth in the CAP Cost Recovery Policy that all of a company's CAP allocation be used by 2034 will also be satisfied. The Company's primary concern is to ensure that the use of the CAP allocations provide direct benefits to our customers at the most reasonable cost.

Staff sought to couch its opposition to recovery of the deferred CAP charge in the "used and useful" concept. As Ms. Hubbard explained, however, the Commission enjoys a great deal of latitude to ascertain what is and is not "used and useful." For example, in Decision No. 62293 (February 1, 2000) concerning the Sun City Water Company and Sun City West Utilities Company (now operational districts of AAWC), the "used and useful" criteria was satisfied by identifying a recharge facility that would be available in the near future to receive the Sun City CAP allocation. The recharge facility, which belongs to the Maricopa Water District ("MWD"), was not located in the Sun City service territory and as such did not provide a direct benefit to the ratepayers. Nevertheless, the deferred CAP M&I capital charges were amortized over the period that the charges had accumulated, five years, with a partial return on the unrecovered balance. Decision No. 62293 at 8. *See also* Decision No. 62450 (April 14, 2000) (the "used and useful" criteria for CAP cost recovery was satisfied by allowing Vail Water Company to recharge its CAP allocation at a remote location, not contiguous to its service territory); Decision No. 64889 (March 19, 2004) (most of the CAP allocation for the Company's Apache Junction system was used for potable and non-potable purposes and a full return on the unrecovered deferred CAP M&I capital charges was authorized).

As discussed throughout its rebuttal filing, the Company has specific plans in place for CAP water treatment plants to provide potable CAP water to its customers in the Casa Grande, White Tank and Coolidge systems in the near future. In addition, the CAP allocation has been used to the customers' benefit by allowing the subdivision of property with the Company's service area. Non-potable CAP water is already being provided to customers in the Casa Grande system, and with the arrival of new developments in the Coolidge and White Tank systems, the demand for non-potable CAP water will increase. Providing non-potable CAP water reduces CAP M&I capital charges and deferred CAP M&I capital charges, which in turn reduces the level of charges to be recovered from the general body of customers. To the extent it applies, Ms. Hubbard testifies the concept is met in this case with respect to deferred CAP M&I charges.

Ms. Hubbard also responds to RUCO. RUCO witness, William A. Rigsby testified that the Company's NP-260 tariff "allows Arizona Water to recover the deferred CAWCD M&I

charges that are attributable to non-potable customers in Casa Grande.” However, non-potable customers are liable for the deferred CAP M&I charges only to the extent that they have a contractual commitment for a portion of the Company’s CAP allocation. These obligations have already been reflected in the deferred CAP M&I balance. In the case of the golf course customers, there is no contractual commitment to the Company’s CAP allocation and the allocation remains available to the Company’s remaining customers.

The CAP Cost Recovery Policy makes a clear distinction between recovery: (1) when CAP water is used; (2) when it is partially used; and/or (3) when it is not currently in use. The Company has demonstrated how its proposal is consistent with the guidance of the Commission’s CAP Cost Recovery of CAP M&I costs Policy. The Company’s goal is to propose a means of recovery of CAP M&I costs that are fair to the ratepayers who benefit from the CAP allocations. As Ms. Hubbard testified, RUCO simply wants to deny the Company recovery of these prudently incurred costs.

Finally, Ms. Hubbard expressed the Company’s most recent proposal for cost recovery in her prefiled rejoinder testimony. The Company’s proposed cost recovery mechanism provides for collection of a hook-up fee for 10 years. The hook-up fee would be paid on new lots and treated as revenue with a corresponding offset of the ongoing M&I charges and the remainder would reduce the balance of deferred CAP M&I charges.

## **2. INCOME STATEMENT ISSUES**

### **a. CAP M&I Capital Charges**

A pro forma adjustment was made by the Company to include CAP M&I capital charges to reflect 1) the ongoing CAP M&I capital charges reflected as a pro forma adjustment to purchased water expense; and 2) the amortization of deferred CAP M&I capital charges reflected as a pro forma adjustment to the test year Depreciation and Amortization Expense in accordance with the CAP Cost Recovery Policy. The ongoing CAP M&I capital charges were computed at the current rate of \$28 per acre-foot (effective January 1, 2005) for each system’s CAP allocation (Casa Grande (8,884 acre feet (“A.F.”)), White Tank (968 A.F.), and Coolidge (2,000 A.F.)). For Casa Grande, 2,279 A.F. (26%) of the CAP allocation is being used and accordingly, only the net incremental CAP M&I capital charges of \$133,483 require Commission approval in this proceeding. The net incremental amount of \$133,483 was computed by calculating the CAP M&I capital charges at \$28 per A.F. on the entire Casa Grande allocation (8,884 A.F. X \$28 = \$248,752) and deducting the CAP M&I capital charges reflected in the test year expenses for non-potable sales of \$115,269. The amortized portion of the deferred CAP balance appears as a pro forma adjustment to the test year Depreciation and Amortization Expense. The deferred CAP M&I capital charges that the Company is seeking authorization to amortize are \$3,525,803 for Casa Grande, which is net of \$989,314 from non-potable sales; \$506,268 for White Tank; and \$1,046,011 for Coolidge. This results in amortization expense of \$352,580 for Casa Grande, \$50,627 for White Tank, and \$104,601 for Coolidge.

As explained in the summary of rate base issues, Staff and RUCO have ignored the CAP Cost Recovery Policy, which contemplates cost recovery upon providing evidence demonstrating

compliance with the four conditions discussed earlier in this testimony. The policy is also very clear about the level of cost recovery that will be allowed upon demonstration of compliance with conditions 1 through 4 of the CAP Cost Recovery Policy. At a minimum, based on the portion of the CAP allocations being used, the Company should be authorized to include 4% of its deferred CAP M&I capital charges in Casa Grande's rate base and earn a return on that portion of its investment with a 10-year amortization to expense. See Garfield Rebuttal at Exhibit WMG-R2. In addition, ongoing CAP M&I capital charges and the balance of deferred CAP M&I capital charges would be fully recovered in commodity charges, however without a rate of return. For the Company's White Tank system, until the Company is actually using all or some of its CAP allocation, the deferred CAP M&I capital charges would be recoverable over a 10-year period, as well as ongoing CAP M&I capital charges, but the deferred CAP balance would not be included in rate base until the Company is actually using some or all of its CAP allocation. For the Coolidge system, the deferred CAP M&I capital charges would be recoverable over a 10-year period, as well as ongoing CAP M&I capital charges, but the deferred CAP balance would not be included in rate base until the Company is actually using some or all of its CAP allocation.

#### **b. Revenue And Expense Annualization**

Ms. Hubbard responds to RUCO's allegation that the Company's pro forma adjustment to annualize revenues fails to reflect year-end customer levels. However, RUCO's allegations are based on stale data and constitute nothing more than a means to distort the basis for its adjustment to annualize revenues. RUCO's average revenue per customer is incorrectly based upon *all* customer classes rather than the average revenue per residential customer, which constitutes 96% of the growth in customers in the Western Group. A similar issue arose in the Eastern Group rate case, where the Commission held that a revenue annualization that averages revenue increases to all customer classes results in an *overstatement* of revenue because it does not recognize that the vast majority of growth occurred in the 5/8 x 3/4-inch residential class. Decision No. 66849 at 12. Unfortunately, RUCO has used the same disapproved approach in this case.

The Company's expense annualization based upon costs per customer statistics was limited to transmission, distribution expenses and customer accounts expense. Statistics representing average operation and maintenance costs per customer or per gallon are accepted within the industry to evaluate a company's operating efficiency as compared to others in the same industry. The cost categories that the Company has increased in its expense annualization adjustment are all operations and maintenance costs. Source of supply, pumping, and water treatment have been computed on a cost per gallon basis while transmission, distribution and customer accounts have been computed using unit costs per customer. The Company is not convinced by RUCO's questionable and highly suspect regression analysis that transmission, distribution and customer accounts expenses will remain constant as a result of providing water to additional customers. It seems obvious that as new customers are added, there will be additional meter installations, maintenance, meter readings, and customer billing and collection activity.

**c. Property Taxes**

RUCO's challenge in this case to property tax expense is the same argument RUCO has made and the Commission has rejected on a number of occasions, including the Company's Eastern Group case. *See e.g., Rio Rico Utilities, Inc.* Decision No. 67279 (October 5, 2004) at 8. *Bella Vista Water Company*, Decision No. 65350 (November 1, 2002) at 15-16; *Far West Water Company*, Decision No. 62649 (June 13, 2000) at 8. As Ms. Hubbard explains, the 2001, 2002, and 2003 revenues that form the basis of RUCO's recommended property tax expense level fail to reflect the known impact of increased revenues on property taxes. Actually, all RUCO has done is use the Arizona Department of Revenue formula to recalculate the Company's 2004 tax bill.

**d. Purchased Power Adjustments**

In this case, Arizona Water proposes a pro forma adjustment to the Company's adjusted test year purchased power expense of \$22,779 for the Western Group to reflect recent increases in the rates paid by the Company for power supplied by APS following Decision No. 67744 (April 7, 2005). The Company's adjustments incorporate the effects of the rate increases granted to APS for both of the tariffs applicable to Arizona Water (Rate 221 and Rate 32), and are based on the Company's test year power usage patterns under each applicable APS tariff. In contrast, RUCO's pro forma adjustments did not incorporate the Rate 221 rate change, but instead applied the 3.5% rate change to APS' Rate 32 to all of the Company's test year purchased power expense. Staff, in contrast, erroneously removed the Company's pro forma adjustment under the misconception that it was somehow tied to the pumping costs related to CAP water.

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ARIZONA WATER COMPANY  
SUMMARY OF PARTIES' SCHEDULE A-1  
COMPUTATION OF INCREASE IN  
GROSS REVENUE REQUIREMENTS  
TEST YEAR 2003 WESTERN GROUP

Line No.	Description	Company		Rejoinder Exh SLH-RJ4 (p. 1) Column (5)	Staff		RUCO	
		Direct Testimony	Rebuttal Exh SLH-R1 (p. 1) Column (6)		Direct Testimony	Surrebuttal Testimony	Direct Testimony	Surrebuttal Testimony
1.	Adjusted Rate Base	29,416,615	25,243,002	24,481,429	23,111,191	23,111,191	23,342,003	23,342,003
2.	Adjusted Operating Income	1,462,933	1,462,933	1,674,449	1,640,062	2,011,473	2,065,077	2,065,077
3.	Current Rate of Return	4.97%	5.60%	N.M.	7.10%	8.70%	8.85%	8.85%
4.	Required Operating Income	3,088,745	2,650,515	2,570,550	2,056,896	2,056,896	2,140,462	2,140,462
5.	Required Rate of Return	11.00%	10.90%	10.90%	8.566%	8.566%	8.68%	8.68%
6.	Operating Income Deficiency	1,625,812	1,187,582	896,101	416,834	45,423	75,385	75,385
7.	Gross Revenue Conversion Factor	1.63245	1.63245	1.63245	1.63195	1.63195	Various	Various
8.	Increase in Gross Revenue	2,654,056	1,938,668	1,462,840	680,466	74,151	110,269	110,269

ARIZONA WATER COMPANY  
SUMMARY OF PARTIES' SCHEDULE A-1  
COMPUTATION OF INCREASE IN  
GROSS REVENUE REQUIREMENTS  
TEST YEAR 2003 CASA GRANDE

Line No.	Description	Company		Rejoinder Exh SLH-RJ4 (p. 2) Column (f)	Staff		RUCO	
		Direct Testimony	Rebuttal Exh SLH-R1 (p. 2) Column (e)		Direct Testimony	Surrebuttal Testimony	Direct Testimony	Surrebuttal Testimony
1.	Adjusted Rate Base	21,996,652	19,375,318	18,613,745	17,352,671	17,352,671	17,380,813	17,380,813
2.	Adjusted Operating Income	1,180,182	1,180,182	1,331,922	1,278,159	1,541,880	1,584,336	1,584,336
3.	Current Rate of Return	5.37%	6.09%	N.M.	7.37%	8.89%	9.12%	9.12%
4.	Required Operating Income	2,308,648	2,034,408	1,954,443	1,544,388	1,544,388	1,593,821	1,593,821
5.	Required Rate of Return	10.50%	10.50%	10.50%	8.90%	8.90%	9.17%	9.17%
6.	Operating Income Deficiency	1,128,466	854,226	622,521	265,229	2,528	9,485	9,485
7.	Gross Revenue Conversion Factor	1.63245	1.63245	1.63245	1.63246	1.63246	1.63249	1.63249
8.	Increase in Gross Revenue	1,843,798	1,394,482	1,016,235	432,975	4,126	15,483	15,483

ARIZONA WATER COMPANY  
SUMMARY OF PARTIES' SCHEDULE A-1  
COMPUTATION OF INCREASE IN  
GROSS REVENUE REQUIREMENTS  
TEST YEAR 2003 STANFIELD

Line No.	Description	Company		Rejoinder Exh SLH-RJ4 (p. 3) Column (5)	Staff		RUCO	
		Direct Testimony	Rebuttal Exh SLH-R1 (p. 3) Column (6)		Direct Testimony	Surrebuttal Testimony	Direct Testimony	Surrebuttal Testimony
1.	Adjusted Rate Base	314,131	314,131	314,131	310,269	310,269	326,427	328,427
2.	Adjusted Operating Income	25,877	25,877	25,877	23,872	24,124	29,511	29,511
3.	Current Rate of Return	8.24%	8.24%	N.M.	7.69%	7.78%	9.04%	9.04%
4.	Required Operating Income	32,984	32,984	32,984	27,814	27,814	29,933	29,933
5.	Required Rate of Return	10.50%	10.50%	10.50%	8.90%	8.90%	9.17%	9.17%
6.	Operating Income Deficiency	7,107	7,107	7,107	3,742	3,490	422	422
7.	Gross Revenue Conversion Factor	1.63245	1.63245	1.63245	1.63246	1.63246	1.26758	1.26758
8.	Increase in Gross Revenue	11,601	11,601	11,601	6,109	5,697	535	535

ARIZONA WATER COMPANY  
SUMMARY OF PARTIES' SCHEDULE A-1  
COMPUTATION OF INCREASE IN  
GROSS REVENUE REQUIREMENTS  
TEST YEAR 2003 WHITE TANK

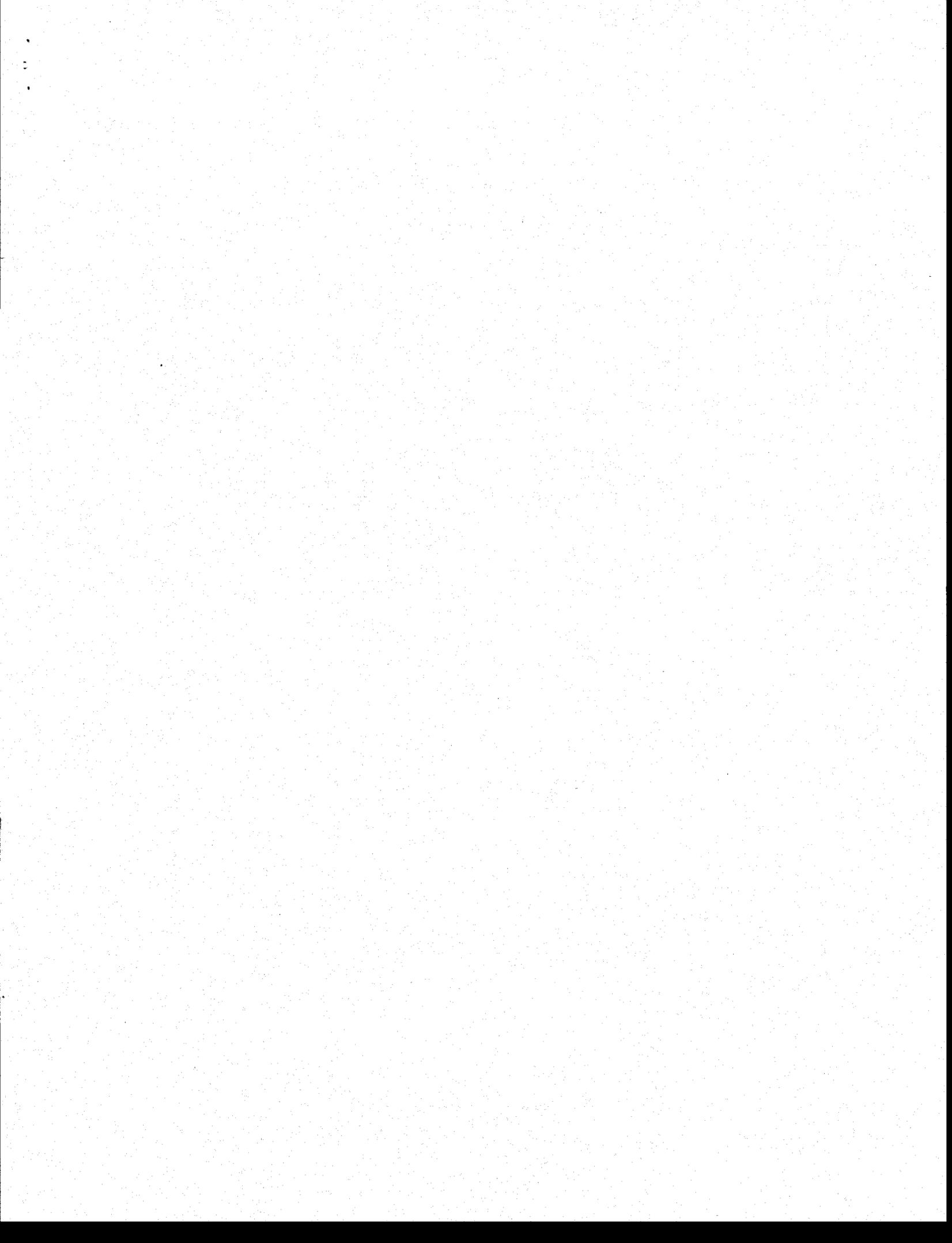
Line No.	Description	Company Rebuttal		Rejoinder Exh SLH-RJ4 (p. 4) Column (5)	Staff		RUCO	
		Direct Testimony	Exh SLH-R1 (p. 4) Column (5)		Direct Testimony	Surrebuttal Testimony	Direct Testimony	Surrebuttal Testimony
1.	Adjusted Rate Base	2,441,155	1,934,887	1,934,887	1,898,133	1,919,400	1,919,400	1,919,400
2.	Adjusted Operating Income	121,440	121,440	140,935	135,769	181,559	181,559	181,559
3.	Current Rate of Return	4.97%	6.28%	N.M.	7.15%	9.46%	9.46%	9.46%
4.	Required Operating Income	256,321	203,163	203,163	168,934	176,009	176,009	176,009
5.	Required Rate of Return	10.50%	10.50%	10.50%	8.90%	9.17%	9.17%	9.17%
6.	Operating Income Deficiency	134,881	81,723	62,228	33,145	(5,550)	(5,550)	(5,550)
7.	Gross Revenue Conversion Factor	1.63245	1.63245	1.63245	1.63248	1.54386	1.54386	1.54386
8.	Increase in Gross Revenue	220,187	133,409	101,584	54,108	(6,568)	(6,568)	(6,568)

ARIZONA WATER COMPANY  
SUMMARY OF PARTIES' SCHEDULE A-1  
COMPUTATION OF INCREASE IN  
GROSS REVENUE REQUIREMENTS  
TEST YEAR 2003 AJO

Line No.	Description	Company		Rejoinder Exh SLH-RJ4 (p. 5) Column (5)	Staff		RUCO	
		Direct Testimony	Rebuttal Exh SLH-R1 (p. 5) Column (5)		Direct Testimony	Surrebuttal Testimony	Direct Testimony	Surrebuttal Testimony
1.	Adjusted Rate Base	847,167	847,167	847,167	837,088	846,711	837,088	846,711
2.	Adjusted Operating Income	34,697	34,697	34,697	35,675	37,858	36,503	37,858
3.	Current Rate of Return	4.10%	4.10%	N.M.	4.26%	4.47%	4.36%	4.47%
4.	Required Operating Income	88,953	88,953	88,953	74,501	77,643	74,501	77,643
5.	Required Rate of Return	10.50%	10.50%	10.50%	8.90%	9.17%	8.90%	9.17%
6.	Operating Income Deficiency	54,256	54,256	54,256	38,626	39,785	37,998	38,785
7.	Gross Revenue Conversion Factor	1.63245	1.63245	1.63245	1.63246	1.31426	1.63246	1.31426
8.	Increase in Gross Revenue	88,569	88,569	88,569	63,362	52,288	62,030	52,288

ARIZONA WATER COMPANY  
SUMMARY OF PARTIES' SCHEDULE A-1  
COMPUTATION OF INCREASE IN  
GROSS REVENUE REQUIREMENTS  
TEST YEAR 2003 COOLIDGE

Line No.	Description	Company		Rejoinder Exh SLH-RJ4 (p. 6) Column (5)	Staff		RUCO	
		Direct Testimony	Rebuttal Exh SLH-R1 (p. 9) Column (5)		Direct Testimony	Surrebuttal Testimony	Direct Testimony	Surrebuttal Testimony
1.	Adjusted Rate Base	3,817,510	2,771,499	2,771,499	2,713,030	2,713,030	2,868,652	2,868,652
2.	Adjusted Operating Income	100,737	100,737	141,018	185,567	237,788	231,813	231,813
3.	Current Rate of Return	2.64%	3.63%	N.M.	6.10%	8.78%	8.08%	8.08%
4.	Required Operating Income	400,839	291,007	291,007	241,460	241,460	263,055	263,055
5.	Required Rate of Return	10.50%	10.50%	10.50%	8.90%	8.90%	9.17%	9.17%
6.	Operating Income Deficiency	300,102	190,270	149,989	75,893	3,672	31,242	31,242
7.	Gross Revenue Conversion Factor	1.63245	1.63245	1.63245	1.63246	1.63246	1.61740	1.61740
8.	Increase in Gross Revenue	489,901	310,607	244,850	123,692	5,984	50,531	50,531



## ARIZONA WATER COMPANY

Docket No. W-01445A-04-0650

### Summary of Testimony of Dr. Thomas M. Zepp

Dr. Zepp testifies on the appropriate cost of equity for Arizona Water Company. He is an economist and Vice President of Utility Resources, Inc., a consulting firm established in 1985. Dr. Zepp received his Ph.D. in Economics at the University of Florida, where he also taught economics and business courses at the graduate and undergraduate level. Before establishing Utility Resources, Dr. Zepp was a consultant at Zinder Companies from 1982 until 1985, and was a senior economist on the staff of the Oregon Public Utility Commissioner from 1976 to 1982. Dr. Zepp has testified before two Canadian regulatory bodies, 4 federal agencies and in 22 states on cost of equity, values of utility properties, economic costs of utility services, appropriate rate designs and other economic issues.

In this case, Dr. Zepp prepared direct, rebuttal and rejoinder testimony on behalf of Arizona Water. His estimates of the cost of equity were based on the discounted cash flow ("DCF") models used by the Federal Energy Regulatory Commission ("FERC") and the Risk Premium method used by the Staff of the California Public Utility Commission ("PUC"). Dr. Zepp also presented evidence on the current cost of equity derived from Arizona Corporation Commission ("ACC") decisions prior to 2001; currently authorized and earned returns on equity ("ROEs") for water utilities; and *Value Line Investment Service* projections of ROEs publicly traded water utilities will earn in the future. Even though Dr. Zepp believes the methods used by FERC and the California PUC Staff produce conservative estimates of the cost of equity, he presented cost of equity estimates based on those approaches to demonstrate the methods used by the ACC Staff and the Residential Utility Consumer Office ("RUCO"), an intervenor in this case, substantially understate a fair rate of return on equity for water utilities. Dr. Zepp noted these equity cost estimates are generally consistent with authorized and realized equity returns of the water utilities in the sample group, and are below the equity returns projected by *Value Line* for 2006 and later periods.

In his rebuttal and rejoinder testimonies, Dr. Zepp identified and discussed a number of significant deficiencies in the methods used by the ACC Staff and RUCO cost of capital witnesses, which result in a downward bias, reducing the cost of equity produced by their models. Dr. Zepp also restated the ACC Staff and RUCO equity cost estimates with conceptually correct inputs in the models they chose to use. The table attached to this summary contains the most recent update of Dr. Zepp's cost of equity estimates as well as a list of equity cost estimates made by using the approaches taken by the ACC Staff and RUCO. The restatements of the ACC Staff and RUCO equity cost estimates generally produce estimates of the benchmark cost of equity that are within or close to the 10.2% to 10.9% ROE range found with the DCF models used by the FERC and the Risk Premium approaches used by the California PUC.

In his testimony, Dr. Zepp also explained why Arizona Water is more risky than the publicly traded water utilities used as proxies by the ACC Staff and RUCO witnesses to determine their benchmark equity costs. Dr. Zepp identified several risks that would cause

investors to require a higher return, including Arizona Water's small size, elimination of the Company's PPAM and PWAM in the Eastern Group, the design of the Company's arsenic treatment cost recovery mechanism, destabilization of revenues from inverted-tier rate designs, and the use of an historic test year with limited adjustments for out-of-period changes. Dr. Zepp concluded that a fair ROE for Arizona Water is 11.25%.

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Arizona Water Company

Rejoinder Table 11

Summary of Rejoinder Equity Cost Estimates for Water  
Utilities Sample and Arizona Water Company

	Water Utilities Sample	Indicated Co: of Equity for Arizona Water
<u>Updates of Zepp Equity Cost Estimates</u>		
FERC 1-Step	10.4%	10.9%
FERC 2-Step	10.2%	10.7%
California RP Analysis	10.5%	11.0%
Modified CPUC Analysis	10.9%	11.4%
<u>Equity Costs Determined in Rebuttal Testimony</u>		
Average of Currently Authorized ROEs	10.4%	10.9%
Average of ROEs Earned in 2004	10.0%	10.5%
Equity Cost based on Average Risk Premium Determined by ACC Prior to 2001		
• Based on Forecasted Rates	10.7%	11.2%
• Based on Rates in March 2005	10.0%	10.5%
FERC 1-Step w/ Mr. Ramirez's data	11.5%	12.0%
FERC 2-Step w/ Mr. Ramirez's data	11.2%	11.7%
Average of Mr. Ramirez's Equity Cost Estimates Restated in Rebuttal Table 12	10.6%	11.1%
Average of Mr. Ramirez's Equity Cost Estimates but with Methods used by the CPUC Staff	10.5%	11.0%
Restatement of Mr. Rigsby's Equity Cost Estimates		
• DCF	10.9%	11.4%
• CAPM	11.0%	11.5%
<u>Equity Costs Determined in Rejoinder Testimony</u>		
Response to Mr. Ramirez		
• Constant Growth DCF with Mr. Ramirez's Projections of DPS, EPS and Intrinsic Growth	10.5%	11.0%
• Mr. Ramirez's Multi-stage growth with Intrinsic growth included in his analysis for 2007-2009 and corrected terminal growth rate	9.9%	10.4%
• Updated CAPM with the same measure of Rf used to determine Rp and Rf	10.1%	10.4%
Response to Mr. Rigsby		
• Mr. Rigsby's DCF analysis but using analysts' forecasts of growth instead of br+sv growth	10.5%	11.0%
• Mr. Rigsby's CAPM based on current long-term Treasury rate of 4.52%	10.3%	10.8%
• Average ROE Projected for Mr. Rigsby's Water Utilities Sample by Value Line for 2008-2010	12.0%	12.5%