ORIGINAL

BEFORE THE ARIZONA CORPORATION COMMISSION

308

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

IN THE MATTER OF THE APPLICATION OF VALLEY UTILITIES WATER COMPANY, INC. FOR RATE ADJUSTMENTS IN ITS WATER RATES AND FINANCING AUTHORIZATION.	Docket No. W-01412A-04-0736 W-01412A-04-0849 **STAFF'S CLOSING BRIEF**

I. INTRODUCTION

Valley Utilities Water Company, Inc. ("Valley Utilities" or "Company") filed applications to raise rates for its water customers on October 7, 2004 and to obtain financing approval for a loan from the Water Infrastructure Finance Authority ("WIFA") on November 26, 2004. On July 14, 2005, a hearing was held on the rate and financing applications in Phoenix, Arizona. Both parties in this case agree that Valley Utilities needs a rate increase and should be allowed to obtain financing.

The parties disagree on what the proper rate design should be in this case and whether or not Utilities Division Staff ("Staff") of the Arizona Corporation Commission ("Commission") should allow the Company to collect an arsenic surcharge for operation and maintenance expenses.

Staff recommends adoption of its rate design. It provides the appropriate price signals consistent with previous Commission decisions.

Since the Staff adjusted rate base is negative $539,804, Staff recommends that the Commission authorize a 10 percent operating margin, or $95,751. Staff's recommendation represents a $129,946, or 15.70 percent, revenue increase from $827,565 to $957,511. Staff's recommended revenue exceeds the Company's proposed step one revenue by $29,162. Staff's recommended rates would increase the typical ¾-inch residential water bill with a median usage of 7,500 gallons, from $28.00 to $31.76, for an increase of $3.76 or 13.45 percent.

Staff recommends that the Commission authorize the proposed WIFA loan in the amount of $1,926,100 for the construction of arsenic treatment facilities.

Staff also recommends that the Company file a plan for approval by Staff to progressively increase its equity position on an annual basis until equity represents 40 percent of total capital.

Staff's introduction is an overview of the case and Staff's recommendations. The following sections discuss the basis for Staff's position on the major issues in this case.

II. ARSENIC SURCHARGE

Staff and Valley Utilities seek a process to implement the new standards for arsenic. The maximum contaminant level ("MCL") has been lowered from 50 parts per billion ("ppb") to 10 ppb. The new standard became effective in January of 2001; however, compliance for existing water systems is not required until January 2006. The process needs to balance the interests of the ratepayers and the interests of Valley Utilities. Staff and Valley Utilities understand that the new standard for arsenic will be placing a heavy financial burden on many water companies in Arizona.

Staff's position is that the Commission should approve an Arsenic Remediation Surcharge Mechanism ("ARSM") for Valley Utilities. The ARSM would enable Valley Utilities to meet its principal and interest obligations on the proposed WIFA loan and income taxes on the surcharge. In his pre-filed testimony, Staff witness Dennis Rogers explained that Valley Utilities should follow "the same methodology presented in Table A- DRR to calculate the incremental revenue needed to meet its interest, principal and incremental income tax obligations on the WIFA loan using actual loan amounts and use the result to develop its arsenic removal surcharge tariff application. The increase in revenue calculation should be included in the arsenic removal surcharge tariff application." (Ex. S-2 at 27). Although Staff is recommending approval of the WIFA loan in this proceeding, the process for obtaining the ARSM will require a subsequent filing by Valley Utilities for consideration by the Commission for approval. The above process is consistent with "other Accelerated Arsenic Cost Recovery Mechanisms previously authorized by the Commission; please see Ash Fork Water Service, Decision No. 67158 and Mountain Glen Water Service Inc., Decision No. 67163." (Ex. S-3 at 5).

Staff's position is that the Commission should not approve an Arsenic Operating and Maintenance Recovery Surcharge Mechanism ("AOMRSM") for Valley Utilities. The Company proposes a surcharge mechanism to recover estimated operation and maintenance ("O & M") costs for arsenic treatment and removal. Staff recommends that the Company file a new rate case application after a period of time has elapsed so that the actual O & M can be determined and the appropriate rates established. Thomas Bourassa, the Company's witness, testified that he used in his pre-filed testimony "the projected costs of $216,000. This was an engineer's estimate provided by the company through a study that was done." (Tr. at 36). Staff noted in its pre-filed testimony that "authorizing estimated costs, to be recovered at some future date, before they are known and measurable, does not allow Staff the opportunity [to] ascertain with any degree of confidence the reasonableness of the charges and whether they are accounted for correctly." (Ex. S-3 at 6).

The Company makes a reference to the Ash Fork case (Decision No. 67158). The Company seems to be suggesting that the Commission has helped other companies with their O & M arsenic costs by increasing their operating margin. According to Mr. Bourassa, "a 28 percent operating margin was used rather than the 10 percent here, and perhaps that may have been the way that the Staff has provided enough money for the company to fund the arsenic. Although the decision does not mention arsenic operating and maintenance costs, but a 28 percent margin was given in that case." (Tr. at 41). However, Mr. Rogers testified that operating margins are not directly comparable among companies and that the 10 percent operating margin recommended by Staff in this case provides earnings and helps the Company build equity even though the Company has no equity investment of its own at this time. *Id.* at 132.

Staff's position is that O & M surcharges for arsenic costs are normally not allowed by the Commission. Typically, the Commission orders that "the operation and maintenance costs associated with arsenic removal be segregated and tracked for a period of time, and that the Company file a new rate case application after the actual costs become known and measurable." (Ex. S-3 at 6). Even Mr. Bourassa admits that he is not aware of any companies the size of Valley Utilities being granted a surcharge for O & M costs. (Tr. at 40-41). The Company is correct that the Commission has allowed other companies an operating and maintenance surcharge for arsenic costs when those costs were actual costs. However, for those specific cases where the O & M surcharge was allowed, the Staff only recommended "giving a deferral to those companies who have equity and are making a substantial investment in the arsenic plant..." *Id.* at 108-109. Mr. Rogers pointed out that Staff has been consistent "in that when it does defer the costs for the O & M, it defers it for a period of 12 months, have the company come in for a rate review, rate case, and have the 12 months that were deferred as a surcharge. I don't think Staff has ever recommended a continuous surcharge for arsenic O & M costs." *Id.* at 117.

Staff is not recommending any type of AOMRSM since the Company, up to this point, has failed to infuse capital into its operations. Mr. Rogers pointed out that "over a period of years, [Valley Utilities] has been offered operating margins and/or returns on its investment that should have provided equity at today's date." *Id.* at 111. Staff's recommendations must focus on what is in the public interest of the Company and the ratepayers. In this case, the negative equity of the Company continues to get worse. Staff does not want to "continually fund everything that the company -- every expense that the company forces the ratepayers to pay for[,] every expense that the company incurs[,] without [the company] having some sort of obligation to infuse some capital into [the company]." *Id.* at 113.

The Company argues that it is not fair that it should have to infuse capital in order to recover expenses that are beyond its control. However, Staff pointed out during its testimony that the Company "is in business. [The Company] operates a viable, going concern. And that any kind of business needs to position itself and be in a position to handle unforeseen events." *Id.* at 97. Furthermore, according to Mr. Rogers, a company "ought to assume some business risk, whether its government mandated, an accident, or anything else." *Id.* at 106. Thus, even if there is some additional business risk for the Company, Staff's position is that it is in the public interest for the Company to infuse capital into its operations. Staff's position is that the Commission should not approve an Arsenic Operating and Maintenance Recovery Surcharge Mechanism ("AOMRSM") for Valley Utilities.

III. RATE DESIGN

Staff's rate design should be implemented in this case. In this case, Staff is recommending an inverted three tier rate design for residential customers on 5/8 x ¾ inch and ¾ inch meters and a two tier rate design for all other customers. Staff's recommended rates acknowledge water use patterns by meter size and in total to encourage efficient consumption.

Staff's recommended first tier is not a discount or "lifeline" rate. Lifeline rates are designed according to a customer's income level. Staff noted in its pre-filed testimony that "Mr. Kozoman's suggestion that Staff's alternative purpose for the first tier for residential 5/8-inch and ¾-inch residential customers is to provide a life line rate is a red herring." (Ex. S-3 at 4). Staff's first tier and overall rate design do not discriminate based on a customer's income level. Staff's rate design is focused on sending the appropriate price signal based on the meter size a customer has and on the number of gallons of water a customer uses. Dennis Rogers, Staff's witness, pointed out in his pre-filed testimony that "Efficient water use is encouraged by producing a higher customer bill with increased consumption or a larger meter." (Ex. S-2 at 19). Staff also noted that "although the first tier for these customers may have some characteristics of a lifeline rate, they are incidental to Staff's overall rate design." (Ex. S-3 at 4).

Staff's rate design is thoroughly consistent with past Commission approved rate designs. Staff's rate design has an inverted three tier design for Residential 5/8-inch and ¾-inch customers and an inverted two tier design for all other classes of customers. Staff's rate design is consistent with the rate design approved in the Arizona-American Water Company rate case (Decision No. 67093) and the Rio Rico Utilities, Inc. rate case (Decision No. 67279). In the Arizona-American rate case, the Commission "adopted Staff's recommended rate design for all seven water systems which consisted of an inverted three tier rate design for Residential 5/8-inch and ¾-inch customers and an inverted two tier structure for all other meter sizes and customer classes." *Id.* at 3. In addition, in the Rio Rico case, "Mr. Kozoman proposed and the Commission adopted his inverted three tier rate design for 5/8-inch customers (both residential and commercial) while all other customer classes have an inverted two tier rate design." *Id.* Staff's rate design is also more likely to allow Valley Utilities a fair opportunity to earn Valley Utilities' authorized rate of return than the rate design proposed by the company. According to the Company's own witness, Ronald Kozoman, the Company's rate design "is probably more risky than Staff's. In other words, the fact that we put more into the commodity rates, which means if customers conserve, we would possibly collect a lot less money." (Tr. at 57).

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IV. ENGINEERING ISSUES

Staff recommends that the average annual water testing expense determined by Staff be adopted. Valley Utilities has reported its water testing expense for the 2003 test year. Staff has reviewed Valley Utilities' reported amount and has "made adjustments to determine [Staff's] average annual cost of $4,014 as shown in Table E-1." (Ex. S-1, MSJ-A at 4). Staff recommends that Staff's average annual cost be adopted for this proceeding.

In its rate application filing, the Company submitted $1,883,600 worth of post-test year plant for arsenic treatment plant facilities for its Well Nos. 1, 2, 4, 5 and 6. At the time of the Staff inspection on March 11, 2005, Staff "noted that these treatment facilities had not been constructed." *Id.* at 5. Thus, Staff recommends that the reported post-test year plant items not be included in rate base.

Staff recommends that Valley Utilities use the depreciation rates recommended by Staff. Valley Utilities has been using a depreciation rate of 2.50% in every National Association of Regulatory Utility Commissioners ("NARUC") plant category. Recently, the Commission has been "shifting away from the use of a composite rate in favor of individual depreciation rates by NARUC category." *Id.* Staff recommends that Valley Utilities use the depreciation rates presented in Table I-1 by individual NARUC category on a going forward basis.

Staff's position is that the service-line meter installation charges recommended by Valley Utilities are appropriate. These charges are "refundable advances and [Valley Utilities'] proposed charges are within Staff's recommended range for these charges." *Id.* at 6. Thus, Staff recommends the acceptance of Valley Utilities' proposed installation charges which includes the use of actual cost for meter sizes of 8-inch and larger as shown in Table J-1.

Staff recommends that Valley Utilities set up a curtailment tariff. A Curtailment Plan Tariff ("CPT") is "an effective tool to allow a water company to manage its resources during periods of shortages due to pump breakdowns, droughts, or other unforeseeable events." *Id.* Staff is proposing an alternative tariff form that is similar to other Class A company approved tariffs. Staff is recommending that this tariff be docketed by Valley Utilities as a compliance item in this case within 45 days of the effective date of an order in this proceeding for review and certification by Staff.

The Company is requesting financing approval for a $1,926,100 loan from the WIFA. This loan is needed to finance the purchase and construction of arsenic removal equipment to meet the new arsenic standard. The cost estimate in the financing request was produced by Narasimham Consulting Services, Inc., ("Narasimham"), a consulting firm hired by the Company. Marlin Scott Jr., Staff's engineering witness, noted in his pre-filed testimony that Narasimham "conducted an arsenic treatment study for the Company and recommended using the absorption media treatment method to reduce arsenic levels in five of the Company's six wells." (Ex. S-1, MSJ-B at 3). Staff's position is that the arsenic treatment facilities are appropriate and the estimated capital costs and O&M costs presented by the Company are reasonable for purposes of the Company's financing request.

V. CONCLUSION

In light of the above and the record in these proceedings, Staff request that the Commission adopt Staff's recommendations. Staff recommends adoption of its rate design. Staff asks that the Commission authorize the proposed WIFA loan.

Staff asks that the Commission approve the ARSM to help the Company meet its principal and interest obligations on the proposed WIFA loan and income taxes on the surcharge. Staff requests that the Commission deny the AOMRSM surcharge for recovering O & M costs for arsenic treatment and removal. Staff requests that the Company be ordered to file a plan for approval by Staff to progressively increase its equity position on an annual basis until equity represents 40 percent of total capital.

RESPECTFULLY SUBMITTED this 25th day of August, 2005.

David Ronald

David M. Ronald
Attorney, Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007
(602) 542-3402

The original and thirteen (13) copies
of the foregoing were filed this
25th day of August, 2005 with:

Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Copies of the foregoing were hand-delivered/mailed this 25th day of August, 2005 to:

Richard L. Sallquist
SALLQUIST & DRUMMOND
4500 South Lakeshore Drive
Suite 339
Tempe, Arizona 85282
Attorneys for Valley Utilities Water Company

Christopher Kempley, Chief Counsel
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Ernest G. Johnson, Director
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Lyn Farmer, Chief Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Angela L. Bennett

Angela L. Bennett, Secretary to
David M. Ronald