

**ORIGINAL EXCEPTION**  
**OPEN MEETING AGENDA ITEM**



**BEFORE THE ARIZONA CORPORATION COMMISSION**

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8 IN THE MATTER OF THE APPLICATION OF  
9 CHAPARRAL CITY WATER COMPANY,  
10 INC., AN ARIZONA CORPORATION, FOR A  
11 DETERMINATION OF THE CURRENT FAIR  
VALUE OF ITS UTILITY PLANT AND  
PROPERTY AND FOR INCREASES IN ITS  
RATES AND CHARGES FOR UTILITY  
SERVICE BASED THEREON.

Docket No. W-02113A-04-0616

**EXCEPTIONS OF THE RESIDENTIAL UTILITY CONSUMER OFFICE**

12  
13 The Residential Utility Consumer Office ("RUCO") makes the following Exceptions to  
14 the Recommended Opinion and Order ("ROO") on the Chaparral City Water Company's  
15 ("Chaparral City" or "Company") application for a rate increase.

16 On September 8, 2005, the Administrative Law Judge ("ALJ") issued her ROO. RUCO  
17 makes the following Exceptions.

18  
19 **RATE BASE**

20 **1) Fountain Hills Boulevard Main**

21 The ROO recommends the inclusion of the entire cost<sup>1</sup> of the Fountain Hills Boulevard  
22 Main extension ("Main") in rate base. The ROO rejects RUCO's argument that the Main

23 \_\_\_\_\_  
24 <sup>1</sup> The entire cost amounts to \$940,797.

1 resulted in cost savings citing insufficient evidence in the record to support RUCO's claim.  
2 ROO at 7. The ROO recommendation ignores the undisputed evidence in this case, fails to  
3 account for cost savings, and is unfair to ratepayers. The Commission should reject the  
4 ROO's recommendation.

5 The basis for the Company's request to include the Main in ratebase is that it improves  
6 service and provides greater operational efficiencies. A-1 at 9. The ROO recognized this and  
7 RUCO did not take issue with this point. However, when originally asked by RUCO about the  
8 Main, the Company responded:

9 "Yes, the extension of the water main was completed to operate the existing  
10 water distribution system in a more efficient manner. Please refer to the attached  
11 report from Entranco dated October 1997. Rather than install the 16" main at the  
12 time that plant #2 came online, pumps were installed to pump to zone 2 and  
13 allow water to flow back into zone one rather than export all flow from plant #2 to  
14 zone one and then only pump as required to meet the demand of zone 2." R-9.

15 The Main now feeds directly to Zone 1, making it no longer necessary to pump the water uphill  
16 to Zone 2 to allow it to gravity feed to Zone 1. The Entranco report referred to the pumping  
17 cost savings as follows:

18 3.63 Pumping Power Cost Savings Under Proposed Operating Conditions  
19 (without Reservoir No. 2 to Reservoir No. 1 Intertie) are as follows:

20 .....Pumping Savings .....\$113,500

21 3.8 Potential 1997 Cost Savings

22 Total potential pumping cost savings over an assumed 10 year project period =  
23 \$142,500. R-9, Entranco report at 13 and 15.

24 The Company never retracted its response or denied it. There simply is no question  
that this evidence supports the fact that prior to the Main being built the Company was  
servicing Zone 1 customers by indirectly pumping water to Zone 2. After the Main was built

1 customers were being serviced by water that was not being pumped to Zone 2 but was gravity  
2 fed through a more efficient distribution system directly to Zone 1.

3 Staff's engineer testified that there were no pumping cost savings because the new  
4 Main does not change the way the system is operated. ROO at 6-7. The ROO rejects the  
5 Company's admission that it was pumping water prior to the Main being built in favor of the  
6 testimony of Staff's engineer, who did not observe the system before the Main was built.  
7 Transcript at 637-638. The Commission should give greater weight to the Company's own  
8 statement of how its system operates than to the admittedly less-than-fully informed statement  
9 of Staff's engineer at least when the Company's statement is adverse to its own position and  
10 favorable to customer interests. The Commission should therefore reject the ROO's  
11 conclusion on this issue. Attachment A<sup>2</sup> to these exceptions includes RUCO's proposed  
12 Amendment #1 which would accomplish this result.

13  
14 **2) CAP Hook-up Fees**

15 In Decision No. 57395 (May 23, 1991), the Commission ordered that a portion of the  
16 Company's revenue requirement be recovered through hook-up fees. All parties to this case  
17 agree that hook-up fees should no longer be treated as revenue. The next question becomes  
18 how should the \$220,000 of hook-up fees paid by ratepayers in the test year be treated? The  
19 ROO recommends that the \$220,000 of test-year hook up fees paid for by ratepayers be  
20 simply removed from revenues without any further adjustments. This recommendation is  
21 unfair to ratepayers and should be rejected by the Commission.

22  
23  
24 <sup>2</sup> Attachment A includes the four Amendments to the ROO which RUCO is proposing.

1 It follows that removing \$220,000 from revenues results in a revenue requirement that is  
2 now \$220,000 greater because of the revenue reduction. Thus absent any other adjustments  
3 shareholders will be credited \$220,000 in revenue that ratepayers have funded. The ROO  
4 completely misses this point. The ROO talks about the use of the hook-up fees for plant  
5 investment versus revenues, which is irrelevant to the issue here – that this \$220,000 is  
6 ratepayer funded capital. The Commission should disregard the ROO's recommendation and  
7 credit ratepayers for the hook-up fees paid in the test-year.

8 RUCO has suggested that the Company's contributions in aid of construction ("CIAC")  
9 be increased by the same amount as the \$220,000 revenue reduction. This has the effect of  
10 reducing ratebase, which would credit ratepayers for the hook-up fees they paid in the test-  
11 year. This is only a suggestion – there are other ways the Commission could achieve the  
12 same result. What is important is that ratepayers are credited for the hook-up fees they paid in  
13 the test-year. The ROO's recommendation to credit shareholders with the hook-up fees paid  
14 by ratepayers is unfair and improper and should be rejected by the Commission. Proposed  
15 Amendment #2 would credit ratepayers for the hook-up fees they paid in the test year.

16  
17 **OPERATING INCOME**

18 **1) Property Tax Expense**

19 RUCO has consistently recommended that the Commission reconsider its position on  
20 property tax expense. It is RUCO's belief that the methodology recommended in the ROO<sup>3</sup> will  
21 result in an overstatement of property tax expense. RUCO has shown in numerous cases

22 \_\_\_\_\_  
23 <sup>3</sup> The ROO calculated average revenue used in the Arizona Department of Revenue's ("ADOR") property tax  
24 formula by summing the Company's proposed revenues plus two times its adjusted test year revenues and  
dividing by three years. RUCO follows ADOR's recommendation and calculated the Company's proposed  
revenue by summing the Company's three previous years of reported gross revenues and dividing by three.

1 including this one, where figures have been available, that RUCO/ADOR's methodology  
2 results in a more accurate estimation of property taxes than the methodology recommended in  
3 the ROO and previously supported by the Commission. The Commission should reconsider  
4 and adopt RUCO/ADOR's methodology.

5 Property taxes, unlike income taxes, are not paid when revenues are earned. Instead,  
6 there are three different lag periods that occur between when new rates are authorized and  
7 the point when the taxes are actually paid –1) when a full year of increased revenues is  
8 realized by the Company 2) when those revenues are recognized in the ADOR formula, and 3)  
9 when property taxes based on those revenues are paid. For example, if an Order is issued at  
10 the end of 2005 (which appears likely in this case), a full year of revenues at the new rates will  
11 not be realized by the Company until the end of 2006. ADOR will not use the new revenues  
12 for its assessment of property taxes until 2007, and the Company will not actually pay these  
13 taxes until October 2007 and March 2008. The test year in this case is 2003. The ROO's  
14 methodology disregards the time lags between the above noted events and recovers a level of  
15 property tax expense that will not be incurred until 2008. This explains why the ROO's  
16 methodology when applied in this case for the actual 2004 property taxes resulted in a \$27,789  
17 overstatement of property taxes. It also explains why the ROO's recommended methodology  
18 will likely continue to overstate property tax expense.

19 RUCO/ADOR's methodology takes into consideration the time lags while at the same  
20 time recognizing that ADOR's formula has a historical element to it. The ROO however,  
21 discounts RUCO/ADOR's methodology because it is "backward-looking" and fails to account  
22 for increases in revenues approved in this proceeding. ROO at 14. At first blush, the ROO's  
23 logic appears valid. The reason it seems to make sense is because of the natural tendency to  
24 think of taxes as being paid when the revenue is earned. That is not the case with property

1 taxes, and explains the flaw in the ROO's logic. Assume the example outlined above. The  
2 first year of revenues with the new rates will be in 2006. The Company's 2007 property tax bill,  
3 using the RUCO/ADOR methodology, will consider the 2006 revenues along with the 2004 and  
4 2005 revenues (i.e. – only one year with the new rates). The 2008 property tax bill will  
5 consider the 2006 and 2007 revenues, and the 2005 revenues. It will not be until the 2009  
6 property tax assessment when ADOR will calculate taxes based entirely on revenues which  
7 include the new rates. Therefore, RUCO/ADOR's methodology does factor in new rates. In  
8 addition, the average of the revenues considered for each property tax assessment will also be  
9 multiplied by a factor of two. In sum, the ROO is wrong – RUCO/ADOR's methodology adjusts  
10 for revenue increases. RUCO/ADOR's methodology, however does not over-account for  
11 additional revenues as will likely be the case using the method recommended in the ROO.  
12 The Commission should reject the ROO's recommendation, and adopt RUCO's proposed  
13 Amendment #3.

## 15           **2)    Depreciation Expense**

16           The ROO recommends approval of what unquestionably are some of the highest  
17 depreciation rates this Commission has authorized in water utility cases. What is troubling is  
18 that the ROO justifies its recommendation on Staff's misguided conclusion that these rates are  
19 typical and customary depreciation rates. Should the Commission decide to approve these  
20 high depreciation rates, it should not fool the public into believing these are typical and  
21 customary rates. They are not typical and customary, nor are they justified in this case. The  
22 Commission should reject the ROO's recommendation.

23           The rates recommended in the ROO compare most closely to the rates the Commission  
24 approved in the recent Rio Rico case. ROO at 34. A comparison of recently approved

1 depreciation rates in the Arizona-American Water Company case to the Rio Rico rates  
2 highlights the high rates recommended in the ROO. In Arizona-American<sup>4</sup> the composite rates  
3 for each of the water districts are; Sun City West – 2.86%, Sun City – 2.80%, Anthem – 2.45%,  
4 Aqua Fria – 2.67%, Mohave – 3.99%, Tubac – 2.56%. By comparison, the composite rate for  
5 Rio Rico is approximately 3.00% and the Company's composite rate in this case is 3.35%. A-5  
6 at 25. Clearly, the Rio Rico rate is not "typical" of the other rates. In the absence of a  
7 depreciation study, the Commission should approve rates that are more in line with the  
8 average rates of other water utilities in Arizona.

9 The ROO highlights the fact that RUCO did not do a depreciation study and suggests  
10 that RUCO's recommendation lacks merit as a result. It is true that in the absence of a  
11 depreciation study it is difficult for the Commission to make an accurate analysis and  
12 comparison of depreciation lives and rates for this particular company. For some reason,  
13 however, the ROO fails to mention that no party did a depreciation study in this case and that  
14 all the Commission has to go by in setting rates is a comparison of depreciation lives and rates  
15 in other cases. Again, should the Commission approve the ROO's recommendation, it should  
16 not portray the facts to give the wrong impression in support of its Decision.

17 The ROO also notes that the Company criticizes RUCO's approach of mixing composite  
18 rates with individual depreciation rates by plant category when making its comparison. ROO at  
19 34. It is unclear whether the ROO supports the Company's argument or if this argument is the  
20 basis for the ROO's recommendation. Nonetheless, the Company's argument is not  
21 persuasive. It is not uncommon for companies to apply for composite rates. Transcript at 496  
22 and 497. In fact, the subject company currently utilizes composite depreciation rates.  
23 Moreover, the rates being compared by RUCO are composite rates to composite rates and

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24 <sup>4</sup> Interestingly, it is the Company who highlights the great difference in the rates in its testimony. A-5 at 25.

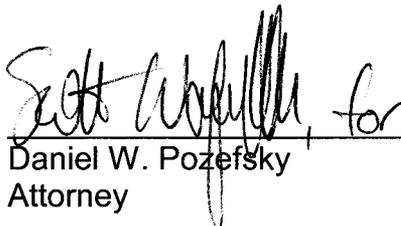
1 therefore provide an apples-to-apples comparison. As long as the comparison is apples to  
2 apples, it does not matter whether depreciation rates are account specific or composites.

3 Finally, the ROO's conclusion that RUCO's proposed depreciation rates would reduce  
4 depreciation expense by \$200,000 is simply wrong. ROO at 34. In fact RUCO's  
5 recommended depreciation rates would **increase** depreciation expense by \$193,973. The  
6 Company's test-year depreciation expense is \$920,648. By simply changing the Company's  
7 accounting treatment from its pre-application use of composite rates to individual rates the  
8 Company is requesting an increase of \$504,877. A-4, Revised Schedule C-1, page 1 of  
9 Thomas Bourassa. RUCO is recommending depreciation expense totaling \$1,114,621, a  
10 difference of \$193,973 (\$1,114,621 - \$920,648) in favor of the Company over its test year  
11 depreciation expense. R-6, Schedule RLM-9, page 1. The ROO should be corrected to  
12 properly state the facts and adopt RUCO's depreciation expense recommendation as set forth  
13 in RUCO's proposed Amendment #4 attached hereto.

14 **CONCLUSION**

15 RUCO recommends the Commission reject the ROO's recommendation to exclude from  
16 rate base the costs associated with the extension of the Main, credit ratepayers with \$220,000  
17 for the hook-up fees paid during the test year and adopt RUCO's recommended property tax  
18 and depreciation expense.

19  
20 RESPECTFULLY SUBMITTED this 19<sup>th</sup> day of September, 2005.

21  
22   
23 Daniel W. Pozefsky  
24 Attorney

1 AN ORIGINAL AND THIRTEEN COPIES  
2 of the foregoing filed this 19<sup>th</sup> day of  
3 September, 2005 with:

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

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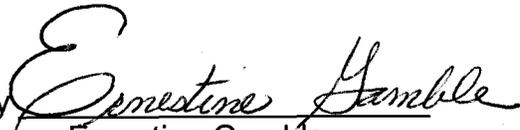
8 Lyn Farmer, Chief Administrative Law  
9 Judge  
10 Hearing Division  
11 Arizona Corporation Commission  
12 1200 West Washington  
13 Phoenix, Arizona 85007

11 Christopher Kempley, Chief Counsel  
12 Legal Division  
13 Arizona Corporation Commission  
14 1200 West Washington  
15 Phoenix, Arizona 85007

14 Ernest Johnson, Director  
15 Utilities Division  
16 Arizona Corporation Commission  
17 1200 West Washington  
18 Phoenix, Arizona 85007

17 Norman D. James  
18 Jay L. Shapiro  
19 Fennemore Craig  
20 3003 North Central Avenue  
21 Suite 2600  
22 Phoenix, Arizona 85012

21 Robert N. Hanford  
22 Chaparral City Water Company  
23 12021 N. Panorama Drive  
24 Fountain Hills, AZ 85268

By   
Ernestine Gamble

ATTACHMENT A

## AMENDMENT 1

Purpose: To amend the ROO to disallow the Fountain Hills Boulevard Main in rate base.

Delete

Page 7, Lines 3-8

“The weight of the evidence does not support a reduction in operating costs attributable to its operation that would necessitate a reduction in its cost. Based on the evidence presented, we find that the Company’s cost associated with the Fountain Hills Boulevard transmission main, \$940,797, should be included in rate base.”

Insert

“However, we cannot include this post-test year plant in the ratebase without a recognition of the economic savings that the Company has acknowledged it produces. (Exh. R-9). We agree with RUCO that when a utility seeks to include post-test year plant in its rates, it has the burden to present a properly matched recognition of any resulting savings. Because the Company has not met its burden to provide a known and measurable quantification of such savings, we must disallow the plant entirely at this time.”

## AMENDMENT 2

Purpose: All parties agree to reduce the Company's test year revenues by \$220,000. This amendment credits ratepayers \$220,000 in hook-up fees paid during the test-year by increasing the CIAC balance by the same amount.

Delete

Page 7, Lines 27 through Page 8, Line 7

"RUCO's proposal assumes that the \$220,000 collected during the test year as hook-up fees was used for plant additions. In most circumstance, such an assumption would be correct, because this Commission normally limits the use of hook-up fees to the installation of utility plan. However, as described by the Company's witness (Tr. At 829-832), Decision No. 57395 did not limit the use of unauthorized "hook-up" fees to plant investment, but clearly intended the "hook-up fees" be treated as operating revenues (Decision No. 57395 at 5-6). The \$220,000 represents test year revenue and not plant additions. RUCO's proposed adjustment is therefore unnecessary and will not be adopted."

Insert

"Given the present day circumstances, it is appropriate to remove the \$220,000 of hook-up fees from test-year revenues. In so doing, the Company's revenue requirement is greater by \$220,000. It is necessary to credit ratepayers for the hook-up fees that they paid in the test-year. We believe that RUCO's recommendation to increase CIAC by \$220,000 which has the effect of reducing rate base by the same amount is a fair and reasonable solution to credit ratepayers for the hook-up fees they paid during the test-year."

## AMENDMENT 3

Purpose: To adopt RUCO's methodology for computing property tax expense which calculates the Company's proposed revenue by summing the Company's three previous years of reported gross revenues and dividing by three.

Delete

Page 14, Lines 1-17.

"We do not agree. Exhibit R-2 does not, and cannot, include a comparison of results of RUCO's backward-looking methodology with results of the Commission's approach for any years beyond 2004, because the actual assessments for the years following 2004 are unknown. What is known is that any increase approved in this proceeding will increase the Company's property taxes, barring the occurrence of very extraordinary circumstances. ADOR will never again use the inputs of revenues for the years 2001, 2002, and 2003, the years RUCO advocates using in this proceeding, to determine tax levels for Chaparral City. RUCO's calculation methodology, which uses only historical revenues, unfairly and unreasonably understates property tax expense, and is therefore inappropriate for ratemaking purposes.

As we have repeatedly found, the input of known revenue increases is necessary in order to fairly estimate property tax expense for ratemaking purposes. RUCO has not demonstrated in this proceeding a basis for departure from our prior determinations on this issue. We will therefore adopt the recommendations of the Company and Staff to follow recent Commission Decisions to use adjusted test year revenues in determining property tax expense.

Insert

"We agree. Property taxes, unlike income taxes, are not paid when revenues are earned. Instead there are three different lag periods that occur between when rates are authorized and when the taxes are actually paid. Staff and the Company's use of proposed revenues and adjusted test year revenues disregard these time lags and recover a level of property tax expense that, in this case, will not be incurred until 2008. RUCO's calculation methodology, which uses only historical revenues, fairly and reasonably measures property tax expense, and is therefore appropriate for ratemaking purposes.

We depart from our previous decisions since enough time has elapsed since ADOR announced its recommended methodology for calculating property tax expense (2001) and we are now able to compare the estimated property tax expense using the different methodologies to actual figures. RUCO has demonstrated that its methodology closely approximates actual property tax expense and is less likely than Staff and the Company's methodology to overstate property tax expense in the future. We will therefore adopt the recommendations of RUCO to use historical revenues in determining property tax expense.

## AMENDMENT 4

Purpose: To adopt RUCO's depreciation rates and restate the facts.

Delete

Page 34, Lines 9-18.

"The result of using depreciation rates that RUCO recommends would reduce depreciation expense by approximately \$200,000 (Hrg. Exh. A-30). The Company criticizes the methodology RUCO used to develop its proposed depreciation rates, because it mixes composite rates with individual depreciation rates by plant category in order to calculate average rates, and because the resulting depreciation rates were not compared with the expected useful lives of the assets to which they applied (Tr. At 554-555). We find that the Staff proposal more closely estimates the expected life of the Company's assets than RUCO's proposal, and will order the Company to adopt the typical and customary depreciation rates that Staff has developed as set forth in Mr. Scott's Direct Testimony, Exhibit MSJ at 16.

Insert

"The result of using depreciation rates that RUCO recommends would increase depreciation expense by \$193,973. (Hrg. Exh. A-30). The Company criticizes the methodology RUCO used to develop its proposed depreciation rates, because it mixes composite rates with individual depreciation rates by plant category in order to calculate average rates, and because the resulting depreciation rates were not compared with the expected useful lives of the assets to which they applied (Tr. At 554-555). Since a depreciation study was not done in this case by any party, the Commission can only set rates by comparing depreciation rates and lives in other cases. RUCO has made the comparisons, comparing composite rates to composite rates and recommended rates that are fair, reasonable and more accurately reflect depreciation rates authorized by this Commission in the past. We find that RUCO's recommended rates are fair and reasonable, and will order the Company to adopt RUCO's rates."