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Z Corporation Commission
Director of Utilities

Eric Nesvig
6144 N. 77th Place
Scottsdale, AZ 85250

AZ CORP COMMISSION
DOCUMENT CONTROL

March 17, 2006

Mr. Alexander Igwe
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Re: Arizona American Water Company
W-01303A-05-0405, Paradise Valley District Rate Request
W-01303A-05-0910

Dear Mr. Igwe:

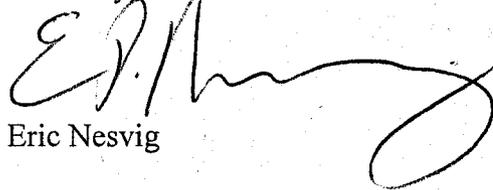
I am a neighbor located adjacent to the site of the infrastructure improvement program which is the basis of the captioned rate request. I would like to have input into this rate request process.

I am enclosing a summary of concepts I feel are relevant to this case. I know that there is a public meeting in the near future, and I would talk to you about this process.

I will try to call you on Monday. If you are not the correct contact at the ACC, please let me know who would be more appropriate. If you would like to call me, my cell phone number 602-318-4996.

Thank you for your time.

Sincerely,



Eric Nesvig

SUMMARY

Please accept this letter as a summary of issues which you may want to consider in your rate case regarding Arizona American Water Company ("AAWC") and its request for two surcharges in the Paradise Valley district. I believe that AAWC's request is flawed in the following ways. (1) AAWC is using the issues of arsenic removal and "fire flow safety" as red herrings in order to circumvent previous rate decisions from the Arizona Corporation Commission ("ACC"); (2) AAWC continues, contrary to its application, to engage in an adversarial relationship with the ACC and its own customers; and (3) AAWC is requesting to profit unreasonably from the sale of two parcels of land on its Paradise Valley property.

BACKGROUND

I live across the Arizona Canal from AAWC's Paradise Valley location. In the fall of 2004, AAWC went through the process required to get approval to build the facilities in the current rate request. AAWC went to great lengths to use the arsenic removal portion of this project to pressure the City of Scottsdale to approve the project in a very short time and, the neighbors believe, without the property disclosures and approvals. Several of the neighbors are currently involved in litigation with AAWC related to these issues. A jury trial is scheduled to begin this summer.

AAWC's application to the City of Scottsdale did not include any mention of the "fire safety" aspect of this project. AAWC insisted that the entire project, and specifically, the two 1.5 million gallon water storage tanks ("Tanks") are necessary for arsenic removal. In fact, in January, 2005, at two city council meetings, residents who had finally become aware of AAWC's plans to build these Tanks completely above ground in a Historic Perseveration area, AAWC told the City Council that customers in the Paradise Valley district would suffer immediate harm if the City delayed the project by even a couple of weeks. Their representative stated that if AAWC missed the January, 2006 deadline that children, babies and the elderly would all suffer immediate harm to their health. Here we are 2 months past that date, and the project is nowhere near completion even though the City believed AAWC's hysteria and fast tracked the project. In the rate request before the ACC, AAWC now states that the project is actually divided into two parts - arsenic removal and "fire flow safety." I believe this is simply another attempt to expand their rate base and increase their profits by way of manipulating the system.

ARGUMENTS AGAINST AAWC's RATE CASE

First, let me address Mr. Townsley's opening statement in the rate request documents. He suggests that AAWC has turned over a new leaf in an attempt to become a partner with the ACC, RUCO and its customers. To the contrary, let me suggest that AAWC has simply become better coached in the skills of regulatory manipulation and public

perception. AAWC, apparently, believes that simply saying they will play by the rules is the same as *actually* playing by the rules. I firmly believe that AAWC is being pressured by its New Jersey management and German owners to do whatever it takes to maximize profits at the local level with little regard for anything else. Please note his argument that AAWC has not been allowed the same rate of return on capital in Arizona that it is allowed in other states. All decisions of any significance are made in California or New Jersey. Anything that they say or do to governmental agencies in Arizona is simply framed in a way to get the approval they are looking for.

For example, in the Paradise Valley district, AAWC would like you to believe that all of the capital expenditures were forced upon them by the urgent need to remove arsenic from the water and to provide additional fire flow (aka "public safety") to the Town of Paradise Valley. They would also like you to believe that they engineered the new facility at the absolute lowest cost in order to benefit their customers.

To the contrary, please see the company's 1999 *Comprehensive Planning Study* ("CPS"). (I assume they have given the ACC a copy of this document.) This is a detailed investigation of all of the current and future capital expenditures necessary to meet the needs of the current, and anticipated, customer base. In it you will find, among other things, the need for 3 million gallons of water storage. In AAWC's application for a rate increase, AAWC states that this water storage, in the form of two 1.5 million gallon tanks, is a necessity for the new uses. They state that one tank is required for arsenic removal and one tank is required for fire flow. It should not be a surprise that the combined amount the company is now building just happens to match the amount which was recommended as general capital improvements back in 1999.

When AAWC applied to the City of Scottsdale for the required approvals for this project, they said it was only for arsenic removal. They said they could not operate the arsenic removal process without these Tanks. They also said that the current placement of the Tanks was chosen after much input from the neighbors. Even though that isn't true, it was a framework which allowed the process to flow through the City very quickly. They tried to make the City it was an emergency public health issue. The proposal to the City never states anything about the water pressure and other general infrastructure improvements that are a major part of this project.

In a sworn deposition by Joe Gross (I can give you a copy if you would like), Mr. Gross spends a lot of time discussing the uses of the two Tanks. He states that you really can't divide up how the Tanks will be used and allocate it to arsenic or fire flow or whatever. He says that they just split the cost of the two tanks between those two uses for the rate increase request to the ACC. He says that the need for 3 million gallons is based on some concept about the maximum number of gallons needed on the highest demand day, at the peak time of day, at the largest anticipated demand growth in 10 years, if they are backwashing the arsenic filters during the peak time instead of at an off-peak time, if there were a commercial fire which took at least 3 hours to put out and if one of the existing wells wasn't working. Maybe that's an appropriate way to determine this

maximum necessary storage, or maybe not. More importantly is that the company does not disclose that they have other options for mitigating the need for increase storage.

In a study, known as the Brown and Caldwell report, these outside consultants did a detailed study of how to increase the water pressure within the Town of Paradise Valley. In the report, they outline a number of options for dealing with the water storage issue. AAWC could use other options to reduce the required size of the new Tanks. For example, if they fill up the lake at the golf course at the Paradise Valley Country Club at a different time of the day, they do not need 3 million gallons of storage. If they backwash the arsenic filters at an off-peak time of day, they do not need Tanks that big. The Brown and Caldwell report actually specifies a number of options that would have reduced the cost of producing the extra water storage related to this project.

Also, AAWC chose to put these tanks in a location which is more expensive than other locations at their existing Paradise Valley site. They chose this part of the parcel because it will maximize the profits on selling the rest of the land. I'll address this issue in the last section.

Additionally, the company put off making plans for building the arsenic removal facility because of spending constraints put on AAWC by its parent company in New Jersey. The delay in the planning and building the Paradise Valley site will certainly have added dramatically to the cost. In our lawsuit against AAWC, they admit in depositions that they put off until the last minute the planning and building of the PV arsenic removal facility solely due to their own capital spending constraints.

Secondly, although AAWC has hired or acquired a number of public relations staff and regulatory relations staff, they a company which has no interest in anything but the bottom line. In its application to City of Scottsdale, they knew that the proposal would likely generate significant neighborhood backlash. They made a decision to, in their words, take the most advantageous position for AAWC and then see what the "situation on the ground" looked like and deal with the neighbors as the process went along. I'm sure that's the same strategy at work with the ACC. They are proposing an outrageous rate increase, using a "unique" surcharge structure and even proposing a high use surcharge that has no basis but will add millions of dollars to their bottom line. I'm sure the strategy was to throw this out there and see how much of it flies. This is not being a partner with ACC, RUCO and its customers. This is just making a cold, calculated decision to maximize profits. The decision makers in California and New Jersey will make sure they have the most professional representation and then live with whatever they get. And, I'm sure they'll threaten to sue if they do not get what they want.

Unearned profit. AAWC has more than one parcel of land in its Paradise Valley district. AAWC plans to sell, or has sold, at least two parcels currently or in the near future. AAWC will argue that the company should be able to keep most or all of the profit from the sale of these parcels. You will understand the logic of the argument that they will

make better than I can explain it. However, I think a more appropriate way to evaluate this case is this:

AAWC has been aware of the Town of Paradise Valley's request for increased water pressure for some time. AAWC discusses these infrastructure improvements back in 1999 in the CPS report. In 2003, AAWC staff considered using profits from their unused land to offset the cost of the planned improvements – in part due to capital spending constraints imposed by New Jersey. They knew they were behind in planning for the arsenic removal facility, and there was no money left in the national budget. But, they elected to just put off the spending for another year.

AAWC has two parcels of land in this district. They have facilities and empty space on both parcels. The value of this land is significantly higher than when they bought it and especially as office space or residential lots instead of public utility land. AAWC specifically planned the placement of the new facilities on these parcels in order to maximize the value of the land it plans to sell. This placement increased the cost of the facilities (by cramming them into a very restricted space which was more difficult to engineer and construct). Now they have more valuable land to sell, and they have increased the cost of the facilities they are building. When I spoke to Rob Antoniak in the spring of 2005, he said that AAWC was not planning to share any of the profits of the sales of these parcels with their customers. Since then, they have offered to split the profits with the customers. This is not an equitable deal for the customers

Why? In Mr. Townsley's section of the rate increase request, he notes that AAWC is only allowed a 9% return on its investment in Arizona rather than the 10% rate of return which it receives in other states. You do not have to look very far to see why this project makes sense for them. First, they maximize what they spend. This increases the amount of money for which they can receive a rate of return from their customers. Second, they intend to keep some or all of the profits from the sale of the land. Therefore, their out of pocket expenditures go way down, but their cash inflows stay constant. That 9% return just jumped way over 10% for their actual out of pocket expenditures.

My argument is that AAWC has both an asset and a liability in the land they own in Paradise Valley and an aging infrastructure. The cost of updating the infrastructure has continued to rise, along with the value of the vacant land, as AAWC has put off making the improvement. It is an unreasonable and unjust penalty to the customers of AAWC to have to pay the increased cost of the improvements while only partially participating in the increased value of the land. This is a very high end, international water company which could have chosen to make these improvements at any time.

As to being cost effective, your staff can certainly explain this:

The level of arsenic contained in the water in the Paradise Valley district is just barely above the new arsenic standards as required by the EPA and ADEQ. I've looked at some of the cost numbers for other arsenic removal facilities, and AAWC is spending more on this one district than some of the cities around Maricopa County. In so many ways, it seems clear that AAWC is just trying to use these two projects as a way to get around the rules put in place by the ACC.

Anyway, I wanted to make sure that ACC and RUCO had seen and reviewed the 1999 CPS study and the Brown and Caldwell report. We determined through depositions of Joe Gross, Peter Keenan and Brian Biesemeyer that the tactical decisions in these issues are made either in California or in New Jersey – which may explain some things.

I assume that you have access to all of those documents. If it would be helpful to have any of the depositions from the case, I would be happy to bring a copy over to you.

Thank you for your time.