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BEFORE THE ARIZONA CORPORATION COMMI...

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COMMISSIONERS

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

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY TO EXAMINE POSSIBLE FORMS OF MITIGATION OF THE ACRM FOR ITS HAVASU WATER DISTRICT	DOCKET NO. W-01303A-05-0890 **ARIZONA-AMERICAN WATER COMPANY'S NOTICE OF FILING DIRECT TESTIMONY**

Arizona-American Water Company hereby files in the above-referenced matter the Direct Testimony of Thomas M. Broderick.

RESPECTFULLY SUBMITTED on April 21, 2006.

Craig A. Marks

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By: ______________________
Courtney Appelhans

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IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY TO EXAMINE POSSIBLE FORMS OF MITIGATION OF THE ACRM FOR ITS HAVASU WATER DISTRICT	DOCKET NO. W-01303A-05-0890

DIRECT TESTIMONY
OF
THOMAS M. BRODERICK
ON BEHALF OF.
ARIZONA-AMERICAN WATER COMPANY
APRIL 21, 2006

**DIRECT TESTIMONY
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EXECUTIVE SUMMARY

Thomas M. Broderick testifies that:

The ACRM, by design, already significantly mitigates arsenic related rate increases through step increases and the exclusion of several important cost categories.

Rate mitigation should be revenue neutral. Unfortunately, Arizona-American Water is already "mitigating" rates in every one of its water and wastewater districts for a variety of reasons and as a result has become an unprofitable company with negative $22 million in retained earnings. Additional mitigation of this nature is unsustainable.

The Company and Commission Staff have already made significant progress on further mitigating the ACRM's impact in Havasu and the Company's reasoning for further mitigation is the fact that twelve months after Step 2 is effective, the ACRM decreases upon conclusion of recovery of the initial twelve months O&M deferral. However, this rate decrease does not reflect any reduction in cost of service.

Two options to reduce Step 2 are under consideration: 1) Capitalize and defer recovery of 12 months of recoverable O&M ($156,724) and 2) Establish a new temporary hook-up fee paid by customers of our Mohave district. Both Commission Staff and the Company agree on option 1. Commission Staff opposes option 2.

The Company accepts two of the three modifications / corrections proposed by Commission Staff witness Crystal Brown to option 1. The Company is opposed to reflecting deferred taxes on arsenic plant in the ACRM rate base calculation on the principle that the ACRM formula is settled and this mitigation proceeding should not alter the basic design of the ACRM.

I. INTRODUCTION AND QUALIFICATIONS

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND TELEPHONE NUMBER.

A. My name is Thomas M. Broderick. My business address is 19820 N. 7th Street, Suite 201, Phoenix, AZ 85024, and my business phone is 623-445-2420.

Q. IN WHAT CAPACITY AND BY WHOM ARE YOU EMPLOYED?

A. I am Manager, Rates & Regulatory Affairs for American Water, Western Region. Arizona-American Water Company ("Arizona-American" or the "Company") is a wholly owned subsidiary of American Water.

Q. PLEASE DESCRIBE YOUR PRIMARY RESPONSIBILITIES FOR THE COMPANY.

A. I manage water and wastewater rate cases in Arizona and Texas, including overall responsibility for liaison with the Arizona Corporation Commission ("Commission"), and I co-manage community relations in Arizona.

Q. PLEASE DESCRIBE YOUR PROFESSIONAL EXPERIENCE AND EDUCATION.

A. For more than 20 years before joining the Company in 2004, I held various management positions in the electric-utility industry with responsibilities in rates, regulatory and government affairs, corporate economics and planning, load forecasting, finance and budgeting with Arizona Public Service Company ("APS"), PG&E National Energy Group, PG&E Energy Services, and the United States Agency for International Development. I was employed at APS for nearly 14 years as Supervisor, Regulatory Affairs, then Supervisor, Forecasting, and then Manager, Planning. I was designated

APS' Chief Economist in the early 1990's. For PG&E National Energy Group, I was Director, Western Region - External Relations.

I have a Masters in Economics from the University of Wisconsin – Madison and a Bachelor in Economics from Arizona State University.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THIS COMMISSION?

A. Yes. I testified on behalf of the Company in the initial phase of its arsenic cost recovery mechanism case (Docket No. W-01303A-05-0280, *et. al.*) in its recent Paradise Valley rate case (Docket No. W-01303A-05-0405, *et. al.*). I testified earlier on many occasions on behalf of APS, PG&E, and the Arizona School Boards Association.

Q. WHAT IS THE SCOPE OF YOUR TESTIMONY IN THIS CASE?

A. The scope of my testimony is as set forth in my Executive Summary.

II. PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. I sponsor the Company's position on the Commission's inquiry to further mitigate the rate impact of Step 2 of the Arsenic Cost Recovery Mechanism ("ACRM") in our Havasu district. I also respond to Commission Staff's initial positions as presented in the January 23, 2006, testimony of Crystal Brown.

Q. WHAT IS THE STATUS OF THE COMPANY'S ARSENIC FACILITY IN ITS HAVASU DISTRICT?

A. The Company placed its new arsenic removal facility in Havasu into service on March 27, 2006. Marlin Scott, an engineer for Commission Staff, toured that facility on April 3, 2006. The Company filed its Step 1 ACRM rate increase on April 4, 2006. The Havasu actual arsenic impact fee contribution through April 1, 2006 was $5,220. This is substantially less than the Company's estimate. The Company continues to estimate 12 months of recoverable O&M costs for this facility at $156,724.

III. MITIGATING THE ACRM IN HAVASU

Q. WHAT WAS THE COMPANY'S ESTIMATE OF THE ACRM IN HAVASU IN ITS EARLIER GENERIC ACRM APPROVAL HEARING?

A. In the Commission's hearing that resulted in Decision No. 68310 dated November 14, 2005, the Company provided a first year ACRM revenue requirements estimate of $18.06 per month, when expressed as an addition to the typical bill. This estimate included eligible O&M, yet a Step 1 ACRM excludes eligible O&M. As a consequence, a Step 2 ACRM includes two years of eligible O&M expense. On page 4 line 20 of the Company's application in this mitigation docket, the Company provided ACRM step 1 and step 2 estimates for Havasu using the same cost data relied upon in calculating the $18.06 per month typical bill:

ACRM Step 1	$10.84
ACRM Step 2	$24.89
12 Months after Step 2	$17.87

(Please note that ACRM procedures require a reduction upon completion of twelve months of the ACRM Step 2 since Step 2 recovers two years of eligible O&M expense and later drops to include only one year of eligible O&M.)

This makes clear that, by design, the ACRM Step 1 increase for Havasu is already mitigated and so the parties in this docket have focused on further mitigating Step 2.

These initial estimates are no longer entirely valid as the Company has filed for a Step 1 ACRM in Havasu using actual (higher) project costs. However, our estimates for recoverable O&M expenses have not changed.

Q. WHAT DID THE COMPANY REQUEST IN ITS APRIL 4, 2006, STEP 1 ACRM FILING FOR ITS HAVASU WATER DISTRICT?

A. The Company requested a larger Step 1 ACRM in Havasu of $12.49 per month for the typical bill on capital expenses to-date for our new Havasu arsenic facility of $1.94 million. Please note that we will later receive additional invoices totaling approximately $0.3 million on this project which will be included in the Company's Step 2 ACRM filing. Given that the Company is already losing money in Havasu and in the Company as a whole, it could not postpone filing its Step 1 ACRM in Havasu.

The Step 1 request does not include any O&M expenses for the new facility such as increased payroll, electricity, and filtering media. When the Company makes its Step 2 filing, only those O&M expenses related to filtering media will be eligible for inclusion as O&M expense. These are estimated to total $156,724.

Q. DOES THE COMPANY BELIEVE THAT THE STEP 2 ACRM INCREASE FOR HAVASU SHOULD BE FURTHER MITIGATED?

A. No, not if "mitigation" means at the Company's expense. Mitigation should be neutral - deferred increases set at a level sufficient to compensate for the time value of the deferred rate increase.

Unfortunately, Arizona-American has, in a sense, been mitigating recovery of its costs and investments, but <u>at its expense</u>. The Company's revenues have been well below what has been required to recover its cost of service for several years now—in all of its districts for a variety of reasons. Although this has meant lower rates for customers, the impact on Arizona-American has been devastating. The Company is now unprofitable, pays no dividend, has negative retained earnings ($22 million) and forecasts an actual loss of income in 2006. The Company's Step 1 ACRM filing for Havasu displays in Schedule ACRM-3 an earnings test with an actual return on equity in 2005 of a negative 35.3%. After various Commission required adjustments, the adjusted return on equity improves, but only to negative 10.2%. At the strong urging of the Commission, the Company earlier requested and, fortunately, received a $35 million equity infusion in March 2006, which we expect to immediately begin slowly losing until rates rise enough to recover costs. At the time Company management requested Board approval of this infusion in the fall of 2005, it believed an infusion of this amount would easily restore the Company's equity ratio to well over 40%. However, it restored our equity ratio to only 38.7% from an unexpectedly low 31.3% at the end of 2005.

Arizona-American's arsenic-remediation investment in Havasu is one that the Company would never have made, except for the federal government's unfunded mandate to reduce arsenic levels below 10 parts per billion. In light of these existing and emerging realities and the need for cash revenues, the Company is extremely reluctant to underwrite further mitigation for Havasu's Step 2 ACRM increase. Therefore, the Company can only accommodate this effort in the context of the Commission recognizing and responding to the totality of the Company's present situation - it cannot continue to "mitigate" rates in every district.

Q. BUT THE COMPANY AND COMMISSION STAFF ARE ALREADY WELL DOWN THE PATH OF AGREEING ON A SPECIFIC MITIGATION OF STEP 2 IN HAVASU – IS THE COMPANY NOW PULLING OUT?

A. While we would prefer the Commission to allow the ACRM in Havasu to go forward as designed, we are willing to continue cooperating and refine a mitigation of Havasu's ACRM Step 2, but only because the ACRM's design causes a large increase in Step 2 in Havasu which is followed by a decrease 12 months later driven solely by the ACRM requirement to recover 24 months of eligible O&M in the first 12 months of Step 2. This feature is exacerbated by the least-cost arsenic filtering technology selected in Havasu - one that is relatively more O&M intensive.

Q. PLEASE DESCRIBE THE EXISTING PROPOSALS FOR MITIGATING HAVASU'S ACRM STEP 2.

A. The Company's December 13, 2005, application stated that Arizona-American has consulted with Commission Staff as instructed and offers two proposals to mitigate the impact of the ACRM on the Havasu system. As far as I know, both Staff and the Company agree in principle upon the first proposal, which reduces the Step 2 increase—because the O&M deferral is capitalized and recovery is deferred until the Company's next rate case for its Havasu Water District.

As fully described in both the Company's application and Ms. Brown's testimony, implementation of the first proposal requires an accounting order from the Commission.

The second proposal would implement *temporary* impact hook-up fees in the Company's Mohave Water District to recover the O&M deferral and on-going recoverable O&M in Havasu until new permanent rates are in effect. The initial amount of the hook-up fee would be $264 for a residential 5/8 inch meter. Estimates of the Mohave hook-up fee for the second and third years are $274 and $456, respectively. These are estimates as the impact hook-up fee would be annually trued-up so as to exactly recover the eligible O&M. Hence, under this alternative proposal, the ACRM Step 1 and Step 2 increases in

Havasu would solely recover actual capital expenses (as offset slightly by the other arsenic impact fee paid for by Havasu customers) and the temporary hook-up fees would recovery O&M expenses.

Commission Staff did not support the second proposal because, by definition, it creates a cross subsidy, since these two districts are not presently consolidated for rate purposes. The Company, in turn, indicated this second proposal was offered in support of a future Commission policy to consolidate the rates of its Havasu and Mohave water districts. The Company does not know whether the Commission supports such a policy, but offers it for consideration.

Q. HAS ARIZONA-AMERICAN CONSIDERED RATE CONSOLIDATION FOR ITS HAVASU AND MOHAVE WATER DISTRICTS?

A. Yes, but we have not yet analyzed in any detail what rates would look like if these two districts were consolidated. However, as a general goal, the Company would very much like to consolidate water rates for its Mohave and Havasu Districts. Employees based in our Bullhead City office jointly operate these two districts, their existing rates are fairly similar, the districts are located along or near the Colorado River and thus face similar water resource issues, and the Company could more efficiently present a consolidated rate case.

The Company presently has a rate case pending for Mohave Water, but that case does not contain a request for either rate consolidation or new impact hook-up fees. As required by the generic ACRM order (Decision 68310), the Company must file a new Havasu rate case not later than May 2008. It would appear that the next opportunity to consolidate permanent rates for Havasu and Mohave would be the May 2008 rate case filing. If the

Commission wished to evaluate consolidated rates for the districts, the Company could file cases both on a consolidated and unconsolidated basis at that time.

Q. THE JANUARY 23, 2006 TESTIMONY OF STAFF WITNESS CRYSTAL BROWN RECOMMENDS THREE MODIFICATIONS/CORRECTONS TO THE COMPANY'S FIRST PROPOSAL. HOW DOES THE COMPANY RESPOND?

A. The Company accepts her proposal to have the calculation of AFUDC on eligible O&M under the accounting order commence upon the effective date of the Step 2 ACRM increase as this is an interpretation consistent with the original ACRM decision adapted to fit the proposal herein. The Company also accepts her proposal to recognize accumulated amortization of CAIC on the rate base calculation for the Step 2 increase as a correction of supporting data earlier provided to Staff. The Company opposes her third recommendation to reflect accumulated deferred income taxes on arsenic plant in the rate base calculation for the Step 2 increase because this departs from the ACRM formula established in the generic ACRM approval decision. The Company does not believe that this mitigation docket is the appropriate forum to modify the ACRM formula. The ACRM is already a partial cost recovery mechanism and the Company believes all parties earlier had a full opportunity to develop and reflect upon the design of the ACRM. The Company has not evaluated book versus tax depreciation rates and cannot state whether in this instance this third recommendation would result in a higher or lower ACRM Step 2 rates

Again, it is important to remember that none of these three items impacts Step 1 ACRM rates for Havasu.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.