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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF HASSAYAMPA UTILITY COMPANY, INC. FOR A CERTIFICATE OF CONVENIENCE AND NECESSITY TO PROVIDE WASTEWATER SERVICE	Docket No. WS- SW-20422A-05-0659 **HASSAYAMPA'S OBJECTIONS TO STAFF REPORT**

Pursuant to the Commission's March 28, 2006 Procedural Order, as amended by the Commission's April 11, 2006 Procedural Order, Hassayampa Utility Company, Inc. ("Hassayampa") provides these objections to the Staff Report. Hassayampa accepts the vast majority of the Staff Report, but wishes to raise two issues: (1) Staff did not increase the proposed revenues to reflect its higher deprecation rates; and (2) Staff's rate design for larger sized meters does not reflect the extra capacity needed to serve such large customers. In addition, Hassayampa requests a clarification of Staff's proposed equity requirement. In support of these objections, Hassayampa states:

RESPONSE TO STAFF

I. Staff's proposed revenues should be increased to reflect its proposed deprecation rates.

Staff's rate calculations assume the utility will not cover its cost of capital in the first four years. However, in Year 5 rates must be set to cover costs, including capital costs. This is the standard approach used by the Commission to set rates for new utilities. Hassayampa agrees with this approach.

Staff modified Hassayampa's proposed depreciation rates. (See Staff Report, Ex. 2 at Table 1). Hassayampa has no objection to Staff's proposed depreciation rates, assuming the impact of the proposed modifications are reflected in a modified revenue requirement. Staff used its deprecation rates in its rate calculations. (See Staff Report, Ex. 3 at 3). This increased depreciation expense by $112,918, and increased operating expenses by the same amount. (*Id.*; *compare* Staff Schedule JRM-1 with Application Schedule CS-2, page 1). However, Staff did not increase operating revenues by the corresponding amount.[1] Basic ratemaking theory dictates that as expenses go up, revenue requirement must also go up. In essence, Staff simply lowered the rate of return, so that it could hold operating revenues constant while increasing operating expenses. This results in an unjustified reduction in the rate of return and operating income.

Under Staff's approach, the rate of return (ROR) and return on equity (ROE) are simply fall-out numbers. In this case, there is no debt in the proposed capital structure, so the ROE is the same as the ROR. Staff's proposed ROR and ROE is 8.02%. Staff's proposed ROE appears to be far below any ROE suggested by Staff or adopted by the Commission for any water or wastewater company in recent times. A utility "is entitled to a fair rate of return." *Litchfield Park Service Co. v. Arizona Corp. Comm'n*, 178 Ariz. 431, 434, 874 P.2d 988, 991 (App. 1994); *see also Turner Ranches Water and Sanitation Co. v. Arizona Corp. Comm'n*, 195 Ariz. 574, 577 ¶ 6, 991 P.2d 804, 807 (App. 1999); *Cogent Public Service, Inc. v. Arizona Corp. Comm'n*, 142 Ariz. 52, 57, 688 P.2d 698, 703 (App. 1984). Accordingly, the Commission should set rates using a reasonable ROR and ROE.

A full cost of capital analysis is generally not conducted in setting initial rates. For the purposes of this case, Hassayampa suggests using an ROE based on ROEs recently proposed by Staff for Arizona wastewater or water utilities. Staff has proposed the following ROEs recently:

[1] Staff did make one other adjustment to Operating Revenues, to which Hassayampa does not object. (Staff Report, Ex. 3 at 3).

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Company	Staff Proposed ROE	Source
Black Mountain Sewer Co.	9.6	Testimony Summary of Pedro Chaves, filed June 2, 2006
Far West Sewer	9.3	Direct Testimony of Steven P. Irvine, page 2, lines 13-14, filed April 11, 2006
Arizona-American (Paradise Valley)	10.4	Staff Closing Brief, page 14, line 4, filed May 26, 2006

Based on these figures, Hassayampa proposes a ROE of 9.5%. To be conservative, this is below the most recent recommendation filed by Staff (for Black Mountain) and is well below the average (9.77%) of the recommendations reported above. And it is well below what Hassayampa would likely propose in a rate case.

Hassayampa has calculated the necessary revenues, using a ROE of 9.5% and using the rate base and operating expenses proposed by Staff. These calculations are shown on Exhibit 1. Replacing Staff's artificially low ROE results in an increase to operating revenues of $107,735. This results in a proposed monthly charge of $57.58 for a standard residential meter, compared to Staff's proposal of $54.25.

Adopting this rate will allow Hassayampa the opportunity to earn a fair ROE based on Staff's own recent ROE recommendations. Staff's approach of reducing the ROE (and thus operating income) to negate the effect of its higher deprecation expense should not be adopted. While Staff's approach will temporarily reduce rates, rates would then have to go up in the company's next rate case. Staff proposes that such a rate case be required in only a few years. Customers should not have to have to face the unnecessary inconvenience of a rate increase made necessary by setting initial rates too low.

II. Staff's rate multiples for larger meters do not reflect the extra capacity required to serve such customers.

In designing rates, the first step is to calculate a rate for a standard residential 5/8 by ¾ inch meter. This rate is then multiplied by a "meter multiple" or "meter capacity ratio" to produce rates for larger meters. Both Staff and Hassayampa use this approach. The meter multiples used by

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Staff and Hassayampa are shown on Exhibit 2. Using meter multiples reflects the fact that larger meters have a larger capacity and can thus exert a larger demand on the system. *See e.g.* American Water Works Association, *Manual M1: Principles of Water Rates, Fees, and Charges* (5th ed. 2000) at 306-07. The meter multiple is based on the operating capacity of the meter. *Id.* While the meters measure water going in, not wastewater going out, there is a strong correlation between water used and wastewater produced. Because customers with larger meters will produce larger wastewater flows, they require larger collection and treatment capacity than would otherwise be needed. These larger customers should therefore pay more than typical residential customers, based on the extra demand they place on the system.

Hassayampa's proposed rates use meter multiples based on operating capacity. *See e.g. Id.* at Page 202, Table 28-2 (reporting multiples for meters through three inches). In contrast, Staff's meter multiples are not based on the relative capacity of the meters. For example, a standard 5/8 inch meter has a maximum operating flow of 20 gallons per minute (gpm), while a two inch meter has a maximum flow of 160 gpm, or 8 times a much. *Id.* Staff's proposed charge for the 2 inch meter is only 1.84 times its proposed charge for the standard 5/8 inch meter. Staff is thus assuming that a meter with 8 times the flow will only need 1.84 times the wastewater capacity. Staff's rate design thus does not reflect the demand associated with the larger meters.

Hassayampa proposes to use the same meter multiples that were used in its Application. Staff has not explained its decision to use different multiples, and Staff's approach is inconsistent with the ratemaking principles described above. Hassayampa's proposed meter multiples, and the resulting rates for larger meters are shown on Exhibit 2. This Exhibit also shows Staff's proposed multiples and rates, and the multiples and rates used in Hassayampa's original application.

III. Staff's equity requirement should be clarified.

Staff suggests that the Commission require Hassayampa to "make its initial investment of equity of $7,150,000 in year one as indicated in the Company's Pro Forma Balance Sheet." (Staff Report at 4). Hassayampa has no objection to making an equity investment in that amount. However, Hassayampa is concerned by the reference to the pro forma financials. Presumably, this

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was done simply to indicate the source of the number. However, it could conceivably be interpreted to require Hassayampa to spend the equity in according to the estimates in the pro forma financials. The pro forma financials are simply projections, and like any projections they will not perfectly predict the future. For example, if the cost of an item was lower than expected, it would not make any sense to force Hassayampa to pay more than necessary for the item. Likewise, if development were delayed, it would make no sense for Hassayampa to build facilities before they are needed. Thus, Hassayampa proposes that the condition be clarified as follows:

> The Company shall be required to have not less than $7,150,000 in equity by the end of the first year of operations. The Company shall file a notice that this condition has been satisfied within three months after the end of the first year of operations.

IV. <u>Conclusion.</u>

Hassayampa appreciates the support of Staff in this case, and Hassayampa has no objection to the vast majority of Staff's recommendations. However, for the reasons described above, Hassayampa recommends that the Commission: (1) adopt the proposed revenue requirement shown on Exhibit 1, which uses a reasonable ROE based on recent Staff recommendations, rather than lowering the ROE to offset Staff's increased deprecation expense; (2) adopt the meter multiples and rates shown on Exhibit 2, to reflect the extra costs imposed by customers with larger flows; and (3) adopt the clarification of the equity requirement as described above.

RESPECTFULLY SUBMITTED this 9th day of June 2006.

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By ______________________

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EXHIBIT

"1"

Exhibit 1

Staff Year 5 Per Schedule JRM-1		
Rate Base Year 5	$	4,464,201
ROR (=ROE b/c no debt)		8.02
Operating Income	$	357,947
Operating Expenses	$	1,570,480
Required Revenue	$	1,928,427
Hassayampa Response to Staff (Year 5)		
Rate Base (per Staff)	$	4,464,201
ROR		9.5
Operating Income	$	424,099
Operating Expenses (per Staff)	$	1,570,480
Required Revenue	$	1,994,579
Deficency From Staff	$	66,152
Gross Revenue Conversion Factor		1.6286
Increase in Revenues	$	107,735.30
Revenues		
Flat Rate Residential (per Staff)	$	1,757,700
Flat Rate Residential (Staff + Proposed Increase)	$	1,865,435
Metered Revenues (per Staff)	$	152,727
Other Revenues (per Staff)	$	18,000
Total Revenues	$	2,036,162
Increase over Staff Proposed Revenues	$	107,735
Revenue Proof		
Residental Customers (Year 5 Average per Staff)		2,700
Required Flat Rate Revenue Per Month	$	155,453
Monthly Charge	$	57.58
Metered and Other charges not changed		

EXHIBIT

"2"

Exhibit 2

Derivation of Rates for Larger Meters

Meter Size	Application	Application Multiple	Staff	Staff Multiple	Hassayampa	Hassayampa Multiple
5/8 x 3/4 Inch	$ 52.00	1.00	$ 54.25	1.00	$ 57.58	1.00
3/4 Inch	$ 52.00	1.00	$ 54.25	1.00	$ 57.58	1.00
1 Inch	$ 130.00	2.50	$ 100.00	1.84	$ 143.95	2.50
1.5 Inch	$ 260.00	5.00	$ 100.00	1.84	$ 287.90	5.00
2 Inch	$ 416.00	8.00	$ 100.00	1.84	$ 460.64	8.00
3 Inch	$ 832.00	16.00	$ 200.00	3.69	$ 921.28	16.00
4 Inch	$ 1,300.00	25.00	$ 200.00	3.69	$ 1,439.50	25.00
6 Inch	$ 2,600.00	50.00	$ 200.00	3.69	$ 2,879.00	50.00