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IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS SUN CITY WEST WATER AND WASTEWATER DISTRICTS.	Docket No. WS-01303A-02-0867
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS SUN CITY WATER AND WASTEWATER DISTRICTS.	Docket No. WS-01303A-02-0868
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS MOHAVE WATER DISTRICT AND ITS HAVASU WATER DISTRICT.	Docket No. W-01303A-02-0869

REPLY BRIEF OF THE RESIDENTIAL UTILITY CONSUMER OFFICE

Arizona Corporation Commission
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IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS AGUA FRIA WATER DISTRICT AND ITS ANTHEM / AGUA FRIA WASTEWATER DISTRICT.	Docket No. WS-01303A-02-0870
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS TUBAC WATER DISTRICT.	Docket No. W-01303A-02-0908

REPLY BRIEF OF THE
RESIDENTIAL UTILITY CONSUMER OFFICE

INTRODUCTION

The Residential Utility Consumer Office ("RUCO") replies to Arizona–American Water Company ("Company" or "Arizona-American") and the Arizona Corporation Commission Staff's ("Staff") Post Hearing Briefs as follows.

THE REVENUE REQUIREMENT

The Company's arguments, while creative, fail to address what is at issue in this case. Instead, the Company engages in a long discourse, complete with a detailed legal analysis, on issues that are neither contested nor relevant in this proceeding. The reason why the Company continues to evade the main issue is clear, as there is no defense to Staff and RUCO's positions on this issue. The Company's position, however, results in a significant overstatement of its revenue requirement.

Throughout this proceeding, RUCO has made it clear that it does not contest the Commission's consideration of the Company's proposed RCND ratebase. RUCO-8 at 2, Trans., Vol. V at 721. The issue is the rate of return the Commission applies to that ratebase in order to determine the revenue requirement. RUCO and Staff posit that the Commission should not adopt a rate of return based on an original cost ratebase ("OCRB") when the Company is proposing the Commission adopt an RCND ratebase. The Company's proposal, if adopted by the Commission, would result in a significantly overstated revenue requirement since both the ratebase and the rate of return factor in inflation – i.e. the Company's proposal double-counts inflation. The Commission should not allow the Company to overstate its revenue requirement by double-counting inflation.

The Company in its Closing Brief ("Brief") fails to address the main issue regarding the revenue requirement. Instead, the Company prefers to raise red-herring issues or address issues that are not contested or even relevant in the Commission's consideration of an appropriate revenue requirement. The reason why the Company continues to evade the main issue is clear – there is no logical or reasonable explanation for double-counting inflation when determining an appropriate revenue requirement. The result, however, is preferable from the Company's standpoint, because it significantly overstates the revenue requirement.

In its Brief, the Company devotes the majority of its revenue requirement argument to the reason why the Commission should adopt its RCND ratebase proposal as the fair value standard in this case. Brief at 4-23. Specifically, argues the Company, in ascertaining the fair value ratebase, the Commission is limited by the Constitution to

consider only the fair value standard, and not the "prudent investment" standard[1] in setting rates in Arizona. Brief at 8. Stated another way, the Company argues that RUCO and Staff's use of a historical cost ratebase is consistent with the "prudent investment" methodology and therefore violates the Arizona Constitution. Brief at 7-8. Incredibly, for the above reasons, the Company concludes that it would be unlawful for the Commission to adopt the methodology that the Commission has typically used in the past of averaging the Company's OCRB and RCND ratebase to arrive at a fair value ratebase. Brief at 20, 23. The Company's arguments are a red-herring and should be given no consideration.

Again, RUCO does not object to the Commission's consideration of an RCND ratebase. Nor would RUCO object to the Commission's adoption of an average of the RCND and OCRB. This is <u>not</u> the issue. The issue is the proper rate of return to be applied to the selected ratebase. At the hearing in this matter, Ms. Diaz Cortez explained in painstaking detail that the revenue requirement will be the same no matter what ratebase the Commission adopts, provided the corresponding rate of return is measured by the same ratebase. Trans., Vol. V at 723 – 732, RUCO-12.

Furthermore, the Company's proposed revenue requirement crumbles under the weight of the Company's legal analysis. The Company argues that it would be unlawful for the Commission to adopt a ratebase based on original cost and not value. Brief at 5-7. However, the Company proposes a rate of return based on an original cost ratebase. It follows that the Company's proposed rate of return is unlawful since it is measured by an unlawful ratebase. In turn, under the Company's analysis, its proposed revenue

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[1] The prudent investment standard reflects the historical cost of the utilities ratebase assets whereas the fair value reflects the value of the utilities ratebase assets. Brief at 7.

requirement must also be unlawful since its rate of return is unlawful. The Commission should not adopt the Company's proposed revenue requirement.

RATE CASE EXPENSE

The Company characterizes RUCO's rate case expense analysis as being overly simplistic. Brief at 36. According to the Company, RUCO's over-reliance on a comparison to Citizens' (the Company's predecessor) last rate case ignores the other circumstances which attribute to the Company's "significant amount of rate case expense". Id. From the Company's perspective, the Company should be reimbursed for the enormous amount of work necessary to bring this rate case. Brief at 36-38. The Company again misses the issue.

The issue is whether the Company's proposed rate case expense is reasonable under the circumstances of the case. The issue is not limited to the amount of work necessary to bring this application, as the Company suggests. This Commission has reduced a company's proposed rate case expense when the Commission has determined that the amount of rate case expense requested is <u>unreasonable</u>. For example, in Decision No. 59079, the Commission reduced Paradise Valley Water Company's proposal for rate case expense where it exceeded its previous rate case expense by 75%. Decision No. 59079 at 21. The Commission noted that the Company's rate case expense was "clearly excessive" when compared to other similarly sized utilities. Moreover, in allowing a 50% increase over the previous case, the Commission acknowledged that while there is evidence of excessive rate case expense, it is "difficult to quantify the dollar amount." Id.

In the recent rate application of Arizona Water Company[2], an Administrative Law Judge ("ALJ") determined that Arizona Water's proposed rate case expense was unreasonable and reduced the Company's proposed amount. See rate application of Arizona Water Company, Docket No. W-01445A-02-0619. The ALJ compared the Company's proposed rate case expense to its request in its last rate case as well as its recent request in its Northern Division application. See Recommended Opinion and Order in Docket No. W-01445A-02-0619 at 15. The ALJ recommended a reduction to Arizona Water's proposed rate case expense of $79,500[3] based on a comparison of these other cases, the complexity of the proceeding, and the number of systems in the case (eight). Id.

RUCO, unlike the Company, is advocating that the Commission do the same thing here. In the last rate case for those systems, Citizens was awarded its estimated rate case expense of $366,231. Decision No. 60172 at 31. Incredibly, in this case the Company estimates its rate case expense to be "roughly $1.5 million" an increase of 310% over Citizens estimate in the last rate case. However, because of what the Company suggests as generosity, the Company is only requesting $715,000, an increase of approximately 98% over Citizens request in its last rate case. Apparently, even the Company recognizes how absurd it would be to attempt to recover $1.5 million from ratepayers in rate case expense. By comparison, the Company's request is a 186% increase over what the ALJ recommends for the eight divisions which make up the Arizona

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[2] The Commission considered Arizona Water's Eastern Division whose operations in Arizona are of a similar size to Arizona-American.

[3] The Company proposed $329,550 and the ALJ recommended $250,000 in rate case expense. Id. at 14-15.

Water Company[4]. The Company's rate case expense request is unreasonable and should be reduced.

While the Company claims that this case was complex, in fact this case is ordinary. At the very least, the issues are no more complex then the issues raised by Citizens in the last rate case. Citizens also argued that the complex issues and great amount of work justified its rate case expense. According to Citizens, its proposed rate case expense was justified because the Joint Application included six rate cases; a very large number of intervenors and data requests; the CAP water issue which required the retention of water resources experts; and Citizens' retention of consultants in the area of rate design and price elasticity. Decision # 60172 at 31. As complex as Citizens claimed that case to be, however, its estimated rate case expense was slightly more than half of what the Company is requesting in this case[5]. The Company's proposed rate case expense is unreasonable.

Finally, it is the Company, through its misguided and unorthodox approach in this case, that is responsible for the resulting excessive rate case expense.[6] If the Company wishes to recover its rate case expense from the ratepayers, it is incumbent on the Company to mitigate its expenses. In this case, among other things, the Company has chosen to pursue a revenue requirement based on a non-traditional approach, which, not surprisingly, has the effect of significantly overstating the Company's revenue requirement. The Company has gone to great lengths to make its case as reflected in its exorbitant estimated rate case expense. While no one contends that the Company should not be allowed to make its argument, ratepayers should not have to pay for the Company's

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[4] In this case, there are ten divisions at issue. Brief at 1.

[5] Citizens subsequently updated its rate case expense to a cap of $750,000. Id. at 31. However, it was awarded its original estimate of $366,231. Id. at 31.

[6] For a further discussion on this point, please see RUCO's Initial Closing Brief at 7-9.

expenses in making the argument. The Company clearly failed to mitigate its rate case expense, and the Commission should reduce the amount of allowable rate case expense.

PROPERTY TAX

In its Brief, the Company criticizes RUCO's use of the Arizona Department of Revenue's ("ADOR") valuation methodology for determining property taxes. Brief at 35. The Company complains that RUCO's, and in turn, ADOR's valuation methodology is not forward-looking because it fails to include proposed revenue increases by only considering the Company's three previous years revenue levels. Id. The Company's valuation approach should be rejected because it does not follow the ADOR policy which is forward-looking.

The Company admits that the ADOR property tax valuation method utilizes the Company's three previous years revenue levels to determine property tax expense. Brief at 35. The argument, as well as any further discussion, should end here. The ADOR formula, as set forth in its letter of January 3, 2001 (R-2, Exhibit-1), was an agreement reached by the ADOR and the Water Utilities Association of Arizona (an association comprised of water utilities including the Company). See R-2, Exhibit 1. One of the objectives of reaching this agreement was to provide the utilities as well as the Commission guidance "... <u>regarding projections of future property tax expense.</u>" (Emphasis added). It should go without saying that a methodology adopted by a state agency charged with the expertise to determine such valuations, in the absence of violating the law, should be respected until modified or changed by law or that agency. The ADOR valuation methodology does not violate the law and was the result of an agreement by the Arizona Water Utilities Association and ADOR for the purpose of

providing guidance to the water companies on how to treat property taxes in their dealings with the Commission. Id. The Commission should respect that Agreement, and adopt ADOR's valuation methodology.

ADOR's valuation methodology is also forward-looking. In the letter of January 3, 2001, ADOR recognized the importance of the formula regarding the utilities projections of future property tax expense. It is reasonable to assume that the Water Utilities Association of Arizona, a partner in the agreement, also recognized the importance of a forward-looking valuation method. The letter makes it clear that both parties considered the new valuation formula forward-looking since one of the stated goals was that the new valuation formula would assist water utilities in their future dealings with the Commission regarding future property tax expenses. It seems disingenuous that the Company, a member of the association, should now recommend that the Commission continue to disregard the new forward-looking methodology.

During the hearing, RUCO's witness, Tim Coley, provided further support that the new formula was forward-looking. According to Mr. Coley, the new formula, as stated in the first bullet-point of the January 3, 2001 letter has a multiplier effect of two. Transcript, Vol. IV at 588, R-2, Exhibit 1. When multiplied by the average of the three previous years of reported gross revenue, the factor of two makes the formula "very forward-looking." Id. The ADOR formula is forward-looking and the Commission should adopt the ADOR formula for property tax valuation.[7]

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[7] As with most if not all the other contested positions advocated by the Company, it should come as no surprise that the Company's proposal results in a greater revenue requirement than the other proposals. Trans., Vol. IV at 546.

HALF-YEAR CONVENTION

It is undisputed that in ratemaking proceedings, the half-year convention is typically utilized in calculating depreciation. Brief at 29. It is also undisputed that the half-year convention should be used absent a reason to depart from it. Id. The Company deviates from the norm and employs a half-month convention, which the Company admits, results in a higher revenue requirement than the half-year convention. Id. at 29-30. There is no reason to depart from the use of a half-year convention and the Commission should adopt the half-year convention.

The Company's predecessor, Citizens, utilized a half-year convention in calculating its depreciation expense, and accordingly the test-year accumulated depreciation reserve reflects Citizens use of the half-year convention. Other than the fact that Arizona-American employs a half-month convention, Arizona-American has not provided a reason why the Commission should change from what is normally used and what was used prior to the time the Company acquired Citizens. There is simply no reason to deviate from generally accepted regulatory practice, nor is it appropriate to restate the historical depreciation reserve balance simply because the Company has chosen to utilize an atypical methodology on a going- forward basis. The Commission should not adopt the half-month convention proposed by the Company.

COST OF CAPITAL

RUCO maintains that its 6.77 percent weighted cost of capital is fair and reasonable in this case. RUCO's 9.61 percent cost of common equity is very reasonable given the Company's capital structure and the current financial environment. The Company, however, disagrees and argues that under the comparable earnings standard (which

compares returns being earned by companies with corresponding risk), RUCO and Staff's recommended returns on equity would be confiscatory. Brief at 49. The Company need not look outside its own family to see how meritless that claim is. In a recent rate case involving a sister water company, West Virginia-American Water Company[8], the Public Service Commission of West Virginia approved a 7.00% cost of common equity. Order at 21. The Commission noted that the Company's 10.0% to 11.5% return on equity recommendation was outside the range of reasonableness. Id. 20-21. The Commission stated that its 7.00% return on equity determination balances the concerns of the Company regarding investor perceptions of the riskiness of the water industry with the need to ensure that the ratepayers pay rates reflecting no more than a fair rate of return while still complying with the Hope and Bluefield decisions. Id. at 21. The Commission should adopt RUCO's recommended cost of capital.

RATE DESIGN

RUCO recommends that the Commission adopt its proposed rate design as set forth in the Direct Testimony of Ms. Diaz Cortez. RUCO-7 at 31, Schedules MDC-16, pp. 1-2. However, should the Commission lean towards an inverted tier-rate structure, RUCO recommends that the Commission adopt the proposal submitted by the Company. RUCO believes that the Company's proposal presents a more reasonable and fair cost allocation amongst the tiers than the proposal recommended by Staff. From an environmental standpoint, the better-cost allocation would encourage conservation.

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[8]RWE Aktiengesellschaft owns both Arizona-American and the West Virginia-American Water Company. See Commission Order, Public Service Commission of West Virginia, Charleston ("Order"), Case No. 03-0353-W-42T, January 2, 2004 at 9 (attached Exhibit A-excerpts from the Order), and Company website at the following address; http://www.amwater.com/awpr/about_us/aboutus1175.html.

TOLLESON AGREEMENT

The Company has proposed an automatic adjustor mechanism to recover costs that are projected to be incurred outside the test-year related to its Agreement with Tolleson. The additional costs associated with the Tolleson Wastewater Treatment plant are not known and measurable at this time. Further, once these expenses do become known and measurable, the amounts will be set amounts that will not fluctuate widely. RUCO-7 at 29. RUCO recommends that these costs continue to be deferred as agreed to by the parties (Staff, the Company, RUCO and the Town of Youngstown) and ordered by the Commission. See Decision No. 66386, October 3, 2003, Docket No. W-01303A-03-0375. The Commission should deny the Company's proposal since the expenses under consideration do not qualify for an automatic adjustment mechanism.

In only limited circumstances may the Commission establish rates without simultaneously determining the effect of changed rates on a utility's rate of return. One of those circumstances is when the Commission has established an automatic adjustor mechanism. *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 535, 578 P.2d 612, 616; *Residential Util. Consumer Office v. Arizona Corp. Comm'n ("Rio Verde")*, 199 Ariz. 588, 591 ¶ 11, 20 P.3d 1169, 1172. An automatic adjustor mechanism permits rates to adjust up or down "in relation to fluctuations in certain, narrowly defined, operating expenses." *Scates* at 535, 616. An automatic adjustor permits a utility's rate of return to remain relatively constant despite fluctuations in the relevant cost. An automatic adjustor clause can only be implemented as part of a full rate hearing. *Rio Verde* at 592 ¶ 19, 1173, *citing Scates* at 535, 616.

The Commission has also defined adjustment mechanisms as applying to expenses that routinely fluctuate widely. In a prior decision in which it eliminated APS' fuel and power adjustor, the Commission stated:

> The principle justification for a fuel adjustor is volatility in fuel prices. A fuel adjustor allows the Commission to approve changes in rates for a utility in response to volatile changes in fuel or purchased power prices without having to conduct a rate case. (Decision No. 56450, page 6, April 13, 1989).

The Commission went on to discuss the undesirability of such adjustors because they can cause piecemeal regulation that is inefficient and undesirable. *Id.* at 8. *See also Scates* at 534, 615.

Here, the additional plant costs do not routinely fluctuate widely. Even the Company does not describe the additional plant costs as fluctuating widely. In its Brief, the Company refers to the costs as "significant, variable, and outside the Company's control." Brief at 68. Nowhere in the Company's description does the Company set forth the criteria mandated by the Arizona Courts and the Commission to qualify for treatment as an automatic adjuster clause.

Moreover, RUCO is not advocating that the Company be denied its costs. RUCO is merely suggesting that the Commission consider those costs when they are known and measurable.

The Company is critical of RUCO noting that RUCO would not reward the Company for making decisions like the Tolleson Agreement which result in benefits to the ratepayers. The Company misses the point. It is the responsibility of the Company to provide wastewater service to its Tolleson customers. In exchange for undertaking that obligation, the Company is guaranteed an exclusive service territory (ratepayers are captive customers who have no choice but to accept the services of the company). The

Company is also entitled to an opportunity to earn a fair rate of return without the worry of competitors. If the Company is unable to provide suitable wastewater service, then other companies who have that ability should be allowed the privilege. Therefore, the Tolleson Agreement does not represent a "benefit" to ratepayers; it simply assures that they will be provided with adequate wastewater service. The Company's proposed adjuster mechanism should be rejected.

INACCURACIES IN THE COMPANY'S BRIEF

Throughout its Brief, the Company has made inaccurate and/or distorted statements about facts in this case and/or RUCO's position. While some have been addressed above, three other, large distortions need to be corrected and/or clarified as follows:

1. RUCO'S PLANT BALANCES AND RATEBASE

The Company alleges that RUCO's plant schedules are "fraught" with error and cannot be relied on in determining the appropriate ratebase. Brief at 28. The Company's Brief cites a purported double-count of an AFUDC adjustment in support of its allegation. Despite the testimony of RUCO's witness Ms. Diaz Cortez that there was no double-count,[9] the Company, through the testimony of Staff's witness Darron Carlson, concludes that there was a double-count. Trans., Vol. VIII at 1489-1490. Mr. Carlson testified he reviewed accounting documentation that showed the AFUDC had been recorded on the Company's books and records. While Ms. Diaz Cortez reviewed the same documentation, RUCO's plant figures represented a reconstruction of the historical plant balances based on the Commission's prior rate case order. These balances did not include the AFUDC

[9] Trans., Vol. V at 774.

adjustments to the books and records. TR at 764, 772-774. Thus, RUCO did not double-count the AFUDC as stated by the Company. Of course, RUCO would be in a better position to state what it did than the Company through a Staff witness. Aside from a few minor mathematical errors in RUCO's accumulated depreciation values, which were acknowledged during the hearing, the record in this docket does not support the Company's assertion that RUCO's plant figures are "fraught" with error. In fact, RUCO was the only party that preformed the audit work necessary to establish the correct beginning plant balances based on the Commission's prior rate case order.

2. TEST-YEAR CORPORATE OVERHEADS, SALARIES AND WAGES

RUCO has agreed with the Company that expense adjustments are necessary to remove the test-year Citizens overheads, Service Company charge and salaries and wage level of expenses, and replace them with Arizona-American's expense levels. However, RUCO does not agree with the Company's ascertain that RUCO's adjustment is understated by $500,000. Brief at 31. The impression left by the Company is that RUCO understated overhead expenses by $500,000. This impression is distorted and inaccurate -- RUCO and the Company agreed on the actual amount of expense for this adjustment.

RUCO's witness, Rodney Moore testified that he misclassified $587,410 by placing it into an "Office" category when it should have been placed in an "Employee Benefit" category. R-4 at 9. However, the aggregate total for these expenses was still correct and the amount of the adjustment remained unchanged. Id. In fact, the Company accepted RUCO's proposed change to include the Company's actual 2002 overhead levels which included this aggregate amount. A-75 at 15.

3. RATE CASE EXPENSE

In support of its position that its recommended rate case expense is reasonable, the Company notes that in the last rate case, Citizens employed specific individuals that were assigned the task of prosecuting rate applications and those expenses were included in management fees charged to the district. Brief at 36. The impression is that Citizens did not include these costs in rate case expense. Again, this is an inaccurate impression.

RUCO's witness, Marylee Diaz Cortez, who participated in that case, testified that Citizens separately billed for its in-house consultants, on an hourly basis and those billings were included in the rate case expense. Trans., Vol. V at 812-813. The evidence, in addition to common sense, supports Ms. Diaz Cortez' testimony of how Citizens accounted for its rate case expense.

CONCLUSION

RUCO recommends the Commission reject the Company's proposed revenue requirement and adopt RUCO's proposed revenue requirement based on the Commission's historical use of an OCRB ratebase. RUCO further recommends the Commission adopt its proposed rate case expense, property tax expense and other proposed adjustments to operating income. RUCO's proposed cost of capital and rate design is also fair and reasonable and should be adopted by the Commission. Finally, the Commission should adopt RUCO's proposed payroll expense capitalization rate and RUCO's position that an adjustor mechanism is not necessary to recover the accrued plant improvement costs under the Company's agreement with Tolleson.

RESPECTFULLY SUBMITTED this 18th day of February, 2004.

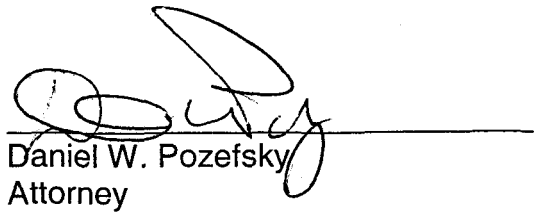

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EXHIBIT A

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PUBLIC SERVICE COMMISSION
OF WEST VIRGINIA
CHARLESTON

At a session of the PUBLIC SERVICE COMMISSION OF WEST VIRGINIA in the City of Charleston on the 2nd day of January, 2004.

CASE NO. 03-0353-W-42T

WEST VIRGINIA-AMERICAN WATER COMPANY
Tariff Rule 42 application to increase
water rates and charges.

COMMISSION ORDER

The Commission is herein presented with the first fully litigated rate case brought by the West Virginia American Water Company (Company) since 1994. After an evidentiary hearing and review of all submitted testimony and argument, the Commission herein authorizes a return on equity of 7.00%, an overall return of 6.63, on a rate base of approximately $394,150,000, and a revenue requirement of approximately $98,885,000.

Procedure

On March 11, 2003, the Company tendered for filing revised tariff sheets reflecting increased rates and charges of approximately 16.4% annually, or $15,550,687, for furnishing water utility service to approximately 164,000 customers in Boone, Braxton, Cabell, Clay, Fayette, Harrison, Kanawha, Lewis, Lincoln, Logan, Mason, Mercer, Putnam, Raleigh, Summers, Wayne and Webster Counties, to become effective on April 11, 2003. In addition to increased commodity rates, the filing requested the institution or increase of certain non- commodity charges, such as the delayed payment penalty, a returned check charge, a tap fee, a reconnection fee, and a leak adjustment rate (collectively referred to as "cost causer" or Customer Specific tariff items).

In addition to its own customers, customers of the following utilities or entities would be directly or indirectly affected by the rate application because these utilities or entities, under agreements approved by the Public Service Commission, are charged water rates which are based on the Company's rates, either in whole or in part: Boone County Public Service District, Cumberland Road Public Service District, the Town of Danville, the Town of Eleanor, Jumping Branch-Nimitz Public Service District, the Kanawha County Regional

Development Authority, Lashmeet Public Service District, the Lewis County Economic Development Authority, New Haven Public Service District, Oakvale Road Public Service District, the Putnam County Building Commission, Putnam-Union Public Service District and Salt Rock Water Public Service District.

In its filing the Company asserted that it had complied with the notice requirements of Rule 10.1.b of the Commission's Rules for the Construction and Filing of Tariffs (Tariff Rules).

The Commission notes that throughout the course of this proceeding it has received a large

Commission ordered the Company to defer the actual costs incurred in increasing the security of the Company's systems on its books of account as a regulatory asset for presentation in the Company's next rate case.

Subsequent to the 2001 rate case, the Company and Thames Water Aqua Holdings GMBH (Thames) filed a petition seeking the Commission's consent and approval of the acquisition of the outstanding common stock of American Water Works Company, Inc.

(AWW), the parent company and controlling shareholder of the Company, by Thames, a wholly owned subsidiary of RWE Aktiengesellschaft (RWE). See Case No. 01-1691-W-PC (the Acquisition Case). As part of a settlement reached by the parties to that case, which the Commission adopted with certain modifications in an order entered on October 23, 2002, the parties agreed that the Company would file its next general rate case no earlier than March 7, 2003, based on a 2002 historical test year, with any changes in the Company's rates and charges from such case to be implemented no earlier than January 1, 2004. Id. at p.40 and Conclusion of Law No. 8 at p. 48. The parties to the Acquisition Case agreed, among other things, that RWE, Thames, AWW, and the Company would make no attempt to allocate or assign to the Company any portion of the purchase price in connection with the transaction or to recover from the Company's customers any portion of the acquisition premium or purchase price for the AWW common stock or any other costs associated with the acquisition. Id. at Joint Stipulation and Agreement for Settlement, p. 7, paragraphs M and L.

In the Company's present filing it originally requested a little over a 16% increase in rates (later revised to an increase of slightly less than 15%). In order to determine the proper disposition of the Company's request, the Commission reviewed all testimonies, briefs, motions, letters of protest and support, and other filings made by the parties, intervenors, and protestants. Additionally, the Commission presided over six public protest hearings and one evidentiary hearing which extended over a five day hearing. The Commission has given careful consideration to all issues raised in this case in reaching its decision. Those issues are addressed on the following pages.

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Capital Structure and Resulting Rate of Return

before market price leveraging, to an inflated rate base that exceeds book value or, in the alternative chosen by the Company, we can continue to use original cost rate base and apply an inflated rate of return to that rate base.

The Company witness has further inflated his DCF analysis by using earnings per share growth rates rather than the dividend growth rates that have been historically used by the Commission in its DCF analysis. The Company witness ' water group dividend growth rate is either a 2.5% historic growth rate or a 2.83% projected growth rate. While there can be disagreement regarding the choice of historic or projected growth rates in the DCF formula, clearly there is not a huge difference in either dividend growth rate. However, the Company witness stretches his recommendation by turning to growth in earnings per share. Here, he takes a measure that has not been historically used by this Commission and suggests that we consider it in evaluating a DCF indicated return on equity. The historic earnings per share he uses is 3.6%, a full 110 basis points above the historic growth in dividends. His projected growth in earnings per share jumps to 6.71%, or more than 320 basis points above the historic growth in dividends.

Looking at the Company witness' sample water group, and using his yield plus historic growth in dividends results in a DCF indicated return on equity of 6.23%. Even using his historic growth in earnings per share produces only an indicated return on equity of 7.33%.

The Company witness' other models for determining a return on equity suffer from a similar effort to simply raise the numbers. For example, in his Capital Asset Pricing Model, he incorporates a projected market premium of 14.71% based on a projected market return of 19.71% less a risk free rate of 5%. This is a full 830 basis points above his historical market premium of 6.4% based on a historical market return of 12.2% less a

historical long-term treasury rate of 5.8%. As a further example, in his Capital Asset Pricing Model, he applies his market value adjustment to leverage his water group beta from .6 to .77. As we have explained above, this market value adjustment is completely unacceptable and unreasonable.

In addition, the Commission agrees with the Staff that the CAPM depends on a determination of an objective and sustainable risk free component. The Company seeks a risk free component of 5%, based on long term treasury bonds. In today's market, with secured savings accounts receiving annual interest of less than 1%, with secured Certificates of Deposit receiving annual interest around 2%, and with short term treasury bonds yielding less than 2%, we simply do not find any credibility in the Company witness' support of a 5% risk free component.

Looking at the Company witness' CAPM stripped of his efforts to leverage unrealistic rates of return through his adjustment to attempt to compensate investors for the fact that they may be paying market prices in excess of the book value rate base used by a regulatory commission, we see a water group beta of .6. Even accepting his excessive risk free component of 5%, his CAPM at a .6 beta would be 8.84%, far below the 10.00% to 11.5% rate of return on equity range which he supports. More importantly, adjusting his CAPM analysis to reflect a more realistic risk free component even using 2% as a short term rate (which is higher than the short term rate used by Staff) results in a return on equity of 7.04%.

Clearly, while we must acknowledge the Company witness' recommendations as being the high end of the range of recommendations made in this case, the Commission finds significant subjective modifications to the empirical data adopted by the Company witness that not only render his recommendations as being on the high side, they simply place his 10.0% to 11.5% return on equity

recommendation outside of any range of reasonableness.

With regard to the CAD witness' recommendation of an 8.25% return on equity, the Commission also finds that Mr. Short fails to support some of the components of his recommendation. We find this to be particularly troublesome with regard to his use of multiple growth rates in his DCF model and his use of multiple risk free components in his Capital Asset Pricing Model. Historically, the Commission has used growth in dividends as the growth rate component in a DCF model. We believe that this is consistent with the use of dividend yield in the model. There is a balance between investor expectations of dividends and the market price. Specifically, we do not find support for the growth rate in the DCF analysis recommended by Mr. Short, and believe that it represents a highly subjective selection from among a number of growth rate considerations. In his CAPM, Mr.

Short again mixes a risk free component based on short-term three month U.S. Treasury bills and thirty year U.S. Treasury bonds. The Commission finds that his use of excessive growth rates as part of his analysis and his use of a 30 year U.S. Treasury bond rate, which we do not consider to be a reasonable measure of the risk free component of the Capital Asset Pricing Model, similarly renders his recommend 8.25% cost of equity to be too high.

Turning to the Staff's recommended return on equity, the Commission finds that the 6.67% recommendation is based on the most realistic and objective measures of investor expectations and market risks. We also find that the end result tests performed by Staff are not, as the Company asserts, the means to the end goal of determining a fair and reasonable rate of return. Instead, these end result analyses help the Commission to determine if a given capital structure, debt costs, and return on equity produce sufficient interest coverage, dividend potential, and internal cash flows to enable the Company to meet the comparable earnings, financial integrity, and capital attraction tests set forth in the Bluefield and Hope cases. Indeed, upon a review of the end results of the Staff's recommended return on equity, particularly with regard to the net income available for preferred dividends and remaining for common stock holders after payment of preferred dividends, the Commission finds that a return on equity in excess of the Staff's recommended 6.67% is needed.

Upon consideration of the testimony and briefs of the parties, the Commission shall set a return on equity capital at a rate of 7.00%. The Commission's rate is at the lower end of the scale as presented by the parties but believes its decision adequately balances the concerns of the Company regarding investor perceptions of the riskiness of the water industry with the need to ensure that the ratepayers pay rates reflecting no more than a fair rate of return, and also will be sufficient to comply with the Hope and Bluefield tests set forth previously in this discussion.

Capital Structure and Resulting Rate of Return

The capital structure issue addresses the sources of capital supporting the net assets (rate base) of the utility. A company's capital structure will normally depict the amount of capital acquired by an entity through retained earnings, other paid in capital contributions from stockholders, the issuance of debt, and the issuance of stock. Capital structure quantifies short-term and long-term debt, as well as preferred and common equity - and establishes a relationship between the various capital sources for subsequent use in a formulaic approach to determine a composite cost of capital.

To determine cost of capital, each type of capital is calculated as a percentage of the total capital structure. The cost rate for each type of capital (long term debt, short term debt, preferred stock, and common stock) is then multiplied by that type of capital's percentage