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BEFORE THE ARIZONA CORPORATION COMM

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IN THE MATTER OF THE COMMISSION'S GENERIC EVALUATION OF THE REGULATORY IMPACTS FROM THE USE OF NON-TRADITIONAL FINANCING ARRANGEMENTS BY WATER UTILITIES AND THEIR AFFILIATES.

DOCKET NO. W-00000C-06-0149__

ARIZONA-AMERICAN WATER COMPANY'S ANSWERS TO COMMISSION STAFF'S QUESTIONS

Arizona-American Water Company ("Arizona-American") hereby responds to each of the questions posed the Staff of the Arizona Corporation Commission in Mr. Johnson's letter to Arizona Water Company Representatives.

Preliminary Statement

Arizona-American believes that every Arizona water and wastewater company will benefit from the Commission's resolution of these issues. Arizona-American believes that "financing" methods employed by certain water companies skirt settled regulatory accounting and ratemaking practices. These practices were designed to ensure that customers gain the full benefit of developer infrastructure funding by offsetting rate base and thereby reducing rates. Any method that instead injects these funds into a utility and does not reduce ratebase and rates is boosting the corporate bottom line at the expense of customers.

The Commission has already found that that one alternative financing arrangement is inequitable. In Decision No. 61943, dated September 17, 1999, the Commission considered two utilities' practice of requiring payment in lieu of revenue ("Pilor") charges from developers. The utilities requested that the Pilor charges be booked as revenue, with no ratebase offset. Then the plan was to use this revenue to fund plant construction. Staff opposed the use of Pilor:

> Staff further recommends that the proposed Pilor fees should be rejected by the Commission because they would be inequitable to … customers because the

> funds would be collected by the homebuilders from the lot buyers and paid to Applicants to fund plant construction and pay operating expenses. Subsequently, as utility plant is constructed with customer funds, in future rate cases the <u>customers will be required to pay in rates a return on utility plant that their own funds have already paid for</u>.[1] (Emphasis added.)

Based on this reasoning, the Commission rejected the proposed Pilor tariffs "due to their inherent inequities to … customers."[2]

The new alternative financing arrangements are fundamentally indistinguishable from the Pilor arrangement that the Commission has already found to be inequitable. Funds are demanded from developers that ultimately flow to the utility, without any ratebase credit for customers. The end result is the same: "[I]n future rate cases the customers will be required to pay in rates a return on utility plant that their own funds have already paid for."

Despite its general opposition to these creative attempts to get around the Commission's Pilor prohibition, Arizona-American's fundamental request is that the playing field should be level for all Arizona water and wastewater utilities. Arizona-American believes that it has been playing by the rules. If the rules have effectively been changed to allow these new arrangements, then the Commission should make the new rules explicit, so that everyone knows the rules of the game. If it is permissible for some Arizona utilities to practice creative financing, then the Commission should come right out and bless these practices for every company. If these types of practices are not sanctioned, then the Commission should deal with these creative attempts to circumvent its Pilor prohibition.

<u>Responses to Questions</u>:

1. What is the preferred regulatory treatment for each of the following financing arrangements?

A. A developer purchases a non-regulated parent company's non-voting stock. Each of the non-voting shares has a par value of $1.00, is not eligible for dividends, is partially refundable and can be repurchased (subject to certain conditions) by the non-regulated parent for one cent ($0.00). See attached diagram at Exhibit A. The parent company

[1] Decision No. 61943, p. 7.
[2] *Id.*, at 9.

subsequently contributes the funds to an ACC regulated subsidiary water utility as additional paid-in capital.

Response: Certainly, these stock purchases are not voluntary. Any additional charge extracted from the developer will ultimately have to be recovered from the home buyers, along with all other costs of doing business. Effectively, this is a phantom hook-up fee, which should directly offset rate base. In this arrangement, just as for the one rejected in Decision No. 61943, "customers will be required to pay in rates a return on utility plant that their own funds have already paid for."

B. *A developer purchases a regulated utility's non-voting stock and that utility invests those funds in plant. The utility records equity for the proceeds. Neither refundable advances in aid of construction nor contributions in aid of construction are recorded.*

Response: Again, this would be a phantom hook-up fee, so that "customers will be required to pay in rates a return on utility plant that their own funds have already paid for."

C. *A developer or a Municipal Government pays a fee for services provided by a non-regulated parent company for services typically covered by "Off-site Hook-up Fees" collected by regulated water and wastewater utilities. Then the parent company invests the proceeds in the regulated utility which is recorded as equity by the utility.*

Response: Once again, the solution is to follow the money. Ultimately, these "fees" will be paid for by homebuyers through a higher-priced home. This would be another phantom hook-up fee, so that "customers will be required to pay in rates a return on utility plant that their own funds have already paid for."

2. *What is the maximum percentage of refundable "Advances in Aid of Construction" ("AIAC") appropriate as a percentage of total capital for a private or investor owned water utility?*

Response: The expected amount of the refund obligation should be treated as debt for ratemaking purposes, funded at the company's overall cost of capital. As to the appropriate debt percentage, please see Arizona-American's response to Question 4.

The balance that is not expected to be refunded should be immediately recognized as CIAC. This would reduce depreciation expens on AIAC-funded plant that will ultimately eventually become CIAC. A company's revenue requirement would correspondingly decrease.

3. What is the maximum percentage of non-refundable "Contributions In Aid of Construction" ("CIAC") appropriate as a percent of total capital for a private or investor owned water utility?

Response: Arizona-American reads this question to ask: How much CIAC is too much?

Arizona-American does not have a ready opinion as to how to relate an appropriate CIAC balance to total capital. A company can attract capital if rates are sufficient to both fund operations and pay a return to investors to compensate them for their investments in utility infrastructure. The CIAC balance does not appear to relate to determining whether total capital is adequate.

4. What is the most appropriate and most economical capital structure for a "new" water or wastewater utility?

There is no single appropriate and economical capital structure for a new utility. A fundamental economic premise is that overall weighted average returns to investors are constant over a wide range of equity ratios. As developed by two Nobel Prize winners, Modigliani and Miller, the basic premise is known as Modigliani and Miller's Proposition II: The expected rate of return on the common stock of a levered firm increases in proportion to the debt-equity ratio (D/E) expressed in market values … ." Or, as put by Dr. Lawrence Kolbe:[3] "There's no magic in financial leverage." Therefore, the cost of capital recovered from customers should be constant over a large range of equity ratios.

Based on recent decisions, the Commission has been over-compensating investors in low-leverage utilities and under-compensating investors in high-leverage utilities. The following table summarizes eight recent Commission ROE determinations and compares those determinations to the parties' positions in Arizona-American's recent rate case for its Paradise Valley Water District.

[3] Principal, The Brattle Group, Cambridge, Massachusetts.

<u>**Recent ACC Overall Cost of Capital Awards**</u>

Utility	Decision	Year	% Equity	Return	% P'fd Equity	Return	% ST Debt	Return	After-tax Return	% LT Debt	Return	After-tax Return	After-tax WACC
AAW RUCO		**2006**	**36.70%**	**10.00**					0.00	**63.30%**	**5.42**	3.28	**5.75%**
AAW Staff		**2006**	**36.70%**	**10.40**					0.00	**63.30%**	**5.42**	3.28	**5.89%**
AAW Requested		**2005**	**36.70%**	**12.00**					0.00	**63.30%**	**5.42**	3.28	**6.48%**
Southwest Gas	68487	2005	40.00%	9.50	5.00%	8.20			0.00	55.00%	7.61	4.60	**6.74%**
Pineview Water	67989	2005	51.00%	8.90					0.00	49.00%	5.43	3.29	**6.15%**
APS	67744	2005	55.00%	10.25					0.00	45.00%	5.80	3.51	**7.22%**
Chapparal City	68176	2005	58.73%	9.30					0.00	41.27%	5.10	3.09	**6.74%**
AZ Water Eastern	66849	2004	66.20%	9.20			5.60%	4.00	2.42	28.00%	8.46	5.12	**7.66%**
AZ Water Western	68302	2005	73.40%	9.10					0.00	26.60%	8.40	5.08	**8.03%**
Las Quintas Serenas	67455	2005	100.00%	8.10					0.00	0.00%	0.00	0.00	**8.10%**
Rio Rico Utilities	67279	2004	100.00%	8.70					0.00	0.00%	0.00	0.00	**8.70%**

This table shows that the overall weighted cost of capital awarded in the last eight major Commission rate cases ranged from 6.15% to 8.7%. What this means is that Rio Rico Utilities' customers were paying $8,700 to the company's investors for $100,000 in rate base, but Pineview Water's customers were paying just $6,150 to that company's investors for $100,000 in rate base.

Despite what economists tells us the result should be, at the Commission, the greater a company's equity percentage is, the greater is its allowed overall return <u>and</u> the corresponding customer revenue requirement.

Interest payments on debt are expenses for tax purposes, so the revenue requirement associated with a dollar of debt investment is substantially lower in today's markets than for a dollar of equity investment. Companies should be encouraged, within reason, to borrow funds rather than finance new investments with equity. However, because the Commission rewards companies with higher and higher returns as equity ratios increase, Arizona companies are reluctant to issue low-cost debt. Further, because the Commission rewards equity investment, it may be inadvertently encouraging financing schemes that inflate equity ratios by extorting "equity" investments from developers.

Arizona-American is not suggesting that a company should be 100% debt financed, any more than that it should be 100% equity financed. However, there is a broad range of acceptable equity ratios. Ratios in the neighborhood of 20 to 80 percent appear reasonable. To encourage new companies to fall within this range, the Commission's policy should be that a company's overall cost of capital should not vary as long as its equity ratio stays in this range.

RESPECTFULLY SUBMITTED on June 22, 2006.

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