

OPEN MEETING ITEM



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

EXECUTIVE DIRECTOR

22

ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission

DOCKETED

JUL 11 2006

DATE: JULY 11, 2006  
DOCKET NOS: W-01303A-05-0405 and W-01303A-05-0910  
TO ALL PARTIES:

DOCKETED BY	NR
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Enclosed please find the recommendation of Administrative Law Judge Teena Wolfe. The recommendation has been filed in the form of an Opinion and Order on:

ARIZONA-AMERICAN WATER COMPANY  
(RATES/AGREEMENT)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and ten (10) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00** p.m. on or before:

JULY 20, 2006

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Working Session and Open Meeting to be held on:

JULY 25, 2006 and JULY 26, 2006

For more information, you may contact Docket Control at (602) 542-3477 or the Hearing Division at (602)542-4250. For information about the Open Meeting, contact the Executive Secretary's Office at (602) 542-3931.

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**BEFORE THE ARIZONA CORPORATION COMMISSION**

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, 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 PARADISE VALLEY WATER DISTRICT.

DOCKET NO. W-01303A-05-0405

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY FOR APPROVAL OF AN AGREEMENT WITH THE PARADISE VALLEY COUNTRY CLUB.

DOCKET NO. W-01303A-05-0910

DECISION NO. \_\_\_\_\_

OPINION AND ORDER

DATES OF HEARING: March 27, 28, 29, and April 3, 2006  
PLACE OF HEARING: Phoenix, Arizona  
ADMINISTRATIVE LAW JUDGE: Teena Wolfe  
APPEARANCES: Mr. Craig A. Marks, Corporate Counsel, on behalf of Arizona-American Water Company;  
Mr. Daniel Pozefsky, Attorney, on behalf of the Residential Utility Consumer Office; and  
Ms. Maureen A. Scott, Senior Staff Counsel, and Mr. Keith A. Layton, Attorney, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

TABLE OF CONTENTS

1			
2	I.	INTRODUCTION.....	4
3		A. Procedural History.....	4
4		B. Rate Application.....	4
5	II.	RATE BASE.....	6
6		A. Plant in Service.....	6
7		1. Post-Test Year Plant – Fire Flow Improvement Projects.....	6
8		a. Discussion.....	6
9		b. Conclusion.....	11
10		2. Plant Held for Future Use – Backup Pumping Equipment.....	12
11		3. Conclusion.....	13
12		B. Gain on Sale of Land.....	14
13		C. Cash Working Capital.....	14
14	III.	ORIGINAL COST RATE BASE.....	15
15	IV.	FAIR VALE RATE BASE.....	15
16	V.	OPERATING INCOME.....	15
17		A. Rate Case Expense.....	15
18		B. Labor and Pension Expenses.....	17
19		C. Property Tax Expense.....	18
20		1. Property Tax Calculation.....	18
21		2. Miller Road Treatment Facility Property Taxes.....	19
22		D. Administrative and General Expenses (A&G).....	20
23		1. AIP, Performance Pay and Stay Bonus.....	20
24		2. Reorganizing/Downsizing Expenses.....	21
25		3. Ice.....	21
26		4. Security Renovations and Repairs and Indoor Plant Maintenance.....	21
27		5. Conclusion.....	22
28		E. State of Operating Income.....	22
	VI.	COST OF CAPITAL.....	22
		A. Capital Structure and Cost of Debt.....	22
		B. Cost of Equity.....	22
		1. Arizona-American.....	22
		2. RUCO.....	22
		3. Staff.....	22
		4. Discussion.....	27
		C. Cost of Capital Summary.....	29
	VII.	AUTHORIZED INCREASE.....	29
	VIII.	RATE DESIGN.....	29
		A. General Rate Design.....	29
		B. Surcharges.....	30
		1. Company Surcharge Proposal.....	30
		2. Staff Recommendation.....	30
		3. Staff's Alternative Fire Flow Surcharge Proposal (Exhibit B).....	31
		4. Accounting Order Modifying AFUDC Methodology.....	32
		5. Analysis and Conclusion.....	32
	IX.	OTHER ISSUES.....	33
		A. Arsenic Cost Recovery Mechanism (“ACRM”).....	33

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**B. PVCC Special Contract .....35**

**FINDINGS OF FACT .....36**

**CONCLUSIONS OF LAW .....41**

**ORDER .....41**

**Exhibits to Decision**

- Exhibit A Copy of Decision No. 68303 (November 14, 2005)**
- Exhibit B Alternative Fire Flow Surcharge (Copy of Hearing Exh. S-9)**

1 **BY THE COMMISSION:**

2 **I. INTRODUCTION**

3 On June 3, 2005, Arizona-American Water Company ("Arizona-American" or "Company")  
4 filed with the Arizona Corporation Commission ("Commission") an application for a rate increase in  
5 its Paradise Valley Water District ("District"). The application also requests approval for the District  
6 of an Arsenic Cost Recovery Mechanism for investments required by the Company to comply with  
7 federal water arsenic reduction requirements; a High Block surcharge that would be imposed for  
8 conservation purposes on usage in the highest consumption block; and a Public Safety surcharge for  
9 investments by the Company related to improvement of fire flow facilities.

10 Arizona-American serves approximately 131,000 customers throughout the State of Arizona  
11 pursuant to various Certificates of Convenience and Necessity granted by the Commission to the  
12 Company and its predecessors in interest. The District serves approximately 4,737 metered  
13 customers, 93 percent of whom are residential customers, located in portions of the Town of Paradise  
14 Valley, the City of Scottsdale, and unincorporated Maricopa County.

15 **A. Procedural History**

16 By Procedural Order issued August 15, 2005, a hearing was set in this matter to commence on  
17 March 27, 2006. A Procedural Order was issued on February 28, 2006 consolidating the Company's  
18 rate application with the above-captioned application filed by the Company on December 22, 2005,  
19 requesting Commission approval of an agreement between the Company and the Paradise Valley  
20 Country Club ("PVCC") that would allow PVCC a 15 percent discount from the Company's standard  
21 turf rates.

22 Intervention was requested by and granted to the Residential Utility Consumer Office  
23 ("RUCO") and PVCC. The Town of Paradise Valley ("Town") filed a letter requesting intervention  
24 on March 20, 2006, but later filed a letter on March 27, 2006 withdrawing its intervention request.  
25 No other intervention requests were filed.

26 On October 26, 2005, the Company docketed an affidavit certifying that a copy of the notice  
27 required by the August 15, 2005 Procedural Order was included in each September 2005 bill mailed  
28 to customers in the Company's Paradise Valley Water District.

1 The rate application originally included a request for an Accounting Order authorizing the  
2 deferral of capital costs incurred by the District related to public safety associated with fire flow.  
3 However, on September 16, 2005, the Company filed a letter in this docket including details  
4 regarding the requested Accounting Order, and on October 4, 2005, the Company filed in a separate  
5 docket, Docket No. W-1303A-05-0704, a request to bifurcate the Accounting Order request from the  
6 rate application. The Commission subsequently issued Decision No. 68303 on November 14, 2005,  
7 granting the Company's request for an Accounting Order allowing it to defer capital costs related to  
8 public safety associated with fire flows. Decision No. 68303 limited the authorized deferral amounts  
9 to depreciation expense and a post in-service allowance for funds used during construction  
10 ("AFUDC") with interest rates set at the Company's cost of debt concurrent with the deferral period.  
11 For convenience of reference, a copy of Decision No. 68303 is attached hereto as Exhibit A.

12 A hearing was held as scheduled commencing on March 27, 2006 and continuing on March  
13 28, March 29 and April 3, 2006. Several members of the public appeared on the first day of hearing  
14 and provided public comment on the application.

15 The Company, RUCO and the Commission's Utilities Division Staff ("Staff") appeared at the  
16 hearing and presented evidence before an Administrative Law Judge of the Commission. Following  
17 post-hearing filings, which included initial and reply briefs timely filed by the parties on May 5 and  
18 May 26, 2006, respectively, the consolidated matters were taken under advisement.

19 On July 3, 2006, the Town filed in these consolidated dockets a Motion for Leave to File  
20 Amicus Curiae Brief, to which was attached an amicus curiae brief.<sup>1</sup>

21 **B. Rate Application**

22 The current rates and charges for the District were authorized in Decision No. 61831 (July 20,  
23 1999), based on a test year ended June 30, 1998, and became effective on August 1, 1999. The  
24 current rate application is based on a twelve month test year ended December 10, 2004. The  
25 Company is requesting an increase in revenues for the District of \$427,939, for an increase of 8.43  
26 percent over test year adjusted revenues of \$5,079,195, for a total revenue requirement of \$5,507,134.

27 <sup>1</sup> Due to the lateness of the filing in relation to the timing requirements for the docketing of a recommended Opinion and  
28 Order for Commission consideration, the amicus curiae brief could not be considered in the preparation of the  
recommended Opinion and Order.

1 RUCO is recommending a decrease in revenues of \$436,352, or 8.59 percent, from test year adjusted  
2 revenues of \$5,079,195, for a total revenue requirement of \$4,642,843. Staff is recommending a  
3 revenue increase of \$254,164, or 5.0 percent over test year adjusted revenues of \$5,079,195, for a  
4 total revenue requirement of \$5,333,359. Based on adjustments to the Company's filing as set forth  
5 herein, we authorize an increase in revenues of \$199,371, which is a 3.93 percent increase over test  
6 year adjusted revenues of \$5,079,195, for a total revenue requirement of \$5,278,566.

7 **II. RATE BASE**

8 The Company proposes an adjusted test year Original Cost Rate Base ("OCRB") of  
9 \$14,412,903. Staff is in agreement with this amount. RUCO proposes an adjusted test year OCRB  
10 of \$10,809,498.

11 **A. Plant in Service**

12 The Company proposes adjusted test year plant in service of \$32,508,049. Staff also  
13 recommends \$32,508,049, and RUCO recommends \$29,358,325.

14 **1. Post-Test Year Plant – Fire Flow Improvement Projects**

15 The OCRB proposed by the Company includes \$3,018,867 of post-test year plant consisting  
16 of fire flow improvement projects known as the Jackrabbit/Invergordon project.

17 **a. Discussion**

18 Staff verified that the post-test year plant at issue entered into service in 2005, is revenue  
19 neutral, and does not materially reduce operating expenses (Direct Testimony of James J. Dorf,  
20 Hearing Exh. S-1 at 4-5). Staff recommends inclusion of the fire flow projects in rate base to  
21 encourage improvement in public fire safety and to minimize the deferral of costs to future periods  
22 pursuant to the Accounting Order adopted by the Commission in Decision No. 68303 (*id.* at 5). The  
23 Company initially requested inclusion of post-test year plant amounts in addition to the \$3,018,867  
24 amount recommended by Staff. Those additional amounts include \$105,164 for work orders the  
25 Company asserts are associated with the Jackrabbit/Invergordon project, and an additional fire flow  
26 improvement project, known as the Nauri Valley Drive improvements, at the Company's asserted  
27 cost of \$420,755 (Rebuttal Testimony of Joel M. Reiker, Hearing Exh. A-15 at 8-9). Staff opposed  
28 the inclusion of the additional post-test year Jackrabbit/Invergordon work order costs and the Nauri

1 Valley Drive costs in the Company's plant in service at this time, because the additional project's in-  
 2 service date, as well as the dates of the work orders, were more than 90 days past the date the rate  
 3 application was found sufficient.<sup>2</sup> The Company ultimately agreed to Staff's position, based on the  
 4 fact that the Jackrabbit/Invergordon work order costs and the Nauni Valley Drive costs may be  
 5 deferred pursuant to the Decision No. 68303 Accounting Order, and on the Company's understanding  
 6 that the disputed amounts will be eligible for recovery as CIAC through funds generated by the  
 7 Public Safety surcharge for which the Company is requesting approval in this proceeding (Tr. at 274).  
 8 The Public Safety surcharge is discussed in a separate section below.

9 The Company states that its request to include the post-test year fire flow improvements in  
 10 rate base is supported by the fact that the projects were requested by and supported by residential  
 11 customers; the projects will protect the lives and properties of residential customers; and the  
 12 District's residential customers are willing to pay for the improvement projects. The Company states  
 13 that the Town also requested the two other water utility service providers operating in the Town,  
 14 Berneil Water Company and the City of Phoenix, to make fire flow improvements, and that the  
 15 decision to request the fire flow improvements was the result of a collaborative, grass-roots process.  
 16 The Company asserts that the Town cannot legally fund the fire flow improvements; that the Town  
 17 and its residents are aware of the rate increases needed to fund the improvements, which are  
 18 estimated to eventually total up to \$16 million at completion (Direct Testimony of David P.  
 19 Stephenson, Hearing Exh. A-19 at 24); and that the improvements will enable the District's  
 20 infrastructure to support the Town Code's requirement to provide a minimum flow of 1,500 gallons  
 21 per minute.<sup>3</sup>

22 \_\_\_\_\_  
 23 <sup>2</sup> Staff based its position on language in Decision No. 61831, the District's prior rate case, which stated:

24 Further, in order to allow Staff and intervenors an adequate time to review and audit any such  
 25 adjustments, the Company shall limit its adjustments to add post-TY plant to include only plant  
 26 that is used and useful and in service within 90 days of the date that the rate application is deemed  
 27 sufficient.

28 Decision No. 61831 at 4.

<sup>3</sup> See Chapter 13, Article 13-1, Section 13 of the Paradise Valley Town Code which provides:

- A. The minimum fire flow from all hydrants in the Town will be 1,500 gallons per minute (5,678.1 liters per minute).
- B. The Chief may increase or decrease minimum hydrant flows based on review of hazard and water distribution system.

1 RUCO believes that the fire flow improvements are discretionary expenditures which should  
2 not be included in the District's rate base at this time or at any time in the future. RUCO proposes  
3 instead that the Town, as the entity requesting the fire flow improvements, should contribute the  
4 projects' costs to the Company, paid for through taxes (RUCO Br. at 9). RUCO argues that there is  
5 no Commission rule, policy or statute that governs or sets a fire flow standard, and no regulatory rate  
6 making principle that requires or supports a fire flow standard. RUCO asserts that typically when a  
7 third party requests the construction of additional water infrastructure from a regulated utility, the  
8 Commission requires an advance in aid of construction ("AIAC") or a contribution in aid of  
9 construction ("CIAC"); that such rate treatment is especially appropriate when the cost of  
10 expenditures outweighs the expected revenue from the project (Direct Testimony of Marylee Diaz  
11 Cortez, Hearing Exh. R-11 at 8); and that it is appropriate in this case because the fire flow  
12 improvements are non-revenue producing. RUCO argues that while ratepayers in the District may be  
13 able to absorb increased rates associated with placing the fire flow improvements in rate base,  
14 ratepayers in other communities may not be able to do so. RUCO fears that allowing the District to  
15 include the improvements in rate base will lead to unaffordable water service in Arizona (RUCO  
16 Initial Br. at 5).

17 The Company states that the Town has informed the Company that A.R.S. § 9-514 and/or the  
18 Gift Clause in the Arizona Constitution would prohibit the Town from spending general fund money  
19 to build the fire infrastructure that would be owned by the Company (*See* Hearing Exh. R-1. *See also*  
20 Hearing Exh. A-29, a copy of a letter from the Town to Commissioner Hatch-Miller dated February  
21 15, 2006 and signed by Town Manager Thomas M. Martinson, which states; "The Town government  
22 cannot, for both statutory and public policy reasons, fund water system improvements for a private  
23 utility."). RUCO disagrees with this legal reasoning. RUCO argues that the Commission should  
24 reject the Town's "claim"<sup>4</sup> that A.R.S. § 9-514 prevents it from funding the fire flow improvements,  
25 based on the Arizona Supreme Court's holding in *Town of Gila Bend v. Walled Lake Door Co.*, 107  
26 Ariz. 545 (1971), 490 P.2d 551 that A.R.S. § 9-514 deals with the power of municipalities to engage

27 \_\_\_\_\_  
28 <sup>4</sup> It must be noted that the Town is not a party to this proceeding.

1 in competition with businesses of a public nature. Regarding the Gift Clause,<sup>5</sup> RUCO argues that  
 2 because the provision of water to provide fire protection is a public purpose for which public monies  
 3 can legally be spent, the Gift Clause does not prohibit the Town from paying for the fire flow  
 4 improvements, citing *Gila Bend* at 549-550, 490 P.2d 551, 555-556. RUCO contends that if the  
 5 Town were to provide the fire flow related mains to the Company as CIAC, the Company would not  
 6 benefit from the Town's expenditure, because the Company's books would reflect the contribution as  
 7 an offset to plant in service, and the Company would not earn a return on the contribution. RUCO  
 8 also argues that the Town's minimum fire flow ordinance does not require the Company to pay for  
 9 the costs of fire flow improvements.<sup>6</sup>

10 The Company disagrees with RUCO's interpretation of *Gila Bend* that would allow a  
 11 municipality to contribute plant to an investor-owned water utility, arguing that the facts in *Gila Bend*  
 12 distinguish it from the facts in this case (Company Reply Br. at 3). Staff also believes the facts of  
 13 *Gila Bend* are significantly different from the facts in this case, primarily because in this case, unlike  
 14 in *Gila Bend*, the Company, and not the Town, will ultimately hold and control the plant. Staff  
 15 disagrees with RUCO's interpretation of the legal holdings of the case, and believes that *Gila Bend*  
 16 supports the Town's legal position regarding both A.R.S. § 9-514 and the Gift Clause.

17 The Company also disagrees with RUCO's contention that the Town's funding of a \$46,175  
 18 interconnection from the City of Scottsdale to the Berneil Water Company system demonstrates that  
 19 the Gift Clause does not prohibit the Town from funding the District's improvements (*see* RUCO Br.  
 20 at 8-9). The Company points out that the interconnection RUCO refers to would be built and owned

21 \_\_\_\_\_  
 22 <sup>5</sup> Ariz. Const. Art. 9, § 7 provides as follows:

23 Neither the state, nor any county, city, town, municipality, or other subdivision of the state shall  
 24 ever give or loan its credit in the aid of, or make any donation or grant, by subsidy or otherwise,  
 25 to any individual, association, or corporation, or become a subscriber to, or a shareholder in, any  
 26 company or corporation, or become a joint owner with any person, company, or corporation,  
 27 except as to such ownerships as may accrue to the state by operation or provision of law or as  
 28 authorized by law solely for investment of the monies in the various funds of the state.

25 <sup>6</sup> RUCO argues that "[i]nterpreting the Town Code to impose such obligations and effectually raise rates impairs the  
 26 Commission's exclusive and absolute power to set rates as set forth in Article 15, Section 3 of the Constitution." (RUCO  
 27 Br. at 11, fn 8). If this were true, one could likewise argue that the federal Safe Drinking Water Act or the U.S.  
 28 Environmental Protection Agency's rules governing maximum contaminant levels for water pollutants impair this  
 Commission's constitutional authority. RUCO makes no similar argument against approval of the Arsenic Cost  
 Recovery Mechanism the Company is proposing in this proceeding.

1 by the City of Scottsdale, not the Berneil Water Company (*see* Hearing Exh. A-31, Town Council  
2 minutes from May 12, 2005), and argues that the Gift Clause therefore would not apply.

3 Staff, while acknowledging that the Company's fire flow improvement plan requires a major  
4 investment and overhaul of the District's system, recommends including prudently incurred costs for  
5 fire flow plant that is used and useful because the investment is necessary to comply with the Town  
6 ordinance. Staff states that the Town's fire flow ordinance brings its fire flow standards up to  
7 Uniform Fire Code standards,<sup>7</sup> based upon recommendations of a task force comprised of Town  
8 officials, Company representatives and Town residents. Staff points out that the Town is requiring all  
9 three water utilities serving the Town to meet minimum fire flow standards, and that much of the  
10 District's infrastructure is 40-50 years old. Staff states that Town residents' safety and the protection  
11 of their property are highly dependent upon the fire flow improvement program (citing Decision No.  
12 68303 at 2). Staff contends that if the Town is legally prohibited from funding the fire flow  
13 investments as the Town stated in its February 15, 2006 letter,<sup>8</sup> allowing rate recovery of the  
14 investment may be the only option available to bring the District's water system up to Uniform Fire  
15 Code standards in order to provide fire flow protection to the District's customers. Staff further states  
16 that it is aware of no previous Commission Decision denying a water company's request for recovery  
17 of its investment in fire flow improvements, and that a recent Commission Decision has recognized  
18 that this is an important public safety issue that must be addressed.<sup>9</sup>

19 Staff takes issue with RUCO's argument that the Commission typically requires AIAC or  
20 CIAC when a third party requests the construction of additional water infrastructure from a regulated  
21 utility, pointing out that under A.A.C. R14-2-406, main extension agreements are discretionary and  
22 not mandatory. Staff further argues that it has been the practice of this Commission to limit CIAC for  
23 new development, and to require utility investment when necessary to maintain balanced capital  
24

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25 <sup>7</sup> Staff notes that the Town's ordinance is consistent with the fire flow requirements of the Town of Scottsdale.

26 <sup>8</sup> *See* Exhibit A-29.

27 <sup>9</sup> Decision No. 67093 at 31 (June 30, 2004) (*Arizona-American Water Company, Inc., Docket Nos. WS-01303A-02-0867*  
28 *et al.*) (ordering the Company to form a fire flow task force to determine whether water production capacity, storage  
capacity, water lines, water pressure, and fire hydrants in the communities served by the systems involved in that rate case  
are sufficient to provide the fire protection capacity desired by each community).

1 structures. In addressing RUCO's position that there is no regulatory rate making principle that  
 2 requires or supports a fire flow standard, Staff responds that although there is no specific  
 3 Commission Rule, policy or standard that directly addresses fire flow, the Town's fire flow ordinance  
 4 addresses public health and safety, and A.R.S. § 40-336<sup>10</sup> and A.R.S. § 40-361.B<sup>11</sup> give the  
 5 Commission discretion to approve use of ratepayer funds for fire flow improvement, which is a  
 6 public health and safety issue. Staff believes that the Company has discretion to upgrade its existing  
 7 system to meet fire flow requirements, as A.A.C. R14-2-606(H) provides that "[t]he Company may  
 8 install main extensions of any diameter meeting the requirements of the Commission or any other  
 9 public agencies having authority over the construction and operation of the water system and mains"  
 10 and supports the Company's exercise of such discretion as long as the plant is used and useful and  
 11 necessary for the service that is required by ordinances and rules and regulations regarding water  
 12 quality or quantity (Staff Reply Br. at 9; Tr. at 535-536, 542).

13                                   b.       Conclusion

14           The question before this Commission is not the hypothetical issue of whether A.R.S. § 9-514  
 15 or the Gift Clause would apply if the Town were to pay for the fire flow improvements as RUCO  
 16 advocates. The question before this Commission is whether the Company's actual deferred expenses  
 17 pursuant to Decision No. 68303, which the Company incurred to comply with the Town's fire flow  
 18 ordinance, should be allowed in rate base as the Company requests. The record here indicates that  
 19 the improvements are necessary to ensure the public health and safety of the District's ratepayers, are  
 20 used and useful to the ratepayers in the District, and that the District's ratepayers are largely in  
 21 support of the improvements and are willing to pay for them through their water utility rates.<sup>12</sup>

22 \_\_\_\_\_  
 23 <sup>10</sup> A.R.S. § 40-336 provides:

24           The commission may by order, rule or regulation, require every public service corporation to maintain  
 and operate its line, plant, system, equipment, and premises in a manner which will promote and  
 safeguard the health and safety of its employees, passengers, customers and the public . . .

25 <sup>11</sup> A.R.S. § 40-361.B provides:

26           Every public service corporation shall furnish and maintain such service, equipment and facilities as  
 will promote the safety, health, comfort and convenience of its patrons, employees and the public, as  
 will be in all respects adequate, efficient and reasonable.

27 <sup>12</sup> Tr. at 100; Tr. at 310-314; Hearing Exh. A-29 (copy of a letter from the Town to Commissioner Hatch-Miller dated  
 28 February 15, 2006 and signed by Town Manager Thomas M. Martinson, also filed in this docket on February 22, 2006).

1 Several District customers who are City of Scottsdale residents provided public comment at the  
2 hearing in opposition to the fire flow improvements, stating that the improvements would not benefit  
3 them. The record in this case shows, however, that improvements in fire flow will assist all  
4 customers who are part of an interconnected grid, regardless of where on the system they are  
5 located.<sup>13</sup> Moreover, as the Company argues, most City of Scottsdale customers of the District will  
6 be exempt from the Public Safety Surcharge for which the Company is requesting approval in this  
7 proceeding.<sup>14</sup>

8 RUCO expresses a concern that allowing the investments in rate base will set a precedent for  
9 future rate proceedings for other water utilities. Our Decision in this matter is limited to the facts  
10 before us in this proceeding, and is not intended to, and should not be interpreted to, set policy with  
11 regard to fire flow improvements. In the event a similar issue arises in another rate case proceeding  
12 for another regulated water utility, the Commission will consider the issue based on the totality of the  
13 facts and circumstances at that time.

14 It is reasonable to include \$3,018,867 of post-test year plant consisting of fire flow  
15 improvement projects, known as the Jackrabbit/Invergordon project, in test year plant in service.

## 16 **2. Plant Held for Future Use - Backup Pumping Equipment**

17 The OCRB proposed by the Company includes \$132,682 for two backup submersible pumps,  
18 motors, and a transformer for the District's Well No. 17. Staff ultimately determined that the  
19 equipment is used and useful because it was used as backup during the test year, and that due to the  
20 size of the wells and pumps, holding the equipment as backup is useful to ratepayers because with the  
21 equipment on site, the Company can get a well up and running very quickly compared to the time it  
22 would take to get replacements (Tr. at 381-382). Staff recommends that the equipment be included in  
23 rate base, but transferred to from the plant held for future use account to the appropriate plant account  
24 (Tr. at 479). On brief, RUCO agreed that the backup equipment is used and useful and has agreed  
25 that it should be included in rate base (RUCO Reply Br. at 14). According to the evidence presented,  
26 the backup equipment is used and useful and should be included in plant in service. As Staff

27 <sup>13</sup> Cross-examination testimony of Paul G. Townsley, Tr. at 115.

28 <sup>14</sup> See Hearing Exh. A-33.

1 recommends, these plant items should be removed from the plant held for future use account and  
2 placed in the appropriate account.

### 3                   **3.       Conclusion**

4           Based on the evidence presented, \$32,508,049 is reasonable for adjusted test year plant in  
5 service for the District. Staff and RUCO accepted the Company's proposed AFUDC debt of \$950  
6 and accumulated depreciation balance of \$10,021,184. These adjustments to plant in service will be  
7 adopted, for a test year adjusted plant in service balance of \$22,487,815.

#### 8           **B.       Gain on Sale of Land**

9           The Company sold its former operations/customer center on Casa Blanca Drive for \$900,000  
10 in 2004, with a net after tax gain on the sale of \$481,681, and is proposing sharing the gain with  
11 ratepayers on a 50/50 basis, through a surcredit refund over five years (Direct Testimony of David P.  
12 Stephenson, Hearing Exh. A-19 at 35-36). Staff accepted the Company's surcredit proposal and  
13 proposed a three year amortization period instead of five years (Exh. S-1 at 8). The Company  
14 subsequently accepted the three year amortization (Rejoinder Testimony of Joel M. Reiker, Hearing  
15 Exh. A-16 at 5).

16           RUCO accepts the three year amortization period, and the 50/50 sharing. Rather than a  
17 surcredit, however, RUCO proposes that the Company offset ratebase by the ratepayers' portion of  
18 the pre-tax gain, by means of an amortized deferred liability account, and also that the annual  
19 distribution of the gain be recorded on the Company's income statement as a credit to operating  
20 expense (Direct Testimony of Timothy J. Coley, Hearing Exh. R-7 at 8). RUCO is concerned that the  
21 proposed surcredit would allow the Company to hold ratepayer money interest-free while the gain is  
22 being repaid through the surcredit (Tr. at 334), and argues that it is therefore appropriate to reduce  
23 ratebase to reflect the gain as a means to compensate ratepayers (RUCO Reply Br. at 7-8).

24           The Company disagrees with RUCO's proposal, pointing out that it requires the Company to  
25 pay the capital-gains taxes associated with the sale and then share the pre-tax gain with the  
26 customers, and that RUCO admits that its proposed treatment is inconsistent with Commission  
27 precedent. Staff also disagrees with RUCO's proposal, and believes that the Staff recommendation  
28 provides a simpler and more appropriate method of refunding ratepayers' share of the gain (Tr. at

1 481, 483). Staff states that the proposed surcredit mechanism appropriately recognizes the net tax  
2 effect of the gain on the revenue requirement, because as revenue is reduced, the surcredit is  
3 amortized, and there would be no tax impact (Tr. at 484, 486).

4 With the three year amortization period proposed by Staff, the surcredit mechanism proposed  
5 by the Company for a 50/50 sharing of the post-tax gain on the land sale is a more reasonable and  
6 appropriate means of sharing the gain than that proposed by RUCO, and provides a fair resolution for  
7 both ratepayers and the Company.

8 **C. Cash Working Capital**

9 Arizona-American performed a lead/lag study, and initially requested working capital in the  
10 amount of \$350,946, which included \$160,359 cash working capital. The Company subsequently  
11 proposed a revised cash working capital lead/lag study, and based on that study revised its proposed  
12 cash working capital to \$115,182 (Rebuttal Testimony of Joel M. Reiker, Hearing Exh. A-15 at 16-  
13 19), but ultimately accepted Staff's recommendation to completely eliminate a cash working capital  
14 allowance, for total working capital of \$190,587.

15 RUCO recommends a negative cash working capital allowance of (\$61,432), for total  
16 working capital of \$129,155. RUCO states that the most accurate way to measure a company's cash  
17 working capital requirement, or the amount of cash a company must have on hand to cover any  
18 differences in the time period between when revenues are received and expenses must be paid, is via  
19 a lead/lag study (Direct Testimony of Timothy J. Coley, Hearing Exh. R-7 at 9). RUCO states that it  
20 analyzed and reviewed the Company's initial and revised lead/lag studies, and that its proposed  
21 (\$61,432) cash working capital recommendation results from adjusting the Company's lead/lag study  
22 to include only those items the Commission has allowed in the past (RUCO Br. at 25). RUCO  
23 contends that the reason for the disparity between the cash working capital calculations of the  
24 Company and RUCO is that the Company's calculations include non-cash items (*id.* at 24).

25 We agree with RUCO that a lead/lag study is the most accurate way to determine a working  
26 capital requirement, and that a lead/lag study is appropriate for a company of Arizona-American's  
27 size. While the Company takes issue with items in RUCO's lead/lag study, the Company proposed  
28 no alternative cash working capital allowance based on a lead/lag study (*see* Company Reply Br. at 5-

1 6). Because RUCO's recommendation is based on a lead/lag study, we find its recommendation  
2 more reasonable than the alternative proposals of the Company and Staff, and will adopt it, for total  
3 working capital of \$129,155.

### 4 **III. ORIGINAL COST RATE BASE**

5 The Company's proposed adjusted test year balances for the District, for CIAC of \$6,486,559;  
6 AIAC of \$635,912; customer deposits of \$3,500, and deferred income tax credits of \$1,139,528 were  
7 not contested and will be adopted, for a total deduction from net plant in service of \$8,265,499. As  
8 discussed above, we adopt adjusted test year working capital of \$129,155, which is added to net plant  
9 in service for an OCRB of \$14,351,471.

### 10 **IV. FAIR VALUE RATE BASE**

11 The Company did not propose a reconstruction cost new less depreciation rate base for the  
12 District, as is allowed by A.A.C. R14-2-103 (Direct Testimony of John A. Chelus, Hearing Exh. S-6  
13 at 6). Therefore, the District's fair value rate base ("FVRB") is the same as its OCRB, or  
14 \$14,351,471.

### 15 **V. OPERATING INCOME**

16 The Company proposed adjusted test year operating income of \$866,762 (*see* Company Br. at  
17 6). Staff recommends \$886,714, and RUCO recommends \$1,035,400.

#### 18 **A. Rate Case Expense**

19 The parties agree on a three-year amortization of rate case expense but disagree on the amount  
20 of recoverable expense. The Company is requesting rate case expense of \$301,832. RUCO proposes  
21 rate case expense of \$73,179, and Staff proposes \$208,700.

22 The Company originally estimated its rate case expense to be \$282,841 (Direct Testimony of  
23 Stacey A. Fulter, Hearing Exh. A-22 at 3). This estimate included a 50/50 sharing between  
24 ratepayers and investors of its initial estimated costs of \$158,766 for the Company's cost of capital  
25 witnesses (*id.*). The Company subsequently updated its estimate, and no longer proposes the 50/50  
26 sharing of the \$158,267 costs for its cost of capital witnesses (Rebuttal Testimony of Thomas  
27 Broderick, Hearing Exh. A-17 at 2 and Exh.TMB-1). The Company argues that its requested rate  
28 case expense is reasonable based on the complex issues in this case, the number of testimony

1 documents, the amount of discovery, the length of the hearing, and the need to file post hearing  
2 briefs, and contends that the expenses are not out of line with rate case expense allowed in recent  
3 Commission cases (Company Br. at 12, citing \$250,000 in rate case expense allowed in Decision No.  
4 68302 (November 14, 2005) and \$285,000 in Decision No. 68176 (September 30, 2005)). The  
5 Company argues that the \$158,267 expense for retaining its cost of capital witnesses was necessary  
6 because of the importance of the issue presented (Company Br. at 8). The Company states that  
7 because the issue was one of first impression for the Commission and one that has implications for all  
8 future rate cases, the Company retained the foremost experts in the field, which was expensive, and  
9 that presentation of the issue required two expert witnesses, one to explain the methodology of  
10 adjusting returns on equity for differences in capital structure, and one to apply it (*id.*).

11 Staff made 10 adjustments to the Company's original rate case expense estimates (*see* Direct  
12 Testimony of Alexander Ibhade Igwe, Hearing Exh. S-6, Schedule AII-9), and recommended  
13 recovery of \$208,700. Staff also reviewed the Company's revised request of \$301,832, and continues  
14 to support recovery of \$208,700, noting that the Company's proposal to incur \$158,267 for cost of  
15 capital analysis is significantly higher than normal and would unduly burden ratepayers (Surrebuttal  
16 Testimony of Darron W. Carlson, Hearing Exh. S-8 at 7; Hearing Exh. S-6 at 10). Staff also noted  
17 that the Company's proposal to increase its initial estimate of \$14,985 for cost of service analysis and  
18 rate design up to \$42,677, or 185 percent over its original proposal, was excessive (Hearing Exh. S-6  
19 at 10-11). Staff's recommendation includes the Company's original proposal for 50/50 sharing of the  
20 costs of the Company's cost of capital witnesses, based on Staff's belief that the benefits of the cost  
21 of capital portion of rate case expenses flow to both investors and ratepayers (Hearing Exh. S-8 at 7).  
22 Staff further argues that the Company failed to mitigate its costs in expending \$158,767 on its cost of  
23 capital consultants, who have presented their methodology in a number of regulatory forums that  
24 have rejected it or failed to implement it (Staff Reply Br. at 22-23; Staff Br. at 15).

25 RUCO's arguments regarding the Company's expenses for its cost of capital, cost of service  
26 and rate design analysis and testimony are in accord with Staff's arguments (RUCO Br. at 13-15).  
27 RUCO also argues that the issues in this case are not complex, and disagrees with the Company's  
28 comparison of the complexity of this case to the complexity of the case leading to Decision No.

1 68176 (RUCO Br. at 15-16, RUCO Reply Br. at 8-9). RUCO based its recommendation for  
2 allowable rate case expense on the amount allowed in the District's previous rate case, grossed-up for  
3 inflation (Direct Testimony of Rodney L. Moore, Hearing Exh. R-5 at 9-12). RUCO believes that the  
4 costs incurred by the Company to argue its request to recover capital investments associated with fire  
5 flow improvements are not a justifiable expense (Surrebuttal Testimony of Rodney L. Moore,  
6 Hearing Exh. R-6 at 5).

7 For the reasons argued by Staff and RUCO, the Company's original proposal to share the  
8 costs of its cost of capital analysis and testimony 50/50 with ratepayers is reasonable, and in this case,  
9 provides an appropriate means for the Company to mitigate the expenses associated with retaining  
10 outside consultants. Staff's recommendation regarding costs related to cost of service and rate design  
11 analysis and testimony also addresses appropriate mitigation of consultant costs. We agree with the  
12 Company that this case is more complicated and contentious than the District's previous rate case,  
13 which the District and Staff settled, and in which only two contested issues were litigated in a hearing  
14 lasting one day. We disagree with RUCO that recovery of expenses the Company incurred  
15 requesting recovery of capital investments associated with fire flow improvements should be  
16 disallowed, and find instead that reasonable costs for this purpose are justifiable and should be  
17 recoverable, as recommended by Staff. We will therefore, in this case, reject RUCO's proposed  
18 methodology for measuring rate case expense. We find that Staff's rate case expense  
19 recommendation is reasonable and will adopt it, allowing rate case expense for this case of \$208,700.

20 **B. Labor and Pension Expenses**

21 RUCO opposes inclusion in test year expenses of employment expenses associated with an  
22 arsenic plant operator the Company hired for the District on October 10, 2005. RUCO recommends  
23 deductions to payroll expense, payroll tax expense, and pension expense totaling \$48,103. As  
24 discussed in the section below related to the Company's requested Arsenic Cost Recovery  
25 Mechanism ("ACRM"), the United States Environmental Protection Agency ("EPA") has mandated a  
26 new standard reducing the maximum contaminant level ("MCL") for arsenic from 50 parts per billion  
27 ("ppb") to 10 ppb, effective January 23, 2006, and the Company has budgeted \$19 million for capital  
28 investment in new arsenic remediation facilities for the District. The Company argues that it is fair to

1 include employment expense for the arsenic plant operator in this case prior to allowing costs for the  
2 arsenic treatment plant, because it would have been imprudent to postpone until 2006 hiring and  
3 training an employee to operate a multi-million dollar plant using new technology (Company Br. at  
4 13). The Company's witness testified that hiring the employee in 2005 has allowed the employee not  
5 only to familiarize himself with the District's entire water system, but also to learn about the  
6 operations of the other arsenic treatment plants that are coming online in the Company's other water  
7 districts located in the valley (Rebuttal Testimony of Brian K. Biesemeyer, Hearing Exh. A-5 at 2-3).  
8 The Company argues that absent inclusion of labor expenses for this employee in this case, the  
9 Company will be unable to recover costs associated with this employee, who is required by an  
10 unfunded federal mandate, until resolution of the Company's next rate case (Company Br. at 13). We  
11 wish to encourage water utilities to make the necessary financial commitments to satisfy the federal  
12 arsenic mandate, and find that under these specific circumstances, it is equitable to include the costs  
13 of this employee in test year expenses.

14 **C. Property Tax Expense**

15 **1. Property Tax Calculation**

16 RUCO argues that the Commission should reject the Company's and Staff's recommended  
17 estimates of property tax, based on the calculation methodology adopted by the Commission in prior  
18 rate proceedings, and instead accept RUCO's recommended property tax expense estimates, which  
19 are \$2,561 lower, based on a calculation methodology rejected in numerous prior rate proceedings.  
20 The methodology used by the Company and Staff to estimate property tax expense, which is to use  
21 adjusted test year revenues and the projected revenues under the newly approved rates as inputs to the  
22 Arizona Department of Revenue ("ADOR") assessment formula, is the same methodology adopted in  
23 numerous prior cases over the objections of RUCO.<sup>15</sup> RUCO proposes, as it has many times before,  
24

25 <sup>15</sup> *E.g., Arizona Water Company*, Decision No. 68302 (November 14, 2005) (finding that RUCO's calculation  
26 methodology, which uses only historical revenues, unfairly and unreasonably understates property tax expense, and is  
27 therefore inappropriate for ratemaking purposes); *Chaparral City Water*, Decision No. 68176 (September 30, 2005) (same  
28 finding); *Rio Rico Utilities*, Decision No. 67279 (October 5, 2004) (finding that use of only historic revenues understates  
the expense level); *Arizona American Water Company*, Decision No. 67093 (June 30, 2004); *Bella Vista Water Company*,  
Decision No. 65350 (November 1, 2002); *Arizona Water Company*, Decision No. 64282 (December 28, 2001). RUCO  
has not appealed any of these Decisions.

1 to instead use revenues from the test year and the two years prior to the test year to calculate property  
2 tax expense (RUCO Br. at 22).

3 Using only historical revenues to calculate property taxes to include in the cost of service fails  
4 to capture the effects of future revenue from new rates. RUCO's calculation methodology, which  
5 uses only historical revenues, unfairly and unreasonably understates property tax expense, and is  
6 therefore inappropriate for ratemaking purposes. RUCO has not demonstrated a basis for departure  
7 from our prior determinations on this issue.<sup>16</sup> The Company and Staff's calculation for property tax  
8 expense yields the best estimate of the Company's property tax expense for the period in which new  
9 rates will be in effect, and we will use that calculation.

## 10 2. Miller Road Treatment Facility Property Taxes

11 RUCO advocates reducing property tax expense by \$42,000, which is the amount of property  
12 tax RUCO claims is attributable to property located on Miller Road that the Company owns and  
13 leases to Motorola. RUCO argues that the property taxes attributable to the property should be  
14 considered as part of Motorola's operating expenses and therefore reimbursed by Motorola (RUCO  
15 Br. at 12). The Company disagrees with RUCO's proposed adjustment, arguing that it is unnecessary  
16 because the property tax expense calculation proposed by the Company and Staff, unlike the  
17 calculation proposed by RUCO, uses adjusted test year revenues, and therefore does not include any  
18 amount related to either Motorola, the property the Company leases to Motorola, or any other non-  
19 regulated activity of the Company (Rejoinder Testimony of Joel M. Reiker, Hearing Exh. A-16 at 9).  
20 We agree with the Company that the adjustment proposed by RUCO would be inappropriate because  
21 no property taxes related to the Miller Road property are included in the Company's proposed  
22 property tax expense.

23  
24  
25 <sup>16</sup>RUCO used its preferred methodology to estimate the District's 2005 taxes, and states that its methodology resulted in  
26 an estimate closer to the Company's actual 2005 property taxes than the calculation methodology adopted by the  
27 Commission in prior rate proceedings and used by the Company and Staff in this proceeding (RUCO Br. at 22-23).  
28 RUCO argues that this proves that its methodology results in a more accurate level of property tax expense than the  
Company and Staff's methodology. RUCO's argument fails to address the fact that new rates will be set in this  
proceeding, and that the Commission must establish a level of property tax expense (which is based on revenues) in this  
proceeding that estimates the Company's property tax expense for the period in which new rates will be in effect, not for  
the year 2005.

1           **D.     Administrative and General Expenses (A&G)**

2                   **1.     AIP, Performance Pay and Stay Bonus**

3           The Company is requesting recovery of \$18,517 for Arizona Corporate allocated management  
4 fees related to Annual Incentive Program (“AIP”) expenses and \$1,520 for Arizona Corporate  
5 allocated management fees related to Performance Pay and Stay Bonus expenses. The Company’s  
6 president testified that the Company’s AIP is a component of its overall employee compensation that  
7 is necessary to allow the District to compete for employees in Arizona’s tight labor market, and that  
8 if it were eliminated, the Company would have to raise base salaries to be competitive in the market,  
9 and that the plan provides benefits to customers by focusing employees on goals that improve the  
10 Company’s ability to deliver high quality customer service (Rejoinder Testimony of Paul G.  
11 Townsley, Hearing Exh. A-3 at 5).

12           RUCO recommends that \$12,795 of the Company’s proposed \$20,037 AIP, Performance Pay  
13 and Stay Bonuses be disallowed. RUCO recommends disallowing 30 percent, or \$5,555 of the  
14 \$18,517 in Arizona Corporate allocated management fees related to the Company’s Annual Incentive  
15 Plan expenses, because 30 percent of the AIP is directly related to Company financial performance  
16 measures and 70 percent to operational and individual performance measures (RUCO Br. at 18).  
17 RUCO argues that the 30 percent portion of AIP expenses based on financial performance measures  
18 benefit only shareholders (*id.*). Of the remaining \$12,962 in AIP expenses, and Performance Pay and  
19 Stay Bonus allocated management fees of \$1,520, RUCO contends that half should be disallowed as  
20 a way of sharing the costs 50/50 between ratepayers and shareholders, both of whom RUCO believes  
21 benefit from the Performance Pay and Stay Bonus expenses and the portion of AIP expenses that are  
22 based on operational and individual performance measures (RUCO Br. at 18-20).

23           We agree with RUCO that shareholders are the primary beneficiaries of additional profit the  
24 Company achieves as the result of the Company meeting its financial targets, and therefore find  
25 RUCO’s proposal to disallow the 30 percent of the AIP that is based on the Company’s financial  
26 performance measures to be reasonable and appropriate. We do not agree, however, with RUCO’s  
27 proposal to disallow half of the remaining expenses as a means of sharing them 50/50 between  
28 shareholders and ratepayers, because testimony in this proceeding demonstrates that the remaining

1 expenses are closely related to salary expense, which is not appropriately shared. An adjustment  
2 reducing AIP expenses by \$5,555 is appropriate and should be adopted.

### 3           **2.       Reorganizing/Downsizing Expenses**

4           RUCO recommends disallowing \$42,441 from Arizona Corporate allocated management fees  
5 related to the Company's reorganization/downsizing and non-incentive pay expenses, based on  
6 RUCO's assertion that these expenses are non-recurring and atypical of test year expenses  
7 (Surrebuttal Testimony of Rodney L. Moore, Hearing Exh. R-6 at 21). In response, the Company  
8 provides no argument in support of allowing these expenses other than a statement that neither the  
9 Company nor Staff accept the disallowance (Company Br. at 43, Reply Br. at 12). Standard  
10 ratemaking principles do not allow nonrecurring expenses incurred during the test year to be included  
11 when determining a company's test year operating expenses, absent justification to the contrary.  
12 RUCO's proposed adjustment of \$42,441 is reasonable and should be adopted.

### 13           **3.       Ice**

14           RUCO recommends disallowing \$161 from the Company's Central Division Corporate  
15 district allocated miscellaneous expenses for the annual cost of ice. RUCO argues that it is a  
16 discretionary expense, that its concern is not the money, but the principle, and that ratepayers should  
17 not be burdened with unnecessary costs (RUCO Br. at 20). The Company provided uncontroverted  
18 testimony that ice is used to keep water samples at proper temperature until it arrives at laboratories  
19 for testing, and that ice is also used to cool down water in large igloo thermoses that utility workers  
20 carry on their trucks to keep outdoor workers hydrated (Rebuttal Testimony of Brian K. Biesemeyer,  
21 Hearing Exh. A-5 at 3). This is a necessary and reasonable expense, and RUCO's proposed  
22 adjustment will not be adopted.

### 23           **4.       Security Renovations and Repairs and Indoor Plant Maintenance**

24           RUCO recommends disallowing \$127 from the Company's Arizona Corporate allocated  
25 miscellaneous expenses. The recommended disallowance includes both the annual cost of indoor  
26 plant maintenance and security renovations and remodeling costs incurred during the test year.  
27 RUCO contends that the Company's proposed indoor plant maintenance expense is not a necessary  
28 expense in the provisioning of water service, and that the proposed security renovation and

1 remodeling expenses are nonrecurring. We agree. RUCO's recommended adjustment of \$127  
2 should be adopted.

3 **5. Conclusion**

4 For the reasons discussed above, we find that reductions totaling \$48,123 to the Company's  
5 proposed allocated A&G expense are reasonable, and will adopt them.

6 **E. Statement of Operating Income**

7 All parties agree that the District's adjusted test year operating revenues were \$5,079,195. In  
8 accordance with the discussion herein, the District's adjusted test year operating expenses for  
9 ratemaking purposes total \$4,163,282, for an adjusted test year net operating income of \$915,913.

10 **VI. COST OF CAPITAL**

11 Arizona-American, Staff and RUCO presented cost of capital analyses for purposes of  
12 determining a fair value rate of return in this proceeding. Arizona-American proposes a cost of  
13 capital and rate of return of 12 percent; Staff recommends 10.4 percent; and RUCO recommends 10.0  
14 percent.

15 **A. Capital Structure and Cost of Debt**

16 The parties agree that the Company's capital structure for the test year was comprised of 36.7  
17 percent equity and 63.3 percent debt. The parties are also in agreement that the Company's cost of  
18 debt for the test year was 5.42 percent.

19 **B. Cost of Equity**

20 Setting the cost of equity component for purposes of determining a just and reasonable rate of  
21 return requires estimation relying on financial analysis. Disagreement exists in this case as to an  
22 appropriate methodology to be used, and in what manner it should be used, in order to reach a cost of  
23 equity estimate. The expert witnesses testifying on behalf of the Company, RUCO and Staff reached  
24 different conclusions based on the use of their models. The Company advocates a cost of equity of  
25 12 percent, based on the analysis of its witnesses. Staff advocates a cost of equity of 10.4 percent and  
26 RUCO advocates a cost of equity of 10.0 percent, based on the analyses of their respective witnesses.

27 **1. Arizona-American**

28 The Company presented testimony in support of its cost of equity proposal through two

1 witnesses from the Brattle Group, Dr. Lawrence Kolbe and Dr. Michael Vilbert. Dr. Kolbe's  
2 testimony promotes a theory of equitable leverage compensation to support the Brattle Group's cost  
3 of capital analysis. Dr. Kolbe bases his "equitable leverage compensation" theory on the premises  
4 that as the amount of debt (leverage) increases, investors demand a correspondingly higher return on  
5 equity to compensate for increased risk associated with more debt. Dr. Kolbe believes that because  
6 the market value of a firm is independent of the debt/equity ratio over a wide range of percentages,  
7 the cost of capital to be recovered from ratepayers should be constant over a large range of equity  
8 ratios.

9 Dr. Vilbert applied the equitable leverage compensation theory discussed by Dr. Kolbe in  
10 calculating the Company's proposed cost of equity. Dr. Vilbert applied both single stage and multi-  
11 stage discounted cash flow ("DCF") models, the capital asset pricing model ("CAPM") and an  
12 "empirical" CAPM ("ECAPM") to a sample of water companies and also to a sample of gas  
13 companies. Dr. Vilbert states that although he considered evidence from both the CAPM and DCF  
14 methods, he relied primarily on the CAPM results, because he does not believe that the DCF method  
15 is completely reliable at this time (Direct Testimony of Michael J. Vilbert, Hearing Exh. A-9 at 6).  
16 Dr. Vilbert used the gas company sample as a check on the results of the water sample, but gave the  
17 results from the water company sample predominant weight (*id.* at 5-6). Applying each model to  
18 both sample groups, Dr. Vilbert's cost of equity estimates for his water company sample ranged from  
19 7.2 percent using the CAPM with a short-term risk-free rate (*id.*, App. C, Table MJV-9, Panel B) to  
20 10.8 percent using a simple DCF model (*id.*, App. C, Table MJV-7, Panel A). For his gas company  
21 sample, Dr. Vilbert's cost of equity estimates ranged from 7.7 percent using the CAPM with a short-  
22 term risk-free rate (*id.*, App. C, Table MJV-20, Panel B), to 9.6 percent utilizing a simple DCF model  
23 (*id.*, App. C, Table MJV-18, Panel A). Dr. Vilbert contends that CAPM estimates that rely on the  
24 short-term risk-free rate are unreliable at this time because some of the resulting cost of equity  
25 estimates are less than the corresponding sample companies' cost of debt and because he believes the  
26 short-term risk-free rate is likely to increase substantially in the near term (*id.* at 7).

27 After estimating the cost of capital for the sample groups, Dr. Vilbert computed an after tax  
28 weighted average cost of capital ("ATWACC") for each firm in the water and gas samples using the

1 firms' "market value capital structure," and then calculated the sample average ATWACC and the  
2 cost of equity for a capital structure with 36.7 percent equity (*id.* at 6; App. C, Tables MJV-8 and  
3 MJV 19 (DCF), and MJV-11 and MJV 22 (CAPM and ECAPM)), in order to compute Arizona-  
4 American's cost of equity so that its ATWACC equals that of the sample's ATWACC (Company Br.  
5 at 23). Using this methodology for the water company sample, Dr. Vilbert reached cost of equity  
6 estimates for Arizona-American ranging from 10.2 percent to 16.5 percent (Direct Testimony of  
7 Michael J. Vilbert, Hearing Exh. A-9, App. C, Tables MJV-8 and MJV 11). For the gas company  
8 sample, Dr. Vilbert reached cost of equity estimates for Arizona-American ranging from 10.1 percent  
9 to 13.3 percent using the ATWACC (*id.*, App. C, Tables MJV-19 and MJV-22).

10 Dr. Vilbert concluded that the midpoint of his water company sample's overall cost of capital  
11 is  $6\frac{3}{4}$  percent with a range of  $6\frac{1}{2}$  to 7 percent, and the midpoint of the gas company sample's overall  
12 cost of capital is  $6\frac{1}{2}$  percent with a range of  $6\frac{1}{4}$  to  $6\frac{3}{4}$  percent, for an overall range of  $6\frac{1}{4}$  to 7  
13 percent. Dr. Vilbert asserts that the corresponding cost of equity at the Company's 36.7 percent  
14 equity thickness is  $12\frac{1}{2}$  percent (with a range of 12 to 13 percent) for the water company sample and  
15 12 percent (with a range of  $11\frac{1}{2}$  to  $12\frac{1}{2}$  percent) for the gas company sample, for an overall range  
16 of  $11\frac{1}{2}$  to 13 percent (*id.* at 7, 59). Based on Dr. Vilbert's analysis, Arizona-American proposes that  
17 its cost of equity be set at 12.0 percent for purposes of determining a just and reasonable rate of  
18 return.

19 The Company contends that while Staff and RUCO adjusted their cost of equity estimates to  
20 compensate for Arizona-American's higher leverage risk due to its debt-heavy capital structure, the  
21 traditional compensatory methods they used do not go far enough.

## 22 2. RUCO

23 RUCO based its cost of equity recommendation on the DCF and CAPM analyses performed  
24 by its witness William Rigsby, and contends that its proposed 10.0 percent cost of equity is  
25 appropriate given the current environment of low inflation and low interest rates (Direct Testimony  
26 of William A. Rigsby, Hearing Exh. R-9 at 47). Mr. Rigsby's DCF analysis yielded a 9.5 percent  
27 cost of equity result for his water company sample and a 9.35 percent result for his gas company  
28 sample (*id.* at 27, Sched. WAR-2). His CAPM analysis resulted in a range from 8.63 percent to

1 10.08 percent for his water company sample and a range from 8.99 percent to 10.55 percent for his  
2 gas company sample (*id.* at 31-32, Sched. WAR-7). Using his CAPM results as a check on the  
3 results of his DCF analysis, Mr. Rigsby based his recommendation on the 9.50 percent result of his  
4 DCF analysis for water companies (*id.*). Just as he did in Arizona-American's most recent rate  
5 proceeding,<sup>17</sup> Mr. Rigsby added 50 basis points to his cost of equity estimate to account for the  
6 increased financial risk faced by Arizona-American as a result of the Company's debt-heavy capital  
7 structure (*id.* at 32-34). RUCO believes that the 10 percent cost of common equity estimated by Mr.  
8 Rigsby is very reasonable when the Company's capital structure of 36.7 percent equity and 63.3  
9 percent debt is compared with the capital structures of other publicly traded water providers used in  
10 Mr. Rigsby's analysis, which averaged 49.9 percent equity and 50.1 percent debt (*id.* at 48).

### 11 3. Staff

12 Staff's cost of capital witness Dennis Rogers states that he chose the DCF model and the  
13 CAPM model to estimate the Company's cost of equity because the models are widely recognized  
14 and accepted as appropriate financial models to estimate cost of equity and this Commission has  
15 consistently relied on their results (Direct Testimony of Dennis Rogers, Hearing Exh. S-3 at 13). To  
16 calculate his DCF estimate of Arizona-American's cost of equity, Staff's witness used both a  
17 constant-growth DCF model and a multi-stage or non-constant growth DCF model using six publicly  
18 traded water utilities (*id.* at 13-14, Sched. DRR-3). Staff's resulting constant growth DCF estimate  
19 was 9.7 percent (*id.* at 24, Sched. DRR-2) and its multi-stage DCF estimate was 9.4 percent (*id.* at 26,  
20 Sched. DRR-8). Mr. Rogers calculated Staff's overall DCF estimate by averaging his constant-  
21 growth DCF estimate with his multi-stage DCF estimate, and reached an overall DCF estimate of 9.6  
22 percent (*id.* at 26, Sched. DRR-2). Mr. Rogers then used the same sample companies to compute the  
23 CAPM to estimate the Company's cost of equity, reaching an overall CAPM estimate of 10.0 percent  
24 (*id.* at 27-31). Mr. Rogers obtained the risk-free rate of interest used in his CAPM calculations by  
25 averaging three intermediate-term U.S. Treasury securities' spot rates as published in the November  
26 2, 2005 edition of the *Wall Street Journal* (*id.* at 29). Mr. Rogers states that while the Company's  
27

28 <sup>17</sup> Decision No. 67093 (June 30, 2004).

1 witness criticized Staff's use of intermediate term Treasury securities, their time to maturity  
2 approximates investors' holding period and thus investor expectations (*id.*). Staff averaged the *Value*  
3 *Line* betas<sup>18</sup> of its sample water companies as the proxy for the Company's beta and estimated a beta  
4 of 0.71 (*id.*). Staff's overall CAPM estimate is the average of the historical market risk premium  
5 CAPM estimate of 9.7 percent and the current market risk premium CAPM estimate of 10.2 percent  
6 (*id.* at 33, Sched. DRR-2). Staff averaged its overall CAPM estimate of 10.0 with its overall DCF  
7 estimate of 9.6 to reach its average estimate of the cost of equity to the sample water utilities of 9.8  
8 percent (*id.* at 34). Staff the reached its 10.4 percent cost of equity recommendation for the Company  
9 by addition of a financial risk adjustment of 60 basis points to Staff's average estimate of the cost of  
10 equity to the sample water utilities (*id.* at 34-35).

11 Staff is critical of Dr. Vilbert's method of estimating the market value capital structure for  
12 each of his sample companies by estimating the market values of common equity (using price per  
13 share times the number of shares outstanding), preferred equity (using book value) and debt (using  
14 book value) from the most recent publicly available data. Staff states that the Company's use of  
15 market value capital structures has no relation to the actual book value capital structure and their use  
16 produces a return on equity estimate that is conjectural and speculative in nature. Staff witness  
17 Rogers explained that use of a market value capital structure to estimate the cost of equity is  
18 predicated on the underlying erroneous logic that the Commission is obligated to maintain stock  
19 prices and perpetuate an ongoing rising spiral between revenues and stock prices (*id.* at 37). Staff  
20 also points to a lack of logic in the equitable leverage compensation method's assumption that the  
21 market value of the Company's stock equals its book value because it is not publicly traded, while  
22 Dr. Vilbert estimated market values for the sample companies that exceed book values.

23 Regarding Dr. Vilbert's use of the ECAPM, Staff states that the adjustment used in the  
24 ECAPM has the effect of flattening the risk/return relationship, which has the effect of raising the  
25 estimated cost of equity for companies with betas below 1.0 and lowering it for companies with betas  
26 above 1.0. As stated above, Staff's estimated beta for the Company is 0.71. Staff also points out that

27 \_\_\_\_\_  
28 <sup>18</sup> Beta measures the systematic risk of a company. The market's beta is 1.0; therefore, a security with a beta higher than 1.0 is riskier than the market, and a security with a beta lower than 1.0 is less risky than the market.

1 the betas published by *Value Line* that are used by its witness in his CAPM calculations are already  
2 adjusted, and there is nothing in the record to indicate that Dr. Vilbert's adjustment under his  
3 ECAPM is superior to the method currently used by Staff and accepted by the Commission in the  
4 past. Staff asserts that the Company has produced no evidence that its estimates using the ECAPM  
5 are representative of the risk/return relationship for utility investments, and the Commission should  
6 therefore reject Dr. Vilbert's proposed ECAPM methodology.

7 Staff notes that the Company failed to use any historical growth rates or examine forecasts of  
8 dividend growth in its DCF estimates, but instead chose to rely on less reliable forecasted growth  
9 rates from Institutional Brokers' Estimate System and *Value Line*. Staff also notes that the  
10 Company's estimates did not consider dividend per share growth in its DCF analysis, despite the fact  
11 that it is a fundamental component of a constant-growth DCF method.

#### 12 4. Discussion

13 Both RUCO and Staff used long-standing methodologies approved by the Commission to  
14 reach their estimates and resulting recommendations for 10.0 percent and 10.4 percent respectively,  
15 while the Company is using a novel and not widely recognized methodology to attain its 12.0 percent  
16 cost of equity recommendation. The equitable leverage compensation model used by the Company's  
17 witnesses to reach the proposed 12 percent cost of equity for the District produces an inflated  
18 estimate that would overcompensate for the Company's financial risk and would require the  
19 Company's customers to overcompensate its investors.

20 The Company claims the Commission has been "overcompensating investors in low-leverage  
21 utilities and under-compensating investors in high-leverage utilities" by rewarding companies with  
22 higher returns on equity as equity ratios increase (Company Br. at 43). The Company argues that  
23 because interest on debt is tax free companies should be encouraged, within reason, to borrow funds  
24 rather than finance new investments with equity, but that because the Commission rewards  
25 companies with higher returns as equity ratios increase, Arizona companies are reluctant to issue low-  
26 cost debt (*id.*). Arizona-American's capital structure itself, with its 63.3 percent debt, belies this  
27 argument.

28 The Company cites as justification for its requested 12.0 percent cost of equity the fact that

1 federal mandates are forcing the Company to heavily invest in new arsenic remediation facilities, and  
2 that its customers are demanding massive new infrastructure investments to satisfy new fire flow  
3 requirements. In this very proceeding, however, we are granting the District's request to implement  
4 an ACRM mechanism which enables the Company to seek approval for expedited recovery of capital  
5 costs and a significant portion of O&M costs associated with arsenic remediation. We are also  
6 approving both a High Block surcharge and a Public Safety surcharge to pay for fire flow  
7 investments. These mechanisms mitigate the risks associated with those capital investment  
8 requirements, and eliminate the need for the higher rates of return the Company advocates.

9       The Company has provided inadequate justification for acceptance of its "equitable leverage  
10 compensation" methodology, which would constitute a break with long-standing precedent. As Staff  
11 points out, the methodology proposed by the Company has been rejected or not adopted by every  
12 state commission before which it has been presented with the exception of one; by the FERC; and by  
13 regulatory bodies outside the United States (Staff Br. at 15). RUCO and Staff appropriately  
14 addressed the Company's higher debt ratio by the generally accepted regulatory means of accounting  
15 for financial risk, adding basis points to the results of their CAPM and DCF analyses. The  
16 Company's methodology would result in an upward adjustment of 360 basis points as compared with  
17 Staff's proposed upward adjustment of 60 basis points and RUCO's proposed 50 basis point  
18 adjustment. We find such an upward adjustment to be outside the zone of reasonableness and must  
19 reject it.

20       Finally, while the Company complains that the most recent authorized returns on equity  
21 authorized by this Commission for other Arizona-American operating districts are at the lower end of  
22 the range that has been authorized for its subsidiaries throughout the United States, Staff  
23 demonstrated at the hearing that the median rate of return on equity for the subsidiaries is currently at  
24 10.09 percent, and Staff's recommended 10.4 percent return on equity would put the District in the  
25 upper range of authorized returns on equity for Arizona-American's other subsidiaries nationwide  
26 (Hearing Exh. S-12 at 2). We find that Staff's recommended cost of equity capital in this proceeding  
27 achieves an appropriate result that is supported by the evidence, and that adoption of Staff's  
28 recommendation results in a just and reasonable return for the District based on the record in this

1 proceeding.

2 We therefore adopt a cost of equity of 10.4 percent, which results in an overall weighted cost  
3 of capital of 7.24 percent.

4 **C. Cost of Capital Summary**

	<u>Percentage</u>	<u>Cost</u>	<u>Weighted Cost</u>
5 Long-Term Debt	63.3 %	5.4 %	3.42%
6 Common Equity	36.7 %	10.4 %	3.82 %
7 Weighted Average Cost of Capital			7.24 %

8  
9 **VII. AUTHORIZED INCREASE**

10 With the adjustments adopted herein, the District's adjusted test year operating income is  
11 \$915,913. Applying the fair value rate of return of 7.24 percent to the District's FVRB of  
12 \$14,351,471 produces a required operating income of \$1,038,329. This is \$122,416 more than the  
13 adjusted test year income under existing rates. The required increase in gross annual revenues for the  
14 District is \$199,371, for a 3.93 percent increase over test year adjusted revenues.<sup>19</sup>

15 **VIII. RATE DESIGN**

16 **A. General Rate Design**

17 Rate design was not a contested issue in this proceeding. The District currently has a  
18 conservation oriented three-tier inverted block rate design, with no gallons included in the minimum.  
19 An exception to this is the District's former Mummy Mountain Water Company customers, who  
20 currently have a single tier commodity rate and 1,000 gallons included in the minimum. The  
21 Company is proposing to align their rates with the rates charged to the District's other ratepayers.  
22 The Company also proposes the addition of a second (high block) tier of 25,000,000 gallons/month to  
23 its turf irrigation tariff commodity rate, but at the same commodity rate as the first tier, so that a  
24 portion of the PVCC's monthly usage may be subject to the High Block surcharge, discussed below  
25 (Rebuttal Testimony of Thomas M. Broderick, Hearing Exh. A-17 at 4). The Company's witness  
26 stated that the addition of the second tier will promote conservation in the summer months so that  
27

28 <sup>19</sup> Using a revenue conversion factor of 1.62863.

1 PVCC will remain within the limit set by the Arizona Department of Water Resources (“ADWR”)  
2 and will also contribute funding to fire flow projects if the High Block surcharge is approved (*id.*).

3 The rate design proposed by the Company, including the addition of a second tier to the turf  
4 irrigation commodity rate, is reasonable and will be adopted.

5 **B. Surcharges**

6 **1. Company Surcharge Proposal**

7 In the past, the District’s high water usage patterns have not been responsive to the imposition  
8 of a conservation-oriented rate design (Direct Testimony of Darron A. Carlson, Hearing Exh. S-7 at  
9 3). In order to better promote water conservation, the Company proposes a High Block surcharge on  
10 residential usage greater than 80,000 gallons (“High Block” usage), with any funds generated by the  
11 proposed surcharges to be treated as CIAC, which would reduce rate base and subsequently lower  
12 revenue requirements in the future (Direct Testimony of David P. Stephenson, Hearing Exh. A-18 at  
13 34-35). The Company also proposed a series of Public Safety surcharges for recovery of its fire flow  
14 investments, with separate surcharges going into effect after corresponding phases of the fire flow  
15 improvement project go into service (*id.* at 20-33).

16 **2. Staff Recommendation**

17 Staff concurred with the Company’s proposed High Block surcharge, and its proposal to treat  
18 revenues from the High Block surcharge as CIAC (Direct Testimony of Darron A. Carlson, Hearing  
19 Exh. S-7 at 3). Staff also recommended that the funds collected through the High Block surcharge be  
20 used directly to offset fire flow plant additions and minimize the post in service AFUDC accruals  
21 authorized by Decision No. 68303 (*id.*). Staff proposed a simplified version of the Company’s  
22 proposed High Block surcharge, with \$2.15 per 1,000 gallons for all High Block (over 80,000  
23 gallons/month) consumption, in addition to the normal tier charge (*id.*). Staff estimated that this  
24 proposed surcharge could produce approximately \$1.7 million per year (*id.*), and would have a  
25 minimal impact upon the average or median customer bill (Staff Brief at 21).

26 Staff testified that the Company’s proposed Public Safety surcharge is unnecessary because  
27 under the Accounting Order issued in Decision No. 68303, the Company is authorized to accrue  
28 AFUDC on fire flow plant in service until the plant is placed in rate base and reflected in rates, such

1 that the Company will be compensated for the time value of its investment (*id.*).

2 **3. Staff's Alternative Fire Flow Surcharge Proposal (Exhibit B)**

3 In rejoinder testimony, the Company stated that without approval of the Public Safety  
4 surcharge in addition to the High Block surcharge, two major projects in its fire flow improvement  
5 plan on Lincoln Drive and Tatum Boulevard will have to be postponed from summer 2007 to summer  
6 2008, which will push back all its other projects by one year, and the Company will need to recast its  
7 overall multi-year plans and schedules for fire flow improvements (Rejoinder Testimony of Paul G.  
8 Townsley, Hearing Exh. A-3 at 2). In response to the Company's concerns over the delays in  
9 implementing its fire flow improvement plan if projects are funded solely from High Block surcharge  
10 revenues, Staff offered an alternative surcharge proposal for Commission consideration. Staff's  
11 alternative proposal, as set forth in Hearing Exh. S-9, includes a modification to its recommended  
12 High Block surcharge and a new Public Safety surcharge. For convenience of reference, a copy of  
13 Hearing Exh. S-9 is attached hereto as Exhibit B.

14 The alternative surcharge proposal as set forth in Exhibit B would increase Staff's  
15 recommended High Block surcharge from \$2.15 to \$3.15 per thousand gallons effective October 1,  
16 2007. It would also institute, effective October 1, 2007, a Public Safety surcharge of \$1.00 per 1,000  
17 gallons on both the second tier and third residential commodity rate and on the first tier commercial  
18 commodity rate. Under the alternative proposal, once the Company has fully recovered its fire flow  
19 project costs, the Public Safety surcharge would terminate, and the High Block surcharge would be  
20 reduced back to \$2.15. Staff estimates that implementation of the October 1, 2007 surcharge  
21 increases would generate an additional \$1.8 million annually, for a total of \$3.5 million annually.  
22 Staff notes that these surcharges would have no impact on the average (22,193 gallons/month)  
23 residential bill or the median (11,500 gallons/month) residential bill, because the surcharge for the  
24 second tier residential commodity charge starts at 25,000 gallons/month.

25 Staff states that notwithstanding its presentation of the alternative surcharge proposal, Staff  
26 continues to recommend implementation of its recommended \$2.15 High Block surcharge when new  
27 rates take effect, and that the monies collected thereby be used to offset the cost of the fire flow  
28 project.

1 The Company accepts the alternative proposal in Exhibit B and urges the Commission to  
2 approve it so that fire flow projects can be completed without undue delay (Company Br. at 39).

3 **4. Accounting Order Modifying AFUDC Methodology**

4 Staff recommends modification of the AFUDC methodology granted in Decision No. 68303  
5 to take into account amounts collected by any fire flow related surcharges that are approved in this  
6 proceeding, either the High Block surcharge, the Public Safety surcharge, or both (Hearing Exh. S-  
7 10). Staff states that it is necessary for the Company to deduct surcharge collections when  
8 calculating the balance to which the AFUDC fire flow rate is applied, in order to allow the Company  
9 to recover capital costs only on its net investment in fire flow projects (*id.*).

10 **5. Analysis and Conclusion**

11 As Staff states in Exhibit B, there are several potential benefits from implementing the High  
12 Block surcharge and the Public Safety surcharge presented therein. First, implementation of these  
13 surcharges would permit implementation of the Company's planned fire safety related infrastructure  
14 in a timely manner. As we discussed earlier, the record in this proceeding demonstrates that the  
15 improvements are necessary to ensure the public health and safety of the District's ratepayers, and  
16 that the District's ratepayers are largely in support of the improvements and are willing to pay for  
17 them through their water utility rates. As we also discussed earlier, most City of Scottsdale  
18 customers of the District will be exempt from the Public Safety surcharge for which the Company is  
19 requesting approval in this proceeding.<sup>20</sup> In addition, implementing the High Block surcharge and  
20 the Public Safety surcharge as set forth in Exhibit B would encourage conservation in the District,  
21 which has historical high usage, and would increase CIAC, which would in turn alleviate future rate  
22 increases for all the ratepayers in the District.

23 For these reasons, we will order the Company to implement the alternative recommendation  
24 presented by Staff commencing October 1, 2007. Once the Company has fully recovered its fire flow  
25 project costs, the Public Safety surcharge will terminate, and the High Block surcharge will be  
26 reduced back to \$2.15, but revenues collected under the reduced High Block surcharge will continue  
27

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28 <sup>20</sup> See Hearing Exh. A-33.

1 to be treated as CIAC in order to alleviate future rate increases, as proposed by the Company (Direct  
2 Testimony of David P. Stephenson, Hearing Exh. A-18 at 34-35). We will also order the Company,  
3 in its application of the methodology approved in Decision 68303, to deduct collections from the  
4 High Block surcharge and the Public Safety surcharge when calculating the balance to which the  
5 AFUDC fire flow rate is applied, so that it will recover capital costs only on its net investment in fire  
6 flow projects, as Staff recommends.

7 **IX. OTHER ISSUES**

8 **A. Arsenic Cost Recovery Mechanism ("ACRM")**

9 The most recent lab analysis for the District indicates that six of its seven wells have arsenic  
10 levels at or above 10 ppb (Direct Testimony of John A. Chelus, Hearing Exh. S-5 at 4). The  
11 Company is requesting approval of an ACRM for the District similar to the ACRM previously  
12 approved for the Company's Havasu Water, Agua Fria Water, Sun City West Water, and Sun City  
13 Water districts in Decision No. 68310 (November 14, 2005). The Company's request is predicated  
14 on the EPA's new standard reducing the MCL for arsenic from 50 ppb to 10 ppb, effective January  
15 23, 2006. The Company has budgeted approximately \$19 million for capital investment in new  
16 arsenic remediation facilities for the District. The Company asserts that an ACRM is necessary to  
17 allow it to recover the capital costs of the facilities and related operation and maintenance ("O&M")  
18 costs. The Company is also requesting authority to defer all capital costs relating to arsenic removal  
19 facilities placed in service prior to the effective date of an ACRM surcharge. Upon approval of the  
20 ACRM, the Company plans to make a series of filings for specific ACRM surcharges to recover the  
21 District's arsenic remediation-related capital costs and O&M expenses.

22 The Company proposes an ACRM for the District consisting of the following (per Direct  
23 Testimony of David P. Stephenson, Hearing Exh. A-19 at 15-16):

- 24 1. The ACRM is based solely on actual costs and costs eligible for recovery, which are  
25 depreciation, gross return, and recoverable O&M costs;
- 26 2. Actual rate recovery via the ACRM commences after new arsenic facilities are in  
27 service and are in compliance with the new EPA MCL for arsenic;
- 28 3. Establishment of deadlines for filing the next rate case, without limit on the

- 1 Company's ability to file earlier, as per existing Commission orders;
- 2 4. An ACRM rate design composed of a 50/50 split of the recovery between monthly
- 3 minimum charges and volumetric charges, with the volumetric charges based on the
- 4 same inclining block rate design as approved in this proceeding;
- 5 5. A financial presentation composed of ten standard schedules;
- 6 6. Recoverable O&M costs to include only media replacement or regeneration, media
- 7 replacement or regeneration service, and waste disposal;
- 8 7. A deferral for future recovery of up to 12 months of recoverable O&M, without return,
- 9 commencing with the in-service date of facilities;
- 10 8. Two step-rate increases;
- 11 9. No true-up of the ACRM for under- or over- collection; and
- 12 10. Gross return included in the ACRM based on the return authorized in this proceeding.

13 Staff states that in general, an ACRM provides a methodology for recovering certain defined

14 costs related to arsenic treatment as well as to establish a mechanism for recovery of arsenic

15 treatment related costs from customers, and that recovery of those costs through an ACRM surcharge

16 terminates upon inclusion of the arsenic remediation related plant in rate base (Direct Testimony of

17 Alexander Igwe, Hearing Exh. S-6 at 20).

18 In relation to the Company's proposed ACRM, Staff recommends the following (*id.* at 22-24):

- 19 1. Authorization of an ACRM;
- 20 2. The Company should file, by July 1 of each year subsequent to any year that has
- 21 ACRM collections, a report with Docket Control showing its ending capital structure
- 22 (equity, long-term debt, and short-term debt) by month for the prior year;
- 23 3. The Earnings Test schedule filed in support of the ACRM should incorporate
- 24 adjustments conforming to Decision No. 67093 (June 30, 2004). For example, the
- 25 acquisition adjustment should be removed from rate base and the amortization of the
- 26 adjustment should be removed from the income statement. The actual period results,
- 27 adjustments, and adjusted period should be clearly shown on each Earnings Test
- 28 schedule. The earnings test places a cap on the ACRM surcharge based on the

- 1 existing rate of return;
- 2 4. Microsoft Excel or compatible electronic versions of the filings and all work papers
- 3 should be concurrently provided to Staff with all ACRM filings;
- 4 5. The Company should file hard copies of the ten schedules discussed in its
- 5 application.<sup>21</sup> In addition, Staff reserves the right for further discovery as it deems
- 6 necessary related to the ACRM filings;
- 7 6. Rate design volumetric charges must be applied equally to all usage tiers; and
- 8 7. The Company should file an application for a permanent rate increase no later than
- 9 September 30, 2008.

10 There was no objection to Staff's recommendations regarding the ACRM.<sup>22</sup> Staff's

11 recommendations are reasonable and should be adopted. The ACRM proposed by the Company will

12 be approved consistent with the Staff recommendations.

13 **B. PVCC Special Contract**

14 The Company filed an application on December 22, 2005, requesting approval of an

15 agreement between the Company and PVCC. After Staff filed a Staff Report on the issue on January

16 31, 2006, the Company requested consolidation of the PVCC application with this rate application,

17 and the cases were consolidated by Procedural Order. The agreement has a term of 15 years, and is

18 written to become effective upon approval of new rates in this proceeding. The agreement allows

19 PVCC a 15 percent discount from the Company's standard turf rates, and requires PVCC to accept

20

21 <sup>21</sup> Staff states that the schedules the Company proposes to file are as follows:

- 22 1. Balance Sheet – The most recent balance sheet for the total Company at the time of filing the ACRM
- 23 request;
- 24 2. Income Statement – The most recent income statement for the total Company and for the District;
- 25 3. Earnings Test – An earnings test calculation for the District;
- 26 4. Rate Review Filing – A rate review calculation for the District;
- 27 5. Arsenic Compliance Revenue Requirement – An arsenic compliance revenue requirement calculation
- for the District that is based upon arsenic plant and recoverable arsenic operating expenses;
- 28 6. Surcharge Calculation – A detailed calculation of the surcharge;
7. Rate Base Schedule – A schedule showing the elements and the calculation of the rate base;
8. CWIP Ledger – A ledger showing the transactions recorded in the construction work in progress
- account.
- 9.

<sup>22</sup>While RUCO initially expressed concern with the review process for ACRM filings (*see* Hearing Exh. R-6 at 31), Staff's witness Steve Olea testified at the hearing regarding the contemplated due process for the Company's ACRM surcharge filings (Tr. at 378-379), and RUCO did not address the issue in post-hearing briefing.

1 delivery of service during off-peak hours, except in circumstances where it can demonstrate to the  
2 Company that its then-existing needs cannot be satisfied during such period. PVCC has constructed,  
3 at its sole expense, a storage reservoir and associated facilities, which allow it to take water from the  
4 Company during off-peak hours and store it for future use.

5 The Staff Report states that treated effluent is not available in the area, and that PVCC has no  
6 alternative source of water for turf irrigation. Staff states that PVCC explored using Central Arizona  
7 Project ("CAP") water, but was unable to obtain all the necessary approvals.

8 Under the terms of the agreement, PVCC has the ability to terminate the agreement upon 60  
9 days' written notice and payment of a termination fee of \$1,000. The agreement calls for binding  
10 arbitration in the event of dispute.

11 Staff recommended approval of the agreement, and further recommended that the Company  
12 be required to request Commission approval of any future amendments to the agreement. Staff also  
13 recommended that the Company be required to file with the Commission an executed copy of the  
14 agreement within 30 days of its execution.

15 The Company did not object to the recommendations in the Staff Report. PVCC was granted  
16 intervention in this proceeding, but filed no testimony and did not appear at the hearing. RUCO did  
17 not take a position on this issue. Staff's recommendations are reasonable and will be adopted.

18 \* \* \* \* \*

19 Having considered the entire record herein and being fully advised in the premises, the  
20 Commission finds, concludes, and orders that:

21 **FINDINGS OF FACT**

22 1. On June 3, 2005, Arizona-American filed with the Commission an application for a  
23 rate increase for the District. The application also requests approval for the District of a public safety  
24 surcharge for investments by the Company related to improvement of fire flow facilities; an Arsenic  
25 Cost Recovery Mechanism for investments required by the Company to comply with federal water  
26 arsenic reduction requirements; and approval of a conservation surcharge that would be imposed for  
27 usage in the highest consumption block.

28 2. On June 17, the Company filed cost of service testimony and Schedules G and H.

1           3.       On July 14, 2005, the Company filed revised H Schedules.

2           4.       On July 18, 2005, Staff docketed a copy of a letter informing the Company that its  
3 application as amended on June 17, 2005 met the sufficiency requirements set forth in the  
4 Commission's rules.

5           5.       On August 1, 2005, RUCO requested intervention, which was granted by Procedural  
6 Order issued August 15, 2006.

7           6.       A Procedural Order was issued on August 15, 2005, setting a hearing in these  
8 consolidated matters to commence on March 27, 2006, and setting associated procedural and filing  
9 deadlines.

10          7.       On August 22, 2005, the Company docketed a copy of a letter to the Company from  
11 the Town.

12          8.       On September 16, 2005, the Company docketed a copy of a letter mailed to each of its  
13 customers in the District. Also on September 16, 2005, the Company docketed a letter including  
14 details regarding its request for an accounting order related to the public safety surcharge requested in  
15 its application.

16          9.       On October 26, 2005, the Company docketed an affidavit certifying that a copy of the  
17 notice required by the August 15, 2005 Procedural Order was included in each September 2005 bill  
18 mailed to customers in the Company's Paradise Valley Water District.

19          10.      On November 14, 2005, the Commission issued Decision No. 68303, which granted  
20 the Company's request to be allowed to defer capital costs incurred by the District related to public  
21 safety associated with fire flows. Decision No. 68303 limited the deferral amounts to depreciation  
22 expense and a post-in-service allowance for funds used during construction with the rates set at the  
23 Company's cost of debt concurrent with the deferral period.

24          11.      On December 16, 2005, PVCC filed an Application to Intervene, which was granted  
25 by Procedural Order issued January 4, 2006.

26          12.      On February 22, 2006, a copy of a letter dated February 15, 2006 from the Town to  
27 Chairman Hatch-Miller was docketed.

28          13.      A Procedural Order was issued on February 28, 2006, consolidating the Company's

1 rate application with the above-captioned application filed by the Company on December 22, 2005.  
2 The December 22, 2005 application requested Commission approval of an agreement between the  
3 Company and PVCC which would allow PVCC a 15 percent discount from the Company's standard  
4 turf rates.

5 14. On March 20, 2006, the Town filed a letter requesting intervention.

6 15. On March 24, 2006, Eric Nesvig filed written public comment in this docket.

7 16. On March 27, 2006, the Town filed a letter withdrawing its intervention request. Also  
8 on March 27, 2006, the Town filed a letter in the docket regarding fire flow improvements.

9 17. A hearing was held as scheduled before a duly authorized Administrative Law Judge  
10 of the Commission commencing on March 27, 2006, and continuing on March 28, March 29 and  
11 April 3, 2006. Several members of the public appeared on the first day of hearing and provided  
12 public comment on the application.

13 18. The Company, RUCO and Staff appeared and presented evidence at the hearing.

14 19. Following the hearing, on March 30, 2005, the Company caused discovery items from  
15 the litigation entitled *Kueffner v. Arizona-American*, pending in Maricopa Superior Court, to be filed  
16 in this docket, as specified during the taking of public comments at the hearing in this matter. These  
17 materials include, among other items, the Company's Paradise Valley Water Company 1999  
18 Comprehensive Planning Study and a copy of report prepared by Brown and Caldwell titled Arizona-  
19 American Water Paradise Valley Water System Fire Flow Capacity Assessment dated March 2004.

20 20. On April 11, 2006, the Company filed Notice of Availability of *Kueffner v. Arizona-*  
21 *American* Discovery Materials.

22 21. On April 21, 2006, RUCO and Staff filed their respective post-hearing schedules. The  
23 Company had previously provided its post-hearing schedules on April 3, 2006, the final day of  
24 hearing.

25 22. On May 5, 2006, the parties filed their initial post-hearing briefs.

26 23. On May 26, 2006, the parties filed their reply briefs, and these consolidated matters  
27 were taken under advisement.

28 24. On July 3, 2006, the Town filed in these consolidated dockets a Motion for Leave to

1 File Amicus Curiae Brief, to which was attached an amicus curiae brief.

2 25. Based on the adjusted test year data, as determined herein, the operating income under  
3 existing rates for the District is \$915,913.

4 26. Based on the adjusted test year data, as determined herein, the FVRB for the District is  
5 \$14,351,471.

6 27. A fair and reasonable fair value rate of return is 7.24 percent.

7 28. The increase proposed by Arizona-American would produce an excessive return on  
8 FVRB.

9 29. The authorized increase in gross annual revenues for the District is \$199,371.

10 30. The rates set herein produce an increase in annual revenues of 3.93 percent which  
11 results in a monthly increase from \$24.61 to \$26.37, or 7.13 percent, for the average usage (22,193  
12 gallons/month) 5/8 x 3/4-inch meter customer, and a monthly increase from \$16.81 to \$18.24, or 8.54  
13 percent, for the median usage (11,500 gallons/month) 5/8 x 3/4-inch meter customer.

14 31. The High Block surcharge approved herein will apply to residential usage in the third  
15 tier (over 80,000 gallons/month), in addition to the normal third tier charge, and will be \$2.15 per  
16 1,000 gallons/month, from the time the new rates approved herein are effective until September 30,  
17 2007.

18 32. The High Block surcharge approved herein will apply to commercial usage in the  
19 second tier (over 400,000 gallons/month), in addition to the normal second tier charge, and will be  
20 \$2.15 per 1,000 gallons/month from the time the new rates approved herein are effective until  
21 September 30, 2007.

22 33. From October 1, 2007 until recovery of fire flow projects is complete, the High Block  
23 surcharge will be \$3.15 per 1,000 gallons/month. After recovery of fire flow project costs is  
24 complete, the High Block Surcharge will return to \$2.15 per 1,000 gallons/month.

25 34. The Public Safety Fire Flow surcharge approved herein will apply to residential usage  
26 in the second and third tier (over 25,000 gallons/month), in addition to normal second and third tier  
27 charges, and will be \$1.00 per 1,000 gallons/month from October 1, 2007 until recovery of fire flow  
28 project costs is complete, at which time it will terminate.

1           35.     The Public Safety Fire Flow surcharge approved herein will apply to commercial  
2 usage in the second tier (over 400,000 gallons/month), in addition to the normal second tier charge,  
3 and will be \$1.00 per 1,000 gallons/month from October 1, 2007 until recovery of fire flow project  
4 costs is complete, at which time it will terminate.

5           36.     It is in the public interest to implement a rate design that promotes long-term  
6 conservation goals by sending appropriate price signals to heavier water users.

7           37.     The rate design approved herein addresses the goals of conservation, efficient water  
8 use, affordability, fairness, simplicity, and rate stability, and is in the public interest.

9           38.     The rates and charges approved herein, including the High Block surcharge and the  
10 Public Safety Fire Flow surcharge as discussed herein, are just and reasonable and shall be approved.

11          39.     The ACRM proposed by the Company is reasonable and shall be approved consistent  
12 with the Staff recommendations.

13          40.     The PVCC special contract as discussed herein is reasonable and shall be approved.

14          41.     Based on information provided by the Company, water use for the year 2004 totaled  
15 3,165,233,000 gallons, and the Company reported producing 3,512,659,000 gallons. This resulted in  
16 a water loss of 9.89 percent, which is acceptable to Staff (Direct Testimony of John A. Chelus,  
17 Hearing Exh. S-5 at 4).

18          42.     Based on data submitted by the Maricopa County Environmental Services Department  
19 ("MCESD"), MCESD has determined that the District is currently delivering water that meets the  
20 water quality standards required by Title 18, Chapter 4 of the Arizona Administrative Code (*id.* at 5).

21          43.     The District is located within the Phoenix Active Management Area ("AMA") and  
22 consequently is subject to reporting and conservation rules administered by ADWR. The Phoenix  
23 AMA reported that the District is in total compliance with the ADWR reporting and conservation  
24 rules (*id.* at 4).

25          44.     The District is using depreciation rates it developed, and Staff recommended that the  
26 District continue to use these rates (*id.* at 5 and Exhibit 4 to Hearing Exh. S-5). No party objected to  
27 these depreciation rates, and the District should continue to use them.

28          45.     The District has no outstanding compliance issues with the Commission.

1 46. The Company has an approved curtailment plan tariff on file that applies to all its  
2 service areas, including the District.

3 47. Because an allowance for the property tax expense of the District is included in the  
4 District's rates and will be collected from its customers, the Commission seeks assurances from the  
5 Company that any taxes collected from ratepayers have been remitted to the appropriate taxing  
6 authority. It has come to the Commission's attention that a number of water companies have been  
7 unwilling or unable to fulfill their obligation to pay the taxes that were collected from ratepayers,  
8 some for as many as twenty years. It is reasonable, therefore, that as a preventive measure Arizona-  
9 American annually file, as part of its annual report, an affidavit with the Utilities Division attesting  
10 that the Company is current in paying its property taxes in Arizona.

11 **CONCLUSIONS OF LAW**

12 1. Arizona-American Water Company is a public service corporation within the meaning  
13 of Article XV of the Arizona Constitution and A.R.S. Sections 40-250 and 40-241.

14 2. The Commission has jurisdiction over the Company and the subject matter of the  
15 application.

16 3. Notice of the applications was provided in the manner prescribed by law.

17 4. The rates and charges for the Paradise Valley Water District approved herein,  
18 including the High Block surcharge and the Public Safety Fire Flow surcharge as discussed herein,  
19 are just and reasonable and shall be approved.

20 **ORDER**

21 IT IS THEREFORE ORDERED that Arizona-American Water Company is hereby directed to  
22 file with the Commission on or before July 31, 2006, revised schedules of rates and charges  
23 consistent with the schedule set forth below and the discussion herein.

	<u>Rates</u>
<u>MONTHLY USAGE CHARGE:</u>	
5/8" x 3/4" Meter	\$ 9.50
3/4" Meter	9.83
1" Meter	15.85
1 1/2" Meter	32.00
2" Meter	51.00

1	3" Meter	94.50
	4" Meter	157.25
2	6" Meter	315.00
3	Paradise Valley Country Club	See Below
4	Fire Protection	\$ 5.00
5	<u>COMMODITY RATES</u>	
	<u>Residential – All Meter Sizes</u>	
6	Gallage Charge – per 1,000 Gallons	
7	From 1 to 25,000 Gallons	\$ 0.76
	From 25,001 to 80,000 Gallons	1.65
8	Over 80,000 Gallons	2.18
9	<u>Commercial – All Meter Sizes</u>	
10	Gallage Charge – per 1,000 Gallons	
	From 1 to 400,000 Gallons	\$ 1.27
11	Over 400,000 Gallons	1.56
12	<u>Turf Facility Customers</u>	
13	Gallage Charge – per 1,000 Gallons	
	All Gallons	\$ 1.00
14	<u>Paradise Valley Country Club (Contract Rate)</u>	
15	Minimum of Charges Based Upon Applicable	
	Meter Size	
16	From 1 to 2,500,000 Gallons	Turf Rate Less 15
		Percent
17	Over 2,500,000 Gallons	Turf Rate Less 15
		Percent
18	All Applicable Surcharges	Less 15 Percent
19	<u>Other General Metered</u>	
20	Gallage Charge – per 1,000 Gallons	
	All Gallons	\$1.46
21	<u>Fire Protection</u>	
22	Gallage Charge – per 1,000 Gallons	
23	All Gallons	No Charge
24	<u>Resale Customers</u>	
25	Gallage Charge – per 1,000 Gallons	
	All Gallons	\$1.46
26	<u>Service Line and Meter Installation Charges:</u>	
27	(Refundable pursuant to A.A.C. R14-2-405)	
	5/8" x 3/4" Meter	\$480.00
28	3/4" Meter	560.00

1	1" Meter	650.00
	1 1/2" Meter	895.00
2	2" Meter	1,555.00
	3" Meter	2,235.00
3	4" Meter	3,440.00
4	6" Meter	6,195.00

SERVICE CHARGES:

6	Establishment	\$20.00
	Establishment (After Hours)	40.00
7	Reconnection (Delinquent)	30.00
	Reconnection (Delinquent & After Hours)	60.00
8	Meter Test, if meter is correct	15.00
9	Deposit	*
	Deposit Interest	*
10	Reestablishment (Within 12 Months)	**
	NSF Check	12.00
11	Deferred Payment, Per Month	1.50%
12	Meter Reread (If Correct)	10.00
	Late Charge per month	1.50%

Monthly Service Charges for Fire Sprinkler

14	4" or Smaller	***
15	6"	***
16	8"	***
17	10"	***
	Larger than 12"	***

\* Per Commission rule A.A.C. R-14-2-403(B).

\*\* Months off system times the monthly minimum per Commission rule A.A.C. R14-2-403(D).

\*\*\* 1% of Monthly Minimum for a Comparable Size Meter Connection, but no less than \$5.00 per month. The Service Charge for Fire Sprinklers is only applicable for service lines separate and distinct for the primary water service line.

CAP Surcharge

There are two current unchanged CAP surcharges which are calculated under a separate docket.

25 ...  
26 ...  
27 ...  
28 ...

1 High Block Usage Surcharge Treated as Contributions in Aid of Construction

2 Per Customer

3 Residential Customers:

4 All residential customers with usage in the third tier  
will pay a surcharge on their third tier usage.

5 All usage in the third tier, in addition to normal third tier charge:  
6 Through September 30, 2007 \$2.15 per 1,000 gallons  
7 October 1, 2007 until recovery of fire flow projects is complete 3.15 per 1,000 gallons

8 Commercial Customers:

9 All commercial customers with usage in the second tier  
will pay a surcharge on their second tier usage.

10 All usage in the second tier, in addition to normal second tier charge:  
11 Through September 30, 2007 \$2.15 per 1,000 gallons  
12 From October 1, 2007 until recovery of fire flow projects is complete 3.15 per 1,000 gallons

12 Public Safety Fire Flow Surcharge Treated as Contributions in Aid of Construction

13 Per Customer

14 Residential Customers:

15 All residential customers with usage in the second and third tier  
16 will pay a surcharge on second and third tier usage.

17 All usage in the second and third tier, in addition to normal  
second and third tier charges  
18 From October 1, 2007 until recovery of fire flow projects is complete \$1.00 per 1,000 gallons  
19

20 Commercial Customers:

21 All commercial customers with usage in the second tier  
22 will pay a surcharge on second tier usage.

23 All usage in the second tier, in addition to normal second tier charges  
24 From October 1, 2007 until recovery of fire flow projects is complete \$1.00 per 1,000 gallons  
25

26 IT IS FURTHER ORDERED that the revised schedule of rates and charges shall be effective  
27 for all service rendered on and after August 1, 2006.

28 IT IS FURTHER ORDERED that Arizona-American Water Company shall notify its affected

1 customers of the revised schedules of rates and charges authorized herein by means of an insert in its  
2 next regularly scheduled billing in a form and manner acceptable to the Commission's Utilities  
3 Division Staff.

4 IT IS FURTHER ORDERED that Arizona-American Water Company's request for authority  
5 to implement an ACRM is approved, to the extent described herein.

6 IT IS FURTHER ORDERED that Arizona-American Water Company shall comply with all  
7 requirements discussed in this Order as a condition of approval of the Arsenic Cost Recovery  
8 Mechanism.

9 IT IS FURTHER ORDERED that Arizona-American Water Company shall file, by July 1st of  
10 each year subsequent to any year in which it collects surcharges under an ACRM, a report with  
11 Docket Control showing the Company's ending capital structure (equity, long-term debt, and short-  
12 term debt) by month for the prior year.

13 IT IS FURTHER ORDERED that, as part of the Earnings Test schedule filed in support of the  
14 ACRM, Arizona-American Water Company shall incorporate adjustments conforming to Decision  
15 No. 67093, as discussed in Staff's recommendations set forth herein.

16 IT IS FURTHER ORDERED that Arizona-American Water Company shall file in this docket  
17 hard copies of the schedules discussed in its application, as set forth in Staff's recommendations  
18 herein, and shall concurrently provide Microsoft Excel or compatible electronic versions of the filings  
19 and all work papers to Staff with all ACRM filings.

20 IT IS FURTHER ORDERED that all ACRM surcharges shall be designed to apply rate design  
21 volumetric charges equally to all usage tiers.

22 IT IS FURTHER ORDERED that Arizona-American Water Company shall file the schedules  
23 and information described above, as well as any additional relevant data requested by Staff, as part of  
24 any request for an Arsenic Cost Recovery Mechanism step increase.

25 IT IS FURTHER ORDERED that Arizona-American Water Company shall file a permanent  
26 rate application for its Paradise Valley Water District no later than September 30, 2008.

27 IT IS FURTHER ORDERED that Arizona-American Water Company shall annually file as  
28 part of its annual report, an affidavit with the Utilities Division attesting that the Company is current

1 in paying its property taxes in Arizona.

2 IT IS FURTHER ORDERED that the special contract agreement between Arizona-American  
3 Water Company and Paradise Valley Country Club discussed herein is hereby approved, and that  
4 Arizona-American Water Company shall request Commission approval of any future amendments to  
5 the agreement.

6 IT IS FURTHER ORDERED that Arizona-American Water Company shall file with  
7 Commission Docket Control, within 30 days of its execution, an executed copy of the special contract  
8 agreement with Paradise Valley Country Club discussed and approved herein, as a compliance item  
9 in this case.

10 IT IS FURTHER ORDERED that Arizona-American Water Company shall continue to use  
11 the depreciation rates for its Paradise Valley Water District set forth in Exhibit 4 to Hearing Exh. S-6.

12 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

13 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.  
14  
15

16 CHAIRMAN

COMMISSIONER

17  
18 COMMISSIONER

COMMISSIONER

COMMISSIONER

19  
20 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive  
21 Director of the Arizona Corporation Commission, have  
22 hereunto set my hand and caused the official seal of the  
23 Commission to be affixed at the Capitol, in the City of Phoenix,  
24 this \_\_\_\_ day of \_\_\_\_\_, 2006.

25  
26 \_\_\_\_\_  
27 BRIAN C. McNEIL  
28 EXECUTIVE DIRECTOR

26 DISSENT \_\_\_\_\_

27  
28 DISSENT \_\_\_\_\_

1 SERVICE LIST FOR: ARIZONA-AMERICAN WATER COMPANY  
(Paradise Valley Water District)

2  
3 DOCKET NO.: W-01303A-05-0405 ET AL.

4 Craig A. Marks  
Arizona-American Water Company  
5 101 Corporate Center  
19820 North 7<sup>th</sup> Street, Ste. 201  
6 Phoenix, AZ 85024

7 Scott S. Wakefield  
RUCO  
8 1110 West Washington Street, Ste. 220  
Phoenix, AZ 85007

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10 Robert J. Metli  
SNELL & WILMER, LLP  
One Arizona Center  
11 400 E. Van Buren  
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12 Attorneys for Paradise Valley Country Club

13 Christopher Kempley, Chief Counsel  
Maureen A. Scott, Senior Staff Attorney  
14 Keith A. Layton, Attorney  
Legal Division  
15 ARIZONA CORPORATION COMMISSION  
1200 West Washington Street  
16 Phoenix, AZ 85007

17 Ernest G. Johnson, Director  
Utilities Division  
18 ARIZONA CORPORATION COMMISSION  
1200 West Washington  
19 Phoenix, AZ 85007

20

21

22

23

24

25

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EXHIBIT A

BEFORE THE ARIZONA CORPORATION COMMISSION

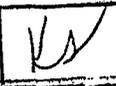
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JEFF HATCH-MILLER  
Chairman  
WILLIAM A. MUNDELL  
Commissioner  
MARC SPITZER  
Commissioner  
MIKE GLEASON  
Commissioner  
KRISTIN K. MAYES  
Commissioner

Arizona Corporation Commission

DOCKETED

NOV 14 2005

DOCKETED BY 

RECEIVED

NOV 16 2005

ARIZONA CORPORATION COMMISSION  
HEARING DIVISION

IN THE MATTER OF THE APPLICATION  
OF ARIZONA-AMERICAN WATER  
COMPANY, INC.'S REQUEST FOR AN  
ACCOUNTING ORDER AUTHORIZING  
THE DEFERRAL OF COSTS ASSOCIATED  
WITH PUBLIC SAFETY/FIRE FLOW  
IMPROVEMENTS IN ITS PARADISE  
VALLEY WATER DISTRICT

DOCKET NO. W-01303A-05-0704  
DECISION NO. 68303  
PUBLIC SAFETY/FIRE FLOWS  
ACCOUNTING ORDER

Open Meeting  
November 8 and 9, 2005  
Phoenix, Arizona

BY THE COMMISSION:

On June 3, 2005, Arizona-American Water Company ("Arizona-American" or "Company") filed a rate application, Docket No. W-01303A-05-0405, with the Arizona Corporation Commission ("Commission") 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 Paradise Valley water district. Within that application was a request for an accounting order authorizing the deferral of capital costs incurred by the Company's Paradise Valley system related to public safety associated with fire flows.

A hearing on the rate application is scheduled to commence on March 27, 2006.

Pursuant to Staff's request to aid the Company in its request for expedited action, on October 5, 2005, the Company filed a request to bifurcate its rate application and to separate the accounting order portion from the rate application. The Company requests an accounting order authorizing the deferral of capital costs by the Company's Paradise Valley system related to public safety associated with fire flows.

1 The Town of Paradise Valley ("Town") has requested the fire-flow improvements since  
2 they are needed to reduce the risk to life and property. Mr. Thomas M. Martinsen, the town  
3 manager of the Town has requested expedited review. Town residents' safety and the protection  
4 of their property are highly dependent on this program.

5 \* \* \* \* \*

6 Having considered the Company's application and Staff's memorandum dated October 20,  
7 2005, the Commission finds, concludes, and orders that:

8 FINDINGS OF FACT

9 1. Arizona-American is a Class-A regulated water and wastewater utility which serves  
10 approximately 131,000 customers throughout the state of Arizona pursuant to various Certificates  
11 of Convenience and Necessity granted by the Commission to the Company and its predecessors in  
12 interest.

13 2. The Company's deferral request in this docket pertains only to the Company's  
14 Paradise Valley water district, where the Company provides service to approximately 5,000  
15 customers in portions of Paradise Valley, Scottsdale and unincorporated Maricopa County.

16 3. The Company seeks an accounting order in this proceeding authorizing the deferral  
17 of capital costs and expenses it expects to incur before these costs can be recognized in rates. An  
18 accounting order is a rate-making mechanism whereby a regulatory commission provides specific  
19 deferral authorization to treat costs in a manner that differs from generally accepted accounting  
20 principles. Such a deferral mechanism, pursuant to an authorized accounting order, is permitted  
21 under National Association of Regulatory Commissioners ("NARUC") Uniform System of  
22 Accounts ("USOA") guidelines.

23 4. Arizona-American seeks an accounting order authorizing it to defer capital costs,  
24 specifically depreciation expense and "gross return" related to public safety/fire flow improvement  
25 facilities placed into service in Paradise Valley.

26 5. The Town has requested the fire-flow improvements since the improvements are  
27 needed to reduce the risk to life and property.

28 ...

**DECISION NO.** \_\_\_\_\_

1           6.       The Company proposes to include capital expenditures for projects that a) improve  
2 fire flows, b) produce no significant additional revenues, and c) do not materially reduce operating  
3 expenses. Records will be maintained to segregate the cost of eligible capital investments and  
4 capital investments that would otherwise be made during the due course of the Paradise Valley on-  
5 going operations.

6           7.       Staff's recommendation for approval of an accounting order for Arizona-American  
7 is subject to the following conditions:

- 8           a)       The deferral is limited to eligible Company expenditures in the Paradise Valley water  
9 district related to public safety/fire flow.
- 10          b)       The Company shall be required to prepare and retain accounting records sufficient to  
11 permit detailed review, in a rate proceeding, of all deferred costs related to public  
12 safety/fire flow improvement facilities.
- 13          c)       The deferral is related to projects that are revenue neutral.
- 14          d)       The deferral is related to projects that do not materially reduce operating expenses.
- 15          e)       The Company's deferral is limited to depreciation expense (at authorized  
16 depreciation rates) and a post-in-service allowance for funds used during construction  
17 ("AFUDC"), with the rate set at its cost of debt concurrent with the deferral period.
- 18          f)       The post-in-service AFUDC will automatically cease when, and if, the related plant is  
19 placed in rate base and recognized in a rate proceeding.

20          8.       While issuance of an accounting order authorizing deferral of the costs being  
21 incurred will not assure the Company that those costs will be recovered in rates, without such an  
22 accounting order, the Company would be foreclosed from possible future recovery of such costs as  
23 a regulatory asset.

24          9.       A determination regarding the recovery of the deferral will be made in the  
25 Company's instant rate case or the Company's future rate cases for the Paradise Valley water  
26 district.

#### CONCLUSIONS OF LAW

27          1.       The Company is a public water service corporation within the meaning of Article  
28 XV of the Arizona Constitution and A.R.S. §§40-250 and 40-252.

          2.       The Commission has jurisdiction over the Company and of the subject matter of the  
application.

**DECISION NO.** \_\_\_\_\_

1 3. The cost deferral authorization granted herein does not constitute a finding or  
2 determination that such costs are reasonable, appropriate, or prudent.

3 4. It is in the public interest to allow the Company to record the capital costs for  
4 projects that improve fire flows, produce no significant additional revenues, and do not materially  
5 reduce operating expenses in a deferred account for the Paradise Valley water district, subject to  
6 the conditions recommended by Staff as set forth and discussed herein.

7 ORDER

8 IT IS THEREFORE ORDERED that the application by Arizona-American Water  
9 Company for an accounting order to improve fire flows for public safety is approved, authorizing  
10 the deferral of depreciation expense (at authorized depreciation rates) and a post-in-service  
11 AFUDC, with the rate set at its cost of debt concurrent with the deferral period, subject to the  
12 conditions and requirements recommended by Staff, as described herein.

13 IT IS FURTHER ORDERED that the cost deferral authorization granted herein does not  
14 constitute a finding or determination that the deferred costs are reasonable, appropriate, or prudent.

15 IT IS FURTHER ORDERED that this Decision shall not be construed as providing the  
16 Arizona-American Water Company any relief through rates with respect to the ultimate recovery  
17 of the above-authorized cost deferrals.

18 IT IS FURTHER ORDERED that the Company shall prepare and retain accounting records  
19 sufficient to permit detailed review, in a rate proceeding, of all deferred costs recorded as  
20 authorized above.

21 ...  
22 ...  
23 ...  
24 ...  
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26 ...  
27 ...  
28 ...

**DECISION NO.** \_\_\_\_\_

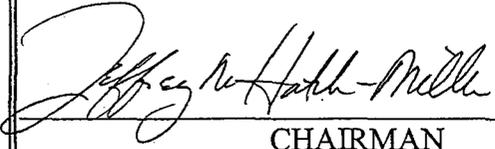
1 IT IS FURTHER ORDERED that a determination of recovery of the deferral will be made  
2 in the Company's instant rate case or the Company's future rate cases for the Paradise Valley  
3 water district.

4 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

5

6 BY THE ORDER OF THE ARIZONA CORPORATION COMMISSION

7

8   
CHAIRMAN

  
COMMISSIONER

9

10

11   
COMMISSIONER

  
COMMISSIONER

12   
COMMISSIONER

13

14

IN WITNESS WHEREOF, I BRIAN C. McNEIL, Executive  
Director of the Arizona Corporation Commission, have  
hereunto, set my hand and caused the official seal of this  
Commission to be affixed at the Capitol, in the City of  
Phoenix, this 14<sup>th</sup> day of November, 2005.

15

16

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BRIAN C. McNEIL  
Executive Director

19

20

21

DISSENT: \_\_\_\_\_

22

23

DISSENT: \_\_\_\_\_

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EGJ:JRM:rdp/

25

26

27

28

DECISION NO. \_\_\_\_\_

1 SERVICE LIST FOR: Arizona-American Water Company, Inc.  
2 DOCKET NO. W-01303A-05-0704

3 Mr. Craig A. Marks  
4 Arizona-American Water Company  
5 101 Corporate Center  
6 19820 North 7th Street, Suite 201  
7 Phoenix, Arizona 85024

8 Mr. Scott S. Wakefield  
9 RUCO  
10 1110 West Washington Street  
11 Suite 220  
12 Phoenix, Arizona 85007

13 Mr. Ernest G. Johnson  
14 Director, Utilities Division  
15 Arizona Corporation Commission  
16 1200 West Washington  
17 Phoenix, Arizona 85007

18 Mr. Christopher C. Kempley  
19 Chief Counsel  
20 Arizona Corporation Commission  
21 1200 West Washington  
22 Phoenix, Arizona 85007

23

24

25

26

27

28

**DECISION NO.** \_\_\_\_\_

EXHIBIT B

EXHIBIT No. S-9ALTERNATIVE FIRE FLOW SURCHARGE  
DOCKET NO. W-01303A-05-0405

In its direct testimony, Staff proposed a "High-Block" surcharge of \$2.15 to be applied to all gallons in the top tier of each rate schedule to be implemented coincident with the new rates in Arizona-American Water Company's ("Company") application. Amounts collected are to be treated as Contributions in Aid of Construction ("CIAC"). In its surrebuttal testimony Staff recommended that the "High Block" surcharge collections be used to offset the fire flow projects.

The Company had proposed a two step "Public Safety" fire flow surcharge. However, in discussing Staff's proposal, the Company's rebuttal testimony indicated that it would defer the timing of the fire flow projects since the High Block surcharge would not produce adequate cash flow. Mr. Townsley's testimony indicates that "the Company has slowed the pace of these projects until the Commission's wishes are more clearly stated".

The Company has asked Staff to explore possible acceleration of the fire flow surcharge collections to assist in completing the project on a more timely basis. As an alternative, in the event the Commission believes a surcharge is appropriate, Staff suggests a second phase, which would also be used specifically for fire flow surcharges, that would take effect on October 1, 2007. The second phase would increase the High Block surcharge from \$2.15 to \$3.15 per 1,000 gallons. A new "Public Safety" surcharge for the 2<sup>nd</sup> Tier residential rate of \$1.00 per 1,000 gallons and for the 1<sup>st</sup> Tier of commercial rate of \$1.00 per 1,000 gallons would also begin October 1, 2007.

Staff estimates that the High Block surcharge of \$2.15 would generate approximately \$1.7 million annually. Implementation of the October 1, 2007 increases would generate an additional \$1.8 million annually for a total of \$3.5 million annually. See Attached Schedule DWC.

The potential benefits from a phase-in fire flow surcharge include the following:

- Encourage conservation in a water district with historically high usage.
- Increase contributions in aid of construction which will reduce future rate increases.
- Permit more timely implementation of fire safety related infrastructure.

The surcharges will have no effect on the median (11,500 gallons) or average (22,193 gallons) residential bills since the surcharge for the 2<sup>nd</sup> Tier residential starts at 25,000 gallons. Thus, the median and average residential users will not be impacted.

Notwithstanding this alternative, Staff continues to recommend a \$2.15 "High Block" surcharge be implemented when new rates take effect and for the monies collected by this surcharge to be used to offset the cost of the fire flow project.

If the Commission adopts this alternative, Staff recommends that that the Public Safety surcharge be terminated and the High Block surcharge be reduced back to \$2.15 once the Company has fully recovered its fire flow project costs.

Arizona-American Water Company/Paradise Valley Water District  
 Docket No. W-01303A-05-0405

Schedule DWC

APPROXIMATE CASH FLOW  
 FIRE FLOW SURCHARGE

Assumes implementation of a top tier \$2.15 surcharge in August, 2006  
 Implementation of the following revised surcharge in October, 2007:

Top Tier-all Rate Schedules      \$3.15  
 2nd Tier-Residential Rates      \$1.00  
 1st Tier-Commercial Rates      \$1.00

ESTIMATED MONTHLY CASH FLOW

	Top Tier at \$2.15	Top Tier at \$3.15	2nd Tier Res at \$1.00	1st Tier Com. at \$1.00	Cummulative
September 2006	170,000				170,000
October 2006	113,333				283,333
November 2006	113,333				396,666
December 2006	113,333				509,999
January 2007	113,333				623,332
February 2007	113,333				736,665
March 2007	113,333				849,998
April 2007	170,000				1,019,998
May 2007	170,000				1,189,998
June 2007	170,000				1,359,998
July 2007	170,000				1,529,998
August 2007	170,000				1,699,998
September 2007	170,000				1,869,998
October 2007	113,333				1,983,331
November 2007		166,666	52,800	12,000	2,214,797
December 2007		166,666	52,800	12,000	2,446,263
January 2008		166,666	52,800	12,000	2,677,729
February 2008		166,666	52,800	12,000	2,909,195
March 2008		166,666	52,800	12,000	3,140,661
April 2008		250,000	79,200	18,000	3,487,861
May 2008		250,000	79,200	18,000	3,835,061
June 2008		250,000	79,200	18,000	4,182,261
July 2008		250,000	79,200	18,000	4,529,461
August 2008		250,000	79,200	18,000	4,876,661
September 2008		250,000	79,200	18,000	5,223,861
October 2008		166,666	52,800	12,000	5,455,327
	<u>1,983,331</u>	<u>2,499,996</u>	<u>792,000</u>	<u>180,000</u>	
			<u>3,471,000</u>		