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Arizona Corporation Commission
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IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS 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

EXCEPTIONS OF THE RESIDENTIAL UTILITY CONSUMER OFFICE

The Residential Utility Consumer Office ("RUCO") makes the following Exceptions to the Recommended Opinion and Order ("ROO") on Arizona American Water Company's ("Arizona American" or "Company") application for a rate increase.

FIRE FLOW IMPROVEMENTS

The ROO recommends the inclusion of $3,018,867 of post-test year plant consisting of discretionary fire flow improvement projects. The issue, which RUCO points out, and the ROO agrees, is whether deferred expenses incurred by the Company for fire flow improvements

should be allowed in ratebase. ROO at 11. The issue is **not** whether the improvements are necessary to ensure the public safety, are used and useful or whether the ratepayers support the improvements. The ROO answers these questions in the affirmative and cites them as the reason why the Commission should include over $3,000,000 in discretionary expenditures.

RUCO does not take issue with the contention that the discretionary improvements ensure public safety, are used and useful, or that some ratepayers support the improvements[1]. However, the ROO misses the point. The fact that the improvements ensure public safety, are used and useful and are supported by ratepayers does not answer the question of **who** should pay for them. These points, at best, provide a reason why the Town of Paradise Valley needs to improve its fire flow system, and not the reason why ratepayers should be the ones to pay for discretionary fire flow improvements.

Perhaps the reason why the ROO, Staff and the Company have not provided a reason why ratepayers should pay for improvements that even the Company considers discretionary is because it comes down to a policy call. In this time of soaring utility rates in every sector the Commission regulates, it is bad policy to allow utilities to ratebase discretionary expenditures and supersede the Commission's ability to regulate costs and prices. The Commission, on numerous occasions, has stated the need for utilities to "cut the fat out" and pass through to ratepayers expenditures that are only necessary for the provision of service. The Commission should remain steadfast and consistent and reject the Company's request to include discretionary expenditures.

The Commission is not in the business of setting fire flow standards any more than it is in the business of marketing a utility to the public. Is the Commission now going to start

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[1] Interestingly, while the Company has made that contention, no public member who appeared at the Commission's public comment supported the improvements.

distinguishing between what types of "fat" it will include in rate base and what it will not include? Allowing discretionary expenditures, of any type, into a utility's rate base is unfair to customers. The Commission should not jeopardize the affordability of water in Arizona by including discretionary and costly fire flow improvements in customers' rates[2]. (See Exhibit A, RUCO's Amendment No. 1)

PROPERTY TAX EXPENSE

The ROO rejects RUCO's property tax recommendation. RUCO has unsuccessfully argued its position before this Commission on numerous occasions and RUCO still maintains that its methodology results in the most accurate estimate of property tax. Stated simply RUCO's methodology is the same methodology using the same inputs that the Arizona Department of Revenue ("ADOR") developed at the request of the association of Arizona's water utilities back in 2001. The ROO discredits RUCO's recommendation by citing several Decisions where the Commission has rejected RUCO's proposed methodology. The ROO, apparently in support of its recommendation notes that RUCO has not appealed any of the Commission's Decisions. See ROO, Footnote 15 at page 18.

The fact that RUCO has not appealed the Commission's prior Decisions on this issue is irrelevant. The ROO's notation of RUCO's decision not to appeal in the past is prejudicial to RUCO and should be stricken. There are many factors that go into a decision to appeal

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[2] To a lesser degree, Footnote 6 of the ROO needs to be addressed. The ROO is critical of RUCO's argument that interpreting the Town's Code to require a utility to fund increased fire flow improvements impinges on the Commission's exclusive ratemaking authority. The ROO notes that RUCO makes no similar argument against approval of the ACRM in this proceeding. ROO at 9. Unlike the situation with the Town code, federal law is superior to the Commission's regulatory authority under the Supremacy Clause of the United States Constitution. Article VI, Paragraph 2 of the United States Constitution. The Commission's regulatory authority is superior to the Town's code in cases where there is a conflict and the matter is of both local and statewide concern. Ariz. Const. art. IV, pt. 1, § 1(8); *Strode v. Sullivan*, 72 Ariz. 360, 363, 236 P.2d 48, 50 (1951). *Mayor and Common Council of City of Prescott v. Randall*, 67 Ariz. 369, 372, 196 P.2d 477, 479 (1948); *City of Tucson v. State*, 191 Ariz. 436, 438, 957 P.2d 341, 343 (1997).

beyond the merits of the property tax question in this case. RUCO's decision to not appeal previous decisions does not have any bearing one way or the other on the merits of RUCO's arguments. The property tax question is not a legal question, it is a policy question. RUCO's decision to not appeal does not mean that RUCO has not reached the right policy position on this issue[3]. The Commission should strike the ROO's reference to the appeal history on this issue. (See Exhibit B, RUCO's Amendment No. 2)

The ROO's reference to RUCO's failure to address the level of property tax expense for the period in which new rates will be in effect (and not for 2005) is also misplaced and should be stricken. See ROO, Footnote 16 at 19. This gets to the heart of the issue and is why RUCO maintains the ROO's recommended methodology is wrong. The impact of additional revenues on property tax is not the same as the impact of additional revenues on income taxes. Whereas the effect of additional revenues on income tax is immediate, the effect of additional revenues on property taxes is not immediate because property taxes based on the increased revenues are not paid until more than a year after new rates go into effect. Even then the increased revenues' impact on property taxes is tempered by the use of two earlier years' revenues. The full impact of increased revenues on property taxes will not be felt until four years after new rates go into effect. An understanding of this timing difference is critical to understand why the ADOR formula using historical inputs is a more accurate method to estimate property taxes than what the ROO recommends. This also explains why the new rates that will go into effect will not affect property taxes immediately. In RUCO's experience, the Commission has not gone more than one year beyond the test year to look at any other

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[3] In general, there does appear to be some frustration with RUCO advocating a position that has been unsuccessful before this Commission. Nonetheless, RUCO will not change a position that it not only believes but knows is right because parties and/or the Commission does not agree. RUCO makes its argument in good faith, RUCO can support it, and hopes that the Commission will come to see that RUCO is right.

expense on the income statement. Here, the test year was 2004, and one year beyond that is 2005. RUCO established a level of property tax for 2005.

The ROO recommends the Commission look beyond one year from the test year and consider new rates to estimate property tax expenses more than one year into the future. Historically, the Commission does not consider a post-test-year expense beyond one year because, among other things, it violates the matching principle and the used and useful principle. The ADOR formula using historical inputs, as RUCO has stated many times before, is forward looking and does consider the fact that new rates will be set. The Commission should strike the ROO's incorrect statement regarding RUCO's failure to address new rates in its property tax recommendation (Footnote 16, last sentence) and adopt RUCO's level of property tax expense. (See Exhibit B, RUCO's Amendment No. 2)

Finally, the ROO should exclude the Miller Road property taxes, as they are part of the Company's property tax expense using RUCO's recommended property tax methodology. (See Exhibit B, RUCO's Amendment No. 2)

LABOR AND PENSION EXPENSE

The ROO recommends inclusion of the operation and maintenance expenses associated with the annual labor cost of an arsenic plant operator the Company hired in October 2004. ROO at 17. The total amount involved, $48,103, should be omitted from the rates and considered when the Company files its next rate case. The parties agreed to an ACRM that by definition was to include only narrowly construed costs associated with the building of arsenic treatment plants and the operation and maintenance thereof. To date, the construction of Paradise Valley's treatment plant is not complete, and any costs associated therewith should not be included in rates.

It should go without saying that the costs associated with the operation of arsenic removal from other arsenic treatment plants in the Company's system should not be included in rates as the ROO recommends. ROO at 18, lines 5-6. The Company's arsenic plant operator will also be performing services for two other Arizona-American Divisions that require arsenic treatment plants. To be fair RUCO believes that should the Commission include the expense of the operator at this time, it should only include one third of the total, $16,034, as attributable to the Paradise Valley plant. The other two-thirds should be attributed to the Company's other Divisions and should be excluded from rates. The Commission should not include the arsenic employee expense in rates; but if the Commission does consider it, it should only include Paradise Valley's share, $16,034. (See Exhibit C, RUCO's Amendment No. 3)

RESPECTFULLY SUBMITTED this 20th day of July, 2006.

Daniel Pozefsky
Attorney

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Exhibit A
RUCO's Amendment No. 1

Page 9 Footnote 6

DELETE Footnote 6

Page 12 Line 8

DELETE Page 12, line 8 through page 12, line 15.

INSERT While the record indicates that there is a need for fire flow improvements in the Town of Paradise Valley, the issue is who should pay for the improvements. The Commission is not in the business of setting fire flow standards and will not establish a policy of establishing fire flow standards in this case. Fire flow improvements are discretionary expenditures on the part of the utility and should not be allowed in rate base.

It is not reasonable to include $3,018,867 of post-test year plant consisting of fire flow improvement projects, known as the Jackrabbit/Invergordon project, in test year plant in service.

Exhibit B
RUCO'S Amendment No. 2

Page 18 lines 10-13

DELETE Page 18, lines 27 – 28 "RUCO has not appealed any of these Decisions."

Page 19 lines 3-9

DELETE The paragraph, including footnote 16

INSERT The ADOR formula utilized by RUCO is the best measure of the Company's property taxes. The method proposed by the Company and Staff applies adjusted and proposed revenues to the ADOR formula and is likely to result in the Company over earning. RUCO's calculation of property tax expense yields the best measure of the Company's property tax expense for the period in which new rates will be in effect, and we will use that calculation.

Lines 20 -22

DELETE The sentence.

INSERT We agree with RUCO that its adjustment would be appropriate because property taxes related to the Miller Road Property are included in RUCO's property tax expense.

Exhibit C
RUCO'S Amendment No. 3

Page 18 lines 10-13

DELETE We wish to encourage water utilities to make the necessary financial commitments to satisfy the federal arsenic mandate, and find that under these specific circumstances, it is equitable to include the costs of this employee in test year expense.

INSERT At this time, construction of the arsenic treatment facilities for Paradise Valley has not been completed and under the Arsenic Cost Recovery Mechanism agreed to by the parties, the expenses related to this employee are not subject to inclusion in rates at this point in time. The costs of this employee shall not be included in test year expenses.