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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF ARIZONA WATER COMPANY, AN ARIZONA CORPORATION, FOR ADJUSTMENTS TO ITS RATES AND CHARGES FOR UTILITY SERVICE FURNISHED BY ITS NORTHERN GROUP AND FOR CERTAIN RELATED APPROVALS.	DOCKET NO. W-01445A-00-0962 **NOTICE OF FILING**

Staff of the Arizona Corporation Commission Utilities Division ("Staff") herein provides the Testimony Summaries of Staff witnesses Crystal S. Brown, Joel M. Reiker and Marlin Scott, Jr.

RESPECTFULLY SUBMITTED this 4th day of September, 2001.

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The original and ten (10) copies of the foregoing filed this 4th day of September, 2001, with:

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SUMMARY OF DIRECT AND SURREBUTTAL TESTIMONY OF CRYSTAL S. BROWN ARIZONA WATER COMPANY DOCKET NO. W-01445A-00-0962

I will appear on behalf of the Arizona Corporation Commission ("Commission") Staff and will testify concerning Staff's position and recommendations regarding Arizona Water Company's Northern Group ("Arizona Water" or "Company") for a permanent rate increase in the areas of original cost rate base, operating income, revenue requirement and rate design. A summary of the significant recommendations that I will testify concerning are listed below. My silence on any particular issue raised in the Company's direct, rebuttal, or rejoinder testimony does not indicate that I agree with the Company's stated position on the issue.

Increase In Gross Revenue Calculation – I recommend that the Increase In Gross Revenue for the Company's Northern Group be calculated as set forth in the Arizona Administrative Code ("A.A.C.") R14-2-103 B, Schedule A-1, "Computation of Increase in Gross Revenue Requirements."

Post-Test Year Plant In Service – My testimony discusses the following:

1. Arizona uses a historical Test Year as the basis for determining a company's rate base and resulting revenue requirement.
2. Plant placed into service long after the historical test year's conclusion will be out of synchronization with test year revenues and expenses.
3. Arizona Water Company controls the timing of plant construction and the filing of its application to include the new construction in rate base.
4. Including revenue neutral plant placed into service on or before December 31, 2000 was a reasonable time period after the test year's end but not so far away as to require recalculating revenues and expenses for consistency.
5. In Arizona Water's prior rate case, Decision No. 58120, dated December 23, 1992, the Commission recognized in rate base non-revenue producing plant placed in service <u>twelve months after the test year;</u> my recommendation in the current case is to, again, recognize non-revenue producing, revenue neutral, post-test year plant in rate base twelve months after the Test Year.December 31, 2000.

Accumulated Depreciation– My testimony discusses the following:

1. The Company's proposed plant and accumulated depreciation fail to match. The Company's error in matching causes an under-statement of accumulated depreciation.
2. An under-stated accumulated depreciation balance causes rate base to be over-stated.
3. The Company's adjustment is unfair because it goes outside the Test Year to include plant that will increase rate base, but ignores the offsetting reduction to rate base (by not recognizing accumulated depreciation to the same cut-off date).
4. My accumulated depreciation adjustment matched annual depreciation expense to the amount of plant recognized at December 31, 2000, and I recognized the amount of accumulated depreciation that would have occurred by that date for that plant. This

required me to calculate depreciation on all plant from January 1, 2000, through December 31, 2000 and add it to the accumulated depreciation balance at December 31, 1999.

5. My proposed pro forma adjustments relating to post-Test Year plant are not recorded in the Company's general ledger. Pro forma adjustments reflect proposed ratemaking treatment. Pro forma adjustments do not directly affect accounting records. Therefore, whether or not the pro forma adjustment to depreciation expense and accumulated depreciation are equal will have no effect on a company's financial records. None of the adjustments I recommended will cause an imbalance of debits and credits on the Company's books.
6. My accumulated depreciation adjustment is necessary to match the cut-off date for plant and accumulated depreciation; otherwise accumulated depreciation would be under-stated.
7. An under-stated accumulated depreciation balance causes rate base to be over-stated.

Construction Work In Progress ("CWIP")– I excluded CWIP from rate base for the following reasons:

1. CWIP is not used and useful.
2. The Commission normally only allows plant that is used and useful in rate base.
3. Most CWIP that existed at the end of the Test Year would have been closed to plant in the year 2000 and is already included in my recommended rate base.
4. The Company's request to include CWIP in rate base because it is a type of advance payment is neither consistent with widely accepted ratemaking principles, nor consistent with the Arizona Administrative Code. Therefore CWIP should not be included in rate base.
5. The Commission normally excludes CWIP as a component of working capital. Further, the Arizona Administrative Code R14-2-103 in Schedule B-5 "Computation of Working Capital" sets forth a working capital calculation, and CWIP is not included in that calculation.
6. The nature of CWIP is different than prepayments, materials and supplies, and bank balances. The balances for CWIP vary with the Company's capital improvement and growth requirements. The components of working capital are dependent upon the Company's operating requirements.

Cash Working Capital Allowance - My testimony discusses the following:

1. In recent decisions, the Commission has not approved the method proposed by the Company to calculate cash working capital. The Company's lead-lag calculation is not consistent with the lead-lag calculation taught by National Association of Regulatory Commissioners ("NARUC") sponsored seminars.
2. The Company's method is flawed. The Company' method treats non-cash expenses inappropriately.
3. The Company's method also inappropriately includes the rate increase and associated taxes, and the return on net invested capital needed to pay dividends on common stock in its calculation of dollar day revenue lag, a component of its cash working capital calculation. The Commission rejected this method in the Company's prior rate proceeding (Decision 58120).

4. Additionally, the Company excludes interest expense, a cash item, from its calculation of dollar day expense lag.

Rate Case Expense- In determining whether or not the amount of rate case expense requested by Arizona Water was reasonable, I compared the Company's requested amount to amounts the Commission has approved for similar companies. I found that Arizona Water is similar to Far West Water Company. The Commission, in Decision No. 62649, reduced Far West's $215,000 rate case expense actually incurred to $120,000. Arizona Water is similar to Far West because:

1. The costs of paying the salaried accounting and engineering staff to analyze, accumulate, summarize and report the financial information for the five individual systems filed in the application was not included in the Company's $216,000 rate case expense request. This is because the Company's salaried employees are paid the same amount whether or not the Company files a rate application. The cost of preparing the financial information to be filed for the Company's five systems is not significantly different than the cost of a large water company with only one system.
2. Arizona Water filed only one application, paid for only one cost of service study, will attend only one hearing and open meeting. It did not file five separate applications, pay for five separate cost of capital studies, nor will it have to attend five separate hearings or open meetings.
3. The Company's proposed rate case expense includes $15,000 for contingencies. Ratepayers should not have to pay for potential contingencies, only for actual and reasonable costs.

Property Tax Expense- My testimony discusses the following:

1. I adopted the Department of Revenue ("DOR") formula and used inputs that produced a normalized level of property tax expense. I adopted the new DOR method because I considered the effect of using the new method to be a known and measurable change. Known and measurable changes are adjustments to the Test Year to reflect on-going levels of costs.
2. Property tax expense under the new DOR method is primarily dependent upon revenue. The new method uses the average of three years' revenues with a two-year lag between the year of billing and the most recent of the years included in the average. For example, a property tax bill issued in August 2002 will be based on revenues for the years 1998, 1999, and 2000.
3. The Company's property tax expense will increase in future years if its revenues increase as the result of a rate increase. However, there is a two-year lag between the year of a rate increase and the year the increase is reflected in property tax expense. I have normalized property tax expense to recognize that the Company will experience an increase in its property taxes two years into the future.
4. The correct CWIP balance to include in the property tax calculation is the Test Year ending balance. I used the Test Year ending balance in the calculation of property tax expense

5. I verified with an official at the Property Valuation and Equalization Section of the DOR that the net book value of vehicles is deducted in the calculation of "Full Cash Value" whether purchased or leased.
6. I also verified that the full cash value is multiplied by the assessment ratio, currently 0.25, to determine the assessed value that is used in the property tax computation. The Company failed to recognize use of the assessment ratio in its calculation of property taxes.

Income Tax Expense- My testimony discusses the following:
1. The Commission has consistently calculated the income tax separately for individual systems within a company. To name a few examples, the income taxes were calculated on an individual system basis for (1) Citizens Utilities Company (2) the water and sewer systems of Far West Water Company and (3) the water and sewer systems of Sedona Venture Company.
2. In Arizona Water's prior rate proceeding Decision No. 58120, dated December 23, 1992, the Commission adopted Staff's recommendation to recognize income tax on an individual system. Page 19, line 5 of the Decision states, "Staff calculated income tax expense by applying the Company's effective federal tax rate . . . and state tax rate . . . to Staff's adjusted net operating income <u>for each system</u> (emphasis added)." The Commission did not accept Arizona Water's method.
3. The Company agreed that the income tax formula I used produces the correct result for given income levels. The Company stated on page 38, beginning at line 15 of Ralph Kennedy's rebuttal testimony, ". . . the program will produce the correct result for a single company . . ."

Depreciation Tax Expense- My testimony discusses the following:
1. The long-run benefits of changing from a composite to component depreciation rates would be in the public interest.
2. Component rates provide customers with a better estimate of the actual cost of services during an accounting period from the use of plant in the revenue generation process. Component rates also provide better matching of cost recovery and asset utilization and consumption in each accounting period
3. The typographical error on Schedule CSB-16 for the Rimrock system had no impact on the rate base schedule or income statement. I used the correct amounts on the rate base schedule and income statement for the Rimrock system.
4. The important issue is not matching the pro forma amounts for depreciation expense and the accumulated depreciation, rather, it is matching the balance of accumulated depreciation to the cut-off date for plant. Moreover, going outside the Test Year to include plant that will increase rate base, while ignoring the offsetting reduction to rate base (by not recognizing the accumulated depreciation to the same cut-off date) is unfair to the customers of Arizona Water.

Rate Design- My testimony discusses the following:
1. The Company's customer demand will not change significantly in the short run (i.e. a year or less) because of a tiered rate structure.

2. A recent study funded by the American Water Works Association Research Foundation and the United States Bureau of Reclamation found that, in the short run, water demand responds very little to changes in price of water primarily because water service has no close substitutes. Consequently, the Company will not experience any significant decrease in customer usage.
3. In the long-run, if the Company finds that customer usage is significantly decreasing, it can file an application to increase its rates.
4. Any number of items other than a tiered rate structure can effect customer usage. For example, the amount of rain customers receive, an increase in rates (regardless of the rate structure), and employment levels can affect customer use. Therefore, the Company's argument that my tiered rate structure alone will cause customer usage to decrease is inaccurate.
5. Revenue stability is largely preserved at the existing level with my proposed rates. In addition, the inelasticity of water provides a large degree of inherent revenue stability.
6. A relatively large utility such as Arizona Water should have no more difficulty implementing tiered rates than the Class D and E water utilities that have accomplished this task successfully.

WITNESS SUMMARY
OF STAFF WITNESS
JOEL M. REIKER
REGARDING
ARIZONA WATER COMPANY
DOCKET NO. W-01445A-00-0962

Direct Testimony

Capital Structure – Mr. Reiker recommends the Commission adopt a capital structure consisting of 34.67 percent long-term debt and 65.33 percent common equity.

Cost of Debt – Mr. Reiker recommends the Commission adopt an 8.48 percent cost of debt.

Cost of Equity – Mr. Reiker recommends the Commission adopt a 10.25 percent return on equity. Mr. Reiker based his return on equity recommendation on his discounted cash flow ("DCF") and capital asset pricing model ("CAPM") analyses.

Overall Rate of Return – Mr. Reiker recommends the Commission adopt an overall rate of return of 9.64 percent. This represents a fair and reasonable rate of return on Arizona Water's rate base.

Responses to Direct Testimony of Company Witness, Thomas M. Zepp, Ph.D. – Mr. Reiker recommends the Commission reject Dr. Zepp's DCF estimates because Dr. Zepp's expected dividend yield is inappropriately calculated, and he relies exclusively on analysts' forecasts for growth, which are generally known to be high.

Mr. Reiker recommends the Commission reject Dr. Zepp's risk premium estimate because it relies on past commission decisions from other jurisdictions and under different capital market conditions. The Commission has no way of knowing how these other commission decisions were developed, the information on which they relied, the issues in the cases, or the risks of the firms involved.

Mr. Reiker recommends the Commission reject Dr. Zepp's CAPM estimates because they are based on forecasted Treasury yields. Dr. Zepps's current market risk premium estimate is based on a DCF analysis that commits the same error as his main DCF analysis: it relies exclusively on forecasted growth.

Surrebuttal Testimony

Mr. Reiker responds to Dr. Zepp's contention that historical growth in dividends per share ("DPS") and estimates of near term growth in DPS should not be included in a DCF analysis. Mr. Reiker states that the price of a security is the discounted value of cash flows received by the investor, and investors receive dividends. Further, the discounted value of dividends in the first few years of owning a stock are reflected in a portion of its market price.

Mr. Reiker responds to Dr. Zepp's claim that an article written by Gordon, Gordon, and Gould shows that past DPS growth should not be included in a DCF cost of equity analysis. Mr. Reiker responds by pointing out that the Gordon, Gordon, and Gould article actually concluded that historical growth in earnings per share ("EPS") performed the worst in their study. Further, the Gordon, Gordon, and Gould article does not suggest that investors rely solely on analysts' forecasts of EPS growth when pricing stocks.

Mr. Reiker responds to Dr. Zepp's claim that whether or not analysts are optimistic in their forecasts is not the issue, the issue is whether investors rely on analyst forecasts. Mr. Reiker disagrees with the assumption that investors rely solely on analysts' forecasts of EPS growth in forming their expectations of dividend growth. Mr. Reiker also states that to the extent that investors are aware of the bias in analysts' EPS forecasts, they will adjust them downward. Mr. Reiker also cites statements by Professor Myron Gordon, in which Dr. Gordon acknowledged the general belief that analysts' forecasts of earnings growth tend to be optimistic and that a more reasonable estimate of growth would be an average of analysts' forecasts and a typically lower figure such as past growth in GNP.

Mr. Reiker responds to Dr. Zepp's comments on risk. Mr. Reiker subscribes to the theory of systematic versus unsystematic risk, which states that the only risks people care about are the ones that they can't get rid of – the systematic ones. To the extent that the company-specific risks Dr. Zepp describes are peculiar to Arizona Water, they are unsystematic, and therefore would not be priced by the market.

Mr. Reiker responds to Dr. Zepp's comments on the Wong article, which concluded that there is no need to adjust for the firm size in utility rate regulations. Dr. Zepp interprets the data in the Wong article as evidence that the "size effect" exists in the utility industry, when in fact, the data show that there is no statistically significant evidence that the "size effect" exists in the utility industry.

Mr. Reiker states that the Commission should not consider Dr. Zepp's study of large and small water utilities in California because the 97 basis point risk premium calculated by Dr. Zepp cannot be said to be different from zero.

Mr. Reiker comments on the use of a historical test year. Mr. Reiker notes that Arizona Water has earned an average 12.45 percent ROE over the past eleven years, and its current rates were based on a historical test year.

SUMMARY OF TESTIMONY
OF MARLIN SCOTT, JR.
ARIZONA WATER COMPANY – NORTHERN GROUP
DOCKET NO. W-01445A-00-0962 (RATES)

I will appear on behalf of the Utilities Division Staff and will testify concerning Staff's position and recommendation regarding Arizona Water Company (AWC) – Northern Group's application for a permanent rate increase in the area of the engineering evaluation. Summaries of my findings and recommendations are:

1. Arizona Department of Environmental Quality (ADEQ) Compliance Status – All eight of AWC's water systems have no major deficiencies and the ADEQ has determined that all these systems are currently delivering water that does not exceed any maximum contaminant levels and meets the Safe Drinking Water Act quality standards.

2. Water Testing Cost – Staff Engineering recommends its estimated annual water testing cost of $72,065 be adopted.

3. Monitoring Assistance Program (MAP) Surcharge – Since Staff's annual testing cost includes ADEQ's MAP, Staff recommends AWC's Monitoring Assistance Program Surcharge, Tariff No. MA-262, be eliminated. (This is for the Northern Group only.)

4. Depreciation Rates - Staff Engineering recommends adoption of AWC's 1991 depreciation study and its rates.

5. Tariff Schedules – Water Pressure – After further review, Staff's recommended water pressure tariff language should be withdrawn.

6. Tariff Schedule Headings – That AWC change its Tariff Schedules' headings to read "Northern Group".

7. Arsenic Removal and Treatment – AWC filed a motion for the issuance of a procedural order establishing a separate phase on arsenic cost recovery.