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Arizona Corporation Commission
DOCKETED

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BEFORE THE ARIZONA CORPORATION COMMISSION

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 WITNESS SUMMARIES**

Arizona Water Company hereby files its summaries of the pre-filed testimony of Ralph J. Kennedy, Michael J. Whitehead, William M. Garfield and Thomas M. Zepp. A copy has also been delivered to each Commissioner and to each Commissioner's administrative assistant.

DATED this 31st day of August, 2001.

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By [signature]
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An original and 10 copies of the foregoing, and attached documents were delivered this 31st day of August, 2001, to:

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A copy of the foregoing, delivered this 31st day of August, 2001, to:

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ARIZONA WATER COMPANY

Docket No. W-01445A-00-0962

SUMMARY OF WITNESSES' PRE-FILED TESTIMONY

Arizona Water Company ("Arizona Water" or "the Company") has applied for adjustments to its rates and charges for water utility service provided by the Company's Northern Group. The Northern Group consists of five water systems organized for administrative and operational purposes in two divisions: The Sedona Division (Sedona, Pinewood and Rimrock) and the Lakeside Division (Lakeside and Overgaard). The Commission previously authorized the Company to implement and utilize a "group concept" for rate applications in order to simplify processing of the application and to increase administrative efficiency. See Decision No. 58120 (Dec. 23, 1992); Procedural Order (Aug. 1, 1995) issued in Docket No. U-1445-91-227. At present, the Northern Group serves approximately 16,000 customers.

The Company's present rates and charges for utility service were approved in Decision No. 58120 and became effective January 1, 1993. Revenues from the Northern Group's utility operations are presently inadequate to provide Arizona Water a reasonable rate of return. Arizona Water is requesting rate adjustments that will produce a revenue increase of $1,121,081 for the Sedona Division and $951,513 for the Lakeside Division, for a combined increase in revenue of $2,072,595. This amounts to an increase of approximately 35 percent. In addition, Arizona Water is requesting approval of rate consolidation under which each individual water system in the Northern Group would be consolidated into two rate schedules, one for the Sedona Division and one for the Lakeside Division, in order to provide for greater administrative efficiency and simplify rate cases and other Commission proceedings.

In support of its application, Arizona Water has submitted testimony from four witnesses:

A. Ralph J. Kennedy.

Mr. Kennedy is employed by the Company as Vice President and Treasurer. Prior to joining the Company in 1987, Mr. Kennedy served as Chief of Accounting and Rates for the Commission and as Manager of Accounts and Finance for the Illinois Commerce Commission. Mr. Kennedy's testimony focuses on accounting and rate design issues.

B. Michael J. Whitehead.

Mr. Whitehead is employed by the Company as Vice President – Engineering. He has been employed by the Company since 1980 and is a Certified Professional Engineer and member of the American Water Works Association. Mr. Whitehead's testimony focuses on the Company's planning and budgeting process for the construction of plant additions and improvements, and certain post test year plant additions that the Company proposes to include in rate base.

C. William M. Garfield.

Mr. Garfield is employed by the Company as Vice President – Operations. He has been employed by the Company since 1984, and is a member of the American Water Works Association and the Arizona Water and Pollution Control Association. Mr. Garfield addresses operations and maintenance issues, including storage tank maintenance, chlorination operating and maintenance costs and water sampling. He also provides testimony concerning regulatory changes that will have a significant impact on the Company, including the U.S. Environmental Protection Agency's proposed reduction in the arsenic maximum contaminant level.

D. Thomas M. Zepp.

Mr. Zepp is an economist and Vice President of Utility Resources, Inc., a consulting firm. He holds a PhD in Economics. Prior to becoming a consultant Mr. Zepp was a senior economist on the staff of the Oregon Public Utility Commission. Mr. Zepp's testimony deals with the appropriate rate of return on Arizona Water's common equity.

1. Summary of Ralph J. Kennedy's Pre-Filed Testimony.

a. Direct Testimony.

Mr. Kennedy explains that the Company's application is based on an historic test year ending December 31, 1999, which, at the time of filing, was the most recent calendar year for which financial statements were available.

Mr. Kennedy's direct testimony first addresses three topics that the Commission directed Arizona Water to address in its next rate filing: (1) its deposit policy; (2) the allocation of Phoenix office and meter shop expenses; and (3) the preparation of a lead/lag study to determine the Company's cash working capital requirements. In addition, Mr. Kennedy addresses the status of the Company's long-term financing in response to direction from the Commission, in Decision No. 62844, that it convert short-term debt to either equity or long-term debt. Mr. Kennedy discusses the status of the Company's attempt to issue and place additional mortgage bonds (the "Series K bond issue"), explaining that at the time the Company's application was filed, it had been unsuccessful in placing this bond issue.

Mr. Kennedy next addresses the financial impact of the proposed change in the Maximum Contaminant Level ("MCL") for arsenic proposed by the U.S. Environmental Protection Agency ("EPA"). Assuming that EPA were to establish a new MCL of 5 parts per billion ("ppb"), Mr. Kennedy states that the capital costs associated with constructing new treatment facilities may exceed $50 million. Mr. Kennedy also states that other Arizona water utilities will likely be similarly impacted by the new MCL and proposes that the Commission adopt an approach that utilizes a combination of memorandum accounts and advice letters, such as the procedures used in California, in order to allow the Company to recover its increased operating expenses and capital costs related to treatment for arsenic.

Mr. Kennedy then introduces the standard schedules required under the Commission's regulations, Schedules A-1 through H-10, for the Company's Northern Group. These schedules provide evidence of the Company's original cost rate base, actual and adjusted net operating income, capital structure and weighted cost of capital, operating income deficiency, required revenue increase and the recommended rate design for the five operating systems in the Sedona and Lakeside Divisions. Mr. Kennedy explains each of the pro forma adjustments made to the Company's recorded test year accounts to make the Company's test year plant, revenues and expenses representative of the period during which new rates will be in effect, as authorized under A.A.C. R14-2-103.

Although Arizona Water was expecting add nearly $2 million in additional plant to upgrade and maintain service in calendar year 2000 and an additional $3 million of plant upgrades in 2001, waiting to file the application until after the year 2000 financial statements became available would have resulted in an unacceptable delay of at least 8 to 10 months. Instead, as Mr. Kennedy explains, Arizona Water has requested that certain post test year plant additions ("PTY Plant Additions") completed and placed in service on or before March 31, 2001, be included in its original cost rate base. Mr. Kennedy explains that this cut-off date would be at least two months prior to the date of the Staff report and four months prior to the anticipated hearing date, which would allow ample time for Staff to verify the completion of the new plant and its construction cost.

Mr. Kennedy also developed the Company's actual and pro forma adjusted Northern Group capital structure, which is based on the overall Company capital structure, weighted cost of debt and cost of common equity. At that time, the Company's new Series K bonds had not been issued, and Mr. Kennedy estimated the likely cost of such long-term debt. Using this estimate and the cost of common equity estimated by Dr. Zepp (12.9%), Mr. Kennedy concludes that the weighted average cost of capital is 11.62%. Mr. Kennedy adopted this adjusted weighted cost of capital as the fair and reasonable return.

Mr. Kennedy calculated each system and division's operating income deficiency by applying the 11.62% required fair return to the original cost rate bases to produce the required return and then deducted the adjusted net operating income from those amounts to produce the operating income deficiencies shown on Schedule A-1. Mr. Kennedy then multiplied the deficiency by the gross revenue conversion factor of 1.65026, which takes into account the impact of federal and state income taxes on the Company. This calculation produces the required increase in gross revenue shown on Schedule A-1. The operating income deficiency and required revenue increase produced by this computation for the Sedona Division was $768,303 and $1,267,898, respectively, and for the Lakeside Division is $616,402 and $1,017,222, respectively.

Mr. Kennedy concludes his direct testimony by discussing rate design and rate consolidation. Mr. Kennedy explains that divisional rate consolidation will match the existing functional organization and smooth out future rate variability. With rate consolidation the cost of service and required capital investments will be spread across a larger divisional customer base. Rate consolidation will also simplify future rate filings for the Northern Group. With respect to rate design, Mr. Kennedy recommends that the Commission eliminate the 1,000 gallons of water included in the current monthly minimum charge, while largely preserving the rate structure that was approved by the Commission in the Company's prior rate order, Decision No. 58120. Mr. Kennedy proposes small increases in the monthly minimum charges in order to move the Company's overall rate design closer to cost-based rates, in accordance with the prior decision.

b. Rebuttal Testimony.[1]

In his rebuttal testimony, Mr. Kennedy addresses the major areas of disagreement between Arizona Water, Staff and RUCO. These issues concern the Company's rate base (PTY Plant Additions, adjusted accumulated depreciation, construction work in progress and working capital) operating income issues (depreciation expense, property tax expense, income taxes, the appropriate gross revenue conversion factor, normalization of revenue and expenses, revenue from construction water sales and rate case expense), the Company's cost of debt, and rate design.

Mr. Kennedy begins by discussing the goal of an adjusted test year under the Commission's regulations governing applications for rate adjustments and the Commission's policies and practices. Mr. Kennedy states that, contrary to certain positions taken by Staff and RUCO, it is appropriate to make adjustments to recorded test year accounts and data in order to make those results representative of the actual period when the new rates will be in effect. Mr. Kennedy notes that pro forma adjustments of this nature must be based on known changes or events that affect test year results.

Mr. Kennedy then discusses several important policy issues presented by Arizona Water's application. First, Mr. Kennedy again explains the advantages that will result from consolidating the five systems of the Northern Group into two systems for ratemaking and other regulatory purposes. In response to opposition to this proposal by both Staff and RUCO, Mr. Kennedy notes that certain cross-subsidization already exists throughout the Northern Group and that rate consolidation would match the functional consolidation that already exists in the Sedona division between the Sedona, Rimrock and Pinewood systems and in the Lakeside division between the Lakeside and Overgaard systems, which share common divisional management and a labor pool. Mr. Kennedy also describes several significant advantages that result from rate consolidation or, as it is sometimes called, single-tariff pricing, as described in a recent publication of EPA and NARUC.

Mr. Kennedy next explains why Staff's recommended change to Arizona Water's method of computing its annual depreciation is unnecessary and inappropriate. For nearly 50 years, Arizona Water has used a single Company-wide composite depreciation rate. Staff, however, proposes that the Company be required to compute depreciation on a plant account by account basis. Mr. Kennedy explains that this would result in an accounting nightmare that would have a number of serious ramifications given that the Company has a total of 18 operating systems, while this proceeding concerns only the five operating systems that comprise the Northern Group. Mr. Kennedy also explains that implementation of Staff's proposal will be difficult and time-consuming. At the same time, Staff has not identified any tangible benefit supporting this change.

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[1] Mr. Kennedy's rebuttal testimony was original filed on July 27, 2001. Corrected rebuttal testimony was later filed on August 7, 2001. Mr. Kennedy corrected his rebuttal testimony to eliminate certain typographical and formatting errors. The substance of his rebuttal testimony did not change.

The next major policy issue addressed by Mr. Kennedy concerns Staff's proposed rate design, under which the Company's commodity charges would be modified from a single, flat charge per 1,000 gallons to an inverted tier rate design. The Staff accounting witness, Ms. Brown, testified that tiered rates would encourage conservation and preserve revenue stability. However, in response to Company data requests, Staff acknowledged that inverted tier rates, in which a greater amount of revenue is recovered from larger water users, create revenue instability. Further, Staff acknowledged that it performed no analysis on the impact of its proposed rate design and that a reduction in consumption due to tiered rates is <u>not</u> expected. Mr. Kennedy concludes that Staff's tiered rate design proposal is premature and requires additional study and analysis in order to determine the impact of this new rate design on the Company and its customers.

Mr. Kennedy then discusses various issues concerning the appropriate rate base, beginning with the Company's proposed pro forma adjustments for PTY Plant Additions. In his rebuttal testimony, Mr. Kennedy provides the actual cost of constructing the various projects that are proposed for inclusion in rate base that were completed and placed in service by March 31, 2001. Mr. Kennedy explains that all of these projects were in service by the cut-off date, with the exception of two projects for the Pinewood system. To help minimize any dispute concerning the PTY Plant Additions, Mr. Kennedy proposes that the actual cost of construction be used for the Pinewood system projects (which is approximately $150,000 <u>less</u> than the estimated amount), and that the estimated cost of construction be used for the remaining four systems (which is approximately $900,000 <u>less</u> than the actual cost of construction).

Mr. Kennedy then explains why Staff's proposed December 31, 2000 cut-off date for PTY Plant Additions is arbitrary and unreasonable. Mr. Kennedy notes that Staff was able to verify the completion of the PTY Plant Additions and Staff had an opportunity to audit the actual costs of construction well before its direct filing was due. Mr. Kennedy also emphasizes that the PTY Plant Additions proposed by the Company satisfy the criteria that are typically employed by the Commission in determining whether to allow the inclusion of additional plant in rate base: (1) the PTY Plant Additions are revenue-neutral, i.e., serve existing customers and not future growth, and (2) were placed in service a reasonable time before the hearing.

Mr. Kennedy next addresses Staff's adjustment to the Company's accumulated depreciation, by which the Company's accrued depreciation balance at the end of the test year was increased by a full 12 months of depreciation on <u>all</u> test year plant, in addition to the PTY Plant Additions. Mr. Kennedy explains why this adjustment to the accumulated depreciation balance is improper and conflicts with the recommendations of the NARUC.

Mr. Kennedy then explains the basis for including construction work in progress ("CWIP") in rate base. Mr. Kennedy testifies that the Company consistently has a substantial CWIP balance as a consequence of its ongoing investment in construction projects to maintain and improve the quality of service. Mr. Kennedy also discusses the areas of disagreement concerning the Company's working capital allowance, explaining why the Company's lead/lag study correctly computed the appropriate amount of cash working capital.

Mr. Kennedy next discusses various areas of dispute affecting Arizona Water's net operating income. With respect to property tax expense, Mr. Kennedy testifies that the Company will agree to use the new methodology adopted by the Arizona Department of Revenue for computing water utilities' full cash value, even though this new methodology will become effective for tax year 2002, but notes the inconsistency between the positions of Staff and RUCO in going two years beyond the end of the test year in estimating property tax expenses, while disputing the Company's pro forma adjustments such as PTY Plant Additions. Mr. Kennedy discusses the errors that appear in the pro forma adjustments to property tax expense proposed by Staff and RUCO, and recommends a different approach that is consistent with the new ADOR methodology.

Mr. Kennedy then discusses adjustments related to income taxes and the Company's gross revenue conversion factor. Mr. Kennedy notes that both Staff and RUCO treat each Northern Group system as if it were a separate corporation, which distorts the income tax effect of the proposed adjustments to revenue and expense items. In addition, this approach results in the computation of individual gross revenue conversion factors for each of the five Northern Group systems, which in turn results in operating income deficiencies.

Mr. Kennedy next testifies that the Company incorrectly annualized revenues in its initial filing, and is accepting Staff's revenue and expense annualization adjustment. Mr. Kennedy also states that the Company will accept an adjustment allowing recognition of revenues from construction water sales, which increases test year revenues and, therefore, lowers the ultimate revenue requirement, even though the revenue from this source is based on temporary service to contractors and, as a result, is unpredictable.

Mr. Kennedy then moves on to Arizona Water's cost of debt. He discusses the erroneous assumptions made by the Staff cost of capital witness, Mr. Reiker, in regard to the Company's Series K bond issue, which was placed in April 2001. Mr. Kennedy testifies that several potential purchasers indicated that they would require a "liquidity premium" due to the Company's small size.

Mr. Kennedy concludes his rebuttal testimony by discussing problems with the rate designs proposed by Staff and RUCO. Both of those parties proposed rates that would shift more revenue recovery into the Company's commodity charge, which is inconsistent with the rate design approved by the Commission in Decision No. 58120, issued in the Company's last rate proceeding. Mr. Kennedy also notes that RUCO's proposed rates would produce a revenue deficiency of nearly $240,000. The rate designs proposed by both parties would increase the volatility of the Company's revenue stream and move away from rates based on the cost of providing service.

c. Rejoinder Testimony.

In his rejoinder testimony, Mr. Kennedy deals with many of the same issues that are discussed in his rebuttal testimony. Mr. Kennedy begins by summarizing Arizona Water's final position which, as indicated above, would result in a total revenue increase for the Northern Group systems of approximately 35%.

Mr. Kennedy next addresses rate consolidation, again emphasizing that some consolidation already exists within the Northern Group and that previous Commission decisions cited in the surrebuttal testimony of RUCO witness Ms. Diaz Cortez reflect that the Commission's policy of encouraging consolidation.

Mr. Kennedy then addresses the areas of dispute concerning the Company's rate base, focusing again on PTY Plant Additions and Staff's erroneous adjustment to accumulated depreciation, which adds a full year of additional expense to the accumulated depreciation balance, effectively reducing rate base by more than $700,000. Mr. Kennedy again emphasizes that the Company's proposed cut-off date of March 31, 2001, is consistent with the Commission's typical requirements. The PTY Plant Additions are revenue-neutral and are intended to provide service to existing customers, as opposed to serving customer growth. Mr. Kennedy again explains that Staff and RUCO had ample time to audit the actual cost of constructing the PTY Additions and to verify that they had been completed and placed in service before their direct filings were due in late June.

Mr. Kennedy next addresses the Company's request to include its CWIP balance at the end of the test year in rate base, again explaining that the Company continually invests in the construction of facilities needed to ensure reliable service, which results in a CWIP balance. Mr. Kennedy concludes his discussion of rate base issues by again explaining the Company's lead/lag study and responding to the criticisms made by Staff and RUCO. Mr. Kennedy notes that the Staff witness's discussion in her surrebuttal testimony is internally inconsistent as well as being inconsistent with recent Commission decisions.

Mr. Kennedy then addresses the key income statement issues including revenue and expense annualizations, construction water sales, property taxes, income taxes and rate case expense. He next addresses the Company's capital structure and weighted cost of capital. Based on the issuance of the Series K bonds in April, the Company's capital structure consists of approximately 34% long-term debt and 66% common equity. Applying Dr. Zepp's estimated return on equity of 12.9%, the Company's overall weighted cost of capital is 11.38%.

Mr. Kennedy concludes his surrebuttal testimony by discussing several rate design issues. He again explains that the inverted tier rates proposed by Staff may result in revenue erosion and instability, and are unsupported by any analysis of the impact of this new rate design on customers' water use. Mr. Kennedy also explains that Staff's proposed monthly minimum charges would move away from cost-based rates and be inconsistent with the rate design approved in Decision No. 58120, in which the Commission rejected a similar proposal by RUCO. Finally, Mr. Kennedy again notes the revenue deficiency produced by RUCO's rates, which is a result of RUCO's adjustments to the test year bill count data. Mr. Kennedy explains why these adjustments are improper and undermine the purpose of the bill count, on which all parties to a rate proceeding must rely to determine the amount of revenue that will be produced by their proposed rates.

2. Summary of Michael J. Whitehead Pre-Filed Testimony.

a. Direct Testimony.

Mr. Whitehead begins by explaining the construction budgeting process that occurs annually for each of the Company's 18 water systems, which determines the Company's ultimate construction budget for the upcoming year. Based on the approved budget, the Company obtains bids from independent contractors, who are then retained by the Company on a project-by-project basis. Normally, these projects are awarded to the low bid contractor. All Company-funded projects are inspected by Company inspectors to ensure compliance with plans and specifications.

Mr. Whitehead goes on to explain that from 1993 to 1999 – the test year for this rate application – the Company has annually funded construction projects for each of the Northern Group systems in order to maintain infrastructure, resolve operational problems, comply with regulatory requirements and improve water service to its customers. Mr. Whitehead provides a table showing the dollar amount of annual plant additions for the 1990 – 2000 time period, as well as the proposed 2001 and 2002 construction budgets.

Mr. Whitehead then discusses the post test year plant additions that the Company proposes to include in rate base. These plant additions include construction projects funded by the Company that will be completed and placed in service prior to March 31, 2001. Mr. Whitehead testifies that these plant additions are non-revenue producing, i.e., they consist of wells, reservoirs, transmission mains and other projects for improving service to customers existing at the end of the test year, as opposed to providing service to new customers. The total adjustment to rate base is $3,374,488. Mr. Whitehead explains that the March 31, 2001 cut-off date is reasonable based on the timing of the application and the anticipated date on which the testimony of Staff will be due.

b. Rebuttal Testimony.

In his rebuttal testimony, Mr. Whitehead focuses on Arizona Water's proposed test year plant additions in response to the recommendations of Staff and RUCO. Mr. Whitehead notes that the Staff auditor, in her direct testimony, drew an arbitrary line at December 31, 2000, and recommended that no plant additions after that date be included in rate base. In addition, the Staff auditor disallowed certain plant items on the basis that these items were not "revenue neutral."

In responding to Staff's recommended cut-off date, Mr. Whitehead testifies that the cut-off date proposed by Arizona Water, March 31, 2001, provided ample opportunity for the Staff engineer to inspect all of the projects included in the Company's post test year plant additions and to verify that these projects had been placed in service and are used or useful. The Staff engineer's inspections took place on May 8 and May 16. Mr. Whitehead also explains that Arizona Water provided Staff, in response to Staff data requests, the final costs of constructing the projects. This information was provided on April 9, well before Staff's direct testimony was filed on June 26. Mr. Whitehead thus concludes that Staff had ample opportunity to both inspect and verify the completion of the projects and to audit their actual cost of construction in advance of Staff's direct filing.

Mr. Whitehead next testifies that Arizona Water will continue to fund additional construction projects after the March 31, 2001 cut-off date. He estimates that the Company will invest an additional $1,400,000 in these projects through the remainder of 2001. Consequently, even if the Company's post test year plant additions through March 31, 2001 are included in rate base, the rates authorized in this proceeding will understate the Company's investment.

Mr. Whitehead then addresses Staff's contention that post test year costs reflected in the Company's Blanket Services and Blanket Meters accounts be excluded from rate base. Mr. Whitehead explains that these blanket accounts include both new services and meters (not revenue neutral) and replacement of old services and meters (revenue neutral). While it is correct to remove the costs associated with new services and meters, it is incorrect to remove the costs associated with the replacement of old services and meters, which serve existing customers. Accordingly, Mr. Whitehead sponsors a revised summary schedule of the post test year plant additions through March 31, 2001, that removes the costs of services and meters installed to provide service to new customers, thus eliminating plant additions that are not revenue neutral.

Mr. Whitehead then addresses RUCO's recommendation that the cost of installing 80 feet of 12-inch steel casing across State Highway 260 in Lakeside be removed from rate base. Mr. Whitehead explains that the steel casing was installed to take advantage of an ADOT highway improvement project, which allowed Arizona Water to install the new casing by means of an open cut rather than having to bore under the highway at a later date. The project cost $17,912 to install, as opposed to a cost of approximately $40,000 in the future. The Company will utilize the new steel casing to replace an existing water line servicing the Show Low Estates subdivision in 2003.

Mr. Whitehead concludes by addressing certain recommendations of the Staff engineer concerning modifications of the Company's fire protection service tariff. The existing tariff language states, in part, that the Company "does not guarantee a specific water pressure or gallons per minute flow rate." This tariff language has been contained in various Company tariffs since 1977. Mr. Whitehead explains that this language is necessary and appropriate because water flow from a fire hydrant or main break will inevitably cause water system pressure to decrease, resulting in lower water pressure. Consequently, the Company cannot guarantee a specific water pressure or flow rate in these types of situations. Mr. Whitehead maintains that the current tariff language should be retained in order to protect the Company from liability.

c. Rejoinder Testimony.

In his rejoinder testimony, Mr. Whitehead again focuses on the Company's pro forma adjustment to rate base for post test year plant additions. Mr. Whitehead initially discusses the Staff auditor's attempt to justify her December 31, 2000 cut-off date, noting that the Staff auditor provided no legitimate reason for selecting that date or for rejecting the March 31, 2001 cut-off date proposed by the Company. Mr. Whitehead again testifies that the Company specifically chose March 31, 2001 to accommodate both Staff and RUCO by giving each party ample time to verify the completion of construction and to conduct audits of the construction costs.

Mr. Whitehead next addresses a new adjustment contained in the Staff auditor's surrebuttal testimony that would remove a project constructed for the Overgaard system. Mr. Whitehead verifies that this project was actually completed and placed in service before December 31, 2000, and that the data request response on which the auditor relied contained a typographical error.

Mr. Whitehead concludes by addressing RUCO's recommended disallowance of the cost of constructing the 12-inch steel casing under State Highway 260. In response to RUCO's argument that this project is not currently used or useful, Mr. Whitehead refers to a recent Commission decision involving Paradise Valley Water Company, Decision No. 59079 (May 5, 1995). In that case, the Commission agreed that a water utility's investment in rebuilding a well pump for use as a back-up in the event of an emergency was useful and prudent, and permitted the utility's investment in that plant to be included in rate base. Mr. Whitehead testifies that the Company's recently completed State Highway 260 improvement was likewise a prudent decision and is useful because it will allow the replacement of a main serving an existing subdivision at a substantially reduced cost, thereby resulting in lower rates in the long run.

3. Summary of William M. Garfield's Pre-Filed Testimony.

a. Direct Filing.

Mr. Garfield's direct testimony addresses four general areas. First, Mr. Garfield's direct testimony provides an overview of the Company's water storage tank maintenance program, which consists of repainting the interior coatings of such tanks every 14 years and the exterior coatings of such tanks every 7 years, on the average. Mr. Garfield testifies to the need for routine tank maintenance and points out that the cost of repainting water storage tanks has increased due to increased per-square-foot coating costs and an increase in the numbers of water storage tanks to be maintained.

Mr. Garfield then describes how water quality testing requirements have significantly changed throughout the Company's Northern Group due to the requirements of the EPA's implementation of the Safe Drinking Water Act, resulting in significant cost increases since 1990 – the Company's last test year that included the Company's Northern Group water systems.

Third, Mr. Garfield describes the Monitoring Assistance Program ("MAP"), a program administered by the Arizona Department of Environmental Quality ("ADEQ") under which water systems serving 10,000 or fewer people must participate and must pay an annual, variable fee to ADEQ. Mr. Garfield goes on to describe the need for a MAP surcharge mechanism whereby costs of MAP are adjusted annually to account for variable changes in costs, ensuring that the ratepayers pay no more or no less than actual MAP costs.

Fourth, Mr. Garfield testifies to a proposal made in June 2000 by the EPA to set a revised drinking water standard for arsenic at 5 parts per billion ("ppb"), with alternative standards considered at 3, 10 and 20 ppb. Mr. Garfield estimates that as many as 25 treatment plants could be needed in the Northern Group, and as many as 74 treatment plants company-wide, in order to comply with a revised arsenic maximum contaminant level of 3 ppb. In addition, Mr. Garfield estimates that capital costs for the Northern Group alone could be $8.4 million.

b. Rebuttal Testimony.

Mr. Garfield's rebuttal testimony and rejoinder testimony focuses on three areas. Mr. Garfield discusses the Staff's estimates of water testing costs and MAP costs and found them to be very similar to the Company's calculated water testing and MAP costs, but disagrees with

Staff's recommendation that the MAP surcharge mechanism be eliminated. MAP costs are variable and outside of the Company's control. Therefore, the MAP surcharge mechanism should be retained to ensure that the Company recovers only, and its ratepayers pay only, actual MAP costs. Mr. Garfield disagrees with RUCO's estimated water testing costs since they did not account for pro forma adjustments outside of the test year.

Second, Mr. Garfield testifies from an engineering perspective that the Staff's proposed minimum monthly charges for the Company's Northern Group would cause a shift away from cost-based rates. Staff gives no explanation given for such a shift, and no analysis is presented supporting such a change in minimum charges.

Third, Mr. Garfield agrees with Staff witnesses Scott and Brown that the revised arsenic MCL may have an adverse impact on the Company and could lead to the long-term detriment to the ratepayers if a mechanism to recover the costs of arsenic treatment is not developed. The Company also agrees with Mr. Scott that the Company's estimates of capital and operating and maintenance costs are reasonable. Mr. Garfield, however, disagrees with the Staff and RUCO and testifies that the issue is now ripe and that this rate case filing is the proper forum and the proper time to develop such a cost recovery mechanism. The new arsenic treatment facilities must be in place by no later than January 2006. Although Mr. Garfield presents evidence that the EPA will likely set the revised arsenic standard at 10 ppb, and not 5 ppb as previously proposed in June 2000, the number of treatment plants will not change significantly for the Northern Group. Mr. Garfield also testifies that the process of designing and constructing the water treatment plants must start before the end of 2001.

c. Rejoinder Testimony.

Mr. Garfield's rejoinder testimony begins with a discussion of the Company's request to continue the MAP surcharge. In response to the surrebuttal testimony of Mr. Scott, Mr. Garfield explains that the purpose of the MAP surcharge is to protect both the Company and its customers. He then explains that Mr. Scott may have misunderstood Mr. Garfield's rebuttal testimony and the Company's position. The Company is requesting that, while the surcharge remains in effect, it would be reset at zero based on the level of water testing expenses determined in this rate proceeding. In future years, the surcharge amount will be increased if MAP costs imposed by ADEQ increase above the authorized expense level or, conversely, will decrease if MAP costs are reduced by ADEQ. The Company is not proposing that the MAP surcharge remain in effect at its current cost recovery level.

Mr. Garfield also emphasizes again the necessity and appropriateness of retaining the surcharge. MAP costs vary annually due to factors outside Arizona Water's control. Consequently, either too much or too little revenue will be recovered under Staff's proposal, which would eliminate the surcharge, when MAP costs are adjusted by ADEQ.

Mr. Garfield next addresses issues pertaining to arsenic treatment and related capital costs and expenses. Mr. Garfield responds to Ms. Brown's assertion that "the issue is not ripe" by pointing out that Arizona Water will need to begin to plan for the construction of new treatment plants and related facilities as early as November 2001. The overall process of pilot testing, design, obtaining ADEQ approval, project bidding, construction, acquiring property, securing financing and training certified operators will take approximately 24 months to complete. Significant capital investment will be needed to treat groundwater for several of the Company's systems.

Mr. Garfield concludes by addressing the issue of Staff's proposed inverted tier rate design, noting that the Staff accounting witness testifies that customers' water demand will not change as a result of this rate design. Mr. Garfield notes that Staff has provided no evidence of the impact on customer demand and no evidence demonstrating that inverted tier rates are actually necessary. Given the lack of evidence supporting Staff's recommendation, Mr. Garfield urges that this proposal be rejected.

4. Summary of Dr. Thomas M. Zepp's Pre-Filed Testimony.

Dr. Zepp determined that Arizona Water's cost of common equity is 12.9% based on his estimates of the cost of common equity of large publicly-traded water and electric utilities and a determination of the additional cost of equity required by Arizona Water. Based on the discounted cash flow ("DCF") model and a risk premium analysis, he found that measures of the market cost of equity for large, publicly-traded water utilities fell in a range of 10.9% to 12.4%. Dr. Zepp found that Arizona Water has an equity cost that is 100 to 150 basis points higher than the publicly-traded utilities because it is more risky.

Dr. Zepp provided substantial support for his conclusion that Arizona Water has an equity cost that is higher than the cost of equity for sample utilities relied upon for DCF and CAPM equity cost estimates. He presented the results of a study that found utilities with a need to make above average size new investments required a return on equity that is 80 basis points higher than those with less of a need to make new investments. He also presented quantitative evidence that smaller water utilities require an equity return that is 97 basis points higher than larger water utilities and, in general, companies the size of Arizona Water require a return that is 137 basis points above the return required by companies the size of the publicly-traded water companies. Arizona Water needs to make such above average investments and is smaller than the utilities relied upon to make market-based equity cost estimates. Arizona Water also faces substantial risk because it must make significant investments of uncertain amounts to remove arsenic from its water supplies that other water utilities do not have to make. With severe limitations on the use of post test-year adjustments, there are increases in risk because of the lag before the new investment requirements and additional expenses are included in rates.

Dr. Zepp reviewed the direct and surrebuttal testimonies of Mr. Reiker and Mr. Rigsby and reported in his rejoinder testimony that even if only obvious problems with their approaches and updated equity costs are appropriately restated, as of August 21, 2001, their testimonies support an equity cost range of 10.7% to 11.6% for the publicly-traded utilities and 11.7% to 13.1% for Arizona Water Company.

With respect to market equity cost estimates for large water utilities:

- Dr. Zepp explains why the worst possible measure of growth to use in the constant growth DCF model is past and near-term forecasts of dividend per share growth. If near-term DPS growth is recognized, a DCF model that has different growth rates for near-term and terminal growth must also be adopted. Mr. Reiker did not propose such a model and thus DPS growth should not be considered. The fact that Mr. Reiker's DCF equity costs are below the cost of debt is clear evidence that use of DPS growth in the constant growth DCF model is flawed.

- Without including DPS growth in the DCF model, Dr. Zepp shows Mr. Reiker's initial equity cost estimate for large water utilities is 11.0% and falls within Dr. Zepp's range of 10.9% to 12.4%. When Mr. Reiker's August 21, 2001 equity costs are restated, Dr. Zepp found the equity cost range for the larger publicly-traded utilities to be 10.7% to 11.6%.

- Mr. Rigsby presented a DCF analysis that is based on internally inconsistent stock prices. Once internally consistent data are used, even if no other changes are made, his DCF equity cost range for large water utilities also falls in a range of 10.7% to 11.6%.

- Dr. Zepp explains that empirical tests of the CAPM approach Mr. Rigsby adopts show it will produce downward biased estimates of equity costs for any company with a beta less than 1.0. Typically utilities have betas less than 1.0 and thus his method will unavoidably bias downward the cost of equity estimate. Dr. Zepp recommends that method be given no weight because it is known to produce biased results.

Dr. Zepp explains that Staff witness Reiker and RUCO witness Rigsby have casually dismissed the fact that Arizona Water is clearly more risky than companies in the samples of larger, publicly-traded utilities they used to determine equity costs. Thus they ignore obvious evidence that Arizona Water has a higher equity cost. In his direct testimony, Dr. Zepp provides substantial quantitative evidence that supports a conclusion that Arizona Water is more risky and requires an equity return that is 100 to 150 basis points higher than the benchmark companies that neither witness has successfully rebutted.

- Arizona Water was unable to issue its Series K bonds at a cost as low as the rate that A-rated utilities could have obtained if they had issued bonds at the time the rate on the Series K bonds was set. Both the Staff and RUCO witnesses have attempted to sidestep this indisputable evidence that Arizona Water has an equity cost above the equity cost for the utilities relied upon to determine DCF and CAPM equity cost estimates. All of the water utilities in the sample of publicly-traded utilities used to determine the benchmark cost of equity have a rating of A or better and thus are less risky than Arizona Water.

- Mr. Reiker would just dismiss Arizona Water's additional risk by claiming it is not "systematic beta risk". He has no basis for such a cavalier dismissal of Arizona Water's added risk. Dr. Zepp presented evidence that indicates that part of the added risk is expected to be higher beta risk. He presented studies by Ibbotson Associates and an estimate of beta risk for Dominguez Water Company, a company approximately the size of Arizona Water, that indicate one should expect Arizona Water to have a beta bigger than the .61 average beta for the sample of larger water companies. The evidence on the expected difference in beta risk alone supports an equity risk premium for Arizona Water near the top of the 100 to 150 basis point range Dr. Zepp found was required.

- Another version of CAPM (that was not considered by Mr. Reiker) suggests there are "systematic risks" for size and distress as well as systematic beta risks. The added risks faced by Arizona Water because it is small and faces distress from the uncertainty of new arsenic removal requirements logically would fall into those classes of systematic risk if those risks did not instead increase beta risk.

- In short, whether one categorizes the extra risk faced by Arizona Water as systematic beta risk or puts the risk in some other category, if investors demand higher returns to provide capital to Arizona Water, the U. S. Supreme Court requires that such added risk be compensated. The available evidence indicates Arizona Water has a cost of equity that is 100 to 150 basis points higher than the larger, publicly-traded utilities.

Dr. Zepp testifies that minimal restatements of Mr. Reiker and Mr. Rigsby's equity cost studies indicate the sample publicly-traded utilities have market costs of equity that fall in a range of 10.7% to 11.6% and that Arizona Water's cost of equity falls in a range of 11.7% to 13.1% as of August 21, 2001. Nothing Mr. Reiker or Mr. Rigsby have presented justifies a return on equity below 12.9% recommended by Dr. Zepp.

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