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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission

COMMISSIONERS

DOCKETED

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

JUL 28 2006

DOCKETED BY *ne*

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. 68858

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.

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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.¹

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 ¹ 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.² 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.³

22 ² Staff based its position on language in Decision No. 61831, the District's prior rate case, which stated:
 23 Further, in order to allow Staff and intervenors an adequate time to review and audit any such
 24 adjustments, the Company shall limit its adjustments to add post-TY plant to include only plant
 25 that is used and useful and in service within 90 days of the date that the rate application is deemed
 sufficient.
 Decision No. 61831 at 4.

26 ³ See Chapter 13, Article 13-1, Section 13 of the Paradise Valley Town Code which provides:
 27 A. The minimum fire flow from all hydrants in the Town will be 1,500 gallons per minute
 (5,678.1 liters per minute).
 28 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 Chairman Hatch-Miller dated February 15,
21 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"⁴ 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 ⁴ 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,⁵ 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.⁶

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 ⁵ 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 ⁶ 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,⁷ 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,⁸ 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.⁹

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

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

26 ⁸ *See* Exhibit A-29.

27 ⁹ 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. § 40-336¹⁰ and A.R.S. § 40-361.B¹¹ 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.¹²

22 ¹⁰ A.R.S. § 40-336 provides:

23 The commission may by order, rule or regulation, require every public service corporation to maintain
 24 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 ¹¹ 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 ¹² Tr. at 100; Tr. at 310-314; Hearing Exh. A-29 (copy of a letter from the Town to Chairman 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.¹³ 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.¹⁴

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 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 ¹³ Cross-examination testimony of Paul G. Townsley, Tr. at 115.

28 ¹⁴ 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 recover \$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.¹⁵ RUCO proposes, as it has many times before,
24

25 ¹⁵ *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.¹⁶ 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 ¹⁶RUCO 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 they arrive 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 an overall cost
13 of capital and rate of return of 7.84 percent; Staff recommends 7.24 percent; and RUCO recommends
14 7.10 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,¹⁷ 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 ¹⁷ 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* betas¹⁸ 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 reached its 10.4 percent cost of equity recommendation for the Company by
9 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 ¹⁸ 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.¹⁹

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 ¹⁹ 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 new Public Safety surcharge. For
12 convenience of reference, a copy of Hearing Exh. S-9 is attached hereto as Exhibit B.

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

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

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

28

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

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

8 **5. Analysis and Conclusion**

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

21 For these reasons, we will order the Company to implement the alternative recommendation
22 presented by Staff commencing October 1, 2007. Once the Company has fully recovered its fire flow
23 project costs, the Public Safety surcharge will terminate, but revenues collected under the reduced
24 High Block surcharge will continue to be treated as CIAC in order to alleviate future rate increases,
25 as proposed by the Company (Direct Testimony of David P. Stephenson, Hearing Exh. A-18 at 34-
26 35). We will also order the Company, in its application of the methodology approved in Decision
27

28 ²⁰ See Hearing Exh. A-33.

1 68303, to deduct collections from the High Block surcharge and the Public Safety surcharge when
2 calculating the balance to which the AFUDC fire flow rate is applied, so that it will recover capital
3 costs only on its net investment in fire flow projects, as Staff recommends.

4 **IX. OTHER ISSUES**

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

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

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

- 21 1. The ACRM is based solely on actual costs and costs eligible for recovery, which are
22 depreciation, gross return, and recoverable O&M costs;
- 23 2. Actual rate recovery via the ACRM commences after new arsenic facilities are in
24 service and are in compliance with the new EPA MCL for arsenic;
- 25 3. Establishment of deadlines for filing the next rate case, without limit on the
26 Company's ability to file earlier, as per existing Commission orders;
- 27 4. An ACRM rate design composed of a 50/50 split of the recovery between monthly
28 minimum charges and volumetric charges, with the volumetric charges based on the

1 same inclining block rate design as approved in this proceeding;

- 2 5. A financial presentation composed of ten standard schedules;
- 3 6. Recoverable O&M costs to include only media replacement or regeneration, media
4 replacement or regeneration service, and waste disposal;
- 5 7. A deferral for future recovery of up to 12 months of recoverable O&M, without return,
6 commencing with the in-service date of facilities;
- 7 8. Two step-rate increases;
- 8 9. No true-up of the ACRM for under- or over- collection; and
- 9 10. Gross return included in the ACRM based on the return authorized in this proceeding.

10 Staff states that in general, an ACRM provides a methodology for recovering certain defined
11 costs related to arsenic treatment as well as to establish a mechanism for recovery of arsenic
12 treatment related costs from customers, and that recovery of those costs through an ACRM surcharge
13 terminates upon inclusion of the arsenic remediation related plant in rate base (Direct Testimony of
14 Alexander Igwe, Hearing Exh. S-6 at 20).

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

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

1 5. The Company should file hard copies of the ten schedules discussed in its
2 application.²¹ In addition, Staff reserves the right for further discovery as it deems
3 necessary related to the ACRM filings;

4 6. Rate design volumetric charges must be applied equally to all usage tiers; and

5 7. The Company should file an application for a permanent rate increase no later than
6 September 30, 2008.

7 There was no objection to Staff's recommendations regarding the ACRM.²² Staff's
8 recommendations are reasonable and should be adopted. The ACRM proposed by the Company will
9 be approved consistent with the Staff recommendations.

10 **B. PVCC Special Contract**

11 The Company filed an application on December 22, 2005, requesting approval of an
12 agreement between the Company and PVCC. After Staff filed a Staff Report on the issue on January
13 31, 2006, the Company requested consolidation of the PVCC application with this rate application,
14 and the cases were consolidated by Procedural Order. The agreement has a term of 15 years, and is
15 written to become effective upon approval of new rates in this proceeding. The agreement allows
16 PVCC a 15 percent discount from the Company's standard turf rates, and requires PVCC to accept
17 delivery of service during off-peak hours, except in circumstances where it can demonstrate to the
18 Company that its then-existing needs cannot be satisfied during such period. PVCC has constructed,
19 at its sole expense, a storage reservoir and associated facilities, which allow it to take water from the
20 Company during off-peak hours and store it for future use.

21

22 ²¹ Staff states that the schedules the Company proposes to file are as follows:

- 23 1. Balance Sheet – The most recent balance sheet for the total Company at the time of filing the ACRM
 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.

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

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

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

7 Staff recommended approval of the agreement, and further recommended that the Company
8 be required to request Commission approval of any future amendments to the agreement. Staff also
9 recommended that the Company be required to file with the Commission an executed copy of the
10 agreement within 30 days of its execution.

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

14 * * * * *

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

17 **FINDINGS OF FACT**

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

24 2. On June 17, 2005 the Company filed cost of service testimony and Schedules G and
25 H.

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

27 4. On July 18, 2005, Staff docketed a copy of a letter informing the Company that its
28 application as amended on June 17, 2005 met the sufficiency requirements set forth in the

1 Commission's rules.

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

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

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

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

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

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

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

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

25 13. A Procedural Order was issued on February 28, 2006, consolidating the Company's
26 rate application with the above-captioned application filed by the Company on December 22, 2005.
27 The December 22, 2005 application requested Commission approval of an agreement between the
28 Company and PVCC which would allow PVCC a 15 percent discount from the Company's standard

1 turf rates.

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

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

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

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

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

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

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

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

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

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

25 24. On July 3, 2006, the Town filed in these consolidated dockets a Motion for Leave to
26 File Amicus Curiae Brief, to which was attached an amicus curiae brief.

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

1 26. Based on the adjusted test year data, as determined herein, the FVRB for the District is
2 \$14,351,471.

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

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

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

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

11 31. The High Block surcharge approved herein will apply to residential usage in the third
12 tier (over 80,000 gallons/month), in addition to the normal third tier charge, and will be \$2.15 per
13 1,000 gallons/month.

14 32. The High Block surcharge approved herein will apply to commercial usage in the
15 second tier (over 400,000 gallons/month), in addition to the normal second tier charge, and will be
16 \$2.15 per 1,000 gallons/month.

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

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

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

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

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

3 38. The ACRM proposed by the Company is reasonable and shall be approved consistent
4 with the Staff recommendations.

5 39. The PVCC special contract as discussed herein is reasonable and shall be approved.

6 40. Based on information provided by the Company, water use for the year 2004 totaled
7 3,165,233,000 gallons, and the Company reported producing 3,512,659,000 gallons. This resulted in
8 a water loss of 9.89 percent, which is acceptable to Staff (Direct Testimony of John A. Chelus,
9 Hearing Exh. S-5 at 4).

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

13 42. The District is located within the Phoenix Active Management Area ("AMA") and
14 consequently is subject to reporting and conservation rules administered by ADWR. The Phoenix
15 AMA reported that the District is in total compliance with the ADWR reporting and conservation
16 rules (*id.* at 4).

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

20 44. The District has no outstanding compliance issues with the Commission.

21 45. The Company has an approved curtailment plan tariff on file that applies to all its
22 service areas, including the District.

23 46. Because an allowance for the property tax expense of the District is included in the
24 District's rates and will be collected from its customers, the Commission seeks assurances from the
25 Company that any taxes collected from ratepayers have been remitted to the appropriate taxing
26 authority. It has come to the Commission's attention that a number of water companies have been
27 unwilling or unable to fulfill their obligation to pay the taxes that were collected from ratepayers,
28 some for as many as twenty years. It is reasonable, therefore, that as a preventive measure Arizona-

1 American annually file, as part of its annual report, an affidavit with the Utilities Division attesting
 2 that the Company is current in paying its property taxes in Arizona.

3 **CONCLUSIONS OF LAW**

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

6 2. The Commission has jurisdiction over the Company and the subject matter of the
 7 applications.

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

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

12 **ORDER**

13 IT IS THEREFORE ORDERED that Arizona-American Water Company is hereby directed to
 14 file with the Commission on or before July 31, 2006, revised schedules of rates and charges
 15 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
3" Meter	94.50
4" Meter	157.25
6" Meter	315.00
Paradise Valley Country Club	See Below
Fire Protection	\$ 5.00

24 COMMODITY RATES

25 Residential – All Meter Sizes

Gallonage Charge – per 1,000 Gallons	
From 1 to 25,000 Gallons	\$ 0.76
From 25,001 to 80,000 Gallons	1.65
Over 80,000 Gallons	2.18

Commercial – All Meter Sizes

Gallage Charge – per 1,000 Gallons	
From 1 to 400,000 Gallons	\$ 1.27
Over 400,000 Gallons	1.56

Turf Facility Customers

Gallage Charge – per 1,000 Gallons	
All Gallons	\$ 1.00

Paradise Valley Country Club (Contract Rate)

Minimum of Charges Based Upon Applicable	
Meter Size	
From 1 to 2,500,000 Gallons	Turf Rate Less 15
	Percent
Over 2,500,000 Gallons	Turf Rate Less 15
	Percent
All Surcharges Applicable to Commercial	
Customers	Less 15 Percent

Other General Metered

Gallage Charge – per 1,000 Gallons	
All Gallons	\$1.46

Fire Protection

Gallage Charge – per 1,000 Gallons	
All Gallons	No Charge

Resale Customers

Gallage Charge – per 1,000 Gallons	
All Gallons	\$1.46

Service Line and Meter Installation Charges:
(Refundable pursuant to A.A.C. R14-2-405)

5/8" x 3/4" Meter	\$480.00
3/4" Meter	560.00
1" Meter	650.00
1 1/2" Meter	895.00
2" Meter	1,555.00
3" Meter	2,235.00
4" Meter	3,440.00
6" Meter	6,195.00

SERVICE CHARGES:

Establishment	\$20.00
Establishment (After Hours)	40.00
Reconnection (Delinquent)	30.00
Reconnection (Delinquent & After Hours)	60.00

1	Meter Test, if meter is correct	15.00
	Deposit	*
2	Deposit Interest	*
	Reestablishment (Within 12 Months)	**
3	NSF Check	12.00
	Deferred Payment, Per Month	1.50%
4	Meter Reread (If Correct)	10.00
5	Late Charge per month	1.50%

Monthly Service Charges for Fire Sprinkler

7	4" or Smaller	***
	6"	***
8	8"	***
	10"	***
9	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.

High Block Usage Surcharge Treated as Contributions in Aid of Construction

Per Customer

Residential Customers:

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

All usage in the third tier, in addition to normal third tier charge: \$2.15 per 1,000 gallons

Commercial Customers:

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

All usage in the second tier, in addition to normal second tier charge: \$2.15 per 1,000 gallons

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

Per Customer

Residential Customers:

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

3 All usage in the second and third tier, in addition to normal
4 second and third tier charges

5 From October 1, 2007 until recovery of fire flow projects is complete \$1.00 per 1,000 gallons

Commercial Customers:

6 All commercial customers with usage in the second tier
7 will pay a surcharge on second tier usage.

8 All usage in the second tier, in addition to normal second tier charges

9 From October 1, 2007 until recovery of fire flow projects is complete \$1.00 per 1,000 gallons
10

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

13 IT IS FURTHER ORDERED that Arizona-American Water Company shall notify its affected
14 customers of the revised schedules of rates and charges authorized herein by means of an insert in its
15 next regularly scheduled billing in a form and manner acceptable to the Commission's Utilities
16 Division Staff.

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

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

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

26 IT IS FURTHER ORDERED that, as part of the Earnings Test schedule filed in support of the
27 ACRM, Arizona-American Water Company shall incorporate adjustments conforming to Decision
28

1 No. 67093, as discussed in Staff's recommendations set forth herein.

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

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

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

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

13 IT IS FURTHER ORDERED that Arizona-American Water Company shall annually file as
14 part of its annual report, an affidavit with the Utilities Division attesting that the Company is current
15 in paying its property taxes in Arizona.

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

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

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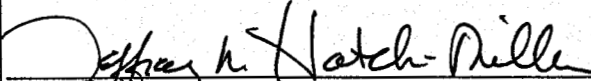
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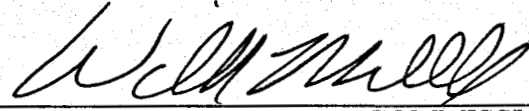
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1 IT IS FURTHER ORDERED that Arizona-American Water Company shall continue to use
2 the depreciation rates for its Paradise Valley Water District set forth in Exhibit 4 to Hearing Exh. S-6.

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

4 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

5
6 
7 CHAIRMAN

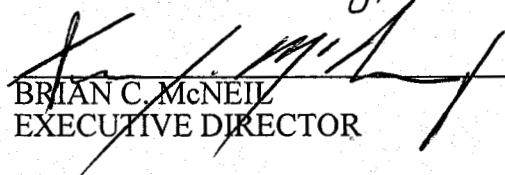

8 COMMISSIONER

9 Commissioner Spitzer resigned
effective 7-21-2006
10 COMMISSIONER


11 COMMISSIONER


12 COMMISSIONER

13 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive
14 Director of the Arizona Corporation Commission, have
15 hereunto set my hand and caused the official seal of the
16 Commission to be affixed at the Capitol, in the City of Phoenix,
17 this 28th day of July, 2006.


18 BRIAN C. McNEIL
19 EXECUTIVE DIRECTOR

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DISSENT _____

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
5 Arizona-American Water Company
6 101 Corporate Center
7 19820 North 7th Street, Ste. 201
8 Phoenix, AZ 85024

9 Scott S. Wakefield
10 RUCO
11 1110 West Washington Street, Ste. 220
12 Phoenix, AZ 85007

13 Robert J. Metli
14 SNELL & WILMER, LLP
15 One Arizona Center
16 400 E. Van Buren
17 Phoenix, AZ 85004
18 Attorneys for Paradise Valley Country Club

19 Christopher Kempley, Chief Counsel
20 Maureen A. Scott, Senior Staff Attorney
21 Keith A. Layton, Attorney
22 Legal Division
23 ARIZONA CORPORATION COMMISSION
24 1200 West Washington Street
25 Phoenix, AZ 85007

26 Ernest G. Johnson, Director
27 Utilities Division
28 ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, AZ 85007

EXHIBIT A

BEFORE THE ARIZONA CORPORATION COMMISSION

1
2 JEFF HATCH-MILLER
Chairman
3 WILLIAM A. MUNDELL
Commissioner
4 MARC SPITZER
Commissioner
5 MIKE GLEASON
Commissioner
6 KRISTIN K. MAYES
Commissioner
7

Arizona Corporation Commission
DOCKETED

NOV 14 2005

DOCKETED BY	
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RECEIVED

NOV 16 2005

ARIZONA CORPORATION COMMISSION
HEARING DIVISION

8 IN THE MATTER OF THE APPLICATION
9 OF ARIZONA-AMERICAN WATER
10 COMPANY, INC.'S REQUEST FOR AN
11 ACCOUNTING ORDER AUTHORIZING
12 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

13 Open Meeting
14 November 8 and 9, 2005
Phoenix, Arizona

15 BY THE COMMISSION:

16 On June 3, 2005, Arizona-American Water Company ("Arizona-American" or
17 "Company") filed a rate application, Docket No. W-01303A-05-0405, with the Arizona
18 Corporation Commission ("Commission") for a determination of the current fair value of its utility
19 plant and property and for increases in its rates and charges based thereon for utility service by its
20 Paradise Valley water district. Within that application was a request for an accounting order
21 authorizing the deferral of capital costs incurred by the Company's Paradise Valley system related
22 to public safety associated with fire flows.

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

24 Pursuant to Staff's request to aid the Company in its request for expedited action, on
25 October 5, 2005, the Company filed a request to bifurcate its rate application and to separate the
26 accounting order portion from the rate application. The Company requests an accounting order
27 authorizing the deferral of capital costs by the Company's Paradise Valley system related to public
28 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. 68858**

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.

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

DECISION NO. 68858

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.

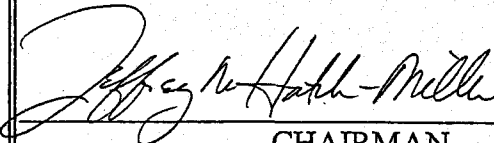
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DECISION NO. 68858

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.

6 BY THE ORDER OF THE ARIZONA CORPORATION COMMISSION

7 
8
9 CHAIRMAN

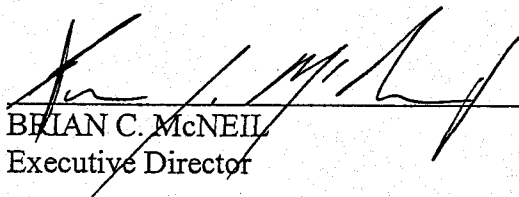

COMMISSIONER

10 
11 COMMISSIONER


12 COMMISSIONER


12 COMMISSIONER

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

18 
19 BRIAN C. McNEIL
20 Executive Director

21 DISSENT: _____

23 DISSENT: _____

24 EGJ:JRM:rdp/
25
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27

28 DECISION NO. 68858

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

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DECISION NO. 68858

EXHIBIT B

EXHIBIT No. S-9

ALTERNATIVE 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 2nd Tier residential rate of \$1.00 per 1,000 gallons and for the 1st 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 2nd 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				Cummulative
	Top Tier at \$2.15	Top Tier at \$3.15	2nd Tier Res at \$1.00	1st Tier Com. at \$1.00	
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>		