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BEFORE THE ARIZONA CORPORATION COMMISSION RECEIVED

1
2 WILLIAM A. MUNDELL
Chairman
3 JIM IRVIN
Commissioner
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Commissioner

Arizona Corporation Commission

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AZ CORP COMMISSION
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6 IN THE MATTER OF THE APPLICATION OF)
7 ARIZONA WATER COMPANY, AN ARIZONA)
CORPORATION, FOR ADJUSTMENTS TO ITS)
8 RATES AND CHARGES FOR UTILITY)
SERVICE FURNISHED BY ITS NORTHERN)
9 GROUP AND FOR CERTAIN RELATED)
APPROVALS.)

Docket No. W-01445A-00-0962

ARIZONA CORPORATION
COMMISSION'S CLOSING
BRIEF

10
11 The Commission's Utilities Division staff ("Staff") hereby files its closing brief in the above-
12 captioned matter. In this brief, Staff will address the major disputed issues between the applicant
13 Arizona Water Company ("AWC" or "Company") and Staff. On any issue not specifically addressed
14 in this brief, Staff maintains its position as represented in its testimony.

15 **I. The Commission Should Adopt Staff's Cut-off Date of December 31, 2000 for Post-Test**
16 **Year Plant Additions, Because Allowing Post-Test Year Plant Additions Through**
17 **March 31, 2001 Is Not in Keeping With Commission Rules and Policy, Would Violate**
Widely-Accepted Ratemaking Principles, and Would Result in Unfair Rates.

18 The Company filed its rate application on November 22, 2000, and chose a test year ending
19 December 31, 1999. Despite its choice of a test year ending December 31, 1999, AWC seeks to
20 include in its rate base plant additions that occurred outside the test year up through March 31, 2001.

21 The Company's post-test year plant addition proposal asks the Commission to accept post-test year
22 rate base additions extending a full 15 months past the end of AWC's chosen test year. This request
23 should be denied as unreasonable. It is unreasonable because allowing post-test year plant installed
24 up to 15 months after the Company's chosen test year would not be in keeping with widely accepted
25 ratemaking principles, would be contrary to Commission policy, and would result in unfair rates.

26 The Commission should therefore reject the Company's proposed cut-off date of March 31, 2001
27 for post-test year plant additions, and should instead adopt Staff witness Crystal Brown's alternative
28 cut-off date of December 31, 2000.

1 **A. The Company's Proposed March 31, 2001 cut-off date is inconsistent with the**
2 **Commission's rule on selecting an appropriate historical test year, and with the**
3 **Commission's normal treatment of post-test year plant.**

4 Commission rules require the end of the test year, which is the 1-year historical period used
5 in determining rate base, operating income and rate of return, to be the most recent practical date
6 available prior to the filing. A.A.C. R14-2-103(A)(3)(p). Compliance with Commission rules and
7 recognition of Commission policy on appropriate test year selection requires a company to choose
8 a test year that includes all major rate base and operating income items needed to support its rate
9 application, and to include pro forma adjustments to its chosen test year that are consistent with past
10 Commission action under similar circumstances. In AWC's last permanent rate proceeding, the
11 Commission allowed one year of post-test year plant additions in rate base. Decision No. 58120
(December 23, 1992) at 4.

12 On cross examination in this proceeding, AWC witness Ralph Kennedy acknowledged that
13 the Company controlled the timing and filing of its application, (Tr. at 59), and that it took the
14 Company about six months to prepare the subject rate application for filing. (Tr. at 61). Based on
15 a six-month preparation period for a rate application filing, AWC could have chosen a test year
16 ending March 31, 2000 and still have filed its application on November 22, 2000. AWC could have
17 made such a test year choice and reasonably requested the inclusion of revenue neutral post-test year
18 plant additions through March 31, 2001, because such a request would have been consistent with the
19 Commission's action regarding post-test year plant additions in Decision No. 58120. However,
20 AWC instead chose to base its filing on a test year ending December 31, 1999 and to argue for
21 inclusion in rate base of not just one year of post test year plant additions, but for the inclusion in rate
22 base of one year plus an additional three months of post test year plant. Inclusion of the additional
23 three months of post-test year plant additions would be inconsistent with prior Commission action.

24 AWC had control over the timing of its rate application filing and was aware of Commission
25 rules and past Commission action in AWC rate proceedings, and voluntarily chose a test year ending
26 December 31, 1999. Under these circumstances, the Commission should not include post-test year
27 plant additions in this case beyond December 31, 2000.

28

1 **The Company's Proposed March 31, 2001 cut-off date would violate widely accepted**
2 **ratemaking principles.**

3 AWC's proposal that the Commission allow a pro forma adjustment to its rate base to
4 account for plant additions occurring after December 31, 2001 is not only inconsistent with the test
5 year AWC chose, but it also offends widely accepted ratemaking principles. The known and
6 measurable and matching concepts are recognized and accepted ratemaking principles. Widely
7 accepted ratemaking principles allow pro forma adjustments to rate base only if those adjustments
8 are known and measurable. Likewise, widely accepted ratemaking principles allow pro forma
9 adjustments to rate base only if those adjustments do not violate the matching principle. The
10 matching principle requires revenues, expenses, and rate base to be properly matched in time, so that
11 the effect of a change in one is reflected in the other two.

12 While the Commission does consider pro forma adjustments allowing post-test year plant
13 additions in rate base, it generally limits such consideration to circumstances in which no significant
14 matching issues or known and measurable issues preclude such pro forma adjustments. The
15 Commission generally limits inclusion of post-test year plant additions to those cases in which the
16 post-test year plant additions are known and measurable, are revenue neutral, i.e., do not violate the
17 matching principle, and extend no more than one year after the test year. Staff recognizes this
18 general Commission practice and uses it as a guideline in making determinations on whether
19 particular post-test year pro forma plant adjustments are appropriate.

20 A pro forma post-test year plant adjustment generally will not violate the matching principle
21 if the adjustment is revenue neutral. However, the more removed the post-test year rate base
22 additions are from the test year on which revenues and expenses are based, the more likely it
23 becomes that the effect of the post-test year plant is not revenue neutral. In this case, Ms. Brown
24 determined that allowing revenue neutral post-test year plant additions one year after the test year
25 in rate base was appropriate and consistent with Commission practice. Specifically, Ms. Brown
26 determined that the practice of allowing 12 months of post-test year plant additions to rate base was
27 appropriate in this case because the plant was revenue neutral and known and measurable, but that
28 allowing post-test year plant additions in rate base beyond 12 months was likely to violate the

1 matching principle. Ms. Brown also determined, based on the application, that a pro forma
2 adjustment allowing plant additions in rate base beyond 12 months was not warranted by any special
3 circumstances. She therefore did not audit the 2001 plant. (See Surrebuttal Testimony of Crystal
4 Brown at 4 at 7).

5 Because of the likelihood that allowing plant additions in rate base beyond 12 months would
6 violate the matching principle, and because the Company has not shown that a pro forma adjustment
7 allowing plant additions in rate base beyond 12 months is warranted by any special circumstances,
8 the Commission should not allow post-test year plant additions beyond December 31, 2000 in rate
9 base.

10 **C. The March 31, 2001 cut-off date would result in unfair rates for both the Company's**
11 **shareholders and customers.**

12 Customers can be asked to pay for plant placed in service after the test year when it will help
13 a company maintain financial health and provide quality service. However, that additional cost
14 should not be excessive or unfair. AWC chose a December 31, 1999 test year, yet requested
15 inclusion of post-test year plant additions through March 31, 2001, thus creating a mismatch of rate
16 base, revenues, and expenses.

17 Ms. Brown, by contrast, made a known and measurable adjustment to test year plant. Ms.
18 Brown allowed inclusion of post-test year plant additions though December 31, 2000, consistent with
19 past Commission decisions. While Staff's recommended December 31, 2000 cut-off date allows the
20 Company to include some plant in rate base that was added after AWC's chosen test year, Staff's
21 cut-off date does not risk a significant mismatch among rate base, revenues, and expenses.

22 Going beyond 12 months after the end of the test year increases the likelihood of a significant
23 mismatch among rate base, revenues, and expenses, thereby increasing the likelihood that AWC's
24 customers will pay too much for their service. Ms. Brown uses recognized methods that produce
25 fair and reasonable results to determine her cut-off date. Her December 31, 2000 cut-off date fairly
26 balances the interests of AWC's shareholders and ratepayers. Ms. Brown's cut-off date results in
27 just and reasonable rates, and for this reason the Commission should reject AWC's proposed cut-off
28 date of March 31, 2001, and should adopt Ms. Brown's cut-off date of December 31, 2000.

1 **II. The Commission Should Adopt Ms. Brown's Recommendation to Calculate The**
2 **Accumulated Depreciation to the Same Cut-off Date As That Used for the Post-Test**
3 **Year Plant.**

4 The Company's pro forma accumulated depreciation adjustment is incorrect because it does
5 not properly account for the pro forma post-test year plant additions, and also because it fails to
6 properly account for depreciation on existing test year plant. Therefore, AWC's proposed
7 adjustment to accumulated depreciation expense should not be adopted. Adoption of AWC's
8 proposed adjustment would yield an unfair result. The Commission should instead adopt Ms.
9 Brown's adjustment to accumulated depreciation expense because it properly accounts for her
10 recommended pro forma post-test year plant additions and for depreciation on existing test year plant
11 through December 31, 2000. Ms. Brown's adjustment will have no adverse effect on AWC's
12 financial records as the Company claims.

13 **A. The Company's proposed accumulated depreciation adjustment is unfair to its**
14 **customers.**

15 The Commission should adopt Ms. Brown's recommendation to calculate the accumulated
16 depreciation to the same cut-off date as that used for the post-test year plant. Going outside the test
17 year to include plant will increase rate base. If the accumulated depreciation account is not
18 correspondingly increased, AWC's shareholders will experience a windfall at the expense of AWC's
19 ratepayers. Therefore, to be fair to AWC's ratepayers, the depreciation expense on post-test year and
20 all other plant should be added to the accumulated depreciation balance and subtracted from gross
21 plant. To do otherwise would overstate rate base, causing AWC's customers to pay more in rates
22 than they should.

23 **B. The amount of the pro forma adjustment to depreciation expense does not need to**
24 **match the pro forma adjustment to accumulated depreciation.**

25 The Company's argument that there is a need to match the depreciation expense amount to
26 the accumulated depreciation amount for ratemaking purposes is fundamentally flawed. Its argument
27 that the depreciation expense amount must match the accumulated depreciation amount is valid for
28 financial accounting purposes, but not for ratemaking purposes. For ratemaking purposes, the
Company's argument is fundamentally flawed because pro forma adjustments relating to post-test

1 year plant are not recorded in a company's general ledger. A pro forma adjustment is a ratemaking
2 tool to effect a more realistic relationship between revenues, expenses, and rate base. A.C.C. R14-2-
3 103 (A)(3)(i). Pro forma adjustments only reflect proposed ratemaking treatment, and do not directly
4 affect accounting records. Therefore, whether or not the pro forma adjustment to depreciation
5 expense and accumulated depreciation are equal will have no effect on a company's financial
6 records. None of the adjustments that Ms. Brown recommended will cause an imbalance of debits
7 and credits on the Company's books, and the Commission must therefore reject this AWC argument.

8 **III. The Commission Should Adopt Ms. Brown's Recommendation to Exclude Construction**
9 **Work In Progress ("CWIP") From Rate Base.**

10 Most of AWC's CWIP that existed at the end of the test year would have been closed to plant
11 in the year 2000. Ms. Brown recommends including revenue neutral year 2000 plant additions in
12 rate base; accordingly, including CWIP in rate base would result in double counting of plant, thus
13 overstating rate base. Any CWIP remaining after the year 2000 plant additions should also be
14 excluded from rate base because CWIP is not used and useful, and the Commission normally only
15 allows plant that is used and useful in rate base. The Company's argument that CWIP should be
16 included in rate base in the same way that prepayments, materials, supplies, and required bank
17 balances, as components of working capital, are included in rate base is contrary to Commission
18 rules and should be rejected.

19 **A. CWIP is not a component of working capital.**

20 The Company did not present any arguments to show why any of Ms. Brown's arguments
21 for excluding CWIP from rate base were inappropriate. Rather, the Company argued that CWIP
22 should be included in rate base in the same way that prepayments, materials, supplies and required
23 bank balances, as components of working capital, are included in rate base. The Company's
24 reasoning does not follow widely accepted ratemaking principles and should be rejected. The nature
25 of CWIP differs from the nature of prepayments, materials and supplies, and bank balances. While
26 CWIP balances vary with the Company's capital improvement and growth requirements, the
27 components of working capital are dependent upon the Company's operating requirements.

28 The Commission normally excludes CWIP as a component of working capital. A.A.C. R14-

1 2-103 in Schedule B-5, "Computation of Working Capital," sets forth a working capital calculation,
2 and CWIP is not included in that calculation. The Commission should reject AWC's arguments for
3 inclusion of CWIP in rate base beyond that which was closed to plant in the year 2000.

4 **IV. The Commission Should Reject the Company's Proposed Cash Working Capital**
5 **Calculation Because It Includes the Rate Increase, Associated Taxes, and the Return**
6 **on Net Invested Capital Needed to Pay Dividends On Common Stock.**

7 AWC proposes a methodology to calculate its cash working capital that the Commission
8 rejected in AWC's last rate decision. The Commission should not adopt that methodology in this
9 rate case, either, because it would result in an overstatement of cash working capital and therefore
10 an overstatement of rate base. The Commission should instead adopt Ms. Brown's cash working
11 capital formula, which is recognized and taught in seminars sponsored by the National Association
12 of Regulatory Utility Commissions ("NARUC").

13 The Company calculated its cash working capital by subtracting its total expense lag days
14 from its total revenue lag days. The result divided by 365 days constitutes the Company's proposed
15 cash working capital. This method is flawed because it includes the rate increase, associated taxes,
16 and the return on net invested capital needed to pay dividends on common stock. Additionally, the
17 Company's method excludes interest expense, a cash item, from the calculation.

18 The Company's calculation of cash working capital for its Lakeside System can be used to
19 demonstrate these flaws. The revenue requirement for the Lakeside system is composed of total
20 operating expenses (including depreciation expense and deferred income tax expense) and a return
21 on rate base. The Company removed depreciation expense and deferred income taxes from total
22 expenses prior to subtracting total expenses from total revenue. Therefore, depreciation expense and
23 deferred income taxes (non-cash expenses) still remain in the company's proposed cash working
24 capital. Company Schedule B-6, Page 1 of 3, replicated below, illustrates the point:

24 Lakeside System

25	Total \$Days Revenue	\$57,954,570	(includes depr exp, def inc tax, all other exp & return)
26	Depreciation Exp	\$0	(Company removed from total expenses)
27	Def Inc Tax Exp	\$0	(Company removed from total expenses)
28	All Other Expenses	<u>\$33,041,502</u>	

1 Net \$Day Rev Lag \$24,913,067 (includes depr exp, def inc tax, & return)

2 Divided by 365 Days 365

3 Co. Proposed CWC \$ 68,255 (includes depr exp, def inc tax, & return)

4 The Company's error overstates cash working capital and therefore overstates rate base. As
5 mentioned earlier, the Company's method contains other errors because it includes the rate increase,
6 associated taxes, and the return on net invested capital needed to pay dividends on common stock.
7 The Commission explicitly rejected the Company's proposed method of calculating cash working
8 capital in its last rate proceeding because it included these items. Decision 58120 at 10.

9 Ms. Brown's cash working capital method is recognized and taught in seminars sponsored
10 by NARUC. The Company's method is not. Ms. Brown's cash working capital formula properly
11 includes interest expense. Interest expense requires a cash payment. The Company collects cash
12 used to make interest payments prior to the interest due date. During the time that AWC has
13 possession of these funds, the funds are a source of cost-free cash that it can use until making
14 payments to the creditors. Ms. Brown's methodology therefore appropriately included interest
15 expense in her lead-lag calculation, whereas the Company's methodology did not.

16 Because AWC's proposed methodology is flawed and the Commission rejected it in Decision
17 58210, the Commission should again reject it. The Commission should instead adopt Ms. Brown's
18 recommendation to utilize the methodology recognized by NARUC.

19 **V. The Commission Should Adopt Ms. Brown's Recommended Rate Case Expense.**

20 AWC requests that the Commission allow rate case expense of \$216,000. Ms. Brown is
21 recommending that AWC be allowed to recover rate case expense of \$100,000, because AWC has
22 expertise in its salaried employees, and this amount is reasonable based on her analysis of the rate
23 case expense the Commission has allowed for other similar companies. Ms. Brown recommends
24 that the Commission reject the Company's arguments that the number of water systems involved in
25 this case justifies a greater rate case expense. Finally, the Commission should not allow the \$15,000
26 included for contingencies in the Company's request.

27 **A. AWC has expertise in its salaried employees.**

28 AWC's witness Ralph Kennedy has past experience as the Chief of Accounting and Rates

1 for the Arizona Corporation Commission. (Direct Testimony of Ralph Kennedy at 2). Mr. Kennedy
2 is now the Vice President and Treasurer of one of the largest privately owned water companies in
3 Arizona with a highly competent staff of accountants and engineers at his disposal. Based on Ms.
4 Brown's analysis of other similar companies, Ms. Brown determined that AWC has the expertise
5 on its staff to develop, file, and defend this rate case for \$100,000. Ms. Brown continues to
6 recommend that the Commission adopt her proposed \$100,000 rate case expense amount.

7 **B. The number of water systems involved in this case does not justify a greater rate case**
8 **expense.**

9 The Company's argument that it should receive a higher amount of rate case expense because
10 it has more water systems is weak. The Company's argument ignores that the number of water
11 systems involved in this case actually results in a large number of common costs and avoided costs.

12 For example, the costs of paying the salaried accounting and engineering staff to analyze,
13 accumulate, summarize and report the financial information for the five individual systems filed in
14 the application was not included in the Company's \$216,000 rate case expense request. This is
15 because the Company's salaried employees are paid the same amount whether or not the Company
16 files a rate case. Further, Arizona Water filed only one application, paid for only one cost of capital
17 study, attended only one hearing, and likely will attend only one open meeting related to this case.

18 AWC did not file five separate applications, pay for five separate cost of capital studies, have to
19 attend five separate hearings, nor will it have to attend five separate open meetings.

20 **C. Ratepayers should have to pay only for actual and reasonable costs.**

21 AWC's proposed rate case expense includes \$15,000 for contingencies. Ratepayers should
22 not have to pay for potential contingencies, but only for actual and reasonable costs. Ms. Brown's
23 recommended rate case expense therefore does not include the Company's proposed \$15,000 for
24 contingencies.

25 Ms. Brown agrees with the Company that rate case expense should be based on the
26 reasonable and necessary expenses actually incurred. However, the terms "reasonable" and "actually
27 incurred" are not synonymous. In the recent Far West Water Company rate case, the Commission
28 reduced the Company's actually incurred \$215,000 rate case expense to \$120,000. See Decision No.

1 62649 (June 13, 2000). In the present case, AWC has experienced far fewer complexities than the
2 Far West case, which had an emergency rate hearing, a permanent rate hearing, and a reopening of
3 the permanent rate hearing in order to determine the amount of plant that would be included in its
4 rate base. Because this case does not involve the same level of complications as the recent Far West
5 rate case, the Commission should not allow the same amount of rate case expense. The Commission
6 should instead adopt Ms. Brown's proposed rate case expense of \$100,000, which is based on her
7 analysis of the rate case expense that the Commission has allowed for similarly situated companies.

8 **VI. The Commission Should Adopt Ms. Brown's Corrected Recommended Property Tax**
9 **Expense Amount.**

10 The Commission should adopt Ms. Brown's property tax calculation methodology because
11 it properly normalizes property tax expense, correctly uses the test year ending balance for CWIP,
12 and uses the correct Arizona Department of Revenue ("ADOR") methodology for determining
13 assessed value. However, Staff has a correction to make to Schedule CSB-17 for each system. It
14 has been discovered that an incorrect rate was used on line 15 of each schedule, which resulted in
15 a property tax expense total of half of what it should be for each system. The corrected property tax
16 expense totals, by system, should be as follows: Lakeside, \$95,646; Overgaard, \$44,810; and
17 Rimrock, \$18,238. Other than the error in using an incorrect rate, Ms. Brown's property tax
18 calculation is correct and should be adopted.

19 Ms. Brown's property tax calculation normalizes property tax expense by using an average
20 revenue in the property tax calculation that is weighted to include one year of recommended revenue
21 and two years of test year revenue. Normalizing property tax in this manner provides the Company
22 with full recovery of property taxes over a three-year period following a rate case.

23 The Company's method of calculating property tax expense should not be adopted because
24 it contains numerous errors. For instance, the correct CWIP balance to use in the property tax
25 calculation is the test year ending balance, but AWC used the December 31, 2000, CWIP balance
26 in its calculation of property tax, while providing no justification for using this alternative. Ms.
27 Brown's methodology used the test year ending CWIP balance in the calculation of property tax
28 expense.

1 Additionally, Ms. Brown verified with an official at the Property Valuation and Equalization
2 Section of the ADOR that the net book value of vehicles is deducted in the calculation of "Full Cash
3 Value" whether purchased or leased. AWC did not make this deduction in its calculation of property
4 tax. Further, Ms. Brown also verified that the full cash value is multiplied by the assessment ratio,
5 currently 0.25, to determine the assessed value that is used in the property tax computation. AWC
6 failed to recognize use of the assessment ratio in its calculation of property taxes.

7 **VII. The Commission Should Adopt Ms. Brown's Recommended Income Tax Expense**
8 **Amount.**

9 The Commission should reject the Company's proposal to calculate the state and federal
10 income taxes for the Northern Group on a company-wide basis because the proposal is not consistent
11 with past Commission decisions on this issue. The Commission has consistently calculated the
12 income tax separately for individual systems within a company. To name a few examples, income
13 tax expenses were calculated on an individual system basis for Citizens Utilities Company,¹ the
14 water and sewer systems of Far West Water Company² and, the water and sewer systems of Sedona
15 Venture Company.³

16 AWC's last rate proceeding included all of its 18 water systems. Consequently, the
17 Commission used one Gross Revenue Conversion Factor in that case. In the instant case, however,
18 AWC has brought in only its Northern Group, which is made up of only five of its 18 water systems.
19 Ms. Brown therefore followed the general Commission practice of calculating the income taxes on
20 an individual system basis rather than on a group basis. In testimony in this case, AWC's witness
21 Mr. Kennedy agreed that Ms. Brown's income tax formula produced the correct result for given
22 income levels, stating that "the program will produce the correct result for a single company"
23 (See Rebuttal Testimony of Ralph Kennedy at 38).

24 The Commission should adopt Ms. Brown's methodology, because it is consistent with past
25 Commission action and produces the correct results for the systems.

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28 1 Decision No. 60172 (May 7, 1997) and Decision No. 58118 (December 12, 1992).

 2 Decision No. 62649 (June 13, 2000).

 3 Decision No. 62425 (April 3, 2000) and Decision No. 57878 (June 3, 1992).

1 **VIII. The Commission Should Adopt Ms. Brown's Recommended Component Depreciation**
2 **Rates.**

3 Compared with a composite depreciation rate, component rates provide a better matching of
4 the cost of individual assets over their useful lives. In addition, component rates more accurately
5 reflect the actual cost of service on an ongoing basis when plant is added or retired. A composite
6 rate fails to recognize changes in the cost of service as individual plant items are added and retired.
7 Because the long-run benefits of changing from composite to component depreciation rates will
8 serve the public interest, Ms. Brown recommends that the Commission adopt component
9 depreciation rates in this case.

10 **IX. The Commission Should Adopt Ms. Brown's Recommended Rate Design.**

11 AWC is requesting that the rates of its Northern Group's five systems be consolidated.
12 Because the Company failed to show any significant benefit that would result from its rate
13 consolidation plan, Ms. Brown recommends that the Commission continue to establish individual
14 rates for each of the Northern Group's five systems in order to avoid cross-subsidization among
15 water systems, which would result in unfair rates.

16 AWC argues against Ms. Brown's recommended tiered rate structure, claiming that it will
17 result in rate instability. However, Ms. Brown's proposed tiered rates involve an insignificant shift
18 in revenue from commodity to minimum charges, and the inelasticity of demand for water provides
19 a large degree of inherent revenue stability. Therefore, AWC's arguments should be rejected, and
20 Ms. Brown's rate design should be adopted.

21 **A. Rate consolidation among the Northern Group's systems would cause cross-**
22 **subsidization among systems and result in unfair rates.**

23 AWC claimed in its direct testimony that rate consolidation would equalize operational cost
24 fluctuations, spread the cost of capital improvements among systems within a division, moderate rate
25 changes, and simplify accounting and rate filings. (See Direct Testimony of Ralph Kennedy at 33-
26 34). However, the Company did not provide any evidence in this proceeding showing that cost
27 reductions would result from the rate consolidation. (Tr. at 57-58). Unless the cost of service is
28 identical (or almost identical) for all systems on a consolidated rate, one or more systems will

1 subsidize the others. Such cost shifting promotes disproportionate growth in high-cost areas, which
2 is detrimental to ratepayers on the whole.

3 Ms. Brown reviewed the average consumption for 5/8-inch meter customers for each of the
4 systems. The average monthly use for the five systems in the two divisions follows:

5 **Lakeside Division:**

6

Lakeside	3,700 gallons
Overgaard	2,100 gallons

7

8 **Sedona Division**

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Sedona	9,300 gallons
Pinewood	2,000 gallons
Rimrock	6,200 gallons

10

11 These large variations in usage provide no support for the Company's proposal to consolidate rates.

12 Because of this, and because the Company failed to show any significant benefit to its rate
13 consolidation plan, the Commission should adopt Ms. Brown's recommendation for individual rates
14 for each of the Northern Group's five systems in accordance with her recommended rate design.

15 **B. Ms. Brown's recommended tiered rate structure is appropriate because of the**
16 **inelasticity of demand for water and because her proposed shift in revenue from**
16 **commodity to minimum charges is insignificant.**

17 A recent study funded by the American Water Works Association Research Foundation and
18 the United States Bureau of Reclamation found that, in the short run (a year or less), water demand
19 responds very little to changes in price of water primarily because water service has no close
20 substitutes. Consequently, the Company is not likely to experience any significant decrease in
21 customer usage. In the long run, if the Company finds that customer usage is significantly
22 decreasing, it can file an application to increase its rates.

23 The shift in revenue from commodity to minimum charges in the rate design Ms. Brown
24 proposed is insignificant. Thus, revenue stability is largely preserved at the existing level with her
25 proposed rates. In addition, the inelasticity of demand for water provides a large degree of inherent
26 revenue stability. Companies and customers throughout the state have implemented and accepted
27 tiered rate structures. A relatively large utility such as Arizona Water should have no more difficulty
28 implementing tiered rates than the Class D and E water utilities that have accomplished this task

1 successfully.

2 **X. The Commission Should Continue to Calculate the “Increase In Gross Revenue”**
3 **According To A.A.C. R14-2-103(B).**

4 The “Increase In Gross Revenue” calculation is set forth in A.A.C. R14-2-103 (B), Schedule
5 A-1, “Computation of Increase in Gross Revenue Requirements.” It is calculated by multiplying the
6 operating deficiency by the Gross Revenue Conversion factor. The “Increase In Gross Revenue” is
7 added to the test year revenue to determine the revenue requirement. (See Direct Testimony of
8 Crystal Brown at 10).

9 The Company calculated its “Increase In Gross Revenue” by first developing a set of rates
10 and then applying these rates to its historical billing determinants. AWC’s method clearly does not
11 follow the widely accepted ratemaking principle that the revenue requirement should be developed
12 using the cost of service. The Commission has adopted this ratemaking principle in A.A.C. R14-2-
13 103(B). AWC did not attempt to defend its erroneous position in its rebuttal testimony, and its
14 witness Ralph Kennedy acknowledged during cross-examination that the Company’s calculation of
15 its proposed “Increase In Gross Revenue” depends upon AWC’s rate consolidation proposal. (Tr.
16 at 69-71). Ms. Brown calculated the “Increase In Gross Revenue” according to the method set forth
17 in A.A.C. R14-2-103 (B), and she recommends that this method be continued in this case.

18 **XI. The Commission Should Adopt Staff’s Recommended Capital Structure, Cost of Debt,**
19 **and Cost Of Equity.**

20 The Commission should adopt Staff witness Joel M. Reiker’s recommended capital structure,
21 cost of debt, and return on equity (ROE), as well as Mr. Reiker’s recommended overall rate of return
22 (“ROR”). Mr. Reiker’s analysis is fair, objective, and relies on mainstream financial theory and
23 principles.

24 **A. Mr. Reiker’s Capital Structure**

25 Mr. Reiker recommends the following capital structure:
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Table 1

Mr. Reiker's Capital Structure	
Long-term debt	34.67%
Common equity	65.33%
Total	100.00%

(See Direct Testimony of Joel M. Reiker at 3).

Mr. Reiker's recommended capital structure represents AWC's most current capital structure. The Commission should adopt Mr. Reiker's capital structure because it is more current than the capital structure proposed by the Company, and the Company does not rebut Mr. Reiker's recommendation.

B. Mr. Reiker's Cost of Debt

Mr. Reiker recommends an 8.48 percent cost of debt. Mr. Reiker has adjusted the Company's proposed 8.88 percent cost of debt by 1) adjusting the yield to maturity on the Company's Series I bonds to correct a mistake in the Company's application, 2) recalculating the yield to maturity on the Company's recently issued Series K bonds to reflect the full \$15,000,000 issuance, and 3) assuming total issuance costs of \$20,000 for the Series K bonds when calculating its yield to maturity. (See Direct Testimony of Joel M. Reiker at 6). The Company offers no rebuttal to Mr. Reiker's recommended cost of debt.

C. Mr. Reiker's Cost of Equity

Mr. Reiker recommends a ROE of 10.25 percent based on the results of his discounted cash flow ("DCF") and capital asset pricing model ("CAPM") analyses. Mr. Reiker calculated six DCF estimates for a sample of publicly traded water companies. Mr. Reiker's DCF estimates are based on historical dividend ("DPS") growth, earnings ("EPS") growth, and sustainable growth, as well as projections for DPS, EPS, and sustainable growth provided by *The Value Line Investment Survey*. The average of Mr. Reiker's DCF estimates for water companies is 9.52 percent. (See Direct Testimony of Joel M. Reiker at 16). Mr. Reiker also calculated CAPM estimates for the water companies. The acceptable results of Mr. Reiker's CAPM analysis of water companies averaged 10.96 percent. The midpoint of Mr. Reiker's DCF and CAPM estimates for water companies is 10.24 percent. (See Direct Testimony of Joel M. Reiker at 20).

1 Mr. Reiker also calculated DCF and CAPM estimates for a sample of publicly traded electric
2 companies. The overall average of Mr. Reiker's DCF estimates for his sample of electric companies
3 was 10.03 percent, and the average of his acceptable CAPM estimates for electric companies was
4 11.06 percent. The midpoint of both Mr. Reiker's DCF and CAPM estimates for electric companies
5 is 10.54 percent. (See Direct Testimony of Joel M. Reiker at 21). The following table presents Mr.
6 Reiker's consolidated DCF and CAPM results:

7 **Table 2**

Sample	Result
Water Companies	10.24%
Electric Companies	10.54%

10 Mr. Reiker recommends a ROE of 10.25 percent, consistent with his cost of equity
11 estimate of 10.24 percent for water companies. Mr. Reiker's ROE recommendation is at the
12 lower end of his consolidated estimates because the average capital structure of the companies
13 used in his analyses contains less equity and more debt than AWC's capital structure. Less
14 equity and more debt equate to greater financial risk to the companies in Mr. Reiker's analyses.
15 Therefore, the companies in Mr. Reiker's analyses have a higher average cost of equity than
16 AWC.

17 **D. Mr. Reiker's Rate of Return**

18 Mr. Reiker recommends an overall ROR of 9.64 percent, which is presented in the following
19 table:

20 **Table 3**

Capital Source	Percentage	Cost	Weighted Cost
Long-term debt	34.67%	8.48%	2.94%
Common equity	65.33%	10.25%	6.70%
Cost of capital			9.64%

24 **XII. Company Witness Zepp's DCF Analyses Should Be Rejected.**

25 **A. Dr. Zepp's Dividend Yield is Inappropriately Calculated**

26 Dr. Zepp performed DCF analyses on the same sample of water companies and a similar
27 sample of electric companies as analyzed by Mr. Reiker. Dr. Zepp does not appropriately calculate
28 the dividend yield component of the DCF model. (See Direct Testimony of Joel M. Reiker at 22-23).

1 Dr. Zepp calculates the average 3-month and 12-month dividend yield of his sample companies by
2 using high and low stock prices for the 3-month and 12-month periods ending in August 2000. (See
3 Direct Testimony of Thomas M. Zepp, Tables 7 and 12). This approach is inappropriate because
4 only the most recent stock price is relevant according to the efficient markets hypothesis. Dr. Zepp's
5 use of a historical, rather than spot, dividend yield results in stale DCF estimates that were irrelevant
6 the day his direct testimony was filed.

7 **B. Dr. Zepp Relies Exclusively on Analysts' Forecasts**

8 Dr. Zepp's DCF analysis should also be rejected because it relies exclusively on analysts'
9 forecasts for future sustainable growth and earnings growth. This method produces unrealistically
10 high DCF estimates because it is widely known in the financial community that professional
11 analysts' forecasts of future earnings tend to be overly optimistic. Dr. Zepp's exclusive use of
12 analysts' forecasts is based on an *unreasonable* assumption that investors rely exclusively upon those
13 forecasts when purchasing stocks. Mr. Reiker provides sufficient evidence in his direct testimony
14 showing that the earnings forecasts of professional analysts tend to be overly optimistic or biased.
15 (See Direct Testimony of Joel M. Reiker at 24-25). Mr. Reiker estimates dividend growth in the
16 DCF model by using a combination of analysts' forecasts of future growth as well as recent historical
17 growth. This approach is based on the *reasonable* assumption that investors in general consider both
18 sources when buying stocks. Dr. Myron Gordon, pioneer of the DCF model in utility rate cases,
19 supports this method of using a combination of analysts' forecasts for future earnings growth along
20 with a typically lower figure. (See Surrebuttal Testimony of Joel M. Reiker at 8).

21 **C. Dr. Zepp's Criticism of Mr. Reiker's Dividend Growth Rate**

22 The Commission should reject Dr. Zepp's criticism of Mr. Reiker's use of historical and
23 projected dividend growth in the DCF model. Dr. Zepp concludes that past DPS growth and near-
24 term DPS growth are the worst indicators of future growth when an industry is in transition and
25 companies within that industry are in the process of attempting to increase their financial strength.
26 (See Rebuttal Testimony of Thomas M. Zepp at 8). In response, Staff contends that dividend
27 growth should be included in the DCF model because the DCF model is predicated on DPS growth.
28 Further, investors receive dividends, not earnings per share, and the discounted value of dividends

1 received in the first few years of owning a stock are reflected in a portion of its market price, whether
2 DPS are expected to grow more rapidly in the future or not. (See Direct Testimony of Joel M. Reiker
3 at 5).

4 The Commission should reject Company Exhibit A-10, which was entered into evidence
5 during Mr. Reiker's cross-examination. In Exhibit A-10, the Company eliminates Mr. Reiker's DCF
6 estimates based on dividend growth, thus inflating Mr. Reiker's final DCF estimates. The Company
7 proposes to eliminate Mr. Reiker's lowest DCF estimates because they are lower than Arizona
8 Water's embedded cost of debt. This reasoning is flawed because the embedded cost of debt cannot
9 be compared to the incremental cost of equity. Further, simple economics can drive the cost of
10 equity below the embedded cost of debt at any given time. In addition to the reasons stated above,
11 Exhibit A-10 should be rejected for the simple reason that it is statistically flawed. When the lowest
12 value in a sample is eliminated, a corresponding adjustment should be made to the highest value in
13 order to calculate the mean.

14 **XII. Dr. Zepp's Risk Premium Estimates Should Be Rejected.**

15 Dr. Zepp performs what he calls a "risk premium" analysis by relying on 485 past
16 Commission decisions concerning ROEs for electric utilities. (See Direct Testimony of Thomas M.
17 Zepp at 39). This Commission should reject Dr. Zepp's analysis because it is circular. If regulatory
18 commissions continually relied on the ROEs granted by other commissions in other jurisdictions,
19 the market would never update the allowed ROE, except to account for changes in the risk-free rate.

20 Further, the Commission should not rely on ROEs determined in other jurisdictions and under
21 unknown circumstances to estimate AWC's cost of equity. Dr. Zepp's approach assumes that other
22 regulators in other jurisdictions possess greater knowledge than this Commission of what a fair and
23 reasonable return on equity is. (See Direct Testimony of Joel M. Reiker at 25).

24 **XIII. Dr. Zepp's CAPM Estimates Should Be Rejected.**

25 In his CAPM analysis, Dr. Zepp relies on the consensus forecast of the 10-year Treasury rate
26 for the first quarter of 2001. (See Direct Testimony of Thomas M. Zepp at 41). The Commission
27 should reject this approach because it is not consistent with the efficient markets hypothesis.
28 Analysts who forecast future Treasury rates do not have any more information about the future than

1 what is already reflected in current Treasury yields. Therefore, the most appropriate Treasury yield
2 to use in the CAPM is the current yield. Analysts' tendencies to be wrong in their Treasury yield
3 forecasts is evident when we examine the actual yield on 10-year Treasuries for the first quarter of
4 2001, which averaged 5.15 percent, seventy-five basis points below the consensus forecast for the
5 same period used by Dr. Zepp. Dr. Zepp's CAPM estimates should also be rejected because his
6 estimate of the current market risk premium relies exclusively on *Value Line's* projected five-year
7 forecasts. (See Direct Testimony of Joel M. Reiker at 26-27).

8 **XIII. Dr. Zepp's 100 To 150 Basis Point Risk Premium Should Be Rejected.**

9 Dr. Zepp suggests adding an additional 100 to 150 basis points to his cost of equity estimates
10 to account for several so-called risk factors. These include the use of a historical test year, a new
11 arsenic standard, and size. (See Direct Testimony of Thomas M. Zepp at 16-26). All three so-called
12 risk factors should be rejected.

13 **A. Historical Test Year**

14 Dr. Zepp asserts that AWC faces more risk than large water utilities because its rates are
15 based on a historical test year. This claim is without merit for several reasons. First, Staff makes
16 reasonable pro forma adjustments to actual test year results to obtain a normal or more realistic
17 relationship between revenues, expenses, and rate base. Second, this Commission does not normally
18 grant cost of equity premiums to account for the use of a historic test year. Finally, to the extent that
19 the risk associated with the use of a historic test year is unique to AWC, it is unsystematic, and has
20 no effect on the cost of equity. (See Direct Testimony of Joel M. Reiker at 28-29).

21 **B. Arsenic Standard**

22 Dr. Zepp claims that AWC's cost of equity is higher than the cost of equity to the water
23 companies used in his analyses because of the Environmental Protection Agency's ("EPA") proposed
24 revision of the arsenic drinking water standard. This claim is also without merit. All of the water
25 companies used in Dr. Zepp's and Mr. Reiker's analyses are subject to the EPA's new arsenic
26 standard. (See tr. at 223). Once again, to the extent that AWC faces any unique risk associated with
27 a new arsenic standard, it is unsystematic and has no effect on the cost of equity. (See Direct
28 Testimony of Joel M. Reiker at 29). Finally, the issue is irrelevant to the cost of capital because the

1 Company has requested that the arsenic-related capital cost recovery mechanism be deferred for
2 another decision in this proceeding. Dr. Zepp was unaware of the Company's request when
3 questioned by Staff at the hearing. (Tr. at 229).

4 **C. Size**

5 Dr. Zepp cites studies that he claims support his position that AWC's small size relative to
6 publicly traded water companies warrants a higher cost of equity. (See Direct Testimony of Thomas
7 M. Zepp at 21-24). The Commission should reject the Ibbotson Associates study cited by Dr. Zepp
8 because it is irrelevant to this proceeding. The Ibbotson Associates study focuses on the phenomenon
9 that smaller firms have historically enjoyed higher returns than larger firms have. (See Direct
10 Testimony of Thomas M. Zepp at 21-22). This study is irrelevant because it is not utility-industry
11 specific.

12 During cross-examination of Dr. Zepp, Commission Staff entered Exhibit S-4 into evidence.
13 Exhibit S-4 is an academic study conducted by Annie Wong, published in the *Journal of the*
14 *Midwest Finance Association* ("Wong study"). (See Staff Exhibit S-4). The Wong study is the only
15 utility-industry specific study cited in this proceeding. The findings of the Wong study support Mr.
16 Reiker's position that small utilities do not have higher equity risk than large utilities. Therefore,
17 it would be improper to adjust for firm size in utility rate proceedings.

18 In his rebuttal testimony, Dr. Zepp misconstrues the data in the Wong study by ignoring the
19 statistical significance of the data. (See Surrebuttal Testimony of Joel M. Reiker at 11). Dr. Zepp
20 again disregarded the statistical significance of the data in the Wong study during re-direct
21 examination when he claimed that the data in Wong's Table 3 do not support her conclusion. This
22 is simply not the case. Ms. Wong considered the statistical significance of her data and concluded
23 that "there is no need to adjust for the firm size in utility rate regulations." Staff has shown that
24 calculating such a test statistic is a normal procedure. (See Staff Exhibit S-3 at 194). Finally, Dr.
25 Zepp's inability to define a Type I Error, a simple statistical term, during cross-examination, (Tr. at
26 224-225), calls into question his ability to interpret the statistical data in the Wong study.

27 Another study cited by Dr. Zepp is a study conducted by the California Public Utilities
28 Commission ("CPUC study"). (See Direct Testimony of Thomas M. Zepp at 22-23). This study is

1 also irrelevant and should be rejected. The CPUC study should be rejected because it focuses on
2 Class B, C, and D companies with fewer than 10,000 customers. AWC has over 60,000 customers.

3 Finally, Dr. Zepp introduces his own study which he claims supports his position that smaller
4 water utilities require higher costs of equity than larger water utilities ("Zepp Study"). (See Direct
5 Testimony of Thomas M. Zepp at 23-24). The Commission should reject the Zepp Study because
6 it inappropriately relies on only four companies. First, the Zepp Study simply compares DCF cost
7 of equity estimates for two publicly traded water companies in California to two larger California
8 companies over eleven years. The companies in the Zepp Study were not randomly selected, which
9 renders its use for statistical inference highly questionable. Second, as Mr. Reiker demonstrates in
10 his surrebuttal testimony, the risk premium calculated in the Zepp Study is not statistically different
11 from zero. (See Surrebuttal Testimony of Joel M. Reiker at 12 and Schedule JMR-S8).

12 Dr. Zepp attempts to invalidate Mr. Reiker's statistical test of the Zepp Study by claiming
13 that Mr. Reiker 1) conducted the wrong type of test and 2) used too high a significance level. (See
14 Rejoinder Testimony of Thomas M. Zepp at 7-8). Dr. Zepp is incorrect on both points. First, the
15 statistical test conducted by Mr. Reiker, a two-tailed test, is the appropriate test because the question
16 is whether the risk premium calculated in the Zepp study is statistically different from zero. A one-
17 tailed test, which Dr. Zepp claims is the appropriate test, is only appropriate when the question is
18 whether a statistic is greater than or less than a test number. Second, Mr. Reiker's use of a 95
19 percent significance level is appropriate because it is the most common significance level used in
20 statistics. Staff Exhibit S-3, an excerpt from a statistics book, states that tests are normally designed
21 "so that the risk of committing a type 1 is less than 5 percent." This corresponds to a 95 to 99
22 percent significance level. Once again, it should be noted that Dr. Zepp's inability to define a Type
23 I Error during cross-examination calls into question his ability to question Mr. Reiker's statistical
24 test of the Zepp Study.

25 **XIV. The Commission Should Only Consider AWC's Systematic Risk.**

26 Following sound principles of corporate finance, Mr. Reiker considers only AWC's
27 systematic risk to be relevant to the cost of equity. (See Direct Testimony of Joel M. Reiker at 7-9).
28 This is in contrast to Dr. Zepp's claim that certain "firm-specific" risks increase AWC's cost of

1 equity. (See Rebuttal Testimony of Thomas M. Zepp at 23-25; see also Rejoinder Testimony of
2 Thomas M. Zepp at 5-6). Consistent with corporate finance theory, to the extent that a particular risk
3 is unique to AWC, it has no effect on the cost of equity and should not be considered when setting
4 the ROR.

5 The Company offers little to rebut Mr. Reiker's reliance on corporate finance theory, except
6 to note that certain financial models have evolved from the original Sharpe-Lintner CAPM. (See
7 Rebuttal Testimony of Thomas M. Zepp at 24-25). The only attempt to discount the CAPM came
8 when the Company asked Mr. Reiker to read from a chapter of the textbook *Fundamentals of*
9 *Corporate Finance*, entitled "What We Do Not Know: Seven Unsolved Problems in Finance." The
10 Commission should note that the financial theories Mr. Reiker subscribes to are located in a chapter
11 of the same textbook, entitled "What We Do Know: The Six Most Important Ideas in Finance."

12 **XVI. The Commission Should Consider Mr. Reiker A Credible Witness.**

13 Rather than question the substance of Mr. Reiker's analysis, the Company focuses on his
14 credibility as a witness. This is a blatant attempt to steer the Commission's attention away from the
15 un rebuttable data in Mr. Reiker's analysis. In doing so, the Company offers Exhibit A-11, a
16 comparison of Mr. Reiker's DCF and CAPM estimates in this case with those calculated by Mr.
17 Reiker in the Gold Canyon Sewer Company rate case. The Commission should reject Exhibit A-11
18 because it is frivolous. The most cursory review of Mr. Reiker's testimony in the Gold Canyon
19 Sewer case shows that he used different companies as comparables. The Company did not take issue
20 with the comparables chosen by Mr. Reiker in this case, nor did Gold Canyon Sewer Company take
21 issue with the comparables chosen by Mr. Reiker in that case. To the contrary, unless it is
22 problematic, Mr. Reiker generally agrees with a company's choice of comparables in order to avoid
23 the issue.

24 The cost of capital analysis of a water company in one case cannot be compared to the cost
25 of capital analysis of another company in a different case, especially if the latter is a *sewer* company.
26 Further, the capital markets determine the cost of capital on a daily basis. The cost of equity of any
27 company can change drastically from day to day.

28 The Commission should reject Exhibit A-11 as irrelevant. Mr. Reiker relied upon sound

1 principles of corporate finance in his analysis with regard to the facts in this particular case.

2 **XVII. The Commission Should Adopt Staff Witness Marlin Scott Jr.'s Recommendation of**
3 **an Annual Water Testing Expense of \$72,065 and the Corresponding Elimination of**
4 **AWC's Existing Monitoring Assistance Program ("MAP") Surcharge.**

5 Staff witness Scott is recommending an adjusted test year annual water testing expense
6 amount of \$72,065, which includes its 2001 annual MAP costs. On cross-examination, AWC
7 witness William M. Garfield agreed that Staff's and the Company's estimates of water testing costs,
8 including MAP costs, were very similar, coming to approximately \$72,000. (Tr. at 104-105). AWC
9 witness Mr. Garfield also testified that the water testing costs including the MAP testing costs should
10 be included in the rate base calculation for the test year. (Tr. at 105). Retaining the MAP surcharge
11 mechanism would require reducing Mr. Scott's adjusted test year water testing expense amount to
12 \$29,394, would result in a continuing need for AWC to make annual filings regarding the MAP
13 surcharge, and would entail additional administrative costs necessary to either charge or refund
14 collected MAP surcharges to customers. (See Surrebuttal Testimony of Marlin Scott, Jr. at 2). The
15 Commission should therefore adopt Mr. Scott's adjusted test year water testing expense amount of
16 \$72,065, along with his recommendation to discontinue the MAP surcharge mechanism.

17 As AWC witness Garfield explained, the MAP program is administered by the Arizona
18 Department of Environmental Quality ("ADEQ"), which bills AWC on a per meter basis. (Tr. at
19 105-106). Staff witness Scott explained that ADEQ MAP charges are currently based on meter size,
20 beginning at \$3.50 per meter and increasing with meter size. (Tr. at 302). Currently, two proposals
21 are pending before the legislature to deal with the current ADEQ surplus of collected MAP fees. (Tr.
22 at 308). One of the proposals would change the charge to \$2.50 per service connection, with
23 institution of a \$250.00 membership fee; the other proposal would refund existing surplus fees,
24 which would drop the amount ADEQ charges per service connection to \$2.10. (Tr. at 308). Under
25 the Company's proposal to keep AWC's existing MAP surcharge in place, with the balance set at
26 zero, the Company would be required to either credit back money to the customers if costs go down
27 or increase the surcharge if costs go up. (Tr. at 105).

28 Keeping the MAP surcharge in place, set at a zero balance, will probably result in refunds
to customers if MAP fees are reduced. For this reason, Staff is not opposed to keeping the MAP

1 surcharge in place. (See Surrebuttal Testimony of Marlin Scott, Jr. at 2). However, to avoid double
2 recovery, the Commission should require a reduction of the adjusted test year water testing expense
3 amount to \$29,394, in order to remove 2001 MAP costs totaling \$42,671 from Mr. Scott's adjusted
4 test year water testing expense amount of \$72,065. (Id.).

5 Staff believes that it is in the best interest of both AWC and AWC's customers to discontinue
6 the MAP surcharge mechanism and to instead adopt Mr. Scott's proposed water testing expense
7 amount of \$72,065, and recommends that the Commission adopt Mr. Scott's position on this matter.

8 **XVIII. Conclusions.**

9 The Commission should reject AWC's proposed cut-off date of March 31, 2001 for post-test
10 year plant additions, and should instead adopt Staff witness Brown's cut-off date of December 31,
11 2000 for plant additions. The Company has not shown that its proposal to include plant additions
12 extending 15 months after the end of its chosen test year is consistent with the Commission's normal
13 ratemaking treatment of post-test year plant, and has not provided any basis for the Commission to
14 act differently in this case.

15 The Commission should also exclude CWIP from rate base, because Ms. Brown's
16 recommendation for a December 2000 cut-off date for post-test year plant includes most of AWC's
17 test year CWIP, which would have been closed to plant in 2000. The remainder should also be
18 excluded from rate base because CWIP by definition is not used and useful. In accordance
19 with Ms. Brown's recommended allowance of post-test year plant additions in rate base through
20 December 31, 2000, the Commission should adopt Ms. Brown's pro forma accumulated depreciation
21 adjustment. The Company's proposed pro forma accumulated depreciation adjustment neither
22 properly accounts for the pro forma test year additions nor properly accounts for depreciation on
23 existing test year plant.

24 The Commission should reject the Company's proposed cash working capital calculation
25 methodology as it did in AWC's last rate proceeding, and should instead accept Ms. Brown's
26 calculation, which is based on NARUC-accepted methodology.

27 The Commission should accept Ms. Brown's recommended rate case expense of \$100,000,
28 because it is reasonable based on the amount of rate case expense the Commission has allowed for

1 other similar companies, and because the Company has failed to show why it should be allowed to
2 recover a greater amount.

3 Ms. Brown's property tax adjustment should be adopted with the correction described herein.
4 The Company's property tax expense amount should be rejected because the Company's
5 methodology used an incorrect CWIP balance and failed to properly use the assessment ratio in its
6 calculation. The Commission should also reject the Company's recommended income tax expense
7 amount, because the Company's methodology is inconsistent with past Commission action in cases
8 involving separate water systems. Ms. Brown's adjustment follows Commission practice and should
9 be adopted.

10 Ms. Brown's recommended component depreciation rates should be adopted because
11 changing from composite to component depreciation rates will provide a better matching of the cost
12 of individual assets over their useful lives.

13 The rate design Ms. Brown recommends is appropriate, and should be adopted. The
14 Company failed to identify any significant benefit from its proposed rate consolidation.
15 Furthermore, the consolidation of rates will result in cross-subsidization among water systems. This
16 would result in unfair rates, and the proposal should therefore be rejected. Along with this, the
17 Commission should also reject the Company's Increase in Gross Revenue calculation, which is based
18 on its proposed rate consolidation. Instead, the Commission should adopt Ms. Brown's Increase in
19 Gross Revenue calculation, which follows Commission rules.

20 It is in the best interest of both AWC and AWC's customers to discontinue the MAP
21 surcharge mechanism and to instead adopt Mr. Scott's proposed water testing expense amount of
22 \$72,065, which includes year 2001 MAP costs. If the MAP surcharge continues, then the proper
23 adjusted water testing expense amount should be \$29,394.

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