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BEFORE THE ARIZONA CORPORATION COMMISSION RECEIVED

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2002 SEP 23 A 11: 38

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IN THE MATTER OF THE APPLICATION OF
ARIZONA WATER COMPANY, AN ARIZONA
CORPORATION, FOR ADJUSTMENTS TO
ITS RATES AND CHARGES FOR UTILITY
SERVICE FURNISHED BY ITS NORTHERN
GROUP AND FOR CERTAIN RELATED
APPROVALS.

Docket No. W-01445A-00-0962

NOTICE OF FILING

The Residential Utility Consumer Office ("RUCO") hereby provides notice of filing the
Phase II Direct Testimony of Marylee Diaz Cortez, in the above-referenced matter.

RESPECTFULLY SUBMITTED this 23rd day of September, 2002.


Daniel W. Pozefsky
Attorney

Arizona Corporation Commission
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1 AN ORIGINAL AND TEN COPIES
2 of the foregoing filed this 23rd day
3 of September, 2002 with:

3 Docket Control
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ARIZONA WATER COMPANY
DOCKET NO. W-01445A-00-0962

PHASE II

DIRECT TESTIMONY
OF
MARYLEE DIAZ CORTEZ

ON BEHALF OF
THE
RESIDENTIAL UTILITY CONSUMER OFFICE

SEPTEMBER 23, 2002

1	Introduction	1
2	Areas of Disagreement	2
3	RUCO's Proposal	7
4	ACRM Filing Requirements	8
5	Scope of the ACRM Proceedings	9
6		
7		

1 **Introduction**

2 Q. Please state your name for the record.

3 A. My name is Marylee Diaz Cortez.

4

5 Q. Have you previously filed testimony in this docket?

6 A. Yes. In Phase I of this docket I filed direct testimony on June 26, 2001,
7 surrebuttal testimony on August 21, 2001, and provided oral testimony at
8 the hearing, which began on September 5, 2001.

9

10 Q. What issues were resolved in the Phase I portion of this docket?

11 A. Rate base, operating income, cost of capital, and the overall revenue
12 requirement issues were resolved by Decision No. 64282.

13

14 Q. What is the purpose of the Phase II portion of this docket?

15 A. The purpose of the Phase II portion of this docket is to address the
16 following two issues: the mechanism for recovery of arsenic related
17 treatment plant and consolidation of rates between certain water systems.

18

19 Q. Did Staff, RUCO, and the Company (the parties) reach agreement on
20 these issues during the negotiation portion of Phase II?

21 A. Partially. The parties reached substantive agreement on some elements
22 of the recovery mechanism. The Company's proposed recovery

1 mechanism includes some of the agreed upon provisions, plus additional
2 elements.

3

4 Q. Do you agree with the Company's arsenic ratemaking proposal as filed on
5 August 23, 2002?

6 A. No. The Company's filing regarding arsenic plant recovery and
7 consolidation as filed is problematic. My testimony in the Phase II portion
8 of this docket addresses the specific areas where the Company's filing
9 departs from state law and ratemaking principles. I will recommend the
10 appropriate ratemaking method of recognizing the new arsenic treatment
11 plant.

12

13 **Areas of Disagreement**

14 Q. Please discuss those aspects of the Company's proposed Arsenic Cost
15 Recovery Mechanism (ACRM) that depart from state law and ratemaking
16 principles.

17 A. The Company's proposed ACRM departs from state law and ratemaking
18 principles in several areas. By far, however, the most significant
19 departure is Arizona Water's proposed inclusion of estimated arsenic
20 O&M costs in the ACRM.

21

1 Q. Did the Company indicate during discussions with Staff and RUCO that it
2 was contemplating the inclusion of estimated arsenic O&M costs in the
3 ACRM?

4 A. No. In fact the Company continually stressed that its proposed ACRM
5 was fair and reasonable because it *did not* include the estimated cost to
6 operate the new arsenic plant. Arizona Water repeatedly represented that
7 it was not requesting O&M expenses (which would not be known and
8 measurable at the time of the step increase request), nor was it requesting
9 recovery of any Construction Work in Progress through the ACRM. The
10 Company stressed that only known and measurable, completed and in
11 service, and used and useful arsenic plant additions would be included in
12 the ACRM.

13
14 Q. Was RUCO's agreement to support an ACRM dependent in large part due
15 to the Company's representation that only incremental used and useful
16 arsenic plant capital costs would be eligible for inclusion in the ACRM?

17 A. Yes. Had the Company represented that it wanted to recover costs in
18 excess of its used and useful investment in new arsenic plant RUCO
19 would not have supported the proposed ACRM.

20
21 Q. Why not?

22 A. Because an ACRM that includes estimated O&M expenses does not
23 comply with legal requirements and sound ratemaking principles. By

1 definition, the estimated cost of operating and maintaining the new arsenic
2 plant will not meet the known and measurable standard of ratemaking at
3 the time the new plant goes into service.

4

5 Q. What other aspects of the Company's proposed ACRM does RUCO
6 disagree with?

7 A. RUCO believes that the abbreviated ACRM process and resultant step
8 rate increases are only acceptable if a full rate case hearing is undertaken
9 by May 2007, upon full completion of the plant. The Company believes
10 that a filing deadline for a full rate case is unnecessary, and requests the
11 requirement for the full rate case in mid-2007 be removed.

12

13 Q. Do you believe that a May 2007 rate case is necessary?

14 A. Yes. The RUCO attorneys have advised me that the law requires that the
15 ACRM rates can only stay in place for a limited period of time and that the
16 ACRM must provide a date certain for a rate proceeding. Step rate
17 increases based on an abbreviated procedure are only permissible if the
18 Commission sets forth on a date certain when a full rate proceeding will
19 take place that would examine all aspects of the Company's financial
20 situation and rates would be trued-up to the Company's actual cost to
21 service. In addition to the legal requirement, this policy will insure that
22 rates are fair and reasonable. Absent the assurance of a full rate
23 examination by a date certain where rates established by the abbreviated

1 procedures can be tried up to actual, RUCO cannot support the proposed
2 ACRM.

3
4 Q. Please discuss the next area of disagreement with the Company's
5 proposal.

6 A. The Company believes that the ACRM should allow for more than two
7 step increases.

8
9 Q. Why do you oppose more than two step increases?

10 A. As discussed earlier, RUCO's willingness to contemplate setting rates
11 without a full rate hearing is in recognition of the extraordinary nature and
12 relative high cost of complying with the new arsenic standard. In agreeing
13 to abbreviated procedures, RUCO seeks to maintain certain safeguards
14 against unfair and unreasonable rates. Limiting the allowed step
15 increases to two restricts the amount of rate increases that can be
16 assessed outside of a full rate and cost of service review. This safeguard
17 prevents rampant changes in rates without the proper full rate analysis.

18
19 Q. Please discuss the next area of disagreement.

20 A. The Company believes that a uniform rate design should be
21 predetermined for all arsenic surcharges and accordingly, the issue would
22 not be addressed in the context of each individual water system.

23

1 Q. Why do you disagree with this rate design method?

2 A. The issue of rate design needs to be considered in the context of the
3 individual characteristics of each water system. A rate design that is fair
4 for the individual characteristics of one water system is not necessarily fair
5 to another system. "One size fits all" rate design is a fallacy that in the
6 context of an already abbreviated procedure has an enhanced potential to
7 create unfair rates.

8

9 Q. Do you agree with the Company's proposal to consolidate rates among
10 individual systems?

11 A. No.

12

13 Q. Why does RUCO oppose the consolidation of rates?

14 A. Ratemaking principles require that utility rates be cost based, and that
15 costs are appropriately allocated to the cost causer. The Rimrock system
16 is the primary cost causer because it has the largest arsenic problem.
17 The Company's proposed consolidation of rates would result in Sedona
18 ratepayers bearing the cost burden for the Rimrock customers. Not only is
19 this subsidization contrary to sound ratemaking policy it is inherently unfair
20 and is more akin to a welfare system, as opposed to cost based rates.

21

1 **RUCO's Proposal**

2 Q. Please describe how the ACRM as proposed in the Company's application
3 could be modified to comply with legal requirements and sound
4 ratemaking principles.

5 A. The ACRM would be modified to only allow the inclusion of completed
6 used and useful arsenic plant in rates. This would be accomplished via
7 two abbreviated rate proceedings (step increases), to be followed by a full
8 rate case upon completion of the arsenic treatment plants in 2006. RUCO
9 would agree to this departure from accepted ratemaking procedure under
10 the following circumstances:

11 1) The abbreviated rate proceedings and resultant step rate
12 increases would be accompanied by a fair value finding, as
13 required by state law.

14 2) Only completed in-service arsenic plant additions would be
15 eligible for recovery through the ACRM (i.e. no CWIP), which
16 is in compliance with the used and useful standard of
17 ratemaking.

18 3) With the exception of depreciation expense on the new
19 arsenic plant, no estimated operating expenses of the new
20 arsenic plant would be included in the ACRM, which is in
21 compliance with the known and measurable rate standard of
22 ratemaking.

1 4) Rate increases pursuant to the ACRM would be limited to
2 two, and a full rate case required in 2007 upon completion of
3 the necessary arsenic treatment plant, which is in
4 compliance with the matching principle of ratemaking.

5 5) There would be no consolidation of rates among individual
6 systems, which is in compliance with the cost causation
7 principle of ratemaking.

8
9 Thus, RUCO would support an ACRM, as outlined above because it
10 provides a methodology that would mitigate the financial burden of the
11 new federal arsenic standard on the Company and comply with state law
12 and ratemaking principles. The ACRM as now proposed by the Company
13 does not achieve these objectives and accordingly is not recommended by
14 RUCO.

15

16 **ACRM Filing Requirements**

17 Q. Have you reviewed the schedules the Company proposes to file in support
18 of its arsenic step increase requests?

19 A. Yes.

20

21

22

23

1 Q. Are all of the proposed schedules necessary for evaluation of the step
2 increase applications?

3 A. Yes. At minimum the Company should be required to file all of the
4 information presented on Exhibit RJK2-5.

5

6 Q. Is there any other information that needs to be presented to facilitate the
7 analysis of arsenic step increases?

8 A. Yes. A proper analysis of the Company's proposed arsenic step
9 increases requires that Arizona Water provide its billing determinants for
10 same time period as is used for its income statement. This information is
11 generally filed in a full rate case as Schedule H-4 and consists of historical
12 consumption and bill counts for each individual meter size and rate class.

13

14 **Scope of the ACRM Proceedings**

15 Q. Please respond to the Company's position that the parties have agreed to
16 "a tightly focused procedure" for the arsenic step increase proceeding.

17 A. The parties agreed that an abbreviated procedure for the incremental cost
18 of arsenic related plan is desirable. However, neither Staff nor RUCO was
19 willing to waive their right to address any issue that they felt was relevant.
20 The understanding between the parties was that no issue is precluded
21 from the proceeding, tempered by the objective of simplifying the process.
22 In this manner the parties will balance the need for timeliness with the
23 requirement for fair and reasonable rates.

1 Q. Does this conclude your testimony?

2 A. Yes.