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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission

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

DOCKET NO. W-01445A-00-0962

STAFF'S CLOSING BRIEF

INTRODUCTION

All parties to this proceeding seek a process to implement the new standards for Arsenic. The maximum contaminant level ("MCL") has been lowered from 50 parts per billion ("ppb") to 10 ppb. The new standard became effective in January of 2001; however, compliance for existing water systems is not required until January 2006. S-3 at 2. The process needs to balance the interests of the ratepayers and the interests of Arizona Water Company ("Arizona Water") or ("Company"). All parties understand that the new standard for arsenic will be placing a heavy financial burden on many water companies in Arizona.

All parties agree that "step increases" are the best approach to balance the interests of the ratepayers and the interests of Arizona Water. Staff supports two "step increases" as part of an Arsenic Cost Recovery Mechanism ("ACRM"). The "step increase" would be in the form of a surcharge. This plan would allow Arizona Water to raise their rates twice without going through the lengthy process of a full rate case. The "step increases" would be tied to investment in plant additions necessary to treat and remove the arsenic. In addition, Staff would analyze the prudence of Arizona Water's chosen arsenic removal process.

As plant additions to treat arsenic are constructed by Arizona Water, there will be additional operation and maintenance expenses ("O&M"). Staff and the Residential Utility Consumer Office ("RUCO") believe that Arizona Water should not be allowed to recover O&M as part of the ACRM. Arizona Water believes that it should be allowed to recover O&M as part of the ACRM.

1 Another area of disagreement between Staff and Arizona Water has to do with rate design.  
2 Staff would prefer that 50 percent of the ACRM revenue requirement be recovered from the monthly  
3 minimum and 50 percent from commodity rates. S-1 at 9. Arizona Water would rather recover the  
4 ACRM revenue requirement related to capital costs entirely through a monthly customer surcharge.  
5 S-1 at 9.

6 The parties also disagree on the issue of rate consolidation. Staff and RUCO ask that rates  
7 not be consolidated at this time. Arizona Water would like to see consolidated rates in order to  
8 allocate costs over a broader customer base. A-1 at 15.

9 Staff's introduction is an overview of the case and Staff's recommendations. The following  
10 sections discuss the basis for Staff's position on the major issues in this case.

11 **OPERATION & MAINTENANCE**

12 The ACRM step increases were conceived for the purpose of providing an administratively  
13 efficient mechanism for recovery of arsenic removal costs. Introducing O&M costs as well as capital  
14 costs into the ACRM increases the regulatory review effort to the level associated with a rate case.  
15 Arizona Water has proposed that it would submit actual O&M costs for recovery. Although Staff  
16 would prefer actual O&M over estimated O&M, actual O&M is still problematic. Staff witness  
17 Gordon Fox pointed out that including O&M would be problematic because Staff would be "taking a  
18 ratemaking mechanism that is balanced in that there is a matching in time by the recognition of  
19 operating expenses and rate base and cost of capital. And in this instance, [Staff] is not getting the  
20 level of scrutiny of any of those items, so there's a potential for over recovery." Tr. at 155. In other  
21 words, including O&M increases the difficulty and complexity of reviewing the ACRM to the point  
22 of practically reviewing a full rate case, which the Company always has the option to file. If O&M,  
23 actual or estimated, is included in the ACRM, the required review cannot be achieved in an  
24 expeditious manner and the contemplated timely implementation of a step increase cannot be  
25 achieved. Thus, anticipated regulatory efficiencies will not be realized.

26 If O&M is included in the ACRM surcharge, assurance that over-earning does not occur  
27 would require a re-examination of the cost of capital and the capital structure for each ACRM  
28 surcharge filing. S-1 at 7. Therefore, including O&M frustrates the goals of Staff's ACRM. Staff's

1 ACRM was designed to expedite the process for the parties and provide funding for the Company,  
2 while still protecting the ratepayers from overpayment.

3 By excluding O&M, Staff's proposal balances the competing interests of the ratepayers and  
4 Arizona Water. Under Staff's proposed ACRM, Arizona Water will receive money to finance its  
5 arsenic facilities much faster than it would in a normal rate case. In addition, Staff's proposed  
6 ACRM will protect the ratepayers by lowering to a reasonable level the risk that this "step increase"  
7 will result in overpayment. Arizona Water seeks to broaden the scope of the ACRM by including  
8 O&M. However, RUCO witness Marylee Diaz Cortez pointed out "if we abbreviate it [the ACRM  
9 process] and broaden the scope, then there's no longer any safeguards in place that gives us any  
10 degree of reasonable assurance that rates are fair and reasonable." Tr. at 91. The inclusion of O&M  
11 will increase the risk that the ratepayer will be harmed in this expedited process. The ACRM should  
12 balance Arizona Water's ability to earn a fair rate of return with the ratepayers' interests in paying  
13 just and reasonable rates. The ACRM does not abrogate Arizona Water's option to file a rate case.  
14 Ratepayers' interests should not be sacrificed in this expeditious process designed specifically to  
15 provide Arizona Water with an appropriate but uncustomary revenue increase.

#### 16 RATE DESIGN

17 Staff and Arizona Water agree that a predetermined rate structure is important to facilitate an  
18 ACRM surcharge. Arizona Water proposes to "recover the portion of the ACRM revenue  
19 requirement related to capital costs through a monthly customer surcharge." S-1 at 8. Staff believes  
20 that an equitable predetermined rate structure should balance the interests of the Company and  
21 ratepayers and should not be unnecessarily skewed toward recovering costs through either the  
22 monthly minimum or commodity rate. S-1 at 9. Thus, Staff proposes that "50 percent of the ACRM  
23 revenue requirement [related to capital] be recovered from the monthly minimum and 50 percent  
24 from commodity rates." S-1 at 9. The commodity rates are fair to customers because the revenue  
25 will be recovered on a cost basis. Tr. at 214. The more water a customer uses, the more a customer  
26 will have to pay for the arsenic treatment plant. The monthly minimum charge increases revenue  
27 stability to Arizona Water.

28 ...

1 **STEP INCREASES**

2 "Step increases" are part of the ACRM proposed by Staff. "Step increases" were addressed  
3 by the Arizona Supreme Court in *Arizona Community Action Ass'n v. Arizona Corp. Comm'n*, 123  
4 Ariz. 228, 599 P.2d 184 (1979). In *Arizona Community Action*, the Court considered a three step  
5 process. The first step was the initial rate case. At that time, the "Commission fulfilled the  
6 constitutional requirements of art. 15, §§ 3, 14, which mandate a finding of the fair value of all  
7 property at the time of fixing a rate." *Id.* at 230. Two more steps were proposed as part of the "step  
8 increase". These additional steps were to be based on a combination of "Construction Work in  
9 Progress" (CWIP) and a percentage of return on common stock equity. The plan was remanded  
10 because the Court felt that the stock component of the plan gave the corporation too much control.  
11 The Court pointed out that construction work in progress (CWIP) but not yet in service may be  
12 included in determining a fair value rate base." *Id.* at 230. The plan proposed a full rate case within  
13 three years of the initial step. Despite the remand, the Court stated that "the adjustments ordered by  
14 the Commission in adding the CWIP to that determination of fair value were adequate to maintain a  
15 reasonable compliance with the constitutional requirements if used only for a limited period of time."  
16 *Id.* at 231.

17 In the present case, Staff's ACRM proposes a 3 step process. The first step was the full rate  
18 case (Decision No. 64282) decided on December 28, 2001. This case established new rates for the  
19 Northern Group. Staff proposes 2 additional steps. A full rate case would follow these "step  
20 increases" by May 31, 2007. The "step increases" will be based on additional plant. Rather than  
21 basing the increase on CWIP, the parties propose that the increases be based on "used and useful"  
22 arsenic treatment plant. As a part of each step increase, Staff will determine whether the plant is  
23 "used and useful".

24 During the course of the hearing, there was a suggestion that "interim rates with a true up"  
25 might work better than Staff's "step increases". Tr. at 325. Interim rate-making authority is limited  
26 to situations where "(1) an emergency exists; (2) a bond is posted by the utility guaranteeing a refund  
27 to customers if the interim rates paid are higher than the final rates determined by the Commission;  
28 and (3) the Commission undertakes to determine final rates after a valuation of the utility's

1 property.” *Residential Utility Consumer Office v. Arizona Corp. Comm’n*, 199 Ariz. 588, 591, 20  
2 P.3d 1169, 1172 (App. 2001) (citing from *Scates v. Arizona Corp. Comm’n*, 118 Ariz. 531, 535, 578  
3 P.2d 612, 616 (App. 1978)). In this case, the proposed ACRM does include a full rate hearing at the  
4 end of the process. However, the arsenic problem is not an emergency for Arizona Water and  
5 Arizona Water has not offered to post a bond in the event a refund of the interim rates is necessary.  
6 Thus, interim rates are not appropriate in this case.

7 Staff’s “step increase” proposal would not require a hearing at any point prior to the Open  
8 Meeting. During her testimony for RUCO, Marylee Diaz Cortez testified that a hearing is required  
9 by law. Tr. at 101. Under A.R.S. § 40-250, “No public service corporation shall raise any rate, . . . ,  
10 to result in any increase thereof, except upon a showing before the commission and a finding by the  
11 commission that an increase is justified.” Since Staff’s ACRM proposes that the “step increase” be  
12 decided at an Open Meeting before the Commission, the “step increase” proposal complies with the  
13 procedures outlined in A.R.S. § 40-250. In addition, although Staff does not believe a hearing is  
14 required under A.R.S. § 40-250, Staff does point out that “any party has the right to request  
15 intervention and exercise any and all rights that are afforded to an intervener.” S-3 at 6.

#### 16 **RATE CONSOLIDATION**

17 Arizona Water proposes rate consolidation to allocate costs over a broader customer base.  
18 Arizona Water anticipates this would ease the impacts in single systems of high cost projects such as  
19 an arsenic treatment plant or well replacement due to arsenic. A-1 at 15. Staff recognizes that rate  
20 consolidation will benefit some customers while burdening others. Staff witness Gordon Fox  
21 pointed out that “rate consolidation would result in some ratepayers being required to . . . subsidize  
22 other ratepayers across independent water systems without any benefit.” S-1 at 12. Although, from  
23 an economic viewpoint, Staff prefers that rates reflect embedded cost, Staff realizes that societal  
24 issues having to do with the affordability of water are factors that need to be considered. However,  
25 in order to analyze rate consolidation from an economic and societal perspective, Staff needs to  
26 know the “actual full impact of complying with the new arsenic standard.” S-3 at 7. Thus, it would  
27 be more appropriate to consider rate consolidation in a future rate case when all the capital and O&M  
28 costs are known. S-1 at 13.

1 **CONCLUSION**

2 In light of the above and the record in these proceedings, Staff requests that the Commission  
3 adopt Staff's proposed ACRM. Staff asks that the Commission not allow Arizona Water to recover  
4 O&M as part of the ACRM. Staff requests that Staff's rate design be implemented and that rates not  
5 be consolidated at this time. In addition, Staff asks that the Commission adopt Staff's  
6 recommendations concerning other matters related to Arizona Water's application as provided in  
7 hearings and in this brief.

8  
9 RESPECTFULLY SUBMITTED this 6<sup>th</sup> day of December, 2002.

10  
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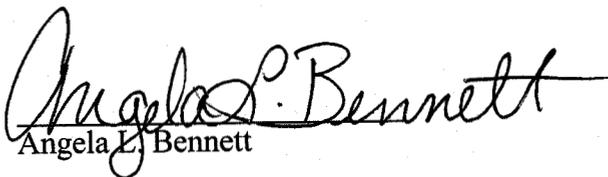
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