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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 NOTICE OF FILING SUPPLEMENTAL TESTIMONY

Staff of the Arizona Corporation Commission hereby files the supplemental testimony of Gordon Fox of the Utilities Division in the above-referenced matter.

RESPECTFULLY SUBMITTED this 18<sup>th</sup> day of June 2003.

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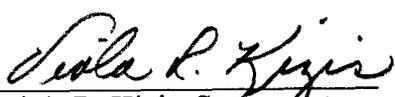
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**SUPPLEMENTAL  
TESTIMONY  
OF  
GORDON L. FOX**

**ARIZONA WATER COMPANY  
DOCKET NO. W-01445A-00-0962**

**JUNE 18, 2003**

BEFORE THE ARIZONA CORPORATION COMMISSION

MARC SPITZER

Chairman

JIM IRVIN

Commissioner

WILLIAM A. MUNDELL

Commissioner

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MIKE GLEASON

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DOCKET NO. W-01445A-00-0962

SUPPLEMENTAL

TESTIMONY

OF

GORDON L. FOX

REVENUE REQUIREMENTS MANAGER

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

JUNE 18, 2003

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**EXECUTIVE SUMMARY  
ARIZONA WATER COMPANY  
DOCKET NO. W-01445A-00-0962**

Arizona Water Company ("AWC" or "Company") provides potable water service to approximately 60,000 customers in eight counties and 18 water systems in Arizona.

The current proceeding is phase two of the Company's permanent rate case for the five water systems (Lakeside, Overgaard, Rimrock, Pinewood, and Sedona) that comprise the Northern Group. Decision No. 64282, dated December 28, 2001, established permanent rates in phase one of this docket. In phase two, the Company is requesting to establish a procedure to recover costs related to complying with the Environmental Protection Agency's new 10 parts per billion ("ppb") maximum contaminant level ("MCL") for arsenic. Through an arsenic cost recovery mechanism ("ACRM"), the Company proposes to recover capital cost related to the removal of arsenic with a surcharge to minimum monthly charges and operation and maintenance ("O&M") expenses with a surcharge to the commodity rate. Arizona Water requests that up to three ACRM surcharge filings be allowed for each water system through the end of 2006 when it must comply with the 10 ppb MCL for arsenic. The Company is also requesting rate consolidation in Sedona and Rimrock.

Staff, RUCO, and the Company ("Parties") filed testimonies, and hearings were held on these issues. The Administrative Law Judge issued a recommended opinion and order ("ROO"), dated April 8, 2003, pertaining to these issues. At the April 22, 2003, Open Meeting the Commission directed the Hearing Division to conduct additional proceedings regarding the inclusion of potential leasing options for arsenic treatment facilities. Lease costs were not addressed in the initial testimonies/hearings.

The Parties met on May 20, 2003, and discussed leasing options. The Company proposed modifications to the ROO to allow recovery of lease costs and certain O&M expenses. Staff did not recommend recovery of any O&M costs in its initial testimony. However, Staff has reviewed the Company's proposal and agrees that under certain procedures/conditions that recovery of three *specific* O&M costs via the ACRM is appropriate. Staff is recommending procedures/conditions for allowing recovery of lease costs and certain O&M expenses.

1 **INTRODUCTION**

2 **Q. Please state your name, occupation, and business address.**

3 A. My name is Gordon L. Fox. I am a Revenue Requirements Manager employed by the  
4 Arizona Corporation Commission ("ACC" or "Commission") in the Utilities Division  
5 ("Staff"). My business address is 1200 West Washington Street, Phoenix, Arizona 85007.

6  
7 **Q. Did you previously file testimony in this docket?**

8 A. Yes. I filed responsive testimony in this docket on September 23, 2002.

9  
10 **BACKGROUND**

11 **Q. Please provide a background that explains the purpose of your testimony.**

12 A. In Decision No. 64282, dated December 28, 2001, the Commission approved a rate  
13 increase for Arizona Water Company's ("AWC" or "Company") Northern Division  
14 ("Phase I"). That decision ordered this docket to remain open to allow Staff, RUCO, the  
15 City of Casa Grande, and AWC ("Parties") to develop a proposed procedure for the  
16 recovery of costs relating to arsenic treatment and to address the issue of rate  
17 consolidation of the Company's systems. Testimonies were filed and hearings were held  
18 on these issues. On April 22, 2003, the Commission discussed the Administrative Law  
19 Judge's ("ALJ") Recommended Opinion and Order ("ROO"), dated April 8, 2003,  
20 pertaining to those issues. At that April 22, 2003, Open Meeting, the Commission  
21 directed the Hearing Division to conduct additional proceedings regarding the inclusion of  
22 potential leasing options for arsenic treatment facilities and directed the Company to  
23 investigate all possible loans and grants that may be available for financing installation of  
24 arsenic treatment facilities.

25

1 On April 25, 2003, the ALJ issued a Procedural Order directing (1) the parties to engage  
2 in and complete settlement discussions on the leasing issues no later than May 30, 2003;  
3 (2) the parties to file, by May 30, 2003, a joint recommendation for resolving the leasing  
4 issues or if no agreement is reached, for testimony to be filed by June 16, 2003, and a  
5 hearing to be held on June 26, 2003; and (3) the Company to separately address the  
6 availability of grants and loans for arsenic treatment facilities.  
7

8 On May 20, 2003, the Parties met and discussed leasing options. AWC proposed  
9 modifications to the arsenic cost recovery mechanism ("ACRM"), as proposed in the  
10 ROO, to allow recovery of lease costs and certain operating and maintenance expenses.  
11 AWC identified nine operating and maintenance ("O&M") expenses (as outlined in the  
12 ADEQ Arsenic Master Plan) related directly to arsenic treatment and proposed allowing  
13 recovery in the ACRM of three of those expenses: (1) media replacement or regeneration;  
14 (2) media replacement or regeneration service; and (3) waste disposal. AWC proposed to  
15 allow recovery of these O&M expenses regardless of whether they are included in lease  
16 payments in order to place leasing and purchasing options on an equal footing. Staff  
17 requested time to consider AWC's proposal, and the Parties agreed to request an extension  
18 of time to consider responses to AWC's proposal.  
19

20 Staff concluded that AWC's proposal, with refinements, would comply with the goals  
21 sought for the ACRM. Those objectives included: (1) legality; (2) administrative  
22 efficiency; (3) timely recovery of costs outside a separate rate case; and (4) fair and  
23 reasonable results. This testimony presents Staff's current position regarding the ACRM.

1 **ACRM MODIFICATIONS**

2 **Q. Does Staff recommend any changes to the ACRM as presented in the ROO?**

3 A. Yes. Staff supports two significant modifications to the ROO ACRM. These  
4 modifications are consistent with those proposed by AWC in the May 20, 2003, meeting.  
5 First, Staff supports allowing recovery of direct costs (no overheads) for media  
6 replacement or regeneration, media replacement or regeneration service, and waste  
7 disposal (recoverable O&M), but no other O&M. Second, Staff supports allowing  
8 recovery of capital and O&M costs under lease obligations. The amount that should be  
9 recoverable under lease obligations is the same as that which would have been recoverable  
10 had the leased assets been purchased. These modifications are subject to the  
11 procedures/conditions described below.

12  
13 **Operating and Maintenance Expenses**

14 **Q. What procedures/conditions does Staff recommend regarding recoverable O&M?**

15 A. The ACRM should provide for recovery of recoverable O&M costs in two parts. The first  
16 part allows deferral and recovery of recoverable O&M via a surcharge. The deferral  
17 period is defined below. The second part provides for recovery of recoverable O&M in  
18 ACRM revised rates on a prospective basis. These two parts provide for deferred  
19 recovery of a limited amount of recoverable O&M and for prospective recovery via  
20 ACRM revised rates based on the historical cost in the deferral period.

21  
22 The ROO ACRM provides for two ACRM revised rate filings. For each arsenic removal  
23 plant, the amount of recoverable O&M to be deferred and the amount to be recognized  
24 prospectively in revised rates should both be determined at the same time, that is, in either  
25 the first or second ACRM filing. AWC should have the option of choosing either the first  
26 or second ACRM filing. If there is no second ACRM filing and AWC does not choose the

1 first ACRM filing, the deferred and prospective O&M amounts should be determined in  
2 the next general rate case. If the first ACRM filing is chosen, then, the dollar amount of  
3 O&M included in the first ACRM revised rates should remain in effect for the second  
4 ACRM revised rates, and the minimum and commodity surcharges and period as  
5 established in the first ACRM filing are unaffected. The amount of recoverable O&M to  
6 be included for annual recovery in ACRM revised rates should be equal to the amount  
7 deferred. Thus, the amount included prospectively in revised rates will be the same as the  
8 recoverable O&M from the deferral period, a period of 12 or fewer months.  
9

10 The deferral period for each arsenic removal plant should begin with its in-service date  
11 and should not exceed 12 months. In the event that AWC's ACRM filing to request  
12 recovery of recoverable O&M occurs more than 12 months after the in-service date, the  
13 deferral period should be adjusted to reflect the 12 consecutive months preceding that  
14 ACRM filing. If the in-service date is less than 12 months prior to AWC's ACRM filing  
15 to request recovery of recoverable O&M, the deferral period should be the period  
16 beginning with the in-service date and ending with the month-end prior to the month of  
17 AWC's request. If AWC makes a second ACRM filing and did not request recovery of  
18 recoverable O&M in its first ACRM filing, it should request recovery of O&M in its  
19 second ACRM filing. In the event that AWC makes no second ACRM filing, the deferral  
20 period should be the test year in AWC's next general rate case. No deferrals should be  
21 recognized preceding or subsequent to the deferral period defined here. No cost of money  
22 should be applied to deferred amounts. The deferred amounts should be recovered via a  
23 surcharge.  
24

25 The surcharge should be determined using the same billing determinants used to establish  
26 revised rates in the ACRM filing. Fifty percent of the surcharge should be recovered from  
27 the monthly minimum charge and 50 percent through the commodity rate to conform with

1 the rate structure used for recovery of other ACRM amounts. The surcharge should be  
2 applied to 12 consecutive monthly billings beginning in the month that the ACRM revised  
3 rates become effective or the month that permanent rates become effective in the next  
4 general rate case as is applicable. There should be no true-up.  
5

6 **Leases**

7 **Q. What procedures/conditions does Staff recommend regarding leases?**

8 A. The ACRM revenue requirement should recognize the same, or essentially the same,  
9 revenue requirement whether arsenic treatment equipment is leased or purchased. To  
10 accomplish equal treatment for leases and purchases, leased equipment should be included  
11 in the ACRM procedures in the same manner as if it had been purchased. Accordingly,  
12 AWC should require lessors to provide the equipment purchase price and the cost of  
13 money rate embedded in its lease payment. Furthermore, for all lease costs that AWC  
14 submits for recovery via the ACRM, AWC should require lessors to provide separate lease  
15 payment components for arsenic treatment equipment, recoverable O&M, and costs not  
16 recoverable via the ACRM. Further, AWC should conduct a lease versus purchase  
17 analysis to support its decision to lease or purchase. AWC should maintain this  
18 supporting analysis and make it available for Staff's review in its next general rate case.  
19

20 **Property Taxes**

21 **Q. Does Staff recommend that the ACRM include a provision for recovery of property**  
22 **taxes?**

23 A. No.  
24

25 **Q. Does this conclude your direct testimony?**

26 A. Yes, it does.