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ARIZONA CORPORATION COMMISSION  
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**BEFORE THE ARIZONA CORPORATION COMMISSION**

- 1
- 2 MARC SPITZER  
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COMMISSIONER
- 4 WILLIAM A. MUNDELL  
COMMISSIONER
- 5 JEFF HATCH-MILLER  
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- 6 MIKE GLEASON  
COMMISSIONER
- 7

Arizona Corporation Commission

**DOCKETED**

AUG 15 2003

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

Docket No. W-01445A-00-0962

**RUCO'S CLOSING BRIEF**

**INTRODUCTION**

14 The Residential Utility Consumer Office ("RUCO") submits the following points in  
 15 support of its position that the Arizona Corporation Commission ("Commission") should not  
 16 approve Arizona Water Company's ("AWC" or "Company") and the Commission's Utilities  
 17 Division ("Staff") proposed ("Staff-Company proposal") Arsenic Cost Recovery Mechanism  
 18 ("ACRM"). The law in Arizona does not support the joint proposal.

19 RUCO proposes that the Commission adopt the April 8, 2003, Recommended  
 20 Order and Opinion ("ROO").

**OVERVIEW**

22 Single-issue ratemaking is fraught with peril. At the very least, it provides utilities  
 23 with an incentive to seek rate increases when costs in a particular area increase. It is  
 24

1 contrary to generally accepted regulatory principles and is highly likely to result in unfair  
2 and unreasonable rates. Only under very limited circumstances, and usually conditioned  
3 upon certain procedural safeguards, have the Courts in Arizona permitted it.

4 The new federal arsenic standard has created a difficult situation for water  
5 companies, like AWC, that do not currently meet the standard. In order to facilitate  
6 compliance with the standard, the parties have accepted the idea that some type of  
7 abbreviated cost recovery mechanism is appropriate to allow the Company to recover its  
8 arsenic related costs.

9 Recognizing the need for an ACRM, RUCO endorses what the Arizona Supreme  
10 Court has said is permissible. For the legal and policy reasons cited below, RUCO does  
11 not endorse the Staff-Company proposal which goes beyond what the Arizona Supreme  
12 Court has said is permissible.

## 12 **BACKGROUND**

13 In Decision No. 64282, dated December 28, 2001, the Commission approved a rate  
14 increase for Arizona Water Company's Northern Division (Phase I). That decision ordered  
15 this docket to remain open to allow Staff, RUCO, City of Casa Grande, and AWC  
16 ("Parties") to develop a proposed ACRM and to address the issue of rate consolidation of  
17 the Company's systems. The parties met on a number of occasions and reached  
18 agreement on some issues. The Commission scheduled a hearing to resolve the disputed  
19 issues. Testimony was filed, a hearing was held, and closing briefs<sup>1</sup> were filed on the  
20 Company's proposed ACRM and the issue of rate consolidation. The parties were in  
21 agreement that an ACRM utilizing step-increases is an appropriate method to address  
22 increased capital costs related to arsenic treatment. However, the parties disagreed on

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23  
24 <sup>1</sup> Attached as Exhibit 1 is a copy of RUCO's Closing Brief filed prior to the issuance of the ROO (December 6, 2002). With the additions set forth below, RUCO's position and arguments are the same. RUCO incorporates the arguments set forth in the attached Closing Brief into this Closing Brief.

1 the recovery of Operation and Maintenance ("O&M") costs associated with the new arsenic  
2 treatment plant.

3 On April 8, 2003, the Administrative Law Judge issued his ROO. The ROO,  
4 consistent with the arguments previously set forth by Staff and RUCO, recommended an  
5 ACRM that excludes O&M costs. The Commission considered the ROO at its Open  
6 Meeting on April 22, 2003. The Commission deferred a decision on the ROO, directing the  
7 Hearing Division to conduct additional proceedings regarding the inclusion of potential  
8 leasing options for arsenic treatment facilities and directing the Company to investigate all  
9 possible loans and grants that may be available for financing installation of arsenic  
treatment facilities.

10 On April 25, 2003, the Commission issued a Procedural Order directing (1) the  
11 parties to engage in and complete settlement discussions on the leasing issues no later  
12 than May 30, 2003; (2) the parties to file, by May 30, 2003, a joint recommendation for  
13 resolving the leasing issues or if no agreement is reached for testimony to be filed by June  
14 16, 2003, and a hearing to be held on June 26, 2003; and (3) the Company to separately  
15 address the availability of grants and loans for arsenic treatment facilities.

16 Thereafter, the parties met and engaged in settlement negotiations. Collectively,  
17 the parties were unable to reach an accommodation. The Company and Staff, however,  
18 were able to reach an accord. Transcript, Vol. III, 355-364.<sup>2</sup> The Company and Staff  
19 agreed that their objectives could be met by permitting limited recovery of O & M costs in  
20 the ACRM. A-3 at 6<sup>3</sup>. The Staff-Company proposal recommends recovery of the direct  
21 cost (no overheads) for media replacement or regeneration, media replacement or

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22  
23 <sup>2</sup> Reference to the Transcript throughout this Brief, unless indicated otherwise, will be to Volume III of the  
Phase II Docket (W-01445A-00-0962) of the proceedings held on June 26, 2003.

24 <sup>3</sup> References will be made to exhibits as they appear in the Transcript of Proceedings of June 26, 2003.

1 regeneration service, and waste disposal ("recoverable O & M"). A-3 at 6-8, S-8 at 3. The  
2 Staff-Company proposal further recommends recovery of capital and O & M costs under  
3 lease obligations. Id. Staff and the Company testified that the amount that the Company  
4 would recover would be the same under the lease provisions as if the Company purchased  
5 the leased assets. Id.

6 The Staff-Company proposal would provide for recovery of recoverable O & M costs  
7 in two parts. Id. The first part would allow deferral and recovery of O & M costs through a  
8 surcharge. Id. The second part provides for the recovery of the recoverable O & M in the  
9 ACRM revised rates on a prospective basis. Id.

10 RUCO agreed that the ACRM should be broadened to consider the ratemaking  
11 treatment of leased plant. R-2 at 6. RUCO, however, maintained that the treatment of  
12 lease costs should parallel the ROO's recommendation regarding capital costs. Id. In  
13 other words, RUCO, consistent with its earlier position, recommends the exclusion of O &  
14 M costs regardless of whether the ACRM includes capital or lease costs. Id.

15 **THE LAW AND POLICY IN ARIZONA DOES NOT SUPPORT INCLUDING O & M**  
16 **EXPENSES IN THE STEP-INCREASES**

17 The Arizona Constitution requires the Commission to make a finding of fair value of  
18 a utility's property when calculating the utilities rates. See *Scates v. Arizona Corp.*  
19 *Comm'n*, 118 Ariz. at 534, 578 P.2d at 615 (quoting *Simms*, 80 Ariz. at 151, 294 P.2d at  
20 382)(internal citations omitted). In only two clearly defined instances has the Court held  
21 that the Commission is free to deviate from the fair value requirement. *Id.* at 534-35, 578  
22 P.2d at 615-16; Op. Att'y Gen. 71-15 (1971)(automatic adjuster mechanisms) (cited with  
23 approval in *Scates* at 535, 578 P.2d at 616); Op. Att'y Gen. 71-17 (1971)(interim  
24 rates)(cited with approval in *Scates* at 535, 578 P.2d at 616).

25 The ACRM recommended in the ROO ("recommended ACRM") involves a step-  
26 increase procedure. The Supreme Court of Arizona in *Arizona Community Action*

1 *Association v. Arizona Corporation Commission*, 123 Az. 228, 599 P. 2d. 184 (1979)  
2 gave tacit approval for an abbreviated step-increase procedure. See RUCO's December  
3 6, 2002 Closing Brief at page 5 (attached). The step-increase procedure in *Arizona*  
4 *Community Action Association* was not an adjuster mechanism or interim rate, but involved  
5 an abbreviated process by which the Commission made a new finding of fair value, to  
6 which it applied its recently-approved rate of return. In *Arizona Community Action*  
7 *Association* the Commission approved a step-increase procedure that would trigger a step-  
8 increase based on a decline in return on common stock equity, and, if the trigger were met,  
9 base the new rates on changes to the utility's rate base. *Id.* at 230, 599 P. 2d. 186. The  
10 Court remanded the matter to the Commission, finding the trigger mechanism  
11 objectionable, but impliedly approved the basis on which the rate step would be computed.  
12 *Id.*

13 The Staff-Company proposal goes beyond the type of abbreviated procedure  
14 contemplated by the Court in *Arizona Community Action Association*. Where the step-  
15 increase in *Arizona Community Action Association* involved only updates to rate base, the  
16 Staff-Company proposal includes updates to operating expenses. There is nothing in the  
17 Court's opinion indicating that step-increases are appropriate for increases in O & M  
18 expenses.

19 Including media-related O & M expenses results in piecemeal ratemaking. As the  
20 Court in *Scates* noted, such piecemeal ratemaking is fraught with abuse. 118 Ariz. at 534,  
21 578 P.2d at 615. Among the many policy reasons why the Commission should not  
22 consider O & M expenses are the following:

23 First, inclusion of O & M expenses presents matching problems, which even Staff  
24 acknowledges will not be resolved by its proposal. R-2 at 43, Transcript, Vol. III at 405.  
The ACRM rates will be based on the revenues, expenses, cost of capital and plant  
determined in the last rate case (which used a historical test-year of 1999). The only thing

1 that will be true-up is the incremental arsenic plant. Id. at 428. However, the Staff-  
2 Company proposal will true up the incremental media plant expenses, which will create  
3 additional mis-matches between costs based on the 1999 test-year and costs based on  
4 more recent periods. Id.

5 Second, the media related expenses are no more intertwined with lease cost  
6 recovery than they are with capital cost recovery. Id. at 424. The utility's legal relationship  
7 to the plant has no bearing on what the plant's media related expenses will be. Id.

8 Third, an ACRM which is limited to consideration of capital costs is by itself single-  
9 issue ratemaking fraught with all the perils associated with single-issue ratemaking.  
10 Nonetheless, the level of risk is acceptable in order to strike a balance given the  
11 extraordinary requirements presented by the new arsenic standard. Id. at 426-427. The  
12 balance becomes miscued when the Commission adjusts for additional rate making  
13 factors.

14 Fourth, the Staff-Company proposal creates additional disconnects between  
15 changes that will be recognized and changes that will not. Id. at 427. It is important to  
16 consider the rate-case elements that are going to be changed by the ACRM. It is equally  
17 important to consider the rate-case elements that are not going to be changed. The Staff-  
18 Company proposal to include media related expenses and exclude other expenses is  
19 arbitrary. In other words, there is no distinction between the incremental media expenses  
20 that will be considered under the Staff-Company proposal and the other incremental  
21 expenses that will not be considered.

22 Fifth, the Commission can put leasing on equal footing with purchasing by simply  
23 allowing all the capital costs of the lease to be included in the ACRM. Id. at 429.

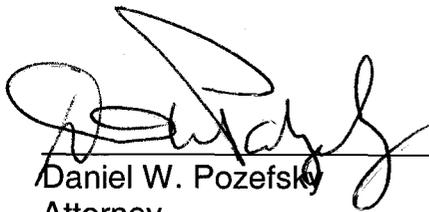
24 Finally, the prospect of arsenic compliance resulting in the Company facing dire  
financial consequences should not be resolved by allowing incremental media expenses in  
the ACRM. The parties had considered an emergency rate increase as the basis for a

1 possible ACRM. However, the Company did not feel that the criteria for an emergency  
2 existed. In the end, the parties agreed not to base the ACRM on an emergency. Id at 430.  
3 Should the Company face an emergency; the Company will always have access to  
4 emergency rates via application to the Commission.

5 **CONCLUSION**

6 RUCO recommends that the Commission approve the ROO. RUCO further  
7 recommends that the Commission not approve the Staff-Company proposal.

8 RESPECTFULLY SUBMITTED this 15<sup>th</sup> day of August, 2003.

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11 Daniel W. Pozefsky  
12 Attorney

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3 of August, 2003 with:

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# Exhibit

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1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 WILLIAM A. MUNDELL  
CHAIRMAN

3 JIM IRVIN  
COMMISSIONER

4 MARC SPITZER  
COMMISSIONER

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6 IN THE MATTER OF THE APPLICATION OF  
7 ARIZONA WATER COMPANY, AN ARIZONA  
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Docket No. W-01445A-00-0962

10 **RUCO'S CLOSING BRIEF**

11 **INTRODUCTION**

12 The Residential Utility Consumer Office ("RUCO") submits the following points in  
13 support of its position that the Arizona Corporation Commission ("Commission") should not  
14 approve Arizona Water Company's ("AWC" or "Company") proposed Arsenic Cost Recovery  
15 Mechanism ("ACRM"). The Company's filing departs from generally accepted ratemaking  
16 principles and exposes ratepayers to unnecessary risk.

17 RUCO proposes that the Commission adopt a modified ACRM that includes completed  
18 used and useful arsenic plant in rates.

19 **THE COMPANY'S PROPOSED ARSENIC COST RECOVERY MECHANISM**

20 The Company's proposed ACRM is designed to provide a return on the arsenic capital  
21 costs for completed facilities placed in service and actually serving customers, and certain  
22 costs related to the operation and maintenance of that plant. Exhibit A-1 at 3, 6. The Company  
23 would recover its arsenic costs through a separate identified surcharge on each customer's

1 monthly bill. The Company proposes to file a limited number of rate increases, two or three,  
2 over the period when the plant is to be placed in service (2003-2006). Exhibit A-1 at 3.  
3 Finally, the Company proposes to file a general rate case with no date certain<sup>1</sup> after all its  
4 arsenic plant is in service, but with a test year no later than December 31, 2006. Exhibit A-1 at  
5 5.

6 RUCO supports much of the Company's proposal. However, there are several  
7 elements of the ACRM that RUCO proposes be modified.

### 8 **THE INCLUSION OF OPERATING AND MAINTENANCE COSTS**

9 The Company originally proposed an ACRM which included estimated operating and  
10 maintenance costs ("O&M"). Exhibit A-1 at 6. RUCO's primary area of disagreement with the  
11 Company's original proposal was the inclusion of estimated O&M costs. RUCO maintained, in  
12 accordance with generally accepted regulatory principles, that only those costs which are  
13 known and measurable are subject to inclusion in rates. Exhibit R-1 at 2. Estimated costs are  
14 not representative of actual costs, and when combined with actual plant in service will result in  
15 inaccurate and unreliable rates. In this case, the actual O&M costs will not be known until the  
16 plant is in operation for over one year. Exhibit S-3 at 7.

17 At the hearing in this matter, the Company changed its position to specify that it would  
18 only seek recovery of actual known and measurable O&M costs. Trans., Vol. 1 at 30-31.  
19 While the Company's clarification is appreciated, it creates additional difficulties that make it  
20 impractical. To include the actual O&M costs would require an analysis of those costs that  
21 would expand the proceeding to a point where it would virtually be a full rate case. Trans. Vol.

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23 <sup>1</sup> At the hearing the Company agreed to a date certain for the filing of September 30, 2007. Trans., Vol. 1 at 44.  
RUCO originally proposed a date certain of May 2007, but has no objection to the September 2007 date.

1 I at 89-90. If the Company intends to include the actual O&M costs, RUCO has no objection  
2 to the filing of a full rate case. However, RUCO will only support an abbreviated procedure if  
3 the O&M costs are excluded.

#### 4 **LEGAL AUTHORITY FOR STEP INCREASES**

5 While the Commission enjoys exclusive authority to set rates, it must nonetheless  
6 comply with the requirements of the Constitution, as interpreted by the courts, in setting "just  
7 and reasonable" rates. See Ariz. Const. Art. 15, § 14; *Scates v. Arizona Corp. Comm'n*, 118  
8 Ariz. 531, 578 P.2d 612 (App. 1978); *Simms v. Round Valley Light & Power*, 80 Ariz. 145, 151,  
9 294 P.2d. 378, 382 (1956). These constitutionally-based requirements are set out in *Simms*  
10 and expanded in *Scates*:

11 It is clear . . . that under our constitution as interpreted by this court, the  
12 commission is required to find the fair value of (the utility's) property and use  
13 such finding as a rate base for the purpose of calculating what are just and  
14 reasonable rates . . . . While our constitution does not establish a formula for  
15 arriving at fair value, it does require such value to be found and used as the base  
16 in fixing rates. The reasonableness and justness of the rates must be related to  
17 this finding of fair value.

18 *Scates*, 118 Ariz. at 534, 578 P.2d at 615 (quoting *Simms*, 80 Ariz. at 151, 294 P.2d at  
19 382)(internal citations omitted).

20 The constitutional basis for these requirements leaves the Commission limited latitude  
21 in setting rates outside a rate case that permits the examination of all costs and revenues, with  
22

1 sound reason. The court in *Scates* acknowledged that such "piecemeal" ratemaking is  
2 "fraught with potential abuse. Such a practice must inevitably serve both as an incentive for  
3 utilities to seek rate increases each time costs in a particular area rise, and as a disincentive  
4 for achieving countervailing economies in the same or other areas of their operations." 118  
5 Ariz. at 534, 578 P.2d at 615.

6 The court in *Scates* invalidated the piecemeal ratemaking in that case because "the  
7 Commission was without authority to increase the rate without any consideration of the overall  
8 impact of that rate increase upon the [company's rate of return], and without, as specifically  
9 required by our law, a determination of [the company's] rate base." *Id.* at 537, 578 P.2d at  
10 618.

11 The Commission is free to deviate from the *Scates* requirement that rates be adjusted  
12 only after examination of all revenue and expenses in two clearly defined instances: 1) interim  
13 rates<sup>2</sup>, or 2) rates modified pursuant to an "automatic adjustment clause." *Id.* at 534-35, 578  
14 P.2d at 615-16; Op. Att'y Gen. 71-15 (1971)(automatic adjuster mechanisms) (cited with  
15 approval in *Scates* at 535, 578 P.2d at 616); Op. Att'y Gen. 71-17 (1971)(interim rates)(cited  
16 with approval in *Scates* at 535, 578 P.2d at 616). No party contends that either exception  
17 applies here.

18 The *Scates* Court did not close the door to the Commission's consideration of  
19 abbreviated fair value findings in every other situation. The Court stated:  
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23 <sup>2</sup> RUCO is not suggesting that compliance with arsenic standards would never create an emergency that might justify interim  
24 relief. However, the Company's ACRM does not rely on the interim rate exception.



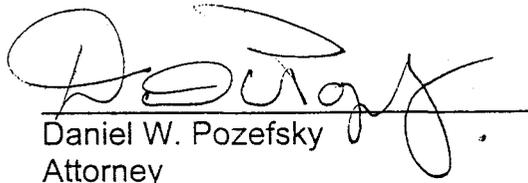
1 **CONCLUSION**

2 RUCO recommends that the Commission approve the Company's original proposal  
3 modified to allow the maximum of two step increases, the exclusion of estimated and actual  
4 O&M costs, and a date certain for the filing of a rate case no later than September 30, 2007.  
5 RUCO further recommends that the Commission not approve the Company's new proposal of  
6 allowing for an abbreviated process which will include actual O&M costs. RUCO would  
7 recommend that the Company be required to file for a full rate case in that situation.

8 RESPECTFULLY SUBMITTED this 6th day of December, 2002

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Daniel W. Pozefsky  
Attorney

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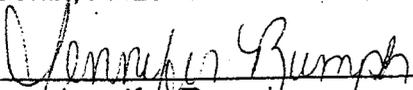
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