ORIGINAL

BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF FAR WEST WATER & SEWER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS SEWER UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES FOR SEWER UITLITY SERVICE BASED THEREON.

Docket No. WS-03478A-05-0801

RUCO'S CLOSING BRIEF

INTRODUCTION

The Residential Utility Consumer Office ("RUCO") submits this Brief in support of its position that the Arizona Corporation Commission ("Commission") should authorize a rate increase of not more than $228,670 for Far West Water & Sewer Company ("Far West" or "Company"). RUCO and the Company are in agreement on most of the issues. However, there are four issues on which RUCO and the Company disagree. With regard to those four issues, RUCO recommends the following ratemaking treatment:

1) Rate Case Expense – RUCO recommends the Commission approve $70,000 as an appropriate level of rate case expense.

2) Rate Design – RUCO recommends that the Commission impute a level of revenue to the Company to compensate ratepayers for the lost revenue as the

result of the Company agreement to provide the Mesa Del Sol Golf Course with treated effluent water at no charge.

3) Property Tax Expense - RUCO recommends the Commission adopt its adjustment to property tax expense based on the formula and inputs used by the Arizona Department of Revenue ("ADOR").

4) Finally, RUCO recommends the Commission adopt its 9.11 percent cost of capital for Far West.

THE COMMISSION SHOULD ADOPT RUCO'S RECOMMENDED RATE CASE EXPENSE

The Company's proposed updated rate case expense is $160,000. R-5 at 16[1]. RUCO recommends $70,000. Id. at 19. The Company's recommended rate case expense is excessive and should be rejected.

The Commission typically looks at a variety of factors when considering rate case expense. Those factors include the complexity of the proceeding, the number of systems involved and a comparison of other cases. See for example Decision No. 67093 (Arizona-American's Sun City et al. rate case), Decision No. 66849 (Arizona Water Company). In terms of complexity, the subject case is not complex. There are no contentious issues requiring an abnormal level of discovery, investigation, documentation, post-hearing expenses, or litigation and/or settlement expenses. R-4 at 18. By comparison the Company's last rate case decided in June 2000 (Decision No. 62649) was far more complex than the present rate case. Id. RUCO's recommendation is based on half ($60,000) of the expense awarded in the 2000 Decision trued up to present day dollars ($70,000). Id.

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[1] For ease of reference, trial exhibits will be identified similar to their identification in the Transcript of Proceedings. The Transcript volume number and page number will identify references to the Transcript.

The Company suggests it does not have control over its costs. A-5 at 16. According to the Company, the Company does not control the Commission's process and it is that process that results in its excessive rate case expense. Id. This argument is absurd. The Company chooses the issues it wants to litigate and the outside consultants it wishes to retain. The Company determines its approach to discovery requests and measures to mitigate expenses related to discovery.

The Company's approach to discovery and its apparent unwillingness to mitigate expenses can be seen in the e-mail that RUCO sent to the Company through its attorney in an attempt to mitigate paperwork. A-6, Exhibit 3. RUCO simply advised the Company that in most cases it did not need duplicate copies of the voluminous paperwork the Company was sending Staff in response to Staff's data requests. RUCO, in good faith and in an effort to mitigate discovery costs suggested the Company contact it in the future when there are volumes of paperwork involved and RUCO would advise the Company, what if anything it needed. In the few instances where this is ever an issue, the slight inconvenience of calling RUCO ahead of time could save time, effort and more importantly could mitigate the exorbitant amount of copying costs the Company claims it must incur in cases like this[2]. The Company misinterpreted RUCO's attempt to mitigate expenses as RUCO's displeasure with the

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[2] According to the Company, in cases like this the copying and mailing costs are "...likely to exceed $15,000..." A-5 at 16. Moreover, RUCO is not really asking the Company to do anything more than what it asks the Company in the cover letter it sends with the data requests. In its standard cover letter, RUCO advises the Company that if its request requires a voluminous amount of material, the Company should contact RUCO to discuss limits to the Company's response.

Company for providing RUCO with copies of responses to Staff's data requests. Id. at 13. The Company infers that RUCO's request to receive copies and RUCO's attempt to mitigate paperwork is a reason why rate case expense is so high and that the Company has no control over the responses or the costs associated with the responses. Id. The Company's knee-jerk response to RUCO's attempt to mitigate costs and the Company's expressed desire to be uncooperative is clearly within the Company's prerogative. The Company's attitude however, explains why the Company's copying costs in small rate cases such as this are likely to exceed the ridiculously inflated amount of $15,000. Contrary to what the Company claims, it does have control over these expenses – it just needs to agree to communicate and cooperate. The Commission should reject the Company's request for $160,000 in rate case expense.

Finally, the Company complains that RUCO's recommendation bears "absolutely no" relationship to the amount of rate case expense the Company will actually incur. A-6 at 11. As of May 2006, the Company has incurred over $128,000 in rate case expense and the Company expects to incur costs "well over $190- to $200,000." Id. at 14, Transcript at 183. The Company does not intend to recover the amount it actually incurs. A-6 at 14. This argument is an attempt by the Company to support it's recommendation by suggesting that ratepayers are somehow getting a good deal because ratepayers will not have to pay the full amount of rate case expense incurred by the Company. In truth, this argument is indicative of the Company's bad business sense and its failure to gauge what a "reasonable" amount of rate case expense should be in a rate case of this size. The Commission has made it clear that it is only going to award a reasonable amount of rate case expense. See Decision No. 67093 at page 20 - "Based on our review of the complexity of this proceeding, the number of systems involved in this rate request, and a comparison of other cases, we find that rate case expense in the amount of $418,941 is *reasonable* for this proceeding" Emphasis added.

Fifteen thousand dollars in copying and mailing costs in this small case where there is only one intervener is not reasonable. The Commission should adopt RUCO's reasonable rate case expense recommendation of $70,000.

THE COMMISSION SHOULD IMPUTE A LEVEL OF REVENUES TO THE COMPANY TO COMPENSATE RATEPAYERS FOR THE LOST REVENUES AS THE RESULT OF THE AGREEMENT THE COMPANY HAS WITH THE MESA DEL SOL GOLF COURSE TO PROVIDE EFFLUENT WATER AT NO CHARGE

The Company provides effluent water to three golf courses within its certified area. As part of this rate application, the Company is proposing an effluent tariff and intends to apply the tariff to two of the three golf courses in its certified area. The Company will continue to provide effluent to the third Golf Course, Mesa Del Sol, at no charge. R-4 at 24. The Company has chosen to not charge Mesa Del Sol for the treated effluent it will provide because of what it claims is the contractual obligation it is under to provide effluent at no charge. Transcript at 283. Ratepayers should not carry the financial burden when the Company fails to recover all the revenues authorized in a Commission approved tariff. R-4 at 25.

By way of background, the Company's predecessor had signed a bulk agreement with the Mesa Del Sol Golf Course ("Mesa Del Sol") to receive the treated effluent at no charge. A-4 at 41. Under the terms of the agreement, the Company's predecessor agreed to provide 500,000 gallons of treated effluent per day to the golf course at no charge. Id. The Company inherited the agreement when it acquired its predecessor. Id. From the Company's perspective, ratepayers benefit from the agreement because the treated effluent would otherwise have to be disposed of at a substantial cost to the ratepayers. Id., Transcript at 284.

The Company's perspective is misplaced. In effect, the Company's perspective ignores the fact that the treated effluent it provides to the Mesa Del Sol golf course has financial value. The Commission needs to look no further to confirm that the treated effluent has financial value than to consider that the Company is receiving revenues and will continue to receive revenues under the tariff from the other two golf courses to which it provides treated effluent. Moreover, the Company itself admits the treated effluent has financial value. Transcript at 283. The offset to the revenues generated by the revenues collected from the other two golf courses that are paying for the effluent, as the Company also admits, results in lower rates to ratepayers. Transcript at 286. There is no offset to revenues that have and will result from the effluent provided to Mesa Del Sol, so ratepayers will be paying higher rates than they should because of the loss of revenues. RUCO recommends that the Commission impute the revenues associated with the effluent deliveries to the Mesa Del Sol golf course at the same commodity charge levied on all other effluent sales. R-5 at 10.

RUCO's recommendation is based on several generally accepted and standard regulatory principles:

1. Recognized ratemaking principles require all customers in a similar service class to be treated equally;
2. Historically, the Commission has recognized the replacement value of effluent over other sources for irrigating golf courses (i.e. potable, well, ground or CAP water, etc.); and
3. Golf courses should adequately compensate the wastewater utility for the effluent since it is superior to the other previously mentioned sources of irrigation (i.e. economically viable, nutrient enriched, conserves scarce water resources, environmentally friendly, etc.). R-5 at 10.

The ratepayers should not carry the financial burden when the Company fails to prudently recover all revenue authorized in a Commission approved tariff. The Commission should impute the value of the effluent provided to the Mesa Del Sol golf course.

The Company attempts to discredit the value of the treated effluent being provided to the Mesa Del Sol golf course by presenting an email from H & S Developer's Director of Golf Operations[3]. A-6, Exhibit 4. The Company's argument and how it was presented is troubling. The email sets forth several reasons why treated effluent is problematic to golf courses and how any financial value associated with the effluent is "lost" due to the added expense associated with management of all the problems inherent in the effluent. Id. This email was dated June 19, 2006. Id.

At the hearing, Gary M. Lee, a professional engineer who testified on behalf of the Company, addressed the issue of the effluent water being provided to Mesa Del Sol. Mr. Lee reviewed Mr. White's email and testified that since the beginning of June the Company was providing the Mesa Del Sol golf course with treated effluent which meets the Arizona Department of Environmental Quality's ("ADEQ") standards for A+ discharge. Transcript at 278. Mr. Lee further testified that he saw two issues raised in the email concerning the quality of the effluent water be provided to Mesa del Sol. Transcript at 270. Both issues have been resolved by the improvements the Company has made and that have been in place since **the beginning of June**. Transcript at 272. In describing the vastly improved quality of the treated effluent provided to the Mesa Del Sol golf course, Mr. Lee noted that the A+ quality discharge has enabled a person to "see to the bottom" of the chlorine disinfection retention tank at the Mesa Del Sol golf course. Id. at 271-272. The Company's argument that the treated effluent being provided to Mesa Del Sol has little or no value as described in the email was and still is

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[3] Interestingly, the Company offers no testimony on this email in the rate design portion of its rejoinder testimony. A-6 at 33.

disingenuous as well as misleading[4]. The Commission should recognize the value of the effluent and allow ratepayers to be credited for that value.

THE COMMISSION SHOULD ADOPT RUCO'S ADJUSTMENT TO PROPERTY TAX EXPENSE BASED ON THE FORMULA USED BY THE ARIZONA DEPARTMENT OF REVENUE ("ADOR").

The use of the ADOR formula using historical inputs to estimate property taxes is a much more accurate estimate of actual property tax than the methodology that the Company proposes and the Commission has historically adopted. R-4 at 13. RUCO's recommended property tax expense calculation was based on the ADOR property tax formula. Id. The property tax formula, as prescribed in ADOR's memo dated January 3, 2001, values water utilities, for property tax purposes by multiplying the average of the water utility's three previous years of reported gross revenues by a factor of two. Id. at 12-13.

The Company has disregarded the revenues required under the ADOR directive and substituted in its place the adjusted test-year revenues twice and its proposed level of revenues once ("Company methodology"). Id. at 12. RUCO, for valuation purposes, has included the test year (2004) and the prior two years (2002, 2003) as directed by ADOR ("ADOR methodology"). Since the ADOR issued its memo, enough time has passed so that actual property tax figures for 2005 are available and the Commission can compare those figures to the estimated figures derived using the Company's and the ADOR methodologies. Far West's actual 2005 property taxes were $35,679. Id. at 13. Using the ADOR methodology, RUCO's estimated 2005 property tax assessment is $48,072, a difference from the actual expense of $12,393. Id. However, using the Company's methodology results in an

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[4] Unbelievably, despite Mr. Lee's testimony concerning the improvements that were made and the enhanced quality of effluent water being provided to the Mesa Del Sol golf course, the Company still maintains that the treated effluent is of very low quality and has little to no financial value as Mr. White concluded in his e-mail.

estimate of $66,142, a difference of $30,463 from the actual expense. Id. This evidence clearly demonstrates that ADOR's method more closely approximates the Company's actual post-test year property tax bill than does the Company and Staff methodology. The Commission should adopt RUCO's approach and recognize the ADOR methodology as the best measure of actual property tax expense.

The Company mistakenly claims that the ADOR methodology using historical inputs ignores the Company's proposed increased revenues. A-5 at 20. In fact, the ADOR formula using historical inputs accounts for additional revenues. The application of proposed revenues, however, to the ADOR formula is likely to overstate property tax expense because of the timing lags inherent in the accrual and collection of property taxes. The impact of additional revenues on property tax is not the same as the impact of additional revenues on income taxes. Whereas the effect of additional revenues on income tax is immediate, the effect of additional revenues on property taxes is not immediate because property taxes based on the increased revenues are not paid until more than a year after new rates go into effect. Even then the increased revenues' impact on property taxes is tempered by the use of two earlier years' revenues. The full impact of increased revenues on property taxes will not be felt until four years after new rates go into effect. An understanding of this timing difference is critical to understand why the ADOR formula using historical inputs is a more accurate method to estimate property taxes than the use of adjusted and pro-forma revenues. This also explains why the new rates that will go into effect will not affect property taxes immediately. In RUCO's experience, the Commission has not gone more than one year beyond the test year

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Transcript at 290-291. The Commission should disregard the Company's position in light of the Company's witnesses' testimony.

to look at any other expense on the income statement. Here, the test year was 2004, and one year beyond that is 2005. RUCO established a level of property tax for 2005.

The Company and Staff recommend the Commission look beyond one year from the test year and consider new rates to estimate property tax expenses more than one year into the future. Historically, the Commission does not consider a post-test-year expense beyond one year because, among other things, it violates the matching, known and measurable and the used and useful principles. The ADOR formula using historical inputs, as RUCO has stated many times before, is forward looking and does consider the fact that new rates will be set. The Commission should adopt the ADOR formula using historical inputs.

The Company relies on previous Commission Decisions that conclude that RUCO's methodology, and hence the ADOR methodology, unreasonably understates property tax expense. Id. With all due respect, the evidence has shown and continues to show, as in this case, that the ADOR methodology is the most accurate. In this case, had the Commission previously approved the Company's methodology, property taxes for 2005 would have been overstated by $30,463 which would have allowed the Company to over earn for several years until that level of tax was actually assessed. The Commission should adopt the ADOR methodology using historical inputs.

COST OF CAPITAL

RUCO believes the Commission should adopt its recommended rate of return of 8.81 percent, which is the weighted cost of RUCO's recommended costs of debt and equity capital. R-7 AT 4.

RUCO believes that its recommended 9.04 percent cost of common equity is appropriate given the current environment of relatively low inflation and historically low interest rates that Far West is operating in. RUCO further believes that the unadjusted 9.04 percent cost of common equity estimated by RUCO witness William A. Rigsby is very reasonable considering RUCO's recommended hypothetical capital structure of 60 percent common equity and 40 percent debt which is heavier in equity than the average capital structure of the water utilities included in Mr. Rigsby's sample. Id. at 6. RUCO's unadjusted 9.04 percent cost of common equity recommendation was derived from a sample of water utilities that had significantly less equity (i.e. approximately 50 percent) in their capital structures than the 60 percent level of common equity that RUCO is recommending for the Company's capital structure. Id. Mr. Rigsby recognized any unique business risk that Far West may face by recommending a capital structure that is higher in common equity and by not making a downward adjustment to the 9.04 percent cost of common equity figure that he derived from his water utilities sample. In addition, Mr. Rigsby's 8.45 percent recommended cost of debt, which is 200 basis points higher than the 6.45 percent average cost of debt of the water utilities included in his sample, also takes any unique business risk that Far West may face into consideration. Mr. Rigsby's cost of equity and cost of debt recommendations are reasonable, fair and should be adopted by the Commission.

Mr. Rigsby further noted that in comparison to other wastewater companies in Arizona there was nothing that made Far West that much different. Transcript at 446. The Company also faces the same types of problems and risks as the water utilities included in Mr. Rigsby's sample. Id. at 446-447. When considered as a whole, the sample water utilities included in Mr. Rigsby's analysis faced greater financial risk than Far West because of the higher level of debt in their capital structures. Id. Despite this fact, Mr. Rigsby did not make a downward adjustment of the cost of common equity estimate derived from his water utilities sample. RUCO's cost of capital recommendation is well reasoned, reasonable, fair, and should be adopted by the Commission.

CONCLUSION

RUCO recommends that the Commission approve $70,000 in rate case expense. RUCO also recommends the Commission impute a level of revenue to the Company to compensate ratepayers for the lost revenues as the result of the agreement the Company has with the Mesa Del Sol Golf Course to provide effluent water at no charge. With regard to property tax, RUCO recommends the Commission adopt its adjustment to property tax expense based on the formula and historical inputs used by ADOR. Finally, RUCO recommends the Commission adopt its 8.81 percent cost of capital for Far West.

RESPECTFULLY SUBMITTED this 8th day of September 2006.

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