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BEFORE THE ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION  
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Arizona Corporation Commission  
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APR -9 2007

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IN THE MATTER OF THE APPLICATION OF  
ARIZONA-AMERICAN WATER COMPANY,  
AN ARIZONA CORPORATION, FOR A  
DETERMINATION OF THE CURRENT FAIR  
VALUE OF ITS UTILITY PLANT AND  
PROPERTY AND FOR INCREASES IN ITS  
RATES AND CHARGES BASED THEREON  
FOR UTILITY SERVICE BY ITS MOHAVE  
WATER AND WASTEWATER DISTRICTS.

Docket No. WS-01303A-06-0014

**EXCEPTIONS OF THE RESIDENTIAL UTILITY CONSUMER OFFICE**

The Residential Utility Consumer Office ("RUCO") makes the following Exceptions to the Recommended Opinion and Order ("ROO") on Arizona American Water Company's ("Arizona American" or "Company") application for a rate increase.

**RATE DESIGN**

The normal practice of the Commission is to allow the recovery of revenues based on a commodity/minimum ratio that does not exceed 60%/40%. This ratio, which is what RUCO is recommending in this case, facilitates the Commission's goal of promoting conservation. The ROO rejects this ratio in favor of the less conservation friendly ratio of 52%/48%. The ROO

1 mistakenly and inaccurately trades off the principle of conservation for what it believes is the  
2 "principal of gradualism<sup>1</sup>."

3 According to the ROO, the 60/40 ratio would impose a sudden and substantial rate  
4 increase on virtually all customers and should therefore be put off for consideration until the  
5 Company's next rate case<sup>2</sup>. However, RUCO's rate design does not impose a "sudden and  
6 substantial rate increases on virtually all customers." Under RUCO's design large users will  
7 receive larger bill increases than smaller users. Thus it is large users that will be primarily  
8 affected and this certainly is an appropriate conservation signal.

9 The ROO relies on the principle of "gradualism" to support its rejection of RUCO's  
10 proposed rate design. However, as the following chart illustrates, the ROO's recommended  
11 rate design does not move toward a more conservation-oriented commodity/minimum ratio  
12 gradually – it actually is a less conservation-oriented rate design than is currently in place.

13 COMMODITY/MINIMUM RATIO (RESIDENTIAL RATES)

	COMMODITY	MINIMUM
14		
15	CURRENT <sup>3</sup>	54% 46%
16	ROO RECOMMENDATION	52% 48%
17	RUCO RECOMMENDATION	60% 40%

18  
19 By comparison to the current rates, under the ROO's recommendation, the ROO's design  
20 would result in 2% more of total revenue being recovered through the minimum charge – and  
21 2% less through the commodity charge. The ROO's recommendation would in fact

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24 <sup>1</sup> ROO at 22.

<sup>2</sup> Id.

<sup>3</sup> See Attached Exhibit A.

1 **discourage** conservation compared to the current rate design by recovering a greater  
2 percentage of revenues being recovered through the minimum charge.

3 On the other hand, RUCO's recommended rate design would decrease the minimum  
4 charge by 6% and increase the percentage recovered through the commodity charge by 6%.  
5 RUCO's rate design, contrary to the ROO's findings, would result in a **decrease in the**  
6 **ratepayer's minimum charge and an increase in the commodity charge.** This sends a  
7 price signal that is more heavily weighted on usage than that proposed in the ROO and this  
8 will further the Commission's goal of conservation. The Commission should reject the ROO's  
9 recommendation and approve RUCO's rate design.

10 In short, RUCO's recommendation to recover a greater percentage of costs from high-  
11 end users is exactly the message the Commission should be sending in order to promote  
12 conservation. The ROO's recommendation will encourage high-end users to use more water  
13 than under either current rates or RUCO's proposed rates and should be rejected by the  
14 Commission<sup>4</sup>.

## 15 **PROPERTY TAX EXPENSE**

16 The ROO rejects RUCO's property tax expense recommendation. According to  
17 the ROO, RUCO has not demonstrated a basis for departure of the Commission's prior  
18 decisions<sup>5</sup>. RUCO respectfully disagrees. RUCO has conducted an extensive property tax  
19 expense study in this case. The purpose of RUCO's study is to present data and show the  
20 results comparing the RUCO/Arizona Department Of Revenue's methodology ("ADOR  
21 Methodology") and the methodology proposed by the Company and Staff and recommended  
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24 <sup>4</sup> See Exhibit 1 – RUCO's proposed Amendment.

<sup>5</sup> ROO AT 10.

1 in the ROO<sup>6</sup>("ROO Methodology") to the actual tax bills of ten different systems of water  
2 utilities that have applied to the Commission for rate increases since ADOR issued its  
3 memorandum setting forth its recommended property tax valuation formula on January 3,  
4 2001. Enough time has passed that the Commission can now consider empirical evidence  
5 and actually see which of the two methodologies results in the closest estimates of actual  
6 property taxes.

7 The overall results of RUCO's study shows that the ADOR Methodology has an  
8 estimation error<sup>7</sup> of 1.6%. The ROO Methodology has an estimation error of 13.7%. While  
9 both methods result in over-estimates of actual property tax assessments, ADOR's  
10 Methodology is **far more accurate** than the ROO's recommended methodology<sup>8</sup>. The  
11 Commission should adopt the ADOR Methodology.

12 The ROO, however, rejected RUCO's study:

13 RUCO's "study" is severely flawed because it arbitrarily excludes water systems  
14 that do not fit its predetermined result and also reflects retroactive effective dates  
for rates, in several instances years before the rates were actually in effect<sup>9</sup>.

15 Again, RUCO respectfully disagrees with the ROO. RUCO did not "exclude" water  
16 systems from its study, but rather selected a sample of comparable water companies. Use of  
17 a sample is standard practice when the entire population of data being analyzed is too large to  
18 practically include.

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21 <sup>6</sup> The ADOR/RUCO Methodology, revised in 2001, values water utilities by multiplying the average of the water utility's  
22 three previous years of reported gross revenues by a factor of two. The Company Methodology substitutes adjusted test-year  
revenues twice, and proposed level of revenues once in the ADOR formula.

23 <sup>7</sup> Estimation error in this context means the degree of error in estimating the actual property tax bill.

24 <sup>8</sup> See RUCO's Final Revised Study attached as Exhibit B. Mr. Coley made several corrections to its final study which  
followed from a slight recording mistake of the amount actually paid by the Company in its Agua Fria system to ADOR for  
2005. The bottom line is a .1% change to the overall average annual collection of all systems using the Company  
methodology (corrected to 13.7% from 13.8%) and no change to the overall annual collection of all systems using the  
ADOR methodology. Transcript at 254-255.

<sup>9</sup> ROO at 10.

1 It should be remembered that originally, it was the main "goal" of the Water Utilities  
2 Association of Arizona ("WUAA") and the ADOR, not RUCO, to come up with a valuation  
3 formula to accurately estimate property tax expense<sup>10</sup>. The ADOR Methodology which the  
4 WUAA and ADOR came up with in 2001, according to WUAA and ADOR met the goals that  
5 they set out to accomplish. Today, the only entity that practices before the Commission that  
6 advocates for and continues to adhere to these goals is RUCO.

7 While the goal of achieving the most accurate estimate has not changed, the  
8 Commission continues to approve a different valuation formula methodology. RUCO's interest  
9 in protecting the ratepayers of Arizona is only to provide the Commission with objective, non-  
10 biased evidence that shows which methodology achieves the goal of providing the most  
11 accurate estimate of future property tax expense. RUCO has no interest or agenda to present  
12 evidence in any other fashion. Out of the ten systems RUCO used in its study, five resulted in  
13 over-estimations using the ADOR formula. The overall results of RUCO's study showed that  
14 the use of the ADOR formula to estimate annual property taxes of all ten systems had a  
15 margin of error of 1.6%. One of the systems RUCO used in its study, Agua Fria (which is one  
16 of the three systems RUCO used in its study that the Company owns - Havasu and Tubac are  
17 the other two) had experienced growth that resulted in the under-estimation of its property  
18 taxes using the ADOR methodology. The growth in Agua Fria was so extensive that it  
19 eliminated most of the over-estimation of the other nine systems that were not experiencing  
20 high rates of growth<sup>11</sup>. If a predetermined result had been RUCO's goal clearly the Agua Fria  
21 system would not have been included.

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24 <sup>10</sup> See attached Exhibit C - ADOR memo dated January 3, 2001

<sup>11</sup> The Company Methodology prevents the Company from earning an appropriate level of property tax expense. Because Mohave Water received a rate reduction in Decision No. 67093, two years are being used in the calculation that are based on the rate reduction and will not allow AZ-AM to recover a fair level of property tax expense on a going forward basis.

1 RUCO did not "arbitrarily" exclude water systems. The basis for the ROO's conclusion  
2 is the Company's assertion "...that RUCO excluded data from seven of the ten former Citizens  
3 systems, apparently because inclusion of those systems would show that Arizona-American  
4 actually under-collected for property taxes under existing rates<sup>12</sup>." The evidence,  
5 overwhelmingly, shows otherwise.

6 Like RUCO, the Company prepared a property tax expense study. The Company's  
7 study, however, only looked at ten of its own operating districts<sup>13</sup>. RUCO's study is comprised  
8 of ten different utilities that vary in size, ownership, and operating characteristics<sup>14</sup>. Thus,  
9 RUCO's study is more representative of the overall Arizona water industry. Moreover,  
10 RUCO's study examines the disparities between actual taxes and tax estimates using the two  
11 different methodologies on a utility- by-utility basis<sup>15</sup>. The Company's study looks at an  
12 aggregate comparison of its own systems<sup>16</sup>. The Company's study does not show the  
13 applicable results on a system-by-system basis and does not account for the large skews  
14 caused by the Company's systems that are experiencing high rates of growth.

15 The Company admits that several of the ten systems it considered, for example  
16 Anthem and Agua Fria, experienced high rates of growth<sup>17</sup>. Systems experiencing high rates  
17 of growth earn greater revenues, which result in greater property tax assessments<sup>18</sup>. The  
18 result of high growth rates, as the Company readily admits, is under-recovery of its actual  
19 property taxes<sup>19</sup>. RUCO did eliminate a few systems from its sample originally selected due  
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22 <sup>12</sup> ROO at 10.

<sup>13</sup> Transcript at 217.

<sup>14</sup> RUCO-4.

23 <sup>15</sup> RUCO-4, A-14 at 40-43.

<sup>16</sup> Id.

24 <sup>17</sup> Transcript at 218.

<sup>18</sup> Id.

<sup>19</sup> Transcript at 219.

1 to aberrations<sup>20</sup>. For example, RUCO excluded the Company's Sun City Water District, which  
2 had a wide range of tax rates associated with it over the five-year period since the ADOR  
3 memorandum was issued<sup>21</sup>. RUCO's study was not arbitrary nor conducted to arrive at a  
4 "predetermined result." Should the Commission adopt the ROO's property tax  
5 recommendation, RUCO requests the portion of the ROO characterizing RUCO's study as  
6 "severely flawed" (page 10, lines 19-21) be stricken.

7 Next, the ROO critiques RUCO's study because it reflects what it claims are  
8 "retroactive effective dates for rates, in several instances years before the rates were actually  
9 in effect"<sup>22</sup>. RUCO went to great lengths on the record, apparently unsuccessfully, to explain  
10 exactly what it is that its study was intended to show. The purpose of RUCO's study is to  
11 present data and show the results comparing the ADOR and the ROO's Methodologies to the  
12 actual tax bills of ten different systems of water utilities that have applied to the Commission  
13 for rate increases since the ADOR memorandum was issued in 2001<sup>23</sup>. First, RUCO's study  
14 compares the results of the Company's Methodology applied to two test year adjusted and  
15 one year of proposed revenues from the respective cases to actual tax bills for the different  
16 systems. Next, the study compares ADOR's Methodology using historical inputs as  
17 recommended by RUCO to the same actual tax bills<sup>24</sup>.

18 In other words, RUCO's study was not designed to consider lags between when the  
19 property tax expense was incurred and when the property tax expense was paid<sup>25</sup>. What  
20 RUCO's study was designed to do was a simple comparison of what property tax expense  
21 was authorized by the Commission using the ROO's Methodology and what the property tax  
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23 <sup>20</sup> Transcript at 258.

<sup>21</sup> Id.

<sup>22</sup> ROO at 10.

24 <sup>23</sup> RUCO-6 at 20-21.

<sup>24</sup> Id.

1 expense would have been using the ADOR Methodology to each utility's actual property taxes  
2 for their respective test years and the following four years<sup>26</sup>. RUCO's study simply is a  
3 comparison of the accuracy of the estimations that result from the two different  
4 methodologies. The ROO shows a misunderstanding of RUCO's study. This  
5 misunderstanding, while unfortunate, in no way affects the validity or accuracy of RUCO's  
6 study.

7 RUCO's study is a fair, unbiased and representative view of the accuracy of the two  
8 methodologies in estimating property tax expense. RUCO in good faith invested significant  
9 resources in performing this study and presenting it to the Commission. RUCO has done this  
10 with the strong belief that the Commission is always willing to consider empirical evidence  
11 which shows that there may be a methodology that provides more accurate estimations than  
12 the methodologies used in the past. RUCO has no axe to grind on this issue and would hope  
13 that if the Commission does not agree with RUCO, it will remain respectful of RUCO's  
14 position<sup>27</sup>.

15 During the hearing, RUCO proposed a compromise solution to the property tax  
16 estimation debate that suggested a property tax calculation that uses two years of historical  
17 gross revenues and one year of projected revenues. This methodology would provide a  
18 better estimate of actual property tax than the methodology recommended by the ROO  
19 because it is based on historical data that ADOR will actually use as the basis of its property  
20 tax assessment. RUCO also provided evidence that Staff, in *Bella Vista Water Company*,  
21 *Docket W-02465A-01-0776, Decision No. 65350 docketed November 1, 2002*, recommended  
22 two different valuation methodologies to estimate property tax expense – the ADOR

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24 <sup>25</sup> Transcript at 289.

<sup>26</sup> Transcript at 289-293.

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22 two different valuation methodologies to estimate property tax expense – the ADOR

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24 <sup>25</sup> Transcript at 289.

<sup>26</sup> Transcript at 289-293.

1 methodology or the compromise position RUCO is now offering<sup>28</sup>. The Commission, while  
2 approving a different methodology, noted in its Decision (Decision No. 65350) "Under  
3 proposed rates, the most logical approach is to use the two most recent historic years'  
4 revenues and the projected revenues under the newly approved rates<sup>29</sup>." The ROO is silent  
5 on that portion of RUCO's property tax position<sup>30</sup>.

6 RESPECTFULLY SUBMITTED this 9th day of April, 2007

7  
8 

9 Daniel W. Pozefsky  
10 Attorney

11 AN ORIGINAL AND THIRTEEN COPIES  
12 of the foregoing filed this 9<sup>th</sup> day  
13 of April, 2007 with:

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17 Phoenix, Arizona 85007

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<sup>27</sup> See Exhibit 2 – RUCO's proposed Amendment.

<sup>28</sup> RUCO-6 at 23

<sup>29</sup> See Decision No. 65350 at 16.

<sup>30</sup> See Exhibit 3 – RUCO's proposed Amendment.

1 By \_\_\_\_\_  
2 Ernestine Gamble  
3 Secretary to Daniel W. Pozefsky  
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2 **EXHIBIT 1**  
3 **RUCO's Amendment No. 1**  
4 **(Rate Design)**

5 Page 11 Line 8

6 **DELETE** Page 22, line 12 through line 24.

7 **INSERT** We agree with RUCO that appropriate price signals should be  
8 given to customers to encourage conservation. Under RUCO's water rate design proposal,  
9 RUCO's recommended rate design in comparison to current rates, would decrease the  
10 minimum charge by 6% and increase the commodity charge by 6%. Under the Staff and  
11 Company proposal, residential ratepayers will experience a 2% increase in their minimum  
12 charges and a 2% decrease in their commodity charges. We adopt RUCO's water rate design  
13 proposal as it results in a decrease in the ratepayer's minimum charge and furthers the  
14 Commission's goal of conservation.

15 Page 25, line 22

16 **DELETE** Page 25, line 22

17 **INSERT** With regard to Mohave Water, we approve RUCO's 60%  
18 commodity/40% minimum ratio and adopt Staff's rate design in all other regards.  
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3 **EXHIBIT 2**  
4 **RUCO'S Amendment No. 2**  
(Property Tax)

5 Page 10 line 9

6 **DELETE** Page 10, lines 9 through Page 11, Line 2

7  
8 **INSERT** The ADOR formula utilized by RUCO is the best estimate of the  
9 Company's property taxes. RUCO has demonstrated through its study new evidence which  
10 shows, when compared to the Company and Staff's methodology, that RUCO's methodology is  
11 significantly more accurate in estimating what future property taxes will be. RUCO's  
12 methodology utilizes historical inputs as agreed upon by the ADOR and the Water Utilities  
13 Association of Arizona in arriving at a recommended valuation formula in 2001. The method  
14 proposed by the Company and Staff applies adjusted and proposed revenues to the ADOR  
15 formula and is likely to result in greater over-earnings by the Company than RUCO's  
16 methodology. RUCO's calculation of property tax expense yields the best estimate of the  
17 Company's property tax expense for the period in which new rates will be in effect, and we will  
18 use that calculation.  
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