

ORIGINAL



0000070758

RECEIVED

2003 NOV 10 P 4:49

RECEIVED
DOCUMENT CONTROL

1 FENNEMORE CRAIG
A Professional Corporation
2 Norman D. James (No. 006901)
Jay L. Shapiro (No. 014650)
3 3003 North Central Avenue
Suite 2600
4 Phoenix, Arizona 85012-2913
Telephone: (602) 916-5000

5 ARIZONA WATER COMPANY
6 Robert W. Geake (No. 009695)
Vice President and General Counsel
7 3805 Black Canyon Highway
Phoenix, Arizona 85015-5351
8 Telephone: (602) 240-6860

9 Attorneys for Arizona Water Company

10

11 **BEFORE THE ARIZONA CORPORATION COMMISSION**

12

13 IN THE MATTER OF THE
APPLICATION OF ARIZONA WATER
14 COMPANY, AN ARIZONA
CORPORATION, FOR ADJUSTMENTS
15 TO ITS RATES AND CHARGES FOR
UTILITY SERVICE FURNISHED BY
16 ITS EASTERN GROUP AND FOR
CERTAIN RELATED APPROVALS.

Docket No. W-01445A-02-0619

Arizona Corporation Commission
DOCKETED

NOV 10 2003

17

DOCKETED BY *CAJ*

18

19

ARIZONA WATER COMPANY'S REPLY BRIEF

20

IN SUPPORT OF APPLICATION FOR RATE ADJUSTMENTS

21

22

23

24

25

26

TABLE OF CONTENTS

		Page
1		
2		
3	I. INTRODUCTION: OVERVIEW OF THE APPLICABLE LEGAL STANDARD	1
4	II. RATE BASE ISSUES	2
5	A. Post-Test Year Plant Additions.....	2
6	1. RUCO's Proposed Projected Test Year	2
7	2. Staff's Accumulated Depreciation	7
8	B. Working Capital Allowance.....	8
9	1. Staff's Arguments Regarding the Property Tax Component of Working Capital are Without Merit.....	8
10	2. The Company Disagrees with RUCO's Income Tax Component of Working Capital.....	10
11	C. Deferred CAP M&I Capital Charges	10
12	1. The Amortization Period Should be Three Years.....	10
13	2. The Amount to be Amortized is \$691,522	11
14	III. INCOME STATEMENT ISSUES	12
15	A. Staff's Revenue Annualization Distorts Test Year Revenues	12
16	B. Eliminating the PPAM and PWAM is Unreasonable	12
17	C. Rate Case Expense	14
18	1. Arizona Water's Rate Case Expense is Reasonable Given the Nature and Complexity of this Rate Proceeding and Should be Approved.....	14
19	2. Staff's Recommended Five Year Amortization Is Too Long.....	16
20	D. CIAC Amortization Methodology	17
21	IV. CAPITAL STRUCTURE AND COST OF CAPITAL ISSUES	18
22	A. Capital Structure and Cost of Debt	18
23	B. Cost of Equity	19
24	1. The Applicable Legal Standard	19
25	2. The Company's Sample Groups of Utilities are Appropriate	19
26	3. Staff's Criticisms of the Company's DCF Estimates Are Misplaced	20
	4. Staff's Reliance on Its CAPM Estimates Is Inappropriate	22
	5. The Evidence in the Record Supports an Additional Risk Premium for Arizona Water.....	26
	V. RATE DESIGN AND CONSOLIDATION ISSUES.....	30

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

TABLE OF CONTENTS
(continued)

	Page
A. Staff's Inverted Tier Rate Design Should Be Rejected	30
B. The Apache Junction and Superior Systems Are Contiguous, Will Be Interconnected, and Should Be Consolidated Now	32
VI. OTHER ISSUES	35
A. Staff has Failed to Provide Sufficient Justification for Adoption of its Water Loss Plan	35
B. There is no Reason to Modify Arizona Water's NP-260 Tariff	36
C. Arsenic Treatment Cost Recovery Mechanism	36
D. PCG Settlement.....	37
1. The Treatment of the PCG Legal Expenses is Immaterial	41
4. Staff's has Not Shown that its Adjustment to Miami Purchased Power Expense is Known and Measurable.....	42

1481104.2

1 **I. INTRODUCTION: OVERVIEW OF THE APPLICABLE LEGAL**
2 **STANDARD.**

3 Arizona Water Company ("Arizona Water" or "the Company") hereby submits its
4 reply brief in support of its application for adjustments to its rates and charges for water
5 utility service by its Eastern Group systems. This brief will address the evidence and
6 argument presented in the closing briefs submitted by the Arizona Corporation
7 Commission ("the Commission") Utilities Division Staff ("Staff") and the Residential
8 Utility Consumer Office ("RUCO"). Generally, Arizona Water will use the same
9 abbreviations and conventions as were used in the Company's initial brief.

10 As a preliminary matter, however, it is necessary to briefly review the applicable
11 legal standard for ratemaking proceedings in Arizona. Under the Arizona Constitution,
12 the Commission is responsible for "prescrib[ing] just and reasonable classifications to be
13 used and just and reasonable rates and charges to be made and collected, by public
14 service corporations within the State for service rendered therein." Ariz. Const. Art. 15, §
15 3. The methodology utilized by the Commission in setting rates that are "just and
16 reasonable" requires that "rates and charges should be sufficient to meet a utility's
17 operating costs and to give the utility and its stockholders a reasonable rate of return on
18 the utility's investment." *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 578 P.2d 612
19 (App. 1978). *See also Litchfield Park Service Co. v. Arizona Corp. Comm'n*, 178 Ariz.
20 431, 434-35, 874 P.2d 988, 991-92 (App. 1994); *Consolidated Water Utilities, Ltd. v.*
21 *Arizona Corp. Comm'n*, 178 Ariz. 478, 481-82, 875 P.2d 137, 140-41 (App. 1993).

22 The Commission's decision must be based on the evidence presented by the
23 parties in this proceeding, with due regard to the credibility of the witnesses and the
24 authorities and precedent supporting the parties' positions, in the same manner as a court.
25 In this case, as shown in the Company's Brief and in this reply brief, Staff and RUCO
26 offer a number of recommendations that are not supported by evidence in the record

1 before the Commission. This is contrary to the process of Commissions is obligated to
2 follow:

3 [A rate case] is a [proceeding] which carries with it
4 fundamental procedural requirements. There must be a full
5 hearing. There must be evidence adequate to support
6 pertinent and necessary findings of fact. Nothing can be
7 treated as evidence which is not introduced as such. Facts
8 and circumstances which ought to be considered must not be
9 excluded. Facts and circumstances must not be considered
10 which should not legally influence the conclusion. Findings
11 based on the evidence must embrace the basic facts which
12 are needed to sustain the order.

13 ...

14 A proceeding of this sort requiring the taking and weighing
15 of evidence, determinations of fact based upon the
16 consideration of the evidence, and the making of an order
17 supported by such findings, has a quality resembling that of a
18 judicial proceeding. Hence it is frequently described as a
19 proceeding of a *quasi judicial* character. The requirement of
20 a 'full hearing' has obvious reference to the tradition of
21 judicial proceedings in which evidence is received and
22 weighted by the trier of the facts. The 'hearing' is designed
23 to afford the safeguard that the one who decides shall be
24 bound in good conscience to consider the evidence, to be
25 guided by that alone, and to reach his conclusion
26 uninfluenced by extraneous considerations which in other
fields might have play in determining purely executive
action. The 'hearing' is the hearing of evidence and
argument.

18 *State ex rel. Corbin v. Arizona Corporation Comm'n*, 143 Ariz. 219, 223-24, 693 P.2d
19 362, 366-67 (App. 1984); *citing Morgan v. United States*, 298 U.S. 468 (1936) (italics in
20 original). In this proceeding, only one party, Arizona Water, has presented substantial
21 evidence concerning the contested issues sufficient to sustain a decision based on the
22 record.

23 **II. RATE BASE ISSUES.**

24 **A. Post-Test Year Plant Additions.**

25 **1. RUCO's Proposed Projected Test Year.**

26 RUCO generally objects to the methodology Arizona Water has employed in this

1 case, contending that Arizona Water has failed to comply with A.A.C. R14-3-103(B),
2 which sets forth the filing requirements for rate applications by public service
3 corporations. Initial Post-Hearing Brief of the Residential Utility Consumer Office
4 (“RUCO Brief”) at 2. More specifically, RUCO argues that Arizona Water failed to base
5 its rate application on a historical test year because Arizona Water “adjust[ed] its test year
6 2001 revenues, expenses, and rate base elements with 2002 estimated amounts that would
7 have the effect of increasing its revenue requirement.” *Id.* This is simply not an accurate
8 description of the methodology employed by Arizona Water, as explained in the
9 introductory portion of the Company’s Brief. Arizona Water Company’s Closing Brief
10 in Support of Application for Rate Adjustments (“Company Brief”) at 3-5. In fact, as
11 explained in the Company’s Brief, the very regulation cited by RUCO specifically
12 contemplates that the historic test year data will be adjusted “to obtain a normal or more
13 realistic relationship between revenues, expenses and rate base.” A.A.C. R14-2-
14 103(A)(3)(i) (definition of “pro forma adjustments”). *See also* Hubbard Rb. (Ex. A-12)
15 at 3-4 (explaining why it is necessary and appropriate to adjust historic test year data in
16 developing rates); Ht. at 729.

17 RUCO complains that Arizona Water used “estimated amounts in making pro
18 forma adjustments to the data for the 2001 test year used in this case.” RUCO Brief at 2.
19 *See also* Rigsby Sb. (Ex. R-1) at 15 (referring to purported “speculative pro forma
20 estimates”). However, other than RUCO’s continued disagreement with the
21 Commission’s longstanding policy of allowing revenue-neutral post-test year plant to be
22 included in rate base, as discussed below, RUCO provides no examples of Arizona
23 Water’s attempt to use “speculative pro forma estimates” to make adjustments to test year
24 data. RUCO has an obligation to identify any adjustment it thinks is inappropriate, rather
25 than making vague and unsupported assertions about the Company’s rate application.

26 RUCO’s primary objection concerns the inclusion of post-test year plant in rate

1 base. RUCO Brief at 3. In fact, Mr. Rigsby testified that it is not normal regulatory
2 practice to include post-test year plant in rate base. Rigsby Dt. (Ex. R-8) at 13.
3 However, there have been numerous instances in which the Commission has authorized
4 water utilities, including AWC, to include post-test year plant in rate base provided that
5 (1) the plant is revenue-neutral, i.e., intended to provide service to customers existing at
6 the end of the test year, and (2) the plant is completed and placed in service a reasonable
7 time before the hearing, so that the plant can be inspected and its costs audited, including
8 the Company's recent Northern Group rate case. *E.g.*, Decision No. 64282 at 2-5. For
9 example, in Bella Vista Water Company's 2002 rate case, the Commission authorized the
10 inclusion in rate base of approximately \$1.8 million of plant constructed after the test
11 year, and placed in service prior to hearing, stating:

12 While this Commission utilizes the historic test year as a
13 starting point, the rules permit, and in the past we have
14 allowed, pro forma adjustments in order to more accurately
15 reflect reality during the period the rates will be in effect. In
16 Decision No. 62993 (November 3, 2000), in which the
17 Commission considers its Water Task Force's Report, the
18 Commission approved Staff's request to order Staff to
19 develop a policy with specific requirements for expense
20 changes, revenue changes, and plant additions that occur
21 after the test year. At that time, in connection with its
22 recommendations concerning a future test year, Staff stated:

18 Staff believes there is no need to change the
19 present method used by the Commission. At
20 present, the Commission employs an historic
21 test year but does allow for pro forma additions
22 for known and measurable costs. It is Staff's
23 opinion that this is a very good combination of
24 both historic and future test years. Presently,
25 this is done on a case-by-case basis.

26 * * *

We believe that it is not in the public interest for Bella Vista
to incur the expense associated with another rate case to
begin earning a return on plant that is being dedicated to
provide service to existing customers. We do not want to
discourage companies like Bella Vista from proactively
addressing system reliability needs. The Company relied on

1 past Commission decisions that allowed post-test year plant
2 in determining the timing of its rate application. We do not
3 agree with Staff and RUCO that the Commission has always
4 required extraordinary circumstances to allow post-test year
5 plant.

6 *Bella Vista Water Co.*, Decision No. 65350 (Nov. 1, 2002) at 10-11. *See also Paradise*
7 *Valley Water Co.*, Decision No. 61831 (July 20, 1999) at 3-5; *Far West Water Co.*,
8 Decision No. 60437 (Sept. 29, 1997) at 5.

9 In reality, RUCO is simply attacking the Commission's policy under which post-
10 test year plant is included in rate base if the foregoing conditions are satisfied. Under
11 those conditions, there is no "mismatch," as RUCO erroneously contends, because the
12 plant that is included in rate base is matched to test year customers, i.e., the plant is
13 intended to serve test year customers and is treated, on a pro forma basis, as being in
14 service during the test year. The cost of such plant is known and measurable because, in
15 this case for example, it was completed and placed in service by no later than December
16 31, 2002 (more than eight months before the commencement of the hearing), and all of
17 the parties had ample opportunity to audit and inspect the plant additions. *Ht.* at 736-38,
18 983. In fact, the hearing was postponed by Judge Wolfe for the express purpose of
19 allowing Staff and RUCO additional time "to complete their analysis and prepare their
20 testimony regarding inclusion of the requested post-test year plant in rate base." *Second*
21 *Rate Case Procedural Order* (March 14, 2003) at 2-3.¹

22 RUCO also claims that a mismatch exists because the post-test year plant
23 additions were financed by means of contributions in aid of construction ("CIAC"), citing
24 Mr. Rigsby's surrebuttal testimony. *RUCO Brief* at 3. However, as Ms. Hubbard
25 testified, RUCO's contention is not true. *Hubbard Rj.* (Ex. A-13) at 18-19. Attached to
26 Ms. Hubbard's rejoinder testimony as Exhibit SLH-RJ6 is a copy of the Company's

¹ Notably, the 90-day extension was not granted for the purpose of allowing RUCO to
create a new test year, as RUCO's incorrectly suggests in its brief. *RUCO Brief* at 3.

1 response to a RUCO data request, which explained that “[a]ll of the projects comprising
2 the Company’s request for a rate base adjustment for post test year construction projects
3 are non-revenue producing, inside-funded projects and, as such, are supported by neither
4 CIAC or AIAC [advances in aid of construction].” Indeed, RUCO’s unsupported
5 contention is illogical because plant financed by CIAC (and by AIAC) normally consists
6 of distribution mains, service lines, hydrants and related facilities constructed to extend
7 service to new customers, as opposed to customers existing at the end of the test. *See*
8 A.A.C. R14-2-406. Thus, RUCO is manipulating the Company’s rate base by attempting
9 to include post-test year CIAC (as well as post-test year AIAC, accumulated depreciation
10 and deferred taxes) that do not relate to the Company’s post-test year plant additions.

11 In short, RUCO’s arguments conflict with established Commission policy and
12 have no support in the record. There is simply no evidence that any of the Company’s
13 post-test year plant additions were financed by CIAC. As a result, RUCO’s claim that
14 the Company’s depreciation and amortization expense is “overstated” (RUCO Brief at 3-
15 4) is nonsense. In reality, RUCO continues to oppose the inclusion of any post-test year
16 plant in a utility’s rate base, even if such plant additions satisfy the criteria the
17 Commission has established in prior rate proceedings, including the Company’s recent
18 Northern Group proceeding. The inclusion of revenue-neutral post-test year plant
19 additions in rate base is as consistent with the so-called “matching principle” as is
20 adjusting revenue and expenses to take into account customers added during the test year,
21 or using a new state corporate income tax rate or a new property tax valuation formula
22 effective after the test year, as the Commission did in the Northern Group’s prior rate
23 proceeding. *See* Decision No. 64282 at 12-14. Conversely, however, adjusting all of the
24 Company’s 2001 test year data by substituting unadjusted data for calendar year 2002, as
25 RUCO proposes, does violate the historic test year concept and, as it was in the
26 Company’s Northern Group proceeding, should be rejected.

1 **2. Staff's Accumulated Depreciation.**

2 As explained in the Company's Brief, the Company made corresponding
3 adjustments to the recorded accumulated depreciation balance at the end of the test year
4 and to test year depreciation expense to properly take into account both plant added
5 during the test year and post-test year plant additions. Company Brief at 6-7.
6 Corresponding adjustments must be made to both the accumulated depreciation balance
7 and to test year depreciation expense for consistency with the basic accounting principle
8 that as depreciation on plant is recovered as an expense, the accumulated depreciation
9 balance increases by the same amount. *Id.* at 7. *See also* Hubbard Rb. (Ex. A-12) at 6-7.
10 While Staff made various adjustments to accumulated depreciation and to test year
11 depreciation expense, these adjustments were not explained in Staff's pre-filed testimony
12 (*see, e.g.*, Ludders Sb. [Ex. S-46] at 3), and Staff's accounting witness, Mr. Ludders, was
13 unable to explain when cross-examined what adjustments Staff made and the basis for
14 those adjustments. Ht. 999-1008.

15 Unfortunately, Staff's brief does not provide any additional insight into Staff's
16 adjustments. Instead, Staff merely recites general principles, stating:

17 As Mr. Ludders explains, rate base is a measurement at a
18 point in time. (Tr. at 986-87). If post-test year plant is
19 included, related accounts should be updated to match. *Id.*
20 In other words, it violates the matching principle to measure
21 plant at one point in time but measure accumulated
depreciation at another point in time. *Id.* The Company
recognized this when it recorded retirements related to the
post-test year plant through the end of 2002. *Id.* at 436-47.

22 Staff Brief at 8-9. Arizona Water agrees with the foregoing statement. As explained in
23 the Company's testimony, Arizona Water did update all related accounts. *E.g.*, Hubbard
24 Dt. (Ex. A-11) at 9-10 and 31-32. However, Staff's statement is not consistent with
25 Staff's adjustments to accumulated depreciation (and to depreciation expense). As also
26 explained in the Company's Brief, the Company adjusted the accounts that are related to

1 the post-test year plant, increasing both the accumulated depreciation balance and the test
2 year depreciation expense. Company Brief at 6-7. The purpose of these adjustments was
3 to “obtain a normal or more realistic relationship between revenues, expenses and rate
4 base” as contemplated by the Commission’s rules. *E.g.*, A.A.C. R14-2-103(a)(3)(i).
5 Thus, as explained in the preceding section addressing RUCO’s attempt to create a new
6 test year, non-revenue producing plant, placed in service within 12 months after the end
7 of the test year, is matched to test year-end customers. Similarly, plant that was retired
8 within 12 months from the end of the test year was removed from rate base because that
9 plant was being used to serve customers at the end of the test year. Finally, the Company
10 has adjusted depreciation expense to recognize that, on a going-forward basis, the post-
11 test year plant (as well as retired plant and plant placed in service during the test year)
12 will result in a known and measurable change to test year operating expenses.

13 In short, the Company has properly matched the elements of rate base at the
14 correct point in time: December 31, 2001. Conversely, the Staff’s adjustments to the
15 Company’s accumulated depreciation balance and test year depreciation expense remain
16 unexplained and unsupported. Staff’s brief merely reiterates the general principle that
17 pro forma adjustments should be made to historic test year data in order to properly
18 reflect known and measurable changes that will impact rates on a going-forward basis
19 and that those adjustments should be consistent with each other. Without knowing what
20 adjustments Staff has made and their specific basis, Staff’s adjustment should be
21 disregarded.

22 **B. Working Capital Allowance.**

23 **1. Staff’s Arguments Regarding the Property Tax Component of**
24 **Working Capital are Without Merit.**

25 Staff argues that it calculated the Company’s working capital allowance “using the
26 leading reference book on the subject by Mr. Dabelstein.” Staff Brief at 5. First, Staff’s

1 repeated efforts to interject the hearsay "testimony" of Mr. Dabelstein on how to
2 calculate the property tax component of working capital were rejected by Judge Nodes,
3 and Staff should not be allowed to improperly interject it again in its closing brief. Ht. at
4 439-41, 1103-04. Moreover, Staff failed to show that Mr. Dabelstein's so-called
5 reference book is any sort of authoritative treatise on the subject of the type that can be
6 cited in a legal document. Indeed, Mr. Dabelstein's reference materials, which Staff cites
7 but fails to provide, are nothing more than a training manual. See Exhibit A, excerpts
8 from Mr. Dabelstein's *Public Utility Working Capital*, attached hereto.

9 More importantly, Mr. Dabelstein's materials fail to support the calculation of the
10 property tax component of working capital recommended by Staff in this proceeding. As
11 Mr. Dabelstein explains (at page 68 of the text), the key date is when the property taxes
12 are "levied" on the utility. The term "levied," according to *Black's Law Dictionary*,
13 means to "assess," as in to assess a tax. According to Mr. Dabelstein, once the tax is
14 levied, the average lag days are determined based on when the tax payments are due. Mr.
15 Dabelstein's illustration, using Minnesota, is readily comparable to the calculation made
16 by Arizona Water and Staff.² Nowhere does Mr. Dabelstein state that the valuation date,
17 which in Arizona occurs approximately 6 months before a valuation notice is received
18 and approximately 18 months before property taxes are actually "levied," i.e., assessed
19 by the county (e.g., Ht. at 396, Ex. A-21), has any bearing on the determination of the
20 lead/lag days for determining the property tax component of working capital. Therefore,
21 Mr. Ludders could not possibly have relied on Mr. Dabelstein's manual because that text

22 _____
23 ² Notably, the average lag days are longer in Minnesota because in that state, the first half
24 of the property tax payment is due on May 15 of the year after the taxes are levied, in
25 contrast to Arizona, in which the first half payment of taxes is due on October 1 of the
26 year in which taxes are levied. If October 1 is substituted for May 15, and May 1 (when
the second half payment is due in Arizona) is substituted for October 15 in Mr.
Dabelstein's Minnesota example, it becomes obvious that Mr. Dabelstein's methodology
mirrors that employed by Arizona Water (and RUCO) to reach an average lag of 212
days. See, e.g., Ht. at 391-95.

1 contradicts Mr. Ludders' own explanation of his working capital allowance calculation.

2 **2. The Company Disagrees with RUCO's Income Tax Component**
3 **of Working Capital.**

4 RUCO's understanding of the Company's calculation of the lag associated with
5 the payment of federal and state income taxes is incorrect. RUCO mischaracterizes the
6 Company's calculation of the lag factor associated with federal and state income taxes,
7 stating that the Company has assumed monthly payments rather than quarterly payments.
8 RUCO Brief at 17. However, in the Company's testimony, it is clearly stated that the
9 Company records its income tax liability on a monthly basis while making quarterly
10 payments, as opposed to making monthly payments. Hubbard Rj. (Ex. A-13) at 20.
11 RUCO then argues that the lead/lag should be calculated based on the payment of taxes,
12 and not when the tax liability is recorded on the Company's books. This, too, is
13 incorrect. The lead/lag method of computing the cash working capital component of rate
14 base requires a calculation of the number of lead or lag days that exist between the time
15 an expense is recorded and the payment of such expense. *Id.* at 7.

16 **C. Deferred CAP M&I Capital Charges.**

17 **1. The Amortization Period Should be Three Years.**

18 Staff seeks to defend its extended amortization period for CAP M&I capital costs
19 by arguing that Arizona Water seeks a dramatic departure from a prior Commission
20 order. Staff Brief at 4. This is incorrect. Although the Commission adopted a 44 year
21 amortization period in the 1992 rate case at that time, Arizona Water, like many of
22 Arizona's water providers, had not yet begun significant use of CAP water and the
23 Commission had not developed a CAP policy. *Ht.* at 489. Today, however, the
24 Company is using its CAP allocation and the Commission's rationale for long-term
25 deferrals is no longer present. *Id.* In fact, in the only applicable precedent, which Staff
26 has ignored (*Ht.* at 1033-34), the Commission matched the amortization period for cost

1 recovery to the deferral period. Decision No. 62293 (Feb. 1, 2000). at 8. Thus, in that
2 case, the Commission authorized a five year amortization period because the CAP costs
3 at issue had been deferred over a five year period.

4 In this case, Arizona Water recommended a three year amortization, although
5 RUCO's recommended ten year amortization is not unreasonable or inconsistent with
6 recent Commission precedent. Thus, the Commission should approve an amortization
7 period of no more than ten years.

8 **2. The Amount to be Amortized is \$691,522.**

9 In its brief (Company Brief at 14, n. 6), Arizona Water indicated that the parties
10 appear to agree on the amount of the deferred CAP M&I charges to be recovered by
11 Arizona Water in this proceeding. However, RUCO now recommends that the
12 Commission authorize amortization of deferred charges totaling only \$645,207, which
13 RUCO claims is the actual amount of deferred charges. RUCO Brief at 16. The
14 \$645,207 of deferred charges are the deferred charges since the Company's 1992 rate
15 proceeding. However, RUCO has overlooked the unamortized balance of \$46,315
16 associated with the deferred CAP M&I capital charges incurred by Arizona Water prior
17 to the 1992 rate case (referred to in the Company's direct testimony as pre-1991 deferred
18 CAP M&I charges), which charges were previously approved for recovery but have not
19 fully recovered by Arizona Water. Hubbard Dt. (Ex. A-11) at 10-15. It is appropriate to
20 include such amount as part of the deferred charges to be recovered because it was
21 previously approved for recovery. *Id.* Therefore, the total deferred CAP balance to be
22 amortized in this proceeding is \$691,522 (\$645,207 plus \$46,315). Hubbard Rj. (Ex. A-
23 13) at Exhibit SLH-RJ2, page 1 of 9.

24 In addition, Staff has reduced the deferred CAP balance to be recovered by
25 \$20,118, which amount represents the first year's amortization under Staff's
26 recommended amortization methodology. Ht. at 964; Exhibit S-50. Given that the

1 Company has not yet recovered any deferred CAP M&I capital costs incurred since the
2 last rate case, the amount of deferral for the first year's recovery should not be reduced.

3 **III. INCOME STATEMENT ISSUES.**

4 **A. Staff's Revenue Annualization Distorts Test Year Revenues.**

5 Staff continues to argue that absent a cost of service study, a proper annualization
6 is not possible. Staff Brief at 20. This is not the case. Ht. at 490. In fact, revenue
7 annualization is common in rate proceedings even when there are no cost of service
8 studies. *See, e.g.,* Decision 64282 at 10; Coley Dt. (Ex. R-5) at 12. Moreover, Staff's
9 annualization adjustment distorts the Company's test year revenue because Staff
10 attempted to average revenue increases in all customer classes, ignoring the fact that
11 virtually all customer growth (98%) during the test year occurred in the 5/8 inch meter
12 class. Hubbard Rb. (Ex. A-12) at 17. Accordingly, Staff has overstated test year revenue
13 by at least \$94,080 and Staff's adjustment should be rejected. Hubbard Rj. (Ex. A-13) at
14 11-12.

15 **B. Eliminating the PPAM and PWAM is Unreasonable.**

16 In an effort to mischaracterize Arizona Water's request for continued approval of
17 the PPAM and PWAM, Staff argues that the Company's request for adjustor mechanisms
18 includes a "postage stamp adjustor." Staff Brief at 7. Staff's exaggeration is simply an
19 attempt to hide the lack of any basis to eliminate these adjustment mechanisms. Arizona
20 Water made it clear that it is not seeking numerous adjustors for operating expenses in
21 this proceeding, including Staff's imagined postage stamp adjuster. Ht. at 490. The
22 Company seeks approval of four adjustor mechanisms, all of which are subject to prior
23 Commission approval and two of which, the MAP and ACRM, are not opposed by Staff
24 or RUCO. In fact, the only dispute in this case involves Staff's adamant yet groundless
25 opposition to continuation of the Company's PPAM and PWAM.

26 The PPAM and PWAM have repeatedly been found by this Commission to be in

1 the public interest as they have been part of the Company's overall rate structure since
2 before the Company's 1992 rate case. *See* Decision No. 58120 (Dec. 23, 1992) at 29-30.
3 At that time, the Commission recognized the benefits of adjustor mechanisms to
4 ratepayers, including pricing signals and rapid rate reductions when purchased power or
5 water costs go down. *Id.* That such adjusted mechanisms are beneficial to ratepayers is
6 further illustrated by the recent savings Arizona Water's Eastern Group customers have
7 realized as a result of several reductions in APS's rates that were passed on to ratepayers
8 by virtue of the PPAM. Hubbard Rb. (Ex. A-12) at 18. Yet, Staff, which supported
9 continuing the PPAM and PWAM in the 1992 case, now argues for their elimination.
10 Staff points, however, to no changed circumstances, other than a new analyst. Frankly,
11 the Company submits that it is no coincidence that after several rate reductions have been
12 passed on to Eastern Group customers, Staff now seeks to eliminate the PPAM while
13 APS has a rate increase request pending.³ It is patently unfair to now preclude the
14 Company from using adjustor mechanisms to protect itself from earnings erosion simply
15 because it now appears that the pendulum may have swung in the other direction.

16 Nor does Staff's argument that the costs associated with the PPAM and PWAM
17 are simply not volatile enough to support adjustor mechanisms justify eliminating the
18 PPAM and PWAM. *See* Staff Brief at 8. Staff points to no Commission precedent, rule
19 or regulation supporting this position nor has Staff demonstrated that the volatility of
20 these costs is any more or less than it was when they were originally approved by the
21 Commission or retained, with Staff support, in 1992.⁴ Indeed, Staff's position is

22 ³ Notably, although the impact on rates will not be known until the conclusion of the APS
23 rate proceeding, on November 4, 2003, the Commission approved several adjustor
24 mechanisms for APS. As a result, Arizona Water may not only be impacted by the
25 currently requested APS rate increase, but also may face additional increases in
purchased power expense that, if Staff's opposition to the PPAM were adopted, will
further erode the Company's earnings.

26 ⁴ Staff's reliance on Mr. Ludders' discussions with unspecified BHP representatives is of
no import. Staff Brief at 8. To begin with, such hearsay should not be allowed to impact

1 somewhat ironic given that it has accepted the Company's recommended pro forma
2 adjustment to reflect a substantial increase in the cost of water purchased from BHP.
3 Hubbard Rj. (Ex. A-13) at Exhibit SLH-RJ3, page 6 of 9 (showing Staff accepting pro
4 forma adjustment to water purchase expense of \$123,525, a nearly 50% increase after the
5 test year); Ludders Dt. (Ex. S-44) at 80. Finally, the testimony is uncontroverted that the
6 Company has no means of controlling cost increases from BHP and that purchasing water
7 from BHP remains the only viable alternative for obtaining necessary water supplies. Ht.
8 at 318-21. The same is true regarding purchased power expense. Ht. at 456-58.
9 Therefore, Staff simply has not provided a persuasive argument that the PPAM and
10 PWAM should be eliminated, and, therefore, Arizona Water's proposal to continue these
11 beneficial, longstanding mechanisms should be approved.

12 **C. Rate Case Expense.**

13 **1. Arizona Water's Rate Case Expense is Reasonable Given the**
14 **Nature and Complexity of this Rate Proceeding and Should be**
15 **Approved.**

16 Staff persists in its argument that the Company's rate case expense should be
17 reduced. Staff Brief at 6. RUCO, which remained silent regarding the Company's rate
18 case expense throughout its pre-filed testimony, belatedly argues that the Company's
19 requested recovery of rate case expenses is unreasonable. RUCO Brief at 13. Through
20 October 31, 2003, (invoices received through November 7, 2003) Arizona Water's rate
21 case expense is \$276,685 in connection with this proceeding. See Exhibit B (Third
22 Supplemental Response to Data Request REL 25-2). Notably, however, this amount does
23 not include costs incurred after October 31, 2003, including preparation of this reply
24 brief, review and analysis of a recommended order, preparation of exceptions (if

25 the manner in which the Company will be allowed to recover its reasonable operating
26 expenses. Further, had Staff felt such evidence was persuasive, certainly it could have
produced something more than the uncorroborated hearsay testimony of the very same
witness proposing elimination of the adjustor mechanism.

1 applicable), and appearances before the Commission. Accordingly, Arizona Water
2 maintains its position that the updated rate case expense request of \$329,550 provided by
3 Arizona Water during the hearing in this matter is reasonable and should be approved.
4 Ht. at 386-87; Exhibit A-18.

5 Staff's recommended reduction to rate case expense continues to be premised on
6 its assertion that the Company "made heavy use of outside lawyers and consultants on
7 this case when it had internal resources it could have used to [sic] instead." Staff Brief at
8 6.⁵ However, Staff has failed to establish that the Company could have relied on such
9 internal resources, as the evidence reveals only that it was not possible for the Company
10 to rely more heavily on internal expertise to process rate cases. Ht. at 305-06. As an
11 example, Mr. Geake, the Company's in-house counsel, has responsibility for dealing with
12 personnel matters, union negotiations, a variety of contract negotiations, property
13 exchanges and other proceedings with the Commission. *Id.* at 305. Of course, this
14 should not be surprising given that Arizona Water operates 18 water systems in Arizona
15 serving approximately 69,000 customers. *Id.* at 306. Furthermore, the very same
16 argument was rejected by the Commission in the recent Northern Group proceeding
17 where Staff argued that rate case expense should be lowered because the Company had
18 internal expertise that could have been relied upon. *See* Decision No. 64282 at 16. In
19 that case, the Commission noted that the rate proceeding was complicated by the fact that
20 the Company's Northern Group consisted of five separate water systems. This case,
21 which has proven to be significantly more complex and costly, contains eight separate
22 water systems, as well as substantially larger rate base, operating revenues, and nearly

23 ⁵ Staff references to increased costs due to federal express and Staff's motion to continue
24 is of little consequence given that these costs amount to a small portion of the Company's
25 overall rate expense. Moreover, despite Staff's continued reference to the Company's
26 failure to disclose PCG matters, Staff's claims regarding the Company's conduct in
discovery concerning the PCG matters are not only unsupported but this issue was not the
basis for Judge Wolfe's ruling granting Staff's motion to continue. *See* Second Rate
Case Procedural Order dated March 14, 2003.

1 twice as many customers. Thus, Staff has simply failed to support its claim that the
2 Company's reliance on external resources is inappropriate.

3 RUCO's opposition to the Company's rate case expense is, put bluntly, bizarre.
4 Throughout this proceeding witnesses from RUCO have criticized Arizona Water for the
5 use of estimates to determine just and reasonable rates. E.g., Ht. at 29; Coley Dt. (Ex. R-
6 5) at 5-6; Rigsby Dt. (Ex. R-8) at 16-17. Now, in a remarkable turn of events, RUCO
7 argues that allowing the Company to recover its actual rate case expense, rather than an
8 earlier estimate is "unfair." RUCO Brief at 14-16. In fact, the amount RUCO suggests is
9 reasonable (\$257,550) is less than the amount actually incurred through October 31, 2003
10 (\$276,684). Moreover, the reasonableness of rate case expense should be determined in
11 light of the complexity of the proceeding. The Commission recognized in the Northern
12 Group proceeding and, as evidenced by substantial discovery and pre-filed testimony,
13 five days of hearing, two closing briefs, and numerous issues in dispute, this has been a
14 far more complex, and therefore, more costly rate proceeding.

15 **2. Staff's Recommended Five Year Amortization Is Too Long.**

16 There does not appear to be any dispute that the amortization of rate case expense
17 should be consistent with the anticipated filing of Arizona Water's next rate case
18 concerning the Eastern Group. Under the assumption that an ACRM similar to the
19 mechanism approved in the Northern Group proceeding will be authorized for the Eastern
20 Group, Arizona Water would be required to file an Eastern Group rate case no later than
21 2007 using a 2006 test year. Ht. at 492-93. However, there is no prohibition against the
22 Company filing a general rate case application before 2007 and it may become necessary
23 for the Company to do so because of the limitations on cost recovery inherent in the
24 ACRM. Even without a rate filing prior to 2007, a five year amortization of rate case
25 expense is still too long. New rates for the Eastern Group resulting from this proceeding
26 are expected to go into effect in early 2004. The rates from a 2006 test year would be

1 effective no later than 2008. Therefore, the interval between rate cases should be no more
2 than four years, making Staff's proposed five year amortization excessive.

3 **D. CIAC Amortization Methodology.**

4 In addition to miscalculating accumulated depreciation and annual depreciation
5 expense, as explained above, Staff also miscalculated the amount of CIAC amortization,
6 as explained in the Company's Brief. Company Brief at 22. In its brief, Staff admits that
7 it calculated the CIAC amortization rate by dividing total depreciation expense by total
8 depreciable plant, i.e., Staff computed a composite depreciation rate, which it then used
9 as its CIAC amortization rate. The problem with Staff's approach is that Arizona Water
10 is being required to implement individual component depreciation rates. As a result,
11 Staff's use of a composite rate to compute CIAC amortization is not consistent with the
12 individual component depreciation rates that will be used on a going-forward basis. The
13 difference between these two approaches is reflected in Staff Exhibit S-55. The upper
14 half of that exhibit contains the composite rates that Staff has used to compute the
15 amount of CIAC amortization, while the lower half of the schedule shows the corrected
16 depreciation rates and, under the mislabeled heading "Staff's Surrebuttal," shows the
17 resulting CIAC amortization. The difference between the two amounts, \$34,093, as
18 shown in the lower half of Exhibit S-55, represents the excess amount of CIAC
19 amortization that Staff has applied to reduce the Company's annual depreciation expense.

20 In its brief, Staff contends that the approach it is using, i.e., computing a system-
21 wide composite depreciation rate, is consistent with the methodology used in the
22 Company's 1992 rate case and its recent Northern Group rate case. Although the Staff
23 accounting witness, Mr. Ludders, makes that statement (Ludders Sb. [Ex. S-46] at 11),
24 neither Decision No. 58120 nor Decision No. 64282 discusses the methodology to be
25 employed in determining the CIAC amortization rate. However, in the latter decision, the
26 Commission directed the Company to implement component depreciation rates at the

1 time of its next rate case application. Decision No. 64282 at 11-12. Accordingly, if a
2 composite rate for contributed plant is developed, it should be based on the annual
3 depreciation associated with the individual plant accounts that actually include contributed
4 plant, Transmission and Distribution Mains, Fire Sprinkler Caps, Services, Meters, and
5 Hydrants, as proposed by the Company, to match the CIAC amortization rate to the
6 depreciation rates for those specific plant accounts. As discussed by Ms. Hubbard in her
7 rebuttal testimony, the use of the depreciation rates for the appropriate plant accounts
8 results in an Eastern Group composite CIAC amortization rate of 2.00%. Hubbard Rb.
9 (Ex. A-12) at 27. That rate is also reflected on Exhibit S-55.

10 **IV. CAPITAL STRUCTURE AND COST OF CAPITAL ISSUES.**

11 **A. Capital Structure and Cost of Debt.**

12 As stated in the Company's brief, there is only very minor disagreement among
13 the parties concerning the Company's capital structure and cost of long-term debt.
14 Company Brief at 22-23. In its brief, however, Staff misstates the Company's position
15 regarding the cost of short-term debt. Staff Brief at 12. The Company maintains that due
16 to the volatile nature of short-term debt costs, the 24-month average short-term debt cost
17 from January 2001 through December 2002 should be used to compute the interest rate,
18 which results in a short-term rate of 5.548% under the terms of the Company's bank loan
19 agreement. Kennedy Rj. (Ex. A-17) at 8-9. The interest rate on short-term debt is
20 variable rather than fixed, and both Staff and RUCO contend that interest rates are
21 unusually low at the present time. *See, e.g.,* Reiker Dt. (Ex. S-38) at 5. At the same time,
22 interest rates are forecasted to increase. *See* Zepp Rb. (Ex. A-5) at 20-21. On a going-
23 forward basis, therefore, the use of a 24-month average interest rate for the short-term
24 debt component of the Company's capital structure is more realistic and, therefore, more
25 appropriate.

26

1 **B. Cost of Equity.**

2 **1. The Applicable Legal Standard.**

3 There appears to be no disagreement concerning the applicable legal standard, i.e.,
4 Arizona Water is entitled to a return on its investment on utility plant and property that
5 includes a return on equity “commensurate with returns on investment in other
6 enterprises having corresponding risks.” *Federal Power Comm’n v. Hope Natural Gas*
7 *Co.*, 320 U.S. 591, 603 (1944). *See* Company Brief at 24-25. However, there remains
8 considerable disagreement over that equity return.

9 **2. The Company’s Sample Groups of Utilities are Appropriate.**

10 Although Staff claims to have “objectively” applied the Discounted Cash Flow
11 (“DCF”) model and the Capital Asset Pricing Model (“CAPM”) (Staff Brief at 12), the
12 evidence in the record demonstrates that Staff failed to do so. An example of Staff’s
13 manipulation of these models is shown by Staff’s criticism of the publicly traded utilities
14 used by Dr. Zepp to estimate the current cost of equity.

15 Staff claims that Dr. Zepp should have included Middlesex Water and Connecticut
16 Water Service in performing his estimates. However, as Dr. Zepp explained, Dr. Zepp
17 did not include those two water utilities in his 2002 sample because their rapid increases
18 in stock prices, combined with low expected growth, indicated these companies were
19 merger or acquisition candidates. Zepp Dt. (Ex. A-4) at 9-10 and Tables 1 and 2; Zepp
20 Rb. (Ex. A-5) at 10. Dr. Zepp also explained that had he included Middlesex Water in
21 performing his 2003 updated estimates, the average DCF equity costs would be higher
22 than the 10.8% estimate because Middlesex Water has an estimated equity cost of 11%.
23 Zepp Rb. (Ex. A-5) at 10. Connecticut Water Service, in contrast had a stock price
24 increase of 50% in 2001 – the largest price increase of any publicly traded water utility
25 other than American Water Works Company (which announced its merger with Thames
26 Water in that year). *Id.* at 11; Zepp Dt. (Ex. A-4) at 9-10 and Table 2. The five other

1 publicly traded water utilities used by Mr. Reiker had stock prices that increased, on
2 average, only 12% during the same time period. The use of Connecticut Water Service
3 may distort the DCF formula by biasing downward the dividend yield component of the
4 DCF model. *Id.*⁶

5 While Staff criticizes the exclusion of Middlesex Water and Connecticut Water,
6 Staff inappropriately included Cascade Natural Gas and Southwest Gas in its sample of
7 publicly traded gas utilities. As Dr. Zepp explained, both of those gas utilities have a
8 bond rating of Baa and are thus more risky than the sample water utilities and remaining
9 gas utilities, all of which have bond ratings of A or better. *Id.* at 12. At the same time,
10 Mr. Reiker failed to include South Jersey Industries in his sample gas utilities, even
11 though that gas utility had a split bond rating of Baa1/A and 80% of its revenues coming
12 from gas operations. *Id.*⁷ Thus, the record shows that Mr. Reiker rather than Dr. Zepp
13 was attempting to manipulate the same water and gas utilities in order to influence the
14 results produced by his models.⁸

15 3. Staff's Criticisms of the Company's DCF Estimates Are 16 Misplaced.

17 Staff claims that it "properly used the spot market price to determine the current
18 stock price" in applying the DCF model. Staff Brief at 13. In his testimony, Dr. Zepp

19 ⁶ It should be noted, however, that in correcting and restating Staff's DCF and CAPM
20 models, Dr. Zepp used all six water utilities. *See* Zepp Rb. at 50-51 (CAPM) and 56-59
(DCF).

21 ⁷ Dr. Zepp did not include South Jersey Industries because, at the time his original equity
22 return estimates were made in the summer of 2002, *C.A. Turner Utility Reports* indicated
that South Jersey Industries had only 53% of its revenues from gas operations. *Id.*

23 ⁸ On this point, it should be noted that RUCO's cost of capital witness, Mr. Rigsby, used
24 only three publicly traded water utilities in performing his cost of equity estimates. In
25 addition, Mr. Rigsby did not consider any other types of utilities for comparison
26 purposes, in contrast to the Company and Staff. Rigsby Dt. (Ex. R-4) at Schedules
WAR-3 through WAR-8. Thus, Staff's criticisms, while inapplicable to the Company for
the reasons explained above, certainly do apply to RUCO.

1 provided three reasons why spot stock prices should not be adopted to determine
2 dividend yield. First, there are no “spot” growth rate estimates to combine with the
3 dividend yields computed using spot prices, creating a mismatch. Second, prices for
4 thinly-traded stocks, such as water utilities, are not as efficient as prices for larger stocks.
5 Finally, as this proceeding itself demonstrates, it takes many weeks for analysts to
6 prepare and ultimately present equity cost estimates. For example, the “current spot
7 prices” used by Mr. Reiker in his DCF estimates are the May 6, 2003 prices, which are
8 now more than six months old. *See* Reiker Dt. (Ex. S-38) at 12. Further, allowing the
9 analyst to choose the spot price also allows the analyst to bias his estimate of the dividend
10 yield by choosing a price that is higher or lower than the stock prices reported on another
11 day. Zepp Rb. (Ex. A-5) at 13-14. To avoid these problems, Dr. Zepp used a three-
12 month average of the utilities’ stock prices in computing his updated DCF estimates.
13 Zepp Rb. (Ex. A-5) at 8-9 and Update Table 11 (Tab A).⁹

14 Staff is also critical of the growth estimate used by Dr. Zepp. Staff Brief at 14.
15 First, Staff criticizes Dr. Zepp for using an industry average forecast, as opposed to
16 averaging growth forecasts for each individual sample utility. However, as Dr. Zepp
17 explained in his testimony, Staff’s own witness used an industry average forecast to
18 estimate future dividend growth for Connecticut Water Service, Middlesex Water and
19 SJW Corp. Zepp Rb. (Ex. A-5) at 14. In addition, Staff criticizes Dr. Zepp for relying on
20 near-term earnings growth and sustainable growth forecasts. However, Dr. Zepp
21 addressed this issue at length in his testimony, explaining that under the current
22 circumstances, the absolute worst indicator of future growth to use in the constant growth
23 DCF Model is past dividend per share (“DPS”) growth or near-term forecasts of DPS
24 growth. *Id.* at 53-54; Zepp Rj. (Ex. A-7) at 34. Dr. Zepp explained that analysts’

25 ⁹ In restating Mr. Reiker’s estimated returns on equity using the DCF model, Dr. Zepp
26 did use spot prices to be consistent with Mr. Reiker’s approach. Zepp Rb. (Ex. A-5) at 53.

1 consensus forecasts of future EPS growth provide better estimates of DCF growth than
2 past DPS growth and past EPS growth, citing an article co-authored by Professor Myron
3 Gordon. Zepp Rb. (Ex. A-5) at 54-55.

4 To support its argument, Staff again misrepresents testimony that was given by Dr.
5 Zepp in a 1999 proceeding before the Public Utility Commission of Oregon. Staff Brief
6 at 14; Reiker Dt. (Ex. S-38) at 44-45. Dr. Zepp addressed these misrepresentations in his
7 testimony, explaining that Mr. Reiker took statements out of context, distorting Dr.
8 Zepp's testimony. Zepp Rb. (Ex. A-5) at 17-19 and Exhibit TMZ-R3 (deposition
9 transcript). Dr. Zepp explained that his testimony in those proceedings is consistent with
10 his testimony in this case that when forecasts of DPS growth (or past DPS growth) are
11 smaller than expected EPS growth (or past EPS growth), reliance on DPS growth as the
12 growth rate in the constant growth DCF model will bias downward the equity cost
13 estimates. *Id.* at 19. This point is well illustrated by Mr. Reiker's approach, in which
14 extremely low DPS growth rates are averaged with EPS and sustainable (or intrinsic)
15 growth rates to derive a lower growth estimate and reduce the resulting DCF estimate.
16 Reiker Dt. (Ex. S-38) at 18 (Table 4).¹⁰

17 4. Staff's Reliance on Its CAPM Estimates Is Inappropriate.

18 Staff argues that the Commission should accept the returns on equity produced by
19 its CAPM model, while rejecting the Company's risk premium estimates. Staff Brief at
20 15-16. Staff contends that the CAPM "is the best-known model of risk and return." *Id.*,
21 *citing* Richard A. Brealey and Stewart C. Myers, *Principles of Corporate Finance* (1988).
22 Professors Brealey and Myers state in a more recent edition of their text:

23
24 ¹⁰ Notably, RUCO's cost of capital witness relies solely on sustainable growth (which
25 Mr. Reiker calls intrinsic growth), which assumes that future dividends are a function of
26 retained earnings and the expected return on equity. *See* Rigsby Dt. (Ex. R-4) at 15-16;
Zepp Dt. (Ex. A-4) at 28-30. Unfortunately, there are other difficulties with RUCO's
DCF model, which has been modified to reduce the resulting return on equity if the
utility's stock is trading above book value. *See* Company Brief at 34.

1 The capital asset pricing theory is the best-known model of
2 risk and return. It is plausible and widely used but far from
3 perfect. Actual returns are related to beta over the long run,
4 but the relationship is not as strong as the CAPM predicts,
5 and other factors seems to explain returns better since the
6 mid-1960s. Stocks of small companies, and stocks with high
7 book values relative to market prices, appear to have risks
8 not captured by the CAPM. [Emphasis added.]

9 Richard A. Brealey and Stewart C. Myers, *Principles of Corporate Finance*, 212 (6th ed.
10 2000). See also Charles F. Phillips, Jr., *The Regulation of Public Utilities*, 396-97 (3rd ed.
11 1993) (summarizing various theoretical and practical problems with the CAPM).

12 In short, regardless of whether the CAPM is popular among “Chief Financial
13 Officers” (Staff Brief at 16), this particular methodology is “far from perfect” in the
14 context of setting rates. See, e.g., Zepp Rb. (Ex. A-5) at 43-49 (discussing various
15 problems associated with implementing the CAPM). For example, since the original
16 form of the CAPM was derived by Professors William Sharpe and John Lintner,
17 empirical studies have shown that the cost of equity for firms with betas less than 1.0
18 (which would include all of the publicly traded utilities in the parties’ sample groups) are
19 closer to the cost of equity for an average risk stock (a beta of 1.0) than the original
20 Sharpe-Lintner model predicts. Zepp Rb. (Ex. A-5) at 46-48. This means that water
21 utilities require a higher equity return than is indicated by the version of the CAPM used
22 by Mr. Reiker (and by Mr. Rigsby, who ultimately disregards the obviously low results
23 produced by his CAPM model).

24 In addition to the difficulties inherent in the basic CAPM model selected by Staff,
25 Staff simply assumes that the average of the *Value Line* betas for the six publicly traded
26 water utilities can be applied to Arizona Water. *Value Line*’s betas are derived from a
 regression analysis between weekly percent changes in the price of a stock and weekly
 percent changes in the New York Stock Exchange average over a period of five years.
 Ht. at 590-92 (testimony of Mr. Rigsby); Roger A. Morin, *Regulatory Finance: Utilities’*

1 *Cost of Capital*, 65 (1994). In other words, beta measures a security's volatility in
2 relation to that of the market. Morin, *supra*, at 63; Brealey and Myers, *supra*, at 174-75.
3 As Dr. Zepp explained, estimating betas for water utilities is especially problematic
4 because they are relatively small companies and are thinly-traded, meaning that as the
5 stock market index changes, the individual utility's stock price remains unchanged due
6 simply to a lack of trading. This results in a downward bias in the beta estimate. Zepp
7 Rb. (Ex. A-5) at 43-44; Ht. at 593-94. *See also* Morin, *supra*, at 72.

8 Finally, putting aside the theoretical problems with the basic CAPM model and
9 with obtaining an accurate estimate of beta for utility stocks, there is one additional,
10 equally serious problem: Arizona Water's stock is not publicly traded and, therefore, it
11 has no estimated beta. Staff states in its brief that it "derived an appropriate beta from the
12 average of the *Value Line* betas for the six proxy water utilities." Staff Brief at 15.
13 Noticeably absent from Staff's brief (as well as Mr. Reiker's testimony), however, is any
14 credible explanation of why this average is an "appropriate beta" for Arizona Water. The
15 estimated betas in Staff's sample group range from a high of 0.7 (Philadelphia Suburban)
16 to a low of 0.5 (SJW Corp.). There is simply no basis in the record to assume, as Staff
17 has done, that Arizona Water's hypothetical beta is substantially less than the *Value Line*
18 beta for Philadelphia Suburban, a substantially larger, publicly traded utility with a AA-
19 credit rating. *See* Company Brief at 40-41 (discussing the proper application of Mr.
20 Reiker's "business risk" formula).

21 Although Staff criticizes Dr. Zepp's risk premium approach, as Dr. Zepp testified,
22 the CAPM is simply a special case of the risk premium approach to estimating the cost of
23 equity. Zepp Rb. (Ex. A-5) at 42-43. *See also* Morin, *supra* at 302-03. As Dr. Zepp also
24 explained, it is preferable to implement the CAPM by using a more general risk premium
25 approach, which provides a direct estimate of the risk premium relevant for a utility,
26 includes any required compensation for other systematic risks that may be priced by

1 investors, and reflects the difference between the bond rate and the required return for the
2 risk free (zero-beta) investment, that must be selected in applying the CAPM. *Id.* at 44.
3 This approach avoids the problems inherent in the CAPM, including the need to estimate
4 betas for thinly-traded utility stocks or make assumptions about the applicability of those
5 beta estimates to a small utility like Arizona Water that is not publicly traded. *Id.*

6 Staff claims that the Company's analyses are "impaired by the reliance on sample
7 companies that are not shown to be comparable in risk to AWC itself." Staff Brief at 16.
8 However, as discussed above, Staff assumes, without any basis, that Arizona Water is
9 comparable in risk to Philadelphia Suburban, which has annual revenue in excess of \$320
10 million, serves approximately 2 million customers in six states, and is given the highest
11 possible ranking for earnings predictability by *Value Line*. Exhibit A-25.¹¹ Staff also
12 criticizes Dr. Zepp for relying, in part, on authorized returns on equity in performing his
13 risk premium analyses. *See Zepp Dt.* (Ex. A-4) at 37-40 (explaining risk premium
14 analyses). Staff would instead have the Commission ignore authorized, realized and
15 forecasted returns on equity, meaning that the Commission would effectively be
16 authorizing returns on equity in a vacuum. This would violate the comparable earnings
17 standard, and allow Staff to make rate of return recommendations based solely on
18 theoretical models with regard to what other utilities are actually earning. *See Zepp Rj.*
19 (Ex. A-7) at 10; *Zepp Rb.* (Ex. A-5) at 5-6.¹²

20 In sum, the Company's risk premium analyses provide better estimates of the

21 ¹¹ Actually, Staff would consider Philadelphia Suburban to be a more risky investment
22 than Arizona Water. *Value Line's* beta for Philadelphia Suburban, as previously noted, is
23 0.7, while Staff assumes that Arizona Water's beta is equal to the average of its sample
24 group of publicly traded utilities. Moreover, Staff also proposes to reduce its cost of
equity estimate based on Arizona Water's lower risk capital structure. This sort of result-
driven approach defies common sense. *See Meek Rb.* (Ex. A-8) at 13.

25 ¹² During the hearing, Mr. Reiker in fact contended that the only way to evaluate whether
26 his "objective" finance models produce realistic results would be to interview millions of
investors (presumably like Mr. Meek) and determine their subjective views on a utility's
earnings. *Ht.* at 824.

1 current cost of equity, from both a theoretical and a practical standpoint, than do Staff's
2 CAPM estimates, which rely on unsupported assumptions regarding Arizona Water's
3 risk.

4 **5. The Evidence in the Record Supports an Additional Risk**
5 **Premium for Arizona Water.**

6 Staff argues that Arizona Water's authorized return on equity should be reduced
7 because its capital structure contains approximately 66% common equity, reducing
8 financial risk. Staff Brief at 16-17. The basis for this argument is that the sample group
9 of publicly traded water utilities has, on average, capital structures containing
10 approximately 50% common equity and therefore greater financial risk. *Id.* Staff's
11 argument ignores the higher business risks faced by Arizona Water, including its small
12 size, lack of financing flexibility, limited access to bond markets, and the need to make
13 significantly larger investments to address arsenic treatment than the water utilities in the
14 sample group. *See, e.g.,* Zepp Rb. (Ex. A-5) at 24-35; Meek Rb. (Ex. A-8) at 11-15.

15 First, the difficulties that Arizona Water experienced in placing its Series K bonds
16 demonstrate that the Company requires a higher equity return than the cost of equity
17 estimated for the A-rated and AA-rated water utilities in the sample group. In its brief,
18 Staff argues that these difficulties are irrelevant because the Company was ultimately
19 able to place its bond issue. Staff Brief at 17-18. However, Staff has completely ignored
20 the fact that at the time the Series K rate of 8.04% was set, the cost of A-rated utility
21 bonds was 7.67% and the cost of AA-rated utility bonds was 7.55%. Obviously, the fact
22 that Arizona Water may have a higher percentage of common equity in its capital
23 structure than a larger, publicly traded utility, made no difference to the bond purchaser:
24 Arizona Water was still required to pay a higher interest rate than utilities issuing
25 investment grade bonds. This provides strong evidence that Arizona Water is more risky
26 than the utilities in the parties' sample groups. Zepp Rj. (Ex. A-7) at 9-10, 17-18; Zepp

1 Rb. (Ex. A-5) at 25. As Mr. Meek explained, investors consider many of the same
2 company-specific financial information that credit rating services do. Meek Rb. (Ex. A-
3 8) at 3-4; Ht. at 772-73.

4 Next, Staff argues that Arizona Water's smaller size relative to the publicly traded
5 water utilities in the sample group does not affect Arizona Water's investment risk. Staff
6 Brief at 18-19. Although Staff claims that it has cited multiple "studies" in support of its
7 position, ultimately Staff's position is predicated on a single paper published in 1993 in
8 the *Journal of the Midwest Finance Association*, written by Annie Wong.¹³ However, the
9 peer-reviewed paper published by Dr. Zepp earlier this year in *The Quarterly Review of*
10 *Economics and Finance* explained why Ms. Wong's 1993 paper cannot be relied on to
11 support Staff's argument. See Company Brief at 36; Zepp Rb. (Ex. A-5) at 33-35 and
12 Exhibit TMZ-R4 (copy of Dr. Zepp's paper). The balance of the testimony of Mr. Reiker
13 that is cited in Staff's brief simply challenges other studies that Dr. Zepp presented in
14 demonstrating that Arizona Water is entitled to a risk premium based on its smaller size.
15 See Reiker Dt. at 59-64.¹⁴

16 Staff also argues that the substantial investment Arizona Water will be required to
17 make to comply with the new maximum contaminant level ("MCL") for arsenic will
18 simply lead to an increase in the Company's rate base, but not result in additional risk to
19 an investor. Staff Brief at 18. Staff also notes that in the Company's Northern Group
20 rate case, the Commission denied a similar risk adjustment. See Decision No. 64282
21 (Dec. 28, 2001) at 19. However, these arguments overlook the fact that the impact of

22
23 ¹³ Staff similarly relied on Ms. Wong's paper in the Northern Group rate case. Direct
24 Testimony of Joel M. Reiker at 30-31, Docket No. W-01445A-00-0962 (dated June 26,
2001).

25 ¹⁴ For example, Dr. Zepp presented a study prepared by the Staff of the California Public
26 Utility Commission, which concluded that business risk increases as the size of a firm
decreases, notwithstanding the amount of equity in the capital structure. Zepp Dt. (Ex.
A-4) at 20; Zepp Rb. (Ex. A-5) at 27-28.

1 constructing and operating arsenic treatment facilities was not addressed in any detail in
2 the initial phase of Northern Group rate case, but instead was addressed in a subsequent
3 phase that only recently concluded. Decision No. 66400 (Oct. 14, 2003). In that
4 proceeding, Staff witnesses expressly acknowledged the severe financial impact that this
5 new regulatory mandate is likely to have on Arizona Water:

6 There is recognition by Staff that the EPA's new MCL
7 standards will require Arizona Water, as well as other
8 affected water companies, to incur significant costs to come
9 into compliance with the revised standards. For example,
10 Staff witness Gordon Fox testified that a large number of
11 Arizona water utilities will be adversely affected by the MCL
12 requirements to the extent that arsenic removal costs could
13 harm their financial integrity. Mr. Fox added that "a stream-
14 lined procedure could reduce the overwhelming
15 administrative preparation and processing anticipated by the
16 normal rate case and financing cases anticipated" (Ex.
17 S-1 at 3-4). Staff Witness Olea agreed that, without some
18 form of streamlined cost recovery procedure, the magnitude
19 of the costs required for arsenic MCL compliance could
20 affect the financial integrity of a number of companies,
21 including Arizona Water (Tr. 149, 172).

22 Decision No. 66400 at 3-4.¹⁵ The decision goes on to state that Arizona Water's
23 estimated capital costs will approach \$30 million on a company-wide basis, and that
24 Arizona Water will face corresponding increases in its operating expenses. *Id.* at 4.

25 In short, since Decision No. 64282 was issued in the initial phase of the Northern
26 Group proceeding, Staff members (including Staff's Assistant Director) have testified
about the severe financial impacts likely to result from complying with the new arsenic
MCL. As explained in the Company's brief, the Company's estimated investment in
arsenic treatment facilities will exceed 37% of the Company's total capitalization.
Company Brief at 38. While the cost recovery mechanism recently approved in Decision
No. 66400 and the analogous mechanism requested in this case for the Eastern Group

¹⁵ Arizona Water requests that the Commission take official notice of the testimony presented by the Company and Staff in the second phase of its Northern Group rate case, Docket No. W-01445A-00-0962, pursuant to A.A.C. R14-3-109(T) and (U).

1 will provide some relief, that mechanism will not allow full recovery of all arsenic-
2 related costs. Moreover, as Mr. Kennedy testified, approximately 46% of the Company's
3 total revenue requirement related to capital investment and operating expenses associated
4 with arsenic treatment are attributable to the Western Group, and the Company will not
5 be able to file a rate case for those systems in sufficient time to implement a comparable
6 cost recovery mechanism. Kennedy Rb. (Ex. A-16) at 26. In short, this is a unique and
7 significant risk that Arizona Water faces, and there is no evidence that any of the publicly
8 traded water utilities in the sample group are facing similar difficulties. See Zepp Rb.
9 (Ex. A-5) at 25-26; Zepp Rj. (Ex. A-7) at 9; Meek Rb. (Ex. A-8) at 11-13.

10 Finally, Staff argues that the ratemaking system utilized in Arizona does not affect
11 investment risk. Staff Brief at 18. That argument is contradicted by the positions taken
12 by Staff (and by RUCO) in this case. For example, Staff recommends that the
13 Commission reduce the Miami system's rate base based on the PCG Settlement
14 Agreement, effectively confiscating a portion of that system's plant in service (Staff Brief
15 at 2-3) and recommends elimination of the Company's longstanding purchased water and
16 purchased power adjustor mechanisms (*id.* at 7-8). Staff professes "reluctant acceptance"
17 of the Company's post-test year plant additions, despite a series of prior Commission
18 decisions approving such adjustments to rate base, but at the same time proposes
19 reducing the Company's rate base based on adjustments to accumulated depreciation that
20 the Staff's accounting witness cannot explain (*id.* at 8-9). The United States Supreme
21 Court has held that risk associated with the particular ratesetting system should be
22 considered in authorizing an appropriate equity return. *Dusquesne Light Co. v. Barasch*,
23 488 U.S. 299, 314-15 (1989). As Mr. Meek's testimony makes clear, investors do
24 consider the decisions and policies of public utility commissions in making investments
25 choices. Meek Rb. (Ex. A-8) at 11. See also Exhibit 25 at 1-3 (discussion in *Value Line*
26 about the impact of regulation by public utility commissions on utilities' earnings).

1 **V. RATE DESIGN AND CONSOLIDATION ISSUES.**

2 **A. Staff's Inverted Tier Rate Design Should Be Rejected.**

3 Staff's primary justification for its rate design is to promote conservation. In fact,
4 the word "conservation" appears four times in the initial paragraph discussing Staff's rate
5 design. Staff Brief at 9. However, according to Staff's rate design witness, Mr.
6 Thornton, "Staff applied the marginal cost pricing approach in this case to inject a
7 forward-looking cost of service approach to rate design." Thornton Sb. (Ex. S-41) at 1.
8 Elsewhere, Mr. Thornton testified that water is "price inelastic," and that "water use
9 changes little with a three-tiered rate design." Thornton Dt. (Ex. S-40) at 6. Mr.
10 Thornton also testified that Staff's three-tier rate design will not cause any reductions in
11 water use, but is "still valuable because it helps encourage economic efficiency, even if
12 consumption [does] not fall, and prices the product higher for greater levels of
13 consumption." In short, the bulk of the discussion found in Staff's brief contradicts the
14 testimony of its rate design witness.

15 Indeed, for the reasons set forth in the Company's Brief, Staff's rate design is
16 plainly not conservation oriented. Instead, as Mr. Thornton admitted, Staff's actual goal
17 is to "price[] the product higher for greater levels of consumption." *Id.* As explained in
18 the Company's Brief, this distorted rate structure (which is not supported by a cost of
19 service study) is necessary to recover the substantial subsidy created by Staff's "lifeline
20 rate," i.e., Staff's discounted commodity rate applicable to the first 3,000 gallons used
21 each month. Thornton Dt. (Ex. S-40) at 2. As explained by the American Water Works
22 Association:

23 Lifeline rates and low-income discounts provide no
24 conservation for water reduction incentive to those who
25 receive the subsidy. Since water is sold below cost, the
26 pricing incentive to reduce consumption is lessened. Water
use among the subsidized customers could increase,
especially during peak periods. The impact on demand
should be carefully considered in areas where water supplies

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

are scarce.

American Water Works Association, *Alternative Rates*, 13 (1992) (Ex. A-28). In contrast to a typical lifeline rate structure, however, Staff recommends in this case that all customers be eligible to receive water at a discount, thus encouraging greater water use by all types of customers.

Staff argues that other water providers, such as Arizona-American Water Company, the City of Scottsdale and the City of Tucson, have inverted block rate designs. Staff Brief at 9. However, these rate designs are significantly different than Staff's proposed rate design, which contains uniform tiers with break points at 3,000 gallons and 50,000 gallons per month, regardless of the customer's type of use, meter size, income or other specific characteristics. The City of Scottsdale has two tiers with different breakpoints for each meter size. Exhibit S-8. Scottsdale's break point between tiers for a customer on a 5/8 inch meter is 7,500 gallons, while the break point for a customer on a 4 inch meter is 92,000 gallons. *Id.* The City of Tucson has a four-tier rate structure for residential customers, while employing a single commodity rate for all non-residential customers, regardless of their level of use. Exhibit S-9. Arizona-American's Paradise Valley district has a three-tier rate design with break points at 25,000 gallons and 80,000 gallons for residential customers, and a two-tier rate design with a break point at 400,000 gallons for commercial customers. Decision No. 61831 (July 20, 1999) at 9. In each of these examples (all of which are cited in Staff's brief), the water provider's inverted tier rate design distinguishes between either meter size (Scottsdale) or type of use (Tucson and Arizona-American), and has implemented rates intended to encourage conservation by all customers.

Staff claims that the 20% premium applicable to all gallons purchased in excess of 50,000 gallons per month is intended "to reflect the marginal costs imposed by heavy

1 water users.” Staff Brief at 10. However, there is no evidence that the cost to serve
2 Eastern Group customers who use more than 50,000 gallons during a month is greater
3 than other customers. Staff failed to perform a cost of service study to support its rate
4 design, and the cryptic, one-half page paper Mr. Thornton relied on (Ex. A-29) does not
5 support Staff’s proposal. In reality, Staff would impose a 20% premium on customers on
6 larger meters, without regard to the cost to serve them, in order to recover the substantial
7 subsidy created by Staff’s discounted “lifeline” rate.

8 In short, Staff’s proposed rate structure will neither encourage water conservation
9 nor result in greater economic efficiencies, as Staff erroneously argues. As shown in the
10 Company’s Brief, the primary effect of Staff’s rate design is to shift a major portion of
11 the Company’s revenue requirement to customers with larger size meters without regard
12 to the actual cost of service. Company Brief at 43-47. This sort of rate design sends the
13 wrong price signal to customers on smaller size meters, and may well result in increased,
14 rather than reduced, water usage. In this case, Staff has failed to propose such a rate
15 design and demonstrate it will actually promote conservation, as opposed to providing
16 discounted water service and generating large subsidies.

17 **B. The Apache Junction and Superior Systems Are Contiguous, Will Be**
18 **Interconnected, and Should Be Consolidated Now.**

19 Both Staff and RUCO oppose consolidation of the Apache Junction and Superior
20 systems. RUCO notes that the Commission recently denied the Company’s request to
21 consolidate two of its Northern Group systems, Sedona and Rimrock. Decision No.
22 66400 (Oct. 14, 2003).¹⁶ The Company’s request to consolidate the Apache Junction and
23 the Superior systems in this case is distinguishable from that decision and, for the reasons
24 explained in the Company’s Brief and again below, consolidation of these systems should

25 _____
26 ¹⁶ The Company filed an application for rehearing of Decision No. 66400 on November
3, 2003, specifically addressing system consolidation.

1 be approved in this proceeding as opposed to a future proceeding, at which time
2 consolidation may be substantially more problematic due to the substantial differences
3 between the systems' rates.

4 In contrast to the consolidation request in the Northern Group proceeding, the
5 Apache Junction and the Superior systems are already contiguous. The Commission, in
6 Decision No. 66235 (Sept. 16, 2003), approved the Company's application to extend the
7 Apache Junction system's certificated area southeast to include a new development
8 project called Entrada del Oro, near Florence Junction. As a consequence, the
9 Company's present certificated area extends continuously from Apache Junction to
10 Superior. Whitehead Dt. (Ex. A-9) at 10 and Exhibit 1 (map of certificated area).

11 Moreover, as Mr. Whitehead explained in his testimony, a 16-inch, "backbone"
12 transmission main is currently under construction from the Gold Canyon area (southeast
13 of Apache Junction) to Entrada del Oro, to be interconnected with facilities being
14 constructed to serve another real estate development project called Ranch 160. Those
15 facilities will be connected to the Superior well field, located approximately four miles
16 south of the Ranch 160 project. *Id. See also* Whitehead Rb. (Ex. A-10) at 4-5; Kennedy
17 Rj. (Ex. A-17) at 7. Therefore, the interconnection of the Apache Junction and Superior
18 systems is not a remote or speculative event, but will be completed within two years and
19 well before the Company's anticipated 2007 Eastern Group rate filing.

20 The primary purpose for the Company's request to consolidate the Apache
21 Junction and Superior systems is to avoid "rate shock" for its Superior customers, based
22 on the small size and limited customer base of the Superior system, and the substantial
23 rate increases that will result from the construction and operation of arsenic treatment
24 facilities. Kennedy Dt. (Ex. A-15) at 11-12. There is no dispute that both of these
25 systems are facing substantial increases in rates as a consequence of the construction and
26 operation of arsenic treatment facilities. On a stand-alone basis, for example, Apache

1 Junction's arsenic treatment facilities will cost \$573 per customer, while Superior's
2 arsenic treatment facilities will cost \$1,309 per customer. Kennedy Rj. (Ex. A-17) at 7.
3 It is also undisputed that Superior has a small population, and is experiencing negative
4 growth as a consequence of that area's depressed economic condition. See Hammon Dt.
5 (Ex. S-51) at 6 (average annual growth rates for Eastern Group systems); Kennedy Rj.
6 (Ex. A-17) at 6 and Exhibit RJK-RJ5 (Apache Junction and Superior community profiles
7 published by the Arizona Department of Commerce).

8 Staff's accounting witness, Mr. Ludders, contends that rate consolidation is
9 inappropriate because it will result in inter-system subsidies and, therefore, "unfair" rates.
10 See Staff Brief at 9. Similarly, RUCO argues that the "individual identity" of the Apache
11 Junction system and the Superior system should be maintained, which will "more
12 accurately reflect a more proper allocation of costs." RUCO Brief at 12. These
13 arguments ignore the fact that Arizona Water already has been allowed to consolidate
14 many physically separated water systems in the past, including River Valley and
15 Rimrock, Arizona City and Casa Grande, Forest Towne and Overgaard, Valley Vista and
16 Sedona, and Tierra Grande and Casa Grande. Kennedy Rj. (Ex. A-17) at 5. In fact, the
17 Commission's own internet site recognizes the benefits of consolidating water and sewer
18 systems:

19 Because there are certain fixed costs of running a water
20 system (for example: billing costs, maintenance, payroll,
21 electricity and water quality testing), there is a move toward
22 consolidation. This helps spread these expenses over a larger
number of customers – *particularly the rising costs of water
testing and treatment* – and consolidation can sometimes
mean lower rates for consumers.

23 *Water and Sewer – Frequently Asked Questions*, available at [http://www.cc.state.az.us/
24 utility/water/faqs.htm](http://www.cc.state.az.us/utility/water/faqs.htm) (visited October 30, 2003) (italics added). The Company's
25 consolidation request is consistent with the Commission's own policy statement, and will
26 result in the creation of an integrated water system, with a continuous certificated area

1 and a base of more than 17,000 customers over which costs can be spread.

2 Finally, RUCO suggests that even if consolidation is appropriate, “there is no
3 urgency or need to consolidate in the context of this case.” RUCO Brief at 13. However,
4 as Mr. Kennedy explained in his testimony, if rate consolidation is not approved in this
5 proceeding, the existing gap between the rates in Apache Junction and the rates in
6 Superior will widen further, regardless of which party’s recommendations are accepted.
7 This rate gap will become even wider as a consequence of the substantial arsenic-related
8 costs, which will have to be spread over Superior’s 1,300 customer base if consolidation
9 is not approved.

10 Accordingly, consolidation of the Apache Junction and Superior systems is
11 appropriate now, and not in a future rate proceeding, at which time the two systems’ rates
12 will have moved even farther apart. Moreover, Arizona Water is not proposing complete
13 consolidation at this time, but instead requests permission to implement a common
14 monthly minimum charge, with full consolidation taking place in the Company’s next
15 rate case. For the foregoing reasons, the Commission should authorize this initial
16 consolidation step in this case.

17 **VI. OTHER ISSUES.**

18 **A. Staff has Failed to Provide Sufficient Justification for Adoption of its**
19 **Water Loss Plan.**

20 Because Staff continues to rely on calculations of unsold water rather than lost
21 water, Staff has failed to even establish that the Company has a problem with water loss.
22 See Ht. at 324, 1128-29; Garfield Rb. (Ex. A-2) at 24. Staff also has not produced any
23 evidence that Arizona Water’s ongoing efforts to address water loss are inadequate or
24 that water loss is having a detrimental impact on ratepayers. Nor has Staff shown that the
25 Company’s efforts to address water loss are insufficient. In fact, Staff references the
26 Company’s water loss reporting system as a basis for adoption of its water loss plan.

1 Staff Brief at 19. However, the fact that the Company generates internal water loss
2 reports does not justify the type of unspecified regulatory micromanagement Staff seeks
3 to impose on the Company in this proceeding, particularly given Staff's recommendation
4 that it be given the unilateral discretion to commence formal Commission proceedings to
5 address water loss. In sum, absent evidence that the Company is ignoring water loss or
6 that water loss is having a significant impact on ratepayers, the Company should be
7 allowed to continue its efforts to address water loss without the threat of unnecessary
8 Commission oversight as well as an opportunity to honor its commitment to work with
9 the Commission's Engineering Staff to address any legitimate concerns.

10 **B. There is no Reason to Modify Arizona Water's NP-260 Tariff.**

11 Staff's reliance on the Commission's decision in the *SLV Properties* complaint is
12 misplaced. To begin with, it is notable that Staff offers no citation to the Commission's
13 decision in that matter, Decision No. 65755 (March 20, 2003). Moreover, nothing in the
14 Commission's decision, which dismissed SLV's complaint and upheld all accrued late
15 charges and related taxes, evidences the alleged problems raised by Staff in its closing
16 brief. *Compare* Staff Brief at 19 *with* Decision 65755. In the end, Staff's recommended
17 modification of the Company's current NP-260 Tariff is nothing more than an
18 unsupported effort by Staff to subsidize the cost of providing non-potable CAP water to
19 customers at the expense of Arizona Water. Kennedy Rb. (Ex. A-16) at 29. There is no
20 justification for such a modification and therefore Staff's recommendation should be
21 rejected.

22 **C. Arsenic Treatment Cost Recovery Mechanism.**

23 Neither Staff nor RUCO has identified any issues or disputes concerning the
24 Company's request for approval of an arsenic cost recovery mechanism, modeled after
25 the mechanism approved in Decision No. 66400 for the Northern Group.

26

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

D. PCG Settlement.

[BEGIN CONFIDENTIAL MATERIAL HERE]

- 1
- 2
- 3
- 4
- 5
- 6
- 7
- 8
- 9
- 10
- 11
- 12
- 13
- 14
- 15
- 16
- 17
- 18
- 19
- 20
- 21
- 22
- 23
- 24
- 25
- 26

- 1
- 2
- 3
- 4
- 5
- 6
- 7
- 8
- 9
- 10
- 11
- 12
- 13
- 14
- 15
- 16
- 17
- 18
- 19
- 20
- 21
- 22
- 23
- 24
- 25
- 26

- 1
- 2
- 3
- 4
- 5
- 6
- 7
- 8
- 9
- 10
- 11
- 12
- 13
- 14
- 15
- 16
- 17
- 18
- 19
- 20
- 21
- 22
- 23
- 24
- 25
- 26

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

[END CONFIDENTIAL MATERIAL HERE]

1. The Treatment of the PCG Legal Expenses is Immaterial.

Staff has mischaracterized Mr. Kennedy’s testimony by also claiming that the Company receives “further compensation through the inclusion of legal fees in rate base of capitalized legal fees.” Staff Brief at 3. To date, however, the Company has received no return on these capitalized legal costs because such amounts were recorded in 1998 and have not yet been included in rate base. The Company invested over \$308,000 to secure a settlement that protects its perpetual Miami system water rights and ensures a long-term water supply for its customers. It is now entitled to a return on that investment, nothing more and nothing less.

RUCO’s proposed reclassification of these legal costs must also be rejected. RUCO Brief at 7-11. First, there is no evidence in the record to support RUCO’s untimely recommendation. Instead, RUCO impermissibly offers an alternative treatment for these legal costs for the first time in its closing brief. This is improper. *See State ex*

1 *rel. Corbin*, 143 Ariz. at 223-24, 693 P.2d at 366-67 (discussing manner in which
2 evidence is to be taken and considered in Commission ratemaking proceedings). Second,
3 the fact of the PCG Settlement is immaterial to the treatment of the legal costs. The
4 treatment is dictated by applicable accounting standards, not by the results of the
5 expenditures, which have benefits beyond the PCG Settlement by protecting the
6 Company's water rights and ensuring a long-term water supply. Ht. at 547.

7 Third and finally, there is no evidence in the record to support RUCO's belatedly
8 expressed belief that the Company's treatment of the PCG legal costs is incorrect.
9 RUCO Brief at 8. In fact, the only evidence in the record is that these costs were incurred
10 to protect the Company's perpetual right to a certain quantity of water, an asset with an
11 unlimited life that is not subject to depreciation. Ht. at 545-47, 560-61. Absent such
12 evidence, there is no basis to adopt RUCO's recommended reclassification of the funds
13 the Company was forced to incur to protect its water rights.

14 **4. Staff's has Not Shown that its Adjustment to Miami Purchased**
15 **Power Expense is Known and Measurable.**

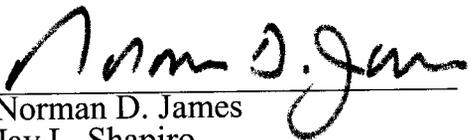
16 Staff argues that its recommended adjustment to Miami purchase power expense is
17 known and measurable. Staff Brief at 4. Yet, Staff's engineering witness admitted on
18 cross-examination that this adjustment was nothing more than an estimate of future costs.
19 Ht. at 1134-35. Absent something more than Staff's speculation over what the
20 Company's expenses might be in the future, the adjustment must be rejected.

21
22
23
24
25
26

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

RESPECTFULLY SUBMITTED this 10th day of November, 2003.

FENNEMORE CRAIG

By 

Norman D. James
Jay L. Shapiro
3003 North Central Avenue
Suite 2600
Phoenix, AZ 85012
Attorneys for Applicant
Arizona Water Company

An original and 13 copies of the foregoing were delivered this 10th day of November, 2003 to:

Docketing Supervisor
Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, AZ 85007

A copy of the foregoing was hand-delivered this 10th day of November, 2003 to:

Chairman Marc Spitzer
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Commissioner William Mundell
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Commissioner Mike Gleason
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Commissioner Jeff Hatch-Miller
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

- 1 Commissioner Kristin Mayes
Arizona Corporation Commission
2 1200 W. Washington St.
Phoenix, AZ 85007
3
- 4 Paul Walker, Aide to Chairman Spitzer
Arizona Corporation Commission
5 1200 W. Washington St.
Phoenix, AZ 85007
6
- 7 Hercules Dellas, Aide to Commissioner Mundell
Arizona Corporation Commission
8 1200 W. Washington St.
Phoenix, AZ 85007
9
- 10 Jodi Jerich, Esq., Aide to Commissioner Gleason
Arizona Corporation Commission
11 1200 W. Washington St.
Phoenix, AZ 85007
12
- 13 Dean Miller, Aide to Commissioner Miller
Arizona Corporation Commission
14 1200 W. Washington St.
Phoenix, AZ 85007
15
- 16 Garry Hayes, II, Aide to Commissioner Mayes
Arizona Corporation Commission
17 1200 W. Washington St.
Phoenix, AZ 85007
18
- 19 Dwight Nodes, Assistant Chief Administrative Law Judge
Hearing Division
Arizona Corporation Commission
20 1200 West Washington
Phoenix, AZ 85007
21
- 22 Timothy Sabo, Esq.
Gary Horton, Esq.
Legal Division
Arizona Corporation Commission
23 1200 West Washington
Phoenix, AZ 85007
24

25 A copy of the foregoing was mailed this 10th
26 day of November, 2003 to:

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

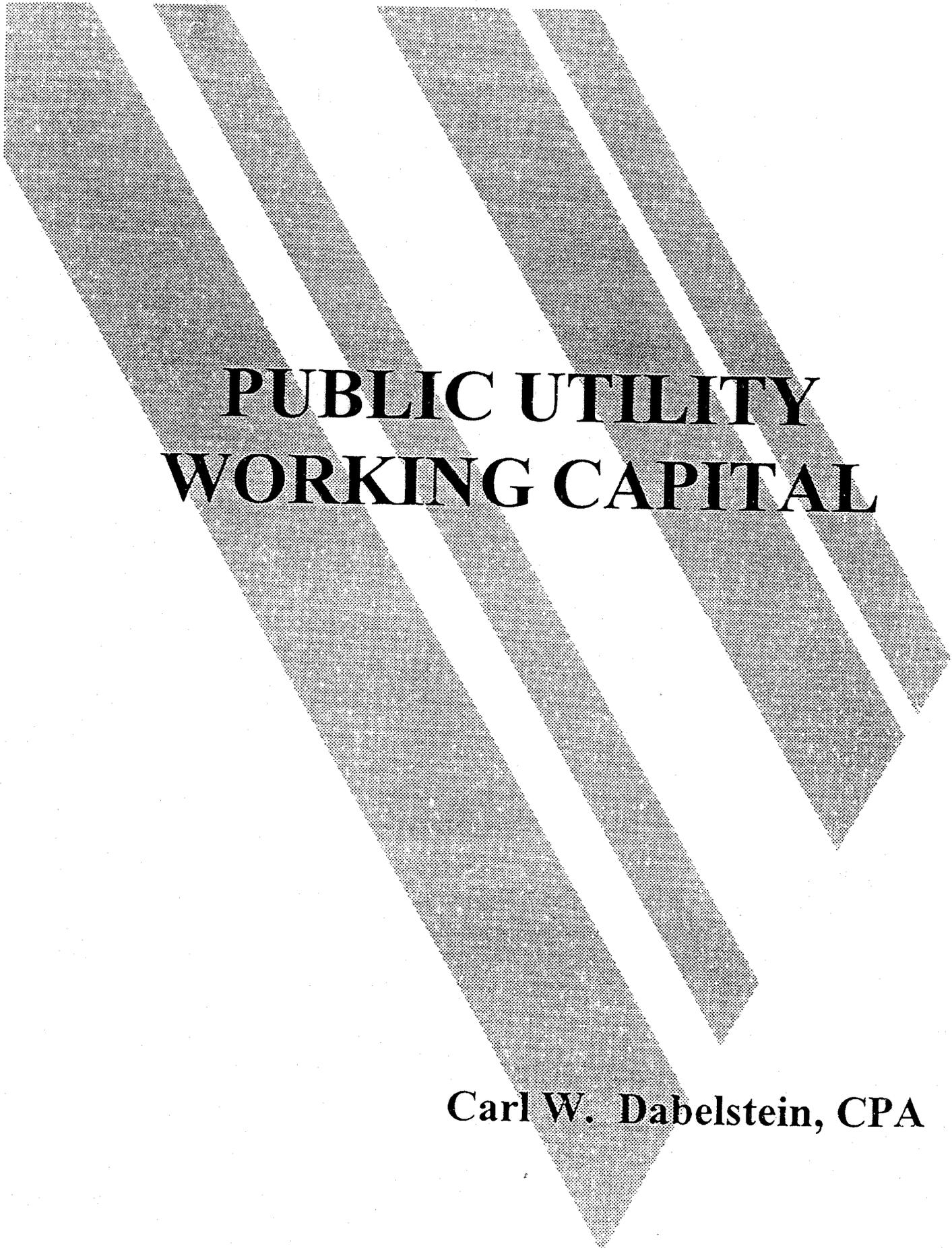
Daniel Pozefsky, Esq.
Residential Utility Consumer Office
1110 W. Washington St., Suite 200
Phoenix, AZ 85007

Robert Skiba
P. O. Box 1057
2000 Mt. Lemmon Hwy.
Oracle, AZ 85623

Kay Bigelow, Esq.
City of Casa Grande Attorney's Office
510 E. Florence Blvd.
Casa Grande, AZ 85222

By: Mary House

EXHIBIT A



**PUBLIC UTILITY
WORKING CAPITAL**

Carl W. Dabelstein, CPA

In performing a Lead/Lag Study, each major operating expenses category (i.e. fuel by type, purchased gas and power, payroll, employee benefits, income taxes, other taxes, etc.) is analyzed separately for the purpose of developing a specific payment lead or lag. Since the computed revenue lag is a composite for all operating revenues, and is based on total revenue requirements, the same revenue lag is used for each Lead/Lag Study category. Once the applicable expense payment lead or lag is known for each study category, it is compared with the revenue lag to determine the net lead or lag days used to calculate the lead/lag factor, which, when multiplied by the respective cost of service amount, produces a measure of Cash Working Capital required (included in rate base) or provided (to be deducted from rate base). The Cash Working Capital to be reflected in rate base will be the aggregate of the computed amounts for all cost of service categories. This process is illustrated on Exhibit III-5, which presents the results of a hypothetical, comprehensive Lead/Lag Study, in a format that is most suitable for discussion of the various components.

The Lead/Lag Study is generally considered to be the best indicator of Cash Working Capital because of the fact that it is based on actual transactions and cash flow, instead of arbitrary formulas or balances taken at a single point in time. As will be covered in greater detail herein, Lead/Lag Studies have been accepted by a majority of state regulators and both the Federal Energy Regulatory Commission and Federal Communications Commission. Another positive aspect of Lead/Lag Studies is that actual test-year pro forma cost of service amounts are used. This eliminates the concerns about the ability to reflect rate case adjustments, and to exclude nonoperating and nonjurisdictional amounts, that exist with the other methodologies.

Electric Utility Company
Cash Working Capital - Lead/Lag Study
(\$ 000's)

<u>Description</u>	<u>Pro Forma Test Year Amount (1)</u> (a)	<u>Revenue Lag Days</u> (b)	<u>Expense Lag Days</u> (c)	<u>Net Lag Days</u> (d)	<u>Lead/Lag Factor (Col. D/365)</u> (e)	<u>Working Capital Required (Col. A X Col. E)</u> (f)
Electric Fuel Expense:						
Coal and Gas	249,000	42.92	15.92	27.00	0.07397	18,419
Gas for Generation	11,000	42.92	35.53	7.39	0.02025	223
Oil for Generation	6,000	42.92	22.69	20.23	0.05542	333
Nuclear Fuel -						
Amortization (2)	33,000	42.92	-	42.92	0.11759	3,880
Disposal	6,000	42.92	76.38	(33.46)	(0.09167)	(550)
Purchased Power	124,000	42.92	34.61	8.31	0.02277	2,823
Salaries and Wages:						
Net Pay	214,000	42.92	10.33	32.59	0.08929	19,108
Income Taxes Withheld	71,000	42.92	14.50	28.42	0.07786	5,528
Payroll Taxes Withheld	25,000	42.92	13.04	29.88	0.08186	2,047
Other Withholdings	36,000	42.92	17.44	25.48	0.06981	2,513
Pensions and Benefits	51,000	42.92	244.05	(201.13)	(0.55104)	(28,103)
Depreciation (2)	181,000	42.92	-	42.92	0.11759	21,284
Other Operating Expenses (3)	273,000	42.92	31.29	11.63	0.03186	8,699
Taxes:						
Employer's Payroll Taxes	18,000	42.92	17.39	25.53	0.06995	1,259
Property Taxes	127,000	42.92	213.50	(170.58)	(0.46734)	(59,352)
Sales Tax Expense	23,000	42.92	64.27	(21.35)	(0.05849)	(1,345)
Federal Income Taxes Payable (4)	85,000	42.92	43.59	(0.67)	(0.00184)	(156)
State Income Taxes Payable (4)	25,000	42.92	69.03	(26.11)	(0.07153)	(1,788)
Deferred Income Taxes (2)	120,000	42.92	-	42.92	0.11759	14,111
Return (5):						
Interest on L-T Debt	176,000	42.92	91.25	(48.33)	(0.13241)	(23,304)
Preferred Dividends	11,000	42.92	45.63	(2.71)	(0.00742)	(82)
Return on Equity	143,000	42.92	-	42.92	0.11759	16,815
Total						<u>2,359</u>

Notes:

- (1) After reclassification, if necessary.
- (2) A "non-cash" expense--may not be permitted by regulators for inclusion in the study.
- (3) Residual O&M--apply average voucher sample lead.
- (4) May be included with or without tax effect of requested revenue increase. If without, the effect of additional income taxes associated with revenue increase may be reflected in revenue conversion factor.
- (5) Frequently, none or only some return components are permitted by regulators for inclusion.

measured from the midpoint of the calendar quarter to the required payment date. This equates to a factor of approximately 75 days.

Property taxes frequently represent the largest source of cash working capital determined in a lead/lag study. That is because most property taxes are generally a very significant expense (due to the capital intensity of utilities) and they are almost always paid substantially in arrears. For example, in Minnesota, the taxes levied on personal property as of the beginning of the year, are not payable until May 15th of the following year. This equates to a payment lag of about 317 days. Moreover, the taxes on real property, also based on beginning of the year assets, are due in equal installments on May 15th and October 15th of the following year. This produces an average lag of 394 days. With revenue lags generally being around forty days, it is easy to see the substantial funds available to utilities from the collection of property taxes in rates until they are ultimately remitted to the taxing authorities.

Most utilities are assessed taxes based on the revenues they bill for service. These are typically in the form of franchise fees levied by local towns and municipalities. Such amounts are included as an element of the company's cost of service, and are reflected on customer bills either in base rates or as a separate line item. In addition, utilities are also frequently required to bill customers for sales taxes. These are an obligation on the customer, not the utility, and are not included in cost of service. The utility's only involvement is that as a collection agent.

Both revenue taxes imposed on utilities and sales taxes collected by utilities affect cash working capital. Generally the payments are required to be made during the month following

EXHIBIT B

ARIZONA WATER COMPANY

Eastern Group

Docket No. U-1445A-02-0619

Witness (es) Hubbard

Data Request No. REL 25-2

Please estimate the cost of outside services through the final disposition of the rate case and update this estimate biweekly from this date forward. Please provide work papers of how the estimate was made.

Response To Data Request No. REL 25-2, 3rd Supplement

In the 2nd Supplement to Response to Data Request No. REL 25-2, the Company revised its estimate of the cost of outside service expenses to be incurred through the final disposition of the Eastern Group rate case and included an allocation of the legal costs incurred in its request for an arsenic cost recovery mechanism ("ACRM"). During the direct examination of the Company's witness Hubbard, the Company withdrew its request for recovery of ACRM legal costs of \$71,000. This revised estimate for rate case expenses excluding the ACRM legal costs for the Eastern Group of \$329,550 was incorporated into the record in this docket as Hearing Exhibit A-18.

Based upon actual expenditures invoiced as of November 7, 2003 of \$276,684, which does not include any legal fees related to the preparation of the Company's reply brief, or other legal expenses to be incurred up through a final decision in this docket, the Company is not revising its estimate for rate case expenses of \$329,550.

**Arizona Water Company
Rate Case Expense**

Response to Data Request No. REL 25-2, 3rd Supplement

In Exhibit A-18, the Company proposed to amortize rate case expense of \$329,550 over a three-year period. Following is a breakdown of that expense:

Attorney Fees	\$199,000
Payroll and Payroll Overheads	48,000
Utility Resources (Cost of Capital Study)	68,000
Temporary Help	1,500
Reproduction Costs	6,000
Computer Setup Charges	600
Phone Charges	200
Shipping Charges	5,000
Publication Notices	350
Bill Inserts	900
Total	\$329,550

Following is a breakdown of actual rate case expenditures invoiced through at 11/7/03:

Attorney Fees	\$182,808
Payroll and Payroll Overheads	23,875
Utility Resources (Cost of Capital Study)	68,279
Temporary Help	0
Reproduction Costs	1,300
Computer Setup Charges	0
Phone Charges	0
Shipping Charges	422
Publication Notices	0
Total	\$276,684