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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF ARIZONA WATER COMPANY, AN ARIZONA CORPORATION, FOR ADJUSTMENTS TO ITS RATES AND CHARGES FOR UTILITY SERVICE FURNISHED BY ITS EASTERN GROUP AND FOR CERTAIN RELATED APPROVALS.	Docket No. W-01445A-02-0619

ARIZONA WATER COMPANY'S CLOSING BRIEF IN SUPPORT OF APPLICATION FOR RATE ADJUSTMENTS

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I. INTRODUCTION AND OVERVIEW OF ARIZONA WATER COMPANY'S APPLICATION AND THE METHODOLOGY EMPLOYED.

A. Overview of Application.

Arizona Water Company ("Arizona Water" or "the Company") has applied for adjustments to its rates and charges for water utility service provided by the Company's Eastern Group. The Eastern Group consists of eight water systems that, as of December 31, 2001, the end of the test year, served over 29,000 customers, as follows:

System	Customers	Percent
Apache Junction	16,093	55.0%
Superior	1,288	4.4%
Bisbee	3,393	11.6%
Sierra Vista	2,294	7.8%
Miami	3,027	10.4%
San Manuel	1,552	5.3%
Oracle	1,401	4.8%
Winkelman	188	0.6%
TOTAL	29,236	

Kennedy Dt. (Ex. A-15) at 3.[1]

The Company's present rates and charges for utility service in the Eastern Group became effective on January 1, 1993, and are based on operating results and investment in plant for test year 1990. Decision No. 58120 (Dec. 23, 1992). Thus, by the time new rates are approved and become effective in this case, there will be an 11-year interval between rate increases for these systems. Notably, from 1990 through May 2002, the

[1] The Company will use the abbreviations Dt., Rb., Sb. and Rj. to identify direct testimony, rebuttal testimony, surrebuttal and rejoinder testimony, respectively, throughout this brief. Each such citation will be preceded by the last name of the witness and followed by the hearing exhibit number and page and/or schedule number.

cost of living has increased by 35%. Kennedy Dt. (Ex. A-15) at 4. In seven of the eight Eastern Group systems, expenses have grown more rapidly than revenue from water sales. But, in Bisbee and Winkelman, the Company's 2001 revenue was actually less than the revenue from water sales during the 1990 test year used in the prior rate case. *Id.* at 5. At the same time, since 1990, the Company's net investment in utility plant has increased by 70%, from $20 million to $34 million – an annual rate of approximately $1.3 million. *Id.* Over the next three years, the Company anticipates investing more than $12 million in its Eastern Group systems in order to comply with the new maximum contaminant level ("MCL") for arsenic, in addition to its ongoing construction program. *Id.* at 6; Kennedy Rb. (Ex. A-16) at 25-27 (discussing costs associated with arsenic treatment.)[2]

Based on the Company's level of investment in utility plant, increases in operating expenses and other changes that have occurred since the Company's last rate decision, revenues from the Eastern Group's utility operations are presently inadequate to provide Arizona Water a reasonable rate of return. As a consequence, Arizona Water is requesting rate adjustments that will produce a combined revenue increase of approximately $3.6 million, or approximately 25%, above adjusted test year revenues.

In addition, Arizona Water is requesting approval of a two-step rate consolidation for the Apache Junction and Superior systems, which have contiguous certificated areas and will be physically interconnected within the next two years. Whitehead Rb. (Ex. A-10) at 4-5. Under the first step, for which approval is sought in this case, the two systems would have a common, consolidated monthly minimum rate, but retain separate commodity rates. In the Company's next rate proceeding, full consolidation would be

[2] On a Company-wide basis, capital costs for arsenic treatment are estimated to exceed $29 million. Annual operations and maintenance expenses associated with those facilities are expected to be at least equal to the capital cost revenue requirement, and are expected to ultimately exceed $6 million annually. Kennedy Rb. (Ex. A-16) at 25-27.

completed by establishing a common commodity rate.

The Company is also requesting approval of an Arsenic Cost Recovery Mechanism ("ACRM") that would allow it to recover capital costs and certain specified recoverable O&M directly related to the construction and operation of facilities to comply with the new arsenic MCL. The ACRM is the same mechanism approved for the Company's Northern Group systems in Decision No. 66400 (Oct. 14, 2003).

B. <u>The Methodology Employed by the Company</u>.

The Company's application, including its proposed pro forma adjustments to rate base, revenue and operating expenses, is consistent with generally accepted ratemaking principles as well as prior decisions and the rules and regulations of the Commission. The Company has used an historic test year consisting of the 12-month period ending December 31, 2001, (the most recent date prior to the filing for which audited financial statements were available) in determining its rate base, operating income and rate of return as required by A.A.C. R14-2-103, with pro forma adjustments to the test year financial data and results based on known and measurable changes.

The Commission's regulation defining the filing requirements in support of a proposed increase in rates and charges for service specifically contemplates adjustments of this nature. For example, the term "pro forma adjustments" is defined as:

> Adjustments to actual test year results and balances to obtain a normal or more realistic relationship between revenues, expenses and rate base.

A.A.C. R14-2-103(A)(3)(i). Similarly, the definitions of "original cost rate base" and "reconstructed cost new depreciated (RCND) rate base" both require that the rate base be adjusted to include "all applicable pro forma adjustments." A.A.C. R14-2-103(A)(3)(h) and (n). The illustrative schedules found in the appendix of the Commission's regulation also indicate that both the rate base and income statement should include pro forma

adjustments. A.A.C. R14-2-103, Appendix B (rate base schedules) and Appendix C (test year income statements). Ht. At 729-36; 968-69.[3]

While the starting point of a permanent rate application is the utility's actual, recorded results during the test year, it is axiomatic that those results must be adjusted to obtain a normal and more realistic relationship between rate base, revenue and expenses that will be representative of the period when the new rates go into effect. *Id.* *See also* Hubbard Rb. (Ex. A-12) at 3-4. The use of an historic test year assumes that the operating relationship will be maintained for several (or more) years into the future, i.e., the time period during which new rates will be in effect. In this case, for example, Arizona Water's new rates will become effective in early 2004, and remain in effect for several years thereafter.[4] Consequently, adjustments to actual test year results are routinely made as part of the ratemaking process. *Id.*

In Arizona Water's prior rate decision for the Eastern Group, Decision No. 58120, for example, the Commission adjusted rate base to include approximately $2.4 million of non-revenue producing plant placed in service following the end of the test year. The Commission also adjusted test year operating revenues and expenses to recognize customer growth, "so that the revenue requirement calculated for ratemaking purposes is representative of the Utility's on-going operations." Decision No. 58120 at 13. The Commission approved similar pro forma adjustments to rate base and expenses in the Company's recent Northern Group proceeding. Decision No. 64282 (Dec. 28, 2001) at 4-5. These adjustments were neither unique nor remarkable. Indeed, they were required to ensure proper matching of rate base, revenues and expenses on a going-forward basis. Without these adjustments, the authorized rates would be based on a distorted

[3] The Hearing Transcript will be referred to herein as "Ht" followed by the page number(s).

[4] Assuming that the Company's request for approval of an arsenic treatment cost recovery mechanism is approved, the Company would file a new rate case for its Eastern Group systems no later than 2007, utilizing a 2006 test year.

relationship between revenues, expenses and rate base and, as a result, the Company would not have an opportunity to earn a fair rate of return on its investment in utility plant and property. The approach taken by the Company in this case again follows these well-established ratemaking principles. As explained below, both the Utilities Division ("Staff") and Residential Utility Consumer Office ("RUCO") have deviated from these principles in certain critical respects.

II. RATE BASE.

A. Plant in Service.

The Company's proposed rate base for the Eastern Group is $39,123,198. This amount represents the $39,002,879 reflected in the Company's rejoinder filing adjusted for the minor change in net plant set forth in Exhibit A-19 ($39,002,879 less rejoinder Net Plant of $66,357,231, plus revised Net Plant of $66,477,550). *See* Hubbard Rj. (Ex. A-13) at Exhibit SLH-RJ2, page 1 of 9 (comparing rate bases of Arizona Water, Staff and RUCO); Exhibit A-19. The Company's recommended gross and net plant in service of $84,722,378 and $66,477,550, respectively, for the Eastern Group are reflected in Exhibit A-19. This exhibit compares the positions of Arizona Water and Staff regarding plant in service, including Staff's replacement of plant associated with the Company's Phoenix Office and Meter Shop, which Staff erroneously removed in its direct presentation and replaced in its surrebuttal presentation. Ludders Sb. (Ex. S-46) at 2. As a result of further discussion between witnesses for Arizona Water and Staff, the two parties came to agreement on the amount of gross plant in service for the Company's Eastern Group. Ht. at 982-83. However, as explained below, there remains a significant difference between Arizona Water and Staff with respect to net plant in service due to Staff's adjustments to accumulated depreciation. *See* Exhibit A-19. Furthermore, as discussed below, there remains a more fundamental disagreement between Arizona Water and RUCO concerning plant in service and rate base in light of RUCO's claim that the

Commission should use an unaudited projected test year to determine rates in this proceeding because the Company is requesting inclusion of post test year plant in rate base. Ht. 410-15.

B. Post-Test Year Plant Additions.

Consistent with Commission practice and precedent, Arizona Water, Staff and RUCO recommend inclusion of post-test year plant additions in rate base in this proceeding. *See, e.g.,* Decision No. 64282 (December 28, 2001) at 2-5. *See also* Ht. 738. These parties further agree that the amount of post-test year plant to be included in rate base is $3,349,416. *See* Whitehead Rb. (Ex. A-10) at Exhibit MJW-R1. *See also* Ht. at 736-38, 983. Further, these parties agree that (1) this amount represents the actual cost of post-test year plant additions that are revenue neutral and were placed in service and serving test year customers prior to the cut-off date of December 31, 2002, and (2) all parties have had an adequate opportunity to audit and inspect such plant additions. Ht. at 736-38, 983. However, Arizona Water does not agree with additional adjustments made by Staff and/or RUCO in connection with such post-test year plant additions.

1. Staff's Accumulated Depreciation.

The Company's proposed accumulated depreciation for the Eastern Group is $18,244,828. Exhibit A-19. The Company began with the actual, recorded accumulated depreciation balance at the end of the test year, and then made two adjustments to that balance. First, an adjustment was made related to plant added during the test year. Second, an adjustment was made related to post-test year plant additions. Hubbard Dt. (Ex. A-11) at 9-10. Corresponding adjustments were also made to test year depreciation expense to ensure proper matching of the amount added to the accumulated depreciation balance and the amount of depreciation expense to be recovered in rates. *Id.* at 21 and 31-32 (explaining income statement adjustments 17 and 18).

The pro forma adjustment related to post-test year plant is the corresponding

adjustment resulting from the depreciation expense on non-revenue producing plant placed in service after the end of the test year. The Company has reflected 12 months of depreciation expense for the post-test year plant additions because no expense is included in the test year expenses for this plant. Similarly, the pro forma adjustment related to test year plant is the corresponding adjustment resulting from annualizing test year depreciation expense to reflect the appropriate expense level to be incurred during the time when new rates will be in effect. *Id.* at 9-10 and 31-32. The purpose of the Company's pro forma adjustments to depreciation expense (and the corresponding adjustments to accumulated depreciation) is to recognize the known and measurable change in test year operating expense levels that will result from additional depreciation on plant not previously included in test year depreciation expense. *Id.* Corresponding adjustments must be to both the accumulated depreciation balance and to test year depreciation expense for consistency with the basic accounting principle that as depreciation on plant is recovered as an expense, the accumulated depreciation balance increases by the same amount. Hubbard Rb. (Ex. A-12) at 6-7.

For this reason, the Company's pro forma depreciation expense adjustments and the corresponding adjustments to the accumulated depreciation are identical. Unfortunately, the Staff's adjustments are not. *Id.* Moreover, on cross-examination, the Staff's accounting witness, Mr. Ludders, was unable to explain the basis for this mismatch. Ht. 999-1008. Any further adjustment to the accumulated depreciation balance should have a corresponding depreciation expense adjustment to provide a reasonable opportunity for the Company to realize a fair rate of return on its investment in plant to serve test year customers. Hubbard Rb. (Ex. A-12) at 6; Hubbard Rj. (Ex. A-13) at 6-7.

While it was impossible to determine precisely what adjustments Staff made and the basis for those adjustments (*see* Ht. at 999-1008), at a minimum Staff failed to

properly adjust depreciation expense (and accumulated depreciation) with respect to the Company's post-test year plant additions. In adjusting the Company's plant in service to include post-test year plant additions, one must assume that those plant additions were placed in service by the end of the test year. Virtually all pro forma adjustments to test year plant, revenue and expenses are made on this basis. *See* Hubbard Rb. (Ex. A-12) at 6. For example, in the Company's recent Northern Group rate case, in which 1999 was used as the test year, the Company's income tax expense was computed on the basis of the state corporate income tax rate that became effective on January 1, 2001, i.e., because it would be in effect when the new rates are in effect. *See* Decision No. 64282 at 13-14. Similarly, in adjusting both depreciation expense and the accumulated depreciation balance for the Company's post-test year plant additions, 12 months of depreciation expense will be recorded in the year the rates go into effect. Hubbard Dt. (Ex. A-11) at 31-32; Hubbard Rb. (Ex. A-12) at 6-7. *See also* Ht. at 430-32, 434. Because a Commission decision in this proceeding will not be issued before the end of 2003, a full year of depreciation on the post-test year plant, in reality, will be expensed in the first year that rates are effective. *Id.*

Consequently, to allow only six-months of depreciation expense for the Company's post-test year plant additions, as proposed by Staff, is punitive to the Company. The pro forma adjustment for depreciation expense on post-test year plant additions should be $93,673, as set forth on A-19, to provide a full 12 months of depreciation expense. This is the amount of depreciation expense that will occur when the new rates are effective; it is the amount that should be included in rates. Further, because the Staff was unable to explain the basis for its adjustments to the accumulated depreciation balance and test year depreciation expense, and because those adjustments fail to properly correspond with each other, Staff's adjustments should be rejected.

2. RUCO's Proposed Projected Test Year

As a result of the inclusion in rate base of post-test year plant additions completed and in service by December 31, 2002, RUCO proposes to bring the test year in this proceeding out to that same date for all purposes, rejecting the historical test year adopted for this proceeding and used by Company and Staff. *See generally* Rigsby Dt. (Ex. R-3) at 4-8, 16; Coley Dt. (Ex. R-5) at 4, 7, 10-13. Thus, in essence, RUCO proposes that the Commission set rates in this case based on a projected test year. *See* A.A.C. R14-3-103(A)(3)(j)(defining "projected test year" as the year following the test year.) As part of this approach, RUCO proposes, for example, to increase the Company's CIAC and AIAC balances to include all contributions and advances received in 2002, based on non-revenue neutral plant serving customers added after the test year. According to RUCO, if all ratemaking components (plant, rate base, expenses, etc.) are not brought out to year-end 2002, this will violate the so-called matching principle. *E.g.,* Coley Dt. (Ex. R-5) at 4; Ht. at 745-77. This situation is very similar to the approach RUCO advocated in the Company's Northern Group proceeding, an approach the Commission rejected. Ht. at 748-49. The Commission should again reject RUCO's attempt to change the test year in this proceeding by relying on its erroneous interpretation of the "matching principle."

To begin with, this so-called principle is not codified in any prior Commission decision or in any of the Commission's rules or regulations leaving it subject to differing interpretations. Ht. at 746-77. Moreover, in reality, the "matching principle" is merely another way of expressing the requirement that a one-year historical period, with pro forma annualizing and normalizing adjustments for known and reasonable changes, be used for ratemaking purposes. Arizona Water has never suggested anything to the contrary. In fact, as explained above, this is the approach the Company has taken in this case. *See, e.g.*, Hubbard Rb. (Ex. A-12) at 3-4. As RUCO's own witnesses recognize, this is the approach the Commission customarily follows. *See, e.g.,* Rigsby Dt. (Ex. R-3)

at 11; Ht. at 726-728.

Perhaps most importantly, there is no mismatch in this case due to the inclusion of post-test year plant additions in rate base because all of the plant at issue is revenue-neutral. Arizona Water did not include any post-test year plant additions that were funded by CIAC or AIAC. Hubbard Rj. (Ex. A-13) at 19). The Company's pro forma adjustments associated with post-test year plant additions, including the Company's corresponding adjustments to accumulated depreciation and depreciation expense, result in this plant being reflected as if in service at the end of the test year, in accordance with Commission requirements. Hubbard Rb. (Ex. A-12) at 6. In contrast, including AIAC and CIAC from 2002 creates a mismatch as such plant is not, by definition, used to serve test year customers. It follows that, as in the Northern Group proceeding, RUCO's arguments should be rejected by the Commission as contrary to the Commission policies under which rates are set for Arizona's public service corporations.

C. Working Capital Allowance.

Arizona Water is requesting a total working capital allowance of $923,871 for the Eastern Group. Schedule B-5 (Ex. A-14). The Company's working capital allowance actually consists of four elements: cash working capital, materials and supplies inventory, required bank balances, and prepayments and special deposits. Only cash working capital is in dispute. The cash component of working capital is generally determined in one of three basic ways: (1) a detailed lead/lag study, which measures the amount of time before expenses must be paid and compares it with the amount of time before revenues are received; (2) a formula method (developed to avoid a costly lead/lag study in every case), which commonly uses 1/8 of a utility's annual operating and maintenance expenses; or (3) a balance sheet method, representing the difference between a utility's current assets and current liabilities. *See* Charles F. Phillips, Jr., *The Regulation of Public Utilities*, 348-49 (1993).

1. The Company Disagrees with Staff's Property Tax Component of Working Capital.

The lead/lag method utilized by Arizona Water, RUCO and Staff requires a calculation of the lead days (prepayments) or lag days (accruals) existing between the time an expense is recorded and paid. Hubbard Rb. (Ex. A-12) at 9; Hubbard Rj. (Ex. A-13) at 7. The dispute between the Company and Staff in this case involves the number of lags days used in determining the property tax component of the working capital allowance. Ht. at 1011. Consistent with the Commission's decision in the recent Northern Group proceeding (Decision No. 64282), Arizona Water (as well as RUCO) calculated the property tax component using an average of 212 lag days. Ht. at 497, 1011, 1022. Staff, however, used a lag period of 532 days. *Id.* The flaw in Staff's calculation of the property tax component of working capital originates with its use of the valuation date as the starting point for its determination of lag days. Ht. at 394.

The Centrally Valued Properties Unit of the Arizona Department of Revenue ("DOR") prepares a notice of valuation setting forth the full cash value, or property tax basis, as of January 1 of the prior year for a given tax year. Ex. A-21; Ht. at 396. Arizona Water receives a preliminary notice of valuation approximately six months later. Hubbard Rj. (Ex. A-13) at Exhibit SLH-RJ-7. However, the notice of valuation merely states the value of the property subject to taxation; it does not establish an amount of tax liability and remains subject to challenge. Ht. at 1014-15; Ludders Sb. (Ex. S-46) at Exhibit REL-2 (DOR Memo dated January 7, 1997). In fact, the DOR never assesses property tax liability; it simply values the utility's property.

Instead, counties issue the actual property tax bills in August of the tax year, more than 18 months after DOR's notice of valuation for that tax year. The first payment is due in October of the tax year and the second payment is due in March of the following year, more than two years after the valuation date. Hubbard Rj. (Ex. A-13) at 7-8. The

notice of valuation clearly states that the value provided in that notice will not be used for property tax purposes until the tax year following the valuation date. Hubbard Rj. (Ex. A-13) at Exhibit SLH-RJ7 (showing a valuation date of January 1, 2002 for property tax year 2003). Also, the preliminary notice of valuation provides that the January 1, 2002 valuation is not even issued until June of 2002, six months after Staff's working capital starting point. While the valuation date is important in determining the property value to which county tax rates will be applied at the time property taxes are determined and assessed, it cannot be the starting point for calculating lag days associated with the payment of property taxes for working capital purposes because it has nothing to do with the actual tax liability. Counties assess property taxes and receive the tax payment. The crucial fact is that the accrual for property taxes on the Company's books is an estimate based on the prior year's expense, not the valuation.

Again, consistent with these facts, the Commission utilized a 212-day lag period in Decision No. 64282, a decision the Staff accounting witness testified should be followed, absent changed circumstances. Ht. at 1010-11. What changed circumstances exist in this proceeding to support Staff's use of a lag period some 2.5 times longer? None, other than Staff's analyst has changed and the analyst in this case claims to have corrected "confusion" on the part of the Commission and the parties in the Northern Group proceeding by relying on a memo from DOR discussing the valuation of property, not the assessment of taxes. Ht. at 1022, 1026. This argument is not persuasive and should be rejected.

Put simply, the memo Staff's witness relies on predates the Commission's decision in the Northern Group proceeding and is entirely silent regarding the determination of lag days to use in calculating the property tax component of working capital. Ht. at 1028; Ludders Sb. (Ex. S-46) at Exhibit REL-2. Nor does Decision No. 64282 reflect any confusion over how to make such a calculation. It follows that Arizona

Water and RUCO's calculation based on 212 average lag days (which is consistent with Decision No. 64282) should be adopted rather than Staff's exaggerated lag period that has the effect of understating the Company's actual revenue requirement.

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

RUCO's calculation of working capital allowance is modestly understated due to its erroneous calculation of the income tax component of working capital. Arizona Water records its annual federal income tax liability on a monthly basis and 90% of that annual liability is paid on a quarterly basis. Hubbard Rj. (Ex. A-13) at 20. In calculating working capital, the Company accounted for the lag associated with payment of 90% of the annual tax liability on a quarterly basis. In contrast, RUCO's calculation of 61.95 lag days is based on RUCO's incorrect assumption that the Company pays all its federal income tax liability on an annual basis. *Id.* As stated, this is not the case.

D. Deferred CAP M&I Capital Charges.

Pursuant to its 1985 contract with the Bureau of Reclamation and CAWCD, Arizona Water purchases Central Arizona Project ("CAP") water for use in its Apache Junction system. Hubbard Dt. (Ex. A-11) at 10. In the Company's last proceeding involving the Eastern Group systems, the Commission addressed the recovery of CAP M&I capital charges that had previously been deferred. These charges must be paid by the Company regardless of the quantity of CAP water actually delivered. Hubbard Dt. (Ex. A-11) at 11, *citing* Decision No. 58120 (Dec. 23, 1992) at 7. At that time, the Company had been taking only limited deliveries of CAP water for delivery to potable customers in its Apache Junction system. However, subsequent to the last rate case, Arizona Water began taking and continues to take increased deliveries of CAP water for sale to customers for both potable purposes and non-potable uses. Hubbard Dt. (Ex. A-11) at 11. Throughout that period, the Company has continued to incur annual M&I

capital charges, which charges have been deferred for future recovery. *Id.* In this proceeding, the Company seeks recovery of deferred CAP M&I capital charges in the amount of $691,522. Hubbard Rj. (Ex. A-13) at Exhibit SLH-RJ2, page 1 of 9.[5]

Because Arizona Water is actually using almost all of its entire CAP allocation to provide water service in its Apache Junction system, Staff and RUCO agree that the Company should be authorized to recover these deferred CAP M&I capital charges through the rates authorized in this proceeding. Ht. at 422-24, 676-77, 1029-30.[6] These parties disagree, however, on the appropriate amortization period for recovery of these CAP charges. Arizona Water proposes a three-year amortization period consistent with the anticipated interval between a decision in this proceeding and the filing of the Company's next rate case involving the Apache Junction system. Hubbard Dt. (Ex. A-11) at 12; Ht at 418-19. RUCO recommends an amortization period of ten years based upon the period of time over which the Company has been deferring CAP M&I capital charges since the last rate case. Rigsby Dt. (Ex. R-3) at 27; Ht. at 677-78.

In contrast to Arizona Water's and RUCO's recommended amortization periods for deferred CAP M&I capital charges, Staff recommends a 32-year amortization period. Ht. at 1033. Staff's recommendation is unreasonable. Ht. at 1036-37. Among other things, Staff's claim (Ludders Sb. [Ex. S-53] at 46) that GAAP requires an amortization period more than three times longer than the deferral period is refuted by the

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[5] These amounts will be included in rate base and subject to the Company's authorized rate of return. *E.g.,* Hubbard Dt. (Ex. A-11) at 12-13; Rigsby Dt. (Ex. R-3) at 26. CAP M&I charges incurred on a going-forward basis would be recovered as operating expenses as it is no longer appropriate to defer such costs for future recovery. *E.g.,* Hubbard Dt. (Ex. A-11) at 15-16; Rigsby Dt. (Ex. R-3) at 28-29.

[6] There has been some confusion over the amount of the deferred CAP M&I capital charges to be recovered by Arizona Water in this proceeding. However, during the hearing, the Company clarified that it is seeking recovery of $645,207 of CAP M&I capital charges that have been deferred between the last rate case and December 31, 2002 plus $46,315 associated with the unamortized balance of deferred charges authorized in Decision No. 58120. Ht. at 422-23.

Commission's recent decision concerning deferred CAP M&I capital charges for Arizona-American Water Company's Sun City and Sun City West water districts. *See* Decision No. 62293 (Feb. 1, 2000). In that decision, the Commission adopted Staff's recommendation and approved an amortization period of 5 years consistent with the period of the deferral. *Id.* at 8.[7] Moreover, the Commission is not required to adopt a 32-year amortization period for deferred CAP M&I capital charges and has broad discretion to select an amortization period. Hubbard Rj. (Ex. A-13) at 9-10. In this case, the Commission should exercise that discretion and approve an amortization period for deferred CAP M&I charges of three years.

III. INCOME STATEMENT ISSUES.

Arizona Water's final position on the appropriate revenue and expense levels is reflected in the Income Statement schedules included in the Company's rejoinder filing. Hubbard Rj. (Ex. A-13) at Exhibit SLH-RJ3. As mentioned above, there is a substantial disagreement between the Company and RUCO over which test year to use for determining not only plant in service and rate base, but also the appropriate levels of revenue and operating expenses. RUCO, claiming that the Company is utilizing "estimated" operating expenses, seeks to use unadjusted 2002 numbers to determine the Company's operating expense levels in this proceeding. There are several flaws in RUCO's approach.

First, as explained above, the Commission uses an adjusted historical test year for setting rates, not a projected test year. *E.g.*, Ht. at 727. Second, the expenses used by the Company are not speculative, as RUCO would have the Commission conclude from its repeated use of the term "estimates" throughout this proceeding. Ht. at 485-86. Rather,

[7] Incredibly, when questioned about the inconsistency between Staff's positions, the Staff accounting witness testified that Decision No. 62293 has no validity in this case. Ht. at 1033-34. But, as noted above, the same Staff witness also recognized that absent changed circumstances, there is simply no basis to ignore Commission precedent. Ht. at 1010-11.

Arizona Water used its test year operating expense levels with pro forma adjustments to annualize and normalize known and measurable changes to those recorded expense levels. *E.g.,* Hubbard Rb. (Ex. A-12) at 3-4; Ht. at 412-13. Third, it is entirely inappropriate to use the 2002 numbers being utilized by RUCO. While it is true that the data RUCO used to support its recommended operating expense levels was supplied by the Company in response to data requests, it is raw data that has not been analyzed and adjusted by any party as it would and should be in a rate case. Ht. at 413-17. Accordingly, RUCO's projected test year approach to determining expenses, like its approach to determining rate base, should be rejected.

Notwithstanding the above, there is little dispute over the actual levels of operating expenses if adjusted test year expense levels are utilized. The few, specific operating expense issues in dispute in this case are discussed below.[8]

A. Revenue Expense Annualization.

Pro forma adjustments to actual test year revenue and expenses are necessary to take into account additional customers added during the course of the test year. Hubbard Dt. (Ex. A-11) at 24-25. The test year average number of customers was 28,636 and Arizona Water served 29,236 customers in the Eastern Group at the end of the test year, a difference of 600 customers. *Id.* The Company determined the average revenue per customer using only the 5/8-inch metered customers because virtually all growth in the Eastern Group (98%) occurred in this meter size. Hubbard Rb. (Ex. A-12) at 16. In its direct filing, the Company made an adjustment of $95,469 to reflect the net effect of the adjustments to revenue and expenses necessary to account for these additional customers added during the test year. Hubbard Dt. (Ex. A-11) at 25.

[8] The Company and Staff disagree regarding the amount of annual depreciation expense to be recovered in rates. Because this dispute relates to the mismatch between Staff's adjustment to accumulated depreciation and its adjusted level of depreciation expense, this issue is addressed in conjunction with the discussion of rate base in the preceding section of this brief, beginning on page 6.

Staff also made adjustments to annualize test year revenue and expenses. Ludders Dt. (Ex. S-44) at 9.[9] Moreover, Staff correctly pointed out that Arizona Water's initial annualization adjustment was overstated by $25,967 because the Company used expenses associated with all customers, rather than simply customers on 5/8-inch meters whose average revenue were used to determine the adjustment. Hubbard Rj. (Ex. A-13) at 11-12. However, Staff's annualization adjustment is overstated due to Staff's attempted calculation of the average revenue increases in all customer classes, rather than just in the 5/8-inch meter class. Hubbard Rb. (Ex. A-12) at 17. As stated above, most of the additional customers added during the test year were residential customers on 5/8-inch meters. As a result, much of the increased revenue accounted for by Staff's adjustment using all customers classes will not materialize. *Id.* As a consequence, the Company's annualization adjustment, which is reflected in its rejoinder position, should be accepted. *See* Hubbard Rj. (Ex. A-13) at Exhibit SLH-RJ3.

B. <u>Purchased Power and Purchased Water Adjustment Mechanisms</u>.

The Commission has previously approved adjustment mechanisms for Arizona Water's Eastern Group, which the Company recommends be reset to zero and retained on a going-forward basis. Hubbard Dt. (Ex. A-11) at 22. Arizona Water purchases electric power for pumping in the Eastern Group systems from several different electric providers and the Purchased Power Adjustment Mechanism ("PPAM") applies to those pumping power costs. Hubbard Rb. (Ex. A-12) at 17. The Company's Purchased Water Adjustment Mechanism ("PWAM") applies only in the San Manuel and Superior systems where the Company purchases water for delivery to its customers. Ht. 453. In both instances, the adjustment mechanisms relate to substantial components of the Company's

[9] Although RUCO agrees that it is appropriate to annualize revenue and expenses in the manner utilized by Staff and the Company, RUCO annualized 2002 revenue and expenses as it did with its improper use of a projected test year in this proceeding. Coley Dt. (Ex. R-5) at 12; Rigsby Dt. (Ex. R-3) at 35. For this reason RUCO's annualization adjustment should be rejected.

operating expenses which are outside of Arizona Water's control. However, the adjustment mechanisms protect both ratepayers and the Company. *See, e.g.,* Hubbard Rj. (Ex. A-13) at 12.

Obviously the Commission has already concluded that these adjustment mechanisms are in the public interest or they would not have been established in the first place. In fact, the Commission rejected changes in these adjustment mechanisms recommended by Staff in the Company's last Company-wide rate case, recognizing the benefits of these mechanisms to ratepayers. *See* Decision No. 58120 (December 23, 1992) at 30-31. In addition to allowing incremental rate increases to be passed on to consumers without costly and protracted rate proceedings, a concern addressed by the Commission in that proceeding, the Company's PPAM has provided significant benefits to ratepayers as reductions in power costs in the Eastern Group have been promptly passed through to customers. Hubbard Rb. (Ex. A-12) at 17-18. These savings would not have been possible without these adjustment mechanisms. Of course, these mechanisms also protect the Company in the face of significant increases in the cost of water and/or power that would otherwise threaten its financial condition. Hubbard Rj. (Ex. A-13) at 12-13. Ensuring that utilities timely recover their operating costs and have an opportunity to earn their authorized rates of return leads to viable public service providers, which is also in the public interest.

RUCO does not oppose retention of the PPAM and PWAM. Ht. at 763. However, Staff has recommended that the Commission eliminate the PPAM and PWAM in this proceeding. Initially, in opposing continued approval of the PPAM and PWAM, Staff argued only that the mechanisms require accounting and reporting work by Arizona Water and Staff. Ludders Dt. (Ex. S-44) at 10-11. Staff made little effort to explain why this is a burden, especially in light of the fact that Arizona Water performs the majority of the work necessary to implement the PPAM and PWAM, which allows Staff to simply

verify any rate changes. Hubbard Rb. (Ex. A-12) at 17-18. After the Company pointed this out, Staff attempted to justify its recommended elimination of the PPAM and PWAM on unspecified and unsupported criteria. Ludders Sb. (Ex. S-46) at 7; Ht. at 1059. However, Staff failed to point to any Commission decision, rule, regulation or standard, or any other authority to support its recommendation.

In the end, Staff has simply failed to meet its burden of proof on this issue. The adjustment mechanisms are lawful and benefit the Company and its customer. Staff points to no changed circumstances justifying elimination of the PPAM and PWAM. Nor has Staff demonstrated that its alleged burden outweighs the benefits. Perhaps Ms. Hubbard summed it up best:

> Why would the Commission reject a mechanism designed to recover costs, like purchased power, that are outside of the Company's control when doing so either threatens the Company's ability to earn its authorized rate of return or causes customers to pay more than the cost of service?

Hubbard Rj. (Ex. A-13) at 12. Staff has not provided a clear answer to that question.

C. Rate Case Expense.

1. The Appropriate Amount of Rate Case Expense

In Arizona, utilities recover rate case expense because they are obligated to go through Commission ratemaking proceedings in order to obtain rate relief. Ht. at 1050. Here, Arizona Water seeks to recover rate case expense based on the actual expenses that the Company is incurring in connection with this proceeding. Ht. at 513. Obviously, while a rate case is pending, total rate case expense must be estimated and, as of the hearings in this matter, Arizona Water projected its total rate case expense to be $329,550. Exhibit A-18.[10] RUCO has not challenged this expense level, which is

[10] Subsequent to the hearings, Arizona Water supplemented its earlier data request responses. Third Supplemental Response to Staff Data Request No. REL 25-1, copy attached hereto at Exhibit A. The Company intends to provide another supplemental response reflecting its actual rate case expense incurred in its reply brief to be filed on November 10, 2003.

justified by the size of the Company and the complexity of this proceeding. The Company's Eastern Group is the equivalent of a Class A Utility with nearly 30,000 customers, an original cost rate base of nearly $40 million and annual operating revenues of approximately $15 million. Nevertheless, Staff inexplicably proposes rate case expense equal to only $180,913. Ludders Dt. (Ex. S-44) at 12-13. Staff's recommended level of rate case expense is not supported by any competent evidence and should be rejected.

Staff's accounting witness bases his recommendation solely on illogical calculations. Staff first fixed April 30, 2003 as the halfway point of this proceeding and then doubled the amount of attorneys' fees that had actually been incurred as of that date. Ludders Dt. (Ex. S-44) at 13; Ht. at 1052-53. Next, Staff took half of the estimated costs for Arizona Water's cost of capital witness and added its own estimated cost of $8,000 as the amount to be incurred for rebuttal testimony and hearings (ignoring rejoinder). *Id.* Finally, Staff estimated the other costs and these three amounts were added together to reach Staff's recommended rate case expense. *Id.* Yet, Staff's accounting witness admitted on cross-examination that April 30, 2003 is nothing more than the mid-point on the Commission's timeclock. *See* Ht. at 1053-54. With respect to the Company's legal counsel and cost of capital expert, the majority of the work performed occurred in the second half of this proceeding, i.e., after April 30, 2003. *Id. See also* Hubbard Rb. (Ex. A-12) at 25-26.

When the Company challenged Staff's flawed calculations, Staff alleged that Arizona Water's outside consultants are "unnecessarily costly" and reiterated its comparison of the requested rate case expense with the Company's last rate case concluded nearly 10 years before this rate case was filed, where outside consultants were not used. Ludders Sb. (Ex. S-46) at 10-11. Comparing this proceeding to the Company's last rate case involving the Eastern Group, decided in 1992, is of little value. For one

thing, the Company's Eastern Group is substantially larger than it was in the prior test year. Ht. at 302-03. Additionally, rate cases are far more complex today. Ht. at 305-07. This case has been complex and time-consuming, with a substantial amount of discovery taking place, five rounds of prefiled testimony, the live testimony of 13 witnesses over five days of hearings and two rounds of post-hearing briefing. *E.g.,* Ht. at 1041-1046, 1051. Moreover, it is uncontroverted that the Company would not have been able to process its application for rate relief through the Commission without its "outside consultants." Ht. at 305-06.

As a starting point, the recent rate case involving Arizona Water's Northern Group is a far more appropriate comparison. Ht. at 463-64. In that case, the Company used outside consultants, and the Commission rejected Staff's arguments for a lower rate case expense because Arizona Water should have relied more heavily on "internal expertise." Decision No. 64282 at 16; Ht. at 463-64. Furthermore, the Company's Eastern Group is substantially larger than the Northern Group with eight water systems instead of five, nearly twice the number of customers and rate base, and more than double the amount of operating revenue. Finally, as illustrated by the Company's actual costs for processing this rate case, and confirmed by the testimony of Staff's own witness, this has been a very complex proceeding. Ht. at 1041-1046, 1051; Exhibit A. Therefore, the Company should be authorized to recover its actually incurred rate case expense in this proceeding.

2. Amortization of Rate Case Expense.

Arizona Water proposes to amortize its rate case expense over three years based on its expected filing of another rate case in 2007, three years after the rates approved in this proceeding will go into effect. Hubbard Rb. at (Ex. A-12) at 26. This amortization period is also consistent with the amortization period approved in the recent Northern Group proceeding. Decision No. 64282 at 16. Accordingly, Staff's recommended five year amortization should be rejected. Ludders Dt. (Ex. S-44) at 14.

D. CIAC Amortization Methodology.

Staff is proposing a change in the rate for amortizing CIAC. Ht. at 1037. According to the Staff accounting witness, Staff proposes a change to a system specific composite amortization rate for CIAC. Staff justifies its recommendation for using a system-specific composite amortization rate as being consistent with the procedure used in the Northern Group proceeding. Ht. at 1038. Staff's rationale is premised on inconsistent procedures and therefore should be disregarded. In the Northern Group proceeding, the Commission ordered Arizona Water to continue using composite depreciation rates to depreciate all of its plant accounts until its next rate proceeding, while in the Eastern Group proceeding, Staff is proposing the use of component depreciation practices. Hubbard Rj (Ex. A-13) at 17. If the Commission authorizes a composite rate for the amortization of CIACs versus the use of individual component depreciation rates, the Company would recommend a group-wide composite depreciation rate based on the plant accounts subject to contributions. The Company computed a composite depreciation rate of two percent (2%), on an Eastern Group basis, that is based on the plant accounts subject to contributions (Transmission and Distribution Mains, Fire Sprinkler Taps, Services, Meters, and Hydrants). Hubbard Rb. (Ex. A-12) at 27. Any adjustment to the depreciation expense to reflect an adjustment to the amortization of CIAC should have a corresponding adjustment to the CIAC balance in rate base. Hubbard Rb. (Ex. A-12) at 27.

IV. CAPITAL STRUCTURE AND COST OF CAPITAL ISSUES.

A. Capital Structure and Cost of Debt.

There is virtually no disagreement among the parties concerning Arizona Water's capital structure. Arizona Water, Staff and RUCO agree that the Company's capital structure as of December 31, 2002 should be used. Kennedy Rj. (Ex. A-17) at 9; Reiker Dt. (Ex. S-38) at 3-4; Rigsby Dt. (Ex. R-4) at 37-38. That capital structure is:

	Amount	Percent
Short-term Debt	$ 4,500,000	5.62%
Long-term Debt	$22,600,000	28.24%
Common Equity	$52,916,454	66.14%
TOTAL	$80,016,454	100.00%

There is also general agreement regarding the cost of long-term debt. The Company proposes the use of 8.46% as the cost of long-term debt, while Staff and RUCO propose that the cost of long-term debt be 8.5% and 8.44%, respectively. *Id.* However, there is serious disagreement concerning the appropriate cost of short-term debt.

The Company borrows funds on a short-term basis from Bank of America. Under its bank loan agreement, the Company's short-term borrowing rate floats with short-term market rates. As Mr. Kennedy explained, the cost of short-term debt has been volatile over the past several years, as illustrated in Exhibit RJK-RJ7. Kennedy Rj. (Ex. A-17) at 8-9. Both Staff and RUCO ignore the volatile nature of the cost of short-term debt, and propose the use of Bank of America's reference rate in effect more than ten months ago. Reiker Dt. (Ex. S-38) at 4-5; Rigsby Dt. (Ex. R-4) at 36-37. This recommendation ignores the volatile nature of short-term debt costs over the past several years, which is inappropriate given that rates in this case will go into effect in early 2004 and will likely remain in effect until the 2007-2008 time period. Under these circumstances, the Company believes that it is more appropriate to use a 24-month average cost. The Company also recommends that the 24-month average from January 2001 through December 2002 be used to compute this cost rate, which results in a short-term rate of 5.548% under the terms of the Company's bank loan agreement. Kennedy Dt. (Ex. A-17) at 9.

B. Cost of Equity.

1. Overview: The Applicable Legal Standard.

Over the past 100 years, the United States Supreme Court, as well as various federal and state courts (including Arizona), have made it clear that a regulated utility is entitled to earn a return on its investment in utility plant and property that includes a return on equity "commensurate with returns on investments in other enterprises having corresponding risks." *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944). These decisions were summarized in a recent article as follows:

> The Supreme Court's *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia (Bluefield)* and *Federal Power Commission v. Hope Natural Gas Co. (Hope)* decisions, as recently reinforced in its *Duquesne Light Co. v. Barasch (Duquesne)* decision, set the standard for judging the lawfulness of equity returns authorized for utilities by ratemaking agencies. Under the *Bluefield-Hope* standard, the equity return must enable the utility to (1) attract additional capital on reasonable terms (the capital attraction standard); and (2) realize a return on equity commensurate with the returns earned by enterprises with comparable risks (the comparable earnings standard). In "reaffirming these teachings of *Hope*," the *Duquesne* Court noted that "[o]ne of the elements *always relevant* to setting the rate under *Hope* is the return investors expect given the risk of the enterprise."

W. Whittaker, "The Discounted Cash Flow Methodology: Its Use In Estimating A Utility's Cost of Equity," 12 *Energy Law Journal* (1991) at 265 (*citing Bluefield Waterworks & Improvement Co. v. Public Serv. Comm'n of West Virginia,* 262 U.S. 679 (1923); *Hope Natural Gas, supra*; *Dusquesne Light Co. v. Barasch,* 488 U.S. 299 (1989)).

Similarly, in summarizing judicial decisions dealing with a utility's rate of return, Dr. Phillips states in his treatise on utility regulation:

> The relevant economic criteria enunciated by the [Supreme] Court are three: financial integrity, capital attraction and comparable earnings. Stated another way, the rate of return allowed a public utility should be high enough (1) to

> maintain the financial integrity of the enterprise, (2) to enable the utility to attract the new capital it needs to serve the public, and (3) to provide a return on common equity that is commensurate with returns on investments and enterprises of corresponding risk. These three economic criteria are interrelated and have been used widely for many years by regulatory commissions throughout the country in determining the rate of return allowed by public utilities.

Charles F. Phillips, Jr., *The Regulation of Public Utilities*, 381-382 (1993).

As these authorities indicate, the rate of return must be sufficient to make required payments on bonds and other outstanding debt and to permit shareholders to earn a fair rate of return on common equity. As recently stated by the Arizona Court of Appeals, the "Commission must permit a utility to realize a fair and reasonable rate of return on the owners' capital investment in the utility." *Turner Ranches Water and Sanitation Co. v. Arizona Corp. Comm'n*, 195 Ariz. 574, 576, 991 P.2d 804, 806 (1999); *see also Sun City Water Co. v. Arizona Corp. Comm'n*, 26 Ariz. App. 304, 309, 547 P.2d 1104, 1109 (1976) (quoting and following *Bluefield Waterworks*, 262 U.S. at 692-693); Zepp Dt. (Ex. A-4) at 4-7 (discussing standard for a "fair rate of return"); Rigsby Dt. (R-4) at 5-6 (acknowledging *Bluefield* and *Hope* criteria).

2. Summary of the Company's Cost of Equity Witnesses.

The Company's primary cost of equity witness, Dr. Zepp, prepared direct, rebuttal and rejoinder testimony on two primary issues: (1) the cost of equity for publicly-traded water utilities and (2) the magnitude of the risk premium Arizona Water requires to compensate the Company for being more risky than the publicly-traded water utilities. In May, 2002, in his direct testimony, he estimated Arizona Water had an equity cost that fell in the range of 11.9% to 12.9%. Zepp Dt. (Ex. A-4) at 7-8. In July 2003, in his rebuttal testimony, Dr. Zepp updated his testimony with current information and found Arizona Water's cost of equity now falls in a range of 11.3% to 12.7%. Zepp Rb. (Ex. A-5) at 7-9 and Update Tables 11-25 (Tab B). As part of his rebuttal presentation, he

restated the equity costs made by Mr. Rigsby and Mr. Reiker using assumptions that are consistent with the approaches they chose to use. *Id.* at 50-52, 56-63 and Rebuttal Tables 6-12 (Tab C). Using the Staff and RUCO models with restated assumptions, he found the current cost of equity for Arizona Water fell in a range of 10.6% to 12.8%. *Id.* at Rebuttal Table 12.

The Company also presented the testimony of Walter M. Meek, the President of the Arizona Utility Investors Association. Meek Rb. (Ex. A-8). Mr. Meek's testimony provides a common sense perspective that rebuts Staff's assertion that firm-specific or "unique" risk is ignored by investors when they make investment decisions. *Id.* at 1. Mr. Meek pointed out that Staff's highly technical, "textbook" arguments ignore the realities of investment in the real world. *Id.* at 2-4. In addition, Mr. Meek testified that Staff's cost of equity estimates are obviously too low, based on current returns on equity and projected returns on equity published by *Value Line Investment Services*, a widely followed investment service. *Id.* at 5, 9-10. Instead, Mr. Reiker (as well as Mr. Rigsby) mechanically applied their models, as shown below.

Finally, Mr. Kennedy discussed several unique risks faced by Arizona Water. Kennedy Rb. (Ex. A-16) at 21-27. Mr. Kennedy explained the difficulty the Company experienced in placing its Series K bonds – its most recent bond issue – during the 2000-2001 time period. *Id.* at 21-24. As explained by Dr. Zepp, the difficulties experienced by the Company, and the fact the interest rate on these bonds exceeded the interest rate on investment grade utility bonds at the time they were placed, shows the Company is more risky than the publicly traded companies used by the parties' witnesses in their finance models. Zepp Dt. (Ex. A-4) at 21-22; Zepp Rb. (Ex. A-5) at 24-25. Mr. Kennedy also discussed the impact that complying with new arsenic MCL will have on Arizona Water, which will require the Company to obtain as much as $30 million in new financing to construct arsenic treatment facilities and result in an annual increase in operating

expenses of at least $6 million. Kennedy Rb. (Ex. A-16) at 25-27.

In sum, based on the estimates of the current cost of equity provided by Dr. Zepp, and the additional risks faced by the Company due to its size, inability to obtain long-term debt financing on terms equivalent to the publicly traded companies with Baa or higher credit ratings, the impact of constructing and operating arsenic treatment facilities, and other firm-specific risks, Arizona Water requests that it be authorized a 12.4% return on its common equity.

3. Dr. Zepp's Cost of Equity Estimates for Publicly-Traded Utilities.

Dr. Zepp used the discounted cash flow ("DCF") model, several risk premium models and the capital asset pricing model ("CAPM") to estimate benchmark equity costs with data for publicly traded water and gas utilities. Based on the data he examined in 2003, gas utilities require equity costs that are 50 basis points higher than the required returns for publicly traded water utilities. Zepp Rb. (Ex. A-5) at 12-13 and Update Table 4. Therefore, in using the data for the gas utilities to determine proxy estimates of equity costs for the benchmark water utilities, he reduced equity cost estimates for the gas utilities by 50 basis points. Zepp Dt. (Ex. A-4) at 35; Zepp Rb. (Ex. A-5) at 12-13 and Update Table 4.

a. DCF Model Estimates

Using the DCF model and an average of two forward-looking measures of growth, Dr. Zepp found the current equity cost for the benchmark water utilities to be in a range of 10.6% to 10.8%. *Id.* at 8-9 and Update Tables 11-13, 15 and 16 (Tab A). Dr. Zepp restated Mr. Reiker's DCF estimates based on the constant growth model, explaining that the worst measure of average future growth for that DCF model is dividends per share ("DPS") when earnings per share ("EPS") are growing more rapidly. Zepp Rb. (Ex. A-5) at 53-56. Restating his constant growth DCF estimates without DPS growth in the

average, Mr. Reiker's equity cost with the constant growth DCF model was found to be in a range of 9.6% to 9.9%. *Id.* at 56-57. Dr. Zepp also restated Mr. Reiker's multi-stage DCF model by including a second stage that reflects investors' expectations that future growth will be higher than current DPS growth when DPS are growing more slowly than EPS. *Id.* at 57-59. Dr. Zepp presented an e-mail communication from Myron Gordon, the father of the DCF model, which supported the inclusion of this second stage. Zepp Rj. (Ex. A-6) at 35-36 and Rejoinder Exhibit 4. With this restatement of Mr. Reiker's multi-stage DCF model, the equity cost for the benchmark water utilities was found to be 10.1%. Zepp Rb. (Ex. A-5) at 59 and Rebuttal Tables 6 and 7.

Dr. Zepp also restated Mr. Rigsby's DCF results by basing Mr. Rigsby's estimate of VS (external) growth on a more realistic forecast of the growth in the number of shares. *Id.* at 61-63 and Rebuttal Table 11. Dr. Zepp showed that past growth in shares had averaged 4.5% and forecasted growth in shares averaged 2.8%, but Mr. Rigsby used a paltry 1.0% growth rate. *Id.* at 61 and Rebuttal Table 10. Dr. Zepp also restated Mr. Rigsby's DCF model results using estimates of future BR (internal) growth and VS growth presented by Mr. Reiker. *Id.* at 60-61, 63 and Rebuttal Table 11. With these two separate restatements of Mr. Rigsby's DCF model, Mr. Rigsby's DCF estimate for the benchmark water utilities is in a range of 10.0% to 11.1%. The restatements of Mr. Reiker's and Mr. Rigsby's DCF models indicate the cost of equity for the benchmark water utilities is in a range of 9.6% to 11.1%, a range that overlaps Dr. Zepp's estimated range of 10.6% to 10.8%. *Id.* at Rebuttal Table 12.

b. Risk Premium Model Estimates.

Dr. Zepp presented three different risk premium models that indicate the cost of equity for publicly-traded water utilities currently falls in a range of 10.3% to 11.2%. *Id.* at 9 and Rebuttal Tables 22, 23 and 24. Mr. Rigsby and Mr. Reiker presented CAPM equity costs but did not present separate risk premium estimates. Dr. Zepp explained that

the versions of the CAPM that Mr. Rigsby and Mr. Reiker relied upon were special cases of the more general risk premium approach. *Id.* at 42-43. *See also* Roger A. Morin, *Regulatory Finance: Utilities' Cost of Capital*, 301-305 (1994).

Mr. Rigsby and Mr. Reiker presented versions of the CAPM that are variations of the original CAPM. *Id.* at 44. Professor William Sharpe, who developed the original CAPM model, has indicated that empirical tests support a model that Dr. Zepp calls the "zero-beta" CAPM. *Id.* at 47-50. Professor Sharpe reports that tests of the version of the CAPM used by Mr. Rigsby and Mr. Reiker show low beta stocks (like water utilities) require higher returns and high beta stocks (like airline stocks) require lower returns than the original CAPM model predict. *Id.* at 47-48. Professor Sharpe also stated that professionals who use the CAPM in their work use the zero-beta version of the model. *Id.*

Dr. Zepp took a conservative approach and used forecasted values for long-term Treasury bonds to restate Mr. Reiker's and Mr. Rigsby's CAPM results. With this restatement, he found the cost of equity for the benchmark water utilities to be in a range of 9.8% to 11.3%. *Id.* at 50-52. Mr. Reiker took issue with the use of forecasted interest rates. Dr. Zepp explained that (1) data underlying Mr. Reiker's Chart 4 show forecasted interest rates are not biased against ratepayer interests and (2) the use of current interest rates instead of forecasted rates will understate the cost of money in 2004 and beyond when the Company's new rates will be in effect. *Id.* at 19-21, 52; Zepp Rj. (Ex. A-7) at 14-17.

Dr. Zepp provided updates of the equity costs made in his direct testimony that show the cost of equity range for benchmark water utilities has dropped from 10.9% to 11.4% to a range of 10.3% to 11.2%. Zepp Rb. (Ex. A-5) at 8-9 and Update Table 25. Mr. Reiker, in contrast, did not update the equity costs he presented in his direct testimony, even though the average cost of intermediate-term Treasury securities, used by

Mr. Reiker in his CAPM model, has increased by 70 basis points since the time he prepared his CAPM estimates. Mr. Rigsby, in contrast, relied on current 91-day Treasury bill rates, which do not reflect the cost of equity relevant to the period when new rates for Arizona Water will be authorized, and thus, an update of his analysis was not made. *Id.* at 48-49.[11]

4. The Authorized, Realized and Forecasted Returns on Common Equity Show that Staff and RUCO's Estimates Are Too Low.

Putting aside the technical arguments made by the witnesses regarding the appropriateness of their respective models, the cost of equity estimates presented by Staff and RUCO are simply not consistent with recent authorized returns on common equity, realized returns on common equity, and *Value Line*'s forecasted returns on common equity, which is indicative of their witnesses' mechanical application of the models. These data provide additional support for Dr. Zepp's cost of equity estimates and the Company's recommended return on equity.

As a reality check, Dr. Zepp prepared a rebuttal schedule containing the authorized returns, realized returns and forecasted returns using Mr. Reiker's sample of publicly traded water utilities.[12] Zepp Rb. (Ex. A-5), Rebuttal Table 1 (Tab B). The data for the 2001-2003 time period are as follows:

[11] In addition, Mr. Rigsby did not rely on the results of his CAPM model, as discussed below.

[12] Mr. Reiker included data for Connecticut Water Services and Middlesex Water in his DCF estimates. Dr. Zepp did not include those two publicly traded water utilities because, at the time his direct testimony was prepared in 2002, both water utilities exhibited rapid increases in their stock prices, indicating that they may be viewed as merger or acquisition candidates and, therefore, the DCF method could understate the cost of equity. Zepp Rb. (Ex. A-5) at 10-11. However, including these two utilities would not alter Dr. Zepp's estimates. Ht. at 221-23.

Authorized Returns on Equity	
2001	10.86%
2002	10.62%
2003	10.59%
Average	**10.69%**
Realized Returns on Equity	
2001	10.27%
2002	10.58%
2003	10.60%
Average	**10.48%**
***Value Line* Forecast**	
2001	11.00%
2002	10.50%
2003	11.00%
Average	**10.83%**

These data are consistent; there are no wild swings up or down, and there is no indication that authorized or realized rates of return will dramatically decline, as the results of the Staff and RUCO models suggest. In fact, the seven-year averages presented in Dr. Zepp's Rebuttal Table 1 are consistent as well: the average authorized return on equity is 10.93%; the average realized return is 10.64% (slightly below the average authorized return, as one would expect); and *Value Line*'s average forecasted return for the group is 10.90%.

In contrast, the estimates of the current cost of equity produced by Mr. Reiker's models, using data from his sample group of publicly traded water utilities, are, with one exception, substantially less than the authorized, realized and forecasted returns on equity for those utilities:

Reiker Cost of Equity Estimates

DCF (Constant Growth)	8.5%
DCF (Multi-Stage)	9.6%
CAPM (Historic Risk Premium)	7.7%
CAPM (Current Risk Premium)	11.1%
Average	**9.2%**

Reiker Dt. (Ex. S-38) at 25 and Schedule JMR-7. Thus, with the exception of his CAPM estimate that utilizes a current market risk premium, all of the results of Mr. Reiker's models are substantially below what an investor would logically expect based on actual data and forecasts from a widely-followed investment service. In fact, if the result of his CAPM model that uses a current market risk premium is excluded, the average of Mr. Reiker's cost of equity estimates drops to only 8.6%. Moreover, Mr. Reiker's models have a history of producing returns on equity that are substantially below his sample group's actual and authorized returns, as shown by Exhibit A-27, indicating that his models are biased downward.

Mr. Rigsby's cost of equity estimates are likewise substantially below the authorized, realized and forecasted returns. The results produced by his models are:

Rigsby Cost of Equity Estimates

DCF	9.18%
CAPM (Geometric Mean)	6.79%
CAPM (Arithmetic Mean)	8.06%
Average	**8.01%**

Rigsby Dt. (R-4) at 27, Schedules WAR-3 and WAR-8. Mr. Rigsby's "final recommendation" is a return of 9.18% on Arizona Water's common equity, i.e., he disregards the obviously low results produced by his CAPM model. Mr. Reiker, in contrast, simply averages all of the results obtained from his models in order to reach his

desired recommendation.

The results produced by Dr. Zepp's models are consistent with recent authorized, realized and forecasted returns on equity for the sample group of publicly traded water utilities. Dr. Zepp's updated estimates using the DCF method and the risk premium method of estimating the cost of equity, presented in his rebuttal testimony, are as follows:

Zepp Cost of Equity Estimates

DCF	10.8%
Risk Premium (Past Water Utilities' ROEs)	11.0%
Risk Premium (Forecasted Cost of Baa Bonds)	11.2%
Average	**11.0%**

Zepp Rb. (Ex. A-5) at 8-9, Update Tables 16, 22 and 25 (Tab A). In addition, as discussed above, Dr. Zepp corrected errors appearing in the DCF and CAPM models used by Mr. Reiker and Mr. Rigsby in his rebuttal testimony, and restated the results of those models using their sample groups of publicly traded water utilities:

Restatements of Reiker and Rigsby Estimates

Reiker DCF	9.6 %
Reiker DCF (Multi-Stage)	10.1 %
Reiker CAPM (Historic Risk Premium)	9.7 %
Reiker CAPM (Current Risk Premium)	12.9 %
Reiker Average	**10.6 %**
Rigsby DCF (Corrected VS growth)	10.0 %
Rigsby DCF (Reiker BR and VS growth)	11.1 %
Rigsby Average	**10.55%**

Id. at Rebuttal Tables 8 and 11 (Tab B). The average of Dr. Zepp's estimates, 11.0%, and his restatements of Mr. Reiker's and Mr. Rigsby's estimates, 10.6% and 10.55%,

respectively, are consistent with the actual data and forecasted returns for the water utility sample group.

In sum, the parties' witnesses have generally employed established methods of estimating the cost of common equity. *See, e.g.,* Phillips, *supra*, at 394-399 (summary of approaches commonly used to estimate the cost of equity). Regardless of the method used, however, it should produce results that are consistent with what utilities are actually earning. As Mr. Meek testifies, "simple common sense indicates that something is wrong with the model when it produces results that low," in discussing Mr. Reiker's basic DCF and CAPM estimates. Meek Rb. (Ex. A-8) at 5. The equity cost produced by Mr. Reiker's basic CAPM model is only 7.7%, which is equal to the forecasted interest rate on Baa utility bonds. Zepp Rj. (Ex. A-7) at Rejoinder Table 1. Rather than disregarding the result produced by that model (as Mr. Rigsby does with the results of his CAPM model), Mr. Reiker simply averages the result in order to obtain a lower cost of equity.

Mr. Rigsby, who relies solely on the result of his DCF model, admitted that his DCF model has been adjusted to lower the resulting cost of equity. The purpose of lowering the cost of equity is to reduce the market price of the utility's stock downward to achieve a market-to-book ratio of 1.0, which he believes is "one of the desired effects of regulation." Rigsby Dt. (Ex. A-4) at 16. *See also* Ht. at 633-37. Given that there is no "market price" for Arizona Water's stock and, further, that reducing Arizona Water's authorized return on equity will have no effect on the price of Philadelphia Suburban or California Water Service's stock (which are currently trading well above book value), there is no basis for this sort of manipulation.

Ultimately, the model must be judged against reality, otherwise it will not produce results that satisfy the attraction-of-capital and comparable earnings standards the United States Supreme Court and Arizona appellate courts have established. In this case, only Dr. Zepp's cost of equity estimates meet those tests, and the recommendations of Staff

and RUCO should be disregarded.

5. Arizona Water Has an Equity Cost That Is Above the Cost of Equity for the Benchmark Water Utilities.

In order to establish a fair rate of return for Arizona Water, Dr. Zepp concluded that 100 to 150 basis points must be added to the foregoing cost of equity estimates to properly account for the additional risk posed by an investment in Arizona Water. Zepp Dt. (Ex. A-4) at 13-23; Zepp Rb. (Ex. A-5) at 24-42. Arizona Water is more risky than the publicly traded water utilities (and natural gas utilities) used by the parties in their cost of equity models. The Company requires the added risk premium to compensate it for being small, the rate-setting system in Arizona, which makes it virtually impossible to match expected revenues with expected plant investment and increases in operating expenses, and the risks associated with having to incur substantial capital costs and additional operating expenses associated with arsenic treatment.

Staff would just dismiss Arizona Water's additional risk by claiming it is not "systematic beta risk." However, Dr. Zepp discussed studies by Fama and French and Ibbotson Associates that indicate there are other "systematic risks" priced by investors. Zepp Dt. (Ex. A-4) at 18-19. Even Professor Sharpe, one of the authors of the original CAPM, has indicated that the basic CAPM model, which relies on only one systematic risk, is too simple to explain investor behavior. Zepp Rb. (Ex. A-5) at 31-32; Zepp Rj. (Ex. A-6) at 21-22. The evidence on the expected difference in beta risk (between small and large utilities), the expected presence of a small firm effect, distress risk caused by difficulty with matching expenses and expected revenues when out-of-period adjustments to historic test year data are limited, and the risk related to recovery of arsenic-related costs supports an equity risk premium for Arizona Water in the range of 100 to 150 basis points. Zepp Dt. (Ex. A-4) at 13-22; Zepp Rb. (Ex. A-5) at 24-37.

a. Arizona Water's Small Size Creates Additional Risk.

Mr. Rigsby and Mr. Reiker assumed no risk premium is required for Arizona Water's small size. The basis for their rejection of the risk premium for size is an article written by Annie Wong and published 10 years ago. Dr. Zepp presented an article that he authored, "Utility Stocks and the Size Effect – Revisited," published in 43 *The Quarterly Review of Economics and Finance*, 578-82 (2003), which responds to Ms. Wong. Zepp Rb. (Ex. A-5) at 33-35 and Exhibit TMZ-R4 (Tab C). In this article, Dr. Zepp addressed the expected negative bias in beta estimates for thinly-traded, small utilities. He also explained why differences in information available for large and small utilities – differences Ms. Wong was not aware of – supports the small firm effect. In his rejoinder testimony, Dr. Zepp also explained that the tables Ms. Wong presented in her article actually support a small firm effect for utilities. Zepp Rj. (Ex. A-7) at 27-28. In one of the two periods reported by Ms. Wong, betas increased as size decreased. In the other period, though there was no clear relationship between betas and size, there was nevertheless a significant size effect. Dr. Zepp explained that Ms. Wong's article, which is the primary basis for Staff's and RUCO's rejection of the need for a risk premium for Arizona Water, can no longer be relied upon. *Id.* at 31.

In response to Dr. Zepp, Mr. Reiker offered a number of complicated, but ultimately flawed, technical arguments. Contrary to the claim by Staff, Staff's beta estimates made with different data support Dr. Zepp's conclusion that betas estimated with annual data for small utilities are indeed closer to 1.0 (the beta for an average risk stock) than are *Value Line* betas estimated with weekly data. *Id.* at 25-26. In Table 2 of his article, Dr. Zepp reported the average beta to be .78 instead of .47 reported by *Value Line*. Staff's data supported an even larger beta of .83. Zepp Rb. (Ex. A-5) at Exhibit TMZ-R4, page 2 of 5. Moreover, if individual beta estimates were made and averaged, as Staff suggested, the average beta estimates for the small utilities were even larger (.83

using Dr. Zepp's data and .87 using Staff's data). Zepp Rj. (Ex. A-5) at 25-26.

Dr. Zepp also explained that other Staff criticisms of the beta estimates are trivial and, if recognized, would not change the magnitude of the beta estimates in any significant way. He explained there are conceptual reasons not to expect high levels of confidence with most beta estimates. *Id.* at 23. If that were not the case, there would be no need for investors to hold diversified portfolios. *Id.* The bottom line is that nothing Mr. Reiker said invalidates the two critical points made in Dr. Zepp's paper, that (1) expected betas for small water utilities are larger than the betas estimated with weekly data and (2) equity costs for small utilities are expected to exceed equity costs for larger utilities.

Moreover, the technical arguments presented by Staff are contradicted by the difficulty Arizona Water experienced in placing its most recent bond issue, as Mr. Kennedy explained. Kennedy Rb. (Ex. A-16) at 21-24. While the Company was ultimately able to place these bonds, their interest rate exceeded the interest rate on Baa utility bonds. Zepp Dt. (Ex. A-4) at 21-22; Zepp Rb. (Ex. A-5) at 24-25. In contrast, all of the bonds placed by the publicly traded water utilities used by the parties in their cost of equity models are rated A or higher. Mr. Reiker admitted during cross-examination that bond ratings issued by independent credit-rating services provide an objective measure of the relative riskiness of a firm. Tr. at 772.

In addition, Dr. Zepp presented an analysis showing that Baa bond rates are tied more closely to equity costs than are Treasury bond rates in recent periods. Zepp Rb. (Ex. A-t) at 19-21; Zepp Rj. (Ex. A-7) at 14-17 and Rejoinder Tables 1 and 2. It also appears that default risk relative to equity costs is fairly stable; otherwise, the Treasury rates would have performed better than the Baa rates in Dr. Zepp's analysis. These empirical results further show that the cost of Arizona Water's Series K bond issue provides strong evidence that the equity risk premium for Arizona Water is no less than

37 to 49 basis points, as recommended by Dr. Zepp.

b. The Cost of Constructing and Operating Arsenic Treatment Facilities Creates Additional Risk.

As a consequence of Arizona Water's small size, it is more heavily impacted by the substantial investment necessary to comply with the new MCL for arsenic. *E.g.*, Garfield Dt. (Ex. A-1) at 8-11; Garfield Rb. (Ex. A-2) at 28; Kennedy Rb. (Ex. A-16) at 25-27. As Mr. Garfield and Mr. Kennedy explained, the Company must construct a large number of treatment facilities in numerous water systems (both in the Eastern Group and its remaining systems) over the next 30 months, at an estimated cost of approximately $30 million.[13] By comparison, Arizona Water's total capitalization, on a Company-wide basis, is approximately $80 million. Kennedy Rj. (Ex. A-17) at 9. Thus, the Company's estimated investment in arsenic treatment facilities will exceed 37% of the Company's current total capitalization. Moreover, the Company anticipates an annual increase in arsenic treatment O&M expenses, again on a Company-wide basis, at least equal to the arsenic treatment capital revenue requirements. Kennedy Rb. (Ex. A-16) at 26.

Neither Staff nor RUCO provided any evidence indicating that the publicly traded water utilities used in their cost of equity estimates face construction requirements of this magnitude, the need to obtain outside financing in excess of 37% of total capitalization, or dramatic increases in operating expenses. They suggest that the mechanism for the recovery of arsenic-related treatment costs ("the ACRM"), which was recently approved by the Commission for Arizona Water's Northern Group in Decision No. 66400, will also be approved for the Eastern Group, thereby eliminating the risk associated with

[13] These estimates are based on the Company's total arsenic treatment requirements, including the Company's Western Group, which will require the most extensive (and costly) plant additions to treat arsenic. *Id.* Because the parties are using the Company's entire capital structure to develop the rate of return on the Eastern Group's rate base, Company-wide risks, such as the construction and operation of company-wide arsenic treatment facilities, must be considered.

constructing and operating arsenic treatment facilities. *See, e.g.*, Rigsby Sb. (Ex. R-8) at 27. However, this conclusion is erroneous for several reasons.

First, even if the Company's request for approval of an ACRM like the mechanism approved for the Northern Group is granted, the Company's Western Group water systems will not have such a mechanism in place. As Mr. Kennedy explained, approximately 46% of the total Company revenue requirement related to capital investment and operating expenses associated with arsenic treatment are attributable to the Western Group. Kennedy Rb. (Ex. A-16) at 26. There is not sufficient lead time to complete a general rate case for the Western Group and put an ACRM into effect for those water systems. *Id.* Furthermore, the ACRM approved by the Commission will not allow the Company to recover a return on its total investment in treatment facilities due to timing differences (e.g., limitations on the number of step increases), nor will it permit recovery of all operating expenses. *See* Decision No. 66400 at 8-9. Consequently, even with an ACRM in place for both the Northern Group and the Eastern Group, Arizona Water must still somehow finance the construction of treatment facilities estimated to cost $30 million and then pay to operate them – a unique and significant risk that must be accounted for in the Company's authorized return on equity.

c. The Proper Application of Staff's "Risk Model" Further Supports a Risk Premium for Arizona Water.

During the hearing, Mr. Reiker presented several pages from a textbook authored by Frank K. Reilly and Keith C. Brown, entitled *Investment Analysis and Portfolio Management*, containing a formula intended to estimate a firm's business risk. Ex. S-21. This formula evaluates changes in operating earnings. Put simply, the greater the change in earnings over the relevant time period, the greater the firm's business risk under the formula. Attached to the excerpts from the textbook is a schedule prepared by Mr. Reiker, applying the author's formula, entitled "Arizona Water Has Lower Business Risk

Than Other Water Utilities." However, as cross-examination during the hearing demonstrated, Mr. Reiker misapplied this formula. Tr. at 843-44. The proper application of the Reilly and Brown business risk formula demonstrates that Arizona Water has higher business risk than the other publicly traded water utilities.

The primary error made by Mr. Reiker is the inclusion of Philadelphia Suburban in his group of publicly traded water utilities. In footnote 11, appearing on the page numbered 339 of the textbook, the authors explain:

> Besides normalizing the standard deviation for size by computing the CV [coefficient of variation], it is also important to recognize that the standard deviation is measured relative to the mean value for the series – that is, it computes deviations from "expected value." The problem arises for firms that experience significant growth that will create very large deviations from the mean for the series even if it is *constant* growth. The way to avoid this bias is to measure deviations from the growth path of the series. . . . [Italics in original.]

As Mr. Reiker's schedules show, Philadelphia Suburban experienced significant growth during the relevant time period, beginning with operating earnings of $66.7 million in 1998 and ending with operating earnings of $140.5 million in 2002. Because Philadelphia Suburban's earnings increased substantially every year, the results of the model are biased, just as the authors warned.

As shown on Mr. Reiker's schedule, Philadelphia Suburban's computed business risk, 0.233, is substantially greater than any other water utility shown on the schedule. The business risk for Philadelphia Suburban resulting from this formula is nearly double that of the next risky utility, American States Water (0.137) and approximately four times the business risk of Connecticut Water and SJW Corp. (0.060 and 0.056, respectively). Once again, Mr. Reiker has taken a model and mechanically applied it without exercising common sense. Of the water utilities used in his calculation, Philadelphia Suburban is the largest (both in terms of customers and net investment in plant), the most

geographically diverse (it has water utility operations in six states), has the highest credit rating (AA-), the highest realized return on equity and the highest forecasted return on equity. *See, e.g.,* Ex. A-25 (*Value Line*, Water Utility Industry, (August 1, 2003)) and Ex. A-23 (*C.A. Turner Utility Reports* (September 2003)). Clearly, from the standpoint of a typical investor, Philadelphia Suburban would present the most attractive investment and the least risk. *See, e.g.*, Meek Rb. (Ex. A-8) at 13. By including Philadelphia Suburban, despite the warning by Messrs. Reilly and Brown, Mr. Reiker has overstated the average business risk of the sample group of publicly traded water utilities. If Philadelphia Suburban is removed from the sample, as suggested by the authors in footnote 11, then the average of the group drops to 0.89 – less than the computed business risk of Arizona Water.

Therefore, whether one categorizes the extra risk faced by Arizona Water as systematic beta risk or puts the risk in some other category, if investors demand higher returns to provide capital to Arizona Water, the United States Supreme Court and the Arizona appellate courts require that such added risk be recognized and compensated. The evidence in this case shows Arizona Water has a cost of equity that is 100 to 150 basis points higher than the larger, publicly-traded utilities require, and the results produced by Dr. Zepp's DCF and risk premium model should be adjusted accordingly.

V. RATE DESIGN AND CONSOLIDATION ISSUES.

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

As it did in the Company's recent Northern Group rate case, Staff is proposing to dramatically change the Company's rate design. *See* Decision No. 64282 at 21-23. Once again, Staff's proposed rate design is not supported by a cost of service study or similar analysis of the impact of Staff's proposal on a system-by-system basis. Instead, Staff relies on a one-half page "incremental cost study" that is, at best, cryptic, and is based on speculative assumptions about future capital investment. Ex. A-29 (Staff's "Study"). *See*

also Kennedy Rb. (Ex. A-16) at 9-10; Kennedy Rj. (Ex. A-17) at 3-4 and Exhibit RJK-RJ1.

The Company has a simple rate design, which has been approved by the Commission in prior rate cases. Decision No. 64282 at 21-22. The Company does not charge different rates to different classes of customers. Instead, the Company has a monthly minimum charge based on meter size rather than on the type of customer receiving service, and a single commodity rate for all gallons sold. Kennedy Dt. (Ex. A-15) at 17. This rate design is easy for customers to understand, simple to administer and produces predictable revenue. Garfield Rb. (Ex. A-2) at 20. This rate design also encourages conservation because customers must pay the cost of service for each 1,000 gallons they use. *See* American Water Works Association, *Alternative Rates*, 22-26 (1992) ("the primary objectives in instituting uniform volume rates are that the single price per unit is readily understood by the consumer, and at the same time, conveys the message that additional water consumption is equally as expensive as initial volumes of water."). *See also* Garfield Rb. (Ex. A-2) at 20.

The Eastern Group's existing rates, like those of the Northern Group, are based on a cost of service study presented in the Company's 1992 rate case. Kennedy Rb. (Ex. A-16) at 15. As Mr. Kennedy explained, the rates authorized in the 1992 rate case deviated somewhat from pure cost-based rates to moderate the impact of the rate increases approved in that proceeding. First, the recommended elimination of 1,000 gallons of "free" water in the monthly minimum charge was postponed. Second, full implementation of the actual meter multiples was postponed to moderate the impact on larger meter sizes. *Id. See also* Decision No. 64282 at 22-23 (approving Company's monthly minimum charges based on the meter multiples). The Company's proposed rate design in this case, which follows the same principles as the rate design recently approved in the Northern Group rate case, addresses the two moderating adjustments

made in the 1992 rate case. First, the 1,000 gallons of "free" water in the monthly minimum would be eliminated. Second, each system's existing meter multiples would be moved half way toward the actual meter multiples. Kennedy Rb. (Ex. A-16) at 15-16.

Staff's rate design, in contrast, deviates from basic cost of service principles and ignores the rate design approved for Arizona Water in both Decision No. 58120 and Decision No. 64282. Put bluntly, Staff's rate design proposal is again seriously flawed and lacks any sort of legitimate analysis that would support its adoption.

First, Staff created a so-called "benchmark" commodity rate for all eight Eastern Group systems by arbitrarily assuming that 75% of each system's revenue requirement should be allocated to commodity-related costs and be recovered through the commodity rate. Thornton Dt. (Ex. S-40) at 9, n. 6. No cost of service study or other analysis was performed by Staff to support this assumption: it is simply a guess. In contrast, the Company's existing rate design is based on a cost of service study, as previously discussed. As shown on Exhibit RJK-RJ3, under the Company's current rate design, the percentage of total revenue recovered by the commodity rate ranges from 38.9% for San Manuel to 66.2% for Apache Junction. Kennedy Rj. (Ex. A-17) at 4 and Exhibit RJK-RJ3. Most of the Eastern Group systems recover between 50% and 60% of their revenue through the commodity rate, as shown on Mr. Kennedy's exhibit. Thus, Staff's rate design would shift recovery of a substantial portion of the revenue requirement from the monthly minimum to the commodity rate with no supporting evidence or analysis, based solely on a footnote appearing in Mr. Thornton's direct testimony. Thornton Dt. (Ex. S-40) at 9, n. 6.

Second, Staff proposes to establish a "lifeline rate," i.e., a discounted commodity rate applicable to the first 3,000 gallons used each month. Thornton Dt. (Ex. S-40) at 2. All customers, regardless of type of use, meter size, income, or other specific characteristics, would automatically receive this special, discounted rate. *Id.* *See also* Ht.

at 875. The amount of the discount is 20%, i.e., Staff's assumed "benchmark" commodity rate, discussed above, is discounted by 20%, which is equivalent to receiving 600 gallons of free water each month. Staff's rate design eliminates the existing 1,000 gallons included in the minimum, but then awards each customer 600 gallons of free water through the 20% lifeline discount.

Once again, Staff's lifeline rate is not supported by any cost of service study or billing analysis. Moreover, Staff's lifeline rate violates several important rate design principles:

> (1) Lifeline rates should only be offered to residential customers who meet pre-established income eligibility requirements (e.g., the federal poverty level for a family of four).
>
> (2) Lifeline rates should be considered only where the local cost of water service is unusually high and a significant percentage of residential customers are perceived to be unable to afford water service.
>
> (3) Because lifeline rates involve the sale of water at a discount, i.e., below cost, they produce a subsidy that must be recovered from other customers. A key consideration in developing lifeline rates, therefore, is how this subsidy is to be recovered from other customers.
>
> (4) Because lifeline rates do not reflect the actual cost of water, they may encourage additional water use. Therefore, lifeline rates should not be used where water conservation is a concern.

American Water Works Association, *supra* (Ex. A-28) at 10-13. *See also* Garfield Rb. (Ex. A-2) at 15-17. None of these issues are addressed in the testimony of the Staff witness sponsoring its rate design. Indeed, Mr. Thornton's direct testimony contains a total of 16 lines explaining the basis for Staff's lifeline rate. Thornton Dt. (Ex. S-40) at 2.

Again, under Staff's proposed rate design, all customers are automatically eligible to receive service at a discount. Ht. at 875. This results in a significant subsidy that must somehow be recovered. For the Apache Junction system, for example, the subsidy is

likely to exceed $200,000 annually (*see* Exhibit A-32), and will increase in future years. Neither Mr. Thornton nor Mr. Ludders (who developed the revenue requirement and rates for each system) addresses this subsidy in his testimony.

Both Mr. Thornton and Mr. Ludders, however, do attempt to justify Staff's rate design on the basis of promoting water conservation. Mr. Thornton, for example, testified that Staff's rate design will send a price signal to customers that water is a scarce commodity that will eventually result in water conservation. Thornton Dt. (Ex. S-40) at 3. Similarly, Mr. Ludders testifies that the Company's uniform commodity rate provides "no incentive to reduce water usage," and that Staff's rate design will "properly affect consumer choices." Ludders Dt. (Ex. S-45) at 16. Clearly, it is nonsensical to contend, as Mr. Ludders and Mr. Thornton do, that deliberately pricing water below cost to all of the Company's 29,000 customers in the Eastern Group provides an incentive to customers to reduce their water use. Solely from a water conservation standpoint, the Company's rate design is more effective. *See* Ht. at 571-72.

In order to recover the subsidy created by Staff's lifeline rates, Staff has proposed to charge a premium to commercial and industrial customers. Ht. at 941. This is accomplished by creating a third commodity rate tier applicable to all gallons purchased by the customer in excess of 50,000 gallons per month. The amount of the premium is 20%, i.e., Staff's assumed "benchmark" commodity rate (which is already inflated, as previously explained) would be increased by 20%. At the same time, Staff has proposed that the monthly minimum charges be increased beyond the meter multiples that were approved in the Company's 1992 rate case and used to establish monthly minimum charges for the Company's Northern Group in its recent rate case. *See* Decision No. 64282 at 22-23. *See also* Garfield Rb. (Ex. A-2) at 17 (table comparing existing and Staff's proposed monthly minimum multipliers); Kennedy Rb. (Ex. A-16) at 17 and Ex. RJK-R2. In short, by arbitrarily allocating 75% of the revenue requirement to the

commodity rate, ignoring the monthly minimum multiples previously approved by the Commission, and imposing a 20% premium on monthly water use in excess of 50,000 gallons, Staff's proposal would radically realign the Company's rate design, shifting a disproportionate amount of the revenue requirement to customers with larger size meters.

The linchpin of Staff's rate design proposal is the one-half page incremental cost study, discussed above. However, application of marginal cost pricing to water utility rate design is both controversial and problematic. As explained by the American Water Works Association:

> A major problem with marginal-cost pricing for water service is that the theory is very difficult to apply to real world situations. Marginal-cost rates are difficult to define, develop, and implement. The interplay of customer demand and usage characteristics, changes in operating costs, growth patterns, capital requirements, weather conditions, metering and billing, and numerous other factors create major barriers to implementing an effective marginal cost structure that achieves the objective of promoting the most efficient use of the resource.

American Water Works Association, *supra*, (Ex. A-28) at 54. These difficulties are not overcome by Staff's cryptic and largely hypothetical study.

Staff's study is based on a number of generic, unproven assumptions. Essentially, Staff estimated the approximate cost of constructing a new well, a new storage tank and three miles of water transmission and distribution mains by a water company (not necessarily Arizona Water), which were estimated to be sufficient to serve 1,324 additional residential customers. *E.g.*, Ht. at 1111-16. None of these estimates are tied to planned capital projects for any of the Eastern Group systems. As Mr. Olea explained, "Mr. Thornton and I just had a general discussion on what a well might cost, a tank, mains, and these numbers were the result of that discussion." Ht. at 1111. Mr. Olea, who was responsible for the generic cost estimates in the study, admitted that he did not consider Mr. Hammon's testimony on individual system growth rates, the number of

customers being served by each system, the size and location of each system's certificated area or any other sort of specific system details. Ht. at 1120. In fact, Mr. Olea admitted that he had no idea how Mr. Thornton intended to use the cost estimates he was asked to provide. *Id.*

Nevertheless, Mr. Thornton took Mr. Olea's generic estimates and assumed that they represented the cost of constructing additional facilities for each Eastern Group system. Mr. Thornton ignored the fact that seven of the eight Eastern Group systems are experiencing little or no customer growth or, as Mr. Hammon testified, are "essentially static." Ht. at 1134. *See also* Hammon Dt. (Ex. S-51) at 6 (table showing growth rates for each Eastern Group system from 1996 to 2002). In fact, two of the Eastern Group systems, Winkelman and Superior, have fewer than 1,324 customers – the number of new customers assumed to be added under Staff's study. The remaining systems, with the exception of Apache Junction, have fewer than 3,500 customers. Hammon Dt. (Ex. S-51) at 6. In addition, Mr. Thornton assumed that the 1,324 additional residential customers would use an average of 148,920 gallons of water each year, that each Eastern Group system's operations and maintenance expense per 1,000 gallons is $1.91 and that each Eastern Group system's water treatment costs would be $0.50 per 1,000 gallons.

In summary, Staff's rate design is, as Mr. Kennedy testified, "inadequately developed and lacks both depth and breadth of quantitative support. . . . Staff relies on suppositions, assumptions, unsupported assertions and fails to acknowledge issues discussed in the very publications it relies on in making its recommendations." Kennedy Rb. (Ex. A-16) at 9. For the reasons explained above, Staff's primary rate design goal appears to be shifting a major portion of the Company's revenue requirement to customers with larger size meters without regard to the actual cost of service. Consequently, Staff's rate design is inequitable and would promote economic inefficiencies. Staff has not met its burden of proof, and there is no legitimate reason to

deviate from the Company's existing rate design, which is based on a cost of service study and was approved by the Commission in the recent decision for the Northern Group systems. *See* Decision No. 64282 at 21-22.

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

Arizona Water is requesting that the Apache Junction and Superior systems be consolidated for ratemaking and accounting purposes. As explained by Mr. Kennedy, in this case, the Company is proposing only a partial rate consolidation, under which uniform monthly minimum charges will be established for both systems, with each system retaining its own separate commodity rate. Full consolidation would take place in the Company's next rate case involving the Apache Junction and Superior systems. Kennedy Dt. (Ex. A-15) at 11-12. Both of these systems are facing substantial increases in rates due to the construction of arsenic treatment facilities. It is currently estimated that the Apache Junction system will incur capital costs of approximately $8.8 million, which amounts to an increase in that system's adjusted original cost rate base of 36%. *Id.* at 7. Capital costs associated with arsenic treatment for the Superior system are estimated to be approximately $1.7 million, which amounts to 63% of that system's adjusted original cost rate base. *Id.* In addition, as explained above, both systems face dramatic increases in annual arsenic treatment O&M expenses.

Unfortunately, the Superior system is considerably smaller than the Apache Junction system. As of December 31, 2001, the Apache Junction system had 16,093 customers, while the Superior system had only 1,288 customers. *Id.* at 3. *See also* Hammon Dt. (Ex. S-51) at 3 (2002 customers). In addition, Superior is experiencing negative growth as a consequence of the area's depressed economic condition. Hammon Dt. (Ex. S-51) at 6 (average annual growth rates for Eastern Group systems); Kennedy Rj. (Ex. A-17) at 6 and Exhibit RJK-RJ5 (Apache Junction and Superior community

profiles).

Superior's existing rates are significantly greater than Apache Junction's rates. At present, the monthly minimum charge for a customer on a 5/8 x 3/4-inch meter is $18.13 in Superior and $12.43 in Apache Junction, while the commodity rate per 1,000 gallons is $4.060 in Superior and $2.569 in Apache Junction. Kennedy Rj. (Ex. A-17) at 6. If the first step toward rate consolidation is not approved in this case, the rates being recommended by the parties (regardless of which party's position is adopted) will significantly increase the differences in the two systems' rates, making future consolidation more difficult, particularly when the cost of arsenic treatment is included. Kennedy Rj. (Ex. A-17) at 7.[14] Even without considering the cost of arsenic treatment, under the Company's proposal and on a stand-alone basis, Apache Junction's revenue requirements would increase by 16.7%, while Superior's revenue requirements would increase by 71.4%.

A number of public utility commissions have recognized the appropriateness of rate consolidation or, as it is sometimes called, single-tariff pricing, in order to create a larger customer base over which costs may be spread and to avoid disproportionate rate increases for small systems. For example, in a recent decision approving rate consolidation, the Indiana Utility Regulatory Commission explained:

> Another significant difference in this case is that the landscape of the water utility industry has changed. With the [Safe Drinking Water Act], costs have increased substantially to provide service, especially in smaller operations. . . . Other small utilities in this state or unserved areas that need water for public health reasons are going to require similar capital outlays. We would be ignoring our purpose if we condemned these customers to a lower quality of life by not establishing mechanisms such as [consolidation] which allows water to be provided at

[14] On a stand-alone basis, Apache Junction's arsenic treatment facilities are estimated to cost $573 per customer, while Superior's arsenic treatment facilities are estimated to cost $1,309 per customer. In contrast, with consolidation, the average cost per customer is estimated to be only $630. *Id.*

affordable rates.

Indiana-American Water Company, Order in Cause 40703 (Dec. 11, 1997). Similarly, the Public Utilities Commission of New Hampshire explained in a recent order:

> Opponents of rate consolidation in this case argue that we should adhere to our traditional ratemaking policy of cost causation. We find their position unpersuasive in this case for two reasons. First, traditional cost of service regulation already includes some measure of rate averaging in that customers are not charged the true cost of serving them on an individual basis. Second, and perhaps most important, stand alone rates in this case produce results for some customers that are well beyond the zone of 'just and reasonable.' . . . Most of the community systems are simply too small to absorb the magnitude of investments mandated by environmental enactments. However, without these investments, it is clear that the small community systems would have been unable to provide safe and adequate water service to their customers.

Pennichuck Water Works, Inc., Order No. 22,883 (March 25, 1998).

In another recent decision involving single tariff pricing, the California Public Utilities Commission authorized a water utility to consolidate eight water systems with separate rate schedules that were located from 5 to 160 miles apart. *Southern California Water Company*, Decision No. 00-06-075 (June 22, 2000). The commission noted that single tariff pricing is generally accepted in eight states and is accepted on a case-by-case basis in another 14 states. *Id.* at 19. *See also* National Association of Water Companies, *Regulatory Incentives for Consolidation: The Public Utility Commission Role in Restructuring the Water Industry*, 2-25 (Dec. 1999) (noting that single tariff pricing has been approved in virtually every state in which a public utility commission regulates a multi-system water utility).

In approving single tariff pricing for Southern California Water's eight systems, the commission determined that "[a] region-wide tariff will benefit existing and future customers by stabilizing rates, making rates more affordable in the smaller rate districts, and facilitating investment in water supply infrastructure and water treatment facilities."

Decision No. 00-06-075 at 23. The commission also rejected the argument that single tariff pricing necessarily results in improper inter-system subsidies, stating:

> Critics of regional rates argue that one water system should not subsidize another. In fact, subsidization (or, as a less pejorative label, cost averaging) is common in telephone, electricity and gas rates and is widely practiced in municipal water systems. Except when one rate is established for one customer, all ratemaking involves some degree of cost averaging. For many water systems, costs are averaged among customers within classes, without regard to variations in the cost of service associated with differences in elevation or different water sources and facilities.
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> * * *
>
> The record before us demonstrates that the ratepayers in these eight districts already enjoy benefits of regional operation. Capital projects are financed at a company level, not district by district. Since 1995, the eight districts that shared such resources as engineering, facilities planning and water quality testing and control. Replacement of infrastructure and construction of new plant is subject to the same standards of timing, financing and quality control. The services delivered to customers, including the quality of water, are similar or identical in all eight districts. Under these circumstances, and given the relatively modest impact of single tariff pricing on any given ratepayer, it cannot be said that cost sharing is unreasonable.

Id. at 25-26.

The rationale of these public utility commission orders certainly applies in this case given the small size and lack of customer growth in the Superior system. On a stand-alone basis, Superior, with adjusted test year revenue of only $700,000, would be classified as a Class C water utility, without rate relief, in contrast to Apache Junction, which had adjusted revenue of approximately $9 million during the test year.

Surprisingly, despite the dramatic impact that the construction and operation of arsenic treatment facilities will have on Superior customers, both Staff and RUCO oppose rate consolidation. The Staff engineering witness, Mr. Hammon, for example, testified that the Apache Junction and Superior systems "must exhibit significant

differences in revenue requirements due to the age of the respective infrastructures, maintenance costs, power costs, and growth rates" and believes that a "stronger case for rate consolidation would have been achieved if the systems were interconnected and if a detailed cost of service study was presented which addressed the inequalities." Hammon Dt. (Ex. S-51) at 12. The Staff rate design witness, Mr. Thornton, testified that "[c]onsolidated rates are inappropriate for water systems whose embedded costs vary from system to system and derive no apparent benefit from consolidation." Thornton Dt. (Ex. S-40) at 10. *See also* Rigsby Dt. (Ex. R-1) at 42-45 (objecting to consolidation because it would create a subsidy and provide no benefit to Apache Junction customers).

However, the Apache Junction and Superior service areas are contiguous and, moreover, will have an interconnected source of supply within the next two years. The Commission, in Decision No. 66235 (Sept. 16, 2003), approved Arizona Water's application to extend its certificated area to include a proposed 1,055 lot subdivision called Entrada del Oro, located northeast of Florence Junction. As shown on Exhibit 1 to Mr. Whitehead's direct testimony, Arizona Water now has a certificated area that extends continuously along State Highway 60 from Apache Junction to Superior. Whitehead Dt. (Ex. A-9) at 10 and Exhibit 1. As Mr. Whitehead further explained in his direct and rebuttal testimony, a 16-inch transmission main is being constructed from the Gold Canyon area (southeast of Apache Junction) to Entrada del Oro, which will then be interconnected with facilities being constructed to serve another real estate development project called Ranch 160. The water facilities located within Ranch 160 will in turn be interconnected with the Superior well field, which is located approximately four miles south of that project. *Id.*; Whitehead Rb. (Ex. A-10) at 4-5; Kennedy Rj. (Ex. A-17) at 7.

Thus, Apache Junction customers and Superior customers will be utilizing a common source of supply within two years and prior to the 2007 rate filing. As explained by Mr. Whitehead, once these interconnections are completed, the Apache

Junction and Superior systems will be fully interconnected, and both systems will benefit by sharing storage facilities, groundwater production facilities, treatment costs for arsenic, and other benefits associated with a large, integrated water system. Whitehead Rb. (Ex. A-10) at 5.

Under these circumstances, Arizona Water submits that the requested consolidation of the Apache Junction and Superior systems is appropriate. The Company's certificated service area is now continuous from Apache Junction to Superior, and the two systems will shortly be interconnected and share common facilities. Conversely, if the Company is not permitted to implement the initial consolidation step, i.e., implementing a common monthly minimum charge, in this case, it will become substantially more difficult to consolidate the systems in the Company's next rate case because the differences between the systems' rates will become much greater, both as a result of a rate increase approved in this proceeding and due to the substantial arsenic treatment costs that Superior's customers would be forced to incur. Ht. at 569-70. For these reasons, beginning the two step consolidation of the Apache Junction and Superior systems is appropriate at this time.

VI. OTHER ISSUES.

A. Water Use.

In its direct presentation, Staff expressed concern over water use in four of the Eastern Group systems, Bisbee, Oracle, San Manuel and Superior. Hammond Dt. (Ex. S-51) at 4. As a result, Staff suggests that the Company undertake a regulatory program involving water auditing and system analyses, regulatory reporting and planning and, at Staff's unilateral discretion, compulsory administrative proceedings. Hammon Dt. (Ex. S-51) at 5. Notably, however, the Staff engineering witness testified that Staff was not recommending that the Commission impose specific requirements on Arizona Water, nor is Staff asserting that its concerns about water use impact the rates and charges to be

authorized in this proceeding. Ht. 1125-26, 1128. Nevertheless, Staff is requesting more than just Arizona Water's commitment to work with Staff outside of some sort of Commission-mandated regulatory supervision. Ht. at 1128.

To begin with, it is important to note that Staff's concerns arise out of its analysis of unsold water rather than water that is unaccounted for or lost. Ht. at 324, 1128-29; Garfield Rb. (Ex. A-2) at 24. Unsold water is defined as the "difference between water produced and received and water sold to customers" in contrast to unaccounted for or lost water, which is water that the utility "cannot account for." Ht. at 324. Thus, unsold water includes water used for a variety of essential operational, maintenance and non-billable community water needs, including, without limitation, overflowing water storage tanks, flushing water distribution systems and fire suppression. Garfield Rb. (Ex. A-2) at 24-25. As a consequence, the Staff engineering witness' testimony overstates the amount of unaccounted for water in the Eastern Group system. *See* Hammon Dt. (Ex. S-51) at 4.

Moreover, Staff's reliance on percentages to identify systems in the Eastern Group that it believes require increased regulatory oversight is misplaced because the use of such percentages to evaluate water system operation and efficiency has long been discounted. Garfield Rb. (Ex. A-2) at 25; Garfield Rj. (Ex. A-3) at 2-3. Instead, system-specific factors, such as the type, diameter, length and age of pipe and water pressure, must be considered before unaccounted for water can properly be said to present an operational concern. Garfield Rb. (Ex. A-2) at 25. Consequently, the reasons for, and impacts of, unaccounted for water must be addressed on a system-by-system basis, as the Company suggested in its last rate case involving the Eastern Group systems. Ht. at 322-23.[15] Indeed, despite suggesting that Arizona Water subject itself to unnecessary

[15] Staff's reliance on the testimony of Company witnesses in that proceeding is equally misplaced. As the hearing record reflects, the discussion in that case involved the experience of one witness addressing unaccounted for, rather than unsold, water. Ht. at 323. Further, over time the industry approach to analyzing system efficiency and water use has shifted away from the use of fixed and potentially arbitrary percentages. *See* Garfield Rj. (Ex. A-3) at 2-3

regulatory micromanagement based on Staff's loosely calculated percentages of unsold water, the Staff engineering witness concedes that a 10% or 15% water loss standard is not meant to be an absolute measure but, instead, is little more than a general rule of thumb. Ht. at 1128; Hammon Sb. (Ex. S-53) at 1.

In sum, Staff recognizes that Arizona Water is a well-run water utility from an "engineering and technical" perspective. Ht. at 1125. Staff further agrees with the Company's understanding of, and efforts to address, unaccounted for water. Ht. at 1129-30; Hammon Sb. (Ex. S-53) at 1. And, Staff has failed to identify any harm to ratepayers as a result of unsold or lost water and agrees that there is no evidence that Arizona Water has failed to comply with any applicable governmental standard or requirement. Ht. at 1125. Accordingly, Staff's suggestion that the Company engage in some sort of undefined Commission-directed audit and reporting program under the threat of formal regulatory proceedings should be rejected. Arizona Water submits that its commitment to work with Staff in a cooperative manner to assess issues related to water use outside of Commission ratemaking proceedings is more than sufficient. Garfield Rj. (Ex. A-3) at 4.

B. NP-260 Tariff.

Staff recommends modification of the Company's current NP-260 Tariff by eliminating the meter charge component of that tariff. Hammon Sb. (Ex. S-53) at 2-3. This tariff is designed to allow the Company to recover all of the actual costs of providing non-potable water service (CAP water delivery) plus administrative costs from the customers taking such service. Kennedy Rb. (A-16) at 28. Thus, the tariff provides a small safety margin to ensure that the provision of this service is not subsidized by the general service customers. Kennedy Rj. (A-17) at 9.

Staff has presented inconsistent positions on the meter charge. Engineering Staff

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(*discussing* the AWWA's Water Loss Control Manual published in 2002).

proposes that the NP-260 Tariff be modified to eliminate the meter charge. Accounting Staff, on the other hand, has included the NP-260 meter revenue in its test year revenue. If this meter revenue is eliminated then there should be an increase in the general service revenue requirements. If an offsetting adjustment to the general service rates and charges was made, elimination of the meter charge component of the NP-260 tariff would result in a subsidy from general service customers. Kennedy Rj. (A-17) at 9-10. However, Staff has not proposed any such adjustment, meaning Arizona Water itself would be required to subsidize this service if Staff's conflicting recommendations were adopted. Kennedy Rb. (A-16) at 29. The Company's maintenance fees and related charges under the NP-260 Tariff were approved as reasonable and proper by the Commission in Decision No. 65755 (March 20, 2003). Absent a compelling reason for their elimination, which Staff has not offered, they should be retained.

C. Arsenic Treatment Cost Recovery Mechanism.

Arizona Water is requesting approval of an adjustment mechanism that would allow recovery of arsenic treatment capital costs and recoverable O&M operating expenses based on the ACRM recently approved by the Commission for the Company's Northern Group systems in Decision No. 66400. The Company estimates that it will be required to incur arsenic treatment capital costs in order to construct facilities necessary to comply with the new MCL for arsenic:

	Amount	Percent
Northern Group	$ 3,950,449	13.4%
Eastern Group	$12,052,993	40.8%
Western Group	$13,555,971	45.9%
TOTAL COMPANY	$29,559,412	100.0%

Kennedy Rb. (Ex. A-16) at 26. *See also* Whitehead Dt. (Ex. A-9) at 8 (discussing construction budget for Eastern Group); Garfield Dt. (Ex. A-1) at 8-9 (discussing steps

the Company will take to comply with the new MCL and estimated costs). In addition to the foregoing arsenic treatment capital costs, the Company estimates that arsenic treatment O&M expenses relating to the facilities needed to remove arsenic will exceed $6.3 million annually for the total Company and $2.6 million annually for the affected Eastern Group systems, which are Apache Junction, Superior and San Manuel. Garfield Dt. (Ex. A-1) at 9; Kennedy Dt. (Ex. A-15) at 7-8; Kennedy Rb. (Ex. A-16) at 26.

Generally, Staff and RUCO, both of which were parties to the proceedings that resulted in the Commission's approval of the ACRM in Decision No. 66400, do not disagree with the significance of the problem caused by the new MCL for arsenic or the need for an ACRM for the Eastern Group in this case. RUCO does not address arsenic cost recovery in its pre-filed testimony. Staff, in contrast, noted that the docket relating to the Company's Northern Group rate case was allowed to remain open for the consideration of an ACRM, and indicated that its recommendation "will likely be based upon the result of the final order regarding arsenic" in that docket. Hammon Dt. (Ex. S-52) at 13. However, neither Mr. Hammon nor any other Staff witness addressed the issue of an ACRM for the Eastern Group in his surrebuttal testimony. Given that the ACRM ultimately approved by the Commission was the result of a settlement reached between the Company and Staff, the Company assumes that Staff supports approval of an ACRM based on Decision No. 66400.

Therefore, given the lack of opposition to an ACRM containing the same terms and conditions as the ACRM approved for the Company's Northern Group, and given that the impact of the new MCL for arsenic will be even greater for the affected Eastern Group systems, Apache Junction, Superior and San Manuel, as explained above, an ACRM should be approved for the Eastern Group. Again, it must be emphasized that even with an ACRM approved for both the Northern Group and the Eastern Group systems, approximately 46% of the estimated capital costs associated with constructing

arsenic treatment facilities, as well as a comparable percentage of the additional expenses associated with operating and maintaining those facilities, will not be subject to recovery through the ACRM. Kennedy Rb. (Ex. A-16) at 26-27. Further, as Mr. Kennedy explained, there is simply not sufficient lead time to complete a general rate case for the Western Group and obtain approval of an ACRM for those water systems. *Id.* Consequently, the Company's earnings and ability to obtain financing for this extremely large construction program will continue to be adversely impacted.

D. PCG Settlement.

The so-called PCG issue in this rate case arises as a result of Staff and RUCO's analysis of a 1998 settlement and release agreement (the "PCG Settlement") entered into by Arizona Water and the members of the Pinal Creek Group ("PCG"), a group of mining interests with copper mining operations in and around the Company's Miami system.[16] [redacted] Kennedy Rj. (Ex. A-16) at 7-8. Moreover, no party disputes that the Company acted prudently in protecting the interests of its customers when the PCG and State of Arizona failed to do so. Nevertheless, RUCO ignores the benefits the customers are and will continue to receive [redacted] and would take away [redacted] the Company received on the basis that ratepayers should receive a disproportionate benefit from the PCG Settlement [redacted] in addition to the current and future benefits provided to ratepayers under the terms of the settlement. Rigsby Dt. (Ex. R-8) at 31. Staff, in contrast, seeks to appropriate all of the benefits for ratepayers as a remedy to address Staff's erroneous belief that the [redacted]

[16] Notably, the PCG Settlement contains a provision requiring that the terms be kept confidential. In this proceeding, confidential material has been provided to Staff and RUCO as well as the Commissioners and the Administrative Law Judge subject to appropriate confidentiality agreements. Portions of the record, including the Hearing Transcript, have been sealed accordingly.

properly recorded. Ht. at 1083. As explained below, however, ratepayers have and will continue to realize the vast majority of the benefits of the PCG Settlement, in the form of [redacted] Therefore, the inequitable allocations recommended by RUCO and Staff should be rejected.

1. Background on the PCG Settlement.

Arizona Water's Miami water system is located in Gila County, Arizona and serves approximately 3,000 customers. The Company's Miami system was once comprised of three or more separate water systems known as the Miami, Claypool and Central Heights water systems, which were consolidated over the past 30 years. Garfield Rb. (Ex. A-2) at 5. Historically, the capacity of the wells in this system was highly variable and subject to reduced production in times of drought or otherwise limited supplies. Over time, the Company drilled a number of wells within the Miami system in an effort to stabilize production capacity and ensure adequate service. Given the prevailing hydrology in the area, however, production capacity consistently declined over time, reserve capacity was impossible to maintain and temporary water shortages leading to conservation restrictions were commonplace. Garfield Rb. (Ex. A-2) at 5-7. In short, as Mr. Kennedy testified, the expenditure of funds does not, by itself, guarantee additional water supplies for the Miami system. Ht. at 549-50, 565-66.

Notwithstanding these difficulties, Arizona Water continued its efforts to stabilize and augment water supplies needed to serve customers in its Miami system. In 1997, while the Company was investigating additional water supply options, it learned that the State of Arizona was about to enter into a consent order concerning alleged contamination of groundwater in the Miami area by the members of the PCG. Garfield Rb. (Ex. A-2) at 7. No notice of the consent order was provided to Arizona Water, and the State's proposed resolution with the PCG did not address the impacts of the PCG's

past actions on the Company and its ratepayers. Ht. at 290. As a result, Arizona Water took immediate steps to insert itself into the PCG matter before the State finalized an agreement with the PCG that could have foreclosed the Company's ability to seek recompense from the PCG for harm to the Company's water supplies. Garfield Rb. (Ex. A-2) at 7. To say the least, the Company's participation was not warmly welcomed by either the State or the PCG. Ht. at 135-36.

Nevertheless, Arizona Water persisted in its efforts to ensure that its needs and those of its customers in the Miami system were adequately addressed before the consent order was finalized. Six to eight months of intense litigation and negotiations over several contested issues followed, during which the Company remained steadfast in its primary demand: a guaranteed replacement water supply for the Miami system. Garfield Rb. (Ex. A-2) at 8; Ht. at 136-37, 141. In the end, fortunately, the Company was successful and the PCG Settlement was reached.

The key component of the PCG Settlement is the [redacted] *See, e.g.,* Garfield Rb. (Ex. A-2) at 10; Kennedy Rb. (Ex. A-15) at 4. [redacted] Exhibit S-1. *See also* Ht. at 276-77; Garfield Rebuttal (Ex. A-2) at 9-10. Had Arizona Water not taken the actions it did, at its risk, the Company and, more importantly, its customers would have realized none of the benefits of the settlement in the Miami system. Ht. at 287-88; Garfield Rj. (Ex. A-3) at 9.

2. Staff and RUCO Ignore the Benefits to Customers.

The PCG Settlement is best viewed as providing Arizona Water and its Miami system customers a basket or bundle of benefits. Ht. at 288, 562, 694. As stated, customers in the Miami system have received and are realizing a number of benefits from

the PCG Settlement. However, the recommendations of RUCO and Staff are premised in those parties' utter refusal to assign any value to the benefit of [redacted] In fact, these benefits have significant value to ratepayers and that value can, in significant part, be quantified. *See* Kennedy Rb. (A-16) at 5-7; Kennedy Rj. (Ex. A-17) 10-12.

First, there is the [redacted] Kennedy Rb. (A-16) at 5-6; Garfield Rb. (A-2) at 11-12. According to Mr. Kennedy, these [redacted][17] Kennedy Rb. (Ex. A-16) at 5-6; Kennedy Rj. (Ex. A-17) at 10-11. While the measurement of these avoided costs is a conservative estimate, this fact does not, as Staff and RUCO would have the Commission conclude in adopting their recommendations, alter the fact that Miami system customers are now receiving and will continue to receive very significant economic benefits.

[redacted] Garfield Rb. (Ex. A-2) at 11. [redacted] *Id.* *See also* Ht. at 694. Third, the water

[17] Notably, Mr. Kennedy's calculations focus only on the projected 10 additional wells the Company would have been required to drill at an average, estimated cost of $500,000 per well. Kennedy Rb. (A-16) at 5-6 Mr. Kennedy has not attempted to quantify the [redacted] necessary to address diminished capacity from wells in the Gila Conglomerate. *Id.* This conservative calculation also excludes the [redacted]

supply for the Miami system is far more reliable as a result of the PCG Settlement, substantially reducing the likelihood of outages and associated water use restrictions. Garfield Rb. (Ex. A-2) at 11-12. Fourth, [redacted] that the Company will need to construct water treatment facilities. Garfield Rb. (Ex. A-2) at 12.

Staff and RUCO make almost no effort to controvert the Company's testimony regarding the benefits realized by Miami system customers. Staff, apparently failing to review Mr. Kennedy's testimony, merely alleges, in one two- sentence paragraph, that the Company failed to quantify the benefits being realized by ratepayers. Ludders Sb. (Ex. S-46) at 12. RUCO simply calls the Company's discussion of the benefits being realized by ratepayers "speculative." Rigsby Sb. (Ex. R-1) at 8. But, Staff and RUCO have not refuted that, out of the bundle of benefits provided by the PCG Settlement, Miami system customers are realizing substantial benefits. In fact, RUCO and Staff admit that ratepayers have benefited and will continue to benefit from the PCG Settlement, even [redacted] Ht. at 702, 1097. Even on a conservative basis, customer benefits are at least four times the value of the benefit retained by the Company. The fact that the value of the benefits to the customers cannot be precisely quantified does not diminish the significant value of those benefits. The value of those benefits realized by customers can certainly be compared very favorably to [redacted] *See* Kennedy Rb. (Ex. A-16) at 5-7.

3. Equitable Allocation of the Benefits of the PCG Settlement.

To begin with, it must be emphasized that the recommendations of Staff and RUCO call for the Commission to reduce the Company's Miami system rate base by removing plant paid for by shareholders which is used and useful in serving customers. Ht. at 1084, 1097. There is no "PCG plant" in the Company's rate base. Therefore, the novel approach recommended by Staff and RUCO effectively confiscates shareholder

investment in plant. *See* Kennedy Rb. (Ex. A-16) at 8-9. Given that the Company acted prudently to protect its customers when the State of Arizona did not, this is clearly the wrong message to send to Arizona Water and the regulated utility industry at large. Indeed, Arizona Water submits that it would be poor public policy, as Staff suggests, to penalize utilities that undertake substantial political, financial and operational risk by depriving them of an equitable share of the benefits realized as a direct result of their efforts. Garfield Rb. (Ex. A-2) at 9, 12-13.

Nor should Staff be allowed to justify depriving the Company of all of the benefit [redacted]on the basis that legal fees associated with the PCG Settlement are included in the Company's rate base. *See* Ht. at 544-45, 548. The Company acted to protected water rights that have been in existence for more than 100 years, rights that have benefit beyond the results of the PCG Settlement. *Id.* at 547. Moreover, the amount of return the Company will realize on the costs of protecting those water rights is [redacted]Staff seeks to confiscate, and inconsequential when compared to the benefits from the PCG Settlement being realized by ratepayers as a result of the Company actions.

The allocation approach utilized by the Company is consistent with the Commission's approach in Tucson Electric Power Company, Decision No. 58497 (Jan. 14, 1994). In the late 1980's, TEP was about to enter into a merger with San Diego Gas and Electric ("SDGE") when Southern California Edison ("SCE") made an unsolicited offer and merged with SDGE. *Id.* at 59. TEP then filed suit against SCE, claiming that SCE had tortuously interfered with the proposed merger, damaging TEP. The suit was eventually settled. Under a complex settlement agreement, TEP received both an immediate $40 million cash payment as well as a ten year agreement to exchange power, with TEP receiving power from SCE during the summer months when TEP's customer demand is greatest. *Id.*

In its next rate case, TEP proposed to share the present value of the settlement equally between its shareholders and its ratepayers. Under TEP's proposal, TEP would retain the $40 million cash payment because its shareholders had borne the costs and risks of the litigation. In addition, TEP proposed a process for sharing the benefits of the power exchange agreement under which ratepayers and shareholders would end up sharing the overall present value of the settlement, including the benefits of the summer-winter power exchange. Although the Commission concluded that the value of the power exchange could not be determined with accuracy, it nevertheless accepted TEP's proposal to obtain further input from other parties and provide an updated proposal regarding the sharing of the value of the power exchange. Notably, however, concurring with Staff, the Commission authorized TEP to retain the cash proceeds from the cash settlement because the utility had assumed the risk and cost of pursuing the litigation against SCE. *Id.* at 59-60. Obviously, Staff's recommendation in this case, which would preclude Arizona Water from sharing in any of the benefits of the PCG Settlement, is in direct conflict with this Commission precedent.

In the end, as discussed above, the benefits of the PCG Settlement must be viewed as a total package. These benefits include, [redacted] that are real, tangible and being realized now by the customers. The Company has already allocated those benefits in an equitable manner by generously providing, conservatively, more than 80% of the measurable present value of the settlement package to the Miami customers. Ht. at 562. It would be wholly inequitable to now deprive the Company of its fair share of the [redacted] from the Miami system rate base.

4. Staff's Adjustment to Miami Purchased Power Expense.

Staff is also recommending an adjustment to purchased power expense in the

Miami system. Ht. at 1134. As stated above, the test year expenses for the Miami system reflect reduced operating expenses resulting from the provision of replacement water by the PCG. Garfield Rb. (Ex. A-2) at 11. If Staff believes an adjustment is proper, Staff must present evidence of known and measurable changes supporting the adjustment. Staff has failed to present such evidence. It is not, as Staff erroneously claims, the Company's responsibility to present evidence demonstrating that Staff's adjustment is improper. Hammon Sb. (Ex. S-53) at 3. Indeed, by Staff's own admission, the proposed adjustment to purchased power expense in the Miami system is improper because it is based solely on an estimate of future power costs. Ht. at 1134-35.

RESPECTFULLY SUBMITTED this 31st day of October, 2003.

FENNEMORE CRAIG

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1477039.1

EXHIBIT A

ARIZONA WATER COMPANY
Eastern Group
Docket No. U-1445A-02-0619
Witness (es) Hubbard

Data Request No. REL 25-1
How much has Arizona Water Company actually spent on outside consultant rate case expenses since last reporting in response to data request REL 18-2. Please provide copies of invoices, billings etc. Additionally, please update this information bi-weekly from this date forward.

Response To Data Request No. REL 25-1, 3rd Supplement
As of October 15, 2003, Arizona Water Company has received invoices for $213,234 for outside consultant rate case expenses. This reflects an increase of $81,734 over the amount reported on September 15, 2003. Copies of the invoices in support of the $81,734 are attached.

Completed 10/15/03-slh