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Arizona Corporation Commission
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IN THE MATTER OF THE APPLICATION 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 APPROVAL.

Docket No. W-01445A-02-0619

INITIAL POST-HEARING BRIEF OF THE RESIDENTIAL UTILITY CONSUMER OFFICE

INTRODUCTION

The Residential Utility Consumer Office ("RUCO") submits the following points in support of its position that the Arizona Corporation Commission ("Commission") should not authorize a rate increase of more than $679,808[1] for the Eastern group of the Arizona Water Company (""AWC" or "Company"). RUCO takes issue with the manner in which the Company determined its recommended revenue requirement, the Company's treatment of

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[1] The sum of RUCO's gross revenue increase recommendation for the Apache Junction, Bisbee, Oracle, San Manuel, Sierra Vista, Superior and Winkelman systems exhibited in the second revision Schedules WAR-1 and TJC-1 filed as Exhibits R-6 and R-7 at hearing and the revised gross revenue increase recommendation for the Miami system displayed in the Pinal Creek Group section of this Brief. [($611,251) + $327,912 + ($18,756) + $335,893 + $87,003 + $278,753 + $18,520] + $261,734 = $679,808. For ease of reference, trial exhibits will be identified similar to their identification in the Transcript of Proceedings. The Transcript volume number and page number will identify references to the Transcript.

[END CONFIDENTIAL], the Company's proposed rate consolidation of the Apache Junction and Superior systems, the Company's recommended rate case expense, the Company's proposed 3-year amortization of deferred Central Arizona Project ("CAP") charges, the Company's calculation of working capital, and the Company's recommended cost of capital.

THE REVENUE REQUIREMENT

The Company proposes a total rate increase for the Eastern Group of $3,642,197. A-13, Exhibit SLH-RJ1. In arriving at that figure, the Company disregarded the requirement of A.A.C. R14-2-103 (B) which requires rate applications be based on a historical test year. Rather, the Company has chosen to adjust its test year 2001 revenues, expenses, and rate base elements with 2002 estimated amounts that would have the effect of increasing its revenue requirement. By comparison, RUCO recommended using the actual 2002 revenues, expenses[2] and rate base elements which are known and measurable, and would result in a more accurate matching of these ratemaking elements to the Company-proposed post-test year plant additions. RUCO's recommended levels of the actual 2002 operating revenues, expenses and rate base elements, however, results in a significantly lower level of required revenue for the Eastern Group. R-9.

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[2] RUCO's recommended expenses include pro forma adjustments for depreciation & amortization, property tax, and income tax expense items.

RUCO has consistently opposed the consideration of mismatching ratemaking elements outside of the historical test year. Transcript, Vol. IV at 723. The partial inclusion of pro forma ratemaking elements violates the matching principle, the used and useful principle, and the use of the historic test year requirement. RUCO recognizes, however, and respects the Commission's decisions to allow post-test year plant in certain circumstances. In the present case, RUCO recommends that, should the Commission consider the Company's request to include select post-test year plant, it should also consider the actual matching post-test year expenses, revenues, and rate base elements which include plant additions financed by advances and contributions. Transcript, Vol. IV at 724. Here, the situation is unique in that the 105-day extension requested by Staff and granted by the Commission allowed RUCO the time to collect and analyze the Company's actual 2002 operating results. R-3 at 16. Thus, RUCO was able to consider the actual figures, which are seldom known when considering post-test year ratemaking elements. The actual figures that RUCO used were factual, truthful, based on unbiased information and do not favor one set of interested parties such as shareholders and/or ratepayers. Id. Moreover, the actual figures are the most current information available that is known and measurable and adhere to the most fundamental accounting rules and principles. Id.

The manner in which the Company treated its Contributions in Aid of Construction ("CIAC") illustrates how the Company has manipulated post-test year additions to allow it to overstate its expenses. The Company failed to properly match the post-test year additions, which were provided through CIAC, with the Company's historical test year plant. R-2 at 14. This resulted in an overstated depreciation and amortization expense level because the pro-forma credit entry for amortization of CIAC expense (associated with the post-test year CIAC) had not been recognized to reduce the Company's pro-forma depreciation & amortization expense on a going forward basis. RUCO recommends, and has included in its analysis, the actual CIAC as of December 31, 2002, resulting in the proper amount of depreciation and amortization expense. R-3 at 25.

If the Commission wishes to consider actual post-test year adjustments, it should only consider actual costs, not estimates. It does not make sense to consider estimates when actual figures are known.

[BEGIN CONFIDENTIAL]

[END CONFIDENTIAL]

CONSOLIDATION

The Company is proposing rate consolidation of the Apache Junction and the Superior systems. The Company believes physical interconnection between the two systems will be achieved before the next rate case, and that it is necessary to consolidate rates in this proceeding to reduce the ratepayer impact of consolidation in the next general rate case. A-16 at 19. Neither RUCO nor Staff supports the Company's recommendation[7].

The Company's recommendation is inconsistent with the Commission's directive to the Company in Decision Nos. 58120, 64282 and most recently 66400 to preserve individual system data and rates. In Decision No. 66400, decided on October 14, 2003, the Commission considered the Company's request to consolidate its Sedona, Pinewood and Rimrock systems and its Overgaard and Lakeside systems. In that case, the Company was proposing a two-step consolidation process in anticipation of the significant costs expected to be incurred for the treatment of arsenic to achieve compliance with the EPA requirements. Decision No. 66400 at 11. In its Decision, the Commission noted that non-consolidation will more accurately reflect a proper allocation of costs to the systems that caused the Company to incur such costs. The Commission was very concerned that the individual identity of each of the systems was maintained for ratemaking purposes. Id. at 12-13.

There is nothing that distinguishes the Company's present consolidation proposal. The Company's Vice President of Engineering, Michael Whitehead, testified that it will take

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[7] For efficiency, and since RUCO concurs with the Commission's previous directive on Consolidation set forth in Decision No. 66400, RUCO will not repeat all its arguments on this issue. RUCO's arguments on consolidation are set forth in R-3 at 43-46 and R-2 at 21-24.

up to another two years before the Apache Junction and Superior systems are interconnected. A-10 at 5. Until such time as physical interconnection is accomplished, the two systems' cost of service are independent. Moreover, the Company anticipates filing its next rate case using a 2006 historical test year. Transcript, Vol. III at 499. It is therefore likely that physical interconnection will coincide with the Company's next filing, and thus there is no urgency or need to consolidate in the context of this case. The Company has raised no other factor which would suggest that the Commission reconsider its previous directive. The Commission should not approve consolidation of the Apache Junction and Superior systems.

RATE CASE EXPENSE

The Company's estimated rate case expense is unreasonable. The Company originally estimated its rate case expense at $257,550. Transcript Vol. II at 468. The Company later updated it to $274,550. Id. At the time of the hearing, the Company's request for rate case expense was $329,550. Id. at 469, Transcript Vol. III at 494. RUCO had no objection to the initial request, and therefore did not raise it as an issue in its pre-filed testimony. However, for the following reasons, RUCO opposes the Company's current request.

The Company's Manager of Rates and Regulatory Accounting, Sheryl Hubbard, testified at the hearing that the Company's rate case expense as of September 15, 2003 was $156,554. Transcript, Vol. III at 504. Ms. Hubbard also testified that the difference between the current request and the September 15, 2003 total ($329,550 - $156,554 = $172,996) was the Company's estimate of additional rate case expense from September

15, 2003 forward. According to Ms. Hubbard, the difference was derived by calculating a ratio of the level of expenditures in the Northern Group case to the level of expenditures in the Eastern Group case at the same point of the respective proceedings. Id. at 504-505. Ms. Hubbard also testified that the total amount of rate case expense authorized for the Northern Group in 2001 was approximately $217,000[8]. Transcript Vol. II at 463.

As far as obtaining an actual rate case expense figure, the Company is willing to provide that figure at the time of the closing briefs. Id. at 513. Ironically, the Company appears to be suggesting that an actual figure would be a better measure of its rate case expense than an estimate.

It would be unreasonable and unfair to use the Company's current recommendation for rate case expense. Simply stated, the Company's calculation, arrived at through its comparable "ratio" formula does not make sense. The hearing in this matter commenced on September 22, 2003, seven days after the Company's September 15, 2003, billing invoice. At that point, either all or the majority of the discovery had been completed, testimony filed, and preparation for trial completed. All that was left at that point was the hearing, post-hearing briefs, possible Exceptions to a Recommended Order and participation in Open meeting. By comparison, under virtually any scenario, the amount of rate case expense incurred after September 15, 2003 should be a fraction of the total rate case expense incurred prior to September 15, 2003. Yet the Company is requesting that ratepayers pay significantly more for the post-September 15, 2003 rate case expense

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[8] The Northern Group expenses reflect charges through January 2002-the Decision in that case was issued in December 2001. Transcript, Volume III at 510. Ms. Hubbard did not include the Phase II (Arsenic) costs in her ratio. Nor has she included the Phase II costs in her present estimate of rate case expense. Id.

($172,996) than it is requesting for the pre-September 15, 2003 rate case expense ($156,554).

The Company's suggestion of considering the actual rate case expense to be provided at the time of briefing is also unfair. This would be the Company's third modification to its original estimate and would not allow parties an opportunity to perform the necessary analyses. Further, a policy that deemed any level of rate case expense recoverable simply because such a level had actually been incurred would encourage abuse and potentially saddle ratepayers with unreasonable and/or imprudent expenditures. The Commission should approve only the Company's original recommendation of its rate case expense.

RECOVERY OF DEFERRED CENTRAL ARIZONA PROJECT CHARGES

Arizona Water originally requested that the Company be permitted to recover $704,903 in deferred Central Arizona Water ("CAP") charges, incurred by the Apache Junction system, over a 3-year period (A-11 at page 13 and Application, Schedule B-2, Page 2 of 11, Column 4). RUCO recommends that the Company be permitted to recover $645,207, the actual level of deferred CAP charges booked by the Company as of December 31, 2002, over a period of no less than ten years (R-3 at pages 27 and 28). Company witness Hubbard stated in her rebuttal testimony that the 10-year amortization period recommended by RUCO was reasonable (A-12 at page 14), however, Ms. Hubbard later reaffirmed the original 3-year amortization period in her rejoinder testimony (A-13 at pages 10-11). Although Ms. Hubbard adjusted the original level of CAP charges from $704,903 in the Company's application to $691,522 in her rejoinder testimony (A-13, Schedule SLH-RJ2, Page 1 of 9), the amount is still $46,315 above RUCO's recommendation of $645,207.

RUCO recommends that the Commission adopt the Company's <u>actual</u> level of deferred charges. The actual figure is the best representation of the true figure. Moreover, the actual figure represents the balance as of December 2002, and is therefore consistent with the matching of 2002 ratemaking elements.

The recovery period should not be less than ten years, which is the approximate amount of time over which the CAP charges were accumulated in the Company's deferral account (R-3 at pages 27-28). The 10-year recovery period is also consistent with the Commission's prior decision on the recovery of deferred CAP charges for Arizona-American Water Company Inc.'s (formerly Citizens') Sun City and Sun City West operating systems (Decision No. 62293 dated February 1, 2000). In that case, the Commission ordered a recovery period that mirrored the amount of time that the CAP deferral charges were accumulated. The Company has failed to provide a good reason why the Commission should adopt an inconsistent position in this case.

WORKING CAPITAL

A utility's working capital requirement represents the amount of cash the utility must have on hand to cover any differences in the time period between when revenues are received and expenses must be paid. RUCO-5 at 5. The most accurate way to measure the working capital requirement is via a lead/lag study. Id. The lead/lag study measures the actual lead and lag days attributable to the individual revenues and expenses. Id.

In calculating its recommended level of working capital, RUCO's witnesses used the same methodology as the Company. At issue in this case is the proper way to calculate the Company's federal and state income tax lag. The Company proposes that calculation of its federal and state be based on monthly income tax payments as opposed to quarterly income tax payments. RUCO-5 at 26. The Internal Revenue Service ("IRS") requires the Company to make quarterly payments of income tax. Id. The Company's proposal results in a higher level of working capital since it assumes monthly payments, which suggest a greater level of cash prepayments than does quarterly payments. The greater the cash prepayment, the greater the lag and the more working capital needed by the Company.

The flaw in the Company's proposal is that lead/lag should be calculated based on the payment of taxes, not when the Company records the taxes on its books. The federal and state taxing authorities require quarterly payments, not monthly. Therefore, the date of recordation is irrelevant for lead/lag purposes. The Commission should not approve a methodology which results in an inflated working capital requirement.

COST OF CAPITAL

The Commission should adopt RUCO's recommended rate of return of 8.68 percent, which is the weighted cost of RUCO's recommended costs of debt and equity capital. RUCO's recommended cost of common equity of 9.18 percent fairly considers the current environment of low inflation and low interest rates in which Arizona Water is operating. R-4 at pages 32 – 35. In addition, RUCO's recommended cost of common equity takes into consideration the fact that the Company's capital structure is heavier in equity than the other water utilities. R-4 at 39. The water utilities included in the proxy used by RUCO's cost of capital witness, to perform his discount analyses, included water utilities that had higher levels of financial risk due to their higher levels of debt. R-4 at 39. By comparison, Arizona Water is less leveraged and has less financial risk than the water utilities included in the proxy. R-4 at 39-40. Despite these facts, RUCO's witness made no downward adjustment to his recommended cost of equity capital. R-4 at 40.

The Company, Staff, and RUCO have utilized some of the same stock valuation models in deriving their cost of capital recommendations. RUCO and Staff reach similar conclusions as a result of their analyses. The conclusions reached by the Company's cost of capital analyses are significantly higher, even when using the same models. The Company achieves this result by selecting the inputs and assumptions to the model that will yield the highest results. A more reasonable and less biased result is achieved through the Staff and RUCO analyses.

CONCLUSION

RUCO recommends that the Commission authorize Arizona Water Company a rate increase of no more than $679,808 for the Eastern group based on RUCO's recommended levels of adjusted expenses, revenues and rate base elements that are based on actual amounts booked by the Company during the 2002 operating period, and appropriately match all ratemaking elements. The Company's position is based on a picking and choosing of ratemaking elements from 2001 and 2002, resulting in a mismatch and higher revenue requirement. **[BEGIN CONFIDENTIAL]**

[END CONFIDENTIAL] The Commission should not approve consolidation of the Apache Junction and Superior systems. RUCO further recommends that the Commission approve the Company's original rate case expense recommendation of $257,550; RUCO's recommended 10-year period for amortization of deferred CAP charges, related to the Company's Apache Junction system; RUCO's recommended level of working capital, which was calculated by using the correct number of lead/lag days for federal and state income taxes; and RUCO's recommended 8.68 percent rate of return on invested capital.

RESPECTFULLY SUBMITTED this 31st day of October, 2003.

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