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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 **NOTICE OF FILING SUMMARIES OF WITNESSES' PRE-FILED TESTIMONY**

Arizona Water Company ("Arizona Water" or "the Company"), hereby files the summaries of its witnesses William M. Garfield, Ralph J. Kennedy, Michael J. Whitehead, Sheryl Hubbard, Dr. Thomas M. Zepp and Walter M. Meek. Collectively, Arizona Water's witnesses support the Company's application 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 and the Company makes this filing utilizing the group concept pursuant to previous authorization from the Commission in Decision 58120 (Dec. 23, 1992). At present, the Eastern Group serves approximately 29,000 customers.

The Company's present rates and charges for utility service in the Eastern Group were approved in Decision No. 58120 and became effective January 1, 1993. Revenues from the Eastern Group's utility operations are presently inadequate to provide Arizona Water a reasonable rate of return. Arizona Water is requesting rate adjustments that will produce a revenue increase of approximately $3,600,000 for the combined Eastern Group systems, which amounts to an increase of approximately 25 percent. In addition, Arizona Water is requesting approval of the first of a two step rate consolidation for Apache Junction and Superior systems, which will be interconnected before the next rate proceeding. Under the first step the two systems would have a common consolidated minimum monthly rate but unique commodity costs.

RESPECTFULLY SUBMITTED this 18th day of September, 2003.

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ARIZONA WATER COMPANY

Docket No. W-01445A-02-0619

SUMMARY OF MICHAEL J. WHITEHEAD PRE-FILED TESTIMONY

Mr. Whitehead is a Certified Professional Engineer and Arizona Water Company's Vice President-Engineering. Mr. Whitehead has been with Arizona Water Company since 1980. Mr. Whitehead prepared direct and rebuttal testimony focused primarily on two issues, Company funded plant construction between 1990 and 2002 and the physical interconnection of the Company's Apache Junction and Superior water systems. Mr. Whitehead's testimony regarding such issues is further summarized below.

1. Company Funded Plant Construction.

Mr. Whitehead provides a summary discussion of the Company's plant additions and improvements between 1990 and 2002, which period includes certain post test year plant additions that the Company proposed to include in rate base in this proceeding. Mr. Whitehead outlines the Company's construction budgeting process, which includes annual planning directed at improving or maintaining the infrastructure needed to serve existing customers. Before final construction budgets are prepared for a given year and presented to the Company's Board of Directors, the Company's engineering and operations departments, along with senior management, meet to review and discuss each proposed construction project.

In Mr. Whitehead's direct testimony he provides a chart identifying the cost of plant additions from 1990 through 2002 along with proposed construction budgets for plant in each of the Company's Eastern Group systems for 2003 and 2004. As Mr. Whitehead testifies, these construction projects were necessary in order to maintain infrastructure, resolve operational problems, comply with regulatory requirements and maintain or improve water service to customers. Mr. Whitehead provides examples of significant projects including the construction of four new reservoirs and three new wells for the Apache Junction system, a new reservoir constructed in 2000 to serve the Bisbee system and the construction of a new well and storage tank for the Company's Sierra Vista system.

Mr. Whitehead also provides specific testimony regarding the Company's proposed post test year plant to be included in rate base. Initially, based on the Company's 2002 construction budget, the Company proposed to include a total of $5.7 million of post test year plant in rate base. All such plant additions were non-revenue producing and consisted of wells, reservoirs, transmission mains and other projects intended to improve service to customers existing at the end of the test year as opposed to providing service to new customers. The Company selected December 31, 2002 as a reasonable cutoff period for the inclusion of post test year plant and rate base in order to provide Staff and RUCO ample opportunity to audit such plant additions.

Later, in response to the direct filings of Staff and RUCO, Mr. Whitehead updated the Company's request for inclusion of post test year plant in rate base. The schedule attached to Mr. Whitehead's rebuttal testimony (Exhibit MJW-R-1) reflects the actual post test year plant additions completed by Arizona Water Company before December 31, 2002 and requested for the inclusion in ratebase, approximately $3.3 million of post test year plant. Again, this amount differs from the amount originally requested because certain projects were not complete and others were cancelled as compared to the Company's construction budget which was used in connection with the Company's initial filing. The Company's final request for inclusion of approximately $3.3 million of post test year plant in rate base reflects plant that has been inspected and verified by Staff and RUCO and all such plant was in service serving existing customers on or before December 31, 2002.

Mr. Whitehead also briefly discusses the Company's plant additions related to arsenic treatment to comply with the new MCL for arsenic under the Safe Drinking Water Act. Mr. Whitehead explains that three of the Company's system in the Eastern Group will be impacted by the new arsenic standard and that the Company will have to construct arsenic treatment facilities for such systems. Mr. Whitehead's testimony includes estimated construction budgets for such systems, including an estimated budget of over $8.5 million for the Apache Junction system in 2003 and 2004, nearly $1.6 million in 2004 and nearly $1.7 million for the Company's Superior system. As Mr. Whitehead points out, however, and as explained further by other Company witnesses, the Company has requested that the Commission approve the same cost recovery mechanism be considered for the Company's Northern Group as being appropriate for the Company's Eastern Group.

2. <u>Apache Junction and Superior System Rate Consolidation</u>.

Mr. Whitehead provides testimony supporting the Company's request for consolidation of rates for the Apache Junction and Superior systems. As Mr. Whitehead explains, the physical interconnection of these two system is already well underway and will be complete in the near future. The interconnection of these systems has occurred, in large part, due to rapid growth in the far eastern portion of the Apache Junction system, including the Company's extension of service to the Entrada del Oro and Ranch 160 developments. Subject to certain right of way clearance and the acquisition of appropriate easements, Mr. Whitehead explains that the Company expects that the Entrada del Oro development will be interconnected to the Ranch 160 development and that the Ranch 160 development will be interconnected to the Superior well field system within the next two years. At that point, the two systems will be fully interconnected and both systems will benefit by the sharing of storage facilities, well production treatment costs for arsenic and other benefits realized with a fully integrated system. As a consequence, Mr. Whitehead testifies to the Company's belief that the time to consolidate the rates for the Apache Junction and Superior systems is now before the interconnection is complete.

As Mr. Whitehead further explains, the respective revenue increases sought by Arizona Water Company for Apache Junction and Superior were 16.7 percent and 71.4 percent, on a stand-alone basis. Following the Company's two-step proposed consolidation, consolidation of the monthly minimums in this proceeding and of the commodity charges in the next proceeding for these systems, would have the significant effect of reducing the Superior system increase from 71.4 percent to 8.9 percent while increasing rates for the Apache Junction system by less than 6 percent, to approximately 22 percent. As Mr. Whitehead explains, this two-step gradual approach is intended to simplify and minimize the impact of consolidation on the Company's customers in its Apache Junction and Superior systems.

ARIZONA WATER COMPANY

Docket No. W-01445A-02-0619

SUMMARY OF WILLIAM M. GARFIELD PRE-FILED TESTIMONY

Mr. Garfield has been with Arizona Water Company since 1984 and is currently the Company's President. Mr. Garfield prepared direct, rebuttal and rejoinder testimony in support of the Company's application for rate increases for its Eastern Group systems. Among other things, Mr. Garfield's pre-filed testimony focuses on certain operational and engineering issues, Staff's proposed new rate design methodology for the Eastern Group, and the Company's settlement with the Pinal Creek Group ("PCG"). A detailed summary of each of the key issues addressed in Mr. Garfield's pre-filed direct, rebuttal and rejoinder testimony follows.

1. Operations and Maintenance Programs and Other Engineering Issues.

Mr. Garfield describes the Company's tank maintenance program, which includes certain routine maintenance and inspections at scheduled intervals and explains that the costs of maintaining water storage tanks has increased over the past 10-15 years. Similarly, Mr. Garfield describes the Company's chlorination program, the costs of which have also increased significantly. Since 1990, water quality sampling requirements have also changed significantly primarily due to requirements associated with the EPA's implementation of the Safe Drinking Water Act. As a result, Mr. Garfield explains that the costs of water sampling have also increased significantly. However, programs like the Company's tank maintenance, chlorination and water sampling are necessary to ensure safe and reliable water utility service to the Company's Eastern Group customers, and therefore, expenses associated with these programs are reasonable and prudent expenses that should be recovered by Arizona Water Company through its rates.

Another significant operational and regulatory issue Mr. Garfield addresses in his pre-filed testimony is the impact of the new arsenic MCL. As Mr. Garfield explains, all of the Company's systems are served primarily with groundwater and many of the Company's systems are located in areas naturally high in arsenic. Mr. Garfield estimates a capital cost of $12.5 million to comply with the new arsenic MCL for the Eastern Group water systems. However, as explained elsewhere in the Company's pre-filed testimony, Arizona Water Company seeks approval of the same mechanism for addressing arsenic related cost recovery for the Company's Eastern Group to be adopted by the Commission in connection with the Company's Northern Group case.

Mr. Garfield also explains the Company's position with respect to Staff's recommendation that the Company file a curtailment tariff. As explained by Mr. Garfield, the Company is in the process of preparing a master, Company-wide curtailment tariff and, although the Company believes that the Commission should promulgate rules regarding curtailment tariffs, it is willing to file a Company-wide curtailment tariff consistent with Staff's recommendations in this docket.

2. The PCG Matter – Miami Water System.

The PCG issue arises in this proceeding as a result of Staff and RUCO's analysis of a 1998 settlement agreement entered into by Arizona Water Company and the members of the PCG (the "PCG Settlement").[1] The PCG Settlement was reached in connection with litigation between the PCG and the State of Arizona over groundwater contamination allegedly caused by the PCG, which contamination the Company believes impacted its water supplies for the Miami system. Arizona Water Company sought to intervene in the litigation to oppose entry of a Consent Order between the State and the PCG because it made no provision for addressing the impacts of contamination of groundwater supplies on the Company and its ratepayers.

By way of background, Arizona Water Company's Miami water system is located in Gila County, Arizona and serves approximately 3000 customers. The Company's Miami system was once comprised of three or more separate water systems that were consolidated over the past 30 years. 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 and over time, the Company drilled a number of wells within the Miami system in an effort to stabilize production capacity and ensure adequate service. Then, in or around 1997, while the Company was investigating additional water supply options, it determined that the State of Arizona was about to enter into a consent order concerning alleged contamination of water supplies by the members of the PCG.

[BEGIN CONFIDENTIAL MATERIAL HERE]

[END CONFIDENTIAL MATERIAL HERE]

[1] 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 ALJ subject to appropriate confidentiality agreements and portions of the parties' pre-filed testimony have been deemed confidential and treated accordingly.

3. Staff's Proposed Rate Design.

Mr. Garfield expresses the Company's concerns over Staff's proposed rate design for the Eastern Group systems. Mr. Garfield has testified that Staff's proposed three-tiered rate design is not based on, and in fact is contrary to traditional cost of service principles that have long been the standard of ratemaking. Moreover, Mr. Garfield explains that Staff has failed to consider any of the disadvantages of three-tiered rates such as revenue instability, subsidization of small users by large users, and a shift of the true cost of service from small to large users. Although Staff claims that it did not intend such a subsidy, Staff's intent is irrelevant. It is clear that Staff's proposed rate design does result in subsidies of residential customers by commercial, industrial and other non-residential large meter customers, as clearly demonstrated in the tables and the subsidy example contained in Mr. Garfield's rebuttal testimony. Adoption of Staff's proposed rate design would raise costs not only for business and industry but also for such entities as schools and hospitals that use large amounts of water. As Mr. Garfield testifies, Staff does all this in order to produce a so-called "lifeline" block rate that is, contrary to Staff testimony, not supported by any ADEQ or other engineering guideline.

Mr. Garfield also testifies regarding Staff's admission that its recommended approach is not effective in promoting conservation which, ironically, appears to be the primary justification for adoption of the new rate design. Mr. Garfield identifies the Company's concern that a dramatic change in rate design in order to address conservation makes no sense where the design threatens the Company's ability to meet its revenue requirement and adversely impacts certain customers but, by Staff's own admission, will not promote the very conservation it seeks to enhance. Citing the findings of the American Water Works Association, Mr. Garfield testifies that "the first goal of any rate structure is to generate sufficient revenues to maintain efficient and reliable utility operations, and the second is fairness in the allocation of utility service costs." Mr. Garfield testifies that Staff's proposed rate design is contrary to these principles and should be rejected by the Commission in favor of the rate design proposal offered by the Company and RUCO in this proceeding.

4. Water Loss.

Mr. Garfield also testifies concerning the Company's opposition to being required to file reports and water loss control plans as a pre-condition to approval of the Company's application to adjust rates. Among other things, Staff has not supported its recommendation by demonstrating that the Company's management of water loss is inadequate. In fact, as Mr. Garfield explains, Staff's entire position is predicated on Staff's use of an arbitrary percentage factor that is inconsistent with industry standards.

For one thing, Staff calculations of water loss from the individual systems in the Eastern Group is based on percentage of water that was not sold to customers rather than the percentage of water that is actually lost, i.e. true water losses from water systems. This means that water used to overflow storage tanks, flush water distribution systems or provide water for fire protection, is not being taken into account. Moreover, Mr. Garfield testifies that the use of percentage to evaluate water system operation and distribution efficiency has long been discounted. There are a variety of reasons for this including the fact that one must also consider the amount of total leakage, which is a function of pipe diameter, length of pipe, water pressure, age of pipe and amount of water delivered to a system's customers. Staff has ignored these other factors and, if Staff's recommendation was adopted, Arizona Water Company would be required to undertake costly and time-consuming procedures that would be unnecessary.

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ARIZONA WATER COMPANY

Docket No. W-01445A-02-0619

SUMMARY OF SHERYL HUBBARD PRE-FILED TESTIMONY

Ms. Hubbard is employed by Arizona Water Company as Manager of Rates and Regulatory Accounting. Ms. Hubbard holds a B.A. from Michigan State University and is a Certified Public Accountant. Ms Hubbard has twenty-three years of public utility accounting and regulation including Audit Manager with the Michigan Public Service Commission and Chief of the Accounting and Rates section of the Arizona Corporation Commission. She has testified in numerous proceedings involving utility rates and other regulatory matters. Ms. Hubbard prepared direct, rebuttal and rejoinder testimony in support of the Company's request for rate increases for its eight Eastern Group systems. Ms. Hubbard's pre-filed testimony addresses a variety of rate base and income statement issues, including testimony on behalf of Arizona Water Company on a number of issues in dispute with Staff and/or RUCO such as plant in service, accumulated depreciation, working capital allowance, deferred Central Arizona Project charges, purchased power and purchased water adjustor mechanisms and rate case expense along with issues related to the selection of a test year and the propriety of pro forma adjustments to test year data.

In addition, Ms. Hubbard's direct testimony introduces and explains the majority of the standard schedules required under the Commission's regulations, including the A, B, C, E and F Schedules for Arizona Water Company's Eastern Group. These schedules provide evidence of the Company's original cost rate base, actual and adjusted net operating income, operating income deficiency and required revenue increase for the eight operating systems in the Eastern Group. Ms. Hubbard also explains each of the pro forma adjustments made to the Company's recorded test year accounts to make the Company's test year plant, revenues and expenses representative of the period during which new rates will be in effect, as authorized under A.A.C. R14-2-103. In her rebuttal and rejoinder testimony, Ms. Hubbard presents additional exhibits prepared in response to the testimonies, schedules and positions advanced by Staff and/or RUCO which schedules further support the Company's request for rate increases. Copies of the summary schedules filed with the Company's rejoinder testimony are reproduced and attached to the Company's filing of Summaries of Testimonies.

A summary of the significant issues Ms. Hubbard addresses in her direct, rebuttal and rejoinder testimony follows.

1. Selection of Test Year/Pro Forma Adjustments.

The Company's case is based on historical test year of 2001; the most recent actual calendar year for which financial statements were available when the case was prepared and filed. Determination of the appropriate test year, Ms. Hubbard testifies, is one of the most important steps in the ratemaking process as the test year must be representative of the period when the rates will be in effect and requires an assessment of how the test period selected compares to that period. From there, Ms. Hubbard explains, adjustments to recognize known and measurable changed circumstances are required if the rates are to be fair and reasonable. Ms. Hubbard further explains that adjustments such as normalizing to restate a historical period for normal conditions, annualizing to reflect an annual level of revenue and expense, and out of period adjustments for items known and measurable but not properly reflected in the test year period are some of the types of adjustments that are needed in order to avoid having rates that are either too low or too high and therefore not fair and reasonable to the Company and/or its customers. Against this background, Ms. Hubbard explains that RUCO's desire to have the Commission set rates for the Eastern Group based on an unadjusted 2002 test year is inappropriate and contrary to the Commission's rules and regulations. RUCO's position is also contrary to prior Commission decisions including the Commission's decision in the Company's recent Northern Group rate case and Ms. Hubbard testifies in support of the Commission should again reject RUCO's efforts to change the Commission's well-established use of an adjusted test year.

2. <u>Various Rate Base Issues</u>.

a. <u>Plant In Service</u>.

Ms. Hubbard testifies that the Company and Staff's gross plant in service numbers are very close, essentially separated only by an error in Staff's direct filing that was recognized and corrected by Staff in its surrebuttal filing, albeit not 100%. Specifically, Ms. Hubbard testifies to Staff's removal of approximately $1.6 million of actual, test year plant associated with Arizona Water Company's Phoenix Office and Meter Shop. Staff agreed that an adjustment was necessary to correct Staff's elimination of the test year plant for the Phoenix Office and Meter Shop but did not accept the Company's adjustment to correct Staff's error. As a result, at the time of the filing of the Company's rejoinder testimony, Ms. Hubbard prepared Exhibit SLH-RJ9, which compares the Company's gross plant of $84,514,771 to Staff's proposed plant of $84,181,288, and testified that Staff's gross plant in service amount was understated by $333,483.

b. <u>Accumulated Depreciation</u>.

Ms. Hubbard also testifies about differences in the determination of accumulated depreciation between Arizona Water Company and Staff and RUCO. Specifically, Ms. Hubbard questions Staff's imputation of an additional full year of depreciation on the adjusted test year plant in service as well as Staff's failure to reflect the impact of using the half-year convention as it applies to plant retirements in calculating its proposed accumulated depreciation balance for the years since the test year adopted in the Company's last rate case. Although Staff corrected its failure to use the half-year convention in its surrebuttal testimony, Staff continues to recommend an additional year of depreciation on all adjusted test year plant. However, Staff offers no rationale or support for this adjustment, which, Ms. Hubbard testifies, has the effect of reducing the Company's investment upon which the revenue requirement is based thereby depriving the Company of the ability to earn a full rate of return on rate base. In contrast, as Ms. Hubbard explains in her testimony, the Company's calculation of net plant limits adjustments to accumulated depreciation expense computed on the year end balance, including the pro forma post test year plant additions that are treated as if they were in service at the end of the test year. The Company's calculations, according to Ms. Hubbard's testimony, conform to conventional treatment where the pro forma depreciation expense adjustments and the adjustment to accumulated depreciation are identical.

c. Working Capital Allowance.

Ms. Hubbard also addresses working capital allowance in her testimony including, most specifically, the dispute with Staff over the appropriate lag factor to be used in calculating the cash working capital component related to property taxes. As Ms. Hubbard explains, the lead/lag method of computing the cash working capital component of rate base requires a calculation of lead days (pre-payments) or lag days (accruals) that exist between the time an expense is recorded and the payment of such expense. The Company suggests that extended lag time for property taxes should be an average of 212 days, which represents the same number of lag days adopted by the Commission for property taxes in the Company's Northern Group rate case decided December 28, 2001. This number is also consistent with the number of lag days computed by RUCO for property tax purposes and, as Ms. Hubbard further notes, no changes in the Arizona Department of Revenue's billing or payment requirements, including the timing when payments are made, have been made since the Commission's calculation of the appropriate number of lag days for property taxes in the Northern Group proceeding.

Ms. Hubbard's testimony reflects that Staff's recommended 592 lag days, revised to 532.5 days in its surrebuttal, is based on Staff's mistaken measurement of the lag between the valuation date, as opposed to the date the expense is recorded, and the date when the Company's payment is due, even though the valuation date has nothing to do with the timing of the liability imposed on the Company to pay property taxes or the timing when such payment is due. Ms. Hubbard also points out that Staff offers little justification for its position that the Company's cash working capital is overstated because the Company did not remove depreciation expense and deferred taxes from its calculation of dollar days revenue lag. Accordingly, Ms. Hubbard testifies that Staff's reduction to the Company's rate base based on its working capital calculation should be rejected.

d. Deferred CAP Charges.

Ms. Hubbard also testifies about the appropriate treatment of deferred Central Arizona Project charges, including deferred CAP charges authorized in the Company's prior rate case involving the Eastern Group and the net balance of the Company's actual deferred CAP M&I charges incurred from the last decision through December 31, 2002. As Ms. Hubbard explains, although Staff and Arizona Water Company are using essentially the same deferred CAP balance, there is significant disagreement between them over the appropriate amortization period. The Company proposes a three-year amortization period for deferred CAP charges to match the period of time between a decision in this proceeding for the Eastern Group and the anticipated filing of the next rate case for these water systems. Ms. Hubbard testifies that the Company has a high degree of certainty regarding the timing of the next rate case due to the installation and anticipated operation of new treatment procedures needed to comply with the new arsenic MCL. Ms. Hubbard further testifies that the Staff's recommended amortization period for deferred CAP charges is not consistent with the Commission's decision for the Sun City and Sun City West water districts of Arizona-American Water Company as decided in

Commission Decision No. 62293 (Feb. 1, 2000) wherein the Commission approved a five-year amortization for those entities deferred CAP charges.

In substantial contrast to the Company's recommendation and these prior Commission decisions, Staff recommends a 44-year amortization period for recovery of deferred CAP charges based on Staff's assertion that the deferred CAP M&I charges are an asset with some estimated future benefit period. As Ms. Hubbard explains, however, the M&I charges are more accurately characterized as a lease payment for the use of the CAP canal system for the annual delivery of Colorado River Water for the Apache Junction system under the CAP contract. Therefore, Ms. Hubbard testifies that under the individual circumstances present in this proceeding a 44-year amortization period is unfair, particularly given the fact that these deferred charges have accrued over a period of approximately nine years. In fact, Ms. Hubbard testifies that in no event should the amortization period be longer than this accrual period, an amortization period consistent with RUCO's recommended amortization period. However, Ms. Hubbard testifies that RUCO's recommendation to allow no more than the level of CAP charges deferred as of December 31, 2002 potentially disallows recovery of CAP M&I charges deferred in 2003 and the period in 2004 prior to the time when new rates become effective on a permanent basis. Given that the Commission has already determined that the deferred CAP charges are a legitimate cost of providing water to Arizona Water's customers, Ms. Hubbard explains that RUCO's respective position to limit the recovery of deferred CAP charges to the 2002 balance is punitive and confiscatory.

3. Various Income Statement Issues.

a. PPAM & PWAM.

Ms. Hubbard provides testimony regarding the Company's recommendation to retain the purchased power adjustment mechanism ("PPAM") and purchased water adjustment mechanism ("PWAM") previously approved by the Commission. As Ms. Hubbard explains, there are a number of reasons to continue use of these adjustment mechanisms, chief among the reasons being that they provide a benefit to both customers and the Company by protecting both from increases or decreases in the costs of electric power or water. For example, with respect to electric power, the PPAM has allowed Arizona Water Company to pass on the recent reductions in APS's rates for electric power. As Ms. Hubbard explains, absent the PPAM customers would not have realized reductions in their rates commensurate with the reduced costs of power to the Company following several settlement agreements that had the effect of implementing annual rate reductions in APS's charges. Now, with an APS rate case pending and the possibility that rates will increase, Ms. Hubbard testifies that it is not only appropriate but fair to leave the adjustor mechanism in place to ensure that the Company is not harmed.

Nevertheless, Staff recommends elimination of the Company's PPAM. Ms. Hubbard testifies that it is difficult to imagine why the Commission would reject a mechanism, previously approved as appropriate to recover costs like purchased power that are outside of the Company's control and subject to significant change, particularly given the State's ongoing transition from a fully regulated environment to a market based deregulated environment. Further, Ms. Hubbard responds to the Staff's complaints that the level of work required of Staff supports eliminating the PPAM. As Ms. Hubbard explains in her testimony, the Company minimizes the number of filings by aggregating all systems affected by a utility's power changes in a single application thus performing the majority of the work necessary for Staff to review in connection with the PPAM.

There is a similar lack of any supporting rationale for elimination of the PWAM. As Ms. Hubbard explains, the PWAM for the San Manuel system is necessary to reduce the risk of the Company's exposure to increases in the cost of purchased water for this system, costs that are large and uncontrollable portions of the Company's operating expenses. Nevertheless, as with the PPAM, Staff recommends elimination of the PWAM. The rationale for maintaining the PWAM, like the PPAM, has not changed since the Commission rejected Staff's recommended changes to these adjustors in the Company's prior rate proceeding involving the Eastern Group systems. At that time, the Commission recognized that where purchased power and water costs are trending upward, gradual recognition of such increasing costs through incremental rate adjustments "sends a more appropriate price signal to users and receives greater customer acceptance than the less frequent, but far larger rate increases" that would be necessary absent such adjustors. Decision No. 58120. For these same reasons, Ms. Hubbard testifies that the Commission should authorize the continued use of the PPAM and the PWAM which equally protect the Company and its ratepayers.

b. Rate Case Expense.

Ms. Hubbard also addresses the Company's request for recovery of its rate case expense in this rate proceeding and voices the Company's objection to Staff's recommendation to limit rate case expense to an arbitrary level based on unsupported and unsupportable estimates. As Ms. Hubbard explains, Staff's recommended rate case expense abandons the "known and measurable concept" Staff utilizes in support of adjustments made to reduce the Company's revenue requirement. Yet, as Ms. Hubbard explains, Staff offers no persuasive rationale for its reduction of rate case expense. For example, Staff premises its recommended level of rate case expense in large part on the comparison of rate case expenses incurred in the Company's 1990 rate case. Setting aside that more than a decade has passed since that case, Staff's comparison fails to recognize that the Company did not utilize any outside counsel or outside cost of capital witnesses in that proceeding, a proceeding which demonstrated to the Company the need for representation by outside counsel and for use of expert witnesses on issues such as cost of capital. Ms. Hubbard further testifies that Staff has also ignored the fact that the Company's use of outside services in this Eastern Group rate proceeding is substantially similar to the Company's use of outside services in its 1999 rate request at which time the Commission adopted the Company's proposed level of rate case expense.

In addition, Ms. Hubbard's testimony questions Staff's assumption in reaching its arbitrarily estimated level of rate case expense that half of the attorneys' fees to be incurred by Arizona Water were incurred as of April 30, 2003, the date Staff selects as the half-way point of the rate case. As Ms. Hubbard explains, while that may be the half-way point on the calendar, it is far from the half-way point in connection with the proceedings that take place in a rate case before the Commission. For instance, as Ms. Hubbard testifies, as of April 30, 2003, Staff's half-way point, the Company had not yet seen any of the other parties' filings, including the hundreds of pages of direct and surrebuttal testimony and schedules filed by Staff and RUCO, had not yet conducted any discovery, had not yet begun preparing a rebuttal or rejoinder filing and no hearings or post-hearing briefing had yet occurred. Thus, Ms. Hubbard estimates that as of April 30, 2003, less than a third of the rate case activities had taken place and the bulk of the work by its outside legal defense team had not yet commenced, rendering Staff's assumption, and therefore one of its predicates to its estimated rate case expense, entirely without foundation. Finally, Ms. Hubbard also questions Staff's recommended five-year amortization of rate case expense testifying that a three-year amortization period is appropriate given fluctuating costs of capital, increased need for capital investments and potential significant infrastructure improvements, all of which make substantially likely that the Company will need to seek additional rate relief in approximately three years and certainly in less than the five years Staff estimates between rate cases for the Company's Eastern Group systems.

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ARIZONA WATER COMPANY

Docket No. W-01445A-02-0619

SUMMARY OF THOMAS M. ZEPP PRE-FILED TESTIMONY

Dr. Zepp is an economist and Vice President of Utility Resources, Inc., a consulting firm. He holds a PhD in Economics. Prior to becoming a consultant Dr. Zepp was a senior economist on the staff of the Oregon Public Utility Commission. Dr. Zepp's testimony deals with the appropriate rate of return on Arizona Water's common equity.

Dr. Zepp prepared direct, rebuttal and rejoinder testimony on two primary issues, the cost of equity for publicly-traded water utilities and the magnitude of the risk premium Arizona Water requires to compensate the Company for being more risky than the publicly-traded water utilities. Dr. Zepp also restated the testimonies of Mr. Reiker and Mr. Rigsby with more reasonable assumptions and responded to their criticisms of his analyses. In May, 2002, he estimated Arizona Water had an equity cost that fell in the range of 11.9% to 12.9% and recommended Arizona Water be authorized an ROE of no less than 12.4%. 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%. As part of his rebuttal, he restated the equity costs made by Mr. Rigsby and Mr. Reiker with assumptions that are consistent with the approaches they chose to use. Using their models with restated assumptions, he found the current cost of equity for Arizona Water fell in a range of 10.6% to 12.8%.

1. **Cost of Equity for Publicly-Traded Water 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 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. 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.

Using the DCF model and an average of two forward-looking measures of growth, Dr. Zepp updated his DCF costs of equity. He found the current equity cost for the benchmark water utilities fell in a range of 10.6% to 10.8%. Dr. Zepp restated Mr. Reiker's DCF estimates based on the constant growth model, noting 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. 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 fall in range of 9.6% to 9.9%. 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. Dr. Zepp presented an e-mail from Myron Gordon, the father of the DCF model, which supported the inclusion of this second stage. (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%.

Dr. Zepp also restated Mr. Rigsby's DCF results by basing Mr. Rigsby's estimate of VS growth on a more realistic forecast of the growth in the number of shares. 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. Dr. Zepp also restated Mr. Rigsby's DCF model results using estimates of future BR growth and VS growth presented by Mr. Reiker. With these two separate restatements of Mr. Rigsby's DCF model, Mr. Rigsby's DCF estimate for the benchmark water utilities fell 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 falls in a range of 9.6% to 11.1%, a range that overlaps Dr. Zepp's estimated range of 10.6% to 10.8%.

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%. 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.

Mr. Rigsby and Mr. Reiker presented versions of the CAPM that are variations of the original CAPM developed by Sharpe and Lintner. William Sharpe, the same person as the Sharpe who developed the original CAPM model, has indicated tests of his model support a model that Dr. Zepp called the "zero-beta" CAPM. 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 model predict. Sharpe also stated that professionals who use the CAPM in their work use the zero-beta version of the model. 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 fell in a range of 9.8% to 11.3%. 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 new tariffs will be authorized.

Dr. Zepp provides 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 10.3% to 11.2%. Mr. Reiker has not updated 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 that 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.

2. Arizona Water has an Equity Cost that is Above the Cost of Equity for the Benchmark Water Utilities.

Dr. Zepp provided substantial support for his conclusion that Arizona Water has an equity cost that is 100 to 150 basis points higher than the cost of equity for the benchmark water utilities. The Company requires that risk premium to compensate it for being small, the rate-setting system in Arizona that makes it difficult to match expected revenues with expected costs, and risks of recovery of arsenic-related capital and operating costs.

Mr. Rigsby and Mr. Reiker assumed no risk premium was required for Arizona Water being small. The linchpin holding together their rejection of the risk premium for size was an article Wong published ten years ago. Dr. Zepp presented an article that he published, "Utility Stocks and the Size Effect – Revisited," *The Quarterly Review of Economics and Finance*, 43 (2003) pp. 578-582, which responds to Wong. 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 Wong was not aware of — supports the small firm effect. In his rejoinder testimony, Dr. Zepp also provided further observations based on the tables Wong presented that actually support a small firm effect for utilities. For the two periods reported by Wong, in one, betas increased as size decreased. In the other period, though there was no clear relationship between betas and size, there was a significant size effect. Dr. Zepp explains that this keystone supporting the Staff and RUCO rejections of the need for a risk premium for Arizona Water can no longer be relied upon.

In response to Dr. Zepp, Mr. Reiker offered a number of complicated, but 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. 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. And, 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).

Dr. Zepp also points out 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. Dr. Zepp dismisses Staff's concern with the level of significance. He explained there are conceptual reasons not to expect high levels of confidence with most beta estimates. If that were not the case, there would be no need to diversify. Staff cannot refute the substance of Dr. Zepp's analysis and thus has attempted to muddle-up the record with technical arguments that are hard to understand. The bottom line is that nothing Mr. Reiker said invalidates the two critical points in Dr. Zepp's paper, that expected betas for small water utilities are larger than the betas estimated with weekly data and equity costs for small utilities are expected to exceed equity costs for larger utilities.

Mr. Reiker also challenges the use of corporate bond rates to estimate risk premiums and to estimate a floor under the risk premium required by Arizona Water. In response to this Staff testimony, Dr. Zepp presented an analysis that shows, notwithstanding default risk of Baa bonds, Baa bond rates are tied more closely to equity costs than are Treasury bond rates in recent periods. Dr. Zepp explains this is not unexpected because there has been a "flight to quality" in recent years that makes it difficult to use historical data to determine average risk premiums. 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 his analysis. These empirical results add support to Dr. Zepp's original observation that the cost of Arizona Water's series K issue provides compelling evidence that the equity risk premium for Arizona Water is no less than 37 to 49 basis points.

Mr. Reiker would just dismiss Arizona Water's additional risk by claiming it is not "systematic beta risk". He has no basis for such a cavalier dismissal of Arizona Water's added risk. Dr. Zepp presented evidence that indicates that part of the added risk is expected to be higher beta risk. He discussed studies by Fama and French and Ibbotson Associates that indicate there are other "systematic risks" priced by investors. Even William Sharpe, one of the authors of the original CAPM has indicated that the simple CAPM model that relies on just one systematic risk is too simple to explain investor behavior. 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 risk with recovery of arsenic-related costs supports an equity risk premium for Arizona Water in the range of 100 to 150 basis points.

In sum, 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 U. S. Supreme Court requires that such added risk be compensated. The available evidence indicates Arizona Water has a cost of equity that is 100 to 150 basis points higher than is required for the larger, publicly-traded utilities.

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ARIZONA WATER COMPANY

Docket No. W-01445A-02-0619

SUMMARY OF WALTER M. MEEK PRE-FILED TESTIMONY

Mr. Meek is the President of the Arizona Utility Investors Association ("AUIA"), a non-profit organization formed to represent the interests of equity owners and bond holders who are invested in utility companies based or doing business in the State of Arizona. Mr. Meek has been involved in the utility business in Arizona for 28 years, and he has participated in dozens of Commission dockets on behalf of AUIA. He has personally testified before the Commission on a variety of topics, including rate of return issues, stranded costs, disposition of regulatory assets, AFUDC, inclusion of CWIP in rate base and the impact of regulatory decisions on analyst and investor expectations.

Mr. Meek is testifying in this proceeding on behalf of Arizona Water Company ("Arizona Water" or "the Company") on the appropriate rate of return on Arizona Water's common equity. Mr. Meek is testifying because the AUIA is very concerned about what Mr. Meek describes as a dangerous trend that will ultimately weaken the viability of Arizona's utility industry. That trend is the progressively lower equity returns being recommended by the Utilities Division ("Staff") of the Arizona Corporation Commission ("the Commission"). Mr. Meek explains that these equity returns are justified on the basis of highly technical, "textbook" arguments that ignore the realities of investment.

Mr. Meek points out that Staff's technical approach ignores firm-specific risks and other factors that are typically considered by investors in deciding whether to invest in a utility's stock. Mr. Meek states that a careful investor evaluating whether to invest any utility would likely examine factors such as liquidity, cash flows, capital structure, customer growth, capital requirements, return on equity, PE ratio, projected earnings and dividend growth, and regulatory risk in addition to specific business conditions. Mr. Meek points out that Staff's costs of equity witness, Mr. Reiker, has ignored these firm-specific factors in arriving at his recommended cost of equity.

Mr. Meek testifies that Staff has placed undue emphasis on "beta" and the Capital Asset Pricing Model or "CAPM" in estimating current returns on equity. Mr. Meek points out that Mr. Reiker's CAPM using historical data results in a return on equity that is only 7.7 percent. Mr. Reiker's projected return is substantially less than what water and gas companies are currently earning, and is well below <u>Value Line</u>'s projected returns for 2004 and the 2006-2008 time period. Common sense indicates the results produced by this method are too low; nevertheless, Mr. Reiker relies on the 7.7 percent return produced by this model (and the 8.5 percent return produced by Mr. Reiker's DCF constant growth model) in order to lower the recommended return on equity for Arizona Water.

Mr. Meek also explains that Mr. Reiker's assertions about how investors view "unique risk" in determining whether to invest in a particular firm's stock are naïve and ignore real life risks. Mr. Meek testifies that each stock will have its own particular set of risks associated with it, and that prudent investors will consider those risks in deciding whether to buy or hold a particular security. He notes, as an example, the information on specific firms published in <u>Value Line</u>. There would be no reason for <u>Value Line</u> and other investment services to gather and publish this information, nor would there be any market for this information, if investors didn't consider it in making decisions.

Mr. Meek also briefly addresses two United States Supreme Court decisions, *Bluefield Waterworks* and *Hope Natural Gas*, which provide that a utility's rates must be set at a level that will allow the utility an opportunity to earn a return that is equal to returns that are being earned on investments in other businesses that have corresponding risks. Mr. Meek states that in order to apply this standard, which is known as the "comparable earnings standard," it is necessary to evaluate firm-specific or unique risks associated with an investment in that particular firm. Mr. Meek believes that Staff violates this standard by ignoring firm-specific risks and relying instead on <u>Value Line</u> betas and the utility's capital structures as the sole determinants of investment risk.

Mr. Meek points out that the 9.0 percent return on equity recommended by Staff is not consistent with the returns on equity currently being reported by Staff's sample of six publicly traded utilities, that are currently earning, on average, 10.6 percent. Mr. Meek also notes that the return on equity for the group of eight natural gas utilities used by Arizona Water's expert are currently reporting an average return on common equity of 11.66 percent. Mr. Meek explains that Staff has chosen to ignore the returns currently being earned by water and gas utilities, which are significantly greater than the return on equity being recommended in this case for Arizona Water.

Mr. Meek also addresses several types of risk that investors typically consider, including the risks associated with regulation (e.g., regulatory lag, use of an historic test year and opposition to adjuster mechanisms) and the risks resulting from new requirements imposed under federal environmental laws. Mr. Meek points out, for example, that Arizona Water is facing substantial capital expenditures, as well as significant increases in operating expenses, to comply with the new maximum contaminant level ("MCL") for arsenic, recently established by the U.S. Environmental Protection Agency. Mr. Meek notes that Staff's witness, Mr. Reiker, apparently made no effort to investigate and consider the impacts of the new MCL for arsenic on Arizona Water or any of the publicly traded utilities used in his sample. Instead, Mr. Reiker simply assumes that all water utilities will be impacted by regulatory requirements in the same way.

Mr. Meek also discusses Arizona Water's pending proceeding in its Northern Group rate case docket, in which the Company is seeking approval of a mechanism that will allow timely recovery of its costs associated with arsenic removal outside a general rate case, noting that RUCO is opposing recovery of operating expenses and Staff, while initially opposing recovery of operating expenses, has agreed to allow some (but not all) operating expenses to be recovered. Mr. Meek states that the difficulties currently faced under Arizona's regulatory process creates additional investment risk that a prudent investor would consider and, therefore, should be considered by the Commission in developing an appropriate rate of return on Arizona Water's common equity.

ARIZONA WATER COMPANY

Docket No. W-01445A-02-0619

SUMMARY OF RALPH J. KENNEDY PRE-FILED TESTIMONY

Mr. Kennedy is employed by Arizona Water Company ("Arizona Water" or "the Company") as Vice President and Treasurer. He has been employed in such capacity since 1987. Mr. Kennedy holds a M.B.A. from the University of Chicago. He is a Certified Public Accountant and a member of both the Arizona Society of Certified Public Accountants and the American Institute of Certified Public Accountants. Mr. Kennedy was the Chief of the Accounting and Rates Section of the Arizona Corporation Commission ("the Commission") from 1985 to 1986 and was the Manager of Accounts and Finance for the Illinois Commerce Commission from 1974 to 1978. He has testified in numerous proceedings involving utility rates and other regulatory matters. Mr. Kennedy prepared direct, rebuttal and rejoinder testimony in support of the Company's application.

A. Overview of the Company's Application.

In his direct testimony, Mr. Kennedy provides an overview of the Company's rate application, which includes only its Eastern Group water systems, based on operating results and investment in those systems for the adjusted test year of 2001. As of December 31, 2001, the Eastern Group included eight systems serving 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	

Mr. Kennedy explains that the Apache Junction system, which is located on the eastern edge of the Phoenix metropolitan area, has experienced significant customer growth. The other seven systems, however, average only 1,643 customers per system and have low to negative growth.

In his overview, Mr. Kennedy also explains that Arizona Water's current rates and charges for service became effective in January 1993, and were based on operating results and investment for test year 1990. Decision No. 58120 (Dec. 23, 1992). Thus, it has been over 10 years since Arizona Water's last rate increase for its Eastern Group systems.

Mr. Kennedy notes that the cost of living has increased by 35% from 1990 through May 2002. He also explains that in seven of the eight Eastern Group systems, operating expenses have grown more quickly than revenues. In fact, in Bisbee and Winkelman, the Company's 2001 revenue was actually <u>less</u> than the Company's 1990 revenue. At the same time, since 1990, the Company's net investment in utility plant has increased by 70 percent, from approximately $20 million to $34 million. Mr. Kennedy testifies that 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.

Based on the Company's level of investment in utility plant, increases in operating expenses and other changes that have occurred during the past 11 years, the Company is requesting an overall increase of 29.5% for its Eastern Group systems.[1]

B. Specific Issues Addressed by Mr. Kennedy.

In addition to providing an overview of Arizona Water's application, Mr. Kennedy addresses various issues that have been raised by the Utilities Division ("Staff") and the Residential Utility Consumer Office ("RUCO") in their respective pre-filed testimony and exhibits. The specific issues addressed by Mr. Kennedy include the proper ratemaking treatment for funds received by Arizona Water under the Pinal Creek Group ("PCG") Settlement, Staff's proposed rate design, consolidation of the Superior and Apache Junction systems, the Company's weighted cost of capital and firm-specific risks relevant to determining an appropriate return on equity, revisions to the Company's depreciation methodology, the Company's NP-260 Non-Potable Water Tariff, and approval of a mechanism that will allow recovery of capital costs and expenses associated with required arsenic treatment facilities. The following is a summary of the more significant issues.

1. PCG Settlement Issues.

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[1] The Company's final requested relief, as adjusted from its direct filing, is an overall increase in revenues of approximately $3.6 million (24.8%)

2. Staff's Experimental Rate Design.

Mr. Kennedy also addresses the experimental rate design proposed by Staff in this case, and explains why it should not be adopted. Staff's rate design is not intended to encourage water conservation but, instead, is based on marginal cost principles. Based on his review of Staff's testimony, the one-half page marginal cost study supporting Staff's rate design, and the impact of this rate design on the Company's customers, Mr. Kennedy concludes that Staff's rate design recommendations are inadequately developed and lack both depth and breadth of quantitative support. Mr. Kennedy notes that Staff's recommendation is inconsistent with its own Tiered Rate Design Policy posted on the Commission's website. He also explains that Staff's rate design will cause significant subsidies between meter sizes by shifting the recovery of revenues to customers on larger meters without any cost of service study or similar analysis.

In contrast, as Mr. Kennedy explains, the Company's existing and proposed rate designs are based on a cost of service study that was presented to and approved by the Commission in the prior rate case involving the eight systems comprising the Eastern Group. Mr. Kennedy also points out that the Company's proposed rate design is the same as the rate design approved in the recent rate case for the Company's Northern Group systems. Decision No. 64282 (Dec. 28, 2001) at pp. 21 - 23. Based on the lack of data supporting Staff's recommendation, Staff's admission that its proposed rate design will have no impact on water usage by customers, and the discriminatory effect of this rate design, Mr. Kennedy recommends that Staff's proposal be rejected.

3. Apache Junction and Superior System Consolidation.

Mr. Kennedy also explains the Company's request to consolidate the Apache Junction and Superior systems for regulatory and ratemaking purposes. Under this proposal, a single set of monthly minimum charges, based on meter size, would be approved for the Apache Junction and Superior systems. However, each system would continue to have its own commodity rate. In the next Eastern Group rate proceeding, the Company would propose a common commodity rate for all Apache Junction and Superior customers, the second step of the proposed rate consolidation. This two-step process will allow rates to be gradually adjusted, and is similar to the consolidation process under consideration in the second phase of the Company's Northern Group rate case.

In his testimony, Mr. Kennedy explains that consolidation of the Apache Junction and the Superior systems is appropriate for several different reasons. The Superior system's existing rates are among the highest in the Company because the town's water must be pumped uphill from a well field located near Florence Junction, more than 20 miles away. Superior is an economically depressed area, while the nearby Apache Junction area is rapidly growing with a stronger local economy. Both systems have water sources that will require arsenic treatment, and without rate consolidation, the already high cost of water in Superior will become disproportionately higher due to Superior's small customer base and lack of growth. Mr. Kennedy also notes that the Company has a continuous set of CCN's extending from Apache Junction to Superior, and, moreover, that these systems will be interconnected in the near future, as another Company witness, Michael J. Whitehead, explains in his testimony.

Mr. Kennedy discusses the fact that neither Staff nor RUCO offers any compelling reasons for their opposition to consolidation under these particular circumstances. The Staff's engineering witness, for example, contends that the Company should be required to perform a detailed cost of service study in order to address inequalities in the rate design. Mr. Kennedy points out that Staff is recommending radical modifications to the rate designs of all of the Company's Eastern Group systems without a cost of service study or any other system-by-system analysis. Mr. Kennedy also testifies that if consolidation is not approved in this proceeding, the Superior system's rates will increase dramatically, creating even greater disparities and making the future post-interconnection consolidation more difficult to achieve.

4. Cost of Capital Issues.

Mr. Kennedy addresses several issues related to Arizona Water's capital structure and weighted cost of capital. In his direct testimony, Mr. Kennedy discusses the Company's capital structure and the cost of each of its components, relying on the current cost of equity recommended by Dr. Thomas M. Zepp, a professional economist. In his rebuttal testimony, Mr. Kennedy identifies and explains certain firm-specific risks and circumstances that support Dr. Zepp's opinion that Arizona Water faces additional risks and requires a higher authorized return on equity than the equity returns being earned by larger, publicly-traded utilities.

Mr. Kennedy discusses the difficulties the Company experienced in placing its most recent bond issue due to the Company's small size, the relatively small size of its proposed debt issue and concerns about the future liquidity of the bonds. Mr. Kennedy also discusses the substantial capital investment that will be required to comply with the new MCL for arsenic adopted by the EPA. Mr. Kennedy notes that even if an arsenic cost recovery mechanism ("ACRM") is approved by the Commission, the ACRM will not provide for recovery of all arsenic-related capital costs and operating expenses. Moreover, the ACRM will not apply to the Company's Western Group systems, which are estimated to require nearly one-half of the Company's total investment in arsenic treatment facilities.

In his rejoinder testimony, Mr. Kennedy also takes issue with the recommendations of Staff and RUCO with regard to the cost of the Company's short-term debt. Mr. Kennedy explains that the cost of short-term debt has been volatile over the past several years, and under its bank loan agreement, the Company's short-term borrowing rate floats with short-term market rates. Based on these circumstances, Mr. Kennedy recommends that the cost of short-term debt be based on a 24-month average as opposed to an interest rate at a particular point in time. He 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.

Combining that debt cost with the Company's imbedded cost of long-term debt (8.46%) and the return on common equity recommended by Dr. Zepp (12.40%), Mr. Kennedy recommends a weighted or composite cost of capital of 10.90%.

5. Arsenic Cost Recovery Mechanism.

Mr. Kennedy addresses the Company's request for approval of an ACRM for the Eastern Group systems. Three Eastern Group systems will specifically be impacted: Apache Junction, Superior and San Manuel. As indicated above, Superior and San Manuel are two of the Company's smaller systems. Mr. Kennedy testifies that as many as 21 water treatment plants with a combined treatment capacity of 23,000,000 gallons per day will be required to comply with the new arsenic MCL. He notes that these costs are in addition to the Company's normal, ongoing construction program.

Mr. Kennedy discusses the procedural background and current status of the Company's proceeding in Docket No. W-01445A-00-0962 for its Northern Group systems, in which the Commission is considering an ACRM that would allow recovery of capital costs and certain operating expenses that will be incurred by the Company's Sedona and Rimrock systems. Mr. Kennedy explains that a similar form of ACRM should be approved for the Eastern Group. He also explains that the high costs associated with constructing and operating arsenic treatment facilities further support consolidating the Apache Junction and Superior systems. Mr. Kennedy testifies that the expected incremental increase in the revenue requirement associated with arsenic capital costs and treatment is estimated to be between 47% and 85% for Superior customers. Consolidation of the Apache Junction and Superior systems will ameliorate the impacts on the Superior customers by providing a larger customer base over which costs may be spread.

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Schedule A-1 Comparisons

ARIZONA WATER COMPANY
COMPUTATION OF INCREASE IN
GROSS REVENUE REQUIREMENTS
TEST YEAR 2001 EASTERN GROUP

Line No.	Description	Company		Staff		RUCO	
		Direct Testimony	Rejoinder Testimony	Direct Testimony	Surrebuttal Testimony	Direct Testimony	Surrebuttal Testimony
1.	Adjusted Rate Base	41,604,880	39,002,879	32,403,018	33,798,552	35,236,992	35,237,938
2.	Adjusted Operating Income	1,969,032	2,019,507	2,398,375	2,284,305 (a)	2,624,724	2,593,425
3.	Current Rate of Return	4.73%	5.18%	7.40%	6.76%	7.45%	7.36%
4.	Required Operating Income	4,576,537	4,251,314	2,775,643	2,895,184	3,059,572	3,059,654
5.	Required Rate of Return	11.00%	10.90%	8.566%	8.566%	8.68%	8.68%
6.	Operating Income Deficiency	2,607,505	2,231,807	377,268	610,879	434,848	466,229
7.	Gross Revenue Conversion Factor	1.63241	1.63195	1.63195	1.63195	Various	Various
8.	Increase in Gross Revenue	4,256,517	3,642,197	615,683	996,924	598,229	648,443

(a) - Includes ($140,787) adjustment to reflect Staff's recommended Purchased Water expense for Apache Junction of $965,689.

Schedule A-1 Comparisons

ARIZONA WATER COMPANY
COMPUTATION OF INCREASE IN
GROSS REVENUE REQUIREMENTS
TEST YEAR 2001 APACHE JUNCTION

Line No.	Description	Company Direct Testimony	Company Rejoinder Testimony	Staff Direct Testimony	Staff Surrebuttal Testimony	RUCO Direct Testimony	RUCO Surrebuttal Testimony
1.	Adjusted Rate Base	* 24,207,016	21,722,321	18,346,065	19,071,140	19,792,392	19,793,353
2.	Adjusted Operating Income	1,862,934	1,885,563	2,123,886	2,004,596 (a)	2,106,210	2,099,279
3.	Current Rate of Return	7.70%	8.68%	11.58%	10.51%	10.64%	10.61%
4.	Required Operating Income	2,662,772	2,367,733	1,571,524	1,633,634	1,718,542	1,718,625
5.	Required Rate of Return	11.00%	10.90%	8.566%	8.566%	8.68%	8.68%
6.	Operating Income Deficiency	799,838	482,169	(552,362)	(370,962)	(387,668)	(380,654)
7.	Gross Revenue Conversion Factor	1.63241	1.63195	1.63195	1.63195	1.63245	1.63245
8.	Increase in Gross Revenue	1,305,663	786,877	(901,427)	(605,392)	(632,849)	(621,398)

(a) - Includes ($140,787) adjustment to reflect Staff's recommended Purchased Water expense of $965,689.

Schedule A-1 Comparisons

ARIZONA WATER COMPANY
COMPUTATION OF INCREASE IN
GROSS REVENUE REQUIREMENTS
TEST YEAR 2001 BISBEE

Line No.	Description	Company		Staff		RUCO	
		Direct Testimony	Rejoinder Testimony	Direct Testimony	Surrebuttal Testimony	Direct Testimony	Surrebuttal Testimony
1.	Adjusted Rate Base	* 3,700,113	3,878,994	3,425,681	3,590,535	3,603,100	3,603,097
2.	Adjusted Operating Income	31,708	29,073	74,498	75,855	120,327	113,054
3.	Current Rate of Return	0.86%	0.75%	2.17%	2.11%	3.34%	3.14%
4.	Required Operating Income	407,012	422,810	293,444	307,565	312,851	312,851
5.	Required Rate of Return	11.00%	10.90%	8.566%	8.566%	8.68%	8.68%
6.	Operating Income Deficiency	375,304	393,738	218,946	231,710	192,524	199,797
7.	Gross Revenue Conversion Factor	1.63241	1.63195	1.63195	1.63195	1.63136	1.63136
8.	Increase in Gross Revenue	612,651	642,560	357,309	378,140	314,077	325,941

Schedule A-1 Comparisons

**ARIZONA WATER COMPANY
COMPUTATION OF INCREASE IN
GROSS REVENUE REQUIREMENTS
TEST YEAR 2001 SIERRA VISTA**

Line No.	Description	Company		Staff		RUCO	
		Direct Testimony	Rejoinder Testimony	Direct Testimony	Surrebuttal Testimony	Direct Testimony	Surrebuttal Testimony
1.	Adjusted Rate Base	* 2,574,687	2,512,878	2,200,445	2,317,564	2,256,648	2,256,646
2.	Adjusted Operating Income	31,076	31,373	60,967	61,972	145,377	140,678
3.	Current Rate of Return	1.21%	1.25%	2.77%	2.67%	6.44%	6.23%
4.	Required Operating Income	283,216	273,904	188,490	198,523	195,941	195,941
5.	Required Rate of Return	11.00%	10.90%	8.566%	8.566%	8.68%	8.68%
6.	Operating Income Deficiency	252,140	242,531	127,523	136,551	50,564	55,263
7.	Gross Revenue Conversion Factor	1.63241	1.63195	1.63195	1.63195	1.55062	1.55062
8.	Increase in Gross Revenue	411,595	395,798	208,111	222,844	78,406	85,692

Schedule A-1 Comparisons

ARIZONA WATER COMPANY
COMPUTATION OF INCREASE IN
GROSS REVENUE REQUIREMENTS
TEST YEAR 2001 MIAMI

Line No.	Description		Company		Staff		RUCO	
			Direct Testimony	Rejoinder Testimony	Direct Testimony	Surrebuttal Testimony	Direct Testimony	Surrebuttal Testimony
1.	Adjusted Rate Base	*	4,570,196	4,507,618	2,740,612	2,918,090	3,600,871	3,600,868
2.	Adjusted Operating Income		59,991	92,973	121,633	122,821	167,256	161,155
3.	Current Rate of Return		1.31%	2.06%	4.44%	4.21%	4.64%	4.48%
4.	Required Operating Income		502,722	491,330	234,761	249,964	312,658	312,658
5.	Required Rate of Return		11.00%	10.90%	8.566%	8.566%	8.68%	8.68%
6.	Operating Income Deficiency		442,731	398,358	113,128	127,143	145,402	151,503
7.	Gross Revenue Conversion Factor		1.63241	1.63195	1.63195	1.63195	1.63121	1.63121
8.	Increase in Gross Revenue		722,718	650,100	184,619	207,490	237,181	247,133

Schedule A-1 Comparisons

**ARIZONA WATER COMPANY
COMPUTATION OF INCREASE IN
GROSS REVENUE REQUIREMENTS
TEST YEAR 2001 SAN MANUEL**

Line No.	Description	Company Direct Testimony	Company Rejoinder Testimony	Staff Direct Testimony	Staff Surrebuttal Testimony	RUCO Direct Testimony	RUCO Surrebuttal Testimony
1.	Adjusted Rate Base	* 793,993	759,504	641,450	699,272	746,978	746,995
2.	Adjusted Operating Income	(186,410)	(181,279)	(157,941)	(157,490)	(196,500)	(196,716)
3.	Current Rate of Return	-23.48%	-23.87%	-24.62%	-22.52%	-26.31%	-26.33%
4.	Required Operating Income	87,339	82,786	54,947	59,900	64,859	64,860
5.	Required Rate of Return	11.00%	10.90%	8.566%	8.566%	8.68%	8.68%
6.	Operating Income Deficiency	273,749	264,065	212,888	217,390	261,359	261,576
7.	Gross Revenue Conversion Factor	1.63241	1.63195	1.63195	1.63195	1.28036	1.28036
8.	Increase in Gross Revenue	446,871	430,940	347,422	354,769	334,633	334,912

Schedule A-1 Comparisons

ARIZONA WATER COMPANY
COMPUTATION OF INCREASE IN
GROSS REVENUE REQUIREMENTS
TEST YEAR 2001 ORACLE

Line No.	Description		Company		Staff		RUCO	
			Direct Testimony	Rejoinder Testimony	Direct Testimony	Surrebuttal Testimony	Direct Testimony	Surrebuttal Testimony
1.	Adjusted Rate Base	*	2,819,400	2,706,211	2,415,268	2,495,716	2,513,635	2,513,634
2.	Adjusted Operating Income		167,200	158,185	159,659	160,336	233,730	230,836
3.	Current Rate of Return		5.93%	5.85%	6.61%	6.42%	9.30%	9.18%
4.	Required Operating Income		310,134	294,977	206,892	213,783	218,255	218,255
5.	Required Rate of Return		11.00%	10.90%	8.566%	8.566%	8.68%	8.68%
6.	Operating Income Deficiency		142,934	136,792	47,233	53,447	(15,475)	(12,581)
7.	Gross Revenue Conversion Factor		1.63241	1.63195	1.63195	1.63195	1.57244	1.57244
8.	Increase in Gross Revenue		233,327	223,238	77,082	87,223	(24,334)	(19,783)

Schedule A-1 Comparisons

**ARIZONA WATER COMPANY
COMPUTATION OF INCREASE IN
GROSS REVENUE REQUIREMENTS
TEST YEAR 2001 WINKELMAN**

Line No.	Description	Company		Staff		RUCO	
		Direct Testimony	Rejoinder Testimony	Direct Testimony	Surrebuttal Testimony	Direct Testimony	Surrebuttal Testimony
1.	Adjusted Rate Base	* 265,899	269,330	232,924	242,504	252,071	252,049
2.	Adjusted Operating Income	9,437	8,419	9,576	9,629	7,933	7,381
3.	Current Rate of Return	3.55%	3.13%	4.11%	3.97%	3.15%	2.93%
4.	Required Operating Income	29,249	29,357	19,952	20,773	21,887	21,885
5.	Required Rate of Return	11.00%	10.90%	8.566%	8.566%	8.68%	8.68%
6.	Operating Income Deficiency	19,812	20,938	10,376	11,144	13,954	14,504
7.	Gross Revenue Conversion Factor	1.63241	1.63195	1.63195	1.63195	1.26755	1.26755
8.	Increase in Gross Revenue	32,341	34,169	16,934	18,186	17,687	18,385

Schedule A-1 Comparisons

ARIZONA WATER COMPANY
COMPUTATION OF INCREASE IN
GROSS REVENUE REQUIREMENTS
TEST YEAR 2001 SUPERIOR

Line No.	Description	Company		Staff		RUCO	
		Direct Testimony	Rejoinder Testimony	Direct Testimony	Surrebuttal Testimony	Direct Testimony	Surrebuttal Testimony
1.	Adjusted Rate Base	* 2,673,576	2,646,023	2,400,573	2,463,731	2,471,297	2,471,296
2.	Adjusted Operating Income	(6,904)	(4,800)	6,097	6,586	40,391 (a)	37,758 (a)
3.	Current Rate of Return	-0.26%	-0.18%	0.25%	0.27%	1.63%	1.53%
4.	Required Operating Income	294,093	288,417	205,633	211,043	214,579	214,579
5.	Required Rate of Return	11.00%	10.90%	8.566%	8.566%	8.68%	8.68%
6.	Operating Income Deficiency	300,997	293,217	199,536	204,457	174,188	176,821
7.	Gross Revenue Conversion Factor	1.63241	1.63195	1.63195	1.63195	1.56973	1.56973
8.	Increase in Gross Revenue	491,351	478,515	325,633	333,664	273,428	277,561

(a) - RUCO's formula did not include the additional $35 adjustment to Other Revenues that they proposed so income has been increased by $35.