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BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONERS

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KRISTIN K. MAYES  
GARY PIERCE

IN THE MATTER OF APPLICATION OF ARIZONA-AMERICAN WATER COMPANY FOR APPROVALS ASSOCIATED WITH A TRANSACTION WITH THE MARICOPA COUNTY MUNICIPAL WATER CONSERVATION DISTRICT NUMBER ONE.

DOCKET NO. W-01303A-05-0718

STAFF'S POST-HEARING BRIEF

On March 26, 2007, hearings in this matter were concluded. Administrative Law Judge Teena Wolfe ordered the parties to prepare closing briefs. Staff hereby submits its brief as directed. Staff recommends approval of the instant application.

**I. Background**

Initially, Arizona-American Water Company ("AAW") filed an application in this matter requesting that the Arizona Corporation Commission ("ACC" or "Commission") approve an agreement between AAW and Maricopa Municipal Water Conservation District Number One ("MWD") in which the parties were to jointly finance, build, and operate a surface water treatment plant.

At some point after the filing of the application, negotiations between the parties broke down. The parties came to believe that pursuing the project as a joint venture was not feasible in that it would not be "net beneficial", as Thomas Broderick testified. *Tr.*, P281, L6. At that point, the parties proceeded individually.

However, as Mr. Broderick described AAW's financial status "we are now a company with rate base of \$148 million with plant eligible for rate base of \$343 million. So we are just carrying that. That's why we are unprofitable." *Tr.*, P283, L1-4. Faced with difficulties in its capital structure and debt-equity ratio, AAW did not believe it could borrow money from an institutional lender at an acceptable interest rate. Instead AAW turned to its parent company,

1 American Water ("AW"), which had previously authorized AAW to borrow money from AW's  
2 subsidiary American Water Capital Corporation ("AWCC"). However, due to concerns that  
3 AAW was "leaning on [AW] so dramatically" *Tr.*, P264, L23, AW did not approve any further  
4 lending between its subsidiaries, preferring instead that AAW "undertake this project without  
5 profit" *Tr.*, P264, L23, and "work hard to get what you have already spent in the rate base"  
6 before AW would agree to allow more spending. *Tr.*, P283, L6-7.

7 AAW had few remaining options. Therefore, the company chose to finance construction  
8 through an increase in "hook-up fees to be treated as contributions" *Tr.*, P266, L4 for new  
9 connections within its Agua Fria district. The company then amended its application to request  
10 ACC approval of the hook-up fee increase.

11 Thereafter, MWD requested and was granted intervention in the matter. Naturally, the  
12 break-down in negotiations has done nothing to lessen MWD's need to treat its surface water.  
13 MWD has taken the position, however, that simply contracting for treatment services from a  
14 separate entity's treatment facility does not provide MWD with adequate security that the benefit  
15 of its surface water will go to its land owners. MWD believes that its only viable option is MWD  
16 ownership of the treatment plant itself, as opposed to contractual treatment rights. Therefore,  
17 MWD intends to build a plant of its own.

18 MWD has stated, and AAW essentially agrees, that, from an economic perspective, the  
19 surface water treatment is most efficiently conducted using a single facility having sufficient  
20 capacity to treat the water needs of both entities. Construction of two separate facilities would be a  
21 waste of the greater public's money. There are three options which can serve this end. The  
22 parties can either build a plant jointly, or one party can build its plant and make arrangements for  
23 the other party to receive treatment services from that plant. Any other course of action would  
24 result in the building of two separate plants. During cross examination, James Sweeney for MWD  
25 was asked the question "[R]egardless of what the commission does, the district intends to go  
26 forward and build its plant, is that correct?", to which he replied, "That has been my direction,  
27 yes." *Tr.*, P481, L17-20.

28 . . .

1 MWD' s belief that it needs ownership of any such facility narrows down the possibilities to  
2 two: either the parties jointly finance and operate a facility owned by MWD, or MWD must build  
3 a plant and lease treatment capacity to AAW. A plant owned by AAW which leases treatment  
4 capacity to MWD is unacceptable to MWD. Therefore, MWD has taken the position that AAW  
5 must not be allowed to build its facility.

6 MWD has requested that the ACC deny AAW' s application because MWD does not want  
7 to lease capacity from an AAW-owned facility. If the Commission grants AAW' s application and  
8 AAW builds its own facility, the greater public' s money will be "wasted" because MWD will  
9 then be "forced" to build a facility of its own.

10 Staff has recommended approval of AAW' s application.

## 11 **II. Issues**

12 In Staff' s view, there is only a single issue involved in this matter: should the Commission  
13 grant AAW' s application to fund construction of a surface water treatment facility through an  
14 increase in hook-up fees in its Agua Fria district?

15 MWD has presented a great deal of evidence regarding which entity can build a facility  
16 more economically, but this is an entirely separate issue which *only* becomes relevant if the  
17 Commission assumes that a single treatment facility provides such enhanced economic benefit to  
18 the public at large that the Commission could not, in good conscience, allow Arizona rate-payer  
19 money to be "wasted" on the construction of two facilities. Upon reaching such a conclusion,  
20 however, the Commission would then have to resolve the issue as to which entity is "at fault" for  
21 the waste. And finally, the Commission would then have to determine which entity, if any, should  
22 be prevented from undertaking that waste.

23 Thankfully, none of MWD' s suggested analysis is necessary or appropriate. AAW is an  
24 entity regulated by the Commission. The Commission has ordered AAW to provide water service  
25 to its customers within its CC&N territory. AAW has identified an item of infrastructure necessary  
26 to accomplish its directive. The company has exhausted the options available in procuring that  
27 infrastructure and has requested permission to proceed using hook-up fees. The single issue the  
28

1 Commission needs to decide is whether or not AAW' s proposal is in the interest of AAW rate-  
2 payers.

### 3 **III. Facts, Law, and Argument**

4 AAW has a CC&N territory and is required to serve customers within that territory. As  
5 Mr. Broderick explained regarding the Agua Fria district, "this is an active management area,  
6 groundwater is being attempted to be replenished and restored", *Tr.*, P279, L15-17 making surface  
7 water an attractive option, provided the treatment can be done economically.

8 AAW has proposed to build a plant with approximately 13.5 MGD, consisting of three  
9 trains at 6.67 MGD each. *Tr.*, P121, L17-21. AAW has competitively bid the project, with the  
10 return bids coming in within 12% of each other. *Tr.*, P122, L9-10. AAW awarded the job to the  
11 lowest bidder, Garney Construction, *Tr.*, P122, L14-16, whose business is not affiliated with  
12 AAW. *Tr.*, P122, L4-6. AAW believes this process to be a "cost-effective way to manage the  
13 plant design and construction." *Tr.*, P154, L18-19.

14 Although a side-by-side comparison is largely irrelevant under the circumstances, the  
15 Commission should take note that such comparison only serves to highlight the superiority of the  
16 AAW proposal.

17 To begin with, it bears emphasis that MWD has not even finalized a plant design, so  
18 comparison of figures is strictly an exercise in financial theory. On behalf of MWD, James Albu  
19 provided whatever plant data was theoretically available. As of the date of the hearing, the  
20 proposed MWD plant size was 20 MGD, which Mr. Albu admitted could as easily be 10 MGD.  
21 *Tr.*, P423, L19-24. And when asked how Malcolm Pirnie, who might construct such a plant,  
22 would determine what size the plant would be, Mr. Albu said this depended on "MWD providing  
23 Malcolm Pirnie information on what size of facility they want to ... design and construct." *Tr.*,  
24 P424, L5-8. So, as of the date of the hearing, the proposed MWD plant exists only in the minds of  
25 MWD staff, and in no firm form even there.

26 Further, because the MWD plant proposal lacks so many specifics, the financial figures  
27 needed to evaluate the plan are not helpful. As Staff' s financial analyst Gerald Becker pointed  
28 out, "[MWD] does not commit to the rate it is going to use in calculating any of ...the rates that it

1 is going to charge to its ratepayers.” *Tr.*, P648, L16-19. Even MWD’ s financial witness, John  
2 Mastrocchio, was unable to provide more than “ scenarios” under which the Commission should  
3 evaluate MWD’ s plant proposal. When asked “ Do you have any information that suggests that  
4 any of these hard numbers that you have been given to plug into these assumptions are actual  
5 numbers that Maricopa would be using in its business with ... the water companies or with its  
6 customers?” *Tr.*, P368, L23 - P369, L3. Mr. Mastrocchio was non-committal. “ I can’ t say for  
7 certain ... No.” *Tr.*, P369, L4-6.

8 Mr. Mastrocchio’ s actual calculations provided no additional certainty. Mastrocchio  
9 originally performed calculations regarding the cost of each plant proposal on a per-customer basis.  
10 He then listened to the testimony of the AAW witnesses and revamped his calculations prior to his  
11 taking the stand.

12 Despite having used an “ interconnection capital” cost and “ additional capital” of \$12  
13 million each in his original calculations, Mastrocchio cut those numbers *in half* for his on-stand  
14 testimony. Mastrocchio justified the change in data as an example of a “ scenario” regarding  
15 MWD’ s plant financing. He further conceded on cross examination that absent the subtraction of  
16 the \$12 million from his figures, the cost per customer of the MWD plant would have been higher  
17 than for the AAW plant. The final savings per customer *after* eliminating the additional \$6 million:  
18 approximately “ \$14.00”. *Tr.*, P352, L16-17.

19 And despite the fact that the infirm status of the plant design has given birth to even murkier  
20 financial data, MWD has nonetheless suggested that its final costs will be lower than those of  
21 AAW. MWD claims that its status as a municipal corporation provides it with access to a much  
22 lower lending rate than AAW would be able to achieve. But the comparison is actually *irrelevant*  
23 because AAW is not looking to borrow from an institutional lender. Again, the *actual* proposal in  
24 the application is for AAW to finance the construction through hook-up fees. According to Gerald  
25 Becker, in comparison to traditional borrowing, and even at MWD’ s claimed “ 3 ½ to 5%” *Tr.*  
26 P648, L16, interest rate, the hook-up fee arrangement actually “ would represent the lower cost of  
27 financing”. *Tr.*, P647, L24-25. As Mr. Becker illustrates, “ hook-up fees are regarded as zero  
28

1 cost capital to an entity." *Tr.*, P647, L22-23. "Zero percent is a lower rate than 3 and a half to 5  
2 percent." *Tr.*, P648, L21-22.

3 Not only would a side-by-side comparison be irrelevant to the application at hand, when  
4 such an analysis is actually conducted, the reality is that AAW has proposed the most cost-effective  
5 option for building a surface water treatment plant. If the Commission were to follow MWD's  
6 suggestions and allow only one plant to be built, that one plant should be built by AAW.

#### 7 **IV. Conclusion**

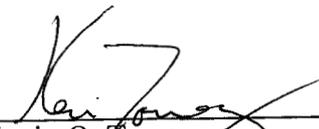
8 The application in this matter is not a comparison between two options. It is an application  
9 for approval or denial of a single option. Staff has evaluated the application and determined that  
10 AAW has presented a viable proposal. Staff recommends that the Commission approve the  
11 application.

12 The Commission should give serious consideration to the public policy implications  
13 represented in this application, as well. AAW is a regulated utility. It has shown a need to build  
14 this proposed plant. It has presented a sound plan to finance construction. AAW has an obligation  
15 to serve its customers based on the mandate the Commission gave it when the Commission  
16 approved AAW's CC&N. The only reason for the Commission to deny this application would be  
17 that it had been persuaded that the greater good of Arizona rate-payers at large would be served by  
18 not allowing the wasteful practice of non-cooperation between two competing utility interests. This  
19 is a dangerous precedent to set in a regulatory scheme based upon regulated monopolies.

20 Denial on the basis of waste to the general public finances would be a very difficult standard  
21 to enforce. It would require the Commission to begin evaluating on a case-by-case basis every  
22 similar application to determine whether or not an alternative exists by which the proposal could be  
23 made more cost-efficient through cooperation between competing utilities. Does the Commission  
24 want to be in a position to declare that two competing entities *must* work together and share a  
25 business interest because one company has proposed a project better handled through cooperation?  
26 Where would the limit be drawn in what the Commission could require regarding cooperation?  
27 How far would the Commission's orders go before a challenge was made that the Commission  
28 was no longer merely regulating, but now actually controlling the utilities under its authority?

1 There is no simple answer except to grant AAW' s application.

2 **RESPECTFULLY SUBMITTED** this 18<sup>th</sup> day of April 2007.

3  
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