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BEFORE THE ARIZONA CORPORATION COMMISSION

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WILLIAM A. MUNDELL
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11-13-07

IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY,
AN ARIZONA CORPORATION, FOR A
DETERMINATION OF THE CURRENT FAIR
VALUE OF ITS UTILITY PLANT AND
PROPERTY AND FOR INCREASES IN ITS
RATES AND CHARGES BASED THEREON
FOR UTILITY SERVICE BY ITS SUN CITY
WASTEWATER AND SUN CITY WEST
WASTEWATER DISTRICTS

DOCKET NO. WS-01303A-06-0491

ARIZONA-AMERICAN WATER
COMPANY

NOTICE OF FILING REPLY BRIEF

1 Arizona-American Water Company hereby files its reply brief in the above-referenced
2 matter.

3 RESPECTFULLY SUBMITTED on November 13, 2007.
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1 Original and 13 copies **filed**
2 on November 13, 2007, with:

3
4 Docket Control
5 Arizona Corporation Commission
6 1200 West Washington
7 Phoenix, Arizona 85007

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9 Copies of the foregoing **delivered**
10 on November 13, 2007, to:

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

MIKE GLEASON, Chairman
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REPLY BRIEF OF ARIZONA-AMERICAN WATER COMPANY

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1 **I INTRODUCTION**

2 All parties recommend significant rate increases for Sun City Wastewater and Sun City
3 West Wastewater.

4 **Table 1R – Recommended Increases in Gross Revenue Requirement**

	Sun City Wastewater	Sun City West Wastewater
Arizona-American	\$ 1,493,529 ¹	\$ 1,271,824 ²
Staff	\$ 1,386,545 ³	\$ 1,100,841 ⁴
RUCO	\$ 1,233,925 ⁵	\$ 1,417,929 ⁶

5 Staff and Arizona-American disagree largely because of differences in cost of capital and
6 the proper amortization of imputed AIAC and CIAC. Arizona-American has already talked
7 about these issues at length in its Initial Brief, so little needs to be added in this Reply Brief. In
8 the Staff Brief, Staff's attorneys also criticize Arizona-American's implementation of its rate-
9 design proposal. The Company will show why this criticism is baseless.

10 RUCO's differences are more numerous, but have largely been addressed in Arizona-
11 American's Initial Brief. Arizona-American will slightly expand on its responses to two RUCO
12 issues concerning Sun City West Wastewater: plant and accumulated depreciation, and the
13 Northwest Valley Regional Water Treatment Facility.

14 **II REPLY TO STAFF**

15 **A AMORTIZATION OF IMPUTED AIAC AND CIAC**

16 This issue was already thoroughly discussed in Arizona-American's Initial Brief.⁷
17 Essentially, Staff would reset Arizona-American's test year to end at December 9, 2005. This is
18 not Staff's decision to make. Arizona-American chose a test year ending December 2005. The

¹ Initial Brief of Arizona-American Water Company, dated October 19, 2007 ("AAW Brief") at 36.

² *Id.*

³ Staff's Final Schedule DRR-1. Docketed September 21, 2007.

⁴ Staff's Final Schedule GWB-1. Attached to Staff Brief, dated October 19, 2007.

⁵ RUCO Brief at 24:9-10.

⁶ *Id.*

⁷ AAW Brief at 6:3 – 10:2.

1 last day of December 2005 is December 31, 2005. Therefore, rate base for both Sun City
2 Wastewater and Sun City West Wastewater should reflect amortization of imputed AIAC and
3 CIAC through the end of the Company's chosen test year.

4 Arizona-American initially sought to reflect the known-and-measurable imputed AIAC
5 and CIAC balances as of June 30, 2007.⁸ Arizona-American has already met Staff much more
6 than halfway on this issue, and agrees to end the amortization as of December 31, 2005. Further,
7 there is no dispute as to the balances for imputed AIAC and CIAC as of December 31, 2005.
8 They are known and measurable. Nor is there any dispute as to whether rate base should
9 ultimately reflect these reductions to the imputed AIAC and CIAC balances. Staff simply wants
10 to delay recognition of these amortizations until Arizona-American's next rate case. Staff's
11 position, if accepted, would make it all that more difficult for Arizona-American to return to
12 financial health.

13 **B RATE DESIGN**

14 Staff labors in vain to create a major issue concerning what the Commission required
15 Arizona-American to file concerning a new volumetric rate design, in part, over disappointment
16 that Arizona-American chose to oppose it. The Commission's expectations were clear. In
17 Decision No. 67093, the Commission:

18 ORDERED that the next rate case filings for the Sun City West, Sun City and
19 Anthem/Agua Fria wastewater Districts shall include a rate design proposal that
20 presents information on 1) whether wastewater rates based on water consumption
21 encourage water conservation; 2) whether higher bills for those who use the system
22 more is a fairer way to collect revenue; and 3) what tiered wastewater rates based on
23 water consumption would look like compared to a flat rate design.⁹

⁸ *Id.* at 9:16-18.

⁹ Decision No. 67093, dated June 30, 2004, at 61:1-6.

1 As discussed in its initial brief, Arizona-American fully complied with the ordering paragraph
2 and included a volumetric rate-design proposal with its filing and addressed the Commission's
3 questions.¹⁰

4 Staff examined Arizona-American's application for sufficiency and determined that it
5 needed much more information concerning the volumetric rate proposal before it could find
6 sufficiency. As summarized by Judge Wolfe:

7 On August 28, 2006, the Commission's Utilities Division ("Staff") filed a Letter of
8 Conditional Sufficiency classifying the Company as a Class A utility and indicating
9 that Arizona-American's application met the sufficiency requirements outlined in
10 A.A.C. R14-2-103. The letter stated that the sufficiency finding was conditioned
11 upon the Company filing volumetric billing determinants that reconcile the proposed
12 volumetric rates to the proposed revenue no later than October 11, 2006, and that the
13 Company and Staff stipulated that if the Company did not file the billing
14 determinants by that date, the timeclock in this matter would be immediately
15 suspended until the information was filed.

16 ...

17 On February 2, 2007, Staff filed a Letter of Sufficiency. The letter indicated that
18 with the supplemental direct testimony and revised schedules filed by the Company
19 on January 29, 2007, Arizona-American's application had met the sufficiency
20 requirements outlined in A.A.C. R14-2-103.¹¹

21 Arizona-American fully absorbed the cost of this suspension in the form of permanently
22 lost revenue and greater rate case expense. During the almost six-month delay in this case,
23 Arizona-American struggled, ultimately successfully, to complete the requested reconciliation to
24 Staff's satisfaction. During that time period Staff never suggested that it had any concerns about
25 customer education or cost-benefit analyses. If Staff had any such concerns, Arizona-American
26 would have done its best to address them during the case suspension. By its sufficiency finding,
27 Staff certified that the application met all the Commission's filing requirements.

¹⁰ AAW Brief at 37:5 – 39:7.

¹¹ Procedural Order dated February 15, 2007, at 1-2.

1 Next, Staff's direct testimony supported Arizona-American's initial rate-design proposal
2 and had no issues at all with the Company's responses to the Commission's questions. In fact,
3 two Staff witnesses testified that Arizona-American's rate-design filing was "[c]onsistent with
4 the direction provided in Decision No. 67093" ¹²

5 After developing significantly more information during the period the case was
6 suspended, then later reviewing other parties' testimony, and finally considering the impacts of
7 volumetric rates on its elderly customers, Arizona-American determined that volumetric rates
8 would not be appropriate for residential customers. ¹³ It was during this never-before-conducted
9 reconciliation of water to wastewater billing determinants that Arizona-American formulated
10 most of its significant concerns about volumetric rates for residential rates in these districts. This
11 position was expressed in Arizona-American's rebuttal testimony. ¹⁴ In response, Staff's
12 surrebuttal testimony still recommended volumetric rates for all customers; although Staff's
13 experts did not change their opinions that Arizona-American's filing was "[c]onsistent with the
14 direction provided in Decision No. 67093." ¹⁵

15 Finally, at the hearing Staff's cross-examination suggested that Staff's attorneys now
16 believed that Arizona-American somehow failed to comply with the Commission's Order. This
17 has now been borne out in Staff's brief. However, Staff fails to demonstrate anything, other than
18 Arizona-American's full compliance with the Order.

19 Before addressing any of Staff's alleged deficiencies, it is important to establish the
20 fundamentals. To the parties' knowledge, the Commission has never been faced with a case
21 involving a switch from flat to volumetric sewer rates. ¹⁶ In fact, no party has provided any
22 precedent, in any jurisdiction, for how to implement such a major change in a retirement
23 community. As a result, the parties could only do the best they could.

¹² See Exhibit S-4 at 1:22 and 2:21; Exhibit S-9 at 1:22 and 2:21.

¹³ Exhibit A-13 at 13:12 – 16:2.

¹⁴ Exhibits A-6 and A-13.

¹⁵ See Exhibits S-5 and S-10.

¹⁶ Tr. at 764:7-16.

1 Arizona-American provided an initial proposal for the other parties to evaluate, and
2 discussed the theoretical support for volumetric rates. After each party evaluated the initial
3 proposal and provided its own direct testimony, Arizona-American concluded that RUCO had
4 confirmed our own valid concerns and reevaluated its initial proposal. Ultimately, Arizona-
5 American modified its initial proposal, so that it now recommends volumetric sewer rates only
6 for its commercial customers.¹⁷

7 It is difficult to understand the Staff attorneys' irritation with this process. The
8 Commission did not order that volumetric rates be implemented in this case. It could have, but it
9 did not. Instead, the Commission asked Arizona-American to file a proposal. This allowed the
10 other parties to react to the initial proposal and make their own proposals. Further, this allowed
11 Arizona-American to review the parties' proposals, consider new issues that it did not think of in
12 its initial proposal, and offer a new rate design proposal.

13 There is nothing unusual about this process. In response to the Commission's request,
14 the parties have investigated whether switching to volumetric rates would be appropriate for
15 wastewater customers in these retirement communities. The debate has been very robust and
16 there are three separate fully developed proposals for the Commission's consideration. Staff
17 agrees that the Commission has all the information that it needs to render a decision.¹⁸

18 Ultimately, after reviewing all this information, the Commission will determine the proper rate
19 design for the wastewater customers. This is exactly how the process is supposed to work.

20 Arizona-American would have been negligent if it had not carefully considered all the
21 information it developed during the suspension and the other parties' testimony in light of the
22 special circumstances of the Sun City Wastewater and Sun City West Wastewater customers and
23 reevaluated its proposal. Yet Staff's attorneys now suggest that Arizona-American was
24 somehow negligent in not marching in lock step with Staff.

¹⁷ Exhibit A-13 at 13:12 – 16:2.

¹⁸ Tr. at 804:6 – 805:6.

1 Staff's attorneys claim that Arizona-American was required to conduct and file the results
2 of a cost-benefit analysis.¹⁹ This is not in the Order. The Commission knows what a cost-
3 benefit analysis is and how to order one. In any event, the Commission has the information that
4 it needs. Mr. Broderick testified that the cost of converting to volumetric rates—to Arizona
5 American—would not be great.²⁰ However, his judgment was that, for residential customers
6 there would be little water conservation and significant customer confusion.²¹ On balance there
7 would be no net benefit in the Sun Cities, even though the cost to Arizona-American would be
8 little.

9 Staff also asserts that Arizona-American should have conducted surveys and "educated"
10 its customers.²² Although this sounds simple enough on the surface, in practice it would have
11 required that Arizona-American first complete a volumetric rate design and then be able to tell
12 each surveyed customer the rate impact of the switch. Staff agreed:

13 Q. A change from flat rates for sewer service to volumetric sewer service, would
14 you characterize that as a significant change from the customer's viewpoint?

15 A. Yes.

16 ...

17 Q. If you were to survey customers about their preference for a flat rate or
18 volumetric rate, would you have to provide definitions of what a flat rate and what a
19 volumetric rate is to get some sort of a meaningful response?

20 A. Yes.

21 Q. And if you were to, to get a further meaningful response or more meaningful
22 response, would you, would the customer in your judgment need to know how it
23 actually affected them and their bills?

24 A. Of course.

¹⁹ Staff Brief at 16:18-23.

²⁰ Tr. at 496:4-7.

²¹ Ex. A-13 at 13:16 – 15:21.

²² Staff Brief at 18:22-24.

1 Q. And to obtain that kind of information before doing a survey, how would you
2 get that kind of information?

3 A. Obviously you would have to do a rate design, a flat rate design, a volumetric
4 rate design.

5 Q. And then you would have to put it together in some form similar to your DRR-
6 20 or DRR-22 or something like that?

7 A. That's correct.

8 Q. And even within those summary schedules, there are some customers, as we
9 learned when we were providing the additional notice in this case, some customers
10 that are well below the average for that customer class and some customers that are
11 well above the average for that customer class, is that correct?

12 A. Of course.

13 Q. And so for a customer to really know whether he or she would be a winner or a
14 loser under a change from flat rate to volumetric rate, that customer would really
15 have to know how it would affect their particular bill, correct?

16 A. I am sorry, sir, I don't agree with the terms winner or loser.

17 Q. Okay. Let me phrase it another way. That's a fair response. In order for a
18 customer to meaningfully evaluate in some sort of survey whether or not they would
19 be in favor of going from a flat rate to a volumetric rate, wouldn't the particular
20 customer want to know how it affected his or her bill?

21 A. And everyone else's.²³

22 Again, the Commission did not ask Arizona-American to survey its customers, which
23 would have required significant effort, expertise, and expense. Without some kind of explicit
24 order from the Commission, along with some kind of assurance that it would have been able to
25 recover the associated costs, it simply would have not been prudent for Arizona-American to
26 undertake a massive program of this nature.

²³ Tr. at 761:17 to 764:6.

1 **C SHORT TERM DEBT**

2 Arizona-American has already discussed the reasons why short-term debt should not be
3 included in its capital structure.²⁴ Fundamentally, Arizona-American is only entitled to a return
4 on its rate base. If the evidence is clear, like it is in this case, that short-term debt does not
5 finance rate base, then it is inappropriate to include short-term debt in the Company's capital
6 structure.

7 Staff quotes the Commission as follows:

8 IT IS FURTHER ORDERED that Arizona-American Water Company shall file a
9 plan with Docket control by December 31, 2005 that describes how the Company
10 expects to attain and maintain a capital structure (equity, long-term debt, and *short-*
11 *term debt*) with equity representing between 40 and 60 percent of total capital.²⁵

12 All this means is that if Arizona-American's capital structure contains short-term debt, then that
13 debt must be reflected. However, as discussed, Arizona-American does not finance rate base
14 with short-term debt, so its capital structure should not contain short-term debt.

15 The Commission agrees. Decision No. 68310 was issued on November 14, 2005. Since
16 that date the Commission has issued two rate orders for Arizona-American districts. On July 26,
17 2006, the Commission issued Decision No. 68858 for Arizona-American's Paradise Valley
18 Water District. The Commission did not include short-term debt as part of Arizona-American's
19 capital structure.²⁶ Similarly, on May 1, 2007, the Commission issued Decision No. 69440 for
20 Arizona-American's Mohave Water and Wastewater Districts. Again, the Commission did not
21 include short-term debt as part of Arizona-American's capital structure.²⁷

22 Staff's recommendation to include short-term debt in Arizona-American's capital
23 structure is new. That does not make it wrong for all companies, but it is not appropriate for
24 Arizona-American. First, Staff has not met its burden of showing that its snap-shot balance of

²⁴ AAW Brief at 27:19 – 29:2.

²⁵ Staff Brief at 21:5-8, quoting Decision No. 68310 at 15. (Emphasis added by Staff)

²⁶ Decision No. 68858, dated July 26, 2006, at 22:16-18.

²⁷ Decision No. 69440, dated May 1, 2007, at 14:20 – 15:24.

1 short-term debt is representative of Arizona-American's typical short-term debt level. Second
2 Staff has not shown that short-term debt is being used to finance long-term, rate-based, assets.
3 Therefore, the Commission should reject the inclusion of an arbitrary short-term debt balance in
4 Arizona-American's capital structure.

5 **D METER READING INVESTIGATION**

6 This issue was thoroughly discussed in Arizona-American's Initial Brief.²⁸ Exhibit A to
7 the Brief was a series of acceptable ordering paragraphs for the Commission's consideration.
8 After further consideration, Arizona-American would like to modify suggested ordering
9 paragraph 12 to read:

10 12. Arizona-American should normally use the cancel/rebill process to correct errors
11 covering just one billing period. However, if the error continues for more than one
12 billing period, the bill may be corrected in whole or part through an account
13 adjustment, as appropriate.

14 **III REPLY TO RUCO**

15 **A PLANT AND ACCUMULATED DEPRECIATION**

16 RUCO continues to recommend adjustments to the Sun City West wastewater
17 accumulated depreciation balance totaling \$969,479.²⁹ First, RUCO alleges the Company
18 recorded improper retirements of \$445,393 of the recommended adjustment.³⁰ In fact, all but
19 \$268 of this amount related to two items (\$355,619 + \$89,506 = \$445,125), which were not plant
20 retirements, but were actually corrections to transfers to plant in service from Construction Work
21 in Progress ("CWIP").³¹ Staff's auditors have reviewed these same accounts and Staff has
22 accepted Arizona-American's treatment. The remaining \$268 is not material. RUCO's
23 \$445,393 adjustment should be rejected.

²⁸ AAW Brief at 41:10 – 47:5.

²⁹ RUCO Brief at 6:12-14

³⁰ *Id.* at 6:14 – 7:10.

³¹ Exhibit A-10 at 7:16 – 8:16.

1 The remaining \$517,086 of RUCO's recommended adjustment resulted from Mr. Coley's
2 recalculation of the Company's accumulated depreciation balance. Ms. Hubbard testified that
3 some of this balance could be attributable to Mr. Coley's incorrect assumption about the
4 \$445,393 discussed above.³² By treating the reclassifications as retirements, Mr. Coley's
5 recalculated balance would be understated as compared to the Company's actual recorded
6 accumulated depreciation. The remainder of the difference is likely attributable to the treatment
7 of costs of removal and salvage in Mr. Coley's recalculations. Unfortunately, it is very difficult
8 to analyze and critique Mr. Coley's work.

9 Again, Staff disagrees with RUCO and supports Arizona-American's balances.

10 **B WORKING CAPITAL**

11 Arizona-American has already thoroughly discussed this issue in its Brief.³³ RUCO has
12 added nothing new that requires additional reply.

13 **C AMORTIZATION OF IMPUTED AIAC AND CIAC**

14 RUCO shares this issue with Staff. In reply to RUCO, Arizona-American incorporates
15 its reply to Staff concerning this issue.³⁴

16 **D TOLLESON DECHLORINATION UPGRADE**

17 Arizona-American has already thoroughly discussed this issue in its Brief.³⁵ RUCO has
18 added nothing new that requires additional reply.

19 **E TOLLESON TRICKLING FILTER**

20 Arizona-American has already thoroughly discussed this issue in its Brief.³⁶ RUCO has
21 added nothing new that requires additional reply.

³² *Id.* at 9:1-8.

³³ AAW Brief at 10:3-22.

³⁴ See Section IIA, above.

³⁵ AAW Brief at 11:8-17.

³⁶ AAW Brief at 11:1-7.

1 **F LABOR EXPENSE**

2 Arizona-American has already thoroughly discussed these issues in its Brief.³⁷ RUCO
3 has added nothing new that requires additional reply.

4 **G PROPERTY TAX EXPENSE**

5 Arizona-American has already thoroughly discussed this issue in its Brief.³⁸ RUCO has
6 added nothing new that requires additional reply.

7 **H RATE CASE EXPENSE**

8 Arizona-American has already thoroughly discussed this issue in its Brief.³⁹ RUCO has
9 added nothing new that requires additional reply.

10 **I DEPRECIATION AND AMORTIZATION EXPENSE**

11 Arizona-American has already thoroughly discussed this issue in its Brief.⁴⁰ RUCO has
12 added nothing new that requires additional reply.

13 **J INDUSTRIAL PRE-TREATMENT LABOR EXPENSE**

14 Arizona-American has already thoroughly discussed this issue in its Brief.⁴¹ RUCO has
15 added nothing new that requires additional reply.

16 **K ADEQ MANDATED LABOR EXPENSE**

17 Arizona-American has already thoroughly discussed this issue in its Brief.⁴² RUCO has
18 added nothing new that requires additional reply.

19 **L ACHIEVEMENT INCENTIVE PAY**

20 Arizona-American has already thoroughly discussed this issue in its Brief.⁴³ RUCO has
21 added nothing new that requires additional reply.

³⁷ AAW Brief at 20:8 – 22:7.

³⁸ AAW Brief at 19:2 – 20:7.

³⁹ AAW Brief at 24:1 – 25:7.

⁴⁰ AAW Brief at 26:14-19.

⁴¹ AAW Brief at 22:8 – 23:8.

⁴² AAW Brief at 23:9-17.

⁴³ AAW Brief at 25:8 – 26:5.

1 **M NORTHWEST VALLEY TREATMENT FACILITY**

2 Arizona-American has already thoroughly discussed this issue in its Brief.⁴⁴ There is one
3 overriding consideration concerning the allocation of the rate base and expenses associated with
4 this facility – the allocations must be consistent in this case for the Sun City West Wastewater
5 district and in Arizona-American’s pending Anthem/Agua Fria Wastewater case and together
6 total 100%.⁴⁵ Otherwise, Arizona-American could be denied its constitutional right to recover its
7 test-year expenses and a return on and of its invested capital. Only a consistent allocation
8 between the districts will assure that all customers pay their fair share and that the Company be
9 fairly compensated for its investment and expenses. Arizona-American supported Staff’s
10 recommendation to allocate 68% of this facility’s costs to the Sun City West Wastewater district
11 during the hearing. The Commission should reject RUCO’s proposal to allocate all associated
12 rate base and 97.75% of expense to this district should be rejected.

13 **N COST OF CAPITAL**

14 Arizona-American has already thoroughly discussed this issue in its Brief.⁴⁶ RUCO has
15 added nothing new that requires additional reply.

16 **O RATE DESIGN**

17 RUCO’s recommendations regarding the commercial class rate design should be rejected.
18 The commercial class already has volumetric rates for large users and Arizona-American’s
19 proposal to extend that to small commercial users (and eliminate the charges for additional
20 dishwashers, toilets, wash racks and washing machines) using meter size equivalents is much
21 superior to the existing design.

⁴⁴ AAW Brief at 11:18 – 12:11; 26:6-13.

⁴⁵ Docket No. WS-01303A-06-0403. Customers in that district also receive wastewater treatment services from the facility. See Tr. at 642:23 – 647:10; 801:19 – 803:15;

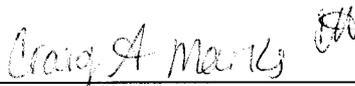
⁴⁶ AAW Brief at 29:12 – 30:2; 34:20 – 35:13.

1 **IV CONCLUSION**

2 For the reasons given in its Initial Brief and this Reply Brief, the Commission should set
3 rates to allow Arizona-American to increase its revenues by \$1,493,529 for its Sun City
4 Wastewater District and \$1,271,824 for its Sun City West Wastewater District. The Commission
5 should implement these revenue increases using Arizona-American's recommended rate design.

6 RESPECTFULLY SUBMITTED on November 13, 2007.

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