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Interim Report of the Arizona Corporation Commission's Water Task Force

October 28, 1999

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I. INTRODUCTION

The Commission's Water Task Force was established by Commission vote on April 24, 1998 and held its first meeting on September 22, 1998. The Task Force's members include consumers, water company representatives, and representatives from the Arizona Department of Water Resources (ADWR), Arizona Department of Environmental Quality (ADEQ), and the Central Arizona Conservation District (CAWCD). The Task Force's meetings are open to the public and several individuals who are not official "members" of the Task Force have taken on active roles. The goal of the Task Force is to develop policies to address a wide variety of problems that private water companies and their customers face. The Task Force has divided into three subcommittees: the Regulatory Reform Subcommittee, the Water Supply Subcommittee, and the Conservation Subcommittee.

This report represents the accomplishments of the Task Force to date. The Task Force was able to agree on what the problems facing the water industry in Arizona are. The Task Force members proposed many possible solutions for these problems. Consensus was reached on some of these proposed solutions. However, the Task Force was divided on the appropriateness of many of the proposed solutions. The report that follows summarizes each of the proposed solutions. The positions of the Task Force members will be presented in a pros and cons format. The members whose views are presented in this report fall into four categories: the industry (consisting of representatives from Brooke Utilities, Inc., Arizona Water Company, Big Park Water Company, and Citizens), the Residential Utility Consumer Office (RUCO), the ADWR, and Commission Staff.

II. REGULATORY REFORM SUBCOMMITTEE

The Regulatory Reform Subcommittee reached the consensus that the following five goals would be their focus:

1. Reduce the number of small, non-viable water systems through new rules and procedures.
2. Strengthen the financial capacity of the water utility industry.
3. Provide greater emphasis on simplifying, shortening, and reducing the cost of the ratemaking process.
4. Improve Consumer Education.
5. Increase Interagency Coordination.

- 1. Reduce the number of small, non-viable water systems through new rules and procedures.**

Many of Arizona's water companies are quite small; the majority of them have less than \$250,000 in annual revenues. Although some small water companies are well run and provide quality service to their customers, many of these small companies are quite problematic. Most of the "problem" companies that the Commission must deal with are quite small. Because of their small base of customers, even quality managers of small companies may find it difficult to raise sufficient revenues to make needed capital investments. The Subcommittee decided that it was not necessary or desirable to establish criteria for identifying a non-viable company.

Also, because of economies of scale, larger companies are likely to be more efficient. A larger company can consolidate the administrative aspects of many smaller "systems" thereby significantly reducing the overall cost of service.

For these reasons the Task Force agrees that reducing the number of small non-viable water systems is a desirable goal. Two areas of Commission policy were discussed for addressing this goal: CC&N applications and consolidation.

CERTIFICATES OF CONVENIENCE & NECESSITY (CC&N)

The Task Force members reached consensus that the Commission must eliminate the establishment of additional non-viable water companies. Therefore, the requirements for establishing new water companies should be made more stringent.

Commission Staff recommended the following Commission policy changes concerning the establishment of new water companies:

1. The application for a new CC&N must show that an existing water company cannot or will not serve the area being applied for. This showing must be made by submitting service rejection letters from all the "A" size water companies in the state (there are 3) and at least five of the "B" size companies (there are 20). The application must also be accompanied by service rejection letters from all the existing water companies within five miles of the area being requested. In addition, the rejection letters must be accompanied by the corresponding request for service that was made to each of the existing water companies by the applicant.
2. The rates could be set such that the company should break even no later than its third year of operation and should achieve its required rate of return no later than its fifth year of operation. The calculations would be based on the company's estimates of customer growth.
3. Because Staff believes that it is not in the public interest, no new CC&N would be issued to any company that was in any way affiliated with any other company or person that was not in compliance with Commission and ADEQ requirements.

4. The rates and tariff establishment portion of the CC&N approval process could be simplified by changing Staff's entire approach to rate review for new CC&Ns. Staff recommends that instead of trying to determine if rates are too high for new CC&Ns, it should be examining if rates are too low. Staff recommends establishing a set of standard non-monthly charges. These standards could be set by looking at the average of the rates that are charged by other Commission regulated companies or possibly even include municipalities. These charges could include such things as late fees, establishment fees, NSF check fees, etc.

For the monthly minimum and commodity charges, Staff should establish some standard that would be a minimum. For example, the standard for the monthly minimum for a 5/8-inch x 3/4-inch meter could be \$25.00 with no gallonage. Therefore, all new CC&N applications for water companies would be reviewed to determine if the rate was at least that much.

As for the commodity charge, the standard could be an inverted tier rate with three tiers. The first tier could be \$1.50 per thousand for the first 3,000 gallons. The second tier could be \$4.00 per thousand for the next 7,000 gallons. The third tier would be 2-times the second tier per thousand for all usage over 10,000 gallons. Although, the numbers used here are just examples, all new companies should have a three tier inverted rate. (See Section III on conservation for more on three tiered rates.)

With the type of standards as discussed above, the rate review portion of new CC&N applications could be done by the Commission's Consumer Services section by simply comparing the requested rates against the standard. If the requested monthly rates were below the standard, Staff would recommend that the Commission approve the standard rates. If the rates requested were above the standard, Staff would recommend that the Commission approve the company requested rates. This would provide much more time for the Accounting & Rates Staff to work on actual rate and financing cases.

Staff believes that the only segment of the population that may be against having Staff determine if rates are too low for new CC&Ns, are developers. Many of the troubled water companies that the Commission regulates today are a result of developer owned water systems that had their initial rates approved as low as possible, at the request of the owner. The reason for doing this was that it was a selling point for the developers. Although the Commission should be concerned for all segments of the Arizona population, including developers, the concern for developers should be second to that for the water company customers and the water companies themselves, especially with regard to the establishment and granting of new CC&Ns.

The Commission's Legal Staff has indicated that there are no significant legal barriers to placing the proposed limits and conditions on CC&N issuance. The Commission has wide latitude and sole jurisdiction in this area.

The industry members of the Task Force indicated that they support most of Staff's recommendations concerning CC&Ns. RUCO had significant objections to Staff's proposals, they will be summarized in the pros and cons section below.

PROS AND CONS

PROS

1. The Task Force agrees that Staff's proposals offer an effective method for limiting the number of small water companies.

CONS:

1. (Staff and RUCO) The initial rates may be set too high allowing the company to over earn.

Staff believes that this concern is mitigated by the following factors: First, the chance of any company over-earning in the first few years of existence is very small. Second, in all these new CC&N approvals, the Staff would recommend that the Commission require the company to file a full rate case within a specified timeframe. If in that first rate case Staff determines that the company is over-earning, Staff could recommend lower rates. Staff believes that it is much easier for the Commission to lower rates than it is to raise them. Third, there are no customers when these rates are set. Any person that becomes a customer does so with the full knowledge of what the rates are. That person becomes a customer by choice, instead of having high rates levied against him *after* becoming a customer.

RUCO believes that this proposal ignores the potential negative consequences of excessive initial rates. For example, customers may be driven away. Potential customers that would have preferred buying homes and beginning businesses in the service territory may select alternate locations. Taken to an extreme, a CC&N could be used to postpone growth in the service territory by charging excessive rates. A CC&N holder with the objective of limiting growth could prevent a developer from building in the service territory by charging grossly excessive rates that no reasonable customer would pay. Also, the cost of service varies significantly by location. No single standard rates will prevent all new water companies from charging inadequate rates. New companies can benefit by the input from Commission Staff, RUCO, and other intervenors in setting rates. Prospective customers will also benefit from the input of multiple parties in developing a probable on-going level for rates in a new water system.

RUCO also believes that establishing standard, minimum monthly customer charges and commodity rates does not ensure a proper balance of revenue from each. A company could choose the minimum monthly customer charges and select commodity rates far in excess of the minimum resulting in an unstable revenue base. Without an analysis of a company's projected underlying costs, the appropriate balance for a given company is unknown. Also, if a company were to choose an inappropriate balance for its initial rates, an unnecessarily large change in the rate structure may be warranted in a future rate case. Avoidance of large changes in rate structure is one of the fundamental goals of rate design. In addition, the proposed minimum rates fail to address other issues including conservation objectives, the high cost of CAP water, and special customer demands, such

as those of a prospective industrial user. The scrutiny provided by Staff, RUCO, developers, and hearing officers is valuable in forming appropriate initial rates and should not be discarded. Furthermore, providing water companies with full initial rate setting discretion is certain to be ill received by the public and public criticism could bring embarrassment to the Commission and RUCO even if real problems did not exist with the proposal.

2. (RUCO) The proposal creates a hierarchy of preferential treatment for various existing companies. An existing company will not necessarily make a more-fit public service provider than a new company. A small or newly formed water company is not necessarily non-viable or unfit to provide public utility service. Also, it is dubious that any pre-determined distance can be established that will represent the distance from which another water company can effectively service any new service territory

3. (RUCO) Large, existing water companies may not be interested in expansion. Company's that are not interested in new service territories may be reluctant to assert that disinterest in a rejection letter. Also, new applicants could seek rejection letters only from those "Class B" companies that always reject proposals for new service territories. This would circumvent the intent of requiring a new CC&N applicant to obtain rejection letters from at least five "Class B" water companies as one of the criteria for obtaining a CC&N.

4. (RUCO) This plan also suggests using only the water company's projected customer growth estimates in setting rates to achieve break-even operating results no later than the third year of operation and for earning the authorized rate of return in the fifth year of operation. RUCO believes that other parties (e.g., RUCO, Staff, Hearing Officers, Commissioners, developers, prospective customers, and others) may have valuable input into the growth projections.

5. (RUCO) The complete compliance with ADEQ requirement is a desirable goal. However, it may be preferable to establish a lesser standard that allows some latitude. For example, a water company in complete compliance could acquire a company in non-compliance resulting in a circumstance that the acquiring company is no longer in compliance and, accordingly, not eligible for the new CC&N. In this instance, the proposed condition provides an undesirable result. Also, a large company with many systems is statistically more likely to have a violation than a smaller company. The proposed condition, therefore, discriminates against large companies and is counter-productive in the effort to reduce the number of small, non-viable companies.

The industry and Staff recognize the validity of many of RUCO's concerns. However they believe that Staff's proposal is fundamentally sound and that RUCO's concerns can be addressed when a more detailed proposal is produced.

INCENTIVES FOR CONSOLIDATION

All of the Task Force members agree that the Commission should implement new policies that provide incentives for large financially sound water companies to purchase and rehabilitate water systems that are small or non-viable. The members could not come to agreement about what the incentives should be.

Also, the industry believes that incentives for consolidation should apply to all water companies since they believe that consumers benefit from the economies of scale realized by the combination of merged entities regardless of the individual sizes of acquiring companies. RUCO is opposed to any policies that are not limited to small systems since if an "A", "B" or "C" size company wants to merge with another such company, it should be strictly a business decision with no need for incentives. Commission Staff is in the middle on this issue. Staff believes that initially incentives for consolidation should be limited to small (D and E class) companies but could be expanded later if the incentives are deemed successful.

The most common (and contentious) incentive discussed has been the use of an acquisition adjustment. Staff and the industry recommend the development of a policy/rule delineating exactly what type of acquisition adjustment the Commission will allow.

Staff believes that conditions for approval of an acquisition adjustment should include, but not be limited to, situations where:

1. The acquisition is in the public interest.
2. The acquisition will not negatively affect the viability of the acquirer.
3. The acquired system's customers will receive improved service in a reasonable timeframe.
4. The purchase price is fair and reasonable (even though that price may be more than the original cost less depreciation book value) and conducted through an arms' length negotiation
5. The recovery period for the acquisition adjustment should be for a specific minimum time (e.g., twenty years).

The industry representatives on the Task Force advocated the adoption of the California Public Utilities Commission's (CPUC) policy on acquisition adjustments. The California Legislature enacted SB 1268 January 1, 1998, which calls for the rate base of an acquired water utility to be based on fair market value. If fair market value is at or below replacement cost new minus depreciation the CPUC will definitely use fair market value to determine the rate base of the acquired water company. If the fair market value of an acquired utility is greater than replacement cost new minus depreciation the CPUC will base rate base on fair market value only if the following conditions are met: 1) The acquisition will improve the reliability of the water system. 2) The acquisition will improve the acquired company's ability to conform to health and safety regulations. 3) The acquisition will result in significant economies of scale. 4) The acquisitions effect on existing customers is fair and reasonable. If these conditions are not met, or if the CPUC determines that the acquisition is not in the public interest, the CPUC can deny the acquisition altogether. To date the CPUC has received only two applications for treatment under SB 1268, one for the merger of two A class utilities and one for the

purchase of a B class. The CPUC has not issued a decision on either application as of September 27, 1999.

All members of the Task Force agreed that negative acquisition adjustments should never be imposed. An acquirer of a water company should not be penalized for the acquisition through application of a negative rate base acquisition adjustment. Instances where negative adjustments to rates due to negative acquisition adjustments are not common. However, there may be many opportunities for acquisition of small water systems that could be discouraged if the acquiring company believed that negative acquisition adjustments would affect current rates or return.

RUCO was opposed to any form of an acquisition adjustment. However, RUCO acknowledged that problems do exist with small non-viable water systems in the state and that acquisition by larger well-run utilities is potentially beneficial. RUCO advocated three policies to encourage the acquisition of small non-viable water companies by larger utilities: a surcharge for capital investment and a rate of return premium, and a deferral accounting order.

RUCO (and Staff) Option 1 - Allowance of an incremental premium on the Company's authorized rate of return. In light of the additional risks a purchasing utility takes on when acquiring a non-viable system, an additional rate of return would be authorized by the Commission. This option would create a monetary incentive for the acquisition of non-viable systems, yet unlike an acquisition adjustment, the authority to determine the appropriate level of the incentive would remain with the Commission. If a rate of return premium were approved, it could be limited to a specific length of time (perhaps five years or until the next rate case, whichever is shorter).

RUCO Option 2 - A surcharge mechanism that would allow the acquiring company to obtain up front ratepayer funding of the capital investment necessary to make the acquired system viable. Since there is a lag between a company's outlay of cash for capital investments and the recognition of the investment in rates, this creates disincentives for acquisition of non-viable companies. This disincentive can be removed by creating a regulatory mechanism that would allow the estimated cost of the necessary improvements to be included in a rate surcharge and funded up front by ratepayers. Once the improvements were completed, the cost estimated would be trued up to actual.

RUCO Option 3 - A deferral accounting order that would allow the acquiring utility to defer for future rate recovery extraordinary repair and maintenance costs necessary to improve the quality of service of the non-viable acquisition. The amount ultimately recoverable would be determined in the context of a rate case.

Commission Staff believes that a rate of return premium should be considered with the same conditions as acquisition adjustments above. Staff does not recommend approving both a rate of return premium and recovery of an acquisition adjustment for the same company for the same purpose. Staff recommends that one or the other be chosen in each case that is applicable.

PROS AND CONS: ACQUISITION ADJUSTMENTS

PROS: Acquisition adjustments are an effective incentive for consolidation.

CONS: RUCO provides the following reasons for opposing acquisition adjustments:

1) An acquisition adjustment would allow buyers and sellers of utility property to dictate the magnitude of the incentive through the buying and selling price. The higher the selling price, the greater the windfall profits to both buyer and seller, with captive ratepayers footing the bill.

2) Staff has developed a proposed set of criteria a utility would have to meet to qualify for an acquisition premium. While this criteria may ultimately be effective in preventing some of the dangers of allowing acquisition premiums, from a practical stand point it would entail additional regulatory oversight, analysis, and create further demands on utilities as well as regulatory agencies. This is in conflict with the task force's stated goal of shorting and streamlining the regulatory process. This is an important point to keep in mind in examining any of the regulatory reforms proposed by the various parties to the task force. It is important that the vehicles and mechanisms we consider in our goal of regulatory reform don't further complicate and encumber an already burdensome process.

The industry counters RUCO's first claim: The water industry is facing unprecedented capital demands to deal with growth, water supply and water quality. The shortage is *capital to invest* not *projects to invest in*. What rational buyer would pay even \$1.00 more than necessary to purchase a water company? The buyer would have no difficulty investing the amount of RUCO's inflated purchase price in actual water facilities that would provide hard assets and solve actual problems. RUCO's claims that a buyer would benefit and presumably realize "windfall profits" by inflating rate base are without merit. Limiting the California fair market value approach to only non-affiliated buyers and sellers would eliminate any incentive for collusion.

PROS AND CONS: RATE OF RETURN PREMIUMS

PROS: Would create a monetary incentive for the acquisition of non-viable systems.

CONS: None identified.

PROS AND CONS: SURCHARGE MECHANISM

PROS: Eliminates the lag between a company's outlay of cash for capital investments and the recognition of the investment in rates, which creates disincentives for acquisition of non-viable companies.

CONS: None Identified.

PROS AND CONS: DEFERRAL ACCOUNTING ORDER

PROS: Allow the acquiring utility to defer for future rate recovery extraordinary repair and maintenance costs necessary to improve the quality of service of the non-viable acquisition.

CONS: None identified (this issue was not addressed by any of the Task Force members other than RUCO).

2. Strengthen the financial capacity of the water utility industry.

PROPERTY TAX

One of the most contentious issues in many rate cases is that of the appropriate allowance for property taxes. Staff has two recommendations with regard to this issue:

1. Work with and/or lobby the legislature (and if necessary the Counties) to eliminate property taxes for water companies. If this could not be accomplished, then,
2. Staff should develop a policy/rule that would allow for a "Property Tax Adjustment Mechanism". This would work in the same fashion as a fuel adjuster mechanism.

The industry recommends that the existing manner of determining and paying water utility property taxes be replaced with a percentage of revenue tax that would be paid monthly to the Department of Revenue (DOR). Revenue is already a key variable in the formula used by the DOR to determine each water utility company's full cash value. The replacement tax would be an add-on to the customers' water utility bills. The tax collected could be reported and paid to DOR as part of the sales tax return. Industry is willing to help develop detailed recommendations and an implementation plan.

PROS AND CONS: PROPERTY TAX CHANGES

PROS: Changes in the current property tax policies could significantly enhance the industries financial capacity.

CONS: The legislature and/or counties may not be receptive to our ideas.

The industry pointed out other problems associated with property taxes and ratemaking and recommends that the Commission's current policy on these issues be reevaluated.

The industry believes that problems result because in Arizona, property taxes are based on beginning-of-the-calendar-year balances of plant accounts, with the resulting payment made in two equal installments—one in November and the other in May of the following year. To the extent a utility has filed a rate case using a calendar 1998 test year and December 31, 1998 rate base, and the case is being heard during May of 1999, the most recent tax bill that would have been received is that which reflects plant balances one year earlier than the end of the test year. No property taxes associated with 1998 plant additions would be provided for in new service rates. In that situation, the utility's actual property taxes prospectively will likely exceed those recovered in rates.

The industry believes that another factor leading to potential under-recovery of property tax expense under current Commission ratemaking practices is the fact that water utilities' property valuations include an element reflecting operating revenues during the tax year. Any adjustments to test year revenues (i.e., annualization to end-of period customer levels) and any authorized rate increase will ultimately cause property taxes to increase. In computing the gross revenue conversion factors necessary to convert earnings deficiencies into increases in annual revenues, it is just as important to consider the effect of additional revenues on property taxes as has traditionally been done with respect to revenue taxes, income taxes and unbilled revenues. The propriety of such

inclusion was recently recognized by the Arizona Court of Appeals who recently remanded to the Commission a rate order for Turner Ranches Water Company that failed to consider the effect of revenues in the determination of property tax valuations.

AUTOMATIC RATE CHANGES

Commission Staff proposes that all "C", "D" and "E" size water companies should be allowed to automatically (without filing a rate case with the Commission) increase the commodity portion of their rates each year by five percent (5%) or the amount of the increase of the Consumer Price Index (CPI) or perhaps the Producer Price Index (PPI) in Arizona, whichever is *less*. This increase would take effect May 1 of each year. However, in order to qualify to do this, a company must meet all of the following requirements:

1. Submit a request for such an increase by February 15 of the year in which the increase is to take effect.
2. Notice all its customers of the request no later than the date the request is filed with the Commission (a standard notice should be developed by Staff).
3. The request must be accompanied by a letter from the Arizona Department of Environmental Quality (ADEQ) stating, "ABC Water Company is delivering water that has no maximum contaminant level violations and meets the quality standards of the Safe Drinking Water Act."
4. The request must be accompanied by a letter from the Arizona Department of Revenue stating, "ABC Water Company is current on its sales tax obligations."
5. The request must be accompanied by a letter from the appropriate county stating, "ABC Water Company is current on its property tax obligations."
6. The request must be accompanied by a fully completed Water Use Data Sheet.
7. For the first time such an increase is requested, the company's present rates must have been approved in a full rate case that used a test year that is no more than three years prior to the year the automatic increase is to take effect.
8. Once such an increase is implemented, the company must file a full rate case at least every five years or five years from its last rate case, whichever is sooner.
9. The company must have had no formal complaints filed against it in which the Commission ruled against the company within the three years prior to the year in which the automatic increase is to take effect.

Staff believes that it is desirable to require companies using this program to file rate cases at least every five years for two reasons. First, it will insure that the automatic rate changes do not allow the company to consistently over-earn. Second, many small companies wait excessive amounts of time between rate cases, some as long as twenty years. This can be very problematic when rate cases are filed.

The Commission Staff would prepare a recommended order for Commission decision no later than April 30 of each year. The order would either deny or approve the increase. The order could contain conditions such as, but not limited to:

1. File a full rate case in less than five years,
2. Install certain plant within a given timeframe,

If a request were filed and not ruled on by the Commission by April 30, the increase would take effect as an interim/refundable rate. If the Commission later denied the increase, the rates would be decreased. The decrease would reduce the rates by twice as much as the increase and would be in effect for as long as the increase was in effect. After this time the rates would return to their original amount. Example:

- the original rate was \$3.00 per thousand
- the increase made the rate \$3.15 per thousand
- the company had the \$3.15 rate for May, June and July before the Commission issued an order stating that the rate increase was inappropriate and should be refunded
- The rate would be decreased to \$2.85 per thousand for the months of August, September and October
- In November the rates would return to \$3.00 per thousand

The industry supports Staff's proposal indicating it is a worthwhile concept. However the industry believes that the exclusion of "A" and "B" companies, the qualifying requirements and the annual two and one half-month timetable are arbitrary and likely to be unworkable. The industry is willing to help develop more detailed recommendations and an implementation plan.

RUCO believes that Staff's proposal to allow Class C, D & E utilities to raise their rates based on a CPI inflation factor is highly biased against ratepayers and will result in annual rate increases without a finding of fair value. Staff's proposal would assume generic across-the-board expense increases, and would ignore the very real fact that costs also decrease. It would also allow utilities to raise rates without examining the mitigating offsets such as customer growth, consumption growth, and depreciation of the rate base.

PROS AND CONS: AUTOMATIC RATE CHANGES

PROS: Provides a mechanism for small water utilities to deal with increases in their costs. Would provide an incentive for small utilities to file rate cases in a more timely manner.

CONS: Would allow utilities to raise rates without examining the mitigating offsets such as customer growth, consumption growth, and depreciation of the rate base.

FUTURE TEST YEAR

Currently, rate base for Arizona's water companies is calculated using an "historic test year." A recent 12 month period is chosen to be the "test year" and the expenses and capital in place during that year are used as the basis for setting rates. The industry favors a "future test year" policy. Under such a policy rate applications can include specific, highly scrutinized planning for capital expenditures and operating expenses that can be predicted with a high degree of certainty in both cost and timing. A rate adjustment applicant can provide a capital expenditure that details the degree of investment and the timing of it over future months and years. Rate adjustments can be granted from the perspective of a contract being entered into between the applicant and the Commission. Prospective rate adjustments can be conditioned on the amount of investment and the actual occurrence of expenditure. In the event capital expenditures for improvements to water systems are not made pursuant to the capital expenditure program filed as part of a

rate application, the previously granted rates would not become effective. The completion milestones of accomplished capital projects are sufficiently easy to measure to ensure delivery of actual benefit to the customer. The industry is not opposed to the adoption of prospective test years for rate applications with reasonable qualifications and conditions including punitive operational and economic consequences if a utility fails to make projected investments that were included in its forecasted test year rate base (without mitigating circumstances) for rate applicants that did not achieve the scheduled results.

According to the National Association of Regulatory Utility Commissioners ("NARUC"), the Commissions of approximately thirty (30) states permit the use of prospective test years for rate applications¹.

RUCO is opposed to adopting a future test year policy. They feel that there are numerous problems with its use. These include the setting of rates based on estimates that are not known and measurable, inclusion of plant in rates that is not used and useful, and violations of the matching concept when certain rate elements are projected or estimated and others are not. An historical test year inherently matches revenues, expenses, and investment, and contains known and measurable data. RUCO believes that the numerous problems and biases that result from the use of projected data far outweigh any potential benefit that could be derived from abandoning a historical test year.

Commission Staff is in the middle on this issue. Staff believes the Commission is currently using a very reasonable combination of historical and future test years. However, Staff recommends developing a policy/rule for allowing pro forma adjustments for future plant additions that met very specific requirements, such as, but not limited to:

1. Revenue-neutral plant, i.e., will serve existing customers and not future growth.
2. The plant will be installed within a specific time frame, preferably within one year.
3. The plant is necessary to provide proper and adequate service to existing customers.

NOTE: Although the above suggestions are highly likely to save time, effort and money for the water companies and their rate payers, most will require additional Commission Staff to process, analyze and monitor (particularly monitor to insure adherence with all the required conditions) in a timely manner.

PROS AND CONS: FUTURE TEST YEAR

PROS: A future test year policy may encourage necessary capital expenditure by Arizona's water companies. This is because such a policy would result in a reduction of the "regulatory lag" often associated with recovery of such expenses.

CONS: Rate setting will involve estimates of future costs that are unauditable at the time rates are set. Will place additional burdens on Commission Staff resources.

GENERIC HOOK-UP FEES

¹ 17th Annual Western Utility Rate School, April 1997, San Diego, California.

Commission Staff has recommended and the Commission has approved Off-site Facilities Hook-up Fees for a handful of water companies in the past. The process that was used required both water companies and Staff to expend a substantial amount of time and effort. Staff recommends developing a generic hook-up fee policy/rule that would allow water companies to collect from new customers a portion of the cost of new wells and storage tanks that will have to be installed in the future. As in the past, any plant that was installed using hook-up fees would be considered contributed plant.

The reason for having the hook-up fee pay for only part of the new plant is to insure that the company retains a balance between contributed plant and its own investment.

The industry supports Staff's proposal while recognizing that many details need to be worked out. The industry emphasizes that generic approaches should not be mandatory in all cases, case specific facts and circumstances should always be considered. The industry is willing to help develop detail recommendations and an implementation plan.

RUCO agrees that working toward a recognized methodology for the use of hook-up fees is a desirable objective. However, comments from the water task force members on this issue were limited and more discussion on this topic is needed.

PROS AND CONS: GENERIC HOOK UP FEES

PROS: 1) Will free up time and resources currently expended on individual hook-up fee applications

2) Will establish a consistent rule or policy for all water utilities

CONS: The details of this plan need to be worked out, care must be used to ensure that the specific details of the generic hook-up fees do not create any undesirable or unanticipated impacts.

PLANT REPLACEMENT FUND

One of the most significant problems facing the Water Industry today is the required re-building of the existing infrastructure as it approaches the end of its useful service life. Based on a recent survey by the Environmental Protection Agency, it is presently forecasted that such investment needs nationwide during the next twenty years approaches \$140 billion, of which nearly \$80 billion relates to transmission and distribution system replacement. While substantial federal and state funding is available, it is clear that such amounts represent only a portion of the overall financing needs. Utilities and the customers served thereby will be called upon to provide the remainder.

The industry indicates that under current regulatory policies and practices, utilities must first obtain or provide the necessary amounts to fund construction projects and see them to completion before seeking rate recovery. This is consistent with the traditional "used and useful" ratemaking standard which prohibits charging current customers for the costs of capital assets not yet devoted to the provision of service. Once the assets are

deemed to be used and useful, there begins a period for rate setting which generally delays the commencement of capital cost recovery. The problem is exacerbated due to the fact that so many of the projects are ongoing and short in duration. The industry feels that this subjects many utilities to a game of constant catch-up. Given the tremendous projected capital requirements for future infrastructure replacement, the industry (and Staff) believes that the need for a new regulatory tool is clear.

Staff recommends that a policy/rule be developed whereby water companies would be allowed to collect in rates money that would be placed in a separate interest bearing account that could be used only to replace aging infrastructure or major plant that experienced a catastrophic failure. The fund would be established during a rate case and contributions to the fund would be in excess of the revenue necessary for the company to earn its approved rate of return.

All water systems will eventually need to have equipment replaced. Staff believes that establishing a fund for such replacement would assist in insuring that the customers receive quality service and that the company is not caught by surprise in having to replace major portions of plant. This fund should not be allowed to be used for normal annual expenses that should be taken care of in ordinary rates, but should only be used for extraordinary expenditures for replacement of infrastructure due either to age or emergency. Staff believes that another customer protection that should be instituted for the plant replacement fund is that any plant installed with these monies could be considered a contribution. Staff recognizes that the tax implications of a plant replacement fund need to be carefully considered when or if the details of this policy are worked out.

In addition, Staff believes that if a company does receive approval for a plant replacement fund, consideration should be given to reducing the rate of return the company is allowed to earn. The reason for this is that Staff believes that such a fund should substantially reduce the risk a company is incurring. The industry does not agree with Staff on this issue.

The industry advocates adoption of a similar policy: the Pennsylvania Public Utility Commission's (PPUC) Distribution Service Investment Charge (DSIC). The DSIC is a surcharge that allows Pennsylvania water utilities to recover the costs of specific types of revenue-neutral capital investments. A key expected benefit of the DSIC is that it will enable utilities to accelerate infrastructure replacements, since such projects will be more affordable for both the utilities and their ratepayers. Other potential benefits include greater rate stability and lower rate case filing expenses.

Under the DSIC program, at the end of each quarter utilities identify the original cost of eligible distribution system improvements placed in service during that period, net of accrued depreciation. These amounts are then used to compute a surcharge reflecting the associated depreciation expense and a return on investment. The return on investment is based on actual capital structure and debt, preferred equity costs as of the end of the calculation period, and the cost of equity approved in the company's last general rate case. Such information must be filed with the PPUC Staff and Pennsylvania's Consumer Advocate at least ten days prior to the effective date of the surcharge.

Only the following investments are covered by the DSIC:

- Services, meters, and hydrants installed as in-kind replacements.
- Mains and valves installed as replacements for worn out facilities or as upgrades to meet PPUC requirements.
- Main extensions installed to eliminate dead ends and to implement solutions to regional water supply and/or health problems.
- Main cleaning and relining.
- Funds needed to relocate facilities necessitated by highway construction.

The PPUC's DSIC policy includes the following provisions to ensure that ratepayers are protected:

- The DSIC surcharge is limited to 5% of the customer's total bill.
- Utilities using the DSIC surcharge are audited annually. Over collections resulting from the surcharge are refunded with interest and under collections are billed in future rates without interest recovery.
- The surcharge is set to zero when new base rates are calculated.
- The surcharge is set to zero if it is determined that the company is over earning.
- Investments covered by the surcharge reflect used and useful plant placed into service during the three-month period prior to the surcharge's effective date.
- Customers must be notified about any changes in the surcharge.

Currently five Pennsylvania water companies are using the DSIC surcharge. These five companies serve over 50% of Pennsylvania's private water customers. The staff of the PPUC regards the DSIC system as a success. A number of other states have since begun considering the introduction of such a mechanism. Most recently, the Illinois legislature passed a bill designed to give the Illinois Commerce Commission the requisite authority to introduce such a mechanism in that State. Arizona Commission Staff is not opposed to a policy similar to Pennsylvania's DSIC.

RUCO agrees that such a mechanism, if properly designed, has the potential to promote the upgrading of deteriorating water systems, without harmful or biased rate impacts on customers.

Commission Staff is not opposed to implementing a policy similar to Pennsylvania's DSIC. However, Staff is concerned that such a policy may overwhelm the Commission's resources if several companies apply at one time. If this is deemed to be a real problem, Staff believes that the DSIC policy should be modified to mitigate this potential problem.

PROS AND CONS: PLANT REPLACEMENT FUND

PROS: Would help facilitate the upgrading of aging water systems and if designed after the Pennsylvania mechanism, would not allow utilities to recover investment prior to their being used and useful.

CONS: 1) The DSIC policy may strain Commission Staff resources.

2) (RUCO) Would allow the utility to mitigate regulatory lag that is unfavorable to the utility, but would not mitigate regulatory lag that is unfavorable to ratepayers. Potential matching/bias problem *if not properly designed*.

DEPRECIATION

In the mid 80's the Commission attempted to increase water companies cash flow to a level that would cover their established cash expenses and debt service requirements. Depreciation rates were doubled for small water utilities, increasing from approximately 2.5% to 5%. This increased cash flow but created other long term problems. Specifically, funds received through the artificially high book depreciation rates were not available to be reinvested in plant; they were required to meet cash expenses and debt service. Also, the high book depreciation rates resulted in net utility plant being exhausted (zero rate base value) at a time when the physical facilities had 20 to 30 years of additional life. (Most water plant has a 40 to 50 year life, under the 5% depreciation rate its economic value is gone at 20 years.)

The effects of the Commission's past depreciation policy will extend over the next 20 to 30 years. Once utility plant is fully depreciated, providing adequate earnings and cash flow becomes very challenging. Since rate base is zero or perhaps even negative the traditional ratemaking formula doesn't produce any authorized net operating income and allowances for depreciation expense are no longer available. Without net operating income or a depreciation allowance there is no source of funds for plant investment.

Today's Staff recognizes the error of a 5% depreciation rate and is recommending changing to a more realistic rate during general rate proceedings, however the industry believes that additional changes are necessary to address the problem over the remainder of this utility plant cycle. Such changes could include increases in allowed rates of return to compensate for the early exhaustion of net utility plant; pro forma staff rate case adjustments to net utility plant:

(1) to eliminate depreciation allowances that were not recovered through the rates; (2) to add back an increment of utility plant in rate base computations as if it had been depreciated over its economic life on a straight line basis (recognizing that the Company should have earned a fair return *on* its investment over the life of the plant; an additional depreciation allowance would not necessarily be provided because the company has already recovered a return *of* its investment); (3) as the depreciation rate is reduced from 5% to 2% or 2.5% during a rate proceeding replace the lost cash flow with a rate of return adjustment, i.e. a 3% or 2.5% return increment respectively on gross utility plant; (4) authorize an Operating and Maintenance Reserve that would be funded by an annual charge equal to 1% to 5% of utility plant. The charge would be deposited in a restricted interest bearing account that could only be used for operations or maintenance expense items not included in the authorized rates, for example major pump repair, tank painting, etc.

Commission Staff and RUCO are opposed to the industry's proposals. Both Staff and RUCO believe that the industry's proposals constitute retroactive ratemaking and would result in double payment by consumers.

Staff recognizes the problems that the industry points out but Staff believes these problems can be solved through a much simpler policy. Since when rate base is zero or negligible the traditional ratemaking formula doesn't produce any authorized net operating income, Staff believes that the traditional ratemaking formula should be abandoned for companies with near zero rate bases. Rates for such companies could be set on an operating margin basis. Plant replacements could then be handled with a mechanism similar to the Pennsylvania DSIC or plant replacement fund discussed above.

Setting rates on an operating margin basis involves determining the companies operating costs and setting rates that cover those costs plus a percentage, or "margin," that can be used for reinvesting in plant or other purposes.

PROS AND CONS: INDUSTRY RECOMMENDATION FOR CORRECTING PAST EXCESSIVE DEPRECIATION RATES.

PROS: Would provide small water companies with needed capital.

CONS: Would result in retroactive ratemaking and double recovery.

PROS AND CONS: COMMISSION STAFF RECOMMENDATION FOR CORRECTING PAST EXCESSIVE DEPRECIATION RATES.

PROS: Would provide small water companies with needed capital. Would not be complicated.

CONS: May not be appropriate for all utilities.

3. Provide greater emphasis on simplifying, shortening, and reducing the cost of the ratemaking process.

PASS THROUGH MECHANISM (SB1252)

In 1997, the Arizona Legislature passed Senate Bill 1252. This bill was enacted to create the statutory basis for the Arizona Corporation Commission to implement a mechanism under which regulated water utilities may be afforded an opportunity to reflect in rates the effects of changes in specific costs without the necessity and expense of filing a general rate case. The operating costs that may be considered in this procedure are limited to specific, readily identifiable costs that are subject to the control of another person, including the cost of purchasing electricity or gas, the cost of purchasing water from another utility or municipality, and the payment of proper taxes or similar taxes and assessments that may be levied on the utility.

Thus far only one utility has applied to the Commission for authority to adjust rates under the provisions on this mechanism. There are a number of reasons that have been cited for the lack of utilization, including ambiguities in the language of the statute and concerns about the symmetry that would exist between rate increases and rate decreases. However, according to the industry, the common understanding is that the Staff's proposed surcharge rules presented to the Water Utilities Association at their annual meeting were unreasonable. Staff proposed that a company that filed for and received a postage surcharge, for example, would have to file sur-refunds not limited to decreases in postage cost but including decreases in ANY of the other cost elements eligible for surcharge treatment. This would be required even though the Company had not been passing on increases in these other cost elements.

Current policy lacks the support of a prior decision, policy statement, rule or any official position of the Commission. The industry believes that clarity of the intent and application of S.B. 1252 is needed before its usage will achieve the objectives of its promoters and supporters. The industry recommends that the Commission clarify their policy on surcharge applications and limit increases or decreases to the specific operating cost included in each companies approved surcharge(s). This matter might also be explored to determine what changes (i.e., legislative, procedural, etc.) might be made that would foster expanded use of the mechanism.

RUCO is opposed to the industry's proposal. They feel that the proposal is extremely biased against consumers since, with the industry proposal, cost increases will be past on to consumers but cost decreases will be ignored.

PROS AND CONS: INDUSTRY PROPOSAL FOR SB 1252

PROS: Would allow companies to recover increases in costs that were outside of their control.

CONS: Will allow utilities to raise rates outside of a rate case for those costs that have increased yet would not recognize cost decreases. Biased against ratepayers.

RATE OF RETURN

Many members of the Task Force suggested that one way of shortening the rate case process was to develop a generic rate of return that would apply to all water companies. Staff does not believe that this would be workable in many cases that come before this Commission because so many of the companies have very little rate base with which to work. However, Staff would recommend developing a policy/rule that would allow a water company to choose which method it preferred for Staff to compute its revenue requirement. The three choices could be:

1. Generic rate of return. The Cost of Capital Group within the Accounting & Rates Section could develop a rate of return appropriate for Arizona water companies on an annual, semi-annual or other appropriate timeframe. This rate of return would then be applied to each individual company's rate base.

2. Operating Margin. This would apply to those companies not having a large enough rate base to allow for a meaningful rate of return.

3. Individual Rate of Return. This would allow a company to go through the typical rate of return case and not use the generic rate of return if the company believed the generic return did not apply to it.

The Industry supports Staff's proposal and is willing to help develop a more detailed plan.

RUCO supports Staff's proposal with one caveat: they feel that a generic rate of return would be inappropriate for large (class A and B) utilities since the rate of return for larger utilities is a highly material item and is dependant on more than the current economic and financial environment. The individual characteristics of a utility effect rate of return (i.e. capital structure).

PROS AND CONS: STAFF PROPOSAL ON RATE OF RETURN SIMPLIFICATION

PROS: Rate of return is typically a resource intensive portion of a rate case, and predetermining the rate would certainly simplify and shorten this portion of a rate case.

CONS: May not be appropriate for all utilities.

ELECTRONIC FILING

The industry and Staff recommend developing an electronic filing procedure that could be used by any water company with a computer (this would be for all filings with the Commission, i.e., rate cases, financing cases, annual reports, etc.). The current filing process could be significantly enhanced by creating a library of standard reporting forms on computer disks that could be copied for use by affected companies.

This process should include exact copies of the electronic spreadsheets used by Staff in the assessment and analysis of rate applicants' filings. Many major regulatory agencies such as the Federal Energy Regulatory Commission, Federal Communications Commission, and the Securities and Exchange Commission, already allow companies subject to their jurisdiction to file annual reports via electronic means. The Commission has talked about just such a thing in the past. The largest impediment in accomplishing this goal has been resources – both in manpower and funds. Once the resources are available, Staff recommends proceeding with this item as a high priority.

RUCO supports the Staff and industry position.

PROS AND CONS: ELECTRONIC FILING.

PROS: Would simplify and reduce the cost of rate filings.

CONS: Implementation would require significant resources.

The industry is concerned about the volume and extent of informational and other filing requirements imposed by the Commission. Some of the requirements originated many years ago when circumstances were quite different from today, and prior to the introduction of sophisticated computer tools that are now at our disposal. Therefore, the industry recommends that a determination be made with respect to the continuing need for and value of the quantity and variety of information presently required to be filed with the Commission. This would encompass an assessment of the current rate case filing requirements, required annual report contents, and the level of detail that water utilities are obligated to include in other types of filings.

Staff believes that such an assessment should be made at the time the Commission implements an electronic filing plan.

MAIN EXTENSION AGREEMENTS (MXAS)

Commission Staff, the industry, and RUCO agree that a new Main Extension Agreement (MXA) rule would be beneficial. The industry and RUCO support the proposal from the Commission Staff that recommends establishing a new MXA rule that requires that each water company submit an MXA tariff detailing exactly the company's MXA procedure. Once the Commission approved that tariff the company would simply have to adhere to that tariff and thus not require Staff to review and approve each and every single MXA. In order for the MXA tariff to remain in effect, the company would have to submit, by each February 1, a letter from (ADEQ) stating, "ABC Water Company is delivering water that has no maximum contaminant level violations and meets the quality standards of the Safe Drinking Water Act."

In addition, Staff recommends changing the present refund mechanism to allow water companies to enter into MXAs that would refund portions of the actual monies collected (the amount actually paid for the plant) and not just a portion of the revenue collected. This would allow water companies to collect a fair share of main extension costs from all customers connecting to a main and not just from the first connection, i.e., customers connecting after should not be allowed to have a “free ride”.

PROS AND CONS: TARIFFED MAIN EXTENSION AGREEMENTS

PROS: Will eliminate the redundancy of approval of each individual agreement a utility enters into with developers and customers.

CONS: As with other regulatory reform proposals, care will need to be taken to ensure that the final rule on MXAs will not create any new regulatory problems or have any unanticipated adverse impacts on customers.

4. Improve Consumer Education.

Both industry and consumer members of the Task Force acknowledge the need for greater consumer education. Many consumers are unfamiliar with the basics of the regulatory process and therefore are reluctant to intervene in cases that directly effect them. Industry and consumer members of the Task Force recommend that RUCO be encouraged to produce a publication (or publications) explaining basic issues in the water utility industry such as:

1. How the rate case process works.
2. What rate base is and how it is calculated.
3. How to read a balance sheet and income statement.
4. How to form a water users association.
5. How to intervene in Commission proceedings.
6. Basic negotiation skills.

These publications should be placed on the Commission's web site, or a separate web site, in order to facilitate maximum public exposure.

RUCO also suggested that public meetings be held throughout the state. The purpose of these meetings would be to educate consumers regarding the different state agencies that deal with utilities and each agency's specific role. The meeting would also present information regarding the various options open to consumers when they have complaints/ concerns regarding their utility company. Meetings would be announced via advertising in local newspapers.

The only impediment to implementing the above policies is the availability of funds. Both the Commission and RUCO would likely require additional appropriations for these projects.

The Task Force members also recognize that operators of many small water companies may lack the necessary regulatory knowledge to file effective rate cases. Industry members of the Task Force felt that workshops conducted by the Commission Staff were very effective in educating water company operators in rural areas. The Task Force strongly encourages Staff to continue these workshops. Staff has indicated that these workshops are currently underway.

Industry members of the Task Force also recommend that the COMMISSION encourage, on a voluntary basis, water companies to distribute educational publications to their customers. These publications could include company newsletters, Customer Service Reference Guides, and/or publications from organizations such as the American Water Works Association.

Many small water companies do not have the resources to produce quality educational publications. Staff recommends that large water companies that are currently producing high quality educational publications make those publications available to smaller water companies to use as models.

PROS AND CONS: CUSTOMER/INDUSTRY EDUCATION

PROS: Would be of direct benefit to both customers and the industry.

CONS: The proposals would require additional appropriations for the Commission and for RUCO.

5. Other Issues

PHASE IN OF RATES

Commission Staff recommends the adoption of a rate phase-in policy. Under such a policy rate increases that were considered to be "large" could be phased in over time. This could avoid "rate shock" and thus allow water companies to come in for rate cases on a less frequent basis, thereby saving the company and its customers rate case expense and the Staff time and effort. Staff believes that under such a policy rates could still be set that allowed the company full recovery of its authorized rate of return.

Staff recommends developing a policy/rule that would define what a large rate increase is, based not only on a percentage increase, but also on the actual rates. For example, an increase from a \$5.00 minimum and \$0.50 per thousand gallons to a \$10.00 minimum and \$1.00 per thousand would be a 100% increase. The question is whether this is a large enough rate increase to require a phasing in of the new rates or were the original rates so low that a 100% increase in this case would not be unfair to the customers, but anything less would be unfair to the company.

Staff sees rate phase-ins as a means to deal with special circumstances, not as a general policy for all rate cases. Staff believes that phase-in rates can be very helpful in dealing with (for example) situations where small water systems are making very large investments in their infrastructure. This was the case in Decision Number 61275 (docketed in December of 1998) where the Commission approved a rate phase-in plan for Alpine Water System, Inc.

The industry opposes this idea. They feel that such a policy could result in the deferral of the full amount of the revenue requirement until a later date. If so, phase-in of rates could damage the financial capacity of the industry.

PROS AND CONS: PHASE-IN OF RATES

PROS: Could alleviate "rate shock."

CONS: Could result in under-recovery for water companies.

RATES TIED TO CONDITIONS

Commission Staff proposes that all rate increases should be conditioned on the company providing acceptable quality service, installation of plant, repair of plant, water quality, etc. Therefore, Staff recommends that a policy/rule be developed to outline what the conditions would be and what the consequences are if the water company does not meet those conditions. The industry and RUCO did not comment on this proposal.

PROS AND CONS: RATES TIED TO CONDITIONS

PROS: Would make necessary rate increases more acceptable to consumers, while holding companies responsible.

CONS: May result in additional work for Staff and companies.

III. CONSERVATION SUBCOMMITTEE

The Conservation Subcommittee of the Commission's Water Task Force mainly focused on coordination between the Commission and the Arizona Department of Water Resources (ADWR.)

BACKGROUND ON ADWR POLICY:

In order to insure adequate conservation of ground water, the ADWR *requires* large private water companies within active management areas (AMAs) to meet certain gallons per capita per day (GPCD) requirements. The GPCD requirements vary across companies based on the geographic location of the company and other factors. The ADWR evaluates companies based solely on whether they meet their GPCD requirements. Companies are free to use whatever conservation measures they deem appropriate to meet the GPCD requirements. Generally, the ADWR does not force companies to use any specific conservation measures, although the ADWR assumes that water providers will implement one or more conservation measures in order to comply with the GPCD requirement. Only *after* a company consistently fails to meet its GPCD requirement will the ADWR issue a Consent Decree that forces the company to adopt a specified conservation program. It should be stressed that complying with the ADWR's GPCD requirement is not discretionary by private water companies (within AMAs); although the choice of which conservation measure to implement is up to the private water company.

PERCEIVED PROBLEM

Industry, consumer, and ADWR representatives on the Task Force indicated that a problem exists because a company that expends funds on conservation programs in order to meet the ADWR's GPCD requirement may not be able to recover fully those expenditures through rates. This is because conservation expenditures may not meet the Commission's "used and useful" standard. The Commission may disallow the conservation expenditures because they were not specifically mandated by the ADWR. However, Commission Staff indicates that this has never happened in practice. Due to this uncertainty and the uncertainty that compliance can be achieved by the implementation of the conservation measures, companies may be reluctant to invest in conservation programs.

The industry recognizes another problem that was not openly discussed, as part of the Task Force. That problem is the regulation of private water companies by two state agencies, namely ADWR and the ACC. The regulations from both agencies are sometimes in conflict, as can be seen concerning water conservation – ADWR requires conservation and the ACC requires that the private water company furnish water on demand to all customers, even if it would cause a private water company to exceed its GPCD limit.

PROPOSED SOLUTION:

The Conservation Subcommittee of the Commission's Water Task Force recommends a program whereby companies can voluntarily seek approval of their conservation programs from the ADWR prior to their application to the Commission for the recovery of conservation costs. Under the program the company will present its conservation program to the ADWR. The ADWR will examine the conservation program and will determine the following: 1) is a conservation program necessary in order for the company to meet its GPCD requirement? 2) Will the company's conservation program allow the company to meet its GPCD requirement? 3) Is the conservation plan reasonably efficient? That is, is there no other potential conservation plan that would allow the company to meet its GPCD requirement at a significantly lower cost?

If the ADWR determines that the answers to all three of the above questions are yes, the company can file a written statement of that determination with its rate application to the Commission. Commission Staff proposes that the Commission should strongly consider the ADWR's determinations concerning the conservation plan when processing the companies rate application.

The industry and ADWR believe that the Commission should do more than strongly consider the ADWR's determination. They recommend that if the ADWR has made such a determination than the Commission should automatically allow for the recovery of conservation costs. They believe that Staff's proposal does not mitigate the uncertainty associated with conservation expenditures. Industry believes that if the ADWR can determine the effectiveness of the conservation measures and the ACC determines the cost-effectiveness of the conservation measure, the ACC should allow full cost recovery.

Staff is opposed to the industry/ADWR proposal because Staff believes that the Commission should have final say on cost and rate determinations. The Staff believes that companies may "gold plate" their conservation programs and then attempt to pass on unreasonable costs to their customers, although this has generally not been the case with private water companies. During meetings of the conservation subcommittee the ADWR indicated that they were not prepared to make determinations on the reasonableness of company costs, since auditing is not their specialty.

This process could be used by a water company that is applying for rates through a traditional rate case or, potentially, through ARS 40-370. Although some members of the conservation subcommittee are of the opinion that ARS-370, which allows for the pass through of costs outside of a water companies control, should apply to costs associated with meeting the ADWR's GPCD requirements, Staff does not concur.

PROS AND CONS: STAFF'S CONSERVATION COST PROPOSAL

PROS: Would (in Staff's opinion) mitigate some of the uncertainty involved in recovery of conservation cost.

CONS: Would (in industry/ADWR's opinion) not mitigate any of the uncertainty involved in recovery of conservation cost nor (in industry's opinion) would it guarantee compliance with the ADWR's GPCD requirement.

PROS AND CONS: INDUSTRY/ADWR'S CONSERVATION COST PROPOSAL

PROS: Would mitigate some of the uncertainty involved in recovery of conservation cost, although (in industry's opinion) it would not guarantee compliance with the ADWR's GPCD requirement.

CONS: Would put final say over the appropriateness of costs with the ADWR, which has little expertise with auditing.

RATE DESIGN

Commission Staff believes that, in order to promote conservation, the rate design for all water companies should incorporate at least a three-tiered inverted rate structure. Staff believes that inverted rates will promote some conservation. All parties agree that, regardless of where a company is located in this State, the Commission should be encouraging conservation. Staff believes that the primary mechanism that the Commission has for such promotion is rate design. In addition, with providing a three-tiered rate design, those people that truly conserve, will save money. Customers that use very little water each month will have a very small water bill. Staff believes that it is desirable that customers should be rewarded for conserving.

Staff's proposal is as follows: At the time of a rate case, two gallonage per month limits (lower and upper) and three rate tiers should be established (bottom, middle, and high.) Customers whose consumption is below the lower gallonage limit will be charged the bottom tier rate, those with consumption between the two limits will be charged the middle tier rate, and customers with consumption above the upper limit will be charged the highest tier rate.

The bottom tier would be less than break-even, the middle tier would provide the desired rate of return, and the highest tier would provide more than the approved rate of return. By setting rates in this manner the Commission would likely be providing the company with revenues in excess of those necessary to generate its approved rate of return. To remedy this over-earning (a company should not be allowed to over-earn, without some very hard, strong and definite strings attached), the company could be required to put 75% of all monies generated by the third tier rates, or 90% of all over-earnings, into a separate interest bearing account. Why only put a percentage of the third tier rates or a percentage of all over-earnings into the separate account? The two primary reasons are:

- a. There is some cost for producing this water. The company should be allowed to recover this cost.
- b. There is the possibility that with such a rate design there could be a significant amount of conservation. If this is the case, there is a possibility that the company could be prevented from earning its allowed rate of return.

The money from this account could be used:

1. To pay penalties to the Arizona Department of Water Resources for not meeting conservation goals,
2. To pay for conservation programs,
3. To pay for CAP water (if used and useful),
4. To pay for the installation of new water production facilities (wells or surface water treatment plants) and/or storage tanks that would be considered as contributed plant,
5. To build up a plant replacement fund, with plant paid for by these monies considered as contributed plant,
6. Any other Staff recommended expenditure.

The above expenditures could not be made without Commission approval and would be audited on a regular basis. The monies collected from the third tier or over-earnings that were set aside in the interest bearing account could not be used for normal everyday expenses, nor operation and maintenance expenses, nor salaries and wages of any type, etc. In addition, the company would be required to file a full rate case at least once every five years.

Staff believes that it is unlikely that the above policy will result in under-earnings for the company. However, if under-earnings do occur, Staff believes that the company should have recourse to recover the "lost" revenues. Also, Staff stresses that this is not a "cookie cutter" approach to rate design. The rate tiers and gallonage limits would be determined on a company by company basis while taking the particular circumstances of the company into account.

The industry is strongly opposed to Staff's three tiered rate proposal. They believe that the proposal could result in significant under-earnings.

RUCO is also strongly opposed to Staff's three tiered rate proposal. They believe that the proposal, "fail(s) to capture the essence, purpose, importance, and complexity of rate design; (is) unsound and (un)supportable; and generate(s) a plethora of inequities, new problems, and unanswered questions." They are concerned that the proposal could result in significant over-earnings and they point out that there is no guarantee that the proposal will actually result in increased conservation.

PROS AND CONS: STAFF'S THREE TIERED RATE STRUCTURE

PROS: Could provide the Commission with a mechanism to promote conservation.

CONS: May result in over/under-earnings. There is no guarantee that the proposal will actually promote conservation. Would add another layer of complexity to water utility reporting and accounting. Would not guarantee compliance with the ADWR's GPCD limitation. Could penalize large families who are using water in compliance with GPCD limitations. May provide disincentives for commercial/industrial development in those areas with tiered pricing. May not adequately consider the facts specific to any one water provider and would arbitrarily impose three-tiered pricing on the private water company.

IV. WATER SUPPLY SUBCOMMITTEE

The Water Supply Subcommittee's (WSS) primary focus was the planning for long term water supplies, such as those provided by the Central Arizona Project (CAP), and how to recover their costs in such a way that is fair and equitable to both the water companies and their customers. The recovery of CAP costs was the single biggest problem that the WSS identified. CAP cost recovery is problematic because companies with CAP allocations must pay for their CAP water whether they use it or not. Such companies are reluctant to give up their allocations because, even though they are not used currently, they may be needed in the future. There were many differing views expressed in the WSS, such as, allowing the recovery of CAP costs just because they are incurred to not allowing them at all until there is actually CAP water flowing through the pipes of a company. Staff proposes that the Commission adopt a combination or compromise position.

Commission Staff proposes that CAP costs should be recoverable on an interim basis once a company has submitted to the Commission, and the Commission has approved, a plan to actually use CAP water. The company must commit to using the CAP water within five years of the approval of the plan, with no time extensions allowed. The recovery would be on an interim basis because if the company did not implement the plan within the five-year time frame, it would be required to refund the monies collected back to its customers.

The recovery of CAP costs would be part of permanent rates and could be set up as an adjuster once the CAP water is actually used by the company. The reason for setting up these costs as an adjuster is because history has shown that these costs are anything but stable. The prices being paid by water companies today for CAP water are much higher than ever projected in the 1980s. Staff believes that these recommendations on handling CAP costs will further promote the use of CAP water. The industry believes that this method of handling costs may force the water industry to use more CAP water than is necessary before it is fully needed or in the event that certain factors prevent the full use of a water provider's CAP allocation, the loss of CAP water supplies could result.

Many members of the WSS believed that a standardized application for approval of cost recovery plans should be developed. The standardized application would include the technical information necessary for the Commission to make an informed decision. A standardized application would remove some uncertainty for companies and customers. The WSS members have started the development of such a standardized application.

Many times the water industry has stated that the Commission and its policies were at direct odds to the groundwater conservation policies of Arizona. Staff disagrees with any such assertion. Staff believes that the Commission has been one of the few, if not the only State agency that has promoted the *actual use* of CAP water. Simply holding on to and paying for a CAP allocation does nothing to conserve groundwater.

However, Committee Members agree that the loss of CAP water, such as when a private water company can no longer afford to pay the holding costs of CAP, would be detrimental to the private water company's customers. The only way to conserve and/or preserve groundwater is to use less of it or replace it (e.g., through the recharge of CAP water). Using CAP water is one of the primary ways to use less groundwater. The Commission has always had a policy of allowing the recovery of CAP costs once CAP water was used. Staff believes that continuing this policy with the modification suggested above will further encourage the *use* of CAP water and not just simply the holding of it.

The WSS agreed that cost recovery for long term water supplies could be accomplished outside of a rate case in most instances. However, if the company is small enough or the costs associated with long term water supply are large enough to significantly change the companies entire cost structure, the Staff believes that a rate case is necessary.

The ADWR and the Industry believes that Staff's proposal is a positive step. However, they feel that the proposal does not go far enough towards ensuring the recovery of CAP costs. The ADWR believes that Staff's proposal should guarantee the recovery of the cost of the companies entire CAP allocation regardless of how much of the allocation is used within the first five years. They also point out that while the ADWR would clearly prefer to see the use of CAP water replace mined groundwater as early as possible, this may not always be practical within the five year period. Also, the capital charge component of the CAP water, while significant, is minor in comparison to infrastructure costs associated with full CAP utilization.

As an alternative to Staff's proposal, the ADWR proposes that capital charges for the entire allocation be recoverable immediately if the company develops a plan which demonstrates that: 1) demand projections for the next 20 years equal or exceed the CAP allocation; 2) a portion of the allocation, determined on a case by case basis between ADWR, the Commission and the company, will be used within the first five years either through direct delivery or by recharging the water in a location which contributes to groundwater availability in the area of the provider's wells; and 3) the use of CAP will increase over a period of time (to be determined in each case) up to the extent of the allocation.

The ADWR also proposes that once a provider has exhausted its CAP supplies (i.e. they are being fully utilized), groundwater use that is replenished by the Central Arizona Ground Water Replenishing District (CAGRDR) should be handled similarly. For example, to the extent that a regulatory structure is established for member lands which provides for replenishment in an area where the provider's wells will pump the water, CAGRDR assessments should be fully recoverable. Such a structure was established for member service areas in last year's legislative session at the urging of Scottsdale and other providers. A similar proposal for member lands may be considered in this next session. The Industry believes that the ADWR's proposal for CAGRDR membership and associated assessments may be necessary for some private water companies, especially where physical availability has been identified as a problem. Cost recovery in these instances should be allowed by the ACC. Membership in the CAGRDR may also provide a mechanism for new growth to occur or to resolve conservation requirements.

RUCO is opposed to both Staff's and the ADWR's proposals. RUCO believes that the recovery of the cost of CAP allocations should not be allowed until the allocation is actually being used. They contend that it is speculative and hypothetical to project what a company *may* do with CAP water over the next 5 years. RUCO has stressed the idea that the used and useful principle of ratemaking rules out proposals such as Staff's and the ADWR's. According to RUCO, the used and useful principle cost recovery can only be allowed for water that is actually being used at the time the company applies for recovery.

RUCO stresses that companies do not need to be actually delivering CAP water to their customers in order for the CAP allocation to be considered used and useful. Alternative usage arrangements such as groundwater replenishment, water exchange agreements, etc. are acceptable to RUCO. RUCO has recently supported CAP cost recovery for three companies with such alternative usage plans: Paradise Valley Water Company rate case (Decision No. 61831), Citizens Utilities' Sun City Water Company, and the Sun City West Utilities Company. RUCO proposes that companies seeking recovery of costs associated with unused CAP allocations should be encouraged to actively seek such alternative usage arrangements.

The industry opposes RUCO's water supply recommendations. They believe that RUCO's comments reflect a single-minded focus on rate minimization rather than open-minded consideration of various alternatives and do not reflect support for long range planning. Long range planning must extend well beyond a 5-year planning horizon. Each AMA has a slightly different goal and each water provider has unique water needs.

PROS AND CONS: STAFF PROPOSAL ON CAP COST RECOVERY

PROS: Would allow recovery of costs while encouraging companies to actually use their allocations.

CONS: Cost recovery would be based on projections of future activity over five years. The Industry believes that the proposal could force water providers to use more CAP water than is needed within five years and in the event that a water provider could not put CAP water to use within 5 years could force the water provider to relinquish its CAP allocation.

PROS AND CONS: ADWR PROPOSAL ON CAP COST RECOVERY

PROS: Would allow recovery of costs while providing some encouragement for companies to actually use their allocations. Allows for longer-range water planning than either the Staff or RUCO's proposals.

CONS: Cost recovery would be based on projections of future activity over twenty years.

PROS AND CONS: RUCO PROPOSAL ON CAP COST RECOVERY

PROS: Would encourage the actual use of CAP water.

CONS: May not allow for cost recovery for companies that are making a good faith effort to put their CAP allocation to use in the near future.

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Appendix: Comments of individual members

**COMMENTS FROM THE INDUSTRY REPRESENTATIVES OF
THE WATER TASK FORCE**

Submitted August 17, 1999

I. REGULATORY REFORM GOAL:

**STRENGTHEN THE FINANCIAL CAPABILITY OF THE
WATER UTILITY INDUSTRY**

1. Distribution infrastructure replacement cost recovery mechanism.

One of the most significant problems facing the Water Industry today is the required rebuilding of the existing infrastructure as it approaches the end of its useful service life. Based on a recent survey by the Environmental Protection Agency, it is presently forecasted that such investment needs nationwide during the next twenty years approaches \$140 billion, of which nearly \$80 billion relates to transmission and distribution system replacement. While substantial federal and state funding is available, it is clear that such amounts represent only a portion of the overall financing needs. Utilities and the customers served thereby will be called upon to provide the remainder.

Under regulatory policies and practices existing in most states, utilities must first obtain or provide the necessary amounts to fund construction projects and see them to completion before seeking rate recovery. This is consistent with traditional "used and useful" ratemaking standard which prohibits charging current customers for the costs of capital assets not yet devoted to the provision of service. Once the assets are deemed to be used and useful, there begins a period for rate setting which generally delays the commencement of capital cost recovery for months or even years after the assets begin to serve customers. The problem is exacerbated due to the fact that so many of the projects are ongoing and short in duration. For many utilities this is a game of constant catch-up. Given the tremendous projected capital requirements for future infrastructure replacement, the need for a new regulatory tool is clear.

One state facing extensive infrastructure replacement has introduced an innovative approach to cost recovery that eliminates the time and expense associated with the traditional approach to ratemaking. In 1996, the Pennsylvania legislature provided statutory authority for the Public Utility Commission to establish a tariffed automatic adjustment clause mechanism designed to give utilities the ability to periodically adjust rates via the introduction of a surcharge intended to recover the costs associated with infrastructure replacement programs, thereby significantly reducing the traditional regulatory lag. Given the title Distribution System Improvement Charge ("DSIC"), this mechanism considers the costs being incurred in connection with specific types of revenue-neutral projects designed to enhance water quality, fire protection reliability, and long-term system viability. These include: main and valve replacement, main cleaning and relining, fire hydrant replacement, and main extensions to eliminate dead ends. A key expected benefit of the DSIC is that it will enable utilities to accelerate infrastructure remediation, thereby making the projects more affordable for both the utilities and their ratepayers. Other potential benefits include greater rate stability and lower rate case filing expenses.

Under the DSIC program, at the end of each calendar quarter utilities identify the original cost of eligible distribution system improvements placed in service during that period, net of accrued depreciation. Such amounts are then used to compute a surcharge reflecting the associated depreciation expense and a return on investment based on actual capital structure and debt and preferred equity costs as of the end of the calculation period, and cost of equity approved in the respective company's last general rate case. Such information must be filed with the PUC Staff and Consumer Advocate at least ten days prior to the effective date of the surcharge which is typically the first day following the end of the calendar quarter succeeding the measurement period. For example, the surcharge intended to begin recovering the cost of eligible additions during the first calendar quarter in a given year would typically begin on July 1st.

The DSIC mechanism in Pennsylvania is not without significant ratepayer protections built in. They limit the surcharge to 5% of the total customer bill, and provide for annual

reconciliation audits, with over-collections refunded with interest. The surcharge is reset to zero at the time of new base rates or at any time that it is determined the utility is over-earning.

The effect of the DSIC thus far has been overwhelming. A number of other states have since begun considering the introduction of such a mechanism. Most recently, the Illinois legislature passed a bill designed to give the Illinois Commerce Commission the requisite authority to introduce such a mechanism in that State.

The Regulatory Reform Committee of the Water Task Force respectfully requests that the Commission assess the anticipated infrastructure replacement requirements currently facing the water utilities in Arizona in light of existing ratemaking policies and practices, and strongly consider the merits of moving toward the establishment of a mechanism comparable to the Pennsylvania DSIC.

2. Expanded utilization of existing pass-through mechanism.

In 1997, the Arizona Legislature passed Senate Bill 1252. This bill was enacted to create the statutory basis for the Arizona Corporation Commission to implement a mechanism under which regulated water utilities may be afforded an opportunity to reflect in rates the effects of changes in specific costs without the necessity and expense of filing a general rate case. The operating costs that may be considered in this procedure are limited to specific, readily identifiable costs that are subject to the control of another person, including the cost of purchasing electricity or gas, the cost of purchasing water from another utility or municipality, and the payment of proper taxes or similar taxes and assessments that may be levied on the utility.

Although the initial reaction to the passage of this legislation was positive, the anticipated widespread utilization has never materialized. Thus far only one utility has applied to the Commission for authority to adjust rates under the provisions on this mechanism. There are a number of reasons that have been cited for the lack of utilization, including

ambiguities in the language of the statute and concerns about the symmetry that would exist between rate increases and rate decreases. However the common understanding is that the Staff's proposed surcharge rules presented to the Water Utilities Association at their annual meeting were unreasonable. The opposition of a former Commissioner led to Staff implementation proposals that would have required a Company that filled for and received a postage surcharge, for example, to file sur-refunds not limited to decreases in postage cost but including decreases in ANY of the other cost elements eligible for surcharge treatment. This would be required even though the Company had not been passing on increases in these other cost elements. Continuing the postage example, if that same company experienced a decrease in power, purchased water or taxes they would be required to file for a sur-refund.

Generally, the water utility industry believes that Staff has developed implementation guidelines for the approval of applications under a S.B. 1252 filing that do not match the intent or the language of the Bill. Potential applicants become easily discouraged when investigating the usage and possible parameters of S.B. 1252 with Staff. Staff's guidelines lack the support of a prior decision, policy statement, rule or any official position of the Commission. Clarity of the intent and application of S.B. 1252 is sorely needed before its usage will achieve the objectives of its promoters and supporters.

For whatever reasons the surcharge authority of SB 1252 is not being fully utilized. The legislation creating this pass-through mechanism was intended to address uncontrollable cost increases being experienced by water utilities in Arizona and to help strengthen their financial capability. It is recommended that the Commission clarify their policy on surcharge applications and limit increases or decreases to the specific operating cost included in each companies approved surcharge(s) This matter might also be explored to determine what changes (i.e., legislative, procedural, etc.) might be made that would foster expanded use of the mechanism.

3. The damage from existing and previous depreciation practices needs to be recognized when establishing rates for the smaller water companies.

In the mid 80's the Staff attempted to "help" water companies by increasing their cash flow to a level that would at least cover their established cash expenses and debt service requirements even if they were denied a reasonably sufficient operating income. Depreciation rates were doubled for small water utilities, increasing from approximately 2.5% to 5%. This increased cash flow but aggravated the industry's problems.

Funds received through the artificially high book depreciation rates were not available to be reinvested in plant; they were required to meet cash expenses and debt service. The high book depreciation rates would result in net utility plant being exhausted (no rate base value) at a time when the physical facilities had 20 to 30 years of additional life. Most water plant has a 40 to 50 year life, under the 5% depreciation rate its economic value is gone at 20 years. Although today's Staff recognizes the error of a 5% depreciation rate and is recommending changing to a more realistic rate during general rate proceedings, no one has yet addressed the problem over the remainder of this utility plant cycle.

The effects of this policy will extend over the next 20 to 30 years. Once utility plant is fully depreciated, providing adequate earnings and cash flow becomes very challenging. Since rate base is zero or perhaps even negative the traditional ratemaking formula doesn't produce any authorized net operating income. Allowances for depreciation expense are no longer available. Without net operating income or depreciation allowance there is no source of funds for plant investment.

Some water utilities were further penalized because they were unable to earn their authorized rates and operated at a loss over a number of years. During the loss years the companies did not actually recover their 5% depreciation allowance. Nevertheless at rate case time Staff would blindly deduct the entire depreciation allowance whether recovered through the rates or not. Rate setting principles provide that a utility company is entitled to a both a return *on* its investment while it is devoted to serving the public and a return *of* its investment as it is used up. The return *of* investment is a source of funds that is

assumed to be reinvested in utility plant. Unfortunately small water company regulation has not worked this way in Arizona.

How can effect of these misguided depreciation practices be remedied by the current Commission? There is no best single solution. It is encouraging that changes are already taking place to correct the excessive 5% rate, but remedies to address the long term effects are also required. Such remedies could include increases in allowed rates of return to compensate for the early exhaustion of net utility plant; pro forma staff rate case adjustments to net utility plant: (1) to eliminate depreciation allowances that were not recovered through the rates; (2) to add back an increment of utility plant in rate base computations as if it had been depreciated over its economic life on a straight line basis (recognizing that the Company should have earned a fair return *on* its investment over the life of the plant; an additional depreciation allowance would not necessarily be provided because the company has already recovered a return *of* its investment); (3) as the depreciation rate is reduced from 5% to 2% or 2.5% during a rate proceeding replace the lost cash flow with a rate of return adjustment, i.e. a 3% or 2.5% return increment respectively on gross utility plant; (4) authorize an Operating and Maintenance Reserve that would be funded by an annual charge equal to 1% to 5% of utility plant. The charge would be deposited in a restricted interest bearing account that could only be used for operations or maintenance expense items not included in the authorized rates, for example major pump repair, tank painting, etc.

REDUCE THE NUMBER OF SMALL, NON-VIABLE WATER SYSTEMS THROUGH NEW RULES AND PROCEDURES

1. Limit the formation of start-up water utility companies by developers and inexperienced organizers. Do not issue CCN's to newly established start-up water companies until all options to have service provided by an existing viable company have been exhausted. Provide notice to existing companies of the need to serve newly developing areas and solicit statements of interest.

2. Encourage industry consolidation to develop larger and stronger companies with greater managerial, technical and financial capability.

Any consideration of consolidation of the water utility industry in Arizona should not be limited to smaller Class “D” and “E” companies. Larger companies should not be excluded from the benefits of industry consolidation. It is likely that consumers benefit from the economies of scale realized by the combination of merged entities regardless of the individual sizes of acquiring companies.

The California Public Water System Investment and Consolidation Act of 1997 (the “Act”) specifically states that “scaled economies are achievable in the operation of public water systems”. Further, the Act states that “providing water corporations with an incentive to achieve these scaled economies will provide benefits to ratepayers”. The California Act does limit its interpretation or application to the size or viability of water systems. The California legislators and Commission have realized that water sources are finite and fewer numbers of distributors of the product accrues to the benefit of the ratepayer.

For purposes of acquisition adjustments, the California Act generally provides that acquisitions of water companies utilize the fair market value (FMV) approach when considering the value of the water system infrastructure assets. However, the Act further provides that the Commission may also include the difference between FMV and reproduction cost when the value differences are considered “fair and reasonable”. The California Commission uses a four level evaluation criteria to determine allowable differences between FMV and reproduction cost as follows: (1) the affect on water system reliability, (2) improvements in compliance of health and safety regulations, (3) the ability to achieve economies of scale that would otherwise not be available but for acquisition, and (4) the fair and equitable affect on current customers. The representatives of the Arizona water utility industry members of the Water Task Force unanimously support the California Act and encourage the Commissioner’s consideration of same.

In addition to those provisions of the California Act, the representatives of the water industry on the Water Task Force believe that any policy developed by the Commission which considers incentives to encourage industry consolidation should ensure that an acquirer of a water company should not be penalized for the acquisition through application of a negative rate base acquisition adjustment. Instances where negative adjustments to rates due to negative acquisition adjustments are not as common. However, there are undoubtedly many opportunities for acquisition of smaller water systems by larger, more resourceful companies that could be discouraged if the acquiring company believed that negative acquisition adjustments would affect current rates or return of, or on, investment.

3. Provide special incentives to encourage the takeover of non-viable companies of any size or any Class D or Class E water utility on the presumption that merely because of their size they cannot provide the managerial, technical and financial resources need to comply with the SDWA.

4. Permit Use of Prospective Test Years in Rate Applications:

According to the National Association of Regulatory Utility Commissioners ("NARUC"), the Commissions of approximately thirty (30) states permit the use of prospective test years for rate applications¹. Staff argues that utilization of historical test years in rate applications makes sufficient provisions for the effect of future water system investment through consideration of "known and measurable" expenses. The critical difference in Staff's viewpoint with that of the water industry is a matter of perspective.

Water industry representatives of the Water Task Force believe, as is conducted in many other states without difficulty, that rate applications can include specific, highly scrutinized planning for capital expenditures and operating expenses that can be predicted with a high degree of certainty in both cost and timing. A rate adjustment applicant can provide a capital expenditure that details the degree of investment and the timing of same

¹ 17th Annual Western Utility Rate School, April 1997, San Diego, California.

over future months and years. Rate adjustments can be granted from the perspective of a contract being entered into between the applicant and the Commission. Prospective rate adjustments can be conditioned on the amount of investment and the actual occurrence of expenditure. In the event capital expenditures for improvements to water systems are not made pursuant to the capital expenditure program filed as part of a rate application, the previously granted rates would not become effective. The completion milestones of accomplished capital projects are sufficiently easy to measure to ensure delivery of actual benefit to the customer.

The "business as usual" perspective of Staff requires expenditure of the capital amounts first and recovery, subject to the usual regulatory delays, thereafter. This policy is discouraging to water system owners and operators in the consideration of needed improvements to the water systems. Water system operators generally know, or can readily determine, what improvements are required in their water systems. The cost associated with such improvements is as easily determinable. The rate adjustment application process is sufficiently resourceful to determine a realistic implementation schedule of water system improvements. The water industry representatives of the Water Task Force believe adoption of a policy of prospective test years would encourage water systems improvements at a rate much more rapid than those presently occurring. The water industry representatives of the Water Task Force would not be opposed to adoption of prospective test years for rate applications with reasonable qualifications and conditions including punitive operational and economic consequences for rate applicants that did not achieve the scheduled results.

**PROVIDE GREATER EMPHASIS OF SIMPLIFYING, SHORTENING
AND REDUCING THE COST OF RATEMAKING
AND REGULATORY COMPLIANCE**

1. Eliminate unnecessary and/or redundant filing requirements and forms, and introduce computerization into the filing process.

Many of the water utilities in Arizona, particularly the smaller ones, are concerned about the volume and extent of informational and other filing requirements imposed by the ACC. Some of the requirements originated many years ago when circumstances were quite different from today, and prior to the introduction of sophisticated computer tools that are now at our disposal. In connection therewith, the Regulatory Reform Committee of the Water Task force recommends that a determination be made with respect to the continuing need for and value of the quantity and variety of information presently required to be filed with the Commission. This would encompass an assessment of the current rate case filing requirements, required annual report contents, and the level of detail that water utilities are obligated to include in other types of filings.

In addition to an evaluation of current filing requirements, it is also recommended that consideration be given to automation of the filing process. In today's business world, even the smallest of companies have access to a personal computer. The current filing process could be significantly enhanced by creating a library of standard reporting forms on computer disks that could be copied for use by affected companies. This process should include exact copies of the electronic spreadsheets used by Staff in the assessment and analysis of rate applicant's filings. This improvement has the potential to significantly reduce the time and cost associated with routine filings with the Commission. In connection therewith, the Commission should also explore the possibility of introducing the option of electronic filing. Many major regulatory agencies such as the Federal Energy Regulatory Commission, Federal Communications Commission, and the Securities and Exchange Commission, already allow companies subject to their jurisdiction to file annual reports via electronic means. The ACC should strongly consider the potential benefits associated with automation of the filing process.

2. Reduction in Regulatory Lag Associated with Rate Decisions:

The water industry representatives of the Water Task Force strongly encourage the Commission and Staff to search for ways in which the affect of regulatory lag may be reduced. At present, many months stretching to more than a year may be required to

determine the appropriateness of rate adjustments. The affect of regulatory is, by itself, a discouragement to water system owners to file rate applications at all. No rule, regulation, or policy should be adopted or passed which does not consider how regulatory lag may be reduced.

II. IMPROVEMENTS IN CONSUMER EDUCATION GOAL:

The water industry representatives of the Water Task Force would like to propose a three-prong approach whereby the Arizona Corporation Commission; the water utility industry and RUCO would take the lead in educating our customers. All three of these groups have the knowledge; experience and manpower to present and communicate with the consumers on many issues which are facing our industry. The following are some of the tasks, which each group can contribute to better educate our customers.

(i) Arizona Corporation Commission (ACC)

- (a) Web site – Although ACC already has a Web Site (<http://www.cc.state.az.us>) in existence, I believe this Web site should be further promoted to the public at large in order for them to learn more about what's happening at the ACC.
- (b) Continue publishing "Water News" on a quarterly basis.
- (c) Continue making visits to each county on an annual basis to discuss issues related to consumers, water utility industry and the local governmental officials.
- (d) Form a Task Force at the county level, which will be in charge to educate and coordinate the issues in the water industry. The Task Force should consist of two representatives from each of the following: ACC, water utility industry, consumer group, and county officials.

(ii) Water Utility Companies

- (a) ADEQ requires that as of October 1, 1999 each water utility company publish a "Consumer Confidence Report" for the previous year. This report will be published on an annual basis and will cover a variety of issues directly related to the operation of that particular water utility company.
- (b) On a volunteer basis, the ACC should encourage water utility companies to publish a company newsletter, a "Customer Service Reference Guide" (see enclosed) or provide the customers with a publication from the American Water Works Association or a similar organization dealing with issues such as conservation, quality of water, quantity of water, etc.

(c) Encourage water utility companies on a volunteer basis to publish in their local newspaper or to discuss on a local radio/television station local issues related to the water industry.

(iii) RUCO – Encourage RUCO to prepare a publication explaining basic issues in the water utility industry such as:

1. How to read a balance sheet and income statement.
2. Explain what is a rate base.
3. Explain how the rate case is developed.
4. Explain how to form a water user association.
5. Explain how to intervene in an ACC proceeding.

This kind of publication can greatly assist the consumer to understand some very complex issues facing the utility industry.

The water industry believes that better informed customers should expect safe and drinkable water to flow from his household tap. We, in the water utility industry, must insure our customers to receive the highest value to which they are entitled. A well informed customer can help us serve him better.

CONCLUSION

The representatives of the water industry appreciate the opportunity to participate in the ACC's Water Task Force. It is clear that many important issues require attention and resolution. The representatives believe that with proper economic incentives, motivation and opportunity that the natural capabilities of the market place can resolve most or all of these issues. Conversely, decreased and efficient regulation provides a similar benefit that can achieve levels of prosperity and compliance in an industry that is sorely deficient.

WATER TASK FORCE
COMMENTS OF THE RESIDENTIAL UTILITY CONSUMER OFFICE
AUGUST 16, 1999

REGULATORY REFORM SUBCOMMITTEE

**ISSUE NO. 1 - REDUCE THE NUMBER OF SMALL, NON-VIABLE
 WATER SYSTEMS THROUGH NEW RULES AND
 PROCEDURES**

A large number of the state's water utilities are small in size, quite often uneconomical, and experience operational problems that they are often unequipped to handle. A potential solution to some of the small non-viable utility problems is the acquisition by larger, better-run utilities. However, it is apparent that acquisition of small, uneconomical, non-viable water systems will not occur absent some sort of regulatory incentive. Most, if not all, of the Task Force members were in agreement on the need for regulatory reform in this area. Agreement, however, was not reached regarding the appropriate incentives and circumstances under which such incentives would be available.

It is RUCO's position that regulatory incentives for acquisition should be available only in those instances where absent the incentive, the acquisition would not take place. For example, acquisitions of larger well-run utilities by other similar type companies are common place and currently occur without the need for incentives. In such situations incentives are unnecessary and would simply constitute regulatory gifts. Incentives should be available only for small utilities (in general Class D & E) that are determined to be non-viable. The Commission in the context of the acquisition proceeding would determine viability. The acquiring company would bear the burden of demonstrating the non-viability of the acquired company.

RUCO strongly opposes the use of acquisition adjustments as a regulatory incentive to acquisition. We believe a policy that would allow rate recovery of acquisition adjustments (the excess purchase price over net book value) would ultimately allow regulated companies to set their own rates in a monopoly environment. Further, the Commission would have no control over the level of regulatory incentive because the buyer and the seller would be able to set the level of the incentive through the asking and purchasing price. A situation would result where the rate bases of utilities could be inflated by the mere buying and selling of property. Both buyer and seller would realize windfall profits through the inflated purchase price with captive ratepayers funding such windfalls. The Commission has options other than acquisitions adjustments to create incentives for larger utilities to acquire small non-viable systems.

- Option 1 - Allowance of an incremental premium on the Company's authorized rate of return. In light of the additional risks a purchasing utility takes on when acquiring a non-viable system, an additional rate of return would be authorized by the Commission. This option would create a monetary incentive for the acquisition of non-viable systems, yet unlike an acquisition adjustment, the authority to determine the appropriate level of the incentive would remain with the Commission.
- Option 2 - A surcharge mechanism that would allow the acquiring company to obtain upfront ratepayer funding of the capital investment necessary to make the acquired system viable. Since there is a lag between a company's outlay of cash for capital investments and the recognition of the investment in rates, this creates disincentives for acquisition of non-viable companies. This disincentive can be removed by creating a regulatory mechanism that would allow the estimated cost of the necessary improvements to be included in a rate surcharge and funded upfront by ratepayers. Once the improvements were completed, the cost estimated would be trued up to actual.
- Option 3 - A deferral accounting order that would allow the acquiring utility to defer for future rate recovery extraordinary repair and maintenance costs necessary to improve the quality of service of the non-viable acquisition. The amount ultimately recoverable would be determined in the context of a rate case.

ISSUE NO. 2 - STRENGTHEN THE FINANCIAL CAPABILITY OF THE WATER UTILITY INDUSTRY

Although the Task Force did agree this was an issue, it was never discussed in depth. RUCO believes the issue of financial capacity is closely related to the small non-viable water company issue discussed above. The acquisition of these types of systems by larger better-run utilities would, for the most part, address this issue. In addition, RUCO suggests the following:

- 1) Increase the number of small water company workshops conducted by ACC Staff. Expand the scope of the workshops to include information on utility accounting, effective financial planning, capitalization alternatives (i.e. CIAC vs. Equity, AIAC vs. Debt), etc.
- 2) Change AAC Staff policy of using 5% depreciation rates for small utilities. This policy has resulted in negative rate bases for numerous small to medium water companies.

- 3) Encourage water companies to file rate cases in a timely manner. Provide ACC assistance to those small companies that do not have the technical expertise to complete their own rate applications.

ISSUE NO. 3 - SIMPLIFYING, SHORTENING, AND REDUCING THE COST OF THE RATEMAKING PROCESS

The Task Force members all agreed this was an area that could benefit from regulatory reform. Members had differing opinions on how this should be accomplished. RUCO suggests the following:

- 1) Develop a comprehensive set of minimum filing requirements (MFRs) to be required with all rate applications. The MFRs would be designed to supply Staff and RUCO with certain generic accounting data that is necessary in all cases to perform a regulatory review. The MFRs would include such items as the general ledger, year-end closing journal entries, test year billing determinants, monthly operating reports, schedules of plant retirements and additions, etc. This would cut down on the number of initial data requests and also remove the 10 day time constraint the utilities currently operate under.
- 2) Improve communications and cooperation among utilities, Staff, and RUCO during the rate review process. Conversations between the utility and the respective analyst can cut down on discovery by clarifying information needs and constraints. An initial meeting between the utility and the analyst to explain the salient points of the application and to answer questions informally would help narrow the scope of the analyst's review.
- 3) Negotiation and settlement discussions can reduce the number of litigation issues, reduce rate case expense, and result in fair and reasonable results.
- 4) Stricter application of ACC sufficiency requirements. Quite often extensive discovery and audit work is required simply because of calculation errors, data omissions, incorrect billing determinants, etc. included in a utility's application. Quite often these problems are not resolved at the discovery stage and then require additional resources to litigate. These types of problems should be resolved before the rate application is found sufficient.

ISSUE NO. 5 - IMPROVE CUSTOMER EDUCATION

Although there was very little discussion by the Task Force on customer education, all agreed it was an issue. From phone calls that RUCO receives from the utility customers it is apparent that the average customer is uninformed as to the state agencies that deal with utilities, the regulatory process, and their individual participation options in the process. RUCO suggests the following:

- 1) Schedule public meetings at various locations throughout the state. The purpose of these meetings would be to educate consumers regarding the different state agencies that deal with utilities and each agency's specific role. The meeting would also present information regarding the various options open to consumers when they have complaints/ concerns regarding their utility company. Meetings would be announced via advertising in local newspapers.
- 2) Develop and distribute statewide a newsletter that contains the information identified in item no. 1 above.
- 3) Develop a web site that includes the above information. Place advertisements statewide regarding location of web site.

While RUCO supports all of the above suggestions we recognize that all will require expending additional resources beyond what is currently included in state regulatory agencies' budgets. Additional appropriations would probably be required.

ISSUE NO. 5 - INCREASE INTERAGENCY COORDINATION

While most of the utility Task Force members agreed that this was a significant issue, RUCO, and to some extent Staff, did not perceive the same problems. Staff argued that many of the specific coordination efforts the utilities indicated they would like to see were already in effect. From a practical standpoint RUCO recognizes that the objectives, mandates, and goals of the individual state agencies that deal with utilities are different and therefore complete coordination is not realistic. RUCO also pointed out that while the ACC can change its way of doing business, it has no control over, for example, ADEQ, DWR, or RUCO. While the goal of interagency coordination is desirable, RUCO believes the other four issues identified by the Task Force are within the control of the ACC and therefore are more obtainable.

WATER SUPPLY SUBCOMMITTEE

The Residential Utility Consumer Office ("RUCO") offers its comments regarding Central Arizona Project ("CAP") cost recovery for water utilities.

RUCO acknowledges and supports the State of Arizona's water policy goals, namely to protect Arizona's groundwater supplies. RUCO believes that this policy is important and should be considered when determining whether water utilities under the jurisdiction of the Arizona Corporation Commission should receive cost recovery for CAP water.

However, each utility is unique and its request for recovery of CAP expenses must be based on its individual history. RUCO's position is that prior to cost recovery being considered, each utility must be using the CAP water (the used and useful ratemaking principle). Although comments were requested on a five year plan, RUCO's position is that it is speculative and hypothetical to project what a company may do with CAP water over the next 5 years. Many intervening events may occur and ratepayers may be paying for water that the utility has never used and ratepayers have never received. Before ratepayers should be asked to pay for CAP water, actual CAP water should be flowing through the companies' pipes and used by their customers or some other CAP usage alternative such as groundwater replenishment, water exchange agreements, etc. should be in place and effective.

Additionally, RUCO offers this comment in regard to the February 10, 1999, letter which sets forth a consensus agreement regarding CAP long term planning expenses. RUCO did not agree that expenses from CAP long term planning should be specifically noted as an expense for which a water utility should seek cost recovery. However, RUCO did not oppose that water utilities may apply to the Commission for cost recovery of CAP expenses outside of a rate case.



**ARIZONA DEPARTMENT OF WATER
RESOURCES**

Office of Assured and Adequate Water Supply
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JANE DEE HULL
Governor

RITA P. PEARSON
Director

MEMORANDUM

To: Matthew Rowell
Arizona Corporation Commission

From: Steve Rossi
Department of Water Resources

Date: August 12, 1999

Re: Comments on Draft Report

At the last Water Task Force Meeting, the group agreed to another round of comments on the draft report prepared by commission staff. The following are the Department's comments regarding the water supply portion of that report.

The proposal by ACC staff is to allow recovery of costs today if the CAP allocation is to be used within five years. The provider must refund the fees if the water is not used. In general, the concept of setting some guidelines that providers must follow in exchange for greater certainty regarding the recovery of CAP costs is a positive step. However, as I pointed out in prior comments, there is a need for additional depth and some changes to these guidelines before they can be considered workable.

There is a presumption (though it is unclear in the report) that a provider is eligible for recovery of only that which is used in the five year period. Thus, if a provider is able to use only half of the allocation in this period (whether the demand exists for the full amount or not), only half of the costs are recoverable. The problem with this approach is that it fails to place any value to current and future customers on that portion of the CAP allocation not used within the five year period. To deny recovery of the costs because the water may not be needed for five or more years is counterproductive to sound long-term water supply planning principles.

While the Department would clearly prefer to see the use of CAP replace mined groundwater supplies as early as possible, we recognize that in this may not always be practical within the five year period. The capitals charge component of the CAP water, while significant, is minor in comparison to infrastructure costs associated with full CAP utilization.

As an alternative, we propose that capital charges for the entire allocation be recoverable immediately if the provider develops a plan which demonstrates that: 1) demand projections for the next 20 years equal or exceed the CAP allocation; 2) a portion of the allocation, determined on a case by case basis between ADWR, ACC and the provider, will be used within the first five years either through direct delivery or by recharging the water in a location which contributes to

groundwater availability in the area of the provider's wells; and 3) the use of CAP will increase over a period of time (to be determined in each case) up to the extent of the allocation.

In addition, once a provider has exhausted its CAP supplies (i.e. they are being fully utilized), groundwater use, which is replenished by the CAGR, should be handled similarly. For example, to the extent that a regulatory structure is established for member lands which provides for replenishment in an area where the provider's wells will pump the water, CAGR assessments should be fully recoverable. Such a structure was established for member service areas in last year's legislative session at the urging of Scottsdale and other providers. A similar proposal for member lands may be considered in this next session.

Please contact me if you would like to discuss these comments further prior to our next meeting.

**AWC's Industry Rebuttal Response To Recommendations Submitted
To The WUTF
Submitted September 20, 1999**

On August 25, 1999 a Special Open Meeting of the Arizona Corporation Commission was scheduled to discuss comments submitted for the Task Force's report and to set a due date for rebuttal comments. September 17, 1999 was the date set for submission of rebuttal comments to Matthew Rowell, the Commission's Task Force Chairman.

Comments were presented at the Special Open Meeting from:

- Department of Water Resources (DWR)
- R. W. Trimble
- Residential Utility Consumer Office (RUCO)
- Industry Representatives (Industry)
- Arizona Corporation Commission Staff (Staff)

Arizona Water Company is providing the following industry rebuttal comments to the commentary and recommendations of DWR and RUCO. It reiterates the Industry's June 29, 1999 comments on the Staff Report recommendations as part of this response.

**DEPARTMENT OF WATER RESOURCES
Industry supports the DWR recommendations**

Recovery of Cap Costs - DWR disagreed with the Staff recommendation and stated that to deny recovery of CAP costs because the water may not be needed for five or more years is counterproductive to sound long-term water supply planning principles.

Industry supports DWR's recommendation that capital charges for the entire allocation be recoverable immediately if the provider develops a plan which demonstrates that: 1) demand projections for the next 20 years equal or exceed the Cap allocation; 2) a portion of the allocation, determined on a case by case basis between DWR, ACC and the provider, will be used within the first five years either through direct delivery or by recharging the water in a location which contributes to ground water availability in the area of the provider's wells; and 3) the use of CAP will increase over a period of time (to be determined in each case) up to the extent of the allocation.

Industry also agrees that CAGR assessments should be fully recoverable.

Recovery Of Conservation Costs – Industry agrees that the Staff recommendations do not address the need for greater certainty regarding the recovery of conservation costs; i.e. a safe harbor for recovery of conservation costs. DWR correctly points out that the Staff's recommendation results in a "business as usual" approach. It provides a several new layers of bureaucratic approval and tests but no greater certainty. As DWR said: "This situation is not acceptable". The Commissioners need to endorse the concept of

regulatory safe harbors for cost recovery and direct the Staff to develop policies in that framework.

RESIDENTIAL UTILITY CONSUMER OFFICE

1. Reduce The Number Of Small, Non-Viable Water Systems Through New Rules And Procedures.

RUCO recognizes the problem: *"A large number of the state's water utilities are small in size, quite often uneconomical, and experience operational problems that they are often unequipped to handle."* However, RUCO's short-term focus on rate minimization for residential customers confines the scope of its analysis and recommendations to a limited, sub-optimal change in Commission policy. .

RUCO is unable to acknowledge even the potential benefit of water industry consolidation in Arizona. Instead they argue that if a variant of the California fair market value approach to encouraging consolidation throughout the water utility industry was adopted in Arizona:

"...the rate bases of utilities could be inflated by the mere buying and selling of property. Both buyer and seller would realize windfall profits through the inflated purchase price."

Although this was a legitimate concern earlier this century when giant holding companies were able to manipulate their portfolios, it is ludicrous in Arizona today. The water industry is facing unprecedented capital demands to deal with growth, water supply and water quality. The shortage is *capital to invest* not *projects to invest in*. What rational buyer would pay even \$1.00 more than necessary to purchase a water company? The buyer would have no difficulty investing the amount of RUCO's inflated purchase price in actual water facilities that would provide hard assets and solve actual problems. RUCO's claims that a buyer would benefit and presumably realize "windfall profits" by inflating rate base are without merit. Limiting the California fair market value approach to only non-affiliated buyers and sellers would eliminate any incentive for collusion.

The California Public Water System Investment and Consolidation Act of 1997 (the "Act") specifically states that "scaled economies are achievable in the operation of public water systems". Further, the Act states that "providing water corporations with an incentive to achieve these scaled economies will provide benefits to ratepayers". The California Act does *not* limit its interpretation or application to the size or viability of water systems. The California legislators and Commission have realized that water sources are finite and fewer numbers of distributors of the product accrues to the benefit of the ratepayer.

Consolidation of the industry based on fair market values would encourage larger and stronger companies with greater managerial, technical and financial capability.

2. Strengthen The Financial Capability Of The Water Utility Industry

“RUCO believes the issue of financial capacity is closely related to the small non-viable water company issue discussed above. The acquisition of these types of systems by larger better-run utilities would, for the most part address this issue.” Doesn’t this support the goal of broad industry consolidation?

RUCO’s three recommendations are acceptable but are unlikely to have the desired impact. They are very limited and conservative. A broader range of initiatives should be employed to deal with this problem; e.g.

- Distribution infrastructure replacement cost recovery mechanism.
- Expanded utilization of existing pass-through mechanism.

1. Provide Greater Emphasis Of Simplifying, Shortening And Reducing The Cost Of Ratemaking And Regulatory Compliance

The first and last of RUCO’s four recommendations would complicate, lengthen and increase the cost of ratemaking for the water industry, they should be rejected outright.

- RUCO’s first recommendation would significantly expand the content of the existing Standard Filing Requirements to include extensive supporting and backup data such as:
 - 1) The company’s entire general ledger
 - 2) Year-end closing journal entries
 - 3) Test year billing determinants
 - 4) Monthly operating reports
 - 5) Schedules of plant retirements and additions
 - 6) Et cetera
- RUCO’s fourth recommendation advocates stricter application of the Commission’s sufficiency requirements so that Staff would be required to dissect each application looking for calculation errors, data omissions, incorrect billing determinants, etc. This recommendation shifts a portion of RUCO’s work to the Staff and is directly at odds with the goal it purports to support.

WATER SUPPLY SUBCOMMITTEE

RUCO's water supply recommendations are off point. They reject the Staff's 5 year time period and are at odds with the second consensus goal of strengthening the financial capability of the water utility industry. They reflect a single-minded focus on rate minimization rather than open-minded consideration of various alternatives.

ARIZONA CORPORATION COMMISSION STAFF
Industry Supports Many Of the Staff Recommendations In Principle

Staff reorganized its earlier recommendations under the five consensus goals adopted by the Regulatory Reform Subcommittee, Water Supply and Conservation. Industry generally supports the thrust of this recommendation but not all of the details as explained in the earlier Industry Response to the Staff Report which is reproduced below. This commentary refers to pages in the earlier Staff report.

1. Rate of Return (page 3)

- Minimal discussion of this topic
- Supports Goal # 3.
- Industry agrees with concept and willing to help develop implementation plan in a manner to also support Goal # 2

2. Phase in Rates (pages 3-4)

- Not discussed. Unclear what Staff is recommending.
- Undermines Goals # 2 and # 3 - Appears that a "large" rate increase might trigger only a limited or partial rate increase at the time the Decision was issued and result in the deferral of the full amount of the revenue requirement until a later date. If this is what the Staff is recommending it could further damage the financial capacity of the water utility industry, while lengthening and complicating the rate making process.
- Industry opposes this concept and any recommendations that further weakens the financial capacity of the industry or lengthens the ratemaking process.

3. Property Tax (page 4)

- Minimal discussion.
- Supports Goals #2 and # 3
- Industry favors a change. Although not previously discussed, the industry recommends that the existing manner of determining and paying water utility property taxes be replaced with a percentage of revenue tax that would be paid monthly to the Department of Revenue (DOR). Revenue is already a key variable in the formula used by the DOR to determine each water utility company's full cash value. The replacement tax would be an add-on to the customers' water utility bills. The tax collected could be reported and paid to DOR as part of the sales tax return. Industry is willing to help develop detail recommendations and implementation plan.

4. Electronic Filing (page 4)

- Minimal but adequate discussion.
 - Supports Goal # 3
 - Industry supports a voluntary electronic filing program and recommends that the Commission develop electronic templates and instructions that would be available from the ACC web site.
5. **4Rate Design** (pages 4-5)
- Never discussed.
 - Undermines Goals # 2 and # 3
 - Industry strongly disagrees with a mandatory three-tier rate structure and the confiscation of utility revenue.
6. **Automatic Rate Increases** (pages 6-7)
- Never discussed.
 - Supports Goal # 2 and # 3
 - Worthwhile concept but exclusion of “A” and “B” companies, qualifying requirements and annual two and one half month timetable are arbitrary and likely unworkable. Industry willing to help develop detail recommendations and implementation plan.
7. **Rates Tied to Conditions** (page 7)
- Never discussed.
 - Not aimed at any of the RRS goals.
8. **Future Test Year** (page 7)
- Minimal discussion of industry recommendation. Staff’s opinion is: “...that the present test year method is adequate, workable and accurate.” The remaining question is: Does the present test year method produce desired results? Changing the existing method would be one way to improve the financial capability of the industry.
 - Supports Goal # 2
 - Industry willing to help develop detail recommendations and implementation plan.
9. **Generic Hook-Up Fees** (page 8)
- Minimal discussion
 - Supports Goal # 2
 - Industry willing to help develop detail recommendations and implementation plan.
10. **Certificates Of Convenience & Necessity – CC&N** (pages 8-11)
- Extensive discussion
 - Supports Goal #1
 - Industry supports most of Staff’s recommendations and is willing to help develop detail recommendations and implementation plan.

11. **Main Extension Agreements** (page 11)

- Adequate discussion
- Supports Goal # 3
- Industry supports most of Staff's recommendations and willing to help develop detail recommendations and implementation plan.

12. **Incentives For Consolidation** (pages 11-13)

- Most thoroughly discussed recommendation.
- Supports Goal #1 and can support # 2
- Staff is unable to accept the idea that there are economic benefits to industry consolidation and that it should be encouraged. Staff takes a narrow view, that consolidation incentives should be limited to acquisitions of the "D" and "E" class water companies for now. The industry strongly believes that encouraging consolidation of all classes of water companies would provide economies of scale, strengthen the financial capability of the consolidated companies and reduce the regulatory burden on the Commission.
- The California Legislature and the California Public Utility Commission are encouraging industry consolidation under Senate Bill 1268 The California Public Water System Investment and Consolidation Act of 1997. That legislation states:
 - "Scale economies are achievable in the operation of public water systems."
 - "Providing water corporations with an incentive to achieve these scale economies will provide benefits to ratepayers."

13. **Plant Replacement Fund** (pages 13-15)

- Limited discussion
- Supports Goal # 2
- Industry agrees with Pennsylvania approach but Staff recommendations to treat plant as a contribution nullifies the concept. Lowering the rate of return for a company with a PRF could cost the company more than it gained.
- Industry is willing to help develop detail recommendations and implementation plan along lines of Pennsylvania program.

14. **Education** (pages 15-16)

- Discussion of subcommittee work limited by time.
- Supports Goal # 4
- Industry supports.

**WATER TASK FORCE
REBUTTAL COMMENTS OF THE RESIDENTIAL UTILITY
CONSUMER OFFICE
September 16, 1999**

REGULATORY REFORM SUBCOMMITTEE

On August 16, 1999 the Water Industry, Commission Staff, and RUCO submitted individual reports to the Task Force setting forth their respective positions on the five issues previously agreed upon by the all members of the Task Force. The purpose of this document is to respond to the various parties' positions.

**ISSUE NO. 1 - REDUCE THE NUMBER OF SMALL, NON-VIABLE
WATER SYSTEMS THROUGH NEW RULES AND
PROCEDURES**

Industry and Staff proposal -

Limit the number of new water companies by refusing to grant CC&Ns to new start-up water companies

RUCO position on the concept -

Task force members have suggested establishing more stringent standards for the issuance of a CC&N as one method for achieving the agreed upon goal of reducing the number of non-viable water systems. RUCO believes establishing new criteria for issuance of a CC&N is one feasible and likely method for reducing the number of non-viable water systems. However, before going forward with a recommendation to establish new CC&N standards, the task force should identify at least one new general or specific area where establishing a new standard will provide an overall benefit. Members of the task force have provided some thought provoking suggestions for improvement. However, in RUCO's view, these suggestions have generated more questions than answers and will not necessarily result in an overall benefit.

PRO - 1) Would prevent an increase in the number of water companies

CON - 1) One proposed plan requires a new water company applying for a CC&N to show that no existing water company will serve the requested service territory as a condition for obtaining a CC&N. Under this plan a new CC&N applicant must show rejection letters from all three "Class A" companies, at least five "Class B" companies, and all existing water companies within five miles of the service territory requested as one condition for obtaining a CC&N. This proposal creates a hierarchy of preferential treatment for

various existing companies. An existing company will not necessarily make a more-fit public service provider than a new company. A small or newly formed water company is not necessarily non-viable or unfit to provide public utility service. Not all small or newly formed water companies have been shown to be unfit. Many large water companies began as smaller entities. It is dubious that any pre-determined distance can be established that will represent the distance from which another water company can effectively service any new service territory. Providing preferential treatment in the CC&N issuance process may be unlawful or present other legal problems.

2) This plan is unworkable. Large, existing water companies may not be interested in expansion. Company's that are not interested in new service territories may be reluctant to assert that disinterest in a rejection letter. Also, new applicants could seek rejection letters only from those "Class B" companies that always reject proposals for new service territories. This would circumvent the intent of requiring a new CC&N applicant to obtain rejection letters from at least five "Class B" water companies as one of the criteria for obtaining a CC&N.

3) This plan also suggests using only the water company's projected customer growth estimates in setting rates to achieve break-even operating results no later than the third year of operation and for earning the authorized rate of return in the fifth year of operation. RUCO believes that other parties (e.g., RUCO, Staff, Hearing Officers, Commissioners, developers, prospective customers, and others) may have valuable input into the growth projections. RUCO does not support this condition because it has the affect of forfeiting RUCO's statutory rights and shirking RUCO's obligation to residential ratepayers to intervene in proceedings that affect rates. Adoption of this condition would lessen the leverage of other parties to encourage proper sizing and economic design of backbone plant and fails to take into consideration other relevant factors such as the number of potential customers. Also, implementing this condition would neither ensure nor even necessarily improve the likelihood that the target third and fifth year operating results would be achieved.

4) Another suggested condition for issuance of a CC&N is that the recipient be in complete compliance with Arizona Department of Environmental Quality (ADEQ) requirements. Complete compliance with ADEQ requirement is a desirable goal. However, it may be preferable to establish a lesser standard that allows some latitude. For example, a water company in complete compliance

could acquire a company in non-compliance resulting in a circumstance that the acquiring company is no longer in compliance and, accordingly, not eligible for the new CC&N. In this instance, the proposed condition provides an undesirable result. Also, a large company with many systems is statistically more likely to have a violation than a smaller company. The proposed condition, therefore, discriminates against large companies and is counter-productive in the effort to reduce the number of small, non-viable companies. RUCO is also concerned that this condition would place ADEQ in an unduly powerful position whereby ADEQ would have a greater influence than the Commission in selecting the companies that operate in new service territories. A more constructive method/model for classifying non-compliance items and eliminating unfit water companies from consideration as new CC&N applicants is needed.

5) Staff has suggested that standard fees be established for service charges (e.g., establishment, late payment, non-sufficient funds check, reconnection, re-establishment, etc.). Although the costs to provide customer services will vary by location, RUCO sees no significant impediment to establishing a standard methodology for establishing initial service charges in CC&N proceedings provided that RUCO is included in the process to establish the initial charges and any subsequent changes to those charges.

6) The Staff proposes the implementation of extensive rules pertaining to revenues and rates. The proposal is to establish standard, minimum monthly customer charges and commodity rates. The Commission Staff would recommend approval of the higher of the standard or company proposed rates. Under this proposal there would be no consideration as to whether rates were excessive. This plan justifies dismissing the possibility that rates may be excessive for three reasons. First, the probability of the company over-earning is small. Second, Staff would recommend an unspecified time-frame for the company to file a rate case. Third, there are no customers when the rates are established.

7) This proposal ignores the potential negative consequences of excessive initial rates. For example, customers may be driven away. Potential customers that would have preferred buying homes and beginning businesses in the service territory may select alternate locations. Taken to an extreme, a CC&N could be used to postpone growth in the service territory by charging excessive rates. A CC&N holder with the objective of limiting growth could prevent a developer from building in the service territory by

charging grossly excessive rates that no reasonable customer would pay. Also, the cost of service varies significantly by location. No single standard rates will prevent all new water companies from charging inadequate rates. New company's can benefit by the input from Commission Staff, RUCO, and other intervenors in setting rates. Prospective customers will also benefit from the input of multiple parties in developing a probable on-going level for rates in a new water system.

8) Establishing standard, minimum monthly customer charges and commodity rates does not ensure a proper balance of revenue from each. A company could choose the minimum monthly customer charges and select commodity rates far in excess of the minimum resulting in an unstable revenue base. Without an analysis of a company's projected underlying costs, the appropriate balance for a given company is unknown. Also, if a company were to choose an inappropriate balance for its initial rates, an unnecessarily large change in the rate structure may be warranted in a future rate case. Avoidance of large changes in rate structure is one of the fundamental goals of rate design. Thus, it is important that initial rates be set appropriately. In addition, the proposed minimum rates fail to address other issues including conservation objectives, the high cost of CAP water, and special customer demands, such as those of a prospective industrial user. The scrutiny provided by Staff, RUCO, developers, and hearing officers is valuable in forming appropriate initial rates and should not be discarded. Furthermore, providing water companies with full initial rate setting discretion is certain to be ill received by the public and public criticism would bring embarrassment to the Commission and RUCO even if real problems did not exist with is proposal.

RUCO, Staff & Industry proposal -

Encourage and create incentives for the consolidation for existing water companies

RUCO position on the concept -

RUCO believes consolidation of small water systems by larger well run companies would be in the public interest. RUCO is also aware that absent regulatory incentives, larger companies will not purchase smaller troubled water companies. It is important, however, that the incentives offered are appropriate, i.e. are not open to abuse, and are not offered in those situations were they are unnecessary to encourage the transaction. In other words, any incentive offered must be limited to transactions that would not occur except for the incentive. This effectively means incentives

should be limited too small (Class D & E) non-viable water companies.

PRO-

1) Encouraging the purchase of small non-viable water companies through regulatory incentives will provide the customers of those small systems with more reliable and better quality service. It will also ease the regulatory burden associated with numerous small systems.

2) If properly designed, incentives can remain in the control of the Commission while at the same time facilitating acquisitions and upgrading of small problem systems that would not otherwise occur, absent the incentive.

CON -

1) It is important that any incentive offered remains within the Commission's control. This objective would preclude the use of an acquisition premium (rate recovery of the purchase price in excess of book value) as a potential regulatory incentive. An acquisition adjustment would allow buyers and sellers of utility property to dictate the magnitude of the incentive through the buying and selling price. The higher the selling price, the greater the windfall profit to both buyer and seller, with captive ratepayers footing the bill.

2) Staff has developed a proposed set of criteria a utility would have to meet to qualify for an acquisition premium. While this criteria may ultimately be effective in preventing some of the dangers of allowing acquisition premiums, from a practical stand point would entail additional regulatory oversight, analysis, and create further demands on utilities as well as regulatory agencies. This is in conflict with the task force's stated goal of shorting and streamlining the regulatory process. This is an important point to keep in mind in examining any of the regulatory reforms proposed by the various parties to the task force. It is important that the vehicles and mechanisms we consider in our goal of regulatory reform don't further complicate and encumber an already burdensome process.

ISSUE NO. 2 - STRENGTHEN THE FINANCIAL CAPABILITY OF THE WATER INDUSTRY

Industry and Staff Proposal -

Distribution infrastructure replacement cost recovery mechanism

RUCO position on concept -

Such a mechanism, if properly designed, has the potential to promote the upgrading of deteriorating water systems, without harmful or biased rate impacts on customers.

PRO -

- 1) Would help facilitate the upgrading of aging water systems.
- 2) If designed after the Pennsylvania mechanism, would not allow utilities to recover investment prior to its used and usefulness.

CON-

- 1) Would allow the utility to circumvent regulatory lag that is unfavorable to the utility, but would not mitigate regulatory lag that is unfavorable to ratepayers. Potential matching/bias problem if not properly designed.
- 2) As proposed by Staff, this mechanism would pre-fund unidentified improvements, that were not known and measurable, nor used and useful, by creating a generic fund. This proposal is subject to too many unknowns and has a potential for numerous problems that are harmful to ratepayers. A mechanism as proposed by the industry that would mitigate the regulatory lag by recognizing certain plant improvements in rates, yet still require the improvements to be completed and in service prior to rate recognition would provide much more protection to ratepayers.

Industry proposal -

Expand utilization of pass through mechanism (Senate Bill 1252)

RUCO position on the concept -

Under the Industry proposal, utilities would be encouraged to avail themselves of the automatic pass-through provisions of Senate Bill 1252, by ensuring that the Commission only look at cost increases and not cost decreases. This is unacceptable and extremely biased against ratepayers.

PRO -

- 1) none

CON -

- 1) Will allow utilities to raise rates outside of a rate case for those costs that have increased yet would not recognize cost decreases. Highly biased against ratepayers.

Industry proposal -

Lower depreciation rates for small utilities and correct prior damage of too high depreciation rates

RUCO position concept -

RUCO agrees that depreciation rates that reflect the actual life of utility plant should be used instead of the generic 5% historically used by Staff for small utilities. We disagree however, that the rate bases of utilities that were subject to the 5% rate in the past should be retroactively restated to reflect actual lives.

PRO - 1) none

CON -

1) Under the Industry proposal, utilities that had already recovered their plant investment over 20 years through the 5% depreciation rate, would be allowed to reinstate a portion of the plant that had already been paid for by ratepayers and to collect it again from ratepayers. Regulation must provide for the opportunity to recover utility investment, but must not provide for double recoveries.

2) The Industry takes the position that if in any prior year a utility did not recover its depreciation expense (i.e. experienced an operating loss) then it should not be required to reflect the depreciation of its plant in its reserve account. This is contrary to ratemaking principles that allow an opportunity to earn a rate of return but not a guarantee. Further, there are a myriad of reasons why a utility experiences an operating loss. In order to implement a policy such as suggested by the Industry, ACC Staff would have to engage in post-mortem audits on utilities with operating losses to determine if retroactive recovery of expenses were appropriate. Such post-mortem rate reviews not only would further encumber the regulatory process, but also would result in a retroactive ratemaking system. Retroactive ratemaking is inconsistent with regulatory principles that offer an opportunity to earn a fair rate of return - not a guarantee.

Staff proposal -

Automatic rate changes

RUCO position on the concept -

RUCO believes automatic rate changes tied to the Consumer Price Index (CPI) is biased against ratepayers, and is not a concept that should be pursued.

PRO -

1) none

CON - 1) Staff's proposal to allow Class C, D & E utilities to carte blanche raise their rates based on a CPI inflation factor is highly biased against ratepayers and will result in annual rate increases without a finding of fair value. Staff's proposal would assume generic across-the-board expense increases, and would ignore the very real fact that costs also decrease. It would also allow utilities to raise rates without examining the mitigating offsets such as customer growth, consumption growth, and depreciation of the rate base.

Industry proposal -

Use of future or prospective test years

RUCO position on the concept -

RUCO strongly opposes the use of future (projected or prospective) test years. There are numerous problems with use of such test years. These include the setting of rates based on estimates that are not known and measurable, inclusion of plant in rates that is not used and useful, and violations of the matching concept when certain rate elements are projected or estimated and others are not. An historical test year inherently matches revenues, expenses, and investment, contains known and measurable data. The numerous problems and biases that result from the use of projected data far outweigh any potential benefit that could be derived from abandoning a historical test year.

PRO -

1) none

CON -

- 1) Projections and estimates forming the basis of permanent rates.
- 2) Mismatch of rate elements.
- 3) Inclusion of non-used and useful plant in rate base
- 4) Revenues, expenses, and investment are unauditable because these items are nothing more than estimates or projections.

Staff proposal -

Generic Hook-up fees

RUCO position on the concept -

RUCO agrees that working toward a recognized methodology for the use of hook-up fees is a desirable objective. Comments from

the water task force members on this issue were limited and more discussion on this topic is needed before proceeding with a recommendation to the Commission to initiate rule-making procedures.

PRO -

- 1) Free up time and resources currently expended on individual hook-up fee applications
- 2) Establish a consist rule or policy for all water utilities

CON -

- 1) Care must be used to ensure that the specific details of the generic hook-up fees do not create any undesirable or unanticipated impacts.

ISSUE NO. 3 - SIMPLIFYING, SHORTENING, AND REDUCING THE COST OF THE RATEMAKING PROCESS

Industry and Staff proposal -

Electronic filing of applications with ACC

RUCO position on the concept -

RUCO agrees with the concept of electronic filing

PRO -

- 1) Simplify and reduce the cost of rate filings

CON -

1) Feasibility dependant on ACC current technology and resources

Staff proposal -

Generic rate of return for all Arizona water companies

RUCO position on the concept -

The concept has merit and would simplify one aspect of a rate case - rate of return

PRO -

- 1) Rate of return is typically a resource intensive portion of a rate case, and predetermining the rate would certainly simplify and shorten this portion of a rate case.

CON -

- 1) Rate of return for larger utilities is a highly material item. Further, rate of return, particularly cost of equity, is dependant on more than the current economic and financial environment. The individual characteristics of a utility effect rate of return (i.e. capital structure). For these reasons a "one-size-fits-all rate of return"

would most likely not be appropriate for larger utilities. RUCO believes generic rates of return should be used only for Class C or smaller utilities.

ISSUE # 4 - IMPROVE CUSTOMER EDUCATION

Industry and RUCO proposal -

ACC Web site, ACC water seminars across the state, continue publishing water news

RUCO position on the concept -

RUCO believes all of these proposals would be in the public interest

PRO -

1) Promote customer awareness, and deliver the information necessary for resolving problems.

CON -

1) The ACC, as a state agency with a finite appropriation, may not have resources available for these items. May require additional appropriation.

Industry proposal -

Utility newsletters, utility "Customer Service Reference Guide"

RUCO position on the concept -

RUCO supports the Industry's proposal to participate in the customer education process.

PRO -

1) Create customer awareness, and promote good relations with community in which the utility operates.

CON -

1) Is subject to the availability of spare utility resources, which for small utilities in particular may not be possible.

Industry and Staff proposal -

RUCO publication that explains the basics of ratemaking and informs customers of their various options in participating in the ratemaking process.

RUCO position concept -

Such a publication would be in the public interest

PRO -

- 1) Promote ratepayer awareness
- 2) Free up time currently expended in individually responding to customer inquiries regarding the ratemaking process and customer rights.

CON -

- 1) RUCO's current appropriation does not contain funding for such a project. Additional appropriation would be necessary.

Staff proposal -

Company specific Main Extension Agreements (MXA)

RUCO position on the concept -

RUCO believes the proposal to set up MXAs in the form of a tariff for each water company has merit.

PRO -

- 1) Will eliminate the redundancy of approval of each individual agreement a utility enters into with developers and customers.

CON -

- 1) As with other regulatory reform proposals, care will need to be taken to ensure that the final rule on MXA's will not create any new regulatory problems or have any unanticipated adverse impacts on customers.

ISSUE # 5 - INCREASE INTERAGENCY COORDINATION

Industry and Staff position -

Neither Staff nor the Industry took a position on this issue in their original comments. Consequently RUCO has no reply.

OTHER ISSUES

The Staff in its filed comments has set forth some issues, which were not identified by the task force as goals for regulatory reform. Nevertheless our response is discussed below:

Staff proposal -

Generic rate design

RUCO position concept -

In RUCO's opinion, the water task force has failed to identify any suggestions pertaining to rate design that are worthy of additional rule-making consideration. Comments regarding rate design made by members of the task force to this point fail to capture the essence, purpose, importance, and complexity of rate design; are unsound and supportable; and generate a plethora of inequities, new problems, and unanswered questions.

PRO -

none

CON -

1) There is no credible study that demonstrates that inverted tier rate designs inherently promote conservation. For regulated utilities, where there is a target revenue requirement, the notion that an inverted tier rate structure automatically encourages a reduction in consumption is contrary to economic theory. There is no study that supports the underlying assumption that the elasticity of water is greater for large users than smaller users. Even if the consumption characteristics of some water company could be shown to be consistent with the assumption that elasticity is directly proportional to usage, it is not a universal truth that should be applied to all water systems.

2) The widely recognized primary purpose of rate design is to align rates with the cost of service. Even where conservation is a major consideration, the relationship between price and cost of service generally remains the primary purpose of rates. Education and water audits are generally recognized as significant factors of conservation programs. There is no basis for using rate design as the primary conservation mechanism.

3) The recommendation to use revenue from the "highest tier" to provide more than the approved rate of return is wrought with problems and ambiguities. How is "over-earning" defined? Who would assess the amount of the over-earnings? How would the over-earnings be treated, e.g., as a contribution? How would the over-earning be treated for tax treatment? Does this over-earnings essentially guarantee the authorized rate of return? If so, should the reduced risk be reflected as by a lower rate of return? Would failure to over-earn be given special treatment? Is the cost and effort for Staff, RUCO, and utilities to have audits conducted of the highest tier revenues justified by any benefits gained from this methodology? Is the suggestion to require utilities to file rate cases at least once every five years really necessary?

4) Rate design is one of the most important aspects of setting rates for public service corporations. A customer whose rates are excessive due to improper rate design is no less harmed than when a utility is allowed an excessive rate of return. The only rate design proposal presented by members of the task force would, apparently, allow both of these transgressions. This would be incompetent and derelict, and it is simply unacceptable. Ratepayers deserve properly designed rates. Due to the complex nature of rate design and the many varying circumstances of water system - it is unlikely that any scripted methodology for designing rates would be appropriate.

WATER SUPPLY SUBCOMMITTEE

The Water Supply Subcommittee was charged with discussing issues of long-term water supply for water utilities under the jurisdiction of the Arizona Corporation Commission ("Commission"). The Subcommittee quickly narrowed the issue to the potential recovery of Central Arizona Project ("CAP") costs by water utilities.

ISSUE:

Under what circumstances should CAP expenses be recovered by water utilities?

Staff proposal:

CAP costs should be recovered on an interim basis once a company has a plan approved by the Commission to use CAP water within five years of the approval of the plan.

Arizona Department of Water Resources:

DWR takes Staff's suggestion noted above and suggests that capital charges for the entire allocation should be recoverable immediately if the provider develops a plan that demonstrates certain criteria.

RUCO Proposal:

As RUCO adheres to the used and useful ratemaking principle, each utility must be using CAP water before such costs may be recovered. "Using" CAP water is not limited to the water flowing through the utilities' pipes, but by the use of groundwater replenishment, water exchange agreements, etc. RUCO's position in the recent Paradise Valley Water Company ("Paradise Valley") rate case (Decision No. 61831) recommended approval of Paradise Valley's use of a water exchange agreement with Salt River Project.

RUCO also recently filed testimony in the application of Citizens Utilities' Sun City Water Company and the Sun City West Utilities Company for approval of a CAP

utilization plan and for an accounting order on deferred charges and the annual ongoing costs of CAP water. RUCO recommends approval of the companies' interim plan to deliver its entire CAP allocation to the Maricopa Water District groundwater saving project ("MWD"). For every acre foot of groundwater not pumped by the farmers in the MWD, Sun City and Sun City West will be able to draw water from wells to meet existing demand in their respective service territories. RUCO also recommends the recovery of the deferred CAP charges and the annual ongoing costs of the CAP water.

Other water companies should look to such utilities to determine whether a similar mechanism may be appropriate in order to "use" their CAP allocations. Until a water company has a CAP water usage plan implemented with CAP water "used", the costs of CAP water should be borne by the utility and not by ratepayers.

PRO:

Ideally, water utilities should already have been planning how to use their CAP allocations. Such plans should facilitate the use of CAP water so that ratepayers see a concrete benefit and the groundwater policies of Arizona are furthered. Perhaps utilities that have not begun planning how to use their CAP allocations will begin to do so.

CON:

The CAP water is not benefiting ratepayers when the CAP water is not being used, whether by actual use by the utility, by a water exchange agreement or by groundwater replenishment. Utilities should have been planning how to use their CAP allocations as a part of their business plans. A utility should not recover costs based on an idea about how to potentially use their CAP allocation in the future. As many intervening events may occur before a utility actually begins to "use" its allocation, it is too speculative and hypothetical to burden ratepayers with a CAP charge when they will not receive benefits for a number of years, if ever. There are a few recent examples where water utilities have implemented the "use" of their CAP allocations through exchanges and ground water saving projects. Other water utilities should look to those companies to determine what the best options are to "use" their CAP allocations.