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BEFORE THE ARIZONA CORPORATION C

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

DOCKET NO. W-01303A-07-0209

STAFF'S REPLY BRIEF

I. INTRODUCTION

The following is Staff's reply to the initial briefs filed by Arizona-American Water Company ("Company"), the Residential Utility Consumer Office ("RUCO") and the Town of Youngtown ("Town"). There remain few areas of disagreement between Staff and the Company and Staff and RUCO. Staff continues to disagree with RUCO on the issue of fire flow improvements and the proposed fire flow cost recovery mechanism ("FCRM"). Contrary to the characterization by RUCO that the discretionary fire flow improvements included in rate base was a "Joint Proposal of Staff, the Company and the Town", Staff did not make a proposal with the Company or the Town but merely agreed that the improvements were necessary for public safety and health and recommended, with changes, that the Company's proposal for a method of recovery for costs expended for fire flow improvements be approved. Staff and the Company continue to disagree on the capital structure.

II. FIRE FLOW IMPROVEMENT PROJECT

A. RUCO's argument that the Town is not legally prohibited from funding private utility investment is contrary to the evidence and case law.

Staff would urge the Commission to approve the proposed fire flow improvement project and the proposed FCRM. All parties in this docket agree that adequate fire flow is necessary to public health and safety. No party is in disagreement as to the Commission's authority to require public

1 service corporations to operate in such a way as to “promote and safeguard” the safety of the
2 ratepayers it serves.

3 In its initial brief, Staff concluded that the Town of Youngtown had no means to fund the fire
4 flow improvement project.¹ Mayor LeVault testified that Youngtown is precluded by constitutional
5 restrictions and its own lack of financial resources from providing funding.² Staff believes, as is
6 believed in the Paradise Valley docket,³ that RUCO’s reliance on *Town of Gila Bend v.*
7 *Walled Lake Door Company*, 107 Ariz. 545, 490 P.2d 551 (1971) is misplaced.

8 RUCO, in its initial brief, argues that there is no legal prohibition preventing the Town or Sun
9 City from funding the Company’s fire flow investment. RUCO also argues that the Commission
10 should reject the Town’s claim that the Gift Clause in the Arizona Constitution prohibits it from
11 funding the investment.⁴ RUCO also argues that the Town’s reliance on A.R.S. § 9-514 is misplaced,
12 but nowhere in the record does the Town argue that it is unable to fund the fire flow improvement
13 project because of A.R.S. § 9-514. However, Staff believes that RUCO has misinterpreted, yet again,
14 the holding in the *Town of Gila Bend*.

15 RUCO narrowly interpreted *Town of Gila Bend*, to hold that “A.R.S. § 9-514 (through 9-516)
16 [only] deals with the power of municipalities to engage in *competition* with businesses of a public
17 nature.”⁵ RUCO also broadly interpreted *Town of Gila Bend* to hold that the Gift Clause is not
18 violated if public funds are spent for public purposes. Based on its interpretations, RUCO concluded
19 that neither A.R.S. § 9-514 nor the Gift Clause prohibits a municipality from funding private utility
20 investment.

21 Not only are the facts of *Town of Gila Bend* distinguishable from the facts in this case, but
22 RUCO also misinterprets the legal holdings. In *Town of Gila Bend*, a municipality entered into a
23 contract with a private company to construct a water main to the company’s plant to provide fire
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26 _____
27 ¹ Staff’s Br. at 13.
² Tr. at 279, 281-83.
³ See Docket No. W-01303A-05-0405 et. al, Staff’s Reply Brief at 2.
⁴ RUCO’s Br. at 4-5.
28 ⁵ *Id.* at 6 (emphasis in the original).

1 flow.⁶ The municipality refused to perform under the contract and the company sued for specific
2 performance.⁷

3 The court examined whether the agreement violated either Article 9, Section 7 (the Gift
4 Clause) of the Arizona Constitution or A.R.S. §§ 9-514 through 9-516. In looking at the Gift Clause,
5 the court explained the purpose of the Gift Clause stating that:

6 This section provides, in essence, that a town may not make gifts,
7 donations or grant subsidies to private enterprises, nor may it pledge its
8 credit or invest public funds in any such private enterprise.⁸

9 The court then rejected the town's argument that the agreement violated the Gift Clause because the
10 water main would only benefit the private company. The court's primary reason was that "ownership
11 and control over the water line are to remain in the Town."⁹ The court further concluded that, even
12 though the private company benefited from the water line, the public at large also directly benefited.¹⁰

13 In this case, the Company will ultimately own and control the plant, unlike the facts in *Town*
14 *of Gila Bend*. Staff would argue that the issue in the instant case is not who benefits from fire flow
15 improvements, which is at the crux of RUCO's argument, but rather who would own and control the
16 plant. The court distinguished cases where ownership and control of an asset remain with a public
17 entity from cases where a private enterprise becomes the owner.

18 The court then addressed the town's argument that A.R.S. §§ 9-514 through 9-516 "require
19 the Town to purchase the whole of the existing waterworks before it can lawfully begin construction
20 of the water line."¹¹ In *Town of Gila Bend*, the agreement required the town to construct a water line
21 from a water tank owned by the Southern Pacific Railroad Company to the plant.¹² Apparently, the
22 town of Gila Bend argued that the agreement violated the statutes because it did not include purchase
23 of the water tank.
24

25 ⁶ *Town of Gila Bend*, 107 Ariz. 547, 490 P.2d 553 (1971).

26 ⁷ *Id.* at 548, 490 P.2d at 554.

27 ⁸ *Id.* at 549, 490 P.2d at 555 (emphasis added).

28 ⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.* at 550, 490 P.2d at 556.

¹² *Id.* at 547, 490 P.2d at 553.

1 The court rejected the town’s argument, explaining that a “*brief reading* of these sections
2 discloses that they deal with the power of municipalities to engage in competition with businesses of
3 a public nature.”¹³ The court concluded that the statutes were inapplicable because the town did not
4 seek to compete “with the existing waterworks.”¹⁴ Therefore, the agreement could require
5 construction of the water line, but not purchase of the water tank, without violating the statutes.

6 Relying on the holding, RUCO argues that the Town is not prohibited by A.R.S. § 9-514 from
7 funding the Company’s fire flow investments because the Town is not competing with the
8 Company.¹⁵ RUCO fails to acknowledge the factual differences between this case and the *Town of*
9 *Gila Bend* as well as misconstrues the court’s reasoning.

10 Unlike the Town of Gila Bend, the Town will not own the fire flow plant. Thus, RUCO’s
11 reliance on the case is unfounded. Additionally, the court’s brief reasoning does not address whether
12 a municipality may invest public funds in a private utility without violating the statutes. Moreover, it
13 is unreasonable to assume that the court would reach such a conclusion because it would be contrary
14 to the court’s holding on the Gift Clause.

15 RUCO’s argument fails to recognize that the improvements would not just be made in
16 Youngtown or Sun City. Portions of the improvements lie within the City of Peoria. RUCO never
17 addresses how the Town or Sun City can fund projects that take place within the boundaries of the
18 City of Peoria. Further RUCO argues that the Sun City Recreation Center has authority to fund the
19 improvements and that the improvement project is the type of discretionary project that is within the
20 purview of the Recreation Center.¹⁶ A review of the Articles of Incorporation of the Recreation
21 Center found at their website does not reveal as a part of the authority of the Center, to “fund or build
22 fire flow improvement projects”.¹⁷

23 RUCO speculates that the Company intends to use the model approved in the Paradise Valley
24 case in all of its districts and the end result would “in the long run jeopardize the affordability of
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26 ¹³ *Id.* at 549, 490 P.2d at 555 (emphasis added).

27 ¹⁴ *Id.*

28 ¹⁵ RUCO’s Br. at 6.

¹⁶ *Id.* at 12.

¹⁷ <http://www.sunaz.com/pdfs/corporate/Articles%20of%20Incorp.pdf>.

1 water service in Arizona”.¹⁸ There is nothing in the record that suggests that protecting public safety
2 would make water unaffordable. In fact, the Sun City District has one of the lowest water rates in the
3 state. And further as shown in both the Company’s and Staff’s late filed exhibits, the burden on
4 ratepayers in terms of cost is relatively small.¹⁹ Further, each case is judged on its own merits as was
5 stated in the Paradise Valley Decision.²⁰ There is nothing that would suggest that the Commission
6 would not investigate and reach a conclusion based on the facts of a specific case.

7 **B. Fire flow improvements already exist in rate base.**

8 RUCO argues that the fire flow improvements should not be included in rate base because
9 they are discretionary, there is no Commission rule or statute that governs or sets a fire flow standard
10 and that the expenditures will significantly increase the rate base and not produce any incremental
11 revenue. Staff Witness Alexander Igwe testified that Staff views public safety projects as revenue
12 neutral.²¹ Further, even RUCO’s witness Marylee Diaz Cortez recognized that fire hydrants and
13 mains already exist in rate base.²²

14 **III. COST OF CAPITAL**

15 Staff continues to disagree with the Company regarding the Company’s Capital Structure.
16 Staff recommends including short-term debt in the capital structure. The Company argues that unless
17 Staff can show that short-term debt is actually being used to finance long term assets and that Staff
18 has calculated a typical short-term debt balance, then Staff has not met the burden of proof to show
19 that short-term debt should be included in the capital structure.

20 Company witness Tom Broderick acknowledged that short-term debt is a component of capital
21 costs.²³ Short-term debt is part of the capital structure, and its use in terms of its representation in the
22 Company’s capital structure is not relevant. Staff could not trace a dollar of short-term debt and
23 assign that particular dollar to a project. Dollars are not color-coded. Staff subscribes to a principle
24

25 _____
26 ¹⁸ RUCO’s Br. at 4.

27 ¹⁹ See Staff’s Br. at 11-12.

28 ²⁰ Decision No. 68858, Dockets No. W-01303A-05-0405, W-01303A-05-0910 (Consolidated), (July 28, 2006).

²¹ Tr. at 974:23-24.

²² *Id* at 630-32.

²³ *Id.* at 420.

1 of financial theory that money is fungible and a dollar collected from any particular source cannot be
2 assigned to a particular project. All funds form a single pool of capital used to finance all activities.

3 The Company argues that short-term debt used to finance working capital and Construction
4 Works in Progress ("CWIP") should not be included in a company's capital structure.²⁴ Staff does
5 not adjust a company's capital structure based on what funds are used for activities whether or not
6 those activities are included in rate base. RUCO argues that the short-term debt used to finance a
7 Central Arizona Project Treatment Facility, White Tanks, should be excluded from the capital
8 structure.²⁵ Staff maintains that it is impossible to determine what dollars in the available pool of
9 capital is assigned to that project. Such debt should be included in the Company's capital structure.

10 Staff contends that the inclusion of short-term debt gives a more accurate view the
11 Company's financial position. Staff continues to urge the adoption of its recommended capital
12 structure of 61% debt and 39% equity.

13 **IV. CONCLUSION**

14 Staff continues to urge that the fire flow improvement project be approved along with the
15 FCRM as proposed by Staff. Staff believes that the project impacts the health and safety of the
16 Company's ratepayers and the approval of such a project is within the Commission's authority.
17 RUCO's position fails to identify an alternative means of to fund the project and facets of their
18 position are not supported by the law or the record and should thus be disregarded. Staff also urges
19 the Commission to adopt its recommended capital structure, of 61% debt, 39% equity.

20 RESPECTFULLY submitted this 27th day of February, 2008.

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23 

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24 Company's Br. at 11.

25 RUCO's Br. at 23.

1 Original and thirteen (13) copies
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