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Executive Director

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ARIZONA CORPORATION COMMISSION

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DATE: APRIL 17, 2008

DOCKET NO: W-01303A-07-0209

TO ALL PARTIES:

Enclosed please find the recommendation of Administrative Law Judge Jane Rodda
The recommendation has been filed in the form of an Opinion and Order on:

ARIZONA-AMERICAN WATER COMPANY
(RATES)

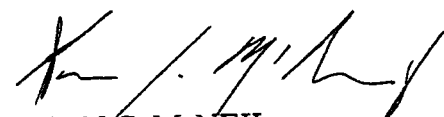
Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of
the Administrative Law Judge by filing an original and ten (10) copies of the exceptions with
the Commission's Docket Control at the address listed below by **4:00** p.m. on or before:

APRIL 28, 2008

The enclosed is NOT an order of the Commission, but a recommendation of the
Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively
been scheduled for the Commission's Working Session and Open Meeting to be held on:


MAY 6, 2008 and MAY 7, 2008

For more information, you may contact Docket Control at (602) 542-3477 or the
Hearing Division at (602)542-4250. For information about the Open Meeting, contact the
Executive Secretary's Office at (602) 542-3931.


BRIAN C. McNEIL
EXECUTIVE DIRECTOR

Arizona Corporation Commission
DOCKETED

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

MIKE GLEASON, Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

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 WATER
DISTRICT.

DOCKET NO. W-01303A-07-0209

DECISION NO. _____

OPINION AND ORDER

DATE OF PUBLIC COMMENT:

May 16, 2007

PLACE OF PUBLIC COMMENT:

Sun City West, Arizona

DATE OF HEARING:

January 7-11, 2008

PLACE OF HEARING:

Phoenix, Arizona

ADMINISTRATIVE LAW JUDGE:

Jane L. Rodda

IN ATTENDANCE

Chairman Mike Gleason
Commissioner William Mundell
Commissioner Kristin Mayes
Commissioner Gary Pierce

APPEARANCES:

Craig Marks, CRAIG MARKS PLC and
Paul Li, Arizona-American Water
Company, on behalf of Arizona-
American Water Co;

William Sullivan, CURTIS, GOODWIN,
SULLIVAN, UDALL & SCWHAB,
PLC, on behalf of The Town of
Youngtown;

Daniel Pozefsky, Staff Counsel, on
behalf of the Residential Utility
Consumer Office; and

Robin Mitchell and Keith Layton, Staff
Attorneys, Legal Division, on behalf of
the Utilities Division of the Arizona
Corporation Commission.

1 **BY THE COMMISSION:**

2 I. Procedural History

3 On April 2, 2007, Arizona-American Water Company (“Arizona-American” or “Company”)
4 filed an application for a rate increase for its Sun City Water District.

5 On April 30, 2007, the Commission’s Utilities Division (“Staff”) filed a letter stating that the
6 application met the sufficiency requirements outlined in A.A.C. R14-2-103, and classifying the
7 Company as a Class A utility.

8 On May 16, 2007, the Commission convened a Special Open Meeting for the purpose of
9 taking public comment on the rate increase in this matter as well as Docket No. WS-01303A-06-
10 0491, Arizona-American’s then pending rate case for its Sun City and Sun City West Wastewater
11 Districts.

12 By Procedural Order dated June 5, 2007, the Commission set the matter for hearing on
13 January 7, 2008, established procedural guidelines and deadlines for filing testimony and granted
14 intervention to the Residential Utility Consumer Office (“RUCO”) and the Sun City Taxpayers
15 Association, Inc. (“SCTA”).

16 On September 13, 2007, the Commission granted intervention to the Town of Youngtown
17 (“Youngtown” or “Town”).

18 On September 19, 2007, Arizona-American filed Notice of Filing Affidavit of Publication,
19 indicating that notice of the hearing in this matter was published on September 11, 2007, in the *Daily*
20 *News-Sun*.

21 On September 21, 2007, Arizona-American filed Notice of Filing Affidavit of Customer
22 Notice, indicating that the notice of the hearing had been mailed to Arizona-American’s Sun City
23 District customers.

24 On October 3, 2007, William E. Downey of Sun City, Arizona, filed a Motion to Intervene.

25 On October 15, 2007, RUCO filed the Direct Testimony of Marylee Diaz Cortez, William
26 Rigsby and Timothy Coley; Youngtown filed the Direct Testimony of Mayor Michael LeVault and
27 Deputy Fire Marshall Ken Rice; and Staff filed the Direct Testimony of Alexander Igwe, Stephen
28 Irvine on cost of capital and Dorothy Hains.

1 On October 19, 2007, the Commission granted intervention to Mr. Downey.

2 On October 29, 2007, Staff filed an Errata for Mr. Irvine's cost of capital testimony filed on
3 October 15, 2007, and also filed Mr. Irvine's Direct Testimony on rate design and Mr. Igwe's Direct
4 Testimony addressing the revision to Staff's recommended revenue requirement and
5 recommendations regarding the Company's request for a Public Safety Surcharge Mechanism.

6 On October 29, 2007, RUCO filed Mr. Coley's Direct Testimony on rate design.

7 On November 30, 2007, Arizona-American filed the Rebuttal Testimony of Linda Gutowski,
8 Bradley Cole, Cindy Datig, and Thomas Broderick.

9 On December 14, 2007, RUCO filed the Surrebuttal Testimony of Ms. Diaz Cortez, Mr.
10 Rigsby and Mr. Coley; Staff filed the Surrebuttal Testimony of Mr. Igwe, Ms. Hains, and Mr. Irvine;
11 and Youngtown filed the Surrebuttal Testimony of Mayor LeVault.

12 On December 11, 2007, the SCTA filed a request to withdraw from intervenor status because
13 it was not represented by an attorney as required by Arizona Supreme Court Rules 31 and 38 and
14 A.R.S. § 40-243.

15 On December 21, 2007, Arizona-American filed the Rejoinder Testimony of Mr. Broderick,
16 Ms. Gutowski and Joseph E. Gross.

17 On January 3, 2008, the Commission conducted a Pre-Hearing Conference to schedule
18 witnesses. The Commission granted the SCTA request to withdraw as an intervenor and invited it to
19 present its position through public comment.

20 The hearing convened as scheduled on January 7, 2008, before a duly authorized
21 Administrative Law Judge. At the commencement of the hearing, the Commission heard comments
22 from a number of Arizona-American Sun City Water District customers, including the SCTA. In
23 addition, during the public comment segment of the hearing, Mr. Downey withdrew as an intervenor
24 and provided public comment.

25 On January 14, 2008, Arizona-American filed Final Schedules.

26 On January 16, 2008, Staff filed its post-hearing exhibit on the bill impact of the proposed
27 surcharge.

28 On January 18, 2008, Arizona-American filed late-filed Exhibits A-14, A-15 (revised) and A-

1 16, concerning the Company's investment policy concerning fire flow investments, its revised
2 calculation of the estimated bill impact of the fire flow project, and status of low income programs in
3 Arizona-American's regulated states.

4 On January 22, 2008, RUCO filed its final post-hearing schedules and final rate design.

5 On January 25, 2008, Arizona-American filed a Response to a billing issue raised during
6 public comment.

7 On February 1, 2008, Youngtown filed late-filed exhibits concerning fire losses and fire
8 sprinkler system costs.

9 On February 13, 2008, RUCO, Youngtown, Staff and Arizona-American filed Closing Briefs.

10 On February 27, 2008, RUCO, Youngtown and Staff filed Reply Briefs.

11 On February 28, 2008, Arizona-American filed its Reply Brief.

12 In April 2008, the Commission received approximately 60 additional emails from Sun City
13 residents opposed to the fire flow improvement project.

14 II. Background of Applicant

15 Arizona-American is the largest, investor-owned water utility in Arizona, serving
16 approximately 131,000 customers in various districts located throughout the state. The Sun City
17 Water District is Arizona-American's second largest water district serving approximately 23,000
18 customers. The Sun City Water District covers roughly 18 square miles and includes all of Sun City
19 and the Town of Youngtown, as well as small sections of the cities of Peoria and Surprise. The Sun
20 City Water District system was built in the 1960s and originally owned and operated by Citizens
21 Utilities. In 1993, Citizens Utilities purchased the Youngtown System and interconnected it with the
22 Sun City System. Arizona-American purchased the Sun City Water District from Citizens Utilities in
23 2003.

24 Arizona-American's Sun City Water District's current rates were set in Decision No. 67093
25 (June 20, 2004).

26 III. Summary of Requested Rate Increase

27 In the Test Year ended December 31, 2006, Arizona-American experienced Operating Income
28

1 of \$755,506, on total revenues of \$7,688,479.¹ Based on an adjusted end of Test Year Original Cost
2 Rate Base (“OCRB”) of \$25,395,922, Arizona-American had a rate of return of 2.99 percent.

3 The Company requests total revenues of \$9,711,596, an increase in annual water revenues of
4 \$2,023,117, or 26.3 percent. Based on Company-adjusted Operating Expenses of \$7,758,974
5 Arizona-American would earn an Operating Income of \$1,952,622, a 7.7 percent rate of return on
6 adjusted OCRB.²

7 Arizona-American asserts that its financial condition is so strained that it cannot make any
8 discretionary capital improvements in Arizona without prompt rate relief. It states that its parent
9 company, American Water, has supported Arizona-American’s statewide operations with capital
10 infusions of \$125 million since the late 1990’s, of which the Sun City Water District’s portion is not
11 yet in rate base. In addition, for all of its Arizona operations Arizona-American claims it is facing the
12 prospect of substantial refunds due in 2008 to Pulte Homes, for the Anthem development, substantial
13 construction costs associated with the White Tanks Regional Water Treatment Plant, and arsenic-
14 remediation investments in 2006. The Company claims that without a special funding mechanism it
15 does not have the financial ability, even with the rate increase requested, to make the fire flow
16 improvements that were recommended by the Youngtown/ Sun City Fire Flow Task Force that was
17 created by Decision No. 67093 (June 30, 2004). Thus, in addition to the requested rate increase,
18 Arizona-American seeks approval of a Fire Flow Cost Recovery Mechanism (“FCRM”) to allow it to
19 make facility upgrades to effectuate the capital improvement plan adopted and recommended by the
20 Youngtown /Sun City Fire Flow Task Force.

21 RUCO recommends a revenue increase of \$1,806,508 for the Sun City Water District, for
22 total Revenues of \$9,496,831, and Operating Income of \$1,865,119, a 7.36 percent rate of return on
23 an adjusted OCRB of \$25,341,290.³ Moreover, RUCO recommends against adopting the FCRM,
24 on the grounds that the improvements are discretionary, and at a time of increasing utility costs,
25 ratepayers should not be burdened with the cost of discretionary projects.⁴ RUCO believes that

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27 ¹ See Discussion § IVB herein.

² Exhibit LJC F-1, Arizona-American Final Schedules filed January 14, 2008.

³ RUCO final schedules, TJC-1, filed January 22, 2008.

⁴ RUCO Opening Brief at 2.

1 because these projects are discretionary, Arizona-American, or parties requesting them, such as the
2 Town, should fund them.

3 Staff recommends a revenue requirement of \$9,632,551, an increase of \$1,944,072, or 25.28
4 percent, over Test Year revenues.⁵ Staff's recommended rates result in Operating Income of
5 \$1,922,490, or a 7.60 percent rate of return on an adjusted OCRB of \$25,295,921.⁶ Staff supports the
6 implementation of the FCRM because Staff believes the fire flow project is necessary for public
7 safety.

8 Youngtown, a member of the Task Force, did not take a position on the requested rate
9 increase, but offered testimony and argument in favor of the FCRM.

10 The Commission received a number of written comments concerning the rate increase and
11 proposed fire flow project. Most customers are concerned with the magnitude of the effect on their
12 bills from the rate increase in addition to the proposed surcharge. Public Comment revealed that at
13 least among the members of the community appearing before the Commission, there is a split of
14 opinion on the FCRM. Those opposing the fire flow improvement project did not believe the
15 improvements were necessary, nor that the costs should be borne by all customers in the Sun City
16 Water District. The SCTA, one of the members of the Task Force, supports the need for the fire flow
17 improvements but did not support the proposed recovery mechanism. SCTA believed that the cost
18 of the fire flow improvements should be recovered through the traditional rate making process.⁷ The
19 Sun City Recreation Association, also a member of the Task Force, and which agreed to the Task
20 Force's findings, expressed the opinion that each area should pay for its own improvements.⁸

21 IV. The Rate Case

22 A. Rate Base Issues

23 Arizona-American and Staff agree on an adjusted rate base of \$25,295,922. RUCO
24 recommends a rate base of \$25,341,290. The difference between RUCO and Arizona-American and
25 Staff is that RUCO includes \$45,368 for cash working capital. Arizona-American did not perform a

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27 ⁵ Ex S-22 Igwe Surrebuttal.

27 ⁶ *Id.*

28 ⁷ Tr at 10-11.

⁸ Tr at 38.

1 lead-lag study and did not request an allowance for cash working capital.

2 RUCO argues that the Company's request for a zero cash working capital balance is not based
3 on an objective analysis of the Company's cash working capital needs. RUCO adopted and adjusted
4 the lead/lag study the Company developed for its Mohave District rate application for use in this
5 proceeding.⁹ RUCO believes that a large portion of the expenses are incurred at the Company's
6 central/corporate headquarters, and are common to both the Mohave and Sun City Districts, so that
7 the study performed for the Mohave District is applicable to the Sun City District. RUCO argues
8 further that the use of a lead/lag study is not biased towards ratepayers or shareholders. RUCO
9 believes the adjusted lead/lag study it utilizes in this case is appropriate and the best indicator of the
10 Company's working capital requirements.

11 RUCO attempts to liken the adjustments it made to the Mohave District lead/lag study in this
12 case to the adjustments it made to the lead/lag study prepared in conjunction with Arizona-
13 American's Paradise Valley rate case in Docket No. WS-01303A-06-0014.¹⁰ However, in the
14 Paradise Valley case, as reported by RUCO, the lead/lag study had been initially prepared by the
15 Company for the Paradise Valley rate case, but ultimately not pursued by the Company. That is not
16 the situation here. We find that it is inappropriate to utilize the lead/lag study performed for another
17 entity that is located some distance from the applicant district, and which was prepared several years
18 earlier, to determine the allowance for cash working capital in this case.

19 The Commission has traditionally required Class A utilities to perform a lead/lag study to
20 support a request for an allowance for working capital, but the Commission has not required that such
21 study be performed if no allowance is requested. In this case, we do not find RUCO's evidence
22 persuasive and will adopt the position of Staff and the Company for a zero balance Cash Working
23 Capital Allowance.

24 Consequently, the Commission adopts an OCRB of \$25,295,922. The Company did not
25 request a reconstruction cost new rate base for the Sun City Water District, so we adopt its OCRB as
26 the Sun City Water District's fair value rate base ("FVRB") in this proceeding.

27 ⁹ The Commission approved the Mohave District rates in Decision No. 69440 (May 1, 2007), which used a test year
ending June 2005.

28 ¹⁰ RUCO Reply Brief at 7-8.

1 B. Operating Income

2 1. Revenue Annualization

3 RUCO annualized the Company's Test Year revenues to a year-end customer level to achieve
4 what it claims is a more accurate accounting of revenue on a going-forward basis. RUCO's
5 adjustment increased revenues from water sales by \$1,844, from \$7,578,436 to \$7,580,280. The
6 Company did not annualize revenues because it asserts the Sun City Water District has experienced
7 virtually no growth. RUCO argues that although growth was small, the District did experience some
8 growth, and annualizing revenues is proper ratemaking procedure.

9 Arizona-American asserts that if the Commission annualizes revenues, it should also
10 annualize expenses, and proposed adjustments, that would increase operating expenses by \$2,649.
11 RUCO had no objection to annualizing expenses, but did take issue with the Company's calculations.
12 RUCO recalculated the annualization of expenses to yield a total expense annualization of \$1,034.
13 Thus, RUCO recommends adopting a net increase in revenues of \$810. The Company continues to
14 believe that annualization is not appropriate, but concedes that RUCO's calculations are correct.

15 We find that the proposed adjustment of \$810 is immaterial for a Company with Test Year
16 revenues of over \$7.5 million. While RUCO's methodology and calculations may be correct, an
17 increase of only 30 residential customers in an area that is essentially built-out does not materially
18 affect the revenue requirement. The calculation adds an unnecessary degree of uncertainty without
19 commensurate benefit. Thus, we decline to adopt RUCO's recommended adjustment, and find the
20 Test Year revenues to be \$7,688,479.

21 2. Property Tax Expense

22 Staff and Arizona-American agree on the methodology to use to calculate the appropriate
23 Property Tax Expense, and any difference in the recommended amount for Property Tax Expense
24 results from Staff's slightly lower revenue deficiency, as well as to a lesser extent to Staff including
25 the net book value of transportation equipment that the Company omitted. The difference in the Test
26 Year under current rates is \$32,528.

27 Arizona-American and RUCO disagree on the methodology to calculate Property Tax
28 Expense. RUCO advocates using the Arizona Department of Revenue ("ADOR") formula to

1 estimate property taxes. RUCO states the ADOR formula multiplies the average of the utility's three
2 previous years of reported gross revenues by a factor of two. RUCO asserts that the ADOR formula
3 would reduce the Company's Property Tax Expense by \$25,999. Because the Commission has not
4 adopted RUCO's proposal in the past, RUCO proposes an alternative methodology to utilize two
5 years of historic data, instead of three, and one year of "RUCO's proposed level of Revenue."
6 RUCO claims the Commission approved this methodology in Decision No. 64282 (December 28,
7 2001), which was the rate case for Arizona Water Company's Northern Group. RUCO believes this
8 methodology results in a better estimate of future property taxes than that proposed by the Company,
9 which utilizes two years of the adjusted test year revenues and one year of the proposed revenues.
10 RUCO claims the Company's proposed methodology allows the Company to over-collect for many
11 years before the actual assessment would catch up with the Company's 2008 projected revenue.
12 RUCO states that using its alternative proposal would reduce the Company's Property Tax Expense
13 by \$4,912.

14 Arizona-American argues that RUCO's proposal in this case, which is slightly different than
15 its past proposals to use three years of historic data, still relies heavily on the historic data. Arizona-
16 American asserts that the Commission has repeatedly rejected RUCO's past proposals to utilize three
17 years of historic data, and should reject RUCO's modified proposal in this case because the heavy
18 reliance on historic revenues will understate the actual property tax expense.

19 In recent years the Commission has consistently utilized the methodology of calculating
20 Property Tax Expense that has been advocated by the Company and Staff. This is the methodology
21 we adopted in the recent rate case for Arizona-American's Sun City Wastewater District and Sun
22 City West Wastewater District in Decision No. 70209 (March 20, 2007). Although we appreciate
23 RUCO's efforts to continue to work to find the best possible workable estimate of actual Property
24 Tax Expense, and look forward to reviewing the evidence resulting from RUCO's study, we are not
25 convinced that RUCO's proposed methodological modification warrants deviating from our recent
26 practice for calculating this expense.

27 Arizona-American did not dispute Staff's calculation using the net book value of
28 transportation equipment, and we will utilize Staff's methodology.

1 3. Annual Incentive Pay ("AIP")

2 RUCO proposes to disallow 30 percent of the Annual Incentive Pay Expense, or \$32,230.
3 RUCO states that its adjustment reflects the Commission's recent rate order for Arizona-American's
4 Paradise Valley Water District in Decision No. 68858 (July 28, 2006). RUCO's adjustment reflects
5 that portion of the Annual Incentive Plan directly related to financial performance, rather than to
6 operational and individual performance measures. In the Paradise Valley District rate case, the
7 Commission adopted RUCO's position that the primary beneficiaries of the Company meeting
8 financial targets are the shareholders.

9 Arizona-American argues that RUCO's reliance on the Paradise Valley decision is
10 unfounded because unlike the Paradise Valley situation, the Sun City Water District is a former
11 Citizens Utilities property and Arizona-American is unprofitable in this District. Hence, the
12 Company argues any increase in net income attributable to employees achieving financial targets
13 only helps reduce losses, and not create profit. Arizona-American asserts this reduces ongoing equity
14 erosion and helps Arizona-American to achieve the shared goal of a 40 percent equity ratio. Thus,
15 Arizona-American argues it is appropriate to reward employees for reducing losses and helping to
16 create a healthier utility, which benefits customers.

17 RUCO asserts that the Company's arguments are without merit. First, RUCO states it is not
18 true that the Company is unprofitable, as in the Test Year, and two previous years, the Company had
19 a positive net operating income. Second, RUCO states the District's profitability is irrelevant. The
20 AIP program is the same incentive program in all of Arizona-American's districts, and if some
21 districts were consistently operating at a loss, RUCO believes it is difficult to imagine that the
22 Company would be paying out rewards for not hitting earnings targets. Furthermore, RUCO asserts
23 shareholders also benefit from the increased profits of a healthier utility and should bear a portion of
24 the AIP costs.

25 We agree with RUCO. Shareholders are the primary beneficiaries of the Company meeting
26 financial targets, and should share in the cost of the AIP. The Company's arguments do not convince
27 us that the financial condition of the Sun City Water District warrants deviating from our earlier
28 practice in the Paradise Valley and Sun City Wastewater and Sun City West Wastewater rate cases.

1 Consequently, we adopt RUCO's adjustment of \$32,230.

2 4. Maintenance Expense

3 On December 14, 2007, Staff recommended a \$27,254 annual amortization expense to
4 recover deferred tank maintenance expense.¹¹ Arizona-American accepted Staff's recommended
5 level of tank-maintenance expense. RUCO did not.

6 RUCO states that this adjustment was filed late and RUCO did not have adequate time to
7 verify or analyze the adjustment and the Company did not provide RUCO with sufficient supporting
8 data to verify this expense.

9 Arizona-American states that it first requested recovery of this expense on November 30,
10 2007, as part of its Rebuttal Testimony. Arizona-American states that RUCO did not address the
11 issue in its Surrebuttal Testimony. Because the amount of the expense was supported by two
12 witnesses, and RUCO did not present any contrary evidence, Arizona-American argues that the
13 Commission should accept the amount.

14 RUCO does not provide any details on why the supporting data provided to it was
15 insufficient. The adjustment was proposed in sufficient time for the parties to analyze it. Based on
16 Staff's recommendation, we adopt this adjustment to Maintenance Expense.

17 5. Rate Case Expense Amortization

18 All parties agree on the total amount of allowable rate case expense. Arizona-American
19 accepts Staff's recommendation to amortize the expense over four years. RUCO did not accept the
20 proposal, and recommends amortizing the expense over three years. RUCO's adjustment would
21 increase Rate Case Expense by \$7,856 from \$23,566 to \$31,422.

22 RUCO is concerned that under a four year amortization schedule, the Company may seek rate
23 relief before the Company would fully recover its rate case expenses in this case. RUCO notes that
24 the Company originally requested a three year amortization and has stated that if there are any
25 unamortized rate case expenses it would seek recovery of those in the next case.¹² Both Staff and
26 RUCO are on record as opposing the Company's suggestion that it could seek recovery of

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28 ¹¹ Ex S-22, Igwe Surrebuttal at 9:14-17.

¹² Ex A-5 Borderick Rejoinder at 6.

1 unamortized rate case expense if it filed its next rate case prior to 2012.¹³ RUCO states that allowing
 2 a utility to re-amortize prior rate case expense would in essence allow the utility to “recover rates that
 3 are no longer in effect”¹⁴ and be inequitable and unfair to ratepayers.

4 We believe that a four year amortization of rate case expense is reasonable. There is always a
 5 risk in determining an appropriate Rate Case Expense that the selected amortization period will be
 6 too long or too short, resulting in over or under recovery of the Rate Case Expense. We do not have
 7 to decide the issue of whether the Company would be entitled to seek recovery of any unamortized
 8 portion of rate case expense at this time, as it is only speculation whether such request will ever be
 9 made. Most discussion at the hearing anticipated a rate filing in 2012 to recover the fire flow project
 10 costs in rate base. We find that the four year estimate of when the next rate case will be filed to be
 11 reasonable, and thus, we adopt the Company’s and Staff’s position.

12 6. Miscellaneous Expense

13 RUCO recommends a net Miscellaneous Expense disallowance of \$4,221. Neither Arizona-
 14 American nor Staff adopted this disallowance. RUCO’s adjustment removed expenses associated
 15 with gifts, flowers and awards, believing that these expenses are appropriately the responsibility of
 16 shareholders, not ratepayers. The Company does not appear to dispute RUCO’s position concerning
 17 gifts, flowers and awards.¹⁵

18 RUCO’s adjustment to Miscellaneous Expenses to remove expenses associated with gifts,
 19 flowers and award is appropriate and we will adopt it.

20 7. Summary of Test Year Operating Income

21	Total Test Year Revenues		\$7,688,479
21	Staff Adjusted Operating Expenses ¹⁶	\$6,966,925	
22	AIP	(32,230)	
22	Misc. Expense	(4,221)	
23	Adjustment to Income Taxes	<u>2,499</u>	
23	Total Operating Expenses		\$6,932,973
24	Adjusted Test Year Operating Income		<u>\$755,506</u>

25

26 ¹³ Igwe Executive Summary filed January 4, 2008.

26 ¹⁴ RUCO Opening Brief at 21.

27 ¹⁵ RUCO had initially also removed \$184 associated with meals, which the Company specifically disagreed with. Ex A-7
 Gutowski Rebuttal at 11-12. RUCO subsequently agreed to add back the \$184 associated with meals. Ex R-7 at 33.

28 ¹⁶ Except as discussed herein, we find Staff’s adjustments to Operating Expenses as reflected in Surrebuttal Testimony to
 be reasonable. Staff made a total of six adjustments to Operating Expenses resulting in a net increase of \$17,758.

C. Cost of Capital1. Capital Structure

Arizona-American supports a capital structure of 58.3 percent debt and 41.7 percent equity. This reflects an equity infusion of \$15,000,000, which was completed in December 2007.

Staff supports a capital structure comprised of 61.0 percent debt and 39.0 percent equity. Staff also includes the \$15,000,000 equity infusion in 2007. The main difference between Staff and Arizona-American is Staff's inclusion of \$28,124,006 of short-term debt in Arizona-American's capital structure.

RUCO supports a capital structure of 57.7 percent debt and 42.3 percent equity. RUCO asserts that whether to include short-term debt in a company's capital structure should be considered on a case-by-case basis. Based on the facts of this case, RUCO recommends that the Commission should not include the short-term debt in the Company's capital structure. RUCO states that the short-term debt relates to the Company's plan to finance a Central Arizona Project treatment facility, known as the White Tanks Plant, through the use of hook-up fees. RUCO asserts that the short-term debt related to the White Tanks Plant will be paid off by the eventual collection of hook-up fees which will be treated as a source of cost-free capital, thus, RUCO believes that the short-term debt associated with the White Tanks Plant should not be included in the Company's capital structure.

Arizona-American believes that Staff's position is a new one, and it argues that short-term debt should not be included in a company's capital structure. The Company argues it should not be included unless it is being used to finance long-term assets, in which case, the return on rate base should recognize the cost of the short-term debt that financed those assets. The Company argues that short-term debt used to finance Working Capital and Construction Work in Progress ("CWIP") should not be included in the capital structure. Arizona-American states that in Arizona, CWIP is not included in rate base, so no return should be provided by customers on CWIP financed by short-term debt. Arizona-American argues that Staff did not meet its burden of identifying the balance of short-term debt, if any, being used to finance long-term assets.

Staff argues that short-term debt is a component of the capital structure and that the use of funds from short-term debt is irrelevant. Staff states that it subscribes to a financial theory that

1 money is fungible and a dollar collected from any particular source cannot be assigned to a particular
2 project. Staff asserts that it does not adjust a company's capital structure based on what the funds are
3 used for and whether those uses are included in rate base. Staff maintains, in response to RUCO, that
4 it is impossible to determine what dollars in the available pool of capital are assigned to the White
5 Tank treatment project. Staff continues to believe that including short-term debt gives a more
6 accurate view of the Company's financial position.¹⁷

7 We concur with Staff's position. We are not convinced by the Company's arguments that
8 short-term debt should be excluded from the capital structure. Short-term debt is another source of
9 funds available to the Company, and the cost of those funds should be recognized. Our determination
10 to include short-term debt is consistent with our prior practices, most recently and relevantly, with
11 our Decision in the Sun City Wastewater and Sun City West Wastewater Districts rate case.¹⁸

12 2. Cost of Debt

13 The parties agreed that the cost of debt is 5.5 percent.

14 3. Cost of Equity

15 Staff recommended a cost of equity of 10.8 percent. Arizona-American agreed to Staff's
16 position. Staff's witness, Mr. Irvine, utilized the Discounted Cash Flow ("DCF") and Capital Asset
17 Pricing Model ("CAPM") to derive his estimated industry return on equity ("ROE") of 9.9 percent.
18 Mr. Irvine then added 90 basis points, or 0.9 percent, to the industry ROE to reflect Arizona-
19 American's greater leverage than the sample utilities.

20 RUCO's witness, Mr. Rigsby, also utilized a DCF and CAPM analyses to calculate an
21 industry sample group return on equity of 9.39 percent. Mr. Rigsby added 50 basis points, 0.5
22 percent, to adjust for Arizona-American's greater leverage, and recommends adopting a cost of
23 equity of 9.89 percent. RUCO argues that its recommended cost of equity is appropriate given the
24 current environment of historically low inflation and low interest rates.

25 Arizona-American argues that RUCO's 50 basis point adjustment is arbitrary, not based on
26 any recognized methodology, and inconsistent with Commission precedent. Arizona-American

27 ¹⁷ Staff Reply Brief at 5.

28 ¹⁸ See Decision No. 70209.

1 states it is well below the adjustments the Commission recently approved for Arizona-American's
 2 other Districts. In Decision No. 69440 (May 1, 2007), the Commission approved an adjustment of
 3 100 basis points for Arizona-American's additional leverage risk. Arizona-American also criticizes
 4 Mr. Rigsby's DCF analysis for equally weighting the DCF evaluations of his water utility and gas
 5 utility samples and for only using four water companies in the sample.

6 We find that Staff's cost of equity recommendation is reasonable and consistent with prior
 7 Commission decisions regarding cost of equity. Staff utilized reasonable inputs for its DCF and
 8 CAPM models and for its financial risk adjustment.¹⁹ Consequently, we adopt a cost of equity of
 9 10.8 percent.

10 4. Overall Cost of Capital

11 Based on the foregoing, we adopt an overall cost of capital for Arizona-American of 7.6
 12 percent, calculated as follows:

	<u>Percentage</u>	<u>Cost</u>	<u>Weighted Cost</u>
14 Debt	61.0 %	5.50%	3.4%
15 Common Equity	<u>39.0 %</u>	10.80%	<u>4.2%</u>
16 Weighted Average Cost of Capital	100.0%		7.6%

18 D. Authorized Increase

19 Based on the foregoing, we approve a rate increase of \$1,907,192, as set forth below:

20 OCRB	\$25,295,922
21 Adjusted Test Year Operating Income	\$755,506
22 Required Operating Income	\$1,922,490
23 Required Rate of Return	7.6%
24 Operating Income Deficiency	\$1,166,984
Gross Revenue Conversion Factor	1.6343
Increase in Gross Revenue Requirement	\$1,907,202
Adjusted Test Year Revenue	\$7,688,479
Approved Annual Revenue	\$9,595,681
Percentage Increase in Revenue	24.81

25 V. Rate Design

26 A. Block Structure

27
 28 ¹⁹ In Decision No. 70209, the Commission approved a risk adjustment of 80 basis points for the Sun City and Sun city West Wastewater Districts.

1 Staff recommends modifying the existing rate design by lowering the break-over points
2 between rate blocks. Arizona-American has accepted Staff's recommended rate design.

3 RUCO recommends that more revenue recovery should come from the commodity charge.
4 RUCO asserts that its recommended rate design promotes conservation and moves closer to a ratio of
5 60 percent of revenue derived from commodity rates and 40 percent from the monthly minimum
6 charge.

7 Arizona-American states that it does not support further shifts to obtaining greater revenue
8 from the commodity charge at this time because of the increase in the last block to fund the low-
9 income program (discussed below) and the uncertainty over the rate design connected with the fire
10 flow surcharge.

11 The Company's current rate design is based on minimum charges that increase with meter
12 size, except that both the 5/8 inch meter and 3/4 inch meters have the same \$6.33 monthly minimum
13 charge. In addition to the monthly minimum charge, residential and commercial customers pay a
14 tiered commodity rate. Currently, the 5/8 inch and 3/4 inch residential classes have a three-tiered rate,
15 with break over points at 4,000 and 18,000 gallons. The other residential meter classes and the
16 commercial meter classes have two-tiered commodity rates, with break over points increasing with
17 meter size. Currently, no gallons are included in the minimum charges. Irrigation, Private Fire and
18 Public Interruptible classes pay a monthly minimum and a flat rate rather than tiered commodity rate.
19 Central Arizona Project water is sold with no minimum charge and a flat commodity rate.

20 Staff's recommended a rate design that is similar to the current structure, except that many of
21 the tier blocks are reduced to encourage more efficient use of water. Staff recommends a three-tier
22 inverted block rate structure for the residential 5/8 inch and 3/4 inch customer classes with break-over
23 points at 3,000 gallons and 10,000 gallons. Staff recommends two-tier blocks for the larger meter
24 residential and all commercial classes. Under Staff's recommended design, the monthly bill at any
25 usage level is higher for a larger meter than for a smaller meter. Staff states that it utilized the
26 methodology that it regularly relies upon in water rate cases, and which has been routinely adopted
27 by the Commission. Staff states that its methodology encourages more efficient use of water because
28 the second tier rate for 5/8 inch meters customers is greater than the rate that would be required to

1 recover the revenue requirement using a uniform commodity rate, and customers experience a greater
 2 incremental cost for all use exceeding 3,000 gallons.²⁰ Staff states that the concept for 5/8 inch
 3 meters is extended to customers with larger meters where the break-over points graduate in
 4 correlation with meter size.

5 The Company's current rates and those proposed by the parties as follows:

		Recommended Rates			
		<u>Current</u> <u>Rates</u>	<u>RUCO</u> ²¹	<u>Company</u> ²²	<u>Staff</u> ²³
8	<u>Monthly Usage Charge:</u>				
9	5/8" & 3/4" meter – residential – low income	\$6.33	\$3.85	\$4.00	N/A ²⁴
10	5/8" meter	6.33	7.70	8.00	8.03
11	3/4" meter	6.33	7.70	8.00	8.03
12	1" meter	16.40	19.25	20.50	20.57
13	1 1/2" meter	33.77	38.50	41.00	41.13
14	2" meter	51.14	61.60	65.60	65.81
15	3" meter	86.84	115.50	131.20	131.62
16	4" meter	135.00	192.50	205.00	205.65
17	6" meter	178.51	385.00	410.00	411.31
18	8" meter	350.00	770.00	656.00	658.00
19	Irrigation 1"	16.46	19.25	20.50	20.57
20	Irrigation 1.5"	33.78	38.50	41.00	41.43
21	Irrigation 2"	51.15	61.60	65.50	65.81
22	Irrigation 3"	86.87	115.50	131.20	131.62
23	Irrigation 4"	135.00	192.50	205.00	205.65
24	Irrigation 6"	178.56	385.00	410.00	411.31
25	Private Fire 3"	7.60	11.10	11.18	11.22
26	Private Fire 4"	11.39	16.75	17.30	17.36
27	Private Fire 6"	15.83	35.10	36.35	36.47
28	Private Fire 8"	25.32	45.90	47.46	47.61
	Private Fire 10"	39.35	66.00	68.34	68.34
	Public Interruptible 3"	4.59	6.90	6.93	6.95
	Public Interruptible 8"	4.59	6.90	6.93	6.95
	Standby – City of Peoria	5.62	6.95	6.98	7.00
	Central Arizona Project Raw	--	--	--	--

²⁰ ExS-14, Irvine Direct at 4.

²¹ RUCO's final schedules filed January 22, 2008.

²² Arizona-American final schedules filed January 14, 2008.

²³ Ex S-17, Irvine Surrebuttal.

²⁴ Although Staff does not oppose the low income program, Staff's recommended rates did not include a separate charge for the low income participants.

1	Commodity Rates – per 1,000 gallons				
2	5/8" meter – residential				
3	From 1 to 4,000 gallons	\$0.7200			
	From 4,001 to 18,000 gallons	1.1000			
4	Over 18,000 gallons	1.3160			
	From 1 to 4,000 gallons		\$0.7298		
5	From 4,001 to 10,000 gallons		1.3900		
6	Over 10,000 gallons		1.7100		
	From 1 to 3,000 gallons			\$0.7336	\$0.7223
7	From 3,001 to 13,000 gallons			1.3551	1.3342
	Over 13,000 gallons			1.6913	1.6653
8	3/4" meter – residential				
9	From 1 to 4,000 gallons	\$0.7200			
10	From 4,001 to 18,000 gallons	1.1000			
	Over 18,000 gallons	1.3160			
11	From 1 to 4,000 gallons		\$0.7298 ²⁵		
	From 4,001 to 10,000 gallons		1.3900		
12	Over 10,000 gallons		1.7100		
	From 1 to 3,000 gallons	N/A		\$0.7336	\$0.7223
13	From 3,001 to 13,000 gallons	N/A		1.3551	1.3342
14	Over 13,000 gallons	N/A		1.6913	1.6653
15	5/8" meter – commercial				
16	From 1 to 18,000 gallons	1.1000			
	Over 18,000 gallons	1.3160			
17	From 1 to 10,000 gallons	N/A	1.3900	1.3551	1.3342
	Over 10,000 gallons	N/A	1,7100	1.7383	1.6653
18	3/4" meter – commercial				
19	From 1 to 18,000 gallons	1.1000			
	Over 18,000 gallons	1.3160			
20	From 1 to 10,000 gallons	N/A	1.3900	1.3551	1.3342
21	Over 10,000 gallons	N/A	1.7100	1.7383	1.6653
22	1" meter – residential & commercial				
23	From 1 to 60,000 gallons	1.1000			
	Over 60,000 gallons	1.3160			
24	From 1 to 46,000 gallons	N/A	1.3900	1.3551	1.3342
	Over 46,000 gallons	N/A	1.7100	1.7383	1.6653
25	1 1/2" meter – residential & commercial				
26	From 1 to 125,000 gallons	1.1000			

27 ²⁵ RUCO's final schedules are not clear with respect to RUCO's position on the break-over points for the tiers for the residential 3/4 inch meters. Based on its testimony, we assume that RUCO intended a three tier structure for the residential
 28 3/4 inch meter class.

1	Over 125,000 gallons	1.3160			
	From 1 to 106,000 gallons	N/A	1.3900	1.3551	1.3342
2	Over 106,000 gallons	N/A	1.7100	1.7383	1.6653
3	2" meter – residential & commercial				
	From 1 to 190,000 gallons	1.1000			
4	Over 190,000 gallons	1.3160			
	From 1 to 175,000 gallons	N/A	1.3900	1.3551	1.3342
5	Over 175,000 gallons	N/A	1.7100	1.7383	1.6653
6	3" meter – residential & commercial				
7	From 1 to 340,000 gallons	1.1000	1.3900	1.3551	1.3342
8	Over 340,000 gallons	1.3160	1.7100	1.7383	1.6653
9	4" meter – residential & commercial				
	From 1 to 550,000 gallons	1.1000	1.3900	1.3551	1.3342
10	Over 550,000 gallons	1.3160	1.7100	1.7383	1.6653
11	6" meter – residential & commercial				
	From 1 to 700,000 gallons	1.1000	1.3900	1.3551	1.3342
12	Over 700,000 gallons	1.3160	1.7100	1.7383	1.6653
13	8" meter – residential & commercial				
14	From 1 to 1,430,000 gallons	1.1000	1.3900	1.3551	1.3342
15	Over 1,430,000 gallons	1.3160	1.7100	1.7383	1.6653
16	Irrigation 1" – all gallons	0.8200	1.1100	1.0645	1.0645
	Irrigation 1.5" – all gallons	0.8200	1.1100	1.0645	1.0679
17	Irrigation 2" – all gallons	0.8200	1.1100	1.0645	1.0679
	Irrigation 3" – all gallons	0.8200	1.1100	1.0645	1.0679
18	Irrigation 4" – all gallons	0.8200	1.1100	1.0645	1.0679
	Irrigation 6" – all gallons	0.8200	1.1100	1.0645	1.0679
19					
20	Private Fire 3" all gallons	0.7600	1.0300	0.9900	0.9898
	Private Fire 4" all gallons	0.7600	1.0300	0.9900	0.9898
21	Private Fire 6" all gallons	0.7600	1.0300	0.9900	0.9898
	Private Fire 8" all gallons	0.7600	1.0300	0.9900	0.9898
22	Private Fire 10" all gallons	0.7600	1.0300	0.9900	0.9898
23	Public interruptible 3" all gallons	0.6300	1.0300	0.8179	0.9898
	Public interruptible 8" all gallons	0.6300	1.0300	0.8179	0.9898
24	Standby – city of Peoria – all gallons	0.7600	1.0300	0.9866	0.9898
25	Central Arizona Project Raw – all gallons	0.6558	0.8800	0.8513	0.8540

26 The Company did not propose changes to its meter and service line installation charges or its
 27 service charges, and there is no dispute among the parties about these charges. Consequently, the
 28

1 chart of comparisons is omitted.

2

3 B. Low Income Program

4 Arizona-American proposed a new low-income program for the Sun City Water District. The
 5 Company proposed a 50 percent discount on the basic service charge for up to 1,000 eligible
 6 residential customers. The Company incorporates the discount into the rate design, with the foregone
 7 revenue from the discount in the monthly charge being recovered by an increase in the commodity
 8 charge for the last tier for all users. Under the Company's plan and based on a projected monthly
 9 charge of approximately \$8.00 per month, participants in the low income program would see a
 10 monthly charge of \$4.00. If 1,000 customers enrolled in the program and participated year-round, the
 11 Company would need to make up \$48,000 from non-participants. The cost to non-participants would
 12 be \$0.19 per month, or \$2.19 per year.²⁶ The Company calculates that the foregone revenue from the
 13 discount would be recovered by increasing the commodity charge in the last block price by \$0.047
 14 per 1,000 gallons for non-participant residential customers and all commercial customers. If fewer
 15 than 1,000 customers enroll, Arizona-American proposed to refund the amount of any over-collection
 16 of revenues.²⁷

17 Arizona-American states that the administrative cost of the program will be approximately
 18 \$30,000, but that it is not seeking recovery of the administrative costs from ratepayers at this time. It
 19 would seek recovery of on-going costs in the next rate case.²⁸ Under the Company's proposal, \$1
 20 Energy Fund, Inc. ("\$1 Energy") would administer the program. To be eligible, a Sun City Water
 21 District customer must be a full-time resident who is the primary account holder, over 64 years of
 22 age, and with an annual household income not more than 150 percent of the Federal Poverty Income
 23 Guideline ("FPIG"). \$1 Energy will work with Arizona-American to confirm eligibility.

24 Staff had some concerns that the cost of the program was on the high side versus the amount
 25 of the benefit received. Nevertheless, Staff did not oppose the program. RUCO supports the
 26

27 ²⁶ $48,000 / (22,878 - 1,000) = \$2.19.$

28 ²⁷ Arizona-American Initial Brief at 23.

²⁸ Id.

1 proposed low income program.²⁹

2 C. Approved Rates.

3 We commend Arizona-American for attempting to find a workable program to assist its low
4 income customers. Information from the SCTA and others indicates that the program is needed in the
5 Sun City Water District. We have some concerns that in the Sun City District there are a number of
6 residents who may otherwise qualify for the program based on age and income, but who reside in
7 condominium buildings and are not the primary account holder. These individuals would not be able
8 to participate in the program. However, no other party has recommended an alternative program or a
9 fair or reasonable way to include these residents in the proposed plan. We find the Company's
10 proposal is reasonable and should be adopted. Spreading the costs of the program to all users in the
11 cost of the last tier block minimizes the cost of the program on non-participants. For a minimal cost
12 to non-participants, the benefit to participants is relatively large. By limiting participation to 1,000
13 participants initially, the Company and the Commission will be able to see if the program is effective
14 and can be administered efficiently without burdening non-participants. We will re-evaluate the
15 program's effectiveness in the next rate case.

16 We accept Staff's recommended rate design, with three inverted blocks for residential 5/8
17 inch and 3/4 inch meters and two inverted blocks for all other meter sizes. The rates we approve are
18 fair and reasonable and encourage conservation. As it is under Staff's proposed rate design, our rate
19 design results in 39 percent of the revenue from residential customers being derived from the monthly
20 minimum charge and 61 percent derived from the commodity charges, while overall, the ratio is 36
21 percent of revenue coming from the monthly minimum and 64 percent from the commodity charge.
22 These percentages are within the range we typically approve, and not significantly different from
23 RUCO's recommended percentages, and we believe they are reasonable in this case.

24 The average usage for a residential 5/8 inch meter customer is 8,269 gallons per month. The
25 median usage for the residential 5/8 inch meter customer is 6,431 gallons per month. Under current
26 rates, the average monthly residential bill is \$13.91 and the median bill is \$11.88.

27
28 ²⁹ RUCO Opening Brief at 10.

1 Under the rates we approve herein, the average residential 5/8 inch meter bill would be
 2 \$17.15, an increase of \$3.24, or 23.33 percent. The median residential 5/8 inch meter bill would be
 3 \$14.71, an increase of \$2.83, or 23.75 percent.

4 A participant in the low income program, with average usage of 8,269 gallons would see a
 5 monthly bill of \$13.15 under our approved rates, a decrease of \$0.76 from current rates.

6 VI. Fire Flow Cost Recovery

7 A. Proposed Fire Flow Improvement Projects

8 In the last water rate case for the Sun City Water District, the Commission ordered the
 9 creation of a Fire Flow Task Force and charged it with the task of determining if the water production
 10 capacity, storage capacity, water lines, water pressure and fire hydrants of Youngtown and Sun City
 11 were sufficient to provide fire protection capacity that is desired by each community.³⁰ The Task
 12 Force was to report its findings and proposed plan of action to the Commission by May 30, 2005.
 13 In October 2004, Arizona-America formed the Youngtown/Sun City Fire Flow Task Force with
 14 representatives from the Sun City Taxpayers Association, the Sun City Homeowners Association, the
 15 Recreation Centers of Sun City, the Sun City Condominium Association, the Sun City Fire
 16 Department, the City of Surprise Fire Department, Youngtown Baptist Village and the Town of
 17 Youngtown.

18 On May 25, 2005, in Docket No. WS-01303A-02-0867, et al., the Task Force filed a copy of
 19 its Youngtown/Sun City Fire Flow Report.³¹ The report recognizes that while Arizona-American has
 20 no regulatory mandate to provide fire flow to the community, fire flow is nonetheless an important
 21 public safety issue for the entire community that should be addressed in a timely manner. The Task
 22 Force concluded that most of the area in the Sun City Water District satisfied the fire flow
 23 requirements recommended by the local fire departments, but that some areas, primarily south of
 24 Grand Avenue, required larger pipelines and more hydrants to satisfy the recommendations. Based
 25 on its analysis, the Task Force unanimously endorsed a four-year capital improvement plan to
 26 upgrade the fire-flow capabilities of the Sun City Water District.

27 _____
 28 ³⁰ Decision No. 67093 (June 30, 2004).

³¹ Exhibit A-13, Brown & Caldwell Fire Flow Study.

1 The four year plan includes main replacements to improve fire flows and new fire hydrants to
 2 provide adequate access. The Fire Flow Task Force recommended a minimum standard fire flow of
 3 1000 Gallons Per Minute ("GPM") for residential areas and 1500 GPM for commercial and multi-
 4 family areas, and a minimum hydrant spacing of 660 feet.³² At the time that the Task Force report
 5 was issued, the estimated cost of the recommended upgrades was approximately \$3.1 million.³³ The
 6 Task Force's four year plan is designed to improve those areas with the least fire flow first, with
 7 residential areas taking priority over commercial areas. Ten distinct improvement projects were
 8 identified, including 44,133 feet of new main and 195 new fire hydrants to be installed throughout the
 9 Sun City Water District.

10 In its testimony, the Company revised the estimated cost of the improvements to reflect
 11 inflation and to account for the failure of the original estimate to allow for contingencies and
 12 engineering costs as well as the Company's internal costs, such as labor, labor overhead, general
 13 overhead and AFUDC. Arizona-American estimates the current cost of the project would be \$5.1
 14 million.

15 The Fire Flow Task Force's Patron Safety Plan, with the Company's revised cost estimates is
 16 summarized as follows:

Year	Description	Cost
Immediately	Sun City and Youngtown pressure reducing/pressure sustaining valve modifications	\$17,000
1	Youngtown neighborhood commercial – 11 th Ave south of Youngtown Avenue; Youngtown residential; fire hydrants in Sun City and Youngtown installed on existing pipe	\$1,099,000
2	City of Peoria – Paradise Mobile Home Park; Sun City residential; Youngtown – 6" piping and fire hydrants	\$1,190,000
3	6" piping and fire hydrants – Sun City and Youngtown	\$1,278,000
4	6" piping and fire hydrants – Sun City and Youngtown; piping improvements – Youngtown Commercial	\$1,534,000
Total		\$5,118,000

32 Tr at 112.

33 Ex A-13, Brown & Caldwell Fire Flow Study at 18.

1 The proposed fire flow improvements, broken down by community are as follows:

2 Sun City 21,492 linear feet of main and 78 fire hydrants
 3 Youngtown 21,391 linear feet of main and 117 fire hydrants
 4 Peoria 1,250 linear feet of main

5 Arizona-American conducted community information forums regarding the Plan and mailed a
 6 survey to all of its customers of record. Customers returned 3,247 survey responses, of which 59
 7 percent supported the fire flow improvements and 51 percent supported including the cost in water
 8 rates. During public comment, it was pointed out that individuals who live in condominiums, where
 9 the condominium association is the customer of record, were not directly mailed copies of the survey.
 10 The survey was mailed to all customers of record, which would have included the condominium
 11 associations, or entity responsible for paying the water bill. It is unknown from the record before us
 12 how many individuals who did not receive a survey directly may have received one from the
 13 condominium association and were able to participate in the survey.

14 As a result of its review of the proposed fire flow improvements, Staff believes that the
 15 Company's costs would be less than the Company has projected. In particular, Staff believes that the
 16 costs of the hydrants and for restoration will be less. Staff's analysis yielded a cost estimate of
 17 approximately \$2.6 million.³⁴ Staff cautions, however, that it has not made a determination of the
 18 capital improvements as "used and useful," but defers such determination until the Company's next
 19 rate case.

20 B. Fire Flow Cost Recovery Mechanism

21 1. Arizona-American's Position

22 Arizona-American states it cannot fund the fire flow projects unless the Commission approves
 23 a mechanism similar to the arsenic cost recovery mechanism ("ACRM"). Under the Company's
 24 proposal, the surcharge amount would be set to recover the authorized rate of return associated with
 25 the completed fire flow projects and would cease after the Company files its next rate case (expected
 26 by May 31, 2012) when the fire flow facilities would be included in rate base. The Company
 27

28 ³⁴ Ex S-18 Hains Direct at 8-9.

1 envisions the fire flow surcharge operating like the ACRM surcharge, except that it would have more
2 step increases. Under the proposal, after completing each phase of the plan, the Company will file
3 supporting invoices and such other information as the parties need to review the project costs and
4 determine the Company's earnings. Parties will be able to audit all construction invoices and verify
5 that the projects are in service, and the surcharge would not go into effect until the Commission
6 issues an order finding that Arizona-American has completed the projects and that the costs are
7 reasonable and prudent.³⁵

8 Staff recommended an earnings test before the FCRM goes into effect.³⁶ Under Staff's
9 recommendation, the Company would submit the same schedules demonstrating current earnings as it
10 does in connection with its ACRM. Staff states that under the earnings test, if it is determined that
11 the Sun City Water District is over earning its authorized rate of return, the requested FCRM step
12 increase would be adjusted.³⁷ Staff recommended the Company file the following schedules at the
13 time it seeks a FCRM step increase: (i) the most current balance sheet; (ii) the most current income
14 statement; (iii) an earnings test schedule (consistent with Decision No. 66400); (iv) a rate review
15 schedule (including incremental and pro forma effects of the proposed increase); (v) a revenue
16 requirement calculation; (vi) a surcharge calculation; (vii) an adjusted rate base schedule; (viii) a
17 CWIP ledger (for each project showing accumulation of charges by month and paid vendor invoices);
18 (ix) calculation of the allocation factors; and (x) a typical bill analysis under present and proposed
19 rates. The Company agreed to Staff's recommendation for an earnings test and to require a
20 Commission Order before the FCRM goes into effect.³⁸

21 At the hearing, as an alternative to the FCRM, witnesses discussed the option of a
22 Commission accounting order that would allow the Company to defer project costs to be collected in
23 a future rate case. The Company believes, however, that an accounting order would not provide
24 sufficient certainty that it could recover deferred project costs and would provide recovery funds too
25

26 ³⁵ Originally, Arizona-American proposed that the FCRM would go into effect automatically 45 days after the filing of
supporting documentation. Staff objected (Ex S-21, Igwe Direct at 9), and the Company agrees that the FCRM would not
27 go into effect until after a Commission Order. (Tr. at 360-361)

³⁶ Ex S-21, Igwe Direct at 9.

³⁷ *Id.* at 10.

³⁸ Tr. at 360-361.

1 late, for the Company to agree to go forward with the project.

2 2. RUCO's Position

3 RUCO does not dispute that the Commission can order the fire flow improvements, but
4 disagrees that it should order the Company to make them. Neither does RUCO disagree that the
5 system has fire flow inadequacies. RUCO believes that the salient question is not whether the
6 improvements are in the public interest, but who should pay for them. According to RUCO, the party
7 that requests the benefit, in this case the Town in RUCO's opinion, not utility customers, should
8 pay.³⁹ RUCO claims further, that it is not responsible for identifying an alternative funding source or
9 offering a solution, but is charged with determining just and reasonable rates.⁴⁰

10 RUCO is concerned about the effect of the proposed surcharge on customer bills at a time
11 when all utility costs are rising. RUCO notes that the surcharge would be in addition to the rate
12 increase approved herein, as well as to the increase in wastewater rates approved in Decision No.
13 70209, and the ACRM approved in Decision 68310 (November 14, 2005).⁴¹

14 RUCO characterizes the fire flow improvement project as "discretionary," and argues the
15 Commission should reject the proposal to fund them with a surcharge. RUCO states there is no
16 Commission rule, policy or statute that governs or sets a fire flow standard, and there is no regulatory
17 rate-making principle that requires, or even supports a fire flow standard. Thus, in RUCO's view, the
18 situation is not analogous to the need to install arsenic treatment facilities where utilities have no
19 choice but to make the required investment, and RUCO opposes using an ACRM-like surcharge to
20 fund the fire flow improvement projects. RUCO believes that an ACRM-like surcharge should not
21 become the template for the pass-through to ratepayers of any expense that is in the public interest
22 outside of a rate case.

23 RUCO asserts that approving the FCRM would send a message that the Commission supports
24 single-issue ratemaking.⁴² RUCO asserts the FCRM will only consider cost increases in one category
25 of expenses and will ignore changes in revenues, cost of capital, rate base and other expense

26

27 ³⁹ RUCO Opening Brief at 4.

⁴⁰ RUCO Reply Brief at 4.

⁴¹ RUCO Reply Brief at 7.

28

⁴² RUCO Reply Brief at 5.

1 categories. RUCO argues ratepayers will not receive the benefits or efficiencies or the other potential
2 off-sets to costs since the sole focus of the step increase review will be the incremental fire flow
3 costs. RUCO says the proposal is “single issue” ratemaking which the *Scates* court recognized is
4 “fraught with potential abuse.”⁴³ RUCO argues that if the Commission is going to consider such
5 mechanisms, it should only do so in the most dire and extreme circumstances. Because RUCO
6 believes the fire flow requirements are not within the purview of what the Commission regulates, the
7 Commission should not approve the FCRM. RUCO argues the ACRM was never meant to be
8 expanded as proposed in this case.

9 RUCO argues that there is no legal impediment preventing Youngtown or Sun City, through
10 its Recreation Centers, from funding the fire flow improvements. RUCO asserts that because
11 Youngtown wants the improvements, Youngtown should pay for them. RUCO argues that the Gift
12 Clause of the Arizona Constitution and A.R.S. § 9-514 have been discussed in the course of this
13 proceeding as preventing municipalities from spending public monies to build infrastructure that
14 would be owned by a private company. RUCO believes that reliance on the Gift Clause or A.R.S.
15 §9-514 as an impediment to Youngtown funding the improvements is misplaced. RUCO cites the
16 holding in *Town of Gila Bend v. Walled Lake Door Co.*, 107 Ariz. 545, 490 P.2d 551 (1971) as
17 support for its position that Youngtown could fund the fire flow improvements.

18 In *Town of Gila Bend*, a private company entered into an agreement with the Town of Gila
19 Bend under which the town agreed to construct and install a water main from the Southern Pacific
20 water tanks a distance of approximately 6,000 feet to the company’s plant, such line to be used for
21 fire protection. An agreement between the town and the water company was submitted to the
22 Arizona Corporation Commission, and was approved subject to the water company’s right to review
23 all plans for installation of the line. The town subsequently breached the contract, and the trial court
24 ordered specific performance. The Arizona Supreme Court upheld the judgment. The Supreme
25 Court held that Article 9, Section 7 of the Arizona Constitution, which prohibits a town from making
26 gifts, donations or granting subsidies to private enterprises was not violated by the agreement. The
27

28 ⁴³ *Scates v Arizona Corporation Commission*, 118 Ariz. 531, 534, 578 P.2nd 612, 615 (1978).

1 Court held that because “ownership and control over the water line are to remain in the Town”, the
2 contract did not violate the Gift Clause. The Court found that the benefit to the company from the
3 fire protection afforded by the main was of “absolutely no consequence.” “Merely because an
4 individual may indirectly benefit from a public expenditure does not create an illegal expenditure.”⁴⁴
5 In addition, the Court found that A.R.S. §§9-514 through -516, which prohibit a municipality from
6 engaging in competition with businesses of a public nature, were not applicable, as the Town of Gila
7 Bend was not going into competition with the water company.

8 RUCO argues that the Arizona Supreme Court’s reasoning squarely addresses the Town’s
9 position in the present case. RUCO asserts that the Court in *Town of Gila Bend*, held that the Gift
10 Clause was intended to avoid “depletion of public treasury or inflation of public debt by engagement
11 in non-public enterprise.”⁴⁵ The fire flow purpose in the current case also is not a “non-public
12 enterprise.” RUCO notes the court in *Town of Gila Bend* held that each case is different and that
13 each case must focus on the objective sought and the degree and manner in which that objective
14 affects the public welfare.”⁴⁶

15 RUCO further argues that community support for the project is “questionable at best,” as the
16 results of the survey are not persuasive. Unlike the ACRM, RUCO notes the community has a
17 choice, and its support is only “half-hearted” with “only” 59 percent supporting the improvements
18 and 51 percent willing to pay for it.

19 RUCO states further that while it does not support an accounting/deferral order, it finds such
20 order to be the lesser of two evils since it would allow for the examination of costs in the context of a
21 rate case where all the ratemaking elements can be reviewed.⁴⁷ RUCO argues that the problems
22 associated with funding the fire flow projects in the Company’s Paradise Valley District are a
23 reminder why the Commission should not approve funding of fire flow projects. RUCO believes that
24 the alleged small magnitude of the surcharge is not compelling. RUCO is concerned that project
25 costs will increase over time and an inability to complete the projects in four years will add to the

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27 ⁴⁴ *Town of Gila Bend*, 107 Ariz at 550.

⁴⁵ *Town of Gila Bend*, 107 Ariz. at 549.

⁴⁶ *Id.*

28 ⁴⁷ RUCO Reply Brief at 5.

1 costs, and consequently, the burden on ratepayers.⁴⁸

2 3. Youngtown's Position

3 Youngtown supports the fire flow improvement project and the FCRM. Youngtown states
4 that fire flow is a critical matter of health and safety, and asserts that the benefits to life and property
5 of ratepayers and the public from adequate fire flow and adequately spaced hydrants are
6 uncontraverted. Youngtown asserts that the Task Force's Plan relates to service throughout the entire
7 district and is not a Youngtown request but reflects the consensus and recommendation of the Task
8 Force, which was comprised of many different community representatives.

9 Youngtown asserts the Commission has the authority to regulate fire flow. The Town cites
10 Article 15, Section 3 of the Arizona Constitution which provides that the Commission "shall . . .
11 make and enforce reasonable rules, regulations and orders for the convenience, comfort, and safety,
12 and the preservation of the health, of the employees and patrons of [public service] corporations."
13 Further, Youngtown cites A.R.S. § 40-336, which provides the Commission may by order, rule or
14 regulation "require every public service corporation to maintain and operate its line, plant, system,
15 equipment, and premises in a manner which will promote and safeguard the health and safety of its
16 employees, passengers, customers and the public," and to "prescribe the installation, use,
17 maintenance and operation of appropriate safety or other devices or appliances . . . establish uniform
18 or other standards of equipment, and require the performance of any other act which health or safety
19 requires." Youngtown cites a number of other Arizona statutes,⁴⁹ which it argues indicate that the
20 Commission's regulatory powers are not limited to making orders respecting health and safety, but
21 also include the power to make orders respecting comfort, convenience, adequacy and reasonableness
22 of service.

23 Youngtown argues that Arizona-American's failure to provide sufficient fire flows and fire
24 hydrant spacing throughout the District violates A.R.S. § 40-361(B) and -334(A) and (B), which
25 place an affirmative duty on the Commission to act to protect the public safety and halt the disparate
26

27 _____
28 ⁴⁸ RUCO Reply Brief at 6.

⁴⁹ *I.e.*, A.R.S. §§ 40-203, 40-202(a), 40-361(B), 40-334(a), 40-334(B).

1 treatment of District customers pursuant to A.R.S. §§ 40-321(A), -331(A) and -203.⁵⁰ Youngtown
 2 argues that suggestions by RUCO and Arizona-American that the improvements are “discretionary”
 3 ignore the specific facts and statutory obligations and the fact that the water systems today are
 4 intended to serve the dual purpose of serving potable water and providing water for fire protection.⁵¹
 5 Youngtown states the Commission can satisfy its statutory obligations by authorizing Arizona-
 6 American to proceed with the Task Force’s Fire Flow Improvement Plan and approving the
 7 surcharge.

8 Youngtown argues that RUCO’s position that ratepayers should not pay for the fire flow
 9 improvements ignores the Arizona Constitution’s express recognition that providing water for fire
 10 prevention is a public purpose. As such, Arizona-American is entitled to a reasonable return on the
 11 fair value of its investment in facilities that provide potable water and fire prevention. In addition,
 12 Youngtown argues RUCO’s position ignores the reality that fire flow and fire hydrants are part of
 13 creating a water company in today’s environment, and that facilities serving fire flow prevention are
 14 already included in the rate base and customer rates, and that the proposed improvements will
 15 eliminate the inequality in fire prevention services currently being provided. Furthermore,
 16 Youngtown argues the Office of the Fire Marshall has adopted IFC (2003 Edition) as the State Fire
 17 Code.⁵² The State Fire Code expressly incorporates Appendix B, which establishes the same
 18 minimum fire flow requirements for the State as the Task Force adopted for the District. Finally,
 19 Youngtown argues Commission Rule R14-2-407(f) requires utilities to construct all facilities in
 20 accordance with the guidelines established by the State Department of Health Services (whose
 21 functions have been transferred to the Arizona Department of Environmental Quality), which in turn
 22 requires water systems to be designed using good engineering practices.⁵³ Youngtown asserts good

23 _____
 24 ⁵⁰ Arizona-American argues that that Youngtown is incorrect to the extent it claims that the Company’s failure to provide
 25 sufficient fire flow and fire hydrants throughout the District violates A.R.S. §§ 40-361B, -334A and B. Arizona-
 26 American argues these statutes relating to a utility’s rates, charges, services and facilities infringe on the Commission’s
 27 exclusive jurisdiction over rates, charges, service and facilities. The Company asserts there is no basis for Youngtown’s
 28 allegation that Arizona-American has violated any statutes, as the Commission has jurisdiction over this matter and has
 exercised it. The Company asserts that to answer the question of whether a utility should upgrade older infrastructure to
 satisfy modern fire flow standards requires the Commission to evaluate service needs and rate impacts, both questions
 exclusively within the Commission’s Article 15 jurisdiction.

⁵¹ Youngtown Opening Brief at 8, fn 30.

⁵² A.A.C. R4-36-201.

⁵³ A.A.C. R18-4-502, Ex S-10.

1 engineering practices criteria are contained in Engineering Bulletin No. 10, "Guidelines for the
 2 Construction of Water Systems" (May 1978), which not only clarifies that the 20 PSI⁵⁴ requirement
 3 applies "under all conditions of Flow" including fire fighting conditions, but also incorporates the fire
 4 flow design standards established by the Office of the State Fire Marshall or local authorities.⁵⁵

5 Youngtown argues that RUCO's discussion of alternative funding sources for the fire flow
 6 improvements and its discussion of the *Town of Gila Bend* case are irrelevant. Youngtown believes
 7 that RUCO's contention that Youngtown or other non-profit associations should pay for the fire flow
 8 improvements ignores the benefits customers derive from the improvements. Further, Youngtown
 9 argues RUCO's suggestion is speculative that such other funding source exists. Youngtown asserts
 10 that RUCO has presented no evidence that Youngtown, Recreation Centers of Sun City and/or the
 11 Condominium Owners Association, Inc. could raise funds and then provide them to Arizona-
 12 American to improve Arizona-American's water system. On the other hand, Youngtown states
 13 Mayor LeVault testified that Youngtown is precluded by constitutional restrictions and its own lack
 14 of financial resources from providing funding for the project.

15 Youngtown distinguishes the *Town of Gila Bend* from the instant case on the grounds it
 16 involved the enforceability of a municipality's contract with a third party business. In *Town of Gila*
 17 *Bend*, the town voluntarily agreed to build the line in exchange for the company rebuilding its plant
 18 after a fire and remaining in Gila Bend. Under the agreement between the two parties, the town
 19 owned and operated the line it installed. Youngtown notes that no similar agreement is at issue in
 20 this case, and all the facilities installed under the proposed fire flow improvement plan will be owned
 21 by Arizona-American.

22 Youngtown claims that Article 9, Sections 7 and 10 of the Arizona Constitution create
 23 significant barriers to the Town's ability to fund the improvements, but whether the barriers are
 24 insurmountable is not relevant to the question of whether implementing the plan promotes the safety,
 25 health, comfort and convenience of the patrons, employees, and the public.⁵⁶

26 Youngtown believes the FCRM, as modified by Staff, is a reasonable method of cost recovery

27 ⁵⁴ Pounds per square inch.

28 ⁵⁵ Ex S-4, ADEQ Engineering Bulletin No.10.

⁵⁶ Youngtown Reply Brief at 5.

1 in this case where the evidence shows that the improvements will enhance the health and safety of the
2 ratepayers and the public, where there is no viable alternative source of funding, and where the
3 financial condition of the Company does not make traditional ratemaking methods viable and would
4 extend the time for making the needed improvements. Youngtown also believes that integrating the
5 costs of the improvements into rates annually over a four year period through the FCRM will
6 minimize the impact on Arizona-American's customers. Youngtown is concerned that waiting for
7 traditional ratemaking forecloses the opportunity to gradually phase-in the fire flow improvements
8 over a four year period and unnecessarily couples the impact of the fire flow improvements with any
9 other rate increase that may be warranted in the future rate case. Youngtown asserts that delays are
10 likely to result in unnecessarily prolonging the fire danger and result in overall increases in project
11 costs.

12 Youngtown states that the fire flow improvements will not generate any additional revenues
13 and will have no, or only minimal, impact on operating costs, therefore, there should be no
14 appreciable impact on the overall rate of return of Arizona-American's a result of the improvements.
15 Youngtown argues the FCRM provides the opportunity for Staff and the Commission to focus on the
16 costs associated with the fire flow improvements, as Arizona-American will be required to
17 demonstrate that all costs are reasonable and prudent before they are included in the FCRM, just like
18 in a rate case, and the earnings test will protect customers. Moreover, Youngtown notes the
19 Commission will have an opportunity to make any adjustment in the next full rate case.⁵⁷
20 Youngtown suggests that the Commission could require the Company to file a full rate case as a pre-
21 condition to filing for the fourth increase under the FCRM, so that the Commission could determine
22 whether the final increase should proceed under the FCRM or as part of the rate filing.

23 In contrast to *Scates v. Ariz. Corp. Commission*, 118 Ariz. 531, 578 P.2d 612 (1978), where
24 the court found the Commission had improperly adjusted rates without considering the overall impact
25 on the utility's return or fair value rate base, Youngtown asserts the Commission in the current case is
26 considering an "adjustment mechanism" in conjunction with a full rate case. Youngtown states the
27

28 ⁵⁷ Tr. at 457-458.

1 FCRM merely recognizes that the Company is undertaking a revenue neutral safety related capital
2 improvement program and enables the Company to recover its authorized return after specific health
3 and safety improvements are constructed and placed in service.

4 Youngtown agrees that the earnings test as proposed by Staff, and adopted by the Company is
5 another safeguard to ensure the FCRM complies with *Scates*. The earnings test ensures that increases
6 allowed under the FCRM will not cause the Company to over-earn. Furthermore, Youngtown notes
7 the earnings test only benefits the ratepayers, as there is no upward adjustment if the earning test
8 indicates the Company is under-earning. Youngtown notes that the *Scates* court found “when courts
9 have upheld such automatic adjustment provisions, they have generally done so because the clauses
10 are initially adopted as part of the utilities rate structure in accordance with all statutory and
11 constitutional requirements and, further, because they are designed to ensure that, through the
12 adoption of a set formula geared to a specific readily identifiable cost, utilities profit or rate or return
13 does not change.”⁵⁸ Youngtown argues the FCRM is just such an automatic adjustment mechanism,
14 tied to investment in non-revenue producing plant.⁵⁹

15 4. Staff’s Position

16 Staff believes that the fire flow improvements are a matter of public safety and should be
17 approved. Mr. Igwe testified that “[b]ased on the Task Force Report, the proposed fire flow capital
18 improvements seem imperative for public safety” in the Sun City area.⁶⁰ In addition, Staff relies on
19 the testimony of the Sun City Fire District Fire Battalion Chief Hank Oleson who spoke of a fire in a
20 four-plex which burned while one of two fire trucks was searching for a water supply.⁶¹ Staff states
21 that ordinarily it would be opposed to a mechanism for recovery of plant investment outside a rate
22 case, but because in this case the proposed project costs are significant and are not a “normal” system
23 upgrade, Staff believes the FCRM should be adopted.

24 Staff responded to the perception, or concern, expressed by some in this case that residents of
25 Youngtown would benefit from the proposed fire flow improvements more than the customers

26 _____
27 ⁵⁸ 115 Ariz. At 535, 578 P.2d at 616.

⁵⁹ Youngtown Reply Brief at 7.

⁶⁰ Ex S-21, Igwe Direct at 6.

28 ⁶¹ Tr at 218-219.

1 located in Sun City. Staff argues that such perception is not supported by the facts as the testimony
2 indicates that more customers in Sun City than in Youngstown would directly benefit.⁶² Staff notes
3 further that the Company views its system as a whole and does not follow political boundaries.⁶³
4 Staff notes that existing fire flow plant is already in rate base and part of the rates paid by all
5 residents in the District, and there is no rate difference for those ratepayers that are receiving
6 inadequate fire flow. Staff concurs with the Company that payment for the fire flow improvements
7 would not result in a “subsidy” by Sun City customers for Youngtown improvements. Staff states
8 that subsidies do not exist in a single tariffed zone.⁶⁴ Furthermore, Staff states, the Company does
9 not calculate separate costs of service for Youngtown or Sun City or Peoria.

10 Staff asserts that improving the fire flow will allow all citizens of the Sun City Water District
11 to receive the same level of service. A.R.S. § 40-334(B) provides that no public service corporation
12 shall establish or maintain any unreasonable difference as to rates, charges, service facilities or in any
13 other respect, either between localities or between classes of service. Staff believes the fire flow
14 improvements are necessary to provide the same level of service to all ratepayers. Staff notes too that
15 there would be benefits to the system from the improvements beyond fire flow, as the new pipes
16 could replace old leaking pipes.

17 Citing A.R.S. § 40-336 and §40-361, Staff believes the Commission has the discretion to
18 approve use of ratepayer funds for the fire flow improvements. A.R.S. § 40-336 provides that “[t]he
19 commission may by order, rule or regulation, require every public service corporation to maintain
20 and operate its line, plant, system, equipment and premises in a manner which will promote and
21 safeguard the health and safety of its employees, passengers, customers and the public” A.R.S.
22 § 40-361(B) provides “[e]very public service corporation shall furnish and maintain such service,
23 equipment and facilities as will promote the safety, health, comfort and convenience of its patrons,
24 employees and the public as will be in all respects adequate, efficient and reasonable.”

25 Staff argues that the issue in the instant case is not who benefits from fire flow improvements,
26 as RUCO argues, but rather who would own and control the plant. As it did in the Paradise Valley

27 ⁶² Tr at 564.

28 ⁶³ Tr.at 567.

⁶⁴ Tr at 404.

1 rate case (Docket No. W-01303A-05-0405), Staff disagrees with RUCO's interpretation of and
 2 reliance on *Town of Gila Bend*. Staff believes the facts of *Town of Gila Bend* are distinguishable
 3 from the facts in this case, and also that RUCO misinterprets the legal holdings. Staff argues that
 4 when the court found that the agreement did not violate the Gift Clause, the court's primary reason
 5 was that "ownership and control over the water line" remained with the town.⁶⁵ Staff states the court
 6 further concluded that even though the private company benefited from the water line, the public at
 7 large also directly benefited.⁶⁶ Staff asserts in this case, the Company will ultimately own and
 8 control the plant, unlike the facts in *Town of Gila Bend*. Staff states that *Town of Gila Bend* court
 9 distinguishes cases where ownership and control over an asset remain with a public entity from cases
 10 where a private enterprise becomes the owner. Staff argues the *Town of Gila Bend* case does not
 11 address whether a municipality may invest public funds in a private utility.

12 5. Effect of Proposed Surcharge

13 Based on a total estimated cost of the fire flow improvements of \$5,118,000, Arizona-
 14 American projects the cumulative impact on of each step of the FCRM on the residential monthly bill
 15 as follows:⁶⁷

	<u>Phase 1</u>	<u>Phase 2</u>	<u>Phase 3</u>	<u>Phase 4</u>
16 Median ⁶⁸	\$0.22	\$0.46	\$0.71	\$1.01
17 Average ⁶⁹	\$0.29	\$0.58	\$0.90	\$1.29

18
 19 Based on Staff's estimated costs of the fire flow improvements of \$2,688,642, Staff projects
 20 the cumulative impact of each step as follows:⁷⁰

	<u>Phase 1</u>	<u>Phase 2</u>	<u>Phase 3</u>	<u>Phase 4</u>
21 Median	\$0.09	\$0.23	\$0.35	\$0.52
22 Average	\$0.12	\$0.29	\$0.45	\$0.67

24 C. Analysis and Resolution

25

26 ⁶⁵ *Town of Gila Bend*, 107 Ariz. At 549, 490 P.2d at 555.

26 ⁶⁶ *Id.*

27 ⁶⁷ Ex A-15 Revised, filed January 18, 2008.

27 ⁶⁸ Based on median usage for the 5/8 inch meter of 6,500 gallons per month.

27 ⁶⁹ Based on average usage for the 5/8 inch meter of 8,300 gallons per month.

28 ⁷⁰ S-23 filed January 16, 2008.

1 Based on the facts in this case, we find that the fire flow improvement project, as set forth in
2 the Task Force's Report and as presented during the hearing, is important to promote and protect the
3 health and safety of the customers of Arizona-America's Sun City Water District. We find that it is
4 in the public interest for Arizona-American to begin constructing the fire flow facilities, and
5 authorize the Company to do so.

6 Unfortunately, the Company does not have the financial ability to construct the facilities and
7 wait until its next rate case to begin earning a return on its investment. The Company has proposed
8 the FCRM that would allow it to commence recovering its investment in fire flow facilities after
9 Commission review and order. Under the proposed procedures for implementing the surcharge,
10 Arizona-American would have to submit all invoices related to the fire flow plant as well as
11 schedules to determine if it is meeting its authorized return, and all parties would have a chance to
12 review those costs before the Commission would implement a surcharge. The surcharge would be
13 subject to an earnings test, under which if it is determined that the imposition of the surcharge would
14 cause Arizona-American to over-earn, the amount of the surcharge would be decreased. The
15 surcharge would not be increased if it were determined that Arizona-American is under-earning and it
16 would not be imposed without a Commission order.

17 We find that based on the particular facts of this case, that the imposition of the FCRM is fair
18 and reasonable and should be adopted. We do not approve the FCRM lightly and have given the
19 public comments careful consideration. However, we believe the construction of the fire flow
20 improvement projects in this case to be of sufficient importance as affecting public health and safety
21 that they merit the action we take. The projects were proposed and unanimously approved by a
22 community Task Force. Without the surcharge, the community would have to wait an undetermined
23 period of time until the Company could contemplate commencing construction, much less complete
24 the projects. We believe the time has come to bring the system up to current accepted standards for
25 fire flow. The evidence in this case is that costs will only increase the longer it takes to make these
26 improvements.

27 The effect of the surcharge on customer bills is minimal. Assuming the Company's estimates
28 of the cost of the project are correct, after the first phase of the project is complete, and costs

1 reviewed, customers using an average of 8,300 gallons would see a surcharge of \$0.29 per month on
2 their bill.

3 We make no finding about whether the Gift Clause or A.R.S. § 9-514 would prevent
4 Youngtown from paying the costs of the projects. We do not accept RUCO's argument that
5 Youngtown, or any other non-profit entity should pay for them. These projects are not being made
6 for the benefit of the Town of Youngtown, but for the residents and customers of the Sun City Water
7 District. While we understand the concerns of some in the community about the impact on their
8 water bills, we believe the improvements are needed and that it is not equitable that some current
9 customers have adequate fire flow, while many do not. The case before us is distinguishable from
10 the situation in Paradise Valley where the rate impact of the fire flow investments was significantly
11 greater because the investment was being recovered over the period of construction as opposed to
12 over the life of the assets as is proposed for the Sun City Water District.

13 Thus, we approve the FCRM as proposed in this case and as modified by Staff's
14 recommendations. We are approving the surcharge in the context of a rate case, and find that Staff's
15 recommendations for an earnings test meets concerns that the surcharge may affect rates without
16 considering the impact on return on FVRB.

17 * * * * *

18 Having considered the entire record herein and being fully advised in the premises, the
19 Commission finds, concludes, and orders that:

20 **FINDINGS OF FACT**

21 1. Arizona-American provides water utility service to approximately 23,000 customers
22 in its Sun City Water District. The Sun City Water District covers roughly 18 square miles and
23 includes all of Sun City and the Town of Youngtown, as well as small sections of the cities of Peoria
24 and Surprise.

25 2. Arizona-American's Sun City Water District's current rates were set in Decision No.
26 67093 (June 20, 2004).

27 3. On April 2, 2007, Arizona-American filed an application for a rate increase for its Sun
28 City Water District.

1 4. On April 30, 2007, Staff filed a letter stating that the application met the sufficiency
2 requirements outlined in A.A.C. R14-2-103, and classifying the Company as a Class A utility.

3 5. On May 16, 2007, the Commission convened a Special Open Meeting for the purpose
4 of taking public comment on the rate increase in this matter as well as Docket No. WS-01303A-06-
5 0491, Arizona-American's then pending rate case for its Sun City and Sun City West Wastewater
6 Districts.

7 6. By Procedural Order dated June 5, 2007, the Commission set the matter for hearing on
8 January 7, 2008, established procedural guidelines and deadlines for filing testimony and granted
9 intervention to RUCO and SCTA.

10 7. On September 13, 2007, the Commission granted intervention to Youngtown.

11 8. On September 19, 2007, Arizona-American filed Notice of Filing Affidavit of
12 Publication, indicating that notice of the hearing in this matter was published on September 11, 2007,
13 in the *Daily News-Sun*.

14 9. On September 21, 2007, Arizona-American filed Notice of Filing Affidavit of
15 Customer Notice, indicating that the notice had been mailed to Arizona-American's Sun City District
16 customers.

17 10. On October 3, 2007, William E. Downey of Sun City, Arizona, filed a Motion to
18 Intervene.

19 11. On October 15, 2007, RUCO filed the Direct Testimony of Marylee Diaz Cortez,
20 William Rigsby and Timothy Coley; Youngtown filed the Direct Testimony of Mayor Michael
21 LeVault and Deputy Fire Marshall Ken Rice; and Staff filed the Direct Testimony of Alexander
22 Igwe, Stephen Irvine on cost of capital and Dorothy Hains.

23 12. On October 19, 2007, the Commission granted intervention to Mr. Downey.

24 13. On October 29, 2007, Staff filed an Errata for Mr. Irvine's cost of capital testimony
25 filed on October 15, 2007, and filed Mr. Irvine's Direct Testimony on rate design, as well as Mr.
26 Igwe's Direct Testimony addressing the revision to Staff's recommended revenue requirement and
27 recommendations regarding the Company's request for a Public Safety Surcharge Mechanism.

28 14. On October 29, 2007, RUCO filed Mr. Coley's Direct Testimony on rate design.

1 15. On November 30, 2007, Arizona-American filed the Rebuttal Testimony of Linda
2 Gutowski, Bradley Cole, Cindy Datig, and Thomas Broderick.

3 16. On December 14, 2007, RUCO filed the Surrebuttal Testimony of Ms. Diaz Cortez,
4 Mr. Rigsby and Mr. Coley; Staff filed the Surrebuttal Testimony of Mr. Igwe, Ms. Hains, and Mr.
5 Irvine; and Youngtown filed the Surrebuttal Testimony of Mayor LeVault.

6 17. On December 11, 2007, the SCTA filed a request to withdraw from intervenor status
7 because it was not represented by an attorney as required by Arizona Supreme Court Rules 31 and 38
8 and A.R.S. § 40-243.

9 18. On December 21, 2007, Arizona-American filed the Rejoinder Testimony of Mr.
10 Broderick, Ms. Gutowski and Joseph E. Gross.

11 19. On January 3, 2008, the Commission conducted a Pre-Hearing Conference to schedule
12 witnesses. The Commission granted the SCTA request to withdraw as an intervenor and invited it to
13 present its position through public comment.

14 20. The hearing convened as scheduled on January 7, 2008, before a duly authorized
15 Administrative Law Judge. At the commencement of the hearing, the Commission heard comments
16 from a number of Arizona-American Sun City District customers, including the SCTA. In addition
17 during the public comment segment of the hearing, Mr. Downey withdrew as an intervenor and
18 provided public comment.

19 21. On January 14, 2008, Arizona-American filed Final Schedules.

20 22. On January 16, 2008, Staff filed its post-hearing exhibit on the bill impact of the
21 proposed surcharge.

22 23. On January 18, 2008, Arizona-American filed late-filed Exhibits A-14, A-15 (revised)
23 and A-16, concerning the Company's investment policy concerning fire flow investments, its revised
24 calculation of the estimated bill impact of the fire flow project, and status of low income programs in
25 Arizona-American's regulated states.

26 24. On January 22, 2008, RUCO filed its final post-hearing schedules and final rate
27 design.

28 25. On January 25, 2008, Arizona-American filed a Response to a billing issue raised

1 during public comment.

2 26. On February 1, 2008, Youngtown filed late-filed exhibits concerning fire losses and
3 fire sprinkler system costs.

4 27. On February 13, 2008, RUCO, Youngtown, Staff and Arizona-American filed Closing
5 Briefs.

6 28. On February 27, 2008, RUCO, Youngtown and Staff filed Reply Briefs.

7 29. On February 28, 2008, Arizona-American filed its Reply Brief.

8 30. In April 2008, the Commission received approximately 60 additional emails from Sun
9 City residents opposed to the fire flow improvement project.

10 31. In the Test Year ended December 31, 2006, the Company experienced Operating
11 Income of \$755,506, on total revenues of \$7,688,479, for a 2.99 percent rate of return on FVRB.

12 32. The Company requested rates that would result in total revenues of \$9,711,596, a
13 revenue increase of \$2,023,117, or 26.3 percent. RUCO recommended rates that would yield total
14 revenues of \$9,496,831, an increase of \$1,806,508, or 23.5 percent. Staff recommended total
15 revenues of \$9,632,551, an increase of \$1,944,072, or 25.3 percent.

16 33. As discussed herein, the Company's FVRB is determined to be \$25,295,922.

17 34. As discussed herein, an appropriate and reasonable capital structure for the Company
18 is 61.0 percent debt and 39 percent equity. The cost of debt is 5.5 percent, and an appropriate and
19 reasonable cost of equity is 10.8 percent.

20 35. For Arizona-American's Sun City Water District, a fair value rate of return on FVRB
21 of 7.6 percent is reasonable and appropriate.

22 36. Arizona-American's Sun City Water District's gross revenue should increase by
23 \$1,907,202.

24 37. The Low Income Program, as discussed herein, is fair and reasonable and should be
25 adopted.

26 38. The rate design proposed by Staff and as modified in the discussion herein should be
27 adopted in this proceeding.

28

1 39. The fire flow improvement project, as set forth in the Task Force's Report, and as
2 presented during the hearing, is important to promote and protect the health and safety of the
3 customers of Arizona-America's Sun City Water District.

4 40. The fire flow improvement project includes facilities to be installed in Sun City,
5 Youngtown and Peoria.

6 41. It is in the public interest for Arizona-American to begin constructing the fire flow
7 facilities, and it is reasonable to authorize the Company to do so.

8 42. We do not make any determination of the proposed fire flow capital improvements as
9 "used and useful," but defer such determination until the Company's next rate case.

10 43. Based on the particular facts of this case, the imposition of the FCRM as set forth
11 herein is fair and reasonable and should be adopted. Initially, the FCRM is set at zero.

12 44. Before the Commission implements a step increase to the FCRM, the Company shall
13 complete the phase improvements and shall file an application with the Commission, providing the
14 following information, as well as such information as Staff may reasonably require to analyze the
15 filing: (i) the most current balance sheet; (ii) the most current income statement; (iii) an earnings test
16 schedule (consistent with Decision No. 66400); (iv) a rate review schedule (including incremental
17 and pro forma effects of the proposed increase); (v) a revenue requirement calculation; (vi) a
18 surcharge calculation; (vii) an adjusted rate base schedule; (viii) a CWIP ledger (for each project
19 showing accumulation of charges by month and paid vendor invoices); (ix) calculation of the
20 allocation factors; and (x) a typical bill analysis under present and proposed rates.

21 45. The FCRM will not be re-set without an Order of the Commission.

22 46. The FCRM will be subject to an earnings test as recommended by Staff.

23 47. The Maricopa County Environmental Services Department ("MCESD") has
24 determined that the Sun City Water District system is currently delivering water that meets the water
25 quality standards required by Arizona Administrative Code, Title 18, Chapter 4.

26 48. The Company's Sun City District is within the Phoenix Active Management Area
27 ("AMA") and is in compliance with the Arizona Department of Water Resources ("ADWR")
28 monitoring and reporting rules.

1 \$25,295,922, and applying a 7.6 percent rate of return on this fair value rate base produces rates and
 2 charges that are just and reasonable.

3 5. The rates and charges approved herein are reasonable.

4 6. The proposed fire flow improvement projects, as set forth in the Youngtown/Sun City
 5 Fire Flow Task Force Report promote the health and safety of the Sun City Water District customers
 6 and are being implemented in a fair and equitable manner.

7 7. Based on the particular facts of this case, the FCRM as proposed by the Company, and
 8 as modified by Staff's recommendations, is fair and reasonable, and will not affect Arizona-American
 9 Water Company's authorized return on fair value rate base.

10 8. Staff's recommendations concerning water loss and water loss reporting are
 11 reasonable and should be adopted.

12 **ORDER**

13 IT IS THEREFORE ORDERED that Arizona-American Water Company is hereby authorized
 14 and directed to file with the Commission, on or before May 30, 2008, the following schedules of
 15 revised rates and charges for its Sun City Water District, which shall be effective for all service
 16 rendered on and after June 1, 2008:

17 Monthly Usage Charge:

18	5/8" & 3/4" meter – residential – low income ⁷¹	\$4.00
	5/8" meter	7.99
19	3/4" meter	7.99
	1" meter	20.49
20	1 1/2" meter	40.97
	2" meter	65.56
21	3" meter	131.12
	4" meter	204.87
22	6" meter	409.73
	8" meter	655.58
23		
	Irrigation 1"	20.49
24	Irrigation 1.5"	40.97
	Irrigation 2"	65.56
25	Irrigation 3"	131.12
	Irrigation 4"	204.87
26	Irrigation 6"	409.73

27

28 ⁷¹ Restricted to 1,000 qualified participants

1	Private Fire 3"	11.14
	Private Fire 4"	17.23
	Private Fire 6"	36.21
2	Private Fire 8"	47.28
	Private Fire 10"	68.34
3		
	Public Interruptible 3"	6.90
4	Public Interruptible 8"	6.90
	Standby – City of Peoria	6.95
5	Central Arizona Project Raw	--
6	Commodity Rates – per 1,000 gallons	
7	5/8" meter – residential	
	From 1 to 3,000 gallons	\$0.7190
8	From 3,001 to 10,000 gallons	1.3290
	Over 10,000 gallons	1.6920
9		
	3/4" meter – residential	
10	From 1 to 3,000 gallons	\$0.7190
	From 3,001 to 10,000 gallons	1.3290
11	Over 10,000 gallons	1.6920
12	5/8" meter – commercial	
	From 1 to 10,000 gallons	1.3290
13	Over 10,000 gallons	1.6920
14	3/4" meter – commercial	
	From 1 to 10,000 gallons	1.3290
15	Over 10,000 gallons	1.6920
16	1" meter – residential & commercial	
	From 1 to 43,000 gallons	1.3290
17	Over 43,000 gallons	1.6920
18	1 1/2" meter – residential & commercial	
	From 1 to 98,000 gallons	1.3290
19	Over 98,000 gallons	1.6920
20	2" meter – residential & commercial	
	From 1 to 164,000 gallons	1.3290
21	Over 164,000 gallons	1.6920
22	3" meter – residential & commercial	
	From 1 to 342,000 gallons	1.3290
23	Over 342,000 gallons	1.6920
24	4" meter – residential & commercial	
	From 1 to 543,000 gallons	1.3290
25	Over 543,000 gallons	1.6920
26	6" meter – residential & commercial	
	From 1 to 700,000 gallons	1.3290
27	Over 700,000 gallons	1.6920
28	8" meter – residential & commercial	

1	From 1 to 1,450,000 gallons	1.3290
	Over 1,450,000 gallons	1.6920
2	Irrigation 1" – all gallons	1.0604
	Irrigation 1.5" – all gallons	1.0604
3	Irrigation 2" – all gallons	1.0604
	Irrigation 3" – all gallons	1.0604
4	Irrigation 4" – all gallons	1.0604
	Irrigation 6" – all gallons	1.0604
5		
	Private Fire 3" all gallons	0.9828
6	Private Fire 4" all gallons	0.9828
	Private Fire 6" all gallons	0.9828
7	Private Fire 8" all gallons	0.9828
	Private Fire 10" all gallons	0.9828
8		
	Public interruptible 3" all gallons	0.9282
9	Public interruptible 8" all gallons	0.9828
	Standby – city of Peoria – all gallons	0.9828
10	Central Arizona Project Raw – all gallons	0.8480

11

12 Service Line and Meter Installation

13	<u>Charges (Refundable):</u>	<u>Line</u>	<u>Meter</u>	<u>Total</u>
	5/8" Meter	\$370	\$130	\$ 500
14	3/4 " Meter	370	205	575
	1" Meter	420	240	660
15	1 1/2" Meter	450	450	900
	2" Turbine Meter	580	945	1,525
16	2" Compound Meter	580	1,640	2,220
	3" Turbine Meter	745	1,420	2,165
17	3" Compound Meter	765	2,195	2,960
	4" Turbine Meter	1,090	2,270	3,360
18	4" Compound Meter	1,120	3,145	4,265
	6" Turbine Meter	1,610	4,425	6,035
19	6" Compound Meter	1,630	6,120	7,750
20	Over 6"	cost	cost	cost

21 Service Charges:

22	Establishment and/or Reconnection	\$30.00
	Establishment and/or Reconnection (after hours)	40.00
23	Meter Test	10.00
	NSF Check	10.00
24	Meter Re-Read	5.00
	Deposit	(a)
25	Deposit Interest	(a)
26	Collection of any privilege, sales, use and franchise taxes(b)	

27 (a) Per Commission Rule AAC R14-2-403B
 (b) Per Commission Rule AAC R14-2-409D

28

1 IT IS FURTHER ORDERED that Arizona-American Water Company shall notify its Sun
2 City Water District customers of the revised schedules of rates and charges authorized herein by
3 means of an insert, in a form acceptable to Staff, included in its next regularly scheduled billing.

4 IT IS FURTHER ORDERED that Arizona-American Water Company is authorized to
5 commence construction of the proposed fire flow improvement project as set forth in the Fire Flow
6 Task Force Report and discussed herein.

7 IT IS FURTHER ORDERED that no determination is made at this time of the proposed fire
8 flow improvement projects as "used and useful" for future rate making treatment.

9 IT IS FURTHER ORDERED that the fire flow cost recovery mechanism, as discussed herein,
10 is approved, and the fire flow cost recovery surcharge shall initially be set at zero.

11 IT IS FURTHER ORDERED that to implement a step increase for the fire flow cost recovery
12 mechanism, Arizona-American Water Company shall file the following schedules: (i) the most
13 current balance sheet; (ii) the most current income statement; (iii) an earnings test schedule
14 (consistent with Decision No. 66400); (iv) a rate review schedule (including incremental and pro
15 forma effects of the proposed increase); (v) a revenue requirement calculation; (vi) a surcharge
16 calculation; (vii) an adjusted rate base schedule; (viii) a CWIP ledger (for each project showing
17 accumulation of charges by month and paid vendor invoices); (ix) calculation of the allocation
18 factors; and (x) a typical bill analysis under present and proposed rates.

19 IT IS FURTHER ORDERED that Arizona-American Water Company's application for the
20 implementation of a FCRM step increase shall be subject to an earnings test, and the proposed
21 surcharge decreased if it is determined that Arizona-American Water Company would exceed its
22 authorized rate of return for its Sun City Water District as a result of the implementation of the step
23 increase. Any proposed FCRM step increase will not be increased if the earnings test indicates that
24 Arizona-American Water Company is under-earning its authorized rate of return.

25 IT IS FURTHER ORDERED that any party to this proceeding, as well as any appropriate
26 future intervenor, shall be entitled to review the materials that Arizona-American Water Company
27 files in connection with the FCRM, and may file comments or objections thereto.

28 IT IS FURTHER ORDERED that no FCRM step increase shall be implemented without an

1 Order of the Commission, and any finding concerning the fire flow project facilities shall be subject
2 to further review and potential adjustment in Arizona-American Water Company's next rate case.

3 IT IS FURTHER ORDERED that Arizona-American Water Company shall file a rate case for
4 its Sun City Water District no later than June 30, 2012, and the fourth proposed step increase for the
5 FCRM, or any prior phase of the project that has not been approved as of June 30, 2012, may be
6 considered as part of the next rate case.

7 IT IS FURTHER ORDERED that if water loss for Arizona-American Water Company's Sun
8 City Water District at any time before the next rate case is greater than 10 percent, the Arizona-
9 American Water Company shall devise a plan to reduce water loss to less than 10 percent, or prepare
10 a report containing a detailed analysis and explanation demonstrating why a water loss reduction to
11 10 percent or less is not feasible or cost effective.

12 IT IS FURTHER ORDERED that Arizona-American Water Company may use its annual
13 report to track water loss, as long as water usage data is reported on a individual system basis in the
14 annual report.

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IT IS FURTHER ORDERED that Arizona-American Water Company shall annually file as part of its annual report, an affidavit with the Utilities Division attesting that the Company is current in paying its property taxes in Arizona.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN _____ COMMISSIONER _____

COMMISSIONER _____ COMMISSIONER _____ COMMISSIONER _____

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Director of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this ____ day of _____, 2008.

BRIAN C. McNEIL
EXECUTIVE DIRECTOR

DISSENT _____

DISSENT _____

JR:

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SERVICE LIST FOR: ARIZONA AMERICAN SUN CITY WATER DISTRICT

DOCKET NO.: W-01303A-07-0209

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