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BEFORE THE ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION
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11 IN THE MATTER OF THE APPLICATION OF
12 ARIZONA-AMERICAN WATER COMPANY,
13 AN ARIZONA CORPORATION, FOR A
14 DETERMINATION OF THE CURRENT FAIR
15 VALUE OF ITS UTILITY PLANT AND
16 PROPERTY AND FOR INCREASES IN ITS
17 RATES AND CHARGES BASED THEREON
18 FOR UTILITY SERVICE BY ITS SUN CITY
19 WATER DISTRICT.

Docket No. W-01303A-07-0209

Arizona Corporation Commission
DOCKETED

FEB 27 2008

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RUCO'S REPLY BRIEF

20 The Residential Utility Consumer Office ("RUCO") replies to Arizona-American Water
21 Company ("Arizona-American" or "Company"), the Town of Youngtown ("Youngtown" or the
22 "Town") and the Arizona Corporation Commission Staff's ("Staff") Post Hearing Briefs as
23 follows.

THE FIRE FLOW IMPROVEMENTS

24 The Company, Staff and the Town each support the proposed fire flow improvements
and recovery for the improvements through the FCRM. Whereas, the Company and Staff
acknowledge that the improvements are discretionary, the Town suggests that the
Commission is statutorily obligated to require the improvements, and the Company is presently

1 violating the law by not having "sufficient fire flows and fire hydrants throughout the District."

2 Town Brief at 8, Staff Brief at 8, A-3 at 8.

3 In its Brief, the Company treats the issue of whether ratepayers should pay for fire flow
4 improvements as a foregone conclusion. The Company presumes that since the Commission-
5 ordered task force recommends the fire-flow improvements, there is no question that
6 ratepayers should pay for the improvements. The only question that the Company addresses
7 is the funding mechanism. On that point, the Company "... cannot fund the fire-flow projects,
8 unless the Commission approves a mechanism very much like the ACRM." Company Brief at
9 21.

10 Staff supports the proposed FCRM, among other reasons, because it is not similar to
11 the method of recovery that Staff proposed and the Commission approved in the Paradise
12 Valley District case. Staff Brief at 11. Not surprisingly, the Town supports the FCRM because
13 of the system's fire flow inadequacies and the resulting danger the public faces. Town's Brief
14 at 14. In addition, the Town argues that "[t]raditional ratemaking treatment does not appear
15 viable." Id.

16 The ultimatums, the danger hysteria and the past history with Paradise Valley should all
17 be red flags that what is being proposed is a solution, but **not the right solution**, to what is
18 needed in the Sun City Water District to remedy its fire flow inadequacies. The Commission
19 should reject the FCRM.

20
21 **1) THE COMMISSION IS NOT STATUTORILY OBLIGATED TO REGULATE FIRE
22 FLOW IMPROVEMENTS.**

23 The Town's interpretation of the law suggests that the Commission is statutorily
24 obligated to regulate fire flow improvements. The Town cites to numerous statutes which

1 define the Commission's powers in support of its contention that the Commission can order the
2 fire flow improvements. RUCO does not disagree that the Commission has the power to order
3 the fire flow improvements. This is not the issue. The issue is *who should pay for the fire flow*
4 *improvements.*

5 The Town then states that the Company is in violation of A.R.S. §§ 40-361 (B) and -
6 334(A) & (B), which the Town claims places an "affirmative duty on the Commission" to protect
7 the public safety of its customers and prevent disparate treatment pursuant to A.R.S. §§ 40-
8 321 (A) and 40-331(A) & 40-203. Town Brief at 8. In the next sentence, the Town concludes
9 that the "Commission need not order the fire flow improvements." The Town's legal
10 conclusions are confusing. RUCO will not attempt to provide a responsive legal analysis
11 beyond what it provided in its Opening Brief. See RUCO Brief at 3-8. In the end, RUCO
12 agrees with the Town that the Commission "need not order the fire flow improvements" nor
13 should it order the fire flow improvements.

14
15 **2) THE PROPOSED FIRE FLOW IMPROVEMENTS ARE IN THE PUBLIC**
16 **INTEREST BUT SHOULD NOT BE PAID FOR BY RATEPAYERS.**

17 Both the Town and Staff argue, at great length, that the fire flow improvements are in
18 the public interest and are necessary to remedy the inadequacies of the system. See Town
19 Brief at 9-11, Staff Brief at 6-8. RUCO does not dispute that the fire flow improvements are in
20 the public's interest and that the system has fire flow inadequacies. Both points miss the
21 issue. It is the party that requests the benefit, not the utility's customers, that should pay for
22 the improvements. Ratepayers would enjoy the same benefits if the Town paid for the fire flow
23 improvements.

1 The Town claims it cannot fund the improvements and that RUCO has failed to identify
2 any viable alternative funding source. Town Brief at 11. The Town claims that RUCO has
3 provided “no evidence” that the Sun City Recreation Centers, Homeowners Association and/or
4 Condominium Association are legally and financially capable of raising funds to pay for the fire
5 flow improvements. The Town is correct – RUCO has provided no such evidence. RUCO is
6 not responsible for identifying an alternative funding source to fund the projects, or even
7 offering solutions to solve fire flow inadequacies. This is an area that is the Town’s and Sun
8 City’s responsibility, not the Commission’s responsibility. RUCO’s charge is to analyze and
9 determine what costs are reasonable and necessary to provide water service to the
10 Company’s customers. Fire flow improvements are not a necessary cost of service, and
11 should not be recovered from ratepayers.

12
13 **3) THE FCRM SHOULD NOT BE APPROVED**

14 The Commission should proceed cautiously, as approval of the FCRM under the
15 present circumstances will have far-reaching consequences. First, the FCRM is patterned
16 after the ACRM. The ACRM, as explained in RUCO’s Opening Brief, was a solution for a very
17 limited purpose, which all of the parties involved recognized was necessary under the unique
18 circumstances presented. RUCO Brief at 11. The situation is not the same, or even close,
19 here. Staff, the Town, and the Company are recommending that the FCRM be applied to
20 discretionary projects that under traditional ratemaking are the financial responsibility of the
21 party requesting the projects – the Town and Sun City.

22 Staff admits that it would normally be opposed to a request like the FCRM but because
23 of the public safety impact, the significant cost and the community support, Staff supports it.
24 Staff Brief at 10. Staff’s reasons are laudable but misguided. RUCO has addressed the public

1 safety and benefit issue above. The costs are high, but most utility improvements are
2 expensive; and unlike the ACRM, the Company is not mandated by federal law to comply
3 within a certain time period. The community support is questionable at best. The results of the
4 Company's survey on this issue are hardly persuasive. In terms of the whole district, of those
5 surveyed only 59% of the District supported the fire flow improvements and only 51% are
6 willing to pay for it. A-5 at 1. Unlike the ACRM, the community does have a choice, and it is
7 clear that even the community at best half-heartedly supports paying for the fire flow projects.

8 The ACRM should not become the template for the pass-through to ratepayers of every
9 expense outside of a rate case that is in the public interest. In effect, the approval of the
10 FCRM would send a message that there is a mechanism that the Commission supports that
11 provides for single-issue ratemaking in circumstances where there is a public interest. The
12 ACRM was never meant to be expanded as it is being proposed here, and the Commission
13 should not approve of it.

14 Second, Staff argues that an accounting/deferral order is not recommended as it would
15 delay the recovery and increase the costs to ratepayers. Staff Brief at 14. This proposal is
16 moot anyway, since the Company has made it clear that the only proposal it will support is the
17 FCRM. Transcript at 1030. It is surprising that Staff would not support the accounting/deferral
18 order, given the legal considerations associated with the FCRM and the fact that many of the
19 Company's financial problems were brought on by itself. Transcript at 1025-1029. While
20 RUCO would not support an accounting/deferral order, it is the better of two evils since it will
21 allow for an examination of costs in a rate case where all the ratemaking elements can be
22 reviewed.

23 The point, however, is that the Company is only willing to consider funding up-front and
24 only in a manner that the Company deems appropriate. In short, the Company is not willing to

1 take any risk and accept any other terms but its own. This is not the way the Commission
2 does business, or should do business. Moreover, if the Commission approves the projects in
3 theory, it should not be limited to utilizing only the Company's proposed funding mechanism.

4 Finally, Staff's argument that the FCRM is not similar to the method of recovery
5 approved by the Commission in Paradise Valley is not persuasive. What happened in
6 Paradise Valley was unfortunate and should serve as a reminder of why the Commission
7 should not be approving the funding of fire flow improvements.

8 The fact that the proposed surcharge **may** have a small effect on rates is not
9 compelling. The FCRM, as proposed, would allow for four step increases between 2009 and
10 2012, when the Company estimates that the project will be completed. A-4, TMB-1. At this
11 point the costs are only estimates. The Company estimates that the total cost will be \$5.1
12 million. A-5 at 2. This estimate is higher than the Company's previous estimate of \$4.9
13 million. A-4 at 19. Staff estimates the costs to be \$2.7 million¹. Transcript at 936. But Staff
14 admits it is doubtful that the projects can be completed by 2012, and Staff agrees with the
15 Company that delays would result in higher costs. Transcript at 947, 962. Staff is unaware of
16 the extent of the cost increases caused by delays. Id. In his direct testimony, the Company's
17 witness, Tom Broderick, estimated that the total step increases, expressed as a percentage of
18 existing revenues will be 10.4%. A-3 at 6. The 10.4% increase associated with the fire flow
19 projects is over and above the 29.01 percent increase the Company is requesting in this rate
20 case. Id. at 2.

21 The rate impact on the district's ratepayers is not just limited to the fire flow project or
22 the rate case for that matter. The District's ratepayers are also facing a rate increase in the
23

24 ¹ Staff did not consider "inflation and other factors" to provide an estimate in 2012 terms. Transcript at 936.

1 Company's Sun City Wastewater District. There is currently pending before the Commission a
2 rate application in the Company's Sun City Wastewater District requesting an increase of
3 \$1,606,495 or 35.84 percent. See Company's Sun City Wastewater District Wastewater
4 application in Docket No. WS-01303A-06-0491 at 3. Moreover, in 2005 the Commission
5 approved an ACRM for this District to allow for the recovery of arsenic treatment. See
6 Decision No. 68310. The escalating utility costs in the Sun City District are threatening and will
7 continue to threaten the very affordability of basic water service in an area where the majority
8 of the people are on fixed incomes. The Commission should not approve unnecessary costs
9 and streamlined funding mechanisms that will jeopardize the affordability of water service in
10 Arizona. The Commission should reject the FCRM.

11
12 **RATE BASE ADJUSTMENTS**

13 **RATE BASE ADJUSTMENT # 3 – WORKING CAPITAL**

14 The Company and Staff recommend a zero cash working capital requirement.
15 Company Brief at 3. The Company discounts RUCO's use of the lead/lag study filed by the
16 Company in its recent Mohave district. Id. at 4. The Company believes RUCO failed to meet
17 its burden to establish that something other than a zero working capital balance was correct.
18 Id.

19 The Commission faced the same issue in the Company's Paradise Valley case. Docket
20 No. WS-01303A-06-0014. In Paradise Valley, both the Company and Staff ultimately made a
21 zero cash working capital recommendation. RUCO relied on the Company's lead/lag study it
22 presented prior to making its final recommendation. Decision No.68858 at 14. RUCO made
23 adjustments to the lead/lag study to include items the Commission had allowed in previous
24 cases. Id. The Commission agreed with RUCO noting that RUCO's recommendation was

1 based on a lead/lag study and was more reasonable than Staff and the Company's zero
2 recommendation. Id.

3 Here, the facts are almost identical. RUCO relies on a lead/lag study done by the
4 Company in its recent Mohave Division case. R-5 at 14. RUCO explained in great length in its
5 Closing Brief why it is appropriate to use the lead/lag study from the Mohave case. See
6 RUCO's Closing Brief at 14. In fact, RUCO's use of the Mohave lead/lag study in this case
7 results in a cash working capital allowance of \$45,368 for the Company's Sun City Water
8 District. RUCO's cash working capital recommendation is reasonable and should be
9 approved.

10 11 **OPERATING ADJUSTMENTS**

12 **RUCO OPERATING ADJUSTMENT #5 - PROPERTY TAX EXPENSE**

13 The Company is critical of RUCO's property tax position, noting that it has been
14 repeatedly rejected by the Commission. Company Brief at 6-7. The Company relies on
15 Decision No. 69440 where the Commission determined that "RUCO has not demonstrated a
16 basis for departure from our prior determination on this issue." Id.

17 RUCO acknowledges that the Commission has rejected ADOR's methodology in the
18 past. See RUCO Brief at 15. The fact that it has been rejected does not equate to the
19 conclusion that it is an inferior methodology for estimating property taxes than what the
20 Company is proposing.

21 The issue of property tax is not a question of who is right and who is wrong. The issue
22 is what calculation methodology provides the best estimate of actual property tax, after the rate
23 goes into effect. RUCO has explained at length in prior cases, as well as this case, why the
24 use of the Company and Staff's methodology is not as accurate as the ADOR methodology in

1 estimating property taxes. For this reason, in addition to all of the other reasons set forth in
2 RUCO's Opening Brief, the Commission should approve RUCO's property tax
3 recommendation.

4 **RUCO OPERATING ADJUSTMENT #6 – REVENUE ANUALIZATION**

5 RUCO incorporates its position set forth in its Closing Brief². RUCO Brief at 16 – 17.
6

7 **RUCO OPERATING ADJUSTMENT #7 – MISCELLANEOUS EXPENSE**

8 RUCO incorporates its position set forth in its Closing Brief. RUCO Brief at 18.
9

10 **RUCO OPERATING ADJUSTMENT #8 – ACHIEVEMENT INCENTIVE PAY (“AIP”)**

11 The Company criticizes RUCO's reference to precedent on this issue, noting that
12 RUCO consistently rejects precedent concerning other issues but is quick to rely on it in this
13 issue³. Despite the Company's perception, the simple truth is the Commission has addressed
14 this issue in the Company's Paradise Valley case and there is nothing new here. Decision No.
15 68858 at 20-21.
16

17 The Company's argument that the Sun City Water District is operating at a loss⁴ is not
18 relevant to the AIP issue for the reasons set forth in RUCO's Closing Brief. RUCO Brief at 19-
19 20.
20

21 ² Where the Company has done little more than just state its position in its Closing Brief or made arguments
22 already addressed by RUCO in its Closing Brief, RUCO's reply will just adopt its position set forth in its
23 Closing Brief.

24 ³ This is a very interesting perception since the Company, like most parties in rate cases, rely on and cite
Commission precedent when it supports their position and usually disagree with precedent when it does not
support their position. To set the record straight, RUCO respects the Commission's Decision's regardless of
the outcome. That does not mean RUCO always agrees with the Commission's Decisions.

⁴ RUCO disagrees with the Company's assertion that it is operating at a loss. See RUCO Brief at 9.

1 **RUCO OPERATING ADJUSTMENT #9 – REGULATORY EXPENSE**

2 The Company notes that RUCO did not explain why it favors a three-year as opposed to
3 a four-year amortization period for rate case expense. Mr. Coley did explain at the hearing
4 that RUCO's concern is that the Company is likely to come in for new rates sooner than four
5 years, resulting in rate case expense and thus would seek to carry over any unrecovered
6 balance from this case. Transcript at 830. However, RUCO apologizes to the Company and
7 the parties if its position was unclear. Hopefully, any confusion will be eliminated after
8 reviewing RUCO's Closing Brief. RUCO's Brief at 20-21.

9
10 **RUCO OPERATING ADJUSTMENT #12 - MAINTENANCE EXPENSE**

11 The issue here is whether or not the Commission should allow recovery for
12 deferred tank maintenance expense. As the Company states in its Closing Brief, the Company
13 first requested recovery of this expense in its rebuttal case, submitted on November 30, 2007.
14 Company Brief at 8. RUCO did not have an opportunity to verify this expense prior to the
15 hearing which started on January 7, 2008. Typically, a utility identifies those expenses for
16 which it requests recovery in its initial application, which in this case was filed on April 2, 2007.
17 It is not a stretch to consider the Company's request as late-filed given that it was, as the
18 Company admits, "first requested" almost eight months after the application was filed and
19 slightly more than one month before the first day of the hearing.

20 The Company, not RUCO, has the burden of supporting its application and providing
21 the support timely. The burden should not shift to RUCO to explain why an expense should not
22 be recovered when the Company failed to provide sufficient documentation to support its late-
23 filed request.

1 **RUCO OPERATING ADJUSTMENT #13 – INCOME TAX EXPENSE**

2 RUCO's disagreement with the Company here is solely a function of the two different
3 operating income levels.

4 **RATE DESIGN**

5 RUCO incorporates its position set forth in its Closing Brief. RUCO Brief at 22.
6

7 **COST OF CAPITAL**

8 RUCO continues to urge the Commission to adopt RUCO's recommended 9.89 percent
9 return on common equity and overall 7.36 rate of return for the Sun City Wastewater District.
10 RUCO agrees with the Company that short-term debt should not be in the Company's capital
11 structure. RUCO Brief at 23. RUCO takes issue with the Company's arguments that RUCO's
12 cost of equity analysis is flawed.

13 First, the Company is critical of RUCO's 50-basis point upward adjustment to its cost of
14 equity based on its cost of capital analysis. A-4 at 2-3, Company Brief at 13. Apparently, the
15 Company believes the adjustment should be higher. The Company refers to prior adjustments
16 approved by the Commission and concludes that RUCO's adjustment is arbitrary. Id. The
17 Company fails to provide support for its conclusion that RUCO's upward adjustment is
18 arbitrary.

19 The determination of a Company's return on equity is not an exact science. R-9 at 12.
20 A fair cost of equity analysis requires a certain amount of judgment and analysis specific to the
21 circumstances of the utility in question. Id. The same holds true in determining what
22 adjustment, if any, should be applied for the risk the utility faces. Id. In this case, Mr. Rigsby's
23 risk adjustment took into consideration the fact that RUCO recommended a lower level of debt
24 in the capital structure than the Company did. Id. RUCO's CAPM analysis was also generous

1 given that recent studies indicate that the actual risk premium used in the CAPM model may
2 be lower than the equity risk premiums published by Morningstar. R-11 at 13. These factors
3 should compensate investors for any perceived additional financial risk beyond the additional
4 50 basis point adjustment. Id.

5 Moreover, a sound argument can be made that a financial risk adjustment is not even
6 needed for a regulated utility, given the fact that a regulated utility can avoid financial distress
7 or bankruptcy by filing for rate relief on a timely basis. Transcript at 758. That option is not
8 available to firms that operate in a competitive environment. Id. Based on this logic, the 50
9 basis point financial risk adjustment that RUCO is recommending is generous. While the
10 Company may not agree with RUCO's upward adjustment, it is based on an up-to-date
11 analysis of the market, the facts specific to this Company, and it is **not** arbitrary.

12 Second, the Company argues that the lower cost of equity calculated on Mr. Rigsby's
13 sample of water companies should be ignored, and that only the higher results of the natural
14 gas companies in Mr. Rigsby's sample should be given any weight. Company Brief at 13.
15 This argument has no merit. Unlike the natural gas providers in Mr. Rigsby's sample, the
16 commodity being provided by Arizona-American has no real substitute. Natural gas customers
17 have the option of switching to electricity as a source of energy for their appliance and heating
18 needs, while water customers have no such option. While Mr. Rigsby admits that water and
19 natural gas companies share some similarities in terms of their product distribution
20 characteristics, the fact remains that water providers, such as Arizona-American, are indeed
21 still the last pure monopoly. Given these facts, the Company's argument that water companies
22 should be ignored in a cost of capital analysis lacks merit and should be given no weight.

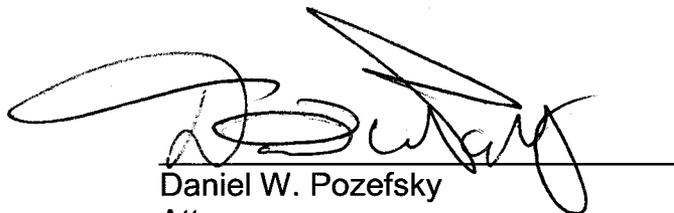
23 Finally, RUCO's recommended cost of common equity is appropriate given the current
24 environment of relatively low inflation and falling interest rates in which the Company is

1 operating. R-8 at 42-50. The Federal Reserve's recent interest rate-cutting actions further
2 support RUCO's 9.89 percent recommended cost of equity. R-9 at 10.

3
4 **CONCLUSION**

5 The Commission should not authorize a rate increase of more than \$1,806,508 for the
6 Sun City District. The Commission should adopt all of the other recommendations set forth in
7 the Conclusion of RUCO's Closing Brief.

8
9 RESPECTFULLY SUBMITTED this 27th day of February, 2008.

10
11 
12 _____
13 Daniel W. Pozefsky
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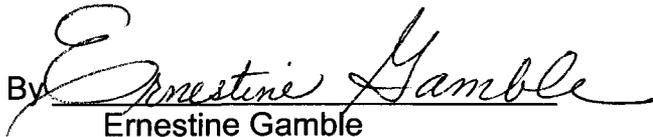
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