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BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONERS

MIKE GLEASON, Chairman  
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KRISTIN K. MAYES  
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AZ CORP COMMISSION  
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IN THE MATTER OF THE APPLICATION OF  
ARIZONA-AMERICAN WATER COMPANY,  
AN ARIZONA CORPORATION, FOR A  
DETERMINATION OF THE CURRENT FAIR  
VALUE OF ITS UTILITY PLANT AND  
PROPERTY AND FOR INCREASES IN ITS  
RATES AND CHARGES BASED THEREON  
FOR UTILITY SERVICE BY ITS SUN CITY  
WATER DISTRICT

DOCKET NO. W-01303A-07-0209

ARIZONA-AMERICAN WATER  
COMPANY

NOTICE OF FILING REPLY BRIEF

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

3 RESPECTFULLY SUBMITTED on February 27, 2008.  
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Arizona Corporation Commission

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FEB 28 2008

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2 on February 27, 2008, with:

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4 Docket Control  
5 Arizona Corporation Commission  
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7 Phoenix, Arizona 85007

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9 Copies of the foregoing **delivered**  
10 on February 27, 2008, to:

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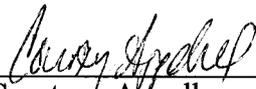
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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

MIKE GLEASON, Chairman  
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DOCKET NO. W-01303A-07-0209

**REPLY BRIEF OF ARIZONA-AMERICAN WATER COMPANY**

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1     **I**        **INTRODUCTION**

2             Arizona-American has already thoroughly discussed most of the remaining issues  
3 between the parties. In its reply brief, the Company will note all remaining issues, but will focus  
4 on just two issues – short-term debt and alleged statutory violations.

5     **II**        **REPLY TO STAFF**

6             **A**        **SHORT-TERM DEBT**

7             Staff misses the point of Arizona-American’s objection to including short-term debt in  
8 the capital structure. Certainly, it can be appropriate to include short-term debt, but only if it is  
9 shown that:

- 10            1. The short-term debt is being used to finance rate base; and
- 11            2. The short-term debt balance is typical.

12            Staff has not satisfied either requirement.

13            As discussed in Arizona-American’s brief, the Commission determines a utility’s cost of  
14 capital to provide investors a return on investment funds used to finance assets that are serving  
15 customers. Short-term debt may appropriately be included as part of the capital structure, but  
16 only if it is being used to finance rate-base assets. If short-term debt is being used for other  
17 purposes, then it should not be included in the capital structure.

18            RUCO considered Staff’s position and rejected it for just this reason. For example,  
19 RUCO understands that Arizona-American has begun constructing the White Tanks water-  
20 treatment facility. Short-term debt will be used to finance construction, but developer  
21 contributions will later be used to offset much or all of the cost of the plant.<sup>1</sup> As a result, the  
22 Company’s short-term debt balance will grow as the plant is being constructed, but ultimately  
23 much or all of the cost of the plant will be excluded from rate base. Therefore, none of the short-  
24 term debt associated with this plant should be included in the Company’s capital structure.

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<sup>1</sup> Decision No. 69914, dated September 27, 2007.

1 Staff has also failed to show that the short-term debt balance is typical. Staff has taken a  
2 snapshot of the Company's short-term debt balance on a particular day. Because of the nature of  
3 short-term debt, balances typically vary widely from month to month as a company pays down  
4 the balance, either through cash flow or long-term financing, or borrows new short-term funds  
5 for needs like new construction, taxes, or other assessments.

6 Again, Arizona-American is not philosophically opposed to including short-term debt in  
7 its capital structure. However, if this is to be done, it must be done correctly. Staff must first  
8 identify and exclude all short-term debt associated with developer-funded projects like the White  
9 Tanks plant. Second, Staff must determine a typical balance of remaining short-term debt,  
10 perhaps by determining a yearly or rolling average of the debt. Because Staff has done neither,  
11 the Commission must reject Staff's proposal to include short-term debt in Arizona-American's  
12 capital structure.

### 13 **III REPLY TO RUCO**

#### 14 **A FIRE-FLOW SURCHARGE**

15 Arizona-American has already thoroughly discussed why the Commission should  
16 approve its request to fund badly needed fire-flow projects through a surcharge mechanism like  
17 that used to fund arsenic-remediation projects. Staff and Youngtown have each done an  
18 admirable job of supporting this request. No further reply to RUCO on this topic is needed.

#### 19 **B CASH WORKING CAPITAL**

20 RUCO has added nothing new on this topic that has not already been addressed by  
21 Arizona-American in its initial brief. No further reply is needed.

#### 22 **C PROPERTY TAX EXPENSE**

23 RUCO has added nothing new on this topic that has not already been addressed by  
24 Arizona-American in its initial brief. No further reply is needed.

1           **D       ANNUALIZED REVENUE AND EXPENSE**

2           For the reasons stated by Arizona-American in its initial brief, revenue and expense  
3 annualization is not appropriate. This is a built-out community.

4           If the Commission does decide to include RUCO's revenue annualization, then it must  
5 also, as RUCO recognizes, annualize expenses. Although Arizona-American does not believe  
6 that these annualizations are appropriate, it does concede that RUCO's calculations are correct.

7           **E       MISCELLANEOUS EXPENSE**

8           RUCO has added nothing new on this topic that has not already been addressed by  
9 Arizona-American in its initial brief. No further reply is needed.

10          **F       ACHIEVEMENT INCENTIVE PAY**

11          RUCO fails to recognize that Arizona-American actually pays out rewards for hitting  
12 earnings targets, even when the target is negative net income, as long as the Company does not  
13 lose even more than budgeted. Otherwise, RUCO has added nothing new on this topic that has  
14 not already been addressed by Arizona-American in its initial brief.

15          **G       MAINTENANCE EXPENSE**

16          RUCO has added nothing new on this topic that has not already been addressed by  
17 Arizona-American in its initial brief. No further reply is needed.

18          **H       INCOME TAX EXPENSE**

19          Arizona-American agrees that any differences with RUCO on this topic are related to the  
20 parties' different recommended levels of operating income.

21          **I       RATE DESIGN**

22          RUCO has added nothing new on this topic that has not already been addressed by  
23 Arizona-American in its initial brief. No further reply is needed.<sup>2</sup>

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<sup>2</sup> After the hearing was over, RUCO did late-file a schedule setting forth its final position concerning rate design. However, no party has had the opportunity to review the schedule or to cross-examine its sponsor. Therefore, the Commission should not consider this schedule.

1           **J       COST OF EQUITY**

2           RUCO has added nothing new on this topic that has not already been addressed by  
3 Arizona-American in its initial brief. No further reply is needed.

4           **IV       REPLY TO YOUNGTOWN**

5           **A       COMPLIANCE WITH STATE LAW**

6           Youngtown alleges that: "AAW's failure to provide sufficient fire flows and fire hydrants  
7 throughout the District violates A.R.S. §§ 40-361(B) and -334(A) & (B) ...." This is incorrect.

8           All three statutes relate to a utility's rates, charges, services, and facilities.<sup>3</sup> This type of  
9 legislation impermissibly infringes on the Corporation Commission's exclusive jurisdiction over  
10 rates, charges, services, and facilities:

11           The framers of the Arizona Constitution created the Commission in article 15,  
12 providing that it should have "full power" to regulate, set rates, and make reasonable  
13 rules for public service companies. ... The framers established the Commission as a  
14 separate, popularly-elected branch of state government.<sup>4</sup>

15           It was clearly the policy of the framers of the Constitution, and the people in  
16 adopting it, to take the powers of supervision, regulation and control of public  
17 utilities from the legislative branch and vest them in the Corporation Commission....<sup>5</sup>

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<sup>3</sup> A.R.S. § 40-361(B). Every public service corporation shall furnish and maintain such service, equipment and facilities as will promote the safety, health, comfort and convenience of its patrons, employees and the public, and as will be in all respects adequate, efficient and reasonable.

A.R.S. § 40-334(A). A public service corporation shall not, as to rates, charges, service, facilities or in any other respect, make or grant any preference or advantage to any person or subject any person to any prejudice or disadvantage.

A.R.S. § 40-334(B). No public service corporation shall establish or maintain any unreasonable difference as to rates, charges, service, facilities or in any other respect, either between localities or between classes of service.

<sup>4</sup> *Arizona Corp. Com'n v. State ex rel. Woods*, 171 Ariz. 286, 290; 830 P.2d 807, 811 (1992).

<sup>5</sup> *State v. Tucson Gas, Elec. Light & Power Co.*, 15 Ariz. 294, 302; 138 P. 781, 784 (1914).

1 Further, Section 6 of Article 15 allows the legislature to “enlarge the powers and extend the  
2 duties of the Commission, and [to] prescribe rules and regulations to govern proceedings by and  
3 before it.” However, the legislature may not restrict the Commission’s powers or duties.<sup>6</sup>

4 The Commission is clearly exercising its exclusive jurisdiction concerning water-utility  
5 rates and services, particularly concerning whether fire-flow investments are needed in the Sun  
6 City Water District. In Arizona-American’s last rate case for Sun City Water, the Commission  
7 issued very specific orders to Arizona-American concerning local fire-flow requirements.

8 IT IS FURTHER ORDERED that Arizona-American Water Company, Inc. shall  
9 form a Fire-flow Task Force to be comprised of members including, but not limited  
10 to, a representative of the company's Arizona management team, representatives  
11 from Youngtown and Sun City, a representative of the Sun City's Taxpayers'  
12 Association, a representative of the Recreation Centers of Sun City, and  
13 representatives from the fire departments serving Youngtown and Sun City. The  
14 purpose of this Task Force shall be to determine if the water production capacity,  
15 storage capacity, water lines, water pressure, and fire hydrants of Youngtown and  
16 Sun City are sufficient to provide the fire protection capacity that is desired by each  
17 community.

18 IT IS FURTHER ORDERED that the Fire-flow Task Force shall be formed in  
19 November 2004.

20 IT IS FURTHER ORDERED that the Fire-flow Task Force shall submit its findings  
21 and proposed plan of action to the Commission no later than May 30, 2005. Those  
22 members of the Fire-flow Task Force that do not agree with the findings and  
23 proposed plan of action may submit their own findings and proposed plan of action,  
24 but must do so by June 30, 2005.

25 IT IS FURTHER ORDERED that Arizona-American Water Company, Inc. shall  
26 work in conjunction with the fire departments serving Youngtown and Sun City to  
27 test the fire hydrants in Youngtown and Sun City in order to determine if those  
28 hydrants are operational. The Company shall submit a progress report on April 1st of  
29 each year to the Commission.<sup>7</sup>

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<sup>6</sup> *Selective Life Ins. Co. v. Equitable Life Assur. Soc’y*, 101 Ariz. 594, 600, 422 P.2d 710, 716 (1967).

<sup>7</sup> Decision No. 67093, dated June 30, 2004, at 59:25 – 60:14.

1 Youngtown does not suggest that Arizona-American has violated the Order's requirements.

2 Further, in the exercise of its exclusive jurisdiction, the Commission has so far not taken  
3 a position, either through rules, or case law, whether a water utility has a general duty to upgrade  
4 its system to meet newer fire-flow standards. It has once before addressed a water utility's  
5 request to approve fire-flow investments in rate base, but approval was only in very specific  
6 circumstances:

7 The record here indicates that the improvements are necessary to ensure the public  
8 health and safety of the District's ratepayers, are used and useful to the ratepayers in  
9 the District, and that the District's ratepayers are largely in support of the  
10 improvements and are willing to pay for them through their water utility rates.<sup>8</sup>

11 Therefore, the Commission has determined that the need for fire-flow investments should be  
12 evaluated on a case-by-case basis, which is exactly what is being done in this docket. The  
13 legislature cannot infringe on the Commission's exercise of its constitutional jurisdiction.

14 There is no basis for Youngtown's allegation that Arizona-American has violated any  
15 statutes. The Commission has jurisdiction over this matter and has exercised it. To answer the  
16 question of whether a utility should upgrade older infrastructure to satisfy modern fire-flow  
17 standards requires the Commission to evaluate service needs and rate impacts, both questions  
18 exclusively within the Commission's Article 15 jurisdiction.

19 **V CONCLUSION**

20 For the reasons set forth in Arizona-American's testimony and pleadings, the  
21 Commission should approve new rates in the Sun City Water District to provide a revenue  
22 increase of \$2,023,117, using the rate design recommended by Staff and the Company. The  
23 Commission should also approve Arizona-American's requests for a fire-flow cost recovery  
24 mechanism and a low-income program.

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<sup>8</sup> Decision No. 68858, dated July 28, 2006, at 11:18-21.

RESPECTFULLY SUBMITTED on February 27, 2008.

Handwritten signature of Craig A. Marks in cursive, with a circled 'A' to the right.

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