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**BEFORE THE ARIZONA CORPORATION COMMISSION**

IN THE MATTER OF THE APPLICATION )  
OF VALLEY UTILITIES WATER )  
COMPANY INC. FOR AN ACCOUNTING )  
ORDER REGARDING DEFFERAL OF )  
ARSENIC TREATMENT OPERATING )  
AND MAINTAINENCE EXPENSES. )

DOCKET NO. W-01412A-07-0278

**APPLICANT'S RESPONSE TO  
STAFF REPORT**

1. On March 27, 2008 the Commission Staff filed a Staff Report in the subject docket recommending that the Application be denied. The Company hereby provides its response thereto.

2. It is essential that the analysis separate consideration of the cost recovery mechanisms for the capital costs, versus the operating and maintenance costs. In anticipation of this very significant capital and operating and maintenance costs mandated on the Company, arsenic treatment costs have been the subject of several Company applications and Commission Decisions over the years.

3. The Company acknowledges and concurs with the Staff Report that in Commission Decision No. 67669, dated March 9, 2005, the Commission authorized an Arsenic Impact Fee Tariff ("AIF") to assist in the recovery of the arsenic treatment plant capital cost. The

1 Commission, thankfully, granted the AIF for \$1,100 for a 5/8" meter, graduated for the larger  
2 meter sizes. The Company is accumulating those AIF's in a separate Bank Account for the  
3 purpose of construction, or payment of debt service, associated with the arsenic treatment plant.  
4 The Company has accumulated \$108,410.63 as of December 31, 2007, which has been duly  
5 reported to the Commission in accordance with Decision No. 67669.

6 4. In Decision No. 68309, dated November 14, 2005, the Company obtained  
7 Commission approval of a \$1.9 million Water Infrastructure Facilities of Arizona ("WIFA") loan  
8 for the arsenic treatment plant construction purposes. That Decision also required that the  
9 Company file for a capital surcharge application, if necessary (presuming that the AIF or  
10 internally generated profits may be insufficient) (See Page 26, Line 23). Therefore, the capital  
11 funding and repayment have been addressed for the present. Upon completion of the  
12 construction of the arsenic treatment plant, the Company will apply for rates sufficient to support  
13 the new plant's Rate Base and long-term financing.

14 5. To address the operating and maintenance costs, the Company's Application  
15 which resulted in Decision No. 68309, also sought an Arsenic Operating and Maintenance  
16 Recovery Surcharge Mechanism, the AOMRSM. This was not a request for approval of a  
17 specific dollar amount, but a procedure to recover those costs once known and after being  
18 audited by Staff. That request was denied. We did not agree with the Decision, but do  
19 acknowledge that the costs were not then known and measurable, so no exact surcharge level  
20 could be authorized, and the Commission apparently did not want to approve a mechanism  
21 without the dollars being known.

22 6. As a result of the AOMRSM's denial, and due to the urgency that those costs  
23 eventually be recovered, the Company filed the present application for an Accounting Order.

1 The operating and maintenance costs for the arsenic treatment plant are a very significant cost  
2 estimated to be approximately \$200,000 per year. That is over 25 percent of the Company's  
3 Total Operating Expenses as established in the last rate case. Those costs will be incurred with  
4 an irregular frequency and in uneven amounts which cannot be predicted with any degree of  
5 accuracy. Even with an operating history of the arsenic treatment plan, which the Company  
6 obviously does not have, the filter media replacements may not occur on a 12 month, or any other  
7 specific time, cycle. The water flows, water quality, and other technical vagaries will impact on  
8 the timing of the filter media replacement and the other operating and maintenance costs.  
9 Further, the first filter media replacement is unlikely to occur during the Test Year in which the  
10 plant goes online, or before the Company files its next rate case on December 1, 2008 based upon  
11 a June 30, 2008 Test Year as required in Decision No. 70138. However, those substantial costs  
12 are likely to be incurred after the June 2008 Test Year, and before the next subsequent rate case  
13 Test Year. As result, those costs would either be "unknown and unmeasurable" expenses, or a  
14 "pre-Test Year" expense, neither of which are typically allowed in Commission's ratemaking  
15 procedures. There can be no doubt that the arsenic operating and maintenance costs are  
16 legitimate costs for ratemaking purposes which the Company must recover from his customers.  
17 In the above scenarios, the Company will never recover those costs.

18         7. It is submitted that the appropriate rate-making methodology which will permit  
19 the Commission's inclusion of these costs in a rate making proceeding is an Accounting Order  
20 authorizing deferral of those costs. That order would merely permit booking of those expenses  
21 as deferred items on the Company's Balance Sheet. This will permit the Commission to consider  
22 them in a rate case. This is not an uncommon procedure for the Commission having authorized  
23 deferral of many multi-period expenses, including rate case expenses. A good example of this is

1 the Arizona-American request for deferral of a multi-year wastewater treatment cost under a  
2 contract with the City of Tolleson which was approved in Decision No. 66386, dated October 6,  
3 2003.

4 8. Arsenic operating and maintenance expenses are precisely the type of expenses  
5 anticipated to be deferred by the Uniform System of Accounts ("USOC") for Class B Water  
6 Utilities in accordance with the NARUC 1996 Chart of Accounts. The definition for  
7 Miscellaneous Deferred Debits includes:

8 "(7) Regulatory created assets, not included in other accounts, resulting in the  
9 rate-making actions of regulatory agencies. (See Definition 27.) The amounts  
10 included in that account are to be established by those charges which would have  
11 been included in net income determinations in the current period under the  
12 general requirements of the Uniform System of Accounts but for it being  
13 probable that such items will be included in a different period(s) for purposes of  
14 developing the rate s that the utility is authorized to charge for its utility services.  
15 ...". (USOC, Page 58)

16 Definition 27 of the USOC defines "Regulatory Assets and Liabilities" as:

17 "... assets and liabilities that result from rate actions of regulatory agencies.  
18 Regulatory assets and liabilities arise from specific revenues, expenses, gains or  
19 losses that would have been included in determination of net income in one  
20 period under the general requirements of the Uniform System of Accounts but for  
21 it being probable that; 1) such items will be included in a different period(s) for  
22 the purposes of developing the rates the utility is authorized to charge for its  
23 utility services...". (USOC, Page 11)

9. The Company is not asking for approval of any particular expense amount, and  
certainly not requesting specific or even tacit approval of that expense which will be considered  
in a plenary rate proceeding. The Company would not object to the Decision in this matter  
containing an ordering paragraph similar to that contained in all financing decisions, or as in the  
Arizona-American Decision No. 66386, to the effect that the decision does not imply the cost  
will be approved for ratemaking purposes.

1           10.     The Company's proposed procedure will permit the Staff and the Commission to  
2 fully review the expenses as actually incurred (albeit not during the Test Year) and determine  
3 what, if any, of those costs should be recovered, and the methodology of that recovery. As  
4 stated, both "unknown and unmeasurable" and "Pre-Test Year" and "Post-Test Year" expenses  
5 are typically unrecoverable by the utility. The Accounting Order merely provides an opportunity  
6 to recover those legitimate costs and is not a tacit approval of those costs.

7           11.     The ability to recover those significant costs is particularly important to this  
8 Company. The record before this Commission is very clear as to the financial frailty of Valley  
9 Utilities Water Company. The Commission has ordered an equity enhancement plan of the  
10 Company in Decision No. 68309, and the Company has filed such a plan. A major component of  
11 the plan is increasing equity through internally generated funds from profits of the Company. If  
12 the Company is unable to recover the arsenic operating and maintenance costs because of the  
13 technical deficiency of having incurred those expenses outside of the historic Test Year, those  
14 costs will never be recovered, and the Company's equity position would not increase, but would  
15 actually decrease.

16           12. The Staff recommends that the Company file a surcharge approval for those  
17 operating and maintenance expenses. Clearly, surcharges must be established in a plenary rate  
18 case. Further, surcharges are for recovery of future cost, not historical cost. Moreover, precisely  
19 the type of surcharge recommended by Staff was requested by the Company and was denied by  
20 the Commission in Decision No. 68309.

21           13.     The Staff believes that the request for deferral of "any and all" arsenic operating  
22 and maintenance expenses is "overly broad". It is submitted that Staffs conclusion is premature  
23 and incorrect. The Company, nor to the best of the Company's knowledge, does the Commission

1 or any Arizona water company regulated by the Commission, know the operating and  
2 maintenance costs associated with an arsenic treatment plant, either the filter media replacement  
3 costs, or otherwise. The deferral of all operation and maintenance costs will permit the  
4 Commission to scrutinize all of those federally mandated costs and establish the appropriate  
5 treatment of those costs. Further, the Staff suggests that only costs incurred during the first 12  
6 months of operation of the treatment plant should be deferrable. Again, those costs are not easily  
7 predictable. Until a definite maintenance cost pattern for a specific arsenic treatment plant has  
8 been established, the deferral of all costs must be allowed which will permit the Commission to  
9 "annualize" an appropriate operating and maintenance expense for future rate-making purposes.  
10 The 12 month period recommended by Staff is inconsistent with the physical operation of an  
11 arsenic treatment plant, and therefore is both illogical and inappropriate.

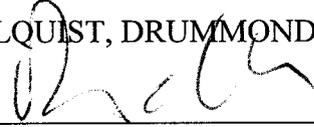
12 14. Finally, the Staff argues that the deferral of the arsenic operating and maintenance  
13 expenses does not provide "adequate protection for the ratepayers". Again, no cost will be  
14 imposed on any ratepayer until the Staff and the Commission have fully reviewed those expenses  
15 at a plenary rate case. How can that review possibly be inadequate protection for the ratepayers?

16 15. The Company again respectfully requests that the Commission set this matter for  
17 hearing, only if deemed necessary, and thereafter issue an Opinion and Order in this Docket  
18 pursuant to ARS §40-221 which will authorize the deferral of any and all Arsenic Operating and  
19 Maintenance Expenses in substantially the following form:

20 "IT IS ORDERED that the Company shall account for all Operating  
21 and Maintenance Expenses associated with the Arsenic Treatment Plant  
22 constructed pursuant to and in accordance with Decision No. 68309, be  
23 recorded in NARUC Account Number 186.2 (Other Deferred Debits), for  
the purposes of permitting recovery of those costs in future rate case(s) as  
determined by the Commission in those proceedings."

1 Respectfully submitted this 10<sup>th</sup> day of April, 2008

2 SALLQUIST, DRUMMOND & O'CONNOR, P.C.

3 By : 

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7  
8 Original and fifteen copies of the  
9 foregoing filed this 10<sup>th</sup> day  
of April, 2008:

10 Docket Control  
11 Arizona Corporation Commission  
12 1200 West Washington  
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14 A copy of the foregoing  
15 mailed/hand delivered this  
16 10<sup>th</sup> day of April, 2008, to:

17 Utilities Division  
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19 1200 West Washington  
20 Phoenix, Arizona 85007

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