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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

Arizona Corporation Commission

DOCKETED

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

MAY 16 2008

DOCKETED BY  
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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

DECISION NO. 70351

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.<sup>1</sup> Based on an adjusted end of Test Year Original Cost  
2 Rate Base ("OCRB") of \$25,295,922, 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.<sup>2</sup>

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.<sup>3</sup> 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.<sup>4</sup> RUCO believes that  
26

27 <sup>1</sup> See Discussion § IVB herein.

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

<sup>3</sup> RUCO final schedules, TJC-1, filed January 22, 2008.

28 <sup>4</sup> 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.<sup>5</sup> 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.<sup>6</sup> 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.<sup>7</sup> 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.<sup>8</sup>

#### 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  
26

27 <sup>5</sup> Ex S-22 Igwe Surrebuttal.

28 <sup>6</sup> *Id.*

<sup>7</sup> Tr at 10-11.

<sup>8</sup> 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.<sup>9</sup> 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.<sup>10</sup> 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 <sup>9</sup> The Commission approved the Mohave District rates in Decision No. 69440 (May 1, 2007), which used a test year  
ending June 2005.

28 <sup>10</sup> 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.<sup>11</sup> 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.<sup>12</sup> Both Staff and  
26 RUCO are on record as opposing the Company's suggestion that it could seek recovery of

27 \_\_\_\_\_  
28 <sup>11</sup> Ex S-22, Igwe Surrebuttal at 9:14-17.

<sup>12</sup> Ex A-5 Borderick Rejoinder at 6.

1 unamortized rate case expense if it filed its next rate case prior to 2012.<sup>13</sup> 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”<sup>14</sup> 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.<sup>15</sup>

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

28 <sup>13</sup> Igwe Executive Summary filed January 4, 2008.

<sup>14</sup> RUCO Opening Brief at 21.

<sup>15</sup> 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.

<sup>16</sup> 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.

1 C. Cost of Capital2 1. Capital Structure

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

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

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

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

27 Staff argues that short-term debt is a component of the capital structure and that the use of  
28 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.<sup>17</sup>

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.<sup>18</sup>

## 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 \_\_\_\_\_  
28 <sup>17</sup> Staff Reply Brief at 5.

<sup>18</sup> 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.<sup>19</sup> 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>
Debt	61.0 %	5.50%	3.4%
Common Equity	<u>39.0 %</u>	10.80%	<u>4.2%</u>
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:

OCRB	\$25,295,922
Adjusted Test Year Operating Income	\$755,506
Required Operating Income	\$1,922,490
Required Rate of Return	7.6%
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 ...  
 26 ...  
 27 \_\_\_\_\_  
 28 <sup>19</sup> 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 by the Commission. Staff states that its methodology encourages more efficient use of water because  
 2 the second tier rate for 5/8 inch meters customers is greater than the rate that would be required to  
 3 recover the revenue requirement using a uniform commodity rate, and customers experience a greater  
 4 incremental cost for all use exceeding 3,000 gallons.<sup>20</sup> Staff states that the concept for 5/8 inch  
 5 meters is extended to customers with larger meters where the break-over points graduate in  
 6 correlation with meter size.

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

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

<sup>20</sup> ExS-14, Irvine Direct at 4.

<sup>21</sup> RUCO's final schedules filed January 22, 2008.

<sup>22</sup> Arizona-American final schedules filed January 14, 2008.

<sup>23</sup> Ex S-17, Irvine Surrebuttal.

<sup>24</sup> 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	Public Interruptible 3"	4.59	6.90	6.93	6.95
	Public Interruptible 8"	4.59	6.90	6.93	6.95
2	Standby – City of Peoria	5.62	6.95	6.98	7.00
	Central Arizona Project Raw	--	--	--	--
3					
4	<b>Commodity Rates – per 1,000 gallons</b>				
5	<b>5/8" meter – residential</b>				
	From 1 to 4,000 gallons	\$0.7200			
6	From 4,001 to 18,000 gallons	1.1000			
	Over 18,000 gallons	1.3160			
7	From 1 to 4,000 gallons		\$0.7298		
	From 4,001 to 10,000 gallons		1.3900		
8	Over 10,000 gallons		1.7100		
9	From 1 to 3,000 gallons			\$0.7336	\$0.7223
	From 3,001 to 13,000 gallons			1.3551	1.3342
10	Over 13,000 gallons			1.6913	1.6653
11	<b>3/4" meter – residential</b>				
	From 1 to 4,000 gallons	\$0.7200			
12	From 4,001 to 18,000 gallons	1.1000			
	Over 18,000 gallons	1.3160			
13	From 1 to 4,000 gallons		\$0.7298 <sup>25</sup>		
14	From 4,001 to 10,000 gallons		1.3900		
	Over 10,000 gallons		1.7100		
15	From 1 to 3,000 gallons	N/A		\$0.7336	\$0.7223
	From 3,001 to 13,000 gallons	N/A		1.3551	1.3342
16	Over 13,000 gallons	N/A		1.6913	1.6653
17					
18	<b>5/8" meter – commercial</b>				
	From 1 to 18,000 gallons	1.1000			
	Over 18,000 gallons	1.3160			
19	From 1 to 10,000 gallons	N/A	1.3900	1.3551	1.3342
20	Over 10,000 gallons	N/A	1.7100	1.7383	1.6653
21					
22	<b>3/4" meter – commercial</b>				
	From 1 to 18,000 gallons	1.1000			
	Over 18,000 gallons	1.3160			
23	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
24					
25	<b>1" meter – residential &amp; commercial</b>				
	From 1 to 60,000 gallons	1.1000			
	Over 60,000 gallons	1.3160			
26	From 1 to 46,000 gallons	N/A	1.3900	1.3551	1.3342

<sup>25</sup> 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 3/4 inch meter class.

1	Over 46,000 gallons	N/A	1.7100	1.7383	1.6653
2	<b>1 ½" meter – residential &amp; commercial</b>				
3	From 1 to 125,000 gallons	1.1000			
3	Over 125,000 gallons	1.3160			
4	From 1 to 106,000 gallons	N/A	1.3900	1.3551	1.3342
4	Over 106,000 gallons	N/A	1.7100	1.7383	1.6653
5	<b>2" meter – residential &amp; commercial</b>				
6	From 1 to 190,000 gallons	1.1000			
6	Over 190,000 gallons	1.3160			
7	From 1 to 175,000 gallons	N/A	1.3900	1.3551	1.3342
8	Over 175,000 gallons	N/A	1.7100	1.7383	1.6653
9	<b>3" meter – residential &amp; commercial</b>				
9	From 1 to 340,000 gallons	1.1000	1.3900	1.3551	1.3342
10	Over 340,000 gallons	1.3160	1.7100	1.7383	1.6653
11	<b>4" meter – residential &amp; commercial</b>				
11	From 1 to 550,000 gallons	1.1000	1.3900	1.3551	1.3342
12	Over 550,000 gallons	1.3160	1.7100	1.7383	1.6653
13	<b>6" meter – residential &amp; commercial</b>				
14	From 1 to 700,000 gallons	1.1000	1.3900	1.3551	1.3342
14	Over 700,000 gallons	1.3160	1.7100	1.7383	1.6653
15	<b>8" meter – residential &amp; commercial</b>				
16	From 1 to 1,430,000 gallons	1.1000	1.3900	1.3551	1.3342
17	Over 1,430,000 gallons	1.3160	1.7100	1.7383	1.6653
18	Irrigation 1" – all gallons	0.8200	1.1100	1.0645	1.0679
18	Irrigation 1.5" – all gallons	0.8200	1.1100	1.0645	1.0679
19	Irrigation 2" – all gallons	0.8200	1.1100	1.0645	1.0679
19	Irrigation 3" – all gallons	0.8200	1.1100	1.0645	1.0679
20	Irrigation 4" – all gallons	0.8200	1.1100	1.0645	1.0679
21	Irrigation 6" – all gallons	0.8200	1.1100	1.0645	1.0679
22	Private Fire 3" all gallons	0.7600	1.0300	0.9900	0.9898
22	Private Fire 4" all gallons	0.7600	1.0300	0.9900	0.9898
23	Private Fire 6" all gallons	0.7600	1.0300	0.9900	0.9898
23	Private Fire 8" all gallons	0.7600	1.0300	0.9900	0.9898
24	Private Fire 10" all gallons	0.7600	1.0300	0.9900	0.9898
25	Public interruptible 3" all gallons	0.6300	1.0300	0.8179	0.9898
26	Public interruptible 8" all gallons	0.6300	1.0300	0.8179	0.9898
26	Standby – city of Peoria – all gallons	0.7600	1.0300	0.9866	0.9898
27	Central Arizona Project Raw – all gallons	0.6558	0.8800	0.8513	0.8540
28					

1 The Company did not propose changes to its meter and service line installation charges or its  
 2 service charges, and there is no dispute among the parties about these charges. Consequently, the  
 3 chart of comparisons is omitted.

4 B. Low Income Program

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

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

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

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

28 <sup>27</sup> Arizona-American Initial Brief at 23.

<sup>28</sup> Id.

1 proposed low income program.<sup>29</sup>

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 <sup>29</sup> 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.<sup>30</sup> 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.<sup>31</sup> 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 <sup>30</sup> Decision No. 67093 (June 30, 2004).

<sup>31</sup> 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.<sup>32</sup> At the time that the Task Force report  
 5 was issued, the estimated cost of the recommended upgrades was approximately \$3.1 million.<sup>33</sup> 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 <sup>th</sup> 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

27  
 28 <sup>32</sup> Tr at 112.

<sup>33</sup> 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.<sup>34</sup> 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 when the Commission establishes new permanent  
26 rates in the next Arizona-American Sun City Water District rate case (expected by May 31, 2012)

27  
28 <sup>34</sup> Ex S-18 Hains Direct at 8-9.

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

8 Staff recommended an earnings test before the FCRM goes into effect.<sup>36</sup> 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.<sup>37</sup> 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.<sup>38</sup>

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

<sup>36</sup> Ex S-21, Igwe Direct at 9.

<sup>37</sup> *Id.* at 10.

<sup>38</sup> 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.<sup>39</sup> 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.<sup>40</sup>

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).<sup>41</sup>

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.<sup>42</sup> 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 <sup>39</sup> RUCO Opening Brief at 4.

<sup>40</sup> RUCO Reply Brief at 4.

<sup>41</sup> RUCO Reply Brief at 7.

28 <sup>42</sup> 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."<sup>43</sup> 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 <sup>43</sup> *Scates v Arizona Corporation Commission*, 118 Ariz. 531, 534, 578 P.2<sup>nd</sup> 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.”<sup>44</sup>  
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.”<sup>45</sup> 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.”<sup>46</sup>

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.<sup>47</sup> 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

26 \_\_\_\_\_  
27 <sup>44</sup> *Town of Gila Bend*, 107 Ariz at 550.

<sup>45</sup> *Town of Gila Bend*, 107 Ariz. at 549.

<sup>46</sup> *Id.*

28 <sup>47</sup> RUCO Reply Brief at 5.

1 costs, and consequently, the burden on ratepayers.<sup>48</sup>

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,<sup>49</sup> 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 <sup>48</sup> RUCO Reply Brief at 6.

<sup>49</sup> *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.<sup>50</sup> 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.<sup>51</sup>  
 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.<sup>52</sup> 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.<sup>53</sup> Youngtown asserts good

23  
 24 <sup>50</sup> 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.

<sup>51</sup> Youngtown Opening Brief at 8, fn 30.

<sup>52</sup> A.A.C. R4-36-201.

<sup>53</sup> 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 PSI<sup>54</sup> 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.<sup>55</sup>

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.<sup>56</sup>

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

27 <sup>54</sup> Pounds per square inch.

28 <sup>55</sup> Ex S-4, ADEQ Engineering Bulletin No.10.

<sup>56</sup> 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.<sup>57</sup>  
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

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28 <sup>57</sup> 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.”<sup>58</sup> Youngtown argues the FCRM is just such an automatic adjustment mechanism,  
14 tied to investment in non-revenue producing plant.<sup>59</sup>

#### 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.<sup>60</sup> 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.<sup>61</sup> 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 <sup>58</sup> 115 Ariz. At 535, 578 P.2d at 616.

<sup>59</sup> Youngtown Reply Brief at 7.

<sup>60</sup> Ex S-21, Igwe Direct at 6.

<sup>61</sup> 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.<sup>62</sup> Staff notes  
3 further that the Company views its system as a whole and does not follow political boundaries.<sup>63</sup>  
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.<sup>64</sup> 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

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27 <sup>62</sup> Tr at 564.

28 <sup>63</sup> Tr.at 567.

<sup>64</sup> 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.<sup>65</sup> 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.<sup>66</sup> 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:<sup>67</sup>

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

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:<sup>70</sup>

	<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
23 Average	\$0.12	\$0.29	\$0.45	\$0.67

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

26 <sup>66</sup> *Id.*

27 <sup>67</sup> Ex A-15 Revised, filed January 18, 2008.

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

28 <sup>69</sup> Based on average usage for the 5/8 inch meter of 8,300 gallons per month.

28 <sup>70</sup> S-23 filed January 16, 2008.

1 C. Analysis and Resolution

2 Our experience with considering major construction projects outside the context of a rate case  
 3 teaches us that often substantial unintended adverse consequences can result from implementing  
 4 surcharges such as the FCRM. Cost recovery mechanisms such as the FCRM should only be  
 5 implemented in extraordinary circumstances. We do not find that the proposed fire flow  
 6 improvement project warrants the extraordinary rate making treatment being proposed by the  
 7 Company, Staff and Youngtown. Consequently, we deny the request to implement the FCRM. Our  
 8 finding on the merits of the FCRM, however, does not affect how the Commission would treat the  
 9 capital improvements if the Company constructed them voluntarily and seeks their inclusion in rate  
 10 base in a rate case.

11 \* \* \* \* \*

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

14 **FINDINGS OF FACT**

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

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

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

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

25 5. On May 16, 2007, the Commission convened a Special Open Meeting for the purpose  
 26 of taking public comment on the rate increase in this matter as well as Docket No. WS-01303A-06-  
 27 0491, Arizona-American's then pending rate case for its Sun City and Sun City West Wastewater  
 28 Districts.

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

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

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

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

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

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

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

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

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

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

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

28          17.       On December 11, 2007, the SCTA filed a request to withdraw from intervenor status

1 because it was not represented by an attorney as required by Arizona Supreme Court Rules 31 and 38  
2 and A.R.S. § 40-243.

3 18. On December 21, 2007, Arizona-American filed the Rejoinder Testimony of Mr.  
4 Broderick, Ms. Gutwoski and Joseph E. Gross.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

16 36. Arizona-American's Sun City Water District's gross revenue should increase by  
17 \$1,907,202.

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

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

22 39. It is not in the public interest to recover the cost of the proposed fire flow  
23 improvement projects by means of the FCRM.

24 40. We do not make any determination at this time whether the proposed fire flow capital  
25 improvements would be "used or useful" or how the Commission would treat such improvements in  
26 the context of a rate case.

27  
28

1           41.    The Maricopa County Environmental Services Department (“MCESD”) has  
2 determined that the Sun City Water District system is currently delivering water that meets the water  
3 quality standards required by Arizona Administrative Code, Title 18, Chapter 4.

4           42.    The Company’s Sun City District is within the Phoenix Active Management Area  
5 (“AMA”) and is in compliance with the Arizona Department of Water Resources (“ADWR”)  
6 monitoring and reporting rules.

7           43.    Staff reports that Arizona-American’s Sun City Water District has a 10 percent water  
8 loss in the Test Year. Staff states that the water loss is within acceptable limits. Staff does not  
9 recommend any specific reporting at this time, but recommends that if water loss at any time before  
10 the next rate case is greater than 10 percent, the Company shall devise a plan to reduce water loss to  
11 less than 10 percent, or prepare a report containing a detailed analysis and explanation demonstrating  
12 why a water loss reduction to 10 percent or less is not feasible or cost effective.

13           44.    Staff has no objection to the Company’s suggested water usage form, and agrees with  
14 the Company that it may use its annual report to track water loss, as long as water usage data is  
15 reported on a individual system basis in the Company’s annual report.

16           45.    The Company has an approved cross connection tariff.

17           46.    The Company has adequate production and storage capacity.

18           47.    The Company is current with its sales and use tax and property tax obligations and is  
19 in compliance with Commission orders and rules and reporting requirements.

20           48.    Because an allowance for the property tax expense of the Company is included in the  
21 Company’s rates and will be collected from its customers, the Commission seeks assurances from the  
22 Company that any taxes collected from ratepayers have been remitted to the appropriate taxing  
23 authority. It has come to the Commission’s attention that a number of water companies have been  
24 unwilling or unable to fulfill their obligation to pay the taxes that were collected from ratepayers,  
25 some for as many as twenty years. It is reasonable, therefore, that as a preventive measure Arizona-  
26 American annually file, as part of its annual report, an affidavit with the Utilities Division attesting  
27 that the Company is current in paying its property taxes in Arizona..

28 ...

CONCLUSIONS OF LAW

1  
2 1. Arizona-American is a public service corporation pursuant to Article XV of the  
3 Arizona Constitution and A.R.S. §§ 40-250 and 40-251.

4 2. The Commission has jurisdiction over Arizona-American and the subject matter of the  
5 application.

6 3. Notice of the proceeding was provided in conformance with law.

7 4. The fair value of Arizona-American's Sun City Water District rate base is  
8 \$25,295,922, and applying a 7.6 percent rate of return on this fair value rate base produces rates and  
9 charges that are just and reasonable.

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

11 6. Implementing the proposed FCRM is not in the public interest.

12 7. Staff's recommendations concerning water loss and water loss reporting are  
13 reasonable and should be adopted.

ORDER

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

Monthly Usage Charge:

20	5/8" & 3/4" meter – residential – low income <sup>71</sup>	\$4.00
	5/8" meter	7.99
21	3/4" meter	7.99
	1" meter	20.49
22	1 1/2" meter	40.97
	2" meter	65.56
23	3" meter	131.12
	4" meter	204.87
24	6" meter	409.73
	8" meter	655.58
25		
	Irrigation 1"	20.49
26	Irrigation 1.5"	40.97
	Irrigation 2"	65.56
27		

28 <sup>71</sup> Restricted to 1,000 qualified participants

1	Irrigation 3"	131.12
	Irrigation 4"	204.87
2	Irrigation 6"	409.73
	Private Fire 3"	11.14
3	Private Fire 4"	17.23
	Private Fire 6"	36.21
4	Private Fire 8"	47.28
5	Private Fire 10"	68.34
	Public Interruptible 3"	6.90
6	Public Interruptible 8"	6.90
	Standby – City of Peoria	6.95
7	Central Arizona Project Raw	--
8	Commodity Rates – per 1,000 gallons	
9	5/8" meter – residential	
	From 1 to 3,000 gallons	\$0.7190
10	From 3,001 to 10,000 gallons	1.3290
11	Over 10,000 gallons	1.6920
12	3/4" meter – residential	
	From 1 to 3,000 gallons	\$0.7190
13	From 3,001 to 10,000 gallons	1.3290
	Over 10,000 gallons	1.6920
14	5/8" meter – commercial	
	From 1 to 10,000 gallons	1.3290
15	Over 10,000 gallons	1.6920
16	3/4" meter – commercial	
	From 1 to 10,000 gallons	1.3290
17	Over 10,000 gallons	1.6920
18	1" meter – residential & commercial	
	From 1 to 43,000 gallons	1.3290
19	Over 43,000 gallons	1.6920
20	1 1/2" meter – residential & commercial	
	From 1 to 98,000 gallons	1.3290
21	Over 98,000 gallons	1.6920
22	2" meter – residential & commercial	
	From 1 to 164,000 gallons	1.3290
23	Over 164,000 gallons	1.6920
24	3" meter – residential & commercial	
	From 1 to 342,000 gallons	1.3290
25	Over 342,000 gallons	1.6920
26	4" meter – residential & commercial	
	From 1 to 543,000 gallons	1.3290
27	Over 543,000 gallons	1.6920
28	6" meter – residential & commercial	

1	From 1 to 700,000 gallons	1.3290
	Over 700,000 gallons	1.6920
2	8" meter – residential & commercial	
	From 1 to 1,450,000 gallons	1.3290
3	Over 1,450,000 gallons	1.6920
4	Irrigation 1" – all gallons	1.0604
	Irrigation 1.5" – all gallons	1.0604
5	Irrigation 2" – all gallons	1.0604
	Irrigation 3" – all gallons	1.0604
6	Irrigation 4" – all gallons	1.0604
	Irrigation 6" – all gallons	1.0604
7		
	Private Fire 3" all gallons	0.9828
8	Private Fire 4" all gallons	0.9828
	Private Fire 6" all gallons	0.9828
9	Private Fire 8" all gallons	0.9828
	Private Fire 10" all gallons	0.9828
10		
	Public interruptible 3" all gallons	0.9828
11	Public interruptible 8" all gallons	0.9828
	Standby – city of Peoria – all gallons	0.9828
12	Central Arizona Project Raw – all gallons	0.8480

13

14 Service Line and Meter Installation

15	<u>Charges (Refundable):</u>			
	<u>Line</u>	<u>Meter</u>	<u>Total</u>	
15				
	5/8" Meter	\$370	\$130	\$ 500
16	3/4 " Meter	370	205	575
	1" Meter	420	240	660
17	1 1/2" Meter	450	450	900
	2" Turbine Meter	580	945	1,525
18	2" Compound Meter	580	1,640	2,220
	3" Turbine Meter	745	1,420	2,165
19	3" Compound Meter	765	2,195	2,960
	4" Turbine Meter	1,090	2,270	3,360
20	4" Compound Meter	1,120	3,145	4,265
	6" Turbine Meter	1,610	4,425	6,035
21	6" Compound Meter	1,630	6,120	7,750
22	Over 6"	cost	cost	cost

23 Service Charges:

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

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

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

6 IT IS FURTHER ORDERED that the request to implement the FCRM is denied.

7 IT IS FURTHER ORDERED that Arizona-American Water Company shall file a rate case for  
8 its Sun City Water District no later than June 30, 2012.

9 IT IS FURTHER ORDERED that if water loss for Arizona-American Water Company's Sun  
10 City Water District at any time before the next rate case is greater than 10 percent, the Arizona-  
11 American Water Company shall devise a plan to reduce water loss to less than 10 percent, or prepare  
12 a report containing a detailed analysis and explanation demonstrating why a water loss reduction to  
13 10 percent or less is not feasible or cost effective.

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

17 ...  
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1 IT IS FURTHER ORDERED that Arizona-American Water Company shall annually file as  
2 part of its annual report, an affidavit with the Utilities Division attesting that the Company is current  
3 in paying its property taxes in Arizona.

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

5 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

6  
7  
8 *Lawell Blossom*  
CHAIRMAN

*William Miller*  
COMMISSIONER

9  
10 *Jeffrey H. Hatcher*  
COMMISSIONER

*[Signature]*  
COMMISSIONER

*Gary R. [Signature]*  
COMMISSIONER

11  
12  
13 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive  
14 Director of the Arizona Corporation Commission, have  
15 hereunto set my hand and caused the official seal of the  
16 Commission to be affixed at the Capitol, in the City of Phoenix,  
17 this 16<sup>th</sup> day of May, 2008.

*[Signature]*  
BRIAN C. McNEIL  
EXECUTIVE DIRECTOR

18  
19 DISSENT \_\_\_\_\_

20  
21 DISSENT \_\_\_\_\_

22 JR:

23  
24  
25  
26  
27  
28

1 SERVICE LIST FOR:

ARIZONA AMERICAN SUN CITY WATER  
DISTRICT

2 DOCKET NO.:

W-01303A-07-0209

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