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BEFORE THE ARIZONA CORPORATION COMM  
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AZ CORP COMMISSION  
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IN THE MATTER OF THE APPLICATION OF  
ARIZONA-AMERICAN WATER COMPANY,  
AN ARIZONA CORPORATION, FOR A  
DETERMINATION OF THE CURRENT FAIR  
VALUE OF ITS UTILITY PLANT AND  
PROPERTY AND FOR INCREASES IN ITS  
RATES AND CHARGES BASED THEREON  
FOR UTILITY SERVICE BY ITS PARADISE  
VALLEY WATER DISTRICT

DOCKET NO. W-01303A-05-0405

IN THE MATTER OF THE APPLICATION OF  
ARIZONA-AMERICAN WATER COMPANY,  
INC., AN ARIZONA CORPORATION, FOR  
APPROVAL OF AN AGREEMENT WITH THE  
PARADISE VALLEY COUNTRY CLUB

DOCKET NO. W-01303A-05-0910

ARIZONA-AMERICAN WATER  
COMPANY

NOTICE OF FILING CLOSING  
BRIEF

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Arizona-American Water Company hereby files its closing brief in the above-referenced matter.

Respectfully submitted on June 13, 2008, by:

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Arizona Corporation Commission  
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JUN 13 2008

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

MIKE GLEASON, Chairman  
WILLIAM A. MUNDELL  
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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 PARADISE VALLEY WATER DISTRICT

DOCKET NO. W-01303A-05-0405

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR APPROVAL OF AN AGREEMENT WITH THE PARADISE VALLEY COUNTRY CLUB

DOCKET NO. W-01303A-05-0910

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

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1     **I     INTRODUCTION**

2             On January 16, 2008, the Town of Paradise Valley (the “Town”) filed a Rate Design  
3 Agreement (“RDA”) seeking rate relief for the customers of the Arizona-American Water  
4 Company (“Arizona-Americana”) Paradise Valley Water District (“PV”).<sup>1</sup> The RDA is signed  
5 by the Town, the Sanctuary on Camelback Mountain, the Camelback Inn, the Scottsdale  
6 Renaissance, the Clearwater Hills Improvement Association, the Camelhead Estates II HOA, and  
7 the Finisterre HOA.<sup>2</sup> Although Arizona-American is not a signatory to the RDA, it participated  
8 in the discussion that lead to the development of the RDA. Arizona-American continues to  
9 support the RDA with few minor technical changes proposed by Arizona-American Witness  
10 Miles H. Kiger.<sup>3</sup> At a Corporation Commission Staff Meeting held on February 27, 2008, the  
11 Commission voted to “reconsider Decision No. 68858 ... for the limited purpose of reviewing  
12 the Rate Design Agreement.”<sup>4</sup> Under the RDA, customers who are paying the surcharges will  
13 see up to a 37.88% reduction in their monthly water bills depending on their level of water  
14 consumption.<sup>5</sup>

15             Arizona-American urges the Commission to adopt the RDA because the RDA creates a  
16 win-win situation for both the customers of PV and Arizona-American. From the customer’s  
17 perspective, the RDA provides an immediate rate reduction until the conclusion of Arizona-  
18 American’s next PV rate case.<sup>6</sup> From Arizona-American’s perspective, the RDA creates a  
19 necessary cost recovery mechanism for Arizona-American to recover and finance the on-going  
20 construction cost of the Paradise Valley Fire Flow Improvement Project (“FFIP”).<sup>7</sup>

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<sup>1</sup> Ex. A-1 4:6-7.

<sup>2</sup> Ex. T-1, p. 6.

<sup>3</sup> Ex. A-1 4:6-8.

<sup>4</sup> Procedural Order Dated 28<sup>th</sup> of February, 2008, page 2, line 9 – 11.

<sup>5</sup> Ex. A-1, Exhibit MHK-3.

<sup>6</sup> Id. 4:10-11.

<sup>7</sup> Ex. A-2 2:19 – 3:3.

1     **II     THE RDA AND PARTIES POSITIONS**

2             **A     HISTORY OF THE EXISTING SURCHARGES**

3             On July 28, 2006, the Commission issued Decision No. 68858 approving the PV Public  
4     Safety Surcharge (“PSS”) and High Block Surcharge (“HBS”) for the purposes of funding the  
5     FFIP and encouraging water conservation.<sup>8</sup> Under Decision No. 68858, PV residential  
6     customers’ usage in the second and third tiers (over 25,000 gallons/month) and commercial  
7     customers’ usage in the second tier (over 400,000 gallons/month) are assessed the PSS in the  
8     amount of \$1.00 per 1,000 gallons per month.<sup>9</sup> To further encourage water conservation and  
9     offset the FFIP-related investment cost, the Commission authorized the HBS of \$2.15 per 1,000  
10    gallons per month applicable to residential usage in the third tier (over 80,000 gallons/month)  
11    and commercial usage in the second tier (over 400,000 gallons/month).<sup>10</sup> The proceeds  
12    generated from the two surcharges are presently being treated by Arizona-American as  
13    Contributions in Aid of Construction (“CIAC”) to offset the FFIP-related construction costs.<sup>11</sup>

14            Shortly after the HBS was implemented, some residential customers who were impacted  
15    by the surcharge contacted the Town to express their frustration with the rate increase.<sup>12</sup> The PV  
16    commercial customers, including the Sanctuary on Camelback Mountain, the Camelback Inn,  
17    and the Scottsdale Renaissance (collectively, the “Resorts”), experienced even higher increase on  
18    their monthly water bills than the residential customers, with one of the Resorts paying 220%  
19    more for its water service after both surcharges were implemented.<sup>13</sup> After hearing the concerns  
20    from both the residential and the commercial customers, the Town facilitated the discussion  
21    among the various stakeholders that ultimately lead to the RDA.<sup>14</sup>

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<sup>8</sup> Decision No. 68858, 32:9-20.

<sup>9</sup> Ex. A-1 2:14-17.

<sup>10</sup> Id. 2:17-20.

<sup>11</sup> Id. 2:20-23.

<sup>12</sup> Ex. T-2 4:9-11

<sup>13</sup> Ex. TR-2:17-18.

<sup>14</sup> Ex. T-2 4:15-18.

1           **B       KEY PROVISIONS OF THE RDA**

2           The objective of the RDA is to provide immediate rate relief to Arizona-American's PV  
3 customers while allowing Arizona-American continue to recover the on-going construction costs  
4 of the FFIP.<sup>15</sup> To achieve this objective, the RDA contains several proposed key changes to the  
5 existing surcharges. First, the RDA decreases the HBS to \$1.00 per 1,000 gallons from \$2.15  
6 per 1,000 gallons and sets the existing PSS to \$0.00 per 1,000 gallons from \$1.00 gallons.  
7 Second, at the conclusion of the FFIP Phase 3 construction, Arizona-American will file with the  
8 Commission a request to implement an "ACRM-like" PSS step increase based on the actual  
9 Phase 3 construction costs incurred by Arizona-American.<sup>16</sup> The proceeds from the new PSS  
10 will be treated as revenues as oppose to CIAC, thereby allowing Arizona-American to begin  
11 recovering the on-going costs of Phase 3 of the FFIP.<sup>17</sup> The approval of subsequent PSS step  
12 increases will be requested by Arizona-American in the next PV rate case.<sup>18</sup> The signatory of  
13 the RDA estimates that the first PSS step increase will be approximately \$0.125 per 1,000  
14 gallons for the PV customers who are currently paying the PSS.<sup>19</sup> This reduction in PSS  
15 contemplated in the RDA is possible because the RDA allows Arizona-American to recover its  
16 FFIP-related investment not currently in rate base or offset by CIAC over a period of up to 40  
17 years, rather than over a period of five years as previously envisioned by the Commission in  
18 Decision No. 68858.<sup>20</sup>

19           During the hearing, RUCO questioned whether the new PSS will be assessed to  
20 residential and commercial customers' first tier water usage.<sup>21</sup> In response to RUCO's question,  
21 Resorts witness Mr. John Thornton stated that the intent of the RDA is "to make sure no  
22 consumer was worse off" under the consensus RDA.<sup>22</sup> According to Mr. Thornton, the

<sup>15</sup> Ex. A-1 4:10-11; A-2:19 – 3:3.

<sup>16</sup> Id. 4:10-11, 4:17-20; T-1 3:11-15.

<sup>17</sup> A-2 2:23 – 3:3; T-1 3:11-15.

<sup>18</sup> Ex. A-1:5-2.

<sup>19</sup> Ex. T-1 3:18-24;

<sup>20</sup> Ex. A-1 6:10-13. Tr. 248:15-18.

<sup>21</sup> Tr. 240:3-4

<sup>22</sup> Tr. 224:11-15; 240:5-17.

1 signatories of the RDA support the RDA with the understanding that the new PSS will only be  
2 applied to the consumption blocks that currently are subject to the existing PSS.<sup>23</sup> Arizona-  
3 American has no objection to Mr. Thornton's interpretation of the applicability of the new PSS.<sup>24</sup>

4 **C POSITIONS OF THE PARTIES**

5 Arizona-American supports the RDA in its entirety except the second sentence of Section  
6 A, and the last sentence of each of Sections C and D.<sup>25</sup> Those sentences should be deleted from  
7 the RDA for the reasons stated below:

8 First, the second sentence of Section A implies that the HBS will terminate once Arizona-  
9 American recovers all of its FFIP costs incurred as of February 29, 2008.<sup>26</sup> This statement  
10 inappropriately limits the amount of Arizona-American's FFIP costs can be recovered via the  
11 HBS based upon an arbitrary HBS expiration date of February 29, 2008 mentioned in the RDA.  
12 Therefore Arizona-American believes this sentence should be deleted from the RDA.

13 Second, the last sentence of Section C limits the use of the proceeds from the new PSS to  
14 offset only the FFIP investment made by Arizona-American after March 1, 2008.<sup>27</sup> Arizona-  
15 American made investment in the FFIP prior to March 1, 2008, which investment has not yet  
16 been recovered through the existing rates or surcharges. Arizona-American proposes to apply  
17 the proceeds from the new PSS to pay for FFIP-related investment made before March 1, 2008,  
18 including deferral costs associated with that investment.<sup>28</sup>

19 Third, Arizona-American is concerned that the last sentence of Section D could be read  
20 to mean that the new PSS can only be used by Arizona-American to recover up to 50% of the  
21 FFIP-related investment made by Arizona-American after March 1, 2008.<sup>29</sup> Based on a forecast  
22 of expected HBS proceeds from August 2008 to September 2009, the reduced HBS under the

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<sup>23</sup> Id. 224:23-225:6.

<sup>24</sup> Id. 202:20-24.

<sup>25</sup> Ex. A-1 4:6-8.

<sup>26</sup> Tr. 185:13-21; T-1 3:8-10.

<sup>27</sup> T-1 3:24 - 4:2

<sup>28</sup> Tr. 186:3-12.

<sup>29</sup> Id. 186:7:16.

1 RDA will allow Arizona-American to recover only approximately 21% of the Phase 3 of the cost  
2 of the FFIP.<sup>30</sup> Thus the last sentence of Section D inappropriately limits the amount of FFIP-  
3 related investment Arizona-American can recover under the new proposed PSS.<sup>31</sup>

4 Arizona-American believes these three changes are technical in nature and have no  
5 substantive impact on the RDA.

6 Arizona-American opposes Staff's alternative to the RDA.

7 Staff proposes to reduce the HBS to \$1.00 per 1,000 gallons from \$2.15 per 1,000 gallons  
8 and to eliminate the PSS, but opposes the RDA provision resetting the PSS as a step-increase as  
9 proposed in the RDA (the "Staff Alternative").<sup>32</sup>

10 RUCO opposes the RDA, but supports the Staff Alternative.

11 The Town supports the RDA in its entirety and opposes the Staff Alternative.<sup>33</sup>

12 The Resorts support the RDA in its entirety and oppose Staff Alternative.<sup>34</sup>

13 **III COMPARISON OF THE RDA TO THE STATUS QUO AND STAFF**  
14 **ALTERNATIVE**

15 **A RDA VS. MAINTAINING EXISTING SURCHARGES**

16 The RDA provides immediate rate relief to the PV customers while also generating the  
17 necessary funding to continue the construction of FFIP.<sup>35</sup> As stated earlier, the RDA decreases  
18 the HBS to \$1.00 per 1,000 gallons from \$2.15 per 1,000 gallons and sets the existing PSS to  
19 \$0.00 per 1,000 gallons from \$1.00 gallons.<sup>36</sup> The proposed reductions in the HBS and the PSS  
20 will reduce the monthly bill of the PV customers who currently are paying the PSS and the HBS  
21 by approximately 10.68% to 37.88%.<sup>37</sup> This reduction is supported by the Town, the Resorts,

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<sup>30</sup> Tr. 186:18-21.

<sup>31</sup> Id. 186:14-17.

<sup>32</sup> S-1. 9:1-5; 10:8-10.

<sup>33</sup> Tr. 147:11-13.

<sup>34</sup> Id. 244:15-20.

<sup>35</sup> Id. 82:18-20.

<sup>36</sup> T-1 3:6-17.

<sup>37</sup> A-1, Exhibit MHK-3.

1 and various homeowners associations. In fact, the record shows no customer of PV has voiced  
2 opposition to the RDA. Arizona-American strongly encourages the Commission to follow the  
3 wishes and recommendation of the customers who will be paying for the PV FFIP-related  
4 investments.

5 In addition to the obvious benefit of rate reduction to the PV customers, the RDA has  
6 other features that enhance the transparency and fairness of the existing surcharges mechanism.  
7 First, the new PSS proposed in the RDA is designed to be “ACRM-like”.<sup>38</sup> The term “ACRM-  
8 like” implies that, before the Commission approves the new PSS, Arizona-American must file a  
9 series of schedules justifying all of the FFIP-related investment it wishes to recover through the  
10 PSS.<sup>39</sup> Staff will have an opportunity to audit costs associated with the FFIP and conduct  
11 engineering inspection of the FFIP.<sup>40</sup> The opportunity to audit Arizona-American’s financial  
12 records and the chance to inspect the FFIP facilities are all the features in the RDA that make the  
13 FFIP more transparent to all the parties and the public.<sup>41</sup>

14 Another important advantage of the RDA is that, by converting the PSS to a revenue  
15 accounting from CIAC accounting, it spreads the recovery of FFIP-related investment over the  
16 life of the assets rather than over five years as it is envisioned under the existing funding  
17 mechanism.<sup>42</sup> Under the existing CIAC funding mechanism, the current PV customers will pay  
18 for 100% of FFIP costs over a five-year period. Any customer who moves into PV after that  
19 five-year period will receive the benefit of improved fire flow without paying any portion for the  
20 FFIP-related investment.<sup>43</sup> This inter-generational subsidy can be alleviated by spreading the  
21 recovery of the FFIP-related investment over the life of the investment so that future PV  
22 customers will pay their fair share for the benefit of the improved fire flow in PV.

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<sup>38</sup> T-1 3:11-15.

<sup>39</sup> Tr. 105:15-24; 239:8-14.

<sup>40</sup> Id. 256:17-22.

<sup>41</sup> Id. 105:12-24.

<sup>42</sup> A-1 6:10-12; Tr. 252:1-6.

<sup>43</sup> Tr. 249:24 – 251:12.

1 If the Commission denies the entire RDA and leaves the PSS and HBS at their existing  
2 levels and continue to treat the proceeds from the surcharges as CIAC, Arizona-American will  
3 resume the construction of the FFIP shortly after the conclusion of this proceeding.<sup>44</sup> This is not  
4 the outcome desired by the Town, the Resorts, or the homeowners associations because it will  
5 deny immediate rate relief to the PV customers.<sup>45</sup>

6 **B RDA VS. STAFF ALTERNATIVE**

7  
8 Arizona-American appreciates Staff's effort in developing an alternative method to  
9 address the impact of the HBS and the PSS on the PV customers. While the Staff Alternative  
10 provides some rate relief to the PV customers until the conclusion of Arizona-American's PV  
11 rate case filed on the May 2, 2008, it also carries the consequence of undermining one of the  
12 purposes of the surcharges – creating a funding mechanism that permits implementation of the  
13 FFIP in a timely manner.<sup>46</sup> Arizona-American management views the Staff Alternative in this  
14 case, along with Commission's rejection of a similar fire flow improvement funding mechanisms  
15 in a recent Sun City Water case, as a sign of deteriorating support for using revenue-based  
16 surcharge mechanism to fund discretionary projects such as the PV FFIP.<sup>47</sup> To minimize the  
17 financial risk of not being able to timely recover the costs of FFIP-related investment through a  
18 surcharge, Arizona-American elected to suspend the construction of Phase 3B and the planning  
19 of Phase 4 of the FFIP shortly after Staff filed its pre-filed testimony opposing the conversion of  
20 proceeds from the PSS to revenues from CIAC accounting.<sup>48</sup> The suspension is necessary  
21 because if the Commission approves the Staff Alternative in this proceeding, the resulting

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<sup>44</sup> Ex. A-2 6:19 – 7:3.

<sup>45</sup> Id. at

<sup>46</sup> Decision No. 68858 32:10-12.

<sup>47</sup> Tr. 86:3-11.

<sup>48</sup> Ex. A-2 3:16-17.

1 reduced of the proceeds from the HBS alone will not generate sufficient CIAC from the HBS to  
2 offset the cost of fund Phase 3 and Phase 4 of the FFIP.<sup>49</sup>

3 An even more unpalatable financial outcome would result if Arizona-American were to  
4 simply invest in the FFIP and seek recovery of its investment in a future rate case. The pending  
5 PV rate case probably will not be concluded until September 2009 or later. Therefore, without  
6 the PSS, Arizona-American will have to carry the financing cost of Phase 3 and possibility Phase  
7 4 of FFIP without earning any return of its investment until at least September 2009. Arizona-  
8 American has had a negative net income and a negative rate of return for several years. As a  
9 result, Arizona-American cannot absorb the cost of any regulatory lag on a discretionary project  
10 such as the FFIP.<sup>50</sup> Further compounding this problem, Arizona-American, as compared with its  
11 sister companies regulated by other utilities commissions, has a dismal record of recovering its  
12 investment on a timely basis.<sup>51</sup> This factor makes it very difficult for Arizona-American to  
13 attract the necessary capital from its parent to invest in discretionary projects like the FFIP.<sup>52</sup>

14 **IV CONCLUSION**

15 In conclusion, Arizona-American respectfully requests the Commission to revise the  
16 existing FFIP funding mechanism pursuant to the RDA, with the changes proposed by Arizona-  
17 American. The RDA is the result of various stakeholders coming together to reach a consensus  
18 interim solution that provides both rate reductions to the PV customers and necessary revenues to  
19 enable Arizona-American to continue the construction of the FFIP. Nothing in the RDA limits  
20 Commission's authority to reevaluate the FFIP funding mechanism in a future rate case.  
21 Arizona-American welcomes the opportunity to work with the Commission, Staff, RUCO, the

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<sup>49</sup> Id. 3:7-13.

<sup>50</sup> Tr. 88:15-89:7.

<sup>51</sup> Id. 100:25 – 101:6.

<sup>52</sup> Id. 101:7-12.

1 Town, the Resorts, and any other interested parties in the pending PV rate case to find a  
2 permanent funding mechanism that meets the needs of all the stakeholders.

3 RESPECTFULLY SUBMITTED on June 13, 2008.

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