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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF H2O, INC., AN ARIZONA CORPORATION, FOR A DETERMINIATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PROPERTY AND FOR AN INCREASE IN ITS WATER RATES AND CHARGES FOR UTILITY SERVICES	DOCKET NO. W-02234A-07-0557 **NOTICE OF FILING REJOINDER TESTIMONY**

H2O, Inc., ("H2O" or the "Company"), by and through the undersigned counsel, hereby gives Notice of the filing of witness Thomas J. Bourassa's Rejoinder Testimony and supporting Schedules in the subject docket.

Respectfully submitted this 22nd day of April 2009.

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

By______________________
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Arizona Corporation Commission
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Original and fifteen copies of the foregoing filed this 22 day of April 2009 with:

Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Copies of the foregoing Hand Delivered this 22nd day of April 2009 to:

Hearing Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

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Phoenix, Arizona 85007

Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONERS

KRISTIN K. MAYES–Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

IN THE MATTER OF THE APPLICATION OF H2O, INC. FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS WATER UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES FOR UTILITY SERVICE.	DOCKET NO. W-02987A-07-0557

REJOINDER TESTIMONY OF

THOMAS J. BOURASSA

(RATE BASE, INCOME STATEMENT,

REVENUE REQUIREMENT, RATE DESIGN)

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I. INTRODUCTION AND QUALIFICATIONS.

Q. PLEASE STATE YOUR NAME AND ADDRESS.

A. My name is Thomas J. Bourassa. My business address is 139 W. Wood Drive, Phoenix, Arizona 85029.

Q. HAVE YOU PREVIOUSLY SUBMITTED DIRECT TESTIMONY IN THE INSTANT CASE?

A. Yes, my rebuttal and direct testimony was submitted in support of the initial application filed.

Q. WHAT IS THE PURPOSE OF THIS REJOINDER TESTIMONY?

A. I will provide rejoinder testimony in response to the surrebuttal testimony of Arizona Corporation Commission Utilities Division Staff ("Staff") as relates to rate base, income statement and rate design for H2O, Inc. ("Company" or "H2O"). More specifically, I will respond to Staff's testimony on the rate base treatment of unexpended hook-up fees ("HUFs") in rate base as contributions-in-aid of construction ("CIAC"), the income tax rate used in the deferred income tax computation, the Company's CAP surcharge "request", and Staff's recommendation to eliminate the off-site capacity reservation charge (hook-up fee)

Q. WHAT IS THE REVENUE REQUIREMENT ADJUSTMENT THAT THE COMPANY IS PROPOSING IN ITS REJOINDER FILING?

A. The Company has not changed its recommendations that are contained in its rebuttal filing. The Company continues to propose a decrease in revenues of $134,153, a decrease of 3.97 percent for a total revenue requirement of $3,244,489.

II. REVENUE REQUIREMENT.

Q. WHAT ARE THE REVENUE REQUIREMENTS AND RATE INCREASES FOR THE COMPANY AND STAFF?

A. The proposed revenue requirements and proposed rate increases at this stage of the proceeding are as follows:

	Revenue Requirement	Revenue Incr.	% Increase
Staff Surrebuttal	$3,218,705	$(159,937)	-4.73%
Company Rejoinder	$3,244,489	$(135,153)	-3.97%

Q. WHAT IS THE COMPANY'S PROPOSED RATE OF RETURN?

A. The Company continues to propose a rate of return on equity of 11.45%. This is based on the weighted average cost of capital. I discuss the Company's proposed rate of return and my cost of capital in the second volume of my rebuttal testimony.

Q. IS STAFF RECOMMENDING AN OPERATING MARGIN APPROACH?

A. Yes. Since Staff is proposing a negative rate base, it is proposing an operating margin approach.[1]

[1] Staff is proposing a 10 percent operating margin.

Q. WHAT ARE THE MAJOR DIFFERENCES BETWEEN STAFF AND THE COMPANY AT THIS STAGE OF THE PROCEEDING?

A. As I will discuss, Staff and the Company remain in disagreement on the rate base treatment of unexpended hook-up fees ("HUFs"). In fact, this is the only major rate base and/or income statement disagreement. By including unexpended HUF's in rate base as CIAC, Staff's rate base is negative. Accordingly, Staff is proposing an operating margin approach.

As I will also discuss, there is a disagreement with respect to the income tax rate used in the deferred income tax computation.

Q. IS THE COMPANY SEEKING A CAP SURCHARGE?

A. No. Staff does not recommend a CAP surcharge at this time.[2] However, neither the Company's Application nor its Amended Application requested such a Surcharge.

III. RATE BASE.

Q. WOULD YOU PLEASE IDENTIFY THE PARTIES' RESPECTIVE RATE BASE RECOMMENDATIONS AT THIS STAGE OF THE PROCEEDING?

A. The rate bases proposed by all parties in the case are as follows:

	OCRB	FVRB
Staff Surrebuttal	$ (500,901)	$ (500,901)
Company Rejoinder	$1,995,695	$1,996,695

[2] *See* Surrebuttal Testimony of Brendan C. Aladi ("Aladi Sb") at 6.

A. Contributions-in-aid of Construction ("CIAC") - Unexpended Hook-up Fees and Construction-Work-in-Progress funded with Hook-up Fees

Q. PLEASE COMMENT ON STAFF'S SURREBUTTAL TESTIMONY REAGARDING THE RATE BASE TREATMENT OF UNXPENDED HOOK-UUP FEES IN RATE BASE AS CIAC?

A. Staff witness, Mr. Aladi, believes that it is proper rate making to include the unexpended HUF's in rate base as CIAC because it preserves the ratemaking balance and removes excess earnings potential.[3] However, I have already testified, there is no plant-in service cost in rate base which corresponds to the unexpended HUF amount and this results in a rate base mismatch.[4] Staff's rate base is "unbalanced" and there is no over earning potential. In fact, there is an under earning potential.

Let me explain. Normally, CIAC funded plant has no rate base impact. That is because the plant costs funded are offset by an equal and corresponding amount of CIAC. CIAC funded plant is revenue neutral as a result. There is no basis for a return on rate base and there is no depreciation recovery of plant costs in rates and the cost of service is not impacted. In fact, the revenue neutrality of CIAC is precisely why utilities can apply and receive approval of HUF's outside the context of a rate case.

Q. IS THEIR AN EXCESS EARNINGS POTENTIAL IF THE UNEXPENDED CASH IS NOT INCLUDED IN RATE BASE AS CIAC?

A. No. This is because, as I previously stated, CIAC funded plant is revenue neutral. Consider, for example, the normal situation where a utility has $100 of plant cost

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[3] Aladi Sb at 5.

[4] See Rebuttal Testimony of Thomas J. Bourassa "(Bourassa Rb") at 7.

that is funded with $100 of CIAC. The rate base is for this plant is zero ($100 of plant cost less $100 of CIAC). Now consider the situation, similar to the instant case, where the plant cost is zero because the utility has not spent the funds on plant ($0 plant cost) and $100 of cash that the utility will use to pay for the plant. The rate base is still zero ($0 plant cost and $0 of CIAC). Under either of these two situations, the rate base is zero and "balanced". The utility neither over earns nor under earns in either situation.

But if there is no plant cost and the $100 of cash is included in rate base as CIAC, the rate base is a negative $100. The rate base is now "unbalanced". In fact, it is artificially lower which gives rate payers an unjustified windfall in two ways. First, the lower rate base results in a lower return component in the cost of service and revenue requirement. Second, lower depreciable plant results in a lower depreciation component in the cost of service and revenue requirement. The utility will under earn, not over earn.

Q. IN THE FUTURE, WHEN THE UTILITY SPENDS THE CASH ON PLANT, WILL THE RATE BASE CHANGE?

A. No, all things remaining the same. Again, using the example above, a future rate base will have $100 of plant and $100 of CIAC, or zero rate base ($100 of plant less $100 of CIAC). It should be clear, when the Company expends the unexpended HUF's it had on hand at the end of the test year on future plant for future capacity to serve future customers, the rate base will not change.

Again, this is the nature of CIAC funded plant. CIAC funded plant is revenue neutral. However, it is not revenue neutral if the plant costs are not properly matched with CIAC is rate base. The Company's proposals result in a properly matched rate base, where as Staff's does not.

B. <u>Deferred Income Taxes</u>

Q. PLEASE EXPLAIN WHY YOU USED A TAX RATE OF 38.6 PERCETN IN YOUR DEFERRED INCOME TAX COMPUTATION?

A. Because that is the income tax rate used in the instant case. The authority for determining deferred income taxes (*Statement of Financial Accounting Standards No. 109* – <u>Accounting for Income Taxes</u>) requires the use of the expected future income tax rates. Arguably, the expected income tax rate is the income tax rate used to compute the revenue requirement.

Q. WHAT IS STAFF'S INCOME TAX RATE USED TO COMPUTE THE REVENUE REQUIREMENT?

A. 38.6 percent, as shown on Staff surrebuttal schedule BCA-2, line 17. Staff used 34.9, as shown on Staff surrebuttal schedule BCA-9-1, to compute deferred income taxes. Again, Staff should have used 38.6 percent, not 34.9 percent.

IV. <u>RATE DESIGN.</u>

A. <u>Offsite Facilities Capacity Reservation Charge (Hook-up Fee)</u>

Q. PLEASE COMMENT ON STAFF'S RECOMMENDATION TO DISCONTINUE THE CURRENTLY AUTHORIZED OFFISITE FACITITIES RESERVATION CHARGE (HUF).

A. Staff recommends the discontinuation of the currently authorized offsite facilities reservation charge.[5] The Company opposes this. The Company's high capitalization of zero cost capital is the result of collecting the HUF's far in advance of constructing the necessary plant. Since the Company is small, has limited earnings and limited access to capital, the HUF's have helped to fund needed plant. Growth has paid for growth. Had the Company not collected the HUF's in advance, it would have had to raise the necessary capital through long-term debt which has a cost and would have resulted a much higher rate base and much higher rates. It is only by the inappropriate treatment of unexpended HUF's by Staff that Staff's rate base is negative.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes, except I do wish to note that my silence on any position taken by Staff or with respect to any public comment, does not signal agreement.

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[5] Aladi Sb at 6.