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4425 E. Maderos del Cuenta Drive,
Paradise Valley, AZ 85253

March 18, 2009

The Commissioners,
Arizona Corporation Commission,
1200 W. Washington St.,
Phoenix, AZ 85007

Re: Docket # W-01303A-08-0227, SW-01303A-08-0227

Dear Commissioners Mayes, Kennedy, Newman, Pierce and Stump:

I am writing with regard to the application by Arizona American Water ("AAW") for a rate increase to its Paradise Valley customers.

I would like to note at the outset that Mr. Townsley and Mr. Broderick of AAW have been helpful and patient in answering questions that I have asked.

AAW is proposing an average increase of 21% over current rates. That increase is higher than the Consumer Price Index for the years 2005-07, the years in question, I believe, for this rate application. The CPI for these three years shows a cumulative increase of 16%. If you factor in that we, the consumer, have already incurred an increase in the recent past to reflect the arsenic recovery program, then the total rate increase including the current proposed 21% will be substantially higher than inflation, probably closer to double the rate of the CPI for the period.

There are two points about the proposed increase that give me particular concern.

1. **Operating & Maintenance ("O&M") costs**
   Using AAW's number, the O&M costs apportioned to Paradise Valley, excluding depreciation, has increased by $0.54M after tax. Using AAW's stated combined federal and state tax rate of 38.6%, O&M has increased by approximately $0.88M. If I understand AAW's financial reporting correctly, that represents 22% of its 2007 O&M cost base (and, likely, a much higher percentage of its 2005 cost base), excluding income taxes and depreciation, as reflected on Schedule C-2 of AAW's February 11, 2009 rebuttal testimony.
   A large component of the O&M cost increase is attributable to the category "management fees," which have increased 31% since 2004 and in 2007 constitute 22% of the O&M costs before depreciation and income taxes.
   This shows AAW and its shared service provider, an affiliated entity, have allowed costs to increase at a faster rate than inflation. I am not sure why the consumer should pay the price for AAW not managing its cost base more aggressively.

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Clearly, those costs have been incurred already, but an adjustment could be made to disallow a percentage of the costs in calculating the rate adjustment. This would accomplish two things:

1. reduce the rate increase now
2. encourage AAW to manage its future costs more aggressively.

2. **Income Taxes**

AAW computes its federal tax expense using a 34% rate. AAW's parent files a consolidated group federal return. It states in its 10K filing that taxes are pushed down to its subsidiaries as if they were stand-alone entities. Perhaps this is the basis for the 34% rate used by AAW.

However, the reality is that AAW's parent does not pay federal income tax at the 34% rate; it generated net operating losses in 2007 for carry forward to future years and in 2008 those NOLs increased. AAW's parent has a growing deferred tax credit, i.e. the actual liability for federal taxes has been less than the tax expense in the income statement. That is often the case in capital-intensive businesses; the actual tax liability is lower than the nominal federal rate, because of tax vs. book depreciation differences.

Given that AAW's parent's real tax position is quite different from that reflected in AAW's income statement, I suggest that AAW's notional tax expense be adjusted to reflect more closely the short-term tax liabilities of the parent. This would be a closer reflection of reality than AAW presents currently.

The result would be that AAW would need a smaller revenue increase to generate the same level of return on its assets.

I know that AAW is requesting an increase to its cost of capital, i.e. an increased return on its net fixed assets. I am unable to assess whether an 8.4% cost of capital is reasonable or not. It seems to me, though, that the combination of more aggressive cost management by AAW and its shared service provider and a federal tax rate that more closely reflects reality will enable AAW generate a fair ROA without the need for a revenue increase of, on average, 21%.

Sincerely,

D.R.M. Wilson

David R.M. Wilson

Cc: RUCO

Ms. Pam Kirby, Chairperson, Paradise Valley Water Committee