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BEFORE THE ARIZONA CORPORATION 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 AGUA FRIA WATER DISTRICT, HAVASU WATER DISTRICT, MOHAVE WATER DISTRICT, PARADISE VALLEY WATER DISTRICT, SUN CITY WEST WATER DISTRICT AND TUBAC WATER DISTRICT.	DOCKET NO. W-01303A-08-0227 Arizona Corporation Commission DOCKETED MAY -1 2009 DOCKETED BY
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTIIITY PLANT AND PROPERTY AND FOR INCRESES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS MOHAVE WASTEWATER DISTRICT.	DOCKET NO. SW-01303A-08-0227 **STAFF'S CLOSING BRIEF**

The Utilities Division of the Arizona Corporation Commission ("Staff") hereby files its closing brief in the above-captioned matter. In this brief, Staff will address the major disputed issues. On any issue not specifically addressed in this brief, Staff maintains its position as represented in its testimony.

I. INTRODUCTION.

The Arizona-American Water Company ("Arizona-American" or the "Company") is the largest, investor-owned water/wastewater utility in the State of Arizona providing water and wastewater service to approximately 131,000 customers. It is a wholly owned subsidiary of American Water. Arizona-American operates thirteen water and wastewater districts. In accordance with deadlines established by previous Commission decisions, in May, 2008, Arizona-American filed for rate increases for seven of its districts: Agua Fria Water District, Havasu Water District, Mohave Water District, Paradise Valley Water District, Tubac Water District and Mohave Wastewater District.[1]

Company witness and President Paul Townsley testified that the Company's financial condition is dire.[2] Arizona-American has requested 11.75% cost of equity and a rate of return of 8.4%. The Company has requested an overall revenue increase of $19,961,632. The Company proposes an original cost rate base ("OCRB") of $188,544,809.

There are several major contested issues between the Company and Staff, the primary issue being the inclusion of construction work in progress ("CWIP") associated with the building of a surface water treatment facility, known as the White Tanks Regional Water Treatment Facility ("White Tanks Plant" or "White Tanks Project"), in its Agua Fria Water district, as well as the deferral of the first-year Operations and Maintenance ("O&M") expenses and the implementation of a cost-recovery mechanism for the O&M expenses associated therewith. In its Mohave Wastewater District, the Company requested inclusion of post-test-year plant associated with its Wishing Well Plant, which was disallowed by Staff. Staff has also recommended disallowance of excess capacity with respect to arsenic treatment vessels in several of the Company's water districts and Staff has proposed to offset rate base with advances and contributions associated with CWIP. Additionally, the Company and Staff disagree on cost of capital issues.

II. SUMMARY OF STAFF RECOMMENDATIONS.

In summary, Staff recommends a 10% cost of equity and a rate of return of 7.4%. Staff's recommendation for an overall revenue increase is $15,944,301. Staff's recommended capital structure consists of 41.62% equity and 58.68% debt which includes short term debt. Staff's final revenue requirement recommendation for each system is as follows:

District	Company Final	Staff Final	Staff Increase	Staff Percentage
Agua Fria	26,623,370	21,297,986	2,479,373	13.2%
Havasu	1,579,423	1,422,783	3,396,196	38.6%

[1] Decision Nos. 68825, 69173, 69181 and 69396.
[2] Ex. A-18 at 3.

Mohave	6,057,207	5,232,111	118,480	2.3%
Paradise Valley	10,037,959	9,165,550	1,316,818	16.8%
Sun City West	9,953,470	9,106,952	373,405,521	59.7%
Tubac	697,102	626,781	215,872	50.6%
Mohave Wastewater	1,381,387	714,893	(81,268)	-10.2%

Overall this equates to a 19.8% rate increase for seven of Arizona-American's thirteen systems. Staff's overall revenue requirement is $47,583,047, which represents an increase in revenue of $7,850,992. Staff proposes an OCRB rate base of $150,388,005. The Company waived a determination of the fair value of its property using a reconstruction cost new valuation. Hence the OCRB and the fair value rate base are the same for purposes of this application.

III. RATE BASE ISSUES.

A. <u>Arizona-American has not demonstrated extraordinary circumstances to warrant the inclusion of CWIP associated with the White Tanks Project in rate base and such inclusion should be rejected.</u>

In 2005, Arizona-American filed for certain approvals associated with the construction of a surface water treatment facility known as the White Tanks Plant. The White Tanks Plant was designed to treat surface water received from the Central Arizona Project for distribution to Arizona-American customers in its Agua Fria District. Initially, the White Tanks Plant was to be financed, built, and owned by Maricopa County Municipal Water Conservation District Number One ("MWD"). Arizona-American would obtain treatment services through a long-term capital lease with MWD and an Arizona-American affiliate would operate the plant through an Operation and Maintenance Agreement with MWD. Negotiations with the MWD and Arizona-American broke down and Arizona-American filed a revised application stating that it was willing to construct and operate the White Tanks Plant if the Commission would provide a number of approvals, including increasing the current water facilities hook-up fee in effect for the Agua Fria District and providing certain accounting relief.[3]

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[3] *See* Docket No. W-01303A-05-0718, *In the Matter of the Application of Arizona-American Water Company for Approvals Associated with a Transaction with the Maricopa County Municipal Water Conservation District Number One.*

The Company testified that the proposal to finance the White Tanks Project with hook-up fees which would be treated as contributions in aid of construction ("CIAC"), was equitable because customer growth was largely driving the need for the plant.[4] The Company requested authorization to record post-in-service Allowance for Funds Used During Construction ("AFUDC") on the excess of construction costs over the amount of hook-up fees collected. The Company requested the ability to book post-in-service AFUDC in order to keep it whole on its investment until such time that the accumulated hook-up fees were sufficient to fund the entire plant balance. The Company also requested authorization to exclude from rate base the contribution balance of hook-up fees directly related to the White Tanks Project that were collected subsequent to the effective date of a decision in that case and that exceeded the aggregate of (1) construction expenditures (including development site acquisition, design, labor, overheads and AFUDC) for the same period that are included in rate base and (2) any costs deemed imprudently incurred from contributions used to calculate rate base until December 31, 2015. Staff recommended new water facilities hook-up fees. In that proceeding, Staff, as well as the Residential Utility Consumer Office ("RUCO"), supported the Company's proposal of using hook-up fees to finance the cost of the White Tanks Project. The Commission issued Decision No. 69914 ("White Tanks Decision"), which approved the new hook-up fee, to be recorded as CIAC, as a means of financing the White Tanks Project. The Commission also approved the Company's request to record post-in-service AFUDC on the excess of the construction cost of the White Tanks Project over directly-related hook-up fees collected through December 31, 2015. The White Tanks decision also approved the Company's request for authority to defer post-in-service depreciation expense in excess of the associated amortization of contributions and also approved the Company's request for authorization to exclude from rate base the contribution balance of hook-up fees, as defined above.

At the time of the filing of the instant rate application, the hook-up fees collected were less than what the Company anticipated. The Company placed its financing hopes on the continued boom in the real estate market. The boom fizzled and now the Company is requesting that the Commission approve $25 million of the White Tanks Plant CWIP in rate base. Staff is opposed to such inclusion.

[4] Decision No. 69914 at 6, quoting the Surrebuttal testimony of Thomas M. Broderick.

While the Commission has the discretion to allow CWIP into rate base,[5] this Commission has a long standing policy of not including CWIP in rate base except under extraordinary circumstances. In testimony in the White Tanks docket, the Company acknowledges that CWIP in rate base is not "well received by this Commission."[6] CWIP is plant that is not completed and providing service to ratepayers during the test year. During the test year, such plant is not used or useful in providing service to the Company's customers. The White Tanks Project was not serving customers during the test year; in fact the Company testified that it anticipated the White Tanks Project would not be in service until November 2009.[7] In general, the ratemaking process is predicated on an examination of the operations of a utility to ensure that the assets upon which ratepayers are required to provide the utility with a rate of return are both prudently incurred and are both used and useful in providing services on a current basis. Facilities in the process of being built are not used or useful. The ratemaking process therefore excludes CWIP from rate base until such projects are completed and providing service to ratepayers in the context of a test year that is being used for determining the utility's revenue requirement.

It is well recognized that the inclusion of CWIP in rate base would also result in a mismatch in the ratemaking process. This mismatch occurs because such plant, and its associated expenses, are not related to the revenues, expenses, and rate base of the test year.

One of the few instances in which the Commission has allowed the inclusion of CWIP in rate base occurred in 1984 in a case involving Arizona Public Service Company ("APS"). In that case, the Commission addressed the need for a CWIP allowance due to extraordinary circumstances involving the Palo Verde Nuclear Generating Station. The Commission allowed approximately $200 million of APS's $600 million CWIP balance as a means of addressing a critical cash-flow deficiency, and as a means to lessen the severe rate shock that would be experienced by customers if the entirety of the nuclear plant were placed in rate base at one time.[8]

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5 *Ariz. Cmty Action Ass. v. Ariz. Corp. Comm'n*, 123 Arizona 228, 599 P.2d. 184 (1979).
6 Docket No.W-01303A-05-0178, Direct Testimony of Thomas Broderick at 17.
7 Tr. 231:17.
8 *In re Arizona Public Service Company*, Docket No. U-1345-83-155, Decision No. 54247 at 19-20.

Staff asserts that Arizona-American has failed to allege an extraordinary circumstance to support its request to include $25 million of CWIP in rate base.[9] Company witness Paul Townsley testified that without Commission approval of the inclusion of $25 million of CWIP into rate base, the Company will suffer severe financial consequences.[10] Staff asserts that "deep financial trouble" that was not adequately described or quantified does not rise to the level of an "extraordinary circumstance" to warrant the inclusion of CWIP in rate base. Further, financial mechanisms were put in place in the White Tanks Decision to alleviate the financial stress that may be suffered by the Company until the White Tanks Project is completed and placed into service and included in rate base in a subsequent rate proceeding.

The White Tanks Decision approved the Company's request to fund the construction with hook-up fees. The Company took the chance that the continuing boom in real estate in Maricopa County would continue unabated. The Company now argues that the White Tanks Project will serve existing customers and that those customers should bear the burden of its cost.[11] In the proceeding that culminated in the approval of an increase in hook-up fees, the Company argued that growth in the West Valley was the major reason for the construction of the White Tanks Project and therefore it was appropriate to use hook-up fees as a mechanism to fund the construction.[12] The Company now admits that hook-up fee receipts will not be sufficient to pay off the estimated $62 million cost of construction.[13] Although the Company softened its rhetoric during the evidentiary hearing, it has threatened to mothball the project if the Commission does not approve its request for CWIP or the O&M deferral.[14] The funding of the White Tanks Project with hook-up fees was approved to allow the construction to continue and not burden the current ratepayers.[15] Certain accounting treatment was accorded to the Company to allow it to remain whole during the construction process. The Company should bear the burden of risk and not its rate payers.

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[9] Ex. S-7 at 21.
[10] Ex. A-19 at 18.
[11] Ex. A-11 at 14.
[12] Ex. A-20 at 3.
[13] Tr. 12:19-20.
[14] Ex. A-20 at 10.
[15] Ex. S-7 at 18.

The White Tanks Decision authorized the Company to propose an O&M deferral mechanism, which the Company did in this Application. Arizona-American proposed to defer twelve months of O&M of approximately $1.93 million and then file for a surcharge similar to an Arsenic Cost Recovery Mechanism (ACRM) whereby the first twelve months of O&M would be added to the second twelve months of O&M and both would be recovered during the second twelve-month period. At the end of the second twelve-month period, the surcharge would be adjusted to reflect the actual on-going O&M until completion of its next rate case.[16]

After a review of the proposal, Staff recommended denial of an O&M deferral mechanism as proposed. The Company appears to argue that because Staff did not oppose the original request for authorization to propose a deferral in its next rate filing, this somehow signaled Staff's recommendation for the mechanism itself.[17] Staff believes that the Company has already been provided protection from the financial harm via the accounting orders for post-in-service AFDUC and depreciation expenses as approved in the White Tanks Decision.[18] Staff also notes that the Company has limited its exposure to unrecovered O&M because the cost of the Central Arizona Project allotment is already included in the Company's O&M in the instant proceeding. Further Staff believes that the cost of providing treated water will be offset by cost savings attached to the present expense of providing ground water which are reflected in current rates.[19]

In the alternative, should the Commission not approve the request to include CWIP, the Company has proposed a temporary surcharge for the Agua Fria District to fund as revenue the equivalent of the $25 million of CWIP. This surcharge would equate to approximately $9/month[20] or a system-wide renewable–water-supply surcharge, both of which Staff opposes.

The Commission should reject the Company's request to include CWIP in rate base in this case and any associated related adjustments to increase depreciation and property taxes relating to the inclusion of CWIP in rate base should also be rejected.

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[16] Ex. A-11 at 18-21.
[17] Ex. A-19 at 18.
[18] Ex. S-7 at 27.
[19] *Id.*
[20] Ex. A-20 at 9-11.

B. The Company's request to include post-test-year plant is inconsistent with the Commission's normal treatment of post-test-year plant.

The Company has sought the inclusion of post-test-year plant in the amount of $3,214,033 relating to the Waddell Haciendas Subdivision and the Sierra Montana Subdivision for its Agua Fria System. For its Mohave Water System, the Company has sought the inclusion of post-test-year plant in the amount of $610,732. For its Mohave Wastewater System, the Company has requested the inclusion of $3,932,080. Staff has recommended the exclusion of post-test-year plant for those systems. The inclusion of post-test-year plant suffers from many of the same flaws as CWIP, namely the inclusion violates principals of ratemaking and results in a mismatch of that plant with the revenues, expenses, and rate base of the test year.[21]

Commission rules require the end of the test year, which is the one-year historical period used in determining rate base, operating income and rate of return, to be the most recent practical date available prior to the filing. A.A.C. R14-2-103(A)(3)(p). Compliance with Commission rules and recognition of Commission policy on appropriate test year selection requires a utility to choose a test year that includes all major rate base and operating income items needed to support its rate application, and to include pro forma adjustments to its chosen test year that are consistent with past Commission action under similar circumstances. While the Commission has allowed the inclusion of post-test-year plant in rate base,[22] as Staff witness Gerald Becker testified, those are situations which are special and unusual and thus warrant the recognition of post-test-year plant. Staff has traditionally recognized two such scenarios: (1) when the magnitude of the investment relative to the utilities total investment is such that not including the post-test-year plant in the cost of service would jeopardize the utility's financial health, and (2) when conditions such as the following exist: (a) the cost of the post-test-year plant is significant and substantial, (b) the net impact on revenue and expenses for the post-test-year plant is known and insignificant or is revenue-neutral, and (c) the post-test-year plant is prudent and necessary for the provision of services and reflects appropriate, efficient, effective, and timely decision-making.[23]

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[21] Ex. S-7 at 20.
[22] Arizona Water Company, Docket No. W-01445A-02-0619, Decision No. 66849.
[23] Ex. S-7 at 20.

With respect to the Agua Fria System, Staff recommended the inclusion of $2,046,765 associated with the Waddell Haciendas Plant, concluding that the plant in question provides a benefit to current ratepayers by creating operational efficiencies and increasing reliability.[24] Staff recommended the disallowance of $1,167,268 of the requested inclusion of post-test-year plant related to this subdivision because Staff determined that it was not revenue-neutral.[25] Staff recommended disallowance of the plant associated with Sierra Montana because it was found not to be revenue-neutral. At the time of the inspection by Staff Engineer Dorothy Hains in September 2008, the plant was not in service. The Company testified that the Sierra Montana plant was not placed into service until December 2008, which is well after the test year.[26]

For the Company's Mohave Wastewater system, the Company commenced work on its Wishing Well facility bringing the work into service in the summer of 2008. The work included not only system improvements but expansion,[27] which suggests the need to service future customers. Mr. Gross testified that the Company had commitments with developers to meet future growth and thus had to undertake plant expansion.[28] Therefore, Staff recommends a disallowance of $3,932,808.

C. <u>Staff's recommendations concerning the Company's arsenic treatment facilities provide for sufficient treatment capacity and should be adopted.</u>

Staff made several recommendations regarding the Company's arsenic treatment facilities in Agua Fria, Havasu and Sun City West. In summary, Staff recommended disallowance of one adsorber vessel at each of these treatment facilities. The Company argues that such disallowance would be improper as the plants could not treat the full output of the associated wells.[29] Company witness Joseph Gross testified that the Company operates its arsenic treatment plants at its Agua Fria, Havasu and Sun City West systems in a "lead/lag mode" which provides operational efficiencies.[30] Staff disagrees and concludes that the three vessels would be more than adequate to properly treat the output from the associated wells.

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[24] *Id.* at 21.
[25] *Id.*
[26] *Id. at 22.*
[27] Ex. A-2 at 12.
[28] Tr. at 139.
[29] Ex. A-2 at 3.
[30] Ex. A-2 at 4, 6, 8.

In its Agua Fria Plant Number 5, the Company has four 11-ft diameter adsorber treatment vessels. Staff concluded that the Company only needed three of the four currently-existing treatment vessels to provide adequate treatment capacity. The resulting adjustment recommended by Staff is $126,352.[31]

Staff witness Dorothy Hains revised the Staff recommendation concerning the Havasu treatment plant after considering the testimony of Company witness Joseph Gross. Ms. Hains concluded that in order to provide adequate treatment capacity, which includes the required amount of time the water has contact with the vessel, the Havasu facility could provide proper treatment with two 11-ft diameter vessels. The Company has two 14-ft vessels currently installed. The resulting plant adjustment is $34,266.[32]

D. The Commission should treat Imputed Regulatory Assets in accordance with Decision No. 63584.

Citizens Utilities and Arizona-American entered into the Asset Purchase Agreement on October 15, 1999. Under that Agreement, Citizens transferred certain assets to Arizona-American and Arizona-American assumed certain obligations.[33] The sale of assets to Arizona-American was approved by the Commission on April 24, 2001, in Decision No. 63584. In Decision No. 63584, the Commission approved a Settlement Agreement under which the unrecovered balance of Imputed Regulatory Advances in Aid of Construction ("IR AIAC") and Imputed Regulatory Contributions in Aid of Construction ("IR CIAC") were to be amortized over 6 1/2 years and 10 years respectively.[34] The Company has requested that the amortization of IR AIAC (except for Paradise Valley) extend seven months beyond the end of the test year.[35] The Company argues that the Settlement Agreement was a bad bargain for the Company. Staff contends that the Company's proposed adjustment is at odds with Commission Decision No. 63584 and would violate the matching principles of ratemaking.[36] Staff's position remains unchanged. The amortization of IR AIAC should coincide with the end of the test year.

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[31] Ex. S-4 at 3.
[32] Tr. 747-750.
[33] Ex. A-21.
[34] Decision No. 63584, Docket No. W-01032A-00-0192 et al.
[35] Ex. A-11.
[36] Ex. S-10 at 14.

E. <u>The Company's proposed treatment of CIAC/AIAC associated with CWIP is not in keeping with traditional ratemaking principles and should be rejected.</u>

The Company argues that since CWIP is not an addition to rate base, then related AIAC and CIAC should not be a reduction to rate base. This position is contrary to traditional ratemaking practices and contrary to the NARUC definition of CIAC, which does not distinguish between CIAC associated with CWIP and CIAC associated with plant in service. The NARUC USOA states the following regarding CIAC:

> 271. Contributions in Aid of Construction
>
> A. This account shall include:
>
> 1. Any amount or item of money, services or property received by a utility from any person or governmental agency, any portion of which is provided at no cost to the utility, which represents an addition or transfer to the capital of the utility, and which is utilized to offset the acquisition, improvement to offset the utility's property, facilities or equipment used to provide utility services to the public.

Further, the Company can record AFUDC to CWIP balances allowing it to earn a return. Reducing rate base by CIAC and AIAC preserves the ratemaking balance and removes the possibility of the Company earning an excess.

The Company also argues that because it does not receive funds from a developer but, rather, receives plant, that this somehow justifies its position. However, it is the Company's choice to accept funds or plant. Staff contends that the funds advanced or contributed by others, even if in the form of plant, are funds that are either available for use by the Company or free up other funds for the Company's use. It is irrelevant whether the Company receives funds or plant, the Company's proposed treatment is improper and Staff's adjustments should be adopted. Staff recommends that the CIAC and AIAC funds that the Company asserts are in CWIP be reflected in the CIAC and AIAC balances used to calculate and properly reflect a reduction to rate base, regardless of its form or how it is used.[37]

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[37] Ex. S-8 at 10.

F. Unless the Company can provide support for certain test year plant additions, such unsupported plant should be disallowed.

Staff recommended disallowance in a number of districts of test year plant that lacked adequate documentation. Because of the lack of documentation, Staff could not determine who paid for the plant, that the plant is actually in place and used and useful. Staff therefore disallowed test year plant in the following systems: Agua Fria ($1,189,832); Mohave Water ($518,976); Mohave Wastewater ($306,362).

Staff's recommendation is consistent with other dockets in which the same recommendation was made. In the matter of Groom Creek Water Users Association,[38] Staff recommended the disallowance of test year plant where the utility lacked the documentation to support the plant. Decision No. 70627 adopted Staff's recommendation with respect to the disallowance of test year plant.[39]

IV. COST OF CAPITAL.

A. Staff recommends that the Commission adopt a capital structure of 58.68% debt and 41.62% equity, that includes short term debt.

The Company proposed a capital structure of 53.25% debt and 46.75% equity. Staff recommended a capital structure comprised of 58.68% debt and 41.62% equity. RUCO recommends a capital structure of 55.2% debt, 44.8% equity. Staff's recommended capital structure includes short-term debt, while the Company and RUCO argue for the exclusion of short-term debt. The Company argues that short term debt should be excluded from its capital structure because short-term debt is used to finance CWIP.[40] Staff's recommendation is reasonable and should be adopted.

Arizona Administrative Code ("A.A.C.") R14-2-103, Schedule D-2 sets forth what should be included in a rate case application filing. The requirements include a listing of an applicant's short-term debt as a component of the cost of capital. It would seem that R14-2-103 contemplates the inclusion of short-term debt in an applicant's capital structure.

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[38] Docket No. W-01865A-07-0385 et. al.
[39] Decision No. 70627, FOF 54, 57.
[40] Ex. A-12 at 13.

The Company has advanced a similar argument in previous rate dockets.[41] The Company's arguments were rejected and the Commission approved the inclusion of short-term debt in the Company's capital structure.

B. Arizona-American should not receive higher profits during this period of economic uncertainty and Staff's recommendation of 10.0% is reasonable and should be adopted.

There is no dispute among the parties on the cost of debt: 5.463%. Overall, Staff is recommending a 7.34% overall rate of return ("ROR").[42] Staff's ROR is based on cost of equity estimates for Arizona-American that range from 9.5% to 10.5%.[43] Staff's Cost of Equity recommendation is 10.0%. Staff's based its recommendations using the Discounted Cash Flow Method, the Capital Asst Pricing Model and the Comparable Earnings Methodology.[44] With the exception of the Comparable Earnings Method, Staff's recommendations are based on market-based financial models that have been accepted by this Commission for many years. All of Staff's inputs are factors which investors can reasonably be expected to consider in determining their expected rate of return. The models are also widely accepted in the financial industry and by most state Commissions in setting just and reasonable rates of return. Finally Staff's recommendation takes into account the state of the nation's economy, where there is rising unemployment, the declining growth in the gross domestic product and industrial production, indicative of a recession. Based on the voluminous public comment in this docket, Arizona-American customers are suffering from the effects of the recession. Certainly this is no environment in which to increase the profit levels for a regulated monopoly such as Arizona-American.

In contrast, Arizona-American recommends an 8.40% overall rate of return, with an 11.75% Cost of Equity. The Company uses a market-value capital structure to determine rates of return. The Company's methodology is inconsistent with standard practices known to investors that regulators authorize returns on the book value of property devoted to public service.[45]

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[41] *See* Docket No. W-01303A-06-0491; Docket No. W-01303A-07-0209.
[42] Ex. S-10 at 2.
[43] Ex. S-10 at 3.
[44] *Id.*
[45] Ex. S-10 at 34.

The after-tax weighted cost of capital ("ATWACC") methodology proposed by the Company has not been extensively used or reviewed in the regulatory environment. Moreover the ATWACC methodology has been recently rejected by the Arizona Corporation Commission in several cases.[46]

The Company argues that neither Staff nor RUCO acknowledges that the Company's leverage translates into a higher financial risk. The Company witness Dr. Bente Villadsen argues that the nation's financial crisis has a broad impact on utilities' access to and the cost of capital. However, as the Company noted in its 2008 Fourth Quarter and Year End Earning Calls, the return on equity for rate cases finalized during 2008 for other American Water subsidiaries were in range of 8.8% to 10.8%. It bears noting again that the Company's request in this case is 11.75%.

In her Rebuttal testimony, Dr. Villadsen makes reference to a November 2008 long-term debt issuance by American Water Capital Corporation ("AWC"), the financing affiliate of American Water, Arizona-American's parent, at a cost rate of 10%. She then implies that this 10% cost rate for this long-term debt issue provides a standard for the cost of common equity for Arizona-American.[47] Staff asserts that such reasoning is flawed and that the 10% cost rate is not an appropriate measure.

Staff witness Cost of Capital witness David Parcell notes that the debt issue dated November 28, 2008 took place at a significant peak of the interest rate levels of late 2008, during which time the US and global economies were undergoing a "flight to quality" associated with the stock market collapse and the movement of significant amounts of investment dollars into safe shelters such as US treasury bonds. During this period, which continues at the present time, the movement of funds into US treasury bonds has driven the yield on government debt to low levels and the yield on corporate and utility debt to high levels. While many companies chose to stay out of the new debt issuance market during this period, AWC sold $75 million of thirty year bonds at what amounted to the peak of interest rate levels of 2008.[48] In fact, in a February 2009 bond issuance by AWC, the cost rate was 8.25%.

Depressed economic conditions and the financial crisis affects virtually all sectors of the economy – households, small businesses, larger commercial and industrials – and, in most cases, the

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[46] *See* Decision Nos. 68858, 70209.
[47] Ex. A-14 at 6.
[48] Ex. S-11 at 3.

impact is greater than is the case for utilities, such as Arizona-American. Arizona-American is a regulated utility that sells a product that has no substitutes. As such, Arizona-American and utilities are partially, if not largely, insulated from the impacts of depressed economic conditions.[49]

One of the major impacts of a recession is to depress the profits of most enterprises. As a result, it is to be expected that capital costs will decrease if a significant recession occurs. There is no justification for increasing the profit level of a regulated utility such as Arizona-American at the same time that other enterprises are experiencing lower profits.

Even assuming that Arizona-American were to incur higher costs of debt and/or other capital costs, these costs can be passed along to ratepayers at the next rate proceeding. Unregulated firms cannot do this.

The United States and global governments have, and are taking, extraordinary measures to avoid a further worsening of the current market turmoil. Most of these measures are designed to put liquidity into the credit markets and make credit more accessible again and, in the process, restore more confidence to the financial markets. All of these measures are clearly designed to lower the cost of capital.[50] In this environment, it would be counter-productive to make any claim that Arizona-American should have a higher return at this time because of the current market turmoil.

V. INCOME STATEMENT ISSUES.

A. <u>Staff's recommended adjustments with respect to the proposed tank maintenance program and meter change-out program are reasonable and should be adopted.</u>

During the testimony of Staff witness Gary McMurry, Staff accepted many of the Company's rebuttal adjustments.[51] Staff has accepted the Company's adjustments relating to labor expense, rate case expense, water testing, and management fees. Staff also made changes to the depreciation expense for Agua Fria and Sun City West.[52] Staff disagrees with the Company's position with respect to waste disposal expense fro Mohave Wastewater. Company witness Sheryl Hubbard testified that to agree with Company witness Stuck, she had revised her waste disposal expense.[53]

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[49] Ex. S-10 at 31.
[50] *Id.*
[51] Tr. 781-789.
[52] Tr. 783:3-11.
[53] Tr. 591:1-16.

Because Staff disagrees with the Company's inclusion of post-test-year plant for the Mohave Wastewater system as discussed above, Staff continues to disagree with the Company's adjustment relating to waste disposal expense.

Staff and the Company disagree on the amount for tank maintenance. Staff's position is that the expenses for tank maintenance be normalized.

The Company proposed a tank maintenance program. The Company's schedule for its storage tanks includes recoating the interiors every fourteen years and painting the exteriors every fourteen years. Further, the Company proposed maintenance costs based on cost proposed by another water utility, Arizona Water Company, as well as an affiliate in Missouri. The Company contends that Arizona Water Company's costs are representative of cost for Arizona water utilities. However, as Company witness Troy Day testified, there is no standard for maintenance on storage tanks because of the differences in climates and of water quality in different areas. Mr. Day further testified that the Missouri American affiliate was one of the sources used to develop its proposed maintenance schedule. Staff was not convinced by this argument; Arizona-American did not show that the costs are directly comparable. Staff also testified that the costs claimed by Arizona Water Company have not been adopted by the Commission.[54] Thus Staff continues to recommend normalization of the expenses.

The Company is recommending a depreciation rate of 6.7% for all districts for Account 334100 Meters based on its proposed 15-year meter change-out program.[55] As support for this program, the Company cites to recommendations of the American Water Works Association and the results of a study performed by the City of Phoenix.[56] Ms. Hains testified that she thought the Company's plan was a "good one."[57] While Staff fully supports the Company's formal proposal to go forward with a 15-year meter change-out program, according to Ms. Hains, the Company has not implemented such a plan in the past.[58] At this time, therefore, it is premature to adjust the

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[54] Ex. S-6 at 3.
[55] Ex. A-26 at 29:3-5.
[56] Ex. A-10 at 5:10-12.
[57] Tr. 764:14
[58] Tr. 773:18-21.

depreciation rates and Staff continues to recommend the meter depreciation rates as previously approved for the Company.

VI. RATE DESIGN.

For its Paradise Valley System, the Company had proposed a five tier rate design. However, during the hearing Paul Herbert, testifying on behalf of Arizona-American, stated that the Company would change to a three tier, inverted rate design.[59]

After listening to the public comment concerning the rates for Paradise Valley and Tubac, Staff submitted alternative rate designs for Commission consideration. Staff prepared for consideration a three tier rate design and a five tier rate design for Paradise Valley. The three tier alternative rate design for Paradise Valley slightly lowers the monthly minimum charge, changes the breakpoints on usage, and lowers the commodity charges. This alternative attempts to lower the bills for those customers who use less water and would increase the bills for the high usage customer. For an average usage of 20,483 gallons on a 3/4-inch meter, that customer's bill would increase by 11.9% to $55.08 from a current bill under the existing rates of $49.20.

Under Staff's five tier alternative, the rates were designed to provide some rate protection to low water users. For a customer who uses between 5,000 to 9,000 gallons, such customer would see a decrease in rates.

For the Tubac system, Staff's alternative proposed a four tier rate structure. The monthly minimums for the 5/8 x 3/4-inch meter and the 1-inch meter were lowered slightly. Staff also proposed different breakpoints. For the average usage of 11,797 gallons for a 5/8 x 3/4-inch meter, the bill would increase by 15.68%. Staff has not changed its position on the rate design offered by Staff witness Marvin Millsap.[60]

VII. WATER LOSS AND WATER DATA.

A. <u>Staff's recommendations that the Company reduce it water loss to 10% is reasonable and in line with previous Commission orders.</u>

Staff has recommended that the Company reduce its water loss to 10% or below. As noted by Staff witness Dorothy Hains, water loss over 10% has been an on-going problem in the Company's

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[59] Tr. 531:1-4.
[60] Ex. S-13.

Mohave, Paradise Valley and Havasu districts for some time.[61] As of 2007, the Company has managed to reduce the water loss in its Paradise Valley system but still show significant loss in its Mohave and Havasu district. The Company argued that it would not be cost-effective to reduce water loss below 10%.[62] However, as Mr. Broderick testified during the hearing, the Company is committed to reducing its water loss, but does not want it to be a "requirement" placed upon the Company to be met by the end of 2009, as it could be costly.[63] To address the Company's concerns, Staff also recommended that the Company docket a report containing a detailed analysis and explanation demonstrating why a water loss reduction to 10% or less is not feasible or cost effective.[64] Staff contends that water loss reduction is a part of the Company's routine maintenance program and such costs can be recoverable in rates.[65] Further the Company has an obligation to properly maintain its systems even in difficult economic times.

B. **The Company should present accurate water use data and Staff recommends that the Company's next rate application be found insufficient if inaccurate water use data is provided.**

In preparing the Cost of Service Study on behalf of Staff, Steve Olea received inconsistent and troubling water use data from the Company.[66] Staff contends that any business, even a regulated water company, should be concerned about how much product it produces and how much of that produced product it sells. The Company testified that there were several reasons for the submittal of inconsistent water use data, with respect to its Mohave system. Mr. Stuck testified that because of incompatible data systems communicating with each other, coupled with problems compiling data at the gross level instead of at the public water system level, the submittal to Staff of the Company's water use data was inaccurate.[67] While Staff is encouraged that the Company is resolving its internal system problems, Staff continues to recommend that the Company's next rate application be found insufficient if it provides inaccurate water use data.[68]

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61 Ex. S-4 at 2.
62 Ex. A-12 at 15-16.
63 Tr. 261:17-25.
64 Ex. S-3 at 7 (Havasu Water District).
65 Ex. S-4 at 2.
66 Ex. S-1 at 6,
67 Tr. 201.
68 Ex. S-1 at 8.

VIII. WHITE TANKS HOOK-UP FEE TARIFF CHANGES.

A. With a few exceptions, Staff finds the Company's proposed changes to be reasonable.

The Company was authorized in the White Tanks Decision, to propose changes to the Agua Fria District Hook-Up Fee Tariff. Arizona-American proposed to separate the single fee hook up fee into two components, with the second component relative to the White Tanks Project, ineligible for offset credits.[69] The majority of the changes were to conform to the Commission's Hook up fee tariff template. Staff is not opposed to the Company's proposed treatment, but still questions the need for developers to provide a water source in the form of a new well. Company witness Ian Crooks testified that in developments that have wells near completion that need to finish, but in the near term the Company would not require a new water source.[70]

Staff is also concerned with the Company proposed Section IV(D). The Company contends that there may be certain facilities that are not subject to refund. The Company argues that certain water facilities such as storage tanks, booster pumps, treatment facilities, and transmission mains that are required for and constructed and built for the exclusive, are not Distribution Mains subject to refund under R14-2-406(D). The Company's rational is that such facilities do not benefit any other properties and thus should be treated as contributions. The Company has misread A.A.C. R14-2-406(D).

A.A.C. R14-2-406 discusses the obligations of the utility with respect to main extension agreements. An applicant may be required to pay to a utility the estimated costs of all mains, subject to refund as an advance. R14-2-406(B) (1) states:

> In the event that additional facilities are required to provide pressure, storage or water supply, exclusively for the new service or services requested, and the cost of the additional facilities is disproportionate to anticipated revenues to be derived from future consumers using these facilities, the estimated reasonable cost of such additional facilities may be included in refundable advances in aid of construction to be paid to the Company.

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[69] Ex. A-12 at 3.
[70] Tr. 164:10-22.

The Commission provides a solution for the issue raised by the Company: to include such costs in the refundable advance. Staff argues that such change as proposed by the Company be rejected by the Commission.

IX. CONSOLIDATION.

A. __Staff supports rate consolidation, but urges the Commission to proceed with caution.__

Chairman Mayes, in a letter to the docket, requested that the parties discuss the possibility of rate consolidation. Mr. Abinah, on behalf of Staff, testified that Staff is supportive of rate consolidation, where it is technically and financially feasible.[71] However, Staff could not recommend consolidation in the instant case.

Rate consolidation is a complex issue that has both public and policy ramifications. Staff recommends that before undertaking rate consolidation, the Commission establish certain criteria regarding public health and safety, proximity, economies of scale and rate shock.[72] For a utility such as Arizona-American, with differing rates among its districts, rates for some customers will decrease while rates will surely increase for others. Before undertaking consolidation, the Company would have to undertake significant public outreach to educate its consumers on the issue, something that did not happen within the confines of the instant case. Staff was concerned that the notice in the instant case was not adequate to notify affected ratepayers, particularly those customers of the districts that were not included, that a rate increase (or decrease) was possible.[73]

Staff recommends that the Commission carefully consider all aspects and impacts that could result from consolidation in an effort to avoid unintended consequences.

X. CONCLUSION.

Staff acknowledges and appreciates the efforts of the Company, RUCO and the other parties to resolve many of the contested issues. Staff respectfully requests the Commission to adopt its recommendations in this proceeding.

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[71] Tr. 872:10-12.
[72] Ex. S-16 at 9-11.
[73] *Id.* at 5.

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