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Executive Director

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ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION
DOCKET CONTROL

DATE: OCTOBER 30, 2009

DOCKET NO.: W-02234A-07-0557

TO ALL PARTIES:

Enclosed please find the recommendation of Administrative Law Judge Dwight D. Nodes. The recommendation has been filed in the form of an Opinion and Order on:

H2O, INC.
(RATES)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and thirteen (13) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00** p.m. on or before:

NOVEMBER 9, 2009

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Open Meeting to be held on:

NOVEMBER 19, 2009 and NOVEMBER 20, 2009

For more information, you may contact Docket Control at (602) 542-3477 or the Hearing Division at (602)542-4250. For information about the Open Meeting, contact the Executive Director's Office at (602) 542-3931.

Arizona Corporation Commission
DOCKETED
OCT 30 2009
DOCKETED BY

ERNEST G. JOHNSON
EXECUTIVE DIRECTOR

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

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

IN THE MATTER OF THE APPLICATION OF H20, INC. FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PROPERTY AND FOR AN INCREASE IN ITS WATER RATES AND CHARGES FOR UTILITY SERVICE.	DOCKET NO. W-02234A-07-0557 DECISION NO. __________ **OPINION AND ORDER**

DATES OF HEARING:	March 9, 2009 (Public Comment); May 1, 2009 (Pre-Hearing Conference); and May 4, 2009 (Evidentiary Hearing)
PLACE OF HEARING:	Phoenix, Arizona
ADMINISTRATIVE LAW JUDGE:	Dwight D. Nodes
APPEARANCES:	Mr. Richard L. Sallquist, SALLQUIST, DRUMMOND & O'CONNOR, P.C., on behalf of H20, Inc.; and Mr. Charles Hains, Staff Attorney, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

BY THE COMMISSION:

Procedural History

On October 1, 2007, H2O, Inc. ("H2O" or "Company") filed with the Arizona Corporation Commission ("Commission") an application for a determination of the current fair value of its utility property and for an increase in its rates and charges for water utility service provided to customers in the Company's certificated service area in parts of Maricopa and Pinal counties, Arizona. As part of its application, H2O filed supporting schedules and the Direct Testimony of its witness Thomas Bourassa.

On November 2, 2007, the Commission's Utilities Division Staff ("Staff") filed a Letter of Insufficiency stating that the application did not meet the sufficiency requirements outlined in Arizona Administrative Code ("A.A.C.") R14-2-103.

On November 14, 2007, the Company filed its response to Staff's Letter of Deficiency.

On May 13, 2008, the Company filed an amended application.

On June 11, 2008, Staff filed a second Letter of Deficiency informing the Company that the application did not meet the Commission's sufficiency requirements.

On June 25, 2008, the Company filed its response to Staff's second Letter of Deficiency.

On July 24, 2008, Staff filed a letter indicating the Company's rate application was sufficient, and classifying the Company as a Class B utility.

By Procedural Order issued July 30, 2008, the hearing was scheduled to commence on March 9, 2009, the Company was directed to mail to customers and publish notice of the hearing date, and other procedural timelines were established.

On October 14, 2008, the Company filed its Affidavits of Publication and Mailing of the Public Notice.

On December 2, 2008, H2O filed a Motion to Continue, requesting that the March 9, 2009, hearing date be rescheduled to begin March 23, 2009, due to the unavailability of counsel for the Company on the previously scheduled hearing date.

On December 18, 2008, Staff filed a Motion to Continue, requesting that the hearing date in this matter be rescheduled to commence no sooner than May 4, 2009, and that the other filing deadlines be extended accordingly. Staff stated that the extension was necessary due to corrected schedules that were filed by the Company. H2O agreed with Staff's proposed continuance.

On December 22, 2008, the Company filed revised schedules.

On January 7, 2009, a Procedural Order was issued rescheduling the hearing to commence on May 4, 2009, with a prehearing conference scheduled for May 1, 2009. Dates for filing of testimony were also changed. The original March 9, 2009 hearing date was maintained for public comment only in accordance with the published notice.

On January 23, 2009, Staff filed the Direct Testimony of Brendan Aladi and Katrin Stukov.

On March 9, 2009, the hearing was called for the purpose of taking public comment. No members of the public appeared on that date to offer comments.

On March 9, 2009, H2O filed the Rebuttal Testimony of Mr. Bourassa.

On April 10, 2009, Staff filed the Surrebuttal Testimony of Mr. Aladi.

On April 22, 2009, H2O filed the Rejoinder testimony of Mr. Bourassa.

On May 1, 2009, a prehearing conference was held to discuss scheduling of witnesses and other procedural matters related to the hearing.

The hearing was held on May 4, 2009, as scheduled. At the hearing, both the Company and Staff were represented by counsel. At the conclusion of the hearing, post-hearing briefs and reply briefs were ordered to be filed on a schedule agreed to by the parties.

On June 12, 2009, H2O filed a Notice of Appearance of Co-Counsel, adding Patrick Black of the law firm Fennemore Craig, P.C., as co-counsel for the Company in this matter.

On June 15, 2009, H2O and Staff filed their respective initial post-hearing briefs.

On June 29, 2009, H2O and Staff filed reply briefs.

Overview of Application

During the test year in this case ending December 31, 2006, H2O provided water utility service to approximately 6,300 customers, mostly residential, in parts of Maricopa and Pinal counties, Arizona. (Ex. S-1, at 1.) The Company's existing rates and charges were established in Decision No. 58641 (May 27, 1994). In Decision No. 69413 (April 16, 2007), H2O was directed by the Commission to file a rate application by September 31, 2007, based on a test year ending no later than December 31, 2006. As described above, H2O filed its rate application on October 1, 2007, with a 2006 test year. An amended application was filed on May 13, 2008, to resolve various deficiencies with the original application.

As set forth in its amended application, H2O proposes that the Commission adopt rates that would result in an overall reduction in revenues of 3.97 percent. Staff recommends a rate reduction of 4.73 percent. Although both proposals would result in rate reductions, the parties arrive at their recommendations by very different means. For example, H2O seeks a revenue requirement of $3,244,489 ($134,153 less than is currently authorized), based on a fair value rate base ("FVRB") that is equal to the Company's proposed original cost rate base ("OCRB") of $1,995,695. The Company recommends a cost of equity of 11.45 percent. (Ex. A-3, at 2-3.) Staff, on the other hand, recommends adoption of an overall revenue requirement $3,218,705 ($159,937 less than currently authorized), based on a FVRB of *negative* $363,842 and using a 10 percent operating margin approach to achieve the revenue requirement. (Ex. S-4, Sched. BCA-1.)

A summary of the parties' final revenue requirement positions follows:

	Company Proposed	Staff Proposed
ORIGINAL COST		
Adjusted Rate Base	$1,995,695	$(363,842)
Rate of Return	11.46%	10% Op. Mar.
Req'd Operating Inc.	228,614	321,871
Operating Inc. Excess	(82,508)	(96,269)
Rev. Conver. Factor	1.6259	1.6614
Gross Rev. Decrease	(134,153)	(159,937)
FAIR VALUE		
Adjusted Rate Base	$1,995,695	$(363,842)
Rate of Return	11.46%	10% Op. Mar.
Req'd Operating Inc.	228,614	321,871
Operating Inc. Excess	(82,508)	(96,269)
Rev, Conver. Factor	1.6259	1.6614
Gross Rev. Decrease	(134,153)	(159,937)

Three primary issues remain in dispute between H2O and Staff. The first, and most contentious, is whether unexpended hook-up fees and developer advances should be treated as contributions in aid of construction ("CIAC") and advances in aid of construction ("AIAC"), respectively, for purposes of reducing H2O's authorized rate base. The second issue is whether the Company's current off-site capacity reservation charge tariff should be eliminated. The final disputed issue is the appropriate allocation of annual revenue between the monthly minimum charge and commodity charges. Each of these issues is discussed below.

<u>Treatment of Contributions and Advances</u>

During the last 20 years, H2O was authorized to collect hook-up fees that were to be used to construct plant needed to serve its growing service area. In Decision No. 56486 (May 17, 1989), the Company was permitted to collect a Facilities Construction Charge ("FCC") that was limited to 280 residential units and no more than $120,000. The FCC was superseded by an Off-Site Capacity Reservation Charge ("CRC") in Decision No. 63259 (December 14, 2000) that eliminated the restriction on number of customers imposed by the FCA. In Decision No. 63259, the Commission indicated that the CRC was intended to collect hook-up fees sufficient to fund an off-site water plant as well as the cost of upgrading adjacent transmission mains.

There is no disagreement between the Company and Staff regarding the amount of plant-in-service of $12,996,414 and test year accumulated depreciation of $1,497,950. (Ex. A-3, Sched. B-2, at 5.) However, the parties remain at odds over the appropriate rate base treatment of $2,859,339 of unexpended CIAC and AIAC, and currently funded construction work in progress ("CWIP"). At the end of the 2006 test year, H2O had collected approximately $8.6 million of CIAC through hook-up fees (after removing accumulated amortization) and more than $3 million in AIAC from developer advances.

According to H2O, a mismatch would be created if the Commission were to adopt Staff's recommendation to deduct CIAC and AIAC from the Company's rate base because there is no corresponding plant-in-service amount to "match" the contributions and advances received by H2O. The Company claims that it has approximately $2.7 million in unexpended funds that are being held to construct future plant for future customers.

Company witness Bourassa testified that H2O's proposed treatment of the unexpended CIAC and AIAC funds is consistent with the Commission's rules because the funds were collected pursuant to an approved CRC tariff and main extension agreements with developers. H2O claims that the contributions and advances collected from developers must be held to construct specific future infrastructure associated with the projects for which the funds were collected. The Company contends that since it may not use these funds for other purposes, deducting unexpended CIAC and AIAC from rate base would be inappropriate. H2O argues that adoption of Staff's proposal to treat unexpended CIAC and AIAC from rate base would effectively penalize the Company for not building infrastructure that it properly determined would result in excess capacity due to slowing of the housing market. In addition, H2O claims that adoption of Staff's recommendation would result in negative consequences for the Company by reducing its cash flow. By including unexpended CIAC in H2O's rate base, the Company's cash flow would be reduced by approximately $195,000 per year as a result of increased depreciation expense under Staff's recommendation. (Tr. at 131.)

The Company also criticizes Staff's reliance on A.A.C. R14-2-103 to support Staff's position.

In Appendix B, Schedule B-1, to Commission rule R14-2-103, CIAC and AIAC are shown as *deductions* to rate base in the calculation of OCRB (Ex. S-5, attached hereto as Attachment 1) and, accordingly, Staff witness Aladi testified that the rule requires the treatment proposed by Staff. (Tr. 147-148.) H2O argues that, contrary to Staff's interpretation, the rule does not address the larger ratemaking "matching" concept. Further, according to the Company, Staff's reliance on the rule as a reflection of Commission "policy" represents an over-simplification that would achieve an inequitable result harmful to H2O's long-term viability.

Two recent Commission Decisions addressed the treatment of unexpended advances[1]. In both cases, the utility companies argued that it is unfair to exclude advances from rate base if the plant associated with those advances is not yet in service and not included in rate base, and that such treatment would discourage companies from seeking advances to offset infrastructure capital costs. The Commission rejected the companies' arguments in those cases, citing to the Commission's rule discussed above (Attachment 1 hereto), as well as the long-standing Commission policy of excluding advances and contributions from rate base. (*Id.*)

The Company argues that the facts in the UNS cases differ from those presented in the instant case. The alleged distinctions include: (1) no CWIP is being requested by H2O unlike the UNS Gas and UNS Electric cases; (2) the disputed amount of rate base is significantly greater in this case; (3) H2O is much smaller than UNS Gas and UNS Electric and H2O is heavily dependent on developer contributions to fund growth; and (4) H2O did not have the ability to choose its test year, unlike the scenario presented in the UNS Gas and UNS Electric cases, because H2O was ordered to file based on a 2006 test year. H2O argues that, due to these factual differences, the conclusions reached in Decision Nos. 70011 and 70360 have little, if any, precedential value for the determination in this case.

The Company's attempt to distinguish the prior cases is not persuasive. First, although the companies in those cases sought inclusion of CWIP (which requests were rejected), both UNS Gas and UNS Electric also submitted as back-up, stand-alone proposals that, absent the inclusion of

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[1] *UNS Gas, Inc.*, Decision No. 70011 (November 27, 2007), at 8-10; *UNS Electric, Inc.*, Decision No. 70360 (May 27, 2008), at 10-11.

CWIP or post-test-year plant in rate base, the Commission should decline to deduct advances from rate base. As noted above, we rejected those arguments based on the Commission's rules, as well as consistency with the treatment afforded other utilities historically.

The next alleged distinction between the UNS cases and the facts presented herein is H2O's claim that the CWIP and/or post-test-year plant requests represented a small fraction of the UNS companies' rate base compared to H2O. H2O does not set forth the point at which the magnitude of contributions and advances should give rise to an exemption from the Commission's rules, other than to suggest that perhaps the Commission should know it when it sees it.

Similarly, the third difference cited by H2O is the argument that the UNS companies are larger and better capitalized compared to H2O's reliance on developer contributions to meet growth infrastructure needs. H2O adds that the UNS companies received rate increases in the prior cases, whereas ratepayers will receive a rate decrease as a result of this case under either the Staff or Company proposals. It is curious that H2O cites to its reliance on developer funding as a basis for seeking what amounts to a waiver of the Commission's rule governing treatment of AIAC and CIAC, since it was H2O's unilateral decision that resulted in a capital structure consisting almost entirely of contributions and advances. The failure by H2O's owners to inject sufficient equity, combined with the Company's continued collection of hook-up fees (see discussion of hook-up fees below), has resulted in a situation in which H2O currently has a negative rate base. Although Mr. Bourassa attempted to dismiss H2O's reliance on contributed capital as a "timing problem," he conceded that such reliance could be detrimental to the Company and its customers in the long-term because, once growth ceases (and by extension the CIAC and AIAC associated with growth), the Company would be left with an inability to earn a return on rate base and would therefore be unable to make necessary repairs and improvements. (Tr. at 53-55.)

The final distinction offered by the Company is that the UNS companies were able to choose their test years whereas H2O was ordered to file a rate case using a 2006 or later test year. It is ironic that H2O raises the voluntary nature of the test year in support of its position given that the reason the Company was ordered to file a rate case with a given test year is that it has not filed a rate case since 1994 and therefore has not undergone an analysis and audit of its rates and operations during that time. Given that both the Company and Staff recommend a rate reduction in this case, there is a strong possibility that H2O has been over-earning for a number of years and reinforces the conclusion that the Commission's rate filing requirement in Decision No. 69413 was necessary to determine the extent of such over-earning.

Nor are we persuaded by H2O's contention that Staff's negative rate base recommendation is punitive to the Company. H2O argues that adoption of Staff's proposal would make it more difficult for the Company to attract potential buyers that are well capitalized and could move the Company towards a more balanced capital structure. In effect, acceptance of H2O's position would confer special treatment that falls outside of the Commission's rules and would reward the Company for its failure to undertake any significant equity investment. For these reasons we find Staff's recommendation for a negative $363,842 rate base is reasonable and should be adopted as the Company's FVRB in this proceeding.

Elimination of Hook-Up Fee Tariff

At the end of the test year, H2O's capital structure consisted of approximately $12.34 million of customer-supplied funds ($9.27 million CIAC and $3.07 million AIAC) and only $820,000 in debt or equity. The vast majority of these funds were collected through H2O's CRC tariff. According to the Company, the significant amount of contributions collected under the CRC and advances received pursuant to main extension agreements has enabled the Company to fund growth with zero-cost capital, allowing H2O to keep rates low for all customers by requiring growth to pay for growth. H2O contends that Staff's recommendation to discontinue the CRC tariff would be devastating to the Company because it does not have the ability to access capital from a corporate parent or through the capital markets[2].

Even Company witness Bourassa agreed that the financing model currently being used by H2O is not sustainable in the long-term and that it may be appropriate at some point for the

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[2] H2O also opposes refund of any portion of the $2.7 million unexpended CIAC, as was suggested as a possibility at the hearing. In a prior case involving Black Mountain Sewer Company (Decision No. 69164, December 5, 2006), the Commission ordered Black Mountain to refund more than $800,000 in unexpended CIAC. H2O argues that the facts in that case are distinguishable because, unlike the instant case involving H2O, Staff had suggested that some of contributed funds were misspent by Black Mountain, Black Mountain's parent company is well capitalized, and Black Mountain ultimately agreed to the customer refund. (*Id.* at 28.)

Commission to terminate the CRC tariff. However, he indicated it would be premature to do so at this point because such action would eliminate a funding source that the Company has relied on to build plant. (Tr. at 55-56.)

Staff, on the other hand, claims that there is a reasonable basis for ending the CRC tariff now. Staff witness Aladi testified that Staff generally recommends a capital structure of approximately 40 percent equity and 60 percent debt, and that contributions and advances should comprise no more than 30 percent of a company's total capitalization. (Tr. at 78-79.) Using those parameters as a guideline (with a capital structure of 30 percent customer-supplied capital and 70 percent combined debt and equity), Mr. Aladi stated that Staff would recommend that at least 28 percent of total capitalization should be made up of equity. Under Staff's analysis, therefore, H2O would need to inject approximately $4.3 million of additional equity to achieve the recommended ratios. (*Id.* at 79-80.)

The arguments raised by H2O and Staff in this proceeding point out the inherent tension that exists between the policy of requiring growth to fund growth and assuring that there is sufficient equity investment for sustainable financial viability. Although H2O attempts to frame the issue as a matter of timing, that will be resolved as developments within the Company's CC&N reach full build out, the solution to the issue of lopsided contributed capitalization is not so simple. For example, if the Company is allowed to continue to collect hook-up fees and developer advances as the primary means of funding infrastructure, the short-term benefits associated with that strategy could result in devastating long-term consequences when the source of contributed capital no longer exists and customers alone are left to support a utility with minimal equity investment in its infrastructure. Under such a scenario, the only likely source of funds would be in the form of substantial, and likely frequent, rate increases because the utility has very little rate base upon which it would be entitled to earn a return.

As discussed above, the Company's extreme reliance on customer-supplied funds portends future calamity unless an infusion of investor capital occurs to bring H2O's capital structure more into balance. The absence of such investment could undermine substantially the Company's future ability to provide necessary capital to fund needed infrastructure investment. The Company acknowledges that its reliance on CIAC and AIAC is not sustainable in the long-term, yet it argues for continuation of the same source of funding that has led to the imbalance. We do not believe it is appropriate to wait until some unknown period in the future to address this issue given the substantial imbalance in H2O's capital structure.

Although we do not believe it is necessary, at this time, to order a refund of the unexpended CIAC as was directed in *Black Mountain*, we agree with Staff that H2O should cease collection of hook-up fees under the CRC tariff. In the event that a new hook-up fee tariff is deemed necessary in the future, the Company may submit a new application to implement such a tariff. However, given the substantial existing amount of unexpended contributions and advances, combined with the lack of equity investment, additional collection of hook-up fees through the CRC is inappropriate at this time.

In addition, we find that H2O should be required to submit an equity capitalization plan to explain, in detail, how the Company intends to increase its non-customer-supplied investment ratio and improve the current imbalance that exists. H2O will be required to file such a plan, as a compliance item in this docket, within 90 days of the effective date of this Decision. After review of the Company's filing, Staff shall present for the Commission's consideration an Order that addresses the Company's plan, including a discussion of any additional Staff recommendations.

Revenue Requirement and Operating Margin

As stated above, Staff proposed adoption of a $321,871 operating margin based on 10 percent of the overall revenue requirement of $3,218,705. (Ex. S-4, Sched. BCA-1; Tr. at 74.) Staff's proposed revenue requirement would reduce H2O's current authorized revenues by $159,937, an overall decrease of approximately 4.73 percent. (*Id.*) Based on the foregoing discussion, we find that Staff's revenue requirement recommendation is reasonable and should be adopted.

Rate Design

The final disputed issue between the Company and Staff involves the appropriate rate design to be employed in this case. H2O's proposed rate design is similar to Staff's to the extent that both include inverted three-tier commodity rates for residential customers, although the Company would establish a two-tier inverted design for commercial, industrial, and irrigation customers served by

5/8-inch through 10-inch meters. (Ex. A-1, Ex. C, at 13.)

For a residential customer served by a 5/8-inch x ¾-inch meter, with average usage of 3,553 gallons per month, the current monthly charges are $21.32. Under the Company's proposed rates, a customer with the same average usage would experience a decrease of $5.71 per month, or 26.8 percent. An average usage customer under Staff's recommended rates would experience a decrease of $5.44 per month, or 25.5 percent. For a median usage residential customer (2,500 gallons per month), the Company's proposal would decrease the current monthly bill by $5.11 (26.25 percent) and Staff's recommendation would reduce the same customer's monthly bill by $5.47 (28.11 percent). (Ex. S-4, Sched. BCA-23.)

Set forth below are the current, Company proposed, and Staff proposed rates and charges according their respective revenue requirement and rate design recommendations. (Ex. S-4, Sched. BCA-22.)

MONTHLY USAGE CHARGE:	Present Rates	Proposed Company	Proposed Staff
5/8" x 3/4" Meter	$15.00	$11.70	$10.40
3/4" Meter	18.00	17.55	15.60
1" Meter	37.00	29.25	25.90
1-1/2" Meter	75.00	58.50	51.90
2" Meter	120.00	93.60	83.00
3" Meter	N/T	187.20	166.10
4" Meter	N/T	292.50	259.50
6" Meter	N/T	585.00	519.00
Irrigation 3/4"	18.00	17.55	15.60
Irrigation 1"	37.00	29.25	25.90
Irrigation 1-1/2"	75.00	58.50	51.90
Irrigation 2"	120.00	93.60	83.00
Construction 2"	120.00	93.60	-
Construction 3"	N/T	187.20	-

COMMODITY CHARGES	Present		Company Proposed			Staff Recommended		
	1st Tier	2nd Tier	1st Tier	2nd Tier	3rd Tier	1st Tier	2nd Tier	3rd Tier
No Gallons included in any Minimum								
Excess of Minimum – per 1,000 Gallons	$1.78	$2.11	$1.20	$1.60	$2.05	$1.43	$2.15	$2.58
5/8 x ¾" Meter	20,000	Infinite	4,000	10,000	Infinite	3,000	10,000	Infinite
3/4" Meter	20,000	Infinite	4,000	10,000	Infinite	3,000	10,000	Infinite
1" Meter	20,000	Infinite		25,000	Infinite		25,000	Infinite
1-1/2" Meter	20,000	Infinite		50,000	Infinite		50,000	Infinite
2" Meter	20,000	Infinite		80,000	Infinite		80,000	Infinite
3" Meter	N/T	N/T		160,000	Infinite		160,000	Infinite
4" Meter	N/T	N/T		250,000	Infinite		250,000	Infinite

6" Meter	N/T	N/T		500,000	Infinite		500,000	Infinite
Irrigation ¾"	20,000	Infinite	4,000	10,000	Infinite	3,000	10,000	Infinite
Irrigation 1"	20,000	Infinite		25,000	Infinite		25,000	Infinite
Irrigation 1-1/2"	20,000	Infinite		50,000	Infinite		50,000	Infinite
Irrigation 2"	20,000	Infinite		80,000	Infinite		80,000	Infinite
Construction 2"	20,000	Infinite			Infinite			Infinite
Construction 3"	N/T	N/T			Infinite			Infinite

SERVICE LINE AND METER INSTALLATION CHARGES:

	Present Rates	Company Proposed			Staff Recommended		
	Total	Service Line	Meter Installation	Total	Service Line	Meter Installation	Total
5/8" x ¾ " Meter	$285.00	$385.00	$135.00	$520.00	$415.00	$105.00	$520.00
3/4 " Meter	320.00	385.00	215.00	600.00	415.00	205.00	620.00
1" Meter	360.00	435.00	255.00	690.00	465.00	265.00	730.00
1-1/2" Meter	545.00	470.00	465.00	935.00	520.00	475.00	995.00
2" Meter	915.00	N/T	N/T	N/T	N/T	N/T	N/T
2" Turbine Meter	N/T	630.00	965.00	1,595.00	800.00	995.00	1,795.00
2" Compound Meter	N/T	630.00	1,690.00	2,320.00	800.00	1,840.00	2,640.00
3" Meter	1,150.00						
3" Turbine Meter	N/T	805.00	1,470.00	2,275.00	1,015.00	1,620.00	2,635.00
3" Compound Meter	N/T	845.00	2,265.00	3,110.00	1,135.00	2,495.00	3,630.00
4" Meter	1,885.00						
4" Turbine Meter	N/T	1,170.00	2,350.00	3,520.00	1,430.00	2,570.00	4,000.00
4" Compound Meter	N/T	1,230.00	3,245.00	4,475.00	1,610.00	3,545.00	5,155.00
6" Meter	3,780.00						
6" Turbine Meter	N/T	1,730.00	4,545.00	6,275.00	2,150.00	4,925.00	7,075.00
6" Compound Meter	N/T	1,770.00	6,280.00	8,050.00	2,270.00	6,820.00	9,090.00
8" Meter and Larger	N/T	At Cost	At Cost	At Cost	At Cost	At Cost	At Cost

SERVICE CHARGES:	Current Charges	Company Proposed	Staff Recommended
Establishment	$15.00	$15.00	$15.00
Establishment (After Hours)	25.00	25.00	25.00
Reconnection (Delinquent)	15.00	15.00	15.00
Reconnection (Delinquent – After hours)	N/A	15.00	15.00
Meter Test (If Correct)	25.00	25.00	25.00
Deposit – Residential Note 1	(1)	(1)	(1)
Deposit – Non-Residential Note 2	(2)	(2)	(2)
Deposit Interest – Note 3	(3)	(3)	(3)
Re-Establishment (Within 12 months) Note 4	(4)	(4)	(4)
Re-Establishment (After Hours) Note 4	(4)	(4)	(4)
NSF Check	15.00	25.00	25.00
Deferred Payment – per Month	12%	1.50%	1.50%
Meter Re-Read (If Correct)	$10.00	$10.00	$10.00
Late Charge per Month	N/T	1.50%	1.50%
Company Locks Damaged by Customer – Note 5	N/T	(5)	(5)
Mains Damaged by Customer – Note 5	N/T	(5)	(5)
Charge of moving customer meters – Per Customer request	N/T	Cost	Cost

Charge of moving customer meters – After hours service charge	Refer to above charges	Cost

N/T = No Tariff

Note 1	Per Commission Rules (R14-2-403.B) Two times the average bill.
Note 2	Per Commission Rules (R14-2-403.B) Two and one-half times the average bill.
Note 3	Per Commission Rules (R14-2-403.B)
Note 4	Months off system times the minimum (R14.2.403.D)
Note 5	Per Commission Rules (R14-2-407.B)

OFF-SITE CAPACITY RESERVATION CHARGE (HOOK-UP FEE)

	Present Rates	Proposed Company	Staff Recommended
5/8" x 3/4" Meter	$875.00	$875.00	-
3/4" Meter	1,050.00	1,050.00	-
1" Meter	1,750.00	1,750.00	-
1-1/2" Meter	3,500.00	3,500.00	-
2" Meter	5,600.00	5,600.00	-
3" Meter	10,500.00	10,500.00	-
4" Meter	17,500.00	17,500.00	-
6" Meter	35,000.00	35,000.00	-

The primary point of disagreement between the parties in the area of rate design is the appropriate distribution of revenues between fixed monthly charges and commodity charges. Staff's rate design would allocate approximately 38.5 percent of revenues to the monthly minimum charge while the Company's design would collect approximately 44 percent from the monthly minimum. (Tr. at 75; Ex. A-3, at 14.) The balance of revenues in each instance would be collected through commodity charges. H2O contends that adoption of Staff's recommendation would result in revenue instability because the Company currently collects approximately 45 percent of revenues from the monthly minimum. Staff, on the other hand, asserts that its rate design position is consistent with prior cases and with typical Staff recommendations to recover between 30 and 40 percent of revenues from the monthly minimum. (Tr. at 75-76.)

We find that Staff's recommended rate design strikes a reasonable balance between encouraging conservation of water through the use of inverted block commodity rates, and protecting revenue stability through collection of almost 40 percent of revenues through monthly minimum charges. As Staff points out, its recommendation in this case is consistent with typical Staff proposals and provides a means for customers to reduce their overall bills by reducing water usage. Staff's recommended rates and charges are reasonable and shall be approved.

* * * * * * * * * *

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

FINDINGS OF FACT

1. On October 1, 2007, H2O filed with the Commission an application for a determination of the current fair value of its utility property and for an increase in its rates and charges for water utility service provided to customers in the Company's certificated service area in parts of Maricopa and Pinal counties, Arizona.

2. On November 2, 2007, Staff filed a Letter of Insufficiency stating that the application did not meet the sufficiency requirements outlined in A.A.C. R14-2-103.

3. On November 14, 2007, the Company filed its response to Staff's Letter of Deficiency.

4. On May 13, 2008, the Company filed an amended application.

5. On June 11, 2008, Staff filed a second Letter of Deficiency informing the Company that the application did not meet the Commission's sufficiency requirements.

6. On June 25, 2008, the Company filed its response to Staff's second Letter of Deficiency.

7. On July 24, 2008, Staff filed a letter indicating the Company's rate application was sufficient, and classifying the Company as a Class B utility.

8. By Procedural Order issued July 30, 2008, the hearing was scheduled to commence on March 9, 2009, the Company was directed to mail to customers and publish notice of the hearing date, and other procedural timelines were established.

9. On October 14, 2008, the Company filed its Affidavits of Publication and Mailing of the Public Notice.

10. On December 2, 2008, H2O filed a Motion to Continue, requesting that the March 9, 2009, hearing date be rescheduled to begin March 23, 2009, due to the unavailability of counsel for

the Company on the previously scheduled hearing date.

11. On December 18, 2008, Staff filed a Motion to Continue, requesting that the hearing date in this matter be rescheduled to commence no sooner than May 4, 2009, and that the other filing deadlines be extended accordingly. Staff stated that the extension was necessary due to corrected schedules that were filed by the Company. H2O agreed with Staff's proposed continuance.

12. On December 22, 2008, the Company filed revised schedules.

13. On January 7, 2009, a Procedural Order was issued rescheduling the hearing to commence on May 4, 2009, with a prehearing conference scheduled for May 1, 2009. Dates for filing of testimony were also changed. The original March 9, 2009 hearing date was maintained for public comment only in accordance with the published notice.

14. On January 23, 2009, Staff filed the Direct Testimony of Brendan Aladi and Katrin Stukov.

15. On March 9, 2009, the hearing was called for the purpose of taking public comment. No members of the public appeared on that date to offer comments.

16. On March 9, 2009, H2O filed the Rebuttal Testimony of Mr. Bourassa.

17. On April 10, 2009, Staff filed the Surrebuttal Testimony of Mr. Aladi.

18. On April 22, 2009, H2O filed the Rejoinder testimony of Mr. Bourassa.

19. The hearing was held on May 4, 2009, as scheduled. At the hearing, both the Company and Staff were represented by counsel. At the conclusion of the hearing, post-hearing briefs and reply briefs were ordered to be filed on a schedule agreed to by the parties.

20. On June 15, 2009, H2O and Staff filed their respective initial post-hearing briefs and on June 29, 2009, H2O and Staff filed reply briefs.

21. As set forth in its amended application, H2O proposes that the Commission adopt rates that would result in an overall reduction in revenues of 3.97 percent. H2O seeks a revenue requirement of $3,244,489 ($134,153 less than is currently authorized), based on a FVRB that is equal to the Company's proposed OCRB of $1,995,695. The Company recommends a cost of equity of 11.45 percent.

22. Staff recommends adoption of an overall revenue requirement of $3,218,705

($159,937 less than currently authorized), based on a FVRB of negative $363,842 and using a 10 percent operating margin approach to achieve the revenue requirement. Staff's recommendation would decrease the current authorized revenues by approximately 4.73 percent.

23. For purposes of this proceeding, we determine that H2O has a FVRB and OCRB of negative $363,842.

24. We find that Staff's recommended $321,871 operating margin based on 10 percent of the overall revenue requirement of $3,218,705, which would reduce H2O's current authorized revenues by $159,937 (approximately 4.73 percent) is reasonable and should be adopted.

25. It is reasonable and within the public interest to require H2O to submit an equity capitalization plan to explain, in detail, how the Company intends to increase its non-customer-supplied investment ratio and improve the current imbalance that exists. H2O will be required to file such a plan, as a compliance item in this docket, within 90 days of the effective date of this Decision. After review of the Company's filing, Staff shall present for the Commission's consideration an Order that addresses the Company's plan, including a discussion of any additional Staff recommendations.

26. Staff's recommended rate design, as described above, is reasonable and should be adopted. Adoption of Staff's recommended revenue requirement and rate design will result in a rate reduction for a residential customer served by a 5/8-inch x ¾-inch meter, with average usage of 3,553 gallons per month, of $5.44 per month (25.5 percent) and a rate decrease of $5.47 (28.11 percent) for a median usage residential customer (2,500 gallons per month).

CONCLUSIONS OF LAW

1. H2O is a public service corporation within the meaning of Article XV of the Arizona Constitution and A.R.S. §§40-250, 40-251, and 40-367.

2. The Commission has jurisdiction over H2O and the subject matter contained in the Company's rate application.

3. H2O's FVRB is negative and is therefore not helpful in setting just and reasonable rates.

4. The rates, charges and conditions of service established herein are just and reasonable

and in the public interest.

ORDER

IT IS THEREFORE ORDERED that H2O, Inc. is hereby authorized and directed to file with the Commission, on or before November 30, 2009, revised schedules of rates and charges consistent with the discussion herein, as set forth below.

MONTHLY USAGE CHARGE:

5/8" x 3/4" Meter	$10.40
3/4" Meter	15.60
1" Meter	25.90
1-1/2" Meter	51.90
2" Meter	83.00
3" Meter	166.10
4" Meter	259.50
6" Meter	519.00
Irrigation 3/4"	15.60
Irrigation 1"	25.90
Irrigation 1-1/2"	51.90
Irrigation 2"	83.00

COMMODITY CHARGES

5/8 x 3/4-inch Meter	
0-3,000 Gallons	$1.43
3,001 – 10,000 Gallons	2.15
Over 10,000 Gallons	2.58
3/4-inch Meter	
0 – 3,000 Gallons	1.43
3,001 – 10,000 Gallons	2.15
Over 10,000 Gallons	2.58
1-inch Meter	
0 to 25,000 Gallons	2.15
Over 25,000 Gallons	2.58
1 1/2- inch Meter	
0 to 50,000 Gallons	2.15
Over 50,000 Gallons	2.58
2-inch Meter	
0 to 80,000 Gallons	2.15
Over 80,000 Gallons	2.58
3-inch Meter	
0 to 160,000 Gallons	2.15
Over 160,000 Gallons	2.58
4 - inch Meter	
0 to 250,000 Gallons	2.15

Over 250,000 Gallons	2.58
6-inch Meter	
0 to 500,000 Gallons	2.15
Over 500,000 Gallons	2.58
3/4-inch Irrigation	
0 to 3,000 Gallons	1.43
3,001 to 10,000 Gallons	2.15
Over 10,000 Gallons	2.58
1-inch Irrigation	
0 to 25,000 Gallons	2.15
Over 25, 000 Gallons	2.58
1 1/2-inch Irrigation	
0 to 50,000 Gallons	2.15
Over 50,000 Gallons	2.58
2-inch Irrigation	
0 to 80,000	2.51
Over 80,000	2.58

SERVICE LINE AND METER INSTALLATION CHARGES:

	Service Line	Meter Installation	Total
5/8" x ¾ " Meter	$415.00	$105.00	$520.00
3/4 " Meter	415.00	205.00	620.00
1" Meter	465.00	265.00	730.00
1-1/2" Meter	520.00	475.00	995.00
2" Meter	N/T	N/T	N/T
2" Turbine Meter	800.00	995.00	1,795.00
2" Compound Meter	800.00	1,840.00	2,640.00
3" Meter			
3" Turbine Meter	1,015.00	1,620.00	2,635.00
3" Compound Meter	1,135.00	2,495.00	3,630.00
4" Meter			
4" Turbine Meter	1,430.00	2,570.00	4,000.00
4" Compound Meter	1,610.00	3,545.00	5,155.00
6" Meter			
6" Turbine Meter	2,150.00	4,925.00	7,075.00
6" Compound Meter	2,270.00	6,820.00	9,090.00
8" Meter and Larger	At Cost	At Cost	At Cost

SERVICE CHARGES:

Establishment	$15.00
Establishment (After Hours)	25.00
Reconnection (Delinquent)	15.00
Reconnection (Delinquent – After hours)	15.00
Meter Test (If Correct)	25.00
Deposit – Residential Note 1	(1)
Deposit – Non-Residential Note 2	(2)
Deposit Interest – Note 3	(3)
Re-Establishment (Within 12 months) Note 4	(4)

Re-Establishment (After Hours) Note 4	(4)
NSF Check	25.00
Deferred Payment – per Month	1.50%
Meter Re-Read (If Correct)	$10.00
Late Charge per Month	1.50%
Company Locks Damaged by Customer – Note 5	(5)
Mains Damaged by Customer – Note 5	(5)
Charge of moving customer meters – Per Customer request	Cost
Charge of moving customer meters – After hours service charge	Cost

Note 1 Per Commission Rules (R14-2-403.B) Two times the average bill.

Note 2 Per Commission Rules (R14-2-403.B) Two and one-half times the average bill.

Note 3 Per Commission Rules (R14-2-403.B)

Note 4 Months off system times the minimum (R14.2.403.D)

Note 5 Per Commission Rules (R14-2-407.B)

IT IS FURTHER ORDERED that the revised schedules of rates and charges shall be effective for all service rendered on and after December 1, 2009.

IT IS FURTHER ORDERED that H2O, Inc. shall notify its customers of the revised schedules of rates and charges authorized herein by means of an insert in its next regularly scheduled billing, or by separate mailing, in a form acceptable to Staff.

IT IS FURTHER ORDERED that H2O, Inc. shall file within 90 days of the effective date of this Decision, as a compliance item in this docket, an equity capitalization plan explaining, in detail, how the Company intends to increase its non-customer-supplied investment ratio and improve the current imbalance that exists.

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IT IS FURTHER ORDERED that, after review of the Company's filing, Staff shall present for the Commission's consideration an Order that addresses the Company's plan, including a discussion of any additional Staff recommendations.

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

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN	COMMISSIONER

COMMISSIONER	COMMISSIONER	COMMISSIONER

IN WITNESS WHEREOF, I, ERNEST G. JOHNSON, Executive Director of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this _______ day of ___________, 2009.

____
ERNEST G. JOHNSON
EXECUTIVE DIRECTOR

DISSENT _______________________

DISSENT _______________________

SERVICE LIST FOR: H20, INC.

DOCKET NO.: W-02234A-07-0557

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ARIZONA CORPORATION COMMISSION
REGULATION R14-2-103

APPENDIX B
RATE BASE SCHEDULES

ARIZONA CORPORATION COMMISSION
REGULATION R14-2-103
APPENDIX
ILLUSTRATIVE SCHEDULE FORMAT

Schedule: B-1
Title: Summary of Original Cost and RCND Base Elements

Explanation:
Schedule showing elements of adjusted original cost and RCND rate bases.

Required For:
All Utilities [X] Special Reqmt. [ ]
Class A [ ]
Class B [ ]
Class C [ ]
Class D [ ]

		Original Cost Rate Base*	RCND Rate Base*
1.	Gross Utility Plant in Service$	$	
2.	Less: Accumulated Depreciation		
3.	Net Utility Plant in Service	$ (a)	$ (b)
	Less:		
4.	Customers' Advances for Construction	(c)	(c)
5.	Contributions in Aid of Construction	(c)	(c)
	Add:		
6.	Allowance for Working Capital	(d)	(d)
7.	Total Rate Base	$ (e)	$ (e)

* Including pro forma adjustments

Note: For combination utilities, above information should be presented in total and by department.

Supporting Schedules:
(a) B-2 (d) B-5
(b) B-3
(c) E-1
(e)

Recap Schedules:
A-1

DECISION NO. ________