ORIGINAL

0000104396

BEFORE THE ARIZONA CORPORATION COMMISSION

RECEIVED

2009 OCT 30 A 11: 28

AZ CORP COMMISSION
DOCKET CONTROL

KRISTIN K. MAYES
CHAIRMAN
GARY PIERCE
COMMISSIONER
SANDRA D. KENNEDY
COMMISSIONER
PAUL NEWMAN
COMMISSIONER
BOB STUMP
COMMISSIONER

| | |
|---|---|
| IN THE MATTER OF THE APPLICATION OF ARIZONA WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY, AND FOR ADJUSTMENTS TO ITS RATES AND CHARGES FOR UTILITY SERVICE AND FOR CERTAIN RELATED APPROVALS BASED THEREON. | Docket No. W-01445A-08-0440 |

Arizona Corporation Commission
DOCKETED
OCT 30 2009
DOCKETED BY

# RUCO'S REPLY BRIEF

## INTRODUCTION

The Residential Utility Consumer Office ("RUCO") submits this Reply Brief on the matters raised at Arizona Water Company's ("AWC" or "Company's") recent rate hearing.

### A. UNRESOLVED RATE BASE ISSUES

#### 1. <u>The Commission should exclude Scenic Highway 179 Project from Rate Base.</u>

The Company seeks 100 percent rate base treatment of post test year plant associated with the replacement and relocation of water lines and plant along Highway 179. The Company admits that only 8 percent of the project was completed on or about July 1, 2008, six months post test year.[1] Because only 8 percent of the improvements to Scenic Highway 179 Water Relocation project were completed by July 1, 2008, RUCO asserts that 92 percent of the costs should not be included in rate base.[2] Highway 179 Water Relocation project were completed by July 1, 2008, RUCO asserts that 92 percent of the costs should not be included in rate base.[3]

In its brief, the Company asserts that the waterline relocation is a health and safety issue similar to an arsenic treatment plant. It is not. The Company did not choose to relocate lines along Scenic Highway 179 to address an unresolved health and safety issue or because of a federal mandate.[4] The Company admits that it made a business decision to relocate the lines to avoid the possibility of the State's condemnation of its waterlines.[5] It was a business decision, not a health and safety mandate.

The Company complains that it paid for the ADOT project in June 2007, during the test year, and therefore the plant should be included in rate base. The question of when plant is included in rate base is not when the Company pays for it, but when it becomes used and useful to ratepayers. The record is clear. The Scenic Highway 179 project was not used and useful to ratepayers in the test year.[6] Moreover, the project was only 8 percent completed six months post test year.[7] Because the Company undertook the project as a

---

[1] See Exhibit R-15 Arizona Water's Response to RUCO's DR 8.01.

[2] Company asserts that RUCO's position is to disallow 65 percent or $665,000 from rate base. In fact as clearly set forth in the testimony of Tim Coley and final schedules regarding Rate Base Adjustment No. 5, RUCO seeds to disallow 92 percent of the plant and associated accumulated depreciation or deduct $1,739,426 from plant and $15,568 from Accumulated Depreciation. See final schedule regarding Adjustment No. 5 attached hereto as Exhibit A.

[3] *Id.*

[4] *Id.*

[5] See Exhibit A-20, Rebuttal Testimony of Joel Reiker at 20-21.

[6] See Exhibit R-15 Arizona Water's Response to RUCO's DR 8.01.

[7] *Id.*

business decision to avoid condemnation by the State, and only 8 percent of the project was completed, and used and useful to ratepayers by July 2008, RUCO recommends disallowance of the remaining 92 percent of the project from rate base. More specifically, RUCO recommends the Commission reduce rate base by $1,739,426 and decrease Accumulated Depreciation by $15,568.

**2. The Commission should exclude the Pinewood electric panel from Rate Base.**

The Company claims that it invested $40,000 in the test year to replace an old electrical panel in its Pinewood system during the test year.[8] Again, the Company misses the point. The question is not when the Company paid for the improvement; the issue is when the Pinewood Electric Panel became used and useful to ratepayers. The undisputed testimony is that the Pinewood Electric Panel was not placed in service until July 10, 2009, eighteen months after the end of the test year.[9] RUCO and Staff concur that the electric panel was not used and useful during the test year.[10] Based on the foregoing, RUCO and Staff agree that the electric panel should be excluded from rate base.[11]

**3. The Commission should exclude Valley Vista Well No. 13 from Rate Base.**

The Company claims that Valley Vista Well No. 13 should be included in rate base. Initially, the Company reported that it put Valley Vista Well No. 13 and pump in service in November 2008.[12] During the hearing, the Company's witness, Frederick Schneider

---

8 *See* Exhibit A-14.
9 T: 979-978.
10 *Id.*
11 *Id.*
12 *See* Exhibit S-4 Arizona Water's Response to Staff DR BKB 11.16

testified that he saw the well and pump in place by the fall of 2007.[13] On further review, Mr. Schneider submitted documentation and testified that the well and pump were in place by May, 2008.[14]

In support of its position, the Company cites several cases for the proposition that "the Commission has frequently included post test year plant in rate base when such plant is revenue neutral (i.e. constructed to serve existing customers) and placed in service within a reasonable time after the test year to allow for audit and inspection."[15] This case is distinguishable from the cases cited by the Company for two reasons. First, Valley Vista Well No. 13 was virtually unused by the current ratepayers in the post test year. In 2008, the Company used 2 acre feet or less than 1 percent of the well's capacity.[16]

Second, RUCO did not have adequate time to audit and inspect the post test year plant. RUCO typically opposes post test year plant, which is placed in service more than six months after the conclusion of the test year.[17] Prior to the hearing, in response to data request BKB 11.16, the Company admitted that the well was not in service until November 2008, eleven months post test year.[18] Accordingly, RUCO did not need to inspect the plant to support its position because the Company's admission supported RUCO's position. However, during the second and third day of testimony, Mr. Schneider changed positions and claimed the plant was completed, or in service, in Fall 2007 and/or May, 2008.[19] Mr. Schneider submitted no further evidence as to when the plant went into service

---

[13] T: 781-782.
[14] _See_ Exhibits A-32 and 33.
[15] _See_ Company's Closing Brief at 16, footnote 59.
[16] _See_ RUCO's Closing Brief at 9-10.
[17] _See_ Exhibit R-18 Coley's Direct Testimony at 17-18 and Exhibit R-19 Coley's Supplemental Testimony at 11-13.
[18] _See_ Exhibit S-4 Arizona Water's Response to Staff DR BKB 11.16
[19] T: 781-782. _See_ also Exhibits A-32 and 33.

other than this vague reference.[20] His change in position came so late that RUCO did not have time to audit and inspect. Mr. Coley, RUCO's witness, testified that he could not verify the Company's testimony.[21] In fact, he testified that the Arizona Department of Water Resources ("ADWR") well registry indicated no pump had been installed at Valley Vista Well No 13.[22] The law requires that the Company notify ADWR within 30 days of installing the pump.[23] The Company could produce no documentation demonstrating it notified the ADWR of the pump installation. Hence, the Company has failed to meet its burden of establishing when the plant actually was completed, in service, and used and useful. Because Valley Vista Well No. 13 was not used and useful to current ratepayers in the test year or in the year subsequent, and because RUCO did not have time to inspect and audit Valley Vista Well No. 13, the post test year plant should not be included in rate base.

#### 4. <u>The Commission should exclude plant held for future use.</u>

The Company seeks to include in rate base the plant identified in Exhibit A-12 and A-13, as plant held for future use. RUCO objects to the inclusion of the plant held for future use in utility plant in service. First, the Company failed to properly identify the plant prior to Hearing, making it difficult, if not impossible, for RUCO and Staff to verify any of the information supplied therein.[24] Second, the plant held for future use does not meet the used and useful standard.[25] Including plant held for future use would also be inconsistent with prior rulings of the Commission.

---

[20] *Id.*
[21] T: 929-930.
[22] *See* Exhibit R-14 Well Registry for Well 212110 Valley Vista Well #13.
[23] A.R.S. §45-600B
[24] T: 913.
[25] T: 971-72.

In Decision No. 64282, the Commission determined that plant held for future use may not be included in rate base until the plant is being used for the provision of utility service.[26] In this instance, the Company acknowledges that plant held for future use is not currently used and useful in the provision of utility service. The Company's plans for the plant in question are contingent upon improvements in the housing market, completion of construction, improvement in earnings, and resolution of bankruptcy filings of contracted construction companies.[27] As Tim Coley, RUCO's witness testified, the Company's plans can only be described as speculative because the plans are contingent on events which may or may not occur in the next 2-10 years.[28] As such, the plant is not used and useful, does not meet the standards established by the Commission in Decision No. 64282 and should be excluded from utility plant in service.

The Company asserts that at least 15 of 20 jurisdictions surveyed permit rate base treatment of plant held for future use.[29] Notably, Arizona is not one of them. As discussed above, the Commission has denied the inclusion of plant held for future use.[30] In Arizona, plant must be used and useful to receive rate base treatment. In this instance, the plant in question is neither used nor useful now. Moreover, in the discussion of other jurisdictions, the Company fails to point out that many of the jurisdictions, which permit the inclusion of plant held for future use do not follow an historical test year or define rate base as used and useful.[31] The other jurisdictions permit the use of prospective or forecasted test

---

26 *In the Matter of Arizona Water*, Docket No.W-01445A-00-0962, Decision No. 64282.
27 T: 918-919. *See also* A-10 Rebuttal Testimony of Frederick K. Schneider at 22-28.
28 T: 918-919.
29 *See* Company's Closing Brief at 19-22.
30 *In the Matter of Arizona Water*, Docket No.W-01445A-00-0962, Decision No. 64282
31 See e.g. Maine ME ST T. 35-A M.R.S.A. §303 (used or required to be used), Mars Hill & Blaine Water Co. v. Public Utilities Commission, 397 A.2d 570(Me.1979)(Commission not limited to one year to compute future rates), Mississippi, State of Mississippi v. Mississippi Public Service Commission,

years. The holdings of jurisdictions which have forecasted or prospective test years and permit the inclusion of plant held for future use is not dispositive, here. It is not an apples to apples comparison as the Company suggests because Arizona uses an historical test year. The Commission has specifically held that plant, which is not used and useful, is not entitled to rate base treatment.[32] There is nothing in the argument offered by the Company that justifies a departure from the prior ruling of the Commission.

### 5. The Commission should reject the Company's request to deduct from CIAC, amount equal to the CWIP balances removed from Rate Base.

The Company has agreed to remove two wells paid for with contributions in aid of construction ("CIAC") from plant in service along with the corresponding CIAC entries. RUCO agrees that the two wells should be removed from plant in service, but objects to removal of the corresponding CIAC.[33] Mr. Coley testified that the Company's proposal to reduce CIAC associated with construction work in progress ("CWIP") is inconsistent with the Commission's Decision No. 70011 and violates the Commission's rule A.A.C. R14-2-103.[34] As the Commission stated in Decision 70011, in agreement with Staff and RUCO, "advances represent customer supplied funds that are properly deducted from the Company's rate base

---

435 S 2d 608, 614,(Miss 1983)(MPC Rules and Regulation Governing Public Utility Service, Rule 7, Application to Adjust Rates allows the use of projected test year), Rhode Island, Narragansett Elec. Co. v. Harsch 117 RI 395(1977)(permits adjusted test year balanced by forecasted economic factors); Texas; 30 TX ADC §291.34(alternative ratemaking);

[32] *In the Matter of Arizona Water*, Docket No.W-01445A-00-0962, Decision No. 64282

[33] T: 914-915.

[34] T: 916-917. *See also*, Exhibit R-23, *In the Matter of UNS Gas, Inc.*, Docket No. G-04204A-06-0463, Decision No. 70011 at 9, *cf. In the Matter of APS*, Decision No. 54247 at 19-20. See also R-24, A.A.C R14-2-103, Schedule B-1.

in compliance with the Commission's own rules." Indeed, the Commission's own rules contemplate that CIAC be deducted from rate base.[35] The Commission concluded that:

> *[T]here was no extraordinary circumstance justifying the inclusion of CWIP in rate base because the plant required to serve new customers will help produce revenues; [the utility] had a means, though accrual of AFUDC, to mitigate the effect of CWIP investment; allowance of CWIP would undermine the balance of test year revenues and expenses; and the regulatory lag inherent in utility regulation may provide benefits to the extent that such items as plant retirements and accumulated depreciation occur between test periods and thereby help to mitigate periods of higher plant investment associated with customer growth.*[36]

The Commission's ruling in Decision No. 70100 is equally applicable to the facts of this rate case because there were no extraordinary circumstances justifying the inclusion of CWIP in rate base or the deduction of equal amounts from CIAC. Accordingly, RUCO recommends the Commission deny the Company's request for rate base recognition of CWIP and its request to deduct from CIAC an amount equal to CWIP.

### B. UNRESOLVED OPERATING INCOME ISSUES

RUCO fully analyzed the issues related to normalization of overtime and related expenses in its Closing Brief.[37] RUCO incorporates those arguments by reference. Based on those arguments, the Commission should adopt RUCO's adjustment normalizing overtime and related income tax, 401k and insurance expenses.

### C. UNRESOLVED COST OF CAPITAL ISSUES

#### 1. <u>The Commission should reject the Companys Market Risk Premium ("MRP") arguments.</u>

---

35 *<u>Id.</u>*
36 <u>See</u> Exhibit R-23, <u>*In the Matter of UNS Gas*</u>, Docket No. G-04204A-06-0463, Decision No. 70100 at 7.
37 <u>See</u> RUCO's Closing Brief at 10.

RUCO fully briefed the issues related to its determination of a market risk premium in its Closing Brief.[38] RUCO incorporates those arguments by reference. The Commission should reject the Company's MRP argument and its recommended cost of equity derived therefrom. The Commission should also adopt RUCO's recommended cost of common equity, which is derived from the MRP included in Mr. Rigsby's CAPM analysis.

2. **<u>The Commission should reject the Company's Multi-Stage Discounted Cash Flow ("DCF") model because gives equal weight to unreliable long-term growth projections.</u>**

The Company's cost of capital witness, Dr. Zepp, uses a multi-stage DCF model, which relies, in part on long-term growth projections. Long-term growth projections are calculated in perpetuity and are not as reliable as near term growth estimates, such as those utilized by Staff and RUCO in their constant growth DCF model.[39] Furthermore long-term growth projections used in the multi-stage DCF model are not reflective of the time periods in which utilities file rate cases (i.e. 3-5 years).[40]

The Company claims that the Federal Energy Regulatory Commission ("FERC") uses multi-stage DCF models. Although FERC may rely on multi-stage DCF models, William Rigsby, RUCO's cost of capital witness testified, FERC places more weight to the near term projections used in a multi-stage DCF than the long-term projections.[41] The FERC's rationale is that near term estimates of growth are more predictable and deserve more weight than long-term growth estimates. The Company's multi-stage DCF model which

---

38 *Id.* at 10-17.
39 *See* Exhibit 33, Rigsby's Surrebuttal Testimony 7-8.
40 *Id.*
41 *Id.*

equally weighs near and long-term growth projections is unreliable.[42] Long-term growth projections are not as reliable as short-term growth projections.[43] Because the Company's multi-stage DCF model is computed on equally weighted long-term growth projections, which are less reliable, the Commission should reject it. Instead, the Commission should adopt RUCO and Staff's constant growth DCF models, which are based on reliable and predictable near term growth projections.

### 3. **The Commission should adopt RUCO's cost of equity because it is supported by the most recent Value Line estimates and is most reliable.**

RUCO calculated the cost of equity at 8.33 percent.[44] The report dated April 24, 2009 was the most recent report issued by Value Line.[45] In its report, Value Line projected return on book equity for 2009 and 2010 as 6.5 percent and 7.0 percent, respectively for the water utility industry.[46] Value Line's projected return on book equity for 2009 is 183 basis points lower than RUCO's recommended cost of common equity. Its projection for 2010 is 153 basis points lower than RUCO's recommended cost of common equity. Value Line projects the return on book equity for 2012-2014 as 7.55 percent or 83 basis points lower than RUCO's recommended cost of common equity.[47] Although the Company may complain that RUCO's 8.33 percent recommended cost of common equity is too low, it is in fact higher than Value Line's 6.5 percent-7.5 percent projections for return on book equity for the period 2009 to 2014. In support of its projections, Value Line reasoned:

> *The Water Utility industry looks to be as good a place to be at this juncture. We suspect that the stocks here will be far more stable than the broader market*

---

42 *Id.*
43 *Id.*
44 *Id.*
45 *See* Exhibit 32, Rigsby's Direct Testimony, Attachment A.
46 *Id.*
47 *Id.*

*indices with the aforementioned attributes providing somewhat of an investment safehaven for the coming six to 12 months.*

Value Line's most recent report for the water utility industry was issued on October 23, 2009.[48] Although it was not available at the time of the hearing, it does lend support to RUCO's calculation of the cost of common equity and is attached for reference. In Value Line's most recent report of the water industry, it projects the return on book equity for 2009-2010 as 7.0 percent and for 2012-2014 as 7.5 percent.[49] Again, Value Line's projections for return on book equity for the periods of 2009-2010 and 2012-2014 are 133 and 83 basis points lower than RUCO's recommended cost of common equity. In concluding its report, Value Line explained:

> *This industry is a good place for cautious investors looking to park themselves until a sustained market recovery is evident. Water utility stocks are historically more recession proof than the broader market, with their steady dividend growth, reducing turbulence in share price and padding returns.*[50]

Although RUCO's recommended cost of equity is higher than Value Line's objective projections of return on book equity, RUCO's recommended cost of cost of equity is closer to Value Line's estimate than the estimates of Staff and the Company. The Commission should reject the recommended cost of equity estimates of the Company and Staff and accept RUCO's 8.33 percent recommended cost of equity.

## D. UNRESOLVED RATE DESIGN ISSUES

### 1. <u>RUCO's rate design can be modified to generate up to $55,874,427.</u>

RUCO supports a cost of service based rate design, but if the Commission considers consolidation to be in the public interest, RUCO supports the rate consolidation for

---

48 <u>See</u> *Value Line Water Utility Industry Report* dated October 23, 2009 attached hereto as Exhibit B.
49 <u>*Id.*</u>
50 <u>*Id.*</u>

all 17 systems as described in Option F set forth in the testimony of RUCO Director, Jodi Jerich.[51] Option F is full consolidation of the monthly minimum charge with individual commodity rates. Most notably, Option F limits increases in rates to no more than $5.00/month. [52]

In its brief, Staff expresses concern that Option F may be unworkable with any revenue requirement other than RUCO's required revenue requirement of $50,862,959.[53] More specifically, Staff asserts that RUCO's limit of a $5.00/month limit on rate increases could not be maintained if the Commission adopted Staff's required revenue of $53,253, 594.[54]

RUCO witness, Rodney Moore testified that Option F could be modified to eliminate decreases under the current proposal and generate additional revenues.[55] To assuage the Staff's concerns, RUCO has calculated the highest amount of revenue, which could be generated by modifying Option F as suggested by Mr. Moore. Its calculations are attached hereto as Exhibit C. [56] If RUCO's Option F was modified to eliminate all decreases, but limited all increases to $5.00/month, RUCO' s Option F could generate up to $55,874,427 in required revenue.[57] Because RUCO's Option F could be modified to cover Staff's proposed required revenue, there should be no concern that Option F is unworkable.

2. **<u>RUCO's rate design mitigates rate shock while maintaining the correct price signals.</u>**

---

[51] *See* Exhibit R-36, Amended Surrebuttal Testimony of Jodi Jerich at 23.
[52] *Id.* and *See also* Exhibit R-32 Rigsby's Direct Testimony WAR-1
[53] *See* Staff's Closing Brief, page 47.
[54] *Id.* at 2 and 47.
[55] T:872
[56] *See* Revenue Generated is all 5/8" Residential Customers received maximum increase, modified Option F, attached as Exhibit C.
[57] *Id.*

The Company's and Staff's phased consolidation rate designs send the wrong price signals and do not mitigate rate shock as well as RUCO's Option F. For example in a cost of service rate design, Stanfield would incur increases of 108.35 percent.[58] Under the Company's partial consolidation proposal, Stanfield would enjoy a 14.58 percent decrease.[59] Likewise, under Staff's phased consolidation proposal, Stanfield would enjoy an 18.57 percent decrease.[60] Clearly, this is the wrong price signal. Furthermore, the purpose of rate consolidation should not eliminate all cost recovery obligations for a system. RUCO's consolidation plan mitigates the rate shock of Stanfield's 108.35 percent cost of service increase, but maintains the correct price signal by requiring a $5.00/month or 11.74 percent increase in the Stanfield system.[61]

Under the cost of service rate design, Miami ratepayers would suffer a 39.20 percent increase in rates.[62] The Company and Staff's proposals mitigate the increase, but send the wrong price signal. The Miami ratepayers would enjoy a 7.39 percent decrease under the Company's proposal and a 2.13 percent decrease under the Staff's proposal.[63] Under RUCO's plan, Miami's 39.20 percent cost of service increase is mitigated, but Miami ratepayers would still incur a $5.00/month or 14.59 percent increase in rates.[64]

Winkelman's ratepayers would suffer a 30.82 percent increase under the cost of service rate design.[65] Although a mitigation of rate shock is a goal of consolidation, neither the Company or Staff's phased consolidation models provides any relief to

---

[58] *See* Exhibit R-36, Exhibit B dated 8/28/09, which evaluates each consolidation model using the required revenue recommended by RUCO in Surrebuttal Testimony.
[59] *Id.*
[60] *Id.*
[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] *Id.*
[65] *Id.*

Winkelman's ratepayers. Under the Company's proposal, Winkelman's ratepayers receive no relief. They will continue to suffer a 30.82 percent increase in rates under the Company's consolidation rate design.[66] More disturbingly, under Staff's proposal, Winkelman's ratepayers would incur an 85.14 percent increase in rates.[67] Not only does Staff's proposal fail to mitigate the 30.82 percent cost of service increase, it adds an additional 50 percent increase. RUCO's plan mitigates Winkelman's 30.82 percent cost of service increase, but maintains the correct price signal. Under Option F, Winkelman's ratepayers would still incur a $5.00/month or 21.10 percent increase in rates.[68] RUCO's proposal, Option F, mitigates the rate shock and sends the correct price signals. Only RUCO's plan mitigates the rate shock in Stanfield, Miami and Winkelman systems, while maintaining the correct price signals.

### 3. <u>RUCO's consolidation rate design is easier to administer than the Company's phased consolidation multi-tariff rate design.</u>

The Company claims that RUCO's consolidation rate design is not a consolidation model. In its brief, the Company refers to Option F as a multi-tariff Pricing Model, while referring to its own multi-tariff rate design as a consolidation rate design. The Company's argument is refuted by the testimony of its witness, Joseph D. Harris. Mr. Harris admitted that RUCO's proposal was no different from the Company's phased consolidations.[69]

RUCO does not dispute that its consolidation rate design includes a single monthly charge and system-specific commodity rates, but RUCO's consolidation model is

---

66 *Id.*
67 *Id.*
68 *Id.*
69 T: 230, 312-313.

easier to administer because it contains one monthly minimum charge and overall, fewer individual tariffs than the Company's rate design as it relates to residential ratepayers. Furthermore, the Company's own *convoluted consolidation* plan does little, if anything, to address the Company's concern of being overburdened by having to keep track of its accounts for each system.

In all, RUCO's model includes 18 separate rates (i.e. one monthly minimum and seventeen commodity rates).[70] However, RUCO's consolidation rate design is less complicated than the Company's rate design in that all ratepayers have the same monthly minimum charge.[71] The Company's multi-tariff proposal includes full consolidation of the Overgaard/Lakeside group, which will share the same monthly minimum charge and commodity rates, but will be different from the proposed monthly minimum charge and commodity rate of the fully consolidated Superstition/Miami group.[72] The Company's rate design includes the phased consolidation of some systems, which will share the same monthly minimum charges, but have different commodity rates: Casa Grande/Coolidge/Stanfield group,[73] Bisbee/Sierra Vista group, and the Sedona/Rimrock/Pinewood group.[74]

In addition to full and phased consolidation groups, the Company's rate design also includes individual monthly charges and commodity rates for the five stand-alone systems: White Tanks, Ajo, San Manuel, Winkelman, and Oracle systems.[75] In total, the

---

[70] T: 1476.
[71] *Id.*
[72] T: 230-231.
[73] Although Casa Grande and Coolidge will share the same monthly minimum and commodity charges, they are in a phased consolidation with Stanfield, which will have a different commodity rate, but the same monthly minimum charge.
[74] T: 230.
[75] T: 234-235.

Company's rate design includes 10 different monthly charges and 12 different commodity rates, or 22 different rates.[76] From RUCO's perspective, its rate design is far less complicated, is easier to administer and facilitates recordkeeping.

### 4. The Commission should adopt RUCO's requirement of system-specific recordkeeping in this first step toward full consolidation.

In its brief, the Company opposes RUCO's Option F claiming that its proposal would require the Company to submit the records for all systems each time it wishes to modify the rates for one of its systems. The Company is correct, but fails to recognize the necessity for such a requirement. RUCO's proposal will prevent the Company from cherry-picking non-performing systems for future rate cases, while ignoring the revenues of systems which may be over-earning. To ensure the Commission, Staff and RUCO are able to identify instances in which the Company's systems are over-earning, the Company should be required to maintain and disclose system-specific records.

RUCO's recordkeeping provision requires nothing more than already required for ordinary business recordkeeping. Mr. Rigsby testified that the Company needs to keep system-specific records to keep track of assets, asset additions and retirements and costs that are specific to certain systems, to comply with the terms of their union contract and for purposes of ADEQ and Department of Water Resource regulations.[77] Given that the Company will need to keep system-specific records for regulatory and non–regulatory purposes, the system-specific recordkeeping requirement under Option F is a non-issue.

The Company complains that maintaining the records for 17 systems for ratemaking and regulatory purposes would negate the administrative and regulatory benefits

---

[76] *Id.*
[77] T: 1399-1400

of consolidation. However, none of the Company's witnesses could quantify the benefit they expected to lose by maintaining system-specific records.[78] Because the Company is unable to identify the purported savings lost with system-specific recordkeeping, the Commission should not hesitate to impose the system-specific recordkeeping requirement, at least for the current case.

The Company argues that its history with consolidation of non-contiguous systems like Sedona and Valley Vista demonstrate that there is no need to maintain system-specific records. RUCO begs to differ. The Company's recordkeeping of plant in its Casa Grande/Tierra Grande and Sedona/Valley Vista systems has been at issue in this case.[79] The Company should be required to maintain system-specific records to ensure the multiple errors discovered in this case are not repeated, and that if errors occur, the Staff and RUCO have sufficient information to audit the records and identify the errors.

## CONCLUSION

Based on the foregoing, RUCO hereby recommends the exclusion from rate base, the post test year plant and plant held for future use. RUCO also recommends that the Commission exclude CWIP from rate base and reject the Company's request to deduct from CIAC amounts equal to CWIP. RUCO further recommends the normalization of overtime and related income tax, insurance and 401K expenses because test year overtime expenses were clearly in excess of normal overtime expenses. RUCO requests the Commission adopt its recommended cost of equity of 8.33% and its recommended WACC of 7.33%, rejecting

---

[78] T: 1480-1481
[79] T: 743-745

the Company's and Staff's recommendations and underlying arguments. Last, RUCO requests that the Commission adopt it consolidation rate design.

**RESPECTFULLY SUBMITTED** this 30th day of October, 2009

Michelle L. Wood
Counsel

AN ORIGINAL AND THIRTEEN COPIES
of the foregoing filed this 30th day
of October, 2009 with:

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

COPIES of the foregoing hand delivered/
mailed this 30th day of October, 2009 to:

Dwight Nodes
Asst. Chief Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Janice Alward, Chief Counsel
Legal Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Steven M. Olea, Director
Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Robert W. Geake
Arizona Water Company
3805 N. Black Canyon Highway
Phoenix, Arizona 85015-5351

Norman James
Jay L. Shapiro
Fennemore Craig
3003 North Central Avenue, Suite 2600
Phoenix, Arizona 85012-2913

Nicholas J. Enoch
Jarrett J. Haskovec
Lubin & Enoch, PC
349 N. Fourth Avenue

Phoenix, Arizona 85003

Michele Van Quathem
Ryley Carlock & Applewhite
One North Central Avenue, Suite 1200
Phoenix, Arizona 85004-4417

By Ernestine Gamble
Ernestine Gamble

# EXHIBITS

# EXHIBIT A

Arizona Water Company
Docket Nos. W-01445A-08-0440
Test Year Ended December 31, 2007

Sedona System
RUCO Rate Base Adjustment #5
Per Informal Data Response May 13, 2009

**POST TEST YEAR PLANT PER INFORMAL DATA RESPONSE MAY 13, 2009**

| DESCRIPTION | AMOUNT |
|---|---|
| ADOT Portion of Hwy. 179 Improvement | $ 1,890,680 |
| RUCO Allowed Percentage of Project 1-4267b | 8% |
| RUCO Allowed Amount of Project 1-4267b | 151,254 |
| RUCO Plant Adjustment Adjustment | $\boxed{(1,739,426)}$ |
| RUCO Accumulated Depreciation Adjustment | $\boxed{15,568}$ |

# WATER UTILITY INDUSTRY

**INDUSTRY TIMELINESS: 72 (of 98)**

**There has not been much change in the Water Utility Industry since our last review in July. Providers continued to reap the benefits of an increasingly favorable regulatory backing, with most in the group posting solid top- and bottom-line growth in the second quarter (September results were not out as of the date this issue was published).**

**However, the industry has fallen well into the bottom half of our *Survey* for Timeliness, as share-price gains paled in comparison to those enjoyed by the seemingly revitalized broader market. We suspect that water utility stocks will continue to lose some of their shine in the months ahead for similar reasons, as hopes of economic stability prompt many to look outside this relative safe-haven in hopes of securing wider gains. Making matter worse, earnings growth is likely to slow in the second half of the year and remain weak thereafter, due to tougher comparisons and burgeoning operating costs.**

**Longer-term growth prospects are not much better either. Despite the brighter regulatory landscape, infrastructure costs are expected to continue ramping up due to aging water systems, geographic expansion, and increasingly stringent EPA regulations. These, along with the subsequent financing expenses, will offset most of the aforementioned help, and thus limit appreciation potential going forward. As a result, most of the stocks in this segment offer minimal 3-to 5-year appeal.**

## Bright Demand Picture

These utilities have the ultimate job security. Water is a necessity, a fact that cannot be changed no matter what. Recognizing that a community's well being is closely tied to a providers health, many state regulatory bodies that were once antagonists, have changed their tune and taken on a more business approach. These authorities, which were put in place to help maintain a balance of power between customers and providers and to ensure fair business practices, are now handing down more favorable rulings. Responsible for reviewing and ruling on general rate requests made by utilities to help recover costs, they hold tremendous power and can potentially make or break a company. The recent about face in demeanor creates a far more favorable climate and augurs well for providers.

## Alarming Costs

That said, the water utility industry has some issues to contend with. Infrastructures are getting older and becoming inadequate in many cases. Some will require heavy investment in order to make the necessary repairs, while EPA standards get tougher due to the potential threat of bioterrorism. In all, infrastructure costs are estimated to amount to hundreds of millions of dollars over the next decade. Unfortunately, most operating in this space are laden with debt and strapped for cash. They will be forced to seek outside financing in order to meet the growing capital outlays, with the higher interest rate costs and greater share counts thwarting shareholder returns. Note, however, that, as a result of the industry's capital intensive nature, consolidation is white hot. Those with the flexibility to meet its commitments have ample opportunity to make deals and grow their customer base.

## Conclusion

This industry is a good place for cautious investors looking to park themselves until a sustained market recovery is evident. Water utility stocks are historically more recession proof than the broader market, with their steady dividend growth reducing turbulence in share price and padding returns. However, those with a penchant for growth will probably want to take a pass, opting for an area with more upside. There are a couple of issues here that stand out for 3- to 5-year appreciation potential, namely *Aqua America* and *Southwest Water Company*, but the latter's Below Average (4) Safety rank and poor Financial Strength rating may evoke some apprehension. Meanwhile, *Aqua*'s dependence on an aggressive acquisition tendency to drive gains may well need to be tempered if finances continue to deteriorate. *American Water Works* is another interesting option, but its short trading history and lack of performance indicators should scare off most. As always, we advise potential investors to read the individual reports of each stock before making a financial commitment.

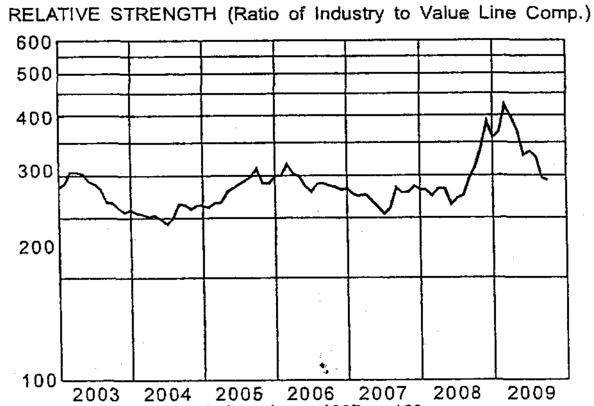
*Andre J. Costanza*

Composite Statistics: Water Utility Industry

| 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | | 12-14 |
|---|---|---|---|---|---|---|---|
| 1256.9 | 3454.1 | 3702.5 | 3913.8 | *4180* | *4475* | Revenues ($mill) | *5425* |
| 148.2 | d5.8 | d183.0 | 352.7 | *425* | *485* | Net Profit ($mill) | *625* |
| 40.5% | NMF | NMF | 37.0% | *38.0%* | *39.0%* | Income Tax Rate | *40.0%* |
| 1.1% | NMF | NMF | 6.5% | *8.0%* | *10.0%* | AFUDC % to Net Profit | *15.0%* |
| 50.4% | 54.0% | 51.0% | 52.6% | *54.0%* | *52.5%* | Long-Term Debt Ratio | *50.0%* |
| 49.5% | 45.9% | 49.0% | 47.4% | *46.0%* | *47.5%* | Common Equity Ratio | *50.0%* |
| 3053.8 | 12113.9 | 12985.9 | 12629.1 | *13600* | *14125* | Total Capital ($mill) | *16250* |
| 4200.7 | 13308.3 | 14315.2 | 15356.1 | *16180* | *16950* | Net Plant ($mill) | *19375* |
| 6.3% | 1.6% | .2% | 4.3% | *5.0%* | *5.0%* | Return on Total Cap'l | *6.0%* |
| 9.8% | NMF | NMF | 5.9% | *7.0%* | *7.0%* | Return on Shr. Equity | *7.5%* |
| 9.8% | NMF | NMF | 5.9% | *7.0%* | *7.0%* | Return on Com Equity | *7.5%* |
| 3.7% | NMF | NMF | 2.9% | *3.0%* | *3.5%* | Retained to Com Eq | *4.5%* |
| 62% | NMF | NMF | 51% | *65%* | *62%* | All Div'ds to Net Prof | *60%* |
| 29.4 | NMF | NMF | | *Bold figures are Value Line estimates* | | Avg Ann'l P/E Ratio | *22.0* |
| 1.57 | NMF | NMF | | | | Relative P/E Ratio | *1.45* |
| 2.1% | 2.0% | 2.3% | | | | Avg Ann'l Div'd Yield | *2.5%* |

Water Utility

RELATIVE STRENGTH (Ratio of Industry to Value Line Comp.)




Index: June, 1967 = 100

# EXHIBIT C

Arizona Water Company
Docket No. W-01445A-08-0440
Test Year Ended December 31, 2007



**RATE DESIGN AND PROOF OF RECOMMENDED REVENUE**
**REVENUE GENERATED IF ALL AVERAGE 5/8" RESIDENTIAL CUSTOMERS RECEIVED MAXIMUM $5.00 INCREASE**

## TOTAL COMPANY BY CUSTOMER CLASS - SUMMARY SCHEDULE

| LINE NO. | DESCRIPTION | (A) GENERATED REVENUE |
|---|---|---|
| 1 | RESIDENTIAL CUSTOMERS | $ 41,126,172 |
| 2 | COMMERCIAL CUSTOMERS | 10,548,084 |
| 3 | INDUSTRIAL CUSTOMERS | 959,536 |
| 4 | PRIVATE FIRE SERVICE CUSTOMERS | 189,150 |
| 5 | OTHER WATER REVENUE CUSTOMERS | 1,500,184 |
| 6 | TOTAL REVENUE | $ 54,323,126 |
| 7 | MISCELLANEOUS REVENUE | 1,551,299 |
| 8 | Unreconciled Difference vs. Billed Revenues | 2 |
| 9 | Consolidated Revenue Adjustment | (0) |
| 10 | TOTAL OPERATIONG REVENUE | $ 55,874,427 |

## TOTAL COMPANY BY GROUP - SUMMARY SCHEDULE

| LINE NO. | DESCRIPTION | GENERATED REVENUE |
|---|---|---|
| | EASTERN GROUP - | |
| 11 | SUPERSTITION SYSTEM | $ 15,641,918 |
| 12 | BISBEE SYSTEM | 1,944,037 |
| 13 | SIERRA VISTA SYSTEM | 1,647,993 |
| 14 | SAN MANUEL SYSTEM | 1,140,832 |
| 15 | ORACLE SYSTEM | 1,268,306 |
| 16 | WINKELMAN SYSTEM | 102,408 |
| 17 | MIAMI SYSTEM - | 2,028,236 |
| 18 | SUB-TOTAL | $ 23,773,731 |
| | WESTERN GROUP - | |
| 19 | CASA GRANDE SYSTEM | $ 14,459,765 |
| 20 | STANFIELD SYSTEM | 155,416 |
| 21 | WHITE TANK SYSTEM | 1,647,565 |
| 22 | AJO SYSTEM | 543,174 |
| 23 | COOLIDGE SYSTEM | 2,545,628 |
| 24 | SUB-TOTAL | $ 19,351,549 |
| | NORTHERN GROUP - | |
| 25 | LAKESIDE SYSTEM | $ 3,260,159 |
| 26 | OVERGAARD SYSTEM | 2,200,999 |
| 27 | SEDONA SYSTEM | 5,029,012 |
| 28 | PINEWOOD SYSTEM | 1,394,768 |
| 29 | RIMROCK SYSTEM | 864,208 |
| 30 | SUB-TOTAL | $ 12,749,146 |
| | | 2 |
| 31 | TOTAL OPERATIONG REVENUE | 55,874,427 |