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BEFORE THE ARIZONA CORPORATION C...

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AZ CORP COMMISSION
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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 UTLITY SERVICE AND FOR CERTAIN RELATED APPROVALS BASED THEREON.	DOCKET NO. W-01445A-08-0440 **STAFF'S REPLY CLOSING BRIEF**

Arizona Corporation Commission
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I. INTRODUCTION.

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby responds to the Closing Brief submitted by Arizona Water Company ("Company" or "AWC"), the Residential Utility Consumer's Office ("RUCO") and Abbott Laboratory ("Abbott"). This case has involved a large number of systems and has presented some interesting and complex issues. Staff, the Company and RUCO have worked diligently to come to agreement, though there are still a significant number of outstanding issues. The issues remaining in this case are: system consolidation; rate consolidation and design; revenue requirement; operating income adjustments; rate base adjustments and exclusions of plant items; cost of capital; reductions in water loss; and adjustor mechanisms.

II. RATE CONSOLIDATION AND RATE DESIGN.

A. Staff's Proposed Rate Consolidation is Appropriate and Should be Approved by the Commission.

Staff recommends partial and full rate consolidation for several systems within the Company's Eastern, Western, and Northern Groups as initial steps towards possible full consolidation or single tariff pricing. Staff and the Company agree that system consolidation could take place; however, their recommendations differ slightly. Staff's proposal achieves the most benefit from consolidation while mitigating the price shock felt by some ratepayers. Staff recommends a combination of full and partial consolidation among the Company's systems as follows:

1. **Eastern Group.**

Full Consolidation for the Apache Junction, Superior and Miami Systems: same monthly minimum charge and commodity rates.

Partial Consolidation for the Bisbee and Sierra Vista Systems: same monthly minimum charge and different commodity rates.

No Consolidation for the San Manuel, Oracle and Winkelman Systems: maintain separate monthly minimum charges and commodity rates.

2. **Western Group.**

Partial Consolidation for the Casa Grande, Coolidge and Stanfield Systems: Casa Grande will have the same monthly minimum charge with differing commodity rates; Coolidge will have the same monthly minimum charge and commodity rates; Stanfield will have the same first tier commodity rate as Casa Grande and Coolidge but a different rate for its second and third tiers.

No Consolidation for the White Tank and Ajo Systems: maintain separate monthly minimums and commodity rates.

3. **Northern Group.**

Full Consolidation for the Lakeside and Overgaard Systems: same monthly minimum charge and commodity rates.

Full Consolidation of the Sedona, Pinewood and Rimrock Systems: same monthly minimum charge and commodity rates.

The gradualism in Staff's proposal mitigates the rate impact of consolidation on ratepayers. Staff also continues to recommend, as compliance items, that the Company file with the docket a detailed timeline for when the Company can achieve interconnection, where technically and financially feasible, and a single rate structure for its systems.[1] The Company should make these filings within 120 days of the Commission's decision.[2] Staff recommends approval of its rate consolidation proposal because it provides benefits to the ratepayer, the utility and the regulator; additionally, "Staff's rate consolidation proposal is very similar to the Company's proposal, [and] the Company generally supports Staff's recommendation." [3]

B. Rate Design.

Staff is recommending tiered rate designs based on their proposed system consolidations, as applied in Staff's Final Schedules.[4] In recent rate decisions, the Commission has concluded that tiered inverted-block rate designs help positively address issues such as: efficient water use, "affordability, fairness, simplicity and revenue stability" [5] In designing rates, several factors should be taken into consideration; cost of service is of course important in calculating appropriate rates, but efficient water use, uniformity of all customer rates, and gradualism are also all important factors.[6] Staff has taken into consideration all of the above-mentioned factors when creating their tiered rate design, and recommends the adoption of the design as laid out in Staff's Final Schedules.

Staff recommends an inverted block rate design for the Industrial Class and believes that the Company's proposed flat rate does not promote the issues that the Commission has deemed important. Namely, flat rates "not only provide no price incentive to conserve water, but [they do] not recognize the value associated with the large use of large amounts of this scarce resource."[7] The Company states that there is no good reason to impose inverted tiered rates on Industrial consumers because a flat rate already sends a price signal to conserve. The Company also argues that the two largest industrial customers have already reduced their water use, so there is no incentive for them to

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[1] Ex. S-12 at 3:25-4.5.
[2] Tr. Vol. VI at 1137:3-25.
[3] AWC Closing Br. at 77:21-78:1.
[4] Staff's Final Schedules; Exs. S-26, S-27.
[5] Decision No. 67093 at 41:17-20; *also see* Ex. R-1 at 26:23-27:1 and Decision No. 68302 at 43:21-24.
[6] Ex. S-24 at 5:1-21 and Tr. IX at 1700:5-10.
[7] Ex. S-27 at 5: 28-6:31.

reduce it even further.[8] As discussed above, the Commission has made a policy decision in promoting efficient water use, through the use of tiered rates. The Industrial Class consumes an extremely large amount of water, and it is in the best interest of the State to see that water is used as efficiently as possible; tiered rates help make that happen.

Staff continues to support its recommendation to eliminate the basic charge for construction water and water for resale, despite the Company's assertion that it incurs fixed costs.[9] Moreover, Arizona Water believes that these customers should continue to pay only third-tiered rates, despite the fact that the other customers that pay a monthly minimum also receive the benefit of paying lower first- and/or second-tier rates.[10] Staff believes that a monthly minimum charge should only apply to customers who own a permanent meter, and in most cases the meter for bulk water sales is not permanently installed on the water line and is used by several customers.[11]

Both Staff and the Company agree that RUCO's multi-tariff pricing proposal should be rejected. First, RUCO contends that maintaining separate rates for separate systems is the appropriate ratemaking model and that consolidation goes against this principle.[12] However, RUCO does concede that whether or not consolidation occurs is a matter of public policy to be determined by the Commission; if the Commission decides to consolidate, RUCO has proposed six different rate design options.[13] None of RUCO's consolidation options are realistic and should not be adopted. RUCO's Option F is more of a rate design technique than a step towards consolidation. The Company would still have all the same requirements it currently has, and little or no benefit from a uniform monthly minimum.[14] In addition, the Company would presumably have to file a rate case application that included all of its systems. It is also important to remember that RUCO's Option F is an alternative for the Commission's consideration. RUCO is not recommending consolidation in this case, and is actually recommending system specific rates.[15]

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[8] AWC Closing Br. at 86-87.
[9] *Id.* at 88-89.
[10] Ex. S-25 at 14:13-18; Ex. A-18 at JMR-8, Sch. H-3.
[11] Ex. S-27 at 7.
[12] Ex. R-35 at 4.
[13] Ex. R-35 at 4, 35.
[14] Tr. Vol VIII at 1547-48.
[15] Tr. Vol. VIII at 1557.

Staff recommends the adoption of its rate design as applied in Staff's Final Schedules.[16] Under Staff's proposed rate consolidation model and rate designs, the increases and decreases in rates may be greater than under the Company's proposal; however, Staff's model will be a benefit to the ratepayer in the long term.[17]

C. Cost of Service.

Staff is in general agreement with the Company's Cost of Service Study and has made minor adjustments, which the Company has accepted. The cost of service is only one of many factors in designing rates. All parties agree that if the Commission decides to adopt any of the proposed consolidation plans, rates may significantly deviate from the cost of service.[18]

D. Staff's Response to Abbott Laboratories.

Abbott Laboratories ("Abbott") charges that Staff's proposed rate design for industrial customers is unfair and discriminatory. [19] Abbott asserts that rates should be designed based on cost of service[20], however in this case, the other parties have all agreed that if any of the proposed system and rate consolidations occur, rate design will not necessarily follow the cost of service. [21] In light of this, Abbott agrees with the rate design recommendations of RUCO for the Casa Grande areas[22] or the Company's proposed single flat rate charge for industrial customers in the Western Group. [23]

Staff is recommending a tiered block rate design for the industrial 6-inch meter customers because tiered rates will promote efficient water use. [24] Abbott asserts that the increase in commodity rates and the break over point of 950,000 gallons is to the disadvantage of the two larges industrial users, themselves and Frio-Lay. However, Abbott does not view the advantages of the tiered design and break over point to the dozens of other industrial users in the system, nor for the benefit of conservation.

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[16] Staff's Final Schedules; Exs. S-26, S-27.
[17] Ex. A-21 at 12; Ex S-27 at 8:9-29.
[18] Ex. S-10 at 4; Tr. Vol. IV at 695:12-16, 703-704; Tr. Vol. III at 576-577.
[19] Abbott Closing Br. at 7:19-20.
[20] Abbott Closing Br. at 3; Ex. Abbott-2 at 2:17-24; Tr. IV at 633 and 641.
[21] Ex. S-10 at 4; Tr. Vol. IV 695:12-16, 703-04; Tr. Vol. III at 576-77.
[22] Abbott Closing Br. at 7.
[23] *Id.* at 5.
[24] Staff's Final Schedules.

It is not unusual for the Commission to approve special contract rates for utilities that use significantly larger quantities of water than other customers in their class.[25] Staff has prepared an alternative rate design that would separate Abbott and Frito Lay into a separate customer class, with different first and second tier commodity rates, and a higher break over point.[26] Staff has calculated and provided the alternative schedules for the Commission's consideration. Despite the objections raised by Abbott, Staff continues to maintain that their proposed tiered block rates for the industrial class are fair and reasonable and help promote efficient water use.

III. STAFF'S REVENUE REQUIREMENT.

Staff continues to recommend a total revenue requirement of $53,253,594, which represents a $9,890,989 (22.82 percent) increase over Staff's adjusted test year revenues of $43,362,605. This proposal results in a rate of return of 8.10 percent. [27] Staff's recommendation is based on the operating income adjustments discussed below. The Company proposes a 31.2 percent increase in revenue over the adjusted test year revenues. However, the Company claims this figure does not represent the *actual* increase.[28] The Company asserts that if the revenue produced by the Company's ACRM and PPAM surcharges is taken out, the actual revenue increase requested will be only 18.7 percent, there by producing a rate of return of 9.2 percent.[29]

A. Operating Income Adjustments.

1. The transmission and distribution expenses for accounts 663 & 673 should be normalized.

Staff continues to propose an adjustment to normalize the transmission and distribution expenses in sub-accounts 663 and 673 for the Casa Grande and Superstition systems.[30] The Company does not believe that normalization is appropriate in this situation and the test year expense should be

[25] Abbott Closing Br. at 4; Tr. Vol IV at 678, 717, Tr. Vol. VI at 1094.
[26] Ex. S-28 (Michlik's Alternative Staff Schedules).
[27] Staff's Final Schedules.
[28] AWC Closing Br. at 1.
[29] AWC Closing Br. at 1-2; Company Final Sch. A-1 at 1.
[30] Staff's Closing Br. at 6; Ex. S-24 at 18.

used.[31] Normalization is necessary when a utility experiences a non-recurring spike in cost during the test year. Normalization therefore reflects a more representative cost.[32]

The accounts at issue here recorded significantly higher than normal costs due to a major repair in the Casa Grande system.[33] Major repairs are infrequent and are not a yearly recurring expense. Therefore, the spike in cost due to this repair is not representative of normal costs and it is unlikely that the Company will incur this level of cost in the future.[34] Staff's recommendation to normalize these expenses over a three-year period is appropriate in order to eliminate an excessive, non-recurring cost that inflates the test year cost.

The Company, in its Closing Brief argues that Staff is taking inconsistent positions by recommending a reduction of expenses for account 673 while at the same time urging the Commission to require the Company to reduce water loss to acceptable industry standards.[35] This argument is misplaced because account 673 is for normal repairs and maintenance of water mains; where as the steps to abating water loss could result in capital investment, requiring planning and potentially replacement of infrastructure. The Company is attempting to make a connection where none exists; expenses allotted for maintenance in account 673 do not relate to the Company's ability to combat water loss. In fact, when the Company ultimately makes these capital improvements, its maintenance expenses should decrease. Staff's recommendation to normalize transmission and distribution expenses for accounts 663 and 673 is not in contradiction to its additional recommendation that the Company reduce its water loss; the Commission should adopt both of Staff's recommendations.

2. Tank maintenance expense should be normalized.

Staff's proposal to normalize tank maintenance expense should be adopted because it is reasonable and utilizes past known and measurable expenses. The Company on the other hand proposes that the Commission adopt accrual accounting, a method never explicitly approved by the

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[31] AWC Closing Br. at 26.
[32] Staff's Closing Br. at 7; Ex. S-22 at 13.
[33] Staff's Closing Br. at 6; Tr. Vol. III at 560-61.
[34] Staff's Closing Br. at 6; Ex. S-24.
[35] AWC Closing Brief at 26:13-17, fn. 115 & 123. The Company has cited CCWC ROO at 24-25 which addresses deferral of CAP M&I charges. However, Staff believes the Company to cite pages 23-24, which addresses expense normalization. Staff's response to the Company's assertion is based on this assumption.

Commission. Staff believes that the Commission should approve reasonable costs.[36] In this proceeding, Staff calculated reasonable costs by normalizing the Company's actual tank maintenance costs from prior years.[37] Additionally, no other water utility in Arizona has a similar accrual system as that proposed by the Company.[38]

The Company's methodology utilizes projected costs and projected inflation rates over a fifteen-year period. The actual 2009 inflation rates have already shown that the Company's calculation is flawed,[39] and there is no mechanism within the accrual account methodology to reevaluate inflation rates in the future.[40] The Company's methodology creates projected costs that are not known or measurable. Staff on the other hand, has normalized past known and measurable costs in calculating the tank maintenance expense. The Company believes that using a three-year average of expenses that recur at intervals of seven and fourteen years is a flawed approach.[41] However, even the Company recognizes that the three year normalization produces a higher cost of tank maintenance than a seven year average.[42]

The Company claims that if Staff's proposition is adopted, "it will leave the Company seriously under recovering this expense in some years, and seriously over recovering in other."[43] But it is important to view the tank maintenance costs in the aggregate and not by individual systems.[44] The Cost of tank maintenance varies from year to year due to its cyclical nature, some years the Company will incur large expenses, other years the expense will be small. However it is up to the Company to manage the costs and the funds on a year to year basis to ensure there is adequate financing for the maintenance as it is required.[45] Staff is proposing a yearly expense in excess of the actual test year costs and in excess of the Company's five and seven year normalized costs. If the

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[36] Tr. Vol. VIII at 1644.
[37] Ex. S-25 at 9-10, Igwe Surrebuttal.
[38] Tr. Vol. VIII at 1646-47.
[39] *Id.* at 1636.
[40] Tr. Vol. III at 631-32.
[41] AWC Closing Br. at 28.
[42] Tr. Vol. III at 540-41; 550-51.
[43] AWC Closing Br. at 27:1-2.
[44] Tr. Vol. VIII at 1640; Ex. S-22 at 12.
[45] *Id.* at 1637-38.

Company continues to exercise responsible management practices, Staff's proposed expense will be adequate to cover tank maintenance.

The Company continues to assert that the document submitted on the last day of the hearing is a tank maintenance plan because it shows lists of timing of maintenance and costs per storage tank.[46] However, the Company also admitted that the document had not been submitted to establish the accuracy of the amount set forth on the tables, or to represent the exact dollar amount of costs to be incurred.[47] In fact the Company only received one non-competitive bid from which to estimate the future costs.[48] Additionally, the Company acknowledges that the document's sole purpose is projection and that it was never even meant to be printed.[49] This is not indicative of a tank maintenance plan. The Company's accrual account relies on projected future interest rates and an inadequate tank maintenance document.

Staff recommends the Commission adopt its tank maintenance expense adjustment because it is reasonable and based on known and measurable past costs.

3. The Commission should reject the Company's proposed conservation adjustment for the Northern Group.

The Company requests that a conservation adjustment be made to the test year revenues for the Northern Group to recover potential lost revenue due to the imposition of inverted block rates on those systems.[50] This adjustment should be rejected. There is no dispute that the purpose of inverted block rates is to promote efficient water use.[51] However, that is not a sufficient reason warrant an adjustment mechanism. First, even though the Company has inverted tiered rates in other Groups, it has never proposed a conservation adjustment before.[52] Second, most private water companies in the State of Arizona have tiered rate structures.[53] Third, the Company provided no proof that the adoption of tiered rates results in loss of revenues. Finally, no party could identify any situation in which the

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[46] AWC Closing Br. at 28; Ex. A-57.
[47] Tr. Vol. IX at 1797-798.
[48] Tr. Vol. III at 539, Vol. IX at 1800-01.
[49] Tr. Vol. IX at 1797-99.
[50] AWC Closing Br. at 90.
[51] Tr. Vol. VIII at 1496; Dec. Nos. 67093 at 41:17-20; Ex. S-2 at 43:21-24; AWC Closing Br. at 91:10-11.
[52] Tr. Vol. III at 564.
[53] Staff Closing Br. at 11; Ex. S-25 at 18.

Commission has adopted an adjustment that would increase revenues as a result of potential conservation from the implementation of tiered rates.[54] The Company has not provided any compelling reason that the Commission should approve the conservation adjustment for the first time in this case, and therefore the Commission should follow its record and disallow the adjustment.

4. The Commission should adopt Staff's CIAC amortization.

Staff recommends CIAC amortization based on the weighted average depreciation rate. This method is employed when a utility cannot identify the specific plant items comprising its CIAC balance. The Company failed to identify the specific plant items in its CIAC.[55] Thus, Staff's recommended CIAC amortization rate is justified.

The Company has cited Decision No. 66849 in support of their proposition that "the Company is not required to come up with specific CIAC balances"[56] and that the "annual CIAC amortization rate should reflect the annual depreciation associated with plant accounts that include contributions"[57] which provides for a 2.00 percent CIAC amortization rate. In that case, the Company did assert that a composite rate for contributed plant should be based on the annual depreciation, but it should be "associated with the *individual* plant accounts that include contributed plant, in order to match the CIAC amount to the depreciation rate for the *specific* plant accounts."[58] The Commission went on to "agree with Arizona Water that consistency with the move to *individual* component depreciation rates requires consideration of the *individual* plant accounts that include contributed plant."[59] It was based on that premise that a 2.00 percent amortization rate was set.

Here, Staff is requesting the approval of their method because the Company did *not* provide information on specific plant items, as the above decision clearly dictates is important when calculating the amortization rate based on that theory. Additionally, the assumption that the rate is constant at 2.00 percent, irrespective of the CIAC balance, per each system's plant accounts is

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[54] Staff's Closing Br. at 11; Tr. Vol. III at 564; Ex. S-24 at 21.
[55] Tr. Vol. III 571-72.
[56] AWC Closing Br. at 31:9-10.
[57] *Id.* at 31:12-13 (*citing* Ex. A-20 at 40 *citing* Decision No. 66849)
[58] Decision No. 66849 at 16:1-2 (emphasis added)
[59] *Id.* at 16:4-6 (emphasis added)

incorrect. The opposite is true; amortization rates vary as the composition of plant balances vary from system to system.

Staff continues to recommend the adoption of its CIAC amortization for calculating deprecation and amortization expenses.

5. Desert Wells pump maintenance accrual account should be rejected and the expense should be normalized.

Staff continues to recommend the normalization of maintenance expense for the Desert Wells Pump Station.[60] Staff has normalized the cost of maintenance over a three year period from 2005-2007 and came to the reasonable cost of $53,249, which is higher than the amount the Company is seeking through its accrual account.[61] Normalization of expenses addresses the Company's concerns over "dramatically" fluctuating maintenance costs from year to year[62] by leveling costs and eliminating fluctuation.[63]

In order to maintain reliable operation of this pump, the equipment needs to be rebuilt every few years; this is not an annual expense.[64] The Company claims that (1) if their accrual account is replaced with a normalized expense level, and (2) during the next test year, the Desert Wells Pump does not incur its large maintenance costs, the cost would be reset to a much lower.[65] However, it is the Company that "misses the point." The reason for "normalization" is to reflect a normal level of cost that is known and measurable. To the extent this varies, it can be adjusted in subsequent rate cases.

B. Rate Base.

Staff is continuing to recommend $145,299,338 in rate base for the 17 systems that are part of this rate case, which is $1,344,731 less that the Company's proposed $146,644,069.

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[60] Ex. S-25 at 18:18-23.
[61] Staff's Closing Br. at 14; Ex. S-25 at 16, 17.
[62] Tr. Vol. IX at 1651, 1652-653.
[63] *Id.* at 1652:2-5.
[64] AWC Closing Br. at 29.
[65] *Id.* at 30.

1. Commission should disallow plant not in service or inactive.

Staff's proposal removes $4,195,661 from Plant in Service. This number is derived from Staff's determination that these plant items, originally included in the Company's application as "in-service", were either not used and useful and in-service during the test year, or were post-test year plant items.[66] The Company, in an attempt to mask the true nature of these plant items to have them included in rate base, has reclassified them into four categories: "plant to be retired," "plant held for future use," "post test year plant," and "plant currently in service/use."

a. Plant the Company as labeled "plant to be retired" should be excluded from rate base.

The Company continues to push for certain plant items, found to be "out of service" during the inspection and discovery phase, to be treated as "plant to be retired."[67] When plant is found to be not-in-service, it is taken out of rate base, along with the amount of depreciation accumulated through the end of the test year.[68] The Company clearly would prefer this plant be treated as retired because the accounting and ratemaking treatment would remove the plant's original cost from both utility plant in service and accumulated depreciation.[69] The Company originally listed the plant as in-service in the application;[70] but later during discovery when it was found to not be in service[71], the company argued that it was plant meant to be retired. However, the plant was not retired during the test year, or the year after that[72]; therefore, Staff's classification as plant not-in-service should be adopted.

The Company took no steps to retire this plant until the filing of rejoinder testimony in this rate case.[73] Since then, the Company claims it has taken the necessary steps to retire these plant items,[74] however it has only provided property disposal reports dated August 11, 2009, and the Company's witness even states that the plant will not be retired from its books until December

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[66] Staff's Closing Br. at 15; Ex S-15 at 8.
[67] AWC Closing Br. at 14.
[68] Ex. S-16 at 4.
[69] AWC Closing Br. at 14; Ex. A-20 at 12-13; Ex. A-22 at 7-9; Tr. Vol. III at 513, 516-19.
[70] Ex. A-18 at 8, Schedule S-2
[71] Ex. S-15 at 8. Schedule BKB 1
[72] Ex. S-16 at 3-4
[73] Ex.A-22, JMR-RJ2.
[74] AWC Closing Br. at 14.

2009.[75] That will be a full two years since the end of the 2007 test year. Additionally, due to the Company's untimely action, Staff has not had an opportunity to confirm the plant in question has been retired, both physically and for accounting purposes.

Although the Company states that RUCO agrees to the plant retirements and associated adjustments,[76] RUCO acknowledges that the Company did not retire the plant in question prior to filings its application and that RUCO is not certain that the plant will be properly retired even by the end of 2009.[77] Under these circumstances, it would be imprudent to grant retirement treatment to these plant items and therefore the Commission should adopt Staff's recommendation to disallow the plant.

b. Plant held for future use was not used and useful during the test, nor is it used and useful today and should be excluded from rate base.

The Company is attempting to have plant items not currently in use to be labeled as "plant held for future use" (PHFFU) and included as plant-in-service.[78] However, by the very nature of its name, plant held for future use is not presently being used and useful; only plant that is used and useful is allowed in rate base.[79] The Company claims that plant should be considered PHFFU because the Company either has a definite plan to return them to service, or with some modification or replacements, they could be returned to service.[80] However, the future use of some of these items is based on the improvement of the housing market[81] or the Company does not anticipate placing them into service until 2010, 2011, or 2012.[82] These plant items were not used and useful to the ratepayer during the test year, and they may not be in service for up to five years after the test year, or longer depending on the housing market.

The Company recognizes that the Commission has never approved a plan where plant held for future use is included in the rate base and that no Arizona utility has ever made such an argument.[83]

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[75] Tr. Vol. III at 514-515.
[76] Ex. R-19 at 5; Tr. Vol. V at 965.
[77] Tr. Vol. III at 584.
[78] Ex. A-20 at 14.
[79] Ex. S-16 at 4.
[80] AWC Closing Br. at 19; Ex. A-13; Ex. A-10 at 21-28.
[81] Ex. A-10 at 22, 27.
[82] *Id.*
[83] Tr. Vol. II at 374.

However, in support of its argument, the Company discusses other jurisdictions that have allowed for PHFFU to be included in rate base, as support for why this Commission should adopt that view as well.

The jurisdictions the Company chose to highlight are split between allowing PHFFU to be included and not included in rate base. As the Company states in its Closing Brief, the jurisdictions that do include PHFFU in rate base have applicable tests that the utility must satisfy in order to receive this treatment.[84] Arizona has no such test, since PHFFU has never been included in rate base. Additionally, the fifteen jurisdiction the Company cites have different tests and applications of the standard: four states have a broad test which allows plant or property if it will serve a future utility purpose;[85] five states have the burden resting with the utility to prove the existence of a definite plan for future use;[86] three states have a timing test that requires the plant or property to be near enough to commencing that it has a quality analogous to working capital; and other state's test require the plant held for future use to be known and measurable, the acquisition necessary, or to be placed in service within the period for which the rates are fixed.[87] The Company does not indicate which of these tests it is proposing. It appears the Company is urging the Commission to allow all of its labeled PHFFU into rate base and justify that decision by combining multiple standards from various jurisdictions.

First, the Commission is under no obligation or requirement to follow the lead or path of any other jurisdiction in the country. Second, this Commission has requirements placed on it by the Arizona Constitution that the other jurisdictions do no have: the Commission is mandated by its State Constitution to prescribe just and reasonable rates for public service corporations.[88] Third, in addition to Constitutional provisions, this Commission's own rules require plant to be used and useful to the ratepayer, for it to be included in rate base.[89] The Company's PHFFU was not in service during the test year, needs repairs or improvements to be placed back into service, or is planned to be returned to service three to five years after the test year or when the economy improves; this hardly represents

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[84] AWC Closing Br. at 20:2.
[85] *Id.* at 20:7-21:2.
[86] AWC Closing Br. at 20: 3-6.
[87] AWC Closing Br. at 21:5-10.
[88] Arizona const. Art. 15 §3.
[89] A.A.C. R14-2-103(h).

used and useful plant. If the Commission includes plant in rate base that is not currently "used or useful" or "used and useful" to the ratepayer the rates will not be just and reasonable. Staff urges this Commission to continue to demonstrate predictability by following its own precedent and disallowing plant held for future use from rate base.

c. Post test year plant should be excluded because it was put into service 18 months after the end of the test year.

Staff is in agreement with the Company that the Commission traditionally allows post test year plant to be included in rate base when it is revenue neutral and is placed in service within a reasonable time after the test year.[90] However, Staff disagrees with the Company that the Pinewood Electrical Panel should be included as post test year plant. While the Company claims that the construction on the panel was complete in January 2007, it was not placed into service or used and useful to ratepayers until July 10, 2009.[91] In the past, the Commission has expressed concern over the Staff's ability to review and audit the effects of post test year plant,[92] and therefore wants to make sure the plant has been placed in service within a reasonable time after the test year and before the rate case to ensure adequate inspection.[93] In Arizona Water's Northern Group Rate Case[94] the Commission allowed plant additions up to twelve months after the test year, but concluded that the Company's request for the inclusion of plant fifteen months after the test year was too long.[95] Here, the test year ended at the end of 2007, and the panel was placed into service on July 10, 2009, eighteen months after the test year.

Additionally, the Commission has asserted that for post year plant to be included in rate base, it must be "used and useful and in-service within ninety days of date that the rate application is deemed sufficient."[96] Here, the Company's rate application was deemed sufficient on October 15, 2008; the Pinewood Electrical Panel was put into service on July 10, 2009, almost nine months later.

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[90] AWC Closing Br. at 16.
[91] Ex. A-10 at 28; Ex. A-13.
[92] Decision No. 61831 at 3-4, *Paradise Valley Water Co.* (July 20, 1999).
[93] *Id.*
[94] Ex. R-13, Dec. No. 64282.
[95] *Id.* at 3-5.
[96] Dec. No. 61831 at 4, *Paradise Valley Water Co.*

Staff continues to recommend the disallowance of the Pinewood Electrical Panel from post test year plant because (1) eighteen months after the end of the test year is an unreasonably long time, and (2) the Commission's previous order states that plant should be used and useful and in service within ninety days of that rate application sufficiency.

d. Staff disagrees with plant labeled as "currently in use."

The Company's Closing Brief erroneously states that an agreement between Staff and the Company has been reached that Casa Grande Cottonwood Well No. 14 (ADWR Well No. 55-616598) is currently in use and serving customers.[97] Staff continues to recommend disallowance of the well, as stated in Staff's Closing Brief at page 22. During the hearing, the Company testified that the well number for Cottonwood Lane Well #14 was originally misidentified as DWR Well No. 55-613443, and the correct well number is 55-616598.[98] However, because the Company's record keeping error was noted at such a late date, Staff has been unable to verify that DWR Well No. 55-616598 is actually owned by the Company and in-service.[99] For this reason, Staff continues to recommend the disallowance of this well.

The Company continues to push for the inclusion of three fences (located in the Superstition, White Tanks, and Sedona Systems) and a 8' x 12' block building (located in the Sedona System) that are associated with plant items that did not provide service to customers during the test year.[100] The Company conceded during the hearing that the fences surround plant items that are not currently in service and the block building encloses a well that is not in service.[101] It is realistic and understandable that the Company wishes to secure plant sites and facilities, even when they are not in-service.[102] However, it is Staff's position that the ratepayers should not bear the burden of securing items from which they do not receive the benefit of their services. This is a cost that should be born by the Company and its shareholders as an appropriate business expense and should therefore be excluded from plant-in-service.

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[97] AWC Closing Br. at 12.
[98] Tr. Vol. VI at 1179:21-1183:7.
[99] *Id.* at 1181:9-22.
[100] Staff's Closing Br. at 21-22; Ex S-16 at 11.
[101] Tr. Vol. II at 377, 382, and 384.
[102] Ex. A-22 at 9-10; Tr. Vol. II at 377-78.

2. Staff Recommends the Adoption of an Adjustment to Remove the Cost of Equity from Working Capital.

Staff continues to maintain that the cost of equity is not a normal or appropriate component for inclusion in a lead-lag study,"[103] and therefore should not be included in the lead-lag study in determining working capital. However, the Company continues to assert that if the cost of debt is included in the lead-lag study, then the cost of equity should be included as well.[104]

Traditionally, the cost of debt is appropriately included because it is a known and measurable item of expense, similar to the other cost components included in the lead-lag study.[105] Cost of equity, however, is not a certain debt or obligation.[106] It does not have to be paid, and if it is paid, it does not have to be in a certain predictable amount.[107] The Company asserts that dividend payments to shareholders should be included in the final determination of working capital.[108] However a Company witnesses during the hearing confirmed that the Company is not required to pay a dividend.[109] Because a dividend payment is neither a required nor a predictable amount, the Commission should not include it in the lead-lag study.

Additionally, the Company has been unable to demonstrate that the Commission has ever approved including the cost of equity in a lead-lag study.[110] Staff urges the Commission to continue excluding the cost of equity from the lead-lag study and to adopt Staff's recommended working capital.

C. Staff's Cost of Capital Should Be Adopted.

All parties are in agreement with Staff's recommended capital structure using the Company's December 31, 2008, figures and including short term debt.[111] The Commission should approve a capital structure of 45.85 percent equity and 54.15 percent debt, with a long term debt cost rate of

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[103] Staff's Closing Br. at 23; Ex S-15 at 15.
[104] AWC Closing Br. at 10; Ex. A-10 at 17-18; Tr. Vol. III at 625-26.
[105] Ex. S-16 at 18.
[106] Ex. S-16 at 18:22-23, 23-24.
[107] Ex. S-16 at 18.
[108] AWC Closing Br. at 11.
[109] Tr. Vol. III at 531.
[110] Tr.Vol. II at 461-62 and Vol. III at 531.
[111] Tr. Vol. VII at 1354:18-1355:25.

6.83 percent, a short term debt rate cost of 3.00 percent.[112] Additionally, the Commission should approve Staff's recommended 10.0 percent cost of common equity, which results in an overall cost of capital of 8.10 percent.[113]

1. Cost of common equity.

The Commission should adopt a 10.0 percent cost of common equity.[114] Staff derived their percentage by using three recognized methodologies applied to three groups of proxy water utilities: Discounted Cash Flow analysis (DCF); Capital Asset Pricing Model analysis (CAPM); and Comparable Earnings (CE) analysis. [115] Utilizing these methods and analyses, Staff's overall cost of capital results in a rate of return range of 7.87 percent to 8.33 percent. The Commission should adopt Staff's recommended 10.0 percent cost of equity and overall cost of capital of 8.10 percent.[116]

Staff utilized both geometric and arithmetic means when calculating the Company's CAPM cost of equity to fall between 8.2-8.6 percent (8.4 percent mid-point) and DCF mean/median cost at 9.0-10.5 percent (9.75 percent mid-point).[117] The Company asserts the use of geometric means to estimate rates in the DCF model and the market premiums in the CAPMS is inappropriate.[118] However, Staff witness, Mr. Parcell, has demonstrated that it is appropriate to use *both* the geometric and arithmetic growth rates in the CAPM analysis because if investors have access to both types of analyses and use them to make investment decisions, then both means have an appropriate place in the analysis.[119] Additionally, as the Commission has stated, "it is appropriate to consider geometric returns in calculating a comparable company CAPM because to do otherwise would fail to give recognition to the fact that many investors have access to this information.[120]

The Company's DCF analysis should be rejected as well. The Company utilized a single type of growth rate estimate in its DCF analysis.[121] This use of the DCF is improper because the "same

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[112] Ex. S-22 at 11-15, Ex. R-33 at 3.
[113] *Id.* at 3:21-22.
[114] *Id* at 3:8-18.
[115] *Id* -22 at 3:9-11.
[116] *Id* .at 3:20-22.
[117] *Id.* at 16:15-24:4.
[118] AWC Closing Br. at 57.
[119] Ex. S-23 at 6:22-7:9; Tr. Vol. VII at 1345:14-1348:3.
[120] Ex S-23 at 7:13-18.
[121] Ex. S-22 at 33:23-41:5.

factors that have caused the DCF results to show . . . increases have caused the CAPM results to show . . . decreases."[122]

The Company continues to articulate concern that as a regulated water utility in Arizona, it is confronted with additional, higher risks.[123] However, the laundry list of risks cited by the Company are not new, in fact, the Commission has chosen to reject those risks in past water rate cases.[124] The Company has repeatedly argued that since it is smaller than the sample utility groups and requires arsenic treatment regulation, that a risk adjustment is necessary. However, the Commission has repeatedly rejected the argument.[125] The Commission should continue to disregard this argument and reject the Company's fifty point risk adjustment to the DCF and CAPM.

2. Return on equity.

The Company claims that in addition to its alleged elevated risk, the current financial crisis is another important factor for increasing the Company's cost of equity or return on equity in this rate case.[126] The Commission has yet to make adjustments to utilities because of the current economy. In fact, unlike the Company's ratepayers, the Company as a regulated monopoly is "partially, if not largely, insulated from the impacts of depressed economic conditions".[127] The Company's evidence provides "no justification for increasing the profit level of a regulated utility such as [the Company] at the same time that other enterprises are experience lower profits."[128] A return of equity of 10 percent is fair and appropriate and Staff urges the Commission to adopt this recommendation.

3. Staff's approach to calculating cost of capital in this case is "Staff's approach" and should be adopted by the Commission.

The Company and its witness Dr. Zepp have continuously asserted that in this case, Staff has failed to follow Dr. Zepp's interpretation of his so called "staff approach."[129] Mr. Parcell is Staff's cost of capital witness in this proceeding and his presented oral and pre-filed testimony represents

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[122] Ex. S-23 at 6:16-19.
[123] AWC Closing Br. at 45.
[124] Ex. S-2 at 39:13; R-1 at 17-23; Ex. R-13, Dec. No. 64282 at 17-19; Ex. S-20 at 17:18-21; Ex. S-22 at 42:4-14; Tr. Vol. VII at 1259:9-1286:24.
[125] Ex. S-2 at 39; Ex. R-1 at 23:20-28; Ex. R-13, Decision No. 64282 at 18:28-19:9
[126] Ex. S-22 at 29:14-30:17; Ex. S-23 at 4:19-5:3; Tr. Vol. VII at 1333:23-1335:17 and 1338:7-12.
[127] Ex. S-22:29-23-25.
[128] Ex. S-22 at 30:2-5.
[129] Ex. S-23 at 5:4-16; AWC Closing Br. at 46.

Staff's position in this matter. Mr. Parcell is a more than competent expert, whose methodology and analysis is well reasoned and independent. The Company's attempts to discredit Mr. Parcell because they disagree with his findings should be entirely disregarded.[130]

Staff has presented more than sufficient evidence to support its recommended cost of capital and cost of equity. Staff strongly urges the Commission to adopted Staff's proposition and not be swayed by the Company's efforts to discredit Staff's witness or its attempt to utilize a downward economy for its own economic gain to the disadvantage of its ratepayers.

D. Staff's Response to RUCO.

In RUCO's Closing Brief, it correctly noted Mr. Parcell's acknowledgment that the CAPM is generally superior to the simple risk premium, and that although Mr. Parcell had performed a CAPM analysis, he did not factor the results into his cost of equity recommendation. [131] RUCO highlighted this testimony as evidence for why the Commission should adopt RUCO's cost of equity capital, which incorporates CAPM.[132] However, RUCO did not include Mr. Parcell's explanation for why he chose to exclude his own CAPM study.

Mr. Parcell explained during the hearing that when he uses three analyses, (DCF, CAPM and comparable earnings) if two give comparable results, while the other gives an outlier result, less weight is given to the outlier.[133] Here, the DCF and comparable earnings analysis resulted in a cost of equity range of 9.5 to 10.5; however, the CAPM produced a range of 8.2 to 8.6, a full 200 basis points less than the bottom of the range.[134] As Mr. Parcell explained, CAPM was used as a factor investors might want to consider, but it was purposefully excluded from the cost of equity range because it was determined to be an outlier.[135]

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[130] Ex. A-43 at 10-16; S-7 at 6:1-8. 7:10-25, and 8:1-8; Tr. Vol. V at 1247-55.
[131] Tr. Vol. VI at 1348-49.
[132] RUCO's Closing Br. at 12:7-8.
[133] Tr. Vol. VII at 1349:18-23.
[134] *Id.* at 1348:20-25.
[135] *Id.* at 1349:1-5.

III. ENGINEERING ISSUES.

A. The Commission Should Order the Company to Reduce Water Loss.

The Company says it has a state of the art, aggressive and comprehensive water loss management and leak detection systems, yet eight of their systems show water losses above 10 percent.[136] The Company claims that the only way to reduce water loss in those systems with water loss of over 10 percent would be to replace the infrastructure.[137] However, the Company makes this assertion without (1) performing a thorough water audit and comprehensive evaluation of water loss for each system,[138] (2) proposing a proactive plan that outlines and prioritizes the specific corrective steps, (3) a procedure and time frame for water loss reductions strategies for each system,[139] or (4) considering the economic value of the water lost or its impact on rates.[140] The Company only estimated costs based on an assumed percentage of replacement needed to achieve the targeted water loss in affected systems, claiming that is the only way to lower water loss.[141]

The Company claims that aging infrastructure, topography, weather and population fluctuations are relevant factors in determining if a system can reduce its water loss levels below 10 percent.[142] Staff is not opposed to revaluating the ability of the Company to achieve water loss reduction levels. However, the Company needs to provide Staff with adequate information. For example, the Company claims that various systems have reduced their water loss since the 2007 test year, however, it has not provided adequate data or evidence as to how or when the water loss reduction occurred.

The Company complains that Staff has "offered no explanation of how the Company should accomplish this requirement."[143] However, Staff has stated that *after* a sufficient analysis, if the Company concludes that mitigation is cost prohibitive in a particular system, it should submit a report to the docket that contains a detailed cost analysis and reasons why mitigation measures are to too

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[136] Tr. Vol. II at 358.
[137] AWC Closing Br. at 103:16-18; Ex. A-6 at 4-7.
[138] Ex. S-14 at 2.
[139] *Id.* at 3.
[140] *Id.*
[141] *Id.*, 313:24; Ex. A-6 JDH-RBI.
[142] AWC Closing Br. at 98-99.
[143] *Id.* at 102; Ex. S-13 at Exhibit KS.

costly.[144] Staff can then adequately analyze the situation and potentially alter its position.[145] Unfortunately, the Company stated in its closing brief that it does not believe it is necessary to supply the Commission with anymore than the reports it produces during its ordinary course of business.[146]

The Company continuously asserts that replacing portions of the systems that have above reasonable water loss is cost prohibitive for numerous reasons, including its inability to raise the capital. However, a Company witness stated shareholders could give a cash infusion for construction[147] and ultimately, whatever mitigation measures are taken would be borne by the customers.[148] Additionally, the Company suggested a Distribution System Improvement Charge (DSIC) as a way to assist with the costs associated with the infrastructure replacements; unfortunately, the Company never actually proposes this.[149] Staff believes that a DSIC is a possible tool to address the cost of infrastructure replacement. However, the Company would need to provide a specific plan that Staff could analyze.

There may be unique circumstances such that certain of the Company's systems cannot meet the 10 percent level,[150] but until the Company provides Staff with data and/or convincing evidence demonstrating that reducing water loss to less than 10 percent does not provide a cost-effective benefit to Arizona Water's customers, Staff's continues to recommend the Company bring its water loss in all systems to below 10 percent by December 31, 2010. However, Staff believes that no system should be above the 15 percent water loss level.[151] The Company has only provided a lump sum cost estimate as a reason the water loss threshold cannot be met.[152] Staff, however, cannot make a reasonableness determination based on such a cost estimate.[153] A detailed water loss report, as outlined in Staff's pre-filed testimony, is needed before Staff can deviate from the industry standard

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[144] Tr. Vol. VI at 1199:23-1200:22.
[145] *Id.*
[146] Tr. Vol. II at 356; AWC Closing Br. at 103.
[147] Tr. Vol. II at 312:11-17.
[148] *Id.* at 320:1-4.
[149] Tr. Vol. I at 222:22-23, 265:23-26, 277:8-17.
[150] Tr. Vol. VI at 1200:23-1201:3.
[151] *Id.* at 1195:21-24, 1201:19-25.
[152] Tr. Vol. VI at 1198:8-11.
[153] *Id.*

10 percent water loss level.[154] This analysis will also be sufficient to verify the decreases in water loss the Company claimed in its rebuttal testimony.[155]

B. ADWR Has Yet to Determine If the Company's Superior and Oracle Systems Are in Compliance with Management Plan Requirements.

The Arizona Department of Water Resources (ADWR) has yet to determine that the Superior and Oracle systems are in full compliance under the "management plan requirements within the AMAs."[156] The Company asserts that it has provided the ADWR with proof that it is mitigating water loss in its Superior and Oracle systems, as it is required to do.[157] However, ADWR has yet to determine and/or confirm that the systems are indeed in compliance. The Company did not address this issue in its Closing Brief, Staff understands that the situation has not changed.

C. CAP Hook-Up Fees Should Continue for the Casa Grande, Coolidge and White Tank Systems.

Staff continues to recommend that the Commission allow the Company to implement its existing CAP Hook-Up-Fees for the Casa Grande, Coolidge and White Tank Systems, subject to the condition that the Commission reevaluate the tariff in its next general rate case for the Western Group.[158]

IV. ADJUSTOR MECHANISM.

Staff recommends the rejection of the Company's proposed purchased power, purchased fuel, and purchased water adjustor mechanisms, as well as the attrition adjustor mechanism. The Commission has previously concluded that "adjustor mechanisms should. . . be used only in extraordinary circumstances to mitigate the effect of uncontrollable price volatility or uncertainty in the marketplace," in addition to costs completely uncontrollable by management.[159] The Commission has previously disallowed adjustor mechanisms for the Company[160] and the Company raises no new arguments. Staff recommends the continued rejection of the adjustor mechanisms.

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[154] *Id.* at 1197:23-1198-2.
[155] *Id.* at 1195:4-9.
[156] Ex. A-10 FSK-RB1, RB2; Tr. Vol. II at 354:21-355:1.
[157] Tr. Vol. II at 426:2-10.
[158] Ex. S-24 at 29-6-9.
[159] Ex. S-2 at 46, Dec. No. 68302.
[160] *Id.*; Ex. R-1, Dec. No. 66849.

The Company in its Closing Brief lists a number of what it claims are "undisputed facts" as evidence to why the adjustor mechanism are necessary and should be approved.[161] However, many of the bulleted items are disputed and contested. The Company states that "there is no sound policy or evidentiary reason for rejecting the Company's requested adjustor mechanism."[162] However, that is far from true as demonstrated by the Commission's position on this issue in the Company's last two rate cases: where the Commission disallowed and discontinued the Company's adjustor mechanism, with clear and articulated reasons.[163]

The Commission has listed the following reasons for rejecting adjustor mechanisms for water companies: the costs of purchased power and purchased water do not significantly impact the costs of service for water utility companies because they do not represent their largest cost, the cost of purchased power and purchased water are not volatile, adjustor mechanism of the kind proposed do not provide utilities with an incentive to seek cost reducing alternatives or practices, and adjustor mechanisms can result in piecemeal ratemaking without consideration for the other components of a full rate case.[164] The Company claims that other jurisdictions allow adjustor mechanisms for water utilities, NARUC has endorsed adjustor mechanisms, and the Company used to have adjustor mechanisms.[165] However, the Company has failed to address the factors the Commission has dictated as important. Since the Company has raised the same arguments that have been rejected in the past and has failed to provide new or adequate evidence for the enactment of adjustor mechanisms Staff strongly recommends the disapproval of the Company's proposed adjuster mechanisms.

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[161] AWC Closing Br. at 33-34.
[162] *Id.* at 35:9.
[163] Ex. S-2; Ex. R-1.
[164] *Id.*
[165] AWC Closing Br. at 35.

V. CONCLUSION.

Staff respectfully requests that the Commission adopt its recommendations on the disputed issues in this case for the reasons stated above, in its Closing Brief, at the hearing and the testimony Staff provided in this case.

RESPECTFULLY SUBMITTED this 30th day of October, 2009.

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