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BEFORE THE ARIZONA CORPORATION COMMISSION

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Commissioner

BOB STUMP
Commissioner

Arizona Corporation Commission
DOCKETED

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IN THE MATTER OF THE APPLICATION OF)
ARIZONA-AMERICAN WATER COMPANY,)
AN ARIZONA CORPORATION, FOR A)
DETERMINATION OF THE CURRENT FAIR)
VALUE OF ITS UTILITY PLANT AND)
PROPERTY AND FOR INCREASES IN ITS)
RATES AND CHARGES BASED THEREON)
FOR UTILITY SERVICE BY ITS ANTHEM)
WATER DISTRICT AND ITS SUN CITY)
WATER DISTRICT.)

DOCKET NO. W-01303A-09-0343

IN THE MATTER OF THE APPLICATION OF)
ARIZONA-AMERICAN WATER COMPANY,)
AN ARIZONA CORPORATION, FOR A)
DETERMINATION OF THE CURRENT FAIR)
VALUE OF ITS UTILITY PLANT AND)
PROPERTY AND FOR INCREASES IN ITS)
RATES AND CHARGES BASED THEREON)
FOR UTILITY SERVICE BY ITS)
ANTHEM/AGUA FRIA WASTEWATER)
DISTRICT, ITS SUN CITY WASTEWATER)
DISTRICT AND ITS SUN CITY WEST)
WASTEWATER DISTRICT.)

DOCKET NO. SW-01303A-09-0343

NOTICE OF FILING TESTIMONY SUMMARIES

Attached are testimony summaries for the following nine witnesses:

1. Thomas M. Broderick
2. Paul G. Townsley

- 1 3. Ian C. Crooks
2 4. Joseph E. Gross
3 5. Linda J. Gutowski
4 6. John C. Lenderking
5 7. Sandra L. Murrey
6 8. Bente Villadsen
7 9. Miles H. Kiger

8 RESPECTFULLY SUBMITTED this 15th day of April, 2010.

9 LEWIS AND ROCA LLP

10 

11 _____
12 Thomas H. Campbell
13 Michael T. Hallam
14 40 North Central Avenue
15 Phoenix, AZ 85004

16 Attorneys for Arizona-American Water Company

17 ORIGINAL and thirteen (13) copies
18 of the foregoing filed this 15th day
19 of April, 2010, with:

20 The Arizona Corporation Commission
21 Utilities Division – Docket Control
22 1200 W. Washington Street
23 Phoenix, Arizona 85007

24 Copy of the foregoing hand-delivered
25 this 15th day of April, 2010, to:

26 Steve Olea
Utilities Division
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, Arizona 85007

Teena Wolfe, Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, Arizona 85007

Robin Mitchell
Maureen Scott
Legal Division
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, Arizona 85007

Chairman Kristin K. Mayes
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, Arizona 85007

1 Commissioner Gary Pierce
Arizona Corporation Commission
2 1200 W. Washington Street
Phoenix, Arizona 85007

3 Commissioner Paul Newman
Arizona Corporation Commission
4 1200 W. Washington Street
Phoenix, Arizona 85007

5 Commissioner Sandra D. Kennedy
Arizona Corporation Commission
6 1200 W. Washington Street
Phoenix, Arizona 85007

7 Commissioner Bob Stump
Arizona Corporation Commission
8 1200 W. Washington Street
Phoenix, Arizona 85007

9 Giancarlo Estrada
Arizona Corporation Commission
10 1200 W. Washington Street
Phoenix, Arizona 85007

11 Copy of the foregoing mailed
12 this 15th day of April, 2010, to:

13
14 Judith M. Dworkin
15 Sacks Tierney PA
4250 N. Drinkwater Blvd., Fourth Floor
16 Scottsdale, AZ 85251-3693
Attorney for Anthem Community Council

17 Daniel W. Pozefsky, Chief Counsel
Residential Utility Consumer Office
18 1110 West Washington Street
Suite 220
19 Phoenix, Arizona 85007

20
21 Larry Woods
Property Owners and Residents Assoc.
22 13815 E. Camino Del Sol
Sun City West, AZ 85375-4409

23
24 W.R. Hansen
12302 W. Swallow Drive
25 Sun City West, AZ 85375

John LeSueur
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, Arizona 85007

Nancy LaPlaca
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, Arizona 85007

Cristina Arzaga-Williams
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, Arizona 85007

Amanda Ho
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, Arizona 85007

Lawrence V. Robertson, Jr.
P.O. Box 1448
Tubac, AZ 85646-1448
Attorney for Anthem Community Council

Jeff Crockett
Robert Metli
SNELL & WILMER
One Arizona Center
400 E. Van Buren Street
Phoenix, AZ 85004-2202
Attorneys for Resorts

Bradley J. Herrema
Robert J. Saperstein
Brownstein Hyatt Farber Schreck, LLP
21 E. Carrillo St
Santa Barbara, CA 83101

Greg Patterson
Water Utility Association of Arizona
916 W. Adams, Suite 3
Phoenix, AZ 85007

1 Andrew M. Miller
Town Attorney
2 Town of Paradise Valley
6401 E. Lincoln Drive
3 Paradise Valley, AZ 85253

Desi Howe
Anthem Golf and Country Club
2708 W. Anthem Club Drive
Anthem, AZ 85086

4 Marshall Magruder
P.O. Box 1267
5 Tubac, AZ 85646

6
7
8
9
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11
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Jayne Williams

Testimony Summary for Thomas M. Broderick:

DIRECT TESTIMONY

The total requested revenue increase is \$20,628,634 and the test year is 2008.

This case includes the districts of Anthem Water, Anthem / Agua Fria Wastewater, Sun City Water, Sun City Wastewater, and Sun City West Wastewater.

Arizona-American (the "Company") has continued to make necessary capital investments to adequately provide water and wastewater service to its customers and it has experienced increases in its operations and maintenance expenses since the 2005 test years for previous rate cases for the districts in this new case (except Sun City Water - 2006 previous test year). The Company is also eligible - due to the passage of time - to include capital investments that were made much earlier than 2005 in rate base pursuant to an earlier agreement with the Commission regarding imputed regulatory advances and contributions.

The primary increased investment and expenses in the three years since the previous test years or these districts include:

1) Additional original cost utility plant in service totaling \$70.7 million (all 5 districts), including the Verrado wastewater treatment plant expansion (only Anthem / Agua Fria wastewater district);

2) Additional amortization of imputed regulatory advances and contributions totaling \$28.4 million (all 5 districts);

3) Anthem developer refunds totaling \$28.1 million (only Anthem water and Anthem / Agua Fria wastewater districts);

4) Additional depreciation expense associated with additional original cost utility plant ; in service (all districts);

5) Increased labor and labor related expenses associated with increased activities across many functions (all districts).

Arizona-American's cost of capital is not less than 8.5%. The average cost of long-term debt is 5.47% and the cost of equity is 12.25%. The forecasted equity ratio is 45.15% and the debt ratio is 54.85%. Short-term debt has again been excluded from the calculation of the capital structure.

Arizona-American's proposed rate case expense is \$678,425.

Amortizations of imputed regulatory advances ended July 14, 2008, the end of the six and one-half year amortization period.

Testimony Summary for Thomas M. Broderick:

Page 2

REBUTTAL TESTIMONY

The total **revised** requested annual revenue increase is \$16,583,067 or a 44.8% increase. The **original** requested annual revenue increase was \$20,628,634. The primary reason for the requested revenue reduction is the Company is accepting Staff's cost of capital which alone reduces the original annual revenue requirement by \$3.6 million.

District	Anthem Water	Sun City Water	Anthem / Agua Fria Wastewater	Sun City Wastewater	Sun City West Wastewater
Revenue Increase	\$5,962,687	\$2,026,980	\$5,308,386	\$1,858,070	\$1,426,944

The Company accepts Staff's 7.2% cost of capital and each of the components comprising that overall amount including the 10.7% return on equity.

Testimony Summary for Paul G. Townsley:

DIRECT TESTIMONY

Arizona-American's current financial condition is poor. The Company has taken a number of important steps to reduce expenses and other drags on its earnings, and timely and adequate rate relief from the Commission are necessary.

There are benefits of the Fourth Amendment to the Agreement for Anthem Water/Wastewater Infrastructure to our customers. Accordingly, Arizona-American's request to include the March 31, 2008, refund of Advances in Aid of Construction to Del Webb/Pulte in the rate base for our Anthem Water District and our Anthem Wastewater District is appropriate.

Arizona-American's Achievement Incentive Pay benefits our customers.

There are long-term benefits to our customers by consolidating Arizona-American districts for ratemaking purposes. Arizona-American supports consolidation of its districts but needs to insure that the consolidation process does not cause further financial harm to Arizona-American through delays in this case.

REBUTTAL TESTIMONY

The Infrastructure System Replacement Surcharge for the Sun City Water District benefits customers by providing for the systematic replacement of aged infrastructure in a manner which does not lead to the type of rate shock that would be encountered under traditional ratemaking.

Arizona-American has made progress in reducing non-account water levels in the Sun City Water District and the Staff proposed reduction in power and chemical expenses for that District should be rejected.

The Annual Incentive Plan costs for Arizona-American employees should be included in rates with only a 30% reduction from total Annual Incentive Plan costs to reflect the financial component of the Plan. Likewise, Annual Incentive Plan costs for employees of the Service Company should be included in rates to the same extent as the Annual Incentive Plan costs for employees of Arizona-American are included in rates. The RUCO proposed adjustment should be rejected.

The 2008 Anthem refund payment to Pulte should be included in ratebase because it was paid before the end of the Test Year and the proposal for a phase-in of this payment into ratebase should not be adopted. The Anthem Community Council proposed adjustment should be rejected.

Testimony Summary for Paul G. Townsley:

Page 2

Mr. Townsley also will adopt the pre-filed direct testimony of Christopher C. Buls, as follows:

Arizona-American supports the implementation of an infrastructure improvement surcharge in the Sun City Water District and a pro forma adjustment for certain assurance fees related to transferring the Anthem water lease from Del Webb to Arizona-American Water Company.

Sun City Water has the oldest infrastructure of any of the Company's, and the infrastructure is at point in the asset life cycle where significant levels of replacement capital will begin to be invested. The qualifying assets would be limited to replacements of existing assets, including replacement mains, hydrants, meters (including AMR replacements), services, tanks and booster stations.

If rate consolidation is approved, the Company would recommend that this surcharge be spread across all of the Company's water customers rather than just the Sun City Water customers and that eligibility be expanded to include qualifying assets in all water districts rather than limiting it only to Sun City.

Testimony Summary for Ian C. Crooks:

Mr. Crooks will adopt the pre-filed direct testimony of Bradley J. Cole, as follows:

The Anthem Water District serves approximately 8,678 customers in an unincorporated area north of Phoenix. The Anthem Water District is part of an integrated water/wastewater system comprised of a Central Arizona Project ("CAP") raw-water pumping station, a nine-mile pipeline that brings CAP water to the Anthem community, a combined water and wastewater treatment plant, booster stations and reservoirs, a wastewater lift station, a network of water and wastewater distribution and collection facilities, and an extensive reuse-water distribution system for landscape and turf-irrigation purposes throughout the Anthem community.

The Sun City Water District is Arizona-American's second largest water district, serving approximately 23,000 customers. The system covers roughly 18 square miles of territory, including all of Sun City and Youngtown, as well as small portions of the cities of Peoria and Surprise. Water is produced from 22 active local wells, chlorinated, and then distributed via seven booster stations to customers.

In the Anthem community, the Company provides wastewater collection and treatment service for approximately 8,034 customers. The Anthem system is an integrated water/wastewater system with a combined water and wastewater treatment plant. The Anthem Wastewater Treatment Plant is an activated sludge, tertiary-treatment plant (membrane bioreactor) that treats the wastewater from the Anthem community. A master-planned wastewater collection system sends waste streams by gravity to the Northeast Agua Fria Lift Station No. 1, where it is pumped for treatment to Arizona-American's Northwest Valley Regional Water Reclamation Facility ("NWVRWRF"). The NWVRWRF is a 5.0 mgd wastewater treatment plant, located in unincorporated Maricopa County, which also treats wastewater flows for the Company's Sun City West Wastewater customers. For Russell Ranch, wastewater flows through a collection system by gravity to a Company-owned wastewater treatment plant. The Russell Ranch Water Reclamation Facility is a wastewater treatment plant with a design capacity of 60,000 gallons per day. Wastewater collected from the Verrado community flows by gravity through a collection system to the Verrado Water Reclamation Facility ("Verrado WRF"). The Verrado WRF has the capacity to collect and treat 830,000 gpd using a conventional activated sludge, biological nutrient removal process.

The Sun City Wastewater District is located in the northwest portion of the Phoenix metropolitan area and provides wastewater service to the communities of Sun City, Youngtown, portions of the City of Surprise, and the City of Peoria. The district includes a wastewater collection system with seven lift stations and a metering station. Arizona-American collects the wastewater and then delivers it through a regional collection system for treatment at the Tolleson Wastewater Treatment Plant.

Testimony Summary for Ian C. Crooks:

Page 2

The Sun City West Wastewater District is also located in the northwest portion of the Phoenix metropolitan area and provides wastewater service for the community of Sun City West. The District includes a wastewater collection system with a single lift station. The wastewater is collected by gravity and then lifted, or boosted, for treatment at Arizona-American's NWVRWRF.

The Sun City Water District infrastructure includes replacement mains, replacement meters, replacement pumps, motors, electrical and control equipment at Sun City booster stations. The Company has identified certain segments of water main in the Sun City Water District that have a higher frequency, or concentration, of failure rates than the rest of the water district and seeks to include the costs of these replacements as part of the surcharge, as well as the cost of repairs for other segments that may need work. The Company also seeks to include the cost of the Sun City Water District main replacement program and the booster replacement program as part of the infrastructure improvement surcharge.

In 2009, the Company procured the services of Tank Industry Consultants to perform inspections on thirteen of its fourteen Sun City water storage tanks. This included a careful study of the tanks' interior, exterior, foundation(s) and accessories. As a result of these inspections, Arizona-American has planned a 14-year maintenance schedule, the Tank Maintenance Program.

The Company has entered into an agreement with Tolleson for wastewater treatment and the rate components in that agreement. The Company describes the benefits of this Agreement as opposed to the Company building its own treatment plant.

Testimony Summary for Joseph E. Gross:

DIRECT TESTIMONY

The Company has the following capital improvement projects included in the proposed rate base in Schedule B-2 Adjustments LJG-5: 1) the replacement and rehabilitation of certain wells in Sun City, 2) the headworks of the Anthem Wastewater Treatment Plant, and 3) the Verrado WRF Phase 2 Expansion.

- 1) In Sun City, the well projects include the abandonment and replacement of Sun City Well 5.1 and the rehabilitation of Sun City Well 6.4. Due to excessive sand and high nitrates, Sun City Well 5.1 had been out of service since January 2007. The Company replaced the well within close proximity to the original well. Due to favorable construction bids for the equipment phase, the project was completed under budget and placed in service on May 27, 2009, at a cost of \$1,587,149.

Sun City Well 6.4 was taken out of service in 1997 due to the large volume of sand it produced. The rehabilitation of this well was successful, producing about 800 gpm with very little sand. The well was placed back in service during the test year on December 31, 2008; however, the work order was not closed to Utility Plant in Service until February 2009. Therefore, the additional post test year capital expense should be added to test year end amounts for Utility Plant in Service. The total cost of the new additions to Well 6.4 was \$502,625.

- 2) The headworks of the Anthem Wastewater Treatment Plant has a screening step to remove larger particles prior to reaching the bioreactor membrane treatment process. Larger particles, if not removed, reduce the life of the membranes thereby increasing costs of operation and maintenance. Membranes have a 20-year life for rate-making purposes and the life of membranes will be much less than 20 years absent the head works project. This project improves the process by augmenting the existing screens to remove finer particles. This improvement was placed in service December 31, 2008; however, by the end of the test year, only \$1,918,925 of the total cost of \$2,524,948 had been moved to Utility Plant in Service. The remaining invoices were received within the first four months of 2009 and added project costs of \$606,023.
- 3) The Verrado WRF plant expansion went into service October 31, 2007. The total project cost was \$12,650,000. Arizona-American expects a true-up payment in the amount of \$1,415,610 to occur in late 2010. Even though this is a post test year event, this future contribution has been reflected by the Company, as a proposed reduction to rate base as an additional means of mitigating the rate increase requested herein.

REBUTTAL TESTIMONY

The Company rebuts RUCO's recommendation to exclude from rate base the replacement of Sun City Well 5.1 which Staff accepted.

Testimony Summary for Joseph E. Gross:

Page 2

The Company accepts Staff's recommendation to exclude a portion of the Verrado WWTP from rate base even though the portion excluded improves reliability.

Testimony Summary for Linda J. Gutowski:

DIRECT TESTIMONY

Individual Rate-Base Adjustments:

Ms. Gutowski sponsors rate base Exhibits B-1 through B-6. Rate base for each district follows:

Table 1 – Summary of Rate Base

<u>District</u>	<u>OCRB</u>
Anthem Water	\$57,431,984
Sun City Water	\$28,186,063
Anthem / Agua Fria Wastewater	\$47,435,732
Sun City Wastewater	\$14,764,087
Sun City West Wastewater	\$17,821,339
Total All Districts	\$165,939,204

Anthem Water Rate-Base Adjustments: Adjustment LJG-6 adds \$5,000,000 to rate base, and adds \$116,667 in accumulated amortization, for the Phoenix Interconnection.

Sun City Water Rate-Base Adjustments: Adjustment LJG-5 adds Post-Test-Year Additions of \$1,625,810 for Wells and deducts the Retirement of \$463,964 for the Wells from Plant and Accumulated Depreciation.

Anthem / Agua Fria Wastewater Rate-Base Adjustments: Adjustment LJG-3 adds 32% of the Northwest Valley Regional Treatment Facility to Anthem / Agua Fria Wastewater District, as per the last Decision No. 70372. Adjustment LJG-5 is for Post Test Year Plant additions for the remaining costs of \$606,023 for the Anthem Wastewater Plant Headworks project and to increase Contributions in Aid of Construction for a future contribution of \$1,415,610 due from Pulte in 2010 for the Verrado Wastewater Reclamation Facility (“WRF”). Adjustment LJG-6 adds \$611,466 to Accumulated Depreciation for the Verrado WRF with the reclassification of the accounts.

Sun City Wastewater Rate-Base Adjustments: No individual adjustments were necessary.

Sun City West Wastewater Rate-Base Adjustments: Adjustment LJG-3 adds 68% of the Northwest Valley Regional Treatment Facility to Sun City West Wastewater District, as per the last Decision No. 70209

Schedules B-3 and B-4: The Company has not submitted an RCND study and requests that Fair Value Rate Base be the same value as Original Cost Rate Base.

Testimony Summary for Linda J. Gutowski:

Page 2

Schedule B-5 and B-6: Ms. Gutowski sponsors the Working Capital Calculation. Materials & Supplies are based on a 13-month average of the monthly balances and Prepayments are the ending test year balances for their portion of the Working Capital Calculation. The Cash Working Capital is determined by a lead / lag study based on the test year experience and is on Schedule B-6.

Income statement adjustments.

Ms Gutowski sponsors the following income-statement adjustments:

Adjustment LJG-1 removes unbilled revenues for each district.

Adjustment LJG-2 annualizes the rate increases granted during the test year, 2008, for Anthem Water, Sun City Water, Anthem / Agua Fria Wastewater, Sun City Wastewater, and Sun City West Wastewater.

Adjustment LJG-3 annualizes the year end number of customers as compared to the average number of customers during the test year. The adjustment annualizes the revenue as well as the expenses associated with providing service to more, or less, customers as the case may be.

Adjustment LJG-4 corrects intra district billing errors that occurred during the test year.

Adjustment LJG-5 annualizes depreciation expense based on year end plant balances times depreciation rates. The Company is requesting several new and/or changed depreciation rates, which will be discussed below.

Ms. Gutowski also sponsors the H Schedules. The Company is proposing across-the-board rate increases for both the basic service charges and the volumetric rates.

REBUTTAL TESTIMONY

For the Rate Base - Utility Plant In Service, the Company rejects RUCO's position to not include Well 5.1 in the Sun City Water District in rate base.

The Company accepts Staff's revision to the allocation of the North West Valley Treatment Plant ("NWVTP") from 32% down to 28% for Anthem / Agua Fria Wastewater District and from 68% up to 72% for Sun City West Wastewater District.

For Rate Base - Cash Working Capital, the Company accepts Staff's adjustment to leave out Chemical Expense for a downward adjustment for the combined districts of \$71,339. The Company accepts Staff's adjustment to remove Bad Debt Expense from Customer Accounting Expense for a downward adjustment for the combined districts of \$26,048.

Testimony Summary for Linda J. Gutowski:

Page 3

After accepting some Staff adjustments, the Company corrects the payment lag for Management Fees from 14.77 days to a lead of 11.25 days.

The Company rejects RUCO's Cash Working Capital positions.

For the Rate Base - Deferred Income Taxes, the Company accepts Staff's downward adjustment for the combined districts of \$173,965 to agree with audited financials.

In the Revenue category, the Company makes several very minor adjustments due to errors found in linking files.

For Operating Expenses - Customer Accounting, the Company accepts Staff's reduction to Bad Debt Expense but changes the amount to a decrease of \$3,827 for the combined districts by comparing Net Charge Offs in the test year to Staff's revised Net Charge Offs.

For Operating Expense - Miscellaneous - Water Testing, the Company accepts Staff's adjustments for Water Testing Expenses.

For Operating Expense - Maintenance - Tank Maintenance, the Company rejects RUCO's disallowance of a Tank Maintenance Reserve.

For Operating Expense - Depreciation, the Company disagrees with Staff for the Corporate Division depreciation rates. New Corporate Division depreciation rates were effective December 1, 2009 as per Decision No. 71410.

Ms. Gutowski also will adopt portions of the pre-filed direct testimony of Sheryl L. Hubbard, as follows:

The following schedules and related testimony for each district in the case:

- Schedule A-2 – Arizona American Summary of Results of Operations
- Schedule A-4 – Arizona American Construction Expenditures and Gross Utility Plant in Service
- Schedule A-5 – Arizona American Summary Statements of Cash Flows
- Schedule E-8 – Taxes Charged to Operations
- Schedule F-1 – Projected Income Statements
- Schedule F-2 – Projected Statements of Changes in Financial Position
- Schedule F-3 – Projected Construction Requirements
- Schedule F-4 – Assumptions Used in Rate Filing

Testimony Summary for Linda J. Gutowski:

Page 4

Operating Income Adjustments:

- Adjustment SLH-5 - Annualize Purchased Water
- Adjustment SLH-6 – Remove CAP Revenue and Expense
- Adjustment SLH-8 – Water Testing Expense
- Adjustment SLH-11 – Tank Maintenance Accrual
- Adjustment SLH-12 – Annualize Property Taxes
- Adjustment SLH-13 – Remove Other Income and Deductions
- Adjustment SLH-15 – Interest Synchronization
- Adjustment SLH-16 – Federal and State Income Taxes

Arizona American's request for a tank maintenance reserve to fund tank maintenance expenditures.

Testimony Summary for John C. Lenderking:

DIRECT TESTIMONY

For Anthem Water District water conservation, in compliance with Decision No. 70372, Arizona-American has implemented six Best Management Practices (“BMPs”), and the BMPs chosen are from Categories 1, 3, 4, and 7.

In Category 1, the public awareness, local and/or regional messaging program BMP is implemented. Since 2000, Arizona-American has been a partner in the “Water-Use It Wisely” media campaign. In fact, Arizona-American was the first private water provider to become a Water-Use It Wisely partner.

In Category 3, Arizona-American has implemented two BMPs. These include the residential audit program and the residential interior retrofit program. In the residential audit program BMP, Arizona-American makes available water conservation home audit kits to all of its water customers free of charge. These kits are offered to customers through bill inserts and the Company’s SAVEH2OARIZONA website. For the residential interior retrofit program BMP, Arizona-American makes available water conservation retrofit kits to all of its water customers free of charge. These kits also are offered to the Company’s customers through bill inserts and the Company’s SAVEH2OARIZONA website.

In Category 4, the Company has implemented two BMPs: the meter repair and/or replacement program BMP and the comprehensive water system audit program BMP. In the meter repair and/or replacement program, Arizona-American repairs and/or replaces water meters as meters fail to perform and schedules meters to be replaced after 15 years of use. In the comprehensive water system audit program BMP, Arizona-American performs multiple tasks. Arizona-American continuously monitors the production and distribution system for any abnormal reading that would indicate a leak or break. Also, under this BMP, all production meters are checked for accuracy each year and calibrated or replaced as necessary. Arizona-American has two standing committees which regularly evaluate the water system.

Finally, in Category 7, the evaluation of new and emerging technologies is implemented. In this BMP, Arizona-American has been analyzing and continues to analyze the combination of two technologies, acoustic leak detection and automatic meter reading, together, to monitor systems leaks.

For Sun City Water District water conservation, Arizona-American implemented a number of conservation BMPs in the Sun City district. They include a regional messaging program, adult education and training, residential audit program, interior retrofit program, and a meter replacement program.

Testimony Summary for Sandra L. Murrey:

DIRECT TESTIMONY

Ms. Murrey sponsors these adjustments that appear on Schedule B-2, Original Cost Rate Base Pro Forma Schedule:

- Adjustment SLM-1 adjusts for Accumulated Depreciation for (Over)/Under Depreciation from the last case to the end of the test year in this case.
- Adjustment SLM-2 allocates the Common, or Corporate, Plant and Accumulated Depreciation to each of the districts based on the 4 Factor Allocations for 2008.
- Adjustment SLM-7 removes the Deferred Debits that are not afforded rate treatment.
- Adjustment SLM-8 decreases the Contributions in Aid of Construction balance for dollars associated with developer-funded projects that are still in Construction Work in Progress ("CWIP") and not included in rate base.

Ms. Murrey sponsors the following schedules for each district in the case:

- Schedule E-1 – Comparative Balance Sheets
- Schedule E-5 – Detail of Plant in Service

REBUTTAL TESTIMONY

In response to Staff and RUCO's testimony concerning certain rate base issues:

Utility Plant in Service & Accumulated Depreciation:

- For Anthem Water, the Company accepts Staff's transfer of plant \$22,289 between NARUC accounts.
- For Sun City Water, the Company accepts Staff's downward adjustment of \$149,497 for the Youngtown Plant and \$22,008 of accumulated depreciation.
- For Anthem/Agua Fria Wastewater, the Company accepts Staff's revision for the downward adjustment of \$1,838,637 for the Verrado Wastewater Plant.

The Company accepts Staff's transfer of generator costs of \$487,000 between NARUC accounts.

The Company accepts RUCO's inclusion of the retirement of 2 – 75 hp pumps at the Verrado Wastewater Treatment Facility for a downward adjustment of \$52,636 offset by identical accumulated depreciation.

- For Sun City Wastewater, the Company accepts Staff's transfer of force main study for Sun City West Wastewater for a downward adjustment of \$12,242. Please see offsetting adjustment in Sun City West Wastewater.

Testimony Summary for Sandra L. Murrey:
Page 2

- For Sun City West Water District, the Company accepts Staff's transfer of force main study for Sun City Wastewater for an upward adjustment of \$12,242. Please see offsetting adjustment in Sun City Wastewater.

Contributions Associated with CWIP:

- The Company accepts RUCO's and Staff's adjustments for all districts as immaterial.

Other:

- The Company notes that no party disagreed with the Company's proposed Tolleson Rate Component costs for Sun City Wastewater District.

Ms. Murrey will adopt portions of the pre-filed direct testimony of Sheryl L. Hubbard, as follows:

Allocation of the Northwest Valley Regional Treatment Facility plant investment and operating expenses between Sun City West Wastewater District and the Anthem/Agua Fria Wastewater District.

Testimony Summary for Dr. Bente Villadsen:

DIRECT TESTIMONY

Dr. Bente Villadsen, a Principal at The Brattle Group, files testimony on the cost of capital for Arizona-American Water Company's Anthem and Sun City water districts as well as for its Anthem/Agua Fria, Sun City and Sun City West wastewater districts.

Dr. Villadsen selects two benchmark samples, water utilities and gas local distribution companies ("LDC"). For the water sample, she primarily relies on a subsample that excluded Southwest Water which recently cut its dividend and also have announced it will restate part of its financials. Using two versions of the Discounted Cash Flow ("DCF") method and three versions of the Capital Asset Pricing Model ("CAPM"), she estimates the sample companies' after-tax weighted-average cost of capital. The after-tax weighted average cost of capital is the measure that companies most commonly use to evaluate investments and the measure recommended in standard financial textbooks. Textbooks, the academic literature as well as businesses weigh debt and equity by the market values in determining the after-tax weighted cost of capital.¹

Having estimated the samples' after-tax weighted-average cost of capital for the samples, she determines the corresponding cost of equity for Arizona-American Water at its target of 45 percent equity. In undertaking her analysis, Dr. Villadsen notes that the overall cost of capital is constant within a broad middle range of capital structures although the distribution of costs and risks among debt and equity holders is not. Because the overall cost of capital is the same in a broad range of capital structures, there are no impacts on the rates customers pay from a higher or lower percentage of equity, so ratepayers are not affected by the choice of capital structure within a broad range. However, as Arizona-American Water's requested target of 45 percent equity is lower than the percentage equity among many utilities, its financial risk is higher and the return required by investors increases with the level of risk they carry, but this return is paid on a smaller amount of equity than is typical in the water industry. Therefore, the dollar amount paid by customers is the same as if the Company had a lower return on equity but a higher equity percentage.

Dr. Villadsen discusses the impact of the ongoing financial crisis on utilities' cost of capital and notes that while the yield on government issued bills and bonds is currently very low, the yield on investment-grade utility bonds is not. As utilities cannot raise debt (or equity) at the same rates as the government, it is necessary to take the yield on investment grade utility bonds into account in assessing the cost of capital for Arizona-American Water. Specifically, the yields on government bills and bonds have been driven artificially down by monetary policy and a flight to safety, so that the yields on these securities are not reflective of normal economic conditions. Consequently, Dr. Villadsen bases her CAPM models on a normalized risk-free rate which consists of the observed risk-free rate plus an adjustment for the increase in the spread between risk-free rates and investment grade utility bond yields. Further, equity investors have

¹ For example, the Hamada article relied upon by Commission Staff in past proceedings uses market value capital structures.

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lost substantial value in capital markets over the past ¾ year and stock prices have been extremely volatile. As a result, investors risk aversion has increased and the premium they require to invest in stocks going forward has increased. Therefore, the risk premium associated with equity investments is currently higher than it has been in the recent past. Dr. Villadsen performs several sensitivity analyses on the impact hereof, but the requested return on equity is fully supported by her baseline analysis, which relies on a historical market risk premium. In other words, her recommended return on equity does not include the current higher risk premium making her recommendation more conservative.

In addition to the cost of capital estimation discussed above, Dr. Villadsen reviewed 20 recent decisions by the Arizona Corporation Commission to assess the reasonableness of Arizona-American Water's current request. When compared in terms of the overall return, the cost of equity requested by Arizona-American Water in this proceeding is comparable to that granted to other water and wastewater utilities in Arizona as adjusted using Arizona-American's targeted equity percentage.

Lastly, Dr. Villadsen notes that the water industry has seen substantial stock price drops in recent months, volatility in stock prices, and increased cost of debt. At the same time, the most commonly used measure of companies' systematic risk, the stock's beta, has remained high for water utilities. This indicates that capital markets continue to perceive water utilities as risky investments rather than safe havens. At the same time the water industry, including Arizona-American Water needs to invest substantial amounts in infrastructure to upgrade the distribution and transmission system as well as to develop new water resources. The industry also need to invest in wastewater collection and treatment. The needed infrastructure investment requires substantial external financing (i.e., new debt and equity) and access to capital requires that investors expect to earn their required return. Failure to provide adequate returns may discourage potential investors. While it may seem counterintuitive to increase the cost of capital during an economic recession, it is necessary to attract needed capital. Specifically, the increase in investment-grade utility bond yields and the decline in available equity capital show that investors are holding onto their funds and in order to attract investments, they will need to expect that they can earn a sufficient return on their investment that it is worth the risk. The June 2009 sale of American Water stock had been expected by the market for a long time and was priced at 80 percent of American Water's April 2008 Initial Public Offering price. The lower price means that everything else equal, investors expect to realize a higher return on their investment than they did a year ago. Thus, at the same income level as a year ago, it is consistent with an increased market risk premium.

Based on the evidence from the samples, Dr. Villadsen finds that Arizona-American Water's request for 12.25% return on equity is reasonable and fully supported by her analysis. The financial crisis has made the range of a reasonable return on equity wider and especially increased the upper bound on the range, so the requested return on equity is below the midpoint of the best range estimate of 11¾ percent to 13 percent.

REBUTTAL TESTIMONY

Dr. Bente Villadsen, a Principal at *The Brattle Group*, filed direct testimony on the cost of capital for Arizona-American's Anthem and Sun City water districts as well as for its Anthem/Agua Fria, Sun City, and Sun City West waste water districts (collectively, "Arizona-American Water") in July 2009, and is now filing rebuttal testimony in response to the testimony submitted by Mr. William A. Rigsby on behalf of the Residential Utility Consumer Office ("RUCO"). As Arizona-American Water has accepted Staff's recommended cost of equity, Dr. Villadsen is not responding to the Direct Testimony of Staff Witness Juan C. Manrique.

Mr. Rigsby's recommended 9.5% return on equity on 39.15% equity is too low to be reasonable. It does not afford Arizona-American Water the opportunity to earn a reasonable return on its assets and to successfully raise equity capital. The main reasons, Mr. Rigsby finds such a low cost of equity is that he (i) fails to take Arizona-American's financial risk into account, (ii) relies on an unconventional adjustment in his DCF analysis, and (iii) includes cost of equity estimates below the cost of debt plus a minimum equity risk premium of 100 basis points in his Capital Asset Pricing Model. Simple modifications to Mr. Rigsby's cost of equity estimation methodology increases the calculated cost of equity by at least 100 basis points.

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DIRECT TESTIMONY

Mr. Kiger sponsors the following schedules for each district in the case:

- Schedule E-2 - Comparative Income Statements
- Schedule E-6 - Comparative Operating Income Statements
- Schedule E-6a - Comparative Operating Income Statements

And the following schedules for the Anthem/Agua Fria Wastewater district and the Sun City West Wastewater districts:

- Schedule E-6b - Comparative Operating Income Statements
- Schedule E-6c - Comparative Operating Income Statements

Mr. Kiger sponsors the following NECESSARY adjustments to operating income:

- Adjustment MHK-1 - Annualize Power Expense
- Adjustment MHK-2 - Annualize Chemicals Expense
- Adjustment MHK-3 - Annualize Management Fees
- Adjustment MHK-4 - Adjust Mgmt. Fees for Other Expenses
- Adjustment MHK-5 - One-Time Service Company Charges
- Adjustment MHK-6 - Annualize Postage Increase
- Adjustment MHK-7 - Normalize Purchased Water for Cost Savings
- Adjustment MHK-8 - Amortize Rate Case Expense
- Adjustment MHK-9 - Line 2 1 Clean-up

REBUTTAL TESTIMONY

The Company seeks Arizona Corporation Commission authority to defer replacement costs paid to the City of Glendale in association with the 99th Avenue Interceptor, pursuant to the City of Glendale Sewage Transportation Agreement.

Arizona-American's rebuttal position for Adjusted Operating Income is:

District	Anthem Water	Sun City Water	Anthem/ Agua Fria Wastewater	Sun City Wastewater	Sun City West Wastewater
Adjusted TY Operating Income	\$528,986	\$776,673	\$88,073	(\$66,402)	\$441,997

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Arizona-American's rebuttal position for Operating Expense is:

District	Anthem Water	Sun City Water	Anthem/ Agua Fria Wastewater	Sun City Wastewater	Sun City West Wastewater
Adjusted TY Operating Expenses	\$6,973,758	\$8,506,428	\$8,548,929	\$6,007,429	\$5,219,712

Mr. Kiger sponsors the following rebuttal adjustments to operating income:

- Adjustment MHK-1R – Accept RUCO C-3, 30% Disallowance of AIP
- Adjustment MHK-2R – Accept RUCO C-4, Removal of Stock Based Compensation
- Adjustment MHK-3R – Accept Staff Fuel & Power Expense Adjustment
- Adjustment MHK-4R – Sun City WW – Glendale Waste Disposal Expense Adjustment
- Adjustment MHK-5R – Adjust Mgmt. Fees for 30% Disallowance of AIP
- Adjustment MHK-6R – Accept RUCO C-9, Mgmt. Fees Other Expenses Adjustment
- Adjustment MHK-7R – Accept RUCO C-14, Mgmt. Fees Business Development Adj
- Adjustment MHK-8R – Accept RUCO C-7, Mgmt. Fees Dues & Donations Adjustment
- Adjustment MHK-9R – Annualize Pension Expense
- Adjustment MHK-10R – Accept Staff Rate Case Expense Adjustment

Mr. Kiger also will adopt portions of the pre-filed direct testimony of Sheryl L. Hubbard, as follows:

The following schedules and related testimony for each district in the case:

- Schedule C-1 – Arizona American Adjusted Test Year Income Statement
- Schedule C-2 – Arizona American Income Statement Pro Forma Adjustments
- Schedule C-3 – Arizona American Computation of Gross Revenue Conversion Factor
- Schedule E-3 – Comparative Statement of Changes in Financial Position
- Schedule E-7 – Operating Statistics

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The following adjustments to operating income and related testimony:

- Adjustment SLH-1 – Annualize Payroll and Payroll Tax Expense
- Adjustment SLH-2 – Annualize Pension Expense
- Adjustment SLH-3 – Annualize 401K Expense
- Adjustment SLH-4 – Annualize Insurance Expense
- Adjustment SLH-7 – Annualize Waste Disposal Expense
- Adjustment SLH-9 – Specialist on Industrial Pre-Treatment
- Adjustment SLH-10 – Adjust Conservation Expenses
- Adjustment SLH-14 – Annualize OPEBs