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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission
DOCKETED

MAY 07 1997

DOCKETED BY 60172 CLN

CARL J. KUNASEK
CHAIRMAN
JIM IRVIN
COMMISSIONER
RENZ D. JENNINGS
COMMISSIONER

IN THE MATTER OF THE APPLICATION OF CITIZENS UTILITIES COMPANY, AGUA FRIA WATER DIVISION, FOR A HEARING TO DETERMINE THE FAIR VALUE OF ITS PROPERTIES FOR RATEMAKING PURPOSES TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, AND TO APPROVE RATE SCHEDULES DESIGNED TO PROVIDE SUCH RATE OF RETURN.	DOCKET NO. E-1032-95-417
IN THE MATTER OF THE APPLICATION OF SUN CITY SEWER COMPANY FOR A HEARING TO DETERMINE THE FAIR VALUE OF ITS PROPERTIES FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, AND TO APPROVE RATE SCHEDULES DESIGNED TO PROVIDE SUCH RATE OF RETURN.	DOCKET NO. U-2276-95-417
IN THE MATTER OF THE APPLICATION OF SUN CITY WATER COMPANY FOR A HEARING TO DETERMINE THE FAIR VALUE OF ITS PROPERTIES FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, AND TO APPROVE RATE SCHEDULES DESIGNED TO PROVIDE SUCH RATE OF RETURN.	DOCKET NO. U-1656-95-417
IN THE MATTER OF THE APPLICATION OF SUN CITY WEST UTILITIES COMPANY FOR A HEARING TO DETERMINE THE FAIR VALUE OF ITS PROPERTIES FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, AND TO APPROVE RATE SCHEDULES DESIGNED TO PROVIDE SUCH RATE OF RETURN.	DOCKET NO. U-2334-95-417

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DOCKET NO. E-1032-95-417 ET AL.

IN THE MATTER OF THE APPLICATION OF TUBAC VALLEY COMPANY FOR A HEARING TO DETERMINE THE FAIR VALUE OF ITS PROPERTIES FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, AND TO APPROVE RATE SCHEDULES DESIGNED TO PROVIDE SUCH RATE OF RETURN.	DOCKET NO. U-1595-95-417
IN THE MATTER OF THE APPLICATION OF SUN CITY SEWER COMPANY FOR REVIEW OF ITS SEWER TREATMENT SURCHARGE.	DOCKET NO. U-2276-95-420
IN THE MATTER OF THE APPLICATION OF SUN CITY WATER COMPANY FOR AN EXTENSION OF ITS CERTIFICATE OF CONVENIENCE AND NECESSITY TO SERVE THE TOWN OF YOUNGTOWN, ARIZONA.	DOCKET NO. U-1656-96-282
IN THE MATTER OF THE APPLICATION OF SUN CITY SEWER COMPANY FOR AN EXTENSION OF ITS CERTIFICATE OF CONVENIENCE AND NECESSITY TO SERVE THE TOWN OF YOUNGTOWN, ARIZONA.	DOCKET NO. U-2276-96-282 DECISION NO. 60172 **OPINION AND ORDER**

PUBLIC COMMENTS: May 15, 1996 (Phoenix, Sun City, and Surprise, Arizona); June 7, 1996 (Nogales, Arizona).

DATES OF HEARING: March 20, April 17, and April 30, 1996 (pre-hearing conferences), October 29, 30, 31; November 1, 4, 5, 6, 7, 8, 12, 13, 14, and 15, 1996.

PLACE OF HEARING: Phoenix, Arizona

PRESIDING OFFICER: Lyn Farmer

IN ATTENDANCE: Renz D. Jennings, Chairman
Marcia Weeks, Commissioner
Carl J. Kunasek, Commissioner

APPEARANCES: Ms. Beth Ann Burns and Ms. Susan Mikes Redner, Associate General Counsels, on behalf of Citizens Utilities Company;

Mr. James P. Beene and Mr. Paul R. Michaud, Staff Attorneys, on behalf of the Residential Utility Consumer Office;

Mr. Josephe E. Larue and Mr. William G. Beyer, BEYER, SPRILSBURY & LARUE, on behalf of the Sun City Homeowners Association, the Recreation Centers of Sun City West, Incorporated, the Sun Village Unity Association, and the City of Surprise;

Mr. Philip H. Vision, in propria persona;

Mr. Lester E. Merydith, in propria persona, on behalf of Sun City Water Users Association;

Mr. Tom Delgado, Staff Counsel, on behalf of Central Arizona Water Conservation District;

Mr. William P. Sullivan, MARTINEZ & CURTIS, P.C., on behalf of Sun City Taxpayers' Association;

Mr. Charles L. Cahoy, Deputy Counsel, on behalf of the Department of Water Resources; and

Mr. Paul A. Bullis, Chief Counsel, and Ms. Deborah R. Scott, Staff Attorneys, on behalf of the Utilities Division of the Arizona Corporation Commission.

TABLE OF CONTENTS

DISCUSSION 3

I. NATURE OF APPLICANT'S OPERATION AND PROPOSED INCREASES 3

II. CENTRAL ARIZONA PROJECT 4
- Background 4
- Recovery of CAP Capital Charges 5
- Analysis 9

III. RATE BASE 10
- A. AR-13 AFUDC ("AR-13") 11
- B. Youngtown Plant Acquisition 14
  - 1. Escrow Account 15
  - 2. Accumulated Depreciation 16
  - 3. Acquisition Adjustment 16
- C. Stamford Administrative Office Common Plant 18
- D. Plant-in-Service 18
- E. Cash Working Capital 19
- F. Sun City West Developer Advances 20
- G. Accumulated Deferred Income Taxes 20
- H. Staff Recommendations 21

IV. ORIGINAL COST RATE BASE SUMMARY 21

V. RECONSTRUCTION COST NEW RATE BASE 21

VI. FAIR VALUE RATE BASE 21

VII. OPERATING INCOME 22
- A. Gross Annual Revenues 22
- B. Annual Operating Expenses 22
  - 1. Adjustments "Agreed" to by Citizens 23
    - a. Administrative Office Expenses 23
    - b. TARGET: Excellence Expense 24
    - c. Incentive Deferred Compensation Program Expense 25
    - d. Post-Retirement Benefits Other Than Pensions 25
  - 2. Depreciation 27
    - a. Depreciation Rates 27
    - b. Amortization of Sun City Wastewater Treatment Plant 29
  - 3. Employee Benefits Expense 29
  - 4. Insurance Expense 30
  - 5. Injuries and Damages Insurance Expense 30
  - 6. Power Costs 30
  - 7. Payroll and Payroll Tax Expense Issues 30

VII. OPERATING INCOME (continued)

8. Rate Case Expense 31
9. Property Tax Expense 31
10. Income Tax Expense 32
11. Conservation Program Cost 32
12. Groundwater Withdrawal Fees 32
13. Investment Tax Credit Amortization 32
14. Water Testing Expenses 32
15. Sun City Sewer Surcharge Revenues and Expenses 33
16. Price Elasticity Adjustment 33
17. Industrial Wastewater Pretreatment Program 33
18. CAP Water Costs 34

C. Statement of Net Operating Income 34

VIII. RATE OF RETURN 34

A. Capital Structure 34
B. Cost of Debt 35
C. Cost of Preferred Stock 35
D. Cost of Common Equity 35
E. Cost of Capital Summary 38

IX. AUTHORIZED INCREASE/DECREASE 39
X. COST OF SERVICE 40
XI. RATE DESIGN 41

A. Water Utilities 41
B. Wastewater Companies 44

XII. YOUNGTOWN CC&N 45
FINDINGS OF FACT 45
CONCLUSIONS OF LAW 49
ORDER 50

BY THE COMMISSION:

On August 17, 1995, Citizens Utilities Company, Agua Fria Water Division, Sun City Sewer Company, Sun City Water Company, Sun City West Utilities Company and Tubac Valley Company, (collectively "Company", "Citizens", or "Maricopa W/WW") filed applications with the Arizona Corporation Commission ("Commission") for rate increases ("Joint Rate Applications").

Between September 15, 1995 and October 2, 1995, the Company revised the application and on October 3, 1995, the Commission's Utilities Division ("Staff") found that the Company had met the filing requirements of A.A.C. R14-2-103 and was classified as a Class A utility.

On October 3, 1995 Sun City Sewer Company filed an application for review of its sewer treatment charges, and on November 3, 1995 the sewer treatment surcharge application was consolidated with the Joint Rate Applications.

On May 8, 1996, Sun City Water and Sun City Sewer filed a Joint Application for extensions to their Certificates of Convenience and Necessity ("Certificate" or "CC&N").

On July 17, 1996, Staff filed a Motion requesting consolidation of the Joint Rate Applications and the Joint CC&N Applications and by Procedural Order issued on August 2, 1996, the consolidation was granted.

During the period between October 3, 1995 through June 12, 1996, the following requested and were granted intervention status: the Sun Village Community Association ("SVCA"); Centurion Management Company ("Centurion"); Bell West Ranch Limited Partnership and Suprise 222 Limited Partnership ("Partnerships"); Shea Homes Limited Partnership ("Shea Homes"); the Residential Utility Consumer Office ("RUCO"); the City of Glendale; Mr. Lester E. Merydith; the Property Owners and Residents Association of Sun City West ("PORA"); Mr. Richard Kithil; Mr. Anthony Pavone; the Tubac Golf Resort ("Tubac"); the Santa Cruz Valley Citizen's Council, Inc. ("SCVCC"); the Sun City Home Owners Association ("SCHOA"); the Sun City West Recreation Centers, Inc. ("SCWRC"); the Sun City Taxpayers' Association ("SCTA"); the Central Arizona Water Conservation District ("CAWCD"); the Happy Trails Community Association ("HTCA") through its Manager, Mr. Leon Rye; the Tubac Fire District Board ("TFDB"); the City of Surprise; and the Arizona Department of Water Resources ("ADWR").

Subsequently, there were numerous discovery disputes between primarily RUCO, Staff, and other parties on the one hand and the Company on the other hand. Oral arguments on the discovery disputes occurred on March 5, March 20, April 3, and April 23, 1996. The Presiding Officer issued the following decision at the March 15, 1996 oral argument, and a Procedural Order was issued on March 22, 1996 which set forth the following:

> We find that pursuant to A.A.C. R14-2-103(B)(11)(e)(ii) there are clearly extraordinary events in this case, including:
>
> (1) Citizens has knowingly failed to respond to discovery requests in a timely manner. On October 11, 1995, Staff filed its Request for Procedural Order. On October 23, 1995, the Company filed a Response, stating that the proposed discovery schedules do not allow it a reasonable and adequate opportunity to prepare responses and objections to discovery. Our October 25, 1996 Procedural Order rejected the Company's arguments and clearly specified a time frame of ten days in which to respond to discovery requests. Citizens did not appeal this ruling. Citizens readily admits that it has been late in responding to data requests,[1] and continues to be late in its responses, even after the Procedural Conference.
>
> (2) Citizens failed to comply with the March 5, 1996 bench ruling as set forth in the March 6, 1996 Procedural Order. Citizens did not immediately respond to all outstanding data requests.
>
> (3) Citizens has not shown that it has taken steps to modify its internal process to insure compliance with the October 25, 1995 or the March 6, 1996 Procedural Orders.
>
> (4) the Motion For Stay filed by Citizens on March 12, 1996.
>
> (5) Citizens' announcement of an "amended application"/"corrected filing" to be filed no later than the end of the week (March 8, 1996), and then its decision announced at the March 20, 1996 Procedural Conference not to make the filing.
>
> (6) Citizens' filing three rate cases within several weeks of each other, including this rate case, which is actually six applications combined into one proceeding.
>
> (7) During a similar discovery Procedural Conference in Docket No. E-1032-95-433, Citizens' pending electric rate application, the Commission suspended the Timeclock Rules.
>
> While we find each of the above is an extraordinary event by itself, cumulatively we find it even more compelling.
>
> We find that the Company's clear, repeated violations of the Commission's rulings and orders has harmed Staff, RUCO, and the other Intervenors' opportunity to analyze data and fully present their case(s). As a result, Staff and RUCO's Motions are granted, and the Timeclock Rules are suspended.

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[1] At the March 5, 1996 Procedural Conference, it indicated that it was an average of 12 days late in responding to Staff and RUCO data requests. Staff indicated that the Company was an average of 14 days late, with some data requests being as late as 40 days. At the March 20, 1996 Procedural Conference, the Company indicated that its average "lateness" was improving.

By Procedural Order issued May 9, 1996, the stay of the Timeclock Rules was lifted and the hearing was rescheduled for October 29, 1996. The May 9, 1996 Procedural Order determined that the time-clock rules were extended by 167 days as a result of the extraordinary events.

This consolidated matter came before a duly authorized Hearing Officer of the Commission at the Commission's offices in Phoenix, Arizona on October 29, 1996. Citizens, RUCO, and various intervenors appeared through counsel and Staff appeared through counsel. At the conclusion of the hearing, the matter was adjourned pending submission of simultaneous initial and reply briefs on December 18, 1996 and January 17, 1997, respectively. On February 21, 1997, the Company, Staff, and RUCO filed composite schedules.

DISCUSSION

I. NATURE OF APPLICANT'S OPERATIONS AND PROPOSED INCREASES

Citizens is a Delaware corporation and diversified public utility which, through its operating divisions and subsidiaries, provides electric, natural gas, telecommunications, water and wastewater service to approximately 1.8 million customers in 20 states. Citizens is engaged in the business of providing public utility water and wastewater service to approximately 90,000 customers in Maricopa and Santa Cruz Counties pursuant to Certificates of Public Convenience and Necessity granted by the Commission. Maricopa W/WW includes six operations with individual rate structures and separate accounting records. They include the Agua Fria Water Division ("Agua Fria"), Citizens' wholly-owned subsidiaries Sun City Sewer Company ("Sun City Sewer"), Sun City Water Company ("Sun City Water"), Sun City West Utilities Company water operations ("Sun City West Water") and wastewater operations ("Sun City West Wastewater"), and Tubac Valley Water Company.

In its application, Citizens requested an increase in operating revenues of approximately $3.68 million. During the course of the proceeding, Citizens revised its request to approximately $2.1 million. For each of the operations, the rate relief requested now is as follows: Sun City Water Company, $364,780; Sun City Sewer Company, $404,392; Sun City West water operations, $127,492; Sun City West wastewater operations, $994,602; Citizens Agua Fria Water Division, $148,555; and Tubac Valley Water Company, $51,662. Staff recommended an overall decrease of $420,162 and RUCO recommended an overall increase in the Company's operating revenues of $525,071.

II. CENTRAL ARIZONA PROJECT

Background

In 1968, Congress passed the Colorado River Basin Project Act in response to comprehensive water resource studies conducted by federal and state agencies which indicated that projected water demand for agricultural and municipal uses could not be effectively met by available local water resources. The Central Arizona Project ("CAP") was planned and built jointly by federal agencies (Department of Interior -- Bureau of Reclamation) and state agencies and was designed and constructed to divert water from the Colorado River and transport it for use within central and southern Arizona to augment current water supplies and to help mitigate continued overdraft of the groundwater supplies. The State of Arizona created the Central Arizona Water Conservation District ("CAWCD") in 1971 to act as the State's authority to contract with the federal government to manage and operate the project, to levy taxes, and to subcontract with potential users for water delivery at rates established by CAWCD.

The CAP was declared complete in October 1993, at a total cost of over $3 billion. It consists of a 24.3 percent interest in the Navajo Generating Plant, aqueducts, pumping plants, check structures, an operation/control center, the new Waddell Dam, canal and pump/generating plant, turnouts and a communications system. The water is diverted from the Colorado River at Lake Havasu and transported through aqueducts and canals to Lake Pleasant, where it can be temporarily stored, and then pumped to Phoenix and Tucson. The CAP was designed to transport approximately 1.5 million acre feet annually to Arizona.

There are three types of subcontractors[2] for CAP water: Indian, non-Indian municipal and industrial ("M&I"), and non-Indian agricultural. There are three categories of CAP costs, including the M&I Capital Charge which is paid semi-annually regardless of whether the water is used and is intended to repay the federal government for construction costs of CAP; the costs related to the energy needed to pump and transport the water ("energy charge") and the operation, maintenance, and replacement of the water delivery system ("OM&R"), both of which are paid only when CAP water is actually being used.

One hundred percent of Citizens' water supply is provided by groundwater. On October 24,

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[2] The CAWCD is the prime contractor with the Department of the Interior, and the individual CAP water user enters into a "subcontract" with CAWCD and the Department of Interior.

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1985, Sun City Water and Agua Fria entered into CAP subcontracts with the United States Bureau of Reclamation and the CAWCD for water allocations of 17,274 acre feet per year.[3] Citizens has also requested from the CAWCD that it be allowed to obtain the Town of Youngtown's ("Youngtown") CAP allocation of 380 acre feet in conjunction with its purchase of Youngtown's water system. If approved, Citizens would have a total allocation of 17,654 acre feet.

In March 1994, the Company completed a Water Resources Planning Study that concluded that continuous reliance solely on groundwater to meet the municipal and industrial demand could result in decreased water levels, increased pumping costs, well failures, diminished water quality, and land subsidence. The study recommended that the Company pursue the development of additional water resources to supplement its water supplies, and noted that the most technically and legally feasible alternative was the development and use of CAP water.

In August 1995, the Company completed a Water Use Feasibility Study which looked at three options for the use of CAP water. The study concluded that all three options were technically feasible, but selected the joint recharge project with the CAWCD along the Agua Fria River as the preferred option due to anticipated economies of scale, the advantage of having CAWD as a partner, and the expected financial benefits from partial state financing.

On June 27, 1994, Sun City Water and Agua Fria filed a Joint Application with the Commission requesting an accounting order authorizing deferral of CAP water charges to allow the companies an opportunity to request recovery of the costs in a future rate proceeding. In Decision No. 58750, (August 31, 1994) the Commission approved the requested accounting order beginning with CAP water charges for 1995. The CAWCD assesses annual M & I Capital Charges based upon a per acre foot charge. The CAP water charges in 1995 were $21.00 per acre foot and have continued to escalate to $30.00 per acre foot in 1996, $39.00 per acre foot in 1997, $48.00 per acre foot for 1998-9, and $54.00 per acre foot in 2000 and thereafter.

Recovery of CAP Capital Charges

In this rate application, Maricopa W/WW requests rate recognition for the deferred and on-going

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[3] 15,835 acre feet per year for Sun City Water and 1,439 acre feet per year for Agua Fria.

CAP water charges in the form of a surcharge mechanism applicable to the customers of Sun City Water, Agua Fria, and Sun City West Water.[4] The surcharge would include a flat fee on the monthly water bill, calculated by dividing the CAP costs to be recovered by the total number of units served, and would also include an annual adjustment to reflect cost changes, any over or under-recovery of CAP costs from the prior year, and an interest component.

In response to the Staff proposal, and in the alternative to its surcharge mechanism, the Company proposed a sharing of CAP costs, with 20 percent to developers/new customers as a reservation fee, 40 percent to existing customers as a volumetric charge, and 40 percent to Sun City Water, Agua Fria, and Sun City West Water as deferred charges until the CAP facilities are placed into service. Maricopa W/WW also proposed treatment as a tax expense as a third, acceptable method for recovery of the CAP charges. Sun City Water and Agua Fria cite A.R.S. Section 48-3715.04 as the basis, and submit that the Commission should treat the CAP charges as a tax, subject to automatic pass through recovery from customers in accordance with the companies' tariffs. The Company's Vice President of Water and Wastewater Sector testified that if the Commission adopts either the Staff or RUCO proposal, he will have no choice but to recommend to the Company's Board of Directors that Sun City Water and Agua Fria dispose of their rights to the CAP allocations.

Staff agreed that the Company needs to develop alternative sources of water, but does not believe that the existing customers should have to pay for the cost of the CAP allocation because it is currently not providing any benefits to the customers. Staff believes that the Commission should not deviate from its long-standing policy that CAP water must actually be put to use prior to or commensurate with cost recovery from existing ratepayers. Staff proposed that the Company be allowed to recover approximately fifty percent[5] of deferred and current CAP M & I charges from new customer connections through the use of the CAP reservation fee. This reservation fee would be per meter for new customer connections in the Sun City Water, Sun City West Water, and Agua Fria service areas. Staff recommended that the Company be allowed to defer, with an earnings component, the remaining CAP M&I Capital Charges

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[4] Citizens has not been assessed any energy or OM&R charges because it is not using any CAP water.

[5] $2,317,986.

for future recovery from ratepayers when the CAP allocation has been put to beneficial use for its customers in the Northwest Valley.

Because of the seriousness of the groundwater overdraft in Citizens' service area, Staff recommended that Citizens be ordered to put its CAP allocation to beneficial use for its customers no later than December 31, 2000. Staff also recommended that the amounts collected through the CAP reservation fee be deemed interim and subject to refund if the Company has not put its CAP allocation to beneficial use for its Northwest Valley customers by December 31, 2000, and that the Company be required to file an annual report with Staff which details on a monthly basis the CAP reservation fees by meter size collected during the fiscal year, the amount of earnings on the deferred CAP costs, and the balance in the CAP deferral account, with the first annual report for the fiscal year ending December 31, 1997 filed with Staff no later than March 31, 1998.

RUCO believes that the Commission should not allow the Company to recover the CAP water charges from residential ratepayers because the Company is not using CAP water in the provision of service to its customers and therefore its CAP allocation is not "used and useful". Additionally, RUCO believes that the Company's proposal to use the CAP allocation is speculative and that the Company has no definitive plan to ever use CAP water. RUCO also recommends that on a going-forward basis, the Commission should rescind Citizens' authorization to defer its CAP costs granted in Decision No. 58750 (August 31, 1994).

The SCTA recommended that the Commission deny recovery of the CAP charges. SCTA believes that the mere existence of a CAP subcontract does not provide any tangible benefit to the residents of Sun City. SCTA believes that groundwater depletion is a regional issue which should be financed through augmentation and water bank programs funded with state imposed groundwater withdrawal fees, CAWCD imposed property taxes, and monies appropriated from the State's general fund. SCTA believes that at most, Citizens should be allowed to continue to accrue the cost associated with maintaining its CAP subcontracts until such time as CAP water is put to use in a manner beneficial to its customers.

The Sun Village Community Association, the Property Owners and Residents Association of Sun City West, the Sun City Home Owners Association, the Sun City West Recreation Centers, Inc., and the

City of Surprise (collectively, "Concerned Customers of Citizens") request that the Commission completely deny cost recovery if the Company refuses to condition cost recovery on delivery or use of CAP water; permit cost recovery based on an approved final plan, obtained through public participation, which addresses the individual needs of the different communities; mandate a date by which the Company must implement the final plan; condition cost recovery on the actual implementation of the plan; and require reimbursement if the Company refuses or is unable to deliver or use CAP water.

The CAWCD intervened in this case to "support the use of CAP water by its subcontractors and to support appropriate reimbursement by rate payers." The CAWCD stated its hope that the Commission's decision in this case will have the effect of encouraging Citizens to commence using its CAP allocation in an expedited manner, and thereby support the public policy goals of diminishing the mining of groundwater and depletion of reservoirs, and support the use of Arizona's full share of its Colorado River entitlement. The CAWCD believes that a long term CAP water allocation, regardless of whether the water is being physically delivered or not, reserves a long term renewable water supply for the service area and serves to sustain property values.

The ADWR intervened in this case to be "certain that the water management goals and policies of the State of Arizona were articulated and considered" by the Commission. According to an ADWR witness, groundwater pumpage by Citizens is a contributor to overdraft conditions in the Phoenix AMA, and in particular, to groundwater level declines in the West Valley. According to the ADWR, the CAP was authorized primarily with the intent of providing Colorado River water to replace over drafted groundwater, and delays in using the state's Colorado River allocation leaves Arizona vulnerable to charges that it does not need its full allocation. Citizens has the largest single CAP allocation among all private water companies, and if Citizens were to relinquish its CAP allocation, it is unlikely that Citizens could acquire municipal CAP water of this quantity in the future, and while water may be available through long-term leases, the associated costs could substantially exceed the costs with the CAP subcontract. The ADWR believes that putting Citizens' CAP allocation to use for its customers would help assure the long-term reliability of the water supply for those and future customers, and thereby help achieve the State's water management goals. The ADWR encouraged the Commission to use its authority to promote the use of Citizens' and other private water companies' CAP allocations so as to

assure that the current and future water demands of Arizona's citizens are met.

Analysis

It is clear from the evidence presented by the Company, ADWR, and Staff that the demand of existing customers is contributing to the groundwater depletion of the aquifer, land subsidence, and other environmental damage. It is also clear that the consequences of such excessive groundwater withdrawal include decreased water levels, diminished water quality, well failures, increased pumping costs, and more land subsidence. Most of the parties agree that action should be taken to attempt to rectify the current situation and prevent further problems, but they don't necessarily agree on the solution; on who should pay; or how or when payment should be made.

We find that the Company's decision to obtain allocations of CAP water was a prudent planning decision. Past Commission Decisions concerning recovery of M&I Capital Charges generally reflect the policy of not allowing cost recovery of CAP charges from existing customers until the water is actually being provided to customers.[6] However, most of the cases establishing that precedent involved using CAP water as a source to provide service to new customers, not using CAP water to prevent decreased water levels, diminished water quality, well failures, increased pumping costs, and land subsidence, caused, in part, by groundwater pumping for existing ratepayers. More recently in Decision No. 59079 (May 5, 1995), the Commission allowed recovery of M&I Capital Charges without CAP water actually being used where Paradise Valley Water Company showed that both existing and future customers benefitted from its CAP allocation.[7]

We find that such is the case here and that the Company contracted for CAP in order to meet the continuing groundwater requirements for its existing customers as well as help it to provide sufficient water to service all of its service areas at ultimate development. Provided that the CAP allocation will ultimately be used, the existing customers will benefit. The new customers will also benefit from the

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[6] See Decision No. 58120 (December 23, 1992) for Arizona Water Company; Decision No. 57395 (May 23, 1991) for Chaparral City Water Company and Decision No. 58100 (December 9, 1992) for Midvale Farms Water Co.

[7] The CAP allocation had allowed the Company to obtain a 100 year assured water supply designation, which allowed development to occur that contributed additional revenues resulting in fixed costs being spread over a larger customer base.

CAP allocation by contributing to the use of renewable sources of water that will be used in the Northwest Valley to prevent diminished water quality, well failures, and future additional land subsidence, and thereby protect their economic investment in the area.

As pointed out by out by the Concerned Customers, SCTA, Staff, and RUCO, the Company has held its CAP allocation for more than eleven years, but has not delivered or put to beneficial use any CAP water, and currently has no final plan for its use.[8] The ADWR, CAWCD, Staff, and most of the parties recognize that the time for Citizens to take action is now - not decades in the future when costs will be higher and alternatives may be restricted or not available. Because Citizens is not utilizing CAP water in the provision of service to its customers, its CAP allocation by definition is not "used" and "useful". Therefore, the costs of Citizens' CAP capital charges should not be borne by the ratepayers. Furthermore, because Citizens has no definite plans to use the CAP water, its proposal to use its CAP allocation is speculative and the use of this water cannot be considered to be a known and measurable event. Therefore, Citizens' request for M&I Capital Charges should be denied.

We will, however, allow Citizens to defer CAP capital costs for future recovery from ratepayers when the CAP allocation has been put to beneficial use for Citizens' ratepayers. This order is subject to a development of a plan and date of implementation by December 31, 2000. If CAP water is not implemented by December 31, 2000, then Citizens will lose its ability to defer future costs.

III. RATE BASE

In its application, the Company proposed a combined original cost rate base ("OCRB") of $39,292,652. Staff and RUCO proposed adjustments which resulted in combined OCRBs of $36,303,808 and $36,425,397, respectively. The Company, Staff, and RUCO final proposed rate base for Sun City Water was $14,313,037, $13,634,041, and $13,826,395; $7,514,755, $7,361,407, and $7,368,982 for Sun City Sewer; $6,685,509, $6,235,619, and $6,193,564 for Sun City West Water; $5,370,026, $5,108,820, and $4,971,516 for Sun City West Wastewater; $3,515,693, $3,305,517, and $3,408,105 for Agua Fria; and $661,875, $658,404, $656,835 for Tubac Valley.

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[8] As pointed out by the SCTA, the subcontracts have fixed 50 year terms, and with each passing year, the amount of water ultimately deliverable is reduced by 1/50th, thereby reducing the maximum potential benefits deliverable under the subcontracts.

A. AR-13 AFUDC ("AR-13")

The Company is allowed to accrue allowance for funds used during construction ("AFUDC") until plant is completed and placed in service. The Federal Energy Regulatory Commission ("FERC") issued an accounting release in 1983 ("AR-13") dealing specifically with calculation of AFUDC when there are restricted-use long-term debt involved in the capital structure that utilities use for financing.

The Company has issued Industrial Development Revenue Bonds ("IDRBs") which can only be utilized for specific construction projects. The proceeds from the IDRB are required to be held in a construction trust fund until the funds are actually needed to finance the specific project. The Company is able to invest these undrawn trust funds in short term securities and earn interest. The interest income is offset against the interest expense Citizens is incurring on the IDRBs. Citizens applies an AFUDC rate comprised of debt and equity to the unspent proceeds, and the difference between the AFUDC rate and the net investment earnings is capitalized as AR-13 costs and added to rate base.

Citizens asserts that its procedures for recording AFUDC are consistent with AR-13 and comply with generally accepted accounting principles. In addition, Citizens indicated that its procedures comply with Decision No. 55474, dated March 18, 1987. According to Citizens, that Decision required the use of an Arizona property specific AFUDC rate which includes any debt that has been issued for construction at a specific operation, a proportionate share of any general corporate debt, and the Commission authorized rate of return on common equity for the specific operation for any common equity funds used to fund construction expenditures. Citizens indicated that where AR-13 and Decision No. 55474 were in conflict, Citizens would always choose the procedure which resulted in the lowest AFUDC rates.

The Commission determined in Decision No. 58360, dated July 23, 1993, that Citizens' procedures did not comply with AR-13 because the entire undrawn balance of IDRB funds was not included with other long-term debt in the AFUDC calculations. The Commission ordered the Company to comply with AR-13. As a result of that Decision, Citizens indicated its calculation of AR-13 AFUDC was inconsistent with the remainder of Citizens operations in Arizona[9]. Although Staff has conducted

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[9] On May 4, 1994, Citizens filed an application in Docket No. E-1032-94-139 requesting that the Commission review in one proceeding the AR-13 AFUDC procedures applicable to all of the

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discovery in that docket, no Staff Report has been issued. The Company requests the Commission direct the Company, Staff, and RUCO to work together and develop a joint recommendation on the correct AFUDC procedures for all of Citizens operations.

If the Commission decides to address the AR-13 AFUDC procedures in this case, Citizens asserted the Commission should approve the methodology used by the Company. According to the Company, neither Staff nor RUCO has taken into account the conflict between Decision No. 55474 and AR-13 procedures.

RUCO concluded that the Company's method of calculating the AFUDC did not follow AR-13 procedures and recommended that the Commission exclude all AR-13 AFUDC capitalized subsequent to 1987. The Company criticizes this recommendation as retroactive ratemaking.

Staff made a similar analysis and recommended an adjustment consistent with the decision in Citizens' Arizona Electric Division ("AED") rate case, Decision No. 59951 (January 3, 1997), to exclude from rate base all AR-13 accrual amounts recorded after 1987, a net reduction in rate base of $1,333,816. According to Staff, the Company's method of calculating AR-13 costs is not appropriate for use in Arizona ratemaking. Staff believes that Citizens does not follow the method prescribed in FERC AR-13 because it does not include the entire issue of the IDRB debt along with other debt in calculating its AFUDC rate. The Company assumes that any construction expenditures not financed by the portion of IDRB anticipated to be drawn down in a given year are financed by common equity. Staff also believes that Citizens' method deprives Arizona ratepayers of any benefit of the undrawn IDRBs because the financing is diluted when included in Citizens' consolidated total company capital structure and Citizens should not be earning an equity return on plant financed with the Arizona IDRBs, and also because the IDRB plant does not qualify for accelerated tax depreciation and this deprives Arizona ratepayers of the higher amount of rate base deductions for ADIT.

Staff further recommended that the Commission order Citizens to:

- Remove the disallowed AR-13 accrual amount from Plant and Accumulated Depreciation on Maricopa W/WW books:
- Cease recording AR-13 accrual amount on Maricopa W/WW's books from the date of this Decision;

Arizona operations that use IDRB funding.

- Remove the AR-13 amounts recorded from the end of the TY through the date of this Decision from Maricopa W/WW's books;
- Calculate AFUDC only on actual construction expenditures, and not upon unexpended IDRB proceeds, and;
- Calculate AFUDC on actual construction expenditures using an AFUDC that is based upon the weighted cost of capital for the Maricopa W/WW that is adopted herein.

It is clear that Citizens used a method to calculate AFUDC other than the FERC AR-13 formula that was approved in Decision No. 55474. Moreover, as Staff has pointed out, FERC AR-13 clearly states that: "[t]he entire issue of the use-restricted, long-term debt should be included with other long-term debt used in calculating AFUDC rates."

Contrary to this clear directive, Citizens does not include the entire issue of the use-restricted, long-term debt in calculating its AFUDC rate. Citizens' calculation includes only the portion of the IDRB issue expected to be drawn down during the current year. By excluding the remaining IDRB proceeds being held by the trustee from the AFUDC rate calculation and excluding these proceeds from the capital structure, Citizens' procedure deprives ratepayers of the benefit of such IDRB debt while the proceeds are being held by the trustee. Citizens' AR-13 accrual calculations have also ignored the specification in FERC AR-13 addressing other long-term debt. FERC Accounting Release 13 requires that other long-term debt be included in calculating the AFUDC rate. Citizens' calculation of an AFUDC rate assumes that the construction not financed by an IDRB is financed by common equity and not by other long-term debt. As a consequence, Citizens' procedure improperly applies a common equity rate for debt financing.

Contrary to Citizens' claims, it is not clear that Citizens' method benefit ratepayers. It is clear that Citizens' method results in a number of detrimental impacts to ratepayers. The AR-13 accrual produces additional amounts of rate base, beyond those produced by the traditional application of an AFUDC rate to actual construction expenditures.

In Decision No. 58360, the previous AED rate case, we found that Citizens failed to calculate the AFUDC rate in accordance with FERC AR-13, and disallowed from rate base Citizens' AR-13 accrual amounts that the Company had recorded on the AED's books since 1987. The flaws in Citizens' AR-13 calculation that were noted in Decision No. 58360 cited above continue to be applicable in the recent AED rate case. Specifically, Citizens does not include the entire issue of the use-restricted, long-term

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IDRB debt with other debt in calculating its AFUDC rates. Moreover, Citizens does not include the entire issue of the use-restricted, long-term IDRB debt with other debt in calculating its capital structure for ratemaking purposes. These failures by Citizens to include the entire issue of the use-restricted, long-term IDRB debt with other debt in calculating its AFUDC rate and to include the trustee-held IDRB proceeds in the ratemaking capital structure serve to deprive ratepayers of any benefit of the undrawn IDRBs upon which Citizens computes its AR-13 accruals. These facts, especially taken in conjunction with the other inequities associated with Citizens' AR-13 method discussed above, require an adjustment for ratemaking purposes. We affirm our previous decisions to exclude Citizens' post-1987 AR-13 accrual amounts from rate base and adopt RUCO and Staff's recommendations to exclude post-1987 AR-13 accruals from rate base. Plant in Service is reduced by $1,438,248 and Accumulated Depreciation is reduced by $104,432 for a net reduction in rate base of $1,333,816.

We also order Citizens to remove the disallowed AR-13 accrual amounts from Plant and Accumulated Depreciation on the Maricopa W/WW 's books. In Decision No. 59951, the Commission ordered the Hearing Division to issue a Procedural Order regarding the proper AFUDC methodology, and we note that a Procedural Order was issued scheduling the filing of testimony and setting a hearing. We expect that proceeding to establish the appropriate AFUDC methodology for all of Citizens' Arizona operations. The result of the calculation of AFUDC and AR-13 AFUDC for the Maricopa Water/Wastewater operations that is ultimately approved in Citizens pending consolidated AR-13 AFUDC proceeding, Docket No. E-1032-94-139, et al. will be applied to undrawn IDRB amounts forward from the end of the test year in these proceedings.

B. Youngtown Plant Acquisition

On February 8, 1995, Sun City Water and Sun City Sewer, respectively, purchased the water and wastewater facilities of the Town of Youngtown, Arizona ("Youngtown" or "Town") and are providing service to 3,720 customers within Youngtown's municipal boundaries. Sun City Water and Sun City Sewer acquired the Youngtown systems for a total purchase price of $1,192,862 which includes an amount of $259,605 placed into escrow pursuant to the Sales Agreement. Staff reduced plant in service to exclude a water acquisition adjustment, plant balances funded by grants, and non used and useful plant by ($423,091) for Sun City Water and by ($426,664) for Sun City Sewer. We agree with Staff's

adjustments, with the exception immediately below.

1. Escrow Amount

In the Sales Agreement, Sun City Water, Sun City Sewer, and Youngtown agreed to place $259,605 of the purchase price into an escrow account to reflect Community Development Block Grants that Youngtown received for construction of the water and wastewater systems. According to Citizens, the parties agreed to place this amount into escrow because there was a lack of precedent as to whether plant funded through grants obtained by a prior municipal owner would be recognized in the Company's rate base. According to the Sales Agreement, if the plant funded by grants is included in rate base, the $259,605 will be released from escrow and paid to Youngtown. If the plant is not included in rate base, the amount in escrow will be returned to Sun City Water and Sun City Sewer. Sun City Water and Sun City Sewer seek rate base treatment for the entire amount of the purchase price, including the amount held in escrow, because they believe that it represents Company investment in the facilities.

Staff and RUCO oppose inclusion of the escrow amount in rate base. Staff believes that since these funds were grant money, it was not supplied by Youngtown as the plant owner, and under traditional ratemaking, only investor-financed plant should be included in rate base. Staff also argues that Citizens can provide no justification for requiring all of its ratepayers to pay this cost for plant used to serve only a portion of those customers; that no harm would result to Citizens, because the amount in escrow would be returned to invest as it sees fit; that the working relationship between Citizens and Youngtown would not suffer; that Youngtown was represented by counsel during negotiations and it negotiated the Sales Agreement with the explicit understanding that the escrow amount was at risk and may not be recovered by Youngtown.

We agree with the Company that the amount held in escrow should be included in rate base. Although generally, only investor-financed plant should be included in rate base, when a municipality is involved, none of the plant is "investor-financed". The grant funds were intended to benefit the municipality, and that benefit would be lost if the plant associated with those funds were not allowed into rate base. If the amount in escrow is not allowed in rate base, then the escrowed funds would not be released to Youngtown, and Citizens' customers both outside and inside of Youngtown would receive the benefit of Youngtown's grant. Accordingly, we will allow $55,902 of the escrow amount in rate base

for Sun City Water and $203,703 in rate base for Sun City Sewer.

2. Accumulated Depreciation

Pursuant to the terms of the Sales Agreement, Sun City Water and Sun City Sewer purchased the facilities based on Youngtown's financial statements as of June 30, 1993, with the exception of certain specified items, not including depreciation, subject to a true-up as of the date of closing. Youngtown continued to depreciate the assets on its books until the time of the transfer, February 8, 1995. In its application, Citizens did not reflect the ongoing depreciation, and reflected as rate base the depreciated value of the plant as of June 30, 1993, rather than the end of test year, March 31, 1995.

Staff removed depreciated plant for the water system and the sewer system to reflect the ongoing depreciation that was recorded by Youngtown prior to the transfer, and for the depreciation from the date of the transfer until the end of the test year.

We agree with Staff that rate base should include the depreciated plant value as of the end of test year. This is not an "imputation" of depreciation as suggested by the Company, but rather, is a reflection of actual depreciation expense which was recorded on Youngtown's books, and which should have been recorded on Citizens's books, both at the time of the transfer and on a going forward basis. Accordingly, we will adjust accumulated depreciation for Sun City Water by $39,435 and for Sun City Sewer by $46,074[10].

3. Acquisition Adjustment

Sun City Water and Sun City Sewer acquired the Youngtown systems for a total purchase price of $1,192,862, which is $52,465[11] above the net book value of the assets. Sun City Water and Sun City Sewer request that the total $52,465 acquisition premium be included in rate base and be amortized above the line. The Company cites two previous Commission Decisions and concludes that the Youngtown acquisition meets the Commission's criteria for rate recognition of the acquisition premium. The

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[10] This reflects our determination to allow the $259,605 escrow amount in rate base.

[11] It is not clear whether Staff agrees that this is the correct amount of the acquisition adjustment. In its reply brief, Staff indicates that it believes that the acquisition adjustment is $137,643, but the summary schedules filed thereafter indicate the $52,465 amount. According to RUCO, the acquisition adjustment is $324,926.

Company lists the following as the benefits to the Youngtown customers: a 44 percent reduction in water and sewer rates; long-term savings through Sun City Sewer's use of the Tolleson Treatment Plant; and "enhanced customer service features". The Company stated that existing wastewater customers will benefit by spreading fixed and variable costs over an expanded customer base, and the interconnection of the systems will improve operating efficiencies and reliability.

Staff and RUCO opposed the request for recovery of the acquisition premium. Staff disagreed that Decision No. 56551 (July 3, 1989) wherein the Commission approved Sun City West Water's purchase of the Cool Well Water Company ("Cool Well") and allowed inclusion of the acquisition adjustment in rate base, is support for allowing recovery of the acquisition premium in this case. Staff noted that Cool Well was a small regulated company that had been operating at a loss for many years and providing unreliable service and that Staff had recommended an acquisition adjustment be allowed to encourage consolidation of small water companies into larger ones. Staff believes that these special circumstances are not present here. Further, Decision No. 56551 only allowed rate base treatment, not both rate base and amortization, as the Company has requested here.

We believe that the benefits cited by the Company support its requested approval of the sale of assets and extension of its CC&N to provided service to the Youngtown customers, but we do not believe that they justify charging ratepayers for an acquisition premium. None of the compelling circumstances of the Cool Well Decision are present here, and we see no reason to encourage public service corporations to acquire municipal water or sewer operations. Further, Citizens is well aware of the Commission's past decisions concerning acquisition adjustments, including Decision No. 58664 (June 6, 1994) where the Commission denied rate base treatment for Citizens' Northern Arizona Gas Division ("NAGD") and cited Decision No. 57647 (December 2, 1991) stating "Citizens must be reminded that Arizona allows for a return on invested plant, not on the sale price paid for the utility."[12] Further, we believe that the criteria established for the NAGD to recover an acquisition premium are not applicable here, when the selling entity is a municipality. Part of the criteria was that Citizens must make a clear demonstration of structural savings, not including those that could or should have been achieved under

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[12] In Citizens' most recent acquisition (Navajo Telephone), an acquisition premium is expressly excluded from rates. Decision No. 59306 (September 22, 1995).

the previous ownership. We agree with Staff that because there is no evidence of the relationship between the Youngtown rates previous to Citizens' acquisition and the underlying costs of providing utility service by Youngtown, whether and to what extent such rates could have been reduced in the absence of Citizens' acquisition is speculative at best. Accordingly, we will not include an acquisition adjustment in rate base.

C. Stamford Administrative Office Common Plant

Staff and RUCO proposed adjustments to Stamford Administrative Office ("SAO") plant to remove plant items that are not appropriate for ratemaking. They removed items that the Commission removed in the last gas and electric proceedings involving Citizens (art work and an office provided to a retired executive) and for other SAO furniture, equipment, and what Staff termed "Cadillac DeVille 'pool cars' that appear to reflect the lavish tastes of Citizens' top executives rather than the necessities of providing utility service to Arizona ratepayers." Both Staff and RUCO also used a more current four factor allocator for SAO plant. We agree with Staff and RUCO's adjustments.

D. Plant-In-Service

Staff made a number of adjustments to the original cost and reconstruction cost new ("RCN") data that was submitted by the Company. Staff reduced Sun City Water's rate base by $88,746 and by $1,674 to reflect the cost of observation wells that Staff believes are not used and useful. The Company opposed the adjustments. Testimony from the Company's witness, Dr. Montgomery, supported the Company's position that production wells may be useful for operating the pumps and understanding what their pumping levels are, and what well efficiencies might be, but they are not appropriate for use in measuring static water level conditions in the aquifer. Additionally, the use of additional observation wells provides for more data points when analyzing overall aquifer characteristics and improves the overall quality and reliability of the studies. However, Staff maintained that the production wells can be utilized for monitoring water level and water quality of the aquifer. Additionally, observation wells have traditionally been classified as "stand-by" wells and not included in rate base. Therefore, we agree with Staff.

We agree with the Company that the observations wells are used and useful in providing water utility service. Monitoring and understanding the groundwater levels in the aquifer is one component

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of the Company's duty of ensuring a continued supply of water for its customers. Accordingly, we will not adopt Staff's adjustment.

E. Cash Working Capital

Both Staff and RUCO proposed adjustments to the Company's cash working capital, a number of which were accepted by the Company, including adjustments to expense lead or lag days with salaries and wages, pumping power expense, administrative office expense, insurance, injuries and damages expense, and other taxes. The Company also accepted inclusion of interest expense in the lead lag study at a 90-day lag and also removed preliminary survey and investigation ("PS&I") charges from the working capital balance. Staff and RUCO agree that the revenue lag should be reduced by one day to reflect the Company's new lock box program which will allow customers to pay their bills through the bank rather than remitting them directly to the Company. Staff and the Company have agreed to certain increases to expense lags to reflect check clearing lags and have revised the pension lag expense to reflect an actual contribution made by Citizens to the pension trust. We will adopt those adjustments. RUCO recommends that, consistent with past Commission decisions, including Decisions Nos. 58360 and 58664, the Commission should exclude $83,354 in rate case and deferred TARGET: Excellence expenses from the cash working capital component. We agree with RUCO.

Staff and RUCO proposed that cash balances should be removed from the determination of cash working capital. RUCO notes that these two asset item have never been included in the calculation of cash working capital in any prior Commission decision. Staff notes that with the exception of only Sun City Sewer, there is a negative cash working capital requirement and to include a cash balance in the cash working capital requirement for these companies would grant them a return on cash when they have no cash requirement. We agree with Staff and RUCO's adjustment to remove cash balances.

We note that RUCO believes that the Company's sampling method for determining the lag for the O&M, administrative and general expense category analyzed too few invoices and does not capture the various types of expenses contained in the category. While we will not adopt RUCO's adjustment in this proceeding, we expect the Company to address the issues raised by RUCO in its next lead/lag study.

F. Sun City West Developer Advances

RUCO proposed and Citizens agreed to an increase in the amount of Sun City West developer advances by $58,650 for water and $121,657 for wastewater, with a corresponding decrease in rate base. We concur.

G. Accumulated Deferred Income Taxes

Staff proposed to adjust Accumulated Deferred Income Taxes ("ADIT") by a total of $202,435 of "Schedule M" items which presents a reconciliation between book income and taxable income. Staff's adjustment was to exclude unbilled revenue and nondeductible employee benefits that are disallowed for ratemaking purposes. Staff believes that unbilled revenue should be excluded from ADIT because it represents an unnecessary tax timing expense. We agree with Staff that this is an artificially created ADIT debit balance rate base increase and therefore will adopt Staff's adjustment. Further, we agree with Staff that since pension expense has been adjusted to reflect coordination of the timing of pension fund payments and the recognition of pension expense for ratemaking purposes, there is no need to increase rate base associated with accrued but unfunded pension expense. Likewise, in Decision No. 59951, we disallowed Citizens' incentive compensation and FAS 106 accrual and we will make the same adjustment here.

In this proceeding, the Company is requesting to convert its deferred income taxes on the differences between accelerated tax depreciation and straight-line tax depreciation to a fully normalized basis. While RUCO does not take exception to the move to full normalization, it recommends that it be implemented on a going-forward basis. Since full normalization accounting was not in effect during the test year and the per book deferred taxes as of the end of the TY were not reduced and will not be reduced until the Commission approves full normalization account, RUCO believes that the Company's requested adjustments are inappropriate for ratemaking purposes. The Company criticized RUCO's proposal because it does not provide recovery of the flow-through amounts as an increase in income tax expense. The Company believes that its method of using full normalization as of the TY to determine the ADIT balance is appropriate and if RUCO's adjustment is adopted, the Company will experience a shortfall in recovery of its tax liability.

We agree with Staff and will adopt its recommended adjustments.

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H. Staff Recommendations

The Engineering Staff made some additional recommendations, including:

- Citizens should be ordered to maintain detailed information about the plant by individual system and such information should be readily available and provided in the annual report;
- Citizens should be ordered to maintain flow meters in order to obtain and provide accurate flow data by system and such information should be readily available and provided in the annual report;
- Citizens should be ordered to file applications to extend its CC&N to encompass all areas where customers are being served;
- Sun City West Water should conduct a detailed analysis to determine whether the Cool Well system needs more storage; and
- Tubac Valley should be ordered to meet with the Arizona Department of Environmental Quality ("ADEQ") and resolve any non-compliances, and should also investigate ways to cost effectively reduce the system's water loss.

We concur with these recommendations.

IV. ORIGINAL COST RATE BASE SUMMARY

Based on the foregoing, the adjusted TY original cost rate base ("OCRB") for ratemaking purposes for Sun City Water is $13,675,576; for Sun City Sewer is $7,515,406; for Sun City West Water is $6,235,619; for Sun City West Wastewater is $5,108,820; for Agua Fria is $3,305,517; and for Tubac is $657,068. Exhibit A attached details the adjustments made to rate base for each operating division.

V. RECONSTRUCTION COST NEW RATE BASE

In Schedule A-1 of the application, Citizens presents a jurisdictional reconstruction cost new rate base ("RCNRB") of $75,320,693. All of the adjustments reflected in our determination of the OCRB are equally applicable to the RCNRB. With the changes in these adjustments necessary to restate them in terms of reconstruction cost new, the RCNRB for Sun City Water is $31,533,666; for Sun City Sewer is $17,701,732; for Sun City West Water is $7,591,825; for Sun City West Wastewater is $6,742,689; for Agua Fria is $3,998,637; and for Tubac is $1,097,065.

VI. FAIR VALUE RATE BASE

The Commission has traditionally determined the "fair value" rate base ("FVRB") by taking the average of OCRB and RCNRB. No party has suggested different weighting be used in this proceeding. Consequently, we will find that the adjusted FVRB at March 31, 1995 for Sun City Water is

$22,604,621; for Sun City Sewer is $12,608,569; for Sun City West Water is $6,913,722; for Sun City West Wastewater is $5,925,755; for Agua Fria is $3,652,077; and for Tubac is $877,067.

VII. OPERATING INCOME

A. Gross Annual Revenues

The Company had actual combined revenues during the TY of $16,836,617 from which pro forma adjustments were made, reducing it to $16,702,301. The parties agreed on several adjustments, including customer growth annualization of revenues and associated expenses, water conservation surcharge revenues and amortized deferred expenses, and updated Youngtown revenues and expenses. Staff recommended that the groundwater withdrawal fees be removed from base rates and be recovered as a through a pass-through mechanism, similar to how sales tax and the Commission's regulatory assessment are recovered as a surcharge. We agree with Staff and will remove actual TY revenues and expenses associated with the groundwater withdrawal fees. Accordingly, the adjusted TY revenues for Sun City Water are $5,731,330; for Sun City Sewer are $4,566,689; for Sun City West Water are $2,898,832; for Sun City West Wastewater are $2,203,793; for Agua Fria $1,106,294; and for Tubac Valley $177,442.

B. Annual Operating Expenses

Based on its application, the Company had actual TY operating expenses of $14,491,592 which it adjusted by ($122,107) to $14,369,485. RUCO and Staff recommended numerous adjustments to Citizen's proposed operating expenses. For the reasons set forth hereinafter, we find that for ratemaking purposes the TY operating expenses for Sun City Water were $4,369,060; for Sun City Sewer were $4,003,838; for Sun City West Water were $2,232,815; for Sun City West Wastewater were $2,224,372; for Agua Fria were $849,443; and for Tubac Valley were $137,632.

The Company, Staff and RUCO have agreed upon the following adjustments: donations expense, life insurance expense for split-dollar life insurance and Company-owned life insurance, rate case expense for past proceedings, shareholders' 60th year memory book expense, and supplemental pension expense of $20,187 of Dr. Tow should be removed; income tax expense and the gross revenue conversion factor should be revised to reflect an effective state income tax rate of 8.257 percent; lockbox program expenses should be updated; purchased power costs for the water operations should be updated and annualized; structure cleaning expense should be updated; and tank painting and water testing expense

should be adjusted.

1. Adjustments "Agreed" to by Citizens

In its rebuttal testimony, the Company agreed to remove certain costs and expenses from the revenue requirement determination in this proceeding. Citizens agreed to remove: a portion of Dr. Tow's compensation, including director fees; directors' and officers' liability insurance expense; Incentive Deferred Compensation Program ("IDCP") expense; TARGET: Excellence expenses; the accrual costs of post-retirement benefits other than pension under Financial Accounting Standard No. 106; and Stamford Administrative Office costs and expenses related to office space for the previous president; certain furnishings and artwork, the Food Services Coordinator, and rent for the vacated 1200 High Ridge Road office. Citizens says that this proposal is "conditioned on corresponding treatment of other parties' issues," and "should the other parties decline to follow precedent, or should the Commission decide to depart from prior decisions, then Citizens will no longer agree to remove the costs and expenses . . . ."

a. Administrative Office Expenses

Citizens' corporate headquarters are located in Stamford, Connecticut and the corporate costs are charged to operating properties through a combination of direct charges and cost allocations. The "allocable" SAO corporate charges are charged out to operating properties using a four factor allocation. The four factors used to determine this allocation are: plant in service; O&M expenses; number of customers; and payroll charged to O&M. In this filing, the Company used a four factor SAO cost allocation totaling 3.46 percent for the six utility systems. Staff adjusted SAO expenses using a more current four factor allocator. Staff also recommended the disallowance of specific SAO costs including: corporate expenses including rental expense for a vacant office building; abnormally high SAO temporary services expenses and outside consulting fees for computer projects; discontinued warranty maintenance service; executive chef salary; maintenance of Cadillac DeVille automobiles; Dr. Tow's 1994 expense allowance and personal expenses, supplemental pension, directors's fees and compensation in excess of $500,000; directors' travel and legal expenses; video expenses; and "corporate other" expenses, including wellness and company sports, executive physicals, and community relations and contributions. Total expense is reduced by approximately $194,000 for the Maricopa W/WW operations. Staff recommended an adjustment to the Company's Phoenix Administrative Office ("PAO") expense

because the use of either actual 1994 or budget 1995 PAO data has substantially overstated the actual PAO expense that occurred in 1995. Staff proposed adjusting PAO expense by $12,292. In rebuttal, the Company adjusted the PAO expense to reflect nine months of the PAO's annualized actual expense for 1994 and three months of its annualized actual expense for 1995.

Staff's adjustments to SAO and PAO expense are identical in theory and method to the Staff adjustments that were accepted by the Commission in Decision No. 59951 (January 3, 1997), and we will adopt them here for the same reasons we enunciated therein.

b. TARGET: Excellence Expense

The Company initiated a corporate level training program in 1993 entitled TARGET: Excellence ("Program"). The purpose of the Program was to improve customer service, productivity, and employee satisfaction. The customers, employees, and shareholders will benefit from the results that should occur as a result of the Program. Citizens is requesting that $206,682 of deferred TARGET: Excellence costs be recovered over two years. These costs include costs incurred during the introduction of the Program and consist of initial training expenses, consultant fees, production costs for manuals, out-of-pocket costs for training sessions, and customer survey expense. Citizens also seeks an annual allowance for on-going TARGET: Excellence training.

Both RUCO and Staff disallowed a portion of the Program costs. RUCO points out that the Company never requested, nor received an accounting order from the Commission which would have allowed the Company to defer these costs and argues that allowing past TARGET: Excellence costs to be recovered in this case would constitute retroactive ratemaking. RUCO removed all the deferred costs and one-half of the 1994 costs which were included in the TY. Staff concurs with RUCO's arguments, and also points out that according to the Company's general ledgers, Citizens was already amortizing deferred TARGET: Excellence costs in 1994 and those costs were included in TY expenses. Staff further points out that the SAO direct charges to each operating property included amounts for TARGET: Excellence costs. Therefore, TY expenses for Maricopa W/WW operations also included charges from SAO for TARGET:Excellence. Staff does not believe that Maricopa W/WW has been able to demonstrate any cost savings related to TARGET:Excellence, but believes that the Program has produced or could produce improvements in operations and other efficiencies that would benefit both ratepayers

and shareholders. Therefore, Staff recommended that fifty percent of the current period expenses incurred directly from Maricopa W/WW operations be recovered through rates. Staff's adjustment also removed the Company's proforma adjustment for the amortization of deferred TARGET: Excellence costs, the amortization expenses recorded by each utility during the TY, and TARGET: Excellence charges from SAO.

Based on previous Commission decisions, including Decision No. 59951 (January 3, 1997), we will allow one-half of the deferred amount to be amortized over two years, and will allow one-half of the TY expenses, as determined by Staff, to be recovered in rates.

c. Incentive Deferred Compensation Program Expense

The Company included in its application a request for $84,781 of TY expense related to its Incentive Deferred Compensation Program ("IDCP"). The Company describes the program as an at-risk incentive compensation plan, not as a bonus arrangement.

RUCO recommended that the entire $84,781 amount be disallowed because the Company's methodology for determining the performance factors under its IDCP is vague and obscure; because contrary to the Company's position that IDCP is designed to shift a portion of base pay compensation into variable pay, RUCO could find no indication that it has reduced increases to base pay or to overall salaries and wages; and because the Company has made no direct showing that the IDCP provides a direct and primary benefit to the ratepayer.

Staff reached the same conclusion as RUCO and also recommended disallowance of the IDCP. Staff believes that the employees participating in the program receive generous awards for achievement of rather ordinary goals that would tend to fall within the normal job responsibility of each employee. Staff believes that IDCP is a bonus that serves to increase employees' pay beyond a "normal" pay level and that shareholders should be responsible for such incentive payments.

We concur with Staff and RUCO. Consistent with Decision No. 58664, and Decision No. 59951, we will deny the IDCP.

d. Post-Retirement Benefits Other Than Pensions

The Company provides post-retirement benefits other than pension ("PBOPs") to employees in the form of medical and life insurance coverage. The Company is requesting the Commission approve

the Company's proposed accrual method of accounting for PBOPs and recognize the associated PBOP cost for the Maricopa W/WW operations. Under this method, the cost of the benefit for current employees will be expenses on the Company's books in accordance with the requirements of the Financial Accounting Standards Board Statement No. 106 ("FAS-106"). Citizens acknowledges that past Commission Decisions have required PBOPs be accounted for under the pay-as-you-go method for ratemaking purposes. The Company has established the necessary funding mechanism and has submitted evidence to show that the use of the accrual method of accounting for PBOPs in the ratemaking process will produce benefits for the Company and its Arizona customers.

Both Staff and RUCO recommended adjustments to eliminate the accrual based PBOP expense and reflect the PBOP expense on a pay-as-you-go basis. RUCO argues that the Company has not demonstrated that on a present value basis pre-funding of PBOP costs under the rate recognition of accrual based expense is in the ratepayers best economic interest; the Company's quantification of PBOP accrual is based upon assumptions which are uncertain and speculative; the FAS Statement 106 does not dictate regulatory policy; the accrual method required by FAS-106 is not appropriate for ratemaking purposes; and finally, the recognition of the amortization of the "transition obligation" results in an intergenerational inequity for ratepayers. Staff agrees with this arguments and notes that the Commission's continuation of the pay-as-you-go method for ratemaking purposes was upheld by the Arizona Court of Appeals.

Based on the evidence of this case, we will approve the accrual method of accounting for PBOPs. This determination is solely for this Company and other determinations will be made on a case by case basis. The Company will need to meet the following conditions in future rate cases for continued approval of the accrual methodology for PBOPs:

- the PBOP expense allowance must meet the conditions of being both reasonable and prudent as determined by the Commission;
- the Company must compute PBOP expense in accordance with Statement of Financial Accounting Standards No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions (SFAS 106);
- the Company must use reasonable, unbiased, and supportable actuarial assumptions as a basis for its calculation of PBOP expense;
- the Company must fund PBOP expense no less frequently than quarterly, and the

amount of each payment must represent a ratable portion of the annual PBOP expense;

- funding deposits must be made in cash to an irrevocable, independently managed external Trust;
- to the extent allowed by law, the Company must maintain a tax deductible status for PBOP expense and a tax exempt status for earnings of the Trust;
- investments made by the Trustee of the Trust must be compatible with meeting PBOP obligations as they come due;
- any accumulated excess of accrual-based over cash-based revenues intended to cover PBOP expenses is subject to refund, to the extent PBOP assets cannot be used for PBOP expenses or have been used for unauthorized, non-PBOP purposes;
- disbursements from the trust fund should be limited to payments for the benefits of retirees in accordance with the Company's benefit plans, administrative costs of the Trust and other purposes as authorized by the Commission; and
- upon termination of the Trust and satisfaction of all PBOP obligations any residual funds are to be utilized only as approved by the Commission.

2. Depreciation

a. Depreciation Rates

Depreciation accounting represents an allocation process by which the consumption of physical assets is recognized in the utility's financial statements. Depreciation expense provides for recovery of invested capital, adjusted for net salvage to be incurred at the time facilities are removed or abandoned. The capital should be recovered from those customers receiving service from the facilities over the expected life of the facilities, consistent with the accounting principle of matching.

The Company conducted depreciation studies and recommended revised depreciation rates. Mr. Mason performed a life analysis using Simulated Plant Records ("SPR") and a life estimation analysis. Mr. Mason employed life analysis and life estimation using statistical life analyses, age distribution simulations, plant histories, transaction summaries, and computed mortality distributions. The Company's proposed depreciation rates are based upon a set of depreciation parameters consisting of service lives, retirement patterns, and future net salvage values. The parameters are actually estimates based upon the above factors, as well as professional judgment.

Staff performed six independent SPR analyses and retirement forecast analyses to test the reasonableness of the Company's proposal. Using the annual historical gross additions for each account

the Company studied, combined with the retirement ratios implicit in the Company's proposed average service lives and dispersion patterns, Staff determined the retirement forecasts implicit in the Company's proposals. Staff compared the actual retirements, by account, for the five years 1990 to 1994 and compared these to the retirement patterns implicit in the Company's depreciation study. The retirements reflected in the Company's proposal are six times the retirements actually experienced in the last five years. Staff believes that this difference is driving the overall increase in the Company's proposed depreciation expense. Staff also tested the reasonableness of the Company's proposal by examining the net salvage factors used by the Company. Staff compared the annual depreciation expense using the Company's net salvage factors against the Company's actual experience for the years 1990 through 1994, and found that the annual depreciation expense was nearly ten times the Company's average annual experience for those five years. Staff criticized the Company's witness for his failure to explain his recommendation, i.e., how and why he exercised his professional judgment in his depreciation studies. In addition, Staff pointed out that the Company stated that there are no accounting, operational and maintenance policy and practice changes since the last study which influenced in any way changes in service life and survivor curves. Further, the Company did not identify any projects, plans, or programs which would tend to increase or decrease its depreciation rates. Staff also disagreed with some, but not all of the depreciation rates for specific accounts. Staff did not oppose the Company's request to use the composite rate approach to calculate depreciation expenses on the Youngtown plant acquisition, Staff recommended that in the future, the Youngtown plant either be studied separately or included in the Sun City studies. RUCO proposed that the actual depreciation expense recorded on the Company's books for the period ended June 30, 1994 should be used to determine proforma Youngtown depreciation expense of $75,415, a reduction of $21,060 to the TY cost of service.

The Company criticized Staff's recommended depreciation rates because it believes that Staff's witness did not consider non-statistical factors, did not perform his statistical analyses consistent with the NARUC manual, did not attempt to clarify his understanding of Maricopa W/WW's data responses, and because the proposed depreciation rates fall below rates for other Arizona water and wastewater operations.

The following are the currently authorized, Company proposed, and Staff proposed composite

depreciation rates:

	Currently Authorized	Company Proposed	Staff Proposed
Sun City Water	2.58%	3.67%	2.68%
Sun City Sewer	2.34%	2.72%	1.85%
Sun City West Water	2.33%	3.02%	2.70%
Sun City West Wastewater	3.55%	3.65%	2.22%
Agua Fria	2.24%	2.64%	2.55%
Tubac Valley	2.42%	2.61%	2.81%

We find that the both the Company and Staff have failed to establish that the currently authorized depreciation rates should be changed. Although the Company conducted depreciation studies, it was unable to explain how the retirement patterns reflected in the Company's study and resulting depreciation rates are reasonable when compared with the actual retirements experienced by the Company. Likewise, Staff has not shown that the rates it proposes address the geographical characteristics associated with the Company's service area. Accordingly, we will not adjust the depreciation rates.

b. Amortization of Sun City Wastewater Treatment Plant

In Decision No. 53166 and Decision No. 55488, the Commission found that a portion of Sun City West Wastewater's treatment plant represented excess capacity, and disallowed that portion from plant. The parties agree that the treatment plant is currently being fully used to provide service. The Company proposed to amortize the unrecovered depreciation expense associated with the portion disallowed as excess capacity, over twenty years. Staff and RUCO disagreed with the Company's adjustment, believing that such an adjustment would be contrary to the Commission's prior orders and would result in retroactive ratemaking. We agree with the Company. The plant which we previously determined was excess capacity has not been depreciated on the Company's books. Return of the prudently incurred investment should be allowed now that it is no longer excess capacity. We will accept the Company's proposed adjustment of $2,346,569, amortized over 24 years at an annual rate of $96,880.

3. Employee Benefits Expense

RUCO was critical of the Company's proposed expenses associated with pensions, group medical, group life, and 401 K benefit plans ("employee benefits") and proposed a reduction to reflect the 1995 actual levels versus the Company's 1995 budgeted amount.

In response, the Company revised employee benefits downward by $27,364 to correct an

overstatement of medical expenses and to substitute actual data for budgeted data used in the last three months of the TY. Staff agreed with this correction, and RUCO continued to argue that its methodology was superior. We concur with the Company and Staff.

4. Insurance Expense

In its application, the Company included TY Insurance expense based upon nine months of actual 1994 costs and three months of budgeted 1995 expense. RUCO annualized the premiums at the end of the TY and recommended an increase of $9,947. Staff proposed an adjustment to exclude 50 percent of the directors' and officers' ("D&O") liability insurance. The Company acknowledged that the Commission had excluded 50 percent of D&O liability insurance in Decision No. 58664 for its Arizona Gas Division, but asked the Commission to reconsider that decision. In Decision No. 59951 (January 3, 1997), we did reconsider and did not accept Staff's adjustment. Accordingly, we will not accept that adjustment here, but we will accept RUCO's recommendation and increase insurance expense by $9,947.

5. Injuries and Damages Insurance Expense

In its application, the Company included TY injuries and damages expense based upon nine months of actual 1994 costs and three months of budgeted 1995 expense. Subsequently, the Company corrected an error and substituted the actual data for the budgeted data used for the last three months of the TY.

RUCO annualized the premiums at the end of the TY and recommended a $56,620 reduction. Staff made a similar adjustment resulting in a reduction of $80,535. In response, the Company asserted that Staff and RUCO's adjustments violate the integrity of the TY.

We concur with RUCO. We find that the use of the end of TY amount is known and measurable. Accordingly, we will reduce TY expenses by $56,620.

6. Power Costs

Staff made an adjustment to the Company's purchased power costs to reflect Arizona Public Service Company's electric rate decrease. The Company accepted Staff's adjustment. We agree with the Company's adjustment to the power costs for the wastewater companies.

7. Payroll and Payroll Tax Expense Issues

The Company proposed to include payroll expense for five employees hired after the end of the

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TY. Staff and RUCO opposed this adjustment, stating that the Company only included revenues from growth that occurred during the TY, and since these employees were hired well after the end of the TY, there would be a substantial mismatch of revenues and expenses. We agree with Staff and RUCO.

8. Rate Case Expense

In its original application, the Company included expense for amortization of prior rate case costs. The Company agreed with Staff that the amortization periods will expire before the rates in this proceeding go into effect, and therefore removed these prior rate case expenses.

In its direct testimony, the Company estimated rate case expenses of $366,231, which it subsequently updated to a "cap" of $750,000. Both Staff and RUCO objected to the Company's requested rate case expense. Staff recommends that the Company not recover any rate case expense over the amount it initially requested, and recommended a total rate case expense of $56,000 amortized over three years. RUCO made a similar recommendation, limiting rate case expenses to $300,000, amortized over five years. Both Staff and RUCO cite the Company's inaccurately prepared rate filing and its own contribution to the unnecessary increased costs by its failure to comply with Procedural Orders and provide timely and responsive answers to discovery. In response, the Company cites the fact that the Joint Application included six rate cases; the very large number of intervenors and data requests; the CAP water issue which required the retention of water resource experts; and the Company's retention of consultants in the area of rate design and price elasticity. The Company believes that rate case expense should be amortized over three years; RUCO presented testimony that five years would represent a more reasonable amortization period, given the past timing history of the Company's rate cases. We find that the Company's initial estimation of its rate case expense is most indicative of what the rate case expenses should have been, had the Company not conducted its discovery in the manner which it did. This estimation would have considered the CAP water and price elasticity issues and would have recognized the potential number of interested parties. Accordingly, we will allow $366,231 in rate case expenses, amortized over four years, for an annual combined rate case expense of $91,558.

9. Property Tax Expense

Staff and the Company agree that, given the property tax rates recently enacted by the Arizona Legislature, the appropriate tax expense to use should be the 1996 actual expense. The Company

provided documentation to Staff that the 1996 property taxes were $841,680 and we will allow that amount for property tax expense.

10. Income Tax Expense

The Company utilized the actual 35 percent income tax rate applicable to Citizens' consolidated federal income tax return. Staff and RUCO recommended that federal income tax be calculated for each Maricopa W/WW utility to reflect the correct tax rate for each utility on a separate return basis. We concur with Staff and RUCO.

11. Conservation Program Cost

Staff recommended that TY conservation expense for Sun City Water be reduced by $148,827. The Company failed to file a required March 1, 1996 report detailing the Company's conservation expense and the Company's witness testified that there is no significant benefit to the current conservation education program. Instead, Staff is proposing a $40,000 allowance for conservation education for the Northwest Valley water customers and recommends that Citizens be required to file a plan with Staff and RUCO for Staff's approval within 120 days of this Decision, and that Citizens be required to file a report with Staff and RUCO on an annual basis to account for the expenditures made for conservation education. We agree with Staff's recommendations.

12. Groundwater Withdrawal Fees

As discussed in the rate base section above, we have accepted Staff's recommendation to exclude the expenses and revenues associated with groundwater withdrawal fees, and instead will allow the recovery of such fees through a pass-through surcharge mechanism.

13. Investment Tax Credit Amortization

Staff adjusted the income tax expense so the annual amount of investment tax credit amortization reflected for rate making purposes is appropriately coordinated with Staff's recommended depreciation rates. Since we are not changing the depreciation rates, the ITC amounts reflected in the original filing should be used.

14. Water Testing Expenses

The only remaining issue concerning water testing expenses is Staff's recommendation to disallow the Company's amortization of initial compliance testing costs. We agree with Staff that the

initial monitoring of the water systems was mostly completed prior to the TY, and accordingly, we will accept Staff's adjustment.

15. Sun City Sewer Surcharge Revenues and Expenses

Consistent with the discussion below in rate design, we have agreed with Staff's recommendation to eliminate the Sun City sewage treatment surcharge on a going forward basis and to include the costs as a normal operating expense to be recovered in base rates.

16. Price Elasticity Adjustment

Consistent with our discussion in the rate design section below, we have not accepted the Company's price elasticity adjustment. Accordingly, we will not adopt the Company's adjustments to reduce TY expenses for the impact of price elasticity inherent in Citizens' proposed rate design.

17. Industrial Wastewater Pretreatment Program

The Company is requesting rate recognition of the expenses of its Industrial Wastewater Pretreatment Program ("Pretreatment Program"). The Pretreatment Program is an inspection, monitoring, and compliance program intended to prevent the high concentration of certain pollutants, not normally associated with domestic water, from entering the sewage collection systems. The federal Clean Water Act requires the owners of publicly owned treatment works to implement pretreatment programs. The Company intends to implement the program for both Sun City Sewer and Sun City West Wastewater, at a total projected cost of approximately $110,000 per year. RUCO recommended that the costs not be allowed because they are not known and measurable, and did not occur in the TY. In response, the Company agreed to include the estimated revenues associated with the Pretreatment Program. We agree with the Company that both the expenses and revenues should be included. As discussed by RUCO, the program is aimed primarily at non-residential customers, and this will be a factor addressed in the rate design. We also agree with Staff's recommendation to approve Citizens' proposed tariffs and to require the Company to track actual revenues and expenses associated with the program and include such information in its next rate filing. Further, the Company shall provide Staff with the requested information about commercial customers wastewater flow in relation to their water usage within fifteen months.

18. CAP Water Costs

Consistent with our discussion of CAP water, above, we will remove the Company's proforma adjustments for CAP M&I charges.

C. Statement of Net Operating Income

Based on the foregoing, the adjusted test year operating expenses for ratemaking purposes for Sun City Water is $4,369,060; for Sun City Sewer is $4,003,838; for Sun City West Water is $2,232,815; for Sun City West Wastewater is $2,224,372; for Agua Fria is $849,443; and for Tubac Valley is $137,632.

Based on the foregoing, the adjusted test year net operating income for ratemaking purposes for Sun City Water is $1,362,270; for Sun City Sewer is $562,851; for Sun City West Water is $666,017; for Sun City West Wastewater is ($20,579); for Agua Fria is $256,851; and for Tubac Valley is $39,810.

VIII. RATE OF RETURN

Witnesses from Staff, RUCO, and Citizens presented cost of capital analyses to be considered as evidence by the Commission in determining a fair value rate of return for purposes of these proceedings. Applicant's witness, Mr. Duda, found the cost of capital to be 9.35 percent. Staff witness, Mr. Cassidy, concluded that 8.51 percent is a reasonable rate of return for Citizens. RUCO witness, Mr. Hill, presented testimony supporting 8.639 percent rate of return.

A. Capital Structure

Citizens' actual, consolidated capital structure at March 31, 1995 and the configurations recommended by the parties are as follows:

	3/31/95	Staff (12-31-95)	RUCO(3-31-96)	Citizens (6/30/96)
Long-Term Debt	40.80%	40.62%	40.142%	43.0%
Preferred Stock	0.00%	5.99%	6.748%	6.0%
Common Equity	59.20%	53.39%	53.11%	51.0%

All parties agree that the actual consolidated capital structure should be used to determine the appropriate rate of return. We will use the Company's June 30, 1996 capital structure as it is the most current actual consolidated capital structure.

B. Cost of Debt

The proposed embedded cost of long-term debt by Citizens, Staff, and RUCO were 7.11 percent, 7.28 percent, and 7.28 percent, respectively. Staff used the average cost of debt as of December 31, 1995, and RUCO and Citizens used the cost as of June 30, 1996. RUCO and Citizens' cost rates are based upon the most recent data, and therefore we will adopt their long-term debt rate of 7.11 percent.

C. Cost of Preferred Stock

In January 1996, the Company issued $201,250,000 in convertible subordinated debentures/preferred stock. The proposed preferred stock cost by the Company, Staff, and RUCO were 5.15 percent, 5.0 percent and 5.15 percent, respectively. Staff did not include issuance costs in the calculation of the allowed return on preferred stock because Staff believes that preferred stock is more like equity than like debt in regard to its duration, and should be handled in the same manner as the issue of flotation costs in the cost of equity determination. We agree that the preferred stock/convertible debt appears to be a hybrid, with some characteristics of debt, and some characteristics of equity. Accordingly, we will allow one-half of the issuance costs to be included in determining the appropriate rate. Therefore, the cost of preferred stock is 5.075 percent.

D. Cost of Common Equity

The Company recommended a cost of equity of 11.75 percent, Staff recommended a cost of 9.834 percent, and RUCO recommended a cost of equity of 10.0 percent.

Citizens' recommended cost of equity resulted from consideration of Discounted Cash Flow ("DCF") model and Capital Asset Pricing Model ("CAPM") and a risk premium analysis. The Company's witness, Mr. Duda, performed the three different analytical methods because he believes that a combination of methods will compensate for phases in the economic cycle that may disproportionately affect one model, for flaws inherent in each model, and for the subjectivity of model inputs. The results were 11.75 percent, 11.94 percent, and 11.55 percent, respectively. The CAPM measures the rate of return on a risk-free investment, plus the risk premium the investor requires for investing in a riskier investment. Mr. Duda's risk premium analysis included deriving an average monthly risk premium for the six publicly traded water companies ("proxy group") whose results are followed in Value Line and added the current expected long-term treasury bond yield, as well as a flotation cost and risk adjustment.

Mr. Duda's DCF analysis used as his expected growth rate the average forecasted growth rates published by Value Line for his proxy group of companies. Mr. Duda applied a flotation cost adjustment to his DCF base cost of equity to calculate his DCF cost of equity of 11.75 percent, including his risk adjustment. The risk adjustment Mr. Duda included was 50 basis points, to reflect what he believes is the greater business risks faced by small companies. To derive his 11.75 percent cost of equity, Mr. Duda averaged the results of the CAPM, risk premium, and DCF analyses. The recommended cost of equity includes a flotation cost adjustment, and a risk adjustment.

Staff's cost of equity recommendation is based upon a DCF analysis and is supported by a CAPM and comparable earnings analysis. Staff's DCF model used a dividend growth rate derived from averaging Value Line's five year forecasted dividend growth rate with the average expected return based on ten year dividend growth rates, resulting in a cost of equity of 9.834 percent. Mr. Cassidy also performed CAPM and comparable earnings analyses which corroborated the DCF results. The CAPM results ranged from 10.2 percent to 11.3 percent, and the comparable earnings results included returns on common equity for Arizona water companies during 1993 and 1994 ranging from 7.0 percent to 8.8 percent, and ranges of 10.4 percent to 11.4 percent for comparable water companies listed by Edward D. Jones.

RUCO's witness, Mr. Hill, performed a DCF model analysis using the market data from the sample of water/wastewater utility companies used by the Company. He also performed a modified earnings price ratio ("EPR") analysis, a market-to-book ("MTB") analysis, and a CAPM analysis. The DCF analysis resulted in a 10.17 percent cost of common equity; the EPR resulted in a range of 8.93 to 9.97 percent; the MTB resulted in a range of 10.10 to 10.55 percent; and the CAPM resulted in a range of 8.96 to 10.09 percent. Mr. Hill testified that his best estimate of the cost of equity capital for a water utility which faces similar risks to the companies analyzed falls in the range of 10.00 to 10.50 percent. He chose the mid-point of the range, 10.25 percent as a market-based equity cost, and adjusted it to 10.00 percent to account for Citizens' lower financial risk.

The Company criticized Staff for its reliance solely on the DCF results, and RUCO's DCF growth rate and dividend yield calculation as being too subjective and arbitrary. It disagreed with Mr. Hill's use of a short-term, instead of a longer term Treasury bill as was used by Mr. Duda and his

averaging the geometric and arithmetic means to derive his market risk premium. The Company recommended that the Commission reject the EPR and MTB because they are outside the mainstream of financial economic thought and unrepresentative of how major investors actually determine their required market return on equity.

The Company criticized Staff for not making an adjustment for what it believes is the substantially greater business risks that the Maricopa W/WW faces. The Company cites Mr. Duda's earnings before taxes ("EBIT") calculation showing that even using EBIT divided by rate base, Maricopa W/WW operations demonstrated significantly greater operating risk than either Staff or RUCO's proxy companies. The Company also faulted both Staff and RUCO for not including adjustments for flotation costs and quarterly dividends.

Staff characterized the Company's requested 11.75 percent return on equity as being a "bloated number containing arbitrary and inappropriate costs which ratepayers should not be required to bear." The most significant cost is Mr. Duda's 50 basis point adjustment to compensate for what he terms the "additional risk that is inherent in small water and wastewater companies." Staff believes that such an add-on is unsupported and arbitrary. Staff pointed out that the six individual operating systems comprising the Maricopa W/WW division are, "on average, one of the largest, if not the largest, water and wastewater utilities regulated by this Commission." Staff argued that its comparable earnings analysis takes into consideration that Citizens' water and wastewater properties are not as large as the water companies reported on the Edward D. Jones by using a comparison group of other Arizona water/wastewater companies who had average returns on equity ranging from 7.0 to 8.8 percent during 1993 and 1994. Further, Staff explained that the difference in variability in the return measured by the Company is due to the fact that Citizens experienced a faster growth in rate base compared to customers than did the comparison companies. Staff concluded that its recommended return on equity adequately recognizes the size of the Maricopa W/WW properties. Staff believes that a flotation adjustment should not be made because flotation costs are not expensed, but are accounted for on the balance sheet; flotation costs are incurred only when issuing new securities[13]; and although it can be argued that flotation costs

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[13] Citizens issued $250 million in equity in 1996, but the net proceed were used to finance telecommunications acquisitions, not fund utility plant to serve Arizona customers.

might have an impact where a utility is paying out cash dividends, Citizens no longer pays cash dividends. Staff points out that the methodology used by Staff is the one that the Commission has historically favored.

RUCO responded to the Company's criticism that no leverage adjustment is necessary by pointing out that Mr. Hill's analysis of the financial risk of companies with lower levels of leverage determined that the adjustment to the cost of equity could be as high as 60 to 80 basis points, and that RUCO did not apply the full amount of the indicated differential to its downward adjustment. RUCO also criticized the Company's heavy reliance on the CAPM, noting that the CAPM has many short-comings as an equity cost estimation tool as discussed in recent studies published in academic literature.[14] RUCO believes that this casts serious doubt on the veracity of beta as a reliable risk measure and encouraged the Commission to reject the Company's CAP methodology. RUCO believes that the Company's DCF analysis was performed to result in an upwardly biased rate by accounting for flotation costs the Company will not incur and by accounting for quarterly compounding of dividends and thereby allowing investors that return twice. RUCO believes that the operating risk of utilities, both large and small, is relatively uniform and no additional rate of return award is due to a smaller utility due simply to its size.

After considering all the record evidence, the Commission finds that 10.5 percent is a reasonable return on equity for Citizens' Maricopa W/WW operations. We find that this cost level adequately reflects the business and financial risks associated with those operations.

E. Cost of Capital Summary

	Percentage	Cost	Weighted Cost
Long-term debt	43.0%	7.11%	3.06%
Preferred stock	6.0%	5.075%	.31%
Common equity	51.0%	10.5%	5.36%
TOTAL			**8.73%**

[14] The Company argues that those studies have been refuted by a more recent study that confirmed that both size and beta are important in understanding utility stock returns.

IX. AUTHORIZED INCREASE/DECREASE

With the adjustments adopted herein, the combined overall revenue effect is to increase the Company's operating revenues by $540,469 or 3.24 percent.

With the adjustments adopted herein, the adjusted TY operating income is for Sun City Water is $1,362,270. Further, the 8.73 percent cost of capital translates into a 5.3 percent rate of return on FVRB as authorized hereinabove. Multiplying the 5.3 percent rate of return by the FVRB produced required operating income of $1,198,045. This is $164,225 less than the Company's TY adjusted operating income. Multiplying the excess by the revenue conversion factor of 1.65152 results in an decrease in revenues of $271,221 or a 4.7 percent net decrease over TY adjusted revenues.

With the adjustments adopted herein, the adjusted TY operating income is for Sun City Sewer is $562,851. Further, the 8.73 percent cost of capital translates into a 5.2 percent rate of return on FVRB as authorized hereinabove. Multiplying the 5.2 percent rate of return by the FVRB produced required operating income of $655,646. This is $92,795 more than the Company's TY adjusted operating income. Multiplying the deficiency by the revenue conversion factor of 1.65152 results in an increase in revenues of $153,253 or a 3.4 percent net increase over TY adjusted revenues.

With the adjustments adopted herein, the adjusted TY operating income is for Sun City West Water is $666,017. Further, the 8.73 percent cost of capital translates into a 7.9 percent rate of return on FVRB as authorized hereinabove. Multiplying the 7.9 percent rate of return by the FVRB produced required operating income of $546,184. This is $119,833 less than the Company's TY adjusted operating income. Multiplying the excess by the revenue conversion factor of 1.65152 results in an decrease in revenues of $197,907 or a 6.8 percent net decrease over TY adjusted revenues.

With the adjustments adopted herein, the adjusted TY operating income is for Sun City West Wastewater is ($20,579). Further, the 8.73 percent cost of capital translates into a 7.6 percent rate of return on FVRB as authorized hereinabove. Multiplying the 7.6 percent rate of return by the FVRB produced required operating income of $450,357. This is $470,936 more than the Company's TY adjusted operating income. Multiplying the deficiency by the revenue conversion factor of 1.65152 results in an increase in revenues of $777,760 or a 35.3 percent net increase over TY adjusted revenues.

With the adjustments adopted herein, the adjusted TY operating income is for Agua Fria is

$256,851. Further, the 8.73 percent cost of capital translates into a 7.9 percent rate of return on FVRB as authorized hereinabove. Multiplying the 7.9 percent rate of return by the FVRB produced required operating income of $288,514. This is $31,663 more than the Company's TY adjusted operating income. Multiplying the deficiency by the revenue conversion factor of 1.65152 results in an increase in revenues of $52,292 or a 4.7 percent net increase over TY adjusted revenues.

With the adjustments adopted herein, the adjusted TY operating income is for Tubac Valley is $39,810. Further, the 8.73 percent cost of capital translates into a 6.6 percent rate of return on FVRB as authorized hereinabove. Multiplying the 6.6 percent rate of return by the FVRB produced required operating income of $57,886. This is $18,076 more than the Company's TY adjusted operating income. Multiplying the deficiency by the revenue conversion factor of 1.45334 results in an increase in revenues of $26,270 or a 14.8 percent net increase over TY adjusted revenues.

X. COST OF SERVICE

The Company conducted cost of service allocation studies to develop the rate of return under present and proposed rates for each of the several customer classifications in each utility. In the four separate water utility studies, the rates of return were developed for the residential, commercial, public authority, irrigation and private fire protection classifications. In the two separate sewer utility studies, the rates of return were developed for the residential and commercial customer classifications. In general, cost of service studies are tools that help determine cost causation by customer class, and what the appropriate revenue requirement for each customer class should be. Other considerations such as rate stability, fairness, conservation, etc. also are important in designing rates.

Both Staff and RUCO analyzed the cost of service studies, and agree with most of the fundamental principles and the basic methodology that was used. Staff believes that costs should be allocated to customers based on the customer's meter size, whereas the Company allocated costs based on the nature of their end use, i.e., residential, commercial, public authority, and other classes. RUCO disagreed with the manner in which the Company allocated demand costs, primarily the ratios of maximum use to average use for each customer class, and the allocation of public fire protection costs to residential, commercial, and public authority classes.

XI. RATE DESIGN

A. Water Utilities

The current rate structures include gallons in the minimum[15] and a single commodity charge. All parties recommended that minimum gallonage allowances be eliminated. We agree that this will send correct price/conservation signals and give customers more control over their water bills. Likewise, the parties agree that the rate design should incorporate rate blocks with price changes between the blocks. We agree with RUCO and the Company that at this time, a two block inclining rate structure is more appropriate. Once the Company's customers have some experience with these rates, and the conservation effect, if any, is known, then a more complex, three tier rate block structure may be appropriate.

The Company established the size of the initial block for each meter size in a manner that it believes maximizes the amount of discretionary use in the second block. The Company did not propose two blocks for 4 inch meter and larger customers, but used a single commodity rate for all usage. RUCO proposed an initial block of 8,000 gallons for all meter sizes and an increased commodity charge in the second block where revenues allowed for it. The Company criticized RUCO's approach as unfairly discriminating against customers with larger meter sizes. We agree with RUCO that charging customers with larger sized meters less per gallon does not send the appropriate price signal in an area where conservation is needed.

Staff recommended that the service charges for irrigation customers be set at the same rates for residential and commercial customers using the same meter size, instead of lower rates as proposed by the Company. We agree with Staff and also agree with the Company and Staff that the current flat commodity rate of $0.65 per thousand gallons remain in effect. We also agree with the Company and Staff that public authority customer fire hydrant rate of a flat $3.50 per fire hydrant for the City of Peoria is appropriate and that the flat commodity rate of $0.50 per thousand gallons to the City of Peoria remain in effect. Staff proposed a commodity rate of $2.02 per thousand gallons on all consumption for the Perryville State Prison which is on the Agua Fria system. Staff agreed that it is possible that this large

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[15] 1,000 gallons for Sun City Water, Agua Fria, and Tubac and 5,000 gallons for Sun City West Water.

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customer could potentially develop alternative water resources to meet its water needs, and if it did leave the system, the remaining ratepayers may have significant increases to remedy the revenue shortfall. Staff proposed that this flat commodity rate be authorized specifically and only for the Perryville Prison, and that the Company should be directed to file a tariff specific to this customer. We agree that such a rate is reasonable under the circumstances.

Staff believes that the Company's miscellaneous service charges and meter and service line installation charges should be revised to be consistent and uniform in all four systems, as well as comply with Commission rules and policy. The Company did not oppose that recommendation and we agree with Staff's recommendation.

Citizens has also requested a tariff to offer raw, untreated CAP water to golf courses and all irrigation-type users. Citizens proposed a $.50 per thousand gallon rate for the water to be delivered under this tariff, and the infrastructure needed to deliver the water would be constructed pursuant to line extension agreements between the Company and the customer. Staff believes that this tariff may be of potential benefit to the irrigation/turf customers. Staff agrees that the infrastructure should be constructed through main extension agreements and recommends that customers must accept the responsibility for the water "as is", meaning that the customer is responsible for any necessary compliance with the ADEQ or other regulatory agencies having jurisdiction concerning water quality, and hold harmless the Company and ratepayers from any injuries or damages arising from the provision of non-potable CAP water.

The Company and RUCO proposed increases in private fire line rates from the current charge of $5.00 per month for all private fire lines regardless of size to a graduated system that ranged from $5.00 per month to $60.00 (Company) or $30.00 (RUCO). According to Staff, its private fire line rates are based on Commission policy established as a result of Decision No. 57395 (May 23, 1991) involving Chaparral City Water Company, and have been consistently implemented and adopted by the Commission in all water utility rate cases subsequent to that decision. The policy is to set the private fire line rate equal to one percent of the general service charge, but not less than $5.00 per month. The Company agrees that this logic is appropriate for recovery of the demand costs from private fire customers, but has no bearing on the portion of the customer costs to be recovered from such customers.

The Company's witness testified that the customer costs for the service line and for billing and collecting, with the exception of meter reading, are not different for private fire customers and general service customers with the same size service. We agree with the Company and RUCO that private fire line charges should more closely match the costs associated with providing that service, and should include recovery of customer costs plus a portion of demand costs.

The Company proposed that the price elasticity of the demand for water be incorporated into the rate design through the projection of the level of future water consumption as a result of new rates. The Company's witness developed models similar to those used with demand side management studies, and derived a price elasticity estimate of .295. This means that for every one percent increase in the price of water, demand is projected to decrease by .295 percent.

Staff recommended that the price elasticity estimate not be incorporated into the rate design because it is not known or measurable. RUCO rejects the price elasticity estimate because it used average price rather than incremental price.

We note that based on a survey of Sun City customers, the Company witness was unable to conclude that current conservation education programs materially reduce water demand. Likewise, a conservation rate design is intended to reduce water demand, but until the rate design is actually implemented, no one knows whether it will actually work. Since we are adopting a rate design that incorporates incremental prices, we agree with RUCO that the use of average price in the price elasticity estimate is inappropriate. Accordingly, we will not incorporate price elasticity into the rate design.

We will adopt the rate design recommended by RUCO for Tubac Valley. The difference in the revenues between RUCO's recommended level and the revenues authorized herein should be added to the commodity rate in the second tier.

As far as the rate design for Sun City Water, Sun City West Water, and Agua Fria, we agree with RUCO and Staff that the service charges should not increase, and that the service charge for Sun City West Water should decrease due to the removal of the 5,000 gallons included in the minimum. The results of the cost of service studies indicate that the service charges should remain the same or decrease to no lower than five dollars for the 5/8-inch meters. The rate design should incorporate a two block inclining rate structure, with a price differential between the two blocks to encourage conservation.

Where possible, the commodity rate should not decrease from its current rate. As indicated above, the initial block should contain 8,000 gallons.

On April 23, 1997, Staff, RUCO and the Company each submitted rate design schedules interpreting these guidelines. We find that for Sun City Water and Sun City West Water, RUCO's schedules are appropriate; and for Agua Fria and Tubac, the Company's schedules are appropriate. Citizens shall submit tariffs which incorporate these guidelines to RUCO and Staff for their review prior to filing with the Commission.

B. Wastewater Companies

The Company proposed equal percent increases to residential and commercial customers in the Sun City Sewer and Sun City West Wastewater systems. Both Staff and RUCO recommended larger increases for commercial customers than for residential customers. The Company agreed that its cost of service allocation study indicated the need for a greater than average increase to the commercial class, but objected to increases that were twice that of the residential class. For Sun City Sewer, Staff recommended adopting a 17.56 percent increase for commercial and larger user customers, with a slight decrease in residential rates. For Sun City West Wastewater, Staff recommended adopting a 57.18 percent increase for commercial and larger user customers, and an increase of 10.61 percent in residential rates. RUCO recommended that the commercial class receive a rate increase that is roughly twice the average increase. As discussed hereinabove, we have allowed wastewater pretreatment charges and revenues which are incurred for commercial customers, and this further supports RUCO and Staff's position that commercial customers' rates should recover most of the increase. Accordingly, we will adopt Staff's recommended rate design. On April 23, 1997, Staff, RUCO and the Company each submitted rate design schedules. We agree with Staff's proposal.

Both Staff and RUCO recommended that the Sun City Sewer's sewer treatment surcharge be eliminated and that the Tolleson wastewater processing charge be treated as a normal operating expense which is recovered in base rates. The Company stated that while it was reluctant to include the treatment costs into base rates, it did not oppose this recommendation. Accordingly, we have eliminated the sewer treatment surcharge and included the costs in base rates. Further, the parties have agreed in concept with the recovery/refund methodology to be developed in connection with the bank balance.

XII. YOUNGTOWN CC&N

On February 8, 1995, Sun City Water and Sun City Sewer purchased the water and wastewater facilities of Youngtown that serve approximately 3,720 customers within the Town's municipal boundaries. On May 8, 1996, Sun City Water and Sun City Sewer filed a Joint Application for an extension of their CC&Ns to serve the Town. The Company's witness testified in support of the Joint Application that there is a public need and necessity for water and wastewater utility service in the areas and that Sun City Water and Sun City Sewer are fit and proper entities to serve the requested areas. Staff recommended approval of the Joint Application and recommended that the Commission order Sun City Water and Sun City Sewer to charge customers in the extension areas the rates approved in this proceeding. We agree with Staff's recommendations and will approve the Joint Application.

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

FINDINGS OF FACT

1. Citizens is a Delaware corporation engaged in providing water and wastewater utility service to the public in certain portions of Mohave and Santa Cruz counties, Arizona.

2. On August 17, 1995 Citizens filed a Joint Application for its six operations for approval of general increases in rates and charges for water and wastewater utility service.

3. On October 2, 1995, Staff filed a notice that the Joint Application has met the sufficiency requirements of A.A.C. R14-2-103 and that the Company has been classified as a Class A.

4. In accordance with A.A.C. R14-3-101, a Procedural Order was issued October 25, 1995 which set the matter for hearing on May 15, 1996.

5. In accordance with the Procedural Order, Citizens published notice of its application for an increase in rates in newspapers of general circulation in its service areas and mailed, by means of a bill insert, a copy of the notice to each of its customers.

6. On February 8, 1995, Sun City Water and Sun City Sewer purchased the water and wastewater facilities of Youngtown and on May 8, 1996, Sun City Water and Sun City Sewer filed a Joint Application for an extension of their CC&Ns to serve Youngtown.

7. On October 2, 1995, Sun City Sewer filed its sewer treatment surcharge application which requested that the Commission retain the currently authorized surcharge rates.

8. On November 3, 1995, the sewer treatment surcharge application was consolidated with the rate applications.

9. By Procedural Order issued August 2, 1996, the Joint Rate Application and the Joint CC&N Application were consolidated.

10. There were numerous discovery disputes and oral arguments on the discovery disputes occurred on March 5, March 20, April 3, and April 23, 1996.

11. On May 9, 1996, the time-clock rules were stayed pursuant to A.A.C. R14-2-103(B)(11)(e)(ii).

12. By Procedural Order issued May 9, 1996, the hearing was rescheduled to commence on October 29, 1996.

13. Public comment hearings were held on the application in Sun City, Surprise, and Nogales, Arizona and at the Commission's offices in Phoenix, Arizona, on the dates indicated hereinabove.

14. A fair and reasonable rate of return on Sun City Water's FVRB is 5.3 percent.

15. For ratemaking purposes, Sun City Water's adjusted TY revenues were $5,731,330, its TY operating expenses are $4,369,060, and its existing rates provided TY net operating income of $1,362,270.

16. For ratemaking purposes, Sun City Water's OCRB, RCNRB, and FVRB for the TY ended March 31, 1995 are determined to be $13,675,576, $31,533,666 and $22,604,621.

17. Operating income of $1,198,045 is necessary to yield a 5.3 percent rate of return on the FVRB.

18. Sun City Water must decrease operating revenues by $271,221 or 4.7 percent to produce operating income of $1,198,045.

19. Sun City Water's proposed increase of $364,780 would produce an excessive return on its FVRB.

20. A fair and reasonable rate of return on Sun City Sewer's FVRB is 5.2 percent.

21. For ratemaking purposes, Sun City Sewer's adjusted TY revenues were $4,566,689, its

TY operating expenses are $4,003,838, and its existing rates provided TY net operating income of $562,851.

22. For ratemaking purposes, Sun City Sewer's OCRB, RCNRB, and FVRB for the TY ended March 31, 1995 are determined to be $7,515,406, $17,701,732 and $12,608,569.

23. Operating income of $655,646 is necessary to yield a 5.2 percent rate of return on the FVRB.

24. Sun City Sewer must increase operating revenues by $153,253 or 3.4 percent to produce operating income of $655,646.

25. Sun City Sewer's proposed increase of $404,392 would produce an excessive return on its FVRB.

26. A fair and reasonable rate of return on Sun City West Water's FVRB is 7.9 percent.

27. For ratemaking purposes, Sun City West Water's adjusted TY revenues were $2,898,832, its TY operating expenses are $2,232,815 and its existing rates provided TY net operating income of $666,017.

28. For ratemaking purposes, Sun City West Water's OCRB, RCNRB, and FVRB for the TY ended March 31, 1995 are determined to be $6,235,619, $7,591,825 and $6,913,722.

29. Operating income of $546,184 is necessary to yield a 7.9 percent rate of return on the FVRB.

30. Sun City West Water must decrease operating revenues by $197,907 or 6.8 percent to produce operating income of $546,184.

31. Sun City West Water's proposed increase of $127,492 would produce an excessive return on its FVRB.

32. A fair and reasonable rate of return on Sun City West Wastewater's FVRB is 7.6 percent.

33. For ratemaking purposes, Sun City West Wastewater's adjusted TY revenues were $2,203,793, its TY operating expenses are $2,224,372, and its existing rates provided TY net operating income of ($20,579).

34. For ratemaking purposes, Sun City West Wastewater's OCRB, RCNRB, and FVRB for the TY ended March 31, 1995 are determined to be $5,108,820, $6,742,689 and $5,925,755.

35. Operating income of $450,357 is necessary to yield a 7.6 percent rate of return on the FVRB.

36. Sun City West Wastewater must increase operating revenues by $777,760 or 35.3 percent to produce operating income of $450,357.

37. Sun City West Wastewater's proposed increase of $994,602 would produce an excessive return on its FVRB.

38. A fair and reasonable rate of return on Agua Fria's FVRB is 7.9 percent.

39. For ratemaking purposes, Agua Fria's adjusted TY revenues were $1,106,294, its TY operating expenses are $849,443, and its existing rates provided TY net operating income of $256,851.

40. For ratemaking purposes, Agua Fria's OCRB, RCNRB, and FVRB for the TY ended March 31, 1995 are determined to be $3,305,517, $3,998,637 and $3,652,077.

41. Operating income of $288,514 is necessary to yield a 7.9 percent rate of return on the FVRB.

42. Agua Fria must increase operating revenues by $52,292 or 4.7 percent to produce operating income of $288,514.

43. Agua Fria's proposed increase of $148,555 would produce an excessive return on its FVRB.

44. A fair and reasonable rate of return on Tubac Valley's FVRB is 6.6 percent.

45. For ratemaking purposes, Tubac Valley's adjusted TY revenues were $177,442, its TY operating expenses are $137,632, and its existing rates provided TY net operating income of $39,810.

46. For ratemaking purposes, Tubac Valley's OCRB, RCNRB, and FVRB for the TY ended March 31, 1995 are determined to be $657,068, $1,097,065 and $877,067.

47. Operating income of $57,886 is necessary to yield a 6.6 percent rate of return on the FVRB.

48. Tubac Valley must increase operating revenues by $26,270 or 14.8 percent to produce operating income of $57,886.

49. Tubac Valley's proposed increase of $51,662 would produce an excessive return on its FVRB.

50. Based on the cost of service studies, the need for conservation, the level of revenues authorized herein, and the principle of gradualism, the revenue distribution methods described herein are appropriate in this case.

51. The demand of existing customers is contributing to the groundwater depletion of the aquifer, land subsidence, and other environmental damage.

52. The consequences of excessive groundwater withdrawal include decreased water levels, diminished water quality, well failures, increased pumping costs, and more land subsidence.

53. Because Citizens is not utilizing CAP water in the provision of service to its customers, its CAP allocation by definition is not "used and useful." Therefore, the costs of Citizens' CAP capital charges should not be borne by the ratepayers. Furthermore, because Citizens has no definite plans to use the CAP water, its proposal to use its CAP allocation is speculative and the use of this water cannot be considered to be a known and measurable event.

54. Citizens shall be allowed to defer its CAP M&I capital charges as set forth herein.

55. The sewer treatment surcharge for Sun City Sewer shall cease when the rates approved herein go into effect, and Staff, RUCO, and the Company shall develop and implement any necessary surcharge mechanism to refund or collect any over/under collected bank balance.

56. Engineering Staff's recommendations are reasonable and should be adopted.

57. Groundwater withdrawal fees shall be recovered through a pass-through surcharge mechanism.

58. Consistent with the Discussion herein, it is reasonable for the Company to utilize the accrual method for PBOPs.

59. Tubac Valley is not in compliance with the regulations of ADEQ.

60. It is reasonable that the rates and charges adopted below for Tubac Valley become effective in the month following Tubac Valley submitting evidence that ADEQ has determined that Tubac Valley's water meets the Safe Drinking Water Act's Standards.

CONCLUSIONS OF LAW

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

2. The Commission has jurisdiction over Citizens and of the subject matter of the applications.

3. Notice of Citizens' applications were given in accordance with the law.

4. The time-clock rules were extended by 167 days as a result of extraordinary events.

5. The rates and charges for water and wastewater service proposed by Citizens are not just and reasonable.

6. The rates and charges established hereinafter are just and reasonable.

7. Citizens should be authorized to file revised tariffs for water and wastewater service consistent with the above Findings of Fact and the Discussion herein under Authorized Increase and Rate Design.

8. Sun City Water and Sun City Sewer are fit and proper entities to receive amended Certificates which encompasses Youngtown, Arizona.

9. The public convenience and necessity require the extension of Sun City Water and Sun City Sewer's Certificates to serve Youngtown, Arizona.

10. Citizens' decision to obtain allocations of CAP water was a prudent planning decision.

ORDER

IT IS THEREFORE ORDERED that Citizens Utilities Company be, and hereby is authorized and directed to file, within ten days of the date of this Decision, revised tariffs for its Agua Fria Water Division, Sun City Sewer Company, Sun City Water Company, Sun City West Utilities Company and Tubac Valley Company setting forth the rates and charges for the provision of water and wastewater service authorized herein and in accordance with the Discussion, Findings of Fact, and Conclusions of Law herein.

IT IS FURTHER ORDERED that the rates and charges contained in said tariffs shall become effective for service rendered on and after May 1, 1997 except that the rates and charges for Tubac Valley shall become effective for all service provided on and after the first day of the month following Tubac Valley filing with the Director of the Utilities Division evidence that Tubac Valley's water system is serving water which the Arizona Department of Environmental Quality has determined meets the Safe Drinking Water Act Standards.

IT IS FURTHER ORDERED that the sewer treatment surcharge for Sun City Sewer shall cease when the rates approved herein go into effect, and Staff, RUCO, and the Company shall develop and implement any necessary surcharge mechanism to refund or collect any over/under collected bank balance.

IT IS FURTHER ORDERED that Citizens Utilities Company is hereby authorized to defer its CAP M&I Capital Charges under the terms and conditions set forth herein.

IT IS FURTHER ORDERED that Citizens Utilities Company shall notify its customers of the rates and charges authorized herein and the effective dates of same by means of inserts in the next regularly scheduled monthly billings.

IT IS FURTHER ORDERED that Citizens Utilities Company shall comply with the reporting requirements as discussed herein.

IT IS FURTHER ORDERED that Citizens Utilities Company shall comply with the Engineering Staff's recommendations.

IT IS FURTHER ORDERED that the Applications of Sun City Water Company and Sun City Sewer Company to extend their Certificates of Convenience and Necessity to serve the Town of Youngtown, Arizona are hereby granted.

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IT IS FURTHER ORDERED that Citizens Utilities Company shall utilize the accrual method for PBOPs in its next rate case consistent with the conditions set forth herein.

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

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN COMMISSIONER COMMISSIONER

IN WITNESS WHEREOF, I, GEOFFREY E. GONSHER, Executive Secretary of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this 7th day of May, 1997.

GEOFFREY E. GONSHER
EXECUTIVE SECRETARY

DISSENT _____
LAF:dap

SERVICE LIST FOR: CITIZENS UTILITIES COMPANY, AGUA FRIA WATER DIVISION; SUN CITY SEWER; SUN CITY WATER COMPANY; SUN CITY WEST UTILITIES COMPANY; and TUBAC VALLEY COMPANY.

DOCKET NOS.: E-1032-95-417; U-2276-95-417; U-1656-95-417; U-2334-95-417; U-1595-95-417; U-2276-95-420; U-1656-96-282 and U-2276-96-282.

Fred Kriess
CITIZENS UTILITIES COMPANY
15626 North Del Webb Boulevard
Sun City, Arizona 85351

Beth Ann Burns
CITIZENS UTILITIES COMPANY
2901 North Central Avenue, Suite 1660
Phoenix, Arizona 85012

Susan Mikes Render
CITIZENS UTILITIES COMPANY
High Ridge Park
Stamford Connecticut 06905

Brian C. Wareing
CENTURION MANAGEMENT COMPANY
2999 North 44th Street, Suite 600
Phoenix, Arizona 85018

G. Ben-Horin
BELL WEST RANCH LIMITED PARTNERSHIP
SURPRISE 222 LIMITED PARTNERSHIP
5050 North 40th Street, Suite 320
Phoenix, Arizona 85018

Kelly House
SHEA HOMES
P.O. Box 15627
Phoenix, Arizona 85060-5627

James M. Flenner
OFFICE OF THE CITY ATTORNEY
CITY OF GLENDALE
5850 West Glendale Avenue
Glendale, Arizona 85301

Lester E. Merydith
c/o Sun City Water Users Association
12630 North 103rd Avenue, Suite 232
Sun City, Arizona 85351

Philip H. Vision
13225 Castlebar Drive
Sun City West, Arizona 85375

0000005030

Richard Kithil
P.O. Box 1493
Tubac, Arizona 85646

Albert Kaufman
TUBAC GOLF RESORT
P.O. Box 1297
Tubac, Arizona 85646

Steven J. Duffy
RIDGE & ISAACSON, P.C.
3101 North Central Avenue, Suite 432
Phoenix, Arizona 85012
Attorneys for Santa Cruz Valley Citizen's Council, Inc.

Richard Bosse, President
SANTA CRUZ VALLEY CITIZEN'S COUNCIL, INC.
P.O. Box 1501
Tubac, Arizona 85646

William G. Beyer, Esq.
Joseph E. La Rue, Esq.
BEYER, SPILSBURY & LA RUE
10448 West Coggins Drive, Suite C
Sun City, Arizona 85351
Attorneys for City of Surprise
Attorneys for Sun City Home Owners Association
Attorneys for Sun Village Community Association
Attorneys for Recreation Centers of Sun City West, Inc.
Attorneys for the Property Owners and Residents Association

Michael A. Curtis, Esq.
William P. Sullivan, Esq.
MARTINEZ & CURTIS, P.C.
2712 North Seventh Street
Phoenix, Arizona 85006-1090
Attorneys for Sun City Taxpayers' Association

Leon Rye, Manager
HAPPY TRAILS COMMUNITY ASSOCIATION
17200 West Bell Road #1690
Surprise, Arizona 85374

Douglas K. Miller, General Counsel
CENTRAL ARIZONA WATER CONSERVATION DISTRICT
23636 North 7th Street
Phoenix, Arizona 85024

Carl Seitz, Chairman
TUBAC FIRE DISTRICT BOARD
P.O. Box 2881
Tubac, Arizona 85646

...

...

Michael J. Pearce, Chief Counsel
ARIZONA DEPARTMENT OF WATER RESOURCES
500 North Third Street
Phoenix, Arizona 85004

Greg Patterson, Director
James P. Beene, Staff Attorney
Paul R. Michaud, Staff Attorney
RESIDENTIAL UTILITY CONSUMER OFFICE
2828 N Central Ave, Suite 1200
Phoenix, Arizona 85004

Lindy Funkhouser, Chief Counsel
Deborah R. Scott, Staff Attorney
Merrill Figley, Staff Attorney
Legal Division
ARIZONA CORPORATION COMMISSION
1200 West Washington Street
Phoenix, Arizona 85007

Carl Dabelstein, Director Utilities Division
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, Arizona 85007

EXHIBIT A

	Sun City Water	Sun City Sewer	Sun City West Water	Sun City West Wastewater	Agua Fria	Tubac
Company Proposed Rate Base	$14,664,768	$7,875,577	$6,685,509	$5,370,026	$3,515,693	$661,875
Commission Approved Adjustments						
AR-13	($410,207)	($89,446)	($431,998)	($242,717)	($217,801)	($1,835)
Youngtown Plant	(148,497)	(96,727)				
SAO Common Plant	(7,826)	(29,014)				
Accumulated Depreciation			24,739	15,808	19,528	(113)
Reserve for Deferred Income	(152,080)	(44,692)	(15,584)	(18,294)	(7,809)	(789)
Cashworking Capital	(258,365)	(101,037)	(27,047)	(16,003)	(4,094)	150
Plant in Service						(1,110)
Observation Wells - Plant	(88,746)					(1,674)
Observation Wells - Accum. Deprec.	33,764					564
Youngtown Adjustment	42,765	745				
Commission Adjusted OCRB	$13,675,576	$7,515,406	$6,235,619	$5,108,820	$3,305,517	$657,068
Commission Adjusted RCNRB	31,533,666	17,701,732	7,591,825	6,742,689	3,998,637	1,097,065
Commission Adjusted FVRB	22,604,621	12,608,569	6,913,722	5,925,755	3,652,077	877,067

DECISION NO. 60172

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EXHIBIT B

	Sun City Water	Sun City Sewer	Sun City West Water	Sun City West Wastewater	Agua Fria	Tubac
Operating Revenues	$5,731,330	$4,566,689	$2,898,832	$2,203,793	$1,106,294	$177,442
Operating Expenses Per Citizens	4,946,235	4,114,512	2,393,171	2,303,349	906,535	148,959
Commission Approved Adjustments						
Settled Issues	(128,610)	(7,329)	(28,301)	11,457	(54,446)	1,110
SAO/PAO	(57,754)	(76,288)	(19,463)	(18,537)	(33,246)	(1,161)
TARGET: Excellence	(70,945)	(47,871)	(30,726)	(31,038)	(5,395)	(1,829)
Employee benefit/IDCPI						
PBOPs/Split Life	(105,397)	(52,673)	(63,874)	(34,381)	(27,011)	(4,634)
Insurance	2,603	301	704	6,325	1	13
Injury and Damages	(4,139)	(6,144)	(6,894)	(34,238)	(4,652)	(553)
Payroll and Payroll Tax	(51,391)	(23,155)	(26,014)	(32,637)	(12,385)	(2,563)
Rate Case	(9,461)	(8,240)	(5,493)	(5,799)	(1,221)	(305)
Property Tax	(1,681)	(6,633)	17,274	(40,529)	27,024	(673)
Conservation Amortization	(148,827)					
Conservation Allowance	25,460		12,748		1,796	
Ground Water Withdrawal fees	(37,800)		(15,027)		(2,600)	(738)
Sewer Surcharge		2,328				
Price Elasticity	31,507		12,504		3,540	2,342
CAP Costs	(48,448)		(24,260)		(3,415)	
Depreciation-Rate	(306,757)	(51,607)	(160,596)	(28,943)	(29,871)	(4,819)
Depreciation AR-13	(10,583)	(2,093)	(9,489)	(8,055)	(4,441)	(42)
State and Federal Income Tax	302,924	165,626	203,769	161,550	75,110	1,902
ITC/SG Amortization	(9,361)	(3,430)	(44,230)	(44,232)	(311)	(363)
PBOP Accrual Increment	13,471	6,411	8,349	11,280	4,608	714
Power	2,714	16	17,707	7,866	6,584	292
Customer Accounting	62	65	958	934	650	24
Groundwater Withdrawal Fee	35,933				2,589	
Income Tax Due to Change in Rate Base	(695)	42				(44)
Total Expenses	4,369,060	4,003,838	2,232,815	2,224,372	849,443	137,632
Net Operating Income	1,362,270	562,851	666,017	(20,579)	256,851	39,810

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