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

DOCKET NO. W-01303A-09-0343

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

DOCKET NO. SW-01303A-09-0343

Arizona Corporation Commission
DOCKETED

JUL 16 2010

DOCKETED BY

POST-HEARING BRIEF

OF ARIZONA-AMERICAN WATER COMPANY

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I. INTRODUCTION

Arizona-American Water Company (“Arizona-American” or “Company”), a wholly-owned subsidiary of American Water, is a public service corporation engaged in providing water and wastewater utility service in portions of Maricopa, Mohave, and Santa Cruz Counties. Arizona-American is Arizona’s largest investor-owned water and wastewater utility, serving approximately 100,000 water customers and 50,000 sewer customers in the state.

As the Arizona Corporation Commission (“Commission”) is aware, Arizona-American’s operating districts have under-earned for several years, and Arizona-American has lost approximately \$30 million since American Water purchased the water and wastewater assets of Citizens Utilities in 2002.¹ Arizona-American had a net loss of \$1.8 million in 2008, which was an improvement over its \$4.6 million loss in 2007.² While 2009 audited results have not yet been released, Arizona-American’s financial condition remains dire.³

This Commission has previously recognized the Company’s poor financial condition. For example, in Decision No. 69730, the Commission evaluated Arizona-American’s times interest earned ratio (“TIER”) and stated that “TIER represents the number of times earnings will cover interest expense on short-term and long-term debt.... A TIER of less than 1.0 is not sustainable in the long-term... .”⁴ So far, despite many actions taken, the Company’s TIER has not improved to adequate levels.⁵ Arizona-American’s TIER was just 0.52 as of December 31, 2008.⁶

¹ Exhibit (“Ex.”) A-7 at 2; Phase I Transcript (“TR.I”) at 301.
² Ex. A-3 at 3.
³ TR.I at 301.
⁴ Decision No. 69730 at 3.
⁵ Ex. A-3 at 3.
⁶ *Id.*

1 Despite these poor earnings, the Company's parent, American Water, has
2 infused approximately \$70 million in equity. Several years ago, the Company was the
3 subject of a three-year rate case filing moratorium and was also ordered to forego recovery
4 of up to \$125 million of utility plant in service for periods of up to ten years ending only in
5 2012.⁷ As a result, the ratepayers have been enjoying the use of substantial assets without
6 paying for their full costs. In addition, this rate case included approximately \$70 million
7 (all 5 districts) additional utility plant put in service in the three years since the previous test
8 years for these districts.⁸

9 Given its financial condition, Arizona-American could not have made all the
10 necessary capital investment in Arizona without American Water's willingness to infuse
11 new equity and make long-term borrowing to Arizona-American at a very attractive rate.⁹
12 Without an adequate return on this investment, however, Arizona-American's access to this
13 capital from or through its parent will not continue.¹⁰ Without American Water's financial
14 commitment to Arizona-American, Arizona-American could face the threat of financial
15 restructuring.¹¹

16 The Company is sympathetic to the difficulty that this rate increase poses for
17 many of its ratepayers. To help alleviate the degree of rate increase needed, the Company
18 has taken many steps over the past few years to reduce expenses.¹² The Company has
19 reduced its workforce in Arizona and has cut back on capital expenditures, all while
20 maintaining safe and reliable service for its customers.¹³ Arizona-American has not paid a
21
22

23 ⁷ *Id.* at 4.

24 ⁸ Ex. A-6 at 3.

24 ⁹ Ex. A-3 at 5.

25 ¹⁰ *Id.*

25 ¹¹ *Id.* at 5-6.

26 ¹² *Id.* at 7-8.

¹³ *Id.*

1 dividend to its shareholder since 2003.¹⁴ In addition, in its last Anthem rate case, Arizona-
2 American renegotiated its agreement with Pulte to reduce and defer refund payments.

3 In this case, Arizona-American is asking this Commission to rebalance the
4 interests of its ratepayers and its shareholders.¹⁵ For many years, the balancing of interests
5 has greatly favored the Company's ratepayers. For example, in the Anthem community,
6 ratepayers have enjoyed the benefits of the system since 1998 without the full carrying cost
7 of that system being reflected in rates.¹⁶ The Company has not earned any return on the
8 investments it has made in Anthem since 2003.¹⁷ In this proceeding, the Company is
9 simply asking that the Commission find a more appropriate balancing point between the
10 interests of the Company's shareholders and the interests of its ratepayers. In order for
11 Arizona-American, the state's largest private water and wastewater utility, to remain stable
12 and viable for its customers and investors, Arizona-American must earn a reasonable return
13 on and return of the investment made by its shareholders.¹⁸

14 Given the tenuous nature of the Company's financial condition, it is critical
15 for the Commission to timely approve the rate relief requested in this case. The Company's
16 most recent rate cases experienced prolonged delays during the Commission-approval
17 process, resulting in millions in lost revenues. The revenue lost from these delays can
18 never be recovered by Arizona-American. Given the magnitude of the rate relief sought in
19 this case, Arizona-American cannot bear any delays in obtaining timely Commission
20 approval of its requested rate increases. For these reasons, the Company respectfully
21 requests that the Commission issue its final decision not later than the end of November
22 2010 in order that new rates can be effective before year-end 2010.

24 ¹⁴ *Id.* at 7.

25 ¹⁵ TR.I at 300.

26 ¹⁶ *Id.* at 299-300.

¹⁷ *Id.* at 300.

¹⁸ Ex. A-3 at 6.

1 **A. Overview of the Company's Request**

2 On July 2, 2009, Arizona-American filed its Application for an adjustment to
3 its existing rates and charges for two of its water districts (Anthem and Sun City) and three
4 of its wastewater districts (Anthem/Agua Fria, Sun City, and Sun City West), utilizing a
5 test year ending December 31, 2008.¹⁹ During the test year in this case, the Company had
6 an adjusted operating income for these five districts of \$1,824,473, which resulted in a
7 return of approximately 1.1 percent.²⁰

8 In this case, the Company seeks a total increase in annual revenues of
9 \$16,599,227.²¹ The Company provided ample support for this requested increase, as
10 evidenced by the fact that Staff recommends a total increase in annual revenues of
11 \$16,003,384, and RUCO recommends a total increase in annual revenues of \$13,269,889.²²
12 The revenue increases recommended for each district in this case are set forth below:²³

13

	Anthem Water	Sun City Water	Anthem/ Agua Fria Wastewater	Sun City Wastewater	Sun City West Wastewater
14 Company	\$5,962,687	\$1,877,910	\$5,292,887	\$1,965,520	\$1,500,223
15 Staff	\$5,928,181	\$1,843,078	\$5,031,198	\$1,725,339	\$1,475,588
16 RUCO	\$5,295,918	\$662,386	\$5,050,262	\$1,501,733	\$759,590

17
18

19 The Anthem Community Council also submitted final revenue increase
20 recommendations. Assuming the success of the Council's novel legal arguments, the
21

22
23
24 ¹⁹ Ex. A-1.

25 ²⁰ Company's Revenue Requirement Schedules (A-1 Schedules).

26 ²¹ *Id.* (A-1 Schedules).

²² Staff's Revenue Requirement Schedules (GWB-1 Schedules and GTM-1 Schedules); RUCO's Schedules (A Schedules).

²³ *Id.*

1 Council still recommends a revenue increase of \$3,770,866 for the Anthem Water District
2 and a revenue increase of \$3,978,174 for the Anthem/Agua Fria Wastewater District.²⁴

3 Arizona-American's final rate base, operating income, and revenue
4 requirement positions are set forth in its final schedules filed on June 11, 2010, as amended
5 by its errata filing dated July 1, 2010 ("Company's Revenue Requirement Schedules").
6 The Company's final rate design position, including its final rate consolidation position, is
7 set forth in its final rate design schedules filed on June 25, 2010, as amended by its errata
8 filing dated July 1, 2010 ("Company's Rate Design Schedules"). The Commission Staff's
9 final position on issues relating to revenue requirement is set forth in its final schedules
10 filed on June 18, 2010, as amended by its errata filing made July 6, 2010 ("Staff's Revenue
11 Requirement Schedules"). Staff's final rate design schedules are set forth in its filing dated
12 June 25, 2010 ("Staff's Rate Design Schedules"). RUCO filed both its final revenue
13 requirement and rate design schedules on June 24, 2010 ("RUCO's Schedules"). The
14 following parties also filed final schedules:

- 15 1. Anthem Community Council ("Anthem's Schedules")
- 16 2. The Camelback Inn, Sanctuary on Camelback Mountain, and
17 Intercontinental Montelucia Resort & Spa ("Resorts' Schedules")
- 18 3. Marshall Magruder ("Magruder Schedules")

19 Following the receipt of the initial positions of the parties in pre-filed
20 testimony, the Company closely reviewed each of their recommendations and endeavored
21 to accept as many as it could to reduce the remaining issues.²⁵ However, as detailed below,
22 certain differences still exist in relation to rate base, operating income, cost of capital, and

23 ²⁴ Anthem's Schedules. Anthem relied upon the Company's rebuttal schedules in making its adjustments.
24 *Id.* These schedules are slightly different than the Company's Final Revenue Requirement Schedules
25 submitted June 11, 2010. The revenue increase for the Anthem/Agua Fria Wastewater District also assumes
26 that the Commission accepts the Council's adjustment to the Northwest Valley Treatment Plant allocation
recommended by the Council. This would also result in a corresponding increase to the revenue
requirement for the Sun City West Wastewater District.

²⁵ Ex. A-7 at 2.

1 rate design. The Company's response and position in relation to those issues is discussed in
2 detail below.

3 II. RATE BASE/REVENUE REQUIREMENT ISSUES

4 Throughout this proceeding, Arizona-American has provided credible and
5 ample evidence to support its rate base figures in this proceeding. Staff has conducted
6 extensive discovery and has audited these rate base numbers through numerous data
7 requests and numerous site visits. RUCO has done the same. As noted by RUCO's
8 counsel, this case involved "a considerable amount of discovery requests on issues which
9 have required an inordinate amount of analysis."²⁶

10 Following this extensive discovery, extensive analysis and extensive
11 testimony, the Company's, Staff's and RUCO's proposed rate bases (as set forth in the
12 parties' final schedules) by District are as follows:²⁷

	Anthem Water	Sun City Water	Anthem/ Agua Fria Wastewater	Sun City Wastewater	Sun City West Wastewater
13 Arizona- 14 American	\$57,422,164	\$28,376,946	\$45,322,775	\$15,656,720	\$18,207,774
15 Staff	\$57,248,934	\$28,558,675	\$45,115,225	\$15,488,742	\$18,098,487
16 RUCO	\$57,258,174	\$26,212,284	\$45,260,942	\$14,595,027	\$18,095,016

17 As displayed in this table, the differences in the final rate base
18 recommendations for the Company, Staff, and RUCO are minimal. Except for minor
19 discrepancies the Company and Staff are generally in agreement regarding the Company's
20 rate base in each of its districts. The primary issues in dispute with RUCO are post-test
21 year plant in the Sun City Water District, recovery of costs under the Glendale Agreement
22 in the Sun City Wastewater District, and cash working capital in each of the districts.

23 The Anthem Community Council has taken issue with the allocation of the
24 Northwest Valley Treatment Plant proposed by Staff and supported by the Company and

25 ²⁶ RUCO's Motion to Extend the Time to File Its Direct Required Revenue Testimony, Feb. 18, 2010.

26 ²⁷ Company's Revenue Requirement Schedules (A Schedules); Staff's Revenue Requirement Schedules (GWB-1 Schedules and GTM-1 Schedules); RUCO's Schedules (A Schedules).

1 RUCO. The Council has also proposed a phasing in of rate base in the Anthem districts,
2 which is discussed separately below, as is the Council's inequitable and unsupported legal
3 argument in relation to the exclusion from rate base of the Company's most recent Pulte
4 refunds.

5 **A. Post-Test Year Plant (Sun City Water)**

6 In May 2009, Arizona-American completed the replacement of Well 5.1 in
7 the Sun City Water District.²⁸ This replacement was necessary to ensure an adequate water
8 supply in the Sun City Water District--a district in which wells are often out of service due
9 to their age and condition.²⁹ As noted by Company witness Gross, the infrastructure in this
10 district, including the wells, is very old and approaching the end of its useful life.³⁰

11 Arizona-American completed this project on an expedited basis and under budget in May
12 2009, which helped to ensure an adequate water supply for the peak summer season.³¹

13 Commission Staff had adequate time to inspect and audit this project and following this
14 inspection agreed that these amounts should be included in rate base.³²

15 The Commission has often allowed the inclusion of post-test year plant in rate
16 base if such plant is revenue neutral (*i.e.*, constructed to serve existing customers) and is
17 placed into service in a reasonable period of time after the test year to allow for auditing of
18 costs and inspection by Staff.³³ Indeed, Staff has noted in prior matters that recognition of
19 post-test year plant is appropriate if the following conditions are met:

- 20 (1) when the magnitude of the investment relative to the utility's total
21 investment is such that not including the post test year plant in the cost
22 of service would jeopardize the utility's financial health; and

23 ²⁸ Ex. A-9 at 2.

24 ²⁹ *Id.* at 1-2; TR.I. at 525.

25 ³⁰ Tr.I at 524-25.

26 ³¹ *Id.* at 525-26.

³² TR.I. at 766; Ex. S-7 at DMH-2.

³³ *See, e.g.*, Decision No. 71410 at 19-22; Decision No. 65350 at 11.

1 (2) when certain conditions exist as follows:

2 (a) the cost of the post test year plant is significant and substantial;

3 (b) the net impact on revenue and expenses for the post test year plant is
4 known and insignificant or is revenue neutral; and

5 (c) the post test year plant is prudent and necessary for the provision of
6 services and reflects appropriate, efficient, effective, and timely
7 decision-making.³⁴

8 In this case, both Staff and the Company concur that Sun City Well 5.1 is
9 appropriate for inclusion in rate base. As noted by Ms. Hains, Staff had the opportunity to
10 inspect this well and to audit the costs and found that the \$1.587 million of costs for this
11 project should be included in rate base.³⁵ Moreover, the well meets each of the more
12 restrictive conditions for inclusion in rate base as stated above:

13 (1) the project cost of \$1.587 million is significant and substantial and
14 represents approximately 5.6% of Sun City's rate base;

15 (2) the project is revenue neutral; and

16 (3) the project was prudent and necessary to provide adequate water
17 supply to the Company's customers during the summer peak
18 demand period in 2009, and reflected appropriate, efficient,
19 effective, and timely decision-making, as the Company was able to
20 complete this well on an expedited basis and under budget.³⁶

21 RUCO claims that the cost for replacement of Sun City well 5.1 should not be
22 included in rate base, arguing that inclusion of this plant in rate base violates the matching
23

24 ³⁴ Decision No. 71410 at 20.

25 ³⁵ Ex. S-7 at DMH-2. As noted by Mr. Gross, the Company completed this replacement for \$200,000 less
than the original cost estimate. TR.I at 525.

26 ³⁶ Ex. A-7 at 8. As noted above, the Company completed the well under its original estimate of both time
and expense. TR.I. at 525-29.

1 principle.³⁷ Despite this claim, RUCO concedes that the Commission has recognized post-
2 test year plant in certain special circumstances – namely, the conditions noted above;
3 conditions that both Staff and the Company agree have been met in this case.³⁸ In
4 analyzing these conditions, RUCO compares the cost of this project to the Company’s total
5 rate base, rather than the relevant rate base in Sun City.³⁹ As a result, RUCO concludes that
6 this project does not meet the first condition relating to the significance of the project’s
7 cost.⁴⁰ RUCO provides no other reason for the exclusion of this amount from rate base.
8 The Commission should reject RUCO’s faulty reasoning and should include this amount in
9 rate base as requested by the Company and supported by Commission Staff.

10 **B. Sun City Plant 9; Wells 9.2 and 9.3**

11 In its direct testimony, Commission Staff requested that the Company provide
12 additional detail relating to the addition of Plant 9 and Wells 9.2 and 9.3 in the Tierra del
13 Rio section of the Sun City Water District.⁴¹ This plant was operational during the test
14 year, although certain limited costs were recorded after the test year following receipt of
15 appropriate invoices.⁴² The amounts related to this plant total \$365,579, and the Company
16 formally requested that these be included in rate base.⁴³ Staff accepted the addition of these
17 amounts as part of its testimony at the hearing as reflected in its final schedules.⁴⁴ RUCO
18 did not address this issue in its testimony and did not include these amounts in its final
19 schedules.

20 The Company provided detailed support for this rate base item, which went
21 into service in 2008. After detailed analysis, Staff concurred with the Company’s request.

22 ³⁷ Ex. R-10 at 6-7.

23 ³⁸ TR.I at 962.

24 ³⁹ Ex. R-10 at 7.

25 ⁴⁰ *Id.*

26 ⁴¹ Ex. S-9 at 38.

⁴² Ex. A-18 at 2; TR.I at 579-81; Ex. A-29.

⁴³ *Id.*

⁴⁴ TR.I at 820; Staff’s Revenue Requirement Schedules (Schedule. GWB-3--Sun City Water).

1 For these reasons, these amounts should be included in rate base in the Sun City Water
2 District.

3 **C. City of Glendale Agreement (Sun City Wastewater)**

4 Arizona-American is a party to a City of Glendale Sewage Transportation
5 Agreement (“Glendale Agreement”) by which the Company long ago acquired rights from
6 the City of Glendale to utilize the 99th Avenue Interceptor to transport sewage from the Sun
7 City Wastewater District to the Tolleson Treatment Plant.⁴⁵ The 99th Avenue Interceptor is
8 a sewer trunk main that is owned by multiple municipalities, which transfers sewage for
9 certain municipalities and the Company to the Tolleson Treatment Plant.⁴⁶ The use of the
10 99th Avenue Interceptor is an extremely cost effective means for the Company to transport
11 wastewater for treatment at the Tolleson Plant and has allowed the Company to forego
12 constructing its own plant for this purpose.⁴⁷ Under the Glendale Agreement, the Company
13 is required to pay for its proportionate share of replacement costs associated with the 99th
14 Avenue Interceptor, in addition to operation and maintenance costs.⁴⁸

15 In November 2009, the Company received an invoice in the amount of
16 \$917,906 for replacement costs incurred prior to that date.⁴⁹ After due diligence to confirm
17 the accuracy of these amounts, the Company paid that invoice in April 2010.⁵⁰

18 At the hearing, the Company provided the testimony of Mr. Weber, a City of
19 Glendale employee, who discussed in great detail these replacement costs and the process
20 that the City utilized to validate these costs prior to invoicing the Company for its
21 contractual share.⁵¹ The Company also offered the testimony of Mr. Crooks and Mr. Kiger,

22
23 ⁴⁵ Ex. A-14 at 2 and Ex. MHK-1R.

⁴⁶ TR.I. at 550-51.

24 ⁴⁷ *Id.* at 551.

⁴⁸ Ex. A-14 at 2 and Ex. MHK-1R.

25 ⁴⁹ Ex. A-14 at 2 and Ex. MHK-2R.

26 ⁵⁰ TR.I. at 135; Ex. A-24.

⁵¹ TR.I. at 458-64.

1 both of whom discussed in great detail the operation of the Glendale Agreement and the
2 types of replacements paid for under the Agreement.⁵²

3 As part of this case, the Company sought an accounting deferral for the
4 amounts paid by the Company under the Glendale Agreement.⁵³ After detailed review of
5 this request, however, including analysis of the Company's testimony and responses to
6 detailed data requests, Staff determined that the arrangement under the Glendale Agreement
7 should be accounted for as a capital lease and thus it was appropriate to include these
8 amounts in rate base for the Sun City Wastewater District.⁵⁴ As Mr. Murray explained,
9 because the Company pays for 100% of the capacity that it uses, this arrangement should be
10 treated as a capital lease under FASB 13.⁵⁵ As a result, Staff found that the \$917,906 of the
11 replacement costs, net of depreciation, should be included in rate base.⁵⁶ The Company has
12 made a similar request in its final schedules.

13 RUCO disagrees with the deferral requested by the Company primarily as a
14 result of the timing of this request, *i.e.*, because the Company raised this request in its
15 rebuttal testimony.⁵⁷ This basis for denial lacks merit given the reasoning provided by the
16 Company for the timing of this request and the substantial evidence provided by the
17 Company to support the request. The efficiencies of handling this rate base item in this
18 proceeding were recognized by Staff in its support for inclusion of this request in rate base
19 in this case.

20 Mr. Smith indicated during the hearing that RUCO would accept the test year
21 amounts if sufficient identification and quantification could be provided.⁵⁸ Despite this
22

23 ⁵² *Id.* at 550-55, 639-50, 991-94.

⁵³ Ex. A-14 at 3; TR.I. at 639-41.

24 ⁵⁴ Phase II Transcript ("TR.II") at 974-75; Exs. S-12, S-13, S-14.

25 ⁵⁵ TR.II at 972; Exs. S-13, S-14.

⁵⁶ TR.II at 975.

26 ⁵⁷ Ex. R-10 at 104.

⁵⁸ TR.I at 932.

1 statement and despite the information provided by the Company and the detailed analysis
2 given by Staff, RUCO did not include the replacement costs under the Glendale Agreement
3 in its final schedules.⁵⁹ RUCO's objection to these amounts is without merit and the
4 Commission should accept the treatment given to these amounts by Commission Staff.

5 **D. Cash Working Capital (all districts)**

6 In preparing its cash working capital requirement for this case, the Company
7 performed a lead/lag study, which is the most accurate method to determine cash working
8 capital.⁶⁰ A lead/lag study measures the actual lead and lag days attributable to individual
9 revenue and expense items.⁶¹ Revenue lag days are determined by measuring the amount
10 of time between provision of services and the receipt of payment for those services.⁶² The
11 time between the incurrence of expenses and the payment for those expenses is referred to
12 as the expense lag, which offsets the revenue lag.⁶³

13 Arizona-American and Staff for the most part agree on the proper calculation
14 of cash working capital.⁶⁴ However, RUCO continues to take a position contrary to the
15 Company's position and contrary to prior Commission decisions affecting Arizona-
16 American.

17 **1. Revenue Lag**

18 In this case, the Company's lead/lag study supported the following revenue
19 lag for each of the districts:⁶⁵

22 ⁵⁹ RUCO's Schedules.

23 ⁶⁰ Decision No. 71410 at 30; TR.I. at 584-85.

24 ⁶¹ *Id.*

24 ⁶² *Id.*

25 ⁶³ *Id.* at 30-31.

26 ⁶⁴ Ex. S-9 at 12 ("With one exception, Staff agrees with the number of days proposed by the Company for its lead lag computation.")

⁶⁵ Company's Revenue Requirement Schedules (B-6 Schedules).

	Anthem Water	Sun City Water	Anthem/ Agua Fria Wastewater	Sun City Wastewater	Sun City West Wastewater
Revenue Lag	46.10509	45.72662	46.04007	45.74292	45.62795

Revenue lag is comprised of three components: the service period lag, the billing lag, and the collection lag.⁶⁶ RUCO accepts the Company's calculation of the service period lag.⁶⁷ Although it takes issue with the Company's billing lag, RUCO did not propose any adjustments to those figures.⁶⁸ RUCO's primary issue of disagreement with the Company is with the Company's proposed collection lag.⁶⁹

The collection lag is the calculation of the time from the billing date to the date collections are received.⁷⁰ Arizona-American calculated the collection lag by the same methodology that it has always used and which the Commission has accepted in prior proceedings.⁷¹ For the test year, this figure came to 26.1 days.⁷²

For Arizona-American, each bill is sent out with a due date that is twenty days after the billing date. However, the Commission's rules and the Company's tariffs contemplate that payment may be made after the due date, with a late payment fee to be charged after the twenty-fifth day.⁷³ After that time, the Company also attempts to provide customers with additional notices prior to disconnection.⁷⁴ Accordingly, given this very

⁶⁶ Ex. R-10 at 12; TR.I. at 584.

⁶⁷ Ex. R-10 at 12.

⁶⁸ *Id.* at 20-21. Because RUCO proposed an adjustment to collection lag, it did not make any adjustment to the billing lag. *Id.* at 20.

⁶⁹ *Id.* at 12-22; RUCO's Schedules.

⁷⁰ TR.I. at 586.

⁷¹ Ex. A-18 at 9. Accounts receivable balances from each day are divided by 365 days to calculate Average Daily Accounts Receivable. Ex. A-18 at 9. This figure is then divided by the calculation of Average Daily Revenue. *Id.*

⁷² Ex. 18 at 9.

⁷³ Ex. A-36.

⁷⁴ TR.I at 587-88.

1 reasonable process and given the large number of charge offs experienced by the Company,
2 a collection lag of approximately 26 days, as set forth in the Company's schedules, is
3 reasonable and appropriate.⁷⁵

4 RUCO's recommendation for a 20 day collection lag,⁷⁶ based solely on the
5 due date of each bill, ignores the realities of the collection process and should not be
6 adopted.

7 **2. Expense Lag--Management Fees**

8 On the expense side of the cash working capital calculation, RUCO and Staff
9 take issue with the Company's calculation of expense lag as it relates to management fees.
10 This portion of expense lag is based on when Arizona-American pays American Water
11 Works Service Company ("Service Company") and results in a lead of 11.25 days.⁷⁷ This
12 calculation arises as a result of a 1989 Agreement with the Service Company in which the
13 Company pays its bill to the Service Company in advance.⁷⁸

14 The Service Company is paid in advance because the Service Company has
15 no water or sewer customers.⁷⁹ It only receives payment from the operating companies and
16 uses these payments to pay payroll, rent, insurance, utilities, and other expenses.⁸⁰ The
17 Service Company does not make a "profit" from these payments. Rather it bills in advance
18 and trues up the amounts to the extent of its actual costs.⁸¹ As noted during the hearing, as
19 part of the true-up process, the Company earns interest on any amounts held in the account
20 until the next month's bill.⁸² The interest earned reduces the Service Company bill.

21
22 ⁷⁵ As Ms. Gutowski notes in her rebuttal testimony, the number of charge offs has increased dramatically in recent years. Ex. A-18 at 8-9.

23 ⁷⁶ Ex. R-10 at 19.

24 ⁷⁷ Ex. A-18 at 10.

25 ⁷⁸ *Id.*

26 ⁷⁹ TR.I. at 589.

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.* at 760.

1 Staff removes this item completely, apparently because it was not sure how
2 best to address it.⁸³ RUCO includes a reduction for this amount.⁸⁴ As with other aspects of
3 the Company's cash working capital calculation, this piece of the expense lag is based on
4 the Company's actual experience, and for all of the reasons set forth above, should be
5 accepted by the Commission.

6 **E. Allocation of Northwest Valley Treatment Plant**
7 **(Anthem/Agua Fria Wastewater; Sun City West**
8 **Wastewater)**

9 The Anthem Community Council ("Anthem Council" or "Council") argues
10 for a revision to the allocation of the Northwest Valley Treatment Plant recommended by
11 Commission Staff and accepted by the Company.⁸⁵ During the hearing, Ms. Hains
12 discussed in detail the method used to allocate the plant between the Sun City West
13 Wastewater District and Anthem/Agua Fria Wastewater District, allocating 72% to Sun
14 City Wastewater and 28% to Anthem/Agua Fria Wastewater.⁸⁶ Because this allocation is
15 based in part on estimates of future population, the Anthem Council disputes the
16 appropriate allocation.⁸⁷

17 The Company recognizes that it is possible to support a narrow range of
18 multiple allocation percentages depending on the type of estimate used, as evidenced by
19 RUCO's acceptance of Staff's original allocation of thirty-two percent.⁸⁸ However, the
20 Company strongly believes that the downward adjustment recommended by Staff is
21 appropriate and will lead to less adjustment in the future. Despite the claims by the
22 Anthem Council, the Company believes that Staff's position is well supported and the

23 ⁸³ Staff's Revenue Requirement Schedules (Schedules GWB-8 and GTM-10).

24 ⁸⁴ Ex. R-10 at 28.

25 ⁸⁵ Ex. Anthem-3 at 5-6.

26 ⁸⁶ TR.I. at 767-70.

⁸⁷ Ex. Anthem-3 at 4-6.

⁸⁸ RUCO Schedules (Schedule B.1 (SCW)).

1 extensive back and forth modification of this allocation percentage based on real estate
2 cycles is not good public policy.⁸⁹

3 **F. Non-Account Water (Sun City Water)**

4 Staff recommends in this case that the Commission reduce Arizona-
5 American's allowable operating expenses for the Sun City Water District because the
6 system's non-account water loss exceeded 10% at the end of the test year. This
7 recommendation is contrary to recent direction from the Commission and does not
8 recognize the significant efforts that Arizona-American has undertaken and continues to
9 undertake to reduce water loss in all of its districts.⁹⁰

10 In the Company's most recent rate case for this district, the Commission
11 ordered Arizona-American to take further steps to reduce water loss:

12 **IT IS FURTHER ORDERED** that if water loss for Arizona-
13 American Water Company's Sun City Water District at any time
14 before the next rate case is greater than 10 percent, the Arizona-
15 American Water Company shall devise a plan to reduce water loss
16 to less than 10 percent, or prepare a report containing a detailed
17 analysis and explanation demonstrating why a water loss
18 reduction to 10 percent or less is not feasible or cost effective.⁹¹

19 As demonstrated during this hearing, Arizona-American has taken and continues to take
20 many steps to reduce unaccounted-for water in the Sun City District.⁹² These include
21 annual testing and calibration of production meters, change-out of customer meters on a 15
22 year cycle, annual testing of large customer meters, systematic roll-out of automatic meter
23 reading devices, leak detection, and other remedial steps.⁹³ As a result, the unaccounted-for

24 ⁸⁹ TR.I. at 146-47.

25 ⁹⁰ Ex. A-23 at 17; Ex. A-26; TR.I at 556.

26 ⁹¹ Decision No. 70351 at 44.

⁹² Ex. A-23 at Ex. BJC-1; TR.I. at 556.

⁹³ Ex. A-23 at Ex. BJC-1; TR.I. at 556.

1 water for the Sun City District has been reduced to below 9.0% as of the end of 2009,
2 which demonstrates Arizona-American's commitment to this program.⁹⁴

3 The Company should not be penalized for these efforts through Staff's
4 recommended imputation of cost reduction. The Commission should instead institute only
5 the more reasonable condition recommended by Ms. Hains in her testimony, which requires
6 the Company to continue to track its water loss for three additional years and submit data
7 collected every six months.⁹⁵

8 III. ANTHEM'S PROPOSED PHASE-IN OF RATE BASE

9 The Anthem Council, as a means to alleviate rate shock in Anthem, proposes
10 to "phase-in" the Pulte refunds made during the 2008 test year and in March 2010. The
11 Council's approach would remove this Anthem water and wastewater investment from
12 Utility Plant in Service and require the Company to account for these investments as Plant
13 Held for Future Use and to cease depreciation on that plant.⁹⁶ Under this proposal,
14 transfers of this investment from Plant Held for Future Use to Utility Plant in Service
15 would occur annually, but the Company would be required to file future rate cases to
16 recover these amounts in rates.⁹⁷

17 The Company is not aware of this type of "phase-in" plan being approved by
18 any Commission in any state in which its affiliates operate.⁹⁸ This is not surprising given
19 the dramatic accounting consequences that such a plan would have for a utility. As
20 explained by Mr. Jenkins, who has worked on accounting issues in the utility industry for
21 more than twenty-five years, Anthem Council's phase-in proposal would be subject to the

22 ⁹⁴ TR.I at 556-57; Ex. A-26. As of the time of the hearing, the rolling 12 month average was closer to 8%.
23 Ex. A-26.

24 ⁹⁵ Exhibit S-7 at Ex. DMH-2. The recommended condition also requires the Company to reduce water loss
25 to below 10% prior to December 31, 2010. However, as noted above, the Company has already met this
26 requirement.

⁹⁶ Ex. Anthem-1; Ex. A-45 at 2-3.

⁹⁷ Ex. Anthem-1; Ex. A-45 at 3; TR.I at 880-81.

⁹⁸ TR.II at 515-16.

1 following accounting guidelines: ASC 980-340 (formerly SFAS 92) pertaining to Phase-In
2 Plans and ASC 980-360 (formerly SFAS 90) pertaining to Plant Disallowances.⁹⁹ In
3 accordance with these accounting guidelines, the phase-in plan proposed by Anthem would
4 require a substantial write off of this plant, resulting in severe financial consequences for
5 the Company.¹⁰⁰ The detailed accounting implications of this proposal are discussed in the
6 confidential provisions of Mr. Jenkins' testimony.¹⁰¹

7 **A. Anthem's Testimony Is Not Credible**

8 The Council responded to the accounting position taken by the Company
9 through the testimony of Mr. Neidlinger and Mr. Arndt. Although both dispute the
10 Company's position regarding the accounting implications of the phase-in proposal, neither
11 provides credible testimony on these issues. Mr. Neidlinger conceded during his testimony
12 that he "did not have any direct experience in applying FAS 92", had not addressed these
13 issues in the role of an auditor, and had never advised any public utilities with regard to the
14 application of FAS 92.¹⁰² Similarly, Mr. Arndt, despite the clear language of the
15 accounting guidelines relied upon by Mr. Jenkins, inexplicably testified that these
16 provisions do not apply to plant constructed after 1988 or to water or wastewater utilities.¹⁰³

17 Ultimately, the most telling evidence is that both witnesses concede, as they
18 must, that the accounting treatment of this proposal would be made by the Company.¹⁰⁴
19 Mr. Jenkins, the Company's Vice President, Finance for American Water's Western
20 Division, and other employees of American Water, in consultation with the Company's
21

22 ⁹⁹ Ex. A-45 at 1, 3.

23 ¹⁰⁰ TR.I. at 310-11.

24 ¹⁰¹ Ex. A-46 at 5-6; Ex. A-44 at Exhibit JMJ-1.

25 ¹⁰² TR.I. at 882-83.

26 ¹⁰³ Ex. Anthem-13 at 6-7; TR.II. at 610-18; Ex. A-47 at 8-9 (*In re* New Jersey-American Water Company, Inc.) (describing required write off by New Jersey-American under FAS 92 if phase-in plan approved by the New Jersey Board of Public Utilities and rejection of the phase-in for this reason); Ex. A-46 at ¶ 4 (describing application of these standards).

¹⁰⁴ TR.II at 622-23; TR.I at 888.

1 outside auditors, would be responsible for making this decision.¹⁰⁵ Therefore, despite the
2 testimony of Mr. Arndt and Mr. Neidlinger regarding the potential accounting treatment for
3 this proposal, it is the Company's sworn testimony on this issue that must be given weight.

4 **B. Anthem's Proposal Would Deny the Company a Return on**
5 **Its Investment**

6 Putting aside the accounting implications of the phase-in plan proposed by
7 Anthem, at a fundamental level, the plan would deny the Company a return on and of its
8 investment in violation of the law. As noted by RUCO, any type of phase-in plan--even
9 one that would make the Company whole at a later date--would require the Company to
10 agree to forego revenue on plant that the Commission has found to be in rate base.¹⁰⁶ As
11 RUCO made clear in its testimony, such phase-in plans ultimately have a detrimental effect
12 on ratepayers, as the Company is entitled to receive its authorized revenue at a later date
13 and results in higher rates following the phase-in.¹⁰⁷ In addition, the Council's proposal is
14 unworkable because they have not identified any particular assets that the Company would
15 assign to future use. The Council did not argue that any plant was imprudent and no one
16 has disputed that the underlying assets are used and useful in serving customers. Finally,
17 the Council did not recommend applying any carrying costs in their phase-in proposal and
18 specifically does not want the Company made whole in a present value sense. Given the
19 Company's current financial position, it cannot agree to a phase-in of plant as proposed by
20 the Anthem Community Council or any phase-in plan that delays its authorized revenue
21 increase.

22 **IV. ANTHEM'S ADDITIONAL LEGAL ARGUMENTS**

23 As an alternative to its request for a phase-in, the Anthem Council has argued
24 in this proceeding that the amounts of the Pulte payments should be excluded from rate

25 ¹⁰⁵ TR.I at 888; TR.II at 601.

26 ¹⁰⁶ Ex. R-13 at 5; TR.II at 728-29.

¹⁰⁷ TR.II at 729-30.

1 base as a result of a failure to receive explicit Commission approval of the Pulte
2 Infrastructure Agreement, as amended (“Infrastructure Agreement”). The Council argues
3 that the refund payments made to Pulte by Arizona-American under the Infrastructure
4 Agreement should be permanently excluded from rate base and denied any associated
5 ratemaking recognition. The Council makes two main arguments: first, that the
6 Infrastructure Agreement is “evidence of indebtedness” requiring prior Commission
7 approval under A.R.S. §§ 40-301 to 303; and second, that the Agreement should have been
8 approved by Staff under Commission Rule 14-2-406. For the reasons discussed below, the
9 Council’s position is in error and the refund payments should not be excluded from
10 Arizona-American’s rate base.

11 **A. The Commission Has Repeatedly Declined to Approve or**
12 **Disapprove the Infrastructure Agreement.**

13 At least three times, the Commission has been presented with the opportunity
14 to approve or disapprove the Infrastructure Agreement but declined to do so. First, in
15 October 1997, Arizona-American’s predecessors (Citizens Utility Company, Citizens
16 Water Services Company of Arizona, and Citizens Water Resources Company of Arizona,
17 collectively “Citizens”) filed a Joint Application for Certificates of Convenience and
18 Necessity to provide public utility service to a planned community development to be
19 known as the Villages at Desert Hills, later renamed Anthem. In addition, the Joint
20 Application specifically sought approval of the Infrastructure Agreement. However, in its
21 Decision No. 60975 (June 1998), the Commission adopted Staff’s recommendation that
22 “the Commission not consider any determination regarding the requested approval of the
23 Infrastructure Agreement.”¹⁰⁸

24 Second, in May 2000, the Commission considered Citizens’ application for
25 an extension of its certificated territory to include a parcel of land known as the Jacka
26

¹⁰⁸ Decision No. 60975 at 6, 10.

1 Parcel. The application also requested approval of the First Amendment to the
2 Infrastructure Agreement, which included the Jacka Parcel within the scope of the
3 Agreement. In Decision No. 63445 (March 2001), the Commission approved the First
4 Amendment, but again did not rule on the Infrastructure Agreement itself.¹⁰⁹

5 Third, in December 2000, Citizens again requested Commission approval of
6 the Infrastructure Agreement, in connection with an application to delete an area in the City
7 of Phoenix from its certificated territory. In connection with its review of this application,
8 Staff prepared a Staff Report, dated December 4, 2001, in which it described the
9 Infrastructure Agreement as a “private contract.”¹¹⁰ Further, in the Report, Staff reasoned
10 that since the Infrastructure Agreement had not been approved, the Commission’s approval
11 of the First Amendment in Decision No. 63445 “was apparently a misunderstanding.”¹¹¹
12 Staff concluded as follows: “The [Infrastructure Agreement] is a *private contract* and, as
13 such, *does not require Commission approval or denial*. Staff recommends that *no action* be
14 taken on this issue.”¹¹² In Decision No. 64897 (June 2002), the Commission agreed with
15 Staff’s conclusion that the Infrastructure Agreement was a “private contract” and one that
16 did “not require the Commission’s approval” and adopted Staff’s recommendation to take
17 “no action” on the request for approval of the Agreement.¹¹³

18 Additionally, in Arizona-American’s most recent rate case for the Anthem
19 Water District, the Council did not raise the issue of excluding from rate base prior refund
20 payments made, and the Commission included the refunds in rate base. Although the
21 Commission did not specifically rule on the reasonableness of the Infrastructure
22 Agreement, it noted: “At this time, no party has alleged, and we do not find, that the
23

24 ¹⁰⁹ See Decision No. 63445 at 6.

25 ¹¹⁰ Staff Report at 3 in A.C.C. Docket No. WS-03454A-00-1022, *et al.*

26 ¹¹¹ *Id.* at 3.

¹¹² *Id.* (emphasis added).

¹¹³ Decision No. 64897 at 6, 10.

1 Company's repayment of developer advances under the Anthem Agreements has been
2 imprudent or improper."¹¹⁴

3 **B. The Infrastructure Agreement Is Not "Evidence of**
4 **Indebtedness" under A.R.S. §§ 40-301 to 303.**

5 The Commission's decisions declining to approve or disapprove the
6 Infrastructure Agreement indicate that it is not the type of agreement that requires prior
7 Commission approval. In fact, to the Company's knowledge, the Commission has never
8 before treated an agreement of this nature as "evidence of indebtedness" under the A.R.S.
9 §§ 40-301 to 303. If the Commission were now to change course and require prior
10 approval under these statutes, nearly every existing main extension and line extension
11 agreement in the state would become invalid.

12 The Infrastructure Agreement is not required to be treated as debt under
13 GAAP and is not booked by Arizona-American as such, which alone is a strong indication
14 that the Agreement is not "evidence of indebtedness".¹¹⁵ Proper statutory construction and
15 application of pertinent equitable principles also compel this conclusion.

16 **1. Principles of Statutory Construction Demonstrate That the**
17 **Agreement Is Not "Evidence of Indebtedness".**

18 The Commission's decades-long position that agreements in the nature of an
19 advance are not "evidence of indebtedness" is a correct interpretation of A.R.S. §§ 40-301
20 to 303, which provide that a "public service corporation may issue *stocks and stock*
21 *certificates, bonds, notes and other evidences of indebtedness* payable at periods of more
22 than twelve months after the date thereof, only when authorized by an order of the
23 commission."¹¹⁶ The statutes further indicate that "[a]ll stock and every stock certificate,

24 ¹¹⁴ Decision No. 70372 at 43.

25 ¹¹⁵ See *In Re APS*, Docket No. E-01345A-06-0779, Decision No. 69947 at 10-13 (indicating that GAAP
26 guides the determination as to whether an "evidence of indebtedness" exists); see also *id.* at 11 n.16
("GAAP status is the determinant for compliance filings and how the condition test for issuance of debt or
equity is calculated.")

¹¹⁶ A.R.S. § 40-301.B (emphasis added).

1 and every bond, note or other evidence of indebtedness” that is “issued” without the
2 Commission’s approval is void.¹¹⁷

3 As an initial matter, because A.R.S. §§ 40-301 to 303 are statutes that restrict
4 a public utility’s right to contract, they must be construed narrowly and must not be
5 extended to transactions outside their plain terms.¹¹⁸ Moreover, under the statutory
6 construction doctrine of *ejusdem generis*, the phrase “other evidences of indebtedness”
7 must be interpreted in light of the character of the terms that precede it. This doctrine holds
8 that “where general words follow the enumeration of particular classes of persons or things,
9 the general words should be construed as applicable only to persons or things of the same
10 general nature or class of those enumerated.”¹¹⁹ The terms preceding the phrase “evidence
11 of indebtedness” in A.R.S. §§ 40-301 to 303 are “stocks”, “stock certificates”, “bonds” and
12 “notes”. Courts in other jurisdictions applying the *ejusdem generis* doctrine have
13 determined that the phrase “evidences of indebtedness” as used in statutes similar to
14 Arizona’s refers to financial instruments used to build up the permanent capital structure of
15 the utility, analogous to stocks, stock certificates, bonds, and notes, which are generally
16 used for that purpose.¹²⁰

17 Narrowly construed and construed in light of preceding terminology, it is
18 clear that the phrase “evidence of indebtedness” does not encompass contracts such as the
19 Infrastructure Agreement. The Infrastructure Agreement was not entered into for the

20 ¹¹⁷ A.R.S. § 40-303.A.

21 ¹¹⁸ See, e.g., *Webster Mfg. Co. v. Byrnes*, 207 Cal. 630, 637 (Cal. 1929) (analogous California statute) (“The
22 right of contract is by the statute abridged to a certain extent and no reason exists for making an application
23 of the statute not plainly warranted by the language employed in it.”); *Wis. So. Gas. Co. v. Pub. Serv.*
Comm’n, 57 Wis. 2d 643, 648 (Wis. 1973) (reasoning that similar Wisconsin statute should be “reasonably
24 construed and [not applied] to transactions not clearly covered” by statutory language) (internal quotation
25 marks omitted).

24 ¹¹⁹ *Wilderness World, Inc. v. Dep’t of Revenue*, 182 Ariz. 196, 199 (Ariz. 1995).

25 ¹²⁰ See, e.g., *Jones v. Hawaiian Electric Co., Inc.*, 64 Haw. 289, 295 (Haw. 1982), *overruled on other*
26 *grounds*, *Camara v. Agsalud*, 67 Haw. 212, 215 (Haw. 1984) (reasoning, under doctrine of *ejusdem generis*,
that lease agreement with option to purchase land was not of “like character” with stocks and stock
certificates, bonds and notes because it was not entered into for the purpose of raising funds for capital
expenditures and did not become “part of the capital structure of the public utility”).

1 purpose of building up the permanent capital structure of Citizens or Arizona-American.
2 Rather, as with any advance in aid of construction, it was executed for the limited purpose
3 of ensuring that Pulte, the developer, rather than Citizens, the regulated public utility,
4 would bear the risk associated with developing the community that later became Anthem.

5 If the Infrastructure Agreement could be considered “evidence of
6 indebtedness,” it is difficult to imagine what unsecured contractual arrangement with
7 payment obligations extending over one year would not fall within that category. Under
8 the Council’s strained logic, nearly every main extension and line extension agreement in
9 the state would become invalid. In fact, under the Council’s analysis, a two year contract
10 with an office cleaning company would require approval as an evidence of indebtedness.
11 In short, if the Legislature had intended that prior Commission approval be required for
12 every contract in which a public utility agrees to make payments more than twelve months
13 into the future, it could have easily made that intention clear. In the absence of such intent,
14 the Commission should not stretch the meaning of the phrase “other evidences of
15 indebtedness” to cover contracts like the Infrastructure Agreement.

16 **2. Equitable Principles Weigh against Treating the**
17 **Infrastructure Agreement as “Evidence of Indebtedness”.**

18 As emphasized above, for decades it has been the Commission’s practice not
19 to require agreements relating to advances to receive prior Commission approval under
20 A.R.S. §§ 40-301 to 303. In addition, although the Infrastructure Agreement has been filed
21 with the Commission on multiple occasions and specific requests for approval have been
22 made, the Commission has so far declined to approve or disapprove the Agreement, finding
23 it to be a type of agreement that does not require approval. Thus, it would be manifestly
24 unfair for the Commission to now determine that the Agreement should have been
25 approved—and for that reason alone, to exclude refund payments from rate base.¹²¹

26

¹²¹ See, e.g., *Hobbs Gas Co. v. Pub. Serv. Comm’n*, 115 N.M. 678, 680, 684 (N.M. 1998).

1 The related doctrine of equitable estoppel leads to the same conclusion.¹²² If
2 the Commission were to treat the Infrastructure Agreement as “evidence of indebtedness”
3 under A.R.S. §§ 40-301 to 303, this would be a diametric shift in position—as to the
4 treatment both of agreements in the nature of an advance generally and of the Infrastructure
5 Agreement specifically. It was perfectly reasonable for Arizona-American to rely on the
6 Commission’s past practice of not requiring such prior approval for this type of agreement
7 as well as on the Commission’s past decisions declining to approve or disapprove the
8 Infrastructure Agreement, and Arizona-American in fact so relied.¹²³ Clearly, Arizona-
9 American would suffer substantial injury if the Commission were now to decide that the
10 refund payments should be excluded from rate base due to lack of prior approval of the
11 Infrastructure Agreement and doing so would be manifestly inequitable.

12 **C. Commission Rule 14-2-406 Does Not Provide a Basis for**
13 **Excluding Refund Payments from Rate Base**

14 As set forth above, Arizona-American or its predecessors has on multiple
15 occasions requested Commission approval of the Infrastructure Agreement, but Staff has
16 indicated that the Agreement is not a type that requires Commission approval, and the
17 Commission has declined to approve or disapprove it. Therefore, as discussed in the
18 preceding section, it would be manifestly unfair for the Commission to exclude the refund
19 payments from rate base for failure to obtain approval. However, even assuming, for the
20 sake of argument, that approval of the Infrastructure Agreement should have been obtained
21 under Commission Rule 14-2-406, that would not provide a basis for excluding the refund
22 payments from rate base.

23 ¹²² Equitable estoppel applies where three elements are present: (1) a party engages in acts inconsistent with
24 a position it later adopts, (2) reasonable reliance by the other party, and (3) injury to the latter resulting from
25 the former’s repudiation of its prior conduct. *See Valencia Energy v. Ariz. Dep’t of Revenue*, 191 Ariz. 565,
567-77 (Ariz. 1998). Equitable estoppel may be maintained against a governmental entity as long as
26 application “will not substantially and adversely affect the exercise of governmental powers.” *Id.* at 576-78.

¹²³ For this reason, the Council’s argument that it was unreasonable, imprudent, and improper for Citizens
and Arizona-American to proceed to make refund payments after the Commission’s decisions declining to
approve or disapprove the Agreement must also be rejected.

1 Commission Rule 14-2-406 is in place to protect developers who enter into
2 main extension agreements with water utilities. This rule requires Staff approval of main
3 extension agreements to ensure they are fair and reasonable.¹²⁴ Specifically included in
4 Rule 14-2-406 is the appropriate remedy for failing to obtain necessary approval: “[T]he
5 refundable advance shall be immediately due and payable to the person making the
6 advance.”¹²⁵ The remedy provided for in Rule 14-2-406 is one that protects the developer,
7 requiring the utility to immediately repay the advance to the developer if approval is not
8 obtained. In this case, Arizona-American has already satisfied its repayment obligations to
9 Pulte. For these reasons, Rule 14-2-406 does not provide a grounds for excluding from rate
10 base the refund payments made under the Infrastructure Agreement.

11 As noted above, adoption of the Council’s position would mean that all
12 existing line extension agreements would be invalid and hundreds of millions of dollars in
13 advances would immediately be due and payable from utilities to developers. Moreover, it
14 would require all future line extension agreements to be approved as evidences of
15 indebtedness in literally hundreds of separate dockets before the Commission. Hardly a
16 good use of Commission resources.

17 **V. OPERATING INCOME ISSUES**

18 As set forth in the parties’ final schedules, the parties’ adjusted test-year
19 operating income positions are as follows:¹²⁶
20
21
22
23
24

25 ¹²⁴ See A.A.C. R14-2-406(M).

¹²⁵ *Id.*

26 ¹²⁶ Company’s Revenue Requirement Schedules; Staff’s Revenue Requirement Schedules; RUCO’s Schedules.

	Anthem Water	Sun City Water	Anthem/ Agua Fria Wastewater	Sun City Wastewater	Sun City West Wastewater
Arizona-American	\$528,986	\$898,210	\$67,162	\$(67,374)	\$397,489
Staff	\$545,925	\$906,189	\$210,381	\$65,615	\$404,542
RUCO	\$684,046	\$1,371,776	\$16,411	\$75,904	\$763,200

A. Pension Expense

In its original filing, the Company utilized 2009 ERISA-based pension expense amounts as the most appropriate known and measurable calculation of this expense item.¹²⁷ These 2009 figures for Arizona-American total approximately \$2.09 million and the appropriate allocation of pension expenses are reflected in each district in the Company's final schedules.¹²⁸ As a result of market turmoil beyond the Company's control, pension expense has increased dramatically over recent years. As detailed in the table below, the Company's actual pension expense remained high in 2010, and the Company expects pension expense to continue to increase in the near future and remain at levels near the current level thereafter:¹²⁹

Actual 2010 Contribution	Projected 2011 Minimum Contribution	Projected 2012 Minimum Contribution	Projected 2013 Minimum Contribution	Projected 2014 Minimum Contribution
\$2.06 million	\$2.591 million	\$2.794 million	\$2.147 million	\$2.034 million

These projections provide support for the use of the 2009 pension expense amounts. The 2009 pension expense is known and measurable and reflects the Company's actual pension expense. The amounts relied upon by the Company for this pension expense item are minimum amounts.¹³⁰ Although management has some discretion in relation to

¹²⁷ Ex. A-1; Ex. A-7 at 10; A-14 at 14-15.

¹²⁸ Company's Revenue Requirement Schedules.

¹²⁹ Ex. A-25.

¹³⁰ TR.I. at 137-38; Ex. A-7 at 10.

1 this funding, it does not have discretion to fund at levels below these ERISA-based
2 amounts.¹³¹ In apparent recognition of the reasonableness of the Company's request, Staff
3 did not take issue with the Company's requested amounts.¹³² Staff also accepts the
4 Company's adjustment to its initial request to address an increase in ERISA-based expense
5 for the Service Company.¹³³

6 Despite the reasonableness of the Company's proposal, RUCO argues for a
7 normalization of these amounts through the use of an average of 2007-08 figures. Despite
8 RUCO's numerous claims in this case relating to the importance of the test year and the
9 matching principle,¹³⁴ in this instance, RUCO believes that the use of the lower average of
10 the 2007-08 figures is appropriate. According to Mr. Smith, "a more normalized approach
11 based on recent actual experience through the test year should be used for ratemaking
12 purposes."¹³⁵ However, as Mr. Kiger notes in his testimony, if the Commission wishes to
13 rely upon the most recent actual experience and wishes to use an averaging or
14 normalization, then the Commission ought to use an average of 2009-10 amounts, both of
15 which are known and measurable.¹³⁶ The much lower figures from 2004-2007 are no
16 longer "normal," as demonstrated above. Accordingly, the Company's proposal to use
17 2009 pension expense is reasonable and should be adopted.

18 In addition to the use of an average of 2007-08 figures, RUCO also claims
19 that the Commission should rely upon FAS 87 amounts rather than ERISA amounts.¹³⁷
20 This recommendation ignores that the Company is an ERISA-based company for
21 ratemaking purposes.¹³⁸ As noted by Mr. Broderick, the Company is not seeking a

22 ¹³¹ TR.I. at 137-38; Ex. A-7 at 10.

23 ¹³² Staff's Revenue Requirement Schedules.

24 ¹³³ Ex. A-14 at 16; Staff's Revenue Requirement Schedules (e.g., Schedule GWB-10).

25 ¹³⁴ See, e.g., Ex. R-10 at 6.

26 ¹³⁵ Ex. R-10 at 61.

¹³⁶ Ex. A-14 at 14-15.

¹³⁷ RUCO's Schedules.

¹³⁸ TR.I at 139-40.

1 transition to FAS 87 in this case and believes it would be more appropriate for more
2 evidence to be provided on this issue.¹³⁹ However, if the Commission does wish to
3 transition to FAS 87 amounts as recommended by RUCO, then it is necessary for the
4 Commission to clearly order the Company to use FAS 87, and to identify the specific FAS
5 87 amount for ratemaking purposes.¹⁴⁰ In that case, the Company would also request that
6 the Commission recognize the accumulated difference between FAS 87 and ERISA.¹⁴¹ As
7 noted by Mr. Broderick, because FAS 87 amounts have historically exceeded ERISA
8 amounts, the Company has regulatory assets on its balance sheet for the accumulated
9 amounts by which FAS 87 has exceeded ERISA. The two FAS 87 related regulatory assets
10 include one for Deferred Service Company Pension Cost and another for Deferred Pension
11 Cost for Arizona-American employees.¹⁴² If the Commission wishes to transition the
12 Company to FAS 87, the Company requests that these amounts be amortized over a five
13 year period.¹⁴³ To be clear, the Company is only seeking recovery of these regulatory
14 assets if the Commission transitions the Company to FAS 87 as RUCO recommends. If the
15 Company continues as an ERISA-based company for ratemaking purposes, which the
16 Company is proposing in this case, then these regulatory assets are not an issue in this
17 proceeding.¹⁴⁴

18 For all of these reasons, the Commission should reject the pension-related
19 adjustments made by RUCO.¹⁴⁵

22 ¹³⁹ Ex. A-7 at 11.

23 ¹⁴⁰ Ex. A-7 at 13.

24 ¹⁴¹ *Id.*

25 ¹⁴² Ex. A-7 at 12. As of February 28, 2010, the balances are \$746,347 and \$1,050,173, respectively, in
account #186408 and #186422. *Id.*

26 ¹⁴³ *Id.* at 14-15.

¹⁴⁴ TR.I at 141.

¹⁴⁵ These include RUCO adjustments C-5 and C-12.

1 **B. Other Post-Employment Benefit (OPEB) Expenses**

2 The same reasoning that supports the Company's pension expense figures
3 also supports the Company's increased cost for other post-employment benefits. The
4 larger-than-typical 22% pro forma increase to the test year level of employee benefits
5 expense was driven by increased funding obligations due to the severe deterioration in
6 financial markets.¹⁴⁶ As with its pension expense, the Company expects OPEB expenses to
7 remain at a higher level in the future and believes that the adjustment to reflect actual 2009
8 OPEB expense for its employees and Service Company employees is appropriate.¹⁴⁷

9 RUCO, in the same manner as it proposed for pension expense, has proposed
10 an adjustment to reflect an averaging of 2007-08 for OPEB expense (adjustment C-6) and
11 an adjustment for the OPEB component of management fees (adjustment C-13).¹⁴⁸ For the
12 same reasons that the pension expense adjustments should be rejected, these adjustments
13 should also be rejected, and the Commission should accept the position of Staff and the
14 Company on these issues.

15 **C. Tank Maintenance Expense (Sun City Water)**

16 The Company requested approval to establish a tank maintenance reserve
17 account to address on-going tank maintenance in its Sun City Water District. In 2009, the
18 Company commissioned Tank Industry Consultants to examine the condition of the tanks
19 in the Sun City Water District and to provide a recommendation for maintenance of these
20 tanks.¹⁴⁹ Given the condition of the tanks as outlined in that study, the Company has
21 planned to commence a tank maintenance program applicable to each of its tanks in this
22 district over the next fourteen years, beginning with those tanks most in need of
23 maintenance.¹⁵⁰ The Company proposed a tank maintenance reserve to ensure adequate

24 ¹⁴⁶ Ex. A-16 at 15.

25 ¹⁴⁷ *Id.*; Company Revenue Requirement Schedules.

26 ¹⁴⁸ Ex. R-10 at 81, 99; RUCO's Schedules.

¹⁴⁹ Ex. A-23 at 15; Exhibit A-35.

¹⁵⁰ Ex. A-23 at 16.

1 funds to perform this tank maintenance so that this maintenance program would not
2 compete with other projects for the scarce capital resources available.¹⁵¹

3 In response to the Company's request and recognizing the importance of this
4 type of program, Staff recommends that this amount be included as a normalized annual
5 expense in the amount of \$362,000, rather than utilize a reserve account.¹⁵² As Mr. Becker
6 noted in his testimony, "if the tanks are well maintained, . . . on a regular basis, it may
7 produce long term benefits to the ratepayers in that it may reduce the long-term capital cost
8 or the long-term capital replacement costs."¹⁵³ As demonstrated in its final schedules, the
9 Company is in agreement with Staff's treatment of these expenses.

10 RUCO recommends that the Commission reject this request. According to
11 RUCO, this approach would lead to an unnecessary prepayment of maintenance expenses
12 and these expenses and should not be recovered until the next rate case.¹⁵⁴ This is contrary
13 to RUCO's position in the prior rate case (and in other dockets), in which it testified that
14 such maintenance reserve accounts benefit ratepayers:

15 Q. Does RUCO support the Company's request for a tank maintenance
16 reserve?

17 A. Yes, at this point in time RUCO believes that the cost estimates
18 obtained from the RFP process are reasonable. RUCO also believes
19 that ratepayers will benefit from regular preventive maintenance and
20 upkeep on large plant assets such as a water tanks. RUCO has
21 supported similar programs in the past such as the one that Arizona
Water Company has in place.¹⁵⁵

22 RUCO's change in position is inexplicable. The same ratepayer benefits recognized by
23 RUCO in the prior case exist in this case. The only difference is that the Staff now

24 ¹⁵¹ Ex. A-18 at 16.

25 ¹⁵² TR.II at 963; Staff's Revenue Requirement Schedules.

26 ¹⁵³ TR.I at 815.

¹⁵⁴ TR.I at 925-26; Ex. R-10 at 85.

¹⁵⁵ Ex. A-37.

1 supports the treatment of these expenses as normalized expenses. The Commission should
2 accept Staff's recommendation in relation to tank maintenance in the Sun City Water
3 District. Furthermore, the Company understands and appreciates the confidence that
4 Commission Staff has placed in the Company to undertake tank maintenance in Sun City
5 and the Company knows that this expense category will be under close examination in the
6 next Sun City Water district rate case.

7 **D. Tank Maintenance Deferral Account (Anthem Water)**

8 Arizona-American currently has a deferral account approved long ago for the
9 Sun City Water District. The Company believes that this type of account is beneficial and
10 is requesting that the Commission authorize such an account for the Anthem Water
11 District.¹⁵⁶ This type of account will allow the Company to defer tank maintenance
12 expenses until the next rate case at which time the Company may seek recovery.¹⁵⁷ The
13 Company believes that this incremental step is appropriate for the Anthem Water District
14 and requests that the Commission authorize this deferral account.

15 **E. Rate Case Expense**

16 As noted by Mr. Broderick, the Company makes every effort to keep its rate
17 case expense as low as possible.¹⁵⁸ However, this was an extraordinary hearing, with
18 numerous parties, numerous witnesses and a multitude of issues. The Company's proposed
19 rate case expense, as set forth in the Company's final schedules and as accepted by Staff, is
20 reasonable and should be accepted.¹⁵⁹

21 RUCO recommends that rate case expense in this case be based on the
22 amount that the Commission approved in the Company's most recent rate case.¹⁶⁰

23
24 ¹⁵⁶ Ex. A-7 at 10.

25 ¹⁵⁷ TR.I. at 145, 600.

26 ¹⁵⁸ Ex. A-7 at 5.

¹⁵⁹ Company's Revenue Requirement Schedules; Staff's Revenue Requirement Schedules.

¹⁶⁰ Ex. R-10 at 46.

1 However, it is not appropriate or reasonable to utilize RUCO's simplistic method of
2 calculating rate case expense. Unlike the prior case, this case involved two phases with
3 numerous intervenors who raised a multitude of issues. As a result, the number of hearing
4 days and the complexity of issues has greatly exceeded those in the prior case. In fact,
5 RUCO formulated its initial position, which it did not revise, prior to the bifurcation of this
6 case into two phases and prior to the addition of the multiple parties intervening for
7 purposes of Phase II of the hearing. Accordingly, its recommended amount did not take
8 into account the extraordinary amount of time and expense involved in this case.

9 For these reasons, the Commission should reject RUCO's recommendation
10 and accept the rate case expense proposed by the Company and found to be reasonable by
11 Commission Staff.

12 **F. AIP for Service Company Employees**

13 Contrary to past practice of this Commission, RUCO suggests that Annual
14 Incentive Plan expenses for Service Company employees should be removed in their
15 entirety.¹⁶¹ RUCO does not provide adequate justification as to why it the Commission
16 should now deviate from their past practice. As the Commission noted in prior matters,
17 Staff, RUCO and the Company have agreed to a disallowance of 30% of these costs--the
18 same as for the Company's direct employees:

19 RUCO proposes disallowance of 30 percent, or \$5,555, of the Company's
20 \$18,517 Arizona Corporate allocated annual incentive pay ("AIP")
21 management fees expenses for the districts in this proceeding. . . . Staff is
22 in agreement with RUCO and the Company that the adjustment should be
23 made. . . . The adjustments proposed by RUCO and agreed to by the
24 Company and Staff, as set forth above are reasonable and will be
25 adopted.¹⁶²

26 ¹⁶¹ Ex. R-10 at 54.

¹⁶² Decision No. 71410 at 35.

1 Arizona-American is supported not only by its own direct employees but also
2 by employees of the Service Company.¹⁶³ Through its relationship with the Service
3 Company, Arizona-American is able to take advantage of expertise and economies of
4 scale.¹⁶⁴ The Commission should not treat AIP costs for Service Company employees
5 differently simply because these employees are employed by a different entity. As with
6 AIP for direct employees, AIP is an important part of the compensation for Service
7 Company employees.¹⁶⁵ Indeed, if these amounts were included in direct salary, it is
8 doubtful that there would be any disallowance recommended. And lastly, many Arizona-
9 based employees are Service Company employees.

10 As RUCO notes in relation to other adjustments, “consistent application of
11 regulation is good public policy and provides for a stable regulatory environment.”¹⁶⁶ For
12 all of these reasons, the Commission should reject RUCO’s inconsistent adjustment for
13 Service Company AIP and should instead apply a 70% factor of AIP costs for Service
14 Company employees, the same as it has done for both Arizona-American and Service
15 Company employees in prior cases.

16 **G. Fuel and Power Expense Adjustment**

17 Staff made an adjustment to the Company’s fuel and power expense to reflect
18 rate increases approved by the Commission in APS’s most recent rate case.¹⁶⁷ These
19 adjustments reflect a known and measurable change to expense.¹⁶⁸ The Company accepted
20 and reflected this adjustment in its final schedules. RUCO provides no explanation for its
21 refusal to include this adjustment in its final schedules. Staff’s power expense adjustment
22 is reasonable and should be adopted.

23 ¹⁶³ Ex. A-4 at 8.

24 ¹⁶⁴ *Id.* at 8.

25 ¹⁶⁵ *Id.* at 7.

26 ¹⁶⁶ Ex. R-10 at 92.

¹⁶⁷ Ex. S-9 at 30.

¹⁶⁸ TR.I at 701.

1 **VI. COST OF CAPITAL ISSUES**

2 **A. Capital Structure and Cost of Debt**

3 In this case, the Company initially proposed and supported a capital structure
4 of 54.85% debt and 45.15% equity, as well as a 5.5% cost of debt.¹⁶⁹ In order to limit the
5 number of issues in this case, however, the Company agreed in its rebuttal testimony to
6 accept Staff's recommended capital structure of 61.1% short term and long term debt and
7 38.9% common equity.¹⁷⁰ The Company also agreed in its rebuttal case with the Staff's
8 cost of debt of 4.91%, resulting in a weighted cost of capital of 7.2%.¹⁷¹

9 Although RUCO separates long term and short term debt, its recommendation
10 on capital structure and cost of debt is very similar to Staff's.¹⁷² RUCO proposes a capital
11 structure of 13.29% short term debt, 47.56% long-term debt and 39.15% common equity.¹⁷³
12 RUCO also proposes a cost of short term debt of 3.41% and long-term debt of 5.47%.¹⁷⁴

13 The primary differences in the positions of Staff (as accepted by the
14 Company) and RUCO relate to the cost of equity. Those positions are discussed below.

15 **B. Cost of Equity**

16 In its direct case, the Company, through the testimony of Dr. Villadsen,
17 supported a return on equity of 12.25%. As set forth in Dr. Villadsen's testimony, this
18 request was conservative and well-supported. Despite the strength of the Company's
19 position, the Company agreed as part of its rebuttal case to accept the Staff's return on
20 equity figure of 10.7% and a weighted cost of capital of 7.2%. RUCO's position of a 9.5%

21
22 ¹⁶⁹ Ex. A-1 (D Schedules).

23 ¹⁷⁰ Ex. A-7 at 15-16; Ex. S-3 at Schedule JCM-1.

24 ¹⁷¹ *Id.*

25 ¹⁷² Ex. R-4 at 4-5 (comparing RUCO's capital structure and cost of debt with Staff's recommendation). If
RUCO combined short term and long term debt, its weighted cost of debt would be 5.02%, which is slightly
higher than Staff's recommendation. *Id.* at 5.

26 ¹⁷³ RUCO's Schedules.

¹⁷⁴ RUCO's Schedules. As noted above, if RUCO combined short-term and long-term debt, its weighted
cost of debt would be 5.02%, which is slightly higher than Staff's recommendation. Ex. R-4 at 5.

1 return on equity and a 6.7% weighted cost of capital is unreasonable, lacks support, and
2 should not be adopted in this matter.

3 **1. The Company's Original Position**

4 As part of her analysis, Dr. Villadsen relies upon two benchmark sample
5 populations with characteristics comparable to those of Arizona-American: water utilities
6 and gas local distribution companies ("LDC").¹⁷⁵ Using two versions of the Discounted
7 Cash Flow ("DCF") method and three versions of the Capital Asset Pricing Model
8 ("CAPM"), Dr. Villadsen then estimated the sample companies' after-tax weighted-average
9 cost of capital, which is the measure that companies most commonly use to evaluate
10 investments.¹⁷⁶ Utilizing the sample companies' after-tax weighted-average cost of capital,
11 Dr. Villadsen then determined the corresponding cost of equity for Arizona-American.¹⁷⁷
12 Because Arizona-American Water's equity is lower than the percentage equity among
13 many utilities, its financial risk is higher, which means that its investors will require a
14 higher return.¹⁷⁸

15 In addition to the cost of capital analysis discussed above, Dr. Villadsen
16 reviewed twenty recent Commission decisions to assess the reasonableness of Arizona-
17 American's request. When compared in terms of the overall return, the cost of equity
18 requested by Arizona-American Water in this proceeding is comparable to that granted to
19 other water and wastewater utilities in Arizona as adjusted for Arizona-American's targeted
20 equity percentage.¹⁷⁹

21 While it may seem counterintuitive to increase the cost of capital during an
22 economic recession, it is in fact necessary to attract needed capital.¹⁸⁰ The financial crisis

23 ¹⁷⁵ Ex. A-20 at 36-37, Appendix B.

24 ¹⁷⁶ *Id.* at Appendix B.

25 ¹⁷⁷ *Id.* at 65-69.

25 ¹⁷⁸ *Id.* at 9, 65-69.

26 ¹⁷⁹ *Id.* at 66-67.

¹⁸⁰ *Id.* at 20-36.

1 has widened the range of a reasonable return on equity and especially increased the upper
2 bound on the range.¹⁸¹ Based on the evidence from the samples, Arizona-American's
3 original request for 12.25% return on equity is reasonable and fully supported by Dr.
4 Villadsen's testimony.

5 **2. RUCO's Position Should be Rejected**

6 RUCO's position, as outlined by Mr. Rigsby, applies several cost of equity
7 estimation techniques to a sample of four water utilities and ten gas LDC companies
8 resulting in a range of estimates from 5.24 to 9.75 percent.¹⁸² The average of RUCO's
9 DCF and CAPM estimates is 7.96%, which RUCO then increases by approximately 150
10 basis points to get a recommendation of 9.50%.¹⁸³

11 For a number of reasons, RUCO's analysis is flawed. RUCO makes an
12 unconventional adjustment to the DCF model and fails to take into account the fact that the
13 cost of equity necessarily is higher than the cost of debt plus a risk premium.¹⁸⁴ RUCO's
14 recommended return on equity also fails to consider the additional risk Arizona-American
15 faces because it has more debt than comparable companies.¹⁸⁵ Unlike RUCO, Staff has
16 appropriately factored in the difference in Arizona-American's and the sample companies'
17 book value capital structure.¹⁸⁶ Finally, RUCO's recommendation fails to recognize the
18 impact of the current financial crisis on the cost of capital and the need to increase cost of
19 capital in order attract needed investment.¹⁸⁷

20 Mr. Rigsby relies on a constant growth DCF model with a sustainable growth
21 rate. As Dr. Villadsen discusses in great detail in her testimony, Mr. Rigsby's adjustments

22
23 ¹⁸¹ *Id.*

¹⁸² Ex. R-3 at 36-37.

24 ¹⁸³ *Id.* at 37.

¹⁸⁴ Ex. A-21 at 8-9.

25 ¹⁸⁵ *Id.* at 7, Sch. R-1.

26 ¹⁸⁶ *Id.* at 7; Ex. S-3 at 41.

¹⁸⁷ Ex. A-21 at 3-4.

1 to the standard sustainable growth have no theoretical support, and Mr. Rigsby has not
2 provided empirical evidence that it is an accurate description of real world phenomena.¹⁸⁸
3 When RUCO's analysis is modified using traditional textbook formulas for sustainable
4 growth, the water companies' cost-of-equity estimate increases by about 80 basis points
5 while the cost-of-equity estimate for the gas LDC sample increases by about 35 basis
6 points, resulting in an average increase of about 60 basis points in the DCF cost-of-equity
7 estimate.¹⁸⁹

8 A cost of equity estimate that is below the cost of debt plus a risk premium is
9 plainly unreasonable.¹⁹⁰ Two of the CAPM estimates presented in Mr. Rigsby's testimony
10 are lower than the current yield on Baa-rated utility bonds, which simply makes no sense,
11 as the cost of equity is higher than the cost of investment grade debt.¹⁹¹ Further, the
12 average CAPM-based cost of equity estimate is essentially equal to the current yield on
13 Baa-rated utility bonds, which again demonstrates that the estimate is flawed.¹⁹² Even
14 though Mr. Rigsby recommends a return on equity in the high end of its estimated range, it
15 is still too low to reflect the return investors require in today's financial markets.

16 In addition to relying on cost of equity estimates that are below the cost of
17 debt, Mr. Rigsby utilizes on a medium-term government bond in his estimation of the
18 CAPM.¹⁹³ While the theoretical CAPM was developed using short-term risk-free rates,
19 most practitioners rely on long-term risk-free rates because long-term risk-free rates are less
20 influenced by current monetary policy.¹⁹⁴ The use of short term rates causes a downward
21 bias. Also, Mr. Rigsby presents two versions of the CAPM, one of which relies on

22
23 ¹⁸⁸ *Id.* at 8-9.

¹⁸⁹ *Id.* at 7-8.

24 ¹⁹⁰ *Id.* at 10-11.

¹⁹¹ *Id.*

25 ¹⁹² *Id.*

26 ¹⁹³ *Id.* at 11.

¹⁹⁴ *Id.*

1 geometric measures of the market risk premium.¹⁹⁵ While the magnitude of the market risk
2 premium currently is the subject of scrutiny in the academic literature, there is little doubt
3 among academics that the geometric market risk premium does not apply to cost-of-capital
4 estimation.¹⁹⁶

5 For all of these reasons, RUCO's analysis results in a recommendation that is
6 too low and should not be accepted.

7 **3. Staff's Cost of Equity Is Reasonable and Should be Accepted**

8 As noted above, despite the support in the record for a higher return on equity
9 and corresponding cost of capital, the Company has agreed to accept Staff's position. Staff
10 supported a cost of equity of 10.7%, resulting in a weighted cost of capital of 7.2%, which
11 is lower than the 7.33% approved by the Commission for the Company in its most recent
12 rate case.¹⁹⁷ Unlike RUCO, Staff's recommendation recognizes the additional risk inherent
13 in the Company's capital structure. Staff's recommended return on equity is within the
14 returns allowed by other jurisdictions and within the range of what credit rating agencies
15 consider appropriate for a utility such as Arizona-American.¹⁹⁸

16 For all of these reasons, including the reasons Dr. Villadsen's analysis in her
17 direct testimony, the Commission should adopt Staff's return on equity of 10.7% and cost
18 of capital of 7.2%.

19 **VII. INFRASTRUCTURE IMPROVEMENT SURCHARGE**

20 As Sun City enjoys its fiftieth anniversary, much of its water infrastructure is
21 equally as old. As a result, major improvements will be required to continue to provide

22 _____
23 ¹⁹⁵ *Id.*

¹⁹⁶ *Id.*; see also Ex. A-20 at Appendix C.

24 ¹⁹⁷ Ex. S-3 at 10; Decision No. 71410 at 45.

25 ¹⁹⁸ Ex. A-21 at 3. By way of example, in the fourth quarter of 2009, the average ROE allowed for natural
26 gas distribution companies was 10.4% and those companies had on average higher equity and therefore less
financial risk than Arizona-American. See *Major Rate Case Decisions--January 2009--December 2009*,
Regulatory Research Associates (Jan. 8, 2010). According to this publication, the average equity percentage
for gas utilities was 49.4%. *Id.*

1 safe and reliable water service in this district.¹⁹⁹ As part of its request in this case, the
2 Company is asking that the Commission authorize the creation of an Infrastructure
3 Improvement Surcharge (“IIS”) for this water district to address these needed infrastructure
4 replacements and to alleviate rate shock in the next rate case.

5 These types of improvement surcharges are in use in many jurisdictions and
6 have been identified by NARUC as a best regulatory practice for water utilities.²⁰⁰ This
7 type of surcharge provides a utility with a return on and of select, qualifying investments
8 made between rate cases. The IIS also allows rate to increase gradually over time as assets
9 are replaced, thereby helping to alleviate rate shock.²⁰¹

10 The IIS is intended to cover the replacement of existing assets, including
11 replacement mains, hydrants, meters, services, tanks and booster stations.²⁰² The
12 infrastructure in the Sun City Water District is at a point in the asset life cycle where
13 significant levels of replacement capital must be invested.²⁰³ For example, in one area of
14 this district, the Company experienced eight main breaks in the past year.²⁰⁴ As this
15 infrastructure continues to age, the Company expects these main breaks to increase and for
16 its replacement program to accelerate as well.²⁰⁵ As Mr. Crooks testified at the hearing,
17 over the next five years, the Company expects that it will need to perform at least \$7.5
18 million in replacement projects in the Sun City Water District.²⁰⁶

19 As noted by Mr. Townsley, the Company would propose calculating the
20 surcharge in the following manner. Twice per year, or at some other Commission-
21 designated frequency, the Company would analyze the qualifying assets placed in

22 ¹⁹⁹ TR.II at 751-53.

23 ²⁰⁰ Ex. A-5 at 2-3; TR.II at 352.

24 ²⁰¹ TR.II at 751-53.

25 ²⁰² Ex. A-5 at 4.

26 ²⁰³ Ex. A-5 at 3; TR.II at 356.

²⁰⁴ TR.II at 751.

²⁰⁵ *Id.*

²⁰⁶ *Id.* at 762.

1 service.²⁰⁷ All of the calculations would be based on factors from the most recently
2 completed rate case, such as depreciation rates, allowed ROE, cost of debt, capital structure
3 and revenue gross-up factors.²⁰⁸ Based on the estimated service life and depreciation rates
4 from the last case, the Company would calculate the depreciation expense attributable to
5 these assets. Additionally, the Company would calculate the appropriate return on these
6 assets based on the authorized return approved in this case or a subsequent case, if
7 applicable.²⁰⁹ The total amount of the surcharge would be the return on and of these
8 qualifying assets based on the revenue gross-up factor from this rate case or a subsequent
9 case, as applicable. Following the implementation of new rates from any subsequent rate
10 case, a revised surcharge would be calculated removing from the surcharge qualifying
11 assets included in the rate base in that rate case.²¹⁰

12 Certain controls utilized in other jurisdictions would be appropriate for use
13 with this proposed IIS. The most important is that all of assets utilized in calculating the
14 surcharge would be subject to normal prudence review in the following rate case.²¹¹ In
15 addition, the Company proposes a limit of 10% in additional revenue generated from these
16 surcharges.²¹²

17 RUCO and Staff argue that these types of improvements are “ordinary” and
18 therefore should not be dealt with in this “extraordinary” manner.²¹³ However, there is
19 nothing ordinary about the improvements that will be necessary in the next few years in
20 Sun City. The Company’s proposed method of dealing with these improvements, a method
21 endorsed by NARUC, should be given serious consideration by the Commission. If

22 ²⁰⁷ Ex. A-5 at 4.

23 ²⁰⁸ *Id.*

24 ²⁰⁹ *Id.*

25 ²¹⁰ *Id.* at 4-5. The revised surcharge would also incorporate changes in depreciation rates, return on rate
base, and the revenue conversion factor from the recently-completed case.

26 ²¹¹ *Id.* at 6.

²¹² *Id.*

²¹³ Ex. S-15 at 9; Ex. R-17 at 5; Ex. R-19 at 4-6.

1 implemented, this surcharge would allow for gradual rate increases and would help to
2 alleviate rate shock in the next rate case.

3 **VIII. RATE DESIGN ISSUES**

4 **A. Stand-Alone Rate Design**

5 On a stand-alone basis, the Company requests that the Commission institute
6 the Company's recommended pro-rata increase to the existing rate design (except for
7 effluent as noted below). RUCO recommends this same approach in its rate design.²¹⁴ If
8 stand-alone rates are continued, the Anthem Council also recommends the use of this pro-
9 rata approach.²¹⁵

10 For the reasons set forth below, the Company continues to request that the
11 Commission reject Staff's suggested rate design for the Anthem/Agua Fria Wastewater
12 District, as well as the tiers utilized by Staff in its five-tier alternative rate design. In
13 addition, Staff's proposed revisions to the private fire rates will inequitably shift revenue
14 away from this customer class and into other classes, these revisions should not be adopted.

15 **1. Effluent Rate**

16 As noted in the Company's final schedules, the Company is no longer
17 requesting that a wastewater tariff be set for the Anthem/Agua Fria Wastewater District.
18 Rather, the Company continues to support an effluent rate of \$1.64 per thousand gallons for
19 the Anthem Water District if stand-alone rates remain in effect.²¹⁶ Although this rate is a
20 slight increase in the Anthem Water District from the current rate of \$1.43, the Company
21 believes that this proposed increase of approximately 14% is reasonable for non-potable
22 water. Although Mr. Howe, the witness for the sole user of this effluent in the Anthem, had
23 not fully analyzed this proposed rate by the time of the hearing, he did testify that "any rate
24 that is going to be proposed that is going to be less than what was originally proposed . . .

25 ²¹⁴ RUCO's Schedules; TR.II at 744.

26 ²¹⁵ Ex. Anthem-18 at 2.

²¹⁶ Company's Rate Design Schedules.

1 and [a rate] in the area of what we are paying today could be reasonable for irrigating golf
2 courses.²¹⁷

3 Although neither Staff nor RUCO addressed this issue in detail during this
4 proceeding, in the final schedules, RUCO utilizes a rate of \$2.477 per thousand gallons and
5 Staff utilizes a rate of \$2.5648 per thousand gallons.²¹⁸ The Company's more moderate
6 proposal for a slight increase in this rate in the Anthem Water District is reasonable and the
7 Company requests that the Commission approve this rate.

8 **2. Staff's Wastewater Rate Design for Anthem/Agua Fria**

9 In its rate design for the Anthem/Agua Fria Wastewater District, Staff has
10 recommended that the Commission eliminate the fixed monthly charge and utilize a
11 commodity only charge.²¹⁹ The commodity charge would be based upon water usage in the
12 months of January, February and March.²²⁰ As Staff notes, Staff has not recommended this
13 approach in any other proceeding (or in any other district in this proceeding), and this
14 wastewater district would be a "pilot" case for this type of rate design.²²¹ Staff's proposal
15 creates numerous issues and should not be adopted in this proceeding.

16 Staff's proposal will unduly increase the dependence of wastewater revenues
17 on water sales which vary significantly from year to year and are declining in Anthem.²²²
18 When rates are based on sales that are declining, the Company cannot recover the approved
19 revenue requirement.²²³ In addition, no party to this case has fully analyzed the potential
20 significant water conservation effect of this proposal or the related consequences.²²⁴

21
22 ²¹⁷ TR.II at 697.

23 ²¹⁸ Staff's Rate Design Schedules; RUCO's Schedules.

24 ²¹⁹ Ex. S-15 at 10-11.

25 ²²⁰ *Id.*

26 ²²¹ TR.II. at 1267, 1270.

²²² Ex. A-39 at 3.

²²³ *Id.*

²²⁴ *Id.* at 4.

1 Staff believes that the winter months it has selected would be a fairer
2 representation of water usage that is actually treated as wastewater.²²⁵ However, in the
3 Anthem community, overseeding of winter lawns is required.²²⁶ Staff did not consider this
4 issue in making its proposal.²²⁷ In addition, this proposal would likely have negative
5 unintended consequences, such as increased summer water usage.²²⁸ Indeed, the
6 community that stands to be most affected by this pilot project, Anthem, is opposed to
7 Staff's proposal.²²⁹

8 3. Private Fire Rate

9 Staff recommends that the Company's private fire rates in each of its water
10 districts be revised to the greater of \$10 or two percent of the monthly minimum charge for
11 the applicable meter size.²³⁰ The Company believes that this revision to the rate design for
12 this service is not warranted, as it will lead to a dramatic shift of approximately \$500,000
13 revenues away from this customer class into other classes.²³¹ Accordingly, the Company
14 proposes that this rate be addressed in the same pro-rata matter as other rates in the
15 Company's stand-alone rate design.

16 4. Staff's Alternative Rate Design

17 At the conclusion of this hearing, the Administrative Law Judge requested
18 that Staff provide an alternative five-tier rate design with its final schedules. Although the
19 Company has not proposed a five-tier rate design in its stand-alone schedules, it is
20 acceptable and if a five-tier design is utilized, the Company recommends the use of the
21 same tiers utilized in the Company's consolidated rate design proposal. Staff's alternative
22

23 ²²⁵ Ex. S-15 at 11.

²²⁶ Ex. A-49.

24 ²²⁷ TR.II at 1322.

²²⁸ Ex. A-39 at 5.

25 ²²⁹ Ex. Anthem-18 at 4.

26 ²³⁰ Ex. S-15 at 5-6.

²³¹ Ex. A-39 at 9.

1 tiers commence with an initial break point that is too low (*i.e.*, 1,000 gallons in Sun City
2 and 2,000 gallons in Anthem).²³² These tiers are not appropriate for the Company's entire
3 system, and if the Commission wishes to move the Company to five tiers, the Company
4 requests that it use the tiers used in the Company's consolidation schedules, which are
5 appropriate for all of the Company's districts.

6 **B. Consolidation**

7 In Decision No. 71410, the Commission expressed its desire to examine in
8 detail the issue of consolidation in this proceeding.²³³ Through this proceeding, the
9 Company has provided an incredible amount of evidence to address the issue of
10 consolidation. In its pre-filed testimony and throughout the evidentiary hearing, the
11 Company outlined in detail the benefits of consolidation. The proceeding has made clear to
12 the Company that, for various reasons, the benefits of consolidation are championed by
13 certain parties, such as the Anthem Council and Mr. Magruder, and not accepted by other
14 parties, including Staff and RUCO.²³⁴ Although it will never be possible to convince all
15 parties that consolidation is beneficial, if the Commission wishes to order consolidation for
16 the Company, this proceeding is the best opportunity to do so. As a result, the Company
17 seeks the Commission's leadership to make a determination regarding consolidation. If the
18 Commission determines that it is appropriate, the Company will use its best efforts to
19 ensure that consolidation is implemented effectively in the manner ordered by the
20 Commission.

21 In its final rate design schedules, the Company has set forth its proposal and
22 recommendation for a consolidated rate design (Company Scenario 1) should the
23

24
25 ²³² Staff's Rate Design Schedules.

26 ²³³ In its testimony, RUCO set forth the possibility of raising certain legal arguments in opposition to rate consolidation in this proceeding. The Company intends to respond to these in its reply brief.

²³⁴ Magruder Schedules; Anthem Schedules; Ex. Woods-1.

1 Commission order consolidation. Some of the important features of this scenario include
2 the following:²³⁵

- 3 a) the consolidation includes all of the Company's water and wastewater
4 districts;
- 5 b) the consolidation is proposed to occur in up to five "revenue neutral"
6 steps;
- 7 c) the residential 1 inch meter water monthly minimum charge is reduced to
8 1.25 times the 5/8 and 3/4 inch meters charge;
- 9 d) the consolidated non-potable water tariff is \$1.24 / kgal in all steps; and
- 10 e) beginning in Step 1, there are five residential rate tiers for all meter sizes
11 and 3 commercial rate tiers for meter sizes two inches and smaller and 2
12 commercial rate tiers for larger commercial meters.²³⁶

13 If consolidation is ordered in this proceeding, the Company strongly believes
14 that Company-wide consolidation is the best method to achieve the full benefits of
15 consolidation. For comparison purposes, the Company has provided as part of its final
16 schedules the consolidation scenarios requested by Chairman Mayes, which set forth
17 consolidation if Sun City is excluded and if Sun City and Sun City West are excluded.

18 IX. OTHER ISSUES

19 A. Request for Depreciation Table

20 The Company has requested that the Commission adopt of schedule of
21 depreciation rates as part of this order in order for the Company to be able to more clearly
22 document to its auditors that depreciation rates order by the Commission. This schedule is
23 set forth as part of the Company's Revenue Requirement Schedules.²³⁷ The Company
24

25 ²³⁵ Company's Rate Design Schedules (Company Scenario 1).

26 ²³⁶ The commercial tiers should address the issues raised by the Resorts in relation to consolidation. See Resorts' Schedules; Ex. RES-1.

²³⁷ Company's Revenue Requirement Schedules.

1 believes that the depreciation rates set forth in that schedule are reasonable and should be
2 adopted.

3 **B. Sun City Low Income Program**

4 The Company seeks to continue the existing low income program in the Sun
5 City District. The Company also requests that the Commission make clear in its order that
6 the current high block funding mechanism should remain in place.²³⁸ The Company has
7 included this in its final schedules. However, although Staff testified at the hearing that the
8 current funding mechanism should remain in place, the Company cannot discern from
9 Staff's final schedules whether this mechanism is included in rates.²³⁹ As a result, the
10 Company respectfully requests that the Commission confirm this funding mechanism in its
11 order in this matter. Although it does not impact the existing program, the Company
12 continues to work through issues relating to program eligibility of residents of the
13 condominium associations within Sun City. The associations that receive the Company's
14 water bills are reluctant to transfer low income credits to their residents and are generally
15 reluctant to accept any administrative responsibilities associated with the low income
16 program. The Company is examining other alternatives which bypass the associations for
17 administration for residents of these HOAs that may involve support from the Sun City
18 Taxpayers Association.

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²³⁸ Ex. A-39 at 11.

²³⁹ TR.II at 1413.

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RESPECTFULLY SUBMITTED this 16th day of July, 2010.

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