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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, AN ARIZONA CORORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS ANTHEM WATER DISTRICT AND ITS SUN CITY WATER DISTRICT.	Docket No. W-01303A-09-0343
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, AN ARIZONA CORORATION, 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
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RUCO'S CLOSING BRIEF

INTRODUCTION

The Residential Utility Consumer Office ("RUCO") submits this Brief in response to Arizona American Water Company's ("Arizona American" or "Company") request that the Arizona Corporation Commission ("Commission") authorize a total rate increase of

$9,816,374[1] for the Company's Anthem and Sun City water districts and a total rate increase of $10,725,216[2] for the Company's Anthem/Agua Fria, Sun City and Sun City West wastewater districts. This is a huge request. What makes this case even more challenging is that one of the water districts, Anthem, recently experienced a significant rate increase.[3] The current proposal, like the last one, is being fueled in large part by the Company's obligation to refund to Pulte large infrastructure costs associated with Anthem's water service. While the payment of these refunds has reached its end with this rate case, past repayments have already hit Anthem's ratepayers with high rates. Anthem's high rates, coupled with the current state of the economy, have left Anthem's ratepayers suffering. Anthem is not the only district feeling the pain – the other Arizona-American districts are too. Just a few months ago, six water districts and one wastewater district also received rate increases.[4] It should go without saying that this Company's rate increase proposal, given the current timing, should be as lean a rate increase request as possible. Unfortunately, that is not the case. This Company has made numerous recommendations in this case that are not only unreasonable under ordinary circumstances, but are particularly unreasonable under the present circumstances.

RUCO recommends revenue increases for the two water districts in the current case no higher than the amounts shown in the "Per RUCO" column in the following table:

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[1] RUCO Final Schedule, RCS-6, Schedule A, page 1; Company amounts are from the Company's Schedule A-1.
[2] RUCO Final Schedule, RCS-7, Schedule A, page 1; Company amounts are from the Company's Schedule A-1.
[3] Dec. No. 70372 (June 13, 2008)
[4] Dec. No. 71410 (Dec. 8, 2009)

Revenue Requirement Summary - Water Districts

	Per Company	Per RUCO	Difference
Anthem Water	$ 7,268,177	$ 5,295,918	$ (1,972,259)
Sun City Water	$ 2,531,127	$ 662,386	$ (1,868,741)
Total	$ 9,799,304	$ 5,958,304	$ (3,841,000)

RUCO recommends revenue increases for the three wastewater districts in the current case no higher than the amounts shown in the "Per RUCO" column in the following table:

Revenue Requirement Summary - Wastewater Districts

	Per Company	Per RUCO	Difference
Anthem/Aqua Fria Wastewater	$ 7,060,837	$ 5,050,262	$ (2,010,575)
Sun City Wastewater	$ 2,156,882	$ 1,501,733	$ (655,149)
Sun City West Wastewater	$ 1,480,756	$ 759,590	$ (721,166)
Total	$ 10,698,475	$ 7,311,585	$ (3,386,890)

SUMMARY OF ISSUES

Among the more significant issues in dispute, RUCO and the Company disagree with the Company's proposed ratemaking treatment of a new well placed into service after the test year in Sun City. The Company has proposed to include the $1.587 million cost of this well into rate base. RUCO-10 at 6.[5] The Company's proposed ratemaking treatment is not consistent with Commission's prior ratemaking treatment of post-test-year plant for this Company, and it is certainly not a reasonable recommendation given the magnitude of the Company's proposed revenue increase.

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[5] For ease of reference, trial exhibits will be identified similar to their identification in the transcript of proceedings. The transcript volume number will identify references to the transcript.

Next, the Company is proposing to include its pension expense based on its ERISA contributions for 2009. The Company's 2008 test year contributions were abnormally high, but its 2009 contributions are clearly excessive for ratemaking purposes. The Company is adamant in its position and will not consider traditional regulatory ratemaking treatments, such as normalizing the test year costs which will ameliorate the rate impact on the Company's customers.

The Company is proposing a positive cash working capital allowance based on a flawed lead-lag study which has excessive revenue lags and service company payment lags.

Another issue in dispute is the Company's request to recover the post-test-year wage increase given to its employees. RUCO has agreed to the Company's request to recover its test year wage increase which itself is a stretch, all things considered. However, at a time when most ratepayers are struggling just to get by, it is not reasonable to ask its customers to pay for the Company's post-test-year pay increases.

Departing from cost of service rate design to a consolidated rate design was a well-discussed matter at hearing. Given the high rates for some districts and the Company's request to increase all of the districts rates on a stand alone basis, it has been suggested that the rates of the Company's districts should be consolidated. On this, it appears that the Company, Staff and RUCO agree – the Commission should not approve rate consolidation of the Company's districts at this time. RUCO believes that there are both legal and policy reasons which weigh against rate consolidation at this time and will be more fully discussed below.

Finally, RUCO's brief will address Commissioner Pierce's request that parties respond to the Anthem Council's April 13, 2010 Pre-hearing Memorandum requesting denial of recovery of the Pulte repayments in rates.

RATE BASE ADJUSTMENTS

SUN CITY WATER POST-TEST-YEAR PLANT

The Company is proposing to place $1.587 million of plant associated with a new well that was placed in service in the Sun City Water district on May 27, 2009, almost six months after the close of the test year. RUCO-10 at 6. This type of ratemaking, while not unprecedented, has only been allowed where there have been exceptional and/or extraordinary circumstances. The circumstances in this case are not exceptional and/or extraordinary and the Commission should reject the Company's recommendation.

The Company's proposal to include the post-test-year plant violates the "matching" principle. The "matching" principle is a fundamental principle of accounting and ratemaking. RUCO-10 at 16. The absence of matching rate case elements distorts the coordination of the elements of the ratemaking formula, and can adversely affect the fairness and reasonableness of rates. RUCO-10 at 6. For the most part, the Commission has frowned on requests to include post-test-year plant additions in rate base. Usually before the Commission will consider such requests there needs to be special or unusual circumstances, neither of which exists here. Id. Moreover, the greater the time period beyond the test year that the improvements were made, the less likely the Commission is to allow recovery.

The Company made a similar request in its last rate case. In that case, the Commission denied the Company's request to include $2,046,765 of post-test-year plant in the Company's Aqua Fria Water District. Decision No. 71410 at 20. The Commission noted that the Company had not demonstrated any special or unusual circumstances. The Commission also denied the Company's request to include $610,731 of post-test-year plant in the Company's Mohave Water district for the same reason. Id. at 21. Admittedly, the Commission did follow RUCO's recommendation and allowed the Company to recover 50 percent of its requested post-test-year plant additions in the Mohave Wastewater district. Id. at 23. The Commission found these post-test-year additions provided "continuous, reliable, safe service to the Company's customers" without which the Commission could not meet the standards of its Aquifer Protection Permit. Id. at 22-23. Such concerns over safe and reliable service are not present here. The Company has not demonstrated special or unusual circumstances to justify the inclusion of the $1.587 million for the new well in Sun City. Furthermore, in light of the current financial struggles facing Arizona ratepayers resulting from the poor economy, the Commission should reject the Company's proposal to include post-test-year plant.

RELIEF REQUESTED: The Commission should reject the Company's proposal to include $1,587,149 of post-test-year plant associated with the new Sun City well. RUCO-10 at 6, Final Schedule RCS-6, B-1 at 1.

CASH WORKING CAPITAL

The Company recommends a positive cash working capital balance. A positive cash working capital balance exists when a Company's cash expenditures, on an aggregate basis, precede the cash recovery of expenses. RUCO-9 at 18. In that situation, investors must provide cash working capital. Id. A positive cash working capital allowance results in an increase to the Company's rate base. RUCO's cash working capital analysis resulted in a negative cash working capital recommendation. A negative cash working capital requirement exists when revenues are received prior to the time expenditures are made. Id.

A positive cash working capital balance is counter-intuitive where utilities are concerned since utilities typically bill monthly and receive revenues prior to paying expenses. Typically, a utility will have a negative balance. Hence, a positive cash working capital balance, like the Company's recommendation in this case raises a red flag.

A cash working capital calculation is made by means of a lead/lag study. The Company performed a lead/lag study in this case. RUCO-9 at 19. RUCO, however, believes that the Company's lead/lag study is flawed which explains why the Company arrived at a positive cash working capital requirement when typically a utilities cash working capital requirement is negative. The revenue lags the Company used in its lead/lag study are overstated and result in an excessive cash working capital requirement. The revenue lag is supposed to measure, on average, the time between (a) the provision of service and (b) the receipt of payment for service. It typically is comprised of three sub-components: (1) the service period lag, (2) the billing lag, and (3) the collection lag. Id. at 20.

The Company's revenue lags for each district are summarized in the table below:

Summary of Revenue Lag as calculated by AAWC					
Revenue Lag Component	**Anthem Water**	**Sun City Water**	**Anthem Agua Fria Wastewater**	**Sun City Wastewater**	**Sun City West Wastewater**
Service Period Lag	**15.148**	**15.219**	**15.248**	**15.335**	**15.394**
Billing Lag	**4.875**	**4.426**	**4.711**	**4.317**	**4.216**
Collection Lag	**26.082**	**26.082**	**26.082**	**26.091**	**26.018**
Total Revenue Lag Days	46.105	45.727	46.040	45.743	45.628

RUCO-10 at 11. It is noteworthy that not one of the Company's districts has a revenue lag less than 45 days. The due date for payment of billings for water and wastewater service is 20 days and does not differ by the type of customer. Id. at 11. The Company's proposed revenue lags assume that customers, on average, throughout the year, are not complying with the payment terms. RUCO-10 at 11.

In support of its excessive revenue lag recommendations, the Company argues the following. First, it claims that the Commission has accepted the Company's revenue lag calculations in other cases without question. A-18 at 8. Second, the Company claims that its charge-offs have increased. Id. Third, for the collection lags, the Company's calculation was made by dividing the accounts receivable balances by 365 days. Fourth, the Company has a late payment fee. Finally, the Company argues that the Commission should ignore the more efficient billing lag periods used by other Arizona utilities and should accept the Company's lag calculations because they were calculated the same way they always have been. Id. at 12-13.

The Company's arguments are not persuasive. For the sake of argument, assuming it is true that the Commission has not questioned the Company's revenue lag calculations in other cases, it still should be of no consequence in the Commission's determination in this case. Rate cases are complex, and contain many issues. Unfortunately, there are issues that are not challenged in every case due to resource constraints or other reasons. Had the Commission made a decision in a prior case where it accepted excessive revenue lags for a reason applicable in this case, the Company would have a point. However, that is not the case and this argument lacks merit.

The next several arguments that the Company makes suggest that the Commission should allow it to continue to add additional amounts of cash working capital in rate base based on what amounts to the Company's inefficient management of its revenue lags. RUCO-10 at 14. For example, the Company claims that uncollectibles have increased. RUCO-10 at 14. The Company has not, however, adjusted its cash working capital to eliminate the uncollectibles. The Company has agreed with Staff to remove bad debt expense from cash working capital. Id. at 15. Bad debt expense is another term for uncollectibles, and like bad debt expense, uncollectibles should be taken out of the Company's cash working capital calculation.

How long a Company carries uncollectible accounts in accounts receivable before they are written off is another consideration in the calculation of the Company's cash working capital. AAWC computes its revenue lag by dividing accounts receivable by 365 days to determine average daily accounts receivable. Id. Accounts that eventually become uncollectible are likely to distort the revenue lag if they are included in accounts receivable for lengthy periods of time without having an adequate reserve established. Id.

In ratemaking, it is normal to compare utilities to each other to check on whether the calculations and/or adjustments being recommended are reasonable. Barring an exceptional circumstance, which no party has alleged, the Company's lags should be pretty consistent with other utilities - but for some inexplicable reason they are not.

RUCO's rate analyst, Ralph Smith compared the revenue lags used by other Arizona utilities in recent rate cases.

See chart on next page

Revenue Lag Typical Arizona Utilities That Use Monthly Billing			
Utility	**Docket**	**Revenue Lag Days**	**Reference**
APS (Arizona Public Service)	**E-01315A-08-0172**	**38.17**	**A**
TEP (Tucson Electric Power)	**E-01933A-07-0402**	**33.79**	**B**
UNS Gas	**G-04204A-08-0571**	**40.70**	**C**
UNS Electric	**E-04204A-09-0206**	**35.59**	**D**
UNS Electric	**E-04204A-06-0783**	**35.59**	**E**
Southwest Gas Corporation	**G-01551A-07-0504**	**39.53**	**F**

Notes and Source:

[A]: APS work paper JCL-WP11, p.9
[B]: TEP Schedule B-5, p. 3
[C]: UNSG Schedule B-5, p. 3
[D]: UNSE Schedule B-5, p. 3
[E]: UNSE filing Schedule B-5, p. 3
[F]: SWG Schedule B-5, p. 2

RUCO-9 at 24. By comparison, the revenue lags used by the Company for all five districts range from 45.628 to 46.105 and are at least four days greater and at most over eleven days greater than the utilities listed above. The Companies revenue lags are excessive and should be rejected.

The Company also seeks to include a pre-payment of affiliated Service Company charges in its cash working capital calculation. RUCO-10 at 22. The Company has not demonstrated that the Service Company agreement it is relying on was ever approved by the Commission. Furthermore, it appears to be relying on a 20-year-old Paradise Valley "Agreement." Id. at 24. Paradise Valley is not a district in this rate case and the Company should not be able to boot strap its authority from a 20-year-old agreement involving a district not involved in this case.

The prepayment of affiliate management fees is unreasonable. Affiliated transactions are not arm's length transactions. Id. at 25. If the Company were obtaining the services from a non-affiliate, normal commercially related terms would apply. Id. at 25-26. The Commission need look no further than the Company's payment lags to the non-affiliated businesses in this case to see that the normal method of doing business in an arms length situation is not by pre-payment before the service is provided. Id. The payment lag applied to management fees paid to the affiliate should be adjusted to commercially reasonable terms. Id. at 28. RUCO recommends that the cash working capital associated with the prepayments made to the affiliate should apply the same 12-day expense lag associated with the Company's direct labor costs. Id. at 28.

RUCO adjusted the collection lag by applying a 20-day due date period as the maximum collection lag that would apply for customers who, on average, pay their bills on time. RUCO-9 at 21. The Company's recommendation which utilizes excessive revenue lags would penalize those same customers who pay their bills on time by increasing the Company's cash working capital requirement. By adjusting the revenue lags RUCO's recommendation will ameliorate the impact of including accounts that eventually become uncollectible in the accounts receivable balance that AAWC used to derive its collection lag portion of the revenue lag. Id. at 15. The cash revenue received by the utility is paid by customers who pay their bills. Id. Adjusting the revenue lags assures that the revenue lags are not overstated because of uncollectibles being carried in accounts receivable. It reflects an allowance for the collection lag based on the receipt of cash revenue from the customers who pay their bills, on average, by the due date. For customers who pay their utility bills after the due date, AAWC charges and records late payment fee revenue.

RELIEF REQUESTED: The Commission should adopt the following adjustments to cash working capital:

Summary of Adjustments to Cash Working Capital

District	Anthem Water	Sun City Water	Anthem/ Agua Fria Wastewater	Sun City Wastewater	Sun City West Wastewater	Total
Adjustment	$ (123,000)	$ (171,000)	$ (134,000)	$ (106,000)	$ (116,000)	$ (650,000)

RUCO-10 at 33, as updated in RUCO's Final Accounting Schedules.

OPERATING INCOME

RATE CASE EXPENSE

The Company has requested $678,425 in rate case expense, normalized over three years. RUCO-10 at 42. RUCO is recommending approval of $460,000 in rate case expense amortized over three years. Id. at 46. This case involves five districts. In its last rate case there were seven districts involved. Decision No. 71410. In that case, the Commission approved rate case expense totaling $456,275, normalized over three years. Id. at 39. Decision No. 71410 was docketed on December 8, 2009. Decision No. 71410 at 1. In other recent Arizona-American cases, the Commission awarded $300,000 in a three-district case in Decision No. 70372, dated June 13, 2008 and $94,264 in a one-district case in Decision No. 70351 dated May 16, 2008. RUCO-10 at 45. What the Company seeks in the present rate case is unreasonable and is not supported by the record.

The Company claims to have spent $229,339 in rate case expense as of March 11, 2010. A-7 at 6. The Company claims that the primary reason for the extra cost in this case has to do with the public notice required for the rate consolidation design. A-6 at 11. The Company's overall budget for publishing related expenses had initially been running slightly under budget because the Company sent the initial public notice as a bill insert and not a separate mailing. RUCO-10 at 43. The Company was able to save approximately $50,000 by sending the notice as a bill insert. Id. at 44. The Company knew that consolidation was going to be an issue in the current case. A similar saving on sending out consolidation notices in the same way to save significant expense should therefore be reflected, whether the Company actually achieved such savings or not.

There is also the concern of double counting raised by charging for Company and affiliate labor cost in rate case expense. Id. Payroll costs and costs for affiliate labor are clearly included elsewhere in the Company's filing, based on adjusted test year amounts. Id. Affiliated company labor and expenses incurred subsequent to the test year as rate case expense would represent an increase to the amount recorded during the test year. Costs for Company and affiliate labor should therefore be excluded from rate case expense to preclude double counting or excessive charges to ratepayers. Id.

An allowance of $460,000 for the current case, involving five districts, normalized over three years, is in line with the allowance $456,275 for seven districts, normalized over three years from Decision No. 71410 at 39.

Finally, the Company suggests that it should be allowed to recover its actual rate case expense. A-7 at 5. The Company agrees to continue to update that cost even after the hearing is over. Id. The Commission should reject this approach for recovery. Allowing continuous updates removes any incentive to keep such costs under control. RUCO-10 at 45. It also does not allow the parties adequate time to review or question the costs. Id. Moreover, actual costs does not necessarily equate to reasonable costs. The standard for recovery is what is reasonable and the Company's request in this case is not reasonable.

RELIEF REQUESTED: The Commission should approve an allowance for rate case expense of $460,000 normalized over three years or a normalized annual allowance of $153,333 for all of the districts. Id. at 46, Final Schedule RCS-6, C-2 at 1.

PENSION EXPENSE

The pension expense issue is one of the larger issues in dispute in this case. The Company's pension expense recommendation is based on the average of the Company's 2009 and 2010 ERISA funding payments. A-14 at 14-15. Previously the Company sought to base its request for pension expense on the 2009 ERISA amount, which was the highest ever. RUCO recommends using the 2008 test year FAS 87 amount of $958,949 as a reasonable allowance for pension expense in this proceeding. RUCO Final Accounting Schedule at Attachment RCS-6, C-5 at 1. The use of the actual 2008 FAS 87 amount is in line with historical experience, and protects ratepayers from the huge increases in 2009, and does not use the 2009 amount for ratemaking purposes because the 2009 amount is abnormally high, as evidenced by the following table, from information provided by the Company in Late Filed Exhibit R-12:

	Actual						
	2004	2005	2006	2007	2008	2009	2010
AZ ERISA Pension Cost	$ 198,415	$ 395,939	$ 1,166,799	$ 1,013,709	$ 1,712,512	$ 2,090,643	$ 2,062,641
AZ FAS 87 Pension Cost	$ 801,536	$ 829,028	$ 895,281	$ 880,693	$ 958,949	$ 2,143,740	$ 1,587,097
Total Service Co. ERISA Cost	$ 802,477	$ 2,246,786	$ 8,346,597	$ 12,062,315	$ 17,524,162	$ 22,106,545	$ 17,692,040
AZ Share	$ 50,012	$ 140,024	$ 520,176	$ 751,746	$ 1,092,139	$ 1,377,722	$ 1,102,602
5 Pending Districts	$ 24,256	$ 67,912	$ 252,285	$ 364,597	$ 529,687	$ 668,195	$ 534,762
Total Service Co. FAS 87 Cost	$ 6,675,903	$ 6,506,947	$ 11,420,879	$ 10,957,999	$ 10,936,775	$ 20,027,657	$ 14,667,197
AZ Share	$ 416,055	$ 405,525	$ 711,771	$ 682,923	$ 681,601	$ 1,248,162	$ 914,088
5 Pending Districts	$ 201,787	$ 196,680	$ 345,209	$ 331,218	$ 330,576	$ 605,358	$ 443,332

There are two parts to the pension expense issue. The first part concerns the appropriateness of using ERISA or FAS 87 to account for pension expense. In this case the Company has accounted for pension expense using ERISA despite the fact that its parent company, American Water Works uses FAS 87 accounting to account for pension expense.

RUCO-10 at 62. RUCO recommends that the Commission approve the FAS 87 accounting treatment over the ERISA method to account for pension expense for the following reasons.

Under its ERISA proposal, the Company is seeking to recover an exceptionally high amount of pension expense. The Company is requesting to recover $2.090 million, before allocation among districts, based on funding payments into its defined pension plan trust for post-test-year 2009. To put the Company's request in perspective, below is a chart illustrating the Company's annual pension amounts.

Comparison of Annual Pension Amounts

Year	Amount		AAWC Request Exceeds By Amount	AAWC Request Exceeds Percent
Actual Recorded:				
2004	$ 146,893	[a]	$ 1,943,107	1322.8%
2005	$ 317,798	[a]	$ 1,772,202	557.7%
2006	$ 1,013,141	[a]	$ 1,076,859	106.3%
2007	$ 903,222	[a]	$ 1,186,778	131.4%
2008	$ 1,734,561	[a]	$ 355,439	20.5%
Averages:				
2004-2008	$ 823,123		$ 1,266,877	153.9%
2006-2008	$ 1,216,975		$ 873,025	71.7%
2007-2008	$ 1,318,892		$ 771,109	58.5%
AAWC Requested	$ 2,090,000	[b]		
RUCO Normalized	$ 1,318,892	[c]		

Notes and Source

[a] Annual recorded amounts from response to RUCO 2-60

[b] Company's requested amount is from AAWC Exhibit SLH-2 and is based upon 2009 funding contributions

[c] Based on two-year average, 2007-2008

RUCO-9 at 49. By historical accounts, the amount the Company seeks to recover here is remarkable, which on its face justifies an alternative accounting methodology that provides a reasonable amount of recovery.

It is apparent that the Company's pension plan is severely underfunded. The Company's pension fund has been significantly underfunded from its inception and now the Company is playing catch up. Transcript at 976. The reason for the pension amounts more than doubling since 2007 can be explained by several factors. Id. at 973. The primary factor is the $209 million loss on the pension trust assets. Id. The decline in the economy has resulted in substantial losses on investments in 2008. Id. at 973-974. The 2009 amount is abnormally high due to the extremely abnormal market conditions. Id.

There has been a pronounced trend away from these types of pension plans because the costs have been going out to control. Id. Whether to move away from this type of pension plan is a decision for the Company to make. The Company has substantial influence in the plan design. Id. The Company is asking its ratepayers to pay for its poorly designed pension plan, and regardless of whether the Commission approves the pension expense using ERISA or FAS 87, it is going to be expensive. Id. at 976. It is also not going to end here. The Company will continue to pay a high pension cost to fund its significantly underfunded plan[6]. Id.

FAS 87, Employer's Accounting for Pensions, was published in December 1985. Id. FAS 87 is not a new accounting requirement. FAS 87 has been applicable for financial accounting and reporting purposes now for 23 years. Id. It has also been widely accepted in the regulatory field. Transcript at 919. Unlike ERISA, the FAS 87 accounting provides for funding amounts that are consistent with generally-accepted accounting principles. Transcript at 982. The FAS 87 amounts can be determined by actuarial tables and can be reviewed. Id. If they are out of line, they can be adjusted or normalized accordingly. Id.

The ERISA method provides for an extremely wide amount of discretion of management on how to fund the plan each year. Transcript at 919. For American Water Works, the amount of funding for the last couple of years was over $600 million. Id. Management's discretion

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[6] Beginning January 1, 2006 the Company changed its plan from a defined-benefit plan to a defined-contribution plan. RUCO believes the new plan is a reasonable way to provide the retirement benefit. Transcript at 982.

under ERISA is so broad that it could hardly be called being held to a standard. Moreover, the Pension Protection Act of 2006 has tightened up its funding requirements and companies like American Water Works have to ramp-up their funding contributions to bring its plan into a more fully-funded status. Id. at 920.

Finally, looking solely at the test year using FAS 87, the amount of pension expense was $958,949. This amount is from Late Filed Exhibit R-12 and is shown on RUCO Final Accounting Schedules, Attachment RCS-6, Schedule C-5, page 1. This FAS 87 amount is lower than the test year ERISA amount and lower than what the Company seeks in this case.

The second issue related to pension expense concerns the appropriate pension expense amount. As previously stated, the Company is seeking to recover its pension expense contributed under ERISA for 2009. In other words its post-test-year amount. RUCO recommends the use of the 2008 test year FAS 87 amount of $958,949. The 2008 actual FAS 87 amount is higher than but is not totally out of line with the amounts of FAS 87 pension expense for prior years, as shown in the following table:

	Actual					
	2004	2005	2006	2007	2008	2009
AZ FAS 87 Pension Cost	$ 801,536	$ 829,028	$ 895,281	$ 880,693	$ 958,949	$ 2,143,740
					Use for ratemaking	

In contrast, the 2009 amount is abnormally high in comparison with any prior year. The 2009 FAS amount is also significantly higher than any future year FAS estimate.[7] The Company's 2009 pension expense amount is abnormally high whether it is measured under an ERISA or a FAS 87 method. Over and over, the Company claims to be doing all that it can to keep rates low. The Company's request, however, does just the opposite. RUCO recommends the Commission deny recovery of the extraordinarily high 2009 pension expense.

[7] See, e.g., Late Filed Exhibit R-12.

RUCO recommends using the actual test year FAS 87 amount for ratemaking purposes for pension expense in this case.

In regulatory accounting, where a test year expense is out of line with what is normal, the Commission traditionally normalizes the expense. To normalize an expense, the Commission typically considers several years of the expense and then calculates the average yearly expense to arrive at an amount that is in line with what is normal. As can be seen from the chart above, even the test year ERISA amount is abnormally high compared to the previous five years. The normal approach to such a situation would be to normalize the test year with previous years. The Company has completely ignored this approach, and instead seeks to recover a post-test-year amount even higher than the test year amount. It would have been more reasonable for the Company to have requested only the abnormally high test year amount or even normalize the test year and post-test-year amounts. Both alternatives would have still been unreasonable here but at least better and more fair to the Company's customers than what the Company is recommending. The Company's request illustrates this Company's true motive to keep rates higher than reasonably necessary to recover its cost of service. This request is unreasonable by any standard and should be rejected.

RELIEF REQUESTED: The Commission should approve RUCO's recommended FAS 87 based pension expense of $958,949 and reject the Company's ERISA based post-test-year amount of $2.090 million.

AMORTIZATION OF PENSION REGULATORY ASSET

Should the Commission determine that pension expense is based on FAS 87 and not the ERISA approach, the Company has requested that the accumulated difference in pension expense between the two approaches be recognized and amortized over a five-year period.

A-7 at 13-14. The Company has recorded the on-going difference between the FAS 87 and ERISA approaches in two accounts – accounts #186408 and #186422 which have balances of $746,347 and $1,050,173 as of February 28, 2010. Id. at 14.

RUCO objects to the Company's request for several reasons. First, AAWC has not demonstrated that it ever requested or received Commission authorization to record such deferrals for any of the districts at issue in the current AAWC rate case. RUCO-10 at 80. The only authority the Company has been able to point to as authority to establish a deferral account is Decision No. 58419. Decision No. 58419 addressed the Company's accrued yearly pension cost based on FAS 87. Id., Transcript at 209. In that case, the Company had not previously requested recognition of the accrued pension costs resulting from FAS 87. Decision No. 58419 at 8. The Commission denied the accrued pension costs under FAS 87 but did say that it would be appropriate for the Company to establish a deferral account as a result of the implementation of FAS 87 from that point forward. Id.

The Company's reliance on Decision No. 58419 is misplaced. The Commission decided that case in 1993. RUCO-2. Decision No. 58419 decided an entirely different rate case seventeen years ago and the system involved in that case, Paradise Valley, is not one of the systems under consideration in this case. There is nothing in Decision No. 58419 that can be interpreted, no matter how broadly read, as applying the establishment of a deferral pension expense account to any of the Company's other systems or even another rate case. RUCO-2 at 8.

Second, AAWC's deferral proposal contains an element of retroactive ratemaking. RUCO-10 at 80. Typically, a utility asks the Commission for a deferral order prior to making the deferral. Here the Company has accrued a significant balance and based on an old case with no connection to the present case is seeking a deferral for the accumulated balance. If the deferrals that AAWC recorded were not specifically authorized by the Commission, the appropriate accounting should be to write the balances off. Id. FAS 87 has been in existence for over 20 years and the Company should have sought a deferral order prospectively, not retroactively.

Finally, as explained above, the total amount of pension expense being included in rates should be reviewed for reasonableness and adjusted to a reasonable and normal level. Id. The Company's request is based on a post-test-year 2009 amount that has been impacted by unprecedented disruptions in the capital markets, is too high and should be normalized at a minimum. It is not appropriate to load additional pension expenses into the 2008 test year based on questionable prior deferrals, and should be rejected.

RELIEF REQUESTED: The Commission should reject the Company's request to defer and amortize pension expense. The previously deferred amounts of $746,347 and $1,050,173 respectively for the water and wastewater utilities at issue in the current rate case were never authorized by the Commission for deferral in an accounting order directed to these specific utilities. These amounts should be removed from the Company's books so that they do not become an additional burden upon ratepayers of these utilities in future rate cases.

NORMALIZE OTHER POST EMPLOYMENT BENEFITS ("OPEB")

The Company proposes to use an OPEB expense based on post-test-year, 2009 amounts. RUCO-10 at 81. As was the case with the pension expense, the 2009 OPEB amounts are significantly higher than the last five years, 2004-2008. RUCO-10 at 81. RUCO's adjustment normalizes the OPEB expense using an average of 2007-2008 as the basis for deriving a normal level of ratemaking. Id. at 82. The OPEB expense, similar to the pension expense, appears to have been affected by the abnormal investment market conditions of the last few years. Id. However, the OPEB expense request is not nearly as egregious as the Company's pension expense request. Still, the appropriate and standard ratemaking treatment in this situation is to normalize the expense.

RELIEF REQUESTED: The Commission should approve RUCO's adjustment to decrease OPEB expense for all of the districts in the amount of $10,389. Id.

TANK MAINTENANCE RESERVE FUND ACCRUAL (SUN CITY AND ANTHEM WATER)

The Company requests an additional expense of $445,000 annually for a Tank Maintenance Reserve Fund Accrual ("TMRFA") in its Sun City Water District and has requested a Reserve Fund Accrual for the Anthem Water District. RUCO-10 at 83. A Reserve Fund Accrual is different than recording an expense as it is incurred in that the Reserve Fund Accrual results in ratepayers pre-paying for the expense. RUCO-10 at 84. There also is an element of single issue ratemaking associated with the TMRFA since it singles out the expense associated with tank painting from all of the utilities other expenses which gets tracked for dollar-for-dollar recovery. Id.

The Company made a similar request in its last rate case. The Commission, in Decision No. 71410 denied the request noting:

> … we do not believe that it is necessary or reasonable to adopt the Company's proposal for advance funding of a Reserve for Tank Maintenance at this time. Because the tank maintenance expense reserve account balance proposed by the Company is not based on known and measureable Company expenditures, we find the normalization of tank maintenance expenses proposed by Staff, which is based on a three year average of expenses for each district, to be the more reasonable alternative. Staff's normalization adjustment will therefore be adopted for each of the six water districts. Decision No. 71410 at 37.

The Commission rejected the Company's proposal in its last rate case and adopted a normalized amount based on a three-year average. Id. The Company has not made a persuasive argument or shown why the Commission should not make a similar decision here.

RELIEF REQUESTED: The Commission should approve RUCO's adjustment to remove the $445,000 additional pro forma accrual that AAWC seeks for Sun City Water to fund a Tank Maintenance Reserve as well as reject the Company's request for a Reserve Fund Accrual related for the Anthem Water District. RUCO-9 at 65.

AFFILIATED MANAGEMENT FEES

The Company has paid numerous management type fees to its affiliate American Water Works Service Company ("AWWSC"). The Company and RUCO have resolved some of the disputes that relate to the management fees. The following management fees however remain in dispute.

- RUCO's removal of the 4 percent affiliated Service Company pay increase that AAWC represents occurred in March 2009.
- RUCO's removal of AAWC's proposed 22 percent increase in employee benefits, which includes a one-year 72.92 percent increase for pensions and a 26.34 percent increase for OPEB, and assumed 4 percent increases for a number of other items, including state and federal unemployment taxes (Adjustment C-10).
- RUCO's removal of all incentive compensation expense included in the Management Fees (Adjustment C-11).
- RUCO's adjustment to the 2008 recorded pension amount to a normalized amount based on a two-year average of 2007-2008 (Adjustment C-12).

- RUCO's adjustment to the 2008 recorded OPEB amount to a normalized amount based on a two-year average of 2007-2008 (Adjustment C-13).

RUCO-10 at 90. Following is a breakdown of what remains in dispute and the relief requested.

POST-TEST-YEAR WAGE INCREASE

In the past, RUCO has agreed to post-test-year wage increases that took place shortly after the end of the test year. Id. at 92. However, given the current economic situation, Arizona's high unemployment and foreclosure rate, the size of the increases being requested in the instant case by AAWC, and the interest shown by Commissioners in the recent open meeting concerning a rate increase by UNS Gas, (Docket No. G-04024A-08-0571) RUCO has reconsidered its position on this issue. Id. At a time when unemployment is approximately 10 percent in Arizona, most private sector employees are grateful to even have a job. Even government employees are losing their jobs at an alarming rate and those who are lucky enough to keep their jobs are having their wages adjusted downward and are subject to work furloughs. Now is not the time for the Commission to be approving post-test year wage increases and placing the responsibility for those wage increases on the backs of the unemployed and others who are being forced to cut back to survive the economic downturn. RUCO is not opposing the test year wage increase but believes it is fair and reasonable to exclude recovery for the post-test-year wage increase to the Company's affiliate.

RELIEF REQUESTED: The Commission should reduce AAWC's requested operating expenses for the six districts by $89,678. The amounts for each district are shown below:

Summary of Adjustments to Management Fees - Remove 4% Post-Test Year Wage Increase

District	Anthem Water	Sun City Water	Anthem/ Agua Fria Wastewater	Sun City Wastewater	Sun City West Wastewater	Total
Adjustment	$ (17,548)	$ (22,871)	$ (23,154)	$ (14,140)	$ (11,965)	$ (89,678)

RUCO-10 at 93.

AFFILIATE MANAGEMENT FEES – REMOVAL OF 22.22 PERCENT POST-TEST-YEAR INCREASE FOR AFFILIATE EMPLOYEE BENEFITS

The Company acknowledges that a 22.22 percent increase is "larger-than-typical" but it nevertheless claims that recovery should be borne by ratepayers because it "was driven by the increase in the known and measurable pension funding obligation under ERISA requirements for 2009." A-14 at 12. Thus, the Company is attempting to justify a "larger-than-typical" increase in affiliated employee benefits on 2009 ERISA funding amounts. RUCO-10 at 93. As explained above, 2009 was a highly abnormal year for pension expense. Id.

The Company's parent company, AWWC, has also put its shareholders on notice via statements in its SEC Form 10-K, that:

> **The disruption in the capital markets** and its actual or perceived effects on particular businesses and the greater economy **also adversely affects the value of the investments held within the Company's employee benefit plan trusts. Significant declines in the value of the investments held within the Company's employee benefit plant trusts may require the Company to increase contributions to those trusts in order to meet future funding requirements if the actual asset returns do not recover these declines in value in the foreseeable future. These trends may also adversely impact** the Company's results of operations, net cash flows and financial positions, including our **shareholder's equity.** Emphasis added

(Emphasis supplied.) RUCO-10 at 93.

It should therefore not come as a surprise to the Company's shareholders that the increases in pension and other post-retirement costs as a result of reduced plan assets may not be fully recoverable from the ratepayers. Id.

The Company claims that "Arizona-American must recover all of its known and measureable pension expense, especially pension expense related to the Service Company, in order for it to recover its cost of service." A-14 at 12. However, there is no guarantee that a utility will recover all of its cost of service from ratepayers. Nor should the Company recover all of its cost if such costs would result in unreasonably high rates or it would be unfair to ratepayers. Ratepayers should not be responsible for unusually high expenses incurred outside of a test year which were the result of unprecedented market conditions. RUCO-10 at 94. This is unfair to ratepayers and will result in unreasonable rates. A reasonable and normal amount of expenses should be allowed. The Company's post-test-year 2009 pension expense, including the Service Company portion that is charged to AAWC through the affiliated Management Fee, is abnormally high in comparison with historical levels of such expense due to the unprecedented investment market conditions that were experienced. Rates based on a 2009 amount of pension expense for AAWC directly or for the affiliated Service Company should simply be rejected. Id.

For these reasons, RUCO has removed AAWC's requested 22.22 percent post-test-year increase for Service Company benefit costs. Id. An itemization of the affiliate employee benefits at issue are as follows:

See chart on next page.

Post-test-year Percentage Increases In Affiliate Employee Benefits Requested by AAWC	
Account	Percent Increase Over 2008
504100 Group Insurance	0.00%
505100 PBOP	26.34%
506100 Pension	72.92%
507100 401k	4.00%
508100 EIP	4.00%
508101 DCP	4.00%
508200 ESPP Oper AG	4.00%
685320 FUTA	4.00%
685325 FICA	4.00%
685350 SUTA	4.00%
Affiliate Employee Benefits Weighted Average Increase	22.22%

RELIEF REQUESTED: The Commission should reduce AAWC's requested operating expenses by 22.22 percent or $274,909 as summarized for each district below.

Summary of Adjustments to Management Fees - Affiliate Employee Benefits

District	Anthem Water	Sun City Water	Anthem/ Agua Fria Wastewater	Sun City Wastewater	Sun City West Wastewater	Total
Adjustment	$ (53,795)	$ (70,111)	$ (70,978)	$ (43,347)	$ (36,678)	$ (274,909)

RUCO-10 at 95.

AFFILIATE MANAGEMENT FEES – REMOVE AFFILIATE INCENTIVE COMPENSATION EXPENSE

RUCO's adjustment removes 100 percent of the identifiable incentive compensation expense included in the affiliate Management Fees for the 2008 test year. RUCO's recommendation differs from the 30 percent disallowance for incentive compensation for the Company and its affiliate approved by the Commission in Decision Nos. 71410 and 68858. Id.

at 96. It appears that the 30 percent disallowance in those cases was approved because the parties to those prior cases, which included AAWC, Staff and RUCO, did not attempt to distinguish the source of the financial trigger leading to the payment of incentive compensation, and apparently made no distinction between incentive compensation for AAWC's own employees, and the incentive compensation expense charged to AAWC for affiliated Service Company employees as part of the Management Fee. Id.

The Annual Incentive Performance ("AIP") plan in those cases indicated that, in 2008, more than 85 percent of the operating income target <u>for the entire Company</u> (meaning the parent, AWWC) had to be achieved before incentive compensation was awarded based on the corporate financial component of the Plan, although such an award could be made on the Divisional/Regional and State financial components if operating income exceeded 85 percent of the target. Id. 895-96. In addition, more than 75 percent of the <u>Corporate operating income target had to be achieved in order for any payments to be made on any components of the Plan for the entire Company.</u> Id.

Here, American Water Works' corporate financial income is only moderately influenced by AAWC's operating results and is heavily influenced by non-Arizona jurisdictional operations as well as American Water Works' non-regulated operations. Id.

Moreover, Karla O. Teasley, the President of Illinois-American Water Company has acknowledged in public testimony that her water utility (which is an affiliate of AAWC) has been denied recovery of incentive compensation expense by the regulatory authority in that jurisdiction due to the presence of a parent company financial trigger. See RUCO-10, Attachment 8. In a recent decision in West Virginia, the West Virginia Commission (while allowing utility direct incentive compensation expense) disallowed affiliate incentive compensation expense (as well as merit increases for utility employees) because such expenses were determined to be unreasonable during periods of economic hardship and high unemployment, and consequently were deemed to not meet a prudence test given the recent financial conditions and economic turmoil. See RUCO-10, Attachment RCS-8.

RUCO believes that a disallowance of 100 percent of the incentive compensation for the affiliated Service Company employees who charge AAWC via the Management Fee is appropriate because the award to Service Company employees is dependent upon the parent, AWWC corporate operating income and corporate financial targets. Id. at 98. It is inappropriate to charge AAWC's ratepayers for affiliate incentive compensation that is premised on a parent company's financial trigger whose operating income and corporate financial results are influenced by operating income of non-jurisdictional and non-regulated operations of American Water Works. Id. at 98. Arizona ratepayers should not have to pay for incentive compensation that is tied to American Water Works corporate or non-jurisdictional and non-regulated income or on non-Arizona jurisdictional operations or non-regulated operations-based financial achievements.

RELIEF REQUESTED: The Commission should reduce AAWC's requested operating expenses by $256,853 as summarized on the schedule below.

.Summary of Adjustments to Management Fees - Affiliate Incentive Compensation

District	Anthem Water	Sun City Water	Anthem/ Agua Fria Wastewater	Sun City Wastewater	Sun City West Wastewater	Total
Adjustment	$ (50,261)	$ (65,506)	$ (66,317)	$ (40,500)	$ (34,269)	$ (256,853)

RUCO-10 at 96.

AFFILIATE MANAGEMENT FEES – NORMALIZE AFFILIATE PENSION EXPENSE AND OPEB EXPENSE

This small adjustment normalizes the amount of affiliate pension expense that was included in the Management Fee charges to AAWC for the 2008 test year for the same reasons discussed above in the section concerning pension expense. The affiliate employees participate in the same AWWC pension plan (subject to eligibility restrictions) as do AAWC employees. Id. at 98 – 99.

Likewise, the OPEB adjustment normalizes the amount of OPEB expense that was included in the affiliate Management Fee charges to AAWC for the 2008 test year. The affiliate employees participate in the same AWWC OPEB plan (subject to eligibility restrictions) as do AAWC employees.

RELIEF REQUESTED: The Commission should reduce AAWC's requested operating expenses by $4,257 for affiliate pension expense as summarized on the table below (normalized expense based on the two-year average of 2007-2008):

<u>Summary of Adjustments to Management Fees - Affiliate Pension Expense</u>

District	Anthem Water	Sun City Water	Anthem/ Agua Fria Wastewater	Sun City Wastewater	Sun City West Wastewater	Total
Adjustment	$ (833)	$ (1,086)	$ (1,099)	$ (671)	$ (568)	$ (4,257)

RUCO-10 at 99. The Commission should reduce AAWC's requested operating expenses by $7,206 for affiliate OPEB expense as summarized on the table below (normalized expense based on the three-year average of 2006-2008):

<u>Summary of Adjustments to Management Fees - Affiliate OPEB Expense</u>

District	Anthem Water	Sun City Water	Anthem/ Agua Fria Wastewater	Sun City Wastewater	Sun City West Wastewater	Total
Adjustment	$ (1,410)	$ (1,838)	$ (1,860)	$ (1,136)	$ (961)	$ (7,206)

RUCO-10 at 99.

OTHER OPERATING ADJUSTMENTS:

INTEREST SYNCHRONIZATION (ALL DISTRICTS)

The interest synchronization adjustment synchronizes interest included in RUCO's tax calculation. The calculation of the interest synchronization adjustment is shown on RUCO-10, Attachments RCS-6 (for water) and RCS-7 (for wastewater). This adjustment decreases income tax expense and increases the Company's achieved operating income by a similar amount, as summarized in the below table.

Summary of Adjustments to Income Tax Expense for Interest Synchronization

District	Anthem Water	Sun City Water	Anthem/ Agua Fria Wastewater	Sun City Wastewater	Sun City West Wastewater	Total
Adjustment	$ (9,934)	$ 17,357	$ 19,177	$ (1,096)	$ (6,977)	$ 18,527

Id. at 101.

DEPRECIATION EXPENSE (SUN CITY WATER)

RUCO has reduced AAWC's proposed depreciation expense for Sun City Water by $36,961 based on applying the applicable depreciation rates to the plant adjustment. RUCO-10 at 102.

DEPRECIATION EXPENSE (AGUA FRIA WASTEWATER)

RUCO's adjustment reduces depreciation expense for Anthem/Agua Fria Wastewater by $2,853 relating to the removal of two 75-horsepower pumps that were retired from plant in service. The retirement of those pumps was covered in RUCO's rate base as shown on Ralph Smith's Attachment to his surrebuttal testimony, RCS-7 (RUCO-10), Schedule B-7. AAWC indicated in its rebuttal filing that it agreed with the removal of such pumps. Id.

DEPRECIATION EXPENSE (ANTHEM WATER)

RUCO's adjustment reflects the impact in Depreciation Expense related to a reclassification of $22,289 from Account 304300 to Account 320100, as described above, under "Other Rate Base Adjustments". Depreciation Expense for Anthem Water is increased by $1,202 as shown Ralph Smith's Attachment to his surrebuttal testimony – RUCO-10, RCS-6, Schedule C-18. Id.

DEPRECIATION EXPENSE (ANTHEM/AGUA FRIA WASTEWATER)

RUCO's adjustment reflects the impact on Depreciation Expense related to a reclassification of $487,000 from Account 354400, Structures and Improvements, to Account 355500, Power Generation Equipment, as described above, under "Other Rate Base Adjustments". Depreciation Expense for Anthem/Agua Fria Wastewater is increased by $13,392 as shown on Ralph Smith's Attachment to his surrebuttal testimony – RUCO-10, RCS-7, Schedule C-19. Id.

AAWC'S REQUEST FOR AUTHORITY TO DEFER REPLACEMENT COSTS PAID TO THE CITY OF GLENDALE IN ASSOCIATION WITH THE 99TH AVENUE INTERCEPTOR, PURSUANT TO A CITY OF GLENDALE SEWAGE TRANSPORTATION AGREEMENT ("GLENDALE AGREEMENT")

AAWC seeks authority to defer replacement costs paid to the City of Glendale in association with the 99th Avenue Interceptor, pursuant to a City of Glendale Sewage Transportation Agreement ("Glendale Agreement"). This request was presented for the first time in the Company's rebuttal's case. Id. at 103. Accordingly, RUCO has not had a sufficient opportunity to flush the matter out in its entirety. However, RUCO would not oppose the inclusion of the 2008 test year expenses associated with the project, provided the Company can identify and quantify the amounts for the test year. Transcript at 932. The Company has provided a summary of the costs associated with the interceptor. A-14, Rebuttal Exhibit MHK-1R. The summary included in the exhibit breaks out the expenses through time periods which include pre-test-year and post-test-year expenses. Again, RUCO does not oppose the expenses in the test year and believes it is the burden of the Company to separate out the test year expenses from the pre and post-test-year amounts[8].

INFRASTRUCTURE IMPROVEMENT SURCHARGE

AAWC is seeking Commission approval of a surcharge mechanism that would recover the costs of certain plant additions placed into service between permanent rate case proceedings. RUCO-17 at 3. The plant additions would include replacement mains, hydrants, meter, (including AMR replacements), services, tanks, and booster stations. AAWC also seeks to include infrastructure relocations as a selected addition that would be eligible for cost recovery under the Company-proposed surcharge. Id.

The surcharge mechanism would work as follows. The Company will analyze the qualifying assets placed into service twice a year. Id. The calculation of the actual surcharge would be based on factors that are established in AAWC's most recent rate case before the ACC. The Company would essentially calculate a required level of revenue associated with the plant additions as it would in a general rate case proceeding in order to arrive at the surcharge amount. Id. The surcharge would then be revised as needed during general rate case filings. Staff would review the Company's regular infrastructure surcharge requests within a thirty-day period and the Commission would vote on it at the following open meeting. Id. at 4. Staff's review would only be for the purpose of a check on the mechanics of the

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[8] At this point, RUCO has no way to establish the test year amounts from the information provided by the Company so late in the case.

infrastructure surcharge mechanism, and not a full prudency review of the plant assets being placed into service. Id. The prudency of the plant improvements would be determined in a future rate case proceeding.

The proposed adjustor mechanism, like the Arsenic Cost Recovery Mechanism ("ACRM") will only consider cost increases in one category of expenses and will ignore changes in revenues, cost of capital, rate base and other expense categories. Ratepayers will not enjoy the benefits of efficiencies or other potential off-sets to costs since the sole focus of the step reviews will be the costs associated with renewable energy. This is "single-issue" ratemaking and as such, the Court of Appeals in this state has recognized it is "fraught with potential abuse." See *Scates v. Arizona Corporation Commission*, 118 AZ. 531, 534, 578 P.2d 612, 615 (1978). To the extent the Commission is willing to consider such mechanisms, it should only do so under the most dire and extreme circumstances. Approving a mechanism for the recovery of expenditures for plant additions and improvements does not qualify for this extraordinary ratemaking device.

The ACRM was the result of a change in the federal law. Id. at 6. In order to comply with the new federal arsenic standard, numerous water utilities would have to expend large amounts of capital in a relatively short time to build the infrastructure in addition to the operation and maintenance costs. Id. RUCO, the Commission's Staff and the water utilities all understood the unique situation confronting the water utilities because of the new law and worked hard to come up with a cost recovery mechanism that was fair to ratepayers and allowed timely cost recovery. Id. at 7. While the ACRM raises the same concerns raised by the *Scates* Court, the mechanism became unavoidable given the change in the law and its simultaneous impact on a large number of water systems. Id.

There is no federal or state law or regulation which requires recovery of the costs of routine infrastructure improvements made in between rate cases. In Decision No. 68302, (In the Matter of Arizona Water's rate application for its Western Group, Docket No. W-01445A-04-0650, docketed on November 14, 2005), the Commission noted:

> Staff states that adjustment mechanisms have traditionally been used to mitigate the regulatory lag for volatile, very large expense items, and are useful when a commodity constitutes a utility's largest expense, such as for electric utilities where purchased power is the utility's single largest expense (Ludders at 7-8; Ludders Sb. At 6). Decision No. 68302 at 44.

At issue in the Arizona Water case was the Company's proposed continuance of an adjustor mechanism to recover the cost for power provided to Arizona Water from APS. Id. The Commission denied the Company's request noting that APS' adjustor had numerous safeguards designed to limit volatility and the evidence in that case did not support a finding that the Company's power costs were subject to such a degree of price volatility or uncertainty that it justified an adjustor mechanism. Id. at 46. The Commission further concluded, undoubtedly based in part on Staff's conclusions in that case, that consistent with numerous prior and subsequent Commission decisions:

> There is a danger of piecemeal regulation inherent in adjustment mechanisms. Because they allow automatic increases in rates without a simultaneous review of a utility's unrelated costs, adjustment mechanisms have a built-in potential of allowing a utility to increase rates based on certain isolated costs when its other costs are declining, or when overall revenues are increasing faster than costs due to customer growth. Adjustment mechanisms should therefore be used only in extraordinary circumstances to mitigate the effect of uncontrollable price volatility or uncertainty in the marketplace. Id. at 45-46.

The Commission also rejected the use of an adjustor mechanism in a recent Chaparral City Water application. Docket No. W-02113A-04-0616, Decision No. 68176 docketed September 30, 2005. In Chaparral, the Company proposed an adjustor for its purchased water and purchased power expenses that even the Commission determined were significant. Decision No. 68176 at 32-33.

> Staff does not believe that the incremental cost level or volatility associated with possible rate increases or decreases associated with the Company's water supply are significant enough to justify a purchased water adjustment mechanism in this case, and recommends denial of the Company's request. Regarding purchased sewer expense, Staff does not disagree that purchased power expense is a significant cost for Chaparral City, but points out that the issue to be considered in implementing an adjustment mechanism is not merely whether the cost is significant, but whether the incremental cost level, or volatility, associated with possible rate increases or decreases is significant. Staff asserts that future rate increases the Company projects from SRP and APS do not constitute a level of volatility great enough to warrant the need for a purchased power adjustment mechanism. In particular, Staff differentiates the possible increases in Chaparral City's purchased power expense from the volatility; of APS' constantly changing fuel and purchased power costs, which led to the Commission's recent approval of a Power Supply Adjustor for APS. Id.

The Commission agreed with Staff and RUCO that the expenses do not rise to a "...level of volatility that would justify the extraordinary ratemaking treatment..." of an adjustor mechanism. Id. at 33. The Commission concluded:

> As we stated in Decision No. 56450, there is a danger of piecemeal regulation inherent in adjustment mechanisms. Because adjustor mechanisms allow automatic increases in rates without simultaneous review of a Company's unrelated costs, an adjustment mechanism has a built-in potential of allowing a Company to increase rates based on certain isolated costs when its other costs are declining, or when overall revenues are increasing faster than costs due to customer growth. Such circumstances can result in increases to ratepayers through adjustors even when the Company's level of earnings would not warrant a rate increase, such that the utility's net income is increased outside a rate case. In addition, as we stated in Decision No. 66849 (March 19, 2004), adjustment mechanisms may also provide a disincentive for a utility to obtain the lowest possible cost commodity because the costs are simply passed through to ratepayers. For these reasons, adjustment mechanisms should be implemented only under very special circumstances. Based on the evidence in this proceeding,

> circumstances do not exist in this case to justify the risks of piecemeal regulation inherent in adjustment mechanisms, and we will not approve the Company's requests. Id.

The circumstances in this case do not warrant an adjustor mechanism. There is no evidence in the record to show that the costs in question rise to the level of volatility that it should require extraordinary ratemaking. In fact, the costs in question have not been incurred and are not even known at this point. The Company's request, if successful, would result in perhaps the most egregious abuse of an adjustor mechanism to date. The future expenses in question are routine plant costs incurred in between rate case. There is nothing extraordinary about the costs or the current situation and recovery of the costs in question should be treated no different than in any other case – the Company should seek recovery in a rate case where all of the rate case elements will be considered.

The proliferation of the number of requests for adjustor mechanisms by utilities in Arizona to recover routine expenses is alarming to the point where the Companies are now making the request without any legal basis as is the case here. Adjustor mechanisms are an exception to Arizona's constitutionally mandated fair value requirement and should only be considered under the most extraordinary circumstances. Those circumstances do not exist here and the Commission should not stretch the exception to include the types of cost under consideration. RUCO respectfully requests that the Company's request for an infrastructure improvement surcharge adjustor mechanism be denied.

RUCO'S RESPONSE TO THE LEGAL PRE-TRIAL MEMEORANDUM OF THE ANTHEM COMMUNITY COUNCIL AND COMMISSIONER PIERCE'S REQUESTS

IMMEDIATE RECOVERY OF 100% OF REFUNDS PAID TO PULTE IS NOT FAIR AND REASONABLE

The Company seeks rate base treatment of 100 percent of its March, 2008 payment of $20.2 million refund to Pulte under the Fourth Amendment to Agreement for Anthem Water/Wastewater Infrastructure Agreement dated October 8, 2007 ("Agreement or Infrastructure Agreement").[9] According to Anthem Community Council ("Council"), the inclusion of the full amount of the $20.2 million *constitutes a 36 percent increase in rate base.*[10] Moreover, Council argues that inclusion of the full refund payment in rate base results in a 100 percent increase in water rates and an 82 percent increase in wastewater rates, resulting in rate shock. Id. Council has presented two different proposals for dealing with the problem.

Council's first proposal is a legal argument which would deny AAWC any recovery of the refunds made to Pulte. Council proffers two legal arguments voiding the payments. First, Council argues that the Agreement constitutes an evidence of indebtedness subject to Commission approval under A.R.S. §§ 40-301et seq.[11] Council argues that the Agreement is void under A.R.S. §40-303 and that the repayments should be included in rate base because the Company failed to receive Commission approval to incur this "evidence of indebtedness" as required under state law. Id. at 16-18. Second, Council argues that the Agreement constitutes an unlawful line extension agreement which has also not been approved by the Commission and could not be approved because it fails to meet the requirement of A.A.C.

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[9] The agreement called for a payment of $20.2 million in March 2008 and an additional payment of $6.7 million in March 2010 or a total of $26.9 million.

[10] *See* Anthem-1, Direct Testimony of Dan L. Neidlinger at 1-4.

[11] Intervenor Anthem Community Council's Pre-Hearing Memorandum on Disputed Refund Payment Issue at 23.

R14-2-406. Id. at 18-27. Therefore, Council argues that the Commission should deny all rate base treatment for the Pulte repayments. Id. at 26.

In the alternative, Council's second proposal is an accounting approach that involves an alternative ratemaking treatment of the refunds. The alternative ratemaking treatment being offered by Council's consultant, Mr. Dan Neidlinger, involves removing the net water and wastewater plant (i.e. gross utility plant less accumulated depreciation) associated with the 2008 and 2010 refunds from plant in service and then parking the net plant into a separate "plant held for future use" account. The net plant would then be ratably transferred to plant in service over a five year period. Under Mr. Neidlinger's proposal, AAWC would not earn a return on or a return of the net plant (through annual depreciation expense) until it is ratably transferred to AAWC's plant in service account.

Commissioner Pierce has requested that the parties comment on whether the Infrastructure Agreement with Pulte is evidence of indebtedness and subject to the provisions of A.R.S. §§ 40-301 et seq. or whether the agreement is a main line extension agreement subject to the terms of A.A.C. R14-2-406. In response to Commissioner Pierce's inquiry and Council's Pre-Hearing Memorandum, RUCO provides the following analysis.

On its face, the Agreement appears to with the purpose of a main line extension agreement within the meaning of A.A.C. R14-2-406 which applies to water utilities. Clearly, the intent of the Agreement was to address repayment to Pulte for Anthem's water and wastewater infrastructure. However, as pointed out by Council, the Agreement requires approval by the Utilities Division.[12] The Utilities Division has not approved the Agreement.

As also pointed out by Council, the Infrastructure Agreement does not meet the standards of A.A.C R14-2-406. The rule requires refund of advances "in a minimum amount equal to 10% of the total gross annual revenue from water sales to each bona fide consumer whose service line is connected to main lines covered by the main extension agreement, for a period of not less than 10 years." The Commission has a similar rule which applies to repayment of advances made for the improvement of sewer line.[13]

The fact that the Agreement does not meet the requirements of a Main Extension Agreement under A.A.C R14-2-406 was recognized by the Commission when the Company's predecessor first sought Commission approval. In 2002, when the Company was owned by Citizens, it sought approval of the original agreement and Amendments One and Two. At that time, the Staff recommended as follows:

> "The agreement includes unequal refunding structure, cost caps, priority services, and penalties that may not be in line with this Commission's standards...Staff does not recommend the Commission consider approval of the Infrastructure Agreement and its amendments....The Commission protects its rights to set rates and conditions it deems necessary to protect public interests by declining to approve this infrastructure agreement. <u>This agreement is a private contract and, as such, does not require Commission approval or denial</u>....Staff further recommends that the Commission take no action on the Anthem water/wastewater infrastructure agreement and its amendments. Staff believes that Commission approval is not necessary. "[14]

After review of the Staff report, the Commission issued Decision No. 64897 holding:

> "There are other reasons for declining to approve the Infrastructure Agreement in this proceeding. <u>Staff points out that the Agreement is a private contract between the Companies and a third party developer that contains "unequal refunding structures, costs caps, priority service, and standards (Staff Report at 30). According to Staff, the Infrastructure Agreement does not require the Commission's approval</u> and, by not making a determination regarding the Agreement,

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[12] A.A.C. R14-2-406(M).
[13] A.A.C. R14-2-606 which calls for an initial 5 year repayment period subject to Commission approval of a longer period of repayment
[14] Staff Report at page 3, lines 7-28.

> the Commission 'protects its rights to set rates and conditions it deems necessary to protect public interest'"[15]

From RUCO's perspective, for the reasons cited in Decision No. 64897, the Agreement does not meet the requirements for a Main Extension Agreement under A.A.C R14-2-406 and does not require Commission approval under the Commission's Rule.

The status of the Agreement under A.R.S. §40-301 is less clear. A.R.S. §40-301 provides in pertinent part:

> A. the power of public service corporations to issue...evidences of indebtedness, ...is a special privilege, <u>the right of supervision, restriction and control of which is vested in the state, and such power shall be exercised as provided by law and under rules, regulations and orders of the commission.</u>
>
> B public service corporation may issue...evidence of indebtedness payable at periods of more than twelve months after the date thereof, <u>only when authorized by and order of the commission</u>. (Emphasis added)

Pursuant to A.R.S. § 40-301, all evidence of indebtedness requiring repayment of periods of more than 12 months are subject to prior Commission review and approval. RUCO agrees that the Infrastructure Agreement includes "evidence of indebtedness" from which the Commission could conclude the Agreement is subject to the provisions of A.R.S. §§40-301. A straight –forward common sense interpretation of the Agreement reveals an instrument whose purpose was to, among other things, prescribe payment of advances and refund obligations among the contracting parties. The relevant period in question exceeded 12 months and therefore the Agreement appears to fall under the provisions of A.R.S. §§40-301.

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[15] In the Matter of Citizen's, Docket Nos. WS-03454A-00-1022, WS-03455A-00-1022, and WS-01032A-00-1022.

While on its face, the Agreement appears to require Commission approval, what is far less clear is whether the Commission, through its actions has in fact given its approval. The Council argues that the Commission has not given approval. There is no Commission Decision specifically approving the Agreement. On the contrary, the excerpt cited above shows that the Commission has explicitly not given its approval. However, the evidence is undisputed that the Commission has approved the Company's recovery through rates of all prior refunds made by the Company. At the very least RUCO recognizes that a possible laches or other legal argument can be made asserting that the Commission has approved the Agreement through its actions. The Commission has sent the message, by allowing the Company to recover prior refunds that the Commission approves of the Company recovering the past refunds it paid. It would be unfair, even if legal, at this point to deny the Company recovery of the pending request or to go back in time and void the recovery of past payments made.

What is now before the Commission is a private Agreement that may or may not have been approved by the Commission. From RUCO's standpoint, whether the Agreement is an evidence of indebtedness or a main extension agreement is really academic at this point. The right and fair thing here is to allow the Company to recover the refunds it made. These infrastructure costs are legitimate costs of service, and the Company should be able to recover its legitimate costs. How the Company recovers its costs, however, is within the Commission's discretion and RUCO believes the Commission would be better off concentrating on this aspect of the question.

The Company claims that it is genuinely concerned with the impact a rate increase will have on its customers and towards that end has made every effort to keep costs down and will do any thing it can within reason to assist its customers in absorbing another rate increase. RUCO has developed an alternative approach for recovery that will not only make the

Company whole, but will lessen the burden on the Company's ratepayers and resolve the matter completely. RUCO makes this suggestion with the hope that the Company is truly sincere about its desire to lessen the ratepayer's burden and will acquiesce to RUCO's proposal,

RUCO's proposal is patterned on the standard ratemaking treatment for advances in aid of construction ("AIAC"). Under RUCO's recommended alternative ratemaking treatment, nine-tenths of the total amount of water and wastewater refunds made to Pulte during 2008 and 2010 would be treated as deductions from the Anthem District's water and wastewater rate bases at the conclusion of this proceeding. AAWC would earn a return on one-tenth of the refund until it files a future rate case application. At that time the amount of the original deduction to rate base would be reduced at a rate of one-tenth per year for each of the years between the time that rates go into effect in this proceeding, and the end of the test year in AAWC's next rate case filing.

Over the period of time between rate cases, the Company would continue to recover the cost of the plant associated with the refunds through annual depreciation expense – just as it would through a standard AIAC arrangement. However it would only earn a return on the amount of the refund included in rate base (initially one-tenth of the total refund amount at the end of this proceeding).

In the next rate case, AAWC would not only be permitted to earn a return on a larger rate base (as a result of the lower deduction associated with the Pulte refunds) but would also be permitted to recover lost operating income in order to make the Company whole. Under RUCO's recommended alternative ratemaking treatment, AAWC would be permitted to recover the difference between the operating income that it received on the original one-tenth of the refund included in rate base (at the end of this proceeding), and the amount of forgone operating income that it would have received between rate cases had the entire amount of the Pulte refunds been included in rate base.

This amount of forgone operating income would be amortized over a three-year period and would be recovered on a dollar-for-dollar basis as an operating expense. The process would continue in subsequent future rate cases until the full amount of the deduction to rate base associated with the Pulte refunds has been reduced to zero (in a ten-year period), and the full amount of forgone operating income associated with the Pulte refunds is recovered through rates (approximately thirteen to fourteen years depending on the frequency of future rate case filings by AAWC).

The attached schedules (Exhibit 1) show that the application of RUCO's recommended alternative ratemaking treatment would result in a percentage increase over current rates for the Council Water District of 59.43 percent as opposed to the percentage increase of 73.35 percent recommended by RUCO in its final schedules filed on June 24, 2010 or the 100 percent requested by the Company. In regard to the Council Wastewater District, the application of RUCO's recommended alternative ratemaking treatment would result in a percentage increase over current rates of 54.13 percent as opposed to the percentage increase of 58.41 percent increase displayed in RUCO's final schedules or the 82 percent requested by the Company.

Based on the foregoing, and to mitigate rate shock, RUCO requests that the Commission deny the Company's request for immediate recovery of 100 percent of the reimbursement payments made to Pulte. Instead, RUCO requests that the Company and parties acquiesce to its alternative proposal which meets the intent of the Commission's equal payment structure, the interests of gradualism and rate continuity and at the same time makes the Company whole over a definitive period of time.

COST OF CAPITAL

SUMMARY OF THE PARTIES' POSITIONS

RUCO recommends an overall weighted average cost of capital ("WACC") 6.77 percent for AAWC based on a cost of long-term debt of 5.47 percent, a cost of short-term debt of 3.41 percent and a cost of equity capital of 9.5 percent. R-3 at 6-7. The Company has abandoned its position on the weighted average cost of capital and adopted the Staff's position. A-7.

There is very little difference between RUCO's and Staff's positions on capital structure and the cost of debt. R-4 at 3-9. Staff has combined the Company's long and short term debt and determined a capital structure of short and long-term debt of 61.47 percent and common equity of 38.86 percent as compared to RUCO's recommendation of a blanket capital structure, for each of the five districts included in the Company's filing, comprised of approximately 13.29 percent short-term debt, 47.56 percent long-term debt and 39.15 percent common equity. Id. The Staff's cost of debt based on a combined short and long term debt is 4.91 percent. Id. If RUCO combined its long and short term debt, its cost of debt would be 5.02 percent or 11 basis points higher than the cost of debt recommended by Staff. Id.

The only significant point of disagreement between RUCO and Staff is that Staff has estimated the Company's cost of equity at 10.70 percent and RUCO estimated the Company's cost of equity at 9.5 percent. As a result of the variances in their cost of equity analysis, the Staff is recommending a weighted average cost of capital of 7.2 percent and RUCO is recommending 6.77 percent.

RUCO'S COST OF EQUITY IS HIGHER THAN VALUE LINE'S PROJECTIONS FOR THE COMPANY'S PARENT.

The Company's witness, Dr. Villadsen, complained that RUCO's recommended cost of common equity is too low to attract investors during a period of turbulence in the financial markets. RUCO's cost of equity is not too low. As Mr. Rigsby testified, his 9.50 percent estimate for a return on common equity for AAWC looks very attractive to investors. Id. at 7-8. He testified that as of January 22, 2010, Value Line's analysts projected a long-term (i.e. the 2012-2014 time frame) 8.00 percent return on book common equity for the water utility industry as a whole. Id. At that same time, Value Line projected a long-term return on common equity for American Water Works, the parent company of AAWC, of 6.00 percent. Id. RUCO's recommended 9.50 percent cost of common equity is 350 basis points higher than Value Line's long-term projection for the Company's parent and 150 basis points higher than Value Line's long-term projection for the industry as a whole. Considering Value Line's projections, RUCO's estimates of the cost of equity are not low.

Dr. Villadsen also argued that investors are more wary of water company stocks, which have been traditionally viewed as safe investments, during periods of financial uncertainty and necessitates a higher return on equity. As Mr. Rigsby also testified, the investment community doesn't seem to view AAWC's parent in that light. Id. American Water Work's stock price has experienced a definite upward trend over the past year. AAWC's parent company increased in value from $17.33 per share on April 23, 2009, to 21.48 per share on April 13, 2010, which is higher than Aqua America's price per share of $17.97. Id. If anything, there clearly appears to be a demand for American Water Works shares despite the recent economic climate. In fact, as RUCO's witness, Ralph Smith testified, the investment recommendation from Hilliard Lyons, issued as recently as February 16, 2010, reflects their recommendation that American Water Works is a buy, and cites its attractive features, including industry consolidation and the fact that American Water works is the biggest player in the space, and has a monopoly-like status with the unregulated leverage to grow earning.[16] Accordingly, Dr. Villadsen's theory is unsupported by the market data admitted to the record herein.

Dr. Villadsen also argues that water utilities are riskier despite the fact that their betas are falling. Dr. Villadsen's assertion directly conflicts with her testimony in prior cases in which she asserted that water utility stocks were riskier as evidenced by the fact that their betas, which measure a security's risk in relation to the market as a whole, were increasing. R-4 at 7-8.33. In order to adopt Dr. Villadsen's most recent assertions that water utilities are riskier now, given the fact that their betas are falling, would require the Commission to turn on its head the long supported reasoning that lower betas indicate lower risk in relation to the market as a whole.

RUCO'S DISCOUNTED CASH FLOW ("DCF") ESTIMATES OF EXTERNAL GROWTH ARE REASONABLE.

Dr. Villadsen criticizes RUCO's DCF estimates of external growth arguing that they are biased downward. As Mr. Rigsby testified, the calculation for external growth takes into consideration the fact that, the market value of a utility's stock will tend to move toward book value, or a market-to-book ratio of 1.0, if regulators allow a rate of return that is equal to the cost of capital of firms with similar risk. Id. at 8-11. RUCO's assumption in its DCF analysis mirrors the analysis of Mr. Stephen Hill, ACC Staff's cost of capital witness in the Southwest Gas rate case proceeding.[17] See also *In the Matter of Southwest Gas*, Docket No. G-01551A-04-0876. Mr. Hill used the same methods as RUCO to arrive at the inputs for his DCF model. His final recommendation for Southwest Gas Corporation, which was adopted by the Commission, was largely based on the results of his DCF analysis, which incorporated the

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[16] T: 998. *See also* Exhibit R-11, Summary of Hillard and Lyon's Buy Recommendation
[17] See also *In the Matter of Southwest Gas*, Docket No. G-01551A-04-0876.

same valid market-to-book ratio assumption that RUCO has consistently used in cases before the Commission. Id. This premise is also recognized among practitioners who have testified in cost of capital proceedings. Id. (namely Willard T. Carleton and Roger A. Morin).

Moreover, as Mr. Rigsby also testified, each of the other utilities included in RUCO's sample, are engaged in unregulated activities to some degree. Id. Because it is difficult to obtain a sample comprised only of "pure play" utilities, the calculation that RUCO used in its DCF model helps to eliminate the impact that those unregulated operating segments would have on the market-to-book ratio of the utilities included in its sample.

RUCO'S RECOMMENDED COST OF EQUITY IS NOT BELOW THE CURRENT YIELDS ON A-RATED AND BAA/BBB-RATED DEBT INSTRUMENTS FOR UTILITIES.

RUCO also used a Capital Asset Pricing Model ("CAPM") to estimate the cost of equity. RUCO completed its CAPM analysis using a geometric mean to calculate the risk premium resulted in an average expected return of 5.90 percent for the water companies and 5.24 percent for the natural gas LDCs. Id. at 11-12. _See also_ Value Line Selected Yield dated July 16, 2010 (Exhibit 2) RUCO's CAPM calculation using an arithmetic mean resulted in an average expected return of 7.46 percent for the water companies and 6.52 percent for the natural gas LDCs. Dr. Villadsen argues that RUCO's overall CAPM results are below the current yields on Baa/BBB debt instruments. First, RUCO is not recommending that the Commission adopt its CAPM results. RUCO is recommending that the Commission adopt its cost of common equity of 9.50 percent, which is 374 to 424 basis points over the most recent yields of 5.24 percent to 5.74 percent for A-rated utility and Baa/BBB-rated bonds, respectively. Id. Second, with the exception of its CAPM calculation using a geometric mean to calculate the risk premium for natural gas LDS's, all of RUCO's CAPM results exceed the current 5.26-5.76 yield on A-rated and Baa/BBB-rated bonds, respectively.

RUCO USED THE APPROPRIATE PROXY FOR A RISK-FREE RATE IN ITS CAPM MODEL.

Dr. Villadsen complains that RUCO did not use the appropriate proxy for a risk-free rate in its CAPM model. RUCO used an appropriate Treasury instrument to calculate the risk premium in my CAPM model for regulatory purposes. As Mr. Rigsby testified, RUCO used the life of a 5-year treasury instrument which closely matches the three to five year time frame in which utilities, such as AAWC, apply for rates. Id. at 12.

RUCO DID NOT ERR IN RELYING ON A GEOMETRIC MEAN IN ITS CAPM ANALYSIS.

Dr. Villadsen argues that RUCO inappropriately relied on geometric means in its CAPM analyses. As Mr. Rigsby testified, there is an on-going debate over which is the better average upon which to rely. Id. at 12-14. The use of geometric mean is the industry standard. Mr. Rigsby testified that geometric means are published in Morningstar stocks, bonds, bills and inflation text and testified that analysts rely on geometric means to calculate a market risk premium. Id. Mr. Rigsby further testified that Value Line analysts use geometric means. Id. Although Staff did not use a geometric mean in this case, it has in the past. As reflected in RUCO's testimony, Mr. Parcell, Staff's cost of capital witness in a recent Arizona water case, testified that he uses both geometric and arithmetic means in his testimony. Id. Mr. Parcell further testified that Value Line calculates both historic and prospective growth rates on a geometric or compound growth rate basis. Id. Moreover, *In the matter of UNS Gas*, the Commission concluded:

> *We agree with the Staff and RUCO witnesses that it is appropriate to consider the geometric returns in calculating a comparable company CAPM because to do otherwise would fail to give recognition to the fact that many*

investors have access to such information for purposes of making investment decisions.[18] Id.

Further, recent empirical research also supports RUCO's market risk premium. Id. Mr. Rigsby testified that empirical studies performed by Aswarth Damdaran and Felicia C. Marston, professors of finance from New York University and the University of Virginia, respectively, indicate that market risk premiums in excess of 4.5 to 5.5 percent are overstated. Id. Indeed, Mr. Rigsby attached the text: Valuation: Measuring and managing the Value of Companies, 4th Edition, Id. which states:

> Although many in the finance profession disagree about how to measure the market risk premium, we believe 4.5-5.5 percent is an appropriate range. Historical estimates found in most textbooks (and locked in the mind of many), which often report numbers near 8 percent, are too high for valuation purposes because they compare the market risk premium versus short-term bonds, use 75 years of data, and are biased by the historical strength of the U.S. market. Id.

The Company adopted Staff's risk premia. Staff's risk premium using an arithmetic mean and historic and current market risk premium is 6.9 percent and 7.97 percent, respectively. Id. RUCO's historic risk premium using both an arithmetic and geometric means ranges between 4.20 percent and 6.10 percent. The average of Mr. Rigsby's geometric and arithmetic mean, 5.10 percent, falls in the range identified as reasonable by recent empirical research. The Company has adopted the Staff's range. The Staff's risk premium range between 6.9 to 7.97 percent with an average of 7.44 percent, which is outside the range identified as reasonable by recent empirical research.

Moreover, one of the best arguments in favor of the geometric mean is that it provides a truer picture of the effects of compounding the value of an investment when return variability

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[18] *See also In the Matter of UNS Gas*, Decision No. 70011.

exists. This is particularly relevant in the case of the return on the stock market, which has had its share of ups and downs over the 1926 to 2008 observation period used in RUCO's CAPM analysis.

Last, the use of both *arithmetic and geometric means* is the industry standard. In the third edition of their book, Valuation: Measuring and Managing the Value of Companies, authors Tom Copeland, Tim Koller and Jack Murrin ("CKM") make the point that, while the arithmetic mean has been regarded as being more forward-looking in determining market risk premiums, a true market risk premium may lie somewhere between the arithmetic and geometric averages published in Morningstar's SBBI yearbook. As the authors explain, in order to believe that the results produced by the arithmetic mean are appropriate, one has to believe that each return possibility included in the calculation is an independent draw. Id. However, research conducted by CKM demonstrates that year-to-year returns are not independent and are actually auto correlated (i.e. a relationship that exists between two or more returns, such that when one return changes, the other, or others, also change), meaning that the arithmetic mean has less credence. Id.

CKM also explains, and Mr. Rigsby testified, that there are two other factors that would make the Morningstar arithmetic mean too high. Id. The first factor deals with the holding period. The arithmetic mean depends on the length of the holding period and there is no "law" that says that holding periods of one year are the "correct" measure. When longer periods (e.g. 2 years, 3 years etc.) are observed, the arithmetic mean drops about 100 basis points. The second factor deals with a situation known as survivor bias.

According to Mr. Rigsby's cited authority, CKM, this is a well-documented problem with the Morningstar historical return series in that it only measures the returns of successful firms. Id. That is, those firms that are listed on stock exchanges. The Morningstar historical return series does not measure the failures, of which there are many. Therefore, the return expectations in the future are likely to be lower than the Morningstar historical averages.

RECENT EVENTS ALSO SUPPORT RUCO'S LOWER WEIGHTED AVERAGE COST OF CAPITAL.

The rate of Company's debt issuances has lowered significantly and should be for the purposes of determining cost of short term debt.

The Company's assertion that RUCO's recommended weighted average cost of capital is too low is undermined by its recent debt issuances. The Company's parent continues to issue debt at historically low rates. In its most recent 10-K filing, the Company's parent issued debt at 0.39 percent as of December, 2009.[19] RUCO's 6.77 percent weighted average cost of capital is based on a cost of debt of 3.41 percent for short-term debt or 302 basis points. Clearly, had RUCO incorporated the 0.39 percent rate at which the Company is actually issuing debt, RUCO's recommended weighted average cost of capital would have fallen 40 basis points, from 6.77 percent to 6.37 percent, as reflected by the analysis below:

WEIGHTED AVERAGE COST OF CAPITAL - WATER AND WASTEWATER DISTRICTS

LINE NO.	DESCRIPTION	(A) DOLLAR AMOUNT	(B) RUCO ADJUSTMENT	(C) RUCO ADJUSTED	(D) CAPITAL RATIO	(E) WEIGHTED COST RATE	COST RATE
1	Short-Term Debt	$ 52,584,000	$ -	$ 52,584,000	13.29%	0.39%	0.05%
2	Long-Term Debt	188,208,140	-	188,208,140	47.56%	5.47%	2.60%
3	Common Equity	154,949,595	-	154,949,595	39.15%	9.50%	3.72%
4	Total Capitalization	$ 395,741,735	$ -	$ 395,741,735	100.00%		
5	**WEIGHTED AVERAGE COST OF CAPITAL**						6.37%

[19] *Id. See also* Exhibit R-5, 2009 Annual Report of American Water Works.

RECENT ACTIONS OF THE FEDERAL RESERVE SUPPORT RUCO'S WACC.

RUCO's position on weighted average cost of capital is supported by the recent rulings of the Federal Reserve. On March 16, 2010, the Federal Reserve decided not to increase or decrease the federal funds rate and kept it between zero and 0.25 percent. According to the minutes to the Federal Open Market Committee's meeting, the Fed affirmed its plan to keep interest rates "exceptionally low" for a long time, as evidenced in this excerpt:

> The Committee will maintain the target range for the federal funds rate at 0 to ¼ percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period. To provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets, the Federal Reserve has been purchasing $1.25 trillion of agency mortgage backed securities and about $175 billion of agency debt; those purchases are nearing completion, and the remaining transactions will be executed by the end of this month. The Committee will continue to monitor the economic outlook and financial developments and will employ its policy tools as necessary to promote economic recovery and price stability. Id at 6.[20]

MR. PUHR'S ESTIMATED WACC SUPPORTS RUCO'S ANALYSIS.

Last, Anthem resident, and Certified Investment Management Analyst, Steven Puhr, submitted public comment reflecting his estimate of a 5.23 percent weighted average cost of capital (Exhibit 3). Although Mr. Puhr is not an intervenor or witness to this proceeding, his public comment deserves some scrutiny because of his expertise as a financial analyst. Mr. Puhr's analysis provides more support for the reasonableness of RUCO's analysis.

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[20] Minutes of the Federal Open Market Committee meeting held on March 16, 2010 http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20100316.pdf

For all of the foregoing reasons, RUCO requests that the Commission adopt its WACC of 6.67 percent and reject Staff's and the Company's proposal of 7.2 percent.

RELIEF REQUESTED: RUCO recommends the Commission adopt its recommended cost of equity of 9.50 percent and weighted average cost of capital of 6.77%. The Company and Staff's proposed cost of equity of 10.70% is unreasonably high and not warranted under the circumstances. Likewise, Staff and the Company's weighted average cost of capital recommendation of 7.20% should also be rejected.

RATE DESIGN

RATE CONSOLIDATION

The issue of rate consolidation is perhaps the most contentious issue in this case. RUCO believes that cost of service ratemaking should be the presumptive rule for the Commission. RUCO-14 at 5. Only when the Commission can identify case-specific public policies in support of rate consolidation should it approve a rate design that deviates from cost of service. Id. In this case, for the following reasons, the law and public policy does not support rate consolidation.

RATE CONSOLIDATION WOULD BE ILLEGAL IN THIS CASE

For purposes of rate consolidation in this case, the Commission will be considering all of the Company's water and wastewater districts. From the total of fifteen districts, the Commission has already determined the fair value revenue requirement for each of the seven districts using a 2007 test year in Decision No. 71410 (Agua Fria Water District, Havasu Water District, Mohave Water District, Paradise Valley Water District, Sun City West Water District, Tubac Water District, and the Mohave Wastewater District).

The Commission did not decide the consolidation issue in Decision No. 71410. The Commission determined the following:

> We believe that the issue of consolidation merits thorough vetting, discussion and public participation. In the instant proceeding, parties have argued that further development of the issue is needed. Accordingly, we find it reasonable to defer this issue in the instant rate case but keep this docket open for the limited purpose of consolidation discussion.
>
> While the Commission will defer addressing consolidation in the instant case, we believe this issue is of critical importance and that unnecessary delay does not allow customers to benefit from administrative expediency, economies of scale and other efficiencies which would otherwise occur through consolidation. Accordingly, we will require Commission Staff to propose at least one consolidation proposal in the Company's next rate case which will allow parties and the public ample opportunity to have notice of this issue and participate in that discussion. We also believe the company should commence a dialogue with its customers as soon as practicable, and will require it to initiate town hall-style meetings in all of its service territories to begin communicating with consumers the various impacts of system consolidation in each of those service territories and to collect feed-back from consumers on such consolidation.

Decision No. 71410 at 51.

The current case requests rate increases for the Company's remaining five districts using a 2008 test year. These districts are the Anthem Water District, Sun City Water District, Anthem/Agua Fria Water District, Sun City Wastewater, and Sun City West Wastewater. In short, consolidating rates for all or part of the systems in both cases, using different test years and different revenue requirements would render the fair value requirement meaningless since ultimately the Commission would be applying revenue requirements to different test years.

Consolidation should be a rate design issue. The problem with using two different test years and then applying a consolidated rate design is that consolidation not only consolidates rates, but it consolidates the fair value rate bases of the two cases and it also consolidates the fair value rates of return for the two cases.

To consolidate rates using two different test years, different cost of equity, different WACCs and different cost of debt conflicts with the constitutional requirement to set rates based on the fair value of the utility's property—not the average of different fair value findings. For to do so, renders the fair value determination in both cases meaningless.

The Arizona Constitution charges the Commission to "ascertain the fair value of the property" of a utility when setting rates. (Ariz. Const. Art. XV, § 14). RUCO-14 at 9. There is no way around it; the Commission must ascertain the fair value of the Company's property. As our Supreme Court said: "It is clear, therefore, that under our constitution as interpreted by this court, the Commission is required to find the fair value of the Company's property and use such finding as a rate base for the purpose of calculating what are just and reasonable rates." *Simms v. Round Valley Light and Power Company*, 90 AZ 145, 149, 294 P.2d. 378, 382 (1956). The Supreme Court in Simms also said: "While our constitution does not establish a formula for arriving at fair value, it does require such value to be found and used as the base in fixing rates." Id. While there may be no formula for finding fair value, the Commission has broad authority in this calculation, provided the Commission does not make the calculation in such a way as to render the fair value finding meaningless. The situation here poses a factual situation of first impression. The result, however, of revenue requirements based on different test years would render a fair value finding meaningless.

The Commission's Rules define the filing requirements in support of a utility's rate application. Arizona Administrative Code ("A.A.C.") R14-2-103 et al. Among those requirements, a utility must choose a test year. A test year is defined as "the one-year historical period used in determining rate base, operating income and rate of return. RUCO-14 at 9. The end of the test year shall be the most recent practical date available prior to the filing." (A.A.C. R14-2-103(A)(p). The test year is used in ascertaining a utility's revenue requirement.

The present situation has not occurred in the past, since every time the Commission has approved rate consolidation all the affected systems were before the Commission at the same time had the same test year. When the Commission approved consolidated rates upon the merger of Bella Vista Water and Nicksville Water, the application brought both systems before the Commission using the same test year. (Decision No. 61730). Id. at 10. The Applicant in that case did not or could not pick one test year for one system and a more favorable test year for the other system.

In the most recent Arizona-American rate case, Decision No. 71410, the Commission approved a weighted average cost of capitol of 7.33 percent, a cost of equity of 9.9 percent a cost of debt of 5.46 percent for the districts that are not currently before it in this docket. Id. The record in this case presents completely different evidence regarding rate making elements. Furthermore, Decision No. 71410 made several operating income adjustments to all of the districts before it at that time including labor expense, waste disposal expense, achievement incentive pay, water testing, tank maintenance, meter depreciation and rate case expense. Id. It is not known whether the Commission will make the same adjustments in this case and to the same degree as in the last case.

To the extent there is guidance by the Arizona courts regarding this issue, the Arizona Court of Appeals' decision in *Scates v. ACC*, 118 Ariz. 531, 578 P.2d. 612 (App. 1978) is to some degree instructive. In *Scates*, the Commission approved charges for 64 percent of costs for Mountain States Telephone when it already had approved rates covering 41 percent of the Company's costs in a proceeding 10 months earlier. *Scates* at 533, 578 P.2d. at 614. The crux of Scates is that the Commission failed to examine the Company's financial condition when approving the subsequent tariffs for the remaining 64 percent of the utility's costs. Id. That is not the case here. However, the *Scates* court noted, "...such piecemeal approach is fraught with potential abuse. Such a practice must inevitably serve both as an incentive for utilities to seek rate increases each time costs in a particular area rise, and as a disincentive for achieving countervailing economies on the same or other areas of their operations." (*Scates* at 534, 578 P.2d. 613).

The concern raised in *Scates* is equally applicable here - if Arizona-American had used a 2007 test year for the Anthem and Sun City water systems and the Sun City, Sun City West and Agua Fria wastewater systems instead of its 2008 test year, then all the systems would have been placed before the Commission on the same footing. RUCO-14 at 11. The rate base, revenues and expenses all would have been reflective of the same time period as the other districts in question were. Furthermore, the time delay between the findings regarding WACC, ROE, debt and operating income adjustments in Decision No. 71410 and the current rate case may result in new economic or marketplace forces that compel the Commission to make findings for these ratemaking elements that differ from those made in its earlier Decision. Id. There is no matching of these integral rate case elements and in the end what is left is a revenue requirement that is based on an arbitrary fair value finding. The Commission should reject rate consolidation in this case.

RUCO further finds rate consolidation unlawful because the Company has failed to comply with Commission Rule that requires the Company to select a single test year (AAC R14-2-103(A)(3)(p)).

Finally, setting aside the legal infirmities of rate consolidation in this case, RUCO believes that allowing a utility to set rates using two test years will result in much mischief in the future. If consolidation can occur using two test years, why not three test years or even more.

RATE CONSOLIDATION WOULD NOT BE IN THE PUBLIC INTEREST IN THIS CASE

There are several reasons why rate consolidation would not be in the public interest in this case.

REVENUE NEUTRALITY

First, RUCO believes that the consolidation proposals under consideration in this case are inconsistent with what the Commission decided in Decision No. 71410. The Commission, in Decision No. 71410 stated,

> "This docket should remain open for the limited purpose of consolidation in the Company's next rate case with a separate docket in which a revenue neutral change to rate design **<u>of all the Company's water districts</u>** or other appropriate proposals ...may be considered."

Emphasis added, Decision No. 71410 at 71-72.

This language implies a consolidation proposal that is revenue neutral for each of the Company's water districts. If the Commission had intended this requirement to apply Company-wide, it would have made clear that the revenue neutrality requirement applied to the *Company's* revenue requirement and ***not*** to the requirement "of *all* the Company's water *districts*". RUCO-14 at 12. Until that happens, the language speaks for itself and as far as consolidation goes, each individual system should be revenue neutral.

Given that each system must retain its individual revenue requirement as per Decision No. 71410, it is mathematically impossible to create a consolidated rate design for all the water districts and maintain revenue neutrality. Id.

RATEPAYER OPPOSITION TO RATE CONSOLIDATION

Second, there has been an extraordinary amount of response from the public on the issue of consolidation. All totaled, RUCO has received more correspondence opposed to consolidation than in favor of consolidation. Not surprisingly, most of the opposition has been from the ratepayers in the Sun City system. When the Commission held a public comment meeting in Sun City, over 1,200 ratepayers appeared unanimously voicing their disapproval of consolidation. Transcript at 1096. When the Commission held a public meeting at Anthem, Sun City residents traveled all the way across the Valley in order to attend and to voice their opposition to rate consolidation. Id. at 12-13. Clearly, the Sun City ratepayers strongly object to subsidizing Anthem's costs. Id.

At the Anthem public comment meeting, Anthem residents strongly opposed the Company's proposed rate increase. But there were very few comments about rate consolidation. Most customers asked the Commission to deny recovery of the Pulte "balloon" payment. From the public comment meeting, RUCO was also left with the impression that many of Anthem's ratepayers may even be unsupportive of the general concept of rate consolidation, since many Anthem residents voiced their objection to their wastewater system being consolidated with the Agua Fria wastewater system. Id. They clearly did not like the fact a portion of the Northwest Treatment Facility is included in their wastewater rates when Anthem is not connected to that wastewater treatment plant. That plant, located within the boundaries of the Sun City West system, provides service to Agua Fria residents. Id. However, after RUCO filed its testimony noting its impression of the Anthem public comment meeting, RUCO has received many letters and emails in strong support for rate consolidation.

At the hearing, RUCO was critical of the quality of information the Company provided to all ratepayers regarding the impact of rate consolidation. At least in terms of notice, the

Anthem Community Council claims that it has received requisite public notice. Transcript at 1064. However, for example, the Company has revealed that it expects to spend approximately $25 million in plant and improvements in the Sun City district over the next five years. From the evidence in this record, it does not appear that the Company has adequately informed neither the people of Sun City or of Anthem of this fact. The Sun City ratepayers oppose rate consolidation because it will result in higher rates to offset the impact of the Anthem rate increase. If the people of Sun City are aware of the expenses that the Company expects to incur over the next five years on the infrastructure related to their systems, consolidation may appear more favorable to them. On the other hand, if the Anthem ratepayers are informed of the anticipated expenses related to Sun City's infrastructure improvements over the next five years, a portion of which they would have to bear, then the Anthem ratepayers may not see consolidation as favorable.

The unfortunate reality of this case is that it pits one group of ratepayers against another. Contrary to what the Company asserts, now **is not the best time** to approve rate consolidation for this company. RUCO's witness on the consolidation issue, Jodi Jerich, said it best:

> Frankly, RUCO believes this is the worst time to consolidate rates because we have so many problems associated with this case. If you just take a look, you have Staff opposing consolidation, RUCO opposing rate consolidation. I'm a little bit confused about the Company, but I thought the Company was opposing consolidation at one point. Many intervenors are formally opposing rate consolidation. There are rate ratepayers who are not -- who have not intervened in this case but we have heard in public comment meetings that they oppose rate consolidation.
>
> There is very bad timing here because just a few months ago most of Arizona-American's water systems just got a rate increase. Some districts had rate increases that went up as high as 66 percent, and those were increases based on their own cost of service. And now some of those districts are going to be asked to have an increase in

> rates in order to subsidize and mitigate the cost of service for other districts.
>
> Like I said, there are legal problems with this case regarding the two different test years and revenue neutrality requirements, and there is a problem with the economy. I know the Commissioners have often asked companies how the Commission should consider the economy or how they should consider their rate application in light of the economy. Well, the economy has hit all of Arizona-American ratepayers, and a bad economy affects all. You can't look at Anthem ratepayers in a vacuum. You have to consider how shifting some of Anthem costs to other ratepayers affects those family budgets.
>
> And also -- again, we have talked about it, but there are notice problems. And, yes, the Company has held meetings and put forth some information, but they really let a good opportunity to educate customers fall through their fingertips. And what we are left with is some angry customers, uninformed customers, and now the issues shifts to the Commission to make a decision in this type of an environment.
>
> Frankly, this is a bad -- this is probably the worst time to consider rate consolidation for this Company.

Transcript at 1092-1094.

RUCO cannot say when is the best time, if there ever is a good time, to approve rate consolidation for this Company. However, a better time than the present will be when there is: (1) one application; (2) that includes all of the districts; (3) based on one test year and (4) one revenue requirement; (5) when the public has had adequate notice and all of the facts; and (6) when there is more support from the public. The Commission should reject rate consolidation in this case at this time.

DISTORTED PRICE SIGNALS CONTRARY TO GOAL OF WATER CONSERVATION

The third reason to reject rate consolidation in this case is rate consolidation can have the unfortunate, negative consequence of contradicting the Commission's important goal of water conservation. RUCO-14 at 14. Rate consolidation is arguably "at odds with water conservation." Id. Water is not the same everywhere in the state. Different systems have different challenges with water quality or water quantity issues. Full rate consolidation ignores the harsh reality of the difficulty of delivery of adequate and safe water in certain areas in Arizona. Id. By consolidating rates and allowing a district with high costs to enjoy subsidized rates, the Commission distorts the true price of water delivery service for those customers. By distorting the price signals, customers no longer have the incentive to use their water wisely. Id.

Within the Arizona-American water systems, there are vastly different water consumption patterns among residential ratepayer. Id. For example, the average 5/8 x 3/4 inch monthly water consumption ranges from 6,702 gallons in Sun City West to a whopping 20,406 gallons in Paradise Valley! In Paradise Valley, there are 130 ***residential*** customers who have an average monthly water consumption of 130,811 gallons! Id.

These systems not only have different water consumption patterns, they have different water delivery challenges. Id. Some systems are on ground water while others take surface water. Some systems are inside an Active Management Area and others are not. Id. at 15.

The Commission has stated time and time again that water conservation is one of its top priorities. Some of the above factors are common to every case, but in this case, consolidated rates include a consolidated commodity rate. RUCO does not believe that the benefits of consolidation justify water prices that do not accurately reflect the cost of water among these diverse systems.

If full rate consolidation were approved, Sun City West would enjoy a decrease in rates. Their rates would be below their cost of service. Sun City West is inside an Active Management Area and receives its drinking water from groundwater. It has a known subsidence issue. RUCO does not believe it is good public policy to send a price single to Sun City West customers that encourages water consumption.

EXISTING CONTRACTS FOR SOME WATER CLASSES

Yet another concern with consolidation, as pointed out by Staff, is that "Certain classes of customers are unique to specific systems or may have special contracts that apply to their rates." S-15 at 18. According to Staff, classes that are affected by these contracts could not be consolidated. Id. Some of these contracts apply to residential users, such as residential ratepayers living in apartments in the Mohave – Bullhead system. Id. It would be less than optimal to have a consolidated rate design that excludes certain sub-classes of ratepayers.

BOOKKEEPING

Finally, rate consolidation will eliminate the need to maintain books for individual systems. This could lead to the Company over-building a system or not maintaining prudent costs.

> "If rates were to be consolidated, there would be no reason to maintain separate books and records for each of the [systems]...However, this loss of operation and financial data would destroy the ability to evaluate the effectiveness and efficiency of the Company's operation of the [systems].
>
> As a result, the [public utility commission] would lose its ability to exercise regulatory oversight and control as it pertains to these systems."

RUCO-14 at 16, Direct Testimony before the New Hampshire Public Utilities Commission in DR 97-058, Pennichuck Water Works, Inc. (1997).

The Commission could eliminate this concern by ordering the Company to maintain system-specific bookkeeping should the Commission believe consolidation is appropriate. RUCO believes that such an order would be helpful for Staff, RUCO and others to determine if costs were appropriately and prudently incurred in future rate cases.

STAFF AND THE COMPANY'S RATE CONSOLIDATION PROPOSALS

Similar to RUCO, Staff and the Company[21] recommend individual stand alone rates for all of the Company's districts. S-15 at 3, A-39 at 11. Staff, however, pursuant to Decision No. 71410, prepared three rate consolidation models. Id. Scenario #1 is a complete, company-wide consolidation of all its water and wastewater districts. Id. at 21. Scenarios #2 and #3 offer sub-groupings. S-15 at 22-23. While Staff does not provide any explanation for its reasoning behind Scenarios #2 and #3, their effect segregates the Sun City and Sun City West systems and shields them from increased rates that mitigate the rate increases of other districts – such as Anthem. RUCO-14 at 20. Unfortunately, all these two options do is shift even more of Anthem's costs to other districts – such as Mohave and Paradise Valley.

At this point RUCO is very unclear as to the Company's position on consolidation. The Company declined to offer a rate consolidation design proposal. A-39, Executive Summary. The Company made clear at the outset that the Company supported stand alone rates and not consolidated rates. A-39 at 11. However, at the end of the hearing in this matter the Company presented three different consolidation scenarios including a scenario where Sun City Water and Sun City Wastewater was excluded and one scenario where Sun City Water and Sun City West Water and Wastewater was excluded. Transcript at 1468. The Company's "preferred scenario" involves all of the systems with five step increases. Id. at 1469.

With regard to Staff's consolidation proposals, RUCO agrees with the opinion stated by the Company's Director of Rates and Regulation, Tom Broderick:

> Staff scenarios Two and Three are essentially arbitrary combinations of various Company's districts that are difficult to justify to customers. These groupings will not reduce the number or frequency of rate cases, but will make odd combinations of communities. Grouping Sun City

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[21] RUCO is unclear on the Company's position on consolidation as will be more fully explained below.

> and Sun City West together is very difficult because, for example, residents of Sun City West will object to paying for Sun City's much older infrastructure. I cannot understand the basis for grouping the small groundwater based Paradise Valley district with the much larger surface water based communities of Anthem and Agua Fria. I cannot find any good reasons either to combine the much larger Mohave district with Tubac."

A-39 at 14-15, RUCO – 14 at 20-21. Scenarios #2 and #3 do not match with some of the reasons RUCO would generally support rate consolidation – such as a reduction in rate case expense and a reduced toll on Staff resources. RUCO-14 at 21. Furthermore, one could find the intent of separating these two retirement communities from a consolidated rate design is to shield these ratepayers living on affixed incomes from subsidizing rates for others – notably Anthem ratepayers. If so, RUCO points out that retirees on fixed incomes and other low income ratepayers live in other Arizona-American districts. By keeping two of the largest systems out of a consolidated design only shifts more costs to other ratepayers in other districts including retirees and low income customers.

Finally, all three of Staff's scenarios provide a rate decrease for Anthem. Id. One benefit of consolidation is to mitigate rate increases for some customers. Some customers will pay more to help their neighbor avoid rate shock. But in all three scenarios, Anthem not only avoids rate shock, but they enjoy a rate decrease at the expense of other ratepayers. Rate consolidation should not provide an unearned rate decrease at the expense of increased rates for others. In all three of Staff's cases, not only is Anthem's cost of service rate increase mitigated, but it is completely eliminated. Id. This unearned financial reward for Anthem comes at a cost to the ratepayers of Paradise Valley, Sun City and Mohave. Id.

RUCO's Revised Exhibit B to the Direct Testimony of Jodi Jerich, RUCO-15, is instructive. Revised Exhibit B attempts to put on to a single piece of paper the various rate proposals that the Commission is being asked to consider[22]. As the Revised Exhibit B shows, it is impossible to consolidate rates without initial "winners" and "losers". RUCO-14 at 22, RUCO-15. The "winners" will receive subsidized rates and the "losers" will pick up the costs of the subsidized districts. There is no way around this. However, all ratepayers of a consolidated system can enjoy certain benefits. First, a consolidated system will result in lower administrative costs – primarily rate case expense. Id. Second, those systems that initially bear a higher rate increase to subsidize other systems in the beginning will enjoy a mitigated rate increase in the future when those other districts pick up their future costs. Id.

RUCO understands that there are benefits to rate consolidation. RUCO also believes that ratepayers are willing to pay a little bit more in the beginning knowing that the benefit will be returned to them in the future. Id. However, there will be resistance if the initial cost shift is too much. Id. In Revised Exhibit B, for illustrative purposes only, RUCO arbitrarily set this resistance threshold level at $5.00 per month. Id., RUCO-15. Those districts shaded in red have more than $5.00 shifted to them through rate consolidation so that other districts can enjoy reduced rates. Id. Once this tolerance threshold is crossed, it may be more difficult to find ratepayer support for consolidated rates. Id. Alternatively, those districts that receive more than a $5.00 monthly decrease in rates due to rate consolidation over a cost of service rate design are shaded in orange and the yellow districts are those that fall within the $5.00 bandwidth where RUCO believes there would be little ratepayer opposition to consolidated rates. Id.

Revised Exhibit B brings to the forefront the financial impact that consolidation will have on residential ratepayers. Id. at 23. Sun City ratepayers are aware (and strongly oppose) rate

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[22] Revised Exhibit B does not consider the three scenarios offered by the Company at the end of the hearing discussed above.

consolidation. But RUCO does not believe ratepayers in Paradise Valley and Mohave have any real idea that the notice they received as a bill insert regarding rate consolidation will have the actual financial impact as shown in Revised Exhibit B.[23]

In the end, the goal of rate consolidation is admirable as a general rule. But each case must be considered independently because each case involves a different set of facts and circumstances. In this case, while consolidation will undoubtedly help to ameliorate the rate increase for some ratepayers, it comes at too high of a cost when all of the other facts and circumstances in this case are considered. Moreover, there does not appear to be a sound legal basis for combining the present case with the Company's last rate case for purposes of consolidation. RUCO recommends that the Commission reject rate consolidation in this case.

CONCLUSION

For the reasons discussed above, RUCO recommends the Commission adopt its position in this case, and reject the positions of Staff, the Company and the other intervenors, to the extent they conflict with RUCO's recommendations.

[23] The notice that was sent to all Arizona-American ratepayers states, "If approved by the Commission, this (rate consolidation) proposal may impact the rates of every Arizona-American water and wastewater customer – either increase or decrease."

RESPECTFULLY SUBMITTED this 16th day of July, 2010.

Daniel W. Pozefsky
Chief Counsel

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EXHIBIT 1

Arizona American Water Company - Anthem Water
Calculation of Revenue Deficiency (Sufficiency)

Test Year Ended December 31, 2008

Attachment RCS-6
Schedule A (A)
Docket No. W-01303A-09-0343
Page 1 of 1
Revised

Line No.	Description	Reference	Per Company (A)	Per RUCO (B)	Difference (C)	RUCO Without Rate Shock Mitigation (D)	Difference (E) = B-D
1	Adjusted rate base	B (A)	$ 57,430,025	$ 46,422,917	$ (11,007,108)	$ 57,259,174	$ (10,836,257)
2	Rate of return	D	8.53%	6.77%		6.77%	
3	Net operating income required		$ 4,898,781	$ 3,144,688	$ (1,754,093)	$ 3,878,736	$ (734,048)
4	Adjusted net operating income	C (A)	$ 514,448	$ 556,315	$ 41,867	$ 684,058	$ (127,743)
5	Net operating income deficiency		$ 4,384,333	$ 2,588,373	$ (1,795,960)	$ 3,194,678	$ (606,305)
6	Gross revenue conversion factor	A-1 (A)	1.6578	1.6578		1.6578	
7	Revenue deficiency (Sufficiency)		$ 7,268,177	$ 4,290,901	$ (2,977,276)	$ 5,296,009	$ (1,005,108)
	Percentage Increase Over Current Rates						
8	Revenue from Sales to Retail Customers	Sch C (A), L.1	$ 7,210,624	$ 7,220,082		$ 7,220,082	$ 7,220,082
9	Percentage Increase	L.7 / L.8	100.80%	59.43%		73.35%	-13.92%

Notes and Source
Col.A: AAWC Filing, Schedule A-1

Calculation of RUCO recommended percentage increase to AAWC's base rates	RUCO Proposed
AAWC's adjusted water revenues per Schedule C (A)	$ 7,220,082
RUCO recommended rate increase (line 7 above)	$ 4,290,901
Total revenues after reflecting RUCO recommended increase	$ 11,510,983
Percentage change in revenues	59.43%

Calculation of AAWC's proposed percentage increase to base rates	AAWC Proposed
AAWC's adjusted water revenues per Schedule C (A)	$ 7,210,624
AAWC proposed rate increase (line 7 above)	$ 7,268,177
Total revenues after reflecting AAWC proposed increase	$ 14,478,801
Percentage change in revenues	100.80%

Arizona American Water Company - Anthem/Agua Fria Wastewater
Calculation of Revenue Deficiency (Sufficiency)

Test Year Ended December 31, 2008

Attachment RCS-7
Schedule A (AAF)
Docket No. SW-01303A-09-0343
Page 1 of 1
Revised

Line No.	Description	Reference	Per Company (A)	Per RUCO (B)	Difference (C)	RUCO Without Rate Shock Mitigation (D)	Difference (E) = B-D
1	Adjusted rate base	B (AAF)	$ 47,735,732	$ 41,198,320	$ (6,537,412)	$ 45,264,942	$ (4,066,622)
2	Rate of return	D	8.53%	6.77%		6.77%	
3	Net operating income required		$ 4,071,858	$ 2,790,774	$ (1,281,084)	$ 3,066,247	$ (275,473)
4	Adjusted net operating income	C (AAF)	$ (191,785)	$ (31,481)	$ 160,304	$ (31,481)	$ -
5	Net operating income deficiency		$ 4,263,643	$ 2,822,255	$ (1,441,388)	$ 3,097,728	$ (275,473)
6	Gross revenue conversion factor	A-1 (AAF)	1.6561	1.6561		1.6561	
7	Revenue deficiency (Sufficiency)		$ 7,060,837	$ 4,673,823	$ (2,387,014)	$ 5,130,023	$ (456,200)
	Percentage Increase Over Current Rates						
8	Revenue from Sales to Retail Customers	Sch C (AAF), L.1	$ 8,634,567	$ 8,634,567		$ 8,634,567	$ 8,634,567
9	Percentage Increase	L.7 / L.8	81.77%	54.13%		59.41%	-5.28%

Notes and Source
Col.A: AAWC Filing, Schedule A-1

Calculation of RUCO recommended percentage increase to AAWC's base rates	RUCO Proposed
AAWC's adjusted water revenues per Schedule C (AAF)	$ 8,634,567
RUCO recommended rate increase (line 7 above)	$ 4,673,823
Total revenues after reflecting RUCO recommended increase	$ 13,308,390
Percentage change in revenues	54.13%

Calculation of AAWC's proposed percentage increase to base rates	AAWC Proposed
AAWC's adjusted water revenues per Schedule C (AAF)	$ 8,634,567
AAWC proposed rate increase (line 7 above)	$ 7,060,837
Total revenues after reflecting AAWC proposed increase	$ 15,695,404
Percentage change in revenues	81.77%

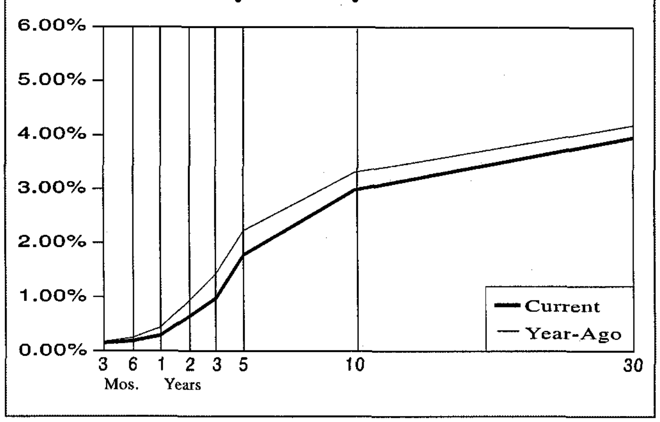
EXHIBIT 2

Selected Yields

	Recent (7/07/10)	3 Months Ago (4/07/10)	Year Ago (7/08/09)
TAXABLE			
Market Rates			
Discount Rate	0.75	0.75	0.50
Federal Funds	0.00-0.25	0.00-0.25	0.00-0.25
Prime Rate	3.25	3.25	3.25
30-day CP (A1/P1)	0.31	0.18	0.36
3-month LIBOR	0.53	0.30	0.53
Bank CDs			
6-month	0.40	0.25	0.65
1-year	0.69	0.44	0.86
5-year	2.00	1.99	1.94
U.S. Treasury Securities			
3-month	0.15	0.16	0.18
6-month	0.19	0.23	0.25
1-year	0.29	0.45	0.44
5-year	1.78	2.60	2.23
10-year	2.98	3.85	3.31
10-year (inflation-protected)	1.24	1.52	1.76
30-year	3.96	4.74	4.19
30-year Zero	4.19	5.00	4.31

	Recent (7/07/10)	3 Months Ago (4/07/10)	Year Ago (7/08/09)
Mortgage-Backed Securities			
GNMA 6.5%	1.55	2.66	3.71
FHLMC 6.5% (Gold)	1.13	1.96	2.99
FNMA 6.5%	1.23	2.25	2.83
FNMA ARM	2.94	2.76	2.98
Corporate Bonds			
Financial (10-year) A	4.57	5.24	6.53
Industrial (25/30-year) A	5.14	5.76	5.82
[redacted]			
Foreign Bonds (10-Year)			
Canada	3.17	3.63	3.28
Germany	2.60	3.12	3.28
Japan	1.15	1.41	1.30
United Kingdom	3.36	4.06	3.62
Preferred Stocks			
Utility A	6.08	6.00	7.59
Financial A	6.52	6.63	6.57
Financial Adjustable A	5.48	5.48	5.48
TAX-EXEMPT			
Bond Buyer Indexes			
20-Bond Index (GOs)	4.38	4.44	4.83
25-Bond Index (Revs)	4.84	4.94	5.75
General Obligation Bonds (GOs)			
1-year Aaa	0.31	0.38	0.43
1-year A	1.18	1.18	0.93
5-year Aaa	1.60	1.86	1.96
5-year A	2.57	2.81	2.40
10-year Aaa	2.99	3.31	3.09
10-year A	4.07	4.29	3.45
25/30-year Aaa	4.38	4.46	4.59
25/30-year A	5.48	5.51	5.05
Revenue Bonds (Revs) (25/30-Year)			
Education AA	4.77	4.78	5.55
Electric AA	4.79	4.79	5.65
Housing AA	5.64	5.73	5.80
Hospital AA	4.95	5.19	5.90
Toll Road Aaa	4.76	4.78	5.60

Treasury Security Yield Curve



Federal Reserve Data

BANK RESERVES

(Two-Week Period; in Millions, Not Seasonally Adjusted)

	Recent Levels			Average Levels Over the Last...		
	6/30/10	6/16/10	Change	12 Wks.	26 Wks.	52 Wks.
Excess Reserves	1027063	1041211	-14148	1047061	1073988	985078
Borrowed Reserves	68636	70668	-2032	75916	100328	193975
Net Free/Borrowed Reserves	958427	970543	-12116	971145	973660	791103

MONEY SUPPLY

(One-Week Period; in Billions, Seasonally Adjusted)

	Recent Levels			Growth Rates Over the Last...		
	6/21/10	6/14/10	Change	3 Mos.	6 Mos.	12 Mos.
M1 (Currency+demand deposits)	1721.8	1693.1	28.7	0.7%	2.7%	3.8%
M2 (M1+savings+small time deposits)	8588.3	8564.7	23.6	4.0%	0.9%	1.6%

EXHIBIT 3

Steve Puhr (623) 249-7049 (H)

Date: June 2, 2010

RECEIVED

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AZ CORP COMMISSION DOCKET CONTROL

To: Arizona Corporation Commission, Utilities Division, Consumer Services

K.K. Mayes, Chairman

G.Pierce, Commissioner

S.D.Kennedy, Commissioner

P. Newman, Commissioner

AZ. Am..

B. Stump, Commissioner

Hon. Teena Wolfe

Re: Docket No. W-01303A-09-0343 & No. SW-01303A-09-0343

I am filing an opinion as a resident of Anthem, AZ and a consumer of Arizona-American Water residing at 2407 W. Hazelhurst Ct., Anthem, AZ. 85086.

In the above case, I filed an opinion on April 28, 2010, which utilized testimony given by Mr. Manrique and Mr. Rigsby and further expressed a valid rational to eliminated some data points resulting in a more appropriate cost of capital. Today, I would like to provide insight to the earlier opinion dated April 28, 2010 which is included. In that filing, starting with page 1 as my introduction, I refer you to page four, the second paragraph, "Mr. Manrique used two DCF methods….." First, my use of Aqua America's retention growth was done as a proxy for American Water Works expected growth since Aqua America is a mid cap stock as is American Water Works. American Water Works and Aqua America are the two largest water utilities listed in the United States; hence they should be expected to grow at very similar rates. The retention growth is a conservative expectation of growth by the company's management and investors. Retention growth equals retained earnings (earnings not paid out in dividends) multiplied by expected return on equity. I ended the paragraph with the following,

"With the current economic outlook expected to be below average for years or at best similar to the last ten years that ended 2008, the table's EPS and sustainable growth projections of 9.7% and 9.1% look unreasonable. These estimates are approximately 3x the growth rates of the ten year period that ended 2008. Schedule JCM-8 should eliminate the 9% growth estimates as outliers and use the remaining four data points that result in a growth estimate of 3.93% to be utilized in the DCF model."

I would like to define an outlier and how is it determined in this case. An outlier is an observation that falls far outside a sample population mean (average) that leads one to believe it is a faulty observation and should not be utilized. Mr. Manrique schedule JCM-8 utilized six data points, three historical and three projected. I will use the historical retention growth rate for Aqua America covering eleven years.

From this data, I will construct a z-score, which tell us the likelihood of the growth estimates in schedule JCM-8 being consistent with the Aqua America's eleven years of retention growth. Z= (observation-average from sample)/standard deviation from the sample. Here is the sample of Aqua America's retention growth for eleven years, 4.3%, 4.7%, 5.1%, 5.2%, 4.2%, 4.6%, 4.9%, 3.7%, 3.2%, 2.8%, 3.5%., the average (mean) is 4.2%, standard deviation is 0.80%. To test an outlier, put the observation (growth estimates from JCM-8) in the z formula, per schedule JCM-8, test 5.2%, z = (5.2-4.2)/0.8= 1.25. Approximately 95% of all valid observations of a sample will have a z-score between -2 and 2, all or almost all (99.74%) of all valid observations of a sample will have a z-score between -3 and 3. If the z-score is greater than 3 for a given observation, it is an outlier and should be eliminated from the sample since it has a close to a zero percent probability of belonging. So back to schedule JCM-8, growth estimates of 9.7% and 9.1% produce z-scores of 6.88 and 6.11, clearly these z-scores are more than double the 3 which would have qualified as outliers; hence they should be eliminated from schedule JCM-8 as outliers. The remaining four data points in schedule JCM-8 produce a growth estimate of 3.93% to be utilized in the DCF model.

The next five pages is my April 28, 2010 opinion filed in this case. The next page is schedule JCM-8.

The next page is information on outliers and z-scores from the third edition of,"Statistics for Business and Economics", by James T. McClave & P. George Benson, pages 96 through 99.

The following two pages is my resume.

To: Arizona Corporation Commission, Utilities Division, Consumer Services

K.K. Mayes, Chairman

G.Pierce, Commissioner

S.D.Kennedy, Commissioner

P. Newman, Commissioner

B. Stump, Commissioner

Hon. Teena Wolfe

Re: Docket No. W-01303A-09-0343 & No. SW-01303A-09-0343

I am filing an opinion as a resident of Anthem, AZ and a consumer of Arizona-American Water residing at 2407 W. Hazelhurst Ct., Anthem, AZ. 85086.

My comments are in two parts, the first pertaining to the weighted cost of capital in presented in testimony by Mr. Manrique and Mr. Rigsby. With supporting references' attached. Utilizing testimony in evidence, I proposed certain data points be eliminated resulting in an more appropriate lower cost of capital.

Second, I commented on the financial stability of Arizona's parent company American Water Works referencing their 2009 Annual Report. This highlights the stability of the company's financial strength.

Sincerely,

Stephen P. Puhr

Stephen P. Puhr, resident of Anthem, az., 2407 W. Hazelhurst Ct., 623-249-7049,

Docket No. W-01303A-09-0343 & No. SW-01303A-09-0343

I would like to address the weighted cost of capital calculation in the direct testimony of Mr. Juan C. Manrique, ACC staff.

In the Direct testimony of Mr. Juan C. Manrique, page 42, table 3, (line 13-14). The combined short and long term debt has a cost of 4.91%. Which appears to be derived from the schedule presented by the Arizona American Water, Test year ended December 31, 2008, Exhibit schedule D-2, page 1, Witness Mr. Broderick. The 4.91% is derived from capital weighting of the cost of long term debt of 5.47% and short term debt, commercial paper, of 3.41%. The annual report for Arizona-American Water's parent filed on 3/1/2010, page 118, and reports that December 31, 2009, the company's short term debt weighted average interest cost was 0.39%. Further, according to www.federalreserve.gov/release/cp, on April 21, 2010, the cost of A2/P2 commercial paper, A2/P2 is the rating of American Water Works the parent of Arizona-American Water company, with maturities from 1 day to 60 days averaged 0.33%, with a high of 0.35 for 1 day to the low of 0.29 for 30 days. Hence, Mr. Manrique's average weighted cost of capital needs to utilize the commercial paper rate of 0.33% instead of the 3.41%, from Mr. Manriques Direct testimony, page 14, and line 25. **The replacement would be the difference between (3.41% less 0.33%) multiplied the weighted short term debt of 16.6% to equal 0.51% reduction from the ACC staff's recommendation in Arizona-American Waters required rate of return (ROR) 7.20%. Staffs new recommendation should be 7.20%- 0.51%= 6.69%.**

Now I would like to address Mr. Manrique's testimony as it relates to the formulation of the Beta estimate for Arizona American Water.

While a bigger sample size is preferred to a smaller one when establishing a valid proxy, it is more important to have companies with comparable attributes that drive risks and returns. Morningstar recognizes the importance of comparing stocks and stock mutual funds as large cap (capitalization), mid-cap and small cap and also as growth, value or a blend. An historical study that looked at stocks' standard deviations of returns (risk) from 1926 through 2001, and found small capitalizations standard deviations of returns (risk) was 33.2% compared to large capitalization stocks of 20.2%. This validates the need to compare or utilize the same market capitalization when building a proxy. All utilities are value stocks so they all qualify on that characteristic. Since, Arizona-American Water's parent company is not a small capitalization stock it would be inappropriate to compare it to a group of small capitalization stocks. Hence, the following stocks are recognized as small capitalization stocks by Value Line and should be removed from the sample; American States Water, California Water, Connecticut Water, Middlesex Water and SJW Corp. These stocks were utilized by Mr. Manrique in testimony, schedule JCM-7. Mr. Rigsby's testimony, schedule WAR -7, list the beta's of his proxy stocks, again one must eliminate the small cap stocks. **The result we have a proxy made up of three stocks Aqua America (AWR), Atmos Energy Corp. (ATO) and AGL Resources (AGL), with betas, respectively of .65 for AWR, .75 for AGL and .65 for ATO. The average of these stocks' beta is .683 and this is the most appropriate proxy beta for Arizona American Water.**

Per Mr. Manrique's testimony in schedule JCM-3, historical CAPM and current CAPM used two different risk free assets. In the historical CAPM, an average of 5 yr., 7 yr., & 10yr. treasury rates was adopted as the risk free asset and for the current CAPM the 30 yr. treasury rate was used as the risk free asset. This use of different maturity risk free assets is not appropriate because the different maturities have different amounts of interest rate risk. The longer the maturity, in general terms, the more interest rate risk. An analysis of historic CAPM and current CAPM should use the same risk free asset, especially as it pertains to maturity.

Second, which risk free asset is appropriate? Mr. Manrique's testimony on page 36, line 2, states, "The risk free rate is the rate of return of an investment with zero risk." I agree but for purest, zero risk may be substituted for near zero risk.

The risk free asset should be a treasury security since it is has a near zero probability of default. . Investors who buy treasury bonds that mature in 5 years, 10 years, and 30 years face interest rate risk, all else being equal, the longer the treasury maturity the greater the risk. **The 91 day t-bill is considered the safest since it has the lowest amount of bankruptcy risk and interest rate risk, I recommend it be used as the risk free asset. The current 91 day bill rate reported by Value Line was 0.16% on 4/7/2010.**

Back to Mr. Manrique's testimony, schedule JCM-3. The use of the historical CAPM in the calculation of the final cost of equity is not relevant to today's investment environment where readily verifiable investment data is available. I would eliminate that formula from the calculation of cost of equity.

Second, he uses of 10.2% return on the stock market in his historic model and then use a 12.7% for the current expectations defies the markets current expectations. That is I am unaware of any professional publication or professional stock market strategist, that has the opinion that future rates of return on the stock market are going to be higher than the last 94 year average (1926-2008), let alone they will be 20% higher. Presenting the arithmetic mean for the stock market returns is a point that is debated and may be a valid starting point, but build on it that premise, I believe in a better place to start.

Surrebuttal testimony from William Rigsby, pages 14 and 15 illustrates that the geometric mean better describes actual results than the arithmetic mean; I find his argument compelling and recommend adopting the geometric mean approach. It reflects reality.

In a July 2009 article, Roger Ibbotson, "Are Bonds Going to Outperform Stocks Over the Long Run? Not Likely." Two data points, first, the S&P 500 returns, geometrically compounded, from January 1926 to March 2009 was 9.44% (page 1). Mr. Ibbotson suggests that earnings growth could approach historic long term growth rate of 5%. Investors' expectations could be 5% plus dividends then at 1.92%, today at 1.84% for the S&P 500. Hence, using a discount cash flow approach, reasonable expectations for the stock market would be 5% + 1.84%= 6.84%. See attachment, Newsweek, 4/19/2010, "The Shape of Things to Come", the articles talk to three economic/finance professor of high regard, Nouriel Roubini, Jeremy Siegel, Laura Tyson and Mohamed El-Erian, CEO of PIMCO(the largest fixed income manager in the world). There is only one who believes a return to average GDP is visible, while the rest see a below average growth rate for some time. Laura Tyson would expect GDP to grow at a 3.5% over five years at best. I bring these up not for precision but directionally, below average GDP growth and hence return on equities is the norm. So the testimony of Mr. Manrique on expected returns for the stock market for the CAPM is, in his historical CAPM = 10.2% and current CAPM = 12.7%. Mr. Rigsby's expected stock market returns (Rm) in his CAPM model, testimony, schedule WAR-7, pages 1 & 2, uses historic stock market returns, geometric of 9.6% and arithmetic 11.7%. **Given the general and expert outlook for subpar to average growth for the foreseeable future, of the given testimony, the estimate for the expected return for the stock market is 9.6% and it should utilized in the CAPM model.**

Current CAPM would be:

CAPM, K= Rf + B (Rm- Rf)

= .16% + .683 (9.6%-.16%)

= 6.61%

As of 4/1/2010, Value line 30 year U.S. treasury YTM of 4.74% and Morningstar reported on 4/28/2010 that American Water Works' bond maturing in 27 years has a yield to maturity of 6.08%. Back to the Ibbotson article above, page 1, long term treasury bonds have outperformed stocks for the following periods; 1 yr., 5 yr., 10 yr., 20 yr., and 40 yr. ending March 2009. So, the expected return of equity which appears to have a narrow premium over its stock is reasonable especially given the evidence above.

Mr. Manrique used two DCF methods, one constant growth and the other is multi-stage (a two stage was used). I do not see any analytical benefit to use a two stage model, the industry is very mature and returns are regulated, providing a consistent visible growth profile. Looking at Aqua America's retention growth over the past eleven years shows a slight bump higher for four years and slow decline the next seven years, 4.3%, 4.7%, 5.1%, 5.2%, 4.2%, 4.6%, 4.9%, 3.7%, 3.2%, 2.8%, 3.5%.= average 4.2%. Mr. Manrique's table of the results calculating the expected dividend growth is found in his testimony, schedule JCM-8. A ten year period ending in 2008 was used to derive historical EPS (earnings per share) growth of 3.3% and DPS (dividend per share) growth rate of 3.1%. With the current economic outlook expected to be below average for years or at best similar to the last ten years that ended 2008, the table's EPS and sustainable growth projections of 9.7% and 9.1% look unreasonable. These estimates are approximately 3x the growth rates of the ten year period that ended 2008. Schedule JCM-8 should eliminate the 9% growth estimates as outliers and use the remaining four data points that result in a growth estimate of 3.93% to be utilized in the DCF model.

DCF constant growth (dividend yield from Mr. Manrique's schedule JCM-3)

DCF = 3.50% + 3.93%

= 3.50% + 3.93% = 7.43%

Current CAPM would be:

CAPM K= Rf + B (Rm- Rf)

= .16% + .683 (9.6%-.16%)

= 6.61%

Final Cost of Equity Estimate = CAPM + DCF / 2= 6.61% + 7.43%/ 2= 7.02%

ACC staff capital recommendation	Staff's Estimates	Steve Puhr Estimates	Difference
Long Tm Debt = 44.6%	@5.47%=2.44%	@5.47%=2.44%	0%
Short Tm Debt = 16.6%	@3.41%=0.57%	@.33%=0.06%	.51%
Total Cm Equity = 38.9%	@10.7%=4.17%	@7.02%=2.73%	1.46%
Overall Rate of Return	*=7.2%*	*=5.23%*	*=-1.97%*

Arizona - American Water Company Cost of Capital Calculation
Calculation of Expected Infinite Annual Growth in Dividends
Sample Water Utilities

[A]	[B]	
Description	g	
DPS Growth - Historical[1]	3.1%	
DPS Growth - Projected[1]	4.1%	
EPS Growth - Historical[1]	3.3%	
EPS Growth - Projected[1]	~~9.7%~~	X
Sustainable Growth - Historical[2]	5.2%	
Sustainable Growth - Projected[2]	~~9.1%~~	X
Average	~~5.8%~~	3.93%

1 Schedule JCM-5

2 Schedule JCM-6

3.10 Detecting Outliers

An *outlier* is an observation that falls far out in the tail of a distribution and may be a faulty observation. Suppose, for example, that you were to sample the weekly sales of fifty salespersons in a company and found that all but one of the sales ranged from $3,000 to $5,000. The sales for the single exception were $750. If the object of the sampling is to learn something about the weekly sales of full-time salespersons, then the $750 observation is suspect and merits investigation. A further check of company records might indicate that the salesperson worked only a partial week because of sickness, etc. If so, this observation is not from the population of interest to you, and it should be deleted from the sample. If the investigation does not provide a reason for eliminating this observation from the sample, then it should not be deleted. Even though extreme values are improbable, their occurrence is not impossible.

The most obvious test for an outlier is to calculate its z-score (Section 3.9). For example, if the z-score for an observation is 4.2, we know that it lies more than 4 standard deviations away from the sample mean. The Empirical Rule (Table 3.7) tells us that a z-score this large is highly improbable and points to the possibility of a faulty observation.

The numerical value of the z-score reflects the relative standing of the measurement. A large positive z-score implies that the measurement is larger than almost all other measurements, whereas a large negative z-score indicates that the measurement is smaller than almost every other measurement. If a z-score is 0 or near 0, the measurement is located near the middle of the sample or population.

We can be more specific if we know that the frequency distribution of the measurements is mound-shaped. In this case, the following interpretation of the z-scores can be given:

Interpretation of z-Scores for Mound-Shaped Distributions of Data

1. Approximately 68% of the measurements will have a z-score between -1 and 1.
2. Approximately 95% of the measurements will have a z-score between -2 and 2.
3. All or almost all the measurements will have a z-score between -3 and 3.

Stephen Puhr, CIMA

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INVESTMENT MANAGEMENT

Top-performing Investment Management Professional with twenty-six years of increasingly responsible experience in the financial services industry. Significant experience applying modern portfolio theory, relationship management, attribution analysis, investment manager analysis and global custody search. Strategic assessment of assets allocations and manager selection included the following asset classes: international equity and fixed income, domestic equity (large, mid & small caps), domestic fixed income classes, alternative investments, real estate and other tangible assets.

PROFESSIONAL EXPERIENCE

Consultant, Phoenix, AZ **2003-2009**

Executive Directive/Portfolio Manager

- Provided strategic assessment for a Native American Community Development & Financial Institution.
- Utilized Ibbotson software to establish asset allocations and investment policy statements for Tribal endowments. Conducted global custody search and investment manager search for over $500 million in assets. Established Treasury policies and procedures that improved the management of the Tribe's liquidity and investments. Maintained relationships with financial institutions. Advised the Tribes on private equity investments.
- Designed the investment plans for high net worth clients. Implemented investment plans along modern portfolio theory from asset allocation to manager selection. Equity research utilized qualitative and quantitative analytical techniques that produced discounted cash flow price targets.

WELLS FARGO BANK, Santa Rosa, CA **2000 – 2003**

Vice President/Regional Investment Manager

As Regional Investment Manager, lead the implementation strategies that increased Investment Management, Trust, and Private Banking sales and profits. Devised and implemented asset allocation and manager selections that met client risk and return parameters for high and ultra high net worth clients.

- Consistently placed among the Top 10 of more than 200 portfolio managers in portfolio returns.
- Successful relationship management of over 100 clients limited attrition to below 1%.
- Utilized Ibbotson analytic's to enhanced returns and dampen volatility through diversification.
- One of twenty portfolio managers to be trained as a Certified Investment Management Analyst (CIMA) to address the ultra high net worth clients market. CIMA covered manager search and due diligence, performance measurement and monitoring, designing investment policies and asset allocation strategies.
- Lead the six person Financial Services equity research team. Co-manager of Value Portfolio.

BRAVURA FINANCIAL SERVICES, INC., Midland, MI **1995 – 2000**

Portfolio Manager

Managed equity portfolio for **The Dow Chemical Company pension**, returns for $140 million in assets exceeded benchmark.

- Delivered relative risk/return ratings on the following sectors; financial services, consumer staples, utilities, communication services and transportation for Dow's internal portfolio managers.
- Provided attribution analysis on equity managers responsible for $6 billion of The Dow Chemical Company pension assets.

MUNDER CAPITAL MANAGEMENT, Birmingham, MI **1992 – 1995**

Portfolio Manager

Recommended and managed investments for key corporate and individual clients for firm with more than $35 billion under management. Responsible for financial equities as a member of the Investment Committee.

- Utilized modern portfolio theory and asset allocation in traditional classes in portfolio construction.
- Personally managed corporate and individual relationships, utilizing Barra Analytic's for performance attribution analysis.
- Stockval and Baseline complemented qualitative analysis to uncover superior risk adjusted returns of sectors and stocks.

RONEY & COMPANY, Detroit, MI **1987 – 1992**

Financial Services Analyst

Served as the expert financial services equity analyst for 40+ regional financial institutions. Opinions and reports appeared in *Wall Street Transcripts, American Banker and Barron's*.

- Called the recovery in bank stocks in 1990, yielding a 70.8% return vs. 42.6% for the bank index.
- Outperformed bank index in 20 of 21 recommendations, returning 36.5% vs. 25.6% for bank index.

LEARNING CREDENTIALS

MASTER OF BUSINESS ADMINISTRATION: Finance/Corporate Strategy
University of Michigan Ann Arbor, MI

BACHELOR OF BUSINESS ADMINISTRATION: Finance
Marquette University Milwaukee, WI

CERTIFICATES & LICENSES

Certified Investment Management Analyst (CIMA)
Series 7, 63, & 65
Chartered Financial Analyst Candidate Level 1

ASSOCIATIONS

CFA Institute
Leadership Redondo Beach 2006