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

DOCKET NO. W-01303A-09-0343

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ARIZONA-AMERICAN WATER COMPANY,)
AN ARIZONA CORPORATION, FOR A)
DETERMINATION OF THE CURRENT FAIR)
VALUE OF ITS UTILITY PLANT AND)
PROPERTY AND FOR INCREASES IN ITS)
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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

POST-HEARING REPLY BRIEF
OF ARIZONA-AMERICAN WATER COMPANY

TABLE OF CONTENTS

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

I.	Introduction.....	1
	A. Overview of the Company’s Request.....	2
II.	Rate Base Issues	3
	A. Post Test Year Plant (Sun City Water).....	3
	B. Sun City Plant 9; Wells 9.2 and 9.3 (Sun City Water)	4
	C. City of Glendale Agreement (Sun City Wastewater)	5
	D. Cash Working Capital (all districts)	5
	E. Allocation of Northwest Valley Treatment Plant (Anthem/Agua Fria Wastewater; Sun City West Wastewater)	6
	F. Non-Account Water (Sun City Water)	6
III.	Anthem’s Proposed Phase-In of Rate Base	7
	A. Anthem’s Initial Phase-In Proposal Should Be Rejected.....	7
	B. Anthem’s New Phase-In Proposal Should Also Be Rejected	8
	C. RUCO’s New Phase-In Proposal	8
IV.	Anthem’s Legal Arguments	10
	A. The Pulte Refund Payments Should Not Be Excluded from Rate Base.	10
	1. “Evidence of Indebtedness” under A.R.S. Sections 40-301 to 303	10
	2. Commission Rule 14-2-406.....	12
	3. Overriding Principles of Equity and Fairness	13
	B. The Refund Payments Provided for in the Infrastructure Agreement Are Reasonable.....	14
V.	Operating Income Issues	15
	A. Pension Expense	15
	B. Other Post-Employment Benefit (OPEB) Expenses	16
	C. Tank Maintenance Expense (Sun City Water)	16
	D. Tank Maintenance Deferral Account (Anthem Water)	17
	E. Rate Case Expense	17
	F. AIP for Service Company Employees.....	17
	G. RUCO’s Adjustment to Management Fees--Labor Expense	18
VI.	Cost of Capital Issues.....	19
	A. The Company’s Original Position.....	19
	B. RUCO’s Recommended Return on Equity Should Be Rejected	20
	C. RUCO’s Post-Hearing “Evidence” Must Be Disregarded	22
	D. Public Comment Relied upon by RUCO and Anthem Community Council Should Not be Given Weight.....	23
	E. Staff’s Position Is Reasonable and Should Be Adopted	23
VII.	Infrastructure Improvement Surcharge.....	24
VIII.	Rate Design Issues.....	24
	A. Stand-Alone Rate Design.....	24
	1. Effluent Rate	25
	2. De-Consolidation of the Anthem/Agua Fria Wastewater District	25
	B. Consolidation.....	26
IX.	Other Issues	27
	A. Sun City Low Income Program.....	27

1 **I. INTRODUCTION**

2 Arizona-American's ("Arizona-American" or "Company") operating districts
3 have under-earned for several years, and Arizona-American has lost approximately \$30
4 million since American Water purchased the water and wastewater assets of Citizens
5 Utilities in 2002.¹ As noted by the Company in its Opening Brief, despite these poor
6 earnings, the Company's parent, American Water, has infused approximately \$70 million in
7 equity over this time frame. Given Arizona-American's poor financial condition, the
8 Company could not have made all the necessary capital investment in Arizona without
9 American Water's willingness to infuse new equity and make long-term borrowing to
10 Arizona-American at a very attractive rate.²

11 Although Staff and RUCO recognize that the appropriate analysis in this case
12 is at the operating company level, the Anthem Community Council ("Anthem Council")
13 asks the Commission to focus on the financials of American Water rather than those of the
14 regulated entity in this case, Arizona-American. As noted by the Company, however, in its
15 Opening Brief and throughout the hearing in this matter, without an adequate return on
16 investment, Arizona-American's access to this capital and long-term borrowing from or
17 through its parent will not continue.³ Without American Water's financial commitment to
18 Arizona-American, Arizona-American could face the very real threat of financial
19 restructuring.⁴

20 Arizona-American continues to make the reasonable request in this
21 proceeding that the Commission rebalance the interests of its ratepayers and its
22 shareholders. For many years, the balancing of interests has greatly favored the Company's
23 ratepayers. For example, in the Anthem community, ratepayers have enjoyed the benefits

24 _____
25 ¹ Exhibit ("Ex.") A-7 at 2; Phase I Transcript ("TR.I") at 301.

26 ² Ex. A-3 at 5.

³ *Id.*

⁴ *Id.* at 5-6.

1 of the system since 1998 without the full carrying cost of that system being reflected in
2 rates.⁵ The Company has not earned any return on the investments it has made in Anthem
3 since 2003.⁶ Although some in the Anthem community believe that they were misled by
4 Del Webb/Pulte when they purchased their home from Del Webb/Pulte, that is an issue
5 appropriately addressed in the pending class action lawsuit against Pulte in federal court
6 and should not be addressed in this proceeding. In this proceeding, the Company is asking
7 that the Commission find a more appropriate balancing point between the interests of the
8 Company's shareholders and the interests of its ratepayers. In order for Arizona-American,
9 the state's largest private water and wastewater utility, to remain stable and viable for its
10 customers and investors, Arizona-American, the entity that is regulated by the Commission,
11 must earn a reasonable return on and return of the investment made by its shareholders.⁷

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

13 In this case, the Company seeks a five-district total increase in annual revenues of
14 \$16,599,227.⁸ In their Opening Briefs, Staff continues to recommend a total increase in
15 annual revenues of \$16,003,384 and RUCO continues to recommend a total increase in
16 annual revenues of \$13,269,889.⁹

17 The amounts recommended by the Anthem Council also recognize that a substantial
18 revenue increase is appropriate. Even assuming the complete disallowance of the Pulte
19 refunds as a result of the Anthem Council's unsupported legal arguments, which are
20 rejected by both Staff and RUCO, the Anthem Council still recommends a revenue increase
21 of \$3,770,866 for the Anthem Water District (as compared to the Company's increase of
22
23

24 ⁵ TR.I. at 299-300.

25 ⁶ *Id.* at 300.

26 ⁷ Ex. A-3 at 6.

⁸ Company's Revenue Requirement Schedules (A-1 Schedules).

⁹ Staff Opening Brief at 3; RUCO Opening Brief at 3.

1 \$5,962,687) and a revenue increase of \$3,978,174 for the Anthem/Agua Fria Wastewater
2 District (as compared to the Company's increase of \$5,292.887).¹⁰

3 In this Reply Brief, the Company will respond to those issues raised by the other
4 parties in their Opening Briefs.¹¹ Unless noted otherwise in this Reply Brief, the Company
5 has not changed its position from its Opening Brief, and the arguments set forth in that brief
6 are incorporated into this Reply Brief.

7 **II. RATE BASE ISSUES**

8 As evidenced again by the Opening Briefs, the differences in the final rate
9 base recommendations for the Company, Staff, and RUCO are minimal. The issues in
10 dispute with regard to rate base are discussed below. The Anthem Community Council
11 also continues to take issue with the allocation of the Northwest Valley Treatment Plant
12 proposed by Staff, and the Company's position on that issue is set forth below. Finally, the
13 Council's legal arguments, which are unsupported by any other party to this proceeding, as
14 well the phase-in plans recommended by the Council, are discussed separately below, as is
15 the new phase-in plan offered by RUCO for the first time in its Opening Brief.

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

17 RUCO's Opening Brief fails to provide any persuasive arguments to support
18 exclusion of Sun City Well 5.1 from rate base. Staff, the party that conducted an inspection
19 and audit of this plant, remains steadfast in support of recognition of this plant in rate
20 base.¹² This well replacement was necessary to ensure a reliable and adequate water supply
21 in the Sun City Water District--a district in which wells are often out of service due to their

22
23 ¹⁰ Anthem Opening Brief at Exhibit C. Anthem relied upon the Company's rebuttal schedules in making its
24 adjustments. *Id.* These schedules are slightly different than the Company's Final Revenue Requirement
25 Schedules submitted June 11, 2010. The revenue increase for the Anthem/Agua Fria Wastewater District
26 also assumes that the Commission accepts the Council's adjustment to the Northwest Valley Treatment
Plant allocation recommended by the Council. This would also result in a corresponding increase to the
revenue requirement for the Sun City West Wastewater District.

¹¹ The Company will refer to each party's initial brief in this matter as its Opening Brief.

¹² Staff Opening Brief at 5.

1 age and condition.¹³ Arizona-American completed this project on an expedited basis and
2 under budget.¹⁴ As further detailed by the Company in its Opening Brief, this replacement
3 meets each of the more restrictive conditions for recognition of post-test year plant often
4 utilized by Staff.

5 RUCO continues to argue selectively that the replacement cost for Sun City Well 5.1
6 should not be included in rate base because it violates the matching principle.¹⁵ RUCO
7 concedes, as it must, that the Commission, based in part on past support from RUCO, has
8 recognized certain post-test year plant in prior Arizona-American rate cases.¹⁶ RUCO
9 specifically cites to the most recent Mohave Wastewater rate case in which the Commission
10 included post-test year plant because it ensured “continuous, reliable, safe service to the
11 Company’s customers.”¹⁷ Despite the evidence in this case that the Sun City well
12 replacement was likewise necessary to ensure reliable and continuous service during the
13 summer months, RUCO concludes, without explanation, that these values are not present in
14 relation to the replacement of Well 5.1.¹⁸

15 The Commission should reject RUCO’s faulty reasoning and should include in rate
16 base the replacement cost for Sun City Well 5.1 as requested by the Company and
17 supported by Commission Staff.

18 **B. Sun City Plant 9; Wells 9.2 and 9.3 (Sun City Water)**

19 Staff verifies its support for the inclusion of the amounts relating to Sun City
20 Plant 9 and Wells 9.2 and 9.3 in its Opening Brief.¹⁹ Although RUCO continues to ignore
21 this issue (yet excludes it from its revenue requirement schedules), nothing in the record

22 ¹³ Ex. A-9 at 1-2; TR.I. at 525.

23 ¹⁴ TR.I. at 525-26.

24 ¹⁵ RUCO Opening Brief at 5.

24 ¹⁶ *Id.* at 5-6.

25 ¹⁷ *Id.* at 6; Decision No. 71410 at 23.

26 ¹⁸ In its Opening Brief, RUCO does not continue to assert the faulty argument that the cost of the well is insignificant.

¹⁹ Staff Opening Brief at 5.

1 supports a rejection of these amounts. The Company, to the satisfaction of Staff, has
2 provided ample evidence to support the inclusion in rate base of these amounts, and as
3 such, the Commission should allow these amounts in rate base.

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

5 Commission Staff also continues to support the inclusion in rate base of the
6 replacement costs under the Company's agreement with the City of Glendale.²⁰ This
7 position stems from Staff's detailed analysis of the Company's testimony and the
8 Company's responses to detailed data requests. Although the Company initially requested a
9 deferral of these amounts, Staff has determined that this arrangement should be treated as a
10 capital lease under FASB 13.²¹ As a result, Staff found that \$917,906 of the replacement
11 costs, net of depreciation, should be included in rate base.²² The Company made a similar
12 request in its final schedules.

13 Although RUCO claims in its Opening Brief that it does not disagree with the
14 inclusion of test year amounts in rate base, the costs at issue are all either within the test
15 year or very close in time to the test year, as noted by Staff.²³ The efficiencies of handling
16 this rate base item in this proceeding were recognized by Staff in its support for inclusion of
17 this request in rate base in this case. For all of these reasons, the Company requests that the
18 Commission accept the position of Staff, as supported by the Company, and include in rate
19 base the replacement costs under the Glendale agreement.

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

21 The Company continues to support its cash working capital position, as
22 supported by its lead/lag study. The Company's position is based upon and supported by
23 its actual experience as well as the Commission's prior decisions adopting the Company's

24 _____
25 ²⁰ *Id.* at 9-10.

26 ²¹ TR.II at 972; Exs. S-13, S-14; Staff Opening Brief at 10.

²² TR.II at 975; Staff Opening Brief at 10.

²³ RUCO Opening Brief at 32; Staff Opening Brief at 10.

1 methodology.²⁴ For these reasons and all of the reasons set forth in its Opening Brief, the
2 Company's cash working capital position should be adopted by the Commission in this
3 proceeding.

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

7 During the hearing and in its Opening Brief, Commission Staff provides
8 detailed support for its recommended allocation percentages for the Northwest Valley
9 Treatment Plant.²⁵ As recognized by Staff, this type of allocation is not an exact science;
10 however, Staff has supported a very reasonable allocation of this plant.²⁶ After reviewing
11 Staff's Opening Brief, the Company believes even more strongly that the more moderate
12 downward adjustment to the Anthem/Agua Fria Wastewater District recommended by Staff
13 is appropriate and will lead to less adjustment in the future. Despite the arguments of the
14 Anthem Council to the contrary, Staff's position as to the allocation of the Northwest
15 Valley Treatment Plant is well supported and should be adopted.

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

17 Commission Staff continues to argue for a reduction of Arizona-American's
18 allowable operating expenses for the Sun City Water District based on the system's non-
19 account water loss exceeding 10% at the end of the test year. This recommendation,
20 however, fails to recognize the significant efforts that Arizona-American has undertaken
21 and continues to undertake to reduce water loss in all of its districts.²⁷ At the time of the
22 hearing, the Company had reduced water loss in this District to 8.31 percent.²⁸ In addition,
23 the Company has fully complied with the Commission's order in the last Sun City Water

24 ²⁴ Company Opening Brief at 12-15.

25 ²⁵ Staff Opening Brief at 8-9.

26 ²⁶ *Id.*

27 ²⁷ Ex. A-23 at 17; Ex. A-26; TR.I at 556.

28 ²⁸ TR.I at 557; Ex. A-26.

1 rate case,²⁹ and Arizona-American should not be penalized going forward for its significant
2 and successful water loss reduction efforts.

3 In its Opening Brief, Staff cites to the acceptance of its recommended
4 condition by Global Water.³⁰ Putting aside the many differences between Global and
5 Arizona-American, the Company is not aware of Global successfully reducing water loss to
6 below 10% in the applicable district. Furthermore, even if Global did accept this
7 adjustment, it does not make it valid in this case. Rather than impute an expense reduction,
8 the Commission should instead institute only the more reasonable condition recommended
9 by Ms. Hains in her testimony, which would require the Company to continue to track its
10 water loss for three additional years and submit data collected every six months.³¹

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

12 **A. Anthem's Initial Phase-In Proposal Should Be Rejected**

13 The Anthem Council, in its Opening Brief, states once again its support for a
14 "phase-in" of the Pulte refunds made during the 2008 test year and in March 2010. The
15 Company continues to object to this proposal, given the dramatic accounting consequences
16 that would result and given that the proposal would deny the Company a return on its
17 investment. In addition to the fact that the plan would require the Company to forego
18 authorized revenue for plant found to be used and useful, the Anthem Council's phase-in
19 plan would also require a substantial write-off of this plant, resulting in severe financial
20 consequences for the Company.³² Anthem Council's Opening Brief still fails to provide
21 any credible support for any different accounting treatment for this proposal. This is not
22 surprising given that both of its witnesses concede, as they must, that the ultimate

23 _____
24 ²⁹ Decision No. 70351 at 44.

³⁰ Staff Opening Brief at 7.

25 ³¹ Exhibit S-7 at Ex. DMH-2. The recommended condition also requires the Company to reduce water loss
to below 10% prior to December 31, 2010.

26 ³² TR.I. at 310-11. The detailed accounting implications of this proposal are discussed in the confidential
provisions of Mr. Jenkins' testimony. Ex. A-46 at 5-6; Ex. A-44 at Exhibit JMJ-1.

1 accounting treatment of this proposal would be made by the Company in consultation with
2 its outside auditors.³³

3 **B. Anthem's New Phase-In Proposal Should Also Be Rejected**

4 Anthem Council also proposes in its Opening Brief that the Commission
5 consider a phase-in that would include carrying charges and make the Company whole at a
6 later date.³⁴ Anthem Council makes this proposal because, in its view, the Company has
7 enjoyed "interest free use of the Plant financed with AIAC for many years."³⁵ What the
8 Anthem Council ignores, of course, is that the use of AIAC to fund the plant has allowed
9 the Anthem community to enjoy interest-free use of this plant since 1998 without full
10 recognition of this used and useful plant in rate base. As noted by RUCO, any type of
11 phase-in plan--even one that would make the Company whole at a later date--would require
12 the Company to agree to forego revenue on plant that the Commission has found to be in
13 rate base.³⁶ As RUCO made clear in its testimony, such phase-in plans ultimately have a
14 detrimental effect on ratepayers, as the Company is entitled to receive its authorized
15 revenue at a later date and results in higher rates following the phase-in.³⁷ Given the
16 Company's current financial position, it cannot agree to a phase-in of plant as proposed by
17 the Anthem Council or any phase-in plan that delays its authorized revenue increase.

18 **C. RUCO's New Phase-In Proposal**

19 Despite the lack of any record evidence to support such a phase-in and
20 despite the fact that RUCO has made no suggestion during this proceeding that any of the
21 plant in Anthem is not used, useful or prudent, RUCO now recommends in its Opening
22 Brief a new phase-in proposal for consideration by the Company and the Commission.³⁸

23 ³³ TR.II at 622-23; TR.I at 888.

24 ³⁴ Anthem Opening Brief at 12.

25 ³⁵ *Id.*

26 ³⁶ Ex. R-13 at 5; TR.II at 728-29.

³⁷ TR.II at 729-30.

³⁸ RUCO Opening Brief at 41-43.

1 RUCO's proposal is surprising as it contradicts its own sworn testimony in which it made
2 clear that these types of phase-in plans ultimately have a detrimental effect on ratepayers.³⁹

3 RUCO's new proposal would first require that nine-tenths of the 2008 refund
4 payment of \$20.2 million and the 2010 refund payment of \$6.7 million be treated as new
5 AIAC (even though the plant has been in service for more than ten years) and amortized
6 over ten additional years.⁴⁰ The proposal recommends annual carrying charges on the
7 difference in operating income resulting from the imputed AIAC be recovered in rates over
8 three years following completion of Anthem's next rate case, and so on through subsequent
9 Anthem rate cases, until fully recovered. For example, just the first year's revenue
10 requirement on the difference in operating income is approximately \$2.9 million. A similar
11 deficiency would exist in each subsequent year and would be recovered at a later date in
12 ultimately higher rates.⁴¹

13 This proposal suffers from most of the same issues as the phase-in plans
14 supported by the Anthem Council. Similar accounting issues would arise with this type of
15 phase-in, and the Company would face a write-off of plant. In addition, given regulatory
16 lag, it would in fact be much longer than ten years before the phased-in amounts would be
17 recognized in rate base. Indeed, RUCO itself suggests that it would be at least thirteen or
18 fourteen years before all of the amounts would be recognized.⁴² Finally, this phase-in plan
19 is unfair and inequitable given, as RUCO found, that these "infrastructure costs are
20 legitimate costs of service, and the Company should be allowed to recover its legitimate
21 costs."⁴³ For all of these reasons, RUCO's new phase-in recommendation should be
22 rejected.

23 ³⁹ TR.II at 729-30.

24 ⁴⁰ RUCO Opening Brief at 42-43.

25 ⁴¹ Based on the Company's review of Exhibit 1 to RUCO's Opening Brief, the Company believes that
RUCO has understated the impact on rate base and revenue requirement that would result from RUCO's
proposal. This highlights the issues inherent in advancing such proposals in briefs.

26 ⁴² *Id.* at 43.

⁴³ *Id.* at 41.

1 **IV. ANTHEM’S LEGAL ARGUMENTS**

2 **A. The Pulte Refund Payments Should Not Be Excluded from**
3 **Rate Base.**

4 Anthem Council continues to argue that the Pulte refund payments should be
5 excluded from rate base because of a failure to receive explicit Commission approval of the
6 Pulte Infrastructure Agreement, as amended (“Infrastructure Agreement” or “Agreement”).
7 The Council’s position is not only entirely void of legal merit but also manifestly unfair.
8 The refund payments represent investment in plant found used and useful in providing
9 service to the Anthem community, as Staff recognized in its Opening Brief.⁴⁴ Arizona-
10 American is legally entitled to a fair return on and of this investment. The Council’s
11 Opening Brief does not provide any reasons that justify a disallowance. The Commission
12 should reject the Council’s arguments and include the Pulte refund payments in rate base.

13 **1. “Evidence of Indebtedness” under A.R.S. Sections 40-301 to**
14 **303**

15 Staff is in agreement with the Company that the Infrastructure Agreement is
16 unequivocally not “evidence of indebtedness” as that term is used in A.R.S. § 40-301 to
17 303.⁴⁵ This position also represents the Commission’s longstanding treatment of
18 agreements in the nature of an advance in aid of construction. Tellingly, the Anthem
19 Council has failed to point to even one instance in which an agreement of this nature was
20 held subject to the requirement of prior Commission approval under A.R.S. § 40-301 to
21 303, and the Company is not aware of any. More than that, as the Company’s Opening
22 Brief outlines in detail that will not be repeated here, the Company, or its predecessor, on
23 multiple occasions did in fact present the Infrastructure Agreement to the Commission and
24 request approval, but the Commission declined to rule on these requests. The
25 Commission’s decisions declining to approve or disapprove the Agreement indicate that it

26 ⁴⁴ Staff Opening Brief at 16.

⁴⁵ *Id.* at 14-15.

1 is a “private contract” and not the type of agreement that requires prior Commission
2 approval. In light of these prior requests, the inequity of a disallowance for failure to obtain
3 explicit Commission approval is clear, as recognized by Staff and RUCO as well.⁴⁶

4 Analysis of the statutory language demonstrates the fallacy of the Council’s
5 position. As explained fully in Arizona-American’s Opening Brief, the term “evidence of
6 indebtedness” as used in A.R.S. § 40-301 to 303 must be read narrowly and with a view to
7 the surrounding statutory terms. These statutes relate to the issuance of “stocks”, “bonds”
8 and “notes” by public utilities, and, as Staff points out in its brief, the heading of A.R.S.
9 § 40-301 specifically reads “Issuance of stocks and bonds; authorized purposes”.⁴⁷ The
10 Infrastructure Agreement is not an equity or debt instrument akin to a stock or bond. It is
11 merely a private contract prescribing the terms of the parties’ agreement, including a
12 schedule for refund of funds advanced. The fact that it was backed by letters of credit does
13 not alter its character in that regard. Furthermore, agreements such as the Infrastructure
14 Agreement are not designed for the purpose of building up the utility’s general and
15 permanent capital structure like an issuance of stock, but rather serve the specific and
16 limited purpose of placing the risks of development on the developer rather than the public
17 utility. For these reasons, the Infrastructure Agreement is not “evidence of indebtedness”
18 under A.R.S. § 40-301 to 303.

19 The Council, in its Opening Brief and pre-hearing memorandum, appears to
20 rely on a barebones argument that the Infrastructure Agreement is “evidence of
21 indebtedness” merely because it creates contractual payment obligations that extend more
22 than one year into the future. As both the Company and Staff emphasized in their Opening
23 Briefs, the Council’s overly simplistic logic would amount to a requirement that any routine
24

25 ⁴⁶ Staff Opening Brief at 14-15; RUCO Opening Brief at 41 (“It would be unfair, even if legal, at this point
26 to deny the Company recovery of the pending request or to go back in time and void the recovery of past
payments made.”)

⁴⁷ Staff Opening Brief at 14.

1 contractual arrangement extending over one year, whether it be for cleaning services,
2 computer software, or document support services, be docketed and presented to the
3 Commission for approval. Nor does the Tenth Circuit case that the Council cites in its
4 Opening Brief provide any relevant or persuasive authority for its position. That case
5 involves interpretation of the federal securities laws, which are of a different nature and
6 purpose than a state law regulating a public utility's issuance of debt and equity.⁴⁸ See
7 *United States v. Austin*, 462 F.2d 724, 736 (10th Cir. 1972). Accepting the Council's
8 strained analysis would result in a drastic change of course for the Commission, and greatly
9 increase the burden on the Commission's limited resources—all without any basis to
10 believe that such was the Legislature's intent.

11 2. Commission Rule 14-2-406

12 Staff, RUCO, and the Company all agree that Commission Rule 14-2-406
13 likewise does not provide a basis for the harsh penalty of denying Arizona-American a
14 return on and of its investment in plant found to be used and useful.⁴⁹ From RUCO's
15 perspective, "for the reasons cited in Decision No. 64897, the Agreement does not meet the
16 requirements for a Main Extension Agreement under AAC R14-2-406 and does not require
17 approval under the Commission Rule."⁵⁰ Staff explicitly acknowledges in its brief, as
18 detailed in Arizona-American's own brief, that the Company sought Commission approval
19 of the Agreement on multiple occasions and that Staff had opined that the Agreement did
20 not require approval.⁵¹ The fact that Staff and the Commission determined on these
21 occasions that approval was not required cannot serve as a basis for disallowing the Pulte
22 refund payments—a drastic penalty that is not the remedy specifically provided for in Rule

23 ⁴⁸ For example, as the Tenth Circuit states in *Austin*, the federal securities laws are to be construed broadly.
24 *Austin*, 462 F.2d at 736. By contrast, as demonstrated in Arizona-American's Opening Brief, statutes like
25 A.R.S. § 44-301 to 303 should be interpreted narrowly. See, e.g., *Webster Mfg. Co. v. Byrnes*, 207 Cal. 630,
637 (Cal. 1929); *Wis. So. Gas. Co. v. Pub. Serv. Comm'n*, 57 Wis. 2d 643, 648 (Wis. 1973).

⁴⁹ Staff Opening Brief at 15; RUCO Opening Brief at 40.

⁵⁰ RUCO Opening Brief at 40.

⁵¹ Staff Opening Brief at 15.

1 14-2-406. The Rule instead prescribes a remedy that is designed to protect the developer's
2 interests, not to penalize the public utility. What the Rule requires is for the utility to
3 immediately refund the advance to the developer, a condition that has already been met in
4 this case as the Company has satisfied its repayment obligations to Pulte. As Staff
5 concludes in its Opening Brief, the "Council's requested remedy is harsh, inequitable and
6 should be disregarded."⁵²

7 **3. Overriding Principles of Equity and Fairness**

8 Even putting aside the arguments demonstrating the lack of a legal basis for
9 disallowance, compelling principles of equity and fairness require rejection of the Council's
10 arguments for exclusion of Pulte refund payments. Arizona-American specifically
11 requested Commission approval of the Infrastructure Agreement, and the Commission's
12 decisions declining to rule on these requests cannot in fairness be used against the
13 Company now. Staff and RUCO had no difficulty in reaching this same conclusion, with
14 Staff specifically acknowledging that it would be inequitable to "penalize" the Company
15 for not obtaining approval of the Agreement "when it had sought such approval on several
16 occasions."⁵³ Moreover, Arizona-American was perfectly reasonable in relying on the
17 Commission's decisions declining to approve or disapprove the Agreement, as well as on
18 the Commission's longstanding practice. Further, as RUCO notes, the Commission has
19 approved the recovery in rates of prior refunds paid by the Company under this agreement,
20 which arguably suggests tacit approval of the Infrastructure Agreement.⁵⁴ For the
21 Commission to disallow recovery of the refund payments in this case would be
22 inconsistent, "harsh" and "inequitable", as recognized by Staff.⁵⁵

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25 ⁵² *Id.*

⁵³ *Id.*; RUCO Opening Brief at 39-41.

⁵⁴ RUCO Opening Brief at 41.

⁵⁵ Staff Opening Brief at 15.

1 payments, which represent Arizona-American's reasonable investment in used and useful
2 plant.

3 V. OPERATING INCOME ISSUES

4 A. Pension Expense

5 The Company requests that the Commission utilize its 2009 ERISA-based
6 pension expense amounts as the most appropriate known and measurable calculation of this
7 expense item.⁵⁹ As a result of market forces beyond the Company's control, pension
8 expense has increased dramatically over recent years. Although management has some
9 discretion in relation to this funding, the amounts utilized by the Company are minimum
10 amounts and management does not have discretion to fund at levels below these ERISA-
11 based amounts.⁶⁰ As set forth in the Company's testimony and exhibits, the Company's
12 actual pension expense remained high in 2010, and the Company expects pension expense
13 to continue to increase in the near future and remain at these higher levels thereafter.⁶¹
14 Staff did not take issue with the Company's requested amounts and also accepts the
15 Company's adjustment to its initial request to address an increase in ERISA-based expense
16 for the Service Company.⁶²

17 Despite the reasonableness of the Company's proposal, RUCO now argues
18 for an even lower amount than it recommended during the hearing. RUCO claims that the
19 Commission should rely upon FAS 87 rather than ERISA and that the amount used should
20 be the test year amount.⁶³ For all of the reasons set forth in the Company's Opening Brief,
21 the Commission should reject RUCO's recommendation, which ignores that the Company
22 is an ERISA-based company for ratemaking purposes (which the Commission has adopted
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24 ⁵⁹ Ex. A-1; Ex. A-7 at 10; A-14 at 14-15.

25 ⁶⁰ TR.I. at 137-38; Ex. A-7 at 10.

26 ⁶¹ Ex. A-25.

⁶² Ex. A-14 at 16; Staff's Revenue Requirement Schedules (*e.g.*, Schedule GWB-10).

⁶³ RUCO Opening Brief at 17.

1 for the Company in numerous cases) and ignores the new realities of the Company's
2 pension expense, as reflected in its 2009 figures.⁶⁴ The Company's position, which is
3 accepted by Staff, is reasonable and should be adopted.

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

5 The same reasoning that supports the Company's pension expense figures
6 also supports the Company's increased cost for other post-employment benefits. The
7 larger-than-typical 22% pro forma increase to the test year level of employee benefits
8 expense was driven by increased funding obligations due to the severe deterioration in
9 financial markets.⁶⁵ As with its pension expense, the Company expects OPEB expenses to
10 remain at a higher level in the future and believes that the adjustment to reflect actual 2009
11 OPEB expense for its employees and Service Company employees is appropriate, and
12 RUCO's position should be rejected.

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

14 In its Opening Brief, RUCO continues to argue against the establishment of a
15 tank maintenance deferral account for the Sun City Water District.⁶⁶ The Company has
16 made clear that it supports Staff's recommended approach to these tank maintenance
17 expenses. Staff advocates for inclusion of \$362,000 as a normalized expense based on its
18 belief that "if the tanks are well maintained, . . . on a regular basis, it may produce long
19 term benefits to the ratepayers in that it may reduce the long-term capital cost or the long-
20 term capital replacement costs."⁶⁷

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23 ⁶⁴ TR.I at 139-40. As noted by the Company in its Opening Brief, if the Commission does wish to
24 transition to FAS 87, then it is necessary for the Commission to clearly order the Company to use FAS 87,
25 and to identify the specific FAS 87 amount for ratemaking purposes. The Company would also request the
26 recognition of its existing regulatory asset and an annual amortization in revenue requirement which reflects
the difference between FAS 87 amounts and ERISA amounts.

⁶⁵ Ex. A-16 at 15.

⁶⁶ RUCO Opening Brief at 21-22.

⁶⁷ TR.I at 815.

1 RUCO does not address Staff's recommendation in its Opening Brief and
2 does not include Staff's proposed expense in its schedules. Rather, RUCO continues to
3 maintain that the Commission should reject the Company's deferral request. As noted
4 during the hearing, this is contrary to RUCO's position in the prior rate case (and in other
5 dockets), in which it testified that such maintenance reserve accounts benefit ratepayers.⁶⁸
6 The Commission should accept Staff's recommendation in relation to tank maintenance in
7 the Sun City Water District.

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

9 For the reasons set forth in its Opening Brief, the Company continues to
10 request the establishment of a deferral account for its Anthem Water District.

11 **E. Rate Case Expense**

12 The Company and Staff continue to agree on the appropriate level of rate case
13 expense in this case. RUCO's argument that the Company could have saved expense on its
14 consolidation notice is flawed, as the Commission ordered the Company to do a separate
15 mailing.⁶⁹ The argument that the Company is double counting affiliate labor is also
16 flawed.⁷⁰ The direct accounting used by the Company for Service Company labor is
17 efficient and eliminates the possibility of double counting.⁷¹ As noted by the Company in
18 its Opening Brief, this case required unprecedented time and expense due to the numerous
19 issues and parties.⁷² For all of these reasons, RUCO's adjustment should be rejected.

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

21 Contrary to past practice of this Commission, RUCO suggests that Annual
22 Incentive Plan expenses for Service Company employees should be removed in their

23 ⁶⁸ Ex. A-37.

24 ⁶⁹ RUCO Opening Brief at 12; Procedural Order dated March 18, 2010 at 9.

25 ⁷⁰ RUCO Opening Brief at 13.

26 ⁷¹ TR.I. at 142-43.

⁷² The rate case expenses incurred by the Company as of this date, not including legal expenses for post-hearing matters, are approximately \$550,000, and the Company expects to reach its estimate by the conclusion of this case.

1 entirety.⁷³ Staff, RUCO, and the Commission have supported a disallowance of 30% of
2 AIP in prior cases.⁷⁴ The Commission should not treat AIP costs for Service Company
3 employees differently simply because these employees are employed by a different entity.
4 As with AIP for direct employees, AIP is an important part of the compensation for Service
5 Company employees, which includes many members of the Arizona-American team.⁷⁵ For
6 these reasons, the Commission should reject RUCO's inconsistent adjustment for Service
7 Company AIP and should instead apply a 70% factor of AIP costs for Service Company
8 employees, the same as it has done for both Arizona-American and Service Company
9 employees in prior cases.

10 **G. RUCO's Adjustment to Management Fees--Labor Expense**

11 RUCO argues for the disallowance of the Company's post test year pay
12 increase for Service Company employees.⁷⁶ As Mr. Smith notes in his testimony, RUCO's
13 position in this case is not consistent with its positions in prior cases and violates RUCO's
14 expressed belief that "consistent application of regulation is good public policy and
15 provides for a stable regulatory environment."⁷⁷ This is a known and measurable increase
16 accepted by Commission Staff in this case and adopted by the Commission in the
17 Company's prior rate cases.⁷⁸ The Commission should continue its past practice of
18 accepting these types of known and measurable increases and reject RUCO's proposed
19 disallowance.

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23 ⁷³ Ex. R-10 at 54.

24 ⁷⁴ Decision No. 71410 at 35.

25 ⁷⁵ Ex. A-4 at 7.

26 ⁷⁶ The Company did not address this issue in its Opening Brief because there was no specific adjustment set forth in RUCO's Final Schedules.

⁷⁷ Ex. R-10 at 92.

⁷⁸ TR.I at 654; Ex. R-10 at 92.

1 **VI. COST OF CAPITAL ISSUES**

2 In its direct case, the Company, through the testimony of Dr. Villadsen,
3 supported a return on equity of 12.25%. As set forth in Dr. Villadsen's testimony, this
4 request was conservative and well-supported. Despite the strength of the Company's
5 position, the Company agreed as part of its rebuttal case to accept the Staff's return on
6 equity figure of 10.7% and a weighted cost of capital of 7.2%. RUCO's position of a 9.5%
7 return on equity and a 6.7% weighted cost of capital is unreasonable, unsupported, and
8 should be rejected by the Commission.

9 **A. The Company's Original Position**

10 In her direct testimony, Dr. Villadsen provided ample support for a 12.25%
11 cost of equity. Using two versions of the Discounted Cash Flow ("DCF") method and three
12 versions of the Capital Asset Pricing Model ("CAPM"), Dr. Villadsen estimated the after-
13 tax weighted-average cost of capital of her samples, which is the measure that companies
14 most commonly use to evaluate investments.⁷⁹ Utilizing this data, Dr. Villadsen then
15 determined the corresponding cost of equity for Arizona-American.⁸⁰ Because Arizona-
16 American's percentage of equity is lower than the percentage of equity among many
17 utilities, its financial risk is higher, which means that its investors will require a higher
18 return.⁸¹

19 In addition to the cost of capital analysis discussed above, Dr. Villadsen
20 reviewed twenty recent Commission decisions to assess the reasonableness of Arizona-
21 American's request. When compared in terms of the overall return, the cost of equity
22 requested by Arizona-American Water in this proceeding is comparable to that granted to
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⁷⁹ Ex. A-20 at Appendix B.

26 ⁸⁰ *Id.* at 65-69.

⁸¹ *Id.* at 9, 65-69.

1 other water and wastewater utilities in Arizona as adjusted for Arizona-American's targeted
2 equity percentage.⁸²

3 As noted by Dr. Villadsen, although it may seem counterintuitive to increase
4 the cost of capital during an economic recession, it is in fact necessary to attract needed
5 capital.⁸³ The financial crisis has widened the range of a reasonable return on equity and
6 especially increased the upper bound on the range.⁸⁴ Based on the evidence from the
7 samples, Arizona-American's original request for 12.25% return on equity is reasonable
8 and fully supported by Dr. Villadsen's testimony.

9 Despite the reasonableness of its request, the Company agreed to accept
10 Staff's cost of equity of 10.7 percent in order to limit the issues in this case. Unlike RUCO,
11 Staff's recommendation recognizes the additional risk inherent in the Company's capital
12 structure. Staff's recommended return on equity is within the returns allowed by other
13 jurisdictions and within the range of what credit rating agencies consider appropriate for a
14 utility such as Arizona-American.⁸⁵

15 **B. RUCO's Recommended Return on Equity Should Be**
16 **Rejected**

17 As noted by RUCO in its Opening Brief, in relation to cost of capital, the
18 "only significant point of disagreement between RUCO and Staff is that Staff has estimated
19 the Company's cost of equity at 10.70 percent and RUCO estimated the Company's cost of
20 equity at 9.5 percent."⁸⁶ For a number of reasons outlined in the Company's Opening
21 Brief, RUCO's analysis is flawed. RUCO makes an unconventional adjustment to the DCF
22 model and fails to take into account the fact that the cost of equity necessarily is higher than
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24 ⁸² *Id.* at 66-67.

25 ⁸³ *Id.* at 20-36.

26 ⁸⁴ *Id.*

⁸⁵ Ex. A-21 at 3.

⁸⁶ RUCO Opening Brief at 44.

1 the cost of debt plus a risk premium.⁸⁷ RUCO's recommended return on equity also fails to
2 consider the additional risk Arizona-American faces because it has more debt than
3 comparable companies.⁸⁸ Finally, RUCO's recommendation ignores the impact of the
4 current financial crisis on the cost of capital and the need to increase cost of capital in order
5 to attract needed investment.⁸⁹

6 RUCO attempts unsuccessfully in its Opening Brief to justify Mr. Rigsby's
7 recommendation by misusing specific Value Line information.⁹⁰ RUCO examines 2010
8 Value Line projections which show a projected long-term (2012-14) return on book
9 common equity for the water utility industry of eight percent and for American Water of six
10 percent.⁹¹ Putting aside the inapplicable time frames used by RUCO, Value Line's
11 projected ROE for the water industry and American Water is not a measure of investors'
12 expected returns, but rather is an estimate of realizable accounting returns.⁹² These are two
13 very different concepts and should not be confused as support for RUCO's position.
14 RUCO also attempts to compare Aqua America's and American Water's stock price as
15 support for the demand for American Water's stock.⁹³ This comparison is also irrelevant as
16 the absolute price per share depends on numerous issues, including the number of shares
17 outstanding. In addition, and critically, none of the metrics cited is relevant to the specific
18 regulated entity, Arizona-American.

19 RUCO also misstates Dr. Villadsen's testimony in an attempt to support its
20 position. Despite RUCO's claims, Dr. Villadsen did not link the decline in water utility
21 betas to water utilities being more risky.⁹⁴ Rather, her testimony makes clear that the

22 ⁸⁷ Ex. A-21 at 8-9.

23 ⁸⁸ *Id.* at 7, Sch. R-1.

24 ⁸⁹ Ex. A-21 at 3-4.

25 ⁹⁰ RUCO Opening Brief at 45.

26 ⁹¹ *Id.*

⁹² Investors recognize that actual returns will be lower.

⁹³ RUCO Opening Brief at 45.

⁹⁴ *Id.* at 46.

1 financial crisis has increased investors' required return.⁹⁵ She also testified that
2 infrastructure investment needs and environmental requirements are increasing the risks of
3 the water utility industry.⁹⁶

4 RUCO also misstates Dr. Villadsen's testimony when it claims that she
5 critiqued Mr. Rigsby's "CAPM results [as] being below the current yield on Baa/BBB debt
6 instruments."⁹⁷ As Dr. Villadsen made clear in her testimony, the issue with Mr. Rigsby's
7 CAPM results is that all estimates used are less than the current yield on Baa-rated utility
8 bonds plus 100 basis points as a risk premium (as used by FERC). Even though Mr.
9 Rigsby recommends a return on equity in the high end of its estimated range, it is still too
10 low to reflect the return investors require in today's financial markets.

11 C. RUCO's Post-Hearing "Evidence" Must Be Disregarded

12 To further justify its unreasonably low cost of capital recommendation,
13 RUCO attempts to shift the focus away from cost of equity by re-opening an examination
14 of its cost of debt recommendation--a recommendation, as set forth in its final schedules,
15 that is slightly higher than that recommended by Staff and the Company. RUCO attempts
16 to do this by re-examining short-term debt costs set forth in recent American Water filings
17 with the SEC and by relying upon recent actions of the Federal Reserve.⁹⁸ First, certain of
18 this "evidence" is clearly not in the record and should be disregarded for that reason alone.
19 Second, RUCO's reliance on this information ignores that the relevant inquiry is the test
20 year and not figures from a year or more thereafter.⁹⁹ Finally, RUCO's analysis ignores the

21 ⁹⁵ Ex. A-21 at 4. Water utility betas only dropped well into the financial crisis, so they follow the market
22 more than, for example, the gas LDC industry. *Id.* at 5.

23 ⁹⁶ *Id.* at 6.

24 ⁹⁷ RUCO Opening Brief at 47.

25 ⁹⁸ The Federal Reserve document cited by RUCO has no relevance to Arizona-American's cost of capital.
26 While the federal funds rate certainly is low and likely to remain low, Arizona-American does not borrow at
the federal fund rate; it borrows at the market cost of debt, which is represented by the yield on Baa rated
utility bonds, which Mr. Rigsby estimated at 6.34%. *See* Ex. R-3 at Ex. WAR-8.

⁹⁹ Anthem Council makes these same invalid comparisons. Anthem Council relies upon the cost of short
term debt as of December 31, 2009, and disregards that the weighted rate for American Water for 2008, the
test year in this case, was 3.51%.

1 fact that Arizona-American's short-term debt is presently very high due to construction of
2 the White Tanks treatment plant in Agua Fria Water District and also that short-term debt
3 by its very nature must eventually become long-term debt and that long-term rates must be
4 given more credence in an examination of the relevant cost of debt.¹⁰⁰

5 **D. Public Comment Relied upon by RUCO and Anthem**
6 **Community Council Should Not be Given Weight**

7 In a belated effort to support a lower cost of capital, the Anthem Council and
8 RUCO seek to interject the unsworn public comment of an Anthem resident.¹⁰¹ Because
9 this resident was not a witness in this proceeding, his findings and credentials were not
10 subject to challenge or cross-examination by the other parties or by the parties' witnesses in
11 this case. This unchallenged public comment, which is replete with weaknesses, should not
12 be given weight in the cost of capital determination.

13 **E. Staff's Position Is Reasonable and Should Be Adopted**

14 Staff supported a cost of equity of 10.7%, resulting in a weighted cost of
15 capital of 7.2%. This amount is lower than the 7.33% approved by the Commission for the
16 Company in its most recent rate case.¹⁰² Staff's recommendation, unlike RUCO's or the
17 Anthem Council's, recognizes the additional risk inherent in the Company's capital
18 structure. Staff's recommended return on equity is within the returns allowed by other
19 jurisdictions and within the range of what credit rating agencies consider appropriate for a
20 utility such as Arizona-American.¹⁰³

21 For all of these reasons, the Commission should adopt Staff's return on equity
22 of 10.7% and cost of capital of 7.2%.

23 ¹⁰⁰ Basing rates on an artificially low cost of short-term debt would also provide a strong disincentive to the
24 refinancing of short-term debt to long-term debt in order to avoid a large increase in interest expense that
25 would not be recovered in rates until after the next rate case. If the Company does not refinance short-term
26 debt into long-term debt, there would be an unacceptable exposure of the Company to future interest rate
risk.

¹⁰¹ RUCO Opening Brief at 52; Anthem Opening Brief at 15 n.49.

¹⁰² Ex. S-3 at 10; Decision No. 71410 at 45.

¹⁰³ Ex. A-21 at 3.

1 **VII. INFRASTRUCTURE IMPROVEMENT SURCHARGE**

2 Staff and RUCO continue to argue that the Company seeks extraordinary
3 treatment for ordinary plant replacements.¹⁰⁴ As noted by the Company in its Opening
4 Brief, although these types of replacements are ordinary, the costs for the replacements that
5 are projected to occur in Sun City are not ordinary, and in fact, are quite large. In addition,
6 even if this type of replacement is ordinary (putting aside the magnitude of the
7 replacements projected), the Company is proposing an approach that would help to
8 alleviate the extraordinary regulatory lag that it experiences in Arizona. This approach
9 would allow the Company an opportunity to earn a return on its investment in a timely
10 manner, while at the same time helping to alleviate the rate shock that will occur if all of
11 the anticipated replacements in Sun City are addressed in one rate case without any
12 intervening means to address these replacements in rates. For these reasons, the Company
13 requests that the Commission give serious consideration to the use of this NARUC Best
14 Practice in the Sun City Water District.

15 **VIII. RATE DESIGN ISSUES**

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

17 With regard to a stand-alone rate design, the Company continues to support a
18 pro rata increase as described in its Opening Brief. If consolidation is not adopted, this rate
19 design continues to be supported by RUCO and by the Anthem Council. For the reasons
20 set forth by the Company in its Opening Brief, the Company requests that the Commission
21 reject Staff's rate design proposals. Following the receipt of the Opening Briefs, the
22 Company has reconsidered its proposed effluent rate and tariff as discussed below. The
23 Company also addresses below the Anthem Council's argument for a de-consolidation of
24 the Anthem/Agua Fria Wastewater District.

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¹⁰⁴ Staff Opening Brief at 11; RUCO Opening Brief at 36.

1 **1. Effluent Rate**

2 After much consideration, discussion and review of the Opening Briefs, the
3 Company now requests that the Commission adopt the rate recommended by DMB and
4 approve an effluent tariff effective in the Anthem/ Agua Fria Wastewater District in the
5 amount of \$250 per acre foot or \$0.77 per kgal.¹⁰⁵ Upon Commission approval of this new
6 wastewater tariff, those customers in the Anthem/Agua Fria Wastewater District presently
7 receiving effluent would cease taking effluent under existing water tariffs and receive
8 effluent pursuant to the new wastewater tariff. The new wastewater tariff would govern the
9 direct use of effluent only and would not include the use, for example, of non-potable CAP
10 water or non-potable raw underground water nor, of course, potable water.¹⁰⁶

11 If this new effluent wastewater tariff is approved, the Company would also
12 request approval to revise the Anthem Water tariff to remove the provision of effluent
13 under that tariff. As part of this revision, it would also be necessary to re-classify the test-
14 year revenues associated with effluent in the Anthem Water District and address revenues
15 associated with effluent in the Anthem/Agua Fria Wastewater District.

16 **2. De-Consolidation of the Anthem/Agua Fria Wastewater
17 District**

18 The Anthem Council argues in support of de-consolidation of the
19 Anthem/Agua Fria Wastewater District.¹⁰⁷ However, there is no evidence in the record in
20 this case to support de-consolidated revenue requirements for this district. If the
21 Commission determines that it is appropriate, the Company does not object to the future de-
22 consolidation of these districts in the Company's next rate case. The Company specifically
23 requests that the Commission in its Order in this docket express its intent on this issue for
24 the Company's future filings. This would provide the Company with direction necessary to

25 ¹⁰⁵ If this rate is approved, it will be necessary to spread the revenue reduction to other customer classes to
allow the Company to recover the approved revenue requirement.

26 ¹⁰⁶ Corte Bella would not be covered by this effluent tariff.

¹⁰⁷ Anthem Opening Brief at 19-20.

1 know whether to file its next rate case for Anthem/Agua Fria Wastewater District as
2 consolidated or whether to file individual rate cases for either or both of these districts on a
3 de-consolidated basis.

4 **B. Consolidation**

5 The Company spent an enormous amount of time and resources on the issue
6 of statewide consolidation in this proceeding. This included the construction of a rate
7 consolidation model that could be used easily by all parties, including Commission Staff; 2)
8 performing numerous scenarios for the parties and Commission and creating many custom
9 spreadsheets to assist with the analysis; 3) timely noticing of all customers on the issue of
10 consolidation; 4) hosting town halls and open houses in every district; 5) responding
11 individually to many of the e-mails and letters received from customers; and 5) making a
12 detailed presentation as part of the hearing in this case. Although Staff argues in its
13 Opening Brief that the Company has not shown any quantifiable cost/benefit analysis, the
14 Company made clear in its testimony that it already operates as a single company with
15 many shared functions and that there would be no significant cost savings (except for future
16 rate case expense) as a result of consolidation.¹⁰⁸ As noted by the Company in its Opening
17 Brief, through this proceeding, the Company has provided an incredible amount of
18 evidence to address the issue of consolidation, including its benefits. If the Commission
19 desires to implement consolidation, ample evidence exists in the record to adopt
20 consolidation and the Company does not believe that RUCO's legal arguments create any
21 impediment to consolidation. The Company continues to believe that, if consolidation is
22 ordered in this proceeding, Company-wide consolidation is the best method to achieve the
23 full benefits of consolidation.

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¹⁰⁸ TR.II at 100, 281-83.

1 Robin Mitchell
2 Maureen Scott
3 Legal Division
4 Arizona Corporation Commission
5 1200 W. Washington Street
6 Phoenix, Arizona 85007

7 Copy of the foregoing mailed/emailed this
8 6th day of August, 2010, to:

9 Judith M. Dworkin
10 Sacks Tierney PA
11 4250 N. Drinkwater Blvd., Fourth Floor
12 Scottsdale, AZ 85251-3693
13 Attorney for Anthem Community Council

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

18 Daniel W. Pozefsky, Chief Counsel
19 Residential Utility Consumer Office
20 1110 West Washington Street
21 Suite 220
22 Phoenix, Arizona 85007

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

13 Larry Woods
14 Property Owners and Residents Assoc.
15 13815 E. Camino Del Sol
16 Sun City West, AZ 85375-4409

17 Bradley J. Herrema
18 Robert J. Saperstein
19 Brownstein Hyatt Farber Schreck, LLP
20 21 E. Carrillo St
21 Santa Barbara, CA 83101

16 W.R. Hansen
17 12302 W. Swallow Drive
18 Sun City West, AZ 85375

19 Greg Patterson
20 Water Utility Association of Arizona
21 916 W. Adams, Suite 3
22 Phoenix, AZ 85007

19 Andrew M. Miller, Town Attorney
20 Town of Paradise Valley
21 6401 E. Lincoln Drive
22 Paradise Valley, AZ 85253

23 Desi Howe
24 Anthem Golf and Country Club
25 2708 W. Anthem Club Drive
26 Anthem, AZ 85086

21 Norman D. James
22 Fennemore Craig, P.C.
23 3003 N. Central
24 Suite 2600
25 Phoenix, AZ 85012
26 Attorney for DMB White Tank, L.L.P.

27 Joan S. Burke
28 Law Office of Joan S. Burke
29 1650 N. First Avenue
30 Phoenix, AZ 85003
31 Joan@jsburkelaw.com
32 Attorney for Mashie, L.L.C.

24 Philip H. Cook
25 10122 W. Signal Butte Circle
26 Sun City AZ 85373

27 Larry D. Woods
28 15141 W. Horseman Lane
29 Sun City West, AZ 85375

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

Jayne Williams