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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 MOHAVE WATER AND WASTEWATER DISTRICTS.	Docket No. WS-01303A-06-0014

Arizona Corporation Commission
DOCKETED
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RUCO'S CLOSING BRIEF

INTRODUCTION

The Residential Utility Consumer Office ("RUCO") submits the following points in support of its position that the Arizona Corporation Commission ("Commission") should not authorize a rate increase of more than $280,860 for the water and $105,239 for the wastewater districts of the Mohave Division of Arizona-American Water Company ("Arizona-American" or "Company"). RUCO has undertaken an extensive study on the issue of property tax expense, the results of which further validate RUCO's recommended property tax calculation methodology. The Commission should also reject the Company's recommendation to include the cost of its equity in its working capital requirement, but include the Company's interest expense in working capital as it is a cash item. The Commission should reject the Company's proposed discriminatory apportionment of rate case expense, as well as the

Company's late attempt to reclassify its deferred tax recommendation as an asset. Finally, the Commission should approve RUCO's recommended return on common equity of 9.10 percent because it is consistent with what the Company recently recommended in its last rate application and the current environment of historically low interest rates.

PROPERTY TAXES

Property taxes for water utilities are based on a formula that values a water company based on an average of its three prior years' of gross revenues. In an apparent attempt to approve property tax recovery based on gross revenues that water utilities will earn as a result of new rates, the Commission has relied on various methodologies to compute estimated property tax expense. RUCO offered a study in this proceeding that demonstrates the degree to which two methodologies have accurately predicted the utilities' actual property taxes from the test-year forward.

The first methodology RUCO analyzed to calculate property tax expense utilized the Arizona Department of Revenue formula ("ADOR Methodology"). The ADOR Methodology, revised in 2001, values water utilities by multiplying the average of the water utility's three previous years of reported gross revenues by a factor of two[1]. RUCO-5 at 39. RUCO is recommending the Commission adopt the ADOR Methodology in this case.

The second methodology RUCO analyzed in its study is the methodology the Company is recommending the Commission approve to calculate property taxes in this case ("Company Methodology"). The Company Methodology substitutes adjusted test-year revenues twice,

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[1] For ease of reference, trial exhibits will be identified similar to their identification in the Transcript of Proceedings. The Transcript page number will identify references to the Transcript.

and proposed level of revenues once in the ADOR formula.[2] RUCO's study proves that the ADOR Methodology more accurately estimates the utilities actual property tax assessment.

1) THE COMMISSION HAS APPROVED SEVERAL DIFFERENT METHODOLOGIES SINCE ADOR REVISED ITS FORMULA

Since 2001, there have been various modifications to the ADOR property tax formula proposed[3] in rate cases, and the Commission has approved several modifications to the ADOR formula. In *Rio Verde Water Company, Docket No. W-02156A-00-0321, and Rio Verde Wastewater Company, Docket No. WS-02156A-00-0323*, Rio Verde used the average of three years of proposed revenues rather than two adjusted years of revenue and one proposed year of revenue as utilized in the instant case. RUCO-5 at 40. Staff recommended the Commission use the actual ADOR formula (ADOR Methodology). Id. at 41-42. The Commission did not approve a property tax calculation methodology in *Rio Verde*. The parties agreed to a settlement which was adopted by the Commission in Decision 63585, docketed on April 24, 2001.

In *Arizona Water Company - Northern Division (Docket No. W-01445A-00-0962, Decision No. 64282 – docketed December 28, 2001)* the Commission approved a property tax calculation based on two years of historical gross revenues plus one year of actual post-test year gross revenues (which were known at that time) and added the Commission's authorized revenue increase into the formula. Decision No. 64282 at 13, and See Rejoinder Testimony of Ralph Kennedy in *Arizona Water Company - Northern Division* at page 38, and Schedule

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[2] The ADOR will never use this methodology to collect property taxes

[3] RUCO has consistently advocated the Commission approve the actual ADOR formula.

RJK-R7 as corrected. The Commission rejected Staff's proposal of using two years of adjusted test year revenues and one year of proposed revenues, which is the same as the Company Methodology proposed in the present case. Decision No. 64282, and see Surrebuttal Testimony of Crystal Brown in *Arizona Water Company - Northern Division* - Schedule CSB-17.

Thereafter, in *Bella Vista Water Company, Docket W-02465A-01-0776, Decision No. 65350 docketed November 1, 2002,* the Commission approved a property tax calculation method based on one historical year, one actual post-test year, and one projected year. RUCO-6 at 23. Interestingly, the Commission noted in its Decision "Under proposed rates, the most logical approach is to use the two most recent historic years' revenues and the projected revenues under the newly approved rates." See Decision No. 65350 at 16. The "most logical approach" suggested by the Commission is what RUCO is suggesting as a compromise in this case. See page 7 below.

A little over one year ago, the Commission was still considering different methodologies for calculating property tax expense. In *Arizona Water Company–Western Group, Docket No. W-01445A-04-0650, Decision No. 68302, docketed November 14, 2005*, the Commission approved the use of two adjusted years of revenues and one projected year of revenues for its property tax calculation. Decision No. 68302 at 28 and 29. Amazingly, even though the Decision says otherwise, no party recommended the methodology that the Commission approved. Staff recommended the use of three previous years' gross revenues, and then Staff added its recommended increase before taking the average. See Staff's Direct Testimony of Ronald Ludders in *Arizona Water Company–Western Group*, filed April 20, 2005-Schedule REL-14 and Staff's Surrebuttal Testimony of Ronald Ludders filed May 25, 2005-Schedule REL-14. The Company advocated the same three years of gross revenues with the Company's proposed increase added before taking the average. See Direct Testimony of Sheryl Hubbard in *Arizona Water Company–Western Group* filed September 8, 2004 at 33 and Schedule C-2.

2) RUCO'S STUDY

The fact that positions on this issue have been so varied since ADOR issued its memo is significant in that it shows there is no methodology that guarantees that the estimated property tax will be the same as the actual property tax. However, the Commission continues to sanction methodologies that ***estimate*** what actual property taxes will be at some point far into the future. In no other instance has the Commission sanctioned expense levels so far outside of the test year. Transcript at 301. Thus, the focus should not be on whether the inputs are forward looking, backward looking, etc., but rather what inputs result in the ***closest estimate*** of actual property taxes in the period immediately after new rates go into effect.

Fortunately, enough time has passed that the Commission can now consider empirical evidence and actually see which of the two methodologies proposed in this case results in the closest estimates of actual property taxes. RUCO has conducted a property tax study of ten different water systems which have been granted rate increases by the Commission since the ADOR memo was issued. The purpose of RUCO's study is to present data and show the results comparing the two methodologies to the actual tax bills of ten different systems of water utilities that have applied to the Commission for rate increases since the ADOR memorandum was issued. RUCO-6 at 20-21. First, RUCO's study compares the results of the Company's Methodology applied to two test year adjusted and one year of proposed revenues from the respective cases to actual tax bills for the different systems. Next, it compares ADOR's Methodology using historical inputs as recommended by RUCO to the same actual tax bills. Id.

The overall results of the study show that the ADOR Methodology has an estimation error[4] of 1.6%. RUCO-4, Final Revised Surrebuttal Testimony Exhibit at page 5. The Company Methodology has an estimation error of 13.8%. Id. While both methods result in over-estimates of actual property tax assessments, ADOR's Methodology is **far less inaccurate** than the Company Methodology.

The Company is skeptical of RUCO's study, claiming that more "relevant" data shows that ten of the Company's operating districts whose rates were based on the Company Methodology, when measured as a whole, actually "under-collected" property taxes. A-14 at 40[5]. In its study, the Company looked at the ten operating districts and presented its results as an aggregate of the ten systems and not on an individual basis. Transcript at 217. The Company admits that several of the ten systems it considered, for example Aqua Fria and Anthem, experienced high rates of growth. Transcript at 218. Systems experiencing high rates of growth earn greater revenues, which result in greater property tax assessments. Id. The result of high growth rates, as the Company readily admits, is under-recovery of its actual property taxes. Transcript at 219. Aqua Fria's growth resulted in the under-recovery of its property taxes to the extent that it eliminated most of the over-recovery of the rest of the systems that were not experiencing high rates of growth[6]. Id. at 261, 274-275.

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[4] Estimation error in this context means the degree of error in estimating the actual property tax bill.

[5] These ten operating districts were formally owned by Citizens Utilities ("Citizens").

[6] The Company Methodology prevents the Company from earning an appropriate level of property tax expense. Because Mohave Water received a rate reduction in Decision No. 67093, two years are being used in the calculation that are based on the rate reduction and will not allow AZ-AM to recover a fair level of property tax expense on a going forward basis. See Transcript at 223.

RUCO believes its study is the more relevant of the two studies presented in this case. First, RUCO's study is comprised of ten different utilities that vary in size, ownership, and operating characteristics. RUCO-4. Thus, it is more representative of the overall Arizona water industry than the Company's study which looks only at Arizona-American's systems. A-14 at 40-43. Second, RUCO's study examines the disparities between actual taxes and tax estimates using the two different methodologies on a utility- by-utility basis. The Company's study looks at an aggregate comparison of ten of its own systems. RUCO-4, A-14 at 40-43. Thus, the Company's Methodology does not show the applicable results on a system-by-system basis and does not account for the large skews caused by the Company's systems that are experiencing high rates of growth.

Finally, RUCO's study focuses on the estimation error that results when comparing the two methodologies to actual taxes. Thus, RUCO's study looks to the accuracy and appropriateness of the two methodologies' estimation of property taxes, and shows that the ADOR methodology using historical inputs is superior since it has an estimation error of 1.6% versus the Company Methodology which has an estimation error of 13.8%. The Commission should not ignore the empirical evidence, and should adopt the ADOR Methodology as it is the best estimate of future property tax expense.

RUCO recommends that the Commission approve a property tax expense calculation in this case based on the actual ADOR property tax formula. RUCO-5 at 39. While RUCO has shown that calculating property taxes using the actual ADOR formula results in the best estimate of what actual property taxes will be in the immediate future, RUCO is aware that the Commission has rejected this methodology in the past. In the spirit of compromise, and if the Commission is still unwilling to accept the ADOR Methodology, RUCO would suggest the Commission approve a property tax calculation that uses two years of historical gross revenues and one year of projected revenues. Transcript at 298. This methodology provides a better estimate of actual property tax than the methodology recommended by the Company and Staff in this case because it is based on historical data that ADOR will actually use as the basis of its property tax assessment.

WORKING CAPITAL

A company's cash working capital requirement represents the amount of cash the company must have on hand to cover any differences in the time period between when revenues are received and expenses must be paid. Transcript at 210, RUCO-5 at 17. The most accurate way to measure the cash working capital requirement is via a lead/lag study. RUCO-5 at 17. The lead/lag study measures the actual lead and lag days attributable to individual revenue and expense items. Id.

The Company originally computed its cash working capital requirement from a lead/lag study that it performed. Id. RUCO reconciled the Company's lead/lag study and made several adjustments. The Company rejected one of RUCO's adjustments relating to interest expense which is the issue that remains in dispute. The Company has agreed to accept RUCO's adjustment to include interest expense provided the equity portion of the Company's cost of capital is recognized in the working capital calculation. A-14 at 15. RUCO recommends that the Commission accept its adjustment to include interest expense in the Company's working capital requirement as it is a cash item. Transcript at 205. RUCO recommends the Commission reject the Company's request to include the cost associated with equity as it is a non-cash item which is typically excluded when calculating a Company's working capital requirement. RUCO-6 at 8, Transcript at 206.

The Commission's position on including non-cash items in working capital calculations is well settled – the Commission does not allow it. In 1995, the Commission decided the Paradise Valley Water Company rate case (Docket No. U-1303-94-182). The Commission disallowed the Company's request to include depreciation and amortization expense in its calculation of cash working capital. (Decision No. 59079, dated May 5, 1995). The Commission stated:

> As we have stated in numerous other decisions, the calculation is for "cash working capital" and not "cash and non-cash working capital".

Decision No. 59079 at 7 (emphasis added). The Commission has not changed its position since. The Commission should not include costs associated with equity in the Company's working capital requirement.

The Company claims that RUCO's suggestion that the Company has "cost-free" equity flies in the face of the most basic financial principles. A-15 at 4. The Company mischaracterizes RUCO's position. RUCO recognizes that the Company's equity has a cost. In fact, RUCO is recommending that the Company be awarded a 9.10 percent return on its equity. RUCO-10 at 5. However, working capital concerns the capital that is necessary for the Company to operate its business[7]. The return on the Company's equity is unrelated to the Company's capital needs necessary to operate. The Commission should reject the Company's recommendation to include the cost of its equity in its working capital requirement.

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[7] Working capital is the "liquid buffer" available to meet the financial demands of a company's operating cycle. Donald E. Kieso Et Al., Intermediate Accounting, Tenth Edition (2001)

RATE CASE EXPENSE

The primary dispute regarding rate case expense concerns the manner in which the Commission should apportion the rate case expense between the two districts that are the subject of the Company's application. The Company believes that rate case expense should be allocated based on the revenue levels of the water and wastewater districts, which was a 90:10 ratio respectively. RUCO-5 at 54. RUCO recommends the Commission apportion rate case expense based on the estimated time that was spent on each district. RUCO-5 at 54.

The issue is one of fairness. Water customers should not subsidize the rate case expense of the sewer customers just because their district generates more revenues. Rate case expense should be borne by the ratepayers that caused the expense. RUCO-6 at 27. The Company's proposal is discriminatory in that it burdens one group of ratepayers (water customers) with more than its fair share of expense. The wastewater customers will actually pay less than their fair share of rate case expense under the Company's proposal. The Commission should not approve the discriminatory apportionment of rate case expense.

There also remains at issue RUCO's disallowance of several rate case expense items. RUCO decreased the rate case expenses associated with the Company's Labor-related expenses by $10,077. RUCO-5 at 54. RUCO adjusted the Data Requests/Discovery costs by 25 percent because relatively few data requests were issued in this case. Id. RUCO disallowed $100,000 for Rate Design and Cost of Service studies expense. The amount of rate case expense RUCO allowed for Rate Design and Cost of Service studies, $43,000, is based on the Company's Paradise Valley Water District's most recent rate case. In that case, the Company's outside expert charged $10,000 for the Cost of Service Study and $5,000 for the Rate Design. The $43,000 recommended by RUCO is more than enough to recognize that two systems were involved in this case. Id.

RUCO further reduced the rate case expense for the Company's Cost of Capital portion by fifty percent (from $90,000 to $45,000). Id. Shareholders receive a benefit from a rate case through potential higher equity rates and should share in the rate case expense. Id. Finally, RUCO reduced Miscellaneous Rate Case Expense by $4,000. Id. That reduction resulted from three adjustments made to the Company's estimates. One was to reduce the number of days the Company estimated for a system tour from four days to two. RUCO did not request an on-site visit. The second reduction was to reduce the Company's estimated ten days for a service company employee to attend the rate case hearing to five days[8]. The final adjustment was a reduction to the number of Public Meetings requested in the rate application. RUCO believes that one meeting is sufficient to assess public opinion. Those three adjustments reduce Miscellaneous Rate Case Expense by $4,000. RUCO's adjustments to rate case expense are fair and reasonable and should be adopted by the Commission.

DEFERRED TAX ASSETS

The matter of deferred tax assets did not become an issue for RUCO until the hearing. During the hearing, the Company introduced a restated Deferred Tax Schedule indicating a net deferred tax asset of $37,200 for the water division and $2,298 for the wastewater division. A-12 at page 1. In the Company's application, the Company was recommending a net deferred tax liability of $(214,497) for its water and $(13,253) for its wastewater division. Id. RUCO is unable to verify the Company's new position given the timing of the new schedule and the lack of source documentation. However, the nature and the characteristics

[8] The hearing actually lasted three days-November, 14-16, 2006.

of the transaction which support the Company's new position do not support the Company's revised deferred tax recommendation.

The issue began with the Company's agreement to remove its request for the recovery of the goodwill portion of the Citizens' acquisition premium. Transcript at 308. The Company appropriately raised the issue of revising its deferred income tax recommendations to reflect the exclusion of the goodwill. Considering the goodwill write- off, the Company in its rebuttal case claimed that the deferred tax liability adjustment for the water division would be $918,735 and $56,765 for the wastewater division. A-7, TMB-R2. The Company's adjustment to its deferred taxes made no sense to RUCO at the time, considering the Company was asking for total recovery on the acquisition premium of $353,635 to begin with. Id. at 9.

Subsequent to the Company's rejoinder filing, the Company filed a restated deferred tax schedule to "... Remove any impact of Citizens Acquisition Premium." The restated amount of deferred tax liability was $85,342 for the water division and $5,273 for the wastewater division. A-16 at 7-8. While RUCO could not verify the numbers because of its inability to conduct further discovery (the time for additional discovery had passed), the numbers made sense to RUCO. Transcript at 309. In RUCO's experience, since utilities are plant and capital intensive, the majority of the timing differences that lead to deferred tax impacts are going to be related to the difference between book depreciation and accelerated tax depreciation. Transcript at 309-310. While there may be instances of deferred tax assets, it is seldom the case where these deferred tax assets exceed the level of deferred tax liabilities attributable to plant, and hence when the deferred tax accounts are netted for presentation on the balance sheet, they will result in deferred tax liabilities. Id. Thus, the Company's recommended deferred tax liability's at this point made sense.

However, at the hearing, the Company again revised its deferred tax recommendations based on its audited financials that it claims it had only recently received. Transcript at 67. The Company is no longer recommending a deferred tax liability but is now recommending a deferred tax asset. A-12 at 1. Specifically, the Company is recommending a $37,300 deferred tax asset for its water division and a $2,298 deferred tax asset for its wastewater division.

RUCO is not able to verify these numbers this late in the proceeding. The opportunity for discovery has passed and there is no supporting documentation to verify the numbers. In short, RUCO can do nothing but rely on the Company's unsupported representations that these figures are true. This clearly raises questions of due process - the Company's revised recommendations should be rejected on due process concerns alone.

From an accounting perspective, the Company's revised recommendations do not make sense. It is difficult to imagine a situation where eliminating goodwill would give rise to a deferred tax asset when there would otherwise be a substantial deferred tax liability. Transcript at 311. The Commission should reject the Company's deferred tax asset recommendation for its water and wastewater systems.

COST OF CAPITAL

The Commission should adopt RUCO's recommended rate of return of 7.07 percent, which is the weighted cost of RUCO's recommended costs of debt and equity capital. RUCO-10 at 5.

A 9.10 percent cost of common equity is appropriate given the current environment of low inflation and low interest rates in which the Company is operating. RUCO-10 at 5-6. Moreover, RUCO's witness Rigsby's recommendation is further supported by the Federal

Reserve's recent announcements to hold interest rates steady and by Value Line analyst's projection of stable interest rates. Id. Further, the 9.10 percent cost of common equity estimated by Mr. Rigsby is very reasonable considering that he added 50 basis points to the results of his discounted cash flow analysis ("DCF") in recognition of the increased level of debt in the Company's capital structure compared to his DCF sample group. RUCO 9 at 66. The capital structure of Mr. Rigsby's sample group of publicly traded water providers averaged 49.9 percent equity and 50.1 percent debt. RUCO-9 at 51-52. The Company proposes that the Commission adopt its projected capital structure of 40 percent equity and 60 percent debt. Id. at 60. Publicly traded companies with a level of debt similar to the Company's would be perceived as riskier than the average of the sample and would therefore have a higher expected rate of return on common equity. Id. In order to account for this added risk Mr. Rigsby's added 50 basis points to the results of his DCF analysis. Id. RUCO's proposed cost of equity recognizes both the current environment of low and stable interest rates, and the Company's debt-heavy capital structure.

RATE DESIGN

RUCO and the Company agree that a three-tier rate design is appropriate. RUCO and the Company disagree, however, on the percentage splits between the commodity charge and monthly minimums. RUCO recommends that the Commission approve its normal practice of a 60/40 percent ratio for the commodity charge and the monthly minimum. RUCO-6 at 31. The Company recommends a 53/47 percent ratio. A-2 at 5.

RUCO's recommendation is premised on the Commission's desire to promote conservation. Recovering a higher percentage of the revenue requirement from the commodity charge, and less through the monthly minimum, provides greater incentive to the customer to conserve on his/her use. The Commission has expressed increasing interest in promoting conservation and RUCO's proposed rate design sends the proper price signal to promote conservation. RUCO-6 at 31. The Commission should adopt RUCO's proposed rate design.

CONCLUSION

The Commission should not authorize a rate increase of more than $280,860 for the Company's water and $105,239 for the Company's wastewater districts. The Commission should not ignore the empirical evidence presented in this case on the issue of property tax, and should adopt RUCO's proposed methodology as it is the best estimate of future property tax expense. The Commission should also reject the Company's recommendation to include the cost of its equity in its working capital requirement. Rather, the Commission should include the Company's interest expense in working capital as it is a cash item. The Commission should not approve the discriminatory apportionment of rate case expense, and allocate rate case expense between the systems based on the amount of work needed per system.

The Commission should reject the Company's late attempt to reclassify its deferred tax recommendation as an asset. Finally, the Commission should adopt RUCO's recommended rate of return of 7.07 percent.

RESPECTFULLY SUBMITTED this 10th day of January, 2007

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