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IN THE MATTER OF THE APPLICATION OF ARIZONA WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY, AND FOR ADJUSTMENTS TO ITS RATES AND CHARGES FOR UTILITY SERVICE FURNISHED BY ITS EASTERN GROUP AND FOR CERTAIN RELATED APPROVALS.	Docket No. W-01445A-11-0310

RUCO'S REPLY BRIEF

The Residential Utility Consumer Office ("RUCO") hereby files its Reply Brief on the matters raised in Arizona Water Company's ("Arizona Water" or "AWC" or the Company") and Staff's Opening Briefs.

I. THE DSIC

RUCO has addressed most of the arguments raised by the Company in support of the DSIC in its Opening Brief. To that extent, RUCO would incorporate by reference those arguments raised in its Opening Brief. RUCO Brief at 2-18. RUCO replies as follows to those points not addressed in RUCO's Opening Brief.

A. The ACRM should not be the legal or other standard for the approval of the DSIC.

The Company compares the DSIC to the Arsenic Cost Recovery Mechanism ("ACRM") and suggests that the ACRM is the legal standard by which the DSIC should be approved. A-1 at 5-6, Company Brief at 23. The ACRM should not be used as the legal or other standard to support the DSIC.

The ACRM is a regulatory accounting mechanism designed to pass-through the plant and O&M costs solely associated with arsenic treatment. The ACRM template was the result of various stakeholders, including RUCO, who came together to address a one-time event that impacted dozens of Arizona water companies simultaneously. R-10 at 7. This extraordinary situation was the result of Arizona's water providers' need to recover the high costs associated with meeting by a certain deadline the more stringent arsenic level standards imposed by the federal government. Id.

The ACRM has been and is currently treated as an adjustor mechanism which is one of the very limited exceptions to Arizona's fair value requirement. *See Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 535, 578 P.2d 612, 616; *Residential Util. Consumer Office v. Arizona Corp. Comm'n ("Rio Verde")*, 199 Ariz. 588, 591 ¶ 11, 20 P.3d 1169, 1172. But its legality has not been called into question or reviewed by an Arizona court. Given the very narrow interpretation the Arizona courts have given adjustor mechanisms and what qualifies as an adjustor mechanism, whether the ACRM meets the adjustor criteria is questionable and should not be presumed. Hence, the ACRM should not be the legal standard used to judge the legality of the DSIC. The legality of the ACRM is not in question in this case – the legality of the DSIC is in question. In ascertaining whether the DSIC is legal, the legality of the ACRM is therefore irrelevant which explains why RUCO did not include it in its legal analysis in RUCO's Opening Brief.

Legal relevance aside, the Company has gone to great lengths to compare the similarities between the ACRM and the DSIC. See for example A-41. There are some similarities, but there are more differences and the entire debate misses the point. The ACRM was the result of a federal mandate which required many Arizona utilities to build plant that was not routine with compliance by a date certain. All of the stakeholders knew that the situation was extraordinary and that traditional rate making would not work in order to meet compliance with the new standard and keep the utilities with adequate financial resources to maintain their operations. Collectively, the stakeholders agreed that there was no option but to come up with an alternative that would allow those Arizona utilities affected by the federal mandate to come into compliance. At least from RUCO's standpoint, the purpose of the ACRM was never to expand the definition of an adjustor mechanism or create an extraordinary regulatory mechanism that companies could use to avoid or mitigate regulatory lag or to shift normal, routine business risk onto its customers.

The DSIC, unlike the ACRM, is a proposed adjuster mechanism used to recover the costs of routine plant that can just as easily be recovered through traditional rate-making. There is no collective feeling here that the situation is extraordinary. On the contrary, only the Company is pushing the DSIC – Staff and RUCO recommend its rejection. Both Staff and RUCO view the plant in question as routine whose costs can be recovered through traditional ratemaking. There is no sense of urgency to make all of the necessary repairs and replacements and the costs can be spread out over time. The Company has failed to show why traditional ratemaking cannot continue to provide just and reasonable rates that provide a fair rate of return that, in turn, allow the Company to supply safe and reliable water delivery service to its customers.

Moreover, comparing the change in the arsenic standard and the effect of the federal mandate on all of Arizona's water utilities to the Commission's Decision No. 71845, is not persuasive. A-1 at 5. In Decision No 71845, the Commission followed Staff's recommendation for a process which would reduce the non-account water for each system below ten percent. Decision No. 71845 at 76. First, the Commission's Decision was directed at the Company, not the whole water industry. Second, the Commission's directive was not meant to be absolute. The Commission did not make it a requirement that the Company achieve a water loss of less than 10 percent at any cost. In fact, the Decision requires the Company to submit a detailed cost analysis if the Company contends that reaching the Commission's objective would not be cost effective. Id. Unlike the federal EPA arsenic standard which was unwavering and mandated compliance regardless of cost, the Commission's Decision No. 71845 placed cost as a major consideration. Finally, the relevant provisions that the Commission adopted were recommended by the Staff. Staff did not recommend then nor is it recommending now the adoption of a DSIC in order for the Company to comply with Decision No. 71845. Staff, however, did recommend the adoption of the ACRM to meet the change in the federal standard regarding arsenic.

The DSIC mechanism is also contrary to the spirit of Decision No. 71845. There is no question that the Commission meant in its Decision that the Company was to achieve the objective of less than 10 percent water loss in a cost effective manner. RUCO, in its Opening brief, explained in detail why the DSIC is not cost effective. See RUCO Brief at 3-16. Among other things, the DSIC will result in inflated rates – the exact opposite of cost effective rates. RUCO Brief at 2, 8. The Commission should reject the DSIC.

B. The Company's legal analysis is misplaced.

The Company concludes that the DSIC does not violate Arizona's Constitution based on the argument that the Commission has wide discretion when it comes to ratemaking. Company Brief at 23-26. RUCO does not take issue with the Company that the Commission has wide discretion when it comes to ratemaking. That wide discretion, however, is not without limits.

With regard to the specific and limited area of increasing rates outside of a rate case, which is what the DSIC does, the Commission's discretion is very limited. *See Scates, supra.* Arizona's courts recognize that, "in limited circumstances," the Commission may engage in rate making without ascertaining a utility's rate base. *Residential Utility Consumer Office v. Arizona Corporation Commission*, 199 Ariz. 588, 591 ¶11, 20 P.3d 1169, 1172 (App. 2001). The DSIC is not "consistent" with those limited circumstances for all of the reasons stated in RUCO's Opening Brief. See RUCO Opening Brief at 11-14. Arizona, unlike the other states with DSIC's or DSIC-like mechanisms, has a constitutionally mandated fair value requirement. The DSIC does not meet Arizona's fair value requirement nor does it qualify as an exception. There is no legal basis for the DSIC in Arizona.

C. Other argument raised by the Company related to the DSIC.

1. The NASUCA Policy v. NARUC Policy v. The Food and Water Watch Article

The Company argues that Staff and RUCO did not present credible evidence that a DSIC is not justified under the circumstances presented in the case. Company Brief at 12. In support of the Company's argument, the Company claims that NASUCA's Policy is "not relevant" on the issue of whether the DSIC is appropriate and that the Food and Water Watch Article is biased and not authoritative. Company Brief at 13. From the Company's perspective, the NARUC

Policy appears to be the only relevant and instructive policy of the three which, not surprisingly, supports the Company's position.

From an evidentiary standpoint, RUCO believes that it is the Judge, and not the Company who determines a document's relevance. The fact that all three documents in question were admitted indicates each is relevant. The question of how much weight the trier of fact wants to give each policy is another issue. While RUCO does not agree with the NARUC position, RUCO understands it is one point of view just like the NASUCA and the Food and Water Watch Article. The fact that there may be a bias supporting each endorsement is not surprising and not a basis for disregarding any of the evidence. Again, bias goes to weight, not to relevance. One noteworthy aspect of the NARUC resolution that RUCO believes is wrong in this case concerns NARUC's conclusion that the DSIC is an automatic adjustment mechanism. R-1. For the reasons cited in RUCO's Opening Brief, RUCO does not believe the DSIC in this case would qualify as an automatic adjustor mechanism in Arizona. See RUCO Brief at 11-12.

The NARUC resolution, which was adopted on February 24, 1999, references the experience of the Pennsylvania DSIC program. Company Brief at 13, R-1. Pennsylvania was the first state that initiated a DSIC in 1997 and since then eleven other states have implemented a DSIC or similar type mechanism. See RAPA Comments at 6-12. Again, the low number of states that have implemented this type of mechanism over a relatively long period (fifteen years) is a testament to its lack of popularity – in spite of the fact that NARUC has endorsed it. Setting aside the legal infirmities of the DSIC, RUCO contends that the DSIC is poor public policy because it results in inflated rates.

2. The benefits of the DSIC to ratepayers.

The Company claims that the DSIC, like the ACRM which it is modeled, would provide significant benefits to ratepayers at a minimal cost. Company Brief at 18. The DSIC, according to the Company, would permit the Company to replace and upgrade its aging infrastructure in a timely and efficient manner, while providing more gradual and smaller rate impacts on those customers. Id. The infrastructure will cost approximately $67 million over the next ten years. Id. at 14-15.

These benefits are illusory. The Company is obligated to provide safe and reliable drinking water. That is part of the regulatory compact – the Company provides safe and reliable drinking water in exchange for the ability to operate in a defined service territory where there is no competition (i.e. captive ratepayers). The Company is further provided the opportunity to earn its authorized rate of return and may seek rate relief if it is unable to do so. The Company benefits under this system – it does not have to compete to sell its service and at any time if it believes it is necessary it can apply to the Commission for a revenue increase. The Company should not have to be incentivized by regulatory gimmicks to do what it has agreed to do. Ratepayers should also not have to pay extra in order for the Company to fulfill its obligation to serve.

The Company has had this infrastructure for a long time - in some instances over 100 years. Company Brief at 7. Why, all of a sudden is the Company facing an infrastructure crisis that needs to be solved immediately and by extraordinary ratemaking? And why should all of the financial risk now be shifted onto the backs of ratepayers? If there really is a financial crisis the Company put itself in that situation by waiting as long as it has to make the necessary repairs. These repairs, and improvements, even the Company admits do not all need to take place immediately – the Company has said over the next ten years. Company Brief at 14-15. The Company can make the repairs and recover the costs by traditional ratemaking.

The Company would rather focus on the illusory benefits rather than the costs to ratepayers. From the Company's perspective the DSIC costs are "minimal". Company Brief at 18. All things being equal, RUCO recognizes a possible benefit to the ratepayer of more frequent and smaller, incremental rate increases. It is easier to accommodate small increases than larger ones. But all things are not equal. The use of the DSIC will result in greater costs to the ratepayers than traditional ratemaking. As discussed in RUCO's Opening Brief, the DSIC removes the utility's inherent incentive to effectively manage its costs in between rate cases. Furthermore, the DSIC results in inflated rates since it does not recognize the operational efficiencies associated with the replacement of old plant with new plant. See RUCO Brief at 3-14. The cost of the DSIC to ratepayers far outweighs the benefits to ratepayers which explains, at least in part, why so many states have not adopted a DSIC or a DSIC type mechanism.

II. CONTESTED RATE BASE ISSUES

Cash Working Capital

The Company argues that consistency is the justification for including the equity cost component of operating income in the calculation of working capital. Company Brief at 41. RUCO would agree that consistency is at least one justification – a justification to keep equity cost **out** of the calculation. The Commission excluded the cost of common equity as recently as the Company's last rate case. See Decision 71845 at 22-23. The Commission should be consistent and continue to keep the cost of equity out of the calculation.

The consistency the Company seeks relates to the Company's cost of debt which is the other aspect of the cost of capital. The Company believes that if the Commission keeps the cost of debt in the calculation, than in order to be consistent it must keep the cost of equity in the calculation. Company Brief at 41. The Company's argument ignores the underlying reason why debt is included and why equity should not be included. The Commission explained the reason in Decision No. 71845.

> "We disagree. As Staff witness Bozzo succinctly points out, "equity is not a certain debt or obligation." (Ex. S-16, at 18.) Contrary to the Company's assertions, debt and equity are not equivalents for purposes of determining working capital. The Company's debt obligations are contractually based and must be paid to avoid default liability. Contrarily, equity costs, such as dividend payments, are not subject to mandatory payment schedules and may be discontinued or reduced at the discretion of the Company's Board of Directors."

Decision No. 71845 at 22-23. The Commission should continue to exclude the cost of common equity from the Company's lead/lag study. The Commission, for the reasons stated in RUCO's Opening Brief should also include dividend payments in the calculation. RUCO Brief at 18-20.

III. CONTESTED OPERATING INCOME ISSUES

A. Pumping, Transmission and Distribution Expense

The Company continues to maintain that it is appropriate to normalize this expense because of its "well-supported analytical evidence of a known and documented" downward trend in the expense over the last three years. Company Brief at 43. The Company calculated its adjustment based on a regression analysis that spanned fourteen years. The Company criticizes RUCO's position as being "inconsistent and contradictory" because of RUCO's change in position from its direct case where it recommended normalization to its surrebuttal case where it recommended against normalization. Company Brief at 44. The Company asserts that the facts did not change in between RUCO's filings the reversal of its adjustment is illogical. Company Brief at 44.

RUCO's witness, Robert Mease, testified in detail why RUCO reversed its original adjustment. Mr. Mease testified that subsequent to the filing of RUCO's direct case, the Company filed its rebuttal testimony and the Company also provided RUCO with some additional information. The testimony and additional information allowed RUCO to further analyze the Company's regression analysis and proposed normalization. Mr. Mease explained the reason for the change in position through RUCO Exhibit 14. The PTDM costs have been going up and down since 1994. R-14 at 2. The 2007 through 2010 period is not the only time period where the costs have trended downward. Id. at 2. The costs trended downward from 1996 through 1999. In 1996 the cost was 29.39 and 1999 the cost was 26.13. The costs then began shifting upward and returned to $30.22 by year 2003. Id. The trend shows that the percentage decrease over those earlier years is approximately the same as the percentage increase that followed over the subsequent years. This type of expenditure history indicates that these costs are cyclic in nature and should not be normalized. Moving to 2007, the cost per customer was $40.64, and by 2010 it was reduced to $31.41. After 2010, the Company used projections, and in 2014 the Company projects the costs to be $46.86 – an increase of 49.2 percent from the 2010 cost. The Company's projections provide for a very large increase in terms of percentage based on the historical data which RUCO questions. Transcript at 665. The estimated percentage increase that follows the 2007 through 2010 time period is out of line with the actual cost increases that followed in the earlier time period (1996-1999).

At the hearing, the Company indicated, and provided evidence, that the actual expense for 2011 was $1,122,104. Transcript at 665. RUCO showed that the Company had projected these expenses to be $1,506,957 for year 2011. The Company's projection was $384,853 more than the actual expense. This is a significant discrepancy that ratepayers would have paid if the Commission approves the Company's methodology and shows why the Commission should not normalize the PTDM expense.

As further support, the Company boasts about its cost-cutting efforts in response to the economic downturn beginning in 2008. Company Brief at 42. However, while some costs have gone down others have gone up. For example, the Company's Administration and General Expenses went up 12.1 percent over the 2007 – 2010 period. R-9 at 19. The Company also continued to pay shareholders dividends each and every quarter, during the same three year period. Id. The fact that some expenses, standing alone, were cut does not justify normalization. Transcript at 666. The Commission should not normalize the PTDM expense.

B. Rate Case Expense

The Company claims that RUCO's level of rate case expense is not supported by the record in this case. Company Brief at 48. RUCO took the amount that the Commission found to be reasonable in the Company's last Eastern Group case, (Decision No. 66848) and trued it up for inflation. R-7 at 22. The Company disagrees with RUCO's methodology and claims that RUCO disregarded the Company's actual expenses incurred in the last Eastern Group case. The Company also contends that RUCO's level of rate case expense is not supported by the record because RUCO did not present any evidence that outside counsel and expert expenses tracked inflation for the years that RUCO used to in calculating its inflation factor. Id.

As is often the case, the utility suggests that the standard for determining rate case expense is the actual expense incurred. The rate case expense standard is what is reasonable under the circumstances of the case. The Commission can surely consider what the Company actually spends on rate case expense, but the Commission is not bound by it. In this case, the Company often had two counsel at the table in the hearing. The hourly rate for the senior counsel is $470 and the hourly rate for the junior counsel is $395. A-40. While the Company may actually pay counsel $865 combined for their combined service per hour that does not equate to a reasonable amount of expense to be borne in its entirety by the ratepayer. In this case, it is the Company that has the burden to show why $476,874 is a reasonable amount of rate case expense. The Company has not shown why such high hourly rates or such a high amount of rate case expense is reasonable even if it is less than what the Company actually paid in rate case expense.

There is nothing difficult in RUCO's rate case expense recommendation. RUCO applied the Consumer Price Index inflation factor ("CPI") for the time period since the last Eastern case Decision and applied it to the Commission's authorized amount or rate case expense in that case. The application of the CPI to true-up an expense or a rate case variable is common and generally accepted practice before the Corporation Commission[1]. There is no legal impediment, or other Commission practice or policy which prevents it. The Company does not argue that adjusting rate case expense for inflation violates the law or is contrary to any Commission practice. RUCO's rate case expense is supported by the record and should be approved by the Commission.

IV. COST OF CAPITAL

RUCO fully briefed the issues related to its determination of cost of equity in its Closing Brief.[2] RUCO incorporates those arguments by reference, which is responsive to the arguments raised by the Company in its Opening Brief with two exceptions. First, the Company

[1] For example, the Commission applies the CPI when determining fair value rate of return.

[2] RUCO Brief at 23-28.

suggests that the Commission should give more weight to its position because its experts are more qualified. Company Brief at 32. Second, the Company believes that its cost of equity recommendation is consistent with the implementation of the DSIC. Neither argument, for the reasons stated below, are persuasive and the Commission should reject the Company's recommended cost of equity and adopt RUCO and the Staff's 9.40 percent recommendation

It would be counterproductive to list the qualifications of each witness that testified on cost of equity. Dr. Zepp, Mr. Cassidy, and RUCO's Mr. Rigsby (who has testified on Cost of Capital in close to forty-five cases before the Commission) are all well known before this Commission and have all testified on a multitude of occasions before the Commission. There has not been a time when the Commission has rejected the testimony of any of these witnesses for lack of qualifications. Dr. Zepp, under cross-examination was asked about numerous water cases that he testified in before this Commission. Transcript at 913-920. In many of those cases he was recommending cost of equity recommendations close to the 12.4 percent recommendation in this case. Id. Dr. Zepp's cost of equity recommendations were not adopted by this Commission in those cases. Id. at 920. In fact, Dr. Zepp testified that at no time where he has testified before the Arizona Commission has his cost of equity recommendation been adopted by the Commission. It is puzzling that the Company believes it is persuasive to tout what it considers the superior qualifications of its witness and to call into question the qualifications of RUCO's and Staff's witnesses when the Company's witness has never had a recommendation adopted by the Commission. It is even more puzzling why the Company's witness would make such a high cost of equity recommendation given the much lower cost of equity awards the Commission has historically approved.

But perhaps the most puzzling aspect of the Company's cost of equity recommendation is that it does not change whether the Commission awards the DSIC or not. The DSIC is an extraordinary ratemaking mechanism that will allow the Company to increase its rates, subject to a very limited review, outside of a rate case. It is elementary that such a mechanism, if approved will reduce the Company's financial risk. Ms. Ahern devotes a section in her rebuttal testimony on the positive effects the DSIC mechanism will have on financial risks the Company faces. A-34 at 21-26. According to Ms. Ahern, for example, "S&P indicates that cost-recovery mechanisms, such as AWC's proposed DSIC mechanism, are supportive of credit quality which enhances a utility's ability to attract necessary new capital." Id. at 22. Ms. Ahern also noted that "It is abundantly clear that S&P views DSIC mechanisms as credit supportive and enhancing, promoting cash flow stability." Id. at 26. The Company readily admits that approval of the DSIC will have a positive effect on its financial risk.

The Commission should reject the Company's recommended cost of equity and DSIC proposal.

V. RATE DESIGN

A. Consolidation

RUCO has nothing further to add beyond what was said in its Opening Brief. See RUCO Brief at 28.

B. Declining Usage

The essence of RUCO's objection to the Company's billing determinant adjustments is the fact that the Company relies on estimates retained from its regression analysis as opposed to the actual billing determinants. Transcript at 801. From RUCO's perspective, a better and more confident result is achieved when relying on known and measureable billing determinants which are available in this case rather than estimates. Transcript at 839.

VI. CONCLUSION

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

RESPECTFULLY SUBMITTED this 11^{th} day of July, 2012

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