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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, AN ARIZONA 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 SUN CITY WASTEWATER AND SUN CITY WEST WASTEWATER DISTRICTS.	Docket No. WS-01303A-06-0491

RUCO'S REPLY BRIEF

November 14, 2007

Arizona Corporation Commission
DOCKETED

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DOCKETED BY MN

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The Residential Utility Consumer Office ("RUCO") replies to Arizona American Water Company's ("Arizona American" or "Company") and the Arizona Corporation Commission Staff's ("Staff") Post Hearing Briefs as follows.

RATE DESIGN

The change from a flat rate design to a volumetric rate design in the Sun Cities would be a significant and likely disruptive change for the Sun City and Sun City West Wastewater ratepayers. No party has made the claim that the present rate design is not working and there needs to be a change. There has not been an outcry from the public requesting a change to a volumetric rate design. No party has conducted a cost-benefit analysis or done any sort of in-depth analysis which would show why a volumetric rate design is preferable to a flat rate design.

What is known is that a change to a volumetric rate design will result in what undoubtedly will be the largest rate increase to some customer classes ever approved by this Commission. See RUCO Closing Brief at 2-3. There certainly will be wide rate fluctuations among the residential and commercial classes if the volumetric rate design is approved. The Commission will not know the extent of the fluctuations prior to making its decision, however, because the data that the Company provided to support the estimated rate impacts is riddled with inaccuracies, uncertainties or the information is simply unknown. Transcript at 781-799.

The Commission should not change the present rate design. It does not need to be fixed – it is not broken. It is an appropriate rate design for the Sun Cities. The Company's arguments opposing the implementation of a volumetric rate design (at least with regard to its residential customers) is worth repeating:

> 1) it is doubtful a volumetric wastewater rate design will measurably reduce water consumption in the Sun Cities Residential class given that thousands of customers never see a water much less a wastewater bill and 2) it is doubtful that a volumetric wastewater rate design will treat all Residential customers fairly, given the difficulty of associating many water meters with the proper wastewater account in addition to the seasonal nature of a large segment of its customers. Two other concerns have been identified in addition to those listed in Decision 67093: 1) it is not known if the new rate design can be implemented cost effectively, and 2) it is uncertain that once implemented there will be confusion and stress for Arizona-American's customers. A-6 at 7-8.

Staff argues that the Commission should "Implement volumetric rates and phase them in over a period of time"[1] to allow ratepayers and the Company an opportunity to adjust to the changes in rate design. Staff's argument presumes that it is appropriate to implement volumetric rates in the first place. For the numerous reasons stated above and in RUCO's Closing Brief, it is not appropriate to implement volumetric rates in this case. Moreover, Staff's proposal if accepted will not lessen the rates. Ratepayers will still experience rate shock – Staff's proposal will only defer the ratepayer's rate shock experience.

Staff and the Company have provided little to explain why the Commission should change the rate design to a volumetric rate design in the Sun Cities. Staff notes that Arizona is an arid climate and in the midst of an 11-year drought. Staff Brief at 20. Staff further argues that volumetric rate design is beneficial in Arizona because of the scarcity of water. Id. RUCO is keenly aware of the present state of the water supply in Arizona as well as Arizona's arid climate. That argument, however, is misplaced with the Sun Cities Wastewater Districts. As explained above and in RUCO's Closing Brief, many residential customers are unaware of their water and wastewater bills because of their living situation and will have no incentive to

[1] Staff Brief at 19.

conserve. A volumetric rate design is likely to result in many residential customers being treated unfairly. There already is a volumetric rate design in place for the high end commercial users established in a prior rate case. In sum, while Staff and the Company have the right idea (conservation), its application is misplaced in the Sun City and Sun City West Wastewater Districts. The Commission should retain the current rate design.

RATE BASE ADJUSTMENTS

RUCO RATE BASE ADJUSTMENT NO. 1 - PLANT AND ACCUMULATED DEPRECIATION -SUN CITY WEST

There remains a significant discrepancy in the Company's Accumulated Depreciation Balance. The Company argues that Staff agrees with its accumulated depreciation balance and that RUCO's witness made some errors and cannot clearly explain its adjustments. Company Brief at 13. At the end of the day, however, there still remains an unexplained discrepancy of $962,479 in the Company's Accumulated Depreciation balance.

The Company implies it is incumbent on RUCO to explain the discrepancy. Id. It is the Company, and not RUCO, requesting an increase in the Company's rates. It is the burden of the Company to explain discrepancies within its books. See Decision No. 68487 at 21.

Regardless of who has the burden, the Company's former employee did explain that the plant retirements in question were in fact transfers and not retirements. R-1 – Attachment 1. The Company, however, refuses to adjust its accumulated depreciation balance to reflect its employee's mistake that the Company does not even dispute.

The depreciation rates are also easily explainable. Neither Staff nor the Company used the Commission's authorized depreciation rates in the Company's last rate case for the plant in question. The Company even admitted it and agreed to correct its error. R-3. The Company has not corrected the error and that is why it remains in dispute. Transcript at 320.

These issues are clear cut and should not be confused. The Commission should adopt RUCO's accumulated depreciation adjustment.

RUCO RATE BASE ADJUSTMENT NO. 3 - WORKING CAPITAL

The Company and Staff recommend a zero cash working capital requirement. Brief at 10. The Company discounts RUCO's use of the lead/lag study filed by the Company in its recent Mohave district. Id. The Company believes RUCO failed to meet its burden to establish that something other than a zero working capital balance was correct. Id.

The Commission faced the same issue in the Company's Paradise Valley case. Docket No. WS-01303A-06-0014. In Paradise Valley, both the Company and Staff ultimately made a zero cash working capital recommendation. RUCO relied on the Company's lead/lag study it presented prior to making its final recommendation. Decision No.68858 at 14. RUCO made adjustments to the lead/lag study to include items the Commission had allowed in previous cases. Id. The Commission agreed with RUCO noting that RUCO's recommendation was based on a lead/lag study and was more reasonable than Staff and the Company's zero recommendation. Id.

Here, the facts are almost identical. RUCO relies on a lead/lag study done by the Company in its recent Mohave Division case. R-14 at 14. RUCO explains in great length in its Closing Brief why it is appropriate to use the lead/lag study from the Mohave case. See RUCO's Closing Brief at 9. In fact, RUCO's use of the Mohave lead/lag study in this case results in a cash working capital allowance of $40,120 for the Company's Sun City district. RUCO's cash working capital recommendation is reasonable and should be approved.

RUCO RATE BASE ADJUSTMENT NO. 4 – POST-TEST-YEAR AMORTIZATION OF IMPUTED REGULATORY ADVANCES ("AIAC") AND IMPUTED REGULATORY CONTRIBUTIONS ("CIAC")

The Company argues that the Commission should amortize its AIAC and CIAC balances through December 31, 2005 and not December 9, 2005 as RUCO and Staff recommend. Company Brief at 8. The Company relies on the testimony of its various witnesses as well as its rate application that the test year ends on December 31, 2005. Id. The Company also relies on RUCO's testimony that December ends on December 31st. Id.

RUCO and the Staff argue that the test year end is December 9, 2005. R-1 at 12, Staff Brief at 13. RUCO's argument is based on the data and supporting documentation that the Company submitted in support of its Application. Id. The data on the schedules and balance sheet cut off on December 9, 2005. Id. This documentation was prepared and submitted by the Company. It is the same documentation that the Company used to support its rate application. It should be given greater weight than the unsupported statements of the Company's witnesses.

The fact that RUCO's witness testified that December ends on the 31st is irrelevant. Every month ends on its last day on the lunar calendar. That is of no consequence to when a test year can end. There is no regulatory requirement that a test year end on the last day of the month. In fact, the Commission has previously adjudicated rate applications that had test years that did not end on the last day of a month. See, e.g. Decision No. 68858 at 5 (test year ended December 10, 2004). The Commission should disregard this argument.

Finally, the Company claims it would be punitive to end the amortizations on December 9, 2005. Company Brief at 9-10. The Company, not RUCO or Staff chose to close its books and submit its supporting data with a cut off date of December 9, 2009. The Company also chose to proceed without revising, withdrawing or changing its application once it became aware that there was an issue. The Company and not ratepayers should have to live with the consequences of its decision.

RUCO RATE BASE ADJUSTMENT NO. 6 – POST-TEST-YEAR DE-CHLORINATION UPGRADE

The post-test-year de-chlorination upgrade in this case did not go into service until a full eight months after the end of the test year as the Company admits in its Closing Brief. Brief at 11. The Company claims that the plant was intended for its customers taking service at the end of the test year. Brief at 11. The Company further claims it was a prudent investment. Id.

For rate base consideration, however, it is the Commission and not the Company that determines prudency. The Commission considers prudency after the plant and/or improvements are completed. In this case, according to the Company, the improvements were completed in August 2006 and were not used and useful during the test year. Brief at 11. Therefore, the test year customers did not receive a benefit during the test year and the Company's proposal to include improvements in rates should be rejected.

RUCO RATE BASE ADJUSTMENT NO. 7 - REMOVAL OF POST-TEST YEAR AMORTIZATION OF THE TOLLESON TRICKLING FILTER FOR SUN CITY.

The issue here is the same as the rate base adjustment for the imputed AIAC and CIAC discussed above and for the same reasons the Commission should exclude the 22 days of amortization expense from ratebase for the Tolleson Trickling Filter.

<u>OPERATING ADJUSTMENTS</u>

RUCO OPERATING ADJUSTMENT NOS. 1, 2, and 3 - DIRECT LABOR EXPENSE, CORPORATE ALLOCATED LABOR EXPENSE, AND CENTRAL DIVISION ALLOCATED LABOR EXPENSE.

The Company attempts to make the case why it is appropriate to go outside the test year to use labor rates that were not in effect during the test year. Company Brief at 20.

The new labor rates went into effect in March 2006. Id. According to the Company it would be unreasonable to disregard the new rates because they are known and measurable. Id.

The Company, not RUCO, chose the test year. The Company should be required to adhere to the generally accepted ratemaking principles that apply to the Company's choice of test year. For example, the matching principle, which is a fundamental tenet underlying the Commission's requirement that a test year be identified and used, requires that revenues and expenses be matched within the test year. Unless there is a compelling reason, the Commission should consider only those revenues and expenses incurred in the test year. By doing so, revenues and expenses can be matched and the Commission will be able to establish a fair and reasonable revenue requirement.

Under the Company's proposal, the Commission would be applying 2006 wage rates to the Company's 2005 employees to arrive at labor expense. RUCO's proposal applies the test year wage rate to the employees who worked in the test year. The Commission must decide which proposal provides a more accurate accounting of the test year labor expense. The answer is obvious - the Company's proposal does not provide an accurate assessment of the test year labor expense and should be rejected.

The same rationale applies to the Company's corporate and central division allocated labor expense.

RUCO OPERATING ADJUSTMENT NO. 6 - PROPERTY TAX EXPENSE

The Company is critical of RUCO's property tax position noting that it has been repeatedly rejected by the Commission. Initial Brief of Arizona-American Water Company. Company Brief at 19. The Company relies on Decision No. 69440 where the Commission determined that "RUCO has not demonstrated a basis for departure from our prior determination on this issue." Company Brief at 19-20.

RUCO acknowledges that the Commission has rejected ADOR's methodology in the past. See RUCO Brief at 12. The fact that it has been rejected does not equate to the conclusion that it is an inferior methodology for estimating property taxes than what the Company is proposing.

The issue of property tax is not a question of who is right and who is wrong. The issue is what calculation methodology provides the best estimate of actual property tax. RUCO has explained at length in prior cases as well as this case why the use of the Company and Staff's methodology is not as accurate as the ADOR methodology in estimating property taxes. In this case, the Company and Staff's proposed methodology is likely to result in the Company under-collecting property taxes from the ratepayers in Sun City Wastewater and over-collecting property taxes from ratepayers in Sun City West Wastewater. See RUCO's Brief at 13.

Recognizing that the Commission has repeatedly rejected the ADOR formula, RUCO has proposed an alternative methodology which provides for the recognition of proposed levels of revenues. The Company claims that RUCO's proposal is a "distinction without a difference." Company Brief at 20. Apparently, the Company will only be satisfied if RUCO fully capitulates and agrees to a methodology which has no historical reference and is only prospective in nature. There is a distinction – a great distinction. RUCO's alternative proposal provides balance - it combines historical data with prospective data as opposed to favoring only prospective or historical data. The goal is to provide the best estimate of what future property taxes will be - it is necessary to consider what the actual taxes were and not solely projections of what the actual taxes may be. RUCO's proposal is balanced and provides a better, more accurate methodology for the purpose of estimating future property taxes than what Staff and the Company are proposing.

RUCO OPERATING ADJUSTMENT NO. 9 - RATE CASE EXPENSE.

The Company complains that RUCO's recommended rate case expense for the Company's rate design and cost of capital case is unreasonable. Company Brief at 24-25. RUCO will not repeat the arguments set forth in response in its Closing Brief. Id. The Company's arguments in support of its recommendations have been rejected by the Commission in previous rate cases as set forth in RUCO's Closing Brief.

When all is said and done, the Company's request for $253,962 is excessive for this case. RUCO does not argue with the Company that the focus in this case on rate design has been greater than what is normal in most rate cases. Company Brief at 24. Every case typically has one or two issues unique to that case that require additional attention by the parties. In this case rate design is one of the larger issues. When viewed in its totality, this is an average case with nothing extraordinary.

Moreover, RUCO is not suggesting that the Company not recover its expenses for the additional work required by the rate design issue. The Company's request to recover $143,000 for its rate design witness is unreasonable. RUCO's recommendation which provides for an additional $11,600 is reasonable.

The Company still relates RUCO's issue with the cost of capital expense the Company seeks to recover as to the reasonableness of the dollars it is requesting. Id. at 24-25. RUCO does not question the amount the Company seeks. RUCO is seeking a 50/50 sharing of the cost between ratepayers and shareholders. R-1 at 24. Shareholder's benefit through higher returns, and thus greater profits through the efforts of the Company's cost of capital witness.

Id. The fact that shareholders "potentially" benefit from rate case expense, as the Company argues does not refute the fact that shareholders benefit from the efforts of the Company's cost of capital witness. Company Brief at 25. The Company's arguments should be rejected.

RUCO OPERATING ADJUSTMENT NO. 10 – DEPRECIATION & AMORTIZATION EXPENSE.

This issue is addressed in the plant and accumulated depreciation rate base adjustment discussed above.

RUCO OPERATING ADJUSTMENT NO. 11 – INDUSTRIAL PRE-TREATMENT ("IPP") LABOR EXPENSE.

The Company claims that it had to reallocate the employee in questions hours between Sun City and Sun City West in order to avoid ratepayers from other districts paying for more than their fair share of the costs. Company Brief at 23. The Company's argument does not address the reasons why RUCO disallowed the expense. RUCO disallowed the expense for several reasons outlined in its Closing brief. RUCO's Brief at 16-17. In sum, the Company already accounted for the expense in the test year and to accept the Company's proposed pro forma adjustment would result in double count of labor expense.

RUCO OPERATING ADJUSTMENT NO. 12 – ADEQ MANDATED LABOR EXPENSE.

RUCO made an adjustment to the Company's pro-forma adjustment regarding the newly-mandated ADEQ labor expense, and for the same reasons set forth in the direct labor expense addressed above, the Company's pro-forma adjustment should be rejected.

RUCO OPERATING ADJUSTMENT NO. 14 – ACHIEVEMENT INCENTIVE PAY ("AIP

The Company criticizes RUCO's reference to precedent on this issue noting that RUCO "disdains" precedent concerning other issues but is quick to rely on it in this issue[2]. Despite the Company's misguided perceptions the simple truth is the Commission has addressed this issue in the Company's Paradise Valley case and there is nothing new here. Decision No. 68858 at 20-21.

The fact that the Sun City Wastewater Districts are operating at a loss is not relevant to the AIP issue for the reasons set forth in RUCO's Closing Brief. RUCO Brief at 18-19.

RUCO OPERATING ADJUSTMENT NO. 15 – RETURN ON NORTHWEST VALLEY TREATMENT FACILITY ("NWVTF").

RUCO agrees with the Company that this is a Sun City West Wastewater issue. Company Brief at 11. It is also an Agua Fria/Anthem Wastewater District issue. The Company points out that RUCO opposes the proposed allocation even though it "<u>reduces</u>" rates for the Sun City West residential and commercial ratepayers. Brief at 12. The Company and Staff's allocation proposal would have the opposite effect on the Anthem/Agua Fria ratepayers – it would raise their rates. The Commission should not establish a precedent which allows Companies to allocate portions of rate base between Districts without a contract specifying the allocation percentages.

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[2] This is a very interesting perception since the Company, like most parties in rate cases, rely on and cite Commission precedent when it supports their position and usually disagree with precedent when it does not support their position. To set the record straight, RUCO respects the Commission's Decision's regardless of the outcome. That does not mean RUCO always agrees with the Commission's Decisions. RUCO's right and privilege to disagree with the Commission's Decisions in no way amounts to "disdain" for that decision.

The change in position to a 32% allocation was first proposed by Staff by its engineering expert on the second to-last-day of the hearing in this matter. Transcript at 639- 647. The new proposal would reduce the Sun City West's ratebase by $1,163,277 and increase the Agua Fria/Anthem's rate base by $1,163,277. See Anthem/Agua Fria Waste Water Final Schedule B-2 at 1, Column F, Line 28. It also includes a 32% allocation of operation and maintenance expenses. There was no pre-filed testimony, schedules or documentation to support Staff's new proposal. It is a last minute, unsupported recommendation which, if approved will have a significant impact on the ratepayers of Sun City West and Agua Fria/Anthem. The Commission should not make a hasty decision that will have significant and lasting implications.

RUCO set forth in its Closing Brief the reasons why it would be improper to allow Sun City West to allocate 2.25% of its rate base to the Anthem/Agua Fria District. RUCO Brief at 20-21. RUCO even proposed a different methodology – to treat the costs associated with treating the Anthem wastewater as an operating lease. Id. Nothing has changed; RUCO still is making the same recommendation.

The basis for Staff and the Company's new proposed allocations is Staff's belief that Sun City West has reached its maximum capacity and that the NWVTF has more than 33% capacity not in use. S-1, Exhibit DMH-2 at 4. Transcript at 644. Staff further believes that the Company's Anthem/Agua Fria District will continue to grow and believes that the NWVTF unused capacity can be used to treat the Anthem/Agua Fria wastewater flow requirements as the District continues to approach build out. S-1, Exhibit DMH-2 at 4-5. Transcript at 640-647.

The Company has only recently made its corresponding filings in the pending Anthem/Agua Fria case in support of its new allocations. See Staff's Notice of Filing of October 3, 2007 in Docket No. WS-0103A-06-0403. RUCO has had very limited time to analyze the new recommendation. Should the Commission consider the new recommendation, RUCO recommends, at the very least, that the Commission should defer the Company and Staff's proposal until a thorough audit is done. If Sun City West is not using nor will use 33% of the plant's capacity, then it has excess capacity. The proper rate ratemaking treatment of excess capacity is not to allocate it to another District's ratebase.

There is also no written agreement governing the terms of the allocations. What, for example would happen if the Commission were to approve the proposal and Sun City West should need 80 percent of the NWVTF capacity to treat its wastewater in the next couple of years? The ratebase allocation will have already been made and will be wrong if the NWVTF continues to treat Sun City West's actual capacity requirements. It would be bad ratemaking and fraught with peril to approve a 32% allocation under the circumstances of this case.

NWVTF LABOR EXPENSE

RUCO believes that the labor expenses associated with the treatment of Sun City West's wastewater at NWVTF should be considered in rates consistent with RUCO's position regarding the return on the NWVTF set forth above.

COST OF CAPITAL

RUCO continues to urge the Commission to adopt RUCO's recommended 10.03 percent return on common equity and overall 7.23 rate of return for the Sun City and Sun City West Wastewater Districts.

CONCLUSION

The Commission should not authorize a rate increase of more than $1,233,925 for the Sun City Wastewater and $1,417,929 for the Sun City West Wastewater Districts. The Commission should adopt all of the other recommendations set forth in the Conclusion of RUCO's Closing Brief.

RESPECTFULLY SUBMITTED this 14th day of November 2007.

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