BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission

DOCKETED

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DOCKETED BY 60172 CLP

CARL J. KUNASEK
CHAIRMAN
JIM IRVIN
COMMISSIONER
RENZ D. JENNINGS
COMMISSIONER

IN THE MATTER OF THE APPLICATION OF CITIZENS UTILITIES COMPANY, AGUA FRIA WATER DIVISION, FOR A HEARING TO DETERMINE THE FAIR VALUE OF ITS PROPERTIES FOR RATEMAKING PURPOSES TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, AND TO APPROVE RATE SCHEDULES DESIGNED TO PROVIDE SUCH RATE OF RETURN.	DOCKET NO. E-1032-95-417
IN THE MATTER OF THE APPLICATION OF SUN CITY SEWER COMPANY FOR A HEARING TO DETERMINE THE FAIR VALUE OF ITS PROPERTIES FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, AND TO APPROVE RATE SCHEDULES DESIGNED TO PROVIDE SUCH RATE OF RETURN.	DOCKET NO. U-2276-95-417
IN THE MATTER OF THE APPLICATION OF SUN CITY WATER COMPANY FOR A HEARING TO DETERMINE THE FAIR VALUE OF ITS PROPERTIES FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, AND TO APPROVE RATE SCHEDULES DESIGNED TO PROVIDE SUCH RATE OF RETURN.	DOCKET NO. U-1656-95-417
IN THE MATTER OF THE APPLICATION OF SUN CITY WEST UTILITIES COMPANY FOR A HEARING TO DETERMINE THE FAIR VALUE OF ITS PROPERTIES FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, AND TO APPROVE RATE SCHEDULES DESIGNED TO PROVIDE SUCH RATE OF RETURN.	DOCKET NO. U-2334-95-417

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DOCKET NO. E-1032-95-417 ET AL.

IN THE MATTER OF THE APPLICATION OF TUBAC VALLEY COMPANY FOR A HEARING TO DETERMINE THE FAIR VALUE OF ITS PROPERTIES FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, AND TO APPROVE RATE SCHEDULES DESIGNED TO PROVIDE SUCH RATE OF RETURN.	DOCKET NO. U-1595-95-417
IN THE MATTER OF THE APPLICATION OF SUN CITY SEWER COMPANY FOR REVIEW OF ITS SEWER TREATMENT SURCHARGE.	DOCKET NO. U-2276-95-420
IN THE MATTER OF THE APPLICATION OF SUN CITY WATER COMPANY FOR AN EXTENSION OF ITS CERTIFICATE OF CONVENIENCE AND NECESSITY TO SERVE THE TOWN OF YOUNGTOWN, ARIZONA.	DOCKET NO. U-1656-96-282
IN THE MATTER OF THE APPLICATION OF SUN CITY SEWER COMPANY FOR AN EXTENSION OF ITS CERTIFICATE OF CONVENIENCE AND NECESSITY TO SERVE THE TOWN OF YOUNGTOWN, ARIZONA.	DOCKET NO. U-2276-96-282 DECISION NO. 60172 **OPINION AND ORDER**

PUBLIC COMMENTS:	May 15, 1996 (Phoenix, Sun City, and Surprise, Arizona); June 7, 1996 (Nogales, Arizona).
DATES OF HEARING:	March 20, April 17, and April 30, 1996 (pre-hearing conferences). October 29, 30, 31; November 1, 4, 5, 6, 7, 8, 12, 13, 14, and 15, 1996.
PLACE OF HEARING:	Phoenix, Arizona
PRESIDING OFFICER:	Lyn Farmer
IN ATTENDANCE:	Renz D. Jennings, Chairman Marcia Weeks, Commissioner Carl J. Kunasek, Commissioner
APPEARANCES:	Ms. Beth Ann Burns and Ms. Susan Mikes Redner, Associate General Counsels, on behalf of Citizens Utilities Company; Mr. James P. Beene and Mr. Paul R. Michaud, Staff Attorneys, on behalf of the Residential Utility Consumer Office;

Mr. Josephe E. Larue and Mr. William G. Beyer, BEYER, SPRILSBURY & LARUE, on behalf of the Sun City Homeowners Association, the Recreation Centers of Sun City West, Incorporated, the Sun Village Unity Association, and the City of Surprise;

Mr. Philip H. Vision, in propria persona;

Mr. Lester E. Merydith, in propria persona, on behalf of Sun City Water Users Association;

Mr. Tom Delgado, Staff Counsel, on behalf of Central Arizona Water Conservation District;

Mr. William P. Sullivan, MARTINEZ & CURTIS, P.C., on behalf of Sun City Taxpayers' Association;

Mr. Charles L. Cahoy, Deputy Counsel, on behalf of the Department of Water Resources; and

Mr. Paul A. Bullis, Chief Counsel, and Ms. Deborah R. Scott, Staff Attorneys, on behalf of the Utilities Division of the Arizona Corporation Commission.

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BY THE COMMISSION:

On August 17, 1995, Citizens Utilities Company, Agua Fria Water Division, Sun City Sewer Company, Sun City Water Company, Sun City West Utilities Company and Tubac Valley Company, (collectively "Company", "Citizens", or "Maricopa W/WW") filed applications with the Arizona Corporation Commission ("Commission") for rate increases ("Joint Rate Applications").

Between September 15, 1995 and October 2, 1995, the Company revised the application and on October 3, 1995, the Commission's Utilities Division ("Staff") found that the Company had met the filing requirements of A.A.C. R14-2-103 and was classified as a Class A utility.

On October 3, 1995 Sun City Sewer Company filed an application for review of its sewer treatment charges, and on November 3, 1995 the sewer treatment surcharge application was consolidated with the Joint Rate Applications.

On May 8, 1996, Sun City Water and Sun City Sewer filed a Joint Application for extensions to their Certificates of Convenience and Necessity ("Certificate" or "CC&N").

On July 17, 1996, Staff filed a Motion requesting consolidation of the Joint Rate Applications and the Joint CC&N Applications and by Procedural Order issued on August 2, 1996, the consolidation was granted.

During the period between October 3, 1995 through June 12, 1996, the following requested and were granted intervention status: the Sun Village Community Association ("SVCA"); Centurion Management Company ("Centurion"); Bell West Ranch Limited Partnership and Suprise 222 Limited Partnership ("Partnerships"); Shea Homes Limited Partnership ("Shea Homes"); the Residential Utility Consumer Office ("RUCO"); the City of Glendale; Mr. Lester E. Merydith; the Property Owners and Residents Association of Sun City West ("PORA"); Mr. Richard Kithil; Mr. Anthony Pavone; the Tubac Golf Resort ("Tubac"); the Santa Cruz Valley Citizen's Council, Inc. ("SCVCC"); the Sun City Home Owners Association ("SCHOA"); the Sun City West Recreation Centers, Inc. ("SCWRC"); the Sun City Taxpayers' Association ("SCTA"); the Central Arizona Water Conservation District ("CAWCD"); the Happy Trails Community Association ("HTCA") through its Manager, Mr. Leon Rye; the Tubac Fire District Board ("TFDB"); the City of Surprise; and the Arizona Department of Water Resources ("ADWR").

Subsequently, there were numerous discovery disputes between primarily RUCO, Staff, and other parties on the one hand and the Company on the other hand. Oral arguments on the discovery disputes occurred on March 5, March 20, April 3, and April 23, 1996. The Presiding Officer issued the following decision at the March 15, 1996 oral argument, and a Procedural Order was issued on March 22, 1996 which set forth the following:

> We find that pursuant to A.A.C. R14-2-103(B)(11)(e)(ii) there are clearly extraordinary events in this case, including:
>
> (1) Citizens has knowingly failed to respond to discovery requests in a timely manner. On October 11, 1995, Staff filed its Request for Procedural Order. On October 23, 1995, the Company filed a Response, stating that the proposed discovery schedules do not allow it a reasonable and adequate opportunity to prepare responses and objections to discovery. Our October 25, 1996 Procedural Order rejected the Company's arguments and clearly specified a time frame of ten days in which to respond to discovery requests. Citizens did not appeal this ruling. Citizens readily admits that it has been late in responding to data requests,[1] and continues to be late in its responses, even after the Procedural Conference.
>
> (2) Citizens failed to comply with the March 5, 1996 bench ruling as set forth in the March 6, 1996 Procedural Order. Citizens did not immediately respond to all outstanding data requests.
>
> (3) Citizens has not shown that it has taken steps to modify its internal process to insure compliance with the October 25, 1995 or the March 6, 1996 Procedural Orders.
>
> (4) the Motion For Stay filed by Citizens on March 12, 1996.
>
> (5) Citizens' announcement of an "amended application"/"corrected filing" to be filed no later than the end of the week (March 8, 1996), and then its decision announced at the March 20, 1996 Procedural Conference not to make the filing.
>
> (6) Citizens' filing three rate cases within several weeks of each other, including this rate case, which is actually six applications combined into one proceeding.
>
> (7) During a similar discovery Procedural Conference in Docket No. E-1032-95-433, Citizens' pending electric rate application, the Commission suspended the Timeclock Rules.
>
> While we find each of the above is an extraordinary event by itself, cumulatively we find it even more compelling.
>
> We find that the Company's clear, repeated violations of the Commission's rulings and orders has harmed Staff, RUCO, and the other Intervenors' opportunity to analyze data and fully present their case(s). As a result, Staff and RUCO's Motions are granted, and the Timeclock Rules are suspended.

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[1] At the March 5, 1996 Procedural Conference, it indicated that it was an average of 12 days late in responding to Staff and RUCO data requests. Staff indicated that the Company was an average of 14 days late, with some data requests being as late as 40 days. At the March 20, 1996 Procedural Conference, the Company indicated that its average "lateness" was improving.

By Procedural Order issued May 9, 1996, the stay of the Timeclock Rules was lifted and the hearing was rescheduled for October 29, 1996. The May 9, 1996 Procedural Order determined that the time-clock rules were extended by 167 days as a result of the extraordinary events.

This consolidated matter came before a duly authorized Hearing Officer of the Commission at the Commission's offices in Phoenix, Arizona on October 29, 1996. Citizens, RUCO, and various intervenors appeared through counsel and Staff appeared through counsel. At the conclusion of the hearing, the matter was adjourned pending submission of simultaneous initial and reply briefs on December 18, 1996 and January 17, 1997, respectively. On February 21, 1997, the Company, Staff, and RUCO filed composite schedules.

DISCUSSION

I. NATURE OF APPLICANT'S OPERATIONS AND PROPOSED INCREASES

Citizens is a Delaware corporation and diversified public utility which, through its operating divisions and subsidiaries, provides electric, natural gas, telecommunications, water and wastewater service to approximately 1.8 million customers in 20 states. Citizens is engaged in the business of providing public utility water and wastewater service to approximately 90,000 customers in Maricopa and Santa Cruz Counties pursuant to Certificates of Public Convenience and Necessity granted by the Commission. Maricopa W/WW includes six operations with individual rate structures and separate accounting records. They include the Agua Fria Water Division ("Agua Fria"), Citizens' wholly-owned subsidiaries Sun City Sewer Company ("Sun City Sewer"), Sun City Water Company ("Sun City Water"), Sun City West Utilities Company water operations ("Sun City West Water") and wastewater operations ("Sun City West Wastewater"), and Tubac Valley Water Company.

In its application, Citizens requested an increase in operating revenues of approximately $3.68 million. During the course of the proceeding, Citizens revised its request to approximately $2.1 million. For each of the operations, the rate relief requested now is as follows: Sun City Water Company, $364,780; Sun City Sewer Company, $404,392; Sun City West water operations, $127,492; Sun City West wastewater operations, $994,602; Citizens Agua Fria Water Division, $148,555; and Tubac Valley Water Company, $51,662. Staff recommended an overall decrease of $420,162 and RUCO recommended an overall increase in the Company's operating revenues of $525,071.

II. CENTRAL ARIZONA PROJECT

Background

In 1968, Congress passed the Colorado River Basin Project Act in response to comprehensive water resource studies conducted by federal and state agencies which indicated that projected water demand for agricultural and municipal uses could not be effectively met by available local water resources. The Central Arizona Project ("CAP") was planned and built jointly by federal agencies (Department of Interior -- Bureau of Reclamation) and state agencies and was designed and constructed to divert water from the Colorado River and transport it for use within central and southern Arizona to augment current water supplies and to help mitigate continued overdraft of the groundwater supplies. The State of Arizona created the Central Arizona Water Conservation District ("CAWCD") in 1971 to act as the State's authority to contract with the federal government to manage and operate the project, to levy taxes, and to subcontract with potential users for water delivery at rates established by CAWCD.

The CAP was declared complete in October 1993, at a total cost of over $3 billion. It consists of a 24.3 percent interest in the Navajo Generating Plant, aqueducts, pumping plants, check structures, an operation/control center, the new Waddell Dam, canal and pump/generating plant, turnouts and a communications system. The water is diverted from the Colorado River at Lake Havasu and transported through aqueducts and canals to Lake Pleasant, where it can be temporarily stored, and then pumped to Phoenix and Tucson. The CAP was designed to transport approximately 1.5 million acre feet annually to Arizona.

There are three types of subcontractors[2] for CAP water: Indian, non-Indian municipal and industrial ("M&I"), and non-Indian agricultural. There are three categories of CAP costs, including the M&I Capital Charge which is paid semi-annually regardless of whether the water is used and is intended to repay the federal government for construction costs of CAP; the costs related to the energy needed to pump and transport the water ("energy charge") and the operation, maintenance, and replacement of the water delivery system ("OM&R"), both of which are paid only when CAP water is actually being used.

One hundred percent of Citizens' water supply is provided by groundwater. On October 24,

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[2] The CAWCD is the prime contractor with the Department of the Interior, and the individual CAP water user enters into a "subcontract" with CAWCD and the Department of Interior.

1985, Sun City Water and Agua Fria entered into CAP subcontracts with the United States Bureau of Reclamation and the CAWCD for water allocations of 17,274 acre feet per year.[3] Citizens has also requested from the CAWCD that it be allowed to obtain the Town of Youngtown's ("Youngtown") CAP allocation of 380 acre feet in conjunction with its purchase of Youngtown's water system. If approved, Citizens would have a total allocation of 17,654 acre feet.

In March 1994, the Company completed a Water Resources Planning Study that concluded that continuous reliance solely on groundwater to meet the municipal and industrial demand could result in decreased water levels, increased pumping costs, well failures, diminished water quality, and land subsidence. The study recommended that the Company pursue the development of additional water resources to supplement its water supplies, and noted that the most technically and legally feasible alternative was the development and use of CAP water.

In August 1995, the Company completed a Water Use Feasibility Study which looked at three options for the use of CAP water. The study concluded that all three options were technically feasible, but selected the joint recharge project with the CAWCD along the Agua Fria River as the preferred option due to anticipated economies of scale, the advantage of having CAWD as a partner, and the expected financial benefits from partial state financing.

On June 27, 1994, Sun City Water and Agua Fria filed a Joint Application with the Commission requesting an accounting order authorizing deferral of CAP water charges to allow the companies an opportunity to request recovery of the costs in a future rate proceeding. In Decision No. 58750, (August 31, 1994) the Commission approved the requested accounting order beginning with CAP water charges for 1995. The CAWCD assesses annual M & I Capital Charges based upon a per acre foot charge. The CAP water charges in 1995 were $21.00 per acre foot and have continued to escalate to $30.00 per acre foot in 1996, $39.00 per acre foot in 1997, $48.00 per acre foot for 1998-9, and $54.00 per acre foot in 2000 and thereafter.

Recovery of CAP Capital Charges

In this rate application, Maricopa W/WW requests rate recognition for the deferred and on-going

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[3] 15,835 acre feet per year for Sun City Water and 1,439 acre feet per year for Agua Fria.

CAP water charges in the form of a surcharge mechanism applicable to the customers of Sun City Water, Agua Fria, and Sun City West Water.[4] The surcharge would include a flat fee on the monthly water bill, calculated by dividing the CAP costs to be recovered by the total number of units served, and would also include an annual adjustment to reflect cost changes, any over or under-recovery of CAP costs from the prior year, and an interest component.

In response to the Staff proposal, and in the alternative to its surcharge mechanism, the Company proposed a sharing of CAP costs, with 20 percent to developers/new customers as a reservation fee, 40 percent to existing customers as a volumetric charge, and 40 percent to Sun City Water, Agua Fria, and Sun City West Water as deferred charges until the CAP facilities are placed into service. Maricopa W/WW also proposed treatment as a tax expense as a third, acceptable method for recovery of the CAP charges. Sun City Water and Agua Fria cite A.R.S. Section 48-3715.04 as the basis, and submit that the Commission should treat the CAP charges as a tax, subject to automatic pass through recovery from customers in accordance with the companies' tariffs. The Company's Vice President of Water and Wastewater Sector testified that if the Commission adopts either the Staff or RUCO proposal, he will have no choice but to recommend to the Company's Board of Directors that Sun City Water and Agua Fria dispose of their rights to the CAP allocations.

Staff agreed that the Company needs to develop alternative sources of water, but does not believe that the existing customers should have to pay for the cost of the CAP allocation because it is currently not providing any benefits to the customers. Staff believes that the Commission should not deviate from its long-standing policy that CAP water must actually be put to use prior to or commensurate with cost recovery from existing ratepayers. Staff proposed that the Company be allowed to recover approximately fifty percent[5] of deferred and current CAP M & I charges from new customer connections through the use of the CAP reservation fee. This reservation fee would be per meter for new customer connections in the Sun City Water, Sun City West Water, and Agua Fria service areas. Staff recommended that the Company be allowed to defer, with an earnings component, the remaining CAP M&I Capital Charges

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[4] Citizens has not been assessed any energy or OM&R charges because it is not using any CAP water.

[5] $2,317,986.

for future recovery from ratepayers when the CAP allocation has been put to beneficial use for its customers in the Northwest Valley.

Because of the seriousness of the groundwater overdraft in Citizens' service area, Staff recommended that Citizens be ordered to put its CAP allocation to beneficial use for its customers no later than December 31, 2000. Staff also recommended that the amounts collected through the CAP reservation fee be deemed interim and subject to refund if the Company has not put its CAP allocation to beneficial use for its Northwest Valley customers by December 31, 2000, and that the Company be required to file an annual report with Staff which details on a monthly basis the CAP reservation fees by meter size collected during the fiscal year, the amount of earnings on the deferred CAP costs, and the balance in the CAP deferral account, with the first annual report for the fiscal year ending December 31, 1997 filed with Staff no later than March 31, 1998.

RUCO believes that the Commission should not allow the Company to recover the CAP water charges from residential ratepayers because the Company is not using CAP water in the provision of service to its customers and therefore its CAP allocation is not "used and useful". Additionally, RUCO believes that the Company's proposal to use the CAP allocation is speculative and that the Company has no definitive plan to ever use CAP water. RUCO also recommends that on a going-forward basis, the Commission should rescind Citizens' authorization to defer its CAP costs granted in Decision No. 58750 (August 31, 1994).

The SCTA recommended that the Commission deny recovery of the CAP charges. SCTA believes that the mere existence of a CAP subcontract does not provide any tangible benefit to the residents of Sun City. SCTA believes that groundwater depletion is a regional issue which should be financed through augmentation and water bank programs funded with state imposed groundwater withdrawal fees, CAWCD imposed property taxes, and monies appropriated from the State's general fund. SCTA believes that at most, Citizens should be allowed to continue to accrue the cost associated with maintaining its CAP subcontracts until such time as CAP water is put to use in a manner beneficial to its customers.

The Sun Village Community Association, the Property Owners and Residents Association of Sun City West, the Sun City Home Owners Association, the Sun City West Recreation Centers, Inc., and the

City of Surprise (collectively, "Concerned Customers of Citizens") request that the Commission completely deny cost recovery if the Company refuses to condition cost recovery on delivery or use of CAP water; permit cost recovery based on an approved final plan, obtained through public participation, which addresses the individual needs of the different communities; mandate a date by which the Company must implement the final plan; condition cost recovery on the actual implementation of the plan; and require reimbursement if the Company refuses or is unable to deliver or use CAP water.

The CAWCD intervened in this case to "support the use of CAP water by its subcontractors and to support appropriate reimbursement by rate payers." The CAWCD stated its hope that the Commission's decision in this case will have the effect of encouraging Citizens to commence using its CAP allocation in an expedited manner, and thereby support the public policy goals of diminishing the mining of groundwater and depletion of reservoirs, and support the use of Arizona's full share of its Colorado River entitlement. The CAWCD believes that a long term CAP water allocation, regardless of whether the water is being physically delivered or not, reserves a long term renewable water supply for the service area and serves to sustain property values.

The ADWR intervened in this case to be "certain that the water management goals and policies of the State of Arizona were articulated and considered" by the Commission. According to an ADWR witness, groundwater pumpage by Citizens is a contributor to overdraft conditions in the Phoenix AMA, and in particular, to groundwater level declines in the West Valley. According to the ADWR, the CAP was authorized primarily with the intent of providing Colorado River water to replace over drafted groundwater, and delays in using the state's Colorado River allocation leaves Arizona vulnerable to charges that it does not need its full allocation. Citizens has the largest single CAP allocation among all private water companies, and if Citizens were to relinquish its CAP allocation, it is unlikely that Citizens could acquire municipal CAP water of this quantity in the future, and while water may be available through long-term leases, the associated costs could substantially exceed the costs with the CAP subcontract. The ADWR believes that putting Citizens' CAP allocation to use for its customers would help assure the long-term reliability of the water supply for those and future customers, and thereby help achieve the State's water management goals. The ADWR encouraged the Commission to use its authority to promote the use of Citizens' and other private water companies' CAP allocations so as to

assure that the current and future water demands of Arizona's citizens are met.

Analysis

It is clear from the evidence presented by the Company, ADWR, and Staff that the demand of existing customers is contributing to the groundwater depletion of the aquifer, land subsidence, and other environmental damage. It is also clear that the consequences of such excessive groundwater withdrawal include decreased water levels, diminished water quality, well failures, increased pumping costs, and more land subsidence. Most of the parties agree that action should be taken to attempt to rectify the current situation and prevent further problems, but they don't necessarily agree on the solution; on who should pay; or how or when payment should be made.

We find that the Company's decision to obtain allocations of CAP water was a prudent planning decision. Past Commission Decisions concerning recovery of M&I Capital Charges generally reflect the policy of not allowing cost recovery of CAP charges from existing customers until the water is actually being provided to customers.[6] However, most of the cases establishing that precedent involved using CAP water as a source to provide service to new customers, not using CAP water to prevent decreased water levels, diminished water quality, well failures, increased pumping costs, and land subsidence, caused, in part, by groundwater pumping for existing ratepayers. More recently in Decision No. 59079 (May 5, 1995), the Commission allowed recovery of M&I Capital Charges without CAP water actually being used where Paradise Valley Water Company showed that both existing and future customers benefitted from its CAP allocation.[7]

We find that such is the case here and that the Company contracted for CAP in order to meet the continuing groundwater requirements for its existing customers as well as help it to provide sufficient water to service all of its service areas at ultimate development. Provided that the CAP allocation will ultimately be used, the existing customers will benefit. The new customers will also benefit from the

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[6] See Decision No. 58120 (December 23, 1992) for Arizona Water Company; Decision No. 57395 (May 23, 1991) for Chaparral City Water Company and Decision No. 58100 (December 9, 1992) for Midvale Farms Water Co.

[7] The CAP allocation had allowed the Company to obtain a 100 year assured water supply designation, which allowed development to occur that contributed additional revenues resulting in fixed costs being spread over a larger customer base.

CAP allocation by contributing to the use of renewable sources of water that will be used in the Northwest Valley to prevent diminished water quality, well failures, and future additional land subsidence, and thereby protect their economic investment in the area.

As pointed out by out by the Concerned Customers, SCTA, Staff, and RUCO, the Company has held its CAP allocation for more than eleven years, but has not delivered or put to beneficial use any CAP water, and currently has no final plan for its use.[8] The ADWR, CAWCD, Staff, and most of the parties recognize that the time for Citizens to take action is now - not decades in the future when costs will be higher and alternatives may be restricted or not available. Because Citizens is not utilizing CAP water in the provision of service to its customers, its CAP allocation by definition is not "used" and "useful". Therefore, the costs of Citizens' CAP capital charges should not be borne by the ratepayers. Furthermore, because Citizens has no definite plans to use the CAP water, its proposal to use its CAP allocation is speculative and the use of this water cannot be considered to be a known and measurable event. Therefore, Citizens' request for M&I Capital Charges should be denied.

We will, however, allow Citizens to defer CAP capital costs for future recovery from ratepayers when the CAP allocation has been put to beneficial use for Citizens' ratepayers. This order is subject to a development of a plan and date of implementation by December 31, 2000. If CAP water is not implemented by December 31, 2000, then Citizens will lose its ability to defer future costs.

III. RATE BASE

In its application, the Company proposed a combined original cost rate base ("OCRB") of $39,292,652. Staff and RUCO proposed adjustments which resulted in combined OCRBs of $36,303,808 and $36,425,397, respectively. The Company, Staff, and RUCO final proposed rate base for Sun City Water was $14,313,037, $13,634,041, and $13,826,395; $7,514,755, $7,361,407, and $7,368,982 for Sun City Sewer; $6,685,509, $6,235,619, and $6,193,564 for Sun City West Water; $5,370,026, $5,108,820, and $4,971,516 for Sun City West Wastewater; $3,515,693, $3,305,517, and $3,408,105 for Agua Fria; and $661,875, $658,404, $656,835 for Tubac Valley.

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[8] As pointed out by the SCTA, the subcontracts have fixed 50 year terms, and with each passing year, the amount of water ultimately deliverable is reduced by 1/50th, thereby reducing the maximum potential benefits deliverable under the subcontracts.

A. AR-13 AFUDC ("AR-13")

The Company is allowed to accrue allowance for funds used during construction ("AFUDC") until plant is completed and placed in service. The Federal Energy Regulatory Commission ("FERC") issued an accounting release in 1983 ("AR-13") dealing specifically with calculation of AFUDC when there are restricted-use long-term debt involved in the capital structure that utilities use for financing.

The Company has issued Industrial Development Revenue Bonds ("IDRBs") which can only be utilized for specific construction projects. The proceeds from the IDRB are required to be held in a construction trust fund until the funds are actually needed to finance the specific project. The Company is able to invest these undrawn trust funds in short term securities and earn interest. The interest income is offset against the interest expense Citizens is incurring on the IDRBs. Citizens applies an AFUDC rate comprised of debt and equity to the unspent proceeds, and the difference between the AFUDC rate and the net investment earnings is capitalized as AR-13 costs and added to rate base.

Citizens asserts that its procedures for recording AFUDC are consistent with AR-13 and comply with generally accepted accounting principles. In addition, Citizens indicated that its procedures comply with Decision No. 55474, dated March 18, 1987. According to Citizens, that Decision required the use of an Arizona property specific AFUDC rate which includes any debt that has been issued for construction at a specific operation, a proportionate share of any general corporate debt, and the Commission authorized rate of return on common equity for the specific operation for any common equity funds used to fund construction expenditures. Citizens indicated that where AR-13 and Decision No. 55474 were in conflict, Citizens would always choose the procedure which resulted in the lowest AFUDC rates.

The Commission determined in Decision No. 58360, dated July 23, 1993, that Citizens' procedures did not comply with AR-13 because the entire undrawn balance of IDRB funds was not included with other long-term debt in the AFUDC calculations. The Commission ordered the Company to comply with AR-13. As a result of that Decision, Citizens indicated its calculation of AR-13 AFUDC was inconsistent with the remainder of Citizens operations in Arizona[9]. Although Staff has conducted

[9] On May 4, 1994, Citizens filed an application in Docket No. E-1032-94-139 requesting that the Commission review in one proceeding the AR-13 AFUDC procedures applicable to all of the

discovery in that docket, no Staff Report has been issued. The Company requests the Commission direct the Company, Staff, and RUCO to work together and develop a joint recommendation on the correct AFUDC procedures for all of Citizens operations.

If the Commission decides to address the AR-13 AFUDC procedures in this case, Citizens asserted the Commission should approve the methodology used by the Company. According to the Company, neither Staff nor RUCO has taken into account the conflict between Decision No. 55474 and AR-13 procedures.

RUCO concluded that the Company's method of calculating the AFUDC did not follow AR-13 procedures and recommended that the Commission exclude all AR-13 AFUDC capitalized subsequent to 1987. The Company criticizes this recommendation as retroactive ratemaking.

Staff made a similar analysis and recommended an adjustment consistent with the decision in Citizens' Arizona Electric Division ("AED") rate case, Decision No. 59951 (January 3, 1997), to exclude from rate base all AR-13 accrual amounts recorded after 1987, a net reduction in rate base of $1,333,816. According to Staff, the Company's method of calculating AR-13 costs is not appropriate for use in Arizona ratemaking. Staff believes that Citizens does not follow the method prescribed in FERC AR-13 because it does not include the entire issue of the IDRB debt along with other debt in calculating its AFUDC rate. The Company assumes that any construction expenditures not financed by the portion of IDRB anticipated to be drawn down in a given year are financed by common equity. Staff also believes that Citizens' method deprives Arizona ratepayers of any benefit of the undrawn IDRBs because the financing is diluted when included in Citizens' consolidated total company capital structure and Citizens should not be earning an equity return on plant financed with the Arizona IDRBs, and also because the IDRB plant does not qualify for accelerated tax depreciation and this deprives Arizona ratepayers of the higher amount of rate base deductions for ADIT.

Staff further recommended that the Commission order Citizens to:

- Remove the disallowed AR-13 accrual amount from Plant and Accumulated Depreciation on Maricopa W/WW books:
- Cease recording AR-13 accrual amount on Maricopa W/WW's books from the date of this Decision;

Arizona operations that use IDRB funding.

- Remove the AR-13 amounts recorded from the end of the TY through the date of this Decision from Maricopa W/WW's books;
- Calculate AFUDC only on actual construction expenditures, and not upon unexpended IDRB proceeds, and;
- Calculate AFUDC on actual construction expenditures using an AFUDC that is based upon the weighted cost of capital for the Maricopa W/WW that is adopted herein.

It is clear that Citizens used a method to calculate AFUDC other than the FERC AR-13 formula that was approved in Decision No. 55474. Moreover, as Staff has pointed out, FERC AR-13 clearly states that: "[t]he entire issue of the use-restricted, long-term debt should be included with other long-term debt used in calculating AFUDC rates."

Contrary to this clear directive, Citizens does not include the entire issue of the use-restricted, long-term debt in calculating its AFUDC rate. Citizens' calculation includes only the portion of the IDRB issue expected to be drawn down during the current year. By excluding the remaining IDRB proceeds being held by the trustee from the AFUDC rate calculation and excluding these proceeds from the capital structure, Citizens' procedure deprives ratepayers of the benefit of such IDRB debt while the proceeds are being held by the trustee. Citizens' AR-13 accrual calculations have also ignored the specification in FERC AR-13 addressing other long-term debt. FERC Accounting Release 13 requires that other long-term debt be included in calculating the AFUDC rate. Citizens' calculation of an AFUDC rate assumes that the construction not financed by an IDRB is financed by common equity and not by other long-term debt. As a consequence, Citizens' procedure improperly applies a common equity rate for debt financing.

Contrary to Citizens' claims, it is not clear that Citizens' method benefit ratepayers. It is clear that Citizens' method results in a number of detrimental impacts to ratepayers. The AR-13 accrual produces additional amounts of rate base, beyond those produced by the traditional application of an AFUDC rate to actual construction expenditures.

In Decision No. 58360, the previous AED rate case, we found that Citizens failed to calculate the AFUDC rate in accordance with FERC AR-13, and disallowed from rate base Citizens' AR-13 accrual amounts that the Company had recorded on the AED's books since 1987. The flaws in Citizens' AR-13 calculation that were noted in Decision No. 58360 cited above continue to be applicable in the recent AED rate case. Specifically, Citizens does not include the entire issue of the use-restricted, long-term

IDRB debt with other debt in calculating its AFUDC rates. Moreover, Citizens does not include the entire issue of the use-restricted, long-term IDRB debt with other debt in calculating its capital structure for ratemaking purposes. These failures by Citizens to include the entire issue of the use-restricted, long-term IDRB debt with other debt in calculating its AFUDC rate and to include the trustee-held IDRB proceeds in the ratemaking capital structure serve to deprive ratepayers of any benefit of the undrawn IDRBs upon which Citizens computes its AR-13 accruals. These facts, especially taken in conjunction with the other inequities associated with Citizens' AR-13 method discussed above, require an adjustment for ratemaking purposes. We affirm our previous decisions to exclude Citizens' post-1987 AR-13 accrual amounts from rate base and adopt RUCO and Staff's recommendations to exclude post-1987 AR-13 accruals from rate base. Plant in Service is reduced by $1,438,248 and Accumulated Depreciation is reduced by $104,432 for a net reduction in rate base of $1,333,816.

We also order Citizens to remove the disallowed AR-13 accrual amounts from Plant and Accumulated Depreciation on the Maricopa W/WW 's books. In Decision No. 59951, the Commission ordered the Hearing Division to issue a Procedural Order regarding the proper AFUDC methodology, and we note that a Procedural Order was issued scheduling the filing of testimony and setting a hearing. We expect that proceeding to establish the appropriate AFUDC methodology for all of Citizens' Arizona operations. The result of the calculation of AFUDC and AR-13 AFUDC for the Maricopa Water/Wastewater operations that is ultimately approved in Citizens pending consolidated AR-13 AFUDC proceeding, Docket No. E-1032-94-139, et al. will be applied to undrawn IDRB amounts forward from the end of the test year in these proceedings.

B. Youngtown Plant Acquisition

On February 8, 1995, Sun City Water and Sun City Sewer, respectively, purchased the water and wastewater facilities of the Town of Youngtown, Arizona ("Youngtown" or "Town") and are providing service to 3,720 customers within Youngtown's municipal boundaries. Sun City Water and Sun City Sewer acquired the Youngtown systems for a total purchase price of $1,192,862 which includes an amount of $259,605 placed into escrow pursuant to the Sales Agreement. Staff reduced plant in service to exclude a water acquisition adjustment, plant balances funded by grants, and non used and useful plant by ($423,091) for Sun City Water and by ($426,664) for Sun City Sewer. We agree with Staff's

adjustments, with the exception immediately below.

1. Escrow Amount

In the Sales Agreement, Sun City Water, Sun City Sewer, and Youngtown agreed to place $259,605 of the purchase price into an escrow account to reflect Community Development Block Grants that Youngtown received for construction of the water and wastewater systems. According to Citizens, the parties agreed to place this amount into escrow because there was a lack of precedent as to whether plant funded through grants obtained by a prior municipal owner would be recognized in the Company's rate base. According to the Sales Agreement, if the plant funded by grants is included in rate base, the $259,605 will be released from escrow and paid to Youngtown. If the plant is not included in rate base, the amount in escrow will be returned to Sun City Water and Sun City Sewer. Sun City Water and Sun City Sewer seek rate base treatment for the entire amount of the purchase price, including the amount held in escrow, because they believe that it represents Company investment in the facilities.

Staff and RUCO oppose inclusion of the escrow amount in rate base. Staff believes that since these funds were grant money, it was not supplied by Youngtown as the plant owner, and under traditional ratemaking, only investor-financed plant should be included in rate base. Staff also argues that Citizens can provide no justification for requiring all of its ratepayers to pay this cost for plant used to serve only a portion of those customers; that no harm would result to Citizens, because the amount in escrow would be returned to invest as it sees fit; that the working relationship between Citizens and Youngtown would not suffer; that Youngtown was represented by counsel during negotiations and it negotiated the Sales Agreement with the explicit understanding that the escrow amount was at risk and may not be recovered by Youngtown.

We agree with the Company that the amount held in escrow should be included in rate base. Although generally, only investor-financed plant should be included in rate base, when a municipality is involved, none of the plant is "investor-financed". The grant funds were intended to benefit the municipality, and that benefit would be lost if the plant associated with those funds were not allowed into rate base. If the amount in escrow is not allowed in rate base, then the escrowed funds would not be released to Youngtown, and Citizens' customers both outside and inside of Youngtown would receive the benefit of Youngtown's grant. Accordingly, we will allow $55,902 of the escrow amount in rate base

for Sun City Water and $203,703 in rate base for Sun City Sewer.

2. Accumulated Depreciation

Pursuant to the terms of the Sales Agreement, Sun City Water and Sun City Sewer purchased the facilities based on Youngtown's financial statements as of June 30, 1993, with the exception of certain specified items, not including depreciation, subject to a true-up as of the date of closing. Youngtown continued to depreciate the assets on its books until the time of the transfer, February 8, 1995. In its application, Citizens did not reflect the ongoing depreciation, and reflected as rate base the depreciated value of the plant as of June 30, 1993, rather than the end of test year, March 31, 1995.

Staff removed depreciated plant for the water system and the sewer system to reflect the ongoing depreciation that was recorded by Youngtown prior to the transfer, and for the depreciation from the date of the transfer until the end of the test year.

We agree with Staff that rate base should include the depreciated plant value as of the end of test year. This is not an "imputation" of depreciation as suggested by the Company, but rather, is a reflection of actual depreciation expense which was recorded on Youngtown's books, and which should have been recorded on Citizens's books, both at the time of the transfer and on a going forward basis. Accordingly, we will adjust accumulated depreciation for Sun City Water by $39,435 and for Sun City Sewer by $46,074[10].

3. Acquisition Adjustment

Sun City Water and Sun City Sewer acquired the Youngtown systems for a total purchase price of $1,192,862, which is $52,465[11] above the net book value of the assets. Sun City Water and Sun City Sewer request that the total $52,465 acquisition premium be included in rate base and be amortized above the line. The Company cites two previous Commission Decisions and concludes that the Youngtown acquisition meets the Commission's criteria for rate recognition of the acquisition premium. The

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[10] This reflects our determination to allow the $259,605 escrow amount in rate base.

[11] It is not clear whether Staff agrees that this is the correct amount of the acquisition adjustment. In its reply brief, Staff indicates that it believes that the acquisition adjustment is $137,643, but the summary schedules filed thereafter indicate the $52,465 amount. According to RUCO, the acquisition adjustment is $324,926.

Company lists the following as the benefits to the Youngtown customers: a 44 percent reduction in water and sewer rates; long-term savings through Sun City Sewer's use of the Tolleson Treatment Plant; and "enhanced customer service features". The Company stated that existing wastewater customers will benefit by spreading fixed and variable costs over an expanded customer base, and the interconnection of the systems will improve operating efficiencies and reliability.

Staff and RUCO opposed the request for recovery of the acquisition premium. Staff disagreed that Decision No. 56551 (July 3, 1989) wherein the Commission approved Sun City West Water's purchase of the Cool Well Water Company ("Cool Well") and allowed inclusion of the acquisition adjustment in rate base, is support for allowing recovery of the acquisition premium in this case. Staff noted that Cool Well was a small regulated company that had been operating at a loss for many years and providing unreliable service and that Staff had recommended an acquisition adjustment be allowed to encourage consolidation of small water companies into larger ones. Staff believes that these special circumstances are not present here. Further, Decision No. 56551 only allowed rate base treatment, not both rate base and amortization, as the Company has requested here.

We believe that the benefits cited by the Company support its requested approval of the sale of assets and extension of its CC&N to provided service to the Youngtown customers, but we do not believe that they justify charging ratepayers for an acquisition premium. None of the compelling circumstances of the Cool Well Decision are present here, and we see no reason to encourage public service corporations to acquire municipal water or sewer operations. Further, Citizens is well aware of the Commission's past decisions concerning acquisition adjustments, including Decision No. 58664 (June 6, 1994) where the Commission denied rate base treatment for Citizens' Northern Arizona Gas Division ("NAGD") and cited Decision No. 57647 (December 2, 1991) stating "Citizens must be reminded that Arizona allows for a return on invested plant, not on the sale price paid for the utility."[12] Further, we believe that the criteria established for the NAGD to recover an acquisition premium are not applicable here, when the selling entity is a municipality. Part of the criteria was that Citizens must make a clear demonstration of structural savings, not including those that could or should have been achieved under

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[12] In Citizens' most recent acquisition (Navajo Telephone), an acquisition premium is expressly excluded from rates. Decision No. 59306 (September 22, 1995).

the previous ownership. We agree with Staff that because there is no evidence of the relationship between the Youngtown rates previous to Citizens' acquisition and the underlying costs of providing utility service by Youngtown, whether and to what extent such rates could have been reduced in the absence of Citizens' acquisition is speculative at best. Accordingly, we will not include an acquisition adjustment in rate base.

C. Stamford Administrative Office Common Plant

Staff and RUCO proposed adjustments to Stamford Administrative Office ("SAO") plant to remove plant items that are not appropriate for ratemaking. They removed items that the Commission removed in the last gas and electric proceedings involving Citizens (art work and an office provided to a retired executive) and for other SAO furniture, equipment, and what Staff termed "Cadillac DeVille 'pool cars' that appear to reflect the lavish tastes of Citizens' top executives rather than the necessities of providing utility service to Arizona ratepayers." Both Staff and RUCO also used a more current four factor allocator for SAO plant. We agree with Staff and RUCO's adjustments.

D. Plant-In-Service

Staff made a number of adjustments to the original cost and reconstruction cost new ("RCN") data that was submitted by the Company. Staff reduced Sun City Water's rate base by $88,746 and by $1,674 to reflect the cost of observation wells that Staff believes are not used and useful. The Company opposed the adjustments. Testimony from the Company's witness, Dr. Montgomery, supported the Company's position that production wells may be useful for operating the pumps and understanding what their pumping levels are, and what well efficiencies might be, but they are not appropriate for use in measuring static water level conditions in the aquifer. Additionally, the use of additional observation wells provides for more data points when analyzing overall aquifer characteristics and improves the overall quality and reliability of the studies. However, Staff maintained that the production wells can be utilized for monitoring water level and water quality of the aquifer. Additionally, observation wells have traditionally been classified as "stand-by" wells and not included in rate base. Therefore, we agree with Staff.

We agree with the Company that the observations wells are used and useful in providing water utility service. Monitoring and understanding the groundwater levels in the aquifer is one component

of the Company's duty of ensuring a continued supply of water for its customers. Accordingly, we will not adopt Staff's adjustment.

E. Cash Working Capital

Both Staff and RUCO proposed adjustments to the Company's cash working capital, a number of which were accepted by the Company, including adjustments to expense lead or lag days with salaries and wages, pumping power expense, administrative office expense, insurance, injuries and damages expense, and other taxes. The Company also accepted inclusion of interest expense in the lead lag study at a 90-day lag and also removed preliminary survey and investigation ("PS&I") charges from the working capital balance. Staff and RUCO agree that the revenue lag should be reduced by one day to reflect the Company's new lock box program which will allow customers to pay their bills through the bank rather than remitting them directly to the Company. Staff and the Company have agreed to certain increases to expense lags to reflect check clearing lags and have revised the pension lag expense to reflect an actual contribution made by Citizens to the pension trust. We will adopt those adjustments. RUCO recommends that, consistent with past Commission decisions, including Decisions Nos. 58360 and 58664, the Commission should exclude $83,354 in rate case and deferred TARGET: Excellence expenses from the cash working capital component. We agree with RUCO.

Staff and RUCO proposed that cash balances should be removed from the determination of cash working capital. RUCO notes that these two asset item have never been included in the calculation of cash working capital in any prior Commission decision. Staff notes that with the exception of only Sun City Sewer, there is a negative cash working capital requirement and to include a cash balance in the cash working capital requirement for these companies would grant them a return on cash when they have no cash requirement. We agree with Staff and RUCO's adjustment to remove cash balances.

We note that RUCO believes that the Company's sampling method for determining the lag for the O&M, administrative and general expense category analyzed too few invoices and does not capture the various types of expenses contained in the category. While we will not adopt RUCO's adjustment in this proceeding, we expect the Company to address the issues raised by RUCO in its next lead/lag study.

F. Sun City West Developer Advances

RUCO proposed and Citizens agreed to an increase in the amount of Sun City West developer advances by $58,650 for water and $121,657 for wastewater, with a corresponding decrease in rate base. We concur.

G. Accumulated Deferred Income Taxes

Staff proposed to adjust Accumulated Deferred Income Taxes ("ADIT") by a total of $202,435 of "Schedule M" items which presents a reconciliation between book income and taxable income. Staff's adjustment was to exclude unbilled revenue and nondeductible employee benefits that are disallowed for ratemaking purposes. Staff believes that unbilled revenue should be excluded from ADIT because it represents an unnecessary tax timing expense. We agree with Staff that this is an artificially created ADIT debit balance rate base increase and therefore will adopt Staff's adjustment. Further, we agree with Staff that since pension expense has been adjusted to reflect coordination of the timing of pension fund payments and the recognition of pension expense for ratemaking purposes, there is no need to increase rate base associated with accrued but unfunded pension expense. Likewise, in Decision No. 59951, we disallowed Citizens' incentive compensation and FAS 106 accrual and we will make the same adjustment here.

In this proceeding, the Company is requesting to convert its deferred income taxes on the differences between accelerated tax depreciation and straight-line tax depreciation to a fully normalized basis. While RUCO does not take exception to the move to full normalization, it recommends that it be implemented on a going-forward basis. Since full normalization accounting was not in effect during the test year and the per book deferred taxes as of the end of the TY were not reduced and will not be reduced until the Commission approves full normalization account, RUCO believes that the Company's requested adjustments are inappropriate for ratemaking purposes. The Company criticized RUCO's proposal because it does not provide recovery of the flow-through amounts as an increase in income tax expense. The Company believes that its method of using full normalization as of the TY to determine the ADIT balance is appropriate and if RUCO's adjustment is adopted, the Company will experience a shortfall in recovery of its tax liability.

We agree with Staff and will adopt its recommended adjustments.

H. Staff Recommendations

The Engineering Staff made some additional recommendations, including:

- Citizens should be ordered to maintain detailed information about the plant by individual system and such information should be readily available and provided in the annual report;
- Citizens should be ordered to maintain flow meters in order to obtain and provide accurate flow data by system and such information should be readily available and provided in the annual report;
- Citizens should be ordered to file applications to extend its CC&N to encompass all areas where customers are being served;
- Sun City West Water should conduct a detailed analysis to determine whether the Cool Well system needs more storage; and
- Tubac Valley should be ordered to meet with the Arizona Department of Environmental Quality ("ADEQ") and resolve any non-compliances, and should also investigate ways to cost effectively reduce the system's water loss.

We concur with these recommendations.

IV. ORIGINAL COST RATE BASE SUMMARY

Based on the foregoing, the adjusted TY original cost rate base ("OCRB") for ratemaking purposes for Sun City Water is $13,675,576; for Sun City Sewer is $7,515,406; for Sun City West Water is $6,235,619; for Sun City West Wastewater is $5,108,820; for Agua Fria is $3,305,517; and for Tubac is $657,068. Exhibit A attached details the adjustments made to rate base for each operating division.

V. RECONSTRUCTION COST NEW RATE BASE

In Schedule A-1 of the application, Citizens presents a jurisdictional reconstruction cost new rate base ("RCNRB") of $75,320,693. All of the adjustments reflected in our determination of the OCRB are equally applicable to the RCNRB. With the changes in these adjustments necessary to restate them in terms of reconstruction cost new, the RCNRB for Sun City Water is $31,533,666; for Sun City Sewer is $17,701,732; for Sun City West Water is $7,591,825; for Sun City West Wastewater is $6,742,689; for Agua Fria is $3,998,637; and for Tubac is $1,097,065.

VI. FAIR VALUE RATE BASE

The Commission has traditionally determined the "fair value" rate base ("FVRB") by taking the average of OCRB and RCNRB. No party has suggested different weighting be used in this proceeding. Consequently, we will find that the adjusted FVRB at March 31, 1995 for Sun City Water is

$22,604,621; for Sun City Sewer is $12,608,569; for Sun City West Water is $6,913,722; for Sun City West Wastewater is $5,925,755; for Agua Fria is $3,652,077; and for Tubac is $877,067.

VII. OPERATING INCOME

A. Gross Annual Revenues

The Company had actual combined revenues during the TY of $16,836,617 from which pro forma adjustments were made, reducing it to $16,702,301. The parties agreed on several adjustments, including customer growth annualization of revenues and associated expenses, water conservation surcharge revenues and amortized deferred expenses, and updated Youngtown revenues and expenses. Staff recommended that the groundwater withdrawal fees be removed from base rates and be recovered as a through a pass-through mechanism, similar to how sales tax and the Commission's regulatory assessment are recovered as a surcharge. We agree with Staff and will remove actual TY revenues and expenses associated with the groundwater withdrawal fees. Accordingly, the adjusted TY revenues for Sun City Water are $5,731,330; for Sun City Sewer are $4,566,689; for Sun City West Water are $2,898,832; for Sun City West Wastewater are $2,203,793; for Agua Fria $1,106,294; and for Tubac Valley $177,442.

B. Annual Operating Expenses

Based on its application, the Company had actual TY operating expenses of $14,491,592 which it adjusted by ($122,107) to $14,369,485. RUCO and Staff recommended numerous adjustments to Citizen's proposed operating expenses. For the reasons set forth hereinafter, we find that for ratemaking purposes the TY operating expenses for Sun City Water were $4,369,060; for Sun City Sewer were $4,003,838; for Sun City West Water were $2,232,815; for Sun City West Wastewater were $2,224,372; for Agua Fria were $849,443; and for Tubac Valley were $137,632.

The Company, Staff and RUCO have agreed upon the following adjustments: donations expense, life insurance expense for split-dollar life insurance and Company-owned life insurance, rate case expense for past proceedings, shareholders' 60th year memory book expense, and supplemental pension expense of $20,187 of Dr. Tow should be removed; income tax expense and the gross revenue conversion factor should be revised to reflect an effective state income tax rate of 8.257 percent; lockbox program expenses should be updated; purchased power costs for the water operations should be updated and annualized; structure cleaning expense should be updated; and tank painting and water testing expense

should be adjusted.

1. Adjustments "Agreed" to by Citizens

In its rebuttal testimony, the Company agreed to remove certain costs and expenses from the revenue requirement determination in this proceeding. Citizens agreed to remove: a portion of Dr. Tow's compensation, including director fees; directors' and officers' liability insurance expense; Incentive Deferred Compensation Program ("IDCP") expense; TARGET: Excellence expenses; the accrual costs of post-retirement benefits other than pension under Financial Accounting Standard No. 106; and Stamford Administrative Office costs and expenses related to office space for the previous president; certain furnishings and artwork, the Food Services Coordinator, and rent for the vacated 1200 High Ridge Road office. Citizens says that this proposal is "conditioned on corresponding treatment of other parties' issues," and "should the other parties decline to follow precedent, or should the Commission decide to depart from prior decisions, then Citizens will no longer agree to remove the costs and expenses . . . ."

a. Administrative Office Expenses

Citizens' corporate headquarters are located in Stamford, Connecticut and the corporate costs are charged to operating properties through a combination of direct charges and cost allocations. The "allocable" SAO corporate charges are charged out to operating properties using a four factor allocation. The four factors used to determine this allocation are: plant in service; O&M expenses; number of customers; and payroll charged to O&M. In this filing, the Company used a four factor SAO cost allocation totaling 3.46 percent for the six utility systems. Staff adjusted SAO expenses using a more current four factor allocator. Staff also recommended the disallowance of specific SAO costs including: corporate expenses including rental expense for a vacant office building; abnormally high SAO temporary services expenses and outside consulting fees for computer projects; discontinued warranty maintenance service; executive chef salary; maintenance of Cadillac DeVille automobiles; Dr. Tow's 1994 expense allowance and personal expenses, supplemental pension, directors's fees and compensation in excess of $500,000; directors' travel and legal expenses; video expenses; and "corporate other" expenses, including wellness and company sports, executive physicals, and community relations and contributions. Total expense is reduced by approximately $194,000 for the Maricopa W/WW operations. Staff recommended an adjustment to the Company's Phoenix Administrative Office ("PAO") expense

because the use of either actual 1994 or budget 1995 PAO data has substantially overstated the actual PAO expense that occurred in 1995. Staff proposed adjusting PAO expense by $12,292. In rebuttal, the Company adjusted the PAO expense to reflect nine months of the PAO's annualized actual expense for 1994 and three months of its annualized actual expense for 1995.

Staff's adjustments to SAO and PAO expense are identical in theory and method to the Staff adjustments that were accepted by the Commission in Decision No. 59951 (January 3, 1997), and we will adopt them here for the same reasons we enunciated therein.

b. TARGET: Excellence Expense

The Company initiated a corporate level training program in 1993 entitled TARGET: Excellence ("Program"). The purpose of the Program was to improve customer service, productivity, and employee satisfaction. The customers, employees, and shareholders will benefit from the results that should occur as a result of the Program. Citizens is requesting that $206,682 of deferred TARGET: Excellence costs be recovered over two years. These costs include costs incurred during the introduction of the Program and consist of initial training expenses, consultant fees, production costs for manuals, out-of-pocket costs for training sessions, and customer survey expense. Citizens also seeks an annual allowance for on-going TARGET: Excellence training.

Both RUCO and Staff disallowed a portion of the Program costs. RUCO points out that the Company never requested, nor received an accounting order from the Commission which would have allowed the Company to defer these costs and argues that allowing past TARGET: Excellence costs to be recovered in this case would constitute retroactive ratemaking. RUCO removed all the deferred costs and one-half of the 1994 costs which were included in the TY. Staff concurs with RUCO's arguments, and also points out that according to the Company's general ledgers, Citizens was already amortizing deferred TARGET: Excellence costs in 1994 and those costs were included in TY expenses. Staff further points out that the SAO direct charges to each operating property included amounts for TARGET: Excellence costs. Therefore, TY expenses for Maricopa W/WW operations also included charges from SAO for TARGET:Excellence. Staff does not believe that Maricopa W/WW has been able to demonstrate any cost savings related to TARGET:Excellence, but believes that the Program has produced or could produce improvements in operations and other efficiencies that would benefit both ratepayers

and shareholders. Therefore, Staff recommended that fifty percent of the current period expenses incurred directly from Maricopa W/WW operations be recovered through rates. Staff's adjustment also removed the Company's proforma adjustment for the amortization of deferred TARGET: Excellence costs, the amortization expenses recorded by each utility during the TY, and TARGET: Excellence charges from SAO.

Based on previous Commission decisions, including Decision No. 59951 (January 3, 1997), we will allow one-half of the deferred amount to be amortized over two years, and will allow one-half of the TY expenses, as determined by Staff, to be recovered in rates.

c. Incentive Deferred Compensation Program Expense

The Company included in its application a request for $84,781 of TY expense related to its Incentive Deferred Compensation Program ("IDCP"). The Company describes the program as an at-risk incentive compensation plan, not as a bonus arrangement.

RUCO recommended that the entire $84,781 amount be disallowed because the Company's methodology for determining the performance factors under its IDCP is vague and obscure; because contrary to the Company's position that IDCP is designed to shift a portion of base pay compensation into variable pay, RUCO could find no indication that it has reduced increases to base pay or to overall salaries and wages; and because the Company has made no direct showing that the IDCP provides a direct and primary benefit to the ratepayer.

Staff reached the same conclusion as RUCO and also recommended disallowance of the IDCP. Staff believes that the employees participating in the program receive generous awards for achievement of rather ordinary goals that would tend to fall within the normal job responsibility of each employee. Staff believes that IDCP is a bonus that serves to increase employees' pay beyond a "normal" pay level and that shareholders should be responsible for such incentive payments.

We concur with Staff and RUCO. Consistent with Decision No. 58664, and Decision No. 59951, we will deny the IDCP.

d. Post-Retirement Benefits Other Than Pensions

The Company provides post-retirement benefits other than pension ("PBOPs") to employees in the form of medical and life insurance coverage. The Company is requesting the Commission approve

the Company's proposed accrual method of accounting for PBOPs and recognize the associated PBOP cost for the Maricopa W/WW operations. Under this method, the cost of the benefit for current employees will be expenses on the Company's books in accordance with the requirements of the Financial Accounting Standards Board Statement No. 106 ("FAS-106"). Citizens acknowledges that past Commission Decisions have required PBOPs be accounted for under the pay-as-you-go method for ratemaking purposes. The Company has established the necessary funding mechanism and has submitted evidence to show that the use of the accrual method of accounting for PBOPs in the ratemaking process will produce benefits for the Company and its Arizona customers.

Both Staff and RUCO recommended adjustments to eliminate the accrual based PBOP expense and reflect the PBOP expense on a pay-as-you-go basis. RUCO argues that the Company has not demonstrated that on a present value basis pre-funding of PBOP costs under the rate recognition of accrual based expense is in the ratepayers best economic interest; the Company's quantification of PBOP accrual is based upon assumptions which are uncertain and speculative; the FAS Statement 106 does not dictate regulatory policy; the accrual method required by FAS-106 is not appropriate for ratemaking purposes; and finally, the recognition of the amortization of the "transition obligation" results in an intergenerational inequity for ratepayers. Staff agrees with this arguments and notes that the Commission's continuation of the pay-as-you-go method for ratemaking purposes was upheld by the Arizona Court of Appeals.

Based on the evidence of this case, we will approve the accrual method of accounting for PBOPs. This determination is solely for this Company and other determinations will be made on a case by case basis. The Company will need to meet the following conditions in future rate cases for continued approval of the accrual methodology for PBOPs:

- the PBOP expense allowance must meet the conditions of being both reasonable and prudent as determined by the Commission;
- the Company must compute PBOP expense in accordance with Statement of Financial Accounting Standards No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions (SFAS 106);
- the Company must use reasonable, unbiased, and supportable actuarial assumptions as a basis for its calculation of PBOP expense;
- the Company must fund PBOP expense no less frequently than quarterly, and the

amount of each payment must represent a ratable portion of the annual PBOP expense;

- funding deposits must be made in cash to an irrevocable, independently managed external Trust;
- to the extent allowed by law, the Company must maintain a tax deductible status for PBOP expense and a tax exempt status for earnings of the Trust;
- investments made by the Trustee of the Trust must be compatible with meeting PBOP obligations as they come due;
- any accumulated excess of accrual-based over cash-based revenues intended to cover PBOP expenses is subject to refund, to the extent PBOP assets cannot be used for PBOP expenses or have been used for unauthorized, non-PBOP purposes;
- disbursements from the trust fund should be limited to payments for the benefits of retirees in accordance with the Company's benefit plans, administrative costs of the Trust and other purposes as authorized by the Commission; and
- upon termination of the Trust and satisfaction of all PBOP obligations any residual funds are to be utilized only as approved by the Commission.

2. Depreciation

a. Depreciation Rates

Depreciation accounting represents an allocation process by which the consumption of physical assets is recognized in the utility's financial statements. Depreciation expense provides for recovery of invested capital, adjusted for net salvage to be incurred at the time facilities are removed or abandoned. The capital should be recovered from those customers receiving service from the facilities over the expected life of the facilities, consistent with the accounting principle of matching.

The Company conducted depreciation studies and recommended revised depreciation rates. Mr. Mason performed a life analysis using Simulated Plant Records ("SPR") and a life estimation analysis. Mr. Mason employed life analysis and life estimation using statistical life analyses, age distribution simulations, plant histories, transaction summaries, and computed mortality distributions. The Company's proposed depreciation rates are based upon a set of depreciation parameters consisting of service lives, retirement patterns, and future net salvage values. The parameters are actually estimates based upon the above factors, as well as professional judgment.

Staff performed six independent SPR analyses and retirement forecast analyses to test the reasonableness of the Company's proposal. Using the annual historical gross additions for each account

the Company studied, combined with the retirement ratios implicit in the Company's proposed average service lives and dispersion patterns, Staff determined the retirement forecasts implicit in the Company's proposals. Staff compared the actual retirements, by account, for the five years 1990 to 1994 and compared these to the retirement patterns implicit in the Company's depreciation study. The retirements reflected in the Company's proposal are six times the retirements actually experienced in the last five years. Staff believes that this difference is driving the overall increase in the Company's proposed depreciation expense. Staff also tested the reasonableness of the Company's proposal by examining the net salvage factors used by the Company. Staff compared the annual depreciation expense using the Company's net salvage factors against the Company's actual experience for the years 1990 through 1994, and found that the annual depreciation expense was nearly ten times the Company's average annual experience for those five years. Staff criticized the Company's witness for his failure to explain his recommendation, i.e., how and why he exercised his professional judgment in his depreciation studies. In addition, Staff pointed out that the Company stated that there are no accounting, operational and maintenance policy and practice changes since the last study which influenced in any way changes in service life and survivor curves. Further, the Company did not identify any projects, plans, or programs which would tend to increase or decrease its depreciation rates. Staff also disagreed with some, but not all of the depreciation rates for specific accounts. Staff did not oppose the Company's request to use the composite rate approach to calculate depreciation expenses on the Youngtown plant acquisition, Staff recommended that in the future, the Youngtown plant either be studied separately or included in the Sun City studies. RUCO proposed that the actual depreciation expense recorded on the Company's books for the period ended June 30, 1994 should be used to determine proforma Youngtown depreciation expense of $75,415, a reduction of $21,060 to the TY cost of service.

The Company criticized Staff's recommended depreciation rates because it believes that Staff's witness did not consider non-statistical factors, did not perform his statistical analyses consistent with the NARUC manual, did not attempt to clarify his understanding of Maricopa W/WW's data responses, and because the proposed depreciation rates fall below rates for other Arizona water and wastewater operations.

The following are the currently authorized, Company proposed, and Staff proposed composite

depreciation rates:

	Currently Authorized	Company Proposed	Staff Proposed
Sun City Water	2.58%	3.67%	2.68%
Sun City Sewer	2.34%	2.72%	1.85%
Sun City West Water	2.33%	3.02%	2.70%
Sun City West Wastewater	3.55%	3.65%	2.22%
Agua Fria	2.24%	2.64%	2.55%
Tubac Valley	2.42%	2.61%	2.81%

We find that the both the Company and Staff have failed to establish that the currently authorized depreciation rates should be changed. Although the Company conducted depreciation studies, it was unable to explain how the retirement patterns reflected in the Company's study and resulting depreciation rates are reasonable when compared with the actual retirements experienced by the Company. Likewise, Staff has not shown that the rates it proposes address the geographical characteristics associated with the Company's service area. Accordingly, we will not adjust the depreciation rates.

b. Amortization of Sun City Wastewater Treatment Plant

In Decision No. 53166 and Decision No. 55488, the Commission found that a portion of Sun City West Wastewater's treatment plant represented excess capacity, and disallowed that portion from plant. The parties agree that the treatment plant is currently being fully used to provide service. The Company proposed to amortize the unrecovered depreciation expense associated with the portion disallowed as excess capacity, over twenty years. Staff and RUCO disagreed with the Company's adjustment, believing that such an adjustment would be contrary to the Commission's prior orders and would result in retroactive ratemaking. We agree with the Company. The plant which we previously determined was excess capacity has not been depreciated on the Company's books. Return of the prudently incurred investment should be allowed now that it is no longer excess capacity. We will accept the Company's proposed adjustment of $2,346,569, amortized over 24 years at an annual rate of $96,880.

3. Employee Benefits Expense

RUCO was critical of the Company's proposed expenses associated with pensions, group medical, group life, and 401 K benefit plans ("employee benefits") and proposed a reduction to reflect the 1995 actual levels versus the Company's 1995 budgeted amount.

In response, the Company revised employee benefits downward by $27,364 to correct an

overstatement of medical expenses and to substitute actual data for budgeted data used in the last three months of the TY. Staff agreed with this correction, and RUCO continued to argue that its methodology was superior. We concur with the Company and Staff.

4. Insurance Expense

In its application, the Company included TY Insurance expense based upon nine months of actual 1994 costs and three months of budgeted 1995 expense. RUCO annualized the premiums at the end of the TY and recommended an increase of $9,947. Staff proposed an adjustment to exclude 50 percent of the directors' and officers' ("D&O") liability insurance. The Company acknowledged that the Commission had excluded 50 percent of D&O liability insurance in Decision No. 58664 for its Arizona Gas Division, but asked the Commission to reconsider that decision. In Decision No. 59951 (January 3, 1997), we did reconsider and did not accept Staff's adjustment. Accordingly, we will not accept that adjustment here, but we will accept RUCO's recommendation and increase insurance expense by $9,947.

5. Injuries and Damages Insurance Expense

In its application, the Company included TY injuries and damages expense based upon nine months of actual 1994 costs and three months of budgeted 1995 expense. Subsequently, the Company corrected an error and substituted the actual data for the budgeted data used for the last three months of the TY.

RUCO annualized the premiums at the end of the TY and recommended a $56,620 reduction. Staff made a similar adjustment resulting in a reduction of $80,535. In response, the Company asserted that Staff and RUCO's adjustments violate the integrity of the TY.

We concur with RUCO. We find that the use of the end of TY amount is known and measurable. Accordingly, we will reduce TY expenses by $56,620.

6. Power Costs

Staff made an adjustment to the Company's purchased power costs to reflect Arizona Public Service Company's electric rate decrease. The Company accepted Staff's adjustment. We agree with the Company's adjustment to the power costs for the wastewater companies.

7. Payroll and Payroll Tax Expense Issues

The Company proposed to include payroll expense for five employees hired after the end of the

TY. Staff and RUCO opposed this adjustment, stating that the Company only included revenues from growth that occurred during the TY, and since these employees were hired well after the end of the TY, there would be a substantial mismatch of revenues and expenses. We agree with Staff and RUCO.

8. Rate Case Expense

In its original application, the Company included expense for amortization of prior rate case costs. The Company agreed with Staff that the amortization periods will expire before the rates in this proceeding go into effect, and therefore removed these prior rate case expenses.

In its direct testimony, the Company estimated rate case expenses of $366,231, which it subsequently updated to a "cap" of $750,000. Both Staff and RUCO objected to the Company's requested rate case expense. Staff recommends that the Company not recover any rate case expense over the amount it initially requested, and recommended a total rate case expense of $56,000 amortized over three years. RUCO made a similar recommendation, limiting rate case expenses to $300,000, amortized over five years. Both Staff and RUCO cite the Company's inaccurately prepared rate filing and its own contribution to the unnecessary increased costs by its failure to comply with Procedural Orders and provide timely and responsive answers to discovery. In response, the Company cites the fact that the Joint Application included six rate cases; the very large number of intervenors and data requests; the CAP water issue which required the retention of water resource experts; and the Company's retention of consultants in the area of rate design and price elasticity. The Company believes that rate case expense should be amortized over three years; RUCO presented testimony that five years would represent a more reasonable amortization period, given the past timing history of the Company's rate cases. We find that the Company's initial estimation of its rate case expense is most indicative of what the rate case expenses should have been, had the Company not conducted its discovery in the manner which it did. This estimation would have considered the CAP water and price elasticity issues and would have recognized the potential number of interested parties. Accordingly, we will allow $366,231 in rate case expenses, amortized over four years, for an annual combined rate case expense of $91,558.

9. Property Tax Expense

Staff and the Company agree that, given the property tax rates recently enacted by the Arizona Legislature, the appropriate tax expense to use should be the 1996 actual expense. The Company

provided documentation to Staff that the 1996 property taxes were $841,680 and we will allow that amount for property tax expense.

10. Income Tax Expense

The Company utilized the actual 35 percent income tax rate applicable to Citizens' consolidated federal income tax return. Staff and RUCO recommended that federal income tax be calculated for each Maricopa W/WW utility to reflect the correct tax rate for each utility on a separate return basis. We concur with Staff and RUCO.

11. Conservation Program Cost

Staff recommended that TY conservation expense for Sun City Water be reduced by $148,827. The Company failed to file a required March 1, 1996 report detailing the Company's conservation expense and the Company's witness testified that there is no significant benefit to the current conservation education program. Instead, Staff is proposing a $40,000 allowance for conservation education for the Northwest Valley water customers and recommends that Citizens be required to file a plan with Staff and RUCO for Staff's approval within 120 days of this Decision, and that Citizens be required to file a report with Staff and RUCO on an annual basis to account for the expenditures made for conservation education. We agree with Staff's recommendations.

12. Groundwater Withdrawal Fees

As discussed in the rate base section above, we have accepted Staff's recommendation to exclude the expenses and revenues associated with groundwater withdrawal fees, and instead will allow the recovery of such fees through a pass-through surcharge mechanism.

13. Investment Tax Credit Amortization

Staff adjusted the income tax expense so the annual amount of investment tax credit amortization reflected for rate making purposes is appropriately coordinated with Staff's recommended depreciation rates. Since we are not changing the depreciation rates, the ITC amounts reflected in the original filing should be used.

14. Water Testing Expenses

The only remaining issue concerning water testing expenses is Staff's recommendation to disallow the Company's amortization of initial compliance testing costs. We agree with Staff that the

initial monitoring of the water systems was mostly completed prior to the TY, and accordingly, we will accept Staff's adjustment.

15. Sun City Sewer Surcharge Revenues and Expenses

Consistent with the discussion below in rate design, we have agreed with Staff's recommendation to eliminate the Sun City sewage treatment surcharge on a going forward basis and to include the costs as a normal operating expense to be recovered in base rates.

16. Price Elasticity Adjustment

Consistent with our discussion in the rate design section below, we have not accepted the Company's price elasticity adjustment. Accordingly, we will not adopt the Company's adjustments to reduce TY expenses for the impact of price elasticity inherent in Citizens' proposed rate design.

17. Industrial Wastewater Pretreatment Program

The Company is requesting rate recognition of the expenses of its Industrial Wastewater Pretreatment Program ("Pretreatment Program"). The Pretreatment Program is an inspection, monitoring, and compliance program intended to prevent the high concentration of certain pollutants, not normally associated with domestic water, from entering the sewage collection systems. The federal Clean Water Act requires the owners of publicly owned treatment works to implement pretreatment programs. The Company intends to implement the program for both Sun City Sewer and Sun City West Wastewater, at a total projected cost of approximately $110,000 per year. RUCO recommended that the costs not be allowed because they are not known and measurable, and did not occur in the TY. In response, the Company agreed to include the estimated revenues associated with the Pretreatment Program. We agree with the Company that both the expenses and revenues should be included. As discussed by RUCO, the program is aimed primarily at non-residential customers, and this will be a factor addressed in the rate design. We also agree with Staff's recommendation to approve Citizens' proposed tariffs and to require the Company to track actual revenues and expenses associated with the program and include such information in its next rate filing. Further, the Company shall provide Staff with the requested information about commercial customers wastewater flow in relation to their water usage within fifteen months.