

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

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7
8 IN THE MATTER OF THE APPLICATION OF
9 ARIZONA-AMERICAN WATER COMPANY,
10 AN ARIZONA CORPORATION, FOR A
11 DETERMINATION OF THE CURRENT FAIR
12 VALUE OF ITS UTILITY PLANT AND
13 PROPERTY AND FOR INCREASES IN ITS
14 RATES AND CHARGES BASED THEREON
15 FOR UTILITY SERVICE BY ITS ANTHEM
16 WATER AND ANTHEM/AGUA FRIA
17 WASTEWATER DISTRICTS.

Docket No. WS-01303A-06-0403

18 **RUCO'S REPLY BRIEF**

19 **December 18, 2007**

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1 **INTRODUCTION**

2 The Residential Utility Consumer Office (“RUCO”) replies to Arizona American Water
3 Company’s (“Arizona American” or “Company”), the Arizona Corporation Commission Staff’s
4 (“Staff”) and the Anthem Community Council’s (“Council”) Post Hearing Briefs as follows.
5

6 **CITY OF PHOENIX INTERCONNECTION AGREEMENT**

7 Should the Commission approve RUCO’s recommended hypothetical capital structure,
8 the Commission should not include the costs associated with the Phoenix Interconnection
9 Agreement in the cost of debt. While it is true that including zero-cost debt reduces the
10 Company’s overall debt cost, it also artificially increases the revenue requirement when used
11 in conjunction with the hypothetical capital structure. Company Brief (“Brief”) at 47, RUCO
12 Brief at 2. In turn, the artificially inflated revenue requirement would result in higher rates to
13 ratepayers. The Commission should approve RUCO’s hypothetical capital structure
14 recommendation and exclude the costs associated with the Phoenix interconnection
15 agreement from the Company’s capital structure.
16

17 **NORTHWEST VALLEY TREATMENT PLANT AND RELATED EXPENSES (“NWVTP”)**

18 Both Staff and the Company continue to argue that 32% of the rate base and expenses
19 associated with the NWVTP should be allocated to the Anthem/Agua Fria Wastewater District.
20 The Company claims that RUCO has “not articulated any clear reasons” for its position and
21 intends to address RUCO’s position in its Reply Brief. Brief at 48. Staff mistakenly sees the
22 issue as what an appropriate allocation of expenses between the Sun City/Sun City West and
23 Anthem/Agua Fria districts should be. Staff Brief at 14.
24

1 The issue does not concern the allocation of expense between the two Districts. The
2 issue concerns the proper ratemaking treatment for that portion of the Anthem/Agua Fria
3 capacity that is treated at the NWVTP. The Commission should treat those costs as an
4 operating expense for the reasons set forth in RUCO's Opening Brief. See RUCO's Brief at 3-
5 6. Among the numerous reasons why the Commission should reject the allocation
6 methodology proposed by Staff and the Company, it would be bad precedent to allow a
7 company which owns several districts to trade and transfer portions of each district's rate base
8 among each other. Each district has its own set of rates, rate bases, and tariffs. R-3 at 14.
9 Each district has its own set of circumstances and should be afforded its own ratemaking
10 treatment.

11 The balance of Staff's argument is a dissertation on the used and useful principal,
12 Staff's theories on excess capacity and how both apply to Staff's proposed allocation
13 methodology. See Staff's Brief at 25. Should the Commission determine that the proper
14 ratemaking treatment is to allocate the ratebase and expenses between the two Districts, the
15 Commission should reject the Company and Staff's final proposal to allocate 32% and the
16 related expenses¹ between the Districts.

17 Staff argues that RUCO's "position and its rationale" for opposing Staff and the
18 Company's allocation is unclear. Staff Brief at 15. On the contrary, RUCO's position is very
19 clear. Staff and the Company's new proposal to allocate 32% (originally it was 2.25%) would
20 have the effect of increasing RUCO's gross revenue requirement \$559,322. Transcript at
21 1314. Given the magnitude of the increase, a detailed analysis is certainly in order. Id. To
22

23 ¹ The adjustment for expenses would increase expenses by \$375,783. Transcript at 1235. RUCO opposes
24 the recovery of these expenses since a large portion of the 32% is not currently used and therefore has no
expense related to it.

1 rubber-stamp the new proposal is to proceed blindly at the peril of ratepayers. RUCO will not
2 sanction such a proposal.

3 Nonetheless, Staff is critical of RUCO's inability to analyze Staff and the Company's
4 new proposal prior to the last days of hearing in this matter. Staff Brief at 16. Prior to the last
5 two days of hearing on October 31 and November 1, 2007, Staff and the Company had filed, in
6 total less than one paragraph of testimony in this case in support of their changed position. To
7 the extent either Staff or the Company have substantiated their new proposal in this case, it
8 has been through last minute witnesses during the last two days of hearing. While Staff had
9 announced its intention to make this change in the Company's Sun City/Sun City West
10 Wastewater case, Staff and the Company were not relieved of their burden to timely
11 substantiate their recommendations in this case. Moreover, Staff's filing in the prior case
12 surely did not provide all the parties with complete details particular to the facts and
13 circumstances of this case. In short, given the timing of Staff and the Company's new
14 proposal, no other party had the opportunity to do the type of analysis necessary to determine
15 if Staff's new proposal is in the best interests of the ratepayers. The Commission should reject
16 Staff and the Company's proposal to reallocate ratebase between the two Districts in addition
17 to recovering the associated expenses.

18 In its Closing Brief Staff has gone to great lengths to explain why the expansion
19 capacity for the NWVTP is not excess capacity and is used and useful. Staff Brief at 14-25. In
20 the process Staff has confused RUCO's position on this issue. Should the Commission
21 consider excess capacity an issue relevant to the question of the proper ratemaking treatment
22 of the NWVTP, RUCO's position is as follows: the basis for Staff and the Company's new
23 proposed allocations is Staff's belief that Sun City West has reached its maximum capacity
24 and that the NWVTP has more than 33% capacity not in use. See Exhibit S-1, Exhibit DMH-2

1 (the engineering report for Sun City West submitted by Dorothy Haines, dated June 13, 2007)
2 at 4 in the Company's Sun City West Waste Water application, Docket No. WS-01303A-06-
3 0491. Transcript in Docket No. WS-01303A-06-0491 at 644. Staff further believes that the
4 Company's Anthem/Agua Fria District will continue to grow and believes that the NWVTP's
5 unused capacity can be used to treat the Anthem/Agua Fria wastewater flow requirements as
6 the District continues to approach build out. S-1, Exhibit DMH-2 at 4-5, and Transcript at 640-
7 647 in Docket No. WS-01303A-06-0491. The number of Anthem/Agua Fria service laterals
8 treated at the NWVTP as of the end of the test year (December 2005) was 1,469. See Staff's
9 Final Schedules dated October 3, 2007 – Engineering Report of Katrin Stukov at 6. The
10 number of sewer laterals projected to be serviced by the NWVTP at Sun City West's build out
11 (2010) is 4800. Id.

12 Staff's witness, Ms. Haines has concluded that "Sun City West basically is reached to its
13 maximum capacity, using capacity." Transcript at 644 in Docket No. WS-01303A-06-0491.
14 The 33% capacity of the NWVTP that is not in use and appears will never be used to treat the
15 service demands of Sun City West's customers, is excess capacity. It is not serving current
16 Sun City/Sun City West customers nor will serve them in the future. Current Sun City/Sun City
17 West customers should not have to pay for plant that will not be used to service their needs.

18 Under Staff and the Company's proposal, this Sun City West excess capacity will be
19 used to service the needs of a select group of Anthem/Agua Fria customers. However, this
20 Sun City West excess capacity will be used to service the needs mostly of future Anthem/Agua
21 Fria customers. In the meantime, by reallocating the entire 32% to Anthem/Agua Fria's rate
22 base the current Anthem/Agua Fria customers will have to pay for service that will not benefit
23 them – it will benefit future ratepayers. Ratepayers should not have to pay for service that they
24 do not benefit from.

1 There are other perils and potential inequities that arise should the Commission
2 approve Staff's position. There is no written agreement governing the terms of the allocations.
3 What, for example, would happen if the Commission was to approve the proposal and Sun City
4 West should need 80 percent of the NWVTP capacity to treat its wastewater in the next couple
5 of years? The ratebase allocation will have already been made and will be wrong if the
6 NWVTP continues to treat Sun City West's actual capacity requirements.

7 This scenario is quite possible. In its Closing Brief Staff explains how its growth
8 projections for Sun City West are not "perfect" and that growth might be higher or lower. Staff
9 Brief at 17-18. Another "uncertainty" that Staff identified is the daily flows per service
10 connection. Id. at 18. According to Staff the large discrepancy between the Sun City West
11 flows and the Anthem/Agua Fria flows is due to the fact that Sun City West is primarily a
12 retirement community. Id. at 18-19. There is insufficient data to accurately predict the peak
13 flows per service lateral for the Anthem/Agua Fria customers in question. Id. These
14 uncertainties almost ensure that ratepayers will be treated inequitably and unfairly under Staff
15 and the Company's proposal. Current ratepayers should only pay for service that benefits
16 them and not for future ratepayers.

17 Staff argues that the Commission should reject RUCO's position on excess capacity
18 because RUCO knew about the issue when Ms. Hains testified on August 28, 2007 in the Sun
19 City West case. Staff's Brief at 21. This argument should be afforded no weight – it actually
20 demeans the Commission's process. The burden of presenting timely and sufficient evidence
21 is on Staff - not RUCO to support Staff's position. Staff, as stated above is not relieved of its
22 burden because another party had prior warning in another case. The Anthem Community
23 Council, a party in this case, was not a party in the Sun City West matter. Staff's argument
24 fails because Staff has the burden of proof and Staff has failed to meet its burden.

1 Next, Staff argues that RUCO's position should be rejected because RUCO is asking
2 the Commission to second guess a utility's decision after it is made. Staff Brief at 23. Staff is
3 referring to the prudence of the utility's decision to expand. Staff Brief at 23-24. This argument
4 is a red herring and irrelevant to the issue. RUCO is not questioning the prudence of the
5 Company's decision to expand. RUCO's argument is that the Commission should only allow
6 plant that is being used to be recovered in rates. In other words, RUCO is questioning the
7 timing of when plant should be recovered. The prudence of the Company's decision is not at
8 issue and should not be the basis upon which the Commission makes its determination².

9 In sum, the Commission should treat the costs associated with the NWVTP as an
10 operating expense. RUCO's proposal assures that ratepayers will only pay for the cost of their
11 service. It is the only fair and equitable proposal.

12

13 **WORKING CAPITAL**

14 The Company and Staff recommend a zero cash working capital requirement. Company
15 Brief at 44. The Company discounts RUCO's use of the lead/lag study filed by the Company
16 in its recent Mohave district. The Company argues that RUCO failed to meet its burden to
17 establish that something other than a zero working capital balance was correct. Id.

18 The Commission faced the same issue in the Company's Paradise Valley case. Docket
19 No. WS-01303A-06-0014. In Paradise Valley, both the Company and Staff ultimately made a
20 zero cash working capital recommendation. RUCO relied on the lead/lag study presented by

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² It is the Commission's practice and standard ratemaking to determine prudence after the plant is built and is being used – not before the plant is built. Moreover, it is the Commission and not the Company that determines prudence.

1 the Company prior to making its final recommendation. Decision No.68858 at 14. RUCO
2 made adjustments to the lead/lag study to include items the Commission had allowed in
3 previous cases. Id. The Commission agreed with RUCO's working capital recommendation in
4 the Paradise Valley case noting that RUCO's recommendation was based on a lead/lag study
5 and was more reasonable than Staff and the Company's zero recommendation. Id.

6 Here, the facts are almost identical. RUCO relies on a lead/lag study done by the
7 Company in its recent Mohave Division case. R-4 at 9. RUCO explains in great length in its
8 Closing Brief why it is appropriate to use the lead/lag study from the Mohave case. See
9 RUCO's Closing Brief at 7.

10 Finally, the Company is mistaken regarding the burden of proof. The Company argues
11 that it has met its burden upon Staff's sufficiency finding. Thereafter, the burden shifted to "...
12 RUCO to establish that something other than a zero working capital balance was correct."
13 Company Brief at 44. It is not the obligation of RUCO to provide evidence to substantiate Staff
14 and the Company's working capital recommendation. It is the burden of Staff and the
15 Company to support their recommendations with credible and sufficient evidence. See
16 Decision No. 68487 at 21.

17 The Company's burden of proof argument makes no sense. According to the
18 Company, Staff, which has taken the same position as the Company on the issue of working
19 capital in this case, determines whether the Company has met its burden in Staff's sufficiency
20 finding. Brief at 44. The sufficiency procedure is completely unrelated to the hearing and the
21 standard of proof required in the hearing. It is the Commission, not the Staff who is the trier of
22 fact. The Commission determines the sufficiency of the evidence. Staff, like the Company and
23 RUCO is only a party to the proceeding. Neither Staff nor the Company has offered any
24 evidence to support a zero working capital balance. The burden does not shift to RUCO to

1 produce evidence to refute the Company and Staff's unsubstantiated position. The burden
2 remains with the Company to substantiate its working capital request. RUCO's working capital
3 allowance is fair, reasonable, supported by the evidence and should be approved by the
4 Commission.

6 **LABOR EXPENSES**

7 RUCO did not raise this in its Initial Brief but it does still remain at issue. The issue
8 concerns the Company's use of post-test year labor rates to calculate direct and corporate
9 payroll. The Company argues that the rates changed post-test year and will continue to
10 change guaranteeing that the Company will under-recover its actual labor rates. Company
11 Brief at 50.

12 RUCO recommends the Commission calculate the labor expense based on the end of
13 test year salary levels. R-3 at 25. RUCO's recommendation provides for the matching of the
14 ratemaking elements within the historical test year and thus adheres to the generally accepted
15 regulatory standard (i.e. the matching principle). In total, RUCO's adjustment to normalize the
16 direct and corporate allocated payroll reduces adjusted test-year operating expenses for
17 Anthem Water by (\$81,214) and Anthem Wastewater by (\$69,693). R-3 at 25-26.

18 **RATE CASE EXPENSE**

19 The Company complains that RUCO's rate case expense adjustment is arbitrary.
20 Company Brief at 51. RUCO will not repeat the arguments set forth in response in its Closing
21 Brief. RUCO Brief at 7-9. The Company's arguments in support of its recommendations have
22 been rejected by the Commission in previous rate cases as set forth in RUCO's Closing Brief.

23 When all is said and done, the Company's request for \$300,000 is excessive for this
24 case. RUCO agrees that there have been an unusual number of days of hearing in this

1 matter. Brief at 52. Part of the reason for the extensive hearing is the Company's last minute
2 change in position regarding the NWVTP. Also, a lot of extra time was spent on issues
3 involving the Company's refund arrangement with Pulte. While a significant amount of time
4 was spent on these issues, the circumstances were not extraordinary. When viewed in its
5 totality, this is an average case with nothing extraordinary.

6 The Company argues that RUCO's recommendation is less than what the Company
7 spent. Id. This is true but is not a sufficient basis to reject RUCO's recommendation. The issue
8 is what a reasonable amount of rate case expense should be, not what the Company actually
9 spent. Here, the difference between what RUCO and the Company is recommending³ is due
10 to three things – the Company's proposed recovery of an extraordinary high level of costs for
11 its rate design testimony, Cost of Capital testimony and the Company's proposal to round up
12 its total rate expense to \$300,000. RUCO's Brief at 6-7.

13 In the first two instances, RUCO has simply followed the Commission's precedent. Id.
14 The Company has not shown a reason why the Commission should deviate from its prior
15 practice. The third reason should be rejected since there is no legitimate basis for rounding up
16 \$16,038 in favor of the Company to arrive at a total figure of \$300,000.

17
18 **DEPRECIATION EXPENSE AND AMORTIZATION OF THE PHOENIX**
19 **INTERCONNECTION AGREEMENT COSTS**

20 RUCO incorporates its position set forth in its Closing Brief⁴. RUCO Brief at 9-10.
21 On a going forward basis, RUCO agrees with the depreciation rates shown in Attachment
22 A of the Company's Brief.

23 ³ \$116,038

24 ⁴ Where the Company has done nothing or little more than just state its position in its Closing Brief, RUCO's
reply will just adopt its position set forth in its Closing Brief.

1 **DISALLOWANCE OF INAPPROPRIATE AND/OR UNNECESSARY MISCELLANEOUS**
2 **EXPENSES**

3 RUCO incorporates its position set forth in its Closing Brief. RUCO Brief at 10

4 **PROPERTY TAX**

5 RUCO incorporates its position set forth in its Closing Brief. RUCO Brief at 10-13

6 **PRO-FORMA EXPENSES BUDGETED FOR CONSERVATION**

7 RUCO incorporates its position set forth in its Closing Brief. RUCO Brief at 14

8 **RATE DESIGN**

9 RUCO incorporates its position set forth in its Closing Brief. RUCO Brief at 16

10 **COST OF CAPITAL**

11 RUCO continues to urge the Commission to adopt RUCO's recommended 10.01
12 percent return on common equity and overall 7.22 rate of return for the Anthem/Agua Fria
13 District.
14

15 On the issue of capital structure, the Company argues that RUCO's hypothetical capital
16 structure recommendation should be rejected because it is based on old data. Brief at 59.
17 RUCO is recommending a hypothetical capital structure of 60% debt and 40% equity. RUCO's
18 recommendation is the same as what the Company proposed in its direct case. The
19 Company's capital structure recommendation changed in its rebuttal case to reflect a future
20 restructuring of debt and an infusion of equity capital that is expected to occur at some point in
21 the near future. R-6 at 5.

22 RUCO did not change its position; rather, the events that the Company describes are
23 speculative and have no basis in fact at this point in time. Id. RUCO's recommended
24

1 hypothetical structure is based on the Company's current financial position and should be
2 approved by the Commission.

3 The Council also takes issue with RUCO's recommended hypothetical capital structure,
4 asserting that RUCO's hypothetical capital structure along with its 50 basis point upward
5 adjustment to its recommended Cost of Equity will result in inflated rates. Council Brief at 11.
6 Apparently, Council has been led to believe that there are no circumstances where it is
7 appropriate to account for risk by allowing for a hypothetical capital structure in addition to an
8 adjustment to the Cost of Equity. Id. The Council is misinformed and, consequently, wrong.

9 RUCO's decision to recommend a hypothetical capital structure in addition to a Cost of
10 Equity adjustment is sound and based on the circumstances of this case. The Company's
11 capital structure is not in line with the industry averages, which explains the reason for RUCO's
12 hypothetical capital structure – to bring the Company's capital structure in line with the industry
13 averages. R-5 at 53. Moreover, the water utilities that RUCO used in its Cost of Capital study
14 had a lower level of financial risk than the Company because of their lower level of debts. Id.
15 at 54. Accordingly, RUCO made a 50 basis point adjustment to its recommended Cost of
16 Equity to account for the Company's higher risk. Id. RUCO based its 50 basis point upward
17 adjustment on what the Commission authorized in two of the Company's prior rate cases. R-6
18 at 11. Each method employed by RUCO to account for the higher risk taken alone was not
19 enough to compensate the Company for the higher risk the Company faced. Combined, the
20 hypothetical capital structure and the Cost of Equity adjustment, in RUCO's opinion, fairly
21 compensate the Company for the additional risk. Id. While RUCO aggressively and
22 successfully pursues its mission to protect residential ratepayers from unreasonable rates it
23 also recognizes that no long-term ratepayer interest is served by weakening utilities and
24 RUCO has balanced its Cost of Capital recommendation to prevent this.

1 In summary, there is a strong and rational basis for RUCO's Cost of Capital
2 recommendation. The Commission should approve RUCO's Cost of Capital recommendation
3 as it is reasonable and fair to both the ratepayers and the Company.
4

5 **CONCLUSION**

6 The Commission should not authorize a rate increase of more than \$2,260,117 for the
7 water district and \$1,187,063 for the wastewater district of the Anthem/Aqua Fria Division of
8 Arizona-American Water Company. The Commission should adopt all of the other
9 recommendations set forth in the Conclusion of RUCO's Closing Brief.
10
11

12 RESPECTFULLY SUBMITTED this 18th day of December, 2007
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16 _____
Daniel W. Pozefsky
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20 of the foregoing filed this 18th day
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