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BEFORE THE ARIZONA CORPORATION COMMISSION

KRISTIN K. MAYES
Chairman

GARY PIERCE
Commissioner

PAUL NEWMAN
Commissioner

SANDRA D. KENNEDY
Commissioner

BOB STUMP
Commissioner

IN THE MATTER OF THE APPLICATION)
OF ARIZONA-AMERICAN WATER) DOCKET NO. W-01303A-10-
COMPANY, AN ARIZONA)
CORPORATION, FOR A)
DETERMINATION OF THE CURRENT)
FAIR VALUE OF ITS UTILITY PLANT)
AND PROPERTY AND FOR INCREASES)
IN ITS RATES AND CHARGES BASED)
THEREON FOR UTILITY SERVICE BY ITS)
AGUA FRIA WATER DISTRICT, HAVASU)
WATER DISTRICT, AND MOHAVE)
WATER DISTRICT.)
_____)

**APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY**

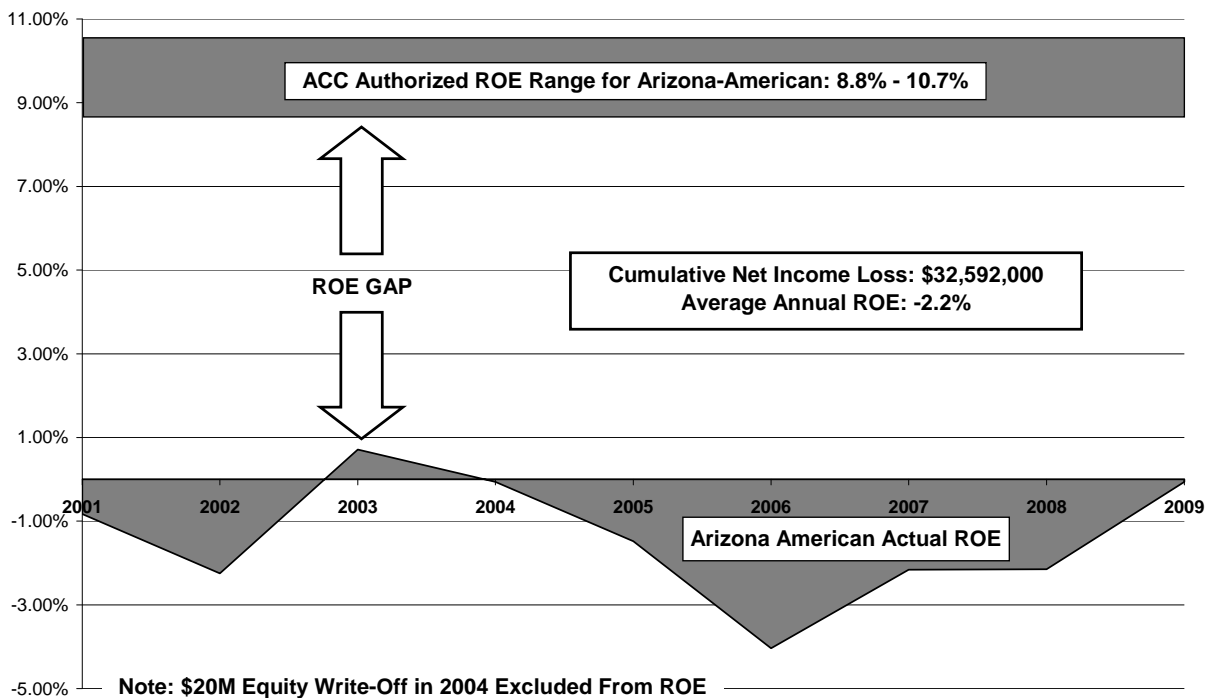
1 **1. Application.** Arizona-American Water Company (“Arizona-American” or
2 the “Company”) is a wholly-owned subsidiary of American Water. Arizona-American
3 applies in accordance with A.R.S. § 40-250 and the Commission’s Rule R14-2-103 for
4 rate increases for the following districts:

- 5 • Agua Fria Water District;
- 6 • Havasu Water District; and
- 7 • Mohave Water District.

8 **2. Arizona-American’s Financial Condition.**

9 Arizona-American’s operating districts have under-earned for many years, and, as a
10 whole, have lost over \$32 million since the purchase of Citizens Utilities’ Arizona water
11 and wastewater assets in 2002. This troubling trend continues. Arizona-American had a
12 net loss of \$0.1 million in 2009, which was an improvement over its \$3.1 million loss in
13 2008. And even after new rates from the pending case are implemented, the Company
14 will still not come close to earning its authorized return. The following chart graphically
15 displays the gap between the Company’s authorized return on equity (“ROE”) return and
16 its actual ROE.

Arizona-American Return on Equity
Allowed vs. Actual



1 The difference in the actual and authorized ROE, labeled as the ROE Gap, shows
2 the magnitude of the historic under-performance. Using historic test years during years of
3 changing economic conditions (both above and below trend) has resulted in customer rates
4 that are well below the Company's actual cost of service once those rates actually become
5 effective. For instance, currently, the Company collects revenues from most customers
6 included in this rate case based on expenses and capital investments dating back to 2007
7 and will continue to do so until new rates are set in this rate case not sooner than late 2011.
8 This means that, until perhaps 2012, customers will be paying water rates based on 2007
9 costs which will be five years obsolete.

10 The Commission is already aware of Arizona-American's faltering financial
11 condition. For example, in Decision No. 69730 (July 30, 2007), the Commission
12 evaluated Arizona-American's "Times Interest Earned Ratio," or "TIER" and stated that
13 "TIER represents the number of times earnings will cover interest expense on short-term
14 and long-term debt.... A TIER of less than 1.0 is not sustainable in the long-term"¹
15 The Commission further concluded that Arizona-American's TIER was only 0.44 at the
16 end of 2006, meaning that Arizona-American cannot be a viable long-term water utility
17 unless it can improve its TIER. Arizona-American's TIER improved to 0.65 at December
18 31, 2009, but this demonstrates the challenges the Company still faces.

19 The financial ratios that Moody's typically uses in assessing a water utility's credit
20 rating further illustrate Arizona-American's financial situation. Among the ratios that
21 Moody's (and other rating agencies) commonly use is the funds from operations ("FFO")²
22 to interest ratio. This ratio is 2.57 for the Company as of the test-year end. This is at the
23 lower bound of what Moody's expects for a "Baa" rating. Arizona-American is also
24 below what Moody's expect in terms of cash flow generation to cover interest when

25 ¹ Decision No. 69730, at 3, ln. 18-21.

26 ² FFO is defined as operating profits from continuing operations, after tax, plus depreciation and amortization, plus deferred income tax (accrued during the period), plus other major recurring noncash items.

1 measured by the Adjusted Interest Coverage ratio.³ This ratio is 1.33 for the Company,
2 while Moody's expects a minimum of 2.5 for an investment grade rating. Cash generation
3 to cover capital expenditure (Retained Cash Flow to CapEx ratio of 0.29 for the Company
4 versus a minimum level of 1.0 for Moody's "Baa" rating), and funds generated in relation
5 to debt (FFO to net debt for the Company of 8.5% versus a minimum level of 10% for
6 Moody's "Baa") also are below investment grade. The only ratio that is clearly within an
7 investment grade category is the applied for debt percentage of 45 percent for the
8 Company versus a Moody's standard of less than 55 percent.

9 **3. Steps Already Taken by Arizona-American to Improve Its Financial**
10 **Health.**

11 In order improve its financial condition, Arizona-American has taken a number of
12 steps. First, Arizona-American has not paid a dividend to its parent, American Water,
13 since 2003. This has helped slow the erosion of Arizona-America's equity balance, but
14 comes at the expense of its shareholders. Arizona-American stands alone among its
15 American Water peer utilities in not paying a dividend to shareholders for such an
16 extended period of time.

17 Second, despite Arizona-American's failure to pay dividends, or even to generate
18 positive earnings, American Water has up until recently still been willing to infuse new
19 equity to offset the equity ratio erosions caused by these continuing losses and the need to
20 issue new debt to fund capital projects. American Water infused \$35 million of equity in
21 2006, \$15 million more in 2007, and another \$20.2 million in 2008. The goal of these
22 equity infusions was to maintain Arizona-American's equity ratio within the
23 Commission's 40% to 45% target.⁴ American Water made no equity contributions in
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26 ³Moody's measures adjusted interest coverage ration as net income before taxes and interest divided by cash used for interest expense.

⁴ Decision No. 68858.

1 2009 and 2010, and has no plans to make any further equity investments until Arizona-
2 American's financial conditions improve substantially.

3 Third and finally, this rate application seeks timely and adequate rate relief. This is
4 a critical part of the Company's strategy to restore Arizona-American's long-term
5 financial health to best serve the needs of its water and wastewater customers.

6 **4. General Reasons For Rate Increases.**

7 In order to be a financially viable and stable water and wastewater utility for its
8 customers and investors, Arizona-American must make a reasonable return on and return
9 of the investment made by the Company's shareholders. Currently, only \$265 million of
10 Arizona-American's investment is included in rate base. In other words, although its
11 customers in Arizona are enjoying the benefit of \$330 million worth of Arizona-
12 American's permanent capital investment, they are only paying for approximately 80% of
13 the assets.⁵ In this case, the Company seeks to put an additional \$74 million of its capital
14 investment into rate base. The investments included in this case are used and useful and
15 were prudently incurred. They are already in service providing benefits that the
16 Company's customers enjoy, including a safe and reliable water supply, high water
17 quality, and good, quality service.

18 **5. Need for Timely Rate Relief.**

19 As noted above, to be a financially viable and stable water and wastewater utility,
20 Arizona-American, an investor-owned utility whose parent company is traded on the New
21 York Stock Exchange, must earn a reasonable return on and return of the investment of its
22 shareholders. It is also important that the Commission timely approve the requested rate
23 relief. Two recent Arizona-American rate cases (Docket Nos. WS-01303A-06-0403 and
24 WS-01303A-06-0491) experienced prolonged delays during the Commission-approval
25 process, resulting in approximately \$3.7 million lost in revenue. The Company's currently

26 ⁵ In Dockets W-01303A-09-0343 and SW-01303A-09-0343, which is Arizona-American's current pending rate case, the Company is seeking Commission approval to place into rate base additional capital investments.

1 pending case before the Commission (Docket Nos. W-01303A-09-0343 and SW-01303A-
2 09-0343) is beyond the Commission's statutory guidelines and self-imposed time clock
3 rules, resulting in approximately \$1.33 million lost in revenue each month. The revenue
4 lost from these delays can never be recovered by Arizona-American.

5 Given the magnitude of the rate relief sought in this case, and because operating
6 losses are expected to continue in 2010, Arizona-American cannot bear any delays in
7 obtaining timely Commission approval of the rate increases requested in this Application.
8 Arizona-American understands that the Commission too is dealing with budget issues, and
9 the Company has worked with Commission Staff to be as efficient as possible in filing this
10 case. For example, Arizona-American provided a Notice of Intent (NOI) of this case in
11 advance of filing and will provide a set of standard data request responses much earlier in
12 the case calendar to reduce workload on Commission resources.

13 **6. Required Revenue Increase.**

14 The total requested revenue increase is \$20.8 million and the test year is June 30,
15 2010.

16 **7. Rate Increase by District.**

17 Arizona-American seeks the following revenue increases for the three districts in
18 this case:

19

District	Agua Fria Water	Havasu Water	Mohave Water
Revenue Increase	\$17,918,540	\$630,633	\$2,206,937

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24 **8. Increase in Authorized Recovery Related to Prior Loan**

25 In 2007, the Company issued a \$10 million note maturing in 2037 with an actual
26 interest rate on this note of 6.593%. This interest rate slightly exceeds the maximum

1 interest rate approved by the Commission, and, at the time of the approval, the Company
2 agreed not to seek the additional 0.093% in rates. As part of this proceeding, the
3 Company requests that the Commission authorize recovery of the additional 0.093% of
4 interest for this note. Given the Company's poor financial condition, it cannot continue to
5 absorb even this slight difference in interest expense, which totals \$9,300 annually.⁶

6 **9. Other Requested Approvals.**

7 As more specifically explained by its witnesses, Arizona-American also requests
8 the following important approvals:

9
10 **Witness**

Approvals

11 Broderick

- Low Income Program for Agua Fria Water District, Havasu Water District and Mohave Water District

12
13 Kiger

- Declining Usage Adjustment

14 Townsley

- Infrastructure System Replacement Surcharge

15 **10. Witnesses.**

16 This Application is supported by the testimony and exhibits of the following
17 witnesses:

18 **a. Thomas M. Broderick.** Mr. Broderick is employed by American Water as
19 Director, Rates & Regulation for operations in Arizona, New Mexico and Hawaii. Mr.
20 Broderick begins by explaining that the three district total requested revenue increase is
21 \$20.8 million and the test year is the period ending June 30, 2010. The primary increased
22 investment and expenses in the two and one-half years since the previous test years for
23 these districts include:

24
25 _____
26 ⁶ To the extent required, the Company requests that the Commission amend Decision No. 69730 to allow the Company to recover this additional interest expense.

- 1 1) Additional original cost utility plant in service totaling \$74 million (3
2 district total), including the White Tanks Regional Treatment Plant in the
3 Agua Fria district;
- 4 2) Additional amortization of imputed regulatory contributions totaling
5 \$2.067 million (3 district total);
- 6 3) Additional depreciation expense associated with additional original cost
7 utility plant in service (3 district total);
- 8 4) Increased labor and labor related expenses associated with increased
9 activities across many functions.

10 Mr. Broderick explains that Arizona-American's cost of capital is not less than
11 8.3%. The average cost of long-term debt is 5.66% and the cost of equity is 11.50%. A
12 hypothetical equity ratio of 45.34% and a debt ratio of 54.66% are proposed as a necessary
13 component of financial recovery. Arizona-American's proposed rate case expense is
14 \$529,210.

15 **b. Paul G. Townsley.** Mr. Townsley is Arizona-American's President. He
16 explains in his testimony that Arizona-American has taken many steps to prevent further
17 deterioration of its financial condition including not paying a dividend to its shareholders,
18 reducing capital expenditures to below internally-generated funds, reducing staffing, and
19 reducing other costs of the business, but that rate relief is critical. The current rate
20 application seeks timely and adequate rate relief. This is the most critical part of its
21 strategy to restore Arizona-American's long-term financial health by closing the ROE Gap
22 between actual ROE and Commission-authorized ROE.

23 Mr. Townsley also supports the adoption of an Infrastructure System Replacement
24 Surcharge (ISRS) program, which will benefit customers in older service areas such as the
25 Mohave and Havasu water districts where infrastructure is reaching the end of its useful
26 life and larger levels of capital investment, coupled with the lag associated with historic
test years, will result in larger step increases in rates at the time new rates are approved by

1 the Commission. Using the ISRS program, once reinvestments are made in qualifying
2 infrastructure, rates would be raised gradually and in smaller steps.

3 Finally, Mr. Townsley describes American Water’s corporate responsibility
4 program, which is ingrained in every aspect of the Company’s operations—from how it
5 advances innovation in water treatment and delivery and serves its customers, to how the
6 Company demonstrates ethical business standards and focus on employee success, to how
7 the Company protects the most precious of all natural resources -- water.

8 **c. Joseph E. Gross.** Mr. Gross is the Director of Engineering for Arizona,
9 New Mexico, Hawaii, and Texas. Mr. Gross testifies that the following major capital
10 projects were completed well before the end of the test year and are included in the
11 requested rate base:

- 12 • White Tanks Regional Water Treatment Plant (Agua Fria)
- 13 • Sierra Montana Storage Tank (Agua Fria)
- 14 • Route 303 Waterline Relocation (Agua Fria)
- 15 • Big Bend Acres Storage Tank (Mohave)

16 The Company is also requesting the inclusion in rate base of one post-test year
17 project, the Lake Mohave Highlands Storage Tank.

18 **d. Linda. J. Gutowski.** Ms. Gutowski is a Senior Rate Analyst for Arizona-
19 American. She sponsors the C Schedules for Operating and Maintenance Expenses
20 (except for electric expense and depreciation expense). Operating and Maintenance
21 Expenses for each district are as follows:

<u>District</u>	<u>O & M Expense</u>
Agua Fria Water	\$23,532,026
Havasu Water	\$1,343,303
Mohave Water	\$5,287,471
Total All Districts	\$30,162,800

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25 Ms. Gutowski sponsors adjustments LJG-1 through LJG-20, which are specific
26 adjustments relating to O&M expenses.

1 e. **Miles H. Kiger**. Mr. Kiger is employed by American Water Works Service
2 Company, Inc. as a Rate Analyst in Rates & Regulation. Mr. Kiger explains that, due to
3 continued declining residential usage per customer that precludes Arizona-American from
4 earning its Commission-authorized revenue requirement, a declining residential usage
5 adjustment to test year residential usage is being proposed for the districts in this case.

6 In addition, Mr. Kiger testifies that the Company is proposing to move some of its
7 irrigation customers to a new proposed potable irrigation rate that includes a basic service
8 charge, as well as create three new non-potable irrigation rates that reflect desired usage
9 incentives in its Agua Fria Water district.

10 Mr. Kiger sponsors the following schedules for each district in the case:

- 11 • Schedule A-5 – Arizona-American Summary Statements of Cash Flows
- 12 • Schedule C-1 – Arizona-American Adjusted Test Year Income Statement
- 13 • Schedule C-2 – Arizona-American Income Statement Pro Forma
 Adjustments
- 14 • Schedule C-3 – Arizona-American Gross Revenue Conversion Factor
- 15 • Schedule E-2 – Comparative Income Statements
- 16 • Schedule E-3 – Comparative Statement of Changes in Financial Position
- 17 • Schedule E-6 – Comparative Operating Income Statements
- 18 • Schedule E-6a – Comparative Operating Income Statements
- 19 • Schedule E-7 – Operating Statistics
- 20 • Schedule E-8 – Taxes Charged to Operations
- 21 • Schedule F-1 – Projected Income Statements
- 22 • Schedule F-2 – Projected Statements of Changes in Financial Position
- 23 • Schedule H-1 – Summary of Revenues by Customer Classification - Present
 & Proposed Rates
- 24 • Schedule H-2 – Analysis of Revenue by Detailed Class
- 25 • Schedule H-3 – Changes in Representative Rate Schedules
- 26 • Schedule H-4 – Typical Bill Analysis
- Schedule H-5 – Bill Count

21 Mr. Kiger also sponsors the following necessary adjustments to operating income:

- 22 • Adjustment MHK-1 – Remove Unbilled Revenue
- 23 • Adjustment MHK-2 – Annualize Rate Increase
- 24 • Adjustment MHK-3 – Annualize Year End Customers
- 25 • Adjustment MHK-4 – Correct Billing Errors
- 26 • Adjustment MHK-5 – Declining Usage Adjustment
- Adjustment MHK-6 – Annualize Power Expense
- Adjustment MHK-7 – Annualize Property Taxes

1 h. **Ian C. Crooks**. Mr. Crooks is the Director of Central Division Operations,
2 which includes the Sun City Water and Wastewater Districts, Sun City West Water and
3 Wastewater Districts, and Agua Fria Water and Wastewater Districts. Mr. Crook testifies
4 that the gross amount of actual White Tanks Plant O&M expense deferred before
5 subtraction of cost savings resulting from the production shifts from wells to White Tanks
6 Plant was \$671,765 through June 30, 2010. The gross amount of actual cost savings
7 resulting from operating the White Tanks Plant was \$121,248 as of June 30, 2010. The
8 net deferral, therefore, as of June 30, 2010 is \$550,842. Mr. Crooks explains that this is
9 not the total amount of the White Tanks O&M net deferral being requested for recovery in
10 rates in this case because O&M expense continues to be incurred and deferred until new
11 rates are effective and the deferral's recovery commences.

12 Mr. Crook further testifies the Company has included the net deferral amounts
13 through the period November 30, 2011, the date estimated for when new rates in this case
14 will be implemented. Total gross White Tanks Plant O&M expense from in-service
15 through November 30, 2011, is currently estimated to be \$3,057,025, the gross realized
16 production savings to be \$639,890, and the authorized cost of accrued interest at the
17 prevailing short-term interest rate to be \$24,672, for a net total deferral of \$2,441,807.

18 Mr. Crook also explains that the Company is proposing two changes to irrigation
19 class customers. First, the Company seeks to modify the format of the existing tariff to
20 provide clarity to the customers and Company regarding irrigation use. The proposed
21 tariff will clearly explain to the customers and Company the availability, applicability,
22 special conditions, rates, and terms and conditions for irrigation service. Second, the
23 Company proposes through rate design to expand the irrigation class from a single tier rate
24 with no minimum monthly charge to a single tier rate but with a minimum monthly service
25 charge based on meter size.
26

1 Finally, Mr. Crook testifies that the tank maintenance plan for Agua Fria is based
2 on a 15-year schedule for recommended repairs and painting. The estimated yearly
3 maintenance expense annualized over the 15-year cycle is estimated to be \$376,478. It is
4 anticipated that this estimated expense would be available for review and adjustment when
5 necessary in subsequent Agua Fria Water District rate cases.

6 i. **John F. Guastella**. Mr. Guastella is the President of Guastella Associates,
7 LLC, which is an entity that provides utility management, valuation and rate consulting
8 services to both regulated and unregulated utilities. He will testify regarding his
9 Depreciation Study for the districts in this case. The purpose of the Depreciation Study is to
10 establish depreciation rates that are reasonably applicable to the depreciable assets of the
11 water and wastewater systems of the Company. The Depreciation Study was performed
12 on the basis of comparative average service lives and depreciation rates. The source data
13 relied upon with respect to average service lives was obtained from Guastella Associates'
14 files and from data provided by the Company with respect to its Arizona and other
15 American Water properties and by the Arizona Corporation Commission Staff.

16 The basis for average service lives resulted from a careful account-by-account
17 review of average service lives that have been established by utilities and regulatory
18 agencies around the country. Mr. Guastella also inspected a number of the Company's
19 systems in Arizona, and discussed their operation and maintenance with Company
20 engineers and operators. Mr. Guastella also discussed the Company's asset management
21 with its accountants and administrative employees.

22 Having selected the average service lives, the next step was to assign net salvage
23 values to each account. Under the required accounting treatment, it is necessary to
24 determine the net salvage value with respect to an item of property being retired. The
25 calculation of depreciation rates also requires the inclusion of net salvage values.
26 Estimates of positive salvage values, such as trade-in payments or discounts, or resale

1 values on meters and transportation equipment are fairly consistent. On the other hand,
2 determining the cost of removal is more challenging for assets being retired as part of a
3 replacement during a common project and, therefore, requiring an allocation of costs.

4 Having selected average service lives and net salvage values, the determination of
5 depreciation rates is simply a matter of arithmetic: the percent depreciation is 1.0 minus
6 percentage net salvage value divided by the average service life. Accordingly, where the
7 net salvage value is negative, indicating cost of removal exceeds the salvage value, the
8 depreciation rate is higher -- because it must recover both the original cost and cost of
9 removal.

10 j. **Bente Villadsen**. Dr. Villadsen is a Principal of The Battle Group, an
11 economic, environmental, and management consulting firm with offices in Cambridge,
12 Washington, San Francisco, London and Brussels.

13 Dr. Villadsen selects two benchmark samples, water utilities and gas local
14 distribution companies (LDC). For the water sample, she primarily relies on a subsample
15 that excluded Southwest Water which recently restated its financials and currently pays no
16 dividends. Using two versions of the Discounted Cash Flow (DCF) method and three
17 versions of the Capital Asset Pricing Model (CAPM), she estimates the sample
18 companies' after-tax weighted-average cost of capital. The after-tax weighted average
19 cost of capital is the measure that companies most commonly use to evaluate investments
20 and the measure recommended in standard financial textbooks. Textbooks, the academic
21 literature as well as businesses weigh debt and equity by the market values in determining
22 the after-tax weighted cost of capital.

23 Having estimated the samples' after-tax weighted-average cost of capital for the
24 samples, she determines the corresponding cost of equity for Arizona-American Water at
25 its target of approximately 45 percent equity. In undertaking her analysis, Dr. Villadsen
26 notes that the overall cost of capital is constant within a broad middle range of capital

1 structures although the distribution of costs and risks among debt and equity holders is not.
2 Because the overall cost of capital is the same in a broad range of capital structures, there
3 are no impacts on the rates customers pay from a higher or lower percentage of equity, so
4 ratepayers are not affected by the choice of capital structure within a broad range.

5 However, Arizona-American Water's capital structure includes only 45 percent equity,
6 which is lower than the percentage equity among many utilities. Therefore, its financial
7 risk is higher and the return required by investors' increases with the level of risk they
8 carry, but this return is paid on a smaller amount of equity than is typical in the water
9 industry. Therefore, the dollar amount paid by customers is the same as if the Company
10 had a lower return on equity but a higher equity percentage.

11 Dr. Villadsen discusses the impact of the recent recession and ongoing turmoil in
12 financial markets on utilities' cost of capital and notes that while the yield on government
13 issued bills and bonds is currently very low, the spread between the yield on investment-
14 grade utility bonds and government bonds is currently unusually high. As utilities cannot
15 raise debt (or equity) at the same rates as the government, it is necessary to take the yield
16 on investment grade utility bonds into account in assessing the cost of capital for Arizona-
17 American Water. Specifically, the yields on government bills and bonds have been driven
18 artificially down by monetary policy and a flight to safety, so that the yields on these
19 securities are not reflective of normal economic conditions. Consequently, Dr. Villadsen
20 bases her CAPM models on a normalized risk-free rate which consists of the observed
21 risk-free rate plus an adjustment for the increase in the spread between risk-free rates and
22 investment grade utility bond yields. Further, equity investors lost substantial value in
23 capital markets over the couple of years and stock prices have been extremely volatile. As
24 a result, investors risk aversion has increased and the premium they require to invest in
25 stocks going forward has increased. Therefore, the risk premium associated with equity
26 investments is currently higher than it has been in the recent past. Dr. Villadsen performs

1 several sensitivity analyses on the impact hereof, but the requested return on equity is fully
2 supported by her baseline analysis, which relies on a historical market risk premium. In
3 other words, her recommended return on equity does not include the current higher risk
4 premium making her recommendation conservative in the current economic environment.

5 In addition to the cost of capital estimation discussed above, Dr. Villadsen reviewed
6 data on Arizona-American Water's earned return over the past 10 years and data on
7 Arizona-American Water's current credit ratios. Both the inability to earn the allowed
8 return on equity and the credit ratios show that it is vital that Arizona-American Water be
9 allowed an opportunity to earn a reasonable return on equity that would support as the bare
10 minimum an investment grade credit rating on a stand alone basis. Further, Dr. Villadsen
11 reviewed 22 recent decisions by the Arizona Corporation Commission to assess the
12 reasonableness of Arizona-American Water's current request. When compared in terms of
13 the overall return, the cost of equity requested by Arizona-American Water in this
14 proceeding is comparable to that granted to other water and wastewater utilities in Arizona
15 as adjusted using Arizona-American's equity percentage.

16 Lastly, the industry needs to invest in wastewater collection and treatment. The
17 needed infrastructure investment requires substantial external financing (i.e., new debt and
18 equity) and access to capital requires that investors expect to earn their required return.
19 Failure to provide adequate returns may discourage potential investors. While it may seem
20 counterintuitive to increase the cost of capital at a time when the economy is performing
21 poorly, it is necessary to attract needed capital. The increase in the spread between utility
22 bond yields and government bond yields along with the fact that investors are holding onto
23 their funds, are indicators that the required return has increased. Thus, in order to attract
24 investments, investors need to expect that they can earn a return on their investment that
25 makes it worth the risk and that return is higher than prior to the financial crisis. The fact
26 that Arizona-American Water has been unable to earn its allowed return since 2000 and on

1 a stand alone basis has weak credit ratios makes the attraction of capital especially difficult
2 for Arizona-American Water. These factors indicate that investors expect a higher risk
3 premium for investing in equity than prior to the financial crisis and that Arizona-
4 American Water face additional challenges in raising capital.

5 Based on the evidence from the samples, Dr. Villadsen finds that Arizona-
6 American Water's request for 11.50% return on equity is reasonable and fully supported
7 by her analysis. The financial turmoil has made the range of a reasonable return on equity
8 wider and especially the water sample shows a wide range from approximately 10½ to
9 14½%, although the risk positioning results are in a narrower range from 11¼ to 12. The
10 gas LDC sample's results are concentrated in the range of 11 to 12%. Based on the data
11 and the analysis of Arizona-American Water's credit metric and the returns allowed other
12 water utilities, I support the request for an allowed return on equity of 11.50%.

13 **11. Organization of Filing.** The filing is organized as follows:

- 14 **a. Application;**
15 **b. Testimony;**
16 **c. Other Required Information; and**
17 **d. Required Schedules (By District).**

18 **12. Requested Relief.** Arizona-American requests that the Commission issue
19 an order consistent with the requests set forth in this Application, as more fully set forth in
20 the testimony, exhibits and schedules that accompany this Application.

21 RESPECTFULLY SUBMITTED this 3rd day of November, 2010.

22 LEWIS AND ROCA LLP

23
24 _____
25 Thomas H. Campbell
26 Michael T. Hallam
40 North Central Avenue
Phoenix, AZ 85004
Attorneys for Arizona-American Water
Company

1 ORIGINAL and thirteen (13) copies
2 of the foregoing filed
3 this 3rd day of November, 2010, with:

4 The Arizona Corporation Commission
5 Utilities Division – Docket Control
6 1200 W. Washington Street
7 Phoenix, Arizona 85007

8 Copy of the foregoing hand-delivered
9 this 3rd day of November, 2010, to:

10 Steve Olea
11 Utilities Division
12 Arizona Corporation Commission
13 1200 W. Washington Street
14 Phoenix, Arizona 85007

15 Lyn Farmer, Chief Administrative Law Judge
16 Hearing Division
17 Arizona Corporation Commission
18 1200 W. Washington Street
19 Phoenix, Arizona 85007

20 Janice Alward
21 Chief Counsel, Legal Department
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