

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

MIKE GLEASON, Chairman  
JEFF HATCH-MILLER  
WILLIAM A. MUNDELL  
KRISTIN K. MAYES  
GARY PIERCE

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS AGUA FRIA WATER DISTRICT, HAVASU WATER DISTRICT, MOHAVE WATER DISTRICT, PARADISE VALLEY WATER DISTRICT, SUN CITY WEST WATER DISTRICT, AND TUBAC WATER DISTRICT.

DOCKET NO. W-01303A-08-0227

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS MOHAVE WASTEWATER DISTRICT

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**REVISED APPLICATION  
OF  
ARIZONA-AMERICAN WATER COMPANY**

1. **Application.** Arizona-American Water Company (“Arizona-American” or the “Company”) is a wholly-owned subsidiary of American Water. Arizona-American hereby applies, as of May 2, 2008, in accordance with A.R.S. § 40-250 and the Commission’s Rule R 14-2-103 for rate increases for its following districts:

- Agua Fria Water District;

- 1 • Havasu Water District;
- 2 • Mohave Water District;
- 3 • Paradise Valley Water District;
- 4 • Sun City West Water District;
- 5 • Tubac Water District; and
- 6 • Mohave Wastewater District.

7 2. **Sufficiency.** On June 2, 2008, the Commission’s Utilities Division Staff (“Staff”) filed a Deficiency Letter which stated that Arizona-American’s May 2, 2008, rate application did not meet the sufficiency requirements as outlined in Arizona Administrative Code R14-2-103. Staff listed specific deficiencies by Arizona-American’s operating districts. In addition, the Deficiency Letter stated that Staff has “serious concerns with ... the inclusion of the filing of applications for ... Anthem Water, Anthem Wastewater, and Agua Fria Wastewater.” This Revised Application is being filed in response to Staff’s Deficiency Letter. It has been revised where appropriate to resolve specific deficiency issues and removes the Anthem Water, Anthem Wastewater, and Agua Fria Wastewater districts from Arizona-American’s application of May 2, 2008. Arizona-American is also filing today a separate “Response to Deficiency Letter.”

17 3. **Filing Deadlines.** This new rate case filing complies with deadlines for filing new rate cases established by the Commission in Decisions 68825, 69173, 69181, and 69396.

19 4. **Arizona-American’s Financial Condition.** Arizona-American’s financial condition continues to decline. Most of Arizona-American’s operating districts have under-earned for several years and Arizona-American, as a whole, has lost nearly \$30 million since American Water purchased the assets of Citizens Water Resources in 2002. This unfortunate trend continues. Arizona-American again had a net income loss of \$4.6 million in 2007 and expects to continue to operate at a loss in 2008 and 2009 until new rates are implemented.

25 5. **Times Interest Ratio.** A company’s Times Interest Earned Ratio (“TIER”) represents the number of times earnings will cover interest expense on short-term and long-term debt. A TIER of less than 1.0 is not sustainable in the long-term. At the end of 2006, the

1 Commission concluded that Arizona-American's TIER was only 0.44, meaning that Arizona-  
2 American cannot be a viable long term water utility unless it can improve its TIER. So far,  
3 despite an equity infusion of \$15 million in 2007, TIER has not materially improved. As of  
4 December 31, 2007, Arizona-American's TIER was still 0.72.

5         6.         **Reasons for Poor Financial Condition.** Arizona-American's current financial  
6 condition can be attributed to at least three factors. First, in Decision No. 65453 the  
7 Commission imposed a moratorium on filing rate case application from January 2003, until  
8 January 2006. This largely prevented Arizona-American's from transferring capital investments  
9 into rate-base and from recovering increased operating expenses. Second, Decision No. 63584  
10 included a provision that assets purchased from Citizens would be not be immediately included  
11 in rate base, but would instead be amortized into rate-base over a period ranging from six-and-  
12 one-half years to ten years. Despite the resulting delay in recognizing these assets, Arizona-  
13 American had agreed to this condition with Staff, but was assuming only a one-year rate  
14 moratorium. The Commission's three-year moratorium meant that Arizona-American could  
15 only begin to recover these assets after the moratorium expired, new rate cases were filed, and  
16 the Commission approved recovery. The first case to approve recovery of any portion of the  
17 amortizations was Decision No. 69440, dated May 1, 2007, for our Mohave Water District. As  
18 of April 30, 2008, Arizona-American has been authorized rate recovery for only \$25 million of  
19 the total \$125 million of deferred AIAC and CIAC. Third, the nature of historic test years in  
20 Arizona automatically causes a lag between the date a company expends capital and the date that  
21 the company starts to earn a return on and of that capital. This is a particular issue for companies  
22 like Arizona-American that must invest to meet the needs of its customers in fast-growing areas  
23 like Maricopa and Mohave Counties.

24         7.         **Steps Already Taken by Arizona-American to Improve Its Financial Health.**  
25 First, Arizona-American has not paid a dividend since 2003 to its parent, American Water. This  
26 has helped slow the erosion of Arizona-America's equity balance. Second, despite Arizona-  
27 American's failure to pay dividends, or even to generate positive earnings, American Water has



District	Agua Fria Water	Havasu Water	Mohave Water	Paradise Valley Water	Sun City West Water	Tubac Water
Revenue Increase	\$9,192,203	\$ 815,803	\$1,655,410	\$3,101,550	\$4,276,305	\$278,214
Percentage Increase	48.8%	79.5%	32.4%	39.5%	75.0%	65.2%

**Table 2. Wastewater Districts**

District	Mohave Wastewater
Revenue Increase	\$ 642,148
Percentage Increase	80.7%

12. **Other Requested Approvals.** As more specifically requested by its witnesses,

Arizona-American’s requests also include the following additional approvals.

**Witness**

**Approvals**

Broderick

- Post-test-year amortization of Imputed AIAC
- White Tanks Plant CWIP in Rate Base
- White Tanks Plant O&M Deferral
- White Tanks Plant accounting authorizations
- Tubac Water ACRM
- Discontinue existing ACRM surcharges for Agua Fria, Havasu, Paradise Valley and Sun City West
- Modify the Paradise Valley Public Safety Surcharge to apply to all customers, with proceeds accounted for as revenue, and with up to four additional step increases
- System Benefit Charge to fund landscape conversion programs.

Cole

- Increase service and meter-installation fees
- Increase meter-test charge
- Standardize after-hours reconnect charge in each district
- End annual fire-hydrant inspections for Sun City Water

Hubbard

- Power-supply adjustment clause
- Tank maintenance reserve
- Formal adoption of filed terms and conditions of service

Lenderking

- Modify Paradise Valley Water CAP Surcharge

Townsley

- Extend Agua Fria Water Hook-up Fee expiration

1           13.    **Witnesses.** This Application is supported by the revised testimony and exhibits  
2 of nine witnesses:

3                   a.    **Thomas M. Broderick.** Mr. Broderick is the Director, Rates &  
4 Regulation for operations in Arizona, New Mexico, and Texas, and has overall  
5 responsibility for interactions with the Arizona Corporation Commission.

6                   Mr. Broderick first summarizes the total requested revenue increase of  
7 \$19,961,632, based on a test year ending December 31, 2007.

8                   Mr. Broderick sponsors Schedules A-1, A-3, D-1, D-2, D-3, D-4, E-4, and E-9.

9                   Mr. Broderick testifies that Arizona-American's cost of capital is not less than  
10 8.40%. The average cost of long-term debt is 5.463% and the cost of equity is 11.75%.  
11 The forecasted equity ratio is 46.75% and the debt ratio is 53.25%. Short-term debt has  
12 again been excluded from the calculation of the capital structure.

13                   Mr. Broderick testifies that Arizona-American's rate case expense is \$612,000.

14                   Mr. Broderick supports and explains Arizona-American's request that  
15 amortizations of imputed regulatory AIAC should be recognized through July 14, 2008.

16                   Mr. Broderick supports and explains Arizona-American's request that \$25 million  
17 of White Tanks Plant CWIP should be included in rate base.

18                   Mr. Broderick supports and explains Arizona-American's request for a White  
19 Tanks Plant O&M deferral mechanism equivalent to an ACRM step increase.

20                   Mr. Broderick supports and explains several specific White Tanks Plant  
21 accounting requests.

22                   Mr. Broderick supports and explains Arizona-American's requests for an ACRM  
23 for Tubac district and to discontinue existing ACRM surcharges for Agua Fria, Havasu,  
24 Paradise Valley and Sun City West.

25                   Mr. Broderick sponsors rate base adjustments TMB-7; TMB-8; and TMB-9.

26                   b.    **Paul G. Townsley.** Mr. Townsley is Arizona-American's President.

1 Mr. Townsley discusses Arizona-American’s current poor financial condition and  
2 emphasizes that timely and adequate rate relief from the Commission is critically  
3 important.

4 Mr. Townsley discusses Arizona-American’s agreement with the Maricopa  
5 County Municipal Water Conservation District Number One (“MWD”), which provides  
6 MWD an option to participate in the White Tanks Plant.

7 Mr. Townsley supports Arizona-American’s requests to extend the expiration date  
8 of the Agua Fria Hook-up Fees and to include construction work in progress in rate base  
9 are appropriate.

10 Mr. Townsley demonstrates that Arizona-American’s Achievement Incentive Pay  
11 benefits our customers.

12 c. **Joseph E. Gross**. Mr. Gross is Arizona-American’s Director of  
13 Engineering for Arizona, New Mexico, Hawaii, and Texas.

14 Mr. Gross discusses three major capital projects under way for which it seeks to  
15 recover associated post-test-year investment: the White Tanks Regional Water Treatment  
16 Plant; the Mohave Wastewater Treatment Plant Expansion; and the Paradise Valley Fire  
17 Flow Project, Phase 3.

18 Mr. Gross discusses four smaller projects underway, which should be completed  
19 in time for the Commission Staff’s engineering report: the Well 12 Replacement  
20 (Paradise Valley Water); the Big Bend Acres Tank (Mohave Water); the Sierra Montana  
21 Tank (Agua Fria Water); and Distribution System Improvements, Phase 2 (Agua Fria  
22 Water);

23 Mr. Gross discusses the planned Tubac Arsenic Treatment Facility.

24 Mr. Gross discusses the Mohave County Comprehensive Planning Study and the  
25 status of projects recommended in the Study.

1 Mr. Gross discusses how construction of the White Tanks Plant will allow a  
2 developer to supply only water to satisfy average-day demand for the development, rather  
3 than maximum-day demand

4 Mr. Gross finally discusses how the recent real-estate slowdown has reduced the  
5 number of customers subject to the Agua Fria Water Hook-up Fee. He includes a  
6 forecast of new customers that will actually be subject to the increased hook-up fees.

7 d. **Bradley J. Cole**. Mr. Cole is Arizona-American's Director of Operations  
8 for Central Arizona, which includes the Sun City Water and Wastewater District, Sun  
9 City West Water and Wastewater Districts and Agua Fria Water and Wastewater  
10 Districts.

11 Mr. Cole first describes the service areas and facilities for each of Arizona-  
12 American's six water districts that are included in this case: Agua Fria Water; Havasu  
13 Water; Mohave Water; Paradise Valley Water; Sun City West Water and Tubac Water.

14 Mr. Cole supports Mr. Broderick's request for a mechanism to recover deferred  
15 first-year O&M costs for the White Tanks Regional Treatment Facility.

16 Mr. Cole discusses the need for an arsenic-treatment facility for the Tubac Water  
17 District.

18 Mr. Cole discusses Arizona-American's new storage-tank maintenance program  
19 and supports Ms. Hubbard's request to fund this program.

20 Mr. Cole explains why chemical and water-quality-testing expenses have  
21 increased in recent years

22 Mr. Cole explains why Arizona-American proposes to increase various service  
23 charges

24 Mr. Cole describes the service areas and facilities for Arizona-American's  
25 Mohave Wastewater Districts that are included in this case.

26 Mr. Cole supports Arizona-American's request to terminate the annual fire-  
27 hydrant inspection compliance report requirement for the Sun City Water District.

1 e. **Sheryl L. Hubbard**. Ms. Hubbard is Arizona-American’s Manager,  
2 Rates & Regulation.

3 Ms. Hubbard sponsors the following schedules for each district in the case:

- 4 • Schedule A-2 – Arizona-American Summary of Operations
- 5 • Schedule A-4 – Arizona-American Construction Expenditures and Gross
- 6 Utility Plant in Service
- 7 • Schedule A-5 – Arizona-American Summary of Cash Flows
- 8 • Schedule B-6 – Arizona-American Computation of Cash Working Capital
- 9 • Schedule C-1 – Arizona-American Adjusted Test Year Income Statement
- 10 • Schedule C-2 – Arizona-American Income Statement Pro Forma
- 11 Adjustments
- 12 • Schedule C-3 – Arizona-American Computation of Gross Revenue
- 13 Conversion Factor
- 14 • Schedule E-2 – Comparative Income Statements
- 15 • Schedule E-3 – Comparative Statement of Changes in Financial Position
- 16 • Schedule E-6 – Comparative Operating Income Statements
- 17 • Schedule E-7 – Operating Statistics
- 18 • Schedule E-8 – Taxes Charged to Operations
- 19 • Schedule F-1 – Projected Income Statements
- 20 • Schedule F-2 – Statement of Cash Flows-Present and Proposed Rates
- 21 • Schedule F-3 – Projected Construction Requirements
- 22 • Schedule F-4 – Assumptions Used in Developing Projections
- 23

24 Ms. Hubbard supports the revenue-requirement calculation for each district.

25 Ms. Hubbard sponsors and explains the lead-lag study that supports Arizona-  
26 American’s request for cash-working capital.

27 Ms. Hubbard sponsors and explains the following adjustments to operating  
28 income:

- 29 • Adjustment SLH-1 – Annualize Payroll Expense
- 30 • Adjustment SLH-2 – Annualize Power Expense
- 31 • Adjustment SLH-3 – Normalize Purchased Water
- 32 • Adjustment SLH-4 – Annualize Chemicals Expense
- 33 • Adjustment SLH-6 - Annualize Management Fees
- 34 • Adjustment SLH-7 - Annualize Pensions Expense
- 35 • Adjustment SLH-8 – Amortize Rate Case Expense
- 36 • Adjustment SLH-9 – Annualize Insurance Expense
- 37 • Adjustment SLH-10 – Tank Maintenance Accrual
- 38 • Adjustment SLH-11 – Annualize Depreciation/CIAC
- 39 • Adjustment SLH-12 – Annualize Property Taxes
- 40 • Adjustment SLH-15 – Annualize 401K Expense
- 41

- Adjustment SLH-16 – Line 21 Clean-up
- Adjustment SLH-17 – Remove CAP Revenue and Expense
- Adjustment SLH-18 – Interest Synchronization
- Adjustment SLH-19 – Federal and State Income Taxes
- Adjustment SLH-20 – Annualize Postage Increase
- Adjustment SLH-21 – One-Time Service Company Charges
- Adjustment SLH-22 – Adjust Conservation Expenses
- Adjustment SLH-23 – Adjustment to Remove Prior Period Labor Adjustment

Ms. Hubbard also supports and explains the following requests by Arizona-American:

- For a power supply adjustment mechanism that will enable Arizona-American to adjust its rates in the future for changes in rates paid for electric and gas costs;
- For a tank maintenance reserve to fund tank maintenance expenditures; and
- For formal adoption by the Commission of the terms and conditions of service on file at the Commission.

f. **Linda J. Gutowski**. Ms. Gutowski is a Senior Rate Analyst for Arizona-American, where she prepares regulatory filings.

Ms. Gutowski sponsors rate base Exhibits B-1 through B-5 for each district.

Ms. Gutowski sponsors and explains the following rate-base adjustments for each district (as applicable): LJG-1; LJG-2; LJG-3; LJG-4; LJG-5; LJG-6; LJG-10; LJG-11; and LJG-12.

Ms. Gutowski sponsors and explains the following income-statements for each district (as applicable): LJG-1; LJG-2; LJG-3; LJG-4; and LJG-5.

Ms. Gutowski sponsors and explains Schedule E-1, the Comparative Balance Sheet schedule for each district, and Schedule E-5, the Detail of Plant in Service schedule for each district.

Ms. Gutowski sponsors and explains the present-rate portion of the H Schedules.

g. **John C. (Jake) Lenderking**. Mr. Lenderking is Arizona-American's Water Resources Manager.

1 Mr. Lenderking discusses Arizona-American's present water-conservation  
2 programs and then discusses what changes, if any, will be required under the new  
3 requirements of the Arizona Department of Water Resources.

4 Mr. Lenderking discusses how Arizona-American will meet its water-supply  
5 requirements for the Paradise Valley Water District, now that it will no longer be using  
6 water supplied from the PCX-1 well owned by the Salt River Project. He explains that  
7 Arizona-American has added storage for the Paradise Valley Water District, presently has  
8 enough capacity to run the system without the PCX-1 well, and among other things, plans  
9 to replace its Well 12 with a new well, which will return its production to its original  
10 level of 2200 gallons per minute.

11 Mr. Lenderking explains that Arizona-American will store and recover the  
12 district's 3,231 acre-feet allocation of CAP water at the Tonopah Desert Recharge  
13 Project, owned by the Central Arizona Water Conservation District. The stored CAP  
14 water will then be "recovered" from wells in the Paradise Valley Water District.

15 h. **Bente Villadsen**. Dr. Villadsen is a Principal of The Brattle Group, an  
16 economic, environmental and management consulting firm with offices in Cambridge,  
17 Washington, San Francisco, London and Brussels.

18 Dr. Villadsen selects two benchmark samples, water utilities and gas local  
19 distribution companies ("LDC"). She estimates the sample companies' cost of equity,  
20 associated after-tax weighted-average cost of capital, and the corresponding cost of  
21 equity at 46.9 and 41.6 percent equity. She also reviews recent Arizona water and  
22 wastewater decisions. In undertaking her analysis, Dr. Villadsen notes that the overall  
23 cost of capital is constant within a broad middle range of capital structures although the  
24 distribution of costs and risks among debt and equity holders is not. Because Arizona-  
25 American's requested target of 46.9 percent equity is lower than the percentage equity  
26 among many utilities, its financial risk is higher and the return required by investors  
27 increases with the level of risk they carry. Should short-term debt be included for an

1 equity percentage of 41.6 percent, Arizona-American's capitalization is further below  
2 that of the average water utility.

3 Based on the evidence from the samples, Dr. Villadsen estimates a cost of equity  
4 for the benchmark samples at Arizona-American's capital structure to be in the range of  
5 11.0 to 12.5 percent, so that Arizona-American's request for 11.75 percent is equal to the  
6 midpoint. Dr. Villadsen also reviewed recent Arizona decisions and found that the  
7 decisions correspond to a cost of equity of approximately 11.0 and 12.25 percent when  
8 applied to an entity with 46.9 and 41.6 percent equity, respectively. She therefore finds  
9 that Arizona-American's request for 11.75 percent return on equity is reasonable and  
10 fully supported by her analysis.

11 i. **Paul R. Herbert**. Mr. Herbert is employed by Gannett Fleming, Inc.,  
12 where he is the President of the Valuation and Rate Division.

13 Mr. Herbert discusses the cost-of-service and rate-design studies prepared for  
14 each of the operating districts submitted in this case. He explains that cost-allocation  
15 studies are used to determine and allocate the total district cost of service to the several  
16 service classifications in each district. The studies provide a basis for determining the  
17 extent to which the revenues to be derived from each classification are commensurate  
18 with the cost of serving that classification, within each district.

19 Mr. Herbert sponsors Schedules G-1 through G-9, and the proposed-rates portion  
20 of the H schedules.

21 14. **Supporting Documents**. In addition to the revised testimony, this Revised  
22 Application is supported by the Other Required Information and Required Schedules (By  
23 District), which accompanied Arizona-American's original May 2, 2008, Application, and  
24 Arizona-American's Response to Deficiency Letter, which is also being filed today in these  
25 dockets.



1 **Copies** of the foregoing **delivered** on  
2 June 20, 2008, to:

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4 Legal Division  
5 Arizona Corporation Commission  
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9 Ernest Johnson  
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