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7 **BEFORE THE ARIZONA CORPORATION COMMISSION**

8 IN THE MATTER OF THE
9 APPLICATION OF ARIZONA-
AMERICAN WATER COMPANY, AN
10 ARIZONA CORPORATION, FOR A
DETERMINATION OF THE CURRENT
11 FAIR VALUE OF ITS UTILITY PLANT
AND PROPERTY AND FOR
12 INCREASES IN ITS RATES AND
CHARGES BASED THEREON FOR
13 UTILITY SERVICE BY ITS SUN CITY
WEST WATER AND WASTEWATER
14 DISTRICTS.

15 IN THE MATTER OF THE
APPLICATION OF ARIZONA-
AMERICAN WATER COMPANY, INC.,
16 AN ARIZONA CORPORATION, FOR A
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17 FAIR VALUE OF ITS UTILITY PLANT
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19 UTILITY SERVICE BY ITS SUN CITY
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AND PROPERTY AND FOR
204 INCREASES IN ITS RATES AND
CHARGES BASED THEREON FOR
25 UTILITY SERVICE BY ITS MOHAVE
WATER AND HAVASU WATER
26 DISTRICTS.

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(CONSOLIDATED)

**ARIZONA-AMERICAN WATER
COMPANY'S EXCEPTIONS TO
RECOMMENDED OPINION AND
ORDER**

Arizona Corporation Commission

DOCKETED

MAY 17 2004

DOCKETED BY

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

14 IN THE MATTER OF THE
15 APPLICATION OF ARIZONA-
16 AMERICAN WATER COMPANY, AN
17 ARIZONA CORPORATION, FOR A
18 DETERMINATION OF THE CURRENT
19 FAIR VALUE OF ITS UTILITY PLANT
20 AND PROPERTY AND FOR
21 INCREASES IN ITS RATES AND
22 CHARGES BASED THEREON FOR
23 UTILITY SERVICE BY ITS TUBAC
24 WATER DISTRICT.

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1 Arizona-American Water Company ("Arizona-American or "the Company")
2 submits its exceptions to the Recommended Opinion and Order ("RO") issued by the
3 Administrative Law Judge ("the ALJ") on April 26, 2004.

4 **I. OVERVIEW AND SUMMARY OF THE ISSUES PRESENTED.**

5 Arizona-American has applied for a determination of the fair value of its utility
6 plant and property and for increases in its rates and charges for utility service. The
7 Company's applications cover 10 water and wastewater districts, and seek rate
8 adjustments based on the fair value rate bases and operating results in those districts
9 utilizing a 12-month test period ending December 31, 2001, with appropriate pro forma
10 adjustments to annualize and normalize rate base, revenues and expenses on a going-
11 forward basis. These districts were previously owned and operated by Citizens
12 Communications Company ("Citizens"), and were acquired by Arizona-American on
13 January 15, 2002.¹

14 None of the districts has received any recent rate increases. Citizens' Agua Fria
15 Water Division, Sun City Water Company, Sun City Sewer Company, Sun City West
16 Utilities Company and Tubac Valley Water Company's last rate orders were issued in May
17 1997 based on test years ending March 31, 1995. Decision No. 60172 (May 7, 1997).²
18 Citizens' Mohave Water Division last received rate increases in February 1990, based on a
19 test year ending March 31, 1988. Decision No. 56806 (Feb. 1, 1990). Havasu Water
20 Company last received rate increases in February 1992, based on a test year ending

21 ¹ A small wastewater district located in Mohave County, formerly known as Sorenson Utility
22 Company, was also acquired by Arizona-American. This wastewater district is not involved in
23 the rate applications, nor is the Paradise Valley water district, which has been owned and operated
24 by Arizona-American since the late 1960s. Both of these districts received rate increases within
the past five years.

25 ² In this decision, Sun City Water Company and Sun City West Utilities' rates for water service
26 were actually reduced.

1 December 31, 1990. Decision No. 57743 (Feb. 21, 1992).³

2 The Company has requested adjustments to its rates and charges for service that
3 would produce an overall increase in revenue of approximately \$8.2 million, as shown on
4 page 6 of the RO, which would provide a rate of return of 7.5% on the fair value of the
5 Company's utility plant and property devoted to public service. Under the RO, the
6 Company's rates would be adjusted to produce a total increase in revenue of
7 approximately \$1.3 million, with rates of return on the Company's fair value rate bases
8 ranging from 4.32% to 6.43%, depending the particular district. RO at 33-35. By
9 contrast, the current yield on a long-term Treasury note is about 5.5%, while the yield on
10 an investment grade corporate bond is about 6.8%.

11 Arizona-American respectfully submits that the following recommendations in the
12 RO are arbitrary, contrary to law, and unsupported by the evidence in the record:

13 1. Rate base issues. The RO would violate the "fair value" standard,
14 contained in Article 15, section 14 of the Arizona Constitution in two different respects.
15 First, in developing the Company's fair value rate base for each district, the RO simply
16 averaged the original cost rate base ("OCRB") and the reconstruction cost new ("RCND")
17 rate base because this method is "traditional," and disregarded the Company's evidence
18 showing that the RCND rate bases are conservative and substantially understate the
19 current value of the Company's utility plant and property. See RO at 14-16. Second, and
20 even more critically, the Company's fair value rate bases are *not* used to determine the
21 Company's authorized level of operating income. Instead, operating income is determined
22 by multiplying the rate of return by the OCRB. See RO at 31-32. This "backing-in"
23 method produces fluctuating rates of return on fair value, as noted above, which are below

24
25 ³ In addition, Arizona-American was required to file for rate review for the Anthem water and
26 wastewater districts by 2004 or, if earlier, when the number of equivalent residential units in
Anthem reached 3,500. Decision No. 60975 (June 19, 1998).

1 the current cost of investment grade bonds and, in some instances, below current yields on
2 Treasury instruments. This method is unlawful and violates the Arizona constitution.

3 **2. Rate of Return.** The RO adopts the rate of return, 6.5%, recommended by
4 the Utilities Division (“Staff”), which is based on the Company’s embedded cost of debt
5 and a return on common equity of only 9.0%. In adopting Staff’s recommendation, the
6 RO arbitrarily rejects the cost of equity estimates of the Company’s expert, as well
7 evidence of the actual and authorized returns on equity of the publicly traded water
8 utilities used by Staff. The RO fails to consider recent increases in interest rates, while
9 rejecting the Company’s Risk Premium and Capital Asset Pricing Model (“CAPM”)
10 estimates because they rely on interest rate projections. RO at 29-30. As discussed below,
11 however, the forecasted interest rates used by the Company’s expert in his cost of equity
12 estimates are actually *lower* than current interest rates.⁴ Moreover, the RO ignores
13 evidence of actual and authorized earnings because this sort of real world information has
14 been “replaced” by “corporate finance models.” RO at 29. Based on current interest rates
15 and actual equity returns, and taking into account the amount of debt in the Company’s
16 capital structure, Arizona-American is entitled to an authorized return on equity
17 substantially greater than 9.0%.

18 **3. Rate Case Expense.** The RO would allow the Company to recover
19 \$418,941 in rate case expense, despite the fact that its actual rate case expense will exceed
20 \$1 million. The primary basis for this recommendation is the Residential Utility
21 Consumer Office’s (“RUCO”) contention that the Company used an inappropriate test
22 year. RO at 20. The reality is that the Company’s rate case expense is significant because
23 of the size and complexity of this proceeding, which involves 10 different water and

24
25 ⁴ As discussed below, Staff used an average of the yields on 5, 7 and 10-year Treasury notes in its
26 CAPM model. Since Staff’s original CAPM estimates were made, the average yield on those
instruments has increased by over 100 basis points (1.0%).

1 wastewater districts, each of which has its own rate base, income statement and rate
2 schedule. Only one significant issue was affected by the Company's use of a 2001 test
3 year. Moreover, a delay in filing would have made it even more difficult to obtain plant
4 records and other historic data from Citizens, resulting in further complications and,
5 ultimately, more expense. Finally, as discussed below, the amount of rate case expense
6 requested by the Company, \$715,000 (amortized over three years), is reasonable when
7 compared to other Citizens and Arizona-American rate proceedings.

8 **4. Other Issues.** The RO also denies Arizona-American's request to
9 implement a mechanism to recover payments to the City of Tolleson under the Company's
10 contract for wastewater treatment services with that city. RO at 42-45. Under an
11 amendment made in April 2003 (Ex. S-1), Arizona-American is required to pay to
12 Tolleson an increased monthly fee under "Rate Component Three" to fund the
13 replacement and contingencies reserve. In addition, under the new "Rate Component
14 Four," the Company must pay a pro rata portion of the cost of constructing major capital
15 improvements to Tolleson's treatment plant, to which wastewater flows from the Sun City
16 wastewater district are delivered for treatment. Payments under Rate Component Four
17 will total approximately \$10 million during the 2004 to 2008 time period or about \$2
18 million annually. RO at 42.⁵ Although there is no dispute that this contractual
19 arrangement is reasonable, prudent and beneficial to Sun City customers (*see, e.g.*, Tr. at
20 1154-56), Staff and RUCO contend that these payments are not sufficiently "known and
21 measurable." The ALJ has accepted that argument and recommends denial of the
22 Company's cost recovery mechanism. RO at 45. Although the Company disagrees with
23 this recommendation, to reduce the areas of disagreement, the Company will accept the

24
25 ⁵ By way of comparison, under the RO, the Sun City wastewater district's total operating income
26 would be \$560,000 per year, which is approximately 25% of the average annual payments the
Company will make to Tolleson under Rate Component Four.

1 ALJ's recommendation, and will capitalize its increased payments under Rate Component
2 Three and its payments under new Rate Component Four and include those payments in
3 rate base in its next general rate case for the Sun City wastewater district.

4
5 **II. THE RECOMMENDED ORDER VIOLATES THE "FAIR VALUE"**
6 **STANDARD MANDATED BY THE ARIZONA CONSTITUTION BY**
7 **IGNORING EVIDENCE OF CURRENT VALUE AND RELYING**
8 **EXCLUSIVELY ON ORIGINAL COST TO SET RATES AND CHARGES**
9 **FOR UTILITY SERVICE.**

10 **A. Overview of the "Fair Value" Standard.**

11 In Arizona, utility rates must be established on the basis of the "fair value" of the
12 utility's property. Ariz. Const. art. 15, § 14. For example, in the seminal decision *Simms*
13 *v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956), the
14 Arizona Supreme Court stated:

15 It is clear, therefore, that under our constitution as interpreted
16 by this court, *the Commission is required to find the fair value*
17 *of the company's property and use such finding as a rate base*
18 *for the purpose of calculating what are just and reasonable*
19 *rates. . . . While our constitution does not establish a formula*
20 *for arriving at fair value, it does require such value to be found*
21 *and used as the base in fixing rates. The reasonableness and*
22 *justness of the rates must be related to this finding of fair*
23 *value.* [Emphasis supplied.]

24 More recently, the Court confirmed that in a monopoly setting, fair value is the exclusive
25 rate base on which a utility's rates are established. *US West Communications, Inc. v. Ariz.*
26 *Corp. Comm'n*, 201 Ariz. 242, 244-46, ¶¶ 13-19, 34 P.3d 351, 354-55 (2001)
(summarizing Arizona court decisions requiring the use of fair value to set rates).

Under the fair value method, rates are set "according to the actual present value of
the assets employed in the public service." *Duquesne Light Co. v. Barasch*, 488 U.S. 299,
308 (1989). "Fair value means the value of properties at the time of inquiry," and not
simply their historic cost. *Simms*, 80 Ariz. at 151, 294 P.2d at 382.

[The] fair value standard mimics the operation of the

1 competitive market. To the extent the utilities' investments in
2 plants are good ones (because the benefits exceed their costs)
3 they are rewarded with an opportunity to earn an "above cost"
4 return, that is, a fair return on the current "market value" of
5 the plant. To the extent the utilities' investments turn out to
6 be bad ones (such as plants that are canceled and so never
7 used and useful to the public), the utilities suffer because the
8 investments have no fair value and so justify no return.

9 *Duquesne Light*, 488 U.S. at 308-09. See also *Bluefield Waterworks & Improvement Co.*
10 *v. Pub. Serv. Comm'n of West Va.*, 262 U.S. 679, 690 (1923) ("If the property, which
11 legally enters into the consideration of the question of rates, has increased in value since it
12 was acquired, the company is entitled to the benefit of such increase."); *City of Tucson v.*
13 *Citizens Utilities Water Co*, 17 Ariz.App. 477, 480, 498 P.2d 551, 554 (1972) ("The Court
14 reiterated [in *Simms*] that fair value meant 'value of properties at the time of inquiry' . . .
15 which figure will necessarily reflect the current cost of construction.").

16 **B. The Use of the Average of the Company's OCRB and RCND Rate Bases
17 is Unlawful and Ignores the Evidence Presented.**

18 Arizona-American presented evidence establishing both an original cost rate base
19 ("OCRB") and a reconstruction cost new less depreciation ("RCND") rate base for each
20 district in accordance with the Commission's rule defining the requirements for an
21 application seeking rate adjustments. A.A.C. R14-2-103(B)(1) and Schedules B-1 through
22 and B-4. There were certain minor disagreements relating to total plant in service and
23 accumulated depreciation, as described on pages 7 through 9 of the RO, which result in
24 the adoption of an adjusted OCRB for all 10 districts totaling approximately \$90.9 million.
25 RO at 10. These adjustments are carried over to the RCND rate bases, which, as adjusted,
26 total approximately \$134.4 million. RO at 11.

The Company maintains that its RCND rate bases should be used as its "fair value"
rate base ("FVRB") because the RCND rate bases provide the best estimate of the current
value of the Company's utility plant and property. In addition to offering reproduction

1 cost new ("RCN") plant-in-service studies for each district, which were accepted by Staff
2 (and not challenged by any other party), the Company also pointed to the recent purchase
3 price paid by Arizona-American in acquiring Citizens' water and wastewater assets as
4 evidence that the fair value of those assets substantially exceeds their original cost. Staff,
5 in contrast, proposed a FVRB based on the average of the OCRB and the RCND rate base
6 for each district because this what the Commission has "traditionally" done.⁶ The RO
7 adopts Staff's position and rejects the Company's position on several different grounds,
8 which are contrary to law and to the evidence presented.

9 First, the ALJ equated the use of the Company's RCND rate base as the FVRB with
10 the recovery of an "acquisition adjustment." RO at 14-15. There is no evidence that the
11 Company's RCND rate base includes any acquisition adjustment.⁷ As shown in the
12 Company's schedules, there is simply no adjustment to any of those rate bases as a result
13 of the acquisition of Citizens' utility plant. *See* Ex. A-24, Rejoinder Schedules B-1 (rate
14 base summary) and B-3 (adjustments to RCRB). *See also* Tr. at 105 ("The [RCRB] does
15 not include an acquisition adjustment It is the company's estimate of the current
16 value of its utility property.") and 123 (same).

17 Nevertheless, the ALJ concluded that the RCND rate bases contain an acquisition
18 adjustment. RO at 15. However, if Citizens had not sold its water and wastewater assets

19
20 ⁶ RUCO and Youngtown ignored the Company's RCND rate bases and, instead, advocated the
21 use of the Company's OCRB to set rates.

22 ⁷ The acquisition adjustment that has been discussed by the parties in this case results from
23 Arizona-American's acquisition of the Citizens' water and wastewater systems, the purchase price
24 of which was approximately \$276,500,000. Ex. A-64 at 10. Under the Uniform System of
25 Accounts, Arizona-American was required to record the difference between (1) the cost (i.e.,
26 purchase price) of Citizens' water and wastewater systems and (2) the original cost of Citizens'
utility plant and property, less any amounts credited at the time of the acquisition to accumulated
depreciation, accumulated amortization and contributions in aid of construction with respect to
such property. *See* Ex. A-86 (Uniform System of Accounts, Balance Sheet Account No. 114).

1 and, instead, had applied for rate adjustments, Citizens' RCND rate bases *would be*
2 *exactly the same* as the Company's RCND rate bases, as testified to by Youngtown's
3 witness, Mr. Burton, during the hearing. Mr. Burton was asked whether it would have
4 been permissible for Citizens to have submitted RCN studies and to have requested a
5 return on an RCND rate base, assuming that no sale had occurred. Mr. Burton agreed that
6 Citizens would have had the right to do so. Tr. at 1279-81. It is inappropriate to prohibit
7 Arizona-American from seeking a return on an RCND rate base simply because there has
8 been a change in ownership, when the prior owner of the districts would have the right to
9 request the same rate-making methodology under the Arizona Constitution.

10 The discussion found on pages 14 and 15 of the RO also confuses the concepts of
11 "cost" and "value." For example, the RO states that the "OCRB methodology is based on
12 current, verifiable and reasonable adjustments to a verifiable, objective record of the *value*
13 of assets" RO at 14-15 (emphasis supplied). However, an "original cost" rate base
14 reflects the *historic cost* to construct the assets, rather than the assets' *current value*.
15 While the historic cost to construct an asset may be "verifiable" and "objective," that cost
16 may have little relation to the asset's value today, which is the crux of the fair value
17 methodology. *E.g., Duquesne Light*, 488 U.S. at 308-09; *Bluefield Waterworks*, 262 U.S.
18 at 690; *US West*, 201 Ariz. 245-56, ¶¶ 13-18, 34 P.3d 354-55.

19 For these reasons, the conclusion that the Company has failed to present a
20 "legitimate basis" for using its RCND rate base as its FVRB is not supported by
21 substantial evidence. Because the principal goal of the fair value method of rate-making is
22 to set rates on the basis of the current value of the property devoted to public service, as
23 opposed to that property's historic cost, averaging the utility's RCRB with its OCRB
24 without a legitimate reason to do so would violate that Arizona Constitution.

25
26 It is well established that values of utility properties fluctuate,
and that owners must bear the decline and are entitled to the

1 increase. The decision of this court in *Smyth v. Ames*
2 . . . declares that to ascertain value 'the present as compared
3 with the original cost of construction' are, among other things,
4 matters for consideration. But this does not mean that the
5 original cost or the present cost or some figure arbitrarily
6 chosen between these two is to be taken as the measure. The
7 weight to be given to such cost figures and other items or
8 classes of evidence is to be determined in the light of the facts
9 of the case in hand.

6 *McCardle v. Indianapolis Water Co.*, 272 U.S. 400, 410 (1926) (quoting *Smyth v. Ames*,
7 169 U.S. 466, 547 (1898)).

8 In this case, Arizona-American presented RCND rate bases for each district and
9 evidence of a recent arms-length transaction involving two independent and sophisticated
10 parties. The evidence shows that the current value of the Company's utility plant exceeds
11 its RCND rate bases and, therefore, that the use of its RCND rate bases as the FVRB is
12 conservative. Conversely, there is no evidence supporting the use of the average of the
13 Company's OCRB and RCND rate bases, other than it is "traditional." Therefore, the
14 Company's RCND rate bases should be used as its FVRB.

15 **C. The ALJ Has Failed to Use the Company's "Fair Value" Rate Base to**
16 **Set Rates, in Violation of the Arizona Constitution.**

17 The RO adopts Staff's recommended rate of return, 6.5%. RO at 31. However,
18 that rate of return is *not* applied to the FVRB for each water and wastewater district.
19 Instead, the ALJ has adopted the so-called "backing-in" method advocated by Staff,
20 RUCO and Youngtown. Under this method, the utility's OCRB and rate of return are first
21 determined. Next, the OCRB is multiplied by the rate of return to determine the utility's
22 operating income. Third, the utility's operating income is divided by its FVRB, to
23 compute what is euphemistically called the "fair value rate of return." Finally, the "fair
24 value rate of return" is multiplied by the FVRB to produce the authorized operating
25 income. The last two steps are meaningless – the utility's operating income is actually
26

1 based on its OCRB.

2 For example, assume that a hypothetical utility's OCRB is \$1 million, its rate of
3 return on rate base is 9.0%, and its FVRB is \$1.5 million. The utility's operating income
4 would be determined, as follows:

5 **Step One – Determine Operating Income**

6	OCRB	1,000,000
7	Rate of Return	<u>x 9%</u>
8	Operating Income	\$ 90,000

9 **Step Two – Compute "Fair Value Rate of Return"**

10		
11	Operating Income	90,000
12	FVRB	<u>÷ 1,500,000</u>
13	"Fair Value Rate of Return"	6%

14 **Step Three – Re-Compute Operating Income**

15	FVRB	1,500,000
16	"Fair Value Rate of Return"	<u>x 6%</u>
17	Operating Income	\$ 90,000

18 Thus, the utility's operating income will always be based on its OCRB as opposed to the
19 fair value of its utility plant. For example, if the hypothetical utility's FVRB were \$1.2
20 million instead of \$1.5 million, the required operating income, \$90,000, would be divided
21 by \$1.2 million to produce a "fair value return" equal to 7.5%. If the utility's FVRB were
22 instead \$900,000, the "fair value rate of return" would be set at 10%. In each case, the
23 utility's authorized operating income, \$90,000, remains unchanged. Consequently, this
24 method renders the fair value of the Company's utility plant meaningless, as well as the
25 Commission's own requirement that a utility submit an RCND rate base. A.A.C. R14-2-
26

1 103(B)(1) and Rate Base Schedules B-1, B-3 and B-4.

2 In this case, each water and wastewater district's OCRB is multiplied by 6.5%,
3 Staff's recommended rate of return, to determine the district's authorized operating
4 income. The district's operating income is then divided by the district's FVRB to produce
5 the "fair value rate of return." The result is that each district has a *different* rate of return
6 on its FVRB, and that return is *less* than the recommended rate of return, 6.5%:

7	<u>District</u>	<u>Rate of Return</u>
8		<u>on Rate Base</u>
9	Sun City Water	4.32%
10	Sun City Wastewater	4.37%
11	Tubac Water	5.12%
12	Havasu Water	5.44%
13	Mohave Water	5.46%
14	Sun City West Wastewater	5.48%
15	Sun City West Water	5.70%
16	Agua Fria Water	6.20%
17	Anthem Water	6.38%
18	Anthem/Agua Fria Wastewater	6.43%
19	Recommended Return	6.5%

20 RO at 33-35. The use of these fluctuating rates of return ensures that the Company's
21 authorized operating income is equal to the operating income produced by using each
22 district's OCRB as its rate base. The recommended rate of return is *never* applied to the
23 fair value of the Company's utility plant and property.

24 The rationale for using this anomalous approach is found on page 32 of the RO.
25 Again, the ALJ simply adopted Staff's argument that this approach "is the approach the
26 Commission has traditionally used." None of the court decisions discussed on page 32

1 actually approves this method. The only decision that actually describes the two-step
2 “backing-in” process is *Litchfield Park Serv. Co. v. Ariz. Corp. Comm’n*, 178 Ariz. 431,
3 434-35, 874 P.2d 988, 991-92 (App. 1994). The description in that case, however, is
4 *dicta*, i.e., general background that has nothing to do with the actual issues presented for
5 review.

6 The RO states that in *Sun City Water Co. v. Ariz. Corp. Comm’n*, 113 Ariz. 464,
7 465, 556 P.2d 1126, 1127 (1976), the Arizona Supreme Court affirmed a Commission
8 decision, stating that “cost of capital estimates must be restated if they are applied to a fair
9 value rate base.” RO at 32. This misstates the holding of that decision in several respects.
10 First, the Court did not discuss the underlying Commission decision. Instead, the issue
11 was the scope of the Court of Appeals’ review of the trial court’s decision. *Id.* at 475, 556
12 P.2d at 1127. Second, none of the issues on appeal concerned the Commission’s use of
13 “backing-in” method. Instead, the issues on appeal were the sufficiency of the rate of
14 return, whether the rates would produce the rate of return, and whether the trial court erred
15 in remanding the Commission’s decision for a new determination of rates. *Id.* Third, in
16 reversing the Court of Appeals, the Supreme Court simply concluded that the trial court’s
17 judgment was supported by “reasonable evidence.” *Id.* Consequently, this decision does
18 not address, let alone support the lawfulness of the “backing-in” method.⁸

19 The remaining decisions cited on page 32 of the RO support the Company’s
20 position. For example, in *Scates v. Ariz. Corp. Comm’n*, 118 Ariz. 531, 533-34, 578 P.2d
21 612, 614-15 (App. 1978), the court explained:

22
23 ⁸ Putting aside the plain language of the Court’s decision, which never mentions how the rate of
24 return is applied to the utility’s rate base, the court of appeals’ subsequent decision in *Ariz. Corp.*
25 *Comm’n v. Citizens Utilities Co.*, 120 Ariz. 184, 584 P.2d 1175 (App. 1978) (review denied),
26 makes it clear that *Sun City Water* is irrelevant. In *Citizens Utilities*, the court explained that its
decision in *Sun City Water* was vacated because “there existed reasonable evidence before the
trial court regarding the Commission’s rate of return.” *Id.* at 188, 584 P.2d at 1179.

1 The general theory of utility regulation is that the total
2 revenue, including income from rates and charges, should be
3 sufficient to meet a utility's operating costs and to give the
4 utility and its stockholders a reasonable rate of return on the
5 utility's investment. . . . To achieve this, ***the Commission must***
6 ***first determine the "fair value" of a utility's property and use***
7 ***this fair value as the utility's rate base.*** . . . The Commission
8 then must determine what the rate of return should be, and
9 then apply that figure to the rate base in order to establish just
10 and reasonable tariffs. [Emphasis supplied; citations omitted.]

11 The *Scates* court relied on *Simms*, quoted above, and *Ariz. Corp. Comm'n v. Arizona*
12 *Public Serv. Co.*, 113 Ariz. 368, 555 P.2d 326 (1976) ("*APS*"). In *APS*, the Arizona
13 Supreme Court stated:

14 Article 15, section 14, [of the Arizona Constitution] requires
15 the Commission to ascertain the fair value of the property
16 within the state, of every public service doing business therein.
17 Under the constitution as interpreted by this court, ***the***
18 ***Commission is required to find the fair value of the***
19 ***company's property and use such finding as a rate base*** for
20 the purpose of determining what are just and reasonable rates.

21 113 Ariz. at 370, 555 P.2d at 328 (emphasis supplied; citing *Simms*).⁹

22 The requirement that the Commission apply the rate of return to the utility's FVRB
23 was emphasized earlier this year in *Phelps Dodge Corp. v. Ariz. Electric Power Coop.*,
24 207 Ariz. 95, 83 P.2d 573 (App. 2004), in which the court stated:

25 In monopolistic markets, "fair value has been the factor by
26 which a reasonable rate of return was multiplied to yield, with
the addition of operating expenses, the total revenue that a
corporation could earn." . . . Although *US West II* held that
this rate-of-return method for rate setting may be inappropriate
in a competitive environment, it affirmed the supreme court's
long-standing view that this method is properly employed in
traditional, non-competitive markets.

⁹ Similarly, in *City of Tucson*, also cited on page 32 of the RO, the court followed *Simms* in holding that the Commission's FVRB was not supported by substantial evidence. 17 Ariz.App. at 480-81, 498 P.2d at 554-55. Again, this decision supports the Company.

1 207 Ariz. at __, ¶ 21, n.8, 83 P.3d at 583, n.8 (quoting *US West*, 201 Ariz. at 245, ¶ 19, 34
2 P.3d at 355). The discussion in the RO conflicts with both *Phelps Dodge* and *US West*.

3 Moreover, the Arizona Supreme Court addressed the “backing in” method
4 employed in the RO, and stated that it is “illegal”:

5 The company contends *the commission . . . first determined*
6 *what the company should be allowed to earn* in order to
7 maintain a sound financial position, attract necessary additions
8 to capital and pay a fair return on common equity; *and second,*
9 *having thus established the amount the company should be*
10 *allowed to earn for such purposes, it proceeded to adjust the*
rate of return to any rate base. If this be true, it would be an
illegal method of establishing a rate base. The standard for
establishing a rate base must be the fair value of the property
and not what the commission might believe was a fair rate of
return on common equity.

11 *Simms*, 80 Ariz. at 155, 294 P.2d at 385 (emphasis supplied). More recently, in *Citizens*
12 *Utilities*, the Arizona Court of Appeals stated that the use of a “fluctuating” rate of return
13 is unlawful:

14 Under our constitution, a utility is entitled to a fair rate of
15 return on the fair value of its properties, “no more and no
16 less.” . . . Dr. Langum [the Staff cost of capital witness]
17 violated this principle by pegging his opinion as to rate of
18 return to the finding of fair value. *This results in a fluctuating*
rate of return. Thus, under Dr. Langum’s theory, it makes no
difference whether the Commission used original cost or
reproduction cost as the base, the amount of dollars in the
Company’s coffers is basically the same.

19 120 Ariz. at 190, n. 5, 584 P.2d at 1181, n. 5 (emphasis supplied; quoting *Ariz. Corp.*
20 *Comm’n v. Arizona Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415(1959)).

21 In short, none of the decisions cited in the RO provides that the Commission may
22 lawfully back into the rate of return on FVRB by applying the rate of return to the OCRB
23 to determine the utility’s operating income. Instead, they provide that the fair value of the
24 utility’s plant and property must be used as its rate base, and that the rate of return must be
25 applied to that rate base. The Commissioners must reject this illegal approach and set
26 Arizona-American’s rates based on the fair value of its utility plant and property.

1 **III. THE RECOMMENDED RATE OF RETURN, 6.5%, IS UNREASONABLY**
2 **LOW AND, IF ADOPTED, WOULD FAIL TO PROVIDE ARIZONA-**
3 **AMERICAN A REASONABLE RETURN ON COMMON EQUITY**
4 **CAPITAL.**

5 **A. Overview of the Parties' Positions.**

6 The RO adopts Staff's recommended rate of return, 6.5%, based on Staff's capital
7 structure, Staff's cost of long-term debt, and Staff's cost of common equity capital. This
8 rate of return is *less* than the current interest rate on investment grade bonds.

9	10-Year Treasury Bond	4.85%
10	20-Year Treasury Bond	5.61%
11	Moody's Aaa Industrial Bonds	6.18%
12	Moody's Baa Industrial Bonds	6.87%

13 Federal Reserve Statistical Release H.15 (May 13, 2004). Although there was some
14 disagreement about the Company's capital structure and its cost of debt, as a practical
15 matter, resolving these disagreements in favor of Staff does not have a material impact on
16 the Company's revenue requirement. The primary area of disagreement is the authorized
17 return on equity.

18 Arizona-American requested a return on equity of 11.5%. RUCO originally
19 recommended a 9.11% return on equity, but increased its recommendation to 9.61% in its
20 surrebuttal filing. Ex. R-5 at 4; Ex. R-6 at 10. Staff originally recommended a 9.7%
21 return on equity, but reduced its recommendation to 9.0% in its surrebuttal filing. Ex. S-
22 45 at 25; Ex. S-46 at 2. All of the parties agreed that it is appropriate to increase the
23 Company's return on equity by 50 basis points to account for the fact that Arizona-
24 American has more debt in its capital structure than the sample group of publicly-traded
25 utilities used in the witnesses' analyses. RO at 23.

26 The RO adopts Staff's 9.0% recommendation. In doing so, the ALJ (1) rejected the

1 equity cost estimates provided by the Company's expert, Dr. Thomas M. Zepp, and
2 accepted Staff's estimates, and (2) ignored the evidence presented by the Company
3 regarding the returns on equity that the comparable utilities are actually earning. *See, e.g.,*
4 Ex. A-49 at 3-4 and Rebuttal Table 1. The ALJ concluded, without authority, that the
5 comparable earnings method "has been replaced by market based corporate finance
6 models." RO at 29.

7 **B. The Legal Standard Applicable to Setting a Utility's Rate of Return.**

8 Over the past 100 years, the United States Supreme Court, as well as various
9 federal and state courts (including Arizona), have held that a regulated utility is entitled to
10 earn a return on equity "commensurate with returns on investments in other enterprises
11 having corresponding risks." *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S.
12 591, 603 (1944). One of the most commonly cited statements of the applicable legal
13 standard is found in *Bluefield Waterworks*:

14 A public utility is entitled to such rates as will permit it to earn
15 a return on the value of the property which it employs for the
16 convenience of the public equal to that generally being made
17 at the same time and in the same part of the country on
18 investments and other business undertakings which are
19 attended by corresponding risks and uncertainties; but it has no
20 constitutional right to profits such as are realized or anticipated
21 in highly profitable enterprises or speculative ventures. The
22 return should be reasonably sufficient to ensure confidence in
23 the financial soundness of the utility and should be adequate
24 under efficient and economical management, to maintain and
25 support its credit and enable it to raise the money necessary for
26 the proper discharge of its public duties.

21 262 U.S. at 692-93. The criteria set forth in *Bluefield Waterworks* remain applicable
22 today. *See, e.g., Duquesne Light*, 488 U.S. at 314-15 (citing *Bluefield Waterworks*, 262
23 U.S. at 692-93)); *Sun City Water*, 26 Ariz. App. 304, 306, 547 P.2d 1104, 1109 (quoting
24 *Bluefield Waterworks*), *vacated on other grounds* 113 Ariz. 464, 556 P.2d 1126 (1976);
25 W. Whittaker, "The Discounted Cash Flow Methodology: Its Use In Estimating A
26

1 Utility's Cost of Equity," 12 *Energy Law Journal* 265 (1991) ("Under the *Bluefield-Hope*
2 standard, the equity return must enable the utility to (1) attract additional capital on
3 reasonable terms (the capital attraction standard); and (2) realize a return on equity
4 commensurate with the returns earned by enterprises with comparable risks (the
5 comparable earnings standard).").

6 **C. The ALJ's Rejection of the Company's Evidence on Cost of Equity,**
7 **Including the Actual Earnings of the Comparable Utilities, is Arbitrary**
8 **and Unreasonable.**

9 It would seem axiomatic that in analyzing the returns on equity earned by a group
10 of publicly traded companies under the comparable earnings standard, the starting point is
11 what those companies are actually earning. In fact, that is what this Commission has
12 traditionally done.* For example, in *Litchfield Park*, the Commission Staff used
13 comparable earnings, along with the Discounted Cash Flow ("DCF") model and an
14 analysis of firm-specific risks, to develop its recommended rate of return. 178 Ariz. at
15 436-37, 874 P.2d at 993-94. See also *Citizens Utilities*, 120 Ariz. at 190-91, 584 P.2d at
16 1181-82 (describing comparative earnings methodology used by Staff's witness); *Sun City*
17 *Water Co. v. Ariz. Corp. Comm'n*, 26 Ariz. App. at 309-10, 547 P.2d at 1109-10 (the
18 Commission "must appraise the equity earnings of other utilities and non-regulated
19 companies and use this appraisal in setting the allowed rate of return on the equity
20 component in the cost of capital").

21 Staff's proxy group have earned the following returns on equity:

	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
American States	9.3%	10.1%	9.5%	5.6%
California Water	10.1%	7.2%	9.5%	7.9%
Philadelphia Suburban ¹⁰	11.7%	12.4%	12.7%	12.3%

22
23
24
25
26 ¹⁰ Earlier this year, Philadelphia Suburban Corporation's name was changed to Aqua America.
(footnote continued on next page)

1	Connecticut Water	12.1%	12.1%	10.9%	11.2%
2	Middlesex Water	7.1%	9.1%	9.6%	8.2%
3	SJW Corp.	7.4%	9.4%	9.3%	9.8%
4	Average Actual ROE	9.6%	10.1%	10.3%	9.2%

6 Ex. A-83; *C.A. Turner Utility Reports*, May, 2004 (copy attached at Tab A). The water
7 utilities currently reporting the lowest equity returns, American States Water and
8 California Water Service, received substantial rate increases during the past nine months,
9 which will result in increased earnings. *See In the Matter of the Application of Southern*
10 *California Water Company*, Decision No. 0403039 (March 16, 2004) 62-73.¹¹ The
11 California Public Utilities Commission (“CPUC”) granted American States rate increases
12 of \$8 million in the year 2003 as well as additional increases of \$1.9 million in 2004 and
13 \$2.8 million in 2005. The CPUC granted California Water Service rate increases of \$12.8
14 million in 2003, and additional increases of \$2.2 million in 2004 and in 2005. In
15 approving these increases, American States was authorized a 9.9% return on equity, while
16 California Water Service was authorized a 9.7% return on equity. In other recent rate
17 decisions issued by the CPUC, Suburban Water Systems was authorized a 9.84% return on
18 equity for 2003-2005, and California-American Water Company was authorized a 10.25%
19 return on equity for the same period. *Id.* at 73, n. 44.¹²

20 (footnote continued from previous page)

21 To be consistent with the record, the Company will continue to refer to that water utility as
22 Philadelphia Suburban.

23 ¹¹ Southern California Water Company is American States’ primary utility subsidiary. *See* Ex. A-
24 83.

25 ¹² While criticizing the comparable earnings method, RUCO ultimately acknowledged that recent
26 authorized equity returns are relevant by citing in its post-hearing reply brief a decision issued in
January 2004 by the West Virginia Public Utilities Commission, in which a 7.0% return on equity
was authorized for West Virginia-American Water. RO at 28. That decision, which is on appeal,
(footnote continued on next page)

1 The foregoing equity returns are significantly higher than the results produced by
2 the versions of the finance models used by Staff and RUCO:

3 Staff Cost of Equity Estimates

4	DCF (Constant Growth)	8.4%
5	DCF (Multi-Stage)	9.6%
6	CAPM (Historic Risk Premium)	8.0%
7	CAPM (Current Risk Premium)	8.1%
8	Staff Average ROE	8.5%

9
10 RUCO Cost of Equity Estimates

11	DCF (Constant Growth)	9.11%
12	CAPM (Geometric Mean)	6.79%
13	CAPM (Arithmetic Mean)	8.06%
14	RUCO Average ROE	7.99%

15 Ex. S-46, Schedule JMR-S7; Ex. R-5, Schedules WAR-3 and WAR-8.¹³

16 Obviously, something is wrong with the finance models used by Staff and RUCO
17 when those models consistently produce returns below the returns the sample group of
18 water utilities is actually earning and is authorized to earn. Neither Staff nor RUCO's cost
19 of capital witness offered any credible explanation for this result. In fact, during the

20 _____
21 (footnote continued from previous page)

22 is an outlier. As shown in the schedule attached at Tab B, since 2002, the equity returns
23 authorized for other American Water Works utility subsidiaries by other public utility
24 commissions have averaged 10.17%.

25 ¹³ To RUCO's credit, its final recommendation, 9.61%, is based on its DCF model estimate
26 (9.11% plus 50 basis points for leverage). RUCO appropriately disregarded the obviously low
results produced by the CAPM. See Ex. R-5 at 7. Staff, in contrast, simply averaged the results
of its CAPM to lower the rate of return.

1 pendency of this rate proceeding, Staff's recommended cost of equity dropped from 9.7%
2 to 9.0% within a period of less than 60 days. *Compare* Ex. S-45 at 25 (filed Sept. 5, 2003)
3 *with* S-46 at 2 (filed Oct. 31, 2003). This drop in Staff's recommended equity return is
4 especially puzzling in a period in which interest rates were increasing from historic lows.
5 Ex. A-50 at 14, 23-26 and Rejoinder Table 6. This casts additional doubt on the validity
6 of Staff's methods.

7 It is also telling that the results produced by Staff's finance models are less than
8 recent returns authorized by the CPUC for American States, California Water Service and
9 California-American Water. California uses projected test years and various forward-
10 looking regulatory mechanisms that reduce business and regulatory risk, such as balancing
11 accounts for purchased water and purchased power and memorandum accounts for
12 significant expenses and capital costs, and allows construction work in progress to be
13 included in rate base. For this reason, authorized returns in California have generally been
14 *lower* than authorized returns in Arizona, which uses an historic test year and generally
15 does not allow the recovery of expenses outside of a general rate case. *See, e.g., In the*
16 *Matter of the Application of Arizona Water Company*, Decision No. 66849 (March 22,
17 2004) at 13-14 (adopting Staff's recommendation that the utility's purchased water and
18 purchased power adjustment mechanisms be discontinued). In short, even though Arizona
19 uses an historic test year and disfavors forward-looking cost recovery techniques, recent
20 returns on equity approved by this Commission are less than the returns approved in
21 California and other jurisdictions that employ more progressive regulatory techniques.¹⁴

22
23 ¹⁴ Arizona Water, for example, was authorized a return on equity of 9.2% in Decision No. 66849
24 last March as compared to the 9.9% return authorized that same month for Southern California
25 Water Company. Arizona Water's capital structure contains only 32% debt, while Arizona-
26 American's capital structure contains 60% debt. Using Staff's recommended equity return for
Arizona Water and adding 50 basis points for Arizona-American's leverage produces a return on
equity of 9.7% in this case, which is still below the returns authorized in California.

1 In contrast, the versions of the finance models used by Arizona-American's expert,
 2 Dr. Thomas Zepp, do produce results consistent with actual and authorized returns on
 3 equity. Dr. Zepp's updated estimates, presented in his Rebuttal Testimony, are:

4 Dr. Zepp Cost of Equity Estimates

5 DCF (Water Companies)	10.5%
6 Risk Premium (Past Water Utilities' ROEs)	11.0 – 11.2%
7 Risk Premium (Natural Gas Utilities' ROEs)	10.4 – 10.7%
8 Risk Premium (Moody's Gas Stock Index)	10.3 – 10.9%
9 Average	10.5 – 10.8%

10 Ex. A-49 at 5-6 and Update Table 24. The average of Dr. Zepp's estimates, 10.5% to
 11 10.8%, are consistent with actual and authorized returns for Staff's water utility sample
 12 group, set forth above.¹⁵

13 Dr. Zepp also restated the equity cost estimates made by Staff and RUCO, using the
 14 same finance models but with more reasonable assumptions. The cost of equity produced
 15 by these restatements is, again, consistent with the actual returns:

	<u>Equity Costs For Water Utility Sample</u>	<u>Equity Cost for Arizona-American</u>
18 DCF Estimates		
19 Staff	9.8% to 10.1%	10.3% to 10.6%
20 RUCO	10.1% to 10.9%	10.6% to 11.4%
21 CAPM Estimates		
22 Staff	9.9% to 10.1%	10.4% to 10.6%
23 RUCO	9.8%	10.3%

24
 25 ¹⁵ These equity cost estimates do not include the additional 50 basis points that, as discussed
 26 above, the Company, Staff and RUCO have agreed should be added to reflect the additional debt
 in the Company's capital structure.

1 Estimated Equity Cost Range
2 for Arizona-American

10.3% to 11.4%

3 Ex. A-50 at 10-14 and Rejoinder Table 14.

4 Finally, as noted above, during the pendency of this case, interest rates have
5 continued to increase. Despite acknowledging that at the time his direct testimony was
6 prepared interest rates were at their lowest level since the 1950s (Ex. S-45 at 5), the Staff
7 witness strongly criticized Dr. Zepp for using forecasted interest rates in implementing the
8 Risk Premium and CAPM models, both of which rely heavily on interest rates. *E.g.*, Ex.
9 S-46 at 17 (“the Commission should not rely on a forecasted interest rate that was likely
10 predicted with no more accuracy than that of a coin toss”). It turns out, however, that the
11 interest rate forecasts used by Dr. Zepp are somewhat conservative:

	<u>Reiker Direct May 6, 2003</u>	<u>Reiker Surrebuttal Sept. 25, 2003</u>	<u>Forecasted Interest Rates Used by Zepp</u>	<u>Current Interest Rates May 13, 2004</u>
14 5-Year Treasury Note	2.74%	3.05%	3.7%	4.01%
15 7-Year Treasury Note	3.38%	3.59%	N/A	4.46%
17 10-Year Treasury Note	3.80%	4.12%	4.6%	4.85%
18 Average	3.3%	3.6%	4.2%	4.4%

19 Ex. S-45 at 23 n. 11; Ex. A-50 at 24-26 and Rejoinder Table 6; Federal Reserve Statistical
20 Release H.15 (May 13, 2004). The ALJ nevertheless accepted Staff’s argument that Dr.
21 Zepp’s use of forecasted interest rates is suspect, and rejected his Risk Premium estimates
22 in favor of Staff’s outdated “spot” interest rates, which do not reflect current capital costs.
23 RO at 29-30.

24 In short, there is no disagreement that the methods used by the cost of capital
25 witnesses for the Company, Staff and RUCO – the DCF model, the Risk Premium model,
26

1 and the CAPM model – are all recognized methods of estimating the cost of equity. *E.g.*,
2 Roger A. Morin, *Regulatory Finance: Utilities Cost of Capital* 28 (1994) (“There are four
3 generic methodologies available to measure the cost of equity: DCF, Risk Premium, and
4 CAPM, which are market-oriented, and Comparable Earnings, which is accounting
5 oriented.”). *See also* Charles F. Phillips, Jr., *The Regulation of Public Utilities*, 394-99
6 (discussion of approaches commonly used to estimate the cost of equity). There is
7 considerable disagreement, however, regarding how these methodologies should be
8 employed. Regardless of the method used, however, it should produce results that are
9 consistent with reality. Here, the ALJ has rejected the Company’s cost of equity
10 estimates, and concluded that “the methodology and variables used by Staff,” such as
11 Staff’s September 25, 2003 spot interest rates in the table above, are “reliable and
12 reasonable.” RO at 31. The data presented by the Company on the actual returns of the
13 water utilities used as proxies for Arizona-American, which conflict with the results of
14 Staff’s models, is summarily rejected. This is arbitrary and unreasonable, and results in an
15 overall rate of return that is less than the current yield on an investment grade bond.

16 **IV. THE AMOUNT OF RATE CASE EXPENSE RECOMMENDED IN THE RO**
17 **IS UNREASONABLE.**

18 This has been a lengthy, complicated and difficult rate proceeding, and Arizona-
19 American has been required to devote extensive resources in its prosecution. At the end
20 of some 18 months, there will have been five applications concerning 115,000 customers,
21 10 parties, hundreds of data requests, five rounds of prefiled testimony, 9 days of hearings,
22 over 100 hundred marked exhibits, over 1,000 pages of hearing transcripts, two rounds of
23 post-hearing briefs, written exceptions and an Open Meeting before the Commissioners.
24 *See* Tr at 799-802. As a consequence, the Company’s witnesses testified that as of
25 November 2003 (i.e., prior to the hearing) its total rate case expense for this proceeding
26 exceeded \$1 million, and that total rate case expense would likely be between \$1.3 million

1 and \$1.4 million. RO at 18. Nevertheless, the Company requested recovery of only
2 \$715,000 in rate case expense, amortized over three years. RO at 18. As explained by
3 Company witness David Stephenson, Arizona-American recognizes that some of its rate
4 case expense needs to be absorbed by the Company. Tr. at 488.

5 Staff supported the Company's requested recovery of rate case expense and
6 included an amortized portion of the \$715,000 in its recommendations. Exs. S-15 through
7 S-24. However, RUCO opposed the Company's request.¹⁶ RUCO recommended that the
8 Company be allowed to recover \$418,941 in rate case expense, which amount is based on
9 the amount that Citizens was allowed to recover in its last rate proceeding in 1997
10 covering only the Maricopa County systems, adjusted for inflation.

11 The RO adopts RUCO's recommended rate case expense, concluding that "the
12 Company chose the test year" and that "ratepayers should not be made to bear the burden
13 of the Company's choices to incur unreasonable increase in expenses." RO at 20. It is
14 unclear what increased expenses the RO refers to, and there is no evidence that the choice
15 of test year had a material impact on the level of rate case expense incurred or sought by
16 the Company. Moreover, in adopting RUCO's position, the ALJ again largely ignored the
17 evidence presented by the Company.

18 First, the ALJ's conclusion that the selection of 2001 as the test year supports
19 lower rate case expense recovery is erroneous. Although RUCO made that argument,
20 claiming that use of a 2001 test year resulted in a substantial amount of additional and
21 unnecessary rate case expense, it failed to produce evidence to support its claim. The
22 evidence before the Commission irrefutably shows that the bulk of the activities

23
24 ¹⁶ The RO states that "only the Company disputed RUCO's proposal" concerning rate case
25 expense, which is misleading. RO at 19. In fact, no other party supported RUCO's punitive
26 amount of rate case expense, and no other party used RUCO's amount of rate case expense in its
recommendations. Instead, the other parties used the Company's requested expense amount.

1 associated with the rate case would have been precisely the same if the Company had
2 delayed its filing. *E.g.*, Tr. at 136-38, 1532-44; Ex. A-102. The most labor-intensive
3 aspect of this case related to the development of plant-in-service and rate base schedules,
4 in accordance with A.A.C. R14-2-103, the Commission's rule governing applications for
5 rate increases. Nearly 80% of the data requests served on the Company pertain to plant-
6 in-service issues. The use of a later test year would not have simplified or eliminated
7 issues relating to plant. Instead, those issues would have been exacerbated by further
8 delay because, as the RO states on page 18, plant records and other historic data were held
9 by another company, Citizens, which no longer existed and no longer had any employees.
10 Tr. at 1537-38, 1540-41. Obviously, it would have been more difficult to access and
11 utilize those records if the Company had, for example, filed its rate applications in 2003,
12 utilizing 2002 as the test year.

13 The only issue that resulted from the selection of a 2001 test year was the dispute
14 over the Company's proposed pro forma adjustment to remove Citizens' test year
15 overheads and salaries and bring in the Company's overheads and salaries, an adjustment
16 supported by RUCO and adopted in the RO. *See* RO at 16-18. However, the amount of
17 additional expense associated with that adjustment is only a small part of the total rate
18 case expense that the Company will incur. *See* Ex. A-102. Ultimately, the amount of rate
19 case expense is a product of the size and complexity of the applications, which would not
20 have been reduced by simply choosing a different test year.

21 Second, RUCO's recommended rate case expense of \$418,941 is unreasonable
22 when compared to other rate proceedings. Citizens' 1995 rate proceeding, the basis for
23 RUCO's recommendation, involved fewer districts, and fewer customers. Tr. at 812. In
24 addition, Citizens employed specific individuals that were assigned the task of prosecuting
25 rate applications, and those expenses were included in the management fees charged to the
26 districts and recovered in rates. Ex. A-74 at 23-24. This is not the case for Arizona-

1 American, something RUCO ignored in its analysis. In fact, the only factor RUCO
2 considered in utilizing the 1995 proceeding was the inflation rate. Tr. at 812. This is
3 simplistic at best.

4 By contrast, in Citizens' 1990 rate proceeding for its Mohave water and wastewater
5 districts, the Commission authorized rate case expense of \$165,000. See Ex. S-4,
6 Decision No. 56806 (February 1, 1990) at 10-11. Had RUCO used that prior Citizens'
7 rate case, and made adjustments for inflation and for the greater number of districts
8 involved in this case (10 districts versus two districts and five applications versus one
9 application), the amount of rate case expense would be far greater than the amount the
10 Company is now requesting. Tr. at 1598. Simply multiplying rate case expense of
11 \$165,000, authorized for only two districts, by five results in rate expense of \$825,000 –
12 with no adjustment for inflation.

13 The same is true if the Company's 1996 rate application for the Paradise Valley
14 water district (formerly Paradise Valley Water Company) is used as a comparison. In that
15 case, the Company filed a single application involving one water system with
16 approximately 4,400 customers. Decision No. 60226 (May 27, 1997). The issue of rate
17 case expense was contested, with the Company seeking and the Commission approving
18 \$62,200 in rate case expense amortized over two years. *Id.* at 12-13. Adjusting that
19 expense amount for the larger number of districts (10 districts versus one district in that
20 case), and taking into account inflation since 1996 when the application was filed, further
21 illustrates that the amount of rate case expense requested by the Company is reasonable.

22 Finally, in this proceeding, the Town of Youngtown, which intervened to address a
23 narrow range of issues affecting only the Sun City water and wastewater districts, incurred
24 approximately \$70,000 on consultants' fees alone. If legal fees are also included,
25 Youngtown's expenses will be approximately equal to \$100,000. Tr. at 1255-57.
26 Certainly, it should come as no surprise that Arizona-American's rate case expense would

1 be at least seven times the amount Youngtown incurred in connection with its
2 intervention, which related to only two districts and a limited number of issues.

3 Despite this compelling evidence, the RO would adopt RUCO's argument with
4 little discussion or analysis. The RO implies that the Company failed to "mitigate the
5 costs" associated with retaining outside counsel and consultants to present the Company's
6 case. RO at 20. Again, there is no evidence to support this conclusion. Moreover, to the
7 extent it were true, it is obvious that the Company has mitigated its costs by requesting
8 \$715,000 as opposed to its actual rate case expense, which exceeds \$1 million. In short,
9 the ALJ's decision to recommend rate case expense in the amount of \$418,941, roughly
10 one-third of the amount the Company will actually incur, or approximately \$40,000 per
11 district, is contrary to the overwhelming weight of evidence and unreasonable given the
12 size and complexity of this proceeding. Therefore, the Company's requested amount of
13 rate case expense should be approved.

14 RESPECTFULLY SUBMITTED this 17th day of May, 2004.

15 FENNEMORE CRAIG

16
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20 ORIGINAL and 21 copies
21 of the foregoing were
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of May, 2004, to:

22 Docket Control
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24 Phoenix, AZ 85007

25 COPY of the foregoing was
delivered this 17th day of
26 May, 2004 to:

- 1 Chairman Marc Spitzer
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- 4 Phoenix, AZ 85007

- 5 Commissioner William Mundell
- 6 Arizona Corporation Commission
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- 9 Commissioner Mike Gleason
- 10 Arizona Corporation Commission
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- 13 Commissioner Jeff Hatch-Miller
- 14 Arizona Corporation Commission
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- 17 Commissioner Kristin Mayes
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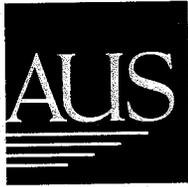
A

ARIZONA-AMERICAN WATER COMPANY

Requested and Approved Returns on Equity
In Recent Rate Cases of Affiliates

<u>Name of Affiliate</u>	<u>Effective Date of Order</u>	<u>Requested ROE</u>	<u>Approved ROE</u>
California-American (Monterey)	Feb. 23, 2003	10.68%	10.26%
ETown Water Company (N.J.)	Feb. 18, 2004	11.25%	9.75%
Hawaii-American Water Company	Apr. 22, 2004	10.90%	10.60%
Illinois-American Water Company	Aug. 12, 2003	11.02%	10.27%
Indiana-American Water Company	Nov. 6, 2002	11.50%	10.50%
Iowa-American Water Company	Feb. 21, 2002	11.33%	10.45%
Missouri-American Water Company	April 16, 2004	11.00%	10.00%
New Jersey-American Water Company	Feb. 18, 2004	11.25%	9.75%
New Mexico-American Water Company	Dec. 12, 2003	11.15%	10.08%
Ohio-American Water Company	Feb. 7, 2002	11.75%	10.30%
Pennsylvania-American Water Company	Jan. 16, 2004	12.00%	10.60%
Tennessee-American Water Company	Aug. 7, 2003	11.00%	9.90%
Virginia-American Water Company	Nov 23, 2003	10.75%	<u>9.80%</u>
Average ROE Approved			10.17%
West Virginia-American Water Company	Jan. 2, 2004	11.00%	7.00%

B



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FENNEMORE CRAIG

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WATER

COMPANY	PER SHARE	
	LATEST 12 MONTHS EARNINGS AVAILABLE	CURRENT ANNUAL DIVIDEND
American States Water Co. (NYSE-AWR)	12/03 0.78	0.88
Aqua America, Inc. (NYSE-WTR)	12/03 0.79	0.48
Artesian Resources Corp. (NDQ-ARTNA)	12/03 0.97	0.81
California Water Service Group (NYSE-CWT)	12/03 1.23	1.13
Connecticut Water Service, Inc. (NDQ-CTWS)	12/03 1.15	0.83
Middlesex Water Company (NDQ-MSEX)	12/03 0.61	0.66
Pennichuck Corporation (NDQ-PNNW)	12/03 0.52	0.86
SJW Corporation (ASE-SJW)	12/03 1.71	1.02
Southwest Water Company (NDQ-SWWC)	12/03 0.49	0.19
York Water Company (NDQ-YORW)	12/03 0.70	0.58
AVERAGE		

COMPANIES

BOOK VALUE (1)	STOCK PRICE 4/22	COMMON SHARES O/S MILL	PERCENT (2)			DIV/ BOOK (2)	PRICE EARN MULT
			DIV PAYOUT	DIV YIELD	MKT/ BOOK		
13.98	24.39	15.2	13	3.6	174	6.3	31.1
7.13	21.00	92.4	61	2.3	294	6.7	26.5
13.53	27.90	3.9	84	2.9	206	6.0	28.8
14.44	29.75	16.9	91	3.8	206	7.8	24.1
10.47	27.74	8.0	72	3.0	265	7.9	24.1
7.54	21.20	10.6	108	3.1	281	8.8	34.8
12.59	26.65	2.4	65	3.2	212	6.8	51.3
18.21	37.09	9.1	60	2.8	204	5.6	21.6
5.43	13.73	14.7	39	1.4	233	3.5	28.0
6.08	20.38	6.4	83	2.8	335	9.5	29.1
			88	2.9	243	6.9	29.9

WATER

COMPANY	OPER REV \$ MILL	% WAT REV	NET PLANT \$ MILL	NET PLANT REV (1)
American States Water Co. (NYSE-AWR)	212.7	88	538.0	2.53
Aqua America, Inc. (NYSE-WTR)	367.2	92	1,620.8	4.41
Artesian Resources Corp. (NDQ-ARTNA)	36.3	97	157.5	4.34
California Water Service Group (NYSE-CWT)	277.1	97	669.0	2.41
Connecticut Water Service, Inc. (NDQ-CTWS)	51.1	92	194.6	3.81
Middlesex Water Company (NDQ-MSEX)	64.1	87	210.8	3.29
Pennichuck Corporation (NDQ-PNNW)	21.4	87	63.8	2.98
SJW Corporation (ASE-SJW)	149.7	98	267.6	1.79
Southwest Water Company (NDQ-SWWC)	173.0	33	138.0	0.80
York Water Company (NDQ-YORW)	20.9	87	103.0	4.93
AVERAGE				

COMPANIES

S&P BOND RATING	MOODY'S BOND RATING	COMMON EQUITY RATIO (3)	% RETURN ON BOOK VALUE		REGULATION	
			COMMON EQUITY (4)	TOTAL CAPITAL	ALLOWED ROE	ORDER DATE
A+	A2	43	5.6	6.0	10.00	4Q/99
AA-	NR	44	12.3	8.4	10.15	-
NR	NR	37	7.4	6.7	10.50	04/03
NR	A2	46	8.7	7.5	9.70	-
A	NR	52	11.2	8.9	12.70	-
A+	NR	41	8.2	6.2	10.38	-
NR	NR	51	4.1	5.5	10.33	-
NR	NR	54	9.8	8.1	9.95	04/01
NR	NR	51	10.2	7.8	9.84	05/03
NR	NR	50	11.7	9.5	-	06/03
		47	8.9	7.5	10.39	-