Arizona Utility Investors Association

2100 N. Central, Ste. 210
P.O. Box 34805
Phoenix, AZ 85067

Tel: (602) 257-9200
Fax: (602) 254-4300

Email: info@auia.org
Web Site: www.auia.org

ORIGINAL OPEN MEETING AGENDA ITEM

0000004737

EXCEPTION

BEFORE THE ARIZONA CORPORATIOI

Marc Spitzer
Chairman
William A. Mundell
Commissioner
Mike Gleason
Commissioner
Jeff Hatch-Miller
Commissioner
Kris Mayes
Commissioner

Arizona Corporation Commission
DOCKETED
MAY 17 2004
DOCKETED BY

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., 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 SUN CITY WEST WATER AND WASTE WATER DISTRICTS.	DOCKET NO. WS-01303A-02-0867
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., 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 SUN CITY WATER AND WASTE WATER DISTRICTS.	DOCKET NO. W-01303A-02-0868
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., 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 WATER DISTRICT AND ITS HAVASU WATER DISTRICT.	DOCKET NO. W-01303A-02-0869
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., 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 ANTHEM WATER DISTRICT, ITS AGUA FRIA WATER DISTRICT AND ITS ANTHEM/AGUA FRIA WASTE WATER DISTRICT.	DOCKET NO. WS-01303A-02-0870

RECEIVED
2004 MAY 17 P 3:48
AZ CORP COMMISSION
DOCUMENT CONTROL

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., 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 ANTHEM WATER DISTRICT, ITS AGUA FRIA WATER DISTRICT AND ITS ANTHEM/AGUA FRIA WASTE WATER DISTRICT.	DOCKET NO. W-01303A-02-0908

AUIA'S EXCEPTIONS TO THE RECOMMENDED OPINION AND ORDER

The ARIZONA UTILITY INVESTORS ASSOCIATION (AUIA) hereby submits its exceptions to the Recommended Opinion and Order (ROO) filed in this proceeding on April 26, 2004 by Administrative Law Judge Teena Wolfe.

Introduction

Regrettably, this case encapsulates fully the Little Shop of Horrors that ratemaking in Arizona has become.

While some jurisdictions use a forward-looking test year, Arizona insists on looking backward to a historical test year, which assures, among other things, that regulatory lag will erode earnings before the ink is dry on the Commission's order.

Some commissions allow tracking mechanisms to equalize weather abnormalities and/or volumetric deviations, but in Arizona, utilities live or die by historical norms.

In some jurisdictions, the rate base can be trended or modified to reflect market conditions, but Arizona brooks no departures from original cost less depreciation (OCLD). Any representation that Arizona uses a blended fair value rate base is pure fiction.

Currently, Arizona is committed to a method of determining cost of capital that produces equity returns that are nowhere near actual market returns or the returns authorized in other jurisdictions. In other words, an Arizona utility has no hope of earning returns that are comparable to the rest of its industry.

These positions form the Staff's ratemaking mantra and the recommended order in this case adopts the Staff position in virtually every respect but one. The Administrative Law Judge did throw the company a significant bone and for that, we are grateful. The ALJ agreed with the company that its test year operating expenses should be adjusted to reflect the fact that Citizens Communications cut costs to the bone during the test year, while the sale to American Water was pending.

Incredibly, Staff insisted that the company should be required to accept fictional expenses for ratemaking purposes, but then, it has become holy writ for the Staff that if there is a choice to be made, it will militate against the utility's ability to earn profits.

<u>The Commission should adopt a real fair value rate base.</u>

The Arizona Supreme Court, in *Simms v. Round Valley Light & Power Co.*, declared that the state constitution requires the Commission to consider the value of a utility's property "at the time of the inquiry." 80 Ariz. 145, 151, 294 P2nd 378, 382 (1956). In other words, the utility's rate base should reflect the current value of the property that is devoted to public service, not some historic or book value.

Commission Staff has a slavish devotion to original cost less depreciation (OCLD), which does not come close to the standard enunciated in *Simms*. OCLD is an accounting fiction that bears no relationship to the real value of the company's property.

The company and AUIA argued at hearing that the *Simms* requirement can be satisfied by determining the reproduction cost new less depreciation (RCND) rate base and applying the approved rate of return. Both the company and AUIA argued that the purchase price of the Citizens properties provides <u>support</u> for the use of RCND, but there is no attempt here to recover the premium paid by American Water.

The Staff implicitly recognized the fallacy of OCLD because it engaged in an RCND calculation, which closely approximated the company's adjusted RCND figure of $136.2 million. Next, the Staff indulged in the charade of averaging the RCND rate base with the OCLD rate base of $91.7 million to produce a so-called Fair Value Rate Base (FVRB) of $113.6 million.

But what is the impact of the FVRB? Nothing. Zero. Nada. Because Staff then alters the calculations to produce the same revenue requirement that results from applying the recommended rate of return to OCLD. In other words, Staff never departs from the OCLD as its real fair value rate base. (See Exh. S-47, P. 7, L. 6-9; see also Tr. P. 1501, L. 19 – P. 1502, L. 24; and see Exh. A-75, P. 20, L. 17-20)

The recommended order sanctions this sleight-of-hand. (See P. 16, L. 2-14) The Commission should reject this finding and adopt a straightforward procedure in which a) it authorizes a fair value rate base that is more reflective of the real value of the company's property that is devoted to public service and b) the revenue requirement is determined by applying the separately determined rate of return to that rate base.

The Commission should authorize a competitive rate of return.

Dueling economists dominated this portion of the case, but the losers in the recommended order are the company's investors.

Staff's cost of capital witness, Joel Reiker, recommended an allowed cost of equity (COE) of 9.0%. It is safe to say that if this company were publicly traded, that recommendation would have generated the same expressions of horror from analysts and rating agencies that greeted a similar Staff recommendation in the pending Arizona Public Service Co. rate case.

Mr. Reiker's conclusion flowed from his development of two discounted cash flow (DCF) models and a capital asset pricing model (CAPM), which he applied to sample groups of publicly held water and gas utilities. He averaged the DCF and CAPM findings to arrive at his COE recommendation.

The DCF result of 9.0%, averaged with the CAPM result of 8.1%, produced a proposed COE of 8.5%. To that, Mr. Reiker added 50 basis points to account for the company's highly leveraged finances.

AUIA questions whether Mr. Reiker had some qualms about the results of his CAPM analysis; he personally favors CAPM over DCF but chose to average them. Although we would be reluctant to relinquish the largesse of 50 basis points due to averaging, we are nevertheless constrained to suggest that combining two models with completely different inputs is an exercise in statistical gibberish.

The company's cost of capital witness, Dr. Thomas Zepp, developed his own DCF and risk premium calculations, which produced a recommended COE range of

10.5% to 11.7%. Obviously, Mr. Reiker and Dr. Zepp differed substantially in the inputs to their models. Suffice it to say that the ALJ sided with the Staff's judgment in virtually every instance.

At the low end of Dr. Zepp's range, the difference between his COE estimate and Mr. Reiker's is 150 basis points, reflecting a difference in the revenue requirement of about $900,000 after taxes. According to the company's lead witness, David Stephenson, that could be the difference between some minimal earnings and none at all. (See Exh. A-74, P. 32,L. 2-7)

How far is Mr. Reiker's recommendation from real world results? When Dr. Zepp examined a 7-year history of the sample companies Mr. Reiker used in his analysis, he found this (See Exh. A-49. Tab B, Table 1):

- The average <u>authorized</u> return on equity (ROE) for those companies was 10.93%, or 193 basis points above Mr. Reiker's recommended COE.
- The <u>actual</u> ROE earned by those companies was 10.35%, or 135 basis points above Mr. Reiker's recommended COE.
- The average ROE forecasted by *Value Line* for those companies was 11.0%, or 200 basis points above Mr. Reiker's recommended COE.

Regardless of the intricacies involved in developing cost-of-equity models, the Commission must ask whether it can continue to support Staff COE recommendations that are conspicuously below market results. In this case, the Commission should add between 125 and 150 basis points to the Staff COE recommendation.

<u>Conclusion</u>

AUIA believes fervently that the Arizona Constitution and a panoply of court precedents require the Commission to strike a fair balance between the consumers' desire for low rates and the ability of the utilities to earn reasonable returns. Furthermore, an expanding state economy depends on reliable infrastructure and a healthy investment climate.

The Commission cannot continue to follow the Staff's lead in suppressing the ability to earn, or Arizona will regain its reputation of the 1980s and early 1990s as the worst place in America to invest in regulated enterprises. Furthermore, corporate managers in Arizona will face serious competition for investment resources from other jurisdictions where significantly higher returns are available.

This case would be a good place to begin the journey toward a more balanced approach.

Respectfully submitted, this 17th day of May, 2004.

Walter W. Meek

Walter W. Meek, President

CERTIFICATE OF SERVICE

An original and 13 copies of the referenced testimony filed this 17th day of May, 2004, with:

Docket Control
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Copies of the referenced testimony hand delivered this 17th day of May, 2004, to:

Christopher Kempley, Esq., Legal Division
Teena Wolfe, Esq., Hearing Division
Ernest Johnson, Esq., Utilities Division

A copy of the referenced testimony was mailed this 17th day of May, 2004, to:

Norman D. James
Fennemore Craig
3003 N. Central Ave., Suite 2600
Phoenix, AZ 85012

Carlton G. Young
3203 W. Steinbeck Drive
Anthem, AZ 85068-1540

Raymond E. Dare
Sun City Taxpayers Association
12611 N. 103rd Ave., Suite D
Sun City, AZ 85351-3467

Kenneth C. Sundlof, Jr.
Jennings Strouss & Salmon
201 E. Washington St., 11th Floor
Phoenix, AZ, 85004-2385

Daniel Pozefsky
RUCO
1110 W. Washington
Phoenix, AZ 85007

Frank J. Grimmelmann
42441 N. Cross Timbers Court
Anthem, AZ 85086

William P. Sullivan
Martinez & Curtis
2712 N Seventh Street
Phoenix, AZ 85006

John A. Buric
Warner Angle et al
3550 N. Central Ave. Ste. 1500
Phoenix, AZ, 85012

Walter W. Meek

Walter W. Meek