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ORIGINAL OPEN MEETING AGENDA ITEM

EXCEPTION

BEFORE THE ARIZONA CORPORATION



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Marc Spitzer
Chairman

William A. Mundell
Commissioner

Mike Gleason
Commissioner

Jeff Hatch-Miller
Commissioner

Kris Mayes
Commissioner

Arizona Corporation Commission

DOCKETED

MAY 17 2004

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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

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

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

12 **The Commission should adopt a real fair value rate base.**

13 The Arizona Supreme Court, in *Simms v. Round Valley Light & Power Co.*,
14 declared that the state constitution requires the Commission to consider the value of
15 a utility's property "at the time of the inquiry." 80 Ariz. 145, 151, 294 P2nd 378, 382
16 (1956). In other words, the utility's rate base should reflect the current value of the
17 property that is devoted to public service, not some historic or book value.

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

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

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

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

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

12 **The Commission should authorize a competitive rate of return.**

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

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

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

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

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

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

1 10.5% to 11.7%. Obviously, Mr. Reiker and Dr. Zepp differed substantially in the
2 inputs to their models. Suffice it to say that the ALJ sided with the Staff's judgment
3 in virtually every instance.

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

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

12 • The average authorized return on equity (ROE) for those companies was
13 10.93%, or 193 basis points above Mr. Reiker's recommended COE.

14 • The actual ROE earned by those companies was 10.35%, or 135 basis points
15 above Mr. Reiker's recommended COE.

16 • The average ROE forecasted by *Value Line* for those companies was 11.0%,
17 or 200 basis points above Mr. Reiker's recommended COE.

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

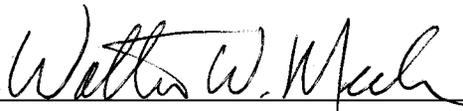
23 Conclusion

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

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

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

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

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8 Walter W. Meek, President

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10 **CERTIFICATE OF SERVICE**

11
12 An original and 13 copies of the referenced testimony
13 filed this 17th day of May, 2004, with:

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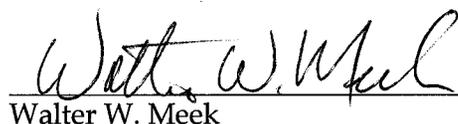
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