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BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission

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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

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

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**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.

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.

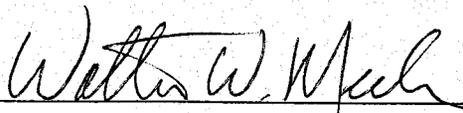
### 23 Conclusion

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.

3  
4 Respectfully submitted, this 17<sup>th</sup> day of May, 2004.

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7  
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 17<sup>th</sup> day of May, 2004, with:

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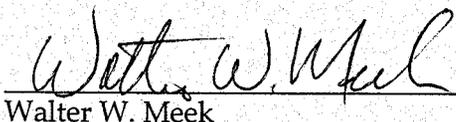
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