0000011449

RECEIVED

ORIGINAL

2004 FEB 18 P 4: 26

AZ CORP COMMISSION
DOCUMENT CONTROL

FENNEMORE CRAIG
Norman D. James (No. 006901)
Jay L. Shapiro (No. 014650)
3003 N. Central Avenue
Suite 2600
Phoenix, Arizona 85012
Attorneys for Arizona-American
Water Company, Inc.

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS SUN CITY WEST WATER AND WASTEWATER DISTRICTS.	**DOCKET NOS. WS-01303A-02-0867** **WS-01303A-02-0868** **W-01303A-02-0869** **WS-01303A-02-0870** **W-01303A-02-0908** **(CONSOLIDATED)**
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 WASTEWATER DISTRICTS.	**ARIZONA-AMERICAN WATER COMPANY'S REPLY BRIEF**
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS MOHAVE WATER AND HAVASU WATER DISTRICTS.	

Arizona Corporation Commission
DOCKETED
FEB 18 2004
DOCKETED BY

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

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

TABLE OF CONTENTS

Page

I. INTRODUCTION 1

II. RATE BASE ISSUES 3

A. The Evidence in This Case Does Not Support Averaging the Company's RCRB and OCRB to Determine Its Fair Value Rate Base 4

1. The Commission Does Not Have Discretion to Violate the Law and Ignore the Evidence 4

2. The Company's RCN Rate Bases Have Not Been Challenged and Are Not in Dispute 5

3. The Amount Recently Paid for the Acquisition of Citizens' Water and Wastewater Systems Supports Use of the RCRB for Each District 7

B. The "Acquisition Adjustment" Is a Red Herring 9

C. The "Backing In" Methodology Advocated by Staff and RUCO Violates the Fair Value Standard 12

1. Under Arizona Law, the Commission Must Find and Use Fair Value to Set Rates 12

2. The Fair Value Method Does Not "Double Count" Inflation 15

3. Staff's Policy Arguments in Support of the "Backing In" Method Conflict with the Fair Value Standard 17

D. Staff's Level of Accumulated Depreciation is Punitive 21

III. INCOME STATEMENT ISSUES 23

A. Staff's Opposition to the Pro Forma Adjustment to Operating Expenses is Goundless and Should Be Rejected 23

1. Arizona-American Is Not Seeking to Evade the Effect of Using a 2001 Test Year 24

2. Staff's Attempts to Exaggerate the Rate Impact of the Company's Pro Forma Adjustment are Misleading and Must be Rejected 25

B. Rate Case Expense 27

1. RUCO's Lone Opposition to Rate Case Expense Should be Rejected 27

2. A Five-Year Amortization Period is Unwarranted 29

C. RUCO's Property Tax Expense Methodology Must Be Rejected, Again 30

IV. COST OF CAPITAL AND RATE OF RETURN 30

A. Capital Structure and Cost of Debt 30

TABLE OF CONTENTS
(continued)

Page

B. Arizona-American's Recommended Cost of Equity Is Reasonable and Should Be Adopted 31

1. Staff's Criticisms of Dr. Zepp's DCF Model Estimates Are Groundless 32

2. Staff's CAPM Equity Cost Estimates Are Unreasonably Low and Should Be Rejected 36

3. The Risk Premium Method Provides a Direct and More Objective Estimate of the Current Cost of Equity Than the CAPM 38

V. RATE DESIGN 40

A. Staff's Proposed Rate Design will not Promote Conservation 40

B. Staff's Criticisms of the Company Are Without Merit 42

C. Youngtown's Request for a Stepped Rate Increase is Unlawful 45

D. Recovery of Increased Costs Under the Tolleson Agreement Should Not Be Denied 46

1511295.1/73244.034

I. INTRODUCTION.

Arizona-American Water Company, an Arizona corporation, ("Arizona-American" or "the Company") hereby submits its reply brief in support of its application for a determination of the fair value of its utility plant and property and for appropriate adjustments to its rates and charges for utility service. At issue in this proceeding are 10 separate districts that provide water or wastewater service to over 120,000 customers in Maricopa, Mohave and Santa Cruz Counties. The specific revenue adjustments being requested are set forth on page 1 of the Company's initial brief and in the schedules attached to Mr. Bourassa's Rejoinder Testimony (Ex. A-24).

This reply brief will focus on the arguments presented by the Utilities Division ("Staff"), Residential Utility Consumer Office ("RUCO") and the Town of Youngtown.[1] These parties advocate positions that, if adopted, would deprive Arizona-American of an opportunity to earn a reasonable return on the fair value of its property. Very simply, their positions are:

- The Company's fair value rate base should be based on an average of the historic cost and reproduction cost of its plant, notwithstanding the evidence that the current value of the Company's plant is no less than its reproduction cost.
- The Company's fair value rate base should not be used to establish its revenue requirement. Instead, the revenue requirement should be based solely on the historic cost of the plant.
- Approximately $2 million of plant should be removed from the Company's rate base because it has been taken out of service. However, $438,000 of accumulated depreciation related to that plant should continue to be deducted from rate base. (Staff only.)
- Test year operating expenses should not be adjusted to remove Citizens Communications' corporate overheads and salaries and

[1] Sun Health Corporation's primary interest is in the rate design for the Sun City and Sun City West districts, and its positions are consistent with the Company. The Arizona Utility Investors Association's primary interests are the development and use of an appropriate fair value rate base and a reasonable rate of return, and is generally aligned with the Company. Frank J. Grimmelman, an Anthem resident who has intervened on his own behalf, generally adopts the positions of Staff and RUCO.

wages and bring in the Company's 2002 expenses, even though Citizens' expenses in 2001 (1) will never recur and (2) were abnormal and understated when compared to 1999 and 2000 levels. (Staff only.)

- The Company's requested amount of rate case expense, $715,000 should not be approved, even though its actual expense exceeds $1 million. (RUCO only.)
- The rate of return on the rate bases, which are based on the historic cost of the Company's plant, should be only 6.5% (Staff) and 6.77% (RUCO). These rates of return, when applied to Staff's fair value rate bases for each district, actually produce returns that approach or, in some cases, are less than the yields on U.S. Treasury securities.
- The Company's authorized return on common equity should be only 9.0% (Staff) and 9.61% (RUCO), even though the parties' sample group of publicly traded water utilities are currently earning over 10% and are projected to earn 11% in 2004.
- The Company's request for a surcharge mechanism to recover payments to be made to the City of Tolleson for wastewater treatment, which are estimated to cost $10 million, should be denied, even though there is no dispute that the contract for this service is prudent and cost effective, and the Company has no means of recovering these costs other than filing additional rate cases. (Staff and RUCO.)
- Staff's three-tier, inverted block rate design should be adopted for all seven Company water districts, even though Staff has admitted this rate design will not cause existing customers to change their water use patterns, while creating a substantial subsidy that would be recovered from large commercial customers, such as schools and hospitals. (Staff only.)
- Rate increases should be phased in over 2 or 3 years, or simply capped at 20%, regardless of the return on the fair value of the Company's property. (Youngtown only.)

When viewed together, these recommendations would place Arizona-American in a break-even position, i.e., having sufficient cash flow to pay annual interest charges on debt, but little left over to finance plant upgrades and improvements and to pay dividends. Considering that the Commission has also prohibited Arizona-American from filing any new rate applications until 2006 in the absence of an emergency, these recommendations would result in rates that are unjust and confiscatory.

II. RATE BASE ISSUES.

In their initial closing briefs, Staff, RUCO and Youngtown oppose the use of the Company's reconstruction cost new rate base ("RCRB") as the fair value of the Company's utility plant and property. Although these parties offer various arguments for using an original cost rate base ("OCRB") instead, each of them would have the Commission violate the Arizona Constitution by failing to determine and ***actually use*** the fair value of the Company's utility plant and property in setting rates. Ariz. Const. art. 15, § 14. In a monopoly setting, fair value is the "exclusive rate base" on which a utility's rates are established. *US West Communications, Inc. v. Ariz. Corp. Comm'n*, 201 Ariz. 242, 244-46, ¶¶ 13-19, 34 P.3d 351, 354-55 (2001).

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).

> [I]n determining present value [of a utility's assets], consideration must be given to prices and wages prevailing at the time of the investigation; and, in the light of all the circumstances, there must be an honest and intelligent forecast as to the probable price and wage levels during a reasonable period in the immediate future. . . . It must be determined whether the rates complained of are yielding and will yield . . . a reasonable rate of return on the value of the property at the time of the investigation and for a reasonable time in the immediate future.

McCardle v. Indianapolis Water Co., 272 U.S. 400, 408-09 (1926). *See also Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 153, 294 P.2d 378, 383 (1956). If the evidence supporting the use of the Company's RCRB as its fair value rate base is disregarded or if the Company's revenue requirement is based on the historic or book cost of the Company's utility plant and assets (i.e., the OCRB) by adjusting the rate of return on fair value to produce the same revenue requirement as Staff and RUCO advocate, the Commission will violate Arizona law.

A. The Evidence in This Case Does Not Support Averaging the Company's RCRB and OCRB to Determine Its Fair Value Rate Base.

Staff argues that the Commission should determine Arizona-American's fair value rate base for each water and wastewater district by averaging the district's RCRB and its OCRB. Staff's Br. at 2-3. However, Staff has provided no reason for doing so in this case other than it has done so in the past. *Id.* For example, Staff's lead accounting witness, Mr. Carlson, testified that "[t]his particular method is the one that this Commission has used most." Carlson Sb. (Ex. S-48) at 6. Mr. Carlson also claimed that the "Commission has determined this method to be reasonable and appropriate" (*id.*), but neither Mr. Carlson nor any other Staff witness has identified any Commission rule or decision containing such a determination.[2] As explained above and in the Company's initial brief, it is well established that under the fair value standard, the *present value* of the utility's plant and property must be determined and used as its fair value rate base in setting rates. The evidence before the Commission shows that the best measure of the present value of the Company's utility plant and property is its RCRB.

1. The Commission Does Not Have Discretion to Violate the Law and Ignore the Evidence.

Staff argues that the Commission "has a range of legislative discretion" and must "use reasonable judgment considering all relevant factors" in finding fair value. Staff Br. at 2, *citing Simms*, 80 Ariz. at 154, 294 P.2d at 384. The existence of such discretion, however, does not allow the Commission to ignore the law or the evidence. As the Arizona Court of Appeals has explained:

> [A rate proceeding] carries with it fundamental procedural requirements. There must be a full hearing. There must be

[2] In contrast, for example, the previous Commission decisions introduced by Staff during the hearing contain no discussion of the basis for this approach, and no "determination" that it is "reasonable and appropriate." Ex. S-2 at 21; Ex. S-4 at 4; Ex. S-5 at 10. In fact, in each of those decisions, the weighting of RCRB and OCRB was not in dispute. *Id.*

> evidence adequate to support pertinent and necessary findings of fact. Nothing can be treated as evidence which is not introduced as such. . . . Facts and circumstances which ought to be considered must not be excluded. Facts and circumstances must not be considered which should not legally influence the conclusion. Findings based on the evidence must embrace the basic facts which are needed to sustain the order. . . .
>
> A proceeding of this sort requiring the taking and weighing of evidence, determinations of fact based upon the consideration of the evidence, and the making of an order supported by such findings, has a quality resembling that of a judicial proceeding. Hence it is frequently described as a proceeding of a *quasi-judicial* character. The requirement of a "full hearing" has obvious reference to the tradition of judicial proceedings in which evidence is received and weighed by the trier of the facts. The "hearing" is designed to afford the safeguard that the one who decides shall be bound in good conscientious to consider the evidence, to be guided by that alone, and to reach his conclusion uninfluenced by extraneous considerations which in other fields might have play in determining purely executive action. The "hearing" is the hearing of evidence and argument.

State ex rel. Corbin v. Arizona Corp. Comm'n, 143 Ariz. 219, 224, 693 P.2d 362, 367 (1984) (italics in original), *quoting Morgan v. United States*, 298 U.S. 468, 480-81 (1936). In this case, neither Staff nor any other party has provided any legitimate basis for using the average of RCRB and OCRB as the Company's fair value rate bases in the face of evidence showing that the current value of the Company's property exceeds RCRB.

2. The Company's RCN Rate Bases Have Not Been Challenged and Are Not in Dispute.

Staff argues that the Commission should not give "great weight" to the RCRB developed for each of the Company's water and wastewater districts because those rate bases are not exactly equal to the current value of the utility plant and assets devoted to public service. Staff Br. at 2-3. This argument ignores the evidence and distorts the Company's position.

First, as discussed in the Company's initial brief, the Company's reproduction cost

new (RCN) plant-in-service study, as revised, and the resulting RCRB for each district have been accepted by Staff. Scott Sb. (Ex. S-39) at 3-4; Bourassa Rj. (Ex. A-24) at 3, 7-8. Mr. Stout, the Company's engineering valuation expert, evaluated the RCN studies performed by both the Company and by Staff, and testified that RCN studies of this nature have been used for many years by valuation experts to obtain an estimate of current value and that the RCN studies "provide a reasonable basis for providing a fair value rate base for each district." Stout Rb. (Ex. A-51) at 4-7. Mr. Stout's opinion, which is based on some 30 years of experience as a valuation engineer (*id.* at 2-4), has not been contested by any party. In short, Staff had ample opportunity to evaluate and, if appropriate, contest the RCB for each district. Staff also had the opportunity to perform and submit its own valuation studies. Instead, Staff has accepted the Company's RCN studies and the resulting rate bases.

Second, the Staff's argument inaccurately suggests that the Company maintains that the current value of its property is equal to the RCRB. This misstates the Company's testimony. Under the fair value standard, rates are based on the present or current value of the utility's assets devoted to public service. *E.g., Duquesne Light*, 488 U.S. at 308-09; *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679, 689-92 (1923). The Company has consistently maintained that under the circumstances in this case, the RCRB for each district provides the best estimate of the current value of the district's utility plant and property. *E.g.*, Bourassa Dt. (Ex. A-1) at 14-15; Zepp Dt. (Ex. A-44) at 8-9; Bourassa Rb. (Ex. A-21) at 9-10; Tr. at 168-69. In contrast, Staff has provided no evidence that the historic cost of the Company's utility plant provides an accurate measure of fair value, nor has Staff shown why the Company's RCRB for each district is inaccurate or otherwise overstates the fair value of its property. Averaging the RCRB and the OCRB in the absence of any legitimate reason to do so would be arbitrary and unsupported by the record.

3. The Amount Recently Paid for the Acquisition of Citizens' Water and Wastewater Systems Supports Use of the RCRB for Each District.

Staff also argues that the recent purchase price paid by Arizona-American in acquiring Citizens' water and wastewater systems is not relevant to the determination of fair value. In support of this argument, Staff misstates the holding of the Arizona Supreme Court in *Arizona Corp. Comm'n v. Arizona Water Co.*, 85 Ariz. 198, 335 P.2d 412 (1959). In that case, the utility had purchased a group of water systems and, shortly thereafter, applied for a determination of the fair value of the systems serving four communities and for appropriate rate adjustments. *Id.*, 85 Ariz. at 200-01, 335 P.2d at 413. During the hearing, the utility and Staff presented various evidence of the value of the utility's properties, including their cost of reproduction new and original cost less depreciation. *Id.* However, the Commission ignored this evidence and instead relied solely on the purchase price paid for the water systems, arguing "that a recent purchase price is market value and that market value would be a fair value *as a matter of law*." *Id.* at 202-03, 335 P.2d at 415 (emphasis added). The court rejected that argument, holding that "the purchase price of a public utility does not constitute, *as a matter of law*, its fair value." *Id.* at 203, 335 P.2d at 415 (emphasis added).

In issuing this holding, the court did <u>not</u> state, as Staff erroneously represents, that the purchase price paid by an acquiring company "should play no role in establishing rate base." Staff Br. at 3. Instead, the court stated that "the Commission must consider all available evidence related to the fair value, and an inquiry into a recent purchase transaction might be of assistance . . . ." *Arizona Water*, 85 Ariz. at 203, 335 P.2d at 415. In *Arizona Water*, the Commission ignored evidence indicating that the seller was willing to accept an amount substantially less than the book value of the water systems "because the transaction would give it a tax savings of one and one-half million dollars, a power contract worth a million dollars, as well as hundreds of thousands of dollars in interest."

Id. at 203, 335 P.2d at 415. The court concluded:

> Thus, if the Commission had taken into consideration the entire recent purchase transaction it would not have been an abuse of discretion. But here the Commission considered only that part of the transaction concerning the amount paid to the seller, and in that respect it acted arbitrarily, as all relevant factors were thus not considered in finding the fair value of the properties.

Id. at 204, 335 P.2d at 415-16.

In this proceeding, in contrast, there are no unique or unusual circumstances affecting the purchase price paid by Arizona-American for Citizens' water and wastewater systems. Mr. Stephenson, who was personally involved in the transaction (*e.g.*, Tr. at 470, 477), testified that the purchase price was determined by arms-length negotiations between two independent and sophisticated utilities. Stephenson Dt. (Ex. A-64) at 8-10. *See also* Tr. at 486. Mr. Stephenson's testimony was not contested by any party. Moreover, the Commission had an opportunity to thoroughly review and investigate the transaction in connection, first by approving the sale and transfer of Citizens' assets to Arizona-American pursuant to A.R.S. § 40-285 and, second, by authorizing Arizona-American to issue new debt and to assume certain industrial development revenue bonds in connection with financing the acquisition. Decision No. 63584 (April 24, 2001) (authorization to transfer assets) and Decision No. 64002 (Aug. 30, 2001) (acquisition financing). There is no evidence that the purchase price paid for Citizens' assets was influenced by income tax considerations or any other factor that would preclude consideration of the purchase price as evidence of fair value.

The other arguments found on page 3 of Staff's brief are simply irrelevant to the issue. For example, the fact that Mr. Bourassa had not previously recommended the use of an RCRB as a utility's fair value rate base has nothing to do with whether, under the facts and circumstances present in this proceeding, the Company's recommendation should be adopted. Mr. Bourassa explained, "I feel more comfortable with the company's

RCN rate base as being its fair value given the recent purchase of the Citizens systems by Arizona-American, which is also an indicator of value." Tr. at 168-69. Similarly, the fact that Mr. Stephenson personally disagreed with the use of an average of the RCND and the OCRB in prior rate proceedings for the Paradise Valley water district (then known as Paradise Valley Water Company) is irrelevant to the issue of the appropriate method to be used in determining the current value of Arizona-American's utility plant and assets in this case. Mr. Stephenson explained that the Paradise Valley water district was very small, and, at that time, it was not worth pursuing a different weighting to determine that district's fair value rate base. Tr. at 489-92 and 513-15.[3]

B. <u>The "Acquisition Adjustment" Is a Red Herring</u>.

In its initial brief, the Company has explained why the acquisition adjustment that has been recorded on the Company's books in accordance with the Uniform System of Accounts is irrelevant to the development of a fair value rate base. Company Br. at 24-26. Both RUCO and Youngtown, however, continue to focus on the acquisition adjustment.

RUCO devotes several pages in its brief to a discussion of why the Company's OCRB for each district is overstated because it includes an acquisition adjustment. RUCO Br. at 4-6. Given that the Company has repeatedly stated that it is not seeking recovery on, or of, an acquisition adjustment in this proceeding, it is unclear why this discussion has been included. *E.g.*, Stephenson Rb. (Ex. A-74) at 11 ("we have requested a revenue requirement based on FVRB [fair value rate base], **<u>excluding</u>** the acquisition adjustment"; emphasis in original). RUCO claims that the Company has argued that the OCRB is greater than the RCRB for certain of its districts. RUCO Br. at 4-5. However, the Company has made no such claim. This confusion appears to have arisen from a line of questioning by RUCO's attorney during the hearing concerning the Company's B-1

[3] For example, during the test year used in setting rates in Decision No. 60220 (May 27, 1997), the Company provided water service to approximately 4,400 customers. Ex. S-6 at 1.

Schedule for the Agua Fria water district, during which Mr. Bourassa repeatedly explained why it is inappropriate to include an acquisition adjustment in an RCRB. Tr. at 131-40. Ultimately, none of this discussion is relevant to the issues before the Commission.

Youngtown is improperly attempting to use the acquisition adjustment as an excuse to disregard the Company's RCRB for the Sun City water and wastewater districts.[4] Preliminarily, it should be noted that Youngtown has no disagreement with the Company's proposed accounting treatment concerning the acquisition adjustment. Tr. at 122-25. The Youngtown accounting witness, Mr. Burnham, has agreed that the Company is required to record an acquisition adjustment for accounting purposes, and has no disagreement with the Company's request to use 40-year mortgage-style amortization, as opposed to straight-line amortization. Tr. at 1222-23. At the same time, however, Youngtown contends that the Commission should give no weight to the RCRB in establishing their fair value rate bases because "anything greater than OCRB" would *implicitly* include an acquisition adjustment. Tr. at 1251-52; Youngtown Br. at 10-11. This argument is erroneous for at least two reasons.

First, there is no acquisition adjustment, or any other type of similar adjustment, included in the Company's calculation of the RCRB for each district. The methodology used by the Company, which Staff has accepted, is discussed at length in the Company's initial brief. Company Br. at 17-20. In summary, Mr. Bourassa prepared a trended RCN plant-in-service study to determine the cost of reproducing the utility plant and property devoted to public service for each district. From that starting point, Mr. Bourassa then trended and restated accumulated depreciation, advances in aid of construction and contributions in aid of construction, which were then deducted from the RCRB, in

[4] Youngtown has intervened only in connection with, and is presenting recommendations relevant to, those particular districts. Tr. at 1214.

accordance with applicable Commission rules. Ultimately, the RCRB for each district, as revised, was accepted by Staff, and neither Youngtown nor any other witness has objected to those amounts. As shown on the Company's schedules, there is simply no adjustment to any of these rate bases reflecting an acquisition adjustment. *See* Bourassa Rj. (Ex. A-24), Rejoinder Schedules B-1 (rate base summary) and B-3 (adjustments to RCRB). *See also* Tr. at 105 ("The [RCRB] does not include an acquisition adjustment . . . . It is the company's estimate of the current value of its utility property.") and 123 (same).

Second, because no acquisition adjustment or other, similar sort of adjustment was included in the RCRB, Youngtown's recommendation would be punitive and discriminatory. This point was demonstrated by the hypothetical posed to Mr. Burton during the hearing, in which Mr. Burton was asked whether it would have been permissible for Citizens to have submitted RCN studies and to have requested a return on an RCRB for the districts, assuming that no sale had occurred. Mr. Burton agreed that Citizens would have had the right to do so. Tr. at 1279-81. Clearly, it would be inappropriate to prohibit Arizona-American from seeking a return on an RCRB for each district simply because the RCRB happens to be greater than the OCRB, when the prior owner of the districts, Citizens, would have the right to request the identical rate-making methodology. Indeed, if Youngtown's argument were carried to its logical conclusion, every Arizona utility *except* Arizona-American would be allowed to file for and request the use of an RCRB as its fair value rate base.

In short, the goal of fair value rate-making is to determine the current value of the utility's property, which is then used as the utility's rate base. *E.g., Duquesne Power*, 488 U.S. at 308; *US West*, 201 Ariz. 245-56, ¶¶ 13-18, 34 P.3d 354-55.

> It is impossible to ascertain what will amount to a fair return upon properties devoted to public service, without giving consideration to the cost of labor, supplies, etc., at the time the investigation is made. An honest and intelligent forecast of probable future values, made upon a view of all the

> relevant circumstances, is essential. If the highly important element of present costs is wholly disregarded, such a forecast becomes impossible. Estimates for to-morrow cannot ignore prices of to-day.

State of Mo. ex rel. Southwestern Bell Telephone Co. v. Pub. Serv. Comm'n, 262 U.S. 276, 287-88 (1923). Book accounting adjustments based on historic costs are irrelevant to this determination, as Mr. Bourassa and Mr. Stephenson have both explained. For this reason, the arguments presented by RUCO and Youngtown are irrelevant.

C. The "Backing In" Methodology Advocated by Staff and RUCO Violates the Fair Value Standard.

1. Under Arizona Law, the Commission Must Find and Use Fair Value to Set Rates.

In their briefs, both Staff and RUCO continue to advocate the use of the so-called "backing in" method, under which the utility's revenue requirement is always based on its OCRB. Staff Br. at 4-6; RUCO Br. at 3-4. As the Company explained in its initial brief, under Arizona law, the fair value of the utility's property is the utility's rate base, and the rate of return must be applied to that rate base in order to establish just and reasonable rates. Company Br. at 13-16, 54-55. To ensure that there is no confusion on this key point, and to respond to Staff's discussion about the Arizona Supreme Court's holding in *US West*, a brief review of Arizona appellate decisions is necessary.

The seminal Arizona decision is, of course, *Simms*, in which the Arizona Supreme Court held, based on Article 15, § 14 of the Arizona Constitution, that the Commission must find the fair value of the utility's property and use that finding as the utility's rate base in setting rates:

> It is clear, therefore, that under our constitution as interpreted by this court, the commission is required to find the fair value of the company's property *and use such finding as a rate base for the purpose of calculating what are just and reasonable rates.*

Simms, 80 Ariz. at 151, 294 P.2d at 382 (emphasis added), *following State v. Tucson Gas,*

Electric Light & Power Co., 15 Ariz. 294, 303, 138 P. 781, 785 (1914), *and Ethington v. Wright*, 66 Ariz. 382, 391-93, 189 P.2d 209, 215-16 (1948).

Simms was followed by the Arizona Supreme Court three years later in *Arizona Water*, discussed above, in which the court stated:

> This court has held that under our constitution the Corporation Commission must find the fair value of the properties devoted to the public use, and that in determining the fair value the Commission cannot be guided by the prudent investment theory nor can it use common equity as the rate base standard. . . . The amount of capital invested is immaterial. *Under the law of fair value a utility is not entitled to a fair return on its investment; it is entitled to a fair return on the fair value of its properties devoted to the public use,* no more and no less.

Arizona Water, 85 Ariz. at 203, 335 P.2d at 415 (emphasis added), *citing and following Simms*.

These two decisions provide the framework for fair value rate-making in Arizona, and have been consistently followed by Arizona appellate courts. *E.g., Arizona Corp. Comm'n v. Arizona Pub. Serv. Co.*, 113 Ariz. 368, 370, 555 P.2d 326, 328 (1976); *Residential Utility Consumer Office v. Arizona Corp. Comm'n*, 199 Ariz. 588, 561, ¶ 11, 20 P.3d 1169, 1172 (App. 2001); *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (App. 1978). Far from overruling this line of decisions, the Arizona Supreme Court in *US West* affirmed these decisions *in a monopoly setting*:

> As we have seen, a line of cases nearly as old as the state itself has sustained the traditional formulaic approach. . . .
>
> We still believe that when a monopoly exists, the rate-of-return method is proper. . . . We agree that our previous cases establishing fair value as the exclusive rate base are inappropriate for application *in a competitive environment*.

US West, 201 Ariz. 242, 246, ¶¶ 18-19, 34 P.3d at 355 (emphasis added).

The Arizona Supreme Court's discussion of fair value rate-making was specifically noted by the Arizona Court of Appeals in a decision issued on January 27, 2004. *Phelps*

Dodge Corp. v. Arizona Electric Power Coop., Inc., ____ Ariz. ____, _____ P.3d ____, 2004 WL 117253 (App. 2004). There the court stated:

> In monopolistic markets, *"fair value has been the factor by 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.

Phelps Dodge, 2004 WL 117253 at *5, ¶ 21 n. 8 (emphasis added), *quoting US West*, 201 Ariz. at 245, ¶ 13, 34 P.3d at 354. There can be no legitimate dispute about what the law requires.

Viewed against this 90-year-old legal framework, it is apparent that the rate setting methodology advocated by Staff and RUCO in this case is illegal. Contrary to the disingenuous arguments appearing on pages 4 and 5 of Staff's brief, the Commission does not have "wide latitude" to ignore settled law and base Arizona-American's revenue requirement solely on the OCRB for each water and wastewater district. Arizona courts (as well as numerous U.S. Supreme Court decisions that address the fair value standard) have held that the Commission must find ***and use*** the fair value of the utility's property to set rates.

Under the "backing in" method advocated by Staff and RUCO, in contrast, a finding of fair value is unnecessary and meaningless. For example, if a utility's OCRB is $1 million, it makes no difference whether the fair value of the utility's property is $500,000 or $1.5 million – the revenue requirement does not change. *E.g.*, Diaz Cortez Sb. (Ex. R-8) at 3-4 (explaining that regardless of the amount of the fair value rate base, "*the revenue requirement remains constant*"; italics in original); Carlson Dt. (Ex. S-47) at 8 ("Operating income should be calculated by applying the recommended cost of capital to the OCLD rate base. Revenue requirement is equal to the sum of operating income,

operating and maintenance expenses, depreciation expense, and income tax expense."). This makes a mockery out of the fair value standard, as at least two Arizona courts have recognized. *Simms*, 80 Ariz. at 155, 294 P.2d at 385; *Arizona Corp. Comm'n v. Citizens Utilities Co.*, 120 Ariz. 184, 190 n. 5, 584 P.2d 1175, 1181 n. 5.[5]

2. The Fair Value Method Does Not "Double Count" Inflation.

RUCO's principal argument in support of using Arizona-American's OCRB to determine the revenue requirement is that the application of a rate of return to the fair value rate base "factors inflation in twice, thereby overstating the Company's proposed revenue requirement." RUCO Br. at 4. This argument has no legal foundation.

For example, in *Simms*, the court discussed the application of a 7.01% rate of return to the utility's fair value rate base, while noting that if the Commission had adjusted the rate of return to produce a pre-determined revenue requirement, the Commission would be acting illegally. 80 Ariz. at 155, 294 P.2d at 385. Similarly, in *Southwestern Bell*, the U.S. Supreme Court discussed the application of a rate of return of 5.33% to the utility's fair value rate base, which return the court found "wholly inadequate, considering the character of the investment and interest rates then prevailing." *Southwestern Bell*, 262 U.S. at 288. In *Bluefield Waterworks*, which is still cited today as establishing the standard for setting a utility's rate of return, the court again applied the rate of return directly to the utility's fair value rate base, holding that "a rate of return of 6 [%] upon the value of the property is substantially too low to constitute just compensation for the use of the property employed to render the service." *Bluefield Waterworks*, 262 U.S. at 695. *See*

[5] In its brief, Staff claims that the "backing in" method was approved in *Litchfield Park Serv. Co. v. Arizona Corp. Comm'n*, 178 Ariz. 431, 874 P.2d 998 (App. 1994). However, Staff has also misstated this decision's holding. In fact, the utility did *not* challenge the use of the "backing in" method to derive the rate of return on its fair value rate base. Instead, the utility challenged an adjustment to the amount of equity in its capital structure, the authorized return on equity and the exclusion of a well from rate base. *Id.* Consequently, it is not surprising that this decision was not mentioned by the Arizona Supreme Court in *US West* or by the Arizona Court of Appeals in *Phelps Dodge*.

also id. at 693-94 (discussing various decisions approving returns of 6% to 8% on fair value rate bases). In none of the decisions did the court suggest that applying the rate of return "double counts" inflation, or that some sort of inflation-related adjustment was required.

Putting aside the lack of any legal support for RUCO's views, RUCO has ignored the fact that the "fair value standard mimics the operation of the competitive market." *Duquesne Light*, 488 U.S. at 308. In a competitive market, as the value of property increases, so does the rent associated with the use of that property. The fair value standard operates the same way:

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

Id., 488 U.S. at 308-09. Under RUCO's argument, however, these changes in value are completely irrelevant to the rate setting process because the utility's revenue requirement is always based solely on OCRB.

In addition, Dr. Zepp explained why RUCO's argument concerning the effect of inflation is misplaced:

> Whatever inflation factors are in the cost of capital, they are investor forecasts of the future – not the past. Moreover, those inflation factors in the cost of capital are not plant specific, but would reflect the more general level of inflation in the economy expected in the future. The fallacy in Ms. Diaz Cortez's analysis is seen most clearly by examining a situation in which the value of the plant at the time of inquiry is lower than original cost. In such a case, there would be negative inflation (deflation) used to determine the FVRB [fair value rate base], but the cost of capital would still reflect the opportunity cost of capital and include positive inflation, if that's what investors anticipate.

Zepp Rb. (Ex. A-49) at 32. *See also* Tr. at 315-17; Zepp Rj. (Ex. A-50) at 8. RUCO has never explained how the use of the Company's embedded debt cost, which comprises 60% of the Company's total capital, in determining the Company's rate of return factors in inflation. Nor has RUCO explained how the "backing in" method actually adjusts the rate of return for inflation. Finally, RUCO does not consider other factors affecting the present value of a utility's property, such as legal and regulatory requirements that increase the cost of construction. In short, RUCO's argument is simplistic and misleading.

3. Staff's Policy Arguments in Support of the "Backing In" Method Conflict with the Fair Value Standard.

Staff's attacks on Dr. Zepp's so-called "legal conclusions" are largely irrelevant to the issues presented. As Staff notes on the top of page 5 of its brief, Dr. Zepp has consistently stated that he is an economist with extensive experience in ratemaking and other types of proceedings involving utilities, and not an attorney. *E.g.*, Zepp Rb. (Ex. A-44) at 12. Further, Arizona-American does not rely on Dr. Zepp's analysis of relevant court decisions such as *Simms, US West* and *Bluefield Waterworks*. Those decisions, and the other authorities that have been discussed in the Company's initial brief and hereinabove addressing the fair value standard, obviously speak for themselves. However, Staff has ignored the most important point made by Dr. Zepp: The determination of a utility's rate base and the determination of the rate of return to be applied to that rate base are separate and independent determinations. *E.g.*, Zepp Dt. (Ex. A-44) at 9-10; Zepp Rb. (Ex. A-49) at 33; Tr. at 309, 316. For example, Dr. Zepp explained:

> My equity cost estimates are independent of the rate base to which they are applied. The equity cost estimates I present are determined from market data and provide an estimate of the equity return an investor requires on dollars invested in shares of common stock. Actual equity returns depend, in

> part, on the rate base that is incorporated into the process that sets rates. Those stock prices also depend in part on the present value of cash or securities that an investor expects to be received if the utility were condemned by a public agency, acquired by a municipality or another utility, or merged into another utility. Thus, the percentage equity cost estimates are independent of whatever formula is used to determine the FVRB [fair value rate base].

Zepp Dt. (Ex. A-44) at 9-10.

As explained in the Company's initial brief, all of the parties' cost of capital witnesses used versions of standard finance models – the Discounted Cash Flow ("DCF") model, the Risk Premium method and the Capital Asset Pricing Model ("CAPM") – to estimate the current cost of equity. Each of these methodologies relies on stock market data for publicly traded firms, and has nothing to do with the rate base used to set rates. For example, Mr. Reiker testified that "[t]he DCF method of estimating the cost of equity is based upon the theory that the market price of a stock is equal to the present value of all expected future dividends." Reiker Dt. (Ex. S-45) at 9. *See also* Staff Br. at 15 (same). Similarly, Mr. Reiker describes the CAPM as presenting "a simple and intuitively appealing picture of financial markets," in which "[a]ll investors hold efficient portfolios [of stock] and all such portfolios move in perfect lock step with the market." Reiker Dt. (Ex. S-45) at 21, *quoting* James Lorie and Mary T. Hamilton, *The Stock Market: Theories and Evidence* 202 (1973). *See also* Staff Br. at 17. Mr. Reiker also explained that "Staff did not apply the models directly to Arizona-American because it does not have publicly traded stock and therefore lacks information necessary to apply the market-based models." Reiker Dt. (Ex. S-45) at 9. For this reason, Mr. Reiker (as well as Dr. Zepp and Mr. Rigsby) used publicly traded water and gas distribution utilities as proxies. In sum, all of the methodologies employed by the parties are completely independent of the rate bases of Arizona-American as well as the publicly traded utilities in each parties' proxy group.[6]

[6] The other component of the cost of capital, the cost of long-term debt, is also

Staff claims in its brief that Mr. Reiker has provided "economic reasons" for applying the weighted average cost of capital to the OCRB, i.e., for using the "backing in" method. Staff Br. at 6. However, these "economic reasons" are simply a restatement of the prudent investment theory originally suggested by Justice Brandeis in *Southwestern Bell*. *See Duquesne Light*, 488 U.S. at 309. The prudent investment method "relies on the actual historical cost of investments as the basis for setting the rate," as opposed to the current or fair value of the utility's plant. *Id.* at 309 n. 6. The argument presented by Mr. Reiker on pages 63 through 66 of his Direct Testimony, referenced in Staff's brief, are predicated on the prudent investment theory. For example, Mr. Reiker has testified:

> Q. When would a utility expect to be able to earn the cost of capital ***on its investment*** if earnings were determined by multiplying the market-based ROR by the RCNRB?
>
> A. A utility would expect to be able to earn the cost of capital ***on its investment*** if earnings were determined by multiplying the ROR by the RCNRB only when the RCNRB is equal to the OCRB. Windfall gains (losses) would result whenever the RCNRB is greater (less) than the OCRB if the Commission multiplied the ROR by the RCNRB to determine earnings.

Reiker Dt. (Ex. S-45) at 64 (emphasis added).

Under Mr. Reiker's reasoning, as shown above, the critical inquiry is the utility's investment, **not** the fair value of the utility's property. Consequently, his argument is in direct conflict with the various decisions discussed above, in which the prudent investment approach was squarely rejected. For example, in *Arizona Water* the Arizona Supreme Court stated: "The amount of capital invested is immaterial. Under the law of fair value a utility is not entitled to a fair return on its investment; it is entitled to a fair

---

independent of the determination of rate base. That cost is simply the average cost of all outstanding long-term debt instruments, as illustrated in Mr. Reiker's testimony. Reiker Sb. (Ex. S-46), Schedule JMR-S17. *See also* Staff Br. at 14.

return on the fair value of its properties devoted to the public use, no more and no less." *Arizona Water*, 85 Ariz. at 203, 335 P.2d at 415. There is no "windfall" gain or loss under the fair value standard because the utility's earnings are dependent on the fair value of its property devoted to public service, and not on its level of investment. *E.g., Duquesne Light*, 488 U.S. at 308-09.

Moreover, the "economic" argument presented by Mr. Reiker is in conflict with Staff's own rate setting methodology. Mr. Reiker's recommended rate of return, 6.5%, is not applied to Arizona-American's investment in the 10 water and wastewater districts involved in this proceeding. Instead, Staff's rate of return is applied to each district's OCRB. Arizona-American's total investment in these districts' utility plant and property is approximately $270 million. Stephenson Supp. Dt. (Ex. A-69 – Ex. A-73) at 1-2 and Tab A.[7] In contrast, the OCRB for each of the 10 districts proposed by Staff total approximately $92 million. Bourassa Rj. (Ex. A-24) at Rejoinder Schedule 2. Thus, Staff's rate bases have nothing to do with Arizona-American's investment. Likewise, the combined operating income produced by Staff's recommendations for each of the districts is approximately $6 million while the Company's annual debt service cost, as computed by Mr. Reiker, exceeds $8 million. Stephenson Rb. (Ex. A-74), Rebuttal Exhibit 4; Reiker Sb. (Ex. S-46), Schedule JMR-S17. Thus, Staff's recommendations have nothing to do with Arizona-American's actual cost of capital.

Another example of the fallacy in Staff's argument is found in cost of capital testimony recently filed by Mr. Reiker in the pending rate application filed by Arizona Public Service Company ("APS"). In that proceeding, Mr. Reiker is recommending that the utility's capital structure include $500 million in long-term debt incurred by APS in providing financing to Pinnacle West Energy Corporation ("PWEC"), an affiliated entity.

[7] This amount is based on the debt and equity used to finance the acquisition of Citizens' water and wastewater systems excluding the Mohave wastewater district (formerly known as Sorenson Utility Company).

At the same time, Staff is recommending that the power generation assets financed by this long-term debt be excluded from rate base. Mr. Reiker has testified that the $500 million of long-term debt must be included in the utility's capital structure and used to compute its rate of return, regardless of whether the PWEC generation assets are included in rate base, explaining that "[i]nvestors do not ignore debt, nor do they color-code it." Direct Testimony of Joel M. Reiker at 3-4, Docket No. E-01345A-03-0437 (filed Feb. 3, 2004). The rate of return is reduced by including the $500 million of low-cost debt in APS's capital structure. At the same time, APS would not earn a return on this capital because the plant this debt is financing is excluded from rate base. Once again, the utility's rate base and its cost of capital are not related.

In short, there is no dispute that the utility's rate base and the rate of return are determined independently, as Dr. Zepp has explained. The rate of return is determined using stock market data for publicly traded firms and the utility's embedded debt cost. The rate of return is then applied to the rate base, without regard to the size of the rate base. It is irrelevant whether the resulting revenue requirement actually allows the utility to earn the cost of capital on its investment.[8] Putting aside the law, which clearly prohibits the use of the prudent investment approach, Mr. Reiker's arguments directly conflict with the methodology Staff actually employs.

D. <u>Staff's Level of Accumulated Depreciation is Punitive</u>.

Staff asserts that the Company attempted to "inflate" its revenue requirement by including $2 million in rate base that should not have been included. Staff Br. at 19. As a

[8] Thus, for example, Mr. Reiker also contends in this case that Staff's rate of return, as applied to Arizona-American's OCRB for each district, produces a pre-tax interest coverage of 3.0, when the Company's annual debt service payments, which total $8.2 million, are approximately equal to Staff's recommended revenue requirement plus taxes. *See* Reiker Sb. (Ex. S-46), Schedules JMR-S8 (showing capital structure and interest coverage) and JMR-S17 (showing annual debt service). Arizona-American's actual cost of capital is irrelevant because Staff's cost of capital and resulting rate of return are independent of Staff's rate base.

result, and as a penalty, when Staff removed this plant it refused to remove an additional $438,000 of accumulated depreciation associated with these plant items.[9] There is no dispute that it is appropriate to adjust the plant balances because, as Staff correctly pointed out, the approximately $2 million of plant is either no longer used and useful or unidentified. Tr. at 1160. Instead, the dispute centers on Staff's efforts to reap a windfall for Arizona-American's ratepayers. Staff's arguments in support of its position are, however, misleading and its recommendation is contrary to sound ratemaking principles.

First, the $2 million is a "gross" plant number, so the effect on rate base would have been smaller. Moreover, this is a very small number compared to total gross plant of $272 million. *See* Bourassa Rj. (Ex. A-24) at Bourassa Rejoinder Schedules B-1. As Staff witness Bozzo conceded, mistakes are common in the process of auditing plant (Tr. at 1189) and this mistake impacted less than **.75%** of the total gross plant on the Company's books.

Additionally, this is not, as Staff erroneously suggests, a case of the Company not accepting the effect of a disallowance. Staff Br. at 19. Again, the Company accepted the removal of $2 million of plant from its gross plant, but did not accept Staff's failure to properly reflect the disallowance. As Mr. Bourassa explained in his Rejoinder Testimony, it is proper to remove <u>both</u> the plant amount and the associated accumulated depreciation when removing plant that is unidentified or no longer used and useful. Bourassa Rj. (Ex. A-24) at 4-6. Staff recognized this, but simply refused to afford this treatment in this case. Tr. at 1186.

Staff's argument that salvage value must first be calculated also fails to support Staff's failure to follow the proper ratemaking treatment. Staff Br. at 19. The lack of a

[9] Staff did remove some of the accumulated depreciation when it removed plant from rate base. Bozzo Dt. (Ex. S-43) at 5-8. However, the parties' dispute centers on whether an additional $438,000 worth of accumulated depreciation should have been removed. Tr. at 1162.

salvage value did not preclude Staff from removing the plant. Perhaps more importantly, Mr. Jones made it clear that such plant effectively has no salvage value and Mr. Bozzo accepted this testimony. Tr. at 1187.

In the end, therefore, Staff's argument that the Company should not be "advantaged" by the removal of $2 million of plant from rate base is nothing more than a smoke screen for Staff's attempt to further disadvantage the Company by inflating the effect of the disallowance, and thereby deflating the revenue requirement. In reality, Staff is simply punishing Arizona-American by removing plant without removing all of the accumulated depreciation related to that plant. The Commission should approve the disallowance of $2 million of plant and with it the removal of an additional $438,000 of accumulated depreciation, in accordance with sound ratemaking principles.

III. INCOME STATEMENT ISSUES.

A. Staff's Opposition to the Pro Forma Adjustment to Operating Expenses is Goundless and Should Be Rejected.

Staff's opposition to the Company's proposed pro forma adjustments to remove Citizens' overheads and salaries and wages and bring in AWW overheads, salaries and wages and Service Company charges is rooted in the assertion that the Company is attempting to "dodge the consequences of selecting 2001 as the test year." Staff Br. at 6. In addition, Staff asserts that: (1) the 2002 figures for AWW overheads, salaries and wages and Service Company charges are not known and measurable; (2) the use of the 2002 figure creates a mismatch; (3) the 2002 figures are imprudently high; and (4) the proposed pro forma adjustments it makes ratepayers responsible for a new owners higher cost. Staff Br. at 6-7. In its initial closing brief, the Company explained in detail, with citation to the evidence in this docket, why the 2002 numbers for AWW overheads, salaries and wages and Service Company charges were known and measurable and further addressed Staff's argument that the proposed pro forma adjustments to operating expenses

did not create an improper mismatch. Company Br. at 31-33. As Staff offers no new argument or evidence, there is no need to reiterate those arguments in this reply brief. However, Staff's claims that the Company is seeking to avoid the impact of a 2001 test year, that the 2002 figures are simply too high and should not be paid by ratepayers as well as Staff's effort to separate out interrelated adjustments in order to more favorably portray its position must be addressed herein. As explained below, none of these reasons supports rejecting the proposed pro forma adjustment to operating expenses.

1. Arizona-American Is Not Seeking to Evade the Effect of Using a 2001 Test Year.

Implicit in Staff's argument is the notion that the Company should have waited another year (or more) to file rate cases for the 10 water and wastewater systems. However, as Mr. Stephenson testified, as a legal, accounting, financial and practical matter, these cases had to be filed using a 2001 test year. Stephenson Rj. (Ex. A-75) at 8-9. For example, the Company was required to file a rate case for the Anthem water and Anthem wastewater systems. In addition, it had been several years since rate cases had been filed, no less than 7, and with respect to the water systems in Mohave County, it had been more than 10 years. *Id.* at 9. Further delays in filing would have made it even more difficult to reconcile plant records since the last rate cases. Tr. at 1537-38. Finally, of course, the Company's decision to file when it did was further justified when the Commission instituted a three-year moratorium on rate increases because, as Mr. Stephenson testified, the Company could not have survived financially without rate relief until sometime in 2007. Stephenson Rj. (Ex. A-74) at 3.

Once the Company selected the 2001 test year for all of these reasons, it was incumbent on the Company to assess the necessity for pro forma adjustments to test year data. As Mr. Bourassa explained, Citizens' corporate overheads and salaries and wages were non-recurring expenses. Tr. at 1544-45. Under proper rate-making, non-recurring

expenses are removed and expenses that are more characteristic of the Company's costs to be incurred during the time the rates are in effect are brought in. Accordingly, the Company's decision to propose a pro forma adjustment is not, as Staff continues to suggest, an attempt to evade the impact of selecting a 2001 test year. It is the appropriate rate making step once the Company was required to file using a 2001 test year.

2. Staff's Attempts to Exaggerate the Rate Impact of the Company's Pro Forma Adjustment are Misleading and Must be Rejected.

In order to exaggerate the impact of the Company's proposed pro forma adjustments, Staff attempts to separate the adjustment to remove non-recurring Citizens' overheads and replace them with AWW overheads and Service Company charges from the interrelated adjustment to remove Citizens' salaries and wages and bring in Arizona-American's salaries and wages. Staff Br. at 6-8; Tr. at 1044-47. As Mr. Bourassa explained, however, the adjustment to remove Citizens' overheads is directly interrelated to the adjustment to remove Citizens' salaries and wages. Tr. at 1545-50. The same is true of the adjustments to bring in AWW overheads and Service Company charges and Arizona-American's salaries and wages, which adjustments are directed related to the removal of Citizens' test year data. *Id.* In sum, the Company proposed a series of interrelated pro forma adjustments, accepted in concept by RUCO, i.e., to remove a Citizens' "apple" and substitute Arizona-American's "apple" because the Arizona-American "apple" reflects the Company's expenses on a going-forward basis. In contrast, Staff seeks to portray the Company's adjustment as first removing the Citizens' "apple" and then bringing in an Arizona-American "orange." This mischaracterizes the Company's pro forma adjustment and should be rejected.

The same is true of Staff's erroneous claim that "Arizona-American's expenses are $3.6 million greater than the former owner's expenses. This level of expense is imprudent, and it should be rejected." Staff Br. at 7. Again, as Mr. Bourassa explained,

when the Company's proposed pro forma adjustment to operating expenses is considered as a whole, the net effect on the Company's ratepayers is an increase of expenses of $1.5 million. Tr. at 1548-50. Moreover, this level of expense *is* prudent. As Mr. Jones and Mr. Stephenson both explained, without the transition to incorporate AWW's administrative and general corporate services, including the Service Company charges, into the operation of these water and wastewater systems, adequate service to customers would not have continued much beyond the test year. Tr. at 284, 1603-05; Jones Rj. (Ex. A-35) at 7-8.

There is overwhelming evidence supporting the Company's testimony that Citizens' 2001 overheads and salaries and wages were irregular. Citizens' test year corporate overheads and salaries and wages were are artificially decreased due to the pending sale of the water and wastewater systems. For example, Ray Jones, who was Vice President of Citizens' Arizona water and wastewater operations prior to Arizona-American's acquisition, testified that Citizens had taken numerous steps to reduce costs in late 1999 and continuing in 2000, and that this cost-cutting reached its peak in 2001. Jones Rj. (Ex. A-35) at 7-8. The evidence further shows that these cost-cutting measures had a substantial impact on the level of Citizens' operating expenses in 2001. Ex. A-88. In fact, Citizens' combined overheads and salaries and wages for 2001 were approximately $7.3 million *less* than the average of such costs for 1999 and 2000. *Id.*

Staff produces no evidence to contradict Mr. Jones' testimony, which is borne out by Citizens' expense data for 1999, 2000 and 2001, clearly showing that Citizens' test year operating expenses were irregular. Instead, Staff selectively ignores the portions of Mr. Jones' testimony and the record that contradicts their position. What cannot be ignored, however, is the fact that the Company's proposed pro forma adjustment results in AWW overheads, Service Company charges and salaries and wages that are significantly *lower* than the average of Citizens' 1999 and 2000 overheads and salaries and wages. Ex.

A-88. Thus, the Company's proposed pro forma adjustment results in an expense level that is not "simply too high" and that reflects necessary expenses being incurred by the Company to the benefit of ratepayers.

B. <u>Rate Case Expense</u>.

1. RUCO's Lone Opposition to Rate Case Expense Should be Rejected.

In its brief, RUCO continues to argue that the Company's rate case expense should be no more than $418,941. RUCO Br. at 7. In support of this recommendation, RUCO argues that the Company "failed to mitigate its rate case expense." *Id.* Each of RUCO's reasons is without support in the record and should be rejected. From the outset, though, it cannot be understated, the Company agrees that its rate case expense for this proceeding, over $1 million, is high. Tr. at 1594. The real question, as RUCO actually frames it, is whether the Company is responsible for that level of rate case expense. The simple answer to that question is no.

The Company is not responsible for, and has little control over, the process utilized by this Commission for setting rates, which includes liberal and substantial discovery, five rounds of pre-hearing filings, liberal intervention, lengthy evidentiary hearings, and multiple rounds of post-hearing briefing, followed eventually by exceptions and the appearances before the Commission at an Open Meeting. The bottom line is that Commission rate case proceedings are complex and involve a substantial expenditure of resources, with the applicant utility bearing the burden of proof and having to invest the greatest amount of time and resources in prosecuting its application.

Nor has the Company employed a "misguided and unorthodox approach" creating its own excessive rate case expense. RUCO Br. at 8. In fact, the sole factor RUCO offers in support of this tiresome allegation is the selection of a 2001 test year, which required review of Citizens' data. *Id.* Yet, the only issue in this case resulting from the use of

2001 test year was the dispute over the pro forma adjustment to remove Citizens' test year overheads and salaries and wages and bring in AWW overheads, Service Company charges and salaries and wages, an adjustment RUCO supports because the Citizens' data is irrelevant to Arizona-American's operations. Tr. at 609; Moore Dt. (Ex. R-3) at 3. Moreover, as discussed above, there were compelling reasons requiring the filing of this case using a 2001 test year. Stephenson Rj. (Ex. A-75) at 8-9. Finally, RUCO simply ignores clear and convincing evidence that delay would have exacerbated, not reduced, rate case expense. Tr. at 1537-38.

RUCO's argument that that the Company spent an exorbitant amount of time and expense with its fair value argument is also without merit. RUCO Br. at 9. To begin with, RUCO has not cited any evidence whatsoever to illustrate the impact this legal position had on rate case expense. Moreover, as clearly seen from the Company's initial closing brief, the Company's assertion that it is entitled to earn a fair rate of return on its fair value rate base is supported by an overwhelming body of law. Company Br. at 4-26. The mere fact that RUCO now disagrees with the Company's legal arguments does not mean that those arguments are incorrect.[10]

Of course, if RUCO were correct that the Company's rate case expense is high due to these factors, the Company shareholders are the ones responsible. Indeed, RUCO never comes to grip with the fact that the evidence in this case reflects that narely half of the total rate case expense incurred by the Company will be absorbed by the utility and its shareholder because the Company has only sought to recover $715,000. In this light, RUCO's continued assertion that the Commission would be sanctioning an "open checkbook policy" is frivolous. RUCO Br. at 7.

---

[10] *Compare, e.g., Residential Utility Consumer Office, supra* (holding that the Commission unlawfully authorized a surcharge to allow a water utility to recover Central Arizona Project water delivery charges in the absence of finding the utility's fair value rate base).

Ultimately, RUCO's entire argument regarding rate case expense is nothing more than a strained effort to justify its own number. However, despite RUCO's representations, it has not "considered what would be a fair amount of rate case expense under the circumstances." RUCO Br. at 9. RUCO's number is derived solely by taking the rate case expense in the last Citizens' rate case and adjusting it for inflation. Tr. at 812. This method is simplistic and ignores all of the unique characteristics of the two cases. It also selectively ignores the fact that the Commission authorized rate case expense of $165,000 in the last rate case for the Mohave districts decided in 1990. *See* Ex. S-4, Decision No. 56806 (February 1, 1990) at 10-11. Had RUCO used that prior Citizens' rate case, made an adjustment for inflation and the greater number of district (10 versus 2), it would have resulted in a far greater amount than the amount the Company is now requesting. Tr. at 1598. In short, RUCO's analysis does not in any way result in a fair level of rate case expense and, for all the reasons testified to by Mr. Stephenson and discussed in the Company's initial brief, the Company's request to recover $715,000 of rate case expense is reasonable under the circumstances in this case.

2. A Five-Year Amortization Period is Unwarranted.

Although it does not contest the Company's request to recover $715,000 of rate case expense, Youngtown recommends that the Commission reject the three-year amortization period supported by all other parties in favor of a five-year amortization period. In response to Youngtown's recommendation regarding rate case expense amortization, Mr. Stephenson explained that the Company is likely to file its next rate case at the earliest possible date. Stephenson Rb. (Ex. A-74) at 24-25. This means a rate case will be filed no later than early 2006, when the current moratorium on rate increase applications imposed by the Commission expires. In contrast, Youngtown cites only the past record of Citizens with respect to the timing of rate case filings. Youngtown Br. at 15. However, Citizens' track record is irrelevant.

C. RUCO's Property Tax Expense Methodology Must Be Rejected, Again.

RUCO witness Tim Coley, who supported RUCO's property tax expense recommendation, admitted that RUCO's position is identical to RUCO's recommendations in recent rate cases. Tr. at 559. He further admitted the Commission has rejected RUCO's position. *Id.; see also, Arizona Water Company*, Decision No. 64282 (Dec. 28, 2001). Since RUCO offers no change in the facts or law, the Commission should do so again.

IV. COST OF CAPITAL AND RATE OF RETURN.

A. Capital Structure and Cost of Debt.

Staff is the only party (other than Arizona-American) to address the Company's capital structure and cost of debt in its brief. Staff Br. at 13-14. As discussed in the Company's initial brief, however, Staff again fails to recommend a capital structure that contains specific amounts of debt and equity, but rather advocates the adoption of percentages of each component of the Company's capital structure, which are used to compute a weighted cost of capital on a Company-wide basis. That cost of capital is then used as the rate of return and is applied to the OCRB for each water and wastewater district to derive Staff's revenue requirement. *E.g.*, Reiker Sb. (Ex. S-46), Schedule JMR-S8 (Staff's recommended capital structure); Carlson Dt. (Ex. S-47) at 8 ("Operating income should be calculated by applying the recommended cost of capital to the [OCRB].").

Staff argues that its recommended capital structure as well as its cost of debt should be approved simply because those recommendations are "based on information provided by Arizona-American." Staff Br. at 13-14. However, it is impossible to determine whether Staff has correctly utilized the information furnished by the Company because Staff has failed to provide the specific amounts of debt and equity in its proposed capital structure. As explained in the Company's initial brief, Staff determined that the Company's rate applications were deficient for precisely this reason. Company Br. at 42.

Staff's position also reinforces the fallacy underlying Staff's so-called "economic" arguments in favor of using the "backing in" method to establish the return on the fair value rate base for each district. As explained on pages 20-21, above, Staff uses percentages of debt and equity to determine the cost of capital, rather than the actual dollar amounts, because the utility's actual investment is not relevant under Staff's methodology. The rate of return is determined independently of the utility's rate base. *Id.* This approach also enables Staff to contend that its recommended rates of return on each district's fair value rate base is sufficient to produce a pre-tax interest coverage ratio in excess of 3.0 when Staff's recommendations will actually result in a pre-tax interest coverage ratio of slightly over 1.0. *Compare* Stephenson Rb. (Ex. A-74), Rebuttal Schedule 4, page 1 (showing calculation of pre-tax interest coverage) *with* Reiker Sb. (Ex. S-46), Schedule JMR-S8 (showing Staff's calculation of pre-tax interest coverage).

B. Arizona-American's Recommended Cost of Equity Is Reasonable and Should Be Adopted.

There is no disagreement that the methods used by the cost of capital witnesses for the Company, Staff and RUCO, the DCF model – the Risk Premium model and the CAPM model – are all recognized methods of estimating the cost of equity. *E.g.*, Roger A. Morin, *Regulatory Finance: Utilities Cost of Capital* 28 ("There are four generic methodologies available to measure the cost of equity: DCF, Risk Premium, and CAPM, which are market-oriented, and Comparable Earnings, which is accounting oriented."). There is considerable disagreement, however, regarding how these methodologies should be employed. As the Arizona Utility Investors Association has pointed out in its brief, the manner in which Staff's witness, Mr. Reiker, has chosen to implement the DCF model and the CAPM in arriving at his recommended 9.0% equity return is designed to produce the lowest possible results. AUIA Br. at 8-9. *See also* Tr. at 1423-30. Using Mr. Reiker's models and their inputs, but applying more reasonable assumptions, Dr. Zepp

demonstrated that Staff's recommended equity return for Arizona-American is understated by more than 100 basis points. *See* Zepp Rj. (Ex. A-50) at 10-14 and Rejoinder Table 14.

Perhaps more importantly, putting aside the technical arguments presented by Mr. Reiker, his cost of equity estimates are simply not consistent with recent authorized returns on common equity, realized returns on common equity, and *Value Line*'s forecasted returns on common equity for the sample group of publicly traded water utilities. As discussed in the Company's initial brief, the manner in which the DCF and CAPM models have been implemented by Mr. Reiker (as well as by Mr. Rigsby, RUCO's cost of capital witness) produce equity cost estimates substantially ***below*** the actual and forecasted returns on equity for the water utility sample group. Company Br. at 48-51. As Mr. Meek testified:

> Simple common sense warns that something is wrong with models that produce such low results compared to actual returns in the market. Mr. Reiker does not really explain how this disconnect occurs. He simply accepts the result produced.

Meek Rb. (Ex. AUIA-1) at 11. When Mr. Reiker's particular version of the CAPM produces a cost of equity of only 8.1% while the sample group of publicly traded water utilities are actually earning returns substantially in excess of 10% and are forecasted by *Value Line* to earn 11.0% on common equity in 2004, something is plainly wrong.

1. Staff's Criticisms of Dr. Zepp's DCF Model Estimates Are Groundless.

A number of Staff's criticisms of Dr. Zepp's cost of equity estimates are simply red herrings that are irrelevant. Staff contends that Dr. Zepp "improperly excluded" Connecticut Water and Middlesex Water from his water utility proxy group. Staff Br. at 14-15. Contrary to Staff's representations, however, Dr. Zepp explained that he excluded

those two utilities in preparing his direct testimony in 2002[11] because their stock prices had increased dramatically between 1999 and 2002 and, as a consequence, these companies appeared to be merger or acquisition targets. Zepp Dt. (Ex. A-44) at 13-14. In fact, this is borne out by the record. The total shareholder return (dividends plus appreciation in stock price) for the two companies as of September 30, 2003, is as follows:

	3-Year Total Return	5-Year Total Return
Connecticut Water	37.6%	90.0%
Middlesex Water	40.8%	110.2%

Ex. A-83. Thus, an investor in the stock of these two utilities would have earned, on average, a return in excess of 13% per year over a three-year period, and a return in excess of 20% per year over a five-year period.[12]

Because of this rapid appreciation in stock price, Dr. Zepp excluded Connecticut Water and Middlesex Water in performing his DCF and Risk Premium estimates. *See* Zepp Rb. (Ex. A-49) at 7-9. Staff contends that these two utilities should have been used. Regardless of who is right, it ultimately makes no difference. As Dr. Zepp testified, Middlesex Water has an estimated equity cost of 10.5% (Zepp Rb. (Ex. A-49) at 8), while both utilities currently have returns on equity substantially in excess of Staff's recommendation. Ex. A-98.[13] Moreover, in restating Mr. Reiker's DCF equity cost estimates, Dr. Zepp included both water utilities. Zepp Rj. (Ex. A-50) at 17.

---

[11] Arizona-American's rate applications were filed for nine of the 10 water and wastewater districts in November 2002, while the application for the Tubac water district was filed in December 2002.

[12] According to Mr. Reiker, these are the returns that utility investors such as Mr. Meek should be primarily concerned about. Obviously, Mr. Meek would have done quite well if he had had the foresight to invest in Connecticut Water and Middlesex Water in the Fall of 1998.

[13] Connecticut Water's current return on equity is 11.4%, while Middlesex Water's current return on equity was 9.6%. Ex. A-98.

Similarly, Staff criticizes Dr. Zepp for using 3-month and 12-month average stock prices to compute dividend yields in his DCF estimates. Staff Br. at 15-16. First, in updating his cost of equity estimates in his rebuttal testimony, Dr. Zepp did ***not*** use 12-month average stock prices. *See* Zepp Rb. (Ex. A-49), Update Tables 8 and 14. Second, while Staff claims that "the best forecast of tomorrow's yield is simply today's yield," Mr. Reiker used stock prices as of September 25, 2003, which are already nearly five months old and will be even more outdated by the time the Commission issues its decision. *See* Reiker Sb. (Ex. S-46), Schedule JMR-S5. Finally, once again, Dr. Zepp used Mr. Reiker's spot prices in restating Mr. Reiker's DCF equity cost estimates. Zepp Rj. (Ex. A-50) at 18 and Rejoinder Tables 3 and 4.

Ultimately, the primary difference between the Company and Staff is the method chosen to estimate growth rates. Dr. Zepp relied on near-term earnings and sustainable growth in his constant growth DCF model estimates, and did not consider dividend per share ("DPS") growth and historic earnings per share ("EPS") growth because, as Dr. Zepp has discussed at length, these measures of growth are substantially less than other recognized measures of dividend growth. *E.g.*, Zepp Rb. (Ex. A-49) at 42-47; Zepp Rj. (Ex. A-50) at 19-21; Tr. at 322. For the water utility sample, EPS growth is expected to be three times faster than DPS growth. For the gas utility sample, EPS are expected to grow six times faster than DPS. Zepp Rb. (Ex. A-49) at 43. In addition, during the past five years, average prices for water utility stocks have increased faster than EPS, DPS and book value. *Id.* at 44 and Rebuttal Table 6. Dr. Zepp explained that this growth in prices would cause investors to expect more rapid growth in the future than in the past – otherwise, investors would not bid up the price of the stock. *Id.* He also showed that the use of historic and forecasted DPS growth in the constant growth DCF model would produce equity cost estimates in the range of 6.5% to 7.4% – a result below the rate for Baa-rated bonds forecasted for 2004. Zepp Rb. (Ex. A-49) at 46-47.

By simply restating the growth component of Mr. Reiker's constant growth DCF equity cost estimates to eliminate historic and forecasted DPS growth, Mr. Reiker's DCF model produced equity cost estimates that averaged 9.8% and 10.0% at the time Dr. Zepp prepared his rebuttal testimony, and 9.8% and 9.9% when Dr. Zepp prepared his rejoinder testimony. Zepp Rb. (Ex. A-49), Rebuttal Tables 10 and 11; Zepp Rj. (Ex. A-50), Tables 3 and 4. With the inclusion of an additional 50 basis points to account for leverage (which is not in dispute), the indicated equity cost for Arizona-American, using Mr. Reiker's own methodology, ranges from 10.3% to 10.5% – substantially greater than Mr. Reiker's 9.0% recommendation.

Staff's attack on Dr. Zepp's restatement of Mr. Reiker's multi-stage DCF model is also misguided. Mr. Reiker improperly used a two-stage DCF model that assumes investors would look at dividend growth for five years ("stage 1") and then adopt a growth rate for the economy as a whole for the terminal growth rate ("stage 2"). Zepp Rb. (Ex. A-49) at 47-48. As explained by Dr. Zepp:

> Knowledgeable investors expect the relatively slow near-term growth in DPS will be rewarded by higher future growth as the utilities gain financial strength from growing their earnings retention ratios. A multi-stage growth DCF model should incorporate this reasonable expectation of investors and not immediately go to a final stage growth rate that has nothing to do with the improved financial strength of the utilities.

Id. at 48. Staff also criticizes Dr. Zepp for using *Value Line* forecasts of intrinsic or sustainable growth to determine second-stage growth in Dr. Zepp's more sophisticated, three-stage restatement of Mr. Reiker's model. Staff Br. at 17. However, Mr. Reiker's two-stage version of the model is far more speculative because it (1) ignores known forecasted growth for the water utilities included in Mr. Reiker's constant growth DCF analysis (but not in his multi-stage analysis[14]), and (2) assumes that an economy-wide

[14] Ironically, Staff criticizes Dr. Zepp for not including Connecticut Water and Middlesex

growth rate will apply to the utility sample group as early as 2009. *Id.* at 48-49; Zepp Rj. (Ex. A-50) at 21 and 23. Notably, Dr. Zepp's approach is supported by Professor Myron Gordon, who is acknowledged by Mr. Reiker to be an authority on the DCF model. Zepp Rj. (Ex. A-50) at 21-22 and Exhibit TMZ-RJ-2 (communication from Professor Gordon); Reiker Dt. (Ex. S-45) at 10, 15, 41 and 50 n.50.

2. Staff's CAPM Equity Cost Estimates Are Unreasonably Low and Should Be Rejected.

Staff begins its discussion of its CAPM estimates by stating that the "CAPM, the work of Nobel Prize winning economists, is the best-known model of risk and return." Staff Br. at 17 (citing Reiker Dt. (Ex. S-45) at 21). In fact, Mr. Reiker's statement is taken out of context and is misleading. The entire statement, which is found in a well-known college finance textbook, is actually as follows:

> The capital asset pricing theory is the best-known model of risk and return. It is plausible and widely used but far from perfect. Actual returns are related to beta over the long run, but the relationship is not as strong as the CAPM predicts, and other factors seem to explain returns better since the mid-1960s. Stocks of small companies, and stocks with high book values relative to market prices, appear to have risks not captured by the CAPM.

Richard A. Brealey and Stewart C. Myers, *Principles of Corporate Finance* 212 (6th ed. 2000). This is another source Mr. Reiker regards as authoritative. Reiker Dt. (Ex. S-45) at 6, 21, 30, 34 and 59 (citing textbook).

The publicly traded water utilities in Staff's sample group are all small companies. Philadelphia Suburban is by far the largest water utility in the sample group, with net utility plant of nearly $1.4 billion and operating revenue in excess of $400 million, as well

---

Water in his water utility sample group, while Mr. Reiker has excluded both of those water utilities as well as SJW Corp. from his water utility sample group in performing his multi-stage DCF estimate.

as operations in 15 states. Ex. A-100. Philadelphia Suburban is nevertheless considered a "Mid Cap" stock, while the remaining five water utilities are considered "Small Cap" stocks. Ex. A-83. In other words, the companies in the water utilities sample group fall within the category of stocks that "appear to have risks not captured by the CAPM," i.e., the results of the basic CAPM ***understate*** their equity cost. Moreover, as Dr. Zepp explained, the stocks of small companies that are thinly traded on the market are expected to have betas that are biased downward, which again understates the equity cost produced by the CAPM. Zepp Dt. (Ex. A-44) at 46-47; Zepp Rb. (Ex. A-49) at 11 and 34-35.[15]

Given these problems with the CAPM generally and in applying this model to the sample groups of utilities used in this case, it is little wonder that Mr. Reiker's CAPM estimates are extremely low: ***only 8.1%***. Reiker Sb. at 2 and Schedule JMR-S7. Mr. Rigsby's revised CAPM estimate is not much better, only 8.75%. Rigsby Sb. (Ex. R-6) at 7. Neither Mr. Reiker nor Mr. Rigsby provides any explanation for the extremely low result produced by his particular version of the model. Moreover, Mr. Reiker has employed a version of the model that is extremely volatile and produced dramatically different results over a period of several months. Between the time Staff filed its direct and its surrebuttal testimonies, Mr. Reiker's indicated cost of equity decreased from 11.1% to only 8.1%. *Compare* Reiker Dt. (Ex. S-45), Schedule JMR-S8 *with* Reiker Sb. (Ex. S-46), Schedule JMR-S7. This dramatic decrease occurred despite the fact that Mr. Reiker used an intermediate-term Treasury spot rate that was actually 30 basis points *higher* when the second CAPM equity cost estimate was made. *Id.* Once again, something is clearly wrong.

Both Mr. Reiker and Staff in its brief contend that Professor William Sharpe is an

[15] As a result, Philadelphia Suburban, the largest and most geographically diverse water utility in the sample group, has a substantially higher beta than Middlesex Water and SJW Corp., whose stocks are infrequently traded. Ex. A-100.

authority on equity cost estimation techniques. Staff Br. at 19.[16] As Dr. Zepp has explained, Professor Sharpe now believes that a different version of the CAPM, known as the "zero-beta" CAPM, provides a better explanation of stock prices, and the version of the CAPM used by Mr. Reiker (and Mr. Rigsby) understates the expected return on the risk-free asset used in the model. Zepp Dt. (Ex. A-44) at 45 n. 14; Zepp Rb. (Ex. A-49) at 39-41. Other tests of the CAPM also indicate that versions of the model Staff and RUCO have used are biased downward. Zepp Rb. (Ex. A-49) at 38-39. Given the uncertainty surrounding the versions of the CAPM used by Staff and RUCO, the problems with estimating the betas for small water utility stocks, the low results produced by their versions of the CAPM (8.1% and 8.75%, respectively), and the fact that Arizona-American is not publicly traded and has no beta, the Staff and RUCO CAPM equity cost estimates must be rejected.

3. The Risk Premium Method Provides a Direct and More Objective Estimate of the Current Cost of Equity Than the CAPM.

Because of the problems in implementing the CAPM, few regulatory commissions give the CAPM much weight when determining equity costs. Zepp Rb. (Ex. A-49) at 39-40. The preferred method to implement the CAPM is to estimate the equity cost using a risk premium approach, as Dr. Zepp has done. Under that approach, the risk premium is directly estimated by comparing authorized and actual returns on equity with rates on bonds or other debt instruments. Under the risk premium approach, "there is no need to estimate betas or market risk premiums, and there is no reason to determine if 'beta risk' is the only risk of relevance to investors holding shares of water utilities. It is a simpler and less subjective approach." *Id.* at 40.

Staff argues that Dr. Zepp's risk premium cost of equity estimates should be

[16] In fact, Professor Sharpe was a co-winner of the Nobel Prize for his work in developing the initial version of the CAPM in the mid-1960s. Brealey and Myers, *supra*, at 195.

rejected because, first, he has relied on forecasts of Baa corporate bond rates. Staff Br. at 18. Staff argues that "current" interest rates (i.e., interest rates as of September 2003) provide a more accurate indication of interest rates during the second half of 2004 and 2005 – the time period during which new rates will be in effect – than forecasted rates. Dr. Zepp explained why this argument is erroneous. *E.g.*, Zepp Rj. (Ex. A-50) at 23-26.

> There are basically three approaches that can be taken. One is Mr. Reiker's approach, adopt current interest rates and assume they are the best forecast of next year's rates. The second is to adopt published forecasts of interest rates. Third is to derive forward rates for 2004 from current short-term rates and current intermediate-term rates. Of the three, the approach Mr. Reiker has taken creates the most uncertainty and the greatest chance that the cost of equity will be understated.

Id. at 24. Dr. Zepp provided evidence showing that interest rates increased in 2003 and are forecasted to be even higher in 2004. *Id.*, Rejoinder Table 6 (comparing current and forecasted treasury rates). In his Direct Testimony, Mr. Reiker stated that interest rates "are currently at their lowest level since the 1950's." Reiker Dt. (Ex. S-45) at 5. Since Mr. Reiker filed that testimony, however, the average of intermediate-term Treasury rates increased by 50 basis points. *Id.* at 2 and Rejoinder Table 6.[17] It is unreasonable to assume that interest rates will remain indefinitely at last summer's levels, as Mr. Reiker does.

Staff also argues that Dr. Zepp's risk premium approach is flawed because Baa corporate bond rates include a default premium. Staff Br. at 19 Dr. Zepp explained that this is another red herring. Whether or not there is a default premium in Baa bond rates does not matter if the same default premium that existed in the past is expected in the future. Zepp Rj. (Ex. A-50) at 26. He also explained that the quotation from Professor

[17] At the same time, however, Staff's recommended equity cost decreased by 70 basis points, from 9.7% to 9.0%. Apparently, as interest rates go up, equity costs go down. *Compare* Reiker Dt. (Ex. A-45) at 6 ("According to the [CAPM], the cost of equity moves in the same direction as interest rates.").

Sharpe in Mr. Reiker's Surrebuttal Testimony (referenced in Staff's brief) does not apply to the analysis Dr. Zepp presented because the analysis already takes into account the existence of a risk premium. *Id.* at 26-27. This is supported by Dr. Morin's view that "the choice of debt instrument in the risk premium analysis is largely immaterial, as long as it is consistently applied." Morin, *supra*, at 278.

Dr. Zepp provided empirical data demonstrating that Baa corporate bond rates provide more reliable estimates of the cost of equity than Treasury rates. Zepp Rb. (Ex. A-49) at 22-23 and Rebuttal Tables 2 and 3. The validity of Dr. Zepp's risk premium method is also supported by the fact that his estimated equity costs for the sample group of publicly traded water utilities range from 10.3% to 11.2% – a range that is consistent with the authorized, actual and forecasted returns on equity for those utilities. This range is far more reasonable than Staff's CAPM equity cost estimate of 8.1%.

V. RATE DESIGN.

A. Staff's Proposed Rate Design will not Promote Conservation.

In its initial brief, the Company discussed at some length the various defects in Staff's proposed three-tier, inverted block rate structure, which, as Staff's rate design witness admitted, will not reduce consumption by existing customers and will primarily impact *future* commercial and industrial customers. Company Br. at 56-60; Tr. at 1099-101 and 1114-15. Nevertheless, Staff argues, with no legitimate basis, that its rate design "targets conservation." Staff Br. at 11. This is simply not accurate. In reality, Staff's proposed rate design will fail to send a price signal to all but the largest customers while providing discounted rates to the majority of Arizona-American's customers because the *same* break-over points would apply to all customers, regardless of the type of use and meter size.

Staff argues that its first tier appropriately recognizes that a certain level of water usage is "non-discretionary" because it is needed for health and safety. Staff Br. at 10.

However, this argument simply misses the point. Every customer will be entitled to receive service at a discounted rate for all usage within that block, i.e., a rate that is below the cost of service. Selling water below cost does not encourage water use efficiency, as Staff claims. Kozoman Rb. (Ex. A-62) at 4-5. A substantial portion of many residential customers' monthly usage will fall in this block, thus creating an incentive to use more, not less, water. *Id.* at 6, *quoting* American Water Works Association, *Alternative Rates* 11 (attached as Rebuttal Exhibit 1). As an example, the following table shows the percentage of usage in Staff's initial discounted rate block for an average residential customer being served by a 5/8 inch meter.

	Average Usage	Percentage of Use in Initial Block
Agua Fria	7,002 gal.	57%
Anthem	10,212 gal.	39%
Havasu	7,650 gal.	52%
Mohave	8,787 gal.	46%
Sun City	8,361 gal.	49%
Sun City West	7,171 gal.	56%
Tubac	13,177 gal.	30%

Kozoman Rj. (Ex. A-63), Rejoinder Schedules H-2. The vast majority of customers will have their monthly bills reduced by virtue of this rate design.

At the same time, however, very few residential customers will have monthly water usage that exceeds the 100,000 gallon break-over point separating Staff's middle and upper commodity rate tiers.[18] In fact, many commercial customers on smaller size meters likewise do not use more than 100,000 gallons each month. Tr. at 1093. All of these

[18] Between 88% and 92% of the Company's customers in each water district are residential. Tr. at 419.

customers will benefit by receiving their first 4,000 gallons of water each month at a discounted rate. However, because the break-over point between the second and third tiers has been set at 100,000 gallons, they will not receive any sort of price signal that will encourage conservation. For example, a single-family residential customer could use an average of 83,333 gallons of water per month, or a total of 1 million gallons of water annually, and never be subject to the higher commodity rate in Staff's upper tier.

As a consequence, as Mr. Kozoman testified, while Staff's rate design may have three inverted tiers, it is not a conservation-oriented rate structure. Kozoman Rb. (Ex. A-62) at 27. *See also* Tr. at 1301-02. "The simple fact is that Staff's rate design is intended to shift the recovery of revenues to larger sized meters, in violation of cost of service principles, and not to achieve conservation or any societal goals." Kozoman Rj. (Ex. A-63) at 5. Mr. Rogers admitted that only a "small minority" of customers would actually be impacted by the 100,000 gallon break-over point. Tr. at 1092-93. In its brief, Staff similarly states that its rate design is intended to have a limited effect on existing customers. Staff Br. at 11. Far from standing "front and center" (Staff Br. at 11), conservation is cowering in the broom closet. Consequently, this rate design must be rejected.

B. Staff's Criticisms of the Company Are Without Merit.

Staff claims that Arizona-American has ignored "the plethora of evidence in support of Staff's rate design" and remains "defiant in its objections." Staff Br. at 11-12. This is, of course, nonsense given the dearth of evidence Staff has presented. The bottom line is that Staff has proposed an extremely poor rate design that, by Mr. Rogers' own admission, is unlikely to have any immediate effect on consumption. *E.g.*, Tr. at 1096.

This same sort of rate structure was proposed by Staff in the rate proceeding for Arizona Water Company's Northern Group water systems and was rejected by the Commission. Decision No. 64282 (Dec. 28, 2001) at 21-22. A similar rate design was

proposed by Staff in that water utility's pending rate proceeding for its Eastern Group water systems, and in the Administrative Law Judge's recommended order, Staff's rate design was again rejected. Recommended Opinion and Order, Docket No. W-01445A-02-0619 (filed Jan. 2, 2004) at 24-26. *See also* Tr. at 1068-71 and Ex. A-90 (excerpt from Direct Testimony of John S. Thornton[19]). As in those proceedings, Staff in this case did not prepare a cost of service study or otherwise perform a detailed billing analysis in order to develop appropriate break-over points and commodity rates by meter size or customer class. Tr. at 1102-07. To contend that there is a "plethora" of evidence supporting Staff's proposal is, at best, hyperbole.

Incredibly, Staff argues that the lack of support for Staff's rate design is the fault of the Company. Staff points out that Arizona-American did not file any cost of service studies, suggesting that this somehow hampered Staff. Staff Br. at 12. This is nonsense. First, Arizona-American did not file any cost of service studies because it did not propose any changes in rate design. Kozoman Dt. (Ex. A-52) at 3-4. Second, Staff had ample time to prepare its own cost of service studies or perform an analysis of the Company's customers and test year billings in order to develop an effective conservation-oriented rate structure. The Company's rate applications were filed in November 2002, and were found sufficient in January 2003. *See* Letter of Sufficiency (docketed Jan. 30, 2003). Staff's direct testimony was not filed until September 5, 2003, which was sufficient time for Staff to conduct the sort of analysis required to support its proposed rate design. Third, the Company *did* perform cost of service studies for each of its water districts as part of its rebuttal filing, using Staff's recommended revenue and rate design. Kozoman Rb. (Ex. A-62) at 9-17 and Rebuttal Schedules G-1 through G-9. In short, Staff cannot blame the Company for the defects in Staff's rate design.

---

[19] Staff's rate design witness in Arizona Water Company's Eastern Group rate case was Mr. Thornton.

Staff also complains in a footnote on page 12 of its brief that Arizona-American "failed" to provide Staff and the other parties with its suggested alternative form of rate design "until January 23, 2004." The Company developed this alternative following the evidentiary hearing, which concluded on December 23, 2003. Despite the holidays, the Company was able to develop inverted-tier rate designs for each of the seven water districts that differentiate among different classes of customers and different size meters. Company Br. at 60-64 and schedules attached at Tab A. *See also* Sun Health Br., attached memorandum from Arizona-American. Put bluntly, the Company did in 30 days following the hearing what Staff was unable to do during the 12 months preceding the hearing.

Finally, Staff states that it identified "problems" regarding the existing rate designs for multi-unit commercial customers served by the Mohave and Havasu water districts. However, according to Staff, because Arizona-American did not submit cost of service studies, Staff could not recommend any "wholesale" changes to the rate design for those customers. Staff Br. at 13. Again, this criticism is groundless. First, as Mr. Kozoman testified, Citizens proposed changes to its rate design to address multi-unit commercial customers in its prior rate case for the Mohave water district. However, Staff recommended that the current rate design be retained, and the Commission adopted Staff's recommendation. Kozoman Rb. (Ex. A-62) at 28. Second, Staff certainly had ample time to develop an alternative rate design for multi-unit commercial customers in those two water districts, and simply chose not to do so. Third, as stated above, Arizona-Arizona did file cost of service studies based on *Staff's* recommended revenue and rate design, which should have allowed Staff to develop a recommendation. There is no evidence in the record suggesting that Arizona-American's failure to file cost of service studies impaired or hindered Staff's ability to develop an alternative rate design over the

past year, and Staff's attacks on Arizona-American are unwarranted.[20]

C. Youngtown's Request for a Stepped Rate Increase is Unlawful.

In its brief, Youngtown has requested that the Commission phase in any rate increase for the Sun City water and wastewater districts in two or three steps: two equal steps if the rate increase is between 20% and 40%, and three equal steps if the increase is greater than 40%. Youngtown Br. at 14. This request is unlawful because it would deprive Arizona-American of a fair return on its rate base.

As authority for this request, Youngtown cites *Arizona Comm. Action Ass'n v. Arizona Corp. Comm'n*, 123 Ariz. 228, 599 P.2d 184 (1979). That case, however, does not allow the Commission to determine the fair value of a utility's plant and property, establish a rate of return to be earned on fair value, and then deny the utility the right to recover that return by phasing in the required rate adjustments. Instead, the court held that it was lawful for the Commission to authorize future rate increases based on construction work in progress ("CWIP") related to the Palo Verde nuclear generation facility, which was then under construction. The court found it "entirely reasonable" for the Commission to allow the inclusion of CWIP in rate base and to allow APS to receive "step" rate increases based on CWIP. *Arizona Comm. Action*, 123 Ariz. at 230-31, 599 P.2d at 186-87. The court stated that the "adjustments ordered by the Commission in adding CWIP to th[e] determination of fair value were adequate to maintain a reasonable compliance with the constitutional requirements if used for only a limited period of time," i.e., until a new rate case was filed by APS. *Id.* at 231, 599 P.2d at 187. However, the court did not hold, or otherwise suggest, that it would be permissible for the Commission to withhold rate increases determined necessary to produce a reasonable on the fair value of APS's property. *Compare, e.g., Scates*, 118 Ariz. at 534, 578 P.2d at 615 ("the rates

[20] It should be noted that Arizona-American has not opposed modifying the rates for multi-unit commercial customers in the Mohave and Havasu water districts. Kozoman Rb. (Ex. A-62) at 28. The decision not to do so was made entirely by Staff.

cannot be considered just and reasonable if they fail to produce a reasonable rate of return").

Youngtown also seems to suggest that if the Commission were to conclude that it is indeed illegal to deprive the Company of a reasonable return by phasing in the rate increases, then the Commission should simply cap the increase based on Youngtown's proposed phasing. Youngtown Br. at 15. This would also be illegal because, if adopted, it would effectively limit Arizona-American to a maximum revenue increase of 20% for each district, regardless of whether that increase would actually produce a reasonable rate of return on fair value. Youngtown offers no authority for this remarkable request, other than suggesting it would be fair to do so. This would be contrary to Arizona law and amount to confiscation of Arizona-American's property, as the Arizona appellate decision discussed at pages 12-14, above, clearly hold. In short, the Commission should reject Youngtown's attempt to rewrite Arizona law and override the Constitution.

D. Recovery of Increased Costs Under the Tolleson Agreement Should Not Be Denied.

In its closing brief, RUCO asserts that the Company should not be allowed to recover increased Tolleson costs under the Third Amendment because it has an accounting order that authorizes the Company both accrual *and* recovery. RUCO Br. at 12. This is simply erroneous. In fact, Ms. Diaz Cortez testified that the accounting order does not guarantee or ensure any recovery of costs by Arizona-American. Tr. at 742. *See also* Tr. at 1470.

Staff's arguments in favor of denying cost recovery are equally unpersuasive. First, Staff asserts that Mr. Bourassa agreed that the Tolleson costs are not known and measurable. Staff Br. at 9. This misstates the record. In the portion of the transcript Staff cites, Mr. Bourassa was asked on cross-examination if the Tolleson costs under Rate Component Four were sufficiently "known and measurable" for a pro forma adjustment.

Mr. Bourassa explained that he was not recommending such an adjustment. Tr. at 146-47. Staff ignores Mr. Bourassa's earlier testimony when Staff actually asked whether the costs under Rate Component Four were "known and measurable." Tr. at 145. In response to that inquiry, Mr. Bourassa explained that the liability was known now and that the costs would be fully known and measurable at the time ratepayers pay for them through rates. *Id.* The very purpose of the "known-and-measurable" standard is to ensure, as nearly as possible, that expenses like these are not under or over-collected. As Mr. Bourassa explained, under the Company's proposed recovery mechanism, ratepayers would pay only for costs at the time they are "known and measurable." Tr. at 146-46.

Staff's argument that Arizona-American has sufficient control over these costs to justify the denial of cost recovery also fails. Staff Br. at 9. Staff witness Darron Carlson testified that the Company has "very little input" on the level of plant investment Tolleson will make. Tr. at 1473. Nevertheless, the Staff's engineering witness, Dorothy Haines, testified that these costs were not only necessary, but would benefit ratepayers when compared to the cost of designing and constructing a new treatment plant. Tr. at 1152-54. Mr. Bourassa testified that the Company can tell Tolleson that it believes the costs are too high, but has no control over Tolleson's final decision. Tr. at 155-56 and 208-09. The contract itself provides Arizona-American nothing more than the right of engineering input. Ex. S-1. Obviously, input is not equivalent to control. Therefore, there is no evidence to support Staff's claim that the Company has "control" over the costs Arizona-American must incur under its agreement with Tolleson.

Finally, Staff's argument that the recovery mechanism is too complex must be rejected. Staff Br. at 9. Staff has not cited any evidence that the mechanism is complex. Instead, Staff counsel merely asked Mr. Bourassa whether he designed it to be simple. Staff Br. at 9, *citing* Tr. at 161. Mr. Bourassa actually testified he thought the adjuster was simple enough. Tr. at 161. Customers will simply see a line item on their bill for the

Tolleson costs being recovered by means of the Company's cost recovery mechanism. Any "complexity" is the result of the Company designing the cost recovery mechanism to spread the expense over the remaining life of the Tolleson Agreement, rather than filing rate applications each year to recover the costs the Company must pay Tolleson to receive wastewater treatment service. Arizona-American should not be deprived of recovery because it has sought to minimize the impact of substantial, but necessary, expenses on its customers.

RESPECTFULLY SUBMITTED this 18th day of February, 2004.

FENNEMORE CRAIG

By Norman D. James

Norman D. James
Jay L. Shapiro
3003 North Central Avenue
Suite 2600
Phoenix, AZ 85012
Attorneys for Applicant
Arizona-American Water Company

An original and 21 copies of the foregoing and attachments were delivered this 18th day of February, 2004, to:

Docketing Supervisor
Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, AZ 85007

A copy of the foregoing and attachments were hand-delivered this 18th day of February, 2004, to:

Chairman Marc Spitzer
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Commissioner William Mundell
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Commissioner Mike Gleason
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Commissioner Jeff Hatch-Miller
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Commissioner Kristin Mayes
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Paul Walker, Aide to Chairman Spitzer
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Adam Stafford, Aide to Commissioner Mundell
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Jodi Jerich, Esq., Aide to Commissioner Gleason
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Dean Miller, Aide to Commissioner Hatch-Miller
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Jerry Hays, II, Aide to Commissioner Mayes
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Teena Wolfe
Administrative Law Judge

Arizona Corporation Commission
1200 West Washington
Phoenix, AZ

Timothy Sabo, Esq.
Gary Horton, Esq.
Legal Division
Arizona Corporation Commission
1200 West Washington
Phoenix, AZ

Darron Carlson
Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, AZ

Daniel Pozefsky
Residential Utilities Consumer Office
1110 W. Washington, Suite 220
Phoenix, AZ 85007

And a copy mailed this 18th
day of February, 2004 to:

Carlton G. Young
3203 W. Steinbeck Dr.
Anthem, AZ 85086

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

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

William P. Sullivan
Paul R. Michaud
Martinez & Curtis
2712 N. 7th St.
Phoenix, AZ 85006
Attorneys for the Town of Youngtown

Walter Meek
Arizona Utility Investors Association
2100 N. Central Ave.
Phoenix, AZ 85004

John Buric, Esq.
Warner Angle Hallam Jackson & Formanek
3550 N. Central Ave., Suite 1500
Phoenix, AZ 85012
Attorneys for Fiesta RV Resort
Kenneth C. Sundlof, Jr., Esq.
Robert Taylor, Esq.
The Collier Center, 11th Floor
201 E. Washington St.
Phoenix, AZ 85004-2385
Attorneys for Sun Health Corporation

By: Mary House