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BEFORE THE ARIZC... ...N

COMMISSIONERS

MARC SPITZER - Chairman
WILLIAM A. MUNDELL
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MIKE GLEASON
KRISTIN K. MAYES

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS SUN CITY WEST WATER AND WASTEWATER DISTRICTS.	DOCKET NO. WS-01303A-02-0867
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS SUN CITY WATER AND WASTEWATER DISTRICTS.	DOCKET NO. WS-01303A-02-0868
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS MOHAVE WATER DISTRICT AND ITS HAVASU WATER DISTRICT.	DOCKET NO. W-01303A-02-0869
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS MOHAVE WATER DISTRICT AND ITS ANTHEM WATER DISTRICT, ITS AGUA FRIA WATER DISTRICT, AND ITS ANTHEM/AGUA FRIA WASTEWATER DISTRICT.	DOCKET NO. WS-01303A-02-0870 **STAFF'S CLOSING BRIEF**

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 TUBAC WATER DISTRICT.	DOCKET NO. W-01303A-02-0908

STAFF'S CLOSING BRIEF

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I. INTRODUCTION.

This case presents eight major issues:

(1) For many years the Commission has computed fair value rate base by averaging original cost rate base and reconstruction cost rate base. Should this long-standing method be abandoned?

(2) The Commission has long applied the weighted average cost of capital to the original cost rate base. Should this method be abandoned?

(3) Arizona-American asks that its overheads and service company charges be determined using post-test year figures which are far greater than the test year amounts. Arizona-American's adjustment is not known and measurable, creates a mismatch, demonstrates an imprudent and inflated level of expense, and it visits the consequences of the purchase of these systems on the ratepayers rather than Arizona-American. Should Arizona-American's adjustment be rejected?

(4) Arizona-American also seeks to use its post-test year levels of salaries and wages. Should this adjustment be rejected?

(5) In 1997, the Commission terminated the adjustor for Tolleson costs. Arizona-American now seeks a new adjustor to collect post-test year payments to Tolleson even though it admits that its obligations are not known and measurable. Should the Commission reject the adjustor and wait until it has actual, verifiable data about the amount, use, and timing of these payments to determine how they should be recovered?

(6) In recent decisions the Commission recognized the reality of Arizona's desert climate by adopting three-tiered inverted block rates to promote conservation. Should the Commission continue to promote conservation by adopting three-tiered inverted block rates?

(7) Staff objectively applied widely-accepted financial models to produce a cost of equity of 9%. Should Staff's cost of equity be adopted?

(8) Arizona-American admits that it put $2 million of plant in rate base that was not used and useful. This resulted in an inflated revenue requirement in its direct filing. Arizona-American proposes to fix this problem by using an accounting maneuver that has no net effect on the revenue requirement, thus leaving the inflated revenues intact. Should this maneuver be rejected?

Staff will also address several minor issues.

Two themes emerge upon examination of these issues. First, Arizona-American asks the Commission to veer sharply away from well-established practices. Second, Arizona-American seeks to disregard the consequences of the test year that it selected.

II. FAIR VALUE RATE BASE SHOULD BE DETERMINED BY AVERAGING OCRB AND RCND.

The Commission has for many years determined Fair Value Rate Base (FVRB) by averaging Original Cost Rate Base (OCRB) and Reconstruction Cost New less Depreciation (RCND). (Tr. at 193; Carlson Surrebuttal, Ex. S-48 at 12). Arizona-American is requesting that its RCND be declared to be its FVRB. This radical departure from a long-established Commission method is without any legal or evidentiary basis and should be rejected.

A. The Commission has broad discretion to determine fair value.

It is well-established that the Commission must find fair value to "aid it in the proper discharge of its duties". Ariz. Const. art. 15 § 14; *U.S. West Communications, Inc. v. Ariz. Corp. Comm'n*, 201 Ariz. 242, 246 ¶¶ 20-21, 34 P.3d 351, 355 (2001) (*US West II*). In setting fair value, the Commission has a "range of legislative discretion." *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 154, 294 P.2d 378, 384 (1956). The only requirement is that the Commission use "reasonable judgment considering all relevant factors" because there is no "set, rigid formula" required. *Id.; see also Ariz. Corp. Comm'n v. Ariz. Pub. Serv. Co.*, 113 Ariz. 368, 370, 555 P.2d 326, 328 (1976). Further, the "weight given to each particular factor is entirely within the discretion of the Commission, so long as that discretion is not abused." *Ariz. Corp. Comm'n v. Ariz. Water Co.*, 85 Ariz. 198, 202, 335 P.2d 412, 414 (1959). Arizona-American's rate base witness, Mr. Bourassa, testified that "the Commission has wide discretion in this area." (Tr. at 166).

B. The Commission should not give great weight to reconstruction cost estimates.

Mr. Bourassa testified that the cost of construction is not equal to current value. (Tr. at 167). Mr. Bourassa agreed that because of this RCND is not an exact measure of fair value and that there are a number of ways RCND could be calculated. (Tr. at 169-71). By their nature, RCND valuations are estimates that should not be given great weight. As the Arizona Supreme Court said in *Simms*:

> It is well recognized that any evidence of what is the present reconstruction cost of an existing plant is at best opinion evidence and carries the weakness of some inaccuracy. It is based upon estimates. The commission is entitled to reasonably determine the probative force of these estimates and is not compelled to find its value upon mere speculation.

Simms, 80 Ariz. at 153, 294 P.2d at 383.

C. The evidence does not support deviating from the Commission's long-standing practice of averaging OCRB and RCND.

Staff is "not aware of any rate case in the past, where this Commission ignored OCRB and used an RCRB-only FVRB." (Carlson Surrebuttal, Ex. S-48 at 12). Arizona-American's request that the Commission abandon the long-standing method of averaging OCRB and RCND is not supported by any evidence and should be rejected. Mr. Bourassa suggests that the purchase price paid by Arizona-American justifies using a 100% RCND rate base. (Tr. at 225). Indeed, the existence of the purchase price is the only distinction between this case and previous cases that Mr. Bourassa points to. *Id.* However, it is settled law in Arizona that the purchase price paid by an acquiring company for utility assets should play no role in establishing rate base. *Ariz. Water Co.*, 85 Ariz. at 203-04, 335 P.2d at 415.[1] Moreover, Mr. Bourassa admitted that using the purchase price in rate setting is circular because the purchase price will depend on the rates. (Tr. 197-98). Except for this legally and factually irrelevant factor, Arizona-American points to no reason to use a 100% RCND rate base.

Further, Arizona-American's own witness, Mr. Bourassa, testified that he had never before recommended a 100% RCND rate base. (Tr. at 226). And Arizona-American's lead witness, Mr. Stephenson, stated that he previously testified in favor of the Commission's traditional "50/50" approach. (Tr. at 473). Remarkably, Mr. Stephenson's explanation was that he secretly disagreed at the time with his sworn testimony in prior dockets. (Tr. at 506-07, 510, 514-15). Mr. Stephenson also admitted that he is "not overly familiar with RCND." (Tr. at 370). Arizona-American can point to no valid reason for the Commission to disregard its traditional practice of averaging OCRB and RCND to produce the FVRB. Arizona-American's radical proposal must therefore be rejected.

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[1] In *Arizona Water*, the Court did state that the Commission could look at the *reasons* for the purchase price. *Id.* But the purchase price standing alone cannot be considered. *Id.* There is no evidence in this record as to why Arizona-American paid so much for the assets.

III. THE WEIGHTED AVERAGE COST OF CAPITAL SHOULD BE APPLIED TO THE ORIGINAL COST RATE BASE.

A. <u>Arizona-American is legally entitled to a reasonable rate of return, not a particular rate of return formula of its own choice</u>.

In *U.S. West II*, the Court held that "while the constitution clearly requires the Arizona Corporation Commission to perform a fair value determination, only our jurisprudence dictates that this finding be plugged into a rigid formula as part of the rate-setting process." 201 Ariz. at 245-46 ¶ 17, 34 P.3d at 354. The Court therefore found that the Commission need not follow the "traditional formulaic approach" but instead has "broad discretion". *Id.* at ¶¶ 18, 21. The Court did note, in *dicta*, that it preferred the traditional approach for monopolies. *Id.* at ¶ 19. Since the Court found that the "traditional formulaic approach" was not mandated by the Arizona Constitution, this *dicta* simply expresses the Court's preference.

Arizona-American will likely argue that this *dicta* means the Commission must follow the traditional, rigid formula established in cases like *Simms*. Even if Arizona-American makes this dubious claim, its argument will fail because Staff's approach is consistent with the traditional, rigid formula. *Simms* requires only that the Commission allow "a reasonable return upon the fair value of the properties at the time the rate is fixed." *Simms*, 80 Ariz. at 153, 294 P.2d at 383. A "reasonable return" is a broad standard that necessarily gives the Commission wide latitude. Given the broad constitutional discretion accorded the Commission, it is difficult to see how Arizona-American can argue that its preference is legally required.

B. <u>Dr. Zepp's legal conclusions should be rejected</u>.

Dr. Zepp claims that the weighted average cost of capital must be applied to the RCND rate base as the rate of return. (Zepp Rebuttal, Ex. A-49 at 27-33). As Mr. Reiker testified, Dr. Zepp does not present "any kind of economic reasoning or theory to support" his claim and instead his "argument is based entirely on his legal interpretation of the Arizona Constitution and court decisions." (Reiker Direct, Ex. S-45 at 66). Dr. Zepp testified that he has <u>never</u> before made this claim. (Tr. at 336). Indeed, Dr. Zepp recently testified before this Commission in support of a cost of capital that his client (Arizona Water Company) then applied to the original cost rate base. (Tr. at

339). Dr. Zepp said "I am not a lawyer. I am not a judge. I am an economist. I was asked to review certain legal decisions and I did." (Tr. at 309). Dr. Zepp's legal opinion should be given little, if any, weight.

Dr. Zepp's legal opinion appears to be based solely on his argument that the *Hope* case[2] does not apply in Arizona. (Tr. at 336). Dr. Zepp notes that the Arizona Supreme Court rejected *Hope*'s "end result" test in *Simms*. (Zepp Sun City Water Direct, Ex. A-44 at 7-8). This was because the "end result" test does not require the use of fair value, while the Arizona Constitution requires the Commission to find fair value. *See Simms*, 80 Ariz. at 150-51, 294 P.2d at 381-82. As noted above, *Simms* simply requires the Commission to determine a "reasonable return." It is not clear to Staff why Dr. Zepp thinks that the Commission's well-established method violates this test.

Indeed, the only Arizona case to directly comment on which rate base the weighted average cost of capital should be applied to supports the Commission's traditional approach. The Arizona Court of Appeals described the appropriate process as follows: "the weighted cost of capital, is multiplied by the utility's original cost rate base; this product then is divided by the fair value rate base." *Litchfield Park Serv. Co. v. Ariz. Corp. Comm'n*, 178 Ariz. 431, 435, 874 P.2d 988, 992 (App. 1994). This is exactly what Staff proposes in this case.

C. **<u>The evidence supports applying the weighted average cost of capital to the OCRB</u>.**

Ms. Diaz-Cortez testified that the Commission's traditional approach is to multiply the weighted average cost of capital by the original cost rate base. (Tr. at 723-28). The fair value rate of return is then calculated by dividing the result by the fair value rate base. *Id.* Ms. Diaz-Cortez demonstrated these calculations using Exhibit RUCO-12. *Id.* Ms. Diaz-Cortez testified that the Commission has used this approach for "30, 40 years." (Tr. at 783). Staff used this traditional approach. (Tr. at 1502-05). Mr. Bourassa calls the Commission's traditional approach "backing-in." (Tr. at 182-83). Mr. Bourassa admitted that he did not know if other fair value jurisdictions use "backing-in," nor did he review prior Commission Decisions concerning Arizona-American or the systems in question to determine if the Commission used "backing-in." (Tr. at 178, 191). When

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[2] *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

confronted with prior decisions, Mr. Bourassa conceded that the Commission used "backing-in" in six prior decisions concerning Arizona-American or the systems at issue in this case. (Tr. at 181-93). Further, Mr. Bourassa admitted that the fair value rate of return can be a different number than the weighted average cost of capital. (Tr. at 185). But Dr. Zepp's whole argument hinges on his legal conclusion that the weighted average cost of capital must be the (fair value) rate of return. (Zepp Sun City Water Direct, Ex. A-44 at 5-12). Arizona-American's own witnesses contradict each other, and its position must be rejected.

Further, Mr. Reiker explains that for economic reasons, the weighted average cost of capital should be applied to the original cost rate base. (Reiker Direct, Ex. S-45 at 63-66). For example, Mr. Reiker shows that if the RCND is double the OCRB, applying the weighted average cost of capital to the RCND results in the utility earning twice the necessary amount. *Id.* at 64. Mr. Reiker also shows that under some circumstances, if Dr. Zepp's claim is adopted, the utility will not be able to maintain its credit. *Id.* at 65.

Lastly, Mr. Carlson testified that Staff's fair value rate of return provided a reasonable return on fair value. (Tr. at 1505). Staff's testimony strongly supports the Commission's traditional method.

IV. THE COMMISSION SHOULD USE TEST YEAR CORPORATE OVERHEADS AND SERVICE COMPANY CHARGES.

Arizona-American's lead witness, Mr. Stephenson, acknowledges that Arizona-American controlled the selection of the test year. (Tr. at 473). Yet Arizona-American seeks to dodge the consequences of selecting 2001 as the test year by casting aside the 2001 figures for corporate overheads and service company charges and replacing them with 2002 figures. Mr. Igwe testified that the test year is presumed to be representative. (Tr. at 996-97; Igwe Surrebuttal, Ex. S-25 at 4-5). Mr. Igwe further testified that Arizona-American's proposal was "very unusual". (Tr. at 1048). This very unusual adjustment increases expenses by $3.6 million. (Tr. at 977).

Mr. Igwe stated four reasons why the test year figures should be used: (1) the 2002 figures are not known and measurable; (2) the use of the 2002 figures creates a mismatch between test year revenues, expenses, and rate base; (3) the 2002 figures are imprudently high; and (4) it makes ratepayers responsible for a new owner's higher costs. (Tr. at 970).

A. The 2002 figures are not known and measurable.

Arizona-American's proposal is complicated by the fact that the test year figures are for the former owner. Mr. Stephenson agreed that the asset sale makes the adjustment "unusual." (Tr. at 1611). RUCO's witness, Mr. Moore, testified that because the 2002 figures proposed by Arizona-American are for the very first year of operations, there is no way of knowing if 2002 represents a normal year of operations for Arizona-American. (Tr. at 611). Indeed, this problem is demonstrated by the dispute between RUCO and Arizona-American regarding the 2002 amount. Further, Mr. Stephenson testified that as Arizona-American gains experience operating the assets, efficiency should increase and the relative cost for "certain items" should decrease. (Tr. at 471). In short, the 2002 figures are not known and measurable and this deviation from the test year is not justified. (Tr. at 966-67).

B. Using the 2002 figures creates a mismatch.

Mr. Igwe testified that using 2002 corporate overheads and service company charges creates a mismatch between test year expenses, revenue and rate base. (Tr. at 966-67, 982-83). Tellingly, Arizona-American wants to use favorable 2002 overheads and service company charges but refuses to use 2002 revenues. As Mr. Igwe notes, "Arizona-American's proposed adjustment matches costs incurred to provide service to the 2002 level of customers and sales with revenues for 2001." (Igwe Surrebuttal, Ex. S-25 at 6). Mr. Igwe testified that Arizona-American's 2002 revenues for the systems in this rate case are $3.6 million greater than the test year. (Tr. at 1027-28). Mr. Stephenson claims that the 2002 revenues are not "ratemaking" numbers, but was unable to provide "ratemaking" numbers. (Tr. at 468, 1609-10). It is not clear why one $3.6 million number should count as a "ratemaking" number while another $3.6 million number should not.

C. 2002 figures are simply too high.

Because the 2001 and 2002 figures are for different companies, the Commission has the unique opportunity to directly compare the operating costs of two utilities for the same assets. As noted above, 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. (Tr. at 970).

D. <u>Using 2002 figures burdens ratepayers with the higher costs of the purchasing company</u>.

As Mr. Igwe stated, ratepayers should be held harmless from the effects of the acquisition. (Tr. at 981). Arizona-American should bear the burden of its higher costs. Further, the Commission's rules define *pro forma* adjustments as "adjustments to actual test year results and balances to obtain a normal or more realistic relationship between revenues, expenses and rate base." A.A.C. R14-2-103(A)(3)(i). As Mr. Igwe notes, Arizona-American has not adjusted test year figures, it has completely replaced them. (Tr. at 959, 1025).

E. <u>Staff consistently applied ratemaking standards in reviewing *pro forma* adjustments</u>.

Arizona-American attacks Staff's position as inconsistent because Staff did accept other *pro forma* adjustments. As Mr. Igwe explained, each of the adjustments accepted by Staff pass the tests that this adjustment fails. (Igwe Surrebuttal, Ex. S-25 at 6). Much ado was made about Del Webb's Payment in Lieu of Revenue (PILOR). As Mr. Igwe points out, the PILOR payments are fixed by a contract that was in place during the test year. *Id.;* Tr. at 972-75, 992-93. Likewise, the adjustment to purchased water expense kept the test year volume in place and only changed the price – a price change that was known at the end of the test year. (Tr. at 985-86, 988-90). Staff has consistently applied time-honored tests to accept some limited adjustments but reject Arizona-American's substantial deviation from the test year because it is not known and measurable, it creates a mismatch, the expense is too high, and because it penalizes the ratepayers for the acquisition.

V. THE COMMISSION SHOULD USE TEST YEAR SALARIES AND WAGES.

Arizona-American's proposal to use 2002 salaries and wages should be rejected for many of the same reasons that 2002 corporate overheads and service company charges are unacceptable. The 2002 salaries and wages directly relate to 2002 operations. (Igwe Surrebuttal, Ex. S-25 at 7). The use of 2002 figures creates a blatant mismatch that links 2001 revenues with 2002 expenses. *Id.*

VI. THE COMMISSION SHOULD REJECT THE PROPOSED TOLLESON ADJUSTOR.

Arizona-American will incur costs for Rate Components 3 & 4 under its wastewater contract with the City of Tolleson. The largest component is Rate Component 4. Mr. Bourassa admits that Arizona-American did not incur any Rate Component 4 costs in the test year. (Tr. at 145). And Mr.

Bourassa admits that the costs under Rate Component 4 are not known and measurable. (Tr. at 146-47). Mr. Bourassa recognized that it would be inappropriate to treat these costs as a *pro forma* expense. *Id.* Rate Component 3 involves a "contingency and reserve fund" that "is reserved for unknown future plant additions and replacements" and there "should be no recovery until plant additions are completed from this fund." (Carlson Surrebuttal, Ex. S-48 at 10-11). Because it can't get these costs into rates using normal methods, Arizona-American has proposed an adjustor mechanism.

Adjustor mechanisms are strongly disfavored, and this one should be rejected. As RUCO notes, adjustors are appropriate only for expenses that are highly volatile. (Diaz-Cortez Surrebuttal, Ex. R-8 at 15; Tr. at 752-53). Mr. Bourassa suggests that adjustors are appropriate if the cost is "a significant cost beyond the control of management." (Bourassa Rejoinder, Ex. A-24 at 19). But Mr. Bourassa concedes that there are contractual procedures for Arizona-American to have input and review of the Tolleson costs. (Tr. at 150-51). These procedures give Arizona-American at least some control over the costs. The proposed adjustor therefore fails even Mr. Bourassa's test.

Further, the costs are simply unknown at this time. The estimated cost for Rate Component 4 has already increased by $2 million over the course of this proceeding. (Tr. at 147-48). Further, the Tolleson contract contains provisions to add new capital projects not included in the current estimates. (Tr. at 150-51; Third Amendment to Tolleson Agreement, Ex. S-1 at 3). Previous Tolleson costs were recovered in an adjustor, but the Commission decided in the 1997 Citizens rate case to eliminate this adjustor. (Tr. at 153). The Commission found that it was appropriate to "include the costs as a normal operating expense to be recovered in rates." (Decision No. 60172, Ex. S-2 at 33). This is consistent with Staff's recommendation to defer consideration of recovery until the costs are actually incurred and known.

Additionally, Arizona-American's adjustor mechanism is complex. (Tr. at 157-60). Simplicity is an important goal of rate design. But Mr. Bourassa admitted that he did not take simplicity into account in designing the adjustor. (Tr. at 161).

VII. THE COMMISSION SHOULD ADOPT STAFF'S THREE-TIERED RATE DESIGN.

The rate design controversy in this case is focused on the water divisions. Arizona-American proposed no change to the rate designs for all of the water systems.[3] Staff proposes a three-tiered rate design that promotes conservation by reducing the average customer's usage over the long-term. Staff's rate design sends an economic price signal to new and existing customers that water is a finite resource. At the same time, Staff's rate design recognizes other important factors such as affordability, simplicity, fairness and revenue stability and balances those factors within the three-tiered structure. Staff's rate design is in the public interest and should be adopted.

A. <u>Staff's rate design achieves the primary goal of promoting conservation while also balancing other important interests.</u>

Staff proposes a three-tier inverted rate block rate design, with break points at 4,000 gallons and 100,000 gallons.[4] The first tier recognizes that water use at this level is nondiscretionary. (Tr. at 1074). Nondiscretionary uses of water are those uses required for health and hygiene. (Tr. at 1074, 1137-38). In other words, the first tier covers the customer's basic health and safety needs. (Rogers Surrebuttal, Ex. S-37 at 5). Even Arizona-American's rate design witness, Mr. Kozoman, acknowledges that a certain level of water usage is nondiscretionary. (Tr. at 433). In addition, the first tier is also a "supplementary lifeline rate providing affordable water to customers willing to limit consumption to their basic needs." (Rogers Direct, Ex. S-36 at 6). However, the first tier is not intended to be a strict lifeline tariff. (Tr. at 1069). Staff's design of the first tier recognizes that usage at this level (up to 4,000 gallons) is not likely to decrease because water is needed at this usage level to sustain life.

The second and third tiers send the appropriate price signal that water is a finite resource and has an increasing cost. (Rogers Direct, Ex. S-36 at 5). Those who do not use water as efficiently will

[3] On January 23, 2004, Arizona-American supplied the parties with a memorandum containing, in its words, "a conservation-oriented rate structure involving the use of inverted-block rates." Staff anticipated receiving the Arizona-American's proposal earlier, rather than this late point in the briefing schedule. Since it will take significant time and resources to analyze the Arizona-American's updated proposal, assuming that the updated rate structure is admitted as evidence, Staff's brief will not comment on the Arizona-American's new rate design proposal. Instead, Staff's brief focuses on the evidence and testimony presented by the Arizona-American that is on the record. Staff does not have an objection to the admission of the updated rate structure, but reserves the right to address the Arizona-American's updated rate structure in Staff's reply brief, as well as the opportunity to provide its own updated rate design proposal.

[4] The first tier would be up to 4,000 gallons. The second tier would be between 4,000 and 100,000 gallons and the third tier would be for usage above 100,000 gallons. The only exception to this structure is for the Tubac division, where the break out point between the second tier and the third tier would be set at 52,000 gallons.

pay a higher price. The goal of conserving water is front and center in the second and third tiers. Overall, the three-tiered rate design by Staff aims to "establish the long-term reduction in average usage." (Tr. at 1088). Staff's rate design reduces the use of a finite resource over the long-term and recognizes the increasing cost of the finite resource against existing and future customers. (Tr. at 1089; Rogers Surrebuttal, Ex. S-37 at 6). Therefore, Staff's rate design, while recognizing that certain uses of water are nondiscretionary, targets conservation as its primary objective.

While the three-tiered structure encourages conservation in the long-term by lowering the average usage over time, Staff's rate design also incorporates the need for revenue stability. Staff testified that a high break over point between the second and third tiers of 100,000 gallons sends a strong price signal to prospective customers while limiting the effect on existing customers. (Rogers Direct, Ex. S-36 at 6). The goal of this break over point is to encourage prospective customers to "make appropriate choices regarding landscaping and other planned water uses." *Id.* In other words, while the rate design will send the appropriate price signals to all customers to use water efficiently immediately, the primary goal is to reduce water use over the long-term as the number of customers grows.

B. <u>Staff's proposed rate design is consistent with Decision No. 60172.</u>

Staff's rate design balances the considerations put forth by the Commission in Decision No. 60172 (Ex. S-2). That decision was the most recent involving rate applications for several of the systems involved in this case. In that decision, the Commission recognized the importance of considering factors such as rate stability, fairness and conservation in designing rates. *Id.* at 40. This decision approved the use of two-tiered inverted block rates for the Agua Fria, Sun City, Sun City West and Tubac water divisions, but also stated that "once Arizona-American's customers have some experience with these rates and the conservation effect, if any, is known, then a more complex three tier rate block structure may be appropriate." *Id.* at 41. Staff's rate design incorporates the factors outlined in Decision No. 60172 in a three-tiered rate design. By contrast, Arizona-American simply proposes to update the old rate design. (Tr. at 431-33).

C. <u>Arizona-American's objections to Staff's rate design are without merit</u>.

Despite the plethora of evidence in support of Staff's rate design, Arizona-American remains defiant in its objections.[5] Arizona-American's principal argument is that Staff's rate design is not cost-based and that Staff did not perform a cost of service study to verify that the rates are cost based. (Kozoman Rebuttal, Ex. A-62 at 9). This argument is hollow. Arizona-American did not file any cost of service studies for any of the water divisions in its direct case. (Tr. at 429). Arizona-American states that a cost of service was not done because the it proposes that the necessary rate increases be allocated to all customers equally. (Kozoman Sun City Water Direct, Ex. A-52 at 3).[6] However, rates previously approved by the Commission for the water divisions were not based strictly on the cost of service and those rates do not reflect the current cost of service. The Commission, in Decision No. 60172, notes that cost of service studies are simply "tools" for establishing revenue requirement per customer class. (Decision No. 60172, Ex. S-2 at 40, 43-44). Staff agrees that a cost of service study is a factor, but only one factor in setting rates. (Rogers Surrebuttal, Ex. S-37 at 6). Even Arizona-American admits that a cost of service study is used to provide guidance in setting rates and that rates are not always set based on the computed cost to serve a particular class of customer. (Kozoman Rebuttal, Ex. A-62 at 10; Tr. at 430-31).

Arizona-American also criticizes Staff's rate design for not differentiating among residential, commercial and industrial customers. However, Arizona-American failed to provide a cost of service study in its direct case for any of the seven water divisions, six of which generate enough revenues to be "Class A" companies standing alone. Therefore, Staff had no basis for differentiating among classes. Staff's three-tiered rate design best accommodates the factors described above, given the information available. Further, it is important for a rate design to be simple and easy to understand. (Tr. at 1076). Without being provided more information that would justify different tiers for different classes of customer, Staff's rate design, while simple in its approach, best balances the multiple factors described above. (Tr. at 1105, 1107).

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[5] Arizona-American did state on the record, based on the interaction between certain Commissioners and counsel for Arizona-American, that it would entertain discussions with the other parties about proposing its own inverted-block rate design. (Tr. at 453-54). Arizona-American failed to provide its alternative to Staff until January 23, 2004.

[6] Mr. Kozoman filed separate direct testimonies for the Agua Fria/Anthem, Mohave/Havasu, Sun City West and Tubac Water Divisions. However, all of Mr. Kozoman's direct testimonies for those divisions in this case echo Mr. Kozoman's direct testimony for the Sun City Water Division as to why Arizona-American did not file a cost of service study in its direct case.

Arizona-American's remaining criticisms fail to recognize this balancing of factors. Arizona-American further complains that if Staff's rate design is adopted it will not receive its required rate of return for usage up through 4,000 gallons because the rates are below cost. However, a company's rate of return is derived from the total usage by customers of all classes, with no right to the authorized rate of return at all levels of usage. (Rogers Surrebuttal, Ex. S-37 at 7). While Staff's first tier may result in a rate that is below cost for customers on certain meters, this shortfall will be picked up in the subsequent two tiers. (Tr. at 1084-85). Finally, while Staff's proposed rate design may impact certain customers more than other customers, Staff's rate design proposal best balances the key factors within the primary goal of promoting conservation. Staff's rate design promotes conservation, but balances that interest with other important factors such as the nondiscretionary use of water at a certain level, affordability, simplicity and revenue stability. Therefore, adopting Staff's rate design best serves the public interest.

D. Multi-unit Commercial Issues.

Additionally, Staff identified specific problems regarding the current rate designs for the Mohave and Havasu systems for multi-unit commercial customers e.g., trailer parks. Without a cost of service study in Arizona-American's direct case, Staff could not recommend a wholesale change to the current structure without unfairly impacting other customer classes. Staff recommends that in the next rate case, Arizona-American propose a rate design where a multi-unit commercial customers are charged a monthly minimum based on the meter size and not the number of housing units served. (Rogers Direct, Ex S-36, at 9).

VIII. STAFF'S RECOMMENDED 6.5 PERCENT WEIGHTED AVERAGE COST OF CAPITAL IS FAIR AND REASONABLE AND SHOULD BE ADOPTED.

A. The Commission should adopt a capital structure of 60.1 percent long-term debt and 39.9 percent common equity.

Staff, Arizona-American and RUCO agree Arizona American's capital structure is approximately 60 percent debt and 40 percent equity. (Reiker Surrebuttal, Ex. S-46 at 28; Stephenson Rebuttal, Ex. A-74 at 26; Rigsby Direct, Ex. R-5 at 38). Staff's recommended capital structure of 60.1 percent debt and 39.9 percent equity is the capital structure provided to Staff by

Arizona-American in answers to Staff data requests and should be adopted. (Reiker Surrebuttal, Ex. S-46 at 28 and Schedule JMR-S21).

B. The Commission should adopt a cost of debt of 4.77 percent based on Arizona-American's actual cost of long-term debt.

The parties' long-term debt recommendations are also very close. Staff computes Arizona-American's actual cost of long-term debt using information supplied by Arizona-American. Staff recommends a cost of debt of 4.77 percent. (Reiker Surrebuttal, Ex. S-46 at 28 and Schedule JMR-S17). Arizona-American's recommendation is 4.86 percent. (Stephenson Rejoinder, Ex. A-75 at 23; Tr. at 640-41). Because Staff's recommendation is based on information provided by Arizona-American, Staff's recommendation should be adopted.

C. Staff's cost of equity estimate results from objective application of sound economic principles and theory and should be adopted.

While the actual cost of debt can be determined from fixed cost rates, equity costs in the capital structure can only be estimated. Proven methods should be adopted to arrive at a reasonable estimate. The Capital Asset Pricing Method ("CAPM") and the Discounted Cash Flow ("DCF") are the two most widely accepted methods of estimation and Staff arrives at a 9.0 percent cost of equity estimate through application of these models. (Reiker Direct, Ex. S-45 at 8). Because Arizona-American's stock is not publicly traded, Staff applies these models to the six publicly traded water companies currently followed by *The Value Line Investment Survey* and *The Value Line Investment Survey Small and Mid Cap Edition* which have a significant percentage of revenue derived from regulated water utility operations. (Reiker Direct, Ex. S-45 at 9 and Schedule JMR-1). Staff also analyzed the cost of equity of ten sample gas companies, which as evidence shows, are riskier than water companies. (Reiker Direct, Ex. S-45 at 26 and Schedules JMR-13-19).

Arizona-American improperly excluded Connecticut Water and Middlesex Water from its sample of water utilities. (Reiker Direct, Ex. S-45 at 32). Arizona-American argues changes in Arizona-American's stock prices indicated an imminent merger or acquisition of Arizona-American.

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(Zepp Surrebuttal, Ex. A-44 at 14).[7] Arizona-American presents no additional evidence to support its merger and acquisition theory. (Reiker Direct, Ex. S-45 at 34). Further, Staff demonstrates that the increases in common stock prices experienced by Connecticut Water and Middlesex Water are not substantially above the increases in prices for the other Value Line water utilities included in the sample. *Id.* at 33, Chart 3. Staff's application of the proven DCF and CAPM models to the six proxy water companies results in a reasonable and reliable cost equity estimate for Arizona-American.

1. Staff's DCF calculation is based on proper variables and results in a reasonable estimation of Arizona-American's equity cost.

The DCF method is based on the theory that a stock's market price is equal to the present value of all expected future dividends. *Id.* at 9. Staff calculated both DCF constant growth and non-constant or multi-stage growth estimates. *Id.* at 10. Staff's DCF analysis results in an estimated 9.0 percent equity cost. (Reiker Surrebuttal, Ex. S-46 at Schedule JMR-S7).

The DCF formula uses three variables: 1) expected annual dividend, 2) current stock price, and 3) expected infinite annual growth rate of dividends. (Reiker Direct, Ex. S-45 at 11). The expected annual dividend is divided by the current stock price and the result (the dividend yield) is added to the expected infinite annual growth rate of dividends yielding the cost of equity estimate. Proper values must be assigned to the variables. As demonstrated below, the variables used by Staff were proper and reasonable, resulting in a reasonable estimate that should be adopted by the Commission.

In accord with the efficient market hypothesis, Staff used the spot market price to determine the current stock price. (Reiker Surrebuttal, Ex. S-46 at 7). Arizona-American inappropriately used 3-month and 12-month average stock prices in its DCF estimates. Use of the averages is contrary to expert opinion. Mr. Kilm's article in *Public Utilities Fortnightly* states use of the averages "leads us away from rather than toward the actual future yield." (Reiker Direct, Ex. S-45 at 37).[8] Evidence shows that "by all accuracy measures, the spot forecast outperforms the forecasts based on historic

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[7] Only Dr. Zepp's Direct Testimony concerning The Sun City Water and Wastewater Districts admitted as Exhibit A-44 is cited. However, Dr. Zepp's testimony is all other Districts marked Exhibits A-45 through A-48 contain identical testimony. (Tr. at 305).

[8] Quoting from Steven G. Kihm, "The Superiority of Spot Yields in Estimating Cost of Capital," *Public Utilities Fortnightly*, February 1, 1996, pp. 42-45.

averages." *Id.* at 8.[9] Simply put, the best forecast of tomorrow's yield is simply today's yield. (Reiker Surrebuttal, Ex. S-46 at 7). Arizona-American's less accurate estimate of the dividend yield should be rejected. The Commission approved the use of spot market data in estimating the cost of equity in the recent *Black Mountain Gas* rate case in Decision No. 64727. (Reiker Direct, Ex. S-45 at 37). Using the spot market price, Staff's dividend yield calculation is 3.44 percent and should be adopted. (Reiker Surrebuttal, Ex. S-46 at 3 and Schedule JMR-S7).

Staff examined historical and projected growth in dividends per share ("DPS"), growth in earnings per share ("EPS"), and intrinsic growth to estimate its growth variable. (Reiker Direct, Ex. S-45 at 12). The average of the historic and projected growth rates is 4.98 percent. (Reiker Surrebuttal, Ex. S-46 at 3 and Schedule JMR-S4). Therefore, Staff's constant-growth DCF estimate is 8.4 percent (3.44% + 4.98%). *Id.* at Schedule JMR-S7.

Arizona-American's exclusive reliance on analyst's forecasts of earnings per share growth and sustainable growth in its DCF analysis is inappropriate because it assumes that investors ignore other information such as historical growth. (Ex. S-46, at 9). The Commission should not rely on restatement of Staff's constant-growth DCF estimate because that restatement ignores dividends per share growth even though the constant-growth DCF formula is predicated on dividend growth. Arizona-American argues that DPS growth estimates should not be considered in a constant-growth DCF model when investors know earnings have grown faster than dividends in the past. (Zepp Rejoinder, Ex. A-50 at 11; Zepp Rebuttal, Ex. A-49 at 46-47). Arizona-American claims that when EPS growth exceeds DPS growth, investors expect that the company is saving for future expenses which creates an expectation of faster future growth. (Zepp Rebuttal, Ex. A-49 at 45). A more reasonable explanation for a company allowing EPS growth to outpace DPS growth is that dividend growth reflects management's outlook for future earnings. (Reiker Surrebuttal, Ex. S-46 at 12). When management lacks confidence that high earnings growth can be sustained, it will slow dividend growth in relation to earnings growth. *Id.* at 12. This allows management to avoid the unpleasant situation of having to cut dividends in the future when earnings decline as management expects they

[9] *Id.*

will. *Id.* at 12.[10]

The multi-stage DCF model incorporates at least two growth rates to account for the assumption that investors expect a certain rate of non-constant dividend growth in the near term (stage-1 growth), as well as a longer-term constant rate of growth (stage-2 growth). Using *Value Line* information concerning the six sample water companies, Staff's multi-stage DCF estimate is 9.6 percent. Staff averages the results of the constant and multi-stage DCF estimates to arrive at an overall DCF estimate of 9.0 percent [(8.4% + 9.6%)/2]. *Id.* at Schedule JMR-S7.

Arizona-American's restatement of Staff's multi-stage DCF analysis should be given no weight. Arizona-American's modifications improperly inject a "supernormal" growth stage between the first and second growth stages. *Id.* at 16. First, Arizona-American assumes that investors would use *Value Line's* projected retention growth rate instead of using the dividend per share growth rate projected by *Value Line* for the years 2007 and 2008. *Id.* Logically, investors would rely on the latter when available. Second, Arizona-American errs by applying *Value Line's* projected retention growth rate for 2006 through 2008 to the years 2009 through 2016. *Id.* Applying the growth rate to the later years is purely speculative. *Id.*

Staff's DCF estimate uses proper variables to determine dividend yield and growth in both its constant and non-constant growth models and Staff's 9.0 percent estimate should be adopted.

2. Staff's CAPM Estimate Properly Estimates Risk and Return and Its Required Return.

CAPM, the work of Nobel Prize winning economists, is the best-known model of risk and return. (Reiker Direct, Ex. S-45 at 21). The model states that the expected return on a risky asset is equal to the sum of the prevailing risk-free interest rate and the market risk premium adjusted for the riskiness of the investment relative to the market. *Id.* Like the DCF model, the CAPM requires the input of proper variables to arrive at a reasonable estimate of a company's equity cost. The CAPM's variables are (1) the risk free rate, (2) the return on market, (3) the risk variable or "beta", and (4) the market risk premium. *Id.* at 22.

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[10] Citing from William F. Sharpe, *Investments* 419 (3rd ed. Prentice-Hall 1985). Professor Sharpe is recognized as an authority in Arizona-American's rebuttal testimony. (Zepp Rebuttal, Ex. A-49 at 36, 40).

Staff properly based its estimate of the prevailing risk-free rate on the average of intermediate-term U.S. Treasury securities' spot rates as published in *The Wall Street Journal.* (Reiker Direct, Ex. S-45 at 22). Staff calculated both a historical market risk premium and a current market risk premium to determine its market risk premium estimate range. *Id.* at 23-25. These published rates are determined by the capital markets and are verifiable, readily available, and most importantly are objective as compared to forecasted rates. *Id.* at 22.

Staff derived the appropriate beta from the average of the *Value Line* beta for the six proxy water utilities. *Id.* at 23. The average beta computed to .59 for the companies. *Id.* at 23 and Schedule JMR-6.

The market risk premium represents the additional return an investor expects for investing in an average or higher risk security over the investors expected return for investing in a risk free security. *Id.* at 23. Staff calculated both a historical market risk premium and a current market risk premium to determine its market risk premium estimate range. *Id.* at 23-25. Staff's historical analysis results in a risk premium of 7.4 percent. (Reiker Surrebuttal, Ex. S-46 at Schedule JMR-S7). Staff's current analysis results in a risk premium of 8.1 percent. *Id.* Staff's CAPM analysis results in an equity cost estimate for Arizona-American of 8.1 percent. *Id.*

Staff's cost of equity estimate is the result of the average of its CAPM results and its DCF results, or 8.5 percent [(9.0% + 8.1%)/2]. *Id.* Arizona-American's capital structure is more "debt-heavy" than that of the sample water companies. Therefore, Staff recommends adding 50 basis points to its estimate resulting in a recommended 9.0 percent cost of equity. *Id.* at 2. Staff's cost of capital estimates accurately estimates Arizona-American's equity cost including a risk premium and should be adopted.

3. Arizona-American's risk premium method to estimate its equity cost is fundamentally flawed and should be rejected.

Arizona-American's risk relies on forecasts of Baa corporate bond rates for its risk premium method, which renders its estimate unreliable. *Id.* at 17. "Professional forecasts of financial variables are notoriously unreliable and appear to be getting worse, not better, over time. The direction of interest rates [including bond yields] cannot be predicted any better than by the flip of a coin." *Id.* at 17.[11] Further undermining Arizona-American's reliance on forecasts of corporate bonds is the fact that corporate bonds contain default risk. *Id.* at 18. The default risk is diversifiable, or unsystematic. *Id.* As stated by Professor Sharpe, (an authority recognized by Dr. Zepp), investors do not expect a return which compensates for the acceptance of unsystematic risk. *Id.* at 18-19.

These are but two of the flaws contained in Arizona-American's risk premium analysis. As shown in Staff's testimony, there are more. *Id.* 19-21. Instead of relying on Arizona-American's flawed risk premium method, the Commission should rely on Staff's estimates using the demonstrably more accurate and widely accepted CAPM method. (Reiker Direct, Ex. S-45 at 21).

IX. THE COMMISSION SHOULD ADOPT STAFF'S LEVEL OF ACCUMULATED DEPRECIATION.

Arizona-American admits that it included $ 2 million in rate base that it should not have included. (Tr. at 161, 1167). By increasing rate base, the revenue requirement was inflated. Yet Arizona-American's proposal to treat the $ 2 million as a retirement results in no reduction in revenue requirement. Mr. Bourassa agreed that the "net effect on revenue requirement is zero." (Tr. at 162). Staff's witness, Mr. Bozzo agreed, noting that the effect of Arizona-American's proposal was a "wash." (Tr. at 1167). In effect, Arizona-American accepts the disallowance but wants it to be without any effect. As Mr. Bozzo stated, "Arizona-American should not reap a benefit due to its improper recordkeeping…." (Tr. at 1166). In contrast to Arizona-American, Staff's calculation of accumulated depreciation reduces Arizona-American's revenue requirement to offset the amount that was improperly added by Arizona-American. As Mr. Bozzo testified, "that's the purpose of a disallowance." (Tr. at 1167).

Further, Mr. Bourassa testified that in order to retire an asset, the asset's salvage value must be calculated. (Tr. at 221). But Mr. Bourassa admitted that he did not calculate the salvage value of these assets. (Tr. at 163). Moreover, a retired asset must be shown as retired on Arizona-American's books. But Mr. Bourassa did not know whether this had in fact been done. (Tr. at 220).

Some of the assets in question are wells. Arizona-American's President, Mr. Jones, admitted that the wells could possibly be returned to service with extensive rehabilitation. (Tr. at 240).

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[11] Kihm, pp.42-45.

Further, these wells give Arizona-American a "future benefit" by making it easier for Arizona-American to obtain permits for new wells. (Tr. at 242, 285). For these reasons, the wells should not be retired.

X. OTHER ISSUES

A. Acquisition Adjustment.

Arizona-American states that it is not attempting to prove that it meets the requirements necessary for the Commission to approve the acquisition adjustment. (Tr. at 391). However, Arizona-American included the acquisition adjustment in its OCRB schedules. Arizona-American's witness, Mr. Stephenson, conceded that if the OCRB is used as part of the FVRB, the acquisition adjustment should be removed. (Tr. at 392). Arizona-American also seeks authorization to adopt "mortgage-style" amortization of the acquisition adjustment. Mr. Stephenson testified that Commission approval is needed because mortgage style amortization violates Generally Accepted Accounting Principles (GAAP), which requires straight line amortization of acquisition adjustments. (Tr. at 372). Mr. Carlson testified that until the acquisition adjustment is recognized, there is no asset to amortize. (Tr. at 1492).

B. Youngtown Lakes.

Youngtown seeks to have the Sun City irrigation tariff extended to it so that it can have cheaper water for its recreational lakes. (Tr. at 1292). Staff opposes this because it will shift costs to residential consumers. (Tr. at 1130).

C. Deferred Income Tax Credits and ITCs.

If Arizona-American ever attempts to prove that it meets the standards set in Decision No. 63584 for allowance of the acquisition adjustment, the Commission should consider the effect of lost accumulated deferred income credits and investment tax credits. These items were eliminated in the transfer from the previous owner to Arizona-American. As Mr. Carlson explains, these items reduced rate base, and their loss must be accounted for in the calculation of "net benefits" as required by Decision No. 63584. (Carlson Direct, Ex. S-47 at 20-21).

D. Mohave Post Test Year Plant.

Staff was unable to verify $72,240 of post test year plant for the Mohave system. (Carlson

Surrebuttal, Ex. S-48 at 13-14). This amount should be removed from rate base. *Id.*

E. Allocation of Computer Adjustment.

Staff removed certain computer equipment from Arizona-American's rate base as not used and useful. (Carlson Surrebuttal, Ex. S-48 at 14-16). Arizona American disputes the allocation of this adjustment. *Id.* Arizona-American's allocation does not match the amount of the adjustment. *Id.* Staff requests that its allocation be adopted. *Id.*

XI. CONCLUSION.

Arizona-American asks that this Commission disregard methods that the Commission has used for decades. And Arizona-American seeks to selectively evade the consequences of the test year that it chose. Staff respectfully requests that the Commission reject Arizona-American's proposals and adopt the recommendations of Staff.

RESPECTFULLY SUBMITTED this 4th day of February 2004.

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