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BEFORE THE ARIZONA CORPORATION COMMISSION

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Commissioner

Arizona Corporation Commission
DOCKETED

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

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS ANTHEM WATER DISTRICT, ITS AGUA FRIA WATER DISTRICT AND ITS ANTHEM/AGUA FRIA WASTE WATER DISTRICT.	DOCKET NO. W-01303A-02-0908

NOTICE OF FILING TESTIMONY

Pursuant to the revised procedural order in this matter dated June 6, 2003, the ARIZONA UTILITY INVESTORS ASSOCIATION (AUIA) hereby submits the rebuttal testimony of Walter W. Meek.

Respectfully submitted, this 10th day of October, 2003.

Walter W. Meek, President

CERTIFICATE OF SERVICE

An original and 13 copies of the referenced testimony filed this 10th day of October, 2003, with:

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

Copies of the referenced testimony hand delivered this 10th day of October, 2003, to:

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

A copy of the referenced testimony was mailed this 10th day of October, 2003, to:

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Walter W. Meek

REBUTTAL TESTIMONY OF WALTER W. MEEK

I. INTRODUCTION, QUALIFICATIONS AND PURPOSE OF TESTIMONY

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Walter W. Meek. My business address is 2100 North Central Avenue, Suite 210, Phoenix, Arizona 85004.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am the president of the Arizona Utility Investors Association ("AUIA"), a non-profit organization formed to represent the interests of equity owners and bondholders who are invested in utility companies that are based in or do business in the State of Arizona.

Q. DOES THE AUIA MEMBERSHIP INCLUDE THE OWNERS AND OPERATORS OF ANY OF ARIZONA'S REGULATED WATER COMPANIES?

A. Yes. AUIA's members include large Class A water companies and smaller Class B and C water companies. In addition, AUIA is an associate member of the Water Utilities Association of Arizona and three of the members of the AUIA Board of Directors are from the water utility industry.

Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS PROCEEDING?

A. On behalf of AUIA, an intervenor in this proceeding. My testimony is being filed concurrently with the company's testimony because AUIA's position is more closely aligned with the company.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to respond to Staff's assertion that firm-specific or so-called "unique" risk should <u>not</u> be considered in determining an equity return because investors in Arizona-American Water Company, or any other Arizona gas, electric, water or sewer utilities, do not consider such firm-specific risks in making investment decisions. I will also discuss the Staff's response to the company's proposal for establishing its Fair Value Rate Base (FVRB).

Q. WOULD YOU PLEASE EXPLAIN WHY YOU ARE QUALIFIED TO PROVIDE TESTIMONY ON THIS SUBJECT MATTER?

A. I represent the largest cross-section of utility stockholders in the State of Arizona and I have been involved with the utility business in Arizona for 28 years. I have participated in dozens of Commission dockets on behalf of AUIA and testified in numerous proceedings. My testimony has covered topics including rate of return issues, stranded costs, disposition of regulatory assets, AFUDC, inclusion of CWIP in rate base and the impact of regulatory decisions on analyst and investor expectations.

Q. THEN, ARE YOU TESTIFYING AS AN EXPERT WITNESS?

A. I am testifying as a "real world" witness. In this docket, Staff recommends an inadequate 9.7% return on equity based on financial theory found in some economics textbooks. Staff also supports a backward-looking FVRB that does not reflect the current value of the company's property that is devoted to customer service.

On the first point, Staff's financial witness, Mr. Joel Reiker, is apparently well schooled in the academic literature dealing with cost of capital, but I think he has an incomplete understanding of how utility investors in the real world think. No matter what Mr. Reiker's textbooks tell him, it is irrational to believe that an investor would ignore a water company's need to meet a draconian new arsenic standard, or threats to the utility's well fields, or the age and condition of its plant, in making a decision to invest in that company.

II. INVESTOR CONSIDERATIONS

Q. HAVE YOU PERSONALLY PURCHASED AND SOLD COMMON STOCK OR OTHER EQUITY INSTRUMENTS?

A. Certainly, both in and outside the utility arena. Currently, I own stock in several utilities that do business in Arizona.

Q. IN YOUR POSITION WITH AUIA, HAVE YOU DISCUSSED INVESTING IN COMMON STOCKS OF UTILITIES AND/OR OTHER CORPORATIONS?

A. Yes. Investment in stock, particularly stock in utilities, is the foundation of AUIA's existence. In order to advance the interests of AUIA's members, I have developed a good working knowledge of the utility industry and, specifically, investment related matters.

Q. ARE YOU FAMILIAR WITH THE CRITERIA THAT A TYPICAL INVESTOR MIGHT CONSIDER WHEN EVALUATING WHETHER TO INVEST IN A UTILITY'S STOCK?

A. I believe I am. At the outset, it may be useful to distinguish between institutional and retail investors. Today, between 60 and 80 percent of the outstanding shares of some utilities are held by institutional investors, such as pension plans and investment trusts. Of the remainder, half or more may be held in "street" name by broker-dealers and the rest are shareholders of record on the corporate books.

Although all investors should in theory employ similar investment criteria, some have access to more information than others. A careful investor evaluating whether to invest in a utility would examine several factors such as liquidity and cash flows, debt service coverage, capital structure, customer growth, capital requirements, return on equity, PE ratio, projected earnings and dividend growth and regulatory risk in addition to specific business conditions. Some institutional investors are prohibited from investing in a company that doesn't pay a dividend.

Retail investors may or may not have professional investment advisors, but should be interested in the same company-specific data and factors, although their analysis is typically less complex. Since many are at or near retirement age, they are in the "fixed-income" syndrome; they want safety along with consistent growth in earnings and dividends. People in this category often do not have the option of diversification and will have a "portfolio" of three or four dividend paying stocks.

III. THE IMPORTANCE OF UNIQUE RISK FACTORS

Q. HAVE YOU REVIEWED THE DIRECT TESTIMONY OF STAFF WITNESS JOEL M. REIKER FILED IN THIS DOCKET?

A. Yes. Mr. Reiker's testimony gives me great concern for the future of investor-owned utilities in Arizona. For example, on page 6 of his direct testimony, Mr. Reiker states that:

> Risk is defined in modern portfolio theory as the sensitivity of an investment's returns to market returns. The most prevalent measure of risk is "beta." Beta is the measurement of an investment's market risk, and it reflects both the business risk and financial risk of a firm.

Q. ARE YOU FAMILIAR WITH THE TERM "BETA"?

A. Yes, I am familiar with the term "beta" as a tool for measuring the market risk of an investment. It generally measures the sensitivity of the market price of a stock to the market as a whole.

Q. IN YOUR EXPERIENCE, DOES A TYPICAL INVESTOR RELY SOLELY ON BETA IN EVALUATING THE RISKS ASSOCIATED WITH AN INVESTMENT IN A UTILITY'S STOCK?

A. In my experience, a prudent investor will not rely solely on a beta in making investment choices, irrespective of how diversified his portfolio might be. Sole reliance on a beta could lead to imprudent decision-making by investors. However, Mr. Reiker also testifies in his direct testimony at page 7:

> Unique risk, or microeconomic risk, is risk that can be eliminated by portfolio diversification, i.e., buying securities in portfolios. Unique risk is not measured by beta nor does it factor into the cost of equity because it can be eliminated through simple shareholder diversification. Unique risks are particular to an individual company or investment project. Investors who hold diversified portfolios do not worry about unique risk; therefore, it does not affect the cost of capital. Additionally, investors who choose to be less than fully diversified will not expect to be compensated for unique risk.

Any investor who completely ignores what Mr. Reiker terms "unique risk" is going to experience severe disappointments, no matter how diversified his portfolio. I could recite a long list of companies engaged in electric distribution, generation, trading, gas transportation, telephone distribution, long distance, wireless communications, software development and semiconductor manufacturing that have fallen flat since 2000. If you were invested in those companies then, you were probably rich. If you are holding their stock today, along with California bonds, your portfolio may be six feet under water.

I would submit that much of the investment loss associated with those companies was the result of the market's failure to recognize and act on "unique" risks that were present in their business plans, their management and the regulatory regimes under which they operated.

Q. **SO YOU DO NOT AGREE WITH MR. REIKER'S ASSERTIONS ABOUT HOW INVESTORS VIEW "UNIQUE RISK"?**

A. No. I have not met the investors Mr. Reiker testifies about. The investors I deal with would not willingly accept losses due to company-specific risks simply because they own stock in Disney or Pepsi. I can attest that after Three Mile Island, an electric utility that was building a nuclear power plant was besieged by investors who were worried about the unique risk of that investment. Those considering investments in Arizona's regulated utilities also would not simply ignore the return on equity this Commission authorizes. Capital is not unlimited and prudent investors who consider all their options are not likely to ignore real life risks, as Mr. Reiker seems to believe.

Q. DO YOU AGREE WITH MR. REIKER'S VIEW THAT THE RISK ASSOCIATED WITH A PARTICULAR FIRM IS "ELIMINATED" IF SECURITIES ARE PURCHASED IN PORTFOLIOS?

A. Mr. Reiker makes that point in his direct testimony at page 7 and I do not agree. I would, instead, argue that the risk associated with purchasing a particular firm's securities cannot ever be eliminated. Presumably, each stock in an investor's portfolio presents its own specific set of risks, which could, in theory, be averaged to create an overall risk for the portfolio. However, each stock will have its own risk profile and I believe prudent investors consider those risks in deciding whether to buy or hold a particular security.

Q. DO YOU BELIEVE THAT MR. REIKER IS CORRECT IN ASSERTING THAT "INVESTORS WHO HOLD DIVERSIFIED PORTFOLIOS DO NOT WORRY ABOUT UNIQUE RISK"?

A. I think Mr. Reiker lacks experience as an equity investor. I know that Arizona utility companies and AUIA receive many inquires from analysts and investors about the probable effect of "unique" or specific risks, including the risk posed by regulatory decisions of this Commission. If Mr.

Reiker were correct, we would not receive these sorts of inquiries. They would just look up the company's beta and assume that it has the same risks as other companies with the same beta.

I certainly do not ignore unique risks associated with a particular firm when I consider the purchase of that firm's stock simply because I hold a "diversified portfolio," whatever that means. After all, I don't have unlimited wealth and I have to do my homework to make sure I maximize my opportunities for returns on my investments. That is one focus of my concern and the reason for my testimony. If this Commission adopts Staff's high-altitude view of finance and economics, and authorizes unreasonably low rates of return, I fear that investment in Arizona's utility industry will suffer a sharp and debilitating decline.

Q. **DOES FIRM-SPECIFIC RISK AFFECT THE COST OF CAPITAL?**

A. I believe it does, and Citigroup, the country's largest financial company, provides a timely example.

Q. **WOULD YOU EXPLAIN?**

A. I have attached to my testimony as Attachment A a copy of a pamphlet distributed this month to its customers by Smith Barney/Citigroup. The pamphlet announces a new stock rating system introduced by the company in September 2003. The company asserts that the new system is a departure because it no longer rates stocks on a relative basis, i.e., in comparison with others in the same industry or in the analyst's universe of coverage. Instead, the rating system is absolute and company-specific. In brief, the system works this way:

First the analyst calculates an expected 12-month total return comprised of a target price for the stock and the one-year projected dividend yield. Next, the analyst develops and assigns a risk rating based on a four-tier rating system. Finally, an investment rating, i.e., Buy, Hold or Sell, is established using a ratings-risk-return matrix. For example, in order to receive a Buy rating, a Low Risk stock must have an indicated total return of at least 10 percent and a Medium Risk stock must show a total return of 15 percent or more.

Q. HOW ARE THE RISK RATINGS DERIVED?

A. The pamphlet says that the risk rating will include "quantitative and fundamental" risks that are inherent in the underlying company and stock and will include historic price volatility. However, in conversation with a senior investment executive at Smith Barney, I was told that the risk factors will be unique to the company and its business and could include factors such as the quality of management, liquidity and cash flows, capital structure, credit quality, capital requirements and regulatory risks.

Q. IN OTHER WORDS, UNIQUE RISKS WILL AFFECT MARKET PRICE AS A RESULT OF THIS SYSTEM?

A. Yes, contrary to Mr. Reiker's assertions, the customers of Smith Barney/Citigroup will be exposed to a system that rates stocks, at least in part, on risk factors that are unique to the company, and that system is designed to influence decisions to buy or sell stocks.

Q. HOW COULD THAT INFLUENCE THE COST OF CAPITAL?

A. In general, if a company can't develop a robust market for its securities and if its stock can't be sold in the market at a reasonable price, it will inevitably face a higher cost of equity and a higher cost of capital. In this example, the investor's view of whether a rated stock is an attractive investment will be influenced by Smith Barney's judgment about a company's future performance. That judgment will be based on an assessment of the company's intrinsic ability to produce earnings, modified by various risk factors.

Q. SO, IS IT YOUR VIEW THAT FIRM-SPECIFIC RISK SHOULD BE WEIGHED IN ESTIMATING THE COST OF CAPITAL?

A. Yes. It is my understanding that in setting rates for utility service, the Commission must allow a utility, in addition to recovering its operating expenses, taxes and depreciation, an opportunity to earn a return that is equal to returns that are being earned on investments in other businesses that have corresponding risks. This is known as the comparable earnings standard, and it has been in effect for decades. For example, in the *Bluefield Waterworks* case, decided in 1923, the United States Supreme Court stated: "A public utility is entitled to such rates as will permit it to earn a return . . . equal to that generally being made at the same time and in the same general part of the country on investments and other business undertakings which are attended by corresponding risks and uncertainties . . . ." *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679, 692 (1923).

In another important decision, *Hope Natural Gas,* the United States Supreme Court re-emphasized the rate of return principles stated in *Bluefield Waterworks:* "The return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks." *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

In order to apply the comparable earnings standard, it is necessary to evaluate the firm-specific or unique risks associated with an investment in that particular firm. From the standpoint of a typical investor, I believe that Mr. Reiker violates this standard by choosing to ignore firm-specific risks and relying instead on Value Line betas and the utilities' debt exposure as the sole determinants of risk.

Q. **IS THERE A CONFLICT BETWEEN THE COMPARABLE EARNINGS STANDARD AND THE CITIGROUP RATING SYSTEM YOU JUST DESCRIBED?**

A. I don't think so. It might appear so because Citigroup is veering away from rating on a relative basis, but the answer is no, in two respects.

First, Citigroup isn't in the regulatory business. Its analysts will pass judgment on a company's earnings capability, but unlike this Commission, they are not responsible for authorizing rates of return. Second, there is nothing to prevent an investor from making his or her own comparisons based in part on Citigroup's analysis. For example, if Citigroup analysts rated all of the water companies in Mr. Reiker's sample, it would be relatively easy for a prospective investor to make his or her own risk comparisons.

Q. **DO YOU HAVE AN OPINION REGARDING THE STAFF'S COST OF EQUITY STUDIES?**

A. As I stated earlier, I disagree with Mr. Reiker's emphasis placed on beta and his failure to acknowledge that investors consider other data and risk factors in evaluating which stock to purchase. Also, his Capital Asset Pricing Model (CAPM) relies on the assumption that all investors hold efficient portfolios and all such portfolios move in lockstep with the market. Reiker Direct at page 21. This may have a theoretical basis, but it is not reality.

The results produced by Staff's Discounted Cash Flow (DCF) and CAPM studies may pass a theoretical test, but they are suspect from a common sense perspective. *See* Reiker Direct at page 25, Tables 6 and 7. The CAPM historical data results in a return of only 7.7% on equity and the constant growth DCF model used by Staff produces a return of only 8.5%.

This projected return is substantially less than what water and gas companies are currently earning, and well below Value Line's projections for 2004 and the 2006 - 2008 time period. However, these low returns are averaged with higher results from other Staff analyses to produce an average return of only 9.2%.

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.

Q. DOES THE STAFF ANALYSIS INCLUDE THE INFORMATION THAT A TYPICAL INVESTOR WOULD CONSIDER IN EVALUATING THE RISKS OF A STOCK INVESTMENT?

A. Not really. As I outlined previously, a typical investor would consider a variety of financial and non-financial factors and circumstances in evaluating whether to purchase a firm's stock. One way of illustrating this point is to consider the information published by Value Line on the water utility industry and on certain publicly traded water companies. Mr. Reiker presumably has reviewed this information since he has used the betas from Value Line in preparing his testimony. *See* Reiker Direct at page 23.

Value Line provides a variety of historical and projected financial data for each of the publicly traded water utilities that it follows, as well as a discussion of various firm-specific and industry-wide events. Applying Mr. Reiker's logic, however, all of this information is simply irrelevant and ignored by investors. There would be no reason for Value Line and other investment services to gather and publish this information, nor would there be any market for this information, if investors didn't consider it in making investment decisions.

Q. ARE YOU CHALLENGING STAFF'S ANALYTICAL METHOD?

A. Not the method, only the result. Both Mr. Reiker and the company's cost of capital witness, Dr. Zepp, have prepared various estimates of the cost of equity for consideration in this case. Dr. Zepp's analysis and his finding in his rebuttal testimony that Arizona-American's cost of equity is in a range of 10.5% to 11.7% make more sense to me than the Staff's findings. However, the Commission ultimately must decide which approach deserves the most weight.

Q. HOW DOES STAFF'S RECOMMENDED RETURN ON EQUITY COMPARE TO THE RETURNS BEING REPORTED BY THE PUBLICLY TRADED WATER UTILITIES USED IN STAFF'S SAMPLE?

A. Staff's sample contains six publicly water traded utilities. According to the information reported in C. A. Turner Utility Reports (Sept. 2003), these companies are currently earning a return on equity of, on average, 10.6%. Actually, Staff's cost of equity finding, based on averaging its DCF and CAPM results, was only 9.2% or 140 basis points below the average in the sample. Mr. Reiker added 50 basis points to his recommendation in recognition of Arizona-American's debt exposure.

Q. BOTH ARIZONA-AMERICAN'S COST OF CAPITAL WITNESS AND MR. REIKER HAVE EMPLOYED AN ADDITIONAL SAMPLE OF NATURAL GAS COMPANIES. WHAT RETURNS ON EQUITY ARE THOSE UTILITIES CURRENTLY REPORTING?

A. Arizona-American's expert has used seven natural gas companies that have A bond ratings. According to C. A. Turner, the average return on common equity for that group of eight gas companies is 11.34%. That is 160 basis points higher than Staff's final recommendation of 9.7% in this case.

Mr. Reiker has added three other gas utilities to the group, NICOR, Inc., Cascade Natural Gas and Southwest Gas. NICOR's current rate of return is 19.4%, exactly double Staff's recommended return on equity for Arizona-American. The other two gas companies have BBB bond ratings and are currently reporting very low returns on equity, according to C. A. Turner. Cascade Natural Gas is reporting a return on common equity of only 7.4% while Southwest Gas, which is the largest natural gas supplier in Arizona, is reporting a return on common equity of only 7.2%. If these three gas utilities are included in the average, the average return on equity is still 11.3%, again well above what Staff is recommending for Arizona-American in this case.

Mr. Reiker does not discuss the current returns on equity being reported by either sample group of publicly traded utilities. Are those returns on equity relevant to investors? I would think they are and, at a minimum, I would have expected Mr. Reiker to explain why the models he is using are producing results substantially below current returns on equity.

IV. THE SIGNIFICANCE OF REGULATORY RISK

Q. AS YOU INDICATED, A SIGNIFICANT PORTION OF SOUTHWEST GAS' OPERATIONS IS IN ARIZONA AND SOUTHWEST GAS IS CURRENTLY REPORTING THE LOWEST RETURN ON EQUITY OF ALL OF THE SAMPLE GAS UTILITIES. DO YOU HAVE ANY COMMENT?

A. I am on record in that docket in opposition to the Commission's decisions regarding rates and commodity charges. However, I should note that Southwest Gas was granted rate increases in Decision No. 64172 (October 30, 2001) and that the return on equity approved for Southwest Gas in that decision was 11.0%, 130 basis points higher than the equity return being recommended by Staff for Arizona-American.

Q. DOES THE NATURE OF REGULATION IMPACT AN INVESTOR'S PERCEPTION OF THE RISK ASSOCIATED WITH A PARTICULAR UTILITY STOCK?

A. Yes. A public utility commission can have a significant impact on the investment risk associated with a particular utility stock. During the recent APS financing docket, rating agencies, stock analysts and hedge fund managers were constantly seeking insights into the Commission's probable decision. I am convinced that if the Commission had denied APS' request, Pinnacle West Capital Corporation and its affiliates would have been damaged in the financial marketplace.

Now, I am not suggesting that the Commission should avoid taking actions simply because it could impact the risk associated with an investment in a utility it regulates. Nevertheless, if the Commission authorizes a rate of return below what is currently being earned by other utilities, it will be more difficult for the utility to raise capital, bond ratings may be reduced, etc.

These factors, which some would call "regulatory risk," are not ignored by investors. In fact, the August 2003 <u>Value Line</u> specifically mentions that regulatory decisions and policies in California are adversely impacting water utilities in that state.

It is probably no coincidence that Southwest Gas also operates in California, and the two water utilities currently reporting the lowest returns, American States Water (formerly named Southern California Water) and California Water Service, are based in California. California Water Service has had its credit rating downgraded in the past year or two. Southwest Gas is currently rated BBB- by S&P, which is barely investment grade.

Q. DOES THE NEW MAXIMUM CONTAMINANT LEVEL ("MCL") FOR ARSENIC, RECENTLY ESTABLISHED BY THE ENVIRONMENTAL PROTECTION AGENCY UNDER THE SAFE DRINKING WATER ACT, CREATE ADDITIONAL RISK?

A. Yes, this is a good example of a firm-specific risk that an investor is going to consider, notwithstanding the finance theory relied on by Mr. Reiker.

Q. BUT DOESN'T STAFF ARGUE THAT THE NEW MCL FOR ARSENIC IS NOT A FIRM-SPECIFIC RISK BECAUSE IT IMPACTS THE ENTIRE WATER UTILITY INDUSTRY?

A. Yes, Mr. Reiker discusses this point on page 59 of his direct testimony. Again, he claims that this is simply a unique risk and would not be "priced by the market." Mr. Reiker does not discuss, and there is no indication that he has investigated, whether the six publicly traded water utilities have arsenic in their water supplies and, if so, how much they will be required to spend to comply with the new EPA requirement.

According to Mr. Reiker, the "Modern Portfolio Theory" justifies ignoring these sorts of risks in setting rates, even though investors can and do consider them, based on my experience.

Q. SO IS IT YOUR BELIEF THAT REGULATION ITSELF AFFECTS INVESTOR RISK?

A. Yes. As I discussed above, there are numerous examples of regulatory decisions (or the lack thereof) impacting stock value, which obviously impacts investor risk. Investors do consider these factors. I know I do and I am an investor.

Regulatory lag is yet another example of risk associated with regulation that an investor is likely to consider. It typically takes 13 months or longer (it will be at least 15 months in this docket) to obtain rate relief in this jurisdiction. *Value Line* specifically emphasizes problems being experienced with the California Public Utilities Commission in its most recent discussion of American States Water and California Water Service. Apparently, both of these companies have been waiting for rate decisions from that commission, while their earnings erode. This is another example of a unique factor that influences investors' perception of the risk associated with an investment in a utility.

Q. ACCORDING TO MR. REIKER, SUCH RISKS ARE IGNORED BY THE MARKET.

A. That's what Mr. Reiker claims, but I do not accept his theory. I can suggest that the most efficient way to minimize or eliminate these types of risks is to reject the investment in the first place, which I fear is the result we are going to see if Staff succeeds in its attempt to drive down equity returns.

V. <u>FAIR VALUE RATE BASE</u>

Q. IS THERE A CONFLICT BETWEEN STAFF AND ARIZONA-AMERCIAN ON HOW TO DEVELOP AN APPROPRIATE FAIR VALUE RATE BASE?

A. Yes. The company proposes that its rate base be determined by reconstruction cost new less depreciation (RCND), while the Staff prefers to use original cost less depreciation (OCLD).

Q. IS THERE A SIGNIFICANT DOLLAR DIFFERENCE?

A. Yes. The company's adjusted RCND rate base, based on its rebuttal filing, totals approximately $137 million while the Staff's OCLD calculation produces a rate base of approximately $92 million.

Q. WHAT DOES THIS DIFFERENCE MEAN TO AN EQUITY INVESTOR?

A. Depending on how the authorized return on equity is applied to the rate base, we would expect that the larger RCND rate base would generate greater dollar returns for the equity investor. However, the underlying issue is which method is more equitable, and which conforms more closely to the requirements of the law. AUIA believes that RCND is superior to OCLD on both grounds.

Q. WHY IS RCND THE SUPERIOR METHOD?

A. Both the law and common sense dictate that a utility company should be allowed to earn a fair return on the actual value of its property devoted to public service. I have already cited the *Bluefield Waterworks* case in which the U.S. Supreme Court enunciated the requirement for providing a fair rate of return to equity investors. In that case, the Court also discussed the test to be used in establishing a FVRB, emphasizing that the rates must be "sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the service." The Court overturned the West Virginia commission's decision because it was based on the original cost, and not the property's value at the time rates are set. 262 U.S. at 689 – 692. To that we can add, for example, the judgment of the Arizona Supreme Court in *Simms v. Round Valley Light & Power*, in which the Court declared that the Commission is required to consider the value of a utility's property "at the time of the inquiry," based on the Arizona Constitution. 80 Ariz. 145, 151, 294 P 2nd 378, 382 (1956). In other words, the utility's rate base should reflect its current value at market, not historic or book cost.

Q. DOES RCND MEET THE COURT'S REQUIREMENT?

A. RCND at least approaches actual value, although the recent purchase of Arizona-American's assets, at a price of $276.5 million, indicates that the company's proposed RCND rate base is well short of market value in 2001 when the sale was consummated.

RCND certainly comes much closer to the Court's requirement than does OCLD, which is a backward-looking calculation that is based on historic cost. Book value has no relationship to market value and, therefore, does not reflect the actual value of the utility's property today.

When you couple OCLD with the historic test year and a regulatory lag in excess of 12 months, you get the worst of all worlds. Not only is the rate base an historic expression, but the data are two to three years old by the time rates go into effect. This is not an equitable ratemaking system, and in my view, does not comply with the "fair value" requirement in our state's Constitution.

Q. WHAT IS AUIA'S POSITION REGARDING THE ACQUISITION ADJUSTMENT?

A. With regard to this proceeding, we agree with the company's approach. At the time of the purchase of these systems by Arizona-American, AUIA argued that the issue of recovering the acquisition premium should be postponed until a rate proceeding. The Commission did that in its order approving the sale, but it imposed certain conditions on any future recovery, including a requirement that the company must demonstrate clear benefits that have accrued to ratepayers as a result of the transaction.

Company witness Stephenson has proposed that Arizona-American be allowed to defer that demonstration without relinquishing its right to pursue recovery in a future proceeding.

Given the transition that Arizona-American has undertaken, from a few thousand customers to roughly 150,000, AUIA believes it is reasonable to postpone consideration of the acquisition adjustment.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.