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BEFORE THE ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION
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IN THE MATTER OF THE APPLICATION OF
CHAPARRAL CITY 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 FOR UTILITY SERVICE
BASED THEREON.

DOCKET NO. W-02113A-04-0616

STAFF'S REPLY BRIEF

I. INTRODUCTION

On July 6, 2005, Utilities Division Staff ("Staff") of the Arizona Corporation Commission ("Commission") received the closing briefs from Chaparral City Water Company, Inc. ("Chaparral City" or "Company") and the Residential Utility Consumer Office ("RUCO"). In this Reply, Staff will address arguments related to post test year plant, rate design, cost of capital, adjustor mechanisms, fair value and normalization issues.

II. POST TEST YEAR PLANT

The Company claims in its brief that allowing post test year plant only in special or unusual situations is contrary to prior Commission decisions. (Co. Cl. Br. at 12). Mr. Moe testified that he reviewed the prior Commission decisions that Mr. Bourassa cited and concluded that "all the post year plant that the Commission had included in those other cases, were revenue neutral." (Tr. at 696). In this case, Staff does not believe that Shea WTP is revenue neutral. Staff's position continues to be that the Main is revenue neutral. Staff is recommending that the Main be included in this case. It is reasonable to infer from Staff's testimony that Staff found the installation of the Main to be a special or unusual situation since it would "provide a more efficient means of transporting water through Zone 1, giving a greater operational flexibility and improving service to customers. This transmission main will also assist in providing CAP water flow to blend Well # 10 groundwater

1 production in order to reduce the arsenic concentration for Well # 10.” (Ex. S-6 at 9). Staff did not
2 identify any concerns over retirements because Staff’s analysis did not uncover any potential related
3 retirements. Staff admits that there are many factors to consider when analyzing post test year plant.
4 Despite the criteria Staff used in this case, Staff admits that “the Commission has not adopted a
5 formal policy concerning post year plant. The Commission considers whether the inclusion of post
6 test year plant is appropriate on a case-by-case basis.” (Ex. S-7 at 2).

7 The Company also claims that Marlin Scott, Jr. did not respond to the Company position that
8 Shea WTP was revenue neutral. The Company claims that Staff’s engineering witness, Mr. Scott,
9 does not explicitly state “that the Shea WTP should be excluded from rate base, nor does he provide
10 any engineering rationale supporting Mr. Moe’s accounting adjustment.” (Co. Cl. Br. at 13). First,
11 Mr. Scott’s testimony only explicitly states that “the transmission main project be included in rate
12 base.” (Ex. S-1, MSJ at 7). Second, despite the Company’s claim that Mr. Scott failed to provide an
13 engineering rationale for exclusion of the Shea WTP, Mr. Scott points out that the Shea WTP will
14 result in “increasing the Shea Treatment Plant # 2 capacity from 5 MGD to 15 MGD.” *Id.* Third, Mr.
15 Scott was subject to cross-examination by the Company and the Company chose not to question Mr.
16 Scott regarding post test year plant. Mr. Scott’s analysis led Mr. Moe to conclude that the Shea WTP
17 is “a revenue producing product as one of the main purposes of the project is to increase capacity.”
18 (Ex. S-6 at 10).

19 The Company continues to argue that the Shea WTP allows it to take modules off-line for
20 repairs and other emergency events. (Co. Cl. Br. at 12). The Company receives a greater benefit
21 from its increased treatment capacity (from 8 million gallons a day (“MGD”) to 18MGD), which will
22 allow it to serve more customers, than the ratepayers do from the additional protection against the
23 unlikely event of an emergency similar to the crisis faced by the City of Phoenix. The Company’s
24 service area is still a rapidly growing customer base. Mr. Scott’s growth analysis indicates that the
25 Company could have approximately 15,800 customers by December 2008. (Ex. S-1, MSJ at 5). It is
26 reasonable to infer that the Shea WTP allows the Company’s customer base to continue growing and
27 creates a mismatch by including this plant and rate base without the revenue it can potentially
28 produce.

1 The Company was able to meet peak demand in the test year using groundwater as a
2 supplement to their CAP allocation. Staff has included water costs from the CAGR in its
3 recommended revenue requirement for the Company. The potential for mismatching of test year
4 revenues and expenses by including the Shea WTP in rate base is very significant due to efficiencies
5 gained by the increased capacity to treat CAP water.

6 **III. RATE DESIGN**

7 Staff maintains that the inverted-tier rate design sends the appropriate price signals which will
8 lead to long-term conservation goals. Residential ¾-inch meter customers using 5,501 gallons a
9 month, the median water usage, will experience a rate increase of \$1.38, or 6.10 percent. (Ex. S-13,
10 Sch. JRM-30). Residential ¾-inch meter customers using 9,187 gallons a month, the average water
11 usage, will experience a rate increase of \$2.39, or 7.83 percent. *Id.* Staff acknowledges that there is
12 the possibility of a short term reduction in water use due to any increase in rates, independent of the
13 actual method used for rate design.

14 The Company claims that Staff says customers will not use less water under Staff's proposed
15 rate design. (Co. Cl. Br. at 53). Staff cannot predict whether customers will actually decide to use
16 less water in a particular year. Staff has not found any evidence supporting the claim that there is a
17 significant short-term change in water use. The Company's service area is still a rapidly growing
18 customer base. Mr. Scott's growth analysis indicates that the Company could have approximately
19 15,800 customers by December 2008. (Ex. S-1, MSJ at 5). Even if there were no growth in the
20 Company's service area, the price signals provided by Staff's recommended rate design educates
21 existing customers on the value of water in Arizona. Staff wants to send a price signal that "with
22 water use, the higher your water use, the higher your water bill is going to be." (Tr. at 784).

23 The Company further claims that desert landscaping is commonly used in Fountain Hills.
24 (Co. Cl. Br. at 58, fn. 25). This would indicate that the water demand is less elastic and that there is
25 even less chance of significant water reduction in the short term. One of the goals of Staff's rate
26 design is "customers in the future, as developers bring people on, that they may be going to go to
27 more conservation landscaping measures and perhaps more desert landscaping, not necessarily the
28 full lawns that will require all the water usage that current lawns need..." (Tr. at 784). Staff

1 maintains that the value of long-term conservation goals is reason enough for the implementation of
2 Staff's recommended rate design.

3 The Company makes the argument that Staff is sending mixed signals with its rate design
4 geared towards long-term conservation goals related to desert landscaping and other conservation-
5 oriented devices while recommending retention of a uniform commodity rate for landscape watering
6 and other exterior uses to prevent "rate shock." (Co. Cl. Br. at 58). Under Staff's recommended rate
7 design, irrigation customers experienced a 26 percent increase to their commodity rate, in addition to
8 the same increase to the minimum charge that the other classes received. Due to the increased
9 likelihood of rate shock related to larger levels of water use typical of irrigation customers, Staff's
10 increase to the irrigation commodity rate is not as great as that proposed by the Company. Staff
11 believes the irrigation commodity rates should progressively be moved closer to the commodity rates
12 of the other customer classes in future rate cases. Staff maintains that the avoidance of rate shock is
13 an important issue as well, and took that into account in developing Staff's recommended rate design.

14 The Company continues to mischaracterize Staff's first tier for residential ¾-inch meter
15 customers as a discounted rate. (Co. Cl. Br. at 50). Staff clearly explained that the first tier
16 commodity rate's price position is set up as part of a three-tier rate design. Thus, the commodity rate
17 for the first tier is by nature going to be smaller. (Tr. at 792-93). Staff's rate design was developed to
18 meet Staff's recommended revenue requirement and the commodity rates assigned to each tier reflect
19 the ratios Staff used in the development of those rates. *Id.* at 793.

20 The Company also continues to incorrectly define the first tier commodity rate for residential
21 ¾-inch meter customers of Staff's recommended rate design as a "lifeline" rate. (Co. Cl. Br. at 56).
22 The Company lists a number of similarities between the American Water Works Association's
23 definition of a "lifeline" rate and Staff's first tier, but it has to continue reaching to make the claim
24 they are the same. The American Water Works Association's manual defines lifeline rates as "low-
25 income discounts are rate alternatives designed to provide a minimal or essential volume of water
26 service at a reduced cost to those residential customers who, **due to their income level**, find it
27 difficult to afford water service. (emphasis added) (Tr. at 794-95). Staff did not conduct an analysis
28 of Chaparral City's customers' income levels in development of its rates. The Company chooses to

1 ignore the definition of lifeline rates from the specific source the Company cited in continuing this
2 argument. Staff's first tier reflects non-discretionary use which Staff has set at about 3,000 gallons
3 for the first tier for all residential 3/4-inch customers. *Id.* at 795.

4 During cross-examination, Staff did argue that the non-discretionary water use tier "doesn't
5 discriminate against anyone. All customers get it." *Id.* At this point, it was clear that Staff's position
6 was that the non-discretionary water use tier applied to all residential 3/4-inch customers. (Ex. S-6 at
7 26). Staff was not trying to claim otherwise. Staff's non-discretionary use rate design applies to
8 residential 3/4-inch customers, the only class for which Staff believes a reasonable estimate of the
9 amount of non-discretionary water use can be made. The Company continues to argue that Staff's
10 first tier commodity rate for residential 3/4-inch meter customers is a "discounted" or "lifeline" rate
11 that creates a subsidy (Co. Cl. Br. at 56-57). However, despite the Company's concerns about the
12 non-discretionary water use tier, the above customers will still experience an increase in their water
13 bills. (Ex. S-13, Sch. JMR-30).

14 **IV. COST OF CAPITAL**

15 The Company claims that firm-specific risks affect the cost of equity. The Company brings
16 up firm-specific risks that include "the use of an historic test year with limited out-of-period
17 adjustments, the lack of balancing accounts and adjustment mechanisms for water utilities, the
18 exclusion of construction work in progress from rate base, and the use of multi-tier, declining block
19 rates to promote water conservation without consideration of the impact on revenues." (Co. Cl. Br. at
20 30). Staff's position is that firm-specific risks do not affect the cost of equity. According to Staff
21 witness Alejandro Ramirez, market risk is "related to the economy-wide perils that affect all business
22 such as inflation, interest rates, and general business cycles." (Ex. S-3 at 10). On the other hand,
23 unique risk does not "affect the cost of equity because these firm-specific risks can be eliminated
24 through shareholder diversification." *Id.*

25 The Company argues the arithmetic average should be used to calculate historical ("GDP")
26 growth. Staff's position is that the geometric average should be used to calculate the GDP growth.
27 Although the arithmetic mean "represents typical performance over single periods," the geometric
28

1 average is more appropriate since it is “typically concerned with long-term performance.” (Ex. S-4 at
2 11).

3 Staff’s position is that Dr. Thomas M. Zepp came up with an incomplete representation of Mr.
4 Ramirez’s analysis when Dr. Zepp “restated Mr. Ramirez’s multi-stage discounted cash flow
5 (“DCF”) estimate using Mr. Ramirez’s data, but also including Mr. Ramirez’s 8.7% estimate of
6 intrinsic growth (Ex. S-4 at Sch. AXR-4).” (Co. Cl. Br. at 41). Dr. Zepp’s selection on Mr.
7 Ramirez’s Schedule AXR-4 of 8.7% intrinsic growth rather than 5.3% intrinsic growth skews the
8 initial analysis made by Mr. Ramirez in the Company’s favor.

9 The Company disputes Staff’s determination that the sample group of water companies have
10 the same estimated beta. The Company argues that “Staff then assumes that Chaparral City, which is
11 not publicly traded and has no estimated beta, has the same estimated beta as the averages of the
12 sample group.” (Co. Cl. Br. at 42). The assumption that all water utilities have similar betas is
13 reasonable. All the water utilities in the sample are regulated and all are “in the same business and
14 they should have, on average, the same [systematic] risk” as Chaparral City. (Tr. at 480). In this
15 case, even if Staff had not used the Capital Asset Pricing Model (“CAPM”) Method, its cost of equity
16 would still be 9.3% based on the DCF Method. (Ex. S-4 at Sch. AXR-8).

17 The Company points to an exhibit (Ex. A-21) in its Closing Brief to attempt to discredit the
18 CAPM Method used by Staff. According to the Company, Exhibit A-21 shows that “Staff’s CAPM
19 estimates . . . move in the opposite direction of interest rates. . . .” (Co. Cl. Br. at 44). However, it is
20 Staff’s position that, aside from the Arizona Water Company case listed in Exhibit A-21, the “cost of
21 equity moves in the same direction as interest rates.” (Ex. S-3 at 7). A comparison of the “Risk Free
22 Rate” column and the “CAPM Estimate” column shows that, with the exception of Arizona Water,
23 the cost of equity (CAPM estimate) moves in the same direction as interest rates (Risk Free Rate).
24 (Co. Cl. Br. at 44, Ex. A-21).

25 **V. ADJUSTOR MECHANISMS**

26 The Company claims that the Commission has recognized that adjustment mechanisms
27 designed to pass on increases (and decreases) in purchased water and power costs are appropriate for
28 Arizona utilities. (Co. Cl. Br. at 25). The above claim seems to imply that the Commission policy is

1 that all adjustment mechanisms are appropriate. However, in discussing the Commission's policy on
2 adjustor mechanisms, the Company pointed to the language in Decision No. 62993 that indicated that
3 the Commission's policy is "...to support appropriate pass-throughs." *Id.* at 26. The word
4 "appropriate" implies that not all adjustor mechanisms are suitable and that the Commission must use
5 its discretion when analyzing an adjustor mechanism for a particular company for a particular
6 expense. In this case, Staff made the determination that purchased power and purchased water
7 adjustment mechanisms for Chaparral City were not appropriate. (Tr. at 814).

8 The Company continues to confuse the true issues in this area. Staff agrees that purchased
9 power and purchased water are significant costs. The issue is whether the incremental cost level, or
10 volatility, associated with possible rate increases or decreases are significant. Staff's analysis of
11 advisory rates shows that the Company's purchased water expense will not increase over test year
12 levels by \$50,000 until 2008. (Ex. S-7, at Ex. 5). This is a far cry from the Company's claim that
13 purchased water will increase by more than \$50,000 per year, which will total over \$100,000. (Ex. A-
14 6 at 24). The Company's purchased water volatility is not great enough to warrant the need of a
15 purchased water adjustor mechanism. As far as purchased power is concerned, the Company has not
16 provided any evidence supporting its claim that "the annual expense increase due to projected rate
17 increases from SRP and APS is likely to exceed 5% per year over adjusted test year levels." (Co. Cl.
18 Br. at 24). The Company's purchased power volatility is not great enough to warrant the need for a
19 purchased power adjustor mechanism.

20 The Company creates further confusion by showing purchased water and purchased power as
21 a percentage of operating income. *Id.* at 24-27. This further complicates the issue by including the
22 various parties' different recommendations regarding rates of return as well as expenses. Although
23 this distorts any true meaning the ratios may possibly have had, it does create the illusion of greater
24 significance. However, Staff is not arguing in this case that the expense levels are insignificant.
25 Staff maintains that the volatility levels are not significant enough to warrant the need for adjustor
26 mechanisms. Neither purchased water nor purchased power expose Chaparral City to the volatility
27 that APS is exposed to related to constantly changing fuel and purchased power costs.

28 ...

1 **VI. FAIR VALUE**

2 The Company claims that Staff ignored fair value in determining its revenue requirement.
3 (Co. Cl. Br. at 6). Staff found a fair value rate base (“FVRB”) of \$18,301,855. Staff recommended a
4 fair rate of return on that fair value of 6.23%. In making its fair value finding, Staff used “50 percent
5 of the original cost rate base and 50 percent of the reconstruction cost new less depreciation rate
6 base.” (Tr. at 818).

7 The Company claims that Staff violated the fair value standard. (Co. Cl. Br. at 10). The
8 Company claims that Arizona law requires “that fair value be used to set rates.” *Id.* Although
9 Arizona law requires the Commission to make a fair value finding, the Arizona Supreme Court has
10 held that the “Commission has broad discretion, however, to determine the weight to be given [fair
11 value] in any particular case.” *U.S. West Communications, Inc. v. Ariz. Corp. Comm’n*, 201 Ariz.
12 242, 246, 34 P.3d 351, 355 (2001).

13 **VII. NORMALIZATION ISSUES**

14 The Company claims that Jamie Moe’s recommendations regarding normalizing certain
15 expenses should be disregarded due to his lack of ratemaking experience. The Company attacks Mr.
16 Moe’s credibility because he has “virtually no ratemaking experience” and claims that Staff “cannot
17 sustain its burden of proof on nothing more than Mr. Moe’s beliefs.” (Co. Cl. Br. at 18). Mr. Moe
18 has a Bachelor of Science degree in Accounting and is a Certified Public Accountant. Mr. Moe
19 worked two years in public accounting before joining the Commission and has attended the National
20 Association of Regulatory Utility Commissioners’ Annual Regulatory Studies Program and Utility
21 Rate School. Although Mr. Moe has only been at the Commission for 2 ½ years, he is a Public
22 Utilities Analyst IV and the ratemaking experience he has gained while at the Commission should not
23 be overlooked. Furthermore, even though Mr. Moe is certainly a qualified witness in his own right,
24 he pointed out that he relied on “Staff’s experience, not just my own, but my managers, supervisors
25 and all Staff included.” (Tr. at 793).

26 **VIII. CONCLUSION**

27 In light of the above and the record in these proceedings, Staff requests that the Commission
28 adopt Staff’s recommendations. Staff asks that the Commission allow post test year plant associated

1 with the Main and not allow the post test year plant associated with the Shea WTP. Staff requests
2 that the Commission adopt Staff's rate design for water services. Staff asks that the Commission
3 adopt Staff's cost of capital and cost of equity. Staff requests that the Commission deny Chaparral
4 City's request for adjustor mechanisms for purchased power and purchased water.

5 Staff recommends total annual operating revenues of \$7,012,536 and operating income of
6 \$1,139,416 for a 7.60% rate of return on an original cost rate base ("OCRB") of \$14,992,322, or a
7 6.23% rate of return on a fair value rate base ("FVRB") of \$18,301,855. Finally, Staff recommends
8 the normalization of the expense accounts related to Office Supplies, Outside Services,
9 Transportation Expense, and Miscellaneous Expenses.

10
11 RESPECTFULLY SUBMITTED this 20th day of July, 2005.

12
13 *David Ronald*

14 David M. Ronald
15 Attorney, Legal Division
16 Arizona Corporation Commission
17 1200 West Washington Street
18 Phoenix, Arizona 85007
19 (602) 542-3402

20 The original and thirteen copies
21 of the foregoing were filed this
22 20th day of July, 2005 with:

23 Docket Control
24 Arizona Corporation Commission
25 1200 West Washington Street
26 Phoenix, Arizona 85007

27 Copy of the foregoing were mailed this
28 20th day of July, 2005 to:

29 Norman D. James, Esq.
30 Jay L. Shapiro, Esq.
31 FENNEMORE CRAIG
32 3003 North Central Avenue
33 Suite 2600
34 Phoenix, Arizona 85012
35 Attorneys for Chaparral City Water Company

36 Scott S. Wakefield, Chief Counsel
37 RUCO
38 1110 West Washington Street
39 Suite 220
40 Phoenix, Arizona 85007

1 Christopher Kempley, Chief Counsel
Legal Division

2 Arizona Corporation Commission
1200 West Washington Street
3 Phoenix, Arizona 85007

4 Lyn Farmer, Chief Hearing Officer
Hearing Division

5 Arizona Corporation Commission
1200 West Washington Street
6 Phoenix, Arizona 85007

7 Ernest Johnson, Director
Utilities Division

8 Arizona Corporation Commission
1200 West Washington Street
9 Phoenix, Arizona 85007

10

11



12

Angela L. Bennett, Secretary to
David M. Ronald

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