ORIGINAL

BEFORE THE ARIZONA CORPORATION 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

REPLY BRIEF OF THE RESIDENTIAL UTILITY CONSUMER OFFICE

INTRODUCTION

The Residential Utility Consumer Office ("RUCO") replies to Chaparral City Water Company's ("Company or Chaparral") and the Arizona Corporation Commission Staff's ("Staff") Post Hearing Briefs as follows.

REQUIRED OPERATING INCOME METHODOLOGY

The Company's arguments fail to support what it has tried to make an issue in this case. The Company is trying to get the Commission to approve an operating income methodology which considers rate base and rate of return on two different bases. Since the result of what the Company proposes grossly overstates the Company's required operating income, and has no accounting or legal basis, the Company has not (nor would it be possible to) put forth a valid argument for its position. Instead, the Company in its Closing Brief ("Brief") mischaracterizes RUCO's position, and engages in long discourses, complete with detailed legal analysis, on issues that are neither contested[1] nor relevant in this proceeding. The Commission should reject the Company's operating income methodology.

When all is said and done, the Commission must state the rate base and the rate of return on the same basis, otherwise the Company's required operating income will be overstated. R-5 at 9. In other words, in calculating operating income, the Commission should, and historically has, applied an FVRB to an FVROR. By mismatching the bases for the rate base and rate of return, as the Company proposes, the resulting operating income is overstated. The reason for the overstatement is because of the inflation factor. Id. at 8. Applying an OCROR to an FVRB factors inflation more than once, thereby overstating the operating income by approximately $443,000. A-6 at 3, Transcript at 493. The Commission should not allow the Company to overstate its revenue requirement by accounting for inflation more than once.

FOUNTAIN HILLS BOULEVARD MAIN

RUCO recommends that the Commission not allow in ratebase $940,979 associated with the Main unless the Commission makes a corresponding adjustment for the savings. The evidence is clear that there were savings resulting from the Main since the Company no longer has to pump water through Zone 2 to get to Zone 1. It is not fair or good ratemaking policy to recognize post-test year improvements in rate base and to ignore the resultant savings.

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[1] For example, no one disputes that the Commission must determine a FVRB. The Company devotes three pages in its Brief on this point. Brief at 8 – 10.

The Company argues that there were no savings associated with the Main, based on the testimony of Staff's engineer that there was no pumping involved in the operation of the Main. Staff testified and argued in its Closing Brief ("Staff's Brief") that there were no pumping costs prior to the Main being built "... because there are no pumping costs because the CAP water goes through treatment in Zone 2 and is gravity fed to Zone 1." Staff's Brief at 10, Transcript at 636-638.

In light of irrefutable evidence, the Commission should disregard both the Company's and Staff's arguments. The evidence is clear in this case. The Company responded to RUCO's Data Request when asked about this issue:

> "Yes, the extension of the water main was completed to operate the existing water distribution system in a more efficient manner. Please refer to the attached report from Entranco dated October 1997. Rather than install the 16" main at the time that plant #2 came online, pumps were installed to pump to zone 2 and allow water to flow back into zone one rather than export all flow from plant #2 to zone one and then only pump as required to meet the demand of zone 2." R-9.

The Main now feeds directly to Zone 1, making it no longer necessary to pump the water uphill to Zone 2 to allow it to gravity feed to Zone 1. The Entranco report referred to the pumping cost savings as follows:

> 3.63 Pumping Power Cost Savings Under Proposed Operating Conditions (without Reservoir No. 2 to Reservoir No. 1 Intertie) are as follows:
>
> ....Pumping Savings $113,500
>
> 3.8 Potential 1997 Cost Savings
>
> Total potential pumping cost savings over an assumed 10 year project period = $142,500. R-9, Entranco report at 13 and 15.

Given the Company's response to RUCO's Data Request, it is disingenuous for the Company to suggest there were no pumping savings based on testimony of Staff's engineer.

The Commission should not allow inclusion of the Main without a corresponding adjustment for the savings.

RECLASSIFICATION OF HOOK-UP FEES

RUCO recommends that the Commission approve an adjustment to include the hook-up fees in the test-year CIAC balance. The Company opposes this adjustment for a variety of reasons, but mostly because the Company claims it "makes no sense." Brief at 16. Apparently, at least from the Company's perspective, it makes sense to simply remove $220,000 in hook-up fees from the Company's test-year revenues without making a corresponding adjustment to rate base. The effect of the Company's proposal, which necessitates RUCO's adjustment, would be to inflate the rate base on a going forward basis and embed higher rates. The Commission should reject the Company's proposed treatment of the hook-up fees.

The Company argues that RUCO's adjustment has the effect of confiscating the shareholders' property by converting shareholder equity into CIAC. Brief at 16. This argument lacks merit. The hook-up fees were paid for by **ratepayers**, not shareholders, and are not shareholder equity as argued by the Company. Under no circumstances should the Commission allow the shareholders to earn a return on this money.

The Company next argues that there is no accounting standard or principle to explain RUCO's adjustment. This situation is not typical and requires an adjustment in order to prevent an injustice to ratepayers. It would be unfair to ratepayers to credit shareholders with ratepayer's money for no reason, just as it would be unfair to credit ratepayers with shareholder's money for no reason. Moreover, simply removing the hook-up fees from revenues without a corresponding adjustment to ratebase not only lacks an accounting or legal basis, it has the effect of treating those ratepayers who did pay the hook-up fees as if they did not pay them at all. Ratepayers should receive credit for the hook-up fees they paid and the Commission should reject the Company's proposal to the contrary.

DEPRECIATION EXPENSE

The Company and RUCO disagree on what constitutes fair depreciation rates for the Company to use in calculating depreciation expense. The Company has taken the position that the Commission should allow what Staff has "typically" recommended. R-5 at 16. In this case, the Company is suggesting that the Commission follow the rates approved in the recent Rio Rico case, as these rates are "typical" of what Staff has recommended. R-6 at 8. Rio Rico's rates, however, are among the highest depreciation rates that the Commission has recently approved. R-5, Schedule RLM-10, p. 1.

RUCO has proposed depreciation rates which represent an average of 25 different water systems in the Rio Rico, Arizona Water and Arizona American water companies. R-5 at 17. RUCO's depreciation rates represent a more balanced approach, which is not skewed toward the high end or the low end.

In its Brief, the Company is critical of RUCO's balanced approached because it does not accurately compare depreciation rates to the expected useful life of the assets to which they compare. Brief at 18. The only way to make such a comparison, however, would be through a depreciation study. Transcript at 560. Neither the Company nor RUCO did such a study which explains why "typical" rates were considered[2]. Interestingly, the Company complains that RUCO's recommended depreciation rates are skewed, but it is the Company's proposed

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[2] Without such a study, there is no way to know if the Company's proposed rates are reflective of the life of the purchased water and purchased power assets to which they compare.

rates which are reflective of some of the highest rates this Commission has allowed. The Commission should adopt the more balanced and far more "typical" depreciation rates proposed by RUCO.

PROPERTY TAX EXPENSE

In this case, as in recent cases, RUCO has maintained that using historical revenues in the Arizona Department of Revenue ("ADOR") formula, as the formula recommends, is the best estimate of future property taxes. RUCO is more convinced than ever that this is the proper way to measure property tax, now that actual post-test year property tax expense is known, and comparisons can be made. In this case the comparison of actual property tax for 2004 to the estimates using the ADOR recommended revenues and the Company's recommended revenues illustrates that the use of ADOR's formula is far more accurate. R-2

The Company cannot, and has not, refuted these comparisons. Instead, it makes the same argument that RUCO's calculation fails to take into account any increased revenues resulting from this proceeding. Brief at 22. This is where the Company, as well as the Commission in previously approving the Company's methodology, is misguided. The formula takes revenue increases into account by multiplying the three year historical average of operating revenues by a factor of two. R-5 at 2. The Company's methodology also doubles the revenues, but it doubles both adjusted and projected revenues. That is why the Company's methodology invariably results in an overstated tax expense. The Commission should adopt the RUCO/ADOR methodology and recognize it as the best estimate of property tax expense.

PURCHASED POWER AND WATER ADJUSTMENT MECHANISMS

The Company complains that neither RUCO nor Staff provides a legitimate basis for their positions that the Commission should not approve adjustment mechanisms for the Company. In RUCO's Closing Brief, ("RUCO's Brief"), RUCO goes to great lengths to explain, from both a legal and fact specific standpoint, why this case does not warrant approval of either adjustor mechanism. RUCO's Brief at 10 – 14. RUCO will not repeat those arguments. RUCO notes, however, that the arguments made in the Company's Brief, considered in the most favorable light to the Company, still do not meet the legal standards necessary to qualify for an adjustor mechanism in Arizona.

For example, the Company argues that the adjustors should be approved because the Company's purchased water and purchased power costs are significant. Brief at 28. With regard to the purchased power costs, the Company notes that SRP has increased its rates five times since 2000 and that APS has been authorized an adjustment mechanism. Id. at 27 – 28. With regard to its water, the Company pays an annual water service capital charge and a separate delivery charge. Brief at 23.

While these costs may be increasing, they are not fluctuating widely. Nor are these costs subject to volatile changes. Gradual, steady and infrequent increases do not qualify for treatment as adjustor mechanisms as defined by *Scates* and previous decisions of this Commission. Biased rates result when small incremental changes in any one particular cost are adjusted without consideration of changes in all other elements of the Company's cost of service. The Commission should deny the Company's request for purchased power and purchased water adjustor mechanisms.

COST OF CAPITAL

RUCO continues to urge the Commission to adopt RUCO's recommended 9.45 percent return on common equity for Chaparral. There is no disagreement between the Company and RUCO over the use of the basic sustainable growth, or discounted cash flow ("DCF") model. However, the Company is critical of Mr. Rigsby's "subjective" methodology in determining the sv component of his DCF growth figure and his belief that, in theory, the market price of a utility's common stock will tend to move toward book value, or a market-to-book ratio of 1.0, if regulators allow a rate of return that is equal to the cost of capital. Brief at 36-39.

The Company's position on these issues lacks merit. All analysts make subjective choices on the inputs that are used in the various models that are used to calculate the cost of common equity. The Company's witness, Dr. Zepp, is no exception. In calculating his cost of common equity for Chaparral, Mr. Rigsby looked critically at historical data and projections of security analysts in order to arrive at objective estimates of growth. R-3 at 7-22. The Company simply relied on projections without attributing any significance to the historical data. A-9, Rejoinder Table 3. Mr. Rigsby's estimates take into account the fact that past projections of Value Line analysts have tended to be somewhat higher than the actual returns on the common equity of water providers. While the Company believes that Mr. Rigsby's growth estimates are too low, the fact is that Mr. Rigsby's average br + sv growth estimate is 49 basis points higher than Zack's average 5-year earnings per share projection for water utilities and is a full 60 basis points higher than the average of Value Line's projections on earnings per share, dividends per share and book value per share. R-3 at 21. Mr. Rigsby's growth estimate is 185 basis points higher than the average projections of analysts at both Zacks and Value Line and is 470 basis points higher than Value Line's 5-year average of historical data for the water utilities that are followed by that publication. Id.

Mr. Rigsby's belief that the market price of a utility's common stock will tend to move toward book value, or a market-to-book ratio of 1.0, if regulators allow a rate of return that is equal to the cost of capital is in fact a valid theoretical assumption that the Company's witness refuses to acknowledge. Mr. Rigsby incorporated this assumption into his DCF model based on his objective reliance on the work of Dr. Roger A. Morin as well as other academics in the field of finance. R-3 at 16, Transcript at 318-322. In fact, on page 412 of his text Regulatory Finance Utilities Cost of Capital, Dr. Roger A. Morin states "Lastly, if regulation performs adequately, the book value and market value of equity will be driven to equality." A-16, DR# 4.5(a). Mr. Rigsby's reliance on this assumption should encourage the Commission to adopt his recommended 9.45 percent cost of common equity for Chaparral.

RATE DESIGN

RUCO's proposed rate design is a balanced approach that does not discriminate between classes or meter sizes. Since the break-over points are based on average customer use, RUCO's proposed rate design provides a price incentive against above-average use. In turn, this could result in the conservation of water resources. The Commission should adopt RUCO's proposed rate design.

MISCELLANEOUS ISSUES

Legal Fees – The Company argues RUCO's removal of the legal fee expenses associated with the sale of the water utility from its prior owner was misplaced. According to the Company, the fact that the sale was unique and the expense non-recurring misses the point. Brief at 21. The Company believes that the Commission should not consider what the expense was for, but whether the expense reflects a level of annual legal expense that a utility of the Company's size is likely to incur. Id. This standard, claims the Company, fits into the goal of ratemaking which is to set expenses at a level that as closely as possible resembles the expenses the Company will incur in the future. Id.

It is incredible that the Company would argue that the Commission should disregard the basis for an expense, and approve it simply if its total cost reflects some value which appears to be appropriate for a utility of the Company's size to incur. This methodology, if approved, is likely to defeat the goal of ratemaking as set forth by the Company. It is incumbent on the parties in a rate application to analyze all of the Company's expenses. Only after a strict inquiry of an expense should the Commission consider approving it. This inquiry is the only way the Commission can arrive at a figure which represents an appropriate level of expense. The Company's proposed methodology makes the inquiry pointless, since the only issue is whether the expense is representative of what a utility of the Company's size is likely to incur. The Company's request is the same as asking the Commission to simply guess what level of legal expense would be appropriate for this Company. It is unlikely that such conjecture would reflect the level of legal expense that the Company will incur in the future. The Commission should reject the Company's absurd request for its legal expenses.

<u>Purchased Power Expense</u> - The Company's proposed adjustment to purchased power expenses for 2005 is more than one year beyond the test-year and will not match with customer revenue. R-6 at 11. The fact that RUCO took another position in another rate case with different circumstances is irrelevant. This proposed adjustment is too far out of the test year and the Commission should reject the adjustment.

<u>Other Miscellaneous Issues</u> - RUCO stands by its positions on the other miscellaneous issues set forth in its initial brief.

CONCLUSION

RUCO recommends the Commission reject the Company's proposed revenue requirement and adopt RUCO's proposed methodology of determining required operating income. RUCO also recommends the Commission exclude from rate base the costs associated with the extension of the Main, and adopt RUCO's property tax expense and other proposed adjustments to operating income. RUCO further requests the Commission deny the Company's request for a PPAM and PWAM. RUCO's proposed rate design and cost of capital are fair and reasonable and should be adopted by the Commission. Finally, the Commission should adopt RUCO's recommendations regarding the miscellaneous issues.

RESPECTFULLY SUBMITTED this 20th day of July, 2005.

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