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BEFORE THE ARIZONA CORPORATION COMMISSION

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Commissioner

KRISTIN K. MAYES

Commissioner

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AZ CORP COMMISSION
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IN THE MATTER OF THE APPLICATION OF
ARIZONA WATER COMPANY, AN ARIZONA
CORPORATION, FOR ADJUSTMENTS TO ITS
RATES AND CHARGES FOR UTILITY SERVICE
FURNISHED BY ITS WESTERN GROUP AND
FOR CERTAIN RELATED APPROVALS.

DOCKET NO. W-01445A-04-0650

STAFFS' CLOSING BRIEF

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1 **I. Rate Design**

2 **A. Arizona Water's proposed single tier rate design is wholly inconsistent with**
3 **Commission policy and must be rejected.**

4 In every major water rate case in the last several years, the Commission has adopted a
5 three tiered rate design to promote long-term conservation. Consistent with this practice, in
6 Arizona Water's last rate case, the Commission adopted a three tiered rate design. The
7 Commission found:

8 we believe that an... inverted tier rate structure is a valid tool for promoting
9 conservation by sending appropriate price signals to heavier users. Similar
10 inverted block structures have been approved in a number of prior cases and we
11 believe it is reasonable to adopt such a rate design in this proceeding. (Ex. S-1
12 at 26:23:26)(*Eastern Group Order*) (Decision No. 66849).

13 Likewise, in the recent Arizona-American (Dec. 67093) rate case, the Commission adopted
14 Staff's proposed inverted block rate design:

15 we find that overall, Staff's revised rate design most appropriately addresses the
16 considerations raised by all the parties, and best addresses the goals of
17 conservation, efficient water use, affordability, fairness, simplicity, and revenue
18 stability. Therefore, we will adopt Staff's revised rate design. (Ex. S-2 at 41:17-
19 20)(*Arizona-American Order*) (Decision No. 66849).

20 Staff's proposed rate design is the only rate design in this case that is consistent with the
21 Commission's decisions in recent cases. Further, Staff's proposed rate design is the only design
22 that takes seriously the State's important policy goal of encouraging conservation in the long
23 term. Arizona Water's witness Mr. Kennedy agreed that rate design should play a "part" in a
24 long-term conservation strategy. (Tr. at 666:1-8). Accordingly, Staff's proposed rate design
25 should be adopted.

26 ...

27 ...

28 ...

1 **B. The Commission should once again reject Arizona Water's purchased**
2 **power and purchased water adjuster mechanisms.**

3
4 Arizona Water seeks to retain its purchased power and purchased water adjuster
5 mechanisms. This is another issue that Arizona Water lost in its last rate case. In that case,
6 the Commission ruled that Arizona Water's "adjustment mechanisms should be discontinued."
7 (*Eastern Group Order* at 13:22). Nothing has changed in the last year to alter this conclusion.

8 As explained in Staff's direct testimony, adjuster mechanisms "traditionally have been
9 established to mitigate the regulatory lag for volatile, very large expense items... that may have
10 a negative effect on the financial health of the utility." (Ex. S-10 at 7-8). As noted in the
11 treatise *Automatic Adjustment Clauses: Theory and Application* by Dr. Michael Schmidt,
12 adjuster clauses:

13 should not serve to preserve the utility's allowed rate of return per se but only to
14 mitigate the effect of changes in cost of a relatively uncontrollable cost item or
15 items. Such cost items should be relatively beyond management control and
16 subject to a degree of price volatility and/or uncertainty in the marketplace. (Ex.
17 S-17 at 123-24).

18 Arizona Water's purchased power and purchased water adjusters fail these tests and should be
19 discontinued.

20 For example, Arizona Water's purchased power costs are not volatile. Arizona Water's
21 witness Mr. Kennedy testified that an expense that goes up by less than the amount of inflation
22 is not volatile. (Tr. at 631:13-18). Since the last time the Western Group's rate were set (in
23 1992). Arizona Water's purchased power costs went up by less than the rate of inflation. (Tr. at
24 633:18-21). Indeed, cumulative inflation was about 40%, but power costs only went up
25 26.24%. (Tr. at 632-33). Arizona Water suggests that the adjuster mechanisms approved for
26 APS may result in volatility. But APS's adjusters have numerous complex safeguards.
27 Kennedy admitted that these safeguards would reduce volatility. (Tr. at 710-11). Notably,
28

1 Arizona Water's adjustors lack these safeguards. For these reasons, Arizona Water's purchased
2 power costs are not volatile.

3 As for purchased water, Arizona Water's purchased water adjustor only applies to its
4 Ajo system. (Tr. at 634:18-19). Kennedy admitted that historically, Ajo water costs are "not
5 particularly volatile". (Tr. at 636:23). Further, Ajo water costs did not change between 1984
6 and 2004. (Tr. at 636:6-12; Ex. S-19).

7 Thus, purchased power and purchased water costs are not volatile. Indeed, these
8 adjustors had a net effect of only \$173,000 for the ten year period 1993-2003. (Tr. at 637:10-
9 13). The average annual effect over this ten year period is thus merely \$17,300. This compares
10 to Arizona Water's claimed overall test year expenses of more than \$ 9,000,000.

11 Under a simple adjustor, the full amount of any changes in costs are passed through to
12 the customers. Adjustors are thus dangerous because they remove the incentive for a
13 company's management to try to reduce costs. As Dr. Schmidt states: "[w]ithout managerial
14 incentives, the firm appears to be operating under simple cost-plus conditions." *Id.* The
15 Company's President, Mr. Garfield, conceded the same point when he testified in the Eastern
16 Group case, stating "Is there an incentive for us to go out and develop a new supply with or
17 without an adjustor? I think that there's probably less of an incentive with an adjustor than
18 without one." (Ex. S-16 at 87:1-10). The Commission agreed, finding that "adjustment
19 mechanisms may also provide a disincentive for the Company to obtain the lowest possible cost
20 commodity because the costs are simply passed through to ratepayers." (*Eastern Group Order*
21 *at 17:24-26*). Although Kennedy disagreed with the testimony of his boss Garfield, Kennedy
22 conceded that the Commission's *Eastern Group Order* is consistent with Garfield's testimony.
23 (Tr. at 624:1-12).

24 Arizona Water's electricity purchases provide a good example of this in action. With a
25 purchased power adjustor, Arizona Water has no incentive to shop for better prices because it
26 can simply pass any increases along to its customers. Kennedy admitted that Arizona Water has
27 not explored obtaining service from competitive electric service providers. (Tr. at 628:15-20).
28 Further, Arizona Water receives service, in part, from various electrical and irrigation districts.

1 (Tr. at 629:4-8). Under the *Hohokam* case, these districts can serve outside their boundaries and
2 even within APS's CC&N area. *Hohokam Irr. and Drainage Dist. v. Arizona Public Service*
3 *Co.*, 204 Ariz. 394, 64 P.3d836 (2003). Kennedy was not aware of Arizona Water ever
4 exploring getting electricity from these districts to replace APS where it would be advantageous
5 for them to do so. (Tr. at 60:5-11).

6 Arizona Water contends that it is entitled to these adjustors under A.R.S. § 40-370. But
7 this is a rate case, not a § 40-370 proceeding. In the alternative, Arizona Water suggests that
8 the "policy" established by this statute compels the Commission to adopt adjustors. But
9 Kennedy agreed that the Commission is "responsible for setting public policy for ratemaking
10 for public service corporations." (Tr. at 613:16-18).

11 In any event, A.R.S. § 40-370 is utterly void. This statute seeks to regulate the granting
12 of certain surcharges to water public service corporations. As the Arizona Supreme Court has
13 held, "in the matter of prescribing classifications, rates, and charges of public service
14 corporations..., the Corporation Commission has **full and exclusive power**. In such field the
15 Commission is **supreme** and such exclusive field may not be invaded by the courts, the
16 legislature, or the executive." *Ethington v. Wright*, 66 Ariz. 382, 392, 189 P.2d 209
17 (1948)(emphasis added); *see also Morris v. Arizona Corp. Comm'n*, 24 Ariz. App. 464, 539
18 P.2d 928 (1975)(citing *Ethington*); *Arizona Corp. Comm'n v. State ex rel. Woods*, 171 Ariz. 286,
19 294, 830 P.2d 807 (1992)(same) . By regulating the approval of surcharges, A.R.S. § 40-370
20 invades the "full and exclusive" rate-making power of the Commission, which is "supreme" in
21 that field. *Id.* It is therefore unconstitutional and void.

22 **C. The Commission should reject Arizona Water's elasticity adjustment.**

23 Staff is not aware of the Commission ever adopting an elasticity adjustment. Arizona
24 Water asks this Commission to adopt this new and untested procedure. Arizona Water has not
25 submitted sufficient evidence to justify the use of this untried procedure.

26 Arizona Water's analysis is based on Professor Beecher's 1994 study *Revenue Effects of Water*
27 *Conservation and Conservation Pricing: Issues and Practices*. (Ex. S-21). Kennedy called
28 this study "the most reliable evidence that we have for price elasticity." (Tr. at 643:22-23).

1 Although Kennedy's testimony was based on this study, he admitted that he had not actually
2 read it for several years. (Tr. at 646:5-8). Moreover, all of the data in Beecher's study is old,
3 coming from before 1994. (Tr. at 701-702).

4 Beecher's study does not give a specific point estimate of elasticity. Instead, the study
5 gives a range of possible elasticities. Further, the study reports that "substantial variations" can
6 occur due to various factors. (Tr. at 657:20; S-21 at 83). For example, each customer class has
7 a different elasticity. (Tr. at 658:8-14; S-21 at 88). But Arizona Water does not have separate
8 customer classes. (Tr. at 658:15-18). Further, elasticity is different for indoor verses outdoor
9 use. (Tr. at 658:19-24). Yet Arizona Water did not distinguish between indoor and outdoor use.
10 (Tr. at 658-59). Likewise elasticity varies by season. (Tr. at 646:15-21) Arizona Water did not
11 adjust for this factor either. (Tr. at 646:22-24). Given all of this uncertainty, Arizona Water's
12 proposal fall far short of the "known and measurable" standard.

13 Kennedy also presented a study of price elasticity in the Eastern Group. Kennedy
14 agreed that weather effects can overwhelm the impact of elasticity. (Tr. at 647:5-15). Staff's
15 accounting witness, Mr. Carlson, testified that the test year was abnormally wet. (Tr. at 1227-
16 31; Ex S-34, S-35; S-36). But Kennedy did not take weather into account in preparing his
17 study. (Tr. at 662:3-9; Ex. S-22 at response 9-10). Moreover, Kennedy's study did not produce
18 results for each system. Kennedy testified that each system in the Eastern Group has different
19 economies, costs, and degrees of urbanization. (Tr. at 661-662). Nor did Kennedy's study
20 consider the effect of growth on usage. (Tr. at 700-701). Kennedy agreed that newer homes
21 are more likely to have desert landscaping, which reduces usage. (Tr. at 662:14-22). Further,
22 newer homes tend to have more efficient appliances, which further reduces usage. (Tr. at 662-
23 663). Kennedy's study is unreliable because it fails to adjust for any of these factors.

24 Moreover, Arizona Water's theory is internally inconsistent. Kennedy argues that an
25 elasticity adjustment is needed if the Commission adopts a tiered rate design. But he is not
26 proposing an elasticity adjustment for the reduced usage (if any) that would result from a
27 higher revenue requirement. (Tr. at 702:18-21). Kennedy agreed that under his theory, if the
28 rates went up, usage would drop. (Tr. at 703:4-8). Kennedy admitted that all other factors

1 being equal, a rate increase of a certain amount would have the same elasticity regardless of
2 whether the increase revenue is due to an increased requirement or tiered rates. (Tr. at 708:21-
3 22). Yet Arizona Water is proposing an elasticity adjustment only for the effect of tiered rates.
4 Arizona Water's inconsistent position merely shows its unfortunate hostility to conservation
5 based rate designs.

6 Arizona Water's proposed elasticity adjustment is not known and measurable. Arizona
7 Water fails to adjust for numerous factors that are known to effect elasticity. Moreover,
8 Arizona Water's position is inconsistent because it only takes into account elasticity for some
9 types of rate increases, but not others. For these reasons, Arizona Water's elasticity adjustment
10 should be rejected.

11 **II. Rate Base.**

12 **A. The deferred CAP M&I charges should be excluded from rate base, but**
13 **Arizona Water should be granted a hook-up fee to recover the deferred**
14 **balance.**

15 Arizona Water has three Central Arizona Project ("CAP") subcontracts for municipal
16 and industrial ("M&I") water at issue in this current rate case. (Ex. A-2, p. 6). These contracts
17 provide for the following annual deliveries:

- | | | |
|----|-----------------|--------------------------|
| 18 | (1) Casa Grande | 8,884 acre-feet of water |
| 19 | (2) Coolidge | 2,000 acre-feet of water |
| 20 | (3) White Tanks | 968 acre-feet of water |

21 (Id.). The M&I capital charges must be paid regardless of whether it actually takes delivery of
22 any CAP water. (Id. at p. 7). Under the three contracts for CAP water, Arizona Water, as of
23 2004, is only using 2,271 acre-feet a year. (Ex. S-9). Arizona Water should not be allowed to
24 include its deferred and/or on-going CAP M&I capital charges in rate base. These charges are
25 simply not used and useful. However, Staff does recognize the prudence of entering into these
26 CAP contracts and the fact that approximately \$5 million worth of M&I charges have been
27 deferred over the last decade. (Ex. A-10, p. 12). Additionally, Arizona Water has shown in its
28 pre-filed rebuttal testimony a more concrete commitment to actually using its CAP allocations

1 within the near future. Staff therefore recommends a CAP Hook-Up Fee Tariff with conditions.
2 (Ex. S-30). This CAP fee will be terminated when all CAP costs, as defined in S-30, have been
3 collected, or when ordered by the Commission, whichever occurs first. (Id.).

4 No deferred M&I charges should be included in rate base. Further, revenues received
5 from the M&I charges should be treated as "other revenue". (Tr. at 821-22).

6 Staff's amortization period of 20 years is based on the length of time the M&I
7 subcontracts have been in existence. (Tr. at 1183:9-10). In contrast, Arizona Water would like
8 to amortize the deferred M&I capital charges over 10 years. Although this period is similar to
9 the period used in the Eastern Group case, there are substantial differences. The most
10 significant difference is that in the Eastern Group "the Company's CAP allocation was, for all
11 intents and purposes, fully utilized." (Ex. A-10, p. 13). But that is not the case here, thus it
12 does not meet the basic requirement of being used and useful. Although Arizona Water argues
13 that the Commission has a policy to allow CAP recovery before actually using that CAP water
14 (Ex. A-2, p. 9), that statement is just incorrect.

15 The plain and simple fact is that the Commission has no formal policy to deal with CAP
16 water. What the Commission has is a **proposed** policy for CAP water that has been languishing
17 in front of the Commission since June 29, 2001 – more than four years. The story of the CAP
18 water proposed policy began in part with Decision 62993, which "approve[d] Staff's
19 recommendations" in the Findings of Facts within that decision (Ex. S-2, attachment to
20 Garfield's rebuttal). Finding of Fact 31 that states "Staff requests that the Commission order
21 Staff to develop, through meetings with members of the industry, RUCO, and other interested
22 parties, a detailed statement of policy on CAP cost recovery by June 30, 2001." Obviously,
23 since Decision 62993 ordered Staff to "develop" a "policy on CAP recovery," then contrary to
24 Garfield's and Arizona Water's position, this Commission decision did not approve **any** CAP
25 recovery policy.

26 Staff followed through with the requirements of Decision 62993 and on June 29, 2001
27 filed a memorandum with several attachments. The memo explicitly stated that "Staff
28 recommends that these policy statements be discussed at an Open Meeting at the Commission's

1 convenience.” (Ex. R-19). At the hearing, Mr. Olea, who led the Water Task Force in
2 developing the policy statements, and who wrote the memo, explained why he had included the
3 above sentence: “So we can get some direction from the Commission as to whether or not they
4 were accepting these policies, modifying them or putting them on hold or whatever they
5 wanted to do.” (Tr. 1217:4-7). Additionally, the Attachment D to that memo was labeled
6 “**Proposed Policy for Central Arizona Project (CAP) Cost Recover**” (emphasis added).

7 For these reasons Staff recommends that the Commission approve a CAP Hook-Up Fee,
8 as described in Mr. Olea’s testimony. The Hook-Up Fee should contain the conditions attached
9 to Mr. Olea’s supplemental testimony. (Ex. S-30). The Hook-Up Fee should be consistent with
10 the calculations shown on Exhibit S-33. (Tr. at 1226).

11 **B. The Commission should disallow the Casa Grande capitalized legal fees.**

12 Arizona Water is asking for more than \$824,000 in legal fees to be included in rate base
13 in perpetuity without ever being depreciated. (Tr. 331:3-12). The legal fees were supposedly
14 incurred in order for Arizona Water to defend itself against an eminent domain suit by Casa
15 Grande and for Arizona Water to gain the exclusive right to sell effluent. These matters directly
16 benefit shareholders, not ratepayers, and therefore the fees are imprudent, as will be discussed
17 below.

18 Further, placing the legal fees in rate base appears to be an attempt to try to recover
19 substantial expenses that were incurred prior to the test year. As shown on Arizona Water’s
20 exhibit, it incurred \$824,374 in Casa Grande related fees, but only \$58,274 was incurred in the
21 test year. (Ex. A-21). The remaining \$766,100 in fees were incurred outside the test year and
22 is thus not recoverable even if they were prudent. Arizona Water placed the legal fees in
23 Account 303. As Carlson explained, only condemnation fees relating to acquiring land can be
24 placed in this account. (Tr. at 1233-34; Ex. S-37, S-38). Further, even if these fees should be
25 capitalized in this account, they can be amortized. (Tr. at 1235; Ex. S-38 at ¶ G). Amortizing
26 the fees would simulate depreciation, and would mean that the fees would not be included in
27 rates forever.
28

1 Additionally, a portion of the legal bills themselves are questionable as to their
2 reasonableness (Ex. S-13). For example: Legal fees charged related to Lake Havasu where the
3 company does not even have a water system (Tr. at 451-452; Tr. at 455:3-13); \$1,007 bill for
4 “discreetly speaking” with legislators about a senate bill (Tr. at 456:6-14); writing a \$1,045
5 letter to oppose a Senate bill and a second letter for \$1,520 (Tr. at 455-456) and then charging
6 for personally delivering those letters (Tr. at 456:18-25); almost \$2,000 to write a position
7 paper for the Arizona governor and personally deliver that paper (Tr. at 457:1-15); and legal
8 fees related to the Apache Junction system, which is not part of the Western group (Tr at
9 457:21-24).

10 **1. Effluent Cases**

11 In June 2000, Casa Grande filed a complaint with the Commission alleging that Arizona
12 Water was not entitled to serve effluent within the city’s service area unless the issue was
13 presented before the Commission as part of a rate case. The city’s complaint was in response to
14 Arizona Water’s proposed systemwide effluent tariff filed with the Commission in May 2000
15 (Tr. 312:19). The August 8, 2000, staff report evaluating the requested tariff specifically stated
16 that “Staff disagrees that a water CC&N grants an entity holding that CC&N an exclusive right
17 to sell a product they cannot produce, (i.e. effluent).” Yet, in December 2000 Arizona Water
18 filed a complaint against Casa Grande in Maricopa County Superior Court alleging that its
19 current CC&N for the Casa Grande area included exclusive rights to sell effluent (CIV-2000-
20 022448).

21 However, the fallacy of Arizona Water’s effluent argument is that this is the same losing
22 stance it took in *Arizona Water Company v. City of Bisbee*, 172 Ariz. 176, 836 P.2d 389 (App.
23 1991). In both the 2000 lawsuit and *Bisbee*, Arizona Water made the same invalid argument
24 that it had a right to sell effluent because it had a right to sell water under its CC&N – and that
25 water and effluent are the same.

26 And if you read the appellate court decision [in *Bisbee*], you will read in there
27 that there is a very good paragraph that talks about effluent that was a noxious
28 byproduct at one time, that as time progresses on and as the methods of
treatment change for effluent, it becomes closer and closer to other water

1 sources such as groundwater and surface water. We made the argument [in CIV-
2000-022448] that it was very much the same as these others. **The courts did
not see it the same way.**

2 (Tr. 441-442 emphasis added).
3

4 And once again, like in the *Bisbee* case, the courts ruled against Arizona Water in CIV-
2000-022448. As Mr. Garfield acknowledged on the stand, that since the time the *Bisbee* case
5 was decided, the legal definition of “effluent” has not changed. “To my knowledge they [the
6 State Legislature] have not. Perhaps they should.” (Tr. 442:23-24). Although Mr. Garfield’s
7 wishful thinking is that “perhaps” the Arizona Legislature should change the definition of
8 effluent, it is not conceivable that ratepayers benefited from this nearly identical, losing suit.
9 Indeed, under the law as it stands now, and has stood for more than a decade, Arizona Water
10 was fighting for a right that it never had - the exclusive legal right to sell effluent.

11 Additionally, Arizona Water has acknowledged that it needs Commission permission to
12 sell effluent. Before selling effluent in Apache Junction, Arizona Water asked for and received a
13 tariff from the Commission. (Ex S-12). Yet Arizona Water never had a tariff to sell effluent in
14 Casa Grande.

15 Prior to filing in Superior Court, Arizona Water sued Casa Grande in federal district
16 court raising the same claim. The fees relating to the federal proceedings are doubly
17 unreasonable. The fees relating to this lawsuit are unjustified for the same reasons as for the
18 superior court case. Further, these fees are also unreasonable because the case should never
19 have been brought in federal court. As the district court ruled, federal law clearly provides that
20 Arizona Water was “obligated to exhaust state inverse condemnation remedies first.” (Ex. R-
21 11). Arizona Water only compounded the problem by appealing. The 9th Circuit swatted this
22 appeal away in an unpublished opinion. (Ex. R-10).

23
24 **2. Eminent Domain**

25 Under Arizona Water’s proposal, Casa Grande ratepayers will pay twice for this
26 litigation. Once because of the City’s expenses and once because of Arizona Water’s expenses.
27 (Tr. 399-401). Arizona Water tries to say it fought the condemnation suit for the good of its
28 Casa Grande customers, but has no concrete justification for its stance. Mr. Garfield admitted

1 that no calculations were performed to even quantify the number of Arizona Water customers
2 who would be affected by the condemnation. (Tr. 419:6-18). Instead, Mr. Garfield argued that
3 there would have been a “significant cost impact to those remaining customers.” (Tr. 420:6-9)
4 But, when asked to quantify what the “significant cost impact” would have been, his answer
5 was that Arizona Water had “never reached the point of determining the value, severance
6 damages, loss of revenues, going concerns, so forth.” (Tr. 420:12-14). In fact, the company
7 acted purely out of self-interest when it made its decision.

8 We made the decision to defend against an attempt by a city to take our system
9 from us. **We did no cost/benefit analysis** to see whether or not we should
10 defend against the condemnation attempt any more than any other utility that is
11 looking to be condemned looks **to see whether it was beneficial or not to**
12 **spend the fees** on that, in that defense of that condemnation attempt.... **So was**
it responsible for the company to proceed to defend against this litigation
not even knowing what those costs were? Yes, it was.

13 (Tr. 421: 16-23; emphasis added and Tr. 423:3-5; emphasis added) Although Arizona Water
14 may think its position was responsible, Staff believes Arizona Water’s position was to benefit
15 itself and not the ratepayer. With no empirical or even suggestive data, it is impossible to see
16 how the condemnation case benefited Arizona Water’s Casa Grande customers.

17 **C. The Commission should adopt Staff’s lead-lag calculation.**

18 Arizona Water seeks of income tax lag days of 2.52 days (federal) and 27.05 (state).
19 (Ex. S-10 at 7:1-3). Staff acknowledges that this calculation is consistent with the *Eastern*
20 *Group Order*. Staff respectfully requests that the Commission reconsider, and adopt 37 lag
21 days for income tax. Staff’s calculation is based directly on the work of the leading expert, Mr.
22 Carl Dabelstein. Dabelstein’s treatise, *Public Utility Working Capital*, demonstrates how to
23 calculate federal and Arizona income tax lag days. (Ex. S-27). Staff’s calculation is consistent
24 with Dabelstein’s work. (Tr. at 789:19). Arizona Water’s witness, Ms. Hubbard, admitted that
25 her only training in working capital was provided by Dabelstein. (Tr. at 788-89).

26 Arizona Water’s calculation is based on its accrual of tax liabilities on its books. But a
27 lead-lag study should be based on actual cash payments, not accounting entries. As Carlson
28

1 explained, a lead-lag study “measures the timing of cash receipts and disbursements.” (Ex. S-
2 10 at 6:6). Therefore, Arizona Water’s calculation is incorrect and should be rejected

3 Further, RUCO demonstrated that Arizona Water’s calculation is different than the
4 calculations used by major Arizona companies in their last rate cases. Specifically, Arizona
5 Water’s figure is substantially more favorable to itself than the figures used by Qwest, APS,
6 TEP and Southwest Gas. (Ex. R-24). Although RUCO mentioned these studies in its pre-field
7 testimony, Hubbard made no effort to review these studies. (Tr. at 787:13-16). Qwest, APS,
8 TEP and Southwest Gas all have the same tax payment days as Arizona Water, and they all are
9 subject to the same tax laws and regulations as is Arizona Water. (Tr. at 823-24).

10 **III. Income Statement.**

11 **A. Arizona Water’s proposed rate case expense is excessive.**

12 Arizona Water seeks \$253,550 in rate case expense. (Tr. at 796:14-21). Hubbard agrees
13 that rate case expense should be reviewed for prudence. (Tr. at 796:9-10). Arizona Water’s
14 proposed rate case expense is excessive compared to comparable cases, and it is therefore
15 imprudent. The *Eastern Group Order* allowed Arizona Water \$250,000 in rate case expense.
16 (Tr. at 797:13-16). The Western Group is smaller than the Eastern Group in a number of ways
17 – it has less (1) rate base; (2) revenues; (3) operating expenses; (4) systems. (Tr. at 798-799).
18 Based on a review of comparable cases, Staff recommends a rate case expense of no more than
19 \$225,000. (Ex. S-10 at 11:16).

20 **B. Property Taxes.**

21 Staff agrees with the property tax methodology shown on Exhibit A-27. (Tr. at 1238:2-
22 5). Staff and Arizona Water disagree on the actual amount of tax, but only because they have
23 different revenue requirements. (Tr. at 1238:6-9).

24 **IV. Cost of Capital.**

25 Staff’s cost of capital analysis is based on the same rigorous, theoretically sound
26 analysis approved by the Commission in the *Eastern Group Order* and the *Arizona-American*
27 *Order*. Arizona Water presents the same witness – Dr. Zepp – whose positions were so roundly
28 rejected in those orders. Indeed, Zepp seems to think that there is something wrong with

1 following the Commission's orders. He attacks Staff for relying on "inherited" methods
2 approved by the Commission. Nor could he remember even bothering to review the
3 Commission's recent orders concerning cost of capital. (Tr. at 96). Zepp's scorn for the
4 Commission is evident in his analysis of why he thinks the Commission keeps disagreeing with
5 him: "they just simply accepted Staff's numbers and didn't pay attention to the other
6 information that went into the record." (Tr. at 109:22-24). Contrary to Zepp's allegation, the
7 Commission's orders reflect a careful and balanced evaluation of the record evidence.

8 Zepp once again raises a myriad of convoluted technical arguments, hoping to divert the
9 Commission from the sound course it has set in cost of capital matters. Each of Zepp's
10 arguments should be rejected.

11 **A. The Commission should continue to use the CAPM model.**

12 Zepp goes so far as to suggest that the Commission reject the CAPM model. As Zepp
13 acknowledged, one of the developers of the CAPM was Professor Sharpe, who won a Nobel
14 prize. (Tr. at 94). If Zepp has a place on his mantel reserved for the Nobel prize, that place
15 remains empty. Zepp concedes that the Commission has approved the CAPM model. (Tr. at
16 97:13-14). Indeed, Zepp testified "it's such a nice model, it's difficult to fight." (Tr. at 97:18-
17 19). The Commission should continue to use this "nice", Nobel-winning model.

18 **B. The Commission should continue to use Spot Prices.**

19 Zepp attacks the Staff's use of spot prices for various purposes. This is another
20 argument that the Commission repeatedly rejected. (*Eastern Group Order* at 22; *Arizona-*
21 *American Order* 67093 at 26 and 31). Zepp proposes to use analyst forecasts instead. But
22 Zepp states that bond prices are "difficult to predict". (Ex. A-15 at 9:19 and 24:16-17). A
23 good example of erroneous analyst prediction is Zepp's survey of analyst predictions, which
24 turned out to be very incorrect. (Ex. S-6 at 43). Not only are analyst forecasts notoriously
25 incorrect, they are also typically high, thereby inflating the cost of capital. (Ex. S-6 at 7:9).

26 The Commission's use of spot prices is based on the efficient market hypothesis. Under
27 this hypothesis, "all the relevant, available information regarding a given stock is reflected in
28 its current price." (Tr. at 108:5-13). The use of spot prices was supported by Dr. Myron

1 Gordon in his testimony to the FCC. (Ex. S-6 at 44). Zepp agreed that Dr. Gordon is the
2 “father of the DCF model” and is a respected expert. (Tr. at 107:18-24). Steven Kihm’s article
3 “The Superiority of Spot Yields in Estimating Cost of Capital” also supports the Commission’s
4 use of spot prices.

5 **C. Zepp’s Risk Premiums should be rejected yet again**

6 Zepp argues for a host of ad hoc risk premiums based on his assessment of various risks
7 faced by Arizona Water. For example, Zepp advocates premiums for firm size, arsenic, and
8 difficulty in bond placements. The Commission has repeatedly rejected Zepp’s arguments on
9 these points. (*Eastern Group Order* at 22-23 & *Northern Group Order* (Decision 64282 at 17-
10 19). There is no reason to revisit these decisions again. As the Commission noted in the
11 *Eastern Group Order*, the CAPM “includes a risk variable” and “is preferable to the Company’s
12 proposed risk premium recommendation.” (*Eastern Group Order* at 22:27 to 23:1).

13 **D. Growth Estimates.**

14 Zepp’s sole source of earnings growth information is analyst forecasts. These forecasts
15 are known to be inaccurate and overly optimistic. (Ex. S-6 at 43). This inaccuracy is
16 demonstrated in numerous articles and books. (Ex. S-6 at 45-46). Further, Dr. Gordon
17 criticized the sole use of analyst forecasts. (Ex. S-6 at 44). In the *Eastern Group Order* the
18 Commission found that “[w]e agree with Staff’s witness that the Company’s exclusive reliance
19 on analyst forecasts erroneously assumes that investors rely only on near-term earnings and
20 sustainable growth without considering past earnings. Reliance solely on analyst projections
21 tends to result in inflated growth projections....” (*Eastern Group Order* at 22:14-17). Zepp has
22 presented no reason to disregard this finding.

23 Zepp also uses an arithmetic average to restate Staff’s growth. But this overstates
24 growth, as Staff’s example demonstrates. (Ex. S-7 at 10).

25 Zepp also creates a middle growth stage in restating Staff’s multistage DCF. The
26 Commission has rejected this 3 stage DCF. (*Arizona-American* Dec. 67093 at 30:22 to 31:4).
27 Further, Zepp takes a growth rate for 2007 to 2009 and misapplies it to 2008 to 2017. (Ex. S-7
28 at 10:24-28).

1 **E. The Commission should reject the use of long-term treasuries in the CAPM.**

2 Zepp's restatement of Staff's CAPM uses forecasts of long-term treasuries to estimate
3 the risk free rate. Staff uses intermediate term treasuries. There are three problems with Zepp's
4 approach. First, as Staff explains, the CAPM is a holding period model, and the holding period
5 of most investors is intermediate. (Ex. S-7 at 11:11-18). Zepp argues that the risk horizon
6 should be the life of the asset. But the Capital Markets Theory – the basis of the CAPM –
7 clearly states that the horizon is the investor's holding period. (Ex. S-7 at 11:20-24). Second,
8 over the long term treasuries contain a liquidity risk premium. If long term treasuries are to be
9 used as the **risk free** rate, this risk must be subtracted out. (Ex. S-7 at 12:1-8). Zepp did not
10 subtract the liquidity risk from the long-term treasuries, and his risk free rate is thus flawed.
11 Third, Zepp's use of analyst forecasts should be rejected for the reasons discussed in the
12 previous sections.

13 **F. Leverage Adjustment.**

14 A company's cost of capital is based on its financial risk. (Ex. S-6 at 11). Its financial
15 risk is strongly influenced by its capital structure – the more debt, the more risky a company is.
16 (Id.). Thus, if a company has more or less debt than the average of the sample group, the cost
17 of equity should be adjusted. In this case, Arizona Water has a very low amount of debt. In the
18 Arizona-American case, Zepp supported a leverage adjustment that increased the cost of
19 capital. (Tr. at 101:3-9). Indeed, Zepp sponsored a leverage adjustment in 9 cases since 1999.
20 (Tr. at 103-106; Ex. S-3). But in this case, Zepp opposes a leverage adjustment, which would
21 lower the cost of capital here. Zepp's testimony is wholly inconsistent with his prior testimony,
22 and it should be rejected. Although Staff is comfortable with its current cost of capital estimate
23 (which does not include a leverage adjustment), if the Commission adopts a higher cost of
24 capital, it should also adopt a leverage adjustment. (Ex. S-7 at 1-2).

25 **G. Zepp's "FERC" and "CPUC" approaches should be rejected.**

26 Recognizing that the Commission has disagreed with his methods in prior cases, Zepp
27 alters his approach by borrowing some concepts from FERC and the CPUC. Zepp suggests
28 that the Commission shouldn't chart its own course, and should instead tag along with the

1 FERC and CPUC, who are presumably the cool kids on the block. The Commission should
2 determine the cost of capital based on evidence, not peer pressure. Further, there are significant
3 problems with the Zepp's so-called FERC and CPUC approaches.

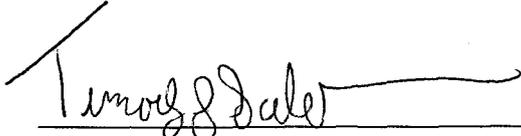
4 Zepp borrows FERC's DCF analysis. Staff's DCF analysis is sound. (Ex. S-6 at 13-
5 25). There is no reason to adopt an alien method which is unproven in Arizona. Moreover,
6 FERC does not regulate water companies. (Tr. at 98:21-22). Instead, FERC regulates interstate
7 gas and electricity companies, who are subject to much greater competition than are water
8 companies. (Tr. at 99:18-20). FERC regulated companies therefore have "different risk
9 characteristics" which would be reflected in their market data. (Tr. at 100) Moreover, Zepp's
10 "FERC" analysis uses both the one-step and two step DCF. FERC uses the one-step DCF in
11 electric cases and the two-step DCF in natural gas cases. *See Southern California Edison*, 92
12 FERC ¶ 61,070 at 14-17 (attached as Attachment 2 to Ex. A-13). FERC expressly ruled that
13 "we believe that significant differences exist in the electric utility industry and the natural gas
14 pipeline industry which warrant the continued use of different growth rates in the DCF models
15 for each." *Id.* at 15. Zepp was not aware of FERC ever using these two methods in the same
16 case. (Tr. at 100:14-16) Yet Zepp's "FERC" approach uses both in the same case, contrary to
17 FERC's actual practice. Further, Zepp does not explain his use of the "FERC" approach for
18 water companies given FERC's statement that different industries should have different DCF
19 models.¹

20 Zepp's CPUC analysis suffers from even greater flaws. Zepp's CPUC analysis uses
21 comparisons to actual or authorized returns on equity (ROE) for a sample group of companies.
22 (Ex. A-13 at 38-45). This sort of "comparable earnings" analysis has long been discredited,
23 and suffers from numerous flaws. For example, use of authorized ROEs ignores the fact the
24 cost of capital is determined by the market, not regulatory commissions. (Ex. S-6 at 53:2-3).
25 Further, these ROE rulings could be based on unknown issues or incentives not relevant to
26 Arizona Water. (*Id.* at 53:9-14) The use of accounting based "actual" ROEs is also flawed,

27
28 ¹ Staff doesn't agree with FERC that different DCF models should be used for different industries. But the point is
that Zepp's "FERC" approach does not take into account FERC's "different industry/different DCF" approach.

1 because accounting returns are, by definition, different than the cost of equity. (Id. at 52:11-
2 18).

3
4 RESPECTFULLY SUBMITTED this 1st day of August 2005.

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7 

8 Timothy J. Sabo
9 Diane M. Targovnik
10 Attorneys, Legal Division
11 Arizona Corporation Commission
12 1200 West Washington Street
13 Phoenix, Arizona 85007

14 The original and thirteen (13) copies
15 of the foregoing were filed this
16 1st day of August 2005 with:

17 Docket Control
18 Arizona Corporation Commission
19 1200 West Washington Street
20 Phoenix, Arizona 85007

21 Copies of the foregoing were mailed
22 this 1st day of August 2005 to:

23 Norman D. James, Esq.
24 Jay L. Shapiro, Esq.
25 Fennemore Craig
26 3003 North Central Avenue, Suite 2600
27 Phoenix, Arizona 85012-2913
28 Attorneys for Arizona Water Company

Robert W. Geake, Esq.
Vice President & General Counsel
Arizona Water Company
3805 N. Black Canyon Hwy.
P. O. Box 29006
Phoenix, AZ 85038-9006

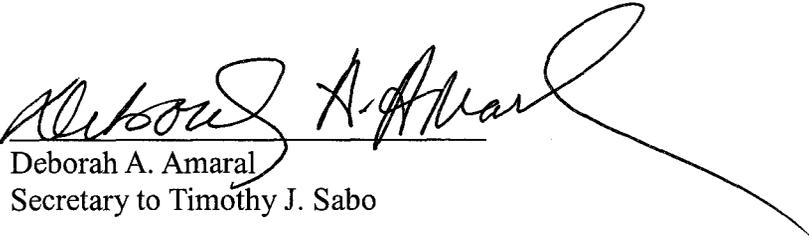
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27
28

RUCO
1110 W. Washington, Suite 220
Phoenix, AZ 85007

Jeffrey W. Crockett, Esq.
Deborah R. Scott, Esq.
Snell & Wilmer
One Arizona Center
400 E. Van Buren
Phoenix, AZ 85004-2202
and
Marvin S. Cohen, Esq.
Sacks Tierney, P. A.
4230 N. Drinkwater Blvd., Floor 4
Scottsdale, AZ 85251
Attorneys for Pivotal Group, Inc.

Joan S. Burke, Esq.
Osborn Maledon, P.A.
2929 N. Central Ave., Suite 2100
Phoenix, AZ 85012-2794
Attorneys for City of Casa Grande

City Attorney
City of Casa Grande
510 E. Florence Blvd.
Casa Grande, AZ 85222-4100


Deborah A. Amaral
Secretary to Timothy J. Sabo