



BEFORE THE ARIZONA CORPORATION COMMISSION

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Chairman
WILLIAM A. MUNDELL
Commissioner
MARC SPITZER
Commissioner
MIKE GLEASON
Commissioner
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Commissioner

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.

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STAFFS' REPLY BRIEF

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1 **I. Introduction**

2 Staff respectfully submits its Reply Brief in this matter. This brief replies to certain
3 arguments made in the closing briefs of the other parties to this case. This brief only responds to
4 those arguments which merit further discussion. On all matters not expressly discussed in this
5 brief, Staff relies on the arguments set forth in its Closing Brief.
6

7 Arizona Water's brief repeatedly criticizes the Commission for perceived inconsistency in
8 its ratemaking methods. For example, Arizona Water cites a Supreme Court case that criticizes
9 commissions that "arbitrarily switch back and forth between methodologies". (AWC Br. at 55).
10 This criticism is ironic, given that Arizona Water's brief mainly consists of a series of requests that
11 the Commission disregard recent orders and modify the ratemaking process in various ways
12 favorable to Arizona Water. The Commission should not "arbitrarily switch back and forth" as
13 suggested by Arizona Water. Also troubling is Arizona Water's repeated use of "evidence" that is
14 not in the record, as will be shown below. Arizona Water had the chance to present rebuttal
15 evidence at the hearing, and it chose not to. (Tr. at 1346:20-23). Arizona Water cannot now
16 introduce new rebuttal "evidence" in its briefs.
17

18 **II. Rate Design**

19 **A. The Commission should adopt a three tiered rate design.**

20 Water is a scarce and precious resource in the Southwest. Thus, many of the most notable
21 events in Arizona history have involved water. For example, the construction of Roosevelt,
22 Hoover, and Glen Canyon Dams, the signing of the Colorado River Compact, the victory in
23 *Arizona v. California*, and the approval of the Central Arizona Project have all had a profound
24 impact on this state. These achievements were only possible due to the foresight and leadership of
25 past Arizona officials. The Commission has shown similar foresight and leadership in requiring
26 conservation-oriented three-tiered rate designs in recent years. These rate designs will send a long-
27 term signal to water users that water is a scarce resource that should not be used profligately.
28

1 Arizona Water raises a variety of technical objections to the three-tiered rate design
2 proposed by Staff. This makes it all the more unfortunate that Arizona Water never proposed its
3 own three-tiered rate design for comparison. Arizona Water's rate design witness also suggested
4 that a seasonal rate design might better serve conservation than a three-tiered rate design. (Tr. at
5 646:24-647:1-2). But Arizona Water did not propose a seasonal rate design either. (Id.) Instead,
6 Arizona Water simply proposed using its existing single-tiered rate design – the same design that
7 was rejected in the *Eastern Group Order* and in numerous other cases.

8 Arizona Water repeatedly cites AWWA's Manual M1 in support of its technical objections.
9 (AWC Br. at 60, 63, 66, and 70). But Arizona Water did not submit this manual into evidence, nor
10 did it cite anywhere in the record where it was discussed. Staff and other parties have thus been
11 denied the opportunity to cross-examine Arizona Water's witness on the use of this manual. Staff
12 and other parties have also been denied the opportunity to present evidence rebutting the quotes
13 from this manual. Further, Staff and other parties have been denied the ability to present in the
14 record other rate-making manuals. For example, the AWWA has a separate manual – Manual M14
15 – that concerns alternative water rates. For all of these reasons, the Commission should not
16 consider this “evidence” which is not in the record.

17 Likewise, Arizona Water presents a rate design table that is not in the record. (AWC Br. at
18 63). Arizona Water cites to Staff's surrebuttal testimony. But neither Arizona Water's table nor the
19 numbers in the table are located in the Staff testimony. Instead, Arizona Water's lawyers seem to
20 have performed some calculations based on the numbers in Staff's testimony. Arizona Water could
21 have presented these calculations at the hearing, if it wanted to. Arizona Water cannot have its
22 lawyers (however erudite) do what its expert witnesses should have done. Thus, the Commission
23 should not consider this table.

24 Arizona Water objects that Staff's analysis is “subjective”. (AWC Br. at 61). Rate design
25 involves deciding how much of the revenue requirement different groups of customers must bear.
26 Such “dividing up the pie” decisions are inherently subjective, policy based questions.

27 Arizona Water objects that the commodity rates for the first two blocks of Staff's rate
28 design are below the current commodity price. In an ideal world, Staff would not reduce the price.

1 In this case, Arizona Water is entitled to a minimal rate increase. If Staff allocated more of the
2 revenue requirement to the first two tiers, the price of the third tier would be lower. This would
3 result in a much weaker price signal. Staff believes that a more robust price signal should be sent
4 for the third tier, in order to meet the long-term goal of encouraging conservation. Further,
5 Arizona Water's analysis is flawed because it fails to take into account the effect of eliminating the
6 current "free" water. Currently, Arizona Water's customers do not pay a commodity charge for
7 their first 1,000 gallons of water. Thus, a Casa Grande customer who uses only 1,000 gallons will
8 see their commodity rate go from zero to \$1.¹

9 Lastly, Arizona Water erroneously asserts that Staff bears the burden of proof on rate
10 design. As the applicant, Arizona Water bears the burden of proof on each and every element of its
11 case. Arizona Water has failed to submit sufficient evidence to support retaining its antiquated
12 single-tier rate design. It has therefore failed to meet its burden of proof.

13 **B. Arizona Water's proposed adjustors should once again be rejected.**

14 Arizona Water wants to keep its purchased power and purchased water adjustors. No
15 other water company in Arizona has similar adjustors. (Tr. at 581:24-582:1). Arizona Water
16 speculates that electric costs are going up. But the evidence is that power costs have gone up by
17 less than the cost of inflation. (See Staff Br. at 2). Arizona Water has presented no evidence to
18 suggest that future power costs will go up faster than past power costs. Its unsupported
19 speculation must be rejected. APS's recent rate increase is fully incorporated into Staff's
20 proposed rates, since Staff accepted Arizona Water's proposed purchased power adjustment.

21 Arizona Water claims that its "costs for power are at least as volatile as APS's cost of
22 producing that power." (AWC Br. at 27). But APS's adjustor contains numerous complex
23 safeguards designed to limit volatility. (Decision No. 67744 at 13-19). Arizona Water's rate
24 design witness admitted that these adjustors reduce volatility. (Tr. at 710-11).

25 Arizona Water also misleadingly suggests that APS has filed a new rate case. (AWC Br. at
26 n.9). What APS actually filed was an application for a surcharge for its power supply
27 adjuster.²

28 ¹ Exhibit S-32 at Casa Grande Schedule REL-16. Price is for a standard 5/8 by 3/4 inch meter.

² Arizona Water cites APS's 7/22/05 filing, and suggests that the Commission can take administrative notice of this filing. Staff will stipulate to taking notice of this filing. The filing explains that the surcharge process was established in the recent APS rate order as part of the Power Supply Adjustor. (See APS Application in Docket No. E-01345A-

1 Arizona Water claims that an adjustor should be used to protect its profits. Arizona Water
2 has confused a **result** of an adjustor with its **purpose**. The purpose of an adjustor is to “mitigate
3 the regulatory lag for volatile, very large expense items... that may have a negative effect on the
4 financial health of the utility.” (Ex. S-10 at 7-8). Dr. Schmidt states that an adjustor should not be
5 used to preserve the utilities rate of return (Staff Br. at 2). Arizona Water cites Staff’s witness, Mr.
6 Carlson, to support its position. (See AWC Br. at 27, citing Tr. at 1246). Arizona Water fails to
7 note that Carlson clarified this statement on redirect. Carlson clearly testified that profit
8 protection is not the proper purpose of an adjustor. (Tr. at 1332:10-16 and 1334:5-12). Instead,
9 any profit protection that occurs is simply an “indirect result” of the adjustor. (Id.).

10 Arizona Water points to a statement in the Commission’s *Water Task Force Order*
11 (Decision No. 62993). The Commission’s more recent ruling in the *Eastern Group Order* was
12 that these same adjustor should be eliminated. Further, as explained in Staff’s Closing Brief, the
13 Commission never adopted the policies proposed as part of the water task force process. (See
14 Staff Br. at 7-8). The *Water Task Force Order* pointed to two prior orders. In one order, the
15 Commission approved a Monitoring Assistance Program (“MAP”) surcharge for Arizona Water.
16 (Decision No. 62141). Staff has not objected to continuing the MAP surcharge. Thus, Staff’s
17 position is not inconsistent with Decision No. 62141. In the second order, the Commission
18 approved a surcharge for Rio Verde. That order was overturned on appeal, and thus should no
19 longer be followed. See *Residential Utility Consumer Office v. Arizona Corp. Comm’n*, 199 Ariz.
20 588, 20 P.3d 1169 (App. 2001)(“*Rio Verde*”).

21 Oddly, Arizona Water cites *Rio Verde* in support of its position. *Rio Verde* declared that
22 adjustors are “fraught with potential abuse”. *Id.*, 199 Ariz. at 593 ¶ 21. It is difficult to see how
23 *Rio Verde* supports Arizona Water’s position. Further, *Rio Verde* emphasized that rates cannot be
24 set without a fair value finding. *Id.* That point was also emphasized in *U.S. West II* and *Phelps*
25 *Dodge*. *US West Communications, Inc. v. Arizona Corp. Com’n*, 201 Ariz. 242, 34 P.3d 35
26 (2001); *Phelps Dodge Corp. v. Arizona Elec. Power Co-op*, 207 Ariz 95, 83 P.3d 573 (Ariz. App.
27 2004). The *Water Task Force Order* looked to A.R.S. § 40-370. That statute purports to allow the

28 05-0526 at 1-2)(See also APS letter dated August 15,2005 and RUCO letter dated August 19,2005 in that docket).
Thus the possibility of a surcharge was expressly contemplated in the recent APS rate order. Of course, whether such
a surcharge should actually be granted is another matter.

1 Commission to impose a surcharge without a fair value finding. As such, the A.R.S. § 40-370
2 violates *Rio Verde*, *U.S. West II*, and *Phelps Dodge*. This trio of cases are more recent than the
3 *Water Task Force Order*, and they supersede that orders' discussion of A.R.S. § 40-370. Other
4 companies have gotten the courts' message, and have not filed applications under A.R.S. § 40-
5 370. (Tr. at 1336). Further, A.R.S. § 40-370 is also unconstitutional because it impinges on the
6 Commission's constitutional rate-making authority. (See Staff Br. at 4). Thus, Arizona Water's
7 reliance on A.R.S. § 40-370 is misplaced.

8 **C. Arizona Water's price elasticity adjustment is not known and measurable.**

9 Arizona Water proposes an elasticity adjustment. Like any adjustment, an elasticity
10 adjustment must be known and measurable. As shown is Staff's Closing Brief, Arizona Water's
11 adjustment falls far short of this standard. (Staff Br. at 4-6). Arizona Water points to Carlson's
12 testimony that Staff does not have evidence of rates reducing usage. (AWC Br. at 68). That's the
13 point – we don't have enough evidence to justify an elasticity adjustment. Further, even if rates
14 did not reduce usage, but only might slow down increases in usage, we don't know how much.
15 There just isn't enough data. In the future, Arizona Water or other utilities might present more
16 detailed data that might satisfy the known and measurable standard. That has not happened here.

17 **III. Rate Base.**

18 **A. The deferred CAP charges should not be placed in rate base and should
19 instead be recovered through a hook-up fee.**

20 Staff supports recovery of Central Arizona Project ("CAP") municipal and industrial
21 ("M&I) capital charges via a hookup fee. However, Arizona Water should not be allowed to
22 include its deferred and/or on-going CAP M&I capital charges in rate base. These charges are
23 simply not used and useful. At the same time, Staff feels it was prudent to incur these
24 approximately \$5 million worth of charges. (Ex. A-10, p. 12). These CAP M&I capital charges
25 must be paid regardless of whether water is actually delivered. (Ex. A-2, p.7). However, during the
26 test year Arizona Water only used a miniscule 2,279 acre-feet of CAP water out of the allocated
27 11,852 acre-feet available to the Western Group - and all that water can be attributed to the Casa
28 Grande system. No CAP water is being used in the White Tanks or Coolidge systems.

1 Arizona Water seeks to include \$142,896 into rate base of CAP M&I capital charges that
2 were accrued and directly relate to the miniscule amount of CAP water used in the Casa Grande
3 system. However, Staff's CAP hook-up fee is designed to recover this amount without having to
4 put the \$142,896 within rate base, where investors would earn an unnecessary rate of return on the
5 money. While Arizona Water's brief notes this issue, it then says that "To minimize disputes, the
6 Company has agreed to Staff's approach." (AWC Br. at 12). Thus, Staff assumes that Arizona
7 Water has waived this issue.

8 Staff's proposed hookup fee is tied to nine conditions. (S-30). The hook-up fee will be
9 terminated when all CAP costs, as defined in S-30, have been collected, or when ordered by the
10 Commission, whichever occurs first. (Id.)

11 Condition 4 requires that Arizona Water prepare a CAP water use plan ("CAPWUP") for its
12 Western Group. Arizona Water has unrealistically implied that Condition 4 will inhibit filing of its
13 mandatory rate case by September 30, 2007. This filing requirement is part of the Arsenic Cost
14 Recovery Mechanism approved in Decision Nos. 66849 and 66400. Under Condition 4, Staff is
15 required to approve the CAPWUP, with Staff's approval being a requirement for sufficiency under
16 A.A.C. R14-2-103. However, if Arizona Water files its rate case on September 30, 2007, Staff will
17 have nine months to review the CAPWUP (condition four requires the submission of the
18 CAPWUP by December 31, 2006 or six months prior to the submission of its next general rate
19 application, whichever is first). Additionally, as Arizona Water knows from its long regulatory
20 history, most rate cases are not considered "sufficient" with the initial filing and so it is an
21 exaggeration to try and blame Condition 4 for trying to "thwart" Commission's orders. (AWC Br.
22 at 13). In any event, Arizona Water can avoid any problem simply by filing an adequate CAPWUP
23 by the date required.

24 Condition 5 is a necessary requirement in order to hold Arizona Water accountable. As
25 explained earlier, the Commission rarely allows recovery of items that are not used and useful.
26 But here Staff recommends a radical exception. In order to ensure that this exception is not
27 misused, Staff has included a refund mechanism. If a full refund was allowed under Condition 5,
28 the CAP M&I capital charges could possibly be collected at a later date when in fact the CAP
water has become used and useful.

1 Staff still feels that a 20-year amortization period of the CAP M&I capital charges is
2 appropriate – it is logically based on the length of time the M&I subcontracts have been in
3 existence. (Tr. at 1183:9-10). There is no support for Arizona Water’s request to shorten this
4 amortization period to ten years. Though the Eastern Group case did allow a ten-year recovery,
5 “the Company’s CAP allocation was, for all intents and purposes, fully utilized.” (Ex. A-10, p. 13).
6 That is simply not the case for the Western Group.

7 **B. The capitalized legal fees should be excluded from rate base.**

8 Arizona Water should not recover the \$824,374 in legal fees that Arizona Water seeks in
9 rate base for perpetuity without depreciation. Placing the legal fees in rate base appears to be an
10 attempt to recover substantial expenses that were incurred prior to the test year. As shown in
11 Arizona Water’s own exhibit, it incurred \$824,374 in Casa Grande related fees, but only \$58,274
12 was incurred in the test year. (Ex. A-21). The remaining \$766,100 in fees were incurred outside the
13 test year and is thus not recoverable even if they were prudent. Arizona Water placed the legal fees
14 in Account 303. However, only condemnation fees relating to acquiring land can be placed in this
15 account. (Tr. at 1233-34; Ex. S-37, S-38). Fees incurred in defending against condemnation should
16 not be placed in this account. (Id.).

17 Legal fees of this type should have been recorded as operating expenses and not in a non-
18 depreciating rate base account. Additionally, as Casa Grande points out, even if included as
19 operating expenses, these expenses should be disallowed because the fees are “unusual” and “not
20 likely to recur.” *Gulf States Utilities Co. v. Louisiana Pub. Serv. Comm’n*, 676 So.2d 571, 580 (La.
21 1996).

22 Though Arizona Water’s closing brief now discusses the possibility of amortizing these
23 legal expenses, on the stand Arizona Water admitted that the current accounting for all the disputed
24 legal fees is included in a non-depreciating account and should **not** be amortized.. (AWC Br. at
25 20).

26 The items that are charged to that account are generally not
27 depreciated...Most of these items are not amortized because they
28 don’t have a specific life. They are of an indefinite life. So as I
said earlier, the condemnation expenditures have a continuing
benefit. **Therefore**, unless someone can assign a specific life to
that, **I would say they would not, should not be amortized.**

1 (Kennedy, Tr. at 587:18-25, emphasis added).

2 Finally, Arizona Water made no attempt in its closing brief to try and explain the other
3 questionable legal fees incurred by Arizona Water. (See Staff Br. at 9)

4 **1. Effluent Cases**

5 Arizona Water again fails to show that the effluent cases it brought at the Commission and
6 in Court actually benefited any ratepayers. Arizona Water never had a tariff to sell effluent in Casa
7 Grande (Tr. 440:15-20). The effluent legal cases initiated by Arizona Water were to monopolize a
8 right for their shareholders, and **not** their ratepayers. The ratepayers would fail to benefit from
9 boosted sales revenue when Arizona Water took the ill-informed legal stance that all effluent
10 customers within Arizona Water's CC&N must purchase their effluent through Arizona Water.
11 Further, Arizona Water does not even have the infrastructure to provide effluent.

12 Arizona Water is not allowed to avoid the obvious – and give its ratepayers the bill - when
13 it makes a purely business decision to sue. This business decision benefits only Arizona Water's
14 shareholders. The effluent suits went directly against controlling precedent of *Arizona Water*
15 *Company v. City of Bisbee*, 172 Ariz. 176, 836 P.2d 389 (App. 1991). (Ex. R-9 at 9 (September
16 21, 2000 District Court Order in CIV00-0345-PHX-PGR); Ex. R-13 at 4-5 (April 1, 2002
17 Superior Court Order in CV2000-022448)). Even after the lower courts pointedly found Arizona
18 Water's legal arguments baseless, it continued to fight via unsuccessful appeals. (Ex. R-10 (April
19 1, 2002 Ninth Circuit Memorandum in No. 01-15179); Ex. R-13 (September 4, 2002 Notice of
20 Appeal in CV2000-022448)). Even Arizona Water's own president admits that the basic statutory
21 definition of "effluent" upon which the *Bisbee* case was decided has not changed to this very day.
22 "To my knowledge they [the State Legislature] have not. Perhaps they should." (Tr. at 442:23-
23 24). Although Mr. Garfield's wishful thinking is that "perhaps" the Arizona Legislature should
24 change the definition of effluent, it is not conceivable that ratepayers benefited from this nearly
25 identical, losing suit. Additionally - only after the fact and without any reference to the transcript
26 or pre-filed testimony - is Arizona Water arguing that effluent would have provided a larger
27 customer base and thus be a benefit to current customers. (AWC Br. at 19). However, Arizona
28 Water has failed to show on the record how the re-selling of effluent would provide a larger

1 customer base and if that were true, how that larger customer base, would help current ratepayers.
2 Again, Arizona Water failed to do the research to back up its allegations.

3 **2. Condemnation Cases.**

4 The condemnation action also provides no benefit to ratepayers and was for the pure
5 benefit of shareholders. As a water company subject to the Arizona law, Arizona Water was well
6 aware that condemnation of parts of its territory by a city is written into law.

7 The city or town which seeks to acquire the facilities of a public
8 service corporation shall have the right to do so under eminent
domain....

9 A.R.S. § 9-516(B). This law, which has been in effect since 1954, is part of the cost of being in
10 the water business within Arizona. Arizona Water never even studied the potential benefits its
11 ratepayers might have seen from being condemned. (Tr. at 419:6-18; 420:6-9; 420:12-14).
12 Additionally, Arizona Water's closing brief only argues that "[s]urely the Company's customers
13 benefited from the Company's defense..." but fails once again to provide research to back up this
14 allegation. (AWC Br. at 18). Thus, the shareholders were the beneficiaries of this suit. And even
15 though Arizona Water prevailed in this matter, both the lower court and appellate court denied the
16 Company's request to recover its legal expenses. If Arizona Water is allowed to pass on the legal
17 expenses for the condemnation cases, even Arizona Water admits that "roughly" the same group
18 of people will be paying twice for this action – the taxpayers of Casa Grande who also happen to
19 be "roughly" the same group of people as the Arizona Water ratepayer base in Casa Grande. (Tr.
20 at 400:17-25).

21 Staff is not aware of the Commission having ever considered this issue before. The
22 Commission may want to consider the California Public Utilities Commission's ("CPUC")
23 analysis is this issue. The CPUC generally does not allow legal fees for defense of condemnation
24 actions into rate base. In *Citizens Utilities Co. of California*, 22 PUR3d 482 (CPUC 1958), the
25 CPUC stated that legal fees rendered in defense of condemnation proceedings are not fees incurred
26 in the operation of the utility company. Thus, the fees should be passed on to the shareholders not
27 the ratepayers. This same view was shared in *Calumet Water Co.*, 17 CPUC 2d 724 (CPUC 1985),
28

1 which concluded that the shareholders should absorb all costs because the utility is wholly
2 responsible for its “reprehensible” actions which led to the condemnation suit.

3 **C. Cash Working Capital should reflect actual cash payments, not accounting**
4 **entries.**

5 Arizona Water asserts that Staff bears the burden of proof on this issue. As the applicant,
6 Arizona Water bears the burden of proof on each and every element of its case. Arizona Water has
7 failed to submit sufficient evidence to support retaining its erroneous working capital calculation.
8 In particular, Arizona Water’s lead-lag calculation for income taxes is incorrect. Arizona Water
9 notes that the Commission approved its calculation in its last rate case. Staff agrees that this
10 determination should not be lightly disregarded. But the Commission should reconsider, because
11 Arizona Water’s calculation suffers from a fundamental flaw. A lead-lag study “measures the
12 timing of cash receipts and disbursements.” (Ex. S-10 at 6:6). Arizona Water’s calculation is
13 based on accounting entries, not the actual movement of cash. (Tr. at 741:5). It is thus incorrect.
14 The proper calculation is shown in the leading treatise by Mr. Dabelstein, which
15 Staff used in making its recommendation. (See Staff Br. at 11).

16 **IV. Income Statement.**

17 Arizona Water objects to Staff’s adjustment to rate case expense. Arizona Water’s rate case
18 expense is excessive when compared with similar cases. (Staff Br. at 12). Arizona Water
19 complains that an analysis of rate case expense should reflect the unique circumstances of each
20 case. (AWC Br. at 25). But Arizona Water has not shown that this case has unique circumstances
21 that justify greater expense. In fact, Arizona Water wants more rate case expense than it was
22 allowed in *Eastern Group Order*. Yet the Western Group is smaller than the Eastern Group in a
23 number of ways – it has less (1) rate base; (2) revenues; (3) operating expenses; and (4) systems.
24 (Tr. at 798-799). Further, the Eastern Group case involved the very contentious “PCG” issue,³
25 which is not present in this case. Therefore, Arizona Water’s requested rate case expense is
26 excessive.

27
28

³ “PCG” means Pinal Creek Group, a collection of mining companies. The issue was the disposition of a large settlement Arizona Water received from PCG.

1 **V. Cost of Capital.**

2 **A. Arizona Water's comparable earnings approach must be rejected.**

3 Surprisingly, Arizona Water suggests that the Commission should go back to the long-
4 discredited "comparable earnings" approach. Professor Phillips, whose treatise Arizona Water
5 cites, states that the "most difficult problem in applying the comparable earnings standard is the
6 determination of relative risk" because "there is no accepted method of measuring relative risk."
7 Charles F. Phillips, Jr., *The Regulation of Public Utilities* at 398 (3rd ed. 1993). Further, Arizona
8 Water argues that the sample group for a comparable earnings analysis should be other water
9 companies. As Professor Bonbright explains, this creates an obvious logical flaw:

10 If the comparable earnings test is applied in the traditional manner is limited to
11 utilities, it frequently is challenged on the basis of circularity. The return on
12 book equity of utilities is itself influenced by the regulatory process, setting the
13 allowed return of a particular utility on the bases of the earned returns of other
14 utilities makes that return dependent on regulatory action. The return set for one
15 utility becomes part of the return set for another utility, and so on. Essentially,
16 this circumvents the market forces which regulation is attempting insofar as
17 possible to replicate. (James C. Bonbright, et al, *Principles of Public Utility*
18 *Rates* at 329-30 (2nd ed. 1988).

19 Newer methods – like the CAPM and DCF models – use market data rather than data influenced
20 by other regulatory decisions. Staff strongly supports the use of market based models, because the
21 cost of equity is set by the market, not regulatory commissions. (Ex. S-6 at 53:2-3). Staff does not
22 believe that it is appropriate to "circumvent" the market in the manner suggested by Arizona Water.

23 For these reasons, the Arizona Court of Appeals strongly criticized the use of utilities as the
24 sample group in a comparable earnings analysis. See *Sun City Water Co. v. Arizona Corp.*
25 *Comm'n*, 26 Ariz. App. 304, 310-311, 547 P.2d 1104 (1976). But in the end, the Supreme Court
26 ruled that the Commission was within its constitutional powers to consider such a group. *Sun City*
27 *Water Co. v. Arizona Corp. Comm'n*, 113 Ariz. 464, 556 P.2d 1126 (1976). Thus, while the
28 Commission could lawfully adopt Arizona Water's approach, it is not a good idea.

29 **B. Staff's use of historic growth is appropriate.**

30 Arizona Water attacks the Staff's use of historic growth in Staff's DCF models. Arizona
31 Water relies on data presented in "Brief Exhibit 2". This Exhibit was never placed in evidence,
32 and it should not be considered. The alternative to using historic growth is using analyst forecasts.

1 Analyst forecasts are notoriously inaccurate. (Staff Br. at 14). Rather than relying solely on
2 analyst **speculation**, Staff prefers to look to actual empirical **evidence** about growth. The
3 Commission has therefore rejected sole reliance on analyst growth forecasts. (*Eastern Group*
4 *Order* at 22:14-17).

5 Arizona Water also concocts an argument that using historic growth rates “double counts”
6 historic growth. (AWC Br. at 41). Notably, Arizona Water does not cite any expert testimony to
7 support this argument. Instead it simply cites the definition of the efficient markets hypothesis,
8 which states that the current price of a stock incorporates “all relevant information available at that
9 time” about the stock. (Id.) Arizona Water then notes that historic growth is part of “all relevant
10 information”, and makes the logical leap that historic growth is double counted. This expert
11 “testimony” from Arizona Water’s lawyers should not be considered. And if it is considered, it
12 should be rejected because it is logically flawed. If historic growth data is part of “all relevant
13 information”, so to is data about analyst forecasts. Thus, under the approach of Arizona Water’s
14 lawyers, no growth rates at all should be considered. That is absurd, and directly contrary to the
15 DCF model.

16 **C. The Commission should use the CAPM model.**

17 Arizona Water concedes that the CAPM model is “theoretically interesting”. (AWC Br.
18 at 43). Arizona Water attacks the CAPM model as dependent on the inputs used. But that is the
19 case with any cost of capital model. Arizona Water’s attacks on the specific inputs used by Staff
20 should be rejected.

21 For example, Arizona Water attacks Staff’s assumption that Arizona Water’s beta is the
22 same as the beta of the sample group. (AWC Br. at 44). This is another version of Dr. Zepp’s oft-
23 rejected ad hoc risk premium analysis. Arizona Water criticizes RUCO for using a “subjective”
24 approach rather than “rather than actual data.” (AWC Br. at 52). This is ironic, given Zepp’s
25 numerous subjective risk premiums. Zepp variously argues that Arizona Water is more risky due
26 to Arizona’s ratemaking system, the loss of adjustors, CAP charges, arsenic risks, rate design, and
27 asserted absence of “uniform regulatory standards”. (AWC Br. at 54-58). These arguments are
28 based on Zepp’s subjective analysis “rather than actual data.” Arizona Water does not submit
“actual data” on the ratemaking systems of other states, the arsenic risks of other companies, and

1 the other matters asserted by Zepp. Moreover, these unique risks do not affect the cost of equity.
2 (Ex. S-6 at 10). Further, the Commission rejected Zepp's approach in the Eastern Group Case.
3 (*Eastern Group Order* at 22:5-9).

4 Arizona Water also attacks the use of intermediate term treasuries as the risk free rate.
5 Staff's Closing Brief explains the three reasons that long term treasuries should not be used.
6 (Staff Br. at 15). Further, Arizona Water's use of long term treasuries is based on its assumption
7 that a corporation has "indefinite life". (AWC Br. at 45). Yet corporations perish all the time.
8 They are not immortal. Just ask Enron.

9 Arizona Water also points to an article by Fama and French. Arizona Water does not cite
10 where this article might be in the record. Moreover, even if the Commission were to consider this
11 article, it states that "finance textbooks often recommend using the Sharpe-Linter CAPM relation
12 to estimate the cost of equity." (AWC Br. at 48). Thus, Arizona Water concedes that Staff's
13 approach is "often" supported by finance textbooks.

14 **D. Multi-Stage DCF.**

15 Arizona Water makes three objections to Staff's Multi-State DCF analysis. (AWC Br. at
16 41-43). First, Arizona Water suggests that Staff used the wrong growth rate for Stage 1 growth.
17 Arizona Water points to other growth rates calculated by Staff, such as EPS growth. However, the
18 DCF is a cash flow model, and it is thus appropriate to focus on dividends (i.e. the cash received
19 by investors). Staff's witness explained that "Staff forecasted four years of dividends for each of
20 the sample water utilities using expected dividends over the next twelve months for the first year
21 and *Value Line*'s projected DPS growth rate for the subsequent years." (Ex. S-6 at 25:1-4).
22 Second, Arizona Water argues that Staff's supposed 3-year stage 1 period is too short. As shown in
23 the previous quote, Staff did not use three years for stage one, as claimed by Arizona Water.
24 Instead, Staff used a four year period. Staff did not use a longer period for Stage 1 because no
25 reliable data exists for longer periods of time. *Value Line* don't go any further into the future. The
26 reliable *Value Line* information is the only reason to depart from the known long term growth rate
27 used in Stage 2. Thus, for periods for which there is not good data, Stage 2 growth should be used.
28 Third, Arizona Water claims that an arithmetic mean should be used rather than a geometric mean.
Staff previously addressed this issue. (Staff Br. at 14).

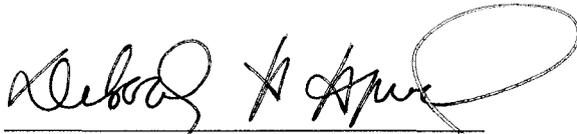
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