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BEFORE THE ARIZONA CORPORATION COMMISSION

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

ARIZONA WATER COMPANY'S APPLICATION FOR REHEARING OF DECISION NO. 68302

Arizona Water Company, an Arizona corporation ("Company"), hereby applies for rehearing of Decision No. 68302 (docketed on November 14, 2005; the "Rate Case Decision"), which approved new rates and charges for the Company's Western Group water systems, pursuant to A.R.S. § 40-253. The Commission approved rates designed to produce an increase in annual revenues of approximately 1.5% above the revenues produced by the existing rates, which were approved in the last rate case in Decision No. 58120 on December 23, 1992 – 13 years ago!

The grounds for rehearing are set forth in the Company's Exceptions to Recommended Order ("Exceptions"), filed in the above-entitled docket on October 13, 2005 and incorporated herein by reference. A copy of the Exceptions is attached for the

Commissioners' convenient reference. This application for rehearing focuses on several obvious errors and omissions the Commission made in determining the Company's authorized return on common equity ("ROE") in addition to the issues raised in its Exceptions.

The 9.1% authorized ROE in the Rate Case Decision is below the levels recommended by *all* of the parties:

- Staff recommended 9.2%
- RUCO recommended 9.44%
- The Company's expert recommended 11.25%

Moreover, the 9.1% ROE in the Rate Case Decision did not correct for two errors Staff acknowledged in its testimony and is based on stale beta values rather than the June 2005 average. These errors are undisputed, and their correction would produce a modest increase to the authorized ROE, at a minimum, from 9.1% to 9.5% as illustrated on Attachment 1. With these corrections the overall rate of return on the Company's original cost rate bases would increase from 8.9% to 9.2%. The overall effect of correcting these errors would increase the revenue requirement by approximately $114,000 annually for the Western Group as illustrated on Attachment 2

A. Errors Acknowledged by Staff and Ignored by the Commission.

The Recommended Order and Opinion and the Rate Case Decision ignored errors that Staff readily acknowledged during the hearing. Staff originally recommended an ROE of 9.1%. During the hearing, the Staff witness, Gordon Fox, admitted that Staff had made rounding errors and that the recommended ROE should be 9.2%.[1] Mr. Fox explained:

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[1] The Staff witness responsible for Staff's recommended ROE, Alejandro Ramirez, left the Commission shortly before the hearing. Consequently, at the hearing, Mr. Fox adopted Mr. Ramirez's pre-filed testimony and schedules. To his credit, Mr. Fox identified the errors discussed below and corrected Mr. Ramirez's pre-filed testimony before adopting it. Hearing Tr. at 178-80.

> [O]ne of the things we do is, on Schedule [AXR-8], we usually round up if there is a rounding. And I don't believe that the calculations here [are] rounded up. So instead of a 9.1 percent rate of return, ***it should say 9.2 percent.***

(Hearing Tr. at 179; emphasis added.)

In addition to acknowledging Staff's rounding errors, Mr. Fox admitted that Staff's CAPM estimate using the current market risk premium was erroneous:

> **A. [By Mr. Fox:]** . . . upon reading Mr. Zepp's rejoinder testimony, we reviewed [and] reexamined the . . . appropriate Treasury rate to use for the risk-free rate for the current market risk premium, which again is one of the items listed on schedule AXR-8. And Mr. Zepp has suggested that, for . . . the current market risk premium, the long-term Treasury rate is the correct rate to use. ***And we agree with that.*** And so that would be a change, because the risk-free rate reflect[ed] on [schedule] AXR-8 is an intermediate-term rate.
>
> **Q. [By Mr. Sabo:]** And with that correction, do you adopt Mr. Ramirez's surrebuttal testimony?
>
> **A.** Yes, I do.

(Hearing Tr. at 179-80; emphasis added.) This correction to the long-term Treasury rate, as shown on Attachment 1, increased Staff's Historical and Current CAPM market risk premium estimates from 9.1% to 9.2% and from 9.3% to 9.9% respectively. (Zepp Rj. at 18, l. 7.) The average of Staff's two CAPM estimates, as corrected, was 9.6%, and the overall average of Staff's estimates was 9.4%. However, these errors, which when corrected would further increase Staff's recommended ROE from 9.2% to at least 9.4%, are not corrected or even mentioned in the Rate Case Decision.

B. Relevant Data Ignored by the Commission.

Staff's cost of capital witness testified that "investors are risk adverse – they require a greater return for bearing greater risk" (Ramirez Dt. at 26). He also testified that "market risk is the only risk that affects the cost of equity, and it is measured by beta.

Beta reflects both the business risk and the financial risk of a firm." (*Id.* at 10.)[2] The calculated ROE is sensitive to small changes in beta. In the Eastern Group rate case, the average beta of the sample water utilities was 0.59. At the time Staff's surrebuttal testimony was filed in this case, the average beta of the same sample water utilities had increased to 0.68, indicating that the business and financial risk of the sample water utilities had increased and that there should be a concurrent increase in Staff's surrebuttal ROE recommendation. This is a significant increase, which, like the increase in interest rates since mid-2003, should lead to a higher estimated cost of equity. Staff's estimate did not increase.

The beta estimates used by Staff (and by RUCO) are published by *Value Line Investment Service*. *Value Line* updates its estimates every 13 weeks. In its updates published in early June, 2005, several weeks before the hearing, *Value Line* increased its beta estimates for four of the six sample water utilities used by Staff, resulting in an average beta of 0.71. The Company's expert, Dr. Thomas Zepp, presented this information in his rejoinder testimony, and it was not disputed by any party. (Zepp Rj. at 17-19.) The increase in the average beta, when combined with the corrections made to Mr. Ramirez's schedules by Mr. Fox, would further increase Staff's CAPM estimate from 9.4% to 9.8% and Staff's overall equity cost estimate to 9.5%, as illustrated on Attachment 1. Like the corrections Mr. Fox made on the record, the Rate Case Decision did not mention the increase in *Value Line*'s estimated betas. The Commission ignored that increase when it erroneously set the 9.1% return on equity.

C. Summary of Recommended and Authorized ROE.

To place the Rate Case Decision ROE in context, at the time of the hearing, the six

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[2] "Beta" is a key component of Staff's CAPM estimates. It measures a security's volatility in relation to that of the market as a whole. The more volatile the particular stock, the higher the stock's beta. And the higher the beta, the higher the cost of equity. (Ramirez Dt. at 26-29.)

water utilities in Staff's sample group were actually earning 10.5% on equity, and the three largest water utilities in the sample group were projected to earn 10.8% in 2006 and 12.0% in 2008 through 2010. (Hearing Exhibits A-19 and A-20.)

In the Company's recent rate case for its Northern Group, the Commission authorized an ROE of 10.25%. Decision No. 64282 (Dec. 28, 2001). In its Eastern Group rate case, the Commission authorized an ROE of 9.2%. Decision No. 66849 (March 19, 2004). The exceptionally low ROE in the Rate Case Decision for the Eastern Group, however, was the result of extremely low June 2003 interest rates. Staff used the average of three intermediate-term (5-year, 7-year and 10-year) Treasuries as the "risk-free" rate, which was only 3.3%.[3] By May 2005, when Staff filed its surrebuttal testimony in this case, the average of the same Treasury instruments had increased to 4.0%. (Ramirez Sb., Schedule AXR-8.) At the time of the Rate Case Decision in November 2005 the average was 4.4%, i.e., more than 100 basis points *higher* than in mid-2003. According to Staff's cost of capital witness, "the cost of equity moves in the same direction as interest rates." (Ramirez Dt. at 7.) Yet, Staff's recommended ROE, 9.2%, did not change, and the Commission adopted an even lower ROE of 9.1%.

Thus, the finance models used by Staff (and accepted by the Commission) produce ROE estimates that move in the *opposite* direction of interest rates, betas and other indicators of the cost of capital. The results contradict Staff's own testimony. Moreover, the Commission ultimately adopted an ROE that may be the lowest ROE authorized for a Class A Arizona water utility in several decades. Even Chaparral City Water Company, whose rate case was just decided by the Commission, was authorized an ROE of 9.3%. Decision No. 68176 (Sept. 30, 2005) and interest rates have increased since then.

[3] Direct Testimony of Joel M. Reiker, Docket No. W-01445A-02-0619 (filed July 8, 2003), Schedule JMR-7.

D. Conclusion.

Staff's own witness testified that the cost of equity should move in the same direction as interest rates and the sample water utilities' betas. In fact, as stated, the six sample utilities used by Staff were, at the time of the hearing earning 10.5% on common equity. Yet, the ROE which the Commission adopted is lower than the ROE approved in the Northern and Eastern Group rate cases, lower than the ROE approved on September 30, 2005, for Chaparral City Water Company, and lower than the recommendations of every party to this case, including Staff. The errors identified above are simply the most obvious defects in the Rate Case Decision. The Company submits that, at a minimum, the Commission should grant rehearing and authorize rates that will produce a return on common equity that is not less than 9.5%.

RESPECTFULLY SUBMITTED this 5th day of December, 2005.

FENNEMORE CRAIG, P.C.

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A copy of the foregoing was
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Arizona Water Company -Western Group-
Final Cost of Equity Estimates
Sample Water Utilities

Original Staff Surebuttal									"On The Record" Corrections & Update		
[A]	[B]		[C]		[D]		[E]		Rounding Correction [1]	L-T Treasury Correction [2]	June Beta Update [3]
DCF Method			D_1/P_0	+	g	=	k		k	k	k
Constant Growth DCF Estimate			3.0%	+	5.8%	=	8.8%		8.8%	8.8%	8.8%
Multi-Stage DCF Estimate						=	9.3%		9.3%	9.3%	9.3%
Average of DCF Estimates							**9.0%**		**9.1%**	**9.1%**	**9.1%**
CAPM Method	Rf	+	β	x	(Rp)	=	k		k	k	k
Historical Market Risk Premium	4.0%	+	0.68	x	7.6%	=	9.1%		9.1%	9.2%	9.4%
Current Market Risk Premium	4.0%	+	0.68	x	7.8%	=	9.3%		9.3%	9.9%	10.1%
Average of CAPM Estimates							**9.2%**		**9.2%**	**9.6%**	**9.8%**
					Average		**9.1%**		**9.2%**	**9.4%**	**9.5%**

Source: The Wall Street Journal, Value Line, Ibbotson Associates SBBI 2004 Yearbook

Supporting Schedules: Schedule AXR-7

Notes

1 Fox Hearing Tr. At 179
2 Fox Hearing Tr. At 117-180
3 Zepp Rj. At 17-19

Arizona Water Company - Western Group
Docket No. W-01445A-04-0650
Test Year Ended December 31, 2003

REVENUE REQUIREMENT

LINE NO.	DESCRIPTION	[A] DECISION NO. 68302	[B] ROUNDING CORRECTION	[C] ANNUAL REVENUE EFFECT	[D] L-T TREASURY CORRECTION	[E] ANNUAL REVENUE EFFECT	[F] JUNE BETA UPDATE	[G] ANNUAL REVENUE EFFECT
1	Adjusted Rate Base	$ 23,254,087	$ 23,254,087		$ 23,254,087		$ 23,254,087	
2	Adjusted Operating Income (Loss)	$ 1,971,289	$ 1,971,289		$ 1,971,289		$ 1,971,289	
3	Current Rate of Return (L2 / L1)	8.48%	8.48%		8.48%		8.48%	
4	**Return on Equity**	**9.1%**	**9.2%**		**9.4%**		**9.5%**	
5	Required Rate of Return	8.9%	9.0%		9.1%		9.2%	
6	Required Operating Income (L5 * L1)	$ 2,069,614	$ 2,092,868		$ 2,116,122		$ 2,139,376	
7	Operating Income Deficiency (L6 - L2)	$ 98,325	$ 121,579		$ 144,833		$ 168,087	
8	Gross Revenue Conversion Factor	1.63246	1.63246		1.63246		1.63246	
9	Increase In Gross Revenue (L8 * L7)	$ 160,511	$ 198,472	**$ 37,961**	$ 236,433	**$ 75,923**	$ 274,395	**$ 113,884**
10	Adjusted Test Year Revenue	$ 10,675,355	$ 10,675,355		$ 10,675,355		$ 10,675,355	
11	Proposed Annual Revenue (L9 + L10)	$ 10,835,866	$ 10,873,827		$ 10,911,788		$ 10,949,750	
12	Require Increase in Revenue (%) (L9/L10)	1.50%	1.86%		2.21%		2.57%	
13	3-Year Loss of Revenue (Line 9 X 3)			**$ 113,884**		**$ 227,768**		**$ 341,652**

ATTACHMENT 2

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BEFORE THE ARIZONA CORPORATION COMMISSION

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 **ARIZONA WATER COMPANY'S EXCEPTIONS TO RECOMMENDED ORDER**

Arizona Water Company, an Arizona corporation ("Arizona Water"), hereby files its exceptions to the Recommended Opinion and Order ("Recommended Order") issued by the Administrative Law Judge ("the ALJ") on October 4, 2005.

I. INTRODUCTION.

Arizona Water is a public service corporation that owns and operates 18 Commission regulated water utility systems throughout Arizona. Tr. at 252.[1] These systems are organized into three groups, the Northern Group, the Eastern Group and the

[1] Citations to the record are made as follows: Citations to a witness' pre-filed testimony are abbreviated using the witness' name and testimony title (e.g., the Direct Testimony of Ralph J. Kennedy is abbreviated as "Kennedy Dt."). Other hearing exhibits are cited by the hearing exhibit number and, where applicable, by page number, e.g., A-15 at 2. The hearing transcript is cited by page number, e.g., Tr. at 1.

Western Group. The Commission recently authorized rate increases for Arizona Water's Eastern and Northern Groups. *See* Decision No. 66849 (March 19, 2004) (Eastern Group systems) and Decision No. 64282 (Dec. 28, 2001) (Northern Group systems). Arizona Water's present rates and charges for utility service in the Western Group became effective over 12 years ago on January 1, 1993, and are based on operating results and investment in plant for test year 1990. Decision No. 58120 (Dec. 23, 1992) (all systems).

The economy has changed substantially since 1990, and so have Arizona Water's operations. From 1990 through mid-2004, inflation increased by more than 38%. Kennedy Dt. at 4. As a result, the cost of doing business has increased. *Id.* at 5 and 7. Regulatory changes, including the amendments to the Safe Drinking Water Act, have also increased the costs of testing, treatment and reporting. *Id.* at 4. Moreover, Arizona Water's net investment in utility plant in the Western Group has increased 67% since 1990, from \$14.5 million to \$24.2 million. *Id.* at 8. These utility plant additions consist of wells, reservoirs, transmission mains, treatment facilities and other construction projects that improve service to existing customers. Whitehead Dt. at 7.

As a consequence, revenues are currently inadequate to cover the current cost of service and provide a reasonable rate of return on Arizona Water's investment. Accordingly, Arizona Water is seeking rate increases for each of its five Western Group systems. These increases are based on Arizona Water's financial data for calendar year 2003, the test year in this case, with appropriate adjustments to actual test year results and balances to obtain a normal or more realistic relationship between revenues, expenses and rate base during the period in which new rates will be in effect.

Arizona Water's proposed increase of \$1,464,966 or 13.72% results in an overall revenue requirement for the five Western Group systems of \$12,140,321. Recommended Order at 4. Under the Recommended Order, however, the revenue requirement for the five Western Group systems is \$10,835,865, an increase of only \$160,510 or 1.5%. This amounts to an increase of approximately 0.1% per year. By system, the percentage increases in revenues requested by Arizona Water and recommended in the Recommended Order are as follows:

System	Requested Increase	Recommended Order
Casa Grande	13.1%	1.13%
Stanfield	8.9%	3.34%
Coolidge	17.2%	0.67%
White Tank	13.6%	- 0.55%
Ajo	21.4%	14.89%

Tr. at 16; Recommended Order at 50-51. Arizona Water is one of the best-managed and most efficient utilities in Arizona, as shown by the relatively modest increases Arizona Water has requested. Nevertheless, an increase of only 1.5% after nearly 13 years is clearly unreasonable.

Moreover, to retain Arizona Water's Central Arizona Project ("CAP") water allocations for the White Tank, Coolidge and Casa Grande water systems, Arizona Water has been required to pay the annual capital charges. Garfield Dt. at 4. Those charges increased dramatically after the CAP delivery system became operational in 1993. Hubbard Dt. at 10. Arizona Water has been recording these payments in a deferred account and, at the end of the test year, the unrecovered balance exceeded $5 million.[2] *Id.* at 12. Arizona Water is requesting authority to begin recovering these costs so that it may retain its CAP subcontracts. Recommended Order at 5-7. Under the Recommended Order, Arizona Water will be allowed to begin to recover these costs through hook-up fees charged to new customers, which will be subject to refund if Staff does not approve Arizona Water's CAP Water Use Plan. Recommended Order at 18. In the meantime,

[2] The December 31, 2003, balances for the three systems with CAP allocations were $3,525,803 for Casa Grande, $506,268 for White Tank and $1,046,011 for Coolidge. *Id.* at 12.

Arizona Water must continue to pay CAP M&I capital charges each year.

II. SUMMARY OF ARIZONA WATER'S EXCEPTIONS.

Arizona Water respectfully submits that the following recommendations in the Recommended Order are arbitrary and unsupported by the evidence in the record:

1. **All Expenditures Recorded in Plant Account 303 Are Appropriate and Should Be Included in Rate Base.** The Recommended Order removes *all* expenditures recorded in Plant Account 303. However, that account also includes $48,807 unrelated to the disputed Casa Grande legal expenses. Arizona Water disagrees with the Recommended Order's recommendation regarding those legal expenses, which were prudently and properly incurred for the benefit of the Arizona Water and its customers, but submits that there is no dispute as to the prudence of the $48,807 expenditure made by Arizona Water to secure land and water rights.

2. **The Recommended Return on Equity Is Based on Staff's Admitted Errors, Including the Inappropriate Use of Intermediate-Term Treasuries Instead of Long-Term Treasuries, Disregards More Appropriate Return on Equity Estimates by Arizona Water, and Is Unreasonable.** The parties have used the same general methods to estimate the current cost of equity. However, the critical inputs chosen by Staff were purposefully or inadvertently chosen to depress the cost of equity. Consequently, Staff's recommended return on equity is unrealistically and artificially low, as further demonstrated by Staff's own models which produce estimates that move in the opposite direction of interest rates and other established indicators of the cost of capital, contrary to Staff's own testimony. The Recommended Order ignores the evidence presented by Arizona Water and recommends a return on equity of 9.1%, reflecting Staff's rounding error, which is less than Staff's own ultimate recommendation of 9.2%.[3] At the same time, the six water utilities in Staff's sample group are currently

[3] Staff's witness Fox, in adopting the Surrebuttal Testimony of Mr. Ramirez, corrected Staff's

earning, on average, 10.5% on equity, and the three largest water utilities in the sample group are projected to earn 10.8% in 2006 and 12.0% in 2008 through 2010. Exhibits A-19 and A-20.

3. Arizona Water's Purchased Power and Purchased Water Adjustment Mechanisms Should Not Be Eliminated. Arizona Water has had purchased power and purchased water adjustment mechanisms in effect for 20 years. Those mechanisms have been reviewed and approved by the Commission in prior rate cases. Now that the cost to generate electricity has become unstable and power costs have begun to escalate, the Recommended Order recommends elimination of these longstanding adjustment mechanisms. This is fundamentally wrong and is poor regulatory policy. The adjusters are in the public interest because they protect both Arizona Water *and* its ratepayers from sharp fluctuations in these key expenses over which neither Arizona Water nor the customers have any control and should be approved consistent with sound ratemaking practice and equity.

4. The Recommended Order's Rate Design Is Not Conservation-Oriented and Instead Creates a Large Subsidy That Customers on Larger Meters Must Pay. The three-tier rate design recommended in the Recommended Order is badly flawed and unsupported by a cost of service study or any other analysis of the rate design's impact on customers or customer classes. The commodity rates in the first two tiers would be set *below* the current commodity rate. For Casa Grande, for example, the recommended commodity rates in the first and second tiers are 36% and 18%, respectively, *less* than the existing commodity rate. As a result, many customers would actually receive substantial reductions in their monthly bills. Obviously, this rate design is not intended to encourage

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return on equity recommendation for a rounding error, which increased Staff's recommendation to 9.2% and admitted to the use of an inappropriate risk-free rate for the current market risk premium (Tr. at 179). The effect of the inappropriate risk-free rate was computed by Dr. Zepp resulting in an increase in Staff's CAPM equity cost of 60 basis points to 9.9%. Zepp Rj. at 18.

water conservation, but is intended to subsidize residential water use by shifting revenue recovery to larger users, with the risk of under-collection borne solely by Arizona Water. This violates basic rate design principles and should be rejected by the Commissioners.

III. THE RECOMMENDED ORDER REMOVES ALL PRUDENTLY INCURRED EXPENDITURES FROM RATE BASE EVEN THOUGH SOME OF THESE EXPENDITURES ARE UNRELATED TO THE CASA GRANDE LEGAL EXPENSES.

The Recommended Order rejects Arizona Water's request to include in rate base legal expenses prudently incurred in several lawsuits with the City of Casa Grande ("the City"). Recommended Order at 19. These expenses totaled $764,454. But the Recommended Order also excludes an additional $48,807 incurred in connection with land and water rights. Exhibit A-21; Tr. at 575. These amounts were unrelated to the lawsuits with the City and were properly recorded in Plant Account 303. Tr. at 573-74. The City specifically agreed that Arizona Water was entitled to rate base treatment of the $48,807 because those costs "were unrelated to the effluent and condemnation litigation. City Br. at 15, n. 4. Likewise, in its closing brief, RUCO argued for exclusion of only the $764,454 of Casa Grande legal expenses, not the unrelated costs properly recorded in the same plant account. RUCO Br. at 3, 9. Finally, Staff failed to audit the costs in Plant Account 303, erroneously assuming all of the costs in that account related to the Casa Grande legal expenses. Tr. at 1314. Consequently, no party presented evidence supporting the exclusion of these legitimate capital expenditures from rate base. Therefore, the Recommended Order should be amended, at a minimum, to increase rate base for the Casa Grande system by $48,807, with corresponding increases in revenues.

IV. THE RECOMMENDED EQUITY RETURN IS UNREASONABLY LOW.

A. <u>Introduction</u>.

Arizona Water requested a weighted cost of capital of 10.5%, based on the capital structure at the end of the test year, Arizona Water's cost of long-term debt of 8.43%, and a return on equity capital of 11.25%[4]. Staff originally recommended an equity return of 9.1%. During the hearing, the Staff witness acknowledged that Staff made a rounding error, and corrected its testimony to recommend an equity return of 9.2%. Tr. at 178-79.[5] The Recommended Order recommends a return on equity of 9.1%, which results in a weighted cost of capital of 8.9%. Recommended Order at 40. The Recommended Order adopted Staff's admittedly incorrect recommendation, stating Staff's methods are based on "sound economic principles," thus producing an equity cost estimate that is "fair and reasonable." *Id.* at 36. Arizona Water respectfully disagrees: The record shows that methods used by Staff are biased and intended to arbitrarily depress the cost of equity.

B. <u>Interest Rates and Other Measures of the Cost of Equity Have Increased Since Arizona Water's Eastern Group Rate Case, Yet Staff's Equity Cost Estimate Is Lower.</u>

In the Eastern Group rate case, Staff used the average of three intermediate-term (5-year, 7-year and 10-year) Treasuries as the "risk-free" rate, just as Staff did in this case. At that time (mid-2003), the average was only 3.3%.[6] By early May, 2005, when Staff filed its Surrebuttal Testimony in this case, the average had increased to 4.0%. Ramirez Sb., Schedule AXR-8. Currently (as of October 3, 2005), the average is 4.3%, i.e., *100 basis points higher than in mid-2003*. According to Staff's witness, "the cost of equity moves in the same direction as interest rates." Ramirez Dt. at 7. Yet, inexplicably, Staff's equity cost estimate, 9.2%, has *not* changed, and the Recommended Order recommends an even *lower* equity return in this case, 9.1%.

Staff's witness also testified that "investors are risk adverse – they require a

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[4] There is no dispute concerning Arizona Water's capital structure or its cost of debt. Recommended Order at 30.

[5] Staff made other "rounding errors" as well, in each case rounding downward to derive a lower equity cost.

[6] Direct Testimony of Joel M. Reiker, Docket No. W-01445A-02-0619 (filed July 8, 2003), Schedule JMR-7.

greater return for bearing greater risk" (*id.* at 26), which is perfectly true. He testified that "market risk is the only risk that affects the cost of equity, and it is measured by beta. Beta reflects both the business risk and the financial risk of a firm." *Id.* at 10.[7] In the Eastern Group rate case, the average beta of the sample water utilities was 0.59. At the time Staff's Surrebuttal Testimony was filed in this case, the average beta had increased to 0.68, and by early June, the average beta had increased again, to 0.71 (which is ignored in the Recommended Order). Zepp Rj. at 17. This sharp increase is significant, reflecting greater risk and therefore a higher equity cost. Yet Staff's equity cost estimate in the Eastern Group case, based on the *same* sample water utilities, was 9.2% -- the same as this case.

Obviously, something is wrong. Staff's own witness testified that the cost of equity should move in the same direction as interest rates. The cost of equity should not decrease as interest rates increase, with corresponding increases in the sample water utilities' betas. In fact, the six sample utilities used by Staff are currently earning 10.5% on common equity, and the three largest utilities are projected to earn 10.8% in 2006 and 12.0% in 2008. Exhibits A-19 and A-20. The reason for this anomalous result is, as Arizona Water has demonstrated, the inputs used by Staff and approved in the Recommended Order are biased and arbitrarily depress the cost of equity.

C. <u>Staff's Discounted Cash Flow Models Are Biased.</u>

Arizona Water's expert, Dr. Zepp, developed equity cost estimates based on the constant growth (one-stage) and multi-stage discounted cash flow ("DCF") models used by the Federal Energy Regulatory Commission ("FERC") in order to provide an objective estimate of the cost of equity. Zepp Dt. at 29-38. Staff also used constant growth and multi-stage DCF models to estimate the cost of equity for the same six,

[7] Put simply, "beta" is a measure of a security's volatility in relation to that of the market as a whole. The more volatile the particular stock, the higher the stock's beta. The market's beta is 1.0. Recommended Order at 33, n.12.

publicly traded water utilities. However, the inputs Staff used to implement these models deviate significantly from those used by FERC, arbitrarily depressing the resulting equity cost estimates.

Staff's Use of "Spot" Prices Distorts the Dividend Yield.

Staff used "spot" stock prices to compute the dividend yield in both its constant growth and multi-stage DCF models. Those stock prices resulted in a dividend yield of only 3.0%. Ramirez Sb., Schedule AXR-8. Yet, in testimony filed only 20 days earlier in the Chaparral City Water Company rate case, the same Staff witness chose stock prices that produced an average dividend yield of 3.3% - 30 basis points (10%) higher. Zepp Rj. at 7; Tr. at 108. As a result, the dividend yield in this case is 30 basis points *less* than Staff's dividend yield in the Chaparral City case, producing a lower equity cost.

The FERC uses a six-month average of dividend yields to avoid this sort of short-term distortion. Zepp Dt. at 29. RUCO similarly uses an eight-week average of stock prices to calculate the dividend yield in its DCF model estimate. Rigsby Dt. at 21; Tr. at 158-59 ("it leaves a little too much to chance if you rely on stock prices for one day"). Accordingly, the Recommended Order should not approve Staff's approach.

Staff Improperly Uses Geometric Growth Rates in Its DCF Models.

In its multi-stage DCF model, Staff used the *geometric* average annual GDP growth rate, which is 6.5%, as the terminal growth rate, rather than the conceptually correct *arithmetic* average annual GDP growth rate, which is 6.8%. Staff also used geometric averages in both of its DCF models to determine forward-looking estimates of growth from past growth in dividends per share and earnings per share, which results in lower growth rates, unreasonably depressing the models' results.

Dr. Zepp explained in his Rejoinder Testimony why an arithmetic annual average is the correct ingredient to use because it takes into account variability in growth. Zepp Rj. at 12-15. He also attached excerpts from two well-known finance texts, Richard A.

Brealey and Stuart C. Myers, *Principles of Corporate Finance* (7th ed. 2003), and Ibbotson Associates, *SBBI Valuation Edition 2005 Yearbook*, explaining why an arithmetic average should be used. Zepp Rj., Exhibits TMZ-1 and TMZ-2. Dr. Roger Morin, in his textbook on regulatory finance, also explained why arithmetic averages should be used for estimating the cost of capital, rather than geometric averages. Roger A. Morin, *Regulatory Finance: Utilities' Cost of Capital*, 298-300 (1994) (cited in Company's Br. at 43). The Recommended Order ignores these authorities in approving Staff's flawed method.

Staff Relies on Historic Growth Rates, Which Produce Unrealistic Results

In its DCF estimates, Staff provided six different growth rates, three historic rates and three projected growth rates. Ramirez Sb., Schedule AXR-6. In its constant growth DCF model, Staff gave 50% weight to the historic growth rates, many of which result in an indicated equity cost *<u>below</u> the cost of debt*. For example, Staff's historic DPS growth rates for American States Water, California Water Services and Connecticut Water are 1.1%, 1.3% and 1.4%, respectively. Ramirez Sb., Schedule AXR-3. Using those growth rates and Staff's spot dividend yields, the resulting equity cost for those three water utilities would be 4.4%, 4.5% and 5.0%, respectively – substantially *below* the current interest rate of most debt instruments.

The FERC, in contrast, relies on forward-looking estimates of growth, and eliminates from consideration any individual utility equity cost estimate that is not at least 40 basis points above the cost of investment grade bonds. "Because investors generally cannot be expected to purchase stock if debt, which has less risk than stock, yields essentially the same return, this low end-return cannot be considered reliable in this case." FERC Opinion No. 445 (attached to Arizona Water's Closing Brief) at 21. The Recommended Order approves Staff's method, notwithstanding the anomalous result it produces.

Staff Ignored Two of Its Three Forward-Looking Growth Rates in Its Multi-Stage DCF Model.

Although Staff obtained three forward-looking estimates of growth and used those growth rates (but gave them only 50% weight) in its constant growth DCF model estimate, Staff ignored two of them in its multi-stage DCF model, choosing the lowest forecasted growth rate as the near-term growth rate. Zepp Rj. at 6-7 and 10-16; Company Br. at 37-43. Again, the Recommended Order finds Staff's biased selection of the lowest growth rate appropriate.

D. <u>Staff's Capital Asset Pricing Model Estimates Are Biased</u>.

Dr. Zepp adopted the Risk Premium method used by the office of the Ratepayer Advocates of the California Public Utility Commission ("PUC") to provide an alternative estimate of the cost of equity. Zepp Dt. at 38-45.[8] Staff used the Capital Asset Pricing Model ("CAPM") as an alternative to the DCF model. In its CAPM estimates, Staff again used inputs that are inappropriate and arbitrarily depress the resulting equity cost estimates. Nevertheless those inputs are approved in the Recommended Order, while Arizona Water's Risk Premium estimates are rejected.

Staff Used Inconsistent Interest Rates

Dr. Zepp pointed out that Staff erroneously used the intermediate-term Treasury rate as its "risk-free" rate and the long-term Treasury rate to estimate the current market risk premium in its CAPM. Zepp Rj. at 17-18. The Staff witness admitted this mismatch during the hearing, and testified that the long-term treasury rate should be used as the "risk-free" rate. Tr. at 179. Dr. Zepp corrected Staff's error, using Staff's own data, and determined that Staff's CAPM equity cost estimate increased by 60 basis points to 9.9%.

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[8] The Risk Premium approach is simpler and easier to implement than the CAPM. For example, there is no need to estimate betas or market risk premiums, for example. *Id.* at 6 and 39. Consequently, the California PUC and other regulatory commissions use the Risk Premium method in setting rates more frequently than the CAPM. *Id.* at 39; Tr. at 123.

Zepp Rj. at 18. This error is ignored in the Recommended Order.[9]

Staff's Use of Intermediate-Term Treasury Rates as the "Risk-Free" Rate Is Unsound and Depresses the Equity Cost Estimate.

Empirical studies show that the value for the "risk-free" rate in the standard CAPM model is higher than Treasury rates. Zepp Rj. at 21. For example, Dr. William Sharpe, who was awarded the Nobel Prize for his role in developing the CAPM in the 1960s, has reported that the "risk-free rate" is significantly higher than the average returns on Treasury securities. *Id., citing* William F. Sharpe, *Investments* (1985) at 401. Recent empirical studies of the CAPM have also shown that the returns estimated for low beta stocks (like the water utility sample group) are too low relative to required returns for average risk stocks. Tr. at 121-22. *E.g.*, Eugene F. Fama and Kenneth R. French, "*The Capital Asset Pricing Model: Theory and Evidence*," 18 Journal of Economic Perspectives 25-46 (Summer 2004) (quoted in Company's Br. at 48). This evidence is ignored in the Recommended Order. At a minimum, the long-term Treasury rate used in Staff's surrebuttal filing, 4.55%, should be used in both CAPM estimates.

Staff's Method of Estimating the Current Market Risk Premium is Extremely Volatile and Produces Distorted Results.

Staff used an extremely volatile method of estimating the current market risk premium, resulting in CAPM equity cost estimates that move in the *opposite* direction of interest rates and beta risk. Zepp Rj. at 19; Zepp Rb. at 25. When the Staff witness prepared his direct testimony in late March, 2005, his method indicated the current risk premium is 6.47%. By May 6, 2005, the current risk premium had increased by 225 basis points to 8.72%. Staff, however, selected data from May 11 instead of May 6 (a difference of only five days), which produced a risk premium of 7.82%. Obviously, this

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[9] If the updated betas for the sample utilities, published by Value Line in early June, had been used in Staff's calculation, the equity cost would be 10.1%. Zepp Rj. at 18.

method is volatile, and by using that method Staff manipulates the result. For example, by choosing data published on May 11 instead of May 6, Staff depressed the cost of equity estimate by 43 basis points. The Recommended Order ignores this improper manipulation.

E. The Commission Should Reject the Recommended Order's Result-Driven Approach.

In short, based on Staff's biased and flawed methods, the Recommended Order recommends a return on equity in this case of only 9.1% – *less* than the return authorized by the Commission in the Eastern Group case. Yet interest rates have increased (and continue to increase) since then, and the average beta of Staff's sample water utilities, which reflects those utilities' market or systematic risk, has increased from 0.58 to 0.71. At the same time, the six water utilities in Staff's sample group are currently earning, on average, 10.5% on equity.

Relatively minor adjustments to Staff's inputs and correction of Staff's admitted errors result in a significant increase in the indicated equity cost. If Staff's spot dividend yields (which, as explained, are too low) and the average of Staff's three forward-looking growth rates shown in Mr. Ramirez's Surrebuttal Schedule AXR-6 are used, the constant growth DCF model produces an equity cost of 10.5%. If Staff's spot dividend yields, Staff's forward-looking growth rates, and the correct long-term (terminal) growth rate of 6.8% are used, the multi-stage DCF model produces an equity cost of 10.2%.

Similarly, if Staff's CAPM estimate using the current market risk premium is revised by using the correct "risk-free" rate, in accordance with Staff's testimony during the hearing, the equity cost estimate increases to 9.9%. If the Value Line betas for the sample water utilities published in early June and reported in Dr. Zepp's Rejoinder Testimony and the long-term Treasury rate were used in both of Staff's CAPM estimates, those equity cost estimates increase to 10.1% (current market risk premium) and 9.7%

(historic market risk premium). Zepp Rj. at 20.

With these simple corrections, and using Staff's data, the resulting equity cost estimates are as follows:

DCF Constant Growth Estimate	10.5%
DCF Multi-Stage Estimate	10.2%
CAPM Historical MRP Estimate	9.7%
CAPM Current MRP Estimate	10.1%
Average	**10.1%**

Instead, the Recommended Order approves each input selected by Staff, including those inputs acknowledged to be erroneous, and rejects all of the evidence presented by Arizona Water (and by RUCO). The Commission should reject this biased result-driven approach and fairly consider all of the evidence in the record.

V. ELIMINATION OF THE PURCHASED POWER AND PURCHASED WATER ADJUSTERS IS UNFAIR AND POOR REGULATORY POLICY NOW THAT POWER COSTS HAVE BECOME UNSTABLE AND ARE RISING.

The Commission approved purchased power and purchased water adjustment mechanisms ("PPAM" and "PWAM") for Arizona Water nearly 20 years ago, finding those mechanisms were in the public interest, benefiting both Arizona Water and its customers by allowing increases and decreases in rates for purchased power and water to be passed on, without having to complete a general rate case – an expensive and time-consuming process. Decision No. 55069 (June 13, 1986). In Arizona Water's 1992 rate order, the Commission recognized that adjustment mechanisms serve the interests of Arizona Water's ratepayers:

> If purchased power and/or water costs are trending upward, gradually recognizing those increasing costs through incremental rate adjustments sends a more appropriate price signal to users and receives greater customer acceptance than the less frequent, but far larger, rate increases contemplated in

> Staff's proposal. If purchased power and/or water costs are trending downward, Staff's proposal would delay the refund owing to customers. We believe these customer interests are best served by retaining the existing thresholds.

Decision No. 58120 (Dec. 23, 1992).

Now, as the Commission is acutely aware, fuel costs have become highly volatile and rates for electric utility service are increasing. Arizona Water's primary power provider, Arizona Public Service Company ("APS"), has applied for a surcharge to recover escalating fuel costs and announced it will shortly file another rate case. Given these circumstances, the PPAM is clearly more appropriate than ever.[10] Yet, the Recommended Order recommends that the PPAM and PWAM be eliminated. This simply makes no sense. The PPAM and PWAM should remain in place so that Arizona Water can continue to pass on changes in the rates for power and water in an equitable fashion, providing an appropriate price signal, as the Commission recognized in Decision No. 58120.

The Recommended Order provides little justification for eliminating Arizona Water's PPAM and PWAM. Adjustment mechanisms are sound ratemaking and serve the public interest, as the Commission has previously recognized. Concerns over "piecemeal regulation" are far outweighed by the need to protect Arizona Water against sharply rising energy expenses over which Arizona Water has no control – and which the Commission (as far as APS is concerned) already found to be reasonable. Nor is there any legitimate concern that the adjusters create a disincentive to conserve water and power. It is apparent Arizona Water is operating in an efficient manner, given the modest increases it is seeking after 13 years.

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[10] The Ajo system must purchase all of its water from another water utility, and has no control over the rates charged by that utility. Without the PWAM in place, the Ajo system would have had negative operating income when that utility's rates were increased by 24% in 2004. Kennedy Rj. at 3-4.

Moreover, the PPAM and PWAM only apply to changes in the *rates* charged by water and power providers, over which Arizona Water has no control, based on the test year expense levels. The adjustment mechanisms do not allow Arizona Water to pass on increases caused by increases in the total quantity of power and water purchased due to growth, weather or other factors that impact demand. Thus, Arizona Water and its customers still retain every incentive to reduce their costs by reducing demand.

In short, given the current volatility in electric utility costs, this is not the time to eliminate Arizona Water's PPAM. Likewise, there is no legitimate reason to eliminate Arizona Water's PWAM, as Arizona Water's recent experience with its Ajo system shows.

VI. THE RATE DESIGN IS BADLY FLAWED AND UNSUPPORTED BY COMPETENT EVIDENCE

A. Arizona Water's Existing Rate Design.

Briefly, Arizona Water's Western Group systems already have a simple, cost-of-service based rate design, which the Commission has routinely approved in prior rate cases. *E.g.*, Decision No. 64282 (Northern Group) at 21-23; Decision No. 58120 (all systems) at 24. Each system has a monthly minimum charge based on meter size rather than on the type of customer receiving service, and a uniform commodity rate for all gallons sold. Kennedy Dt. at 24. This type of rate design is recognized as having important advantages, including the following:

- Simplicity – uniform rates are easily understood and implemented, and other utility functions (including the design of rates) are simplified.
- Equity – uniform rates are generally considered equitable because all customers pay the same unit price for general water service, avoiding the appearance of large-volume customers subsidizing small-volume customers or vice versa.
- Revenue Stability – uniform rates provide utilities with greater revenue stability in comparison to inverted-block rates and other more complex rate designs, resulting in a more predictable and dependable revenue stream.

- Conservation – uniform rates facilitate conservation because customer bills vary directly with the level of water usage, providing a powerful price signal to customers.
- Implementation – uniform rates are easily implemented, avoiding the difficulty and expense associated with detailed cost allocations necessary to implement more complex rate designs.

American Water Works Association, *Principles of Water Rates, Fees, and Charges* 87 (5th ed. 2000) (hereinafter "AWWA *Manual M1*").

B. Staff's Rate Design is Badly Flawed and Should be Rejected.

Staff, in contrast, proposed an inverted-block rate structure, under which customers on 5/8 x 3/4-inch meters would have three commodity rate blocks (including an initial "lifeline" rate block), while all customers on larger size meters would have two commodity rate blocks. *See* Ludders Sb., Schedules REL-16 (Casa Grande), REL-12 (Stanfield), REL-15 (White Tank), REL-15 (Coolidge) and REL-12 (Ajo). In developing this rate design, Staff did not prepare a cost of service study or similar analysis, did not perform a billing analysis evaluating the impacts of its rate design on customers, and did not analyze possible consumption and revenue impacts caused by its rate design. Kennedy Rb. at 15 and Staff's Responses to Data Requests 2-14, 2-15 and 2-16; Tr. at 1262-65. The Recommended Order ignores Staff's lack of evidence and adopts Staff's approach because it is purportedly "conservation-oriented." Recommended Order at 43.

Following Staff's approach, the Recommended Order establishes two discounted commodity rate blocks in which water would be priced *below* the system's *existing* commodity rate:

Water System	Discount in 1st Block	Discount in 2nd Block
Casa Grande	-36%	-18%
Stanfield	-34%	-7%
White Tank	-59%	-28%
Coolidge	-52%	-9%

Ajo	-17%	+1%

Recommended Order at 50-51 and Exhibit G. In every case except Ajo, each commodity rate is less than the existing commodity rate, and in many cases, it is substantially less. Obviously, significantly lowering the commodity rate for most customers cannot, by any sense of logic, be considered a conservation-oriented rate design.

The initial rate block, which contains the largest price discount, would be available to customers on 5/8 x 3/4-inch meters, Arizona Water's largest customer group. *See* Exhibit A-17, Schedule H-2 (analysis of revenue by meter size, listing average number of customers). This rate is often called a "lifeline" rate: "Lifeline rates are often thought of as providing a minimal amount of water at a reduced cost to all customers, independent of income level or ability to pay." AWWA, *Manual M1* at 129. This discounted rate block is based on Staff's "internal policy," developed by "some of the chief accountants," under which a discounted rate is provided for the first 3,000 to 4,000 gallons (depending on the utility) of "nondiscretionary" water use each month. Tr. at 1301-04.[11]

The impact of the subsidy created by the "nondiscretionary use" block is exacerbated by the Recommended Order's discounted commodity rates in the second block. With the sole exception of Ajo, the Recommended Order's commodity rates in that block are, again, less than Arizona Water's existing commodity rates. In the most extreme case, Casa Grande, the second block's commodity rate is discounted by 18%, a percentage that is almost as large as the "lifeline" rate discount that Staff proposed, and which the Commission rejected, in the Eastern Group case. Decision No. 66849 at 24-26. This radical change is unsupported by any study or analysis of the impacts on various types of customers and cannot be relied upon to promote conservation.

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[11] This so-called Staff "policy" is not in writing (and therefore not available to the regulated community); however, Staff claims to always follow it. Tr. at 1309.

As a result of the discounted rates in the first and second blocks, most customers on 5/8 x 3/4-inch meters will experience a *decrease* in their monthly bills:

	Average Use	Median Use	Revenue Increase
Casa Grande	-5.1%	-4.8%	+1.13%
Coolidge	-11.2%	-12.0%	+0.67%
White Tanks	-7.9%	-11.5%	-0.55%
Stanfield	-2.8%	-1.9%	+3.34%
Ajo	+13.7%	+16.8%	+14.89%

Recommended Order at 50-51. Clearly, significant reductions in monthly bills will not encourage reductions in water use, which is the justification for this flawed rate design in the Recommended Order.

As the foregoing table demonstrates, the Recommended Order's rate design requires a large subsidy that customers on larger sized meters must pay. This creates revenue volatility, making it likely that Arizona Water will not be able to earn its authorized rate of return. Revised Exhibit A-39,[12] which is attached at Tab A, graphically depicts how the Recommended Order's rate design shifts revenue responsibility from smaller to larger-size meters in Casa Grande. , As this table shows, nearly 82% of water use by customers on 6-inch meters is priced at the *highest* third block rate of $2.15 per 1,000 gallons, while the balance of water use for these customers (18%) would be priced at the second block rate of $1.28 per 1,000 gallons. Customers on 1-inch, 2-inch and 3-inch meters similarly have approximately 60% of their water use priced at the highest commodity rate. The rate designs for the other Western Group systems produce similar results.

Obviously, this rate design is merely a device to reallocate revenue recovery

[12] This exhibit, which was presented during the hearing, has been revised to reflect the commodity rates for the Casa Grande system recommended in the Recommended Order.

among customer groups. Staff's rate design witness admitted that Staff is unaware of inverted block rate designs actually resulting in reductions in water use. Tr. at 1311. This radical change in rate design is made even more remarkable by the complete lack of any supporting study or analysis regarding its impact on customers or on Arizona Water's ability to actually recover its revenue requirement. Therefore, this rate design should be rejected, and Arizona Water's existing rate design retained.

RESPECTFULLY SUBMITTED this 13th day of October, 2005.

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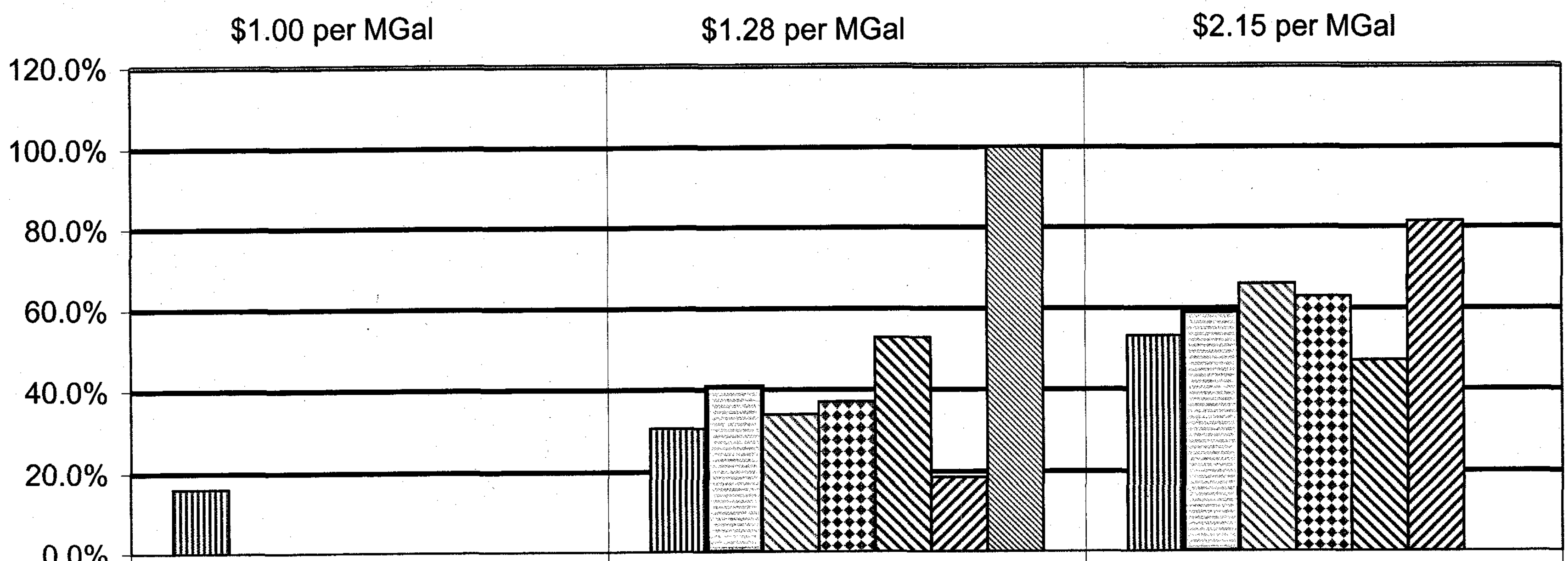
1721131.2

EXHIBIT
A

Percent of Revenue In Each Tier By Meter Size
Casa Grande



	1st Block	2nd Block	3rd Block
5/8" x 3/4"	16.1%	30.7%	53.3%
1"	0.0%	40.8%	59.2%
2"	0.0%	34.0%	66.0%
3"	0.0%	37.0%	63.0%
4"	0.0%	52.9%	47.1%
6"	0.0%	18.5%	81.5%
8"	0.0%	100.0%	0.0%