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**BEFORE THE ARIZONA CORPORATION COMMISSION**

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| IN THE MATTER OF THE APPLICATION OF BELLA VISTA WATER CO., INC. AN ARIZONA CORPORATION TO DETERMINE THE FAIR VALUE OF ITS PROPERTIES FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES AND TARIFFS DESIGNED TO DEVELOP SUCH RETURN | DOCKET NO. W-02465A-01-0776<br><br>**ARIZONA CORPORATION COMMISSION STAFF'S CLOSING BRIEF** |

Arizona Corporation Commission
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Staff of the Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby files its closing brief in the above-captioned matter. In this brief, Staff will address the major disputed issues between the applicant Bella Vista Water Company ("BVWC" or "Company") and Staff. On any issue not specifically addressed in this brief, Staff maintains its position as represented in its testimony.

This rate case is all about accuracy. The issues over rate base and cost of capital boil down to what party used the most accurate analysis. Staff's analysis of rate base is the most accurate analysis because Staff's analysis adheres to widely accepted rate making principles. Staff properly rejects inclusion of post-test year plant into rate base because the impacts on revenues and expenses are not known and measurable. To add post-test year plant to rate base would violate the widely held and accepted matching principle and the Company's position directly violates that basic precept. The Company fails to meet its burden to justify inclusion of post-test year plant in rate base, inclusion of approximately $143,846 of cash working capital ("CWC"), and inclusion of professional fees not directly benefiting the rate payers.

Staff's cost of capital analysis is also the most accurate analysis. Staff based its rate of return



\\ADMIN3000_1\DATA\SHARED\LEGAL\JGELLMAN\BELLA VISTA\BVWC-BRIEF.DOC recommendation ("ROR") on its cost of capital analysis, which in turn was based on Staff's determination of capital structure, cost of debt, and cost of equity. Cost of capital is a financial analysis looking at investor's present and future expectations. It is a forward-looking financial analysis, independent of the analysis used to determine whether post-test year plant should be included in rate base. The Company's cost of capital analysis and ROR recommendation is based on misconception on top of misconception and is an inaccurate measure of investor expectation. While Staff's analysis adheres to these fundamental concepts, the Company's recommendation is based on direct violations of those concepts.

## I. THE COMMISSION SHOULD NOT ALLOW THE POST TEST-YEAR PLANT ADVOCATED BY THE COMPANY BECAUSE TO DO SO WOULD VIOLATE THE MATCHING PRINCIPLE AND WOULD VIOLATE WIDELY ACCEPTED RATE MAKING PRINCIPLES.

The Company filed its rate application on September 28, 2001, and chose a test year ending December 31, 2000. Despite its choice of a test year ending December 31, 2000, BVWC seeks to include in its rate base plant additions that occurred outside the test year up through March 6, 2002. This request should be denied as unreasonable. It is unreasonable because allowing post-test year plant installed well after the Company's chosen test year would result in violating the matching principle and not be in keeping with widely accepted rate making principles. The impacts of the Company's proposed post-test year plant on revenues and expenses, despite the Company's intentions, are not known and measurable. The Commission should therefore reject the inclusion of post-test year plant additions, and should instead adopt Staff witness Alexander Igwe's recommendation of the disallowance of post-test year plant in rate base.

### A. <u>The Commission should not allow pro forma adjustments to the historical test-year chosen by the Company unless the impacts are known and measurable.</u>

Arizona is a historical test-year state. Commission rules require the end of the test year, the one-year historical period used in determining rate base and operating income, to be the most recent practical date available prior to the filing. A.A.C. R14-2-103(A)(3)(p). While pro forma adjustments are allowed, when appropriate, the starting point for determining rate base, revenues and expenses is the historical test-year the Company chooses when applying for a rate adjustment. Pro forma adjustments are defined as "adjustments to actual test year results and balances to obtain a more normal relationship between revenues, expenses and rate base." A.A.C. R14-2-103(A)(3)(I ). The definition of Original Cost Rate Base, or the rate base used as part of the determination of fair value, is defined as the "depreciated original cost, prudently invested, of the property (exclusive of contributions and/or advances in aid of construction) *at the end of the test year*, used or useful, plus a proper allowance for working capital and including all *applicable* pro forma adjustments." A.A.C. R14-3-103(A)(3)(h). The issue here is whether the post-test year plant the Company proposes to include in rate base also includes known and measurable changes to revenues and expenses. The answer, in this case, is no, for the following reasons.

BVWC's proposal that the Commission allow a pro forma adjustment to its rate base to account for plant additions occurring after December 31, 2000 is not only inconsistent with the test year BVWC chose, but it also offends widely accepted rate making principles. The known and measurable and matching concepts are recognized and accepted rate making principles. These widely accepted rate making principles allow pro forma adjustments to rate base only if those adjustments are known and measurable. Likewise, widely accepted rate making principles allow pro forma adjustments to rate base only if those adjustments do not violate the matching principle. The matching principle requires revenues, expenses, and rate base to be properly matched in time, so that the effect of a change in one is reflected in the other two. In this case, BVWC has failed to quantify the effects of post-test year plant on revenues and expenses and has failed to apply the matching principle.

**B. <u>The impacts of the Company's post-test year plant on revenues are not quantifiable and are therefore not known and measurable.</u>**

A pro forma post-test year plant adjustment will violate the matching principle if the adjustment is not revenue neutral. The Company argues that the inclusion of post test-year plant in this case was not intended to increase revenues and should be allowed. (See Rebuttal Testimony of Judith A. Gignac at 9). However, intent is different from impact. The more removed the post-test year rate base additions are from the test year on which revenues and expenses are based, the more likely it becomes that the effect of the post-test year plant is not revenue neutral. Through Ms.

Gignac's own testimony, the majority of the post-test year plant was placed in service during the latter half of 2001. (See Rebuttal Testimony of Judith A. Gignac, Exhibit A; see also T.R. at 301 [Testimony of Thomas Bourassa]). This is the heart of the problem for Staff.

As Staff witness Mr. Alexander Igwe testified on several occasions, the inclusion of post-test year plant poses a significant problem with the matching principle. Mr. Igwe testified that "it is incorrect to assume that because plant additions do not provide service to new customers, the impact is revenue neutral." (See Direct Testimony of Alexander Ibhade Igwe at 13). Furthermore, Mr. Igwe testified that "new plant may increase system efficiency and reliability resulting in lower expenses and increased revenues." Id. Mr. Igwe, during the hearing, further explained that pro forma adjustments are made when all the impacts are known and measurable and that this is the foundation of the matching principle. (T.R. at 424-25). In this case, the impacts of including post-test year plant on revenues and expenses are not known and measurable. (T.R. at 425-26). Mr. Igwe explained:

> Even if we were to agree that the post test year [plant] was not installed to provide service to new customers, the impact on the existing customer is not known. I might have gone on system efficiency, which would have impacted system requirements. The company has agreed, especially Ms. Gignac has stated it might have had some impact on operating expenses. We don't know what those impacts are. That is the difficulty in this case.
>
> (T.R. at 426).

Because allowing the post-test year plant in rate base would violate the matching principle and because the impacts on revenues and expenses are not known, the Commission should not allow post-test year plant additions beyond December 31, 2000 in rate base.

In addition, no extraordinary circumstances justify inclusion of new plant into rate base. Despite the curtailment issues that Ms. Gignac testified to, such issues are not considered extraordinary to justify inclusion of post-test year plant. (T.R. at 427). Even the Company's witness Mr. Ronald Kozoman, indicates no extraordinary events occurred during the test year. (See Exhibit S-13; T.R. at 426-27). Thus, the extraordinary circumstances justification does not exist in this case.

### C. <u>The Arguments by the Company cannot justify inclusion of post-test year plant into rate base.</u>

BVWC puts forth several arguments as to why this Commission should reject Staff's arguments. The Company accuses Staff of 'speculation' and presenting no evidence that post test year plant will add to revenues. (See Rebuttal Testimony of Judith A. Gignac at 13). However, it is the Company that is asking for the rate increase, not Staff. It falls on the Company to bear the burden of proof to justify the rate increase it is asking for, regardless of its magnitude. In any event, the Company never quantified the impacts on revenues or expenses, but merely relied on its intention to have this post-test year plant not increase revenues. Staff emphasized that the Company could not substantiate its claim because it is impossible to quantify the impacts this post-test year plant will have on revenues and expenses. (See Surrebuttal Testimony of Alexander Ibhade Igwe at 4). The Company has simply not met its burden to justify the inclusion of this post-test year plant.

Ms. Gignac attempts to justify the inclusion of post-test year plant by testifying as to the need for the plant. For instance, Ms. Gignac states that the post-test year plant was put into place to respond to a vulnerability to drought conditions. (See Rebuttal Testimony of Judith A. Gignac at 7). Specifically, she testifies that curtailment for the Rail Oaks portion of the system was less severe in 2002 than in 2000 because of the post-test year plant additions. (T.R. at 51). But Ms. Gignac also had to admit that curtailment affects revenues and that putting in this post-test year plant can affect revenue (See T.R. at 43, 45). In addition, the post-test year plant, which leads to a more efficient and more reliable system could make the system more attractive to future growth and development (T.R. at 48). The presence of these factors, and the lack of quantifiable evidence that no impacts on revenues will occur, further justifies exclusion of post-test year plant in this case.

Mr. Thomas Bourassa also puts forth several arguments justifying the inclusion of post-test year plant. Mr. Bourassa argues that Staff perverts the matching principle by not allowing post-test year plant. (See Rebuttal Testimony of Thomas Bourassa at 16). However, Mr. Bourassa never quantified the impacts of including post-test year plant in rate base on revenues and expenses. (See Surrebuttal Testimony of Alexander Ibhade Igwe at 3). Mr. Bourassa could only assert that the post-test year plant was not intended for new growth and that there was little to no customer growth on the system. (T.R. at 250-51). Mr. Bourassa did not testify as to what impacts the new plant would have on water usage by present customers. Furthermore, Mr. Bourassa ignores the fact that a majority of the new plant was put in only during the latter half of 2001, making it impossible to quantify what impacts it would have on present usage or new growth. Mr. Lyndon Hammon, Staff Engineer, testified that the system would be able to better accommodate growth with the new plant. (T.R. at 420).

The bottom line is while Mr. Bourassa relied on certain factors in making his assertion, he could never quantify the impacts of new plant on revenues. (T.R. at 251). The majority of the new plant was not in place until the latter half of 2001. There is no way to quantify the impacts on revenues. Similarly, the Company could not quantify all the impacts on operating expenses. (See Surrebuttal Testimony of Alexander Ibhade Igwe at 4). While the Company witnesses argue that operating costs will go up, they never attempt to quantify the impacts of new plant on expenses other than depreciation. Id. Because Mr. Bourassa could not quantify the impacts on the new plant on revenues and expenses, and because those impacts are not known and measurable, the inclusion of post-test year plant violates the matching principle.

Mr. Bourassa also tries to use the Commission Decisions of other rate cases as justification for inclusion of post-test year plant. (See Rebuttal Testimony of Thomas Bourassa at 21). However, those cases are factually distinguishable in their unique health and safety issues from this case. For instance the Far West Water & Sewer Rate Case involved a problem with total dissolved solids ("TDS") which warranted inclusion of post-test year plant. (See Commission Decision No. 62429 at 3). In the Paradise Valley Water Company rate case, a problem existed with periods of low water pressure or no water. (See Commission Decision No. 60220 at 4). Neither problem was in existence in this case. (T.R. at 46). Many of these decisions were the result of settlements and do not have binding precedent on this case. (See Commission Decision Nos. 62649 [Far West Water & Sewer], 64186 [Gold Canyon Sewer Company]). The prior BVWC rate decision was also the result of a settlement agreement. (See Exhibit S-7 [Commission Decision No. 61730]). Those cases are not applicable to the case here.

Mr. Bourassa attempts to use Arizona case law to justify his assertion that Staff's exclusion of post-test year plant violates Arizona law. (See Rebuttal Testimony of Thomas Bourassa at 11-14). The case law does not support his assertion. Contrary to Mr. Bourassa's interpretation, the Commission has the discretion to consider pro forma adjustments and it may include those adjustments into rate base, but no requirement exists that it must put post-test year plant into rate base. The Arizona Courts have recognized the Commission's constitutional power to set rates and to prescribe just and reasonable classifications to be used in setting rates under the Arizona Constitution. See Consol. Water Util., Ltd. v. Arizona Corp. Comm'n, 178 Ariz. 478, 483-84, 875 P.2d 137, 142-43 (App. 1994). While the Court can consider matters subsequent to the historical test year, the Commission is under no obligation to do so. See Litchfield Park Serv. Co. v. Arizona Corp. Comm'n, 178 Ariz. 431, 437-38, 874 P.2d 988, 994-95. In Litchfield Park, the Court upheld the Commission exclusion of a well from rate base because that well was not used and useful during the test year. Id. at 437, 874 P.2d at 994. The Court in Litchfield Park referred to the Commission decision, which reasoned that inclusion of the well would result in a violation of the matching principle. Id. The situation in Litchfield Park is very similar in this case. The new plant was not serving customers in the test year. The matching principle is violated if new plant is included. The Commission has ample justification to exclude BVWC post-test year plant and no case law requires otherwise.

Mr. Bourassa argues that the Commission must consider fair value at the time the rate is fixed. (See Rebuttal Testimony of Thomas Bourassa at 12; T.R. at 101). Mr. Bourassa equates the time the rate is fixed to the time of inquiry. Fair value is determined at the time of inquiry. See Simms v. Round Valley Light & Power Co., 80 Ariz. 145, 152, 294 P.2d 378, 382 (1956). But no case law exists that proscribes what the time of inquiry is. The problem here is that the Company has not proven its post-test year plant does not affect revenues or expenses, thereby not showing that it should be included. Staff has considered the addition, and for the litany of reasons outline above, had to disallow it.

The Arizona Supreme Court in Arizona Corp. Comm'n v. Arizona Water Co., which upheld the requirement of a fair value determination, sanctioned the use of a test period. 85 Ariz. 198, 200, 335 P.2d 412, 413 (1959). So long as no abuse occurs, how the Commission determines fair value is within its discretion. Id. at 202, 335 P.2d at 414. Furthermore, while the Commission must determine fair value, the Commission is not limited to using a particular formula to determine the fair value. See Arizona Corp. Comm'n v. Arizona Pub. Serv. Co., 113 Ariz. 368, 370, 555 P.2d 326, 328 (1976); Arizona Water Co., 85 Ariz. at 202, 335 P.2d at 414. The use of the historical test year concept has been upheld. Arizona Pub. Serv. Co., 113 Ariz. at 370, 555 P.2d at 328. Therefore, the Commission has broad power to consider how to formulate fair value on rate base and is not under any obligation to include post-test year plant that the Company suggests. In fact, as explained above, Staff has given ample justification why such inclusion is not appropriate.

Finally, Mr. Bourassa cites Arizona Cmty. Action Ass'n v. Arizona Corp. Comm'n, 123 Ariz. 228, 599 P.2d 184 (1979) to support his assertion that Staff's position is inconsistent with the Courts. All the Court did in that case was uphold the Commission decision based on the Commission's broad power to determine fair value. Id. at 230, 599 P.2d at 186. While, in that case, the Court may have upheld the Commission's decision to include construction work in progress ("CWIP"), the Court's have also upheld Commission's decisions *not* to include CWIP into rate base. See Consol. Water, 178 Ariz. at 482-83, 875 P.2d at 141-42; Litchfield Park, 178 Ariz. at 437, 874 P.2d at 994. There is no mandate to include CWIP or any post-test year plant into rate base, contrary to Mr. Bourassa's interpretation. Since the Commission has never had any legal obligation to include post-test year plant into rate base, Mr. Bourassa's reliance is misplaced.

Adding post-test year plant to rate base, in this case, would violate the matching principle. The Commission is under no obligation to include post-test year plant into rate base. Given the fact that the Company cannot quantify the impacts on revenues and expenses, the impacts cannot be known and measurable. Despite the Company's intent that post-test year plant is not designed to affect revenues, the impacts on revenues are still unknown. It is the Company's burden to show those impacts. The Company has failed to meet this burden. For those reasons, this Commission should not include post-test year plant into rate base.

## II. THE COMMISSION SHOULD DISALLOW CASH WORKING CAPITAL INTO RATE BASE.

The main question for the Commission on this issue is whether the Company has satisfied its burden to justify cash working capital ("CWC") solely based on its using the formula method, as opposed to using a lead-lag study. BVWC has argued for $143,846 in working capital and advocated the use of the formula method in its case. (See Rebuttal Testimony of Thomas Bourassa at 32-35).

The Company argues that a lead-lag study advocated by Staff is not required and that it would cost too much. (See Rebuttal Testimony of Thomas Bourassa at 34; T.R. at 261). However, Mr. Bourassa could never state that the study would be impossible for the Company to perform.

Staff witness Alexander Igwe testified that a lead-lag study is the more accurate method of determining the required cash flow because "it measures the timing of actual transactions and cash flow." (See Direct Testimony of Alexander Ibhade Igwe at 20). As Mr. Igwe stated that a cash working capital requirement could be positive or negative. (See Surrebuttal Testimony of Alexander Ibhade Igwe at 9). Mr. Bourassa agreed with that assessment. (T.R. at 261). Because of that fact, a lead lag study would be cost effective. (See Surrebuttal Testimony of Alexander Ibhade Igwe at 9).

The Company counters by arguing that Staff has presented no evidence to show that the cash working capital would be zero or negative and that Staff has not done any lead-lag studies itself. (See Rebuttal Testimony of Thomas Bourassa at 35). The Company's argument misplaces the burden. It is the Company's obligation to persuade this Commission of the need for a significant cash flow allowance of over $140,000. Staff has presented this Commission with the justification it needs to reject the Company's argument. Because the Company has not presented evidence to show what the actual CWC is and because the Company's argument is entirely dependent on a method that always provides a positive outcome even when actual CWC is negative, the Company has failed to meet its burden. It is for that reason, that the Commission can and should reject the Company's argument.

## III. THE COMMISSION SHOULD DISALLOW $37,490 OF THE $42,077 THE COMPANY IS ASKING FOR IN PROFESSIONAL FEES.

The Company is asking for $42,077 in professional fees as a result of $27,600 going toward an environmental review related to selling its operations and $9,890 going toward a due diligence review of its system relating to potential acquisition of three water companies. The environmental review was not related to providing water service. (See Direct Testimony of Alexander Ibhade Igwe at 32). The due diligence review was not the result of its normal cost of doing business. (See Direct Testimony of Alexander Ibhade Igwe at 33). The benefits of these services are for the shareholders of BVWC, not for the ratepayers. (See Surrebuttal Testimony of Alexander Ibhade Igwe at 11-12). While the Company attempts to argue that the expenditures were valuable in identifying potential problems, the fact remains that these services are not essential for normal and efficient operation and provide no direct benefit for the ratepayers. Had the Company not been seeking to sell operations or acquire other companies, the Company would have never had to engage in either study. Therefore, the Company did not pay to benefit ratepayers, but to benefit shareholders. Consequently, the Company should be denied $37,490 in professional fees.

## IV. THE COMMISSION SHOULD ADOPT STAFF'S RECOMMENDED RATE OF RETURN USING STAFF'S RECOMMENDED CAPITAL STRUCTURE, COST OF DEBT, AND COST OF EQUITY.

Staff is recommending an regulatory rate of return ("ROR") of 8.1 percent based on a cost of equity of 9.1 percent and a cost of debt of 5.94 percent, using the Company's current capital structure. The regulatory ROR is based on the widely held principles of maintaining financial integrity, attracting capital and equating earnings with firms of comparable risk. To determine ROR, an analysis of cost of capital must be performed. Cost of capital analysis is done by determining a Company's current capital structure, the contemporary cost of debt, and the expected return on equity ("ROE"). ROE is determined by analyzing cost of equity based on financial models to measure investor expectations. These criteria are all forward-looking (See Surrebuttal Testimony of Joel M. Reiker at 5).

BVWC is only entitled to a fair rate of return on the fair value of its property, no more and no less. <u>See</u> <u>Litchfield Park</u>, 178 Ariz. at 434, 874 P.2d at 991. The goal is to determine what is the appropriate rate of return. The Court's have upheld as reasonable the Commission's determination of ROR using a utility's capital structure, i.e. the amount of equity and debt, and the Commission has discretion to determine the appropriate capital structure. <u>Id</u>. at 435, 874 P.2d at 992. The Commission has recently supported Staff's cost of capital analysis and rejected the Company's mismatch argument in the recent Black Mountain Gas Company rate case. See Commission Decision No. 64727 at 14. The matching principle does not apply to cost of capital analysis because cost of capital is a financial analysis looking at investor's present and future expectations and is not an accounting analysis of looking at the inclusion of post-test year plant and whether the impact on revenues and expenses is known and measurable. Therefore, Staff's cost of capital analysis is reasonable and supported by the evidence as the most accurate and comprehensive determination of cost of equity, cost of debt, cost of capital and ROR.

## A. Staff's cost of capital analysis is based on sound financial principles and should be adopted by this Commission.

Staff's cost of capital analysis and determination of ROR is just and reasonable because it is based on sound financial principles. Mr. Reiker's analysis relies on mainstream corporate finance theory and principles. Staff's recommended capital structure is the accurate snapshot of BVWC's capital structure as it exists today and is expected to be on a going-forward basis. Staff's ROE analysis incorporates actual market returns and uses a variety of formulas accepted in the financial community into its ROE analysis. (See Surrebuttal Testimony of Joel M. Reiker at 1). These formulas are not just financial theories but are market-based models widely accepted in the financial community to estimate cost of equity. (See Direct Testimony of Joel M. Reiker at 8).

Cost of capital analysis is central to determining the fair rate of return. Cost of capital is a forward-looking financial analysis and as such should not be confused with the accounting concept of the matching principle. Cost of capital is dependent upon capital structure, cost of debt and return on equity ("ROE"). ROE is based on cost of equity analysis. Staff witness Joel Reiker used financial models that accurately reflect market conditions to determine cost of equity. Mr. Reiker's recommended capital structure most accurately reflects the Company's combination of debt and equity as it exists today. For these reasons, the Commission should adopt Staff's cost of capital recommendation.

### 1. Mr. Reiker's Capital Structure is the most accurate snapshot of the Company on a forward-looking basis.

As a result of Staff witness Joel Reiker's analysis of the Company, Staff recommends the following capital structure:

...

Table 1

| Capital Source | Percentage |
|---|---|
| Long-term Debt | 31.9% |
| Common Equity | 68.1% |
| | 100.00% |

(See Direct Testimony of Joel M. Reiker at 3).

Mr. Reiker's recommended capital structure is appropriate because it represents the most recent information available concerning Bella Vista's capital structure. Because cost of capital is a forward-looking analysis, and because financial decisions are based on the present and future, Mr. Reiker's recommended capital structure is appropriately forward-looking (See Surrebuttal Testimony of Joel M. Reiker at 4-5). The Commission must include the Water Infrastructure Finance Authority ("WIFA") loan into BVWC's capital structure in order to reflect the Company's actual capital structure on a forward-looking basis (See Direct Testimony of Joel M. Reiker at 3). Since the criteria to determining a fair rate of return is forward-looking, it defies logic to not use the contemporary capital structure when determining the rate of return for BVWC.

**2. Mr. Reiker's Cost of Debt is appropriate.**

Mr. Reiker recommends a 5.94 percent cost of debt. Mr. Reiker calculated his recommended cost of debt by adjusting test year interest expense to reflect the stated interest rate on each of the Company's eight loans, and dividing that amount (adjusted for interest income) by the principal amount of debt outstanding (See Direct Testimony of Joel M. Reiker at 4). Mr. Reiker's recommended cost of debt is the appropriate cost of debt because it is the best estimate of what the relevant embedded cost of debt will be going forward.

**3. Mr. Reiker's Cost of Equity is reasonable and should be adopted.**

Staff witness Joel Reiker used two finance models to estimate the Company's cost of equity. The first model is the Discounted Cash Flow ("DCF") model that estimates cost of equity based on the present value of future dividends and the current stock price (See Direct Testimony of Joel M. Reiker at 9). In his analysis, Mr. Reiker used both the constant-growth DCF analysis, as well as the multi-stage or non-constant growth DCF analysis. The second model is the Capital Asset Pricing Model ("CAPM") that calculates cost of capital by adding the risk-free interest rate to the market risk premium adjusted for the level of risk of the investment relative to the market. (See Direct Testimony of Joel M. Reiker at 19). Staff's determination of ROE, using the above methodologies, results in the most complete, accurate, and comprehensive analysis in this case.

Mr. Reiker recommends a ROE of 9.1 percent based on the results of his DCF and CAPM analyses. Mr. Reiker conducted his analyses using eight publicly traded water companies ("Sample Companies") followed by *The Value Line Investment Survey* ("Value Line"). For his constant-growth DCF analysis Mr. Reiker examined six indicators of expected infinite annual dividend growth: 5-year historical earnings per share ("EPS") growth, projected EPS growth, 5-year historical dividend ("DPS") growth, projected DPS growth, 5-year intrinsic growth, and projected intrinsic growth. (See Direct Testimony of Joel M. Reiker at 9-17). Mr. Reiker's constant-growth DCF estimate using an average of these six growth indicators was 9.1 percent (See Direct Testimony of Joel M. Reiker at 17). Mr. Reiker also conducted a multi-stage, or non-constant growth DCF estimate, which incorporated Value Line's projected dividends for the next five years, and the historical rate of growth in gross domestic product ("GDP"). (See Direct Testimony of Joel M. Reiker at 17-18). Mr. Reiker's multi-stage DCF estimate was 9.25 percent (See Direct Testimony of Joel M. Reiker at 18). Finally, Mr. Reiker also calculated CAPM cost of equity estimates using his sample companies. (See Direct Testimony of Joel M. Reiker at 19-22). Mr. Reiker's CAPM cost of equity estimates ranged from 9.4 percent to 9.5 percent (See Direct Testimony of Joel M. Reiker at 22).

The following table presents Mr. Reiker's DCF and CAPM cost of equity estimates:

...

**Table 2**

| Method | Estimate |
|---|---|
| Constant Growth DCF | 9.1% |
| Multi-Stage DCF | 9.3% |
| Historical MRP CAPM | 9.4% |
| Current MRP CAPM | 9.5% |
| **Average** | **9.3%** |

(See Direct Testimony of Joel M. Reiker at 23).

As a result his analysis, Mr. Reiker's "reasonable" range of cost of equity estimates for the sample companies is 9.1 percent to 9.5 percent.

Mr. Reiker then performed a mathematical adjustment straight from accepted standard corporate finance theory to estimate the effect that BVWC's capital structure has on its cost of equity. Capital structure affects cost of equity because a greater percentage of debt in the capital structure results in a greater level of financial risk (See Direct Testimony of Joel M. Reiker at 7). Therefore, a lower level of debt relative to the sample companies results in a lower cost of equity. BVWC's capital structure contains a significantly lower ratio of debt than the sample companies, which lowers BVWC's cost of equity. Therefore, BVWC's financial risk and cost of equity are lower than that of the sample companies. Mr. Reiker calculated the effect of BVWC's capital structure on its cost of equity and concluded that BVWC's adjusted cost of equity is somewhere in the range of 8.4 percent (See Direct Testimony of Joel M. Reiker at 25-27). Therefore, Mr. Reiker recommended a ROE at the lower end of his reasonable range of estimates: 9.1 percent.

**4. Mr. Reiker's Rate of Return**

Based on Mr. Reiker's cost of capital analysis, Staff recommends an overall ROR of 8.1 percent based on his cost of capital analysis, which is presented in the following table:

. . .

**Table 3**

| | Weight | Cost | Weighted Cost |
|---|---|---|---|
| Long-term Debt | 31.9% | 5.94% | 1.9% |
| Common Equity | 68.1% | 9.1% | 6.2% |
| **Cost of Capital/ROR** | | | **8.1%** |

(See Direct Testimony of Joel M. Reiker at 27).

## B. The Company's Requested ROR Should be Rejected

The Company's recommended ROR is based upon faulty assumptions that lead to an inaccurate picture of the actual conditions that exist with BWVC. Despite its assertions to the contrary, no mismatch exists between capital structure in cost of capital and rate based because cost of capital analysis is designed to measure present and future expectations. While the Company argues for inclusion of unique risks into cost of equity, such would fly in the face of established precepts on cost of equity. Mr. Kozoman's reliance on accounting returns gives a misleading picture as to the actual market returns and investor expectations. Finally, no evidence exists that the Company's financial integrity would be compromised if Staff's recommendations were adopted.

### 1. The Company's Position on Capital Structure is Incorrect

The Company argues that Staff's inclusion of a $2.1 million WIFA loan results in a mismatch because the associated plant has been excluded from rate base. (See Rebuttal Testimony of Ronald L. Kozoman at 11). The Company contends that either the WIFA loan should be removed from the capital structure, or the plant should be included in rate base. (T.R. at 326-27). However, capital structure is a forward-looking financial analysis, because investors make financial decisions based on present and future conditions. (See Surrebuttal Testimony of Joel M. Reiker at 4). If a company's test year capital structure is significantly different than its actual going-forward capital structure, then it should not be used to calculate the company's cost of capital on a going forward basis regardless of the rate base determination. Id. The cost of equity should be estimated on a going-forward basis, the cost of debt should be the reliable and relevant cost of debt on a going-forward basis, and the capital structure must follow the two, i.e. on a going-forward basis regardless of rate base exclusions (See Surrebuttal Testimony of Joel M. Reiker at 4-5). Company witness Ron Kozoman acknowledged that the appropriate capital structure to use is the capital structure as it now stands or as it will stand in the not too distant future (T.R. at 326, 329). Despite Mr. Kozoman's contention that Staff's analysis results in a mismatch, no evidence was presented to support his assertion that cost of capital must be matched with rate base. The concept of matching rate base with revenues and expenses, an accounting principle, is different from cost of capital analysis, which is a forward-looking financial analysis. Because of this fundamental difference, no mismatch exists in Staff's analysis and the Company's assertion should be rebuffed.

**2. The Company's cost of equity should not be increased because of any unique risks facing it.**

The Company argues that it has an increased cost of equity due to several unsystematic risks that it faces. Unsystematic or "unique" risks are those risks particular to an individual company or investment project. The Company argues that because of these unique risks the Commission should add "basis points" to the Company's cost of equity on top of the DCF and CAPM results. The Commission should not adopt these arguments, because Staff's DCF and CAPM analyses do involve real-world analysis and because unsystematic risk is not part of market risk and is something that can be easily avoided. Finally, much of what the Company perceives as risks unique to it are really risks that all water companies face and have already been reflected in the DCF and CAPM analyses by Staff. To adopt the Company's position would be to accept a position replete with several misconceptions over the subject of finance.

Ms. Gignac argues that reliance on "financial theories" such as the DCF and CAPM models do not reflect the realities of doing business in Arizona as a private water company. (See Rebuttal Testimony of Judith A. Gignac at 17). But Ms. Gignac acknowledges that Staff's analysis involved the use of actual market figures. (T.R. at 53). In addition, Mr. Reiker testified extensively as to how he incorporated actual market analyses from Value Line when determining ROE, using stock prices and other market date. (See Direct Testimony of Joel M. Reiker at 9-22). The bottom line is that by incorporating market figures into the analysis, Staff has accurately reflected in its analysis the kinds of risks that companies in the water service industry are currently facing in the real world, as defined by the capital markets.

The Company also tries to rebut Staff's analysis by arguing that the Company should be given a high cost of equity due to increased unsystematic risks the Company is facing. As Mr. Reiker testified to in this case, unsystematic risk is eliminated through portfolio diversification, and investors who choose to be less than fully diversified will not be compensated by the market for this type of risk (See Direct Testimony of Joel M. Reiker at 6). This idea also ties into the concept of Modern Portfolio Theory ("MPT"), which is the concept that investors are not rewarded for unsystematic risks because they diversify them away by holding portfolios. (See Direct Testimony of Joel M. Reiker at 40). MPT is a concept widely accepted that earned its developers the Nobel Prize in Economic Sciences in 1990. Id. Based on the established credibility of MPT, it is wholly reasonable for the Commission to reject the idea of incorporating unique risk, despite the Company's pleas to the contrary. The Company has presented no evidence to rebut the use of MPT and its argument should be rebuffed.

The Company argues, through the testimonies of Ms. Gignac and Mr. Kozoman, that the Company has a higher cost of equity due to its size and the special circumstances facing the Company. (See Rejoinder Testimony of Judith A. Gignac at 7-8; see also Rejoinder Testimony of Ronald L. Kozoman at 26-27). This is the same argument as the unique risk argument and the Company's ignorance of MPT is evident in its continued assertion that the ROE should reward BVWC's shareholders for these unsystematic risks. As Mr. Reiker testified to, unsystematic risk is not part of market risk because it is risk that can be avoided. (See Direct Testimony of Joel M. Reiker at 6). Financial risk and business risk are part of market risk because they are risks that are unavoidable. (See Direct Testimony of Joel M. Reiker at 7). Business risk has to do with risks inherent in a particular industry while financial risk relates to the dependence on debt financing. Id. Even if the shareholders of Bella Vista *were* less than diversified, they would not be rewarded for unsystematic risk (See Surrebuttal Testimony of Joel M. Reiker at 7).

The Company argues that its small size leads to additional risk. However, the Company's argument consciously ignores evidence provided by Staff and previously recognized by the

Commission, which indicates that due to the regulated financial structure of utilities and the exclusive right to provide service to a particular area, the "firm size phenomenon" does not exist in this industry (See Direct Testimony of Joel M. Reiker at 42-43). Firm size has no relevance to cost of equity analysis and should not be accepted.

Finally, the Company ignores the fact that many of the risks it cites as unique are common throughout the water industry. All water companies are dependent upon certain consumers and certain industries. While Fort Huachuca may be of particular concern to BVWC, other water companies are equally dependent on large industrial users and the local economy in their service area. All water companies, whether in the desert, or in other parts of the nation with significantly more rainfall, face the mounting concern of drought and have to deal with environmental issues and conservation. Therefore, it can be argued that the vast majority, if not all, the risks cited by Mr. Kozoman and Ms. Gignac as unique are actually business risks or risks inherent in the business. Therefore, Staff's use of market figures in determining the DCF and CAPM models already take into account many of the risks facing BVWC. For all of the above reasons, the Commission should reject the incorporation of unique risk into the cost of equity tabulation.

**3. The Company's Reliance on Accounting Returns to Infer Market Returns is Incorrect.**

In arriving at his ROE recommendation, Mr. Kozoman also used the DCF and CAPM analyses. The results of his DCF and CAPM analyses averaged 7.51 percent. Then, in order to "match what the nationally traded companies were earning", he first added over 400 basis points to his DCF and CAPM estimates to arrive at his ROE recommendation of 12.00 percent, for an ROR of 10.75 percent. (See Direct Testimony of Ronald L. Kozoman at 3; T.R. at 333-34). The "nationally traded" water companies followed by Value Line have not earned equity returns of 12.00 percent in years. Mr. Kozoman later adjusted his ROE recommendation down to 10.50 percent for an ROR of 9.50 percent (See Rejoinder Testimony of Ronald L. Kozoman at 5).

In truth, the "nationally traded" water companies followed by Value Line earned an average 9.9 percent *accounting* return on equity in 2000, and were projected to record earnings of 10.0 percent on book equity in 2001 (See Direct Testimony of Ronald L. Kozoman, Schedule D-4.3). But what is troubling about Mr. Kozoman's maneuver is that he is referring to book, or *accounting* returns, not *market* returns. The book, or accounting return, is simply what these companies' accounting firms reported as earnings as a percentage of book equity (See Direct Testimony of Joel M. Reiker at 38). The market return (using the DCF and CAPM models) is the far more accurate gauge of investor expectations because the shareholder is not directly interested in the ratio of book earnings to book equity. Rather, the investor is interested in anticipated dividends and capital gains relative to the price the investor has to pay (See Surrebuttal Testimony of Joel M. Reiker at 9). At the hearing Mr. Kozoman was presented with the May 3, 2002, edition of Value Line, which reported its projected average annual *market* return (price appreciation plus dividend income) for 2005-2007 for American States Water, American Water Works, California Water Company, and Philadelphia Suburban, the four sample water companies used by Staff to determine cost of equity. Those projections, as read into the record by Mr. Kozoman, were as follows:

**Table 4**

| | **High** | **Low** | **Average** |
|---|---|---|---|
| American States Water | 8.0% | -1.0% | 3.5% |
| American Water Works | 3.0% | Nil | 1.5% |
| California Water Co. | 11.0% | 4.0% | 7.5% |
| Philadelphia Suburban | 12.0% | 3.0% | 7.5% |
| **Average** | | | **5.0%** |

(See T.R. at 340-44; see also Exhibit S-10).

As shown in the above table, Value Line is projecting a *5.0%* average annual *market* return three to five years out. To rely on accounting returns would be especially troubling in light of the recent publicity in the financial community surrounding the accounting practices and reported earnings of publicly traded companies (See Surrebuttal Testimony of Joel M. Reiker at 9). Therefore, the Commission should rely on market-based models and not on accounting returns, to determine the appropriate cost of equity in this case.

**4. The Company's Testimony on Financial Integrity is Incorrect.**

In his direct testimony Mr. Reiker calculated a pre-tax interest coverage ratio of 6.4 based on his recommended ROR (See Direct Testimony of Joel M. Reiker at Schedule JMR-9). In his surrebuttal testimony Mr. Reiker again tested the financial integrity of his ROR recommendation by calculating a times interest earned ratio ("TIER") and debt service coverage ("DSC") ratio based on Staff's overall recommended rates. This analysis resulted in a TIER and DSC of 6.31 and 3.46, respectively. (See Surrebuttal Testimony of Joel M. Reiker at 11). Despite Mr. Kozoman's assertion to the contrary, Staff did appropriately determine DSC and TIER. Staff's analysis is in accordance with past Commission practice. (T.R. at 347-48; Exhibit S-8 [Commission Decision No. 62450]). Mr. Kozoman did not even rely upon WIFA's policy manual when determining DSC (T.R. at 350). During cross-examination by Staff and the Administrative Law Judge ("ALJ") during the hearing, Mr. Kozoman claimed that staff did not use the proper amount of interest related to the $2.1 million WIFA loan (T.R. at 349, 356). In truth, Mr. Reiker used Staff's synchronized interest amount, and the actual amount of principal repaid during the test year (See Surrebuttal Testimony of Joel M. Reiker at 11, Schedule JMR-S1). Mr. Kozoman failed to calculate DSC based on his determination of what he thought was the correct interest amount, without explanation. (T.R. at 356). With a calculated TIER and DSC of 6.31 and 3.46, respectively, Mr. Kozoman could have *quadrupled* the amount of interest expense included in Mr. Reiker's calculation and still have arrived at a TIER above 1.5. At the same time Mr. Kozoman could have *doubled* the amount of principal included in Mr. Reiker's calculation and still have arrived at a DSC ratio above 1.20. Even using all of Mr. Kozoman's theories, the DSC calculation came out to 2.12, well above the 1.2 requirement for a WIFA loan. (See Rebuttal Testimony of Ronald L. Kozoman at 34; T.R. at 349-50). With the Company's present rates, they would still be able to service the debt (See Exhibit RUCO-6 at 2; T.R. at 51-52, 344-45). Financial integrity has not been an issue with the Company and will not be with Staff's recommended rates.

**5. Mr. Kozoman's testimony is incorrect with regard to Staff's analysis.**

Mr. Kozoman makes several inaccurate comments regarding Staff's analysis. Mr. Kozoman accuses Staff of trying to drive the market-to-book ratio for utility stocks down to one (See Rebuttal Testimony of Ronald L. Kozoman at 10). Mr. Kozoman's assertion is without any shred of merit. Mr. Reiker's explained that when a regulator awards a utility a return on its assets equal to its cost of capital, the market will price that utility's stock at book value. (See Direct Testimony of Joel M. Reiker at 15). But Mr. Reiker also takes into account the fact that there are several reasons for the market to expect a company to earn returns higher than its cost of capital, thus driving the market price of its stock above book value. Id. Mr. Reiker accounted for the fact that the average market-to-book ratio of the sample companies is above 1.0 by including the *vs* component. (See Direct Testimony of Joel M. Reiker at 13-16). In fact, to the extent that investors expect the market-to-book ratio of the sample companies to equal one as opposed to greater than one in the future, Mr. Reiker's dividend growth estimate is generous to BVWC (See Direct Testimony of Joel M. Reiker at 15). Mr. Kozoman's assertion on this point has no substance.

Mr. Kozoman's reliance on Simms is also misplaced. Simms states that the Commission must find fair value to determine just and reasonable rates. 80 Ariz. at 151, 294 P.2d at 382. The Simms case is referring to finding the fair value of a company's property, i.e. finding the rate base of the Company. However, no case law precludes the Commission from using cost of equity analysis to determine an appropriate return on that rate base. As discussed above, Staff's analysis incorporates market expectations and the appropriate measures of risk to determine what is the appropriate return on the rate base. Staff's analysis uses comprehensive financial models accepted in the financial community as appropriate for determining cost of equity to determine ROE and ROR. For all of the above reasons, the Commission can and should adopt Staff's ROR recommendation as reasonable and appropriate for BVWC.

## V. CONCLUSION

The main concern for Staff in this case is not the legality of any of the rates proposed by any of the parties in this case. However, the fact that all the proposed rates might be legal does not mean that the Company's rates do not violate fundamental principles of accounting and finance. As shown throughout the hearings, the Company's advocacy of inclusion of post-test year plant into rate base violates the fundamental accounting principle of matching pro forma adjustments to rate base with revenues and expenses. As shown, the impacts of inclusion of post-test year plant in this case are not known and measurable, despite the Company's intentions. The Company's cost of capital analysis violates several precepts of corporate finance theory to produce an artificially inflated recommendation. Staff's analysis adheres to the proper principles to rightly exclude post-test year plant and to accurately determine a fair ROR for the Company. Staff's analysis shows that the customers of BVWC need not pay a penny more for their service and should pay less for service without detriment to the Company's financial integrity. Staff's recommendations are reasonable, legal and accurately determined. For all of the above reasons, the Commission should adopt Staff's recommendations.

RESPECTFULLY SUBMITTED this 9th day of September, 2002.

Jason D. Gellman
Attorney, Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007
(602) 542-3402

The original and fifteen (15) copies
of the foregoing was filed this
9th day of September, 2002, with:

Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

COPIES of the foregoing
Hand-delivered and mailed
this 9th day of September, 2002, to:

Lyn Farmer, Chief Hearing Officer
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Christopher Kempley, Chief Counsel
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85008

Ernest Johnson, Director
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

William P. Sullivan, Esq.
Martinez & Curtis, P.C.
2712 North 7th Street
Phoenix, Arizona 85006-1090

Daniel W. Pozefsky, Esq.
Residential Utility Consumer Office
1110 West Washington Street, Suite 220
Phoenix, Arizona 85007

Angela L. Bennett

Angela L. Bennett