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IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS SUN CITY WEST WATER AND WASTE WATER DISTRICTS.

DOCKET NO.
WS-01303A-02-0867

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS SUN CITY WATER AND WASTE WATER DISTRICTS.

DOCKET NO.
W-01303A-02-0868

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS MOHAVE WATER DISTRICT AND ITS HAVASU WATER DISTRICT.

DOCKET NO.
W-01303A-02-0869

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS ANTHEM WATER DISTRICT, ITS AGUA FRIA WATER DISTRICT AND ITS ANTHEM/ AGUA FRIA WASTE WATER DISTRICT.

DOCKET NO.
WS-01303A-02-0870

IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY, INC.,
AN ARIZONA CORPORATION, FOR A
DETERMINATION OF THE CURRENT FAIR
VALUE OF ITS UTILITY PLANT AND PROPERTY
AND FOR INCREASES IN ITS RATES AND
CHARGES BASED THEREON FOR UTILITY
SERVICE BY ITS ANTHEM WATER DISTRICT, ITS
AGUA FRIA WATER DISTRICT AND ITS
ANTHEM/ AGUA FRIA WASTE WATER
DISTRICT.

DOCKET NO.
W. 01303A-02-0908

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AUIA'S OPENING BRIEF

Pursuant to the instructions of the Administrative Law Judge at the close of hearing, December 23, 2003, the ARIZONA UTILITY INVESTORS ASSOCIATION (AUIA) hereby submits its opening brief in the above captioned matter.

Introduction

Although the parties to a rate case may differ over permissible expenses and many other issues, the dominant factor in determining Arizona-American Water Company's revenue requirement is the application of a Commission-authorized rate of return to an approved rate base.

The record in this case demonstrates conclusively that the ratemaking process pursued by the Commission Staff¹ and the Residential Utility Consumers Office (RUCO) severely stacks the financial cards against the Applicant. If supported by the Commission, the Staff approach virtually decrees an inequitable result.

The inequity begins with the historic test year. Unlike jurisdictions which allow a forward test year, the data used in Arizona will be, on average, at two years old when new rates are put into effect. In this case, the average test year data will be approximately three years old.

¹AUIA does not intend to ignore the testimony of the Residential Utility Consumers Organization in this proceeding. However, with the exception of marginal differences in recommended rate of return, RUCO's positions on the issues raised in this brief are undifferentiated from Staff's. Therefore, the Commission may assume that AUIA's arguments apply to RUCO as well as Staff.

1 Next, the Staff insists on a rate base calculation, based on original cost less
2 depreciation (OCLD), that is also mired in the past and bears no relationship to the
3 actual value of the utility's property. Still worse, the Staff approach makes a
4 mockery of the constitutionally mandated concept of fair value.

5 Finally, the Staff's view of determining the rate of return is essentially, "It's
6 our way or the highway." The Staff's formulas for calculating cost of equity (COE)
7 are inflexible and backward looking, producing low-ball recommendations
8 compared with market realities.

9 In summary, the Staff approach looks to the past in every respect. Clearly,
10 this strategy is destined to provide minimum rate relief and to apply maximum
11 financial pressure on the Applicant. The resulting recommendations, if adopted by
12 the Commission, will expose the company to a real danger of experiencing higher
13 costs than its revenues can support.

14 Legal Foundation

15 AUIA proposes to set out the legal basis for its arguments early in this brief
16 so that subsequent references and citations can be minimized.

17 With regard to rate base considerations, we hold with the judgment of the
18 Arizona Supreme Court in *Simms v. Round Valley*, in which the Court declared that
19 the Commission is required to consider the value of a utility's property "at the time
20 of the inquiry," based on the Arizona Constitution. 80 Ariz. 145, 151, 294 P2nd 378,
21 382 (1956). In other words, the utility's rate base should reflect the current value of
22 its property devoted to public service, at market, not historic or book cost.

23 We believe that the United States Supreme Court has established clearly the
24 appropriate basis for rate-of-return regulation of monopoly utilities. In setting rates
25 for utility service, the Commission must allow a utility, in addition to recovering its
26 operating expenses, taxes and depreciation, an opportunity to earn a return that is
27 equal to returns that are being earned on investments in other businesses that have
28 corresponding risks.

29 This is known as the comparable earnings standard and it has been in effect
30 for decades. For example, in the *Bluefield Waterworks* case, decided in 1923, the
31 United States Supreme Court stated: "A public utility is entitled to such rates as will
32 permit it to earn a return . . . equal to that generally being made at the same time and
33 in the same general part of the country on investments and other business

1 undertakings which are attended by corresponding risks and uncertainties . . .”
2 *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia*,
3 262 U.S. 679, 692 (1923).

4 In another significant decision, *Hope Natural Gas*, the United States Supreme
5 Court re-emphasized the rate of return principles stated in *Bluefield Waterworks*:
6 “The return to the equity owner should be commensurate with returns on
7 investments in other enterprises having corresponding risks.” *Federal Power*
8 *Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944)

9 Finally, Arizona court annals are replete with decisions requiring the use of
10 fair value determinations, as specified in Article XV, Section 14 of the Arizona
11 Constitution. Last week, the Arizona Court of Appeals dealt with the issue in a
12 decision that disemboweled the Commission’s electric competition rules. In *Phelps*
13 *Dodge Corp., et al v. Grand Canyon Electric Cooperative, et al*, the court acknowledged
14 that, “The Commission has broad discretion in determining the weight to be given
15 the fair value factor in any particular case, but may not simply ignore it.” (emphasis
16 added)²

17 That is exactly what the Staff and RUCO are guilty of in their approach to fair
18 value in this case. And, as we will demonstrate, their methods of dealing with rate
19 base and rate of return are directly and purposely contrary to the dictates of the
20 highest courts in Arizona and the United States.

21 Rate Base Calculations

22 The company initially proposed that its fair value rate base should be
23 approximately \$149 million, based on a study of reproduction cost new less
24 depreciation (RCND). Ultimately, the company reduced its RCND rate base
25 calculation to \$136.2 million in response to Staff concerns.³ As support for an RCND
26 rate base, the company cited the purchase of the property from Citizens
27 Communications at a price of \$276.5 million, which included an acquisition
28 premium of \$71 million above book value.⁴

² See *Phelps Dodge, et al v. Grand Canyon Electric Cooperative*, 1 CA-CV 01-0068, Court of Appeals Div. One, Opinion filed Jan. 27, 2004, ¶152, P. 82

³ See Exh. A-24, Sched. 2

⁴ See Exh. A-65, P. 10, L. 16-18

1 Although there was some early confusion on this point, Arizona-American's
2 witnesses clarified that the company was not attempting to recover the acquisition
3 premium in this rate case under any rate base proposal.⁵

4 The rationale for employing the RCND rate base also is supported by the
5 *Simms* decision cited previously. While it could be argued that the sale price of the
6 property in an arms length transaction represents its actual value, both Arizona-
7 American and AUJA agree that RCND is an acceptable proxy for the value of the
8 property "at the time of the inquiry."

9 Staff's lead witness, Darron Carlson, objected to the exclusive use of an
10 RCND rate base and proposed, instead, a rate base calculation of \$91.7 million based
11 on original cost less depreciation (OCLD).⁶

12 We contend that OCLD has nothing to do with the actual value of the
13 company's property. As we saw during California's divestiture, mandated by
14 electric deregulation in 1998, virtually all generation assets were sold at multiples of
15 book value. This demonstrated that book value is an accounting fiction that is
16 unrelated to real value and is not responsive to the requirements of *Simms*.

17 In fact, Staff did perform an RCND analysis, which closely approximated the
18 company's result,⁷ and the company's OCLD calculation was similar to Staff's with
19 the exclusion of the acquisition premium.⁸

20 **Fair Value Considerations**

21 According to Mr. Carlson, Staff used its RCND analysis to calculate a "fair
22 value rate base" for Arizona-American. This was done by averaging the RCND and
23 OCLD findings, resulting in a fair value of \$113.6 million.⁹ But Mr. Carlson also
24 testified that Staff calculated the company's revenue requirement by multiplying the
25 Staff's recommended rate of return (discussed below) by the OCLD rate base.¹⁰

26 What happened to fair value? Why bother to calculate it?

⁵ See Exh. A-65, P. 22, L. 11-25

⁶ See Exh. S-48, P. 16, L. 16-18

⁷ See Exh. S-48, P. 17, L. 16-19

⁸ See Exh. S-47, P. 8, L. 8-9

⁹ See Exh. S-48, P. 17, L. 16-19

¹⁰ See Exh. S-47, P. 7, L. 6-9

1 It turns out that something called the "fair value rate of return" which is
2 undefined, is brought into play with the "fair value rate base."¹¹ In other words, if
3 the rate base calculation moves upward from OCLD, then Staff simply alters the rate
4 of return to produce the same revenue requirement calculated with the OCLD.¹²
5 This was described at hearing as the "backing in" method of determining the rate
6 base and revenue requirement.¹³

7 The testimony also demonstrated clearly that the Staff's cost of capital
8 witness, Joel Reiker, developed only one rate of return recommendation, which is
9 independent of rate base calculations.¹⁴ So, how does Staff justify changing a rate of
10 return recommendation that is allegedly based on elaborate technical analysis in
11 order to match a preconceived revenue requirement?

12 The Staff has no justification. It's just the way they choose to do it. RUCO
13 supports this methodology enthusiastically, in spite of being the Great Defender of
14 fair value in legal proceedings against this Commission.

15 Clearly, the Staff's entire approach to fair value is a sham and a deceit. There
16 is no kinder face to put on it. It is a cynical and purposeful evasion of the
17 requirements of the Arizona Constitution and the dicta of the Arizona Supreme
18 Court in *Simms* and the Court of Appeals in *Phelps Dodge*.

19 The Commission should not consent to be a party to this deceit and should
20 insist instead on a true finding of fair value that more closely reflects the actual
21 value of the company's property at the time of this inquiry. The company's trended
22 RCND rate base is a valid starting point.

23 Rate of Return

24 We referred earlier to the independence of Mr. Reiker's rate of return
25 recommendation and to the elaborate analysis involved in his conclusions. The
26 reality is that Mr. Reiker's analyses are also focused on the past and they are
27 completely inflexible.

28 In other words, Mr. Reiker's attitude is, "It's my way or the highway," and he
29 accepts no adjustments to his formulas.

¹¹Ibid.

¹²Ibid.

¹³ See Tr., P. 1501, L. 19 - P. 1502, L. 24; see also, Exh. A 75, P.20, L. 17-20.

¹⁴ See Tr., P. 1498, L 16-24

1 In his attempt to estimate the company's cost of equity (COE), Mr. Reiker
2 developed two discounted cash flow (DCF) models (constant growth and multi-
3 stage) and a capital asset pricing model (CAPM) which he applied to sample groups
4 of water and gas utilities. Although he personally favors the CAPM analysis, he
5 averaged the DCF and CAPM findings to arrive at a COE recommendation.¹⁵

6 COE is what matters in the rate of return equation since the company's
7 capital structure and its weighted cost of debt are largely agreed upon.

8 By averaging the results of his DCF analysis, 9.0%, and his CAPM model,
9 \$8.1%, Mr. Reiker arrived at a cost of equity of 8.5%. He then added a risk premium
10 of 50 basis points to account for the company's highly leveraged financial position,
11 resulting in a final COE recommendation of 9.0%.¹⁶

12 Between his direct and surrebuttal testimony, Mr. Reiker found reason to
13 reduce his COE recommendation by 70 basis points, which effectively slashed Staff's
14 proposed revenue increase by 27%.¹⁷

15 In contrast, the company's cost of capital witness, Dr. Thomas Zepp,
16 produced these results in his analysis: DCF model, a range of 10.5% to 11.0%; risk
17 premium analysis, a range of 10.8% to 11.7%; estimated COE, a range from 10.5% to
18 11.7%.

19 At the low end of Dr. Zepp's range, the difference between his COE estimate
20 and Mr. Reiker's recommendation is 150 basis points. If we insert that difference in
21 the rate of return applied to the OCLD rate base, the difference in the revenue
22 requirement is \$900,000 after taxes. At the midpoint of Dr. Zepp's range, 11.1%, the
23 difference in the revenue requirement rises to \$1.4 million after taxes.

24 This compares to the measly after-tax revenue increase of \$346,647 that
25 results from the Staff's calculations.¹⁸ This tells us that if Dr. Zepp is right and Staff
26 is wrong, Arizona-American will be living on the edge of a financial precipice. In
27 fact, the Applicant's lead witness, David Stephenson, testified that the Staff
28 recommendation would enable the company to support debt but make no profit.¹⁹

¹⁵ See Exh. S-46, P. 2, L. 6-17

¹⁶ Ibid.

¹⁷ See Exh. S-48, P. 18, L. 18-19

¹⁸ See Exh. S-48, P. 18, L. 15-18

¹⁹ See Exh. A-74, P. 32, L. 2-7

1 Two philosophical differences separate Dr. Zepp and Mr. Reiker. First, Dr.
2 Zepp believes that a utility's authorized rate of return should reflect the comparable
3 risk principle enunciated by the U.S. Supreme Court in the *Bluefield* and *Hope* cases
4 cited earlier.²⁰ Thus, Dr. Zepp supports a market-based rate of return²¹ and looks to
5 real world examples to guide his analysis, while Mr. Reiker prefers a textbook
6 approach dependent on historical data.

7 For example, we noted earlier that Mr. Reiker perused the performance of a
8 group of sample water companies as a part of his DCF analysis. However, when Dr.
9 Zepp examined a 7-year history of those companies, here is what he found:²²

10 • The average authorized return on equity (ROE) for those companies was
11 10.93%, or 193 basis points above Mr. Reiker's recommended ROE for Arizona-
12 American.

13 • The actual ROE earned by those companies was 10.35%, or 135 basis points
14 above Mr. Reiker's recommended ROE.

15 • The average ROE forecasted by *Value Line* for those companies was 11.0%,
16 or 200 basis points above Mr. Reiker's recommended ROE.

17 Another difference in philosophy arises from Dr. Zepp's belief that the
18 assumptions underlying an authorized ROE should reflect, as closely as possible, the
19 conditions that will prevail in the financial markets at the time rates are in effect.
20 Mr. Reiker distrusts forecasts and seems to believe that investors will rely primarily
21 on past performance for guidance and will also forsake predictive data.²³

22 Thus, for example, Dr. Zepp would factor interest rate forecasts into his
23 analysis while Mr. Reiker utilizes current rates,²⁴ even though, by his own estimate,
24 current rates are lower they have been "in decades."²⁵

25 Regardless of how precise the formulas for determining COE seem to be, they
26 are full of subjective decision points. Regardless of how they are portrayed by the
27 proponents, there is nothing about these formulas that precludes some flexibility, to
28 account for actual and forecasted market conditions.

²⁰ See Exh. A-45, P. 12, L. 2-6

²¹ See Exh. A-45, P. 9, L. 22 - P. 11, L. 23

²² See Exh. A-49, Tab B, Table 1

²³ See Exh. S-45, P. 39, L. 17 - P. 44, L. 19

²⁴ See Exh. S-46, P. 17, L. 1-7

²⁵ See Exh. S-46, P. 6, L. 1-3

1 During cross-examination, Mr. Reiker was questioned about 15 separate
2 conclusions, assumptions or decision points on which he differed with Dr. Zepp in
3 determining Arizona-American's COE.²⁶ While he remained rigid in defending his
4 DCF and CAPM formulas, Mr. Reiker could not deny that all of his decisions led
5 inexorably to a lower rate of return for the Applicant.²⁷

6 **Conclusion**

7 The evidence in this case demonstrates clearly the fundamental unfairness of
8 the rate-setting procedure promoted by the Commission Staff and RUCO. The
9 combination of the historic test year, the use of the OCLD rate base and the
10 application of a low-balled cost of equity virtually ensure that the Applicant will
11 confront the future with a rate structure that is mired in the past.

12 The Staff's rate-of-return recommendation and the resulting revenue
13 requirement are confiscatory and inadequate for a utility that must serve a growing
14 customer base.

15 In this case, we have before us a recent sale of the company's property that
16 shows clearly that the OCLD rate base has no relationship to present value, as
17 required by the Arizona Supreme Court in *Simms*, and it is, therefore, inappropriate.
18 The Applicant has not proposed that the purchase price should equal its fair value
19 rate base, but it provides strong support for constructing an RCND rate base.

20 Staff simply laughs at the law in its deceitful response to the fair value
21 requirements of the Arizona Constitution. The evidence here shows that any fair
22 value calculation is meaningless because the Staff will simply manipulate the
23 recommended rate of return to produce the same revenue requirement that is
24 derived from the lowest rate base calculation.

25 Finally, the Staff's methodology in determining cost of equity is obviously
26 biased toward producing the lowest possible result, regardless of clear evidence that
27 returns experienced elsewhere in the water industry are markedly higher. Staff's
28 COE recommendation of 9.0% is not only inadequate, but it flies in the face of the
29 comparable risk dictum articulated by the U.S. Supreme Court in *Bluefield* and *Hope*.

30 Although Staff's cost of capital expert is rigid in defending the integrity of his

²⁶ Tr., P. 1423, L.1 -P. 1430, L. 21

²⁷ Tr., P. 1430, L. 1-L.21

1 models, they are filled with subjective assumptions and the evidence shows that his
2 choices are consistently biased toward a low COE recommendation.

3 The Commission is obligated to authorize rates that are fair to consumers but
4 will also give the Applicant an opportunity to earn a reasonable rate of return on the
5 value of its property when rates are in effect. With that objective in mind, AUJA
6 urges the Commission to examine carefully the arguments put forward on both
7 sides.

8 We are not naive. We do not expect the Commission to accept fully and
9 without reservation the claims of the company or AUJA. However, we suggest that
10 this case cries out for balance in the treatment of rate base, fair value and rate of
11 return and the Commission has the ability to strike a fair balance.

12

13 Respectfully submitted, this 4th day of February, 2004.

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Walter W. Meek, President

1 **CERTIFICATE OF SERVICE**

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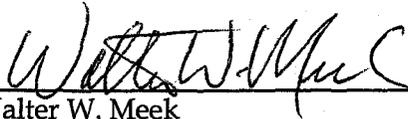
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