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2007 JAN 29 P 3: 43

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IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, 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 AND WASTEWATER DISTRICTS

DOCKET NO. WS-01303A-06-0014

STAFF'S REPLY BRIEF

Arizona Corporation Commission
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I. INTRODUCTION

Staff has reviewed the closing briefs in the above-captioned matter by Arizona-American Water Company ("Company") and the Residential Utility Consumer Office ("RUCO") filed on January 10, 2007. Staff continues to rely on the arguments set forth in its Closing Brief. However, Staff feels it is necessary to respond to issues raised by the Company's Initial Post Hearing Brief.

II. DISCUSSION

A. Deferred Tax Issue

This issue revolves around the Company's effort in its application to recover a portion of the acquisition premium paid to Citizens Utilities Company for its Arizona operations. Although the Company later withdrew the application's request to recover this premium, its accounting treatment failed to achieve its stated goal of returning the application to what it would have been had the acquisition premium never been paid. Toward that stated purpose, the Company claimed it was going to remove decreases to its deferred tax liability that it had made in its original filing for both the Mohave Water and Wastewater District. As Staff testified at the hearing, it believes that the

Company's original application reflected the correct accounting treatment for deferred tax liability and that the Company's proposed decreases were incorrect accounting. Staff's position therefore reduced the deferred tax liability as reflected in its final schedules. (Staff's final schedules, JRM-3, JRM-25.)

A deferred tax liability adjustment to rate base reflects a deferral in tax expense that the Company does not have to pay at that time. It therefore reduces rate base, whereas a deferred tax asset increases rate base. The Company's final position on this issue was that the deferred taxes represent an asset. Staff testified that the Company's proposed adjustment would increase rate base for Mohave Water District by $918,738 and Mohave Wastewater District by $56,765. (Moe Surrebuttal at 7.)

Far from being innocuous, as the Company's opening brief suggests (AZ-AM Br. at 9-10), the Company's proposed adjustment will increase rate base significantly on the premise of an acquisition premium that it states is impaired. Neither the acquisition premium nor this impairment have ever been recognized by the Commission and the sole authority for taking this step is the demand that the Company do so by its outside accountants. (*See* Tr. at 85 (write off was at Company auditors' direction, not due to a factual recognition by the Commission).) As Staff witness Carlson testified, the Commission has never approved an acquisition adjustment or a goodwill impairment adjustment. Therefore any Company accounting treatment for deferred tax liability/asset based upon unapproved accounting treatment for acquisition and goodwill impairment needs to be removed from the case. Staff's final schedules show the appropriate accounting. (Tr. at 385-87.)

The Company's proposed adjustment to deferred tax liability first provided in Exhibit A-12 was both untimely and failed to surmount Staff's reasons opposing the proposed accounting. As Staff witness Moe explained, "[i]t is inappropriate to use the impairment of an unauthorized non-regulatory account balance resulting in a one-time financial statement adjustment as a means of increasing regulatory rate base, regardless of the marginal benefits, if any, that may have occurred." (Moe Surrebuttal at 7.) Likewise it would be inappropriate, if the goal is to return the deferred

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taxes back to the position they would be if the acquisition premium did not exist, to allow the 'nonexistent' premium increase rate base despite its exclusion.

B. Cost of Equity Issues

1. Staff's Final Post Hearing Schedules Memorialize Changes Explained in Hearing.

As an initial matter it is necessary to clarify an issue raised by the Company in its closing brief as to the acceptability of Staff's post hearing final schedules related to cost of capital. During the course of the hearing, Staff adopted a change to its position regarding $30 million initially classified as debt, effectively accepting the Company's position. (Tr at 408.) The effect of that change was discussed in hearing but not spoken to in any written filing prior to the final post hearing schedules. The Company expressed concerns about these changes to the effect that they represent late filed testimony not subject to cross examination. (AZ-AM Br. at 21, 23 n. 77.)

The Company was aware that Staff had adopted a number of changes in its final position at hearing regarding the $30 million that was reclassified as <u>not debt</u> at hearing as well as the inclusion of the Tolleson obligation as debt that was testified to in prefiled surrebuttal. The same methods used to calculate the cost of debt, when applied to the changes that the Company did not object to when made in hearing (*See* Tr at 408 (Staff witness Chaves accepting removal of $30 million from capital structure)) naturally produce different numbers when the inputs vary. The natural consequence of the changes taken, when applied to the same methodologies that Staff discussed produce different results for the cost of debt or the amount of financial risk adjustment as a result of Staff's modified position.

Further, contrary to the assertion of the Company, the final numerical consequence of these changes was discussed and quantified at hearing under cross examination. "I can give you a ballpark figure if we were just to take out the $30 million out of the capital structure… we have 62.8 percent debt and 37.2 percent equity." (Tr at 432:14-20.) Further, the incorporation of changes to the capital structure that would modify the final amounts used for determining the financial risk adjustment was both considered and quantified at hearing.

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> And, you know, after the hearing process, we could come up with a different financial risk adjustment that's lower... With these numbers, and again this is a ballpark figure, you would be looking at an amount of adjustment of around 70 basis points. So technically that adjustment is going to go lower. The cost of equity would be around 10.4 percent.

(Tr at 432:6-24) Some of the impact of these changes was not only forecasted but was tentatively quantified at the time of hearing. Thus there are no after hearing surprises in this matter.

2. Over and Undercompensation for Leverage inconsistent with expectations.

The Company argues that adopting Staff's recommendation would overcompensate investors in low-leveraged companies and undercompensate investors in highly leveraged companies. (AZ-AM Br. at 27-28.) This contention is unpersuasive and should be disregarded.

First, the example table that the Company supplies to bolster this premise is inaccurate. It bases its estimation of the Company's ATWACC using Staff's capital structure but incorrectly states that the Staff proposed capital structure is 37.2% equity and 63.3% debt which produces a total of 100.5% of their capital structure. (*Id.* at 28.) Consequently, it is not possible to rely on the information the table presents on this basis alone.

Second, the Company founds its contention on a comparison of ATWACCs of approved costs of capital for various utilities including gas and electric utilities. This stems from flawed reasoning because gas and electric companies do not have risk comparable to water utilities and would thus command higher returns on equity than the Company before financial risk is even a consideration. In addition, the ATWACC is not generally accepted as an appropriate means to calculate financial risk. When recently considered, the Commission "rejected the ATWACC methodology recognizing that the ATWACC methodology produces an inflated estimate that would overcompensate for financial risk..." (Chaves Direct at 35:24-36:2, citing Decision No. 68858 at 27.) As was conceded by the Company, the method has only been used by one federal agency, the Surface Transportation Board and by one state, the Missouri PSC. (Dr. Villadsen Rebuttal at 7:1-7.) However, as elucidated during the hearing, though the Missouri PSC made use of the ATWACC method in one case, the Missouri PSC did not accept the ATWACC method in its entirety. (Tr. at 176-77.) In fact, the Missouri PSC ultimately only granted a 30 basis point adjustment when use of the method suggested a 60 basis point adjustment was appropriate. (Tr. at 176-77.)

Finally, although high leverage represents a risk to the Company, it is far from being out of the Company's control. It can build equity by a number of methods, including improving efficiency and increasing revenues. (Tr. at 435-36.) As the Company recognizes, it can also sell more shares to build its equity. (Tr. at 236.) Further, the utility, as part of its obligation to serve must obtain sufficient capital to provide its service. (Tr. at 233.) The Company has only one shareholder. (Tr. at 234.) The Company admits that it is that one shareholder's decision to invest additional equity. (Tr. at 239.) It would be inappropriate to reward the Company's high leverage with use of a hypothetical capital structure and ATWACC adjustment when so many tools are at the Company's disposal to remedy the situation.

3. A Hamada Adjustment using the Actual Capital Structure is the Appropriate Method of Dealing with the Financial Risk of the Company's Highly Leveraged Capital Structure

Staff used appropriate methods to establish the corresponding risk associated with the Company's leverage issue. Staff removed the $30 million from the short term debt capital structure. Further, Staff correctly identified the Tolleson obligation as a debt item that belongs in the Company's debt capital structure rather than have it isolated as a cost of service to be borne solely by the Sun City Wastewater customers. This results in a double counting over the short-term until Sun City comes in for a new rate case, but it corrects an error in the methodology used in that case. (*See* Tr. at 394 (by NARUC standards, the Tolleson obligation is debt and Staff is not bound to persist in an erroneous prior accounting).)

The Company's contention that this creates a subsidy is likewise unpersuasive on the issue. As Staff explained, all Company investment in this state to some extent is subsidized by all Company customers regardless of their distance from the particular system invested in. (Tr. 392:10-393:3.)

Finally, Staff correctly used the Company's actual capital structure. All parties agree the Company should improve its equity position. However, Staff continues to recommend using the actual capital structure with a clear Hamada adjustment. As opposed to the imprecisely derived hypothetical capital structure the Company proposes, this has the advantage of utilizing an established formula rooted in financial theory and will help the Company improve its equity. (Chaves Direct at 6.) In addition, it can be supplemented by numerous actions the Company can take to improve its equity and thus need not be used on a continuing basis to subsidize the Company's lack of sufficient equity.

A hypothetical capital structure such as the Company proposes is not the result of any calculation to determine a precise level. The Company appears to have simply chosen the particular distribution of 40% equity and 60% debt because that has been recommended by Staff in two cases, the Southwest Gas case ("SWG"), Docket No. G-01551A-04-0876, and the Tucson Electric Power ("TEP") case, Docket No. E-01933A-04-0408. (AZ-AM Br. at 17-20.) The Company is distinct from those in the two cases mentioned because it does not share a comparable risk (financial or otherwise) to either. Both TEP and SWG are engaged in industries that even the Company conceded are riskier than the water industry. (*See* Tr. at 178:4-5 (water companies are not as risky as electric companies), 178:5-8 (traditionally gas industry is riskier than water industry).)

In addition, those two cases are not directly comparable to the present application because the leverage issues facing the utilities in those examples were both more heavily leveraged than the Company. In the TEP example cited by the Company, Staff recommended a hypothetical capital structure for TEP which had an actual capital structure of 26.4% equity and 73.6% debt.[1] In the SWG example the Company points to, the actual capital structure of the gas company's parent was 34.5% equity and 65.5% debt.[2] Consequently the Company has not demonstrated that it requires more financial risk adjustment than the Hamada adjustment applied to the final Company capital structure to compensate for its leverage generated financial risk.

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[1] *In the Matter of the Filing of General Rate Case Information by Tucson Electric Power Company Pursuant to Decision No. 62103,* Docket No. E-01933A-04-0408 (*See* Dorf Direct at 3, June 24, 2005).

[2] *Application to Reset the Southwest Gas Corporation Demand Side Management Adjustor Rate for May 2006,* Docket No. G-01551A-04-0876 (*See* Hill Direct at 21 (July 26, 2005).

III. CONCLUSION

For the above stated reasons and those expressed in Staff's Closing Brief, Staff's recommendation regarding the appropriate rate treatment of deferred taxes and the cost of capital, as well as recommendations made in Staff's opening brief should be adopted.

RESPECTFULLY SUBMITTED this 29th day of January 2007.

Maureen A. Scott, Senior Legal Attorney
Charles H. Hains, Attorney
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007
(602) 542-3402

Original and fifteen (13) copies
of the foregoing were filed this
29th day of January, 2007 with:

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

Copies of the foregoing mailed this
29th day of January, 2007 to:

Craig A. Marks
Corporate Counsel
Arizona – American Water Company
19820 North Seventh Street, Suite 201
Phoenix, Arizona 85024

Tom M. Broderick
Arizona-American Water Company
19820 North Seventh Street
Phoenix, Arizona 85024

Scott S. Wakefield
RUCO
1110 West Washington Street, Suite 220
Phoenix, Arizona 85007