0000070476

ARIZONA WATER COMPANY

Docket No. W-1445A-02-0619

2002 RATE HEARING EXHIBIT NO. ___

For Test Year Ending 12/31/01

PREPARED

REBUTTAL TESTIMONY & EXHIBITS

OF

Walter W. Meek

EXHIBIT

A-8

~~Admitted~~

FENNEMORE CRAIG
A Professional Corporation
Norman D. James (No. 006901)
Jay L. Shapiro (No. 014650)
3003 North Central Avenue
Suite 2600
Phoenix, Arizona 85012-2913
Telephone: (602) 916-5000

Attorneys for Arizona Water Company

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 EASTERN GROUP AND FOR CERTAIN RELATED APPROVALS.	Docket No. W-01445A-02-0619

REBUTTAL TESTIMONY OF WALTER W. MEEK

Table of Contents

I. INTRODUCTION, QUALIFICATIONS AND PURPOSE OF TESTIMONY

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Walter W. Meek. My business address is 2100 North Central Avenue, Suite 210, Phoenix, Arizona 85004.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am the president of the Arizona Utility Investors Association ("AUIA"), a non-profit organization formed to represent the interests of equity owners and bondholders who are invested in utility companies that are based in or do business in the State of Arizona.

Q. DOES THE AUIA MEMBERSHIP INCLUDE THE OWNERS AND OPERATORS OF ANY OF ARIZONA'S REGULATED WATER COMPANIES?

A. Yes. AUIA's members include large Class A water companies and smaller Class B and C water companies. In addition, AUIA is an associate member of the Water Utilities Association of Arizona and three of the members of the AUIA Board of Directors are from the water utility industry.

Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS PROCEEDING?

A. On behalf of Arizona Water Company, the applicant.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to rebut Staff's assertion that firm-specific or so-called "unique" risk should <u>not</u> be considered in determining an equity return because investors in Arizona Water Company, or any other Arizona gas, electric, water or sewer utility providers, do not consider such firm-specific risks in making investment decisions.

. . .

. . .

Q. WOULD YOU PLEASE EXPLAIN WHY YOU ARE QUALIFIED TO PROVIDE TESTIMONY ON THIS SUBJECT MATTER?

A. I represent the largest cross-section of utility stockholders in the State of Arizona. I have been involved with the utility business in Arizona for 28 years. I have participated in dozens of Commission dockets on behalf of AUIA and testified in numerous proceedings. My testimony has covered topics including rate of return issues, stranded costs, disposition of regulatory assets, AFUDC, inclusion of CWIP in rate base and the impact of regulatory decisions on analyst and investor expectations.

Q. ARE YOU SAYING YOU ARE TESTIFYING AS AN EXPERT WITNESS?

A. I am testifying as a "real world" witness. In this docket, Staff recommends an anemic 9% return on equity based on financial theory found in some economics textbooks. Admittedly, I do not have a degree in Global Business, specializing in finance like Mr. Reiker. But I do have something I do not think Mr. Reiker has developed yet—an understanding of how utility investors in the real world think. To be blunt, I do not think any one can rationally conclude, no matter what Mr. Reiker's textbooks tell him, that an investor would ignore a water company's need to meet a draconian new arsenic standard, or threats to the utility's well fields, or the age and condition of its plant, in making investment decisions simply because the investor may have a diversified portfolio.

Q. ARE YOU BEING PAID FOR YOUR PARTICIPATION AS A WITNESS IN THIS PROCEEDING?

A. No, I am testifying because AUIA is very concerned about what we see as a dangerous trend that will ultimately weaken the viability of Arizona's utility industry. That trend, specifically, is the progressively lower equity returns being recommended by Staff based on financial theory rather than a well-reasoned consideration of all of the factors that impact the determination of a just and reasonable return.

II. INVESTOR CONSIDERATIONS

Q. HAVE YOU PERSONALLY PURCHASED AND SOLD COMMON STOCK OR OTHER EQUITY INSTRUMENTS?

A. Certainly, both in and outside the utility arena. Currently, I own stock in several utilities that do business in Arizona.

Q. IN YOUR POSITION WITH AUIA, HAVE YOU DISCUSSED INVESTING IN COMMON STOCKS OF UTILITIES AND/OR OTHER CORPORATIONS?

A. Yes. Investment in stock, particularly stock in utilities, is the foundation of AUIA's existence. In order to represent the interests of AUIA's members, I have developed a good working knowledge of the utility industry and, specifically, investment related matters.

Q. ARE YOU FAMILIAR WITH THE CRITERIA THAT A TYPICAL INVESTOR MIGHT CONSIDER WHEN EVALUATING WHETHER TO INVEST IN THE STOCK OF A UTILITY?

A. I believe I am. At the outset, it may be useful to distinguish between institutional and retail investors. Today, between 60 and 80 percent of the outstanding shares of some utilities are held by institutional investors, such as pension plans and investment trusts. Of the remainder, half or more may be held in "street" name by broker-dealers and the rest are shareholders of record on the corporate books.

Although all investors should in theory employ similar investment criteria, some have access to more information than others. A careful investor evaluating whether to invest in a utility would examine several factors such as liquidity and cash flows, capital structure, customer growth, capital requirements, return on equity, PE ratio, projected earnings and dividend growth and regulatory risk in addition to specific business conditions. Some institutional investors are prohibited from investing in a company that doesn't pay a dividend.

Retail investors may or may not have professional investment advisors, but should be interested in the same company-specific data and factors, although their analysis is typically less complex. Since many are at or near retirement age, they are in the "fixed-income" syndrome; they want safety along with consistent growth in earnings and dividends. People in this category often do not have the option of diversification and will have a "portfolio" of three or four dividend paying stocks.

Q. HAVE YOU REVIEWED THE DIRECT TESTIMONY OF STAFF WITNESS JOEL M. REIKER FILED IN THIS DOCKET?

A. Yes. Candidly, it is Mr. Reiker's testimony that led me to decide to testify for Arizona Water. For example, on page 7 of his direct testimony, Mr. Reiker states that:

> Risk is defined in modern portfolio theory as the sensitivity of an investment's returns to market returns. The most prevalent measure of risk is "beta." Beta is the measurement of an investment's market risk, and it reflects both the business risk and financial risk of a firm.

Q. ARE YOU FAMILIAR WITH THE TERM "BETA"?

A. Yes, I am familiar with the term "beta" as a tool for measuring the market risk of an investment. In my experience, an investor, at least a prudent one voluntarily making investment decisions, will not rely solely on a beta in making investment choices, irrespective of how diversified his portfolio might be.

Q. WHAT DO YOU VIEW AS THE PROBLEMS ASSOCIATED WITH RELYING ON A BETA TO REPRESENT ALL OF THE RISKS ASSOCIATED WITH AN EQUITY INVESTMENT IN A FIRM?

A. To begin with, I disagree with Mr. Reiker's emphasis placed on beta and his failure to acknowledge that investors consider other data and factors in evaluating which stock to purchase. Next, from a practical standpoint, there are a number of different issues surrounding a beta as it is used in the Capital Asset Pricing Model or "CAPM." The CAPM relies on the assumption that all investors hold efficient portfolios and all such portfolios move in perfect lockstep with the market. Fine theoretically, but this is not reality. *See* Reiker Direct at 21, l. 11.

Further, the results being produced, while they may be theoretically sound, are suspect, from a common sense perspective. *See* Reiker Direct at 25, Tables 6 and 7. The CAPM historical data results in a return that is only 7.7% (and the constant growth DCF model used by Staff produces only 8.5% return on equity). I understand Arizona Water's last series of bonds had an interest rate over 8%. This projected return is substantially less than what water and gas companies are currently earning, and well below Value Line's projections for 2004 and the 2006 - 2008 time period. However, this very low return (and the 8.5% return produced by the DCF constant growth model) is averaged with the higher return of 11.1% to produce an average return using the CAPM of only 9.0%.

Again, simple common sense indicates that something is wrong with a model when it produces results that low. What will cause the average return on equity to decline that much? Mr. Reiker makes no attempt to explain what will cause this to occur. He simply accepts the result produced.

Q. IN YOUR EXPERIENCE, DOES A TYPICAL INVESTOR RELY PRIMARILY ON BETA IN EVALUATING THE RISKS ASSOCIATED WITH AN INVESTMENT IN A UTILITY'S STOCK?

A. Having reviewed Mr. Reiker's testimony, I would say that relying solely on a beta could lead to imprudent decision-making by investors. Mr. Reiker also testifies in his direct testimony (at 7):

> Unique risk, or microeconomic risk, is risk that can be eliminated by portfolio diversification, i.e., buying securities in portfolios. Unique risk is not measured by beta nor does it factor into the cost of equity because it can be eliminated through simple shareholder diversification. Unique risks are particular to an individual company or investment project. Investors who hold diversified portfolios do not worry about unique risk; therefore, it does not affect the cost of capital. Additionally, investors who choose to be less than fully diversified will not expect to be compensated for unique risk.

Any investor who completely ignores what Mr. Reiker terms "unique risk" is not going to be very successful in his investments, no matter how diversified his portfolio. I could recite a long list of companies engaged in electric distribution, generation, trading, gas transportation, telephone distribution, long distance, wireless communications, software development and semiconductor manufacturing that have fallen flat since 2000. If you were invested in those companies then, you were probably rich. If you are holding their stock today, along with California bonds, your portfolio is six feet under water.

I would submit that much of the investment loss associated with those companies was the result of the market's failure to recognize and act on "unique" risks that were present in their business plans and the regulatory regimes under which they operated.

Q. SO YOU DO NOT AGREE WITH MR. REIKER'S ASSERTIONS ABOUT HOW INVESTORS VIEW "UNIQUE RISK"?

A. No. I would like to meet these "investors" Mr. Reiker testifies about. Are there really investors who will say "I don't care about the financial impact of the EPA's new arsenic standards on my equity return because I also own stock in Disney and Pepsi?" Would these same investors, making investments in Arizona's regulated utilities, turn a blind eye to the return on equity this Commission authorizes? Capital is not unlimited and prudent investors who consider all their options are not likely to ignore real life risks, as Mr. Reiker seems to believe.

Q. DO YOU AGREE WITH MR. REIKER'S VIEW THAT THE RISK ASSOCIATED WITH A PARTICULAR FIRM IS "ELIMINATED" IF SECURITIES ARE PURCHASED IN PORTFOLIOS?

A. Mr. Reiker makes that point in his direct testimony (at 7) and I do not agree. I would, instead, argue that the risk associated with purchasing a particular firm's securities can never be eliminated. Presumably, the various stocks in an investor's portfolio each presents its own specific set of risks, which could, in theory, be averaged to create an overall risk for that particular portfolio. However, each stock will have its own particular set of risks associated with it and I believe prudent investors consider those risks in deciding whether to buy or hold a particular security.

Q. DO YOU BELIEVE THAT MR. REIKER IS CORRECT IN ASSERTING THAT "INVESTORS WHO HOLD DIVERSIFIED PORTFOLIOS DO NOT WORRY ABOUT UNIQUE RISK"?

A. I think Mr. Reiker lacks experience as an equity investor. I know that Arizona utility companies and AUIA receive many inquires from analysts and investors about the probable effect of "unique" or specific risks, including the risk posed by regulatory decisions of this Commission.

I certainly do not ignore unique risks associated with a particular firm when I consider the purchase of that firm's stock simply because I hold a "diversified portfolio," whatever that means. After all, I am not of unlimited wealth and I have to do my homework to make sure I maximize my opportunities for returns on my investments. I respectfully suggest that Arizona Water's shareholders do the same thing when determining the level of investment to make in the Company.

That is the focus of my concern and the reason for my testimony. If this

Commission adopts Staff's "ivory tower" view of finance and economics, and authorizes unreasonably low rates of return, I fear that investment in Arizona's utility industry will suffer a sharp and ultimately devastating decline.

Q. DO YOU BELIEVE THAT FIRM-SPECIFIC RISK AFFECTS THE COST OF CAPITAL?

A. I certainly do. It is my understanding that in setting rates for utility service, the Commission must allow a utility, in addition to recovering its operating expenses, taxes and depreciation, an opportunity to earn a return that is equal to returns that are being earned on investments in other businesses that have corresponding risks. This is known as the comparable earnings standard, and it has been in effect for decades. For example, in the *Bluefield Waterworks* case, decided in 1923, the United States Supreme Court stated: "A public utility is entitled to such rates as will permit it to earn a return . . . equal to that generally being made at the same time and in the same general part of the country on investments and other business undertakings which are attended by corresponding risks and uncertainties . . . ." *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679, 692 (1923).

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

In order to apply the comparable earning standard, it is necessary to evaluate the firm-specific or unique risks associated with an investment in that particular firm. From the standpoint of a typical investor, I believe that Mr. Reiker violates this standard by choosing to ignore firm-specific risks and relying instead on <u>Value</u>

Line betas and the utilities' capital structures as the sole determinants of risk.

Q. WHAT SORT OF DATA AND INFORMATION MIGHT A TYPICAL INVESTOR CONSIDER IN EVALUATING THE RISKS ASSOCIATED WITH INVESTMENT IN A PARTICULAR FIRM'S STOCK?

A. Again, as I outlined previously, a typical investor would consider a variety of financial and non-financial factors and circumstances in evaluating whether to purchase a firm's stock. A good way of illustrating this point is to consider the information that is published by Value Line on the water utility industry and on certain publicly traded water companies. Mr. Reiker has presumably reviewed this information since he has used the betas from Value Line in preparing his testimony. *See* Schedule JMR-5. Value Line provides a variety of historical and projected financial data for each of the publicly traded water utilities that it follows, as well as a discussion of various firm-specific and industry-wide events. Applying Mr. Reiker's logic, however, all of this financial data and other information is simply irrelevant and ignored by investors. There would be no reason for Value Line and other investment services to gather and publish this information, nor would there be any market for this information, if investors didn't consider it in making investment decisions.

Q. STAFF IS RECOMMENDING A RETURN ON EQUITY OF ONLY 9.0% FOR ARIZONA WATER. HOW DOES THAT RETURN COMPARE TO THE RETURNS ON EQUITY BEING REPORTED BY THE PUBLICLY TRADED WATER UTILITIES USED IN STAFF'S SAMPLE?

A. Staff's sample contains six publicly traded utilities. According to the information reported in C. A. Turner Utility Reports (July 2003), these companies are currently earning a return on equity of, on average, 10.6%. Of course, it should be obvious that these comparable companies are larger than Arizona Water, meaning an investor is, at least based on that factor, going to view the comparable companies as less risky.

Q. **BOTH ARIZONA WATER'S COST OF EQUITY WITNESS AND MR. REIKER HAVE ALSO USED A GROUP OF NATURAL GAS COMPANIES. WHAT RETURNS ON EQUITY ARE THOSE UTILITIES CURRENTLY REPORTING?**

A. Arizona Water's expert has used eight natural gas companies that have A bond ratings. According to C. A. Turner, the average return on common equity for that group of eight gas companies is 11.66%.

Mr. Reiker has added two other gas utilities to the group, Cascade Natural Gas and Southwest Gas. Both of those gas companies have BBB bond ratings and are currently reporting very low returns on equity, according to C. A. Turner. Cascade Natural Gas is reporting a return on common equity of only 6.7% while Southwest Gas, which is the largest natural gas supplier in Arizona, is reporting a return on common equity of only 4.4%. If those two gas utilities are included in the average, the average return on equity drops to 10.44%, which is still nearly 150 basis points above what the Staff is recommending for Arizona Water in this case.

Mr. Reiker does not discuss the current returns on equity being reported by either sample group of publicly traded utilities. Are those returns on equity relevant to investors? I would think they are and, at a minimum, I would have expected Mr. Reiker to explain why the models he is using are producing results substantially below current returns on equity.

Q. **AS YOU INDICATED, A SIGNIFICANT PORTION OF SOUTHWEST GAS' BUSINESS IS IN ARIZONA AND SOUTHWEST GAS IS CURRENTLY REPORTING THE LOWEST RETURN ON EQUITY OF ALL OF THE PUBLICLY TRADED UTILITIES. DO YOU HAVE ANY**

COMMENT?

A. I am on record in that docket in opposition to the Commission's decisions regarding rates and commodity charges. However, I should note that Southwest Gas was granted rate increases in Decision No. 64172 (October 30, 2001) and that the return on equity approved for Southwest Gas in that decision was 11.0%, 200 basis points higher than the equity return being recommended for Arizona Water by Staff.

Q. DOES THE NATURE OF REGULATION IMPACT AN INVESTOR'S PERCEPTION OF THE RISK ASSOCIATED WITH A PARTICULAR UTILITY STOCK?

A. Yes. A public utility commission can have a significant impact on the investment risk associated with a particular utility stock. I am sure Commission-watchers will recall the unintended impact on the stock price of Pinnacle West Capital Corporation just a few years ago after an offhand comment by a Commissioner, as well as the general impact years of deregulation proceedings have had on Pinnacle West shares. Now, I am not suggesting that the Commission should avoid taking actions simply because it could impact the risk associated with an investment in a utility it regulates. Nevertheless, if the Commission authorizes a rate of return below that currently being earned by other utilities, it will be more difficult for the utility to raise capital, bond ratings may be reduced, etc. These factors, some might call "regulatory risk," are not ignored by investors. In fact, the May 2003 Value Line specifically mentions that regulatory decisions and policies in California are adversely impacting water utilities in that state.

Q. DOES THE NEW MAXIMUM CONTAMINANT LEVEL ("MCL") FOR ARSENIC, RECENTLY ESTABLISHED BY THE ENVIRONMENTAL PROTECTION AGENCY UNDER THE SAFE DRINKING WATER ACT,

CREATE ADDITIONAL RISK?

A. Yes, this is a good example of a firm-specific risk that an investor is going to consider, notwithstanding the theory relied on by Mr. Reiker.

Q. BUT DOESN'T STAFF ARGUE THAT THE NEW MCL FOR ARSENIC IS NOT A FIRM-SPECIFIC RISK BECAUSE IT IMPACTS THE ENTIRE WATER UTILITY INDUSTRY?

A. Yes, Mr. Reiker discusses this point in his direct testimony (at 57). Again, he claims that this is simply a unique risk and would not be "priced by the market." Moreover, Mr. Reiker does not discuss, and there is no indication that he has investigated, whether the six publicly traded water utilities have arsenic in their water supplies and, if so, how much they will be required to spend to comply with the new EPA requirement. He simply assumes, without any basis, that all water utilities will be impacted in the same way.

The AUIA has intervened in Arizona Water's Northern Group (Phase II) proceeding in which the Company is seeking to recover expenses associated with having to construct and operate new arsenic treatment facilities. Arsenic mitigation will be a very expensive undertaking for Arizona Water. According to the testimony filed in that docket, the Company anticipates having to finance nearly $30 million of arsenic treatment facilities and related plant, and faces increases in annual operating expenses of approximately $5 million over the next four years. These costs are very significant and, without rate relief, will have a significantly adverse impact on Arizona Water's earnings and financial viability. A prudent investor would certainly take these circumstances into account in deciding whether to invest in Arizona Water Company. Moreover, without some mechanism to assure insurance companies or other candidates for Arizona Water's bonds that there will be timely rate relief, I would expect it to be difficult for the Company to borrow funds at a reasonable cost, which would also adversely impact both the Company and its customers.

Q. DOES ARIZONA WATER'S RELATIVELY SMALL SIZE AFFECT THE RISKINESS OF AN INVESTMENT IN ITS COMMON STOCK?

A. From the standpoint of a typical investor, the answer is yes. I note that Mr. Reiker spends a substantial portion of his direct testimony attempting to disprove several studies that the Company's expert has provided to demonstrate that the size of a company does affect its investment risk. Common sense suggests that Mr. Reiker is simply wrong. A relatively small utility with a limited customer base and smaller revenue stream is more susceptible to adverse impacts resulting from circumstances like the new MCL for arsenic. Also, it is often more difficult for potential investors to find objective information about smaller companies because securities analysts don't follow them.

By contrast, a relatively large utility like Philadelphia Suburban, which is reported in C. A. Turner to have operating revenue in excess of $330 million and net utility plant in excess of $1.5 billion, and which operates in multiple jurisdictions, is likely to be less affected by new regulatory requirements or other unanticipated events. I would also note that Philadelphia Suburban is reporting a return on common equity of 14.0% – some 500 basis points higher than Mr. Reiker and Mr. Rigsby are recommending be authorized for Arizona Water, a smaller and more risky utility.

Q. SO IS IT YOUR BELIEF THAT REGULATION ITSELF AFFECTS INVESTOR RISK?

A. Yes. As I discussed above, there are numerous examples of regulatory decisions impacting stock value, which obviously impact investor risk. Investors do consider these factors. I know I do and I am an investor.

Again, Arizona Water's proceeding related to the recovery of costs associated with arsenic treatment is a perfect example. Arizona Water is attempting to obtain approval of a mechanism that will allow it to timely recover costs and expenses. However, RUCO is opposing recovery of operating expenses outside of a general rate case and Staff, while initially opposing recovery of operating expenses, has agreed to allow some operating expenses to be recovered. Is it really Mr. Reiker's belief that an investor would not be concerned about Arizona Water's ability to earn a return on the enormous investment, relative to its size, required to construct arsenic treatment facilities or to recover increased operating expenses? If so, I again respectfully suggest that Mr. Reiker lacks an appreciation for the realities of the business world.

Regulatory lag is yet another example of risk associated with regulation that an investor is likely to consider. It typically takes 13 months or longer (it will be at least 16 months in this docket) to obtain rate relief in this jurisdiction. In addition, in a brief recently filed with the Arizona Court of Appeals, the Commission has indicated that a utility that has just obtained a decision from the Commission setting new rates must wait a full 12 months before filing a new rate application, which would dramatically increase the amount of regulatory lag in this jurisdiction. (*Arizona American Water Company v. Arizona Corporation Commission*, No. 1 CA-CC 03-0001, Commission Responsive Brief at 23.) While I disagree with Staff, this new "policy," which is not reflected in the Commission's rules or any decision, will most assuredly adversely impact investors' perception of the risk associated with an investment in Arizona Water as compared to other publicly-traded utilities, or any other available investment for that matter.

Q. BUT ACCORDING TO MR. REIKER, AREN'T SUCH RISKS ARE AMELIORATED BY DIVERSIFICATION?

A. That's what Mr. Reiker claims, but as explained above, I do not accept his theory. In fact, I can suggest another way to minimize or eliminate these types of risks – not make the investment in the first place, which I fear is the result we are going to see if Staff's attempt to drive down equity returns is accepted by the Commission.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.

1448010.1/12001.187