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BEFORE THE ARIZONA CORPORATION COMMISSION

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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 APPROVAL	DOCKET NO. W-01445A-02-0619 **NOTICE OF FILING**

Staff hereby provides notice of filing the summaries of testimony for Staff Witnesses Joel M. Reiker, John S. Thornton, Jr., Ronald E. Ludders, and Lyndon R. Hammon.

RESPECTFULLY SUBMITTED this 18 day of September 2003.

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WITNESS SUMMARY
DIRECT TESTIMONY OF JOEL M. REIKER
ARIZONA PUBLIC SERVICE COMPANY
DOCKET NO. W-01445A-02-0619

Staff's cost of capital testimony is presented by Staff witness Joel M. Reiker. Staff recommends the Commission adopt a capital structure consisting of 28.2 percent long-term debt, 5.6 percent short-term debt, and 66.1 percent equity.

Staff recommends the Commission adopt an 8.46 percent cost of long-term debt and a 4.0 percent cost of short-term debt.

Staff recommends the Commission adopt a 9.0 percent return on equity ("ROE"). Staff bases its ROE recommendation on its discounted cash flow ("DCF") and capital asset pricing model ("CAPM") analyses. Staff recommended ROE range is 7.7 percent to 11.1 percent.

Staff recommends the Commission adopt an overall rate of return ("ROR") of 8.6 percent. Staff's ROR recommendation results in a pre-tax interest coverage ratio of 4.7. This represents a fair and reasonable rate of return on Arizona Water's rate base and is evidence that the Company will maintain financial integrity.

The Commission should reject Company witness Thomas M. Zepp's proposed 12.4 percent ROE because Staff disagrees with his methods and his estimates are not representative of current costs of equity.

There are several problems associated with Dr. Zepp's DCF estimates including; sample selection, inappropriate calculation of the expected dividend yield, exclusive reliance on analysts' forecasts, and failure to consider dividends per share ("DPS") growth.

Dr. Zepp's "risk premium" analysis should be rejected because (1) it relies on analysts' forecasts of future interest rates, (2) it is based on a general rule of thumb rather than theory developed in the financial literature, and (3) the yield to maturity on corporate bonds cannot be meaningfully compared to the cost of equity.

Dr. Zepp's testimony on the Baa corporate bond rate is incorrect, and when corrected supports a cost of equity *below* Staff's recommended 9.0 percent when considered with his overall analysis.

Dr. Zepp's proposed 100 to 150 basis point small company premium should be rejected because it is (1) inconsistent with financial theory, and (2) contrary to utility industry-specific studies. Further, the Commission has previously rejected a small-firm size risk premium in rate proceedings.

Dr. Zepp's recommendations should be rejected because he fails to make a capital structure adjustment to account for decreased financial risk – an adjustment he makes in another docket before the Commission.

The Commission should give little weight to such alternative three-factor asset pricing models as proposed by Dr. Zepp because they have not been widely accepted by the academic community, and a number of recent studies indicate that the models are not correct.

Dr. Zepp's soon-to-be published article on small utility risk should not be relied upon because Staff has found several problems with it: Including: comparability problems between Dr. Zepp's "annual" beta and Value Line betas; and the "new evidence" on small utility risk premiums, which Staff addressed in it's direct testimony. Part of this "new evidence" is a study, slightly altered and previously submitted as evidence before the Commission, the results of which Staff has shown in its direct testimony to be statistically insignificant.

Dr. Zepp's extended version of the CAPM presented in his rebuttal testimony and his ad hoc risk premium approach are not preferred to the original CAPM. Dr. Zepp has not shown that CAPM tests using short-term Treasuries and raw betas can be appropriately applied to Staff's CAPM, which already produces required returns higher than what the original CAPM would produce. Dr. Zepp has not shown that a zero-beta CAPM, appropriately applied, would produce higher required returns than Staff's CAPM.

Dr. Zepp has not shown that investors ignore past or projected DPS growth, and he has not shown that past or projected DPS growth should not be used in a constant-growth DCF application for water utilities. The DCF method is predicated on DPS growth.

The Commission should reject the testimony of Intervener Walter W. Meek. Mr. Meek's testimony erroneously assumes that book/accounting returns represent investors' required returns. Information regarding historical returns for average risk securities shows that Staff's recommended ROE is reasonable. Capital costs are currently lower than they have been in decades.

WITNESS SUMMARY
DIRECT TESTIMONY OF JOHN S. THORNTON
ARIZONA WATER COMPANY
DOCKET NO. W-01445A-02-0619

Mr. Thornton's testimony addresses the appropriateness of an inverted-block three-tiered rate design for Arizona Water Company's Eastern Group based on accepted marginal cost rate design principles. Mr. Ron Ludders applies these principles to the individual systems to design specific rates. Specifically, the inverted block rate design principle that Staff recommends includes a lifeline rate for the first 3,000 gallons of consumption, a marginal-cost-based premium rate for the third block of consumption, and a middle block rate that is derived to achieve the desired revenue requirement in conjunction with the first and third blocks. Staff refers to this rate design as a three-tiered rate design. The first tier covers the first two thousand gallons of consumption and is priced at a twenty-percent discount to the second tier rate. The third tier is priced at a twenty-percent premium to the second tier rate. The second tier is derived for each system depending on the system revenue requirement and other rate design considerations.

The three-tiered rate structure is not expected to effect conservation in the short run: it is primarily a cost-based rate structure using a marginal cost concept. However, a three-tiered price signal is expected to affect long-run consumption patterns and it offers the potential for conservation in the longer term.

WITNESS SUMMARY
SURREBUTTAL TESTIMONY OF JOHN S. THORNTON
ARIZONA WATER COMPANY
DOCKET NO. W-01445A-02-0619

Mr. Thornton's surrebuttal testimony responds to Arizona Water Company's ("Arizona Water" or the "Company") testimony regarding the three-tiered rate design and its basis in marginal cost principles. The Company argues that three-tiered rate design is flawed for a number of reasons. Mr. Thornton addresses the Company's concerns and continues to recommend a three-tiered commodity rate structure given the increasing marginal cost of new supply.

WITNESS SUMMARY
SURREBUTTAL TESTIMONY OF RONALD E. LUDDERS
ARIZONA WATER COMPANY
EASTERN GROUP
DOCKET NO. W-01445A-02-0619

General Background

Arizona Water Company is a certificated Arizona public service corporation with headquarters located in Phoenix, Arizona. The Company supplies water to approximately 60,000 customers in eight counties throughout Arizona. The Company is composed of 18 separate water systems located in Ajo Heights, Apache Junction, Bisbee, Casa Grande, Coolidge, Lakeside, Miami, Oracle, Overgaard, Pinewood, Rimrock, San Manuel, Sedona, Sierra Vista, Stanfield, Superior, White Tank, and Winkelman. This permanent rate application applies only to the eight systems that comprise the Eastern Group (i.e. Apache Junction, Bisbee, Miami, Oracle, San Manuel, Sierra Vista, Superior, and Winkelman). The Eastern Group serves approximately 29,000 customers.

Apache Junction System

<u>Proposed Revenue Increase – Apache Junction</u>

The Company requested total annual operating revenues of $10,249,590. This revenue amount represents an increase of $1,305,663, or 14.60 percent, over the Company filed adjusted test year revenue of $8,943,927.

Staff, in its surrebuttal testimony, recommends total annual operating revenues of $8,203,493. This revenue amount represents a decrease of $835,149, or 9.24 percent, below Staff's adjusted test year revenue of $9,038,642.

<u>Rate Base – Apache Junction</u>

Staff, in its surrebuttal testimony, recommends an original cost rate base of $19,071,140, a reduction of $5,135,876, or 21.22, percent compared to the Company's proposed rate base of $24,207,016.

<u>Operating Income – Apache Junction</u>

Staff, in its surrebuttal testimony, recommends adjusted operating income of $1,633,634, a decrease of $1,029,138, or 38.65 percent, compared to the Company's proposal of $2,662,772.

Adopting Staff's recommended operating income results in an 8.566 rate of return versus the

Company's proposal of 11.00 percent.

Bisbee System

Proposed Revenue Increase – Bisbee

The Company requested total annual operating revenues of $1,869,599. This revenue amount represents an increase of $612,649, or 48.74 percent, over the Company filed adjusted test year revenue of $1,256,950.

Staff, in its surrebuttal testimony, recommends total annual operating revenues of $1,634,742. This revenue amount represents an increase of $378,139, or 30.09 percent, over the Staff adjusted test year revenue of $1,256,603.

Rate Base - Bisbee

Staff, in its surrebuttal testimony, recommends an original cost rate base of $3,590,535, a reduction of $109,578, or 2.96 percent, compared to the Company's proposed rate base of $3,700,113.

Operating Income - Bisbee

Staff, in its surrebuttal testimony, recommends operating income of $307,565, a decrease of $99,447, or 24.43 percent, compared to the Company's proposed operating income of $407,012.

Adopting Staff's recommended operating income results in an 8.566 percent rate of return versus the Company's proposed 11.00 percent.

Miami System

Proposed Revenue Increase – Miami

The Company requested total annual operating revenues of $2,179,657. This revenue amount represents an increase of $722,718, or 49.61 percent, over the Company filed adjusted test year revenue of $1,456,939.

Staff, in its surrebuttal testimony, recommends total annual operating revenues of $1,664,212. This revenue amount represents an increase of $207,490, or 14.24 percent, over the Staff adjusted test year revenue of $1,456,722.

Rate Base - Miami

Staff, in its surrebuttal testimony, recommends an original cost rate base of $2,918,090, a reduction of $1,652,106, or 36.15 percent, compared to the Company's proposed rate base of $4,570,196.

Operating Income - Miami

Staff, in its surrebuttal testimony, recommends operating income of $249,964, a decrease of $252,758, or 50.28 percent, compared to the Company's proposed operating income of $502,722.

Adopting Staff's recommended rates results in an 8.566 percent rate of return versus the Company's proposed 11.00 percent.

Oracle System

Proposed Revenue Increase – Oracle

The Company requested total annual operating revenues of $1,060,904. This revenue amount represents an increase of $233,327, or 28.19 percent, over the Company filed adjusted test year revenue of $827,577.

Staff, in its surrebuttal testimony, recommends total annual operating revenues of $915,992. This revenue amount represents an increase of $87,224, or 10.52 percent, over the Staff adjusted test year revenue of $828,768.

Rate Base - Oracle

Staff, in its surrebuttal testimony, recommends an original cost rate base of $2,495,716, a reduction of $323,684, or 11.48 percent, compared to the Company's proposed rate base of $2,819,400.

Operating Income - Oracle

Staff, in its surrebuttal testimony, recommends operating income of $213,783, a decrease of $70,849, or 49.57 percent, compared to the Company's proposed operating income of $142,934.

Adopting Staff's recommended operating income results in an 8.566 percent rate of return versus the Company's proposed 11.00 percent.

San Manuel System

Proposed Revenue Increase – San Manuel

The Company requested total annual operating revenues of $921,119. This revenue amount represents an increase of $446,869, or 94.23 percent, over the Company filed adjusted test year revenue of $474,250.

Staff, in its surrebuttal testimony, recommends total annual operating revenues of $828,885. This revenue amount represents an increase of $354,769, or 74.83 percent, over the Staff adjusted test year revenue of $474,116.

Rate Base Adjustments – San Manuel

Staff, in its surrebuttal testimony, recommends an original cost rate base of $699,272, a reduction of $94.721, or 11.93 percent, compared to the Company's proposed rate base of $793,993.

Operating Income – San Manuel

Staff, in its surrebuttal testimony, recommends operating income of $59,900, a decrease of $27,439, or 31.42 percent, compared to the Company's proposed operating income of $87,339.

Adopting Staff's recommended operating income results in an 8.566 percent rate of return versus the Company's proposed 11.00 percent.

Sierra Vista System

Proposed Revenue Increase – Sierra Vista

The Company requested total annual operating revenues of $1,308,079. This revenue amount represents an increase of $411,594, or 45.91 percent, over the Company adjusted test year revenue of $896,485.

Staff, in its surrebuttal testimony, recommends total annual operating revenues of $1,120,001. This revenue amount represents an increase of $222,838, or 24.83 percent, over the Staff adjusted test year revenue of $897,163.

Rate Base – Sierra Vista

Staff, in its surrebuttal testimony, recommends an original cost rate base of $2,317,637, a reduction of $257,050, or 9.98 percent, compared to the Company's proposed rate base of $2,574,687.

Operating Income – Sierra Vista

Staff, in its surrebuttal testimony, recommends operating income of $198,520, a decrease of $84,696, or 29.91 percent, compared to the Company's proposed operating income of $283,216.

Adopting Staff's recommended operating income results in an 8.566 percent rate of return versus the Company's proposed 11.00 percent.

Superior System

Proposed Revenue Increase – Superior

The Company requested total annual operating revenues of $1,190,319. This revenue amount represents an increase of $491,351, or 70.30 percent, over the Company filed adjusted test year revenue of $698,968.

Staff, in its surrebuttal testimony, recommends total annual operating revenues of $1,032,254. This revenue amount represents an increase of $333,665, or 47.76 percent, over the Staff adjusted test year revenue of $698,589.

Rate Base - Superior

Staff, in its surrebuttal testimony, recommends an original cost rate base of $2,463,731, a reduction of $209,845, or 7.85 percent, compared to the Company's proposed rate base of $2,673,576.

Operating Income - Superior

Staff, in its surrebuttal testimony, recommends operating income of $211,043, a decrease of $83,050, or 28.23 percent, compared to the Company's proposed operating income of $294,093.

Adopting Staff's recommended operating income results in an 8.566 percent rate of return versus the Company's proposed 11.00 percent.

Winkelman System

Proposed Revenue Increase – Winkelman

The Company requested total annual operating revenues of $129,358. According to the Company, this revenue amount represents an increase of $32,343, or 31.97 percent, over the Company adjusted test year revenue of $98,022.

Staff, in its surrebuttal testimony, recommends total annual operating revenues of $116,911. This revenue amount represents an increase of $18,187, or 18.42 percent, over the Staff adjusted test year revenue of $98,724.

Rate Base - Winkelman

Staff, in its surrebuttal testimony, recommends an original cost rate base of $242,504, a reduction of $23,395, or 8.80 percent, compared to the Company's proposed rate base of $265,899.

Operating Income - Winkelman

Staff, in its surrebuttal testimony, recommends total operating revenue of $20,773, a decrease of $8,476, or 28.97 percent, compared to the Company's proposed operating revenue of $29,249.

Adopting Staff's recommended operating income results in an 8.566 percent rate of return versus the Company's proposed 11.00 percent.

Arsenic Removal Recovery Mechanism

There is currently no arsenic removal plant constructed in the Eastern Group. However, the recommended arsenic order is pending and, therefore, Staff's recommendation regarding an arsenic cost recovery system cannot be finalized until the Commission determines what action it accepts in dealing with this issue.

WITNESS SUMMARY
DIRECT TESTIMONY OF LYNDON R. HAMMON
ARIZONA PUBLIC SERVICE COMPANY
DOCKET NO. W-01445A-02-0619

(1) The Arizona Department of Environmental Quality ("DEQ") reported that all eight water systems are in **total** compliance with its rules and regulations. DEQ determined that all eight systems are currently delivering water that meets State and Federal drinking water quality standards required by the Arizona Administrative Code, Title 18, Chapter 4.

(2) For Bisbee, Oracle, San Manuel, and Superior, Staff recommends that the Company perform a water audit and system analysis to determine if loss reductions to less than 10 percent are feasible or cost effective. If the reduction of water losses to less than 10 percent is feasible and cost effective, the Company shall submit to the Utilities Division Director, a plan which outlines the procedures, steps, and schedules to achieve acceptable water losses. If the reduction of water losses to less than 10 percent is not cost-effective, the Company shall submit a report, containing a detailed cost analysis and explanation demonstrating why a water loss reduction to less than 10 percent or, as an alternative, incremental reduction, is prohibitive. Such water loss plans or reports shall be submitted to the Director of Utilities within one year of a Decision in this rate case.

(3) Staff recommends the adoption of the depreciation rates contained in Exhibit E of this direct testimony. These new component rates, by NARUC account, will be applicable to all 18 water systems of the Arizona Water Company.

(4) *Pro Forma* Expenses:

(a) Routine water testing expenses were estimated on an annual basis and the adjustments are delineated on page 10 of this direct testimony. Staff recommends that the MA-262 tariff, "Monitoring Assistance Program Surcharge", be revised to conform with the new ADEQ MAP fee structure. Staff also recommends that the revised MA-262 tariff be filed with the Director of the Utilities Division for review and certification, and the filing of that revised tariff shall be made within 60 days of a decision in this matter, but no later than the Company's annual surcharge calculation for each water system participating in MAP.

(b) Staff accepts the Company's *pro forma* expense for tank maintenance (adjustment # 15).

(c) Staff recommends that actual 2002 labor and material expenses be used instead of the Company's *pro forma* expense adjustment #11 for chlorination.

(d) Staff recommends that the purchased power expense for Miami, be adjusted downward (decreased) by $39,000.

(5) Staff recommends that the Company file a curtailment tariff for each of the eight water systems within the Eastern Division, within 120 days after the effective date of any decision and order pursuant to this application. The tariff shall be submitted to the Director of Utilities Division for his review and certification. Staff also recommends that the tariff shall generally conform to the sample tariff found in Exhibit G of this direct testimony.

(6) Staff recommends that the existing Non-Potable Central Arizona Project Water tariff (herein "NP-260") be replaced with a new NP-260 tariff. Staff's proposed tariff is presented in Exhibit J.

- The new NP-260 tariff shall eliminate the fixed meter charge.
- The new NP-260 tariff shall eliminate the depreciation charge.
- The new NP-260 tariff shall contain a provision which indemnifies the customer from maintenance, repair, or replacement charges, when the damage or injuries to the CAP facilities are a result of the failure of the Company to operate the facilities or install protective devices in accordance with customary or sound construction and engineering practices.
- The customer shall continue to be responsible for repair or replacement of the meter.
- The new NP-260 tariff shall contain administrative charges, which are representative of the Company's actual costs, but the charges shall be fixed and defined as actual dollar amounts. Actual administrative costs notwithstanding, the total administrative charges in the new tariff, shall not be more than 50 dollars per month per CAP non-potable meter.