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AZ CORP COMMISSION
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MIKE GLEASON, Chairman
WILLIAM A. MUNDELL
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KRISTIN K. MAYES
GARY PIERCE

IN THE MATTER OF THE APPLICATION OF CHAPARRAL CITY WATER COMPANY FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.	DOCKET NO. W-02113A-04-0616 **NOTICE OF FILING**

Staff of the Arizona Corporation Commission hereby provides notice of filing the Summary Testimonies of David C. Parcell and Ralph C. Smith in the above-referenced matter.

RESPECTFULLY submitted this 28th day of January, 2008.

Janet Wagner

Christopher C. Kempley, Chief Counsel
Janet Wagner, Senior Staff Counsel
Legal Division
1200 West Washington Street
Phoenix, Arizona 85007
Telephone: (602) 542-3402

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Arizona Corporation Commission
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JAN 28 2008
DOCKETED BY ne

Norman D. James
Jay L. Shapiro
FENNEMORE CRAIG, P.C.
3002 North Central Avenue, Suite 2600
Phoenix, Arizona 85012

Daniel M. Pozefsky
RUCO
1110 West Washington Street, Suite 220
Phoenix, Arizona 85007

Roseann Osorio

RALPH SMITH

EXECUTIVE SUMMARY
CHAPARRAL CITY WATER COMPANY, INC.
DOCKET NO. E-02113A-04-0616

My testimony addresses the following issues:

- The development of Staff's recommended revenue requirement for the Company using an appropriate fair value rate of return developed for application to the Fair Value Rate Base (FVRB) ordered by the Commission in Decision No. 68176 (9/30/05).

My findings and recommendations for each of these areas are as follows:

- The Company's proposed additional revenue requirement of approximately $1.122 million is overstated.

- Staff is presenting the Commission with two alternative sets of calculations of the fair value rate of return for application to the Fair Value Rate Base ("FVRB"). The first set of calculations is shown on Attachment RCS-2 and the second set is shown on Attachment RCS-3.

- As shown on Attachment RCS-2, Schedule D, Staff's first alternative is based on applying a 6.34 percent fair value rate of return to the FVRB. The fair value rate of return for FVRB results from adjusting the rate of return applicable to Original Cost Rate Base ("OCRB"). In the capital structure applicable to FVRB, a zero cost of capital is applied to the difference between FVRB and OCRB. As explained in my testimony and in the testimony of Staff witness David C. Parcell ("Parcell"), a zero cost rate for that portion of the FVRB is appropriate because that amount of FVRB has not been financed by investors. As shown on Attachment RCS-2, Schedule A, under this alternative, the revenue increase of $1,107,596 granted in Decision No. 68176 is revised downward by $7,734 to $ $1,099,862.

- If the Commission determines that it is appropriate to apply an above-zero cost rate to the fair value increment (i.e., the difference between FVRB and OCRB), Staff recommends that the Commission consider a range bounded by zero and a maximum of 2.5 percent. As described in the testimony of Staff witness Parcell, 2.5 percent is the real risk-free rate of return (i.e., it is the rate of return on a risk-free investment, less inflation). As shown on Attachment RCS-3, Schedule D, applying the mid-point of this range, 1.25 percent, to the difference between FVRB and OCRB produces an overall fair value rate of return of 6.54 percent to be applied to the FVRB. As shown on Attachment RCS-3, Schedule A, the application of the 6.54 percent fair value rate of return to the Fair Value Rate Base results in a revenue requirement of $1,166,116, which is an increase of $58,520 over the $1,107,596 granted in Decision No. 68176.

- The amount of net operating income of $614,247 that was determined by the Commission in Decision No. 68176 was not in dispute in the Company's appeal and should therefore not be subject to revision in this remand proceeding.

- In its July 6, 2007 amended filing, the Company requested an additional $100,000 of rate case cost. Staff recommends that no additional amount of rate case cost be charged to ratepayers because: (1) Staff legal counsel has advised me that Arizona law prohibits the recovery of attorney fees and costs related to an appeal of a rate order; (2) the Company's rationale for the additional rate case expense appears questionable; and (3) a normalized level of reasonable and prudent rate case cost was already reflected in the determination of net operating income; consequently, to increase the rate case expense beyond that normalized level would result in ratepayers paying an abnormal level of such expense.

My Surrebuttal Testimony is organized into four sections, based on issue discussions. First, I address the Company's attempt to apply the weighted average cost of capital (WACC), without adjustment, to the FVRB. In this section, I explain why Staff's proposals are reasonable and appropriately consider the fair value of the utility's property in setting rates.

Second, I address the Company's attempt to re-litigate the determination of the amount of achieved net operating income and property tax expense that was determined by the Commission in Decision No. 68176. I recommend that the Company's request for additional property tax expense and a decrease of $9,320 in adjusted net operating income be rejected.

Third, I address the Company's request to charge ratepayers for additional rate case expense relating to the appeal and remand.

Fourth, I address estimated impacts on customer bills that would be produced by the Company's and Staff's proposals.

Fifth and finally, I summarize Staff's recommendations.

My findings and recommendations for each of these areas are as follows:

- The Company's revised proposed additional revenue requirement of approximately $1.135 million is significantly overstated and should therefore be rejected.

- The Company's presented no direct testimony in this remand proceeding in support of its proposal, and its rebuttal testimony offers no compelling reasons for applying the weighted average cost of capital (WACC), without adjustment, to the FVRB. The Company's rebuttal testimony offers no new recommendation, but continues to advocate applying the (WACC), without adjustment to the FVRB. This Company proposal was rejected by the Commission in Decision No. 68176. Moreover, the Court of Appeals clearly stated that the Commission is not bound to use the weighted average cost of capital as the rate of return to be applied to the FVRB, which is exactly what the Company continues to propose.

- The amount of net operating income of $614,247 that was determined by the Commission in Decision No. 68176 was not in dispute in the Company's appeal and should therefore not be subject to revision in this remand proceeding. Similarly, the amount of property taxes determined by the Commission in Decision No. 68176 was not in dispute in the Company's appeal and should therefore not be subject to revision in this remand proceeding. My surrebuttal testimony presents additional reasons why the Company's proposed adjustment to property tax expense should be rejected.

- In its July 6, 2007 amended filing and in its rebuttal testimony, the Company requested charging ratepayers with an additional $100,000 of rate case cost over a one-year period. Staff continues to recommend that no additional amount of rate case cost be charged to ratepayers because: (1) Staff legal counsel has advised me that Arizona law prohibits the recovery of attorney fees and costs related to an appeal of a rate order; (2) the Company's rationale for the additional rate case expense appears questionable; and (3) a normalized level of reasonable and prudent rate case cost was already reflected in the determination of net operating income; consequently, to increase the rate case expense beyond that normalized level would result in ratepayers paying an abnormal level of such expense.

- To appropriately address the requirements of the Court of Appeals' remand, in my and Staff witness Parcell's direct testimony, Staff has presented the Commission with two alternative sets of calculations of the fair value rate of return for application to the FVRB. The first set of calculations was presented on Attachment RCS-2, and the second set on Attachment RCS-3. Both of these attachments were filed with my direct testimony.

- As shown on Attachment RCS-2, Schedule D, Staff's first alternative is based on applying a 6.34 percent fair value rate of return to the Fair Value Rate Base (FVRB). The fair value rate of return for FVRB results from adjusting the WACC applicable to Original Cost Rate Base (OCRB). In the capital structure applicable to FVRB, a zero cost of capital is applied to the FV Increment. As explained in my testimony and in the testimony of Staff witness Parcell, a zero cost rate for the FV Increment is appropriate because that amount of FVRB has not been recorded on the Company's books, and has not been financed by investors. This calculation is not a mere "superfluous mathematical exercise," as claimed by the Company. Unlike the Commission's older "backing in" method of determining the required return on FVRB, Staff's proposed method for determining the fair value rate of return for application to the FVRB under alternative one does not produce results that are exactly the same as applying the WACC to the OCRB. Moreover, it is supported by appropriate economic and financial theory, as explained by Mr. Parcell and me. As shown on Attachment RCS-2, Schedule A, under this alternative, the revenue increase of $1,107,596 granted in Decision No. 68176 is revised downward by $7,734 to $1,099,862. If the Commission selects this alternative, Staff is not recommending any rate change at this time, due to the de minimus impact. Thus, there would be no impact on customer bills under this alternative.

- If the Commission determines that it is appropriate to apply an above-zero cost rate to the fair value increment, Staff recommends that the Commission consider a range bounded by zero and a maximum of 2.5 percent. As described in the testimony of Staff witness Parcell, 2.5 percent is the real risk-free rate of return (i.e., it is the rate of return on a risk-free investment, less inflation). As shown on Attachment RCS-3, Schedule D, applying the mid-point of this range, 1.25 percent, to the FV increment in the capital structure produces an overall fair value rate of return of 6.54 percent to be applied to the FVRB. As shown on Attachment RCS-3, Schedule A, the application of the 6.54 percent fair value rate of return to the Fair Value Rate Base results in a revenue requirement of $1,166,116, which is an increase of $58,520 over the $1,107,596 granted in Decision No. 68176. If the Commission selects this alternative, it would result in a total amount to be recovered of $137,264 and an increase in the average customer's monthly bill of $2.71 per month, or approximately 7.9 percent.

TESTIMONY SUMMARY OF DAVID C. PARCELL
DOCKET NO. W-02113A-04-0616

The purpose of my testimony in this proceeding is to offer, for the Commission's consideration, two alternative fair value rate of return ("FVROR") estimates that may properly be applied to the fair value rate base ("FVRB") of Chaparral City Water Company ("Chaparral City") to determine the Company's revenue requirement relative to this proceeding. My testimony, as well as this entire remand phase of this proceeding, is designed to be responsive to the February 15, 2007 Court of Appeals decision. From the perspective of my testimony, the following conclusions of the Court of Appeals decision are relevant:

- The Commission must "find" the fair value of a utility's property and "use that finding as a rate base in calculating just and reasonable rates."
- The Commission has the "discretion to determine the appropriate methodology" to use as the rate of return applicable to a FVRB
- The Commission is specifically "not bound to use the weighted cost of capital", as derived from the accounting capital structure, as the rate of return applicable to the Company's FVRB.

My testimony thus addresses the issue of the proper FVROR to be applied to Chaparral City's FVRB. In developing the FVROR, I note that I am not making any proposed modifications to the FVRB, but rather am proposing FVRORs that are consistent with, and applicable to, the FVRB of Chaparral City.

My testimony, in conjunction with the testimony of Staff Witness Ralph Smith, is proposing two FVROR alternatives. First, we propose that a FVROR be established by recognizing the differential between the original cost rate base ("OCRB") and the FVRB – the FVRB Increment. The FVRB Increment is then included in the capital structure, in essence creating a FV capital structure. Since the FVRB Increment is not supported with any investor-supplied funds, there is no capital cost associated with these funds; thus they have a zero cost. Using the same cost rates for long-term debt and common equity as approved by the Commission in the initial phase of this proceeding, a FVROR is developed which in then applied to the FVRB. This FVROR is 6.34%.

The second alternative FVROR uses the same FV capital structure, but assigns a positive cost rate to the FVRB Increment. This is done to provide the Commission with a relevant FVROR, should they believe, from a public policy perspective, that some positive return be applied to the FVRB Increment. My proposed maximum FVRB Increment cost rate is the real risk-free rate of return. The nominal risk free rate, at the time I prepared my Direct Testimony, was 5.0% -- the yield on U.S. Treasury securities. This yield included an inflation component of 2.5 %, which should not be included in the FVRB Increment cost since inflation is reflected in the FVRB and should not be double counted. The resulting maximum real risk free rate is thus 2.5 %, or the 5.0 % nominal yield on U.S. Treasury securities less the 2.5 % inflation component. I conclude that any point between 0 % and 2.5 % can be used as the FVRB Increment and specifically recommend the mid-point of this range, or 1.25 %. Applying this to the FV capital structure, along with the previously-cited cost rates for debt and common equity, results in a FVROR of 6.54 %.

Both of Staff's proposed FVROR proposals are designed to be applied to Chaparral City's FVRB, as directed by the Court of Appeals. In addition, both of the proposals provide for investors having an opportunity to recover the costs associated with all of their investment in Chaparral City.

During the course of this proceeding, Chaparral City, RUCO and Staff have had the opportunity to pre-file five sets of testimony. My review of these testimonies indicates several disputed issues. I have below summarized these disputed issues and provide Staff's position on each issue.