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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF CHAPARRAL CITY WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE 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-07-0551

STAFF'S OPENING BRIEF

RE: COST OF CAPITAL

The Utilities Division of the Arizona Corporation Commission ("Staff") files its closing brief for Phase II of the above-captioned matter. The briefing schedule and hearing in this matter were bifurcated. The parties submitted separate briefs addressing rate base, operating expenses and rate design. In this brief, Staff addresses cost of capital issues.

I. BACKGROUND.

Chaparral City Water Company ("Chaparral" or "Company") is a Class A water utility serving approximately 13,000 customers in and around Fountain Hills, Arizona. Chaparral is a subsidiary of American States Water Company. In August, 2004 the Company filed an application for an increase in rates. The Commission issued Decision No. 68176 granting the Company a rate increase.[1] The Company appealed this decision to the Arizona Court of Appeals asserting, among other things, that the Commission did not use the Company's fair value rate base to determine its rates. The Court of Appeals agreed with the Company in part and remanded the case to the Commission. The Commission held a hearing on the remand in January 2008 and issued a decision in July 2008 ("Remand Proceeding").

[1] Dec. No. 68176, Docket No. W-02213A-04-1616 (September 30, 2005).

Chaparral filed, in this docket, an application for the approval of permanent rates in September 2007. In this application the Company was seeking a 41.14% increase over test year revenues. Staff moved to suspend the time clock on that application because the Remand Proceeding was pending and its outcome would impact the September 2007 application. The ALJ granted Staff's motion. Further, by her January 18, 2008 procedural order, the ALJ directed the parties to continue discovery, in order to minimize any delay in the implementation of new rates. Additionally, the ALJ ordered that a hearing be scheduled as soon as practicable after the issuance of a final order in the Remand Proceeding.

On July 7, 2008, the Company filed a "Notice of Implementation of Interim Rates Pursuant to Arizona Revised Statutes ("ARS") § 40-256." The Company's filing stated that the Company intended to unilaterally implement an increase in its rates on an interim basis on August 18, 2008, and to provide notice to its customers of its intention within 10 days after its July 7, 2008 filing. The Company subsequently agreed to hold in abeyance its intent to implement interim rates and proceed with its rate application in the instant case.

II. SUMMARY OF THE PARTIES RECOMMENDATIONS.

The following is a summary of parties' positions regarding Cost of Capital:

	WACC	FVROR	Capital Structure	Cost of Equity	Cost of Debt
Staff	8.8%	7.6%	75.6% equity/24.4% debt	10.0%	5.0% (includes short term debt
Company	9.6%	9.96%	76.6% equity/23.4% debt	11.5%	4.92% (includes short term debt)
RUCO	6.38%	6.38%	76.75% equity/19.17% long term debt/4.08 % short term debt	6.83%	5.34%

III. STAFF'S METHOD FOR DETERMINING OPERATING INCOME IS REASONABLE AND SHOULD BE ADOPTED.

A. Effect of Remand Proceeding.

In Chaparral's 2004 rate proceeding, which culminated in Decision No. 68176, the Commission determined operating income, and set rates in a manner consistent with its prior decisions. The Commission determined operating income by multiplying the weighted average cost of capital ("WACC") by the original cost rate base ("OCRB"). The resulting product was then divided by the fair value rate base ("FVRB") to determine a fair value rate of return ("FVROR"). Under this method, the operating income, determined by multiplying the FVRB times the FVROR, provided the same operating income as multiplying the WACC by the OCRB.

Thereafter, the Company appealed the Commission's decision to the Arizona Court of Appeals, asserting primarily that the Commission had not used the Company's FVRB when determining its rates. The Court of Appeals agreed with the Company, in part, and remanded the case to the Commission.

In Decision No. 70441 ("Remand Decision"), the Commission revised the method of calculating operating income.[2] The Commission calculated operating income by multiplying the FVROR times the FVRB. The Commission used a FVRB that reflects a 50/50 weighting of OCRB, and the reconstruction cost new rate base ("RCND"). This was not in dispute. However, the parties did dispute the method for determining the FVROR. Chaparral urged the Commission to apply the WACC to the FVRB. This is the methodology the Company continues to advocate in this proceeding. The Commission adopted a FVROR by adjusting the WACC to reflect a 2.00 percent reduction to the cost of equity as an inflation adjustment but not the cost of debt ("Method 1"). The Remand Decision left the door open for adjustments to the adopted formula. Specifically, the Remand Decision states: "Although we believe that the cost of debt may reflect the effects of inflation, we are not convinced that the evidence presented in this proceeding is developed sufficiently enough to make that determination with certainty."[3] In this proceeding Staff offers a

[2] Dec. No. 70441, Docket No. W-02113A-04-0616 (July 28, 2008).
[3] Remand Decision at 36.

refinement of the methodology developed in the Remand Proceeding to account for inflation within the cost of debt.

B. <u>Staff Recommends An Adjustment To Remove The Inflation Component.</u>

Staff recommends a FVROR that includes an adjustment to remove the inflation component, *i.e.* an "accretion return" from the cost of debt. Staff Witness Gordon Fox testified that inflation is recognized, in financial literature, as a component of debt.[4] Mr. Fox further testified that Staff studied the correlation between inflation and the cost of debt and noted that there is a high correlation of interest rates with inflation.[5] Staff recommends the removal of half of the inflation component from the cost of equity and the cost of debt.[6]

Staff's recommended method for calculating operating income, multiplies the FVROR times the FVRB. In using this method, the FVRB reflects a 50/50 weighting of the original cost rate base, and the RCND and the FVROR is the WACC reduced by half of the inflation/accretion return factor. Staff refers to this method as Method 2.

The Company criticized this method claiming that it fails to account for the impact of inflation on the other aspects of the Company's business such as operating expenses and earnings results.[7] Staff witness Fox testified that the adjustment made to inflation on the WACC (to arrive at the FVROR) is not an adjustment to reflect matching, FVROR is forward looking, and operating expenses are matched historically with revenues.[8] Mr. Fox further testified that an adjustment to the WACC to arrive at the FVROR is necessary to avoid double counting of inflation that is found in the RCN and in cost of equity and debt.[9] Finally Mr. Fox explained that the ratemaking framework recognizes that there may be inflation in operating expenses and that such recognition of inflation in operating expenses should encourage utilities to provide efficiencies.[10]

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[4] Ex. S-5 at 5.
[5] Ex. S-5 at 7.
[6] *Id.*
[7] Ex. A-21at 15.
[8] Tr. 461:1-7.
[9] Tr. 461:8-15.
[10] Tr. 461:20-25.

The Company continues to assert that the WACC should be applied to the Company's fair value rate base to determine the Company's required operating income.[11] However, the Commission rejected the Company's argument in Decision No. 68176 and it was also rejected in the Remand Decision. Further, the Company's argument cannot be reconciled with the Court of Appeals' decision in *Chaparral City v. Arizona Corp. Comm'n.*[12] The Commission, in the Remand Decision, found the company's arguments unpersuasive.[13] The Court of Appeals ruling was limited to a criticism of *how* the Commission calculated its adjustment to the WACC—not *whether* the Commission may undertake such an adjustment and did not specifically require the Commission to undertake any specific methodology when determining the fair value rate of return.[14] The Company's arguments are simply a rehash of its position in the Remand Proceeding and add nothing new to assist in a determination of just and reasonable rates in this proceeding.

The Company, in its Rebuttal criticizes Staff's use of Method 2. Staff wanted to be clear that the method adopted in the Remand Decision is still a viable alternative. Staff Witness Elijah Abinah testified that there are two methods for the Commission to consider.[15]

Staff asserts that using Method 2 benefits a utility by providing higher returns when its property appreciates at a rate exceeding the additional return required by investors due to inflation. This method represents a fundamental change from the "prudent investment" or "historical cost" approach, where a utility is compensated for the actual cost or property prudently invested.[16] In its previous rate case, Chaparral objected to the use of the historical cost approach as results oriented.[17] This refinement to Method 1 should alleviate the objections raised by the Company.

III. STAFF'S COST OF CAPITAL RECOMMENDATIONS ARE REASONABLE AND SHOULD BE ADOPTED.

The latter half of 2008 saw extreme and unprecedented volatility in the world's financial markets. The United States economy worsened to the point that the only similar comparison was of

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[11] Ex. A-21 at 2.
[12] 1 CA-CC 05-0002, (Ariz. App. 2007) (Unpublished).
[13] Remand Decision at 29.
[14] *Chaparral City* at 13, ¶ 17.
[15] Tr. 552:4-6.
[16] Ex. S-5 at 10.
[17] Remand Decision at 8.

the Great Depression. Because of the unique volatility of the U.S. financial markets, Staff sought the advice of a national expert in the area of cost of capital. During the course of preparing its surrebuttal testimony, Staff realized that its cost of capital numbers were markedly skewed from the cost of capital recommendation in its direct testimony. As a result, Staff thought it was necessary to present testimony from a national expert to ensure that a complete record was made to assist the Commission in making its determination of just and reasonable rates. Staff substituted Dave Parcell as its cost of capital witness. Mr. Parcell adopted portions of the direct testimony of Pedro Chaves, Staff's initial cost of capital witness.[18]

The Company is requesting a return on equity of 11.5% and an overall return on its FVRB of 9.96%, which is equal to the WACC.[19] In response, the Company asserts that to adopt a rate of return that is lower than the current cost of equity is unjust and confiscatory.[20] The Company simply ignores the relationship between economic conditions and the cost of capital. The court held in *Bluefield:*

> "What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of fair and enlightened judgment, having regard to all relevant facts...A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally."[21]

Staff contends that the Company's methods to derive its cost of equity ignore the realities of the current market conditions. The Company seems to imply that because Staff has departed from the methods that it previously used to calculate cost of equity, Staff and the Commission are somehow precluded from using another method. But Staff recognizes that these are not normal times and that such times as these may require a departure from its prior recommendations. The Commission may consider all of the available evidence and may use its expertise to reconcile the evidence and develop a reasonable resolution. The ratemaking process does not lend itself to rule formulation because relevant factors may be given different weight at the discretion of the Commission at the time of

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18 Ex. S-8.
19 Ex. A-18 at 2.
20 *Id.*
21 *Bluefield Water Works v Public Service Commission of West Virginia* 262 U.S. 679 (1923).

inquiry.[22] Staff has proposed a more reasoned approach to the cost of capital methodology to account for the volatile market conditions.

In its rebuttal, the Company, in calculating its cost of equity using the Discounted Cash Flow ("DCF") model and the Capital Asset Pricing Model ("CAPM"), noted that its cost of equity had increased since its direct filing.[23] By its supplemental rejoinder filing in December, its cost of equity analysis yielded a cost of equity of 13%. The Company used spot or current stock prices and interest rates to develop its cost of capital using the DCF and CAPM models. Although the Company continues to request 11.5%, its own analysis supports Staff's position that the use of the standard models in this economic climate yields skewed results.

In the 27 day interval between the Company's filing of its Rejoinder testimony and its Supplemental Rejoinder, its DCF results changed 40 basis points and its CAPM results changed 70 basis points. It is doubtful that the Company's cost of equity actually changed 40 to 70 basis points in such a brief time period.[24] Such a change speaks to the volatility of the market and the need to depart, during this time in the country's economic history, from the models and the inputs typically used by Staff. Staff witness Parcell testified that in this current economic and financial market environment, spot prices for stocks should not be used. The Company and Staff used spot prices in prior rate cases. Mr. Parcell testified that it is unwise to use spot prices, at this time, in the standard market models. The reason is that market models such as the DCF and CAPM are forward looking, assuming that stock prices and interest rates reflect current expectations of the future, which is not the case at this time in our country's history.[25]

Staff witness Parcell also cautions against the use of the CAPM model in the current environment, as Staff and the Company have traditionally used it. He recommends using both arithmetic averages and geometric averages in the development of the historic risk premium,[26] whereas Staff has traditionally used the arithmetic averages as a component of its historic risk premium. Mr. Parcell noted that, since investors use both arithmetic and geometric average returns,

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[22] *Morris v. Ariz. Corp. Comm'n*, 24 Ariz. App. 454, 457, 539 P2d 928, 931 (1975).
[23] Ex. A-20 at 2.
[24] Tr. 745-746.
[25] Tr. 740:10-19.
[26] Ex. S-7 at 10.

both should be considered in the development of a historic risk premium. With respect to the current risk premium, Mr. Parcel testified that he has concerns with the growth component that is normally used by Staff in the development of its current risk premium. Mr. Parcell's concern lies with the fact that the growth component of a DCF, derived return on equity, is based upon a potential increase in stock prices for the 1700 stocks covered by Value Line. Because current stock prices are depressed, the use of an appreciation potential from a low base naturally reflects a higher-than-normal growth rate.[27] Mr. Parcell has the same concerns with the Company's use of stock price growth as the growth component.[28]

The Company asserts that there is little or no inflation in comparing the differential between long-term treasury bonds and long-term interest rate swaps using the same maturity to develop a proxy for inflation.[29] The Company asserts that, because this proxy for inflation was deemed to be very small in the current markets, it is also small for the FVRB determination and the FVROR. Staff witness Parcell testified that, in normal times, this may be a reasonable way to look at inflation, because the proxy developed shows the difference between inflation-indexed bonds and non-inflation indexed bonds. However, bonds have been driven to such low levels because of the flight to quality that it may be wise to consult other indicators of projected inflation, like the Blue Chip Economic Indicators.[30] In fact, Mr. Parcell referenced his prefiled testimony in Docket No. E-1345A-08-0172, where the consensus forecast for inflation was 2 to 2.5 percent, which coincidentally was Staff's forecast recommendation in August 2008.[31] In Mr. Parcell's opinion, economists' opinions of projected inflation would be a better indicator than a comparison of treasury bonds offered by the Company.[32]

Chaparral seems to conclude that as a regulated entity, it should somehow be shielded from the negative impacts of today's economy that affect its ratepayers and virtually every other business. It would be unfair for Chaparral to claim that its risk and/or required return should be higher at this

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[27] *Id* at 11.
[28] *Id* at 15.
[29] *See* generally Ex A-17.
[30] Tr. 748-749.
[31] Tr. 749:6-22.
[32] Tr. 749-750.

time. Company witness Bourassa evaded the question when asked whether Chaparral's position was that, in this time of recession, its ratepayers should pay more, responding only with the statement that the cost of equity should be enough to attract investors.[33] Clearly the Company is not focused on what the impact would be on its ratepayers. Staff's cost of equity recommendation of 10% is consistent with recent Commission decisions[34] and results in the setting of just and reasonable rates, balancing the needs of the Company and its ratepayers in the tradition of *Hope.*[35]

RESPECTFULLY SUBMITTED this 13th day of February, 2009.

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[33] Tr. 597:10-20.

[34] *See* Decision No. 70665,Docket No. G-01551A-07-050, In the matter of the application of Southwest Gas; Decision No. 70011, Docket No. G-04204A-06-0463 In the matter of the application of UNS Gas, Inc.

[35] The Court stated: ..."the fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests." *Federal Power Commission v Hope Natural Gas*; 320 U.S. 571, 64 S.Ct. 281 (1944).

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