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BEFORE THE ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION
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Arizona Corporation Commission
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8 IN THE MATTER OF THE APPLICATION OF
9 CHAPARRAL CITY WATER COMPANY, INC.,
10 AN ARIZONA CORPORATION, FOR A
11 DETERMINATION OF THE FAIR VALUE OF
12 ITS UTILITY PLANT AND PROPERTY AND
13 FOR INCREASES IN ITS RATES AND
14 CHARGES FOR UTILITY SERVICE BASED
15 THEREON.

DOCKET NO. W-02113A-07-0551

**STAFF'S COST OF CAPITAL REPLY
BRIEF**

11 The Utilities Division of the Arizona Corporation Commission ("Staff") hereby responds to
12 the Closing Brief of Chaparral City Water Company ("Chaparral City" or "Company" or "CCWC")
13 that was filed on February 13, 2009. Staff recommends that the Commission: (1) adopt a fair value
14 rate of return ("FVROR") for the Company, utilizing Staff's Method 2, 7.6%, (2) use Staff's Method
15 2 as in this case the methodology to adjust the Weighted Average Cost of Capital ("WACC") by
16 making an adjustment to the cost of debt to account for inflation. Nothing presented by the
17 Company's Closing Brief warrants a change in Staff's positions.

18 **I. INTRODUCTION.**

19 As a prelude to its arguments, the Company poses three questions in its brief, which sound
20 simple, but belie the complex nature of developing a cost of capital recommendation:

- 21 1. What is the basic cost of equity for Chaparral City i.e. the estimated cost of equity of the sample
- 22 utilities used by the parties?
- 23 2. Is a downward adjustment to the cost of equity for financial risk appropriate?
- 24 3. Should the WACC be used as the rate of return or should the WACC be adjusted downward to
- 25 account for inflation?

26 Staff responds to these questions as follow:

- 27 1. Staff's recommends a cost of equity of 10.1% not 11.8%. The Company in its brief persistently
- 28 misstates Staff's recommendation regarding cost of equity.

1 2. There are occasions when a downward adjustment of the cost of equity for financial risk is
2 appropriate¹; but Staff's final position on cost of equity does not reflect any downward adjustment for
3 financial risk.

4 3. The WACC should **not** be used as the fair value rate of return and should be adjusted to account
5 for the effects of inflation.

6 **II. STAFF'S RECOMMENDATION FOR COST OF EQUITY IS 10.1 PERCENT.**

7 Staff **has not recommended and is not recommending** 11.8% as its cost of equity. Contrary
8 to the numerous assertions by Chaparral,² Staff's cost of equity recommendation has never been
9 11.8%. The use of the phrase "basic cost of capital" in the Company's cost of capital closing brief to
10 somehow imply that Staff recommended a cost of equity of 11.8% is a misstatement of Staff's
11 position.³ To be clear, Staff is recommending a 10.1% cost of equity.⁴ Staff's recommendation has
12 never been similar to or more than what the Company is recommending as the Company somehow
13 asserts.⁵ Presumably, the Company's persistence in misstating Staff's position, is either an attempt to
14 either make its recommendation of 11.5% appear more reasonable or merely reflects the Company's
15 lack of understanding of Staff's position.

16 Chaparral also claims that "Staff's final post-hearing position relies on Mr. Chaves' direct
17 testimony."⁶ This too is incomplete. As outlined in Staff's initial cost of capital brief, Staff substituted
18 its cost of capital witness due in large part to the economic climate that existed and continues to exist.
19 Staff filed Surrebuttal testimony of Staff Witness David Parcell, which was admitted into evidence.
20 In addition, Mr. Parcell adopted portions of Mr. Chaves' direct testimony. It is a mischaracterization
21 of the record and the chain of events in this case to imply that Staff relied solely on Mr. Chaves'
22 direct testimony.

23
24
25 ¹ See Decision No. 70372, *In the matter of Arizona-American Water Company*, Docket No. WS-01303A-06-0403, where
a 150 basis point downward adjustment was approved.

26 ² CCWC COC Br. at 1, 2, 28, 32, 29; Prehearing TR 14-15.

27 ³ CCWC COC Br. at 2.

28 ⁴ TR 736:1-15. Mr. Parcell's corrected a math error found in pre-filed testimony; the correct cost of equity
recommendation is 10.1%.

⁵ CCWC Cl. Br. at 33, 51.

⁶ CCWC Cl. Br. at 7, 49.

1 Chaparral claims that Staff's actual return on equity recommendation "reflects a downward
2 adjustment of 180 basis points...to reflect the lower financial risk of the Company".⁷ Later in its
3 brief, the Company states that Staff's adjustment is based on the Hamada Equation⁸. This is also
4 incorrect. Staff's 10.1% recommendation is based on Staff witness Parcell's DCF and CAPM
5 findings, as adopted from Mr. Chaves' analyses, and does not use the Hamada adjustment to make
6 any adjustment for financial risk.⁹

7 Chaparral seeks to purposely ignore the testimony of Mr. Parcell, stating, "Mr. Parcell's
8 testimony has limited relevance to this case."¹⁰ Perhaps the Company's failure to recognize Mr.
9 Parcell's testimony explains the Company's numerous misstatements of Staff's position. Staff
10 requested and was granted permission to substitute David Parcell as its cost of capital witness. Mr.
11 Parcell prepared testimony as well as adopted portions of Mr. Chaves' testimony. Mr. Parcell's
12 testimony represents Staff's position. It is the Company's choice to refuse to address Staff's positions
13 as offered through Staff witness Parcell.

14 As Chaparral correctly notes, the most recently authorized cost of equity for Chaparral is 9.3
15 percent.¹¹ The Commission's methodology for arriving at this cost of equity has withstood the
16 scrutiny of the Court of Appeals.¹² The Court of Appeals rejected the arguments of the Company and
17 affirmed the methodology employed by the Commission. Staff's cost of equity recommendation is
18 10.1%, an 80 basis point increase from that authorized by Decision No. 68176 and Decision No.
19 70441 ("the Remand Decision"). The Company recommends a cost of equity of 11.5%, a 220 basis
20 points increase.¹³ The Company has failed to justify why, as a regulated monopoly that has more
21 access to the capital markets¹⁴ than most and that is somewhat shielded from the volatility of today's
22 market, it should be entitled to such a large increase in its cost of equity. Staff's recommendation on
23 the other hand is the more reasoned and sound approach.

24 _____
25 ⁷ Id at 2, 28, 32, 51, 52.

26 ⁸ Id. at 28, 54.

27 ⁹ Ex. S-7.

28 ¹⁰ Id. at 49.

¹¹ CCWC Cl. Br. at 4.

¹² *Chaparral City Water Co. v. Arizona Corp. Comm'n*, 1 CA-CC 05-0002 at 27, ¶ 48 (Ariz.App. 2007) (Unpublished).

¹³ The Company's actual calculation of its cost of capital yielded 12.7%, but in the spirit of compromise, was proposing 11.5%.

¹⁴ TR 193.

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2 **III. THE COMMISSION WAS CORRECT WHEN IT REJECTED THE COMPANY'S**
3 **POSITION TO APPLY THE WEIGHTED AVERAGE COST OF CAPITAL TO THE**
4 **FAIR VALUE RATE BASE.**

5 The Company's proposed rate of return methodology, adopting the WACC as the FVROR
6 and applying it to the FVRB, produces excessive returns. The Commission made this finding in
7 Decision No. 68176 and the Remand Decision.¹⁵ Because using the Company's methodology
8 produces returns that would be excessive, the resulting rates would be neither just nor reasonable.
9 Yet, Chaparral continues to advocate for this methodology. Twice the Commission has soundly
10 rejected the methodology advanced by the Company. The Court of Appeals in *Chaparral City* noted:
11 "The commission asserts that it was not bound to use the weighted average cost of capital as the rate
12 of return to be applied to the FVRB. *The Commission is correct.* (emphasis added).¹⁶ Thus, the
13 Court of Appeals found that the Commission, in the exercise of its discretion, may determine the
14 appropriate methodology. Because of the Commission's previous determinations, coupled with the
15 decision from the Court of Appeals, it is clear that the Company's testimony is largely irrelevant and
16 certainly not aimed at assisting the Commission in developing a method for adjusting the WACC that
17 will both comport with the Arizona Constitution and lead to a *reasonable* return.

18 While the Company calls the results of the Commission's result in the Remand Proceeding,
19 "anomalous", the Commission was completely within its constitutional authority to craft a
20 methodology that removed the effects of inflation.¹⁷ Staff's position is simple, while the
21 methodology set forth in the Remand Decision is certainly viable, Staff's refinement of that
22 methodology, addresses the issue of inflation as a component of debt.

23 Despite the Commission's authority, the Company is persistent in its efforts to re-litigate this
24 issue.¹⁸ The Company claims that one of its reasons for restating its arguments from the Remand
25 Proceeding and the appeal is to assure that it did not appear to waive its right to assert that the

26 ¹⁵ Decision Nos. 68176 at 26-27, 70441 at 4.

27 ¹⁶ *Chaparral City Water Co. v. Arizona Corp. Comm'n*, 1 CA-CC 05-0002 at 13-14, ¶ 17 (Ariz.App. 2007)
(Unpublished).

28 ¹⁷ CCWC Cl. Br. at 6; 70441 at 37.

¹⁸ In order to make a complete record, Staff would request that the Administrative Law Judge either admits Staff's
testimony in the Remand Proceeding as a late-filed exhibit or take administrative notice of the complete record of Docket
No. W-02113A-04-0616.

1 approach adopted in the Remand Proceeding was erroneous.¹⁹ The Company also relies on the
2 arguments it proffered in its application for rehearing in Docket No. W-02113A-04-0616.²⁰

3 The Company is still advocating for a methodology that would produce higher rates. Staff
4 contends that a methodology that produces comparably higher rates would appear to conflict with the
5 most basic tenets of rate regulation, i.e., that a utility should be provided with rates that will allow it
6 an opportunity to earn a return that is comparable to those of similarly situated enterprises.²¹

7 The Commission found in the Remand Decision that applying WACC to the FVRB would
8 inappropriately allow inflation to be reflected in both the WACC and in the FVRB, and that while the
9 inflation is not necessarily “doubled”, it is overstated.²² The Commission adjusted the WACC to
10 remove the inflation component.²³ As stated in Staff’s Opening Brief, Staff has proposed an
11 alternative methodology: Method 2 that adjusts the debt component of the WACC to account for
12 inflation.²⁴

13 The Company offers a number of criticisms to Staff’s determination of its FVROR
14 recommendation that was used to derive its operating income recommendation. Contrary to the
15 Company’s criticisms, Staff does not, as the Company suggests, misapprehend the basic requirement
16 that rates cannot be based on investment but must be based on the fair value of the utility’s
17 property.²⁵ Staff’s Method 2 benefits a utility by providing higher returns when its property
18 appreciates at a rate exceeding the additional return required by investors due to inflation.²⁶

19 In support of its argument, the Company relies upon a North Carolina case, *State ex rel.*
20 *Utilities. Comm’n v. Duke Power Co.*,²⁷ in which the court determined that North Carolina’s
21 ratemaking statutes, required their commission to treat the difference between the OCRB and the
22 FVRB as equity. The Company continues to ignore, as it did in the Remand proceeding, the
23

24 ¹⁹ Ex A-20 at 6.

²⁰ Id.

25 ²¹ “...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*; 320 U.S. 591, 603, 64 S.Ct. 281, 288 (1944).

26 ²² Decision No. 70441 at 36.

²³ Staff refers to this methodology as Method 1.

²⁴ Staff COC Op. Br. at 4.

27 ²⁵ Company Cl. Br. at 13; *Chaparral City Water*, ¶ 16 (citing *Ariz. Water*, 85 Ariz. at 203, 335 P2d at 415 and *Simms*, 80
Ariz. at 151, 294 P2d. at 382).

28 ²⁶ Ex. S-5 at 10.

²⁷ 206 S.E.2d 269 (1974).

1 Commission's status as a constitutionally created entity, with plenary powers over ratemaking. In
2 North Carolina, as in most other states, the state's police power regarding ratemaking resides with the
3 legislature. The North Carolina court in *Duke Power* and in previous cases dealt with the
4 interpretation of a state statute and accordingly concluded that the statute required its commission to
5 treat the difference between OCRB and the FVRB as equity.²⁸ By contrast, Arizona's Constitution
6 places the state's ratemaking authority exclusively with the Commission.²⁹ The Commission in its
7 Remand Decision also noted the company's misplaced reliance on *Duke Power*:

8
9 The Company's reliance on [*Duke Power*] is misplaced. In that case, the North
10 Carolina supreme Court remanded the issue of the appropriate fair rate of
11 return on the fair value of Duke Power's properties because it was apparent to
12 the court that the North Carolina Commission had made its determination
13 "through a misunderstanding" of another decision by the Court.³⁰

14 The Company also cites *City of Alton v. Commerce Comm'n* as holding that the cost of capital
15 methodology can be used to derive a return on the fair value of its assets.³¹ As the Commission noted
16 in the Remand Decision:

17 Although the Supreme Court of Illinois does discuss the rate of return with
18 FVRB, it finds that several methods of computing the appropriate rate of return
19 might be used, such as subtracting out debt and operating costs from revenues
20 to "produce net income allocable to equity, subtracting the par value of debt
21 and preferred stock, to reflect that all increments in value belong to equity or
22 dividing fair value as book value. These methods seem to be after the fact
23 determinations as opposed to methods to use or determinations made to set
24 rates. As such they are not helpful in Arizona.³²

25 The Company appears to argue that the appreciation in the fair value of its plant is the sole
26 province of the shareholder, because the shareholder has no ready means to obtain that appreciation.³³
27 Staff contends that the investors anticipate a return from the appreciation of utility plant that is

28 ²⁸ See 206 S.E.2d at 396; *Utilities Comm'n v. Tel. Co.*, 189 S.E.2d 705, 720 (1972).

29 ²⁹ *Arizona Corp. Comm'n v. State ex rel. Woods*, 171 Ariz. 286, 297, 830 P.2d 807, 818 (1992).

30 ³⁰ Decision No. 70441 at 24.

31 ³¹ 165 N.E.2d 513 (Ill. 1960).

32 ³² Decision No. 70441 at 25-26. The Commission noted that these determinations appear to be "fall out numbers".

33 ³³ CCWC Cl. Br. at 66-67.

1 subsequently included in rate-base, which is the effect of using RCND as a component of FVRB. In
2 other words, investors earn their total return through appreciation and current rates. Further,
3 Chaparral's view ignores the fact, that while the plant is in rate base, ratepayers pay the expenses, the
4 taxes, and the fair return related to the property.³⁴ Accordingly, the full risk of the gain or loss does
5 not lie with the investor.³⁵

6 The Company alleges that Staff's Method 2, which makes an inflation adjustment to both the
7 equity and debt portions of the Company's capital structure is improper.³⁶ The Company further
8 asserts that the embedded debt cost is not affected by inflation once the debt is issued. This argument
9 shows that the Company has a fundamental misunderstanding of Staff's Method 2. Table 2 in Staff
10 witness Fox's direct testimony presents a method for adjusting the FVROR for inflation by adjusting
11 the WACC.³⁷ This method supports Staff's position that the costs of equity and debt include an
12 inflation component that should be removed to arrive at the FVROR. The same FVROR (7.6%) will
13 result using a method that reduces the WACC (8.8%) by the inflation factor (1.2%). Although
14 Methods 1 and 2 are mathematically identical, Mr. Fox explained that Staff's Method 2 adjusts for
15 inflation reflected in plant.³⁸ Staff made an inflation adjustment to the FVROR to remove the
16 inflation in the plant. Staff did not make an adjustment to remove inflation from the Company's
17 embedded cost of debt nor from the cost of equity.

18 The Company argues that Staff has obscured the fact that the Commission uses the pre-
19 existing cost of debt, not the current market debt cost, through the use of a graph which compares the
20 CPI and yields on intermediate term Treasuries from 1962 to 2008.³⁹ Staff witness Fox utilized a
21 graph to demonstrate the correlation between inflation and the cost of debt. The graph shows a lag
22 between inflation and the market responses.⁴⁰ The graph further supports Staff's position that
23 because inflation is a component of the cost of debt the inflationary adjustment (accretion rate)
24

25 ³⁴ See *Re California Water Service Co.*, 56 CPUC 2d 4, 155 P.U.R. 4th 417, 1994 WL 652720 (Cal. P.U.C. 1994).

26 ³⁵ *Id.* (noting that sharing the gain of the sale of utility plant recognizes ratepayers' contributions to mitigating risk).

27 ³⁶ CCWC Closing Br at 67.

28 ³⁷ Ex. S-5 at 9-10.

³⁸ TR. 508-509

³⁹ CCWC Cl. Br. at 67.

⁴⁰ Ex. S-5 at 4.

1 should apply to the entire plant, not just to the portion funded by equity. Therefore, the Company's
2 embedded debt cost and the portion of that cost that is attributable to inflation remains fixed and is
3 irrelevant.

4 The Company argues that there is no inflation in the cost of debt. Staff disagrees. Staff
5 provided through testimony several sources that support the concept of inflation as a part of the cost
6 of debt, none of which were controverted by the Company.⁴¹ Contrary to the Company's assertion
7 that inflation is not a component of the cost of debt, the Company acknowledges in footnote 279 of its
8 brief, that inflation is a component of the cost of debt.⁴² The statement in the footnote suggests that
9 an investor will bid at different prices for debt instruments that pay fixed interest depending upon the
10 expected interest rate; effectively, the investor sees the fixed cash flows divided into principal and
11 interest portions in different amounts depending upon the inflation rate. This change in the interest
12 rate reflects the change in the debt cost that the investor requires due to inflation. It may be helpful to
13 consider these various recommendations by considering the nature of the inquiry underlying the
14 determination of a FVROR. Such a determination requires the exercise of judgment.

15 In determining an appropriate FVROR for Chaparral City, the Commission may consider all
16 of the available evidence and may use its expertise to reconcile the evidence and develop a
17 reasonable resolution. In other words, the Commission is not bound to adopt the specific
18 recommendation of any particular expert, but instead may use its expertise to synthesize the evidence
19 and arrive at a reasoned policy judgment.⁴³

20 **IV. CONCLUSION.**

21 Setting FVROR is within the discretion of the Commission, despite the Company's
22 protestations to the contrary. As such, the Commission is mindful that not only must the FVROR be
23 set to allow a utility to attract capital and provide a fair return, but that the Commission must also
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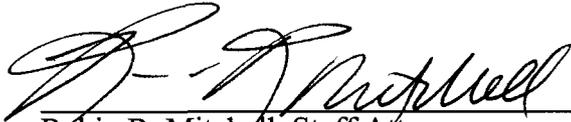
26 ⁴¹ Ex. S-5 at 6.

27 ⁴² Fn. 279 states "in some cases, there may be a secondary market for bonds, notes and other debt instruments. The price
that a purchaser is willing to pay for a particular debt instrument is affected by a number of different factors, including
expected inflation

28 ⁴³ See *Maine v. Norton*, 257 F.Supp.2d 357, 389 (D. Me. 2003); *Citizens Tel. Co. v. Public Service Comm'n of Kentucky*,
247 S.W.2d 510, 514 (1952).

1 take into account the interests of the ratepayers.⁴⁴ It is no easy task to balance the needs of such a
2 diverse constituent base. Staff's recommendations provide a more balanced approach that is mindful
3 of the Company's needs and the interests of the ratepayers. Staff respectfully requests that the
4 Commission adopt its recommendations of 10.1% cost of equity and 7.6% FVROR.

5 RESPECTFULLY SUBMITTED this 27th day of February, 2009.

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7 

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⁴⁴ See *Woods*, 171 Ariz. at 296, 830 P.2d at 817 (noting that legitimate purpose of Commission's ratemaking authority is to protect consumers).

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A handwritten signature in cursive script, reading "Ashley Hodge", is written over a horizontal line. The signature is positioned between the line numbers 9 and 11.