

ORIGINAL



0000102528

RECEIVED

2009 SEP -4 A 10: 51

ARIZONA CORPORATION COMMISSION  
DOCKET CONTROL

1 ARIZONA WATER COMPANY  
2 Robert W. Geake (No. 009695)  
3 Vice President and General Counsel  
4 3805 N. Black Canyon Highway  
5 Phoenix, Arizona 85012-5351  
6 Telephone: (602) 240-6860

7 FENNEMORE CRAIG, P.C.  
8 A Professional Corporation  
9 Norman D. James (No. 006901)  
10 Jay L. Shapiro (No. 014650)  
11 3003 North Central Avenue  
12 Suite 2600  
13 Phoenix, Arizona 85012-2913  
14 Telephone: (602) 916-5000

15 Attorneys for Applicant Arizona Water Company

Arizona Corporation Commission  
**DOCKETED**

SEP - 4 2009

DOCKETED BY

**BEFORE THE ARIZONA CORPORATION COMMISSION**

12 IN THE MATTER OF THE APPLICATION OF  
13 ARIZONA WATER COMPANY, AN ARIZONA  
14 CORPORATION, FOR A DETERMINATION OF  
15 THE FAIR VALUE OF ITS UTILITY PLANT  
16 AND PROPERTY, AND FOR ADJUSTMENTS  
17 TO ITS RATES AND CHARGES FOR UTILITY  
18 SERVICE AND FOR CERTAIN RELATED  
19 APPROVALS BASED THEREON.

DOCKET NO. W-01445A-08-0440

**NOTICE OF FILING WITNESS  
SUMMARIES**

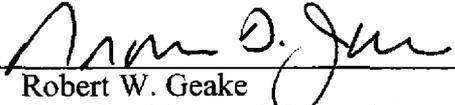
18 Pursuant to the Procedural Order dated November 4, 2008, Arizona Water Company  
19 ("Company"), an Arizona corporation, hereby submits this Notice of Filing Testimony  
20 Summaries in the above-referenced matter. The Company expects to call the following as a  
21 witness on Wednesday, September 9, 2009 and attaches his testimony summary herewith.

- 22 1. Dr. Thomas Zepp.

1  
2  
3  
4  
5  
6  
7  
8  
9  
10  
11  
12  
13  
14  
15  
16  
17  
18  
19  
20  
21  
22  
23  
24  
25  
26

DATED this 4th day of September, 2009.

ARIZONA WATER COMPANY

By:   
Robert W. Geake  
Vice President and General Counsel  
ARIZONA WATER COMPANY  
Post Office Box 29006  
Phoenix, Arizona 85038-9006

and

Norman D. James  
Jay L. Shapiro  
Fennemore Craig  
3003 North Central Avenue  
Suite 2600  
Phoenix, Arizona 85012  
Attorneys for Applicant  
Arizona Water Company

An original and thirteen (13) copies of the foregoing were delivered this 4th day of September, 2009 to:

Docketing Supervisor  
Docket Control Division  
Arizona Corporation Commission  
1200 West Washington Street  
Phoenix, Arizona 85007

A copy of the foregoing was hand-delivered this 4th day of September, 2009 to:

Chairman Kristin Mayes  
Arizona Corporation Commission  
1200 W. Washington St.  
Phoenix, AZ 85007

Commissioner Gary Pierce  
Arizona Corporation Commission  
1200 W. Washington St.  
Phoenix, AZ 85007

Commission Paul Newman  
Arizona Corporation Commission  
1200 W. Washington St.  
Phoenix, AZ 85007

- 1 Commissioner Sandra Kennedy  
Arizona Corporation Commission  
1200 W. Washington St.  
Phoenix, AZ 85007
- 2
- 3 Commissioner Bob Stump  
Arizona Corporation Commission  
1200 W. Washington St.  
Phoenix, AZ 85007
- 4
- 5
- 6 Sheila Stoeller  
Aide to Chairman Kristin Mayes  
Arizona Corporation Commission  
1200 W. Washington Street  
Phoenix, AZ 85007
- 7
- 8
- 9 Antonio Gill  
Aide to Commissioner Gary Pierce  
Arizona Corporation Commission  
1200 W. Washington Street  
Phoenix, AZ 85007
- 10
- 11
- 12 Jennifer Ybarra  
Aide to Commissioner Paul Newman  
Arizona Corporation Commission  
1200 W. Washington Street  
Phoenix, AZ 85007
- 13
- 14
- 15 Katherine Nutt  
Aide to Commissioner Sandra D. Kennedy  
Arizona Corporation Commission  
1200 W. Washington Street  
Phoenix, AZ 85007
- 16
- 17
- 18 Trisha Morgan  
Aide to Commissioner Bob Stump  
Arizona Corporation Commission  
1200 W. Washington Street  
Phoenix, AZ 85007
- 19
- 20
- 21 Ms. Lyn Farmer  
Chief Administrative Law Judge  
Hearing Division  
Arizona Corporation Commission  
1200 West Washington Street  
Phoenix, Arizona 85007
- 22
- 23
- 24
- 25
- 26

1 Mr. Ernest G. Johnson, Director  
Utilities Division  
2 Arizona Corporation Commission  
1200 West Washington Street  
3 Phoenix, Arizona 85007

4 Janice Alward, Chief Counsel  
Legal Division  
5 Arizona Corporation Commission  
1200 West Washington Street  
6 Phoenix, Arizona 85007

7 Daniel Pozefsky, Chief Counsel  
Residential Utility Consumer Office  
8 1110 West Washington Street, Suite 220  
Phoenix, Arizona 85007

9  
and a copy mailed this 4th day of September, 2009 to:

10  
11 Nicholas J. Enoch  
Jarrett J. Haskovec  
Lubin & Enoch, PC  
12 349 N. Fourth Avenue  
Phoenix, Arizona 85003  
13 Attorneys for IBEW Local 387

14 Michele Van Quathem  
Ryley, Carlock & Applewhite  
15 One North Central Avenue, Suite 1200  
Phoenix, Arizona 85004-4417  
16 Attorneys for Abbott Laboratories

17

18

19

By:   
2230983.1/12001.194

20

21

22

23

24

25

26

## ARIZONA WATER COMPANY

Docket No. W-01445A-08-0440

### Summary of Testimony of Thomas M. Zepp

Dr. Zepp is an economist and Vice President of Utility Resources, Inc., a consulting firm which he jointly established in 1985. He received his Ph.D. in Economics from the University of Florida. Prior to 1985, he was a consultant at Zinder Companies from 1982 to 1985, and a senior economist on the staff of the Oregon Public Utility Commissioner between 1976 and 1982. Prior to 1976, he taught business and economics courses at the graduate and undergraduate levels.

Dr. Zepp has testified on various topics before regulatory commissions, courts and legislative committees in 22 states, before two Canadian regulatory authorities, and before four Federal agencies. In addition to cost of capital studies, Dr. Zepp has testified regarding incremental costs of energy and telecommunications services and the value of utilities' assets.

Dr. Zepp prepared direct, rebuttal and rejoinder testimony on behalf of Arizona Water Company (the "Company") in this case regarding the Company's cost of equity. He recommends that the Company be authorized a return on equity ("ROE") of 12.4% in this case.

He provides an overview and perspective on what one should expect the fair rate of return on common equity for the Company to be in years 2009 to 2010. He also discusses the concept of a fair rate of return and specific additional risks faced by the Company when compared to the publicly traded water utilities in the sample group. The Company faces additional risks because it is smaller than the sample used to determine benchmark equity costs and is disadvantaged by rate-making policies in Arizona that reduce its opportunity to earn a fair ROE. The Commission routinely imposes limitations on out-of-period adjustments which are more restrictive than are faced by water utilities in the sample used to determine benchmark equity costs. This limitation is of special concern if the Commission decides not to authorize requested adjustment mechanisms when such mechanisms and projected test periods are available to the water utilities sample used to determine benchmark equity costs. The Company also faces added risks due to required inverted rate block structures designed to achieve conservation unless the Commission modifies its policy and adjusts test year sales to reflect such anticipated conservation. Taken together, Dr. Zepp concludes Arizona Water has a risk premium of at least 50 basis points, even if the adjusters proposed by the Company are adopted.

Dr. Zepp provides equity cost estimates determined with the Discounted Cash Flow ("DCF") model and the Capital Asset Pricing Model ("CAPM") based on methods and inputs that he has used in previous rate cases. He used the sample of six publicly traded water utilities that has been used by the Commission in prior water and wastewater rate cases to estimate the cost of equity. His updated estimates indicate that the Commission's water utilities sample has

an equity cost in the range of 11.9% to 12.4% and the Company's cost of equity falls in the range of 12.4% to 12.9%.

He also presents an equity cost estimate using the versions of the DCF and CAPM models that have been used by the Utilities Division ("Staff") and accepted by the Commission in recent water and wastewater rate cases, including the Company's previous rate cases for its Eastern and Western Groups. An update of Staff's cost of equity models indicates that the cost of equity for this sample of six publicly traded water utilities is 11.2%. Once the Company's additional risk is recognized, the 11.2% cost of equity increases to no less than 11.7%.

Dr. Zepp responds to the testimony and recommendations of Mr. Parcell, who has been retained to testify on behalf of Staff in this case. Dr. Zepp explains that Mr. Parcell has advocated a number of techniques that are designed to bias downward the cost of equity estimate. Once these improper techniques are corrected, a restatement of Mr. Parcell's methods indicates that the cost of equity for the water utilities sample used by the Commission and the Staff in water and wastewater utility rate cases falls in the range of 11.2% to 12.3%. Adjusting the cost of equity to account for the Company's additional risk produces a cost of equity in the range of 11.7% to 12.8%, which is consistent with the models and inputs used by Dr. Zepp and by the Staff.

Dr. Zepp also responds to the testimony and recommendations of RUCO's cost of capital witness, Mr. Rigsby. Dr. Zepp explains that Mr. Rigsby has made several significant errors in performing his cost of equity estimates. He has also used a sample group of natural gas distribution companies as a proxy for the Company, even though the use of such utilities as proxies was rejected by the Commission in the Company's rate case for its Eastern Group systems in 2004 based on differences in risk. Once Mr. Rigsby's analysis is corrected and restated, and a 50 basis point premium is included for the Company, his analysis indicates that the Company's cost of equity falls in a range of 12.0% to 12.4%.

Dr. Zepp prepared rejoinder testimony on the cost of equity for the Company. He explains the current and continuing financial crisis and recession have increased the cost of equity for water utilities as well as other businesses, not reduced the cost of equity as is suggested by Mr. Parcell. Mr. Parcell's analysis fails to give reasonable weight to analysts' forecasts of growth and does not include an estimate of the current market risk premium and thus his DCF and CAPM estimates are flawed and not realistic. Mr. Rigsby relies on CAPM estimates below the cost of investment grade debt and DCF estimates which double-count potential movement of stock prices toward book values. Once corrected, Mr. Rigsby's equity cost estimate is not 8.33% but in line with the cost of equity determined by Dr. Zepp. Dr. Zepp concludes nothing in either Mr. Parcell's surrebuttal testimony or Mr. Rigsby's surrebuttal testimony show the analysis presented in his rebuttal testimony is erroneous or results in 12.4% being an unreasonable estimate of the Company's cost of equity at this time.