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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS
GARY PIERCE, CHAIRMAN
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP
BRENDA BURNS

APPLICATION OF RAY WATER COMPANY FOR A PERMANENT INCREASE IN ITS RATES

Docket No. W-01380A-12-0254

FILING OF MATT ROWELL'S REBUTTAL TESTIMONY

Ray Water Company, ("Company"), hereby files rebuttal testimony of Matt Rowell. *See* Attachment 1.

Dated this 4th day of January, 2013.

MOYES SELLERS & HENDRICKS LTD.

Steve Wene

Steve Wene

Arizona Corporation Commission
DOCKETED
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Original and 13 copies of the foregoing filed this 4th day of January, 2013, with:

Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Dinney Herbert

ATTACHMENT 1

BEFORE THE ARIZONA CORPORATION COMMISSION

<u>COMMISSIONERS</u>
GARY PIERCE, CHAIRMAN
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP
BRENDA BURNS

APPLICATION OF RAY WATER COMPANY FOR A PERMANENT INCREASE IN ITS RATES	Docket No. W-01380A-12-0254 **REBUTTAL TESTIMONY OF MATTHEW ROWELL**

Q. Are you the same Matthew Rowell that submitted testimony in support of Ray Water Company's ("Company" or "Ray") Application in this Docket?

A. Yes.

Q. Please summarize your rebuttal testimony.

A. Staff's recommended prohibition on the Company's use of short term debt should be rejected. Staff's capital structure and cost of debt are appropriate only if Well No. 8 is included in rate base. If Well No. 8 is excluded from rate base a 100% equity capital structure should be adopted. Staff's proposed ROE of 9.5% is acceptable but several factors will deny Ray the opportunity to actually earn a 9.5% ROE. If those factors are not addressed a ROE of 10.9% is necessary. Further, Staff apparently does not understand my testimony regarding my proposed 65 basis point risk adjustment, which I will explain in detail below to ensure the misunderstandings are resolved. Nonetheless, Staff's direct testimony on this issue should be afforded little weight.

Q. At page 8 of his testimony Mr. Cassidy raises concerns regarding a line of credit and seems to indicate that the Company is prohibited from accessing this line of credit. How do you respond?

A. As long as the Company uses the line of credit as a source of short term (less than 12 month) financing, Staff's concerns are unfounded.

Q. Does this short term debt issue have any bearing on the revenue requirement or rates in this proceeding?

A. No. The Company currently has no short term debt so this is a prospective issue only.

Q. Please discuss the Company's and Staff's proposed cost of debt.

A. The Company proposes a cost of debt of 6.25%. Staff is proposing a cost of debt of 6.3% which is acceptable to the Company.

Q. Please discuss the Company's and Staff's proposed capital structures.

A. Staff is proposing a capital structure made up of $87,346 of debt and $1,059,748 in equity or 7.61% debt and 92.39% equity. This is somewhat different from the capital structure proposed by the Company: 7.41% debt and 92.59% equity. I do not fully agree with how Staff developed their proposed capital structure, nonetheless, the difference is immaterial. So in order to decrease the issues in dispute, the Company accepts Staff's proposed capital structure subject to the caveat below.

Q. Does the testimony of Staff witness Crystal Brown raise any concerns regarding Ray's capital structure?

A. Yes. Staff is recommending that Well No. 8, which was financed with the loan authorized in Decision 71691, not be included in rate base (Staff Rate Base Adjustment #1). All of the debt included in the Company's capital structure was used to finance Well No 8. If Well No 8 is removed from rate base then the corresponding debt should be removed from the capital structure. So if the Commission were to adopt Staff's recommendation regarding Well No 8, the capital structure should be 100% equity. If the

Commission sides with the Company on this issue and allows Well No 8 into rate base than Staff's recommended capital structure of 7.61% debt and 92.39% equity is appropriate.

Q. Do you have any general comments about Staff's cost of equity recommendation?

A. Staff's cost of equity recommendation is, on the whole, reasonable. Staff's decision not to impose "a downward financial risk adjustment" because Ray does not have access to equity capital markets is a rational and realistic approach to the capital structure issues in this case. Further, Staff's decision to add a positive 60 basis point "Economic Assessment Adjustment" to the cost of equity estimates derived from averaging their financial models is a reasonable and fair way to deal with the shortcomings of those models.

Q. Staff is proposing a 9.5% ROE, how does that compare to ROEs approved around the country?

A. Each Fall, Public Utilities Fortnightly publishes its Rate Case Study that lists the approved ROE's for gas and electric utilities around the country. The 2012 edition lists authorized ROEs for 79 different utilities across the country. Staff's recommended ROE of 9.5% is less than 82% of those authorized ROEs.

Q. What is your response to Staff's proposed 9.5% ROE?

A. A 9.5% ROE is low. But to limit the number of issues in dispute, the Company is willing to agree to the 9.5% ROE provided the Company actually has an opportunity to earn 9.5%. The main problem is that Staff's other recommendations and adjustments deny the Company the opportunity to earn 9.5%. In other words, Staff's recommendations and adjustments discussed below render the 9.5% ROE illusory, and the Company will agree to this proposed ROE only if those recommendations and adjustments are not adopted.

Q. Does Staff's rate design adversely affect Ray's opportunity to earn its authorized ROE?

A. Yes. There are two primary issues. First, Staff's tiered rates are intended to promote water conservation. But when setting rates to meet the revenue requirement, Staff presumes that water conservation will not occur. So we know that tiered rates will lead to conservation, which leads to revenue requirements not being met, which leads to authorized ROEs not being met. The second issue is that under Staff's proposal most of the monthly minimum charges do not change materially. This means the bulk of the increase is set forth in the commodity charges. Thus, as customers use less water, the adverse impact to the Company's revenue is even greater.

This is why a revenue adjustment mechanism as recommended in the Rebuttal Testimony of Sonn Rowell is appropriate. Alternatively, this issue could be addressed by putting a much higher percentage of the increase on the monthly minimum charge. Another alternative is to include an upward adjustment to the ROE.

Q. **Is it normal to assign 100% of a recommended increase to commodity charges?**

A. No. This is a radical departure from normal ratemaking practices. Staff has provided no explanation for why they chose this position. Staff's radical and unexplained recommendation insures that Ray will not have an opportunity to achieve its authorized ROE.

Q. How do you recommend that these rate design issues be dealt with?

A. The problems associated with tiered rates can be alleviated through a revenue adjustment mechanism as recommended in the Rebuttal Testimony of Sonn Rowell. It could also be alleviated by putting a much higher percentage of the increase on the monthly minimum charge. Another alternative is to include an upward adjustment to the ROE.

Q. What accounting adjustments recommended by Staff will deny Ray the opportunity to earn its authorized rate of return?

A. Staff is recommending several adjustments that incorrectly reduce Ray's recoverable expenses. These adjustments artificially reduce Ray's operating costs (on paper). A revenue requirement based on artificially low operating costs ensures that Ray's authorized ROE is unobtainable. For example, Staff Adjustment #6 reduces rent expense based on incorrect assumptions about Ray's Court Avenue location. Staff Adjustment # 7 artificially reduces maintenance expenses for Ray's vehicles. Staff Adjustment #10 results in an artificially low level of property taxes.

Q. What about Staff's recommendation to exclude Well No. 8 from rate base?

A. Of course excluding used and useful plant from rate base will result in an inability to achieve the authorized ROE. Staff's recommendation regarding Well No. 8 also raises other issues relevant to ROE. This recommendation demonstrates the extreme risks faced by Arizona water utilities. A utility that makes pro-active investments to replace aging infrastructure faces the risk of having those investments disallowed. A utility that foregoes such investments faces the risk that its existing infrastructure will fail catastrophically. Such risks are not reflected in the standard ROE estimation techniques employed by Staff (the CAPM and DCF).

Staff's recommendation to exclude Well No. 8 from rate base has increased rate case expense because it has forced the Company to hire additional engineering witnesses. If this additional rate case expense is not included in rates it will further inhibit Ray from achieving its authorized ROE.

Q. Are there other aspects of Staff's engineering testimony that you find troubling?

A. Yes. Staff is recommending the adoption of 5 BMP tariffs, water loss reduction measures, and a study on drive motors. Yet, there is no provision in rates for the costs of complying with these recommendations. Adoption of these recommendations without approving revenue enhancements to cover their costs is further insurance that Ray will not have an opportunity to achieve its authorized ROE

Q. Please summarize your testimony regarding the appropriate ROE for Ray.

A. If the Staff recommendations discussed above are not adopted an authorized ROE as recommended by Staff (9.5%) is acceptable. However, if these Staff recommendations are adopted an authorized ROE as I originally recommended (10.9%) is necessary to account for the fact that Staff's recommendations deny the Company an opportunity to achieve its authorized ROE.

Q. How do you respond to Staff's contention that the Comparable Earnings method is inappropriate (at pages 37 and 38 of Mr. Cassidy's Direct Testimony)?

A. First, comparable earnings is an accepted method of developing authorized ROEs; it is employed by many utility commissions around the country and it is included as a legitimate method in every text on the subject of utility ROE that I am aware of. Second, Staff's critique of the comparable earnings method completely ignores the standards laid out in the Hope and Bluefield cases. While Staff insists that only forward looking factors be included in ROE analysis, the Hope and Bluefield cases contain no such limitation. In fact, the standards set forth in Hope and Bluefield requires that authorized ROEs be "commensurate with returns on investments in other enterprises having corresponding risks."[1] Third, Staff asserts that I am implicitly recommending that "returns on equity

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[1] *Federal Power Commission et. al. v. Hope Natural Gas Company (320 U.S. 591).*

authorized by other regulatory jurisdictions are appropriate for RWC"[2] even though I state explicitly that returns authorized in other jurisdictions are not sufficient to account for the risks of an Arizona water utility and I propose and adjustment for those risks. Fourth, Staff criticizes the use of historical accounting returns but employs such returns itself when developing its DCF model.[3] Finally, each technique for developing authorized ROEs has its pros and cons. Staff's focus on the cons of the Comparable Earnings technique with no acknowledgement of its pros is not reasonable.

Q. **Staff characterizes your proposed risk adjustment as a small company risk premium. How do you respond?**

A. That characterization is wrong. I proposed a 65 basis point adjustment to account for the demonstrated difference (both in terms of level and spread) between achieved ROEs by Arizona utilities and the sample utilities. I listed several factors that I believe result in that difference. The small size of Arizona's utilities was just one of those several factors. In their data requests, Staff asked questions about the tiered rates factor.[4] Ironically, Staff is recommending an adjustment to their ROE recommendation very similar to the one I proposed (60 basis points vs. 65). Staff did not offer a detailed rationale for their adjustment. So even though Staff mischaracterizes my testimony, Staff is offering virtually the same result with no explanation, so their criticism should be afforded little weight.

Q. Does this conclude your testimony?

A. Yes

[2] Direct Testimony of John Cassidy page 37 line 18.
[3] See Direct Testimony of John Cassidy page 19 lines 10-11.
[4] Staff data request JAC 8.11.