ORIGINAL OPEN MEETING AGENDA ITEM

0000142169

BEFORE THE ARIZONA CORPORATION COMMISSION

BOB STUMP
CHAIRMAN
GARY PIERCE
COMMISSIONER
BRENDA BURNS
COMMISSIONER
BOB BURNS
COMMISSIONER
SUSAN BITTER SMITH
COMMISSIONER

AZ CORP COMMISSION
DOCKET CONTROL
2013 FEB 8 AM 9 52

Arizona Corporation Commission
DOCKETED
FEB 08 2013
DOCKETED BY

IN THE MATTER OF THE APPLICATION OF ARIZONA WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY, AND FOR ADJUSTMENTS TO ITS RATES AND CHARGES FOR UTILITY SERVICE FURNISHED BY ITS EASTERN GROUP AND FOR CERTAIN RELATED APPROVALS.	Docket No. W-01445A-11-0310

EXCEPTIONS OF THE RESIDENTIAL UTILITY CONSUMER OFFICE

The Residential Utility Consumer Office ("RUCO") makes the following Exceptions to the Recommended Opinion and Order ("ROO").

INTRODUCTION

To the average ratepayer, the most contentious issue in this case, the Distribution System Improvement Charge ("DSIC") is of little consequence. The ratepayer is concerned primarily with the rates and how much more he/she will pay in rates as the result of this case. To that end, the bottom line is the increase in the revenue requirement, not how the Commission got there. It is true that the Administrative Law Judge in her Recommended Opinion and Order ("ROO") in this case did not award the Company the DSIC it requested.

However, the Company more than made up for it in the ROO's recommended Cost of Equity ("COE"). By all measures, the recommended COE is overstated under the circumstances of this case which, in turn results in an overstated Cost of Capital and Revenue Requirement. The Company requested an overall revenue increase of $5,198,671 whereas the ROO recommends $3,719,591. By comparison, RUCO's recommended overall revenue increase is $2,864,878 and Staff's final recommended revenue increase is $2,709,876.

THE ROO'S PROPOSED REVENUE INCREASE IS OVERSTATED

It is noteworthy that the ROO did not recommend approval of the DSIC or SWIP, but did recommend a Cost of Equity of 10.55 percent out of concern for the Company's aged infrastructure and the need for infrastructure replacement and improvement. ROO at 61. However, among the many reasons the ROO cites for rejecting the DSIC, the ROO notes that AWC's Board of Directors has not found its financial circumstances that dire that it could not pay out several million dollars in shareholder dividends each year. ROO at 105. In fact, the ROO notes that two years of shareholder dividends at the 2010 level would nearly cover the estimated costs of the three-year plan for the Superstition, Oracle and Bisbee divisions. ROO at 105. Clearly, the additional risk associated with the Company's alleged infrastructure needs has not affected the Board's thinking when it comes to the payment of dividends.

Neither Staff nor RUCO recommended the approval of the Company's proposed DSIC. The Company recommended a COE of 12.5 percent. RUCO and Staff both recommend a COE of 9.40 percent. The difference between the Company's COE recommendation and Staff and RUCO's is striking, and the fact that the Company would request such a high COE in addition to a DSIC strains credibility.

Nonetheless, both Staff and RUCO considered the Company's infrastructure needs in their COE recommendation. It is true that determining the COE is more of an art than a science, but the science aspect should not be discounted. From both the science and the art perspective, the ROOs COE is overstated. From the science perspective, Staff's sample group of utilities used in its COE analysis had an average capital structure very similar to the Company's capital structure. Based on that fact, Staff concluded that the Company's stockholders bear slightly less financial risk than do the Stockholders of Staff's sample group. Staff took the average of its DCF estimate of 9.0 percent and its CAPM estimate of 9.7 percent to arrive at its 9.4 percent COE recommendation and did not adjust for additional risk because of the similar capital structures of its proxy group to the Company's.

RUCO's approach also used a sample group and relied on both the DCF and the CAPM models. RUCO's COE results ranged from a low of 3.90 percent using the CAPM method to a high of 9.47 percent using the DCF method. RUCO checked its numbers with the then current Value Line report on the water industry and increased its original 9.30 percent COE recommendation to 9.40 percent to be consistent with current stock information. RUCO noted that the Company's 12.50 percent COE would reflect a 1.48 beta which would place the Company among the most competitive unregulated industries and not among the relatively safe regulated utilities.

Again, the point of the technical analysis is to show that by both industry standards and what the Commission has traditionally relied on in the past to determine COE, the ROO's recommended 10.55 percent COE is overstated. The more nebulous "art" perspective does not fare much better. The Company requested a 90 basis point risk premium be added in arriving at its COE recommendation. The ROO dispatches with the 90 basis point request noting that the Company's location in Arizona and its size is not a persuasive reason for the risk premium.

Which leaves the Company's infrastructure needs – ironically, the ROO persuasively sets forth the reasons why the Company's infrastructure needs should not be determinative of a high COE. The ROO sets out at length all of the reasons why awarding a DSIC is inappropriate here. See ROO at 104 – 107. So why should the Commission entertain a higher COE based on those very reasons - it is simply counterintuitive. No one argues that the infrastructure demands in question are routine, were entirely foreseeable and not the result of an "ambush". ROO at 104-105. Moreover, with a little better planning and use of its revenues, as noted by the ROO, the Company would not be in its current situation. ROO at 105. Awarding a higher COE because of the Company's infrastructure needs, like awarding a DISC in this case, is tantamount to awarding the Company for its own failure to maintain and improve its system responsibly. ROO at 105.

The replacement of routine infrastructure is not extraordinary and does not require extraordinary ratemaking. ROO at 104. Nor does it require elevating the COE which will have the same ultimate effect on the ratepayer – higher rates. The Commission should reject the ROOs COE and adopt RUCO's 9.40 percent COE recommendation. RUCO estimates that by adopting the 9.40 percent COE, the result would lower the ROO's recommended revenue requirement by approximately $618,000 which would still produce a revenue increase greater than what both Staff and RUCO are recommending.

CONCLUSION

The old saying – "There is more than one way to peel a grape" for the most part sums up the ROO. The Company was not awarded the DSIC but more than made up for it in the Cost of Equity. To the ratepayer the result is the same – higher rates. The Commission should reject the ROO's recommended COE and adopt RUCO and Staff's proposed 9.40 percent.[1]

RESPECTFULLY SUBMITTED this 8th day of February, 2013

Daniel Pozefsky
Chief Counsel

AN ORIGINAL AND THIRTEEN COPIES
of the foregoing filed this 8th day
of February 2013 with:

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

COPIES of the foregoing hand delivered/
mailed this 8th day of February, 2013 to:

The Honorable Sarah Harping
Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Janice Alward, Chief Counsel
Wes Van Cleve
Legal Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

---

[1] RUCO has attached a proposed amendment as Exhibit 1.

Steven M. Olea, Director
Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Robert W. Geake
Vice President and General Counsel
Arizona Water Company
Post Office Box 29006
Phoenix, Arizona 85038-9006

Steven A. Hirsch
Stanley B. Lutz
Bryan Cave LLP
Two North Central Avenue, Suite 2200
Phoenix, AZ 85004

Kathie Wyatt
1940 N. Monterey Drive
Apache Junction, AZ 85120

By Cheryl Fraulob
Cheryl Fraulob

EXHIBIT 1

RUCO'S PROPOSED AMENDMENT 1

COST OF CAPITAL

Page 61

Line 11 Delete: "10.55"

Insert: "9.40"

Lines 14 -17 Delete: Additionally, although our decision in the 2012 Western Group Rate Case adopted a COE of 10.0 percent for the Western Group, we conclude that the Eastern Group, due to the age of some of its systems and the resulting increased need for infrastructure replacement and improvement, necessitates a somewhat higher COE.

Line 27 Delete: "10.55"

Insert: "9.40"

Page 62

Line 7 Delete: "10.55"

Insert: "9.40"

Make all conforming changes.