

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 KRISTIN K. MAYES
CHAIRMAN

3 GARY PIERCE
COMMISSIONER

4 SANDRA D. KENNEDY
COMMISSIONER

5 PAUL NEWMAN
COMMISSIONER

6 BOB STUMP
COMMISSIONER

7
8 IN THE MATTER OF THE APPLICATION OF
9 ARIZONA WATER COMPANY, AN ARIZONA
10 CORPORATION, FOR A DETERMINATION
11 OF THE FAIR VALUE OF ITS UTILITY
12 PLANT AND PROPERTY, AND FOR
13 ADJUSTMENTS TO ITS RATES AND
14 CHARGES FOR UTILITY SERVICE AND
15 FOR CERTAIN RELATED APPROVALS
16 BASED THEREON.

Docket No. W-01445A-08-0440

13 **RUCO'S INITIAL CLOSING BRIEF**

14 The Residential Utility Consumer Office ("RUCO") submits this Initial Closing Brief on
15 the matters raised at Arizona Water Company's ("AWC" or "Company's") recent rate hearing.

16
17 **A. ISSUES RESOVED BETWEEN RUCO AND AWC AND/OR STAFF**

18 RUCO and AWC have reached agreement on a number of issues, which were initially
19 disputed. Those agreements are as follows:

20 **1. Oracle/Saddlebrook Depreciation Expense**

21 In its Application, the Company agreed to exclude \$1,129,708 from utility plant in
22 service ("UPIS") because the Saddlebrook plant was not operational.¹ Commensurate with
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24 ¹ Application of Arizona Water, Schedule B-2, page 9 of 24.

1 removing the Saddlebrook plant from the Oracle System’s rate base, the Company should
2 also have removed the depreciation expense associated therewith. It did not. In Adjustment
3 No. 7, RUCO deducted \$27,957 from the total depreciation expense.² Although the
4 Company did not accept the adjustment in rebuttal or rejoinder testimony, Joel Reiker, the
5 Company’s expert witness agreed to RUCO’s adjustment to depreciation expense during the
6 hearing.³

7 **2. Utility Plant In Service (“UPIS”)/Accumulated Depreciation**

8 The Company’s Schedule B-2 for the Casa Grande System included \$822,694 of
9 Intangible Plant.⁴ RUCO could not reconcile the \$822,694.⁵ In its Adjustment No. 1, RUCO
10 deducted the \$822,694 and increased accumulated depreciation by \$1,579. The Company
11 failed to respond in testimony, but on cross-examination, Mr. Reiker admitted that \$822,694
12 of the intangible plant was plant disallowed by the Commission in a prior rate case and
13 agreed to accept RUCO’s Adjustment No. 1 to Plant and Accumulated Depreciation.⁶

14 **3. Customer Deposits**

15 RUCO, the Company and Staff concur that Customer Deposits should be a
16 deduction to rate base as the deposits are not investor supplied.⁷

17 **4. Deferred Regulatory Asset-Amortization**

18 RUCO and the Company concur with Staff’s position regarding deferred regulatory
19 asset amortization for the Casa Grande System.

22 ² T: 909-910, Exhibit R-21

23 ³ T: 614-615

24 ⁴ Application of Arizona Water, Schedule B-2, page 13 of 24.

⁵ T: 909. See Also Exhibit R-21 Direct Testimony of Tim Coley, Schedule TJC-3.

⁶ T: 495-496.

⁷ T: 612-611.

1 **5. Working Capital**

2 **a. Purchased Water**

3 RUCO and the Company agreed on the number of lead/lag days for purchased water
4 expense except for the White Tank System. Staff pointed out that White Tank will not
5 purchase water going forward. RUCO and the Company have accepted the Staff's position
6 that purchased water expense should be removed from White Tank's income statement and
7 be eliminated from the lead/lag study.

8 **b. Cost of Equity:**

9 The Company asserted that if the cost of debt was included in the lead/lag study, the
10 cost of equity should be too. RUCO and Staff disagreed and argued that the cost of equity
11 should not be included in the lead/lag study.⁸ RUCO and Staff further argued that consistent
12 with the Commission's past rulings; the cost of equity does not involve cash payments by the
13 Company to a third party and should not be included in a lead/lag study.⁹ RUCO, citing
14 Dabelstein's treatise,¹⁰ acknowledged in rare circumstances that dividend payments may be
15 included in a lead/lag study. RUCO asserted and the Company agreed that if dividend
16 payments are considered in the Company's lead/lag study, the Company must use a
17 quarterly expense lag, plus the amount of days from the end of the quarter until the payments
18 are actually made. Using this formula, RUCO derived a 50.625-day expense lag.¹¹ The
19 Company accepted RUCO's method of calculating dividend payments.¹²

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22 ⁸ T: 977-78.

23 ⁹ T: 920-21 and 972-73.

24 ¹⁰ Id., See also R-25, Public Utility Working Capital, by Carl W. Dabelstein, CPA.

¹¹ T: 921.

¹² T: 972-974.

1 **6. Retirements**

2 The Company proposes and RUCO does not object to retirement of plant identified as
3 such on Exhibits A-12 and A-13. Although RUCO believes the Company should have made
4 greater effort to identify all retired plant prior to the hearing, RUCO has no objection to the
5 retirement of plant identified by the Company in its exhibits.¹³ Nor does RUCO object to the
6 methodology proposed by the Company for retirement, specifically, a reduction in UPIS equal
7 to the amount of the original cost of the plant and a reduction to Accumulated Depreciation in
8 the same amount. RUCO's adjustments are set forth in revised scheduled identified as
9 Exhibit R-22.¹⁴ RUCO disagrees with the Company's proposal to remove contributions in aid
10 of construction ("CIAC") as more fully discussed in section B2 below.

11 **7. Post Test Year Plant-Carrol Canyon Well**

12 The Company and Staff have accepted RUCO's adjustment reducing utility plant in
13 service by \$413,817 and adjustment to subtract \$1,249 to accumulated depreciation for
14 Carrol Canyon Well.¹⁵

15 **8. Capital Structure**

16 RUCO recommends and Staff and the Company agree to a capital structure
17 composed of 4.80 percent short-term debt, 49.35 percent long-term debt, and 45.85 percent
18 common equity.¹⁶

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23 ¹³ T: 913

¹⁴ T: 912-913 and 966-967.

¹⁵ T: 916

24 ¹⁶ See Exhibit R-33, Rigsby's Surrebuttal Testimony at 2.

1 **9. Cost of Short and Long Term Debt**

2 RUCO recommends and Staff and the Company concur with a cost of short-term debt
3 of 3.00 percent, and a cost of long-term debt of 6.83 percent.¹⁷

4 Based on the foregoing agreements, RUCO will not brief these matters further.
5 Notwithstanding the language of the procedural order, the absence of further briefing does
6 not constitute RUCO's waiver on the above-referenced issues.

7 **B. UNRESOLVED ISSUES RELATED TO REQUIRED REVENUE**

8 **1. Plant Held for Future Use**

9 In Exhibit A-12 and A-13, the Company identifies plant to be held for future use.
10 RUCO objects to the inclusion of the plant held for future use in utility plant in service. First,
11 the Company failed to properly identify the plant prior to hearing making it difficult if not
12 impossible for RUCO and or Staff to verify any of the information supplied therein.¹⁸ Second,
13 the plant held for future use does not meet the used and useful standard.¹⁹ Including plant
14 held for future use would also be inconsistent with prior rulings of the Commission. In
15 Decision No. 64282, the Commission determined that plant held for future use may not be
16 included in rate base until the plant is being used for the provision of utility service.²⁰ In this
17 instance, the Company acknowledges that plant held for future use is not currently used and
18 useful in the provision of utility service. The Company's plans for use of plant categorized as
19 plant held for future use are contingent upon improvements in the housing market,
20 completion of construction, improvement in earnings, and resolution of bankruptcy filings of
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23 ¹⁷ *Id.* at 3.

¹⁸ T: 913.

¹⁹ T: 971-72.

²⁰ *In the Matter of Arizona Water*, Docket No.W-01445A-00-0962, Decision No. 64282.

1 contracted construction companies.²¹ As Tim Coley, RUCO's witness testified, the
2 Company's plans can only be described as speculative because the plans are contingent on
3 events, which may or may not occur in the next 2-10 years.²² As such, the plant is not used
4 and useful, does not meet the standards established by the Commission in Decision No.
5 64282 and should be excluded from utility plant in service.

6 **2. Treatment of CIAC on Retirement of Plant**

7 RUCO and the Company agree to retirement of several plant items from utility plant
8 and service. RUCO and Company agree that the retirement method should include a
9 reduction in UPIS equal to the amount of the original cost of the plant and a reduction to
10 Accumulated Depreciation in the same amount. The Company proposed to deduct any CIAC
11 associated with retired plant which would amount to an increase in rate base. RUCO
12 disagrees. Mr. Coley testified that the Company's proposal to reduce CIAC associated with
13 retired plant is inconsistent with the Commission's Decision No. 70011 and violates the
14 Commission's rule A.A.C. R14-2-103.²³ As the Commission stated in Decision 70011, in
15 agreement with Staff and RUCO "advances represent customer supplied funds that are
16 properly deducted from the Company's rate base in compliance with the Commission's own
17 rules." Indeed, the Commission's own rules contemplate that AIAC and CIAC be deducted
18 from rate base.²⁴

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²¹ T: 918-919. See also A-10 Rebuttal Testimony of Frederick K. Schneider at 22-28.

²² T: 918-919.

²³ T: 916-917. See also, Exhibit R-23, Decision No. 70011, In the Matter of UNS Gas, Inc., Docket No. G-04204A-06-0463 at 9 and R-24, A.A.C R14-2-103, Schedule B-1.

²⁴ Id.

1 **3. Post Test Year Plant:**

2 **a. Scenic Highway 179 Project**

3 The Company seeks 100 percent rate base treatment of plant associated with the
4 replacement of water lines and plant along Highway 179. The Company admits that only 8
5 percent of the project was completed on or about July 1, 2008, six months post test year.²⁵
6 Because only 8 percent of the improvements to Scenic Highway 179 Water Relocation
7 project were completed by July 1, 2008, RUCO asserts that 92 percent of the costs should
8 not be included in rate base.

9 The Company asserts that 100 percent of the project should be included in rate base.
10 Mr. Coley testified that RUCO excludes post test year plant past the six month post test year
11 plant if it is not related to health and safety concerns such as an arsenic removal treatment
12 plant.²⁶ The Company asserts that the waterline relocation is a health and safety issue
13 similar to an arsenic treatment plant. It is not. The Company did not choose to relocate lines
14 along Scenic Highway 179 to address an unresolved health and safety issue or because of a
15 federal mandate.²⁷ The Company made a business decision to relocate the lines to avoid
16 the possibility of the State's condemnation of its waterlines.²⁸ It was a business decision.
17 RUCO is not criticizing or questioning the prudence of the Company's decision. RUCO
18 simply maintains that the post test year Scenic Highway 179 water relocation project is
19 distinguishable from the development of an arsenic treatment plant to meet federal
20 mandates. Because the project and the project was undertaken as a business decision by
21 the Company to avoid condemnation by the State, and only 8 percent of the project was

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23 ²⁵ See Exhibit R-15 Arizona Water's Response to RUCO's DR 8.01.

²⁶ T: 991-992.

²⁷ *Id.*

²⁸ See Exhibit A-20, Rebuttal Testimony of Joel Reiker at 20-21.

1 complete and used and useful to ratepayers, RUCO recommends denial of the remaining 92
2 percent of the costs.

3 **b. Pinewood Electric Panel**

4 The Company proposes to include an electric panel in rate base. The Pinewood
5 Electric Panel was not placed in service until July 10, 2009, 18 months after the end of the
6 test year.²⁹ RUCO and Staff concur that the electric panel was not used and useful during
7 the test year.³⁰ Based on the foregoing, RUCO and Staff concur the costs of the
8 replacement of the electric panel should be excluded from rate base.³¹

9 **c. Valley Vista Well**

10 The Company seeks rate base treatment for Valley Vista Well in the Sedona System.
11 RUCO recommends denial of the request because the Valley Vista Well was not completed
12 by the end of the test year. Initially, the Company reported that Valley Vista Well No. 13 and
13 pump was put in service in November, 2008.³² Thereafter, the Company's witness, Frederick
14 Schneider testified that he saw the well and pump in place by Fall of 2007.³³ Last, Mr.
15 Schneider submitted documentation asserting that the well and pump were in place by May
16 2008.³⁴ He also submitted a Community Water Report indicating that the well produced 2
17 acre-feet of water in 2008.³⁵ Unfortunately, he did not testify or provide pumping data
18 demonstrating when the well produced the 2 acre-feet of water in 2008. The Company has
19 the burden of proof. The Company's conflicting testimony certainly undermines its ability to
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22 ²⁹ T: 979-978.

³⁰ *Id.*

³¹ *Id.*

³² See Exhibit S-4 Arizona Water's Response to Staff DR BKB 11.16

³³ T: 781-782.

³⁴ See Exhibits A-32 and 33.

³⁵ See A-32 Community Water System report dated 5/13/2009.

1 meet the standard of proof. Mr. Coley, RUCO's witness, testified that he could not verify the
2 Company's testimony.³⁶ In fact, he testified that the Arizona Department of Water Resources
3 ("ADWR") well registry indicated no pump had been installed at Valley Vista Well No 13.³⁷
4 The law requires that the Company notify ADWR within 30 days of installing the pump.³⁸ The
5 Company could produce no documentation demonstrating it notified the ADWR of the pump
6 installation.

7 Even assuming facts in a light most favorable to the Company, there is no basis for
8 giving 100 percent rate base treatment to the well because it was not used in the test year.
9 Moreover, the well only produced 2 acre-feet in 2008. The pump on Valley Vista Well is a
10 750-gpm pump. The conversion factor for gallons per minute to acre-feet per annum is
11 1.612.³⁹ At 750 gpm, Valley Vista Well can produce 1,209 acre-feet per annum.⁴⁰ If the well
12 produced 2 acre-feet in the 12 months post test year, 99.98 percent of the well's capacity
13 was unused.⁴¹ There was some testimony that the Company reduced the well capacity to
14 300 gpm.⁴² At 300 gpm, Valley Vista Well could produce 483.6 acre feet per annum.⁴³ Two
15 acre feet of water is less than 1 percent of the purported capacity of the well throttled back to
16 300 gpm.⁴⁴ Given that the well was not completed or utilized in the test year and 99 percent
17 of the well's capacity was unused in the post test year, Valley Vista Well No. 13 should be
18 excluded from rate base.

20 ³⁶ T: 929-930.

21 ³⁷ See Exhibit R-14 Well Registry for Well 212110 Valley Vista Well #13.

22 ³⁸ A.R.S. §45-600B

23 ³⁹ T: 1221-1222.

24 ⁴⁰ $1.612 \times 750 = 1,209$ acre feet per annum.

⁴¹ $2 \text{ afa} / 1,209 \text{ afa} = 0.00165 \times 100 = 0.165$ used post test year, leaving 99.98 percent unused ($100.00 - 0.165 = 99.98$ percent).

⁴² See S-13 Testimony of Stukov

⁴³ $1.612 \times 300 = 483.6$ acre feet per annum.

⁴⁴ $2 \text{ afa} / 483.6 \text{ afa} = 0.00413 \times 100 = 0.413$ percent or less than 1 percent.

1 assets and the risk as measured by beta.⁴⁹ The underlying theory behind the CAPM states
2 that the expected return on a given investment is the sum of a risk-free rate of return plus a
3 market risk premium that is proportional to the systematic, non-diversifiable risk, associated
4 with that investment.⁵⁰

5 The Company arrived at its CAPM cost of equity capital of 12.4 percent by averaging
6 a 12.3 percent CAPM derived from long horizon average market risk premium and a 12.5
7 percent CAPM derived from a current forecasted market risk premium.⁵¹ RUCO derived its
8 CAPM cost of equity capital based on a historic market risk premium.⁵² RUCO calculated a
9 range for its CAPM cost of equity capital between 6.04 percent-7.43 percent for its water
10 sample and 5.26 percent-6.39 percent for its natural gas proxy.⁵³

11 The Company claims that RUCO's CAPM analysis is not reliable because it is based
12 on a historic market risk premium.⁵⁴ William Rigsby, RUCO's expert witness, asserts that
13 use of a historic market risk premium to derive a CAPM cost of equity capital is appropriate.⁵⁵
14 Reliance on past performance as an indicator of future performance is sounder than reliance
15 on analysts' projections of market return and treasury yields.

16 Staff witness, David Parcell, performed a CAPM analysis using a historic market risk
17 premium. Mr. Parcell's analysis produced a CAPM cost of equity in the range of 8.2 percent

19 ⁴⁹ Beta is defined as an index of volatility or risk, in the return of an asset relative to the return of a market
20 portfolio of assets. It is a measure of systematic or non-diversifiable risk. The returns on a stock with a beta of
21 1.0 will mirror the returns of the overall stock market. The returns on stocks with betas greater than 1.0 are
more volatile or riskier than those of the overall stock market; and if a stock's beta is less than 1.0, its returns
are less volatile or riskier than the overall stock market.

⁵⁰ See Exhibit R-32 at 28-31.

⁵¹ See Exhibit A-41 Zepp Rebuttal Testimony at 33-34. Dr. Zepp's long horizon MRP was 7.1 percent and his
current forecasted MRP was 7.7 percent.

⁵² See Exhibit R-32 Rigsby Direct Testimony at 32-33.

⁵³ Id.

⁵⁴ See Exhibit A-42 Zepp Rejoinder Testimony at 48.

⁵⁵ See Exhibit R-32 Rigsby Direct Testimony at 32-33.

1 to 8.6 percent.⁵⁶ It is important to note that although Mr. Parcell performed a CAPM analysis,
2 he did not factor the CAPM results into his cost of equity recommendation.⁵⁷ However, Mr.
3 Parcell acknowledged that the CAPM is generally superior to the simple risk premium
4 because it specifically recognizes the risk of a particular company or industry.⁵⁸ Moreover,
5 Mr. Parcell acknowledged that the Commission's reliance on CAPM would be reasonable
6 given the current economic conditions.⁵⁹ Given Mr. Parcell's acknowledgement and the
7 current economic circumstances, RUCO recommends the Commission adopt RUCO's cost
8 of equity capital, which incorporates the CAPM.

9 **2. RUCO'S Use of a Geometric Mean to Determine its Historic Market Risk**
10 **Premium in the CAPM is Appropriate.**

11 The Company claims that RUCO's historic market risk premium is also unreliable
12 because it is based in part on a geometric mean.⁶⁰ The Company claims that RUCO's
13 historic market risk premium should be based upon an arithmetic mean. RUCO's historic
14 market premium was derived from both a geometric and an arithmetic mean of the historical
15 returns on the Standard and Poor 500 ("S&P 500") index from 1926 to 2007 as the proxy for
16 the market rate of return.⁶¹ For the risk-free portion of the risk premium component, RUCO
17 used the geometric mean of the yields of long-term government bonds for the same eighty-
18 one year period resulting in a historic risk premium of 5.10 percent using a geometric mean
19 and a historic risk premium of 6.80 percent using an arithmetic mean.⁶²

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22 ⁵⁶ *Id.*

⁵⁷ T: 1348-49.

⁵⁸ *Id.*

⁵⁹ T: 1352

⁶⁰ *See* A-42 Zepp's Rebuttal Testimony at 30.

⁶¹ *See* Exhibit R-32, Rigby's Direct Testimony at 32-33.

⁶² *Id.* at 33.

1 The use of geometric mean is the industry standard. Mr. Rigsby testified that
2 geometric means are published in Morningstar stocks, bonds, bills and inflation text and
3 testified that analysts rely on geometric means to calculate a market risk premium.⁶³ Mr.
4 Rigsby further testified that Value Line analysts use geometric means. Mr. Parcell, Staff's
5 expert, concurred admitting that he uses both geometric and arithmetic means in his
6 testimony and did so in this case.⁶⁴ Mr. Parcell further testified that Value Line calculates
7 both historic and prospective growth rates on a geometric or compound growth rate basis.⁶⁵
8 He further testified that because investors, the Securities & Exchange Commission and this
9 Commission use arithmetic and geometric means, analysts developing cost of capital should
10 too.⁶⁶

11 Recent empirical research also supports RUCO's market risk premium.⁶⁷ Mr. Rigsby
12 testified that empirical studies performed by Aswarth Damdaran and Felicia C. Marston,
13 professors of finance from New York University and the University of Virginia, respectively,
14 indicate that market risk premiums in excess of 4.5 to 5.5 percent are overstated.⁶⁸ Indeed,
15 Mr. Rigsby cited to the text: *Valuation: Measuring and managing the Value of Companies*,
16 4th Edition,⁶⁹ which states:

17 Although many in the finance profession disagree about how to measure the
18 market risk premium, we believe 4.5-5.5 percent is an appropriate range.
19 Historical estimates found in most textbooks (and locked in the mind of many),
20 which often report numbers near 8 percent, are too high for valuation purposes
because they compare the market risk premium versus short-term bonds, use
75 years of data, and are biased by the historical strength of the U.S. market.⁷⁰

21 ⁶³ See Exhibit R-33, Rigby's Surrebuttal Testimony at 8.

22 ⁶⁴ T: 1345-46

23 ⁶⁵ *Id.*

24 ⁶⁶ *Id.*

⁶⁷ See Exhibit R-33, Rigsby's Surrebuttal Testimony at 13-14.

⁶⁸ *Id.* at 10-11.

⁶⁹ See Exhibit R-34 *Valuation: Measuring and managing the Value of Companies*, 4th Edition

⁷⁰ See Exhibit R-32, Rigsby's Direct Testimony at 21-22

1 Dr. Zepp's range of risk premium using an arithmetic mean and long horizon historic and
2 forecasted current market risk premium is 7.1 to 7.7 percent. RUCO's historic risk premium
3 using both an arithmetic and geometric means ranges between 5.10 percent and 6.80
4 percent. The average of Mr. Rigsby's geometric and arithmetic mean, 5.95 percent, falls
5 reasonably close to the range identified as reasonable by recent empirical research. Dr.
6 Zepp's range of risk premium does not. The Commission should reject the Company's cost
7 of equity capital recommendation.

8 **3. Publically Traded Gas Companies are Comparable to the Company for the**
9 **Purposes of Calculating the Cost of Capital.**

10 The Company contends that RUCO erred in using a proxy of gas utilities to derive its
11 cost of capital because the average beta for RUCO's water utility sample is .82, compared
12 with its natural gas sample of .67.⁷¹ The Company used a water proxy of six water utilities to
13 complete its cost of capital analysis.⁷² The Company's proxy included Aqua America, which
14 has a beta of .65.⁷³ The Company cannot complain that RUCO used gas utilities with
15 average beta of .67 when one sixth of the companies in its water proxy have a lower beta of
16 .65. The Company contends that gas companies are less risky investments than water
17 companies as evidenced by their low beta and therefore, should not be used as proxies for
18 the Company. RUCO and Staff disagree.⁷⁴

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⁷¹ See Exhibit A-42 Zepp Rebuttal Testimony; See also Exhibit R-32 Rigsby Direct Testimony, Schedule WAR

23 ⁷² See Exhibit S-22, Direct Testimony of David C. Parcell, Schedule 10.

24 ⁷³ See Exhibit A-48, Value Line Report on Water Industry, dated July 24, 2009.

⁷⁴ T: 1384 and 1406.

1 Mr. Rigsby testified that beta is only one method of evaluating the risk of a security
2 and that the best way to evaluate risk is to look at the accounting data and the actual returns
3 paid.⁷⁵ There are multiple measures of risk. Beta is one, and Value Line safety and financial
4 strength as well as Standard and Poor's stock ranking are also alternatives.

5 Mr. Parcell concurred and testified that higher betas do not necessarily indicate that
6 water companies are more risky.⁷⁶ When asked if beta was an appropriate means to
7 estimate risk, he testified:

8 "Well appropriate, that's, beauty in the eye of the beholder, but it is recognized.
9 Some people challenge it is appropriate more so than others".⁷⁷

10 The Company's assertion that gas utilities with a lower average beta of .67 are not
11 comparable for purposes of establishing a proxy group is erroneous. The Company witness,
12 Mr. Reiker, has utilized gas utilities as a proxy to determine the cost of equity capital in water
13 utility cases. In the Matter of Arizona Water, Docket No. W-01445A-02-0619, Decision no.
14 66849, Mr. Reiker testified on behalf of the Staff using a gas proxy with an average beta of
15 .69 and a water proxy with an average beta of .59 to determine the cost of equity capital of
16 the Company.⁷⁸ Mr. Reiker testified that the use of gas proxy was appropriate given that
17 Arizona Water was not a publicly traded company.⁷⁹ Arizona Water is still privately held.
18 Accordingly, the same reasons for utilizing a gas proxy are applicable here. Given these
19 facts and considering that the Commission in Decision No. 66849 adopted Mr. Reiker's cost

21 ⁷⁵ T: 690-691

22 ⁷⁶ *Id.*

23 ⁷⁷ T: 1382.

24 ⁷⁸ S-2, In the Matter of Arizona Water, Docket No. W-01445A-02-0619, Decision No. 66849 at 21-23.
Although Mr. Reiker argued in that case that the 100 basis point difference in beta necessitated an adjustment
to the cost of equity, the Commission did not make the adjustment. The Commission adopted the Staff's 9.2
percent CAPM cost of equity capital derived from averaging the gas and water proxies.

⁷⁹ *Id.* at 21.

1 of equity capital based in part on a gas proxy, it is disingenuous for the Company to suggest
2 that RUCO's analyst erred in doing the same.

3 The Company's reliance on beta alone also ignores the clear guidance of the courts.
4 United Railways & Electric Company of Baltimore v. West, 280 U.S. 234, 249-50, 251, 50
5 S.Ct. 123, 125, 125-26, 74 L.Ed. 390 (1930); Simms v. Round Valley Light & Power
6 Company, 80 Ariz. 145, 154, 294 P. 378, 384 (1956). To determine an appropriate cost of
7 equity capital, the Commission needs to consider all relevant factors, including: (1)
8 comparisons with other companies having corresponding risks, (2) the attraction of capital,
9 (3) current financial and economic conditions, (4) the cost of capital, (5) the risks of the
10 enterprise, (6) the financial policy and capital structure of the utility, (7) the competence of
11 management, and (8) the company's financial history. Litchfield Park Service Corporation v.
12 Arizona Corporation Commission 178 Ariz. 431, 874 P.2d 988 (Ariz. App. Div. 1 1994). Mr.
13 Rigsby testified that he used gas utilities as a proxy because they have similar operating
14 characteristics to water companies in terms of distribution and similar risks.⁸⁰ Mr. Parcell
15 testified that the movement is to use gas utilities proxies to derive cost of capital for water
16 companies.⁸¹ He noted that he has seen a company witness do so and has done so
17 himself.⁸² Based on the foregoing, RUCO did not err in deriving its cost of equity capital
18 using a gas proxy.

19 **4. RUCO'S 8.33 Percent Cost of Equity Capital is Not Too Low.**

20 The Company asserts that RUCO's cost of common equity 8.33 percent is too low
21 because common shareholders bear a greater risk than bondholders and expect a higher
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23 ⁸⁰ T: 1406. See also Exhibit R-33 Rigsby Rebuttal Testimony, Schedule A and Exhibit A-48 Value Line
Industry Report.

24 ⁸¹ T: 1384

⁸² Id.

1 return than the risk of a utility debt instrument.⁸³ The question of what level of additional
2 market risk premium is necessary to derive a higher return is a moot issue. RUCO's cost of
3 equity capital is 119 basis points higher than the 7.14 percent yield on Baa/BBB rated utility
4 bonds and 254 basis points higher than the recent 5.79 percent yield on A-rated utility bonds.
5 RUCO's cost of equity capital includes a sufficient margin to satisfy common shareholders for
6 any perceived additional market risk.⁸⁴

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8 **D. RATE DESIGN**

9 **1. Consolidation and Rate Design**

10 The Company proposes a rate consolidation plan that is convoluted and not in the
11 best interest of all of its ratepayers. The Company proposes a complete consolidation of four
12 systems, limited consolidation of other systems and no consolidation of five of its smaller
13 systems. Alternatively, RUCO supports rates for each system that are based on cost of
14 service, but if the Commission decides to consolidate AWC's systems, RUCO would have no
15 objection to a consolidation based on Option F listed in final revised Exhibit B of the
16 Surrebuttal Testimony of Jodi Jerich.⁸⁵ Ms. Jerich, Director of RUCO, testified that Option F
17 does the best job at dispelling the concerns usually associated with consolidation. She
18 testified that the benefits of Option F are as follows:

- 19 a. Option F limits the rate increase for all systems to no more than \$5 for the
20 average residential ratepayer mitigating rate shock;

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22 ⁸³ See Exhibit A-42 Zepp Rebuttal Testimony

23 ⁸⁴ Notably, based on the most recent Value Line Selection and Opinion publication, dated October 16, 2009
and attached as Exhibit A, Mr. Rigsby's cost of equity is 238 basis points higher than the most recent yield on
Baa/BBB utility bonds and 289 basis points higher than the most recently published A-rated utility bond rate.

24 ⁸⁵ T: 1478.

- 1 b. Option F provides rate consolidation through a single monthly minimum base
2 rate, which is a fair and practical consolidation method permitting large
 systems greater opportunity to realize financial benefits from consolidation;
- 3 c. Option F retains individual commodity rates for each system eliminating the
4 concern that full consolidation distorts price signals and discourages water
 conservation.
- 5 d. Option F requires the Company to maintain system specific financial records
6 preserving adequate regulatory oversight.

7 The Company opposed RUCO's proposal in part arguing that it was not a true
8 consolidation. Ms. Jerich pointed out in her testimony that the Company is not offering full
9 consolidation, either. The Company's proposal excludes the five smaller systems of San
10 Manuel, Oracle, White Tank, Winkelman and Ajo and provides a phased consolidation of all
11 other systems with varying monthly charges and commodity rates. Ms. Jerich testified that
12 RUCO's Option F was all-inclusive and provided greater simplicity in administration and rate
13 design than the Company's proposal.⁸⁶

14 The Company also expressed concern that RUCO's request to maintain system
15 specific records undermines the benefits associated with full consolidation. As Ms. Jerich
16 testified, the argument was irrelevant, as no party had proposed full consolidation; and there
17 was no evidence on the record of any calculation or even an estimate of the cost savings
18 associated with eliminating system specific record keeping.⁸⁷ Because RUCO's proposal
19 mitigates rate shock, sends appropriate price signals, encourages water conservation and
20 avoids unilateral cross subsidization by larger systems to the benefit of smaller systems,
21 RUCO recommends the Commission adopt Option F.

23 ⁸⁶ T: 1479.

24 ⁸⁷ T: 1480-1481.

1 **2. Adjustor Mechanisms**

2 The Company proposes adjustor mechanisms for purchased power (“PPAM”),
3 purchased water (“PWAM”) and purchased fuel (“PFAM”) or in the alternative an attrition
4 adjustor mechanism (“AAM”). More specifically, the Company seeks to restore PPAM” for its
5 Eastern and Western Groups and continue the PPAM that is currently in place in the
6 Northern Group. The Company also seeks to establish PFAM for all systems to pass the
7 cost of fuel through to ratepayers. For the systems with purchased water, the Company
8 seeks to establish a PWAM to pass the costs through to ratepayers. Last, as an alternative,
9 the Company seeks an AAM similar to an ACRM as an alternative to the PPAM and the
10 PFAM. RUCO recommends denial of all adjustor mechanisms because adjustor
11 mechanisms are extraordinary ratemaking. Moreover, RUCO recommends the Commission
12 discontinue the Northern Group PPAM.

13 In Decision No. 68302 the Commission denied AWC’s prior request for PPAM and
14 PWAM stating:

15 There is a danger of piecemeal regulation inherent in adjustment
16 mechanisms. Because they allow automatic increases in rates without a
17 simultaneous review of a utility’s unrelated costs, adjustment mechanisms
18 have a built-in potential of allowing a utility to increase rates based on
19 certain isolated costs when its other costs are declining, or when overall
revenues are increasing faster than costs due to customer growth. Adjustment mechanisms should therefore be used only in extraordinary circumstances to mitigate the effect of uncontrollable price volatility or uncertainty in the marketplace.⁸⁸

20 Likewise, in Decision No. 66849, the Commission denied AWC’s request for a PWAM
21 and PPAM stating:

22 _____
23

24 ⁸⁸ See Exhibit R-32 Rigsby’s Direct Testimony at 23-24.

1 Although Arizona Water argues that such mechanisms benefit both the
2 Company and ratepayers by passing on increased costs and savings,
3 adjustment mechanisms may also provide a disincentive for the Company
to obtain the lowest possible cost commodity because the costs are simply
passed through to ratepayers.⁸⁹

4 RUCO asserts that the Commission's rationale for denial of PPAM and PWAM is equally
5 applicable to PFAM and the AAM proposed by the Company.

6 Mr. Reiker acknowledged that on a total company basis, purchased fuel constituted
7 less and 1.3 percent of AWC's total expenses.⁹⁰ Mr. Garfield also acknowledged that the
8 Company's purchased water expense was less than 4.19 percent of its total operating
9 expenses.⁹¹ RUCO witness, Mr. Rigsby testified, that neither purchased fuel or water are a
10 significant portion of the Company's total operating expenses. Given the Commission's prior
11 rulings and that purchased fuel and water are not a significant portion of the Company total
12 operating expenses, RUCO recommends denial of the PWAM and the PFAM.

13 The Company claims that purchased power constitutes 20 percent of its overall
14 budget. Mr. Rigsby testified that although purchased power may be a more significant
15 portion of the Company's total operating expenses than purchased fuel or water, it was not
16 sufficiently significant to warrant the imposition of a PPAM. Moreover, he testified that while
17 purchased power is steadily increasing, it is not volatile and the Company's existing pro
18 forma adjustment was sufficient to address the additional increases in purchased power
19 expenses.⁹²

20 Based on the Commission's prior rulings, RUCO recommends denial of the PWAM,
21 PFAM and PPAM because water and fuel are not a significant portion of AWC's budget and

22
23 ⁸⁹ *Id.*

⁹⁰ T: 460-461.

⁹¹ T: 84-85.

⁹² T: 1012-1013, 1018-1019.

1 although purchased power may be increasing and is a more significant portion of the
2 Company's total budget, it is not volatile or sufficiently significant to warrant an adjustor
3 mechanism.

4 **E. CONCLUSION**

5 For the reasons discussed above, RUCO recommends the Commission adopt its
6 position in this case, and reject the positions of Staff and the Company, to the extent they
7 conflict with RUCO's recommendations.
8

9 **RESPECTFULLY SUBMITTED** this 16th day of October, 2009
10

11 _____
12 Michelle L. Wood
13 Counsel

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15 of the foregoing filed this 16th day
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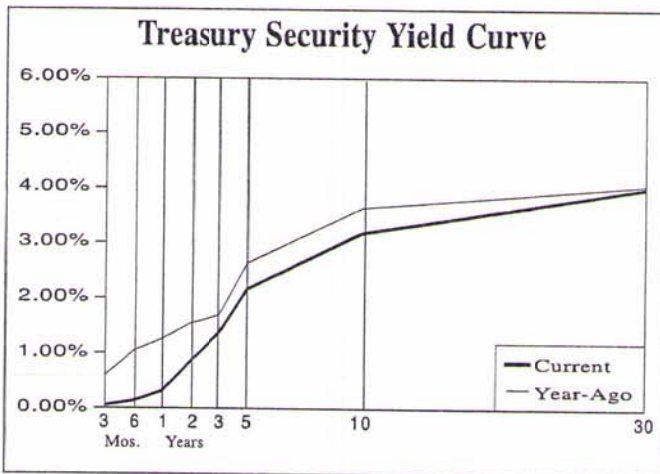
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EXHIBIT A

Selected Yields

	Recent (10/07/09)	3 Months Ago (7/08/09)	Year Ago (10/08/08)		Recent (10/07/09)	3 Months Ago (7/08/09)	Year Ago (10/08/08)
TAXABLE							
Market Rates							
Discount Rate	0.50	0.50	1.75				
Federal Funds	0.00-0.25	0.00-0.25	1.50				
Prime Rate	3.25	3.25	4.50				
30-day CP (A1/P1)	0.16	0.36	4.55				
3-month LIBOR	0.28	0.53	4.52				
Bank CDs							
6-month	0.40	0.65	1.73				
1-year	0.64	0.86	2.27				
5-year	2.24	1.94	3.48				
U.S. Treasury Securities							
3-month	0.06	0.18	0.61				
6-month	0.14	0.25	1.05				
1-year	0.32	0.44	1.26				
5-year	2.17	2.23	2.63				
10-year	3.18	3.31	3.64				
10-year (inflation-protected)	1.42	1.76	2.66				
30-year	4.00	4.19	4.05				
30-year Zero	4.10	4.31	3.97				
Mortgage-Backed Securities							
GNMA 6.5%	3.44	3.71	5.82				
FHLMC 6.5% (Gold)	2.38	2.99	5.70				
FNMA 6.5%	2.33	2.83	5.62				
FNMA ARM	2.56	2.98	3.84				
Corporate Bonds							
Financial (10-year) A	5.46	6.53	7.34				
Industrial (25/30-year) A	5.28	5.82	6.66				
Utility (25/30-year) A	5.44	5.71	6.58				
Utility (25/30-year) Baa/BBB	5.95	6.85	6.93				
Foreign Bonds (10-Year)							
Canada	3.29	3.28	3.59				
Germany	3.12	3.28	3.80				
Japan	1.27	1.30	1.39				
United Kingdom	3.39	3.62	4.30				
Preferred Stocks							
Utility A	6.29	7.59	6.99				
Financial A	6.89	6.57	8.54				
Financial Adjustable A	5.48	5.48	5.48				



TAX-EXEMPT

Bond Buyer Indexes							
20-Bond Index (GOs)	3.94	4.83	5.36				
25-Bond Index (Revs)	4.69	5.75	5.69				
General Obligation Bonds (GOs)							
1-year Aaa	0.37	0.43	2.18				
1-year A	0.87	0.93	2.25				
5-year Aaa	1.57	1.96	3.34				
5-year A	2.77	2.40	3.44				
10-year Aaa	2.57	3.09	4.31				
10-year A	3.77	3.45	4.51				
25/30-year Aaa	3.81	4.59	5.35				
25/30-year A	5.01	5.05	5.70				
Revenue Bonds (Revs) (25/30-Year)							
Education AA	4.85	5.55	5.80				
Electric AA	4.90	5.65	5.90				
Housing AA	5.20	5.80	6.00				
Hospital AA	5.20	5.90	6.10				
Toll Road Aaa	4.85	5.60	5.95				

Federal Reserve Data

BANK RESERVES

(Two-Week Period; in Millions, Not Seasonally Adjusted)

	Recent Levels			Average Levels Over the Last...		
	9/9/09	8/26/09	Change	12 Wks.	26 Wks.	52 Wks.
Excess Reserves	823187	794531	28656	754073	773681	643433
Borrowed Reserves	320295	327647	-7352	369408	467326	513721
Net Free/Borrowed Reserves	502892	466884	36008	384665	306355	129711

MONEY SUPPLY

(One-Week Period; in Billions, Seasonally Adjusted)

	Recent Levels			Growth Rates Over the Last...		
	9/21/09	9/14/09	Change	3 Mos.	6 Mos.	12 Mos.
M1 (Currency+demand deposits)	1639.8	1670.9	-31.1	-6.8%	11.4%	11.3%
M2 (M1+savings+small time deposits)	8310.3	8318.3	-8.0	-3.5%	-1.1%	5.2%