

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 MIKE GLEASON
CHAIRMAN

3 WILLIAM A. MUNDELL
COMMISSIONER

4 JEFF HATCH-MILLER
COMMISSIONER

5 KRISTIN K. MAYES
COMMISSIONER

6 GARY PIERCE
COMMISSIONER

7
8 IN THE MATTER OF THE APPLICATION OF
9 CHAPARRAL CITY WATER COMPANY,
10 INC., AN ARIZONA CORPORATION, FOR A
11 DETERMINATION OF THE CURRENT FAIR
VALUE OF ITS UTILITY PLANT AND
PROPERTY AND FOR INCREASES IN ITS
RATES AND CHARGES FOR UTILITY
SERVICE BASED THEREON.

Docket No. W-02113A-04-0616

12
13 **REPLY BRIEF OF THE**
14 **RESIDENTIAL UTILITY CONSUMER OFFICE**

15 **INTRODUCTION**

16 The Residential Utility Consumer Office ("RUCO") replies to Chaparral City Water
17 Company's ("Company or Chaparral") and the Arizona Corporation Commission Staff's
18 ("Staff") Remand Closing Briefs as follows:

19
20 **THE ISSUE ON REMAND IS THE APPROPRIATE RATE OF RETURN TO APPLY TO**
21 **CHAPARRAL CITY'S FVRB.**

22 RUCO agrees with the Company that the primary issue is the appropriate rate of return
23 to apply to the Company's FVRB. RUCO is at a loss to understand why the Company would
24 dedicate the first 24 pages of its Opening Brief discussing arguments in support of the

1 Commission's FVRB determination. Neither Staff nor RUCO are contesting the FVRB on
2 remand. Yet, the Company feels compelled to make issues where none exist. For example,
3 the Company claims that RUCO challenges the Commission's FVRB finding by suggesting
4 that the Company's reproduction cost study overstates the current value of the Company's
5 utility plant in service. Company Remand Brief at 2. In support of its claim, the Company
6 misinterprets Dr. Johnson's testimony that the averaging of OCRB and RCND overstates the
7 current value of Chaparral City's property. Company Remand Brief at 21. The Company
8 views what it perceives as RUCO's on-going challenge to the Commission's finding of FVRB
9 as a "red herring."

10 RUCO, on remand, is not challenging the Commission's FVRB finding – period. The
11 Company's references to the record do not indicate anywhere that RUCO is challenging the
12 Commission's FVRB finding. In his direct testimony cited by the Company, Dr. Johnson
13 testifies that he believes that reproduction costs tend to overstate the current value of property.
14 R-R-1 at 32. The costs associated with reproducing an existing system, according to Dr.
15 Johnson, are not representative of current value because they do not take into account current
16 relative prices, technologies and available efficiencies. Id. at 32 -34. Dr. Johnson's testimony
17 concerning the characteristics of reproduction costs were made as part of his discussion of
18 why applying the WACC to the FVRB would not result in reasonable rates. Dr. Johnson never
19 raised or even suggested a challenge to the Commission's FVRB finding.

20 At hearing, Dr. Johnson's testimony was consistent with his pre-filed testimony. While
21 discussing the costs of reproducing plant, Dr. Johnson testified that "there is a better way of
22 doing things, now, with computer technology..." Transcript at 177. Dr. Johnson further
23 testified,

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1 “ ...when the Commission uses this 50/50 weighing, they are
2 using the high side cost estimate and they are using original cost and
3 they are averaging the two together and they are using that as a
4 benchmark in arriving at an intermediate step which they call fair value.
5 And perfect precision in that methodology has never been of total
6 importance to the Commission as long as they were doing a reasonable
7 job with that process because they also had the opportunity to take
8 judgment on the fair return. And then ultimately they are looking at
9 rates in arriving at a judgment as to whether the final rates are fair and
10 reasonable, and that’s the ultimate test.” Id. at 177-178.

11 The Company has translated Dr. Johnson’s testimony as RUCO’s opposition to the
12 Commission’s FVRB finding. The Company’s misinterpretation is the “red herring” and should
13 be given no weight.

14 **THE RECOMMENDATIONS OF RUCO DO NOT VIOLATE THE FAIR VALUE STANDARD**
15 **OR SIMMS.**

16 The Company argues that Staff and RUCO’s recommendations ignore the fair value
17 standard, under which the appropriateness of the return must be judged in the context of the
18 fair value of the utility’s property, not the historic cost of its plant or the book amount invested.
19 Company Remand Brief at 31. The Company’s argument is confusing. The Company is
20 critical of Staff and RUCO because it claims neither party’s rate of return methodologies
21 consider the fair value of the utility’s property. Id. The Company also argues that the
22 “methods used to estimate the costs of the components of Chaparral City’s capital structure
23 are also independent of the rate base to which the WACC is applied.” Company Remand Brief
24 at 28. The Company cannot have it both ways – Staff and RUCO’s methodologies focus on
the rate of return, and do not violate the fair value standard.

1 In fact, neither RUCO, nor Staff for that matter, are suggesting that the Commission
2 reconsider or change the fair value finding made in Decision No. 68176. RUCO's focus is
3 strictly to ascertain an appropriate return methodology. RUCO understood the Company's
4 disagreement with RUCO's methodology to be RUCO's consideration of the Company's FVRB
5 as being closely linked to the rate of return¹. The fact that RUCO believes it appropriate to
6 consider FVRB in establishing an appropriate return does not violate the fair value standard as
7 the Company suggests. The Company's argument that return is independent of the type of
8 rate base used, contradicts the Company's other argument that the "appropriateness of the
9 return must be judged in the context of the fair value of the utility's property." Company
10 Remand Brief at 31. The Commission should reject the Company's argument that return is
11 independent of ratebase.

12 Throughout its Remand Brief, the Company has consistently brought RUCO and Staff's
13 methodologies back to the FVRB finding. The Company construes RUCO's return
14 recommendation as an adaptation of the prudent investment theory. Company Remand Brief
15 at 36-38. The Company discounts RUCO's argument, noting that the Arizona Supreme Court
16 invalidated the application of the prudent investment theory in Arizona. Company Remand
17 Brief at 36-38, *Simms v. Round Valley Light & Power Company*, 80 Ariz. 145, 150-151, 294 P.
18 2d 378, 381-382 (1956). The Company concludes that Dr. Johnson relies on the *Hope Natural*
19 *Gas* "end result" standard to yield the appropriate result. Company Remand Brief at 37.

20 RUCO does not dispute that the *Simms* Court disapproved the prudent investment
21 approach. The prudent investment approach, after all, was one approach that the *Simms*
22 Court considered in determining what would be an appropriate ratebase. See *Simms*, supra at

23
24 ¹ RUCO's Closing Brief discussed at length the issue of the dependant relationship between the rate of return and
the type of rate base used. See RUCO's Closing Brief at 8-9.

1 149, 294 P. 2d 378, 382. In fact, the *Simms* Court squarely addressed the prudent investment
2 approach in the context that it was presented – as an alternative to the fair value approach for
3 determining an appropriate ratebase. See *Simms*, supra at 149 – 151, 294 P. 2d 378, 382-
4 384. The issue here does not concern the rate base determination – RUCO agrees that the
5 Commission must use the FVRB in its determination.

6 The basis for RUCO’s methodology is quite simple – in determining an appropriate
7 return, the Commission should only account for inflation once. There is no case that the
8 Company has presented, or can present, which states that it is proper for the Commission to
9 double-count inflation when determining an appropriate return. The Company even believes
10 that the Commission should not double-count inflation. Transcript at 75.

11 RUCO has proposed a methodology which eliminates the double-count of inflation that
12 occurs when the Company’s operating income is determined by multiplying the FVRB by the
13 WACC. RUCO’s methodology does not adjust or change the FVRB. RUCO’s return
14 methodology considers FVRB in ascertaining what an appropriate return would be. The Court
15 of Appeal’s decision contemplates that the Commission can consider the fact that a FVRB is
16 being used in determining a rate of return without impermissibly undermining the requirement
17 to use a FVRB. AR-13 at 7 (fn. 5) and 13. In the end, however, RUCO’s proposal simply
18 adjusts the WACC for excessive inflation. The Company’s legal analysis is fixated on the
19 Commission’s FVRB determination and, like its misguided and inaccurate perception of
20 RUCO’s case, is itself nothing more than a “red herring.”

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1 **RUCO'S INFLATION ADJUSTMENT IS NOT ARBITRARY NOR IS ITS PROPOSED**
2 **RATE OF RETURN.**

3 The Company disagrees with RUCO's approach to exclude the effects of excessive
4 inflation from WACC. According to the Company, RUCO's approach would result in the
5 imposition of an "arbitrary rate of return." Company Remand Brief at 44. In theory and
6 practice, the Company's argument fails since no party disputes that the Commission should
7 not double-count inflation.

8 The Company's criticism appears to be aimed at the method that RUCO used to
9 determine its recommended adjustment. The Company claims that inflation affects all aspects
10 of the Company's business and not just its rate of return. Company Remand Brief at 40. For
11 example, the Company opines that with regard to ratebase, to the extent that inflation can be
12 found in the estimate of the Company's RCND ratebase, the effects of inflation are offset by
13 the averaging of the OCRB and the RCND. Id. at 42. The Company argues that it is
14 appropriate to disregard the effects of inflation on return because of what it perceives as the
15 adverse effects of inflation (that it claims RUCO has chosen to ignore) and the other offsets to
16 ratebase (such as depreciation which wash out the effects of inflation). Id. at 40, 42-43. The
17 Company concludes that RUCO's adjustment for inflation is "ham-fisted", "simplistic and
18 speculative" and that the Commission should approve the WACC (7.6%) applied to the FVRB.

19 Interestingly, it is the Company who has chosen to ignore the findings and conclusions
20 of the Commission and the Court of Appeals. The Commission has already determined that
21 the Company's rate of return methodology and the Company's proposed revenue increase
22 would produce "an excessive return on FVRB." Decision No. 68176 at 27-28. The
23 Commission noted that the Company attempted to equate the WACC to a rate of return when,
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1 in fact, the **cost of capital estimate is used as a tool to determine a just and reasonable**
2 **rate of return.** Id. at 27.

3 The Court of Appeals noted the Commission's position that the cost of capital analysis
4 "is geared to concepts of original cost measures of rate base, not fair value measures of rate
5 base" and was appropriately applied to the OCRB. AR-13 at 13. The Court did not reject the
6 Commission's position, and even stated that the Commission is not bound to use the WACC
7 as the rate of return to be applied to the FVRB. Id.

8 The Company continues to equate the WACC with the rate of return on FVRB. The
9 Company offers no alternative methodology and disregards what the Commission and the
10 Court of Appeals have said. Despite the fact that the Commission has already said that the
11 Company's proposal will result in an excessive return, the Company continues to argue that
12 anything less than what it proposes would be unconstitutional and deprive its investors of an
13 opportunity to earn a fair rate of return.

14 RUCO's proposed methodology is relatively simple and does involve some degree of
15 estimation. Neither should be considered unusual when it comes to performing a cost of
16 capital analysis. Determining cost of capital is an inexact science and always involves
17 estimates. Often risk adjustments are made to cost of equity estimates based on what the
18 analyst perceives are risk factors at the time. There is no exact science to cost of capital - just
19 sound discretion. The WACC, as the Commission concluded, should be used as a tool to
20 determine a just and reasonable rate of return on FVRB.

21 Given the Commission's determination that the application of the WACC to the OCRB
22 would result in just and reasonable rates, it make sense that applying the same WACC to a
23 higher ratebase does not result in fair and reasonable rates. R-R2 at 8. In most states where
24 OCRB is used, applying the WACC results in reasonable rates since the cost of equity

1 includes adequate compensation for the effects of inflation. Id. However, where the rate base
2 is growing with inflation because it is partly tied to reproduction costs, reasonable rates can be
3 best achieved by using a return that is reduced for the inflation already recognized in the
4 ratebase. Id.

5 RUCO proposes an adjustment to the WACC for general inflation – inflation that is
6 recognized by equity investors generally because such inflation is already compensated for
7 within the cost of equity. R-R2 at 16. Since deriving an adjustment for inflation, like
8 determining the cost of equity, is not an exact science, RUCO has proposed an adjustment
9 based on several data series that are publicly available and provide contemporary information
10 regarding inflation in general. Id. Those data sources include data for annual changes in
11 consumer prices and various measures of producer prices including annual changes in the
12 Gross Domestic Product Deflator. Id. RUCO's recommendation to adjust the WACC from
13 7.6% by 200 basis points for inflation to 5.6%, is fair, has a sound basis and should be
14 approved by the Commission.

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16 RESPECTFULLY SUBMITTED this 21st day of March, 2008.

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19 _____
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