

**IN THE COURT OF APPEALS**  
**STATE OF ARIZONA**  
**DIVISION ONE**

CHAPARRAL CITY WATER	)	
COMPANY, an Arizona corporation,	)	No. 1 CA-CC 08-0002
	)	
Appellant,	)	
	)	
v.	)	
	)	Arizona Corporation Commission
ARIZONA CORPORATION	)	No. W-02113A-04-0616
COMMISSION, an agency of the	)	
State of Arizona,	)	Decision No. 70441
	)	
Appellee,	)	
and	)	
	)	
RESIDENTIAL UTILITY	)	
CONSUMER OFFICE,	)	
	)	
Intervenor-Appellee.	)	
_____	)	

**INTERVENOR-APPELLEE**  
**RESIDENTIAL UTILITY CONSUMER OFFICE'S**  
**ANSWERING BRIEF**

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**INTERVENOR-APPELLEE RESIDENTIAL UTILITY CONSUMER  
OFFICE'S ANSWERING BRIEF**

**INTRODUCTION**

The Residential Utility Consumer Office<sup>1</sup> (“RUCO”) is a statutorily created agency of the State of Arizona charged with representing the interests of Arizona's residential utility consumers in proceedings before the Arizona Corporation Commission (“Commission”).<sup>2</sup> RUCO intervened in the underlying proceeding before the Arizona Corporation Commission. After consultation with the Commission’s utilities staff, (“Staff”), RUCO hereby submits a separate brief in support of the Commission’s decision.

**A. STATEMENT OF JURISDICTION**

Appellant seeks review of the Commission’s decision finding a reasonable rate of return on Chaparral City Water Company’s (“Chaparral City” or “the

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<sup>1</sup> RUCO is a state agency, independent of the Corporation Commission, which is empowered by statute to "represent the interests of residential utility consumers in regulatory proceedings involving public service corporations before the Corporation Commission." A.R.S. § 40-462 (1983).

<sup>2</sup> Ariz. Rev. Stat. Ann. ("A.R.S.") §§ 40-461, 40-462, 40-464. Citations will be to the Certified Record (“CR”) Document Index (Tab 5 in Chaparral City’s Appendix to its Opening Brief).

Company”) Fair Value Rate Base (“FVRB”) of 6.40 percent.<sup>3</sup> This Court has jurisdiction to hear direct appeals of Commission decisions "relating to ratemaking ... pursuant to A.R.S. §40-250....".<sup>4</sup> The Commission’s decision to approve a rate of return of 6.40 percent is related to ratemaking and is properly before this Court. This Court has jurisdiction to hear that matter.

## **B. COMBINED STATEMENT OF THE CASE AND FACTS**

In Decision No. 70441, filed May July 28, 2008, the Commission denied the Company’s request to apply the Weighted Average Cost of Capital (“WACC”) to the Company’s Fair Value Rate Base (“FVRB”) when determining the Company’s level of operating income.<sup>5</sup> The Commission determined that the Company’s method of applying the WACC to the FVRB overstates inflation.<sup>6</sup>

Instead, the Commission agreed with RUCO that the WACC should be adjusted to remove the inflation component.<sup>7</sup> While the Commission did not adopt RUCO’s proposed inflation adjustment calculation, it excluded inflation from its calculation of the cost of equity component of the cost of captal. The Commission

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<sup>3</sup> *In the Matter of the Application of Chaparral City Water Company*, Docket No. W-02113A-04-0616, Decision No. 70441 (July 28, 2008 – the “Remand Decision”) at 37 (CR, Tab A-108).

<sup>4</sup> *See* A.R.S § 40-254.01(A).

<sup>5</sup> Remand Decision at 36, (CR, Tab A-108).

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

arrived at a 7.3 percent cost of equity after adjusting for inflation.<sup>8</sup> In this appeal, the Company argues that the Commission's decision was unlawful and unreasonable.<sup>9</sup>

By way of further background, this case dates back to August 24, 2004, when the Company filed its original rate application with the Commission requesting an increase in its rates.<sup>10</sup> The procedural history of this appeal is set forth in detail in the Commission's decision and RUCO will touch upon the procedural highlights here for background purposes.<sup>11</sup> The Company's application moved through the discovery process and hearings were held in May and June 2005. Briefs were filed, Open Meeting was held and the Commission issued its Opinion and Order (Decision No. 68176) on September 30, 2005.<sup>12</sup>

The Company appealed the Commission's Decision and on February 13, 2007, this Court issued its Memorandum Decision.<sup>13</sup> Among other things, this

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<sup>8</sup> Id. at 37.

<sup>9</sup> Ex. S-R8 at 55, (CR, Tab C-83).

<sup>10</sup> Remand Decision at 1, (CR, Tab A-108).

<sup>11</sup> Id. at 1-4.

<sup>12</sup> Id. at 2.

<sup>13</sup> Id.

Court found that the Commission did not comply with Article 15, §14 of the Arizona Constitution when the Commission set the rates based on the original cost instead of the fair value of the Company's property.<sup>14</sup> This Court remanded the matter back to the Commission for a further determination of rates consistent with this Court's findings.<sup>15</sup>

Thereafter, the Commission issued a procedural order, the parties filed their testimonies, and hearings were held in the remand proceeding in January 2008. The parties then filed post-hearing briefs and the Administrative Law Judge issued her Recommended Opinion and Order. The Commission held an Open Meeting and then issued Decision No. 70441 on July 28, 2008, setting rates after determining the fair value of the Company's assets and authorizing the Company to receive a 6.4% rate of return on these assets.<sup>16</sup> Decision No. 70441 authorized an increase in revenues of \$1,119,739 which, on an annual basis is \$12,143 more than what the Commission authorized in Decision No. 68176.<sup>17</sup>

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<sup>14</sup> Id.

<sup>15</sup> *Chaparral City Water Company v. Ariz. Corp. Comm'n*, No. 1 CA-CC 05-0002, Mem. Decision ("Memorandum Decision") (Feb. 13, 2007) at 2, (CR, Tab C-70).

<sup>16</sup> Remand Decision at 3-4, (CR, Tab A-108).

<sup>17</sup> Id. at 41. The Company's recommended methodology of applying the WACC to the FVRB results in a gross revenue increase over test year adjusted revenues/expenses of \$1,532,440. Exhibit A5 at 6, Remand Schedule A-1, (CR, Tab C-5).

On July 31, 2008, the Company filed an Application for Rehearing of Decision No. 70441.<sup>18</sup> The Commission did not rule on the Application and it was denied by operation of law. Having exhausted its administrative remedies, the Company timely filed its Notice of Appeal pursuant to A.R.S. § 40-254.01(A).

### **C. ISSUES PRESENTED**

1. What is the Standard of Review applicable to this appeal?
2. Did the Commission abuse its discretion in determining a fair rate of return of 6.40%?
3. Does the evidence support the Commission's finding of a 6.40% rate of return?
4. Did the Commission act lawfully and reasonably in approving the 6.40% rate of return?

### **D. ARGUMENT**

#### **I. STANDARD OF REVIEW**

To prevail in a direct appeal of a Commission decision, the Appellant must show by clear and convincing evidence that the Commission's action was unlawful or unreasonable.<sup>19</sup> The Court will not disturb a Commission decision, unless the Appellant demonstrates that the decision is “arbitrary, unlawful, or unsupported by

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<sup>18</sup> Chaparral City Water Company's Application for a Rehearing, Docket No. W-02113A-04-0616 (Filed July 31, 2008), (CR, Tab A-109).

<sup>19</sup> A.R.S. §40-254.01(E); *Consolidated Water Util., Ltd. V. Arizona Corp. Comm'n*, 178 Ariz. 478, 481, 875 P2d, 137, 140 (App. 1993).

substantial evidence.”<sup>20</sup> Furthermore, this Court will not reweigh the evidence and substitute its judgment for that of the Commission.<sup>21</sup>

## II. THE COMMISSION DID NOT ABUSE ITS DISCRETION BY ADJUSTING THE WACC FOR INFLATION.

On remand, Chaparral City argued that in order to comply with this Court’s previous decision, the Commission should have applied the WACC to the FVRB to determine the Company’s required level of operating income.<sup>22</sup> The Company, however, has not made the argument that the Commission lacks discretion in determining what constitutes a fair rate of return (“FROR”) to be applied to the FVRB.

In fact, this Court in its previous decision was unequivocal on the subject:

“The Commission asserts that it was not bound to use the weighted average cost of capital as the rate of return to be applied to the FVRB. The Commission is correct. If the Commission determined that the cost of capital analysis is not the appropriate methodology to determine the rate of return to be applied to the FVRB, the Commission has the discretion to determine the appropriate methodology. The same is true if the Commission were to determine that applying the weighted average cost of capital to the FVRB resulted in double counting inflation, as argued by RUCO.”<sup>23</sup> (Emphasis Added)

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<sup>20</sup> *Litchfield Park Service Co. v. Arizona Corp. Comm’n*, 178 Ariz. 431, 434, 874 P.2d 988, 991 (App. 1994).

<sup>21</sup> *Tucson Elec. Power Co. v. Arizona Corp. Comm’n*, 132 Ariz. 240, 243, 645 P.2d 231, 234 (1982).

<sup>22</sup> Chaparral City Water Company’s Exceptions, Docket No. W-02113A-04-0616 (Filed July 10, 2008) at 2, (CR, Tab A-105), Chaparral City Water Company’s Closing Brief filed March 5, 2008 at 18, (CR, Tab A-95).

<sup>23</sup> Memorandum Decision at 13, (CR, Tab C-70).

This Court's interpretation of the Commission's discretionary authority is consistent with the recognition that other Arizona courts have given regarding the Commission's constitutional ratemaking authority. The Commission's authority over ratemaking is plenary and cannot be interfered with by the legislature, the courts, or the executive branch.<sup>24</sup> Even if this Court were to review and reweigh the evidence as suggested by the Appellant, and come to a contrary result, it would not be a sufficient basis for reversal of the Commission's decision unless the Commission's decision is determined to be unlawful or unreasonable.<sup>25</sup>

The Commission, on remand, and consistent with this Court's earlier decision, determined that the application of the WACC to the FVRB results in the overstatement of inflation.<sup>26</sup> The Commission's decision to adjust the WACC for inflation is not an abuse of the Commission's discretion and is clearly within its

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<sup>24</sup> See *Ethington*, 66 Ariz. at 392, 189 P.2d at 216; *Morris v. Arizona Corp. Comm'n*, 24 Ariz. App. 454, 457, 539 P. 2d 928, 931 (1975).

<sup>25</sup> *Arizona Water Co. v. the Arizona Corporation Commission*, 217 Ariz. 652, 177 P.3d 1224 (App. Div. 1, 2008); *Arizona Corporation Commission v. Fred Harvey Transp.*, 95 Ariz. at 189, 388 P. 2d 238 (Ariz. 1964) (citing *State ex rel. Consol. Freight Lines v. Murray*, 182 Wash. 98, 44 P.2d 1031, 1033 (1935) (Given that it has complete and exclusive power to set rates, the Commission clearly has the authority to enter into rate contracts, including those specifying rates for a definite period of time, where it believes it necessary to fulfill its ratemaking function. No further grant of authority is necessary.)

<sup>26</sup> Remand Decision at 36 (CR, Tab A-108). Memorandum Decision at 13, (CR Tab C-70).

ratemaking authority. In fact, this court's memorandum decision expressly opined that the adjustments for inflation were within the Commission's discretion.<sup>27</sup>

### **III. THE COMMISSION'S DETERMINATION OF THE COMPANY'S FROR WAS SUPPORTED BY SUBSTANTIAL EVIDENCE.**

The Court should not disturb the Commission's decision because there is substantial evidence to support the Commission's decision in this case.<sup>28</sup>

The Company argues that the WACC can be applied to any rate base, including the FVRB.<sup>29</sup> Certainly it is within the Commission's discretion to apply whatever return it determines appropriate to the FVRB as long as it is supported by substantial evidence, is not arbitrary, and not done illegally. Applying the WACC to the FVRB, however, is not appropriate because it will overstate inflation and overcompensate the Company.<sup>30</sup> The Commission developed an extensive record on the issue of inflation. An appropriate return is one that compensates the Company for its costs, but does not overcompensate the Company for its costs.<sup>31</sup>

A utility's operating income is the product of its ratebase and the rate of return. When setting reasonable rates the Commission must consider the fair value

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<sup>27</sup> Memorandum Decision at 13, (CR, Tab C-70).

<sup>28</sup> *Litchfield Park Service Co. v. Arizona Corp. Comm'n*, 178 Ariz. 431, 434, 874 P.2d 988, 991 (App. 1994).

<sup>29</sup> Exhibit S-R8 at 31, (CR, Tab C-83).

<sup>30</sup> Exhibit R-R2 at 9, (CR, Tab C-74).

<sup>31</sup> *Id.*

to comply with the Commission's constitutional obligations.<sup>32</sup> The FVRB is the average of the Company's adjusted Original Cost Rate Base ("OCRB") and its Reconstruction Cost New Less Depreciation rate base ("RCND").<sup>33</sup> The FVRB, or current value, includes a measure of general inflation because it is based, in part, on reproduction cost.<sup>34</sup> The RCND is developed by applying plant-specific inflation indices to utility specific account balances.<sup>35</sup> By comparison, the OCRB is the depreciated original cost at the end of the test year, used and useful, plus a proper allowance for working capital.<sup>36</sup> The fair value cost tends to be higher than the original cost valuation because it reflects the impact of inflation and other factors which contribute to an increase in value over time.<sup>37</sup>

The other component of operating income is the WACC. The WACC is almost always computed based on a composite, or weighted average, of the utility's cost of debt, preferred stock, and equity, with each component calculated in reference to the amounts recorded in the company's books.<sup>38</sup> The WACC is largely derived from accounting data, with the exception of the cost of equity

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<sup>32</sup> *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 385 (1956). Memorandum Decision at 70, (CR, Tab C-70).

<sup>33</sup> Exhibit R-R1 at 2, (CR, Tab C-73).

<sup>34</sup> *Id.* at 17.

<sup>35</sup> *Id.*

<sup>36</sup> See AAC R-14-2-103(A)(3)(h).

<sup>37</sup> Exhibit R-R1 at 17, (CR, Tab C-73).

<sup>38</sup> Exhibit R-R2 at 4, (CR, Tab C-74).

component which usually relies on analyst judgment and stock market data.<sup>39</sup>

Hence, inflation is also incorporated into the WACC.<sup>40</sup>

The relationship between the rate of return and the rate base is not one that should be considered independently as argued by the Company.<sup>41</sup> As this Court has recognized, rates of return vary, depending on the type of rate base used.<sup>42</sup>

Staff's witness, David Parcell testified<sup>43</sup> that the cost of capital is derived from the equity side of the balance sheet using the book values of the capital structure components.<sup>44</sup> The rate base is derived from the asset side of the balance sheet.<sup>45</sup>

The relationship between the cost of capital and rate base has meaning when the rate base is the OCRB because there is a matching of rate base and capitalization.<sup>46</sup>

The relationship between rate base and rate of return however is broken when the rate base being considered is the FVRB.<sup>47</sup> The reason for the difference, according

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<sup>39</sup> Id.

<sup>40</sup> Id. at 5.

<sup>41</sup> Exhibit S-R8 at 39, (CR, Tab C-83). According to the Company there is no "link" or "relationship" that exists between cost of capital and OCRB in Arizona and the components of WACC are independent of rate base. Exhibit A-R4 at 18, (CR, Tab C-61), Exhibit S-R8 at 39, (CR, Tab C-83).

<sup>42</sup> Memorandum Decision at 7, Footnote 5, (CR, Tab C-70), Charles F. Phillips, Jr., *The Regulation of Public Utilities – Theory and Practice* at 358 (Public Utilities Reports, Inc., 2d ed. 1988).

<sup>43</sup> RUCO's witness, Dr. Ben Johnson also testified at length why he believes that value and return are not independent of each other. Exhibit R-R1 at 14-17, (CR, Tab C-73), Exhibit R-R2 at 6-7, (CR, Tab C-74).

<sup>44</sup> Exhibit S-R5 at 4-5, (CR, Tab C-80).

<sup>45</sup> Id.

<sup>46</sup> Id.

<sup>47</sup> Id.

to Mr. Parcell, is that the amount of fair value ratebase that exceeds OCRB is not financed with investor-supplied capital.<sup>48</sup> Therefore, the typical cost of capital analysis cannot be applied to the FVRB since there is no financial link between the two concepts.<sup>49</sup>

If the goal of regulation is to achieve consistency with the competitive market standard, then applying the same return percentage figure to both the OCRB and the FVRB as the Company advocates will not achieve the goal nor result in fair or reasonable rates.<sup>50</sup> It is common sense that if the end result of multiplying WACC to OCRB is just and reasonable rates, then the end result of multiplying a WACC to the FVRB will be excessive if FVRB is systematically higher than OCRB as is the case here.<sup>51</sup> The Commission must determine FVRB in a meaningful way, but the Commission is not precluded from considering the different types of ratebases when determining what is the appropriate rate of return.

The Commission's conclusion that applying the WACC to the FVRB overstates inflation is clearly supported by the evidence in the record. Likewise, the Commission's adjustment to the cost of capital to correct for inflation is also supported by substantial evidence. Based on the evidence in the record, the Commission broke down the Cost of Capital to its debt and equity components.

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<sup>48</sup> Id.

<sup>49</sup> Id.

<sup>50</sup> Exhibit R-R1 at 23, (CR, Tab C-73).

<sup>51</sup> Exhibit R-R1 at 23, (CR, Tab C-73).

The Commission concluded that an inflation adjustment (a 2% inflation factor reduction) should be made to the equity component only since the evidence in the record did not support an inflation adjustment to the debt component.<sup>52</sup> RUCO's witness, Dr. Ben Johnson, performed an inflation analysis which considered the data published by the Bureau of Labor Statistics for the annual rate of change in the Gross Domestic Product Deflator, as well as annual changes in consumer prices and various measures of producer prices.<sup>53</sup> Dr. Johnson also considered other data which provided expectations regarding future levels of inflation.<sup>54</sup> Specifically, Dr. Johnson's analysis compared the yields on Treasury Inflation-Protected Securities ("TIPS") and other securities issued by the Treasury Department with similar liquidity and duration.<sup>55</sup>

Dr. Johnson's analysis produced a range of expected future inflation levels with a low of 1.70 percent in 2001 to a high of 2.90 percent in 2004.<sup>56</sup> The mean of Dr. Johnson's range is 2.34 percent over the most recent 6.5 years. Dr. Johnson's recommendation, however, is, as he describes "conservative" at 2 percent. The Commission adjusted the cost of equity by a 2 percent inflation factor

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<sup>52</sup> Remand Decision at 36-37, (CR, Tab A-108).

<sup>53</sup> Exhibit R-R1 at 34, (CR, Tab C-73).

<sup>54</sup> *Id.* at 36.

<sup>55</sup> *Id.*

<sup>56</sup> *Id.* at 38.

which the Commission, relying on Dr. Johnson’s analysis notes is conservative and falls within the low end of the historical data.<sup>57</sup>

In addition, the uncontroverted testimony in the record shows that the Commission “evaluated and weighed” the following in its deliberations of an appropriate fair value rate of return:

“... that the FVRB reflects a 50/50 weighing of OCRB and RCND; that the RCND proposed by the Company includes inflation; that the market-based models used to estimate equity are related to the utility’s OCRB; that the Arizona Constitution requires the Commission to consider the fair value of the property; the Company’s argument that the effects of inflation on regulated utilities can affect whether the utility earns its authorized return; our allowance of post-test-year adjustments to the Company’s rate base in Decision No. 68176; our acceptance of the Company’s proposed RCND values and method for determining FVRB; and the guidance provided by the Court of Appeals in its Remand Decision.”<sup>58</sup>

The Commission’s Decision was not arbitrary. The Company may disagree with the result, but there is no question that the Commission’s decision was well reasoned, not arbitrary and based on substantial evidence in the record.

#### **IV. THE COMMISSION’S DETERMINATION OF THE COMPANY’S FROR WAS NOT ILLEGAL.**

Article XV, § 14 of the Arizona Constitution on its face speaks only to the rate base portion of the rate setting equation. It establishes no limitations on the

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<sup>57</sup> Remand Decision at 37, (CR, Tab A-108).

<sup>58</sup> Id.

Commission's discretion to determine the appropriate rate of return to be applied to the rate base. Any such limitations in setting a rate of return arise under the Commission's general rate setting authority of Art. XV, § 3, or under the federal and state due process standards. The "fair value" requirement of Art. XV, § 14 ensures that the Commission consider the current value of the utility's investment, as opposed to relying only on historic values, when setting rates.<sup>59</sup> As explained more fully above, the difference between the historic value of rate base and the fair value rate base is a recognition of the inflation (or deflation) that has occurred since the investments were made. The "fair value" requirement assures that inflation is taken into account in setting rates, but nothing requires the Commission to consider that inflation in **both** elements of the rate setting equation (rate base and rate of return). The Commission's approach to "translate" the WACC which considered inflation to a FROR so that inflation is not overstated in setting rates is within the Commission's discretion in establishing rates, while permitting the Commission to comply with the "fair value" requirement of Art. XV, § 14.

Nonetheless, the Company persists in its efforts to require the Commission to apply the WACC to the FVROR despite the fact that doing so would result in excessive returns. The adoption of rates that are not reasonable and are excessive,

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<sup>59</sup> Memorandum Decision at 11, (CR, Tab C-70).

as the Company recommends, would violate the Commission’s constitutional obligation to set rates that are “just and reasonable.”<sup>60</sup>

The Company relies on case law from other state jurisdictions to support its argument that the WACC should be applied to the FVRB.<sup>61</sup> The Company cited to these same authorities in the remand proceeding.<sup>62</sup> The Commission properly distinguished the cases that the company relied on noting that *Duke Power* was decided based on a statutory mandate particular to North Carolina for which Arizona has no corresponding statutory or constitutional provision.<sup>63</sup> The Commission distinguished the *City of Alton* decision by noting that the several methods of computing the appropriate rate of return in the *Alton* case seemed to be “after-the-fact determinations, as opposed to methods to use or determinations made to set rates”.<sup>64</sup>

Another case cited by the Commission’s Staff that the Commission considered “informative” was *Harbour Water Corp.*, Case No. 41661, 2001 WL170550 (Jan. 10, 2001 Ind. Util. Reg. Comm’n).<sup>65</sup> In that case, the Indiana

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<sup>60</sup> Article 15, § 3, Arizona Constitution.

<sup>61</sup> Company’s Opening Brief at 26-30, citing *State ex rel. Utilities Commission v. Duke Power Co.*, 206 S.E.2d 269, 281 (N.C. 1974) and *City of Alton v. Commerce Commission*, 165 N.E. 2d 513 (Ill.1960).

<sup>62</sup> Remand Decision at 24-26, (CR, Tab A-108).

<sup>63</sup> *Id.*

<sup>64</sup> *Id.* RUCO incorporates by reference the Commission’s legal argument set forth in Decision No. 70441.

<sup>65</sup> Remand Decision at 26, (CR, Tab A-108).

Utility Regulatory Commission noted that multiplying a FVRB by a cost of capital that includes historic inflation “... may overstate the required return by reflecting inflation twice. In order to avoid any such redundancy, it is necessary to make an adjustment to the cost of capital in arriving at reasonable rate of return to be applied to the fair value rate base.”<sup>66</sup>

Most important, however, is the Commission’s recognition that these out-of-state cases do not compel the Commission to adopt any particular method when determining rate of return.<sup>67</sup> The Arizona Constitution speaks to that point, and the Constitution establishes no limitations on the Commission’s discretion to determine the appropriate rate of return to be applied to the FVRB.<sup>68</sup>

**V. THE COMMISSION DID NOT MANIPULATE THE COMPANY’S RATE OF RETURN FOR THE PURPOSE OF ENSURING A CERTAIN LEVEL OF EARNINGS.**

The Company is “most critical” of the Commission’s application of the fair value standard.<sup>69</sup> Specifically, the Company claims that the Commission’s FROR methodology was illegal because the Commission cannot adjust the Company’s rate of return to ensure the same result produced by using the original cost approach.<sup>70</sup> The Company’s main argument clearly suggests that the

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<sup>66</sup> Id.

<sup>67</sup> Remand Decision at 26, (CR, Tab A-108).

<sup>68</sup> This Court acknowledged as much in its memorandum decision. Memorandum Decision at 13-14, (CR, Tab C-70).

<sup>69</sup> Exhibit S-R8 at 32, (CR, Tab C-83).

<sup>70</sup> Id. at 32-33.

Commission's intent on remand was to formulate a rate of return methodology which results in the same level of operating income that is produced by applying the WACC to the OCRB.<sup>71</sup> In support of its argument, the Company, in great detail, has picked apart and placed its own interpretation on the Commission's methodology for determining an appropriate rate of return but has failed to provide any support which shows that the Commission illegally manipulated the rate of return "to render the fair value standard meaningless." In fact, the evidence in the record indicates otherwise.

The Commission concluded that the Company's proposed methodology allows inflation to be reflected in both the WACC and the FVRB and therefore overstates the effects of inflation.<sup>72</sup> The Commission found that either Staff's or RUCO's methodology would result in a fair rate of return on FVRB.<sup>73</sup> The Commission went through a very precise analysis of the Company's, RUCO and Staff's methodologies for determining FROR. Its conclusion that the WACC should be adjusted for inflation is based on sound and supported financial concepts. The Commission's decision is clear that its purpose was to formulate a rate of return methodology that does not overstate the effects of inflation.

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<sup>71</sup> Id. at 33.

<sup>72</sup> Remand Decision at 36, (CR, Tab A-108).

<sup>73</sup> Id. at 34.

Moreover, as the Company points out, the Commission did not determine that that the same level of operating income is appropriate but that an increase in the Company's operating income of \$7,441 is appropriate.<sup>74</sup> The Commission came to this conclusion despite the fact that there is ample evidence in the record that supports an inflation adjustment of greater than two percent which would result in a smaller increase and perhaps a decrease in the Company's operating income.<sup>75</sup> The Commission, in its discretion chose to be conservative which has the effect of providing for a greater level of operating income for the Company.

There is no evidence in the record that supports the inference that the Commission's purpose in formulating its rate of return methodology is to arrive at a level of earnings that is equivalent to the level of earnings that results from applying the WACC to the OCRB.<sup>76</sup> Such a conclusion is mere conjecture and as the Company aptly notes, should carry little, if any weight before this court.<sup>77</sup>

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<sup>74</sup> Exhibit S-R8 at 1, (CR, Tab C-83).

<sup>75</sup> Exhibit R-R1 at 38, (CR, Tab C-73).

<sup>76</sup> Remand Decision at 37, (CR, Tab A-108). Since the evidence in the record shows that the Commission's intent was to arrive at a rate of return that adjusts for inflation, there is no point to analyze the authority that the Company relies on in support of its argument that the Commission cannot manipulate the WACC to arrive at a predetermined level of income.

<sup>77</sup> Exhibit S-R8 at 45, (CR, Tab C-8) citing City of Tucson, 17 Ariz. App. at 481, 498 P. 2d at 555.

## **CONCLUSION**

Requiring the Commission to apply a WACC to the FVRB would result in unjust and unreasonable rates that overstate the effects of inflation. While the Arizona Constitution does require that the Commission determine the fair value of the Company's property when setting rates, it does not require that the Commission overstate the effects of inflation in the rate of return. The Commission's approach to setting rates in this case, by translating a WACC into a FROR, is within the Commission's exclusive discretion to set just and reasonable rates.

RESPECTFULLY SUBMITTED this 6<sup>th</sup> day of April, 2009.

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## **CERTIFICATE OF COMPLIANCE**

Pursuant to Rule 14, Arizona Rules of Civil Appellate Procedure, the undersigned counsel certifies that this brief uses a proportionately spaced typeface of Times New Roman at 14 points. According to the Microsoft Word word-count function, this brief contains 3,323 words, excluding the Table of Contents, Table of Authorities, Certificate of Service, and this Certificate of Compliance.

RESPECTFULLY SUBMITTED this 6<sup>th</sup> day of April, 2009.

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## CERTIFICATE OF SERVICE

The undersigned hereby certifies that a copy of the foregoing Answering Brief was served upon the Appellant and all parties in the above-referenced docketed proceedings in the following manner:

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Dated this 6<sup>th</sup> day of April, 2009

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