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See Ariz. R. Supreme Court 111(c); ARCAP 28(c);
Ariz. R. Crim. P. 31.24

IN THE COURT OF APPEALS
STATE OF ARIZONA
DIVISION ONE



DIVISION ONE
FILED: 06-10-2010
PHILIP G. URRY, CLERK
BY: GH

CHAPARRAL CITY WATER COMPANY, an) 1 CA-CC 08-0002
Arizona corporation,)
) DEPARTMENT A
Appellant,)
) **MEMORANDUM DECISION**
v.) (Not for Publication -
) Rule 28, Arizona Rules of
ARIZONA CORPORATION COMMISSION,) Civil Appellate Procedure)
an agency of the State of)
Arizona,)
)
Appellee,)
)
RESIDENTIAL UTILITY CONSUMER)
OFFICE,)
)
Intervenor/Appellee.)
)

Arizona Corporation Commission

Docket No. W-02113A-04-0616

AFFIRMED

Fennemore Craig, P.C. Phoenix
By Norman D. James
Jay L. Shapiro
Attorneys for Appellant

Arizona Corporation Commission Legal Division Phoenix
By Maureen A. Scott
Charles H. Hains
Janet Wagner
Attorneys for Appellee

W I N T H R O P, Judge

¶1 This is the second direct appeal from this rate case before the Arizona Corporation Commission ("the Commission") by Chaparral City Water Company ("Chaparral City"). In the prior appeal, this court found that the Commission violated the Arizona Constitution by using the original cost rate base ("OCRB") rather than the fair value rate base ("FVRB") to set rates. See *Chaparral City Water Co. v. Ariz. Corp. Comm'n*, 1 CA-CC 05-0002, at 28, ¶ 49 (Ariz. App. Feb. 13, 2007) (mem. decision). In this appeal after remand, Chaparral City contends that the Commission improperly adjusted the cost of equity downward for inflation, resulting in a lower rate of return. Chaparral City argues that the Commission should have applied the same rate of return to the FVRB as it had previously applied to the OCRB, without adjustment. For the following reasons, we affirm.

FACTS AND PROCEDURAL HISTORY

¶2 In August 2004, Chaparral City filed an application with the Commission for a determination of the fair value of its utility plant and for an increase in its service rates based on that determination. Chaparral City sought a total revenue

increase of \$1,797,182. The Commission, in Decision No. 68176, found that Chaparral City's FVRB was \$20,340,298 and that the fair value rate of return on the FVRB was 6.36 percent. The Commission granted a rate increase of \$1,107,596.

¶13 Chaparral City appealed, and in a memorandum decision, this court found that the Commission had set the rate by first determining the operating income based on the OCRB¹ and then mathematically finding the "fair value rate of return" that could be applied to the FVRB to provide the same operating income.² *Chaparral City*, 1 CA-CC 05-0002, slip op. at **7-8, ¶¶ 7-8. Because the rate was based on the OCRB and not current fair value, we found that the Commission's decision violated Article 15, Section 14, of the Arizona Constitution, and we

¹ OCRB is defined as "[a]n amount consisting of the depreciated original cost, prudently invested, of the property (exclusive of contributions and/or advances in aid of construction) at the end of the test year, used or useful, plus a proper allowance for working capital and including all applicable pro forma adjustments." Ariz. Admin. Code R14-2-103(A)(3)(h).

² In setting rates, the Commission uses the general equation that a utility's revenue requirement equals its operating income plus its expenses. *Chaparral City*, 1 CA-CC 05-0002, slip op. at *7, ¶ 7. The operating income is the product of the rate base and the rate of return. See *id.* "[T]he rate of return is the amount of money earned by a public utility, over and above operating costs, expressed as a percentage of the rate base." Charles F. Phillips, Jr., *The Regulation of Public Utilities - Theory and Practice* 358 (Public Utilities Reports, Inc., 2d ed. 1988).

remanded the matter to the Commission for further proceedings. *Id.* at *28, ¶ 49.

¶4 The Commission held the Remand Hearing on January 28 and 29, 2008. It characterized the matters before it as, among other things, ascertaining the appropriate methodology to determine the rate of return on Chaparral City's rate base and determining that rate of return. Chaparral City argued that the weighted average cost of capital ("WACC")³ of 7.6 percent, which was determined in the earlier proceeding, should be used as the rate of return on the FVRB of \$20,340,298, which was also determined in the earlier proceeding. The Residential Utility Consumer Office ("RUCO")⁴ argued that the WACC was developed to be used with the OCRB and that using it for the rate of return on the FVRB would result in double counting inflation. RUCO contended that the FVRB is tied to reproduction costs, which are increased by inflation, and that the WACC includes the cost of equity, which relies on data and analytical assumptions that also account for inflation. RUCO asserted that the WACC should

³ WACC is calculated by (1) multiplying the percentage of the company's long-term debt by the cost of that debt to obtain the weighted cost of debt, (2) multiplying the percentage of common stock equity by the cost of that equity to obtain the weighted cost of equity, and (3) adding the two products together.

⁴ RUCO is an organization created by statute to represent the interests of residential utility consumers in regulatory proceedings involving public service corporations before the Commission. Ariz. Rev. Stat. ("A.R.S.") § 40-462(A) (2001).

be adjusted for inflation before being used for the rate of return on the FVRB. The Commission staff ("Staff") also asserted that the WACC was tied to the OCRB and should not be applied to the FVRB without adjustment. Staff presented two alternative approaches to adjust the WACC and determine an appropriate rate of return. In the first, Staff suggested eliminating from the calculation of the WACC that percentage representing the difference between the OCRB and the FVRB. According to Staff, that difference, termed "the fair value increment," represented capital appreciation that had not been financed by either equity or debt and therefore had no cost. Therefore, Staff argued, a cost rate of zero should be applied to that percentage, which would lower the rate of return. Alternatively, Staff argued that, if the Commission attributed a cost to the fair value increment, that cost should be no larger than the real risk-free rate of return - that is, the rate after the removal of inflation.

¶15 After considering testimony presented by all three parties, the Commission in Decision No. 70441 concluded that the WACC was related to the OCRB and that an adjustment to the WACC was appropriate in determining a rate of return on the FVRB. The Commission found that Chaparral City's method of determining the rate of return would overstate inflation. The Commission concluded that the WACC should be adjusted to remove the

inflation component. However, rather than reduce the WACC by an inflation factor, as advocated by RUCO, the Commission applied the inflation factor only to the cost of equity. The Commission reduced the cost rate for common equity from 9.3 percent to 7.3 percent, which when multiplied by the percent of common stock equity of 58.73 percent, resulted in a weighted cost of equity excluding inflation of 4.29 percent. That percentage plus the weighted cost of debt of 2.11 percent resulted in a total adjusted WACC, or fair value rate of return ("FVROR"), of 6.4 percent, which the Commission found to be an appropriate rate of return on the FVRB. Relying on the testimony of RUCO's expert, the Commission found that the 2 percent inflation factor was "conservative" and fell "toward the low end of the historical data." Multiplying the 6.4 percent FVROR by the \$20,340,298 FVRB produced an operating income of \$1,301,779, which translated to an authorized revenue increase of \$1,119,739, or \$12,143 more annually than the increase authorized by Decision No. 68176.

¶16 Chaparral City filed an application for rehearing pursuant to A.R.S. § 40-253(A) (2001). Chaparral City argued that the Commission unlawfully manipulated the rate of return determination to achieve a result equivalent to using the OCRB to set rates, and that the unadjusted WACC found in Decision No. 68176 was not linked to the OCRB and should have been used to

determine operating income. The application for rehearing was deemed denied by operation of law. See A.R.S. § 40-253(A).

¶17 Chaparral City then filed a notice of direct appeal. Because the decision from which Chaparral City appeals relates to rate making, this court has jurisdiction pursuant to A.R.S. § 40-254.01(A) (2001).

ANALYSIS

¶18 The Commission has exclusive, plenary authority to set just and reasonable rates for public service corporations in Arizona. See Ariz. Const. art. 15, § 3; *Tucson Elec. Power Co. v. Ariz. Corp. Comm'n*, 132 Ariz. 240, 242, 645 P.2d 231, 233 (1982); *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 154, 294 P.2d 378, 384 (1956). A party challenging a Commission decision setting rates must make a "clear and satisfactory showing that the order is unlawful or unreasonable." A.R.S. § 40-254.01(A). A "clear and satisfactory" showing is synonymous with a "clear and convincing" showing. *Consol. Water Utils., Ltd. v. Ariz. Corp. Comm'n*, 178 Ariz. 478, 481, 875 P.2d 137, 140 (App. 1993). In reviewing a Commission ruling, we do not reweigh the evidence and will affirm the Commission's decision unless it is unsupported by substantial evidence, is arbitrary, or is unlawful. See *Tucson Elec.*, 132 Ariz. at 243, 645 P.2d at 234; *Simms*, 80 Ariz. at 154-55, 294 P.2d at 384. We review matters of law, however, *de novo*. *U.S. W. Commc'ns, Inc.*

v. *Ariz. Corp. Comm'n*, 201 Ariz. 242, 244, ¶ 7, 34 P.3d 351, 353 (2001).

¶19 The Arizona Constitution requires the Commission to "prescribe . . . just and reasonable rates and charges" for public utilities and to "ascertain the fair value of the property within the State of every public service corporation doing business therein" to aid it in its duties. Ariz. Const. art. 15, §§ 3, 14. These provisions have been interpreted as requiring the Commission to find the "fair value" of the utility's property and to use that value in calculating just and reasonable rates, so that the utility receives a fair return on the fair value of the property it devotes to public use. *Ariz. Corp. Comm'n v. Ariz. Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415 (1959); *Simms*, 80 Ariz. at 151, 294 P.2d at 382. The amount of capital invested in the utility is immaterial. *Ariz. Water*, 85 Ariz. at 203, 335 P.2d at 415. A fair rate of return was defined in *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923):

A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time in the same general part of the country on investments in other business undertakings which are attended by corresponding[] risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence

in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.

Id. at 692-93. Finding the rate of return requires determining the capital costs of the business, which involves finding the percentage figure it would cost the utility to obtain debt and equity capital. See *Sun City Water Co. v. Ariz. Corp. Comm'n*, 26 Ariz. App. 304, 309, 547 P.2d 1104, 1109, *vacated on other grounds*, 113 Ariz. 464, 556 P.2d 1126 (1976). The cost of debt is usually a historical fact, whereas determining the cost of equity involves exercising judgment in light of numerous factors. See *id.*

¶10 Chaparral City contends that the Commission illegally adjusted the rate of return to ensure that Chaparral City's earnings remained essentially the same as if the rate had been based on the OCRB instead of fair value. Chaparral City contends that the WACC previously used in conjunction with the OCRB should be applied to the FVRB without adjustment. It argues that the Commission's contention that to do so would overstate inflation is incorrect, in part because half the FVRB is the original cost of the company's plant, which contains no inflation.

¶11 Chaparral City argues that the WACC is not connected to the OCRB and can be used with any rate base. David Parcell,

a consulting economist and Staff's expert, testified that the concept of cost of capital was designed to apply to OCRB:

This is the case since the cost of capital is derived from the liabilities/owners' equity side of a utility's balance sheet using the book values of the capital structure components. The cost of capital, once determined, is then applied to (i.e., multiplied by) the rate base, which is derived from the asset side of the balance sheet (i.e.,] OCRB). From a financial perspective, the rationale for this relationship is that the rate base is financed by the capitalization. Under this relationship, a provision is provided for investors (both lenders and owners) to receive a return on their invested capital. Such a relationship is meaningful as long as the cost of capital is applied to the original cost (i.e., book value) rate base, because there is a matching of rate base and capitalization.

Parcell went on to explain that the amount of fair value rate base that exceeds the original cost rate base is not financed. No financial link therefore exists between the FVRB and the cost of capital analysis, and the cost of capital analysis cannot automatically be applied to the FVRB.

¶12 Dr. Ben Johnson, a consulting economist specializing in public utility regulation and RUCO's expert, similarly testified that the WACC was conceptually related to the OCRB, with both factors being derived largely from the utility's accounting records, except for the cost of equity, which relies in part on analyst judgment and stock market data. Dr. Johnson further testified that the WACC was specifically designed to maintain consistency with the OCRB, that applying the WACC to

the OCRB had been recognized for many years as providing reasonable rates for both utilities and consumers, and that changing the methodology to use the FVRB with the WACC would result in a windfall for stockholders.

¶13 Given the testimony of these experts, we cannot say the Commission's findings that the WACC was linked to the OCRB and that it required adjustment to be used with the FVRB were unsupported by the evidence.

¶14 Chaparral City cites two cases from other jurisdictions to support its position that the WACC should be applied to the FVRB - *State ex rel. Utilities Commission v. Duke Power Co.*, 206 S.E.2d 269 (N.C. 1974), and *City of Alton v. Commerce Commission*, 165 N.E.2d 513 (Ill. 1960). Even to the extent that these cases provide general support for Chaparral City's position, the Commission is nevertheless not obligated to adopt their methodology. Nor is it within this court's purview to direct the Commission to employ any particular method of determining rates. See Ariz. Const. art. 15, § 3; *Tucson Elec.*, 132 Ariz. at 242, 645 P.2d at 233; *Ethington v. Wright*, 66 Ariz. 382, 392, 189 P.2d 209, 216 (1948).

¶15 Chaparral City argues that the Commission's conclusion that the WACC needed to be adjusted for inflation was an attempt to create rates using the FVRB that were equivalent to those obtained using the OCRB. Chaparral City contends that Dr.

Johnson's testimony supporting the inflation adjustment was the "end-result" test, which was disapproved of by our supreme court in *Simms*.

¶16 In *Simms*, the Arizona Supreme Court interpreted *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), as concluding that, because Congress had not specified the formula by which the Federal Power Commission was required to set just and reasonable rates, the final result reached and not the method used to reach that result was controlling. 80 Ariz. at 150, 294 P.2d at 381. Our supreme court held, however, that the *Hope* analysis did not apply in Arizona because the Arizona Constitution requires the Commission to ascertain and use fair value in setting just and reasonable rates. *Id.* at 151, 294 P.2d at 382. Chaparral City contends Dr. Johnson argued that the resulting rates "must be equivalent to the result produced by applying the WACC to the utility's OCRB" and therefore advocated the rejected "end result" methodology. Dr. Johnson actually testified that the end result of applying the WACC to the OCRB produces just and reasonable rates, so applying the WACC to the FVRB, which is generally higher than the OCRB, would produce excessive rates.

¶17 When viewed in isolation, this testimony could be interpreted as suggesting that the "correct" rate of return is achieved by applying the WACC to the OCRB and that therefore the

WACC must be modified to achieve an equivalent result. However, Dr. Johnson was describing why the WACC was not appropriately used in conjunction with the FVRB. He explained that the goal was to set just and reasonable rates, and that, when used together, the WACC and the OCRB reached that goal. Therefore, using the WACC with the FVRB would not achieve that goal, in part because both the WACC and the FVRB include components reflecting inflation. He also noted that the objective of regulation is to produce results that parallel those that would be obtained under conditions of competition - a theory with which Chaparral City agrees⁵ - and that therefore, if applying the OCRB to the WACC achieves that goal, applying the WACC to the FVRB would deviate from competitive circumstances.

¶18 Dr. Johnson further testified that both the FVRB and the cost of equity (and therefore the WACC) take inflation into account and that applying the WACC to the FVRB would overstate inflation. Dr. Johnson proposed reducing the WACC by a percentage related to the rate of inflation. He provided a table of publically available data on inflation, which indicated a range of from 1.71 to 4.6 percent, but he recommended that the Commission adopt a conservative inflation factor - specifically 2 percent.

⁵ In its opening brief, Chaparral City states that a goal of the fair value standard is to mimic the competitive market.

¶119 The Commission noted that James C. Bonbright, in *The Principles of Public Utility Rates* 281 (1961), stated, “[T]he rate of return should include no allowance for price inflation, realized or anticipated, since any such allowance would be incorporated in the rate base,” a statement that supports Dr. Johnson’s view. The Commission further noted that, in making its argument, Staff had cited an unpublished Indiana Regulatory Commission decision that concluded that determining a rate of return by multiplying a fair value rate base, which includes historic inflation, by the cost of capital, which also includes an inflation component, could overstate inflation. See *Re Harbour Water Corp.*, 2001 WL 170550, at *10 (Ind. U.R.C. Jan. 10, 2001). The Indiana commission found it necessary to remove a percentage representing inflation from the cost of equity. See *id.*

¶120 Although Dr. Johnson’s reasoning appears based on the presumption that traditional ratemaking based on the OCRB produces just and reasonable rates, we cannot say that the method employed here was calculated to achieve rates based on the OCRB. The conclusion that using the WACC in conjunction with the FVRB requires an adjustment for inflation has support in a treatise on utility rates as well as in another regulatory jurisdiction. As we have recognized, it is for the Commission to determine the appropriate formula for setting rates. The

Commission's decision to adjust the WACC for inflation in setting rates based on the FVRB is supported by the record. Chaparral City has not clearly and convincingly demonstrated that the decision was arbitrary or unlawful.

¶21 Chaparral City also argues that the 2 percent adjustment for inflation was excessive. Chaparral City asserts that, because the FVRB is derived from the average of the OCRB and the reconstructed cost new depreciated ("RCND") rate base, and because the OCRB by definition contains no inflationary component, then the 2 percent inflation factor should have been halved.

¶22 RUCO presented evidence of inflation values ranging up to 4.6 percent. RUCO advocated that the Commission reduce the WACC by a conservative inflation rate of 2 percent. The Commission adopted the 2 percent rate - less than half of the highest rate in the range - and applied it only to the cost of equity component in the WACC, not the WACC itself, concluding that insufficient evidence had been presented that the cost of debt had incurred inflation. The Commission expressly stated that, in reaching its decision, it took into account numerous factors, including the "50/50 weighting of OCRB and RCND." This court will not reweigh the evidence presented.

¶23 Chaparral City also argues that the inflation adjustment constitutes piecemeal ratemaking because it adjusted

for general inflation but did not consider inflation on Chaparral City's cost of business. Chaparral City asserts that those increases in costs will be immediate and any increase in FVRB will await another rate case, and even then the new rates will be based on a test year rather than current costs and expenses. Consequently, Chaparral City argues, it will experience a dramatic increase in operating expenses because of inflation, while its operating income will not keep pace because of the inflation adjustment.

¶24 This decision did not involve piecemeal ratemaking. Piecemeal ratemaking occurs when the Commission approves an increase in rates without the benefit of a rate case that takes into account the company's assets and the effect of the increase on the rate of return. *See generally Residential Util. Consumer Office v. Ariz. Corp. Comm'n*, 199 Ariz. 588, 593, ¶¶ 21-22, 20 P.3d 1169, 1174 (App. 2001); *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 534-37, 578 P.2d 612, 615-18 (App. 1978). The rates here were set after a full hearing in a formal rate case, at which Chaparral City was able to present its inflation evidence.

¶25 Chaparral City also argues that Staff's methodology was improper. Because the Commission adopted RUCO's methodology and we affirm the Commission's decision in this case, we do not address Chaparral City's argument with respect to Staff's

approach and offer no opinion on the propriety of that methodology.

CONCLUSION

¶26 We affirm the Commission's Decision No. 70441. Chaparral City has not shown by clear and satisfactory evidence that the decision was unlawful or unreasonable.

_____/S/_____
LAWRENCE F. WINTHROP, Judge

CONCURRING:

_____/S/_____
MAURICE PORTLEY, Presiding Judge

_____/S/_____
MARGARET H. DOWNIE, Judge