

MEMORANDUM

TO: Bea Teyechea  
Anne Rusher  
Harriet Colburn ✓

FROM: Jack LaSota

DATE: October 1, 1976

R74-25

In a recent Opinion of the Arizona State Supreme Court, entitled Arizona Corporation Commission, et al. v. Arizona Public Service Company (September 16, 1976), the Court mentioned Attorney General Opinion No. 74-25 (R51). The Court said the following:

We have no intention of discussing the whole of that opinion, but we do find that insofar as it advises the Corporation Commission that the Arizona Constitution and our cases require that the Commission may not consider additional plant [sic] under construction at the close of the historic year, it is not correct. (Emphasis added.)

Some notation should be made in our indexing system, and perhaps on the text of the opinion itself, that the Supreme Court reached this conclusion.

Can you take some steps to assure that we do not in the future erroneously rely on the incorrect portion of that opinion.

Thank you.

N. WARNER LEE, THE ATTORNEY GENERAL  
STATE CAPITOL  
PHOENIX, ARIZONA

October 11, 1974

DEPARTMENT OF LAW OPINION NO. 74-25 (R-51)

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REQUESTED BY: THE HONORABLE ERNEST GARFIELD  
Chairman  
Arizona Corporation Commission

QUESTION: Does the Arizona Corporation Commission have the power to use the future test period or forward looking test year to determine rate base in prescribing just and reasonable rates to be charged by public service corporations?

ANSWER: The Arizona Constitution prohibits the Corporation Commission from adopting the use of the future test period or any other period which would take into account the future value of property not used or useful for the public benefit or in existence at the time of the valuation inquiry.

The Arizona Supreme Court has established, in an unbroken line of cases beginning shortly after adoption of the Arizona Constitution, that in matters of rate-making and in the establishment of rules, regulations and orders bearing on rate-making, ". . . the Corporation Commission has full and exclusive power. In such field the Commission is supreme and such exclusive field may not be invaded by the courts, the legislature, or the executive." Ethington v. Wright, 66 Ariz. 382, 189 P.2d 209, 216 (1948). See, for example, State v. Tucson Gas, Electric Light & Power Co., 15 Ariz. 294, 138 P. 781 (1914); Corporation Commission v. Pacific Greyhound Lines, 54 Ariz. 139, 94 P.2d 443 (1939); Simms v. Round Valley Light & Power Co., 80 Ariz. 145, 294 P.2d 378 (1956); Arizona Corporation Commission v. Superior Court, 107 Ariz. 24, 480 P.2d 988 (1971). It follows, therefore, that the only restrictions on the Commission's rate-making discretion are those imposed by the Constitution and court decisions interpreting the Constitution.

For the following reasons, we conclude that the Corporation Commission, by virtue of Article XV, Section 14 of the Arizona Constitution and judicial opinions interpreting that section, is precluded from establishing rates on a base which would include properties not being used by the utility for the convenience of the public at the time of the inquiry.

An analysis of the Arizona Constitution, the case law and Attorney General's opinions interpreting the Constitution clearly demonstrates that in determining a utility's rate base the Commission may consider only the fair value of property in existence at the time of the inquiry and being used by the utility for the convenience of the public. Article 15, Section 14, of the Arizona Constitution provides that the Commission shall "ascertain the fair value of the property within the State." The leading case on the interpretation of this constitutional language is Simms v. Round Valley Light & Power Company, supra. The Simms case discusses the nature of a rate hearing and observes that a reasonable rate means two things: (a) that the company whose property is committed to public service be allowed to earn a fair and reasonable return; and (b) that the rate be reasonable from the standpoint of the public whose interests the utility is committed to serve.

To find such a reasonable rate the Simms court stated that ". . . the Commission is required to find the fair value of the company's property. . ." and that it is to use this finding ". . . as a rate base for the purpose of calculating what are just and reasonable rates." 294 P.2d at 382. In reaching a determination as to what constitutes fair value, the court cited State of Missouri, ex rel. Southwestern Bell Telephone Company v. Public Service Commission, 262 U.S. 276 (1923), for the proposition that "the company is entitled to a reasonable return upon the fair value of its properties at the time the rate is fixed." In the most recent Arizona case concerned with the issue of what constitutes fair value, the court interpreted Simms as saying that "the Court reiterated that fair value meant 'value of properties at the time of the inquiry', 294 P.2d at 382, which figure will necessarily reflect the current cost of construction." City of Tucson v. Citizens Utilities Water Company, 17 Ariz.App. 477, 480, 498 P.2d 551 (1972).

In the Citizens case the court noted that the property of the utility investment is not controlling and said:

In Arizona Water Co., supra, the Court stated:

"\* \* \* The amount of capital invested is immaterial. Under the law of fair value, a utility is not entitled to a fair return

on its investment; it is entitled to a fair return on the fair value of its properties devoted to the public use, no more and no less. . . .335 P.2d at 415. Id. at 482.

It must be noted that the above language does not mean that the Commission may never consider other factors, such as increase in cost since the plant was constructed, in reaching its determination as to what constitutes fair value. Indeed, the Simms court approved the use of increased costs as a factor in determining current reproduction cost. Nevertheless, the Simms case emphasizes that the use of estimates such as reconstruction costs and other speculative values, if supported by legitimate evidence, must be allowed to influence the rate base in some degree, but need not be accepted at full value. If development of reproduction cost on the basis of current costs is speculative, then a fortiori the wholesale projection of expenses and revenues as required by the use of a future test period is nothing more than speculation as to what might happen at a later point in time. In commenting upon the use of data equally as speculative, the Citizens court stated, "What could have happened is mere speculation." Citizens, supra, at 482. Further, "Mere speculation and arbitrary conclusions are not substantial evidence and cannot be determinative." Id. at 481.

Thus, it is clear, in light of Article 15, Section 14, of the Arizona Constitution and the cases interpreting this provision, that to the extent a forward look takes into consideration property not being used by the utility for the convenience of the public at the time the rates are set or takes into consideration probable future values of existing property at the time the rates are set, a forward look is unconstitutional.

The Arizona Supreme Court, in Arizona Corporation Commission v. Arizona Water Company, 85 Ariz. 198, 335 P.2d 412 (1959), approved the following conclusion of law made by the trial court:

"In the determination of the fair value of the Company's properties devoted to the public use at the time of the inquiry, the Commission must, in each instance, consider the original cost less depreciation of the Company's property devoted to the public use at the end of the test period, together

with reproduction cost new less depreciation of the Company's properties at the end of the test period, where such evidence is submitted." (Emphasis added.)

335 P.2d at 414.

In its discussion the Supreme Court made the following observations:

. . . [I]n finding the fair value rate base the only relevant original cost figure is that computed at the time of the inquiry, or as near as possible thereto. . . . The estimates of reproduction cost new less observed depreciation should also be as close to the time of the inquiry as possible.

335 P.2d at 414.

Reading this as a whole, it is evident that the Supreme Court has determined that valuation findings made at the end of the test period satisfy the requirement that such valuation be made "at the time of the inquiry, or as near as possible thereto." The court has thus recognized in some instances the impracticability of attempting to receive into evidence updated figures in revised exhibits, which none of the parties have been able to audit or test properly. Indeed the admission in evidence of updated valuation and operating data for use in determining rate base and revenue and expense findings might well violate due process if the parties to the proceedings are denied a reasonable time in which to audit, investigate, challenge and rebut such evidence.

The practical difficulty of using evidence updated from the end of the test period can be illustrated by a simple hypothetical. Assume that a test period of the year ending March 31, 1974, has been selected for a rate case, and assume that hearings are scheduled to commence three months later on July 1, 1974. The intervening time is necessary for the applicant to close its books and prepare its exhibits and for the Commission staff and intervenors to examine these exhibits and prepare exhibits of their own. Assume further that the applicant puts into service a new and significant segment of plant only a week or two prior to the commencement of the hearing. Even assuming that reliable cost figures for the

new plant could be obtained the day the new segment is put into service, the applicant corporation must still assimilate these figures into its exhibits. More importantly, Corporation Commission staff and intervenors must have sufficient time in which to discover and check these new figures and to determine whether all relevant data is accurately reflected in the updated exhibits of the applicant. In effect, then, to ensure a fair end result the test period would have to be updated to reflect all conditions existing as of the date of activation of the new plant segment. Obviously one or two weeks is scarcely enough time in which to obtain the information from the utility and to evaluate carefully the full impact of a major facility on the revenues and expenditures of a utility of anything but minimal size and complexity.

That is not to say that the use of updated evidence will pose a problem of impracticability in every instance. For example, if an issue involving rate of return on short term, long term or imbedded debt should arise, the current and past rates of return may be easily obtained by referring to current and past trade journals and national publications. Cost of debt, therefore, could be easily updated to the time of the inquiry by all parties without having to undergo the extensive discovery and evaluation procedures noted in the first example.

The foregoing examples are recited with the notion in mind that the purpose of using a test year is to provide a definite cut-off date so that the Commission can proceed with its determinations. If the evidence sought to be introduced is of such a nature that to allow an update of that evidence would have the effect of continuing the proceedings indefinitely while the new evidence is heard, it is then suggested that an update of evidence of that nature is entirely impracticable. In that instance, a final determination could never be made.

In certain instances (such as the exceptions noted above), however, the practical objections to using updated evidence are absent; therefore, this is not to say that the Commission may not continue its current practice of recognizing, in determining a fair rate of return, certain changes which have occurred subsequent to the test period but prior to the close of evidence taking. Of course, the rights of all parties to challenge such evidence must be preserved. Should the situation of the utility have changed since the end of the test

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period so markedly that rates based on end of test period figures would leave the company faced with a financial emergency, the utility might at any time request emergency or interim rate relief. See Arizona Attorney General Opinion No. 71-17.

Respectfully submitted,



N. WARNER LEE  
The Attorney General

NWL:lf

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