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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF JOHNSON UTILITIES, LLC FOR AN INCREASE IN ITS WATER AND WASTEWATER RATES FOR CUSTOMERS WITHIN PINAL COUNTY, ARIZONA.	Docket No. WS-02987A-08-0180

RESIDENTIAL UTILITY CONSUMER OFFICE'S REPLY BRIEF

The Residential Utility Consumer Office ("RUCO") replies in response to Johnson Utility, LLC's ("Johnson or the Company"), Swing First Golf, LLC's ("Swing First") and the Arizona Corporation Commission Staff's ("Staff") post hearing briefs as follows.

PLANT-IN-SERVICE

RUCO incorporates its position set forth in its Opening Brief. Opening Brief at 4. RUCO accepted the Commission Staff's ("Staff") findings and has nothing to add beyond what Staff set forth in its post hearing brief ("Staff's Brief"). Staff's Brief at 2-11.

POST TEST-YEAR PLANT

RUCO incorporates its position set forth in its opening brief ("RUCO's Brief"). RUCO's Brief at 4.

CONTRIBUTIONS IN AID OF CONSTRUCTION ("CIAC") AND THE ACCUMULATED AMORTIZATION ASSOCIATED WITH THE CIAC

The Company seeks to remove the unexpended CIAC from its CIAC balance in both the water and wastewater divisions. The argument is a timing argument as to when the HUF should be treated as CIAC. Unfortunately for the Company, neither the NARUC definition of CIAC nor the Commission's own rules differentiate when the contributions are received and when the contributions are expended.

The Commission addressed this issue in a recent UNS Gas rate case (Decision No. 70011, Docket No.G-04204A-06-0463, (2007)). In Decision No. 70011, the Company proposed to exclude from rate base advances that were associated with plant not yet in service. While the facts differ from the present case the concept and its application are the same. The Commission noted:

> We agree with Staff and RUCO that advances represent customer-supplied funds that are properly deducted from the Company's rate base. Indeed, the Commission's own rules contemplate that such a deduction is required, as Staff witness Smith testified. Had UNS not requested the inclusion of CWIP in rate base, a ratemaking treatment that is only afforded under extraordinary circumstances (and apparently has not occurred for more than 20 years), there would presumably not have been an issue raised by the Company with respect to an alleged "mismatch" between exclusion of CWIP and deducting advances from rate base. The Company's attempt to frame this issue as one in which it is being treated in a discriminatory manner is unpersuasive.
>
> As we have stated in prior cases, regulated utility companies control the timing of their rate case filings and should not be heard to complain when their chosen test periods do not coincide with the completion of plant that may be considered used and useful and therefore properly included in rate base. We believe our conclusions regarding UNS's CWIP-related proposals are entirely consistent with the treatment that has been afforded to other utility companies regulated by the Commission and provide a result that is fair to both the Company and its customers. Decision No.70011 at 9-10.

In the present case, if the Company has a concern about its CIAC balance, the Company should wait and file its rate case when the service associated with the HUF is provided to the customer. Typically, as Mr. Michlik explains, the Company builds the infrastructure in advance and then collects the HUF upon each new connection. S-39 at 5. The Commission should not change the normal accounting procedure because the Company decides to collect the HUF before the service is provided.

ACCUMULATED DEPRECIATION

RUCO incorporates its position set forth in its Opening Brief. RUCO Brief at 5...

ALLOWANCE FOR MATERIALS AND SUPPLIES

The Company has agreed to remove materials and supplies from ratebase so this no longer remains at issue. Company Closing Brief ("Company Brief") at 16.

SERVICE LINE AND METER CHARGES

RUCO incorporates its position set forth in its Opening Brief. RUCO Brief at 6.

CONTESTED OPERATING INCOME ISSUES

DEPRECIATION EXPENSE

RUCO incorporates its position set forth in its Opening Brief. RUCO Brief at 6.

PROPERTY TAX EXPENSE

RUCO incorporates its position set forth in its Opening Brief. RUCO Brief at 6.

RATE CASE EXPENSE

The only issue here is the amortization period. The Company recommends three years and RUCO recommends five years. Among other things the five year amortization will help ameliorate the rate increase for the wastewater division.

INCOME TAXES

The Company has raised several arguments in support of its position that even though it is a limited liability corporation ("LLC") it should be treated as a pass-through entity for income tax purposes. Company Brief at 31-35. The Company cites examples of other states but the Company's argument is unpersuasive since the result of the Company's analysis is that some states allow recovery and others do not – no big surprise. Id. at 33 – 34. Moreover, the analysis is not insightful because it is unclear what the laws are in other states, if and how the LLC recovers the taxes from members and other factors that would make the comparison apples to apples.

The Company also argues that the failure to include the tax would be unfair because its revenue requirement would be lower and the ratepayers would receive an "unjustified windfall." Id. at 32. The flaw in the argument is that the Company, not the ratepayers chose the corporate status. The reason why the Company chose the corporate status was because it benefited and continues to benefit its members. The Company admits as much – the obvious benefit to the shareholder of the LLC structure is the avoidance of double taxation. A-3 at 25. The Company and its members knew the consequences of selecting the LLC filing status – the members knew that the taxes would become their responsibility and through reimbursement agreements have effectively eliminated this obligation.

Now, the Company wants the ratepayers to pay for the reimbursement of taxes it paid its members. In other words, if the Company is reimbursed, ratepayers will be paying for an obligation that the Company volunteered to pay, not that it was obligated to pay. This would be a bad public policy and the Commission will also be clearing the way for this type of accounting treatment in the future which would undoubtedly become the norm.

Finally, the Company analogizes the situation to a subsidiary C Corporation utility of a parent holding company whose tax return is consolidated with the parent. Company Brief at 32. However, to repeat, this argument is really not analogous since the Company is not a subsidiary of a parent who files a consolidated return. See RUCO Brief at 7-8. Moreover, the obligation of a parent company for income taxes is not comparable to the personal obligation of an individual member. Id. Corporate and personal tax obligations are computed and treated completely different under the tax code. The Company's recommendation to recover income tax expense should be rejected.

THE CENTRAL ARIZONA GROUNDWATER REPLENISHMENT DISTRICT ("CAGRD")

The issue here does not concern the recovery of the CAGRD expense but the manner of recovery. Both Staff and the Company argued in their closing briefs over the conditions Staff recommended as part of its proposed adjustor mechanism. Staff Brief at 20-23, Company Brief at 28-31. RUCO remains puzzled at the notion of an adjustor mechanism to account for this expense. No matter how far one stretches the criteria that the Arizona courts and the Commission have required for the implementation of an adjustor mechanism, the circumstances of this expense simply do no qualify. That is not to say that the Company should not recover the expense – in fact RUCO is recommending that the Company recover this expense. However, for the reasons set forth in RUCO's Opening Brief, the use of an extraordinary rate making mechanism is not necessary or appropriate to recover the CAGRD expense. RUCO Brief at 8-14. RUCO's recommendation provides for the recovery of the expense without violating the notion of fair value and requiring extraordinary ratemaking treatment for such a routine cost.

COST OF CAPITAL

RUCO's sustained growth is balanced and representative of investor expectations.

The Company complains that RUCO's constant growth Discounted Cash Flow ("DCF") analysis should be rejected because it is based on a sustainable growth method that cannot be replicated. Company Brief at 45-46. This argument is a red herring. Each expert develops his analysis using his own methodology and judgment. Mr. Rigsby's estimate of average sustainable growth for his water utility proxy is 6.51 percent or 54 basis points higher than Mr. Bourassa's estimate of 5.97 percent. R-8 at 26, Direct Testimony of Thomas Bourassa at 33. All things being equal a higher sustainable growth recommendation results in a higher required return recommendation. It is curious why the Company would be complaining about RUCO's sustained growth estimate.

Regardless, RUCO's recommendation is based on a solid analysis of growth projections that are available to investors. R-8 at 26. RUCO's 6.51 percent estimate falls between Zacks' average long-term EPS projection of 9.47 percent and Value Line's growth projection of 5.03 percent (which is an average of EPS, DPS and BVPS). Id. RUCO's 6.51 percent estimate is also 93 basis points higher than the 5.58 percent average of Value Line's historical and projected data (and the consensus opinions published by Zacks) but is 48 basis points lower than Value Lines 5-year compound historical average of EPS, DPS and BVPS. Id. The estimates of analysts at Value Line indicate that investors are expecting somewhat lower increased performance from water utilities in the future. Id. On balance, RUCO's 6.51 percent estimate is a good representation of the growth projections that are available to the investing public. Id.

RUCO's use of a gas utility proxy is appropriate.

The Company complains that RUCO reliance on gas utilities to develop a cost of equity is problematic because gas utilities are less risky and therefore not comparable. Company Brief at 42. The average beta for RUCO's natural gas sample is 0.70. R-8, Schedule WAR-7 at 1. The Company contends that gas utilities are less risky investments than water companies as evidenced by their low beta and therefore, should not be used as proxies for the Company. Company Brief at 42. The Company's assertion that gas utilities with beta in the range of 0.80-0.90 are not comparable for purposes of establishing a proxy group is erroneous because beta is not the only measurement of risk to establish comparability.

Courts require greater analysis of elements of comparability than suggested by the Company.[1] In *Litchfield Park Service Corporation v. Arizona Corporation Commission*, the Arizona Court of Appeals held that to determine an appropriate cost of equity capital, the Commission needs to consider all relevant factors, including: (1) comparisons with other companies having corresponding risks, (2) the attraction of capital, (3) current financial and economic conditions, (4) the cost of capital, (5) the risks of the enterprise, (6) the financial policy and capital structure of the utility, (7) the competence of management, and (8) the company's financial history.[2] Mr. Rigsby testified that he used gas utilities as a proxy because they have similar operating characteristics to water companies in terms of distribution and share similar risks. R-9 at 7. Their inclusion in the cost of equity analysis also gives the Commission a larger sample to obtain an estimate from. Id. In other water rate applications, such as the recent Arizona-American case, Docket No. WS-01303A-06-0491, water utilities have been critical of RUCO for not giving more weight to its natural gas proxy results. Id. at 7-8. In the Arizona-American case, Arizona-American's cost of capital consultant did use a sample of natural gas companies in her DCF analysis. Id. Given that the gas utilities share similar operating characteristics and similar risks and that the movement among cost of capital

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[1] Litchfield Park Service Corporation v. Arizona Corporation Commission, 178 Ariz. 431, 874 P.2d 988 (Ariz. App. Div. 1 1994). See also United Railways & Electric Company of Baltimore v. West, 280 U.S. 234, 249- 50, 251, 50 S.Ct. 123, 125, 125-26, 74 L.Ed. 390 (1930); Simms v. Round Valley Light & Power Company, 80 Ariz.145, 154, 294 P. 378, 384 (1956).
[2] Id.

analysts in water cases is to utilize gas utilities, RUCO recommends the Commission reject the Company's argument.

RUCO's estimate of market risk premium is more consistent with recent empirical data and respected authorities than the company's estimate.

The Company claims that RUCO's CAPM analysis is not reliable because it ignores the current market risk premium and is based on a historic market risk premium calculated using a geometric mean. Company Brief at 44-45. RUCO estimated its historic risk premium, using both geometric and arithmetic means. R-8 at 33. The market risk premium that RUCO calculated using the geometric mean is 5.10 percent. Id. The risk premium that results using the arithmetic mean calculation is 6.80 percent. Id.

The use of both means is preferable in determining an appropriate market risk premium for several reasons. The information on both means is published by Morningstar and is widely available to the investment community. R-8 at 12. For this reason the use of both means in a CAPM analysis is appropriate.

The geometric mean provides a truer picture of the effects of compounding on the value of an investment when return variability exists. Id. This is particularly relevant in the case of the return on the stock market, which has had its share of ups and downs over the 1926 to 2007 observation period used in RUCO's CAPM analysis.

Moreover, the use of a historic market risk premium is preferable over the use of a current risk premium. Reliance on past performance as an indicator of future performance is sounder than reliance on analysts' projections of market return and treasury yields, particularly in the current economic circumstances.

Regardless of the methodology or analysis, in the end, recent empirical research supports RUCO's analysis of market risk premium. Mr. Rigsby testified that empirical studies performed by Aswarth Damdaran and Felicia C. Marston, professors of finance from New York

University and the University of Virginia, respectively, indicate that market risk premiums in excess of 4.5 to 5.5 percent are overstated. R-9 at 16. Indeed, the text cited by Mr. Rigsby, *Valuation: Measuring and managing the Value of Companies*, 4th Edition,[3] states:

> *Although many in the finance profession disagree about how to measure the market risk premium, we believe 4.5-5.5 percent is an appropriate range. Historical estimates found in most textbooks (and locked in the mind of many), 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 only 75 years of data, and are biased by the historical strength of the U.S. market.*

R-13. Mr. Bourassa's current risk premium using an arithmetic mean is 21.3 percent. Transcript at 1365. The average of RUCO's historic market premium using geometric and arithmetic means is 5.95 percent, and falls reasonably close to the range identified as reasonable by recent empirical research. R-8, Schedule WAR-7 at 1-2. Mr. Bourassa's risk premium does not. The Commission should accept RUCO's cost of equity capital recommendation because it is based on a market risk premium that more closely approximates the appropriate range identified by recent empirical data, financial authorities and treatises.

Next, the Company claims that RUCO's market risk premium is understated because RUCO used improper U.S. Treasury returns. Company Brief at 44. Apparently, the Company believes that stale data acquired at the time the Company filed its direct case is still relevant and a better input when determining the "current market risk premium." R-8 at 62. In fact, as more fully set forth in RUCO's Opening Brief, the economic climate has changed dramatically since the Company filed its direct case. RUCO Brief at 17. Treasury yields have decreased substantially since the Company filed its rate case which makes sense given the downturn in the economy. Id. From all the economic indicators it would only make sense that the

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[3] <u>See</u> Exhibit R-15 *Valuation: Measuring and managing the Value of Companies*, 4th Edition

Company's market risk premium recommendation would go down (as well as its cost of equity recommendation). However, the Company's recommendation is just the opposite. The Company's market risk premium recommendation went from 8.9 percent in its direct case to 21.3 percent in its rebuttal case. Transcript at 1365. One thing is certain; there is no concern that the Company's market risk premium recommendation is understated!

RUCO's use of a hypothetical capital structure is appropriate in this case.

RUCO incorporates its position set forth in its Opening Brief. RUCO Brief at 15.

ENVIORNMENTAL ISSUES

To the extent the Company addressed the environmental issues raised in RUCO's Opening Brief it was in response to Swing First Golf's recommendations. Company Brief at 51 -61. Most of the Company's discussion relates to the billing dispute which RUCO believes would be better addressed in the Complaint docket. RUCO's Brief at 2. RUCO will address the Company's arguments to the extent RUCO believes they touch upon the environmental issues RUCO raised in its Opening Brief.

1) Investigation of the Company's Management Practices – RUCO recommends that the Company be subject to more onerous reporting requirements until all the outstanding NOVs are closed as more fully set forth in RUCO's Opening Brief at 29-30.

2) Immediate Reduction of Water Rates – RUCO has not made a recommendation.

3) Refund of Superfund Tax Collections - RUCO has not made a recommendation.

4) Disallowance of Pecan WWTP in rate base - RUCO has not made a recommendation.

5) Defamation Lawsuits against customers - RUCO has not made a recommendation.

6) Fines for alleged disregard of public service obligations, environmental laws and commission orders – Based on the evidence in the record RUCO believes that the Company has violated environmental laws and regulations but has not made a recommendation of fines. RUCO's focus is on the safe and reliable provision of service and RUCO believes that its recommendations will accommodate and result in that objective.

7) Reducing Johnsons return on equity - RUCO has not made a recommendation.

8) Surrender of CC&N - RUCO has not made a recommendation.

9) Bifurcation of rate case proceeding - RUCO has not made a recommendation.

CONCLUSION

RUCO recommends that the Commission should authorize a rate ***decrease*** of $2,233,479 for its Water Division and a rate ***increase*** of $2,239,804 for its Wastewater Division based on the above discussion and as reflected in its final schedules. RUCO recommends an operating margin of 8.18 percent for the Water Division and an 8.31 percent return on equity for the Wastewater District. RUCO further recommends an 8.18 percent FVROR for the wastewater district. RUCO recommends that the Commission adopt RUCO's rate design and recommendation to monitor the Company more closely on the environmental issues which RUCO believes place the public's health and safety at risk.

RESPECTFULLY SUBMITTED this 11th day of December, 2009.

Daniel W. Pozefsky
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