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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF RIO RICO UTILITIES, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANTS AND PROPERTY AND FOR INCREASES IN ITS WATER AND WASTEWATER RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.	Docket No. WS-02676A-09-0257

Arizona Corporation Commission
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RUCO'S CLOSING BRIEF

INTRODUCTION

The Residential Utility Consumer Office ("RUCO") submits the following points in support of its position that the Arizona Corporation Commission ("Commission") should not authorize a rate increase of more than $957,929 for the Water Division of Rio Rico Utilities ("Rio Rico" or "Company") and a decrease of ($493,946) for the Wastewater Division of Rio Rico. While RUCO takes issue with several of the Company's recommendations, however, the major issues concern (1) the Accumulated Deferred Income Taxes ("ADIT"), (2) the Company's Central Cost allocations, and (3) the Cost of Capital. The other issues which remain in dispute will also be further discussed below.

I. RATE BASE ADJUSTMENTS

Accumulated Deferred Income Taxes ("ADIT")

The Company and Staff both recommend an ADIT debit (asset) for the water and wastewater divisions whereas RUCO recommends an ADIT credit (liability) for the water and wastewater divisions. S-7 at 17, RUCO-9 at 31. Specifically, RUCO is recommending an ADIT liability of $501,450 for the water division and $208,519 for the wastewater division. RUCO-9 at 31. Staff is recommending an ADIT asset of $117,205 for both divisions and the Company is recommending an asset of $445,238 for both divisions. S-7 at 17.

ADIT is a balance sheet item that is derived through the normalization of income tax expense on the income statement. RUCO-9 at 10. ADIT's can be classified as either ADIT liabilities or ADIT assets. RUCO-9 at 10. ADIT's are created by temporary inter-period timing differences between the book and taxable income treatment of certain accounting events and transactions. Id. These differences typically originate in one period and reverse in one or more subsequent periods. Id. For utilities, the largest such timing difference is the extent to which accelerated tax depreciation[1] generally exceeds straight-line book depreciation[2] during the early years of an asset's service life. Id. at 11. ADIT represents the cumulative net deferred tax amounts. Id.

ADIT assets are an addition to rate base and ADIT liabilities are a reduction to rate base. S-6 at 13. Normally, as Staff admits, a utility's ADIT balance is a credit (i.e. a liability) and hence a reduction to rate base. The reason it is normally a liability is that in the early years of an asset's life, customers are providing more in cash for income taxes than the

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[1] Accelerated Depreciation is how the Company books the depreciation for income tax purposes – i.e. the income tax that it pays. RUCO-9 at 12.

[2] Straight line depreciation is how the Company books the depreciation for book or ratemaking purposes. RUCO-9 at 12.

Company actually pays. Id. at 13-14. This would seem to be especially true for this Company since according to the Company's Director of Operations, Greg Sorensen, the Company has invested over $4 million in plant and assets since the Company's last rate case. A-1 at 5.

According to Staff's rate analyst, Gerald W. Becker, an ADIT asset would raise a "red flag." S-6 at 14. An ADIT asset in the present case would raise a red flag for numerous reasons. First, as mentioned above, both Staff and the Company claim an ADIT asset where the Company has recently spent over $4 million in new assets. The assets in consideration are in the early years of their depreciable life.

Second, according to Mr.Becker an ADIT asset "... would indicate a potential error in calculation or some type of unusual circumstance." S-6 at 14. Id. Mr. Becker admits that the basis of his ADIT asset recommendation is not error. Transcript at 896. Mr. Becker further admits that there is nothing unusual about AIAC or the balance of AIAC in this case. Transcript at 897. In fact, Staff's ADIT asset recommendation is the result of the ADIT associated with the Company's AIAC. S-7 at 17. The ADIT is not the result of error, there is nothing *unusual* about the Company having an AIAC balance or the amount of the balance of AIAC in this case. Id.

Third, the Company's Schedule E balance sheet filed with its application shows no ADIT amount. RUCO-9 at 14, RUCO-2. When asked, the Company's response was that its ADIT balances are maintained on the parent level. RUCO-9 at 14. The Company's parent, however, reported a net ADIT ***liability*** in the amount of $83,951,000 for 2008 (the Company's test year ends December 31, 2008). RUCO-9 at 14, Exhibit 1.

Fourth, the Company's annual report for 2008 reported a $72,985 ADIT liability. Id. at 16, Exhibit 2. The Company's response when questioned was that amount was not an ADIT liability but a deferred rate case expense that was misclassified. Id., Exhibit 3. While mistakes are not uncommon, the unusual number of mistakes, modifications and changes to the numbers that this Company has made in this and other areas (such as the area of central costs allocations) calls into question the accuracy of the Company's calculations and final recommendations.

A further example of this, and yet another area of concern with the Company's ADIT asset recommendation, is the magnitude of the change in the Company's ADIT recommendation from its direct to its rebuttal case. For the water division, the Company started with a whopping end of test year asset of $778,203 which in rebuttal was reduced by $463,238 for a final rebuttal recommendation of $314,965. A-6 at 6, Water Schedule B-2 at 2. For the wastewater division, the Company started with an adjusted end of test year amount of $323,602 and in rebuttal decreased that amount by $192,629 to $130,973. A-6 at 6, Wastewater Schedule B-2 at 2. In total, the Company's reduced its recommended ADIT asset by $655,867 from its direct to its rebuttal position – a change of more than 50% from what it started with! Given the mistakes, the discrepancies and the magnitude of the change in position, the Company's final recommendation should be given little if any weight.

Staff's ADIT asset recommendation differs from the Company's because Staff did not include the net operating loss carry forward. S-7 at 15-16. Staff's ADIT recommendation on the fixed asset component alone is a $21,868 - an ADIT liability. Id. at 17. By factoring in the ADIT associated with the AIAC component, Staff's net ADIT recommendation, like the Company's, results in an asset.

Both the Company and Staff have recommended an ADIT asset associated with the Company's AIAC balance in the amount of $139,073. S-7 at 17. The Company and Staff's recommendations are based on a 100% "Probability of Realization of Future Tax Benefit." A-8, Bourassa Rejoinder Schedule B-2 at 6. In other words, the asset associated with the AIAC is based on **100%** of the advances being refunded by the Company. Id. The evidence in the record shows otherwise.

The evidence in this record indicates that it is highly unlikely that the Company will refund the full amount of the advances. In response to a data request submitted by Staff the Company provided Staff with schedules of the Company's AIAC starting with the amounts approved in the Company's last rate case for both the water and wastewater divisions. RUCO-15. The Company's Water Division AIAC schedule shows three AIAC accounts, two of which have a refund history for the last 9[3] years. RUCO-15. The first account, the account associated with Luis and Elizabeth Parra, started with an AIAC balance of $3,049.00. RUCO-15. The total amount of refunds for the 9 years was $544.53 or 17.9% of the total. Id. The second account, the AIAC associated with the Pilot Corporation, started with a balance of $35,145.00 and had 9 years of refunds totaling $4, 624.29 or 13.2%[4]. Id. It is clear from the evidence that the probability of realization of the future tax benefits associated with the AIAC is not 100%, or even close to it. It is the Company's burden to prove that 100% of the AIAC will be refunded for tax purposes so that the Company will realize the tax benefit it proposes and the Company has failed to meet its burden. The Company's recommendation of ADIT associated with the AIAC is severely flawed and Staff's reliance on the Company's ADIT balance associated with the AIAC is misplaced. The Commission should reject the Company and Staff's ADIT balance recommendations.

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[3] AIAC is normally converted to CIAC after 10 years. Transcript at 898. The Company does not pay income taxes on CIAC upon receipt so there is no ADIT associated with CIAC. Transcript at 899.

[4] The third account, the *Rio Rico Fire District account* had only made refunds for five years and started with a balance of $89,799.00 and had refunded a total of $452.51 over the five years or 0.5%. RUCO-15. The wastewater AIAC accounts (two) also showed refunds substantially short of the beginning balance (9 and 10.2 percent over 5 and 6 years. Id.

Because of the mistakes, the improbability of an ADIT asset due to recent capital investment, the actual AIAC refunds, and the difficulty associated with computing ADIT by Staff and the Company's methodology, the Commission should not conclude the Company has an ADIT asset.

RUCO recommends that the Commission follow the guidelines set forth in the Statement of Financial Accounting Standards ("SFAS") No. 109 that was issued in February 1992 and specifically for companies that file consolidated tax returns as Algonquin Power Income Fund ("APIF")[5] does with Rio Rico. RUCO-9 at 30. Pursuant SFAS No. 109, the Company must recognize an ADIT liability.

The relevant portion of Section 40, page 19, of SFAS No. 109 states the following: "The consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements" as is the case with RRUI for this rate proceeding. SFAS No. 109 further states:

> **Separate Financial Statements of a Subsidiary**
> 40. This Statement does not require a single allocation method. The method adopted, however, shall be systematic, rationale, and consistent with the broad principles established by this Statement. A method that allocates current and deferred taxes to members of the group by applying this Statement to each member as if it were a separate taxpayer meets those criteria...

Id. at 30, Exhibit 5.

In accordance with SFAS 109, RUCO adopted a systematic and rationale method consistent with SFAS 109 to allocate APIF's net deferred income tax liabilities. Id. at 31.

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[5] The reference here is to the parent which has been called several different names throughout this proceeding. The Company's Manager of Financial Planning and Analysis, Peter Eichler refers to the parent as APIF so for purposes of this brief the parent will be referred to as APIF. Eichler rebuttal at 3.

RUCO arrived at its allocation factor by taking the Company's total asset cost ($8.8 million) and dividing it by APIF's total assets ($978.1 million) to arrive at Rio Rico's asset ratio, as reported on its 2008 Annual Report. Id. RUCO's allocation methodology allocates current and deferred taxes to members of the group by applying SFAS No. 109 to each member as if it were a separate taxpayer. Id. Therefore it meets the criteria established in SFAS 109. Id. These deferred income tax liabilities are attributable to all of APIF's affiliates. The ratepayers of Rio Rico are entitled to those tax benefits that it contributed towards. Id.

RELIEF REQUESTED: RUCO recommends an ADIT Liability balance of $501,450 for the Water Division and $208,519 for the Wastewater Division. Id. at 31, Schedules TJC-2 with the supporting detail on Schedules TJC-2 and TJC-5.

II. OPERATING INCOME ADJUSTMENTS

Central Cost Allocations

According to the Company, Rio Rico is operated by APIF's affiliate, Algonquin Water Services ("AWS"), which operates under the name Liberty Water ("Liberty"). A-10 at 8. Liberty provides all of the direct costs – the "day-to-day administration and operations personnel" for the Company and the six other regulated Arizona water and wastewater services. Id. at 4 and 8. APIF's other affiliate, Algonquin Power Trust ("APT") provides the Company and APIF's other regulated utilities in Arizona all of the corporate administration costs associated with the running of the company. Id. In total, APIF claims to own 46 electric facilities and 17 water and wastewater treatment facilities in Canada and the United States. Id. at 3.

The main issue in dispute concerns the cost pool to be allocated and what expenses are appropriate expenses to be included in the pool. RUCO does not agree with the actual allocation methodology that the Company used and adopted a slightly modified version[6] of it.

RUCO, however, rejected most of the costs the Company included in its proposed cost pool. The proposed cost pool, like the ADIT asset discussed above, can best be described as a moving target. The Company in its direct case had a total cost pool of $3,950,800 and its total budgeted cost pool for 2008 was $3,950,700. RUCO-9 at 47, A-15. At the time the Company filed its rebuttal, the total cost pool had increased to $5,269,882. A-6, Bourassa Rebuttal Schedule C-2 at 9. The Company's witness, Thomas Bourassa, while giving his summary on the witness stand at the hearing of this matter, testified that the total cost pool would be reduced "$454,000 approximately" to $4,815,000. Transcript at 97. After it became clear that many of the expenses in the cost allocation pool were not appropriate for allocation to Rio Rico, the Company revised the total cost allocation pool to $4,731,412. A-15

At the hearing it was made clear that the newly revised $4,731,412 total cost pool continued to contain inappropriate expenses for purposes of allocation. Staff's attorney presented to the Company's witness a worksheet listing over 1700 entries of the expenses in the cost pool. S-4. Those expenses still included such entries as "Skye Body Wash" from "Valentine's Beauty Boutique" and the expense associated with that relocation of the vehicle. Transcript at 322-324. Such entries should clearly be excluded from the total cost pool. Incredibly, on redirect, the Company tried to pass these expenses off as necessary and proper for inclusion in the cost pool. Transcript at 322-323. Specifically, the Company tried to pass

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[6] RUCO's methodology provides for an allocation factor of 24.29 percent rather than the 26.98 percent used by the Company. The Company divided the 17 regulated utilities by the 63 total utilities that it claims it owns to arrive at its allocation factor. RUCO used 70 utilities as its denominator based on APIF's 2008 annual report. RUCO-9 at 47, 49.

the beauty aids off as an office expense. Id. The entry on the worksheet, however, includes a category for office expense and the beauty supplies are listed not as office expenses (which there is a category for) but as "other professional services." Id. at 350, S-4. The point here is not the insignificant cost of this item but the fact that most of the invoices for the expenses in the cost pool contained little or no detail and only a very small portion of the costs allocated to the utility infrastructure group are directly attributable to Rio Rico. RUCO-9 at 48. It is clear that the Company is still predisposed to include all expenses, related and/or unrelated to providing service to Rio Rico, in the corporate allocation pool and shift the burden to Staff and RUCO to prove which expenses are not related.

In its final schedules, the Company has come up with still another total cost pool allocation. The final total cost pool now has been reduced to $3,970,000 converted to US dollars. Bourassa Final Schedules C-2, page 8 and C-2 page 10. The cost pool consists of hundreds of entries and the case is now post-hearing. The final cost pool and the subsequent post hearing reductions leave far more questions than answers. Among other reasons, given the Company's predisposition to include unnecessary costs in the cost pool, this "final" schedule remains highly suspect. The time for discovery has long past and there is nothing fair about the way the Company is presenting its recommendation on this point. The Commission should reject the Company's recommendation on cost allocation.

At best, only a fraction of the costs appear to be necessary for the provision of service to the roughly 2,100 customers of Rio Rico, a small sewer company. Id. at 48-49. Given the nature and the lack of detail of so many of the invoices, along with the bills and expenses that RUCO was able to directly tie into the cost of providing service to Rio Rico, RUCO recommends that the Commission allow no more than 25% of the audit, tax services, legal, and depreciation expenses and disallow the other APT expenses. RUCO-9 at 25. The rest of the expenses are more attributable to APIF's other operating activities. Id.

RUCO's recommendation is designed to allocate only the portion of the expenses that RUCO believes can be directly attributable to the Company. RUCO acknowledges that its recommendation is an estimate, but in the absence of detailed bills and/or a showing by the Company of how the cost pool expenses provide benefit to the Company's ratepayers, an estimate is the best recommendation RUCO can make. Rio Rico's ratepayers should not, under any circumstances, pay for the services of the Company's unregulated solar, electric and wind providers located in other states and/or other countries. It is the burden of the Company to show that the expenses that are part of the cost pool are necessary for the provision of service to Rio Rico's ratepayers. The failure of the Company to do so in this case should result in the rejection of the Company's recommendation.

RELIEF REQUESTED: The Commission should approve RUCO's adjustment to remove $96,643 and $31,604 from Outside Services for the Water and Wastewater Divisions. RUCO-9 at 51, Schedule TJC-16.

Revenue Annualization

RUCO disagrees with the Company's downward annualization adjustment. RUCO-9 at 12. RUCO recommends against any annualization adjustments to test year revenues. Id. The basis for RUCO's recommendation is that the Company has experienced a small level of customer growth from year to year. Id. at 13, RUCO-3. A downward adjustment would understate test year and going forward revenues. Id.

RUCO is however, recommending an annualization adjustment to increase the Company's purchase power expenses in the amount of $2,334 and $388 for the water and wastewater divisions as well as an increase of $212 for chemical expenses for the Company's wastewater division. Id. at 15.

RELIEF REQUESTED: The Commission should reject the Company's annualization adjustment of $4,794 for the water and $4,505 for the Wastewater Divisions and increase the Company's purchase power expenses in the amount of $2,334 and $388 for the water and wastewater divisions as well as increase chemical expenses by $212 for the Company's wastewater division. RUCO-11 at 14.

Rate Case Expense

RUCO's recommendation here is to decrease by 10 percent the Company's original request of $210,000 ($21,000) and decrease by 25% the Company's original request of $125,000 ($31,250) for the water and wastewater divisions respectively. RUCO's total combined rate case expense recommendation is $282,750 amortized over three years. RUCO acknowledges that RUCO has not stated a specific amount throughout this proceeding. But how could RUCO have made a final recommendation when it did not know the Company's actual rate case expense until the Company submitted its final schedules? The Company, in its rebuttal case, even noted the futility in making a recommendation on the ultimate level of rate case expense at that point in the case. "It is entirely premature to make any meaningful determinations about the ultimate level of rate case expense that will be incurred in the instant case." A-6 at 27.

RUCO in its surrebuttal case, similar to direct, argued that a 25 percent downward adjustment to the Company's recommendation at the time was appropriate. RUCO-11 at 17. The Company has now made its final recommendation of rate case expense in the total amount of $360,000. RUCO believes the Company's request is unreasonable. The standard of recovery is reasonable expense, not actual expense or the amount of expense that it takes this Company to prepare its case. Moreover, where is it written or said that ratepayers should bear the full cost of the Company's rate case expense? RUCO is still at a loss to understand how ratepayers benefit by paying for a Company's rate case expense which has at its core the sole purpose of raising ratepayer's rates. RUCO believes a reasonable amount of combined rate case expense is $282,750 amortized over three years.

RELIEF REQUESTED: The Commission should adopt RUCO's recommended amount of combined rate case expense of $282,750 amortized over three years.

III. COST OF CAPITAL

Capital Structure

The Company has an actual capital structure of 100% equity. RUCO-18 at 19. Both the Company and Staff are recommending the Commission adopt the Company's actual capital structure of 100% equity. Id. RUCO recommends the Commission adopt a far more balanced hypothetical capital structure of 60% equity and 40% debt. Id.

The Commission should approve RUCO's cost of capital recommendation because it provides for a balanced capital structure that is more prudent and thus more appropriate than the Company's actual capital structure. The Company chose a capital structure that is 100 percent equity. The Company's choice to utilize higher cost equity and not lower cost debt deprives ratepayers the benefits associated with debt in the capital structure. Debt is used to reduce income taxes and is often referred to as a tax shield. Id. at 20. Utilities often assume debt solely because of the tax advantages associated with debt financing. Id. Utilities that are able to lower their income tax liabilities due to debt are also able to increase their earnings. Id. On the equity side, this cannot be done with dividend payments on shares of common stock, because dividends cannot be deducted from income taxes. Id. at 20 -21. According to Staff, who recommends the Company's actual 100% capital structure, a 100% equity capital structure would unnecessarily burden the ratepayers and that ideally Staff looks for a capital structure that has a balance of debt and equity that does not unnecessarily burden the ratepayers. Transcript at 1093.

The Company should not be rewarded for its imprudent and unbalanced capital structure. As a general proposition, a Company with a capital structure that has no debt should have a lower cost of equity compared to a company with debt because of the lower financial risk associated with no debt.

A hypothetical capital structure that emulates the industry provides balance between the interests of the ratepayers and the interests of the shareholders. It eliminates the accounting/ratemaking benefits that one group derives over the other with a lopsided capital structure. All things equal, a hypothetical capital structure results in a weighted average cost of capital that is more in line with the industry, and less in line with shareholder or ratepayer's interests.

RUCO's recommended hypothetical capital structure of 60% equity and 40% debt is not arbitrary. The average capital structure for the water companies included in RUCO's witness William Rigsby's cost of equity proxy was comprised of approximately 47.8 percent debt and 51.7 percent equity, whereas the local distribution company's in the proxy had an average capital structure of approximately 45.9 percent debt and 53.4 percent equity. RUCO-17, WAR-9. If there was any doubt, Mr. Rigsby's analysis made it clear that Rio Rico's 100 percent equity capital structure was not in line with similar firms operating in the regulated water and natural gas utility industries. In order to achieve a weighted cost of capital that is more in line with the regulated utilities in the proxy, a hypothetical capital structure comprised of 40 percent debt and 60 percent equity is more appropriate. The Commission should adopt RUCO's proposed hypothetical capital structure of 60% equity and 40% debt.

Staff does not oppose RUCO's hypothetical capital structure methodology. Transcript at 1093-1094. Staff recognizes the hypothetical capital structure as a methodology to adjust for the Company's imprudent capital structure. Transcript at 1093-1094. Staff, however, prefers to use the Hamada methodology to adjust for the Company's imprudent capital structure. S-13 at 33. The Hamada methodology "re-levers" the Beta used in the CAPM model to reflect a capital structure that has debt in it. Transcript at 931. The re-levered beta is placed into the CAPM model to produce an appropriate expected rate of return for a utility with a capital structure comprised of 40 percent debt and 60 percent equity. Id. at 33-34. RUCO recognizes the Hamada method as a method to adjust for an imprudent capital structure. The problem with Staff's use of the Hamada methodology is that Staff's original cost of equity estimate is derived from a combination of the ranges resulting from Staff's CAPM and DCF results. Id. at 34. The Hamada calculation may have produced an appropriate adjustment for Staff's CAPM estimates, but no similar calculation unique to the DCF was performed to derive a similar type of adjustment to Staff's DCF results. Nonetheless, Staff then applies the 130 basis point Hamada adjustment to Staff's original <u>**DCF**</u> and CAPM estimates to arrive at its final 9.2% cost of equity adjustment. Id. Staff makes the mistaken assumption that the same 130 basis point adjustment calculated for its CAPM estimates, should be applied equally to its DCF estimates as well.

The use of a hypothetical capital structure is preferable over the Hamada methodology to arrive at a weighted average cost of capital. In the recent[7] Gold Canyon rehearing decision,

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[7] Decision No. 70624 was docketed on November 19, 2008 and is currently on appeal.

Decision No. 70664, the Commission adopted RUCO's hypothetical capital structure methodology over the Staff's proposed Hamada methodology to adjust for the fact that the Company has no debt in its capital structure. Decision No. 70624 at 14. Gold Canyon, like Rio Rico is an affiliate of Liberty and had a 100 percent equity capital structure. The very same arguments made in this case on this issue were made by Gold Canyon and Staff in the Gold Canyon case, and were rejected by the Commission. There is nothing new or different here - the same imprudent capital structure, the same parent company, the same interest synchronization issue – the Commission's logic behind its decision in Gold Canyon should apply here as well.

Finally, it is worth noting that the Commission in Gold Canyon recognized the imprudence of a 100 percent capital structure.

> We agree with RUCO's hypothetical structure of 40 percent debt and 60 percent equity. A capital structure comprised of 100 percent equity would be viewed as having little to no financial risk. The proposed capital structure adopted by the Commission will bring the Company's capital structure and weighted cost of capital in line with the industry average and it will result in lower rates for the customers of the system. We therefore adopt a hypothetical capital structure of 40 percent debt and 60 percent equity.

Decision No. 70624 at 14. The Commission should adopt RUCO's hypothetical capital structure.

Cost of Equity

The Company is recommending an 11.70 percent cost of common equity. RUCO-18 at 3. RUCO is recommending a 9.00 percent cost of equity and Staff is recommending a 9.20 percent cost of equity. Id. The Company's cost of equity recommendation is too high given the current environment of low inflation and low interest rates in which the Company is operating. Moreover, RUCO witness, Mr. William Rigsby's recommendation is further supported by the Federal Reserve's recent announcements to hold interest rates steady and Value Line analyst's projection of interest rate costs. RUCO-18 at 4.

The Company is recommending a capital structure of 100% equity. RUCO-18 at 19. It should follow that the Company's cost of equity would be low because of the decreased financial risk due to the Company's lack of debt. Incredibly, the Company's cost of equity recommendation is 11.70 percent, compared to RUCO's recommended 9.00 percent and Staff's recommendation of 9.00 percent. Id. Despite logic and consideration of the current state of the economy, the Company requests a cost of equity that if approved would exceed anything the Commission has approved for a company of this size in years.

The Company claims that it faces business risk because of its small size compared to sample companies and the regulatory environment the Company faces in Arizona. A-6 at 11-18. Even if there is a basis for the Company's argument, it does not justify a cost of equity recommendation of 11.70 percent given a 100% equity capital structure. The Company's cost of capital recommendation should be rejected.

The Company's suggestion that it faces higher risk due to Arizona's regulatory environment is misplaced. Moreover, the facts do not support the Company's contention. If the regulatory environment is as adverse to investor's interests as the Company contends, then why did the Company's parent invest in so many water and wastewater utilities in Arizona? When asked, the Company's cost of capital expert, Thomas Bourassa could not provide an explanation that supported his testimony – his response was that he could not speak for the Company but from Mr. Bourassa's standpoint he did not believe that "... the companies generally view Arizona – the regulatory framework in Arizona using historical test years as being necessarily bad or unfair."[8] Transcript at 178. If Mr. Bourassa does not have faith in his argument then why should the Commission?

Finally, RUCO's 9.00 percent cost of common equity is very reasonable when the Company's proposed projected capital structure of 100 percent equity is compared with the capital structures of other publicly traded water providers, which averaged 51.7 percent equity and 47.8 percent debt. RUCO-17, Schedule WAR-9. Mr. Rigsby's belief that the Company is subject to less financial risk compared to the other utilities considered in his Cost of Capital analysis is validated by the lower level of debt in the Company's capital structure compared to the sample companies. Publicly traded companies with a level of debt similar to the Company's would be perceived as much less risky than the average of the sample and would, therefore, have a lower expected rate of return on common equity. RUCO-17 at 54. In order to account for less risk, it is customary in the regulatory practice to make a downward adjustment to the Company's cost of equity.

In terms of risk, RUCO's recommended 9.00 percent cost of equity, if anything, is fair and reasonable. RUCO could have easily recommended a 7.90 percent cost of equity based on the average of its DCF and CAPM results. RUCO-17, Schedule WAR-1, page 3 of 3. RUCO could have easily made this downward adjustment for risk to reflect the fact that RUCO's cost of common equity figure was derived from a sample group of companies that face greater financial risk as a result of higher levels of debt in their capital structure. Instead, RUCO made an upward adjustment of 110 basis points to arrive at its recommended 9.00

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[8] Mr. Bourassa further added that he believes the regulatory environment here is less friendly when the differences in risk between this regulatory environment and others is not recognized in the rate of return. Transcript at 178-179.

percent cost of equity. In short, RUCO's cost of capital recommendation is well reasoned, reasonable, fair, and should be adopted by the Commission.

IV. RATE DESIGN

Like the Company RUCO proposes an inverted tier design. A-6 at 37. RUCO's recommended break over points are the same as under the Company's present rate design. Id. RUCO's rate design supports its recommended revenue requirements for both divisions. Coley Rate Design Testimony at 2. The Company admits that RUCO's rate design spreads the rate increase more evenly than Staff's rate design. Id. The Company's critique of RUCO's rate design is that it excessively shifts revenues. Id., Issue Matrix at 4. RUCO disagrees and believes that its rate design spreads the increase in a fair and balanced manor.

V. HOOK-UP FEE TARRIFF ("HUF")

RUCO objects to the language of the Company's latest version of its proposed HUFF tariff. RUCO objects to the following language in the water and Wastewater Divisions tariffs: "The Company shall not record amounts collected under this tariff as Contributions in Aid of Construction ("CIAC") until such amounts have been expended for plant."

CIAC is non-investor funded capital. The Company has the use of the contribution from the day the Company collects the CIAC from the developer or customer. Id. at 54 CIAC also frees up the investor supplied capital to be expended on other investments. Id. The CIAC balance at any given point in time is the amount that has been collected up to that point in time. Arizona ratemaking does not defer CIAC to be recorded at a later time in the future. Id.

The Commission has approved accounting orders that allowed a company to not record CIAC until a plant is in use, but this is usually allowed where there are extraordinary circumstances. Id. There is nothing unusual about the Company's circumstances. Id. In fact, the Company's request for this extraordinary treatment of CIAC is for quite ordinary purposes.

Similar to the hypothetical capital structure issue above, this issue of including unexpended CIAC recently came before the Commission. In the rate application of H2O, Inc. Decision No. 71414 and Arizona-American (Decision No. 71410), the Commission rejected similar requests by those utilities to include unexpended CIAC in rate base prior to the plant going into service. RUCO-13 and RUCO-14. The issue is no different here and the Commission should not approve the tariff as written.

However, if the Commission is inclined to accept the language in the tariff, RUCO would recommend the following:

1. The funds should be kept in a separate restricted interest bearing account with a third party financial institution,
2. The interest drawn on that account be treated as above the line other revenues.

CONCLUSION

For the reasons discussed above, RUCO recommends the Commission adopt its position in this case, and reject the positions of Staff and the Company, to the extent they conflict with RUCO's recommendations.

RESPECTFULLY SUBMITTED this 19th day of April, 2010.

Daniel W. Pozefsky
Chief Counsel

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