ORIGINAL

0000110250

RECEIVED

2010 APR 19 P 3:41

AZ CORP COMMISSION
DOCKET CONTROL

FENNEMORE CRAIG, P.C.
Jay L. Shapiro (No. 014650)
Todd C. Wiley (No. 015358)
3003 N. Central Ave.
Suite 2600
Phoenix, Arizona 85012
Attorneys for Rio Rico Utilities, Inc.

BEFORE THE ARIZONA CORPORATION COMMISSION

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
DOCKETED
APR 19 2010
DOCKETED BY

RIO RICO UTILITIES, INC.

INITIAL CLOSING BRIEF

April 19, 2010

TABLE OF CONTENTS

TABLE OF ABBREVIATIONS AND CONVENTIONS

Rio Rico Utilities, Inc. uses the following abbreviations in citing to the pre-filed testimony and hearing transcripts in this brief. Other documents that were admitted as exhibits during the hearing are cited by hearing exhibit number. The parties' final schedules setting forth their respective final positions will be cited in abbreviated format as follows: Company Final Schedule XXX, Staff Final Schedule XXX; RUCO Final Schedule XXX.* Other citations to testimony and documents are provided in full, including (where applicable) the Corporation Commission's docket number and filing date.

RIO RICO UTILITIES, INC.
PRE-FILED TESTIMONY

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of Greg Sorensen	**A-1**	Sorensen Dt.
Rebuttal Testimony of Greg Sorensen	**A-2**	Sorensen Rb.
Rejoinder Testimony of Greg Sorensen	**A-3**	Sorensen Rj.
Direct Testimony of Thomas J. Bourassa (Rate Base)	**A-4**	Bourassa Dt.
Direct Testimony of Thomas J. Bourassa (Cost of Capital)	**A-5**	Bourassa COC Dt.
Rebuttal Testimony of Thomas J. Bourassa (Rate Base)	**A-6**	Bourassa Rb.
Rebuttal Testimony of Thomas J. Bourassa (Cost of Capital)	**A-7**	Bourassa COC Rb.
Rejoinder Testimony of Thomas J. Bourassa (Rate Base)	**A-8**	Bourassa Rj.
Rejoinder Testimony of Thomas J. Bourassa (Cost of Capital)	**A-9**	Bourassa COC Rj.
Rebuttal Testimony of Peter Eichler	**A-10**	Eichler Rb.
Rejoinder Testimony of Peter Eichler	**A-11**	Eichler Rj.

* RRUI filed its Final Schedules on April 9, 2010.

RESIDENTIAL UTILITY CONSUMER OFFICE
PRE-FILED TESTIMONY

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of Timothy J. Coley (Revenue Requirement)	**R-9**	Coley Dt.
Surrebuttal Testimony of Timothy J. Coley	**R-11**	Coley Sb.
Direct Testimony of William A. Rigsby	**R-17**	Rigsby Dt.
Surrebuttal Testimony of William A. Rigsby	**R-18**	Rigsby Sb.

STAFF
PRE-FILED TESTIMONY

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of Gerald W. Becker	**S-6**	Becker Dt.
Surrebuttal Testimony of Gerald W. Becker	**S-7**	Becker Sb.
Direct Testimony of Jian W. Liu	**S-8**	Liu Dt.
Surrebuttal Testimony of Jian W. Liu	**S-9**	Liu Sb.
Direct Testimony of Juan C. Manrique	**S-13**	Manrique Dt.
Surrebuttal Testimony of Juan C. Manrique	**S-14**	Manrique Sb.

RIO RICO PROPERTIES, INC.
PRE-FILED TESTIMONY

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of Matthew Rowell	**I-3**	Rowell Dt.
Surrebuttal Testimony of Matthew Rowell	**I-4**	Rowell Sb.

OTHER PORTIONS OF THE RECORD

	Hearing Exhibit
RRUI Monthly APT Costs per Customer	**A-12**
Comparison of shared services to stand-alones, total operating cost per customer (water)	**A-13**
Comparison of shared services to stand-alones, total operating cost per customer (wastewater)	**A-14**
Decision No. 71447 (December 23, 2009), *Far West Water & Sewer, Inc.*, Docket No. WS-03478A-08-0608	**A-17**
RRUI Water Master Plan	**A-20**
RRUI Wastewater Master Plan	**A-21**
Value Line information on water utility industry published January 22, 2010	**A-23**
Direct Testimony of Joel M. Reiker dated March 11, 2004, *Rio Rico Utilities, Inc.*, Docket No. WS-02676A-03-0434	**A-25**

	Hearing Exhibit
Decision No. 68858 (July 28, 2006), *Arizona - American Water Company*, Docket No. W-01303A-05-0910	**A-27**
Decision No. 70209 (March 20, 2008), *Arizona - American Water Company*, Docket No. WS-01303A-06-0491	**A-28**
Decision No. 70351 (May 16, 2008), *Arizona - American Water Company*, Docket No. W-01303A-07-0209	
Decision No. 69164 (December 5, 2006), *Black Mountain Sewer Corporation*, Docket No. SW-02361A-05-0657	**R-1**
Decision No. 70624 (November 19, 2008), *Gold Canyon Sewer Company*, Docket No. SW-02519A-06-0015	**R-7**
Decision No. 67279 (October 5, 2004), *Rio Rico Utilities Inc.*, Docket No. WS-02676A-03-0434	**R-19**
Memorandum of Agreement dated December 8, 2006 between City of Nogales and Rio Rico Utilities, Inc.	**S-2**
NARUC Guidelines for Cost Allocation	**S-3**

2305427.6

INTRODUCTION

Rio Rico Utilities, Inc. ("RRUI" or "the Company") hereby submits the following Initial Closing Brief in support of its application for a rate increase.[1] Since 2002, RRUI has spent considerable money to upgrade and improve its water and wastewater systems. The Company has improved the quality and reliability of utility services to its customers, a fact which was recognized during public comments.[2] As such, the Company requests that the Commission approve certain adjustments to the Company's rates and charges for utility service so that the Company may recover its operating expenses and be given an opportunity to earn a just and reasonable rate of return on the fair value of its property. The Company is requesting a rate increase only for its water division and is requesting a decrease in wastewater utility revenues.

OVERVIEW OF RRUI AND ITS REQUEST FOR RATE RELIEF

The Company's CC&N is located in Santa Cruz County, Arizona, north of the City of Nogales.[3] The Company's water and wastewater service areas are geographically the same; however, due to the varied terrain, wastewater service is generally concentrated in the central portion of the territory. As a result, RRUI has fewer sewer customers than water customers; water customers who do not get sewer service from RRUI utilize septic tanks.[4] During the test year, RRUI provided water utility service to approximately 6,600 customers and wastewater utility service to approximately 2,200 customers.[5] The Company's customer base is predominantly residential.[6]

---

[1] The key for abbreviations and citations to a witness pre-filed testimony is set forth in the Table of Abbreviations and Conventions in pages iii to vi following the Table of Contents. The table also lists the hearing exhibit numbers of the parties' pre-filed testimony. Other hearing exhibits are cited by the hearing exhibit number and, where applicable, by page number, e.g., Ex. R-13 at 2. The transcript of the hearings is cited by page number, e.g., Tr. at 1.

[2] Tr. at 26 – 27 (comments by County Supervisor J. Maynard).

[3] Direct Testimony of Greg Sorensen ("Sorensen Dt.") at 2:19-25.

[4] *Id.*

[5] *Id.* at 4:26 – 5:1.

[6] *Id.* at 2:26 – 3:3.

The Company's water supply comes from groundwater.[7] RRUI has six wells and five storage facilities. The water supply is chlorinated for disinfection but treatment for arsenic and nitrates is not required at this time. Due to the vast elevation differences within the distribution system, which includes seven different 150-foot pressure zones, the Company utilizes 27 booster stations to maintain proper pressure for its customers. RRUI's service territory is within the Santa Cruz Active Management Area.[8] The Company also implements its list of ten (10) Best Management Practices (BMPs), which is double the required compliance level of five.[9] The Company does not provide water for landscape irrigation to any golf courses at this time.[10]

RRUI has purchased 550,000 gallons per day of treatment capacity from the City of Nogales, and the Company also has several evaporative ponds providing additional treatment capacity of up to 40,000 gallons per day to some parts of the service territory.[11] The collection system includes five lift stations, four of which pump wastewater for treatment under the agreement with the City, and the remaining pump to the aforementioned evaporative ponds.

The Company's current rates were approved in Decision No. 67279 (October 5, 2004), based on a test year ending December 31, 2002. Because the Company is utilizing a December 31, 2008 test year in this filing, it will be six years between test years.[12] This is the first rate case since RRUI was acquired by Liberty Water. There have been a number of significant plant improvements since the last test year, including the purchase of an additional 100,000 gallons per day (gpd) of treatment capacity from the City to bring

[7] *Id.* at 3:9-22.

[8] *Id.*

[9] *Id.* at 3:17-22. *See also* RRUI's Notice of Filing dated March 26, 2010. The Company is currently implementing more than ten BPMs.

[10] Sorensen Dt. at 4:5-6.

[11] *Id.* at 4:7-16.

[12] *Id.* at 4:17-21.

the amount of capacity to its current level of 550,000 gpd. The cost of this capacity purchased in 2005 was $300,000 and was necessary because RRUI had reached 90% utilization of its then-existing capacity.[13] RRUI also was required by the City to pay $427,000 towards the cost of upgrading the shared treatment facilities. These upgrades are for the current capacity utilized by the Company, and are not related to any increased growth or additional planned flows in the future.[14]

On the water side, RRUI has two new wells and another well was refurbished at a combined total cost in excess of $1.6 million.[15] The Company refurbished three water plants, which include booster stations and storage facilities, spent approximately $830,000 to increase the storage and replace the two booster station pumping facilities at Water Plant #1 in 2003 and then approximately $550,000 to replace Water Plant #59 booster station, including the pumps, motors, electrical controls, and telemetry, all of which plant had reached the end of its operating life. In 2008, RRUI completed the $1.1 million renovation of Water Plant #81, which included replacement of the 25-year old booster station and addition of a 1,000,000 gallon storage facility necessary to provide service and fire flow to customers.[16] All of these projects led to the additional $4 million of rate base for the water division presented in this rate case.[17]

The Company's application was filed on May 21, 2009 seeking a finding of fair value rate base and the setting of rates thereon for both water and wastewater utility service. During the test year, RRUI's adjusted gross revenues were $1,847,256 from water utility service and $1,829,976 from wastewater utility service.[18] The adjusted

---

[13] *Id.* at 6:13-17.
[14] *Id.* at 7:3-7.
[15] *Id.* at 7:9 – 8:6.
[16] *Id.*
[17] Tr. at 61:18 – 62:14.
[18] Direct Testimony of Thomas J. Bourassa – Rate Base, Income Statement and Rate Design ("Bourassa Dt.") at Schedule A-1 (water and wastewater).

operating income (loss) for the water division was $173,579, leading to an operating income deficiency of $1,108,676. The adjusted operating income from the wastewater division was $474,319 leading to an operating income of $85,475. Thus, the rate of return on the Company's water operations during the test year was a negative 2.17 percent, and the rate of return on the Company's wastewater operations during the test year was 14.27 percent.[19]

In its Final Schedules, the Company requests revenue requirements of $3,652,884 from water utility service and $1,690,768 in revenues from sewer utility service.[20] These proposed revenue requirements are based on water and wastewater fair value rate bases equal to $7,992,279 and $3,323,449 respectively, total operating expenses of $935,097 and $388,844 respectively for the water and wastewater divisions, and a weighted average cost of capital equal to 11.70 percent.[21] The Company's final proposed rates by class are reflected in RRUI's Final "H" Schedules, as are the Company's final requested HUF charges. The proposed HUF tariffs, and the proposed low income tariff, all of which were attached to the Company's Application, are reproduced at **Brief Exhibit 1**[22] and **Brief Exhibit 2**, respectively.

---

[19] *Id.*

[20] Company Final Schedule A-1 (water and wastewater).

[21] *Id.*

[22] The HUF tariffs attached as **Brief Exhibit 1** are identical to those that were attached to RRUI's Application with one exception. The wastewater HUF tariff originally filed contained an inadvertent error. The Terms and Conditions section was numbered "V," but it should have been numbered "IV." The correction is reflected in the wastewater HUF attached hereto. *See also* Company's response to RRPI Data Request 2.20 (this data request response is not attached, but has been previously provided to all of the parties).

ARGUMENT

I. SUMMARY OF ISSUES ADDRESSED.

A. Overview of Rate Base, Revenue Requirement and Rate Design Issues in Dispute.

With respect to plant in service, the primary issue in dispute involves deferred income taxes. With respect to the income statement, the issues in dispute include Staff and RUCO's opposition to the "Central Cost allocation," RUCO's failure to annualize test year revenues, and adjustments to rate case expense by both Staff and RUCO. Regarding the cost of capital, Staff and the Company agree on capital structure, while RUCO proposes a hypothetical capital structure in order to justify a further reduction to the Company's operating expenses of nearly $250,000. All three parties disagree on the cost of equity. With respect to rate design, the Company disagrees with Staff's rate design because it furthers the subsidization of residential customers by other customers, and Staff, RUCO and intervener RRUI oppose approval of RRUI's requested HUF tariffs. While there are only a small number of issues still in dispute, the issues are important and have been thoroughly contested by the parties. Each of these disputed issues is addressed below.[23]

B. Overview of Legal Framework for Ratemaking in Arizona.

Throughout this case, RUCO has implied, suggested and asserted that rates should be lower because of the prevailing economic conditions.[24] According to RUCO witness Mr. Rigsby, the Commission should consider these economic conditions in setting rates.[25]

---

[23] While it isn't clear that the issues between Staff and RRUI over the low income tariff reach the level of a disputed issue, in an effort to clarify where the parties do agree, this issue also is addressed in the Rate Design section of this brief.

[24] Tr. at 1034.

[25] *Id.*

RRUI respectfully suggests that caution is warranted before following Mr. Rigsby's advice.[26]

The Commission is responsible for setting "just and reasonable" rates and charges for utility services furnished by utilities.[27] The process followed by the Commission in setting rates that are "just and reasonable" has been summarized as follows:

> The general theory of utility regulation is that total revenue, including income from rates and charges, should be sufficient to meet a utility's operating costs and to give the utility and its stockholders a reasonable rate of return on the utility's investment. To achieve this, the Commission must first determine the "fair value" of a utility's property and use this value as the utility's rate base. The Commission then must determine what the rate of return should be, and then apply that figure to the rate base in order to establish just and reasonable tariffs.[28]

Nearly 100 years of decisions by Arizona courts have required the Commission to set rates that will produce sufficient revenue to allow the utility to recover its operating expenses and earn a reasonable rate of return on the fair value of its property devoted to public service.[29] As the Arizona Court of Appeals explained in *Scates*:

> [T]he rates established by the Commission should meet the overall operating costs of the utility and produce a reasonable rate of return. It is equally clear that the rates cannot be considered just and reasonable if they fail to produce a reasonable rate of return or if they produce revenue which exceeds a reasonable rate of return.[30]

---

[26] *Id.* at 33 – 35.

[27] *See* Ariz. Const. Art. 15, § 3.

[28] *Scates v. Ariz. Corp. Comm'n,* 118 Ariz. 531, 533 – 34, 578 P.2d 612, 614 – 15 (App. 1978) (citations omitted). *See also US West Comm., Inc. v. Ariz. Corp. Comm'n*, 201 Ariz. 242, 244, 34 P.3d 351, 353, ¶ 13 (2001) (The "fair value [of the utility's plant and property] has been the factor by which a reasonable rate of return [is] multiplied to yield, with the addition of operating expenses, the total revenue that a corporation could earn.") (citing *Scates*).

[29] *See US West,* 201 Ariz. at 246, 578 P.2d at 355, ¶ 18 ("a line of cases nearly as old as the state itself has sustained the traditional formulaic approach" to setting rates).

[30] *Scates*, 118 Ariz. at 534, 578 P.2d at 615.

The process that the Commission follows to gather and consider evidence in setting rates is quasi-judicial in character. Perhaps the clearest statement of the Commission's duties is found in *State ex rel. Corbin v. Ariz. Corp. Comm'n*, 143 Ariz. 219, 223-24, 693 P.2d 362, 366-67 (App. 1984):

> [A proceeding to fix rates] carries with it fundamental procedural requirements. There must be a full hearing. There must be evidence adequate to support pertinent and necessary findings of fact. Nothing can be treated as evidence which is not introduced as such. ... Facts and circumstances which ought to be considered must not be excluded. Facts and circumstances must not be considered which should not legally influence the conclusion. Findings based on the evidence must embrace the basic facts which are needed to sustain the order. ...
>
> A proceeding of this sort requiring the taking and weighing of evidence, determinations of fact based upon the consideration of the evidence, and the making of an order supported by such findings, has a quality resembling that of a judicial proceeding. Hence it is frequently described as a proceeding of a *quasi judicial* character. The requirement of a "full hearing" has obvious reference to the tradition of judicial proceedings in which evidence is received and weighed by the trier of the facts. The "hearing" is designed to afford the safeguard that the one who decides shall be bound in good conscience to consider the evidence, to be guided by that alone, and to reach his conclusion uninfluenced by extraneous considerations which in other fields might have play in determining purely executive action. The "hearing" is the hearing of evidence and argument.[31]

The clear message of *Scates* is that rates are <u>not</u> just and reasonable if they do not produce sufficient revenue to allow for recovery of reasonable operating expenses and a fair rate of return.[32] "A utility is entitled to a fair rate of return on the fair value of its property, no more and no less."[33] "What the company is entitled to ask is a fair return

---

[31] *State ex rel. Corbin v. Ariz. Corp. Comm'n*, 143 Ariz. 219, 224, 693 P.2d 362, 367 (App. 1984), *quoting Morgan v. United States*, 298 U.S. 468 (1936).

[32] *See generally, Scates*, 118 Ariz. 531, 578 P.2d 612.

[33] *Litchfield Park Service Co. v. Ariz. Corp. Comm'n*, 178 Ariz. 431, 434, 874 P.2d 988, 991 (App. 1994) (internal quote omitted).

upon the value of that which it employs for the public convenience. On the other hand, what the public is entitled to demand is that no more be exacted from it . . . than the services rendered . . . are reasonably worth."[34] The Commission certainly has a duty to protect the public interest, but that duty is based on preventing "excessive and discriminatory rates and inferior service."[35] Consumers are entitled to protection from excessive rates, but they are never entitled to receive service at rates that fail to provide a reasonable return.[36] As the United States Supreme Court has explained, "[r]ates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment."[37]

Under these fundamental constitutional principles, the Commission must provide due process and a fair return to utilities in both good and bad economic times. The cost to provide utility service does not necessarily go down with the prevailing economy. To the extent current economic conditions are relevant to determining a revenue requirement, they are already incorporated in the parties' cost of capital analysis. The Commission shouldn't impose an additional "discount" that is not supported by the evidence, based on assumed difficulties experienced by individual consumers.

II. RATE BASE.

A. Summary of Rate Base Recommendations.

As reflected in their respective Final Schedules, RRUI's, Staff's and RUCO's proposed rate bases for the water division are as follows:

---

[34] *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 149, 294 P.2d 378, 381 (1956) (quoting *State of Missouri ex rel. SW Bell Tele. Co. v. Public Service Comm'n*, 262 U.S. 276 (1923)).

[35] *SW Gas Corp. v. Ariz. Corp. Comm'n*, 169 Ariz. 279, 286, 818 P.2d 714, 721 (App. 1991) (quoting *Petrolane-Ariz. Gas Serv. v. Ariz. Corp. Comm'n*, 119 Ariz. 257, 259, 580 P.2d 718, 720 (1978)).

[36] *Scates*, 118 Ariz. at 534, 578 P.2d at 615.

[37] *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 690 (1923).

	OCRB	FVRB
Company	$7,992,279	$7,992,279
Staff	$7,808,822	$7,808,822
RUCO	$7,175,864	$7,175,864

For the wastewater division, the rate bases proposed are as follows:

	OCRB	FVRB
Company	$3,323,449	$3,323,449
Staff	$3,226,899	$3,226,899
RUCO	$2,983,957	$2,983,957[38]

As noted, the only issue in dispute involves deferred income taxes.

B. Deferred Income Taxes (DITs) – Water and Wastewater.

1. DITs 101.

It's likely that no one has ever been overheard screaming "hurry-up, we need to get to that rate case trial before they get to deferred income taxes." DITs are chock full of complicated numbers that somehow relate to plant and property, income taxes and depreciation, and mysteriously arise out of differences between ratemaking and tax preparation. It isn't surprising that DITs can "confuzzle" even the best utility lawyers. For better or worse, however, DITs are critical to the ratemaking process. If DITs are not properly reflected in the ratemaking formula, ratepayers will either pay too much or too little for utility service.[39]

Actually, the reason DITs impact just and reasonable rates is relatively simple. DITs result from the normalization of tax timing differences between actual tax

[38] Company Final Schedule B-1 (water and wastewater); RUCO Final Schedule TJC-2, page 1 of 1 (water and wastewater); Staff Final Schedule GWB-1 (water and wastewater).

[39] Rebuttal Testimony of Thomas J. Bourassa – Rate Base, Income Statement and Rate Design ("Bourassa Rb.) at 12:21 – 13:3; Rejoinder Testimony of Thomas J. Bourassa – Rate Base, Income Statement and Rate Design ("Bourassa Rj.") at 6:12-18.

calculations for tax purposes and the determination of taxes for ratemaking.[40] For example, depreciation for tax purposes may be accelerated or straight-line; however, such an option is not given or taken in calculating depreciation for ratemaking purposes.[41] Tax depreciation also may result from tax law changes, bonus depreciation and other reasons that are not part of the ratemaking process.[42] No matter how the timing difference arises, if the utility gets a greater deduction for depreciation for tax purposes its taxes are reduced relative to the amount of taxes assumed to set rates.[43] In other words, the utility gets the benefit of the extra revenue as reflected in a deferred tax liability, a deduction to rate base.[44] But it works the other way around too. When the utility pays more in taxes than anticipated, it has lost the use of money.[45] Either way, the use of the money or the loss of use of money is recognized in rate base, much the same way working capital is recognized in rate base. Fortunately, none of this seems to be in dispute.

Mr. Bourassa calculated DIT assets of $314,965 and $130,973, for the water and wastewater divisions, respectively.[46] Because calculation of DITs is "very specific to the circumstances of each utility," Mr. Bourassa used the Company's own books and records.[47] He also used the same method he used in other Liberty Water rate cases, including the BMSC rate case.[48] As Mr. Bourassa further explained, when you use a

---

[40] *Id.; see also* Tr. at 109:1-18; Direct Testimony of Gerald W. Becker (revenue requirement) ("Becker Dt.") at 12:6-9; Direct Testimony of Timothy J. Coley (revenue requirement) ("Coley Dt.") at 11:1-8.

[41] Becker Dt. at 12:6-9.

[42] Tr. at 109:6-12, 111:1-8.

[43] *Id.* at 775:2 – 776:20.

[44] Surrebuttal Testimony of Gerald W. Becker ("Becker Sb.") 12:21 – 13:20; Tr. at 120:9-14 *referencing* Schedules B-2. *See also* Company Final Schedule B-2, page 6 (water and wastewater).

[45] *Id.*

[46] Company Final Schedule B-2, page 6 (water and wastewater). The Company's DIT calculations have changed as the case progressed and positions were accepted and denied and additional known and measurable changes came to light. This is not unusual. Tr. at 813:15 – 814:5. However, the Company's methodology never changed. *Id.* at 765:6-22.

[47] *Id.* at 129:3-10.

[48] *Id.* at 802:16-22.

historical test year, it is simply a matter of chance whether DITs are positive or negative as they can change from one test year to another.[49]

What is in dispute in this rate case depends on the parties to the dispute. RRUI and Staff generally agree on the means of determining DITs, i.e., both use the Company's books and records. Staff, however, makes two adjustments to Mr. Bourassa's DITs calculation. On the other hand, in order to reduce rate base by more than $1 million, RUCO has resurrected a methodology involving the books and records of a third-party that was expressly rejected by the Commission in a recent rate case for RRUI's affiliate, Black Mountain Sewer Corporation.[50]

2. <u>Staff's Adjustments Are Not Supported by Substantial Evidence</u>.

Like RRUI, Staff used the Company's own books and records and calculated deferred tax assets for the water and wastewater divisions.[51] The Company and Staff also agree on the general methodology, although Staff makes two adjustments to the calculation.[52] First, Staff opposes inclusion of the net loss carry forward or NOL related to the unused portion of special bonus depreciation taken by the Company during the test year. Staff opposes inclusion of the NOL "because existing rates already include a provision for income taxes and the opportunity for the Company to earn a stated rate of return."[53] Factually, this isn't in dispute, but it's unexplained and wholly irrelevant. So is Mr. Becker's testimony that ratepayers shouldn't be burdened because RRUI didn't "meet its earnings goals."[54] The NOL arose from special "bonus" depreciation allowed during the test year, a one time take it or lose it tax opportunity.[55] This was never previously

---

[49] *Id.* at 122:16 – 125:4.
[50] Ex. R-1 at 5 – 6.
[51] Tr. at 910:3-10.
[52] *Id.* at 910:11-17.
[53] Becker Sb. at 16:2-4.
[54] *Id.* at 16:4-6.
[55] Tr. at 117:16 – 118:19, 912:3-8.

reflected in the Company's rates.[56] Recognition of the special depreciation and related tax timing differences is needed to retain consistent position and protect future tax benefits.[57] The NOL also is fairly considered in the DIT calculation because the taking of the special depreciation lowered the amount of the DIT asset in the first place, lowering rate base and rates.[58] Additionally, the NOL could provide tax benefits to the Company and ratepayers in the future.[59]

Second, Staff disallows $105,049 of the deferred regulatory asset claiming there is "unidentified plant."[60] The fact that the specific plant item could not be identified does not mean the calculation is tainted, and Staff provides no explanation why it believes that to be the case. The calculation was reconciled to the Company's books and records and the amount is not in dispute.[61] In sum, Staff's argument is akin to removing a tree from the forest because we cannot identify its type with certainty. But adoption of Staff's adjustment would create a further mismatch, and for all these reasons, it should be rejected.

3. <u>RUCO's DIT Liability Ignores RRUI's Books and Records and Directly Relevant Commission Precedent</u>.

Likely dissatisfied with Mr. Bourassa's proposed deferred tax assets for the water and wastewater divisions, RUCO went to its database and found another methodology that resulted in a substantial DIT liability, a reduction in rate base of over $1 million. Unfortunately for RUCO, the Commission rejected that exact methodology just a few years ago in the last BMSC rate case.[62] RUCO's method relies on the ratio of a past stock

---

[56] *Id.* at 814:9-13, 911:23 – 912:2.
[57] *Id.* at 771:20 – 774:17.
[58] *Id.* at 118:15-19, 814:17-20.
[59] *Id.* at 770:6-11, 778:22 – 780:4, 814:21-24.
[60] Becker Sb. at 15:1-4.
[61] Bourassa Rj. at 7:17 – 8:2; Tr. at 780:14 – 781:14.
[62] Tr. at 859:19 – 860:4.

acquisition to the parent's total assets and the parent's books and records.[63] Mr. Coley claimed his methodology was perfectly fine because FASB 109 says only that the methodology for determining DITs be "rational."[64] But Mr. Coley wasn't able to explain the rationality in basing the Company's DITs on a stock acquisition price five years ago, or including things like foreign exchange hedge funds, debt restructuring costs and valuation allowances.[65] These things have nothing to do with RRUI.

It's irrational to use a third-party allocation when utility-specific information is available. RUCO recognized the availability of such information when it sought to advance the silly argument that its method was justified because Mr. Bourassa's calculation did not match RRUI's annual report. Setting aside that the number in RRUI's annual report is totally unrelated to RUCO's DIT calculation, the discrepancy was explained at trial.[66] But Mr. Coley ignored all of these flaws in his methodology and calculation in a result-driven effort to reduce rates. Such efforts were rejected once before and there is no reason to not reject them again.

III. INCOME STATEMENT.

A. The Central Cost Allocation/General – Water and Wastewater.

1. The Final APT Cost Pool Reflects Charges and Services Necessary for Utility Service and Beneficial to Ratepayers.

The Central Office Cost allocations from APT have been a focal issue in all of the pending rate cases involving Liberty Water's Arizona utilities. The importance of this

---

[63] Coley Dt. at 30:1 – 32:2.

[64] Tr. at 860:6 – 861:21.

[65] *Id.* at 130:5-11.

[66] *Id.* at 133:3 – 136:7. The problem arose from the uncertainty of the tax treatment of property contributed by the former owner's development arm more than a decade ago. *See also Id.* at 788:10 – 789:11.

FENNEMORE CRAIG
A PROFESSIONAL CORPORATION
PHOENIX

issue can't be understated: denial of the APT costs will place Liberty Water at a tipping point relating to its current business model and ongoing operations in Arizona.[67]

On the APT costs, RRUI has shown that the Central Office Costs were actually incurred by APT/RRUI, that those costs are reasonable ($1.40/month per customer) and that the APT costs are necessary expenses under RRUI's business model.[68] The Company also has shown that its customers benefit from the APT services, including access to capital financing, reduced operating costs and sound fiscal management.[69] The evidence presented by Mr. Bourassa, Mr. Sorensen and Mr. Eichler on these issues demonstrate the necessity and benefits of the APT Central Office Cost allocations.[70]

In no uncertain terms, Liberty Water's shared services model works.[71] Liberty Water's shared services model allows RRUI to provide high quality utility service with reasonable operating expenses.[72] At trial, Staff and RUCO agreed that RRUI provides reliable, adequate and high quality utility service to its customers.[73] In public comments, County Supervisor John Maynard stated that water service "has improved dramatically since I have started buying water in our community 10 or 15 years ago."[74] He went on to say that "I have no complaints with the service whatsoever. It's definitely improved ..."[75]

---

[67] Rebuttal Testimony of Peter Eichler ("Eichler Rb.") at 18 – 19, 22 – 25, 36 – 37; Rejoinder Testimony of Peter Eichler ("Eichler Rj.") at 2 – 3.

[68] Eichler Rb. at 22 – 37, Exhibit PE-RB1; Eichler Rj. at 4 – 8; Tr. at 226 – 227.

[69] Eichler Rb. at 25 – 32; Tr. at 205 – 206, 223 – 228, 295 – 296, 315, 452 – 454, 547.

[70] Bourassa Dt. at 12 – 13; Eichler Rb. at 22 – 37, Exhibits PE-RB1 and PE-RB3; Eichler Rj. at 2 – 7, Exhibits PE-RJ1 and PE-RJ2; Bourassa Rb. at 22 – 23; Sorensen Dt. at 6 – 8.

[71] Eichler Rb. at 18 – 21, Exhibit PE-RB3; Eichler Rj. at 13 – 16, Exhibits PE-RJ1, PE-RJ2 and PE-RJ3; Exs. A-12, A-13 and A-14; Tr. at 216 – 220, 223 – 228, 295 – 296, 315, 452 – 454, 547.

[72] Bourassa Dt. at 12 – 13; Eichler Rb. at 21 – 23, Exhibit PE-RB1; Eichler Rj. at 15 – 17, Exhibits PE-RJ2 and PE-RJ3; Bourassa Rb. at 22 – 23; Sorensen Dt. at 6 – 9; Tr. at 216 – 220, 223 – 228.

[73] Tr. at 422 – 423, 540.

[74] *Id.* at 26 – 27 (comments by County Supervisor J. Maynard). Mr. Maynard is Chairman of the Santa Cruz County Board of Supervisors. Supervisor Maynard's public comments are not evidence, but they are consistent with the evidence presented at hearing relating to the reliable and improved service provided by RRUI.

[75] Tr. at 30 – 31.

Supervisor Maynard's comments illustrate that Liberty Water's shared services model has allowed RRUI to provide improved service to customers.[76]

Denying the APT costs under these circumstances would turn the ratemaking process on its head by disallowing reasonable and beneficial costs of service. The Commission should encourage, not punish, such shared services models. Yet Staff and RUCO presumptively deny 99.9% of the APT costs.[77] Staff's and RUCO's analyses of the APT cost allocations are superficial, at best. Mr. Becker disallowed over 90% of the cost pool based on invoices that Staff believes are improper, which total less than 10% of the cost pool.[78] Staff and RUCO simply close their eyes to the remaining APT cost pool, which is comprised of beneficial services utilized by RRUI in providing utility service to customers. At trial, both Mr. Becker and Mr. Coley conceded that RRUI actually used and benefited from capital financing provided by APT.[79]

At hearing, Staff and RUCO raised questions about whether certain invoices should have been included in the cost pool. Those invoices related to other non-regulated facilities owned by APIF and other non-utility services. Once those invoices were brought to RRUI's attention, the Company removed those invoices from the pool.[80] But those invoices do not taint the entire pool. A few bad apples don't spoil the whole bushel.

In RRUI's Final Schedules, the total cost pool is $3,970,127.[81] Exhibit 3 to RRUI's Notice of Filing Final Schedules is a list of all costs and items included in the Central Office Cost pool as noted in final schedules C-2, page 10 (water division) and C-2, page 8 (wastewater division). Besides the invoices identified by Staff and RUCO at hearing, the Company removed additional invoices from the Central Office Cost pool in

---

[76] Sorensen Dt. at 6 – 8; Tr. at 422 – 423, 540.

[77] Eichler Rj. at 2; Becker Dt. at 28; Tr. at 510 – 511, 516 – 517, 522 – 523.

[78] Tr. at 516 – 517, 523 – 524.

[79] Tr. at 405 – 506, 408, 413 – 414, 422 – 423, 426 – 427, 439 – 440, 452, 541 – 542, 547.

[80] *Id.* at 213 – 215, 260 – 261, 267 – 270, 277 – 279, 295 – 296, 331 – 332, 520 – 522.

[81] Company Final Schedule C-2, page 10 (water) and page 8 (wastewater).

an effort to reduce the amount in dispute between the parties.[82] The final cost pool includes only costs that are reasonably necessary in the provision of service and directly or indirectly attributable to RRUI.[83] ***Staff and RUCO have not identified any other specific invoices that they contend should be removed from the pool.***[84]

2. <u>It Is Improper and Arbitrary for Staff and RUCO to Presumptively Deny 99% of the APT Cost Pool.</u>

The Commission has not adopted any standards or rules governing affiliate cost allocations. Without any governing standards, review and determination of the cost pool is an "organic process" that necessitates give and take between the parties.[85] Liberty Water has and continues to refine and improve its cost allocations based on Staff's and RUCO's concerns.[86] But Staff and RUCO have done nothing more than presumptively deny the APT costs based on their beliefs that those costs benefit APIF more than ratepayers. In making that determination, Staff has applied different cost allocation standards to Liberty Water as compared to other Arizona utilities.[87] It is a violation of both due process and controlling Arizona law for the Commission and Staff to presumptively deny the APT costs based on undisclosed standards, which Staff created solely to justify disallowance of the APT costs in Liberty Water's pending rate cases.[88]

---

[82] *See* RRUI Notice of Filing Final Schedules dated April 9, 2010.

[83] *Id.*

[84] Tr. at 448 – 449, 514 – 517.

[85] *Id.* at 326 – 328, 343 – 349.

[86] *Id.* at 342 – 343.

[87] *Id.* at 543 – 545. At hearing, Mr. Becker expressly testified that is would not be "fair" for "Staff or the Commission to apply a different standard for determining a proper central office cost allocation to Rio Rico as compared to other utilities in the state." Tr. at 545.

[88] *Arizona Public Service Company*, Decision No. 55931, 91 P.U.R. 4th 337, 350 (April 1, 1988). *See also State v. Thompson*, 204 Ariz. 471, 65 P.3d 420 (2003)(stating that "laws must provide explicit standards for those charged with enforcing them..."); *Giaccio v. Pennsylvania*, 382 U.S. 399 (1966) (stating that "a law fails to meet the requirements of the Due Process Clause if it is so vague and standardless that it leaves ... judges and jurors free to decide, without any legally fixed standards, what is prohibited and what is not in each particular case").

Further, Staff's and RUCO's inability or lack of manpower to analyze the entire APT cost pool is not justification for denying 99% of those costs.[89] The NARUC Guidelines for Cost Allocations and Affiliate Transactions expressly state that "Regulators should have complete access to all relevant information necessary to evaluate whether subsidization exists. ***The auditors, not the audited utilities, should determine what information is relevant for a particular audit objective***."[90] Mr. Becker acknowledged at hearing that such audit obligation would include Staff.[91] Here, RRUI has provided access to any and all invoices contained in the cost pool. Unfortunately, neither Staff nor the Commission has ever stated exactly what type of documentation would satisfy them regarding affiliate costs for audit purposes. The Company cannot be faulted for failing to meet Staff's undisclosed cost allocation principles or documentation standards.

3. Liberty Water Is Willing to Provide an Independent Attestation of the APT Cost Pool.

At trial, Staff counsel asked Mr. Eichler what "assurances" RRUI could provide relating to contents of the cost pool.[92] Mr. Eichler responded that RRUI would consider any "alternatives" proposed by Staff.[93] On that issue, the NARUC Guidelines state: "Any jurisdictional regulatory authority may request an independent attestation engagement of the [Cost Allocation Manual]."[94] To the extent the Commission, Staff and/or RUCO are concerned about whether the final APT cost pool includes charges relating to unregulated business operations or reflect services that can't be verified from invoices, upon approval

---

[89] Tr. at 450.

[90] Ex. S-3 at 4, ¶ E(1) (emphasis added); Tr. at 560. In his testimony, Mr. Becker relies on the NARUC Guidelines, but he conceded that Staff and the Commission have not formally adopted the Guidelines for utility cost allocations. *Id.* at 533. It also should be noted that the NARUC Guidelines are merely a guidance document. Ex. S-3 at 1; Tr. at 461; Eichler Rb. at 5 – 6.

[91] Tr. at 558 – 559.

[92] *Id.* at 325 – 326.

[93] Tr. at 326.

[94] Ex. S-3 at 4, ¶ E(3).

of the APT costs, Liberty Water and RRUI are willing to provide an "Attestation Engagement" to verify the contents of the cost pool.[95]

4. The Evidence Is Undisputed that RRUI Provides High Quality Utility Service With Reasonable and Low Operating Costs.

Staff and RUCO oppose the Central Office Cost allocations even though it is undisputed that RRUI's operating costs are reasonable and below the operating costs of other comparable utilities.[96] In his pre-filed testimony, Mr. Eichler demonstrated that RRUI's operating costs per customer for water are substantially below the other comparable utilities; and for wastewater are within the range of the comparable sewer companies.[97]

Further, Mr. Eichler compared RRUI's operating costs per customer for sewer and water service to stand-alone utilities and utilities with shared services models.[98] RRUI's total operating costs per customer rank well below the group average of comparable sewer and water utilities.[99] Finally, on rejoinder, Mr. Eichler compared RRUI's total operating costs per customer to 23 water utilities and 11 sewer utilities, including the comparable utilities cited by Mr. Coley in his surrebuttal testimony.[100] Even with the comparable utilities cited by Mr. Coley, RRUI's total operating costs per customer for water service

---

[95] *Id.* at 1, ¶ (A)(2)(defining "Attestation Engagement" as "one in which a certified public accountant who is in the practice of public accounting is contracted to issue a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party.").

[96] Eichler Rb. at 17 – 21, Exhibit PE-RB3, Eichler Rj. at 4 – 5, Exhibits PE-RJ1, PE-RJ2 and PE-RJ3; Tr. at 216 – 220, 225 – 227, 414 – 415, 536.

[97] Eichler Rb. at 21, Exhibit. PE-RB3; Eichler Rj. at Exhibits PE-RJ1, PE-RJ2 and PE-RJ3; Tr. at 216 – 220.

[98] Exs. A-13 and A-14; Tr. at 225 – 227.

[99] Exs. A-13 and A-14; Tr. at 225 – 227. As noted in Ex. A-13, RRUI's total cost per customer for water service is $346.96/customer compared to an average of $487.50 for four stand-alone utilities, $470.05/customer for the average of eleven utilities with shared services model, and $471.22/customer for the average in eight divisions of Arizona Water Company. Ex. A-13. Likewise, Ex. A-14 demonstrates that RRUI's cost per customer ($377.49) is lower than the average of three comparable stand-alone sewer companies ($394.96) and seven sewer utilities with shared service models ($414.19). Ex. A-14.

[100] Eichler Rj., Exhibit PE-RJ2 at 1; Tr. at 217 – 218. Exhibit PE-RJ2 includes various comparable utilities cited by Mr. Coley in his surrebuttal testimony. Surrebuttal Testimony of Timothy J. Coley ("Coley Sb.") at Exhibit 1.

rank sixth lowest out of 23 utilities.[101] For wastewater service, RRUI ranks fourth lowest out of eleven comparable utilities.[102] Staff (Mr. Becker) and RUCO (Mr. Coley) did ***not*** dispute that testimony and evidence.[103]

What's more, the average customer cost per month for the APT Central Office Costs is $1.42/month for RRUI's water customers and $1.36/month for RRUI's sewer customers.[104] The monthly cost per customer for the APT services is less than a gallon of gasoline in Nogales, Arizona. Customers get substantial bang for their buck. "They get strategic management service. They get continued access to capital."[105] The services provided by APT also prevent financial and service problems experienced by other stand-alone Arizona utilities, including the Far West and McLain utilities.[106] A charge of $1.40 per month for continuing access to capital, sound fiscal management and increased service is not excessive or unfair by any stretch of the imagination. One can readily assume that customers of the Far West and McClain utilities would have gladly paid $1.40/month to avoid the problems they experienced.

5. <u>The APT Cost Allocation Amounts in Dispute</u>.

The only cost allocation issues in dispute relate to Central Office Costs allocated from APT to RRUI. Staff and RUCO do not dispute the affiliate cost allocations from

---

[101] Eichler Rj., Exhibit PE-RJ2 at 1.

[102] *Id.* at 2.

[103] Tr. at 414 – 415, 536 – 537.

[104] *See* Ex. A-12; Tr. at 222 – 223. As reflected in RRUI's Final Schedules, the total Central Office Costs allocated to RRUI is $136,056, with $102,310 allocated to the water division and $33,746 allocated to the wastewater division. RRUI Final Schedules C-2, page 8 (water) and page 10 (wastewater). The final schedules reflect that RRUI has 6,025 water customers and 2,071 sewer customers. As such, the yearly cost per water customer is $16.98 or $1.42 per month. Likewise, the yearly cost per sewer customer is $16.29 or $1.36 per month.

[105] Tr. at 223 – 224.

[106] *Id.* at 224 ("Our strategic management and the access to capital would definitely not ever allow a utility to hit that type of situation. I also think the financial controls we have in place would prohibit situations with the McLain systems, the former McLain systems. So I do believe these costs and services received for them have a great benefit, and that they would prevent situations like the ones we have seen with the McLain system and the Far West systems.").

AWS d/b/a Liberty Water to RRUI.[107] In RRUI's Final Schedules, the total Central Office Cost pool is $3,970,127.[108] Those costs reflect an adjustment accepting Staff's position on exchange rates relating to the APT costs.[109] The Company converted each invoice incurred in Canadian dollars to United States dollars based on the monthly average exchange rate from the Bank of Canada for the month each invoice was received by APT.[110]

For RRUI's water and wastewater divisions, 73.02% of that Central Office Cost pool is allocated to APIF's Energy Group (46 facilities) and 26.98% is allocated to Liberty Water's Utility Infrastructure Group (17 utilities, including RRUI).[111] Under that method, $1,071,304 is allocated to the 17 regulated utilities owned by APIF.[112] Based on customer count, 9.55% of those costs are allocated to RRUI's water division or $102,310.[113] And 3.15% of those costs are allocated to RRUI's wastewater division, which equals $33,746.[114] ***The total Central Office Costs allocated to RRUI is $136,056.***[115]

In its Final Schedules, Staff disallowed $342,158 of the cost pool and allocated $4,715,579 of the remaining cost pool to APIF, which amounts to an effective disallowance of $5,057,737.[116] For all facilities owned by APIF, Staff allocated a total of

---

[107] Tr. at 437, 510.

[108] Company Final Schedule C-2, page 10 (water) and page 8 (wastewater).

[109] *See* RRUI Notice of Filing Final Schedules dated April 9, 2010.

[110] *Id.* At hearing, Mr. Becker agreed that the Company did not need to convert the Liberty Water costs because those costs were incurred in American dollars. Tr. at 546 – 547.

[111] Company Final Schedule C-2, page 10 (water) and page 8 (wastewater); Eichler Rb. at 15 – 17, Exhibit PE-RB1 at 9; Tr. at 208 – 210.

[112] Company Final Schedule C-2, page 10 (water) and page 8 (wastewater).

[113] Company Final Schedule C-2, page 10 (water).

[114] Company Final Schedule C-2, page 8 (wastewater).

[115] *Id.*; Company Final Schedule C-2, page 10 (water).

[116] Staff Final Schedule GWB-20 (water) and GWB-19 (wastewater). Staff calculated that deduction based on a total cost pool of $5,269,882. Staff disallowed $342,158, which means the total cost pool (according to Staff) was $4,926,724. Of that amount, Staff allocated $4,715,579 to APIF, which means Staff allocated 95.7% of the cost pool to APIF.

$190,931, which includes $91,945 for audit services, $11,844 for tax services, $68,130 for legal services and $19,013 for depreciation.[117] Staff then allocates 1.43% of that cost pool to each entity owned by APIF based on a ratio of 1/70. That calculation results in $2,728 in total allocated to RRUI's water and wastewater divisions.[118] Obviously, it's unlikely that APT can continue to provide financial capital, tax services, audit services, fiscal controls and management to RRUI if customers share less than 0.1% of those costs.

In its final schedules, RUCO calculates its disallowances based on a total cost pool of $5,269,882.[119] In turn, RUCO disallows $4,903,044 of the APT cost pool (91.1%).[120] RUCO allows $466,837 in APT costs and allocates 24.29% of those costs to the 17 regulated utilities owned by Liberty Water.[121] RUCO's final schedules result in a total Central Cost allocation of $113,375; and, RUCO then allocated 12.92% of that amount each to RRUI's water and wastewater divisions.[122] In total, RUCO allocates $14,645 in Central Office Costs to RRUI's water and wastewater divisions.[123]

6. **Brief Summary of Staff's and RUCO's Disallowances.**

Staff and RUCO disallow virtually the entire Central Office Cost pool based on their belief that the services provided by and costs incurred by APT do not primarily benefit RRUI or its ratepayers.[124] Specifically, "[b]ased upon review of the actual supporting invoices provided by the Company, Staff determined that almost all of the costs were obviously attributable to the operations of the APIF or one of its affiliates; therefore, Staff assigned 90 percent of the costs to APIF. The remaining 10 percent

---

[117] *Id.*

[118] *Id.*

[119] RUCO Final Schedule TJC-15 (water) and TJC-15 (wastewater).

[120] *Id.*

[121] *Id.* RUCO believes that APIF owns 70 facilities and RUCO calculates the allocation percentage of the regulated utilities as 17/70, which equals 24.29%.

[122] *Id.*

[123] *Id.*

[124] Becker Dt. at 28; Becker Sb. at 11; Coley Dt. at 45.

recognizes that the other affiliates receive a benefit from the common costs, and therefore, should be allocated a percentage greater than zero." [125]

At hearing, Mr. Becker explained that he attributed 90% of the cost pool to APIF because of statements in APIF's 2007 Annual Report that APIF intended to grow its business.[126] Mr. Becker decided that 90% of the APT costs were attributable to APIF "based on the nature and objectives of the parent company" as stated in the annual reports.[127] Put simply, what Mr. Becker did was read generic statements from APIF's annual reports relating to business growth and then he arbitrarily determined that 90% of the APT costs in the test year relate to APIF's efforts to grow its business.[128]

But Mr. Becker could not relate any specific invoices in the final APT cost pool to such future growth.[129] Put another way, Mr. Becker's disallowance is based primarily on the objectives of APIF – not on any substantial evidence relating to the actual APT cost pool. In fact, Mr. Becker admitted that RRUI removed all invoices relating to other facilities or future growth.[130] Mr. Becker simply theorized that effectively over 97% of the pool relates to APIF's unregulated business efforts but does not have any evidentiary basis for that conclusion. Staff's attempt to throw the baby out with the bath water by disallowing $5,000,000 in costs based on $500,000 in improper invoices or generic statements from an annual report is a textbook case of arbitrary action without substantial evidence. [131]

Mr. Coley disallowed the majority of the APT costs primarily because "most of the expenses being allocated to the Arizona Utility Infrastructure regulated affiliates,

---

[125] Becker Dt. at 29 – 30. *See also id.* at 28 – 29.
[126] Tr. at 512 – 516.
[127] *Id.* at 511.
[128] *Id.* at 512 – 513.
[129] *Id.* at 516 – 517.
[130] *Id.* at 522.
[131] *Id.* at 523 – 524.

including RRUI, are unnecessary and not directly attributable in the provisioning of water and wastewater services."[132] Mr. Coley's disallowance stems from his belief that the APT costs should be "directly charged."[133] Mr. Coley believes that 75% of the cost pool should be directly charged to APIF and 25% should be allocated to the 17 regulated utilities.[134] Mr. Coley disallowed 75% of the cost pool as not directly charged to specific facilities owned by APIF even though the APT costs are "indirect" costs, which can't be directly charged in the first place.[135] Simply put, all charges that are direct are not in the APT pool. Mr. Coley also echoed Mr. Becker's comments that the APT costs relate to future growth in APIF.[136] But Mr. Coley admitted that APIF's future growth does <u>not</u> impact the actual APT cost pool in this rate case.[137] Mr. Coley's testimony is entirely unpersuasive. He simply is not a credible witness on the cost allocation issues.

Ultimately, Staff's (and RUCO's) approach to the cost allocation issue is fundamentally flawed. Read closely, the testimony of Mr. Becker and Mr. Coley does nothing more than state their beliefs or generic opinions that the APT costs do not benefit ratepayers. As a matter of law, however, more than just *any* evidence is required to support Staff's or RUCO's disallowance. "Substantial evidence is evidence which would permit a reasonable person to reach the trial court's result."[138] Thus, a Commission decision must be "rationally based on evidence of substance."[139] "Mere speculation and

---

[132] Coley Dt. at 45.
[133] Tr. at 438 – 439.
[134] *Id.*
[135] *Id.* at 443 – 444, 456 – 459; Eichler Rb. at 17 – 18.
[136] Tr. at 448 – 449.
[137] *Id.* at 449 – 451. Mr. Coley even described such an adjustment in this case as "very speculative." *Id.* at 449.
[138] *Estate of Pousner*, 193 Ariz. 574, 579, 975 P. 2d 704, 709 (1999). *See also Denise R. v. Ariz. Dep't of Economic Security*, 2009 WL 1451452 (Ariz. App. 2009).
[139] *Tucson Elec. Power v. Ariz. Corp. Comm'n*, 132 Ariz. 240, 245, 645 P.3d 231, 237 (1982).

FENNEMORE CRAIG
A PROFESSIONAL CORPORATION
PHOENIX

arbitrary conclusions are not substantial evidence and cannot be determinative."[140] Staff and RUCO do not meet the substantial evidence test for their disallowances.

Staff and RUCO also apply the wrong ratemaking standard by failing to recognize that the APT costs are necessary for RRUI to provide utility services ***under the Liberty Water business model***. Put another way, Staff and RUCO must evaluate the corporate allocations ***within APIF's business model***, which Staff and RUCO have not done. "Public utilities must be given the opportunity to prove the necessity and reasonableness of any expenditure challenged by a commission (or intervenor). To justify expenditure, a company must show that the expense was actually incurred (or will be incurred in the near future), that the expense was necessary ***in the proper conduct of its business or was of direct benefit to the utility's ratepayers***, and that the amount of the expenditure was reasonable."[141] Staff and RUCO focus on "direct benefit" to RRUI's ratepayers without addressing whether the APT costs are necessary under Liberty Water's business model. Notwithstanding this focus, it is quite clear from the evidence that the direct benefits received by the ratepayers are the strategic management, access to capital, and other services provided by APT.

Staff's and RUCO's objection to a shared services model that delivers high quality utility service at a reasonable price is puzzling given Arizona's long history of failed

---

[140] *City of Tucson v. Citizens Utils. Water Co*, 17 Ariz. App. 477, 481, 498 P.2d 551, 555 (1972).
[141] The Regulation of Public Utilities, C. Phillips (1993) at p. 258 (emphasis added).

stand-alone utilities.[142] Staff seems intent on encouraging risky stand-alone utility business models by proposing to authorize only those costs that would be incurred by RRUI as a stand-alone utility. Staff fails to recognize that such stand-alone business models result in lower quality service, higher costs and greater risks.[143]

As a matter of law, it's improper for Staff or RUCO to presume that the APT costs should be disallowed without supporting evidence. In a prior decision, this Commission found that affiliate cost allocations "must be closely scrutinized in a general rate case" but that "such heightened degree of scrutiny ***may not amount to a presumptive disallowance of all costs incurred as a result of transactions with affiliates***..."[144] The Commission also found that affiliate costs are not presumptively allowed, ***which means that RRUI's allocations must be judged based on the evidence presented at hearing***.[145]

Rather than providing substantial evidence, Staff simply presumes that 97% of the APT costs relate to other businesses and Staff argues that RRUI has not shown that the APT costs would have been incurred by a stand-alone Arizona utility, a standard that Mr. Becker himself has not used to evaluate RRUI's cost allocations.[146] Incredibly, the Commission has approved affiliate cost or shared service allocations for Arizona-

---

[142] *See* Ex. A-17 at 11 ("Currently, Far West states that its wastewater system does not meet regulatory requirements and as a result its ability to maintain safe and reliable sewer service is in doubt."); *Id.* at 26 ("Given the Company's high leverage and ongoing disputes with ADEQ, it would appear to be an unlikely candidate to receive additional debt or equity capital."). *See also Northern Sunrise Water Company and Southern Sunrise Water Company*, Decision No. 68826 (June 29, 2006) (McLain Systems) at 4 ("The McLain Systems are in serious disrepair and under the management of Arizona Small Utilities Association ("ASUA"), an interim operator."); Decision No. 62701 (June 30, 2000) (Arizona Utility Supply & Services) at 4 – 10 (appointing interim operator because AUSS was incapable of providing adequate service and declared Chapter 7 bankruptcy); Decision No. 65858 (April 25, 2003) (Sonoita Valley Water Co.) at 2 – 3, 6 (appointing interim operator because the operation of the water utility "constitutes a clear and present danger to the public health and safety.); Decision No. 63136 (November 16, 2000) (Subrosa Water Co.) at 3 – 7 (appointing interim operator); Decision No. 65236 (October 2, 2002) (American Public Service Co.) at 6 – 7 (appointing interim operator).

[143] *Id.*; Eichler Rb. at 22 – 23.

[144] *Arizona Public Service Company*, Decision No. 55931, 91 P.U.R. 4th 337, 350 (April 1, 1988) (emphasis added).

[145] *See* Decision No. 55931, 91 P.U.R. 4th at 350.

[146] Tr. at 536 – 537.

American, Arizona Water Company and Chaparral City Water Company.[147] Yet Staff has not applied that stand-alone test to any other Arizona water or sewer utilities, which means Staff is treating RRUI differently than other similarly situated utilities.[148]

7. **The Commission Should Approve the APIF Corporate Business Model and Structure.**

In Decision No. 55931, this Commission specifically found that "the allocation of general corporate expenses among affiliates represents a pooling and sharing of expenses to minimize costs, not the sale of services to maximize revenues."[149] That's exactly how Liberty Water's shared service model and corporate cost allocation methodology works. The affiliate cost allocations from APT to RRUI do not generate or maximize revenue for APIF, nor do they serve objectives of growing the business. Rather, they are recovery of necessary costs under a shared service model designed to provide high quality service while minimizing operating costs.[150]

a. **The Role of APIF, APT and Liberty Water.**

RRUI is one of seven Arizona utilities owned by the Algonquin Power Income Fund ("APIF").[151] Those regulated utilities are wholly-owned subsidiaries of Liberty Water Company ("LWC").[152] LWC, in turn, is owned by APIF, which is actually now known as Algonquin Power & Utilities Corp. ("APUC").[153]

APIF's primary business is ownership of generating and infrastructure facilities through investments in securities of subsidiaries.[154] APIF owns 46 electric facilities and

---

[147] *Id.* at 433 – 435.
[148] *Id.* at 542 – 544.
[149] Decision No. 55931, 91 P.U.R. 4th at 348.
[150] Eichler Rj. at 4 – 6; Eichler Rb. at 12 – 13.
[151] Eichler Rb. at 2 – 3.
[152] *Id.* at 2.
[153] *Id.* at 2 – 3; Tr. at 333 – 334. For simplicity, APIF will continue to be used herein.
[154] Eichler Rb. at 3 – 4.

17 water and wastewater facilities in Canada and the United States.[155] APIF also has an operating interest in seven other facilities, but does not own them.[156] APIF is publicly traded on the Toronto Stock Exchange (TSX).[157] Like publicly traded companies in the United States, APIF is subject to various public reporting, financial, audit and other rules and requirements of the TSX.[158] For our purposes, the various services provided by APT are a necessary condition of RRUI's access to capital from the TSX.[159]

RRUI is operated by Algonquin Water Services d/b/a Liberty Water, along with six other regulated Arizona water and sewer utilities, and eleven regulated water and sewer providers in Texas, Missouri and Illinois.[160] Liberty Water provides all day-to-day administration and operations personnel for RRUI.[161] APT provides financial, strategic management, compliance, administrative and support services to the regulated utilities operated by Liberty Water, as well as to the unregulated facilities owned by APIF.[162] The head office of APT is located in Canada.[163]

b. <u>The APT Cost Allocation Methodology</u>.

At trial, Mr. Eichler presented a detailed paper entitled "Liberty Water Affiliate Cost Allocation Methodology," which is attached to his rebuttal testimony as Exhibit PE-RB1. That paper explains in detail the APT cost allocations and demonstrates the substantial benefits that RRUI and its customers receive from the services provided by

---

[155] *Id.* at 3 – 5.
[156] *Id.*; Tr. at 255.
[157] Eichler Rb. at 7 – 8, Exhibit PE-RB1.
[158] *Id.*; Tr. at 315, 453, 547.
[159] Eichler Rb. at 11 – 15, Exhibit PE-RB1 at 9 – 15; Eichler Rj. at 2 – 5; Tr. at 205 – 207, 223 – 228, 315, 348, 406 – 408, 423, 541 – 542.
[160] Eichler Rb. at 4, 8 – 10, Exhibit PE-RB1 at 4 – 7.
[161] *Id.* The allocation method for these operational costs is set forth on Exhibit PE-RB1 at 4 – 7. Staff and RUCO do not contest the allocations for Liberty Water. Tr. at 437, 510.
[162] Eichler Rb. at 8 – 10, Exhibit PE-RB1 at 2 – 3; Tr. at 205 – 207, 239 – 240.
[163] *Id.*

APT.[164] The services provided by APT are necessary to allow RRUI and other regulated utilities to have access to capital markets for capital projects and operations, and are necessary to allow RRUI to provide a high level of service at low operating expense.[165]

All of the APT costs are indirect costs.[166] These costs include professional services like third-party legal, accounting, tax, and auditing that are done for the benefit of RRUI.[167] ***APT's only business is to provide services to the facilities and utilities owned by APIF.***[168] These costs include costs for licenses, fees and permits, IT, payroll, and HRIS maintenance contracts, as well as the rent and depreciation of office furniture and equipment and computers in the central office.[169] Obviously, given that the APT costs are "indirect costs," they cannot be directly charged to any specific facility or utility.[170]

The APT allocation is made in two parts. To start, there are 63 total entities owned and operated by APIF, 17 of which are the regulated utilities operated by Liberty Water.[171] In turn, 17 divided by 63 is 26.98%, which means 26.98% of the total Central Office Cost pool is allocated to Liberty Water.[172] In other words, 73.02% of the cost pool

---

[164] Eichler Rb. at 13 – 16, Exhibit PE-RB1 at 7 – 15.
[165] *Id.*
[166] *Id.*; Tr. at 442 – 444.
[167] Eichler Rb. at 7 – 15, Exhibit PE-RB1 at 7 – 13.
[168] Eichler Rb. at 12 – 13.
[169] *Id.* at 7 – 15, Exhibit PE-RB1 at 7 – 13.
[170] Eichler Rb. at 5 – 7; Ex. S-3 at 2; Tr. at 442 – 444.
[171] Eichler Rb. at 15 – 16, Exhibit PE-RB1 at 7 – 10; Tr. at 280; Ex. A-17.
[172] *Id.* RRUI and Staff/RUCO can't even agree on the number of facilities actually owned by APIF. Staff and RUCO claim that APIF owns 70 facilities, not 63. Becker Dt. at 31; Tr. at 527; Coley Dt. at 70. Frankly, it's hard to believe Staff or RUCO can make that argument with a straight face because of the undisputed record. APIF only owns and operates 63 facilities, not 71. Tr. at 280; Eichler Rb. at 15 – 16; Ex. A-17. Staff's confusion apparently stems from the fact that APIF owns the debt of seven companies (the Trafalgar facilities). *Id.* Those seven facilities are not owned by APIF and do not use any APT services. The eighth facility is a landfill gas facility that has not been operational for years. Tr. at 281. It's undisputed that APT does not incur any central office costs or provide capital investment for those eight facilities. Tr. at 255, 281. By Mr. Becker's own testimony, those eight facilities should not receive any allocation from APT. Tr. at 528.

is allocated to APIF and the unregulated facilities.[173] The second phase allocates the 26.98% between RRUI and the 16 other regulated utilities based on customer counts.[174]

As presented at hearing, APIF considered other allocation cost drivers, including revenues, plant and operating costs.[175] Using those drivers, the allocation percentages for the initial phase of the allocation to the 17 regulated utilities were 17.02% (revenue), 28.87% (operating costs) and 29.74% for plant. When weighted equally, the result is an allocation of 24.96% to the 17 regulated utilities.[176] Liberty Water's use of facility counts as the initial allocation methodology complies with the NARUC Guidelines and results in a reasonable allocation of necessary costs to RRUI.[177] Even so, if the Commission feels that use of a blended allocation methodology is preferable, RRUI would adopt such blended methodology.

At hearing, Mr. Eichler also demonstrated that the APT costs are "under control" and comparatively lower than other public traded utilities.[178] In Exhibit PE-RJ3, Mr. Eichler compared RRUI's allocations from APT to the costs of the public traded utilities used in Staff's cost of capital sample group.[179] Mr. Eichler compared RRUI's costs per customer for director fees, audit fees, tax fees and management/CEO fees for RRUI to the same costs for the sample group utilities.[180] As testified by Mr. Eichler, "This exhibit shows that [Liberty Water is] quite good at controlling costs and that relative

---

[173] Tr. at 208, 220 – 221.
[174] Eichler Rb. at 5 – 7, Exhibit PE-RB1 at 6 – 12.
[175] Tr. at 209 – 210; Eichler Rb. at 16 – 17, Exhibit PE-RB2.
[176] Eichler Rb., Exhibit PE-RB2 at 2.
[177] *Id.* at 5 – 8; Tr. at 312-313..
[178] Eichler Rj. at 17, Exhibit PE-RJ3; Tr. at 219 – 220.
[179] *Id.* Those utilities are Connecticut Water, San Jose Water, American States, Aqua America, California Water and Middlesex Water, all publicly traded.
[180] *Id.*

to our peer group, we are able to control our audit services, tax services management services quite reasonably."[181] ***RRUI had the second lowest costs of the group.***[182]

c. <u>The APT Allocations Follow the NARUC Guidelines</u>.

Staff relies heavily on a stand-alone comparison as a requirement for approval of cost allocations, even though there is no authority for any such standard.[183] Neither Staff nor the Commission has formally adopted that standard as the defining standard for corporate cost allocations, let alone disclosed that standard prior to the filing of this case or the start of RRUI's test year. Left without any support for that standard, Mr. Becker claims the NARUC Guidelines support the notion that a utility should only incur those costs that a stand-alone utility would incur.[184] Mr. Becker relies on a sentence from the NARUC Guidelines that does not even remotely support Staff's stand-alone standard:

> The objective of the affiliate transactions guidelines is to lessen the possibility of subsidization in order to protect monopoly ratepayers and to help establish and preserve competition in the electric generation and electric gas supply market. It provides ample flexibility to accommodate exceptions where the outcome is in the best interest of the utility, its ratepayers and competition.[185]

The suggestion that this sentence from the NARUC Guidelines supports Staff's stand-alone standard is preposterous. That sentence is nothing more than a general guideline relating to potential subsidization by ratepayers.

On that issue, Staff's and RUCO's concerns about subsidization by RRUI's ratepayers for unregulated business operations are a red herring. Here, there is no evidence of subsidization by RRUI's ratepayers – approximately 73% of the entire Central Office Cost pool is allocated to unregulated electric facilities.[186] Only 27% of the cost

---

[181] Tr. at 220.

[182] Eichler Rj. at Exhibit PE-RJ3.

[183] Becker Dt. at 26 – 30; Tr. at 536.

[184] Tr. at 532.

[185] *Id. See also* Ex. S-3.

[186] Tr. at 205 – 229, 219 – 221; Eichler Rb., Exhibit PE-RB1 at 9.

pool is allocated to regulated utilities, such as RRUI. In fact, RRUI only gets 12% of the APT costs allocated to the infrastructure division. That means RRUI receives only 3.24% of the APT cost pool. What's ironic about Staff's subsidization argument is that, under Staff's allocation methodology, the other 56 facilities owned by APIF would subsidize the APT services provided to the seven Arizona utilities. Mr. Becker expressly acknowledged that such reverse subsidization is improper and unfair.[187] Staff's proposed 90% allocation to APIF violates the very NARUC guideline cited by Mr. Becker.

On the other hand, Liberty Water's cost allocation methodology complies with the NARUC Guidelines. Mr. Becker claims that "the Company did not identify the costs as direct or indirect "under the NARUC Guidelines."[188] RRUI, however, has complied with the NARUC Guidelines by directly charging the Liberty Water costs and reporting all of the APT costs as indirect costs.[189] Under the NARUC Guidelines, "indirect costs" are defined as "costs that cannot be identified with a particular service or product. This includes, but is not limited to, overhead costs, administrative and general, and taxes."[190] The APT costs clearly meet that definition. The cost allocation methodology used by Liberty Water clearly complies with the NARUC Guidelines.[191]

8. The APT Costs and Services Provide Substantial Benefits to RRUI and Its Ratepayers.

To say the least, RRUI has provided substantial evidence demonstrating that the APT services and costs directly benefit RRUI and its customers. The notion that these allocated costs from APT do not benefit the ratepayers is undercut by the very high level of service RRUI is providing to customers, a fact which Staff and RUCO don't contest.[192]

---

[187] Tr. at 530 – 531.
[188] Becker Dt. at 29.
[189] Eichler Rj. at 8 – 9, Exhibit PE-RB1; Eichler Rb. at 5 – 7; Tr. at 312 – 313.
[190] Ex. S-3 at 2.
[191] Eichler Rb. at 4 – 6; Tr. at 312-313; Eichler Rj. at 8 – 9.
[192] Eichler Rb. at Ex. PE-RB3; Tr. at 422, 540.

APT provides four types of services to RRUI: (1) Strategic Management, which includes management fees, general legal services and other professional services; (2) Capital Access, which includes licenses/fees/permits, unit holder communications and escrow fees; (3) Financial Controls, which include audit services, tax services and trustee fees; and (4) Administrative/Overhead Costs.[193]

Each of these categories of APT costs provides substantial benefits to RRUI through access to capital and strong corporate governance.[194] To start, strategic management services are necessary for RRUI to provide service and obtain capital financing under the APIF business model.[195] These services include legal expenses incurred by APT for general legal matters pertaining to all facilities owned by APIF, which are required in order for APIF to provide capital funding to individual utilities, without which the utilities could not provide adequate service.[196]

Strategic management decisions are critical for any utility. The need for strategic management is even more pronounced for RRUI as a regulated utility that depends on access to capital for operational and capital needs.[197] These legal services are required in order for APIF to provide capital funding to individual utilities, without which the utilities could not provide adequate service.[198] These legal services involve matters not specific to a single facility, including review of audited financial statements, annual information filings, Sedar filings (mandatory filings for companies listed on the Toronto Stock Exchange, similar to EDGAR filings for the SEC in the United States), tax issues, market

---

[193] Eichler Rb. at 13 – 17, Exhibit PE-RB1 at 7 – 15.
[194] *Id.*
[195] *Id.*
[196] *Id.*
[197] *Id.*
[198] *Id.*; Tr. at 341, 453, 547.

compliance, and other similar legal costs.[199] These legal services are a prerequisite for RRUI's continued access to capital markets available to APIF.[200]

The Strategic Management Costs incorporate management fees paid to APT for strategic management of all APIF facilities.[201] These fees provide strategic planning for ongoing access to capital markets.[202] Management Fees are charged to APT as a monthly fee which is then allocated to the utilities division (26.98%), and then to each individual utility based on customer count.[203] ***Under RRUI's proposed allocation, customers would pay only 31 cents per month in management fees.***[204]

One of APT's primary functions is to ensure that APIF's facilities have access to financial capital. In order for RRUI to have continued access to capital markets, APT incurs a variety of costs for the benefit of the utilities, including RRUI.[205] Mr. Becker conceded that RRUI and its customers benefit from access to capital provided by APT:

> Q. And it's your understanding that the capital that was used to pay for that plant was provided by the parent, agreed?
>
> A. Yes . . . .
>
> Q. And if the – if Rio Rico used funding from its parent company to pay for the plant, then the ratepayers benefited because the plant was built and used to provide sewer and water service, agreed?
>
> A. Yes.[206]

Likewise, Mr. Manrique testified that "the fact that Rio Rico is owned by a large publicly-traded company is a benefit to Rio Rico in order to acquire low debt – or low-cost

---

[199] *Id.*
[200] Eichler Rb., Exhibit PE-RB1 at 12 – 15.
[201] Eichler Rb. at 13 – 17, Exhibit PE-RB1; Tr. at 341 – 342.
[202] Tr. at 342.
[203] *Id.*
[204] Tr. at 341.
[205] Eichler Rb. at 12 – 15, Exhibit PE-RB1; Tr. at 205 – 207, 223 – 228, 348, 427 – 428, 542.
[206] Tr. at 541 – 542.

financing."[207] Mr. Coley also acknowledged the benefits provided to RRUI from access to capital through APT.[208]

To provide continuing access to capital, APT incurs license fees to ensure that APIF can participate in the TSX.[209] The benefit of these costs is undisputed – RRUI has access to capital only so long as APIF is able to access capital markets. Escrow Fees to pay investor dividends are incurred in order to ensure that unit holders of APIF continue to maintain ownership and that new shareholders are enticed to invest in the fund.[210]

Similarly, unit holder communication costs are incurred by APT to comply with the filing and regulatory requirements of the TSX.[211] These disclosures are required by law to ensure a level of integrity and rigor is applied to the management of the regulated utilities.[212] It can't be stressed enough that in the absence of unit holder communication costs, investors would not invest in the units of APIF, and APIF wouldn't have capital to invest in RRUI.[213] Both Mr. Becker and Mr. Coley acknowledged that Liberty Water must comply with these legal requirements as a publicly traded company.[214]

Financial control costs incurred by APT are another integrated piece of corporate governance. The financial control services provided by APT are critical and necessary to RRUI's ongoing viability.[215] Put another way, absent those services provided by APT, RRUI would be forced to operate as a stand-alone utility with higher costs and operating expenses.[216] Operating as a stand-alone utility also raises the very real possibility of

---

207 *Id.*. at 1090.
208 *Id.* at 427 – 428.
209 Eichler Rb., Exhibit PE-RB1 at 11 – 13; Tr. at 315.
210 Eichler Rb., Exhibit PE-RB1 at 12.
211 *Id.* at 12 – 13; Tr. at 315.
212 Eichler Rb., Exhibit PE-RB1 at 12; Tr. at 453, 547.
213 Eichler Rb., Exhibit PE-RB1 at 12.
214 Tr. at 453, 547.
215 Eichler Rb., Exhibit PE-RB1 at 12 – 14.
216 Eichler Rb. at 12 – 13.

declining quality of service.[217] RRUI is a healthy utility largely because of the financial controls and corporate governance services provided by APT.[218]

Under financial controls, APT incurs costs for tax filings, planning and management.[219] Taxes are paid on behalf of RRUI at the parent level as part of a consolidated tax return. Tax services are provided by third parties, including KPMG.[220] Audit services are likewise necessary to ensure that the regulated utilities are operated in a manner that meets audit standards and regulatory requirements.[221] Without these services, RRUI would not have a readily available source of capital funding.[222]

These financial controls are required by the rules of the TSX.[223] At trial, Mr. Coley acknowledged the legal necessity of audit services, boards of trustees and other services for publicly traded companies.[224] Mr. Becker also testified that APIF is legally required to make informational filings with investors, filings with governmental agencies, tax filings and to have boards of directors.[225] Both Mr. Becker and Mr. Coley acknowledged that these tax and audit service benefit RRUI's ratepayers.[226]

Ultimately, APIF's corporate model must be viewed as an integrated whole. On the whole, RRUI's operating costs compare very favorably to other Arizona utilities, and given the added benefits of corporate governance, access to capital and stability, APIF's corporate model should be approved. The Commission should be encouraging owners like APIF who are willing to invest capital in this state with an overriding corporate model

---

[217] *Id.* at 20 – 22.
[218] *Id.*; Tr. at 1090.
[219] Eichler Rb., Exhibit PE-RB1 at 14; Tr. at 267.
[220] *Id.*
[221] Eichler Rb., Exhibit PE-RB1 at 13.
[222] Eichler Rb. at 28 – 31.
[223] *Id.*; *Id.* at Exhibit PE-RB1 at 13.
[224] Tr. at 439 – 440.
[225] *Id.* at 547 – 548.
[226] *Id.* at 466 – 467, 510 – 511, 542.

of good governance. Liberty Water's rescue of the McLain systems is a shining example of the benefits of APIF's business model.[227] Disallowance of the APT costs as suggested by Staff effectively will reject Liberty Water's business model. In turn, the Commission simply can't expect RRUI to provide the same level of service with the same level of operating expenses. Any such Commission decision would likely force RRUI to disavow its shared services model, prevent RRUI from obtaining ongoing access to equity capital and require RRUI to again operate as a stand-alone utility.

B. Revenue Annualization – Water and Wastewater.

In preparing the case for filing, Mr. Bourassa annualized revenues to test year-end customer numbers.[228] The annualization resulted in a slight, less than $5,000, downward adjustment to test year revenues for both divisions.[229] Mr. Bourassa used the same revenue annualization method typically used in rate cases for water and sewer utilities.[230] Staff accepted Mr. Bourassa's revenue annualization without adjustment.[231] RUCO did not. Instead, RUCO annualized to the test year–end for all customers *except* the residential customers.[232] RUCO opposes the revenue annualization for the 5/8-meter customers, the large majority of the Company's customer base, because it reflects a decrease in test year revenues.[233] In other words, since test year revenues were going down, a larger rate increase is needed to meet the same revenue requirement. That's RUCO's real opposition to annualizing for all customers in this rate case.

To avoid the impact of the revenue annualization on the Company's residential water customers, RUCO first suggested that "averaging" customer counts was more

---

[227] *See* Decision No. 68826.
[228] Bourassa Dt. at 12:13.
[229] Tr. at 148:1-4.
[230] *Id.* at 148:8-17, 863:1-3.
[231] *See, generally,* Staff's Final Schedules.
[232] Coley Dt. at 33:14-23.
[233] Coley Sb. at 13:9-12.

appropriate because the customer base was "seasonal."[234] Then, in the "spirit of cooperation," RUCO abandoned the recommended averaging method.[235] Unfortunately, RUCO isn't actually being cooperative at all. RUCO recommends no annualization and is still asserting that the decline in revenues was the result of customer seasonality, and therefore not permanent.[236]

No one can know whether the decline in water revenues that started during the test year is permanent, but as RUCO likes to say, the economy in Arizona is lagging behind the rest of the country in recovery.[237] This is certainly borne out by the evidence. The Company's revenue decline was far more substantial in 2009.[238] Mr. Coley didn't even look at the evidence contradicting his testimony, and further admitted that he had no contrary evidence.[239] There is simply no basis to deviate from traditional rate making, and the adjustment proposed by RRUI and accepted by Staff is anything but "overstated," as RUCO tried but failed to show.

C. Rate Case Expense.

Initially, and up until hearings, RRUI sought a total rate case expense equal to $335,000, allocated $210,000 to the water division and $125,000 to the sewer division.[240] At the conclusion of the hearings, RRUI indicated that its Final Schedules would reflect an increase in the amount of requested rate case expense.[241] The Company's Final Schedules include $360,000 in rate case expense, allocated $225,000 and $135,000 to the

[234] Coley Dt. at 34:11-19.

[235] Coley Sb. at 13:1-5.

[236] Frankly, even Mr. Coley doesn't seem to know why RUCO changed its position. At trial he testified that RUCO changed its position "to be consistent. Tr. at 862:23-25. Of course, RUCO's previous positions have been to annualize to test year-end customer numbers, and in this case RUCO recommends no such annualization for residential customers. So, either way, RUCO is hardly being consistent.

[237] *Id.* at 1035:4-9; *see also* Bourassa Rb. at 26:19 – 27:5.

[238] Tr. at 151:10-17 (RRUI has a combined revenue decrease of some 140,000 in the first year after the test year).

[239] *Id.* at 865:7-23.

[240] Bourassa Rj. at 18:1-9 and Schedules C-1 (water and wastewater).

[241] Tr. at 1097 – 1098.

water and wastewater divisions, respectively.[242] This level of rate case expense more closely tracks the actual amounts incurred, including additional hearing, transcript and travel costs when the trial was not completed as scheduled, although this level of expense will still leave the Company's shareholders sharing some of the cost of this rate case. Again, it bears noting that RRUI is not only seeking a decrease in its own rates, but it was forced to spend more time and money than initially estimated to do so.

Staff did not oppose the Company's initial estimate of rate case expense, however Staff did not update its schedules to reflect recovery of the final requested amount of $360,000.[243] Before and during trial, RUCO proposed to reduce rate case expense by 25 percent.[244] The only reason offered for RUCO's recommended downward adjustment to rate case expense is that RRUI had not yet incurred the amount of rate case expense it was requesting.[245] RUCO seems to have forgotten that the Company can only estimate its rate case expense before it actually incurs it. In any event, its reasoning is not sound and its adjustment is not supported.[246]

IV. <u>THE COST OF CAPITAL AND RATE OF RETURN</u>.

A. <u>Overview</u>.

RRUI is requesting a rate of return on its rate base[247] based on a weighted average cost of capital ("WACC") of 11.7 percent. The WACC is based on the Company's capital structure at the end of the 2008 test year, which consisted of $11,476,445 of common

---

[242] Company Final Schedule C-2, page 9 (water) and C-2, page 7 (wastewater).

[243] If Staff addresses the issue in its closing brief, RRUI will then respond if necessary.

[244] Coley Dt. at 43:4-13; Coley Sb. at 16:15 – 17:19.

[245] Tr. at 866:21-24.

[246] In its Final Schedules, RUCO recommends only a 10% reduction to the water rate case expense initially requested by the Company, a lower amount than the amount being requested. RUCO's reason for this last minute change is unknown. To the extent it becomes known, RRUI will address it then if necessary.

[247] The Company has accepted the depreciated original cost of its utility plant and property as its fair value rate base in this case.

equity and no debt.[248] The return on common equity requested by the Company is 11.7 percent, based on the updated analysis presented in Mr. Bourassa's rebuttal testimony.

In his analysis, Mr. Bourassa utilized the same market-based finance models – the Discounted Cash Flow Model ("DCF") and the Capital Asset Pricing Model ("CAPM") – that the Commission has relied on in numerous water and wastewater utility rate cases during the past decade (including the Company's prior case).[249] These models are implemented through the use of financial information for comparable firms with common stock that is traded on a national exchange. Because RRUI's stock is not publicly traded, Mr. Bourassa used as his proxy the same six publicly traded water utilities that Staff has consistently used in prior water and wastewater utility rate cases,[250] with appropriate adjustments to account for RRUI's specific risk profile.

First, Mr. Bourassa adjusted the cost of equity produced by the DCF and CAPM downward by 100 basis points to account for the absence of debt in the Company's capital structure, using the method normally used by the Commission.[251] Second, he adjusted the cost of equity upward by 50 basis points to account for the Company's small size relative to the proxy companies; RRUI's lack of investment liquidity (i.e., an equity investment in the Company cannot be sold quickly on a stock exchange); and the additional risk that results from the particular rate-making methods employed in Arizona.[252] The table below summarizes the Company's final position:

---

[248] *See also* Rebuttal Testimony of Thomas J. Bourassa – Cost of Capital ("Bourassa COC Rb.") at 2, Rb. Schedule D-1.

[249] *See, e.g., Rio Rico Utilities, Inc.*, Decision No. 67279 (Oct. 5, 2004) at 13 ("The DCF and CAPM are respected, sound and oft relied upon models for determining a firm's cost of equity."); Ex. A-25 (excerpt from Staff's cost of capital testimony in the Company's prior rate case).

[250] Direct Testimony of Thomas J. Bourassa ("Bourassa COC Dt.") at 15 – 18 (describing sample utilities); Tr. at 1070. *Compare* Ex. A-25 (Staff's sample group from the Company's prior rate case).

[251] Bourassa COC Dt. at 36 – 37. This method is often called the Hamada formula because it was developed by Professor Robert Hamada of the University of Chicago. As discussed below, it is an extension of CAPM and also relies on market-based inputs. *Id.*

[252] *Id.* at 37 – 40.

Method	Low	High	Midpoint
DCF Estimates	10.8%	12.2%	11.5%
CAPM Estimates	10.3%	15.6%	13.0%
Average	10.6%	13.9%	12.2%
Risk Adjustment for the Company's Capital Structure	-1.0%	-1.0%	-1.0%
Risk Adjustment for Other Company-Specific Risks	0.5%	0.5%	0.5%
Indicated Cost of Equity	10.1%	13.4%	**11.7%**

The Staff and RUCO cost of capital witnesses also used the DCF and CAPM to develop their cost of equity recommendations. There are, however, significant differences between the inputs used by Mr. Bourassa and the inputs used by the witnesses for Staff and RUCO. As a result, the estimates produced by their models differ from Mr. Bourassa's estimates:

Party	DCF	CAPM	Average
RRUI	10.5%	13.0%	12.2%
Staff	9.9%	10.6%	10.3%
RUCO	9.71%	6.1%	7.9%[253]

The Staff witness, Mr. Manrique, also has proposed a downward adjustment of 110 basis points to account for the Company's lack of debt using the Hamada method while ignoring all other firm-specific risks, which reduces the cost of equity to only 9.2 percent.[254] In contrast, the RUCO witness, Mr. Rigsby, has proposed an upward

[253] Bourassa COC Rb. at Schedule D-4.1; Surrebuttal Testimony of Juan C. Manrique ("Manrique Sb.") at Schedule JCM-3; Direct Testimony of William A. Rigsby ("Rigsby Dt.") at Schedule WAR-1, page 3.
[254] Manrique Sb. at Schedule JCM-3.

adjustment of 110 basis points to his estimated equity cost, based on expected increases in capital costs.[255] RRUI does not take issue with RUCO's upward adjustment, which is required to properly account for the Company's investment risk relative to the publicly traded utilities.[256]

RUCO, however, has proposed the use of a hypothetical capital structure consisting of 40 percent debt and 60 percent equity on the basis that RRUI – with 8,000 customers and annual revenue of $3.8 million – should have a capital structure that is similar to a large, publicly traded utility. Moreover, RUCO has proposed an interest rate on its hypothetical debt of only 6.26 percent, which is equivalent to the current yield on an investment grade (Baa) corporate bond,[257] even though there is no evidence that RRUI could actually finance 40 percent of its plant at such a rate.[258]

RUCO's hypothetical capital structure, containing some $4.6 million of fictional debt, produces a WACC of 7.9 percent, which RUCO has proposed as the return on RRUI's rate base. However, the effective return on rate base – and on the Company's common equity – drops to <u>only 6.9 percent</u> when the fictional interest expense generated by RUCO's fictional debt is taken into account.[259] Such a return is plainly unreasonable and confiscatory.

---

[255] Tr. at 980, 1009.

[256] Mr. Bourassa estimated that the small company risk premium for RRUI ranges from 99 basis points to 181 basis points. Bourassa COC Dt. at 37 – 38, Schedule D-4.16. Therefore, the Company's proposed upward risk adjustment of 50 basis points is very conservative. *Id.* at 38.

[257] Tr. at 937 (explaining that the yield on Baa-rated utility bonds has averaged 6.35 percent over the past eight weeks).

[258] In the rate case for Gold Canyon Sewer Corporation, for example, RUCO proposed a hypothetical debt cost of 8.4 percent. Tr. at 943.

[259] *E.g.*, Bourassa COC Rb. at 44 – 45.

In sum, the parties' respective recommended returns on equity for RRUI are:

RRUI	11.7%
Staff	9.2%
RUCO	6.9%

The major differences between the parties' methods and inputs are discussed below. However, before discussing these differences, it is necessary to briefly summarize the applicable legal standard for determining a fair rate of return for a regulated utility.

B. **The Applicable Legal Standard.**

The Constitution guarantees utilities such as RRUI an opportunity to earn the reasonable cost of conducting their business, including a return on its property devoted to public service that is sufficient to (1) allow the utility to attract capital on reasonable terms; (2) maintain the utility's financial integrity; and (3) allow the utility an opportunity to earn a return that is commensurate with the returns earned by enterprises with comparable risks.[260] The seminal case stating these requirements is *Bluefield Waterworks,* in which the Supreme Court explained:

> 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 and 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 returns should be reasonably sufficient to ensure 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.[261]

---

[260] *See* Bourassa COC Dt. at 14.

[261] *Bluefield Waterworks*, 262 U.S. at 692 – 693.

The Supreme Court also stated: "Rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment."[262] Thus, the rates set in this proceeding must be sufficient to allow the Company to earn its authorized rate of return during the period the rates will be in effect.

In a more recent case, the Supreme Court repeated these requirements, explaining:

> [T]he investor interest has a legitimate concern with the financial integrity of the company whose rates are regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for capital costs of the business. These include service on the debt and dividends on the stock.... By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises with corresponding risks. The return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[263]

The criteria established by the Supreme Court in decisions such as *Bluefield Water Works* and *Hope Natural Gas* require the use of comparable companies, i.e., companies that would be viewed by investors as having similar risk. As Mr. Manrique explained:

> The cost of equity is the rate of return that investors expect to earn on their investment in a business enterprise given its risk. In other words, the cost of equity to the entity is the investors' expected return on other investments of similar risk. As investors have a wide selection of stocks to choose from, they will choose stocks with similar risks but higher returns.[264]

However, there is no comparable market data for small utility companies like RRUI. The average revenue of the proxy water utilities is <u>over 78 times</u> that of RRUI, and the average

---

[262] *Id.* at 690.

[263] *Federal Power Comm'n v. Hope Natural Gas,* 320 U.S. 591, 603 (1944).

[264] Direct Testimony of Juan C. Manrique ("Manrique Dt.") at 7.

net plant of the water utility sample companies is <u>29 times</u> that of RRUI.[265] Even the smallest company in the proxy group, Connecticut Water, has over 8 times the net plant of RRUI and nearly 16.5 times the revenue.[266] As Mr. Manrique acknowledged, it is well established that investment risk increases as the size of the firm diminishes.[267] Moreover, RRUI's lack of liquidity increases investment risk.[268] No rational investor would regard RRUI as having the same level of risk as Aqua America or even Connecticut Water, nor can RRUI effectively compete with those firms to attract capital on reasonable terms.[269] Consequently, the results produced by the DCF and CAPM methodologies, utilizing data for the proxy utilities, understates the cost of equity for RRUI.

In addition, the Commission must consider the specific risks affecting the utility's operations and earnings, including risks created by the regulatory standards and requirements to which the utility is subject. The Supreme Court has stated:

> [T]he impact of certain rates can only be evaluated in the context of the system under which they are imposed. One of the elements always relevant to setting the rate ... is the return investors expect given the risk of the enterprise. ... The risks a utility faces are in large part defined by the rate methodology because utilities are virtually always public monopolies dealing in an essential service, and so relatively immune to the usual market risks.[270]

In short, "[r]egulation can increase business risk if it does not provide adequate returns and/or if it does not provide the utility with the opportunity to earn a fair rate of return."[271] Consequently, the impact of the Commission's particular rate-setting policies and

---

[265] Bourassa COC Dt. at 16.

[266] *Id.*

[267] Tr. at 1079 – 80.

[268] Tr. at 1080.

[269] *See* Bourassa COC Dt. at 16 – 22; Bourassa COC Rb. at 11 – 14. Nor are the shareholders of Aqua American and Connecticut Water required to obtain financing for the utility, and would certainly demand a substantially greater return if they were required to do so, as Mr. Manrique testified. Tr. at 1091 – 92.

[270] *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 314 – 15 (1989).

[271] Roger A. Morin, *New Regulatory Finance* 38 – 39 (Public Utility Reports, Inc. 2006) (hereinafter "*Morin*").

FENNEMORE CRAIG
A PROFESSIONAL CORPORATION
PHOENIX

requirements on the utility's ability to actually earn its authorized rate of return at the time service is provided must be taken into account in determining a fair rate of return.

In this case, the Company has proposed an upward adjustment to the cost of equity of 50 basis points to account for its small size, lack of investment liquidity and the additional risk created by Arizona's particular ratemaking system. RUCO has proposed an even greater upward adjustment, 110 basis points, which, as noted above, is within the range estimated by Mr. Bourassa.[272] RRUI supports the adoption of that adjustment. Staff, in contrast, has ignored all firm-specific risk except risk relating to RRUI's capital structure, and proposes a reduction in the cost of equity of 110 basis points, even though its witness admitted that RRUI's small size and lack of liquidity increase investment risk.[273] This is one-sided and arbitrary, and violates the *Bluefield/Hope* attraction of capital and comparable earnings standard discussed above.

C. **Specific Errors and Problems with the Staff and RUCO Cost of Equity Estimates.**

1. **Introduction.**

Both Staff and RUCO have proposed equity costs based on their respective sample groups of publicly traded utilities that are well below the Company's current cost of equity and that will not allow the Company an opportunity to actually earn its authorized rate of return during the period in which rates will be in effect. There are several obvious indications that the recommendations of Staff and RUCO are too low and fail to accurately reflect both current market risk and the Company's individual risk profile.

First, the relative riskiness of the publicly traded water utilities in the parties' sample groups has increased dramatically since RRUI's previous rate case, as shown by the increase in the sample groups' average beta. "Beta" measures a security's volatility

[272] Bourassa COC Dt. at 37 – 38.
[273] Tr. at 1079 – 80.

FENNEMORE CRAIG
A PROFESSIONAL CORPORATION
PHOENIX

relative to that of the market, and is widely accepted as a useful measure of investment risk.[274] "According to both financial theory and empirical evidence, betas are critical and sufficient measures of risk."[275] An increase in a stock's beta indicates that the stock has become more risky relative to the market as a whole, and, as a result, investors would require a greater return to purchase that stock.[276] And as Mr. Rigsby explained, "[f]inance theory has always held that as the risk associated with a given investment increases, so should the expected rate of return on that investment and vice versa."[277]

In RRUI's prior rate case, Docket No. WS-02676A-03-0434, the average beta of Staff's sample utilities was 0.62.[278] At that time, RRUI was authorized a return on equity of 8.7 percent, based on capital structure that consisted of 100 percent equity.[279] Staff's sample utilities currently have an average beta of 0.79, which is significantly greater than their average beta in the Company's prior case.[280] By contrast, if their average beta had been 0.79 in the Company's prior case, the estimate produced by Staff's CAPM, using Staff's 2004 inputs, would have been 100 basis points higher.[281]

Moreover, Value Line warns investors that water utility stocks are currently a risky investment. For example, Value Line's water utility industry analyst, Andre J. Costanza, states in the most current discussion of the water industry that the "risk profiles of [the water utility stocks] are higher than one might think," and that investors "with a more conservative bent and an affinity for income can do better by looking elsewhere,

---

274 *See Morin* at 69 – 71; 400 – 02 (discussing use of beta as a risk measure to develop an appropriate proxy group of firms with comparable investment risk), 407 – 10 (same).
275 *Id.* at 81.
276 Tr. at 1057 – 59.
277 Rigsby Dt. at 31.
278 Ex. A-25.
279 Decision No. 67279 at 13 (Ex. R-19).
280 Manrique Sb. at Schedule JCM-3.
281 *See* Ex. A-25, Schedule JMR-7.

specifically the Electric Utility segment."[282] Similarly, RUCO's gas industry proxy group, with a beta of only 0.67, is less risky than its water industry proxy group, with an average beta of 0.83.[283] This indicates that the water utility industry is currently viewed by investors as being riskier than both the electric and gas utility industries, and higher equity returns are required to attract investor capital.

Second, the risk of the market has increased, and the cost of equity is therefore higher as a result. This is evidenced by the increase in the current market risk premium – another critical input in the CAPM. In RRUI's prior rate case, Staff's current market risk premium was only 4.6 percent, as compared to Staff's current market risk premium of 10.0 percent in this case.[284] The substitution of Staff's current market risk premium for its 2004 market risk premium produces an increase of 340 basis points in Staff's CAPM estimate using the current market risk premium and an increase of 170 basis points in Staff's average CAPM estimate. Therefore, a significantly higher return is required to attract capital at the present time. Yet Staff's proposed return on equity is only 50 basis points higher than the return on equity authorized by the Commission in Decision No. 67279, while RUCO's effective return on equity is nearly 200 basis points lower! Clearly, these recommendations cannot be squared with the *Bluefield/Hope* standard.

Third, there are other unbiased indications that the Staff and RUCO recommendations are too low. All of the cost of capital witnesses relied heavily on the information for publicly traded firms published by Value Line, a reputable publication

---

[282] Ex. A-23.

[283] *See* Rigsby Dt., Schedule WAR-7 at 2. The beta of Staff's water industry proxy is slightly lower, 0.79, but is still significantly greater than the gas industry beta. *See* Manrique Sb. at Schedule JCM-3. Notably, the average risk free rate used by Mr. Manrique is slightly higher in this case than in RRUI's 2004 rate case. *Compare* Ex. A-25 *with* Manrique Sb., Schedule JCM-3.

[284] Ex. A-25 at Schedule JMR-7; Manrique Sb. at Schedule JCM-3.

that is widely used by the investment community[285] Value Line publishes forecasts of returns on common equity for larger publicly traded companies, including the three utilities in RUCO's water industry proxy group.[286] Value Line currently projects the following returns on equity for those utilities for 2010 and for 2012:

	2010	2012
American States Water	10.5%	12.0%
Aqua America	10.5%	12.0%
California Water	10.5%	12.0%
Average	10.5%	12.0%[287]

All of these utilities are significantly larger than RRUI. AUS Utility Reports (January 2010) reports the following information for these utilities (in millions of dollars):

	Net Plant	Revenue
American States Water	$959.8	$358.9
Aqua America	$2,695.6	$662.5
California Water	$754.2	$442.6
Average	$1,470 million	$488 million[288]

Moreover, these utilities operate in jurisdictions such as California and Pennsylvania that use projected or partially projected test years, and authorize surcharges and other cost recovery mechanisms which allow the recovery of increases in costs outside a general rate case.[289] Therefore, they are less risky than RRUI.

---

[285] Tr. at 947, 969 (Mr. Rigsby), 1056 (Mr. Manrique). In fact, Mr. Rigsby was unable to use the sample group of publicly traded water utilities normally used by Staff to estimate the cost of equity (including RRUI's prior rate case) because Value Line doesn't publish the same forward-looking projections for the three smaller utilities in Staff's water industry group. Tr. at 948.

[286] These water utilities were included in the Company's sample group and in Staff's sample group.

[287] Ex. A-23.

[288] Bourassa COC Rb. at 7.

[289] *Id.* at 7 – 8. *See also* Bourassa COC Dt. at 16 – 22 (describing the water industry sample group and the additional risks faced by RRUI compared to that group).

These data provide an unbiased indication that the Staff and RUCO recommendations for RRUI are simply too low and should not be adopted by the Commission. The risk associated with the water utility industry has increased relative to other industries, and is currently viewed as having significantly more risk than six or seven years ago, when RRUI's current rates were established. At the same time, the market itself is riskier than in 2004. Furthermore, there should be no dispute that RRUI would be perceived by investors as having more risk than the large, publicly traded utilities in the parties' water industry proxy groups. Therefore, RRUI's cost of capital exceeds the results produced by the finance models.

2. Staff's Cost of Equity Estimates.

The methods and inputs used by Staff and the Company are similar in many respects. In contrast to RUCO, for example, Staff and the Company have used the same proxy group of publicly traded water utilities, which are the utilities that have been used by the Commission in setting rates for water and wastewater utilities for many years (including RRUI's last rate case).[290] Staff and the Company also used conceptually correct arithmetic averages and account for current market risk in their CAPM estimates.[291] Nevertheless, there are serious conceptual problems with certain of Staff's inputs and its ultimate recommendation.

a. Staff Has Double-Counted Historic Growth Rates.

First, Staff has overemphasized historic growth rates in estimating the future dividend growth rate – *g* – in implementing the DCF, and has failed to properly utilize the best estimate of expected dividend growth, analysts' forecasts. As a result, Staff's DCF estimate is significantly understated.

[290] Rejoinder Testimony of Thomas J. Bourassa – Cost of Capital ("Bourassa COC Rj.") at 12 – 13.
[291] Tr. at 1063 – 64.

As Mr. Manrique testified, the "cost of equity represents investors' *expected* returns and not realized [i.e., historic] returns."[292] Thus, what is relevant in setting a utility's rates is the investor's expected future return on her investment, not what may have occurred in the past.[293] For this reason, Staff has used spot (i.e., current) stock prices for a number of years to calculate the dividend yield component of the DCF, as well as spot yields on Treasury securities to determine the risk-free rate in the CAPM.[294] The theoretical basis for doing so is the Efficient Market Hypothesis, which, as Mr. Manrique explained, "asserts that the current spot price reflects all available information on a stock including investors' expectations of future returns."[295] Thus, according to Mr. Manrique, the use of historic stock prices in the DCF (and historic interest rates in the CAPM) "illogically discounts the most recent information" and fails to account for current market conditions.[296]

Yet Mr. Manrique has illogically discounted the most current information on dividends and earnings growth by averaging historic dividend per share ("DPS"), earnings per share ("EPS") and sustainable growth rates for the period 1998 to 2008 with current forecasts of growth rates.[297] The effect of this error is significant: Mr. Manrique's historic growth rates average only 3.9 percent while the conceptually correct projected growth rates average 7.6 percent – a difference of 370 basis points.[298] Thus, by simply averaging the growth rates, Mr. Manrique has depressed dramatically the result produced by the DCF model.

---

[292] Manrique Dt. at 9 (italics original). *See also id.* at 7; Tr. at 1049-1050.
[293] Tr. at 935, 1049 – 50.
[294] Tr. at 1050 – 54.
[295] Manrique Dt. at 16. *See also* Morin at 279 – 80 (discussing the Efficient Market Hypothesis); Tr. at 1051, 1054.
[296] Manrique Dt. at 16.
[297] Manrique Dt. at 17 – 18, Schedules JCM-5, JCM-6 and JCM-8. *See also* Manrique Sb., Schedules JCM-5, JCM-6 and JCM-8.
[298] *See* Manrique Sb. at Schedule JCM-8.

The DCF requires estimates of dividend and earnings growth that investors expect in the future, not what took place 10 years ago. For this reason, numerous authorities on cost of capital estimation support the use of analysts' forecasts in implementing the DCF.[299] In estimating future growth, financial institutions and analysts have already considered relevant historical information as well as current information on the firm and broader financial and economic trends,[300] as Mr. Manrique acknowledged.[301] To the extent that past results provide useful indications of future growth prospects, analysts' forecasts would already incorporate that information. Furthermore, under the Efficient Market Hypothesis, a stock's current price reflects all known historic information on the firm, including its past dividend and earnings history, as well expected future cash flows.[302] Any further recognition of the past double-counts what has already occurred. Therefore, forward-looking growth rates are conceptually correct and should be used.

Nevertheless, to be conservative, Mr. Bourassa also used the 5-year historical average growth rates in the stock price, book value per share ("BVPS"), EPS and DPS along with the average of analysts' forecasts.[303] The primary differences between Mr. Bourassa's DCF estimate and Mr. Manrique's DCF estimate, therefore, is the excessive weight given to historic data by Mr. Manrique, and the fact that Mr. Manrique relied on data prior to 2004, which obviously is of less relevance to current investors.

---

[299] Bourassa COC Rb. at 22 – 30, Exhibit TJB-COC-RB1.

[300] David A. Gordon, Myron J. Gordon and Lawrence I Gould, "Choice Among Methods of Estimating Share Yield," *Journal of Portfolio Management* 50 – 55(Spring 1989). The authors found that a consensus of analysts' forecasts of earnings per share growth for the next five years provides a more accurate estimate of growth required in the DCF model than three different historical measures of growth (historical EPS, historical DPS, and historical sustainable growth). They explain that this result makes sense because analysts would take into account such past growth as indicators of future growth as well as any new information on the firm.

[301] Tr. at 1050.

[302] Manrique Dt. at 16; Tr. at 1051, 1054.

[303] Bourassa COC Dt. at 29. *See also* Bourassa COC Rb. at 21, Schedule D-4.4.

In short, all of the witnesses recognize that cost of equity represents investors' expected returns in the future, not returns that were realized a decade ago.[304] Yet Staff has given substantially more weight to historic data going back into the 1990s in estimating future growth. This makes no sense. Historic growth is already reflected in the current stock prices of the publicly traded sample utilities and was considered by analysts in developing their growth rate forecasts. Consequently, Staff's DCF estimate is conceptually flawed and understates the current cost of equity.

b. Staff's Adjustment for Financial Risk Is Overstated.

In adjusting the cost of equity produced by his finance models downward to account for the absence of debt in RRUI's capital structure, Mr. Manrique has misapplied the Hamada formula by using the book value of the sample utilities' equity rather than the conceptually correct market value of their equity. Moreover, he erroneously assumed that the average beta of the sample water utilities can be applied directly to RRUI, even though RRUI is much smaller and riskier than the sample utilities.

The Hamada formula is an extension of the CAPM.[305] This equation separates the beta of a security into a business-risk component or "unlevered" beta, and a financial-risk component relating to debt financing.[306] The starting point in this case is the water industry proxy group. First, the average unlevered beta of the sample group is computed. Next, the unlevered beta is "relevered" to reflect RRUI's capital structure. The relevered beta is then used in the CAPM to estimate the cost of equity based on RRUI's own debt ratio.[307]

---

[304] Tr. at 935, 1049.
[305] Bourassa COC Dt. at 36; Bourassa COC Rb. at 9 – 10.
[306] *Id. See also* Morin at 221 – 24 (providing examples).
[307] Bourassa COC Dt. at 36, Schedules D-4.13, D-4.14 and D-4.15; Bourassa COC Rb. at 9 – 10, Schedules D-4.13, D-4.14 and D-4.15.

Unfortunately, Staff used the wrong inputs in unlevering and relevering the average beta of the sample group. Specifically, Staff used the book values of the proxy utilities' capital structures rather than their market values.[308] Professor Hamada developed his equation using market values, not recorded book costs. This is logical given that the Hamada formula is an extension of the CAPM, which is a market-based model that does not consider any book or accounting data.[309] The critical component, beta, is an estimate of a publicly traded security's investment risk based on its volatility relative to the market as a whole.[310] Consequently, numerous authorities state that the market value of a firm's equity should be used in estimating the effect of leverage on a security's risk.[311]

Staff, therefore, has violated basic finance principles in using book values to unlever and relever the proxy group's average beta. As a result of this error, Staff's downward adjustment to RRUI's cost of equity for financial risk of 110 basis points, as proposed in Mr. Manrique's surrebuttal testimony, is overstated by at least 50 basis points. Accordingly, Staff's cost of equity estimate would increase from 9.2 percent to at 9.7 percent if the conceptually correct market values are used in the Hamada formula, rather than book values.[312]

---

[308] Bourassa COC Rb. at 9 – 10.

[309] *Id.*

[310] *Morin* at 70 – 71 (discussing the derivation of Value Line's reported betas, which all of the parties used). *See also* Manrique Dt. at 28; Bourassa COC Dt. at 34 – 35.

[311] *See, e.g.*, *Morin* at 223 – 24; Richard A. Brealey, Stewart C. Myers and Franklin Allen, *Principles of Corporate Finance* 516 – 20 (McGraw Hill/Irwin 8th ed. 2006); Tim Koller, Marc Goedhart and David Wessels, *Valuation: Measuring and Managing the Value of Companies* 312 – 13 (John Wiley & Sons, Inc. 4th ed. 2005); Shannon, P. Pratt, *Cost of Capital – Estimations and Applications* 83 – 85 (John Wiley & Sons 2nd ed. 2002).

[312] Bourassa COC Rj. at 8 (Staff unadjusted cost of equity of 10.3% less 50 basis points). It should be noted that Mr. Bourassa's financial risk adjustment, 100 basis points, is larger than Staff's corrected risk adjustment using the Hamada formula because that formula is related to the CAPM result. Staff's final CAPM estimate is 10.6 percent, while Mr. Bourassa's final CAPM estimate is 12 percent. *See* Manrique Sb. at Schedule JCM-3; Bourassa COC Rb. at Schedule D-4.13. Consequently, the correct adjustment using Staff's CAPM inputs is lower than Mr. Bourassa's adjustment.

However, as Mr. Bourassa explained, even if Staff's erroneous use of the Hamada formula error is corrected, the Company's cost of equity will still be too low.[313] Mr. Manrique has assumed that RRUI's risk is accurately estimated by the average beta of the sample water utilities. As discussed above, RRUI's small size, lack of liquidity and the additional risk created by Arizona's particular ratemaking system must be considered, in addition to RRUI's capital structure.[314]

For example, SJW Corporation ("SJW') owns San Jose Water, which provides water service to 226,000 customers in the San Jose, California area and to another 8,700 customers in Texas, in addition to owning several commercial buildings and providing certain non-regulated services.[315] Revenues for SJW exceeded $220 million in 2008, and its net plant exceeded $490 million at the end of 2008.[316] Put simply, no rational investor would regard RRUI as having the same level of risk as SJW. As Mr. Rigsby, stated, investors look at the underlying "fundamentals" of the firm in evaluating whether to invest.[317] Mr. Manrique agreed, testifying that there are "many pieces of information that an investor would look at."[318] Yet, according to Staff, SJW, with a beta of 0.95, would be regarded as having significantly more risk than RRUI, with an assumed beta of 0.79. Using Staff's CAPM inputs but substituting SJW's beta produces an indicated cost of equity of 12.0 percent – 140 basis point greater than the 10.6 percent CAPM estimate for RRUI.[319]

The bottom line is that it is one-sided and arbitrary to compare RRUI's capital structure to that of the proxy group while ignoring other differences which investors

---

[313] Bourassa COC Rb. at 11 – 13.
[314] *See, e.g.*, Tr. at 1079 – 80.
[315] Ex. A-23 (final page).
[316] Bourassa COC Dt. at 18.
[317] Tr. at 945 – 46, 955.
[318] Tr. at 1062.
[319] See Manrique Sb. at Schedule JCM-3.

would consider in determining whether to invest in the Company. As Mr. Manrique explained, "investors have a wide selection of stocks to choose from, [and] they will choose stocks with similar risks but higher returns."[320] Nevertheless, Staff has ignored all firm-specific risks associated with RRUI but one, and has assumed that an equity investment in RRUI is less risky than owning common stock in a much larger publicly traded utility. This violates both the attraction of capital and comparable earnings standards.

3. RUCO's Cost of Equity Estimates.

a. RUCO's Water Industry Group Is Flawed.

In estimating the cost of capital, Staff has consistently used, and the Commission has consistently approved the use of, the same six publicly traded water utilities as its industry sample group in determining the cost of equity in water and wastewater utility rate cases, including RRUI's prior rate case.[321] Those utilities are American States Water, Aqua America, California Water Service, Connecticut Water Service, Middlesex Water Company and SJW Corporation.[322] Those utilities were used by both Mr. Manrique and Mr. Bourassa in this case. RUCO, in contrast, used different proxy utilities, eliminating Connecticut Water Service, Middlesex Water Company and SJW Corporation, and substituting Southwest Water Company. Southwest Water, however, is not comparable to Chaparral City or to the publicly traded water utilities in Staff's proxy group.

First, less than 50 percent of Southwest Water's revenues are derived from regulated activities, while the other three utilities on average derive nearly 89 percent of

---

[320] Manrique Dt. at 7.

[321] Decision No. 67279 at 11 – 12; Ex. A-25. *See also, e.g., Arizona Water Co. (Western Group)*, Decision No. 68302 (Nov. 14, 2005) at 32 n.11; *Black Mountain Sewer Corp.*, Decision No. 69164 (Dec. 5, 2006) at 24, n. 9; *Arizona-American Water Co. (Sun City and Sun City West Wastewater Districts)*, Decision No. 70209 (March 28, 2008) at 27; *Chaparral City Water Co.*, Decision No. 68176 (Sept. 30, 2005) at 18, n. 4.

[322] *Id.*

revenues from regulated activities.[323] Staff would exclude Southwest Water on that basis alone.[324] Further, Southwest Water is a financially distressed utility. For example, the equity returns for the years 2004, 2005, 2006, 2007, and 2008 have been 3.6%, 5.0%, 5.6%, 3.2%, and 0.8%, respectively.[325] Also, Value Line reports that the Company has been delinquent in filing its SEC reports because of errors made in reporting depreciation rates of assets gained through acquisitions and accounting issues for revenues and related costs for water and sewer taps.[326] As Mr. Bourassa explained, these mistakes have skewed year-over-year results.[327] In addition, Value Line reports that the Company's dividends have been reduced from $0.24 to $0.13, which indicates severe cash flow problems.[328] Given these problems, it is not surprising that Southwest Water has a weak financial strength rating of C++, while the other three utilities in Mr. Rigsby's water proxy group have financial strength rating of B+.[329]

Given this evidence, Southwest Water should not be used to estimate the cost of equity for RRUI. It is axiomatic that utilities (or other companies) in a financially sick condition should not be used for comparison purposes in determining the cost of equity.[330] In fact, Mr. Rigsby himself excluded Southwest Water from his sample in the pending Arizona Water Company rate case because Value Line had suspended all projections and estimates for that utility due to accounting and financial statement reporting errors.[331] Southwest Water should not be used as a proxy in this case, either.

---

[323] Bourassa COC Rb. at 31.

[324] Tr. at 1067 – 68.

[325] Ex. A-23.

[326] Value Line Ratings and Reports, October 23, 2009 (Rigsby Dt., Attachment A).

[327] Bourassa COC Rb. at 32.

[328] Ex. A-23.

[329] *Id.*

[330] *Sun City Water Co.*, 26 Ariz. App. 304, 310, 547 P.2d 1104, 1110 (1976), *vacated on other grounds,* 113 Ariz. 464, 556 P.2d 1126 (1976) ("Companies which are used for comparison purposes must be successful and not in a financially sick condition.").

[331] Direct Testimony of William A. Rigsby on Cost of Capital, Docket No. W-01445A-08-0440 (June 12, 2009), at 19.

b. RUCO's Gas Utility Sample Group Is Not Comparable and Should Not Be Used.

RUCO has proposed the use of a sample group of 10 gas distribution utilities. However, these utilities are not comparable to the Company. RUCO's water utility sample has an average beta of 0.83, while RUCO's gas utility sample has an average beta of 0.67.[332] As discussed above, beta is "a useful, simple, objective measure of risk when used to gauge the relative risks of securities."[333] Therefore, the water industry sample has significantly more market risk than the gas industry sample, and cannot be used to estimate the Company's cost of equity unless an adjustment is made to account for the difference in risk, as Staff did in Arizona Water Company's Eastern Group rate case.[334] It is improper to simply average the cost of equity estimates, as RUCO proposes in this case.[335]

At the time of the Arizona Water rate case, the average beta of the gas utility sample was 0.69 and the average of the water utility sample was only 0.59.[336] Staff estimated that the equity costs for the sample gas utilities and sample water utilities were 10.3% and 9.2%, respectively.[337] Thus, the average cost of equity for the two groups was 9.8%. Consequently, if RUCO's approach had been used, Arizona Water's authorized return on equity would have been 9.8% rather than 9.2%.

Instead, Staff performed a CAPM analysis, and determined that the cost of equity for the gas utilities was approximately 100 basis points higher than the sample water

---

[332] Rigsby Dt. at Schedule WAR-7, at 2.

[333] *Morin* at 153. *See also id.* at 400-02 (discussing use of beta as a risk measure to develop an appropriate proxy group of firms with comparable investment risk), 407 – 10 (same).

[334] *Arizona Water Co. (Eastern Group)*, Decision No. 66849 (March 19, 2004) at 21.

[335] *See* Rigsby Dt., Schedule WAR-1 at 3 (showing Mr. Rigsby's calculation of the cost of equity).

[336] *See* Direct Testimony of Joel M. Reiker, filed July 8, 2003 in Docket No. W-01445A-02-0619 ("Reiker Dt."), at 26, Schedule JMR-5 and Schedule JMR-16. As previously explained, the water industry has become far more risky for investors, and therefore has a significantly higher cost of equity. *See* Ex. A-23.

[337] Decision No. 66849 at 21.

utility group based on the difference in market risk (i.e., the average betas for each industry).[338] Therefore, Staff argued that its estimate of the gas utilities' cost of equity "would require a *significant downward adjustment*" to make the two groups comparable.[339] As a result, the indicated cost of equity based on the gas utilities was approximately the same as the water utility group, and the Commission disregarded the gas utilities in setting Arizona Water's return on equity.[340]

In this case, the average beta of RUCO's gas utility sample group is 0.67, while the average beta of Staff's customary water utility sample group is 0.79 and therefore has far greater investment risk.[341] Therefore, a significant <u>upward</u> adjustment to the cost of equity for the gas utility sample group is needed to account for the difference in market risk. As shown by Mr. Bourassa, this upward adjustment should be 120 basis points.[342] Given this risk differential, it is improper and result-driven to simply average the gas utilities' equity cost with the water utilities' equity cost to lower the cost of equity for RRUI, as Mr. Rigsby has done. This error assumes that a typical gas utility currently has the same investment risk as a typical water utility, which is clearly not the case at the present time.

c. <u>**RUCO's CAPM Estimates Are Ridiculously Low and Must Be Disregarded.**</u>

Perhaps the most remarkable testimony in this case is RUCO's assertion that its CAPM estimates produce a reasonable estimate of the current cost of equity. Three out of four of Mr. Rigsby's CAPM estimates as well as his average CAPM estimate are at or

---

[338] Staff estimated that the cost of equity for the gas utilities was 10.4% using the CAPM, while the cost of equity for the water utilities was 9.4% – a difference of 100 basis points. *See* Reiker Dt. at Schedules JMR-7 and JMR-18.

[339] Reiker Dt. at 26 (italics original). *See also* Decision No. 66849 at 21.

[340] Decision No. 66849 at 21 – 23.

[341] Tr. at 1073 – 74.

[342] Bourassa COC Rb. at 34 – 35.

below the current cost of Baa investment grade bonds.[343] The following are the results produced by the particular methods and inputs used by Mr. Rigsby:

Geometric mean CAPM estimate - water companies	5.72%
Arithmetic mean CAPM estimate - water companies	7.29%
Geometric mean CAPM estimate - gas companies	5.05%
Arithmetic mean CAPM estimate - gas companies	6.32%
Average	6.10%[344]

Yet, according to Mr. Rigsby, the current yield on Baa utility bonds is approximately 6.35 percent.[345]

It is axiomatic that the cost of equity is higher than the cost of debt. For example, Dr. Morin, in his textbook on regulatory finance, explains:

> [S]ince investors in stocks take greater risk than investors in bonds, the former expect to earn a return on a stock investment that reflects a "premium" over and above the return they expect to earn on a bond investment. This is because the return on equity, being a residual return, is less certain than the yield on bonds and investors must be compensated for this uncertainty. The equity premium compensates stock investors for the additional risk they bear in making stock versus bond investments.[346]

Because Mr. Rigsby's CAPM estimate, 6.10 percent, is below the yield on investment grade bonds, it should not be considered.

There are a number of conceptual errors that lead to RUCO's absurdly low CAPM estimates. First, Mr. Rigsby's used a geometric mean (average) to estimate the market risk premium in the CAPM. In contrast, both the Company and Staff used an arithmetic average in determining the historic market risk premium in the CAPM, not a geometric

---

[343] Bourassa COC Rb. at 42.
[344] Rigsby Dt., Schedule WAR-1 at 3.
[345] Tr. at 937.
[346] *Morin* at 108.

average.[347] In his rebuttal testimony, Mr. Bourassa explained why an arithmetic mean (average) should be used to forecast what may happen in the future, i.e., the investor-expected return on equity.[348] Mr. Rigsby himself testified in RRUI's previous rate case that "the consensus among financial analysts is that the arithmetic mean appears to be the better of the two averages."[349]

Attached to Mr. Bourassa's rebuttal testimony as Exhibit TJB-COC-RB3 is an excerpt from Dr. Roger Morin's textbook on regulatory finance, which provides an in depth analysis of the differences between the two types of averages and how they should be used, citing numerous authorities.[350] In short, while geometric averages provide a useful way to compare the past performance of assets, they fail to capture future volatility (i.e., risk). As a result, geometric averages understate the required future return on an investment in a risky asset, and therefore depress the cost of equity.

Second, Mr. Rigsby has ignored current market risk, which, as previously discussed, affects the cost of equity.[351] The Commission has consistently approved the use of a current market risk premium in implementing the CAPM in water and wastewater utility rate cases. For example, in RRUI's previous rate case, Staff used both an historic and a current market risk premium in implementing the CAPM.[352] At that time, the current market risk premium was only 4.6 percent, which produced a CAPM estimate that was 170 basis points less than Staff's CAPM estimate using an historic market risk premium and lowered the cost of equity estimate.[353]

---

[347] Bourassa COC Dt. at 33 – 35 (explaining how the market risk premium was determined); Manrique Dt. at 28 – 29 (same); Tr. at 1061 – 64.
[348] Bourassa COC Rb. at 36 – 37.
[349] Ex. at 26 (internal page number).
[350] *Morin* at 133 – 43.
[351] Bourassa COC Rb. at 39 – 42.
[352] Ex. A-25.
[353] *Id.*

In Black Mountain Sewer Corporation's rate case, filed in 2005, the Commission relied on the current market risk premium in approving Staff's recommended 9.6 percent cost of equity.[354] In that case, interest rates and the average beta of the sample group were higher than in RRUI's previous rate case, and although the result produced by Staff's models was higher, the increase was not as large as would be expected.[355] The reason was that the current market risk premium was only 5.7 percent, reducing the result produced by the CAPM. Thus, while interest rates increased and the investment risk of the water industry sample had increased, Staff explained that those increases were offset by a decline in the current market risk premium, indicating that the overall risk of the market had declined.[356]

In this case, Mr. Bourassa and Mr. Manrique developed their CAPM estimates using both an historic and a current market risk premium.[357] Just as current spot stock prices and analysts' forecasts should be used in implementing the DCF, consideration of the premium for market risk currently required by investors is necessary to obtain an accurate, forward-looking CAPM estimate. Indeed, Mr. Rigsby has acknowledged the importance of considering current market conditions in determining the cost of equity:

> Consideration of the economic environment is necessary because trends in interest rates, present and projected levels of inflation, and the overall state of the U.S. economy determine the rate of return that investors earn on their invested funds. Each of these factors represent potential risks that must be weighed when estimating the cost of equity capital for a regulated utility and are, most often, the same

---

[354] *Black Mountain Sewer Corporation*, Decision No. 69164 (December 5, 2006).

[355] In the Black Mountain case, the intermediate-term Treasury used by Staff in its CAPM was 4.8 percent, while the average beta of Staff's sample group was 0.74. Surrebuttal Testimony of Pedro M. Chaves, filed May 4, 2006 in Docket No. SW-02361A-05-0657, at Schedule PMC-2. In RRUI's prior case, in contrast, the intermediate-term Treasury used by Staff in its CAPM was 3.5 percent, while the average beta of Staff's sample group was 0.62. Ex. A-25.

[356] Decision No. 69164 at 25 – 26.

[357] Bourassa COC Dt. at 33 – 35 (discussing CAPM market risk premiums); Manrique Dt. at 28 – 29 (same).

> factors considered by individuals who are also investing in non-regulated entities.[358]

Therefore, RUCO's use of two <u>historic</u> market risk premiums (one of which is conceptually wrong for the reasons given previously) without considering the impact of <u>current</u> market risk on investor expectations invalidates RUCO's CAPM estimate.

Mr. Rigsby has made several other conceptual errors that depress his CAPM estimate. He used a 5-year U.S. Treasury yield as his risk-free rate, which is conceptually incorrect.[359] As Dr. Morin states:

> At the conceptual level, because common stock is a long-term investment and because cash flows to investors in the form of dividends last indefinitely, the yield on very long-term government bonds, namely the 30-year Treasury bonds, is the best measure of the risk free rate for use in the CAPM and risk premium methods. The expected stock return is based upon long-term cash flows, regardless of an individual's holding period. Utility asset investments generally have long-term useful lives and should be correspondingly matched with longer-term maturity financing instruments. Moreover, short-term Treasury bill yields reflect the impact of factors different from those influencing the yields on longer term securities such as common stock.[360]

Currently, the difference in yields between a 5-year U.S. Treasury and a 30-year U.S. Treasury is over 100 basis points.[361] Thus, this error depressed his CAPM estimate.

Mr. Rigsby also incorrectly used the U.S. Treasury <u>total</u> returns rather than income returns in calculating the market risk premium.[362] The income return is the portion of the total return that results from the bond's periodic cash flow, i.e., the interest payments.

---

[358] Rigsby Dt. at 38 – 39.

[359] Bourassa COC Rb. at 38 – 39.

[360] *Morin* at 151 – 152.

[361] Bourassa COC Rb. at 39. Mr. Manrique used the correct long-term Treasury spot yield in his CAPM estimate using the current market risk premium, but improperly used the average spot yield on 5-, 7- and 10-year Treasuries as the risk free rate in his other CAPM estimate. *See* Manrique Dt. at 27 – 28. This error depressed Staff's CAPM estimate.

[362] Bourassa COC Rb. at 37 – 38. As Mr. Bourassa explained in his direct testimony, the market risk premium is calculated by subtracting the risk-free rate from the market return. Bourassa COC Dt. at 29.

The income return provides an unbiased estimate of the riskless rate of return because an investor can hold the Treasury security to maturity and receive fixed interest payments with no capital loss or capital gain. If the total return on a Treasury security is used instead, additional risk is injected into the CAPM estimate, which is inconsistent with treating the security as a riskless asset.[363] This error, again, depressed the equity cost produced by the CAPM.[364]

As a consequence of these errors, Mr. Rigsby's CAPM estimate dramatically understates the cost of equity, producing a result that is less than the cost of debt.[365]

4. **<u>RUCO's Hypothetical Capital Structure Is Unfair and Conflicts With Prior Commission Decisions</u>.**

a. **<u>Introduction</u>.**

RUCO has proposed the use of a hypothetical capital structure consisting of 40 percent debt with an interest rate of 6.26 percent and 60 percent common equity with a cost of 9.0 percent. According to Mr. Rigsby, the interest rate of the hypothetical debt – which, ironically, is higher than the cost of equity produced by his CAPM – is the cost of the outstanding debt issued by a different group of publicly traded water utilities and is slightly below the yield on investment grade utility bonds.[366] Mr. Rigsby explained that RRUI's parent should be able to procure debt financing at a cost equivalent to an A-rated or Baa-rated firm for the utility.[367] In effect, therefore, the utility's equity investor would be required to furnish debt financing, which dramatically increases RRUI's relative

---

363 Bourassa COC Rb. at 38 (quoting *Ibbotson SBBI 2009 Valuation Yearbook* 75-76).

364 *Id.*

365 In addition, Mr. Rigsby's DCF estimate is flawed because of the method used to estimate future dividend growth. As Mr. Bourassa explained, the particular data used to estimate expected growth is subjective and cannot be replicated. Bourassa COC Rb. at 48.

366 Rigsby Dt. at 55 – 56; Tr. at 937.

367 *Id.* at 56.

investment risk, as the shareholders of the proxy utilities are not required to procure loans for the utility as a condition of owning common stock.[368]

RUCO's rationale for imposing a fictitious capital structure on RRUI is twofold. First, Mr. Rigsby asserted that RRUI's capital structure is not "in line with industry averages" (even though no industry-wide average has been provided) and "the cost of equity derived from [Mr. Rigsby's] DCF analysis is applicable to companies that are more leveraged and, theoretically speaking, riskier than a utility such as RRUI."[369] Thus, the use of a hypothetical capital structure is intended to be a substitute for the Hamada formula, which, as Mr. Manrique explained, is the method Staff normally uses to adjust the cost of equity based on financial risk in order to fairly balance the interests of the utility and ratepayers.[370]

Second, and far more troubling, the hypothetical capital structure is intended to penalize RRUI for its capital structure by artificially lowering its operating expenses through fictional interest expense that is used to re-calculate income taxes.[371] The fictional interest expense imputed to RRUI totals nearly $250,000, thereby artificially reducing income tax expense by that amount.[372]

The overall impact of RUCO's approach is dramatic. Although Mr. Rigsby's recommended return on equity is 9.0 percent, the WACC produced by the hypothetical capital structure, which contains 40 percent debt at an interest rate of only 6.26 percent, is 7.9 percent – the same result produced by simply averaging Mr. Rigsby's DCF and CAPM estimates.[373] Putting aside this remarkable coincidence, the impact of imputing almost $250,000 of fictional interest expense reduces the effective return on RRUI's

---

[368] Tr. at 1077.
[369] *Id.* at 53, 54.
[370] Tr. at 1095 – 96.
[371] Rigsby Sb. at 20 – 21.
[372] Bourassa COC Rb. at 45.
[373] Rigsby Dt., Schedule WAR-1 at 1, 3.

equity to only 6.9 percent.[374] Thus, the implied financial risk adjustment based on Mr. Rigby's recommendations is actually a negative 210 basis points (9.0% – 6.9%).[375] In contrast, the Hamada formula produces a downward adjustment of 60 basis points using Mr. Rigsby's CAPM inputs, while in RRUI's prior rate case, Mr. Rigsby proposed a downward adjustment of 21 basis points to account for RRUI's lack of debt.[376]

Put bluntly, RUCO's hypothetical is simply a sleight of hand intended to lower RRUI's rate of return and produce lower rates. As explained below, with one exception, the Commission has never approved this sort of result-driven approach, and the exception must be regarded as an outlier given that the Commission failed to reconcile its decision with the evidence in the record or explain why it rejected the Hamada formula in the face of prior decisions involving the same issue.

b. In Many Instances, No Downward Adjustment to the Equity Return Has Been Made.

In a number of recent rate cases involving Arizona water and wastewater utilities, the Commission has not reduced the utility's cost of equity for financial risk even though the utility's capital structure contained a higher percentage of equity than the water utility proxy companies. In Black Mountain Sewer Corporation's 2006 rate case, for example, Staff recommended the use of the utility's actual capital structure, which contained 100 percent equity and no debt, while RUCO recommended a hypothetical capital structure containing 57 percent equity and 43 percent debt.[377] RUCO's rationale for using a hypothetical capital structure was the same rationale RUCO has provided in this case, i.e., to account for lower financial risk.[378] The Commission squarely rejected RUCO's

---

[374] Bourassa COC Rb. at 45.
[375] *Id.*
[376] Bourassa COC Rb. at 45; Tr. at 977.
[377] Ex. R-1 at 19 – 20.
[378] Direct Testimony of William A. Rigsby, filed March 9, 2006 in Docket No. SW-02361A-05-0657, at 52.

recommendation for Black Mountain, stating: "We believe RUCO's hypothetical capital structure recommendation is results oriented and is not consistent with the Company's actual capital structure."[379] The Commission instead used the utility's actual capital structure, and found that an equity return of 9.60 percent based on that capital structure was reasonable and satisfied due process requirements.[380] Notably, no downward adjustment was made to Black Mountain's return on equity.

In other recent cases, no downward adjustment to cost of equity was authorized. For example, in Arizona Water Company's Western Group case, the utility had a capital structure containing over 73 percent equity, and no adjustment to the cost of equity was made.[381] In a prior case for the same utility, the percentage of debt in the capital structure was again greater than the average of the water proxy group, and no adjustment was made. In fact, in that case, Staff's 20 basis point downward adjustment for financial risk was rejected.[382] In Chaparral City Water Company's recent rate case, the Commission found that the utility's capital structure was reasonable, despite the fact that it contained 76 percent equity.[383] RUCO's position in this case is not consistent with prior Commission decisions and is arbitrary and result-driven.

c. **When an Adjustment Has Been Made to Reflect Financial Risk, the Commission Has Approved the Hamada Formula.**

As discussed above, in order to estimate the impact of the lack of leverage on investment risk, the Company and Staff used the Hamada formula, which decomposes the

[379] Ex. R-1 at 20 (emphasis supplied).
[380] *Id.* at 26.
[381] *Arizona Water Co. (Western Group)*, Decision No. 68302 (November 14, 2005) at 30, 34 – 36.
[382] *Arizona Water Co. (Eastern Group)*, Decision No. 66849 (March 19, 2004) at 23 – 24, (66.2 percent common equity).
[383] Tr. at 1025 – 26.

beta (representing the total risk) into separate business risk and financial risk components. As summarized by Dr. Morin:

> The important issue here is that beta is a measure of the systematic risk of the levered equity of the proxy firms, and these proxy companies will often employ leverage different from that used by the [utility] for which the cost of equity is being measured. If we assume that the proxy companies are considered comparable in every way except for capital structure, their betas are not directly comparable. To circumvent this difficulty, the observed "levered" betas of the proxy firms must be "unlevered" in order to isolate their peer business risk component, and then "relevered" using the [utility's] own target capital structure. The unlevering of the company betas removes the effect of financial risk to focus on the pure business risk component of the pure-play companies. The relevering of the pure business risk betas accounts for the [utility's] own financial leverage.[384]

As Mr. Manrique explained, this is the method normally used by Staff when it proposes an adjustment for financial risk.[385] In Staff's opinion, this method properly balances the interests of both the utility and ratepayers, and avoids the need to impute fictional interest expense to the utility at a cost that is speculative.[386]

The Commission has approved this method on a number of occasions. For example, in a recent rate case for Arizona-American Water Company's Paradise Valley District, the Commission adopted Staff's 10.4 percent return on common equity, which included an upward adjustment of 50 basis points to account for the high percentage of debt in that utility's capital structure.[387] In approving this approach, the Commission explained: "RUCO and Staff appropriately addressed the Company's higher debt ratio by the generally accepted regulatory means of accounting for financial risk, adding basis

---

[384] *Morin* at 222. Of course, the proxy water utilities are not "comparable in every way" to RRUI. Consequently, an adjustment must be made to account for RRUI's additional business risk, as previously explained.

[385] Tr. at 1077, 1082 – 83.

[386] Tr. at 1082, 1096 – 97.

[387] Decision No. 68858 (July 28, 2006) at 28 (Ex. A-27).

points to the results of their CAPM and DCF analyses."[388] Notably, in that case, Mr. Rigsby "added 50 basis points to his cost of equity estimate to account for the increased financial risk faced by Arizona-American as a result of the Company's debt-heavy capital structure," just as he did in Arizona-American's prior rate case, decided in 2004.[389]

More recently, in Arizona-American's rate case for its Sun City and Sun City West Wastewater Districts, Staff relied on the Hamada formula to calculate a financial risk adjustment of positive 80 basis points, which was added to Staff's cost of equity estimate, resulting in a 10.6 percent cost of equity.[390] Mr. Rigsby added 50 basis points to his cost of equity estimate to adjust for Arizona-American's greater leverage, as well as proposing a hypothetical capital structure containing more equity and less debt.[391] The Commission again determined that "Staff appropriately addressed the Company's financial risk by the generally accepted regulatory means of adding basis points to the cost of equity analysis."[392]

To the extent an adjustment for financial risk is found necessary – and as explained, in many instances (such as the Black Mountain case) it has not been, the Commission should adhere to its precedent and employ the Hamada formula. Other than wishing to lower RRUI's revenues and deprive RRUI of an opportunity to actually earn a fair return on equity, RUCO has provided no legitimate basis to depart from "the generally accepted regulatory means" for accounting for differences in financial risk in setting rates in this case, and certainly no basis to impute a capital structure containing 40 percent debt to RRUI, and thereby reduce RRUI's return on equity by 210 basis points.

---

[388] *Id.*
[389] *Id.* at 25.
[390] *Arizona-American Water Co.*, Decision No. 70209 (March 20, 2008) at 29 (excerpt included in Ex. A-28).
[391] *Id.* at 26 – 27.
[392] *Id.* at 30.

d. <u>The Gold Canyon Decision Is an Outlier that Conflicts With Commission Precedent and Has Been Appealed</u>.

RUCO's primary authority for proposing a hypothetical capital structure is the Gold Canyon Sewer Company decision. That decision, however, is an outlier that cannot be squared with previous Commission decisions, including the Black Mountain decision discussed above. Moreover, the decision is presently on appeal to the Arizona Court of Appeals.[393] Accordingly, it should be ignored in this case.

In Decision No. 69664, the Commission approved new rates for Gold Canyon, under which the residential rate for service increased by more than 70 percent.[394] In that decision, the Commission adopted the recommendation of Staff, which adjusted the cost of equity downward by 100 basis points using the Hamada formula to reflect the absence of debt in GCSC's capital structure.[395] On rehearing, however, the Commission adopted RUCO's proposed "hypothetical" capital structure consisting of 40 percent debt and 60 percent equity, rather than using GCSC's actual capital structure.[396] Unfortunately, the Commission gave no explanation for departing from its previous decisions.[397] The Commission ignored the Black Mountain decision, in which RUCO's arguments were rejected as "results driven," as well as the recent Commission decisions which specifically approved the use of the Hamada method to reflect financial risk.

Under these circumstances, the best way to make sense out of the Gold Canyon rehearing decision is to regard it as an outlier in which the evidence in the record and prior agency decisions were ignored in order to lower that utility's rates. This view is

---

[393] *Gold Canyon Sewer Co. v. Ariz. Corp. Comm'n,* Nos. 1 CA-CC 09-0001 and 1 CA-CC 09-0002 (Consolidated).
[394] *Gold Canyon Sewer Co.*, Decision No. 69664 (June 28, 2007).
[395] *Id.* at 24 – 25.
[396] Ex. R-7 at 14.
[397] *Id.* at 9 – 14.

supported by then-Commissioner Hatch-Miller's explanation for his vote at Open Meeting:

> This is a faulty, it is a faulty order. The only reason we are doing it is to lower the rates somehow and try and find a way to do it. It is not, we are not using any real math here or any kind of real process. We are just trying to drive the rates down. But, you know, the only reason we are here today is because this Commission sat on a Staff meeting and decided as a group we were going to, we were going to hear RUCO's arguments. We wouldn't be here if we didn't decide that. The Commission was the one that said, okay, let's give them a shot, let's rehear it. And that's why we are here. We did rehear it, went through a long process, basically blew off the Judge's and the Staff's opinion on how to do it, came up with some new numbers and drove the rates down 6 or 7 bucks. That was the outcome they were seeking. It was a faulty order, problematic order, don't even know if it is right on. But that's the result we wanted, so I will vote aye.[398]

The bottom line is that an outlier is not precedent, particularly when the Commissioners themselves regarded the decision as "faulty" and "problematic." Therefore, the Gold Canyon decision should be ignored.

In sum, RUCO has provided no legitimate reason for departing from established precedent, which supports the use of the Hamada formula to account for financial risk. RUCO's proposed hypothetical capital structure should be rejected.

V. <u>RATE DESIGN</u>.

A. <u>Brief Summary of Rate Design Recommendations</u>.

The Company proposes to use the existing rate designs for both the water and wastewater divisions. For the water division, Mr. Bourassa used the existing inverted three-tier rate design for the 5/8-inch customers, which customers account for 95 percent of the Company's water utility ratepayers.[399] Mr. Bourassa also retained the two-tier

---

[398] *Gold Canyon Sewer Co.*, Docket No. SW-02519A-06-0015, open meeting transcript (November 13, 2008) at 221.

[399] Company Final Schedule H-2, pages 1 and 2 (water). *See also* Bourassa Rb. at 35:10-13.

commodity for the few larger residential customers and all commercial and industrial ratepayers. The Company has also retained the same break over points used in the existing rates for the 5/8-inch meter class, but scaled the remaining classes in response to Staff's proposed rate design for the water division.[400] Staff and RUCO also propose inverted block rate designs for the water division.[401] On the wastewater side, all parties recommend the same rate design for the Company's wastewater divisions and all parties spread their respective recommended revenue increases evenly across all customer classes.[402]

RRUI has also proposed new, low-income tariffs and new hook-up fee tariffs or HUFs for both divisions. All parties generally support the low-income tariff, although there are some areas of debate between Staff and the Company. Staff and RUCO, joined by the intervener RRPI, oppose approval of the HUFs.

B. <u>Rate Design Should Not Be About Revenue Shifting</u>.

Inverted tier rate designs are not based on cost of service; they are conservation oriented.[403] The purpose is to encourage water conservation by making larger users pay more for water. The theory is that the commodity is precious and those that use more of it must pay more for it. Unfortunately, Staff uses the inverted tier rate design to discount water service for the residential customers by creating a subsidized lower tier.[404] Although Staff steadfastly denies this, it is easily illustrated.[405]

---

[400] Bourassa Rb. at 33:1-10.
[401] Tr. at 902:2-5.
[402] Bourassa Rb. at 39:10-14; Tr. at 901:24 – 902:1. The Company also addressed using a volumetric charge for sewer in its direct filing as required by Decision No. 67279. Bourassa Dt. at 29 – 35.
[403] Bourassa Dt. at 36:3-4.
[404] Bourassa Rb. at 34:15-20.
[405] Staff did not challenge Mr. Bourassa's rebuttal or rejoinder testimony criticizing Staff's rate design, question him at trial or present any evidence to the contrary.

First, despite recommending an overall rate increase of 57 percent, Staff increases the first tier rate by only $.06 for the 5/8 inch customers by only 4 percent.[406] Minimizing the increase to the residential customers is accomplished by passing along more of the revenue requirement to the commercial and industrial customers. This is why, under Staff's rate design, the 5/8 inch residential customers will experience only a 49 percent increase, despite Staff's recommended 57 percent increase, while the commercial and industrial customers experience increases in the range of 57 to 70 percent.[407] In other words, Staff provides more revenue from the non-residential classes than under present rates, i.e., it shifts revenues.

Second, Staff generally recommends that as much as 40 percent and no less than 30 percent of the revenue come from the fixed or minimum charge. Under the Company's existing rates, roughly 29.6 percent of RRUI's revenues come from the fixed charge.[408] Under Staff's recommended rates, 28.8 percent of the revenue would come from the fixed charge. This furthers the subsidy of residential users by the larger commercial customers and puts the Company's revenues at greater risk.[409]

Third, Staff's revenue shift is illustrated by comparison of the revenues from monthly minimum to the revenues from the first tier commodity rates. Under present rates, approximately 34.6 percent of revenues are recovered from these two components of metered revenues. Under Staff's rate design, this percentage drops to about 33.2 percent.[410]

Staff will likely claim that its rate design ensures that non-discretionary water levels are not overpriced. But the purpose of a low income tariff is to ensure that those

---

[406] Bourassa Rb. at 34:3-14.
[407] *Id.* at 34:15 – 35:13, Exhibits TJB-RB2 and TJB-RB3.
[408] Bourassa Rb. at 36:1-16.
[409] *Id.* at 36:6-8, 14 – 16.
[410] *Id.* at 36:17 – 37:3 and Exhibit TJB-RB4.

who cannot afford water can pay for it. A low income tariff is not intended to be a water conservation oriented rate design, especially when the price of this lifeline rate is a subsidy by commercial and industrial customers and revenue instability for the utility.

C. <u>Low Income Tariff – Water and Wastewater.</u>

RRUI has proposed a low-income tariff.[411] The proposed low income tariff is modeled after the one approved by the Commission in the most recent Chaparral City Water Company rate case, which in turn, modeled its low income tariff after one used by its affiliate in California, Golden States Water Company which serves several hundred thousand customers.[412] This is the same form of low income tariff proposed in each of the pending rate cases for Liberty Water's utilities. The Company provided specific detail regarding the requirements for qualification, notification of program availability, recording and reporting, and cost recovery.[413] Regarding the latter, Staff's assertion that the administrative fee is a "profit center" is disappointing.[414] For starters, low income tariffs do not benefit the utility or its shareholders, they are for the ratepayers.[415] Furthermore, the fees are structured exactly like the one approved by the Commission for Chaparral City, it is based on the WACC plus a small margin for added administrative costs and is unlikely to even make the utility whole, even if the full amount of the Low Income Assistance Charge is actually collected.[416] Again, this was explained in detail in the Company's direct filing and at trial.[417]

On the other hand, Staff has made two suggestions for modifying the low income tariff that RRUI agrees to in this case. First, Staff recommends participation caps, which

---

[411] **Brief Exhibit 2**. *See also* Sorensen Dt. at 9 – 10; Application at Attachment 1.
[412] Bourassa Dt. at 18:2-6.
[413] *Id.* at 18 – 20; Tr. at 100 – 104.
[414] Tr. at 919.
[415] *Id.* at 103:22 – 104:4.
[416] Rejoinder Testimony of Greg Sorensen ("Sorensen Rj.") at 3:11-22.
[417] Bourassa Dt. at 19:7 – 20:24; Tr. at 101:13 – 103:14.

the Company does not oppose.[418] Second, Staff recertification is an improvement the Company endorses, even though it will likely increase the administrative costs.[419]

D. Hook-Up Fee Tariff – Water and Wastewater.

1. Staff's and RUCO's Opposition to the Hook-Up Fees Should Be Disregarded.

The Company has proposed hook-up fee tariffs for both of its divisions.[420] HUF tariffs are a common way for regulated water and sewer utilities to raise zero cost capital, which can be used to offset the cost of off-site plant, including water supply and wastewater treatment capacity. The Company views HUF tariffs as critical to ensuring that rates remain within a reasonably acceptable range.[421] This follows from the fact that HUFs, especially when combined with use of main extension agreements, ensure that developers – not utilities and ratepayers – take the build-out risk associated with new development.[422] The proposed HUF is entirely consistent with a "growth pays for growth" philosophy.[423] Therefore, it is not surprising that the developer RRPI opposes the HUF, since it has every incentive to have someone else pay for growth. Staff and RUCO's opposition to a traditional means of financing off-site plant, however, is surprising.

RUCO's opposition to the proposed HUF tariffs is focused on language in the proposed tariffs regarding when a HUF payment is recorded as CIAC.[424] RRUI's proposed HUFs are consistent with the NARUC definition of CIAC, which states that a

---

[418] Sorensen Rj. at 5:1-6 *referring to* Becker Sb. at 6:18-25.
[419] Sorensen Rj. at 5:7-10.
[420] **Brief Exhibit 1.**
[421] Tr. at 637:3 – 640:8; 654:19 – 655:10; Sorensen Rj. at 12:8 – 13:15. *See also* Sorensen Dt. at 10:13 – 11:25.
[422] Tr. at 677:19 – 679:12, 690:1-18.
[423] *Id.* at 656:9-15.
[424] *Id.* at 481:22-25.

HUF payment does not become CIAC until the funds are "utilized to **offset** the acquisition, improvement or construction" of utility plant or property (emphasis added).[425] Mr. Coley paid no attention whatsoever to this definition in connection with his testimony in this rate case, and therefore, he could not reconcile his arguments with what NARUC says about CIAC.[426] Instead, Mr. Coley claimed that HUF funds were CIAC because the Company will have beneficial use of the HUF fees until they are spent on plant.[427] When the Company pointed out to Mr. Coley that the HUF tariff requires all funds to be segregated in "separate interest bearing account," Mr. Coley claimed that "separate," "interest bearing" and "account" do not necessarily mean the funds would be held in a "bank" account, therefore RRUI could still use them.[428] Mr. Coley's testimony is nonsense. The Company never intended this and no reasonable person would read this language as anything but an unaffiliated "bank" account.[429] That's where HUF funds are held until used to fund plant, at which point they then become CIAC.[430]

Staff's opposition to the proposed HUFs appears to be grounded in two of its engineer's conclusions – one, that Staff does not know what facilities will be built with the HUF funds and two, that RRUI does not need a HUF tariff because it does not need additional capacity.[431] RRUI does not agree with Staff's second conclusion and has submitted evidence that suggests Staff's view is, at best, overly simplistic. Staff's first reason is insufficient basis to deny the Company this important tool for financing a portion of the total cost of capital improvements needed to serve new growth.

---

[425] Sorensen Rj. at 6:12-24 and Exhibit GS-RJ2.
[426] Tr. at 482:21 – 486:1.
[427] *Id.* at 486:8-25.
[428] *Id.* at 488:5 – 490:19.
[429] *Id.* at 620:10 – 621:3, 684:14-25. The Company would not oppose the addition of language like "third-party bank account" in case anyone else read the language the way Mr. Coley did.
[430] Sorensen Rj. at Exhibit GS-RJ2.
[431] Surrebuttal Testimony of Jian W. Liu ("Liu Sb.") at 3:5 – 4:25.

The argument that Staff needs to know exactly what will be funded may appear, at first blush, reasonable. It is not. First, the language of the proposed HUFs, like every HUF tariff the Commission approves, clearly defines the types of facilities that can be funded with HUF funds.[432] Expenditure of HUFs is limited to enumerated types of plant facilities needed to serve new service connections.[433] If Staff is claiming that it needs to know the exact plant size, type and location before a HUF can be approved, the Company is wholly unaware of any such requirement. Nor has Staff provided any support for that contention. Even worse, any such requirement would be extremely impracticable. How could such a requirement even be met? By the time a utility would know such specific details about new plant needed to service new customers, it would be too late to fund such plant construction with HUFs. The bottom line is RRUI cannot predict when and to what extent future growth will take place, nor can it know for certain what facilities will be needed to serve such growth. But the Company does know that growth should pay for itself and before the plant needs to be funded, not after.

As for Staff's conclusion that no additional capacity is needed, RRUI again disagrees. Staff's argument is flawed on several fronts. To start, Mr. Liu's conclusion is overly simplistic. In determining water supply and storage capacity, Mr. Liu considered only the Company's water use data sheets; he did not consider things like peak demand, even though he admitted the Company must consider and meet peak demand.[434] Further, it appears Mr. Liu did nothing more than perform a simple mathematical calculation to determine whether the Company needs more off-site water plant. As for the sewer side, Mr. Liu's conclusions are largely unexplained.[435] In any case, the evidence shows that RRUI is already within 20 percent of exceeding its allotted capacity in the City of

[432] **Brief Exhibit 1** at Section IV(B) (water and wastewater).
[433] *Id.*
[434] Tr. at 708:18 – 25, 711:1-5.
[435] Liu Sb. at 4:10-25.

Nogales' treatment facility, and there is no certainty how and when and at what cost additional capacity can be secured by the Company.[436]

Of course, Staff's conclusions are belied by the comprehensive system planning documents Westland Resources prepared for the Company.[437] Westland concluded that RRUI needs additional storage and supply facilities, to the point where if such capacity was not available the Company would not be able to properly operate.[438] In the end, it comes down to what is at best a difference of opinion between engineers. The Company asserts it is best to be conservative and ensure that the means of having growth pay for growth is already in place and the funds accruing so they are available to the Company when needed. Mr. Liu agrees.[439] Besides, if development does not take place, there won't likely be anyone to pay HUFs.

2. <u>RRPI's HUF Arguments Are Illusory</u>.

RRPI intervened in this rate case in order to address concerns over the proposed HUF on its "substantial" development property in the service territory.[440] RRPI is "the developer" in the Company's CC&N.[441] RRPI's witness (Mr. Rowell), however, did not and could not provide any description of the properties that have been or will be developed by RRPI in the Company's CC&N.[442] Mr. Rowell did not address the status of any development and he did not provide any evidence regarding past extension agreements or past contributions of advances of plant.[443] Rather than supporting RRPI's concerns, Mr. Rowell instead testified that he didn't even know if his client knew what

---

[436] Tr. at 667:13-18.
[437] Exs. A-20 at 15, 19, 22 – 25; and A-21 at 7, 11.
[438] *See* Sorensen Rj. at 9:21 – 12:3.
[439] Tr. at 726:4-9.
[440] Direct Testimony of Matthew J. Rowell at 1:16-20.
[441] Tr. at 568:20 – 569:4.
[442] *Id.* at 570:7 – 571:13.
[443] *Id.*

they had already done with respect to providing plant or funds for plant to the Company, nor whether such plant could be used to serve RRPI's future development.[444] How can the Company or the Commission be expected to address the impacts of the proposed HUF on RRPI or address any specific needs when RRPI cannot even tell RRUI what it has done or will do in the future? The answer is obviously that nothing can be properly addressed, which means RRPI has fallen well short of meeting any burden of proof regarding the impact of the HUF on its interests.

As for the more general concerns Mr. Rowell expressed on behalf of his client, these concerns are of little import for several reasons. First, the Company has made it abundantly clear that it does not intend to make a developer pay twice for the same facilities, whether by paying again for facilities already advanced or contributed or by charging for the same facilities under both a HUF and an extension agreement.[445] Second, the developer may provide facilities in lieu of HUFs.[446] Third, and finally, Mr. Rowell's fears over the Company having too much CIAC and not making investment are unfounded.[447] The record is replete with references to RRUI's access to capital through its shareholder, and Liberty Water already has a substantial track record of plant investment in the state. In sum, Mr. Rowell confuses the Company's desire to balance the total capitalization of plant in a manner that keeps rates in an acceptable range with a lack of investment. Given this track record and that the HUF tariff is limited to off-site plant needed for new connections and excluded from use for repair or replacement of existing plant, there is simply no basis for RRPI to speculate that RRUI will join the ranks of over-

---

[444] *Id.* at 572:8 – 573:6.
[445] Tr. at 622:2 – 623:6; Sorensen Rj. at 17.
[446] **Brief Exhibit 1** at Section IV(D) (water and wastewater).
[447] Surrebuttal Testimony of Matthew J. Rowell at 2.

CIACed, under-equitized water and sewer utilities regulated by the Commission.[448] This Commission should disregard such speculation and innuendo.

CONCLUSION

Based on the foregoing, RRUI respectfully requests the following relief:

a. A finding that the fair value of RRUI's property devoted to water and wastewater service is $7,992,279 and $3,323,449, respectively;

b. Approval of an overall rate of return on such rate base equal to 11.70 percent; and

c. A determination of a revenue requirement for RRUI's water and sewer divisions of $3,652,884 and $1,690,628 respectively, which constitute increases over adjusted test year water revenues of $1,805,628, or 97.75 percent, and $(139,208), or negative 7.61 percent, over the test year.

RESPECTFULLY SUBMITTED this 19th day of April, 2010.

FENNEMORE CRAIG, P.C.

By ____________________

Jay L. Shapiro
Todd C. Wiley
3003 North Central Avenue
Suite 2600
Phoenix, Arizona 85012
Attorneys for Rio Rico Utilities, Inc.

ORIGINAL and thirteen (13) copies of the foregoing were filed this 19th day of April, 2010, with:

Docket Control
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

[448] Tr. at 687:10 – 688:5; Sorensen Rj. at 12:8-24.

COPY of the foregoing hand-delivered this 19th day of April, 2010 to:

Robin Mitchell, Esq.
Legal Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

COPY of the foregoing emailed/mailed this 19th day of April, 2010 to:

Jane L. Rodda
Administrative Law Judge
Hearing Division
Arizona Corporation Commission
400 West Congress
Tucson, AZ 85701-1347

Michael Patten
Roshka Heyman & DeWulf, PLC
One Arizona Center
400 E. Van Buren St. - 800
Phoenix, Arizona 85004

Daniel W. Pozefsky, Esq.
RUCO
1110 W. Washington St., Suite 220
Phoenix, Arizona 85007

By: Maria San Jose

Rio Rico Utilities, Inc.
Docket No. WS-02676A-09-0257

INITIAL CLOSING BRIEF
April 19, 2010

Brief Exhibit 1

HOOK UP FEES

Applies to all **WATER** service areas

WATER HUF

I. Purpose and Applicability.

The purpose of the hook-up fees payable to **Rio Rico Utilities, Inc. – Water Division** ("the Company") pursuant to this tariff is to equitably apportion the costs of constructing additional shared Off-Site Facilities necessary to provide water production, delivery, storage and pressure among all new service connections. These charges are applicable to all new service connections undertaken via Main Extension Agreements or requests for service not requiring a Main Extension Agreement entered into after the effective date of this tariff. The charges are one-time charges and are payable as a condition to Company's establishment of service, as more particularly provided below.

II. Definitions.

Unless the context otherwise requires, the definitions set forth in A.C.C. R14-2-401 of the Arizona Corporation Commission's ("Commission") rules and regulations governing water utilities shall apply in interpreting this tariff schedule.

"Applicant" means any party entering into an agreement with Company for the installation of water facilities to serve new service connections, and may include Developers and/or Builders of new residential subdivisions and/or commercial and industrial properties.

"Company" means Rio Rico Utilities, Inc. – Water Division.

"Main Extension Agreement" means an agreement whereby an Applicant, Developer and/or Builder agrees to advance the costs of the installation of water facilities necessary or desirable to serve new service connections within a development, or; installs such water facilities necessary or desirable to serve new service connections and transfers ownership of such water facilities to the Company, which agreement shall require the approval of the Commission pursuant to A.A.C. R14-2-406, and shall have the same meaning as "Water Facilities Agreement" or "Line Extension Agreement."

"Off-Site Facilities" means wells and other water supply facilities, storage tanks and related appurtenances necessary for proper operation, including engineering and design costs. Off-Site Facilities also may include booster pumps, pressure tanks, transmission mains and related appurtenances necessary for proper operation, if these facilities are not for the exclusive use of the applicant and will benefit the entire water system or provide regional or division wide benefits.

"Service Connection" means and includes all service connections for single-family residential, commercial, industrial or other uses, regardless of meter size.

III. Off-Site Hook-Up Fee.

For each new service connection, the Company shall collect a Hook-Up Fee derived as follows:

OFF-SITE HOOK-UP FEE TABLE		
Meter Size	Size Factor	Total Fee
5/8" x 3/4 "	1	$1,800
3/4"	1.5	$2,700
1"	2.5	$4,500
1-1/2 "	5	$9,000
2"	8	$14,400
3"	16	$28,800
4"	25	$45,000
6" or larger	50	$90,000

IV. Terms and Conditions.

(A) Assessment of One Time Hook-Up Fee: The Hook-Up Fee may be assessed only once per parcel, service connection, or lot within a subdivision or commercial/industrial property although a supplemental assessment may apply to conform to the above table if the intended use of a parcel is subsequently altered from that originally intended when the first assessment was paid.

(B) Use of Hook-Up Fee: Hook-Up Fees only may be used to pay for capital items of Off-Site Facilities, or for repayment of loans obtained to fund the cost of installation of Off-Site Facilities. Hook-Up Fees shall not be used to cover repairs, maintenance, or other operating costs. All funds collected by the Company as Hook-Up Fees shall be deposited into a separate account and bear interest and shall be used solely for the purposes of paying for the costs of the installation of Off-Site Facilities, including repayment of loans previously obtained for the installation of Off-Site Facilities that will benefit the water system. The Company shall not record amounts collected under this tariff as CIAC until such amounts have been expended for plant.

(C) Time of Payment:

1. For those requiring a Main Extension Agreement: In the event that the person or entity that will be constructing improvements ("Applicant", "Developer" or "Builder") is otherwise required to enter into a Main Extension Agreement, whereby the Applicant, Developer or Builder agrees to advance the costs of installing mains, valves, fittings, hydrants and other on-site improvements in order to extend service in accordance with R-

14-2-406(B), payment of the Hook-Up Fee required hereunder shall be made by the Applicant, Developer or Builder concurrent with execution of the Main Extension Agreement.

2. For those connecting to an existing main that was installed pursuant to a Main Extension Agreement that was approved by the Arizona Corporation Commission: In the event that the Applicant, Developer or Builder for service is not required to enter into a Main Extension Agreement, the Hook-Up Fee charges hereunder shall be due and payable at the time the meter and service line installation fee is due and payable.

(D) Off-Site Facilities Construction By Developer: Company and Applicant, Developer or Builder may agree to construction of Off-Site Facilities necessary to serve a particular development by Applicant, Developer or Builder, which facilities are then conveyed to Company. In that event, Company shall credit the total cost of such Off-Site Facilities as an offset to Hook-Up Fees due under this Tariff or against additional facilities required by the Company for the provision of service. If the total cost of the Off-Site Facilities constructed by Applicant, Developer or Builder and conveyed to Company is less than the applicable Hook-Up Fees under this Tariff, plus any additional requirements imposed by the Company then Applicant, Developer or Builder shall pay the remaining amount owed hereunder. If the total cost of the Off-Site Facilities constructed by Applicant, Developer or Builder and conveyed to Company is more than the applicable Hook-Up Fees under this Tariff plus the additional requirements then Applicant, Developer or Builder shall not be entitled to any refunds.

(E) Failure to Pay Charges; Delinquent Payments: The Company will not be obligated to make an advance commitment to provide or actually provide water service to any Developer, Builder or other Applicant for service in the event that the Developer, Builder or other Applicant for service has not paid in full all charges hereunder. Under no circumstances will the Company set a meter or otherwise allow service to be established if the entire amount of any payment due hereunder has not been paid.

(F) Large Subdivision Projects: In the event that the Applicant, Developer or Builder is engaged in the development of a residential subdivision containing more than 150 lots, the Company may, in its discretion, agree to payment of Hook-Up Fees in installments. Such installments may be based on the residential subdivision development's phasing, and should attempt to equitably apportion the payment of charges hereunder based on the Applicant's, Developer's or Builder's construction schedule and water service requirements.

(G) Hook-Up Fees Non-refundable: The amounts collected by the Company as Hook-Up Fees pursuant to this Hook-Up Fee Tariff shall be non-refundable contributions in aid of construction.

(H) Hook-Up Fee in Addition to On-Site Facilities: The Hook-Up Fee shall be in addition to any costs associated with the construction of on-site facilities under a Main Extension Agreement. The applicable Hook-Up Fee under this Tariff may not cover the total costs to be borne by Applicant for necessary Off-Site Facilities necessary to provide service to Applicant's property or development.

(I) Disposition of Excess Funds: After all necessary and desirable Off-Site Facilities are constructed utilizing funds collected pursuant to the Hook-Up Fees, or if the Hook-Up Fee has been terminated by order of the Arizona Corporation Commission, any funds remaining in the account shall be refunded. The manner of the refund shall be determined by the Commission at the time a refund becomes necessary.

(J) Fire Flow Requirements: In the event the Applicant for service has fire flow requirements that require additional facilities beyond those facilities whose costs were included in the Hook-Up Fee, and which are contemplated to be constructed using the proceeds of the Hook-Up Fees, the Company may require the Applicant to install such additional facilities as are required to meet those additional fire flow requirements, as a non-refundable contribution, in addition to the Hook-Up Fee.

(K) Status Reporting Requirements to the Commission: The Company shall submit a calendar year Hook-Up Fee status report each January 31st to Docket Control for the prior twelve (12) month period, beginning January 31, 2010, until the hook-up fee tariff is no longer in effect. This status report shall contain a list of all customers that have paid the hook-up fee tariff, the amount each has paid, the physical property in respect of which such fee was paid, the amount of money spent from the account, the amount of interest earned on the funds within the tariff account, and an itemization of all facilities that have been installed using the tariff funds during the 12 month period.

HOOK UP FEES

Applies to all **WASTEWATER** service areas

WASTEWATER HUF

I. Purpose and Availability

The purpose of the facilities hook-up fees payable to **Rio Rico Utilities, Inc. - Wastewater Division** ("the Company") pursuant to this tariff is to equitably apportion the costs of constructing additional Off-Site Facilities to provide wastewater treatment and disposal facilities among all new service laterals and connections. These charges are applicable to all new service laterals and connections undertaken via Collection Main Extension Agreements, or requests for service not requiring a Collection Main Extension Agreement, entered into after the effective date of this tariff. The charges are one-time charges and are payable as a condition to Company's establishment of service, as more particularly provided below.

II. Definitions

Unless the context otherwise requires, the definitions set forth in R-14-2-601 of the Arizona Corporation Commission's ("Commission") rules and regulations governing sewer utilities shall apply interpreting this tariff schedule.

"Applicant" means any party entering into an agreement with Company for the installation of wastewater facilities to serve new service laterals, and may include Developers and/or Builders of new residential subdivisions, and industrial or commercial properties.

"Company" means Rio Rico Utilities, Inc. – Wastewater Division.

"Collection Main Extension Agreement" means an agreement whereby an Applicant, Developer and/or Builder agrees to advance the costs of the installation of wastewater facilities necessary or desirable to serve new service laterals, or installs wastewater facilities to serve new service laterals and transfer ownership of such wastewater facilities to the company, which agreement does not require the approval of the Commission pursuant to A.A.C. R-14-2-606, and shall have the same meaning as "Wastewater Facilities Agreement."

"Off-Site Facilities" means the wastewater treatment plant, sludge disposal facilities, effluent disposal facilities and related appurtenances necessary for proper operation, including engineering and design costs. Off-Site Facilities also may include lift stations, force mains, collection mains, transportation mains and related appurtenances necessary for proper operation if these facilities are not for the exclusive use of the Applicant and benefit the entire wastewater system or provide regional or division wide benefits.

"Service Lateral" means and includes all service laterals and/or connections for single-family residential, commercial, industrial or other uses.

III. Hook-up Fee

For each new Service Lateral, the Company shall collect a Hook-Up Fee ("HUF") of $1,800, based on the Equivalent Residential Unit (ERU) of 320 gallons per day. Commercial Applicants shall pay based on the total ERUs of their development calculated by dividing the estimated total daily wastewater capacity usage needed for service using standard engineering standards and criteria by the ERU factor of 320 gallons per day.

IV. Terms and Conditions

(A) Assessment of One Time Hook-up Fee: The Hook-Up Fee may be assessed only once per parcel, service lateral, or lot within a subdivision or commercial/industrial although a supplemental assessment may apply to conform to the above table if the intended use of a parcel is subsequently altered from that originally intended when the first assessment was paid.

(B) Use of Hook-up Fee: Hook-Up Fees may only be used to pay for capital items of Off-Site Facilities, or for repayment of loans obtained to fund the cost of installation of Off-Site Facilities. Hook-Up Fees shall not be used to cover repairs, maintenance, or other operating costs. All funds collected by the Company as Hook-Up Fees shall be deposited into a separate account and bear interest and shall be used solely for the purposes of paying for the costs of installation of Off-Site Facilities, including repayment of loans previously obtained for the installation of Off-Site Facilities. The Company shall not record amounts collected under this tariff as CIAC until such amounts have been expended for plant.

(C) Time of Payment:

(1) In the event that the person or entity that will be constructing improvements ("Applicant," "Developer," or "Builder") is otherwise required to enter into a Collection Main Extension Agreement, payment of the fees required hereunder shall be made by the Applicant, Developer or Builder to the Company concurrent with the execution of a Collection Main Extension Agreement.

(2) In the event that the Applicant, Developer or Builder for service is not required to enter into a Collection Main Extension Agreement, the HUF charges hereunder shall be due and payable at the time wastewater service is requested for the property.

(D) Off-Site Facilities Construction by Developer: Company and Applicant, Developer, or Builder may agree to construction of Off-Site Facilities necessary to serve a particular development by Applicant, Developer or Builder, which facilities shall then be conveyed to Company. In that event, Company shall credit the total cost of such Off-Site Facilities as an offset to Hook-Up Fees due under this Tariff or against additional facilities required by the Company for the provision of service. If the total cost of the Off-Site Facilities constructed by Applicant, Developer or Builder and conveyed to Company is less than the applicable Hook-Up Fees under this Tariff plus any additional requirements imposed by the Company, Applicant, Developer or Builder shall pay the remaining amount of Off-Site Facilities Hook-Up Fees owed hereunder. If the total cost of the Off-Site Facilities constructed by Applicant, Developer or Builder and conveyed to Company is more than the applicable Hook-Up Fees under this Tariff plus the additional requirements then Applicant, Developer or Builder shall not be entitled to any refunds.

(E) Failure to Pay Charges; Delinquent Payments: The Company will not be obligated to make an advance commitment to provide or actually provide wastewater services to any Developer, Builder or other Applicant for service in the event that the Developer, Builder or other Applicant for service has not paid in full all charges hereunder. Under no circumstances will the Company connect service or otherwise allow service to be established if the entire amount of any payment has not been paid.

(F) Hook-Up Fees Non-refundable: The amounts collected by the Company pursuant to this Hook-Up Fee tariff shall be non-refundable contributions in aid of construction.

(G) Hook-Up Fee in Addition to On-Site Facilities: The Hook-Up Fee shall be in addition to any costs associated with the construction of On-Site Facilities under a Collection Main Extension Agreement. The applicable Hook-Up Fee under this Tariff may not cover the total costs to be borne by Applicant for Off-Site Facilities necessary to provide service to Applicant's property or development.

(H) Disposition of Excess Funds: After all necessary and desirable Off-Site Facilities are constructed utilizing funds collected pursuant to the Hook-Up Fees, or if the Hook-Up Fee has been terminated by order of the Arizona Corporation Commission, any funds remaining in the trust account shall be refunded. The manner of the refund shall be determined by the Commission at the time a refund becomes necessary.

(I) Status Reporting Requirements to the Commission: The Company shall submit a calendar year Hook-Up Fee status report each January 31st to Docket Control for the prior twelve (12) month period, beginning January 31, 2010, until the hook-up fee tariff is no longer in effect. This status report shall contain a list of all customers that have paid the hook-up fee tariff, the amount each has paid, the physical property in respect of which such fee was paid, the amount of money spent from the account, the amount of interest earned on the funds within the tariff account, and an itemization of all facilities that have been installed using the tariff funds during the 12 month period.

Rio Rico Utilities, Inc.
Docket No. WS-02676A-09-0257

INITIAL CLOSING BRIEF
April 19, 2010

Brief Exhibit 2

Applies to all **WATER** and **WASTEWATER** service areas

ALTERNATE RATES FOR WATER (ARW)
DOMESTIC SERVICE – SINGLE FAMILY ACCOMMODATION

APPLICABILITY

Applicable to residential water service for domestic use rendered to low-income households where the customer meets all the Program qualifications and Special Conditions of this rate schedule.

TERRITORY

Within all Customer Service Areas served by the Company.

RATES

Fifteen percent (15%) discount applied to the regular filed tariff.

PROGRAM QUALIFICATIONS

1. The Rio Rico Utilities bill must be in your name and the address must be your primary residence or you must be a tenant receiving water service by a sub-metered system in a mobile home park.
2. You may not be claimed as a dependent on another person's tax return.
3. You must reapply each time you move.
4. You must renew your application every two years, or sooner, if requested.
5. You must notify Rio Rico Utilities within 30 days if you become ineligible for ARW.
6. Your total gross annual income of all persons living in your household cannot exceed the income levels below:

Issued: ______________ Effective : ____________

ISSUED BY:

Greg Sorensen, Director Of Operations
Rio Rico Utilities, Inc.
12725 W. Indian School Road, Suite D-101
Avondale, AZ 85392

Effective January 1, 2009

No. of Person in Household	Total Gross Annual Income
1	$10,830
2	14,570
3	18,310
4	22,050
5	25,790
6	29,530

For each additional person residing in the household, add $3,740

For the purpose of the program the "gross household income" means all money and non cash benefits, available for living expenses, from all sources, both taxable and non taxable, before deductions for all people who live in my home. This includes, but is not limited to:

Wages or salaries
Interest or dividends from:
Savings account, stocks or bonds
Unemployment benefits
TANF (AFDC)
Pensions
Gifts

Social Security, SSI, SSP
Scholarships, grants, or other aid used for living expenses
Disability payments
Food Stamps
Insurance settlements

Rental or royalty income
Profit from self-employment (IRS form Schedule C, Line 29)
Worker's Compensation
Child Support
Spousal Support

Issued: ______________ Effective : ______________

ISSUED BY:

Greg Sorensen, Director Of Operations
Rio Rico Utilities, Inc.
12725 W. Indian School Road, Suite D-101
Avondale, AZ 85392

2193588.1

SPECIAL CONDITIONS

1. Application and Eligibility Declaration: An Application and eligibility declaration on a form authorized by the Commission is required for each request for service under this schedule. Renewal of a customer's eligibility declaration will be required, at least, every two years.

2. Commencement of Rate: Eligible customers shall be billed on this schedule commencing with the next regularly scheduled billing period that follows receipt of application by the Utility.

3. Verification: Information provided by the applicant is subject to verification by the Utility. Refusal or failure of a customer to provide documentation of eligibility acceptable to the Utility, upon request by the Utility, shall result in removal from this rate schedule.

4. Notice From Customer: It is the customer's responsibility to notify the Utility if there is a change of eligibility status.

5. Rebilling: Customers may be re-billed for periods of ineligibility under the applicable rate schedule.

6. Mobile Home Park and Master-metered: A reduction will be calculated in the bill of mobile home park and master-metered customers, who have sub-metered tenants that meet the income eligibility criteria, so an equivalent discount (15%) can be passed through to eligible customer(s).

Issued: ______________ Effective : ____________

ISSUED BY:

Greg Sorensen, Director Of Operations
Rio Rico Utilities, Inc.
12725 W. Indian School Road, Suite D-101
Avondale, AZ 85392

RIO RICO UTILITIES, INC.
APPLICATION AND DECLARATION FOR
ALTERNATE RATES FOR WATER PROGRAM

____
Your Name (Please Print)

☐ I am a sub-metered tenant of a mobile home park or apartment complex

Rio Rico Utilities, Inc. Account No. |__|__|__|__|__|__|__|__|__|__|__|__|

Service Address ____

Mailing Address ____
(if different from above address)

Telephone No. (home) _______________ (work) _________________

Number of people living in your household: Adults |__|__| + Children |__|__| = Total |__|__|

Total Gross Annual Income of Household __________

Please attach proof of income for eligibility verification.

By signing below, I certify under penalty of perjury that this information is true and correct under the laws of the State of Arizona. I will provide proof of income and I will notify Rio Rico Utilities, Inc. of any changes that affect my eligibility. I understand that if I receive the discount without meeting the qualifications for it, I may be required to pay back the discount I received.

____________________________________ ______________________
Customer Signature Date

Issued: ______________ Effective : ____________

ISSUED BY:

Greg Sorensen, Director Of Operations
Rio Rico Utilities, Inc.
12725 W. Indian School Road, Suite D-101
Avondale, AZ 85392

2193588.1

Mail completed application to:

FOR RIO RICO UTILITIES, INC. USE ONLY

Date received ____________ Date Verified ______________ Verified By _____________

Issued: _______________ Effective : _____________

ISSUED BY:

Greg Sorensen, Director Of Operations
Rio Rico Utilities, Inc.
12725 W. Indian School Road, Suite D-101
Avondale, AZ 85392

2193588.1