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KRISTIN K. MAYES, Chairman
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IN THE MATTER OF THE APPLICATION OF RIO RICO UTILITIES, INC. FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS WATER AND WASTEWATER RATES AND CHARGES FOR UTILITY SERVICE THEREON.

DOCKET NO. WS-02676A-09-0257

STAFF'S OPENING BRIEF

The Utilities Division of the Arizona Corporation Commission ("Staff") hereby files its opening brief in the above-captioned matter. In this brief, Staff will address the major disputed issues. On any issue not specifically addressed in this brief, Staff maintains its position as presented in its testimony.

I. INTRODUCTION.

Rio Rico Utilities ("RRUI" or "Company") is a class A utility that provides water and sewer service in and near the community of Rio Rico-AZ, within portions of Santa Cruz County, Arizona. RRUI provides water service to approximately 6,600 customers and wastewater service to approximately 2,200 customers. In December 2005, RRUI became a wholly-owned subsidiary of Algonquin Water Resources of America, Inc. ("AWRA"), now known as Liberty Water, Inc ("Liberty"). AWRA is RRUI's only shareholder. AWRA is a wholly-owned subsidiary of Algonquin Power Income Fund ("APIF").[1] (AWRA and APIF are collectively referred to as "Algonquin").

In addition to RRUI, Algonquin owns seven other utilities located in Arizona: Litchfield Park Service Company, Gold Canyon Sewer Company, Black Mountain Sewer Corporation, Entrada Del

[1] Algonquin Power Income Fund is an investment trust that owns or has interests in 71 companies in the United States and Canada, including 41 hydroelectric facilities, 5 natural gas cogeneration facilities, and 15 water and sewer facilities. In October 2009, APIF converted to a corporation known as Algonquin Power and Utilities Corp. ("APUC")

Oro Sewer Company, Northern Sunrise Water Company, Inc., Southern Sunrise Water Company, Inc., and Bella Vista Water Company. Algonquin also operates water and wastewater systems in Texas and Illinois.

RRUI's current rates were authorized in Decision No. 67279, dated October 5, 2004. That Decision authorized a $308,081 revenue increase for the water division to provide an 8.70 percent rate of return on a $2,462,446 fair value rate base. For the wastewater division, the Recommended Order and Opinion would have otherwise recommended graduated rates of return beginning with 1.95 percent in year one, increasing to 6.45 percent in year two, and increasing to 8.7 percent in year three, representing an initial revenue increase of $299,575 in year one for total of $905,727, an additional $299,575 in year two for a total of $1,205,302, and an additional $149,787 in year three for a total of $1,355,089 or $748,937 over test year revenues. However, to mitigate the impact of increased rates, RRUI agreed to an increase in the third and subsequent years of $700,103, or 115.41 percent, over test year revenues to provide a lower rate of return than the otherwise authorized 8.7 percent rate of return on a $4,136,931 fair value rate base.[2]

On May 21, 2009, the Company filed an application for a permanent rate increase for both its water and wastewater systems, using a 12 month ending December 31, 2008 test year.

II. SUMMARY OF POSITIONS.

The Company is seeking a finding of fair value rate base ("FVRB") in the amount of $7,992,279 for its water division and $3,323,499 for its wastewater division, which is the original cost rate base ("OCRB") for both divisions. For its gross revenue requirement, RRUI is seeking $3,652,884 for its water division and $1,690,768 for its wastewater division. The Company is seeking a rate of return of 11.70 percent resulting in a revenue increase of $1,805,628 for its water division and a revenue decrease of $139,208 for its wastewater division. The overall increase is 97.75 percent for the water division and a 7.61 percent decrease for the wastewater division. The Company's capital structure is 100 percent equity, 0 percent debt and the Company is proposing a cost of common equity of 11.70 percent.

[2] Decision No. 67279 at 22-23.

Staff is recommending a FVRB of $7,808,822 for the water division and $3,226,899 for the wastewater division. For the gross revenue requirement, Staff is recommending $3,192,376 for the water division and $1,527,074 for the wastewater division. Staff is recommending a 9.2 percent rate of return resulting in a revenue increase of $1,345,120 for the water division and a decrease of $302,902 for the wastewater division. The overall increase is 72.82 percent for the water division and a 16.55 percent decrease for the wastewater division.

Among the major contested issues between Staff and the Company are the treatment of accumulated deferred income taxes, the central cost allocation from the parent and the calculation of cost of equity. Staff and the Company also disagree on the issue of rate design. The Company and Staff also disagree on the necessity of a hook up fee tariff.

III. RATE BASE ISSUES.

The major area of disagreement between Staff and the Company on rate base adjustments is the treatment of accumulated deferred income taxes. There is no longer a dispute between the Company and Staff regarding the Company's accumulated depreciation balance for the water division.[3]

A. <u>Accumulated Deferred Income Tax.</u>

Accumulated deferred income taxes ("ADIT") reflect the timing difference between when income taxes are calculated for ratemaking purposes and the actual federal and state income taxes paid by the Company.[4] The timing difference is primarily due to the fact that straight line depreciation is used for ratemaking purposes, whereas accelerated depreciation is used for income tax reporting purposes. The Statement of Financial Accounting Standards ("SFAS") No. 109, Accounting for Income Taxes, requires companies to use deferred tax accounting to recognize income tax timing differences.[5] Staff witness Gerald Becker testified that the primary cause of the income tax difference is the straight line depreciation method used for rate making purposes as

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[3] Although Staff's final schedules reflect the removal of $48,000 in the accumulated depreciation balance, this is in error. *See* Schedule GWB -3 (Water).

[4] Decision No. 69164 at 5.

[5] *Id.*

compared to the accelerated depreciation method used for federal and state income tax reporting purposes.[6]

According to Mr. Becker's testimony, the NARUC USOA requires utilities to use straight line depreciation. Straight line depreciation, in the early years of an asset's life, typically results in a lower depreciation expense which, in turn, results in a higher income tax. Conversely, the Internal Revenue Service allows companies to use accelerated depreciation. Accelerated depreciation, in the early years of an asset's life, typically results in a higher depreciation expense which, in turn, results in lower income taxes. In the later years of an asset life, the book depreciation expense the tax depreciation and the temporary differences begin to reverse. Eventually, the ADIT balance reduces to zero when the asset is fully depreciated under straight line depreciation.[7]

While the Company and Staff agree with the basic methodology for calculating ADIT, Staff and the Company disagree with respect to what components comprise ADIT.[8] Further, the Company proposes to add the ADIT to rate base because the Company as calculated a debit ADIT.[9] In contrast, Staff proposes a credit ADIT, which would result in a deduction to rate base.[10]

The Company proposes 3 components for ADIT: the tax benefits associated with the differences between the book and tax treatment of fixed assets and associated depreciation, the tax benefits associated with net Advances in Aid of Construction ("AIAC") on its books and the tax benefits of net operating loss carryforwards ("NOL").[11] Staff and the Company agree on that fixed assets and AIAC components but disagree on the inclusion of NOLs.[12]

For the Fixed Asset Component, Staff recommends removal of $105,409, as this amount is unidentified plant.[13] Staff and the Company are in agreement regarding the AIAC associated component of ADIT.[14]

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6 Becker Dir. Test., Ex. S-6 at 12.
7 *Id.*
8 Tr at 910.
9 Becker Dir. Test., Ex. S-6 at 13.
10 *See* Staff Final Schedule GWB-4.
11 Becker Dir. Test., Ex S-6 at 14.
12 Becker Dir. Test., Ex. S-7 at 15.
13 *Id.*
14 *Id.*

Staff argues that NOLs are not appropriate for inclusion in the ADIT calculation. The NOL represents losses incurred by the Company when the Company failed to earn its authorized rate of return or any other taxable profit in previous years.[15] Staff could not find any authority or requirement to include NOLs in the calculation of ADIT.[16] As Mr. Becker testified, the inclusion of NOLs in the ADIT calculation would be unfair to ratepayers because it would mean that ratepayers would essentially be paying a carrying charge on the Company's expected future recovery of a tax benefit while the ratepayers have already paid their share of income tax expense in rates and the Company has the opportunity to earn its authorized rate of return.[17]

The Company asserts that the NOL carryforward represents the unused portion of the special depreciation allowance that the Company elected to take during the test year.[18] The Company asserts that if Staff's recommendations were followed, excluded the NOL, would be in violation of the IRS rules on normalization.[19] Staff witness Becker testified that normalization is not required by the tax code for NOLs.[20] Normalization provides an incentive for a company to invest because of the treatment of accelerated depreciation by regulated utilizes. Congress has repeatedly said that the purpose of accelerated depreciation is to encourage capital investment at the corporate level not to lower utility rates for consumers.

Normalization is the interperiod allocation of the income tax effects of accelerated depreciation deductions, the investment tax credit and the alternative minimum tax for regulatory ratemaking purposes. "Normalization" involves: (1) setting up a deferred tax reserve for the difference between depreciation expense used by regulators to determine cost of service (normally the straight line method) and the accelerated method used for calculating tax expense on income tax returns; and then, (2) drawing down that reserve in later years as the accelerated depreciation benefits reverse.[21]

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15 Becker Dir. Test., Ex. S-6 at 19.
16 Tr. at 915-16.
17 Becker Dir. Test., Ex. S-6 at 19; Becker Surreb. Test., Ex. S-7 at 16.
18 Bourassa Rebuttal Test., Ex A-6 at 11-12.
19 *Id.* At 12.
20 Tr. at 891.
21 http://www.narucmeetings.org/Presentations/(4b)%20Normalization%20Accounting%20-%20Matheny.ppt.

In summary, Staff is recommending that the fixed asset component as a credit and an overall debit balance. Staff's recommendations regarding the treatment of ADIT are both fair to the Company and its ratepayers and should be adopted.

IV. INCOME STATEMENT.

The major area of disagreement continues to be the central office cost allocation from the Company's parent. This allocation method and the amounts have been a source of disagreement between Staff and RRUI's sister companies, Black Mountain Sewer Company and Litchfield Park Service Company, in their pending rate cases.[22]

A. Cost Allocation.

At the time of the filing of the application, APIF, the ultimate parent of RRUI, (now APUC) is an unregulated entity whose primary business activity is the acquisition and ownership of generation and infrastructure companies. Algonquin Power Trust ("APT") is an entity that provides services to the APIF family of companies. APIF consists of four major divisions, with 71 facilities. The infrastructure group is made up of the water and sewer companies owned by APIF.[23]

According to Company witness Peter Eichler, the shared services model contains 2 components. First, Liberty Water is the entity that provides all the day-to-day administration and operations personnel for its regulated utilities including RRUI.[24] Some services such as operations and engineering labor are charged by Liberty directly to RRUI. Some services, such labor for accounting, billing and customer service and corporate finance, provided to Liberty Water are not directly allocated, but allocated based on customer count. Overhead costs, like rent, office furniture are allocated by use of a four factor methodology.[25] Staff is not opposed to the allocation of these costs from Liberty Water to RRUI.[26]

In addition to operations and engineering costs and the allocated overhead/administration costs, there are costs that are allocated from APT. This pool of costs is referred to as central office cost. These costs consist of expenses such as rent at the central office, strategic planning costs, audit,

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[22] *See* Docket Nos. SW-02361A-08-0609; Docket No. SW-01428A-09-0103.
[23] Becker Dir. Test., Ex. S-6 at 26-27.
[24] Eichler Rebuttal Test., Ex. A-10 at 4.
[25] *Id.*
[26] Tr. at 510.

tax services, unit holder communication, trustee fees, and other costs. These are indirect costs. These costs are allocated to Liberty Water based on the relative number of utilities to total facilities and then further allocated by Liberty Water to each utility based on customer count.

It is the amount of the cost pool, the various expenses in the cost pool and allocation method that has caused disagreement in this case.[27] Staff contends that the central office costs were incurred primarily for the benefit of the shareholders of APIF.[28] Staff's review indicated that nearly all of the costs were obviously attributable to the operations of APIF or one of its affiliates. As a result, Staff assigned 90 percent of the costs to APIF.[29] The remaining ten percent constitutes Staff's recognition that the other affiliates receive a benefit from the common costs, and therefore should be allocated a percentage greater than zero.[30]

Before determining the allocation, APT first determines the pool amount. In this case, in the Company's initial filing, the cost pool was erroneously based on a budgeted amount of $3,950,700 based on a 1:1 conversion of CND to USN.[31] In response to a Staff data request, the Company subsequently revised this amount to $5.27 million. In its final schedules, the Company asserts that the cost pool amount is $4,070,103CN and 3,970,127 USD.[32] These expenses were allocated to the Infrastructure division of APT based on a single allocation factor of 26.98 percent. Those costs are then allocated to each company within the Infrastructure Division based upon relative customer count. Of the total to be allocated, 3.49 percent of the total cost pool was allocated to RRUI, $102,310 is allocated to the water division and 33,746 to the wastewater division.[33]

The correct number of companies that are used to calculate the allocation factor is at dispute. Staff recommends an allocation factor of 1/70 or 1.43 percent. Staff based its calculation on a total of 70 facilities. As explained by Staff witness Becker, a review of the APIF 2008 Annual Report lists 70 facilities owned by APIF.[34] In contrast, the Company contends that only 63 facilities should be

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[27] Tr. at 506.
[28] Becker Surreb. Test., Ex. S-7 at 13.
[29] Tr. at 506-507.
[30] *Id.* at 507.
[31] Becker Surreb. Test., Ex S-6 at 28.
[32] RRUI final schedules C-2 at 10. The Company accepted Staff's position that a foreign exchange adjustment was necessary for the cost pool amounts.
[33] RRUI final schedule C-2 at 10 for water and C-2 at 8 for wastewater.
[34] Becker Dir. Test., Ex. S-6 at 31.

the basis of the allocation factor. The Company argues that in Staff's allocation number, the Staff formula uses the incorrect number of facilities. The Company contends that there are several facilities of which APIF only has an equity interest as well as some facilities that are inactive and thus receive no benefit from the services provided by APT.[35] Staff would argue that APT has to perform some type of monitoring of its interest and thus there are costs associated with that activity and those entities should be counted in the allocation factor.

Staff also disagrees with the amount of the cost pool. In its audit, Staff found a number of costs that were not associated with the provision of service to RRUI's ratepayers, for example $7800 for a hootenanny. The Company acknowledges that some inappropriate costs were included in the cost pool and removed a total of $1,199,799 which results in a much smaller cost pool than originally requested by the Company.

In its review of the Company's cost allocation, Staff relied on the NARUC Guidelines for Cost Allocation and Affiliate Transactions.[36] These guidelines require that costs primarily attributable to a business operation should be to the extent appropriate, directly assigned to that business operation.[37] Company witness Peter Eichler asserts that RRUI's allocation method is consistent with these guidelines.[38] Staff continues to disagree with RRUI. Staff reviewed the amounts comprising the amounts being allocated, including the underlying invoices for the costs, and determined that the Company did not identify the costs as direct or indirect as consistent with the guidelines provided by the National Association of Regulatory Utility Commissioners for Cost Allocation and Affiliate Transactions.[39]

Staff asserts that the goal of cost allocation between an unregulated affiliate and a regulated affiliate is the fair distribution of costs between the unregulated and regulated affiliate through proper allocation bases but the amounts allocated to the regulated entities should not be in excess of the amounts that regulated entities would incur on a stand alone basis. When costs incurred primarily for the benefit of an unregulated affiliate's business are improperly identified and allocated as

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[35] Tr. at 231-33.
[36] Guidelines for Cost Allocation and Affiliate transactions, Ex. S-3.
[37] Becker Surreb. Test., Ex. S-7 at 9.
[38] Eichler Rebuttal Test., Ex. A-10 at 4.
[39] Becker Surreb. Test., Ex. S-7 at 9-10.

overhead/common costs, then costs of the unregulated affiliate are shifted to the captive customers of the regulated utility. This cost shifting results in the captive customers of the regulated utility subsidizing the business operations of the unregulated affiliate. This harms customers by creating artificially higher rates.[40]

State Commissions have subjected affiliate transactions to a greater scrutiny. For example, in *U.S. West Communications v. the Arizona Corporation Comm'n*, 185 Ariz. 277, 915 P.2d 1232 (App. 1996), the Arizona Court of Appeals held that the "Commission has broad powers to scrutinize transactions between a regulated company and its unregulated affiliates" and disallow excessive costs.[41] Even Company witness Eichler recognized that affiliate transactions are subjected to greater scrutiny.[42] The Company alleges that its shared services model results in lower costs and efficiencies. While Staff has acknowledged that it is not opposed to the concept of a shared services model, Staff still has concerns given some of the inappropriate costs it found during its audit of the cost pool. While not entirely opposed to the shared services model, Staff would urge the Company to review its cost pool and only include those expenses that are necessary to provide services to the ratepayer. Company witness Eichler has offered to continue to work with Staff and RUCO regarding the cost allocation method to identify issues prior to hearing.[43]

V. RATE DESIGN.

For the water division, Staff recommends a rate structure that is similar to that currently in place, but Staff increases all the break-over points for larger meters. Staffs rate design recognizes the growing importance of managing water as a finite resource and promotes more efficient water use. Staffs rate structure provides an economic benefit to customers that limit consumption.

Staffs recommended monthly minimum charges by meter size are as follows: 5/8 x 3/4-inch, $10.00; 3/4-inch, $15.00; 1-inch, $25.00; 1 1/2-inch, $50.00; 2-inch, $80.00; 3-inch, $160.00; 4-inch, $250.00; 6-inch, $500.00; 8-inch, $800.00; 10-inch, $1,150.00; and 12-inch $2,150.00. For customers with a 5/8 x 3/4-inch meter, Staff recommends an inverted tier rate design that consists of

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40 Becker Dir. Test., Ex. S-6 at 28.
41 *Id.*, 185 Ariz. at 282, 915 P.2d at 1237 (citations omitted).
42 Tr. at 295.
43 *Id.* at 364; Algonquin has one pending rate case, Docket No. W-02465A-09-0411 (consolidated).

three tiers with the residential commodity rates of $1.50 per thousand gallons for 0 to 3,000 gallons, $2.75 per thousand gallons for 3,001 to 9,000 gallons, and $3.42 per thousand gallons for any consumption over 9,000 gallons. Staff recommends a two-tier inverted block rate structure for all customers with meters larger than 5/8 x 3/4-inch.[44]

Under the Staffs recommended rates, the median residential 5/8 x 3/4-inch meter customer consuming 7,000 gallons per month would experience an $8.19, or 47.3 percent increase, from $17.31 to $25.50.[45] Staff further recommends adoption of the Company's proposal to implement a meter re-read (if correct) charge, a late payment charge, a deferred payment charge, a charge to move the meter at the customer's request, and an hourly charge for after-hours service calls, and also recommends approval of the changes for service line connection charges.[46]

For the wastewater division, Staff recommends a comparable rate structure to that currently in place. Staff recommends a decrease of $11.21, or 19.89 percent, in the monthly charge, from $56.36 to $45.15.[47] Staff also recommends adoption of the Company's proposal to implement a late payment charge, a deferred payment charge, and a charge for after-hours service calls, and also recommends approval of the Company's proposed changes for service line connection charges.[48]

The Company asserts that the rate design proposed by Staff constitutes "blatant revenue shifting."[49] While in general Staff designs rates so that 30 to 40 percent of the revenues should come from the fixed monthly charge,[50] Staff's original and revised design derives approximately 28.6 percent of the revenue from the fixed charge, 1.4 percent less than the "rule of thumb", but the Company complains that because of this difference, less revenue is derived from the fixed monthly charge.[51] Nonetheless, Staff is steadfast in recommending a rate design that seeks to maintain the

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[44] Becker Rate Design Test. At 1. Staff witness Becker's Direct Rate Design testimony was filed in Docket Control and served on the parties on January 6, 2010, but was inadvertently not offered at the hearing for admission as a hearing exhibit. Neither the Company nor RUCO objects to the citing of Mr. Becker's pre-filed testimony in post hearing briefs.

[45] *Id.* at 2.

[46] *Id.* at 2-3.

[47] *Id.* at 5.

[48] *Id.* at 6.

[49] Bourassa Rebuttal Test., Ex. A-6 at 34.

[50] Tr. at 902.

[51] *Id.* at 798-99.

affordability of non-discretionary usage and to encourage efficient use of water through appropriate price signals.[52] The Company argues that Staff's rate design mimics a lifeline or low income tariff.[53] Affordable, non-discretionary usage should be available to all ratepayers with reduced costs for those qualifying under established low income guidelines.

A. Low Income Tariff.

The Company has proposed a low income tariff, modeled on a low income tariff approved for Chaparral City Water Company.[54] Staff supports a low income tariff, with the following recommendations:[55]

Income Eligibility – The Company proposes to use 100 percent of the federal poverty level as the eligibility cutoff because of the income level in its service area is lower than the service area for Chaparral City.[56] This proposal represents a significant decrease from the 150 percent level adopted for Chaparral City Water Company. Staff still recommends an eligibility standard equal to 150 percent of the federal poverty level should be adopted pending further consideration of its impact.

Recertification – While Staff agrees with the Company proposal for participants to reapply at least once every two years, the Company proposes passive, not proactive, reporting of continuing eligibility. Staff concludes that participants should be required to submit an affidavit yearly attesting to their continuing eligibility.

Participation Cap – Staff recommends that participation be limited to 2,200 customers for the water division and 725 for the wastewater division (approximately 30 percent). The Company agrees.[57]

Administrative Fee – The Company proposes an administrative fee pertaining to its low income program. The Company proposes to recover the program costs (the discounts given to participants plus a 10 percent fee for administration and carrying costs) from non-participants via a commodity surcharge.[58] Staff is still unclear how the Company derives the 10 percent and from

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[52] Becker Surreb. Test., Ex. S-7 at 20.
[53] Tr. at 789.
[54] Tr. at 907.
[55] Becker Surreb. Test., Ex S-7 at 7-9.
[56] Tr. at 78.
[57] Sorenson Rej. Test., Ex. A-3 at 5.
[58] Bourassa Dir. Test., Ex. A-4 at 19.

what. Staff recommends that the Company be allowed to seek recovery of direct costs (i.e., costs directly associated with the program – those that would not be incurred in the absence of the program), and that the Company account for these direct costs separately from other costs. Staff recommends that the authorized rate of return is a reasonable for the carrying rate. The carrying rate should be applied monthly to the average of the beginning and ending balance of the cumulative unrecovered program costs and included in the beginning balance for the following month.

Surcharge Initiation, Recalculation Frequency and Approval – The Company proposes to initiate a surcharge to recover the program costs (discounts, administrative fee and carrying charges) as soon as practicable after the first twelve months of implementation. However, it is unclear how often the surcharge would be recalculated; the Company's proposal references both a six-month and a twelve-month period. The Company's proposal has a provision for annual reporting to the Commission, but does not specifically require Commission approval of the proposed surcharge before implementation. Staff concludes that its recommended revenue combined with Staff recommended limits on participation will provide RRUI with sufficient cash flow to carry the program costs for twelve months, and that the surcharge should be implemented twelve months after authorization of the program and subsequent to Commission approval of the specific surcharge amount, and recalculated each twelve months thereafter. Staff further concludes that resetting the surcharge in mid-year without Commission oversight would be inappropriate and providing oversight for resetting the surcharge every six months would not be an efficient use of regulatory resources.

Surcharge Recovery Customer Base –Staff recommends that recovery of low income program costs via a surcharge be applicable only to the residential customer class.

Surcharge Calculation - Staff recommends that a separate balancing account be used and a separate surcharge should be calculated for the water customers and the wastewater customers. Staff further recommends the following as an appropriate surcharge calculation method. The surcharge shall equal a dollar-and-cents amount resulting from dividing the ending balance of the low income balancing account properly calculated by the number of bills properly issued to non-participating residential customers during the past twelve-month tracking period. The ending balance in the balancing account should equal the beginning balance plus discounts allowed on bills in the twelve-month tracking period plus direct program costs incurred in the twelve-month tracking period plus carrying charges less surcharge fees billed in the twelve-month tracking period.

Reporting Requirement - Staff recommends that the Company submit an annual report as one step of the annual process for the Commission to approve and reset the surcharge amount.

VI. COST OF CAPITAL.

Staff, and the Company, recommends the adoption of the Company's actual capital structure of 100.0 percent equity and 0.0 percent debt.[59] Staff's final recommended cost of equity ("COE") is 9.2 percent and the final recommended rate of return ("ROR") is also 9.2 percent.[60] The Company's final recommended COE is 11.7 percent.[61]

Staff's COE recommendations employ market-based financial models consistently accepted by this Commission. Staff selects their inputs by first identifying available market data, and determining whether investors are expected to rely on that data. Staff does not use results to determine inputs; it approaches it through a balanced methodology. If the inputs are selected appropriately, then the results will speak for themselves. These methods utilize both historical and forecasted economic information; all information a typical investor can reasonably be expected to consider in determining the expected rate of return. Additionally, the models are widely accepted in the financial industry, and by this Commission, in setting just and reasonable rates of return.

The Company's recommendations are based on the application of the discounted cash flow ("DCF") model and capital asset pricing made ("CAPM") to a sample group of water utilities, also used by Staff. The return produced in those models is adjusted downward 100 basis points to reflect the financial risk associated with a capital structure free of debt; but then adjusted upward 50 basis points to account for what the Company considers firm specific risks such as: small size, lack of investment liquidity, and Arizona's regulatory environment.[62] The Company's selectively chosen inputs in its models results in an inflated COE. Generally, analysts should not eliminate or modify

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[59] Manrique Dir. Test., Ex. S-13 at 7 and Bourassa Cost of Capital Rej. Test., Ex. A-9 at 1.
[60] Manrique Dir. Test., Ex. S-13 at 3; Staff's Final Schedules at JCM-1.
[61] Bourassa Rej. Test., Ex. A-9 at 1; Co.'s Final Schedules.
[62] Bourassa Rej. Test., Ex. A-9 at 1.

inputs in the COE estimate because they produce unfavorable outputs, its skews the results and creates an unbalanced COE.

A. <u>The Commission Should Adopt Staff's Recommended Return On Equity Of 9.2 Percent Because It Is Based On Proven Financial Models Involving Balanced And Reasonable Inputs.</u>

To determine the required rate of return, Staff used the discounted cash flow model and the capital asset pricing model. Staff used two DCF estimates, the constant growth DCF model (9.4 percent) and the multi-stage DCF model (10.3 percent); and two CAPM estimates, one using an historical market risk premium (8.6 percent) and one using a current market risk premium (12.6 percent).[63] Staff first averaged the DCF results (9.9 percent) and then calculated an average for the CAPM results (10.6 percent).[64] Staff then took the average of both models (10.3 percent) and subtracted 110 basis points (1.1 percent) for financial risk calculated using the Hamada method, and arrived at a COE of 9.2 percent.[65]

For the constant growth DCF, Staff calculated the growth factor by averaging the results of historical and forecasted earnings per share ("EPS")[66], dividends per share ("DPS")[67], and sustainable growth.[68] Staff utilized a balanced methodology that gives equal weight to historical and projected EPS, DPS, and sustainable growth.[69] The advantage to this approach is it produces a more balanced outcome. The multi-stage DCF uses two stages of growth; the first stage is four years, followed by the second constant growth stage.[70] Staff averaged the constant growth DCF (9.4 percent)[71] and the multi-stage DCF (10.3 percent)[72] to calculate the over DCF estimate of 9.9 percent.[73]

The Company's analysis uses two constant growth DCF models, Past and Future Growth, and Future Only Growth, instead of a multi-stage and constant growth model like Staff.[74] Mr. Bourassa's

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63 Manrique Surreb. Test., Ex. S-14 at Schedule JCM-3.
64 *Id.*
65 *Id.*
66 *Id.* at Schedule JCM-5.
67 *Id.*
68 *Id.* at Schedule JCM-6.
69 Manrique Dir. Test., Ex. S-13 at 17-18; Schedules JCM-5, 6.
70 Manrique Dir. Test., Ex. S-13 at 24.
71 Manrique Surreb. Test., Ex. S-14 Surrebuttal Schedule JCM-5, 6.
72 *Id.* at JCM-9.
73 *Id.* at JCM-3.
74 Bourassa Cost of Capital Dir. Test., Ex. A-5 at 28-29.

cost of equity analysis is based on the midpoint of these two estimates. Half of the Past and Future Growth estimate relies on analysts' projections, while the Future Growth estimate relies entirely on analysts' projection. Thus, Mr. Bourassa's choice to use this midpoint gives analyst projections 75 percent of the weight, and historical data only 25 percent.[75] Staff's DCF model gives *equal* weight to the historical data and the analysts' forecasts, because they both hold important information used by investors.[76] According to Staff witness Juan Manrique, because analyst forecasts are known to be overly optimistic by relying too heavily on these on analyst produced growth figures could produce rates that are consistently too high.[77] Mr. Bourassa claims that giving equal weight to historical and prospective looking data "depresses the result produced by the DCF model,"[78] however his choice of weighing the data differently can skew the outcome. Equal weight is the appropriate and reasonable method for calculating the growth factor in the DCF model.

Additionally, the Company only used five years of historical data when calculating the DCF dividend growth rate in the Past and Future DCF method.[79] Five years may be too limited a time period to capture a full business cycle, and it is susceptible to significant variances if there is a single high or low data point.[80] Company witness Bourassa testified that a "five year or ten year period may equally reflect the earnings and earnings growth and dividend growth,"[81] but then acknowledged that Value Line reports provides ten year historical growth rates for revenue, earnings, dividends, and book value because this "information is of value to investors, and investors use that in making their determinations of their expectations."[82] However, the Company chose to utilize less information, only looking at five years of historical data. Staff's use of ten years is much more reasonable, captures a better picture of the economic environment, and is information used by investors.

Staff's overall CAPM cost of equity estimate is 10.6 percent; it is calculated by averaging the historical market risk premium CAPM (8.6 percent) with the current market risk premium CAPM

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75 Manrique Dir. Test., Ex. S-13 at 35.
76 *Id.* at 39.
77 *Id.* at 35-36.
78 Bourassa Cost of Capital Rej. Test., Ex. A-9 at 3.
79 Bourassa Cost of Capital Dir. Test., Ex. A-5 at 29.
80 Manrique Dir. Test., Ex. S-13 at 40.
81 Tr. at 371-73.
82 Tr. at 373-74.

(12.6 percent)[83]. Since RRUI itself is not a publically traded company, Staff had to calculate the average of the *Value Line* betas of the sample water utilities as a proxy for RRUI's beta in it's CAPM calculation; the Company also used the average beta in it's CAPM calculations.[84] The average beta of the sample water utilities was calculated at 0.80. It is undisputed among the parties that a stock with a higher beta is generally riskier from an investment standpoint than a stock with a lower beta.[85] While both parties used the average beta in their respective calculations, they disagree on whether it is an accurate reflection of RRUI's risk. The Company argues that because of its "small" size, it is riskier than the sample companies, but since it does not have its own higher beta, the risk should be reflected in a lower financial risk adjustment using the Hamada formula.[86] However, RRUI is not an unassociated small company, it is a subsidiary of a much larger Company, availing it to other resources and capital markets that most truly small companies would never have access. Staff believes that any risk that would be reflected in RRUI's beta is dissipated by this association and no other adjustment is necessary.

Staff used the Hamada method to calculate a downward financial risk adjustment for RRUI of 110 basis points (1.1 percent) based on its actual capital structure of 100.0 percent equity and 0.0 percent debt.[87] The DCF and CAPM averages for the sample utilities came to 10.3 percent, when 110 basis points is subtracted to calculate RRUI financial risk adjustment, the cost of equity becomes 9.2 percent.

B. Staff's Use Of The Hamada Adjustment Was An Appropriate Method To Adjust Of The 100 % Capital Structure.

While the use of a hypothetical capital structure is a method to balance a capital structure, the Commission has also recognized that the Hamada equation as used by Staff is an appropriate method to address a company's unbalanced capital structure. The Hamada equation uses quantifiable data and uses a company's actual capital structure. The Commission has adopted Staff's approach in numerous cases, and Staff's use of the Hamada equation was appropriate in this case.

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83 Manrique Surreb. Test., Ex. S-14 at Schedule JCM-3.
84 Bourassa Cost of Capital Dir. Test., Ex. A-5 at 32, 36-37.
85 Tr. at 1057.
86 Bourassa Cost of Capital Rebuttal Test., Ex. A-7 at 9.
87 Manrique Dir. Test., Ex. S-13 at 33.

While 100 percent equity is not an ideal capital structure for a company with access to capital markets, it is preferable to the more frequent situation of companies with an inadequate capital structure that has too little equity and excessive debt.[88] Excessive debt increases financial risk.

While the Company also utilized the Hamada method to calculate a downward adjustment for financial risk, it has criticized Staff's use of book value of equity, as opposed to market values, in their calculation.[89] However, Staff's method has been consistently employed by Staff in numerous rate cases and adopted by the Commission in many decisions.

C. <u>The Commission Should Reject The Company's Argument That It Is Susceptible To Additional "firm specific risk".</u>

The Company has argued through out this case that "firm specific risks" make RRUI a riskier utility; risks such as small size, lack of diversification, limited revenue and cash flow, small customer base, lack of liquidity, and the Arizona regulatory environment.[90] These are risks they believe should be reflected by increasing the COE by 50 basis points. Moreover, the Company asserts that Staff has ignored RRUI's firm-specific risks, thereby making their recommended ROE unreasonable.[91] Staff does not ignore firm specific risks; Staff has long taken the view that "firm specific risk" is a non-market risk that can be eliminated by holding a diverse portfolio; therefore it would not affect the cost of equity.[92] Despite Staff's consistent handling of "firm specific risk," the Company continues to advocate the position that RRUI's size, its lack of liquidity and Arizona's regulatory environment make RRUI riskier, necessitating an upward adjustment of the COE to reflect that risk.

The Company continues to advocate a "small firm risk adjustment" be applied to RRUI despite the Company's inability to precisely quantify the effect a "small firm risk" has on the Company.[93] It interesting to note that the Company argues that one of the benefits of a shared services model is the access APIF provides to the capital markets, thus touting the benefits of being

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[88] In Tucson Electric Power ("TEP"), Decision No. 67454, the Commission adopted a hypothetical capital structure, because of TEP's poor financial condition. In another TEP matter, Decision No. 58497, the Commission added equity in its adoption of a hypothetical capital structure because TEP's capital structure was 100% debt.

[89] Bourassa Cost of Capital Rebuttal Test., Ex. A-7 at 9.

[90] Bourassa Cost of Capital Dir. Test., Ex. A-5 at 37.

[91] Bourassa Cost of Capital Rebuttal Test., Ex. A-7 at 5.

[92] Manrique Dir. Test., Ex. S-13 at 11-12.

[93] Bourassa Cost of Capital Rebuttal Test., Ex. A-7 at 13.

associated with a large firm, yet argues for a small firm risk premium.[94] The Company failed to cite any recent Commission decisions where a small company risk premium was adopted."[95] The Commission has expressly rejected them, stating that "we do not agree with the Company's proposal to assign a risk premium to Arizona Water based on its size relative to other publicly traded water companies."[96] Staff recommends that the Commission continue their pattern of disallowing a "small firm risk premium."

States acknowledged that monopolies that provide basic services to the public such as water and wastewater services require regulation, hence the creation of public utility commissions. However, it is presumed that upon entering any regulated market, that businesses and investors understand the attributes of regulation. Regardless of the Company's criticisms Arizona's ratemaking process, it is the regulatory environment in which it must operate. RRUI's contention that it should be given a risk adjustment because it operates under Arizona's regulatory regime lacks merit. Every utility in Arizona operates under the same regulatory framework, RRUI is not unique. The idea that the Company should be given an adjustment based on Arizona's regulatory environment should be quickly disregarded.

Staff urges the Commission to adopt their proposed cost of equity of 9.2 percent because it is based on a sound, reasonable methodology.

VI. ENGINEERING ISSUES.

A. <u>Hook-Up Fee Tariff.</u>

The Company has proposed a hook-up fee tariff. For its water division, the Company proposed an $1800 hook-up fee for a new 5/8" by ¾" meter service connection. For the wastewater division, the Company proposes an $1800 hook-up fee per new service lateral based on the equivalent residential unit of 320 gallons per day. Staff has recommended denial of the proposed hook-up fee tariffs.

As Staff witness Jian Liu testified, the purpose of hook up fees is to equitably apportion the costs of constructing additional off-site facilities to provide water production, delivery, storage and

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[94] *See* Tr. at 223.
[95] *Id.* at 376.
[96] Dec. No. 64282, Ex. S-5 at 18-19.

pressure among all new service connections. "Off-site Facilities" means wells, storage tanks and related appurtenances necessary for proper operation, including engineering and design costs. Offsite facilities may also 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*** (emphasis added). The determination of a reasonable hook-up fee amount is based on the off-site plant that will be needed to meet future growth divided by the ultimate number of connections that can be served by the required plant.[97]

Staff asserts that there is no need for a hook up fee at this time. The Company could not identify any capital expenditures detailing plant items in support of its requests.[98] Staff further contends that for the water division, there is adequate production and storage capacity and storage capacity to serve its existing customer base and reasonable growth for the foreseeable future.[99]

The Company contends that, based on its Master Plan, its calculation on water storage capacity is conservative to ensure that it has enough water to serve its customer base and that using the Master Plan methodology, under the Company has a slight deficit.[100] Company witness Greg Sorenson testified on the first day of the hearing that the Company was not running out of water and was "fine our water supply from a well standpoint."[101] He further testified that the Company was going to look into additional storage in the future.[102] Staff disagrees with the later testimony by the Company with respect to its water supply and cites the Company's water use data sheets as support, which shows an adequate amount of water to serve its customers and no deficit.[103]

As Staff witness Liu explained, the Company used a number of assumptions in its Master Plan that account for the overly conservative water use data. The Company's calculation used 341.6 gpd per unit instead of its actual water use of 310 gpd per unit.[104] The Company added an additional 1,000 connections; by the Company's own admission, growth is flat to negative.[105] Additionally, the

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[97] Liu Surreb. Test., Ex S-9 at 2.
[98] *Id.* at 3.
[99] *Id.* at 4.
[100] Sorenson Rej. Test., Ex. A-3 at 11; Tr. at 657.
[101] Tr. at 75.
[102] *Id.*
[103] *Id.* at 708.
[104] *Id.* at 711.
[105] *Id.* at 711, 713.

Company, in its calculations, removed the largest producing well from service.[106] Staff's calculations used the Company's actual water use data and concluded that the Company has not used 50 percent of its capacity.[107]

For its wastewater division, Staff witness Liu testified that the Company has adequate treatment capacity for the next three years.[108] The Company has available to it 550,000 gallons of treatment capacity through its agreement with the City of Nogales.[109] In the Company's service area, about two-thirds of its customers are on septic, only one-third of its customers require wastewater service.

In addition to Staff's position that the Company has adequate treatment capacity, Staff has concerns regarding the amount proposed by the Company. In a review of the Company's proposed calculations, the Company stated that if capacity were purchased from the City of Nogales[110], the hook-up fee would be $2598 per new connection.[111] If the Company were to build its own treatment facility, the connection fee would be $6,667.[112] The Company's inability to truly capture the costs for treatment for new connections supports Staff's position that now is not the time for a hook-up fee.

The Company's proposed forms of tariff deviate from the standard form recommended by Staff. Should the Commission decided to grant the Company's request, Staff would recommend that the Company be directed to use the standard form.[113] There is nothing to preclude the Company for filing a request for a hook-up fee tariff when there is actually a need.[114]

B. Water Loss.

Staff recommends that the Company file, annually after the effective date of the Decision in this matter, reports within 30 days of the end of each calendar year, with the Commission's Docket control, which indicate the quantity of water pumped and sold each month during the year. In the event the non-account water level for the Company exceeds 10 percent during a reporting period, the

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106 *Id.* at 711.
107 *Id.* at 712.
108 *Id.* at 716.
109 Water Treatment Services Agreement, Ex. S-1.
110 *See id.*
111 March 12, 2010 E-mail, Ex. S-10; Tr. at 715.
112 Tr. at 715.
113 Becker Surreb. Test., Ex. S-7 at 20-21.
114 March 12, 2010 E-mail, Ex. S-10 at 664.

Company shall report the efforts taken to reduce water loss, such as the number of leaks repaired. If after three consecutive reports have been filed the Company's non-account water levels remains below the 10 percent threshold, Staff recommends that the reporting requirement be eliminated.[115]

The Company appears to argue that because it knows where some of the water goes, for example, if the loss results from a leak known by the Company, it's not "lost". The Company, for example argues that when it responded to Staff's Data Request JWL 1.5, its Company use was over 30 million gallons. Some of the water was used for things such as fire flow purposes and line flushing. However, some of the 30 million gallons resulted from leaks. According to Mr. Liu, a leak is a water loss even if the Company knows that it is a leak and how much water was lost during the leak.[116] For Staff, a water loss is a water loss whether it is counted or not counted.[117]

C. Best Management Practices.

The Modified Non-Per Capita Conservation Program ("Modified NPCCP") is a regulatory program administered by the Arizona Department of Resources that was added to the Third Management Plan for Arizona's Active Management Areas ("AMAs"). It is a performance-based program that requires participating providers to implement water conservation measures that result in water use efficiency in their services areas.[118] Providers must implement a Public Education Program and one or more additional Best Management Practices ("BMPs") based on their total number of residential and non-residential water service connections.[119]

Because the Company is in an AMA, it is subject to the requirements. Company witness Sorenson testified that even though the Company is required to have five BMPs in place, it has ten.[120] The Company listed its BMPs in a late filed exhibit. Staff witness Liu testified that Staff was in the process of working through the issue of processing the BMPs but suggested that the Company submit each BMP as a tariff.[121]

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115 Liu Surreb. Test., Ex. S-9 at 2.
116 Tr.707.
117 Tr. at 719.
118 See http://www.azwater.gov/azdwr/WaterManagement/AMAs/documents/MNPCCPFAQs.pdf.
119 *Id.*
120 Tr. at 673.
121 Tr. at 757.

VIII. CONCLUSION.

Staff's recommendations are reasonable and should be adopted.

RESPECTFULLY submitted this 19th day of April, 2010.

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