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BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission

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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 REPLY BRIEF

I. INTRODUCTION.

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") has already responded in its Post-hearing brief to many of the arguments made by Rio Rico Utilities, Inc. ("RRUI" or "Company") and responds as follows to the closing briefs filed by the Company and the Residential Utility Consumer Office ("RUCO"). The purpose of this Reply Brief is not to repeat every point made in Staff's Initial Closing Brief, nor will it attempt to refute every single issue raised by the Company or RUCO; instead Staff relies upon its testimony on those issues not specifically addressed in this Reply Brief. The recommendations of Staff and its positions have been outlined in its Opening Brief as well as its testimony. Staff will highlight some of the major points of disagreement with the Company in this brief.

II. THE LEGAL FRAMEWORK FOR RATEMAKING.

A. In Exercising Its Mandate Under The Arizona Constitution, The Commission, Exercising Its Broad Discretion, Sets Rates That Are Just And Reasonable Balancing The Interest Of Utilities And Those Of The Ratepayers.

The Company's singular focus in its discussion of ratemaking and the responsibility of the Commission is that a utility is entitled to rates that provide sufficient revenue to allow recovery of reasonable operating expenses and a fair rate of return. The Company appears to argue that the

1 Commission is limited in the factors it can consider when setting just and reasonable rates. Staff
2 would caution against a narrow interpretation of the Commission's plenary rate making authority.

3 Article 15, section 3, of the Arizona Constitution provides, in relevant part, that the
4 Commission "shall have full power to, and shall, prescribe just and reasonable classifications to be
5 used and just and reasonable rates and charges to be made and collected, by public service
6 corporations within the State for service rendered therein..." In determining just and reasonable
7 rates, the Commission has broad discretion, subject to the obligation to ascertain the fair value of the
8 utility's property and to establish rates that "meet the overall operating costs of the utility and
9 produce a reasonable rate of return."¹ Under the Arizona Constitution, a utility company is entitled to
10 a fair rate of return on the fair value of its properties, "no more and no less."² Arizona law does not
11 mandate that the Commission (1) follow a particular method in its rate making determinations or (2)
12 exclude consideration of relevant factors.³

13 The Company argues the Commission, in the discharge of its duties, should not consider the
14 current state of this nation's economy in the setting of just and reasonable rates, arguing that such
15 factors are incorporated in the cost of capital analysis of the parties.⁴ The Commission may consider
16 all of the available evidence and may use its expertise to reconcile the evidence and develop a
17 reasonable resolution. The ratemaking process does not lend itself to rule formulation because
18 relevant factors may be given different weight at the discretion of the Commission at the time of
19 inquiry.⁵ The court held in *Bluefield*:

20 "What annual rate will constitute just compensation depends upon many
21 circumstances and must be determined by the exercise of fair and enlightened
22 judgment, having regard to all relevant facts....A rate of return may be
23 reasonable at one time and become too high or too low by changes affecting
24 opportunities for investment, the money market and business conditions
25 generally."⁶

26 ¹ *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 534, 578 P.2d 615 (App. 1978).

27 ² *Litchfield Park Serv. Co. v. Ariz. Corp. Comm'n*, 178 Ariz. 451, 874 P.2d 988, 991 (App. 1994) (citing *Ariz. Corp. Comm'n v. Citizens Util. Co.*, 120 Ariz. 184, 190n.5, 431, 584 P.2d 1175, 1181n.5 (App. 1978)).

28 ³ *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956).

⁴ Co. Initial Cl. Br. at 8.

⁵ *Morris v. Ariz. Corp. Comm'n*, 24 Ariz. App. 454, 457, 539 P.2d 928, 931 (1975).

⁶ *Bluefield Waterworks & Imp. Co. v. Pub. Serv. Comm'n of W.Va.*, 262 U.S. 679, 692 (1923).

1 The Company seemingly understates the responsibilities of the Commission in the setting of
2 rates. Protecting ratepayers, however, is part of the balancing in the public interest performed by the
3 Commission. The Commission not only sets just and reasonable rates for public service corporations,
4 but also sets rates to protect ratepayers from overreaching by those very corporations.⁷ The
5 Company's arguments are no more than an attempt to undermine the Commission's responsibility of
6 balancing the customer and utility interests at the expense of ratepayers. "The jurisprudence of our
7 State made it plain long ago that the interests of the public-service corporation stockholders must not
8 be permitted to overshadow those of the public served."⁸

9 **III. RATE BASE.**

10 **A. Staff's Adjustments Regarding Accumulated Deferred Income Tax Are Properly**
11 **Supported By The Record.**

12 In its brief, the Company continues to disagree with the Staff's exclusion of net operating loss
13 carry forwards ("NOL"s) and the disallowance of \$105,049 in the fixed asset component for
14 unidentified plant from the accumulated deferred income tax ("ADIT") adjustment. In summary,
15 Staff recommends an ADIT debit in the amount of \$82,782.⁹

16 **B. Net Operating Loss Carry Forwards Should Be Excluded From The ADIT**
17 **Calculation.**

18 Staff still maintains that such inclusion of NOLs is inappropriate. As Staff witness Becker
19 testified, Staff researched the Internal Revenue Code and was unable to locate any citation requiring
20 the normalization of anything other differences arising from the number of years or depreciation
21 methods.¹⁰ A NOL does not fall into either category because it is simply a net tax loss that may have
22 arisen from all operational circumstances. The Company has testified that the NOL arose from a
23 special bonus depreciation allowed during the test year, a one time take it or lose it tax opportunity
24

25 ⁷ *Scates*, 118 Ariz. at 534, 578 P.2d 612 at 615.

26 ⁸ *Ariz. Cmty. Action Ass'n v. Ariz. Corp. Comm'n*, 123 Ariz. 228, 231, 559 P.2d 184, 187(1979); *Ariz. Corp. Comm'n*
27 *v. Woods*, 171 Ariz. 286, 296, 830 P.2d 807, 817 (1992) ("The Commission was not designed to protect public
service corporations and their management, but rather, was established to protect our citizens from the results of
speculation, mismanagement and the abuse of power.").

28 ⁹ In Staff's Opening Brief discussion on ADIT refers to a credit, when it is really a debit. See p. 4 at line 14.

¹⁰ Tr. page 891.

1 and was the result of a one time bonus depreciation.¹¹ The Economic Stimulus Act of 2008 included
2 a provision allowing businesses to claim a bonus first-year depreciation deduction of 50 percent of
3 personal property that was acquired and placed in service during calendar year 2008.¹² This
4 economic stimulus incentive was originally introduced in 2002 in the aftermath of the September 11
5 terrorist attacks. However, NOLs are not book versus tax timing differences, but instead, represent a
6 tax loss that can be carried forward to offset taxable income in future years. Therefore, the NOL
7 component should not be included in the ADIT calculation. The Company's proposal to include the
8 entire amount of the NOL in its rate base inappropriate, but as Staff witness Becker testified, the
9 parent company has already turned these NOL's into cash less than 12 months after the end of the test
10 year.¹³

11 For the Fixed Asset Component, Staff continues to recommends removal of \$105,409, as this
12 amount is unidentified plant.¹⁴ Staff would submit that it is reasonable that plant be identified. The
13 Company likens Staff's adjustment to removing a tree from the forest because the company could not
14 identify the type with certainty.¹⁵ Staff's position is that it would like to know that there was even a
15 tree before passing along these costs to ratepayers.

16 C. **Staff's Recommendation Regarding The ADIT Fixed Assets Component AIAC**
17 **Should Be Adopted.**

18 Staff and the Company are in agreement regarding the Advances in Aid of Construction
19 ("AIAC") associated component of ADIT. However, RUCO has recommended that the Commission
20 disregard the Staff and Company position regarding the AIAC component.

21 As Staff witness Becker explained, a future tax benefit is created to the extent that the
22 Company pays taxes on AIAC received.¹⁶ A temporary difference or ADIT balance is created by the
23 Company paying taxes before it makes any AIAC refunds which create a tax basis in the plant
24 constructed. The Company is then entitled to record tax basis depreciation on that plant.¹⁷ Thus the

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26 ¹¹ Co. Initial Cl. Op. Br. at 11-12.

¹² 26 U.S.C. § 179.

¹³ Tr. at 917.

¹⁴ Becker Surreb. Test., Ex. S-7 at 15.

¹⁵ Co. Initial Cl. Br. at 12.

¹⁶ Becker Dir. Test., Ex. S-6 at 11.

¹⁷ *Id.* at 18.

1 AIAC balance on the Company's books represents the unrefunded AIAC received and can be used, in
2 this instance, as the basis for calculation of the future tax benefit, or an ADIT debit.¹⁸ Staff's
3 recommended an AIAC balance for both water and wastewater of \$360,293. Staff calculated the
4 balance by multiplying the tax rate of 38.6% times the AIAC balance for a debit of \$139,073.¹⁹

5 **IV. INCOME STATEMENT.**

6 **A. Central Office Cost Allocation.**

7 The Company spends a substantial portion of its brief defending the shared services model
8 and the cost pool allocation. As stated earlier, Staff is not opposed to a shared services model; in
9 fact, Staff made no adjustment for the costs that were allocated to RRUI from Liberty Water.²⁰ As
10 the testimony developed during the evidentiary hearing demonstrated, there remained costs in the
11 cost pool that should be excluded.²¹ Some costs, while insignificant, have nothing to do with
12 providing services to RRUI rate payers. In fact, the Company removed additional expenses and
13 reduced the cost pool in its final schedules.

14 The Company contends that the appropriate standard for allowing recovery of the expenses
15 contained in the APT cost pool should be whether the expense was necessary because of the chosen
16 business model.²² Further the Company argues that the standard for recovery is whether the expense
17 was necessary" "...in the proper conduct of its business or was of direct benefit to the utility's
18 ratepayers...."²³ The Company's arguments are superficial and are a misapplication of the standards
19 guiding recovery of reasonable and prudent expenses. The business referred to in the quote is the
20 utility business, not the operation of a corporation that is in the renewable energy field and whose
21 stated goal is "growth in cash flow and earnings in the business segments in which it operates."²⁴

22 Even assuming that the costs in the APT costs are necessary under the Liberty Water business
23 model, a model that was chosen by Algonquin, it does not preclude the denial of costs that are more

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18 *Id.*

19 *Id.*

20 Tr. at 510.

26 21 Tr. at 322-24. In a review of the listing of expenses (Ex. S-4) was an expense for Sky Body Wash. The Company
27 attempted to pass off this beauty aid as an office expenses. However, it was listed as "other professional services."
See tr. at 350.

22 Co. Initial Cl. Br. at 24.

23 *Id.*

28 24 Becker Surreb. Test., Ex. S-7 at 10.

1 appropriately borne by the Algonquin shareholder. The Commission has on numerous occasions
2 disallowed expenses, finding that it was a cost that was more of a benefit to a company's
3 shareholders. For example, the Commission, *In the Matter of Southwest Gas Company*, denied
4 recovery of 40% of the cost associated with dues for the American Gas Association, 50% of the cost
5 associated with the management incentive plan and 100% of the cost associated with the
6 supplemental executive retirement plan.²⁵ While these programs may be "necessary for the proper
7 conduct of its business," the Commission disallowed costs that should not be recovered in rates.

8 The Company asserts that Staff's (and RUCO's) inability or lack of manpower to analyze the
9 entire APT cost pool is not a justification for denying 99% of those costs.²⁶ While the Company's
10 math is questionable in arriving at a 99% denial rate,²⁷ it is the Company, not Staff or RUCO, which
11 bears the burden of proof in this case. Staff offered considerable testimony on its removal of costs
12 from the cost pool. There is no requirement, as the Company seems to suggest, that Staff expend
13 considerable resources performing the kind of audit of the cost pool that the Company should have
14 undertaken in the first place. In fact, Judge Rodda even questioned why the Company did not review
15 the cost pool more closely and remove questionable or inappropriate expenses, rather than rely on
16 Staff to perform an exhaustive review.²⁸

17 The Company seems to imply that if the Commission does not accept all the cost allocation
18 methodology and the APT costs, it would not be able to provide the same level of service. As a
19 public service corporation, RRUI is obligated to provide safe and reliable service, regardless of the
20 business model employed.

21 The Company's entire argument in support of its cost pool and its allocation ignores the
22 ratemaking principles underlying recovery of expenses: were the expenses incurred reasonable and
23 necessary for the provision of service to ratepayers? The Company has not adequately demonstrated
24 that all of the costs in the pool are related to providing service to its ratepayers. Staff's
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27 ²⁵ See Dec. No. 70665 (December 24, 2008) at 58.

28 ²⁶ Co. Initial Cl. Br. at 17.

²⁷ See Tr. at 506; Staff assigned 90% of the cost to APIF.

²⁸ Tr. at 326.

1 recommendations strike a balance between an appropriate allocation between the ratepayers and the
2 shareholders and should be adopted.

3 **B. The Company's Request For Additional Rate Case Expense Should Be Denied.**

4 There were very few contested major issues in this case: ADIT, Cost Allocation, Cost of
5 Capital, and Hook up Fees. The majority of the case focused on the cost allocation pool, which the
6 majority of the cost pool benefits the ultimate shareholders of Algonquin Power and Utilities Corp.
7 This issue is not new and has been contested in two recent rate cases. The Company states in its brief
8 that the level of rate case expense it is requesting "more closely tracks the actual amounts
9 incurred...."²⁹ The ratepayers should not bear the entire burden of rate case expense, when the most
10 contested issues involved the continued attempt by the Company to pass off expenses that should be
11 borne by APUC shareholders. Further, the Company argues "it was forced to spend more time and
12 money than initially estimated to do so."³⁰ The Company does not identify who forced it to spend
13 more money, and it is not in the interest of its ratepayers to pay for those extra costs. Staff
14 recommended rejection of the additional rate case expense requested by the Company. Staff found
15 the Company's initial estimate to be reasonable and continues to recommend \$70,000.³¹ \$70,000 is
16 for the water division only, plus \$41,667 for the wastewater division. Staff would urge the
17 Commission to reject the Company's request of \$360,000.³²

18 **V. COST OF CAPITAL.**

19 **A. The Company's Proposed ROE Is Inflated.**

20 The Company's proposal for a return on common equity capital of 11.7 percent, which includes
21 a 50 basis points upward adjustment for firm-specific risk, is excessive compared to recent rates of
22 return set by the Commission for comparable companies.³³

23 The Company argues that there are no comparable market data for small utilities like RRUI,
24 stating that the average revenue of the proxy water utilities is over 78 times that of RRUI.³⁴ The
25

26 ²⁹ Co. Initial Cl. Br. at 38.

27 ³⁰ *Id.*

28 ³¹ Staff final schedule GWB-11.

³² Co. Initial Cl. Br. at 38.

³³ See Dec. No. 71410 (9.9%) at 45; Dec. No. 71308 (9.9%) at 37.

³⁴ Co. Initial Cl. Br. at 43.

1 Company's argument ignores the fact that what the proxy group and RRUI all have in common is that
2 they are all regulated monopolies whose product is water and that companies within the proxy group
3 are composed of multiple individual water systems and that RRUI is but one entity and one of many
4 utilities under APIF. The Company cites the U.S. Supreme Court decision in *Hope Natural Gas* to
5 support its proposition that rates set in this proceeding must be sufficient to allow the company to
6 earn its authorized rate of return during the period the rates will be in effect.³⁵ *Hope* also requires
7 that rate regulation must take account of both the consumer and investor interests. The Court went on
8 to state in *Hope* that the "fixing of 'just and reasonable' rates, involves a balancing of the investor
9 and the consumer interests."³⁶

10 There is no dispute that in the setting of a fair rate of return, the Commission should set a rate
11 that both attracts capital and provides a return that commensurate with returns on other investments
12 attended by corresponding risks. But the Commission, in the exercise of its authority, must also
13 include in its setting of a fair rate of return, the impact on the public interest, something the Company
14 completely ignores.

15 **VI. THE COMMISSION SHOULD REJECT THE COMPANY'S REQUEST FOR A**
16 **HOOK UP FEE TARIFF.**

17 The Company's arguments regarding the necessity of a hook up fee tariff remain
18 unpersuasive. The Company ignores the purpose of a hook up fee and disregards the information
19 necessary for a determination of an appropriate hook up fee.

20 According to the Company, Staff cites two reasons for its opposition to a hook up fee tariff:
21 (1) the inability of the Company to identify what plant is to be funded and (2) that the Company has
22 enough capacity in both its systems to preclude the necessity of a hook-up fee tariff at this time.³⁷

23 The Company states that the plain language of the proposed tariff describes the plant to be
24 funded. This argument turns the definition on its head. What plant is the Company proposing to
25 construct is the real question and for the Company to argue that it does not understand that to be the
26 issue misses the point.

27 _____
³⁵ 320 U.S. 591 (1944).

28 ³⁶ *Id.* at 603.

³⁷ Co. Initial Cl. Br. at 75.

1 In its brief the Company claims that it would be impossible to state with certainty what plant
2 is needed and the cost of such plant, making Staff's recommendation unreasonable.³⁸ Despite the
3 Company's plea of impossibility, other water utilities have managed to provide Staff and the
4 Commission with the requested information. For example, *In the matter of Pineview Water Company*,
5 Pineview submitted cost information, projected number of new customers, as well a listing of the
6 plant items to be constructed.³⁹ Staff was then able to develop an appropriate recommendation with
7 respect to Pineview's request. The Commission adopted Staff's recommendations.⁴⁰

8 As Staff noted in its Closing Brief, there is nothing to preclude the Company from seeking
9 approval of a hook-up fee tariff at a later date.⁴¹

10 **VII. CONCLUSION.**

11 The Commission should adopt the Staff's recommendations as discussed herein and in the
12 Staff's Closing Brief as the rates produced thereby are just and reasonable and in the public interest.

13 RESPECTFULLY submitted this 10th day of May, 2010.

14
15 
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24 ...

25 ...

27 ³⁸ *Id.* at 76.

³⁹ See Co. Application, Dkt. No. W-01676A-04-0462.

28 ⁴⁰ Dec. No. 67275 (October 5, 2004).

⁴¹ Staff Op. Br. at 20.

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