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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

RIO RICO UTILITIES, INC.

REPLY CLOSING BRIEF

May 10, 2010

Arizona Corporation Commission
DOCKETED

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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**
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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	
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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**

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RRUI hereby replies to the closing briefs filed by Staff, RUCO and RRPI in this rate case.[1]

I. REPLY ON RATE BASE ISSUES

A. ADITs, ADITs, ADITs.

The parties generally agree that DITs arise from tax timing difference and that these differences need to be recognized pursuant to SFAS 109.[2] Staff and RRUI also are in agreement regarding the methodology for calculating the ADIT.[3] Although Staff also asserts that it proposes a "credit ADIT," a "reduction" to rate base, while RRUI proposes to add to rate base with an "ADIT debit,"[4] actually, both Staff and RRUI are recommending DIT assets, additions to rate base, as Mr. Becker testified at trial.[5] The only difference between Staff and RRUI on the ADIT balance is in the amount of the asset; Staff's being smaller because Staff has modified two components of the Company's ADIT calculation. Staff calls the first excluded component as "unidentified" plant.[6] No reason is given for the exclusion of $105,409 of tax basis in plant, and Staff has never been able to respond to the Company's explanation, which is that the ADIT calculation has been reconciled to the Company's books and records and the amount is not in dispute.[7] Thus, it is immaterial that the specific invoice(s) for one or more plant items

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[1] In this reply brief, RRUI uses the same citation format, abbreviations and conventions as utilized in its initial closing brief dated April 19, 2010. Additionally, the parties' closing briefs will be identified as "Staff Br.," "RUCO Br.," "RRPI Br.," and "RRUI Br." respectively.

[2] Staff Br. at 3:21–23; RUCO Br. at 6:5-9; RRUI Br. at 9:21 – 10:1.

[3] Staff Br. at 4:11.

[4] *Id.* at 4:12-14.

[5] Tr. at 910:3-7. *See also* Surrebuttal Testimony of Gerald W. Becker at 17 – 18, Schedule GWB-3 (water and wastewater); Staff Final Schedules GWB-3 (water and wastewater) and GWB-7 (water and wastewater). Undersigned counsel spoke with counsel for Staff and it appears that the confusion arose because rate base additions are shown as negative numbers in the deductions section of the schedules.

[6] *E.g.,* Staff Br. at 4:21.

[7] Rejoinder Testimony of Thomas J. Bourassa – Rate Base, Income Statement and Rate Design ("Bourassa Rj.") at 7:17 – 8:2; Tr. at 780:14 – 781:14.

totaling $105,409 could not be located. Staff agrees the plant is there because it does not dispute the amount of the ADIT calculation.

Staff's exclusion of the NOL is based primarily on Staff's failure to find authority for its inclusion for rate making purposes.[8] But Staff also failed to find any authority for exclusion of the NOL from the ADIT calculation. Staff's "fairness" assertion also is erroneous. As explained in the Company's closing brief, ratepayers have not yet paid any rates associated with the NOL because it arose from a one-time special depreciation allowance available during the test year.[9] Moreover, it is entirely fair to include the NOL in the ADIT calculation given that the taking of the bonus depreciation has already lowered the DIT asset, and thus rate base, and could provide future tax savings to the benefit of the Company and its ratepayers if the tax treatment is consistent as is required by federal tax law.[10]

RUCO's position on ADITs is a whole other matter. RUCO's allocation methodology is based on an allocation of the parent company's ADITs based on the 2005 stock acquisition price of RRUI, and RUCO spends roughly one-third of its brief arguing in support of its ADIT methodology.[11] Amazingly, though, nowhere in those pages does RUCO acknowledge that its recommended methodology is identical to that rejected by the Commission in a recent rate case for RRUI's affiliate, BMSC.[12] Nor can RUCO dismiss this clear precedent by the typical refrain – rate cases are decided case-by-case. That's true, but like facts should be treated in a like fashion absent a rational basis based on evidence to the contrary. Because RUCO fails to even acknowledge the existence of directly applicable precedent, RUCO makes no effort to differentiate this case and its facts

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[8] Staff Br. at 5:3-4, 10 – 13.

[9] Tr. at 117:16 – 118:19, 912:3-8.

[10] RRUI Br. at 12:1-6 (several citations).

[11] *Id.* at 2 – 7.

[12] *See* Tr. at 851:9-24. *See also Black Mountain Sewer Corporation*, Decision No. 69164 (December 5, 2006) at 5:27 – 6:15.

from the similarly situated BMSC. Therefore, there is simply no basis not to reject RUCO's argument again.

Perhaps recognizing the weakness of its position, RUCO seeks to cast aspersions on the Company's calculation and then to hide behind SFAS 109. Both these efforts fail. ADIT calculations change every time rate base changes during the lead up to final positions in a rate case.[13] Further, the Company explained each of its changes to the ADIT calculation at each stage of the proceedings.[14] That there is nothing suspect in the calculation is borne out by Staff's agreement, less the two components discussed above, the amounts of which have never been in dispute. As for SFAS 109, it requires only that the allocation of deferred taxes between parent and subsidiary be systematic and rational.[15] That's not in dispute because neither Staff nor RRUI are allocating deferred taxes from the parent. There is no reason to do so in this case because RRUI's books and records are available and a DIT calculation can be made for RRUI.[16] SFAS 109 does not say that it is rational to ignore the specific utility's books and records in order to create a rate base reduction. Nor is RUCO's calculation methodology systematic and rational. RUCO is basing a portion of RRUI's rate base on assets in Manitoba, upstate New York and Texas based on a ratio created from a five-year old stock purchase transaction. This has nothing to do with whether RRUI has a tax asset or liability, which is why the Commission already has rejected RUCO's methodology and supporting arguments once before.[17] There is simply no reason not to do so again.

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[13] *See* Tr. at 122:20 – 123:6.

[14] Rebuttal Testimony of Thomas J. Bourassa – Rate Base, Income Statement and Rate Design ("Bourassa Rb.") at 6 – 7, 20 – 21.

[15] RUCO Br. at 6:15-18.

[16] *E.g.*, Tr. at 910:8-10.

[17] Decision No. 69164 at 5:27 – 6:15.

II. <u>REPLY ON INCOME STATEMENT ISSUES</u>

Author Jessamyn West once said: "*We want the facts to fit the preconceptions. When they don't, it is easier to ignore the facts than to change the preconceptions.*" That statement summarizes the closing briefs of Staff and RUCO on the APT Central Office Cost allocations. Staff and RUCO began this case with a preconceived notion that the APT Central Office Costs do not benefit ratepayers and artificially increase utility rates.

But the undisputed facts presented at hearing have shown those preconceptions to be wrong. The underlying record demonstrates that RRUI and its ratepayers derive substantial benefits from the APT services at truly minimal cost. The record demonstrates that RRUI's operating costs per customer rank below other Arizona utilities – clear proof that Liberty Water's shared services model works by allowing RRUI to provide high quality utility service at reasonable cost.[18] Rather than change their views on the APT costs, however, Staff and RUCO continue to assume that the APT costs are improper.

A. <u>Staff's and RUCO's Presumptions Against the APT Cost Allocations Are Misguided and Not Supported by Substantial Evidence.</u>

In their closing briefs, Staff and RUCO seek to disallow 98% of RRUI's Central Office Cost allocations from APT despite the ***undisputed*** evidence that RRUI provides high quality utility service at a reasonable cost.[19] Staff and RUCO deny the APT costs even though the services provided by APT were used by RRUI in the provision of service during the Test Year.[20] It's ***undisputed*** that RRUI actually used capital financing to install and construct significant plant and system improvements.[21] This capital financing would not have been available without the services provided by APT.

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[18] *See* Exs. A-12, A-13, A-14, A-15.

[19] *Id.*; Tr. at 26 – 27, 422 – 423, 450.

[20] Tr. at 427 – 428, 541 – 542, 1090.

[21] *Id.*; Direct Testimony of Thomas J. Bourassa – Rate Base, Income Statement and Rate Design ("Bourassa Dt.") at 12 – 13; Rebuttal Testimony of Peter Eichler ("Eichler Rb.") at 22 – 37; Direct Testimony of Greg Sorensen ("Sorensen Dt.") at 6 – 8.

Staff's and RUCO's primary objections to the APT cost allocations stem from their belief that the costs incurred by APT do not benefit RRUI's ratepayers and instead primarily benefit APIF and its shareholders.[22] "Staff contends that the central office costs were incurred primarily for the benefit of shareholders of APIF."[23] RUCO argues that "Rio Rico's ratepayers should not, under any circumstances, pay for the services of the Company's unregulated solar, electric and wind providers located in other states and/or other countries."[24] RUCO also contends that "only a very small portion of the costs allocated to the utility infrastructure group are directly attributable to Rio Rico."[25] These objections to the APT cost allocations are without merit, contrary to the underlying record and ignore the obvious benefits to ratepayers.

1. <u>The APT Costs and Services Directly Benefit RRUI And Do Not Primarily Benefit APIF and Its Shareholders.</u>

The focus of Staff's closing argument is that "the central office costs were incurred primarily for the benefit of the shareholders of APIF. Staff's review indicated that nearly all of the costs were obviously attributable to the operations of APIF or one of its affiliates."[26] In turn, Staff randomly removed 90% of the total APT cost pool as attributable to APIF, and Staff then allocated the remaining 10% of the total cost pool to

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[22] Staff Br. at 7 – 8; RUCO Br. at 8 – 9.

[23] Staff Br. at 7.

[24] RUCO Br. at 10.

[25] *Id.* at 9. This argument originates from Mr. Coley's testimony that the APT costs are "not directly attributable in the provisioning of water and wastewater service." Direct Testimony of Timothy J. Coley ("Coley Dt.") at 45; Tr. at 437 – 438. At trial, Mr. Coley testified that "directly attributable" means that RUCO would "like to see it being directly charged to a particular utility." Tr. at 438. That concession from Mr. Coley highlights his and RUCO's fundamental misunderstanding of Liberty Water's shared services model and the APT costs. All of the APT costs are "indirect costs" incurred by APT for the various utilities and facilities owned by APIF. Under the NARUC Guidelines, indirect costs are "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." Ex. S-3 at 2, ¶ A(10). In essence, Mr. Coley and RUCO are critical of Liberty Water for not directly charging the APT costs, which makes little sense given that the APT costs are "indirect costs." By definition, "indirect costs" cannot be directly charged to a single utility or facility, which is what necessitates use of an affiliate cost allocation methodology in the first place.

[26] Staff Br. at 7.

all facilities owned by APIF based on a ratio of 1/70.[27] The random and arbitrary nature of this disallowance is illustrated by Mr. Becker's concession at trial that he used a small sampling of improper invoices totaling less than 10% of the pool as justification for removing 90% of the pool.[28]

What Staff's methodology means is that 98% of the original pool is allocated to APIF and 2% is allocated to the 17 regulated utilities owned by APIF.[29] In total, Staff allocates $1,364 each to RRUI's water and sewer divisions.[30] Apparently Staff expects RRUI to obtain capital funding from the Toronto Stock Exchange, make necessary tax and regulatory filings, perform required financial audits and perform strategic and capital planning for the total cost of $2,728, which amounts to $0.33/year per customer or $0.028/month. Obviously, APIF and its unregulated facilities will not continue to subsidize 98% of a $3,900,000 cost pool for the benefit of RRUI and the other Arizona regulated utilities in the event the Commission adopts all of Staff's or RUCO's disallowances.

Staff's presumption that the APT costs primarily benefit APIF or its shareholders is not valid because all of the APT costs are incurred solely for the facilities owned by Liberty Water, including RRUI.[31] Rather than accept these facts, Staff and RUCO simply don't believe that RRUI's customers should pay for the services provided by APT at the

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[27] *Id.* Contrary to the undisputed evidence, Staff claims that APIF owns 70 facilities, not 63 as testified by the Company. Tr. at 240 – 242, 280 – 282; Eichler Rb. at 7 – 8.

[28] Tr. at 523 – 524.

[29] To illustrate the effects of Staff's methodology, let's suppose that the entire APT cost pool was $1,000,000. Staff immediately deducts 90% of that pool, or $900,000, as attributable to APIF. Under Staff's methodology, the remaining 10%, or $100,000, may be allocated to the utilities and facilities owned by APIF. Staff then allocates that $100,000 to each facility or utility owned by APIF based on a ratio of 1/70. Because APIF owns 17 regulated utilities, that means 75.7% (53/70) of that pool ($75,700) will be allocated to APIF and its unregulated facilities. The remaining 24.3% is allocated to the 17 regulated utilities, with each utility getting 1.43% (1/70) of the $100,000. In this hypothetical, RRUI would be allocated $1,430. ***The end result of Staff's methodology is that 98% of the APT cost pool is allocated to APIF and its unregulated facilities, with approximately 2% of the cost pool allocated to the 17 regulated utilities.***

[30] Staff Final Schedules GWB-20 (water) and GWB-19 (wastewater).

[31] Eichler Rb. at 12 – 13.

corporate level. Staff and RUCO have subjectively determined that the APT costs are not necessary in providing utility services because the APT costs primarily benefit APIF and its shareholders. These arguments make little sense. How does filing consolidated tax returns for RRUI and the other regulated utilities benefit APIF's shareholders? How do consolidated audits, including RRUI's finances and operations, generate revenue for APIF? How does strategic planning for capital and operations of the 17 regulated utilities promote growth for APIF's unregulated operations?

To make matters worse, Staff allocates the remaining 10% of the APT costs equally among 70 facilities which Staff claims are owned by APIF, resulting in allocation of 1.43% of the APT costs to RRUI.[32] Staff's and RUCO's insistence on allocating costs to 70 facilities defies logic and the evidence.[33] Mr. Eichler explained that APIF does not own seven (7) of those facilities and that those seven facilities do not use any APT services.[34] Staff and RUCO provide their own interpretation of APIF's 2008 Annual Report rather than acknowledge the undisputed evidence and testimony from the Company.[35] At trial, Mr. Eichler testified that APIF did not own the seven "Trafalgar" facilities, but only owned the debt notes relating to those facilities.[36] That testimony is confirmed by page 44 of APIF's 2008 Annual Report, which references the sale of debt obligations in the Trafalgar facilities to APIF, and the ensuing legal dispute relating to sale of those notes.[37] No matter how Staff and RUCO interpret the 2008 Annual Report, the simple fact is that APIF only owns 63 facilities. Staff's and RUCO's efforts to

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[32] Staff Br. at 7 – 8.

[33] Ex. A-16; Tr. at 240 – 242, 280 – 282; Eichler Rb. at 7 – 8; Staff Br. at 7 – 8; RUCO Br. at 8.

[34] Tr. at 240 – 242, 280 – 282; Eichler Rb. at 7 – 8.

[35] Staff Br. at 7 – 8; RUCO Br. at 8.

[36] Tr. at 240 – 242.

[37] 2008 Algonquin Power Income Fund Annual Financial Results at 44 (copy attached as **Reply Brief Exhibit 1**).

allocate costs to 70 facilities is an attempt to force APIF to cross-subsidize services provided to the Arizona utilities, which Staff concedes is improper.[38]

As Mr. Becker testified at trial, the operating premise for Staff's disallowance of the APT costs is that the APT costs relate primarily to services for unregulated business operations of APIF.[39] That operating premise is fundamentally flawed and isn't supported by any evidence, let alone substantial evidence. Mr. Becker didn't rely on any evidence, but instead presumptively denied 90% of the cost pool based on a few unrelated invoices:

> Q. When you decided to disallow 90 percent of the APT cost allocations, did you have invoices that should be charged to other facilities or projects amounting to 90 percent of the cost pool?
> A. No, sir.
> Q. So what you did was you took a representative sample of 1 or $200,000 of invoices that you thought shouldn't be included in the cost pool and used that as justification for disallowing 90 percent of the pool; fair?
> A. I think it was a bit more than 1 or $200,000, but I don't disagree with the basic concept.
> Q. But the basic concept, let's say that removals amounted to roughly $500,000 of a $5 million cost pool, so that is roughly 10 percent, correct?
> A. Correct.
> Q. Okay. So you used invoices totaling 10 percent of the cost pool that you felt shouldn't be allowed to justify removing and disallowing 90 percent of costs in the APT cost pool?
> A. In tandem with other considerations, yes.[40]

That type of presumptive disallowance is forbidden by Arizona law.[41]

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[38] Tr. at 530 – 531. On page 8 of its brief, Staff argues "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 Br. at 8. That argument is flawed for three reasons. First, the evidence is undisputed that APIF does not own or operate the seven Trafalgar facilities. Two, Staff is simply speculating that APT incurs monitoring costs associated with those seven facilities. Third, the final APT cost pool does not include any costs associated with monitoring the Trafalgar facilities.

[39] Tr. at 512 – 516.

[40] Id. at 523 – 524.

[41] *Arizona Public Serv. Co.*, Decision No. 55931, 91 P.U.R. 4th 337, 350 (April 1, 1988). The case cited by Staff on page 9 of its brief, *Ariz. Corp. Comm'n v. U.S. West Commns.*, 185 Ariz. 277, 915 P.2d 1232 (App. 1996) also supports this principle. There, the Court of Appeals upheld the Commission's decision to disallow certain affiliate costs for lease payments because there were adequate lower cost alternatives available to the utility. *Id.* 282, 915 P.2d at 1237. The Commission's decision in that case was based on a

RUCO's arguments are even more superficial and arbitrary. RUCO allocates 25% "of the audit, tax services, legal and depreciation expenses" to the regulated utilities and 75% to the unregulated facilities.[42] RUCO then concludes that "the rest of the expenses are more attributable to APIF's other operating activities."[43] RUCO does not support that statement with any compelling evidence. And RUCO does not identify any specific invoices from the final cost pool that it believes are attributable to APIF's other business activities. Instead, RUCO contends the entire APT cost pool is tainted because the pool previously included invoices that RUCO deems improper.[44] For RUCO, the final cost pool "remains highly suspect."[45] Such presumption is a violation of Arizona law.[46]

The arbitrary basis for RUCO's disallowance is further evidenced by RUCO's allowance of 25% in APT depreciation expenses, but total disallowance of rent expense.[47] As noted by the Administrative Law Judge at trial, RUCO allowed depreciation expense relating to office furniture at the Central Office in Canada, but disallowed rent for the very same building.[48] RUCO conceded that RRUI benefited from audit, tax, legal and depreciation expenses at the Central Office, but then disallowed rent for the building

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substantive investigation conducted by Commission investigators relating to "the space other large corporate clients leased in the mid-1980s…" *Id.* In turn the Court of Appeals found that such "substantial evidence supports the Commission's decision." *Id.* Here, Staff has not undertaken any investigation of the costs incurred by RRUI as compared to other utilities, nor has Staff even attempted to evaluate RRUI's costs compared to other stand-alone utilities. Lacking any such substantial evidence, the Commission cannot presumptively deny the APT costs. *See id.*.

[42] RUCO Br. at 9 – 10.

[43] *Id.* at 10.

[44] *Id.* at 8 – 9. In its brief, RUCO acknowledged that its recommended allocation "is an estimate," which is an admission of the arbitrary and capricious nature of RUCO's disallowance. *Id.* at 10.

[45] *Id.* at 9. In its brief, RUCO also regurgitates the silly argument raised by Staff at hearing relating to an invoice for "Skye Body Wash" from "Valentine's Beauty Boutique." Tr. at 322 – 323; RUCO Br. 8 – 9. At trial, Mr. Eichler verified that such invoice related to hand soap used in the ladies bathroom at the central office in Canada. Tr. at 332 – 333. RUCO's attempt to characterize that entry as "beauty aids" is disingenuous. Skye Body Hand and Body Wash is a Canadian made soap that is used in the bathroom at the central office in Canada. *See* http://omnibeauty.ca/products/catalogue/files/Omni_Skye%20Body.pdf. Such products clearly are a necessary office expense.

[46] Decision No. 55931, 91 P.U.R. 4th at 350.

[47] RUCO Br. at 9 – 10.

[48] Tr. at 465 – 468.

where those services are housed and obtained.[49] That is a classic case of arbitrary decision-making.

2. <u>APT's Only Business Is To Provide Services to the Regulated Utilities and Unregulated Facilities Owned by APIF.</u>

In their closing briefs, Staff and RUCO imply that the APT costs and services provide some hidden business opportunities or revenue for APIF and its shareholders. That simply isn't true. ***All of the APT costs are indirect costs of doing business as a Canadian income fund.***[50] It goes without saying that consolidated tax filings for RRUI and the other 17 utilities, audits of the various APIF facilities, capital funding provided to RRUI or the other 17 regulated utilities do not generate revenue for APIF or its shareholders. To the contrary, the services provided by APT are necessary to allow RRUI and other regulated utilities to have access to capital markets on the Toronto Stock Exchange for capital projects and operations.[51]

APT's only business is to provide services to the facilities and utilities owned by APIF.[52] Obviously, given that the APT costs are "indirect costs," they cannot be directly charged to any specific facility or utility.[53] The affiliate cost allocations from APT to RRUI do not generate or maximize revenue for APIF, nor do they serve objectives of growing unregulated businesses. Dividends are not issued to investors based on payment of the corporate operating costs, such as tax services or audits. Rather, the APT allocations are recovery of necessary costs under a shared service model designed to provide high quality service while minimizing operating costs.[54]

[49] *Id.* at 467.
[50] *Id.* at 442 – 444.
[51] Eichler Rb. at 13 – 17; Exhibit PE-RB1 at 7 – 15.
[52] *Id.* at 12 – 13.
[53] *Id.* at 5 – 7; Ex. S-3 at 2; Tr. at 442 – 444.
[54] Rejoinder Testimony of Peter Eichler ("Eichler Rj.") at 4 – 6; Eichler Rb. at 12 – 13.

Ultimately, Staff's and RUCO's attempt to deny 98% of the APT cost pool is not supported by substantial evidence. "Substantial evidence is evidence which would permit a reasonable person to reach the trial court's result."[55] A Commission decision must be "rationally based on evidence of substance."[56] "Mere speculation and arbitrary conclusions are not substantial evidence and cannot be determinative."[57]

B. The Undisputed Evidence Demonstrates That Customers Receive Substantial Benefits From the APT Cost Allocations–At Minimal Cost.

In their closing briefs, Staff and RUCO simply disregard the evidentiary record relating to the costs in the APT pool and the benefits of those services to RRUI and its ratepayers. Staff and RUCO ignore the underlying evidence on several levels.

1. Liberty Water's Shared Services Model Works.

To start, Staff and RUCO oppose the Central Office Cost allocations even though the factual record is ***undisputed*** that RRUI's operating costs are reasonable and below the operating costs of other comparable utilities.[58] RUCO and Staff don't contest Mr. Eichler's testimony demonstrating 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.[59] Likewise, Staff and RUCO ignore the ***undisputed*** evidence that RRUI's total operating costs per customer rank well below the group average of comparable sewer and water utilities.[60]

Even worse, Staff and RUCO ignore Mr. Eichler's comparison of RRUI's total

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[55] *Estate of Pousner*, 193 Ariz. 574, 579, 975 P. 2d 704, 709 (1999). *See also Denise R. v. Ariz. Dep't of Economic Security*, 221 Ariz. 92, 93-94, 210 P.3d 1263, 1264-65 (App. 2009).

[56] *Tucson Elec. Power v. Ariz. Corp. Comm'n*, 132 Ariz. 240, 245, 645 P.3d 231, 237 (1982).

[57] *City of Tucson v. Citizens Utils. Water Co*, 17 Ariz. App. 477, 481, 498 P.2d 551, 555 (1972).

[58] 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.

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

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

operating costs per customer to 23 water utilities and 11 sewer utilities.[61] RRUI's total operating costs per customer for water service rank sixth lowest out of 23 utilities.[62] For wastewater service, RRUI ranks fourth lowest out of eleven comparable utilities.[63] Further, exhibits A-13 and A-14 show that RRUI's operating expenses per customer are significantly below the averages of comparable stand-alone utilities, which is the comparison suggested by Staff.[64]

Under these circumstances, the suggestion that utility rates are being artificially increased or that customers are being charged for unnecessary services is false. Liberty Water's shared services model allows RRUI to provide high quality utility service with reasonable operating expenses.[65] At trial, Staff and RUCO agreed that RRUI provides reliable, adequate and high quality utility service to its customers.[66] Both Mr. Becker and Mr. Coley conceded that RRUI actually used and benefited from capital financing which is only available because of the services provided by APT.[67] The evidence is ***undisputed*** that Liberty Water's shared services model works as one integrated whole, which has allowed RRUI to dramatically improve service to customers while maintaining a level of operating expenses ranking well below the average of comparable utilities.

2. <u>The Benefits of the APT Services Far Outweigh Their Costs.</u>

Perhaps even more startling about Staff's and RUCO's approach to the APT cost allocations is that neither Staff nor RUCO have done any in-depth analysis of the costs and benefits from the services provided by APT. A simple cost-benefit analysis

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[61] 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.

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

[63] *Id.* at 2.

[64] Exs. A-13 and A-14.

[65] 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.

[66] Tr. at 422 – 423, 540.

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

demonstrates the just and reasonable nature of the APT cost allocations. Again, it is ***undisputed*** that 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.[68]

For $1.40 per month, RRUI's customers get ongoing access to financial capital from the Toronto Stock Exchange, they get financial oversight of utility operations, they get strategic planning, they get auditing services and they get tax filings for the regulated utilities.[69] The services provided by APT also avert financial and service problems experienced by other stand-alone Arizona utilities, such as the Far West and McLain disasters.[70] ***A charge of $1.40 per month for access to capital, sound fiscal management and increased service is not excessive or unfair to RRUI's ratepayers.***

The benefits provided by the Liberty Water business model substantially outweigh the ***minimal*** costs to RRUI's customers. To illustrate these points even more clearly, RRUI prepared the charts attached as **Reply Brief Exhibit 2.** Those charts break down the yearly and monthly cost per customer for each cost category contained in the APT cost pool on the Company's final schedules.

The analysis is astonishing. On a combined basis for both the water and sewer divisions, the monthly costs per customer range from $0.33/month for audit services to less than one cent per month for licenses/fees to participate in the TSX.[71] Rent for the corporate office in Canada costs $0.10/month and strategic management services provided by APT costs each customer 22 cents ($0.22) per month.[72] The escrow fees required to pay public investor dividends equal two cents ($0.02) per month and the costs for legally required communications with APIF's investors is $0.08 per month.[73] For the water

[68] *See* Ex. A-12; Tr. at 222 – 223.
[69] Tr. at 222 – 224.
[70] *Id.* at 224.
[71] **Reply Brief Exhibit 2** at 1.
[72] *Id.*
[73] *Id.*

division, the APT costs constitute 3.56 percent of the requested average monthly bill for a residential customer.[74] For the wastewater division, the APT costs constitute 2.61 percent of the requested average monthly bill for a residential customer.[75] ***The benefits of the APT cost allocations far outweigh the actual costs to customers.***

Aside from this cost/benefit analysis, Staff and RUCO 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.*** "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."[76] RRUI has met its burden on both of these prongs.

Further, Staff proposes to authorize only those costs that would be incurred by RRUI as a stand-alone utility.[77] Yet Mr. Becker himself did not compare RRUI's operating costs to any stand-alone utilities.[78] Instead, Staff simply presumes that RRUI's costs would not be incurred by a stand-alone utility. Even worse, the Commission has ***not*** adopted that stand-alone comparison as a formal rule, Staff did not advise RRUI of that standard prior to the test year and 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.[79]

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[74] *Id.* at 4.

[75] *Id.* at 5.

[76] The Regulation of Public Utilities, C. Phillips (1993) at p. 258 (emphasis added).

[77] Tr. at 536 – 537.

[78] *Id.*

[79] *Id.* at 542 – 544. The Commission approved affiliate cost or shared service allocations for Arizona-American, Arizona Water Company and Chaparral City Water Company under different standards than Staff is applying to Liberty Water in this case. *Id.* at 433 – 435.

C. <u>The Commission Should Ignore The Other Red Herrings Raised by Staff and RUCO.</u>

Staff and RUCO each dedicate a total of four pages of their closing brief to the APT cost allocation issues.[80] In those briefs, Staff and RUCO raise a variety of red herrings that should be rejected summarily by the Commission.

For example, Staff argues that "[w]hen costs incurred primarily for the benefit of an unregulated affiliate's business are improperly identified and allocated as overhead/common costs, the costs of the unregulated affiliate are shifted to the captive customers of the regulated utility."[81] Staff surmises that the APT cost allocations are subsidizing the business operations of APIF's unregulated facilities. Here, however, the record does not contain any evidence of subsidization by RRUI's ratepayers – 73 percent of the entire Central Office Cost pool is allocated to unregulated electric facilities.[82] Only 27 percent of the cost pool is allocated to regulated utilities, such as RRUI. In fact, RRUI only gets 12 percent of the APT costs allocated to the infrastructure division. That means RRUI receives only 3.24 percent of the APT cost pool. Interestingly, Staff violates its own policy against subsidization. Under Staff's allocation methodology, the other 46 facilities owned by APIF would subsidize 98 percent of the APT services provided to the seven Arizona utilities. At trial, Mr. Becker expressly acknowledged that such reverse subsidization is improper and unfair.[83]

In closing briefs, Staff and RUCO continue to raise 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. This issue is a classic

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[80] Staff Br. at 6 – 9; RUCO Br. at 7 – 10.

[81] Staff Br. at 8 – 9.

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

[83] Tr. at 530 – 531.

red herring because the Company has removed ***all*** of those invoices from the pool.[84] Staff and RUCO focus on what has been excluded from the APT cost pool, not what actually is contained in the final pool. The final cost pool is comprised solely of beneficial services utilized by RRUI in providing utility service to customers.[85]

In RRUI's Final Schedules, the total cost pool is $3,970,127.[86] 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 an effort to address Staff's concerns and reduce the amount in dispute between the parties.[87] ***In their briefs, Staff and RUCO have not identified any other specific invoices or entries in the final pool that they contend relate to unregulated business operations.*** Nor could they identify any further invoices at trial.[88] It simply isn't fair or justified for RUCO and Staff to deny 98% of the cost pool because the original cost pool included some improper invoices, which now have been voluntarily removed by RRUI. Rather than disallow the entire cost pool, the solution is to remove the improper invoices, which RRUI has done.

In its brief, RUCO argues that RRUI has failed to properly invoice and document the APT costs.[89] These arguments are meritless, circular and self-serving for several reasons. First, neither Staff nor the Commission has ever stated exactly what type of documentation is required for affiliate costs. RRUI should not be penalized for failing to

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[84] *Id.* at 213 – 215, 260 – 261, 267 – 270, 277 – 279, 295 – 296, 331 – 332, 520 – 522; RRUI Notice of Filing Final Schedules dated April 9, 2010.

[85] RRUI Notice of Filing Final Schedules at 1.

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

[87] RRUI Notice of Filing Final Schedules at 1.

[88] Tr. at 448 – 449, 514 – 517.

[89] RUCO Br. at 9 – 10.

comply with some unknown documentation standard. It would be a violation of both due process and controlling Arizona law for the Commission to presumptively deny the APT costs based on undisclosed documentation standards asserted by Staff or RUCO.[90]

Second, RUCO's use of alleged lack of documentation as a means to deny the APT costs places form over substance.[91] Whether or not an invoice from APT or a vendor mentions RRUI does not change the nature of the service provided or the actual use of the APT services by RRUI. Presumably, RRUI could cure this defect by wordsmithing the invoices to mention RRUI. Of course, the services provided by APT would remain the same, which demonstrates RUCO's nonsensical position on this issue.

Third, RRUI answered numerous data requests on cost allocations. The Company provided all invoices over $5,000 relating to these allocated costs and offered to provide further invoices below $5,000 upon request. Neither RUCO nor Staff made any such request. At trial, Mr. Eichler presented a detailed paper entitled "Liberty Water Affiliate Cost Allocation Methodology," which explains in detail all of the affiliate cost allocations.[92] That paper and the thousands of pages of invoices provided by RRUI more than document the APT costs. To the extent Mr. Coley did not believe that he had adequate information to evaluate the APT costs or determine whether those APT services benefit RRUI's customers, RUCO should have advised RRUI of exactly what additional

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[90] *Arizona Public Service Company*, 91 P.U.R. 4th at 350; *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").

[91] Apparently RUCO wants RRUI to produce invoices demonstrating benefits of the services to RRUI's ratepayers. That argument is silly. Invoices are not written for purposes of documenting that the service provided benefits a utility's ratepayers. Rather, an invoice is a bill for services provided. To the extent Staff or RUCO questions whether the services listed on the invoices benefit RRUI, Staff and RUCO must analyze whether RRUI uses the services provided by APT in providing utility services to customers, an exercise which RUCO and Staff have not done.

[92] Eichler Rb. at Exhibit PE-RB1.

information it needed to evaluate the APT cost allocations. RUCO's failure to request such information is not a justifiable reason for denying all of the APT costs.

One final red herring raised by Staff relates to compliance with the NARUC Guidelines. In its brief, Staff claims 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 ("NARUC") for Cost Allocations and Affiliate Transactions."[93] 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.[94]

D. RRUI Supports Staff's Careful Scrutiny of the APT Cost Allocations and Has Adequately Addressed and Resolved Staff's Concerns.

In its closing brief, "Staff has acknowledged that it is not opposed to the concept of a shared services model, [but] Staff still has some concerns given some of the inappropriate costs it found during its audit of the cost pool. While not entirely opposed to the shared service 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."[95]

RRUI already has done exactly that. To its credit, Staff has acknowledged the benefits of the Liberty Water shared services model and now seeks verification that the final pool doesn't include any improper invoices. In light of Staff's concerns, RRUI removed all of the invoices questioned by Staff and RUCO at hearing, and removed any additional invoices that might be questionable from the cost pool. This effort resulted in reduction of the APT cost pool from $5.2 million to $3.9 million. The final cost pool includes only those invoices that relate to services used by RRUI in providing water or sewer service to customers.[96]

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[93] Staff Br. at 8.
[94] Eichler Rj. at 8 – 9; Eichler Rb. at 5 – 7, Exhibit PE-RB1; Tr. at 312 – 313.
[95] Staff Br. at 9.
[96] RRUI Notice of Filing Final Schedules at 1.

To the extent Staff or RUCO still question the contents of the final cost pool, RRUI proposes to alleviate such concerns by providing an independent "attestation" of the final APT cost pool.[97] Specifically, the NARUC Guidelines state: "Any jurisdictional regulatory authority may request an independent attestation engagement of the [Cost Allocation Manual]."[98] An independent attestation by an independent CPA would resolve Staff's and RUCO's concerns about whether the final APT cost pool includes charges relating to unregulated business operations or reflect services that can't be verified from invoices. Rather than deny 98% of the APT costs, the Commission should approve the APT costs allocations subject to RRUI providing an "Attestation Engagement" to verify the contents of the cost pool.[99]

All in all, Liberty Water supports Staff's careful scrutiny of the APT cost allocations. 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."[100] That's exactly what Liberty Water's shared service does. This Commission has established 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***..."[101] Although Staff and RUCO have the burden of proof to support their disallowances, Liberty Water has attempted to address Staff's concerns by removing all invoices questioned by Staff and RUCO at hearing and

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[97] RRUI Br. at 17 – 18; Tr. at 325 – 326.

[98] Ex. S-3 at 4, ¶ E(3).

[99] *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."). In essence, the Commission would approve the APT cost allocations subject to RRUI providing a letter from an independent CPA attesting to the contents of the APT cost pool and verifying that the cost pool does not include any costs that should or could be directly charged to any specific utilities or facilities.

[100] Decision No. 55931, 91 P.U.R. 4th at 348.

[101] *Id.* at 350.

by removing additional invoices in order to eliminate any further doubt about the final APT cost pool.

RUCO's attempt to characterize the final cost pool as tainted because of RRUI's voluntary deductions should be ignored.[102] RRUI should be acknowledged for recognizing and addressing Staff's and RUCO's concerns. That's not to mention that 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" necessitating dialogue between the parties.[103] As stated at trial, Liberty Water is committed to refining its cost allocations based on input from Staff and RUCO.[104] Complete disallowance of the APT costs, however, would preclude such ongoing dialogue and force RRUI to changes its business model to the detriment of its customers.

E. <u>Staff And RUCO Have Not Considered The Consequences Of Disallowing The APT Costs.</u>

Ultimately, adoption of Staff's or RUCO's disallowance of 98% of APT's affiliate costs would be a clear rejection of the APIF business model. If that corporate service model is rejected, then Liberty Water may have no choice but to operate RRUI differently, which certainly will increase operating costs. In short, it is unreasonable to assume that APIF and its other regulated utilities and unregulated businesses will absorb 98% of the APT cost pool for the benefit of the Arizona utilities.[105] In that situation, APT would not have any choice but to withdraw the various corporate services from RRUI, which would cause the quality of services provided by RRUI to decline or operating expenses to increase.[106]

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[102] RUCO Br. at 8 – 9.
[103] Tr. at 326 – 328, 343 – 349.
[104] *Id.* at 342 – 343.
[105] Eichler Rb. at 37.
[106] *Id.*

To the extent the Commission has concerns or hesitations about Liberty Water's allocation methodology, the Commission should not deny all of the APT costs as suggested by Staff or RUCO. Instead, the Commission should approve the APT cost allocations subject to the attestation engagement by a CPA or, at minimum, the Commission should advise Liberty Water and RRUI of exactly what affiliate cost methodology is acceptable to the Commission. Rather than deny all of the APT costs, the Administrative Law Judge and/or the Commission could consider other allocation cost drivers or methodologies, such as revenues, plant and operating costs. RRUI provided evidence relating to those methodologies at hearing, including the pros and cons of each.[107] RRUI is willing to consider use of such alternative allocation methodologies.

F. <u>Revenue Annualization.</u>

RUCO disagrees with the revenue annualization proposed by the Company and adopted by Staff because it results in a downward adjustment to revenues.[108] But the process of annualizing revenues to test year-end customer numbers is standard operating procedure in rate cases.[109] Moreover, revenues are being annualized to test year-end customer counts, so any increase in customer numbers is being recognized and considered. It's just that the few additional customers are not resulting in higher revenues, as RUCO seems to believe despite the lack of any evidence to that effect. In fact, revenues are trending downward and the proposed annualization likely understates revenues going forward.[110] But it should still be adopted.

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[107] Tr. at 209 – 210; Eichler Rb. at 16 – 17, Exhibit PE-RB2.
[108] RUCO Br. at 10:17.
[109] Bourassa Rb. at 26:24 – 27:5.
[110] Tr. at 151:10-17.

G. **Rate Case Expense.**

RRUI requests a total of $360,000 in rate case expense, allocated $225,000 and $135,000 to the water and wastewater divisions, respectively.[111] Staff has not opposed the Company's request at any stage of this proceeding. RUCO does not believe the Company's requested amount is reasonable but does not say why. RUCO's brief states one thing correctly, however, the actual amount of rate case expense incurred cannot be known until the case is finished.[112] Even now, RRUI does not know how much it will incur for this reply brief, or for analysis of the ROO and preparation for and appearance at open meeting. Likewise, the costs of post decision notice and other compliance requirements are not yet known. That's why the Company used an estimate in its initial filing nearly a year ago and continually updated it throughout.[113] Then, at the end of trial and in its final schedules, when it had the benefit of actual evidence, it made a final request. The only difference between the final rate case expense request and the estimate used from direct through rejoinder was the additional $25,000 RRUI sought at the end of the second unanticipated extra day of trial, a change in the expense level of under 10 percent.[114]

These facts do not give RUCO license to fail to present evidence or otherwise explain its position. It's simply not enough to say, "we think they should get this much less than they requested," but never explain why.[115] RUCO offers no reference to comparable rate cases, nor does it point to anything in the actual rate case expense incurred to support its argument that the requested expense level is unreasonable. Perhaps RRUI should view RUCO's recommendation as generous, given that RUCO does not

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

[112] RUCO Br. at 11:12-15.

[113] Bourassa Dt. at 11:16 – 12:10; Bourassa Rb. at 28:3-5. All invoices and other evidence of rate case expense we also made available to the parties for review during the case.

[114] Tr. at 1097:19 – 1098:12.

[115] RUCO Br. at 11:9 – 12:8.

understand why utilities are awarded any rate case expense at all when rates are being raised.[116] But it doesn't find RUCO to be generous, and there is simply no evidence that the amount requested by RRUI is unreasonable.

III. REPLY ON COST OF CAPITAL AND RATE OF RETURN

A. Introduction.

RRUI requests a rate of return on its rate base based on a weighted average cost of capital ("WACC") of 11.7 percent. As explained in RRUI's initial brief, that return is based on Mr. Bourassa's estimate of the current cost of equity using the same market-based finance models that the Commission normally uses, the Discounted Cash Flow Model ("DCF") and the Capital Asset Pricing Model ("CAPM"), applied to the same proxy group of publicly traded water utilities that Staff has relied on for many years, including RRUI's previous rate case.[117]

In addition, Mr. Bourassa adjusted RRUI's cost of equity downward by 100 basis points to account for the absence of debt in the Company's capital structure, using the Hamada formula, which is the same method the Commission normally uses to account for financial risk.[118] As Mr. Manrique testified, this method properly balances the interests of the utility and its ratepayers and is fair to everyone.[119] Finally, Mr. Bourassa adjusted the cost of equity upward by 50 basis points to account for RRUI's additional risk, an adjustment which is substantially less than the 110 basis-point upward adjustment proposed by RUCO.[120]

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[116] *Id.* at 12:3-5. This statement is laughable given that RRUI voluntarily sought a rate decrease for sewer service. RUCO also ignores the obvious. Utilities are awarded reasonable rate case expense because the utility is not able to raise its rates with out approval, has no control over the approval, or, to a significant extent, the cost of getting new rates established.

[117] *See* Exs. R-19 and A-25.

[118] Direct Testimony of Thomas J. Bourassa – Cost of Capital ("Bourassa COC Dt.") at 36 – 37. *See, e.g.*, Ex. A-28 (Decision No. 70209) at 30; Ex. A-27 at 28.

[119] Tr. at 1082, 1096 – 1097.

[120] 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.

In short, the Company's methodology, including its use of the DCF and CAPM, Staff's sample water utilities and the Hamada method, is consistent with prior Commission decisions and provides a reasonable estimate of the current cost of equity for a small water utility like RRUI.

Remarkably, Staff accuses Mr. Bourassa of using "selectively chosen inputs" in estimating the cost of equity, while Staff has employed the "market-based finance models consistently accepted by this Commission," beginning with "available market data" on which investors are expected to rely.[121] Of course, that is precisely what Mr. Bourassa has done in this case, such as using the conceptually correct market values of the proxy utilities' capital structures rather than their book values to calculate the adjustment to RRUI's cost of equity using the Hamada formula.[122]

In reality, Staff accuses RRUI of doing what Staff has done, i.e., selecting inputs that reduce the cost of equity, while ignoring other objective indications that RRUI's current cost of equity is significantly greater than 9.2 percent, including the increase in the average beta of Staff's water utility proxy group and the increase in current market risk.[123] As Staff points out, "analysts should not eliminate or modify inputs in the COE estimate because they produce unfavorable results."[124] Consequently, Staff's cost of equity recommendation is biased downward, and must be rejected by the Commission.

RUCO, on the other hand, argues that a 9.0 percent return on equity "is very reasonable"[125] while actually proposing an effective return of only 6.9 percent when the

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[121] Staff Br. at 13.

[122] *See* RRUI Br. at 52 – 53. *See also* Roger A. Morin, *New Regulatory Finance* 223 – 224 (Public Utility Reports, Inc. 2006) (hereinafter "*Morin*"); Richard A. Brealey, Stewart C. Myers and Franklin Allen, *Principles of Corporate Finance* 516 – 520 (McGraw Hill/Irwin 8th ed. 2006); Tim Koller, Marc Goedhart and David Wessels, *Valuation: Measuring and Managing the Value of Companies* 312 – 313 (John Wiley & Sons, Inc. 4th ed. 2005); Shannon, P. Pratt, *Cost of Capital – Estimations and Applications* 83 – 85 (John Wiley & Sons 2nd ed. 2002).

[123] *Id.* at 45 – 49.

[124] Staff Br. at 13 – 14.

[125] RUCO Br. at 17.

impact of RUCO's hypothetical capital structure is considered.[126] In fact, RUCO states that it could have "easily" eliminated its 110 basis-point upward adjustment to the cost of equity,[127] which would produce effective equity return of only 5.8 percent – well below the current yield on an investment grade bond!

RUCO's cavalier attitude about the cost of equity is indicative of the result-driven and punitive approach RUCO has advocated in this case. To be reasonable, the return on equity must satisfy the comparable earnings and attraction of capital standard set forth by the Supreme Court in decisions such as *Bluefield Waterworks*[128] and *Hope Natural Gas*.[129] 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.[130] At the same time, the market itself is riskier than in 2004, increasing the cost of capital.[131] Under these circumstances, setting RRUI's return on equity at an effective rate of 6.9 percent would not be just and reasonable.

B. Response to Staff's Arguments.

1. Staff's DCF Inputs Are Conceptually Flawed and Are Neither Balanced Nor Reasonable.

When a party asserts that its position is balanced and reasonable, it is usually neither. Such is the case with the inputs Staff has selected in this case to implement the DCF model, which attempts to estimate a firm's cost of equity by projecting the firm's earnings and dividends into the future.[132]

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[126] Rebuttal Testimony of Thomas J. Bourassa – Cost of Capital ("Bourassa COC Rb.") at 44 – 45.

[127] RUCO Br. at 17.

[128] *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 692 – 693 (1923).

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

[130] RRUI Br. at 45 – 47.

[131] *Id.* at 47.

[132] Tr. at 1053 – 1054.

Staff used two versions of DCF model: a constant growth model and a non-constant growth model in which dividends are assumed to grow in two stages.[133] Staff's estimate of the cost of equity using its non-constant growth model was 10.3 percent.[134] Although Staff has used a very conservative growth rate, the Company has not challenged this equity cost estimate, which is 90 basis points greater than the estimate produced by Staff's constant growth model.

The principal problem with Staff's DCF method is that it places excessive weight on historic data 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. Staff maintains that averaging historic and forecasted growth rates is "a balanced methodology" that "produces a more balanced outcome."[135] This argument is simplistic and misleading for the reasons set forth in RRUI's initial brief.[136] In fact, Staff's inputs are unbalanced and depress the cost of equity.

As Mr. Manrique testified, the "cost of equity represents investors' *expected* returns and not realized [i.e., historic] returns."[137] Thus, what is relevant in setting a utility's rates is the investor's expected <u>future</u> return on the investment, not what occurred 10 years ago.[138] The bottom line is that the cost of equity is forwarding-looking, not backward-looking, as the witnesses acknowledged.[139] While historic data has some relevance, investors are much more likely to be influenced by current events and trends, as opposed to events and trends occurring during the Clinton Administration. Yet Staff argues that equal weight should be given to the latter.

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[133] *See* Direct Testimony of Juan C. Manrique ("Manrique Dt.") at 24 – 25.
[134] Surrebuttal Testimony of Juan C. Manrique ("Manrique Sb.") at Schedule JMC-9.
[135] Staff Br. at 13.
[136] RRUI Br. at 49 – 51.
[137] Manrique Dt. at 9 (italics original). *See also id.* at 7; Tr. at 1049 – 1050.
[138] Tr. at 935, 1049 – 1050.
[139] *Id.*

Putting aside that error, the historic data on dividend and earnings growth (as well as other financial and economic factors affecting a firm's performance) have already been considered by means of other DCF inputs. Staff used spot stock prices 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.[140] The theoretical basis for doing so is the Efficient Market Hypothesis, which, according to Mr. Manrique, "asserts that the current spot price reflects all available information on a stock including investors' expectations of future returns."[141] Therefore, historic data on earnings, dividends and other historic information relevant to investors is already reflected in the current stock price.

Moreover, as discussed in detail by Mr. Bourassa, numerous authorities on cost of capital estimation support the use of analysts' forecasts in implementing the DCF.[142] Financial institutions and analysts have already considered relevant historical information as well as current information on the firm and broader financial and economic trends, as Mr. Manrique admitted.[143] To the extent that past results provide useful indications of future growth, that information would already be incorporated in analysts' forecasts, in addition to current stock prices.

Accordingly, by using a simple 50/50 weighting of historic and forecasted growth rates, Staff has given significantly more weight to historic data that go back into the 1990s than current information on the proxy utilities. This backward-looking approach skews the results produced by the DCF model and depresses the cost of equity. This is unfair to RRUI, and should be rejected by the Commission.

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[140] *Id.* at 1050 – 1054.
[141] Manrique Dt. at 16. *See also* Tr. at 1051, 1054.
[142] Bourassa COC Rb. at 22 – 30, Exhibit TJB-COC-RB1.
[143] Tr. at 1050.

Staff's remaining criticisms of Mr. Bourassa have no merit. Staff complains that Mr. Bourassa used five years of historic data rather than 10 years of historic data.[144] However, as Mr. Bourassa explained, a five-year historical time period is more appropriate because it includes one recent period of economic expansion and one period of economic recession, while a 10-year period includes one period of economic expansion and two periods of economic recession.[145] In reality, Staff's use of a 10-year period skews the growth rate downward, depressing the cost of equity.

Staff also claims that because Value Line reports 10-year historical growth rates, such information is of value to investors and should be used to estimate RRUI's cost of equity.[146] As Mr. Bourassa pointed out, however, Value Line also reports five-year historic growth rates as well as five-year forecasts of growth, as do other securities' analysts.[147] Moreover, Value Line reports a variety of additional information regarding each of the firms it follows, which investors consider in evaluating whether to invest.[148] But according to Staff, this information is irrelevant because investors don't care about a firm's specific risk characteristics when they make investment decisions.[149] Apparently, investors care only about the information reported in Value Line that Staff selects for its models. This seems arbitrary and one-sided rather than balanced and reasonable.

Furthermore, regardless of the time period, past growth rates may be misleading because past growth rates may reflect changes in relevant variables that may not be expected to continue in the future.[150] Therefore, data that are 10 years old are less reliable than more current data and forecasts made by experts upon whom investors rely. Staff's

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[144] Staff Br. at 15.
[145] Bourassa COC Rb. at 30.
[146] Staff Br. at 15.
[147] Bourassa COC Rb. at 31.
[148] Ex. A-23.
[149] Staff Br. at 17.
[150] *Id.*

emphasis on data prior to 2005 to estimate the current cost of equity is inappropriate, as is the excessive weight Staff gives to historic growth rates. For all of these reasons, Staff's DCF estimates understate the cost of equity for its proxy group.

2. Staff's Use of the Hamada Formula to Calculate RRUI's Financial Risk Is Appropriate, But the Correct Inputs Should Be Used.

Staff argues that the Hamada formula is an appropriate method to reflect firm-specific differences in investment risk stemming from a firm capital structure. RRUI agrees with Staff on this issue. As discussed in RRUI's initial brief, to the extent an adjustment for financial risk is found necessary – and as RRUI explained, in some instances (such as the 2006 Black Mountain rate case[151]) it has not been, the Commission should adhere to its precedent and make a direct adjustment to the cost of equity, which the Commission considers "the generally accepted regulatory means" for accounting for differences in financial risk.[152] Accordingly, RRUI's witness, Mr. Bourassa, has proposed a downward adjustment to his cost of capital estimate using Dr. Hamada's methodology.

The Company's only disagreement with Staff stems from the fact that the Staff witness used the wrong inputs in the Hamada formula, which produce a larger downward adjustment and further depressed Staff's cost of equity estimate. As Staff argues in its brief, "[i]f the inputs are selected appropriately, then the results will speak for themselves."[153] However, there is no dispute that Staff selected inappropriate inputs in implementing the Hamada formula, which is an extension of the CAPM and utilizes market values of the proxy utilities' capital structures rather than their book values.[154] Staff's only response is that it has made this error in the past and, apparently, has never

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[151] Ex. R-1 at 19 – 26. *See also* RRUI Br. at 65 – 68.
[152] Ex. A-28 (Decision No. 70209) at 30; Ex. A-27 at 28. *See also* RRUI Br. at 65 – 66 (summarizing previous Commission decisions).
[153] Staff Br. at 13.
[154] RRUI Br. at 52 – 53; Bourassa COC Rb. at 9 – 10.

been caught, so it should be allowed to continue to use the wrong inputs.[155] This error works against the Company by producing a larger downward adjustment to the cost of equity and lower rate of return on rate base.[156]

The Company has not been able to locate a Commission decision approving the misuse of the Hamada formula, nor has Staff cited a Commission decision that addresses whether book values or market values should be used. However, the Commission has consistently emphasized the use of market-based finance models, such as the DCF and CAPM, to estimate the cost of equity. For example, in a decision setting rates for another Arizona water utility, the Commission stated:

> In estimating its cost of equity, Arizona Water relied on a risk premium analysis methodology used by the [California] PUC staff, which uses comparisons to actual or authorized returns on equity. This sort of "comparable earnings" analysis has long been discredited for several reasons ... . Market-based methods like the DCF model and the CAPM provide more reliable estimates of equity cost, because it is capital markets, not regulatory commissions that determine the cost of equity. Use of the risk premium analysis urged by the Company would circumvent the market forces that regulation attempts, as much as possible, to replicate.[157]

It would make no sense for the Commission to consistently reject cost of equity estimation techniques that rely on returns earned on utilities' book or accounting equity, then approve the use of book equity in a formula designed to estimate the proportion of a firm's <u>market</u> risk attributable to its capital structure.

In short, Staff's position is groundless. The fact that the same error was made in a prior case and it went undiscovered doesn't mean that the error shouldn't be corrected

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[155] Staff Br. at 17.

[156] Rejoinder Testimony of Thomas J. Bourassa – Cost of Capital ("Bourassa COC Rj.") at 8. The correct adjustment is 60 basis points, not 110 basis points, based on Staff's CAPM inputs.

[157] *Arizona Water Company (Western Group)*, Decision No. 68302 (November 14, 2005) at 37 – 38. *See also Arizona-American Water Company*, Decision No. 67093 (June 30, 2004) at 29 (approving the use of the DCF and CAPM equity estimates and rejecting the use of comparable earnings methods).

when it is discovered. Consequently, the correct inputs into the Hamada formula should be used.

3. <u>All of RRUI's Firm-Specific Risk Should Be Considered, Not Just Risk Related to Its Particular Capital Structure.</u>

Staff contends that all of RRUI's firm-specific risk should be ignored, except for risk associated with RRUI's capital structure.[158] Capital structure risk is, of course, firm specific, as it is based on the firm's particular capital structure. And as stated above, the Company doesn't object to an appropriate (i.e., correctly calculated) downward adjustment to its cost of equity to reflect the fact that its capital structure contains no debt. Yet while Staff proposes a downward adjustment to the cost of equity based on RRUI's capital structure, it refuses to consider any other attributes of RRUI that an investor would consider in deciding whether to invest in the Company. Again, this seems to be one-sided rather than balanced and reasonable.

In his direct testimony, 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.[159]

This means that regardless of the stocks in a particular investor's portfolio, an investor, when evaluating the various stocks sold on the market, will chose to buy a stock that (a) meets the investor's desired risk profile and (b) is expected to produce a higher return that other stocks with similar risk profiles. In evaluating these investment criteria, an investor must necessarily consider a variety of factors, not simply the stocks' respective

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[158] Staff Br. at 17.

[159] Manrique Dt. at 7.

capital structures or their respective betas. Put another way, investors normally "look at the underlying fundamentals of the company," as Mr. Rigsby testified.[160]

This type of "fundamental" information on publicly traded firms is available from a variety of sources such as Value Line, as shown by the excerpt from Value Line in the record in this case.[161] However, there is no comparable data for small utility companies without publicly traded stock, such as RRUI. That doesn't mean, however, that RRUI's firm-specific characteristics should be ignored. Indeed, all of the parties have proposed adjustments to RRUI's cost of equity based on the amount of debt in its capital structure as compared to the capital structures of the publicly traded water utilities. There is no reason why other attributes of RRUI cannot be considered as well. Certainly, an investor would do so, as Mr. Manrique's succinct summary of rational investor behavior indicates.

Staff, however, argues that the fundamentals of a publicly traded firm should be ignored under modern portfolio theory.[162] This theory assumes that investors, being risk-adverse, will diversify their portfolios by purchasing a large number of stocks directly or though a mutual fund. As long as the firm-specific risk factors are uncorrelated, diversification reduces the significance of a particular stock's individual risk characteristics. Thus, for a truly diversified investor, the relevant risk is reduced to market risk, which is estimated by the firm's beta. Risks related to holding specific stocks are effectively cancelled out by risks associated with holding other stocks.[163] This is a fine theory, but it cannot be applied in this case for several reasons.

The first and most obvious problem is that RRUI has no beta because its stock is not publicly traded. In order to develop an estimate of RRUI's risk, therefore, it is necessary to evaluate RRUI's fundamentals, which Staff has ignored. Instead, Staff has

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[160] Tr. at 946.
[161] Ex. A-23.
[162] Staff Br. at 17.
[163] *See Morin* at 54 – 56 (discussing risk from a portfolio standpoint).

assumed that RRUI has a beta equal to the average beta of a group of substantially larger firms with publicly traded stock. In effect, Staff argues that every small, privately held firm in a particular industry has the same risk as a cross-section of large, publicly traded firms in the same industry. Of course, this is nonsense. It is elementary finance that investors require higher returns on small company stocks like RRUI.[164] In fact, Mr. Manrique admitted that RRUI's small size and lack of liquidity increase RRUI's investment risk.[165]

The current betas of the Staff sample group, as estimated by Value Line, are as follows:

SJW Corp.	0.95
American States Water	0.80
Connecticut Water	0.80
Middlesex Water	0.80
AVERAGE	**0.79**
California Water	0.75
Aqua America	0.65[166]

According to Staff, RRUI, if it were publicly traded, would have a beta of 0.79, i.e., a beta equal to the average of the sample companies. Thus, Staff effectively assumes that RRUI is less risky than SJW Corporation, which provides water service to over 230,000 customers, had revenues of $220 million in 2008, and net plant of $490 million at the end of 2008.[167] But Staff performed no analysis of each of its sample utilities and RRUI to support this assumption.

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[164] Bourassa COC Rb. at 11; Bourassa COC Dt. 37 – 38.
[165] Tr. at 1079 – 1080; Manrique Dt. at 42. *See also* Bourassa COC Dt. at 37 – 38 (discussing empirical evidence that shows smaller utilities have greater investment risk).
[166] Manrique Sb. at Schedule JCM-7.
[167] Bourassa COC Dt. at 18; Ex. A-23 (final page).

Mr. Bourassa, in contrast, performed such an analysis by examining the fundamentals of the six publicly traded water utilities in Staff's proxy group.[168] He concluded that while these utilities provide a useful starting point for developing a cost of equity for RRUI, RRUI has greater investment risk and requires a higher return on equity.[169] He estimated that an upward adjustment in the range of 99 to 181 basis points is appropriate for RRUI, but to be conservative recommended an adjustment of only 50 basis points.[170]

In short, Staff's assumption that any specific risk factor not explained by the market can be diversified away by holding a large, diversified stock portfolio cannot be applied here. There is no credible evidence that a rational investor would regard an equity investment in RRUI as having significantly less investment risk than an equity investment in SJW Corp. or as having the same investment risk as American States Water, Connecticut Water and Middlesex Water. For this reason, Staff's position is one-sided and depresses the cost of equity.

Staff also argues that Mr. Bourassa's upward adjustment for risk is inappropriate because RRUI's shareholder is a large company that provides assistance to RRUI in raising capital and other services that would be more costly if RRUI had to obtain them on its own.[171] This argument is a classic red herring. A firm's cost of equity is not determined on the basis of the make-up of its shareholders. Otherwise, we would be analyzing and comparing the shareholders of Aqua American and California Water in this case. Instead, cost of equity is based on the firm's expected earnings, cash flow, dividends, capital structure, size, liquidity, and a variety of additional factors that are specific to that firm – again, the firm's fundamentals – not the firm's shareholders.

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[168] Bourassa COC Dt. at 16 – 22.
[169] *Id.* at 16, 21.
[170] *Id.* at 38, Schedule D-4.16.
[171] Staff Br. at 17 – 18.

Finally, Staff argues that the unique aspects of Arizona's regulatory regime are irrelevant to evaluating RRUI's investment risk because "[e]very utility in Arizona operates under the same regulatory framework."[172] Again, Staff has missed the point. Staff has assumed that the six water utilities in its proxy group are comparable to RRUI in investment risk. Yet only one of those utilities operates in Arizona, and that utility owns a small Arizona water company with about 13,000 customers.[173] Thus, the proxy utilities' business operations and earnings are not affected to any material extent by Arizona's particular rate-making policies and requirements. RRUI, on the other hand, operates only in Arizona, and its earnings, cash flow, and ability to pay dividends are directly dependent on the Commission's particular rate-setting process and requirements.

As explained in the Company's initial brief, the Supreme Court has stated that a utility's investment risk is affected by a state's choice of rate-setting methodology and, therefore, should be considered in setting rates.[174] Consequently, to the extent Arizona's particular policies and methods – e.g., use of historic test years, lack adjustment mechanisms for water and wastewater utilities, inability to adjust rates without completing a general rate case, and delays in obtaining rate relief – differ from other jurisdictions that have adopted more progressive regulatory policies and methods, such differences must be considered in developing a reasonable cost of equity for RRUI.[175]

This is <u>not</u> a criticism of Arizona's particular rate-making policies and methods, as Staff erroneously suggests in its brief. Rather, accounting for these differences and the impact on investment risk is required under the *Bluefield/Hope* comparable earnings standard and under *Duquesne Light* to ensure that the return on equity properly reflects all factors that affect investment risk.

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[172] *Id.* at 18.

[173] Bourassa COC Dt. at 16 – 18 (summarizing key data for the proxy utilities).

[174] *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 314 – 315 (1989).

[175] Bourassa COC Dt. at 20 – 21.

C. Response to RUCO's Arguments.

1. RUCO's Hypothetical Capital Structure Should Be Rejected.

In its initial brief, RRUI explained why RUCO's proposed hypothetical capital structure is fundamentally unfair and conflicts with prior Commission decisions addressing capital structure risk.[176] Its adoption would result in an effective return on equity of only 6.9 percent, which amounts to a negative financial risk adjustment of 210 basis points below RUCO's 9.0 percent cost of equity (which is itself too low). RUCO is obviously attempting to use a hypothetical capital structure as a device to drive down RRUI's return on equity and lower rates, rather than developing a fair return on equity. This case is no different than the Black Mountain Sewer Corporation rate case, in which RUCO made the same arguments and they were rejected by the Commission as "results oriented" and "not consistent with the Company's actual capital structure," which consisted entirely of equity.[177] The Commission's reasoning applies with equal force here.

RUCO argues that RRUI should have a capital structure that is "more in line with the industry" and with "similar firms operating in the regulated water and natural gas industries."[178] This begs the question of the question of what capital structure is commonly used in the "water industry." RUCO has provided information on four publicly traded water utilities (and 10 publicly traded gas distribution utilities). Obviously, these four utilities do not constitute the water industry, nor do the three additional publicly water utilities in Staff's proxy group. As previously stated, these utilities are used as proxies because they have publicly traded stock and, as a result, have available the data needed to implement the DCF and CAPM.

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[176] RRUI Br. at 64 – 69.
[177] Ex. R-1 at 20.
[178] RUCO Br. at 13.

By contrast, Arizona alone has roughly 300 water utilities and another 40 or so wastewater utilities. Although the numbers vary from state to state, it is reasonable to assume that there are several thousand private water and wastewater utilities in other states. We know nothing about the capital structures of those utilities, which collectively comprise "the industry" – not RUCO's four publicly traded water utilities.

Moreover, RRUI is not "similar" to RUCO's water publicly traded water utilities (or to RUCO's publicly traded gas utilities). At the end of the test year, RRUI had approximately 6,000 customers (4,000 water only customers and 2,000 water and wastewater customers). Its revenues totaled under $3.8 million, and its water and wastewater net plant-in-service was approximately $30.6 million.[179] RUCO's sample utilities are significantly larger, with far more customers, far more revenues, geographically diverse service territories and, in the case of Southwest Water, a substantial percentage of revenues from non-regulated businesses. As Mr. Bourassa explained, these utilities are not directly comparable to RRUI.[180] There is no basis on which to assume, as RUCO does, that RRUI's capital structure should mirror the capital structure of Aqua America or California Water.

As Mr. Bourassa also explained, small utilities like RRUI have less access to the capital markets and tend to have more plant funded by "zero-cost" capital, i.e., advances and contributions in aid of construction, provided by developers.[181] In fact, RRUI has two to three times as much plant financed by advances and contributions in aid of construction as Staff's sample water utilities.[182] While this benefits customers because plant financed in this manner is not included in rate base, it creates additional stress on earnings and

[179] Bourassa COC Dt. at 18.
[180] *Id.* at 15 – 22.
[181] *Id.* at 18.
[182] *Id.*

increases risk.[183] It also means that RRUI has even less financial flexibility, and when combined with RRUI's small customer base and limited revenues and cash flow (a portion of which must be used to pay refunds of advances), limits RRUI's ability to take on the amount of debt assumed to be reasonable by RUCO.

The bottom line is that there is no "industry" standard in terms of capital structure. As discussed in RRUI's opening brief, the Commission has found capital structures with 100 percent equity (Black Mountain), 76 percent equity (Chaparral City), and 74 percent equity (Arizona Water) reasonable, and made no adjustment to the return on equity.[184] It would be anomalous to impute a fictional capital structure containing $4.6 million of fictional debt with a fictional cost of 6.26 percent on RRUI in light of these decisions. At best, this is speculative and ultimately punitive in nature when combined with RUCO's imputation of fictional interest expense to lower RRUI's operating expenses.

RUCO also objects to using the Hamada method to estimate an appropriate adjustment to the cost of equity,[185] despite the Commission's recent decisions in which direct adjustments to the cost of equity have been approved as "the generally accepted regulatory means" for accounting for differences in financial risk, as opposed to using a hypothetical capital structure.[186] According to RUCO, the Hamada formula is an extension of the CAPM and, therefore, this calculation cannot be used in connection with cost of equity estimates produced by any finance model or cost of equity estimation technique other than the CAPM.[187] This argument is another red herring.

Although the Hamada formula is derived from the financial theory underlying the CAPM, the formula is rooted in the relationship between beta and a security's investment

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[183] *Id.*
[184] RRUI Br. at 65 – 66.
[185] RUCO Br. at 13.
[186] Bourassa COC Dt. at 36 – 37. *See, e.g.*, Ex. A-28 (Decision No. 70209) at 30; Ex. A-27 at 28.
[187] RUCO Br. at 13.

risk. In other words, it is intended to estimate and quantify differences in risk, *not* to estimate the cost of equity. Therefore, this method can be used to quantify risk differences resulting from different amounts of capital structure leverage, as RRUI and Staff did in this case.[188] Given that beta is, by itself, a useful and well established method of comparing the risks of securities,[189] and that under the comparable earnings standard, a fair return should be commensurate with the returns earned by other companies with corresponding risks, there is no legitimate basis for RUCO's objection to the Hamada formula's use. The principal problem with the Hamada formula is, as previously explained, that RRUI has no beta to "unlever" and "relever." Instead, the Hamada formula is applied to average beta of the publicly traded proxy utilities, which understates RRUI's investment risk.[190]

Finally, RUCO relies on the Gold Canyon rehearing decisions to support its hypothetical capital structure.[191] As explained in the Company's initial brief, that decision is best viewed as an outlier given that the Commission failed provide any explanation for deviating from its prior decisions, including the Black Mountain decision in which a capital structure consisting of 100 percent equity was found to be reasonable.[192] As Staff explained, "a number of prior Commission Decisions have adopted 100 percent equity capital structures for water and sewer utilities."[193] Moreover, in no prior case had the Commission adopted a hypothetical capital structure in which the debt component was increased.[194] Consequently, the Gold Canyon decision should be ignored.

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[188] *See, e.g., Morin* at 386 (discussing the use of differences in beta to calculate a risk adjustment when the Comparable Earnings method of estimating the cost of equity is used), 400 – 402 (discussing the use of beta as a risk measure to develop an appropriate proxy group of firms with comparable investment risk).
[189] *Id.* at 69 – 71.
[190] Bourassa COC Dt. at 36 – 37; Bourassa COC Rb. at 8 – 9.
[191] RUCO Br. at 14 – 15.
[192] RRUI Br. at 69 – 70; Ex. R-1 at 20.
[193] Ex. R-7 at 11.
[194] *Id.*

2. RUCO's Recommended Return on Equity Is Unreasonable.

RUCO asserts that the Company's 11.7 percent cost of equity is "too high given the current environment of low inflation and low interest rates."[195] Yet if RUCO's CAPM estimate is eliminated because it is below the cost of debt,[196] and if RUCO's estimates using gas utilities are eliminated because the gas utility sample has substantially less investment risk than the water utility sample and is not comparable,[197] RUCO's estimated cost of equity is 11.04 percent.[198] It is apparent that RUCO has deliberately selected methods and inputs that are designed to drive the cost of equity as low as possible, without regard to the comparable earnings and attraction of capital standards. This is hardly reasonable. Instead, it is unfair and ultimately unlawful.

RUCO's arguments in support of its proposed cost of equity largely consist of its assertion that a 9.0 percent cost of equity is reasonable given current interest rates and given RRUI's capital structure. These arguments have no merit.

Interest rates may be low (although not as low as the bulk of RUCO's CAPM estimates), but other risk indicators have increased significantly since RRUI's last rate case. As explained in RRUI's initial brief, the relative riskiness of the publicly traded water utilities in the parties' sample groups has increased dramatically, and Value Line's analyst warns that the risk profiles of the water utility stocks "are higher than one might think."[199] Moreover, market risk has increased significantly, as shown by the difference between Staff's market risk premium in RRUI's prior rate case – 4.6 percent – and its market risk premium in the current case – 10.0 percent.[200] Yet RUCO's recommended

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195 RUCO Br. at 15.
196 Bourassa COC Rb. at 42.
197 RRUI Br. at 57 – 58.
198 Direct Testimony of William A. Rigsby, Schedule War 1 at 3 (9.94 percent cost of equity + 1.10 percent adjustment for anticipated economic changes).
199 RRUI Br. at 47 – 48.
200 *Id.* at 48.

cost of equity is only 17 basis points higher than in RRUI's prior case, when the sample utilities were less risky and market risk was extremely low.[201] Further, RUCO did not recommend a hypothetical capital structure or a downward adjustment to the return on equity, and instead argued that its 8.83 percent "recommended rate of return is reasonable when the Company's equity-heavy capital structure is taken into account."[202] Obviously, RUCO position in this case makes little sense relative to its position in RRUI's prior case.

Second, RRUI's capital structure is irrelevant to RUCO's 9.0 percent cost of equity recommendation. That recommendation is based on RUCO's analysis of the cost of equity for its sample groups of publicly traded utilities. Whether the estimated cost of equity for the proxy utilities should be adjusted based on RRUI's capital structure and other firm-specific characteristics (e.g., size, lack of liquidity, and differences in rate-setting methods) is a separate issue. RUCO argues for the use of a hypothetical capital structure, while Staff and RRUI propose that the Commission adhere to its precedent and directly adjust the cost of equity for the proxy utilities. In short, RUCO is double-dipping by arguing that the cost of equity should be reduced based on RRUI's capital structure while simultaneously arguing for a hypothetical capital structure that reduces RRUI's effective return on equity to only 6.9 percent.

In reality, RUCO has used various methods and inputs that are conceptually flawed and dramatically lower the sample utilities' cost of equity, as shown in RRUI's initial brief.[203] RUCO argues that Mr. Rigsby's recommendation is supported by "Value Line's projection of interest rate costs.[204] But Value Line also projects equity returns of 12.0 percent for the three largest water utilities in RUCO's proxy group. Under the comparable earnings standard, and taking into account RRUI's risk profile, a cost of

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[201] Ex. R-19 at 13 (RUCO recommended a return on equity of 8.83 percent).

[202] *Id.*

[203] *Id.* at 55 – 63.

[204] RUCO Br. at 16.

equity of 11.7 percent is reasonable and satisfies the comparable earnings standard. Conversely, a cost of equity of 9.0 percent for the proxy utilities and an effective return of 6.9 percent would be confiscatory.

IV. REPLY ON RATE DESIGN AND TARIFF ISSUES

A. Water Rate Design.

Staff says that its rate design "recognizes the growing importance of managing water as a finite resource and promotes more efficient water use."[205] So does the Company's recommended rate design.[206] Inverted block rate designs are conservation-oriented rate designs.[207] These rate designs promote conservation by pricing larger amounts of water at higher commodity rates. Unfortunately, Staff uses its conservation-oriented rate design as a de facto low income tariff by shifting revenue collection away from the residential customers, especially in the lower tier, and towards commercial customers. Because residential customers comprise the lion-share of the customer base, this revenue shifting exposes RRUI to a greater risk of revenue erosion.

Staff also takes issue with the Company's description of Staff's recommendation as "blatant" revenue shifting.[208] But Staff's revenue shifting is open, obvious and unabashed. Staff actually admits that RRUI's current rate design is already flawed because the proportion of the revenues coming from the fixed charge is already too low.[209] Nevertheless, Staff moves more revenue collection to the commodity charges where more of it will have to come from the larger commercial users. If, as is the point of a conservation-oriented rate, revenues go down with less water consumption, there will be revenue erosion. To this, Staff argues, "even if we are shifting revenues, it's only

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[205] Staff Br. at 9:19-20.
[206] Bourassa Dt. at 17:16-20.
[207] *Id.*; Tr. at 924:12-23.
[208] Staff Br. at 10:17-18.
[209] *Id.* at 10:18-19.

1.4 percent."[210] 1.4 percent of the Company's proposed revenue requirement is over $50,000, an amount not so easily ignored.[211] Conservation can be encouraged in RRUI's service territory without shifting more revenue recovery to commercial customers where the Company's ability to earn its revenue requirement will be made a great deal more uncertain. On the other side, relief for low income residential customers is available in the form of the low-income tariff. Staff's embedded lifeline rate for small residential users is simply a disguised second low income tariff and its presence is why Staff is revenue shifting and why Staff's proposed rate design is risky to RRUI. It's time to separate water conservation from revenue shifting.

B. Low Income Tariff.

In its closing brief, RRUI indicated that it would adopt some of the changes recommended by Staff.[212] Now, RRUI is prepared to accept all of Staff's recommended changes to the low-income tariff. As a result, RRUI believes Staff and the Company are now in total agreement on this issue in this rate case.[213]

C. Hook Up Fee Tariff.

RRUI believes that hook-up fee tariffs (HUFs) are an important source of funding backbone plant additions needed to serve new development in water and sewer utility CC&Ns.[214] Hook up fees are treated as CIAC, which allows the utility to plan its long term capital budgeting in a manner that helps keep rates within an acceptable range of reasonable.[215] Candidly, the Company thought HUF tariffs were something the

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[210] *Id.* at 10:20-22.

[211] *Id.*

[212] RRUI Br. at 73:20 – 74:2.

[213] RRUI was opposed to certain changes proposed by Staff to the administrative fee, however, after receiving clarification from Staff in the pending Coronado Utilities rate case RRUI accepts Staff's recommended administrative fee for the low income tariff to enhance consistency and eliminate another issue in dispute. The Company will late-file a revised "final" form of low income tariff.

[214] Rebuttal Testimony of Greg Sorensen ("Sorensen Rb.") at 5:20 – 6:15; Rejoinder Testimony of Greg Sorensen ("Sorensen Rj.") at 13:22 – 14:14.

[215] *Id.*

Commissioners wanted every utility to have in order to ensure that "growth pays for growth." Despite this, Staff and even RUCO oppose the HUF. In contrast, RRPI's opposition is less surprising – every dollar the developer saves goes back to RRPI's bottom line. Nevertheless, these oppositions are singularly and collectively unpersuasive.

1. <u>Reply to RUCO.</u>

RUCO has only one problem with RRUI's proposed HUF – the proposed inclusion of language that HUF funds not be recorded as CIAC until they are expended on plant.[216] This language squares with the NARUC definition of "CIAC," which "<u>offsets</u>" the cost of plant.[217] RUCO makes no effort to address this fact. Instead, RUCO argues that the HUF payment must be deemed CIAC and immediately deducted from rate base to recognize the Company's beneficial use of the HUF funds from the day they are received.[218] RUCO is wrong. The Company will have **<u>no beneficial use</u>** of the funds until they are expended on plant because the funds are to be retained in a "separate interest bearing" account until spent on allowed plant items.[219] RRUI does not get to keep the interest and it does not have use of the funds for anything because the use of the funds is restricted to the purposes set forth in the tariff itself. In other words, the money just sits there accruing interest for the benefit of ratepayers until it is used for plant.

RRUI is aware of the two recent cases relied upon by RUCO – H2O and Arizona-American.[220] But RUCO is wrong that this situation is "no different." Here, the Company's tariff would expressly provide, consistent with NARUC, that HUF funds are not CIAC until expended in accordance with the strict language of the tariff. Therefore,

[216] RUCO Br. at 18-19. *See also* RRUI Br., Brief Exhibit 1 at IV.B (water and wastewater).
[217] Sorensen Rj. at 6:12-24, Exhibit GS-RJ2.
[218] RUCO Br. at 18:17-21.
[219] RRUI Br., Brief Exhibit 1 at IV.B (water and wastewater). If RUCO wants the terms "with a non-affiliated bank" inserted after "account" to address its concern over this not being a "bank account" (Tr. at 488:5 – 490:19), RRUI would not be opposed.
[220] RUCO Br. at 19:4-7.

the Commission's concern in those cases – that its rules require CIAC to be deducted from rate base – will be addressed.[221] There won't be any CIAC until HUF monies are spent on plant. And since there won't be any beneficial use of the funds by RRUI in the meantime, there is no reason to force the Company to recognize funds that it cannot use. These funds are HUF funds and nothing more until they become CIAC when spent on plant.[222]

2. Reply to Staff.

Staff asserts that "the purpose of hook up fees is to equitably apportion the cost of constructing additional off-site facilities . . . among all new service connections."[223] RRUI agrees.[224] The Company wishes to implement the HUF tariff in order to ensure that new development equitably contributes to the total cost of backbone plant by infusing CIAC into the total capitalization of all plant.[225] Likewise, the Company agrees that HUF tariffs should benefit the overall system, not just the new development.[226] For this reason, RRUI included language to that effect in both of its proposed HUF tariffs.[227] Not only do off-site facilities by their very nature benefit large numbers of customers, in contrast to on-sites, but preventing existing ratepayers from covering the cost of growth clearly is of benefit to RRUI and every ratepayer connected to its water and sewer utility systems.

In light of these fundamental areas of agreement, it's hard to understand Staff's reluctance to support the HUF because the Company does not "need" to fund off-site plant at this time.[228] Growth is an ongoing largely unpredictable phenomenon beyond the

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[221] *See generally,* Exs. R-13 at 4 – 8 and R-14 at 26 – 28.
[222] Sorensen Rj. at 6:12, Exhibit GS-RJ2.
[223] Staff Br. at 18:25 – 19:1. *See also* RRPI Br. at 1:1.
[224] Sorensen Rb. at 5:20 – 6:15; Sorensen Rj. at 13:22 – 14:14.
[225] *Id.*
[226] Staff Br. at 19:1-5.
[227] RRUI Br., Brief Exhibit 1 at II (Definition of Off-Site Facilities) (water and wastewater).
[228] Staff Br. at 19:8.

utility's control and, therefore, a utility like RRUI always needs a HUF. Perhaps for this reason Staff has not offered or identified a single instance where the Commission has denied a HUF because the utility did not identify the specific plant items it "needs" to fund. In this case, RRUI "needs" the HUF to help fund the cost of the types of off-site facilities enumerated in the tariff.[229]

The Company likewise disagrees with Staff's conclusion that RRUI does not need a HUF because it already has adequate capacity.[230] As to wastewater treatment capacity, Staff's conclusion is contrary to the evidence. RRUI has purchased 550,000 gallons of treatment capacity per day from Nogales and is already using more than 80 percent of that capacity.[231] Given ADEQ and Staff Engineering's well-known "80-90" rule, the Company does not have treatment capacity presently available to serve additional development in its CC&N.[232] And, while it is unknown where additional capacity will come from, it will clearly cost money.[233] Hence the Company's request for a HUF tariff for its wastewater division.

As asserted in RRUI's closing brief, Staff's analysis and conclusion that there is adequate water capacity is overly simplistic. In short, Staff simply states that according to Water Use Data Sheets the Company has no water deficit, therefore it does not need more water capacity.[234] Based on a comprehensive analysis, the Company's third-party engineers have concluded that the RRUI will need additional storage and supply to

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[229] RRUI Br., Brief Exhibit 1 at II (Definition of Off-Site Facilities) (water and wastewater); *see also* Ex. A-20.

[230] Staff Br. at 19:9-11, 20:4-8.

[231] Tr. at 665:12-22, 667:13-20.

[232] The Commission can take notice of this oft-cited rule whereby the regulatory agencies expect sewer utilities to begin planning for additional capacity when it reaches 80 percent of capacity and to be in construction when it reaches 90 percent. Given this rule, Staff's conclusion leaves the Company without the expected safety margin.

[233] Tr. at 667:24 – 668:8.

[234] Staff Br. at 19:12-19.

accommodate near-term growth.[235] Staff's only response to this study is that RRUI is being too conservative.[236] Maybe so, but the Company wishes to not only make sure that it has adequate water storage, pressure and supply as new growth needs to be accommodated, but that this growth pays for itself.

Finally, Staff takes issue with the Company's form of HUF, and the HUF amount, at least for wastewater.[237] But Staff does not identify what it does not like about the Company's proposed HUF form, which form is consistent with the HUF proposed for other Liberty Water utilities in Arizona. Nor does Staff allege that the Company has failed to explain and support its requested HUF Tariff language. As such, Staff has not sustained its burden of proof and the Company's proposed form of tariff should be approved. The same is true of the HUF amount. Seemingly, Staff does not like the sewer HUF amount and reasons that the Company cannot provide details on the plant it will build with HUF funds costs. So what? We know what type of plant will be built and for whom it will be built. We also know why the Company came up with the proposed HUF amount, which, in the absence of a supported and viable, should be approved.[238]

3. Reply to RRPI.

RRPI comes to this issue having failed to present any specific evidence of (1) what it has built already, (2) what it has already advanced or contributed, (3) when it will be building in the future, (4) what it will be building in the future, and (5) what it's willing to advance or contribute to fund the capacity RRUI will need to serve its future development. This would be remarkable, even if RRPI wasn't also trying to take away the Company's rights under the Commission's main extension rules as well as its inherent

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[235] Ex. A-20 at 15, 19, 22 – 25; Sorensen Rj. at 10:12 – 12:3.
[236] Staff Br. at 19:20 – 20:3.
[237] *Id.* at 20:9-14.
[238] Sorensen Dt. at 10:19 – 11:25.

right to manage its own affairs.[239] But what makes it most extraordinary is RRPI's obvious motivation – every dollar for infrastructure it shifts to RRUI and its ratepayers is another dollar of profit. While the Company does not begrudge the developer every dollar it can make on its business activities, the Company isn't interested in having it and its customers take development risk. Fortunately, RRPI's arguments are easily addressed.

RRPI's concern over the Company's capital structure, while appreciated, is unnecessary.[240] The Commission is well aware of Liberty Water's access to capital through its parent, APUC, and there is simply no rational basis to predict that the Company will end up with little to no rate base because all of its plant is being financed with CIAC. In addition to the significant investment Liberty Water has already made in RRUI, the "Algonquin" family has already invested tens of millions of dollars of shareholder capital in Arizona at LPSCO, Black Mountain Sewer, Gold Canyon Sewer, Bella Vista Water and the former McLain systems. Furthermore, HUF funds can only be used for facilities for new development, but there will be no shortage of capital costs for repair and replacement of existing infrastructure. In other words, this is not about the Company's share of needed capital investment, it's about RRPI's.

RRPI's concerns over "double-dipping" are likewise unnecessary.[241] The Company has repeatedly stated that that it has no intention of making a developer pay twice for the same facilities.[242] If, as RRPI has claimed but not yet shown, the developer has already entered into extension agreements or otherwise advanced and/or contributed off-site facilities necessary for service to new connections, then the HUF should not apply. Or, a developer could obtain wastewater treatment capacity from Nogales and

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[239] *Southern Pacific Co. v. Ariz. Corp. Comm'n*, 98 Ariz. 339, 343, 404 P.2d 692, 696 (1965).
[240] RRPI Br. at 2:17 – 4:11.
[241] *Id.* at 4:12-22.
[242] RRUI Br. at 78:10-12 with citations.

contribute it to RRUI in lieu of the HUF.[243] Beyond that, however, hard and fast rules like those proposed by RRPI are not in the public interest.[244] The fact that an extension agreement was entered into decades ago and a subdivision partially built out, without more, is insufficient to excuse an applicant for service today from any and all obligations. Given the dearth of evidence of this developer's past contribution and future needs, this would be a huge windfall for RRPI. Such risk to the Company and its ratepayers is simply unwarranted.

RRPI's attempt to further avoid its obligation to fund growth by prohibiting RRUI from entering into main extension agreements if it has a HUF also must be rejected.[245] There is no precedent for such a finding, nor has RRPI presented any authority for the proposition that a HUF tariff somehow abridges the utility's rights under the Commission's main extension rules for water and sewer utilities.[246] Like many of RRPI's assertions, the developer seeks an advance prohibition against actions RRUI might take in the future. RRPI is really seeking adjudication of issues that are neither ripe nor presently before the Commission on specifically applied facts.

In sum, RRPI's positions and recommendations are designed solely to reduce the burden on the developer for off-site infrastructure needed to serve new development. If the relief sought were granted, the end-result would be higher rates to both existing and new customers as such customers will have to provide a return on and of the capital the Company will then be forced to invest to accommodate RRPI's development. The

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[243] *Id.*, Brief Exhibit 1 at IV.D (water and wastewater).

[244] RRPI Br. at 5:1 – 7:5.

[245] *Id.* at 4:18-19.

[246] R14-2-406 and -606. The main extension rules expressly allow a utility to require applicants to advance plant for capacity, which includes facilities for treatment of wastewater and for water supply, pressure and storage. Of course, HUF funds are CIAC while main extensions generally provide utilities plant funded by AIAC, which is both depreciable and subject to refund, the latter allowing the utility to establish rate base as plant built by the developer becomes used and useful. AIAC and CIAC are simply two other means of financing plant and equity, to go along with debt and equity.

Company does not believe allowing the developer to set the terms of its own development would be in the public interest.

4. Conclusions.

The Company's requested HUF tariff has created a lot of controversy in this case. RRUI remains puzzled by this given that it has heard the Commission routinely suggesting and approving HUFs for numerous utilities over the last several years. Sifting through the dispute, however, one thing is abundantly clear – no evidence has been presented to show that approval of the HUF would be harmful to the public interest. It certainly isn't prejudicial to the developer to expect it to fund its lawful share of the cost of off-site plant to serve its ongoing development activities in the Company's CC&N, especially not when the alternative funding source is the Company and its ratepayers. RUCO's concerns are already addressed in the language of the tariff, which ties CIAC to plant consistent with NARUC and the Commission's rules. And a utility like RRUI always will need new off-site plant to serve new development, a fact well demonstrated by RRUI's master planning. Therefore, while Staff is right that growth is uncertain at this time, the need to pay for plant in the future is not. For all these reasons, RRUI asks that its proposed forms of HUF tariff be approved for both divisions.

V. OTHER ISSUES

A. Water Loss.

RRUI does not have a water loss problem. RRUI's water loss has exceeded 10 percent only once in the last several years, the test year, and even then water loss reached a high point of 10.2 percent.[247] In 2009, post test year, RRUI's water loss was also less than 10 percent, all of which led Mr. Liu to recommend that RRUI undergo certain non-account water monitoring just to make sure water loss is under Staff's desired 10 percent

[247] Sorensen Rb. at 3:1-19.

level. Because water is a precious resource, the Company has accepted Staff's non-account water monitoring recommendations.[248]

B. BMPs.

In its brief, for the first time, Staff recommends that the Company's Best Management Practices (BMPs) regarding water conservation be filed as a tariff.[249] There is no record regarding implementation of a BMP tariff, and several of the BMPs cannot be implemented by tariff.[250] For example, the Company's ADWR-approved BMPs include "Special Events Programming and Community Presentations" and "new Homeowner Landscape Information." How does the Company enforce these BMPs? It can't, and therefore some effort to determine which of the Company's 10 total BMPs can be implemented via tariff must be made before Staff's recommendation can be granted.[251]

This concludes the Company's arguments. However, as noted, the Company will be late filing a form of the low income tariff reflecting the agreement with Staff and RRPI.[252]

RESPECTFULLY SUBMITTED this 10th day of May, 2010.

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[248] Sorensen Rj. at 1:15 – 2:2.

[249] Staff Br. at 21.

[250] *See* RRUI's Notice of Filing dated March 26, 2010.

[251] The Company is willing to work with Staff to create a tariff for BMPs consistent with its concerns expressed herein.

[252] As a final note, RRUI would like to point out that it is a Class B utility, not a Class A as stated by Staff. Staff Br. at 1:17. Class A utilities have revenues, from water *or* sewer, in excess of $5 million. R14-2-103.A.3.q. While not relevant to the issues in dispute, there are certain scheduling differences between the two classes of utility.

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

REPLY CLOSING BRIEF
May 10, 2010

Reply Brief Exhibit 1

2008

ALGONQUIN POWER INCOME FUND

ANNUAL FINANCIAL RESULTS

ALGONQUIN POWER

depreciation and amortization expense which are derived from a number of non-operating factors, accounting methods and assumptions. APMI believes that presentation of this measure will enhance an investor's understanding of Algonquin's operating performance. EBITDA is not intended to be representative of cash provided by operating activities or results of operations determined in accordance with GAAP.

Overview

Algonquin is a company that owns and has interests in a diverse portfolio of clean, renewable power generation and sustainable infrastructure assets across North America, including 42 renewable energy facilities, 11 thermal energy facilities, and 17 water distribution and waste-water facilities. Algonquin Power was established in 1997 and produces stable earnings through a diversified portfolio of renewable energy and utility assets.

Algonquin owns 41 hydroelectric facilities operating in Ontario, Québec, Newfoundland, Alberta, New York State, New Hampshire, Vermont and New Jersey with a combined generating capacity of 140 MW. The company also owns a 99 MW wind farm in Manitoba. The renewable energy facilities are generally facilities operating under power purchase agreements with major utilities that have an average remaining life of 18 years. The Company's 11 thermal energy facilities also operate under power purchase agreements with an average remaining contract length of 10 years with a combined generating capacity of 320 MW. The Company's Utility Services business unit owns 17 regulated utilities in the United States of America providing water and wastewater services in the states of Arizona, Texas, Missouri and Illinois. These utility operating companies are regulated investor-owned utilities subject to regulation, including rate regulation, by the public utility commissions of the states in which they operate.

Business Strategy

Algonquin's business strategy is to maximize long term unitholder value by strengthening its position as a strong renewable energy and infrastructure company. The Company is focused on growth in cash flow and earnings in the business segments in which it operates. Algonquin currently makes monthly cash distributions to unitholders of $0.02 per trust unit per month or $0.24 per trust unit per annum. This sustainable level of cash distributions allows for both an immediate return on investment for unitholders and retention of sufficient cash to fund growth opportunities, fund anticipated tax liabilities when the new tax policies affecting income trusts are implemented, and mitigate the impact of volatility in foreign exchange.

Algonquin's operations are aligned into two major business units: *Power Generation & Development*, and *Utility Services*. The two business units reflect the Company's business strategy to be a leading provider of essential services and how Algonquin manages its business and classifies its operations for planning and measuring performance.

The Power Generation & Development business unit develops and operates a diversified portfolio of electrical energy generation facilities. Within this business unit there are three distinct divisions: Renewable Energy, Thermal Energy and Development. The Renewable Energy division operates the Company's hydro-electric and wind power facilities. The Thermal Energy division operates co-generation, energy from waste, steam production and other thermal facilities. The Development division develops Algonquin's greenfield power generation projects, pursues accretive acquisitions of electrical energy generation facilities as well as development of organic growth opportunities within Algonquin's existing portfolio of renewable energy and thermal energy facilities. The renewable power and thermal energy generation business of Algonquin is managed with an emphasis on growth through the development of green-field projects and opportunities within Algonquin's existing portfolio. This involves building on the Company's expertise in the origination of greenfield renewable energy projects, building upon the Company's existing portfolio of assets for further growth, and capitalizing on opportunities that may emerge in the current turbulence of the capital markets.

The Utility Services business unit provides safe, reliable transportation and delivery of water and waste-water treatment in its service area and pursues accretive water and waste-water utility acquisition opportunities. Building on its experience in the regulated water utility sector, Utility Services is also considering expanding its operations into other regulated essential utilities such as natural gas distribution and electricity distribution.

- Algonquin's BCI facility's energy services agreement includes provisions which reduce its exposure to natural gas price risk. In this regard, a $1.00 increase in the price of natural gas per mmbtu, based on expected production levels, would result in an increase in expenses of approximately $0.3 million on an annual basis. However, because the facility's energy price is linked to the price of natural gas, this increase would result in a corresponding increase in revenue of $0.4 million or a net increase in operating profits of approximately $0.1 million.

Litigation risks and other contingencies

Algonquin and certain of its subsidiaries are involved in various litigations, claims and other legal proceedings that arise from time to time in the ordinary course of business. Accruals for any contingencies related to these items are recorded in the financial statements at the time it is concluded that its occurrence is probable and the related liability is estimable. Anticipated recoveries under existing insurance policies are recorded when assured of recovery.

As reported in previous public filings of Algonquin, Trafalgar Power Inc. and Christine Falls Power Corporation (collectively, "Trafalgar") commenced an action in 1999 in U.S. District Court against Algonquin, APMI and various other entities related to them in connection with the sale of the Trafalgar Class A and B Notes by Aetna Life Insurance Company to Algonquin entities and the Company's foreclosure on the security for the Notes. In 2001, Trafalgar and other entities also filed for Chapter 11 reorganization in bankruptcy court and also filed a multi-count adversary complaint against certain Algonquin entities, which complaint was then transferred to the District Court. In 2006, the District Court decided that Aetna had complied with the provisions concerning the sale of the A and B Notes and that Algonquin was therefore the holder and owner of the Notes, and further that all claims asserted by Trafalgar with respect to the transfer of the Notes were without merit. Further, on November 6, 2008, the claims that were remaining in the District Court were dismissed by summary judgement. This decision provides further support for Algonquin's efforts to enforce its rights under the loan documents and the U.S. Bankruptcy Code in the bankruptcy proceeding. On November 21, 2008, Trafalgar requested that the summary judgement be vacated based on alleged new evidence. The new evidence has, in the view of Algonquin, been falsified, and Algonquin has vigorously contested the request and has also taken further investigative steps in relation to the falsification. The motion was submitted for decision by the Court on January 9, 2009. The likelihood of the summary judgement being vacated is low. Following disposition of this motion, an appeal by Trafalgar is expected.

Obligations to serve

Algonquin's utility facilities may be located within areas of the United States experiencing growth. These utilities may have an obligation to service new residential, commercial and industrial customers. While expansion to serve new customers will likely result in increased future cash flows, it may require significant capital commitments in the immediate term. Accordingly, Algonquin may be required to access capital markets or obtain additional borrowings to finance these future construction obligations.

Changes to income tax laws

Changes to income tax laws and the current tax treatment of mutual fund trusts could negatively impact Algonquin. Although Algonquin is of the view that it currently qualifies under current legislation as a mutual fund trust, there can be no assurance that the legislation will not be changed in the future or that Canada Revenue Agency ("CRA") will agree with this position. If Algonquin ceases to qualify as a mutual fund trust, the return to unitholders may be adversely affected.

On June 22, 2007, Bill C-52 was enacted, which included legislation to impose a tax on certain income distributed to unitholders by certain publicly traded income trusts and partnerships (the "SIFT Rules"). The SIFT Rules apply to "specified investment flow-throughs" ("SIFT") which includes trusts resident in Canada whose units are listed or traded on a stock exchange or other public market if the trust holds one or more "non-portfolio properties" .

Algonquin is a SIFT trust as defined under the SIFT Rules. Algonquin would have been a SIFT trust on October 31, 2006 had the SIFT Rules been in force on that date. The SIFT rules will not apply to

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

REPLY CLOSING BRIEF
May 10, 2010

Reply Brief Exhibit 2

RRUI WATER AND SEWER DIVISIONS COMBINED: YEARLY/MONTHLY COSTS PER CUSTOMERS FOR THE APT CENTRAL OFFICE COSTS

APT COST CATEGORY	RRUI FINAL SCHEDULE AMOUNTS <1>	ALLOCATION % <2>	ALLOCATED AMOUNT	RRUI WATER ALLOCATION %	AMOUNT ALLOCATED TO RRUI	# OF WATER & SEWER CUSTOMERS	YEARLY COST PER CUSTOMER	MONTHLY COST PER CUSTOMER
Audit	$949,550	26.98%	$256,188.59	12.70%	$32,535.95	8,096	$4.02	$0.33
Tax Services	$242,944	26.98%	$65,546.29	12.70%	$8,324.38	8,096	$1.03	$0.09
Legal Services	$253,766	26.98%	$68,466.07	12.70%	$8,695.19	8,096	$1.07	$0.09
Other Prof. Services	$316,709	26.98%	$85,448.09	12.70%	$10,851.91	8,096	$1.34	$0.11
Management Fees	$623,350	26.98%	$168,179.83	12.70%	$21,358.84	8,096	$2.64	$0.22
Unit Holder Commun.	$215,227	26.98%	$58,068.24	12.70%	$7,374.67	8,096	$0.91	$0.08
Trustee Fees	$127,116	26.98%	$34,295.90	12.70%	$4,355.58	8,096	$0.54	$0.04
Escrow Fees	$70,407	26.98%	$18,995.81	12.70%	$2,412.47	8,096	$0.30	$0.02
Rent	$294,725	26.98%	$79,516.81	12.70%	$10,098.63	8,096	$1.25	$0.10
License/Fees	$8,705	26.98%	$2,348.61	12.70%	$298.27	8,096	$0.04	$0.00
Office Expenses	$669,169	26.98%	$180,541.80	12.70%	$22,928.81	8,096	$2.83	$0.24
Depreciation	$211,253	26.98%	$56,996.06	12.70%	$7,238.50	8,096	$0.89	$0.07
TOTALS	$3,982,921	26.98%	$1,074,592.09	12.70%	$136,473.19	8,096	$16.86	$1.40

NOTES:

<1> The RRUI Final Schedule amounts are the final amounts allocated to RRUI for the APT Central Office Costs as set forth in the Company's Final Schedules filed on April 9, 2010. The amounts are stated in United States dollars as converted from Canadian dollars using the prevailing monthly exchange rate published by the Bank of Canada.

<2> The allocation percentage reflects that 26.98% of the total costs are allocated to the 17 regulated utilities owned by APIF, with the remaining 73.02% allocated to the remaining 46 unregulated facilities owned by APIF.

RRUI WASTEWATER DIVISION: YEARLY AND MONTHLY COSTS PER CUSTOMER FOR THE APT CENTRAL OFFICE COSTS

APT COST CATEGORY	FINAL SCHEDULE AMOUNTS <1>	ALLOCATION PERCENTAGE <2>	TOTAL ALLOCATED AMOUNT	RRUI WATER ALLOCATION PERCENTAGE	AMOUNT ALLOCATED TO RRUI	NUMBER OF WATER CUSTOMERS	YEARLY COST PER CUSTOMER	MONTHLY COST PER CUSTOMER
Audit	$949,550	26.98%	$256,188.59	3.15%	$8,069.94	2,071	$3.90	$0.32
Tax Services	$242,944	26.98%	$65,546.29	3.15%	$2,064.71	2,071	$1.00	$0.08
Legal Services	$253,766	26.98%	$68,466.07	3.15%	$2,156.68	2,071	$1.04	$0.09
Other Prof. Services	$316,709	26.98%	$85,448.09	3.15%	$2,691.61	2,071	$1.30	$0.11
Management Fees	$623,350	26.98%	$168,179.83	3.15%	$5,297.66	2,071	$2.56	$0.21
Unit Holder Commun.	$215,227	26.98%	$58,068.24	3.15%	$1,829.15	2,071	$0.88	$0.07
Trustee Fees	$127,116	26.98%	$34,295.90	3.15%	$1,080.32	2,071	$0.52	$0.04
Escrow Fees	$70,407	26.98%	$18,995.81	3.15%	$598.37	2,071	$0.29	$0.02
Rent	$294,725	26.98%	$79,516.81	3.15%	$2,504.78	2,071	$1.21	$0.10
License/Fees	$8,705	26.98%	$2,348.61	3.15%	$73.98	2,071	$0.04	$0.00
Office Expenses	$669,169	26.98%	$180,541.80	3.15%	$5,687.07	2,071	$2.75	$0.23
Depreciation	$211,253	26.98%	$56,996.06	3.15%	$1,795.38	2,071	$0.87	$0.07
TOTALS	$3,982,921	26.98%	$1,074,592.09	3.15%	$33,849.65	2,071	$16.34	$1.36

NOTES:

<1> The RRUI Final Schedule amounts are the final amounts allocated to RRUI for the APT Central Office Costs from the Company's final schedules filed on April 9, 2010. The final schedule amounts are stated in United States dollars as converted from Canadian dollars using the prevailing monthly exchange rate published by the Bank of Canada.

<2> The allocation percentage reflects that 26.98% of the total costs are allocated to the 17 regulated utilities owned by APIF, with the remaining 73.02% allocated to the remaining 46 unregulated facilities owned by APIF.

RRUI REPLY BRIEF EXHIBIT 2

RRUI WATER DIVISION: YEARLY AND MONTHLY COSTS PER CUSTOMERS FOR THE APT CENTRAL OFFICE COSTS

APT COST CATEGORY	FINAL SCHEDULE AMOUNTS <1>	ALLOCATION PERCENTAGE <2>	TOTAL ALLOCATED AMOUNT	RRUI WATER ALLOCATION PERCENTAGE	AMOUNT ALLOCATED TO RRUI	NUMBER OF WATER CUSTOMERS	YEARLY COST PER CUSTOMER	MONTHLY COST PER CUSTOMER
Audit	$949,550	26.98%	$256,188.59	9.55%	$24,466.01	6,025	$4.06	$0.34
Tax Services	$242,944	26.98%	$65,546.29	9.55%	$6,259.67	6,025	$1.04	$0.09
Legal Services	$253,766	26.98%	$68,466.07	9.55%	$6,538.51	6,025	$1.09	$0.09
Other Prof. Services	$316,709	26.98%	$85,448.09	9.55%	$8,160.29	6,025	$1.35	$0.11
Management Fees	$623,350	26.98%	$168,179.83	9.55%	$16,061.17	6,025	$2.67	$0.22
Unit Holder Commun.	$215,227	26.98%	$58,068.24	9.55%	$5,545.52	6,025	$0.92	$0.08
Trustee Fees	$127,116	26.98%	$34,295.90	9.55%	$3,275.26	6,025	$0.54	$0.05
Escrow Fees	$70,407	26.98%	$18,995.81	9.55%	$1,814.10	6,205	$0.29	$0.02
Rent	$294,725	26.98%	$79,516.81	9.55%	$7,593.85	6,025	$1.26	$0.11
License/Fees	$8,705	26.98%	$2,348.61	9.55%	$224.29	6,025	$0.04	$0.00
Office Expenses	$669,169	26.98%	$180,541.80	9.55%	$17,241.74	6,025	$2.86	$0.24
Depreciation	$211,253	26.98%	$56,996.06	9.55%	$5,443.12	6,025	$0.90	$0.08
TOTALS	$3,982,921	26.98%	$1,074,592.09	9.55%	$102,623.54	6,025	$17.02	$1.42

NOTES:

<1> The RRUI Final Schedule amounts are the final amounts allocated to RRUI for the APT Central Office Costs from the Company's final schedules filed on April 9, 2010. The final schedule amounts are stated in United States dollars as converted from Canadian dollars using the prevailing monthly exchange rate published by the Bank of Canada.

<2> The allocation percentage reflects that 26.98% of the total costs are allocated to the 17 regulated utilities owned by APIF, with the remaining 73.02% *allocated to the remaining* 46 unregulated facilities owned by APIF.

RRUI WATER DIVISION: APT COSTS AS PERCENTAGE OF AVERAGE MONTHLY BILL

APT COST CATEGORY	FINAL SCHEDULE AMOUNTS <1>	TOTAL ALLOCATED AMOUNT	AMOUNT ALLOCATED TO RRUI	NUMBER OF WATER CUSTOMERS	YEARLY COST PER CUSTOMER	MONTHLY COST PER CUSTOMER	% OF AVERAGE MONTHLY BILL <3>
Audit	$949,550	$256,188.59	$24,466.01	6,025	$4.06	$0.34	0.850%
Tax Services	$242,944	$65,546.29	$6,259.67	6,025	$1.04	$0.09	0.218%
Legal Services	$253,766	$68,466.07	$6,538.51	6,025	$1.09	$0.09	0.227%
Other Prof. Services	$316,709	$85,448.09	$8,160.29	6,025	$1.35	$0.11	0.284%
Management Fees	$623,350	$168,179.83	$16,061.17	6,025	$2.67	$0.22	0.558%
Unit Holder Commun.	$215,227	$58,068.24	$5,545.52	6,025	$0.92	$0.08	0.193%
Trustee Fees	$127,116	$34,295.90	$3,275.26	6,025	$0.54	$0.05	0.114%
Escrow Fees	$70,407	$18,995.81	$1,814.10	6,205	$0.29	$0.02	0.061%
Rent	$294,725	$79,516.81	$7,593.85	6,025	$1.26	$0.11	0.264%
License/Fees	$8,705	$2,348.61	$224.29	6,025	$0.04	$0.00	0.008%
Office Expenses	$669,169	$180,541.80	$17,241.74	6,025	$2.86	$0.24	0.599%
Depreciation	$211,253	$56,996.06	$5,443.12	6,025	$0.90	$0.08	0.189%
TOTALS	$3,982,921	$1,074,592.09	$102,623.54	6,025	$17.02	$1.42	3.565%

NOTES:

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<2> The allocation percentage reflects that 26.98% of the total costs are allocated to the 17 regulated utilities owned by APIF, with the remaining 73.02% allocated to the remaining 46 unregulated facilities owned by APIF.

<3> As state in RRUI's final schedules, the average monthly bill for a residential customer on a 5/8" x 3/4" meter is $39.80 (as proposed). *See* Final Schedule H-2 (Water) at 1.

RRUI REPLY BRIEF EXHIBIT 2

RRUI WASTEWATER DIVISION: APT COSTS AS PERCENTAGE OF AVERAGE MONTHLY BILL

APT COST CATEGORY	FINAL SCHEDULE AMOUNTS <1>	TOTAL ALLOCATED AMOUNT	AMOUNT ALLOCATED TO RRUI	NUMBER OF WATER CUSTOMERS	YEARLY COST PER CUSTOMER	MONTHLY COST PER CUSTOMER	% OF AVERAGE MONTHLY BILL <3>
Audit	$949,550	$256,188.59	$8,069.94	2,071	$3.90	$0.32	0.623%
Tax Services	$242,944	$65,546.29	$2,064.71	2,071	$1.00	$0.08	0.159%
Legal Services	$253,766	$68,466.07	$2,156.68	2,071	$1.04	$0.09	0.167%
Other Prof. Services	$316,709	$85,448.09	$2,691.61	2,071	$1.30	$0.11	0.208%
Management Fees	$623,350	$168,179.83	$5,297.66	2,071	$2.56	$0.21	0.409%
Unit Holder Commun.	$215,227	$58,068.24	$1,829.15	2,071	$0.88	$0.07	0.141%
Trustee Fees	$127,116	$34,295.90	$1,080.32	2,071	$0.52	$0.04	0.083%
Escrow Fees	$70,407	$18,995.81	$598.37	2,071	$0.29	$0.02	0.046%
Rent	$294,725	$79,516.81	$2,504.78	2,071	$1.21	$0.10	0.193%
License/Fees	$8,705	$2,348.61	$73.98	2,071	$0.04	$0.00	0.006%
Office Expenses	$669,169	$180,541.80	$5,687.07	2,071	$2.75	$0.23	0.439%
Depreciation	$211,253	$56,996.06	$1,795.38	2,071	$0.87	$0.07	0.139%
TOTALS	$3,982,921	$1,074,592.09	$33,849.65	2,071	$16.34	$1.36	2.614%

NOTES:

<1> The RRUI Final Schedule amounts are the final amounts allocated to RRUI for the APT Central Office Costs from the Company's final schedules filed on April 9, 2010. The final schedule amounts are stated in United States dollars as converted from Canadian dollars using the prevailing monthly exchange rate published by the Bank of Canada.

<2> The allocation percentage reflects that 26.98% of the total costs are allocated to the 17 regulated utilities owned by APIF, with the remaining 73.02% allocated to the remaining 46 unregulated facilities owned by APIF.

<3> As stated in RRUI's final schedules, the average monthly bill for a residential customer on a 5/8" x 3/4" meter is $52.10 (as proposed). *See* Final Schedule H-2 (Wastewater) at 1.