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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF RIO RICO UTILITIES, INC. FOR A RATE INCREASE.	DOCKET NO. WS-02676A-12-0196 **STAFF'S CLOSING BRIEF**

The Utilities Division Staff ("Staff") of the Arizona Corporation Commission ("Commission") hereby files its closing brief in the above captioned matter. This brief only addresses the disputed issues between Staff and the Company and the issues resolved subsequent to pre-filed testimony. Staff maintains its position as presented in its pre-filed testimony on any issue not specifically addressed here.

I. INTRODUCTION.

Rio Rico Utilities, Inc. ("RRUI" or the "Company") is a certified Arizona public service corporation that provides water utility services in portions of Santa Cruz County, Arizona, pursuant to a certificate of convenience and necessity granted by the Arizona Corporation Commission.[1] During the test year, RRUI served approximately 6,751 water only and 2,207 water and sewer utility service connections.[2] RRUI is owned by Liberty Water, Inc., a wholly-owned subsidiary of Algonquin Power & Utilities Corporation ("APUC"), a publically-traded corporation on the Toronto Stock Exchange.[3]

The Company filed its application for a permanent rate increase based on a test year ending February 29, 2012.[4] For the water division, Staff is recommending a total revenue requirement of $3,218,519.[5] This represents an increase of $353,697 or 12.35 percent over adjusted test year

[1] Sorensen Direct, Ex. A-7 at 3.
[2] Appl. RRUI, Ex. A-1 at 1.
[3] Ex. A-7 at 3.
[4] Bourassa Direct, Ex. A-1 at 3.
[5] Staff Final Sch. MJR-W1 (4-23-2012).

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revenues;[6] Staff is proposing an Original Cost Rate Base ("OCRB") of $7,731,209[7] and a rate of return of 8.20 percent.[8] For the wastewater division, Staff is recommending a total revenue requirement of $1,492,819.[9] This represents an increase of $89,976 or 6.41 percent over adjusted test year revenues;[10] Staff is proposing an Original Cost Rate Base ("OCRB") of $4,790,738 and a rate of return of 8.20 percent.[11] The parties agree that RRUI has a capital structure that consists of 100 percent equity.[12] Staff is recommending a cost of equity ("COE") of 8.2 percent and a return on equity ("ROE") of 8.2 percent.[13]

While the Company, Staff, RUCO and the other interveners worked diligently through the pre-filed testimony process to narrow the issues in this case, there remained a few contested issues and adjustments as of the filing of RRUI's Rejoinder testimony. Rate base adjustments and income and expense adjustments that remained at issue between Staff and the Company included: plant retirements and their impact on both accumulated depreciation and depreciation expense; allocation of corporate costs from APUC to RRUI; employee benefits; a declining usage adjustment; rate design and cost of capital. Prior to the hearing herein, Staff and RRUI reached an agreement on all issues other than the cost of capital. RUCO subsequently agreed to that resolution.[14]

II. RATE BASE ADJUSTMENTS/PLANT RETIREMENTS.

The Company is seeking to treat OCRB as its FVRB and originally requested a FVRB of $7,629,604 for the water division and $4,600,312 for the wastewater Division.[15] In reviewing RRUI's application, Staff determined that the RRUI's schedules for both the water and waste water divisions showed recognition of depreciation expense after the balance in accumulated depreciation

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[6] *Id.*
[7] *Id.*
[8] Tr. vol. 2 at 240.
[9] Staff Final Sch. MJR-WW1 (4-23-2012).
[10] *Id.*
[11] *Id.*
[12] Tr. vol. 1 at 93:22-25; Tr. vol. 2 at 151:1-4, 240:25-241:3.
[13] Cassidy Surrebut. Ex. S-2 at 2.
[14] Tr. vol. 3 at 93.
[15] Ex. A-1 at 3.

equaled plant balance, indicating that the accumulated depreciation included depreciation on fully depreciated plant. Because depreciation expense continued to be recognized, that expense was also overstated by $290,873.[16] Both Staff[17] and RRUI[18] then proposed similar adjustments to the depreciation expense correct the error. However, each used a different methodology to arrive at its proposed adjustment, giving rise to the plant retirement issue.[19]

Staff was concerned that RRUI's adjustment was not based on actual plant retirements, but on the useful life of that plant, contrary to NARUC's USoA,[20] and that RRUI would continue to use this methodology in the future. Ultimately it became clear that the Company's failure to retire plant and/or discontinue accrual of depreciation expense was the result of poor record keeping on the part of RRUI's prior owner. RRUI was willing to properly track plant in the future.[21]

The two adjustment amounts were sufficiently close that there would have been minimal impact on rates and Staff accepted RRUI's adjustment to depreciation expense of $109,768 and RRUI's assurances of proper tracking of plant. Because of its concern that RRUI did not appear to notice its error in overstating depreciation and because of continuing issues of plant retirement among Liberty's water and waste water utilities, Staff also required that the Decision in this matter include the follow language: "On a going forward basis, RRUI shall accurately track and record plant additions, plant retirements, depreciation expense and accumulated depreciation. RRUI's failure to do so may subject the Company to sanctions, fines or other penalties."[22] RRUI agreed.[23]

III. INCOME STATEMENT ADJUSTMENTS.

Following the filing of all pre-filed testimony, two expense issues remained for both the water and waste water divisions: corporate cost allocations and the cost of a revised employee benefits plan. Staff proposed an adjustment to allocated corporate costs of $38,083 for the water division[24] and

[16] Rimback Direct, Ex. S-3 at 16.
[17] Ex. S-3 at 16:21-23 and 26:1-15; Rimback Surrebut., Ex. S-4 at 4:3-23. .
[18] Bourassa Rebut., Ex. A-3 at 5:13-5:13; Bourassa Rejoin. Ex. A-5 at 5-14 (generally).
[19] *Id.*
[20] Ex. S-4 at 6.
[21] Tr. vol. 1 at 32:2-13.
[22] Ex. S-4 at12.
[23] Tr. vol. 1 at 34:20-35:1.
[24] Ex. S-4 at 16:4-7.

$27,931 for the wastewater division,[25] not for substantive reasons, but because RRUI had failed to sufficiently document certain items.[26] Similarly, Staff opposed RRUI's expense item for a new employee benefit plan first addressed by RRUI in its rebuttal for the reason that Staff would not have a reasonable opportunity to evaluate that plan due to its late introduction and that Staff did have a number of concerns in that regard.[27]

After Staff and the Company met and discussed these issues, and the plant retirement issue, RRUI agreed to adjustment to the corporate cost allocations by $38,083 for the water division[28] and $27,931 for the wastewater division.[29] Staff was then able to refine its recommendations and testified that these adjustments would be Staff's recommendations if Staff were now submitting its pre-filed testimony.[30]

IV. RATE DESIGN.

Prior to the hearing herein, the parties' various rate designs were quite similar. At hearing, it was agreed that Staff's rate design would be adopted.[31] On April 23, 2013, Staff filed its updated rate design reflecting the resolution of the issues set forth herein and utilizing the same rate design as presented in its surrebuttal testimony.[32]

V. COST OF CAPITAL.

Staff, the Company, and RUCO recommend the adoption of the Company's actual capital structure of 100 percent equity and 0.0 percent debt.[33] Staff's final recommended cost of equity ("COE") is 8.5 percent and the final recommended return on equity ("ROE") is 8.2 percent.[34] The

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[25] *Id.*
[26] *Id.* at 16:15-16.
[27] *Id.* at 19-20.
[28] Tr. vol.1 at 32:21-33:10; Ex. A-17.
[29] *Id.*
[30] Tr. vol. 3 at 446-47.
[31] Tr. vol. 1 at 35; Tr. vol. 3 at 402.
[32] Staff Final Sch. MJR-W42 and MJR-WW24.
[33] Tr. vol. 1, at 100-01; Tr. vol. 2 at 151, 242.
[34] Cassidy Surrebut., Ex. S-2 at 2.

Company's final recommended COE is 9.8 percent and the final recommended ROE is 9.5 percent.[35] RUCO's final recommended COE and ROE are 8.25 percent.[36]

Staff's cost of capital recommendations are based on sound and reasonable financial analyses using the discounted cash flow ("DCF") model and capital asset pricing model ("CAPM"), which are the market-based financial models consistently accepted by this Commission.[37] Staff selects the inputs to these models by identifying available market data and then determining whether investors are expected to rely on that data. These models utilize both historical and forecasted economic information which result in a balanced methodology. As a result, Staff's recommendations concerning cost of capital are objectively reasonable.[38]

The Company's cost of capital recommendations are based on selective and unbalanced applications of the DCF and CAPM analyses which result in an inflated COE.[39] In addition, the Company's unwarranted "firm specific risk" premium adjustment to COE results in a similarly inflated ROE. The Company has selectively chosen inputs in the COE estimate in order to produce outputs more favorable to the Company. Generally, analysts should not eliminate or modify inputs in the COE estimate because they produce favorable outputs and skew the results to create an unbalanced COE. However, in this case, the Company's selective methodology has resulted in an unbalanced and inflated COE. For the forgoing reasons, the Commission should reject the Company's ROE in favor of the ROE recommended by Staff.[40]

A. The Commission Should Adopt Staff's Recommended Return On Equity of 8.2 Percent Because It Is Based On Proven Financial Models Involving Balanced and Reasonable Inputs.

To determine a just and reasonable ROE, Staff utilized the DFC and CAPM models. Staff first averaged the DCF results (8.8 percent) and then calculated an average for the CAPM results (8.2 percent).[41] Staff then took the average of both models (8.5 percent) and made two adjustments: a 90

[35] Bourassa Rejoin., Ex. A-4 at 4.
[36] Rigsby Surrebut., Ex. R-2 at 7.
[37] Cassidy Direct, Ex. S-1 at 14-15.
[38] *Id.*
[39] *Id.* at 37.
[40] *Id.* at 37-42, generally.
[41] *Id.* at 2-3.

basis point downward financial risk adjustment calculated using the Hamada method and a 60 basis point upward economic assessment adjustment to account for the current economic environment.[42] Staff's adjustments result in a just and reasonable ROE of 8.2 percent.[43]

1. Discounted cash flow model.

Staff utilized two versions of the DCF model, the constant growth DCF and the multi-stage growth DCF in determining the DCF estimated cost of equity.[44] As Staff Witness John Cassidy explained, the constant-growth DCF model assumes that an entity will grow indefinitely at the same rate, whereas the multi-stage growth DCF assumes the dividend growth rate will change at some point in the future.[45]

For the constant-growth DCF, Staff calculated the growth factor by averaging the results of historical and forecasted earnings per share ("EPS"), dividends per share ("DPS"), and sustainable growth.[46] Staff utilized a balanced methodology that gives equal weight to historical and projected EPS, DPS, and sustainable growth.[47] The advantage to this approach is that it produces a more balanced COE.[48]

For the multi-stage growth DCF, Staff analyzed two stages of growth: the first stage (near-term) has a four-year duration, followed by the second stage (long-term) of constant growth.[49] Staff averaged the constant-growth DCF (8.0 percent) and the multi-stage growth DCF (9.5 percent) to calculate an average DCF estimate of 8.8 percent.[50]

Unlike Staff, the Company's DCF analysis disregards the multi-stage growth model in favor of employing two constant-growth DCF models, Past and Future Growth and Future Growth. The Company's COE analysis is based on the midpoint of these two estimates: half of the Past and Future Growth estimate relies on analysts' projections, while the Future Growth estimate relies entirely on

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[42] *Id.*
[43] *Id.* at 31-34.
[44] *Id* at 16.
[45]*Id* at 16-17.
[46] *Id.* at 17-25.
[47] *Id.*
[48] *Id* at 17.
[49] *Id* at 25-26.
[50] *Id* at 27.

analysts' projections.[51] As a result, the Company's choice to use this midpoint gives analyst projections 75 percent of the weight while historical data is only entitled to 25 percent weight. Overreliance on analysts' projections is problematic because those forecasts tend to be both biased and overly optimistic.[52]

Staff's DCF analysis is preferential to the Company's because it gives *equal* weight to analysts' forecasts and historical data. As explained by Staff witness John Cassidy, overreliance on analysts' forecasts to calculate the expected dividend growth rate serves to inflate that component of the DCF model and, consequently, the estimated COE.[53] The Company's failure to weigh the data equally has skewed the outcome of its DCF analysis. Equal weight is the appropriate and reasonable method for calculating the growth factor in the DCF model.

The Company's DCF model is also problematic because the Company only used five years of historical data when calculating the DCF dividend growth rate in the Past and Future DCF method.[54] Five years may be too limited a time period to capture a full business cycle and it is susceptible to significant variances if there is a single high or low data point.[55] Although the Company purports to have considered both a five and ten year period, the Company used only the five year period in its DCF model growth rate calculations.[56] Not surprisingly, choosing the five year period over the ten year period resulted in a higher growth rate which further served to inflate the COE in the Company's DCF analysis.[57] Staff's use of ten years of historical data in the DCF model is more reasonable because it captures a more robust picture of the economic environment and is information widely used by investors.[58]

2. *Capital asset pricing model.*

Staff's CAPM analysis considers the historical market risk premium and the current market risk premium. Since RRUI is not a publically traded company, Staff had to calculate the average of

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[51] Ex. A-2 at 43-44.
[52] Ex. S-1 at 38-40.
[53] Ex. S-1 at 38.
[54] *Id* at 37-38.
[55] *Id.* at 38-39.
[56] Tr. vol. 1 at 95:18-25.
[57] Tr. vol. 1 at 96:1-3.
[58] Ex. S-1 at 43-44.

the Value Line betas of the sample water utilities as a proxy for RRUI's beta in the CAPM calculation.[59] The average beta of the sample water utilities was calculated at 0.71.[60] A stock with a higher beta is generally riskier from an investment standpoint than a stock with a lower beta.[61] Staff appropriately applied historical and current U.S. Treasury securities' spot rates in its historical and current market risk premia CAPM analyses.[62] Staff averaged the historical market risk premium (6.3 percent) and the current market risk premium (10.0 percent) to calculate an average CAPM estimate of 8.2 percent.[63]

The Company also relied on a CAPM analysis. However, unlike Staff, the Company utilized a *forecasted* risk-free interest rate in both the Company's historical and current market risk premia CAPM analyses.[64] The forecasted rate used by the Company in its CAPM analyses is higher than the current 30-year long term Treasury yield which overstates the risk-free interest rate and inflates the COE in the Company's CAPM analysis.[65]

B. The Commission Should Continue To Reject RRUI's "Small Firm Risk Adjustment."

RRUI contends its small size makes it more risky in comparison to the large publicly traded utilities in the proxy group and therefore RRUI requires a "small firm risk premium" as compensation.[66] However, RRUI's argument should be rejected for several important reasons.

First, RRUI is not an unassociated small company; rather, it is a subsidiary of a much larger parent corporation, Algonquin Power & Utilities Corporation ("APUC"), which is a publically traded corporation on the Toronto Stock Exchange.[67] As a result, RRUI is able to avail itself of other resources and capital markets to which most truly small companies do not have access. Staff believes that any risk that would be reflected in RRUI's beta as a result of its "small" size is dissipated by

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[59] *Id.* at 29-30.
[60] *Id.* at 33.
[61] *Id* at 29.
[62] *Id.*
[63] Ex. S-1, Schedule JAC-3.
[64] Ex. S-1 at 38.
[65] *Id.*
[66] *Id* at 41-42.
[67] Sorensen Direct, Ex A-7 at 3.

RRUI's association with its much larger parent company; therefore, no additional adjustment is necessary.[68]

Second, any risk associated with the size of a company is an unsystematic or "firm specific risk." Investors are not concerned with "firm specific risk" because investors can eliminate that risk by holding diverse investment portfolios.[69] Therefore, any adjustment to COE to account for the Company's purported "firm specific risk" is unwarranted.[70]

Third, it has been the sound policy of the Commission to appropriately and continually reject such an adjustment.[71] Indeed, the Company has failed to cite any Commission decisions where a small company risk premium was adopted. Staff recommends the Commission likewise reject this adjustment in this case.[72]

VI. CONCLUSION.

Staff respectfully requests that the Commission adopt its recommendations on the disputed issues for the reasons stated above and the testimony provided.

RESPECTFULLY SUBMITTED this 3rd day of May, 2013.

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[68] Ex. S-1 at 35.
[69] Ex. S-1 at 46; Tr. vol. 2 at 213:6-19.
[70] Ex. S-1 at 44.
[71] Ex. S-1 at 46.
[72] Tr. vol. 2 at213:6-19.

Original and thirteen (13) copies
of the foregoing filed this
3rd day of May, 2013, with:

Docket Control
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Copy of the foregoing mailed and/or
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