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BEFORE THE ARIZONA CORPORATION COMMISSION

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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-12-0196

Arizona Corporation Commission
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RUCO'S CLOSING BRIEF

The Residential Utility Consumer Office ("RUC0") hereby files its closing brief. RUCO and the Company have reached agreement on all major issues except the Cost of Equity and the Weighted Average Cost of Capital.

A. Capital Structure

The Company, RUCO and Staff agree that the Commission should adopt a 100 percent equity capital structure as opposed to a hypothetical capital structure composed of equity and debt. Although the Company offered to add debt to its capital structure, it has not. Because the Company's capital structure contains no debt, the parties have all agreed to adopt the Company's actual capital structure.

B. Cost of Equity/ Weighted Average Cost of Capital

The only remaining issue is the appropriate Cost of Equity Capital ("COE") and the Company's overall Weighted Average Cost of Capital ("WACC"). In the absence of debt in its capital structure, the Company's COE becomes its WACC. RUCO recommends an 8.25 percent cost of common equity which includes a 50 basis point adjustment for the reduced financial risk associated with the absence of debt in the Company's capital structure.[1] The Staff recommends an 8.2 percent cost of common equity which includes a 90 basis downward adjustment for financial risk and a 60 basis point upward adjustment for economic instability.[2] The Company recommends an 9.5 percent cost of common equity which includes a downward adjustment of 90 basis points for the absence of financial risk and an 80 basis point upward adjustment for what it identifies as a specific firm adjustment.[3]

1. DCF and CAPM analyses are appropriate methodologies to calculate the cost of equity capital.

RUCO's cost of equity analysis utilized both the discounted cash flow ("DCF") method, and the capital asset pricing model ("CAPM").[4] The DCF and CAPM are methods that RUCO and ACC Staff have consistently used for calculating the cost of equity capital in rate case proceedings in the past, and are the methodologies that the ACC has given the most weight to in setting allowed rates of return for utilities that operate in the Arizona jurisdiction. *Id.* at 5. RUCO's cost of common equity is 50 basis points lower than the high end result of its Discounted Cash Flow analysis. *Id.* at 7.

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[1] Transcript: 151.
[2] Ex. S-2 at 2.
[3] Ex. A-6 at 4.
[4] Ex. RUCO-1 at 5-7.

Although the Company, Staff and RUCO may utilize different inputs, they all performed DCF and CAPM analyses in determining their costs of equity capital. The primary points of disagreement are the selection of proxy groups, the applicability of returns on book equity, and financial and small firm adjustments.

2. RUCO's water and natural gas proxy groups are appropriate.

RUCO's analyst, Mr. Rigsby utilized a water company proxy group which includes American Water Works Company, Inc. (stock ticker symbol "AWK"); American States Water Company (stock ticker symbol "AWR"), California Water Service Group ("CWT"), Middlesex Water Company (stock ticker symbol "MSEX", which is traded on the NASDAQ), SJW Corporation ("SJW"), and Aqua America, Inc. ("WTR").[5] Each of these water companies face the same types of risk that RRUI faces. *Id.*

The Company's analyst, Thomas Bourassa, also relies on a proxy made up of the many of the same water companies except that he excluded AWK and included Connecticut Water Company. *Id* at 24. The Company claims that RUCO should have done the same with its water proxy. RUCO disagrees that AWK should be excluded. AWK is the largest investor-owned water and wastewater utility in the U.S. *Id* .at 21. AWK has been followed by Value Line since July of 2008 after the New Jersey-based water provider was spun off from its German parent, RWE, AG and became a publicly traded entity. *Id.* At the time, RUCO filed testimony in this matter; Value Line had four years of operating numbers available on American Water Works Company, Inc. *Id.* Under these circumstances, RUCO's use of AWK in its water proxy group is appropriate.

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[5] Ex. RUCO-1 at 20-21.

RUCO did not use Connecticut Water Services, Inc., but acknowledges that it would be appropriate to do so.[6] Initially, RUCO did not use Connecticut Water because the Company was followed in Value Line's Small and Mid-Cap edition which does not provide the same type of forward-looking information (i.e. long-term estimates on return on common equity and share growth) as Value Line's Large-Cap edition.[7] However, at some point, Value Line moved Connecticut Water to its Large-Cap edition.[8] RUCO acknowledges that at that point it could have used Connecticut Water, but did not. *Id.* Prior to testifying, RUCO's witness, Mr. Rigsby updated his data, included Connecticut Water and determined that even if he had used Connecticut Water in his DCF and CAPM proxies, it would not have altered his final recommendation of 8.25 percent cost of equity capital. *Id* at 154.

RUCO also used a proxy of nine natural gas LDCs: AGL Resources, Inc. ("AGL"), Atmos Energy Corp. ("ATO"), Laclede Group, Inc. ("LG"), New Jersey Resources Corporation ("NJR"), Northwest Natural Gas Co. ("NWN"), Piedmont Natural Gas Company ("PNY"), South Jersey Industries, Inc. ("SJI") Southwest Gas Corporation ("SWX"), which is the dominant natural gas provider in Arizona, and WGL Holdings, Inc. ("WGL").[9] The Company did not use an LDC proxy. RUCO's use of LDC's as a sample proxy to determine a cost of equity capital for a water utility is appropriate because LDC's and water and wastewater utilities face similar risks and challenges.[10] RUCO's water proxy had an average beta of .69 and its gas proxy had an average beta of .66.

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6 T: 151-154.
7 Ex. RUCO-1 at 24-25.
8 T: 151-154.
9 Ex. RUCO-1 at 22.
10 T: 205.

Id. Because RUCO's LDC proxy is slightly lower, Mr. Rigsby's use of LDC's in his analysis serves to increase RUCO's recommended cost of equity, not lower it.

3. Long-term projections of returns on book common equity are not estimated costs of equity capital.

The Company complains that RUCO's cost of equity capital is lower than an average of long-term projections of returns on <u>book</u> common equity published in Value Line's recent quarterly updates on the water and natural gas industries. RUCO witness William Rigsby, Chief of Accounting and Rates, testified that the Company's criticism is based on Value Line's long-term projections of returns on <u>book</u> common equity, as opposed to estimated costs of common equity.[11] Mr. Rigsby testified that by definition, the cost of common equity has to be lower than the return on book common equity for the Company to show a profit. [12] The Financial Times Lexicon is a dictionary of financial terms published by Financial Times of London states:

> ROE is the ratio of net profit to shareholders' equity(also called book value, net assets or net worth) expressed as a percentage...ROE is often said to the ultimate ratio or "mother of all ratios" that can be obtained from a company's financial statement. A Company can only create shareholder value, economic profits, if the return on equity is greater than the its costs of equity capital (the expected return shareholders require for investing in the company give the particular risk of the company)[13]

Mr. Rigsby provided the definition in his testimony, but did not cite to the dictionary by name in his testimony.[14] RUCO requests that the Commission take judicial notice of the published dictionary definition.

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[11] Ex. RUCO-2 at 9-10.
[12] Id. at 9-10. See also T: 155-156.
[13] See Financial Times Lexicon, Attachment A, hereto.
[14] T: 200

Mr. Rigsby also testified rather than rely on solely on long-term projections; the Company should have considered all of Value Line's projections for 2012 through 2017, as RUCO did.[15] First, near term projections tend to have greater reliability. Second, the accepted methodology for considering such data to calculate growth is the average of all projections (2012 through 2017), rather than the relying on long-term projections which have the least reliability, as the Company did. *Id.* As Mr. Rigsby testified, if the Company considered all of the projections, the Company's average return on book equity would be 9.69 percent. *Id.* If the Company included American Water Works, in its sample, the 2012 through 2017 average return on <u>book</u> equity would be 9.55 percent, not the 10.3 percent average identified by the Company in Rejoinder. *Id.* The average return on book equity for RUCO's sample, which includes American Water Works, but does not include Connecticut Water, is 9.36 percent. *Id.*

Contrary to the Company's assertions, the use of analysts' long-term projected returns on book equity is not the same as costs of equity capital. Although long-term projections of returns on book equity are considered along with historical returns and near-term projections to determine the growth, long-term projections of returns on book equity are not equal to the cost of equity capital. As Mr. Rigsby testified, averaging of returns on book equity can be considered, but these projections are not the primary indicator of an appropriate cost of equity capital because the cost of equity capital must be lower than the average projected returns on book equity for a Company to be profitable. *Id.* at 9-10. The Commission should reject the Company's suggested methodology.

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[15] Ex. RUCO-2 at 9.

4. RUCO's downward adjustment for the absence of financial risk is reasonable.

The Company admittedly has a 100 percent equity capital structure. The parties have accepted the structure for the purpose of calculating cost of equity capital in this case. RUCO's sample of publicly-traded water and natural gas companies had average capital structures comprised of 50 percent common equity and 50 percent debt. All parties agree that in these circumstances, a downward adjustment for financial risk is appropriate.

The disagreement is the methodology used to derive the adjustment. RUCO's 8.25 percent cost of equity includes a downward adjustment of 50 basis points.[16] Staff's 8.20 percent cost of equity capital includes a 90 basis point downward adjustment for the absence of financial risk associated with the Company's capital structure.[17] The Company's 9.5 percent cost of equity includes a financial risk adjustment of 90 basis points and an upward adjustment of 80 basis point for a small firm adjustment.[18] The Company is critical of RUCO's downward adjustment of 50 basis points, asserting that it is made without use of a Hamada adjustment or adjustment using like methodology.

Regardless of the methodology utilized to derive the financial risk adjustment, the adjustment must be reasonable. The Company derived an unadjusted 9.9 percent cost of equity by averaging the mid-point of the results of its DCF and CAPM analyses[19]. The Company's 90 basis point adjustment constitutes a 9 percent downward adjustment of

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[16] T: 151.
[17] Surrebuttal Testimony of John Cassidy at 2.
[18] Rejoinder Testimony of Thomas Bourassa at 3-4. Note Company begins with an unadjusted COE of 9.9, makes an upward adjustment of 90 basis points and a downward adjustment of 80 basis points to derive a 9.8 percent COE. The Company then ignores these results and adopts a 9.5 percent COE.
[19] Ex. A-6 at 3

unadjusted 9.9 percent cost of equity. RUCO derived a 8.25 percent cost of equity after making a 50 basis points downward adjustment to an 8.75 percent unadjusted cost of equity it derived using the top of the range of its DCF analysis. RUCO's adjustment of 50 basis point adjustment constitutes a 5.7 percent downward adjustment to its unadjusted cost of equity. Staff's adjustment of 90 basis points constitutes a downward adjustment of 10.5 percent of its 8.5 percent unadjusted cost of equity. RUCO's adjustment is the lowest of all three of the parties and is reasonable.

5. An upward small firm adjustment is not appropriate.

The Company has made an upward adjustment of 80 basis points to its cost of equity for what it has identified as a Specific Firm Adjustment. The Company's Specific Firm Adjustment is really a "small firm" adjustment.[20] RUCO disagrees that a small firm adjuster of any type is appropriate on the facts of this case.[21] Although RRUI is a Class B Arizona public service corporation that is organized as a C Corporation, RRUI is a subsidiary of Liberty Utilities, whose ultimate parent is Algonquin Power Utility Corporation ("APUC" or "Parent Company"), a publicly traded member of the Toronto Stock Exchange.[22] Mr. Rigsby testified that the Company obtained all of its capital via APUC, its parent company.[23] APUC just like the water companies in the Company and RUCO's proxies is a conglomeration of smaller utilities companies.[24] There is no factual or legal basis for a small firm adjustment in this case. *Id.* The Company's suggestion to the contrary is undermined by the fact that in this same case, the Company has sought

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[20] Ex. A-6 at 3.
[21] T: 155-56.
[22] Ex. RUCO-1 at 2-3.
[23] T: 155-56 and 174.
[24] Ex. RUCO-1 at 2-3.

to allocate APUC expenses associated with its operation in the Toronto Stock Exchange and obtained agreement with RUCO and Staff for allocation of a portion of those expenses. RUCO requests that the Commission deny the Company's request for a small firm adjustment to the cost of equity capital.

Requested Relief:

Based on the foregoing, RUCO's cost of capital recommendation is reasonable and fair, and RUCO requests that the ALJ adopt an 8.25 percent cost of equity capital.

RESPECTFULLY SUBMITTED this 3rd day of May, 2013

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Counsel

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FINANCIAL TIMES LEXICON

return on equity ROE

The ratio of net profit to shareholders' equity (also called book value, net assets or net worth), expressed as a percentage. A measure of how well a company uses shareholders' funds to generate a profit. [1]

Return on equity (ROE), is a financial ratio that measures the return generated on stockholders'/shareholders' equity, the book or accounting value of stockholders'/shareholders' equity which reflects the accumulation over time of amounts received by the company from stock/share issues plus the profits/earnings retained by the company, i.e., not yet distributed in dividends (accounting value of shareholders' equity is also equal to a company's net assets, i.e., assets minus liabilities). The typical formula can be expressed as follows:

profit for the year (or net income after taxes) / stockholders' or shareholders' equity

This is generally calculated over a year and expressed as a percentage, so a company that generated £100 worth of profit for the year for £1000 of equity has a ROE of 10%.

ROE is often said to be the ultimate ratio or 'mother of all ratios' that can be obtained from a company's financial statement. A company can only create shareholder value, economic profits, if the ROE is greater than its cost of equity capital (the expected return shareholders require for investing in the company given the particular risk of the company).

Historically, the average ROE has been around 10% to 12%, at least in the US and UK.

Furthermore, the ROE can be decomposed to understand the fundamental drivers of value creation in a company. This is known as the DuPont decomposition and can be calculated as:

ROE = return on assets (ROA) X gearing (also called leverage)
ROE = (profit for the year ÷ assets) X (assets ÷ shareholders' equity)

Note that since return on assets (ROA) is profit margin multiplied by asset turnover, the DuPont decomposition is sometimes represented as follows:

ROE = profit margin X asset turnover X gearing
ROE = (profit for the year ÷ sales) X (sales ÷ assets) X (assets ÷ shareholders' equity)

The profit margin, asset turnover and gearing ratios can further be decomposed to complete the financial statement analysis or ratio analysis of a company.

The profit margin tells us how much profit a company makes on every dollar of sales. The asset turnover indicates how efficient a company is in using its assets and reflects how many dollars of sales a company generates from every pound/dollar of assets in the company.

Finally, the gearing ratio indicates how a company finances the assets it holds or more precisely the amount of assets per dollar of shareholder/stockholder equity investment in the company.

Assets being financed either by shareholders (equity) or by creditors such as banks and suppliers (called liabilities or debt), a higher ratio means a firm is getting more financing from outside creditors (since assets must equal equity plus liabilities, an all equity firm has a gearing ratio of one since all assets are financed by equity).

It would appear that greater gearing increases ROE, but this must be traded off against higher financing costs which reduces profit.

Unfortunately, there are variations in ratio definitions, a normal part of practical financial ratio analysis. There are issues regarding the numerator, e.g., which profit number should be used: before or after taxes; adjusted or not for non-recurring or one-time items; or operating type profit numbers, e.g., earnings before interest and taxes (EBIT), earnings before interest, taxes and depreciation & amortisation (EBITDA).

As for the denominator, a balance sheet number is for a specific point in time by contrast to the numerator which is for a period, so some use beginning-of-year equity, others use end-of-year equity or some average over the year.

Note: One of the challenges in giving a definition of accounting or finance terms is the differences in the terminology used. E.g., in the US and UK: shareholder/stockholder and profit for the year/net income. [2]

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