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6 **BEFORE THE ARIZONA CORPORATION COMMISSION**

7
8 IN THE MATTER OF THE
APPLICATION OF RIO RICO
9 UTILITIES, INC., AN ARIZONA
CORPORATION, FOR A
10 DETERMINATION OF THE FAIR
11 VALUE OF ITS UTILITY PLANTS AND
PROPERTY AND FOR INCREASES IN
12 ITS WATER AND WASTEWATER
RATES AND CHARGES FOR UTILITY
13 SERVICE BASED THEREON.

DOCKET NO: WS-02676A-12-0196

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16 **RIO RICO UTILITIES, INC.**
17 **REPLY CLOSING BRIEF**
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19 **May 15, 2013**

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21 Arizona Corporation Commission
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TABLE OF ABBREVIATIONS AND CONVENTIONS

1 Rio Rico Utilities, Inc. uses the following abbreviations in citing to the pre-filed
2 testimony and hearing transcripts in this brief. Other documents that were admitted as
3 exhibits during the hearing are cited by hearing exhibit number. The parties' final
4 schedules setting forth their respective final positions will be cited in abbreviated format
5 as follows: Company Final Schedule XXX, Staff Final Schedule XXX; RUCO Final
6 Schedule XXX.* Other citations to testimony and documents are provided in full,
7 including (where applicable) the Corporation Commission's docket number and filing
8 date.

RIO RICO UTILITIES, INC. PRE-FILED TESTIMONY

9	Pre-Filed Testimony	Hearing Exhibit	Abbreviation
10	Direct Testimony of Tom Bourassa (Rate Base)	A-1	Bourassa Dt.
11	Direct Testimony of Tom Bourassa (Cost of Capital)	A-2	Bourassa COC Dt.
12	Rebuttal Testimony of Thomas J. Bourassa (Rate Base)	A-3	Bourassa Rb.
13	Rebuttal Testimony of Thomas J. Bourassa (Cost of Capital)	A-4	Bourassa COC Rb.
14	Rejoinder Testimony of Thomas J. Bourassa (Rate Base)	A-5	Bourassa Rj.
15	Rejoinder Testimony of Thomas J. Bourassa (Cost of Capital)	A-6	Bourassa COC Rj.
16	Direct Testimony of Greg Sorensen	A-7	Sorensen Dt.
17	Rebuttal Testimony of Greg Sorensen	A-8	Sorensen Rb.
18	Rejoinder Testimony of Greg Sorensen	A-9	Sorensen Rj.
19	Direct Testimony of Peter Eichler	A-10	Eichler Dt.
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* RRUI, Staff and RUCO filed their respective Final Schedules on April 23, 2013.

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**RESIDENTIAL UTILITY CONSUMER OFFICE
PRE-FILED TESTIMONY**

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of William Rigsby (Cost of Capital)	RUCO-1	Rigsby COC Dt.
Surrebuttal Testimony of William Rigsby (Cost of Capital)	RUCO-2	Rigsby COC Sb.
Direct Testimony of Timothy Coley (Redacted)	RUCO-4	Coley Redacted Dt.
Direct Testimony of Timothy Coley (Rate Design)	RUCO-5	Coley Dt.
Surrebuttal Testimony of Timothy Coley	RUCO-6	Coley Sb.

**STAFF
PRE-FILED TESTIMONY**

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of John Cassidy	S-1	Cassidy Dt.
Surrebuttal Testimony of John Cassidy	S-2	Cassidy Sb.
Direct Testimony of Mary Rimback	S-3	Rimback Dt.
Surrebuttal Testimony of Mary Rimback	S-4	Rimback Sb.
Direct Testimony of Jian Liu	S-5	Liu Dt.

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OTHER PORTIONS OF THE RECORD

Hearing Exhibit

RUCO's Response to RRUI's 6.1	A-11
Morningstar Exhibits- SBBI 2012 Valuation Yearbook	A-12
Major U.S. Stock Market Indexes WSJ Bon Yields- 3 year average	A-13
Corporate Borrowing Rates And Yields	A-14
Duff & Phelps Report p. 40 The Size Study	A-15
Settlement Summary	A-16
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Correction: Revised TJB-COC-2	A-18
RRUI's Response to RUCO 13.1	RUCO-3
RUCO's Notice of Errata	RUCO-7
Excerpt from Liberty Water Web Page	County 1
03/26/13 Letter from Suarez to RRUI	County 2
Excerpt from Liberty Water Web Page on rates	County 3
Liberty Water Organization Chart	County 5
Excerpts from Phillips	SCVUSD-1
Federal Reserve Chairman Bernanke's Press Conference Transcript	SCVUSD-2
Chart of Treasury Rates	SCVUSD-3
Morningstar SBBI Book	SCVUSD-4

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Hearing Exhibit

William Sharpe's book on Investments	SCVUSD-5
VIX Chart	SCVUSD-6
Duff & Phelps Report Page	SCVUSD-7
WSJ Excerpts U.S. Treasury Rate Quotes from March 22, 2013	SCVUSD-8
Morning Star Excerpt- SBBI 2010 Valuation Yearbook	SCVUSD-9

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1 Rio Rico Utilities, Inc. (“RRUI” or “the Company”) hereby replies to the initial
2 closing briefs filed by Staff and RUCO, and to the joint brief filed by the Intervenors
3 Santa Cruz County and Santa Cruz Valley Unified School District #35.¹

4 **I. REPLY TO JOINT BRIEF BY COUNTY AND SCHOOL DISTRICT**

5 **A. Introduction**

6 Liberty Utilities provides water and wastewater utility services in Arizona through
7 its several subsidiaries, including the Company. Liberty strives to provide a high quality
8 of service at a fair and reasonable cost, and the very low number of customer complaints
9 and excellent compliance history reflects Liberty’s success.² Liberty is committed to
10 being a part of the communities it serves. Liberty encourages its employees to take part in
11 community activities and charitable efforts.³ Liberty holds seminars on water
12 conservation and pipe wrapping, among other things, for customers.⁴ As Mr. Sorensen,
13 Liberty’s senior Arizona officer, put it when explaining why he prefers not to refer to
14 customers as ratepayers:

15 Because the term ‘ratepayer’, I think, implies that we look at
16 our customers as dollar signs. That’s not what our company
17 is about. We have six core values in the Company, two of
18 which are family and community; and I don’t think from our
19 perspective the term ‘ratepayer’ really reflects what we’re
20 about.⁵

21 During the trial, the County sought to portray the Company as insensitive to its
22 Spanish-speaking customers.⁶ This attack was clearly unwarranted given Liberty’s

23 ¹ In this reply brief, RRUI uses the same citation format, abbreviations and conventions as utilized in its
24 initial closing brief dated May 3, 2013. Additionally, the parties’ initial closing briefs will be identified as
25 “Staff Br.,” “RUCO Br.,” “Intervenors Br.,” and “RRUI Br.” respectively. Additionally, the County and
26 the School District will be referred to collectively in this reply brief as “Intervenors.”

² Rimback Dt. at 5; Sorensen Dt. at 16:16-25; Liu Dt. at 3:22 – 5:2, 6:12-22 (referring to RRUI, although it
is a matter of public record that all of the Liberty utilities share this excellent compliance record).

³ Sorensen Dt. at 19:1-13.

⁴ Sorensen Dt. at 18:1-25.

⁵ Tr. at 397:3 (Sorensen).

⁶ Tr. at 339:13 – 340:17, 342:9 – 344:7 (Sorensen).

1 current efforts and policies to work with the communities it serves. Liberty employs
2 bilingual customer service representatives and operations personnel operating RRUI and
3 Mr. Sorensen agreed it would be an improvement to send bilingual notices in the future
4 and to take steps to make the Company's website more user friendly for Spanish-speaking
5 customers.⁷ The Company also responded to concerns expressed by the School District
6 over the difficulty that a public agency would have paying higher costs for water and
7 wastewater services. The rate design adopted as part of the settlement with Staff and
8 RUCO includes a special discount for the School District.⁸ Amazingly, there isn't a single
9 word concerning these efforts by Liberty in the Intervenors' Brief.

10 Instead, the Intervenors have pursued a singular goal – use their voice as elected
11 representatives to convince the Commission to deny the Company any rate increase, or at
12 least grant the smallest possible increase after as long a delay as possible. Liberty is not
13 sure why the County's leadership has chosen to approach its business this way. Before
14 this rate case was filed, the Company met with the County to inform its representatives of
15 the forthcoming rate case.⁹ The rate case was and is necessary. To ensure the continued
16 provision of safe and reliable water and wastewater utility service, the Company has made
17 substantial capital investment since the last rate case – over \$4M.¹⁰ As a result, RRUI is
18 under-earning and unable to earn a return on the fair value of its property devoted to
19 service.¹¹

20 Neither of the Intervenors has moved to intervene in the pending UNS Electric rate
21 case, thus giving the appearance that it is just Liberty's water and wastewater revenues
22

23 ⁷ Tr. at 340:17, 387:25 – 389:10 (Sorensen). Stunningly, given the criticism of RRUI by the County
24 Attorney, the County's website is not in Spanish. Tr. at 389:11 – 390:4 (Sorensen). Mr. Sorensen
25 nevertheless admitted it was a valid point. Tr. at 390:5-10 (Sorensen).

26 ⁸ See Company Final Schedules at Exs. 5 and 6.

⁹ Tr. at 326:16-20 (Sorensen).

¹⁰ Bourassa COC Dt. at 22:21-23.

¹¹ Tr. at 373:8 – 375:4, 395:20 – 396:22 (Sorensen).

1 on the County's hit list. Liberty can only wonder why the County's current leadership
2 does not see a well-run and financially healthy water and wastewater utility as an integral
3 part of their community.

4 **B. Summary of Legal Standards for Ratemaking in Arizona**

5 The County was granted leave to intervene on December 28, 2012, before the
6 deadlines for filing testimony.¹² The County did not pre-file testimony from its
7 consultant.

8 The School District moved to intervene after the deadline, and stipulated that its
9 intervention would not delay the proceeding, including not asking to change any deadlines
10 for filing of witness testimony.¹³ Now, lacking any evidence to support their positions,
11 they seek to twist the evidence in the record to their own ends. This remarkably
12 aggressive yet unsupported and unsubstantiated effort by the Intervenors to deprive RRUI
13 of necessary rate increases prompts a brief discussion of the Arizona law underlying rate
14 decisions.

15 In Arizona, the Commission is responsible for setting "just and reasonable" rates
16 and charges for utility services furnished by utilities.¹⁴ The process followed by the
17 Commission in setting rates that are "just and reasonable" has been summarized as
18 follows:

19 The general theory of utility regulation is that total revenue,
20 including income from rates and charges, should be sufficient
21 to meet a utility's operating costs and to give the utility and
22 its stockholders a reasonable rate of return on the utility's
23 investment. To achieve this, the Commission must first
24 determine the "fair value" of a utility's property and use this
25 value as the utility's rate base. The Commission then must
26 determine what the rate of return should be, and then apply

24 ¹² Procedural Order dated July 13, 2012 ordering Staff and Intervenors to file direct testimony on or before
December 31, 2012, and surrebuttal testimony on or before February 19, 2013.

25 ¹³ The School District's application to intervene was granted in the Procedural Order dated February 4,
2012.

26 ¹⁴ See Ariz. Const. Art. 15, § 3.

1 that figure to the rate base in order to establish just and
2 reasonable tariffs.¹⁵

3 Nearly 100 years of decisions by Arizona courts have required the Commission to
4 set rates that will produce sufficient revenue to allow the utility to recover its operating
5 expenses and earn a reasonable rate of return on the fair value of its property devoted to
6 public service.¹⁶ Thus, as the Arizona Court of Appeals explained in *Scates*:

7 [T]he rates established by the Commission should meet the
8 overall operating costs of the utility and produce a reasonable
9 rate of return. It is equally clear that the rates cannot be
10 considered just and reasonable if they fail to produce a
11 reasonable rate of return or if they produce revenue which
12 exceeds a reasonable rate of return.¹⁷

13 While the starting point of a permanent rate application is the utility's actual,
14 recorded results during the test year, those results must be adjusted to obtain a normal and
15 more realistic relationship between rate base, revenue, and expenses that will be
16 representative of the period *when the new rates are in effect*. The Commission's
17 regulation defining the filing requirements in support of a proposed increase in rates and
18 charges for service specifically contemplates consideration of post-test year
19 circumstances. For example, the term "pro forma adjustments" is defined as:

20 Adjustments to actual test year results and balances to obtain
21 a normal or more realistic relationship between revenues,
22 expenses and rate base.¹⁸

23 ¹⁵ *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (App. 1978) (citations
24 omitted). See also *US West Comm., Inc. v. Ariz. Corp. Comm'n*, 201 Ariz. 242, 244, 34 P.3d 351, 353,
25 ¶ 13 (2001) (The "fair value [of the utility's plant and property] has been the factor by which a reasonable
26 rate of return [is] multiplied to yield, with the addition of operating expenses, the total revenue that a
27 corporation could earn.") (citing *Scates*).

28 ¹⁶ See *US West*, 201 Ariz. at 246; 34 P.3d at 355 ("... a line of cases nearly as old as the state itself has
29 sustained the traditional formulaic approach" to setting rates).

30 ¹⁷ *Scates*, 118 Ariz. at 534, 578 P.2d at 615.

31 ¹⁸ A.A.C. R14-2-103(A)(3)(i).

1 The process and procedures the Commission follows to gather and consider
2 evidence in setting rates are quasi-judicial in character. Perhaps the clearest statement of
3 the Commission's duties is found in *State ex rel. Corbin v. Ariz. Corp. Comm'n*, 143 Ariz.
4 219, 223-24, 693 P.2d 362, 366-67 (App. 1984), which explained:

5 [A proceeding to fix rates] carries with it fundamental
6 procedural requirements. There must be a full hearing. There
7 must be evidence adequate to support pertinent and necessary
8 findings of fact. Nothing can be treated as evidence which is
9 not introduced as such. ... Facts and circumstances which
10 ought to be considered must not be excluded. Facts and
11 circumstances must not be considered which should not
12 legally influence the conclusion. Findings based on the
13 evidence must embrace the basic facts which are needed to
14 sustain the order. ...

15 A proceeding of this sort requiring the taking and weighing of
16 evidence, determinations of fact based upon the consideration
17 of the evidence, and the making of an order supported by
18 such findings, has a quality resembling that of a judicial
19 proceeding. Hence it is frequently described as a proceeding
20 of a *quasi judicial* character. The requirement of a "full
21 hearing" has obvious reference to the tradition of judicial
22 proceedings in which evidence is received and weighed by
23 the trier of the facts. The "hearing" is designed to afford the
24 safeguard that the one who decides shall be bound in good
25 conscience to consider the evidence, to be guided by that
26 alone, and to reach his conclusion uninfluenced by extraneous
considerations which in other fields might have play in
determining purely executive action. The "hearing" is the
hearing of evidence and argument.¹⁹

19 Under the Arizona Administrative Procedure Act ("APA"), A.R.S. § 41-1001 *et*
20 *seq.*, the Commission's "final decision shall include findings of fact and conclusions of
21 law, separately stated. Findings of fact, if set forth in statutory language, shall be
22 accompanied by a concise and explicit statement of the underlying facts supporting the
23 findings."²⁰ "Findings of fact shall be based exclusively on the evidence and on matters

¹⁹ *Id.* at 224, 693 P.2d at 367 (quoting *Morgan v. United States*, 298 U.S. 468 (1936)).

²⁰ A.R.S. § 41-1063.

1 officially noticed.”²¹ “Findings of fact by the Commission must show which evidence it
2 accepts as competent and worthy of belief, and that which it rejects.”²²

3 Every Commission decision must be supported by “substantial evidence.”²³
4 “Substantial evidence is that which would permit a reasonable person to reach the trial
5 court’s result.”²⁴ Thus, a Commission decision must be “rationally based on evidence of
6 substance.”²⁵ “Mere speculation and arbitrary conclusions are not substantial evidence
7 and cannot be determinative.”²⁶ The positions and recommendations of the Intervenor
8 are not supported by substantial evidence and, taken in whole or in part, would deprive the
9 Company of just and reasonable rates as explained below.

10 **C. A Cost of Service Study Was Not Required**

11 The Intervenor starts their efforts to deprive the Company of just and reasonable
12 rates with a Hail Mary – a plea that the case be dismissed, or if not dismissed, retried after
13 the Company files a cost of service study.²⁷ This request is simply frivolous. For starters,
14 the request for dismissal is untimely. While the Commission does not strictly adhere to
15 the Rules of Civil Procedure, this is a procedural request. Clearly, a motion to dismiss of
16 this kind should be brought at the outset of a case or at least at the time of their
17 intervention. By lying in wait and declining to raise a concern over the sufficiency of the
18

19 ²¹ A.R.S. § 41-1061(G).

20 ²² *Colorado-Ute Elec. Assoc. v. P.U.C.*, 760 P.2d 627, 641 (Colo. 1988). See also *Matter of Water Use*
21 *Permit Applications*, 9 P.3d 409, 475-76 (Haw. 2000) (“where the record demonstrates considerable
22 conflict or uncertainty in the evidence, the agency must articulate its factual analysis with reasonable
23 clarity, giving some reason for discounting the evidence rejected”); *Porter v. South Carolina Pub. Serv.*
24 *Comm’n*, 507 S.E.2d 328, 332 (S.C. 1998) (a “recital of conflicting testimony followed by a general
25 conclusion is patently insufficient”), quoting *Able Communications, Inc. v. South Carolina Pub. Serv.*
26 *Comm’n*, 351 S.E.2d 151, 152 (S.C. 1986).

²³ See *Litchfield Park Service Co. v. Ariz. Corp. Comm’n*, 178 Ariz. 431, 434; 874 P.2d 988, 991 (App.
1994); *Tucson Elec. Power Co. v. Ariz. Corp. Comm’n*, 132 Ariz. 240, 244; 645 P.2d 231, 235 (1982).

²⁴ *Estate of Pousner*, 193 Ariz. 574, 579, 975 P.2d 704, 709 (1999). See also *Denise R. v. Ariz. Dep’t of*
Economic Security, 2009 WL 1451452 (Ariz. App. 2009).

²⁵ *City of Tucson v. Citizens Utils. Water Co.*, 17 Ariz. App. 477, 481, 498 P.2d 551, 555 (1972).

²⁶ *Tucson Elec. Power v. Ariz. Corp. Comm’n*, 132 Ariz. 240, 245; 645 P.3d 231, 237 (1982).

²⁷ Intervenor Br. at 1:8 – 3:3.

1 application until its brief, after the evidence was presented, the Intervenor should be
2 deemed to have waived any such claim.²⁸

3 Additionally, the Commission has delegated the determination of whether an
4 application meets the agency's filing requirements to Staff. Following the filing, Staff has
5 30 days to review Company's application to determine whether it contains the necessary
6 information for the application to move forward.²⁹ Staff deemed the application sufficient
7 on July 3, 2012.³⁰ This is a finding by Staff that the G Schedules were neither necessary
8 nor required in this case. The Intervenor could have petitioned the Commission to
9 reconsider the Staff sufficiency finding, but did not. Thus, the finding by Staff that the
10 application was sufficient, without the G Schedules, must stand.

11 It is not unusual for water and wastewater company rate applications to be filed and
12 determined without a cost of service study (G Schedules). Liberty Utilities has filed and
13 received several rate orders in Arizona since it acquired its first public service corporation
14 in 2001. Only a couple of those cases have contained G Schedules and none have been
15 dismissed for lack of a cost of service study.³¹ Global Water, which is a similarly situated
16 holding company, currently has an application pending, it has been found sufficient,
17 testimony is forthcoming, yet Global did not file G Schedules.³² Likewise, Far West,
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20 ²⁸ See *Douglas v. Mundell*, 2009 WL 2766746, at *5 (Ariz. App. 2009) ("Nor will we address the
21 Defendants' argument that counts one and two were barred by failure to exhaust administrative remedies
22 because, at best, they only made that argument in their reply memorandum..."); see also *Westin Tucson
Hotel Co. v. Ariz. Dep't of Rev.*, 183 Ariz. 360, 364; 936 P.2d 183, 187 (App. 1997) (arguments raised for
the first time in reply memorandum in the trial court deemed waived and will not be considered on
appeal).

23 ²⁹ A.A.C. R14-2-103.B.7.

24 ³⁰ Sufficiency Letter dated July 2, 2012 to Greg Sorensen from Nancy Scott, Utilities Division; Procedural
Order dated July 13, 2012 at 1:15-17.

25 ³¹ Only two rate cases have been filed with a cost of service study after Liberty acquired the utility. The
first one was for Litchfield Park Service Company, Docket No. W-01427A-09-0104; the second was for
Bella Vista Water Company, Inc., Docket No. W-02465A-09-0411.

26 ³² See *Global Water-Palo Verde Utilities Company*, Docket No. SW-20445A-12-0310, Sufficiency Letter
dated October 26, 2012 and Procedural Order dated November 20, 2012.

1 which the Intervenors appear to believe to be a model for utility financing,³³ did not file a
2 cost of service study in its pending rate case.³⁴ This shows, despite Intervenors' assertion,
3 that cost of service studies are not mandatory for water and wastewater rate cases in
4 Arizona.³⁵

5 In short, rate applications are prosecuted and decided by this Commission without
6 G schedules all the time. And for good reason: as Mr. Bourassa explained, cost of service
7 studies are very expensive and the Commission does not generally use the results of cost
8 of service studies in setting rates.³⁶ The Intervenors raised this issue at trial, and then
9 chose to ignore the sole and contradictory testimony in their quest to deprive RRUI of just
10 and reasonable rates.

11 Here, RUCO and the Company have adopted Staff's rate design.³⁷ Staff did not
12 feel a cost of service study was needed, either as a requirement of the application, or to
13 support its rate design. Neither did RUCO. Either of those parties and the Intervenors
14 could have prepared and submitted one if they thought it necessary. No party did so,
15
16

17 ³³ Intervenors Br. at 9:9-11 (referencing Far West Water cap structure). Judge Rodda is certainly aware of
18 Far West Water's inability to pay its bills and general precarious financial condition. *E.g.*, Decision No.
19 71447 (December 23, 2009) at 33:24-25 (denying Far West Water's application for an interim rate
20 increase).

21 ³⁴ See *Far West Water & Sewer, Inc.*, Docket No. WS-03478A-12-0307, Direct Testimony of Ray Jones at
22 9:4-7, Sufficiency Letter dated August 2, 2012, and Procedural Order dated August 30, 2012. Far West
23 Water did not file a cost of service study later in the proceeding nor were there any COSS issues later in
24 the case.

25 ³⁵ See Intervenors Br. at 1:18-24 (relying on last RRUI rate case to establish pattern). Intervenors'
26 reliance on Mr. Bourassa's testimony is misplaced because RRUI did not file a cost of service study in its
last rate case. Mr. Bourassa can be forgiven for misspeaking as he was on the witness stand and working
from memory. Perhaps he was recalling the last Bella Vista Water rate case where a cost of service study
was filed because that Liberty utility sought rate consolidation. Tr. at 411:13-17 (Bourassa). Intervenors'
counsel's failure to verify facts it expressly relies upon to establish an argument for dismissal is less
forgivable. The Commission's records are readily available and a simple check would have revealed that
RRUI did not file a cost of service study in its last rate application, or in the one before that filed in 2002.
Notably, Judge Rodda presided over all three of these Liberty rate filings.

³⁶ Tr. at 411:2-12 (Bourassa).

³⁷ Ex. A-17.

1 leaving the Intervenor's desperate, last minute claims, as well as its unsupported and
2 unexplained rate design,³⁸ flawed and without merit.

3 **D. The Employee Benefits Costs Are Known And Measurable And**
4 **Ratepayers Are Fully Protected**

5 The Intervenor's argue that the pension costs are not known and measurable and
6 should be denied in their entirety.³⁹ This argument should be rejected for several reasons,
7 not the least of which is that the Intervenor's are seeking to take advantage of the
8 settlement of issues by the other three parties by targeting a single settled issue that went
9 in favor of the Company's position.⁴⁰

10 First, there can be no dispute that pro forma adjustments are not only authorized by
11 the Commission's rules, they are common, and they are often necessary if the rates are
12 going to reflect a utility's actual costs during the time the rates are in effect, one of the
13 fundamental goals of utility ratemaking. Second, there can be no legitimate dispute that
14 Liberty Utilities is implementing a pension plan in 2013, the same year the new rates will
15 go into effect. The plan is a critical component of Liberty's ability to attract qualified
16 personnel to operate RRUI and their other systems in Arizona.⁴¹ The Company has
17 produced (and continues to produce as requested by Judge Rodda) evidence of costs
18 incurred to produce a pension program as well other documents evidencing
19 implementation of the plan.⁴² As for the alleged lack of further evidence,⁴³ Mr. Sorensen

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21 ³⁸ Intervenor's Br. at 3:4-8.

22 ³⁹ Intervenor's Br. at 12:6-7.

23 ⁴⁰ See Ex. A-17 illustrating adoption of the Company's recommended pro forma adjustment.

24 ⁴¹ Sorensen Rb. at 6:14-18; Tr. at 356:7-23 (Sorensen).

25 ⁴² Ex. RUCO-3. See also Summary Plan Description for Liberty Utilities Cash Balance Pension Plan,
26 copy of which was provided to Administrative Law Judge Rodda and the other parties with the Company's
Initial Closing Brief. In addition, with this brief the Company has furnished further evidence – a copy of
the fully executed Liberty Utilities Cash Balance Pension Plan. As with the other confidential
information, it was supplied as a compliance item, but only to Judge Rodda and the parties by letter sent at
the same time as this brief.

⁴³ See Intervenor's Br. at 11:20 – 12:5.

1 explained in great detail the planning with respect to the pension program.⁴⁴ He also
2 testified that, despite the name on the invoice being “Liberty Energy,” the program applies
3 to Liberty Utilities too.⁴⁵

4 Third, the costs are known and measurable, as agreed to by Staff and RUCO, both
5 of which include an amount for this expense in their final schedules.⁴⁶ Most importantly,
6 customers are fully protected because the Company has agreed to a mechanism that would
7 create a customer credit in the next rate case in the event this pension plan really is, as
8 Intervenors would have the Commission believe, a big fiction.⁴⁷ As such, not only is the
9 amount currently known and measurable, RUCO, Staff and the Company have created a
10 mechanism to cover the unlikely possibility that no pension funds were actually paid.

11 Finally, Intervenors’ position should be rejected because it would undermine the
12 good faith resolutions on all issues but one reached between RUCO, Staff and the
13 Company. As Staff explained, this issue and cost allocations were a joint give and take, a
14 black box sort of situation.⁴⁸ Taking away over \$32,891 in water revenue and \$11,811 in
15 wastewater revenue would send a message that parties should not work to resolve issues,
16 and here, it would leave the Company without the benefit of its bargain. While that is a
17 risk all settling parties take in a rate case, in this case, with the concurrence of Staff and
18 RUCO and safeguards in place, there is simply no basis to disallow this expense.

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21 ⁴⁴ *E.g.*, Sorensen Rb. at 5:20 – 7:7; Tr. at 361:22 – 364:16, 393:11 – 395:18 (Sorensen).

22 ⁴⁵ *Id.* The Intervenors point to no testimony to contradict Mr. Sorensen’s sworn testimony. In essence,
23 they are simply implying that he either does not know what he is talking about, or that he is lying. *See*
24 Intervenors Br. at 11:27-28 (“RRUI unable to produce any evidence”). The Company is confident the
25 Judge can evaluate Mr. Sorensen’s veracity on her own merit. Notably, both of these documents provided
26 post trial reference to a pension program for “Liberty Utilities”.

⁴⁶ *See* Staff Operating Income Adjustment No. 8 - Employee Benefits for water division and wastewater
division; RUCO Operating Income Adjustment No. 16 - Employee Benefits for water division and
wastewater division.

⁴⁷ Ex. A-17; Tr. at 403:9 – 404:1 (Krygier).

⁴⁸ Staff Br. at 4:6-10; Tr. at 446:3-14 (Fox); Tr. at 34:3-7 (Krygier); Tr. at 439:25 – 440:8 (Rigsby).

1 **E. The Intervenors' Recommended Capital Structure and Cost of Capital**
2 **is Without Evidentiary Support, Economic Basis or Legal Merit**

3 As noted, RUCO, Staff and RRUI reached consensus on a capital structure for the
4 Company. Furthermore, while the three parties could not agree on the ROE, each party
5 offered a witness that made their recommendations in prefiled testimony, supported that
6 recommendation with the evidence they thought necessary to sustain it, and then
7 presented their witness to be cross-examined at trial concerning that testimony and those
8 recommendations. In contrast, the Intervenors offered no cost of capital testimony or
9 recommendations prior to or even during the hearing, waiting instead to make such
10 recommendations in their post-trial closing brief. As explained below, however, each of
11 the Intervenors' 14 separate arguments in favor of their newly recommended capital
12 structure and cost of capital falls flat.

13 **1. Mr. Bourassa is a Qualified Cost of Capital Witness.**

14 To start, Intervenors argue that Mr. Bourassa is not qualified to testify on cost of
15 capital issues. Unfortunately, this claim shows the misguided and desperate nature of the
16 Intervenors' efforts to deny the Company just and reasonable rates. Fortunately, the entire
17 claim is easily disregarded.⁴⁹ First, Intervenors do not define "financial economist,"⁵⁰ but
18 it would appear that Mr. Bourassa qualifies. Mr. Bourassa has a B.S. in Chemistry
19 /Accounting, an MBA with an emphasis in Finance, and is a CPA.⁵¹ He has testified
20 before the Commission on cost of capital in roughly three dozen rate cases over the past
21 ten plus years. Never once has the Commission questioned his qualifications or
22 discounted his testimony because he is not qualified. If Mr. Bourassa is not qualified,

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24 ⁴⁹ Arguably, Intervenors should have raised this issue at the prehearing conference or at least when
25 Mr. Bourassa's prefiled testimony was introduced and admitted without objection. By not objecting at that
26 time to Mr. Bourassa's qualifications to submit expert prefiled testimony, Intervenors should be deemed to
have waived this challenge to Mr. Bourassa's qualifications.

⁵⁰ See Intervenors Br. at 3:22 (asserting a cost of capital witness must be a "financial economist").

⁵¹ Bourassa Dt. at 1:5-9; Tr. at 112:15 – 113:6 (Bourassa).

1 then neither is Mr. Cassidy, who has a B.S. in History, a Master in Library Science and an
2 MBA, and only two years experience as a cost of capital witness; nor would Mr. Rigsby
3 of RUCO qualify, who despite more than a decade of experience testifying on cost of
4 capital, only has a B.S. in Finance and an MBA.⁵²

5 Second, the claim that Mr. Bourassa cannot testify because he does not have a
6 CRRA is laughable.⁵³ It is likely no coincidence that counsel for the Intervenors did not
7 ask Mr. Cassidy if he had a CRRA, as they would not want it on the record that Staff's
8 cost of capital witness does not have the magic CRRA. The Company and undersigned
9 counsel would go so far as to suggest that no Staff cost of capital witness in the past ten or
10 more years has had a CRRA. Not even Mr. Rigsby, who has a CRRA, went so far as to
11 suggest that Mr. Bourassa lacks qualification to testify on the subject of cost of capital.⁵⁴

12 In fact, Mr. Rigsby is the only cost of capital witness who appears to tout the
13 importance of a CRRA. According to his direct testimony, the designation is "awarded
14 based upon experience and the successful completion of a written examination."⁵⁵ There
15 is nothing in the record showing what experience is required or what the exam entails to
16 obtain a CRRA designation. However, one can easily glean from the website,
17 <http://www.surfa.com/crra.php>, that anyone with a little ratemaking experience,
18 willingness to take a test, and the money for the fees can get a CRRA designation. It
19 appears all one needs to do is (1) register for a SURFA Conference; (2) register to take the
20 CRRA test; (3) fly, drive and/or walk to the conference site to take the test; (4) take the

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24 ⁵² Cassidy Dt. at 1:14-21; Rigsby COC Dt. at 1:7-21.

⁵³ See Intervenors Br. at 3:23.

⁵⁴ Tr. at 171:4-15 (Rigsby).

⁵⁵ Rigsby COC Dt. at 1:14-18 (awarded CRRA based upon experience and completion of written examination).

1 test; and (5) wait for the certificate in the mail. Mr. Krygier did it, and if absolutely
2 necessary, he can adopt Mr. Bourassa's cost of capital testimony.⁵⁶

3 **2. Generalizations and Conclusions About the Economy and Stock**
4 **Market are Not Substantial Evidence.**

5 Lacking substantial evidence, Intervenors cobble together selected snippets from
6 the hearing transcript where the other parties' cost of capital witnesses agree to certain
7 facts that were never really in dispute. For instance, no one is disputing that interest rates
8 are at historical lows due to the actions of the Federal Reserve in the wake of the great
9 recession.⁵⁷ Nor does the Company dispute that the VIX is at its lowest point since
10 2008.⁵⁸ The information introduced by the Intervenors also shows that we are in very
11 uncertain economic times, during which it is acknowledged and understood that such
12 uncertainty increases risk.⁵⁹ All of these are things that a cost of capital expert (a.k.a., a
13 "financial economist") considers in his or her analysis. He or she considers a lot of
14 factors. For instance, he or she might consider that right now the stock market is at all
15 time highs and the Company's investors may be better off putting their money in an Index
16 Fund rather than in RRUI.

17 The test is not whether treasuries and interest rates are at historic lows. Those are
18 factors that can and should be considered and they are through the use of financial
19 models.⁶⁰ The test is whether RRUI's authorized cost of capital meets the comparable
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22 ⁵⁶ See Exhibit A attached hereto. The Company will leave it to the Judge to determine whether the exhibit
23 needs to be admitted or whether it can be subject to administrative notice. Notably, Mr. Krygier also has a
24 B.S. in Economics. See Direct Testimony of Christopher D. Krygier (filed but not admitted in this docket)
25 at 1:18-26. As a financial economist awarded the CRRRA designation, Mr. Krygier can be assumed to
26 support the Company's requested 9.5 percent ROE.

⁵⁷ Intervenors Br. at 4:3-8. See also Tr. at 65:5-8 (Bourassa).

⁵⁸ Intervenors Br. at 4:26-27. See also Tr. at 73:15 – 74:21 (Bourassa).

⁵⁹ Tr. at 58:8 – 59:5 (Bourassa).

⁶⁰ Tr. at 119:21 – 121:7 (Bourassa).

1 earnings test set forth in the *Hope* and *Bluefield* decisions.⁶¹ That test requires the
2 Commission to set a return that compares with other business with like risks – i.e., other
3 utilities. The one-year average total return for the sample companies is 17.15 percent and
4 the recent three-year average of the sample companies is 10.14 percent.⁶² There is simply
5 nothing about the general economy that justifies dramatically lower returns for RRUI.

6 **3. AIAC and CIAC Are Risk Factors.**

7 AIAC and CIAC are one of many factors that Mr. Bourassa considered in assessing
8 the risks faced by RRUI. As he explained, AIAC creates risk because there is a defined
9 obligation to make payments from revenues to a third-party.⁶³ In this sense, AIAC is
10 comparable to debt, which adds risk to an equity investment because debt has to be paid
11 back.⁶⁴ CIAC adds risk because at some point the plant funded by CIAC has to be
12 operated, maintained and repaired at the utility's expense, and then replaced with debt or
13 equity capital.⁶⁵ Mr. Bourassa never attempted to quantify the impact of AIAC and CIAC
14 on the Company's ROE, he just identified it as a factor. Intervenors can quibble about
15 how much risk exists, but they can point to no evidence in the record to the contrary and
16 any suggestion that AIAC and CIAC create no risk is unsupported and simply not
17 credible.

18 **4. Size Matters.**

19 During the hearing, Intervenors' counsel handed Mr. Rigsby an outdated copy of
20 Morningstar and asked him to read a passage referencing the "January Effect."⁶⁶ That
21 was it. They asked him no further questions on the subject of this "January Effect," which
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23 ⁶¹ See *Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia*, 262
U.S. 679, 692-93 (1923); *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

24 ⁶² Value Line Investment Survey January 18, 2013.

25 ⁶³ Bourassa COC Dt. at 22:1-19.

26 ⁶⁴ Tr. at 76:3-7 (Bourassa).

⁶⁵ Bourassa COC Dt. at 22:16-19.

⁶⁶ Tr. at 158:25 – 159:22, 160:22 – 161:6 (Rigsby).

1 he did not address in his prefiled testimony.⁶⁷ Intervenors did not even introduce the
2 excerpt from Morningstar into evidence. Yet, from this mere reading by Mr. Rigsby, the
3 Intervenors argue that size should be disregarded because it is really just the “January
4 Effect.”⁶⁸ Rarely has anyone tried to make so much from so little.

5 Intervenors admit that “there is no generally accepted explanation” of this effect.⁶⁹
6 Even Morningstar and Duff & Phelps seems to believe it irrelevant.⁷⁰ Intervenors cannot
7 point to any evidence that this “January Effect” impacts RRUI because there is nothing in
8 the record to show that the January Effect even exists. Even if it did exist, it cannot
9 possibly impact RRUI because its RRUI’s shareholder cannot just flip RRUI’s stock at
10 year-end for tax reasons.⁷¹

11 Therefore, this is nothing more than another desperate and disingenuous attempt by
12 the Intervenors to discount the Company’s rates for service. The Commission can decide
13 whether to quantify the impact of RRUI’s size, as the Small Risk Premium does, or it can
14 consider it one more of a number of important factors that impact the determination of an
15 ROE. But clearly any assertion that RRUI’s small size does not matter at all is simply not
16 credible. Even Mr. Rigsby admits that “astute” investors will consider size.⁷² Investors
17 require higher returns for smaller firms because they are more risky.⁷³

18 **5. The DCF and CAPM Will Be Heard.**

19 Even the Intervenors want to debate the DCF and CAPM. First, Intervenors argue
20 that Mr. Bourassa over-estimated his DCF.⁷⁴ It isn’t entirely clear why Intervenors think

21 ⁶⁷ Tr. at 161:25 – 162:5 (Rigsby).

22 ⁶⁸ Intervenors Br. at 7:10-12.

23 ⁶⁹ Intervenors Br. at 6:12-13.

24 ⁷⁰ See Morningstar Ibbotson SBBI 2013 Valuation Yearbook at 99; Duff & Phelps Risk Premium Report
2013 at 39; Tr. at 166:13-15, Tr. at 183:13-22 (Rigsby).

25 ⁷¹ See Tr. at 162:17 – 163:2 (Rigsby) (explaining that the January Effect involves the sale of stock at year-
end for tax reasons).

26 ⁷² Tr. at 169:1-3 (Rigsby).

⁷³ Bourassa COC Dt. at 42:3-23; Bourassa COC Rb. at 16:18 – 17:19.

⁷⁴ Intervenors Br. at 5:13-25.

1 this is true, because, again, they chose not to file any testimony nor call any witnesses.
2 The only evidence referenced is cross-examination of Mr. Bourassa and he certainly did
3 not agree that he overstated his DCF. Mr. Bourassa explained that the current dividend
4 yield is the currently declared annual dividend divided by the current stock price.⁷⁵ If an
5 investor buys a stock today, he or she can expect to receive the dividends the Company
6 has declared. As such, Mr. Bourassa used the most current declared dividend as reported
7 by Value Line, which happens to be the actual dividends paid in 2011 for each of the
8 publicly traded utilities.⁷⁶ The Company will pay out the currently declared dividend over
9 the next year, which is why Mr. Bourassa responded in the affirmative to Mr. Decker's
10 question regarding dividends to be paid over the next year.⁷⁷

11 Second, the Intervenors accuse Mr. Bourassa of "misestimating his CAPM" and
12 using "Inaccurate Forecasts."⁷⁸ The Company does not know the basis for these opinions
13 either. Again, the only evidence offered is citation to Mr. Bourassa's testimony, and he
14 certainly did not agree that his CAPM is wrong because he used "old data."⁷⁹
15 Mr. Bourassa's CAPM uses the actual February 2013 monthly average rate as a spot rate
16 for 30 year U.S. Treasuries as reported by the Federal Reserve.⁸⁰ He did use the forecast
17 2014 and 2015 rates as reported by Value Line (February 22, 2013) and Blue Chip
18 Financial Forecasts (Dec 2012).⁸¹ Mr. Bourassa explained why he uses these forecasts –
19 because investors consider forecasts, which is why Value Line, Blue Chip, and many
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22 ⁷⁵ See footnotes on Final Schedule D-4.7.

23 ⁷⁶ Value Line Investment Survey January 18, 2013.

24 ⁷⁷ Tr. at 81:14-16 (Bourassa).

25 ⁷⁸ Intervenors Br. at 6:1-4, 7:15-25.

26 ⁷⁹ Intervenors Br. at 6:2-3.

⁸⁰ See Company Final Schedule D-4.10; see also Bourassa COC Dt. at 37:23-25 (describing use of spot and forecast interest rates).

⁸¹ See Company Final Schedule D-4.

1 others provide this information.⁸² If investors consider the information, then it is relevant
2 to any cost of capital analysis.⁸³

3 In the final analysis, the arguments made by the Intervenors lack substantial
4 evidence; they are merely unsupported and mistaken opinions by counsel, further
5 illustrating that strict reliance on the DCF and CAPM is fraught with limitations and
6 impracticalities.

7 **6. Intervenors' Recommended Capital Structures Are Not**
8 **Supported by Substantial Evidence and Should be Rejected.**

9 After spending several pages attacking Mr. Bourassa, the Intervenors recommend
10 that the Commission approve a 50-50 capital structure for RRUI with a 4.13 percent cost
11 of debt.⁸⁴ No witness testified that RRUI should have a 50-50 capital structure. Not a
12 shred of evidence in the record addresses the impact of imputing 50 percent debt on the
13 return on equity, which obviously goes up with that much additional financial risk.⁸⁵ This
14 recommendation is simply unsupported and cannot be adopted on this record in this case.

15 Nor should the Commission adopt the Intervenors' alternative recommendation of
16 an 80-20 hypothetical capital structure.⁸⁶ To begin with, it is not "RRUI's Proposed 100%
17 Equity Capital Structure," it is the joint recommendation of RUCO, Staff and the
18 Company, supported by the actual testimony of actually testifying experts.⁸⁷ Nor are the
19 Intervenors as ignorant of the circumstances leading up to this joint recommendation as
20 their pleading would have the reader believe. The facts are relatively straightforward.
21 Consistent with its assurance in the last case that it would infuse debt into its capital

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23 ⁸² Bourassa COC Rb. at 22:19 – 23:5.

⁸³ *Id.*; Tr. 236:14-21 (Cassidy).

24 ⁸⁴ Intervenors Br. at 8:19 – 9:26.

25 ⁸⁵ *E.g.* Tr. at 203:23-25, 249:9-13 (Rigsby); Tr. at 104:3-12 (Bourassa); Bourassa COC Dt. at 14:13-15;
Cassidy Dt. at 13:7-10, 34:17-21.

26 ⁸⁶ Intervenors Br. at 10:21 – 11:10.

⁸⁷ Company Final Schedule D-1; Staff Sb. Schedule JAC-1; RUCO Final Schedule WAR-1.

1 structure, the Company proposed an 80-20 hypothetical capital structure in its
2 application.⁸⁸ It is undisputed that the Company's proposal was the same as if it had
3 actually borrowed the money at the RRUI level.⁸⁹ Staff never accepted the Company's
4 proposal and recommended that the Company's actual 100 percent equity be used to set
5 rates in this case.⁹⁰ RUCO initially joined the Company in using the 80-20 hypothetical
6 capital structure, but then adopted Staff's 100 percent equity capital structure.⁹¹ At that
7 point, Mr. Bourassa gave in and accepted the position of the other two parties.⁹² In other
8 words, this was simply one more issue the three parties resolved.

9 The Intervenors chose not to join any aspect of the resolutions reached between
10 RUCO, Staff and the Company. That is their right. But the Intervenors are again
11 attempting to pick apart the resolution of issues to lower the Company's rates, and their
12 effort is incomplete. Nowhere do the Intervenors account for the additional risk that
13 would come with the imputation of debt into the capital structure.⁹³ Yet, both Mr.
14 Bourassa and Mr. Rigsby recognized that the ROE would be higher if a hypothetical
15 capital structure with 20 percent debt was used.⁹⁴

16 The Company certainly isn't surprised by the Intervenors' effort to cast the
17 Company in a bad light.⁹⁵ RRUI left itself open to criticism, and the Intervenors have left
18 no stone unturned in their effort to discount the Company's rates. However, while it is
19 true that the Company did not actually incur the debt, there is no evidence it did so with
20 intent to harm the customers or unnecessarily increase the cost of service. Most

21 ⁸⁸ Bourassa COC Dt. at 2:13-19.

22 ⁸⁹ Ex. A-11; Tr. at 112:6-8 (Bourassa).

23 ⁹⁰ Cassidy Dt. at 7:18-22.

24 ⁹¹ Rigsby COC Sb. at 6:12-17.

25 ⁹² Bourassa COC Rj. at 2:23 – 3:11; Tr. at 100:3 – 102:15 (Bourassa).

26 ⁹³ See Intervenors Br. at 10:21 – 11:10.

⁹⁴ Rigsby COC Dt., WAR-1, Page 1 of 3 (9% ROE with 80/20); Bourassa COC Dt., Schedule D-4.1 (10.7% on 80.20 structure).

⁹⁵ See e.g., Intervenors Br. at 10:24.

1 importantly, RRUI tried to have its rates set exactly as if it did infuse the debt.⁹⁶ Lastly,
2 when the parties' various risk adjustments are applied to the determination of an ROE, the
3 difference between the final cost of capital with or without 20 percent debt is minimal.⁹⁷

4 7. **An ROE of 8% Is Unreasonable and Would not Satisfy the**
5 **Comparable Earnings Test.**⁹⁸

6 The Intervenors have provided no witness to support their recommended returns,
7 nor the new calculations presented for the first time in their briefs. This lack of evidence
8 dooms any of their recommendations from being adopted. Moreover, any recommended
9 return offered by the Intervenors is flawed for the same reasons as Staff and RUCO's –
10 their limited analysis results in ROEs that cannot pass the comparable earnings standards
11 articulated in *Hope* and *Bluefield*:

12 [T]he return to the equity owner should be commensurate
13 with returns on investments in other enterprises having
14 corresponding risks. That return, moreover, should be
sufficient to assure confidence in the financial integrity of the
enterprise, so as to maintain its credit and to attract capital.⁹⁹

15 ROEs of 8 percent or lower do not reasonably compare to utilities, water or gas, with
16 authorized returns over 10 percent and projected returns from 10.3 for water to 11.5 for
17 gas.¹⁰⁰

18 **II. REPLY TO STAFF AND RUCO ON COST OF CAPITAL**

19 **A. Brief Introduction**

20 The Company had hoped to avoid digging into some of the more esoteric details
21 over cost of capital.¹⁰¹ As discussed above, the Intervenors made that virtually

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23 ⁹⁶ Ex. A-11.

24 ⁹⁷ Tr. at 184:10 – 185:5 (Rigsby); Tr. 106:25 – 107:10 (Bourassa).

25 ⁹⁸ The Company hereby incorporates its responses to Staff and RUCO on the issue of an ROE in response
to the newly recommended but unsupported equity recommendation of the Intervenors.

26 ⁹⁹ *Hope*, 320 U.S. at 603.

¹⁰⁰ Bourassa COC Rb. at 8:20 – 10:24.

¹⁰¹ RRUI Br. at 9:13 – 10:16.

1 impossible. Staff and RUCO also wish to debate the details, which isn't surprising. If
2 you can't defend the results – 8.2 and 8.25 percent – defend the mechanism. What may be
3 surprising, however, is how much agreement there is between the three parties. For
4 instance, RUCO asserts “the DCF and CAPM are appropriate models to calculate the cost
5 of equity.”¹⁰² The Company agrees, which is why Mr. Bourassa used both the DCF and
6 CAPM in his cost of capital analysis.¹⁰³ Nor does RRUI take issue with Staff and
7 RUCO's use of proxy groups to determine the cost of capital, including RUCO's use of
8 gas utilities.¹⁰⁴ Like the water companies in the sample groups, RUCO's gas utility proxy
9 group, with authorized returns of 10.29 percent and projected returns of 11.5 percent,
10 furthers the Company's point that the Staff and RUCO recommended ROEs are simply
11 too low to pass the comparable earnings standards established in *Bluefield* and *Hope*.

12 **B. The Commission Should Consider Analysts' Projections and**
13 **Expectations When Setting the ROE**

14 While neither Staff nor RUCO went so far as to suggest Mr. Bourassa is not
15 qualified, they do continue the tradition of criticizing the inputs he uses in his DCF and
16 CAPM. If you can't challenge the result – a reasonable and conservative 9.5 percent –
17 attack the process. For instance, RUCO attacks Mr. Bourassa's use of Value Line
18 forecasts of book returns arguing such “long-term projections are not estimates of the cost
19 of capital.”¹⁰⁵ This is ironic for two reasons. For one thing, we are establishing a rate of
20 return that will ultimately determine the book equity return RRUI will have an
21 opportunity to earn when new rates are in effect – a point in time that is in the future.¹⁰⁶

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24 ¹⁰² RUCO Br. at 2:13-14; see also Staff Br. at 5:19-20.

¹⁰³ Bourassa COC Dt. at 26:20 – 27:2.

¹⁰⁴ RUCO Br. at 3:5 – 5:2; see also Bourassa COC Rb. at 8:20 – 11:8.

¹⁰⁵ RUCO Br. at 5:3-4.

¹⁰⁶ Bourassa Rj. at 11:12-17.

1 Moreover, in response to past criticism by Staff for exclusively relying on analyst
2 forecasts of earnings growth for the DCF model,¹⁰⁷ Mr. Bourassa has incorporated
3 historical growth rates into his growth estimates and DCF model.¹⁰⁸ He has done this
4 despite the fact the analyst's earnings growth forecasts been shown to be the best proxy
5 for DCF growth for estimating the returns on equity for utility companies, superior to
6 historical earnings and dividend growth rates.¹⁰⁹ He just can't seem to win.

7 Staff likewise criticizes Mr. Bourassa for his use of "forecasted" interest rates in
8 his CAPM.¹¹⁰ The problem Staff and RUCO have with forecasts is that they are often
9 higher than one-day spot interest rates. That's not really the point. It was one thing to
10 criticize Mr. Bourassa when he relied solely on forecasted information. But in response to
11 criticism by Staff for his exclusive reliance on forecast interest rates,¹¹¹ Mr. Bourassa has
12 incorporated spot interest rates in his estimate of the risk-free rate from the CAPM.¹¹² In
13 contrast to Staff and RUCO, however, Mr. Bourassa does not use only spot rates.
14 Ignoring forecasts of interest rates, which investors consider, results in an incomplete
15 assessment of investor expectations.¹¹³

16 It is easy to see that Mr. Bourassa's cost of capital analysis and testimony before
17 the Commission has evolved in response to criticism from Staff and RUCO (and rejection

18 ¹⁰⁷ See, e.g., Direct Testimony of Steven P. Irvine at 33, *Goodman Water Company*, Docket No. W-
19 02500A-06-0281; Direct Testimony of Steven P. Irvine at 39, *Far West Water and Sewer Company*,
20 Docket No. WS-03478A-05-0801; Direct Testimony of Pedro Chaves at 35, *Black Mountain Sewer*
Company, Docket No. SW-02361-05-0657.

21 ¹⁰⁸ See Bourassa COC Dt. at 31:16 – 32:9.

22 ¹⁰⁹ See Bourassa COC Dt. at 31:3-15.

23 ¹¹⁰ Staff Br. at 8:8-12.

24 ¹¹¹ See, e.g., Direct Testimony Steven P. Irvine at 39, *Goodman Water Company*, Docket No. W-02500A-
25 06-0281; Direct Testimony of Steven P. Irvine at 46, *Far West Water and Sewer Company*, Docket No.
26 WS-03478A-05-0801; Direct Testimony of Pedro Chaves at 40, and *Black Mountain Sewer Company*,
Docket No. SW-02361-05-0657.

¹¹² See Bourassa COC Dt. at 31:22-25.

¹¹³ Mr. Bourassa uses a 3-month average of the current market risk premium to provide a more stable and
reliable estimate of the current market risk premium. See RRUI Final COC Schedule D-4.11. Staff uses a
spot (single point) estimate that results in a very unstable estimate of the current market risk premium. See
Bourassa COC Dt. at 37.

1 by the Commission). Now, he incorporates historical measures of growth into his growth
2 estimate for the DCF even though he believes analysts' estimates already consider the
3 past.¹¹⁴ Likewise, weary of debating Staff and RUCO over the limits and shortcomings of
4 the DCF and CAPM and which inputs to the models are appropriate, Mr. Bourassa looked
5 for a more objective way to test the results of these models – a simple sanity test like the
6 build-up method.¹¹⁵ The data used is provided by Morningstar and Duff & Phelps; the
7 data is objective because this methodology does not require a market beta, market stock
8 price, and market dividend yield, which are not available for privately held entities.¹¹⁶
9 The build-up method is a reasonable comparative benchmark against which the DCF and
10 CAPM results can be compared; and neither Staff nor RUCO dispute the results.

11 This is what the standards set forth by the U.S. Supreme Court call for and is
12 consistent with the broader view the Company is not-so-subtly advocating in this case.
13 The result seems to speak for itself – Mr. Bourassa's recommended ROE is only
14 9.5 percent, which compares, for further example, to the undisputed ROE for the water
15 proxy group of 10.69 percent reflected in build-up analysis using the Duff & Phelps
16 data.¹¹⁷

17 Mr. Bourassa's evolution is reflected in another issue raised by RUCO – financial
18 risk adjustments.¹¹⁸ A financial risk adjustment is often appropriate to reflect a
19 measurable difference between the sample companies and the applicant, in this case the
20 Company that has no debt in its capital structure.¹¹⁹ Mr. Bourassa has adopted the
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23 ¹¹⁴ Bourassa COC Dt. at 32:7-9.

¹¹⁵ Bourassa COC Dt. at 3:17-23.

24 ¹¹⁶ Bourassa COC Dt. at 38:4 – 40:7.

¹¹⁷ See Table 6 in RRUI Rejoinder Exhibit TJB-COC-RJ1. The same data supports an ROE of over 13.8 percent for RRUI.

25 ¹¹⁸ RUCO Br. at 7:1-8:7.

26 ¹¹⁹ Cassidy Dt. at 7:19-22.

1 Hamada method for estimating the financial risk adjustment.¹²⁰ Staff typically employs
2 this same method for determining its financial risk adjustment. However, just because a
3 utility has lower debt than the sample companies, and a financial risk adjustment is used,
4 does not mean RRUI is substantially less risky than the sample companies. Financial risk
5 is one factor that needs to be considered and assessed in determining an ROE. It is not the
6 only factor.

7 Similarly, investors do not ignore size or other unique risks faced by utilities.¹²¹
8 These things may not lend themselves to ready quantification and maneuvering like
9 financial risk under the DCF and CAPM, but that does not mean they are not risks that
10 should be considered. Specifically, to respond to the arguments by Staff that firm size is a
11 unique risk and should not be considered,¹²² Mr. Bourassa has used the market based
12 build-up methods to show the cost of equity for smaller firms is not a unique risk, but
13 rather another market risk factor that explains the differences in returns between large and
14 small firms.¹²³ The financial literature confirms that the small firm risk premium is real
15 and explains the failure of the traditional CAPM to explain the returns of smaller firms.¹²⁴

16 C. Brief Summary

17 In sum, Staff, RUCO and the Company do a lot of things the same – DCF, CAPM,
18 financial risk adjustments. The difference is that after the Staff and RUCO models create
19 numbers, they adjust for the amount of debt, and call the result “just and reasonable.”
20 Mr. Bourassa has tried, working within the same general framework, to say that is not
21 enough – he tests the models against actual, observable data in the market. This case

22 ¹²⁰ Mr. Bourassa uses conceptually correct market values for equity and debt in his computation. *See*
23 Bourassa COC Rb. at 14. Staff uses book values for equity and debt which overstate Staff’s financial risk
adjustment. *Id.*

24 ¹²¹ Tr. at 169:1-3 (Rigsby).

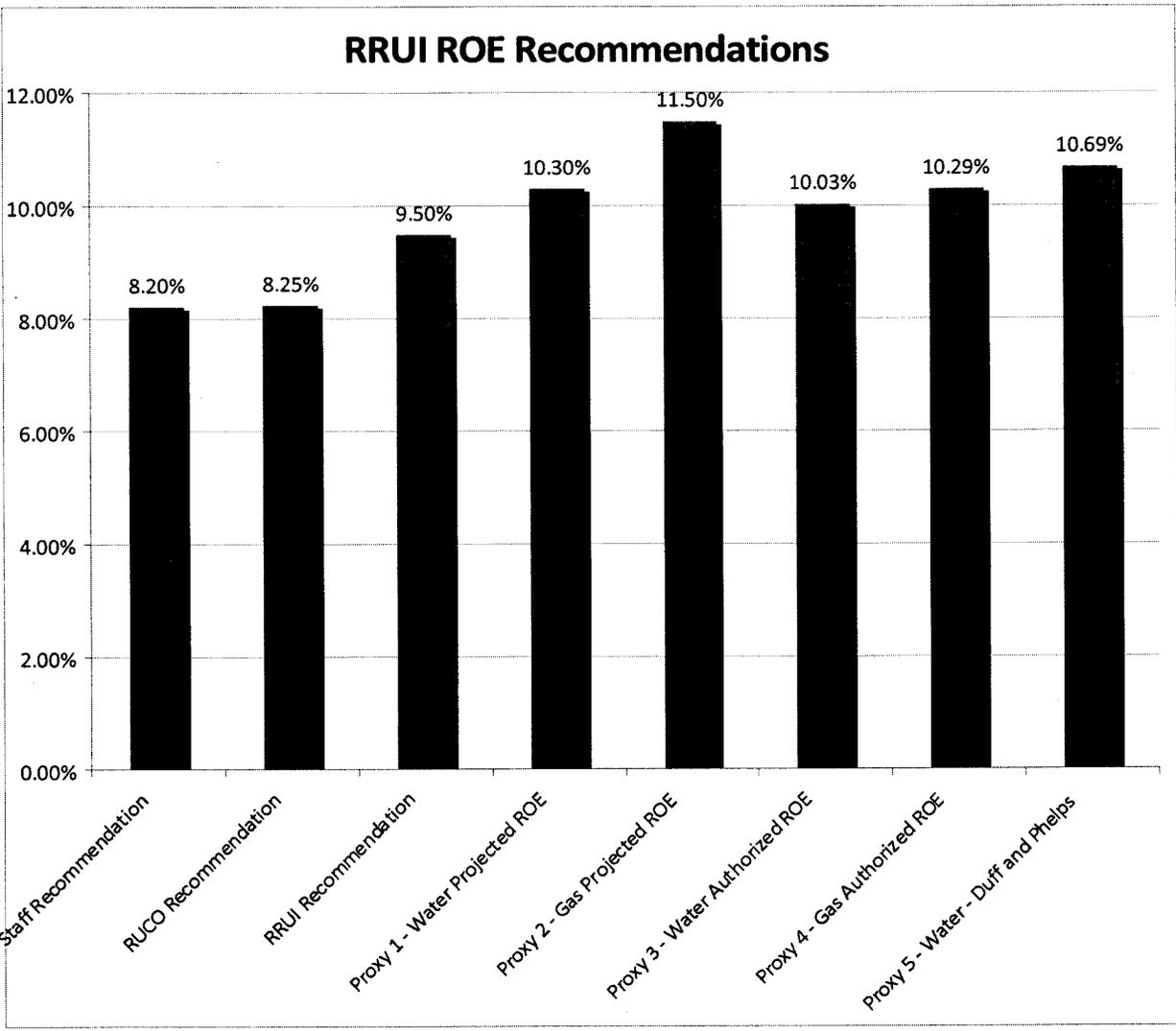
25 ¹²² *E.g.*, Staff Br. at 8:13-14; RUCO Br. at 8:8. This is not the first time the two parties have made such
arguments.

26 ¹²³ Bourassa COC Dt. at 42:4-12; Bourassa Rb. at 16:8 – 17:23.

¹²⁴ *Id.*

1 shows he is right. The recommended equity returns in this case – 6 percent, 8 percent,
2 8.2 percent and 8.25 percent cannot pass a simple economic sanity check.

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22 This is exactly the sort of check required under *Hope* and *Bluefield*, which require that:

- 23 (1) The rate of return should be similar to the return in businesses with similar
24 or comparable risks;
- 25 (2) The return should be sufficient to ensure the confidence in the financial
26 integrity of the utility; and

1 (3) The return should be sufficient to maintain and support the utility's credit.¹²⁵
2 The other parties' recommended ROEs simply can't pass this test.

3

4 RESPECTFULLY SUBMITTED this 15th day of May, 2013.

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FENNEMORE CRAIG, P.C.

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7

By _____
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ORIGINAL and thirteen (13) copies
of the foregoing were filed
this 15th day of May, 2013 with:

14

15

16

Docket Control
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

17

18

COPY of the foregoing hand-delivered
this 15th day of May, 2013 to:

19

20

21

22

Bridget A. Humphrey, Esq.
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Legal Division
Arizona Corporation Commission
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Phoenix, Arizona 85007

23

24

¹²⁵ See, e.g., Roger A. Morin, *New Regulatory Finance* 9-12 (Public Utility Reports, Inc. 2006) (summarizing the legal principles underlying the regulation of a utility's rate of return); Charles F. Phillips, Jr., *The Regulation of Public Utilities: Theory and Practice* 376-79 (Public Utility Reports, Inc. 1993) (summarizing the legal principles underlying the regulation of a utility's rate of return).

25

26

1 **COPY** of the foregoing emailed/mailed
2 this 15th day of May, 2013 to:

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23
24
25
26

RIO RICO UTILITIES, INC.

REPLY CLOSING BRIEF

May 15, 2013

Exhibit A

*Society of Utility and
Regulatory Financial Analysts*
certifies that

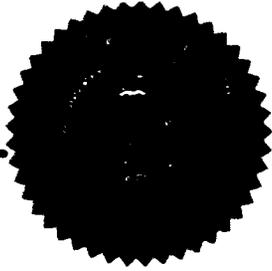
Christopher D. Krygier

*has successfully completed the requirements for and is
hereby awarded the professional designation*

Certified Rate of Return Analyst

Certificate No. **110**

Date **May 25, 2011**



David C. Lovell

On behalf of Executive Committee - CRRFA

W.M. Owen

President, Society of Utility and Regulatory Financial Analysts