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BEFORE THE ARIZONA CORPORATION C[OMMISSION]

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2013 MAY 15 P 3: 31

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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

RUCO'S REPLY BRIEF

The Residential Utility Consumer Office ("RUC0") hereby files its Reply Brief. As previously noted, RUCO and the Company have reached agreement on all major issues except the Cost of Equity Capital and the Weighted Average Cost of Capital. RUCO has already responded in its Closing Brief to many of the arguments made by the other parties. RUCO will not repeat those arguments here. The purpose of this brief is to respond to those issues not previously addressed.

A. Nogales Wastewater Treatment Plant Expense

Most of the Company's wastewater customers are serviced by the Nogales Wastewater Treatment Plant ("NWWTP") which is owned by the City of Nogales, but operated by the International Boundary Water Commission ("IBWC"). In its application, the Company sought approximately $13,000 per month ($165,000 per annum) to cover the cost of it agreement with the City of Nogales for operation and maintenance expenses associated with the NWWTP. The Company entered into an agreement with the City of Nogales which resulted in retroactive reductions to test year level expense to $9,083 per month. While it is true that the Company's annual expense was subject to an annual truing up with the City of Nogales and the IBWC, that truing up in March of 2013 resulted in a credit to the Company further reducing the $9,083 monthly expense. Because the Company has been paying $9,083 per month since February, 2012, RUCO believes and the Company agrees that the NWTTP monthly expense will be the $9.083, not the higher $13,000 amount requested in the Company's application.

The parties have agreed that any additional amounts paid to the City of Nogales for the NWWTP will be recorded as a regulatory asset. One point of clarification is that the Company also agreed that it will not seek deferred or accrued carrying costs or interest on additional amounts paid to the City of Nogales for the NWWTP.[1] Likewise, the Company also agreed that if the NWWTP expenses decrease, the Company will record this as a regulatory liability and ratepayers will receive the benefit of that regulatory liability.

B. Cost of Equity/ Weighted Average Cost of Capital

1. RUCO's return on equity capital is derived from application of appropriate methodologies.

RUCO's determination of a return on equity capital is based on results obtained from a Discounted Cash Flow model ("DCF") and a Capital Asset Pricing Model ("CAPM"). DCF and CAPM analyses are the methodologies historically accepted by the Commission and used by Staff. Although the Company has offered alternative methodologies, it too used a DCF and CAPM methodologies to derive its return on equity capital. RUCO adjusted its 8.75 percent cost of common equity by making a downward adjustment of 50 basis points for the absence of financial risk to arrive at an 8.25 percent cost of common equity. 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. The Company recommends a 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.

2. RUCO's return on equity capital meets constitutional requirements.

The Company asserts that RUCO's cost of equity capital of 8.25 percent is too low and therefore unconstitutional. Mr. Rigsby testified that the his weighted average cost of capital meets the criteria established in the *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923) and *Federal Power Commission v. Hope Natural Gas Company* 320 U.S. 391, (1944).[2] RUCO agrees that the rate of return adopted for the utility should be comparable to a return that investors would expect to receive from investments with similar risk and that the utility should have the opportunity to earn a reasonable rate of return on its investment. Id. However, the opportunity to earn that return is contingent upon the Company exercising good judgment and management of its assets and resources in a manner that is both prudent and economically efficient. Id. RUCO believes its recommended 8.25 percent WACC affords the Company the opportunity to earn a reasonable rate of return.

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[1] Transcript: 376 at ll. 17-18.
[2] RUCO-1 at 7-8.

3. Averaging of projected returns on book equity is not an appropriate method of deriving a return on equity capital.

The Company argues that RUCO's recommended return on equity capital is unreasonably low when compared to the average projected returns of its proxy companies and therefore unconstitutional. The Company is attempting to perform a comparable earnings analysis which has long been criticized for its circular logic. The Company relies on analysts' projection for returns on book equity for 2015 and 2017. Setting aside the issue that the Company is relying on returns on book equity; averaging analysts' projected returns for 2015-2017 is simply not an accepted methodology for testing the reasonableness of RUCO's analysis of a return on equity capital or of any other parties' analysis, either. The Company's attempt to average analysts' projected returns on book equity for 2015-2017 is not a substitute for employing appropriate methodologies and inputs to derive a current cost of equity capital or a basis for any meaningful comparison. The Company's assertion that RUCO's or Staff's cost of equity is too low because it falls below analysts' projections for book returns on equity in 2015-2017 is simply without merit.

4. Returns on book equity are not returns on equity capital.

The Company also asserts that RUCO's cost of equity capital is unreasonably low when compared to actual returns on book equity of its proxy companies. Returns on book equity are not the same as costs of equity capital.[3] RUCO discussed this issue in detail in its Closing Brief.[4] There is no need to repeat those prior arguments again. Suffice is to say, the comparison of *actual or projected* returns on book equity is not an apples to apples comparison. *Id.* Mr. Rigsby testified that by definition, the cost of common equity has to be

[3] Ex. RUCO-2 at 9-10.
[4] *See* Closing Brief pages 4-5.

lower than the return on book common equity for the Company to show a profit.[5] He also stated that returns on book equity are not costs of equity capital.[6] Simply averaging returns on book equity of proxy companies is not a substitute for use of appropriate methodologies. Moreover, comparing returns on book equity with costs of equity capital derived appropriately is not a means of testing the results derived from the use of accepted methodologies.

5. Prior authorized returns based on unknown circumstances are not used to determine or test current returns on equity capital.

The Company also asserts that RUCO's return on equity capital is low as compared to the previously authorized returns of its proxy companies. Again, the Company is attempting to perform a comparable earnings analysis which has long been criticized for its circular logic. Second, the Company has not submitted any copies of the reports upon which it purportedly relies. Last, there is no way to determine from the limited information the Company has provided when, where and how the authorized returns were approved. We do not know for example how far removed in time these returns were purportedly approved or the market conditions that existed at the time the returns were approved. We do not know the circumstances under which the returns were approved. For example, we do not know if an authorized return was approved based on a settlement agreement that resulted in a higher return in exchange for other concessions. The Company has not provided that information. Moreover, we have no information about the reasoning of the public utility commissions in approving those authorized returns. Prior authorized returns based on unknown circumstances have no bearing in this matter. What is important is that RUCO's cost of equity capital is based on the most recent market data available on its sample companies and that market data

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[5] Ex. RUCO-2 at 9-10. *See also* T: 155-156. *See also* Financial Times Lexicon, Attachment A to RUCO's Closing Brief.
[6] T: 180, lines 11-12.

has been applied in the cost of equity models accepted by this Commission to derive an appropriate cost of equity capital.

6. 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.[7] RUCO disagrees that a small firm adjustment of any type is appropriate on the facts of this case.[8] RUCO has discussed this matter in its Closing Brief and will not re-address those arguments here.[9] However, in its Closing Brief, the Company asserts that RRUI is not a publicly traded company and therefore is not geographically as diverse as a publicly traded company, does not have the greater economies of scale afforded publicly traded companies and does not have the revenue or earnings stability of a publicly traded company.[10]

RRUI is a subsidiary of Liberty Utilities, whose parent is Algonquin Power Utility Corporation ("APUC" or "Parent Company"), a publicly traded company on the Toronto Stock Exchange.[11] APUC is geographically as diverse as any other publicly traded company in RUCO's proxy and perhaps more so. APUC operates in two countries, the U.S. and Canada.[12] The Company operates regulated and unregulated facilities in several Canadian provinces and U.S. states. APUC's regulated facilities in the U.S. stretch from New Hampshire to California. *Id.* They are not regionally constrained by one jurisdiction, climate, or economy. APUC is

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[7] Ex. A-6 at 3.
[8] T: 155-56.
[9] RUCO's Closing Brief at 8-9.
[10] Company's Initial Closing Brief, p.16.
[11] Ex. RUCO-1 at 2-3.
[12] See Attached announcement dated April 1, 2013 from APUC

more economically diverse than most of the companies in RUCO's proxy. APUC owns and operates a diversified $3.0 billion portfolio of regulated and non-regulated utilities generation, transmission and distribution utility systems. *Id.* The Company has regulated gas, electric, water and wastewater companies as well as several unregulated thermal, renewable and sustainable energy facilities. *Id.* While RRUI is not publicly traded, it is owned 100 percent by APUC (via its subsidiary Liberty Utilities) which is publicly traded and has all of the benefits commensurate with a large diversified publicly traded company. For the Company to seek a small firm adjuster for RRUI as if it suffered the same liquidity or size constraints that might be experienced by other small stand-alone water companies regulated by the Arizona Corporation Commission is unreasonable. RUCO requests that the Commission deny the Company's request for a small firm adjustment to the cost of equity capital.

7. Upward Economic Adjustments are not warranted.

The Staff has calculated an 8.2 percent return. RUCO does not disagree with the Staff's final calculation because it reached nearly the same cost of equity capital RUCO derived from its own analysis. However, RUCO does question the use of a 60 basis point upward economic adjustment. First, the Staff asserts the economic adjustment is needed to address the economic uncertainty of the current economy. RUCO does not dispute the economic uncertainty exits, but it exits for ratepayers, as well. By adopting the upward economic adjustment of 60 basis points to its return on equity capital, the Staff seeks to insulate the $3.0 billion international company from the impact of an economic instability when ratepayers are not insulated from the same economic uncertainty.

The evidence shows that Santa Cruz County suffers from record unemployment of 17 to 20 percent as compared to the national average of 7.6 percent unemployment.[13] There was some public comment indicating that 78 percent of Santa Cruz school students qualify for federal subsidized lunch programs because their families' incomes fall below the poverty level.[14] If so, Staff's upward economic adjustment of 60 basis points to its recommended return on equity will insulate the Company from the impact of economic instability, but at the expense of customers who remain captive to those same conditions. On these circumstances, such an adjustment seems misplaced. Setting aside the issue of the economic adjustment, RUCO has no objection to the Staff's recommended 8.2 percent cost of equity. In total, it is objectively fair and reasonable and otherwise supported by the testimony and analysis of Staff's witness.

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. In addition, RUCO requests that the final order reflect that the Company has agreed that any additional amounts paid for the NWWTP will not include accrued or deferred carrying costs or interest.

RESPECTFULLY SUBMITTED this 15th day of May, 2013

Michelle L. Wood
Counsel

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[13] T: 357.
[14] T: 13

AN ORIGINAL AND THIRTEEN COPIES of the foregoing filed this 15th day of May, 2013 with:

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By ______________________

ATTACHMENT A

ALGONQUIN
Power & Utilities Corp.

Algonquin Power & Utilities Corp. announces closing of Georgia Natural Gas Distribution Acquisition

Company Release - 04/01/2013 17:01

OAKVILLE, ON, April 1, 2013 /CNW/ - Algonquin Power & Utilities Corp. ("APUC") (TSX: AQN) announced today that a subsidiary of APUC has closed the acquisition of assets of the regulated natural gas distribution utility serving Columbus and Gainesville, Georgia from Atmos Energy Corporation. The acquisition was originally announced in August 2012 and final regulatory approvals were received in February 2013.

Consideration for the utility asset purchase was approximately U.S. $140.7 million representing a multiple of net regulatory assets of 1.1x, plus working capital and closing adjustments.

Funding of the acquisition is within APUC's targeted 50% equity, 50% debt consolidated capital structure. A portion of the equity was funded through proceeds of $29.3 million from a previously announced private placement of 3.96 million shares issued to Emera Incorporated which closed on March 26, 2013.

The regulated natural gas distribution utilities provide natural gas service to approximately 64,000 customers in Georgia.

"Consistent with our objective of growing to more than one million customers in the US regulated utility sector by 2017, we are very pleased to have successfully closed the acquisition of this natural gas distribution utility in Georgia", commented Ian Robertson, Chief Executive Officer of APUC. "We are excited at expanding our utility footprint to the State of Georgia which we view as a supportive regulatory environment and one where we will continue to seek further opportunities for growth."

About Algonquin Power & Utilities Corp.
Algonquin Power & Utilities Corp. owns and operates a diversified $3.0 billion portfolio of regulated and non-regulated utilities in North America. The company's regulated utility business is committed to provide water, electricity and natural gas utility services to over 465,000 customers through a nationwide portfolio of regulated generation, transmission and distribution utility systems. The company's non-regulated electric generation subsidiary owns or has interests in renewable energy and thermal energy facilities representing more than 1,100 MW of installed capacity. Algonquin Power & Utilities Corp. delivers continuing growth through an expanding pipeline of renewable power and clean energy projects, organic growth within its regulated utilities and the pursuit of accretive acquisition opportunities. Common shares and preferred shares are traded on the Toronto Stock Exchange under the symbols AQN and AQN.PR.A respectively. Visit Algonquin Power and Utilities at www.AlgonquinPowerandUtilities.com and follow us on Twitter @AQN_Utilities.

Caution Regarding Forward-Looking Information
Certain statements included in this news release contain information that is forward-looking within the meaning of certain securities laws, including information and statements regarding prospective results of operations, financial position or cash flows. These statements are based on factors or assumptions that were applied in drawing a conclusion or making a forecast or projection, including assumptions based on historical trends, current conditions and expected future developments. Since forward-looking statements relate to future events and conditions, by their very nature they require making assumptions and involve inherent risks and uncertainties. APUC cautions that although it is believed that the assumptions are reasonable in the circumstances, these risks and uncertainties give rise to the possibility that actual results may differ materially from the expectations set out in the forward-looking statements. Material risk factors include those set out in the management's discussion and analysis section of APUC's most recent annual report, quarterly report, and APUC's Annual Information Form. Given these risks, undue reliance should not be placed on these forward-looking statements, which apply only as of their dates. Other than as specifically required by law, APUC undertakes no obligation to update any forward-looking statements or information to reflect new information, subsequent or otherwise.

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