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BEFORE THE ARIZONA CORPORATION

COMMISSIONERS

BOB STUMP - Chairman
GARY PIERCE
BRENDA BURNS
BOB BURNS
SUSAN BITTER SMITH

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

DECISION NO. 73996

OPINION AND ORDER

DATE OF HEARING:	March 27-29, 2013
PLACE OF HEARING:	Tucson, Arizona
ADMINISTRATIVE LAW JUDGE:	Jane L. Rodda
APPEARANCES:	Jay Shapiro, FENNEMORE CRAIG, PC, for Rio Rico Utilities, Inc.;
	Michelle Wood, Staff Attorney, Residential Utility Consumer Office;
	Charlene Laplante, Office of the Santa Cruz County Attorney, for Santa Cruz County;
	Roger C. Decker, UDALL SHUMWAY, PLC, for Santa Cruz Valley School District No. 35; and
	Bridget A. Humphrey, Scott Hesla, Matthew Laudone, Staff Attorneys, Legal Division for the Arizona Corporation Commission Utilities Division.

BY THE COMMISSION:

I. Background and Procedural History

Rio Rico Utilities, Inc. ("RRUI" or the "Company") provides water and wastewater service to an area of Santa Cruz County, Arizona. In the test year ended February 29, 2012, the Company provided water-only service to approximately 6,751 connections, and combined water and wastewater service to 2,207 connections. RRUI is a subsidiary of Liberty Utilities Co. ("Liberty Utilities"), which in turn is a subsidiary of Algonquin Power & Utilities Corporation ("APUC"), a publicly-traded corporation on the Toronto Stock Exchange.[1] Liberty Utilities is APUC's regulated utility business division and provides water, wastewater and electric utility services to more than 120,000 customers through 22 utility systems.[2] RRUI's current rates were set in Decision No. 72059 (January 6, 2011).

RRUI's service territory is very hilly, causing the water system to be divided into seven pressure zones and dotted with about 26 small pressure tanks and booster stations in addition to the major pumping and storage facilities.[3] The Company has six wells and 2,130,000 gallons of storage capacity. RRUI has two separate wastewater systems. The larger wastewater system, which serves approximately 2,060 customers, consists of five large pumping stations and enters the City of Nogales sewage collection system where it eventually reaches the Nogales International Wastewater Treatment facility. RRUI contracts with the City of Nogales for capacity. RRUI also operates a much smaller wastewater system which serves the "Villas Unit 12" subdivision, consisting of a single pumping station and an aerobic stabilization pond. This facility serves about 140 customers.

On May 31, 2012, RRUI filed an application with the Arizona Corporation Commission ("Commission") for a rate increase ("Rate Application").

On June 28, 2012, RRUI filed an Amendment to its Application.

On July 2, 2012, the Commission's Utilities Division ("Staff") notified the Company that its Rate Application was sufficient under the guidelines outlined in the Arizona Administrative Code ("A.A.C.") R14-2-103, and classified the utility as Class B.

On July 5, 2012, Staff filed a Proposed Schedule and Request for Procedural Order.

On July 6, 2012, the Residential Utility Consumer Office ("RUCO") filed an Application to Intervene.

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[1] Liberty Utilities also owns Liberty Energy Utilities, Co., which holds interests in a number of energy companies.
[2] Ex A-7 Sorensen Dir at 2. In addition, after filing its Rate Application, Liberty Utilities acquired two additional utilities, an electric distribution utility in New Hampshire and a natural gas distribution utility in Missouri, Illinois and Iowa, which together serve approximately 213,000 customers. *See* Tr. at 331 (Sorensen).
[3] Ex S-5 Liu Dir at Engineering Report.

By Procedural Order dated July 13, 2012, RUCO was granted intervention, the hearing in this matter was set for March 26, 2013, and other procedural deadlines were established, including dates to file written testimony and for intervention.[4]

On August 13, 2012, RRUI filed a Request to Modify Procedural Schedule by moving the start of the hearing one day later to March 27, 2013. By Procedural Order dated August 17, 2012, the request was granted.

On October 5, 2012, RRUI filed an Affidavit of Certification of Mailing and Publication indicating that notice of the hearing was published in the *Nogales International* on September 21, 2012, and mailed to customers on September 7, 2012, September 12, 2012, and September 24, 2012.

On December 13, 2012, Santa Cruz County ("County") filed a Request to Intervene, which was granted on December 28, 2012.

On December 31, 2012, Staff and RUCO filed direct testimony related to rate base and revenue requirement.

On January 7, 2013, Staff and RUCO filed direct testimony related to cost of capital and rate design.

On January 25, 2013, the Santa Cruz County School District No. 35 ("School District"), a customer of RRUI, filed a Motion to Intervene.[5]

On January 28, 2013, RRUI filed its rebuttal testimony.

On January 30, 2013, RRUI filed a Response to School District's request to intervene, stating that it did not object to the late request for intervention as long as the School District complied with the existing procedural schedule.

On February 4, 2013, School District was granted intervention, however, the Notification of Intervention recognized that the deadline to intervene was December 15, 2012, and specifically provided that School District must accept established deadlines for testimony and hearing, and would only be allowed to represent its own interests and not those of students, faculty or employees.

On February 19, 2013, RUCO and Staff filed their surrebuttal testimony.[6]

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[4] By Procedural Order dated July 19, 2012, the date for filing rejoinder testimony was corrected.
[5] The July 13, 2012, Procedural Order set December 15, 2012, as the deadline to request intervention.

On February 26, 2013, RRUI filed an Unopposed Request for Extension of Time to file rejoinder testimony. The Request was granted by Procedural Order dated February 28, 2013.

On March 1, 2013, RRUI filed a Request for Change to Pre-hearing Conference, to have the scheduled Pre-hearing Conference conducted telephonically. RRUI also filed a Motion to Bifurcate, requesting that the rate case be conducted in two phases, with the first phase addressing issues related to fair value and charges, and the second phase addressing the Company's request for a Distribution System Improvement Charge ("DSIC") for the Water Division and a Collection System Improvement Charge for the Wastewater Division. RRUI proposed that Phase 1 commence as scheduled on March 27, 2013, and that Phase 2 commence 20 days after a final decision by the Commission in the second phase of Arizona Water Company's ("AWC") pending rate case (Docket No. W-01445A-11-0310) in which a DSIC proposal was being considered.

On March 7, 2013, RUCO filed a Response to the Motion to Bifurcate. RUCO did not oppose bifurcation as long as: 1) all parties were allowed to supplement the record on how the cost of equity might be affected by the adoption of a DSIC mechanism; and 2) all pre-filed testimony related to the DSIC or the Sustainable Water Loss Improvement Program ("SWIP")[7] was included in the record.

On March 8, 2013, School District and County (collectively "Intervenors") filed a Response to RRUI's Motion to Bifurcate. Intervenors opposed bifurcation on the grounds that the DSIC is not a stand-alone rate-making issue and its approval would affect the Company's financial risk and cost of equity. Intervenors also alleged that they were prejudiced in this proceeding by RRUI's shifting positions on the issue of a DSIC-like mechanism, having first proposed a SWIP, then a Systems Betterment Cost Recovery ("SBCR") mechanism and then a DSIC. They requested that they be allowed to present verbal testimony or allowed additional time to file written testimony on the DSIC issue.

On March 11, 2013, RRUI filed a Reply to RUCO's Response and a Reply to the Intervenors' Response/Objection. RRUI objected to the Intervenors' request to file additional testimony during the

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[6] On February 21, 2013, RUCO filed a Notice of Errata, that corrected and replaced several pages of Mr. Coley's surrebuttal testimony.

[7] A predecessor proposal to the DSIC.

first phase of the proposed bifurcated proceeding because it would violate the deadlines established in Procedural Orders and would not give RRUI sufficient opportunity to conduct discovery or prepare. RRUI objected to RUCO's condition to supplement the record in Phase 2 because RRUI believed it would defeat the purpose of bifurcation and would result in re-litigating the cost of equity.

On March 12, 2013, Staff filed a Response in Support of Company's Motion to Bifurcate. Staff believed that any proceeding on the DSIC should await the outcome of the decision in the on-going AWC rate case because it was likely that any DSIC approved in the AWC docket would be used as a template for other utilities.

By Procedural Order dated March 20, 2013, it was determined that bifurcation of the proceeding as proposed by RRUI was not in the public interest given the issues raised by the parties concerning single issue rate making and the overlap of a DSIC or DSIC-like mechanism with other rate issues. The Procedural Order identified three options for proceeding, including: 1) proceed with the rate case on all issues as currently scheduled; 2) postpone the hearing on all issues until after the Commission's Decision in the AWC DSIC proceeding; or 3) proceed with a process along the lines suggested by RUCO, which would keep the current hearing dates, but also keep the record open to allow parties to file additional testimony on whether a DSIC is appropriate for RRUI, how the DSIC would function, and any effects of the DSIC on other ratemaking elements. Parties were instructed that the issue would be discussed at the March 21, 2013 Pre-hearing Conference.

A Pre-hearing Conference convened telephonically on March 21, 2013, to discuss the conduct of the hearing. In response to the ruling in the March 20, 2013 Procedural Order regarding the issue of the DSIC, RRUI withdrew its request for a DSIC in this proceeding. The parties agreed that the pre-filed testimony addressing the DSIC and its predecessor-mechanisms would be withdrawn.[8]

The Hearing convened on March 27, 2013, as scheduled, and continued over the following two days, concluding on March 29, 2013. Christopher Krygier, the utility rates and regulatory manager for Liberty Utilities, Greg Sorensen, Vice President and General Manager for Liberty

[8] Transcript of March 21, 2013 Prehearing Conference at 6-8.

Utilities and Tom Bourassa, a rate consultant, testified for RRUI; William Rigsby testified for RUCO;[9] and John Cassidy, Jian Liu and Gordon Fox testified for Staff. Neither County nor School District filed written testimony and consequently did not have their own witnesses, but participated in cross examination.

On April 23, 2013, RRUI, RUCO and Staff filed Final Schedules.

RRUI, RUCO, Intervenors,[10] and Staff filed Closing Briefs on May 3, 2013.

Staff filed its Reply Brief on May 10, 2013; and RRUI and RUCO filed their Reply Briefs on May 15, 2013. Intervenors did not file a Reply Brief.

The Commission received approximately ten written consumer comments (one including a "petition" of 27 names) objecting to the rate increase. At the commencement of the hearing, the Commission took public comment and heard from a School District employee about the effect of the rate increase on the School District, and from a Santa Cruz County Supervisor.[11] The over-riding concern of commenters was the magnitude of the rate increase and the adverse impact on an economically depressed area. One other member of the public, unaffiliated with any party and not a customer of RRUI, appeared in person to make comment to address rate design.[12]

II. Summary of the Rate Application

In a rate case it is typical that the parties' positions on rate base, revenue requirement and rate design, etc., evolve as they engage in discovery and review the positions of the other parties. In this case, the process of narrowing issues resulted in agreement by the Company, RUCO, and Staff on all rate base, operating expense and rate design issues, as well as on capital structure. At the hearing the only issue between these three parties was the cost of capital and the fair value rate of return.[13] The County and School District did not reach agreement with the other parties, and contested certain operating expenses, capital structure and cost of capital.

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[9] Mr. Rigsby adopted the testimony of Mr. Coley. Transcript of the March 27-29, 2013 Hearing ("Tr.") at 435-36.
[10] County and School District filed a Combined Opening Brief.
[11] Although normally the Commission expects Intervenors to make their positions known through their participation as parties and does not allow them to also make public comments, in this case, because neither County nor School District were presenting witnesses, and were not familiar with Commission practice, the individuals affiliated with the Intervenors were allowed to make public comment.
[12] Tr. at 20-26.
[13] RUCO Closing Brief at 1; Staff Closing Brief at 2; RRUI Initial Closing Brief at 1.

In its Rate Application, the Company originally requested a revenue increase of $604,079 for its Water Division, which represented a 21.16 percent increase over test year revenues of $2,854,838. The Company proposed a rate base of $7,629,607 for its Water Division, and a rate of return of 9.7 percent, using a pro forma capital structure of 20 percent debt and 80 percent equity.[14] For its Wastewater Division, RRUI requested a revenue increase of $393,612, which represented a 28.93 percent increase of over adjusted test year revenues of $1,360,583. The Company proposed a rate base of $4,600,012 for the Wastewater Division, and a rate of return of 9.7 percent based on a pro forma capital structure of 20 percent debt and 80 percent equity.[15] Initially, the Company was also requesting a SWIP mechanism, but as discussed above, subsequently withdrew that request.

As a final position, RRUI, Staff and RUCO agreed that the Original Cost Rate Base ("OCRB") for the Water Division should be $7,731,209.[16] RRUI did not provide Reconstruction Cost New Less Depreciation data, and thus its Fair Value Rate Base ("FVRB") is deemed to be the same as its OCRB. For the Wastewater Division, RRUI, Staff and RUCO recommend a FVRB of $4,790,738.[17]

As a final position, RRUI agrees with Staff and RUCO that the Company's actual capital structure consisting of 100 percent equity should be used to determine its authorized rate of return. Because these parties recommend employing the actual capital structure of 100 percent equity, their proposed Cost of Equity ("COE") is also the Company's Weighed Average Cost of Capital ("WACC") and recommended authorized return. RRUI proposes a fair value return of 9.5 percent.[18] RUCO recommends a fair value return of 8.25 percent.[19] Staff recommends a fair value return of 8.2 percent.[20]

The Intervenors argue that the RRUI's Rate Application should be denied because it does not comply with the filing requirements set forth in A.A.C. Title 14, Chapter 2, by failing to include the

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[14] Ex A-1 Bourassa Rev Req Dir. Sch A-1 (Water). In direct testimony the Company proposed a cost of debt of 5.7 percent and cost of equity of 10.7 percent for a Weighted Average Cost of Capital of 9.7 percent.
[15] Ex A-1 Bourassa Rev Req Dir at Sch A-1 (Wastewater).
[16] Staff Final Sch MJR-W1; RRUI Final Sch W A-1; RUCO Final Sch TJC-1 (W).
[17] Staff Final Sch MJR-WW-1; RRUI Final Sch A-1 (WW); RUCO Final Sch TJC-1(WW).
[18] Ex A-6 Bourassa COC Rj at 4; RRUI Closing Brief at 12.
[19] Tr. at 151 (Rigsby).
[20] Ex S-2 Cassidy Surr at 2.

G Schedules regarding a Cost of Service Study ("COSS"). If the Commission does not deny the Rate Application, the Intervenors argue as an alternative position, that the proceeding should be delayed until the Company files the G Schedules and there is an opportunity to vet them in a hearing. As a second alternative, the Intervenors argue that if the Rate Application is not denied or delayed, the new rate increase should be applied proportionately across all rates and charges.[21]

In the event that the Commission determines that the Rate Application is sufficient, the Intervenors recommend employing a capital structure composed of 50 percent debt and 50 percent equity, with a cost of debt of 4.13 percent, cost of equity of 8.0 percent, and an authorized return of 6.07 percent.[22] If the Commission does not adopt their preferred recommended 50/50 debt/equity capital structure, the Intervenors recommend employing RRUI's originally proposed capital structure consisting of 20 percent debt and 80 percent equity, with a cost of debt of 4.13 percent, and COE of no more than 8.0 percent, and a WACC of 7.226 percent.[23]

For the Water Division, a summary of the parties' proposed revenue requirements and proposed revenue increases follows:

	Revenue Requirement	Revenue Increase	% Increase
Company – Direct[24]	$3,458,917	$604,079	21.16%
Staff – Direct[25]	$3,199,993	$345,155	12.09%
RUCO – Direct[26]	$2,987,529	$90,894	3.14%
Company –Rebuttal[27]	$3,360,630	$581,865	20.94%
Staff – Surrebuttal[28]	$3,122,698	$257,875	9.00%
RUCO – Surrebuttal[29]	$3,071,393	$206,273	8.25%
Company – Rejoinder[30]	$3,432,784	$644,939	23.13%

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[21] Intervenors' Combined Closing Brief at 1-3.
[22] Intervenors' Combined Closing Brief at 3-12.
[23] Intervenors' Combined Closing Brief at 11.
[24] Ex A-1 Bourassa Rev Req Dir at Sch A-1(W).
[25] Ex S-3 Rimback Dir at Sch MJR-W1.
[26] Ex RUCO-4 Coley Rev Req Dir at TJC-1(W).
[27] Ex A-3 Bourassa Rev Req Reb at 3.
[28] Ex S-4 Rimback Surr at Sch MJR-W1.
[29] Ex RUCO-6 Coley Rev Req Surr at TLC-1(W).
[30] Ex A-5 Bourassa Rev Req at 3.

Company – Final[31]	**$3,385,270**	**$520,150**	**18.15%**
Staff - Final[32]	**$3,218,519**	**$353,697**	**12.35%**
RUCO – Final[33]	**$3,224,824**	**$359,704**	**12.55%**

The Intervenors did not file Final Schedules. For the Water Division, assuming a FVRB of $7,731,209 (as agreed by the other parties) and an authorized rate of return of 6.07 percent, the required operating income for the Water Division would be $469,284. Based on test year operating income of $420,933, the operating income deficiency would be $48,534, and assuming a gross revenue conversion factor of 1.6589, the required revenue increase under the Intervenors' positions would be $80,513, or 2.8 percent greater than adjusted test year revenues.[34]

For the Wastewater Division, the parties recommended the following rate increases:

	Revenue Requirement	Revenue Increase	% Increase
Company – Direct[35]	$1,754,195	$393,612	28.93%
Staff – Direct[36]	$1,535,236	$141,635	10.16%
RUCO – Direct[37]	$1,405,272	$3,060	0.22%
Company –Rebuttal[38]	$1,605,670	$235,540	17.19%
Staff – Surrebuttal[39]	$1,522,877	$120,034	8.56%
RUCO – Surrebuttal[40]	$1,467,898	$65,054	4.64%
Company - Rejoinder[41]	$1,649,662	$279,532	20.40%
Company - Final[42]	**$1,596,136**	**$193,293**	**13.78%**
Staff - Final[43]	**$1,492,819**	**$89,976**	**6.41%**

[31] RRUI Final Sch (W) A-1. RRUI's Final Schedules show adjusted test year revenue of $2,865,120.
[32] Staff Final Sch MJR-W1. Staff's Final Schedules indicate adjusted test year revenue of $2,864,823.
[33] RUCO Final Sch TJC-1 (W). RUCO's Final Schedules reflect adjusted test year revenues of $2,865,120.
[34] These estimates to not include the impact on operating income that would result under Intervenors' pro forma capital structures.
[35] Ex A-1 Bourassa Rev Req Dir at Sch A-1 (WW).
[36] Ex S-3 Rimback Dir at Sch MJR WW-1.
[37] Ex RUCO-4 Coley Rev Req TJC-1 (WW).
[38] Ex A-3 Bourassa Rev Req Reb at 3.
[39] Ex S-4 Rimback Surr at Sch MJR WW-1.
[40] Ex RUCO-6 Coley Rev Req Surr TJC-1 (WW).
[41] Ex A-5 Bourassa Rate Base Rj at 3.
[42] RRUI Final Sch WW A-1.

RUCO - Final[44]	**$1,496,766**	**$93,922**	**6.70%**

For the Wastewater Division, the Intervenors' recommendations would produce a required operating income of $290,798.[45] Based on test year adjusted operating income of $338,603, the Intervenors' recommendations would result in a revenue decrease of $47,805, or 3.4 percent, for the Wastewater Division.

III. Is RRUI's Application Sufficient?

The Intervenors state that A.A.C. R14-2-103(B) defines the filing requirements that all utilities must follow when filing an application for a proposed increase in rates or charges. They assert that a Class B Utility, such as RRUI, is required to file COSS G Schedules when: 1) the utility is in a segment of the utility industry that recognizes cost of service studies as important tools for rate design; and 2) costs incurred by the utility are likely to vary significantly from one defined segment of customers to another.[46]

Intervenors argue that the fact that RRUI filed a COSS in its previous rate case supports the conclusion that RRUI is in a segment of the utility industry that recognizes cost of service studies as important tools for rate design, and acknowledges that the costs incurred by RRUI are likely to vary significantly from one defined segment of customers to another.[47] The Intervenors argue further that because RRUI is the same utility in this case as it was in the last case, RRUI is required to file the G schedules; and the failure to file G Schedules violates the filing requirements of R14-2-103(B) and results in an application that is insufficient on its face.

RRUI argues that Intervenors' claim that a COSS is required is untimely.[48] The Company asserts that a Motion to Dismiss of this kind should be brought at the outset of the case, or at least at the time of intervention. RRUI argues that because Intervenors waited until after the evidence was

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43 Staff Final Sch MJR-WW1.
44 RUCO Final Sch TJC-1 (WW).
45 The agreed FVRB of $4,790,738 x 0.0607.
46 A.A.C. R14-2-103.
47 Intervenors' Combined Opening Brief at 1. Intervenors asserted that RRUI filed a COSS in its last rate case, based on the testimony of Mr. Bourassa in this case (Tr. at 411), but RRUI states that records show that RRUI did not file a COSS in its last rate case, and that Mr. Bourassa misspoke on the stand. RRUI Reply Closing Brief at 8, fn 35.
48 RRUI Reply Closing Brief at 6.

presented, they should be deemed to have waived any such claim.[49] In addition, RRUI states that the Commission has delegated to Staff the determination of whether an application meets its filing requirements.[50] The Company notes that in this case, Staff found that the Rate Application was sufficient on July 3, 2012, which equates to a finding by Staff that the G Schedules were neither necessary nor required in this case. RRUI argues that Intervenors could have petitioned the Commission to reconsider Staff's sufficiency finding, but did not, and thus, Staff's finding of sufficiency, without the G Schedules must stand.

RRUI also claims that it is not unusual for water and wastewater company rate applications to be filed and decided without a COSS. The Company states that Liberty Utilities filed and received several rate orders in Arizona since it acquired its first public service corporation in 2001, and only a couple of those cases contained the G Schedules, and none were dismissed for lack of a COSS.[51] RRUI also asserts that often rate applications are decided by this Commission without G Schedules and currently, there are several pending rate cases in which the applicant did not file G Schedules.[52]

RRUI asserts that the cost of performing a COSS is one of the reasons that they are not always performed. In this case, the Company notes that it and RUCO agreed to adopt Staff's rate design, and neither Staff nor RUCO felt that a COSS was needed, either as a requirement of the application, or to support rate design. RRUI states that either Staff or RUCO could have submitted their own COSS if they believed one was necessary.

Staff asserts that no evidence was presented in this case that costs incurred by RRUI are likely to vary significantly between customer segments.[53] Staff disagrees with the Intervenors' conclusion that filing a COSS in a previous rate case, means that a company: 1) is in a segment of the utility industry that recognizes that cost of service studies are important tools for rate design; or 2) the costs incurred by the utility are likely to vary by customer class. Staff asserts that RRUI may have opted

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[49] *Citing*, *Douglas v, Mundell*, 2009 WL 2766746 at *5 (Ariz. App. 2009), and *Westin Tucson Hotel Co. v Ariz. Dep't of Rev.*, 183 Ariz. 360, 364; 936 P.2d 183, 187 (App. 1997); RRUI Reply Closing Brief at 7.

[50] A.A.C. R14-2-103.B.7 provides that after a rate application is filed, Staff has 30 days to determine sufficiency.

[51] RRUI Reply Closing Brief at 7.

[52] RRUI Reply Closing Brief at 8; Global Water-Palo Verde Utilities Company, Docket No. WS-20445A-12-0310 and Far West Water & Sewer, Inc., Docket No. WS-03478A-12-0307.

[53] Staff Reply Brief at 2.

for a COSS in the last case for reasons other than a significant difference between costs among customer segments. Staff states further that a COSS is relevant primarily in addressing rate design issues, but rate design is not a disputed issue in this proceeding—even for Intervenors.[54] Furthermore, Staff argues that Intervenors had opportunity to raise the issue, or engage in discovery, at or before the hearing, but failed to do either.

Intervenors did not raise their claim about the sufficiency of RRUI's Rate Application until they filed their closing brief. They could have raised the issue at the time that they sought intervention or at the pre-hearing conference, or any time in between. To wait until the conclusion of the evidentiary hearing to raise a claim of sufficiency is unreasonable, and inconsistent with judicial efficiency. We find that by not raising the issue earlier Intervenors waived this claim.

Moreover, the Commission's Rules delegate the authority to determine sufficiency of an application to Staff, and the Commission relies on Staff's expertise to determine when an application is sufficient. Often Staff will conclude that a rate application is sufficient for water and wastewater companies when the applicant has not filed a COSS; and the Commission often makes determinations of just and reasonable rates without a COSS. At no time in this proceeding, did any party claim that information contained the G Schedules is necessary to a decision in this matter. Not even Intervenors make that claim. There is no indication that RRUI's cost of serving its various rate classes varies significantly such that a COSS is necessary to set rates in this case. Consequently, we deny the Intervenors' request to delay this proceeding.

IV. Rate Base

In its Rate Application, the Company proposed a FVRB of $7,629,604 for the Water Division and $4,600,312 for the Wastewater Division. By the time RRUI filed its rejoinder testimony, there was only one rate base issue in dispute—how RRUI was accounting for retired plant and its depreciation of fully depreciated or retired plant. Initially, Staff expressed concerns that the Company was recording depreciation expense on plant that had been fully depreciated, which affected the depreciation expense and accumulated depreciation balances. RRUI, Staff and RUCO

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[54] Staff Reply Brief at 2.

each proposed an adjustment to correct the retired plant issue using a different methodology and the issue remained unresolved.[55]

This issue arose because of poor record keeping by RRUI's predecessor.[56] RRUI and Staff agreed to resolve this issue consistent with the resolution of a similar issue affecting the Bella Vista Water Company.[57] RUCO ultimately agreed to the FVRB resolution worked out between Staff and RRUI. The resolution among the three parties results in (1) a finding of fair value rate base equal to $7,731,209 (Water), and $4,790,738 (Wastewater); (2) a level of depreciation expense equal to $441,453 (Water) and $223,774 (Wastewater) which the parties agree eliminates potential overstatement or over-recovery by the Company.[58] In addition, in order to ensure that the Company remedies the problem permanently, RRUI has been put on notice that a repeat of this issue could result in the imposition of penalties.[59]

For the Water Division, RRUI, RUCO and Staff agree on the following components of rate base:

Utility Plant-In-Service	$34,454,989
Accumulated Depreciation	$13,754,657
Net Utility Plant	$20,700,332
Advances in Aid of Construction	$660,955
Contributions in Aid of Construction	$20,179,119
CIAC – Amortization	$8,617,752
Customer Meter Deposits	$284,084
ADIT	$462,717
Total Rate Base	$7,731,209

For the Wastewater Division, RRUI, RUCO and Staff agree on the following:

[55] Ex A-3 Bourassa Rev Req Reb at 6. Staff Closing Brief at 3.
[56] Ex A-3 Bourassa Rev Req Reb at 8; Ex A-5 Bourassa Rj at 10
[57] Ex A-3 Bourassa Rev Req Reb at 7-8; Ex A-5 Bourassa Rj at 7; RRUI Initial Closing Brief at 4; Staff Closing Brief at 3; Tr. at 34 (Krygier); *See* Decision No. 72251 (April 4, 2011). Bella Vista Water Co. is also owned by Liberty Utilities.
[58] Tr. at 440 (Rigsby) and at 540 (Fox). RRUI and RUCO accepted Staff's adjustments to Depreciation Expense of $109,768 for the Water Division and $135,855 for the Wastewater Division. Staff Reply Brief at 1; *See also* Final Schedules.
[59] RRUI Initial Opening Brief at 5; Staff Closing Brief at 3.

Utility Plant-In-Service	$12,751,357
Accumulated Depreciation	$4,698,882
Net Utility Plant	$8,052,475
Advances in Aid of Construction	$293,794
Contributions in Aid of Construction	$5,152,673
CIAC – Amortization	$2,491,137
Customer Meter Deposits	$22,963
ADIT	$283,444
Total Rate Base	$4,790,738

Intervenors did not recommend adjustments to RRUI's proposed FVRB for either the Water or Wastewater Divisions, nor did they join in the other parties' recommendations that resolved issues.

The evidence presented in the proceeding indicates that RRUI's FVRB is $7,731,209 for the Water Division, and $4,790,738 for the Wastewater Division.

V. Income Statement Adjustments

After the filing of written testimony, several issues affecting operating revenue and expenses remained. Staff and RUCO both disputed the amount of corporate cost allocations as well as the Company's request for declining usage and purchased power adjustments. Staff disputed the amount of employee benefit expenses related to a new pension plan; and RUCO disputed the amount of incentive pay, the amortization period for rate case expense, and the level of expense for the Nogales Wastewater Treatment Plant ("NWWTP"). On the first day of the hearing, Staff and RRUI reached agreement on all rate base and income statement issues, as well as on rate design.[60] RUCO reached agreement with the Company and Staff on these issues by the second day of hearing.[61] Intervenors did not reach agreement with RRUI on the employee benefit expense; they did not raise any other objections to specific revenue or expense adjustments.

[60] Ex A-16; Tr. at 31-35; 265-68 (Krygier).
[61] Ex A-17; Tr. at 401-405 (Krygier).

A. Pension Plan

The issue concerning employee benefits involved a new employee benefit plan that was announced late in 2012, (after the start of this rate case), and implemented as of January 1, 2013, (after the end of the test year). In its rebuttal testimony, the Company proposed a pro forma adjustment of $32,891 for the Water Division and $11,811 for the Wastewater Division for the allocation of pension plan expenses.[62] Staff initially opposed the pro forma adjustments because Staff believed that RRUI had failed to sufficiently document certain items and because Staff claimed that it did not have a reasonable opportunity to evaluate the plan.[63] However, during the hearing, RRUI, Staff and RUCO agreed that a total expense level of $32,891 for the Water Division and $11,811 for the Wastewater is fair and reasonable.[64] In addition, in order to ensure that the Company does not fail to contribute to the pension plan in 2013 as intended, RRUI agreed to: (1) make a compliance filing reflecting that the pension fund payments have been made in 2013; and (2) an accounting order that would allow it to track any amounts that are lower than the amounts authorized in this case.[65]

Intervenors argue that the pro forma employee benefit adjustment should be rejected because the expense is out-of-test year and not auditable as it still has not been incurred. In addition, they argue that RRUI was unable to provide any information or documentation supporting these expenses as they relate to RRUI, and that the adjustments fail the "known and measurable" standard. In their closing brief, Intervenors assert that there is no third-party documentation supporting its applicability to RRUI because there is no evidence linking the Cottonwood Group's services with RRUI's spreadsheet showing the expense for each employee.[66] Intervenors argue that although the Company

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[62] Ex A-8 Sorensen Reb at 6; Ex A-9 Sorensen Rj at 5; Ex A-3 Bourassa Rev Req Reb at 33 and 46.
[63] Ex S-4 Rimback Surr at 16 and 19.
[64] Tr. at 394 (Sorensen); Tr. at 440 (Rigsby); Tr. at 450 (Fox).
[65] Ex A-17, n 1. The Company states that it is its understanding that the accounting order would create a regulatory liability in the event of major changes in the level of pension funding. The Company states, however, that it does not believe that it should face a liability for fluctuations in the annual amount of pension contributions that arise strictly from changes in personnel, any more than it would expect a regulatory asset to be created if pension contributions were to increase each year for the next few years between rate cases. The Company states that the goal of the regulatory liability is to create assurances to RUCO that the expense would be incurred at the level authorized in rates, and if not, captured on the balance sheet accordingly. Tr. at 394 (Sorensen) and 403 (Krygier). *See* RRUI Initial Opening Brief at 6, n 29.
[66] The Cottonwood Group provided actuarial, administrative and consulting services to Liberty Utilities regarding the pension plan. Confidential Ex RUCO-3.

provided a spread sheet listing employee names and the amount of the alleged employee benefits expenses, it provided no supporting documentation of how they arrived at the alleged figures. They state that at the hearing RRUI was only able to provide a contract for services between Liberty Energy Utilities and the Cottonwood Group for pension consulting services. Intervenors state that Liberty Energy Utilities is a separate legal entity, and RRUI was unable to produce any evidence that the Liberty Energy Utilities Contract with the Cottonwood Group applied to, or included, RRUI.[67] Intervenors argue that RRUI failed to produce any plan by the Cottonwood Group recommending employee benefit payments to the individuals claimed in RRUI's pro forma adjustment.

RRUI argues that pro forma adjustments, such as the pension plan costs in this case, are not only authorized by the Commission's Rules, but are common and necessary to properly reflect a utility's costs of providing service during the time the new rates will be in effect.[68] RRUI asserts that there can be no legitimate dispute that Liberty Utilities is implementing a pension plan in 2013. The Company asserts that the pension plan is a critical component of its ability to attract qualified personnel, and the pension costs are known and measureable. In response to the Intervenors' claim that there is no evidence that the plan applies to Liberty Utilities, RRUI cites the testimony of Mr. Sorensen explaining the plan and its applicability to Liberty Utilities.[69] Moreover, the Company asserts that the ratepayers are fully protected in this case because the Company has agreed to a mechanism that would create a customer credit in the next rate case in the event that the pension plan is not funded in 2013.

Staff disagreed with Intervenors' position objecting to the pro forma employee benefit adjustment because although at the time of the hearing the written plan was still being prepared for RRUI, the evidence indicates that the plan is a national plan applicable to RRUI's affiliates; the Company provided details about the names of employees to receive benefits and the anticipated amounts thereunder; and the Company testified about the annual cost of the plan, including payments to be made in 2013.[70]

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[67] Ex Santa Cruz County-5.
[68] RRUI Reply Closing Brief at 9.
[69] Ex A-8 Sorensen Rb at 5-7; Tr. at 361-364, 393-395 (Sorensen); and late-field confidential exhibits filed with the closing briefs.
[70] Tr. at 281, 287-288, 261-363. Staff's Reply Brief at 4-5.

On May 3, 2013, (with its Initial Closing Brief), RRUI provided a confidential Summary of Liberty Utilities' Cash Balance Pension Plan (Effective January 1, 2013). On May 15, 2013, RRUI provided a copy of Liberty Utilities' Cash Balance Pension Plan signed by the Chief Executive Officer of APUC, the ultimate parent of RRUI.[71] These documents indicate that the pension plan applies to Liberty Utilities Co., as the sponsor, and Liberty Water as the Employer, and any person employed by the Employer or an Affiliate. As a subsidiary of Liberty Water, RRUI would be an affiliate. Although at the time of the hearing, RRUI did not have access to the final pension plan agreement, the evidence shows that Liberty Water and RRUI employees are covered by the pension plan. Commission Rules allow for pro forma adjustments to test year results in order to obtain a normal or more realistic relationship between revenues, expenses and rate base.[72] The cost of the pension plan is known and measureable, and is an appropriate pro forma expense as the pension plan applies to test year employees and costs will be incurred during the time the new rates go into effect. If for some reason, the pension plan costs are not incurred at the level anticipated, RRUI ratepayers will be protected by the creation of a regulatory liability. The pension plan costs approved are for current employees, and any increased pension costs attributed to future employees are not being collected in the rates we approve herein, nor are we approving an accounting order that would allow RRUI to seek future recovery of pension plan costs incurred between rate cases attributable to future employees, or even to increased costs attributed to current employees. The accounting order in this case is solely to protect ratepayers in the event that the pension plan is not funded as anticipated. It is not an adjustor type mechanism to recover increased pension plan costs. Consequently, we adopt the positions of RRUI, RUCO and Staff concerning pension plan costs, which include $32,891 for the Water Division and $11,811 for the Wastewater Division.

B. <u>Incentive Pay</u>

In pre-filed testimony, RUCO recommended adjustments to wages and salary expense of $19,997 for the Water Division and $9,448 for the Wastewater Division, for incentive pay.[73] RUCO

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[71] RRUI stated that the Plan is not available to the public and requested that it be treated as "confidential."
[72] A.A.C. R14-2-103.
[73] Ex RUCO-4 Coley Rev Req Dir at 10 and 48; Sch TJC-11 (W) and (WW). Staff did not make a similar adjustment.

recommended a 50/50 sharing of the incentive pay expenses between ratepayers and shareholders.[74] The Company countered that the incentive pay expense was part of Liberty Water's compensation plan and important in attracting the most qualified personnel.[75] The Company argued that the incentives are based on metrics such as "Customer Experience, Employee programs, Operational Excellence, Safety, Efficiency and personal performance."[76] At the hearing, RUCO agreed to drop this adjustment.[77]

For purposes of this rate case, we accept the parties' positions that incentive pay is at an appropriate level in this case. The evidence supports a finding that it is a part of the basic compensation package for employees and provides benefits to rate payers. Staff's testimony always supported its inclusion. However, our adoption of this expense item at this level as part of a "settlement-like" arrangement among the parties should not be interpreted as limiting our ability to evaluate this expense item, and its allocation between ratepayers and shareholders, in future rate cases.

C. <u>Nogales Wastewater Treatment Plant Expense</u>

Most of RRUI's wastewater customers are serviced by the NWWTP which is owned by the City of Nogales, but operated by the International Boundary Water Commission ("IBWC"). RRUI contracts with the City of Nogales for use of the plant facilities.

In its Rate Application, the Company utilized the test year level of expenses related to the NWWTP of $165,896 ($13,829 per month) for the cost of the operation and maintenance of the plant. RRUI and the City of Nogales entered into an agreement that resulted in retroactive reductions to the test year level of expense, reducing the monthly cost to $9,083.[78] Because the Company had been paying $9,083 per month since February 2012, RUCO adjusted the test year operating expense to reflect this amount.[79]

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[74] Ex RUCO-4 Coley Rev Req Dir at 10 and 45; Ex RUCO-6 Coley Rev Req Surr at 22.
[75] Ex A-8 Sorensen Reb at 4-5; Ex A-9 Sorensen Rj at 2-3.
[76] Ex A-8 Sorensen Reb at 5.
[77] Ex A-17.
[78] Ex RUCO-6 Coley Surr at 35-36; RUCO Reply Brief at 2.
[79] Staff did not raise this issue in pre-filed testimony.

The contract with the City of Nogales is subject to true-up depending on the actual cost of operating the plant. RRUI asserts that the City of Nogales has not always reconciled the annual amounts in a timely manner which created uncertainty surrounding the test year level of expense and whether there may be a lump sum payment due in the future as a result of the true-up process.[80]

Ultimately, RRUI, RUCO and Staff agreed to utilize RUCO's recommended expense level for the NWWTP based on the amount that the Company is currently paying, and that an accounting order should be issued allowing RRUI to track any additional amounts it is required to pay for treatment after the City of Nogales trues-up the charges.[81] The result is that in a future rate case, the Company can seek to recover any additional amounts paid to the City of Nogales as a regulatory asset, or if the costs decrease, the customers would receive the benefit of a regulatory liability.[82] In addition, the Company 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.[83] RUCO's adjustment decreased the NWWTP annual expense by $56,897, from $165,896 to $108,999.

The parties' agreed treatment for the expenses associated with the NWWTP is reasonable. At the time of the hearing RRUI was paying $9,083 a month to the City of Nogales. In a letter from the City of Nogales to RRUI dated March 26, 2013, it appears that RRUI will incur this level of expense through the end of 2013.[84] RRUI does not have control over the expenses of the NWWTP. In the annual true-up process, the expense may be further adjusted, up or down, by the IBWC and City of Nogales. Because the cost of operating the NWWTP is a necessary cost of providing service, it is reasonable that RRUI track any changes in the contract price in the period between rate cases. RRUI would then be allowed to seek recovery of any increased costs as a result of the true-up of the contract. Likewise, if costs are lower than those recognized herein, ratepayers should receive the benefit of the contract true-up. The Commission will determine at the time RRUI files its request

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[80] Ex A-5 Bourassa Rj at 29.
[81] Ex A-17, n 4.
[82] RRUI Initial Opening Brief at 8. The Company states that it is its understanding that it is possible it will pay lower amounts and that a regulatory liability would be created and further that neither RUCO nor Staff are waiving their rights to object to the recovery of amounts tracked per the accounting order in a future rate case. Tr. at 406 (Krygier).
[83] Tr. at 376 (Sorensen).
[84] Ex Santa Cruz County-2, Tr. at 332-336 (Sorensen).

whether, and how, to grant the request to recover or refund any additional costs or reductions incurred between rate cases.

D. Amortization of Rate Case Expense

RRUI, RUCO and Staff agreed on a total Rate Case Expense of $350,000, allocated between the two divisions based on customer numbers.[85] Initially, RRUI and Staff utilized a three year amortization/normalization schedule, while RUCO recommended a four year schedule. RRUI argued that the three year schedule reflects Liberty Water's policy to bring its companies in for rate increases in roughly three-year intervals and RRUI's history under Liberty Water ownership.[86] RUCO ultimately agreed to a three year schedule, and all parties agree that the annual expense level of $87,500 for the Water Division and $29,167 for the Wastewater Division is fair and reasonable.[87]

A three year normalization period is reasonable based on RRUI's history of applying for rate adjustments. The rate case amount of $350,000 appears reasonable given the size of the utility and number of issues addressed. We adopt the recommendations of the parties.

E. Declining Usage Adjustment and Purchased Power Adjustment

The Company claims that it has experienced declining revenues from water sales under the rate designs approved in recent rate cases.[88] In its rebuttal testimony, RRUI proposed reducing test year revenue by $77,275 for the Water Division and $32,713 for the Wastewater Division to account for the declining sales.[89] In addition, the Company noted that its electric provider UNS Electric has filed an application with the Commission for a rate increase, which will increase RRUI's cost of service.[90] The Company proposed a purchased power adjustment of $17,083 for the Water Division and $2,819 for the Wastewater Division.[91] Staff and RUCO recommended against these adjustments, and the Company withdrew both of these proposed adjustments.[92]

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[85] Ex A-1 Bourassa Rev Req Dir at 11. RRUI Initial Opening Brief states that the rate case expenses were $335,000. This appears to be a misstatement. RRUI Initial Opening Brief at 8.
[86] Ex A-3 Bourassa Rev Req Reb at 34-35; Ex A-5 Bourassa Rev Req Rj at 24.
[87] Tr. at 440 (Rigsby) and 450 (Fox).
[88] RRUI Initial Opening Brief at 8.
[89] Ex A-3 Bourassa Rev Req Reb at 29 and 41.
[90] Ex A-3 Bourassa Rev Req Reb at 32.
[91] Ex A-3 Bourassa Rev Req Reb at Sched C-1 2.1 (W) and (WW).
[92] RRUI Initial Opening Brief at 8.

The Company has determined not to pursue these adjustments. We accept that decision. We note that the rates that will result from the pending UNS Electric rate case were not known and measurable at the time of this proceeding and thus, a pro forma adjustment would not have been appropriate.[93]

VI. Cost of Capital

In their final positions, RRUI, RUCO and Staff utilized the Company's actual capital structure of 100 percent equity. Thus, for these parties, their recommended COE is equivalent to the WACC and their recommended fair value rate of return. The Intervenors recommend utilizing a pro forma capital structure and a fair value rate of return equal to the calculated WACC.

RRUI proposed a COE of 9.5 percent; RUCO recommended a COE of 8.25 percent; Staff recommended a COE of 8.2 percent; and Intervenors recommended a COE of not more than 8.0 percent, a cost of debt of 4.13 percent, and a WACC ranging between 6.07 percent and 7.226 percent depending on the pro forma capital structure utilized.

A. RRUI

As a final position, RRUI utilized the Company's actual capital structure, and argued that the choice between the hypothetical and actual capital structure was not material because while the use of a pro forma capital structure would include interest synchronization, which would lower operating expenses, it would increase the cost of equity because of greater financial risk, thus effectively offsetting the benefit of the interest synchronization.[94]

Because RRUI is not publicly traded, there is no market data specific to RRUI. As a result, RRUI's cost of capital witness, Mr. Bourassa, used the Discounted Cash Flow ("DCF") model and Capital Asset Pricing Model ("CAPM") to estimate a cost of equity for RRUI based on a sample of water utilities selected from the *Value Line* Investment Survey ("*Value Line*").[95] Mr. Bourassa's DCF analyses indicated returns on equity ("ROEs") in the range of 8.6 percent to 9.7 percent with a midpoint of 9.2 percent.[96] His CAPM analysis indicated ROEs in the range from 8.6 percent to 12.7

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[93] *See* Docket No. E-04204A-12-0508 filed December 31, 2012. Currently, the hearing in the UNS Electric matter is set to commence September 30, 2013.
[94] RRUI Initial Opening Brief at 9.
[95] Ex A-2 Bourassa COC Dir at 3.
[96] Ex A-6 Bourassa Rj at Sch D-4.1.

percent with a midpoint of 10.6. The average of the midpoints of Mr. Bourassa's DCF and CAPM analyses is 9.8 percent, which he then adjusted lower by 0.9 percent to account for the lower financial risk in a 100 percent equity capital structure, and adjusted upward by 0.8 percent for his "Small Company Risk Premium."[97] The result of Mr. Bourassa's adjustments was a COE of 9.8 percent, which he further reduced to a recommended return of 9.5 percent to be "conservative."[98]

The DCF model uses comparable risk companies and estimates the cost of capital directly, and rests on the premise that the fundamental value of an asset (stock) is its ability to generate future cash flows. The DCF is the sum of a stock's expected dividend yield and the expected long-term growth rates.[99] For his DCF growth estimate, Mr. Bourassa used analyst growth forecasts and the 5-year historical average growth rates in the stock price, book value per share ("BVPS"), dividends per share ("DPS") and earnings per share ("EPS").[100]

The CAPM formula uses a risk-free rate plus a risk premium and quantifies the additional return investors require for bearing incremental risk.[101]Mr. Bourassa used long-term Treasury rates for the risk-free rate. The CAPM requires calculating a "beta" which is a measure of the relative risk of a security in relation to the market.[102] Because RRUI is not publicly traded, RRUI doesn't have a beta, so the beta of the sample group is used as a proxy. Mr. Bourassa calculated a beta of 0.72 for RRUI. Mr. Bourassa prepared two calculations for the market risk premium estimates: an historical market risk and a current market risk.[103] The historical market risk premium is based on the average premium of the market over long-term securities from 1926 through 2011. For the current market risk premium, Mr. Bourassa first used the DCF model to compute an expected market return for the past 12 months then subtracted the 30-year Treasury yield.[104]

RRUI argues that Staff's and RUCO's recommended ROEs of 8.2 and 8.25 percent, respectively, are too low and cannot pass the comparable earnings standard established in *Bluefield*

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[97] Ex A-6 Bourassa COC RJ at Sch D-4.1
[98] Tr. at 103 (Bourassa).
[99] Ex A-2 Bourassa COC Dir at 25-26.
[100] Ex A-2 Bourassa COC Dir at 30-33.
[101] Ex A-2 Bourassa COC Dir at 32.
[102] Ex A-2. Bourassa COC Dir at 33.
[103] Ex A-2 Bourassa COC Dir at 36.
[104] Ex A-2 Bourassa COC Dir at 36.

Water Works and Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679, 692-93 (1923) and *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

RRUI argues that in the *Bluefield* and *Hope* decisions, the United States Supreme Court established a "comparable earnings" standard to determine if state regulators are adopting a reasonable return for utility companies. In *Bluefield*, the Court held:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments on other business undertakings which are attended by corresponding risks and uncertainties.... The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally.[105]

The Court further held that "[r]ates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment."[106]

In *Hope*, the United States Supreme Court found:

> [T]he return to the equity owner should be commensurate with returns on investments in other enterprises having 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.[107]

RRUI claims that RUCO and Staff believe their recommendations meet the legal requirements because Staff and RUCO have compared RRUI to proxy utilities. RRUI argues, however that just because a DCF or CAPM analysis produces a value, it does not mean that the result is reasonable or credible. RRUI asserts that if the models result in returns on equity that do not allow

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[105] *Bluefield*, 262 U.S. at 692-93.
[106] *Bluefield*, 262 U.S. at 690.
[107] *Hope*, 320 U.S. at 603.

the utility to attract capital and maintain its value, then the returns should not be approved and there might be something wrong with the comparative analysis.[108]

RRUI asserts that it is undisputed that: (1) as of January 18, 2013, *Value Line* projects the expected average return on equity for the proxy group of water utilities to be 10.3 percent; (2) as of December 7, 2012, *Value Line* projected the average expected returns on equity for the sample gas utilities to be 11.5 percent; that as of January 2013, the currently authorized ROE's for the sample water utilities companies as reported by *AUS Utility Reports* is 10.03 percent; and (4) the currently authorized ROEs for the sample natural gas distribution companies as reported by AUS as of January 2013, is 10.29 percent.[109] RRUI argues that Staff's and RUCO's recommended authorized returns are 178 to 183 basis points lower than the average of the currently authorized ROEs for the proxy water utilities; 204 to 209 basis points lower than the average of the currently authorized ROEs for the proxy gas companies. RRUI asserts that these results support a conclusion that Staff's and RUCO's recommended returns are not credible.

RRUI states that a major difference between RRUI and the proxy group of water companies used in the models is the size difference, with the average net plant and revenues of the proxy group many times greater than RRUI's.[110] Secondly, RRUI states that the proxy group's stock is publicly traded and can be sold within minutes, while RRUI's owner cannot liquidate its ownership quickly. RRUI claims that the difference in liquidity risk between RRUI and the sample companies is so significant that it equals or exceeds the difference in financial risk.[111] RRUI believes that publicly traded utility holding companies that are geographically more diverse and that enjoy economies of scale, benefit from greater revenue and earnings stability than a small utility. It asserts that investing in the publicly traded utility is less risky because business risks are lower. RRUI believes that it borders on the "absurd" to claim, by recommending a rate of return 210 to 300 basis points lower, that a small company like RRUI is a safer investment than an investment in the sample companies.[112]

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[108] RRUI Initial Opening Brief at 12.
[109] RRUI Initial Opening Brief at 13-14.
[110] RRUI Initial Opening Brief at 15. According to RRUI's chart, the average proxy group's net plant is $1.229 billion compared to RRUI's net plant of $28.1 million, and the average proxy group revenue of $344 million versus RRUI's revenue of $4.2 million.
[111] RRUI's Initial Opening Brief at 16.
[112] RRUI's Initial Opening Brief at 16.

RRUI asserts that Staff and RUCO are recommending ROEs that are completely unrelated to the data from their own proxy group.

In addition, RRUI asserts that in order for the Company to pay dividends if the Staff or RUCO recommended ROEs are adopted, the dividend payout ratio required to meet investor expectations will be at or near 100 percent of earnings (94 percent under Staff's and 93 percent under RUCO's), which RRUI claims is not sustainable.[113] RRUI states that under its recommended ROE, the dividend payout ratio is 71 percent, which is the same as the five-year average dividend payout ratio for the sample companies.[114] RRUI claims that if the Company is forced to exist with the high dividend payout ratios that result from the Staff and RUCO recommendations, the value of the equity investment in RRUI would decrease, further increasing risk. RRUI argues that a cost of capital that reduces the entity's value is not likely to attract capital and fails the critical elements of the comparable earnings test.

In response to criticism that Mr. Bourassa relied too heavily on analyst forecasts or forecasted interest rates in his models, RRUI argues that the Commission should consider analysts' projections and expectations when setting ROE because the rate of return that is being calculated is going to be in effect in the future.[115] Moreover, RRUI states that Mr. Bourassa incorporated historical growth rates into his growth estimates and the DCF model and spot rates into the estimate of the risk-free rate in his CAPM.[116] In an attempt to avoid the arguments over the proper inputs to the DCF and CAPM analyses, RRUI also employed the build-up method to estimate a reasonable COE.[117] RRUI states that because it utilizes objective data from *Morning Star* and *Duff & Phelps*, the build-up method is a reasonable comparative benchmark against which to compare the DCF and CAPM results.[118] RRUI claims that the build-up method demonstrates that the cost of equity for smaller firms is not a unique

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[113] Ex A-18 at Table 1 and Table 2. RRUI's Initial Opening Brief at 18.
[114] Ex A-18 at Table 3; Ex A-6 Bourassa COC RJ at 12.
[115] RRUI Reply Closing Brief at 20.
[116] Ex A-2 Bourassa COC Dir at 31-32. RRUI Reply Closing Brief at 21.
[117] According to Mr. Bourassa, the build-up method is an additive model in which the return on a security is the sum of the risk free rate and one or more risk premia. Using information from *Morning Star* and *Duff & Phelps*, Mr. Bourassa calculated a risk free rate and added risk premia for financial risk and company specific risk. Ex A-2 Bourassa COC Dir at 38-44.
[118] RRUI Reply Closing Brief at 22.

risk as argued by Staff, but another market risk factor that explains the differences in returns between large and small firms.[119]

Finally, RRUI argues that it is impossible for an ROE of 8.2 or 8.25 to pass any reasonable comparative earnings test when the investor would be better off putting his money in any average stock (9.4 percent three-year average), three-year treasuries (9.16 percent annualized return), or even corporate bonds (8.23 percent average).

B. **RUCO**

RUCO recommends an 8.25 percent COE which includes a 50 basis point adjustment for the reduced financial risk associated with the absence of debt in the Company's capital structure.[120] RUCO utilized the DCF and CAPM to determine its recommended COE, and asserts that the methodology it used to calculate the COE are the methodologies to which the Commission has given the most weight in setting allowed rates of return.[121]

RUCO utilized a slightly different water company proxy group than RRUI, with RUCO including American Water Works, Inc., American States Water Company, California Water Service Group, Middlesex Water Company, SJW Corporation and Aqua America. RRUI used the same group, except excluded American Water Works, Inc. and included Connecticut Water Company.[122] RUCO disagrees that American Water Works Company, Inc. should be excluded, as the company has been followed by *Value Line* since July 2008 after the New Jersey-based provider was spun off from its German parent and became a publicly-traded entity.[123] At the time RUCO filed testimony, there were four years of *Value Line* data and under the circumstances, RUCO believes its inclusion in the proxy group is appropriate.[124] RUCO did not use Connecticut Water Services, Inc. in its analysis because the company used to be followed under *Value Line's* Small and Mid-Cap edition which did not include the same forward-looking data as provided in *Value Line's* Large-Cap Edition. However, RUCO notes that at some point *Value Line* moved Connecticut Water to the Large-Cap edition and it

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[119] Ex A-2 Bourassa COC Dir at 42; Ex A-4 Bourassa Rb at 16-17.
[120] RUCO Closing Brief at 2.
[121] RUCO Closing Brief at 2.
[122] RUCO Closing Brief at 3.
[123] Ex RUCO-1 Rigsby DOD Dir at 21.
[124] RUCO Closing Brief at 3.

is not inappropriate to include Connecticut Water Services in the proxy group, although RUCO did not in this case.[125]

RUCO also used a proxy group of nine natural gas local distribution companies ("LDCs"). RUCO argues that using natural gas LDCs as a sample proxy to determine a COE for a water utility is appropriate because LDCs and water and wastewater utilities face similar risks and challenges.[126] RUCO's water company proxy group had an average beta of 0.69 and its gas company proxy group had an average beta of 0.66.[127] RUCO states that because its LDC proxy beta is slightly lower, the use of LDCs in the analysis serves to increase RUCO's recommended COE, not lower it.[128]

In response to RRUI's criticism that RUCO's COE is lower than an average of long-term projections on book common equity published in *Value Line*, RUCO's witness 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.[129] RUCO argues that returns on book equity are not the same as costs of equity capital.[130] Thus, RUCO argues that comparing actual or projected returns on book equity is not a valid comparison.[131]

RUCO argued that the Company should have considered all of *Value Line's* projections for 2012 through 2017 rather than relying solely on long-term projections. RUCO asserts that near-term projections have greater reliability and the accepted methodology for calculating growth is the average of all projections rather than just the long-term projections.[132]RUCO states that if RRUI had considered all of the projections, the Company's average return on book equity would be 9.69 percent; if the Company had included American Water Works in its sample, the 2012 through 2017 average return on book equity would be 9.55 percent, and not the 10.3 percent average in the

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[125] RUCO Closing Brief at 4.
[126] Tr. at 205 (Rigsby).
[127] RUCO's Closing Brief at 4.
[128] RUCO's Closing Brief at 5.
[129] Ex RUCO-2 Rigsby COC Sur at 9-10; citing definition of ROE; Tr. at 155-56.
[130] RUCO Reply Closing Brief at 4.
[131] RUCO Reply Brief at 4.
[132] RUCO's Closing Brief at 6; RUCO Reply Brief at 4. RUCO argue that averaging analysts' projected returns on book equity is not a substitute for using an appropriate methodology and inputs.

Company's Rejoinder.[133] The average return on book equity for RUCO's sample, which includes American Water Works, but not Connecticut Water, is 9.36 percent.

In response to claims that RUCO's ROE is low compared to the authorized returns of the proxy companies, RUCO argues that prior authorized returns based on unknown circumstances should not be used to determine or test current returns on equity capital.[134] RUCO states that the Company is attempting to perform a comparable earnings analysis which has long been criticized for its circular logic. Furthermore, RUCO asserts that the Company has not submitted any of the reports on which it relies, nor any way to determine from the information that the Company has provided when, where, and how the authorized returns were approved. Thus, according to RUCO, the time period in which the returns were authorized and the circumstances of their approval (e.g. whether they were based on a settlement agreement, and the reasoning of the public utility commissions in approving these returns) are unknown.[135]

RUCO adjusted its COE estimate downward by 50 basis points to account for RRUI's lower financial risk resulting from a capital structure consisting of 100 percent equity.[136] RUCO did not use the Hamada adjustment methodology to make its downward adjustment.[137] RUCO argues that the Company's small firm adjustment is not appropriate on the facts of this case because RRUI is a subsidiary of APUC, receives all of its capital from its parent, and is allocated APUC expenses associated with its operation in the Toronto Stock Exchange.[138] RUCO states that APUC is a conglomeration of smaller utilities, just like the water companies in the proxy groups, and there is no factual or legal basis for a small firm adjustment.[139]

RUCO also questions Staff's 60 basis point upward adjustment to address economic uncertainty in the current economy. RUCO does not dispute the existence of economic uncertainly,

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[133] RUCO's Closing Brief at 6.
[134] RUCO Reply Brief at 5.
[135] RUCO Reply Brief at 5.
[136] RUCO's Closing Brief at 7.
[137] The Hamada methodology uses a formula to "unlever" the beta of the proxy group and then "relever" the beta to reflect the capital structure and financial risk of the company under analysis. The re-levered beta is then used in the CAPM models and compared to the original CAPM results. The difference is the basis for the financial risk adjustment. Ex A-2 Bourassa COC Dir at 40-41.
[138] RUCO's Closing Brief at 8; RUCO Reply Brief at 6.
[139] RUCO's Closing Brief at 8; RUCO Reply Brief at 7.

but states that by adopting the upward adjustment of 60 basis points, Staff is insulating a $3.0 billion international company from the impact of an economic instability when ratepayers are not insulated from the same economic uncertainty.[140]

C. **Staff**

Staff also utilized the DCF and CAPM models to arrive at its recommended COE and ROE. Staff asserts that the Commission has consistently accepted these models and that Staff used objectively reasonable inputs based on both historical and forecasted economic information. Staff averaged its DCF results (8.8 percent)[141] and did the same for the CAPM results (8.2 percent),[142] and then took the average of both models (8.5 percent). Staff made two adjustments to the average of both models, first a 90 basis point downward financial risk adjustment using the Hamada method and a 60 basis point upward "economic assessment adjustment" to account for the current economic environment.[143] As a result, Staff recommends a ROE of 8.2 percent.[144]

Staff utilized two versions of the DCF—the constant growth DCF and the multi-stage growth DCF. For the constant-growth DCF, Staff calculated the growth factor by averaging the historical and forecasted earnings per share ("EPS"), dividends per share ("DPS") and sustainable growth.[145] Staff gave equal weight to historical and projected EPS, DPS and sustainable growth. Staff argues that in so doing, it used a balanced approach to determining COE.[146] For the multi-stage growth DCF, Staff analyzed two stages of growth: the first stage has a four-year duration with the growth rate based on *Value Line's* projected dividends for the next twelve months and the average dividend growth rate of 4.8 percent calculated in Staff's DCF analysis; followed by a second stage of constant growth using a growth rate based on Gross Domestic Product from 1929 to 2011.[147]

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[140] RUCO Reply Brief at 8.
[141] Ex S-2 Cassidy Surr at Sch JAC-3. Staff's DCF results were 8.0 percent for the Constant Growth model and 9.5 percent for the Multi-Stage model.
[142] Ex S-2 Cassidy Surr at Sch JAC-3. The Historical Market Risk Premium result was 6.3 percent, and the Current Market Risk Premium analysis was 10.0 percent.
[143] Ex S-1 Cassidy Dir at 2-3.
[144] Staff's Closing Brief at 4.
[145] Ex S-1 Cassidy Dir at 17-25.
[146] Staff Closing Brief at 6.
[147] Ex S-1 Cassidy Dir at 25-27.

Staff criticizes the Company's methodology of disregarding the multi-stage growth model in favor of employing two constant-growth DCF models: Past and Future Growth and Future Growth. Staff states that half of the Past and Future Growth estimate relies on analysts' projections, while the Future Growth model relies entirely on analysts' projections.[148] Staff argues that the Company's use of this midpoint gives analyst projections 75 percent of the weight, while historical data is given only 25 percent. Staff asserts that over-reliance on analysts' projections is problematic because those forecasts tend to be biased and overly optimistic.[149] Staff believes that by not giving equal weight to the historic data and projections, the Company inflated the dividend growth rate and skewed the outcome of the DCF analysis. Staff believes that the Company's DCF analysis is also problematic because the Company used only five years of historic data in calculating the dividend growth rate in the Past and Future DCF method. Staff believes that five years is too limited a period to capture a full business cycle and is susceptible to significant variances if there is a single high or low data point. Staff states that choosing the five year period over the ten year period resulted in a higher growth rate which further inflated the COE in the Company's DCF analysis. Staff used ten years of historical data and believes that period is more reasonable because it captures a more robust picture of the economic environment and is information widely used by investors.[150]

Staff states that its CAPM analysis considers the historical market risk premium and the current market risk premium. The average beta of Staff's proxy group was calculated at 0.71.[151] Staff then applied the historical and current U.S. Treasury spot rates in its historical and current market risk CAPM analysis. Staff asserts that in the Company's CAPM analysis, it utilized a forecasted risk-free interest rate in both its historical and current market risk premia, and that because the forecasted rate is higher than the current 30-year long term Treasury yield, it overstates the risk-free interest rate and inflates the COE in the Company's CAPM analysis.[152]

Staff argues that the Commission should reject RRUI's "Small Firm Risk Adjustment" because: 1) RRUI is not an unassociated small company, but the subsidiary of a much larger parent

[148] Ex A-2 at 43-44.
[149] Ex S-1 Cassidy COC Dir at 38-40.
[150] Ex S-1 Cassidy COC Dir at 43-44.
[151] Ex S-1 Cassidy COC Dir at 33.
[152] Ex S-1 Cassidy COC Dir at 38.

corporation; 2) any risk associated with the size of the company is unsystematic or "firm specific risk" which does not affect investor decisions; and 3) the Commission has appropriately and continually rejected such an adjustment in the past. Staff argues that as a subsidiary of APUC, a publicly traded corporation, RRUI is able to avail itself of other resources and capital markets to which most truly small companies do not have access, and any risk that would be reflected in RRUI's beta as a result of size is dissipated by its association with the larger parent company. Staff also believes that investors are not concerned with "firm specific" risk because investors can eliminate it by holding diverse portfolios, and any adjustment to COE to account for such risk is unwarranted.

D. Intervenors

Intervenors argue that the allowed return on equity should be no greater than 8.0 percent. They base their recommendation on the average of Staff's and RUCO's estimates of the cost of equity before their adjustment for "unique business risk" and "Economic Assessment Adjustment."[153] They calculate a WACC of 6.07 percent based on a 50/50 debt/equity capital structure, a 4.13 percent cost of debt, and 8.0 percent. Under Intervenors' alternative position, which is a capital structure of 20 percent debt and 80 percent equity, they calculate a WACC of 7.226 percent based on an 8.0 percent maximum return on equity and the 4.13 percent cost of debt.[154]

Intervenors argue that the testimony of Mr. Bourassa, RRUI's witness on Cost of Capital, should be given little weight as he is a Certified Public Accountant ("CPA") and does not hold a degree in economics or hold a Certified Rate of Return Analyst certificate.[155] They question his command of the subject, based on responses to questions concerning the Capital Market Line ("CML").[156]

In addition, the Intervenors argue that the authorized return on equity should be historically low because indications of capital costs are near historic lows.[157] Intervenors note that the Federal

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[153] Intervenors state that prior to adjustment, RUCO's cost of equity was 7.31 percent and Staff's was 8.5 percent, which results in an average of 7.9 percent.

[154] Intervenors' Combined Opening Brief at 11. They state that the issue of how to adjust the cost of equity downward to correct for the fact that 80 percent equity is less risky than the industry average of 50 percent lacks clear evidence and makes the finding of 20/80 debt/equity capital structure more difficult than simply adopting the industry averages for capital structure and cost of equity.

[155] Intervenors' Combined Closing Brief at 3.

[156] Tr. at 69 (Bourassa).

[157] Intervenors' Combined Opening Brief at 4.

Reserve lowered the federal funds target rate to near zero and has expressed an intent to keep the target federal funds rate at 0.0 percent to 0.25 percent for a considerable time even after its asset purchase program ends and economic recovery strengthens.[158] In addition, they state the benchmark U.S. Treasury note yield is at historic lows,[159] and the ten-year Treasuries are lower than in the past.[160]

Intervenors assert that the average historical market risk premium over long-term Treasury securities is 6.6 percent,[161] and that the 30-year U. S. Treasury Bond was trading at 3.151 percent on March 22, 2013.[162] Thus, they argue an estimate of the average stock's return going forward is about 9.8 percent (6.6% + 3.151%), but based on Mr. Bourassa's beta of 0.72, RRUI should have a lower return than the average stock. In addition, Intervenors argue that RRUI's COE should be reduced to account for its capital structure. They state:

> RRUI merits a 90 basis point reduction to an average 50/50 water utility to correct if one uses the 100 % equity capitalization. Therefore, it would be reasonable to award a 4.8% utility risk premium (0.72 X 6.6%) plus 3.151% current long-term US Treasury yield for a 7.9% cost of equity, reduced by 80 basis points to account for 100% equity . . . or a 7.1% return on equity if relying on Mr. Bourassa's testimony.[163]

Intervenors also argue that the authorized return on equity should be low because stock market volatility, as measured by the Volatility Index ("VIX") is at historic lows since at least January 2, 2008.[164] They state that relating the VIX to the CML, one concludes that the expected return on market portfolio would also be low.

The Intervenors also dispute RRUI's claim that Contributions in Aid of Construction ("CIAC") and Advances in Aid of Construction ("AIAC") in RRUI's capital structure raises the Company's risk, because CIAC does not have fixed principal or interest payments and AIAC is refunded contingent on the developer reaching certain goals, and might never by refunded.[165] They

[158] Tr. at 60-61 (Bourassa); Ex SCVUSD-2 at 2.
[159] Ex SCVUSD-3.
[160] Tr. at 64 (Bourassa).
[161] Ex A-2 Bourassa COC Dir at 36.
[162] Ex SCVUSD-8.
[163] Intervenors' Combined Opening Brief at 4, citations omitted.
[164] Intervenors' Combined Opening Brief at 4-5.
[165] Ex A-2 Bourassa COC Dir at 22; Tr. at 75-76.

also assert that Mr. Bourassa over-estimated the dividend yield in his DCF and therefore over-estimated his DCF calculations. They claim that when he calculated his current dividend yield, Mr. Bourassa utilized the dividend yield for the next year instead of the current yield which biased his calculations upwards. The Intervenors also criticize Mr. Bourassa's reliance on analyst forecasts of earnings growth instead of forecasts of dividend growth.[166] They criticize Mr. Bourassa's CAPM for using data that is more than a year old to calculate the "current" market risk premium. They argue that his calculations are not current and merit no weight.[167]

Intervenors argue that for his CAPM analyses, Mr. Bourassa relied on forecasts of the long-term US Treasury rate that were higher than the actual market-based 30-year U.S. Treasury rates at the time of the hearing.[168] They state that the interest rates utilized by Mr. Bourassa were made by forecasting services, and argue that observable market rates should be relied on in performing a CAPM cost of equity analysis.

Intervenors argue that there is a lack of evidence that would support applying a small company risk premium.[169] They believe that the Company's recommended small company risk premium should not be given any weight, and they argue that the appearance that small firms seem inherently riskier than larger companies is really a "January effect" that affects all size groups.

Intervenors also argue against the "Economic Assessment Adjustment" of 60 basis points used by Staff.[170] They claim that the adjustment is not based on any treatise or peer-reviewed journal and argue that no adjustment is warranted. They state that under the efficient market hypothesis, stock prices already reflect expectations of uncertainty and therefore the uncertain status of the economy is already factored into market data.

Intervenors argue that the record supports employing a capital structure of 50 percent debt and 50 percent equity.[171] They note that the capital structure of the proxy group used by the Company was approximately 50/50 debt/equity (RUCO's proxy group contained 45.7 percent equity, and

[166] Intervenors' Combined Opening Brief at 5.
[167] Intervenors' Combined Opening Brief at 6.
[168] Intervenors' Combined Opening Brief at 7. Intervenors state that Mr. Bourassa used rates of 3.8 percent and 3.7 percent, but that the 30-year US Treasury rate was 3.151 percent at the time of the hearing. Ex SCVUSD-8.
[169] Intervenors' Combined Opening Brief at 6-7.
[170] Intervenors' Combined Opening Brief at 8.
[171] Intevenors' Combined Opening Brief at 8-9.

Staff's proxy group consisted of 48.8 percent equity) and argue that a capital structure of 100 percent equity is out of the norm and inefficient. They urge the Commission to adopt the industry norm of approximately 50 percent equity and apply an appropriately-calculated proxy group average cost of equity. They believe such approach is the most transparent way to coordinate the cost of equity and capital structure and minimizes judgment and miscalculations from the Hamada adjustment. They assert that the Commission should utilize a cost of debt of 4.13 percent which was RUCO's estimated cost of debt based on the current yield on a Baa/BBB-rated utility bond. They assert that RUCO's estimate takes account of current capital market conditions, and argue that RRUI's initially proposed 5.7 percent cost of debt was derived from the rate used in the last rate case and has no relationship to current capital market conditions.

E. **Responses to Intervenors' Cost of Capital Recommendations**[172]

RRUI asserts that Mr. Bourassa is a qualified cost of capital witness with a B.S. in Chemistry/Accounting, an MBA with an emphasis in Finance, and a CPA.[173] RRUI states that Mr. Bourassa has testified before the Commission on cost of capital in approximately three dozen cases over ten years and the Commission has never questioned his qualifications. RRUI also notes that Mr. Bourassa is as qualified as either of the other two cost of capital witnesses in this case.[174]

RRUI argues that generalizations and conclusions about the economy are not substantial evidence.[175] RRUI does not dispute that interest rates are at historic lows or that the VIX is at its lowest point since 2008, but asserts that the test of whether the authorized return is appropriate is not whether interest rates are at historic lows, but whether the cost of capital meets the comparable earnings test set forth in *Hope* and *Bluefield*.[176] RRUI states that the one-year average total return for the sample companies is 17.15 percent and the recent three-year average of the sample companies is

[172] Because Intervenors did not present a cost of capital witness, the first time the other parties were aware of their position on Cost of Capital was in the Closing Brief.
[173] Ex A-9 Bourassa COC Dir at 1-9; Tr at 112-113 (Bourassa).
[174] RRUI Reply Opening Brief at 11-12.
[175] Substantial evidence is defined as "more than a scintilla but less than preponderance, "and consists of such relevant evidence as a reasonable person would accept as adequate to support a conclusion." *Mareno v. Apfel*, 1999 U.S. Dist. LEXIS 8575.
[176] RRUI Reply Closing Brief at 13.

10.14 percent, and that there is nothing about the general economy that justifies dramatically lower returns for RRUI. [177]

RRUI asserts that AIAC and CIAC are indeed two of the many factors that should be considered in assessing risks faced by the Company, and that having AIAC and CIAC in a capital structure adds to risk – AIAC because it is an obligation owed to a third party and is similar to debt, and CIAC because plant funded by contributions still has to be operated and repaired at the Company's expense and then replaced with debt or equity capital.[178] RRUI asserts that Intervenors can "quibble about how much risk exists, but they can point to no evidence in the record to the contrary and any suggestion that AIAC and CIAC create no risk is unsupported and simply not credible."[179]

RRUI argues that the Intervenors' reliance on the "January Effect" as a basis to disregard consideration of size in assessing risk is not well-placed.[180] RRUI asserts that any claim that RRUI's small size relative to the proxy group does not matter at all, is not credible. RRUI also claims that Intervenors provide no basis for their claims that Mr. Bourassa overstated his DCF or CAPM analyses. RRUI assert that the arguments made by Intervenors lack substantial evidence, and are merely unsupported and mistaken opinions of counsel.[181]

RRUI also argues that Intervenors' recommended capital structures (either 50/50 debt/equity or 20/80 debt/equity) are not supported by substantial evidence and should be rejected.[182] RRUI notes that Staff and RUCO agree that the Company's actual capital structure should be used. In addition, RRUI asserts that in making their recommendations on cost of capital, Intervenors do not account for the additional risk that would come with the imputation of debt into the capital structure. RRUI acknowledges that its parent did not infuse debt into the Company, but also states that there is no evidence that it did so with the intent to harm customers or unnecessarily increase the cost of service, and moreover, it "tried to have its rates set exactly as if it did infuse the debt."[183] RRUI states that

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[177] *Value Line* Investment Survey January 18, 2013; RRUI Reply Closing Brief at 14.
[178] Ex A-2 Bourassa COC Dir at 22; Tr. at 76 (Bourassa); RRUI Reply Closing Brief at 14.
[179] RRUI Reply Closing Brief at 14.
[180] RRUI Reply Closing Brief at 15.
[181] RRUI Reply Closing Brief at 17.
[182] RRUI Reply Closing Brief at 17-18.
[183] RRUI Reply Closing Brief at 19.

with the parties' various risk adjustments to determine the ROE, the difference between the final cost of capital with or without the 20 percent debt is minimal.[184]

RRUI argues that an ROE of 8 percent is unreasonable and would not satisfy the comparable earnings test. The Company asserts that Intervenors provided no witness to support their recommended returns or the calculations in their brief, and their recommended ROE does not reasonably compare to comparable utilities.[185]

Staff argues that Intervenors' recommendation that the Commission should utilize a 50/50 debt/equity capital structure should be rejected because it is not based on evidence and ignores the actual capital structure of RRUI.[186] Staff asserts that there is no evidence that a 50 percent debt/equity structure is more appropriate, or more transparent or minimizes judgment and miscalculation from the Hamada adjustment, than the capital structure recommended by every other party to the proceeding.[187]

In addition, Staff argues that its economic assessment adjustment of 60 basis points is reasonable and appropriate.[188] Staff states that it agrees that its market-based cost of equity estimation already reflects expectations of uncertainty at the time the analysis is conducted, but that "the ratemaking process is less agile than market responses and the cost of equity authorized in this case will remain in place until the Company's next rate case."[189] Staff asserts that its Economic Assessment Adjustment is appropriate:

> because it considers the disconnect between the responsiveness of the market to changes in the cost of equity and the responsiveness of the ratemaking process in recognizing these changes at a time when extraordinary macro-economic conditions (e.g., countries with large GDPs teetering on the edge of defaulting on their debt, massive debt by the United States, multi-year historical and projected spending deficits in the United States with no consensus for resolution, long-term high unemployment in the United States and the European Union, simultaneous new record high stock prices and near record low interest rates) exist.[190]

[184] Tr. at 184-185 (Rigsby); Tr. at 106-107 (Bourassa).
[185] RRUI Reply Brief at 19.
[186] Staff Reply Brief at 2-3.
[187] Staff Reply Brief at 3.
[188] Staff Reply Brief at 3-4.
[189] Staff Reply Brief at 3.
[190] Staff Reply Brief at 4.

F. **Analysis and Conclusion**

1. **Capital Structure**

In RRUI's last rate case, the Commission found that a capital structure consisting of 20 percent debt and 80 percent equity was reasonable.[191] At that time, the Commission utilized a cost of debt of 5.7 percent and a cost of equity of 9.5 percent resulting in a WACC of 8.74 percent. The Commission considered using a pro forma capital structure containing 20 percent debt and 80 percent equity in the rate case prior to that, but ultimately decided not to because of an operating loss for the Wastewater Division.[192]

When it filed the Rate Application, RRUI employed a pro forma capital structure consisting of 20 percent debt and 80 percent equity.[193] In direct testimony, RUCO also utilized a 20/80 pro forma capital structure, but Staff employed the actual capital structure and adjusted the cost of equity to reflect less financial risk. In rebuttal testimony, RRUI continued to utilize a 20/80 debt/equity capital structure. In surrebuttal testimony RUCO changed its recommendation, and at that point, both RUCO and Staff were advocating using the Company's actual 100 percent capital structure.[194] In rejoinder testimony, RRUI adopted Staff's and RUCO's recommended 100 equity capital structure in order to eliminate issues.[195]

At this time, debt financing rates are at, or near, historically low levels. By continuing to utilize a 100 percent equity capital structure, the Company is not taking advantage of a low cost source of capital. The Company initially imputed the cost of debt as if it had infused the debt, but did not offer an explanation for why it did not inject the debt. When it approved RRUI's last rate case, the Commission expected that the debt infusion would be made, and that three years later, RRUI would have debt as part of its capital structure. The Company initially recognized this but backed-off that proposal to narrow issues. Narrowing issues is encouraged when the resolution of the issue is in

[191] Decision No. 72059 at 33.
[192] Decision No. 67279 (October 5, 2004) (Prior to Liberty Water ownership) the rate of return adopted in 2004 was 8.7 percent.
[193] Ex A-2 Bourassa COC Dir at 2.
[194] Ex RUCO-2 Rigsby COC Surr at 8; Ex S-2 Cassidy Surr at 1.
[195] Ex A-6 Bourassa COC Rj at 3.

the public interest. In this case, we believe the Company's and RUCO's initial positions on capital structure should have prevailed as issues were narrowed.

For this Company, which has a parent company with access to the capital markets, at this point in time, a 100 percent capital structure is not reasonably balanced, and unnecessarily increases the cost of service for ratepayers. We believe that a modest level of debt in RRUI's capital structure is in the public interest, will not unduly increase financial risk, and will better balance the interests of the shareholders and ratepayers. Consequently, we continue to authorize a pro forma capital structure consisting of 20 percent debt and 80 percent equity. The parties claim that by adjusting the cost of equity to reflect the absence of debt in the capital structure, they account for the equity rich capital structure. However, although this adjustment appropriately reduces the cost of equity, it does not provide the benefits of including a modest degree of lower-cost debt in the capital structure.

2. Cost of Debt

In its direct testimony RRUI utilized 5.7 percent as the cost of debt because this was the rate utilized in the last rate case.[196] However, RRUI did not actually infuse debt into RRUI at 5.7 percent, or at any rate. In rebuttal, RRUI testified that Liberty Utilities' current bond rating is BBB-, and that the 5.7 percent cost of debt utilized in its calculations comports with a 2010 Liberty Utilities credit facility that bears a 5.6 percent interest rate.[197] RRUI states that with the financing costs included, the effective interest rate is 5.7 percent.

In its direct case, RUCO proposed utilizing a cost of debt of 4.13 percent which was the current yield on a Baa/BBB rated utility bond.[198] Although RUCO no longer recommends utilizing a pro forma capital structure, Intervenors currently recommend utilizing 4.13 percent as the cost of debt.[199]

Liberty Utilities' credit rating appears to be a grade below that utilized by RUCO and Intervenors. We find that a 5.7 percent cost of debt is reasonable as it is based on the cost of a 2010

[196] Ex A-2 Bourassa COC Dir at 2.
[197] Ex A-4 Bourassa COC Reb at 19.
[198] Ex RUCO-1 Rigsby COC Dir at 56.
[199] Intervenors' Combined Closing Brief at 9.

credit facility obtained by Liberty Utilities. There is no evidence that APUC, Liberty Water or RRUI could borrow at the 4.13 percent rate suggested by Intervenors.

3. <u>Cost of Equity</u>

All of the parties presenting testimony on the cost of equity use the same methodology of using a proxy group of publicly traded utilities and the CAPM and DCF models to estimate RRUI's COE. They presented evidence for the COE that ranged from 8.5 percent to 9.8 percent before making adjustments for various alleged risks. Their ultimate recommended COEs ranged from 8.2 percent to 9.5 percent, after adjusting for financial risk, small firm size and/or economic conditions. Although they all use versions of the DCF and CAPM models, they used different inputs for time frames, risk-free rates, and growth factors. RRUI was criticized for relying too heavily on analyst forecasts and making an upward adjustment for RRUI's small size relative to the proxy group. RUCO's choice of proxy companies was criticized, as was Staff's "economic assessment adjustment," because under the efficient market theory that underpins the DCF and CAPM, rates already reflect economic conditions.[200]

As we noted in the prior RRUI rate case, The *Hope* and *Bluefield* decisions provide that the Commission must determine a return that is equivalent to an investment with similar risk made at generally the same time, and should be sufficient under efficient management to enable the company to discharge its duties. The *Bluefield* court also held, "[w]hat annual rate will constitute just compensation depends on many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts."[201] Based on all of the evidence presented, including the impact on ratepayers, we find that a COE of 9.2 percent is appropriate, will provide the Company with a reasonable and appropriate return on its investment, and will result in just and reasonable rates.

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[200] Relying on the other parties' witnesses, Intervenors argue for a cost of equity of no more than 8.0 percent based on a pro forma capital structure. First, we reject Intervenors assertion that Mr. Bourassa is not qualified to testify in the area of cost of capital. In this and many other rate cases, Mr. Bourassa has demonstrated knowledge of the subject matter; and even if the Commission has not always adopted his recommendations, we find that he is well-qualified to make them. Second, we exclude Intervenors' suggested COE of either 7.1 or 8.0 percent from the ranges of estimated COEs because they did not offer a witness to support their calculations, and their assertions have not been tested by cross examination and cannot be relied upon.

[201] *Bluefield*, 262 U.S. at 692.

4. Weighted Average Cost of Capital and Authorized Return

Using a pro forma capital structure of 20 percent debt and 80 percent equity, and applying a cost of debt of 5.7 percent, and cost of equity of 9.2 percent, we reach a WACC of 8.5 percent. Accordingly, we find that a fair value rate of return of 8.5 percent will result in just and reasonable rates.

VIII. Revenue Requirement

Based on the discussion herein, revenue increases for RRUI's Water and Wastewater Divisions are authorized as follows:

A. Water Division

Based on our findings herein, we determine the gross revenue for RRUI's Water Division should increase by $335,737 or 11.72 percent, from $2,864,823 in the test year, to $3,200,560.

Fair Value Rate Base	$7,731,209
Adjusted Test Year Operating Income[202]	$454,769
Required Fair Value Rate of Return	8.5%
Required Operating Income	$657,153
Operating Income Deficiency	$202,384
Gross Revenue Conversion Factor	1.6589
Gross Revenue Increase	$335,737
Adjusted Test Year Revenue	$2,864,823
Authorized Revenue Requirement	$3,200,560
Revenue Increase	11.72%

B. Wastewater Division

Based on our findings herein, we determine that gross revenue for RRUI's Wastewater Division should increase by $78,847 or 5.62 percent, from $1,402,843 to $1,481,690.

Fair Value Rate Base	$4,790,738
Adjusted Test Year Operating Income	$359,684

[202] Using a pro forma capital structure affected adjusted test year income as presented by the parties because of the interest synchronization associated with the imputed debt.

Required Fair Value Rate of Return	8.5%
Required Operating Income	$407,213
Operating Income Deficiency	$47,529
Gross Revenue Conversion Factor	1.6589
Gross Revenue Increase	$78,847
Adjusted Test Year Revenue	$1,402,843
Authorized Revenue Requirement	$1,481,690
Revenue Increase (%)	5.62%

IX. Rate Design

RRUI, RUCO and Staff agreed to utilize Staff's recommended rate designs. Intervenors did not provide a rate design recommendation, other than to suggest applying any increase evenly across rate classes

A. Water Division

RRUI's current rate design for its Water Division is based on monthly minimum charges that increase by meter size. There are five meter sizes serving residential customers, seven meter sizes serving commercial customers, two serving industrial customers and two serving multi-family customers. All customers in the 5/8 x ¾-inch rate class have a three-tiered rate design, while all other rate classes with meters greater than the 5/8 x ¾-inch have a two-tiered rate design. In addition, there are three fire sprinkler rates with a fixed monthly charge only.

Staff's proposed rate design maintains the current basic design and attempts to keep the percentage of total revenues derived from each class close to current percentages. Subsequent to the hearing, RRUI, RUCO and Staff also agreed to provide the School District with a 5 percent discount.[203]

Using the parties' recommended rate design, and the revenue requirement we authorized herein, we approve the following rates and charges for RRUI's Water Division:

. . .

[203] RRUI Final Schedules at Exhibits 5 and 6.

Monthly Usage Charge	**Current Rates**	**Approved Rates[1]**
Meter Size (All Classes)		
5/8 x ¾ inch	$10.98	$15.46
5/8 x ¾ inch (low income)	9.33	13.14
¾ inch	16.47	23.19
¾ inch (low income)	14.00	19.71
1 inch	27.45	38.65
1 inch (low income)	23.33	32.85
1 ½ inch	54.90	77.30
2 inch	87.84	123.68
3 inch	175.68	247.36
4 inch	274.50	366.50
6 inch	549.00	773.00
8 inch	878.40	1,236.80
10 inch	1,262.70	1,777.90
12 inch	2,360.70	3,323.90
Morningstar Ranch Community Association – 6 inch[204]	N/A	549.00
Commodity Charge (per 1,000 gallons) all classes (less 15% for low income customers as applicable)		
5/8 x ¾ inch meter		
First 3,000 gallons	$1.59	$1.49
3,001-9,000 gallons	2.92	2.98
Over 9,000 gallons	3.64	3.49
¾ inch meter		
First 6,000 gallons	2.92	NA
Over 6,000 gallons	3.64	NA
First 4,000 gallons	NA	2.98
Over 4,000 gallons	NA	3.49
1 inch meter		
First 15,000 gallons	2.92	NA
Over 15,000 gallons	3.64	NA
First 23,000 gallons	NA	2.98
Over 23,000 gallons	NA	3.49
1 ½ inch meter		
First 20,000 gallons	2.92	NA
Over 20,000 gallons	3.64	NA
First 45,000 gallons	NA	2.98
Over 45,000 gallons	NA	3.49
2 inch meter		
First 57,000 gallons	2.92	NA
Over 57,000 gallons	3.64	NA
First 72,000 gallons	NA	2.98
Over 72,000 gallons	NA	3.49
3 inch meter		

[204] Morningstar Ranch is a development that is not within RRUI's certificated area.

First 57,000 gallons	2.92	NA
Over 57,000 gallons	3.64	NA
First 144,000 gallons	NA	2.98
Over 144,000 gallons	NA	3.49
4 inch meter		
First 57,000 gallons	2.92	NA
Over 57,000 gallons	3.64	NA
First 225,000 gallons	NA	2.98
Over 225, 000 gallons	NA	3.49
6 inch meter		
First 125,000 gallons	2.92	NA
Over 125,000 gallons	3.64	NA
First 450,000 gallons	NA	2.98
Over 450,000 gallons	NA	3.49
8 inch meter		
First 125,000 gallons	2.92	NA
Over 125,000 gallons	3.64	NA
First 720,000 gallons	NA	2.98
Over 720,000 gallons	NA	3.49
10 inch meter		
First 125,000 gallons	2.92	NA
Over 125,000 gallons	3.64	NA
First 1,025,000 gallons	NA	2.98
Over 1,025,000 gallons	NA	3.49
12 inch meter		
First 125,000 gallons	2.92	NA
Over 125,000 gallons	3.64	NA
First 1,025,000 gallons	NA	2.98
Over 1,025,000 gallons	NA	3.49
Morningstar Ranch Community Association	N/A	4.79
Fire Lines:		
Up to 8 inches	Per Rule ****	Per Rule ****
10 inches	Per Rule****	Per Rule****
12 inches	Per Rule ****	Per Rule ****
Other Service Charges:		
Establishment	$15.00	$15.00
Establishment (After Hours)	NT	25.00
Reconnection (Delinquent)	15.00	15.00
Reconnection (Delinquent) (After Hours)	25.00	NT
Meter Test (If correct)	15.00	15.00
Meter Re-Read (if correct)	20.00	20.00
Deposit	*	*
Deposit Interest	**	**
Re-establishment (within 12 months)	***	***
NSF Check	15.00	15.00
Late Payment Penalty	1.5% per mo.	1.5% per mo.
Deferred Payment	1.5% per mo.	1.5% per mo.
Moving Meter at Customer Request	At Cost	At Cost

Service Calls – per hour/after hours (a)	40.00	NT
After hours service calls – at customer's request	NT	50.00

(1) A 5 percent discount is applicable to the public schools operated by the Santa Cruz County School District No. 35 receiving water and/or wastewater utility services from the Company.

*Per Commission Rule A.A.C. R14-2-403 (B)
**Per Commission Rule A.A.C. R14-2-403(B)
***Per Commission Rule A.A.C. R14-2-403(D) – months off the system times the monthly minimum
****1 percent of monthly minimum for a comparable size meter, but no less than that $5.00 per month. The service charge for fire sprinklers is only applicable for service line separate and distinct from the primary water service line.

(a) No charge for service calls during normal working hours.

In addition to the collection of regular rates, the utility will collect from its customers a proportionate share of any privilege, sales, use and franchise tax, per commission Rules A.A.C. R14-2-408(5).

Service and Meter Installation Charges
(Refundable pursuant to A.A.C. R14-2-405)

	Current Rates			Authorized Rates		
Service Size	Service Line	Meter	Total	Service Line	Meter	Total
5/8 inch	At Cost	At Cost	At Cost	At Cost	At Cost	At Cost
¾ inch	At Cost	At Cost	At Cost	At Cost	At Cost	At Cost
1 inch	At Cost	At Cost	At Cost	At Cost	At Cost	At Cost
1 ½ inch	At Cost	At Cost	At Cost	At Cost	At Cost	At Cost
2 inch	At Cost	At Cost	At Cost	At Cost	At Cost	At Cost
3 inch	At Cost	At Cost	At Cost	At Cost	At Cost	At Cost
4 inch	At Cost	At Cost	At Cost	At Cost	At Cost	At Cost
6 inch	At Cost	At Cost	At Cost	At Cost	At Cost	At Cost
8 inch	At Cost	At Cost	At Cost	At Cost	At Cost	At Cost
10 inch	At Cost	At Cost	At Cost	At Cost	At Cost	At Cost
12 inch	At Cost	At Cost	At Cost	At Cost	At Cost	At Cost

The rates approved herein would increase the monthly bill for an average 5/8 x ¾ inch meter residential customer with usage of 9,061 gallons by $4.53, or 13.5 percent, from $33.49 to $38.02.

B. Wastewater Division

RRUI's current wastewater rate design is based largely on flat monthly rates. Single-family residential customers pay a flat monthly rate based on the size of their water meter. In addition to paying the same monthly customer charges as single-family residential customers, commercial and multifamily residential customers also pay a commodity charge that is based on water use that exceeds 7,000 gallons per month. The proposed rates reflect the same basic design as the current rates, but include a 5 percent discount for School District.

Using the parties' recommended rate design, and the revenue requirement established above, we approve the following rates and charges for RRUI's Wastewater Division:

Monthly Usage Charge	**Current Rates**	**Approved Rates[1]**
Meter Size (All Classes)		
5/8 x ¾ inch	$45.88	$49.00
5/8 x ¾ inch (low income)	39.00	41.65
¾ inch	52.88	56.50
¾ inch (low income)	44.95	48.03
1 inch	64.64	69.10
1 inch (low income)	54.94	58.74
1 ½ inch	95.44	102.00
2 inch	132.38	141.50
3 inch	230.62	246.50
4 inch	341.83	365.40
6 inch	649.58	694.40
8 inch	944.45	1,057.78
10 inch	1,415.24	1,585.07
12 inch	2,012.57	2,254.08
Commodity Charge – per 1,000 gallons		
Commercial and Multi-Tenant Only		
0 gallons to 7,000 gallons	--	--
Over 7,000 gallons	$4.67	$5.00
Other Service Charges		
Establishment	$15.00	$15.00
Establishment (After Hours)	25.00	NT
Reconnection (Delinquent)	15.00	15.00
Reconnection (Delinquent) After Hours	25.00	NT
Deposit	*	*
Deposit Interest	**	**
Re-establishment (within 12 months)	***	***
NSF Check	25.00	25.00
Late Payment Penalty	1.5% per mo.	1.5 % per mo.
Deferred Payment	1.5% per mo.	1.5% per mo.
Service Calls – per hour/after hours(a)	40.00	NT
After Hours Service Charge – at customer's request	NT	50.00
Service Line Installation Charges		
Service Line Size		
4 inch	At Cost	At Cost
6 inch	At Cost	At Cost
8 inch	At Cost	At Cost
10 inch	At Cost	At Cost
12 inch	At Cost	At Cost

(1) A 5 percent discount is applicable to the public schools operated by the Santa Cruz County School District No. 35 receiving water and/or wastewater utility services from the Company.

*Per Commission Rule A.A.C. R14-2-603(B)

**Per Commission Rule A.A.C. R14-2-603(B)
*** Per Commission Rule A.A.C. R14-2-603(D) – Months off system times the monthly minimum.
(a) No charge for service calls during normal working hours.

Under the authorized rates, the monthly residential wastewater bill would increase $3.12, or 6.8 percent, from $45.88 to $49.00.

X. **Other Issues**

Staff's investigation of RRUI led to the following findings and conclusions:[205]

1. The Arizona Department of Environmental Quality ("ADEQ") regulates RRUI's water system under ADEQ Public Water System ("PWS") No. 12-011. Based on compliance information submitted by the Company, the system has no deficiencies and ADEQ has determined that the system is currently delivering water that meets water quality standards required by A.A.C. Title 18, Chapter 4 (ADEQ report dated November 6, 2012);
2. RRUI is located within the Santa Cruz Active Management Area ("AMA") and is subject to its AMA reporting and conservation requirements. Staff received an Arizona Department of Water Resources ("ADWR") compliance status report on November 6, 2012, which indicated that RRUI is currently in compliance with ADWR requirements governing water providers and/or community water systems;
3. Staff concluded that the Company has adequate water production and storage capacity to serve the existing customer base and reasonable growth;
4. The Commission's Utilities Division Compliance Section shows no delinquent compliance items for RRUI;
5. RRUI has approved Curtailment Plan and Backflow Prevention Tariffs on file with the Commission;
6. RRUI has ten approved Best Management Practice ("BMP") tariffs on file with the Commission;
7. The Company reported 807,817,000 gallons pumped, 678,845,000 gallons sold and 48,810,000 gallons used for flushing lines, construction, backwashing and fire

[205] Ex S-5 Liu Dir at 3-7.

suppression, resulting in a water loss of 9.92 percent for the test year;

8. ADEQ regulates the RRUI wastewater treatment plants under Permit No. 14919 and 52015, and pursuant to the November 10, 2012 Compliance Status Reports issued by ADEQ, the systems are in compliance with ADEQ requirements; and
9. RRUI has adequate wastewater treatment capacity to serve the existing customer base and reasonable growth for both wastewater systems.

In addition to rates and charges, Staff recommends the following:

1. RRUI file documentation showing specific procedures and steps taken to ensure that there is an accurate accounting of the amount of water actually used for "Authorized Use" purposes, and that the documentation should be filed as a compliance item with Docket Control within 60 days of the effective date of the Commission Decision in this matter;
2. If the water used by "Authorized Use" in one month is more than 5,000,000 gallons the Company should explain in detail the reason(s) for this use in its annual water loss compliance reporting per Decision No. 72059;[206]
3. The Company continue to record and monitor monthly water losses and repair any leak as soon as it is discovered; and
4. RRUI be required to provide separate wastewater descriptions for its major wastewater system (wastewater flows to the NWWTP) and small wastewater system (the aerobic stabilization pond) in future Commission Annual Reports, beginning with the 2013 Annual Report filed in 2014.

RRUI has agreed to Staff's recommendations. We find that Staff's recommendations concerning plant operations and reporting are reasonable and adopt them.

During the hearing, the issue of the number of Spanish speaking residents in RRUI's service territory was discussed.[207] In addition, the Company reported that despite claims that the service territory was located in an economically depressed area, there is a low "take rate" for the low income

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[206] In the last rate case, the Commission ordered RRUI to file an annual water loss report within 90 days of the end of each calendar year.
[207] Tr. at 338-344 (Sorenson).

tariff that was approved in the last rate case.[208] The Company appeared committed to finding effective ways to communicate with its Spanish-speaking customers. The Company already employs Spanish speaking customer service representatives, but Mr. Sorensen suggested there may be other ways to reach out to Spanish-speaking customers, such as making better use of its newsletter.[209] In this period before the next rate case, the Company, with assistance from Staff and RUCO, should attempt to devise an efficient and cost-effective means for conveying information about its low income tariff as well as any future proposed rate increases to its bilingual and Spanish-speaking community. This may be (but is not limited to) by providing information in Spanish on the website, making use of its newsletter or community forums and/or in bill inserts about who qualifies and how to apply for its low income tariff and how to receive complete translated public notices in writing.

* * * * * * * * * *

Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

FINDINGS OF FACT

1. RRUI provides water and wastewater service to an area of Santa Cruz County, Arizona. In the test year ended February 29, 2012, the Company provided water-only service to approximately 6,751 connections, and combined water and wastewater service to 2,207 connections.

2. RRUI is a subsidiary of Liberty Utilities is a subsidiary of APUC, a publicly-traded corporation on the Toronto Stock Exchange.

3. RRUI's current rates were set in Decision No. 72059 (January 6, 2011).

4. On May 31, 2012, RRUI filed its Rate Application.

5. On June 28, 2012, RRUI filed an Amendment to its Application.

6. On July 2, 2012, Staff notified the Company that its Rate Application was sufficient under the guidelines outlined in A.A.C. R14-2-103, and classified the utility as Class B.

7. On July 5, 2012, Staff filed a Proposed Schedule and Request for Procedural Order.

8. On July 6, 2012, RUCO filed an Application to Intervene.

[208] Tr. at 325 (Sorensen).
[209] Tr. at 326 (Sorensen).

9. By Procedural Order dated July 13, 2012, RUCO was granted intervention, the hearing was set for March 26, 2013, and other procedural deadlines were established, including dates to file pre-filed written testimony and for intervention.

10. On August 13, 2012, RRUI filed a Request to Modify Procedural Schedule by moving the start of the hearing one day later to March 27, 2013. By Procedural Order dated August 17, 2012, the request was granted.

11. On October 5, 2012, RRUI filed an Affidavit of Certification of Mailing and Publication indicating that notice of the hearing was published in the *Nogales International* on September 21, 2012, and mailed to customers on September 7, 2012, September 12, 2012, and September 24, 2012.

12. On December 13, 2012, the County filed a Request to Intervene, which was granted on December 28, 2012.

13. On December 31, 2012, Staff and RUCO filed direct testimony related to rate base and revenue requirement.

14. On January 7, 2013, Staff and RUCO filed direct testimony related to cost of capital and rate design.

15. On January 25, 2013, the School District, a customer of RRUI, filed a Motion to Intervene.

16. On January 28, 2013, RRUI filed its rebuttal testimony.

17. On January 30, 2013, RRUI filed a Response to School District's request to intervene, stating that it did not object to the late request for intervention as long as the School District complied with the existing procedural schedule.

18. On February 4, 2013, the School District was granted intervention, on the condition that School District accept established deadlines for testimony and hearing.

19. On February 19, 2013, RUCO and Staff filed their surrebuttal testimony.

20. On February 26, 2013, RRUI filed an Unopposed Request for Extension of Time to file rejoinder testimony. The Request was granted by Procedural Order dated February 28, 2013.

. . .

21. On March 1, 2013, RRUI filed a Request for Change to Pre-hearing Conference, to have the scheduled Pre-hearing Conference conducted telephonically. RRUI also filed a Motion to Bifurcate, requesting that the hearing be conducted in two phases, with the first phase addressing issues related to fair value and charges, and the second phase addressing the Company's request for a DSIC.

22. On March 7, 2013, RUCO filed a Response to the Motion to Bifurcate. RUCO did not oppose bifurcation as long as: 1) all parties were allowed to supplement the record on how the cost of equity might be affected by the adoption of a DSIC mechanism; and 2) all pre-filed testimony related to the DSIC or a DSIC-like mechanism was included in the record.

23. On March 8, 2013, Intervenors filed a Response to RRUI's Motion to Bifurcate. Intervenors opposed bifurcation on the grounds that they believed that the DSIC is not a stand-alone rate-making issue and its approval would affect the Company's financial risk and cost of equity.

24. On March 11, 2013, RRUI filed a Reply to RUCO's Response and a Reply to the Intervenors' Response/Objection. RRUI objected to the Intervenors' request to file additional testimony during the first phase of the proposed bifurcated proceeding and objected to RUCO's condition to supplement the record in Phase 2 because RRUI believed it would defeat the purpose of bifurcation and would result in re-litigating the cost of equity.

25. On March 12, 2013, Staff filed a Response in Support of Company's Motion to Bifurcate. Staff believed that any proceeding on the DSIC should await the outcome of the decision in the on-going AWC rate case because it was likely that any DSIC approved in the AWC docket would be used as a template for other utilities.

26. By Procedural Order dated March 20, 2013, it was determined that bifurcation of the proceeding as proposed by RRUI was not in the public interest given the issues raised by the parties concerning single issue rate making and the overlap of a DSIC or DSIC-like mechanism with other rate issues.

27. A Pre-hearing Conference convened telephonically on March 21, 2013, to discuss the conduct of the hearing. In response to the ruling in the March 20, 2013, Procedural Order regarding the issue of the DSIC, RRUI withdrew its request for a DSIC in this proceeding. The parties agreed

that the pre-filed testimony addressing the DSIC and its predecessor-mechanisms would be withdrawn.

28. The Hearing convened on March 27, 2013, as scheduled, before a duly authorized Administrative Law Judge, and continued over the following two days, concluding on March 29, 2013. Christopher Krygier, the utility rates and regulatory manager for Liberty Utilities, Greg Sorensen, Vice President and General Manager for Liberty Utilities and Tom Bourassa, a rate consultant, testified for RRUI; William Rigsby testified for RUCO;[210] and John Cassidy, Jian Liu and Gordon Fox testified for Staff. Neither the County nor School District filed written testimony and did not offer witnesses.

29. On April 23, 2013, RRUI, RUCO and Staff filed Final Schedules.

30. RRUI, RUCO, Intervenors, and Staff filed Closing Briefs on May 3, 2013.

31. Staff filed its Reply Brief on May 10, 2013; and RRUI and RUCO filed their Reply Briefs on May 15, 2013. Intervenors did not file a Reply Brief.

32. The Commission received a number of comments from the public objecting to the proposed rate increase.

33. RRUI's FVRB for its Water Division is $7,731,209.

34. RRUI's FVRB for its Wastewater Division is $4,790,738.

35. In the test year, RRUI's Water Division had adjusted operating income of $454,769, on total adjusted test year revenues of $2,864,823. RRUI's test year rate of return was 5.88 percent.

36. In the test year, RRUI's Wastewater Division had adjusted operating income of $359,684 on total revenues of $1,402,842, which was a 7.51 percent rate of return.

37. Utilizing a pro forma capital structure, as discussed herein, consisting of 20 percent debt and 80 percent equity is reasonable under current circumstances, with a cost of debt of 5.7 percent and cost of equity of no more than 9.2 percent.

38. A fair value rate of return of 8.5 percent will provide RRUI with a reasonable and appropriate return on its investment and will result in just and reasonable rates.

[210] Mr. Rigsby adopted the testimony of Mr. Coley. Tr. at 435-36.

39. Based on a FVRB of $7,731,209 for the Water Division and an authorized fair value rate of return of 8.5 percent, RRUI is entitled to a revenue increase of $335,737, or 11.72 percent, over test year revenues.

40. Based on a FVRB of $4,790,738 for the Wastewater Division, and a fair value rate of return of 8.5 percent, RRUI is entitled to a revenue increase of $78,847, or 5.62 percent, over test year revenues.

41. As discussed herein, it is reasonable and in the public interest that RRUI track any increases and decreases in the contract with the City of Nogales for the NWWTP such that in a future rate case, the Company can seek to recover increased costs, or to credit ratepayers for lower costs, that result from the contract true-up process.

42. As discussed herein, it is reasonable and in the public interest that RRUI file documentation with Docket Control that it has incurred the authorized pension plan costs in 2013, and that RRUI track any lower than authorized pension plan costs such that in the next rate case, ratepayers can be credited for any authorized pension plan costs that were not actually made.

43. Staff's proposed rate design, modified to provide a 5 percent discount to School District as reflected in the parties' Final Schedules and to provide the revenue requirement authorized herein, is reasonable.

44. ADEQ regulates RRUI's water system under ADEQ PWS No. 12-011, and has determined that the system has no deficiencies and is currently delivering water that meets water quality standards required by A.A.C. Title 18, Chapter 4.

45. RRUI is located within the Santa Cruz AMA and is subject to its AMA reporting and conservation requirements. ADWR has indicated that RRUI is currently in compliance with ADWR requirements governing water providers and/or community water systems.

46. The Company has adequate water production and storage capacity to serve the existing customer base and reasonable growth.

47. There are no delinquent Commission compliance items for RRUI.

48. RRUI has approved Curtailment Plan and Backflow Prevention Tariffs on file with the Commission.

49. RRUI has ten approved BMP tariffs on file with the Commission.

50. The Company reported 807,817,000 gallons pumped, 678,845,000 gallons sold and 48,810,000 gallons used for flushing lines, construction, backwashing and fire suppression resulting in a water loss of 9.92 percent for the test year.

51. ADEQ regulates the RRUI wastewater treatment plants under Permit No. 14919 and 52015, and has determined the systems are in compliance with ADEQ requirements.

52. RRUI has adequate wastewater treatment capacity to serve the existing customer base and reasonable growth for both wastewater systems.

53. Staff recommends the following:

a. RRUI file documentation showing specific procedures followed by its operations staff and steps taken to ensure that there is an accurate accounting of the amount of water actually used for "Authorized Use" purposes, and that the documentation should be filed as a compliance item with Docket Control within 60 days of the effective date of the Commission Decision in this matter;

b. If the water used by "Authorized Use" in one month is more than 5,000,000 gallons the Company shall explain in detail the reason(s) for this use in its annual water loss compliance reporting per Decision No. 72059;

c. The Company continue to record and monitor monthly water losses and repair any leak as soon as it is discovered; and

d. RRUI be required to provide separate wastewater descriptions for its two wastewater systems in future Commission Annual Reports, beginning with the 2013 Annual Report filed in 2014.

54. The Company does not object to Staff's recommendations. We find that they are reasonable and should be adopted.

55. The Company should continue to evaluate ways to improve communications with its Spanish-speaking customers, and should consult with Staff and RUCO to devise ways to inform its customers about its low income tariff as well as to improve bi-lingual notice procedures for any future rate cases.

CONCLUSIONS OF LAW

1. RRUI is a public service corporation within the meaning of Article XV of the Arizona Constitution and A.R.S. §§ 40-250 and 40-251.

2. The Commission has jurisdiction over RRUI and the subject matter of the Rate Application.

3. Notice of the Rate Application was provided in the manner prescribed by law.

4. The rates and charges authorized herein are just and reasonable and should be approved.

ORDER

IT IS THEREFORE ORDERED that Rio Rico Utilities, Inc. shall file with Docket Control, as a compliance item in this docket, by July 31, 2013, revised rate schedules setting forth the following rates and charges:

WATER DIVISION

Monthly Usage Charge **Meter Size (All Classes)**	**Authorized Rates**[1]
5/8 x ¾ inch	$15.46
5/8 x ¾ inch (low income)	13.14
¾ inch	23.19
¾ inch (low income)	19.71
1 inch	38.65
1 inch (low income)	32.85
1 ½ inch	77.30
2 inch	123.68
3 inch	247.36
4 inch	366.50
6 inch	773.00
8 inch	1,236.80
10 inch	1,777.90
12 inch	3,323.90
Morningstar Ranch Community Association – 6 inch	549.00
Commodity Charge (per 1,000 gallons) all classes **(less 15% for low income customers as applicable)**	
5/8 x ¾ inch meter	
First 3,000 gallons	$1.49
3,001-9,000 gallons	2.98
Over 9,000 gallons	3.49
¾ inch meter	
First 4,000 gallons	2.98
Over 4,000 gallons	3.49

1 inch meter	
First 23,000 gallons	2.98
Over 23,000 gallons	3.49
1 ½ inch meter	
First 45,000 gallons	2.98
Over 45,000 gallons	3.49
2 inch meter	
First 72,000 gallons	2.98
Over 72,000 gallons	3.49
3 inch meter	
First 144,000 gallons	2.98
Over 144,000 gallons	3.49
4 inch meter	
First 225,000 gallons	2.98
Over 225, 000 gallons	3.49
6 inch meter	
First 450,000 gallons	2.98
Over 450,000 gallons	3.49
8 inch meter	
First 720,000 gallons	2.98
Over 720,000 gallons	3.49
10 inch meter	
First 1,025,000 gallons	2.98
Over 1,025,000 gallons	3.49
12 inch meter	
First 1,025,000 gallons	2.98
Over 1,025,000 gallons	3.49
Morningstar Ranch Community Association	4.79
Fire Lines:	
Up to 8 inches	Per Rule ****
10 inches	Per Rule****
12 inches	Per Rule ****

Other Service Charges:

Establishment	$15.00
Reconnection (Delinquent)	15.00
Meter Test (If correct)	15.00
Meter Re-Read (if correct)	20.00
Deposit	*
Deposit Interest	**
Re-establishment (within 12 months)	***
NSF Check	15.00
Late Payment Penalty	1.5% per mo.
Deferred Payment	1.5% per mo.
Moving Meter at Customer Request	At Cost

After hours service calls – at customer's request(a) 50.00

(1) A 5 percent discount is applicable to the public schools operated by the Santa Cruz County School District No. 35 receiving water and/or wastewater utility services from the Company.

*Per Commission Rule A.A.C. R14-2-403 (B)
**Per Commission Rule A.A.C. R14-2-403(B)
***Per Commission Rule A.A.C. R14-2-403(D) – months off the system times the monthly minimum
****1 percent of monthly minimum for a comparable size meter, but no less than that $5.00 per month. The service charge for fire sprinklers is only applicable for service line separate and distinct from the primary water service line.

(b) No charge for service calls during normal working hours.

In addition to the collection of regular rates, the utility will collect from its customers a proportionate share of any privilege, sales, use and franchise tax, per commission Rules A.A.C. R14-2-408(5).

Service and Meter Installation Charges
(Refundable pursuant to A.A.C. R14-2-405)

Service Size	Service Line	Meter	Total
5/8 inch	At Cost	At Cost	At Cost
¾ inch	At Cost	At Cost	At Cost
1 inch	At Cost	At Cost	At Cost
1 ½ inch	At Cost	At Cost	At Cost
2 inch	At Cost	At Cost	At Cost
3 inch	At Cost	At Cost	At Cost
4 inch	At Cost	At Cost	At Cost
6 inch	At Cost	At Cost	At Cost
8 inch	At Cost	At Cost	At Cost
10 inch	At Cost	At Cost	At Cost
12 inch	At Cost	At Cost	At Cost

WASTEWATER DIVISION

Monthly Usage Charge **Meter Size (All Classes)**	**Approved Rates[1]**
5/8 x ¾ inch	$49.00
5/8 x ¾ inch (low income)	41.65
¾ inch	56.50
¾ inch (low income)	48.03
1 inch	69.10
1 inch (low income)	58.74
1 ½ inch	102.00
2 inch	141.50
3 inch	246.50
4 inch	365.40
6 inch	694.40
8 inch	1,057.78
10 inch	1,585.07

12 inch	2,254.08
Commodity Charge – per 1,000 gallons	
<u>Commercial and Multi-Tenant Only</u>	
0 gallons to 7,000 gallons	--
Over 7,000 gallons	$5.00
<u>Other Service Charges</u>	
Establishment	$15.00
Reconnection (Delinquent)	15.00
Deposit	*
Deposit Interest	**
Re-establishment (within 12 months)	***
NSF Check	25.00
Late Payment Penalty	1.5 % per mo.
Deferred Payment	1.5% per mo.
After Hours Service Charge – at customer's request (a)	50.00
<u>Service Line Installation Charges</u>	
Service Line Size	
4 inch	At Cost
6 inch	At Cost
8 inch	At Cost
10 inch	At Cost
12 inch	At Cost

(1) A 5 percent discount is applicable to the public schools operated by the Santa Cruz County School District No. 35 receiving water and/or wastewater utility services from the Company.

*Per Commission Rule A.A.C. R14-2-603(B)
**Per Commission Rule A.A.C. R14-2-603(B)
*** Per Commission Rule A.A.C. R14-2-603(D) – Months off system times the monthly minimum

(a) No Charge for service calls during normal working hours.

IT IS FURTHER ORDERED that the above rates and charges shall be effective for all service provided on and after August 1, 2013.

IT IS FURTHER ORDERED that Rio Rico Utilities, Inc. shall notify its customers of the rates and charges authorized herein, and their effective date, in a form acceptable to the Commission's Utilities Division Staff, by means of an insert in its next regularly scheduled billing or as a separate mailing.

IT IS FURTHER ORDERED that, in addition to the collection of its regular rates and charges, Rio Rico Utilities, Inc. shall collect from its customers a proportionate share of any privilege, sales or use tax per A.A.C. R14-2-409(D).

IT IS FURTHER ORDERED that within 60 days of the effective date of this Decision, Rio

Rico Utilities, Inc. shall file documentation with Docket Control as a compliance item, showing specific procedures followed by its operations staff and steps taken to ensure that there is an accurate accounting of the amount of water actually used for “Authorized Use” purposes.

IT IS FURTHER ORDERED that Rio Rico Utilities, Inc. shall record and monitor monthly water losses and shall continue to file its annual water loss reports within 90 days of the end of each calendar year; and if the water used by “Authorized Use” in one month is more than 5,000,000 gallons, Rio Rico Utilities, Inc. shall explain in detail the reason(s) for this use in its annual water loss compliance reporting.

IT IS FURTHER ORDERED that Rio Rico Utilities, Inc. shall provide separate wastewater descriptions for its two wastewater systems in future Commission Annual Reports, beginning with the 2013 Annual Report filed in 2014.

IT IS FURTHER ORDERED that on a going forward basis, Rio Rico Utilities, Inc. shall accurately track and record plant additions, plant retirements, depreciation expense and accumulated depreciation, and that Rio Rico Utilities, Inc.'s failure to do so may subject the Company to sanctions, fines or other penalties.

IT IS FURTHER ORDERED that by February 28, 2014, Rio Rico Utilities, Inc. shall file with Docket Control, as a compliance filing, a statement verified by an officer that it funded the Pension Plan in 2013 as authorized herein; and Rio Rico shall track any pension plan payments that are lower than the amounts authorized herein, such that in a future rate case ratepayers can be credited if the pension plan was not funded as authorized.

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IT IS FURTHER ORDERED that Rio Rico Utilities, Inc. shall track any increases or decreases in the contract price related to the Nogales Wastewater Treatment Plant, such that in a future rate case, it may seek recovery of any increased costs, or propose to credit ratepayers with lower costs, resulting from the contract true-up process with the City of Nogales.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN | COMMISSIONER

COMMISSIONER | COMMISSIONER | COMMISSIONER

IN WITNESS WHEREOF, I, JODI JERICH, Executive Director of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this 30th day of July 2013.

JODI JERICH
EXECUTIVE DIRECTOR

DISSENT ____________________

DISSENT ____________________

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DOCKET NO.: WS-02676A-12-0196

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