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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF ARIZONA WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY, AND FOR ADJUSTMENTS TO ITS RATES AND CHARGES FOR UTILITY SERVICE FURNISHED BY ITS EASTERN GROUP AND FOR CERTAIN RELATED APPROVALS.	DOCKET NO. W-01445A-11-0310 **NOTICE OF FILING REBUTTAL TESTIMONY (REHEARING)**

Arizona Water Company hereby files the Rebuttal Testimonies of Joel M. Reiker and Pauline M. Ahern in the above-captioned docket regarding the rehearing/reopening, respectively, of Decision Nos. 73938 and 73736.

RESPECTFULLY SUBMITTED this 31st day of October, 2013.

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ARIZONA WATER COMPANY

Rebuttal Testimony of

Joel M. Reiker

I. <u>Introduction</u>

Q. PLEASE STATE YOUR NAME, EMPLOYER AND TITLE.

A. My name is Joel M. Reiker. I am employed by Arizona Water Company (the "Company") as Vice President – Rates and Revenue.

Q. ARE YOU THE SAME JOEL M. REIKER THAT PREVIOUSLY PROVIDED DIRECT TESTIMONY ON OCTOBER 4, 2013, IN THIS REHEARING PROCEEDING?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of my testimony is to respond to the direct testimony of Residential Utility Consumer Office ("RUCO") witnesses David C. Parcell, Ralph C. Smith and Robert B. Mease, filed on October 4, 2013.

Q. ARE ANY OTHER COMPANY WITNESSES SPONSORING REBUTTAL TESTIMONY IN THIS REHEARING PROCEEDING?

A. Yes. Company witness Pauline M. Ahern responds to RUCO witness Mr. Parcell's testimony concerning return on equity ("ROE").

II. <u>Response to RUCO</u>

Q. DOES RUCO PROVIDE ANY EVIDENCE IN ITS DIRECT TESTIMONY TO SUPPORT THE ARGUMENTS MADE IN ITS JULY 17, 2013, APPLICATION FOR REHEARING OF DECISION NO. 73938 ("APPLICATION")?

A. No. In its Application, RUCO argued that the Commission's "failure" to decrease the ROE it already authorized for the Company's Eastern Group when it approved the System Improvement Benefits ("SIB") mechanism in Decision No. 73938 was both "unlawful" and "unreasonable." As I explained in my direct

testimony filed on October 4, 2013, RUCO failed to cite any evidence in its Application to support those arguments. In its direct testimony on rehearing, RUCO fails to provide any evidence to show the Commission's actions were "unreasonable." Instead, RUCO attempts to distract the Commission by introducing a new cost of equity analysis and to re-argue various issues that are unrelated to its Application. In any event, both are outside the scope of this rehearing proceeding. Lacking any evidence to support RUCO's argument that the Commission acted "unreasonably," the Commission should reject RUCO's recommendations and Decision Nos. 73736 and 73938 should stand.

Q. DOES RUCO INTRODUCE A NEW ARGUMENT REGARDING ROE IN ITS DIRECT TESTIMONY?

A. Yes. On page 20 (lines 8-14) of the direct testimony of Mr. Parcell filed on October 4, 2013, RUCO now acknowledges that the Commission was *correct* when it concluded in Decision No. 73938 that "...to the extent (if any) that a DSIC impacts risk, the reduced risk would be reflected in the sample companies used to set the ROE..." As a result of this finding, the Commission went on to state in Decision No. 73938 that "we are not persuaded that any adjustment to the ROE is warranted."[1] Recognizing that a market-based cost of equity estimate already includes any effect that a SIB-like mechanism has on risk, RUCO is left with no other option at this stage of the proceeding than to re-argue the cost of equity applicable to the *entire water utility industry*. But RUCO's revised cost of equity analysis, sponsored by Mr. Parcell, is clearly outside of the scope of RUCO's Application and is irrelevant. The Commission determined the appropriate cost of equity "based upon all of the evidence"[2] *at the same time it determined all other components of the Company's cost of service* in the Eastern Group - based

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[1] *See* Decision No. 73938. p. 55, lines 11 – 20.
[2] *See* Decision No. 73736. p. 61, lines 3 – 11.

on a 2010 test year. It is inappropriate for RUCO to completely revise its original cost of equity analysis nearly three years after the end of the test year simply because RUCO disagrees with the SIB mechanism. RUCO's attempt to introduce a revised cost of equity analysis is not only out of bounds, but it contradicts RUCO's own argument in the Pima Utility Company rehearing proceeding currently pending before the Commission. In that case, RUCO argues that raising rates more than two years after the end of the test year to reflect an additional component of the utility's cost of service "violate[s] the Commission's Constitutional obligation to prescribe just and reasonable rates."[3]

Notwithstanding the irrelevance of RUCO's revised cost of equity analysis, it is contradicted by a general *increase* in capital costs in the months since the Commission determined the Company's cost of equity in this proceeding, as explained by Company witness Ms. Ahern in her rebuttal testimony.

Q. TURNING TO ANOTHER RUCO WITNESS, DOES MR. SMITH PROVIDE ANY EVIDENCE TO SHOW THE COMMISSION ACTED UNREASONABLY WHEN IT AUTHORIZED A SIB MECHANISM WITHOUT LOWERING THE ROE IT ALREADY ADOPTED?

A. No. Mr. Smith provides a general discussion of distribution system improvement charges ("DSIC") and cites to a report on DSIC-type mechanisms prepared by the Alaska Attorney General's Office's Regulatory Affairs and Public Advocacy Section ("RAPA"). According to page 5 (lines 15-16) of Mr. Smith's testimony, the RAPA report identifies "concerns regarding DSICs that should be of interest to regulators." However, on page 26 (lines 5-10) of the RAPA report, RAPA advocates the position that regulatory lag should be *embraced* as a tool to ensure that regulated utilities, on average, *do not* recover their prudently incurred costs. Clearly, RAPA's position is an outlier opinion at odds with Arizona's (and

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[3] *See* RUCO's Motion to Rehear Decision No. 73993 in Docket Nos. 11-0329 & 11-0330.

most other jurisdictions') policies and procedures. RAPA's position that regulated utilities should, on average, *not* recover their prudently incurred costs of service directly conflicts with the same "Constitutional obligation to prescribe just and reasonable rates" that RUCO vigorously cites in the Pima Utility Company case, and violates the long-standing (and widely accepted) regulatory compact that exists between a public utility and its regulator.

The regulatory compact requires that, in return for being granted the exclusive right to provide utility service to the certificated area, the regulated utility assumes an obligation to serve, with "just and reasonable" compensation for such service being equal to the costs incurred.[4] As cited on page 8 (lines 15-19) of my direct testimony on rehearing, the Commission recognized in Decision No. 73938 that it is in the best interest of customers for utility rates to be based on *no less* than cost, consistent with its Constitutional obligation to prescribe just and reasonable rates. RUCO apparently either rejects the requirement of just and reasonable rates (although RUCO insists on such a requirement in the Pima Utility Company case), or simply chooses to ignore the regulatory compact.

Q. IS THERE ANY EVIDENCE TO SHOW THAT RUCO EITHER REJECTS THE REQUIREMENT OF JUST AND REASONABLE RATES OR IGNORES THE REGULATORY COMPACT?

A. Yes. This is revealed in RUCO's fourth reason for rejecting the DSIC presented on page 6 (lines 6-15) of Mr. Mease's testimony, in which he states that "RUCO does not find that a DSIC surcharge is necessary for AWC to meet the Company's *obligation to provide safe and reliable water service*" [emphasis added]. In forming that conclusion, RUCO's witness relies on no evidence in the record and brushes aside all of the uncontested documentation and physical

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[4] *See* Bonbright, James C., Albert L. Danielsen and David R. Kamerschen. Principles of Public Utility Rates. Public Utilities Reports, Inc. 1988. p. 109 & Phillips, Charles Jr. The Regulation of Public Utilities: Theory and Practice. Public Utilities Reports, Inc. 1988. pp. 109 – 111.

evidence presented throughout this proceeding that demonstrates that a SIB mechanism is necessary and justified.

The fact that most, if not all, state regulatory bodies (including the Commission) recognize that regulated utilities *are* entitled to just and reasonable compensation in return for fulfilling their obligation to serve led the National Association of Regulatory Utility Commissioners ("NARUC") to adopt a Resolution on July 24, 2013, "Addressing [the] Gap Between Authorized Versus Actual Returns on Equity in Regulation of Water and Wastewater Utilities." That gap (illustrated in Exhibit JMR-RH1) is striking compared to the relationship between authorized and actual ROEs in the electric and natural gas utilities. In its July 24, 2013 Resolution (attached hereto as Exhibit JMR-RH2), NARUC identified "the implementation and effective use of" the "Best Practices" outlined in its 2005 Resolution[5] "as a critical component of a water and/or wastewater utility's reasonable ability to earn its authorized return." Among those "Best Practices" is the implementation of DSIC (or SIB) mechanisms.

Q. DOES MR. MEASE PROVIDE ANY EVIDENCE TO SHOW THE COMMISSION ACTED UNREASONABLY?

A. No. On pages 3 (line 20) through 6 (line 15) of his direct testimony, Mr. Mease simply repeats RUCO's arguments from Phase 1 of this proceeding regarding DSIC-type mechanisms in general. Then, on pages 11 (line 18) through 13 (line 16) of his testimony, Mr. Mease again attempts to repeat arguments RUCO made in Phase 1 against various *operating expenses* that the Commission found reasonable in determining the Company's revenue requirement (for which RUCO did not seek rehearing). Neither portion of Mr. Mease's testimony is relevant to RUCO's Application and is outside the scope of this rehearing proceeding. In

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[5] *See* Phase 1 Exhibit A-9 (Direct Testimony of Joseph D. Harris, Exhibit JDH-3, Exhibit F (Resolution Supporting Consideration of Regulatory Policies as "Best Practices")).

any event, such issues have already been addressed by the Commission in this proceeding. The remainder of Mr. Mease's testimony focuses on SIB mechanism eligibility requirements and the SIB Efficiency Credit, which are also outside the scope of this rehearing proceeding.

Q. IS THERE ANY MERIT TO MR. MEASE'S CLAIM THAT THE SIB MECHANISM WOULD GIVE THE COMPANY THE OPPORTUNITY TO REPLACE PLANT ITEMS THAT WOULD NOT BE RECOVERED UNDER A TYPICAL SIB MECHANISM?

A. No. Mr. Mease has provided no basis or evidence that the Company could seek a surcharge to recover the costs associated with eligible plant replacements not normally recovered under a "typical" SIB mechanism. In fact, Mr. Mease does not even describe what is included in a "typical" SIB mechanism, ignoring the extensive evidence on eligible projects that is already part of the record in this docket, and which the Commission has expressly acknowledged and approved.[6]

Q. DOES THE SIB MECHANISM CONTAIN GREATER CUSTOMER PROTECTIONS AND MONTETARY BENEFITS THAN THE A TYPICAL DSIC MECHANISM?

A. Yes. Unlike the first DSIC mechanism approved by the Pennsylvania Public Utility Commission[7] in 1996 (which can reasonably be described as "typical"), the SIB mechanism requires a detailed up-front prudency review in order for projects to be eligible for cost recovery. To facilitate such a review in Phase 1 of this proceeding, the Company provided a 394-page engineering analysis[8] supporting the 52 SIB-eligible projects before those projects were constructed. This type of up-front review was not required in the first DSIC mechanism in Pennsylvania

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[6] *See* Decision No. 73938, Attachment A (Paragraph 2.4 & Exhibit A).
[7] *See* Phase 1 Exhibit A-9 (Direct Testimony of Joseph D. Harris, Exhibit JDH-3, Exhibit C (Opinion and Order - Philadelphia Suburban Water Company)).
[8] *See* Phase 1 Exhibit A-28 (Direct Testimony of Fredrick K. Schneider, Exhibit FKS-13).

and would not occur in a general rate case absent the SIB mechanism. Further, the Company will provide Staff and RUCO with 100 percent of the contractor invoices supporting SIB-eligible projects upon filing for surcharge recovery – a stark difference from the *random sampling* of invoices audited by Staff during a general rate case. Contrary to RUCO's unsupported claims, the regulatory review of qualifying infrastructure replacements is more rigorous under the SIB mechanism.

Q. DOES THE SIB MECHANISM INCLUDE ANY OTHER CUSTOMER BENEFITS THAT WERE NOT INCLUDED IN THE ORIGINAL DSIC APPROVED BY THE PENNSYLVANIA PUBLIC UTILITY COMMISSION?

A. Yes. The SIB mechanism includes an Efficiency Credit equal to five percent of the required SIB mechanism revenues. This Efficiency Credit is a monetary benefit to customers in that it is not tied to any known and measurable reductions in costs.[9] The effect of the Efficiency Credit is an 87-basis point reduction to the ROE applicable to all SIB-eligible infrastructure replacements.[10]

Q. SHOULD THE COMMISSION GIVE ANY WEIGHT TO MR. MEASE'S TESTIMONY, ON PAGE 13 (LINES 14 – 16), WHERE HE ASSERTS THAT THE EFFICIENCY CREDIT "WILL BE FAR LESS THAN THE REDUCTION OF O&M EXPENSES THAT THE COMPANY WILL EXPERIENCE?"

A. No. Mr. Mease fails to provide any evidence of known and measurable reductions in O&M expenses related to the SIB mechanism. Instead, Mr. Mease offers his unsupported *opinion*, on page 13 (lines 12-13) of his testimony, that "it just makes logical sense." Contrary to Mr. Mease's opinion, the evidence in this proceeding shows that water utilities operate in a rising-cost industry.[11] In any

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[9] *See* Phase 2 transcript, p. 276.

[10] *See* Decision No. 73938, Attachment A (SIB Settlement), Paragraph 3 & Exhibit F to Attachment A (SIB Schedule D).

[11] *See* Phase 1 Exhibit A-28 (Direct Testimony of Fredrick K. Schneider, Exhibit FKS-13), Phase 1 Exhibit A-9 (Direct Testimony of Joseph D. Harris, Section VI), Phase 1 Exhibit A-3 (2011 Rate Hearing Exhibit

event, the earnings test required under the SIB mechanism effectively precludes the Company from implementing a SIB surcharge to the extent the Company exceeds its authorized rate of return as a result of reduced operating expenses or otherwise.[12]

Q. DOES THAT CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.

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for Test Year Ending 12/31/10, Schedule C), Phase 1 Exhibit A-4 (Rebuttal Testimony of Joel M. Reiker, pp. 14 – 17 & 31 - 32), Phase 1 Exhibit A-6 (T&D Maintenance Cost Per Customer 1966-2010) & Phase 2 transcript, p. 65.

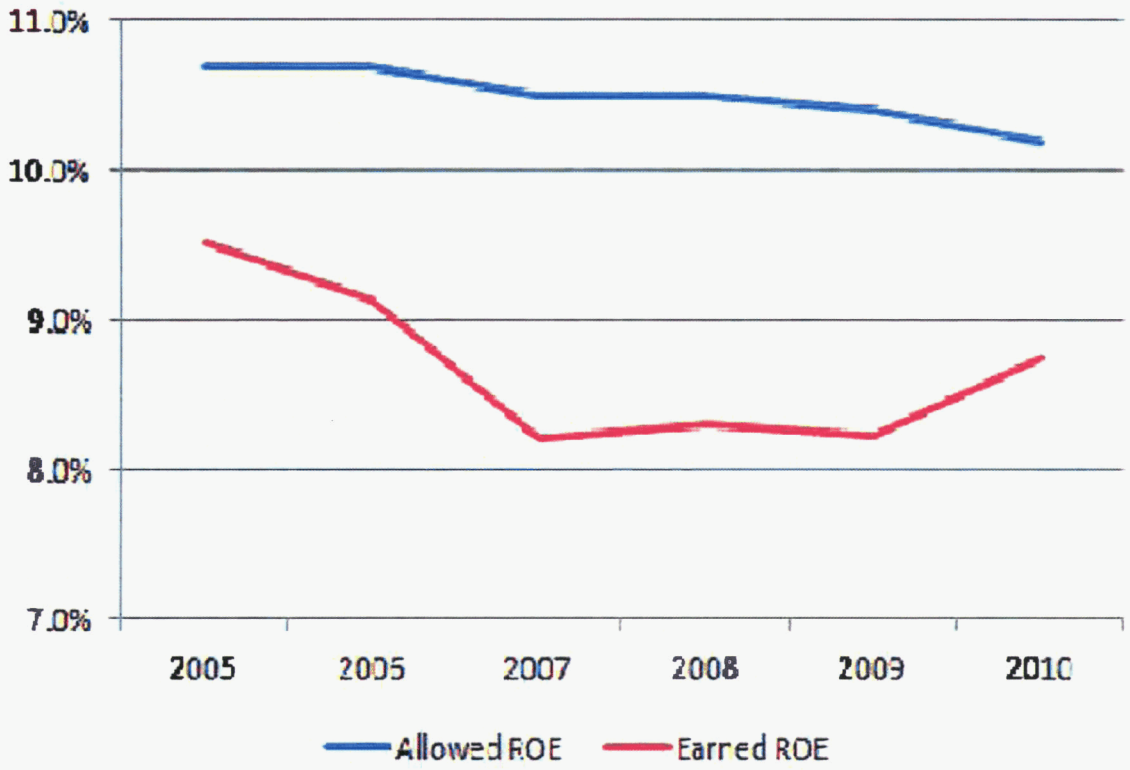
[12] *See* Decision No. 73938, p. 51, lines 6 – 28.

EXHIBIT JMR-RH1

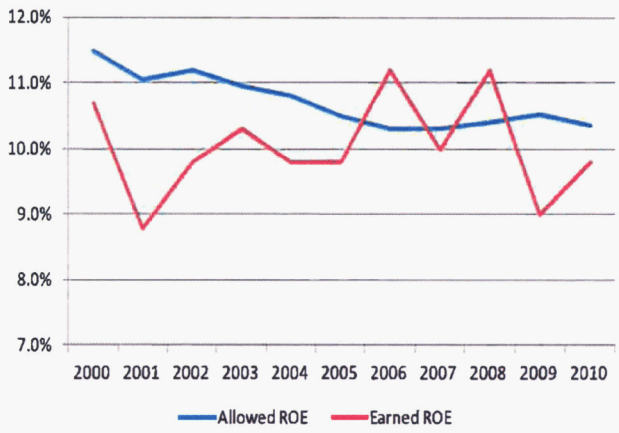
Return on Equity (ROE)
Allowed vs. Earned Comparison

BAIRD

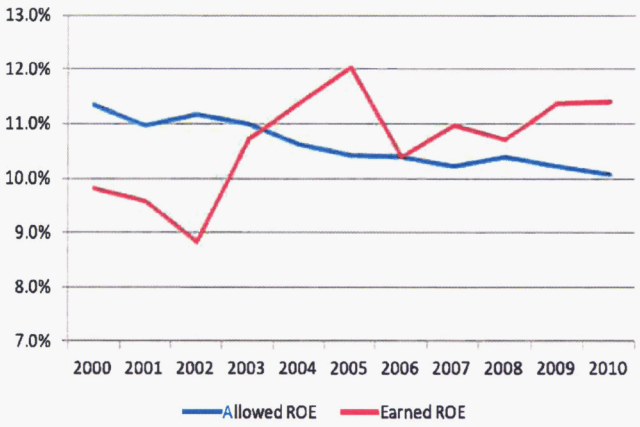
Water Utilities



Electric Utilities



Natural Gas Utilities



Source: SNL Energy, RW Baird

EXHIBIT JMR-RH2

Resolution Addressing Gap Between Authorized Versus Actual Returns on Equity in Regulation of Water and Wastewater Utilities

WHEREAS, There is both a constitutional basis and judicial precedent allowing investor owned public water and wastewater utilities the opportunity to earn a rate of return that is reasonably sufficient to assure confidence in the financial soundness of the utility and its ability to provide quality service; *and*

WHEREAS, Through the *Resolution Supporting Consideration of Regulatory Policies Deemed as "Best Practices"* (2005), the National Association of Regulatory Utility Commissioners has previously recognized the role of innovative regulatory policies and mechanisms in the ability for public water and wastewater utilities to address significant infrastructure investment challenges facing water and wastewater system operators; *and*

WHEREAS, Public utilities carry the responsibility to invest prudently, provide safe and reliable service, and take reasonable action to take precautionary measures to address business risk and economic forces, as necessary; *and*

WHEREAS, Recent analysis shows that as compared to other regulated utility sectors, significant and widespread discrepancies continue to be observed between commission authorized returns on equity and observed actual returns on equity among regulated water and wastewater utilities; *and*

WHEREAS, The extent of such discrepancies suggests the existence of challenges unique to the regulation of water and wastewater utilities; *and*

WHEREAS, Ratemaking that has worked reasonably well in the past for water and wastewater utilities no longer addresses the challenges of today and tomorrow. Revenue, driven by declining use per customer, is flat to decreasing while the nature of investment (rate base) has shifted largely from plant needed to serve new customers to non-revenue producing infrastructure replacement; *and*

WHEREAS, Deficient returns present a clear challenge to the ability of the water and wastewater industry to attract the capital necessary to address future infrastructure investment requirements necessary to provide safe and reliable service, which could exceed one trillion dollars over a 20-year period; *and*

WHEREAS, The NARUC Committee on Water recognizes the critical role of the implementation and the effective use of sound regulatory practice and the innovative regulatory policies identified in the *Resolution Supporting Consideration of Regulatory Policies Deemed as "Best Practices"* (2005); *and*

WHEREAS, It is recognized that State legislative bodies play a significant and important role in considering and addressing the challenges present in the regulation of water and wastewater utilities; therefore, it is critical that economic regulators strive to continue to foster an environment of cooperation and open communication between themselves, legislative bodies,

and other State agencies involved in the oversight of water and wastewater utilities such that implementation and effective use of sound regulatory practice and the innovative regulatory policies identified in the *Resolution Supporting Consideration of Regulatory Policies Deemed as "Best Practices"* (2005) is both possible and effective; *and*

WHEREAS, A number of issues have been identified that if addressed may assist in lessening the discrepancy between authorized and actual returns, including: a) reducing, where appropriate, the length of time between rate cases and/or the length of time to process rate cases for regulated water and wastewater utilities; b) reducing rate case expense relative to requested revenue increases through the encouragement of mediation and settlement as appropriate; and c) examining the rate of infrastructure replacement and system improvements among regulated water and wastewater utilities; *now, therefore be it*

RESOLVED, That the Board of Directors of the National Association of Regulatory Utility Commissioners, convened at its 2013 Summer Meeting in Denver, Colorado, identifies the implementation and effective use of sound regulatory practice and the innovative regulatory policies identified in the *Resolution Supporting Consideration of Regulatory Policies Deemed as "Best Practices"* (2005) as a critical component of a water and/or wastewater utility's reasonable ability to earn its authorized return; *and be it further*

RESOLVED, That NARUC recommends that economic regulators carefully consider and implement appropriate ratemaking measures as needed so that water and wastewater utilities have a reasonable opportunity to earn their authorized returns within their jurisdictions; *and be it further*

RESOLVED, That the Committee on Water stands ready to assist economic regulators with the execution of a sound regulatory environment for regulated water utilities, and will continue to monitor progress on this issue at future national committee meetings until satisfactorily improved.

Sponsored by the Committee on Water
Adopted by the NARUC Board of Directors, July 24, 2013

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Interest Rate Trends – February-September 2013 ..... PMA-1

ARIZONA WATER COMPANY

Rebuttal Testimony of

Pauline M. Ahern

I. Introduction

Q. PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS ADDRESS.

A. My name is Pauline M. Ahern. I am a Principal of AUS Consultants. My business address is 155 Gaither Drive, Suite A, Mt. Laurel, New Jersey 08054.

Q. ARE YOU THE SAME PAULINE M. AHERN WHO TESTIFIED IN PHASE 1 OF THIS PROCEEDING?

A. Yes.

Q. HAVE YOU PREPARED AN EXHIBIT WHICH SUPPORTS YOUR REBUTTAL TESTIMONY?

A. Yes. It has been marked as Exhibit PMA-1.

II. Purpose

Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?

A. The purpose is to provide testimony on behalf of Arizona Water Company ("AWC" or "Company") in response to the direct testimony of Residential Utility Consumer Office ("RUCO") witness David C. Parcell. As Company witness Mr. Reiker testifies, Mr. Parcell's revised cost of equity analysis is outside the scope of RUCO's Application for Rehearing and is irrelevant. Notwithstanding the irrelevance of Mr. Parcell's testimony and revised analysis, I demonstrate that capital costs, including the Company's cost of equity, have increased since the Commission determined that cost of equity to be 10.55% in Decision No. 73736, issued on February 20, 2013, in Phase 1 of this proceeding. For these reasons the Arizona Corporation Commission ("Commission") should reject RUCO's argument that the Commission should reduce the Return on Equity ("ROE") it already authorized for the Company in Phase 1 of this proceeding.

III. Response to RUCO

Q. DO YOU HAVE ANY GENERAL COMMENTS ON MR. PARCELL'S TESTIMONY?

A. Yes. On page 2, lines 2-4 of his testimony, Mr. Parcell, states that he was retained by RUCO to "address the impact of the proposed System Improvement Benefits ("SIB") mechanism on the cost of common equity for AWC." However, after providing a lengthy description of his revised cost of equity analysis, Mr. Parcell, on page 19, line 29 of his testimony, concedes that the impact of a SIB mechanism on the cost of equity cannot be quantified. As a result, the sum and totality of the evidence RUCO musters in support of its argument that the Commission acted "unreasonably" by not reducing the ROE it already authorized for the Company's Eastern Group when it approved the SIB mechanism is nothing more than an unauthorized revision of its original cost of equity analysis. Not surprisingly, RUCO's new analysis produces a "point estimate" of 9.25%, which is not materially different than RUCO's originally-proposed ROE in Phase 1 of this proceeding of 9.3%. In other words, RUCO's revised cost of equity recommendation is effectively unchanged from its testimony in Phase 1 of this proceeding. The Commission rejected such a low ROE in Decision No. 73736 when it determined, based upon all of the evidence, that the Company's cost of equity in its Eastern Group is 10.55%.

Q. DO YOU HAVE ANY EVIDENCE THAT SHOWS THE COMPANY'S COST OF EQUITY HAS INCREASED SINCE THE COMMISSION ISSUED DECISION NO. 73736 ON FEBRUARY 20, 2013, IN PHASE 1 OF THIS PROCEEDING?

A. Yes. Although I have not prepared new cost of equity estimates, which are normally prepared only in the context of a general rate case with all ratemaking elements considered and would be outside the scope of this rehearing proceeding, evidence from the capital markets shows that capital costs (including the cost of equity) have increased since February 2013. Page 1 of Exhibit PMA-

1 charts the trend in the yields on 20- and 30-year U.S. Treasury Bonds between February 2013 and September 2013, as well as the trends in the *Blue Chip Financial Forecasts* ("*Blue Chip*") consensus forecasts over the next six quarters at month end.[1] As is clear from the trends shown on page 1 of Exhibit PMA-1, both historical and forecasted U.S. Treasury yields increased since February 2013. Yields on 20-year U.S. Treasury Bonds rose 75 basis points, from an average of 2.78% in February 2013 to 3.53% in September 2013. Likewise, yields on 30-year U.S. Treasury Bonds rose 62 basis points from 3.17% to 3.79%, while consensus *Blue Chip* forecasted yields on 30-year U.S. Treasury Bonds rose 73 basis points, from 3.30% to 4.03% over the same period. Public utility bond yields rose similarly from February 2013 through September 2013, with yields on Moody's A-rated public utility bonds rising 62 basis points, from 4.18% to 4.80% and yields on Moody's Baa-rated public utility bonds rising 57 basis points, from 4.74% to 5.31% over the same period.

Q. WHAT EFFECT DOES THIS EVIDENCE HAVE ON THE COMPANY'S COST OF EQUITY?

A. It is a basic financial principle that as interest rates rise or fall, the common equity risk premium moves by approximately one-half in the opposite direction. For example, if interest rates rise by 100 basis points, the common equity risk premium will fall by 50 basis points.[2] The interest rates shown on pages 1 and 2 of Exhibit PMA-1 averaged 3.63% in February 2013 and 4.29% in September 2013, rising an average of 66 basis points. Hence, the common equity risk premium would now be 6.59% instead of 6.92%, a difference of 33 basis points, all else equal.

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[1] Since the yields on page 1 of Exhibit PMA-1 are average for each month, *Blue Chip Financial Forecasts* for the next month were used, e.g. the September 2013 yields are the averages for September, while the forecasted yields are derived from the October 1, 2013 *Blue Chip*.

[2] Morin 128-129

The Commission determined a 10.55% cost of equity for the Company's Eastern Group in February 2013. At that time, a 10.55% cost of equity reflected a 6.92% equity risk premium over the average 3.63% February 2013 interest rate. Thus, the equity risk premium in September 2013 would be 6.59% (6.92% - 0.33%) which, when added to the average September 2013 interest rate of 4.29%, results in a cost of equity of 10.88% (4.29% + 6.59%). Thus, evidence from the capital markets shows that the cost of equity has increased since the Commission authorized a 10.55% ROE in Phase 1 of this proceeding. In view of all of the foregoing, the 10.55% ROE authorized by the Commission in Decision No. 73736 should not be lowered.

Q. DO YOU HAVE ANY ADDITIONAL COMMENTS ON MR. PARCELL'S TESTIMONY ABOUT LOWERING THE COMMISSION'S 10.55% AUTHORIZED ROE TO 10.00% AS A RESULT OF THE SIB MECHANISM IN THIS PROCEEDING?

A. Yes. On page 19, line 29 - page 20, line 6 of his testimony, Mr. Parcell states that although he does "not believe the impact of SIB on AWC's cost of equity can be quantified precisely...the Commission implicitly, if not explicitly, increased the return on equity for AWC's Eastern Group..." to reflect the "...increased need for infrastructure replacement and improvement." He then leaps to the conclusion that the authorized ROE "should be reduced to no more than 10.0 percent," which represents a 55 basis point reduction due to the SIB mechanism, although he fails to provide any evidence to support such a conclusion. However, the Commission's finding that "the Eastern Group, due to the age of some of its systems and the resulting increased need for infrastructure replacement and improvement, necessitates a somewhat higher [cost of equity]" still holds true despite its adoption of the SIB mechanism in Phase 2 of this proceeding. This is because the Company is still left with the burden of raising the needed capital to invest in such infrastructure. The SIB

mechanism itself does not fund any of the $67 million the Company needs to invest to replace what the Commission acknowledges is necessary for infrastructure replacement and improvement, as explained by Mr. Reiker on page 13, lines 7-19, of his direct testimony on rehearing.

Additionally, the Commission did not state, imply, or suggest that it should reevaluate the 10.55% ROE it authorized in Decision No. 73736 if the SIB is adopted. When RUCO argued that the Commission should lower its authorized ROE in Phase 2, the Commission fully considered and rejected RUCO's argument in Decision No. 73938. Mr. Parcell also ignores Staff's position, as outlined in Decision No. 73938 which states on page 37, lines 4-8 that "the 10.55 percent ROE approved in Decision No. 73736 should not be modified in Phase 2 because <u>there is no evidence that AWC's overall risk would be reduced by adoption of the SIB</u>, and the negotiated five percent efficiency credit is effectively a surrogate for a ROE adjustment because it reduces the ROE on SIB-eligible plant by approximately 87 basis points."

In Decision No. 73938, at page 55, lines 11-13, the Commission also has already disagreed with RUCO's position by stating that "[a]s Mr. Olea testified, the existence or lack of a DSIC does not change the risk of the utility, and therefore the existence or lack of a DSIC should not change the utility's ROE." The Commission also found "RUCO's argument ironic; while today RUCO argues that adding a DSIC reduces risk, we do not recall RUCO ever arguing that the absence of a DSIC results in higher risk" and "to the extent (if any) that a DSIC impacts risk, the reduced risk would be reflected in the sample companies used to set the ROE, and we are not persuaded that any adjustment to the ROE is warranted." Mr. Parcell agrees with the Commission's conclusion on page 20, lines 13-17, of his testimony. Based on the range of cost of equity estimates presented in Phase 1 of this proceeding of 9.3% to 12.5%, the

Commission's 10.55% authorized ROE already takes into account any effect that a SIB mechanism has on the cost of equity into account.

Q. BASED ON THE EVIDENCE ABOVE AND THE RECORD IN THIS PROCEEDING, WHAT ARE YOUR CONCLUSIONS REGARDING RUCO'S APPLICATION FOR REHEARING?

A. I conclude that RUCO's has not met its burden of demonstrating on rehearing that the Commission should revisit and change the Company's authorized ROE in the face of a SIB mechanism, and the Commission should reject RUCO's arguments as unsupported by the record in this proceeding and by evidence of relevant economic indicators since Decision No. 73736 was issued.

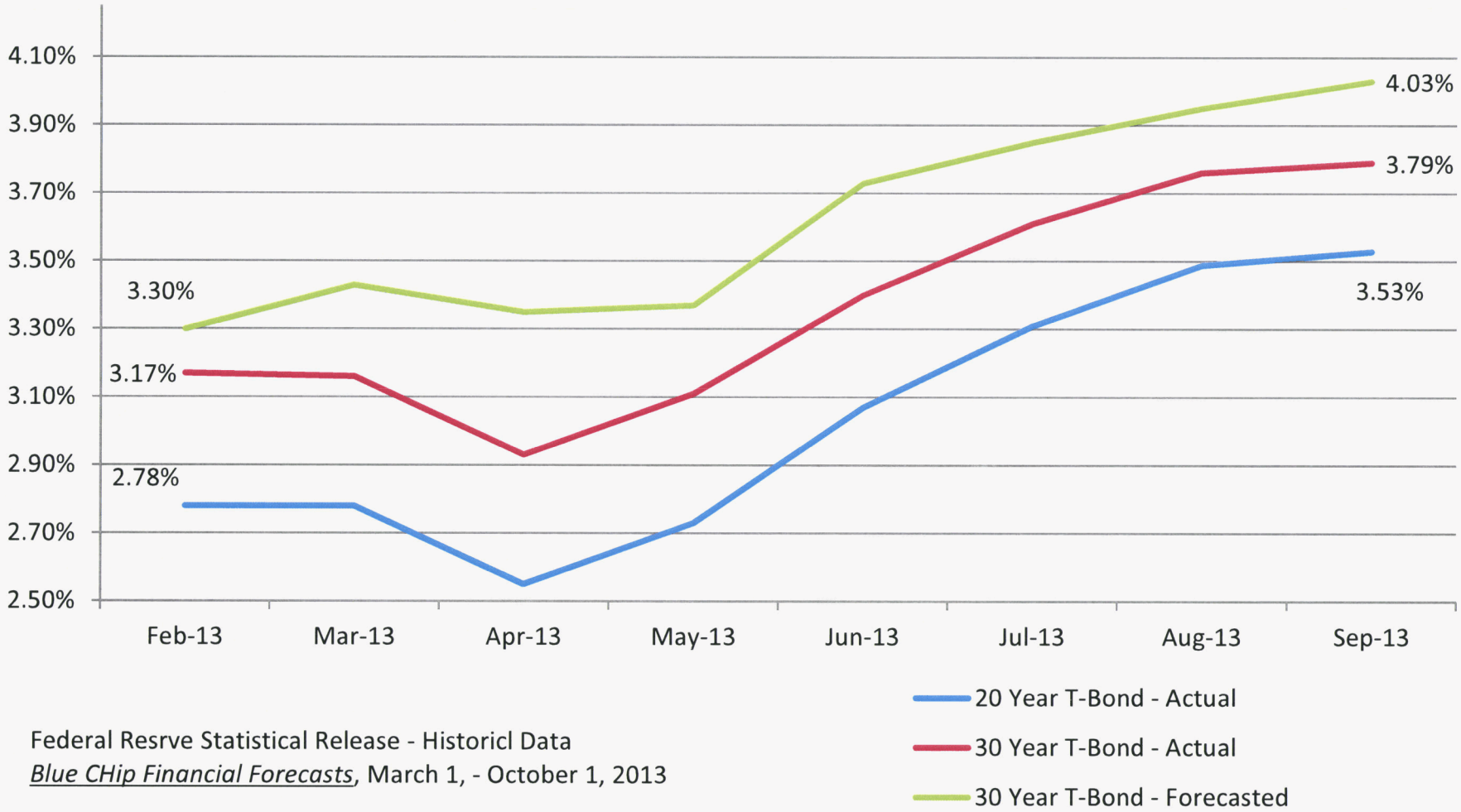
Q. HAVE YOU ANALYZED AND CRITIQUED MR. PARCELL'S DISCOUNTED CASH FLOW, CAPITAL ASSET PRICING MODEL AND COMPARABLE EARNINGS ANALYSES SET FORTH IN HIS TESTIMONY?

A Yes I have. I am prepared to set forth compelling reasons why these revised models are either inapplicable to this case or flawed in multiple respects, but since the interjection of new studies and models are outside the scope of RUCO's application in this rehearing proceeding, I have not done so in this rebuttal testimony.

Q. DOES THAT CONCLUDE YOUR REBUTTAL TESTIMONY?

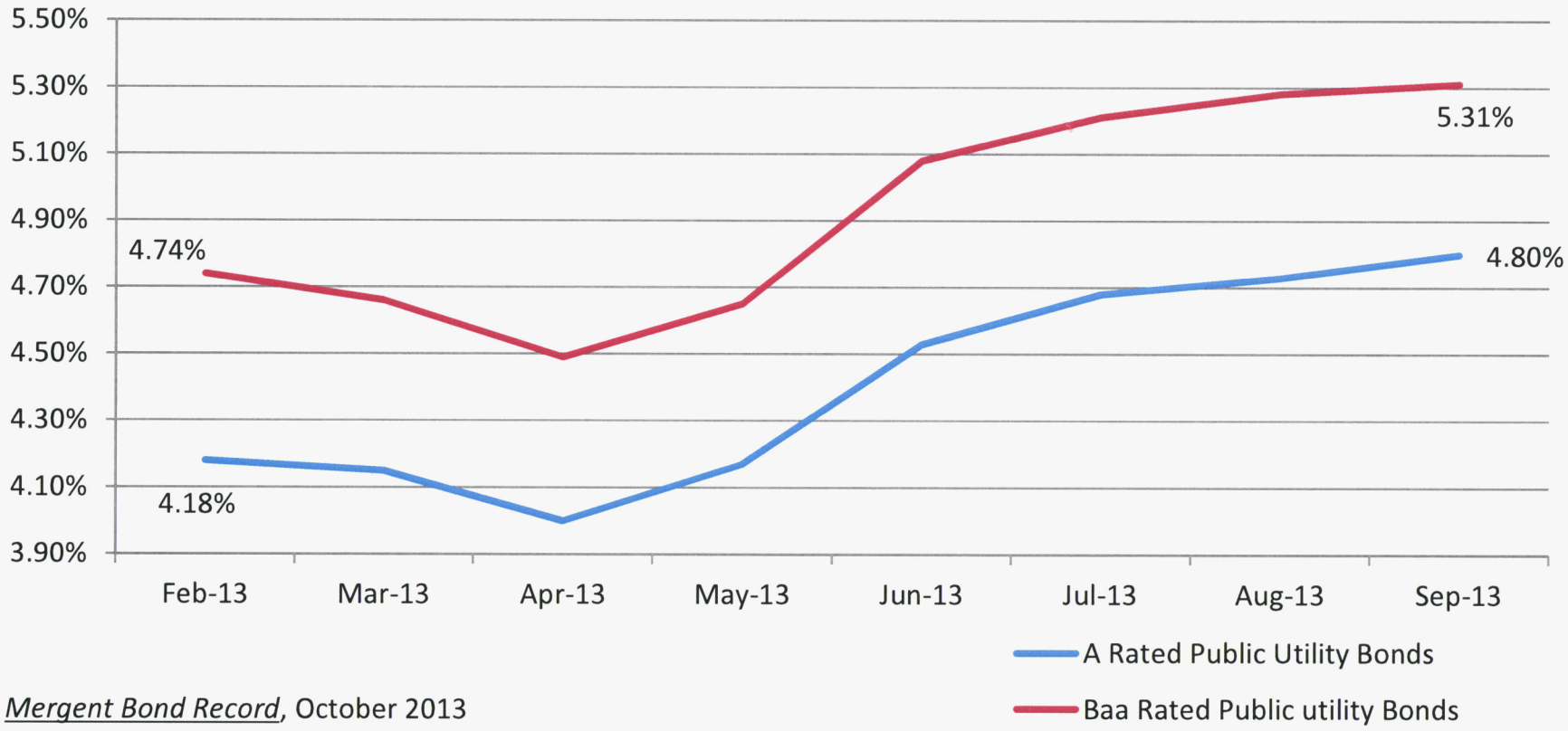
A. Yes.

Yields on 20 & 30 Year U.S. Treasury Bonds
February 2013 - September 2013



Federal Resrve Statistical Release - Historicl Data
Blue CHip Financial Forecasts, March 1, - October 1, 2013

Yields on A Rated & Baa Rated Public Utility Bonds
February 2013 - September 2013



Mergent Bond Record, October 2013