ORIGINAL

0000150401

RECEIVED

2013 DEC -9 P 3:00

AZ CORP COMMISSION
DOCKET CONTROL

FENNEMORE CRAIG, P.C.
Jay L. Shapiro (No. 014650)
Todd Wiley (No. 015358)
2394 E. Camelback Road
Suite 600
Phoenix, Arizona 85016
Attorneys for Liberty Utilities (Litchfield Park Water & Sewer) Corp.

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF LITCHFIELD PARK SERVICE COMPANY, AN ARIZONA CORPORATION FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANTS AND PROPERTY AND FOR INCREASES IN ITS WASTEWATER RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE.	DOCKET NO: SW-01428A-13-0042
IN THE MATTER OF THE APPLICATION OF LITCHFIELD PARK SERVICE COMPANY, AN ARIZONA CORPORATION FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANTS AND PROPERTY AND FOR INCREASES IN ITS WATER RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE.	DOCKET NO: W-01427A-13-0043 **NOTICE OF FILING WITNESS SUMMARIES**

Liberty Utilities (Litchfield Park Water & Sewer) Corp. hereby submits the witness summaries of its Cost of Capital witnesses, Thomas J. Bourassa and Wendell Licon, PhD, CFA.

...

...

...

...

...

Arizona Corporation Commission
DOCKETED
DEC 09 2013
DOCKETED BY

RESPECTFULLY SUBMITTED this 9th day of December, 2013.

FENNEMORE CRAIG, P.C.

By: ______________________

Jay L. Shapiro
Todd C. Wiley
Attorneys for Liberty Utilities
(Litchfield Park Water & Sewer) Corp.

ORIGINAL and 13 copies filed
this 9th day of December, 2013, with:

Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

COPY hand-delivered
this 9th day of December, 2013 to:

Chairman Bob Stump
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Commissioner Gary Pierce
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Commissioner Brenda Burns
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Commissioner Bob Burns
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Commissioner Susan Bitter Smith
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Amanda Ho
Advisor to Chairman Bob Stump
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Steve Court
Advisor to Commissioner Gary Pierce
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Thomas F. Galvin Jr.
Advisor to Commissioner Brenda Burns
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Angela Kebric
Advisor to Commissioner Bob Burns
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Laura Woodall
Advisor to Susan Bitter Smith
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Trisha Morgan
Aide to Chairman Bob Stump
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Eric Van Epps
Aide to Commissioner Gary Pierce
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Kelly Aceto
Aide to Commissioner Brenda Burns
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Robyn Berndt
Aide to Commissioner Bob Burns
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Teresa Tenbrink
Aide to Commissioner Susan Bitter Smith
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Teena Jibilian, Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington
Phoenix, AZ 85007

Robin Mitchell, Esq.
Matthew Laudone, Esq.
Legal Division
Arizona Corporation Commission
1200 West Washington
Phoenix, AZ 85007

Dan Pozefsky, Esq.
Residential Utility Consumer Office
1110 W. Washington St., Suite 220
Phoenix, Arizona 85007

COPY sent via U.S. mail
this 9th day of December, 2013, to:

Olivia Burnes
356 N. Cloverfield Circle
Litchfield Park, Arizona 85340

By: Sandra Baker

8721901.1/035227.0022

THOMAS J. BOURASSA

Cost of Capital

Summary of
Pre-Filed Testimony

Liberty Utilities (Litchfield Park Water & Sewer) Corp.
SW-01428A-13-0042, W-01427A-13-0043

Thomas J. Bourassa--Summary of Prefiled Testimony (Cost of Capital)

Thomas J. Bourassa is a Certified Public Accountant who provides consulting services to public utilities. He has testified on numerous occasions before the Arizona Corporation Commission ("the Commission") on behalf of Arizona water and wastewater utilities. In this case he is testifying on behalf of Liberty Utilities (Litchfield Park Water & Sewer) Corp. ("the Company") on the topics of the Company's cost of capital. [1]

Cost of Equity and WACC

Mr. Bourassa performed estimates of the cost of equity using the Commission's preferred models, the Discounted Cash Flow ("DCF") model, Capital Asset Pricing Model ("CAPM"), and the Build-up Method. Mr. Bourassa's updated estimate of the cost of equity is 9.7 percent. He recommends a return on equity ('ROE") of 9.7 percent and a cost of debt of 6.4 percent. The Company proposes a 15.84 percent debt and 84.13 percent equity capital structure. Accordingly, weighted cost of capital ("WACC") is 9.18 percent.

Mr. Bourassa explains the difference in risk between the Company and the publicly traded companies which include business and operation risk, regulatory risk, financial risk, construction risk, and liquidity risk.

To serve as a check on the results of the ROE recommendation of each of the parties, Mr. Bourassa completed a comparative earnings analysis on the public traded water utilities which showed:

1) The average water proxy group projected ROE's is 9.9 percent;

2) The currently authorized water proxy group ROE's is 10.03 percent;

3) The NYU Stern School equity-to-debt cost analysis indicates a 10.7 percent ROE;

4) The Commission precedent equity-to-debt cost analysis indicates a 10.1 percent ROE;

5) A dividend payout analysis based on equity capital indicates an ROE of 11.42 percent;

[1] Mr. Bourassa is also testifying on the Company's rate base, its income statement (i.e., revenue and operating expenses), its required increase in revenue, and its rate design and proposed rates and charges for service.

6) A dividend payout analysis based on Staff recommended rate base indicates an ROE of 9.82 percent; and

7) A dividend payout analysis based on the RUCO recommended rate base indicates an ROE of 9.93 percent.

Staff recommends an 8.4 percent ROE and a 6.4% cost of debt. Staff recommends a WACC of 8.1 percent based on a 15.9 percent debt and 84.1 percent equity capital structure. Staff's unadjusted cost of equity is 8.4 percent and cost of debt is 6.4 percent. Staff proposes a 60 basis point reduction to the cost of equity for financial risk and an upward adjustment of 60 basis points to the cost of equity for its Economic Assessment Adjustment ("EAA").

RUCO, in contrast, proposes a WACC of 8.76 percent using a capital structure consisting of 15.87 percent debt and 84.13 percent equity. RUCO recommends a cost of debt of 6.4 percent and a ROE of 9.0 percent. RUCO did not perform a cost of capital analysis but rather based its recommended return on equity on the 9.0 return on equity adopted most recent decision for Rio Rico Utilities, Inc. (Decision 73996 dated July 30, 2013).

The Company's primary areas of disagreement with Staff and RUCO are that the Staff and RUCO recommendations fail to pass the comparable earnings test as set forth in *Hope* and *Bluefield* and to account for the differences in risk between the publicly traded utilities and the Company. Putting aside the differences in risk between an investment in the Company and the publicly traded utilities, the mid-point of Mr. Bourassa's comparative earnings analysis is 10.6 percent, which is 160 to 220 basis points above the Staff and RUCO recommendations.

Mr. Bourassa expresses concerns about the downward bias in the Staff models resulting from Staff's improper application of the Hamada method to compute Staff's financial risk adjustment. Mr. Bourassa explains the market values for debt and equity are the conceptually correct inputs to the Hamada. Mr. Bourassa states that Staff's financial risk adjustment is overstated by at least 30 basis points.

8720960.1/035227.0022

WENDELL LICON, PhD, CFA

Summary of Pre-Filed Testimony

Liberty Utilities (Litchfield Park Water & Sewer) Corp.
SW-01428A-13-0042, W-01427A-13-0043

Wendell Licon--Summary of Prefiled Testimony

Wendell Licon, PHD, CFA, submitted pre-filed Rebuttal Testimony and Rejoinder Testimony in this case. Dr. Licon was retained by Liberty Utilities (Litchfield Park Water & Sewer) Corp. ("LPSCO") as an expert witness relating to Cost of Capital and Return on Equity (ROE). Summaries of Dr. Licon's testimonies are set forth below.

I. BACKGROUND.

Dr. Licon obtained a BBA with a Finance concentration and a Minor in Actuarial Science from the University of Texas at Austin (UT) in 1985. Dr. Licon completed his MBA at UT in 1987, concentrating in Finance. He completed his PhD in Finance with Minors in Statistics and Economics from UT in 2003. Dr. Licon is a Chartered Financial Analyst as designated by the CFA Institute (1992).

Dr. Licon has taught undergraduate and/or graduate level finance students at Arizona State University since 2003. He teaches Fundamentals of Finance, Managerial Finance and Advanced Corporate Finance, among other courses. Overall, Dr. Licon has been teaching finance related courses since 1998 to thousands of undergraduate and graduate students. He is well acquainted with and has taught financial subjects such as the Discounted Cash Flow (DCF) and Capital Asset Pricing Model (CAPM) extensively.

Prior to his academic career, Dr. Licon worked with numerous private sector firms utilizing his financial expertise including Towers Perrin, Enron, HR Sense, Lola Wright Foundation, Liberty Mutual Insurance Company and Electronic Data Systems Corporation. From 1988-1995, he worked for Electronic Data Systems Corporation handling financial treasury related activities including Corporate Finance, Foreign Exchange Trading and as an Investment Portfolio Manager. In these capacities, Dr. Licon was responsible for, among other things, evaluating risk and return for various investments, including underwriting $650 million of long-term debt, tracking and hedging a $500 million foreign currency portfolio and managing an investment portfolio ranging in value from $500 million to $750 million.

II. DIRECT TESTIMONY.

In his direct testimony, Dr. Licon focuses primarily on the recommendations and testimony of Staff's analyst, Mr. Cassidy, relating to Staff's recommended ROE of 8.4 percent. Dr. Licon's expert testimony demonstrates that Mr. Cassidy's recommended ROE of 8.4 percent is too low, unreasonable and contrary to fundamental financial theory. Dr. Licon provides testimony designed to assist the Commission and ALJ in considering LPSCO's ROE based on his expertise in business and finance, including his experience advising investors in the private sector and teaching at ASU. Dr. Licon's critique of Staff's analysis and recommendations is based on actual business experience and sound financial theory, in turn illustrating the real world flaws in Staff's recommended ROE.

Specifically, Dr. Licon illustrates how Staff's calculations supporting its ROE recommendation are biased towards achieving a low cost of capital as the end result. Dr. Licon found inconsistent applications of the CAPM model used by Staff. As shown by Dr. Licon, underestimating a regulatory rate of return for LPSCO will have a long-term effect of rationing capital to LPSCO. Dr. Licon's direct testimony focuses on three errors in Staff's analysis as demonstrative of Staff's incorrect ROE models.

A. <u>Staff's Risk Free Rate.</u>

The first flaw in Staff's ROE analysis is that Staff uses an unrealistic risk free rate in its CAPM methodology. Dr. Licon's testimony illustrates that Mr. Cassidy's CAPM methodology is predisposed downward by use of a spot Treasury rate of return that does not have a maturity commensurate with the average useful life of LPSCO's current projects. Dr. Licon explains that Mr. Cassidy's Security Market Line (SML) Equation inputs 2.2% as the risk-free rate based on the average current rate generated by 5, 7, and 10-year Treasury Securities. Dr. Licon shows that use of medium term maturity risk-free proxies in order to estimate the expected rate of return for a firm with an average asset life greater than 30 years is improper and counter to sound financial principles. Investors in the assets of LPSCO are financing long-lived assets with an average life of 30 years. Therefore, their investment horizon is 30 years. Using a 5, 7 and 10-year Treasury rate is a mismatch of the lives of the investments.

In his expert testimony, Dr. Licon establishes that the 30-year Treasury is a much more appropriate proxy for the risk-free rate in the SML estimation of LPSCO's cost of equity given the very long-term nature of LPSCO's assets. Put simply, Dr. Licon provides persuasive expert testimony illustrating that Staff's recommended risk-free rates don't reflect the correct investment horizon for LPSCO, in turn artificially and improperly deflating LPSCO's recommended ROE.

B. <u>Staff's Historical Market Risk Premium.</u>

Next, Dr. Licon explains how Staff's excel model misapplies the Market Risk Premium (MRP) relating to LPSCO. In its analysis, Staff calculates an MRP of 7.13%, comprised of a 2.1% dividend rate plus a price appreciation rate of 8.78%, less a current 30 year Treasury rate of 3.75%. That 8.78% number is determined by taking a Value Line forecasted market price appreciation rate of 40% over the next 3 – 5 years. Mr. Cassidy annualized that rate over a 4-year period to arrive at 8.78%.

Dr. Licon shows that Mr. Cassidy didn't provide any valid financial justification for spreading that return over 4 years. Based on real world markets and Dr. Licon's experience, that return should be annualized over 3 years. If that 40% return were annualized over a 3-year period, then the annualized market appreciation rate of return would be 11.87% or a difference of 3.09% in total. This would lead to a MRP of 10.22% rather than 7.13%. Dr. Licon's testimony shows that Staff's MRP analysis is arbitrary and without a theoretical basis in finance theory, significantly lowering the final ROE recommendation.

C. Staff's Hamada Adjustment.

Dr. Licon's final critique relates to Mr. Cassidy's improper use of the Hamada Adjustment. Specifically, Mr. Cassidy's Hamada adjustments were made on the Staff's cost of capital comparison group based on book values of equity rather than market values. Dr. Licon explains that such methodology is contrary to sound and accepted financial principles. Given that the market values of equity for these firms is greater than the book value of equity for these firms, that incorrect use of the Hamada adjustment is generating a downward bias for the beta value calculated for LPSCO.

To be more precise, Dr. Licon explains that a firm with more leverage would be subject to greater systematic risk than that of a firm without leverage. Staff correctly recognizes this but Dr. Licon shows that Mr. Cassidy's use of the book value of a firm's equity to measure this effect rather than the market value is flawed. As a financial expert, Dr. Licon demonstrates that the net effect of that fundamental error is to underestimate the leverage adjusted beta for LPSCO, which translates into a lower calculated expected rate of return for investing in LPSCO equity. Mr. Cassidy's models misapply the Hamada adjustment creating a downward bias estimate of beta for LPSCO which further underestimates the cost of equity capital for the firm. The Hamada adjustment is intended for market values, not book values as Mr. Cassidy states.

D. Real World Investment Decisions Resulting from an 8.4% ROE.

Based on his real world, private sector experience and the flaws in Mr. Cassidy's models, Dr. Licon then explains that Staff's ROE recommendations have a bias toward a lower ROE than would be required by investors in this industry. Investors have access to public market information and prices, and will allocate capital toward decisions that have the potential to generate the greatest returns. If an investment has little chance of achieving the returns of other firms within an industry, then capital for that firm's future needs will become rationed.

In his testimony, Dr. Licon's simple comparison of ROEs illustrates the real world impacts of an 8.4% ROE for LPSCO. The October 2013 issue of Value Line estimates that the average *earned* ROE for the utility comparison group over the next three to five years is 9.9%, over 150 basis points greater than Staff's *recommended* ROE for LPSCO.

For an investor or analyst, Dr. Licon explains that it is a simple decision to invest in any of the comparison group over LPSCO. They are comparable utilities, facing the same market, regulatory, and inflation risks; but the LPSCO ROE advocated by Staff is 150 basis points lower than its peers. Dr. Licon explains why rational investors would not invest in LPSCO given the choice of companies with better returns in the same sector.

II. REJOINDER TESTIMONY.

In his rejoinder testimony, Dr. Licon responds to the surrebuttal testimony of Mr. Cassidy. To start, Dr. Licon demonstrates that Mr. Cassidy's analysis and testimony don't address the real world issues faced by a utility such as LPSCO in its effort to attract capital on equal footing with other companies. As shown by Dr. Licon, Mr. Cassidy purports to apply a market based analysis, but inexplicably uses book values in his market based Hamada equation, artificially biasing the result towards a lower beta and, thus, a lower cost of equity.

Dr. Licon shows that Mr. Cassidy fails to provide any accepted financial reason or theory supporting his use of book values in the capital structure under the Hamada equation. Dr. Licon establishes that Mr. Cassidy's book value analysis is contrary to sound financial theory. Best practice, as well as the theoretical justification for the Hamada Adjustment, dictate use of market value of debt and equity whenever available.

In rejoinder, Dr. Licon provides a real world home mortgage example illustrating the errors and flaws in Mr. Cassidy's book value methodology. As illustrated in that example, Staff's recommendations regarding the use of book values obscure the true picture regarding the risk on debt, just like the home mortgage example. In short, Staff's recommendation (using Hamada's book values versus market values) is tantamount to asking a bank to make a home mortgage loan based on the original loan value rather than the current market value of the home.

Dr. Licon also addresses Mr. Cassidy's testimony relating to his use of risk free rates in the CAPM. Unfortunately, Dr. Licon explains that Mr. Cassidy did not respond to Dr. Licon's fundamental argument. Specifically, common equity securities do not have a maturity because they are infinitely lived securities. With that infinite life in mind, the closest proxy for that maturity range would be the 30-year Treasury security. As a matter of fundamental financial theory, the CAPM necessitates that analysts generally consider the entire economic life of the asset. The correct liquidity proxy for an equity security should be as long as possible. Here, the 30-year rate is most appropriate and should be used as the proxy for the risk free rate of return.

Finally, Dr. Licon addresses Mr. Cassidy's responses to use of a 4-year forecast instead of a 3-year forecast in the MRP. As a financial expert, Dr. Licon demonstrates that Mr. Cassidy's 4-year forecast isn't based on any accepted financial theory.