

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 KRISTIN K. MAYES  
CHAIRMAN

3 GARY PIERCE  
COMMISSIONER

4 SANDRA D. KENNEDY  
COMMISSIONER

5 PAUL NEWMAN  
COMMISSIONER

6 BOB STUMP  
COMMISSIONER

7  
8 IN THE MATTER OF THE APPLICATION OF  
9 LITCHFIELD PARK SERVICE COMPANY,  
10 AN ARIZONA CORPORATION, FOR A  
11 DETERMINATION OF THE FAIR VALUE OF  
ITS UTILITY PLANTS AND PROPERTY AND  
FOR INCREASES IN ITS WASTEWATER  
RATES AND CHARGES FOR UTILITY  
SERVICE BASED THEREON.

Docket No. SW-01428A-09-0103

12 IN THE MATTER OF THE APPLICATION OF  
13 LITCHFIELD PARK SERVICE COMPANY,  
14 AN ARIZONA CORPORATION, FOR A  
15 DETERMINATION OF THE FAIR VALUE OF  
16 ITS UTILITY PLANTS AND PROPERTY AND  
FOR INCREASES IN ITS WATER RATES  
AND CHARGES FOR UTILITY SERVICE  
BASED THEREON.

Docket No. W-01427A-09-0104

17 IN THE MATTER OF THE APPLICATION OF  
18 LITCHFIELD PARK SERVICE COMPANY,  
19 AN ARIZONA CORPORATION, FOR  
20 AUTHORITY (1) TO ISSUE EVIDENCE OF  
21 INDEBTEDNESS IN AN AMOUNT NOT TO  
EXCEED \$1,755,000 IN CONNECTION  
WITH (A) THE CONSTRUCTION OF TWO  
RECHARGE WELL INFRASTRUCTURE  
IMPROVEMENTS AND (2) TO ENCUMBER  
22 ITS REAL PROPERTY AND PLANT AS  
SECURITY FOR SUCH INDEBTEDNESS.

Docket No. W-01427A-09-0116

23 IN THE MATTER OF THE APPLICATION OF  
24 LITCHFIELD PARK SERVICE COMPANY,  
AN ARIZONA CORPORATION, FOR  
AUTHORITY (1) TO ISSUE EVIDENCE OF

Docket No. W-01427A-09-0120

1 INDEBTEDNESS IN AN AMOUNT NOT TO  
2 EXCEED \$1,170,000 IN CONNECTION  
3 WITH (A) THE CONSTRUCTION OF ONE  
4 200 KW ROOF MOUNTED SOLAR  
5 GENERATOR INFRASTRUCTURE  
6 IMPROVEMENTS AND (2) TO ENCUMBER  
7 ITS REAL PROPERTY AND PLANT AS  
8 SECURITY FOR SUCH INDEBTEDNESS.

## 6 RUCO'S INITIAL CLOSING BRIEF

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8 The Residential Utility Consumer Office ("RUCO") submits this Initial Closing Brief on  
9 the matters raised at Litchfield Park Service Company's ("LPSCO" or "Company's") recent  
10 rate hearing.

### 11 I. Issues upon which the Company and RUCO substantially agree.

12 RUCO and LPSCO have reached agreement on a number of issues, which were  
13 initially disputed. Those agreements are as follows:

#### 14 a. Security Deposits:

15 The Company has excluded from rate base \$68,685 in security deposits. RUCO  
16 agrees that the security deposits should be removed from rate base because they are not  
17 investor supplied funds and therefore should not have received rate base treatment. Staff  
18 disagrees.

#### 19 b. Bonuses:

20 RUCO and the Company agree and recommend the inclusion of \$26,477 at-risk  
21 incentive pay in operating expenses in this case as the amounts appear to be part of a  
22 reasonable compensation package. The Staff disagrees.

1           **c.     Property Taxes:**

2           RUCO and the Company agree on the methodology utilized to calculate property  
3 taxes. The differences in property tax calculations result from the difference in levels of  
4 adjusted and proposed revenue.

5           **II.     Unresolved Issues Related to Rate Base**

6           **a.     Palm Valley Water Reclamation Facility**

7           Since the Company's last rate case in 2001, it has made substantial plant additions.  
8 According to the Company, it completed \$14.9 million in additions in 2002 to the Palm Valley  
9 Water Reclamation Facility ("PVWRF").<sup>1</sup> The Company made \$7.0 million dollars of repairs  
10 to the PVWRF in the test year. *Id.* The Company claims that a large investment in plant was  
11 necessary to remedy deficiencies at the PVWRF which the Company discovered in 2006,  
12 three years after completion of the initial construction. *Id.* The Company is requesting that  
13 the Commission allow it to recover all of the initial improvements plus the \$7.0 million in  
14 repairs from the ratepayers in this case. In his Direct Testimony, LPSCO witness Greg  
15 Sorensen states:

16           *"...in the summer of 2007, the plant had two spill events that confirmed that the*  
17 *plant, as originally designed and constructed by our predecessor owners, was*  
18 *lacking certain redundancy capabilities and needed some upgrades to achieve*  
19 *an acceptable level of reliability." (Emphasis added.) Additionally, in response*  
20 *to RUCO data request MJR 2.14 the Company provided excerpts from a report*  
*developed by McBride Engineering Solutions, Inc. ("MES") that document*  
*several design problems at the PVWRF that resulted in excessive odors,*  
*insufficient reliability and a lack of redundancy capability. Correcting these*  
*problems necessitated significant upgrades.*<sup>2</sup>

21 The additional plant associated with those upgrades was put into service during the test year.  
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24 <sup>1</sup> See Exhibit A-8 Direct Testimony of Greg Sorenson at 7.

<sup>2</sup> *Id.*

1 It is unfair that LPSCO customers should bear the full cost of the upgrades  
2 necessitated by the PVWRF's design problems. Utilities have an obligation to design and  
3 build plant that meets acceptable levels of reliability.<sup>3</sup> It is inherently unfair to saddle the  
4 ratepayers with the excessive and duplicative costs that result when utilities fail in that  
5 obligation. *Id.* Given the magnitude of the cost of the repairs in relation to the total cost of the  
6 plant, it is neither fair nor reasonable to require the ratepayers to shoulder the entire burden  
7 of the repairs. There was obviously something wrong with the plant if the Company needed  
8 to spend \$7.0 million dollars to repair the facility after spending \$14.9 million dollars to  
9 expand it. The Commission should reject the Company's request to have ratepayers bear  
10 the entire cost of the plant repairs. In an effort to be fair to both shareholders and ratepayers,  
11 RUCO submits that the costs of the PVWRF upgrades necessitated by the PVWRF's design  
12 problems should be shared between the shareholders and the ratepayers. *Id.* RUCO  
13 recommends that the \$7.0 million dollar costs of these improvements be split 50/50 between  
14 the ratepayers and the shareholders. *Id.* This results in a reduction of \$3.5 million of test  
15 year plant additions.

16 In response, the Company claims that it should not be saddled with the costs of  
17 repairs because the former owner, Suncor, built the plant.<sup>4</sup> The Company's argument is  
18 unpersuasive. Prior to making a purchase as substantial as LPSCO, sound business  
19 practices would require a thorough review of LPSCO's facilities.<sup>5</sup> Reliability problems  
20 identified at that stage would have provided the purchaser with significant leverage in price  
21 negotiations. *Id.* The Company may claim that the plant was approved by all reviewing  
22 agencies and therefore it need not have done anything else to complete its due diligence.

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23 <sup>3</sup> See Exhibit R-22 Direct Testimony of Matthew Rowell at 5.

24 <sup>4</sup> See Exhibit A-8 Direct Testimony of Greg Sorenson at 7.

<sup>5</sup> See Exhibit R-22 Direct Testimony of Matthew Rowell at 5.

1 The argument is without merit. If reliability issues existed, the Company should have  
2 discovered them at the time of purchase with the exercise of due diligence.<sup>6</sup> The Company  
3 can not ignore its responsibility to inspect the plant to ascertain operational problems prior to  
4 purchase. Moreover, upon discovery of the problems, the Company should have pursued its  
5 legal rights against its predecessor instead of expecting to recover fully from captive  
6 ratepayers.

7 Additionally, the Company's position contravenes good public policy. As Mr. Rowell  
8 testified, if the Commission allowed for full recovery of the PVWRF redesign costs based on  
9 the fact that the facility changed hands, it would send the wrong signal to the industry. *Id.* at  
10 6. Companies looking to purchase utilities in Arizona would have less incentive to do proper  
11 due diligence if they knew that the costs of fixing any existing problems could be imposed on  
12 the ratepayers. *Id.* Conversely, if utilities building plant believed that any problems with the  
13 plant could be dispensed with through a sale to another entity their incentive to build the plant  
14 properly in the first place would be diminished. *Id.* And finally, regardless of a change in  
15 ownership, a Company should understand it will be held responsible, at least to some  
16 degree, for non-operational plant or plant that requires excessive repairs regardless of fault.

17 Based on the foregoing, RUCO recommends an equal sharing of the \$7.0 million  
18 dollar improvements and therefore requests exclusion of \$3.5 million dollars of the capital  
19 improvements to the PVWRF.

20 **b. PVWRF Phase II Expansion Costs**

21 The Company seeks to capitalize the 2004 expenses associated with a 2004 Phase  
22 II report drafted by Pacific Advanced Civil Engineers, Inc. ("PACE") and used to an Aquifer  
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24 <sup>6</sup> *Id.* at 6.

1 Protection Permit (“APP”) to expand the PVWRF plant from 4.1mgd to 8.2 mgd.<sup>7</sup> The  
2 PACE design report calls for the expansion of the facility from two treatments trains of  
3 approximately 2.0 mgd to four treatment trains of approximately 2.0 mgd, each. Id. At full  
4 expansion, the PVWRF would have a total capacity of 8.2mgd. Id. The Company’s current  
5 average flows are 3.8 mgd.<sup>8</sup> The Company contends that no construction has occurred  
6 on the 8.2 mgd plant. T:292. RUCO’s witness, William A. Rigsby testified that \$36,500  
7 associated with the expansion of the PVWRF from 4.1 mgd to 8.2 mgd should be  
8 excluded from rate base.<sup>9</sup> Accordingly, RUCO recommends the cost of expanding or  
9 designing the expansion of plant which has not been constructed and is not currently used  
10 and useful be excluded from rate base.

11 In addition, to the \$36,500 incurred in Phase II expansion report drafted by PACE,  
12 the Company also incurred additional expansion related engineering expense via McBride  
13 Engineering.<sup>10</sup> In an August 28, 2007 change order request, the Company agreed to pay  
14 \$552,100 to McBride for *inter alia*, programming to configure a third 5mgd ultraviolet filter  
15 (“UV”) to work with two existing 5mgd UV units in a lead/lag/standby configuration; and  
16 technical work to allow two new SBR units being provided by Jet Tech to work in  
17 conjunction with existing SBR units currently operating on site to allow for operation of all  
18 four SBR units. Id. Clearly, McBride Engineering design expenses related to the Phase II  
19 expansion of the plant from two trains to four trains. Because the Company claims the  
20 expansion has not been built, these design and all related costs are not used and useful  
21 to current ratepayers. RUCO recommends that any and all cost of expanding the plant  
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23 <sup>7</sup> See Exhibit R-27 Direct Testimony of William Rigsby at 4.

24 <sup>8</sup> See Exhibit R-7 2008 Annual Report for LPSCO-Wastewater Flows at 12.

<sup>9</sup> Id. at 5.

<sup>10</sup> See Exhibit R-35 Change Order Request dated August 28, 2007.

1 should be excluded from rate base, including but not limited to the \$36,500 for the Phase II  
2 design report and the \$552,100 for the change order request.<sup>11</sup>

3 **c. Deferred Regulatory Asset**

4 The Company proposes to include in rate base \$82,561 for costs incurred protecting  
5 its water supplies and ensuring its ability to bring legal action, if necessary for contamination  
6 of its aquifer. The Company recommends amortization of 9 years. The data demonstrates  
7 that there is a spread of the contamination plume. RUCO agrees to the inclusion of these  
8 costs as deferred regulatory asset, but RUCO recommends the amount of \$74,305 for the  
9 deferred regulatory asset in rate base and amortization of 10% of the cost, (\$8,256) each  
10 year until the full amount of \$82,561 is recovered.<sup>12</sup>

11 **d. Capitalized Labor**

12 The Company seeks to include affiliate capitalized labor in plant-in-service in its water  
13 and wastewater division. The Company's witness, Mr. Bourassa asserts that the Company's  
14 documentation of capitalized affiliate labor is supported, but acknowledges that he did not  
15 audit the Company's records prior to filing the rate case. T: 548. Because he failed to audit  
16 the Company's accounts, Mr. Bourassa can not avow the Company's position is supported.  
17 He can only testify that the Company says its position is supported.

18 RUCO asserts the calculations submitted by the Company are inconsistent. RUCO's  
19 witness, Sonn Rowell performed a detailed audit of the Company's invoices and data  
20 responses. T: 684. Ms. Rowell testified that the data submitted by the Company  
21 conflicted.<sup>13</sup> The Company provided data levels of capitalized labor in three data sources:  
22 B-2 schedules, pp 3.1-3.8, responses to DR MJR 3.7 and in response to Staff's data

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23 <sup>11</sup> *Id.* at 5-7.

24 <sup>12</sup> *See* Exhibit R-15 Direct Testimony of Sonn Rowell at 5.

<sup>13</sup> *See* R-15 Direct Testimony of Sonn Rowell at 17-19.

1 response JMM 1.52 and 1.77. Id. at 17. Although the Company provided back up data to  
2 support each data response, Ms. Rowell testified that there were significant discrepancies  
3 between the B-2 schedules and the response to data request MJR 3.7. Id. at 18. She also  
4 testified that the information provided by the Company in response to MJR 3.7 could not be  
5 reconciled with the back up information provided in response to the Staff data requests JMM  
6 1.52 and 1.77. Id.

7 Moreover, the Company's documentation of capitalized affiliate labor is woefully  
8 inadequate. Ms. Rowell testified that the information of the Company's spreadsheet did not  
9 match the back up invoices actually in the file. Id. Ms. Rowell further testified that the back  
10 up invoices could not be reconciled with the Company's accounting records because most of  
11 the documentation was not adequate to identify the employee, the project upon which the  
12 employee worked, the work the employee performed or to identify the NARUC plant account  
13 to which the work applied. T: 740. Ms. Rowell testified that with the exception of accounts  
14 304 and 333 for 2008, the back up information provided for affiliate transactions in response  
15 to Staff data requests JMM 1.52 and 1.77 was inadequate to support capitalization of the  
16 affiliate billings. Id. at 19, T: 740. Ms. Rowell further indicated the nonaffiliated or third-party  
17 invoices, over which the Company has little or no control, were much more detailed than the  
18 affiliate invoices and contained sufficient information to determine whether the costs should  
19 be capitalized or expensed. T: 689. Because the Company has the burden of proof and  
20 submitted inconsistent calculations for capitalized affiliate labor and back-up documentation  
21 which was inadequate and could not be reconciled, the Commission should adopt RUCO's  
22 recommendation to remove \$1,841,196 in capitalized affiliate labor from the wastewater  
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1 division plant in service and \$508,512 dollars of capitalized affiliate labor from the water  
2 division plant in service.<sup>14</sup>

3 **e. Capitalized Repairs**

4 The Company has categorized some costs of repairs as capital costs. The Company  
5 asserts that costs which either extend the life of existing plant or have a benefit of more than  
6 one year should be capitalized.<sup>15</sup> The Company's witness Mr. Bourassa asserts that this is a  
7 generally accepted accounting principle ("GAAP"). *Id.* However, Mr. Bourassa fails to  
8 provide any support for the assertion. Moreover, the Company's actual policy does not  
9 reflect compliance with the standard offered by Mr. Bourassa. In Staff's data request, JMM  
10 1.23, Staff requested the information on the manner in which costs are expensed versus  
11 capitalized.<sup>16</sup> The Company responded acknowledging that "All capital work is order driven.  
12 That is to say, if a project is categorized as a capital job, all costs are capitalized, thus there  
13 is no dollar threshold." *Id.* The Company's policy is inconsistent with the standard proposed  
14 by Mr. Bourassa because the Company makes no analysis of whether a cost would extend  
15 the life of existing plant or have a benefit of more than one year.

16 Further, the Company's policy is inconsistent with the standards set forth in the  
17 Uniform System of Accounts for Water and Wastewater Facilities.<sup>17</sup> NARUC provides that:

18 *When a minor item of depreciable property is replaced independently of the*  
19 *retirement unit of which it is a part, the cost of replacement shall be charged to the*  
20 *maintenance expense account appropriate for the item except that if the*  
21 *replacement effects a substantial betterment (the primary aim of which is to make*  
22 *the property affected more useful, more efficient, of greater durability, or of greater*  
23 *capacity), the excess cost of the replacement of the estimated cost at current prices*

22 <sup>14</sup> See RUCO Final Schedule 3, pages 2 and 3 of 4 (Water) and RUCO Final Schedule 3, pages 3 and 4 of  
23 4 (Wastewater)

23 <sup>15</sup> See Exhibit A-16.

23 <sup>16</sup> See Exhibit R-19 Company's response to Staff data request JMM 1.23.

24 <sup>17</sup> See Exhibits R-20 and R-21, NARUC Uniform System of Account for Class A Wastewater and Water  
Utilities (1966).

1           *of replacing without betterment shall be charged to the appropriate utility plant*  
2           *account.*

3 In order to be capitalized, the Company's costs for repairs must contribute to the substantial  
4 benefit of the plant item. By its own admission, the Company made no such analysis.<sup>18</sup>

5           RUCO believes that certain of the Company's capitalized repairs should be removed  
6 from rate base. Unlike Mr. Bourassa, RUCO's witness, Sonn Rowell actually audited the  
7 Company's records.<sup>19</sup> She determined whether the expenses identified by the Company as  
8 capital costs constituted repairs or replacement of existing plant and whether the repair or  
9 replacement contributed to the extension of the life of the plant.<sup>20</sup> From her analysis, Ms.  
10 Rowell concluded that some of the costs capitalized by the Company were actually repairs  
11 which did not extend the life of the plant and therefore were expenses, not capital costs.<sup>21</sup>  
12 She further testified that if the costs were capital costs, they would have to meet the standard  
13 of substantial betterment of the plant and they did not. Moreover, she concluded if the  
14 Company had replaced existing plant as it asserts, the Company should have retired the  
15 existing plant consistent with the NARUC Accounting Instructions and did not. *Id.* In the  
16 absence of retirements, Ms. Rowell testified that these costs are repairs and should be  
17 removed from plant, and expensed. *Id.* Further to the extent the cost occurred outside of  
18 the test year, RUCO asserts that those amounts must be removed from consideration in this  
19 case. *Id.*

20           The Company failed to follow the standard proffered by its own witness. The  
21 Company failed to follow the standard imposed by NARUC. The Company by its own  
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23 <sup>18</sup> See Exhibit R-19 Company's response to Staff data request JMM 1.23.

24 <sup>19</sup> T: 685.

<sup>20</sup> T: 714.

<sup>21</sup> T: 720.

1 admission performed no analysis of individual expenditures.<sup>22</sup> Because the Company has  
2 failed to meet its burden of demonstrating that the costs identified by RUCO should be  
3 capitalized, RUCO recommends removal of \$58,628 and \$170,375 from plant in service for  
4 the water division and wastewater divisions, respectively.<sup>23</sup>

5 **f. Deferred Income Tax**

6 In Rejoinder, the Company proposes a deferred income tax liability (“DIT”) of  
7 \$188,053 for the water division and \$140,544 for the wastewater division. The Company  
8 asserts its DIT is based on the requirements of a Financial Accounting Standards.  
9 (“FAS109”). In Surrebuttal, RUCO and Staff calculated the Company’s DIT for the test year  
10 October 1, 2007 through September 30, 2008 using the Company provided 2006 tax records.  
11 At that time, RUCO proposed DIT liability of \$446,530 for the water division and \$333,803 for  
12 the wastewater division.<sup>24</sup> The Staff proposed similar amounts of DIT liability, \$448,160 for  
13 the water division and \$335,020 for the wastewater division.<sup>25</sup> The Company complained that  
14 the Staff and RUCO’s calculations were incorrect in part because they are based on 2006  
15 income tax data. RUCO’s and Staff’s reliance on 2006 income tax returns is not in error,  
16 because the 2006 income tax records were the most recent complete tax year information  
17 available prior to the beginning of the test year which began on October, 2007 before the end  
18 of tax year 2007. Moreover, even if Mr. Bourassa had more recent information upon which to  
19 base his calculations, it doesn’t appear that it resulted in more accurate calculations. For  
20 example in 2008, the Company reported to the Commission DIT for its wastewater divisions  
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23 <sup>22</sup> See Exhibit R-19 Company’s response to Staff data request JMM 1.23.

24 <sup>23</sup> See Final Schedules, Schedule 3 Water page 3-4. Schedule 3 Wastewater, pages 2-3.

25 <sup>24</sup> See R-16, Surrebuttal Testimony of Sonn Rowell, pp. 4, 14 and Schedule 2 for Water Division pp. 1-4;  
Schedule 2 Wastewater Division pp. 1-3.

<sup>25</sup> See Exhibits S-13-S-17, Direct and Surrebuttal Testimony of Jeffrey Michlik.

1 of \$335,487 which is \$1,684 more than RUCO's calculation, but nearly \$200,000 more than  
2 Mr. Bourassa's calculation.<sup>26</sup>

3 Because the calculations made by RUCO and Staff are based on the most recent tax  
4 year information available prior to the commencement of the test year and are more reliable  
5 and accurate than those provided by the Company's witness, the ALJ should adopt RUCO  
6 and Staff's position on deferred income tax liability of \$446,530 for the water division and  
7 \$333,803 for the wastewater division.<sup>27</sup>

## 8 **II. Unresolved Issues Related to Operating Income and Expenses**

### 9 **a. Algonquin Power Trust Cost Allocations**

10 Initially the Company sought to allocate costs from Algonquin Power Trust ("APT"), an  
11 operating affiliate of Algonquin Power Income Fund ("APIF") in the amount of \$291,708 to the  
12 water division and \$191,850 to the wastewater division, the amounts purportedly incurred  
13 during the test year. As of the filing of Rebuttal Testimony, in December, 2009, the Company  
14 decided the amounts to be allocated should be \$310,479 to the water division and \$343,688  
15 to the wastewater division. Except for limited audit, tax and rent expense, the APT costs  
16 should be disallowed because the vast majority of the costs are inappropriate and  
17 undocumented.

18 These costs include:

19 1. Audit: Matthew Rowell, RUCO's financial analyst testified that his review of the  
20 back-up information provided for the Audit category reveals that only a very small portion of  
21 these costs could be associated with LPSCO.<sup>28</sup> He testified that only one KPMG invoice  
22 (dated May 30, 2008) indicates a charge of \$8,200 for consultation on "overall US Tax

23 <sup>26</sup> See Exhibit R-7 Annual Report for Wastewater for Year ending December 31, 2008.

24 <sup>27</sup> See R-16, Surrebuttal Testimony of Sonn Rowell, pp. 4, 14 and Schedule 2 for Water Division pp. 1-4;  
Schedule 2 Wastewater Division pp. 1-3.

<sup>28</sup> See Exhibit R-23 Direct Testimony of Matthew Rowell at 6.

1 Matters.” *Id.* Mr. Rowell also testified that the remaining invoices indicate audit or consulting  
2 work done for APT or its affiliates, but not LPSCO. *Id.* Generally, APT’s audit expenses  
3 should not be recoverable from the utilities. However, the KPMG invoice in the amount of  
4 \$8,200 should be allocated across Algonquin’s US operations. *Id.* at 9. This results in \$405  
5 allocated to LPSCO’s waste water division and \$413 allocated to LPSCO water division.

6 2. Tax Services: Mr. Rowell testified, and the Company confirmed that LPSCO’s taxes  
7 are prepared on a consolidated basis at APT.<sup>29</sup> Thus LPSCO does benefit from some of  
8 these tax services. However, Mr. Rowell also testified that the cost pool for tax services  
9 includes some costs that are unrelated to preparation of LPSCO’s taxes. For example, a  
10 KPMG 1 invoice dated June 26, 2008 pertains only to Canadian tax matters.<sup>30</sup> Conversely,  
11 some of the Grant Thornton invoices for tax preparation appeared to be divided allocating a  
12 portion of the cost to each utility. To the extent the Grant Thornton invoices for tax services  
13 do specifically identify LPSCO as a beneficiary of tax preparation services, RUCO believes  
14 the costs may be allocated to LPSCO. Mr. Rowell testified that from his review there were  
15 only \$586 in tax costs allocated to LPSCO.<sup>31</sup> Accordingly, RUCO recommends splitting this  
16 cost 50/50 between LPSCO’s water and wastewater divisions allocating \$293 to each  
17 division.<sup>32</sup>

18 3. Legal: The Company describes the legal fees as “council for review of audited  
19 financial statements, annual information forms, SEDAR filings, review of contracts with credit  
20 facility-BLAKES listed in our annual report as prime legal council.”<sup>33</sup> LPSCO does not file  
21 audited financial statements necessitating legal review. It is not publicly traded in Canada

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23 <sup>29</sup> See Exhibit R-23 surrebuttal testimony of Matthew Rowell at 6.

<sup>30</sup> *Id.* at 8.

<sup>31</sup> *Id.* at 10

<sup>32</sup> *Id.*

<sup>33</sup> See R-26 Infrastructure Allocation for Utility Division.

1 and therefore has no SEDAR filings. Nor does the record reflect that LPSCO has contracts  
2 with credit facilities necessitating legal review during the test year. Except for two IDA bonds  
3 issued in 1999 and 2001, LPSCO had no debt instruments.<sup>34</sup> Last, LPSCO's local counsel is  
4 Fennemore Craig and RUCO has not objected to the Company's inclusion of \$14,317 per  
5 year for Outside Services-Legal expense for the water division and \$24,084 for Contractual  
6 Services-Legal for the wastewater division.<sup>35</sup> Nor has RUCO objected to the inclusion of legal  
7 costs as a deferred regulatory asset. Id. Because LPSCO's legal expenses are already  
8 included as an operating expense and a deferred regulatory asset, and APT's legal expenses  
9 provided no demonstrable benefit to the operation of LPSCO in the test year, RUCO  
10 recommends that the APT legal expenses be disallowed.

11 4. Other Professional Services: The Company indicates that \$448,761 in costs are  
12 attributable to Other Professional Services.<sup>36</sup> The Company describes Other Professional  
13 Services as costs including the payroll system, 401K services, health benefit services and  
14 enterprise resource planning (ERP) system used by AWS (and thus the Arizona utilities.)<sup>37</sup>  
15 Mr. Rowell testified that such expenses are employee related expenses which should be  
16 allocated based on employee headcount or wages. However, the Company has provided no  
17 employee headcounts for the Algonquin subsidiaries, so RUCO recommends an alternative  
18 method of allocation. Id. at 10. Specifically RUCO recommends allocating the costs equally  
19 among the total number of facilities. The Company contends that it has only 63 facilities.  
20 However, a review of its annual report indicates otherwise.<sup>38</sup> In its annual report, the  
21 Company claims to operate 42 hydroelectric facilities, 11 thermal energy facilities and 17

22 <sup>34</sup> See A-18 Bourassa's Direct Testimony (COC) Schedule D-2 at 1.

23 <sup>35</sup> See R-16, Surrebuttal Testimony of Sonn Rowell, Schedule 4 for Water Division at 1 and Schedule 4  
Wastewater Division at 1.

24 <sup>36</sup> See R-23 Surrebuttal Testimony of Matthew Rowell at 10.

<sup>37</sup> See R-26 Infrastructure for the Utility Division.

<sup>38</sup> See Annual Report of Algonquin Power at page 3, lines 5-10.

1 regulated utilities or a total of 70 facilities. *Id.* Dividing \$448,761 by the total number of  
2 reported Algonquin facilities (70) yields \$6,410. Splitting this between the LPSCO water and  
3 Sewer division yields \$3,205.43 to be allocated to each LPSCO division.

4       5. Management Fee: The Company claims that APT incurred management fees of  
5 \$636,255 of which \$171,688 was allocated to LPSCO. The Company initially indicated that  
6 these costs were associated with “provid(ing) management services including strategic  
7 advice and consultation concerning business planning, support, guidance and policymaking  
8 and general services.”<sup>39</sup> In rebuttal, the Company indicated that the “management fees” are  
9 actually a “ a myriad of Central Office Administration costs that are incurred, including those  
10 for trustee fees, management fees, unit holder communications, other professional services  
11 (i.e., maintenance of the ERP System), general office costs, public registrant fees, and  
12 depreciation expense.”<sup>40</sup> Thereafter, RUCO received a breakdown of corporate cost  
13 allocations, based on a 2008 budget identifying management fees as “salaries.”<sup>41</sup> To  
14 address the latter, management fees incurred by the Company do not appear to be  
15 “salaries.” As indicated on the Company’s annual report, the management fees are the  
16 amount paid by APT/APIF, the Company’s parent to APMI, an affiliate for “management  
17 services including advice and consultation concerning business planning, support, guidance  
18 and policy making and general management services.”<sup>42</sup> The management fees include all  
19 “costs incurred and charged” and an incentive fee of 25% on all distributable cash generated  
20 in excess of \$0.92 per trust unit. *Id.* Mr. Tremblay testified that all the “management fees”  
21

22  
23 <sup>39</sup> See Exhibit R-23, Surrebuttal Testimony of Matthew Rowell at 7, footnote 12 and R-26 Infrastructure  
Allocation for the Utility Division.

24 <sup>40</sup> See Exhibit A-2- Rebuttal Testimony of Greg Sorenson at 27.

<sup>41</sup> See Exhibit R-26 Infrastructure Allocation for the Utility Division.

<sup>42</sup> See Exhibit R-11 Algonquin Power Income Fund 2008 Annual Report at 79.

1 billed by APMI to APT/APIF are allocated to the subsidiaries.<sup>43</sup> Essentially the incentives  
 2 and costs paid to APMI are allocated to LPSCO under the auspices of “management fees.”  
 3 Although some measure of the fees may be salaries, there is no evidence on the record to  
 4 demonstrate the actual costs.

5 Moreover, as Mr. Rowell testified, the Company has not established that LPSCO  
 6 receives any benefit from these services.<sup>44</sup> The Company provided inadequate invoices for  
 7 these “management fee” costs. Id. at 7-8. All of these invoices are from an entity identified  
 8 only as “Private Companies” that has the same address as APT. A representative invoice is  
 9 reproduced below:

10  
 11 Sales / Invoices SALES000000000290061  
**Private Companies**  
 2845 Bristol Circle  
 12 Oakville ON La 7H7  
 13 Date 10/28/2007  
 Algonquin Power Trust  
 14 2845 Bristol Circle  
 15 Oakville ON La 7H7  
 Purchase Order Customer ID Salesperson ID Shipping Method Payment Terms ID  
 16 003APT AR  
 Management Fee Inc.Oct07 APT \$72,406.42  
 17 Subtotal \$72,406.42  
 18 Misc \$0.00  
 Tax 5,068.45  
 19 Freight \$0.00  
 Trade Discount \$0.00  
 Payment \$0.00  
 Total Due \$77,474.87

21 Other than the description “Management Fee” the Company has provided no  
 22 documentation of what specific work was done for the benefit of LPSCO ratepayers. The  
 23

24 <sup>43</sup> T: 487  
<sup>44</sup> See Exhibit R-23, Surrebuttal Testimony of Matt Rowell at 7.

1 burden is on the Company to support its recommendations. In the absence of sufficient  
2 documentation demonstrating that the management fees were beneficial to ratepayers, the  
3 Management fees should be disallowed.

4 6. Unit Holder Communication, Trustee, Escrow and Transfer Agent Fees:

5 The Company seeks to include \$152,858 in expenses for unit holder communications,  
6 trustee fees, escrow and transfer agent fees. Mr. Rowell testified and the Company  
7 confirmed that these costs pertain exclusively to ATP/APIF distributions to shareholders.<sup>45</sup>  
8 As such RUCO submits that the expenses have no connection to the operation of LPSCO,  
9 no benefit to ratepayers and should be disallowed.

10 7. Rent/ Office Expenses/ Depreciation:

11 Central office costs include a rent expense allocation of \$295,887.<sup>46</sup> RUCO does not  
12 oppose the inclusion of some rent expense for APT's Ontario office because APT provides  
13 tax and payroll services to LPSCO<sup>47</sup>. However, APIF which owns the building should pay an  
14 equal share and the remaining amount should be shared equally by the subsidiaries. As  
15 RUCO's witness, Mr. Rowell testified the calculation of rent expense should be determined  
16 by dividing the total rent expense 50/50 between the utilities and the APIF yielding \$147,944  
17 to be allocated across the utilities.<sup>48</sup> Dividing \$147,944 by 70 (the total number of reported  
18 facilities) yields \$2,113.48 total rent expense to be shared by LPSCO's water and wastewater  
19 divisions. Id. RUCO recommends rent expense of \$1,056 to be allocated to LPSCO's water  
20 and waste water divisions. Id.

21 <sup>45</sup> Id. at 8.

22 <sup>46</sup> In rebuttal, the Company sought \$295,887 as rent expense. See Exhibit A-16 Rebuttal Testimony of Tom  
23 Bourassa, Schedule C-2. Thereafter, the Company submitted separate documentation reflecting rent expense  
of \$430,739. See R-26 Infrastructure Allocation for the Utility Division. Because the Company has not  
provided in prior testimony.

24 <sup>47</sup> See R-23 at 8 and 11.

<sup>48</sup> Id. at 11.

1           8. Licenses/Fees & Permits/ Office Expenses: APT's central office costs include  
2 \$128,206 in license fees and permits and \$761,628 in offices expenses of which \$191,828  
3 was to be allocated to LPSCO. In rebuttal, the Company's witness, Mr. Bourassa agreed  
4 with Staff that \$191,828 would be excluded. In rejoinder, Company witness, Mr. Tremblay  
5 testified that licenses fees and permits costs include the costs to be listed in the Toronto  
6 Stock Exchange, and were "crucial to the business model and therefore beneficial to  
7 ratepayers." In fact, the \$191,828 was predominantly charitable contributions, gifts, sporting  
8 tickets and related entertainment costs. Ultimately, the Company agreed with RUCO and  
9 Staff that such costs should be disallowed.

10           The Company has failed to support the expenses associated with the central office  
11 costs allocated by APT/APIF. Moreover, the Company has failed to prove such costs are  
12 beneficial to LPSCO ratepayers with the exception of limited rent, professional services audit  
13 and tax expenses. Accordingly, RUCO recommends reducing APT central office costs to  
14 \$4,908.50 and \$4,900.50 for the water and wastewater Divisions, respectively and  
15 disallowance of all other costs.

16           **b. Allocation of Corporate Jet Expenses.**

17           The Company seeks allowance of AWS allocations in the amount of \$153,174 and  
18 \$102,116 for its water and wastewater divisions, respectively. In surrebuttal, RUCO agreed  
19 to allow the costs.<sup>49</sup> However, during the course of the hearing, the Company revealed, for  
20 the first time, its relationship with Airlink. Mr. Tremblay testified Airlink is actually "Algonquin  
21 Airlink," an airline owned by an affiliate of APMI.<sup>50</sup> He further revealed that the managers of  
22 the Fund own the plane. *Id.* He also disclosed that the Fund may also lease another plane.  
23 *Id.* Algonquin Airlink which is owned by the managers of the APT/APIF, bills APT/APIF for

24 <sup>49</sup> See Exhibit R-23 Surrebuttal Testimony of Matthew Rowell at 13.

<sup>50</sup> T: 555.

1 the use of its corporate jets.<sup>51</sup> Upon further examination of two Airlink invoices during the  
2 hearing, the Company revealed that Airlink billings for use of the planes are billed directly to  
3 Algonquin Water services or Algonquin's power generation division and then allocated to the  
4 utilities based on a four-factor analysis. At hearing, the Company agreed to the removal of  
5 \$24,302 and \$16,201 from Transportation expense allocated by AWS to LPSCO water and  
6 wastewater divisions, respectively.

7 **c. Allocation of Other AWS Expenses**

8 AWS essentially acts as a management company for the Algonquin water and  
9 wastewater utilities. The utilities (including LPSCO) have no employees of their own. All of  
10 the employees that operate the utilities work for AWS. RUCO did not audit the AWS  
11 expenses because the back-up provided for them was insufficient. RUCO did determine that  
12 those expenses (on a per-customer basis) are consistent with what other management  
13 companies charge utilities.<sup>52</sup> Although RUCO recommended approval of the AWS expenses,  
14 given the discovery of the Airlink corporate jet expenses that were allocated to LPSCO  
15 through AWS, RUCO believes that the AWS expenses should be subject to greater scrutiny  
16 in subsequent rate cases.

17 **d. Rate Case Expense**

18 Initially, the Company sought \$210,000 in rate case expense from each division of  
19 LPSCO for a total of \$420,000. Thereafter, on the last day of the hearing the Company  
20 increased its requests to \$500,000. The Company proposes a 3-year amortization period.  
21 RUCO and Staff agreed to rate case expense of \$420,000, but recommended amortization  
22 over a 5-year period. The Company may argue that a 5-year amortization period is too long.  
23

24 <sup>51</sup> T: 566.

<sup>52</sup> See Exhibit R-22 Direct Testimony of Matthew Rowell at 11-12.

1 RUCO disagrees because the Company's prior rate case was in 2001 based on a 2000 test  
2 year. The fact that the Company has not filed a rate case for nine years supports a longer  
3 amortization period. Moreover, as testified by Ms. Rowell, a five-year amortization period is  
4 common in rate cases and in her opinion, a reasonable period of time.<sup>53</sup> The Company may  
5 argue that in Global water, RUCO agreed to a 3-year amortization period.<sup>54</sup> The Company  
6 is correct, but the case of Global is distinguishable from this case. Global was not  
7 incorporated in Arizona until 2003. Global did not come in for a rate case earlier in part  
8 because it had little plant on which to base a rate case and few customers. *Id.* In that  
9 respect, Global is clearly distinguishable from this case. Accordingly, RUCO's position on a  
10 3-year amortization in Global is not relevant to this proceeding.

11 The Company requests additional rate case expense in the amount of \$40,000 per  
12 division due to a delay in the hearing process. RUCO objects. The delays in this proceeding  
13 are necessitated in large part by the Company's dilatory practices. RUCO inquired as to  
14 affiliated transactions during the course of the proceeding and the Company filed  
15 inappropriate responses which resulted in delay in the proceeding. The Company failed to  
16 respond to multiple inquiries by RUCO as to the nature of the expense.<sup>55</sup> In data request  
17 MJR 2.5 RUCO requested a complete list (in Excel format) of all affiliate accounts and/or  
18 asset classes that are allocated or billed to the utilities. *Id.* at Attachment 3. For each  
19 account/asset class RUCO requested the Company provide the name of the affiliate, the total  
20 test-year amount of the account/asset class, the allocation method used, the amount  
21 allocated to each (i.e., not just LPSCO) utility level affiliate, and asked the Company to

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22  
23  
24 <sup>53</sup> T: 762.

<sup>54</sup> See Exhibit A-23 Stipulated Facts.

<sup>55</sup> See Exhibit R-23 Surrebuttal Testimony of Matt Rowell at 13

1 identify the specific utility level account(s) where they are ultimately booked (e.g., "Outside  
2 Services — Other."). *Id.* The Company responded:

3 *OBJECTION: This is a proceeding to set the rates for LPSCO. As such, the*  
4 *relationships between third parties that are not parties to this rate case is*  
5 *immaterial, and not calculated to lead to the discovery of admissible evidence*  
6 *in this proceeding. Furthermore, to the extent RUCO seeks information*  
7 *regarding "all" such third party transactions the request is overly broad and*  
8 *unduly burdensome.*

9 *Id.* at Attachment 3. RUCO accepted the Company's response on its face. The Company  
10 argues that RUCO did not pursue a motion to compel further discovery. The fact that RUCO  
11 accepted the Company's avowal that it had no information which would "lead to the discovery  
12 of admissible evidence" does not excuse the Company's failure to respond fully to  
13 appropriate discovery requests. Clearly, RUCO's inquiry into the allocations from affiliates  
14 was appropriate and had the Company responded in good faith, its response would have  
15 lead to discoverable information—namely the Algonquin Airlink related expenses. Moreover,  
16 had the Company responded fully to RUCO's data requests, such matters would have been  
17 resolved more expediently.<sup>56</sup>

18 In addition, the Company also failed to respond in good faith to RUCO's inquiries  
19 about expansion of PVWRF. In its 6<sup>th</sup> and 9<sup>th</sup> Data Request, RUCO requested cost data on  
20 expansion of the PVWRF plant and copies of all engineering reports related to the expansion  
21 of the PVWRF, including but not limited to the 2004 PVWRF engineering report submitted to

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22 <sup>56</sup> During the hearing, the Company acknowledged that APT/APIF paid Airlink, \$1.3 million as an advance  
23 against expense reimbursements for the Fund's use of the aircraft in 2004. In addition, the Fund revealed that it  
24 incurred costs in connection with the use of the aircraft of \$332,000 in 2008 and \$422,000 in 2007 and  
amortization expenses related to the advances against expense re-imbursements of \$90,000 in 2008 and  
\$168,000 in 2007. The Company agreed to clarify whether any of the costs reflected in APIF's annual report  
were allocated to LPSCO. The Company has deleted two invoices allocated via AWS under transportation, but  
has not clarified whether any of APIF's expenses have been allocated to LPSCO under the auspices of APMI  
management fees or any other expense category.

1 obtain expansion of the plant from 4.1mgd to 8.2mgd.<sup>57</sup> The Company portended that there  
2 was no expansion sought. *Id.* at 291. At the hearing Mr. Sorenson testified that the plant had  
3 not been expanded beyond 4.1mgd. *Id.* at 290, 292. When presented with a copy of the  
4 Company's application for expansion submitted to ADEQ, Mr. Sorenson testified that the  
5 engineer sought the request without the Company's permission. *Id.* When presented with a  
6 letter from the Chris Jarratt, the Company's CEO, supporting the expansion request, Mr.  
7 Sorenson admitted the expansion request had been submitted and that the ADEQ approved  
8 the expansion request in June, 2006.<sup>58</sup> The record is clear that the Company has elongated  
9 the proceedings by failing to respond to RUCO's data requests. While the Company may  
10 have spent more attorneys' fees at hearing, the problem is of their own making. Accordingly,  
11 the Company should not recover additional attorneys' fees. RUCO recommended approval of  
12 the Company's initial request of rate case expense in the amount of \$210,000 per division  
13 amortized over a five-year period. RUCO defers to the Commission to decide if a lesser  
14 amount is appropriate.

15 **e. Bad Debt Expense**

16 The Company claimed bad debt expense for the test year in the amount of \$43,889 for  
17 its wastewater division. The Company and Staff have agreed to normalization of bad debt  
18 expense at \$22,098. Ms. Rowell, RUCO's witness testified that the bad debt expense  
19 incurred by LPSCO's wastewater division during the test year is excessive<sup>59</sup>. Ms. Rowell  
20 testified that bad debt expense of LPSCO's wastewater division increased by 1,483 percent  
21 (from \$2,773 to \$43,889) from the year ended September 30, 2006 to the test year. *Id.* This  
22 massive increase in bad debt expense is not explained by LPSCO. LPSCO's water division

23 <sup>57</sup> See Exhibit R-6 Company's data response to RUCO's 9<sup>th</sup> DRs. See also Exhibit R-34 Company's data  
responses to RUCO's 6<sup>th</sup> DRs.

24 <sup>58</sup> *Id.* at 292. See also Exhibit 3 ADEQ Documents at page 125.

<sup>59</sup> See Exhibit R-15 Direct Testimony of Sonn Rowell at 16.

1 did not experience a similar remarkable increase in bad debt expense. Ms. Rowell testified  
2 that the water division's bad debt expense was \$3,264 or 0.0476 percent of total revenues.  
3 Id. at Schedule 4 for the Wastewater Division at page 15 of 19. Because of the  
4 extraordinary nature of the wastewater division's test year bad debt expense, RUCO  
5 recommends an adjustment be made to bring the bad debt expense into a more typical range  
6 by multiplying the bad debt expense as a percent of revenue for the water division in the test  
7 year (0.0476 percent) and applying that percentage to LPSCO wastewater division's  
8 revenues (\$6,383,886) to arrive at a bad debt expense of \$3,041.

9 The Company and Staff propose bad debt expense of \$8,548 for the water division  
10 based on normalization. The Company's actual bad debt expense for the test year is \$3,264  
11 or 0476 percent of its revenues for the water division n the test year. Id. RUCO submits that  
12 the test year bad debt expense of 0.0476 percent is a reasonable level of bad debt and  
13 recommends that bad debt expense in excess of \$3,264 be disallowed.

#### 14 **f. Effluent Fees**

15 The Company's effluent rates are not defined. The Company purports to charge  
16 "market rates," which means that the Company can charge whatever rate for effluent it  
17 negotiates with each effluent customer.<sup>60</sup> LPSCO's current charge to effluent customers is  
18 excessively low. Id. at 23-24. Most of LPSCO's customer's are paying \$0.17 per thousand  
19 gallons.<sup>61</sup> RUCO proposes that the Company establish a tariff rate of \$1.50 per thousand  
20 gallons for treated effluent. Because effluent is a valuable resource and effluent revenues  
21 help to offset the impact of rate increases on other customer classes, RUCO believes an  
22 adjustment to effluent rates is appropriate. Accordingly, RUCO recommends cessation of  
23

24 <sup>60</sup> See R-15 Direct Testimony of Sonn Rowell at 23.

<sup>61</sup> See Exhibit R-17 LPSCO Test Year Effluent Sales.

1 “market rates” and the establishment of a tariff rate of \$1.50 per thousand gallons for treated  
2 effluent.

3 **g. Non-recurring Expenses or Unnecessary Expenses.**

4 **i. Fuel and Power Adjustment**

5 The Company proposes a fuel for power production adjustment of \$56,381 for its  
6 water division. RUCO opposes the amount because the invoices supporting the test year  
7 amount are to Kohler Rental Power.<sup>62</sup> The rental generators which may have been used by  
8 the Company during the test year for construction are not recurring expenses. Accordingly,  
9 RUCO recommends disallowance of the fuel for power production adjustment of \$56,381.

10 **ii. Effluent Disposal**

11 The Company seeks \$19,784 for effluent clean up and oat crop planting at SunCor  
12 Farms, \$11,500 to GreensKeeper, LLC for removal of weeds at the LPSCO farm and \$4,928  
13 for cleaning sewer lines in Gilbert, Arizona for a total of \$36,212.<sup>63</sup> The Company asserts  
14 these costs are related to effluent disposal. The charges on their face are related to  
15 maintenance of properties not utilized by the utility for the benefit of ratepayers. The  
16 Company is not providing sewage service in Gilbert, Arizona. The Company’s does not own  
17 SunCor Farms. Although the Company may own the LPSCO farm, the pulling of weeds is  
18 unrelated to the provision of water and wastewater service to ratepayers. Unless the  
19 Company can demonstrate that the expenses are beneficial to ratepayers, RUCO  
20 recommends the costs be disallowed.

21  
22  
23  
24 <sup>62</sup> See Exhibit R-15 Direct Testimony of Sonn Rowell, Schedule 4 at page 3 of 15.

<sup>63</sup> *Id.* at page 5.

1                   **iii. Dues and memberships**

2                   The Company seeks to include in expenses \$5,260 and \$5,122 of expenses related to  
3 dues and memberships in its expense for Contractual Services Other for the water and  
4 wastewater divisions, respectively. *Id.* at Schedule 4. RUCO disagrees that these expenses  
5 are necessary and beneficial to ratepayers and therefore recommends that the costs be  
6 disallowed.

7  
8                   **III. UNRESOLVED ISSUES RELATED TO COST OF CAPITAL**

9                   Although the parties concur on capital structure and the cost of long and short-term  
10 debt, they disagree on the cost of equity and the overall weighted average cost of capital.  
11 RUCO recommends a cost of equity of 9.00 percent and an overall cost of capital of 8.54  
12 percent, which results in a fair and reasonable recommended rate of return.<sup>64</sup>

13                   **a. RUCO'S Use of an Historic Market Risk Premium to Determine its CAPM Cost of  
14 Equity Capital is Appropriate.**

15                   In calculating a cost of equity, both the Company and RUCO used the Capital Asset  
16 Pricing Model ("CAPM"). The CAPM is a mathematical tool developed during the early  
17 1960's by William F. Sharpe, the Timken professor Emeritus of Finance at Stanford  
18 University.<sup>65</sup> CAPM is used to analyze the relationships between rates of return on various  
19 assets and the risk as measured by beta.<sup>66</sup> The underlying theory behind the CAPM states  
20 that the expected return on a given investment is the sum of a risk-free rate of return plus a

21  
22 <sup>64</sup> See Exhibit R-29 Rigsby's Surrebuttal Testimony at 6.

23 <sup>65</sup> See Exhibit R-28 Rigsby Direct Testimony at 28.

24 <sup>66</sup> Id. Beta is defined as an index of volatility or risk, in the return of an asset relative to the return of a market portfolio of assets. It is a measure of systematic or non-diversifiable risk. The returns on a stock with a beta of 1.0 will mirror the returns of the overall stock market. The returns on stocks with betas greater than 1.0 are more volatile or riskier than those of the overall stock market; and if a stock's beta is less than 1.0, its returns are less volatile or riskier than the overall stock market.

1 market risk premium that is proportional to the systematic, non-diversifiable risk, associated  
2 with that investment.<sup>67</sup>

3 The Company arrived at its CAPM cost of equity capital of 12.0 percent by averaging  
4 an 8.3 percent CAPM result derived from long horizon average market risk premium and a  
5 16.7 percent CAPM result derived from a current market risk premium.<sup>68</sup> RUCO derived its  
6 CAPM cost of equity capital based on an historic market risk premium.<sup>69</sup> RUCO calculated a  
7 range for its CAPM cost of equity capital between 5.92 percent-7.49 percent for its water  
8 sample and 5.25 percent-6.51 percent for its natural gas proxy.<sup>70</sup>

9 The Company claims that RUCO's CAPM analysis is not reliable because it is based  
10 on an historic market risk premium.<sup>71</sup> RUCO submits that reliance on past performance as  
11 an indicator of future performance is sounder than reliance on analysts' projections of market  
12 return and treasury yields as evidenced by Staff's use of the same historic market risk  
13 premium. Staff witness, Juan Manrique, performed a CAPM analysis using a historic market  
14 risk premium. Mr. Manrique's historical market risk premium estimate is 6.5 percent.<sup>72</sup>

15 **b. RUCO'S Use of a Geometric Mean to Determine its Historic Market Risk**  
16 **Premium in the CAPM is Appropriate.**

17 The Company claims that RUCO's historic market risk premium is also unreliable  
18 because it is based in part on a geometric mean.<sup>73</sup> The Company claims that RUCO's  
19 historic market risk premium should be based upon an arithmetic mean. RUCO's historic  
20 market premium was derived from both a geometric and an arithmetic mean of the historical

21 <sup>67</sup> See Exhibit R-28 at 31-33.

22 <sup>68</sup> See Exhibit A-19 Bourassa Rebuttal Testimony at 2. See also A-18 at 32-33. Mr. Bourassa's historical MRP  
was 7.5 percent and his current MRP was 21.3 percent.

23 <sup>69</sup> See Exhibit R-32 Rigsby Direct Testimony at 35-37.

24 <sup>70</sup> *Id.* at Schedule WAR 7 pages 1 and 2.

<sup>71</sup> See Exhibit A-18 Bourassa's Direct Testimony (COC) at 23.

<sup>72</sup> See Exhibit S-12 Direct Testimony of Juan Manrique at 30.

<sup>73</sup> See Exhibit A-19 Bourassa's Rebuttal Testimony at 18.

1 returns on the Standard and Poor 500 (“S&P 500”) index from 1926 to 2008 as the proxy for  
2 the market rate of return.<sup>74</sup> For the risk-free portion of the risk premium component, RUCO  
3 used the geometric mean of the yields of long-term government bonds for the same eighty-  
4 two year period resulting in an historic risk premium of 4.20 percent using a geometric mean  
5 and a historic risk premium of 6.10 percent using an arithmetic mean.<sup>75</sup>

6 The use of geometric mean is the industry standard. Mr. Rigsby testified that  
7 geometric means are published in Morningstar stocks, bonds, bills and inflation text and  
8 testified that analysts rely on geometric means to calculate a market risk premium.<sup>76</sup> Mr.  
9 Rigsby further testified that Value Line analysts use geometric means. Although Staff did not  
10 use a geometric mean in this case, it has in the past. As reflected in the testimony, Mr.  
11 Parcell, Staff’s cost of capital witness in a recent Arizona water case, testified that he uses  
12 both geometric and arithmetic means in his testimony.<sup>77</sup> Mr. Parcell further testified that  
13 Value Line calculates both historic and prospective growth rates on a geometric or compound  
14 growth rate basis.<sup>78</sup> Moreover, in the matter of UNS Gas, the Commission concluded:

15 *We agree with the Staff and RUCO witnesses that it is appropriate to*  
16 *consider the geometric returns in calculating a comparable company CAPM*  
17 *because to do otherwise would fail to give recognition to the fact that many*  
*investors have access to such information for purposes of making*  
*investment decisions.*<sup>79</sup>

18 Recent empirical research also supports RUCO’s market risk premium.<sup>80</sup> Mr. Rigsby  
19 testified that empirical studies performed by Aswarth Damdaran and Felicia C. Marston,  
20 professors of finance from New York University and the University of Virginia, respectively,

21  
22 <sup>74</sup> See Exhibit R-32, Rigby’s Direct Testimony at 33-35.

<sup>75</sup> *Id.* at 35.

<sup>76</sup> See Exhibit R-29, Rigby’s Surrebuttal Testimony at 15.

<sup>77</sup> *Id.* at 15-16.

<sup>78</sup> *Id.* at 16.

<sup>79</sup> *Id.* at 15.

<sup>80</sup> See Exhibit R-33, Rigsby’s Surrebuttal Testimony at 13-14.

1 indicate that market risk premiums in excess of 4.5 to 5.5 percent are overstated.<sup>81</sup> Indeed,  
2 Mr. Rigsby attached the text: *Valuation: Measuring and managing the Value of Companies*,  
3 4th Edition,<sup>82</sup> which states:

4       Although many in the finance profession disagree about how to measure the  
5       market risk premium, we believe 4.5-5.5 percent is an appropriate range.  
6       Historical estimates found in most textbooks (and locked in the mind of many),  
7       which often report numbers near 8 percent, are too high for valuation purposes  
8       because they compare the market risk premium versus short-term bonds, use  
9       75 years of data, and are biased by the historical strength of the U.S. market.<sup>83</sup>

10       Mr. Bourassa's range of risk premium using an arithmetic mean and historic and  
11       current market risk premium is 7.5 percent and 21.3 percent, respectively.<sup>84</sup> RUCO's historic  
12       risk premium using both an arithmetic and geometric means ranges between 4.20 percent  
13       and 6.10 percent. The average of Mr. Rigsby's geometric and arithmetic mean, 5.10 percent,  
14       falls in the range identified as reasonable by recent empirical research. Mr. Bourassa's  
15       range of risk premium does not. The Commission should reject the Company's cost of equity  
16       capital recommendation.

17       **c. Publically Traded Gas Companies are Comparable to the Company for the**  
18       **Purposes of Calculating the Cost of Capital.**

19       The Company contends that RUCO erred in using a proxy of gas utilities to derive its  
20       cost of capital because the average beta for RUCO's water utility sample is .83, compared  
21       with its natural gas sample of .67.<sup>85</sup> The Company used a water proxy of six water utilities to  
22       complete its cost of capital analysis.<sup>86</sup> The Company's proxy included Aqua America, which

23       <sup>81</sup> *Id.* at 20-21.

24       <sup>82</sup> *See* Exhibit R-29 Attachment *Valuation: Measuring and Managing the Value of Companies*, 4th Edition

<sup>83</sup> *See* Exhibit R-32, Rigsby's Direct Testimony at 21-22

<sup>84</sup> *See* Exhibit A-18 Bourassa's Direct Testimony at 32-33

<sup>85</sup> *See* Exhibit A-18 Bourassa's Rebuttal Testimony; *See also* Exhibit R-28 Rigsby's Direct Testimony,  
      Schedule WAR 7.

<sup>86</sup> *Id.*

1 has a beta of .65.<sup>87</sup> The Company cannot complain that RUCO used gas utilities with  
2 average beta of .67 when one sixth of the companies in its water proxy have a lower beta of  
3 .65.

4 The Company contends that gas companies are less risky investments than water  
5 companies as evidenced by their low beta and therefore, should not be used as proxies for  
6 the Company. Mr. Rigsby testified that in the current economy utilities are viewed as a safe  
7 haven for investors and that both water and gas utilities share that the perception of being  
8 recession proof.<sup>88</sup> There are multiple measures of risk. Beta is one, and Value Line safety  
9 and financial strength as well as Standard and Poor's stock ranking are also alternatives.

10 The Company's reliance on beta alone also ignores the clear guidance of the courts<sup>89</sup>.  
11 To determine an appropriate cost of equity capital, the Commission needs to consider all  
12 relevant factors, including: (1) comparisons with other companies having corresponding risks,  
13 (2) the attraction of capital, (3) current financial and economic conditions, (4) the cost of  
14 capital, (5) the risks of the enterprise, (6) the financial policy and capital structure of the  
15 utility, (7) the competence of management, and (8) the company's financial history.<sup>90</sup> Mr.  
16 Rigsby testified that he used gas utilities as a proxy because they have similar operating  
17 characteristics to water companies in terms of distribution and similar risks.<sup>91</sup> Based on the  
18 foregoing, RUCO did not err in deriving its cost of equity capital using a gas proxy.

21 <sup>87</sup> See Exhibit R-14, Value Line Report on Water Industry, dated October 23, 2009.

22 <sup>88</sup> See Exhibit R-29 Rigsby's Surrebuttal Testimony at 12-13.

23 <sup>89</sup> United Railways & Electric Company of Baltimore v. West, 280 U.S. 234, 249-50, 251, 50 S.Ct. 123, 125,  
125-26, 74 L.Ed. 390 (1930); Simms v. Round Valley Light & Power Company, 80 Ariz. 145, 154, 294 P.  
378, 384 (1956).

24 <sup>90</sup> Litchfield Park Service Corporation v. Arizona Corporation Commission 178 Ariz. 431, 874 P.2d 988 (Ariz.  
App. Div. 1 1994).

<sup>91</sup> Id.

1 **IV. CONCLUSION**

2 For the reasons discussed above, RUCO recommends the Commission adopt its  
3 position in this case, and reject the positions of Staff and the Company, to the extent they  
4 conflict with RUCO's recommendations.

5 RESPECTFULLY SUBMITTED this 10<sup>th</sup> day of February, 2010.

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Michelle L. Wood  
Counsel

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10 AN ORIGINAL AND THIRTEEN COPIES  
11 of the foregoing filed this 10<sup>th</sup> day  
of February, 2010 with:

12 Docket Control  
13 Arizona Corporation Commission  
1200 West Washington  
14 Phoenix, Arizona 85007

15 COPIES of the foregoing hand delivered/  
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