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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF BLACK MOUNTAIN SEWER CORPORATION, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.	DOCKET NO: SW-02361A-05-0657 **NOTICE OF FILING SUMMARY OF WITNESS' PRE-FILED TESTIMONY**

Black Mountain Sewer Corporation ("Black Mountain" or "Company"), an Arizona corporation, hereby files the summary of the pre-filed testimony of Thomas J. Bourassa, CPA.

RESPECTFULLY SUBMITTED this 5th day of June, 2006.

FENNEMORE CRAIG, P.C.

By ______________________

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ORIGINAL and thirteen (13) copies of the foregoing were delivered this 5th day of June, 2006 to:

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BLACK MOUNTAIN SEWER CORPORATION

Docket No. SW-02361A-05-0657

<u>Summary of Testimony of Thomas J. Bourassa</u>

Mr. Bourassa is a Certified Public Accountant providing various accounting and consulting services to businesses, including utilities. He has prepared or has assisted in the preparation of rate applications for a number of Arizona water and wastewater utilities. In this rate proceeding, Mr. Bourassa was responsible for preparing, and is sponsoring, Schedules A through H of the standard filing requirements for Class B water utilities, as set forth in A.A.C. R14-2-103, and for the overall development of the revenue requirement for Black Mountain Sewer Corporation ("BMSC" or "Company") in this case.

Mr. Bourassa filed direct, rebuttal and rejoinder testimony, which generally addresses the following aspects of BMSC's rate application:

(1) Revenue Requirement.
(2) Rate Base (original cost, reconstruction cost and fair value).
(3) Revenues and Expenses (including depreciation and taxes).
(4) Cost of Capital
(5) Rates and Rate Design.

A summary of the key issues addressed in Mr. Bourassa's pre-filed testimony follows:

I. REVENUE REQUIREMENT

The parties' respective revenue requirements as of the rejoinder stage of this proceeding are as follows:

	Revenue Req.	Revenue Incr.	% Increase
Staff - Surrebuttal	$1,422,442	$ 216,990	18.00%
RUCO – Surrebuttal	$1,213,210	$ 5,470	0.45%
Company Rejoinder	$1,473,999	$ 268,547	22.28%

The Company proposes its original cost rate base ("OCRB") be used as its fair value rate base ("FVRB") to determine the revenue requirement.

II. RATE BASE

A. Overview of Rate Base

The parties' respective rate bases as of the rejoinder stage of this proceeding are as follows:

	OCRB	FVRB
Staff - Surrebuttal	$ 1,753,118	$ 1,753,118
RUCO - Surrebuttal	$ 1,372,834	$ 1,372,834
Company - Rejoinder	$ 1,642,269	$ 1,642,269

B. Post Test Year Plant

BMSC, Staff and RUCO agree on the inclusion of post test year plant (a chlorinator) in rate base and all parties agree to a cost of $86,699, although Staff failed to adjust its plant-in-service by that amount. The Company further proposes to adjust plant-in-service and accumulated depreciation for a related retirement totaling $19,537, an adjustment not recommended by Staff. Staff does not make an adjustment

C. Deferred Income Taxes

BMSC accepted Staff's proposal to include a deferred income tax asset equal to approximately $164,000 in rate base and rejects RUCO's proposal to include a deferred tax liability in rate base). RUCO's proposed deferred income tax is unsupported, not based on the Company's books and records and contrary to Statement of Financing Accounting Standard ("SFAS") 109, Accounting for Income Taxes (February 1992). In contrast, the recommendation made by Staff and adopted by the Company is consistent with SFAS 109 because it is based on the amounts of assets and liabilities on the books of the Company that created the deferred taxes.

D. Scottsdale Capacity Agreement

The Company's agreement with the City of Scottsdale allows it to send wastewater flows to Scottsdale for treatment and disposal ("Scottsdale Capacity"). Under the approach adopted by the Commission in the Company's last rate case, the debt service on the debt used to fund the acquisition of the Scottsdale Capacity is treated as an operating lease and included in operating expenses as lease expense. Both the Company and Staff propose that the Scottsdale Capacity continue to be treated as an operating lease.

RUCO proposes that the Scottsdale Capacity now be given rate base treatment. However, RUCO's argument that treatment of the Scottsdale Capacity is "fictitious" is ridiculous. BMSC is simply followed the Commission's mandate, as it was legally required to do despite its opposition to such treatment in the last rate case. In the prior rate case, rate base treatment of the Scottsdale Capacity would have resulted in higher rates. In the instant case, rate base treatment results in lower rates because the original cost of the Scottsdale Capacity has been amortized. RUCO offers no valid justification for a switch in ratemaking treatment.

RUCO's argument that under the operating lease treatment, rate payers do not receive "credit" for the portion of the Scottsdale Capacity they have paid for does not warrant the relief RUCO seeks. The Company does not own capacity in Scottsdale's wastewater systems or anyone else's by virtue of the Scottsdale Capacity payments and customers have paid neither a return on nor of the cost of acquiring capacity through rates. RUCO's argument that BMSC is an entirely different company with different ownership and different capitalization is also flawed. Algonquin purchased the stock of Boulders Carefree Sewer Company in 2001 and the name was changed to Black Mountain Sewer Company. However, BMSC remains the same corporate entity. There was no new stock and the capitalization before and after the purchase of the stock remain the same.

E. AIAC and CIAC Balances

The Company's agrees to Staff's corrected CIAC balance accept that failed to reclassify expired AIAC contracts identified by BMSC. In addition, Staff has failed to make a corresponding adjustment to plant-in-service of $339,883 to coincide with its revised CIAC balance. As a result, Staff's proposed adjustments to CIAC will be one-sided and rate base will be understated. In contrast, the net effect on rate base of the Company's adjustments plant-in-service, AIAC, and CIAC is zero.

F. Termination of Hook-up Fee and Customer Refunds

The Company and Staff agree to terminate the Company's hook-up fee and refund amounts already collected and either incorrectly spent on an existing plant site or still held in the hook up fee account. As a result, the Company's balance sheets reflects an increase in plant of service and a reduction to the CIAC balance in the amount of $833,367, the amount that will be refunded to ratepayers before new rates go into effect. The Company's proposed refund would be computed on a per customer basis, irrespective of customer class. Based on the test year end number of customers, the refund per customer would be $447.33.

G. Affiliate Profit

The Company challenges Staff's proposal to eliminate affiliate profit from plant-in-service totaling $20,926. This amount, equal to approximately 8 percent of project costs, was primarily incurred for engineering and project management services at hourly rates at or below known third-party hourly rates This means that BMSC paid no more and likely far less for these services than it would for equivalent services from non-affiliates, if such services were available from non-affiliates, which they are not. Staff simply failed to conduct any sort of prudency review instead of simply determining that affiliates are not entitled to a profit on services they provide to the Company. Moreover, $15,256 of the affiliate profit Staff proposes to eliminate relates to CIAC funded plant, for which Staff made no corresponding adjustment to reduce CIAC resulting in a further understatement of rate base.

H. Working Capital

The Company is in agreement with Staff to set working capital to zero. RUCO proposes negative working capital, however, RUCO offers no lead-lag study, which would be needed to accurately show the revenue and expense leads and lags and a working capital amount. Therefore, the best course of action is to allow zero working capital, which both Staff and the Company have done.

I. Miscellaneous Rate Base Issues in Dispute

The Company disagrees with Staff's or RUCO's proposal to capitalize legal expense relating to an operating agreement between the Town of Carefree. BMSC further questions RUCO's proposal to capitalize $3,465 for the cost of purchasing and providing training on safety equipment, but accepts Staff's adjustment to capitalize safety equipment in the amount of $2,185. The training costs, $1,280, should not be capitalized as training is a normal and recurring period expense.

III. REVENUES AND EXPENSES

A. Overview of Income Statement

Some of the Company's more notable adjustments to the test year in order to normalize revenues and expenses and to take into account known and measurable changes include :

(1) Annualizing depreciation expense using account specific depreciation rates based on Staff's typical and customary rates rather than the previously approved 5.0% composite rate;
(2) Increasing property and income taxes to reflect proposed revenues;
(3) Inclusion of rate case expense amortized over 4 years;
(4 Increasing "lease" expense for the Scottsdale Capacity which reflects the annual debt service on the debt funding the capacity plus a gross-up for income taxes on the non-deductible principle portion of the debt service;
(5) Increasing purchased power to reflect the 2004 rate increase from APS; and,
(6) Annualizing purchased wastewater, purchased power, and chemical expense.

A number of additional adjustments were made at the rebuttal and rejoinder stages based on the positions of the other parties. Notable adjustments include:

(1) Removal of capitalized expenses;
(2) Removal of non-recurring truck expenses;
(3) Increasing rate case expense;
(4) Removal of food and beverages expense;
(5) Removal of ACC assessments;
(6) Reduction of management fees;
(7) Removal of non-affiliate long distance charges; and,
(8) Removal of bad debt expense.

With these various adjustments based on known and measurable changes, the Company's proposed adjusted test year level of operating expenses is equal to $1,192,776. Staff and RUCO's recommended operating expenses are lower and there remain a number of income statement issues in dispute between the parties.[1]

B. Affiliate Profit

Staff's elimination of affiliated profits from operating expenses is consistent with Staff's recommendation for similar adjustments to rate base discussed above. To begin with, the amount Staff proposes to remove, $21,761, which represents a "profit" of approximately 4.5 percent. BMSC saves over $220,000 annually by obtaining essential operations, administration and management services from affiliates due to economies of scale achieved by Algonquin Water Services as compared to hiring workers directly. The cost per customer per month was also shown to be less than third party non-affiliates offering non-equivalent (lesser) service. The amount of operating expenses Staff eliminates is necessary if BMSC is going to achieve these services at reduced cost to the benefit of the Company and ratepayers.

C. Property Taxes

The Company and Staff agree on the method to be used to determine property taxes, which methodology uses proposed revenues and follows the Arizona Department of Revenue property tax calculation. The difference between the Company and Staff on the recommended property tax expense level is due to the different revenue levels recommended. RUCO, in contrast, continues to offer the same historical revenue approach, using the test year and the two prior years. This approach has repeatedly been rejected by the Commission because it fails to account for increased revenues which will result in increased property tax expense during the period rates will be in effect. *Rio Rico Utilities*, Decision No. 67279 at 8; *Arizona Water Company,* Decision No. 64282 at 12-13; *Bella Vista Water Company,* Decision No. 65350 at 16; *Arizona-American Water Company,* Decision No. 67093 at 9-10. RUCO's reference to Senate Bill 1432 is also of no account in this rate proceeding as there is currently no law exempting utilities from property tax expense..

D. Rate Case Expense

BMSC has estimated it will incur $200,000 in rate case expense, an amount that has increased as the matter has progressed due to the excessive discovery and interventions. The Company has, to date, sought to recover $150,000 amortized over 4 years ($37,500 annually) as rate case expense in this proceeding, meaning it intends to absorb roughly 25% of the cost. BMSC responds to Staff's proposal rate increase of $124,800 by asserting that Staff has failed to take adequate account of the increased expenses caused by matters beyond the Company's control. RUCO's argument that the Company should be precluded from recovering any more

[1] Most notably for RUCO is its proposal to give rate base treatment to the Scottsdale Capacity, as discussed above. Per its proposal, RUCO has excluded the "lease" expense from operating expenses and increased depreciation expense for the amortization of the Scottsdale Capacity. BMSC opposes this treatment as explained above.

than its original estimate of $120,000 is similarly flawed. The best evidence of the Company's rate case expense is the amount it actually incurs.

E. Income Taxes

The Company does not agree with Staff's adjustment to remove the tax gross-up on the principle portion of the operating lease for the Scottsdale Capacity. If the tax gross-up is removed and Staff's method for income tax calculation is adopted, income tax expense will be overstated by over $50,000. While the higher computed income taxes of Staff benefit the Company, it translates to higher costs to ratepayers.

F. Capitalized Expenses

BMSC agrees with Staff to remove expenses that should have been capitalized to plant-in-service totaling $17,348. Staff's direct adjustment included $2,700 of expense that was already capitalized, but Staff corrected this in its surrebuttal filing. The Company disagrees with proposals by both Staff and RUCO to capitalize legal expense relating to an operating agreement between the Town of Carefree. Further, the Company agrees with Staff to capitalize $2,185 of safety equipment but disagrees with RUCO to capitalize an additional $1,280 for safety training.

G. Miscellaneous Income Statement Issues in Dispute

Staff agreed to the inclusion of $1,693 of bad debt expense in operating expenses but the Company remains in disagreement with Staff and RUCO on the removal of legal expenses related to the Town of Carefree as noted above. The same is true of RUCO's the removal of safety training costs of $1,280.

IV. COST OF CAPITAL

BMSC's updated cost of capital analysis indicated that a return on equity ("ROE") of 11.0% is appropriate, within the ranges produced by the analysis and conservative when BMSC's extremely small size and other business risks are considered. BMSC's cost of equity estimates were based on the discounted cash flow ("DCF") model. The risk premium analysis, comparable earnings analysis (the current, authorized, and projected equity returns for the sample group of publicly traded utilities), and the economic conditions expected to prevail during the period in which new rates will be in effect, serve as a check of the reasonableness of the DCF results and ensure meaningful and realistic results.

There are a number of deficiencies in the methods used by Staff and RUCO, deficiencies that result in a downward bias, reducing the cost of equity produced by their models. The Staff historical dividend per share ("DPS") and earnings per share ('EPS") growth rates in the DCF model produce indicated costs of equity of below the cost of investment grade bonds (Baa). Staff's current market risk premium Capital Asset Pricing Model is extremely unstable and should not be used. Similarly, RUCO relies on its analyst's own estimates of growth and his own conclusions about those estimates, with downward adjustments to set internal growth estimates for the DCF analysis. However, RUCO downward adjustment assumes that the market-to-book ratio should move toward 1.0, which further skew's the DCF results downward.

There are also problems with Staff and RUCO's CAPM analyses. An inherent problem in the CAPM approach to estimating the cost of equity is the assumption that the average beta of their respective water utility sample groups is the beta for BMSC's. However, neither Staff nor RUCO witness's presented any evidence or data suggesting that BMSC, if it were publicly traded, would have a beta equal to that of their sample group. They have made no attempt to analyze the particular risks associated with an investment in BMSC or to compare those risks with the publicly traded water utilities in their sample groups. Instead, both simply assumed that all water utilities, regardless of a particular water utility's size and other firm-specific characteristics, have the same beta. In fact, BMSC is more risky than the large publicly traded water utilities. The Company's unique risks, which would most certainly be considered by investors and require a higher return, include BMSC's small size, limited growth, and lack of diversification.

V. <u>RATE DESIGN</u>

Staff and RUCO propose the same rate design as the Company. Like the Company, Staff and RUCO apply their respective recommended rate increase equally across all classes of customers to produce their respective revenue requirements.

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