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AZ CORP COMMISSION
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Ernest Johnson, Director
Arizona Corporation Commission
Utilities Division
1200 W. Washington
Phoenix, AZ 85007

Re: Non-traditional Financing; Docket No. W-0000C-06-0149

Dear Mr. Johnson:

Thank you for the opportunity to respond as an "interested person" to your June 2, 2006 letter in the subject docket. I am aware that you have provided that opportunity to numerous companies, including many of my clients who may respond directly, and that your letter provides hypothetical scenarios. I will respond accordingly.

In your Scenario 1A, I assume all proceeds are invested in new Plant in Service. Given that assumption, in my opinion the only necessary or appropriate involvement by the Commission should be at a subsequent rate proceeding where the Commission may review the company's Cost of Capital. There is no dividend on the subject stock, and it is partially refundable, neither of which are normal assumptions included in the Staff's Cost of Capital model, so the model would need to be adjusted. This method of financing would be ideal for a company that has a relatively low Rate Base per customer. As you know, Rate Base, and a reasonable return thereon, is the well conceived plan of the Constitution to assure healthy utilities that can provide good quality service, respond to emergencies, comply with the many regulatory requirements placed upon the utility, and support growth which benefits all customers. The Constitutional plan also provides the company with the ability to attract new capital when needed, either from preferred loan sources such as WIFA or U.S. Rural Development, and/or third-party lenders. Further, the Constitution and the supporting case law, contemplates that the company's can attract more expensive equity capital with reasonable terms and conditions.

With that said, the Staff and Commission should not take offense that the parent or utility has a "no cost" source of capital. Recall that the Arizona Supreme Court has noted that a company is entitled to a fair return on the fair value of the property dedicated to public use and that under that test "it makes no difference whether the utility bought it, received it as a gift, or won it in a lottery" ACC v. Arizona Water Company, 85 Az 198, 335 P2d 412 (1959).

Scenario 1B poses two alternatives. If this is a new entity, or if the Company is issuing new common stock, the provisions of ARS §40-301 & 302 would be controling. If this is the secondary market sale of previously issued and outstanding common stock of the company, a portion of which is sold by the shareholder to a new investor with the proceeds invested in the company as paid in capital, it is not subject to Commission regulation, and my comments on Scenario 1A apply. Note that neither the parent's issuance of common stock and investing the proceeds as Paid in Capital, nor the change in ownership of the issued and outstanding stock of the utility in any way further encumbers the assets of the company. Again, I would think the Commission should encourage new capital in a company which is necessary to expand or improve the facilities. The Commission should recognize that when these hypothetical developers "invest" in the utility or the parent, they do so after considerable negotiations regarding the consideration, and based on their free will. If the developers were to conclude that the investment is in excess of that required to fund the facilities necessary for their project, they would either not do the deal, or pursue whatever other legal remedies available to them. The existing and future customers are protected from a utility "gold plating" a system by the Commission's review and determination of the "prudency" of that level of investment in a subsequent rate proceeding.

A Hook-Up-Fee in this context is no different than a Commission approved HUF. HUF's are merely an equitable, shorthand method of allocating an appropriate capital cost for the demand to be placed on the utility system. The Commission establishes HUF's based on a "sample" or "typical" piece of utility plant, then determines the number of customers that plant will serve, and the level of the HUF is thereafter established accordingly. It is a surrogate of the average backbone plant cost per unit. The HUF is then collected from all customers until the Commission modifies the HUF, and will in all likelihood recover funds in excess of the "sample" plant cost. In the scenario presented, the procedure is even more precise and equitable because it is based upon the <u>actual</u> plant cost to be built, and the <u>actual</u> plant capacity. It recovers only the actual cost of the actual plant serving that development. That allocation is stated on a per unit basis because these plants typically serve several unrelated builders in a master planned community, and the fixed "fee" assures equal treatment among the various builders. That cost could be expressed as a percentage of the total plant cost to arrive at the same dollar amount, but developers and customers are accustom to seeing that cost from a private or municipal utility stated as a per unit fee. This procedure does not harm any new or existing customer or the developer, nor does it unduly benefit the utility company.

In Scenario 1C, the method of determining the value to the developer of contracting for utility services should be of no concern to the Commission, anymore than the developer's engineering, legal, or land costs for the development. The issue arises only when the regulated utility company invests in the Plant in Service that ultimately becomes Rate Base which is addressed in a rate proceeding. The source of capital to the parent company or the individual owner is not relevant. The fact remains; the investor placed that capital in the company and constructed utility plant with those proceeds.

Staff's questions 2, 3, and 4 are akin to asking "How long is a piece of string?" It depends on the facts, including among other things the size, age, location, historic growth, projected growth, existing levels of AIAC and CIAC, as well as the capital structure of the company. Certainly it is not ideal if AIAC or CIAC result in a negative Rate Base for the company. However, given the historic use of those mechanisms, in many cases the Commission will be forced to establish rates based upon an Operating Margin instead of historic Rate Base. The adverse effect of converting Advances to Contributions after 10 years could be ameliorated by the Commission encouraging longer payback periods. This would permit more Advances to become Rate Base and permit continued depreciation of those facilities. However, it would impact on the company's cash flow caused by making additional refunds. Reasonable rates would need to acknowledge the impact of that extended refund period.

For the lowest cost capital structure, I would defer to the accountants you have polled. As to the "ideal" capital structure, that ideal could perhaps be determined by the Commission, but you should recognize that it may not be attainable by the company. Many small companies cannot obtain all ideal debt from a WIFA or US Rural Development, and traditional banks often will not lend based upon the company's financial strength, or lack thereof. Also, independent investors will not invest because of the high risk associated with a small regulated company. That leaves only non-traditional financing, AIAC or CIAC as capital sources, with the later two often detrimental to the company.

In recent years the Commission has refused to grant any debt for startup companies. In theory, debt reduces the cost of capital and thereby moderates rate levels. However, the Commission has typically assumed operating losses for between two and five years in startup companies, so by definition the company is not getting a fair return and the cost of capital is not meaningful. Debt has been disallowed due to the fixed costs associated with principal and interest. Most companies are now started by entities developing the underlying property, and consequently have resources available to them other than utility revenues. To authorize an appropriate debt/equity ratio at the outset, the Commission could approve interest-only or interest-free debt during startup years, or require investors to establish a "sinking fund", not unlike the presently required performance bond, that would assure the ability to meet its debt obligations. Alternatively, at the mandated fifth year rate case for new companies, the Commission could require a more balanced capital structure. This could include some unsecured, non-recourse developer debt, or equity not unlike the developer provided equity in Scenarios 1A or 1B. This would also lessen the adverse effects of AIAC or CIAC.

I am sorry I cannot be more specific in my responses, but I would urge the Staff and Commission to not summarily reject any company's proposal and to forgo any preconceived notion that a utility or parent is being unjustly enriched, or that any developer or customer is being disadvantaged. The bottom line question is always, does it result in a reasonable rate on one hand, and a reasonable return on the plant devoted to public use on the other. It does not appear that the above scenarios necessarily result in anything inconsistent with that Constitutional guidance.

In the event you have any questions regarding this matter, please do not hesitate to call.

Sincerely,

Richard L. Sallquist

Enclosures
cc: Docket Control