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BEFORE THE ARIZONA CORPORATION COMMISSION

9 IN THE MATTER OF THE
 10 APPLICATION OF FAR WEST WATER
 & SEWER COMPANY, AN ARIZONA
 11 CORPORATION, FOR A
 DETERMINATION OF THE FAIR
 12 VALUE OF ITS SEWER UTILITY
 PLANT AND PROPERTY AND FOR
 13 INCREASES IN ITS RATES AND
 CHARGES FOR SEWER UTILITY
 SERVICE BASED THEREON.

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FAR WEST WATER AND SEWER COMPANY'S REPLY BRIEF

October 18, 2006

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TABLE OF CONTENTS

		Page
1		
2		
3	I. ISSUES REMAINING IN DISPUTE WITH STAFF	1
4	A. FWS Made A Prima Facie Showing That All The Costs Of Plant	
5	Included In Rate Base Were Reasonable; Staff Then Failed To	
6	Produce Any Evidence To The Contrary	1
7	1. Staff Failed To Demonstrate That The Affiliated Costs Are	
8	Unreasonable	2
9	2. Staff's Improper Bookkeeping Argument is a Red-Herring	3
10	3. There Is No Evidence Of Sham, Fraud And Injustice,	
11	Therefore The Commission Should Not Pierce The Corporate	
12	Veil	4
13	B. Staff's Recommended Working Capital Allowance is Unsupported	
14	by Evidence and Punitive	6
15	C. Staff's Adjustment To Repairs And Maintenance Expense Is	
16	Unsupported By The Evidence	7
17	II. ISSUES REMAINING IN DISPUTE WITH RUCO	8
18	A. RUCO And Property Taxes—Will It Ever End?	8
19	B. RUCO Recommended That Revenues From Effluent Sales Provide	
20	An Undue Windfall to Ratepayers At The Company's Expense	10
21	C. RUCO's Argument On Rate Case Expense Is Distorted.....	12
22	III. ISSUES IN DISPUTE WITH BOTH STAFF AND RUCO: CAPITAL	
23	STRUCTURE AND COST OF CAPITAL	15
24	A. Reply To Staff Concerning Capital Structure And Cost of Capital	15
25	1. Staff's Recommended Capital Structure Is Hypothetical; The	
26	Company's Recommended Capital Structure Is FWS's Actual	
	Capital Structure	15
	2. Staff's Exclusive Reliance On Financial Models Results In A	
	Recommended ROE That Is Unrealistically Low	17
	B. Reply to RUCO Concerning Capital Structure and Cost of Capital	20
	IV. CONCLUDING COMMENTS	21

Far West Water & Sewer Company

	Pre-Filed Testimony	Hearing Exhibit	Abbreviation
1	Rebuttal Testimony of Paula S. Capestro	A-1	Capestro RB
2	Rebuttal Testimony of Mark Kaveney	A-2	Kaveney RB
3	Rejoinder Testimony of Gary M. Lee	A-3	Lee RJ
4	Direct Testimony of Thomas J. Bourassa	A-4	Bourassa DT
5	Rebuttal Testimony of Thomas J. Bourassa	A-5	Bourassa RB
6	Rejoinder Testimony of Thomas J. Bourassa	A-6	Bourassa RJ
7			
8			

Residential Utility Consumer Office

	Pre-Filed Testimony	Hearing Exhibit	Abbreviation
9			
10	Direct Testimony of Rodney L. Moore	R-4	Moore DT
11	Surrebuttal Testimony of Rodney L. Moore	R-5	Moore SB
12	Direct Testimony of William A. Rigsby	R-6	Rigsby DT
13	Surrebuttal Testimony of William A. Rigsby	R-7	Rigsby SB
14			
15			

Arizona Corporation Commission Staff

	Pre-Filed Testimony	Hearing Exhibit	Abbreviation
16			
17	Direct Testimony of Steven P. Irvine	S-18	Irvine DT
18	Surrebuttal Testimony of Steven P. Irvine	S-18A	Irvine SB
19	Direct Testimony of Jian W. Liu	S-19	Liu DT
20	Direct Testimony of Crystal Brown	S-22	Brown DT
21	Surrebuttal Testimony of Crystal Brown	S-23	Brown SB
22			
23			

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1 FWS's reply brief in support of its request for rate increases is organized as
2 follows.¹ In the first section, the Company addresses those issues remaining in dispute
3 with Staff. In the second section, the Company addresses the issues that remain in dispute
4 with RUCO. In the third section, FWS addresses capital structure and cost of capital,
5 issues that remain in dispute with both Staff and RUCO. Finally, in the last section of this
6 reply brief, FWS provides its concluding remarks in support of its request for rate relief.

7 **I. ISSUES REMAINING IN DISPUTE WITH STAFF.**

8 Staff asserts that the Commission should adopt its rate base, operating expenses
9 and revenue requirement. Staff BR at 22-23. The Company disagrees. In general, as
10 Staff asserts, differences in several components of rate base, operating expenses and the
11 revenue requirement exist by virtue of the parties' disputed positions on other components
12 of the ratemaking formula. *Id.* More specifically, however, there are three distinct issues
13 remaining in dispute between Staff and the Company: (1) the cost of certain plant to be
14 included in rate base; (2) working capital allowance; and (3) Staff's adjustment to Repairs
15 and Maintenance Expense. For the reasons explained below, Staff's position on these
16 three issues is little more than an attempt to mask its failure to conduct a proper analysis.
17 As a result, Staff has failed to meet its burden of proof on each of the three issues.

18 **A. FWS Made A Prima Facie Showing That All The Costs Of Plant**
19 **Included In Rate Base Were Reasonable; Staff Then Failed To Produce**
20 **Any Evidence To The Contrary.**

21 Staff removed \$147,525 from the rate base, comprised of \$110,000 of overhead
22 and \$37,525 of profit on construction projects built for FWS by an affiliate of the
23 Company, H&S Developers ("H&S"). Bourassa RB (Ex. A-5) at 8. Staff urges the

24 ¹ Citations to the record are made using the same format, abbreviations and conventions
25 as in FWS's Closing Brief, abbreviated "FWS BR" herein. Staff's Closing Brief is
26 abbreviated as "Staff BR" and RUCO's Closing Brief is abbreviated as "RUCO BR". A
list of the witnesses' pre-filed testimony is again provided after the Table of Contents for
the Administrative Law Judge's convenience.

1 Commission to adopt its adjustment even though Staff agrees: (1) that H&S incurs
2 overhead costs; and (2) that such costs are recoverable. Staff BR at 7, 9. Nevertheless,
3 Staff claims that it “believes affiliate profits should not be included in the utility’s rate
4 base” and that it “believes” that FWS has not provided sufficient evidence. Staff BR at 13
5 (emphasis added). Fortunately, the Commission can rely on the evidence before it, none
6 of which was provided by Staff, as well as the relevant law, instead of relying on what
7 Staff believes. In so doing, the Commission can readily conclude that the total costs of
8 the plant at issue, including overhead and a small profit, were reasonable.

9 **1. Staff Failed To Demonstrate That The Affiliated Costs Are**
10 **Unreasonable.**

11 There is no dispute that the Commission can scrutinize transactions between FWS
12 and its affiliates. See FWS BR at 5-6. Scrutiny, however, does not mean disallow on the
13 basis of what Staff “believes”. It means that the Commission’s responsibility when
14 regulating rates is to “assure that they are just and reasonable.” See, e.g., *Washington*
15 *Utilities and Transportation Comm’n v. Washington Power Co.*, 24 P.U.R. 4th 427 at 13
16 (1978); *Central Louisiana Electric Co. v. Louisiana Pub. Serv. Comm’n*, 373 So. 2d 123,
17 127 (La. 1979). See also Arizona Constitution, Article 15, Section 3. The initial burden
18 of showing that the plant costs at issue are reasonable initially rests with the utility. But,
19 upon making a *prima facie* showing of reasonableness by FWS, the burden then shifted to
20 Staff, as the party recommending adjustment to such expenses, “to produce evidence
21 showing why the payments to affiliates were not reasonable and should not be allowed.”
22 See *Turpen*, 769 P. 2d at 1323. See also *Central Louisiana*, 373 So.2d at 127 (Before the
23 regulatory body can make adjustments for unreasonably high charges “there must be . . . a
24 factual finding, or at least a reasonable inference, that the charges are unreasonable.”)

25 As discussed in FWS’s brief, all of the amounts removed by Staff involve costs of
26 used and useful plant constructed for FWS by H&S. Brown DT (Ex. S-22) at 11. Typical

1 of similar businesses, H&S bills for plant construction on a labor and materials cost plus
2 18.5% basis, the 18.5% representing overhead and profit. TR at 38-39 (Capestro), 546-
3 552 (Brown). *See also* Ex. S-14. Absent recovery of these embedded costs, i.e.,
4 overhead, and a profit, a construction company like H&S can hardly remain in business.
5 *See* TR at 551-52 (Brown). Moreover, the Company did provide evidence showing the
6 breakdown of the amount Staff removed between overhead and profit, with the
7 lion's share, approximately \$110,000 of the so-called "affiliate profit" Staff removed,
8 actually being overhead. Bourassa RB (Ex. A-6) at 8-9 and Bourassa Rebuttal Exhibit 1.
9 Staff witness Brown simply denies, without relying on any evidence, that H&S incurred
10 any overhead. TR at 558, 560 (Brown).

11 **2. Staff's Improper Bookkeeping Argument is a Red-Herring.**

12 FWS met its initial burden of showing *prima facie* that its payments to H&S were
13 reasonable. The burden then shifted to Staff to show why the payments were not
14 reasonable and should not be allowed. *Id.* Staff failed to meet its burden. It did not even
15 attempt to. Staff relied solely on its pre-determined belief that because FWS and H&S
16 were affiliated, FWS's payments to H&S of overhead and profit in addition to labor and
17 materials were some sort of injustice. All the evidence is to the contrary. All the
18 evidence shows that the payments were reasonable. Indeed, all the evidence shows that
19 the provision of services by the affiliated entities provided economic benefits to the
20 ratepayers. Thus, finding that the costs of affiliated services were unreasonable based on
21 nothing other than the fact that the parties are related would not be proper ratemaking.
22 *Turpen*, 769 P.2d at 1321. Accordingly, the Commission should reject Staff's
23 recommendations and allow FWS's payments to H&S. *Central Louisiana Electric*, 373
24 So.2d at 127 (To make adjustments for unreasonably high charges "there must be . . . a
25 factual finding, or at least a reasonable inference, that the charges are unreasonable.").

26 The failure to make any evidentiary showing that the amounts included in rate base

1 were unreasonable cannot be cured by Staff's claim that accounting rules have not been
2 followed. *See, e.g.*, Staff BR at 10. Staff never connected its claim that FWS violated
3 bookkeeping requirements to its removal of plant costs. In fact, Staff provided no
4 evidence showing that FWS violated NARUC or any Commission rule or regulation.
5 Moreover, H&S is a construction company, it is not subject to NARUC or any
6 Commission imposed bookkeeping requirement.

7 This is not to say that if the Company seeks to include plant construction costs in
8 rate base it can avoid producing evidence to support such costs because the construction
9 company is not regulated or subject to the same requirements as FWS. But, as FWS
10 explained in its initial brief, Staff ignored all of the evidence produced by FWS in favor of
11 a total prohibition against affiliates recovering overhead or profit. *See* FWS BR at 7, n. 3
12 *citing* TR at 559, 567-68 (Brown). Put bluntly, Staff, relying on its "beliefs," simply
13 removed any amount it deemed "affiliate profit" irrespective of any claimed, albeit
14 unproved, bookkeeping deficiency. Again, this is not proper ratemaking and is contrary to
15 the law. *See Turpen*, 769 P.2d at 1323; and *Central Louisiana Electric*, 373 So.2d at 127.

16 **3. There Is No Evidence Of Sham, Fraud And Injustice, Therefore**
17 **The Commission Should Not Pierce The Corporate Veil.**

18 Staff also asks the Commission to pierce the corporate veil because "[a]lthough the
19 companies are separate legal entities, the companies have common shareholders, directors
20 and officers."² Staff BR at 10-20. As an initial matter, it is critical to recognize two flaws
21 in Staff's argument. First, common ownership is not a ground for disallowing costs
22 incurred with affiliates. *See Turpen*, 769 P.2d at 1321. Second, there is no evidence of
23

24 ² Staff also makes a bare allegation that FWS and H&S have a "long history of
25 commingling their businesses." Staff BR at 10. Staff witness Brown showed a significant
26 bias against FWS in her testimony during the hearing (*see e.g.*, TR at 561-62), but no
objective or credible evidence in support of these allegations was ever presented.

1 the existence of a sham corporate entity, fraud or injustice here. Thus, there is no basis for
2 the Commission to pierce the corporate veil.

3 Arizona strongly supports the treatment of corporations as separate entities. *See,*
4 *e.g., Arizona Public Service Co. v. Arizona Corp. Comm'n*, 155 Ariz. 263, 267, 746 P.2d
5 4, 8 (App. 1987) (Declining to pierce the corporate veil because the Commission offered
6 no evidence of undercapitalization, fraud, misconduct or impropriety in the management
7 of the affiliated companies.); *Deutsche Credit Corp. v. Case Power & Equipment Co.*, 179
8 Ariz. 155, 160, 876 P.2d 1190, 1195 (App. 1994) (“The concept of a corporation as a
9 separate entity is a legal fact, not a fiction.”). The general rule is that “corporate status
10 will not be lightly disregarded.” *Keams v. Tempe Technical Institute, Inc.*, 993 F.Supp.
11 714, 723 (D.Ariz 1997). Here, the evidence shows the separate nature of FWS and H&S
12 and the proper nature of their business dealings.

13 For example, it is undisputed that the Company’s day-to-day operations are run by
14 its employees, not the employees of any third-party. TR at 545 (Brown). It is also
15 undisputed that H&S is available to and performs construction related services for entities
16 other than the Company. TR at 123-24 (Capestro).³ Staff even agrees that sewer utilities
17 like FWS are not likely to use their own employees to build plant, but rather, that FWS
18 would be expected to hire an entity in the business of constructing plant. TR at 545-46
19 (Brown). Additionally, all of the affiliate costs in dispute were obviously recorded in the
20 Company’s plant accounts or Staff would not have removed them. Finally, and perhaps
21 most importantly, Staff even admits that “there is no evidence in the record that Staff
22 believes Far West should not transact any business with its sole shareholder, H&S

23 _____
24 ³ Staff witness Brown actually testified that she simply “assumed” that H&S worked only
25 for FWS. TR at 574-75 (Brown). Staff’s “assumption” is without foundation and should
26 be disregarded by the Commission, particularly given the fact that the assumption is
shown to be completely false. TR at 123-24 (Capestro).

1 Developers.” Staff BR at 8.⁴ Accordingly, the Commission should follow the general
2 rule and maintain the separate corporate status of FWS and H&S because no evidence of a
3 sham, fraud, misconduct, injustice or impropriety exists.

4 **B. Staff’s Recommended Working Capital Allowance is Unsupported by**
5 **Evidence and Punitive.**

6 Staff asserts that “the evidence clearly supports its recommendation” of a zero
7 working capital allowance for FWS. Staff BR at 22. What evidence? Staff did not
8 determine a working capital allowance utilizing the lead-lag, formula or any other method
9 of determining working capital. See Brown DT (Ex. S-22) at 16-18; Brown SB (Ex. S-23)
10 at 17. The only thing Staff has offered is the self-serving testimony of its witness
11 concerning past decisions involving Far West’s water utility division, which testimony is
12 offered as a substitute for proper ratemaking. Now, in its brief, Staff goes further and
13 argues that in a rate case for one particular water utility, the Commission adopted a
14 requirement that every Class B utility file a lead-lag study. Staff BR at 21.

15 Staff’s reliance on Decision No. 65350 to establish a rule or policy that all Class B
16 utilities employ a lead-lag study is disingenuous. Staff BR at 21. There is no
17 Commission rule or regulation that establishes such a requirement. Moreover, Staff’s
18 witness in this case testified that the Commission decides the merits of a working capital
19 allowance on a case-by-case basis. Brown SB (Ex. S-23) at 17. Ms. Brown’s testimony is
20 consistent with recent testimony by a senior Staff member in another rate case. Staff
21 Utilities Analyst Manager Darron Carlson testified that the “Commission has no policies
22 except to explore every issue case by case. I have a policy book in my office that has
23 nothing in it because there are no policies.” *Arizona Water Company-Western Group,*

24 _____
25 ⁴ Staff is incorrect that H&S is the Company’s sole shareholder. In fact, the chart on page
26 11 of Staff’s brief shows that H&S is owned by the same shareholders rather than being
the shareholder of FWS.

1 Docket No. W-01445A-04-0650, Hearing Transcript Vol. VI at 1249. In this light, Staff
2 should not be heard to claim that the Commission has a working capital allowance policy
3 for Class B utilities.

4 Staff's reliance on Decision No. 60437 is also misplaced. That case involved Far
5 West's water division, a separate division providing services to a different customer base
6 and utilizing different assets than those at issue in this proceeding. Since the
7 Commission's rules expressly separate the revenues from sales of water and sewer utility
8 services for ratemaking purposes, it follows that a rate order for the water utility does not
9 bind the Company in this sewer rate case. See R14-2-103.A.3.q. This is particularly true
10 given the fact that the determination of working capital in the last rate case for the water
11 division was the result of a black-box settlement, a fact Staff conveniently ignores.
12 Bourassa RJ (Ex. A-6) at 6.

13 In short, the decision in this case should be based on the evidence presented in this
14 case, and the evidence in this case shows that FWS utilized a recognized method of
15 determining working capital. *See, e.g.*, TR at 536 (Brown); Bourassa RB (Ex. A-5) at 13.
16 Moreover, the Company utilized this recognized method of determining working capital
17 in an effort to reduce rate case expense—an effort that benefits both ratepayers and FWS.
18 Bourassa DT (Ex. A-4) at 5; TR at 338 (Bourassa). It would be inequitable to punish
19 FWS for utilizing a recognized methodology and seeking to reduce the level of rate case
20 expense incurred. Nonetheless, punishment is what Staff proposes as a substitute for its
21 failure to present any actual evidence regarding the determination of working capital.

22 **C. Staff's Adjustment To Repairs And Maintenance Expense Is**
23 **Unsupported By The Evidence.**

24 Boiled down, Staff's argument in support of its more than \$43,000 adjustment to
25 Repairs and Maintenance Expense is that the Company witness Bourassa failed to
26

1 “adequately explain his opposition” to Staff’s adjustment. Staff BR at 23.⁵ This argument
2 is without merit. Obviously, Staff was required to sustain its burden of proof in support of
3 its adjustment before the Company had any obligation to rebut Staff’s position. Yet, Staff
4 witness Brown was utterly unable to explain the basis for her adjustment when questioned
5 during the hearing. TR at 540-41 (Brown). In fact, Ms. Brown even contradicted herself
6 concerning the import of the test year level of an operating expense. *Compare* TR at 537
7 (Brown) *with* TR at 539 (Brown).

8 Perhaps, most importantly, despite concluding that the test year was abnormal,
9 Staff witness Brown did not look at any information regarding the level of Repairs and
10 Maintenance Expense to be incurred when the rates approved in this proceeding are in
11 effect. Staff did not point to single test year invoice claimed to be abnormal or non-
12 recurring. Staff only looked backwards. Brown DT (Ex. S-22) at 20; TR at 538 (Brown).
13 Had Staff looked at 2005, it would have found that the test year level of expense is less
14 than the amount the Company was likely to incur going-forward and that 2002 and 2003,
15 the years Staff used to support the adjustment, bore little resemblance to the level of this
16 expense the Company will likely incur when the new rates go into effect. *See* Ex. A-8. In
17 short, Staff did not meet its burden of proof on its adjustment; therefore, its adjustment
18 should not be adopted.

19 **II. ISSUES REMAINING IN DISPUTE WITH RUCO.**

20 **A. RUCO And Property Taxes—Will It Ever End?**

21 RUCO’s argument on property tax expense is founded on the fundamentally
22 flawed perception that it, and only it, uses the ADOR formula. RUCO BR at 8. In truth,
23 all parties are using the ADOR formula to estimate a level of property tax expense to be
24

25 ⁵ FWS addressed Staff’s adjustment to Repairs and Maintenance Expense in its prefiled
26 testimony. Bourassa RJ (Ex. A-6) at 16. Staff then elected, of its own accord, not to
cross-examine FWS’s witnesses on the issue.

1 incurred throughout the entire period new rates will be in effect. The Commission
2 likewise uses the ADOR formula in this manner. *See, e.g., Chaparral City Water*
3 *Company*, Decision No. 68176 (September 30, 2006) at 13.⁶ The only difference is the
4 inputs used, i.e., the annual revenue amounts used in the formula. Staff and the Company
5 have utilized one year of projected revenues consistent with Commission precedent. *E.g.,*
6 *Rio Rico Utilities*, Decision No. 67279 at 8; *Arizona Water Company*, Decision No. 64282
7 at 12-13; *Bella Vista Water Company*, Decision No. 65350 (November 1, 2002) at 16;
8 *Arizona-American Water Company*, Decision No. 67093 (June 30, 2004) at 9-10. RUCO
9 refuses to do so and continues to assert that only historic revenues should be used.

10 Now, in this case, RUCO seeks to portray the exclusive use of historic revenues as
11 somehow “required” or “directed” by ADOR. RUCO BR at 8. But the Commission is
12 not assessing property taxes on FWS, it is estimating the expense for ratemaking
13 purposes. The possibility of over- or under-collection of this expense is not a basis to
14 throw out the formula for estimating this expense as RUCO wants the Commission to do.
15 RUCO BR at 8-10. Under- or over-recovery of an expense is not just common, it is the
16 inevitable by-product of using a historical test year in an ever-changing world.⁷ The
17 methodology repeatedly approved by the Commission and employed by Staff and the
18 Company utilizes the revenues recommended in this ratemaking proceeding as one of the
19 three years of revenue in the ADOR formula. As the Commission has found again and
20

21
22 ⁶ RUCO’s effort to portray the property tax methodology utilized by the Company as the
23 “Company Methodology” is disingenuous. RUCO BR at 8. The formula is the same as
24 that used by Staff and by the Commission in case after case.

25 ⁷ RUCO is correct that the full impact of revenue increases will not be felt for 4 years,
26 which is why Staff and the Company use only one year of projected revenues in the
ADOR formula to estimate property taxes. Bourassa DT (Ex. A-4) at 8; Brown DT (Ex.
S-22) at 23 (explaining that Staff’s adjustment is limited to use of its proposed revenues).

1 again, it is the most accurate means of setting a level of property tax expense on a going-
2 forward basis.

3 In sum, nothing has changed, except that RUCO is getting better at calculating the
4 test year level of property tax expense. RUCO BR at 8-9. Nowhere, however, does
5 RUCO account for the impact of increased revenues on this expense, an impact that
6 makes use of the test year level of expense unreasonable.⁸ For this reason, the
7 Commission last held that “RUCO’s backward-looking methodology . . . unfairly and
8 unreasonably understates property tax expense, and is therefore inappropriate for
9 ratemaking.” Decision No. 68176 at 14. It should do so again.

10 **B. RUCO Recommended That Revenues From Effluent Sales Provide An**
11 **Undue Windfall to Ratepayers At The Company’s Expense.**

12 RUCO recommends that the Commission assume that FWS will sell \$31,000 of
13 effluent to the Mesa del Sol golf course on an annual basis. Moore DT (Ex. R-4) at 23-24;
14 RUCO BR at 5-8. However, there is no evidence suggesting that FWS will sell any
15 effluent to the Mesa del Sol golf course during the period the rates approved in this
16 proceeding will be in effect. First, when it acquired the Mesa del Sol treatment facility,
17 the Company assumed an existing bulk effluent delivery agreement between the plant
18 owner and the golf course. Bourassa RB (Ex. A-5) at 21. Under that contract, the golf
19 course is obligated to take all of the effluent produced at the treatment facility. *Id.*
20 Second, if the Company were to charge the golf course for the effluent, despite the
21 contract, it is quite possible that the golf course would not purchase the effluent because it

22
23 _____
24 ⁸ RUCO asserts that the “ADOR formula uses only historical input accounts for
25 additional revenues.” RUCO BR at 9. RUCO offers no citation to support this
26 conclusory assertion. RUCO is also wrong. Using 2002, 2003 and 2004, revenues years
ADOR will never again use to determine property taxes for FWS, simply does not account
for revenue increases that will impact the amount of taxes assessed.

1 has its own well and may have concerns over the impact of effluent on its landscaping.
2 Bourassa RJ (Ex. A-6) at 15-16 and Bourassa RJ Ex. 4.

3 Despite this, RUCO argues that the Commission should assume revenues from
4 sales of effluent to the Mesa del Sol golf course because it would be imprudent to not sell
5 effluent to this golf course. RUCO BR at 6. This is because, RUCO also argues, effluent
6 has financial value, which RUCO accuses the Company of disregarding. *Id.* at 5.
7 Contrary to RUCO's assertions, FWS agrees that effluent has financial value to the extent
8 someone wishes to purchase the product. But RUCO has failed to present a shred of
9 evidence demonstrating that Mesa del Sol will buy any effluent from FWS, rather than
10 honoring its agreement to take and dispose of all the effluent from the Mesa del Sol
11 treatment plant as the golf course does now.⁹ Despite RUCO's implication to the contrary
12 (RUCO BR at 6), there is nothing to compel any golf course to buy effluent from FWS,
13 even if effluent is superior to other sources of irrigation for landscaping or political
14 reasons.

15 Meanwhile, it is RUCO that is ignoring the evidence that the Mesa del Sol golf
16 course's obligation to take and dispose of all of the effluent from the Mesa del Sol plant is
17 of benefit to ratepayers and the Company. In addition to minimizing the use of
18 groundwater, which RUCO apparently does recognize as a benefit (*see* RUCO BR. at 6,
19 ls. 15-17), the arrangement with the Mesa del Sol golf course has financial value because

20
21 ⁹ RUCO attempts to use the testimony of Gary Lee to establish that the Mesa del Sol golf
22 course would buy the effluent because it will soon be of a higher quality. RUCO BR at 7-
23 8. However, Mr. Lee merely testified that when the new plant improvements are
24 completed, FWS will produce a higher quality effluent than it does today. TR at 278.
25 RUCO failed to direct the Commission's attention to Mr. Lee's testimony that he had no
26 knowledge of potential concerns over rapid blight caused by effluent, that he did not know
when higher quality effluent would be available, and that he did not know if the golf
course would prefer its own water sources to paying for effluent from FWS. TR at 273-
74.

1 FWS is not required to pay to dispose of 500,000 gallons of effluent per day. Bourassa
2 RB (Ex. A-5) at 21; TR at 291, 333, 336-7 (Bourassa).¹⁰ If the Mesa del Sol golf course
3 chooses to use its own groundwater resources and not pay for effluent, as it is likely free
4 to do if FWS breaches the contract and charges the golf course, this benefit will be lost
5 and both the Company and ratepayers will be burdened with the costs of disposal. In
6 short, the situation is far from the one-way street that RUCO seeks to portray. As a
7 consequence, RUCO's recommendation should be rejected as unfairly punitive to FWS
8 and contrary to the public interest.

9 **C. RUCO's Argument On Rate Case Expense Is Distorted.**

10 In its brief, RUCO asserts that the Commission should base the authorized rate case
11 expense on "the complexity of the proceeding, the number of systems involved and a
12 comparison to other cases." RUCO BR at 2. Then, RUCO proceeds to make the singular
13 argument that the requested rate case expense is excessive because the Company would
14 not work with RUCO to mitigate copying costs associated with data request responses.
15 *Id.* at 3-5.¹¹ The truth is, RUCO has distorted both the facts and the Company's position,
16 as well as failed to present any credible evidence to support its position that FWS should
17 recover rate case expense equal to roughly 30% of the amount actually incurred. It is
18 easily shown that RUCO's recommendation is punitive and should be rejected.

19 For starters, contrary to RUCO's claim, it is not the Company's position that it has

20 _____
21 ¹⁰ RUCO implies that not selling effluent to Mesa del Sol would be discriminatory.
22 RUCO BR at 6. However, the Commission is certainly aware that many utilities enter
23 into various bulk sales arrangements in which bulk customers acquire services at other
24 than tariffed rates, which is what is taking place here. Nowhere does RUCO provide
25 citation to any legal authority showing this arrangement is unlawful.

26 ¹¹ Although RUCO claims other factors should be considered, including comparable
cases, RUCO presents no analysis of these factors in its brief. See RUCO BR at 2-5. As a
consequence, FWS is forced to expressly reserve its right to respond to additional or new
argument should RUCO elect to make it for the first time in its reply brief.

1 no control over the costs it incurs. RUCO BR at 3. Rather, FWS has asserted that (1) it
2 cannot raise its rates without going through the Commission's ratemaking process; (2) that
3 process is dictated by the Commission; and (3) there is a certain minimum level of rate
4 case expense that will be incurred irrespective of the complexity of the case, the number
5 of systems, or any other unique aspect of each rate case. *E.g.*, Bourassa DT (Ex. A-4) at
6 10-11; Bourassa RJ 9 Ex. A-6) at 11-12. The Company also has an incentive to keep its
7 rate case expense as low as possible as it must incur the cost now, subject to recovery of
8 an unknown amount over five years in this case. TR at 200 (Bourassa). RUCO calls all
9 this "absurd" because FWS chooses the issues it litigates and the outside consultants it
10 hires. RUCO BR at 3. Yet RUCO does not argue that FWS should have hired cheaper
11 consultants, or no consultants at all, and, as noted, the only thing RUCO criticizes the
12 Company for is not agreeing to RUCO's proposal to mitigate rate case expense.

13 RUCO's argument regarding FWS exacerbating rate case expense by not
14 cooperating with RUCO to reduce rate case expense is the classic "red herring". RUCO
15 has made no effort to quantify the impact of the Company's alleged misconduct on rate
16 case expense. RUCO's e-mail requesting that the Company not provide multiple copies
17 of data requests was sent in mid-June, 2006, well after the direct and rebuttal filings were
18 made and far after the vast majority of discovery was completed. How much rate case
19 expense the Company could have saved by giving RUCO only one copy of "voluminous"
20 data requests at that late stage of the proceeding is unknown, but clearly that amount is far
21 less than the \$90,000 of rate case expense RUCO seeks to have the Commission "fine"
22 FWS for the alleged lack of cooperation. Moreover, even if FWS had done something
23 wrong, any additional rate case expense resulting from such conduct would be borne by
24 the shareholders, who are already absorbing approximately 25% of the total rate case
25 expense incurred. FWS BR at 12.

26 Ultimately, though, RUCO's argument fails because the Company (1) has not

1 failed to cooperate with RUCO; (2) has not unnecessarily increased rate case expense; and
2 (3) has done nothing improper. The Company responded to RUCO's suggestion that it
3 contact RUCO when data request responses are "voluminous" by indicating that it would
4 not be placed in a position of making subjective determinations of what RUCO wants and
5 does not want. Bourassa RJ (Ex. A-6) at Bourassa RJ Ex. 3. At the same time, FWS
6 offered an alternative that would have avoided the Company making such subjective
7 decisions for RUCO and that would have allowed RUCO to review responsive material
8 and decide for itself what it needed before costs to make copies for RUCO were incurred.
9 *Id.* RUCO failed to respond, in any way, to the Company's offer of cooperation. RUCO
10 did not modify the discovery instructions FWS objected to, did not modify its data
11 requests, and did not seek intervention of the Hearing Division. In fact, given RUCO's
12 failure to accept or even address the Company's prompt and reasonable response to the
13 dispute RUCO raised, one could conclude that the entire issue was concocted by RUCO to
14 bolster its ridiculously low and punitive rate case expense recommendation.

15 The truth is, the record reflects that the Company and Staff's recommended rate
16 case expense of \$160,000 is very reasonable. A comparison to relevant cases support this
17 conclusion. *See* Bourassa RB (Ex. A-5) at 17-18; Bourassa RJ (Ex. A-6) at 13-14.¹²
18 Also supportive of this conclusion is the analysis of the actual amount of rate case
19 expense incurred in this specific case, something RUCO implicitly suggests the
20 Commission give no weight whatsoever. Actual rate case expense incurred is certainly a
21

22 ¹² The sole comparison case RUCO cites in its brief is the last case for the Company's
23 water division, Decision No. 62649 (July 13, 2000). RUCO BR at 2. In that case,
24 decided more than six years ago, the Commission awarded \$120,000 as reasonable rate
25 case expense. Decision No. 62649 at 8-9. That case provides a poor comparison,
26 however, as it was decided by a "black-box" settlement. *See* Decision No. 62649. RUCO
does not provide citation to a single decision of the Commission, recent or otherwise,
awarding rate case expense as low as it recommends in this case.

1 reasonable factor to consider and, in this case, it shows that the Company should be
2 authorized rate case expense of \$160,000 amortized over 5 years.

3 **III. ISSUES IN DISPUTE WITH BOTH STAFF AND RUCO: CAPITAL**
4 **STRUCTURE AND COST OF CAPITAL.**

5 **A. Reply To Staff Concerning Capital Structure And Cost of Capital.**

6 **1. Staff's Recommended Capital Structure Is Hypothetical; The**
7 **Company's Recommended Capital Structure Is FWS's Actual**
8 **Capital Structure.**

8 Staff expresses its "belief" that FWS is proposing a "hypothetical" capital structure
9 for FWS. Staff BR at 23. Staff further claims that its recommended capital structure of
10 46.5% debt and 53.5% equity is an "actual" capital structure for the legal entity known as
11 Far West Water and Sewer Company. *Id.* Staff then goes on to assert that the
12 Commission should adopt its capital structure because capital structure is a financial, not a
13 regulatory concept. Staff BR at 24-25. In reality, Staff's recommended capital structure
14 is a hypothetical capital structure based on a strained interpretation of available but
15 inapplicable data intended to result in a lower rates. *See* TR at 524 (Irvine) (admitting that
16 Staff's recommendation lowers the revenue requirement).

17 This proceeding is regulatory, a rate case, not a course on financial concepts. In
18 regulation there is a concept known as the matching principle under which capital
19 structure is matched to the assets used to provide the service subject to the rates at issue.
20 *See, e.g.,* TR at 496 (Irvine). While there is no dispute that Far West Water and Sewer
21 Company is the "legal entity" seeking rate relief from the Commission in this docket,
22 there is also no dispute that only the rates for sewer utility service are at issue in this case.
23 TR at 521-22 (Irvine). Presumably, there is likewise no dispute that the Commission is
24 required to set rates at a level that produces a fair return on the fair value of the assets
25 dedicated to the provision of that service.

1 All parties in this case include only plant providing sewer utility service in their
2 proposed rate bases, no plant providing water utility service is included. *See, e.g.,* Brown
3 DT (Ex. S-22) at Schedules; Moore DT (Ex. R-4) at Schedules; Bourassa DT (Ex. A-4) at
4 Schedules.¹³ Staff did not produce evidence showing that the rates approved by the
5 Commission for water utility service are based on any plant dedicated to the provision of
6 sewer service. Nor could Staff rebut the fact that the Company files separate annual
7 reports for its water and sewer divisions, or that the Commission's rules separate revenues
8 from water and sewer sales for classification purposes. TR at 521-22. More importantly,
9 when questioned during the hearing, Staff witness Irvine admitted that he could not
10 produce any evidence of any debt financing any of the plant in rate base in this rate case.
11 TR at 489 (Irvine).

12 It follows that Staff's recommended capital structure results in a mismatch of
13 capital structure to rate base. Bourassa RJ (Ex. A-6) at 20; TR at 319, 321 (Bourassa).
14 Moreover, if adopted, the discrepancy between the capital investment and the rate base
15 will prevent FWS from earning a fair return on the equity financing plant in rate base
16 because all of the plant in the sewer division was paid for by equity — there is no debt.
17 TR at 489 (Irvine). Notwithstanding this fact, Staff believes that the matching principle
18 can be ignored and violated in this case because financing for the water and sewer
19 divisions is so "intertwined that use of a separate capital structure is unreasonable." Staff
20 BR at 26. Again, as noted above, there is no evidence that the water division's rates are
21 based on anything related to the sewer division.

22 Furthermore, Staff's assertion, that all money is fungible and that no specific
23 financing can be traced to a specific asset, does not stand up to scrutiny. Staff witness

24 _____
25 ¹³ Similarly, no party included revenues or expenses from the water division in their
26 income statements in this case. *See, e.g.,* Brown DT (Ex. S-22) at Schedules; Moore DT
(Ex. R-4) at Schedules; Bourassa DT (Ex. A-4) at Schedules.

1 Irvine readily admitted under cross-examination that advances and contributions in aid of
2 construction are tied to specific assets. TR at 490-491 (Irvine). He also admitted that the
3 Company's WIFA loan was specifically approved by the Commission and used to finance
4 a surface water treatment plant for the water division. TR at 494-495 (Irvine). The fact
5 that certain approvals are required by WIFA for the Company to finance sewer utility
6 plant does not mean that financing is intertwined, it means that the lender was doing what
7 it felt it needed to do to secure its loan. Meanwhile, the evidence clearly shows that
8 specific financing of specific assets can be identified.

9 Staff's recommendation is further flawed by its inclusion of amounts owed to H&S
10 for plant construction as debt in the capital structure. To begin with, H&S and FWS are
11 not operated as a single entity and Staff offers no evidence to support this assertion. Staff
12 BR at 27. There has been no credible evidence presented by Staff of any commingling of
13 revenues or expenses between the two entities, which are separate legal entities with
14 common shareholders. In fact, as discussed above, the evidence shows that the
15 Company's day-to-day operations are run by its employees, not the employees of H&S,
16 and that H&S does business with entities besides the Company. TR at 545 (Brown); TR
17 at 123-24 (Capestro). In addition, Staff's attempt to create FWS debt in this rate case at
18 an interest rate of 5.93 percent forces H&S, an unregulated affiliate that built used and
19 useful plant for FWS, to become a captive lender at an interest rate that is well below the
20 prevailing interest rates. See TR at 497-499 (Irvine).

21 For these reasons, Staff's recommended capital structure should be rejected in
22 favor of a capital structure of 100% equity, which matches the financing of the assets
23 included in rate base, as recommended by the Company.

24 **2. Staff's Exclusive Reliance On Financial Models Results In A**
25 **Recommended ROE That Is Unrealistically Low.**

26 Disputes over the appropriate ROE are typically complex and highly subjective.

1 This case does not appear to be any exception. It is for this reason that FWS attempted in
2 its initial brief to focus on the big picture. Despite all the highly technical testimony
3 offered by Staff in this and other recent rate cases, something is amiss because Staff's
4 recommended ROEs have remained remarkably consistent for several years. *See* FWS
5 BR at 17-19; Bourassa RB (Ex. A-5) at 52-53. The discussion in support of Staff's
6 recommended ROE in Staff's brief does nothing to dispel such concerns. Instead, Staff's
7 arguments further support the Company's claim that Staff's approach is predetermined to
8 produce ROEs in a particular range.

9 In this case, Staff assigned a witness who had never previously testified concerning
10 cost of capital and who had virtually no experience in the area. Staff gave him previous
11 testimony by Staff witnesses on the subject of cost of capital and the computer programs
12 to run Staff's DCF and CAPM models. TR at 483, 486-87, 507-08 (Irvine). Staff witness
13 Irvine then ran the Staff models and accepted the results. No effort was made to consider
14 how FWS compared to other utilities considered by Staff or to the regulated utility
15 industry in general. TR at 505-07 (Irvine). Rather, it was simply assumed that all
16 regulated utilities face the same risks, even though it was admitted that FWS is not even a
17 part of the same "market" as the sample companies. TR at 507 (Irvine).

18 Staff also failed to provide an adequate explanation of the failure of its ROEs to be
19 materially impacted by the dramatic changes in interest rates and betas that have occurred
20 over the past three years. *See* Bourassa RB (Ex. A-5) at 52. Instead, Staff simply asserted
21 that other variables must be considered. Staff BR at 29. This is highly suspect given that
22 for several years Staff argued that its ROEs were appropriate given the historically low
23 interest rates that were prevailing in the marketplace. *See, e.g., Rio Rico Utilities*, Docket
24 No. WS-02676A-03-0434, Reiker SB at 27; *Arizona Water Company-Eastern Group*,
25 Docket No. W-01445A-02-0619, Reiker DT at 5-6. In short, FWS submits that these

26

1 factors are unexplained because Staff mechanically runs its models and blindly accepted
2 the results.

3 In contrast, while FWS witness Bourassa also used the DCF model and similar
4 sample companies, he did not simply accept the results of his modeling. Instead, the
5 results of the DCF modeling were “checked” using other recognized methods of
6 determining cost of equity, including a risk premium analysis, the comparable earnings
7 methodology and consideration of the economic conditions expected to be present when
8 the rates approved in this proceeding are in effect. *See, e.g.*, Bourassa RB (Ex. A-4) at 13.
9 The Company further considered the growth rates employed and the indicated costs of
10 equity. Bourassa DT (Ex. A-4) at 34. In contrast, the results of Staff’s DCF using
11 historical growth rates produces indicated costs of equity below the cost of debt, which
12 clearly does not pass any reasonable reality check, nor does it provide a “balanced
13 approach”. Bourassa RB (Ex. A-5) at 64-65. The Company also looked at past total
14 market returns, which are far greater than any of the parties recommendations. *See*
15 Bourassa RB (Ex. A-5) at 57; Bourassa RJ (Ex. A-6) at 28. Finally, Company witness
16 Bourassa considered the assumptions of the DCF model — that dividend, earning, book
17 value, and price all grow at the same rate, which has not been historically true. *See*
18 Bourassa RJ (Ex. A-6) at 28-29.

19 The Company conducted these additional analyses because the inputs and results of
20 any financial model used in determining the cost of capital should not be blindly accepted.
21 Bourassa RB (Ex. A-5) at 39. Further, it is unrealistic to assert that utilities like Aqua
22 America and American States, large, publicly held entities with millions of customers,
23 billions of dollars of assets and hundreds of millions of dollars of revenue have greater
24 risk than a small sewer company in Yuma, Arizona serving less than 6,000 customers with
25 a few million dollars of assets simply because they have more debt in their capital
26

1 structure. Bourassa DT (Ex. A-4) at 24-26; Bourassa RB (Ex. A-5) at 42-43.¹⁴ In other
2 words, in contrast to the approach used by Staff, some consideration of the utility before
3 the Commission in this case was conducted. It follows that Staff's recommended ROE is
4 too low and should not be adopted in this case.

5 **B. Reply to RUCO Concerning Capital Structure and Cost of Capital.**

6 To its credit, RUCO's arguments on capital structure and cost of capital are concise
7 and to the point. However, they are not persuasive. RUCO attempts to justify its use of a
8 hypothetical capital structure by reference to the capital structures of the sample utilities
9 considered in its cost of capital analysis. RUCO BR at 11. According to RUCO, had it
10 not utilized a hypothetical capital structure for FWS, it would have had to make a
11 downward adjustment to its recommended ROE. *Id.* In other words, faced with an
12 already unrealistically low rate of return, RUCO witness Rigsby found another way to
13 reduce the revenue requirement without proposing a return on equity that would have
14 been near or below the cost of debt. But FWS is not one of the sample companies and, as
15 discussed above, there is no debt financing plant in rate base in this case. TR at 443
16 (Rigsby). Moreover, the capital structure should match rate base in order to avoid
17 depriving the Company of a fair return on the equity financing plant dedicated to public
18 service. RUCO's recommended capital structure fails to do so and should be rejected.

19 RUCO's recommended ROE of a meager 9.04% should also be rejected. RUCO
20 made no effort whatsoever to consider the utility before the Commission in this rate case,
21 opting instead to assume that every regulated water and sewer utility in the country faces
22 the same business risks. *See* RUCO BR at 11. *See also* TR at 446-49 (Rigsby). The
23 detrimental impact of this assumption is exacerbated by RUCO's conclusion that all of the

24
25 ¹⁴ It is curious at best that Staff imputed debt into FWS's capital structure for purposes of
26 recommending a capital structure, and then seemingly ignored the same debt when
recommending an ROE.

1 sample companies have greater risk than FWS because they have more debt in their
2 capital structure. *Id.* Like Staff, RUCO apparently did not consider the debt it seeks to
3 impute in the Company's capital structure, nor does it adequately explain how a tiny little
4 sewer utility in Yuma can really be said to be less risky than the several utility "giants"
5 analyzed. Finally, RUCO has never adequately explained how its recommended ROEs
6 are essentially unaffected by significant increases in interest rates as compared to "historic
7 low" just three years ago when RUCO was recommending higher ROEs. See TR at 449-
8 452. In short, RUCO's recommended 9.04% ROE is unrealistically low for FWS and
9 should be rejected.

10 **IV. CONCLUDING COMMENTS.**

11 All parties agree that the Company is entitled to increases in its rates and charges
12 for sewer utility services. The differences in the parties' recommendations arise from the
13 various issues addressed in the respective post-hearing briefs and need not be reiterated.
14 What remains to be addressed, however, are several recommendations spelled out in
15 Staff's brief. See Staff BR at 31-33.

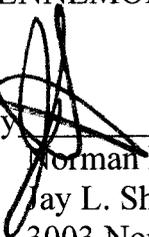
16 While FWS obviously does not agree with Staff's attempt to portray the Company
17 in a negative light (*see, e.g.*, Staff BR at 31 referring, without citation, to a long and
18 troubled history of compliance), FWS does accept Staff's recommendations concerning
19 health and safety as set forth in Staff witness Liu's engineering report and Staff Exhibit S-
20 21 (Staff BR at 32), as well as Staff's recommendation that rate increases not take effect
21 until the Company has reached a consent order with ADEQ for each of its wastewater
22 treatment facilities (Staff BR at 32). Although none of the operational problems Staff
23 focuses on in this case have been shown to have a negative impact on the rates to be
24 approved in this proceeding, the Company accepts responsibility for its current
25 compliance issues as well as responsibility to resolve them completely and as quickly as
26 reasonably possible. See FWS BR at 3-4. It is for this reason that the Company has

1 accepted the two recommendations of Staff discussed immediately above.

2 FWS does not agree with Staff, however, that the Commission should decide, in
3 this rate case, that future plant additions should be subject to some type of heightened
4 scrutiny in a future rate proceeding. Staff BR at 33. In a future rate proceeding, Staff and
5 any other party will have ample opportunity to review the costs of plant to be included in
6 rate base and make recommendations at that time concerning disallowance. For now,
7 Staff has offered nothing that warrants the Commission foreshadowing, in this case,
8 problems with the cost of plant that might be sought for inclusion in rate base in a future
9 case. In summary, the Commission should base its decision in this case on the evidence in
10 this docket, leaving the future to be addressed when and if it comes. Based on the
11 evidence in this case, and for the first time since its initial rates were established more
12 than 12 years ago, FWS is entitled to an increase in revenues of \$433,577, an increase of
13 just under 30%.

14 DATED this 18th day of October, 2006.

15 FENNEMORE CRAIG, P.C.

16
17 By  _____

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24 foregoing filed this 18th day of October, 2006:

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