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BEFORE THE ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION
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IN THE MATTER OF THE APPLICATION OF GOLD CANYON SEWER COMPANY, 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-02519A-06-0015

Arizona Corporation Commission
DOCKETED
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RUCO'S CLOSING BRIEF

INTRODUCTION

The Residential Utility Consumer Office ("RUCO") submits this Brief in support of its position that the Arizona Corporation Commission ("Commission") should not authorize a rate increase of more than $2,474,767 for Gold Canyon Sewer Company ("Gold Canyon" or "Company"). The Company's request represents an increase in revenues of 99.13%, and is unwarranted given the facts and circumstances of this case. The Commission should disallow for rate consideration at this time the excess capacity associated with Company's plant improvements and reject the Company and Staff's zero working capital allowance and the Company's rate case expense request. The Commission should adopt RUCO's proposed methodology for calculating property tax expense, depreciation and interest expense, and remove inappropriate expenses associated with payments for memberships, gifts and refreshments. Finally, the Commission should approve RUCO's recommended rate of return of 8.54 percent, as well as RUCO's rate design.

DISALLOWANCE OF EXCESS CAPACITY

Excess capacity is capacity over and above what is necessary to provide service to the existing customer base. From a regulatory accounting standpoint, excess capacity is neither used nor useful, and is generally excluded from rate base consideration. The Commission should exclude the Company's excess capacity from rate base consideration at this time.

At the end of the test year – October 31, 2005 - the Company's wastewater facility had a maximum capacity of 1,900,000 gallons per day ("GPD"). A-5 at 4-5[1]. According to the Company, at the end of 2005, the influent flow rate at the Company's Reclamation facility was 708,000 GPD, so that 62.74 percent of its maximum capacity is not necessary to meet test year demand. R-9 at 10, R-2. The Company claims that the 708,000 figure represents the influent rate flow in terms of average gallons per day. Transcript at 266. In terms of maximum or peak flow, the Company estimated that peak day flow for the test year was 1.1 million GPD. Transcript at 271. The Company's estimate is consistent with the results of Staff's engineering report, which estimated test-year monthly peak flow at 1,170,000 GPD during the month of February 2005. S-1, Schedule MSJ page 10. Based on Staff's monthly peak flow estimate for the test year, the Company had excess capacity of 730,000 gallons or 38.42 percent of its

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[1] For ease of reference, trial exhibits will be identified similar to their identification in the Transcript of Proceedings. The Transcript volume number and page number will identify references to the Transcript.

maximum capacity of 1,900,000 GPD. Without question, the Company had excess capacity during the test year.

Staff further concluded that the Company will utilize 80% of its capacity by mid-2007, and its capacity can "be expanded to serve the projected growth" by year ending 2010. S-1, Exhibit MSJ, page 4. The Company agreed with Staff's figures. Transcript at 315 – 316. Despite Staff's figures, which no party disputes, the Company argues it does not presently have excess capacity. A-6 at 4. According to the Company, it does not have excess capacity because the increase in its maximum capacity limits from 1 million GPD to 1.9 million GPD is necessary to meet future growth, results in cost savings and is the prudent thing to do. Id. at 6, Transcript at 301-303. The Company's argument is misplaced. The issue is not one of future growth, prudency of the investment, or whether the improvements themselves should be recovered. RUCO does not take issue with the fact that there may be future growth, that the improvements are prudent, and that they will likely result in cost savings. Nor does RUCO argue whether the cost should be recovered. The issue is when the plant should be recovered and who should pay for it. The regulatory accounting standard which governs this situation provides for the recovery of plant when it becomes used and useful. The Commission should disallow the Company's excess capacity at this time since it is not used and useful.

The Company claims that capacity should be measured in terms of peak flow per day and not average flow per day. Transcript at 268. While RUCO disputes the Company's claim, it is nonetheless of little relevance to the question of whether there is excess capacity, since it only addresses the **quantity** of excess capacity **and not the issue of whether there is excess capacity**. Nonetheless, there is excess capacity whether the standard is peak flow per day or average flow per day. As mentioned previously, during the test year, February 2005 had the highest peak day flow "when 1,170,000 gallons were treated in one day." S-1, Exhibit MSJ at page 4. In terms of average peak flow for any given day, the Company admits that the system's capacity needs have never reached maximum capacity, and "hangs in about 1.1 and 1.2" million GPD. Transcript at 277 – 278. Regardless, the proper measure of capacity flow, as confirmed in the Company's Preliminary Design Report for the improvements dated April 2004, is the Company's average daily flow. According to the report, its purpose was to summarize "the preliminary design for the upgrade and expansion of the Water Reclamation Facility from a maximum-month Average Day Flow (ADF) capacity of 1.0 mgd to a maximum-month ADF capacity of 1.9 mgd." R-1 at 1. Wastewater storage systems include equalization basins whose purpose is to accommodate fluctuations in flows. Transcript at 272 – 273. The Company's Preliminary Design Report noted that the design of the improvements should be based on "equalized flow loading characteristics rather than peak hour loads." R-1 at 5. Assuming the system was designed properly, where there is storage as in the subject case, peak flows are not a relevant measure of needed capacity[2]. The Commission should measure the Company's excess capacity in terms of ADF, and not peak flow.

However, should the Commission determine that the proper measure of capacity is peak flow, the Commission should consider the peak flow characteristics of the plant and not the daily flow characteristics. The Company's wastewater facility with the improvements was designed to have a maximum month flow of 1,900,000 gallons per day. R-1 at 2. In terms of peak flow, the improvements were designed for a maximum day flow of 3,300,000 gallons per day and a maximum hourly flow of 5,515,000 gallons per day. Id. Even assuming that during

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[2] Peak flow is the proper measurement of capacity when considering utilities that do not have storage, such as an electric utility.

the test year, February 2005 had the highest peak day flow of 1,170,000 gallons, there still is no question that the Company has excess capacity. S-1, Exhibit MSJ at page 4.

RUCO's recommended disallowance for excess capacity is fair and reasonable. Based on the test year and the influent flow rate of 708,000 GPD reported by the Company, it is reasonable to disallow 62.74 percent of the Company's capacity as excess and make a corresponding adjustment. RUCO, however, incorporated a margin of reserve into its determination and selected the projected flow rate at the end of 2008 of 1,367,000 GPD, which equates to excess capacity of 28.05 percent. R-9 at 11. Ratepayers should not be burdened with the net costs associated with 28.05 percent of the test year plant improvements at this time since a portion of the plant is not used and useful.

RUCO is not suggesting that the Company never recover the costs associated with its excess capacity. In fact, RUCO is recommending the Commission grant the Company an Accounting Order that will allow the Company the opportunity to recover all of its costs when its excess capacity becomes used and useful. R-9 at 17. In the meantime, RUCO recommends the Company establish a deferred depreciation expense account to record the depreciation expenses on the disallowed plant. RUCO's recommendation is fair, reasonable, and should be adopted by the Commission.

WORKING CAPITAL

A utility's working capital requirement represents the amount of cash the utility must have on hand to cover any differences in the time period between when revenues are received and expenses must be paid. The most accurate way to measure the working capital requirement is via a lead/lag study. S-18 at 17. The lead/lag study measures the actual lead and lag days attributable to the individual revenues and expenses. No party performed a lead/lag study in this case. Id. The Company accepted Staff's recommendation of zero working capital in an effort to eliminate issues between Staff and the Company. R-10 at 4. Staff's recommendation is consistent with its working capital recommendation in past cases and appears to be more of a policy consideration, and not based on any analysis. See for example Staff's working capital recommendations in *Black Mountain Sewer Company, Docket No. SW-02361A-05-0657, Arizona-American Water Company-Paradise Valley Water District, Docket No. W-01303A-05-0405.* Typically, as Staff has admitted in other Class A water utility cases, most utilities have a negative cash working capital requirement. For example, see the Direct Testimony of Staff's witness, James J. Dorf, at page 6 in *Arizona American, Paradise Valley Water District Rate Application,* Docket No. W-01303A-05-0405 ("Staff has typically found that most sophisticated utilities will have a negative rather than a positive Cash Working Capital Allowance.") Contrary to the Company's and Staff's working capital position, RUCO's working capital analysis considers the Company's operations and maintenance expenses. R-10 at 5. The result is a ***positive*** working capital allowance, which as Staff has found, is not typical. RUCO is less concerned with the numerical result than it is with the Commission sanctioning an adjustment made for policy reasons that has no regulatory accounting basis. Staff and the Company's recommendation of a zero working capital allowance ignore the expense and revenue components of cash working capital and should be rejected by the Commission.

RATE CASE EXPENSE

The Company requests $160,000 in rate case expense. RUCO is recommending $70,000 in rate case expense given the lack of complexity and circumstances of this case. In typical fashion, RUCO requested and the Company submitted details to support the Company's estimated rate case expense. R-10 at 11. RUCO, however, was unable to substantiate approximately $72,000 of the documentation submitted by the Company. Id. at 12. The Company's submission included questionable support for its expenses, bills with redacted information, and unreasonable amounts for legal and accounting services. R-10-Exhibit C, R-4. Moreover, the Company would not cooperate with RUCO in its attempts to mitigate rate case expenses such as copying costs. Id. 12 -13. Finally, during the hearing, the Company submitted its final rate case itemization, referencing for support documentation it had previously submitted (i.e. redacted legal bills, etc.) A-23. RUCO is still not able to verify the Company's actual rate case expense.

Perhaps the best example of what RUCO claims is insufficient supporting documentation is the Company's submission of redacted legal bills. The Company redacted its bills based on its invocation of the attorney-client privilege. Transcript at 573. The Company's decision to redact information suggests that the Company views its legal privilege superior to the Commission's right to know the information. This is the Company's prerogative, however, the Commission should not approve the Company's recommended rate expense for several reasons. First, the Company is attempting to make this a legal issue. It is not a legal issue. No one is challenging the Company's legal privilege. The issue is what is a verifiable and reasonable amount of rate case expense. Like every expense the Company is seeking to recover, the Company must verify and justify the reasonableness of the expense. If the Company cannot provide such substantiation, it should be denied. Second, the burden is on the Company to provide documentation of its expenses. *In the Matter of the Application of Southwest Gas Corporation for Establishment of Just and Reasonable Rates, Decision No.*

68487 at 21. The burden is not on RUCO to substantiate the Company's expenses. It is the Company, not RUCO that is requesting recovery of the Company's rate case expense. By redacting its bills, the Company is really asking the Commission to accept its word in lieu of adequately substantiating its expenses. The Company's own witness, when asked at the hearing, could not explain what service was performed for certain redacted entries. Transcript at 461-469. If the Company's own witness does not know what services were performed, then certainly the expense has not been adequately substantiated.

Staff, like RUCO, generally requires supporting documentation to verify an expense. Transcript at 1164. In the absence of supporting documentation, Staff does not approve an expense[3]. Id Staff's normal practice is to disallow costs associated with information where a party fails to provide the information for the reason of attorney/client privilege. Transcript at 1165. Moreover, Staff, like RUCO, believes that the burden is on the Company to verify its rate case expense recommendation. Transcript at 1167. The Commission does not allow unsubstantiated expenses for any other type of cost and should not make an exception for rate case expense.

Finally, the Company is not without recourse. RUCO is not suggesting that breaching the attorney/client privilege is the only way that RUCO can verify the expense. A general description of the service is sufficient to verify the expense. While this may present a minor inconvenience to the attorney by having to change the manner in which he/she bills their client, it is an option which would allow the Parties and the Commission to verify the expense.

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[3] In this case, Staff did not remove the redacted entries from its recommendation because of time constraints. Transcript at 1176.

The Company's final rate case expense schedule is not reasonable. For example, the Company has listed attorney fees of $11,683.00 for costs associated with the "Preparation/Review of Responses to Data Requests". A-13. For the same service the Company's rate analyst has listed $486.55. Id. RUCO does not believe it is reasonable for the attorney's cost to be 24 times more than the Company's rate analyst witness to prepare and review data requests which, for the most part, are answered by the Company's witnesses. Id. Likewise, the Company is seeking the recovery of "Copying, printing, and CD duplication of $10,194.01" Id. While this case did become more involved as the proceeding progressed, at some point the Company must mitigate its expenses. Spending over $10,000.00 for copying costs is not reasonable given the facts and circumstances of this case.

The facts and circumstances of this case are what RUCO considered in making its rate case expense recommendation. RUCO considered the complexity of this proceeding, the number of systems involved (one) and a comparison to other rate case expenses (i.e. *Arizona-American Water Company, Inc. Sun City/Sun City West et. al Water and Wastewater Districts* – Decision No. 67093, Commission approved an average of $41,894 per district, *Arizona Water Company, Northern Group* – Decision No. 64282 (Commission approved $43,400 per district), *Arizona Water Company, Eastern Group* – Decision No. 66849 (Commission approved $31,250 per district), *Arizona Water Company, Western Group* – Decision No. 68302 (Commission approved $50,710 per district) to come up with its recommended rate case expense of $70,000. R-9 at 23- 5. The Commission should approve rate case expense of $70,000.

PROPERTY TAX

RUCO recommends the Commission adopt its adjustment to property tax expense based on the formula used by the Arizona Department of Revenue ("ADOR"). The evidence shows that the use of the ADOR formula to estimate property taxes is a much more accurate estimate of actual property tax than the methodology that the Company proposes and any of the different methodologies the Commission has recently adopted. R-10 at 10. RUCO's recommended property tax expense calculation was based on the ADOR property tax formula. R-9 at 17. The property tax formula, as prescribed in ADOR's memo dated January 3, 2001, values water utilities for property tax purposes by multiplying the average of the water utility's three previous years of reported gross revenues by a factor of two. Id. at 18.

The Company has disregarded the revenues required under the ADOR directive and substituted in its place the adjusted test-year revenues twice, and its proposed level of revenues once ("Company methodology"). Id. RUCO, for valuation purposes, has included the test year (ending October 31, 2004) and the prior two years (2002, 2003) as directed by ADOR ("ADOR methodology"). Since the ADOR issued its memo, enough time has passed so that actual property tax figures for 2005 are available and the Commission can compare those figures to the estimated figures derived using the Company's and the ADOR methodologies. The Company's actual 2005 test-year property taxes were $143,662.58. R-10 at 10. Using the ADOR methodology, RUCO's estimated 2005 property tax assessment is $175,355, a difference from the actual expense of $31,692. Id. However, using the Company's methodology results in an estimate of $255,139, a difference of $111,476 from the actual expense. Id. This evidence clearly demonstrates that once again, ADOR's method more closely approximates the Company's actual post-test year property tax bill than does the

Company and Staff methodology. The Commission should adopt RUCO's approach and recognize the ADOR methodology as the best measure of actual property tax expense.

The Company mistakenly claims that the ADOR methodology uses historical inputs and ignores the Company's proposed revenues. A-11 at 11. In fact, the ADOR formula using historical inputs accounts for additional revenues. The application of proposed revenues, however, to the ADOR formula is likely to overstate property tax expense because of the timing lags inherent in the assessment and collection of property taxes. The impact of additional revenues on property tax is not the same as the impact of additional revenues on income taxes. The effect of additional revenues on income tax is immediate, but the effect of additional revenues on property taxes is not immediate because property taxes based on the increased revenues are not paid until more than a year after new rates go into effect. Even then the increased revenues' impact on property taxes is tempered by the use of two earlier years' revenues. The full impact of increased revenues on property taxes will not be felt until four years after new rates go into effect. An understanding of this timing difference is critical to understand why the ADOR formula using historical inputs is a more accurate method to estimate property taxes than the use of adjusted and pro-forma revenues. This also explains why the new rates that will go into effect will not affect property taxes immediately. In RUCO's experience, the Commission has not gone more than one year beyond the test year to look at any other expense on the income statement. Here, the test year was 2004, and one year beyond that is 2005. RUCO established a level of property tax for 2005.

The Company and Staff recommend the Commission look beyond one year from the test year, and consider new rates to estimate property tax expenses more than one year into the future. Historically, the Commission does not consider a post-test-year expense beyond one year because, among other things, it violates the matching principle and the used and useful principle. The ADOR formula using historical inputs is forward looking and does consider the fact that new rates will be set. The Commission should adopt the ADOR formula using historical inputs.

The Company relies on previous Commission Decisions that conclude that RUCO's methodology, and hence the ADOR methodology, unreasonably understates property tax expense. A-12 at 12. With all due respect, the evidence in this case once again proves that the ADOR methodology is the most accurate method. In this case, had the Commission previously approved the Company's methodology, property taxes for 2005 would have been overstated by $111,476, which would have allowed the Company to over earn for several years until that level of tax was actually assessed. The Commission should adopt the ADOR methodology.

DEPRECIATION EXPENSE

RUCO recommends the Commission adopt its calculation for depreciation expense based on RUCO's end of test year gross plant in service using depreciation rates proposed by the Company. R-10 at 9. This adjustment decreases total year rate base by ($2,789,016). Id.

REMOVAL OF INAPPROPRIATE EXENSES AND INCOME TAX EXPENSE

RUCO recommends the Commission disallow inappropriate and/or unnecessary costs associated with payments for memberships, gifts and refreshments ($264). RUCO further recommends the Commission adopt its adjustment to income tax expense to reflect RUCO's adjusted test-year revenue and expense calculations. ($81,921).

THE COMPANY'S PREVIOUS REPRESENTATIONS TO THE PUBLIC

RUCO filed its response to the pre-filed testimony of Trevor Hill on November 22, 2006. RUCO incorporates, by reference, its response into this Closing Brief. In the response, RUCO reserved its right to add or modify its position after the hearing on this issue concluded. RUCO has nothing to add to its prior filing.

COST OF CAPITAL

The Commission should adopt RUCO's recommended rate of return of 8.54 percent, which is the weighted cost of RUCO's recommended costs of debt and equity capital. R-8 at 5.

An 8.60 percent cost of common equity is appropriate, given the current environment of low inflation and low interest rates in which the Company is operating. Id. at 4-8. Moreover, RUCO witness, Mr. William Rigsby's recommendation is further supported by the Federal Reserve's recent announcements to hold interest rates steady and Value Line analyst's projection of interest rate costs. Id. at 3.

The Company is recommending a capital structure of 100% equity. R-7 at 49. It should follow that the Company's cost of equity would be low because of the decreased financial risk because the Company has no debt. Incredibly, the Company's cost of equity recommendation is 10.50%, compared to RUCO's recommended 8.60% and Staff's recommendation of 8.40%. R-8 at 10. The Company's cost of capital recommendation does not make sense and should be rejected by the Commission.

In response, the Company claims that it faces business risk because of its small size compared to sample companies and the regulatory environment the Company faces in Arizona. A-11 at 19-20. Even if there is a basis for the Company's argument, it does not justify a cost of equity recommendation of 10.50% given a 100% equity capital structure. The Company's cost of capital recommendation should be rejected.

Finally, RUCO's 8.60 percent cost of common equity is very reasonable when the Company's proposed projected capital structure of 100 percent equity is compared with the capital structures of other publicly traded water providers, which averaged 49.7 percent equity and 50.3 percent debt. R-7 at 49. Mr. Rigsby's belief that the Company is subject to less financial risk compared to the other utilities considered in his Cost of Capital analysis is validated by the lower level of debt in the Company's capital structure compared to the sample companies. R-7 at 50. Publicly traded companies with a level of debt similar to the Company's would be perceived as much less risky than the average of the sample and would, therefore, have a lower expected rate of return on common equity. Id. In order to account for less risk, it is customary in the regulatory practice to make a downward adjustment to the Company's cost of equity.

This lack of risk is the reason why RUCO is recommending a hypothetical capital structure of 60% equity and 40% debt. R-7 at 50. It is not uncommon to use a hypothetical capital structure when a company's capital structure is unbalanced as is the case here. RUCO's proposed capital structure will bring the Company's capital structure and weighted cost of capital in line with the industry average, and will result in lower rates to ratepayers. Id. at 52.

In terms of risk, RUCO's recommended 8.60 percent cost of equity, if anything, is fair and reasonable. RUCO could have easily made a downward adjustment to reflect the fact that the RUCO's cost of common equity figure was derived from a sample group of companies that face greater financial risk as a result of higher levels of debt in their capital structure. R-7 at 51. RUCO believes a better method to reflect the lower level of risk is to recommend a hypothetical capital structure. Id. at 52. RUCO also revised its cost of equity analysis in its surrebuttal testimony to reflect the decline in stock prices of the publicly traded water utilities used in RUCO sample as a result of rising interest rates. R-8 at 4. In short, RUCO's cost of capital recommendation is well reasoned, reasonable, fair, and should be adopted by the Commission.

RATE DESIGN

RUCO recommends the Commission approve its rate design, which is consistent with RUCO's recommended revenue allocations and requirements. R-10 at 16.

CONCLUSION

The Commission should not authorize a rate increase of more than $2,474,767. The Commission should disallow for rate consideration at this time the excess capacity associated with Company's plant improvements. The Commission should reject the Company and Staff's zero working capital allowance and the Company's request for $160,000 of rate case expense. The Commission should adopt RUCO's proposed methodology for calculating property tax expense, as it is the best estimate of future property tax expense. The Commission should also adopt RUCO's recommendations for depreciation and interest expense, and removal of inappropriate expenses associated with payments for memberships, gifts and refreshments. The Commission should adopt RUCO's recommended rate of return of 8.54 percent. Finally, RUCO recommends the Commission approve its rate design which is consistent with RUCO's recommended revenue allocations and requirements.

RESPECTFULLY SUBMITTED this 19th day of January 2007

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