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DATE: NOVEMBER 6, 2006

DOCKET NO: SW-02361A-05-657

TO ALL PARTIES:

Enclosed please find the recommendation of Administrative Law Judge Dwight D. Nodes. The recommendation has been filed in the form of an Opinion and Order on:

BLACK MOUNTAIN SEWER CORPORATION
(RATES)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and ten (10) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00** p.m. on or before:

NOVEMBER 15, 2006

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Working Session and Open Meeting to be held on:

NOVEMBER 21, 2006 and NOVEMBER 22, 2006

For more information, you may contact Docket Control at (602) 542-3477 or the Hearing Division at (602)542-4250. For information about the Open Meeting, contact the Executive Secretary's Office at (602) 542-3931.

BRIAN C. McNEIL
EXECUTIVE DIRECTOR

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MIKE GLEASON
KRISTIN K. MAYES
BARRY WONG

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 DECISION NO. ____________ **OPINION AND ORDER**

DATE OF HEARING:	June 7, 8, 9, and 20, 2006
PLACE OF HEARING:	Phoenix, Arizona
ADMINISTRATIVE LAW JUDGE:	Dwight D. Nodes
APPEARANCES:	Jay Shapiro, FENNEMORE CRAIG, P.C., on behalf of Black Mountain Sewer Corporation; Daniel Pozefsky, on behalf of the Residential Utility Consumer Office; David W. Garbarino, MOHR, HACKETTT, PEDERSON, BLAKLEY & RANDOLPH, P.C., on behalf of Intervenor Town of Carefree; Robert Williams, on behalf of Intervenor Boulders Homeowners Association; and Keith Layton, Staff Attorney, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

BY THE COMMISSION:

On September 16, 2005, Black Mountain Sewer Corporation ("BMSC" or "Company") filed an application with the Arizona Corporation Commission ("Commission") for a rate increase. BMSC currently provides wastewater service to approximately 1,957 customers in and around Carefree, Arizona, 1,836 of which are residential customers and 121 are commercial (Ex. A-4, at 3).

BMSC's current rates and charges were authorized in Decision No. 59944 (December 26,

1996) for Boulders Carefree Sewer Corporation ("Boulders Carefree"). In 2001, the common stock of Boulders Carefree was acquired by Algonquin Water Resources of America ("AWRA"), which is a wholly owned subsidiary of Algonquin Power Income Fund ("APIF"). APIF owns energy, water and wastewater, and related assets of approximately $800 million in the United States and Canada. In Arizona, APIF owns seven water and wastewater companies serving approximately 50,000 customers[1]. APIF also owns 10 other water and wastewater utilities in Texas, Illinois, and Missouri (Ex. A-4, at 3; Ex. A-5, at 2-3).

On September 26, 2005, the Residential Utility Consumer Office ("RUCO") filed an Application to Intervene, which was granted by Procedural Order issued October 7, 2005.

On October 14, 2005, the Commission's Utilities Division ("Staff") filed a Deficiency Letter, stating that the application did not meet the sufficiency requirements set forth in A.A.C. R14-2-103 because the Company had failed to include a cost of service study with its application. The Deficiency Letter also stated that Staff would not require a cost of service study if BMSC provided the information attached to the Letter.

On October 28, 2005, a Procedural Order was issued addressing an agreement between the Company and Staff whereby the application would be deemed sufficient, subject to the condition that the information requested by Staff must be submitted within 60 days of a Procedural Order approving the Stipulation, and failure to submit the required information would result in suspension of the applicable time clock. The Procedural Order declined to approve the Stipulation between BMSC and Staff, on the basis that such approval would require an advance determination of the Commission's time clock rule in the absence of a factual justification being presented.

On November 1, 2005, Staff issued a Letter of Sufficiency and classified BMSC as a Class B utility.

On November 2, 2005, a Procedural Order was issued setting a hearing to commence on June 7, 2006, directing the Company to publish and mail notice of the hearing, and establishing other procedural deadlines.

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[1] In addition to BMSC, AWRA also controls in Arizona Bella Vista Water Company, Litchfield Park Service Company, and Gold Canyon Sewer Company (Ex. S-13). AWRA added Northern Sunrise Water Company and Southern Sunrise Water Company after the close of the hearing (Decision No. 68826 – June 29, 2006).

On December 30, 2005, BMSC filed a "simplified cost of service study" as requested by Staff.

On January 24, 2006, BMSC filed a Certification of Publication and Proof of Mailing, attesting to compliance with the notice requirements set forth in the November 2, 2005 Procedural Order.

On February 14, 2006, Robert Williams filed a letter requesting intervention on behalf of the Boulders Homeowners Association ("Boulders HOA" or "HOA").

On February 16, 2006, the Town of Carefree ("Town" or "Carefree") filed an Application to Intervene.

On February 21, 2006, M. M. Schirtzinger filed a letter requesting intervention as an individual customer of BMSC.

On March 8, 2006, a Procedural Order was issued granting intervention to the Boulders HOA, Carefree, and M. M. Schirtzinger.

With its application, BMSC filed the Direct Testimony of Michael Weber and Thomas Bourassa.

On March 9, 2006, Staff filed the Direct Testimony of Crystal Brown, Marlin Scott, Jr., and Pedro Chaves; RUCO filed the Direct Testimony of William Rigsby and Marylee Diaz Cortez; and Carefree filed Affidavits of Stan Francom, Jonathon Pearson, and Jason Bethke, as well as several attachments.

On April 6, 2006, BMSC filed the Rebuttal Testimony of Michael Weber, Joel Wade, and Thomas Bourassa.

On May 4, 2006, Staff filed the Surrebuttal Testimony of Marlin Scott, Jr., and Pedro Chaves; RUCO filed the Surrebuttal Testimony of William Rigsby and Marylee Diaz Cortez; and Carefree filed the Surrebuttal Testimony of Stan Francom and Jonathon Pearson.

On May 5, 2006, Staff filed the Surrebuttal Testimony of Crystal Brown.

On May 26, 2006, BMSC filed the Rejoinder Testimony of Joel Wade and Thomas Bourassa.

On June 2, 2006, BMSC filed a Motion to Strike Affidavit of M. M. Schirtzinger, dated May 31, 2006, based on the failure to file the statement within the timeframe established for intervenor testimony[2].

A prehearing conference was conducted on June 5, 2006.

The hearing commenced on June 7, 2006, and additional hearing days were held on June 8, 9, and 20, 2006.

On June 15, 2006, Staff filed updated Surrebuttal Schedules.

On July 26, 2006, Staff filed Post-Hearing Recommendations based on documentation provided by the Company on June 22, 2006. The adjustments to Staff's recommendations were presented to reflect Staff witness Crystal Brown's testimony during the hearing that Staff would review its position on several items if the Company could support its position with documentation. The adjustments recommended by Staff are reflected in Staff's final schedules attached to its Post-Hearing Brief.

Initial Post-Hearing Briefs were filed on August 18, 2006 by the Boulders HOA, and on August 21, 2006 by BMSC, Staff, RUCO, and Carefree.

Reply Briefs were filed on September 5, 2006 by BMSC, Staff, RUCO, Carefree, and the Boulders HOA.

Rate Application

According to the Company's application, as modified, in the test year ended December 31, 2004 BMSC had adjusted operating income of $11,595 on an adjusted Fair Value Rate Base ("FVRB") and Original Cost Rate Base ("OCRB") of $1,568,502, for a 0.74 percent rate of return. Pursuant to its final schedules, BMSC requests a gross revenue increase of $256,063 (21.54 percent). Staff recommends a gross revenue increase of $250,195 (20.76 percent), and RUCO recommends an increase of $5,470 (0.45 percent). A summary of the parties' final revenue requirement positions follows[3]:

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[2] Docket Control records do not reflect that an Affidavit was filed on May 31, 2006, and M. M. Schirtzinger did not appear at the hearing. Mr. Williams, appearing on behalf of intervenor Boulders HOA, did not submit pre-filed testimony but was given the opportunity to present a statement in the public comment portion of the hearing (Tr. 30-44). Mr. Williams also posed cross-examination questions to various witnesses during the hearing.

[3] Intervenors Carefree and the Boulders HOA raised only non-revenue requirement issues (*i.e.*, odor problems) which are discussed below.

	Company Proposed	Staff Proposed	RUCO Proposed
FVRB/OCRB			
Adjusted Rate Base	$1,568,502	$1,550,710	$1,372,834
Rate of Return	11.00%	9.60%	9.45%
Req'd Operating Inc.	172,535	148,868	129,733
Op. Income Available	11,595	4,819	125,730
Operating Inc. Def.	160,940	144,049	4,003
Rev.Conver. Factor	1.5911	1.73688	1.3663
Gross Rev. Increase	256,063	250,195	5,470

REVENUE REQUIREMENT

Rate Base Issues

As indicated above, BMSC proposes an OCRB of $1,568,502; Staff proposes an OCRB of $1,550,710; and RUCO proposes an OCRB of $1,372,834. Each of the disputed issues regarding rate base items is discussed below.

Accumulated Deferred Income Taxes

Accumulated deferred income taxes ("ADIT") reflect the timing difference between when income taxes are calculated for ratemaking purposes and the actual federal and state income taxes paid by the Company. The timing difference is primarily due to the fact that straight line depreciation is used for ratemaking purposes, whereas accelerated depreciation is used for income tax reporting purposes (Ex. S-9, at 19). According to Staff witness Crystal Brown, the Statement of Financial Accounting Standards ("SFAS") No. 109, Accounting for Income Taxes, requires companies to use deferred tax accounting to recognize income tax timing differences.

Ms. Brown stated that although BMSC did not initially reflect an ADIT liability in its application, in response to a RUCO data request the Company stated that it had a deferred income tax credit (liability) of $360,000. However, BMSC's response also indicated that it had a deferred tax asset of $524,000 resulting from the Company's advances in aid of construction ("AIAC") account. According to Staff, the net difference between the $360,000 deferred tax liability and the $524,000 deferred tax asset, is a net deferred tax asset of $164,000, and therefore an increase to the Company's rate base of that amount (*Id.* at 20-21).

RUCO witness Marylee Diaz Cortez disagrees with the Company's and Staff's proposed

ADIT asset and RUCO instead recommends an ADIT liability of $161,250 (reduction to rate base). RUCO's recommendation is based on BMSC's parent company's (APIF's) 2004 Annual Report, which reflects a net tax liability. RUCO developed its proposal in this case by allocating BMSC's portion of the tax liability based on the ratio of the price paid by APIF for BMSC's stock compared to APIF's total assets (RUCO Ex. 12, at 4-7; Tr. 417-418). Ms. Diaz Cortez stated that utility companies "almost unfailingly create net deferred tax liabilities" (RUCO Ex. 12, at 4).

Whether other utilities normally report net deferred tax liabilities is not a controlling factor in determining whether BMSC should have a net asset or liability in this case. BMSC's ultimate parent, APIF, controls myriad companies (*see, e.g.* Ex. S-13) and the fact that its Annual Report reflects a net deferred tax liability is not necessarily indicative of whether its individual subsidiaries have a net liability or asset on their respective books. As Mr. Bourassa explained, "[w]hen a significant amount of plant has been financed by CIAC [contributions in aid of construction] and AIAC, or when there are net operating losses, DIT assets are common" (Ex. A-2, at 4). We agree with the Company and Staff that BMSC properly included $164,000 as a net deferred income tax asset for purposes of setting rates in this case.

<u>Cash Working Capital</u>

Cash working capital represents the amount of cash a company must have on hand to pay its bills when they are due (Tr. 386). All parties agree that using a lead/lag study, which measures the timing of funds received compared to expenses paid, is the most accurate method of determining cash working capital.

In this case, BMSC did not conduct a lead/lag study. In its application, BMSC calculated a positive cash working capital requirement of $130,508, based on the "formula method." The formula method calculates cash working capital based on one-eighth of the Company's operating expenses less depreciation, taxes, purchased water, and purchased pumping power expense, plus one twenty-fourth of purchased water and purchased pumping power expense (Ex. S-9, at 23).

In her direct testimony, Staff witness Crystal Brown stated that use of the formula method is not appropriate for BMSC and is, in general, appropriate only for Class D and E utilities that do not have the resources to conduct a lead/lag study (*Id.*). Ms. Brown indicated that, "[h]ad a lead-lag study been conducted, it might have shown that Cash Working Capital is a negative component of rate base" (*Id.* at 24). Therefore, Staff recommended removal of BMSC's proposed working capital requirement, in effect resulting in a zero working capital requirement (*Id.*). On rebuttal, Company witness Bourassa accepted Staff's zero working capital recommendation (Ex. A-2, at 11).

RUCO believes that BMSC has a negative cash working capital requirement because the Company "receives its revenues prior to having to pay its expenses" (RUCO Ex. 12, at 8). According to RUCO witness Diaz Cortez, unlike many utilities that bill after service is rendered, BMSC customers are required to pay for service in a given month prior to receiving an entire month of service. Ms. Diaz Cortez testified that the formula method assumes that there exists an average lag of 45 days for operating and maintenance ("O&M") expenses, and an average lag of 15 days for purchased power expenses. Ms. Diaz Cortez stated that RUCO performed a modified lead/lag study in which a sampling of actual customer bills was reviewed showing the service period, bill date, and payment due date (*Id.*). Based on this review, RUCO calculated an average revenue collection lead of 7.83 days (Tr. 382). RUCO also used the formula method's 45 lag days for O&M expenses and 15 lag days for purchased power expenses, which the Company was initially advocating in this case and, based on its analysis proposes a negative cash working capital for BMSC of $87,253 (RUCO Ex. 11, at 14).

We agree with RUCO's negative working capital proposal in this proceeding based on its analysis which, while not as accurate as a full scale lead/lag study, provides a more accurate representation of BMSC's actual cash working capital situation. Although BMSC argues in its brief that "RUCO has not met its burden of proof" on this issue (BMSC Reply Brief at 10), it is the Company which has failed to sustain its burden of presenting evidence to support its zero working capital proposal as a more accurate reflection of BMSC's actual working capital requirement. BMSC is critical of RUCO's acceptance of 45 O&M lag days and 15 purchased power lag days, yet its own witness initially proposed using the formula method, which employs those very estimates (Tr. 126-127). We therefore adopt RUCO's proposal regarding the working capital issue.

Scottsdale Treatment Capacity

In order to serve its approximately 2,000 customers, BMSC currently operates one 120,000 gallon per day ("gpd") wastewater treatment facility located near the Boulders Resort. The remainder of the Company's wastewater flows are diverted into the City of Scottsdale's ("City" or "Scottsdale") wastewater treatment system and ultimately delivered to the City of Phoenix Regional 91st Avenue Wastewater Treatment Plant (Ex. A-4, at 3).

In order to divert wastewater flows into Scottsdale's system, BMSC's predecessor, Boulders Carefree, entered into a 20-year Agreement with Scottsdale in 1996 that allows the Company to deliver up to 1,000,000 gpd to the City (Ex. A-15). According to the Agreement, no "right, title or interest in the other party's utility plant or facilities" is granted to either party (*Id.* at 2).

In the Company's prior rate case, both the Company and RUCO sought to have the amounts paid under the contract treated as plant and included in rate base. However, in Decision No. 59944 (December 26, 1996), the Commission agreed with Staff and treated the debt service on the debt used to fund the Scottsdale treatment capacity as an operating lease, that is included in operating expenses as lease expense (Ex. A-2, at 22). Mr. Bourassa stated that the Commission's treatment of the capacity as a lease expense has resulted in lower rates to customers and lower revenues to the Company compared to a rate base treatment scenario (*Id.* at 25-27). Staff agrees with the Company that the Scottsdale capacity should continue to be treated as a lease expense consistent with the Commission's prior Order (Ex. S-9, at 32-33).

RUCO claims that the operating lease treatment of the Scottsdale capacity costs was a "fallacy" in 1996, and is an even greater fallacy now because of BMSC's acquisition of Boulder Carefree (RUCO Ex. 11, at 3-4). Ms. Diaz Cortez contends that because the original capacity was purchased with a loan from Boulders Carefree's parent, and because BMSC's acquisition was financed with equity from AWRA, there is no basis for continuing to treat the capacity as an operating lease because to do so would not provide a credit to ratepayers for capacity that is already paid for (*Id.* at 7).

We disagree with RUCO's proposed treatment of the Scottsdale treatment capacity. As Mr. Bourassa points out, if rate base treatment of the Scottsdale capacity costs had been approved in the Company's prior rate case, the revenue requirement would have included a return on and of the capacity costs, thereby resulting in significantly higher rates in the interim period since the last case.

In this case, RUCO's proposal to accord rate base treatment to the capacity rights would result in a reduction to the Company's revenue requirement because the original cost of the Scottsdale capacity has been amortized. To switch ratemaking treatment after more than a decade, would be arbitrary and inherently unfair to the Company. We therefore reject RUCO's position on this issue.

Gross-Up Factor for Income Taxes

With respect to the income tax effect for the Scottsdale capacity operating lease, the Company proposed to include $27,801 in operating expenses as a gross-up for income taxes. Under the Company's proposal, income taxes would be included on the principal amount of loan payments for the Scottsdale treatment capacity agreement (Ex. S-9, at 32).

Staff recommended a treatment that does not require a gross-up factor and which Staff believes is a simpler and cleaner method. Under Staff's proposal, the loan payments would not be included in the ratemaking calculation of taxable income, which would result in a higher taxable income and an offsetting, higher income tax expense to be included in rates (*Id.*). Staff argues that the Company's method would understate income tax expense, and adoption of Staff's recommendation would result in a more realistic level of income taxes expense for ratemaking purposes (*Id.* at 33).

The Company did not brief this issue and we assume that it therefore accepts Staff's proposed treatment of this issue. We will adopt Staff's recommendation.

Summary of Rate Base Adjustments

Based on the foregoing discussion, we adopt an adjusted OCRB and FVRB of $1,472,969 for BMSC in this proceeding.

	Commission Approved
OCRB	
Plant in Service	$8,630,686
Less: Accumulated Depreciation	4,331,129
Net Plant in Service	4,299,557
Deductions:	
AIAC	1,311349
CIAC	4,857,632
Less: Accumulated Amortization	3,256,134
Net CIAC	1,601,498
Total AIAC and CIAC	2,912,847

ADIT	164,000
Additions:	
Prepayments	9,512
Working Capital	(87,253)
Total OCRB	$1,472,969

Operating Income Issues

In the test year, the Company's adjusted operating revenues were $1,205,452. In its final schedules, BMSC reported adjusted test year operating expenses of $1,221,973, and test year net operating income of negative $14,233. As set forth in its final schedules, Staff's proposed adjusted test year operating expenses are $1,200,633, resulting in test year operating income of $4,819. RUCO's schedules show proposed adjusted test year total operating expenses of $1,083,477, yielding test year operating income of $129,733. The disputed expense adjustments are discussed below.

Property Tax Expense

The Arizona Department of Revenue ("ADOR") determines the value of utility property for tax purposes using a formula that is based on the utility's historical revenues. BMSC and Staff propose to follow a line of recent Commission decisions to use adjusted test year revenues in the application of the ADOR formula in order to determine the allowable property tax expense in this proceeding (*See, e.g., Chaparral City Water Company*, Decision No. 68176 (September 30, 2005); *Rio Rico Utilities Co.*, Decision No. 67279 (October 5, 2004); *Arizona-American Water Company*, Decision No. 67093 (June 30, 2004); *Bella Vista Water Company*, Decision No. 65350 (November 1, 2002); *Arizona Water Company*, Decision No. 64282 (December 28, 2001)). RUCO continues to disagree with the Commission's use of adjusted test year revenues in the application of the ADOR formula for estimating property tax expense for ratemaking purposes, and argues as it has in a number of prior cases that only historical revenues should be used (RUCO Ex. 13, at 13-17).

RUCO compared the results of its methodology, based on the Company's historical revenues for the test year, and the two years prior, with the results of the Commission's methodology. RUCO contends that since its methodology more accurately predicted the actual 2005 assessment, the Commission should adopt its approach on this issue (*Id.* at 15).

We once again disagree with RUCO's position. Consistent with numerous prior decisions, we do not believe RUCO's backward-looking methodology properly recognizes that, barring extraordinary circumstances, any increase granted in this case will increase the Company's property taxes. As we stated in the *Chaparral City* case cited above, "RUCO's calculation methodology, which uses only historical revenues, unfairly and unreasonably understates property tax expense, and is therefore inappropriate for ratemaking purposes" (Decision No. 68176, at 14). RUCO has not demonstrated a basis for departure from our prior determinations on this issue and we will therefore adopt the recommendations of the Company and Staff to follow Commission precedent and use adjusted test year revenues in determining property tax expense.

Rate Case Expense

In its direct case, BMSC estimated rate case expense in the amount of $120,000, but indicated that it would true-up costs as the case progressed (Ex. A-1, at 10-12). On rebuttal, Mr. Bourassa adjusted the Company's estimated rate case expense upward, to $150,000, which would be amortized over four years. Mr. Bourassa claimed that the additional rate case expense allowance is justified because the Company has incurred additional expenses due to the intervention of Carefree and the Boulders HOA, as well as more extensive discovery than expected by Staff and RUCO (Ex. A-2, at 31-32). BMSC attached to its Opening Brief an exhibit (Brief Exhibit 3) that purports to show that it had incurred actual rate case expenses of more than $194,000 through the end of July 2006, prior to the filing of briefs in this case.

Staff recommends that the Company be allowed rate case expense of $124,800, amortized over four years. Staff witness Brown stated that the additional $4,800 over the Company's original estimate is sufficient to cover any additional expenses incurred by the Company to address the issues raised by the Town's and Boulders HOA's intervention (Ex. S-10, at 16-18). Ms. Brown testified that the $4,800 figure is based on a $400 hourly rate, multiplied by an additional 24 hours that Staff believes is sufficient to address intervenor issues, less removal of half of the additional amount "to reflect only the amount that customers should pay" (*Id.* at 18).

RUCO witness William Rigsby filed testimony recommending recognition of only the Company's original estimate of $120,000, amortized over four years. Mr. Rigsby stated that RUCO found the original estimate to be reasonable and "decided that the prudent approach would be to wait until a final figure can be accurately calculated and compared to the Company's request" (RUCO Ex.

13, at 17). However, once the Company presented an updated estimate of rate case expenses due primarily to odor issues raised by the intervenors, RUCO continued to propose that only the original $120,000 estimate should be recognized.

We believe the Company has justified recognition of its proposed rate case expense of $150,000 in this proceeding. Mr. Bourassa testified that BMSC had incurred actual rate case expenses of approximately $115,000 through April 2006, more than a month before the evidentiary hearing commenced and several months before post-hearing briefs were prepared (Ex. A-3, at 19). We believe that the Company's $150,000 rate case expense represents a reasonable allowance under the facts and circumstances of this case and is consistent with rate case expense allowances in other proceedings. *See, e.g., Arizona-American Water Company* ($419,000), Decision No. 67093 June 30, 2004); *Arizona Water Company* ($250,000), Decision No. 66849 (March 19, 2004). To hold a company strictly to its original estimate, regardless of intervening events, would create an incentive for over-estimating costs on the front end rather than attempting to provide a good faith estimate subject to reconciliation based on actual events. We do not believe Staff's or RUCO's proposals provide adequate recognition of the additional costs incurred by BMSC in prosecuting its rate case and we will therefore adopt the Company's position on this issue.

<u>Removal of Legal Costs</u>

Staff witness Brown recommended removal from test year expenses of $3,228 in legal costs associated with negotiating an operating agreement with Carefree. She proposed, instead, that the legal costs should be capitalized and amortized over the life of the agreement (Ex. S-9, at 31). The Company did not oppose Staff's recommendation and we will therefore adopt Staff's position.

<u>Affiliate Company Profits</u>

As described above, AWRA [Algonquin Water Resources of America, Inc.] is a wholly owned subsidiary of APIF [Algonquin Power Income Fund]. In Arizona, AWRA owns and operates Black Mountain Sewer Corporation, Bella Vista Water Company, Litchfield Park Service Company, Gold Canyon Sewer Company, Northern Sunrise Water Company and Southern Sunrise Water Company.

AWRA employs an organizational model that is unique in Arizona. AWRA, BMSC's sole shareholder, has no employees. BMSC, as well as all of the other regulated utility companies listed above, have no employees. Instead, almost all operational services are provided by an allegedly unregulated affiliate called Algonquin Water Services ("AWS") that has between 70 and 90 employees and which, apparently, provides similar services received by the regulated public service corporations owned by Algonquin in Arizona, including BMSC (Tr. 529-530)[4]. The written contract that exists between BMSC and AWS for provision of wastewater services was not negotiated, but was based on a template that is used by the Algonquin Power System to manage its hydroelectric plants in Canada (Tr. 510).

<u>Staff's Position</u>

Based on its analysis, Staff recommends that the Commission disallow $20,871 that the Company is seeking in rate base for capitalized affiliate profit, and $21,761 the Company seeks to recover in operating expenses for affiliate profit (Staff Ex. 9, at 27; Staff Br. Sched. CSB-6)[5]. Staff points out that BMSC has in effect turned over the entirety of its operations and management to an (allegedly) unregulated affiliate, and that the affiliate's shareholders have imposed a contract on BMSC, without negotiation, that provides the affiliate with guaranteed profits at the expense of BMSC's captive ratepayers (Ex. S-10, at 4-5). Ms. Brown stated that BMSC's affiliate is essentially operating as an unregulated monopoly based on the Company's claims that there are no other companies or individuals that could provide comparable services to BMSC[6]. Ms. Brown dismissed the Company's claims that the affiliate arrangement resulted in $222,000 in savings as unsupported assertions but, regardless of savings, Staff contends that it is reasonable for the affiliate to recover only the reasonable actual costs from customers (*Id.* at 7-8). Staff also asserts that there may be additional affiliate profit that it was unable to specifically identify. As an example, Staff cites to a billing rate for a "general manager" of $150 per hour that was charged to BMSC by its affiliate. Ms.

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[4] Staff witness Crystal Brown indicated that, during the test year, the Company was billed $275,460 by AWS, $32,017 by Algonquin Power Trust, and $27,311 by Algonquin Power Systems, for a total of $332,604 in billings by the Company's affiliates (Ex. S-9, at 26).

[5] The capitalized affiliate profit represents 8 percent of project costs billed to BMSC and, for operating expenses the affiliate billings included a 6.5 percent profit (*Id.*; Ex. A-2, at 17).

[6] As evidence of the potentially manipulative effect of affiliate control, Ms. Brown pointed out that the affiliate increased its management fees to BMSC from $7,500 per month in 2003 to $13,062 per month in 2004, the test year (Ex. S-10, at 6).

Brown stated that the $150 hourly rate equates to $312,000 on an annual basis to perform management duties for BMSC (*Id.* at 8).

In support of its recommended disallowance of capitalized and expensed affiliate profits, Staff argues that the record supports piercing the corporate veil and treating all of the Algonquin affiliates as a single entity. Staff cites to a prior case involving *Consolidated Water Utilities, LTD*, Decision No. 57666 (December 19, 1991), wherein the Commission stated: "We do not believe it is appropriate for ratepayers to pay a profit margin for each layer of related companies. Hence we totally agree with Staff that all of the profit margin of CUC should be disallowed as part of the allocation." (*Id.* at 18-19). Staff also cites *Walker v. Southwest Mines Development Co.*, 52 Ariz. 403, 81 P.2d 90 (1938), wherein the Arizona Supreme Court stated:

> [W]hen one corporation so dominates and controls another to make that other a simple instrumentality or adjunct to it, the courts will look beyond the legal fiction of distinct corporate existence, as the interests of justice require; and where stock ownership is resorted to not for the purpose of participating in the affairs of the corporation in the customary and usual manner, but for the purpose of controlling the subsidiary company so that it may be used as a mere agency or instrumentality of the owning company, the court will not permit itself to be blinded by mere corporate form, but will, in a proper case, disregard corporate entity, and treat the two entities as one.[7]

According to Staff, the case of *Deutsche Credit Corp. v. Case Power & Equip. Co.*, 179 Ariz. 155, 876 P.2d 1190 (App. 1994), provides additional support for this view. In that case, the Arizona Court of Appeals quoted *Jabczenski v. Southern Pacific Memorial Hospital, Inc.*, 119 Ariz. 15, 21, 579 P.2d 53, 59 (App. 1978), as follows:

> Two corporations can be regarded as the same if "[e]ither the dominant corporation ... so control[s] and use[s] the other as a mere tool or instrument in carrying out its own plans and purposes that justice requires it be held liable for the results, or, there [is] such a confusion of identities and acts as to work a fraud upon third persons."

Staff further argues that, pursuant to *Gatecliff v. Great Republic Life Insurance Co.*, 170 Ariz. 34, 37, 821 P.2d 725, 728 (1991), the standard for imposing the alter ego theory requires a showing of unity of control and that the corporate form would sanction a fraud or promote injustice.

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[7] *Id.*, 52 Ariz. At 414-415, 81 P.2d at 95, quoting *Platt v. Bradner Co.*, 131 Wash. 573, 230 P. 633 (Wash. 1924).

Staff also cites a decision by the Washington Utilities and Transportation Commission, in *Washington Water Power Co.*, 24 P.U.R. 4th 427 (at page 13) (1978), in which the Washington Commission, citing *Mississippi River Fuel Corp. v. Federal Power Comm'n*, 102 US App 238, 252 F.2d 619 (D.C. Cir. 1957), made the following finding:

> [T]he clearly stated concern appears to be not the level of price at which the transaction is accomplished in comparison with prices in nonaffiliated transactions, but instead a level of earnings by the unregulated arm of the utility at a rate higher than the utility is authorized and would be allowed to achieve if no corporate device were utilized. In effect, the courts approve for rate-making purposes the placement of a 100 percent affiliate in the same position as an integrated [part] of a utility.

Based on these decisions, as well as several others cited in its Brief, Staff claims that the corporate veil should be pierced to avoid an injustice. Staff points to the fact that neither BMSC nor AWRA have any employees and, as a result, the Algonquin affiliates provide virtually all of the services needed to serve the Company's customers; contracts between BMSC and AWC are presented to the Company without negotiation based on a template provided by the ultimate parent, APIF; that AWS was "specifically created" to provide the majority of services to BMSC; and the vice-president and general manager of AWS directs day-to-day management and operations of the water and wastewater systems owned by AWRA (including BMSC) (Ex. A-5, at 1). Staff asserts that the record supports the conclusion that BMSC is merely an agency or instrumentality of the Algonquin affiliates, and the corporate structure created by the Algonquin companies results in an injustice to ratepayers by creating a layer of profit that is inconsistent with Arizona's regulatory ratemaking standards.

Finally, Staff expressed concern with BMSC's suggestion in this case that, if the Commission disallows the Company's requested affiliate profit request, Algonquin will reorganize its corporate structure in a manner that will be more costly to ratepayers. As described in the Company's testimony, "[e]ither operating expenses increase because BMSC will have to hire personnel to perform all of the essential services or many of the services that benefit the Company and ratepayers will not be provided. There really is no other possible outcome because AWS is not going to stay in business if it cannot realize a return on its investment." (Ex. A-5, at 5). Staff requests that the

Commission make a finding in this Decision that it expects AWRA to operate its affiliate companies as efficiently as possible.

BMSC's Position

The Company contends that Staff's recommendation should be disregarded because common ownership alone is not a sufficient reason to pierce the corporate veil of the Company and its affiliates. BMSC claims that Staff failed to meet the burden of proving its proposal because, once Staff raised the issue of affiliate profit disallowance, the Company presented evidence as to the reasonableness of its affiliate costs. According to Mr. Bourassa, the Company is not aware of any local companies that could provide the type of services supplied by the Algonquin affiliates. However, he indicated that the Company attempted to compare its costs with those of a management services firm and estimated that such a firm would charge approximately $10 to $12 per customer per month, compared to $10 to $11 for the BMSC affiliate (Ex. A-2, at 34). Mr. Bourassa testified that Chaparral City Water Company has operational costs of approximately $14 to $16 per customer and he believed some other companies had costs of more than $18 per customer (Tr. 171-172).

The Company argues that, once this evidence was presented, it was incumbent upon Staff to present evidence showing why BMSC's proposed costs are unreasonable. BMSC claims that Staff could have sought to audit the affiliate companies' books and records, but Staff did not do so. The Company contends that the only evidence in the record shows that bids for comparable services were not available and, in any event, there is no evidence of excessive profits.

With respect to Staff's proposal to pierce the Company's corporate veil, BMSC asserts that the cases cited by Staff stand for the proposition that corporate structures will not be ignored unless they were created for essentially fraudulent purposes. BMSC cites *Arizona Public Service Co. v. Arizona Corp. Comm'n*, 155 Ariz. 263, 267, 746 P.2d 4, 8 (App. 1987), wherein the court declined to pierce the corporate veil because the Commission did not show undercapitalization, fraud, misconduct or impropriety in the management of the affiliated companies. The Company also claims the court in *Deutsche Credit, supra,* held that "[t]he concept of a corporation as a separate entity is a legal fact, not a fiction." *Deutsche Credit* at 160. In addition, BMSC cites *Kearns v. Tempe Technical Institute, Inc.*, 993 F.Supp. 714, 723 (D. Ariz. 1997), in which the court stated that "corporate status will not be lightly disregarded."

With respect to the *Washington Water Power* case cited by Staff, as well as *Central Louisiana Electric Co.*, 373 So.2d 123 (La. 1979), BMSC argues that the central holding of both cases is that the regulatory commission must assure that rates are just and reasonable, and the evidence presented in this proceeding supports a finding that BMSC's affiliate company expenses are reasonable. The Company also contends that the profit on the affiliated transactions is not guaranteed because all costs are subject to intense scrutiny in the ratemaking process and all costs can go up or down during intervening periods between rate cases. BMSC asserts that Staff has not provided evidence to disprove the reasonableness of the affiliate costs, including the requested profits, and thus Staff's recommendation should be rejected.

<u>RUCO's Position</u>

RUCO did not present testimony or take a position on this issue.

<u>Resolution</u>

We agree with Staff that, at a minimum, the profit component of both capitalized costs and expenses by the BMSC affiliate companies should be disallowed. We will not countenance a corporate shell game that allows companies to hide behind corporate structures in order to avoid scrutiny of what would normally be the function of the regulated public service company. BMSC criticizes Staff's failure to present evidence as to the unreasonableness of the subsidiary costs. Although Staff could have pursued discovery of the affiliate companies, given Staff's heavy caseload and the constraints for processing this matter under the time clock rules, it was not unreasonable for Staff to pursue other means of supporting its recommendation to disallow affiliate company profits.

Presumably, the Algonquin companies conducted a due diligence analysis prior to acquiring BMSC and understood the regulatory framework in Arizona. The rate base/rate of return regulatory scheme provides that, in exchange for being granted an exclusive service territory with monopoly status, public service corporations are granted an opportunity to earn an authorized return on investment used and useful, plus reasonable operating expenses. We believe it is inherently unreasonable for an affiliate company that performs all of the operational functions of the utility company, under a non-negotiated contract, to seek an additional profit margin simply because the affiliate was structured as a separate corporate entity. The question that must be asked is whether an affiliate company under common ownership and control should be permitted to add an additional layer of profit, and to do what a regulated public service corporation is otherwise legally prohibited from doing (*i.e.*, recover an additional profit margin for its services), based solely on the parent company's decision to create a separate affiliate company. Our answer is a resounding no.

We believe our finding is consistent with the line of cases which indicate regulatory commissions have broad authority to scrutinize transactions between a regulated company and its unregulated affiliates, and to disallow excessive costs. *See, e.g., U.S. West Communications, Inc. v. Arizona Corporation Comm'n*, 185 Ariz. 277, 282, 915 P.2d 1232 (App. 1996); *General Telephone Co. of New York v. Public Service Commission of New York*, 17 N.Y.2d 373, 378 (N.Y. 1966) ("[w]hen a utility and its suppliers are both owned and controlled by the same holding company, the safeguards provided by arm's length bargaining are absent, and ever present is the danger that the utility will be charged exorbitant prices which will, by inclusion in its operating costs, become the predicate for excessive rates."). *See also, State of North Carolina v. Morg*an, 177 S.E.2d 405, 416 (Supreme Court of North Carolina, 1970) ("the doctrine of the corporate entity may not be used as a means for defeating the public interest and circumventing public policy. In order to prevent such a result, a parent corporation and its wholly owned subsidiaries may be treated as one." [citations omitted]); *Washington Water Power, supra,* at page 15, quoting the Public Utilities Commission of Ohio's decision in *Columbus Gas & Fuel Co.*, PUR1933A 337 ("[A] company enjoying the immunities of a public utility has no right to impose upon the consumers a heavier burden than that which would be justly borne, and that will produce a proper rate of return, considering the value of the property devoted to this public service and to the risks involved."). Moreover, as this Commission stated in the *Consolidated Water* case, "[w]e do not believe it is appropriate for ratepayers to pay a profit margin for each layer of related companies....[and] all of the profit margin of CUC [the affiliate company] should be disallowed as part of the allocation." (Decision No. 57666, at 18-19).

We also share the concern raised by Staff that there may be additional profit margins built into the affiliate billings that have not been specifically identified. Because we do not have any specific record evidence of additional inappropriate profits in this case, we will exclude only the "profits" that have been clearly identified by Staff. In doing so, however, we make no finding as to the reasonableness of the Algonquin affiliate structure and, in future cases involving the Algonquin companies, we expect all affiliate salaries, expenses, and billings to be scrutinized to avoid potential abuses.

Net Operating Income

Consistent with the foregoing discussion, we will allow adjusted test year operating expenses of $1,205,533, which based on test year revenues of $1,205,452, results in test year adjusted operating income of negative $81, for no rate of return on FVRB.

COST OF CAPITAL

BMSC recommends that the Commission determine the Company's cost of common equity to be 11.0 percent. Staff recommends a cost of common equity rate of 9.6 percent. Both the Company and Staff recommend a capital structure of 100 percent equity and no debt. RUCO proposes a return on equity of 9.49 percent, with a hypothetical capital structure of 43 percent debt and 57 percent equity, resulting in an 8.92 percent weighted cost of capital (RUCO Ex. 14, at 9-10)[8].

Capital Structure

Company witness Bourassa stated that BMSC's capital structure consists of 100 percent equity because, although the Company has $1,184,732 of long-term debt on its books due to acquisition of the Scottsdale treatment capacity, that debt service is included in operating expenses pursuant to prior Commission Order and there is no other long-term debt (Ex. A-2, at 39). Staff agrees with the Company's proposed 100 percent equity capital structure (Ex. S-4, at 6). RUCO, however, proposes the use of a hypothetical structure of 43 percent debt and 57 percent equity (RUCO Ex. 14, at 9-11).

According to Mr. Rigsby, the Commission should adopt a hypothetical capital structure based on the Algonquin parent company's capital structure. Mr. Rigsby claims that adoption of a

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[8] Mr. Rigsby recommended that, if the Commission adopts RUCO's position on the Scottsdale capacity issue, the capital structure should be weighted at 44 percent debt and 56 percent equity, with a 9.45 percent weighted cost of capital (RUCO Ex. 14, at 9; Tr. 539). Since we have adopted the Company's position regarding the Scottsdale capacity issue, RUCO's position is as stated above.

hypothetical capital structure is appropriate in this case because his estimate of a 9.49 percent return on common equity ("ROE") was derived from a sample group of companies that have capital structures that consist of approximately 50 percent debt and 50 percent equity. He therefore proposed using the weighted cost of debt reported in APIF's 2004 Annual Report (Tr. 550-553).

We agree with Staff and the Company that a capital structure comprised of 100 percent equity should be used for calculating BMSC's cost of equity capital in this proceeding. Although RUCO proposes using a hypothetical capital structure based on the 2004 APIF Annual Report, its witness admitted that the APIF capital structure would incorporate the debt and equity of a variety of companies under the Algonquin umbrella, including a Canadian waste reclamation company, a hydroelectric company in New Hampshire, and a sewer company in Texas (Tr. 553-554). In fact, the plant in BMSC's rate base is financed entirely by equity. Although there is some long-term debt on the Company's books associated with the Scottsdale treatment capacity, as explained above that debt has been treated as an operating lease for nearly a decade pursuant to prior Commission Decisions and, therefore, there is no plant in rate base associated with the Scottsdale capacity debt. We believe RUCO's hypothetical capital structure recommendation is results oriented and is not consistent with the Company's actual capital structure. We therefore adopt a 100 percent equity capital structure for BMSC in this case.

Cost of Common Equity

Determining a company's cost of common equity for purposes of setting its overall cost of capital requires an estimation that is both art and science. As evidenced by the competing methodologies employed in this case, and most other rate cases, there is no clear-cut answer as to which formula should be used for reaching the appropriate outcome. Rather, the three expert cost of capital witnesses, Messrs. Bourassa, Chavez, and Rigsby, each rely on various analyses for their recommendations.

BMSC's Position

The Company's expert witness, Mr. Bourassa, based his common equity cost recommendation of 11.00 percent on the results of his discounted cash flow ("DCF") model using six proxy companies (American States Water, Aqua America, California Water, Connecticut Water, Middlesex Water, and SJW Corp.). Mr. Bourassa employed a risk premium analysis and a comparable earnings analysis as a check on the reasonableness of the DCF results (Ex. A-1, at 13-14; Ex. A-3, at 21-25).

The Company's DCF analysis produced ROE results for the proxy companies ranging from 8.5 to 11.0 percent (Ex. A-3, at 22). Mr. Bourassa's risk premium analysis resulted in an ROE range of 10.2 to 11.0 percent; while the earnings analysis produced results in the 7.8 to 12.7 percent range (*Id.*). He also looked at *Value Line* projections for ROE in the water industry for 2006, 2007, and 2009, and found projected returns of 10.0, 10.5, and 11.5 percent, respectively (*Id.*). BMSC argues that Mr. Bourassa's analysis supports the Company's proposed 11.0 ROE in this case considering BMSC's risks and investor expectations.

BMSC criticizes the recommendations of both Staff and RUCO (9.6 and 9.49 percent ROE, respectively), because the Company claims that Staff and RUCO blindly followed the results of their models without regard for whether their proxy companies are actually comparable in terms of investment risk. The Company contends that the Staff and RUCO recommendations, compared to ROE proposals in prior cases, have not kept pace with rising interest rates over the past several years, thereby producing skewed results. BMSC asserts that the Staff and RUCO analyses ignore firm-specific risk based on their claim that under modern finance theory all risk is reflected in a stock's "beta" (which estimates risk by comparing a stock's volatility relative to the market in which it is traded). The Company argues that the Staff and RUCO beta assumption ignores factors such as firm size; diversification of the utility; regulatory risk; and liquidity risk (Ex. A-2, at 48). BMSC cites additional alleged defects with the Staff and RUCO methodologies, including: the sample group consists primarily of water utilities; only one of the companies in the group has operations in Arizona; the stock of the sample companies is traded on a national exchange; and all but one of the companies has published credit ratings (Ex. A-1, Sched. D-4.1).

BMSC is critical of Staff's use of a multi-stage DCF model, which assumes that earnings and dividend growth will occur in multiple stages, compared to the constant growth version of the DCF model, which assumes constant growth of earnings and dividends (Ex. A-1, at 31). The Company also claims that while its analysis relies on forward-looking growth, Staff's methodology gives a 50 percent weighting to historical growth (1995 to 2005) which produces unrealistic results and depresses the equity cost estimate. BMSC claims that giving a 50 percent weighting to historical growth effectively double counts what has happened in the past, because historical information is already embedded in the stock prices used to calculate the dividend yield (*Id.*).

With respect to Staff's use of the Capital Asset Pricing Model ("CAPM"), the Company asserts that the CAPM is difficult to implement in practice, especially when applied to a small, closely-held firm (*Id.*). The CAPM is calculated using the subject company's beta (measurement of a security's volatility in relation to the market); the risk free rate (the return an investor expects to earn on a theoretical "riskless" investment); and the average market return (from which the market risk premium is calculated). BMSC claims that the 0.74 beta for Staff's six proxy companies (as calculated by *Value Line*) should not be applied to BMSC because it is not publicly traded and has no estimated beta. With respect to the risk free rate selected by Staff (average yield on 5, 7 and 10-year Treasury securities), the Company claims that because a corporation has an indefinite life, the use of intermediate Treasury securities is inappropriate.

According to BMSC, the inputs Staff used in its CAPM produce results that are contrary to the CAPM theory. The Company claims that, although under the CAPM theory cost of equity moves in the same direction as interest rates and estimated beta, Staff's CAPM estimates move in the opposite direction of both interest rates and beta risk. In addition to the alleged application problems perceived by BMSC, the Company contends that the CAPM has empirical shortcomings that invalidate its use for estimating ROE. BMSC cites to several articles in Economics journals to support its claim the CAPM is flawed. The Company argues that the Risk Premium Model ("RPM") is superior to CAPM because under the RPM the risk premium is directly estimated by comparing authorized and actual returns on equity with the current yield of investment grade bonds or other debt instruments.

BMSC is also critical of the RUCO DCF analysis because the Company claims that Mr. Rigsby substituted his own subjective judgment for market data in its DCF model. The Company claims that RUCO used the sustainable growth method to estimate dividend growth, but substituted its witness' subjective dividend growth rate, thereby understating substantially the Company's cost of equity. BMSC argues that RUCO's witness ignored the actual and forecasted stock financing rates reported in his own schedules.

RUCO's Position

RUCO witness Rigsby based his ROE recommendation on the results of his DCF and CAPM analyses, which ranged from 8.89 percent to 10.69 percent for his sample group of publicly traded water and gas companies. His 9.49 percent ROE recommendation is the result of the DCF analysis, which utilized a sample of publicly traded water companies (RUCO Ex. 14, at 8).

RUCO contends that Mr. Rigsby's DCF model relied on objective estimates of external growth using *Value Line* analyst projections as a guide (RUCO Ex. 15, at 24). RUCO argues that Mr. Rigsby's growth estimates properly recognize that the market price of a utility's common stock will tend to move towards book value if regulators allow a rate of return that is equal to the cost of capital (*Id.* at 19-20). According to RUCO, the Commission recently adopted the same methodology in determining the cost of common equity for Southwest Gas Company in Decision No. 68487 (February 23, 2006).

RUCO asserts that the Company's criticism of the CAPM employed by RUCO and Staff is unfounded. RUCO claims that the Company's risk premium analysis is simply a variation of the CAPM, but the RPM fails to account for the additional market-based information that is included in the CAPM. RUCO contends that the estimated return produced by either the CAPM or the RPM is one of a number of factors that investors take into consideration when evaluating a company's stock. RUCO also argues that, despite *Value Line* projections of lower ROEs for water utilities, the Company made no comparable downward adjustment to its original 11.0 percent recommendation. RUCO claims that its cost of capital recommendation is reasonable and should be adopted by the Commission.

Staff's Position

In formulating its ROE recommendation in this case, Staff employed a constant growth DCF model, a multi-stage DCF model, and a two-part CAPM analysis. The two CAPM estimates were based on an historical market risk premium and a current market risk premium. Staff's DCF model produced a ROE of 9.6 percent; the average of its two CAPM results was 9.5 percent; and the average of the DCF and CAPM results was 9.6 percent, which is its recommendation in this proceeding. For purposes of its analysis, Staff selected six publicly traded water companies that derive most of their earnings from regulated operations and which are analyzed by *Value Line* publications (Ex. S-4, at 13)[9].

Staff's cost of capital witness, Pedro Chaves, calculated the growth factor for his DCF model by averaging the results of six growth projection methods[10] (*Id.* at 16). Mr. Chavez explained that the most controversial element of a DCF analysis is the choice of inputs for the growth rate. He stated that Staff's use of both historical and projected EPS, DPS and sustainable growth components provide a balanced outcome that avoids a skewed result which could occur if only historical or projected growth results are analyzed (Ex. S-5, at 4).

In response to BMSC's criticisms, Staff contends that its methodologies reflect a properly balanced analysis compared to the Company's proposal. Staff refutes the Company's claim that it blindly followed the results of its models and argues that Mr. Bourassa used professional judgment inappropriately. According to Staff, its inputs were chosen by identifying available market data, and then analyzing whether investors could be expected to rely on such data prior to inputting the data into its models. Staff argues that the Company's methodology, on the other hand, is results oriented in order to produce the highest ROE result possible. Mr. Chaves testified that Staff selects the dates for its inputs before the date occurs, and attempts to use the most recent dates before its testimony is finalized (Tr. 717-718). Staff also disagrees that its CAPM is subject to manipulation, as suggested by the Company, because it picks dates for the inputs without regard to the end result that will fall out from the analysis.

With respect to the Company's criticism that rising interest rates are not reflected in Staff's cost of capital analysis, Staff contends that three of the CAPM variables do not necessarily move in the same direction at the same time. Although Mr. Chaves conceded that there is a relationship between interest rates and the cost of equity capital, he stated that cost of equity would tend to move

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[9] The six proxy companies chosen by Staff are American States Water, California Water, Aqua America, Connecticut Water, Middlesex Water, and SJW Corp. (*Id.*, Sched. PMC-3).

[10] The six methods involve calculations of historical and projected dividends per share ("DPS"), historical and projected earnings per share ("EPS"), and historical and projected sustainable growth (Ex. S-5, Sched. PMC-7).

in the same direction as interest rates only if all other variables are constant (Tr. 684). According to Mr. Chaves, while interest rates increased between the filing of his direct and surrebuttal testimonies from 3.3 to 4.7 percent, Staff's current MRP declined from 13.1 to 5.7 percent, thereby offsetting the interest rate increase (Tr. 719-722).

Staff asserts that the Commission should reject BMSC's proposed 11.0 percent ROE because it is based on inputs that artificially inflate the required return. Staff points out that the Company's DCF results are identical to Staff's DCF results (*i.e.*, 9.6 percent) (Tr. 144). However, Mr. Bourassa excluded Middlesex Water because its cost of equity was only 40 basis points above the projected cost of Baa investment grade bonds (Ex. A-3, Sched.D-4.9). Mr. Chaves stated that he believed the reason for exclusion of Middlesex was insufficient, and if Middlesex were included in the Company's DCF analysis, the overall results would drop from 9.6 to 9.5 percent (Tr. 712-713; Ex. S-8).

Staff argues that the Company's use of the risk premium and comparable earnings analyses, as well as the Company's size, for purposes of inflating its ROE proposal have been rejected by the Commission in the past. *See, e.g., Southwest Gas Corp.*, Decision No. 68487 (February 23, 2006). Staff claims that BMSC's witness used only forecasted EPS growth estimates, while excluding historical DPS, EPS, and forecasted DPS growth. Staff also points out that although his DCF analysis produced a range of 8.5 to 11.0 percent for the sample group of companies, Mr. Bourassa chose the highest point in that range for his ROE recommendation. Staff therefore recommends that the Commission adopt its 9.6 percent cost of capital recommendation in this proceeding.

<u>Conclusion on Cost of Capital</u>

We believe that Staff's recommended cost of capital achieves an appropriate result that is supported by the evidence in the record. Staff's witness' use of the DCF model as the primary basis for determining the Company's reasonable estimated cost of equity capital is a methodology that has been used for many years by this Commission, as well as other regulatory commissions across the country.

With respect to the methodology employed for calculating the return on common equity, we believe Staff's analysis is appropriate and consistent with prior Commission decisions regarding cost of capital. The companies included in Staff's sample group are appropriate because they have objective data that is publicly available through *Value Line* and other investor publications. We agree with Staff that the Company's proposal to exclude Middlesex Water, because its cost of equity was perceived by the Company to be too low for inclusion in its DCF analysis, is an artificial means of skewing the end result in the Company's favor.

We are not persuaded by the Company's legal arguments that adoption of Staff's cost of equity recommendation would result in a violation of the Commission's authority under the Arizona Constitution, the case law interpreting that authority, or of the *Hope*, *Bluefield, and Duquesne* decisions[11]. Article 15, Section 3 of the Arizona Constitution provides in relevant part that the Commission "shall have full power to, and shall, prescribe just and reasonable classifications to be used and just and reasonable rates and charges to be made and collected, by public service corporations within the State for service rendered therein." In determining just and reasonable rates, the Commission has broad discretion subject to the obligation to ascertain the fair value of the utility's property, and establishing rates that "meet the overall operating costs of the utility and produce a reasonable rate of return." *Scates, et al. v. Arizona Corp. Comm'n*, 118 Ariz. 531, 534, 578 P.2d 612 (Ct. App. 1978). Under the Arizona Constitution, a utility company is entitled to a fair rate of return on the fair value of its properties, "no more and no less." *Litchfield Park Service Co. v. Arizona Corp. Comm'n*, 178 Ariz. 431, 434, 874 P.2d 988 (Ct. App. 1994), *citing Arizona Corp. Comm'n v. Citizens Utilities Co.*, 120 Ariz. 184 (Ct. App. 1978). The oft cited *Hope* and *Bluefield* cases provide that the return determined by the Commission must be equal to an investment with similar risks made at generally the same time, and should be sufficient under efficient management to enable the Company to maintain its credit standing and raise funds needed for the proper discharge of its duties.

For the reasons described above, we believe that adoption of Staff's recommendation for a 9.60 cost of equity capital, which is also its overall cost of capital with a 100 percent equity capital structure, complies with these obligations. Staff's expert witness, although primarily relying on the well-established DCF method for calculating his cost of equity capital, also employed two other tests

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[11] *Federal Power Commission et al. v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia, et al.*, 262 U.S. 679 (1923); *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989).

as a check on the reasonableness of his results. Staff pointed out that the Company's witness arbitrarily excluded one of the companies in his proxy group because inclusion of that company resulted in a lower DCF and ROE result, and thus skewed downward the overall results on his analysis. We believe that adoption of Staff's recommendation results in a just and reasonable return for BMSC based on the record of this proceeding.

We therefore adopt a cost of equity of 9.60 percent, which also results in an overall weighted cost of capital of 9.60 percent.

AUTHORIZED INCREASE

Based on our findings herein, we determine that BMSC is entitled to a gross revenue increase of $141,486.

Fair Value Rate Base	$1,472,969
Adjusted Operating Income	(81)
Required Rate of Return	9.60%
Required Operating Income	$141,405
Operating Income Deficiency	141,486
Gross Revenue Conversion Factor	1.74051
Gross Revenue Increase	$246,257

RATE DESIGN ISSUES

The current monthly customer charge for residential customers is $38.00 with no commodity charge. Regular commercial customers currently pay $0.15236 per gallon of sewer flow (based on ADEQ Engineering average daily flows for various types of customers), and no monthly service charge. In addition, there are 14 special commercial customers that pay a monthly customer charge only, that varies by customer, based on an estimate for each customer's sewer volume flow (Ex. S-9, at 35; Sched. CSB-24).

As updated in their final schedules, the Company and Staff recommended percentage increases of 21.42 percent and 20.41 percent, respectively, be applied to all customers under their existing rate structures (Co. Final Sched. H3; Staff Brief Sched. CSB-25). RUCO recommended that its proposed revenue requirement be applied under the Company's current rate design.

In accordance with the revenue requirement determined above, the increase will be applied to all classes equally. Accordingly, the current residential rate of $38.00 per month will increase by

20.1 percent, to $45.64, and the regular commercial customer rate will increase from $0.15236 to $0.18298, also an increase of 20.1 percent. The special commercial customer rates will be increased by the same percentage.

Refund of Hook-Up Fee Funds

In her Direct Testimony, Staff witness Crystal Brown stated that BMSC's predecessor was authorized in the Decision in 1980 granting the original Certificate of Convenience and Necessity ("CC&N") to charge a hook-up fee. Ms. Brown indicated that at the time the Company was relatively small and had little ability to attract capital needed to build infrastructure and to fund growth (Ex. S-9, at 36). Use of hook-up fee funds is generally limited to costs associated with building infrastructure to serve growth in the utility's service area.

Ms. Brown also pointed out that, in the Company's last rate case (Decision No. 59944), the Commission stated that the Company's hook-up fee may be rescinded for reasons including, but not limited to, "failure to track and account for hook-up fees, misuse of hook-up fees, or no need for additional capital" (*Id.* at 10). During its investigation in this proceeding, Staff discovered that the Company had purchased computer equipment totaling approximately $142,232, vehicles totaling approximately $20,000, and land totaling $451,000 from the hook-up fees (Ex. S-9, at 35-38). Ms. Brown recommended that these funds be refunded to customers (*Id.*).

In his Rebuttal Testimony, Mr. Bourassa proposed a reduction to CIAC of $833,367 to account for $452,467 of land purchased with hook-up fee funds, and $380,900 for unexpended hook-up fees. The Company agreed that this amount should be refunded to customers. Although BMSC does not agree that the identified amounts for land purchases were improper, it agreed with Staff's recommendation to avoid litigation of the issue (Ex. A-2, at 18-22). As a result, the Company's parent would be required to provide paid in capital of $452,467 to replace the hook-up fees used for land purchases (*Id.*). Regarding the remaining $380,900, the refunds will come from funds held in a restricted cash account (*Id.* at 19).

In her Surrebuttal Testimony, Ms. Brown agreed with the Company's proposed refund amount, but disagreed with the Company's recommendation as to how the individual refunds are to be calculated. She stated that the refunds should be calculated based upon the amount contributed by each customer class, and that the Company should "propose an equitable way to calculate the CIAC refunds" (Ex. S-10, at 18). She also indicated that the rates from this case should not go into effect until after the refunds are made.

Mr. Bourassa responded that the proposed refund should be calculated on a per customer basis, irrespective of customer class. He explained that the information regarding contributions by customer class is not available, but since over 92 percent of the customer base is residential and most of the growth is in the residential class, the refund will be made primarily to residential customers (Ex. A-3, at 7-8).

RUCO opposes a refund of any of the hook-up fees. Although RUCO did not file testimony on the issue, at hearing Ms. Diaz Cortez testified that refunding hook-up fees is contrary to the spirit of why the fees were collected in the first place (*i.e.*, to defray costs of future plant) (Tr. 390). RUCO contends that the Company will likely have a need for the accumulated hook-up fees in the future and the Commission should reject the proposal by Staff and the Company to terminate and refund the hook-up fees.

We agree with Staff and the Company that $833,367 should be refunded to customers to account for $452,467 of land purchased with hook-up fee funds, and $380,900 for unexpended hook-up fees. BMSC indicated it does not need the hook-up fee funds to resolve odor problems (see discussion below) because the Company is adequately capitalized to make necessary capital investments for infrastructure (Tr. 470).

We agree with BMSC that the proposed refund should be calculated on a per customer basis, irrespective of customer class. Further, as recommended by Staff, the rates from this case should not go into effect until after the refunds are made.

<u>Withdrawn Staff Alternative Proposal</u>

On the third day of the hearing, Staff witness Marlin Scott, Jr. stated in his direct testimony on the stand that, in response to concerns expressed by the Town and customers, Staff proposed that instead of refunding the hook-up fees, perhaps those funds could be used to fund system improvements needed to alleviate noise and odor problems described at the hearing (see discussion below) (Tr. 617-618). Because Staff developed the alternative recommendation on the morning of the third day of the hearing, it did not have any specific ideas of how the proposal may be accomplished. The Administrative Law Judge therefore directed Staff to file a written description of its alternative recommendation prior to the close of the hearing (Tr. 624).

Staff decided to withdraw its alternative recommendation and, on the final day of the hearing, a discussion occurred regarding the issue (Tr. 653-674). In general terms, RUCO, the Town and the Boulders HOA were interested in pursuing the Staff alternative. However, the Company objected to Staff's "eleventh hour" proposal and to the attempt by the Town and the HOA to resurrect the issue after it was withdrawn by Staff (*Id.*). The Company also raised the issue of whether the hook-up fee funds could legally be used for the purposes suggested in Staff's alternative. In any event, the Company represented that financial resources to make necessary system improvements are not lacking (Tr. 470).

Given Staff's withdrawal of its alternative recommendation, the hearing concluded without further consideration of the proposal.

OTHER ISSUES

Odor Issues

The most contentious issue in this proceeding involves claims made by a number of the Company's customers, as well as the Town of Carefree and the Boulders HOA, that the BMSC system emits significant odors. For the Town and the HOA, the odor problem was the only issue pursued. In addition to Mr. Williams on behalf of the Boulders HOA, public comment was given at the hearing by seven customers, each of whom described various experiences regarding odors at their properties due to the BMSC wastewater system (Tr. 30-80). In addition, a number of other customers submitted written comments or contacted the Commission's Consumer Services Division to register complaints regarding odors and/or the Company's proposed rate increase.

In response to the odor complaints, the Company initially took the position that any odor problems that may exist were not related to the BMSC system (Ex. A-6, at 2). In its rejoinder testimony, the Company's witness indicated that BMSC does not have an odor problem, "it has an odor complaint problem" (Ex. A-7, at 1). In opening statements, the Company's counsel reiterated BMSC's position that "we don't have a problem with odors; we have a problem with odor complaints" (Tr. 15). During cross-examination, the Company's position appeared to soften as evidenced by the testimony given by Robert Dodds, APIF's director of operations and president of several of Algonquin's operating companies. Although Mr. Dodds was hesitant to commit unlimited resources to resolve the odor issues, he conceded that "there is an issue [and] obviously customers are smelling odors" (Tr. 482). However, in its initial post-hearing brief the Company appeared to move closer to its pre-hearing position, arguing that it is not possible to set a standard that would satisfy everyone, "[n]or is it possible to eliminate odors from a wastewater collection and treatment system" (BMSC Closing Brief, at 4). In response to arguments by the Town and the HOA that rate relief should be delayed until the odor issues are resolved, or that conditions should be imposed in conjunction with any rate increase granted in this case, the Company argues that the Commission should defer to the Maricopa County Environmental Services Department ("MCESD") which has determined that the Company meets the applicable odor control standards (*Id.* at 5).

Cause of Odors

Based on the public comments received, as well as the sworn testimony presented by various witnesses, there appears to be general agreement that the odor problems reported by customers stem from two separate sources, the CIE Lift Station and the wastewater line that flows under Boulder Drive in the Boulders subdivision.

CIE Lift Station

During prior updates to the wastewater system by BMSC's predecessor, all but one of the older lift stations (CIE lift station) was replaced. Operational problems at the CIE lift station have caused frequent odor issues and have required the Company to pump raw sewage from the site into trucks, which then deposit the sewage into other locations in the system. The Town's witness, Stan Francom stated that the CIE lift station should be replaced or bypassed because of regular breakdowns at the facility, and the inability to continue patching the lift station to keep it operational (Tr. 292, 334). An engineering report commissioned by the Town ("Carter Burgess Report") recommended replacing the CIE Lift Station due to operational problems (Ex. T-3, Ex. A., at 14).

BMSC witness Dodds also recognized the problems associated with the CIE Lift Station and indicated that the Company was studying ways to bypass or eliminate the facility (Tr. 466-467). The

Company attached to its initial Closing Brief an agreement dated August 9, 2006 between Algonquin and an engineering company to eliminate and bypass the CIE Lift Station (BMSC Closing Brief, Ex. 2).

Given the Company's decision to eliminate the CIE Lift Station, that particular source of odors should be eliminated in the near future. The Company should notify the Commission and all other parties, within 30 days of the effective date of this Decision, as to the status of the CIE Lift Station project and projected completion date. The project should be completed within 180 days of the effective date of this Decision unless an extension is granted upon an appropriate timely request.

Boulders Community

The more complicated odor issue involves ongoing complaints by residents in the Boulders subdivision, especially along Boulders Drive where the sewer line flows from the CIE Lift Station to the Boulders wastewater treatment plant ("Boulders WWTP" or "WWTP"). According to Carefree witness Francom, the odors in the Boulders community are attributable to two problems: the long retention time that sewage sits in the Boulders line, thereby allowing the sewage to become septic (Tr. 283-285); and "positive pressure" between the CIE Lift Station and the Boulders WWTP due to the fact that the lines between the lift station and discharge manholes in the Boulders community are pressurized, but are gravity lines from the Boulders manholes to the WWTP (*Id.*). Mr. Francom explained that, once sewage is released suddenly into the Boulders discharge manholes, turbulence is created because the sewage displaces gasses within the system thereby pushing odors out into the community through any gaps, such as unsealed manhole covers or residential vent stacks (Id. at 286).

The Town asserts that Mr. Francom's analysis is confirmed by an engineering study by Lamb Technical Services, Inc. ("LTS Report"), which was commissioned by BMSC (Ex. A-6, Ex. 1, Attach. F). The LTS Report indicated that hydrogen sulfide concentrations are "extremely high" at the locations where the force mains discharge into the gravity lines upstream from the WWTP, and those locations "had positive pressures that tend to drive the odors and hydrogen sulfide concentrations out through the manhole cover pickholes" (*Id.*). The LTS Report noted that the Company's addition of the chemical treatment Thioguard in the Boulders area was partially successful in reducing hydrogen sulfide concentrations. However, LTS indicated that even with those reductions the odors being driven out of residential vent stacks were still significant, and a redesign at the Boulder/Quartz discharge location "is recommended if turbulence could be reduced" (*Id.* at 5). The LTS Report stated that "[e]ven with reduced concentrations due to less turbulence a fan generating negative pressures will still most likely be needed at the Quartz and Boulder Drive location to prevent odors from being forced out the local vent stacks" (*Id.*).

Mr. Francom testified that there were two possible solutions to the Boulders odor problems: replacement of the gravity flow lines with pressure lines all the way to the Boulders WWTP; or installation of fans and carbon filters to create a negative pressure filtration system within the sewer lines between the discharge manholes and the WWTP (Tr. 334-335). Mr. Francom pointed out that the Town offered to install a temporary fan system to test the effectiveness of that method of odor remediation, but the offer was previously rejected by the Company on the basis that no odor problems existed (Tr. 315-318).

BMSC contends that it takes the odor complaints seriously and has been taking reasonable steps to address those complaints. The Company states that AWRA has invested more than $1.4 million on system improvements, much of which was designed to address odor issues (Ex. A-4, at 4). The Company argues that the standards suggested by the Town and the HOA for resolving the odor issues are too vague, because they would presumably require every customer to be totally satisfied, possibly well in excess of applicable government standards. BMSC argues that the public comment relied upon by the Town and HOA is not evidence in this proceeding, and the Company points out that it has never been found to be in violation of MCESD odor regulations (Tr. 322-323, 354, 620). The Company asserts that it would be unfair for the Commission to impose additional requirements, especially when such requirements may be beyond the Commission's jurisdiction. The Company claims that it has already addressed the odor problems by starting to remove the CIE Lift Station, and that it is willing to commence "yet another engineering study to evaluate allegations of continuing odors from facilities located within Boulders Drive" (BMSC Reply Brief, at 6). However, BMSC argues that ordering the specific steps recommended by the Town and HOA is "not related to ratemaking, and in the absence of any evidence that BMSC's operations violate the governing standards, would constitute improper interference with management of the utility" (*Id.*).

The Town and the Boulders HOA cite to several statutes that they argue give the Commission authority to impose remedial measures in cases such as this. Pursuant to A.R.S. §40-361(B), the intervenors argue that BMSC is obligated to "furnish and maintain such service, equipment and facilities as will promote the safety, health, comfort and convenience of its patrons...." They also contend that, under A.R.S. §40-334(B), BMSC may not "maintain any unreasonable difference as to ... service, facilities or in any other respect, either between localities...." The Town argues that this provision is applicable because customers in different areas of the BMSC service territory are affected by odors disproportionately. The intervenors further claim that Maricopa County regulations prohibit wastewater treatment facilities from producing air pollution that unreasonably interferes with property owners' enjoyment of life or property.

The Town claims that its recommendations are not vague because they propose specific remedies for resolving the odor issues raised in this proceeding. Therefore, Carefree requests that a condition be placed on any rate increase granted to BMSC requiring the Company to either replace the gravity line discussed above with pressure lines and/or install fans and carbon filters to create a negative filtration system between the Boulders discharge manhole and the Boulders WWTP. The HOA also argues that any rate increase granted in this case should be conditioned on BMSC being required to undertake an audit of the Company's sewer system; if the hook-up fee refund plan is rejected, all funds derived from the rate increase should be escrowed and used only for system improvements; an independent audit of BMSC's management structure should be conducted; the $833,000 in hook-up fees should be used to fix the odor problems identified in this case; the Town's grease trap ordinance inspection and compliance reports should be monitored and publicized; and an expedited hearing should be conducted if BMSC fails to comply with the proposed conditions.

<u>Resolution</u>

We believe the evidentiary record in this case amply supports the appropriateness of, and the need for, imposition of odor remediation requirements as a condition of granting the rate relief approved herein. We turn first to the evidentiary standard for dealing with public comment since that issue was raised by the Company in its post-hearing Brief. Although we agree with BMSC that unsworn public comments made by ratepayers are not treated as evidence in a strict sense, we believe ratepayer input is important to consider as an indication of how customers view the operations of a regulated utility company. For example, it may not be appropriate to rely solely on unsubstantiated claims made in public comments, because such comments are not subject to cross-examination. However, if corroborating sworn testimony or documentary evidence is presented in the course of the hearing, it is entirely appropriate to treat the public comments as an indicator of customer perception and experience in dealing with regulated monopoly utility companies. Indeed, such comments are invaluable for the Commission to understand both positive and negative experiences of customers, especially since those customers have no choice but to take service from the utility holding an exclusive Certificate to provide service.

We disagree with BMSC that the intervenor proposals are impossibly vague and would impose an undue compliance burden on the Company. As the Town points out, at least one of its proposed remedies for reducing odors in the Boulders subdivision was cited in both the Carter Burgess Report and LTS Report. The evidence in the record suggests that, despite the Company's attempts to solve the odor problems in that area through the introduction of Thioguard, there is an ongoing problem that cannot be solved by chemical injections alone. In addition to replacement of the CIE Lift Station, the prior engineering studies appear to have pinpointed not only the remaining cause of the odor problems (*i.e.*, pumping of sewage into the Boulders discharge manhole), but a possible solution (*i.e.*, fans to create negative pressure in the line leading from the Boulders manhole to the WWTP). Mr. Francom indicated that another solution may be the installation of a pressurized line to the WWTP, to replace the existing gravity line. As such, it is hardly requires speculation to address the source of, and the solution for, the odor issues in the Boulders community. Rather, there is ample record evidence to support the conclusion that the Company should take action consistent with the prior engineering reports, as well as the credible testimony presented by the Town's witness, in order to remedy the odor problems discussed herein.

We are not persuaded by the Company's arguments that the Commission is without authority to take action to protect the public health and welfare of customers served by utilities under its jurisdiction. With respect to a public service corporation's adequacy of service, A.R.S. §40-321(A) states:

> When the commission finds that the equipment, appliances, facilities or service of any public service corporation, or the methods of manufacture, distribution, transmission, storage or supply employed by it are unjust, unreasonable, unsafe, improper, inadequate or insufficient, the commission shall determine what is just, reasonable, safe, proper, adequate or sufficient, and shall enforce its determination by order or regulation.

As set forth in A.R.S. §40-331(A):

> When the Commission finds that additions or improvements to or changes in the existing plant or physical property of a public service corporation ought reasonably to be made, or that a new structure or structures should be erected, to promote the security or convenience of its employees or the public, the commission shall make and serve an order directing that such changes be made or such structure be erected in the manner and within the time specified in the order. If the commission orders erection of a new structure, it may also fix the site thereof.

In addition, A.R.S. §40-361(B) provides as follows:

> Every public service corporation shall furnish and maintain such service, equipment and facilities as will promote the safety, health, comfort and convenience of its patrons, employees and the public, and as will be in all respects adequate, efficient and reasonable.

As these statutes make abundantly clear, the Commission has the authority and the duty to protect the health, safety and welfare of a public service corporation's customers. And, contrary to BMSC's "micromanagement" arguments, the law just as clearly states that in order to protect the security or convenience of the public, the Commission may specify not only the type of facilities that are required, but the timeframe in which the facilities must be constructed.

A.R.S. §40-202(A), provides additional supervisory authority to the Commission for regulation of public service corporations[12]. The authority granted to the Commission under these statutes, as well as the Commission's constitutional powers pursuant to Article 15, §3 of the Arizona Constitution, was discussed in *Arizona Corp. Comm'n v. Palm Springs Utility Co., Inc.*, 24 Ariz. App. 124, 128, 536 P.2d 245, 249 (App. 1975). In that case, the court held that "the regulatory powers of the Commission are not limited to making orders respecting the health and safety, but also

[12] A.R.S. §40-202(A), provides in relevant part: "The commission may supervise and regulate every public service corporation in the state and do all things, whether specifically designated in this title or in addition thereto, necessary and convenient in the exercise of that power and jurisdiction."

include the power to make orders respecting comfort, convenience, adequacy and reasonableness of service…." (*Id.*). Given our determination that our constitutional and statutory powers provide the requisite authority to require actions by the Company to resolve the odor problems cited herein, we need not decide whether the Maricopa County rules and regulations cited by the intervenors are implicated by the facts presented in this case.

Having determined that the record supports a finding that odor problems exist on the BMSC system, and that we have legal authority to craft a remedy for those problems, we turn next to the appropriate directives that should be given to the Company as a condition of our approval of the rate increase discussed hereinabove. We find that the Boulders odor problems should be addressed by the Company's adoption of one of the two solutions suggested by Mr. Francom. As he explained on the record, the odors being experienced by members of that community may be solved by implementing a pressurized line to replace the gravity line that currently exists between the Boulders discharge manhole and the Boulders WWTP, or by installing fans and carbon filters to create a negative pressure filtration system between the Boulders discharge manhole and the Boulders WWTP[13].

The implementation of these remedies should be completed within 180 days of the effective date of this Decision although, for good cause shown and with the agreement of all other parties to this proceeding, the timeline may be extended by the Commission upon timely receipt of a request for extension of time. We also wish to make clear that failure by BMSC to comply with this order, or to otherwise continue to operate its system in a manner that fails to reasonably mitigate odors affecting customer residences and properties, may result in penalties or other action deemed necessary by the Commission to enforce this Decision.

By imposing this requirement, we wish to make clear that we are not attempting to manage the Company's affairs. However, based on the record, we believe action needs to be taken to advance a solution that will enable all customers on the BMSC system to enjoy fully their property without enduring offensive odors.

* * * * * * * * * *

[13] With the mutual agreement of all other parties to this proceeding, an alternative remedy may be employed to accomplish the desired goal of odor remediation in the Boulders community.

Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

FINDINGS OF FACT

1. On September 16, 2005, BMSC filed an application with the Commission for an increase in rates.

2. On October 14, 2005, the Commission's Utilities Division Staff filed a Letter of Insufficiency.

3. Following an agreement between the Company and Staff regarding the submission of information, Staff issued a Letter of Sufficiency on November 1, 2005, and classified BMSC as a Class B utility.

4. By Procedural Order issued November 2, 2005, procedural timeframes were established and a hearing was scheduled to commence on June 7, 2006.

5. Intervention was granted to RUCO, the Town of Carefree, the Boulders HOA, and M.M. Schirtzinger.

6. On December 30, 2005, BMSC filed a "simplified cost of service study" as requested by Staff.

7. On January 24, 2006, BMSC filed a Certification of Publication and Proof of Mailing, attesting to compliance with the notice requirements set forth in the November 2, 2005 Procedural Order.

8. With its application, BMSC filed the Direct Testimony of Michael Weber and Thomas Bourassa, and, on March 9, 2006, Staff filed the Direct Testimony of Crystal Brown, Marlin Scott, Jr., and Pedro Chaves; RUCO filed the Direct Testimony of William Rigsby and Marylee Diaz Cortez; and Carefree filed Affidavits of Stan Francom, Jonathon Pearson, and Jason Bethke, as well as several attachments.

9. On April 6, 2006, BMSC filed the Rebuttal Testimony of Michael Weber, Joel Wade, and Thomas Bourassa. On May 4, 2006, Staff filed the Surrebuttal Testimony of Marlin Scott, Jr., and Pedro Chaves; RUCO filed the Surrebuttal Testimony of William Rigsby and Marylee Diaz Cortez; and Carefree filed the Surrebuttal Testimony of Stan Francom and Jonathon Pearson. On

May 5, 2006, Staff filed the Surrebuttal Testimony of Crystal Brown. On May 26, 2006, BMSC filed the Rejoinder Testimony of Joel Wade and Thomas Bourassa.

10. The hearing commenced on June 7, 2006, and additional hearing days were held on June 8, 9, and 20, 2006.

11. On June 15, 2006, Staff filed updated Surrebuttal Schedules. On July 26, 2006, Staff filed Post-Hearing Recommendations based on documentation provided by the Company on June 22, 2006.

12. Initial Post-Hearing Briefs were filed on August 18, 2006 by the Boulders HOA, and on August 21, 2006 by BMSC, Staff, RUCO, and Carefree.

13. Reply Briefs were filed on September 5, 2006 by BMSC, Staff, RUCO, Carefree, and the Boulders HOA.

14. According to the Company's application, as modified, in the test year ending December 31, 2005, BMSC had adjusted operating income of $11,595 on an adjusted FVRB and OCRB of $1,568,502, for a 0.74 percent rate of return.

15. In its application, as modified, the Company requested a gross revenue increase of $256,063 (21.54 percent), based on OCRB of $1,568,502, and a recommended return on common equity of 11.00 percent.

16. Staff recommends a gross revenue increase of $250,195 (20.76 percent), based on OCRB of $1,550,710, and a recommended return on common equity of 9.60 percent.

17. RUCO recommends a gross revenue increase of $5,470 (0.45 percent), based on OCRB of $1,372,834, and a recommended return on common equity of 9.45 percent.

18. For purposes of this proceeding, we determine that BMSC has a FVRB and OCRB of $1,472,969.

19. A rate of return on FVRB of 9.60 percent, based on a capital structure of 100 percent common equity, is reasonable and appropriate.

20. BMSC is entitled to a gross revenue increase of $246,257.

21. The rate design recommended by Staff should be adopted in this proceeding.

22. Staff's recommendation to exclude affiliate profits is adopted, and no finding is made

regarding the reasonableness of the Algonquin affiliate structure. In future cases involving the Algonquin companies, the Commission will scrutinize all affiliate salaries, expenses and billings.

23. The record supports a finding that customers should be refunded $833,367 for hook-up fees that were used to purchase land and that have not been expended. The refunds should be distributed in the manner proposed by the Company, on a per customer basis irrespective of customer class. The rates granted in this Decision should not go into effect until the refunds have been distributed.

24. The record supports a finding that BMSC should, within 30 days, notify the Commission and all other parties as to the status of the CIE Lift Station project and projected completion date.

25. The record supports a finding that odor problems exist on BMSC's system, and that the steps taken by the Company to date have not been sufficient to resolve the problems. BMSC should therefore be required to pursue one of the remedies proposed by the Town of Carefree in order to mitigate the odor problems that currently exist in the Boulders community. The implementation of the remedies should be completed within 180 days from the effective date of this Decision.

CONCLUSIONS OF LAW

1. BMSC is a public service corporation within the meaning of Article XV of the Arizona Constitution and A.R.S. §§40-250, 40-251, 40-367, 40-202, 40-321, 40-331, and 40-361.

2. The Commission has jurisdiction over BMSC and the subject matter contained in the Company's rate application.

3. Pursuant to A.R.S. §§40-202(A), 40-321(A), 40-331(A), 40-361(B), and the authority under Article 15 of the Arizona Constitution, the Commission has jurisdiction to impose requirements for public service corporations to improve and repair facilities necessary to protect the health and safety of the public, and provide for the comfort and convenience of customers.

4. The rates, charges and conditions of service established herein are just and reasonable and in the public interest.

ORDER

IT IS THEREFORE ORDERED that Black Mountain Sewer Corporation is hereby authorized and directed to file with the Commission, on or before November 30, 2006, revised schedules of rates and charges consistent with the discussion herein, as set forth below.

Residential Service – Per Month	$45.64
Commercial - Regular (c)	$0.18298

Commercial – Special Rates	Gallons Per Day	Rate Per Day	Monthly Charge
Name of Business			
BH Enterprises – West	2,525	$0.14034	$354.35
BH Enterprises – East	1,400	$0.14034	$196.47
Barb's Pet Grooming	250	$0.14034	$35.08
Boulders Resort	29,345	$0.14223	$4,173.87
Carefree Dental	1,625	$0.14034	$228.05
Ridgecrest Realty	450	$0.14193	$63.87
Desert Forest	7,000	$0.16344	$1,144.11
Desert Hills Pharmacy	800	$0.17061	$136.49
El Pedregal	15,787	$0.14034	$2,215.50
Lemon Tree	300	$0.13691	$41.07
Body Shop	1,000	$0.17467	$174.67
Spanish Village	4,985	$0.14034	$699.58
Boulders Club	1,200	$0.14034	$168.40
Anthony Vuitaggio	300	$015597	$46.79

Effluent Sales	
Per thousand gallons	$0.374400

Service Charges	
Establishment	$25.00
Re-establishment	$25.00
Re-connection	No Charge
Minimum Deposit (Residential)	(a)
Minimum Deposit (Non-Residential)	(a)
Deposit Interest	(a)
NSF Check Charge	$10.00
Deferred Payment Finance Charge	1.50%
Late Charge	1.50%
Main Extension Tariff (b)	Cost
Hook-up Fee for New Service	Discontinue

(a) Per A.A.C. R14-2-603B; Residential – two times average bill, Non-residential – two and one-half times average bill;

(b) Per A.A.C. R14-2-406(B);

(c) Per Gallon per Day. Wastewater flows are based on Engineering Bulletin 12, Table 1 for purposes of determining a monthly charge for individual customers on this rate.

IT IS FURTHER ORDERED that the revised schedules of rates and charges shall be effective for all service rendered on and after December 1, 2006, subject to the requirement that Black Mountain Sewer Corporation has mailed to each customer prior to that date a refund check for the hook-up fee funds, consistent with and in the manner described hereinabove. The new rates may not go into effect until the Company has provided, to the satisfaction of the Director of the Utilities Division, sufficient information to show that the refunds have been issued in accordance with the discussion set forth herein.

IT IS FURTHER ORDERED that Black Mountain Sewer Corporation shall notify its customers of the revised schedules of rates and charges authorized herein by means of an insert in its next regularly scheduled billing, or by separate mailing, in a form acceptable to Staff.

IT IS FURTHER ORDERED that Black Mountain Sewer Corporation shall, within 30 days of the effective date of this Decision, notify the Commission and all other parties as to the status of the CIE Lift Station project and projected completion date. The project shall be completed within 180 days of the effective date of this Decision unless an extension is granted upon an appropriate timely request.

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IT IS FURTHER ORDERED that Black Mountain Sewer Corporation shall pursue one of the remedies proposed by the Town of Carefree in order to mitigate the odor problems that currently exist in the Boulders community, and notify the Commission and all parties, within 90 days, regarding the option chosen through a filing in this docket. The implementation of the remedies shall be completed within 180 days from the effective date of this Decision unless an extension is granted upon an appropriate request. The Company shall file as a compliance item in this docket, notification of completion of the Boulders community odor mitigation project, within 30 days of completion of the project.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN COMMISSIONER

COMMISSIONER COMMISSIONER COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Director of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this _____ day of _________, 2006.

BRIAN C. McNEIL
EXECUTIVE DIRECTOR

DISSENT ______________________

DISSENT ______________________

DECISION NO. ___________

SERVICE LIST FOR: BLACK MOUNTAIN SEWER CORPORATION

DOCKET NO.: SW-02361A-05-0657

Jay Shapiro
FENNEMORE CRAIG, P.C.
3003 North Central Avenue, Ste. 2600
Phoenix, AZ 85012
Attorneys for Black Mountain Sewer Corporation

Daniel Pozefsky, Attorney
RUCO
1110 West Washington Street, Ste. 220
Phoenix, AZ 85007

Robert E. Williams
P.O. Box 1170
Carefree, AZ 85377

M. M. Shirtzinger
34773 N. Indian Camp Trail
Scottsdale, AZ 85262

Thomas K. Chenal
David W. Garbarino
MOHR, HACKETT, PEDERSON,
BLAKLEY & RANDOLPH, P.C.
7047 East Greenway Parkway, Ste. 155
Scottsdale, AZ 85254
Attorneys for the Town of Carefree

Christopher Kempley, Chief Counsel
Keith Layton, Attorney
Legal Division
ARIZONA CORPORATION COMMISSION
1200 West Washington Street
Phoenix, AZ 85007

Ernest G. Johnson, Director
Utilities Division
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, AZ 85007