OPEN MEETING AGENDA ITEM

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BEFORE THE ARIZONA CORPORATION COMMISSION

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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

EXCEPTIONS OF THE RESIDENTIAL UTILITY CONSUMER OFFICE

The Residential Utility Consumer Office ("RUCO") makes the following Exceptions to the Recommended Opinion and Order ("ROO") on Black Mountain Sewer Corporation's ("Black Mountain" or "Company") application for a rate increase. When all is said and done, the ROO recommends a gross revenue increase of $82,978 more than what the Company was asking for in its original Application[1].

ACCUMULATED DEFERRED INCOME TAXES ("ADIT")

The ROO recommends the adoption of the Company's and Staff's recommendation of $164,000 ***net deferred income tax asset***. The ROO offers no explanation for its

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[1] The Company originally requested a revenue increase of $163,279 or 13.52%. The ROO recommends a gross revenue increase of $246,257.

recommendation other than its reliance on Staff's interpretation of what the Company represented to RUCO in response to a data request. The ROO's reliance is misplaced and the result is unfair to ratepayers.

In its application, the Company's proposed rate base reflected a zero balance for Accumulated Deferred Income Taxes ("ADIT".) With few exceptions, RUCO is not aware of any Arizona utility filing a rate application that has proposed a rate base with no ADIT. Normally, utilities report ADIT as a liability. RUCO, in a data request, asked the Company about it and was advised that the Company filed a consolidated tax return with its parent Company – Algonquin – and the ADIT balance resided on Algonquin's balance sheet.

The majority of Arizona's larger utilities, and many of its smaller utilities, have parent company structures and file consolidated tax returns. The practice of filing consolidated tax returns is common in the industry, and these utilities apportion their percentage of their ADIT in their rate base. And for at least five of Arizona's larger utilities that have parent company structures, their recent rate applications indicate an ADIT liability. Transcript at 102-106. RUCO referred to the parent Company's **audited** 2004 annual report, and identified the consolidated ADIT balance for the parent company as a whole. RUCO then allocated a portion back to the Company, based on the ratio of the purchase price of the Company to the parent company's total assets. The result is RUCO's recommendation of a $161,250 ADIT liability (i.e. reduction in rate base).

Staff followed up on RUCO's ADIT inquiry, and received information back from the Company indicating a $164,000 ADIT asset. Staff relied on the Company's figures and recommended a $164,000 rate base increase as its ADIT adjustment. Not surprisingly, the Company changed its position and joined in Staff's recommendation.

The Company's change of position late in the proceeding was, at best, highly suspect. The Company, a highly sophisticated sewer utility, claims that it overlooked an ADIT adjustment that would have increased its rate base by $164,000 in its original filing – a clear benefit to the Company. Then, after the Company realized its oversight and had reviewed Staff's reasons for including the ADIT asset, the Company changed its position and concurred with Staff. Staff, however, provided no reason for its recommendation, other than it relied on the Company's representation that its ADIT balance netted out to a $164,000 asset. There is nothing on the books or in the Company's records provided to the parties that supported the Company's figures, as can be more fully seen by the attached copy of the Company's data request response which it provided in support of its ADIT figure. (This attachment is Exhibit 2 of the Company's Exhibit A-2 in the underlying record). Moreover, the Company readily admits that nowhere on its 2002, 2003 and 2004 financial statements was there an entry for an ADIT asset. There is no basis to support the ROO's recommendation, and it should be rejected by the Commission.

It is not coincidence that utilities almost always report an ADIT liability. Simply stated, ADIT is just what its name implies – a deferred tax. The Company still owes the tax, it does not go away – it is still a liability. RUCO reviewed the Company's parent's ADIT balance, noted that it was a liability as is usually the case, and apportioned it accordingly. RUCO's methodology is the custom in the industry and the practice of this Commission, and is the best and most reasonable methodology for determining the Company's ADIT adjustment. The Commission should adopt RUCO's recommended ADIT adjustment of ($161,250).

THE SCOTTSDALE CAPACITY

A large percentage[2] of the recommended revenue increase is the result of the ROO's recommended treatment of the Scottsdale capacity as an operating lease. The issue focuses on the appropriate ratemaking treatment of an agreement between the Company's predecessor, Boulders Carefree Sewer Company ("Boulders") and the City of Scottsdale ("City") dating back to 1995. The City agreed to treat and deliver a percentage of Boulder's wastewater flows, provided the Company purchased a portion of the City's Wastewater capacity.

In order to understand how the Commission originally handled this matter and to put this issue in a proper context, it is necessary to provide background. The issue dates back to the Company's last rate case, which was decided in two phases in 1995 and 1996. In that case, Boulders applied for, among other things, ratemaking treatment of the Scottsdale Capacity. Boulders purchased the capacity from the City of Scottsdale with the proceeds of a loan it obtained from its parent Company at the time – Boulders Joint Venture. Boulders had originally entered into negotiations with the City in 1989 and had not finalized an agreement prior to the filing of its previous rate case on January 6, 1995. Since there was not a finalized agreement, it was not possible for the Commission to incorporate the Scottsdale Capacity into a fair value finding until such time as the costs became known and measurable. The parties reached an agreement on the other aspects of the rate application, and agreed to hold the docket open for the limited purpose of deciding the ratemaking treatment of the Scottsdale Capacity and the related financing.

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[2] RUCO's adjustment on this issue removes $189,622 of fictitious lease expense from the Company's Income Statement.

The Commission approved the settlement agreement. Decision No. 59166 (July 20, 1995).

Thereafter, Boulders and the City of Scottsdale finalized a capacity agreement and the capacity issue was brought back before the Commission. The Company and RUCO both argued that the Scottsdale Capacity should be put into rate base and treated just like any other asset purchase. Staff, however, took a very narrow view of the Commission's previous Decision (Decision No. 59166) holding the docket open and did not want to make a recommendation that would amend the Commission's previous fair value finding. Despite the fact that the Company actually owned the capacity, Staff recommended that the capacity be treated as an operating lease because doing so had the effect of isolating the capacity issue from any other issue, including the Commission's previous fair value finding. The Commission adopted Staff's illusory "operating lease" recommendation noting that Staff's recommendation "most nearly complies with the procedure outlined in the Settlement Agreement to govern this phase of the case". Calling the loan an "operating lease" in the Company's last rate case was merely an expedient mechanism to incorporate the capacity into rates without amending the Company's fair value rate base.

In March 2001, Algonquin Water Resources of America, Inc. ("Algonquin") purchased the stock of Boulders. The purchase was financed with equity from Algonquin and debt from Black Mountain to Algonquin (promissory notes). The debt and equity are the capitalization that supports all of the assets of what is now Black Mountain Sewer Corporation, including the Scottsdale Capacity.

The ROO recommends the Commission continue with the status quo and not change the ratemaking treatment. According to the ROO, "To switch ratemaking treatment after more than a decade would be arbitrary and inherently unfair to the Company." The

ROO ignores the fact that the circumstances have changed, and that the Company would not be prejudiced by changing the ratemaking treatment.

The circumstances have changed since the last rate case, and the nexus connecting the capacity to an "operating lease" is even farther divorced from reality. The loan no longer exists between Boulders and its parent. The combination of debt and equity utilized to purchase the present company has not been, nor can it be, apportioned specifically to the treatment capacity. The Company now has an asset on its balance sheet supported by a combination of debt and equity which cannot be specifically apportioned to the treatment capacity[3]. The Commission should recognize the change in circumstances and treat the capacity as an asset for ratemaking purposes.

It is perfectly appropriate for the Commission to revise a previously adopted ratemaking treatment when circumstances have changed. For example, the Commission removes plant from rate base if it is no longer used to provide utility service, even if the utility continues to own the plant. Here, the circumstances that were the foundation of the "operating lease" treatment – the desire to not amend the fair value finding of Decision 59166, and the specifically-identifiable loan from the Boulders' parent to finance the capacity acquisition – have vanished. Thus, it is appropriate to treat the Scottsdale Capacity as an asset and include it in the Company's rate base. Changing the ratemaking treatment at this time, and under these circumstances, would not be arbitrary.

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[3] It has been suggested that if RUCO disagreed with the Commission's prior order regarding the capacity (Decision No. 59944), RUCO's remedy was through the appellate process. The issue is not whether the operating lease treatment was appropriate in 1996, but whether it remains appropriate today in light of the unusual procedural posture of the issue in 1996, and the vastly changed circumstances. In 1996, the Commission approved the operating lease methodology because it found that that approach most closely complied with the procedural requirements set forth in the Commission's Decision in the first phase of the proceeding in 1995.

It would also not be unfair to the Company to change the ratemaking treatment at this time. Affording the proper ratemaking treatment will still enable the Company to recover its costs associated with the capacity. The purchased treatment capacity will be treated as a utility asset and included in rate base, which will allow the Company to earn the Commission-approved rate of return on it. Through RUCO's recommended level of depreciation and amortization expense, the Company will fully recover the principal portion of the loan and will have the opportunity to recover the interest associated with the loan as a below-the-line expense that will reduce the Company's income tax liability. Moreover, if the capacity is rate based, there would be no need for the Company consultant's gross-up adjustment on the principal portion of the loans since the loans, and the asset (i.e. Scottsdale treatment capacity) that were purchased by the Company will be treated as they would under normal ratemaking practice. The Company would not be prejudiced by now affording the proper rate-based treatment of the Scottsdale Capacity.

In truth, the unfairness with maintaining the status quo would inure to the detriment of the ratepayers for several reasons. First, when Algonquin purchased the stock of Boulders, it had no basis to believe that the Commission would be forever bound to the accounting treatment it approved in Decision No. 59944. The Company did not assume it was forever bound by the rates the Commission approved in the Company's last rate case, so it should not expect the Commission would be bound by its Decision regarding the non-existent operating lease. Every Company knows that there is risk in filing a rate case. In any given application, the Commission can reject a Company's request, or even lower its rates. Everything, unless stated otherwise by the Commission, is subject to change depending on the circumstances. The Company's circumstances have changed, and the Commission should set rates that reflect the changed circumstances.

Second, *the Company does not have an "operating lease" with the City of Scottsdale*. From a regulatory accounting perspective, the capacity is an asset, and not an operating lease. It does not make sense to continue to treat the capacity as something other than what it is because 10 years ago the Commission did not want to amend a fair value finding, and felt procedurally restricted to consider the capacity as an operating lease. Moreover, it is bad policy, and has never been the policy of the Commission to blindly and recklessly adhere to a convenient fiction from a previous Decision, and ignore current and changed circumstances.

Finally, the continued treatment of the capacity as an "operating lease" deprives ratepayers of the credit for that portion of the capacity for which ratepayers have already paid. While ratepayers are paying for 5% of this plant capacity each year through "operating lease" expense, the "operating lease" methodology never provides credit for the portion of the capacity that ratepayers have already paid for. When the correct ratemaking methodology is used to account for this capacity, that credit is reflected in the Accumulated Depreciation balance that serves to decrease rate base and, in turn, decrease rates. The "operating lease" methodology robs ratepayers of this credit. The Commission should recognize the change in circumstances that has taken place in the last ten years and treat the Scottsdale Capacity as an asset purchase and allow it in ratebase.

PROPERTY TAX EXPENSE

The ROO rejects RUCO's property tax recommendation. RUCO has unsuccessfully argued its position before this Commission on numerous occasions and RUCO still maintains that its methodology results in the most accurate estimate of property tax. Simply stated, RUCO's methodology is the same methodology using the same inputs that the Arizona Department of Revenue ("ADOR") developed at the request of the association of Arizona's water utilities back in 2001. The ROO discredits RUCO's recommendation by citing several Decisions where the Commission has rejected RUCO's proposed methodology.

The ROO, relying on the Commission's prior decision in *Chaparral City Water Company*, Decision No. 68176, notes that RUCO's methodology unfairly and unreasonably understates property tax expense. The ROO's conclusion appears to be based on its misplaced and unsupported supposition that RUCO's methodology does not recognize the increase that will be granted in this rate case. That increase, however, will not have an immediate impact on property tax expense. The impact of additional revenues on property tax is not the same as the impact of additional revenues on income taxes. Whereas the effect of additional revenues on income tax is immediate, the effect of additional revenues on property taxes is not immediate because property taxes based on the increased revenues are not paid until more than a year after new rates go into effect. Even then, the increased revenues' impact on property taxes is tempered by the use of two earlier years' revenues. The full impact of increased revenues on property taxes will not be felt until four years after new rates go into effect. An understanding of this timing difference is critical to understand why the ADOR formula using historical inputs is a more accurate method to estimate property taxes than what the ROO recommends. This also explains why the new rates that will go into effect will not affect property taxes immediately. In RUCO's experience, the Commission has not gone more than one year beyond the test year to look at any other expense on the income statement. Here, the test year was 2004, and one year beyond that is 2005. RUCO established a level of property tax for 2005.

The ROO recommends the Commission look beyond one year from the test year and consider new rates to estimate property tax expenses more than one year into the future. Historically, the Commission does not consider a post-test-year expense beyond one year because, among other things, it violates the matching principle and the used and useful principle. The ADOR formula using historical inputs, as RUCO has stated many times before, is forward looking and does consider the fact that new rates will be set. The Commission should strike the ROO's incorrect statement regarding RUCO's "backward-looking methodology and its failure to address new rates in its property tax recommendation" (ROO at 10-11), and adopt RUCO's level of property tax expense.

In support of its position, RUCO has shown in this case that had the Commission previously approved the Company's methodology, property taxes for 2005 would have been overstated by $13,796 which would have allowed the Company to over earn for several years until that level of tax was actually assessed. RUCO's method more closely approximates the Company's actual post-test year property tax bill than does the recommendation of the ROO. The Commission should adopt RUCO's approach and recognize the RUCO/ADOR methodology as the best measure of actual property tax expense.

RATE CASE EXPENSE

The ROO recommends rate case expense of $150,000. RUCO is recommending what the Company originally estimated - $120,000. The standard for measuring rate case expense, as recognized in the ROO, is what is reasonable. In looking at what is reasonable, the Commission has looked at the complexity of the proceedings, the number of systems involved and a comparison of other rate cases. See Decision No. 67093

(Arizona-American's Sun City et al. rate case), Decision No. 66849 (Arizona Water Company). In terms of complexity, the subject case is not complex. There were no contentious issues requiring an abnormal level of discovery, investigation, documentation, post-hearing expenses, or litigation and/or settlement expenses. There is only one system involved. By comparison, the two cases mentioned above and cited in the ROO, Arizona Water Company (Decision No. 66849), and the Arizona-American Water Company (Decision No. 66849) each involved myriad issues and multiple systems. The Arizona Water Eastern Division case alone involved eight systems. The Arizona-American case involved ten districts. Both these cases were far more involved than the subject case. While it is true that the amount of rate case expense allowed in these two cases was more than what is being recommended here, given the great disparity of what was involved in this case compared to the other two, the ROO's recommendation is not reasonable.

A closer look at exactly what expenses the Company is requesting, and the ROO is recommending recovery of, bears out the fact that the Company's request is unreasonable. The Company requested $6,787.50 for "Miscellaneous" costs. The Company has not described or itemized the costs and expects the Commission to take its word that these costs are necessary. This is not reasonable. The Company is requesting $12,143.85 for "Copying, printing, and CD duplication." This does not include the transcript for which the Company is requesting $2,227.50. On its face, this large amount for copying is not a reasonable request for a case of this size. The Company is further requesting $1,665.60 for it's rate analyst's "Meals, Travel and Parking." Ratepayers should not have to reimburse the Company's rate analyst for his meals, travel or parking. RUCO's recommendation is fair and reasonable, and should be adopted by the Commission.

COST OF CAPITAL

RUCO takes exception to the ROO's recommended 9.60 percent return on common equity. The ROO adopts Staff's cost of equity recommendation of 9.60 percent but fails to consider Staff's 0.5 percent downward adjustment it calculated due to the lack of risk in its recommended 100 percent equity capital structure. The 0.5 percent downward adjustment takes into consideration the fact that Staff's unadjusted 9.60 percent cost of common equity was derived from a sample of water utilities which have leveraged capital structures, and that the 9.60 percent cost reflects a level of financial risk that would not exist for a utility that has no debt in its capital structure. This is the same logic that RUCO's cost of capital witness applied in defense of his recommended hypothetical capital structures, which would have reduced the weighted cost of capital in the same manner as the .5 percent downward adjustment calculated by Staff. Given the fact that the ROO recommends a capital structure that contains no debt, RUCO believes that the 0.5 percent downward adjustment should be applied to the unadjusted 9.60 percent cost of common equity, resulting in a final overall cost of equity of 9.10 percent.

RATE DESIGN ISSUES

The ROO recommends the termination of the Company's hook-up fees and the issuance of a refund to ratepayers in the total amount of $883,367. The basis of the ROO's recommendation is to account for land purchased with the hook-up fees and unexpended hook-up fees. Refunding the hook-up fees is contrary to the purpose of hook-up-fees and not the best way to resolve the issue. The purpose of hook-up fees is to defray the cost of growth from rates. Companies typically accumulate hook-up fees and apply the fees towards the cost of new plant and/or capacity when it becomes needed. This proposal of accumulating hook-up fees and refunding them is contrary to the spirit of why the hook-up fees were collected in the first place - to defray costs of future plant. Moreover, the Company will undoubtedly have a use for the accumulated hook-up fees in the future, and the hook-up fees will then serve the purpose for which they were intended – defraying costs and lowering rates. The Commission should reject the ROO's proposal to terminate and refund the hook-up fees.

RESPECTFULLY SUBMITTED this 15th day of November, 2006.

Daniel Pozefsky
Attorney

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ATTACHMENT

BLACK MOUNTAIN SEWER CORPORATION
2005 GENERAL RATE CASE
DOCKET NO. SW-02361A-05-0657
RESPONSE TO STAFF'S TWELFTH SET OF DATA REQUESTS

Response provided by: Greg Sorensen

Title: Controller – Algonquin Water

Company Name: Black Mountain Sewer Corporation
Address: 12725 W. Indian School Road, Suite D-101
Avondale, AZ 85323

Company Response Number: CSB 12.1

Q. $360,000 Deferred Tax Liability – Referring to your response to RUCO 2.7, please provide a detailed schedule showing the calculation for the $360,000 deferred tax liability. As part of your response, please state whether or not the $360,000 deferred tax liability is the accumulated deferred tax balance. If not, please state the accumulated deferred tax balance and provide all calculations and work papers to support the balance.

A. Please see attached spreadsheet supporting response to RUCO 2.7. The $360,000 represents the tax affected difference between book and tax net book value of fixed assets.

BLACK MOUNTAIN SEWER CORPORATION
2005 GENERAL RATE CASE
DOCKET NO. SW-02361A-05-0657
RESPONSE TO STAFF'S TWELFTH SET OF DATA REQUESTS

Response provided by: Greg Sorensen

Title: Controller – Algonquin Water

Company Name: Black Mountain Sewer Corporation
Address: 12725 W. Indian School Road, Suite D-101
Avondale, AZ 85323

Company Response Number: CSB 12.2

Q. $524,000 AIAC Deferred Tax Asset – Referring to your response to RUCO 2.7, please provide a complete explanation along with all calculations and work papers to support the $524,000 AIAC Deferred Tax Asset. As part of your response, please identify the AIAC's and provide the related AIAC agreements. Also, please identify any component of the Deferred Tax Asset that would not be within the scope of the Arizona Corporation Commission's regulation.

A. See attached spreadsheet for calculation. Detail of $1,315,900 AIAC was provided in response to CSB 7.9, and is attached hereto, along with AIAC agreements requested.. Effective tax rate is that of AWRA, the parent company of Black Mountain.

1768049.1

BMSC
Deferred Tax Analysis
YE 2004

	deferred tax
Accounting Basis at end of year	3,632,095
Tax basis of capital assets at end of year	2,727,656
Timing Difference	(904,439)
Tax rate	39.82%
Defered tax liability	(360,142)
AIAC End of Year (Accounting Basis)	(1,315,900)
AIAC End of Year (Tax Basis)	-
Timing Difference	1,315,900
Tax rate	39.82%
Defered tax Asset	523,983
Net Deferred Tax Asset	163,841

	Tax	Book
Plant in Service		8,370,448
WIP		103,804
Scottsdale Plant		1,913,706
CIAC		(5,800,321)
Amort on CIAC		3,486,218
Asset Cost	5,768,359	8,073,855
Accum	(3,040,703)	(4,441,760)
NBV	2,727,656	3,632,095

Black Mountain Sewer Company				
Customer Advances for Aid in Construction				
8100.2.0200.20.2770.0002				
December 31, 2004				
		AIAC		
Date	**Trans Description**	**Debit Amt**	**Credit Amt**	**Balance**
2/12/01	Canyon Crossings Holdings LLC - Cave Creek Rd & New River Rd			
	refund 2003	129.20		129.20
7/1/04	Montalbano Homes - Canyon Creek Estates advance		36,840.00	
	Canyon Creek Estates deposit		5,000.00	
	record remaining AIAC per BOS		31,737.90	
	refund 2000	292.60		
	refund 2001	380.00		
	refund 2002	699.20		
	refund 2003	862.60		71,343.50
8/31/04	Monterey Homes - Carefree Ironwood		109,936.54	
	deposit		19,997.00	
7/31/04	record refund 2003	57.00		129,876.54
	Parkview Investors - Ridgeview Estates		148,058.00	
	deposit		10,000.00	
	refund 1999	429.40		
	refund 2000	615.60		
	refund 2001	672.60		
	refund 2002	843.60		
	refund 2003	938.60		154,558.20
7/1/04	Pulte - Winfield		568,734.70	
	Pulte - deposit		20,000.00	
8/17/04	Winfield - refund deposit balance	5,546.92		
	refund 1998	740.91		
	refund 1999	6,778.75		
	refund 2000	10,821.95		
	refund 2001	18,349.75		
	refund 2002	20,390.80		
	refund 2003	21,169.80		504,935.82
4/27/04	Ray & Alma School LLC (107th & Indian School) - Eckerd Drug Store			
	deposit balance		17,730.00	
	BOS booked		205,244.56	222,974.56
	TCC Carefree LP - Condos @ Carefree Inn		231,836.00	
	deposit		4,000.00	
	refund 2002	3,914.00		
	refund 2003	2,584.00		229,338.00
				1,313,155.82
	Adjustment to be booked		3,002.77	3,002.77
		96,217.28	1,412,117.47	1,315,900.19
	Total AIAC			
12/31/2004	AIAC GL Balance 8100.2.0200.20.2770.0002			-1,315,900.19
	Difference			0.00