ORIGINAL

BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF GOLD CANYON SEWER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.	Docket No. SW-02519A-06-0015

REPLY BRIEF OF THE RESIDENTIAL UTILITY CONSUMER OFFICE

INTRODUCTION

The Residential Utility Consumer Office ("RUCO") replies to Gold Canyon Sewer Company's ("Gold Canyon" or "Company") and the Arizona Corporation Commission Staff's ("Staff") Post Hearing Briefs as follows. RUCO replies only to the issues raised by the Company and Staff in their Brief. On any issues that the Company and/or Staff have not addressed, RUCO stands by its position in its Closing Brief.

DISALLOWANCE OF EXCESS CAPACITY

The Company and Staff view the issue of excess capacity from an engineering perspective, rather than a ratemaking perspective, and conclude that the entirety of the cost of the Company's Plant Renovation Project should be included in ratebase as it is currently in use. Company Brief at 12, Staff brief at 30. Both the Company and Staff relied on Staff's engineering report to support their conclusion that the improvements are used and useful. Id. RUCO recommends that a portion of the plant be disallowed at this time as it is excess capacity.

The regulatory principle of used and useful, and the related concept of excess capacity, are rate making concepts, not engineering concepts. The rate making standard is whether the entirety of the plant was used and useful at the end of the test year. If a portion of the plant is not used and useful that portion should not be included in rate base. The reason is obvious – current ratepayers should not have to pay for plant that was built to serve future ratepayers.

Staff's engineering report ("Staff Report"), on which both the Company and Staff rely, clearly indicates that not all of the plant is necessary, even though Staff refuses to characterize that condition as "excess capacity." The Staff Report concluded that the Company will utilize 80% of its capacity by mid-2007, and its capacity can "be expanded to serve the projected growth" by year ending 2010. S-1, Exhibit MSJ, page 4. There is no other evidence in the record that conflicts with Staff's Report, and the Company even accepted its findings. Transcript at 315-316. Thus, from a ratemaking point of view, the Company had excess capacity during the test year and is projected to have excess capacity through 2010.

The Company, and to a lesser degree Staff, attempts to analyze excess capacity by making it exclusively an engineering concept. The Company attempts to trivialize RUCO's position because of RUCO's alleged lack of expertise in understanding the engineering analysis that underlies the plant improvements and capacity determinations. Company Brief at 11. The Company argues the "80 percent rule[1]" and peak flow characteristics of the plant support the Company and Staff's engineering conclusion that there is not excess capacity. Id. RUCO addresses the engineering arguments in its Closing Brief. RUCO Brief at 3-5. However, excess capacity is also a ratemaking issue, not just an engineering issue. By the Company's own records at the end of 2005, the influent flow rate at the Company's Reclamation facility was 708,000 GPD, so that 62.74 percent of its maximum capacity was not necessary to meet test year demand. R-9 at 10, R-2. The Company and Staff's "engineering" interpretations do not contradict Staff's projections that the plant will utilize only 80% of its capacity by mid-2007, and its full capacity by year ending 2010. For ratemaking purposes, the Company had during the test year, and will continue to have, excess capacity. The Commission should reject the Company and Staff's argument that there is no excess capacity.

The Company believes that RUCO's recommendation would penalize it for its proactive and prudent investment strategies. Company Brief at 12. The Company's argument sidesteps the issue. RUCO does not suggest that the Company acted imprudently, nor does RUCO claim that the Company should be forever denied recovery of its prudently incurred costs. The Company's argument is a red herring. The issue of prudency is irrelevant to the question of whether the improvements are fully used and useful as of the end of the test year. The Company's proactive investment strategy is also irrelevant to the question of whether the

[1] Under the 80 percent rule, according to the company, a sewer utility is expected to submit plans for approval of new capacity when demand meets 80% of the capacity.

improvements were fully used and useful at the end of the test year. The Commission should reject these arguments.

Moreover, RUCO is not suggesting that the Company be denied recovery of its prudently incurred costs. As mentioned in RUCO's Closing Brief, RUCO is recommending the Commission grant the Company an Accounting Order that will allow the Company the opportunity to recover all of its costs when its excess capacity becomes used and useful. RUCO Brief at 9. Further, because the deferred costs will be eligible to earn a return when the excess capacity becomes used and useful, the Company will have the opportunity to earn a return on the full cost of the plant at that time. RUCO's excess capacity recommendation is fair, reasonable and should be adopted by the Commission.

RATE CASE EXPENSE

The Company maintains that it should recover $160,000 in rate case expense. The Company is obviously inflamed with RUCO's position on this issue, and goes to great lengths to expose what it believes is RUCO's lack of evidence, credible or otherwise, in support of its position. See Company Brief at 18-21. Rhetoric aside, RUCO has provided sufficient and credible evidence to support its position.

The Commission typically looks at a variety of factors when considering rate case expense. Those factors include the complexity of the proceeding, the number of systems involved and a comparison of other cases. See for example Decision No. 67093 (*Arizona-American's Sun City et al. rate case*), and Decision No. 66849 (*Arizona Water Company*). RUCO took all of these factors into consideration when determining what would be a reasonable amount of rate case expense. R-9 at 22, RUCO Brief at 9.

In terms of complexity, the subject case is not complex. There are 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. RUCO recognizes that the Company, as well as all the parties, had to address issues raised by statements of the Company's previous representative, Trevor Hill. These issues were initially raised by Commissioner Mayes in her letter of August 9, 2006. Nonetheless, this was an otherwise straightforward, simple case.

RUCO attempted unsuccessfully to substantiate the costs the Company was requesting in rate case expense. The Company failed to provide RUCO with adequate substantiation of its rate case expense. See RUCO's Brief at 7-8. The Company suggests RUCO was obligated to take additional steps in order to get the necessary information from the Company. Company Brief at 21. The Company has lost sight of the fact that the burden is on the Company, not RUCO, to substantiate the Company's rate case expense. See *In the Matter of the Application of Southwest Gas Corporation for Establishment of Just and Reasonable Rates, Decision No. 68487* at 21 (the burden is on the Company to provide documentation of its expenses). The Company is requesting recovery of the expense and is required to substantiate it. The Commission should reject the Company's recommendation because the Company has failed to substantiate its rate case expense. See RUCO Brief at 6-8.

RUCO requested the information; the Company's responses included redacted and questionable entries. R-10 – Exhibit C, R-4. Even the Company's own witness, when asked at the hearing, could not explain what service was performed for certain redacted entries. Transcript at 461-469. RUCO was not able to substantiate the Company's recommendation so

RUCO based its recommendation on the simplicity of this proceeding, the fact that there is only one system involved and a comparison to other rate cases. See RUCO's Brief at 9. RUCO's recommendation of $70,000 for rate case expense is fair and reasonable.

PROPERTY TAX EXPENSE

The Company argues that the ADOR methodology using historical inputs ("ADOR methodology") has been repeatedly rejected by the Commission. Company Brief at 17. It is true that the Commission has rejected the ADOR methodology. Nonetheless, RUCO has repeatedly shown that the ADOR methodology is the most accurate estimate of the Company's property tax. In this case, as in others where the actual tax figures for the test year are known, the ADOR formula is consistently more accurate than the Company's methodology. Here, using the Company's as well as Staff's methodology, property taxes for 2005 would have been overstated by $111,476, which would have allowed the Company to over earn for several years until that level of tax was actually assessed. Using the ADOR methodology, property taxes for 2005 would have been overstated by $31,692.

The goal of the Commission in determining property tax expense is to estimate what future property tax expense will be in the period when new rates become effective. The method which provides the most accurate estimate is the method that the Commission should approve. The ADOR methodology provides the most accurate estimate and should be approved by the Commission.

COST OF CAPITAL

The Company claims RUCO's cost of equity ("COE") recommendation lacks credibility. Company Brief at 26. However, the Company provides no substantive analysis of why RUCO's recommendation lacks credibility. Id at 26-27. The fact that RUCO's witness, William Rigsby, testified that this is probably the lowest ROE he has ever recommended is not a persuasive reason why Mr. Rigsby's recommendation lacks credibility. Mr. Rigsby performed a quantitative analysis using the cost of capital models and practices historically relied on by the Commission. Had Mr. Rigsby's analysis resulted in a high COE, the Company would undoubtedly not be complaining. The fact that RUCO used a hypothetical capital structure is also not a persuasive reason why RUCO's recommendation lacks credibility. As RUCO explained in its Closing Brief, hypothetical capital structures are common in situations where a utility's capital structure is unbalanced. RUCO Brief at 14. Applying a hypothetical capital structure is an accepted regulatory practice to bring the Company's capital structure more in line with the industry average and to also account for the Company's lower risk. Id. The Commission should approve RUCO's recommended cost of capital.

CONCLUSION

The Commission should disallow for rate consideration at this time the excess capacity associated with Company's plant improvements. The Commission should adopt RUCO's proposed rate case expense of $70,000 as well as RUCO's proposed methodology for calculating property tax expense, as it is the best estimate of future property tax expense. Finally, the Commission should adopt RUCO's recommended rate of return of 8.54 percent.

RESPECTFULLY SUBMITTED this 2nd day of February 2007

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