**BEFORE THE ARIZONA CORPORATION COMMISSION**



COMMISSIONERS
MIKE GLEASON, Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

IN THE MATTER OF THE APPLICATION OF GOLD CANYON SEWER COMPANY FOR A DETERMINATION OF 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

DECISION NO. 69664

**OPINION AND ORDER**

DATE OF HEARINGS: November 1, 2, 3, 2006; December 4, 5, and 11, 2006

DATE OF PUBLIC COMMENT: September 13, 2006 (Gold Canyon, Arizona)

PLACE OF HEARING: Phoenix, Arizona

ADMINISTRATIVE LAW JUDGE: Dwight D. Nodes

APPEARANCES: Mr. Jay L. Shapiro, FENNEMORE CRAIG, P.C., on behalf of Gold Canyon Sewer Company;

Mr. Daniel Pozefsky on behalf of the Residential Utility Consumers Office;

Mr. Mark Tucker, MARK TUCKER, P.C., on behalf of Cal-Am Properties, Inc.; and

Mr. Keith Layton and Ms. Robin Mitchell, Staff Attorneys, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

**BY THE COMMISSION:**

On January 13, 2006, Gold Canyon Sewer Company ("Gold Canyon" or "Company") filed with the Arizona Corporation Commission ("Commission") an application for a determination of the current fair value of its utility plant and property and for increases in its rates and charges for wastewater utility service provided to customers in the Company's certificated service area in Pinal County, Arizona. With its application, the Company filed the Direct Testimony of Michael Weber and Thomas Bourassa.

Gold Canyon's current rates and charges were authorized in Decision No. 64186 (October 30, 2001). In 2001, Gold Canyon 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 water and wastewater utilities serving approximately 50,000 customers. The other Arizona utilities, in addition to Gold Canyon, are Black Mountain Sewer Corporation ("BMSC"), Bella Vista Water Company, Rio Rico Utilities, Inc., Litchfield Park Service Company, Northern Sunrise Water Company, and Southern Sunrise Water Company. APIF also owns 10 other water and wastewater utilities in Texas, Illinois and Missouri (Ex. S-3).

On February 10, 2006, the Commission's Utilities Division ("Staff") filed a Letter of Deficiency, setting forth the specific areas of the Company's application Staff deemed deficient.

On February 14, 2006, Gold Canyon filed a letter in opposition to certain of the deficiencies claimed by Staff.

On February 17, 2006, a telephonic procedural conference was conducted with the parties to discuss the alleged deficiencies. The parties indicated at that time that the dispute had been resolved.

On February 17, 2006, Staff filed a Letter of Sufficiency, classifying Gold Canyon as a Class B utility.

By Procedural Order issued February 27, 2006, as modified on March 3, 2006, a hearing in this matter was scheduled to commence on October 3, 2006, publication of the application and hearing date was ordered, and other procedural deadlines were established.

By Procedural Order issued May 9, 2006, the Residential Utility Consumer Office ("RUCO") and the MountainBrook Village at Gold Canyon Ranch Association ("HOA") were granted intervention.

On May 22, 2006, Gold Canyon filed a Certification of Publication and Proof of Mailing of the required customer notice.

On June 16, 2006, Staff filed the Direct Testimony of Steven Irvine and Marlin Scott, Jr., and RUCO filed the Direct Testimony of Rodney Moore and William Rigsby.

On June 20, 2006, a Procedural Order was issued extending certain of the testimony filing deadlines.

On June 23, 2006, Staff filed the Direct Testimony of Crystal Brown.

On July 27, 2006, Gold Canyon filed the Rebuttal Testimony of Mr. Bourassa and Charles Hernandez. The Company filed an Errata to Mr. Bourassa's Rebuttal Testimony on August 1, 2006, and on August 23, 2006, filed a Supplement to Mr. Hernandez' Rebuttal Testimony.

By Procedural Order issued August 1, 2006, Cal-Am Properties, Inc. ("Cal-Am") was granted intervention.

On August 9, 2006, Commissioner Mayes filed a letter in the docket requesting the parties to address, among other things, odor complaints and prior comments made by a Company representative regarding the need for future rate increases.

On August 9, 2006, a Procedural Order was issued scheduling a public comment session for September 13, 2006 in Gold Canyon, Arizona.

By Procedural Order issued August 11, 2006, the pre-hearing conference was rescheduled for September 25, 2006.

On August 30, 2006, Staff filed the Surrebuttal Testimony of Mr. Irvine, Mr. Scott, and Ms. Brown, and RUCO filed Surrebuttal Testimony of Mr. Moore and Mr. Rigsby.

On September 13, 2006, the Company filed a Legal Brief Regarding Prior Company Statements, in response to Commissioner Mayes' letter.

The public comment session was conducted by the Commissioners, as scheduled, on September 13, 2006. A number of customers offered public comment in opposition to the proposed rate increase and on related matters.[1]

On September 20, 2006, Gold Canyon filed a Proof of Publication for the required notice to customers of the public comment session.

On September 25, 2006, the pre-hearing conference was held. During the pre-hearing conference, Gold Canyon requested a continuance of the hearing date due to an injury sustained by the Company's lead counsel.

On September 27, 2006, a teleconference was conducted with all parties in the case. The parties agreed to a continuation of the hearing date until November 1, 2006.

[1] The Commission has also received hundreds of letters and contacts through the Consumer Services Division stating opposition to Gold Canyon's proposed rate increase.

By Procedural Order issued September 27, 2006, the evidentiary hearing was formally continued until November 1, 2006; a prehearing conference was scheduled for October 25, 2006; and the original October 3, 2006 hearing date was reserved for public comment to comply with the notice that had been mailed to customers and published.

On October 3, 2006, the hearing was called on the noticed date of the hearing. One customer offered public comment at that time.

On October 25, 2006, a second prehearing conference was held to discuss scheduling of witnesses.

The evidentiary hearing in this matter commenced on November 1, 2006, with additional hearing days on November 2 and 3, 2006. At the hearing on November 3, 2006, the Administrative Law Judge indicated the need for testimony by Trevor Hill, the former president of Gold Canyon, regarding alleged statements that were made with respect to the need for future rate increases due to treatment plant upgrades (Tr. 493-502) (see discussion below). Although the Company disagreed with the relevance of Mr. Hill's prior statements, it agreed to pre-file his testimony prior to continuing the hearing at a later date (Tr. 653-654).

On November 13, 2006, Gold Canyon filed Mr. Hill's testimony.

On November 22, 2006, Staff filed the Direct Testimony of Steve Olea in response to Mr. Hill's testimony.

Also on November 22, 2006, RUCO filed its Response to Mr. Hill's testimony.

The hearing resumed on December 4, 2006, with additional hearing days on December 5 and 11, 2006.

Gold Canyon submitted Late-Filed Exhibits on December 12, 2006, January 5, 2007, January 12, 2007, and February 2, 2007.

By agreement of the parties, initial post-hearing briefs were filed by the Company, Staff, and RUCO on January 19, 2007. Reply briefs were filed on February 2, 2007.

Rate Application

According to the Company's final schedules attached to its post-hearing brief, in the test year ended October 31, 2005, Gold Canyon had adjusted operating income of $241,752 on an adjusted

Fair Value Rate Base ("FVRB") and Original Cost Rate Base ("OCRB") of 15,742,719, for a 1.54 percent rate of return. The Company seeks a gross revenue increase of $2,298,383 (92.07 percent over test year gross revenue of $2,497,860). Staff recommends in its final schedules a gross revenue increase of $1,822,101 (73 percent), and RUCO proposes a gross revenue increase of $1,044,378 (41.84 percent).[2] A summary of the parties' final revenue requirement positions follows:[3]

| | Company Proposed | Staff Proposed | RUCO Proposed |
|---|---|---|---|
| FVRB/OCRB | | | |
| Adjusted Rate Base | $15,742,719 | $15,725,787 | $13,983,602 |
| Rate of Return | 1.54% | 2.09% | 3.95% |
| Req'd Operating Inc. | 1,652,985 | 1,446,772 | 1,194,200 |
| Op. Income Available | 241,752 | 327,982 | 552,940 |
| Operating Inc. Def. | 1,411,233 | 1,118,791 | 641,260 |
| Rev. Conver. Factor | 1.6286 | 1.6286 | 1.6286 |
| Gross Rev. Increase | 2,298,383 | 1,822,101 | 1,044,378 |

## REVENUE REQUIREMENT

Rate Base Issues

As indicated above, Gold Canyon proposes an adjusted rate base of $15,742,719; Staff proposes an adjusted rate base of $15,725,787; and RUCO proposes an adjusted rate base of $13,983,602. Each of the disputed issues regarding rate base items is discussed below.

Excess Capacity

Although the Company and Staff have proposed FVRB amounts that are fairly close, RUCO recommends a rate base adjustment of $2,789,016 to exclude an amount that RUCO claims reflects "excess capacity" in Gold Canyon's plant (RUCO Ex. 11, Sched. RLM-5). RUCO argues that a downward adjustment to Gold Canyon's rate base is necessary because the treatment plant upgrade undertaken by the Company resulted in available plant capacity that exceeds the amount necessary to serve current customers.

According to RUCO witness Rodney Moore, the Gold Canyon treatment plant had a maximum capacity of 1.9 million gallons per day ("mgd") at the end of the test year, yet the average

[2] Based on RUCO's Revised Surrebuttal Schedules presented at the hearing on December 5, 2006 (Tr. 980-981; RUCO Ex. 11). RUCO did not file final schedules with its post-hearing brief so its final position is presumably reflected in RUCO Ex. 11.

[3] Cal-Am and the HOA did not take a position regarding specific revenue requirement issues.

influent flow rate was only 708,000 gallons per day at that time. Mr. Moore determined that the plant therefore had test year excess capacity of 62.74 percent. However, he incorporated an "excess reserve" component into his analysis based on the projected influent flow rate of 1.367 mgd at the end of 2008, and concluded that an excess capacity adjustment of 28.05 percent is appropriate in this case (RUCO Ex. 9, at 10-11). Mr. Moore conceded that the Company must consider peak flows in its planning decisions (Tr. 951-954), and that the Company's decision to expand the plant to 1.9 mgd was "prudent" and "appropriate" (Tr. 943). However, RUCO proposes to disallow $2.8 million from the Company's rate base on the basis that a portion of the plant is not used and useful from a ratemaking perspective (*Id.*).

Staff witness Marlin Scott, Jr., conducted Staff's engineering analysis of the Company's treatment capacity. Mr. Scott stated that the treatment plant was recently expanded from a capacity of 1.0 mgd to 1.9 mgd and, based on information provided by the Company, the peak day flow during the test year occurred in February 2005, when 1.17 million gallons of wastewater was treated in one day. He concluded that the 1.9 mgd treatment capacity is adequate to serve the current customer base (approximately 5,300 test year service laterals) and projected growth within a five-year period (approximately 8,600 projected service laterals by the end of 2010). Mr. Scott also indicated that when 80 percent of the plant's treatment capacity is reached (projected 1.52 mgd by approximately mid 2007), the Arizona Department of Environmental Quality ("ADEQ") would require the Company to submit plans for additional capacity (Ex. S-1, at Attach. Ex. MSJ).

Gold Canyon contends that when it was in the process of upgrading and expanding the treatment plant, the smallest increment for expansion was 500,000 gpd, which would have increased the capacity to 1.5 mgd (Ex. A-6, at 5). Instead, the Company decided to expand the plant to 1.9 mgd because the incremental cost of the additional 400,000 gpd was less than $1 million (Tr. 303-304). Company witness Hernandez also stated, in addition to being more costly to add plant capacity in smaller increments, increasing the plant to 1.9 mgd allowed the Company to avoid the noise and odors associated with repeated construction projects (*Id.*).

Based on the evidence presented in this case, we disagree with RUCO's proposal to disallow a portion of the Company's upgraded treatment plant as excess capacity. Simply put, RUCO cannot

have it both ways. If the decision to upgrade the treatment plant to a capacity of 1.9 mgd was prudent, as RUCO concedes, Gold Canyon should not be subjected to a purely mathematical after-the-fact accounting disallowance without consideration of engineering analyses and the context of the events surrounding the decision to increase plant capacity to its current level.

As Staff witness Marlin Scott, Jr., explained, capacity requirements are evaluated over a five-year horizon and, based on ADEQ's "80 percent rule," a sewer utility is expected to have plans in place to increase capacity when demand reaches 80 percent of then current capacity, and to have construction under way when demand reaches 90 percent of capacity (Tr. 305; 1039-1041). Company witness Hernandez testified that, during the test year, the Company experienced a peak flow of almost 1.2 mgd in February 2005 (Ex. A-6, at 4). Mr. Scott estimated that Gold Canyon would have a peak flow of more than 1.5 mgd by mid 2007 (Ex. S-1, Ex. MSJ at 4). Thus, not only did test year peak flows exceed the then-current capacity, but if the Company had expanded the plant to only 1.5 mgd, in order to avoid RUCO's proposed excess capacity disallowance, it would have needed to almost immediately begin planning to add another incremental amount of capacity to meet ongoing demand increases. Implementation of such a planning strategy would have ultimately resulted in higher costs to customers, and would have imposed on RUCO's clients (*i.e.*, Gold Canyon's residential customers) a nearly constant stream of construction activity, especially customers located near the treatment plant who have chronicled the noises and odors they have endured during the past several years. RUCO's excess capacity disallowance proposal is not consistent with the peak capacity requirements reflected in the record, and is short-sighted to the extent that it fails to recognize the higher costs associated with adding capacity in smaller increments, as well as the less tangible disruptions to customers. Accordingly, we do not adopt RUCO's proposal.

Cash Working Capital

Gold Canyon initially proposed to include in rates $134,672 for cash working capital. The Company's recommendation was based on the "formula method" of calculating working capital, which is equal to 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.

RUCO proposed use of the formula method in this proceeding, and did not agree with Staff's recommendation to reduce cash working capital to zero (RUCO Ex. 9, at 9). In his Surrebuttal Testimony, Mr. Moore set forth RUCO's proposal to increase the Company's rate base by $119,398 for cash working capital (RUCO Ex. 10, at 4-5).

Staff witness Crystal Brown stated in her testimony that use of formula method is generally appropriate only for very small companies for which development of a "lead-lag study" is cost prohibitive (Ex. S-18, at 16-18). For Gold Canyon, however, Ms. Brown testified that the formula method is inappropriate for calculating cash working capital because it always produces a positive result, thereby effectively ignoring the cash working capital provided by ratepayers. She indicated that if Gold Canyon had conducted a lead-lag study in this case, it might have shown that the Company actually has a negative cash working capital requirement because the Company collects funds prior to the due date of certain payments, including income tax and property tax expenses (*Id.*). As a result, Staff recommended that Gold Canyon's cash working capital be set at zero in this case.

In his Rebuttal Testimony, Company witness Bourassa stated that although the Company disagrees with Staff's rationale, it would accept Staff's adjustment in order to eliminate the issue between the Company and Staff (Ex. A-11, at 8).

We agree with Staff's recommendation to reduce Gold Canyon's cash working capital requirement to zero. Ms. Brown explained that absent a lead-lag study being conducted by the Company, it is not sufficient to simply rely on the formula method for a company the size of Gold Canyon. As she pointed out, Gold Canyon's cash working capital needs may have produced a negative requirement if the Company's payments and revenues had been evaluated through a lead-lag study. In fact, we recently adopted a negative cash working capital requirement for Gold Canyon's sister company in the *Black Mountain Sewer* case (Decision No. 69164, at 6-7). We therefore adopt a zero cash working capital requirement for Gold Canyon in this case.

Summary of Rate Base Adjustments

Based on the foregoing discussion, we adopt an adjusted OCRB and FVRB of $15,725,787 for Gold Canyon in this proceeding. The Company did not request a reconstruction cost new rate

base, so we adopt OCRB as the Company's FVRB in this proceeding.

| | Commission Approved |
|---|---|
| OCRB | |
| Plant in Service | $21,033,564 |
| Less: Accumulated Depreciation | 1,269,431 |
| Net Plant in Service | 19,764,133 |
| Deductions: | |
| AIAC | 2,064,125 |
| CIAC | 1,827,557 |
| Less: Accumulated Amortization | 138,788 |
| Net CIAC | 1,688,769 |
| Total AIAC and CIAC | 3,752,894 |
| ADIT | (254,681) |
| Total OCRB | $15,725,787 |

Operating Income Issues

In the test year, the Company's adjusted operating revenues were $2,496,380. In its final schedules, Gold Canyon reported adjusted test year operating expenses of $2,254,628, and test year net operating income of $241,752. As set forth in its final schedules, Staff's proposed adjusted test year operating expenses of $2,168,398, resulting in test year operating income of $327,982. RUCO's schedules show proposed adjusted test year total operating expenses of $1,943,440, yielding test year operating income of $552,940. 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. Gold Canyon 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., Arizona-American Water Co.*, Decision No. 69440 (May 1, 2007); *Black Mountain Sewer Corp.*, Decision No. 69164 (December 5, 2006); *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)).

Company witness Thomas Bourassa explained that he computed property taxes based on the ADOR methodology which determines full cash value by using twice the average of three years of revenue, and reducing the tax rate from 25 percent to 24 percent to account for recent legislation contained in A.R.S. §42-15001 (Ex. A-10, at 8-9). Mr. Bourassa stated that the Company's methodology is consistent with a long line of prior Commission decisions that set property tax rates based on a company's tax liability under the new rates established by the Commission. Mr. Bourassa testified that similar to income taxes, property taxes must be adjusted to ensure that the new rates are sufficient to produce the authorized return. He indicated that, although the actual property tax bill would not be received by the Company for more than a year after the new rates go into effect, the Company should be accruing property taxes to match the revenues collected to avoid a mismatch between revenues and expenses. Mr. Bourassa claims that the Company's proposed property tax expense is actually conservative because it is based on an average of proposed and historic revenues, as opposed to solely on proposed revenues (*Id.* at 10).

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. 9, at 18-22; RUCO Ex. 10, at 10-11). 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 RUCO's approach on this issue (*Id.*).

We continue to 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 *Black Mountain* 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. 69164, at 11; quoting *Chaparral City* 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, Gold Canyon estimated rate case expense in the amount of $160,000, amortized over four years, but indicated that it would true-up costs as the case progressed (Ex. A-10, at 10-12). The Company claims that despite a number of intervening circumstances that increased significantly its rate case related costs, it is not seeking to increase its rate case expense request in this proceeding (Tr. 450-451; 1220-1221). The Company contends that issues related to odor complaints and prior statements made by Gold Canyon's former president, Trevor Hill, were not anticipated at the time of the application's filing and required additional testimony, briefing, and hearing days.

Although Staff agreed that $160,000 is a reasonable amount for rate case expense (Tr. 1174-1175), RUCO proposes to reduce allowable rate case expense to $70,000, amortized over four years. RUCO witness Rodney Moore claims that $72,000 of the actual expenses claimed by the Company at the time of RUCO's analysis were "questionable" and required further scrutiny. He contends that the Company was unable to explain many of the cost components of its claimed rate case expense, and the Company failed to mitigate its costs (RUCO Ex. 10, at 12-13). Mr. Moore testified at the hearing that RUCO's primary concern with rate case expense is related to the Company's redaction of certain information on invoices from Fennemore Craig, based on the Company's claim of attorney client privilege (Tr. 573). RUCO argues that there was not sufficient information available on the invoices for RUCO to verify that the costs were related to the rate case or that the costs were reasonable.

We agree with RUCO's calculation of rate case expense and find that the allowable rate case expense should be $70,000, amortized over four years. The Commission finds that it was appropriate to exclude from rate base costs associated with information redacted from the Company's legal invoices. While Staff did not file written testimony on this issue during the hearing, Staff Witness Crystal Brown testified that if Staff would have had time they "most likely" would have removed the redacted amounts from Staff's calculation of rate case expense.

It is the Company's responsibility to provide Staff and the intervenors with the necessary documentation in support of the Company's application. The Company failed to meet this burden in

this case, and consequently, the Commission will decrease the Company's proposed rate case expense by $90,000 and will approve a recommended rate case expense of $70,000, amortized over four years.

Affiliate Company Profits

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

AWRA employs an organizational model that is unique in Arizona, with one exception (Global Water Resources, Inc.). AWRA, which is Gold Canyon's sole shareholder, has no employees. Gold Canyon, as well as the other regulated utility companies listed above, has no employees. Instead, almost all operational services are provided by an allegedly unregulated affiliate called Algonquin Water Services ("AWS"). The written contract that exists between Gold Canyon and AWS for provision of wastewater services was not negotiated at arms-length because the parties to the agreement are under common ownership (Tr. 329-330), and the agreement is based on a template that is used by the Algonquin Power System to manage its hydroelectric plants in Canada (Tr. 1260). Further, there is no written agreement for additional services billed to Gold Canyon by APIF and Algonquin Power Systems (Tr. 345-346).

Company witness David Kerr testified that APIF operates its regulated utility companies in a manner that is similar to a real estate investment trust ("REIT"). He explained that, in Canada, income funds such as APIF are treated in a similar fashion to REITs in the United States. Mr. Kerr stated that "the mutual fund trust owns a group of revenue-generating assets [*i.e.*, the utility companies], and it's often managed by an outside firm....the management and operations, accounting services are provided outside of the ownership of the assets, because assets are revenue-generated assets. And we apply the same operating model to the utility business..." (Tr. 1245-1247). Mr. Kerr conceded that he was not aware of any REIT in the United States that owns regulated utility companies (Tr. 1261).

Staff's Position

Based on its analysis, Staff recommends that the Commission disallow $67,449 that the Company is seeking in rate base for capitalized affiliate profit, and $78,607 the Company seeks to recover in operating expenses for affiliate profit (Ex. S-19, Scheds. CSB-4 and CSB-19).

Staff argues that AWRA's organizational model creates unnecessary layers of profits for its unregulated affiliates in addition to the authorized returns on equity for its regulated utility companies. According to Staff, because the regulated utility companies (including Gold Canyon) have no employees, affiliate profits are embedded in each utility's cost of service and rate base. Staff contends that under traditional ratemaking principles, operating expenses are passed through to ratepayers without an additional layer of return; yet, in this case, the Algonquin operational services provider [AWS] targets a pre-tax profit margin of approximately 10 percent (Ex. A-9, at 5). Staff points out that, as shown in the AWS budgets for 2004 and 2005, the actual post-tax profits realized by AWS for the Gold Canyon system were 14.01 and 15.64 percent, respectively (Ex. S-9, CSB 2.37c). Moreover, the contract between Gold Canyon and AWS provides for an annual escalation of three percent per year, regardless of the profit margin actually realized by AWS for preceding years (Ex. S-4).

Staff witness Crystal Brown testified that Gold Canyon's affiliate, AWS, is operating as an unregulated monopoly, and that allowing an additional layer of profit to AWS effectively results in an increase to Gold Canyon's return on equity (Ex. S-19, at 6-7). Staff argues that there is no competitive market for the provision of services rendered by AWS to Gold Canyon and it is therefore not possible to accurately compare the reasonableness of costs imposed by AWS on Gold Canyon. Staff claims that there is no arms-length transaction between Gold Canyon and AWS (as well as the other Algonquin affiliates) because the same individuals represent both entities. For example, Staff points out that the contract between AWS and Gold Canyon was "negotiated" by Peter Kampian on behalf of Gold Canyon and Bob Dodds on behalf of AWS (Ex. S-4); yet corporate filings at the Commission list Mr. Kampian as the manager of AWS and Mr. Dodds as president of Gold Canyon (Ex. S-5). The APIF website also shows Mr. Kampian as the Chief Financial Officer of APIF and Bob Dodds as the Division Manager of Infrastructure of APIF (Ex. S-6). Thus, Staff argues that

inherent conflicts of interest exist with respect to the ability to negotiate agreements between the regulated subsidiary and the unregulated operating affiliate. According to Staff, additional conflicts exist because Gold Canyon receives "professional services" from other unregulated affiliates, Algonquin Power Systems and Algonquin Power Trust, on an hourly "as incurred" basis without written contracts (Ex. A-9, at 2; Tr. 344-345).

With respect to the standard to be applied for evaluating the reasonableness of affiliate costs, Staff points to the case of *US West Communications v. Arizona Corp. Comm.*, 185 Ariz. 277, 282, 915 P.2d 1232, 1237 (App.1996), in which the Arizona Court of Appeals stated that the "Commission has broad powers to scrutinize transactions between a regulated company and its unregulated affiliates" and disallow excessive costs. Staff also cites *General Telephone Co. of New York v. Public Service Commission of New York*, 17 N.Y.2d 373, 378 (N.Y. 1966), in which the Court of Appeals of New York indicated that the presence of affiliate transactions, where both entities are controlled by the same holding company, raised the specter that the utility company could be charged excessive rates for services by its unregulated affiliate. Another case cited by Staff is *Turpen v. Oklahoma Corp. Comm.*, 769 P.2d 1309, 1323 (Okla. 1989), wherein the Supreme Court of Oklahoma held:

> The utility's burden of proving that payments to affiliates are reasonable includes both a burden of production and of persuasion. The utility has the initial burden of producing evidence to show *prima facia* the reasonableness of its payments to affiliates—a mere showing of the expenses' incurrence will not suffice. The utility must produce evidence, for example, that it charged affiliates the same amount as it did arms-length buyers. Unless the utility meets this affirmative duty of showing the reasonableness of payments to affiliates, no such expenses may be allowed. (citations omitted)

Staff argues that there is no market for the services provided by AWS to Gold Canyon because companies that provide such services are typically either utility holding companies or the utilities themselves. Staff further contends that the Company did not issue any requests for proposals for the services provided by AWS because the Company claims that there are no competitors for the type of services provided by AWS. Although Staff agrees that affiliate transactions require greater scrutiny than non-affiliate agreements, Staff asserts that sample auditing and looking at limited

comparables are an insufficient means of evaluating the Algonquin operational structure. According to Staff, Gold Canyon has not presented sufficient, competent and reliable evidence to satisfy its burden of production or persuasion.

Based on the evidence, Staff recommends that the Commission pierce the corporate veil and treat the Algonquin affiliates as a single entity to avoid imposing an injustice on the Company's regulated customers. Staff makes essentially the same legal arguments as it raised in the recent *Black Mountain Sewer* case (Decision No. 69164) in support of its recommended disallowance of capitalized and expensed affiliate profits. Staff cites to a prior case involving *Consolidated Water Utilities, LTD*, Decision No. 57666 (December 19, 1991), wherein the Commission stated:

> The Company portrayed outrage that the Commission would attempt to regulate its non-regulated entity, CUC. In response to the Company's last argument, we will simply state that the Commission only has to approve reasonable expenses for ratemaking purposes, whether those expenses originate from a regulated or non-regulated entity is not controlling. Staff has raised the issue of reasonableness of the expenses allocated from an entity related to the Company and we agree that those expenses should be carefully scrutinized. 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. For that reason we will approve of the CUC allocation, but shall direct the Company in its next rate case to provide the amount of profit to CUC under its contractual arrangement. (Decision No. 57666 at 17-19, emphasis added)

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.[4]

According to Staff, the case of *Deutsche Credit Corp. v. Case Power & Equip. Co.*, 179 Ariz.

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

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. In that case, the Arizona Supreme Court reversed the lower court's finding that the plaintiffs had failed to show unity of control over an affiliate company, based on evidence that the agreement with the affiliate was not negotiated at arms-length, and that the affiliate exercised substantially total control of the affiliate and performed virtually every service necessary for the sister company's operations (*Id.* at 37-38).

According to Staff, the case of *State of North Carolina v. Morgan*, 177 S.E.2d 405 (N.C. 1970) also supports its argument. In that case, the Supreme Court of North Carolina held that corporate structure may not be used as a means for defeating the public interest. Staff also cites *Central Louisiana Electric Co. v. Louisiana Pub. Serv. Comm.*, 373 So.2d 123, 126 (La. 1979), wherein the Supreme Court of Louisiana stated that "Manipulation by a parent utility of a subsidiary for the purpose of creating excessive profits at the expense of the ratepayer would provide a reason for the regulatory agency to disregard [the] corporate entity...."

Finally, Staff 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 Gold Canyon 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 Gold Canyon 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 Gold Canyon; 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 Gold Canyon). Staff asserts that the record supports the conclusion that Gold Canyon 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.

Gold Canyon'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. Gold Canyon argues that there is no prohibition against affiliate profits, and cites *GTE Florida, Inc. v. Deason,* 642 So.2d 545 (Fla. 1994), in which the Florida Supreme Court overruled a decision by the Florida Public Service Commission to disallow affiliate profits and held:

> [T]he PSC abused its discretion in its decision to reduce in whole or in part certain costs arising from transactions between GTE and its affiliates, GTE Data Services and GTE Supply. The evidence indicates that GTE's costs were no greater than they would have been had GTE purchased services and supplies elsewhere. The mere fact that a utility is doing business with an affiliate does not mean that unfair or excess profits are being generated, without more. Charles F. Phillips, Jr., *The Regulation of Public Utilities* 254-55 (1988). We believe the standard must be whether the transactions exceed the going market rate or are otherwise inherently unfair. *See Id.* If the answer is "no," then the PSC may not reject the utility's position. The PSC obviously applied a different standard, and we thus must reverse the PSC's determination of this question.

Gold Canyon also cites *Washington Water Power v. Idaho Pub. Util. Comm.*, 617 P.2d 1242, 1248-49 (Idaho 1980), for the proposition that the "majority" approach allows recovery of affiliate profit under the right circumstances and views the affiliate as an independent entity and compares prices and levels of profit for affiliates with profits and prices of comparable enterprises.

Gold Canyon argues that Staff's claim of a prohibition on affiliate profits is unfounded. The Company contends that the so-called "no profit to affiliates" standard originated with the Federal Energy Regulatory Commission ("FERC"), but even the FERC bases its determination on a factual balancing test. Gold Canyon also disputes Staff's reliance on the *Turpen* case, *supra*, which, according to the Company, indicates only that the utility bears the initial burden of demonstrating the reasonableness of its expenses, not that all agreements with affiliates must be disregarded. With respect to *General Telephone*, the Company argues that although the court recognized the need for heightened scrutiny of affiliate transactions, and excluded the affiliate's profit, it did not prohibit affiliate profit recovery in all instances. Similarly, Gold Canyon claims that the *Washington Water Power* case cited by Staff does not claim that there is a nationwide prohibition against recovery of affiliate profit under return on equity ("ROE") regulation.

According to Gold Canyon, the Commission should refrain from imposing a prohibition on affiliate transactions or affiliate profit. The Company argues that the traditional approach to regulating utilities is under increasing market pressures and companies such as Gold Canyon have little choice but to take advantage of economies of scale offered by affiliate transactions. Absent the ability to enter into affiliate transactions, the Company claims that it would incur higher costs, and customers would ultimately be saddled with higher rates. Gold Canyon contends that its affiliates must recover a profit margin because those companies are not in the business of subsidizing utility customers. The Company also asserts that the Commission does not have jurisdiction over the unregulated affiliates, and threatens that if the Commission disallows a profit for affiliates those companies would cease providing services to the regulated utility. However, even if the profit components of affiliate costs are excluded, Gold Canyon claims that its rate base and operating expenses are reasonable.

Gold Canyon also disagrees with Staff's arguments in favor of piercing the corporate veil.

The Company contends that Arizona law strongly supports the treatment of corporations as separate entities, and cites several cases that have made that finding. *Arizona Public Service Co. v. Arizona Corp. Comm.*, 155 Ariz. 263, 267, 746 P.2d 4,8 (App. 1987); *Deutsche Credit Corp. v. Case Power & Equipment Co.*, 179 Ariz. 155, 160, 876 P. 2d 1190, 1195 (App. 1994); *Kearns v. Tempe Technical Institute, Inc.*, 993 F.Supp. 714, 723 (D. Ariz. 1997); *Dietal v. Day*, 16 Ariz. App. 206, 208, 492 P.2d 455, 457 (App. 1972). The Company argues that Staff has provided no evidence that the affiliate corporate entities are shams, or that the affiliates were improperly incorporated, disregard corporate formalities, intermingle corporate assets, or present themselves to the public in a fraudulent manner.

According to Gold Canyon, evidence of common ownership and common officers alone does not create a sham under Arizona law. The Company cites *Deutsche Credit*, 179 Ariz. At 160-161, in support of its claim that much more than common control is required to make a finding of "alter ego" and piercing the corporate veil. The court in that case stated:

> Additional proof [other than common ownership and officers] is required to show that the corporations were "alter egos"....Arizona decisions have identified the following considerations, among others, as material to this issue: common officers or directors; payment of salaries and other expenses of subsidiary by parent (or of corporation by shareholders); failure to maintain formalities of separate corporate existence; similarity of corporate logos; plaintiff's knowledge of separate corporate existence; owners' making of interest-free loans to corporation; maintaining of corporate financial records; commingling of personal and corporate funds; diversion of corporate property for shareholders' personal use; observance of formalities of corporate meetings; intermixing of shareholders' actions with those of corporation; and filing of corporate income tax returns and ACC annual reports.

The Company contends that Staff has not shown that the affiliate corporate structure employed by Algonquin is a sham and, further, Staff has supplied no evidence that observing the separate corporate status of the affiliates would represent a fraud or cause an injustice. Gold Canyon argues that although its business model may be relatively new, there is no factual basis for piercing the corporate veil. Instead of approving a rigid policy that excludes affiliate profit, the Company urges the Commission to strike a balance between preventing discriminatory conduct by utilities and affiliates, and preserving possible economies of vertical integration.

RUCO's Position

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

Resolution

Consistent with our determination in the recent *Black Mountain Sewer* case (Decision No. 69164), we agree with Staff that, at a minimum, the profit component of both capitalized costs and expenses by the Gold Canyon affiliate companies should be disallowed. As we stated in *Black Mountain*, "[w]e 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" (Decision No. 69164, at 17).

It would be reasonable to assume that the Algonquin companies conducted, or should have conducted, a due diligence analysis prior to acquiring Gold Canyon and the other Arizona utilities, and therefore 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. Even a cursory review of the corporate structures of other public service corporations in Arizona would have provided an indication that the Commission had never before approved a structure that allowed a utility company an opportunity to earn an authorized return on its assets, plus reasonable expenses, and also allowed affiliate companies to bill the monopoly utility company for services that included an additional profit margin.

Apparently, the Algonquin family of companies (with more than $800 million in assets) did not investigate thoroughly whether they would be permitted to impose such a structure on captive utility companies prior to making the various acquisitions of utilities in Arizona and elsewhere. Company witness Dave Kerr, an Executive Director of Algonquin Power Management, Inc., conceded that "[w]e were a bit naïve when we first got involved in the utility business...[and] we kind of invented it as we went along" (Tr. 1259-1260). This naivete led Algonquin to copy an affiliate structure that had previously been used only for the provision of wholesale electric power sales in Canada, and which is operated in a manner similar to a Real Estate Investment Trust in the

United States. However, the Company could not identify any other REITs in the United States that operate monopoly utility companies (Tr. 1260-1261).

As we indicated in *Black Mountain*, 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. As we stated therein, "[t]he 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" (Decision No. 69164, at 18).

We agree with Staff that this 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).

Based on the evidence presented, we believe the appropriate remedy in this proceeding is to disallow $67,449 that the Company is seeking in rate base for capitalized affiliate profit, and $78,607 the Company seeks to recover in operating expenses for affiliate profit. The level of expense authorized herein is reasonable and will allow the Company to provide adequate service to its customers. We share the concerns raised by Staff that the corporate structure set up by the Algonquin companies is not appropriate for services provided to a monopoly utility company, where the utility company and all of the affiliates are under common ownership and control and there is no ability to negotiate for services on an arms-length basis.

Overhead Allocations

The Company also requested that its operating expenses include $48,000 for the test year (*i.e.*, $4,000 per month) for allocations to Gold Canyon from Algonquin Power Trust ("APT"). The APT allocations are for overhead services such as human resources support, engineering and management support, strategic and capital planning, and regulatory and environmental compliance (Tr. 1207-1209).

Staff recommended that the Company should be allowed to recover the costs of overhead allocations for corporate consolidated audits, corporate tax services, corporate computer hardware and software, and corporate networks, servers and email (Ex. S-19, at 18). However, Ms. Brown recommended disallowance of $34,807 of affiliate overhead costs for "executive salaries for the income fund management, corporate office rent, corporate legal services, corporate travel, and costs labeled as 'other professional' and 'other administration,'" based on Staff's claim that such services are not needed in the provision of service to Gold Canyon's customers (*Id.*). Staff asserts that it could not verify the Company's claim that such costs are necessary for provision of service, nor could Staff verify the amounts for such services, because the Company did not provide Staff with backup information such as studies, time sheets, or unaffiliated third party invoices to support the additional

layer of affiliate overhead costs (*Id.* at 19). Ms. Brown testified that Staff's proposal to disallow certain overhead costs is reasonable because "[t]o include unverified affiliate overhead costs would provide an opportunity for captive customers to subsidize the operations of the unregulated affiliate and to unfairly inflate the Company's rate of return" (*Id.* at 21).

Gold Canyon contends that the central office overheads allocated by APT are necessary "support" services, and that such allocations are not unusual (Ex. A-10, at 14). The Company points out that a similar allocation was included in the *Black Mountain* case. The Company claims that Staff does not dispute that the overhead costs were incurred, only that Staff was unable to satisfy itself that that the costs actually benefited Gold Canyon. The Company also argues that Staff never asked for the backup information Staff claims is needed. Gold Canyon requests that the overhead expenses be allowed in this case just as they were allowed in *Black Mountain*.

We agree with Staff that the APT overhead allocations should be disallowed from cost of service in this case. Ms. Brown explained in her detailed testimony the basis of Staff's concerns with a portion of the unregulated affiliate overhead allocations, including Staff's concern that it was unable to verify the amounts of the allocations and whether those costs were necessary in the provision of service to Gold Canyon's customers. Gold Canyon's reliance on our allowance of similar overhead allocations in the *Black Mountain* case is misplaced. The *Black Mountain* case was our first opportunity to review the novel affiliate structure that has been set up by the Algonquin family of companies, and we specifically indicated that we were concerned in that case with the possibility that there may additional affiliate profits built into the affiliate billings. Although we excluded only the affiliate "profits" identified by Staff in *Black Mountain*, we stated very clearly that, "[i]n 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" (Decision No. 69164, at 18-19, emphasis added). We remain concerned with the level of expenses that are being allocated by various unregulated Algonquin affiliate companies to a number of small Arizona water and wastewater companies that may not require the level of sophisticated services that are necessary for larger companies. As we indicated in *Black Mountain*, we expect that the Algonquin affiliate

structure will continue to be scrutinized in future cases.

Net Operating Income

Consistent with the foregoing discussion, we will adopt adjusted test year operating expenses of $2,154,213, which, based on test year revenues of $2,496,380, results in test year adjusted operating income of $342,167, for 2.18 percent rate of return on FVRB.

## COST OF CAPITAL

Gold Canyon recommends that the Commission determine the Company's cost of common equity to be 10.50 percent. Staff recommends a cost of common equity rate of 9.20 percent. Both the Company and Staff recommend a capital structure of 100 percent equity and no debt. RUCO proposes a return on equity of 8.60 percent based on a hypothetical capital structure of 40 percent debt and 60 percent equity, with a 8.45 percent hypothetical cost of debt, resulting in an 8.54 percent weighted cost of capital (RUCO Ex. 8, at 6-7).

Capital Structure

Company witness Bourassa stated that Gold Canyon's capital structure consists of 100 percent equity (Ex. A-10, at 28). Staff agrees with the Company's proposed 100 percent equity capital structure (Ex. S-15, at 2). RUCO, however, proposes the use of a hypothetical structure of 40 percent debt and 60 percent equity (RUCO Ex. 8, at 6).

Mr. Rigsby claims that adoption of a hypothetical capital structure is appropriate in this case because his estimate of an 8.60 percent 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 proposes using 40 percent debt and 60 percent equity for Gold Canyon because the Company has a lower level of risk due to its actual capital structure.

We agree with Staff and the Company that a capital structure comprised of 100 percent equity should be used for calculating Gold Canyon's cost of equity capital in this proceeding. Although RUCO proposes using a hypothetical capital structure based on a sample group of utilities, the Company's actual capital structure is comprised of 100 percent paid in capital. In fact, the plant in Gold Canyon's rate base is financed entirely by equity. Although RUCO's proposed hypothetical

capital structure would result in lower rates to customers,[5] that fact does not justify adoption of RUCO's recommendation. We therefore adopt a 100 percent equity capital structure for Gold Canyon 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 significant dispute as to which formula should be used for reaching the appropriate outcome. Rather, the three expert cost of capital witnesses, Messrs. Bourassa, Irvine, and Rigsby, each rely on various analyses for their recommendations.

Gold Canyon's Position

The Company's expert witness, Mr. Bourassa, based his common equity cost recommendation of 10.50 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-11, at 30).

The Company's DCF analysis produced ROE results for the proxy companies ranging from 8.9 to 12.1 percent (Ex. A-12, at 18-22). Mr. Bourassa's risk premium analysis resulted in an ROE range of 10.2 to 11.3 percent; while the comparable earnings analysis produced results in the 4.0 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.*). Gold Canyon argues that Mr. Bourassa's analysis supports the Company's proposed 10.5 ROE in this case considering the Company's risks and investor expectations.

Gold Canyon criticizes the Commission's adoption of Staff's ROE recommendation in past cases "regardless of the evidence presented" (Gold Canyon Initial Brief, at 23). The Company contends that Staff's ROE recommendation in this case fails to reflect changing market conditions,

[5] Mr. Rigsby stated, "[r]atepayers also benefit from my recommended weighted cost of capital which is lower than what would have been obtained from a capital structure comprised of 100 percent common equity" (RUCO Ex. 7, at 55; *see also*, 636-638).

and cites the fact that Staff's 9.2 percent ROE recommendation in this case is the same as Staff's recommendation in 2003 in an Arizona Water rate case, when interest rates were at historic lows (Ex. A-11, at 35). The Company argues that although Staff's DCF and CAPM models resulted in an ROE of 10.2 percent, Staff lowered its recommendation by 100 basis points to reflect Gold Canyon's lower risk compared to other companies that lack access to capital.

The Company criticizes the recommendations of both Staff and RUCO (9.2 and 8.60 percent ROE, respectively), because the Company claims that Staff and RUCO mechanically applied the results of their models without regard for whether their proxy companies are actually comparable in terms of investment risk. Gold Canyon asserts that its risk premium analysis, comparable earnings analysis, and the economic conditions expected to prevail during the period in which new rates will be in effect, serve as a check on the reasonableness of its cost of capital recommendation. As an additional check on the reasonableness of its results, the Company points to Mr. Bourassa's market based risk premium analysis, which it claims confirms that Gold Canyon's proposal is actually conservative.

RUCO's Position

RUCO witness Rigsby based his ROE recommendation on the results of his DCF and CAPM analyses, which ranged from 8.92 percent to 10.69 percent for his sample group of publicly traded water and gas companies. His 8.60 percent ROE recommendation is the result of the DCF analysis, which utilized a sample of publicly traded water companies (RUCO Ex. 8, at 2).

RUCO contends that Mr. Rigsby's 8.60 percent cost of common equity recommendation is reasonable considering the lower risk associated with the Company's proposed 100 percent equity capital structure, compared to the capital structures of the sample publicly traded companies used in Mr. Rigsby's analysis. As indicated above, Mr. Rigsby testified that companies with 100 percent equity would generally be perceived by investors to have less risk, and would therefore require a lower expected return on common equity (RUCO Ex. 7, at 49-50). To account for Gold Canyon's lower degree of risk, RUCO contends it is customary in regulatory practice to make a downward adjustment to the cost of equity.

RUCO argues that, as an alternative, it could have made a downward adjustment to reflect the

fact that its cost of equity proposal was determined from a sample group of companies that face greater financial risk as a result of higher levels of debt in their capital structures (*Id.* at 51). However, Mr. Rigsby indicated that the better method of reflecting Gold Canyon's relative risk, compared to the proxy companies, is the use a hypothetical capital structure (*Id.* at 52). Based on all of these factors, 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 two-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. As revised by its Surrebuttal Testimony, Staff's DCF model produced an ROE of 9.1 percent; the average of its two CAPM results was 11.2 percent; and the average of the DCF and CAPM results was 10.2 percent. However, Staff made a downward adjustment of 100 basis points to account for "Gold Canyon's financial risk being less than that of the sample companies" (Ex. S-15, at 2). 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-15, Sched. SPI-2)[6]. Staff's cost of capital witness, Steve Irvine, calculated the growth factor for his DCF model by averaging the results of six growth projection methods.[7] Staff points out that the most controversial element of a DCF analysis is the choice of inputs for the growth rate. Mr. Irvine stated that Staff's methodology gives equal weight to historical and projected EPS, DPS and sustainable growth components, and provides a balanced outcome that avoids a skewed result which could occur if only historical or projected growth results are analyzed (Ex. S-15, at 5).

In response to Gold Canyon'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 mechanically followed the results of its models and argues that Mr. Bourassa used professional

[6] The six proxy companies chosen by Staff are the same companies used by Gold Canyon's witness - American States Water, California Water, Aqua America, Connecticut Water, Middlesex Water, and SJW Corp. (Ex. S-17, at 12).

[7] 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-17, Sched. SPI-7).

judgment improperly. 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. Staff argues that its inputs are pre-selected as specified from a balanced methodology and Staff does not use results to determine inputs.

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. Staff argues that the Commission has previously rejected attempts by utility companies to increase ROE based on risk premium and comparable earnings analyses, as well based on a company's small size. Staff also cites *Southwest Gas*, Decision No. 68487 (February 23, 2006), to support its argument that the Commission has determined Staff's methodology for determining ROE does not violate the *Bluefield Water Works* or *Hope Natural Gas*[8] decisions.

Conclusion on Cost of Capital

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 and CAPM models as the primary basis for determining the Company's reasonable estimated cost of equity capital are methodologies that have 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 reasonable 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. The same sample group was also used by the Company in its analysis.

We are not persuaded by the Company's suggestion (Ex. A-10, at 28) that use of a comparable earnings methodology is necessary to comply with the *Hope* and *Bluefield* cases. Article

[8] *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).

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 9.20 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 relied on a constant growth DCF model, a two-stage DCF model, and a two-part CAPM analysis for calculating his cost of equity capital, consistent with a long line of prior Commission decisions that have adopted comparable methodologies for determining cost of capital. We believe that adoption of Staff's recommendation results in just and reasonable rates and charges for Gold Canyon based on the record of this proceeding.

We therefore adopt a cost of equity of 9.20 percent, which also results in an overall weighted cost of capital of 9.20 percent.

## AUTHORIZED INCREASE

Based on our findings herein, we determine that Gold Canyon is entitled to a gross revenue increase of $1,798,999.

| | |
|---|---|
| Fair Value Rate Base | $15,725,787 |

| | |
|---|---|
| Adjusted Operating Income | 342,167 |
| Required Rate of Return | 9.20% |
| Required Operating Income | $1,446,772 |
| Operating Income Deficiency | 1,104,606 |
| Gross Revenue Conversion Factor | 1.62863 |
| Gross Revenue Increase | $1,798,999 |

## RATE DESIGN ISSUES

The current monthly customer charge for residential customers is $35.00 with no commodity charge. As updated in their final schedules, the Company and Staff recommended increases to $67.79 per month (93.69 percent) and $60.89 per month (74 percent), respectively, for residential customers (Co. Final Sched. H4; Staff Brief Sched. CSB-23). RUCO recommended a rate increase for residential customers to $49.88 per month (42.5 percent) based its proposed revenue requirement (RUCO Sched. Surr. RLM-15).[9]

For commercial customers, rates are based on average daily flows as calculated from monthly water usage data supplied by Arizona Water Company. The current charge is $0.1750 per gallon per day. For effluent customers, rates are based on per 1,000 gallons charge, which is currently $0.391 per 1,000 gallons. The increase approved will be applied to both commercial and effluent sales customers on a percentage basis that is equivalent to all other customers.

In accordance with the revenue requirement determined above, the increase will be applied in accordance with the Company's proposed rate design. Accordingly, the current residential rate of $35.00 per month will increase by 72 percent, to $60.55.

## OTHER ISSUES

Two additional issues in this proceeding engendered significant public comment, testimony, and evidence. Those issues involve odor complaints registered by customers and statements made by Gold Canyon's former president, Trevor Hill, regarding future rate effects associated with plant improvements. Both of these issues are addressed below.

Odor Issues

According to Gold Canyon, AWRA acquired in 2001 a company that was in poor repair,

[9] For residential customers with less than 700 square feet, the current monthly rate of $19.09 would increase to $36.97 under the Company's proposal; to $33.21 under Staff's recommendation; and to $27.21 under RUCO's proposal (*Id.*).

lacking in necessary permits, and with a problem of where to put excess effluent flows during non-peak periods of the year (Tr. 668-669). Mr. Hill testified that the Company had no billing system, hundreds of customers were connected to the system without having any account, and there were frequent customer complaints about odors (Tr. 708). Company witness Charles Hernandez confirmed that Gold Canyon previously had major odor and noise problems at its treatment plant (Tr. 243; Ex. A-8, at 2). According to William Hare, a field inspector and compliance officer with ADEQ, between February 2002 and May 2006, ADEQ conducted 16 inspections of the Gold Canyon treatment facilities in response to customer complaints (Tr. 100-101; Comm. Ex. 1). Mr. Hill testified that improvements to the treatment plant began soon after Algonquin's acquisition to address odor and capacity issues associated with the plant (Tr. 678), and the process of obtaining the necessary permits for plant improvements was begun shortly thereafter (Tr. 725-727). The Company's $11.2 million plant expansion and improvement project was completed in October, 2005.

In October, 2006, in response to customer complaints and concerns raised by Commissioner Mayes' letter, Gold Canyon retained the engineering firm of Brown and Caldwell to investigate the cause of ongoing odor complaints from customers. Steven Davidson was the engineer who conducted an analysis of the wastewater treatment facility and provided recommendations to the Company (Exs. A-3 and A-4). The Brown and Caldwell report stated that the odor control elements of the upgraded treatment plant included:

> a wet chemical scrubber serving the headworks building, primary clarifiers and aeration basins. An activated carbon system serves the aerobic digesters, solids thickener, solids, belt press and final clarifiers. All present areas of the plant through the final clarifiers are either total[ly] enclosed by a building totally covered by flat aluminum covers or tank domes, or provided with exhaust hoods.

Mr. Davidson testified that, in his opinion, all of the treatment plant's components that were capable of being covered were covered or enclosed (Tr. 148). During his testimony, Mr. Hare also indicated that the Gold Canyon plant is now equipped with more sophisticated odor control features than he sees in most sewer plants, and that, short of moving the location of the treatment plant, the Company has done all it can do to mitigate odors from the plant (Tr. 124, 128).

In addition to the odor analysis undertaken by Brown and Caldwell, ADEQ has conducted three odor inspections since the plant upgrade project was completed and has not found offensive odors during any of the inspections (Exs. A-1 and A-2; January 5, 2007 Late-Filed Exhibit). In addition, Staff witness Marlin Scott, Jr., testified that he conducted five inspections of the treatment plant and detected odors during one visit for a brief period. He stated that the odors were due to an open vault, which was open for pump maintenance, and the odors were confined to the immediate area (Ex. S-2, at 2-3; Tr. 1034-1035). Mr. Hernandez, who has an office at the treatment plant site, added that he does not believe the plant has been a source of offensive odors since the plant renovation was completed (Tr. 1188-1190; Ex. A-8, at 2-3).

The Brown and Caldwell report summarized its findings as follows (Ex. A-4, at 3):

> Our overall assessment of the odor control system design is that it is capable of achieving very high odor removal. The level of odor control was adequate to produce negligible fenceline odors during odor surveys. Odor containment is virtually 100 percent effective because all odor producing sources are enclosed, covered or hooded, and connected to odor control devices. Scrubber performance is excellent. Our data reflect H2S concentrations were reduced from 5 ppm to approximately 0.04 [ppm] in [the] scrubber. Thus, 99.2 percent H2S removal efficiency was obtained when all scrubber operating parameters were within their recommended ranges.

As a result of his study, Mr. Davidson recommended that Gold Canyon obtain hand-held analyzers to monitor scrubber exhaust concentrations (*Id.* at 4; Tr. 159). As described in its January 12, 2007 and February 2, 2007 Late-Filed Exhibits, the Company has installed fenceline odor monitoring equipment, and has obtained Odalog readings from the equipment which indicate that there are no measurable odors emanating from the treatment plant. Mr. Davidson suggested that a nearby grocery store's garbage bins and oil recovery area could be a contributing factor in odors experienced by area residents. He also pointed out that the grocery store has now installed an odor control unit on its wastewater pump station, to address odors that were previously believed to be coming from that facility (Tr. 153).

Gold Canyon argues that it did not create the problems at the treatment plant that resulted in a number of complaints from customers, and that the Company has acted promptly and invested

significant capital to remedy the odor problems. The Company asserts that no remedy should be imposed to require it to take further action regarding the odor problems because the Company has taken all necessary and appropriate remedial actions to resolve the problems. Gold Canyon believes, instead, that it should be commended for its success in addressing the problems it adopted from the prior owner.

Resolution

With respect to the Commission's authority to address issues such as the odor problems raised in this proceeding, the Commission clearly has authority to require that remedial action be taken to protect the public interest in situations where operational problems, including offensive odors, are caused by a regulated utility. For example, A.R.S. §40-321 states that the Commission may determine whether any public service corporation's facilities or equipment are inadequate or insufficient, and shall determine "what is just, reasonable, safe, proper, adequate or sufficient and shall enforce its determination by order or regulation." A.R.S. §40-361(A) provides additional authority to the Commission to require improvements or changes to existing facilities to promote the security or convenience of the utility company's employees or the public. A.R.S. §40-361(B) also requires public service corporations to "furnish and maintain such service, equipment and facilities as will promote the safety, health, comfort and convenience of its patrons, employees and the public as will be in all respects adequate, efficient and reasonable." *See, also, Black Mountain Sewer Corp.* (Decision No. 69164, at 34-37).

In response to customer complaints, as well as the August 9, 2006 letter to the docket from Commissioner Mayes, Staff conducted five site visits to the Gold Canyon service area between March 20, 2006 and August 29, 2006. Staff witness Marlin Scott, Jr., testified that he noticed odors from the plant on only one of the five visits, which the Company attributed to opening of a vault to repair three pumps that had been damaged during a storm on July 21, 2006. However, he indicated that the odor was confined to the immediate area of the open vault (Ex. S-2, at 2-3).

As described above, the Company produced three witnesses to address the customer complaints regarding odors that have been registered in various forms over the past several years. Each of these witnesses, Mr. Hare of ADEQ, Mr. Davidson from Brown and Caldwell, and the plant

operations manager, Charlie Hernandez, provided testimony that supports the Company's claims that it has taken reasonable steps to address the odor issues associated with the Gold Canyon treatment plant. The Company has installed odor abatement equipment and has covered or enclosed all of the equipment that is capable of being contained. Mr. Hernandez stated that once the Company's odor mitigation measures were completed, complaints made to him dropped to almost zero (Tr. 291). He also indicated odors from the operations of an adjacent grocery store also appear to have now been repaired (*Id.*).

Mr. Davidson testified that during his site visit, a short-term odor was detected down wind from the odor control scrubber stack (Ex. A-4). Upon inspection, it was discovered that there was a malfunction in the chemical feed system in the scrubber stack. However, once that chemical feed problem was remedied, he stated that the scrubber's efficiency was greater than 99 percent for H2S removal (*Id.*).

In response to the Brown and Caldwell report, as well as questions raised during the hearing, Gold Canyon purchased and installed odor detection monitors at the plant site's north wall; north corner; gate; west wall; east wall; scrubber; scrubber inlet; and scrubber outlet. According to readings obtained from the monitoring equipment between December 18, 2006 and January 5, 2007, readings at the perimeter ranged from 0 to 0.5 ppm, and interior readings ranged from 0 to 20 ppm, ranges well below levels that would be noticeable as offensive (January 12, 2007 and February 2, 2007 Late-Filed Exhibits).

We believe Gold Canyon has responded appropriately to the odor complaints which have been an ongoing issue since Algonquin acquired the system in 2001. The record supports a conclusion that the Company has acted responsibly to solve its treatment plant's odor problems and there does not appear to currently be an odor problem at the Gold Canyon treatment facilities that would require remedial action. However, in order to ensure that the facilities continue to operate in an efficient manner, and that odor mitigation efforts continue to be effective, we direct Staff to conduct annual odor detection site visits and provide a report in this docket by December 31 of each year, as a compliance measure, with the first report to be filed by no later than December 31, 2007. Staff's Compliance Division should also continue to respond to customer complaints on an as needed

basis, and should coordinate odor complaint response efforts with ADEQ, as the Compliance Division deems appropriate.

Prior Statements Made by Trevor Hill

Trevor Hill is the former president of Gold Canyon Sewer Company and was director of operations of AWRA from 2000 to 2003 (Comm. Ord Ex. 2, at 4). According to the Company, Mr. Hill's employment was terminated in August 2003 and since that time he has been the president and CEO of Global Water Resources, a provider of water and wastewater services in Arizona.

In late 2002 and early 2003, at the time Gold Canyon/Algonquin was planning to upgrade the Company's treatment plant, Mr. Hill was communicating with groups of customers as part of an organized informational campaign regarding the implications of the plant improvements, including the effect on future rates (*Id.*). According to Mr. Hill, he explained to customers that Gold Canyon intended to resolve the noise and odor issues at the treatment plant and would not seek a rate increase until those problems had been solved. He also prepared a handout that was given to customers during that same period discussing, in question and answer format, the odor issue and planned upgrades to the system (*Id.* at 5, Ex. A). On the second page of the handout, the following question and answer appears:

> Will the upgrade mean an increase in Rates?
>
> No. GCSC is committed to providing the upgrade through a combination of paid-in-capital and new development hook-ups.

Mr. Hill stated in his testimony that Algonquin intended to fund renovation through paid-in-capital and hook-up fees (which were already in place under the Company's existing tariffs). However, Mr. Hill claims that he "did not make any promises that GCSC would not seek an increase in sewer rates as a result of Company investments for plant renovation, but I did indicate to customers that rates would not increase until the plant renovation was complete and the odor and noise problems were resolved which, as I indicated, would take approximately five years" (*Id.* at 5-6). In response to claims from public comment witnesses that they were told the plant renovation would be funded entirely by hook-up fees, Mr. Hill claimed, "I do not recall making such statements to customers" (*Id.*). With respect to use of the term "paid-in-capital" in the handout, Mr. Hill asserts that the term

referred to the investment that would be made by Algonquin and later recovered through Gold Canyon's rate base (*Id.* at 6-7).

Gold Canyon's Position

Gold Canyon argues that Mr. Hill's prior statements are not relevant to this proceeding for a variety of reasons.[10] According to the Company, the Commission should not deny rate relief, or take other remedial action based on Mr. Hill's comments to customers, for the following reasons: 1) Mr. Hill did not have authority to make financial and rate recovery decisions for Gold Canyon during his tenure as president of the Company; 2) Mr. Hill's comments must be considered in the context of the serious problems with the plant that existed in 2002, and customer concerns that there would not be an "immediate" increase in rates; 3) Customers were not harmed, damaged or impacted by Mr. Hill's statements, and parties in this case have confused customer expectations with actual injury that would give rise to any legal rights for customers; 4) The Commission does not have authority to deny or reduce the rate increase based on Mr. Hill's statements because the Commission must grant rate relief based on a fair return on the Company's fair value rate base; 5) Mr. Hill's statements are not legally binding on the Company as a matter of contract law because there was no detrimental reliance by customers and no consideration received from customers; 6) Mr. Hill did not have actual or apparent authority to make the statements, and Algonquin's shareholders were not aware the statements had been made until 2005; 7) The Commission has no authority or jurisdiction to decide contractual or quasi-contractual disputes between the Company and its customers; and 8) Staff and RUCO agree that the prior statements should not impact the Company's rate increase request.

Based on these claims, Gold Canyon urges the Commission to disregard Mr. Hill's comments in deciding this case. In addition to the arguments described above, Gold Canyon argues that the rates in this case will not become effective until almost five years after the statements were made and, therefore, Mr. Hill's prediction that there would be no rate impact for five years was essentially accurate. The Company threatens in its brief that "[i]f the Commission rejects, reduces or delays GCSC's requested rate increase based on the comments of Mr. Hill, GCSC would have no choice but

[10] As explained above, Mr. Hill was provided by the Company as a witness in response to Commissioner Mayes' letter, and at the directive of the Administrative Law Judge that testimony from Mr. Hill should be provided to respond to questions raised during the hearing about his prior comments (Tr. 496-502).

to appeal such decision. In that event, GCSC customers would be subject to an additional future rate increase in the event GCSC prevails in such appeal" (Gold Canyon Closing Brief, at 43).

In response to Staff's suggestion that the Commission could order that future misleading or inaccurate statements by the Company would result in penalties (see discussion below), Gold Canyon argues that Staff's proposed remedy is "unnecessary and unworkable, not to mention a violation of the Company's rights to commercial free speech" (Gold Canyon Reply Brief, at 32). The Company claims that Mr. Hill's statements were not made in bad faith, they were just poorly worded. Gold Canyon argues that requiring the Company to seek prior Commission approval regarding communications with customers is unworkable, and would result in unnecessary regulatory proceedings and delays.

RUCO's Position

In its Response to Mr. Hill's Testimony, RUCO argues that Mr. Hill's written statement in the 2002 customer handout indicates that there would be no rate increase due to the plant upgrades, and "no means no." RUCO contends that although some customers may have understood that the use of paid-in-capital to partially fund the improvements may result in a future rate increase, most readers would interpret the handout to mean there would be no rate increase.

RUCO dismisses the Company's attempt to frame the issue as a contract dispute and claims that the Commission has authority under the Arizona Constitution, Article 15, Section 3, to, among other things, "make such reasonable rules, regulations, and orders, by which [public service corporations] shall be governed." RUCO also cites A.R.S. §40-203 as giving the Commission authority to proscribe practices that are unjust, illegal or insufficient. Despite this authority, RUCO does not advocate disallowance in rates of the plant upgrades. RUCO contends that denial of rate recovery would put the Company in financial distress and would provide a disincentive for Gold Canyon and other utility companies to make necessary plant improvements.

Although it is opposed to disallowance of plant costs from rate base due to Mr. Hill's statements, RUCO asserts that the Commission is authorized, pursuant to A.R.S. §40-425, to impose a fine on a public service corporation for failure to comply with the Constitution, applicable statutes, or failure or neglect "to obey or comply with any order, rule or requirement of the commission...."

However, RUCO argues that there is no provision of the Constitution, Arizona Revised Statutes, or Commission Rules which prohibit a company's misrepresentation to its customers. According to RUCO, since Gold Canyon (through Mr. Hill's statements) did not violate a law, or Commission rule or order, the Commission may not impose a penalty or fine in this case. RUCO recommends, instead, that the Commission initiate a rulemaking proceeding to establish rules governing utility companies' dealings with the public.

Staff's Position

Staff witness Steve Olea provided testimony on the issue of Mr. Hill's prior statements (Ex. S-16). Mr. Olea stated that the handout given to customers by Mr. Hill (RUCO Ex. 3) is confusing because it states affirmatively that there would be no rate increase associated with the plant upgrades, and then in the following sentence indicates that paid-in-capital would be used to fund the plant (investment for which shareholders would normally seek a return). Mr. Olea testified that, based on the question and answer provided by Mr. Hill to customers, an average customer would likely not understand that the Company would later seek a rate increase for the plant upgrades (Ex. S-16, at 3-4). Mr. Olea also contends that the information in the handout provided by Mr. Hill is inconsistent with his testimony, in which he claims to have told customers only that they would not see an increase in rates for approximately five years (*Id.* at 5).

Mr. Olea indicated that although Mr. Hill's statements were inaccurate and misleading, there is no specific rule or regulation that prohibits a company from making inaccurate or misleading statements regarding when a company may require a rate increase. However, Mr. Olea suggests that A.R.S. §40-322.A.1[11] may allow the Commission to provide a remedy for the prior misleading statements. Based on this authority, Mr. Olea claims that the Commission could order the Company to refrain from making misleading or inaccurate statements in the future regarding any aspect of its operations, and that future violations could result in monetary penalties or other sanctions that would not be recoverable from ratepayers (*Id.* at 6-7).

In its Brief, Staff argues that the Commission has the authority to act on misrepresentations

[11] A.R.S. §40-322.A.1 provides that the Commission may "[a]scertain and set just and reasonable standards, classifications, regulations, practices, measurements or service to be furnished and followed by public service corporations...."

made by public service corporations under Article 15, Section 3 of the Arizona Constitution, as well as various statutes. Staff cites A.R.S. §§40-202(A) and 40-202(C), to support its argument that the Commission has general powers to investigate and remedy misrepresentations in order to protect utility company customers. Staff contends that Mr. Hill's statements were not taken out of context, especially considering the "no" response given to the question of whether Gold Canyon's plant upgrades would require a rate increase. However, Staff concludes that Gold Canyon should not be denied a rate increase due to the misleading statements but, instead, the Company should be cautioned to be more prudent in the future with respect to statements made to customers.

Resolution

We agree with Staff and RUCO that Mr. Hill's statements to customers in 2002 and 2003 were in effect promises made by Gold Canyon's highest ranking officer that there would not be any rate increases associated with the treatment plant improvements. Mr. Hill admits that the statements he made were poorly worded (Tr. 690), but the fact remains that he was seeking to appease customers who were complaining, apparently justifiably, about odor and noise problems that existed at that time at the Gold Canyon treatment facilities.

Algonquin's attempt to distance itself from Mr. Hill's statements, on the basis that Mr. Hill was not authorized to make promises to customers about future rate relief, strains credulity. The record shows that not only was Mr. Hill the president of Gold Canyon Sewer Company, but he engaged in an organized public relations effort (with the assistance of a public relations firm, Tr. 711-714), to inform customers about what the Company planned to do at the plant and what the consequences of those efforts would be. Mr. Hill clearly held himself out as possessing the authority to make decisions on behalf of Gold Canyon and, indeed, Mr. Hill himself believed he had such authority (Tr. 696-697, 720, 731). Although there is no dispute that the plant improvements made by the Company were necessary, we believe that a public service corporation must be accountable for its actions, including statements made by its officers to customers.

Gold Canyon also contends that customers suffered no adverse consequences as a result of Mr. Hill's statements, and thus were not prejudiced by those statements; but what is unknown is whether customers who believed the promises Mr. Hill made in 2002 and 2003 decided to forgo

filing a complaint with the Commission or another agency, whether those customers would have made different decisions regarding the purchase or sale of property in Gold Canyon's service area, or whether those customers may have sought some other recourse against the Company regarding treatment plant upgrades if they had been presented with an accurate picture of the full effect of the Company's efforts.

We also disagree with the Company's attempt to frame the issue as a matter of contract law over which the Commission has no authority. The statutes cited by Staff and RUCO provide the Commission with broad regulatory authority to require that service provided by a public service corporation in all respects be reasonable. For example, A.R.S. §§40-202(A) and 40-202(C) state in relevant part:

> A. 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....
>
> C. In supervising and regulating public service corporations, the commission's authority is confirmed to adopt rules to:
>
> 1. Protect the public against deceptive, unfair and abusive business practices....

In addition, A.R.S. §40-321.A., states in part that:

> A. When the commission finds that the...service of any public service corporation...[is] 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.

A.R.S. §40-361.B., requires that:

> B. 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.

Despite their citation to the statutes quoted above (and others), both RUCO and Staff appear to suggest that the Commission is ultimately powerless to act on the statements made by Mr. Hill in 2002 and 2003 because "the Company did not violate a Commission Rule, Order or law which would

allow the Commission to establish a penalty and impose a fine" (RUCO's November 22, 2006 Response, at 5) and "the parties are in agreement that the statements made by Mr. Hill should not be used to deny a rate increase to Gold Canyon" (Staff Reply Brief, at 5). We do not believe our authority to address this situation is so limited.

In *Arizona Corp Comm. v. Palm Springs Utility Co., Inc.*, 24 Ariz. App. 124, 536 P.2d 245 (App.1975), the Court of Appeals of Arizona upheld the Commission's authority under the statutes cited above to protect the public interest by requiring a utility to provide its customers with water that met certain quality standards. Although that case addressed water quality issues, the court also held that the Commission's regulatory powers are not limited to health and safety issues, "but also include the power to make orders respecting the comfort, convenience, adequacy and reasonableness of service...." 24 Ariz. App. at 128. The court in *Palm Springs* stated that in addition to accomplishing its goals through implementation of rules and regulations, the Commission could achieve other goals by using specialized orders "pertaining to particular situations or to particular public service corporations." *Id.* Although the court recognized that, as a general principle of administrative law, promulgation of rules and regulations is preferable to making policies through individual orders, "any rigid requirement to that effect would make the administrative process inflexible and incapable of dealing with many of the specialized problems which arise" *Palm Springs, supra*, at 129, *quoting Securities and Exchange Comm. v. Chenery Corp.*, 332 U.S. 194, 67 S.Ct. 1575 (1947). The United States Supreme Court in *Chenery* also agreed that regulatory agencies may be best suited to address specialized problems through individual orders, rather than being bound by general rules and regulations, stating:

> In those situations, the agency must retain power to deal with the problems on a case-by-case basis if the administrative process is to be effective. There is thus a very definite place for the case-by-case evolution of statutory standards. And the choice made between proceeding by general rule or by individual, ad hoc litigation is one that lies primarily in the informed discretion of the administrative agency. *See Columbia Broadcasting System v. United States* [citation omitted].

The court in *Palm Springs* indicated that the Commission could address specialized situations on a case-by-case approach as long as a rational statutory or constitutional basis exists, and the action is

not so discriminatory so as to constitute a denial of the equal protection clause. According to the court, any other interpretation would impart "an unintended rigidity to the administrative process, rendering it inflexible and incapable of dealing with many of the complex and specialized problems which arise within the area of its constitutionally and statutorily invested competence." 24 Ariz. App. at 129-130.

Thus, contrary to the limitations described by the various parties that, absent an existing rule or regulation, the Commission is without authority to take action under the facts of this case, we believe the existing statutory framework empowers the Commission to fashion a remedy commensurate with the inaccurate and misleading statements made by Mr. Hill on behalf of Gold Canyon. Based on the representations made by Mr. Hill in 2002 and 2003 that no increase in rates would result from the then-proposed plant upgrade, we find that a penalty in the amount of $15,000 should be imposed on Gold Canyon Sewer Company. This penalty is based on $5,000 per year for the approximately three-year period from when the misleading statements were made to the time of the Company's filing of the rate application seeking recovery of the treatment plant improvements in rates. In making this finding, we wish to make clear that we are not reducing the reasonable return on fair value rate base that was established above in this rate order. Rather, we have reached the conclusion that a public service corporation may not simply walk away from the representations to customers made by the company's highest officer, especially when the statements involve future rate impacts associated with the company's actions. In other words, Gold Canyon must bear some responsibility for the promises made by its former president, even if the Company contends after-the-fact that the statements were made in error.

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 January 13, 2006, Gold Canyon filed an application for a determination of the current fair value of its utility plant and property and for increases in its rates and charges for wastewater utility service provided to customers in the Company's certificated service area in Pinal County, Arizona.

2. On February 10, 2006, Staff filed a Letter of Deficiency, setting forth the specific areas of the Company's application Staff deemed deficient.

3. On February 14, 2006, Gold Canyon filed a letter in opposition to certain of the deficiencies claimed by Staff.

4. On February 17, 2006, a telephonic procedural conference was conducted with the parties to discuss the alleged deficiencies. The parties indicated at that time that the dispute had been resolved.

5. On February 17, 2006, Staff filed a Letter of Sufficiency, classifying Gold Canyon as a Class B utility.

6. By Procedural Order issued February 27, 2006, as modified on March 3, 2006, a hearing in this matter was scheduled to commence on October 3, 2006, publication of the application and hearing date was ordered, and other procedural deadlines were established.

7. By Procedural Order issued May 9, 2006, RUCO and the MountainBrook Village at Gold Canyon Ranch Association were granted intervention.

8. On May 22, 2006, Gold Canyon filed Certification of Publication and Proof of Mailing of the required customer notice.

9. On June 16, 2006, Staff filed the Direct Testimony of Steven Irvine and Marlin Scott, Jr., and RUCO filed the Direct Testimony of Rodney Moore and William Rigsby.

10. On June 20, 2006, a Procedural Order was issued extending certain of the testimony filing deadlines.

11. On June 23, 2006, Staff filed the Direct Testimony of Crystal Brown.

12. On July 27, 2006, Gold Canyon filed the Rebuttal Testimony of Mr. Bourassa and Charles Hernandez. The Company filed an Errata to Mr. Bourassa's Rebuttal Testimony on August 1, 2006, and on August 23, 2006, filed a Supplement to Mr. Hernandez' Rebuttal Testimony.

13. By Procedural Order issued August 1, 2006, Cal-Am Properties, Inc. was granted intervention.

14. On August 9, 2006, a Procedural Order was issued scheduling a public comment session for September 13, 2006 in Gold Canyon, Arizona.

15. By Procedural Order issued August 11, 2006, the pre-hearing conference was rescheduled for September 25, 2006.

16. On August 30, 2006, Staff filed the Surrebuttal Testimony of Mr. Irvine, Mr. Scott, and Ms. Brown, and RUCO filed Surrebuttal Testimony of Mr. Moore and Mr. Rigsby.

17. On September 13, 2006, the Company filed a Legal Brief Regarding Prior Company Statements, in response to Commissioner Mayes' August 9, 2006, letter.

18. The public comment session was conducted by the Commissioners, as scheduled, on September 13, 2006. A number of customers offered public comment in opposition to the proposed rate increase and on related matters.

19. On September 20, 2006, Gold Canyon filed Proof of Publication for the required notice to customers of the public comment session.

20. On September 25, 2006, the pre-hearing conference was held. During the pre-hearing conference, Gold Canyon requested a continuance of the hearing date.

21. On September 27, 2006, a teleconference was conducted with all parties in the case. The parties agreed to a continuation of the hearing date until November 1, 2006.

22. By Procedural Order issued September 27, 2006, the evidentiary hearing was formally continued until November 1, 2006; a prehearing conference was scheduled for October 25, 2006; and the original October 3, 2006 hearing date was reserved for public comment to comply with the notice that had been mailed to customers and published.

23. On October 3, 2006, the hearing was called on the noticed date of the hearing. One customer offered public comment at that time.

24. On October 25, 2006, a second prehearing conference was held to discuss scheduling of witnesses.

25. The evidentiary hearing in this matter commenced on November 1, 2006, with additional hearing days on November 2 and 3, 2006. At the hearing on November 3, 2006, the Administrative Law Judge indicated the need for testimony by Trevor Hill, the former president of Gold Canyon, regarding alleged statements that were made with respect to the need for future rate increases due to treatment plant upgrades.

26. On November 13, 2006, Gold Canyon filed Mr. Hill's testimony.

27. On November 22, 2006, Staff filed the Direct Testimony of Steve Olea in response to Mr. Hill's testimony, and RUCO filed its Response to Mr. Hill's testimony.

28. The hearing resumed on December 4, 2006, with additional hearing days on December 5 and 11, 2006.

29. Gold Canyon submitted Late-Filed Exhibits on December 12, 2006, January 5, 2007, and January 12, 2007.

30. Initial post-hearing briefs were filed by the Company, Staff, and RUCO on January 19, 2007. Reply briefs were filed on February 2, 2007.

31. According to the Company's application, as modified, in the test year ending October 31, 2005, Gold Canyon had adjusted operating income of $241,752 on an adjusted FVRB and OCRB of $15,742,719, for a 1.54 percent rate of return.

32. 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.

33. Staff recommends a gross revenue increase of $1,822,101 (73 percent), based on OCRB of $15,725,787, and a recommended return on common equity of 9.20 percent.

34. RUCO recommends a gross revenue increase of $1,044,378 (41.84 percent), based on OCRB of $13,983,602, and a recommended return on common equity of 8.60 percent.

35. The Commission finds that allowable rate case expense should be decreased by $90,000 from the Company's proposal, and will approve a recommended rate case expense of $70,000, amortized over four years.

36. For purposes of this proceeding, we determine that Gold Canyon has a FVRB and OCRB of $15,725,787.

37. A rate of return on FVRB of 9.20 percent, based on a capital structure of 100 percent common equity, is reasonable and appropriate.

38. Gold Canyon is entitled to a gross revenue increase of $1,798,999.

39. The rate design recommended by the Company and Staff should be adopted in this

proceeding.

40. Staff's recommendation to exclude affiliate profits, as well as certain central overhead allocations, 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 continue to scrutinize all affiliate salaries, expenses and billings.

41. Gold Canyon has responded adequately to the odor complaints which have been an ongoing issue since Algonquin acquired the system in 2001. The record supports a conclusion that the Company has acted responsibly to solve its treatment plant's odor problems and there does not appear to currently be an odor problem at the Gold canyon treatment facilities that would require remedial action. However, in order to ensure that the facilities continue to operate in an efficient manner, and that odor mitigation efforts continue to be effective, Staff should conduct annual odor detection site visits and provide a report in this docket by December 31 of each year, as a compliance measure, with the first report to be filed by no later than December 31, 2007. Staff's Compliance Division should also continue to respond to customer complaints on an as needed basis, and should coordinate odor complaint response efforts with ADEQ as Compliance Division Staff deems appropriate.

42. Based on the representations made by Mr. Hill in 2002 and 2003 that no increase in rates would result from the then-proposed plant upgrade, we find that a penalty in the amount of $15,000 should be imposed on Gold Canyon Sewer Company. This penalty is based on $5,000 per year for the approximately three-year period from when the misleading statements were made to the time of the Company's filing of the rate application seeking recovery of the treatment plant improvements in rates.

## CONCLUSIONS OF LAW

1. Gold Canyon 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, and 40-361.

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

3. Pursuant to A.R.S. §§40-202(A) and (C), 40-321(A), 40-361(B), and the authority

under Article 15 of the Arizona Constitution, the Commission has jurisdiction to impose a penalty on a public service corporation to remedy inaccurate and misleading statements made by an officer of the company to 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 Gold Canyon Sewer Company is hereby authorized and directed to file with the Commission, on or before June 29, 2007, revised schedules of rates and charges consistent with the discussion herein, as set forth below.

| | |
|---|---|
| Residential Service – Per Month | $60.55 |
| Residential Service (less than 700 Square Feet) | 33.03 |
| Residential Units (Home Owners Association) | 55.05 |
| Commercial – Per gallon per day | 0.30276 |
| Effluent Sales – Per 1,000 gallons | 0.786 |
| | |
| SERVICE CHARGES: | |
| Establishment | $25.00 |
| Establishment (After Hours) | 50.00 |
| Re-establishment (Within 12 Months) | (b) |
| Re-establishment (After Hours)(b) | $40.00 |
| Re-connection (Delinquent) | (c) |
| Re-connection (Delinquent and After Hours)(c) | $30.00 |
| Minimum Deposit (Residential) | (a) |
| Minimum Deposit (Non-Residential) | (a) |
| Deposit Interest | 6.00% |
| NSF Check Charge | $10.00 |
| Deferred Payment Finance Charge Per Month | 1.50% |
| Late Payment Charge | 1.50% |
| | |
| Main Extension Tariff (b) | Cost |
| | |
| HOOK-UP FEE FOR NEW SERVICE | |
| 4 Inch Service Line | $900.00 |
| 6 Inch Service Line | 2,025.00 |
| 8 Inch Service Line | 3,600.00 |
| Larger than 8 Inch Service Line | 5,625.00 |

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

(b) Minimum charge times the number of full months disconnected.

(c) Actual cost of physical disconnection an reconnection (if same customer) and there shall be no charge if there is no physical work performed.

IT IS FURTHER ORDERED that the revised schedules of rates and charges shall be effective for all service rendered on and after July 1, 2007.

IT IS FURTHER ORDERED that Gold Canyon Sewer Company 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 Staff's Compliance Division shall conduct annual odor detection site visits and provide a report in this docket by December 31 of each year, as a compliance measure, with the first report to be filed by no later than December 31, 2007. This report shall be filed until further order of the Commission. Staff's Utilities Division shall also continue to respond to customer complaints on an as needed basis, and shall coordinate odor complaint response efforts with ADEQ, as the Utilities Division deems appropriate.

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IT IS FURTHER ORDERED that Gold Canyon Sewer Company shall pay a $15,000 penalty by either cashiers check or money order, within 30 days of the effective date of this Decision, payable to the "State of Arizona" and presented to the Arizona Corporation Commission's business office for deposit to the general fund for the State of Arizona.

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 28th day of June, 2007.

BRIAN C. McNEIL
EXECUTIVE DIRECTOR

DISSENT

DISSENT

SERVICE LIST FOR: GOLD CANYON SEWER COMPANY

DOCKET NO.: SW-02519A-06-0015

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