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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF UTILITY SOURCE, L.L.C. FOR A DETERMINIATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PROPERTY AND FOR AN INCREASE IN ITS WATER AND WASTEWATER RATES AND CHARGES FOR UTILITY SERVICES	WS-04235A-06-0303 **APPLICANT'S BRIEF**

Utility Source, L.L.C. (the "Company") hereby files its Brief regarding the remaining issues as ordered by Administrative Law Judge Teena Wolfe (the "ALJ") on June 22, 2007.

BACKGROUND

On May 1, 2006, the Company filed an Application for an increase its water and wastewater rates and charges for utility services in this Docket. On July 3, 2006 the Utilities Division Staff (the "Staff") declared the Application sufficient. Subsequently, several Procedural Orders were issued establishing the critical dates in this Docket and granting certain parties Intervenor status. On March 19, 2007 a Public Comment session was conducted in Flagstaff, Arizona. All Parties duly filed their testimony and exhibits, and an evidentiary hearing was held on this matter on June 19 and June 20, 2007. During the proceeding the ALJ requested that the Company file copies of deeds for the well sites. Copies of those deeds, which were it originally docketed on February 2, 2005 in accordance with Decision No. 67446, were docketed in this proceeding on July 10, 2007. The ALJ also requested the Staff file an alternative scenario for her consideration ("Scenario # 4"), which was done on June 22, 2007. Comments and

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Objections to that scenario were filed by the Company on June 29, 2007, copy of which is attached hereto as Exhibit A and incorporated herein by this reference for all purposes.

REMAINING ISSUES

The issues remaining before the Commission in this matter are relatively few, but very important. The Parties are in substantial agreement on several of the major issues, including the Rate Base and Adjusted Operating Income (Loss) as set forth below:

	Company	Staff
Water Rate Base	$2,753,096	$2,753,095
Water Operating Income (Loss)	($23,286)	($21,340)
Wastewater Rate Base	$1,111,382	$1,113,582
Wastewater Operating Income (Loss)	($22,959)	($22,441)

The major contested issues remaining deal with the recommended Rate of Return for the Company, both on an overall basis and for the Company's Operating Divisions. These issues can be summarized as follows:

	Company	Staff
WATER		
Revenue Requirement	$486,689	$367,185
Revenue Increase	$312,361	$192,858
Increase	179.18%	110.63%
Recommended Rate of Return	10.5%	6.23%

WASTEWATER	Company	Staff
Revenue Requirement	$253,359	$235,454
Revenue Increase	$139,654	$121,549
Increase	122.61%	106.71%
Recommended Rate of Return	10.5%	8.9%

The dollar differences between the Parties recommendations all relate to the differing Rates of Return.

OVERALL RATE OF RETURN

A. Staff's recommended Rate of Return fails to provide a "comparable return" or "financial soundness" to the Company.

The Company objects to the Staff's overall recommended Rate of Return of 8.9% on legal, technical and logical bases.

There exists a well established standard by which this, and virtually all utility regulatory agencies, must authorize returns for companies which they regulate. This standard must meet the U.S. Constitution's Fourteenth Amendment protections against confiscating the utilities' property. It is set forth in the *Bluefield Waterworks* case. The often cited case states:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The returns should be reasonably sufficient to ensure confidence in the financial soundness of the utility and should be adequate under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of his public duties. (262 U.S. at 692)

The Arizona Supreme Court has very succinctly summarized that in *Simms v. Round Valley Light & Power* (1966) 80 Ariz., 145, 294 P.2d 378, 380, wherein it stated "It is elementary that a public utility subject to regulation and fixing rates is entitled to realize a fair and reasonable profit from its operations in the service of the public." That embodies the "comparable earnings standard" set forth in *Bluefield* cited above. It is submitted that "fair" in this context does not mean that it meets the standard if the Commission merely grants the same return, or even uses the same financial model to establish those rates of return. That would obviously be circular in reasoning and not necessarily "comparable" or "fair". Staff indicated that they gathered the input data from the sources which they always use in their models. This is the unacceptable circular thinking that *Simms* cannot support. Mr. Irvine's inputs were biased against the Company and Mr. Michlik's computations, as discussed below, were further biased against the Company.

Not only does Staff's recommended Rate of Return fail the comparable earnings standard of *Bluefield*, that recommendation does not meet the financial soundness standard set forth in the last sentence of the above quotation from *Bluefield.* Please see the below discussion regarding the unreasonableness of Staff's recommendation.

B. The Staff's cost of capital models inputs were biased against the Company, and the output of the models are unreasonable.

Staff's recommended Rate of Return fails the comparable earnings test because Staff used inputs to the cost of capital models that are technically improper. In the DCF model the significant factor in which the Staff and Company disagree is the Staff's use of the historical Earnings Per Share ("EPS") and historical Dividends Per Share ("DPS) growth components. Those growth components when used in the DCF model result in indicated costs of equity below the cost of Baa bonds and are clearly unrealistic and cannot reasonably reflect investor expectations. (Exhibit A-4, Bourassa Rejoinder, Page 20-22) In Staff's DCF model the projected EPS growth input was a Staff generated number, not the readily available data from reliable financial sources but rather computes its own from other Value Line data which then makes it subject to judgments about the time period used in the computation.

Upon the witnesses updating testimony from the Direct Case to subsequent filings, and using the same timeframe as used in Staff's Surrebuttal testimony, Staff's projected EPS growth rate estimate dropped 160 basis points, while the Company's increased by 70 basis points. (Exhibit A-5, Bourassa Rejoinder, Page 8) Staff's machinations produce an average DCF of 8.4%, approaching prime rate of 8.25%, and the constant growth DCF result of 7.7%, which is less than the prime rate of 8.25%. Messer's Irvine and Michlik acknowledged that fact. (TR201 and 275).

Likewise, in Mr. Irvine's CAPM model he applied data skewed against the Company by using the <u>median</u> dividend yields and <u>median</u> price apprciation for growth, not <u>average</u> dividend yields and price appreciation. If one invests in the market and is 'diversifed' as Staff suggests investors should be, one should earn the average returns, not the median returns. Use of median yields and price appreciation are not only technically and logically incorrect but produce results which are exteremly volatile, and a bias against the Company. The use of averages are much less volatile. (Exhibit A-5, Bourassa Rejoinder, Page 12) The same analysis, using the correct average dividend yield and price apprication versus the median dividend yield and price appreciation result in a growth rate that is nearly 370 basis points higher than Staff's and an indicated cost of equity 360 basis points higher than Staff's. (Exhibit A-5, Bourassa Rejoinder, Page 11). Staff's computed DCF growth rate used to compute the current market risk premium produces a much lower and much more volatile Current Market Risk CAPM result. Staff's model produces a Current Market Risk CAPM of 7.8% (Surrebuttal Schedule SPI-2) , well below the prime rate. Compare this to 9.5% in Staff's Direct filing – a drop of 170 basis points over a few short months. Using the correct average values in the computation of growth and the current market risk premium results in a Current Market Risk Premium CAPM result of 11.4%. Compare this to 11.2% for Staff's Direct filing if Staff had used the average values – a drop of only 20 basis points. (Exhibit A-5, Bourassa Rejoinder, Page 12).

C. The results of Staff's cost of capital analysis are illogical and unreasonable.

Aside from being illegal and technically incorrect, Staff's cost of capital position is illogical and unreasonable. Staff is insistent that there are no unique risks associated with a small company, and if there are, the market will adjust to those by diversifying their investments. Diversification is a marvelous theoretical position, but it is as remote from reality as are Staff's other conclusions in this regard. Putting aside the market data used by both of the parties includes that of large publicly traded companies and arguably this data does not capture the perceived risks and returns required by investors in companies like USLLC, it is submitted that real live investors in small utility companies, and rational people, do not consider diversification to be the remedy for low returns. If a utility company investor expects to earn 10.5% in a company that is operating in an environment of historic test years, no automatic cost adjustors, increasing wastewater regulations, arsenic limitations, dropping water tables, drought, conservation and unstable rate designs, limits on capital availability (at any cost), and regulatory lag, that investor is not going to accept the same return he or she could receive from a company in the same industry that is unbridled by those above listed risks. Further, all Parties agree that including the 350 customers[1] and assuming that those revenues will actually be received is a huge risk for the Company. (TR 83 and 276) Note that the 6.23% recommenced by Staff is

[1] Despite the 2006 and 2007 YTD addition of zero new customers (TR 41)

below even the low end of the range of Mr. Irvine's analysis of 7.0% to 11.0% (Surrebutal Schedule SPI-2 and TR 207).

Staff does not deny the existence of these unique risks, however, they argue that diversification will solve that investors lesser return dilemma. To deny recovery for that risk in a company's cost of equity is as unrealistic as Staff's recommendation of a return less than the present prime interest rate. How can one credibly argue an equity investor, who has no guarantee of return, would overlook the same unique risks that a banker would consider when setting an interest rate on a secured loan? A banker clearly would not make a bad loan just because he has a diversified portfolio that includes less risky, lower interest rate, loans. Staff has input data into their models without any consideration of reality.

The results of Staff's models are therefore equally unreasonable. However precise the fourth decimal place computation, however perfect the sample companies represent the universe, the result of Staff's analysis was not held up against reality. Mr. Irvine testified that following his analysis he performed a "check for reasonableness" (TR 187) or a "smell test" (TR 188). However, on further examination he described no concrete check or test, and admitted he did not even test his recommendation against two very basic financial indicators.

> Q. But again, I'm not sure that you specifically answered this, but did you not, in fact, look at an operating margin for this company based upon your recommended cost of capital?
> A. I did not.
> Q. And you didn't look if there was sufficient cash flows for the Company's operations?
> A. I did not.
> Q. Did you make a--let me ask you this. If you were to know that your 8.9% return resulted in insufficient cash flows for the company's operation, would that impact at all in your analysis?
> A. Well, again, our formulas are what they are and they don't include specific adjustment for that. So would it figure in? No, it's not a part of our formulas. (TR 193 -- 194)

It is submitted that one cannot apply these sophisticated models mechanically. The expertise required to analyze and implement these models requires a certain level of judgment that has clearly not been applied by Staff. One does not need to be a financial analyst, or know anything about financial models, to know that this result is absurd. Because Mr. Irvine's analysis produces such an absurd result, the Commission must totally disregard his recommendation as not being supported by substantial evidence.

WATER DIVISION RATE OF RETURN

In addition to the inadequate Cost of Capital of 8.9% proposed by Staff, Staff further erred by not even applying that inadequate return to the Fair Value Rate Base ("FVRB") of the Water Division.

A. Staff's method of determining the Water Division's Rate of Return is illegal.

The controlling authority on this procedure is set forth in *Simms*. Although addressing rate base in that instance, the principle is identical.

> "The company contends the commission in arriving at just and reasonable rates first determined what the company should be allowed to earn…; and second, having thus established the amount the company should be allowed to earn for such purposes, <u>it proceeded to adjust the rate of return to any rate base</u>. If this be true, it would be an illegal method of establishing a rate base. The standard for establishing a rate base must be the fair value of the property and not what the commission might believe was a fair rate of return on common equity. (Emphasis added) (*Simms* at 380)

In *Simms*, the Commission backed-into a rate base. For the Water Division in this case, Staff backed-into a Rate of Return.

Basically, there are three key <u>conclusions</u> or decisions to be made by the Commission in rate-making: (1) the establishment of a Fair Value Rate Base, (2) the determination of an Adjusted Operating Income for the Test Year, and (3) an appropriate Rate of Return. The Revenue Increase is a <u>computation</u> using the above three <u>conclusions</u>. Mr. Michlik confirmed this procedure on cross examination at Transcript Page 272. *Simms* makes it clear, that a conclusion can not be based upon a computation. It must be the other way around.

In their Direct Case, (Exhibit S-1) Staff followed the *Simms* guideline and determined the Adjusted Rate Base for the Water Division to be $2,048,228 (Schedule JMM-W1, Line 1), then multiply that Rate Base by their then-recommended Required Rate of Return of 9.6% (Line 4) to determine a Required Operating Income of $196,630 (Line 5). The Adjusted Operating Income/Loss of $3,508 (Line 2) was then subtracted from the Required Operating Income to obtain the Operating Income Deficiency of $193,122 (Line 6) which converts to the Required Revenue Increase (Line 8). The Staff's Direct Case filing recommended a Required Revenue Increase for the Water Division of 110.78% (Line 11).

The above mathematical procedure is the long-established and well accepted method used to determine a rate increase, and is fully supported by the Arizona law. This same procedure was used in computing the Wastewater Division wherein Staff's Direct Case they recommended an increase of $111,003, a 97.45 % revenue increase (Lines 6 and 11, respectively).

In the Staff's corrected Surrebuttal case for the Wastewater Division (Exhibit S-3, Revised Surrebuttal Schedule JMM-WW1), Staff modified the Adjusted Rate Base and Operating Income (Loss) based on the Company's Data Responses, and also reduced the Rate of Return to 8.9% in response to Mr. Irvine's recomputed cost of capital. Using those numbers, the new Required Revenue Increase became $121,549, with a Required Increase in Revenues of 106.71% (Lines 8 and 11, respectively)[2]. All of these calculations were confirmed by Mr. Michlik (TR 253-259), and are consistent with *Simms*.

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[2] Note that in the original Surrebuttal Case, Staff recommended a $162,931 Required Revenue Increase and a 273.59% increase (Lines 8 and 11).

The Staff then deviated from *Simms* and made the totally illegal computation for the Water Division resulting in a Required Rate of Return of 6.23% (Exhibit S-2, Late Filed Schedule JMM-W1 (Line 4). Although they adjusted the Schedule for the Water Division to reflect the new Rate Base and Operating Income (Loss), the Required Operating Deficiency and the Required Increase in Revenue are virtually identical to the recommendations contained in the Direct Case, $192,858 and 110.63%. ($264 and 0.15% differences due to Rate Design and rounding)

When asked regarding his recommended Required Increase in Revenues, Mr. Michlik stated: "Q. So you are looking for the $193,000 target that was in your schedule W1 on January 19th, (the Direct Case recommendation) correct? A. Correct." (TR 262) The recommended Water Division Required Increase in Revenue was not established as done in the Direct Case for both Water and Wastewater Divisions, nor was it done in the manner of the Wastewater Division Surrebuttal Case. The Rate of Return was computed to be 6.23%. In response to counsel for the Company's question, Mr. Michlik said:

> Q. Did you not compute line four on W1 by dividing the $2.7 million rate base by the $192,000 operating deficiency?
> A. Correct."
> Q. OK. So that is a simple mathematical computation of dividing those two to get your 6.23?
> A. Correct. " (TR 268)

For the Water Division Surrebuttal recommendation Staff used the Required Revenue Increase and Required Increase in Revenue percentage based on a different Adjusted Rate Base, with a different Adjusted Operating Income, but used the same, and now an arbitrary, target revenue increase and percentage increase as previously computed in the January Direct Case, resulting in a different Required Rate of Return. Staff clearly "backed-into" their ultimately recommended Required Rate of Return of 6.23%. Mr. Michlik's 6.23 %

recommended Rate of Return for the Water Division may be his computation, but it is not a conclusion based on the evidence as required by the *Simms* standard. *Simms* sets forth the **only** standard for rate making. The Staff method is clearly in violation of Arizona law.

To illustrate how inappropriate it is to reverse the roles of conclusions and computations by using a revenue target for rate making, assume Staff is still is looking for a $192,858 or 110% increase as they have testified. Now assume they did not adjust the Adjusted Operating Income (Loss) from $3,508 to ($21,340), but left the January Income level. Using that established formula would mean that the Required Operating Income would be $189,350 ($192,688 minus $3,508). Therefore, the Required Operating Income of $189,180, divided by the Rate Base of $2,753,095 would produce a 6.88% Required Rate of Return. We are not suggesting that Staff did this, but it merely shows how the computation of the Rate of Return changes if you manipulate the results to reach a preconceived revenue target. The Commission is required to utilize conclusions based on the evidence in the case. Staff's recommendation admittedly did not do this. Staff's approach is clearly inappropriate, and it is illegal.

When Mr. Michlik was asked if Mr. Irvine had advised him to use the 6.23% return for the Water Divsion he responded: "He stated it should be 8.9 percent in both cases" (TR 261). When Mr. Irvine was asked if he determined a different cost of capital for the Water and Wastewater Divisions, or advised Mr. Michlik to utilize a return other than 8.9%, he responded in the negative (TR 197). There is no evidence in this record showing how the 6.23% was independently determined. Note that the 6.23 % recommenced by Staff is below even the low end of the range of Mr. Irvine's analysis of 7.7% to 11.0% (Exhibit S-2, Schedule SPI-2 and TR 207).

Staff, went one step beyond computing the Rate of Return, by concluding the ultimate Required Increase in Revenues. That increase for the Water Division was based solely upon a

Required Increase in Revenues that produced an approximate 110% increase. The targeted increase was set by the correct procedure used in the Wastewater Division which produced that level of increase. (Exhibit S-3 Revised Surrebutal Schedule JMM-WW1) The rationale then was to recommend the same increase to water and wastewater customers. (TR 263) The record clearly establishes that the water and wastewater customers are identical, with the possible exception of a standpipe customer. Therefore, there can be no legitimate concern for discrimination among customers. (TR 263) There is no explanation as to why the two Divisions needed to be, or should be, the same. Discrimination is even less possible with the wastewater rate design being tied directly to water consumption. (Exhibit S-2 Surrebuttal Schedule JMM-WW12) Staff's method does explain why they never tested their Rate of Return results against any financial indicator.

Staff clearly abandon one half of the *Arizona Constitution's Article 15 Section 3* well established regulatory compact to prescribe "…just and reasonable rates…" when they considered <u>only</u> the impact on customers, <u>not</u> the impact on the Company. Staff's own internally created method of establishing rates for the Water Division blatantly violates the legal procedures set forth above.

B. Staff's recommended Rate of Return of 6.23% is unreasonable

Upon inquiry as to why the Staff was not allowing the full rate of return on the investment of 8.9 percent, but rather 6.23 percent, Mr. Michlik responded it was "…for the sole benefit of the current customers". (TR 249) The Company's inclusion of Well Number 4 and 350 customers has already reduced the proposed rates by approximately one-half. (See Well Number 4 discussion below)

Mr. Michlik was then asked if he had looked at the rate of return on a Company-wide basis, to which he responded he had not. He did acknowledge Mr. Bourassa's testimony that the combine return was approximately 7%, but Staff did not test the reasonableness of his 6.23% return, or any other return, against the market price for Baa bonds or the prime rate. (TR 275).

The Company's proposed 10.5% Rate of Return is the minimum the Commission should allow the Company in this Application. First, the cost of capital model of the Company uses data that investors would actually use, projected earnings estimates. The Company used projections only when at least two analysts had provided their estimates. Likewise, Mr. Bourassa rejected historic earnings when they provided illogical results, i.e., produced rates less than baa bonds or the prime rate. Further, Mr. Bourassa's cost of capital, when applied to the full customer level pro forma, and measured against the Test Year, provided a positive Rate of Return and Operating Margin for the Company. The Test Year is the period that must be used for the analysis in this proceeding. Rejoinder Exhibit 1 shows a positive Rate of Return of 2% (with the Operating Margin at 21%) on Pages 1 and 2, with a negative rate of return of 0.07% and negative 4.01% Operating Margin for the Wastewater Division. When combined, those results provide a slight positive Return and Operating Margin. Please note that the Return and Operating Margin for the Staff's scenarios are negative, with the Rate of Return as low as negative 1.55% (per pages 7 and 8). When netted with the positive scenario for the Water Division (Pages 9 and 10), they still produce negative indicators. The Commission must provide a Rate of Return and Operating Margin that will permit the Company to provide service to its customers <u>now</u>, not if and when the 350 proforma customers arrive.

Staff's recommended 8.9% and 6.23% Rates of Return are illegal and unreasonable. The evidence is clear that a differing return for the different operating divisions of the Company is not only based upon an illegal computation, but it has no substantial evidentiary support. Beyond that, it is contrary to the recommendation of Staff's own cost of capital witness. The 6.23% Water Division recommendation shares the deficiency with the 8.9% Wastewater

Division recommendation in that the Staff's inputs to the DCF and CAPM models were by design biased against the Company. Further, there is no evidence in this record that Staff tested either of those those recommendations for reasonableness. When so tested those recommendations produce rates that are clearly confiscatory of the Company's property.

On the other hand, the Company's recommended Rate of Return of 10.5% is fully supported in the record, and withstands the reasonableness test by providing a small premium over the investment-grade bond returns and the prime interest rate. It is also proven reasonable as it provides a reasonable, albeit minimal, rate of return and operating margin for the Company during the Test Year.

C. This is not a "hybrid" Case

It is fair to state that the owners of Utility Source have gone out of their way to provide good and low-cost utility service to their customers. They have been subsidizing the utility's operations since its inception, including a $180,000 loss during the Test Year. (TR32) Staff will argue that a low return is appropriate because this is a "hybrid" case, between a certificate application and a rate case application, and therefore there is no requirement to provide a return on Rate Base. Why then is Staff going through the Cost of Capital exercise? Further, there is no basis in fact or law for that position. First, this Application must be either fish or fowl, it cannot be both. In fact, the Commission was aware of the unique facts in this case and, as they do in all new certificate applications, they knew that the rates they established would, by definition, be wrong. New company rates are always based upon proforma data. Merely because this case includes a pro forma adjustment, does not change the nature of the case. The Company has not proposed, nor would the Staff likely accept, the multitude of proforma additions to plant and operating expenses that would be typical in a certificate application. The anticipated operating loss in a new company is not embodied in a statute or case law, it is merely an economic reality with any business. Even with a target 8% or 9% Rate of Return in year five for a new company (TR 279), the Company, which had 201 customers at the time of its certification (See Decision No. 67446, Finding of Fact 2, Page 4), should now be at least at the breakeven point, or slightly above, as proposed by the Company. The ramping up of plant, expenses, and customers is why a rate case is required as a condition in virtually all new certificate applications. The Commission required precisely that for this Company, and this Docket is the time to set those rates based upon the now known actual plant and customer data, as adjusted. Proforma adjustments do not alter Arizona's law which clearly states the strict criteria of granting a comparable returns and financial soundness in rate proceedings.

WELL NUMBER 4

A. The Company's proposed inclusion benefits the Ratepayers

Both the Company and Staff recommend including Well Number 4 and the 350 customers in this proceeding for the benefit of the current customers. (TR 229) There is no substantial evidence in the record suggesting otherwise. The Company was sensitive to the result of the "normal" computation of a required increase, and determined that the increase mandated by that normal method was overly burdensome on ratepayers if implemented at this time (TR 38), especially when compared to the totally inadequate rates now in effect. That required increase would have been well over 300 percent. (TR 85) Therefore, the Company proposed including the 350 proforma customers from the new Flagstaff Meadows Unit 3 Subdivision, for both the Water and Wastewater Divisions. To justify and support that adjustment, which obviously spreads recovery of the adjusted Test Year costs and return over 350 additional non-existing customers, it was only appropriate to "match" the customers with the plant that will serve those illusionary customers. The Company included Well Number 4 at the agreed-upon cost incurred through the Test Year of $736,583. (Exhibit A-5, Bourassa Rejoinder Schedule B-2, Water Division) Note that there was not a Company proposal to adjust the pumping power costs, repair and maintenance costs, or Depreciation Expense associated with that plant.[3] Staff agreed that the "normal" method as set forth in their Scenario 3 results in an increase of approximate 290% and was too high. Staff accepted the Company's proposed plant/customer adjustment to the Test Year. (Michlik Surrebuttal Testimony p 12). However, as set forth above, they incorrectly used an unrelated and illegally computed Required Revenue Requirement in that scenario as the basis for determining their recommended Rate of Return.

The effect of including both the Well Number 4 and the proforma customers is consistent with the essential ratemaking practice of matching revenues, expenses and plant; it is also consistent with the concept of "gradualism" in a change to customer's rates to avoid rate shock. However, it is submitted at rate shock must be measured against a realistic starting point. The Company's existing rates, which mirrored the Town of Flagstaff rates, was an unrealistically low starting point. The Commission was aware of this when they set the rates in Decision No. 67446. That Decision required the Company to advise customers that large increases may be forthcoming. Inclusion of Well Number 4 and the pro forma customers addresses the rate shock issue. With 307 Test Year customers, plus 350 proforma customers, the Required Revenue Increase is obviously spread over twice the number of customers, reducing the forewarned increase by nearly one half.

B. Excluding Well Number 4 and reducing the Rate of Return is punitive

Staff justifies its computation of a lower Rate of Return on the basis of "gradualism, and attempts to rationalize its 6.23% Rate of Return recommended by stating that "...we wanted to lower this amount just a little bit more to give the ratepayers a little bit more of a break. (TR 233)

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[3] It is submitted that at the 3.3% depreciation rate for Pumping Plant the Depreciation Expense forgone by the

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The Staff's improper use of the January revenue requirement target as support for further "gradualism" is totally inappropriate. Including those 350 additional customers clearly results in a more gradual burden on customers, but it also denies the Company's receipt of the revenues associated with the authorized rates. The Staff's denial of an additional nearly $75,000[4] to the Water Division, caused solely by their reduction in the Rate of Return from 8.9% to 6.3% on the basis of gradualism, is double jeopardy for the Company and unduly penalizes the Company. When the rate base and return dictate a given dollar revenue increase, if that revenue requirement is arbitrarily reduced, the effect is that the Company will not receive those dollars until a subsequent rate proceeding. That is, at best, an additional phasing-in of the otherwise justified increase as explained by Mr. Bourassa (TR 148 -- 149). In reality, Staff's reduction of Rate of Return is not a phasing, which merely defers receipt of revenue increases, but it is a denial. Those denied revenues of $75,000 cannot <u>ever</u> be recovered by the Company, and the rates that would produce those revenues will not be approved until the next rate case. Not only is it "two bites" at the gradualism apple, it results in an unreasonablely low Rate of Return to the Company as argued above.

Recall that the testimony was that the full 350 customers will never be added to the system. The Flagstaff Meadows Unit 3 zoning has been reduced to 276 units, so the pro forma revenues for 350 customers is a total fiction (TR 39 and 88). Staff's 8.9% for the Water Division and 6.23% ROR for Wastewater Division result in Test Year Rates of Return of <u>negative</u> 1.55% and <u>negative</u> 0.33%, and Operating Margins of <u>negative</u> 14.43% and <u>negative</u> 4.9%. (Exhibit A-5, Rejoinder Exhibit 1)

The Staff's method of determining a Rate of Return and a Required Revenue Increase for the Water Division is blatantly illegal and not supported by any evidence in this case. The

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Company is approximately $22,000 per year.

"normal" method utilizing adjusted rate base and return to establish revenue levels was set forth in Staff Scenarios number two as was described in its Surrebuttal Case (Exhibit S-2, Michlik Surrebuttal Testimony at Page 11), and is the appropriate method. The method Staff adopted as Staff's recommendation is the inappropriate Scenario number one.

C. Scenario # 4 is totally inappropriate

Scenario # 4 attempts to override the agreement between the Company and Staff regarding inclusion of Well Number 4, which agreement greatly benefits the current customers. As indicated in the Company's Comments and Objections, the ALJ Scenario # 4 is a clever mechanical device to make the Water Division Rate of Return equal to the Wastewater Division Rate of Return at 8.9%. This scenario also looks suspiciously like the manipulation of numbers to reach a preconceived result as discussed above, albeit more artfully done. The scenario certainly would save face for Staff's unsupportable and illegal position, but that does not justify its adoption. Scenario # 4 freely accepts the Water and Wastewater Division pro forma revenue adjustments[5], but rejects the inclusion of Well Number 4 as Rate Base by proposing it be treated as a Contribution in Aid of Construction. Mr. McCleve testified that the water company's investors are paying for Well Number 4 and its operating costs with their own funds. (TR 37). There was no testimony or exhibit rebutting that fact. That Well Number 4 was funded by equity, not a contribution, is further evidenced by the fact that the Company has booked Depreciation Expense for Well Number 4 as shown on Exhibit A-9. (TR 224) Depreciation cannot be charged against contributed plant.

Well Number 4 was not funded by Contributions. The *National Association of Regulatory Utility Commissioners, 1996 Uniform System of Accounts for Class C Water Utilities,*

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[4] $267,225 (Schedule JMM-W14) less $193,858 (Schedule JMM-W1) equals $74,367

[5] $54,353 for Wastewater and $83,560 for Water (Exhibit A-1, Sewer Division, Schedule C-1, Line 1 & Schedule C-2, Adjustment 6) and (Water Division, Schedule C-1, Line 1 & Schedule C-2, Adjustment 5)

under which the Company is mandated to keep its accounting records by Decision No. 67446, states at Paragraph 6:

> 6. Utility Plant-Contributions in Aid of Construction
>
> A. Nonrefundable contributions of cash or plant facilities donated to the water utility to assist it in constructing, extending or relocating its water facilities shall be credited to account 271-Contributions in Aid of Construction (See account 271 description of items includable in this account). (Emphasis added) (*NARUC* at page 10)
>
> Account 271 says in pertinent part:
>
> 271. Contributions in Aid of Construction
>
> A. This account shall include:
>
> 1. Any amount or item of money, services or property received by a utility, from any person or governmental agency, any portion of which is provided at no cost to the utility, which represents in addition or transfer to the capital of the utility, and which is utilized to offset the acquisition, improvement or construction costs of the utility's company, facilities, or equipment used to provide utility service to the public. (Emphasis added) (*NARUC* at Page 33)

Clearly, the concepts of "donated" or "no cost" are an integral part of a Contribution and the unique element distinguishing a Contribution from other plant. Neither of those elements exist regarding Well Number 4. Some may argue that the investment was required in order to develop Flagstaff Meadows Unit 3. That is not only irrelevant, it is wrong. Mr. McCleve testified that Well Number 4 will serve the entire community and provide the entire area with an adequate water supply, greatly benefiting all homeowners beyond their actual water supply (TR 33). Secondly, if "required for development" is a test for excluding plant from Rate Base, most plant would be excluded. Between the requirements of the Commission, Arizona Department of Environmental Quality, Arizona Department of Water Resources, Arizona Department of Real Estate, and County governments, virtually every item used to serve customers is "required". If Well Number 4 is not included in the Rate Base, the proforma revenues associated with the customers served by that well must be removed. The requested increase then becomes the 300% testified to previously. The Comments and Objections attached hereto further enumerate the deficiencies of Scenario # 4.

SUMMARY

In this Application, the Company has balanced its interests in receiving a reasonable Rate of Return on its investment, with the interests of its customers by proposing the inclusion of a pro forma plant and customer adjustment, which adjustments reduce the otherwise legitimate increase in rates by approximately one half. In doing so, the Company undertakes enormous risk that those customers may not (and certainly almost 100 of those customers will not) ever receive service or provide revenues. The Company incurred a $180,000 loss during the Test Year, and is willing to sustain additional losses in anticipation of that growth.

Despite this magnanimous gesture on behalf of the Company, Staff is recommending substantially less increases based upon a cost of capital analysis that includes equity elements that are less than baseline debt cost. There is no possible way that anyone can consider that reasonable under any legal test or standard. Further, Staff concocted its own rate-making formula for one half of this Application by using the percentage revenue increase determined for the other half of the Company. This clearly is beyond any legal basis of establishing rates. We hope that Scenario #4 is not being given serious consideration. It was a creative method of exploring an alternative to a desired result, but it is clearly not consistent with the facts in this proceeding.

The Company has proposed a reasonable rate of return on an adjusted Test Year basis that provides just and reasonable rates both to it, and to its customers. The Company certainly acknowledges that the increases are substantial, but the rates themselves are not large. The large percentage increase results from two things. The unrealistically low starting point from which the increase is computed, and the high cost of the extraordinary plant required to provide service to this area.

The Company requests the ALJ and Commission grant the Company's requested increase and adopt the Company's proposed rate design.

Respectfully submitted this 16th day of July 2007.

SALLQUIST, DRUMMOND & O'CONNOR, P.C.

By

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AZ CORP COMMISSION
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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF UTILITY SOURCE, L.L.C. FOR A DETERMINIATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PROPERTY AND FOR AN INCREASE IN ITS WATER AND WASTEWATER RATES AND CHARGES FOR UTILITY SERVICES	**WS-04235A-06-0303** **COMMENTS ON, AND OBJECTIONS TO, LATE FILED ALJ SCENERIO #4**

Utility Source, L.L.C. (the "Company") hereby files its comments and objections to Scenario # 4 filed by Staff at Administrative Law Judges Teena Wolfe's request on June 22, 2007.

At the hearing in the subject docket on June 20, 2007 Administrative Law Judge Teena Wolfe (the "ALJ") requested that the Staff file as a late filed exhibit (hereinafter referred to as Scenario # 4) an exhibit similar to Staff's Exhibit S-2, Schedule JMM-W-1, embodying what the ALJ referred to as Scenario # 4. That Scenario was to utilize the assumptions contained in the Staff's Scenario # 2 for the Company's Water Division as set forth in Staff Exhibit S-2, (Staff's Surrebuttal filing), but incorporating the ALJ's requested revisions. Staff duly docketed Scenario # 4 on June 22, 2007.

All Parties were granted an opportunity to comment on Scenario # 4 by June 29, 2007, and the Company hereby files its comments and objections to that scenario.

Staff's Scenarios # 1 and 2 included the Company's Well Number 4 in Rate Base and the 350 pro-formed customers and related revenues, which resolved that issue between the Staff and

EXHIBIT A

Company (the "Resolution"), although the Parties still had differing opinions as to the Depreciation Expense, Property Taxes and Rate of Return. Scenario # 4 includes the 350 customers, but considers Well Number 4 to be a Contribution in Aid of Construction and thereby excluding the capital cost from Rate Base and excluding Depreciation Expense from the Income Statement.

The Company objects to the ALJ or the Commission considering Scenario # 4 for several reasons:

1. There is No Evidence Supporting Scenario # 4. There is no testimony nor any exhibit in the record of this proceeding supporting the proposition that Well Number 4 was constructed with the proceeds of an Advance In Aide of Construction ("AIAC") or a Contribution In Aide of Construction ("CIAC") made by the Owners of the Company or by any Developer. To the contrary, there was testimony that the Owners of the Company paid for that well. The 350 customers in the Resolution are located in Flagstaff Meadows Unit Three, a development owned by a third-party company, Empire Builders, who are not the owners of the Company. Payment for the improvements by the Owners of the utility company is the definition of equity investment in Rate Base.

2. Scenario # 4 Effectively Confiscates Company Property and the Owners' Equity. This scenario in which Well Number 4 is considered as CIAC, arbitrarily and in direct opposition to the evidence in this case, results in an illegal confiscation of the Owners investment in Well Number 4. There is no legal basis, or even a logical basis, for disallowing this plant in Rate Base or denying a Rate of Return thereon, except the ALJ's desire to reach

a preconceived decision to establish and support the otherwise improperly computed Revenue Requirement proposed by Staff. That is blatantly unconstitutional.

3. Scenario # 4 Totally Disregards the Resolution between the Company and Staff. Although no formal agreement between the Staff and Company was docketed, the record is clear that the bargain was to leave the plant in Rate Base in exchange for including 350 customers and their revenues. This is not a sham resolution to permit only a Rate Base increase, but it genuinely benefited the present and future customers. Staff's Scenario # 3 was the "clean" or traditional Arizona rate-making procedure; Well Number 4 was not considered, nor were the 350 additional customers and Revenues. Both Staff and Company testified that the rate increase in that scenario is in the 300% range. That is precisely why the Company offered, and the Staff accepted, the compromise Resolution. If Well Number 4 is disregarded, the customers must be disregarded, and the present and future customers of the Company will suffer the consequences.

4. Scenario # 4 Misses the Purpose of the Post Test-Year Adjustments. The evidence is clear that the Company included the 350 customers in the water and wastewater application analysis, and the substantial revenues were also included in this proceeding solely in response to the Staff's proposed disallowance of the Well Number 4 capital cost and the exclusion of the operating costs[1] as "post Test-Year" matters. The Company was not, and is not, obligated to voluntarily include those

[1] Note , no Pumping Power Costs or any Repair & Maintenance Costs were included, only Depreciation Expense.

customers and revenues. It did so to "match" the post Test-Year plant which is necessary for obtaining the Arizona Department of Water Resources Adequate Water Supply Letter associated with <u>all</u> customers to be served from Well Number 4. The inclusion of that well makes clear the larger capacity of Well Number 4 will be matched with all the customers it would serve, not just Flagstaff Meadows Unit Three customers. If the 350 customers revenues ($83,560 used by both Staff and the Company) are to be included in any analysis, the well costs (agreed by the Company and Staff to be $736,583) <u>must</u> be included as Rate Base.

5. <u>Scenario # 4's Adoption Would be a Permanent Irreversible Ruling Addressing a Temporary Problem</u>. Although it may meet the ALJ's perception of rational rate-making, this extreme action denies the Company's ability to earn a reasonable return on that plant <u>forever</u>. Disallowing the $736,583 booked during the Test Year, with an additional $300,000 or $400,000 subsequently booked to complete the well, denies <u>any</u> return on or of that owner invested capital in the Revenue Requirement in this or any future rate case. Any aberration in Rate of Return or Operating Margin caused by the Resolution is a phenomenon caused by the timing of the required plant additions. Properly applied, the Resolution circumvents the other untenable proposals under Staff Scenario 3 and ALJ Scenario # 4, while providing the Company with needed revenues. When the Flagstaff Meadows Unit Three customers come on-line, the next rate case will be "normal" with no proformed revenues and the plant serving those customers will properly be in the Rate Base.

6. The Company Cannot Be Forced to Accept Pro Forma Revenues. With all due respect, neither the ALJ nor the Commission can force the Company to include the 350 customers and the associated revenues in this proceeding. The number of customers is not a "known and measurable" post test-year adjustment. The evidence is clear that the additional customer level is more probably maximized at 276 customers. The revenue level for each of those customers is totally assumed. Likewise, the Well Number 4 costs are not known and measurable. The $736,583 is certainly known, but as the testimony indicates that is not the total cost of that well, which will increase by $300,000 or $400,000. Without the Company agreeing to the revenue level for these non-existent customers, and the Staff agreeing to the Rate Base inclusion, (both adopted solely for the stated purpose of ameliorating the otherwise 300% required increase), neither the Rate Base nor the proforma revenue can be included. The Resolution is in everyone's best interest, especially the present and future customers of the Company.

7. Scenario # 4 Does Not Remedy the Flaws of the Staff Position. Although Scenario # 4 addresses one of the flaws in the Staff's position, that is, the unsupportable difference in the recommended Rates of Return between the Water Division and the Wastewater Division, the Scenario is equally flawed by arbitrarily declaring the $736,583 investment by the Company to be CIAC. Although a cosmetic correction of the Rate of Return discrepancy, it merely raises the other flaws cited above. It still does not

address the underlying flaw in the Staff position, that is, the recommended Revenue Requirement.

8. Scenario # 4 Provides Insufficient Operating Margin. As stated, although the treatment of Well Number 4 as CIAC artificially reduces Rate Base so that the Staff's improperly computed recommended Rate of Return coincidentally produces the approximate Staff Revenue Requirement, the resultant Operating Margin and Rate of Return are totally inadequate. Attached are two sheets in the format of Rejoinder Exhibit 1 to Company Exhibit A-5, the Rejoinder Testimony of Thomas Bourassa, showing the resultant returns from Scenario # 4. The Operating Margin, as with the other Staff Revenue Recommendations, provides insufficient Operating Margins and Rate of Return for the Company to continue providing quality service.

In summary, Scenario # 4 should not be considered by the ALJ due to the fact that it would result in improper, illegal and artificially forced computations to meet Staff's Revenue Requirement, which are also unsupported. The Scenario cannot be adopted without the Company's acceptance of the pro forma revenues, which the Company can not agree to accept without the inclusion of Well Number 4 in Rate Base. Further, Scenario # 4 disregards the Resolution between the Company and the Staff which provides a rationale procedure to set just and reasonable rates, and greatly benefits the customers over the only other legal method of setting the Company's Revenue Requirement as set forth in Staff Scenario # 3. Scenario # 4 should be rejected by the ALJ.

The Company vehemently objects to the consideration of Scenario # 4 for the above stated reasons, and in the event any consideration of the matter continues, the Company reserves the right to withdraw the 350 customers and the associated proformed revenues from consideration in this proceeding.

Respectfully submitted this 29TH day of June 2007.

SALLQUIST, DRUMMOND & O'CONNOR, P.C.

By

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Utility Source, L.L.C. - Combined Water and Sewer
Test Year Ended December 31, 2005
Projected Revenues and Expense and Return on Rate Base Using Staff Proposed Rates (8.9% ROR)
Based On ALJ Scenario #4 for Water Division and Staff Proposed Sewer

	Adjusted Test Year at Present Rates[1]	Adjusted Test Year at Proposed Rates[1]	Projected Year 1	Projected Year 2	Projected Year 3
Customer Growth			**50**	**50**	**50**
Cummulative Additional Customers			50	100	150
Effective Customer Growth 1/2 year			25	75	125
Revenues[2]	$ 150,320	$ 305,775	$ 327,881	$ 368,093	$ 408,305
Operating Expenses	$ 331,897	$ 305,058	$ 305,058	$ 305,058	$ 305,058
Operating Income	$ (181,577)	$ 717	$ 22,823	$ 63,035	$ 103,247
Operating Margin	-120.79%	0.23%	6.96%	17.12%	25.29%
Rate Base	$ 3,168,479	$ 3,168,479	$ 3,168,479	$ 3,168,479	$ 3,168,479
Return on Rate Base	-5.73%	0.02%	0.72%	1.99%	3.26%

[1] Excludes pro-forma revenues from customer growth.
[2] Half-year convention used for projected customer growth and revenues. Based on average bill for 3/4 inch metered customer.

Utility Source, L.L.C. - Combined Water and Sewer
Test Year Ended December 31, 2005
Projected Revenues and Expense and Return on Rate Base Using Staff Proposed Rates (8.9% ROR)
Based On ALJ Scenario #4 for Water Division and Staff Proposed Sewer

	Adjusted Test Year at Present Rates[1]	Adjusted Test Year at Proposed Rates[1]	Projected Year 1	Projected Year 2	Projected Year 3
Customer Growth			**100**	**100**	**100**
Cummulative Additional Customers			100	200	300
Effective Customer Growth 1/2 year			50	150	250
Revenues[2]	$ 150,320	$ 305,775	$ 349,987	$ 430,411	$ 510,835
Operating Expenses	$ 331,895	$ 305,056	$ 305,056	$ 305,056	$ 305,056
Operating Income	$ (181,575)	$ 719	$ 44,931	$ 125,355	$ 205,779
Operating Margin	-120.79%	0.23%	12.84%	29.12%	40.28%
Rate Base	$ 3,168,479	$ 3,168,479	$ 3,864,478	$ 3,864,478	$ 3,864,478
Return on Rate Base	-5.73%	0.02%	1.16%	3.24%	5.32%

[1] Excludes pro-forma revenues from customer growth.
[2] Half-year convention used for projected customer growth and revenues. Based on average bill for 3/4 inch metered customer.