



BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission

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7  
8 IN THE MATTER OF THE APPLICATION OF  
9 GOLD CANYON SEWER COMPANY, AN  
10 ARIZONA CORPORATION, FOR A  
11 DETERMINATION OF THE FAIR VALUE OF  
12 ITS UTILITY PLANT AND PROPERTY AND  
13 FOR INCREASES IN ITS RATES AND  
14 CHARGES FOR UTILITY SERVICE BASED  
15 THEREON.

Docket No. SW-02519A-06-0015

**RUCO'S APPLICATION FOR  
REHEARING OF DECISION NO. 69440**

16 Pursuant to A.R.S. § 40-253, the Residential Utility Consumer Office ("RUCO")  
17 requests that the Arizona Corporation Commission ("Commission") rehear Decision No.  
18 69664, docketed June 28, 2007. Decision No. 69664 approved the Recommended Opinion  
19 and Order ("ROO") on Gold Canyon Sewer Company's ("Gold Canyon" or "Company")  
20 application for a rate increase. The Commission approved a 72.02% revenue increase which  
21 is not reasonable, nor fair to ratepayers under the facts and circumstances of this case. In  
22 determining what fair and reasonable rates are, the Commission must balance the interests  
23 of the Company and its ratepayers. *Arizona Community Association v. Arizona Corporation*  
24 *Commission v. Arizona Public Service*, 123 Ariz. 228, 231, 599 P.2d 184, 187 (Supreme  
*Court*, 1979), *Arizona Corporation Commission v. State ex. rel. Woods*, 171 Ariz. 286, 290,

1 830 P. 2d. 807, 811 (Supreme Court, 1992). Decision No. 69664 heavily favors the  
2 Company's interests over the interests of the ratepayers. Ratepayers deserve better and the  
3 Commission should reconsider its Decision.

4 **DECISION NO. 69664 IS UNFAIR TO RATEPAYERS AND FAVORS THE COMPANY'S**  
5 **INTERESTS OVER THE INTERESTS OF THE RATEPAYERS.**

6 The Commission determined that a 72.02% revenue increase is reasonable, despite  
7 the fact that ratepayers were previously told by the Company's former president that rates  
8 would not increase as a result of the costs associated with the improvements that made up  
9 the majority of the Company's request. The Commission determined that a \$15,000 fine that  
10 will be paid into the state fund, and will likely be of no direct benefit to Gold Canyon's  
11 ratepayers, is an appropriate balance to strike for the good of both the ratepayers and the  
12 Company. Even the Company had proposed that the fine be placed into accounts that would  
13 directly benefit Gold Canyon's ratepayers. Not only was the Company's request overlooked,  
14 but Commissioner Mayes' proposed amendment to increase the fine was rejected even  
15 though, at the very least, it would have been more of a deterrent of future misconduct.

16 Commissioner Mayes proposed four other amendments. Of the four, only one  
17 passed. Commissioner Mayes' amendment in support of RUCO's recommendation to  
18 reduce the rate case expense by \$90,000 passed. Of all of Commissioner Mayes'  
19 amendments, this amendment had the smallest impact – it will lower ratepayer's bills by  
20 approximately 34 cents per month.

21 Perhaps the amendment that would have had the greatest impact in ameliorating the  
22 impending rate shock was Commissioner Mayes' proposal that supported RUCO's excess  
23 capacity recommendation. RUCO argued that the Company had excess capacity at the Gold  
24 Canyon treatment plant during the test year and that current ratepayers should not pay for  
the capacity to serve future growth. What remains undisputed is that at the end of the test

1 year – October 31, 2005 - the Company’s wastewater facility had a maximum capacity of  
2 1,900,000 gallons per day (“GPD”)<sup>1</sup>. According to the Company, at the end of 2005, the  
3 influent flow rate at the Company’s Reclamation facility was 708,000 GPD, so that 62.74  
4 percent of its maximum capacity was not necessary to meet test-year demand<sup>2</sup>. The  
5 Company claimed that the 708,000 figure represents the influent rate flow in terms of  
6 average gallons per day<sup>3</sup>. In terms of maximum or peak flow, the Company estimated that  
7 peak day flow for the test year was 1.1 million GPD<sup>4</sup>. The Company’s estimate is consistent  
8 with the results of Staff’s engineering report, which estimated test-year monthly peak flow at  
9 1,170,000 GPD during the month of February 2005<sup>5</sup>. Based on Staff’s monthly peak flow  
10 estimate for the test year, the Company had excess capacity of 730,000 gallons or 38.42  
11 percent of its maximum capacity of 1,900,000 GPD. Therefore, even in terms of peak  
12 capacity, the Company’s maximum peak flow did not reach its maximum capacity of  
1,900,000 GPD. Without question, the Company had excess capacity during the test year.

13 In balancing the interests of ratepayers and the Company, the Commission sides with  
14 the Company and rejects RUCO’s proposal based on a prudence determination. In  
15 ratemaking, prudence determinations are made when infrastructure is complete and the  
16 Commission is called upon to decide whether to include the costs of the plant in rate base.  
17 Here, no one questioned the costs of the improvements. The question was who should pay  
18 for the excess capacity – current or future customers. Decision No. 69664 unfairly places the  
19 costs of future growth on current ratepayers, concluding that it would have been imprudent

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22 <sup>1</sup> A-5 at 4-5

23 <sup>2</sup> R-9 at 10, R-2.

24 <sup>3</sup> Transcript at 266.

<sup>4</sup> Transcript at 271.

<sup>5</sup> S-1, Schedule MSJ page 10.

1 for the Company to have built the plant any other way. The Decision shifts to current  
2 ratepayers the risk that growth will not occur, and that the excess capacity will remain  
3 unused. Current ratepayers will now pay for the excess capacity whether it is used or not.  
4 Future ratepayers, who are the ultimate users of the excess capacity, will pay less for their  
5 capacity since current ratepayers will be paying now for the excess capacity. It is unfair to  
6 burden current ratepayers with the entire risk of future growth. Current ratepayers should  
7 only pay for their fair share of their wastewater service costs, especially considering the  
8 magnitude of the recommended rate increase and the past history of this case.

9 Commissioner Mayes' proposed amendment went one step further and recognized  
10 the prudence argument. The amendment would have included in ratebase the capacity  
11 projected to be needed through 2008. While still balanced in favor of the Company, the  
12 amendment would have provided ratepayers with some immediate rate relief by deferring the  
13 cost of the excess capacity post 2008. Nonetheless, the Commission determined that this  
14 proposal was short sighted in that it failed to recognize the higher costs associated with  
15 adding capacity in smaller increments "as well as the less tangible disruptions to customers".  
16 In siding with the Company, the Commission failed to consider the "disruptions" to customers  
17 that will undoubtedly occur as the result of a 72.02 percent increase. Decision No. 69664 is  
18 biased in favor of the Company and is unfair to ratepayers.

19 Further, the Commission rejected the only other amendment that could have gone far  
20 to provide ratepayers rate relief in this case. Commissioner Mayes proposed that the  
21 Commission adopt RUCO's hypothetical capital structure of 40 percent debt and 60 percent  
22 equity. Commissioner Mayes' amendment noted that the hypothetical capital structure would  
23 bring the Company's capital structure in line with the industry average and would result, as  
24 even the Commission admits, in lower rates for ratepayers. The Commission decided

1 otherwise. In balancing the interests of ratepayers and the Company, fair rates do not  
2 appear to be a concern of the Arizona Corporation Commission.

3 In fact, the Commission stated that lower rates do not justify adoption of RUCO's  
4 hypothetical capital recommendation. The Decision provides little guidance why a  
5 hypothetical capital structure should not be adopted in this case. At the Open Meeting, one  
6 Commissioner commented that there did not appear to be an adequate basis in the record to  
7 support a hypothetical capital structure. The record, however, has ample evidence to  
8 support a hypothetical capital structure<sup>6</sup>.

9 Gold Canyon's actual capital structure is comprised entirely of equity as opposed to  
10 the capital structures of other water companies in the industry. In RUCO's cost of capital  
11 analysis, the capital structures for a sample of those utilities averaged 50.3 percent for debt  
12 and 49.7 percent for equity (approximately 49.6 percent common equity + 0.1 percent  
13 preferred equity)<sup>7</sup>.

14 The water utilities used in RUCO's sample are representative of the industry and, by  
15 comparison to the Company, would be considered as having a higher level of financial risk  
16 (i.e. the risk associated with debt repayment) because of their higher levels of debt<sup>8</sup>. The  
17 additional financial risk due to debt leverage is embedded in the cost of equities derived for  
18 those companies through the DCF analysis that RUCO performed. Thus, the cost of equity  
19 derived in RUCO's DCF analysis is applicable to companies that are more leveraged and,  
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22 <sup>6</sup> See for example R-7 at 49-56, R-8 at 7-9.

23 <sup>7</sup> R-7 at 49.

24 <sup>8</sup> Id.

1 theoretically speaking, riskier than a utility such as Gold Canyon, which has no debt in its  
2 capital structure. In the case of a publicly traded company, like those included in RUCO's  
3 proxy of companies, a company with Gold Canyon's level of equity would be perceived as  
4 having extremely low to no financial risk and would therefore also have a lower expected  
5 return on common equity. Because of this, a 60/40 hypothetical capital structure that  
6 produces a lower weighted cost of common equity is appropriate for Gold Canyon<sup>9</sup>.

7 Commissioner Mayes' amendment attempted to address and solve the problem  
8 inherent with a 100% equity capital structure. The problem concerns an appropriate  
9 adjustment to the Company's cost of common equity to bring it in line with sample groups of  
10 companies that have capital structures more representative of the industry and face greater  
11 financial risk as a result of the level of debt in their capital structures. A lower weighted cost  
12 of capital, reflecting Gold Canyon's lower level of risk, is warranted. This can only be  
13 achieved by either making a direct downward adjustment to the results of a DCF analysis,  
14 which reflects the financial risk of the sample utilities, or by the use of a hypothetical capital  
15 structure<sup>10</sup>. By using the hypothetical capital structure approach, a lower weighted cost of  
16 capital that reflects the Company's lack of financial risk, is achieved. This brings the  
17 Company's capital structure in line with the industry average and results in lower rates to  
18 Gold Canyon's ratepayers.

19 During the open meeting, the Company argued that the adoption of a hypothetical  
20 capital structure constituted a "fiction" that should not be imposed upon Gold Canyon. As  
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22  
23 <sup>9</sup> Id.  
<sup>10</sup> Id. at 52.

1 Commissioner Mayes noted, the Commission has adopted hypothetical capital structures in a  
2 number of rate case proceedings<sup>11</sup>. **These cases generally involved utilities that**  
3 **requested hypothetical capital structures comprised of more equity than what their**  
4 **actual capital structures contained.** In those cases the Commission adopted capital  
5 structures that clearly benefited utilities, yet in this case the Commission has refused to adopt  
6 a capital structure that would clearly benefit ratepayers.

7 The Company and Staff claim, and the Commission apparently believes, that a  
8 hypothetical capital structure would not allow the Company an adequate level of income tax  
9 expense because of the interest deduction associated with RUCO's recommended level of  
10 debt. This argument is disingenuous from the standpoint that the burden of paying higher  
11 levels of income tax expense for utilities with Commission-approved hypothetical capital  
12 structures containing additional equity always falls on ratepayers. The adoption of a  
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19 <sup>11</sup> Decision No. 58497 adopted a hypothetical capital structure of 44 percent equity and 56 percent debt for  
20 Tucson Electric Power ("TEP") at a time when TEP's capital structure was comprised of 100 percent debt.  
21 The Commission later approved a hypothetical capital structure for TEP that contained 37 percent equity in  
22 Decision No. 59594. Since the early 1990's TEP's rates have been based on hypothetical capital structures  
23 that contain more equity than the Company actually has (pages 30 and 31 of Dec. No. 67454, dated January  
24 4, 2005). Decision No. 68487, dated February 23, 2006 approved a hypothetical capital structure of 40  
percent common equity, 5 percent preferred equity and 55 percent debt for Southwest Gas Corporation  
("SWG") when SWG's actual test-year capital structure was comprised of 34.5 percent common equity, 5.3  
percent preferred equity and 60 percent debt. In Decision No. 69440, dated May 1, 2007, the Commission  
adopted a hypothetical capital structure comprised of 40 percent common equity and 60 percent debt for  
Arizona-American Water Company's Mohave Water and Wastewater Districts when an actual capital  
structure of approximately 37 percent common equity and 63 percent debt existed during the test year.

1 hypothetical capital structure should be a two-way street. It is only just and reasonable that  
2 Gold Canyon ratepayers should not bear the burden of paying a higher level of income tax  
3 expense in rates simply because the Company has made the decision to adopt a 100  
4 percent equity capital structure, which is clearly out of line with the rest of the industry.

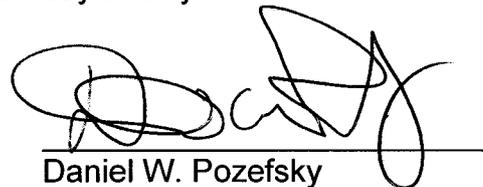
5 The Company also claimed, during the open meeting, that the adoption of RUCO's  
6 hypothetical capital structure would be akin to taking a "cleaver" to the ROO's recommended  
7 level of revenue. Again, nothing can be further from the truth. The adoption of RUCO's  
8 hypothetical capital structure would only impact the Company's level of below-the-line  
9 operating income. The Company would still receive dollar-for-dollar recovery on the ROO's  
10 recommended level of operating expenses.

11 The Commission in this case had multiple opportunities to fairly and evenly balance  
12 the interests of the Company and its customers. At each such opportunity where the impact  
13 was meaningful, the Commission aligned with the Company, and against Gold Canyon's  
14 ratepayers.

15  
16 **CONCLUSION**

17 For the foregoing reasons, RUCO requests that that Commission reconsider Decision  
18 No. 69664.

19  
20 RESPECTFULLY SUBMITTED this 18<sup>th</sup> day of July 2007

21  
22   
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