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COMMISSIONERS
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WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

OPEN MEETING ITEM



0000090006

Executive Director

ARIZONA CORPORATION COMMISSION

DATE: OCTOBER 28, 2008

DOCKET NO: SW-02519A-06-0015

TO ALL PARTIES:

Enclosed please find the recommendation of Administrative Law Judge Dwight D. Nodes. The recommendation has been filed in the form of an Opinion and Order on:

GOLD CANYON SEWER COMPANY
(REHEARING OF DECISION NO. 69664)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and ten (10) copies of the exceptions with the Commission's Docket Control at the address listed below by 4:00 p.m. on or before:

NOVEMBER 6, 2008

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Working Session and Open Meeting to be held on:

NOVEMBER 12, 2008 and NOVEMBER 13, 2008

For more information, you may contact Docket Control at (602) 542-3477 or the Hearing Division at (602)542-4250. For information about the Open Meeting, contact the Executive Director's Office at (602) 542-3931.

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BRIAN C. McNEIL
EXECUTIVE DIRECTOR

Arizona Corporation Commission
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1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 **COMMISSIONERS**

3 MIKE GLEASON, Chairman
4 WILLIAM A. MUNDELL
5 JEFF HATCH-MILLER
6 KRISTIN K. MAYES
7 GARY PIERCE

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

DOCKET NO. SW-02519A-06-0015

DECISION NO. _____

REHEARING OPINION AND ORDER

11 DATES OF REHEARING: November 14, 2007; February 25, 2008; March 31, 2008

12 PLACE OF HEARING: Phoenix, Arizona

13 ADMINISTRATIVE LAW JUDGE: Dwight D. Nodes

14 IN ATTENDANCE: Mike Gleason, Chairman
15 William A. Mundell, Commissioner
16 Kristin K. Mayes, Commissioner
17 Gary Pierce, Commissioner

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

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

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

24 Ms. Robin Mitchell, Mr. Keith Layton, and Ms. Nancy
25 Scott, Staff Attorneys, Legal Division, on behalf of the
26 Utilities Division of the Arizona Corporation
27 Commission.

28 **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

1 County, Arizona.

2 On June 28, 2007, the Commission issued Decision No. 69664, granting a rate increase to
3 Gold Canyon.

4 On July 18, 2007, the Residential Utility Consumer Office ("RUCO") filed an Application for
5 Rehearing on two issues raised by RUCO during the hearing: (1) an allegation of "excess capacity" in
6 the Company's treatment plant and (2) the capital structure employed in the Commission's Order for
7 purposes of determining the Company's cost of capital.

8 During an Open Staff Meeting held on August 1, 2007, the Commission granted rehearing to
9 RUCO.

10 A procedural conference was held on September 5, 2007. During the procedural conference,
11 the parties discussed, among other things, testimony filing dates and potential hearing dates.

12 By Procedural Order issued September 14, 2007, a hearing was scheduled to begin on
13 November 13, 2007, Gold Canyon was directed to publish notice of the hearing, and testimony filing
14 dates were established.

15 By Procedural Order issued October 15, 2007, a procedural conference was scheduled for
16 October 22, 2007, to discuss a discovery dispute between the Company and the Commission's
17 Utilities Division Staff ("Staff"). The Procedural Order also granted an extension of the testimony
18 filing deadline.

19 The November 13, 2007, hearing was vacated due to unavailability of the hearing facility.
20 The hearing commenced on November 14, 2007, but did not conclude that day. At the end of the
21 hearing on November 14, 2007, the parties were directed to discuss scheduling of additional hearing
22 days and to submit a proposed schedule.

23 On November 20, 2007, RUCO, Staff, and the Company filed a Joint Motion to Set
24 Continued Rehearing Dates. The parties requested that additional hearing days be scheduled for
25 January 17 and 18, 2008.

26 By Procedural Order issued November 29, 2007, the rehearing in this matter was scheduled to
27 resume on January 17 and 18, 2008.

28 On December 11, 2007, RUCO requested that the rehearing be rescheduled to resume on

1 February 25, 2008, due to an out-of-state commitment by RUCO's counsel.

2 By Procedural Order issued December 12, 2007, the hearing was rescheduled to resume on
3 February 25, 2008. An additional day of hearing was conducted, as scheduled, on February 25, 2008,
4 but the hearing was not concluded on that day. The parties agreed to an additional hearing day on
5 March 31, 2008.

6 On March 31, 2008, the hearing resumed with the cross-examination of Staff witnesses. The
7 hearing did not conclude on that date, however, due to the unavailability of a RUCO witness.

8 On April 10, 2008, a teleconference was conducted with the parties. Due to the continuing
9 unavailability of the RUCO witness for cross-examination, the parties agreed that portions of the
10 RUCO witness's prior testimony would be stricken.¹ In addition, a briefing schedule was established.

11 Opening briefs were filed on May 5, 2008, by RUCO, Gold Canyon and Staff, and reply
12 briefs were filed on May 22, 2008, by the same parties.

13 * * * * *

14 Having considered the entire record herein and being fully advised in the premises, the
15 Commission finds, concludes, and orders that:

16 **FINDINGS OF FACT**

17 1. In Decision No. 69664, the Commission granted Gold Canyon a revenue increase of
18 approximately \$1.8 million, resulting in an increase to residential sewer rates from \$35.00 to \$60.55
19 per month, or approximately 72 percent.

20 2. In its Application for Rehearing, RUCO argued that the rate increase is unfair to
21 customers due to its magnitude. RUCO raised two specific issues as a basis for its rehearing request:
22 (1) the Commission should have disallowed from rate base approximately \$2.8 million to reflect what
23 RUCO claims is "excess capacity" in Gold Canyon's wastewater treatment plant; and (2) the
24 Commission should have adopted RUCO's proposed hypothetical capital structure of 60 percent
25 equity and 40 percent debt, rather than the actual 100 percent equity capital structure used by the
26 Commission, to calculate the Company's cost of capital.

27 ¹ Under the parties' agreement, page 87, line 12 through page 92, line 9, and page 100, line 21 through page 101, line 15,
28 of the verbal testimony of RUCO witness Marylee Diaz Cortez at the November 14, 2007, hearing was deleted from the
evidentiary record.

1 3. During a Staff Meeting held on August 1, 2007, the Commission voted to grant
2 RUCO's rehearing request and send the matter back for additional hearings on the issues raised by
3 RUCO.

4 4. Hearings were held before an Administrative Law Judge, and additional testimony and
5 exhibits were admitted into the evidentiary record. The record produced by the prior hearings in this
6 docket was incorporated into the rehearing record of this case.

7 **Excess Capacity**

8 5. In Decision No. 69664, the Commission agreed with the Company and Staff that Gold
9 Canyon's decision to increase the treatment plant's capacity from 1.0 million gallons per day ("gpd")
10 to 1.9 million gpd was reasonable and should not result in a disallowance from rate base. As
11 described in that Decision, the Commission disagreed with RUCO's proposed use of a mathematical
12 disallowance, because of the evidence in the record that increasing the plant's capacity to 1.9 million
13 gpd was a prudent decision based on peak flows and growth projections available to the Company at
14 the time the decision was made.

15 6. As stated in Decision No. 69664, RUCO witness Rodney Moore conceded that Gold
16 Canyon's decision to expand the treatment plant to 1.9 million gpd, rather than to 1.5 million gpd,
17 was "reasonable" and "appropriate" and that the Company must consider *peak* flows in its analysis,
18 as opposed to *average* daily flows, in making its plant expansion decisions. (Tr. 943, 951-54.)
19 Despite these admissions, Mr. Moore advocated use of an average daily flow rate of 708,000 gpd for
20 purposes of calculating RUCO's proposed \$2.8 million disallowance. RUCO's proposal is based on
21 its contention that approximately 28 percent of the plant is not "used and useful" from a "ratemaking
22 perspective." (Decision No. 69664, at 6.)

23 7. As set forth in Decision No. 69664, Company witness Charles Hernandez, Gold
24 Canyon's treatment plant operator, testified that Gold Canyon experienced a peak flow of almost 1.2
25 million gpd in February 2005. Based on growth projections at the time, Staff witness Marlin Scott,
26 Jr., estimated that Gold Canyon would have a peak flow of more than 1.5 million gpd by mid-2007.
27 As we stated in that Decision:

28

not only did test year peak flows exceed the then-current capacity, but if the Company had expanded the plant to only 1.5 [million gpd], 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." (*Id.* at 7.)²

We also cited to testimony in the record that the additional 400,000 gpd of capacity was installed at a cost of approximately \$1 million, whereas adding the same increment of capacity at a later date would have cost substantially more.³

RUCO's Position

8. In the rehearing phase of this proceeding, RUCO witness Moore continues to rely on the Company's average daily flows, rather than peak flows, for purposes of calculating RUCO's excess capacity adjustment. He also stated that RUCO's proposed disallowance is supported by the slower than anticipated growth that has occurred in the past two years (RUCO RH-1, at 2-5). In its post-hearing brief, RUCO states that "[w]hile no one has a crystal ball, given the actual growth that Gold Canyon has experienced since 2006, it is unlikely the Company will reach build-out by 2010" (RUCO Closing Brief at 2).

9. RUCO cites to several Commission decisions as precedent for its proposed excess capacity adjustment. RUCO cites Decision No. 50273 (*Litchfield Park Service Co.*, September 20, 1979), an accounting order in which the Commission excluded 50 percent of a new wastewater treatment plant because only 50 percent of the plant was being utilized. There was no hearing held in the case and, in the two-page accounting order, there was no discussion of the details of the plant's construction or whether LPSCO opposed the exclusion. When LPSCO sought inclusion of the remaining 50 percent of the plant in rate base approximately 10 years later, RUCO claims, Staff recommended disallowance, and LPSCO did not oppose that recommendation. (*See* Decision No. 56362, February 22, 1989, at 7).

² Staff witness Marlin Scott explained that capacity requirements are evaluated over a five-year planning horizon and, under the Arizona Department of Environmental Quality's ("ADEQ's") "80 percent rule," sewer utilities are expected to have plans in place to increase capacity when demand reaches 80 percent of capacity and to have construction under way when demand reaches 90 percent of capacity (*Id.*).

³ Mr. Hernandez stated that adding 400,000 gpd of capacity at a later date would have cost the Company as much as \$9 million. He also indicated that adding the additional capacity separately would have caused significant disruption to neighboring customers in the form of noises and odors that were experienced during the prior plant expansion (Rh. Tr. 246, 301-03).

1 10. RUCO also cites Decision No. 57395 (*Chaparral City Water Co.*, May 23, 1991, at 5)
2 for the proposition that Chaparral City, not ratepayers, was required to bear the risk that anticipated
3 growth would not occur. In that case, the Commission specifically did not exclude the Central
4 Arizona Project ("CAP") facilities from rate base but, instead, adopted a rate design that allocated a
5 portion of the recovery of some of the plant investment onto future customers through a hook-up fee.
6 (*Id.* at 5-6.) However, Chaparral City's revenue requirement allowed for a return on the full cost of
7 the plant. (*Id.*)

8 11. RUCO next argues that Decision No. 58743 (*Pima Utility Co.*, August 11, 1994, at 4-
9 5) supports its claim that plant not serving customers is properly excluded from rate base because it is
10 not used and useful. In that case, the Commission denied Pima Utility's request for inclusion of
11 construction work in progress ("CWIP") in rate base and, according to RUCO, drew a distinction
12 between the used and useful concept from a ratemaking and an engineering standpoint. In that
13 Decision, the Commission found that, 15 months after the test year, the phase of the development to
14 be served by the new plant was completely uninhabited, and therefore, the plant built to serve future
15 customers was not used and useful and should be excluded from rate base. (*Id.*)

16 12. The final case cited by RUCO is Decision No. 56659 (*Tucson Electric Power Co.*,
17 October 21, 1989, at 19-21), wherein the Commission excluded from rate base approximately \$32.5
18 million related to TEP's investment in a mineable source of coal located in Gallo Wash, New
19 Mexico, through an agreement that required TEP to make royalty payments whether or not any coal
20 was actually mined. In making the disallowance, the Commission stated that there was no evidence
21 any coal would ever be mined at the location and no railroad access to the mine that would enable
22 transportation of the coal even if it were mined. As a result, the Commission found that the property
23 was not used and useful and that "the investment is imprudent." (*Id.* at 20.)

24 Gold Canyon and Staff Positions

25 13. The Company and Staff argue that the cases cited by RUCO do not support its
26 proposed excess capacity recommendation. Both point out that the *Chaparral City* case (Decision
27 No. 57395) provided for recovery of the full costs of the CAP plant, despite the plant's capacity being
28 greater than was needed to serve existing customers. With respect to the *LPSCO* matter, Gold

1 Canyon contends that the Commission's accounting order (Decision No. 50273) included virtually no
2 discussion concerning the reason for the disallowance, and when the plant was still not being used to
3 serve customers 10 years later, LPSCO did not challenge Staff's continued disallowance
4 recommendation. (Decision No. 56362.) The Company claims that, in contrast to the LPSCO
5 situation, Gold Canyon's plant was prudently built (by RUCO's admission), and the capacity is used
6 and useful to serve customers over a five-year planning horizon.

7 14. Staff and the Company also argue that the *Pima Utility* case (Decision No. 58743)
8 does not support RUCO's claims. Staff asserts that the case shows the Commission's reluctance to
9 allow CWIP in rate base and, as such, has no bearing on the factual situation at issue in the Gold
10 Canyon case. Staff pointed out that because the area intended to be served by the new Pima Utility
11 plant was almost completely vacant well after the test year, inclusion in rate base would violate the
12 ratemaking principle of matching revenues and expenses. The Company added that CWIP plant is
13 entirely different from plant that is completed during the test year and is built to serve current
14 customers and expected growth over a five-year horizon. Regarding the *TEP* case, Gold Canyon
15 cited to the Commission's finding that TEP's investment was imprudent, because no coal was or
16 could be delivered from the site, and the investment was therefore not used and useful. In contrast,
17 the Company points out that RUCO has acknowledged that Gold Canyon's addition of the 400,000
18 gpd increment of capacity was prudent.

19 Resolution of Excess Capacity Issue

20 15. The Gold Canyon system was acquired in 2003 by Algonquin Water Resources of
21 America ("Algonquin"). At that time, it had become apparent that the prior owner of the Company, a
22 homebuilder, had constructed a treatment system that, by all accounts, contained insufficient
23 treatment capacity for existing and expected customers. The inadequacy of the Gold Canyon
24 system's facilities was evidenced by the issuance of several Arizona Department of Environmental
25 Quality ("ADEQ") Notices of Violation to the Company due to raw sewage overflows into a wash
26 adjacent to the treatment plant during periods of heavy rainfall. The Company had also received
27 numerous complaints from area residents regarding odors and noise emanating from the original
28 treatment facility. (See Decision No. 69664 at 30-35.)

1 16. The evidence indicates that almost immediately upon acquisition of Gold Canyon
2 Sewer Company by Algonquin, the Company began planning to increase the plant's capacity and,
3 based on growth and peak flow projections at the time, decided that expansion of the plant from 1.0
4 to 1.9 million gpd would provide adequate capacity over a five-year planning horizon, pursuant to
5 ADEQ and Commission Staff guidelines, and would be the most cost-effective and least disruptive
6 means of expanding the plant. The testimony also indicates that the treatment plant had been built in
7 a less-than-ideal location adjacent to residential lots and a portion of a golf course. Following the
8 acquisition, Gold Canyon moved quickly to invest significant capital (approximately \$11 million) to
9 upgrade and expand the plant in order to meet growth projections and respond to the many
10 complaints registered by customers in the Gold Canyon community. (Tr. 678, 725-27.)

11 17. The record reflects that the guidelines employed by ADEQ and Commission Staff
12 require wastewater utility companies to plan treatment capacity needs using a five-year planning
13 horizon, based on peak flows. (Reh'g. Tr. at 512-14.) The ADEQ guidelines require companies to
14 begin planning to add additional capacity when peak flows reach 80 percent of capacity, and to have
15 construction underway when peak flows reach 90 percent of capacity. (Tr. at 305-06; Reh'g. Tr. at
16 523-34.) The plant's operator and Staff's engineer testified that Gold Canyon's treatment facility
17 achieved a peak flow of 117 percent of then-current capacity in February 2005. (Tr. at 254; Ex. S-1,
18 Attach. Ex. MSJ at 4.) In addition, it is undisputed that the smallest additional increment of capacity
19 that could have been added at that time was 500,000 gpd and that peak flows were projected to
20 exceed 1.5 million gpd by June 2007 (Tr. at 1066, Reh'g. Tr. at 257-58; Ex. S-1, Attach. Ex. MSJ at
21 4.) Under the facts known at the time, the Company had a choice. It could add the minimum
22 500,000 gpd of capacity and almost immediately begin construction of additional capacity to meet
23 projected demand, or it could increase treatment capacity to the maximum permitted capacity of 1.9
24 million gpd all at one time. The testimony indicates that adding the additional 400,000 gpd
25 increment of capacity at that time cost less than \$1 million, saving at least several million dollars
26 compared to increasing the capacity in phases. (Reh'g. Tr. at 257-58, 513.) The Company's decision
27 also avoided additional disruptions to customers that would have been experienced if the plant had
28 been built in phases.

18. RUCO does not dispute that Gold Canyon's decision to increase the plant's capacity to 1.9 million gpd was prudent. However, RUCO now seeks to hold the Company accountable for the growth that actually occurred, rather than the projected growth at the time the plant expansion decision was required to be made. Although RUCO admits in its post-hearing brief that "no one has a crystal ball," (RUCO Brief at 2), it proceeds to advocate disallowance of \$2.8 million of admittedly prudent plant investment based on the assertion that actual growth turned out to be less than expected. RUCO's post-hoc disallowance proposal would not only deny Gold Canyon an opportunity to earn a return on and of its prudent investment, but would be directly contrary to the definition of "prudently invested" set forth in the Commission's rules.⁴

19. RUCO argues that, in determining whether plant is "used and useful" for ratemaking purposes, the Commission should not consider the information known at the time the Company's investment decision was made but, instead, should evaluate the Company's decision based on facts and circumstances existing at the time rate relief is sought for the plant investment. As the Company and Staff point out, RUCO's proposed analysis would hold companies to the impossible standard of having to predict the future, a standard that has never been employed by the Commission. Adoption of RUCO's argument in this case would require us to determine now whether Gold Canyon's plant expansion is used and useful, and therefore prudent, based on actual growth rather than the projections that existed at the time the Company's decision had to be made. Moreover, the standard advocated by RUCO is contrary to the definition of "Projections" contained in the Commission's rules. As set forth in A.A.C. R14-2-103(A)(3)(k), projections are "estimate[s] of future results of operations based on known facts or logical assumptions concerning future events."

20. For many years, the Commission has been faced with the fallout from water and wastewater infrastructure that is undersized and/or shoddily constructed by developers interested primarily in selling lots, without regard to the long-term consequences of inadequate utility infrastructure. Often, the system deficiencies for these small companies do not become apparent until a development has been fully built-out, at which point the developer that constructed the system is

⁴ A.A.C. R14-2-103(A)(3)(l) provides that the prudence of investments shall be "viewed in the light of all relevant conditions known or which in the exercise of reasonable judgment should have been known, at the time such investments were made."

1 usually long gone, and the utility company's customers are left to support a water and/or wastewater
2 system that is in need of more capacity and substantial additional investment.

3 21. Adoption of RUCO's position would set a precedent that creates a significant financial
4 incentive for utility companies to plan and build undersized capacity in order to escape a
5 mathematical after-the-fact disallowance. This Commission has been confronted in prior instances
6 with the consequences of inadequate sewer treatment capacity and the specter of raw sewage running
7 through residential streets as a result.⁵

8 22. Contrary to RUCO's theory of ratemaking, we believe utility companies should be
9 encouraged to plan prudently for future growth because to do otherwise could leave such companies
10 and their customers vulnerable to outages and potentially disastrous consequences. Adoption of
11 RUCO's proposal would also send a signal to utility companies to build infrastructure in a piecemeal
12 fashion, without regard to future expansion costs, because to do otherwise would subject such
13 companies to potential disallowances of prudently invested capital. The testimony in this case
14 indicates that the Company's decision to expand the treatment plant to 1.9 million gpd is in accord
15 not only with the capacity standards applied consistently by Staff and the Commission over many
16 years, but also with the planning standards employed by ADEQ for wastewater treatment plants.
17 Moreover, even RUCO agrees that the Company's management decision to expand the plant to 1.9
18 million gpd was prudent. RUCO's theory is that, despite the prudence of the investment of capital for
19 expansion, that outlay of capital should be subjected to a mathematical disallowance based on growth
20 that failed to materialize as anticipated. Following RUCO's reasoning to its logical conclusion, any
21 prudently managed utility company would likely hesitate to invest in needed infrastructure under the
22 threat that at least part of its investment would be unrecoverable if growth projections, based on the
23 best information available at the time the decision needs to be made, turn out to be incorrect.

24 23. We wish to make clear that our rejection of RUCO's arguments should not be taken as
25

26 ⁵ See, e.g., Decision No. 66036 (July 3, 2003), *Staff v. American Public Service Co., et al.*, at 4-5: "[T]he wastewater
27 collection system was in such disrepair that raw sewage would overflow and run down the streets of the [Casitas Bonitas]
28 subdivision." Decision No. 67586 (February 15, 2005), *Arizona Utility Supply and Service* ("AUSS"), at 11: "Due to
multiple and ongoing ADEQ violations [there was] ... by mid-2004, a significant health and safety concern for residents
in the AUSS service territory." Through emergency action taken by several parties, "a public health crisis in the area was
narrowly averted." (*Id.*)

1 an indication that companies have a blank check to build infrastructure at any cost, without regard to
2 anticipated growth. Rather, this decision merely reinforces the concept that companies making
3 prudent investment decisions, based on all available information that the company knows at the time,
4 or should know at the time investment decisions are made, should not be subjected to purely
5 mathematical after-the-fact disallowances based on unknown and unforeseeable events.

6 24. Based on the record before us, we believe RUCO's proposed disallowance of a portion
7 of Gold Canyon's treatment plant should again be denied, and we therefore affirm the findings set
8 forth in Decision No. 69664 regarding RUCO's excess capacity arguments.

9 **Hypothetical Capital Structure**

10 Decision No. 69664 Findings

11 25. In Decision No. 69664, we rejected RUCO's proposal to employ a hypothetical capital
12 structure of 40 percent debt and 60 percent equity for purposes of establishing Gold Canyon's cost of
13 capital. We agreed with Gold Canyon and Staff that the Company's actual 100 percent equity capital
14 structure should be used. Because a 100 percent equity capital structure tends to minimize the overall
15 financial risk for a company, we also adopted Staff's recommendation to employ a so-called
16 "Hamada" adjustment of 100 basis points to the cost of equity calculated by Staff, thereby reducing
17 Staff's Discounted Cash Flow ("DCF") and Capital Asset Pricing Model ("CAPM") average of 10.2
18 percent to 9.2 percent. (Decision No. 69664, at 24-29.) With the 100 basis point reduction to Staff's
19 cost of equity determination, to account for Gold Canyon's risk being less than that of the sample
20 companies' used in Staff's analysis, the 9.2 percent rate of return adopted in the Decision was found
21 to be a reasonable reflection of the Company's weighted cost of capital in this proceeding. (*Id.* at 27-
22 29.)

23 RUCO's Position

24 26. In the rehearing phase, RUCO continues to advocate for adoption of a hypothetical
25 capital structure of 40 percent debt and 60 percent equity to account for Gold Canyon's lower level of
26 financial risk, due to the absence of debt in the Company's capital structure. In its Application for
27 Rehearing, as well as in the testimony of RUCO witness William Rigsby, RUCO agreed that the
28 recognition of a lower level of financial risk could be accomplished by either adjusting DCF results

1 downward or employing a hypothetical capital structure. (RUCO RH-4, Attach. 1, at 50-53.)

2 27. RUCO claims that its hypothetical capital proposal provides a more balanced result for
3 ratepayers and shareholders and would reduce the current monthly bill of \$60.55 to \$53.84 (RUCO
4 RH-1 at 6.) RUCO disputes the Company's assertion that RUCO is simply trying to lower customer
5 bills by any means possible. RUCO contends that its proposed methodology is consistent with past
6 Commission practices and takes into account the magnitude of the increase authorized by the
7 underlying Decision. RUCO cites to Article 15, Section 3, of the Arizona Constitution, which
8 requires the Commission to set "just and reasonable rates," and to language contained in a decision
9 rendered by the Arizona Supreme Court in *Arizona Community Action Assoc. v. Arizona Corporation*
10 *Comm'n*, 123 Ariz. 228, 231, 599 P.2d 184, 187 (1979), which provides: "A reasonable rate is not
11 one ascertained solely from considering the bearing of facts upon the profits of the corporation. The
12 effect of the rate upon persons to whom services are rendered is as deep a concern in the fixing
13 thereof as is the effect upon the stockholders." RUCO argues that it is within the Commission's
14 discretion to consider the magnitude of rate increases and the effects on customers in setting rates.
15 RUCO asserts that the Commission should take into account ratepayer comments that have been
16 received by the Commission through numerous letters and public comments.

17 28. RUCO also supports its hypothetical capital structure proposal with the claim that it
18 was the Company's choice to capitalize with 100 percent equity rather than with a mix of lower cost
19 debt. According to RUCO witness Rigsby, debt has the advantage of being able to reduce income
20 taxes, and thus overall expenses, whereas dividend payments to equity holders do not offer a similar
21 tax advantage. (RUCO RH-4, at 33.) RUCO argues that Gold Canyon should not be rewarded for its
22 "imprudent and unbalanced capital structure." (RUCO Brief at 9.) RUCO also claims that the
23 Company's capital structure should emulate the proxy group of companies used in the industry,
24 which Mr. Rigsby stated had average capital structures of 51 percent debt and 49 percent equity (*Id.*
25 at 13.)

26 29. RUCO contends that use of a hypothetical capital structure is preferable to Staff's
27 Hamada adjustment. Mr. Rigsby asserts that the problem with Staff's use of the Hamada
28 methodology is that Staff applied it to the average of its DCF and CAPM results instead of just the

1 CAPM. Mr. Rigsby also criticizes the Hamada adjustment's failure to produce an appropriate
2 interest deduction to reflect debt in the capital structure. He stated that the additional cash flows
3 associated with higher income tax expense benefits shareholders rather than ratepayers, whereas use
4 of a hypothetical capital structure reflects a more balanced capital structure and results in a lower cost
5 of capital for ratemaking purposes (*Id.* at 34.)

6 Staff's Position

7 30. Staff contends that RUCO has not offered any new testimony in the rehearing phase of
8 this case that was not previously considered by the Commission. Staff claims that none of the prior
9 Commission Decisions cited by RUCO in which the Commission adopted a hypothetical capital
10 structure involved an increase in the debt component. Rather, Staff says, they increased the equity
11 component as a means of enabling highly leveraged companies to earn their authorized rates of
12 return.

13 31. Staff concedes that a balanced capital structure is preferable, but disagrees that a
14 company that is capitalized with only equity has an imprudent capital structure. Staff claims that a
15 number of prior Commission Decisions have adopted 100 percent equity capital structures for water
16 and sewer companies. Staff also points out that the Commission has previously recognized the
17 appropriateness of using a Hamada adjustment to address a company's unbalanced capital structure
18 and has adopted Staff's Hamada recommendations in many prior cases.

19 32. Staff witness Steve Irvine testified that, contrary to RUCO's criticism, application of
20 the Hamada adjustment to the average of the DCF and CAPM results is an appropriate method to
21 adjust for financial risk. (Reh'g Tr. at 447-48.) Mr. Irvine conceded that using a hypothetical capital
22 structure may be an appropriate alternative to the Hamada adjustment for purposes of adjusting an
23 unbalanced capital structure, but he testified that Staff usually prefers the Hamada method because it
24 is a less subjective methodology. (*Id.* at 446.) Staff argues that excessive debt increases financial risk
25 and generally views excessive equity as less problematic than excessive debt. Staff also contends
26 that use of the Hamada adjustment to recognize a company's financial risk, which in this case
27 reduced Gold Canyon's cost of equity by 100 basis points, provides an incentive to the Company to
28 maintain a reasonable level of debt in its capital structure or face reductions to its authorized return

1 on equity.

2 Gold Canyon's Position

3 33. Gold Canyon contends that the Commission's Decision in the recent *Black Mountain*
4 *Sewer Corporation*, case (Decision No. 69164, (December 5, 2006)), should be considered as
5 controlling precedent in this proceeding because the stock of both Black Mountain and Gold Canyon
6 is owned by Algonquin, both rate cases were filed in approximately the same time frame, and the
7 Commission rejected RUCO's proposed hypothetical capital structure argument in *Black Mountain*
8 and adopted Staff's 9.6 percent cost of equity recommendation. Staff's analysis in *Black Mountain*
9 was based on an average of its DCF and CAPM calculations, but did not include a downward
10 Hamada adjustment as was done in this case. (*Id.* at 23-27.)

11 34. The Company also cites a recent *Arizona-American Water Company (Paradise Valley)*
12 case (Decision No. 68858 (July 28, 2006)), in which the Commission adopted Staff's recommended
13 10.4 percent cost of common equity, including a 50 basis point upward adjustment to reflect a higher
14 financial risk associated with that company's high percentage of debt. (Decision No. 68858 at 28.)
15 Gold Canyon claims that the *Paradise Valley* Decision properly reflects the Commission's use of an
16 equity adjustment to recognize financial risk. The Company also points out that in a number of other
17 recent cases involving both water and wastewater companies, the Commission has adopted Staff's
18 recommended cost of equity, either with or without risk adjustments, but has not employed a
19 hypothetical capital structure as a means of recognizing relative financial risk.⁶

20 35. Gold Canyon contends that the only two recent cases in which the Commission
21 adopted a hypothetical capital structure involved Arizona-American's Mohave Water and
22 Wastewater Districts and Southwest Gas Corporation.⁷ The Company argues that in both of those
23 cases, the Commission made only minor adjustments to the companies' *actual* capital structures in
24 setting the cost of equity. In the *Arizona-American* case, the Commission increased the company's

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26 ⁶ The Company cited *Far West Water and Sewer*, Decision No. 69335 (February 20, 2007); *Arizona Water Co. (Western*
27 *Group)*, Decision No. 68302 (November 14, 2005); *Chaparral City Water Co.*, Decision No. 68176 (September 30,
2005); *Arizona Water Co. (Eastern Group)*, Decision No. 66849 (March 9, 2004); and *Rio Rico Utilities*, Decision No.
67279 (October 5, 2004).

28 ⁷ The Company cited *Arizona-American (Mohave)*, Decision No. 69440 (May 1, 2007); and *Southwest Gas Corp.*,
Decision No. 68487 (February 23, 2006).

1 equity component from 37.2 percent to 40 percent; in *Southwest Gas*, the company's equity was
2 increased from 37 percent to 40 percent for purposes of establishing the cost of equity. Gold Canyon
3 asserts that these minor hypothetical capital structure adjustments are the exception rather than the
4 rule in Commission Orders and that they are significantly different from RUCO's proposal to reduce
5 Gold Canyon's equity ratio of 100 percent to a hypothetical level of 60 percent.

6 36. The Company claims that RUCO's real motive in proposing a hypothetical capital
7 structure is to lower Gold Canyon's operating expenses by creating a further hypothetical interest
8 expense resulting from the hypothetical debt creation. According to the Company, after assuming
9 Gold Canyon has hypothetical interest expense associated with the hypothetical debt, RUCO next
10 uses the hypothetical interest to calculate the Company's federal and state income tax expenses,
11 thereby calculating a hypothetical reduced income tax obligation, and ultimately fictionally reducing
12 the Company's actual test year operating expenses. Gold Canyon points out that, without the
13 additional hypothetical interest adjustment, simply applying RUCO's proposed hypothetical capital
14 structure to the authorized rate base of \$15,725,787 would actually increase the revenues authorized
15 in Decision No. 69664 from \$1,446,772 to \$1,493,950, increasing the authorized return on rate base
16 from 9.2 percent to 9.5 percent. Gold Canyon argues that it is only by recognizing RUCO's proposed
17 hypothetical debt interest expense that the authorized revenue requirement would be reduced – by
18 over \$205,000. The Company contends that RUCO's recommendation would result in an
19 approximate 10 percent reduction of its authorized revenues, thus reducing the Company's actual
20 authorized return on rate base to 7.24 percent. (GC RH-8 at 16-17.) Gold Canyon claims that Staff's
21 100 basis point reduction to a 9.2 percent return on common equity is a more appropriate means of
22 recognizing the Company's lower financial risk associated with its 100 percent equity capital
23 structure.

24 37. Gold Canyon also argues that RUCO's analysis fails to recognize that a reduction in
25 income taxes would be offset by payment of interest and principal to the lender of the debt. The
26 Company claims that incurrence of debt would reduce its net income from operations and could limit
27 its ability to invest in improvements and pay dividends. (GC RH-7 at 7.) Gold Canyon asserts that
28 companies should not be required to have capital structures consisting primarily of debt as a means of

1 providing a tax shield, especially in the case of smaller companies that may need to undertake
2 significant expenditures for plant additions and replacements. The Company therefore requests that
3 RUCO's request to amend the prior Decision be denied.

4 Resolution of Hypothetical Capital Structure Issue

5 38. We find that the adoption of Staff's recommended cost of equity of 10.2 percent,
6 reduced by 100 basis points (9.2 percent) to recognize a lower level of risk due to Gold Canyon's 100
7 percent equity capitalization, is an appropriate and reasonable determination of the Company's
8 overall weighted cost of capital. We therefore affirm Decision No. 69664 with respect to the cost of
9 capital findings.

10 39. We agree with Staff and the Company that this Decision is consistent with a number
11 of prior cases in which 100 percent equity capitalization has been adopted by the Commission and
12 with many previous cases in which a Hamada adjustment has been used to recognize either lesser or
13 greater risk associated with capital structures of companies. In the *Black Mountain* case cited above,
14 involving a sister company of Gold Canyon, we adopted a 100 percent equity capital structure that
15 resulted in a 9.6 percent return on rate base. Financial risk was also reflected through upward
16 Hamada adjustments in several recent cases for Arizona-American Water Company, which has a
17 highly debt leveraged capital structure.⁸

18 40. RUCO acknowledged in its Application for Rehearing and testimony that the purpose
19 of its hypothetical capital structure proposal is to reflect a lower level of financial risk, and that a risk
20 adjustment can also be accomplished through a downward adjustment to the Company's return on
21 equity. RUCO does not dispute that the Commission's adoption of Staff's 100 basis point reduction
22 to Gold Canyon's equity return is a valid means of reflecting the Company's lower risk due to 100
23 percent equity capital structure. RUCO has not cited any cases in which a hypothetical capital
24 structure has been used to drastically alter a company's actual capital structure, which in this case
25 would reduce Gold Canyon's equity component by 40 percent.

26 41. Even if we were to accept RUCO's hypothetical capital structure argument, the

27 ⁸ See *Arizona-American (Paradise Valley)*, Decision No. 68858 (July 28, 2006), at 28; *Arizona-American (Sun City*
28 *Water)*, Decision No. 70351 (May 16, 2008), at 14-15; *Arizona-American (Sun City and Sun City West Water and*
Wastewater), Decision No. 70209 (March 20, 2008), at 28-30.

1 Company's witness pointed out that Gold Canyon's revenue requirement would actually increase by
2 \$47,000 if RUCO's recommendation were applied to the 10.2 cost of equity determined by Staff
3 through its DCF and CAPM average, prior to applying the 100 basis point Hamada adjustment. It is
4 only by manipulating the Company's operating expenses, through a parade of additional hypothetical
5 assumptions, that RUCO's proposal results in a lower revenue requirement for Gold Canyon. In
6 order to reach RUCO's desired result, one must assume that Gold Canyon has 40 percent less equity
7 in its capital structure than actually exists, that the Company incurs hypothetical interest expense on
8 its hypothetical 40 percent debt capitalization, that Gold Canyon therefore hypothetically has lower
9 federal and state income tax obligations, and that Gold Canyon thereby experiences hypothetical
10 expenses that are \$205,000 less than the expenses the Company actually incurs.⁹

11 42. Nor are we persuaded by RUCO's criticism of Staff's method of applying the Hamada
12 adjustment. Staff's 100 basis point reduction to its cost of equity calculations results in a direct
13 adjustment, to account for Gold Canyon's lower financial risk relative to the six proxy companies
14 used in Staff's DCF and CAPM analyses. Indeed, this adjustment is consistent with the position
15 taken by RUCO in the *Arizona-American (Paradise Valley)* case cited previously. (See Decision No.
16 68858.) In that case, Mr. Rigsby advocated a 50 basis point direct upward adjustment to Arizona-
17 American's overall cost of equity to reflect its higher financial risk associated with a capital structure
18 comprised of 63.3 percent debt. (*Id.* at 25.) Mr. Rigsby conceded on cross-examination that if he had
19 used a hypothetical capital structure in the *Paradise Valley* case, the company's revenue requirement
20 would have been higher than under the direct Hamada adjustment. (Tr. at 346; GC RH-4.) As a
21 result, it does not appear that RUCO has a valid theoretical concern with recommending a direct
22 Hamada adjustment to a company's cost of equity in order to reflect financial risk.

23 43. For these reasons, we conclude that Staff's analysis and recommendation for a 9.2
24 percent overall weighted cost of capital is reasonable. We therefore affirm the findings made in

25 ⁹ Gold Canyon argues that RUCO did not raise the argument in its Application for Rehearing that the Company's
26 operating expenses should be adjusted to include hypothetical interest expense and therefore RUCO's proposed expense
27 adjustment is improper and should not be considered pursuant to the requirements of A.R.S. § 40-253(C). The statute
28 cited by Gold Canyon states that an application for rehearing must "set forth specifically the grounds on which it is
based" and failure to do so precludes any person, or the state, from relying in any court "on any ground not set forth in the
application." Given our rejection of RUCO's arguments on this issue, we need not address the legal argument raised by
Gold Canyon.

1 Decision No. 69664 with respect to Gold Canyon's cost of capital.

2 Rate Case Expense

3 44. In Decision No. 69664, the Commission reduced Gold Canyon's request for
4 recognition of rate case expenses in the amount of \$160,000 to \$70,000, amortized over four years,
5 on the basis that the Company failed to provide to Staff and intervenors necessary documentation to
6 support the request.

7 45. Although no party requested rehearing on the issue of rate case expense, during the
8 Staff Meeting in which RUCO's request for rehearing was granted, the Commission also indicated an
9 intent to reconsider the issue of rate case expense. (See Procedural Order issued August 23, 2007.)

10 46. Gold Canyon argues that, pursuant to the requirements of A.R.S. § 40-253, because
11 no party raised the issue of rate case expense through a request for rehearing, the Commission may
12 not now consider whether the \$70,000 rate case expense allowance should be modified. However,
13 the Company contends that the Commission may grant an allowance for rate case expenses incurred
14 during the rehearing phase of this proceeding and requests that the Commission approve an additional
15 amount of \$90,000 for rehearing rate case expense. Gold Canyon claims that Staff and RUCO were
16 provided unredacted copies of the Company's rehearing expenses, but Staff declined to recommend
17 granting recognition of such expenses, and RUCO took no position regarding the request.

18 47. We do not believe that the parties presented sufficient evidence on the issue of
19 rehearing rate case expenses incurred by Gold Canyon to support the adjustment suggested by the
20 Company. We therefore decline to adjust the amount for rate case expense authorized in Decision
21 No. 69664.

22 CONCLUSIONS OF LAW

23 1. Gold Canyon is a public service corporation within the meaning of Article XV of the
24 Arizona Constitution and A.R.S. §§ 40-250, 40-251, 40-367, 40-202, 40-321, and 40-361.

25 2 The Commission has jurisdiction over Gold Canyon and the subject matter set forth in
26 the Company's rate application and in RUCO's Application for Rehearing.

27 3. Pursuant to A.R.S. § 40-253, the Commission has considered the evidence and
28 arguments presented by RUCO, Gold Canyon, and Staff pertaining to the Commission's grant of

1 rehearing to RUCO on the issues of excess capacity and hypothetical capital structure, as discussed
2 hereinabove.

3 4. After considering the issues raised by RUCO's Application for Rehearing, the
4 Commission affirms the Findings and Conclusions set forth in Decision No. 69664.

5 **ORDER**

6 IT IS THEREFORE ORDERED that, after consideration of the facts, circumstances, and
7 evidence presented in the rehearing phase of this proceeding, the relief sought by RUCO's
8 Application for Rehearing is denied, and Decision No. 69664 is affirmed in its entirety.

9 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

10 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.
11
12

13 CHAIRMAN _____ COMMISSIONER _____

14
15 COMMISSIONER _____ COMMISSIONER _____ COMMISSIONER _____
16

17 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive
18 Director of the Arizona Corporation Commission, have
19 hereunto set my hand and caused the official seal of the
20 Commission to be affixed at the Capitol, in the City of Phoenix,
21 this _____ day of _____, 2008.

22 _____
23 BRIAN C. McNEIL
24 EXECUTIVE DIRECTOR

25 DISSENT _____

26 DISSENT _____
27
28

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