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BEFORE THE ARIZONA CORPORATION COMMISSION

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

GOLD CANYON SEWER COMPANY'S PETITION FOR REHEARING PURSUANT TO A.R.S. § 40-253

Arizona Corporation Commission
DOCKETED
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ABBREVIATIONS USED IN CITATIONS TO THE RECORD

GOLD CANYON SEWER COMPANY - PRE-FILED TESTIMONY

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of Michael D. Weber	**A-5**	Weber Dt.
Rebuttal Testimony of Charles A. Hernandez	**A-6**	Hernandez Rb.
Rejoinder Testimony of Charles A. Hernandez	**A-8**	Hernandez Rj.
Direct Testimony of Thomas J. Bourassa	**A-10**	Bourassa Dt.
Rebuttal Testimony of Thomas J. Bourassa	**A-11**	Bourassa Rb.
Rejoinder Testimony of Thomas J. Bourassa	**A-12**	Bourassa Rj.
Responsive Rehearing Testimony of Charles A. Hernandez	**GC-RH-6**	Hernandez Rh.
Responsive Rehearing Testimony of Ian Robertson	**GC-RH-7**	Robertson Rh.
Responsive Rehearing Testimony of Thomas J. Bourassa	**GC-RH-8**	Bourassa Rh.

RESIDENTIAL UTILITY CONSUMER OFFICE - PRE-FILED TESTIMONY

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of William A. Rigsby	**R-7**	Rigsby Dt.
Surrebuttal Testimony of William A. Rigsby	**R-8**	Rigsby Sb.
Direct Testimony of Rodney L. Moore	**R-9**	Moore Dt.

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RESIDENTIAL UTILITY CONSUMER OFFICE - PRE-FILED TESTIMONY

Pre-Filed Testimony	**Hearing Exhibit**	**Abbreviation**
Surrebuttal Testimony of Rodney L. Moore	**R-10**	Moore Sb.
Prefiled Rehearing Testimony of Rodney L. Moore	**RUCO-RH-1**	Moore Rh.
Prefiled Rehearing Testimony of Marylee Diaz Cortez	**RUCO-RH-2**	Diaz Cortez Rh.
Prefiled Rehearing Testimony of William A. Rigsby	**RUCO-RH-4**	Rigsby Rh.

STAFF - PRE-FILED TESTIMONY

Pre-Filed Testimony	**Hearing Exhibit**	**Abbreviation**
Direct Testimony of Marlin Scott	**S-1**	Scott Dt.
Surrebuttal Testimony of Marlin Scott	**S-2**	Scott Sb.
Direct Testimony of Steven P. Irvine	**S-17**	Irvine Dt.
Surrebuttal Testimony of Steven P. Irvine	**S-15**	Irvine Sb.
Responsive Testimony of Crystal Brown	**S-RH-1**	Brown Rh.

OTHER PORTIONS OF THE RECORD

Document	**Hearing Exhibit**	**Abbreviation**
Hearing Transcript (Nov. 1-3, Dec. 4, 5 and 11, 2006)		Tr.
Open Meeting Transcript (June 26, 2007)		OM Tr.
RUCO's Application for Rehearing of Decision No. 69660 (July 18, 2007)	**GC-RH-1**	RUCO Rh. App.

OTHER PORTIONS OF THE RECORD

Document	Hearing Exhibit	Abbreviation
RUCO's Closing Brief (Jan. 19, 2007)	**GC-RH-2**	RUCO Cl. Br.
William Rigsby - Analysis of a Hypothetical Capital Structure	**GC-RH-4**	
Rehearing Transcript (Nov. 14, 2007, Feb. 25 and Mar. 31, 2008)		Rh. Tr.
Gold Canyon Sewer Company Rehearing Closing Brief		GCSC Rh. Cl. Br.
Staff Rehearing Closing Brief		Staff Rh. Cl. Br.
RUCO Rehearing Closing Brief		RUCO Rh. Cl. Br.

I. INTRODUCTION AND RELIEF REQUESTED.

Gold Canyon Sewer Company ("GCSC" or "the Company") hereby petitions the Arizona Corporation Commission ("the Commission") for rehearing of Decision No. 70662 (December 23, 2008) ("the Decision") under A.R.S. § 40-253. The Decision purported to "clarify the language and... intent" of Decision No. 70624 (November 19, 2008) ("the Rehearing Decision) pursuant to A.R.S. § 10-252 and/or § 40-253. In doing so, the Company's revenue requirement was reduced by an additional $301,515 from the revenue requirement authorized in the Rehearing Decision, which was already $275,891 lower than the revenue requirement approved in Decision No. 69664 (June 28, 2007). Thus, the Decision and Rehearing Decision together reduced GCSC's rates by $577,406 – nearly one-third of the increase originally authorized in this case.

This result was achieved by means of the Commission's rejection of Decision No. 69664, its rejection of the recommendations of the Utilities Division ("Staff") (including its Engineering Section), its rejection of the evidence in the record, its rejection of the recommendation of the Commission's Assistant Chief Administrative Law Judge, and its adoption of the recommendation of the Residential Utility Consumer Office ("RUCO"). Given this result-driven process, it is not surprising that the Rehearing Decision is internally inconsistent with findings of fact that are in direct conflict with the result reached. The Decision, issued five weeks after the Rehearing Decision, simply compounds the Commission's errors and inconsistencies.

In summary, the Company submits that the Decision, together with the Rehearing Decision, is arbitrary, capricious and unlawful in the following respects:

- The Decision (as well as the Rehearing Decision) was the product of result-driven ratemaking, in which the evidence presented during the hearings, the findings of fact based on that evidence, and prior Commission precedent were ignored in order to achieve the desired result – lower rates. This was arbitrary, capricious and unlawful.

- The Decision (as well as the Rehearing Decision) conflicts with A.A.C. R14-2-103(A)(3)(l) because the Commission has second-guessed GCSC's planning decision after the fact, notwithstanding the undisputed evidence in the record (including the testimony of the Commission's own Engineering Section) that GCSC acted prudently in investing more than $11 million to upgrade and expand its wastewater treatment plant.

- GCSC's decision to expand the capacity of its wastewater treatment plant to 1.9 million gallons per day ("gpd") was prudent, given the inability of the original plant to treat daily peak wastewater flows as early as 2005, the peak daily wastewater flows projected for 2007, and the nominal incremental cost of adding an additional 400,000 gpd of treatment capacity which was less than the total cost of the project. The Commission arbitrarily ignored this evidence to lower rates.

- The Commission's adoption of RUCO's 8.6 percent cost of equity on rehearing was arbitrary, capricious and unlawful. RUCO never challenged the Commission's adoption of its Staff's cost of equity estimate in its application for rehearing. RUCO instead argued that the Commission should have adopted a hypothetical capital structure rather than using GCSC's actual capital structure, with a downward adjustment to the cost of equity to reflect the Company's low financial risk. Therefore, RUCO's challenge to the cost of equity adopted in Decision No. 69664 was improper and could not be considered on rehearing. *See* A.R.S. § 40-253(C).

- The Commission's adoption of a hypothetical capital structure on rehearing conflicts with prior Commission decisions, including *Black Mountain Sewer Corp.,* Decision 69164 (Dec. 5, 2006), in which the Commission concluded that RUCO's use of a hypothetical capital structure to drive down a utility's rates was "results-oriented." *Compare Arizona-American Water Co.*, Decision No. 68858 (July 28, 2006) at 28. (explaining that the "generally accepted regulatory means of accounting for financial risk" is by adjusting the cost of equity up or down).

- RUCO's real disagreement was not with Staff's estimate of the risk differential produced by the lack of debt in GCSC's capital structure, but with the amount of test year *operating expenses* adopted in the Decision. Boiled down, RUCO opposed the direct adjustment approach because it failed to reduce GCSC's operating expenses.

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- RUCO conceded that a downward adjustment to the cost of equity – the method normally used by the Commission – can be used to reflect lower financial risk. Therefore, if a downward adjustment to the return on equity and the use of a hypothetical capital structure are interchangeable and produce the same result, as RUCO has stated, it would be improper to adjust the utility's operating expenses based on fictional interest expense. The Commission nevertheless did so in the Decision. This was arbitrary, capricious and unlawful.

- RUCO did not ask that the Commission rehear any of the Company's approved operating expenses. *See* RUCO Rh. App. at 4-8. RUCO did not question the methodology or inputs used by the Commission to calculate adjusted test year income tax expenses in determining GCSC's operating expenses and operating income. Therefore, RUCO's adjustment to the methodology and inputs used to determine test year operating expenses was improper and could not be considered on rehearing. *See* A.R.S. § 40-253(C). The Commission nevertheless adopted RUCO's adjustment. This was arbitrary, capricious and unlawful.

The Company also incorporates by reference (1) its Rehearing Closing Brief, filed on May 5, 2008, (2) its Rehearing Reply Brief, filed on May 22, 2008, and the evidence and arguments set forth therein, and (3) the Company's Petition for Rehearing Pursuant to A.R.S. § 40-253, filed in the above-entitled docket on December 5, 2008, in support of this petition.

The Company respectfully requests that the Commission grant this petition and order that this matter be promptly heard and determined within 20 days of final submission, in accordance with A.R.S. § 40-253(a). The Company further requests that the Commission re-authorize the rates approved in Decision No. 69664 and authorize a surcharge designed to allow the Company to recover the revenue deficiency resulting from the Commission's Decision and the Rehearing Decision together with interest thereon equal to Company's weighted cost of capital.

II. SUMMARY OF PRIOR PROCEEDINGS.

On January 13, 2006, the Company filed an application for a determination of the fair value of its utility plant and property devoted to public service and for increases in its rates and charges for sewer utility service. In its application, the Company used the 12-month period that ended October 31, 2005 as its test year, in accordance with A.A.C. R14-2-103. The Company maintained that, during the test year, it had adjusted operating income of $241,752, which produced a return of 1.54 percent on its rate base of $15,742,719. *See* Decision No. 69664 at 4-5.[1] The Company sought an increase in its gross revenues (i.e., revenues before income taxes) of $2,298,383 (92 percent). Notably, prior to this case, GCSC's rates for sewer utility service had been increased on only one occasion. In Decision No. 64186 (Oct. 30, 2001), the Company was allowed to increase its rates by approximately 6 percent. Thus, since the Company was formed in 1989 until July 2007 – a period of nearly 18 years – the Company's customers had experienced only one small rate increase.

The need for rate increases was driven by the Company's investment of $16 million in utility plant since its last rate case, $11.2 million of which was spent to upgrade and expand its wastewater treatment plant, which had been plagued by odor and noise problems, and lacked capacity to meet the needs of current and projected customers with a reasonable margin of safety.[2] The record before the Commission showed that as a result of this plant renovation project, the odor and noise problems associated with the treatment plant were resolved (*see* Decision No. 69664 at 30-34); the treatment plant's capacity was sufficient to meet current and projected customer demand (including winter peak flows) with a reasonable margin of safety (*see, e.g.,* Scott Dt., Ex. MSJ at 4; Tr. at

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[1] The Company accepted the use of its original cost rate base as its fair value rate base. *See* Decision No. 69664 at 4-5. Consequently, the Company will refer to its "rate base" in the remainder of this petition.

[2] Notably, these noise and odor problems existed when GCSC's parent, Algonquin Power Income Fund, acquired GCSC from its previous owner.

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1031-32[3]); the treatment plant is producing Class A+ effluent, which is sold to local golf courses for turf irrigation or otherwise properly discharged in accordance with regulatory requirements (*see, e.g.*, Hernandez Dt. at 8); and GCSC is operating in compliance with applicable regulations and providing safe and reliable sewer utility service (*see, e.g.*, Scott Dt., Ex. MSJ at 4; Tr. at 1031-32). GCSC's investment in plant caused its original cost rate base to increase fourfold, from $3,797,387 in 2000 to $15,725,787 in this case. *Compare* Decision No. 64186 at 5 *with* Decision No. 69664 at 9.

The Commission's Utilities Division ("Staff") recommended an increase of $1,822,101 (73 percent), and the Residential Utility Consumer Office ("RUCO") recommended an increase of only $1,044,378 (42 percent). *Id.* at 5. The primary areas of disagreement concerned the amount of the Company's rate base and the appropriate cost of capital/rate of return. In summary, the parties' positions were as follows:

	Rate Base	Rate of Return
GCSC	$15,742,719	10.50 percent
Staff	$15,725,787	9.20 percent
RUCO	$13,983,602	8.54 percent

After multiple rounds of pre-filed testimony, several days of hearing, and extensive briefing, the Commission ultimately adopted its Staff's position (with certain minor modifications), and issued Decision No. 69664 in July 2007. That decision authorized rates producing a gross revenue increase of $1,798,999 (72 percent) and

[3] Citations to the record are made as follows: Citations to a witness' pre-filed testimony are abbreviated using the format set forth on pages ii to iv, above, following the Table of Contents, which also lists the hearing exhibit numbers of the parties' pre-filed testimony. Other hearing exhibits are cited by the hearing exhibit number and, where applicable, by page number, *e.g.*, GC-RH-1 at 1. The transcript from the rate case hearings before the Decision will be referred to as "Tr."; the transcript from the June 26, 2007 Open Meeting will be referred to as "OM Tr."; the transcript from the rehearing hearings will be referred to as "Rh. Tr." Transcripts from other proceedings will be referred to by specific citation.

providing a return of 9.2 percent on the Company's rate base. The basic rate for residential sewer service was increased from $35.00 per month to $60.55 per month. *See* Decision No. 69664 at 45-47.

On July 18, 2007, RUCO filed an application for rehearing of Decision No. 69664 pursuant to A.R.S. 40-253. *See generally* Rehearing Decision at 1-3 (summarizing procedural background). As the Commission found in the Rehearing Decision, RUCO raised two issues for rehearing:

> (1) The Commission should have disallowed $2.8 million to reflect what RUCO claimed was excess capacity in Gold Canyon's wastewater treatment plant; and
>
> (2) The Commission should have adopted RUCO's hypothetical capital structure of 60 percent equity and 40 percent debt, rather than the actual capital structure used by the Commission to calculate the Company's cost of capital.

Id. at 3, Finding of Fact ("FOF") 2. However, the Commission ultimately reheard Decision No. 69664 on additional grounds, and relied on those additional grounds to lower GCSC's rates, in violation of A.R.S. § 40-253.

On August 1, 2007, the Commission granted RUCO's application. Various proceedings were conducted over the next 15 months, including three additional days of hearing and additional briefing. *Id.* at 2-3. On October 28, 2008, the Commission's Assistant Chief Administrative Law Judge issued his recommended Rehearing Opinion and Order, which contained a thorough review of the evidence and arguments presented by RUCO, the Company and the Commission's Staff, and concluded that Decision No. 69664 should be affirmed in its entirety. At an open meeting held on November 13, 2008, however, four of the five Commissioners voted to amend Decision No. 69664 for the purpose of lowering the Company's rate increase. Unfortunately, the Commissioners were confused about precisely what they were doing other than voting for lower rates. Commissioner Hatch-Miller, for example, stated prior to his vote:

> So, approximately, approximately a million dollars isn't a million dollars. It is some other number; we just don't know what it is.
>
> This is a faulty, it is a faulty order. The only reason we are doing it is to lower the rates somehow and find a way to do it. It is not, we are not using any real math here or any kind of real process. ***We are just trying to drive the rates down.***

Transcript from November 13, 2008 Open Meeting ("OM Tr.") at 221 (emphasis supplied).

The Rehearing Decision modified Decision No. 69664 in two specific ways by ordering as follows:

> IT IS THEREFORE ORDERED that Gold Canyon Sewer Company's rate base be reduced by $1.0 million as discussed herein and that Gold Canyon Sewer Company submit by November 30, 2008, for Commission approval, rates and charges revised per this rate base reduction. These revised rates and charges will be applied on a prospective basis and will not be applied retroactively.
>
> ...
>
> IT IS FURTHER ORDERED that the weighted cost of capital approved in this case shall be 8.54 percent and that Gold Canyon Sewer Company submit by November 30, 2008, rates and charges revised per this cost of capital. These revised rates and charges will be applied on a prospective basis and will not be applied retroactively.

Rehearing Decision at 15-16. In accordance with these ordering paragraphs, on November 28, 2008, GCSC filed a schedule of revised rates and charges for Commission review and approval. These rates were based on a revenue requirement that was

$275,891 lower than the revenue requirement approved in Decision No. 69664. This was the result produced by arbitrarily reducing the Company's rate base by $1 million and reducing the cost of capital (rate of return on rate base) to 8.54 percent, in accordance with the ordering paragraphs of the Rehearing Decision.

Given the result-driven nature of the Commission's action, it is not surprising that the Rehearing Decision itself generated additional controversy and confusion. On December 3, 2008, RUCO filed a response to the Company's new schedule of rates, and moved to disapprove those rates. Remarkably, RUCO argued that the Company should not have complied with the ordering paragraphs of the Rehearing Decision and, instead, should have treated certain statements made during the November 13, 2008 Open Meeting as binding on the Company. In short, according to RUCO, the Company should have submitted new rates that produced an even lower revenue requirement, notwithstanding the plain language of the Rehearing Decision.

On December 22, 2008, the Commissioners addressed RUCO's motion at a special open meeting. The Commissioners criticized the Company for filing revised rates based on the ordering paragraphs of the Rehearing Decision, and voted to adopt the Decision to "clarify" the Rehearing Decision.[4] Specifically, the Commission modified the ordering paragraphs quoted above to provide:

> IT IS THEREFORE ORDERED that [GCSC's] plant in service (as reflected in Attachment 1) be reduced by $1.0 million as discussed herein and that [GCSC] submit by December 29, 2008, in a form acceptable to Staff, rates and charges revised per this plant in service reduction. Depreciation on the plant removed from plant in service shall be deferred for recovery in a future rate case and the deferral account shall also include interest calculated using the

[4] Chairman Mike Gleason, who had dissented from the Rehearing Decision, was unavailable and did not participate in the special open meeting.

> Company's rate of return authorized in Decision No. 70624.
>
> . . .
>
> IT IS FURTHER ORDERED that the weighted cost of capital approved in this case shall be 8.54 percent and that [GCSC] shall submit by December 29, 2008, rates and charges revised per this cost of capital. [GCSC's] weighted cost of debt is 3.38 percent and the Company's weighted cost of equity is 5.16 percent. The Company will use the weighted cost of debt of 3.38 percent in order to calculate [GCSC's] test year adjusted level of income tax expense, using the interest synchronization method, to arrive at the revised level of operating revenue that will be generated by the revised rates and charges.

Decision at 3-4. These "clarifications" lowered the Company's revenue requirement by an additional \$301,515, bringing the total reduction in the Company's revenues to \$577,406 – a 32 percent reduction from the revenue increase approved in Decision No. 69664.

In the meantime, on December 5, 2008, the Company submitted its petition for rehearing of the Rehearing decision in accordance with A.R.S. § 40-253. The public notice concerning the December 22, 2008 special open meeting indicated that the Commissioners may consider and take action on the Company's petition. However, the Company's petition was not discussed, and it was denied instead by operation of law on December 26, 2008. *See* A.R.S. § 40-253(a).

In summary, the three decisions issued by the Commission in this case (which has been pending for nearly three years) have resulted in the following adjustments:

	Rate Base	Revenue Increase
Decision No. 69664	\$15,725,787	\$1,798,999
Rehearing Decision	\$14,725,787	\$1,523,108
Decision	\$15,371,260	\$1,221,593

As explained below, the revenue decrease authorized on rehearing and as "clarification" in the Decision was arbitrary and result-driven, and was plainly unlawful because the decrease was based on issues that were not before the Commission on rehearing, as the Rehearing Decision itself plainly states. Consequently, the Company seeks rehearing to allow the Commission an opportunity to correct its unlawful action and reinstate Decision No. 69664.

III. THE ISSUES ON WHICH REHEARING IS SOUGHT.

A. <u>Summary of the Issues Properly Before the Commission on Rehearing</u>

As discussed above, the Commission properly found that RUCO raised two issues as the basis for rehearing:

(1) Does GCSC's wastewater treatment plant contain "excess capacity" that should be excluded from rate base?

(2) Should a hypothetical capital structure be imputed to GCSC to account for the reduced financial risk resulting from the absence of debt in GCSC's capital structure?

Rehearing Decision at 3, FOF 2. Only after rehearing was granted did RUCO assert that the Commission should have adopted its recommended 8.6 percent cost of equity instead of the cost of equity recommended by Staff and adopted in Decision No. 69664, which was 9.2 percent after a 100 points Hamada adjustment was utilized to account for the level of financial risk in GCSC's capital structure. October 22, 2007 Procedural Conference Tr. at 22-25. *Compare* Decision No. 69664 at 25-29 (containing the Commission's discussion and rationale for adopting Staff's 9.2 percent cost of equity). RUCO, however, did not and never has challenged Staff's recommended cost of equity or the Commission's adoption of Staff's recommendation. Nor does the Rehearing Decision or the Decision explain why RUCO's recommended cost of equity was superior to Staff's recommendation. Obviously, the Commission was searching for a way to lower rates,

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and simply selected RUCO's cost of equity because it resulted in a lower rate of return and, ultimately, lower rates.

The Commission also violated A.R.S. § 40-253 by adjusting the Company's operating expenses on rehearing by creating fictitious interest expense and using that expense to lower the Company's income taxes. Indeed, this fictitious adjustment is the primary reason why the Company's revenue requirement decreased by more than $300,000 between the Rehearing Decision and the Decision. According to RUCO, the purpose of using a hypothetical capital structure is to properly account for GCSC's lower level of financial risk, resulting from the absence of debt in GCSC's capital structure as compared to the amount of debt in the capital structures of the large, publicly traded water utilities used in the parties' equity cost estimation models. *See* RUCO Rh. App. at 4-8. RUCO did not question the methodology or inputs used by the Commission to calculate adjusted test year income tax expenses in determining GCSC's operating expenses and operating income. Consequently, while the issue of whether the Commission should have adjusted GCSC's capital structure rather than adjusting the return on equity downward (the normal Commission practice) was properly before the Commission on rehearing, RUCO's adjustment to the methodology and inputs used to determine test year income tax expense was not.

As a consequence, only those two issues specifically raised in RUCO's application, excess capacity and hypothetical capital structure, could be reheard under A.R.S. § 40-253. In Decision No. 69664, the Commission rejected RUCO's arguments on both of these issues. By considering other issues on remand, and ultimately adopting RUCO's arguments on those issues, the Commission violated Arizona law, rendering both the Rehearing Decision and the Decision unlawful.

B. **The Commission's Reduction of the Company's Rate Base Was Arbitrary, Capricious and Contrary to the Evidence in the Record**

In the Rehearing Decision, the Commission adopted RUCO's position that the Company's wastewater treatment plant has excess capacity and ordered that the Company's rate base be reduced by $1 million. *See* Rehearing Decision at 15. This reduction was completely arbitrary and was unrelated to the evidence in the record, as discussed in the Company's December 5, 2008 rehearing petition. In the Decision, the Commission corrected this error by reducing the Company's plant-in-service account by $1 million, resulting in a rate base that is greater than the rate base that was approved in the Rehearing Decision, but is nevertheless $354,527 less than the rate base approved in Decision No. 69664. The rationale for this reduction was not disclosed in either the Rehearing Decision or the Decision. Apparently, the Commission intended to prevent recovery of the amount invested by the Company to expand the capacity of its wastewater treatment plant to 1.9 million gallons per day ("gpd").

It is undisputed that GCSC designed and built the amount of wastewater treatment capacity necessary to comply with the Commission's expectation that sewer utilities plan and build treatment capacity to serve customers over a five-year future planning horizon to ensure that safe and reliable service will be furnished. Rehearing Decision at 4-5, FOF 7 and n. 2. Likewise, it is undisputed that ADEQ requires that a sewer utility begin planning for additional treatment capacity when plant throughput reaches 80 percent of permitted capacity and begin constructing that additional capacity before 90 percent of permitted capacity throughput is reached. *Ibid.*; *see also id.* at 8, FOF 16 and 17. The Company's wastewater treatment plant was designed and built to comply with these regulatory requirements. This was supported by the Staff Engineering Report and Staff expert witness testimony specifically finding that there is no excess capacity in the GCSC plant.

In contrast, none of RUCO's witnesses had any technical background or experience concerning the design, construction or operation of wastewater treatment plants. As a result, RUCO's adjustment to reduce GCSC's rate base was erroneously based on average *annual* wastewater flow, rather than *peak* wastewater flow. *See* Tr. at 276-277; Moore Sb. at 7. According to RUCO, a treatment plant with a capacity of 1.367 million gpd is adequate to safely treat peak daily wastewater flow in excess of 1.5 million gpd – GCSC's projected peak daily flow in 2007, the year in which new rates became effective. On its face, this is absurd. Yet RUCO's rationale was apparently accepted by the Commission and used to reduce the Company's rate base, thereby lowering rates.

At the same time, however, all of the parties, including RUCO, agreed that the Company's decision to expand its treatment capacity to 1.9 million gpd was a prudent decision. Rehearing Decision at 4, FOF 6. For example, RUCO's witness stated:

> We commend the Company for its proactive approach to eliminating the odor and noise and the customer problems with the undercapacity of existing plant when they took it over.

Tr. at 943. In fact, RUCO's witness repeatedly testified during the hearing that GCSC made a prudent decision to expand the capacity of its treatment plant by 900,000 gpd rather than 500,000 gpd. Tr. at 957-58, 962-63, 988. RUCO also agreed that it is reasonable and prudent to add additional capacity earlier than might otherwise be required if there are cost savings to be achieved in constructing the plant earlier. Tr. at 955. Despite this testimony, the Commission has now second-guessed GCSC based on information that was not known to the Company, and that could not have been known to the Company, when it was obligated to design and construct its plant renovation and expansion.

For example, GCSC experienced peak flows of almost 1.2 million gpd in February 2005, 80 percent of its minimum necessary capacity of 1.5 million gpd. Rehearing Decision at 4, FOF 7; *see also id.* at 8, FOF 17. Furthermore, based on growth projections at that time, Staff's engineering witness estimated that GCSC was likely to have peak flows in excess of 1.5 million gpd in 2007. *Ibid.* As such, GCSC would have been obligated to have capacity substantially greater than 1.5 million gpd in place by then or already be re-engaged in constructing additional capacity to meet ADEQ's expectations and the Commission's required five year planning horizon.

The Commission's rules require that plant investment decisions be evaluated based on information that was known or should have been known ***at the time plant investment decisions are made***. A.A.C. R14-2-103(A)(3)(l). Specifically, this regulation defines the term "prudently invested" as:

> Investments which under ordinary circumstances would be deemed reasonable and not dishonest and obviously wasteful. All investments shall be presumed to have been prudently made, and such presumptions may be set aside only by clear and convincing evidence that such investments were imprudent when viewed in 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.

The definition of the term "original cost rate base" in turn includes "[a]n amount consisting of the depreciated original cost, prudent invested, of the property … at the end of the test year …." A.A.C. R14-2-103(A)(3)(h). Here, there was no dispute that GCSC's investment in the new wastewater treatment plant was prudent and was made prior to the end of the test year. The Commission simply ignored its own regulations (as well as the testimony of its own Staff) and, in order to lower rates, arbitrarily reduced GCSC's rate base. This was unlawful.

In sum, the Commission adopted a flawed methodology that was contrary to its own rules and effectively penalized the Company for acting prudently to ensure that safe and adequate treatment capacity is available at a reasonable cost. The Commission's Staff explained that a five-year planning period is used in determining appropriate plant capacity. *E.g.*, Rh. Tr. at 513-14, 526. Further, utilities are encouraged to invest capital to ensure that "backbone" plant is sufficient to meet peak customer service requirements with a reasonable margin of safety. The Rehearing Decision and the Decision conflict with this policy, and are unsupported by competent evidence and have no evidentiary basis of support in the record of this docket. Consequently, the downward adjustment to the Company's rate base to remove $1 million from its plant in service was arbitrary, capricious and unlawful.

C. <u>**The Adoption of RUCO's Cost of Capital and Operating Expense Adjustments Was Arbitrary and Unlawful**</u>

In the Rehearing Decision, the Company's return on rate base was reduced from 9.2 percent to only 8.54 percent. Rehearing Decision at 16. This return was affirmed in the Decision. Decision at 4. This return was derived by adopting RUCO's recommended cost of equity of 8.6 percent, RUCO's recommended cost of debt of 8.45 percent, and RUCO's hypothetical capital structure of 40 percent debt and 60 percent equity. As explained in the Company's December 5, 2008, rehearing petition, at pages 5 through 9, the adoption of a weighted average cost of capital of 8.54 percent is unsupported by substantial evidence, is arbitrary, capricious or otherwise unlawful for several different reasons.

1. <u>By RUCO's Own Admission, the Use of a Hypothetical Capital Structure Is Unnecessary to Account for Financial Risk</u>.

According to RUCO, the purpose of using a hypothetical capital structure is to properly account for GCSC's lower level of financial risk, resulting from the absence of debt in GCSC's capital structure as compared to the amount of debt in the capital structures of the large, publicly traded water utilities used in the parties' equity cost estimation models. RUCO acknowledged that this can be accomplished by either adjusting the return on equity estimate for the sample water utilities or by using a hypothetical capital structure. For example, in its rehearing application, RUCO explained:

> The problem concerns an appropriate adjustment to the Company's cost of common equity to bring it in line with sample group of companies that have capital structures more representative of the industry and face greater financial risk as a result of the level of debt in their capital structures. A lower weighted cost of capital, reflecting Gold Canyon's lower level of risk, is warranted. *This can only be achieved by either making a direct downward adjustment to the results of a DCF analysis, which reflects the financial risk of the sample utilities, or by the use of a hypothetical capital structure.* By using the hypothetical capital structure approach, a lower weighted cost of capital that reflects the Company's lack of financial risk, is achieved. This brings the Company's capital structure in line with the industry average and results in lower rates to Gold Canyon's ratepayers.

RUCO Rh. App. at 6 (footnote omitted; emphasis supplied). The pre-filed testimony of RUCO's cost of capital witness, William Rigsby, contains a similar explanation of the basis for RUCO's proposed hypothetical capital structure, again acknowledging that the lower level of financial risk in GCSC's capital structure "could be achieved by either making a direct downward estimated adjustment to my DCF result" or by using a hypothetical capital structure. Rigsby Dt. at 50-53; Rh. Tr. at 148-49. *See also* RUCO's Cl. Br. at 15 (similarly explaining that the purpose of using a hypothetical capital structure is to account for differences in financial risk).

In Decision No. 69664, the Commission did precisely what RUCO advocated: The Commission adjusted Staff's recommended cost of equity (which RUCO did not challenge) downward by 100 basis points, from 10.2 percent to 9.2 percent, to account for GCSC's financial risk being less than that of the publicly traded utilities in Staff's sample group. Decision No. 69664 at 27.[5] This direct adjustment to the return on equity reduced GCSC's operating income and revenue requirement by over $256,000 annually. Bourassa Rh. at 26-27. The simple reality is that RUCO's hypothetical capital structure is unnecessary and conflicts with Commission precedent.

2. <u>The Decision and Rehearing Decision Conflict with Black Mountain Sewer's Rate Decision</u>.

Perhaps the most remarkable aspect of the Decision and the Rehearing Decision is that they directly conflict with *Black Mountain Sewer Corp.*, Decision No. 69164 (Dec. 5, 2006). The GCSC and Black Mountain rate cases involve virtually identical circumstances and were decided by the Commission within eight months of each other. In fact, Black Mountain's application for rate increases was filed on September 16, 2005, while GCSC's application for rate increases was filed on January 13, 2006. Thus, the two cases were separated by only four months. Decision No. 69164 at 1; Decision No. 69664 at 1. The common stock of both sewer utilities was acquired by Algonquin Water Resources of America in 2001. Decision No. 69164 at 2; Decision No. 69664 at 1-2. The service territories of both sewer utilities are on the outskirts of Phoenix metropolitan area, and are approximately 30 miles apart. Decision No. 69164 at 1; Hernandez Dt. at 3. Finally, and most importantly, for ratemaking purposes both sewer utilities have capital structures consisting of 100 percent equity and no debt. Decision No. 69164 at 19;

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[5] GCSC challenged Staff's recommendation in the proceedings leading to the Decision because the reduction in financial risk resulting from the Company's capital structure is offset by the greater business risk faced as a result of its small size, the lack of liquidity in the Company's stock, regulatory treatment uncertainty and other firm-specific factors. However, GCSC did not seek rehearing on the Commission's adoption of Staff's 9.2 percent recommended return on equity. Nor, as stated, did RUCO.

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Decision No. 69664 at 24. In other words, GCSC and Black Mountain are two truly comparable utilities that had applications for rate increases pending before the Commission at the same time.

In Black Mountain's case, the utility and the Commission's Staff recommended the use of the sewer utility's 100 percent equity capital structure, while RUCO proposed a hypothetical capital structure containing 57 percent equity and 43 percent debt. Decision No. 69164 at 19. The rationale provided by RUCO for using a hypothetical capital structure in Black Mountain's case is the same rationale that RUCO provided in this case:

> The water utilities in my sample, from which I derived an estimated cost of common equity of 9.49 percent, would be considered as having a higher level of financial risk (i.e. the risk associated with debt repayment) because of their higher levels of debt. The additional financial risk due to debt leverage is embedded in the cost of equities [sic] derived for those companies through the DCF analysis. Thus, the 9.49 percent cost of equity derived in my DCF analysis is applicable to companies that are more leveraged and, theoretically speaking, riskier than a utility with no debt in its capital structure.

Direct Testimony of William A. Rigsby, Docket No. SW-02361A-05-0657 (March 9, 2006) at 52. The Commission rejected RUCO's proposed hypothetical capital structure, concluding that a capital structure comprised of 100 percent equity should be used in calculating Black Mountain's cost of equity. The Commission stated: "We believe RUCO's hypothetical capital structure recommendation is results oriented and is not consistent with the Company's actual capital structure." Decision No. 69164 at 20.

Instead, the Commission adopted Staff's recommended capital structure, containing 100 percent equity, as well as Staff's 9.6 percent return on equity and Staff's 9.6 percent return on rate base. *Id.* at 26-27. Staff's cost of capital witness summarized

Staff's position as follows:

> Staff's updated ROE [return on equity] estimate is 9.6 percent. Staff's ROE is based on cost of equity estimates for the sample companies of 9.5 percent for the capital asset pricing model ("CAPM") and 9.6 percent for the discounted cash flow method ("DCF"), as evidenced in Surrebuttal Schedule PMC-2. Staff's recommend ROE does not include a 50 basis point downward financial risk adjustment that would be applicable as quantified by the Hamada equation. Staff's ROE recommendation does not reflect a financial risk adjustment due to the lower financial risk reflected in the Applicant's capital structure in relation to that of the sample companies *because the Applicant's capital structure is reasonable and the Applicant should be encouraged, not discouraged, to maintain a healthy capital structure*.

Surrebuttal Testimony of Pedro M. Chavez, Docket No. SW-02361A-05-0657 (May 4, 2006) at 2 (emphasis supplied).[6] The Commission expressly determined "that adoption of Staff's recommendation results in a just and reasonable return for [Black Mountain]," and further found that a "rate of return on [rate base] of 9.60 percent based on a capital structure of 100 percent common equity is reasonable and appropriate." Decision No. 69164 at 27, 39 (finding of fact 19).

These findings should have been controlling in GCSC's case. There is nothing that distinguishes Black Mountain from GCSC. Both utilities are small sewer utilities owned by the same parent and providing service in the same general area. The plant owned by both utilities and used to furnish service is financed entirely by equity with no debt in the balance sheet for ratemaking purposes. In the Black Mountain case, RUCO's hypothetical capital structure was rejected as "results oriented," and RUCO did not

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[6] Notably, Mr. Chavez's surrebuttal testimony in the Black Mountain case was filed approximately five weeks prior to the direct testimony of Steven Irvine, Staff's cost of capital witness in GCSC's rate case.

challenge that finding. Therefore, given the close similarity between the two sewer utilities and the fact that the two cases substantially overlapped, the Commission's adoption of a hypothetical capital structure for GCSC on remand was arbitrary and capricious.

3. The Decision and Rehearing Decision Conflict With Other Recent Decisions Involving Water and Wastewater Utilities.

Although RUCO argued that hypothetical capital structures have been adopted in a number of instances, the reality is much different. With one exception (which will be discussed below), in recent decisions involving water and sewer utilities, the Commission has always used the utility's actual capital structure and, in some cases, has adjusted the return on equity to account for financial risk. Hypothetical capital structures are *not* commonly adopted by the Commission. This method was adopted on rehearing to lower the Company's rates, without any discussion of why such a capital structure is appropriate for GCSC, but not for other Arizona water and wastewater utilities.

For example, in a recent rate case for Arizona-American Water Company's ("Arizona-American") Paradise Valley District, the Commission adopted Staff's 10.4 percent return on common equity, which included an upward adjustment of 50 basis points to account for the high percentage of debt in that utility's capital structure. Decision No. 68858 (July 28, 2006) at 28. In approving this approach, the Commission explained: "RUCO and Staff appropriately addressed the Company's higher debt ratio by the *generally accepted regulatory means of accounting for financial risk*, adding basis points to the results of their CAPM and DCF analyses." *Id.* (emphasis supplied). Notably, in that case, RUCO's cost of capital witness, Mr. Rigsby, "added 50 basis points to his cost of equity estimate to account for the increased financial risk faced by Arizona-American as a result of the Company's debt-heavy capital structure," just as he did in

Arizona-American's prior rate case, decided in 2004. *Id.* at 25.[7] RUCO did not propose a hypothetical capital structure.

In other recent cases involving larger-sized Arizona water and wastewater utilities, the Commission has generally adopted Staff's recommended return on equity, either with or without an adjustment for financial risk, depending on the circumstances. *See, e.g., Far West Water and Sewer (Sewer Division)*, Decision No. 69335 (Feb. 20, 2007) at 17-18 (56 percent debt; no financial risk adjustment); *Arizona Water Co. (Western Group)*, Decision No. 68302 (Nov. 14, 2005) at 30, 34-36 (73.4 percent equity; no financial risk adjustment); *Chaparral City Water Co.*, Decision No. 68176 (Sept. 30, 2005) at 16, 25-26 (58.7 percent equity; no financial risk adjustment); *Arizona Water Co. (Eastern Group)*, Decision No. 66849 (March 19, 2004) at 23-24, (66.2 percent common equity; Staff's 20 basis point downward adjustment for financial risk rejected); *Rio Rico Utilities*, Decision No. 67279 (Oct. 5, 2004) at 11 (100 percent equity; no financial risk adjustment). In none of these cases did the Commission consider using a hypothetical capital structure to account for financial risk. Moreover, the adjustment to the return on equity initially approved in Decision No. 69664, 100 basis points, which reduced the return on equity from 10.2 percent to only 9.2 percent, is significantly greater than the adjustment proposed in any of these decisions.

The only recent decision involving an Arizona water or wastewater utility in which the Commission adjusted the amounts of equity and debt in the utility's capital structure involved Arizona-American's Mohave Water and Wastewater Districts, Decision No. 69440 (May 1, 2007). In that case, the utility's actual capital structure

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[7] It is also notable that, had RUCO utilized a hypothetical capital structure, the rates it recommended for Arizona-American's Paradise Valley district would have been higher than the rates resulting from use of the direct adjustment methodology. Exhibit RH 4; Rh. Tr. at 346-47.

consisted of 37.2 percent equity and 62.8 percent debt. Decision No. 69440 at 13. The utility and RUCO recommended use of a hypothetical capital structure of 40 percent equity and 60 percent debt. *Id.* at 13. Arizona-American asserted that a hypothetical capital structure was necessary "because its shareholder is currently experiencing an economic loss on its Arizona investment and will continue to do so for at least another five years." *Id.* While the Commission adopted the hypothetical capital structure proposed by Arizona-American and RUCO, it went on to warn explicitly that "we offer no assurance that a similar capital structure will be employed in future cases." *Id.* at 14.

In this case, RUCO proposed, and the Commission adopted on rehearing, a fictional reduction in GCSC's equity ratio from 100 percent to 60 percent – ***a decrease of 40 percentage points***. Such an adjustment radically altered GCSC's capital structure for ratemaking purposes, in contrast to the marginal adjustment approved in the Arizona-American Mohave Water and Wastewater case. There are no recent decisions in which the Commission has adopted this ham-fisted approach in lieu of directly adjusting the return on equity upward or downward, which, as the Commission has stated, is the "generally accepted regulatory means of accounting for financial risk." *Arizona-American Water Co. (Paradise Valley District)*, Decision No. 68858 at 28. It is apparent that the Commission chose an approach designed to force GCSC's rates down as low as possible, without regard to other recent decisions. This was arbitrary and unlawful.

4. RUCO's Cost of Capital Was Not an Issue on Remand, and Its Adoption Conflicts With Recent Commission Decisions.

RUCO did not file exceptions to Decision No. 69664 objecting to the adoption of Staff's recommended 9.2 percent cost of equity, nor did RUCO challenge the Commission's adoption of Staff's cost of equity estimate in its application for rehearing. As stated, RUCO instead argued in its rehearing application that GCSC's treatment plant has "excess capacity" and that the Commission should have adopted RUCO's hypothetical capital structure rather than using GCSC's actual capital structure and adjusting the cost of equity downward to reflect the Company's low financial risk. Therefore, the Commission's adoption of RUCO's 8.6 percent cost of equity was unlawful. *See* A.R.S. § 40-253(C).

Even if this fundamental error is ignored, RUCO presented no credible basis for the adoption of its 8.6 percent cost of equity recommendation, and none is discussed in either the Decision or the Rehearing Decision. In fact, RUCO effectively acknowledged that it failed to adequately support its recommendation, arguing in its rehearing closing brief that "[t]he issue is not whether there is sufficiency of the record to support either Staff or RUCO's recommendation. The issue is which recommendation is more appropriate under the circumstances of this case." RUCO Rh. Cl. Br. at 6. In other words, according to RUCO, the Commission should adopt the cost of equity estimate that produces the "best" result for the ratepayers, rather than a cost of equity that is based on conceptually sound estimation techniques and inputs. Obviously, RUCO's position was entirely result-driven and intended to reduce the cost of capital and lower the utility's revenue requirement. Yet it was adopted by the Commission, notwithstanding its discussion and findings in Decision No. 69664.

In Decision No. 69664, the Commission provided a detailed discussion of the parties' methodologies for estimating GCSC's cost of equity. Decision No. 69664 at 25-29. In adopting Staff's recommendation, the Commission emphasized that such recommendation is supported by the evidence in the record, consistent with the mandates of the Arizona Constitution and supported by prior Commission decisions. *Id.* at 28-29. Among other things, the Commission explained that "Staff's expert witness relied on a constant growth DCF model, a two-stage DCF model, and a two-part CAPM analysis for calculating its cost of equity capital, consistent with a long line of prior Commission decisions that have adopted comparable methodologies for determining cost of capital."

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Id. at 29. The methodologies employed by RUCO, in contrast, were conceptually flawed, used inappropriate inputs and were inconsistent with prior Commission decisions.

Given the record before the Commission and the detailed discussion and findings contained in Decision No. 69664, one would have expected RUCO to have provided extensive testimony addressing the methodologies and inputs employed by Staff and adopted by the Commission so that the Commission would have an evidentiary basis for rejecting Staff's recommendation on remand. Yet the rehearing testimony of RUCO's cost of capital witness, Mr. Rigsby, contained no discussion of any errors or conceptual flaws in Staff's DCF and CAPM estimates. Mr. Rigsby's remand testimony, instead, simply summarized, in conclusory fashion, the testimony he presented in the initial phase of this case, without addressing the methodologies employed by Staff and adopted by the Commission in Decision No. 69664.

In fact, there were significant differences between the methodologies used by Staff and adopted by the Commission in Decision No. 69664, and the methodologies used by RUCO and adopted by the Commission on remand. But none of these differences were squarely addressed and explained, much less reconciled with prior Commission decisions, by the Commission. *Compare* Rehearing Decision at 14, FOF 33, *and* Decision at 4 *with* Decision No. 69664 at 25-29. These differences include the following:

First, Staff (as well as GCSC) used six publicly traded water utilities that derive most of their earnings from regulated operations and which are analyzed by *Value Line* publications as its proxy group for estimating the cost of equity. Decision No. 69664 at 27 & n.6. That sample group of water utilities has been consistently used by Staff and approved by the Commission in prior rate cases. *See, e.g., Arizona-American Water Co. (Sun City and Sun City West Wastewater Districts)*, Decision No. 70209 (March 20, 2007) at 27; *Black Mountain Sewer Corp.*, Decision No. 69164 (December 5, 2006) at 25-26; *Arizona Water Co. (Western Group)*, Decision No. 68302 (November 14, 2005) at

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31-32 & n.11. RUCO, in contrast, used a proxy group consisting of four publicly traded water utilities.[8] Rigsby Dt. at 21-22. Moreover, one of RUCO's proxy water utilities is Southwest Water, which receives less than 50 percent of its revenues from water services and is therefore not comparable. Bourassa Rb. at 29. Neither Staff nor GCSC used Southwest Water as a result. *See also* Decision No. 70209, *supra*, at 27, 30 (explaining that Staff excluded Southwest Water from its proxy group, and adopting Staff's methodologies and recommended cost of equity). In order to adopt RUCO's recommended cost of equity, however, the Commission was required to explain why RUCO's proxy group (including Southwest Water) was appropriate. The Commission failed to do so.

Second, as previously stated, Staff used two different types of DCF models as well as a two-part CAPM analysis in estimating its cost of equity. RUCO, in contrast, relied solely on the constant growth (or Gordon) DCF model to estimate the cost of equity. Rigsby Rh. at 21; Decision No. 69664 at 26. RUCO's witness performed two estimates using the CAPM, but ignored those estimates in arriving at his cost of equity estimate for GCSC. *Id.* Notably, RUCO's CAPM estimates were 10.7 percent and 8.9 percent – *greater than RUCO's recommended equity cost.*[9] The Commission, however,

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[8] In his direct testimony, Mr. Rigsby also considered eight natural gas companies, but did not rely on those utilities in making his recommendation. Rigsby Dt. at 9. The natural gas companies were not mentioned in Mr. Rigsby's surrebuttal testimony, however, and were not used to support RUCO's ultimate recommendation in this case. *See* Rigsby Sb., Sch. WAR-1 to WAR -9.

[9] RUCO's CAPM estimates contain a number of conceptual flaws. For example, RUCO used a six-week average of the 91-day Treasury bill rate as the "risk free" rate in its model. *See* Rigsby Dt. at 31. Staff, in contrast, used intermediate and long-term Treasuries as its "risk free" rate, which are higher than short-term Treasuries and produce a higher equity cost estimate. Irvine Dt. at 28-29, Sch. SPI-2. Putting aside that problem, if RUCO's CAPM estimate using the conceptually correct method of computing the historic market risk premium were considered, and that estimate – 10.7 percent – were averaged with RUCO's DCF estimate, the resulting equity cost would be 9.7 percent. *See* Bourassa Rb. at 57-58.

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erroneously stated in the Rehearing Decision that RUCO's witness "relied on a CAPM analysis." Rehearing Decision at 14, FOF 33. If that were true, then RUCO's recommended equity cost would have been higher than Staff's recommended 9.2 percent equity cost. Moreover, the Commission ignored the cost of equity estimates produced by Staff's two-stage DCF model and its CAPM, and failed to reconcile RUCO's simplistic methodology and inputs with prior decisions in which the Commission has used multiple DCF and CAPM-based cost of equity estimates.

Third, while both Staff and RUCO used the constant growth DCF model, the methodology and inputs chosen by each were dramatically different. In its constant growth model, Staff averaged the results of six different growth projection methods to calculate expected dividend growth. Decision No. 69664 at 27 & n.7. RUCO, however, used only one growth projection method, sustainable growth, in its DCF estimate. Rigsby Dt. at 17; Bourassa Rb. at 53.[10] Staff also used that method of estimating dividend growth (in addition to five other methods), but Staff's sustainable growth rate was 8.3 percent, as opposed to RUCO's growth rate of 6.2 percent. *Compare* Irvine Sb., Sch. SPI-7 *with* Rigsby Sb., Sch. WAR-2. Using only that method of estimating dividend growth, RUCO's estimated equity cost was 8.6 percent, while Staff's estimated equity cost was 11.3 percent. The reason for this difference is that, in addition to using a different proxy group, Mr. Rigsby arbitrarily adjusted the market-to-book ratios of his proxy utilities downward, based on his personal view that the prices of their stock will fall in the future. Bourassa Rb. at 53. Despite these significant differences, the Commission failed to explain why it has chosen to use RUCO's method of estimating

[10] "Sustainable" growth is future dividend growth estimated on the basis of the entity's earnings multiplied by its retention ratio (i.e., the percentage of earnings retained and reinvested), adjusted for changes in the company's outstanding shares of common stock. *See, e.g.*, Irvine Dt. at 16-17; Rigsby Dt. at 11-12.

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sustainable growth (rather than Staff's) and to ignore the other estimates of dividend growth employed by Staff and GCSC.

In sum, RUCO used a different and more limited sample group (with inappropriate proxies), relied on only one equity cost estimation method (the DCF model), used only one method of estimating future dividend growth (with subjective adjustments to lower the growth rate that would otherwise be produced), and ignored the results produced by the CAPM. None of these differences were even acknowledged in the Decision and the Rehearing Decision, much less reconciled with recent Commission decisions in which RUCO's methods and inputs were rejected. RUCO's cost of equity methods were adopted here simply because they resulted in lower rates. Lower rates are an insufficient basis for this arbitrary departure from the overwhelming weight of precedent against RUCO's request. Consequently, even if RUCO's failure to raise the cost of equity as an issue in its rehearing application is ignored, the adoption of RUCO's cost of equity on remand was arbitrary and unlawful.

5. <u>The Commission Adjustment to the Company's Operating Expenses Based on Fictitious Interest Expense Was Unlawful</u>.

The Commission has compounded the errors discussed above by adopting RUCO's adjustment to the Company's test year operating expenses. This adjustment assumed the existence of hypothetical interest expense resulting from the existence of hypothetical debt with a hypothetical interest rate. The hypothetical interest expense was then used to calculate GCSC's federal and state income taxes, reducing the amount of income tax expense and, ultimately, reducing GCSC's adjusted test year operating expenses. This is a purely fictional adjustment – there is no interest expense, because the Company has no debt. *See* RUCO Data Request Response 1.58, Bourassa Rh. at Exhibit 1. As a result, the Company's operating expenses were arbitrarily reduced by over $200,000.

As previously discussed, according to RUCO, the purpose of using a hypothetical capital structure is to properly account for GCSC's lower level of financial risk. In fact, throughout this case, RUCO has maintained that (1) GCSC has minimal financial risk due to the absence of debt in its capital structure, (2) a lower weighted cost of capital is needed to reflect GCSC's minimal financial risk, and (3) this can be achieved by *either* adjusting the return on equity downward or using a hypothetical capital structure. For example, in its closing brief, RUCO explained:

> *RUCO could just as easily made a downward adjustment to reflect* the fact that RUCO's cost of common equity figure was derived from a sample group of companies that face greater *financial risk* as a result of higher levels of debt in their capital structure. R-7 [Rigsby Dt.] at 51. RUCO believes that a better method to reflect the lower level of risk is to recommend a hypothetical capital structure.

RUCO Cl. Br. at 15 (emphasis supplied). *See also* Rigsby Dt. at 52; RUCO Rh. App. at 6. On rehearing, RUCO's cost of capital witness again explained that he utilized a hypothetical capital structure to "achieve a weighted average cost of capital" more in line with his sample companies. Rigsby Rh. at 12-13. Mr. Rigsby was determining a recommended cost of equity, but such a return does *not* require fictional interest to be imputed to the utility. Bourassa Rh. at 27 (*citing* RUCO Data Request Responses). Therefore, if a downward adjustment to the cost of equity and the use of a hypothetical capital structure are interchangeable and produce the same result, as RUCO consistently represented in this case, it would be improper to adjust GCSC's operating expenses based on fictional interest expense, in addition to adjusting GCSC's capital structure.

This is especially true given that RUCO did not ask that the Commission rehear any of the Company's approved operating expenses. *See* RUCO Rh. App. at 4-8. RUCO did not question the methodology or inputs used by the Commission to calculate adjusted test year income tax expenses in determining GCSC's operating expenses and operating income. *See* Rehearing Decision at 3, FOF 2 (identifying the issues raised for rehearing.)

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Consequently, while the issue of whether the Commission should have adjusted GCSC's capital structure so that it consists of 60 percent equity and 40 percent debt rather than adjusting the return on equity downward was properly before the Commission on rehearing, RUCO's previously unexplained and unsupported adjustment to the methodology and inputs used to determine test year operating expenses was not properly before the Commission and could not be considered.

In summary, RUCO did not challenge Staff's DCF and CAPM estimates or object to Staff's cost of equity estimate, which was 10.2 percent. Staff adjusted its DCF and CAPM estimates downward by 100 basis points to account for the absence of debt in GCSC's capital structure. RUCO acknowledged in its rehearing application that this adjustment was an appropriate way to reflect GCSC's investment risk. Consequently, there should have been nothing to rehear. Instead, this issue was used as a Trojan horse, to obtain approval of a different adjustment, which was not explained by RUCO's witnesses during the hearings and which conflicts with RUCO's justification for using a hypothetical capital structure. The Commission nevertheless adopted this sleight of hand because it lowered GCSC's operating expenses, producing a lower revenue requirement and lower rates. This was clearly arbitrary and result-driven.

IV. CONCLUSION.

For these reasons, the Company again asks that the Commission rehear this matter and issue a new order consistent with the foregoing and the evidence in the record.

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RESPECTFULLY SUBMITTED this 12th day of January, 2009.

FENNEMORE CRAIG, P.C.

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