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BEFORE THE ARIZONA CORPORATION C

COMMISSIONERS

KRISTIN K. MAYES - Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

IN THE MATTER OF THE APPLICATION OF BLACK MOUNTAIN SEWER CORPORATION, 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-02361A-08-0609 **NOTICE OF FILING STAFF'S REPLY BRIEF**

The Arizona Corporation Commission ("Commission") Utilities Division Staff ("Staff") hereby provides its reply brief in the above-referenced matter.

RESPECTFULLY SUBMITTED this 22nd day of December, 2009.

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I. INTRODUCTION.

On December 19, 2008, Black Mountain Sewer Corporation ("BMSC" or "Company") filed before the Arizona Corporation Commission ("Commission") an application for a rate increase.

The application was filed using a test year ending June 30, 2008.[1] The Company reported adjusted gross revenues of $1,580,170.[2] These revenues produced an overall loss in operating income of $84,485.[3] The Company claimed a fair value rate base of $3,723,245[4] and a rate of return of negative 2.27%.[5] As a result, Black Mountain requested a 57.83% increase in revenues, equal to $913,762.[6] The proposed increase would result in a rate of return on fair value rate base of 12.8%.[7]

Commission Utilities Division Staff ("Staff") continues to recommend a revenue increase of $610,375, or 38.63%.[8] Staff's proposed increase would produce an operating income of $320,611, a 9.40% rate of return on an original cost rate base of $3,410,758.[9]

II. COST OF CAPITAL.

A. <u>Capital Structure.</u>

Staff has recommended a "capital structure composed of 0.0 percent debt and 100.0 percent common equity."[10] Staff recognizes that the "Company's actual capital structure is 21.6 percent debt and 78.4 percent equity."[11] Staff is aware that the Company has two operating leases that would normally be considered debt, but as Staff pointed out in its Direct Testimony, Decision No. 59944, dated December 26, 1996, "states that these leases shall be considered as lease expense, i.e., not as debt."[12] Under the Company's current circumstances, Staff sees no reason to change the way the leases are treated. Therefore, Staff continues to support a capital structure consisting of 100 percent equity.

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[1] App. at 3:8-10.
[2] *Id.* at 3: 14-15.
[3] *Id.* at 3: 15-16.
[4] .A-4 at 3: 8 (Bourassa Dir.).
[5] App., 3: 17-18.
[6] A-4 at 3: 10 (Bourassa Dir.).
[7] *Id.* at 4: 2.
[8] S-7 at 2: 2 (Brown Supp.Surr.).
[9] *Id.* at 2: 3-5.
[10] S-3 at 6: 9-10 (Manrique Dir.).
[11] S-3 at 6: 17 (Manrique Dir.).
[12] S-3 at 6: 19-20 (Manrique Dir.).

B. **Return on Equity.**

A company's cost of equity represents "investors' expected rate of return on other investments of similar risk."[13] Because investors are risk averse, they tend to require a greater potential return to invest in relatively greater risk opportunities.[14] Therefore, cost of equity is market driven. Given an array of choices, investors will tend to "choose stocks with similar risks but higher returns."[15] The way to understand the investment potential of a regulated utility like BMSC and the market as a whole is by a comparison of the potential volatility, or systematic risk, each type of investment represents, which is measured by betas.[16] While it is generally understood that smaller companies tend to have higher betas than larger companies due to larger variations in earnings, and thus making the smaller companies more risky from an investment standpoint, a study specific to the utility industry concluded that there was no need to adjust betas based upon firm size for the purposes of utility regulation.[17] As a result, in Decision No. 64727, dated April 17, 2002, the Commission has recognized that "the 'firm size phenomenon' does not exist for regulated utilities" and the Commission therefore declined to "adjust for risk for small firm size in utility rate regulation."[18]

There are essentially two types of risk – market risk and non-market risk. Market risk stems from factors inherent in the securities trading process and can not be reduced through diversification of investments. Market risk consists of business risk and financial risk. Business risk represents the fluctuations in earnings in a firm's operations and environment such as competition.[19] Financial risk represents the fluctuations in earnings inherent in the use of debt financing which may impair a company's ability to provide adequate return.[20] When investors are deciding whether or not to invest in BMSC, they must compare the potential return to be earned by such an investment as compared to the potential return associated with a firm of similar risk.

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[13] S-3 at 7: 23 (Manrique Dir.).
[14] S-3 at 10: 22-24 (Manrique Dir.).
[15] S-3 at 7: 23-25 (Manrique Dir.).
[16] S-3 at 27: 17 (Manrique Dir.).
[17] S-3 at 3: 8-13 (Manrique Dir.).
[18] S-3 at 41: 8-11 (Manrique Dir.).
[19] S-3 at 11: 10-12 (Manrique Dir.).
[20] S-3 at 11: 16-17 (Manrique Dir.).

To make that comparison, investors use various financial models, including the Capital Asset Pricing Model ("CAPM"). The CAPM "describes the relationship between a security's investment risk and its market rate of return.[21] To make its comparisons to the general market, Staff used a set of proxy companies consisting of six water companies. These utilities were chosen because they are publicly-traded and receive a majority of their earnings from regulated operations, just as BMSC does. While the Company used the arithmetic mean to approximate future rate of return and as a result criticizes RUCO's use of the geometric mean for that same purpose, Staff has chosen to use both, taking into account the results provided by each. Because Staff's method takes into account more information, Staff's CAPM results are inherently more reliable than either of the more limited methods relied upon by the other parties.

The Company asserts that RUCO's methodology results in deflated CAPM results, which in turn lead to RUCO's deflated overall recommended Return on Equity. The Company then claims that Staff's calculations, while more beneficial to the Company, are nonetheless flawed, primarily due to the fact that the beta Staff used was tied to the water companies Staff used in its proxy group. The Company asserts that the water companies were inappropriate proxy firm because they "clearly have less risk than BMSC."[22] The Company, however, relies on the firm size argument disproven above. Staff's recommendations are in line with previous Commission findings and take into account the Company's current circumstances as well.

The Commission should adopt Staff's recommendations regarding cost of capital, return on equity, and overall rate of return.

III. REVENUE REQUIREMENT.

A. Central Office Allocation.

The Company has argued that the shared services model it employs is effective in cutting costs to each of the member utilities for which Algonquin Power Income Fund ("APIF") provides service. Staff has recommended that the Commission recognize 1.28% of those as chargeable to

[21] S-3 at 25: 25 – 26: 1 (Manrique Dir.).
[22] Black Mountain Opening Brief at 34: 11.

BMSC in the instant case. The Company has argued that if the Commission adopts Staff's recommendations, the Company will likely abandon the shared services model because it will not be financially viable if "90 percent of an over $1 million allocation pool to the seven Arizona utilities is disallowed."[23]

Staff disagrees with this argument. Staff is not recommending that 90 percent of the costs associated with BMSC be disallowed. Staff is merely recommending that each of the utilities for which APIF provides services pay its proportionate share of the costs of those services. In this case, BMSC has been unable to substantiate that it has actually received many of the services for which APIF is seeking to allocate costs. For those services that BMSC acknowledges it used either little or not at all, there has been no showing that these services are of the type that BMSC should pay to have "on reserve". In short, the reason Staff has recommended disallowance of a great many of the costs being allocated is the inadequate support provided. Staff suggests that even if the Commission adopts its recommendations regarding central office cost allocation in the instant matter, such an action does not necessarily sound the death knell for the shared services model. The Company has acknowledged that it only finalized the shared services model after the completion of the test year and then had to extrapolate and relate back data to support the allocations it has requested. As a result, it is likely that in future rate matters, the Company will have more accurate accounting and explanation of the model, and if the model truly does result in savings to the various utilities it serves, the Company would likely receive a greater portion of the costs it allocates than is recommended in the instant matter.

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[23] Black Mountain Initial Brief at 18: 12-13.

B. <u>Accumulated Deferred Income Taxes ("ADIT")</u>.

Staff remains unable to respond to the Company's deferred tax claims in the absence of documentation that would verify or refute the Company's assertions. Despite the fact that the Company eventually produced its 2007 and 2008 tax depreciation schedules and limited supporting documentation, it remains true that the documents provided were never fully reconciled, leaving Staff to guess as to which documents to rely upon when data conflicts arose. Further, the limited reconciliations that the Company did provide, could not be audited using the limited accompanying documentation. In the absence of a complete reconciliation, Staff was still unable to verify the Company's ADIT calculations. The issue remains unresolved, and as Staff has stated before, the Company should not be granted relief for which it has not provided proper support.

Black Mountain Sewer Company cannot escape the reality that it is not harmed by Staff's disallowance of the tax asset. Staff has recommended a level of $1,711,260 for advances in aid of construction ("AIAC").[24] AIAC plant, by definition, is plant that is not funded by the investor. It is typically funded by developers. Staff has calculated depreciation expense on the AIAC plant and included a dollar for dollar recovery of the depreciation expense in the revenue requirement. The amount of depreciation expense calculated for the AIAC plant is approximately $67,766 ($1,711,260 AIAC x .0396 composite depreciation rate).

The Company is receiving approximately $67,766 in revenue on plant that was paid for with non-investor capital. In addition to recovering revenue on plant in which it has no investment, the Company is proposing to earn a rate of return on the income tax timing difference that is caused by Staff's practice of providing recovery of depreciation expense on AIAC plant. An example of how allowance of depreciation expense on AIAC funded plant causes an income tax timing difference follows:

[24] S-7 (Brown Surr.), Schedule CSB-3

For Illustrative Purposes Only	Ratemaking Income Tax Calculation	Difference	IRS Income Tax Calculation
Staff Recommended Revenue	$2,133,410	$0	$2,133,410
Less: All Expenses Except Depreciation Expense	-$1,581,323	$0	-$1,581,323
Less: Depreciation Expense on Investor Funded Plant	-$199,810	$0	-$199,810
Less: Depreciation Expense on AIAC Funded Plant	-$67,766	-$67,766	$0
Taxable Income	$284,511	-$67,766	$352,277
Combined Federal and State Income Tax and Property Tax Rate	40.9860%	0%	40.9860%
Income Taxes Paid	$116,610	$27,774	$144,384
Income Tax Timing Difference		$27,774	

It is unreasonable and inequitable to require Black Mountain's customers to pay a rate of return on the Company's proposed tax asset when the tax asset is caused by the Company receiving a return of non-investor capital via depreciation expense. Further, disallowance of the tax asset whose net impact on the revenue requirement totals approximately $40,000[25] is more than offset by Staff's allowance of depreciation expense totaling approximately $67,766 on AIAC funded plant.

[25] A-8 at 10: 17 (Bourassa RBRej.).