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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF BLACK MOUNTAIN SEWER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY, AND FOR ADJUSTMENTS TO ITS RATES AND CHARGES FOR UTILITY SERVICE AND FOR CERTAIN RELATED APPROVALS BASED THEREON.	Docket No. SW-02361A-08-0609

Arizona Corporation Commission
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RUCO'S INITIAL CLOSING BRIEF

The Residential Utility Consumer Office ("RUCO") submits this Initial Closing Brief on the matters raised at Black Mountain Sewer Company's ("BMSC" or "Company's") recent rate hearing.

A. ISSUES RESOVED BETWEEN RUCO AND BMSC AND/OR STAFF

RUCO and BMSC have reached agreement on a number of issues, which were initially disputed. Those agreements are as follows:

1. Plant-in-Service and Accumulated Depreciation.

The Company and RUCO have resolved all issues regarding gross plant-in-service and accumulated depreciation with the exception of $966 in accumulated depreciation.

RUCO acknowledges the miscalculation of accumulated depreciation and accepts the Company's calculation.

2. ADIT

RUCO accepts the Company's adjustment of $24,344 and the Company's Accumulated Deferred Income Tax ("ADIT") calculation. However, RUCO received Staff's Surrebuttal Testimony on November 9, 2009 recommending a reduction of rate base by $170,554 for ADIT. RUCO finds the Staff's arguments compelling. Although RUCO has not modified its position in this case, it reserves the right to do so in future rate filings.

3. Working Capital

RUCO and the Company initially agreed to a $0 working capital allowance to avoid any dispute. Thereafter, Staff proposed a working capital of a negative $94,091 based on a reduction of $101,242 for cash working capital and an addition of $7,151 for prepayments. Staff estimates were based on generalized leads and lags. In response, the Company performed a lead/lag study and in rebuttal testimony proposed a working capital allowance of $32,142. RUCO had inadequate time to verify or perform a lead/lag study and therefore could not agree to the Company's revised position. In rejoinder, the Company once again proposed a $0 allowance for working capital. Although the Company's position has fluctuated, RUCO and the Company are currently in accord as to a $0 allowance of working capital.

4. Property and Income Tax Expense

The Company and RUCO agree to the method of computing property tax expense. The difference in recommendations results from differences in recommended required revenue. RUCO recommends a reduction of property tax expense of $2,440 based on its recommended required revenue.

The Company and Staff computed income tax expense excluding the Scottsdale capacity-operating lease. RUCO initially computed income tax including the lease, but has since modified its position and accepts the Company and Staff's treatment of the lease. Although the parties agree as to the treatment of the Scottsdale capacity lease, the parties have different recommended income tax expense. RUCO's revised recommended income tax is $153,998.

5. Depreciation Expense

The Company's depreciation expense is $243,986. RUCO agrees with the Company's position.

6. Testing Expense

The Company adjusts test year testing expenses by $12,094 for a total of $29,049. RUCO agrees with the Company's position because the changes to testing expenses are necessitated by known and measurable changes to the number and frequency of effluent tests required by the City of Scottsdale.

7. Contractual Service Expenses-Other

The Company proposed a $42,200 adjustment to the Contractual Service Expense-Other account to correct the Company's accounting error in which the services were incorrectly booked to LPSCO. RUCO agrees with the Company.

8. Transportation Expense.

The Company included the cost of a vehicle it asserts is used exclusively by Black Mountain. RUCO accepts the Company's position.

9. Wage and Salary Expenses

The Company's application included $13,460 for employee bonuses. RUCO did not adjust for employee bonuses.

10. Affiliate Cost Increase

The Company seeks a $50,302 increase in affiliate costs from Algonquin Water Service ("AWS"). RUCO made no adjustment to AWS affiliate costs.

11. Special Rate Classes

The company wants to remove special rates. The elimination of special commercial rates would not negatively effect residential ratepayers; therefore, RUCO has no objection.

RUCO recommends and Staff and the Company concur with a cost of short-term debt of 3.00 percent, and a cost of long-term debt of 6.83 percent.[1]

Based on the foregoing agreements, RUCO will not brief these matters further. Notwithstanding the language of the procedural order, the absence of further briefing does not constitute RUCO's waiver on the above-referenced issues.

B. UNRESOLVED ISSUES RELATED TO REQUIRED REVENUE

1. Non-recurring Expenses

The Company seeks to include an additional $4,723 in contractual legal and survey expenses and an additional $51,000 for outside contractual services. RUCO disagrees. As to legal and survey expenses, RUCO recommends disallowance of $1,500 of the additional contractual legal and survey expenses because the amount deals with a one-time easement dispute that has since been resolved. As to outside contractual expenses, RUCO recommends disallowance of $39,870 of the additional contractual expenses because the

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[1] Id. at 3.

amount is related to a one-time sewer spill. The Company acknowledges that it has not incurred outside contractual expenses for sewer spill clean in such a magnitude before or after the test year. Accordingly, RUCO recommends disallowance of the amount. The Company argues that RUCO's recommendation is against public interest. It is not. RUCO disallowed $39,870 of the total of $51,000 in the account set aside for outside contractual services for sewer spill clean up. Therefore, the Company retains sufficient funds to address such issues should they arise again, in a lesser magnitude.

2. Bad Debt Expense

The Company initially used the recorded test year level of bad debt expense and RUCO agreed with the Company's position. Thereafter, in response to Staff, the Company recalculated bad debt expense excluding debt from the prior year, $4,067 and including bad debt expense incurred post test year in the amount of $6,479. As of the hearing, neither RUCO nor the Staff could verify the Company's new calculations. RUCO asserts that the actual historic test year amount of bad debt expense is reflective of a fair and reasonable, known and measurable level of bad debt expense and therefore recommends the same.

3. Rate Case Expense

The Company seeks $230,000 in rate case expense. RUCO recommended at hearing $180,000 subject to verification. RUCO has reviewed the Company's invoices for rate case expense for legal fees and costs and expert witness fees. The amount incurred through November 30, 2009 was $157, 693. From that amount, RUCO has excluded $19, 000 associated with negotiation of the BHOA settlement agreement resulting in $138,000 for rate case expense through November 30, 2009. The Company estimates $42,000 for briefing and related matters through conclusion of the matter. Based on the Company's assertion, RUCO estimates rate case expense at $180,000 normalized over three years for an annual amount of $60,000. RUCO disallowed expenses associated with negotiation of the BHOA agreement because the settlement of the matter is a one-time event unrelated to normal rate case proceedings. Staff also recommended a $180,000 rate case expense normalized over three years or $60,000 for an annual amount of $60,000.

C. UNRESOLVED ISSUES RELATED TO COST OF CAPITAL

The parties disagree on capital structure, the cost of debt, the cost of equity and the overall weighted average cost of capital. RUCO recommends a hypothetical capital structure comprised of 40 percent debt and 60 percent equity, a cost of debt of 6.26 percent, a cost of equity of 8.22 percent and an overall weighted average cost of capital of 7.43 percent, which results in a fair and reasonable recommended rate of return.[2]

1. Capital Structure

All of the parties agree that the Company's capital structure for rate making purposes is comprised of 100 percent equity.[3] The Company and Staff adopt a 100 percent capital structure. RUCO proposes a hypothetical capital structure of 40 percent debt and 60 percent equity.[4] Although Staff did not propose a hypothetical capital structure, Staff's cost of capital witness, Juan Manrique, acknowledges that RUCO's use of a hypothetical capital structure is

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[2] *See* Exhibit R-6 William A. Rigsby's Direct Testimony and Exhibit R-7 William A. Rigsby's Surrebuttal Testimony.

[3] The Company has a capacity lease with the City of Scottsdale which is treated for rate making purposes as an operating lease. The Company receives a dollar for dollar reimbursement through rates as an operating expense. Accordingly, for rate making purposes none of the parties treat the lease as a debt. All parties agree that the Company currently has a 100% equity capital structure.

[4] *See* Exhibit R-6 Rigsby's Direct Testimony at 50-53.

a reasonable methodology of addressing the absence of risk inherent in the Company's 100% capital structure. [5]

The Company asserts that the use of a hypothetical capital structure is "results oriented" suggesting that it is inappropriate. The Commission has the authority to impute hypothetical capital structures. In Litchfield Park Service Co. v. Arizona Corporation Comm'n, the Arizona Court of Appeals upheld the Commission's decision to make a downward adjustment to a utility's cost of equity capital to reflect reduced investor risk from its equity-rich plant.[6] Moreover, the Court held that the Commission did not act contrary to its prior decision in reducing the amount of common equity from 68.6 percent to 51.8 percent.[7]

The Company asserts that there are a few cases in which the Commission has addressed financial risk by use of a hypothetical capital structure. In fact, there are other instances in which the Commission has imputed a hypothetical capital structure for the benefit of shareholders.[8] Utilities which had little or no equity and a disproportionate amount of debt have requested the Commission impute a hypothetical capital structure for a more balanced debt equity structure and the Commission has granted the requests.[9] The result has been a greater return for the shareholders. If it is appropriate for the Commission to impute a hypothetical capital structure for the benefit of shareholders, it must be equally appropriate to impute a hypothetical capital structure for the benefit of ratepayers.

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[5] T: 682.

[6] *Litchfield Park Service Co. v. Arizona Corp. Comm'n*, 178 Ariz. 431, 434, 874 P.2d 988, 991 (App. 1994).

[7] In the prior decision-involving the utility, the Commission approved a capital structure for the sewer division of 30.95 percent debt and 69.05 percent equity. *Litchfield Park Service Co.*, Decision No 56362.

[8] *In the Matter of Southwest Gas* – Docket # G-01551A-04-0876, Decision No. 68487 dated February 23, 2006; *In the Matter of Arizona American Mohave District* – Docket # WS-01303A-06-0014, Decision No. 69440 dated May 1, 2007; *In the Matter of UNS Gas* – Docket No. G-04204A-06-0463 et. al., Decision 70011 dated November 27, 2007; *In the Matter of Tucson Electric Power* Docket No. U-1933-93-006, Decision No. 58497 dated January 13, 1994; *In the Matter of Tucson Electric Power* Docket No. U-1933-88-280, Decision No. 56659 dated October 24, 1989.

[9] *Id.*

RUCO asserts that the Company's 100 percent equity structure is inconsistent with the capital structures of similar water utilities. William Rigsby, RUCO's cost of capital witness, testified that the companies in his water proxy averaged 50.4 percent debt and 49.6 percent equity.[10] Mr. Rigsby further testified that a hypothetical cost of capital should be imputed to emulate the proxy group of companies.[11] Both the Company and the Staff witnesses acknowledge that the utilities in their water proxies do not have 100 percent equity capital structures. Thomas Bourassa, the Company's witness, testified that based on book value, the water utilities in his proxy averaged 48.5 percent debt and 51.5 percent equity.[12] Juan Manrique, the Staff's witness, testified that the companies used in his proxy averaged 50.2 percent debt and 49.8 percent equity.[13]

RUCO further asserts that the absence of debt in the Company's capital structure represents a lesser amount of risk than present in the utilities in the parties' water proxies for which there must be an adjustment. Mr. Rigsby testified that the companies in the water proxy would be considered to have a higher level of financial risk (i.e. the risk associate with debt repayment) because of their higher levels of debt.[14] He further testified that the additional financial risk due to debt leverage is embedded in the cost of equities derived from those companies through the Discounted Cash Flow ("DCF") analysis.[15] Conversely, according to Mr. Rigsby, a company with BMSC's level of equity would therefore also have a lower expected return on common equity because it has no debt and therefore no risk

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[10] _See_ Exhibit R-6 Rigsby's Direct Testimony at 54.
[11] _Id._
[12] _See also_ Exhibit A-7, Schedule D-4.2
[13] _See_ Exhibit S- 3 Direct Testimony of Juan Manrique at page 7.
[14] _See_ Exhibit R-6 Direct Testimony of William Rigsby at 54
[15] _Id._

associated with debt.[16] Mr. Rigsby's position is supported by the testimony of Mr. Manrique, Staff's witness. Mr. Manrique testified that because of the Company's financial structure, its shareholders bear less financial risk than the shareholders of the sample companies in his water proxy.[17] Mr. Manrique did not use a hypothetical capital structure, but he employed the Hamada Methodology to adjust for the absence of debt associated risk in the Company's 100% equity capital structure.[18]

RUCO asserts and the Staff concurs that the cost of debt financing is generally less expensive than the cost of equity financing.[19] Mr. Rigsby testified that a hypothetical capital structure provides a mix of lower cost debt which has the advantage of reducing income taxes and overall expenses; whereas dividend payments to equity holders do not offer a similar tax advantage.[20] He also testified that a hypothetical structure provided a more balanced result for ratepayers and shareholders.[21] Because the failure to balance debt and equity will result in unfair benefits to shareholders to the detriment of ratepayers, RUCO requests the ALJ adopt its recommendation of a hypothetical capital structure.

The Company asserts that the adoption of a hypothetical capital structure would conflict with the Commission's conclusions in the Company's prior rate case.[22] In Decision 69164, the Commission adopted Black Mountain's 100 percent equity capital structure.[23] The Company presumes that the ruling in Black Mountain is the precedent upon which all future decisions of the Commission should be based. Clearly, the Commission has the

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16 *Id.*
17 *See* Exhibit S-3 Direct Testimony of Juan Manrique at 12.
18 *Id.* at 12, 32-33.
19 T: 678
20 T: 509-511.
21 *See* Exhibit R-6 Direct Testimony of William Rigsby at 54
22 *In the Matter of Black Mountain Sewer Company* Docket No. SW-02361A-05-0657, Decision No. 69164
23 *Id.*

discretion to rule differently in similar cases.[24] It is equally clear that the Commission's view of 100 percent equity capital structures has shifted since the determination of the Company's last rate case. In considering the rate application of Gold Canyon Sewer Company, an Algonquin affiliate, the Commission vote reflects some recognition that a 100 percent equity structure is unfair to ratepayers and should not be permitted. In casting her vote, Commissioner Mayes stated:

> "I think in our original case, unfortunately, the Commission was over, well, erred on the side of the shareholders. And in this case we have at least rebalanced that equation, and in particular we rebalanced that equation with the introduction of the hypothetical capital structure. And I can tell you from my standpoint that I will be very vigilant from this day forward about the use of 100 percent equity structures by companies. It just is not appropriate. It is no more appropriate than if a company walked in here with 100 percent debt structure".[25]

The Commission's adoption of a hypothetical capital structure in Gold Canyon represents a shift in policy and recognition of the imbalance struck by 100 percent equity structures. Accordingly, in light of the Commission's vote in Gold Canyon and the well-reasoned position of Commissioner Mayes, this ALJ should not perceive the prior Black Mountain decision as a precedent from which the Commission cannot depart.

Because the Commission has the authority to impute hypothetical capital structures, and the adoption of a 40/60 percent debt/equity hypothetical capital structure would bring the Company's capital structure in line with similar utilities, address the reduced investor risk associated with the Company's 100% equity rich plant and provide a means of making an

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[24] *Litchfield Park Service Co. v. Arizona Corp. Comm'n,* 178 Ariz. 431, 434, 874 P.2d 988, 991 (App. 1994).

[25] *See* R-7 Surrebuttal Testimony of William A. Rigsby at 14. *See Also* Transcript of Commission Open Meeting on Gold Canyon, dated November 13, 2008, attached hereto as Exhibit A at 221-225.

interest synchronization calculation for tax purposes, RUCO recommends adoption of its hypothetical capital structure.

2. Cost of Debt

The Company asserts that RUCO's cost of debt of 6.26 percent is too low because it is lower than the cost of Baa/BBB rated bonds. The Company is wrong. According to the November 27, 2009 Value Line Selection & Opinion, the most recently reported rate for Utility Baa/BBB bonds is 6.24 percent, two points lower than RUCO's estimated cost of debt.[26] The Company also complained that RUCO's cost of debt is lower than the 7.0 percent rate at which Algonquin recently issued debentures. Algonquin's recently issued debentures were unsecured and subordinate. Unsecured subordinate debt carries a greater risk than secured debt. RUCO and the Company agree that unsecured subordinate debt is procured at a higher cost than secured debt.[27] Therefore, the fact that Algonquin's unsecured subordinate debentures were issued at a higher rate of 7.0 percent, supports Mr. Rigsby's cost of debt.

3. Cost of Equity

a. RUCO'S Use of a Historic Market Risk Premium to Determine its CAPM Cost of Equity Capital was Appropriate.

In calculating a cost of equity, both the Company and RUCO used the Capital Asset Pricing Model ("CAPM"). The CAPM is a mathematical tool developed during the early 1960's by William F. Sharpe, the Timken professor Emeritus of Finance at Stanford University.[28] CAPM is used to analyze the relationships between rates of return on various

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[26] *See* Exhibit R-1 Value line Section & Opinion Report of Selected Yields dated November 27, 2009.
[27] T:279, 506
[28] *See* Exhibit R-6 Rigsby Direct Testimony at 31.

assets and the risk as measured by beta.[29] The underlying theory behind the CAPM states that the expected return on a given investment is the sum of a risk-free rate of return plus a market risk premium that is proportional to the systematic, non-diversifiable risk, associated with that investment.[30]

The Company arrived at its CAPM cost of equity capital of 14.6 percent by averaging a 9.8 percent CAPM derived from long horizon average market risk premium and a 19.4 percent CAPM derived from a current forecasted market risk premium.[31] RUCO derived its CAPM cost of equity capital based on a historic market risk premium.[32] RUCO calculated a range for its CAPM cost of equity capital between 5.66 percent-7.08 percent for its water sample and 5.30 percent-6.56 percent for its natural gas proxy.[33]

The Company claims that RUCO's CAPM analysis is not reliable because it is based on a historic market risk premium.[34] RUCO asserts that use of a historic market risk premium to derive a CAPM cost of equity capital is appropriate. Reliance on past performance as an indicator of future performance is sounder than reliance on analysts' projections of market return and treasury yields.

Staff witness, Juan Manrique, performed a CAPM analysis using a historic market risk premium.[35] Mr. Manrique's analysis produced a CAPM cost of equity in the range of 8.7 percent using a historical market risk premium and incorporated those results into his final

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[29] *Id.* at 31, footnote 9: Beta is defined as an index of volatility or risk, in the return of an asset relative to the return of a market portfolio of assets. It is a measure of systematic or non-diversifiable risk. The returns on a stock with a beta of 1.0 will mirror the returns of the overall stock market. The returns on stocks with betas greater than 1.0 are more volatile or riskier than those of the overall stock market; and if a stock's beta is less than 1.0, its returns are less volatile or riskier than the overall stock market.

[30] *See* Exhibit R-6 at 31-34.

[31] *See* Exhibit A-5 Bourassa Direct Testimony at 35-40. Mr. Bourassa's long horizon MRP was 7.5 percent and his current forecasted MRP was 16.04 percent.

[32] *See* Exhibit R-6 Rigsby Direct Testimony at 31-36

[33] *Id.*

[34] *See* Exhibit A-7 Bourassa Rebuttal Testimony at 18-19.

[35] *See* Exhibit S-3 Manrique Direct Testimony at 25-26.

analysis of the cost of equity.[36] Given Mr. Manrique's acknowledgement and the current economic circumstances, RUCO recommends the Commission adopt RUCO's cost of equity capital, which incorporates the CAPM.

b. RUCO'S Use of a Geometric Mean to Determine its Historic Market Risk Premium in the CAPM is Appropriate.

The Company claims that RUCO's historic market risk premium is also unreliable because it is based in part on a geometric mean.[37] The Company claims that RUCO's historic market risk premium should be based upon an arithmetic mean. RUCO's historic market premium was derived from both a geometric and an arithmetic mean of the historical returns on the Standard and Poor 500 ("S&P 500") index from 1926 to 2007 as the proxy for the market rate of return.[38] For the risk-free portion of the risk premium component, RUCO used the geometric mean of the yields of long-term government bonds for the same eighty-one year period resulting in a historic risk premium of 5.10 percent using a geometric mean and a historic risk premium of 6.80 percent using an arithmetic mean.[39]

The use of geometric mean is the industry standard. Mr. Rigsby testified that geometric means are published in Morningstar stocks, bonds, bills and inflation text and testified that analysts rely on geometric means to calculate a market risk premium.[40] Recent empirical research also supports RUCO's market risk premium.[41] Mr. Rigsby testified that empirical studies performed by Aswarth Damdaran and Felicia C. Marston, professors of finance from New York University and the University of Virginia, respectively, indicate that

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36 *Id.*
37 See A-7 Bourassa's Rebuttal Testimony at 18.
38 See Exhibit R-7, Rigby's Surrebuttal Testimony at 19-25.
39 Id. at 19.
40 See Exhibit R-6, Rigby's Surrebuttal Testimony at 23-25.
41 *Id.* at 23-25.

market risk premiums in excess of 4.5 to 5.5 percent are overstated.[42] Indeed, Mr. Rigsby cited to the text in oral testimony: Valuation: Measuring and managing the Value of Companies, 4th Edition,[43] which states:

> Although many in the finance profession disagree about how to measure the market risk premium, we believe 4.5-5.5 percent is an appropriate range. Historical estimates found in most textbooks (and locked in the mind of many), which often report numbers near 8 percent, are too high for valuation purposes because they compare the market risk premium versus short-term bonds, use 75 years of data, and are biased by the historical strength of the U.S. market.[44]

Mr. Bourassa's range of risk premium using an arithmetic mean and long horizon historic and forecasted current market risk premium is 7.5 to 16.04 percent.[45] RUCO's historic risk premium using both an arithmetic and geometric means ranges between 4.20 percent and 6.10 percent. The average of Mr. Rigsby's geometric and arithmetic mean, 5.15 percent, falls within the range identified as reasonable by recent empirical research. Mr. Bourassa's range of risk premium does not. The ALJ should reject the Company's cost of equity capital recommendation.

c. Publically Traded Gas Companies are Comparable to the Company for the Purposes of Calculating the Cost of Capital.

The Company contends that RUCO erred in using a proxy of gas utilities to derive its cost of capital because the average beta for RUCO's water utility sample is .75, compared with its natural gas sample of .67.[46] The Company used a water proxy of six water utilities to

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42 Id. at 10-11.
43 See Exhibit R-8 Valuation: Measuring and Managing the Value of Companies, 4th Edition
44 *Id.* at 306.
45 *See* Exhibit A-3 at 39.
46 See Exhibit A-7 Bourassa Rebuttal Testimony at 13; See also Exhibit R-7 Rigsby Surrebuttal Testimony at 36.

complete its cost of capital analysis.[47] Staff used the same water proxy. At the time of filing surrebuttal testimony, Staff reported the average raw beta of the water proxy was .67 and an average beta of .80 as reported by Value Line. Value Line also reported that California Water and Aqua American had betas of .75 and .65, respectively.[48] The Company cannot complain that RUCO used gas utilities with average beta of .67 when the average raw beta of its water utility is .67 and one-sixth of the companies in its water proxy have a lower beta of .65 as reported by Value Line.

The Company contends that gas companies are less risky investments than water companies as evidenced by their low beta and therefore, should not be used as proxies for the Company. RUCO disagrees.[49] The Company's reliance on beta alone also ignores the clear guidance of the courts. United Railways & Electric Company of Baltimore v. West, 280 U.S. 234, 249-50, 251, 50 S.Ct. 123, 125, 125-26, 74 L.Ed. 390 (1930); Simms v. Round Valley Light & Power Company, 80 Ariz. 145, 154, 294 P. 378, 384 (1956). To determine an appropriate cost of equity capital, the Commission needs to consider all relevant factors, including: (1) comparisons with other companies having corresponding risks, (2) the attraction of capital, (3) current financial and economic conditions, (4) the cost of capital, (5) the risks of the enterprise, (6) the financial policy and capital structure of the utility, (7) the competence of management, and (8) the company's financial history. Litchfield Park Service Corporation v. Arizona Corporation Commission 178 Ariz. 431, 874 P.2d 988 (Ariz. App. Div. 1 1994). Mr. Rigsby testified that he used gas utilities as a proxy because they have similar

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[47] *See* Exhibit S-4, Schedule JCM-7

[48] *Id.*

[49] See also Exhibit R-7 Rigsby Surrebuttal Testimony at 36.

operating characteristics to water companies in terms of distribution and similar risks.[50] He noted that he has seen a company witness do so.[51] Based on the foregoing, RUCO did not err in deriving its cost of equity capital using a gas proxy.

4. RUCO'S 8.22 Percent Cost of Equity Capital is Not Too Low.

The Company asserts that RUCO's cost of common equity 8.22 percent is too low because common shareholders bear a greater risk than bondholders and expect a higher return than the risk of a utility debt instrument.[52] The question of what level of additional market risk premium is necessary to derive a higher return is a moot issue. RUCO's cost of equity capital is 198 basis points higher than the 6.24 percent yield on Baa/BBB rated utility bonds and 271 basis points higher than the recent 5.51 percent yield on A-rated utility bonds. Given the low risk nature of regulated utilities, RUCO's cost of equity capital includes a sufficient margin to satisfy common shareholders for any perceived additional market risk.[53]

D. RATE DESIGN

1. Cost Recovery Mechanism

The Company and the Boulders Homeowner Association have entered into an agreement to retire the BMSC wastewater treatment plant and redirect its flows to the City of Scottsdale. The Company and BHOA propose to recover the associated costs via an adjustor mechanism. RUCO recommends denial of adjustor mechanisms and cost recovery mechanisms because they often represent extraordinary ratemaking. In Decision No. 68302 the Commission denied Arizona Water's request for an adjustor stating:

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50 *Id.*.
51 *Id.*
52 *See* Exhibit A-7 Bourassa Rejoinder Testimony at 15.
53 *See* Exhibit R-1.

> There is a danger of piecemeal regulation inherent in adjustment mechanisms. Because they allow automatic increases in rates without a simultaneous review of a utility's unrelated costs, adjustment mechanisms have a built-in potential of allowing a utility to increase rates based on certain isolated costs when its other costs are declining, or when overall revenues are increasing faster than costs due to customer growth. Adjustment mechanisms should therefore be used only in extraordinary circumstances to mitigate the effect of uncontrollable price volatility or uncertainty in the marketplace.[54]

2. Purchased Wastewater Adjustor Mechanism.

The Company seeks a purchased wastewater adjustor mechanism ("PWWAM"). RUCO objects because wastewater capacity and treatment are not commodities subject to volatility. The Company's witness, Mr. Sorenson, acknowledges that the City of Scottsdale wastewater treatment capacity may be purchased for $6.00/thousand gallons until 2016. [55] Moreover, he acknowledged that the City of Scottsdale treatment rates increase at a predictable 3-6 percent per year.[56] Even if wastewater capacity and treatment could be characterized as commodities, based on the testimony of Mr. Sorenson, the costs for both are not volatile.

If the Commission approves the BHOA agreement, the Company would lose all incentive to reduce wastewater capacity and treatment costs. A PWWAM would simply allow the Company to modify rates based on the cost of doing so without attempting to secure the lowest prices. In Decision No. 66849, the Commission denied AWC's request for a PWAM and PPAM stating:

> Although Arizona Water argues that such mechanisms benefit both the Company and ratepayers by passing on increased costs and savings,

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[54] *See* Exhibit R-7 Rigsby's Surrebuttal Testimony at 5-6, citing *In the Matter of Arizona Water*, Docket No. Docket No.W-01445A-04-0650, Decision No. 68302 dated September 8, 2004.
[55] T: 117
[56] T: 209-210

> adjustment mechanisms may also provide a disincentive for the Company to obtain the lowest possible cost commodity because the costs are simply passed through to ratepayers.[57]

RUCO asserts that the Commission's rationale for denial of PPAM and PWAM is equally applicable to PWWAM proposed by the Company. The negative impact of a PWWAM would be felt by ratepayers and would be exacerbated if BMSC diverts 100% of its flows to the City of Scottsdale. Essentially with approval of an PWWAM the Company would be able to transfer all increased costs associated with wastewater capacity and treatment without consideration of any of the savings achieved via reduction in expenses or additional revenues. For all the reasons more fully addressed above, RUCO opposes adjustor mechanisms, such as the PWWAM. Based on the Commission's prior rulings, RUCO recommends denial of the PWWAM, because wastewater treatment and capacity are not commodities or sufficiently volatile to warrant an adjustor mechanism.

E. CONCLUSION

For the reasons discussed above, RUCO recommends the Commission adopt its position in this case, and reject the positions of Staff, other Intervenors and the Company, to the extent they conflict with RUCO's recommendations.

RESPECTFULLY SUBMITTED this 14th day of December, 2009

Michelle L. Wood
Counsel

[57] _In the Matter of Arizona Water_, Docket No. Docket No.W-01445A-02-0619, Decision No. 66849 dated March 19, 2004/

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EXHIBIT A

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF GOLD CANYON SEWER COMPANY FOR A DETERMINATION OF 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 REHEARING OPEN MEETING

At: Phoenix, Arizona

Date: November 13, 2008

Filed:

REPORTER'S TRANSCRIPT OF PROCEEDINGS
AGENDA ITEM NO. 18

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Prepared for:

By: COLETTE E. ROSS
Certified Reporter
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BE IT REMEMBERED that the above-entitled and numbered matter came on regularly to be heard before the Arizona Corporation Commission, in Hearing Room 1 of said Commission, 1200 West Washington Street, Phoenix, Arizona, commencing at 10:00 a.m. on the 13th of November, 2008.

BEFORE: MIKE GLEASON, Chairman
WILLIAM MUNDELL, Commissioner
JEFF HATCH-MILLER, Commissioner
KRISTIN K. MAYES, Commissioner
GARY PIERCE, Commissioner

APPEARANCES:

For the Arizona Corporation Commission:

Dwight Nodes, Assistant Chief Administrative Law Judge

For the Applicant:

Mr. Jay L. Shapiro

For RUCO:

Mr. Daniel Pozefsky

COLETTE E. ROSS
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ACALJ NODES: Actually, although now that I am looking at it, the conclusion of law number 4 probably needs to be -- I will do that as a conforming change.

CHMN. GLEASON: So we covered that with a conforming change then, okay.

The board is clear. Please call the -- move this.

COM. MUNDELL: I will move U-18 as amended, Mr. Chair.

CHMN. GLEASON: Okay. Please call the roll.

SECRETARY HOGAN: Commissioner Pierce.

COM. PIERCE: Thank you. And I appreciate how much time we have had to take on this. It seems like we duplicated yesterday. In order to get it right, I think I would stay here another day because the important thing in my view is to get this right. And I, and I won't walk away with the feeling in my stomach, as a rookie a year and a half ago doing this, that I felt like I don't know if I got this exactly right. I think today as we have gone through this process I feel much more comfortable with it and the approach that we took on it.

So I know that it is still an increase to the folks in Gold Canyon, although it is a reduction from what they have been paying over the last while. But I think that what we have done is we have accomplished something that everybody had a part in here that I think is good for, actually for all parties. And I am pleased to vote aye.

SECRETARY HOGAN: Commissioner Mayes.

COM. MAYES: Thank you. I also appreciate the fortitude of all the parties and of all the people who have, from Gold Canyon, who have come to the Commission time after time after time on this case. And, you know, I don't know for certain that we got it right but we got it better.

And I would remind my colleagues that even though we knocked off approximately $8 from this bill, and I think we did so based on evidence in the record and based on needed changes, we started out with a $60.65 increase, 72 percent. So we are really only diminishing that increase by a small amount. People are still going to feel the brunt of this rate increase. And if we had implemented both of my amendments in their entirety in their original form, it would have been a $12 decrease. So we did -- that number did come down.

Commissioner Mundell often cites a case called Arizona Community Action Association versus Arizona Corporation Commission. And in that case, the court states that this Commission has responsibility to consider the interests of ratepayers as much as we do the interests of shareholders. And I think in our original case unfortunately the Commission was over, well, erred on the side of the shareholders. And in this case we have at least rebalanced that equation, and in particular we rebalanced that equation with the introduction of the hypothetical capital structure.

And I can tell you from my standpoint that I will be very vigilant from this day forward about the use of 100 percent equity structures by companies. It just is not appropriate. It is no more appropriate than if a company walked in here with 100 percent debt structure.

So I do appreciate all of our work, and I vote aye.

SECRETARY HOGAN: Commissioner Hatch-Miller.

COM. HATCH-MILLER: Boy, there are so many things going on in this particular case. It is, you know, now we don't know if Staff ought to use the Hamada process, or I mean that's up in the air; how much excess capacity should be built, that's up in the air; you know, kind of right, almost right. That's problematic. We shouldn't be passing things that are almost right.

You know, I learned a long time, I have lived long enough, when a contractor comes to my house and says it will be approximately $1,000, I know it is going to be more than $1,000, probably won't be $1,000. 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 try 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.

But, you know, the only reason we are here today is because this Commission sat on a Staff meeting and decided as a group we were going to, we were going to hear RUCO's arguments. We wouldn't be here if we didn't decide that. The Commission was the one that said, okay, let's give them a shot, let's rehear it. And that's why we are here.

We did rehear it, went through a long process, basically blew off the Judge's and the Staff's opinion on how to do it, came up with some new numbers and drove the rates down 6 or 7 bucks. That was the outcome they were seeking.

It was a faulty order, problematic order, don't even know if it is right on. But that's the result we wanted, so I will vote aye.

SECRETARY HOGAN: Commissioner Mundell.

COM. MUNDELL: I didn't hear you call my name. You know, from a -- first of all, I want to thank everybody that has participated. And the wheels of justice turn slowly. I know it has been a long, long hard process. And we voted to rehear this because we didn't get it right the first time. It was a three to two vote. Commissioner Mayes and I voted against the rate increase. And then RUCO filed the request for reconsideration. And that's why we are here today.

And so, again, this is from a fairness standpoint. This is still a tremendous rate increase, going from $35 to, you know, $52 a month. I haven't calculated the percentage, but it is a dramatic increase.

And there was evidence in the record for the dollar figure. We have seen that before where we have an approximate amount.

And so I appreciate Commissioner Mayes' hard work initially when we voted on this matter. And I appreciate her coming back with her amendments here today. And I think that we have at least taken into consideration the ratepayers, as the case that Commissioner Mayes cited, in trying to do our constitutional job to balance, being protecting the customers and also basing our decision on the evidence in the record.

And there is certainly plenty of evidence in the record to support this minor reduction in the rates that we will be still passing on to the customers of this company.

And as I said earlier, we are not just bean counters. You have got to remember the evidence in this case early on about the promise made from the president of the company that rates would not go up. And then subsequent to that there was an application filed. So from my perspective you have to look at all of the facts and not just put blinders on and do, as I said, accounting calculations when we fulfill our constitutional responsibilities to protect the ratepayer and also try to be fair to the company.

I vote aye.

SECRETARY HOGAN: Chairman Gleason.

CHMN. GLEASON: Yes, this Gold Canyon Sewer I think has been through two hearings where Judge Nodes listened to all parties, weighted the evidence and came forth with his decision. What we have today is, we have passed things with poor numbers that we don't know anything about. We have used hypothetical situations which are not absolute.

I am sorry to say but I think this is the, this case is the greatest miscarriage of fairness and justice that I have participated in my four years. I vote no.

By a vote of four ayes and one no you have passed the Gold Canyon.

(The Certified Reporter was excused.)

(TIME NOTED: 6:13 p.m.)

STATE OF ARIZONA)
) ss.
COUNTY OF MARICOPA)

I, COLETTE E. ROSS, Certified Reporter No. 50658 for the State of Arizona, do hereby certify that the foregoing printed pages constitute a full, true and accurate transcript of the proceedings had in the foregoing matter, all done to the best of my skill and ability.

WITNESS my hand this 21st day of November, 2008.

COLETTE E. ROSS
Certified Reporter
Certificate No. 50658