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BEFORE THE ARIZONA CORPORATION COMMISSION

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11 IN THE MATTER OF THE APPLICATION OF
 12 BLACK MOUNTAIN SEWER
 13 CORPORATION, AN ARIZONA
 14 CORPORATION, FOR A DETERMINATION
 15 OF THE FAIR VALUE OF ITS UTILITY
 16 PLANT AND PROPERTY, AND FOR
 17 ADJUSTMENTS TO ITS RATES AND
 18 CHARGES FOR UTILITY SERVICE AND
 19 FOR CERTAIN RELATED APPROVALS
 20 BASED THEREON.

Docket No. SW-02361A-08-0609

Arizona Corporation Commission
DOCKETED

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RUCO'S REPLY BRIEF

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

A. UNRESOLVED ISSUES RELATED TO REQUIRED REVENUE

1. Non-recurring Expenses

The Company seeks a \$51,000 increase in contractual services - of which \$39,000 was spent on an exceptionally large sewage spill. RUCO did not oppose the inclusion of all expenses, just those associated with non-recurring expenses. The Company admits that it has not incurred an expense as large as the test year spill which resulted in \$39,000 in clean

1 up costs. The Company claims that the most recent spill was \$5,000. The other contractual
2 services account in which outside services for spills are accounted includes \$12,000, to
3 which RUCO did not object, and which is more than sufficient to cover spills of a \$5,000
4 nature.

5 **2. Rate Case Expense**

6 RUCO has previously addressed the issue of rate case expense in its Initial Brief and
7 notes that its position mirrors the Staff's position.

8 **B. UNRESOLVED ISSUES RELATED TO COST OF CAPITAL**

9 The parties disagree on capital structure, the cost of debt, the cost of equity and the
10 overall weighted average cost of capital. RUCO recommends a hypothetical capital structure
11 comprised of 40 percent debt and 60 percent equity, a cost of debt of 6.26 percent, a cost of
12 equity of 8.22 percent and an overall weighted average cost of capital of 7.43 percent, which
13 results in a fair and reasonable rate of return.¹

14 **1. Capital Structure**

15 In its Initial Closing Brief, RUCO addressed multiple issues related to capital structure
16 as identified by the Company in testimony and incorporates those arguments by reference.
17 RUCO supplements its arguments to address those issues raised in the Company's Closing
18 Brief. First, the Company asserts that RUCO's use of a hypothetical capital is inappropriate
19 in light of prior decisions reached in BMSC cases. The Company's argument suggests that
20 the Commission is not permitted to decide each rate case on its own merits. It bases this
21 contention upon the theory that the Commission is bound by prior rate orders to certain rate
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23 _____
24 ¹ See Exhibit R-6 William A. Rigsby's Direct Testimony and Exhibit R-7 William A. Rigsby's Surrebuttal
Testimony.

1 making treatment for BMSC. However, it is clear that such a position is contrary to
2 established law. *Morris v. Ariz. Corp. Comm'n*, 24 Ariz. App. 454, 457, 539 P.2d 928, 931
3 (1975) (The ratemaking process does not lend itself to rule formulation because the relevant
4 factors may be given different weight in the discretion of the Commission at the time of the
5 inquiry).

6 The issues presented in a rate proceeding, the positions advanced by the parties
7 during the proceeding, and any other factors that the Commission deems relevant may all
8 contribute to different treatment at different times, if warranted.² The Commission decides
9 each case on the record before it. The Company has not demonstrated that the
10 Commission's prior decisions in Black Mountain bind the Commission to certain
11 determinations in this case

12 Second, the Company asserts that because the Gold Canyon and Black Mountain are
13 factually distinguishable the Commission may not impute a capital structure as it did in Gold
14 Canyon Sewer Company, an Algonquin affiliate. RUCO has not suggested that the ALJ's
15 recommendation must follow the decision rendered in Gold Canyon, but that it should. In
16 considering the rate application of Gold Canyon, the Commission's vote recognized that a
17 100 percent equity structure is unfair to ratepayers. In casting her vote, Commissioner
18 Mayes stated:

19 "I think in our original case, unfortunately, the Commission was over, well,
20 erred on the side of the shareholders. And in this case we have at least
21 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

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23 ² The opinions in *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 534, 578 P.2d 612, 615, (1978) and *Simms*,
24 80 Ariz. at 150, 294 P.2d at 382 indicated that the Commission should consider all relevant factors when setting
rates. In both cases, reviewing courts criticized the Commission for mechanical, formula-based rate setting that
failed to consider all available information.

1 about the use of 100 percent equity structures by companies. It just is not
2 appropriate. It is no more appropriate than if a company walked in here
3 with 100 percent debt structure".³

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

9 Because the Commission has the discretion to impute a hypothetical capital structure
10 of 40/60 percent debt/equity which would bring the Company's capital structure in line with
11 similar utilities, while addressing the reduced investor risk and providing a means of making
12 an interest synchronization calculation for tax purposes, RUCO recommends adoption of its
13 hypothetical capital structure.

14 **2. Cost of Debt**

15 The Company asserts that RUCO's cost of debt of 6.26 percent is too low because it
16 is lower than the cost of Baa/BBB rated bonds. The Company is wrong. RUCO's cost of debt
17 is 2 points higher than the most recently reported rate for Utility Baa/BBB bonds.⁴ The
18 Company also complained that RUCO's cost of debt is lower than the 7.0 percent rate at
19 which Algonquin recently issued debentures. Algonquin's recently issued debentures were
20 unsecured and subordinate. Unsecured subordinate debt is procured at a higher cost than
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23 ³ See R-7 Surrebuttal Testimony of William A. Rigsby at 14. See Also Transcript of Commission Open
24 Meeting on Gold Canyon, dated November 13, 2008, attached hereto as Exhibit A at 221-225.

⁴ See Exhibit R-1 Value line Section & Opinion Report of Selected Yields dated November 27, 2009.

1 secured debt.⁵ Therefore, the fact that Algonquin's unsecured subordinate debentures were
2 issued at a higher rate of 7.0 percent, supports Mr. Rigsby's cost of debt.

3 **3. Cost of Equity**

4 **a. RUCO'S Use of a Historic Market Risk Premium to Determine its 5 CAPM Cost of Equity Capital was Appropriate.**

6 RUCO has addressed the issue of the use of a historic market risk premium in lieu of
7 a current market risk premium in its Initial Closing Brief. RUCO supplements those
8 arguments to address the Company's complaint regarding its use of total treasury returns
9 instead of income returns.⁶ Mr. Rigsby testified that he used an appropriate Treasury
10 instrument to calculate the risk premium in his CAPM model. The risk premium Mr. Rigsby
11 used has been used by both ACC Staff and other cost of capital witnesses whose cost of
12 capital recommendations have been adopted by the Commission. While investors are
13 typically attracted to utility stocks for their income needs, it is simply not rational to think that
14 they would not expect some capital gains as well.

15 **b. RUCO'S Use of a Geometric Mean to Determine its Historic Market 16 Risk Premium in the CAPM is Appropriate.**

17 The Company claims that RUCO's historic market risk premium is also unreliable
18 because it is based in part on a geometric mean.⁷ RUCO has fully addressed this issue in its
19 Initial Closing Brief and incorporates those arguments by reference. RUCO will not
20 supplement the arguments, but reiterates the prior argument that the average of Mr. Rigsby's
21 geometric and arithmetic mean, 5.15 percent, falls within the range identified as reasonable
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23 ⁵ T:279, 506

24 ⁶ See Exhibit R-7 William A. Rigsby's Surrebuttal Testimony 18-19.

⁷ See A-7 Bourassa's Rebuttal Testimony at 18.

1 by recent empirical research.⁸ Mr. Bourassa's range of risk premium does not. The ALJ
2 should reject the Company's cost of equity capital recommendation.

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

5 The Company contends that RUCO erred in using a proxy of gas utilities ("LDC") to
6 derive its cost of capital. As previously discussed in RUCO's Initial Closing Brief, beta is not
7 the only measurement of risk.⁹ Second, the Company cannot complain that RUCO sued an
8 LDC proxy with an average beta of .67 when the average raw beta of the Company's water
9 proxy is also .67 and one-sixth of the Company's water proxy have a lower beta of .65 as
10 reported by Value Line.¹⁰ RUCO did not err in using an LDC proxy.

11 RUCO's use of an LDC proxy is entirely consistent with the guidance provided by the
12 courts.¹¹ The Company's reliance on beta alone also ignores the clear guidance of the
13 courts.¹² To determine an appropriate cost of equity capital, the Commission needs to
14 consider all relevant factors, including: (1) comparisons with other companies having
15 corresponding risks, (2) the attraction of capital, (3) current financial and economic
16 conditions, (4) the cost of capital, (5) the risks of the enterprise, (6) the financial policy and
17 capital structure of the utility, (7) the competence of management, and (8) the company's
18 financial history. Litchfield Park Service Corporation v. Arizona Corporation Commission 178
19 Ariz. 431, 874 P.2d 988 (Ariz. App. Div. 1 1994). Mr. Rigsby testified that he used gas

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21 ⁸ See RUCO's Initial Closing Brief at Section C 3 (b).

22 ⁹ 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).

23 ¹⁰ See Exhibit S-4, Schedule JCM-7.

24 ¹¹ See also Exhibit R-7 Rigsby Surrebuttal Testimony at 36.

¹² 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).

1 utilities as a proxy because they have similar operating characteristics to water companies in
2 terms of distribution and similar risks.¹³ He noted that he has seen a company witness do
3 so.¹⁴ Based on the foregoing, RUCO did not err in deriving its cost of equity capital using a
4 gas proxy.

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

6 The Company asserts that RUCO's cost of common equity of 8.22 percent is too low
7 because common shareholders bear a greater risk than bondholders and expect a higher
8 return than the risk of a utility debt instrument.¹⁵ The question of what level of additional
9 market risk premium is necessary to derive a higher return is a moot issue. RUCO's cost of
10 equity capital is 198 basis points higher than the 6.24 percent yield on Baa/BBB rated utility
11 bonds and 271 basis points higher than the recent 5.51 percent yield on A-rated utility bonds.
12 Given the low risk nature of regulated utilities, RUCO's cost of equity capital includes a
13 sufficient margin to satisfy common shareholders for any perceived additional market risk.¹⁶

14 **C. RATE DESIGN**

15 **1. BOULDERS HOMEOWNER ASSOCIATION ("BHOA") AGREEMENT**

16 BHOA and the Company have reached an agreement which calls for the retirement of
17 the BMSC WWTP and redirection of flows to the City of Scottsdale. RUCO does not object
18 to the retirement of the plant if the Commission determines that it is in the public interest to
19 do so as long as retirement of the plant resolves all odor issues. The comments of
20 Intervener Schirtzinger and the testimony of Dorothy Hains, Staff's engineer, raise significant
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23 ¹³ Id.

¹⁴ Id.

¹⁵ See Exhibit A-7 Bourassa Rejoinder Testimony at 15.

24 ¹⁶ See Exhibit R-1.

1 concerns of the Company's operations of the plant and its ability to resolve the odor issues.
2 However, these issues were not fully developed at hearing. The Commission may wish to
3 explore the matters prior to approving the request to retire the BMSC WWTP.

4 Although RUCO does not object to the closure of the WWTP if the Commission
5 determines it is in the public interest to do so, RUCO does oppose the cost recovery
6 mechanism proposed by the BHOA agreement for all of the reasons set forth in its Initial
7 Closing Brief. Moreover, RUCO is concerned with the unintended consequences that may
8 follow adoption of such a mechanism. Namely, the Company is unable to define the cost of
9 plant closure and redirection of flow. As such approving the mechanism as proposed
10 provides no way to limit the monetary impact on ratepayers. Second, the Company claims
11 that it will continue the surcharge until its next rate case, but is unable to identify when that
12 rate case will be brought. Essentially, the Company could continue to charge the monthly
13 rates based on existing rate base and operating expenses, retire the plant, achieve great
14 operating expense savings and continue to charge customers the same rates and an
15 additional surcharge, indefinitely. RUCO submits that if the Company wishes to retire the
16 plant, it should do so and then seek recovery in a subsequent rate case. Accordingly,
17 because of the concerns expressed here and those set forth in its Initial Closing Brief RUCO
18 recommends denial of the cost recovery mechanism proposed by the Company and BHOA.

19
20 **D. CONCLUSION**

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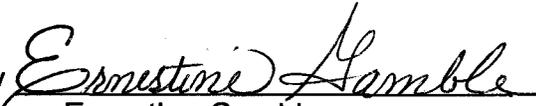
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