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ARIZONA CORPORATION COMMISSION

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DATE: AUGUST 3, 2010  
DOCKET NO.: SW-02361A-08-0609

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TO ALL PARTIES:

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

BLACK MOUNTAIN SEWER CORPORATION  
(RATES)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and thirteen (13) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00** p.m. on or before:

AUGUST 12, 2010

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

AUGUST 24, 2010 and AUGUST 25, 2010

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

Arizona Corporation Commission

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ERNEST G. JOHNSON  
EXECUTIVE DIRECTOR

INVEST

BEFORE THE ARIZONA CORPORATION COMMISSION

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

DECISION NO. \_\_\_\_\_

OPINION AND ORDER

11	DATES OF HEARING:	September 21, 2009 (Public Comment), November 11, 2009 (Pre-Hearing Conference), November 18, 23, 24 and 25, 2009.
12		
13	PLACE OF HEARING:	Phoenix, Arizona
14	ADMINISTRATIVE LAW JUDGE:	Dwight D. Nodes
15	APPEARANCES:	Mr. Jay L. Shapiro, FENNEMORE CRAIG, P.C., on behalf of Black Mountain Sewer Corporation;
16		
17		Ms. Michelle Wood, on behalf of the Residential Utility Consumer Office;
18		
19		Mr. Scott S. Wakefield, RIDENOUR, HIENTON & LEWIS, P.L.L.C., on behalf of the Boulders Homeowners Association;
20		
21		Mr. Thomas K. Chenal, SHERMAN & HOWARD, L.L.C., on behalf of the Town of Carefree;
22		Dr. Dennis Doelle, D.D.S., in propria persona;
23		Mr. M.M. Schirtzinger, in propria persona; and
24		Mr. Kevin O. Torrey, Staff Attorney, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.
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1 **BY THE COMMISSION:**

2 **I. INTRODUCTION AND PROCEDURAL HISTORY**

3 On December 19, 2008, Black Mountain Sewer Corporation ("BMSC" or "Company") filed  
4 with the Arizona Corporation Commission ("Commission") an application for a rate increase.  
5 During the test year, BMSC provided wastewater service to approximately 2,100 customers in and  
6 around Carefree, Arizona, 1,968 of which are residential customers, 125 of which are commercial,  
7 and the remainder served under special tariffs.

8 On January 20, 2009, the Commission's Utilities Division ("Staff") filed its Letter of  
9 Sufficiency indicating that BMSC satisfied the requirements of Arizona Administrative Code  
10 ("A.A.C.") R14-2-103 and classifying the Company as a Class B utility.

11 By Procedural Order issued January 23, 2009, a hearing date of September 21, 2009, was  
12 established, publication and mailing of notice was ordered, and various other filing dates were  
13 established.

14 On April 7, 2009, the Boulders Homeowners' Association ("BHOA") filed a Motion to  
15 Intervene.

16 On April 13, 2009, the Residential Utility Consumer Office ("RUCO") filed an Application to  
17 Intervene.

18 On May 20, 2009, a Procedural Order was issued granting intervention to the BHOA and  
19 RUCO.

20 On June 5, 2009, Mr. M. Schirtzinger filed a Motion to Intervene.

21 On June 8, 2009, the Town of Carefree ("Carefree" or "Town") filed an Application to  
22 Intervene.

23 On June 12, 2009, Staff filed a Motion for Extension of Time. In its Motion, Staff requested  
24 an additional 60 days to file its direct testimony due the departure of the lead Staff analyst and Staff's  
25 heavy workload.

26 On June 15, 2009, BMSC filed a Response in opposition to Staff's Motion on the basis that a  
27 change of rate analysts was an insufficient reason for granting an extension of the procedural  
28 schedule. The Company claimed, among other things, that it had done nothing wrong and "should

1 not be made to shoulder the burden of another party's personnel changes." BMSC suggested that if  
2 Staff's Motion were granted, the Commission should provide a remedy that would allow the  
3 Company to recover any revenue lost as a result of the delay.

4 On June 16, 2009, Staff filed a Reply in Support of its Motion for Extension of Time.

5 By Procedural Order issued June 17, 2009, a procedural conference was scheduled for June  
6 30, 2009, to discuss Staff's Motion for Extension of Time, and the intervention requests of Carefree  
7 and Mr. Schirtzinger were granted.

8 On June 17, 2009, Dr. Dennis E. Doelle, D.D.S., filed a Motion to Intervene.

9 The procedural conference was held, as scheduled, on June 30, 2009. Following the  
10 arguments regarding Staff's extension request, Staff's Motion was granted and the parties were  
11 directed to develop a new procedural schedule and hearing date in accordance with that ruling.

12 On July 13, 2009, Staff filed a Request for a Procedural Order. Staff proposed new testimony  
13 filing dates and a new hearing date consistent with its requested 60-day extension.

14 By Procedural Order issued July 20, 2009, the evidentiary hearing was rescheduled to  
15 commence on November 18, 2009, the prior hearing date was reserved for public comment, and new  
16 testimony filing dates were established. In addition, Dr. Doelle's intervention request was granted.

17 With its application, BMSC filed the direct testimony of Greg Sorenson and Thomas  
18 Bourassa.

19 On September 18, 2009, RUCO filed the direct testimony of William Rigsby and Rodney  
20 Moore; the BHOA filed the direct testimony of Les Peterson; the Town filed the direct testimony of  
21 Brian Kincaid; and Dr. Doelle filed his direct testimony.

22 On September 21, 2009, Staff filed the direct testimony of Crystal Brown, Dorothy Hains, and  
23 Juan Manrique.

24 On September 21, 2009, the previously scheduled hearing was convened for purposes of  
25 taking public comment. No public comment was received at that time.

26 On October 20, 2009, the Company filed the rebuttal testimony of Mr. Sorenson and Mr.  
27 Bourassa.

28 On November 9, 2009, Staff filed the surrebuttal testimony of Ms. Brown, Ms. Hains, and Mr.

1 Manrique; RUCO filed the surrebuttal testimony of Mr. Rigsby and Mr. Moore; the BHOA filed  
2 surrebuttal testimony of Mr. Peterson; and Dr. Doelle filed his surrebuttal testimony.

3 On November 16, 2009, BMSC filed the rejoinder testimony of Mr. Sorenson and Mr.  
4 Bourassa.

5 On November 17, 2009, the prehearing conference was held to discuss scheduling of  
6 witnesses and other procedural issues.

7 On November 18, 2009, the hearing commenced as scheduled. The hearing resumed on  
8 November 23, 2009, with additional hearing days on November 24 and 25, 2009.

9 On November 19, 2009, Staff filed the supplemental surrebuttal testimony of Crystal Brown.

10 On December 10, 2009, BMSC, Staff, and RUCO filed final schedules. The Company also  
11 submitted Late-Filed Exhibits on December 10, 2009.

12 On December 14, 2009, initial briefs were filed by BMSC, Staff, RUCO, BHOA, and the  
13 Town.

14 On December 22, 2009, reply briefs were filed by BMSC, Staff, RUCO, and the BHOA.

15 BMSC's current rates and charges were authorized in Decision No. 69164 (December 5,  
16 2006). In 2001, BMSC was acquired by Algonquin Water Resources ("AWR")<sup>1</sup>, which is a wholly  
17 owned subsidiary of Algonquin Power Income Fund ("APIF"). APIF owns energy, water and  
18 wastewater, and related assets in the United States and Canada. Liberty Water operates eight water  
19 and/or wastewater companies in Arizona,<sup>2</sup> as well as other water and wastewater utilities in Texas,  
20 Illinois, and Missouri. (Ex. S-5, at 2-3.)

## 21 **II. APPLICATION**

22 According to the Company's application, in the test year ended June 30, 2008, BMSC had  
23 adjusted operating income of negative \$128,478 on an adjusted Fair Value Rate Base ("FVRB") and  
24 Original Cost Rate Base ("OCRB") of \$3,682,741, for a negative 3.49 percent rate of return.  
25 Pursuant to its final schedules, BMSC requests a gross revenue increase of \$952,956 (60.31 percent).

26 \_\_\_\_\_  
27 <sup>1</sup> AWR was subsequently renamed Liberty Water.

28 <sup>2</sup> In addition to BMSC, Liberty Water also controls Bella Vista Water Company, Litchfield Park Service Company ("LPSCO"), Gold Canyon Sewer Company, Rio Rico Utilities, Entrada Del Oro Sewer Company, Northern Sunrise Water Company and Southern Sunrise Water Company.

1 Staff recommends a gross revenue increase of \$610,375 (38.63 percent), and RUCO recommends an  
 2 increase of \$604,630 (38.26 percent). A summary of the parties' final revenue requirement positions  
 3 follows<sup>3</sup>:

	<u>Company Proposed</u>	<u>Staff Proposed</u>	<u>RUCO Proposed</u>
5 FVRB/OCRB			
6 Adjusted Rate Base	\$3,682,741	\$3,410,758	\$3,682,905
7 Rate of Return	12.40%	9.40%	7.43%
8 Req'd Operating Inc.	456,660	320,611	273,640
9 Op. Income Available	(128,478)	(41,470)	(97,610)
10 Operating Inc. Def.	585,138	362,081	371,249
11 Rev.Conver. Factor	1.6286	1.6857	1.6286
12 Gross Rev. Increase	952,956	610,375	604,630

### 11 III. ISSUES RESOLVED AFTER CLOSE OF THE HEARING

12 In its brief, BMSC claims that two issues that were in dispute between the Company and Staff  
 13 were resolved after the hearing ended. The first issue relates to an odor scrubber for which Staff  
 14 requested documentation to verify the scrubber's cost. According to the Company, Staff is satisfied  
 15 with an invoice provided by BMSC, and the scrubber is included in Staff's final schedules as part of  
 16 the Company's rate base.

17 The second issue that was resolved involves test year costs incurred by BMSC for services  
 18 provided by a vendor called Aerotek. The Company indicates that Staff has now verified that the  
 19 Aerotek costs were removed from the books of BMSC's affiliate, LPSCO, and are now reflected in  
 20 BMSC's operating expenses in this case. According to the Company, the Aerotek expenses are  
 21 included in Staff's final schedules. (BMSC Initial Brief, at 20.)

### 22 IV. RATE BASE ISSUES

23 As indicated above, BMSC proposes an OCRB of \$3,682,741; Staff proposes an OCRB of  
 24 \$3,410,758; and RUCO proposes an OCRB of \$3,682,905. Each of the disputed issues regarding rate  
 25 base items is discussed below.

26 ...

27  
 28 <sup>3</sup> Intervenors Carefree, Dr. Doelle, and the BHOA raised only non-revenue requirement issues which are discussed below.

1           **A.     Accumulated Deferred Income Taxes**

2           Accumulated deferred income taxes ("ADITs") reflect the timing difference between when  
3 income taxes are calculated for ratemaking purposes and the actual federal and state income taxes  
4 paid by the Company. The timing difference is primarily due to the fact that straight line  
5 depreciation is used for ratemaking purposes, whereas accelerated depreciation is used for income tax  
6 reporting purposes. (Ex. S-6, at 6-7.) According to Staff witness Crystal Brown, the National  
7 Association of Regulatory Utility Commissioners ("NARUC") Uniform System of Accounts  
8 ("USOA") requires utilities to use straight-line depreciation which, in the early years of an asset's  
9 life, results in a lower depreciation expense but higher income tax liability. By comparison, Ms.  
10 Brown indicated that accelerated depreciation results in higher depreciation expense, but lower  
11 income taxes. However, when the asset is fully depreciated, the situation begins to reverse. Ms.  
12 Brown stated that the ADIT balance is reduced to zero when the asset is fully depreciated under  
13 straight line depreciation. (*Id.* at 7.)

14           Ms. Brown explained that ADITs typically result in a reduction to rate base to reflect that, in  
15 the early years of an asset's life, customers are providing more cash for income taxes than a company  
16 has to pay. This extra cash, according to Ms. Brown, represents cost-free capital from ratepayers. (*Id.*  
17 at 8.) She testified that BMSC calculated a negative ADIT balance in this case, resulting in a net  
18 ADIT addition to rate base. Ms. Brown stated that a negative ADIT balance suggests a calculation  
19 error or some unusual treatment by the Commission or the Internal Revenue Service ("IRS"). (*Id.*)  
20 She also indicated that the Company improperly included almost all of its advances in aid of  
21 construction ("AIAC") balance in the ADIT calculation, even though the IRS allows only AIAC for  
22 service connections to be included as revenue. Staff therefore recommends that the Company's  
23 proposed ADIT be increased from negative \$170,554 to zero. (*Id.* at 9; Ex. S-7, at 3-4.)

24           As stated above, BMSC initially requested an increase to rate base to reflect a net ADIT asset  
25 of \$170,898. However, Company witness Bourassa subsequently increased the amount of the ADIT  
26 upwards, to \$196,009, to reflect adjusted plant-in-service, accumulated depreciation, AIAC and  
27 contributions in aid of construction ("CIAC"). (Ex. A-6, at 6-7; Ex. A-8, at 6; BMSC Final Sched. B-  
28 2.)

1 According to BMSC, Staff's recommendation is contrary to Standard of Financial Statement  
2 of Accounts ("SFAS") No. 109, which requires recognition of ADITs. The Company claims that,  
3 unlike water companies, sewer companies do not have service connection fees. (Tr. 746.) Mr.  
4 Bourassa also pointed out that the Commission recognized that net ADIT assets are more common  
5 for companies, such as BMSC, that have significant amounts of plant funded by AIAC and CIAC.  
6 (Ex. A-8, at 7-8; Decision No. 69164, at 6.)

7 The Company contends that although RUCO eventually agreed with BMSC's ADIT asset as  
8 an addition to rate base, Staff continues to oppose the Company's position. At the hearing, Ms.  
9 Brown agreed that the Company's methodology for calculating ADIT was correct because some  
10 companies have a net deferred tax asset, rather than the usual net deferred tax liability. (Tr. 702, 740.)  
11 However, Staff opposes recognition of the ADIT asset in rate base based on Ms. Brown's testimony  
12 that BMSC did not provide adequate documentation, including the actual tax depreciation schedule  
13 for 2008, to support its position. (*Id.* at 740-51.)

14 BMSC argues that Staff never specifically requested the 2008 tax depreciation schedule, and  
15 the Company had no reason to believe that the schedule was necessary to reconcile its ADIT position.  
16 According to BMSC, it provided the information necessary to reconcile its ADIT calculation through  
17 the end of the test year, June 30, 2008, and did not understand that Staff needed additional  
18 information. After the conclusion of the hearing, BMSC late-filed several documents including what  
19 it labeled Exhibits A-17 and A-18, the 2008 tax depreciation schedule and reconciliation. (December  
20 10, 2009 Late-Filed Exhibits). In its brief, the Company asserts that the late-filed exhibits show that  
21 its ADIT calculation is actually understated, although BMSC continues to advocate adoption of its  
22 hearing position, a net ADIT asset of \$196,009. (BMSC Initial Brief, at 25.)

23 We agree with the Company that its proposed net ADIT asset of \$196,009 should be  
24 recognized as an addition to BMSC's rate base. In the Company's last case, we declined to adopt  
25 RUCO's argument that ADIT should always result in a net liability, agreeing instead with the  
26 position taken by BMSC and Staff that significant CIAC and AIAC funding of plant can often result  
27 in a net ADIT asset. (Decision No. 69164, at 5-6.) We believe the Company adequately documented  
28 its ADIT calculation through the end of the test year, and provided additional support for its proposal

1 through the late-filed submissions. We therefore adopt BMSC's position to recognize a net ADIT  
2 asset of \$196,009.

3 **B. Working Capital**

4 A working capital allowance is calculated by considering a company's cash working capital  
5 requirements, materials and supplies inventories, and prepayments. (A.A.C. R14-2-103, Appendix B,  
6 Sched. B-5.) Although the materials and supplies, and prepayments components are often not in  
7 dispute, parties often disagree regarding the cash component of working capital.

8 As described by Staff witness Brown, cash working capital represents the amount of cash that  
9 a company needs to pay day-to-day operating expenses during the period that service is provided,  
10 until the date customers pay for that service. (Ex. S-6, at 10.) Ms. Brown indicated that cash working  
11 capital may be negative or positive, depending on whether customers provide cash prior to, or after,  
12 the rendering of service. (*Id.*)

13 In its application, BMSC proposed a zero cash working capital allowance based on its  
14 calculation using the "formula method." Company witness Bourassa stated that because the preferred  
15 method of calculating cash working capital (a "lead-lag study") is more expensive, BMSC hoped to  
16 avoid a disputed issue by simply proposing that no cash working capital allowance be granted.  
17 However, after Staff recommended negative cash working capital of \$127,713, the Company decided  
18 to conduct a lead-lag study to show that it has a positive cash working capital requirement. (Ex. A-6,  
19 at 8-9.) Mr. Bourassa's lead-lag study resulted in a cash working capital requirement of \$14,816  
20 which, combined with materials and supplies inventory and prepayments of \$17,326, produced a  
21 revised Company proposal of \$32,142 for its total working capital allowance. (*Id.* at 9.)

22 Mr. Bourassa explained that the calculation of "revenue lag" consists of three components:  
23 service lag; billing lag; and payment lag. (Ex. A-8, at 12.) He claims that the "service lag" for a  
24 wastewater company is measured from the mid-point to the end of the service period (*i.e.*, 15 days).  
25 When a wastewater company, like BMSC, bills in advance of service being provided, the service lag  
26 is negative, in this instance a negative 15 days service lag. (*Id.*) According to Mr. Bourassa, the  
27 "billing lag" is measured from the end of the service period to the billing date. He contends that, for  
28 BMSC, the billing lag is a positive 4.65 days based on a review of customer billing data. Mr.

1 Bourassa stated that the "payment lag" is measured from the customer billing date to the customer  
2 payment date. Because customers do not often prepay their bills, he indicates that the payment lag is  
3 almost always a positive number. Mr. Bourassa claimed that the weighted average payment lag is  
4 21.75 days, based on the Company's billing data. (*Id.* at 13.) Combining the service lag (negative 15  
5 days), the billing lag (positive 4.65 days), and the payment lag (positive 21.75 days), BMSC  
6 calculated a net revenue lag of 11.40 days. (*Id.*)

7 Staff witness Brown disputed the Company's 11.40 revenue lag day result. In her surrebuttal  
8 testimony, she determined a 9.6 day revenue lag by averaging the revenue lag days used in BMSC's  
9 prior case (7.83 days) with the Company's revenue lag day proposal in this case (11.40 days). (Ex. S-  
10 6, at 13-15.) In her supplemental surrebuttal testimony, Ms. Brown offered a revised revenue lag  
11 recommendation based on a more detailed review of BMSC billing and payment records. Based on  
12 that review, she claimed that customers paid their bills on average 19.23 days after the billing date.  
13 When combined with the 4.65 days billing lag, Ms. Brown calculated an average customer payment  
14 date of 23.88 days which, combined with the negative 15 day service lag, results in a net revenue lag  
15 for BMSC of 8.88 days. (Ex. S-7, at 4.) Staff also removed synchronized interest from the lead-lag  
16 study, to reflect that there is no debt in the Company's capital structure. (*Id.* at 5.) Staff's final  
17 recommendation is that BMSC should have a negative \$83,132 cash working capital which, when  
18 adjusted for prepayments, results in a net working capital requirement of negative \$75,980. (*Id.*; Tr.  
19 752-53.)

20 We agree that Staff's working capital analysis is consistent with the methodology employed  
21 in BMSC's last case, in which a 7.83 day revenue lag was employed in establishing the Company's  
22 cash working capital at negative \$87,253. (BHOA Ex. 1, at 7.) We believe Staff's recommendation,  
23 including the assumption that insurance costs are paid annually; that a 212 day expense lag should be  
24 employed for property tax expenses; that rate case expense should be excluded from the lead-lag  
25 calculation; and that an 8.88 day revenue lag is appropriate, are reasonable conclusions for purposes  
26 of setting BMSC's working capital requirement in this case. The Company's net working capital  
27 shall therefore be negative \$75,980.

28 ...



1 truck under the existing master agreement than creating a new lease. (Ex. A-2, at 14-15.) He stated  
2 that documentation was provided showing that the truck is used solely by BMSC, including vehicle  
3 inspection reports signed by a BMSC supervisor; environmental health and safety weekly reports;  
4 and Algonquin Water Resources fleet reports showing that the vehicle is assigned to BMSC. (*Id.* at  
5 15-16.) Mr. Sorenson contends that the lease was obtained by GCSC in order to ensure the best deal  
6 possible under the master lease agreement, but that “[t]he truck is BMSC’s, it is used exclusively for  
7 BMSC and no other utility, and the expense belongs 100 percent in BMSC’s operating expenses.”  
8 (Ex. A-3, at 15.) He added that the BMSC and GCSC service areas are 40 miles apart and the  
9 affiliates do not typically share trucks, regardless of the name on the title of the vehicle. (*Id.*)

10 Staff recommends that the Company’s transportation expenses be reduced by \$5,375,  
11 representing 50 percent of the test year lease expenses associated with the truck. (Ex. S-5, at 22.)  
12 Staff witness Brown testified that because the lease was signed by GCSC, and because the Company  
13 does not maintain truck usage logs to show that the truck was used only by BMSC, the cost of the  
14 lease should be allocated equally between BMSC and GCSC. (*Id.*)

15 In her surrebuttal testimony, Ms. Brown stated that Staff noted several record keeping errors  
16 with ledgers maintained by the affiliates. She pointed to certain expenses of BMSC that were  
17 recorded on LPSCO’s books, and an odor control unit that was used by BMSC but previously  
18 included on LPSCO’s plant records. (Ex. S-6, at 32.) Ms. Brown suggested that these record keeping  
19 errors are indicative of the types of problems that could occur with respect to the truck lease obtained  
20 in GCSC’s name. As an example, she stated that although the Company seeks to recover the truck  
21 lease costs in this case for BMSC, the Company could later assign responsibility to GCSC which  
22 could seek to recover operating expenses for the lease in a subsequent rate case. (*Id.*) She indicated  
23 that absent logs showing that the vehicle was used exclusively by BMSC, Staff’s 50 percent  
24 allocation is a reasonable recommendation regarding the truck lease. (*Id.* at 33.)

25 We agree with the Company that the record supports its contention that the truck leased by  
26 GCSC was used solely by BMSC during the test year and should be a recoverable expense. While  
27 we understand Staff’s concerns, we believe that the title of the vehicle being held in the name of an  
28 affiliate company is not dispositive of the issue of proper allocation of the expense. As established in

1 the Company's testimony, as well as other supporting documentation, the truck was, and is, used  
2 solely for the benefit of BMSC and its customers. In this case, we find that the Company has  
3 provided an adequate basis for inclusion of the truck lease expenses. However, in future cases  
4 BMSC and its affiliates should undertake better efforts to ensure that proper documentation is in  
5 place to support their proposed expenses.

## 6 **2. Discharge Remediation Expense**

7 During the test year, BMSC incurred \$39,870 for cleanup costs resulting from an  
8 unauthorized wastewater discharge. (Ex. S-5, at 19-20.) The discharge was properly reported to  
9 ADEQ and the Commission and, according to Mr. Sorenson, due to the Company's rapid response to  
10 the discharge, it was not issued a notice of violation ("NOV") for the spill. (Ex. A-3, at 6.) Mr.  
11 Sorenson stated that ADEQ and the Maricopa County Environmental Services Department  
12 ("MCESD") recognize that discharges sometimes occur on wastewater systems and those  
13 environmental agencies encourage immediate response and remediation for such spills. (*Id.*)

14 Staff witness Brown indicated that because such spill remediation expenses are not likely to  
15 be incurred on a regular basis, the \$39,870 cleanup costs should be normalized over a three-year  
16 period. (Ex. S-5, at 20.) The Company agreed with Staff's normalization recommendation. (Ex. A-6,  
17 at 14.)

18 RUCO disagrees with the inclusion of any costs related to cleanup of spills and proposes that  
19 the entire \$39,870 be removed from BMSC's operating expenses in this case. RUCO witness Moore  
20 stated that cleanup costs should not be borne by customers because BMSC "has a duty to provide safe  
21 conduct and handling of the sewage from the customer's point of collection." (Ex. R-4, at 11.) Mr.  
22 Moore testified that allowing recovery of spill cleanup costs, even if they are normalized, "creates an  
23 atmosphere of expectation and ... acceptance of a future spill." (Tr. 492.)

24 We believe it is reasonable to allow the costs associated with the unauthorized test year  
25 discharge in this proceeding, with the three-year normalization recommended by Staff and accepted  
26 by the Company. RUCO's concern with creating an expectation or acceptance of future spills by the  
27 Company is not supported by the record. In fact, the testimony reflects that BMSC acted  
28 immediately to remediate the discharge, promptly reported the spill to the proper environmental

1 authorities and the Commission and, as a result of its responsiveness to the discharge, avoided  
2 issuance of a NOV or other penalties. We recognize that spill events sometimes occur on wastewater  
3 systems, and we believe that recognition of a reasonable level of operating expenses for remediation  
4 efforts in this case sends an appropriate message to BMSC that its rapid response to such spills is  
5 proper.

6 We wish to make clear that if credible evidence is presented in a future case that indicates  
7 repeated unauthorized discharges are occurring, that a discharge is directly attributable to the actions  
8 of the Company, or that a discharge is due to the Company's inaction (*i.e.*, lack of repairs and  
9 maintenance), the result is likely to be different. In this case, we believe a three-year normalization  
10 of the test year expenses is reasonable and shall be adopted.

### 11 **3. Bad Debt Expense**

12 BMSC originally sought recovery of \$11,965 for bad debt expense, but later increased its  
13 request by \$2,412 "to reflect the known and measurable write-offs ... related to test year revenues  
14 which occurred after the end of the test year." (Ex. A-6, at 16.) Based on documentation provided by  
15 the Company, Staff agreed with the proposed adjustment and accepted BMSC's bad debt expense of  
16 \$14,377. (Ex. S-6, at 23; Ex. S-7, at 5-6.)

17 RUCO proposes to allow bad debt expense in the original amount of \$11,962. (Ex. R-4, at 5.)  
18 At the hearing, RUCO witness Moore explained that the unadjusted amount is reflective of a  
19 reasonable test year level of bad debt expenses. He indicated that because BMSC makes monthly  
20 adjustments to bad debt expense, the amount would change frequently and the original amount  
21 appeared reasonable. (Tr. 473, 494-95.)

22 We agree with BMSC and Staff that appropriate documentation was provided to support the  
23 slight increase in bad debt expense proposed by the Company. Although the additional increment  
24 was written off after the test year, it is related to test year revenues. (Ex. S-7, at 5.) We will therefore  
25 allow bad debt expense of \$14,377 in this case.

### 26 **4. Contractual Services – Legal & Engineering (Easement Dispute)**

27 RUCO witness Moore initially proposed that \$4,723 be disallowed from test year expenses  
28 for survey and legal costs associated with an easement dispute, based on his claim that they are non-

1 recurring. (Ex. R-3, at 13; Sched. RLM-12.) RUCO subsequently amended its proposal, and  
2 recommends disallowance of \$1,500 of the easement dispute legal and survey costs. (Tr. 65, 470-71;  
3 RUCO Final Sched. RLM-12.)

4 Staff agreed that the \$1,500 should be removed from test year expenses, but claimed it should  
5 instead be treated as a capital cost. (Ex. S-6, at 22.) After removing the \$1,500 from test year  
6 expenses, Ms. Brown normalized over three years the Contract Services – Legal & Engineering  
7 account, reducing the Company’s test year expenses by \$4,861. (*Id.*, Schedules. CSB-19 and CSB-20.)  
8 BMSC agreed with Staff’s normalization of the expenses in that account, but indicated that Staff  
9 made a computational error in doing so. (Ex. A-6, at 14-15.)

10 BMSC witness Bourassa stated that Staff erroneously included \$1,500 of capitalized expense  
11 in its normalization adjustment. According to Mr. Bourassa, Staff removed the \$1,500 from expenses  
12 but proceeded to use the unadjusted test year expense (\$9,362) in its three-year normalization  
13 computation rather than the adjusted amount (\$7,862). (Ex. A-8, at 29.) As a result, Mr. Bourassa  
14 claimed that Staff overstated its adjustment by \$1,500. (Ex. A-6, at 15.)

15 We agree with Staff and the Company that the \$1,500 of identified contractual services, legal  
16 and engineering costs related to an easement dispute to should be removed from test year expenses  
17 and should instead be capitalized. We also agree with the Company’s assertion that Staff’s  
18 normalization computation effectively overstated its intended adjustment. We therefore adopt  
19 BMSC’s position on this issue, as reflected in its final schedules.

## 20 **5. Rate Case Expense**

21 In the Company’s last rate case, the Commission recognized \$150,000, amortized over three  
22 years, for rate case expense incurred by BMSC. (Decision No. 69164, at 11-12.) In this proceeding,  
23 the Company initially estimated its rate case expense to be \$180,000, and again requested that it be  
24 recovered over three years. (Ex. A-4, at 12-13.) According to Mr. Bourassa, BMSC incurred over  
25 \$225,000 in rate case expenses in the last case and believed \$180,000 was significantly less than the  
26 amount expected to be incurred in this proceeding. (*Id.*)

27 In his rebuttal testimony, Mr. Bourassa proposed an increase of \$50,000, or \$16,667 annually,  
28 to BMSC’s rate case expense estimate. He indicated that the increased amount was necessary to

1 recognize the additional costs incurred by the Company in responding to the BHOA's intervention,  
2 including the negotiation of a settlement with BHOA regarding closure of the Company's wastewater  
3 treatment plant (see discussion below regarding the treatment plant issue). (Ex. A-6, at 24-25.) At the  
4 hearing, Mr. Bourassa testified that BMSC was revising its proposal to a total requested rate case  
5 expense of \$220,000, amortized over three years. (Tr. 239-42.)

6 Neither Staff nor RUCO opposed the Company's original request for \$180,000 for rate case  
7 expense. In her surrebuttal testimony, Staff witness Brown stated that Staff agreed with the  
8 Company's request to increase the expense by \$50,000, subject to Staff's review of supporting  
9 documentation. (Ex. S-6, at 23-24.) In her supplemental surrebuttal testimony, however, Ms. Brown  
10 indicated that the additional requested amount should be denied because it was related to negotiation  
11 of the settlement with the BHOA, which Staff believes is "not pertinent to the processing of the rate  
12 case." (Ex. S-7, at 6.)

13 RUCO witness Moore stated in his surrebuttal testimony that RUCO would provide a final  
14 recommendation on rate case expense "when it files its final schedules." (Ex. R-3, at 5.) At the  
15 hearing, Mr. Moore initially indicated that RUCO could not support more than approximately  
16 \$95,000, based on review of actual expenses incurred through October 2009. (Tr. 479-82.) However,  
17 after reviewing additional supporting documentation, Mr. Moore testified that RUCO proposed  
18 allowance of the original \$180,000 requested by BMSC, amortized over three years. (*Id.* at 502.)

19 We agree with Staff and RUCO that allowance of \$180,000, amortized over three years, is a  
20 reasonable amount of rate case expense for this case. We believe this amount provides proper  
21 recognition to the passage of time since the last case, while also recognizing that both the prior case  
22 and the instant case covered four days of hearing and involved intervention by the BHOA and  
23 Carefree. BMSC argues that the BHOA intervention, and in particular the negotiation of a settlement  
24 agreement, resulted in substantial additional costs. The Company's argument does not consider that  
25 issues surrounding odor complaints were heavily litigated and briefed in the last case and likely  
26 required a comparable amount of time and effort by the parties. Indeed, the odor issue was described  
27 as "the most contentious issue" in the prior case. (*See*, Decision No. 69164, at 30-37.)

28 We will therefore allow \$180,000, amortized over three years, as the reasonable level of rate

1 case expense for BMSC in this case.

2 **6. Testing Expense**

3 BMSC incurs wastewater chemical testing expenses for both its Boulders wastewater  
4 treatment plant ("WWTP" or "treatment plant") and pursuant to its contract with the City of  
5 Scottsdale for treatment of the remainder of the Company's wastewater. Staff engineering witness  
6 Dorothy Hains determined that BMSC's annual testing costs are \$15,222, which is Staff's  
7 recommendation as an allowable expense in this case. (Ex. S-2, at 3-4.)

8 Company witness Sorenson stated that BMSC agreed with the minor adjustments  
9 recommended in Staff's surrebuttal testimony. However, he indicated that after the filing of Staff's  
10 direct testimony, the Company received notification from Scottsdale that additional testing should be  
11 undertaken by BMSC. Mr. Sorenson testified that in addition to the testing done at the Boulders  
12 WWTP, Scottsdale suggested that the Company employ a different sample point and conduct  
13 additional tests. (Ex. A-2, at 14.) The Company claims that the testing requirements would cause  
14 BMSC to incur additional annual testing costs of \$13,360 annually. (*Id.*) RUCO agreed that it is  
15 reasonable to increase the testing costs, but adjusted the amount slightly, to an additional \$12,094, to  
16 reflect known and measurable July 2009 testing costs. (Ex. R-4, at 16.) In its Final Schedules, BMSC  
17 requested an increase of \$12,094 over its original testing expense request of \$16,955, for total testing  
18 expense of \$29,049. (BMSC Final Sched. C-2, at 9.1.)

19 Staff witness Hains disputes the need for additional testing costs. She claims that the  
20 September 29, 2009 letter, upon which the Company relies for requesting additional testing expenses,  
21 does not mandate the additional testing but only "suggested" that the tests be performed. (Ex. S-2, at  
22 4.) According to Ms. Hains, the current contract between the Company and Scottsdale indicates that  
23 quarterly testing is all that is required and the Company has no obligation to alter its testing until the  
24 contract expires in 2016. (*Id.*)

25 According to the letter sent to BMSC by Bill Hurd<sup>4</sup>, although the current contract does not  
26 specify the testing compliance requirements, the sample provided by BMSC does "not appear to met  
27

28 <sup>4</sup> Mr. Hurd is identified as the Pretreatment Coordinator for the City of Scottsdale's Water Quality Division.

1 (sic) the sample collection methods approved by Scottsdale Revised Code Sec. 49-91 or 40 CFR  
 2 403.12(g)(3) and (4).” (Ex. S-2, at Ex. 2.) The letter goes on to state that:

3 I suggest BMSC mirror the sampling schedule requirements the City of  
 4 Scottsdale follows for its discharge to the City of Phoenix. *I have*  
 5 *attached with this letter a summary of the parameters and frequency*  
 6 *required. Conformance to required sampling protocols for the collection*  
 7 *of these samples is mandatory.*

8 (*Id.*, emphasis added.)

9 As reflected in the passage above, it is difficult to interpret Scottsdale’s letter as anything  
 10 other than a mandatory requirement that BMSC follow the testing parameters set forth in the  
 11 attachment to the letter. Although we make no finding as to whether Scottsdale’s additional testing  
 12 requirements are consistent with the terms of the contract, we agree with BMSC that it is appropriate  
 13 to perform the tests identified by Scottsdale. We further agree that the Company’s requested total net  
 14 testing expenses of \$29,049 are reasonable and should be approved.

#### 15 7. Shared Services Expense

16 As discussed above, BMSC does not operate as a stand-alone company but is operated by  
 17 Liberty Water, along with six other water and wastewater companies in Arizona and eleven other  
 18 regulated water and wastewater companies in Texas, Missouri, and Illinois. (Ex. A-1, at 1.) BMSC  
 19 does not have any employees, and Liberty Water provides all of the administration and operations  
 20 personnel for the regulated utilities operating in the United States. Liberty Water is wholly owned by  
 21 APIF, a Canadian entity that that is the ultimate parent company of approximately 71 companies,<sup>5</sup> 17  
 22 of which are part of the regulated “utilities group,” and the remainder within the unregulated “power  
 23 generation group” that produces and sells wholesale power, primarily from hydroelectric facilities, in  
 24 Canada and the United States. (Tr. 301.)

25 In its last rate case, BMSC sought recovery of central office costs billed by APIF, plus a profit  
 26 margin on those services, as part of a non-negotiated “shared services” agreement between APIF and

27 <sup>5</sup> Staff proposed using the 71 total number of companies that were under the APIF umbrella at the end of the test year, but  
 28 BMSC contends the proper allocation should be based on a total of 63 affiliate companies because APIF has only an  
 operating interest in the 8 additional companies but does not actually own them. However, the Company’s witness, Mr.  
 Bourassa, testified that “APIF now owns and operates 71 different assets in North America.” (Ex. A-8, at 24; Tr. 300-  
 302.)

1 Liberty Water's predecessor. (Decision No. 69164, at 12-13.) In that Decision, we indicated that the  
 2 allocation of central office expenses under a shared services allocation model was an issue of first  
 3 impression, and we disallowed only the clearly identified "profit" portion of the allocated expenses,  
 4 stating:

5 We will not countenance a corporate shell game that allows companies to  
 6 hide behind corporate structures in order to avoid scrutiny of what would  
 7 normally be the function of the regulated public service company....We  
 8 believe it is inherently unreasonable for an affiliate company that performs  
 9 all of the operational functions of the utility company, under a non-  
 10 negotiated contract, to seek an additional profit margin simply because the  
 11 affiliate was structured as a separate corporate entity. The question that  
 12 must be asked is whether an affiliate company under common ownership  
 13 and control should be permitted to add an additional layer of profit, and to  
 14 do what a regulated public service corporation is otherwise legally  
 15 prohibited from doing (*i.e.*, recover an additional profit margin for its  
 16 services), based solely on the parent company's decision to create a  
 17 separate affiliate company. Our answer is a resounding no.

18 (*Id.* at 17-18.)<sup>6</sup> Although we excluded only the "profit" portion of allocated central office expenses in  
 19 that prior BMSC case, we also stated that:

20 [W]e make no finding as to the reasonableness of the Algonquin affiliate  
 21 structure and, in future cases involving the Algonquin companies, we  
 22 expect all affiliate salaries, expenses, and billings to be scrutinized to  
 23 avoid potential abuses.

24 (*Id.* at 19.) It is against this background that we consider BMSC's request in this case to recover an  
 25 allocated portion of operating expenses that flow through Liberty Water.

26 **a. Overview of Allocation Methodology**

27 Company witness Bourassa stated that, since BMSC's last rate case, APIF "developed  
 28 methodologies consistent with rate making practices to allocate and record shared costs used by  
 29 similarly situated holding companies," and has excluded affiliate profit from the requested expenses.  
 30 (Ex. A-4, at 14.) He explained that BMSC's proposal in this case is based on a new allocation  
 31 methodology in which "operation labor costs are directly allocated based on operator time,  
 32 accounting and billing costs are allocated based on a customer allocation factor, and corporate  
 33 overhead is allocated based upon a 4-factor methodology." (*Id.* at 14-15.)

<sup>6</sup> In Decision No. 69664 (June 28, 2007), we similarly disallowed the profit portion of APIF allocated central office expenses for BMSC's affiliate, Gold Canyon Sewer Company.

1                   **b.     Liberty Water Allocations**

2           Liberty Water provides all of the day-to-day administrative and operations personnel for  
3 BMSC and each of the other 16 regulated utility companies in Arizona, Texas, Illinois and Missouri.  
4 Liberty Water charges BMSC and the other companies the dollar hourly rate per employee, grossed  
5 up by 35 percent for payroll taxes, health benefits, retirement plans, and insurance. Other services,  
6 such as accounting, billing, customer service, human resources, health and safety, and corporate  
7 finance are not allocated on a timesheet basis but are, instead, allocated based on the customer counts  
8 for each of the 17 utility companies.

9           Other overhead expenses, such as rent, insurance, administration costs, depreciation of office  
10 furniture, and computers, are allocated to BMSC and the other utilities through a weighted four-factor  
11 methodology based on total plant, total customers, expenses and labor. These costs are allocated  
12 based on actual costs.

13                   **c.     Corporate Central Office Cost Allocations**

14           Under the APIF allocation methodology, a number of general expenses incurred by APIF's  
15 operating arm, Algonquin Power Trust ("APT"), at its headquarters in Oakville, Ontario, are billed to  
16 its subsidiaries, both regulated and unregulated, through a formula developed since BMSC's last rate  
17 case. The types of central office expenses that are billed to affiliates include: administrative fees for  
18 rent, depreciation and office costs; corporate tax preparation costs; corporate audit costs; unitholder  
19 (shareholder) communication expenses; escrow fees for payment of dividends; strategic planning  
20 expenses; benefits consulting; capital market advisory expenses; APIF management fees for strategic  
21 management of APIF facilities; trustee fees for Trustee Board meetings; APIF professional services  
22 fees; corporate general legal expenses; budget support and planning; financial support and planning;  
23 human resources; employee benefits; and information systems and regulatory services.<sup>7</sup> (Ex. A-6, at  
24 18-24; Tr. 189, 196, 296.)

25           The Company asserts that the services provided by APT are necessary to allow the  
26

27 <sup>7</sup> No written document was presented at the hearing describing the allocation methodology and services because no  
28 written summary of the methodology apparently existed. However, BMSC attached to its reply brief a 17-page document  
titled "Liberty Water Affiliate Cost Allocation Methodology" ("Allocation Report") that was prepared as an exhibit in the  
pending LPSCO rate case. (BMSC Reply Brief, Ex. 1.)

1 subsidiaries to have access to capital markets for capital projects and operations, and for the affiliates  
2 to provide a high level of service at the lowest cost. (Allocation Report, at 3.) The Allocation Report  
3 indicates that the expenses for the various central office services are routine and recurring in nature,  
4 and are incurred as part of normal business operations for the affiliated companies. (*Id.*)

5 The first step of the methodology involves an initial allocation of 26.98 percent of total  
6 corporate overhead (approximately \$4,000,000 during the test year) to Liberty Water, based on it  
7 being comprised of 17 of the 63 APIF affiliates (*i.e.*,  $17/63=26.98$  percent). The remainder of the  
8 \$4,000,000 is billed to the other 46 unregulated affiliates. (*Id.*)

9 The next step of the process is an allocation between the 17 Liberty Water operating  
10 companies based on the number of customers served by each of the affiliates. The Company claims  
11 that the general Liberty Water costs inure to the benefit of all 17 companies, but the cost  
12 responsibility is assigned on the basis of customer counts to ensure the costs are paid by the  
13 originator. (*Id.* at 3-4.)

14 The Allocation Report indicates that the fundamental principle of the allocation methodology  
15 is that each of the regulated operating water and wastewater companies “should be charged for all  
16 costs incurred by affiliates – both Liberty Water and APT – so that the [utility affiliates] can provide  
17 a high level of safe and reliable water and wastewater utility service to customers.” (*Id.* at 4.)

18 **d. BMSC’s Position**

19 In addition to the direct labor allocations made by Liberty Water based on timesheets, BMSC  
20 is assessed expenses for items such as accounting, billing, customer service, and human resources.  
21 BMSC contends that these types of services are not capable of being allocated on a per company  
22 timesheet basis because it is not practical to keep track of employee time that is devoted to multiple  
23 companies in small increments. As an example, the Company points to the shared call center that  
24 fields calls from customers of all of the regulated utilities and which costs are then allocated to each  
25 of those companies on a customer count basis. At the hearing, Company witness Sorenson responded  
26 to another example in which an accountant or information technology employee that is hired for one  
27 of affiliates in Texas or Arizona. He stated that the costs associated with that employee would be  
28 placed into the “pool” of costs allocated by Liberty Water to each of the 17 utility companies,

1 irrespective of the direct benefit provided to any specific company. (Tr. 394-404.) For other  
2 expenses such as rent, office furniture depreciation, and computers, the Company argues that its four-  
3 factor allocation methodology is reasonable and is used by other Arizona utilities such as Chaparral  
4 City Water Company and Global Water.

5         With respect to the APT central office allocations, BMSC claims that it is appropriate for the  
6 operating companies to be assessed an allocated share of those costs because the services provided by  
7 APT, and by extension APIF, allow even smaller companies like BMSC to benefit from expertise and  
8 resources that might not otherwise be available. In addition to tax, accounting, legal, and  
9 administrative services, the Company points to the access to capital markets and strategic planning as  
10 examples of services that companies like BMSC could not afford if operated as a stand-alone entity.  
11 BMSC contends that the allocated amount is minimal relative to the high levels of expertise  
12 available, and that the inclusion of general administrative expenses incurred by APT at its Canadian  
13 headquarters is reasonable.

14         BMSC disputes Staff's recommended adjustments to the allocation process. The Company  
15 asserts that Staff's removal of 90 percent of the APT costs, before even reaching the second step of  
16 the allocation process at the Liberty Water level, is inappropriate and appears to be based primarily  
17 on Staff's claim that it did not have sufficient documentation to support the central office costs.  
18 BMSC argues that it answered dozens of data requests on expense issues, and provided all invoices  
19 for expenses over \$5,000 related to allocated costs.

20         The Company also disagrees with Staff's claim that the allocation of APT expenses such as  
21 administrative, central office, and third-party professional services does not benefit BMSC. The  
22 Company asserts that, unlike labor costs that are directly allocable by Liberty Water, the APT  
23 expenses are incurred for the benefit of all APIF subsidiaries, regulated and unregulated, and that the  
24 second allocation step based on customer counts provides assurance that each of the regulated  
25 operating companies pays its fair share of those costs. BMSC argues that APT would not incur the  
26 central office expenses if ownership of the utilities and generation assets did not exist, and the model  
27 must be applied as a whole and not in divisible parts.

28 ...

1                   **e.       RUCO's Position**

2           RUCO offered no testimony and took no position on this issue.

3                   **f.       Staff's Position**

4           Staff witness Crystal Brown recommended an allocation approach that differs substantially  
5 from the Company's proposal. She stated that the costs of a regulated company, such as BMSC,  
6 "should only include those costs that would have been incurred on a "stand-alone basis." (Ex. S-5,  
7 at 14.) Ms. Brown explained that, in Staff's view, costs incurred primarily for the benefit of  
8 unregulated affiliates should not be shifted to the regulated companies owned by a parent company  
9 because such cost-shifting could result in captive utility customers subsidizing the unregulated  
10 business interests. (*Id.*) Ms. Brown defined stand-alone basis as "reflecting the costs as if the  
11 regulated utility produced the service by itself." (*Id.* at 15.)

12           Staff indicated that BMSC was assessed \$26,944 for test year corporate overhead from APIF,  
13 as a result of the total \$3.95 million total allocated costs. (*Id.*) Ms. Brown claims that Staff reviewed  
14 the underlying invoices supporting the allocated costs and determined that BMSC did not identify the  
15 costs as "direct" (costs that can be identified with a particular service) or "indirect" (costs that can not  
16 be identified with a particular service), in accordance with NARUC Guidelines for Cost Allocation  
17 and Affiliate Transactions. She stated that the NARUC guidelines require that costs primarily  
18 attributable to a business should be, to the extent appropriate, directly assigned to that business  
19 operation. (*Id.* at 16.)

20           During its review, Staff identified \$191,828 of the \$3.95 million that it claims should not be  
21 considered. Ms. Brown stated that the disallowed amounts included \$68,350 for charitable  
22 contributions, \$5,066 for hockey game tickets, \$3,500 for Super Bowl tickets, \$16,864 for gold  
23 watches and clocks, and \$33,000 for IRS taxes and penalties related to the affiliate's unregulated  
24 business.<sup>8</sup> (*Id.*)

25           Based on its review of supporting documentation, Staff concluded that many of requested  
26 central office expense allocations should be disallowed in their entirety (*e.g.*, rent, other professional  
27

28 <sup>8</sup> In rebuttal testimony, Mr. Bourassa agreed to remove the \$191,828 identified by Staff which, converted from Canadian to U.S. dollars, totals \$182,693. (Ex. A-6, at 18.)

1 services, management fees, unit holder communications, Trustee fees, office costs, fees and permits,  
 2 escrow and transfer fees), and that others (*i.e.*, audit fees, tax services, legal fees, and depreciation  
 3 expense) should be allocated 90 percent to APIF and 10 percent to the 78 companies owned or  
 4 operated by APIF.<sup>9</sup> In other words, after Staff excluded 90 percent of the allowable type of costs, it  
 5 then allocated the remaining 10 percent on an equal 1/78 basis to each affiliate company. The 1/78  
 6 method produces an allocation factor of 1.28 percent for BMSC that, as applied to the 10 percent of  
 7 Staff's allowable service costs, results in a total allocation of \$1,451.59 to BMSC for corporate  
 8 central office expenses. (*Id.*, Sched. CSB-12.)

9 In support of its recommended disallowances, Staff asserts that APIF's central office expenses  
 10 are incurred primarily for the benefit of its unitholders, rather than the regulated utility companies.  
 11 Ms. Brown claims that the central office costs would have been incurred even if APIF did not own  
 12 BMSC and, as such, the benefit to BMSC is only incidental to APIF's for-profit operations. (Ex. S-6,  
 13 at 27.) With respect to specific service costs, such as for tax preparation and audits, Ms. Brown  
 14 contends that BMSC would incur only minor expenses for those services if it were operated on a  
 15 stand-alone basis. (*Id.* at 27-28.)

16 **g. Resolution**

17 Although we agree, as a general proposition, that a shared services model may provide  
 18 economies of scale that result in more efficient operations, the common expenses that are incurred  
 19 and allocated to regulated utility companies must provide a clearly defined benefit to customers to be  
 20 considered reasonably necessary for the provision of service. As discussed in BMSC's prior rate  
 21 case, the cost of services provided by affiliated entities, under non-negotiated no-bid agreements,  
 22 must be given greater scrutiny because the company being billed for those services is effectively  
 23 without input regarding the types of services provided, or the cost of those services. In addition, the  
 24 subsidiary company has virtually no recourse against the parent company's decision to assess  
 25 common expenses that are incurred at the parent level.

26 While the standard to be applied in consideration of common expenses may not necessarily be

27 \_\_\_\_\_  
 28 <sup>9</sup> Ms. Brown used 78 companies in her allocation based on an average of the number of total companies that APIF owned  
 or operated at the end of 2006 (85) and at the end of 2007 (71). (Ex. S-5, at 17.)

1 what the utility would have required as a stand-alone company, the allocated costs must bear some  
2 semblance of reasonableness considering the company's size and service area. For example, a  
3 wastewater company with 2,000 customers, such as BMSC, may not require sophisticated legal,  
4 accounting, billing, and strategic management expertise at the same level as a company with tens of  
5 thousands of customers and a large service territory; and it is not sufficient to simply make the claim  
6 that there exists a nebulous, undefined benefit that may provide a benefit to the regulated subsidiary,  
7 and ultimately its customers. Rather, it is incumbent on the company seeking recovery of a wide  
8 array of corporate office expenses to show that the type of costs being allocated are reasonably  
9 necessary for the provision of utility service provided, and that the level of such expenses is  
10 reasonable.

11 With these parameters in mind, we turn to consideration of BMSC's requested corporate  
12 central office expenses. We are in general agreement with the allocation methodology recommended  
13 by Staff for corporate central office expenses incurred by APIF/APT. As Ms. Brown points out, the  
14 central office costs are related primarily to APIF's function as a holding company that controls both  
15 regulated and unregulated businesses. Given the corporate structure that exists, with a series of  
16 subsidiaries and affiliated companies, we believe that the central office expenses are intermingled  
17 between the regulated and unregulated companies to such an extent that it is not appropriate to allow  
18 an across-the-board recognition of all such expenses for purposes of setting rates. For example,  
19 according to Staff the APIF management fees are related to management of the income fund and no  
20 time sheets or other documentation was provided to show that the central office managers provided  
21 any services that directly benefitted BMSC. (Ex. S-6, at 29.) Similarly, Trustee fees and unitholder  
22 communication fees are incurred by APIF for the purpose of unitholder (shareholder) activities, and  
23 are items that have traditionally been excluded from operating expenses because they benefit  
24 shareholders almost exclusively. We also agree with Staff's exclusion of "APIF Other Professional  
25 Services" fees based on Staff's review that found the supporting invoices were related to special  
26 software for the APIF, and not to payroll matters. (*Id.*)

27 We will therefore allow as reasonable common expenses in this case those items identified by  
28 Staff as properly allocable to BMSC. As set forth in Staff's testimony, those expenses are a

1 reasonable level of audit expenses, tax service expenses, general legal expenses, and depreciation  
 2 expense. (See, Ex. S-5, Sched. CSB-12.) With respect to the allocation methodology, however, we  
 3 find that a modification of Staff's recommendation is appropriate.

4 Based on the record in this case, we adopt the following allocation of common corporate costs  
 5 that we believe represents a level that may be considered reasonable and necessary for the provision  
 6 of service by BMSC.

- 7 1. Allowable common expenses for BMSC in this case shall be  
 8 limited to those items identified by Staff (*i.e.*, audit, tax, legal,  
 depreciation);
- 9 2. The total company allocation for each item, as set forth in Staff's  
 10 testimony, shall be allocated based on the number of regulated  
 11 Liberty Water companies (17) divided by the total number of  
 companies owned or operated by APIF at the end of the test year  
 (71) (*i.e.*,  $17/71 = 23.94\%$  allocated to Liberty Water)<sup>10</sup>;
- 12 3. The Liberty Water allocation shall be further allocated to BMSC  
 13 on the basis of number of customers, as set forth in BMSC's  
 14 testimony. (Ex. A-6, Sched. C-2, at 16.) The allocable percentage  
 15 identified by the Company is 3.18% for BMSC, based on the  
 number of customers relative to Liberty Water's other operating  
 companies.<sup>11</sup>

16 We believe allowing a total of \$9,716 of allowable common corporate central office expenses  
 17 for BMSC represents a reasonable amount in this proceeding based on consideration of the  
 18 Company's overall size, the level of necessary services, and efficiencies available through the APIF  
 19 shared services methodology. The expenses allowed for BMSC in this case, and the methodology  
 20 employed for determination of appropriate central office allocations, is not necessarily applicable to  
 21 other water and wastewater companies that are operated under a shared services structure.

22 As a final matter on this issue, we wish to point out that whether a public service corporation  
 23 in Arizona operates as a stand-alone entity, or as part of a much larger multi-level corporate structure,  
 24 we expect that it will operate in the most efficient manner possible. Denial of a portion of the APIF  
 25

26 <sup>10</sup> In accordance with Staff's testimony, this initial Liberty Water allocation results in \$121,376 for audit expenses  
 (23.94% of \$507,000); \$63,441 for tax expenses (23.94% of \$265,000); \$71,820 for general legal expenses (23.94% of  
 27 \$300,000); and \$48,896 for depreciation expense (23.94% of \$204,242). (Ex. S-5, Sched. CSB-12.)

28 <sup>11</sup> The total central office expenses for BMSC in this proceeding total \$9,716 (3.18% of \$305,533), based on \$3,860 for  
 audit expenses (3.18% of \$121,376); \$2,017 for tax expenses (3.18% of \$63,441); \$2,284 for general legal expenses  
 (3.18% of \$71,820); and \$1,555 for depreciation expense (3.18% of \$48,896).

1 corporate expenses should not be interpreted as an invitation to set up each Arizona company as a  
2 wholly independent utility, or to shun opportunities to share common costs where it is appropriate.  
3 For the Algonquin companies, certain efficiencies are inherent in its operation of multiple systems,  
4 and we anticipate that BMSC and the other Arizona affiliates will continue to provide quality service  
5 at the lowest possible cost.

#### 6 **8. Annualized Labor Cost Allocations**

7 BMSC requested that \$50,302 be included in expenses for known and measurable increases to  
8 allocated accounting/billing and overhead expenses. (Ex. A-6, at 24.) The Company claims that the  
9 increased expenses are related to additional annualized labor costs from annualization of salaries and  
10 wages to a full 12 months, additional labor costs from annualization of pay increases that occurred  
11 during the test year, and the cost of additional employees hired after the end of the test year for  
12 positions that were vacant during the test year. (*Id.*)

13 Staff recommended that the proposed expense adjustment be disallowed because the AWS  
14 (Liberty) employees could work for any of the other Algonquin affiliates and because the increase is  
15 based on "speculation" rather than actual data. (Ex. S-6, at 31.) Ms. Brown stated that the proposed  
16 \$50,302 post-test year increase is in addition to a \$110,000 (28 percent) increase in the management  
17 fees charged to BMSC by AWS between 2007 and 2008 (from \$392,538 to \$502,741). (*Id.*)

18 We agree with Staff that the additional expenses for annualized affiliate labor allocations  
19 should be disallowed. Staff indicated that the increases are in addition to a substantial increase in  
20 allocated labor costs from BMSC's parent between 2007 and 2008, and that the proposed additional  
21 post-test year amounts were not based on actual data reviewed by Staff. Staff's recommendation is  
22 therefore adopted.

#### 23 **9. Performance Pay/Bonuses**

24 Staff recommended that \$13,945 be excluded from BMSC's test year operating expenses for  
25 "bonuses" paid to the Company's employees as part of their compensation. (Ex. S-6, at 24; Sched.  
26 CSB-25.) Staff witness Brown stated that including bonuses in operating expenses is not appropriate  
27 because it represents compensation that is not necessary for the provision of service to customers and,  
28 to the extent such bonuses are not paid in the future, the Company's customers would be required to

1 pay costs that would flow directly to shareholders. (*Id.*)

2       BMSC disputes Staff's characterization of the payments as bonuses, claiming that the  
3 employee pay above base salaries is more accurately characterized as "pay at risk." (Ex. A-3, at 14.)  
4 Mr. Sorenson claimed that the issue is one of total employee compensation, and whether salaries are  
5 commensurate with those paid for comparable jobs in the local and national job market. He stated  
6 that the Company pays wages at prevailing rates, including the pay that remains at risk if  
7 performance falls below certain standards. (*Id.*)

8       We agree with Staff that the performance pay, or bonus pay, should not be included as part of  
9 expenses included in rates. Although the Company seeks to offer assurance that its incentive pay  
10 structure is beneficial to ratepayers because it encourages employee performance, BMSC does not  
11 explain that if rates are set based on the assumption that performance pay/bonuses will always be  
12 paid, only shareholders benefit from non-payment of bonuses while customers continue to pay for  
13 salaries based on superior service even if employee performance is sub-standard. Staff's  
14 recommendation is therefore adopted.

### 15       **C.     Operating Income Summary**

16       Based on the discussion of operating income expenses set forth above, we find the total test  
17 year operating expenses to be \$1,643,016, which based on adjusted test year revenues of \$1,580,170,  
18 results in test year adjusted operating income of \$(62,846).

## 19     **VI.    COST OF CAPITAL**

20       BMSC recommends that the Commission determine the Company's cost of common equity to  
21 be 12.4 percent. Staff recommends a cost of common equity rate of 9.4 percent. Both the Company  
22 and Staff recommend a capital structure of 100 percent equity and no debt. RUCO proposes a return  
23 on equity of 8.22 percent, with a hypothetical capital structure of 40 percent debt and 60 percent  
24 equity, and a hypothetical long-term debt cost of 6.26 percent, resulting in a 7.43 percent weighted  
25 cost of capital (Ex. R-7, at 9-11).

26       Staff witness Juan Manrique explained that the concept of cost of capital relates to the  
27 opportunity cost associated with choosing one investment over others with equivalent risk. He  
28 indicated that the cost of capital represents "the return that stakeholders expect for investing in a

1 determined business venture over another business venture.” (Ex. S-3, at 3.)

2 **A. Capital Structure**

3 Company witness Bourassa stated that BMSC’s capital structure consists of 100 percent  
4 equity because, although the Company has long-term debt on its books associated with the Scottsdale  
5 treatment capacity agreement, that debt service has been included in operating expenses as a lease  
6 pursuant to prior Commission Orders. (Ex. A-5, at 4.) Staff agrees with the Company’s proposed 100  
7 percent equity capital structure (Ex. S-4, at 2). RUCO, however, proposes the use of a hypothetical  
8 structure of 40 percent debt and 60 percent equity (Ex. R-7, at 9-11).

9 According to RUCO witness Rigsby, adoption of his proposed hypothetical capital structure  
10 would take “into account any perceived additional business risk that BMSC may face,” compared to  
11 the average capital structures of his sample companies of 50.4 percent debt and 49.6 percent equity.  
12 (*Id.* at 55.) He stated that his 6.26 percent hypothetical cost of debt recommendation is based on the  
13 average of the weighted costs of long-term debt of his sample companies, and is 13 basis points  
14 higher than the then-current yield on Baa/BBB-rated utility bonds. (*Id.* at 56.) RUCO proposes that  
15 its resulting 7.43 percent weighted average cost of capital (“WACC”) should be adopted in this  
16 proceeding. (*Id.* at 58.)

17 In the most recent case addressing an Algonquin operating company’s cost of capital, we  
18 determined that it was appropriate to adopt a hypothetical capital structure proposed by RUCO. In a  
19 Rehearing Opinion and Order (Decision No. 70624, November 19, 2008), we agreed with RUCO’s  
20 recommended use of a hypothetical capital structure for Gold Canyon Sewer Company consisting of  
21 60 percent equity and 40 percent debt.<sup>12</sup> We therefore adopted RUCO’s recommendation for a cost  
22 of equity of 8.60 percent, and a WACC of 8.54 percent. (Decision No. 70624, at 14.)

23 Consistent with our decision in the Gold Canyon Rehearing Order, we believe it is appropriate  
24 to adopt a hypothetical capital structure in this proceeding. However, we find that a hypothetical  
25 structure that more closely approximates the actual equity and debt on BMSC’s books should be used  
26 in this determination. As Mr. Bourassa pointed out in his testimony, the Company’s test year capital

27 \_\_\_\_\_  
28 <sup>12</sup> Decision No. 70624 was recently affirmed by the Arizona Court of Appeals, Division One, in a Memorandum Decision issued in Case No. 1 CA-CC 09-0001 et al. (May 20, 2010).

1 structure consisted of approximately 19.3 percent debt and 80.7 percent equity, based on adjusted  
2 total capital of \$5,225,205 consisting of \$1,010,649 long-term debt and \$4,214,556 common equity.  
3 (Ex. A-5, at 1-2.) Because BMSC's long-term debt has been treated as an operating lease in prior  
4 Commission Orders, rather than being included in the Company's rate base, the long-term debt has  
5 been excluded from the capital structure for ratemaking purposes.<sup>13</sup> We believe, in this case,  
6 adopting an 80/20 hypothetical capital structure recognizes a reasonable level of debt on the  
7 Company's books and is consistent with our finding in *Gold Canyon* that a capital structure  
8 consisting of 100 percent equity may not be appropriate because equity is generally more costly than  
9 debt for ratemaking purposes.

#### 10 1. Cost of Debt

11 We believe it is appropriate to adopt RUCO's proposed 6.26 percent hypothetical cost of debt,  
12 which is based on the average of the weighted costs of long-term debt of Mr. Rigsby's sample  
13 companies, and is 13 basis points higher than the yield on Baa/BBB-rated utility bonds at the time of  
14 the hearing. Mr. Rigsby pointed out that Arizona Water Company recently reported its weighted cost  
15 of debt as 6.83 percent, and Arizona-American Water had a weighted cost of debt of 5.50 percent.  
16 He indicated that the average of these debt costs is 6.17 percent, which is 9 basis points lower than  
17 his recommended 6.26 percent cost of debt for BMSC. (Ex. R-6, at 57.) We find that RUCO's  
18 recommendation is reasonable and should be adopted.

#### 19 2. Cost of Common Equity

20 Determining a company's cost of common equity for purposes of setting its overall cost of  
21 capital requires an estimation that is both art and science. As evidenced by the competing  
22 methodologies employed in this case, and most other rate cases, there is no clear-cut answer as to  
23 which formula should be used for reaching the appropriate outcome. Rather, the three expert cost of  
24 capital witnesses, Messrs. Bourassa, Manrique, and Rigsby, each rely on various analyses for their  
25 recommendations.

26 As described by Mr. Manrique, two methodologies are typically used for estimating a  
27

28 <sup>13</sup> See, Decision No. 69164, at 7-9. The debt was incurred by BMSC to purchase wastewater treatment capacity of up to 1,000,000 gallons per day from the City of Scottsdale.

1 company's cost of equity: the discounted cash flow ("DCF") model and the capital asset pricing  
2 model ("CAPM"). He stated that the DCF method of stock valuation is based on the theory that the  
3 value of an investment is equal to the sum of the future cash flows generated from the investment,  
4 discounted to the present time. Mr. Manrique indicated that the DCF method is widely used to  
5 estimate the cost of equity for public utilities "due to its theoretical merit and simplicity." The DCF  
6 uses expected dividends, market price and dividend growth rate to calculate cost of equity. (Ex. S-3,  
7 at 14.)

8 The CAPM is used to determine the prices of securities in a competitive market. The model  
9 reflects the relationship between a security's investment risk and its market rate of return. Mr.  
10 Manrique stated that under the CAPM an investor requires the expected return of a security to equal  
11 the rate on a risk-free security, plus a risk premium. (*Id.* at 28.)

### 12 3. BMSC's Position

13 The Company's witness, Mr. Bourassa, based his common equity cost recommendation of  
14 12.40 percent on the results of both constant growth and multi-stage growth DCF models and the  
15 CAPM for six proxy companies (American States Water, Aqua America, California Water,  
16 Connecticut Water, Middlesex Water, and SJW Corp.). Mr. Bourassa also based his recommendation  
17 on a review of economic conditions that he expects to occur while the rates from this case are in  
18 effect; his judgments about risks associated with small companies like BMSC; and his view of the  
19 financial risk associated with debt in BMSC's capital structure. (Ex. A-5, at 4; Ex. A-7, at 3; Ex. A-9,  
20 at 2.)

21 The Company's DCF analysis produced return on equity ("ROE") results for the proxy  
22 companies ranging from 9.9 to 13.5 percent, while the CAPM analysis produced ROE results of 9.9  
23 to 19.4 percent. (Ex. A-5, at 4.) In his rebuttal testimony, Mr. Bourassa described the economic  
24 upheaval in financial markets, the uncertainty that exists regarding economic recovery, and a lack of  
25 available capital for small and mid-sized companies. (Ex. A-7, at 3-4.) He explained that his updated  
26 DCF and CAPM analyses produced results that were lower than originally calculated and, as a result,  
27 the Company lowered its ROE recommendation from 12.80 percent to its current 12.40 percent level.  
28 Mr. Bourassa stated that the average DCF mid-point of his sample companies was 11.7 percent, and

1 the average CAPM mid-point was 13.2, which produced an overall average mid-point of 12.40  
2 percent, which is BMSC's ROE recommendation in this case. (*Id.* at 2.)

3 BMSC criticizes the recommendations of both Staff and RUCO (9.4 and 8.22 percent ROE,  
4 respectively) claiming that adoption of either of their recommendations would make it difficult for  
5 BMSC to attract capital to Arizona considering the returns being earned on other investments by  
6 BMSC's parent company. (Ex. A-2, at 11.) The Company contends that ROE models should not be  
7 used to mask evidence as to what real investors are doing in the real world. BMSC argues that it  
8 must be able to earn a competitive return in order to attract capital for investment in Arizona.

9 With respect to the Staff recommendation, the Company's primary criticism is that Staff  
10 overstated its downward risk adjustment, because the "beta" (risk variable) used by Staff was derived  
11 from Staff's sample group of companies which the Company claims have less risk than BMSC due to  
12 its smaller size. The Company asserts that Staff's application of the so-called "Hamada"  
13 methodology for determining BMSC's risk is improper because the Hamada calculation is intended  
14 to be used only for market values, and not book values. (Ex. A-7, at 5-9; Ex. A-9, at 4-5.)

15 The Company is even more critical of RUCO's ROE recommendation, and the underlying  
16 analysis that formed RUCO's proposal. In addition to several water companies, Mr. Rigsby utilized  
17 10 natural gas utilities in his proxy group, which the Company claims are not comparable to BMSC  
18 because the gas companies have significantly less risk. The Company cites a case involving Arizona  
19 Water, Decision No. 66849 (March 19, 2004), to support its argument that the Commission has  
20 previously rejected the use of a gas company proxy due to the disparity in risk between the gas and  
21 water company sample groups. In *Arizona Water*, the Commission found that the gas company beta  
22 was lower than that for the water companies and should therefore not be used as a proxy for  
23 determining ROE. (*Id.* at 21.) In this case, however, BMSC argues that the gas companies are less  
24 risky and the gas proxy group should not be used. (Ex. A-7, at 15-16.)

25 BMSC also disputes RUCO's use of a geometric mean in its CAPM calculation. Company  
26 witness Bourassa claims that only the arithmetic mean should be used in calculating the market risk  
27 premium of the CAPM, in accordance with the opinions of experts on regulatory finance. (*Id.* at 16.)  
28 In addition, the Company asserts that Mr. Rigsby improperly included U.S. Treasury *total* return in

1 his CAPM calculation, rather than the average *income* return. According to Mr. Bourassa, the  
2 Treasury income return provides an unbiased estimate of the riskless rate of return because an  
3 investor can hold the Treasury to maturity and receive fixed interest payments with no capital loss or  
4 gain; whereas use of the total return on a Treasury security injects additional risk into the CAPM  
5 estimate, which Mr. Bourassa asserts is inconsistent with treating the security as a riskless asset. (*Id.*  
6 at 17.) Mr. Bourassa contends that the net result of these errors is a reduction in RUCO's overall  
7 CAPM result to 6.15 percent, which is below the then-current cost of Baa investment grade bonds.  
8 (*Id.* at 21.) The Company concludes that RUCO's methods contributed to its overall low ROE  
9 recommendation of 8.22 percent.

#### 10 4. RUCO's Position

11 RUCO witness Rigsby based his ROE recommendation on the results of his DCF and CAPM  
12 analyses, which ranged from 5.30 percent to 10.73 percent for his sample group of publicly traded  
13 water and gas companies. His 8.22 percent ROE recommendation is the result of the average of his  
14 DCF and CAPM analyses for his proxy group of gas and water companies. (Ex. R-6, Sched. WAR-1,  
15 p.3.)

16 RUCO contends that Mr. Rigsby's DCF model relied on objective estimates of dividend  
17 growth using *Value Line* analyst projections as a guide. (*Id.* at 25-30.) RUCO disagrees with the  
18 Company's assertion that use of a historic market risk premium in the CAPM is inappropriate.  
19 RUCO argues that past performance is a better indicator of risk than use of analyst projections of  
20 market return and Treasury yields. RUCO also points out that Staff's witness used historic market  
21 risk premium in his CAPM analysis.

22 With respect to the geometric mean argument, RUCO asserts that its historic market risk  
23 premium was based on both a geometric and arithmetic mean analysis of historic returns on the S&P  
24 500 index from 1926 to 2007. Mr. Rigsby stated that it is appropriate to consider both means because  
25 they are widely available to the investment community. (Ex. R-7, at 19.) Mr. Rigsby referenced a  
26 panel discussion he attended in 2007 in which certain regulatory financial analysts concluded that a  
27 reasonable market risk premium would fall between 4.0 and 5.0 percent. He stated that using such a  
28 risk premium in his CAPM analysis would produce ROE results substantially lower than his

1 proposed 8.22 percent ROE, thus confirming the reasonableness of RUCO's recommendation. (*Id.* at  
2 23-25.)

3 RUCO contends that the Company's criticism of Mr. Rigsby's proxy group is misplaced.  
4 According to Mr. Rigsby, natural gas local distribution companies ("LDCs") have similar operating  
5 characteristics to companies such as BMSC, and the LDCs are a good proxy for water and  
6 wastewater cost of capital evaluations. (*Id.* at 15.) He also claims that LDCs have a comparable level  
7 of risk to water and wastewater companies. (*Id.* at 17.) Mr. Rigsby claims that given the current state  
8 of the economy, it is not necessary to make an upward adjustment to his proposed ROE despite his  
9 use of gas LDCs with generally lower betas than water and wastewater companies. (*Id.* at 16.)

10 RUCO asserts that its 8.22 ROE recommendation is reasonable and should be adopted.

#### 11 5. Staff's Position

12 In formulating its ROE recommendation in this case, Staff employed a constant growth DCF  
13 model, a multi-stage DCF model, and a two-part CAPM analysis. The two CAPM estimates were  
14 based on a historical market risk premium and a current market risk premium. Staff's DCF model  
15 produced an average ROE of 9.8 percent; the average of its two CAPM results was 10.7 percent; and  
16 the average of the DCF and CAPM results was 10.3 percent which, after subtracting 0.7 percent as an  
17 indicator of BMSC's lower risk compared to the proxy group,<sup>14</sup> produced Staff's original 9.6 percent  
18 ROE recommendation in this proceeding. (Ex. S-3, at 13-41.) Staff subsequently amended its ROE  
19 recommendation to 9.4 percent, based on: revised DCF results that produced an average ROE of 9.9  
20 percent; a revised average of Staff's CAPM results of 10.5 percent; and an average of the DCF and  
21 CAPM results of 10.2 percent which, after subtracting 0.8 percent as an indicator of BMSC's lower  
22 risk,<sup>15</sup> produced the overall ROE recommendation. (Ex. S-4, at 2.)

23 Staff's cost of capital witness, Juan Manrique, calculated the growth factor for his DCF model  
24 by averaging the results of six growth projection methods.<sup>16</sup> Mr. Manrique explained that Staff's

25 <sup>14</sup> Staff's proxy group is comprised of the same six water companies used by BMSC in its cost of capital analysis. (Ex. S-  
26 3, at 13.) The six companies are American States Water, California Water, Aqua America, Connecticut Water, Middlesex  
Water, and SJW Corp. (*Id.*)

27 <sup>15</sup> Staff's downward adjustment to its ROE results is intended recognize that BMSC, with a capital structure of 100  
percent equity, has a lower financial risk than the sample companies. (Ex. S-3, at 3.)

28 <sup>16</sup> The six methods involve calculations of historical and projected dividends per share ("DPS"), historical and projected  
earnings per share ("EPS"), and historical and projected sustainable growth (Ex. S-3, Sched. JCM-8).

1 DCF analysis included two versions; constant growth (assumes dividends will grow indefinitely at  
2 the same rate) and multi-stage (assumes dividend growth will change at some point in the future. (*Id.*  
3 at 14.)

4 Mr. Manrique agreed with BMSC that, in general, smaller companies have higher betas than  
5 larger companies. However, he stated that the Ibbotson reports underlying the Company's argument  
6 are not specific to the utility industry. Mr. Manrique cited to an article that he claims supports Staff's  
7 position that there is no need to adjust for firm size in utility rate regulation. (Ex. S-4, at 3.) In  
8 response to other criticisms of Staff's methodologies, Staff contends that its recommendation reflects  
9 a properly balanced analysis that takes into account both high and low outcomes. Mr. Manrique  
10 points out that Mr. Bourassa selectively eliminated historical DPS growth rates that produced results  
11 unfavorable to the Company, which Mr. Manrique claims is inconsistent with Staff's cost of equity  
12 estimation analysis that includes a balance of inputs. (*Id.*) In response to the Company's assertion  
13 that only forecasted growth rates should be employed to determine cost of equity, Mr. Manrique  
14 stated that investors also factor into investment decisions considerations such as historic growth rates.  
15 (*Id.* at 4.)

## 16 6. Resolution

17 We believe that Staff's unadjusted average cost of equity capital calculations produce an  
18 appropriate result that is supported by the evidence in the record. The DCF and CAPM are  
19 methodologies that have been used for many years by this Commission, as well as other regulatory  
20 commissions across the country.

21 With respect to the methodology employed for calculating the return on common equity, we  
22 believe Staff's analysis is appropriate and consistent with prior Commission decisions regarding cost  
23 of capital. The companies included in Staff's sample group are the same as those used by BMSC's  
24 witness, and they are appropriate because they have objective data that is publicly available through  
25 *Value Line* and other investor publications. Although we make no finding as to RUCO's  
26 employment of gas LDCs, we believe Staff's sample group of water companies is a better proxy for  
27 assessing BMSC's cost of equity in this proceeding.

28 Article 15, Section 3 of the Arizona Constitution provides in relevant part that the

Commission “shall have full power to, and shall, prescribe just and reasonable classifications to be used and just and reasonable rates and charges to be made and collected, by public service corporations within the State for service rendered therein.” In determining just and reasonable rates, the Commission has broad discretion subject to the obligation to ascertain the fair value of the utility’s property, and establishing rates that “meet the overall operating costs of the utility and produce a reasonable rate of return.” *Scates, et al. v. Arizona Corp. Comm’n*, 118 Ariz. 531, 534, 578 P.2d 612 (Ct. App. 1978). Under the Arizona Constitution, a utility company is entitled to a fair rate of return on the fair value of its properties, “no more and no less.” *Litchfield Park Service Co. v. Arizona Corp. Comm’n*, 178 Ariz. 431, 434, 874 P.2d 988 (Ct. App. 1994), citing *Arizona Corp. Comm’n v. Citizens Utilities Co.*, 120 Ariz. 184 (Ct. App. 1978). The oft cited *Hope*, *Bluefield*, and *Duquesne* cases<sup>17</sup> provide that the return determined by the Commission must be equal to an investment with similar risks made at generally the same time, and should be sufficient under efficient management to enable the Company to maintain its credit standing and raise funds needed for the proper discharge of its duties.

We believe that adoption of Staff’s revised average DCF and CAPM results, which produces a 10.20 percent cost of equity capital, complies with those obligations and results in a just and reasonable return for BMSC based on the record of this proceeding. Given our adoption of a hypothetical capital structure consisting of 80 percent equity and 20 percent debt, it is not necessary to make the additional downward risk adjustment set forth in Staff’s recommendation. Applying the 10.20 percent cost of equity and hypothetical cost of debt to the capital structure results in an overall weighted average cost of capital for BMSC of 9.41 percent.

#### **B. Cost of Capital Summary**

	<u>Percentage</u>	<u>Cost</u>	<u>Wtd. Avg. Cost</u>
Common Equity	80.0%	10.20%	8.16%
Long-Term Debt (Hypothetical)	20.0%	6.26%	<u>1.25%</u>

<sup>17</sup> *Federal Power Commission et al. v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia, et al.*, 262 U.S. 679 (1923); *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989).



1 Necessity ("CC&N"). (*Id.*; Decision No. 50544, January 3, 1980.) Decision No. 50544 indicated that  
2 although the Boulders WWTP was originally intended to serve only the Boulders Carefree  
3 development and golf course, by 1980 it was processing all the treated sewage in Carefree which, at  
4 that time, consisted of approximately 200 customers including 15 commercial users. (Decision No.  
5 50544, at 2.) That Decision stated that the WWTP was operating at its 120,000 gallons per day  
6 ("gpd") capacity, and Boulders Carefree was authorized to construct an additional "package plant" on  
7 the same site to add 60,000 gpd of capacity.<sup>18</sup>

8 Mr. Peterson testified that the Boulders WWTP remains in the same location where it was  
9 originally constructed, and residences were constructed in close proximity to the plant during a period  
10 of rapid expansion. He stated that the WWTP is located less than 100 feet from 3 homes, less than  
11 300 feet from 10 homes, less than 500 feet from 17 homes, and within 1,000 feet of 200 to 300  
12 homes, as well as the primary dining and conference facilities of the Boulders Resort. (BHOA Ex. 4,  
13 at 3-4.) Mr. Peterson claims that the rapid expansion caused severe financial problems for Boulders  
14 Carefree, and required several interim and permanent rate increases in 1981 (Decision No. 52585),  
15 1982 (Decision No. 53300), and 1985 (Decision No. 54537). He indicated that since 1989, flows in  
16 excess of the WWTP's 120,000 gpd capacity have been sent to Scottsdale for treatment, and currently  
17 only 20 percent of BMSC's total annual raw sewage is treated at the Boulders WWTP. (*Id.*)

18 In 1996, Boulders Carefree entered into a new Wastewater Treatment Agreement with  
19 Scottsdale ("Scottsdale Agreement") that permitted Boulders Carefree (and now BMSC) to purchase  
20 increments of capacity of up to 1,000,000 gpd for Scottsdale's treatment facilities at a rate of \$6.00  
21 per gpd. (BHOA Ex. 2.) The Company's wastewater flows not treated at the Boulders WWTP are  
22 diverted into Scottsdale's wastewater treatment system and ultimately delivered to the City of  
23 Phoenix Regional 91<sup>st</sup> Avenue wastewater treatment plant. The Scottsdale Agreement has a term of  
24 20 years and expires at the end of 2016. (*Id.*) BMSC also has a 20-year Effluent Delivery Agreement  
25 with the Boulders Resort ("Effluent Agreement"), executed in 2001, that requires BMSC to deliver  
26 all effluent produced by the Boulders WWTP to the Boulders Resort for landscaping and golf course

27 <sup>18</sup> It is not clear if the additional 60,000 gpd package plant was ever constructed. In addition, the Commission denied the  
28 request by Boulders Carefree to approve a new site for future plant construction because "the request is too indefinite."  
(*Id.* at 3, 10.)

1 irrigation. (BHOA Ex. 3.) According to Mr. Peterson, the Boulders WWTP provides approximately  
2 30 percent of the Boulders Resort's effluent needs, and the remaining 70 percent is purchased from  
3 the Scottsdale treatment facilities. (BHOA Ex. 4, at 8.)

## 4                   2.       **Background of BMSC Odor Issues**

5           The subject of odor problems on BMSC's system has been an ongoing concern for residents  
6 in the Boulders community for a number of years. The nature and depth of customer complaints was  
7 described in BMSC's prior rate case and a proposed remedy was identified and approved in Decision  
8 No. 69164. For purposes of establishing a background for the issue, it is necessary to recount the  
9 facts and findings presented in the prior case.

10           In its prior case, the Company initially took the position that any odor problems that may exist  
11 were not related to the BMSC system. However, the Company later conceded that there was an odor  
12 problem being experienced by certain of its customers. Based on the public comments and sworn  
13 testimony presented by various witnesses in the prior case, there appeared to be general agreement  
14 that the odor problems reported by customers came from two separate sources, the CIE Lift Station  
15 and the wastewater line that flows under Boulder Drive in the Boulders subdivision. (Decision No.  
16 69164, at 30-31.)

17           With respect to the CIE lift station, BMSC recognized the problems associated with the CIE  
18 Lift Station and indicated that it was studying ways to bypass or eliminate the facility. The Company  
19 subsequently entered an agreement with an engineering company to eliminate and bypass the lift  
20 station and ultimately closed the lift station.

21           As described in BMSC's prior rate case, the more complicated odor issue involved ongoing  
22 complaints by residents in the Boulders subdivision, especially along Boulders Drive where the sewer  
23 line flowed to the Boulders WWTP. Testimony given in that case indicated that it was likely that the  
24 odors in the Boulders community were attributable to two problems: the long retention time that  
25 sewage sits in the Boulders line, thereby allowing the sewage to become septic; and "positive  
26 pressure" between the CIE Lift Station and the Boulders WWTP due to the fact that the lines between  
27 the lift station and discharge manholes in the Boulders community are pressurized, but were gravity  
28 lines from the Boulders manholes to the WWTP. (*Id.* at 32.)

1 In the prior case, BMSC asserted that it would be unfair for the Commission to impose  
2 additional odor remediation requirements, beyond compliance with ADEQ and MCESD standards,  
3 especially when such requirements may be beyond the Commission's jurisdiction. The Company  
4 argued that ordering additional remedial steps to be taken was not related to ratemaking, and absent  
5 evidence that BMSC's operations violated the governing odor standards, additional requirements  
6 would constitute improper interference with management of the utility. (*Id.* at 33.)

7 In Decision No. 69164, we rejected BMSC's jurisdictional arguments, finding that "the  
8 evidentiary record in this case amply supports the appropriateness of, and the need for, imposition of  
9 odor remediation requirements as a condition of granting the rate relief approved herein." (*Id.* at 34.)  
10 Citing to several statutes granting the Commission broad powers to remedy problems, in addition to  
11 its ratemaking authority, we directed BMSC to undertake certain specified actions. Specifically, we  
12 indicated that, with respect to a public service corporation's adequacy of service, A.R.S. §40-321(A)  
13 states:

14 When the commission finds that the equipment, appliances, facilities or  
15 service of any public service corporation, or the methods of manufacture,  
16 distribution, transmission, storage or supply employed by it are unjust,  
17 unreasonable, unsafe, improper, inadequate or insufficient, the  
18 commission shall determine what is just, reasonable, safe, proper,  
19 adequate or sufficient, and shall enforce its determination by order or  
20 regulation.

21 We also cited to A.R.S. §40-331(A), which states:

22 When the Commission finds that additions or improvements to or changes  
23 in the existing plant or physical property of a public service corporation  
24 ought reasonably to be made, or that a new structure or structures should  
25 be erected, to promote the security or convenience of its employees or the  
26 public, the commission shall make and serve an order directing that such  
27 changes be made or such structure be erected in the manner and within the  
28 time specified in the order. If the commission orders erection of a new  
structure, it may also fix the site thereof.

29 Finally, we referenced the authority granted to the Commission in A.R.S. §40-361(B), which  
30 provides as follows:

31 Every public service corporation shall furnish and maintain such service,  
32 equipment and facilities as will promote the safety, health, comfort and

1 convenience of its patrons, employees and the public, and as will be in all  
2 respects adequate, efficient and reasonable.

3 Based on these statutes, we concluded the Commission has the authority and the duty to  
4 protect the health, safety and welfare of a public service corporation's customers, and that in order to  
5 protect the security or convenience of the public, the Commission may specify not only the type of  
6 facilities that are required, but the timeframe in which the facilities must be constructed. (*Id.* at 35-  
7 36.)

8 In addition to the specific statutes cited above, we found that A.R.S. §40-202(A), provides  
9 additional supervisory authority to the Commission for regulation of public service corporations<sup>19</sup>.  
10 We also pointed out that the authority granted to the Commission under these statutes, as well as the  
11 Commission's constitutional powers pursuant to Article 15, §3 of the Arizona Constitution, was  
12 discussed in *Arizona Corp. Comm'n v. Palm Springs Utility Co., Inc.*, 24 Ariz. App. 124, 128, 536  
13 P.2d 245, 249 (App. 1975). In that case, the court held that "the regulatory powers of the  
14 Commission are not limited to making orders respecting the health and safety, but also include the  
15 power to make orders respecting comfort, convenience, adequacy and reasonableness of service...."  
16 (*Id.*). Accordingly, we directed BMSC to implement the system changes recommended by Carefree's  
17 witness, or undertake alternative solutions agreed to by the parties to the case, in order to enable all  
18 customers on the BMSC system to enjoy fully their property without enduring offensive odors. (*Id.* at  
19 37.)

### 20 3. Actions Taken by BMSC Following Decision No. 69164

21 Mr. Sorenson testified that BMSC deactivated the CIE lift station and, to address the odor  
22 problems along Boulders Drive, the Company rerouted sewer lines and installed air-jumper pipelines  
23 at four locations along the street between manholes to allow air to flow with the sewage and stop it  
24 from being released into the atmosphere. (Ex. A-1, at 4-5.) To remedy additional odor problems later  
25 discovered on Quartz Valley Court, the Company constructed a new sewer line and grinder pump  
26 station to permit sewage to flow freely. (*Id.* at 5.) He added that BMSC installed an odor scrubber at

27 <sup>19</sup> A.R.S. §40-202(A), provides in relevant part: "The commission may supervise and regulate every public service  
28 corporation in the state and do all things, whether specifically designated in this title or in addition thereto, necessary and  
convenient in the exercise of that power and jurisdiction."

1 the plant, placed heavy rubber mats over grate openings covering treatment basins, and commissioned  
2 a noise study to determine the source of noises emanating from the plant. The noise study led to  
3 several projects aimed at reducing noises coming from the treatment plant. (*Id.* at 6.)

4 According to Mr. Sorenson's direct testimony, the Company's odor remediation efforts have  
5 resulted in reduced odors in the areas leading to the sewer plant, and BMSC had not received a single  
6 odor complaint from surrounding neighbors since the projects were completed. He added, however,  
7 that there continues to be occasional odor events and the Company meets regularly with officials  
8 from Carefree and the BHOA to address their ongoing concerns. (*Id.*) Mr. Sorenson claimed that the  
9 Company has worked with Carefree and Scottsdale to enforce commercial grease trap cleaning  
10 requirements, and to implement a fats, oils and grease disposal program to reduce dumping of those  
11 wastes into the sewer system. He indicated that BMSC has also introduced chemical additives into  
12 the collection system and installed Odor Loggers at the plant to detect and measure hydrogen sulfide  
13 levels. Mr. Sorenson stated that MCESD conducted one inspection since the last rate case, and the  
14 treatment plant was found to have only one minor violation, related to a signage issue that has since  
15 been corrected. (*Id.* at 7.)

#### 16 4. Boulders Community

17 The Boulders WWTP is situated in the midst of, and in close proximity to, a number of  
18 residences. According to the BHOA, odor problems persist in the community despite the Company's  
19 efforts to reduce odors from the collection system. The BHOA argues that the many letters, petitions  
20 and in-person public comment provided by residents confirm the existence of ongoing odor problems  
21 that directly affect their lifestyle, including an inability to leave windows open, noises that disturb  
22 sleep, embarrassment hosting guests at their homes, and putting up with noxious odors on parts of the  
23 Boulders Resort golf course. (*See*, Tr. 10-44.) The BHOA claims that it is now clear that the odors  
24 experienced by Boulders residents were caused not only by the collection system, but also by the  
25 treatment plant. The BHOA also contends that BMSC has been much more cooperative since the  
26 Company's last rate case, when the Commission asserted its authority to require that odor  
27 remediation efforts be undertaken by BMSC. Mr. Peterson explained that BMSC has met regularly  
28 with the BHOA since the last case to identify and attempt to resolve ongoing odor issues. (Tr. 356,

1 362, 371.)

2 The BHOA points out that although it could have intervened to complain about the odor  
3 issues and looked to the Commission to fashion a remedy, it instead worked in cooperation with  
4 BMSC to come up with a solution for the odor issues. As a result of those discussions, BMSC and  
5 the BHOA came to an agreement that provides for closing of the Boulders WWTP, subject to several  
6 conditions. (BHOA Ex. 4, Ex. B.)

7 **5. Wastewater Treatment Plant Closure Agreement**

8 The Wastewater Treatment Plant Closure Agreement ("Closure Agreement") is a settlement  
9 agreement between the Company and the BHOA that requires BMSC to shut down the Boulders  
10 WWTP within 15 months of certain conditions being satisfied. Under the terms of the Closure  
11 Agreement, the conditions summarized below must be met before BMSC is obligated to close the  
12 treatment plant:

- 13 a. Existence of sufficient downstream collection system line capacity and  
14 flow-through capacity to the Scottsdale plant sufficient to  
accommodate the additional 120,000 gpd from the current treatment  
plant;
- 15 b. Successful negotiation of the purchase by BMSC from Scottsdale of  
16 120,000 gpd of additional capacity, and including renegotiation of the  
17 Scottsdale Agreement to allow purchase of the additional capacity  
beyond 2016, and a long-term right by BMSC to purchase additional  
capacity at market rates;
- 18 c. Successful renegotiation of the Effluent Agreement with the Boulders  
19 Resort to allow termination of the agreement with little or no cost to  
BMSC upon closure of the treatment plant;
- 20 d. Approval to close the treatment plant from applicable regulatory  
agencies; and
- 21 e. Approval by the Commission of a cost recovery mechanism that  
22 permits BMSC to recover a return on and of the capital costs of  
closure, including costs of procuring additional capacity from the City  
23 of Scottsdale, costs of engineering and other analyses necessary to  
complete the closure, system upgrades required as a result of the  
24 closure and/or delivery of the flows to Scottsdale previously treated at  
the plant. BMSC must also be authorized to recover reasonable costs  
25 of reaching agreements with BHOA, Scottsdale, and the Boulders  
Resort as required under the agreement, and costs of obtaining  
26 approval from the Commission. BMSC has no obligation under the  
agreement if the Commission does not approve a recovery mechanism  
27 in a form acceptable to the Company.

28 The Closure Agreement also requires BMSC to use all commercially reasonable efforts to

1 complete termination of treatment plant operations within 15 months of satisfaction of the conditions,  
2 and remove all of the treatment plant's structures and equipment not needed for continued operation  
3 of the Company's collection or transportation systems. Following restoration of the plant property,  
4 BMSC would retain full ownership of the site and would be required to sell the site as residential  
5 property, with the gain on the sale being split evenly between shareholders and ratepayers for  
6 ratemaking purposes. (*Id.* at 2-4.)

7                   **6. Positions of the Parties Regarding Closure Agreement**

8                   **a. BMSC**

9           BMSC contends that approval of the Closure Agreement is in the public interest and is a  
10 reasonable response to an extraordinary situation that exists currently on the Company's system. The  
11 Company points to the nearly unanimous support expressed by more than 500 customers, as well as  
12 the Mayor of Carefree, where approximately three-quarters of the Company's customers reside,  
13 through letters, petitions, and live statements, including support for the surcharge mechanism  
14 contained in the Closure Agreement. BMSC noted that support for the plant closure was also  
15 received from residents in the Boulders South community who are members of the OABS rather than  
16 the BHOA.

17           BMSC argues that it complied fully with the directives issued by the Commission in the  
18 Company's prior case to take remedial actions to mitigate odors on its collection and transportation  
19 system, and it has taken other steps beyond those directives such as installing an odor scrubber at the  
20 plant. According to the Company, it has taken all reasonable measures to eliminate odors on its  
21 system, but the presence of the treatment plant within the Boulders community presents an  
22 extraordinary challenge given the age of the plant and its close proximity to residential structures.

23           The Company claims that the treatment plant meets all applicable regulations and that no  
24 party disputes that it is used and useful in the provision of service to customers. However, according  
25 to Mr. Sorenson, BMSC attempted to accommodate its customers and the Town of Carefree by  
26 agreeing to a mechanism that would enable the Company to close the plant. Mr. Sorenson stated that  
27 BMSC would agree to close the plant, reroute sewage flows currently treated at the plant, and acquire  
28 additional treatment capacity only if it receives assurance from the Commission that the Company

1 would not have to wait for a return on and of its investment, or that it would be second-guessed as to  
2 why it agreed to invest more than \$1 million closing a treatment plant that is currently deemed used  
3 and useful. (Ex. A-2, at 7-8.) Mr. Sorenson contends that the plant closure project is estimated to cost  
4 in excess of \$1.5 million, and replacement capacity from Scottsdale for the plant flows would require  
5 approximately \$720,000 (at \$6.00 per gallon). (*Id.*)

6 BMSC witness Bourassa explained at the hearing how the Company envisions that the  
7 surcharge mechanism would operate, and presented an exhibit containing an illustration of the  
8 surcharge calculation. (Ex. A-11; Tr. 243-49.) According to Mr. Bourassa, once the cost of the plant  
9 closure project is known and measurable, an annual amortization would be computed and the return  
10 component, gross revenue conversion, and incremental income tax factors would be employed to  
11 calculate the additional revenue requirement associated with the project. (*Id.*) Under the Company's  
12 proposal, the plant closure revenue requirement would be divided by 12 to determine the overall  
13 monthly surcharge requirement, and that amount would then be divided by the number of customers  
14 to calculate the monthly surcharge per customer. (*Id.*) The same process would be undertaken after  
15 the plant site is sold to reflect the reduction to rate base associated with the sharing of the gain on sale  
16 of the property. Mr. Bourassa suggested that it would also be appropriate to require an annual true-up  
17 of the surcharge amount to avoid under or over-collection of the plant closure costs. (Tr. 249.)

18 For verification purposes, BMSC agrees that the surcharge should not go into effect until Staff  
19 (as well as other interested parties) have an opportunity to review documentation submitted by the  
20 Company in support of the surcharge, to ensure that the claimed costs were spent for the purposes  
21 intended and necessary for closure of the plant. BMSC contends that the process it proposes is  
22 similar to that used by the Commission for arsenic surcharge mechanisms during the past several  
23 years, and the Company contemplates that the Staff review process could be accomplished within 60  
24 days after submission of the necessary documentation, followed by the issuance of a Commission  
25 Order approving the surcharge. (Tr. 248, 252-53.) Mr. Bourassa testified that the requested surcharge  
26 would be comprised only of capital costs related to the plant decommissioning, and no O&M  
27 expenses would be included in the surcharge calculation. (Tr. 254.)

28 The Company disputes RUCO's claim that the proposed surcharge is not justified because it

1 does not address an extraordinary situation. BMSC argues that RUCO's philosophical opposition to  
2 adjustor and surcharge mechanisms should not override the desire expressed by a multitude of  
3 customers that they are willing to pay a surcharge in exchange for relief from ongoing odors caused  
4 by the treatment plant. The Company also claims that the Commission can limit the requested relief  
5 to the unique facts presented in this case in order to prevent the surcharge mechanism from being  
6 cited as precedent in future cases.

7 BMSC contends that RUCO has not offered any viable alternatives to the Company/BHOA  
8 proposal, and requiring BMSC to wait until after the closure project is completed, requiring rerouting  
9 of flows and the purchase of additional capacity, waiting for an additional year to ascertain changes  
10 in operating expenses, and then filing another rate case, is not a reasonable means of remedying the  
11 problems identified in this case. The Company argues that, contrary to RUCO's suggestion, it is not  
12 clear that the Commission has the legal authority to order BMSC to remove plant that is used and  
13 useful, and which is operating within regulatory requirements, because the decision of whether to  
14 close the treatment plant should be considered a decision within management's discretion. BMSC  
15 claims that the statutes cited by the Commission in the Company's last rate case as authority for  
16 ordering odor remediation measures do not expressly authorize the Commission to order the  
17 Company to make a substantial investment to retire used and useful plant. Citing *Southern Pacific*  
18 *Co. v. Arizona Corp. Comm'n*, 98 Ariz. 339, 346-48, P.2d 692, 694 (Ariz. 1965), BMSC contends  
19 that the Commission may not interfere with a utility company's management decisions absent clear  
20 statutory language.

21 The Company suggests that the debate over the Commission's authority should not  
22 overshadow the important concerns expressed by BMSC's customers, and the plant closure proposal  
23 presented in this case is not meant to diminish the Commission's broad powers. Rather, according to  
24 BMSC, its arguments on this point are intended to reflect that there exists a reasonable question as to  
25 whether the Commission has the authority to require the Company to spend substantial funds to  
26 decommission used and useful plant without a funding mechanism. BMSC contends that it is not  
27 necessary to reach that issue in this case because its customers overwhelmingly support paying a  
28 reasonable fee to eliminate the presence of the treatment plant in their community.

1                                   **b.     BHOA**

2           The BHOA also supports approval of the Closure Agreement, for many of the same reasons  
3 cited by the Company. Mr. Peterson testified that, since the last rate case, BMSC has taken a more  
4 cooperative stance in working with the BHOA and Carefree in addressing the odor issues and that the  
5 Company meets regularly with the BHOA and the Town regarding odor concerns. (BHOA Ex. 4, at  
6 5; Tr. 356, 362-63, 371-73.)

7           The BHOA claims that RUCO's skepticism about whether removing the treatment plant  
8 would resolve the odor problems, is misplaced. The BHOA points out that the Closure Agreement  
9 requires that the entire plant be removed, as well as the associated lift station, which would leave only  
10 underground pipes and possibly a sealed manhole at the site. (Tr. 138-39.)

11          The BHOA also disputes RUCO's assertion that the implementation of a surcharge would  
12 violate the matching principle. According to the BHOA, the Commission regularly allows in rate  
13 base post-test year plant that is in service before the hearing in the case, and the Closure Agreement  
14 would allow review by the parties and the Commission of the actual closure costs before they are  
15 included in a surcharge mechanism. (Tr. 248, 252-53.)

16          The BHOA contends that the reasons for Staff's opposition to the Closure Agreement are less  
17 clear. BHOA points out that Staff witness Brown claimed that the Agreement was not relevant to  
18 BMSC's rate case, despite the Commission's lengthy discussion in the last rate case regarding odor  
19 issues. (Tr. 727-28.) The BHOA also asserts that the Staff engineer, Dorothy Hains, agreed that the  
20 Company should remedy the odor issues and, although she did not know if closing the plant would  
21 eliminate all of the odor and noise problems, she believed the closure would reduce the odors at the  
22 current plant site. (Tr. 657-58.)

23          The BHOA states that no party opposes closure of the treatment plant, and the only real  
24 opposition to the Closure Agreement is RUCO's concern is with the approval of a surcharge  
25 mechanism absent extraordinary circumstances. The BHOA argues that, contrary to RUCO's  
26 assertion, the ongoing odor problems do represent an extraordinary situation that calls for an  
27 extraordinary solution. The BHOA claims that the remedy afforded by the Closure Agreement,  
28 including implementation of a surcharge mechanism, is justified as a proportional response to the

1 demand by customers to eliminate the treatment plant in order to solve the odor problems. As  
 2 outlined by the BHOA, the level and magnitude of concern about this issue is evidenced by customer  
 3 claims that the plant odors are extremely offensive and interfere with enjoyment of their property.  
 4 BHOA concludes that given the Commission's prior expressions of a need to remedy odor issues, as  
 5 well as the customers' overwhelming support for closure of plant and willingness to pay increased  
 6 rates for that purpose, the Commission should approve the mechanism proposed in the Closure  
 7 Agreement.

8 **c. RUCO**

9 RUCO contends that it does not oppose closure of the treatment plant, as provided for in the  
 10 Closure Agreement, but it does oppose the funding mechanism contained in that agreement. RUCO  
 11 witness Rigsby stated that RUCO's primary concern "is whether or not the terms of the proposed  
 12 Agreement will actually solve the odor problem." (Ex. R-7, at 4.) He claims that RUCO is also  
 13 concerned about "the broader ratemaking impacts and precedents that the Agreement may have on  
 14 those BMSC residential ratepayers that are not directly affected by the odor problems and on Arizona  
 15 residential ratepayers in general." (*Id.*)

16 According to Mr. Rigsby, there is no definitive agreement as to the source of the odor  
 17 problems and the Commission should ascertain the actual source of the odors before adopting the  
 18 Closure Agreement. (*Id.*) With respect to the ratemaking implications of approving a surcharge, Mr.  
 19 Rigsby cites to two prior cases involving Arizona Water wherein the Commission discussed potential  
 20 concerns with "automatic adjustment mechanisms." (*Id.* at 5-6.)<sup>20</sup> Mr. Rigsby claims that the same  
 21 type of "mismatch" concerns would be presented with the mechanism proposed in the Closure  
 22 Agreement. He distinguished the proposed surcharge mechanism in this case from arsenic cost  
 23 recovery mechanisms on the basis that the arsenic reduction requirements were imposed by federal  
 24 regulations and had a substantial impact on certain water utilities in Arizona. (*Id.* at 7-8.) Mr. Rigsby

25 \_\_\_\_\_  
 26 <sup>20</sup> In Decision No. 66849 (March 19, 2004), at 13-14, the Commission discussed automatic purchased power and water  
 27 adjustment mechanisms for Arizona Water and stated that such automatic pass-throughs could provide a disincentive to  
 28 obtain the lowest possible costs for those commodities. In Decision No. 68302 (November 14, 2005), at 45-46, the  
 Commission expressed concerns with adjustment mechanisms because they allow automatic adjustments without a  
 simultaneous review of unrelated costs. The Commission concluded that such mechanisms should only be used in  
 "extraordinary circumstances."

1 recommended that the Commission reject the Closure Agreement's recovery mechanism, and only if  
2 "the treatment facility is found to be the source of the odor problem...[should] the Commission allow  
3 BMSC to retire the treatment facility and require the Company to file a general rate case application  
4 twelve months after the retirement." (*Id.* at 9.)

5 Mr. Rigsby testified that he is not aware of any prior cases where a substantial number of a  
6 company's customers came forward and agreed to imposition of a surcharge in exchange for remedial  
7 action, but indicated that the situation does not rise to the level of an extraordinary event that would  
8 justify a recovery mechanism. (Tr. 529-31, 560-61.) He explained that because it is RUCO's role to  
9 represent residential ratepayers, "yeah, I guess it's – you want to put it that way, that we are trying to  
10 save people from themselves or we are trying to put forth an alternative that might work out better in  
11 their interest in the long run." (*Id.* at 527.) He admitted, however, that the "alternative" RUCO was  
12 suggesting (*i.e.*, allowing deferral of the capital costs associated with the closure project through an  
13 accounting order), would likely not actually help the Company or its customers, or cause BMSC to  
14 voluntarily decommission the plant. (*Id.* at 527-29, 552-62.)

15 RUCO argues on brief that it is concerned with the unintended consequences of approving a  
16 recovery mechanism because it would not limit the monetary impact on customers, and the Company  
17 did not identify when it plans to file its next rate case. RUCO theorizes that BMSC could continue to  
18 assess the Closure Agreement surcharge indefinitely, thereby producing a windfall for shareholders at  
19 the expense of ratepayers. (RUCO Reply Brief at 8.)

20 **d. Staff**

21 Staff asserts that odors are an unavoidable byproduct of the sewer business and it is not  
22 certain that removing the treatment plant and lift station would resolve all of the odor problems that  
23 currently exist. Staff's engineer testified at the hearing that odors could come from other parts of the  
24 Company's system, including other lift stations, although she agreed that the public comment by  
25 customers indicated that the odors were caused by the treatment plant. (Tr. 640-41.)

26 Staff witness Hains testified at the hearing that because houses in Arizona typically have air  
27 conditioning, residents could keep their windows shut to avoid unpleasant odors because the odors  
28 are not constant. (Tr. 650-51.) She suggested that BMSC could place additional odor control

1 equipment on the plant or completely enclose the plant, and the customers may “have to [choose  
2 between] the odor problem or looking pretty around there.” (*Id.* at 653.)

3 Staff contends that the proposed decommissioning presents a unique set of circumstances, but  
4 that it is difficult to justify removal of the plant since the plant is currently used and useful, it is  
5 functioning normally, and the complaints regarding odors and noises at the plant are due to its  
6 proximity to homes rather than mechanical problems. Staff argues that despite the near unanimous  
7 desire of the Company’s customers to close the treatment plant, “where reliability and compliance are  
8 being met, it is difficult to justify such an exorbitant price tag [estimated \$1.5 to \$2 million] as a  
9 simple gesture of good will.” (Staff Initial Brief at 25.) Staff then states that although there is no  
10 “down side” to the project, except for the cost and possibility that all odors will not be eliminated,  
11 “[i]t is Staff’s position that a consideration of the circumstances yields no clear choice.” (*Id.* at 26.)

#### 12 7. Resolution

13 Based on the unique facts and circumstances presented in this case through testimony and  
14 exhibits, and upon consideration of the overwhelming and extraordinary level of customer  
15 participation and comment in support of closure of the Boulders WWTP, we find, subject to the  
16 clarifications and modifications discussed herein, that the Closure Agreement proposed by the  
17 Company and the BHOA represents a reasonable resolution of the current odor concerns expressed  
18 by hundreds of BMSC’s customers.

19 We do not believe that customers should be required to endure offensive odors at levels and  
20 frequencies that have been described in the public comments provided in this case. As we have  
21 indicated previously, although public comment is not considered evidence in a proceeding, it  
22 provides useful insight to the Commission regarding customer experiences, both observational and, in  
23 this instance, olfactory. In addition to the more than 500 public comment letters and petitions filed in  
24 this case requesting closure of the treatment plant, and expressing agreement with implementation of  
25 a surcharge, a number of customers traveled to the Commission to offer in-person public comment on  
26 the first day of the hearing. The Mayor of Carefree, David Schwann, stated that he believes the  
27 citizens of the Town support the agreement negotiated by the BHOA, even those residents not  
28 directly affected by the odors from the treatment plant. (Tr. 10-12.) Other residents described dealing

1 with odor issues for more than 20 years, and the level of frustration with not having a solution to the  
2 problem; the need to apologize to guests for having to endure “third world [odor] conditions in a first  
3 class resort;” ongoing odor issues despite improvements along Boulders Drive after the prior case;  
4 not being to eat meals on the patio due to odors; the almost unbearable smell on parts of the golf  
5 course; and an inability to barbecue because of the treatment plant odor, and continuous blower  
6 noises from the plant. (Tr. 12-25.) A resident of the South Boulders community, and member of the  
7 OABS, indicated that visitors to the Boulders Resort golf course are “amazed and disgusted” by the  
8 smell from the treatment plant that is located near several holes on the course (Tr. 26-27), while  
9 another resident described having to move Thanksgiving dinner indoors from his patio due to the  
10 treatment plant odors. (Tr. 30-31.) A former reporter indicated that he did not live close to the plant  
11 but experienced odors when passing by the vicinity of the plant (Tr. 32), and another resident stated  
12 that the odors from the plant are hurting home values and, despite BMSC’s efforts to solve the  
13 problem, there does not appear to be a solution short of decommissioning the plant. (Tr. 34.) Another  
14 resident claimed that the treatment plant was intended as a temporary facility to serve a small number  
15 of homes and the plant is more than 40 years old and is obsolete. He added that because an  
16 alternative is available through rerouting of flows to the Scottsdale treatment facility, and because the  
17 odors are “a blight on real estate titles in the area,” the only viable solution is closure of the plant. (Tr.  
18 37-38.) A customer that lives adjacent to the treatment plant stated that he has been awakened during  
19 the night by loud banging noises from the plant, that he is embarrassed to invite guests over, and he  
20 must keep his doors and windows closed to block odors from the treatment plant. He also expressed  
21 health-related concerns with living near the treatment plant due to the use of chemicals at the site.  
22 (Tr. 39-40.) A mother with young children indicated that the treatment plant should be  
23 decommissioned because the equipment is antiquated and inefficient, and that closure is necessary to  
24 provide a healthy environment for families living in the community. (Tr. 42-43.) Numerous other  
25 customers appeared at the hearing and signed slips indicating that they did not wish to speak but  
26 supported closure of the treatment plant and the Closure Agreement, including the surcharge  
27  
28

1 mechanism.<sup>21</sup>

2       The public comments offered in this proceeding make clear that customers in BMSC's service  
3 area, especially those living in close proximity to the treatment plant, have endured and continue to  
4 endure offensive odors related to the Boulders WWTP. The unrefuted evidence establishes that: the  
5 treatment plant is more than 40 years old; the plant was not intended to be a permanent sewage  
6 treatment solution and was not designed to serve more than a fraction of the Company's current  
7 customer base; and houses were built closer to the plant than was initially intended and closer than  
8 current regulations would permit. The record also indicates that despite its age, the treatment plant  
9 operates within regulatory limits imposed by ADEQ and MCESD with respect to odors and noises,  
10 and that the plant is considered used and useful for purposes of setting rates. Given these established  
11 facts, and considering the almost unanimous support by customers for closing the plant, it was  
12 entirely appropriate for the Company to engage affected parties in settlement discussions to find an  
13 acceptable solution to the odor problems. The product of those discussions is the Closure Agreement,  
14 which was executed by the Company and the BHOA.

15       As summarized above in detail, the Closure Agreement provides that BMSC will, among  
16 other things: close the Boulders WWTP within 15 months of satisfaction of the listed conditions;  
17 acquire additional capacity rights with the City of Scottsdale to replace the treatment plant capacity;  
18 renegotiate the Effluent Agreement with the Boulders Resort to allow termination of the agreement;  
19 obtain regulatory approvals from applicable regulatory agencies; undertake engineering and other  
20 analyses necessary to complete the closure; and complete system upgrades required as a result of the  
21 closure and/or delivery of the flows to Scottsdale previously treated at the plant.

22       Staff's position on the Closure Agreement is not entirely clear, but it appears Staff's only  
23 concern is that there may still be odors on BMSC's system even if the treatment plant is closed and  
24

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25 <sup>21</sup> The only opposing public comment at the hearing was from Max Schirtzinger, an intervenor who stated that he is a  
26 professional engineer. Although Mr. Schirtzinger was granted intervention, he did not pre-file testimony. At the hearing,  
27 Mr. Schirtzinger agreed that his "opening statement" would be treated as public comment. (Tr. 79-81.) He offered a  
28 number of comments related to alleged deficiencies in the Company's operation of the treatment plant, and suggested that  
the plant should remain in operation as a "water reclamation facility." (Tr. 73-74.) Mr. Schirtzinger added that: if the  
plant is decommissioned, the entire Company should be decommissioned and the City of Scottsdale should assume  
operational control; customers should not bear the costs of decommissioning; and he suggested that instead of  
decommissioning, the treatment plant could be upgraded to treat 240,000 gpd of wastewater flows. (Tr. 75-78.)

1 therefore the cost of decommissioning the plant is too high. Although it is likely some odors will  
2 continue to be noticed on occasion from other parts of the Company's system, as is the case with  
3 virtually any wastewater system, the treatment plant appears to be the primary source of the ongoing  
4 and frequent noxious odors described by customers. The odors, as well as loud noises, are  
5 experienced not only by residents that live near the plant, but also by visitors to the golf course and  
6 Boulders Resort. We do not believe it is sufficient, as suggested by the Staff witness, to require  
7 residents and visitors alike to simply deal with the odors and noises from the plant by being forced  
8 inside with closed windows and doors.

9 Nor are we persuaded by the arguments made by RUCO. Mr. Rigsby indicated that, similar to  
10 Staff's assertion, RUCO's primary concern is that the odor problem will not be solved by the plant  
11 closure. However, Mr. Rigsby admitted that closure of the plant and lift station at the plant site,  
12 along with placing all remaining pipes underground, would resolve the odor issues at the current plant  
13 site. There is no evidence that excessive, persistent odors have been experienced on other areas of  
14 BMSC's system (following completion of the CIE and Boulders Drive work) and, to the extent that  
15 future odor complaints are received following the treatment plant's closure, those issues may be  
16 addressed in a future proceeding.

17 RUCO's other concern is that approval of the surcharge mechanism proposed in the Closure  
18 Agreement would open the door for other companies to seek similar relief. Mr. Rigsby cited to two  
19 prior Decisions involving Arizona Water in which the Commission denied proposals for automatic  
20 adjustment mechanisms. Mr. Rigsby conceded, however, that those adjustors were distinguishable  
21 from the mechanism proposed in this case because they involved automatic adjustors for purchased  
22 water and electricity that would have continued in perpetuity unless ended by the Commission,  
23 compared with the temporary surcharge that would end after the first rate case following completion  
24 of the plant's closure. The proposed closure surcharge is actually much more similar to the ACRMs  
25 that have been approved in a number of prior cases, and which were agreed to by RUCO. Indeed, the  
26 proposed surcharge in this case is actually more benign than the ACRM to the extent that the closure  
27 surcharge would allow only capital costs to be recovered, whereas the ACRMs allowed multiple  
28 recovery filings and permitted recovery of some O&M costs in addition to capital costs.

1 Mr. Rigsby agreed that he had never in his many years of experience witnessed a case in  
2 which more than 500 customers submitted and expressed support for closure of a plant, as well as a  
3 willingness to pay a surcharge to complete the closure. He also agreed that to avoid the possibility  
4 that other companies would seek to use the closure surcharge as a means of obtaining adjustment  
5 mechanisms, the Commission could, as it often does, limit the approval to the specific facts in this  
6 case.

7 We believe that allowance of a reasonable surcharge to permit BMSC to collect legitimate  
8 capital costs, for the narrow and explicit purpose of affording relief from noxious odors, is within the  
9 Commission's constitutional and statutory authority and is consistent with our obligation to balance  
10 the interests of public service corporations and their customers. We do not believe that being  
11 responsive to the concerns expressed by customers in this case will open the floodgates to a spate of  
12 adjustment mechanism applications, given the unique characteristics of this case. There is no other  
13 instance recounted in the record in which customers of a company have so overwhelmingly supported  
14 a solution to a quality of life issue, as well as a willingness to pay a reasonable charge to bring that  
15 solution to fruition. RUCO's attempt to save BMSC's customers from themselves is contrary to the  
16 wishes of the very customers RUCO represents. Moreover, RUCO's position fails to give  
17 recognition to the real world experiences that were described so forcefully by customers regarding the  
18 inability to enjoy their own property, the embarrassment of inviting guests to their homes, and the  
19 possibility that treatment plant odors and noises have an effect on community property values.

20 All of these facts, and the broad support shown by customers for decommissioning of the  
21 treatment plant, lead us to the conclusion that the Closure Agreement signed by BMSC and the  
22 BHOA provides an appropriate and creative solution for what we believe is a unique set of  
23 circumstances that is not likely to be repeated. Absent the strong community support for closure,  
24 including the willingness of customers to offset the closure costs through the mechanism surcharge,  
25 as well as the ability of the Company to divert the current treatment plant flows by acquiring  
26 additional capacity from Scottsdale under an existing agreement, it is likely that the Boulders WWTP  
27  
28

1 would have remained in operation for the foreseeable future.<sup>22</sup>

2 We wish to make clear that our approval of the surcharge mechanism approved in this Order  
3 is based solely on the facts of this case, and should not be interpreted as precedent for other surcharge  
4 or adjustment mechanisms. This case presents an extraordinary set of facts and circumstances that  
5 calls for an extraordinary remedy that we believe is achieved by the Closure Agreement.

### 6 8. Surcharge Mechanism

7 Having approved the surcharge mechanism, as outlined in the Closure Agreement, it is  
8 necessary to develop a framework for its operation. Consistent with Company witness Bourassa's  
9 testimony, we find that the function of the surcharge process should be similar to those employed in  
10 the prior ACRM cases. In addition to the conditions set forth in the Closure Agreement, BMSC will  
11 be required to comply with the following requirements:

- 12 a. BMSC will be required to collect and track all surcharge revenues and  
13 expenditures in a separate account to allow expedited review.
- 14 b. In order to effectuate the surcharge, BMSC will be required to file a  
15 set of schedules (and provide copies to the other parties) that includes  
16 the type of information required by Staff to review the ACRM step  
17 increase requests.
- 18 c. Only a single surcharge filing request will be permitted and no  
19 additional "true-ups" will be permitted until the Company's post-  
20 completion rate case.
- 21 d. The Company shall cooperate with Staff and provide all information  
22 requested by Staff to perform its review of the revenues and  
23 expenditures that support the requested surcharge, in accordance with  
24 the terms of the Closure Agreement.
- 25 e. Upon completion of its review, Staff shall prepare a recommendation  
26 for the Commission's consideration and approval. Staff should  
27 attempt to complete its review and recommendation within 60 days of  
28 the surcharge request filing, but no specific deadline will be imposed  
for completion of Staff's review.
- f. The closure surcharge shall not exceed \$15 per month, per customer,  
and shall be discontinued upon issuance of a Decision in the  
Company's first rate case following completion of the closure project.
- g. BMSC will be required to file a full rate application no later than 12  
months after completion of the closure project.
- h. The methodology for calculating the surcharge shall be consistent  
with, although not necessarily identical to, that described in Ex. A-11

<sup>22</sup> We need not, at this time, address the Company's argument that the Commission lacks authority to order that the treatment plant be closed without a recovery mechanism, given the agreement reached with the BHOA.

in the evidentiary record of this proceeding.

- 1 i. The surcharge shall not go into effect until the Commission has  
2 approved the amount of the surcharge following Staff's review and  
3 recommendation.

4 With these additional requirements, we find that the Closure Agreement, and surcharge  
5 mechanism contained therein, properly balances the needs of BMSC and its customers for the  
6 provision of wastewater service in a safe, reliable and, to the extent possible, odor-free manner.

7 **B. Refund of Hook-Up Fee Funds**

8 In BMSC's prior rate case, we agreed with the Company and Staff that \$833,367 should be  
9 refunded to customers due to unexpended hook-up fees held by BMSC. The \$833,367 represented  
10 \$452,467 for land purchased with hook-up fee funds and \$380,900 for hook-up fees held in a  
11 Company account. (Decision No. 69164, at 29.) We required BMSC, as a condition of implementing  
12 the rate increase authorized by that Decision, to calculate the amount of the refund due to customers  
13 on a per customer basis, irrespective of customer class. (*Id.*) As a result, BMSC refunded \$412.15 to  
14 each customer on record. (Carefree Ex. 1, at 3.) After the refunds were issued, the Carefree Estates  
15 Homeowners Association ("CEHA") sought to require BMSC to issue refund checks to each of its 33  
16 members rather than the single check the CEHA received as the customer of record that is billed by  
17 BMSC for all 33 residents.<sup>23</sup>

18 On December 7, 2007, a Joint Stipulation between Carefree, BMSC, and RUCO was filed in  
19 the Company's prior rate case docket (Docket No. SW-02361A-05-0657), along with a request for  
20 clarification or amendment of Decision No. 69164 pursuant to A.R.S. § 40-252. The Stipulation  
21 provided that BMSC would refund \$405.73 to each of the Carefree Estates residents, and would debit  
22 the accounts of its other customers by \$6.62, in order for the \$833,367 overall refund amount ordered  
23 to remain unaltered. (Carefree Ex. 1, Attach. 1.) The Commission did not act to amend or reconsider  
24 the issue raised by the joint filing and the matter was raised again by the Town in this docket.

25 The Company continues to support the relief requested by the CEHA on behalf of its residents  
26 as long as the additional refunds remain revenue and rate base neutral. Mr. Sorenson stated that  
27 although the Company made refunds in the manner ordered by the Commission, it has worked with

28 <sup>23</sup> The Town of Carefree represented the interests of the 33 residents in seeking individual refunds and intervened in this proceeding to continue its advocacy for the CEHA residents.

1 the Town and Carefree Estates residents in order to reach an equitable result. (Ex. A-2, at 4.) BMSC  
2 does not oppose, on a going-forward basis, treating each of the Carefree Estates residents as  
3 individual customers and billing them accordingly. (*Id.*) In order to accomplish the Carefree Estates  
4 refund, the Company proposed that refunds of \$404.64 would be given to each of the 33 residents,  
5 and debits of \$7.51 would be made each of the 1,671 accounts that received the prior refund and that  
6 are still customers on BMSC's system. (*Id.*)<sup>24</sup>

7 No party disagrees with the proposal put forth by the Company and we agree it represents an  
8 equitable result that is consistent with the intent of Decision No. 69164. It appears that BMSC issued  
9 the refunds in accordance with the directive of the prior Decision, and the record in this case provides  
10 no clarity as to why a single customer account was established for the residents of Carefree Estates.  
11 Even the president of the CEHA indicated that no one seems to know why wastewater service for the  
12 development was set up as a single account. (Tr. 233.)

13 BMSC is therefore authorized to issue refunds to the 33 residents in Carefree Estates, with  
14 corresponding debits to the remaining accounts that received refunds in accordance with Decision  
15 No. 69164. The Company should make the refunds and debits within 30 days of the effective date of  
16 this Decision, and also file within 30 days, as a compliance item with Docket Control, notification of  
17 completion of the refunds and debit. For accounts that incur a debit as a result of this action, BMSC  
18 should provide notification as to the reason for the debit in the first billing cycle following the  
19 effective date of this Decision.

20 Finally, we believe that the 33 residents in the Carefree Estates subdivision should be billed as  
21 individual customers with separate accounts, rather than paying their bills through the CEHA  
22 account. BMSC should, within 90 days of the effective date of this decision, file as a compliance  
23 item with Docket Control notification that the Carefree Estates customers have been assigned  
24 separate accounts and will be billed in the future as individual customers.

25 ...

26 \_\_\_\_\_  
27 <sup>24</sup> To the extent the number of remaining customer accounts that received refunds has changed, the refund and debit  
28 would need to change slightly to recognize that fact. In their post-hearing briefs, both the Town and BMSC agreed that  
the debit to customer accounts that previously received refunds would not constitute retroactive ratemaking under  
applicable laws.

1           **C.     Special Commercial Rates**

2           Mr. Sorenson testified that because wastewater flows cannot be metered efficiently, except at  
3 high volumes, BMSC's current tariff for commercial customers uses ADEQ Engineering Bulletin No.  
4 12 ("Bulletin No. 12") to determine flow levels for various types of commercial establishments. (Ex.  
5 A-2, at 5-6.) The Company argues that although it is unclear why this approach was initially used,  
6 absent a viable alternative proposal Bulletin No. 12 should continue to be the basis for determining  
7 rates charged to the more than 130 commercial customers in BMSC's service area. (*Id.* at 6.)

8           BMSC also proposes that the special commercial rates that are in effect for 13 specific  
9 commercial businesses should be eliminated. Mr. Bourassa stated that 8 of those businesses no  
10 longer exist and there is no current justification for continuing special rates for the remaining 5  
11 businesses. (Ex. A-4, at 16-18.) The Company contends that the special commercial rates appear  
12 unnecessarily discriminatory and require special administrative handling for billing purposes.

13                   **1.     Dr. Doelle**

14           Dr. Dennis Doelle, D.D.S., requested intervention in this case to express his concern with the  
15 significant increase that he believes would be imposed on his dental practice as a result of BMSC's  
16 rate application and proposed rate design. Dr. Doelle submitted pre-filed testimony and testified at  
17 the hearing regarding his concerns with BMSC's use of Bulletin No. 12 as the basis for establishing  
18 rates for his practice. (Doelle Exs. 1, 2, and 3.)

19           Dr. Doelle stated that Bulletin No. 12 is based on assumptions from the 1970s regarding water  
20 usage, and thus sewage flows, that are no longer applicable in a modern dental practice.<sup>25</sup> He  
21 testified that ADEQ's Bulletin No. 12 established sewage flows at 500 gpd, per dental chair, based on  
22 the assumption that each chair had a "cuspidor" (*i.e.*, a chair-side sink) with continuously circulating  
23 water. Dr. Doelle added that modern dental practices use no more water than any other health care  
24 provider because in addition to discontinuance of the use of continuous flow cuspidors, x-ray  
25 technology is digitized rather than using circulating water tanks, and dentists now use sterile gloves

26 \_\_\_\_\_  
27 <sup>25</sup> Dr. Doelle filed a complaint with the Commission in 1996 which resulted in issuance of Decision No. 60258 (June 13,  
28 1997). In that Decision, the Commission agreed with Dr. Doelle that Bulletin No. 12 vastly overstated assumed sewage  
flows by his dental office, directed that he be charged under the category of a "health care provider" (25 gpd per exam  
room and 25 gpd per employee), and directed Boulders Carefree to refund payments made in excess of the applicable rate  
that would apply according to Dr. Doelle's reclassification as a health care provider.

1 and waterless hand sanitizer rather than constantly washing their hands with harsh soaps. (Tr. 94-95.)

2 Dr. Doelle produced exhibits that were introduced in his prior complaint case, including a  
3 1997 affidavit by one of the authors of Bulletin No. 12 and a 1996 letter from a hydrologist at ADEQ.  
4 In the affidavit, the affiant states that the sewage flow rate for dental practices was based on his  
5 incorrect assumption that dental chairs had constantly running cuspidors. The letter from the ADEQ  
6 hydrologist, dated August 30, 1996, stated that "Bulletin No. 12 is being rewritten because of some  
7 existing technical problems within the document," and suggested that Dr. Doelle's wastewater  
8 discharge amounts should be calculated based on water usage.<sup>26</sup> Dr. Doelle attached to his testimony  
9 one of his water bills from Carefree Water Company showing actual water usage at his office of  
10 11,650 gallons for the month. (Doelle Ex. 2.) This compares to the 60,000 gallons of sewage flows  
11 that would be assumed for a dental practice with 4 dental chairs, using Bulletin No. 12 as a guideline.

12 **a. BMSC's Position**

13 The Company claims that its use of Bulletin No. 12 is necessary because it does not have  
14 access to the actual water usage information from the various water providers that operate within  
15 BMSC's system. However, BMSC agrees that Dr. Doelle makes a persuasive case that Bulletin No.  
16 12 is not an appropriate proxy for a modern dental office, and therefore the Company is not opposed  
17 to the Commission adopting a rate that recognizes the reduced water usage in such a dental facility.  
18 The Company points out that the relief sought by Dr. Doelle would not be a "special rate" but would  
19 apply to any dental office that can show it uses comparable low-flow technology.

20 **b. Resolution**

21 We agree with Dr. Doelle that, at least with respect to dental offices, the assumptions  
22 contained in ADEQ's Engineering Bulletin No. 12 are outdated and do not reflect modern practices  
23 that are in effect due to improvements in technology and conservation efforts. Therefore, BMSC  
24 should bill Dr. Doelle, and any other similarly situated dental offices, at the standard commercial rate  
25 established in this Decision under the category of a health care provider for purposes of wastewater  
26 flow levels.

27 \_\_\_\_\_  
28 <sup>26</sup> It appears that, despite the claim that Bulletin No. 12 was being rewritten, no revision has actually occurred since it was last updated in 1989.

1 We agree with the Company's request to discontinue the special rates that currently exist for  
2 13 specific customers. It is uncertain from the record why certain customers were afforded special  
3 rates in the past, but in the future all commercial customers should be assessed the same standard  
4 commercial rate established in this case. Because the remaining five special tariff rate customers will  
5 now be combined under a single standard commercial rate, the effect of the authorized increase will  
6 be greater on those customers because they have historically been served under rates that were lower  
7 than the vast majority of current commercial standard rate customers.

8 With the exception discussed above, the Company may, for now, continue to rely on Bulletin  
9 No. 12 for flow assumptions. However, the evidence presented by Dr. Doelle shows that the  
10 assumptions made in Bulletin No. 12 regarding dental offices is extremely outdated and needs to be  
11 revised. The obvious inaccuracy of the assumptions made in that document raises the concern that  
12 other assumptions in Bulletin No. 12, on which the Company relies for billing all of its commercial  
13 customers, may also be outdated.

14 Although we understand that BMSC does not currently have access to actual water usage data  
15 from the unaffiliated water utilities in its service area, it is not clear why Bulletin No. 12 has not been  
16 revised for more than 20 years. Therefore, in its next rate application, we direct BMSC to present  
17 evidence regarding alternative methods for calculating sewage flow assumptions used for billing its  
18 commercial customers. The Company should consider, at a minimum: contacting ADEQ regarding  
19 plans for revising Bulletin No. 12; other sewage flow data based on technological improvements and  
20 conservation assumptions; and whether it is possible to obtain actual water usage data from the water  
21 utilities in BMSC's service area for purposes of calculating more accurate wastewater flows on its  
22 system.

#### 23 **D. Hook-Up Fee Tariff**

24 In its application, BMSC proposed approval of a hook-up fee as a means of requiring growth  
25 to pay for growth. (Ex. A-1, at 13.) Mr. Sorenson stated that future treatment capacity requirements  
26 would need to be purchased from Scottsdale or new plant constructed when the current Scottsdale  
27 Agreement expires in 2016. He claimed that new capacity needs could be very expensive and a  
28 portion of that additional burden should be borne by future development. (*Id.*)

1           BMSC argues that it currently has the right to send up to 400,000 gpd to Scottsdale and, if the  
2 treatment plant is closed, an additional 120,000 gpd of flows would be sent to Scottsdale. (Tr. 104.)  
3 Under the terms of the Scottsdale Agreement, which runs through 2016, BMSC has the right to  
4 purchase up to a total of 1,000,000 gpd of capacity for a charge of \$6.00 per gallon. (Tr. 117.)  
5 However, the Company disputes Staff's assertion that BMSC already has 1,000,000 of available  
6 capacity, claiming that the Staff engineer misinterpreted the Company's ability to purchase additional  
7 capacity as already having those capacity rights. (Tr. 117-18; Ex. S-1, at 7.)

8           Staff witness Hains stated that, based on her belief that BMSC has 1,000,000 gpd of treatment  
9 capacity available from Scottsdale, there is no need for the Company to collect hook-up fees to fund  
10 future growth needs. She indicated that according to Staff's calculations, BMSC had sufficient  
11 available treatment capacity to serve estimated growth through 2027. (Ex. S-1, at 7.) In her  
12 surrebuttal testimony, Ms. Hains continued to oppose adoption of the proposed hook-up fee tariff but  
13 provided a calculation for such a tariff in the event the Commission finds it appropriate. (Ex. S-2, at  
14 1-2, Ex. 1.)

15           In response, BMSC indicated that it would agree to the hook-up fee calculations provided in  
16 Staff's alternative proposal. (Ex. A-3, at 11.) Mr. Sorenson stated that the Company prepared a form  
17 of tariff proposed by Staff in the pending LPSCO case, with the meter size hook-up fee dollar  
18 amounts suggested by Ms. Hains. (*Id.*, Ex. 1.) In its final schedules, the Company added additional  
19 language in the proposed tariff that addresses the concern expressed by Ms. Hains at the hearing that  
20 the hook-up fees not be used for closure of the treatment plant. (BMSC Initial Brief, at 39.)

21           We find that BMSC's proposed hook-up fee tariff, as contained in its final schedules, is  
22 reasonable. We agree with the Company that purchasing additional treatment capacity, or building a  
23 treatment plant, in order to serve growth on its system will require significant capital investments.  
24 Although it is not known, at this time, when that additional treatment capacity will be needed, and in  
25 what quantities, the existence of a hook-up fee tariff will enable BMSC to at least partially offset the  
26 capital requirements needed to fund future capacity requirements. Having such a tariff in place will  
27 contribute to the furtherance of growth paying for growth thereby mitigating the impact of new  
28 development on existing ratepayers. Given BMSC's strong equity ratio, we are not concerned with

1 the Company becoming overly reliant on contributed capital. In BMSC's next rate case, we will have  
 2 the opportunity to review the amounts collected spent under the hook-up fee tariff and can address  
 3 the ongoing need for the tariff at that time.

4 \* \* \* \* \*

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

7 **FINDINGS OF FACT**

8 1. On December 19, 2008, BMSC filed an application with the Commission for an  
 9 increase in rates.

10 2. On January 20, 2009, the Commission's Utilities Division Staff filed a Letter of  
 11 Sufficiency, and classified BMSC as a Class B utility.

12 3. By Procedural Order issued January 23, 2009, procedural timeframes were established  
 13 and a hearing was scheduled to commence on September 21, 2009.

14 4. Intervention was granted to RUCO, the Town of Carefree, the Boulders HOA, Dr.  
 15 Doelle, and M.M. Schirtzinger.

16 5. On June 12, 2009, Staff filed a Motion for Extension of Time to file its direct  
 17 testimony.

18 6. On June 15, 2009, BMSC filed a Response in opposition to Staff's Motion on the  
 19 basis that a change of rate analysts was an insufficient reason for granting an extension of the  
 20 procedural schedule.

21 7. On June 16, 2009, Staff filed a Reply in Support of its Motion for Extension of Time.

22 8. By Procedural Order issued June 17, 2009, a procedural conference was scheduled for  
 23 June 30, 2009, to discuss Staff's Motion for Extension of Time.

24 9. The procedural conference was held, as scheduled, on June 30, 2009. Staff's Motion  
 25 was granted and the parties were directed to develop a new procedural schedule and hearing date in  
 26 accordance with that ruling.

27 10. On July 13, 2009, Staff filed a Request for a Procedural Order. Staff proposed new  
 28 testimony filing dates and a new hearing date consistent with its requested 60-day extension.

1           11.    By Procedural Order issued July 20, 2009, the evidentiary hearing was rescheduled to  
2 commence on November 18, 2009, the prior hearing date was reserved for public comment, and new  
3 testimony filing dates were established.

4           12.    With its application, BMSC filed the direct testimony of Greg Sorenson and Thomas  
5 Bourassa.

6           13.    On September 18, 2009, RUCO filed the direct testimony of William Rigsby and  
7 Rodney Moore; the Boulders HOA filed the direct testimony of Les Peterson; the Town filed the  
8 direct testimony of Brian Kincaid; and Dr. Doelle filed his direct testimony.

9           14.    On September 21, 2009, Staff filed the direct testimony of Crystal Brown, Dorothy  
10 Hains, and Juan Manrique.

11          15.    On September 21, 2009, the previously scheduled hearing was called for purposes of  
12 taking public comment. No public comment was received at that time.

13          16.    On October 20, 2009, the Company filed the rebuttal testimony of Mr. Sorenson and  
14 Mr. Bourassa.

15          17.    On November 9, 2009, Staff filed the surrebuttal testimony of Ms. Brown, Ms. Hains,  
16 and Mr. Manrique; RUCO filed the surrebuttal testimony of Mr. Rigsby and Mr. Moore; the Boulders  
17 HOA filed surrebuttal testimony of Mr. Peterson; and Dr. Doelle filed his surrebuttal testimony.

18          18.    On November 16, 2009, BMSC filed the rejoinder testimony of Mr. Sorenson and Mr.  
19 Bourassa.

20          19.    On November 17, 2009, the prehearing conference was held to discuss scheduling of  
21 witnesses and other procedural issues.

22          20.    On November 18, 2009, the hearing commenced as scheduled. The hearing resumed  
23 on November 23, 2009, with additional hearing days on November 24 and 25, 2009.

24          21.    On November 19, 2009, Staff filed the supplemental surrebuttal testimony of Crystal  
25 Brown.

26          22.    On December 10, 2009, BMSC, Staff, and RUCO filed Final Schedules. The  
27 Company also submitted Late-Filed Exhibits on December 10, 2009.

28          23.    On December 14, 2009, initial briefs were filed by BMSC, Staff, RUCO, Boulders

1 HOA, and the Town.

2 24. On December 22, 2009, reply briefs were filed by BMSC, Staff, RUCO, and the  
3 Boulders HOA.

4 25. As set forth in its final schedules, the Company requested a gross revenue increase of  
5 \$952,956, based on OCRB of \$3,682,741, and a recommended return on common equity and overall  
6 cost of capital of 12.40 percent.

7 26. In its final schedules, Staff recommended a gross revenue increase of \$610,375, based  
8 on OCRB of \$3,410,758, and a recommended return on common equity of 9.40 percent.

9 27. RUCO recommends a gross revenue increase of \$604,630, based on OCRB of  
10 \$3,682,905, and a recommended return on common equity of 7.43 percent.

11 28. For purposes of this proceeding, we determine that BMSC has a FVRB and OCRB of  
12 \$3,606,767.

13 29. A rate of return on FVRB of 9.41 percent, based on a hypothetical capital structure of  
14 80 percent common equity and 20 percent debt, is reasonable and appropriate.

15 30. BMSC is entitled to a gross revenue increase of \$669,781.

16 31. The rate design recommended by all parties, distributing an equal percentage increase  
17 on both the residential and commercial classes, should be adopted in this proceeding.

18 32. In accordance with the revenue requirement authorized by this Decision, monthly  
19 residential customer rates will increase from \$45.64 to \$65.24, an increase of \$19.60 per month, or 43  
20 percent. The standard commercial rate will increase from \$0.18298 per gallon per day to \$0.248734  
21 per gallon per day. Customers currently receiving service under special tariff rates ranging from  
22 \$0.14034 to \$0.16344 will be migrated to the standard commercial rate of \$0.248734.

23 32. Staff's recommendation regarding the allocation of shared services expenses, as  
24 modified herein, is reasonable and should be approved. In future cases involving the Algonquin  
25 companies, the Commission will continue to scrutinize all affiliate salaries, expenses and billings to  
26 ensure the reasonableness of the Algonquin shared services allocations.

27 33. The record supports a finding that residents in the Carefree Estates subdivision should  
28 receive a proportionate share of the hook-up fee refunds that were distributed following issuance of

1 Decision No. 69164, to be calculated in the manner described herein, and that residents in the  
 2 Carefree Estates should henceforth be billed as individual customers by BMSC.

3 34. The record supports a finding that, as modified and clarified herein, the Closure  
 4 Agreement between BMSC and the BHOA represents a reasonable resolution of the current odor  
 5 concerns expressed by hundreds of BMSC's customers. As provided in the Closure Agreement, a  
 6 surcharge mechanism is authorized under the framework discussed herein to accomplish closure and  
 7 decommissioning of the Boulders WWTP.

8 35. The record supports a finding that intervenor Dr. Doelle's dental office, as well as  
 9 other similarly situated dental office customers of BMSC, should be billed as health care providers  
 10 under ADEQ Bulletin No. 12, as provided in the discussion herein.

11 36. The record supports a finding that BMSC should be authorized to implement a hook-  
 12 up fee tariff in the form submitted with the Company's final schedules.

13 **CONCLUSIONS OF LAW**

14 1. BMSC is a public service corporation within the meaning of Article XV of the  
 15 Arizona Constitution and A.R.S. §§40-250, 40-251, 40-367, 40-202, 40-321, 40-331, and 40-361.

16 2. The Commission has jurisdiction over BMSC and the subject matter contained in the  
 17 Company's rate application.

18 3. The rates, charges and conditions of service established herein are just and reasonable  
 19 and in the public interest.

20 **ORDER**

21 IT IS THEREFORE ORDERED that Black Mountain Sewer Corporation is hereby authorized  
 22 and directed to file with the Commission, on or before August 31, 2010, revised schedules of rates  
 23 and charges consistent with the discussion herein, as set forth below.

24 Residential Service – Per Month	\$65.24
25 Commercial - Regular (c)	\$0.248734
26 Effluent Sales	
27 Per thousand gallons	\$0.460510
28 Service Charges	

1	Establishment	\$25.00
	Re-establishment	\$25.00
2	Re-connection	No Charge
	Minimum Deposit (Residential)	(a)
3	Minimum Deposit (Non-Residential)	(a)
	Deposit Interest	6%
4	NSF Check Charge	\$10.00
5	Deferred Payment Finance Charge	1.50%
	Late Charge	1.50%
6	Main Extension Tariff (b)	Cost
	Off-site Facilities Hook-up Fee	Per Tariff

- 7
- 8 (a) Per A.A.C. R14-2-603B; Residential – two times average bill, Non-residential – two  
and one-half times average bill;
- 9 (b) Per A.A.C. R14-2-606(B);
- 10 (c) Per Gallon per Day. Wastewater flows are based on ADEQ Engineering Bulletin No.  
12, in accordance with this Decision.

11 IT IS FURTHER ORDERED that the revised schedules of rates and charges shall be effective  
12 for all service rendered on and after September 1, 2010.

13 IT IS FURTHER ORDERED that Black Mountain Sewer Corporation shall notify its  
14 customers of the revised schedules of rates and charges authorized herein by means of an insert in its  
15 next regularly scheduled billing, or by separate mailing, in a form acceptable to Staff.

16 IT IS FURTHER ORDERED that Black Mountain Sewer Corporation shall file its request for  
17 a treatment plant closure surcharge in accordance with the terms of the Closure Agreement and the  
18 conditions and requirements set forth hereinabove. The closure surcharge shall not go into effect  
19 until the Commission has approved the amount of the surcharge following Staff's review and  
20 recommendation.

21 IT IS FURTHER ORDERED that Black Mountain Sewer Corporation shall file a full rate  
22 application no later than 12 months after completion of the treatment plant closure project.

23 IT IS FURTHER ORDERED that Black Mountain Sewer Corporation shall issue refunds to  
24 the residents in Carefree Estates, with corresponding debits to the remaining accounts that received  
25 refunds of hook-up fee funds in accordance with Decision No. 69164. The Company shall make the  
26 refunds and debits within 30 days of the effective date of this Decision, and shall file within 30 days,  
27 as a compliance item with Docket Control, notification of completion of the refunds and debit. For  
28 accounts that incur a debit as a result of this action, The Company shall provide notification as to the

1 reason for the debit in the first billing cycle following the effective date of this Decision.

2 IT IS FURTHER ORDERED that Black Mountain Sewer Corporation shall, in its next rate  
3 application, present evidence regarding alternative methods for calculating sewage flow assumptions  
4 used for billing its commercial customers. The Company shall consider, at a minimum: contacting  
5 ADEQ regarding plans for revising Bulletin No. 12; other sewage flow data based on technological  
6 improvements and conservation assumptions; and whether it is possible to obtain actual water usage  
7 data from the water utilities in the Company's service area for purposes of calculating more accurate  
8 wastewater flows on its system.

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

10 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

11  
12  
13 CHAIRMAN

COMMISSIONER

14  
15 COMMISSIONER

COMMISSIONER

COMMISSIONER

16  
17 IN WITNESS WHEREOF, I, ERNEST G. JOHNSON,  
18 Executive Director of the Arizona Corporation Commission,  
19 have hereunto set my hand and caused the official seal of the  
20 Commission to be affixed at the Capitol, in the City of Phoenix,  
21 this \_\_\_\_\_ day of \_\_\_\_\_, 2010.

22 \_\_\_\_\_  
ERNEST G. JOHNSON  
EXECUTIVE DIRECTOR

23 DISSENT \_\_\_\_\_

24  
25 DISSENT \_\_\_\_\_

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