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BEFORE THE ARIZONA CORPORATION COMMISSION

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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-05-0657

**REPLY BRIEF OF
COMMISSION STAFF**

The Staff of the Arizona Corporation Commission (the "Commission") ("Staff") hereby submits its Reply Brief in the above captioned matter. To the extent that Staff does not address an issue raised in the parties' closing briefs, Staff rests on its positions as discussed in its Closing Brief. However, Staff replies to certain matters discussed by Black Mountain Sewer Company (the "Company" or "BMSC")¹ and the interveners, the Residential Utility Consumer Office ("RUCO"), the Town of Carefree ("Carefree" or the "Town") and the Boulders Homeowners Association (the "Boulders HOA"), in their closing briefs. The following issues are addressed in this Reply Brief: (1) rate case expense, (2) affiliate profits, (3) odor and noise related to the operation of the Company's waste water treatment facility and collection system and, (4) the appropriate method to calculate return on equity ("ROE").

¹ Staff uses the same references for the Company's affiliates as it did in its Closing Brief. See Staff Closing Brief at 1, 11, 1-10 and at 2, footnote 14.

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1 **I. THE COMMISSION SHOULD ADOPT STAFF'S RECOMMENDED AMOUNT OF**
2 **RATE CASE EXPENSE**

3 The Company argues that the best evidence of rate case expense is actual costs incurred by
4 the Company.² In an exhibit attached to its closing brief, the Company identified actual costs
5 incurred to date in the amount of \$194,812.08.³ Staff first notes that actual costs are not the only
6 evidence, and sometimes are not the best evidence, for *allowable* rate case expense. Costs may be
7 incurred, but then disallowed as rate case expenses for a variety of reasons.⁴

8 Staff also notes that the record in a case is typically closed at the conclusion of evidentiary
9 hearings.⁵ Therefore, rate case expense necessarily must include an estimate for at least a portion of
10 costs. Staff objects to BSMC Exhibit Number 3, and requests that it be stricken from the record.
11 Staff has not had an opportunity to audit updated costs. Moreover, the Company offered this exhibit
12 after the evidentiary hearings were concluded.
13

14 **A. Staff believes that it has provided sufficient evidentiary support for its**
15 **recommendation to reduce allowable rate case expense.**

16 Prior to addressing the Company's substantive arguments against Staff's recommended rate
17 case expense, Staff addresses correspondence received from the Company's counsel. The
18 Company's counsel objected to a comment made by Staff in its Closing Brief. Staff noted that it
19 "continues to doubt that all information has been fully disclosed."⁶ Counsel suggested that Staff's
20 intent was to question the integrity of the Company and its counsel. Staff had no such intent.
21

22 Staff's doubt is based on, and was intended to reflect, evidence in the record. Company
23 witness Robert Dodds testified that hourly rates charged by affiliates include profit margins. He was
24 not able to testify that profit margins disclosed to Staff included profit margins imbedded in hourly
25

26 ² BSMC's Closing Brief at 13, ll. 5-7.

27 ³ *Id.* at Exhibit 3.

28 ⁴ See, e.g. Decision 67093 at 19 (reducing allowable rate case expenses for expert fees).

⁵ However, the Commission typically accepts late-filed exhibits that include final recommendations based on the evidentiary record. In this case, Administrative Law Judge Dwight D. Nodes ("Judge Nodes") left the record open to allow the Company to provide source documentation to Staff. See Tr. 773, ll. 15-22. Staff's recommendations were revised based on review of the documentation.

1 rates.⁷ Accordingly, profit margins disclosed in discovery may be understated. Additionally, the
2 Company identified three different percentages for affiliate profit margin, 4.5%, 6.5%, and 10.4%.⁸
3 In its closing brief, the Company continues to identify 4.5% as the actual profit margin.⁹

4 Staff witness Crystal Brown also testified that some of the overhead allocated to BMSC from
5 its affiliates may be subsidizing other Algonquin affiliates.¹⁰ Staff's comment in its Closing Brief
6 was intended to reflect the uncertainty created by conflicting and incomplete evidence. Staff never
7 intended to question the integrity of anyone.
8

9 Staff recognizes that corporate records may not always be accurate or consistent.
10 Furthermore, absent an arm's length bidding process, affiliate profit margins may be allocated in the
11 same manner as overhead expenses.¹¹ The Company still has not adequately explained how its
12 affiliates allocate profit margins to individual operating companies or individual capital projects.¹² In
13 response to Staff data request CSB 1.52, the Company stated that:

14
15 The price for affiliate transactions is not based on fair market value.
16 Rather, the price is based on allocation of costs amongst the systems
17 receiving benefits of affiliate transactions and includes a small, but
18 appropriate "operating margin."¹³

19 It is unclear whether the operating margin charged to BMSC is the same operating margin charged to
20 other Algonquin affiliates. It is also unclear how the Company calculated the "operating margin."

21 ⁶ Staff Closing Brief at 21, ll. 15-16.

⁷ *Id.* at 17, l. 22 to 18, l. 5.

22 ⁸ *Id.* at 18, ll. 6-21. See also Exhibit No. S-17, S-18 (The Company did offer an ambiguous explanation in response to a
23 Staff data request. However, the Company did not explain how or why it distinguishes between "estimated" and "actual"
24 or between "pre-tax" and "post-tax" profit margins. The Company stated that "The estimate included a 10.4% pre-tax
25 and 6.2% post tax operating margin. However, the actual test year AWS pre-tax operating margin for the services to
26 BMSC was only 6.5% and the post tax operating margin was only 3.92%.")

⁹ BMSC Closing Brief at 16, ll. 18-20. See also footnote 7, *supra*. It is unclear whether the Company's identified 4.5%
27 profit margin is pre-tax or post-tax. Staff assumes that the 4.5% represents the Company's claim of what affiliates
28 actually invoiced to BMSC.

¹⁰ Staff Closing Brief at 18, ll. 3-5. See also Tr. 788, ll. 7-9.

¹¹ See Exhibit No. S-19 ("Post-tax Operating Margin for AWS overall for 2002 and 2003 was 13% and 7.2%,
29 respectively. In 2002 and 2003, *separation of expenses was not done so profitability by customer information is not*
30 *available for these years.*") (emphasis added).

¹² But see Exhibit No. S-18 ("Beginning in 2004, revenues and costs, *to the extent they were specifically identifiable*, were
31 coded to the AWS customer to which they belonged. Costs not specifically identifiable to a particular customer of AWS
32 were allocated to each customer based upon that customer's percentage of billings for AWS.")

¹³ Exhibit No. S-17 (emphasis added).

1 Notably, the conflicting and incomplete evidence is further support for Staff's
2 recommendation to pierce the corporate veil. When separate legal entities are functionally operated
3 as a single entity, the confusion reflected in the record is no surprise. Conflicting and incomplete
4 evidence is also support for Staff's recommendation to disallow a portion of costs incurred for the
5 rate case.

6 **B. Staff appropriately excluded additional discovery costs related to Staff data**
7 **requests and RUCO data requests.**

8 The Company argues that Staff's disallowance of additional rate case expense is unfounded.
9 Specifically, the Company states that "Staff gave no consideration of the Company's assertion that
10 discovery costs were higher than anticipated."¹⁴ The Company is incorrect that Staff did not consider
11 the Company's assertion. Staff simply rejected the Company's request for additional rate case
12 expense related to discovery.
13

14 Staff witness Crystal Brown testified that the Company's responses to increased discovery
15 were minimal.¹⁵ For many of the responses, the Company answered in the negative or objected to the
16 questions.¹⁶ Ms. Brown also testified that if the Company "does something improper, or advances
17 positions in bad faith, it should shoulder the burden of such costs."¹⁷
18

19 Ms. Brown recommended no increase in rate case expense because of the Company's
20 frequent objections and incomplete responses.¹⁸ The Company may argue that Staff failed to timely
21 respond to the Company's objections during discovery.¹⁹ It may further argue that Staff could have
22 resolved any discovery dispute by seeking a resolution with the assigned administrative law judge.
23

24
25 ¹⁴ BMSC Closing Brief at 12, ll. 13-14.

26 ¹⁵ Exhibit No. S-10 at 18, ll. 2-5. See also Tr. 741, ll. 2-6.

27 ¹⁶ *Id.*

28 ¹⁷ Exhibit No. S-10 at 16, l. 21 to 17, l. 4 (Ms. Brown agreed with Company witness Thomas Bourassa on an appropriate reason to disallow rate case expenses under certain circumstances.).

¹⁸ Exhibit No. S-10 at 17, ll. 8 to 18, l. 22.

¹⁹ Tr. 801, ll. 13-16. Staff notes that the Company objected to various Staff data requests via email. The emails were not submitted as evidence in the record. Instead, Staff submitted the numerous data requests and responses related to affiliate profit.

1 Staff did consider this possibility.²⁰

2 Even though Staff did not agree with the Company's objections, it decided to use a different
3 strategy. Staff rephrased its questions to get around the objections. Unfortunately, it still took Staff
4 12 weeks to get enough information to make a recommendation. Staff witness Ms. Brown cited the
5 above reasons for recommending no increase in rate case expense for discovery.²¹

6 Furthermore, Ms. Brown described another instance where the Company did not adequately
7 respond to a Staff data request. Staff disallowed certain costs because the Company did not provide
8 source documentation. At hearing, the Company characterized the data request as an "implied" data
9 request.²²

10 The Company did not provide the identified documentation because Staff did not *directly*
11 request it.²³ Staff believes that the discovery process should be mutually cooperative. Ms. Brown
12 testified that the Company could have reasonably responded by providing the documentation to
13 Staff.²⁴ Briefing was subsequently delayed after the Company agreed to provide the information at
14 the hearing.²⁵

15 Moreover, the Company ignores the fact that the initial burden of production is on the
16 Company. The Company should produce sufficient, relevant and reliable evidence to support any
17 expense without the need for discovery. The Company did not meet its initial burden, and instead
18 criticized Staff for not producing evidence of its own.²⁶ The Company should not be allowed to shift
19 the burden of production.
20
21
22

23 ²⁰ As required by the Arizona Rules of Civil Procedure, counsel for Staff had several conversations with counsel for the
24 Company in an attempt to informally resolve the discovery dispute. Ultimately, the informal efforts resulted in a
25 resolution, and Staff did not need to involve the administrative law judge. It is noteworthy that Staff received some of the
26 information only after stating that it would request a procedural conference.

27 ²¹ Exhibit No. S-10 at 17, ll. 6-18.

28 ²² Tr. 760, l. 13 to 763, l. 2.

²³ *Id.* 206, l. 23 to 208, l. 4.

²⁴ *Id.* 762, ll. 6-10.

²⁵ *Id.* 772, ll. 21-25.

²⁶ Exhibit A-2 at 16, l. 22 to 17, l. 2. See also BMSC Closing Brief at 16, ll. 14-15 ("This is largely true because Staff failed to actually conduct an analysis of the reasonableness of the costs incurred by BMSC in transactions with

1 **C. The Company has not provided evidence on the record to rebut Staff's**
2 **calculation for additional costs related to intervenors.**

3 The Company also criticizes Staff's belief that an additional \$4,800 is sufficient for rate case
4 expenses due to intervention by Carefree and the Boulders HOA.²⁷ The Company did not provide an
5 explanation for its criticism. Therefore, Staff cannot adequately respond, and rests on its Closing
6 Brief and the record. Staff notes, however, that the Company did not provide any evidence in its pre-
7 filed testimony or at hearing rebutting Staff's calculation.²⁸

8 **II. THE COMMISSION SHOULD PIERCE THE CORPORATE VEIL AND DISALLOW**
9 **ALL AFFILIATE PROFITS**

10 The Company urges the Commission to allow affiliate profits for the following four reasons:

11 (1) "AWS is a separate and distinct legal entity, investing in pursuit of a return and facing a risk of
12 loss."²⁹; (2) Use of a shared services center creates economies of scale and lowers costs.³⁰; (3) Use of
13 affiliates allows BMSC "to provide a broader range of benefits to its ratepayers, at prices, including
14 profit, equal to or less than market rates;"³¹ and (4) Use of affiliates allows BMSC to "better control
15 health, safety and environmental concerns."³² Staff agrees that the second reason is true, but
16 disagrees that it is a reason to allow affiliate profits.³³ Staff also disagrees with the other three
17 reasons.
18

19 **A. The Commission should pierce the corporate veil**

20 In its closing brief, the Company claims that Staff has already supported Algonquin's
21 business model. The Company refers to the Staff's reports in two applications for Certificates of
22

23 affiliates."); and BMSC Closing Brief at 17, ll. 4-6 ("In short, Staff failed to conduct any meaningful analysis of the
24 reasonableness of the costs incurred, opting instead to suggest a black-line, one-size fits all approach.").

24 ²⁷ BMSC's Closing Brief at 12, ll. 9-13.

25 ²⁸ For example, Staff used the following inputs in its calculation of additional rate case expense: (1) an hourly composite
26 rate of \$400, (2) 24 hours, and (3) 50% sharing between the Company and ratepayers. The Company did not specifically
27 address any of the inputs. Instead, the Company criticized Staff by assuming that its witness "felt that the Company's
28 third-party consultants needed minimal effort with respect to the issues raised by the Town." BMSC's Closing Brief at
12, ll. 9-13.

27 ²⁹ BMSC Closing Brief at 13, ll. 20-21.

30 *Id.* at 13, l. 26 to 14, l. 1.

31 *Id.* at 14, ll. 2-4.

32 *Id.* at 14, ll. 8-9.

1 Convenience and Necessity (“CC&Ns”) transferring the assets of the water systems formally know as
2 the McLain Systems.³⁴ AWRA now owns the systems operating as Northern Sunrise Water
3 Company, Inc. (“Northern”) and Southern Sunrise Water Company, Inc (“Southern”).³⁵

4 Staff strongly objects to the Company’s characterization of Staff’s position in the dockets
5 concerning the McLain Systems. Staff only reviewed and approved AWRA’s overall first year
6 expenses based on pro forma estimates.³⁶ Staff also noted that it estimated slightly lower operating
7 expenses in an Emergency Rate proceeding for the McLain Systems.³⁷

8
9 The Commission recognized that Northern and Southern would not have employees of their
10 own. Instead, the companies would contract with its affiliate, AWS.³⁸ However, Staff did not
11 complete a full audit of the expenses and did not identify affiliate profits anywhere in its Staff Report.
12 The Company has not presented any evidence that Staff was even aware that affiliate profits were
13 included in the Company’s pro forma financial information. Furthermore, Staff noted that “Northern
14 and Southern have agreed to use of a 2007 test year in its next general rate filing so adjustments can
15 be made as more reliable financial information is available.”³⁹

16
17 In its Closing Brief, Staff extensively addressed the first issue identified by the Company. In
18 its Closing Brief, the Company claims that Staff has presented no “evidence to contradict the
19 Company’s evidence.”⁴⁰ Ms. Brown specifically testified that:

20 Staff is looking at the Company from a consolidated perspective.
21 The money is going in from one pocket to another pocket. From a
22 consolidated perspective, the Company is one company. A
23 company cannot make a profit by buying and selling from [sic]
24 itself. The affiliate is providing - - in Staff’s opinion the business
arrangement that Black Mountain and the affiliate[s] have is - - the
primary purpose is so that the owners have an opportunity to

25 ³³ Tr. 778, l. 23 to 779, l. 7.

26 ³⁴ BMSC Closing Brief at 15, ll. 3-6. See also footnote 7 (“It is noteworthy that in the McClain matters, Staff accepted
the utilities’ proposed operating expenses, which included affiliate costs, without adjustments.”).

27 ³⁵ Decision No. 68826 (June 19, 2006).

28 ³⁶ See Staff Attachment No. 1 at 2. See also Decision No. 68826 at 13, ¶ 55 (June 19, 2006).

³⁷ *Id.*

³⁸ Decision No. 68826 at 6, ¶ 27 (June 19, 2006).

³⁹ *Id.*

⁴⁰ BMSC Closing Brief at 16, ll. 11-13.

1 charge an additional profit. So Staff would see any related party
2 transaction - - wherein the affiliate bears little or no risk, that the
3 affiliate has undue influence, there is no showing of the
4 competitive bid, the affiliate does not provide the same services to
unregulated third parties - - Staff would say that any profit charged
in a business arrangement such as that is unnecessary in the
provision of service and is therefore unreasonable.⁴¹

5 Ms. Brown also provided evidence of other Arizona utilities using shared services. These example
6 utilities do not charge a profit margin to affiliated operating companies.⁴²

7
8 Ms. Brown's testimony certainly contradicts the evidence provided by the Company.
9 Additionally, Staff has already argued that the evidence in the record supports piercing the corporate
10 veil, and treating all of the Algonquin affiliates as a single entity.⁴³

11 **B. The Company never established a fair market value for affiliate services**

12 For the Company's third issue, the Company admitted that it never conducted a complete
13 analysis of fair market value.⁴⁴ It also admitted that it did not issue a request for bids ("RFP") or
14 conduct a competitive bidding process.⁴⁵ Finally, Company witness Thomas Bourassa testified that
15 he did not know if an RFP issued nationally would have resulted in any competitive bids.⁴⁶

16
17 Therefore, the Company's claim about market value is an unsupported assertion.

18 Staff could not analyze whether all affiliate services provided to BMSC were necessary and
19 appropriately priced. To complete such an analysis, Staff would need to audit the books of all
20 Algonquin affiliates providing service to BMSC. Staff did not believe it had any authority to conduct
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25 ⁴¹ Tr. 777, l. 20 to 778, l. 11. See also *Id.* at 780, ll. 10-24.

26 ⁴² See Exhibit No. S-10 at 7, ll. 20-26. See also Exhibit No. S-12.

27 ⁴³ See Staff's Closing Brief at 9, l. 19 to 13, l. 24.

28 ⁴⁴ Exhibit No. S-17

⁴⁵ Exhibit No. A-3 at 11, ll. 20-24.

⁴⁶ Tr. 174, l. 22 to 175, l. 17.

1 the audits.⁴⁷ Staff also recognizes and shares the concerns expressed by Judge Nodes in his questions
2 of Mr. Bourassa.⁴⁸

3 **C. The Commission should disallow affiliate profits even if the Company's business**
4 **model achieves economies of scale**

5 Staff witness Crystal Brown acknowledged that "Black Mountain and its affiliates have a very
6 economically efficient operation and management of Black Mountain."⁴⁹ On the other hand, she
7 testified that economies of scale are not a sufficient justification for allowing affiliate profits.⁵⁰

8 Ms. Brown explained that Staff expects Algonquin to operate like other Arizona holding
9 companies.⁵¹ She testified that it is a common industry practice to create a shared services center to
10 achieve economies of scale. Ms. Brown further testified that the industry practice is to pass the
11 savings on to ratepayers without charging a profit.⁵² Lastly, she stated that affiliates do not place
12 their assets at any greater risk than BMSC. Because the risk is the same, the utility's ROE is a
13 sufficient incentive to operate efficiently.⁵³

15 **III. COMMISSION STAFF DID NOT CONDUCT AN INDEPENDENT INVESTIGATION**
16 **OF THE COMPANY'S COMPLIANCE WITH ODOR AND NOISE LAWS AND**
17 **REGULATIONS BECAUSE IT RELIED ON AGENCIES' FINDINGS WHO HAVE**
18 **JURISDICTION**

19 Carefree requests the Commission to condition any rate increase on BMSC resolving "the
20 odor problems at the CIE Lift Station and in the Boulders community."⁵⁴ The Boulders HOA also
21 requests the Commission escrow any monies from a rate increase. It requests the Commission to
22 order the Company to use the escrow monies to improve its infrastructure. The Boulders HOA
23

24 ⁴⁷ *Id.* at 798, ll. 13-25. See also Exhibit No. S-13 ("...the Company reserves the right to challenge any and all assertions
25 that any entity is an "affiliate" as such term is defined in the Commission rules or regulations.").

26 ⁴⁸ Tr. 183, l. 19 to 184, l. 15 (\$13,000 per month of affiliate expenses may be excessive for a company with fewer than
27 2,000 customers.); and *Id.* at 186, ll. 1-8 ("But from what we heard here this morning, this doesn't sound like a state-of-
28 the-art system that is being run by Black Mountain Sewer Company either.").

⁴⁹ Tr. 779, ll. 2-7.

⁵⁰ *Id.*

⁵¹ *Id.* at 789, ll. 15-18.

⁵² *Id.* at 812, l. 14 to 813, l. 22.

⁵³ *Id.* at 780, ll. 3-24.

⁵⁴ Carefree Closing Brief at 24, ll. 3-6.

1 claims that improvements are necessary to eliminate odor and noise emanating from Company
2 plant.⁵⁵

3 Both Carefree and the Boulders HOA criticize Staff's inspection of the Company's
4 wastewater treatment facility and collection system. They also support Staff's withdrawn alternate
5 proposal for use of funds in the Company's hook-up fee account. The Boulders HOA further claims
6 that its due process rights were violated. The HOA correctly states that Staff calculated rates based
7 on source documentation provided after the hearing. It claims that its due process rights were
8 violated because it could not cross examine witnesses on the change.⁵⁶ Staff addresses the three
9 issues below.

10
11 **A. Although Staff may inspect utility facilities, it may also rely on findings from
agencies having jurisdiction over specific environmental standards.**

12 Both Carefree and the Boulders HOA criticized Staff's inspection of BMSC's wastewater
13 system. Staff engineer Marlin Scott, Jr. conducted the inspection on January 11, 2006.⁵⁷ Carefree
14 argued that:

15 Scott's evaluation of the BMSC system can be described only as
16 cursory or incomplete as it completely disregards the
17 Commission's statutory mandates (i.e. A.R.S. §§ 40-361(B) and
18 40-334(B)), the actual service BMSC provides to its ratepayers, the
19 reports of engineers commissioned to evaluate the odor issues, and
20 even the complaints of ratepayers overheard during Scott's onsite
inspection...Instead Scott relied on other regulatory bodies that
21 have no obligation to consider the application of Commission
22 statutes including A.R.S. §§ 40-361(B) and 40-334(B).⁵⁸

23 The Boulders HOA similarly claimed that "The testimony of Marlin Scott, Jr., the Commission
24 Utilities Division engineer assigned to this rate case, reveals the casual approach he demonstrated in
25 his duties as a State inspector."⁵⁹

26 Carefree and the Boulders HOA unfairly criticize one of the Commission's most experienced
27 and valued engineers. Both intervenors have a fundamental misunderstanding about the role
28 Commission engineers perform during an inspection of a utility's facilities. Staff never disputed that

⁵⁵ Boulders HOA Closing Brief at 17.

⁵⁶ *Id.* at 16.

⁵⁷ Tr. 626, ll. 7-8.

⁵⁸ Carefree Closing Brief at 16, ll. 20-25 and at 17, ll. 20-22.

⁵⁹ Boulders HOA Closing Brief at 14.

1 it has overlapping jurisdiction with sister agencies related to environmental compliance of public
2 service corporations. Nevertheless, the primary purpose of an inspection is to determine whether
3 utility plant is used and useful in the provision of utility service. Neither intervenor disputed that Mr.
4 Scott professionally performed the inspection for ratemaking purposes. Instead, they believe he
5 should have conducted an onsite environmental assessment related to odor and noise.

6 In his Direct Testimony, Mr. Scott testified that BMSC was in total compliance with the
7 Arizona Department of Environmental Quality (“ADEQ”).⁶⁰ He also stated that, for pending cases,
8 Staff checks “with DEQ, Maricopa County, [and] ADWR to see if they are meeting the State
9 agency’s compliance.”⁶¹ Mr. Scott was also aware of customer complaints in this proceeding. As a
10 result, he had several additional conversations with the Maricopa County Department of
11 Environmental Services (“Maricopa County”)⁶² and ADEQ, before and during the hearing.⁶³

12 Finally, Mr. Scott testified that Staff’s practice is to defer to agencies’ with primary
13 jurisdiction to *initially* determine environmental compliance.⁶⁴ If a public service corporation
14 (“PSC”) is out of compliance, Staff conditions its approval of an application upon the PSC getting
15 back into compliance.⁶⁵ The Commission’s practice has been vetted in case law and tacitly approved.

16 In *Arizona Water Company v. Arizona Department of Water Resources*, 208 Ariz. 147, 91
17 P.3d 990 (2004), the Arizona Supreme Court recognized the Commission’s practice. The
18 Commission argued that:

19 Because it had worked collaboratively with “sister state agencies”
20 in the past when issues of *overlapping regulation* were presented,
21 it was confident that it would be able to work with ADWR should
a conflict arise in the future.⁶⁶

22 At hearing, Judge Nodes asked Mr. Scott a question about primary jurisdiction.⁶⁷ Courts use the
23 doctrine of primary jurisdiction to delay acting until an agency with primary jurisdiction first decides
24 a matter within its jurisdiction.⁶⁸

25 ⁶⁰ Exhibit No. S-1, Exhibit MSJ at 4.

26 ⁶¹ Tr. 610, l. 21 to 611, l. 1.

27 ⁶² *Id.* at 620, ll. 13-25 and *Id.* at 610, ll. 17-20 (The County has delegated authority from ADEQ.); see also Arizona
Revised Statute (“ARS”) § 49-107.

28 ⁶³ *Id.* 615, l. 12 to 616, l. 7.

⁶⁴ *Id.* 631, ll. 1-13.

⁶⁵ *Id.* 631, ll. 14-20.

⁶⁶ *Arizona Water Company*, 208 Ariz. at 150, 91 P. 3rd at 993.

⁶⁷ Tr. 620, ll. 20-22.

1 Mr. Scott testified that Staff generally relies on its sister-agencies' findings related to
2 environmental compliance. Staff only follows up if facts or circumstances warrant further
3 investigation. Even then, Staff would generally work with its sister-agencies to resolve the
4 compliance issue.

5 When Mr. Scott became aware of odor and noise issues with BMSC's wastewater facilities he
6 had several additional contacts with ADEQ and Maricopa County. Both agencies assured him that the
7 Company was in compliance with all noise and odor rules.⁶⁹

8 **B. Staff's withdrawn alternative proposal for use of hook-up fee funds**

9 Carefree and the Boulders HOA support Staff's alternate proposal for use of hook-up fee funds. Staff
10 originally proposed that the funds be refunded to ratepayers. Mr. Scott proposed the alternative at
11 hearing.⁷⁰ Judge Nodes ordered Staff to make a filing "in writing that kind of flushes out this
12 alternative a little better."⁷¹ Staff made its filing on June 15, 2006 as ordered by Judge Nodes.
13 However, Staff withdrew its alternative recommendation because (1) the Company opposed it, (2)
14 neither intervenor expressed an interest when Mr. Scott testified, and (3) to prevent further
15 complication of the case.⁷²

16 Subsequently, both Carefree and the Boulders HOA expressed strong interest in the
17 alternative proposal.⁷³ Carefree now takes the position that the hook-up fees should only be refunded
18 if the Commission conditions any rate increase "upon resolution of the odor problems."⁷⁴ The
19 Boulders HOA continues to support the alternative recommendation. Because Staff withdrew its
20 alternative recommendation, it takes no position on the intervenors' current recommendations.

22 ⁶⁸ See e.g. *Qwest Corporation v. Kelley*, 204 Ariz. 25, 31, 59 P.3d 789, 795 ("The court explained that the purpose of the
23 doctrine is to provide guidance to a court in determining whether to 'refrain from exercising its jurisdiction until after an
24 administrative agency has determined some question or some aspect of some question arising in the proceeding before the
court.") (citation for quotation omitted).

25 ⁶⁹ Tr. 611, ll. 15-25; Tr. 615, ll. 12-22.

26 ⁷⁰ Tr. 616, l. 17 to 619, l. 25.

27 ⁷¹ *Id.* 624, ll. 12-20.

28 ⁷² Staff's Alternative Recommendation for Use of Funds in the Hook-Up Fee Account, June 15, 2006.

⁷³ See Carefree Closing Brief at 23, ll. 3-21 ("The Alternative Proposal offered a means of guarantee[d] funding."); see
also Boulders HOA Closing Brief at 10 ("Commission Staff ultimately withdrew this recommendation. However, . . . , we
continue to believe that it is a viable and excellent mechanism to ensure at least some of the odor, spillage and noise
problems are fixed.").

⁷⁴ Carefree Closing Brief at 23, ll. 18-21.

1 In its Closing Brief, Carefree stated that:

2 If Commission Staff truly believed that no basis existed for the
3 Commission to impose such a condition upon BMSC for
4 improvements to resolve the odor problems, or that there were no
5 odor problems requiring the attention of the Commission, the
6 Alternative Proposal would not have been offered by [Mr.] Scott
7 during his testimony.⁷⁵

8 Staff respectfully disagrees with Carefree's characterization of Staff's motivation for offering the
9 alternative recommendation. Staff presented the alternative recommendation as a compromise
10 between the Company and intervenors. Staff's position on environmental compliance was discussed
11 above. Staff does not disagree that there may be an odor problem. However, Staff reasonably relied
12 on ADEQ's and Maricopa County's investigations and findings.

13 **C. Boulders HOA's due process rights were not violated by Staff's post-hearing
14 consideration of source documentation.**

15 In its Closing Brief, Boulders HOA took exception to Staff's final recommendation of a
16 20.42% rate increase.⁷⁶ The HOA stated that "The increase is based on new information given to
17 Staff after the closing of the hearings. Consideration of this information would constitute a violation
18 of our due process rights to cross examination."⁷⁷

19 Staff does not believe that the Boulders HOA's due process rights were violated. Staff's
20 recommended disallowances were described in detail in its pre-filed testimony. The recommended
21 disallowances were also the subject of cross examination.⁷⁸ It is also noteworthy that the Boulders
22 HOA did not have any cross examination on ratemaking issues. Its intervention appeared to be
23 focused on the odor and noise issues.

24 **IV. THE COMMISSION SHOULD ADOPT STAFF'S RECOMMENDED RETURN ON
25 EQUITY.**

26 In its Closing Brief, the Company discusses the theoretical bases for its methodology and
27 Staff's methodology. Staff will not revisit those issues in its Reply Brief. Staff rests on its arguments

28 ⁷⁵ *Id.* at 18, ll. 19-24.

⁷⁶ Boulders Closing Brief at 16.

⁷⁷ *Id.*

⁷⁸ See e.g. Tr. 757, l. 10 to 772, l. 25.

1 made in its Closing Brief. Staff will, however, address some of the factual issues raised by the
2 Company in its Closing Brief.

3 **A. Staff's choice of inputs for its financial models is reasonable and consistent with**
4 **market data.**

5 The Company claims that Staff "blindly" applies the results of its financial models.⁷⁹ It also
6 states that "the inputs Staff uses in implementing the CAPM produce results that run counter to
7 CAPM theory."⁸⁰ The Company argues that Staff's Capital Asset Pricing Model ("CAPM") creates
8 unreasonable results. The Company presented an example of how it believes that Staff's CAPM
9 results are unreasonable.⁸¹ It points out that Staff's overall recommended ROE did not change during
10 the last three years. The Company argues that Staff's recommendation is unreasonable because
11 Staff's risk-free rate and average beta have increased during this time.⁸²

12 Rather than supporting the Company's claim, the example illustrates why Staff appropriately
13 chooses its inputs, and then allows the results to speak for themselves. Mr. Chaves testified that he
14 uses the most recent market data available to meet the deadline for filing his testimony.⁸³ His method
15 is consistent with the efficient market hypothesis.

16 In its Closing Brief, the Company pointed out that Staff used the same CAPM methods in
17 Arizona Water's Eastern Group case.⁸⁴ The Company compared Staff's risk-free interest rate and
18 average beta in that case to the present case. It stated that the risk-free interest rate increased by 120
19 basis points.⁸⁵ The Company further points out that the average beta increased from 0.59 to 0.74.
20 The Company then claims that Staff's recommended ROE should have increased accordingly.

21 Staff's CAPM results did increase, but they only increased from 9.2% to 9.6%.⁸⁶ Mr. Chaves
22 testified that the Company only compared two of the three components of the CAPM model.⁸⁷ The

23 ⁷⁹ BMSC Closing Brief at 20, l. 22 to 21, l. 3. Note that Staff already addressed its choice of inputs for its Discounted
24 Cash Flow ("DCF") models in its Closing Brief.

⁸⁰ *Id.* at 26, ll. 11-12.

⁸¹ *Id.* at 21, ll. 4-12 and 26, l. 20 to 27, l. 13.

⁸² *Id.* at 26, ll. 16-19 ("Thus, according to the CAPM, as interest rates and the estimated beta increase, the cost of equity
26 increases. Staff's CAPM estimates, however, move in the opposite direction of both interest rates and beta risk.").

⁸³ Tr. 717, l. 22 to 719, l. 1.

⁸⁴ BMSC Closing Brief at 26, ll. 20-23. See also Decision No. 66849.

⁸⁵ *Id.* at 27, ll. 8-10. But note that the Company's statement used Exhibit No. S-6. Staff updated its final Brief Schedule
27 PMC-2. Staff will compare the changes from Schedule JMR-7 to the final brief schedule.

⁸⁶ See Exhibit No. A-21 at Schedule JMR-7 and Staff Brief Schedule PMC-2.

⁸⁷ Tr. 719, ll. 18-20.

1 Company did not include the change in market risk premium in its analysis. The market risk
2 premium declined from an average of 10.25% to 6.25%, partially offsetting the increases in the other
3 two variables.⁸⁸ Therefore, the Company's example does not support its position.

4 The Company next argues that Staff should only use future growth rates to be consistent with
5 the efficient market hypothesis.⁸⁹ It explains that "in an efficient market, stock prices fully reflect all
6 relevant information available at that time." The Company then argues that Staff should ignore
7 historical information using the efficient market hypothesis. It points out that even Staff
8 acknowledges that "current stock price includes investors' expectations of future returns."⁹⁰

9 Staff agrees that current stock prices fully reflect all relevant information. However, all
10 relevant information includes both historical information and investors' expectations of future
11 returns. Staff has repeatedly testified that investors consider all relevant information, including
12 historical information.⁹¹ Correspondingly, current stock price includes investors' consideration of
13 past market returns.

14 The Company next criticizes Staff's use of a geometric average. It states that "Staff also uses
15 the *geometric* average growth rates, rather than the conceptually correct *arithmetic* average growth
16 rates, which further lowers the average growth rate and resulting equity cost estimate."⁹² Staff
17 acknowledges that use of an arithmetic average may be appropriate in certain circumstances. In its
18 testimony and Closing Brief, the Company frequently cites expert Dr. Roger Morin. Even Dr. Morin
19 expresses concerns about use of an arithmetic average. Dr. Morin cautions that "the arithmetic mean
20 can be very misleading..."⁹³

21 Finally, in its Closing Brief, the Company argued that the method used by the Federal Energy
22 Regulatory Commission ("FERC") demonstrates the unreasonableness of Staff's inputs. The FERC
23 model rejects proxy companies that have cost estimates that are not at least 40 basis points above the
24 cost of investment grade bonds.⁹⁴ Staff first notes that there is no evidence in the record regarding the

25 _____
26 ⁸⁸ *Id.* 721, l. 21 to 722, l. 17.

⁸⁹ BMSC Closing Brief at 24, ll. 13-21.

⁹⁰ *Id.* at 24, l. 14.

⁹¹ Tr. 703, ll. 23-25 and 704 l. 1.

⁹² BMSC Closing Brief at 24, footnote 10 (emphasis in the original).

⁹³ Dr. Roger Morin, *Utilities' Cost of Capital* (1984) p. 92.

⁹⁴ BMSC Closing Brief at 24, ll. 8-9.

1 FERC model. As a result, the Commission should disregard this argument. However, the
2 Commission has previously stated, “We are not convinced that the methodology FERC uses to
3 estimate cost of capital for the energy and gas industry companies it regulates is appropriately applied
4 to monopoly water utilities.”⁹⁵

5 **B. Staff’s use of a sample of proxy companies to estimate BMSC’s expected ROE is**
6 **reasonable.**

7 Inexplicably, the Company criticizes Staff’s use of a sample of proxy companies to estimate
8 BMSC’s expected ROE.⁹⁶ The Company claims that there is no evidence that use of the average
9 betas is representative of the industry.⁹⁷ The Company used the same sample and same method in its
10 DCF analyses. The sample was chosen by both the Company and Staff for the same reason. The
11 companies are followed by publications that have necessary inputs for the financial models. It is also
12 noteworthy that very few water utilities are followed by the publications. Additionally, no stand-
13 alone wastewater utilities are followed.

14 Nevertheless, Staff’s use of the proxy companies to estimate BMSC’s beta is reasonable. Use
15 of an industry beta is an accepted practice among financial analysts.⁹⁸ The Company argues that the
16 average beta does not represent the entire industry. Its primary reason appears to be that the proxy
17 companies only consist of the “largest publicly traded water utilities in the United States.”⁹⁹ The
18 argument is unfounded. Not only are the proxy companies the best representation of the industry
19 beta, they are probably the only representation.

20 The Company further argues that Staff’s estimated beta does not include the following four
21 risk factors: (1) firm size; (2) diversification, (3) regulatory risk, and (4) liquidity risk.¹⁰⁰ Company
22 witness Thomas Bourassa acknowledged that the Company did not quantify any of these risk factors.
23 Staff witness Pedro Chaves also testified that he is not aware of any studies that address the effects of
24 regulatory jurisdiction.¹⁰¹ He also testified that the CAPM appropriately addresses all of the above

25 ⁹⁵ Decision No. 68176 at 25, l. 27 to 26, l. 2.

26 ⁹⁶ BMSC Closing Brief at 22, ll. 18-23.

27 ⁹⁷ *Id.*

28 ⁹⁸ See e.g. Richard A. Brealey & Stuart O. C. Myers, *Principles of Corporate Finance* (7th ed. 2003) at 226 (“[E]stimation errors tend to cancel out when estimating betas for portfolios. That is why financial managers often turn to industry betas.”).

⁹⁹ BMSC Closing Brief at 22, ll. 20-23.

¹⁰⁰ BMSC Closing Brief at 22, ll. 10-16.

¹⁰¹ Tr. 714, l. 15 to 715, l. 4.

1 risk factors.¹⁰² In its Closing Brief, Staff addressed the other three factors. Staff believes that its
2 estimation of an industry beta results in a reasonable estimation of BMSC's ROE.

3 Finally, Staff believes the Company's use of the proxy company method was unreasonable.
4 Staff addressed this issue in its Closing Brief. Even with the Company's selective use of it proxy
5 companies, its DCF results are only 10 basis points above Staff's results. However, the Company
6 excluded one of the proxy companies in its DCF studies. The Company excluded Middlesex from its
7 sample because the indicated ROE was only 40 basis points above projected costs for Baa investment
8 grade bonds.¹⁰³ Mr. Chaves used the Company's inputs and included Middlesex. Including
9 Middlesex caused the Company's ROE to be 30 basis points *below* Staff's results.¹⁰⁴

10
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12
13
14 RESPECTFULLY SUBMITTED this 5th day of September 2006.

15 

16 Keith Layton, Attorney
17 Legal Division
18 Arizona Corporation Commission
19 1200 West Washington Street
20 Phoenix, Arizona 85007
21 *Attorney for Staff*

22 Original and thirteen copies filed
23 this 5th day of September, 2006 with:

24 Docket Control
25 Arizona Corporation Commission
26 1200 West Washington Street
27 Phoenix, Arizona 85007

28 Copies of the foregoing were mailed
on this 5th day of September, 2006 to:

¹⁰² Chaves Direct at 11-13.

¹⁰³ See Company Exhibit No. A-3, Bourassa Rejoinder Schedule D4.9, footnote (b).

¹⁰⁴ Staff Exhibit No. S-8.

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ATTACHMENT

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MEMORANDUM

RECEIVED

30

2006 MAY 17 P 3: 59

TO: Docket Control

FROM: Ernest G. Johnson
for Director
Utilities Division

AZ CORP COMMISSION
DOCUMENT CONTROL

DATE: May 17, 2006

IN THE MATTER OF THE APPLICATION OF NORTHERN SUNRISE WATER COMPANY INC. AND SOUTHERN SUNRISE WATER COMPANY INC. FOR A CERTIFICATE OF CONVIENENCE AND NECESSITY TO PROVIDE WATER SERVICE IN COCHISE COUNTY, ARIZONA.
DOCKET NOS. W-20453A-06-0247 AND W-20454A-06-0248

IN THE MATTER OF THE JOINT APPLICATION OF NORTHERN SUNRISE WATER COMPANY INC. AND SOUTHERN SUNRISE WATER COMPANY INC. FOR THE APPROVAL OF SALE AND TRANSFER OF WATER UTILITY ASSETS, AND CANCELLATION OF CERTIFICATES OF CONVENIENCE AND NECESSITY, FOR MIRACLE VALLEY WATER COMPANY, COCHISE WATER COMPANY, HORSESHOE RANCH WATER COMPANY, CRYSTAL WATER COMPANY, MUSTANG WATER COMPANY, CORONADO ESTATES WATER COMPANY, AND SIERRA SUNSET WATER COMPANY, LOCATED IN COCHISE COUNTY, ARIZONA.
DOCKET NOS. W-20453A-06-0251, W-20454A-06-0251, W-01646A-06-0251, W-01868A-06-0251, W-02235A-06-0251, W-02316A-06-0251, W-02230A-06-0251, W-01629A-06-0251, W-02240A-06-0251

Attached is the Staff Report for the above referenced applications. Staff recommends approval of the applications subject to several conditions.

EGJ:LAJ:tdp

Originator: Linda A. Jaress

Hook-up Fees

Staff recommends a hook-up fee of \$1,000. Staff also recommends that the hook-up fees collected be considered as a non-refundable contribution in aid of construction. The hook-up fees will help offset the costs noted above. Northern and Southern shall provide an analysis of collected hook-up fees and whether any adjustment to the amount be made in its 2008 general rate filing.

REVENUE AND EXPENSES

As justification for the initial rates, Northern and Southern have estimated its revenue and expenses. Staff has reviewed the estimates and found them to be reasonable. Based upon these estimates, Northern and Southern will experience an estimated return on rate base of approximately 9.77 percent for Northern and 11.90 percent for Southern (combined 11.17 percent) during the first year of operation. See Schedule REL-2. Although higher than Staff has recommended recently for similarly sized water companies, Staff recognizes that a somewhat higher return is warranted given that this case involves unique and extraordinary circumstances when assuming responsibility for multiple bankrupt water companies. Staff also notes that the returns will decline once Northern and Southern add additional plant. Staff also notes that Northern and Southern have agreed to use a 2007 test year in its next general rate filing so adjustments can be made as more reliable financial information is available. This will provide a reasonable time period within which adjustments to the rate of return can be made, if necessary.

The revenues were estimated based upon an average customer usage of 7,300 gallons per month and appears reasonable. The combined revenues for Northern and Southern total \$684,320.

First year expenses for Northern and Southern are estimated at \$488,872. In the Emergency Rate proceeding³ Staff estimated annual operating expenses of \$456,457 which did not provide for a profit and related income taxes. Northern and Southern prepared detailed estimates for variable and other costs on a basis consistent with new CC&N filings.

It appears that Northern and Southern have made reasonable estimates of annual expenditures. Because the McLain Water Systems are in such disrepair, obtaining consistent and reliable operating results has been difficult.

Depreciation

As shown in their Exhibits, Northern and Southern adopted Staff's recommended depreciation rates and are noted at Schedule REL-3. These rates have been approved in numerous water rate cases. Staff recommends that Northern and Southern continue the use of

³ Staff Report, Attachment B, in Docket No. W-01646A-06-0010.

Northern and Southern Sunrise Water Companies
Docket No. W-20453A-06-0247, W-20454A-06-0248
Plant Balances

SCHEDULE REL-1

	Northern Sunrise Water Company		Southern Sunrise Water Company	
	Company Per Decision Number 68142	Staff Per Decision Number 68142	Company Per Decision Number 68142	Staff Per Decision Number 68142
301 Organization	-	-	-	-
302 Franchises	-	-	-	-
303 Land and Land Rights	\$ 27,812	\$ 16,709	\$ 361,364	\$ 273,391
304 Structures and Improvements	\$ 319	\$ 349	\$ 1,094	\$ 1,218
305 Collecting and Impounding Reservoirs	-	-	-	-
306 Lake, River and Other Intakes	-	-	-	-
307 Wells and Springs	-	-	\$ 23,379	\$ 28,521
308 Infiltration Galleries and Tunnels	-	-	-	\$ -
309 Supply Mains	-	-	-	\$ -
310 Power Generation Equipment	-	-	-	\$ -
311 Pumping Equipment	\$ 23,364	\$ 27,210	\$ 40,555	\$ 61,085
320 Water Treatment Equipment	-	-	-	-
330 Distribution Reservoirs and Standpipe	\$ 4,351	\$ 4,563	\$ 25,972	\$ 170,298
331 Transmission and Distribution	\$ 35,134	\$ 41,716	\$ 152,106	\$ 70,372
333 Services	\$ 1,012	\$ 1,039	-	-
334 Meters and Meter Deposits	-	-	-	-
335 Hydrants	-	-	\$ 255	\$ 284
336 Backflow Prevention Devices	-	-	-	-
339 Other Plant and Miscellaneous	-	-	-	-
340 Office Furniture and Equipment	-	-	-	-
341 Transportation Equipment	-	-	-	-
342 Stores Equipment	-	-	-	-
343 Tools, Shop and Garage Equipment	-	-	-	-
344 Laboratory Equipment	-	-	-	-
345 Power Operated Equipment	-	-	-	-
346 Communication Equipment	-	-	-	-
347 Miscellaneous Equipment	-	-	-	-
348 Other Tangible Plant	-	-	-	-
	<u>\$ 91,992</u>	<u>\$ 91,585</u>	<u>\$ 604,725</u>	<u>\$ 605,168</u>

Northern and Southern Sunrise Water Companies
Docket No. W-20453A-06-0247, W-20454A-06-0248
ESTIMATED FIRST AND SECOND YEAR RATE BASE

SCHEDULE REL-2

	Northern Sunrise		Southern Sunrise		Staff
	Company First Year	Staff First Year	Company First Year	Staff First Year	Combined First Year
Plant in Service (per Decision No. 48412)	\$ 91,992	\$ 91,585	\$ 604,725	\$ 605,168	\$ 696,752
Less Accumulated Depreciation *	\$ (13,476)	\$ (4,383)	\$ (16,526)	\$ (13,820)	\$ (18,203)
Pro Forma Plant Additions	\$ 480,200	\$ 480,200	\$ 321,900	\$ 321,900	\$ 802,100
Less Depreciation		\$ (9,264)		\$ (6,725)	\$ (15,989)
Deferred Regulatory Assets	\$ 64,619	\$ 64,619	\$ 235,381	\$ 235,381	\$ 300,000
Less Accumulated Amortization *	\$ (3,231)	\$ (3,231)	\$ (11,769)	\$ (11,769)	\$ (15,000)
Rate Base	<u>\$ 620,104</u>	<u>\$ 619,526</u>	<u>\$ 1,133,711</u>	<u>\$ 1,130,135</u>	<u>\$ 1,749,660</u>
Pro Forma Revenue (per Company)	\$ 204,444	\$ 204,444	\$ 479,876	\$ 479,876	\$ 684,320
Total Operating Expense	\$ (143,866)	\$ (143,866)	\$ (345,006)	\$ (345,006)	\$ (488,872)
Operating Income	<u>\$ 60,578</u>	<u>\$ 60,578</u>	<u>\$ 134,870</u>	<u>\$ 134,870</u>	<u>\$ 195,448</u>
Rate of Return	9.77%	9.78%	11.90%	11.93%	11.17%
	Company Second Year	Staff Second Year	Company Second Year	Staff Second Year	Staff Combined Second Year
Plant in Service (per Decision No. 48412)	\$ 91,992	\$ 91,585	\$ 604,725	\$ 605,168	\$ 696,752
Less Accumulated Depreciation *	\$ (36,835)	\$ (8,766)	\$ (40,241)	\$ (27,639)	\$ (36,405)
Pro Forma Plant Additions	\$ 484,300	\$ 484,300	\$ 326,000	\$ 326,000	\$ 810,300
Less Accumulated Depreciation *	\$ -	\$ (18,699)	\$ -	\$ (13,621)	\$ (32,320)
Deferred Regulatory Assets	\$ 64,619	\$ 64,619	\$ 235,381	\$ 235,381	\$ 300,000
Less Accumulated Amortization *	\$ (6,462)	\$ (6,462)	\$ (23,538)	\$ (23,538)	\$ (30,000)
Rate Base	<u>\$ 597,614</u>	<u>\$ 606,577</u>	<u>\$ 1,102,327</u>	<u>\$ 1,101,750</u>	<u>\$ 1,708,327</u>
Pro Forma Revenue (per Company)	\$ 207,534	\$ 207,534	\$ 482,965	\$ 482,965	\$ 690,499
Total Operating Expense	\$ (154,823)	\$ (154,823)	\$ (355,045)	\$ (355,045)	\$ (509,868)
Operating Income	<u>\$ 52,711</u>	<u>\$ 52,711</u>	<u>\$ 127,920</u>	<u>\$ 127,920</u>	<u>\$ 180,631</u>
Rate of Return	8.82%	8.69%	11.60%	11.61%	10.57%

* Company schedules do not separate depreciation between Decision No. 68412 plant and pro forma plant. Staff reclassified certain plant which caused a lower depreciation rate than that used by the Company.

ATTACHMENT

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

Arizona Corporation Commission

DOCKETED

JUN 29 2006

DOCKETED BY **RSB**

**IN THE MATTER OF THE APPLICATION OF
NORTHERN SUNRISE WATER COMPANY FOR
A CERTIFICATE OF CONVENIENCE AND
NECESSITY TO PROVIDE WATER SERVICE IN
COCHISE COUNTY, ARIZONA.**

DOCKET NO. W-20453A-06-0247

**IN THE MATTER OF THE APPLICATION OF
SOUTHERN SUNRISE WATER COMPANY FOR
A CERTIFICATE OF CONVENIENCE AND
NECESSITY TO PROVIDE WATER SERVICE IN
COCHISE COUNTY, ARIZONA.**

DOCKET NO. W-20454A-06-0248

**IN THE MATTER OF THE JOINT APPLICATION
OF NORTHERN SUNRISE WATER COMPANY
AND SOUTHERN SUNRISE WATER COMPANY
FOR THE APPROVAL OF SALE AND
TRANSFER OF WATER UTILITY ASSETS, AND
CANCELLATION OF CERTIFICATES OF
CONVENIENCE AND NECESSITY, FOR
MIRACLE VALLEY WATER COMPANY,
COCHISE WATER COMPANY, HORSESHOE
RANCH WATER COMPANY, CRYSTAL WATER
COMPANY, MUSTANG WATER COMPANY,
CORONADO ESTATES WATER COMPANY,
AND SIERRA SUNSET WATER COMPANY,
LOCATED IN COCHISE COUNTY, ARIZONA.**

**DOCKET NOS. W-20453A-06-0251
W-20454A-06-0251
W-01646A-06-0251
W-01868A-06-0251
W-02235A-06-0251
W-02316A-06-0251
W-02230A-06-0251
W-01629A-06-0251
W-02240A-06-0251**

DECISION NO. 68826

OPINION AND ORDER

DATE OF PUBLIC COMMENT:

May 22, 2006

PLACE OF PUBLIC COMMENT:

Sierra Vista, Arizona

DATE OF HEARING:

May 30, 2006

PLACE OF HEARING:

Tucson, Arizona

ADMINISTRATIVE LAW JUDGE:

Jane L. Rodda

IN ATTENDANCE:

Kristin K. Mayes, Commissioner

DOCKET NO. W-20453A-06-0247 ET AL

1 transaction.

2 Revenues and Expenses

3 55. Applicants have proposed revenues and projected expenses that indicate Southern
4 would experience in the first year an estimated return on rate base of approximately 11.9 percent and
5 9.77 percent for Northern. Staff reviewed the Applicants' estimates of revenues and expenses and
6 found them to be reasonable. Staff notes that the expected return is higher than Staff's recent
7 recommendations for similarly sized water companies, but Staff states that this is a unique case and
8 that Applicants will face greater risk than most companies in bringing these companies out of
9 bankruptcy and into compliance.

10 56. The estimated revenues are based on an average customer usage of 7,300 gallons per
11 month. Staff believes that the estimate is reasonable.

12 57. Staff has recommended depreciation rates as set forth in the Staff Report as Schedule
13 REL-3. Staff notes that its recommended depreciation rates have been approved in numerous water
14 rate cases. Staff recommends that Northern and Southern continue to use the depreciation rates
15 delineated in REL-3 for each individual National Association of Regulatory Utility Commissioners
16 ("NARUC") asset category. Staff recommends, however, that Account No. 305 - Collecting and
17 Impounding Reservoirs not be used and that all reported plant costs in Account No. 305 be
18 reclassified to Account No. 330 - Distribution Reservoirs and Standpipes. Staff states that it
19 classified storage tanks and pressure tanks to Account No. 330 as shown in the RCN and RCND
20 spreadsheets in Decision No. 68412.

21 Financing

22 58. Applicants proposed to finance the acquisition with common stock.

23 59. Given the extraordinary nature of this transaction, Staff believes that equity financing
24 is appropriate and warranted.

25 Rates

26 60. Applicants propose a single rate design for the Northern and Southern systems.

27 61. Staff believes that a single rate design is appropriate at this time as all systems will be
28 operated under a single management team and economies of scale can begin to be achieved. To