

GOLD CANYON SEWER COMPANY

DOCKET NO. SW-02519A-06-0015

REHEARING TESTIMONY

OF

MARYLEE DIAZ CORTEZ, CPA

ON BEHALF OF

THE

RESIDENTIAL UTILITY CONSUMER OFFICE

SEPTEMBER 28, 2007

1
2
3
4
5
6

TABLE OF CONTENTS

INTRODUCTION1

REGULATORY STANDARD FOR FAIR AND REASONABLE RATES2

CAPITAL STRUCTURE AND WEIGHTED COST OF CAPITAL3

PLANT BUILT FOR FUTURE CUSTOMERS – EXCESS CAPACITY5

CONCLUSION.....9

1 **INTRODUCTION**

2 Q. Please state your name, occupation, and business address for the record.

3 A. My name is Marylee Diaz Cortez. I am a Certified Public Accountant
4 employed by the Residential Utility Consumer Office (RUCO) 1110 W.
5 Washington, Phoenix, Arizona. My title is Chief of Accounting and Rates.

6

7 Q. Have you previously filed testimony in this docket.

8 A. No.

9

10 Q. What is the purpose of your testimony in this docket?

11 A. The purpose of my testimony is to discuss from a policy standpoint why
12 the Commission should modify the position it took in Decision No. 69664
13 as it pertained to Gold Canyon Sewer Company's (Gold Canyon) capital
14 structure, weighted cost of capital and the issue of plant excess capacity.
15 The testimony of William A. Rigsby supports the factual basis for RUCO's
16 recommended capital structure and weighted cost of capital and the
17 testimony of Rodney L. Moore supports the factual basis for RUCO's
18 recommendation regarding plant excess capacity.

19

1 **REGULATORY STANDARD FOR FAIR AND REASONABLE RATES**

2 Q. What is the overall regulatory standard used in Arizona to establish public
3 utility rates?

4 A. The regulatory standard is that there must be a balancing of the interests
5 of the utility and its ratepayers in order to determine fair and reasonable
6 rates.¹

7
8 Q. Did Decision No. 69664 adequately balance the interests of shareholders
9 and ratepayers?

10 A. No, I do not believe so. Decision No. 69664 authorized a 72.02 percent
11 increase, which was biased in favor of the Gold Canyon's shareholders.

12
13 Q. Why do you believe Decision No. 69664 was biased in favor of
14 shareholders?

15 A. There were two issues in particular (both of which had a material impact
16 on the required rate increase) that Decision No. 69664 ruled decidedly in
17 the favor of the Company, despite substantial evidence that such a ruling
18 would be unfair to ratepayers.

19
20
21

¹ *Arizona Community Association v. Arizona Corporation Commission v. Arizona Public Service*, 123 Ariz. 228, 231, 599 P.2d 184, 187 (Supreme Court, 1979), *Arizona Corporation Commission v. State ex. rel. Woods*, 171 Ariz. 286, 290, 830 P. 2d. 807, 811 (Supreme Court, 1992).

1 Q. What were these two issues?

2 A. The two issues were: 1) the appropriate capital structure and weighted
3 cost of capital and, 2) who should be required to pay for capacity built to
4 serve future customers and when the cost of such excess capacity should
5 be recovered. On both of these issues Decision No. 69664 ruled in favor
6 of the position that rendered the highest revenue requirement, and that
7 accordingly was most advantageous to Gold Canyon Sewer shareholders.

8

9 **CAPITAL STRUCTURE AND WEIGHTED COST OF CAPITAL**

10 Q. Please discuss the capital structure/weighted cost of capital issue.

11 A. Gold Canyon Sewer has an actual capital structure that is comprised of
12 100 percent equity, which renders the highest weighted cost of capital
13 possible. Financing a public utility (after its start-up stage) with nothing
14 but high cost equity is imprudent.

15

16 Q. Under utility regulation aren't imprudent actions on the part of the utility
17 disallowed by the regulator in order to protect ratepayers from high rates
18 that result from poor management decisions?

19 A. Yes, generally that is case. However, in this instance a decision was
20 made to allow the cost of an imprudent capital structure, thereby requiring
21 ratepayers to bear the cost of the poor management decision to maintain
22 the all-equity capital structure.

23

1 Q. Is this a good message to send to the regulated public utility industry in
2 Arizona?

3 A. No. In general, it is bad public policy to encourage and condone poor
4 management decisions made by regulated utilities and to force captive
5 customers to pay for imprudent management decisions. Further, Decision
6 No. 69664 sends a message that utilities will be rewarded with higher
7 rates when they set up imprudent capital structures.

8
9 Q. Is a hypothetical capital structure, as proposed by RUCO in this case, an
10 extraordinary ratemaking concept?

11 A. No. Use of hypothetical capital structures to balance the interest of
12 shareholders and ratepayers is no different than any other proforma
13 adjustment that the Commission considers routinely in a rate case. In
14 both cases, the Commission sets rates based not on the actual data
15 reflected in the utility's books and records, but based on more prudent
16 levels of costs. It has been quite common in Arizona for the Commission
17 to utilize hypothetical capital structures when a utility's actual equity is so
18 low that use of the actual capital structure will result in an unacceptable
19 low return to the shareholders. The situation is merely the converse here,
20 where the shareholders will be allowed unreasonable profits at ratepayer
21 expense if the actual, equity-heavy, capital structure is used to set rates.

22

1 Q. Typically, what is the accepted regulatory solution when a utility's capital
2 structure is imbalanced?

3 A. Use of a hypothetical capital structure is the regulatory tool commonly
4 used to adjust any inequities that result between ratepayer and
5 shareholder interests when an unbalanced capital structure exists. This is
6 entirely consistent and appropriate under the regulatory requirement to
7 balance ratepayer and shareholder interests to determine fair and
8 reasonable rates, and accordingly, should be adopted here.

9

10 **PLANT BUILT FOR FUTURE CUSTOMERS – EXCESS CAPACITY**

11 Q. Please discuss the excess capacity issue.

12 A. The rates requested in Gold Canyon's rate application included 100
13 percent of the cost of Gold Canyon's recent wastewater treatment plant
14 expansion. Decision No. 69664 authorized recovery of 100 percent of
15 this plant, and as a result failed to adequately balance the interests of
16 ratepayers and shareholders.

17

18 Q. Please explain.

19 A. Evidence was put on the record showing that Gold Canyon's wastewater
20 treatment plant expansion was built in part to serve existing test year
21 customers and also in part to serve future customers, based on growth
22 projections.

23

1 Q. Is it normal for a business entity, whether regulated or not regulated, to
2 expand its capacity prior to actually having an immediate use for the
3 incremental capacity?

4 A. Yes, it is a typical business practice to plan ahead for growth. If an
5 enterprise expects to grow and expand it must plan ahead for such
6 growth.

7

8 Q. In a non-regulated enterprise, would that entity expect to immediately
9 recover incremental investment it had made in anticipation of increased
10 sales?

11 A. No. Non-regulated enterprises would not expect to be able to raise the
12 price of their existing product to recover costs invested to generate future
13 growth in output. Competitive pressures would not allow a non-regulated
14 enterprise to recover the cost of investment made to accommodate a
15 future sales level.

16

17 Q. Please provide an example.

18 A. Assume XYZ Company builds two different models of cars – the X Car
19 and the Y Car. Management decides it desires to increase its sales by
20 adding a third model - the Z Car – that will appeal to a market segment not
21 targeted by the X and Y Cars. In 2007 XYZ Company invests \$100 million
22 in a production plant that will eventually build the Z Car. The first Z Car
23 however, will not roll off the assembly line until 2010. XYZ Company

1 cannot increase the price of its Model X and Model Y cars in 2007 to begin
2 recovering its \$100 million investment in the Z Car. Competition will not
3 allow it to do so. Likewise, Gold Canyon's rates would not be reasonable
4 if the Company were allowed to charge existing customers (X Car and Y
5 Car buyers) for investment made to serve future customers (Z Car
6 buyers).

7

8 Q. In your example, even if XYZ Company's investment in the Z Car plant
9 turns out to be prudent (customers do in fact begin to purchase Z Cars),
10 does that mean the Company can recover its investment prior to
11 producing the Z Car?

12 A. No. Simply because an investment may ultimately prove to be prudent
13 (i.e. profitable) does not mean that that investment must or should be
14 recovered immediately. Likewise, the fact that RUCO believes that Gold
15 Canyon's investment in the additional wastewater treatment capacity was
16 prudent does not mean that it must begin recovering that investment prior
17 to the arrival of the customers that will use the additional plant.

18

19 Q. If the Commission were to exclude the excess capacity from rates until
20 such time as it was utilized would that result in utilities failing to build for
21 the future?

22 A. No. First, a regulated utility has an obligation to serve, which is part of the
23 regulatory compact that a public service company enters into in exchange

1 for an exclusive service territory. Second, the nature of investment is such
2 that returns are not realized immediately. Third, there is inherent risk in all
3 investment. In my example, XYZ Company has a risk that its \$100 million
4 investment in the Z Car plant may never be recovered if no one buys the
5 output of that plant (i.e. the Z Car). In Gold Canyon's case it likewise
6 should bear the risk that it may never recover the investment it made in
7 the additional capacity, in the event growth does not materialize.

8

9 Q. Does Decision No. 69664 shift that investment risk from shareholders to
10 ratepayers?

11 A. Yes. Because Decision No. 69664 allows recovery of 100 percent of the
12 wastewater treatment plant expansion from the existing customer base,
13 the Company is at no risk of recovery if the anticipated growth does not
14 occur. Instead this risk is shifted to the existing ratepayers. This does not
15 result in a fair balancing of the interests of shareholders and ratepayers,
16 but rather is biased against ratepayers.

17

18 Q. If Decision No. 69664 were modified to exclude the portion of the plant
19 expansion related to future customers, would the Company be left
20 unwhole for its investment in the treatment plant expansion?

21 A. No. Exclusion of the excess capacity in current rates merely changes
22 from whom the costs are recovered and when. When growth actually
23 occurs, the full amount of the investment found at that time to be prudent

1 would receive rate base treatment and rate recovery. RUCO has also
2 recommended that any excess capacity disallowance² in this case carry
3 with it an accounting order that would allow the Company to eventually
4 recover any depreciation expense that accrued on the excess capacity
5 prior to the time it was placed in rate base. This would be accomplished
6 through a deferral accounting order and eventual amortization when the
7 capacity becomes used and useful. Thus, once new customers
8 materialize and the excess portions of the plant are placed in rate base,
9 the Company would be made whole.

10
11 **CONCLUSION**

12 Q. What changes are you recommending for Decision No. 69664?

13 A. I recommend that the Commission take this opportunity and rebalance
14 Decision No. 69664 to better address the ratepayers' interests pertaining
15 to the imprudent capital structure issue and the inequities inherent in
16 burdening current ratepayers with the costs incurred to serve future
17 customers (excess capacity). The specific adjustments necessary to
18 achieve this rebalancing are detailed in the testimonies Mr. Rigsby and
19 Mr. Moore. In addition, Mr. Moore discusses how the modifications would
20 impact customers' bills.

² As discussed in RUCO witness Rodney L. Moore's rehearing testimony, RUCO is not recommending disallowance of all of the plant capacity that exceeded test year requirements. RUCO recognizes that a utility should have some reserve margin. In this case, RUCO proposes a reserve margin for three years of projected growth beyond the test year. RUCO's excess capacity adjustment would only disallow the capacity beyond what is necessary to serve growth after 2008.