

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

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CHAIRMAN

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COMMISSIONER

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5 KRISTIN K. MAYES
COMMISSIONER

6 GARY PIERCE
COMMISSIONER

7
8 IN THE MATTER OF THE APPLICATION OF
9 GOLD CANYON SEWER COMPANY, AN
10 ARIZONA CORPORATION, FOR A
11 DETERMINATION OF THE FAIR VALUE OF
12 ITS UTILITY PLANT AND PROPERTY AND
13 FOR INCREASES IN ITS RATES AND
14 CHARGES FOR UTILITY SERVICE BASED
15 THEREON.

Docket No. SW-02519A-06-0015

16 **REHEARING CLOSING BRIEF**

17 **OF THE RESIDENTIAL UTILITY CONSUMER OFFICE**

18 **MAY 5, 2008**

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1 **INTRODUCTION**

2 The Residential Utility Consumer Office (“RUCO”) submits this Brief in support of its
3 position that the Arizona Corporation Commission (“Commission”) should reconsider Decision
4 No. 69664 and adopt RUCO’s excess capacity recommendation and/or cost of capital
5 recommendation. As it stands, the ratepayers of Gold Canyon Sewer Company (“Gold
6 Canyon” or “Company”) have been subject to a 72.02% revenue increase under Decision No.
7 69664. The end result is Gold Canyon’s ratepayers are paying some of the highest sewer
8 rates in the state. It is no surprise that there has been so much public response to this case.

9 Nonetheless, the Company recommends that the Commission disregard RUCO’s
10 recommendations and not make any change to Decision No. 69664. The Commission’s Staff
11 (“Staff”) recommends that the Commission should disregard RUCO’s recommendations and, in
12 addition, allow the Company recovery of an additional \$90,000 for its rate case expense
13 attributable to the rehearing. Both Staff’s and the Company’s recommendations would continue
14 to favor the interests of the Company’s shareholders, and result in unfair and unreasonable
15 rates to Gold Canyon’s ratepayers.

16
17 **1) EXCESS CAPACITY**

18 The evidence in the rehearing indicates that the Company’s post-test year growth
19 projections are inconsistent with actual growth. Since RUCO filed its direct testimony in the
20 underlying docket on June 16, 2006, the Company’s growth has slowed dramatically. RH-1 at
21 4. The Company’s projections reflect anticipated growth at a time when the housing market
22 and economy were flourishing – 2005 and 2006. Since then, the housing market and the
23

1 economy have slowed dramatically. At least for the short term, it does not appear that either
2 the housing market or the economy will change dramatically over the next few years. While no
3 one has a crystal ball, given the actual growth that Gold Canyon has experienced since 2006,
4 it is unlikely the Company will reach build-out by 2010. The actual growth numbers lend
5 further support for RUCO's conservative "reserve margin" recommendation.

6 To recap, RUCO is recommending that 28.05 percent of the net costs of the Water
7 Reclamation Facility plant expansion be excluded from rate consideration as excess capacity.
8 Id. RUCO's recommendation is based on the year-end 2008 Company-projected flow rate. Id.
9 The Company's projected 2008 wastewater flow was based on 401 additional connections in
10 2006. Id. The actual number of new connections in 2006 was 31. Id. The Company's 2008
11 projections were based on 430 new connections for 2007. Id. at 5. The actual number of new
12 connections for 2007 was 92. See 2007 Annual Report filed with the Commission on April 16,
13 2008 at page 11. Excerpt attached hereto as Exhibit 1. The District's growth is clearly not
14 meeting the Company's growth projections.

15 In terms of the Company's projections at build out, the Company estimates 2,490 new
16 connections for the 2007-2010 time period. Id. at 5. By comparison, for the four years prior to
17 2007 (2003-2006) the actual number of new connections was 1,490. Id. The Company's
18 projections are optimistic, and are unlikely to be reached given the actual prior growth and the
19 current and projected state of the economy and housing market. RUCO's recommendation to
20 allow a reserve margin equal to three years of projected growth is, at the very least, generous.

21 RUCO's reserve margin recommendation will result in reasonable rates. Should the
22 Commission adopt RUCO's reserve margin recommendation, the result would be an
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1 approximate 57 percent rate increase from an original residential monthly bill of \$35.00 to
2 \$55.22. The Commission should adopt RUCO's reserve margin recommendation.

3
4 **A) RUCO'S RESERVE MARGIN RECOMMENDATION IS SUPPORTED BY
COMMISSION PRECEDENT.**

5
6 There are a number of cases that the Commission has decided that support
7 RUCO's recommendation. As with all precedents, there are no two cases that are exactly
8 alike, but taken altogether, the Commission has favored RUCO's approach in the past. In
9 Decision No. 50273 (*the Matter of the Application of Litchfield Park, Docket No. 50273*) the
10 Commission excluded 50% as excess capacity of a new sewage treatment plant. Decision No.
11 50273 at 2. The Commission included the other 50% since the Commission concluded that it
12 was "used and useful." *Id.* In a subsequent rate case filed by Litchfield Park in 1988, Litchfield
13 Park attempted to include for rate base treatment the 50% of the sewage treatment plant that
14 was excluded as excess capacity in Decision No. 50273. Staff disallowed Litchfield Park's
15 request, and Litchfield Park did not oppose Staff's disallowance. Decision No. 56362 at 7.

16 In the matter of the *Application of Chaparral City Water Company, Docket No. U-2113-*
17 *89-212* the Commission had to decide the appropriate rate making treatment for certain CAP
18 facilities that came on line. Decision No. 57395 at 3. At the time there was a settlement
19 agreement that required the current customers to pay for 100% of the existing facilities. *Id.* at
20 4. The Commission considered several options but recognized that in the end it was
21 Chaparral, and not current ratepayers, that "should bear the risk that anticipated growth will not
22 occur." *Id.* The Commission determined that in an "effort to balance the costs of the CAP

1 between current and future customers” it was going to apportion operating revenues related to
2 the CAP facilities to be based on a hook-up fee for new customers. Id.

3 The same logic and wisdom should be applied in the subject case. The Commission
4 should balance the interests of the Company’s customers with the shareholders. The current
5 customers should not bear the entire risk of future growth, which is the result of Decision No.
6 69664. The Commission should provide for a better balance of ratepayers’ and shareholders’
7 interests.

8 In the *Application of the Pima Utility Company, Docket No. U-2199-93-222*, Pima Utility
9 requested rate base treatment of various proforma sewer plant additions. Decision No. 58743
10 at 4. Pima Utility argued that the Commission may allow CWIP into ratebase within two years
11 of the test year. Id. At the time, the CWIP was completed, but the additional plant was not
12 serving any customers. Id. at 5. Staff and RUCO opposed rate base treatment of the
13 additions arguing that they were not “used and useful,” and that rate base treatment would
14 violate the matching principle. Id. at 4-5. The Commission rejected the additions, noting that
15 the Company was asking for current customers to pay for plant that was not used and useful
16 and would be used only to serve future customers. Id. at 5. The Commission then went on to
17 distinguish the ratemaking principle of “used and useful” for ratemaking purposes from the
18 concept of “used and useful” from an engineering standpoint.” The Commission made clear
19 that there was a distinction and that for ratemaking purposes, the additional plant was not used
20 and useful. Id. at 5. Again, the logic in Pima Utility supports RUCO’s position in the subject
21 case and is inconsistent with the rationale of Decision No. 69664.

1 provide for a reserve margin which serves the interests of ratepayers and also benefits the
2 shareholders.

3 4 **COST OF CAPITAL**

5 RUCO's recommendation in the rehearing has not changed from the underlying case.
6 RUCO continues to recommend a cost of equity of 8.60 percent and a cost of debt of 8.45
7 percent. RH-4 at 4. RUCO recommends a weighted cost of capital of 8.54 percent. Finally,
8 RUCO recommends a hypothetical capital structure of 40 percent debt and 60 percent equity.
9 Id.

10 In Decision No. 69664 the Commission adopted Staff's underlying recommendation for
11 a 9.20 percent cost of equity, which was also Staff's overall cost of capital and a 100 percent
12 equity capital structure. Decision No. 69664 at 29. The Company's actual capital structure is
13 100 percent equity. RH-4 at 5.

14 In this docket, there is substantial evidence in the record to support RUCO's
15 recommendations on cost of capital. The issue is not whether there is sufficiency of the record
16 to support either Staff or RUCO's recommendation. The issue is which recommendation is
17 more appropriate under the circumstances of this case. For several reasons, RUCO's
18 recommendation is more appropriate in this case.

19 First, considering this case in its totality, RUCO's recommendation provides a more
20 balanced result between ratepayers and shareholders. It follows that RUCO's lower cost of
21 capital recommendation results in lower rates. In terms of a typical monthly bill, the adoption
22 of RUCO's cost of capital recommendation would result in an approximately 53 percent rate
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1 increase from an original residential monthly bill of \$35.00 to \$53.84. RH-1 at 6. The typical
2 monthly bill under Decision No. 69664 will increase from \$35.00 to \$60.55 or approximately 72
3 percent. Id. An average monthly sewer bill of \$53.84 is still high compared to what other
4 Arizona ratepayers pay throughout the state. Nonetheless, it is still preferable to the outcome
5 of Decision No. 69664 and better balances the interests of ratepayers and shareholders.

6 The Company, throughout the rehearing, has continually objected to RUCO's cost of
7 capital recommendation claiming that it is "results driven." The Company sees the rehearing
8 process as an attempt by RUCO to lower revenues. GC-RH-8 at 2. The Company views
9 RUCO's cost of capital analysis as one of the "results-oriented" means by which RUCO will, by
10 "any means," try to achieve its goal of lowering the revenues. Id. The Company believes that
11 the Commission should not consider the magnitude of the rate increase in deciding what fair
12 and reasonable rates are. RUCO-RH-5, Data Request ("DR") # 1.22, Transcript at 270. The
13 Company further believes that should the Commission consider the magnitude of the rate
14 increase, the Commission must establish guidelines for utilities so investment decisions can be
15 effectively made. Id.

16 The Company's arguments are red herrings, not persuasive and should be dismissed.
17 The Company has presented no evidence to show that RUCO's cost of capital
18 recommendation was made for the sole objective of lowering rates. And if, in fact, that was the
19 case, it is of no consequence. RUCO's cost of capital analysis followed the generally accepted
20 formula and methodologies practiced and accepted by the Commission. The fact that RUCO's
21 final cost of capital results and recommendation were lower than Staff's and the Company's is

1 of no more significance than the fact that the Company's underlying cost of capital
2 recommendations¹ were higher than what either Staff or RUCO proposed.

3 Interestingly, the Company's policy witness, Ian Robertson testified to the following in
4 rehearing:

5 The Commission adopted the position advocated by Staff on
6 every contested issue consistent with precedent and tried and tested
7 ratemaking techniques. Had the Commission chosen the highest
8 revenue requirement, it would have (1) adopted the return on equity
9 advocated by the Company; (2) allowed the reasonable costs of
10 affiliated services to be fully recovered through rates; and (3) not taken
away \$90,000 of rate case expense merely because the Company
would not waive the attorney-client privilege. Had the Commission
done these three things, the Decision would have resulted on an
increase of just under \$2.3 million, an increase of roughly 92%. GC-
RH-7.

11 Mr. Robertson's testimony reinforces the fact that had the Commission approved the
12 Company's approach, which too appears to have been results-oriented, the result would have
13 been an even more unbalanced and unfair result for the Company's ratepayers.

14 The Company's next argument, that the Commission should not consider the magnitude
15 of the rate increase in its deliberations, is absurd. Article 15, Section 3 empowers the
16 Commission to prescribe "just and reasonable rates." Article 15, Section 3 of the Arizona
17 Constitution. Nothing in the Constitution, the Arizona statutes or otherwise limits or even
18 suggests that the Commission cannot consider the magnitude of the rate increase in its
19 deliberations. In fact, as Commissioner Mundell pointed out in the rehearing, the case law
20 suggests otherwise:

21 _____
22 ¹ The Company's underlying cost of equity recommendation was 10.50 percent and its overall weighted
23 cost of capital recommendation was 10.50 percent. A-12 at 18 and Decision No. 69664 at 24.

1 should have a lower cost of equity compared to a company with debt because of the lower
2 financial risk associated with no debt.

3 A hypothetical capital structure that emulates the industry provides balance between the
4 interests of the ratepayers and the interests of the shareholders. It eliminates the
5 accounting/ratemaking benefits that one group derives over the other with a lopsided capital
6 structure. All things equal, a hypothetical capital structure results in a weighted average cost
7 of capital that is more in line with the industry, and less in line with shareholder or ratepayer's
8 interests.

9 RUCO's recommended hypothetical capital structure of 60% debt and 40% equity is not
10 arbitrary. The average capital structure for the four water companies included in RUCO's
11 witness William Rigsby's cost of equity proxy was comprised of approximately 50 percent debt
12 and 50 percent equity, whereas the local distribution company's in the proxy had an average
13 capital structure of approximately 51 percent debt and 49 percent equity. RH-4 at 13. If there
14 was any doubt, Mr. Rigsby's analysis made it clear that Gold Canyon's 100 percent equity
15 capital structure was not in line with similar firms operating in the regulated water and natural
16 gas utility industries. In order to achieve a weighted cost of capital that is more in line with the
17 regulated utilities in the proxy, a hypothetical capital structure comprised of 40 percent debt
18 and 60 percent equity is more appropriate. The Commission should adopt RUCO's proposed
19 hypothetical capital structure of 60% debt and 40% equity.

20 Finally, the use of a hypothetical capital structure is preferable over the Hamada
21 methodology to arrive at a weighted average cost of capital. In Decision No. 69664, the
22 Commission adopted Staff's proposed Hamada methodology to adjust for the fact that the
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1 Company has no debt in its capital structure. Decision No. 69664, RH-4 at 30. Staff used the
2 Hamada methodology to calculate an adjustment that would produce a cost of equity that
3 reflects a capital structure comprised of 40 percent debt and 60 percent equity. RH-4 at 31.

4 The Hamada methodology “re-levers” the Beta used in the CAPM model to reflect a
5 capital structure of 40 percent debt and 60 percent equity (i.e. a capital structure which has
6 financial risk). RH-4 at 32. The re-levered beta is placed into the CAPM model to produce an
7 appropriate expected rate of return for a utility with a capital structure comprised of 40 percent
8 debt and 60 percent equity. Id. The problem with Staff’s use of the Hamada methodology is
9 that Staff’s original cost of equity estimate is an average of both Staff’s CAPM and DCF
10 results. Id. The Hamada calculation may have produced an appropriate adjustment for Staff’s
11 CAPM estimates, but no similar calculation unique to the DCF was performed to derive a
12 similar type of adjustment to Staff’s DCF results. Nonetheless, Staff then applies the 100 basis
13 point Hamada adjustment to Staff’s revised original **DCF** and CAPM estimates to arrive at its
14 final 9.2% cost of equity adjustment. Id. Staff makes the mistaken assumption that the same
15 100 basis point adjustment calculated for its CAPM estimates, should be applied equally to its
16 DCF estimates as well.

17 The hypothetical capital structure applies a 60% weighing to RUCO’s final cost of equity
18 recommendation to produce a lower cost of equity component in RUCO’s final cost of capital
19 recommendation. The weighing does not distinguish, nor should it distinguish between the
20 CAPM and DCF results. It is applied the same to both and, therefore, provides a superior
21 estimate of the weighted cost of capital.

1 Another major flaw of the Hamada method is its failure to produce an appropriate
2 interest deduction that is reflective of a capital structure that contains debt. Id. at 33. Although
3 the Hamada methodology produces a recommended cost of equity that in theory reflects a
4 capital structure comprised of 40 percent debt and 60 percent equity, the Commission's
5 adoption of the actual 100 percent capital structure has no real impact on the level of income
6 taxes that are calculated for ratemaking purposes. Id. at 34. The reason why there is no
7 impact is the Hamada methodology does not produce a weighted cost of debt that is used to
8 calculate an appropriate interest expense deduction to income taxes. Id. The end result is that
9 the shareholders, not the ratepayers, benefit from additional cash flows associated with a
10 higher level of income tax expense calculated for ratemaking purposes, which does not
11 accurately reflect a balanced capital structure that contains debt. Id. In the end, ratepayers
12 are harmed from the standpoint that they will have to pay higher rates for a higher level of
13 income tax expense that should be lower if the capital structure were not lopsided. Id. The
14 application of a hypothetical capital structure removes the shortcomings associated with the
15 Hamada methodology and, in this case, results in a lower cost of capital.

16 17 **CONCLUSION**

18 The ratepayers of Gold Canyon are paying too much for their wastewater service as a
19 result of Decision No. 69664. RUCO has provided new evidence with regard to future growth
20 on the issue of excess capacity, which further suggests that the Commission should reconsider
21 its prior Decision and adopt RUCO's recommendation. RUCO's excess capacity
22 recommendation provides for a reserve margin which protects the interests and addresses the
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1 concerns of the shareholders. At the same time, RUCO's excess capacity recommendation
2 provides rate relief for ratepayers, and overall, strikes the appropriate balance between the
3 interests of ratepayers and the interests of shareholders.

4 RUCO's cost of capital recommendation is also more appropriate than what was
5 adopted in Decision No. 69664. RUCO does not argue that there is evidence to support the
6 cost of capital adopted in Decision No. 69664. But the evidence brought out in the original
7 hearing, and the rehearing, shows that RUCO's cost of capital recommendation is more
8 appropriate. RUCO's cost of capital recommendation also results in lower rates to ratepayers
9 and provides a better balance of shareholder and ratepayers' interests. The Commission
10 should adopt RUCO's excess capacity and/or cost of capital recommendations in this case.

11
12 RESPECTFULLY SUBMITTED this 5th day of May 2008

13
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15 _____
Daniel Pozefsky
Attorney

16
17 AN ORIGINAL AND THIRTEEN COPIES
18 of the foregoing filed this 5th day
of May 2008 with:

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**REHEARING CLOSING BRIEF
OF THE RESIDENTIAL UTILITY CONSUMER OFFICE**

MAY 5, 2008

EXHIBIT 1

ARIZONA CORPORATION COMMISSION
UTILITIES DIVISION

ANNUAL REPORT MAILING LABEL - MAKE CHANGES AS NECESSARY

G

SW - 02519A
Gold Canyon Sewer Corporation
12725 W. Indian School Rd. Suite D101
Avondale, AZ 85392

RECEIVED

APR 16 2008

AZ CORPORATION COMMISSION
DIRECTOR OF UTILITIES

ANNUAL REPORT

FOR YEAR ENDING

12	31	2007
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FOR COMMISSION USE

ANN06	07
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4-16-08

COMPANY NAME GOLD CANYON SEWER CORPORATION

WASTEWATER FLOWS

MONTH/YEAR (Most Recent 12 Months)	NUMBER OF SERVICES	TOTAL MONTHLY SEWAGE FLOW	SEWAGE FLOW ON PEAK DAY
Jan-07	5,354	24262000	1,059,000
Feb-07	5,359	22743000	1,170,000
Mar-07	5,373	25890000	1,291,000
Apr-07	5,372	18996000	854,000
May-07	5,376	17506000	802,000
Jun-07	5,381	16651000	764,000
Jul-07	5,378	17460000	861,000
Aug-07	5,355	17597000	814,000
Sep-07	5,400	17409000	693,000
Oct-07	5,415	20404000	810,000
Nov-07	5,423	22738000	1,041,000
Dec-07	5,429	24458000	997,000

PROVIDE THE FOLLOWING INFORMATION AS APPLICABLE

Method of Effluent Disposal (leach field, surface water discharge, reuse, injection wells, groundwater recharge, evaporation ponds, etc.)	Reuse & Recharge
Wastewater Inventory Number (all wastewater systems are assigned an inventory number)	100217
Groundwater Permit Number	N/A
ADEQ Aquifer Protection Permit Number	P100217
ADEQ Reuse Permit Number	R100217
EPA NPDES Permit Number	N/A