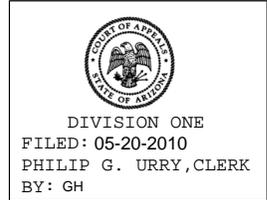


NOTICE: THIS DECISION DOES NOT CREATE LEGAL PRECEDENT AND MAY NOT BE CITED  
EXCEPT AS AUTHORIZED BY APPLICABLE RULES.  
See Ariz. R. Supreme Court 111(c); ARCAP 28(c);  
Ariz. R. Crim. P. 31.24

IN THE COURT OF APPEALS  
STATE OF ARIZONA  
DIVISION ONE



GOLD CANYON SEWER COMPANY, an ) 1 CA-CC 09-0001  
Arizona corporation, ) 1 CA-CC 09-0002  
) (Consolidated)  
Appellant, )  
) DEPARTMENT D  
v. )  
) **MEMORANDUM DECISION**  
ARIZONA CORPORATION COMMISSION, ) (Not for Publication -  
an agency of the State of ) Rule 28, Arizona Rules of  
Arizona, ) Civil Appellate Procedure)  
)  
Appellee, )  
)  
and )  
)  
RESIDENTIAL UTILITY CONSUMER )  
OFFICE, )  
)  
Intervenor/Appellee. )  
\_\_\_\_\_ )

ACC No. SW-02519A-06-0015

**AFFIRMED**

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and Jay L. Shapiro  
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By Robin R. Mitchell  
and Ayesha Vohra  
Attorneys for Appellee

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**T H O M P S O N, Judge**

¶1 In this consolidated appeal, Gold Canyon Sewer Company ("Gold Canyon") appeals from decision numbers 70624 and 70662 of the Arizona Corporation Commission ("the Commission"). For the following reasons, we affirm.

**FACTUAL AND PROCEDURAL HISTORY**

¶2 In January 2006, Gold Canyon filed an application with the Commission for an increase in its rates for wastewater utility service provided to customers in Pinal County. In setting rates, the Commission generally determines the original cost rate base ("OCRB")<sup>1</sup> and the reconstructed cost new ("RCND")<sup>2</sup> rate base and then takes the average of the two to determine the fair value rate base ("FVRB"). See *Litchfield Park Serv. Co. v.*

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<sup>1</sup> "Original cost rate base" is defined as "[a]n amount consisting of the depreciated original cost, prudently invested, of the property . . . at the end of the test year, used or useful, plus a proper allowance for working capital and including all applicable pro forma adjustments." Ariz. Admin. Code R14-2-103(A)(3)(h).

<sup>2</sup> "Reconstructed cost new rate base" is defined as "[a]n amount consisting of the depreciated reconstruction cost new of the property . . . at the end of the test year, used and useful, plus a proper allowance for working capital and including all applicable pro forma adjustments. Contributions and advances in aid of construction, if recorded in the accounts of the public service corporation, shall be increased to a reconstruction new basis." A.A.C. R14-2-103(A)(3)(n).

*Ariz. Corp. Comm'n*, 178 Ariz. 431, 434-35, 874 P.2d 988, 991-92 (App. 1994). In this case, Gold Canyon did not request an RCND, so the Commission adopted the OCRB as Gold Canyon's FVRB. In addition to the FVRB, the Commission also finds the weighted average cost of capital ("WACC"). It first determines the capital structure of the company, which is the percentage of debt and the percentage of equity. It multiplies the percentage of debt with the cost of debt to find the weighted average cost of debt and multiplies the percentage of equity with the cost of equity to find the weighted average cost of equity. It then adds these two products to determine the WACC, which is used as the rate of return. The rate of return represents the income earned by a utility after operating expenses. *Turner Ranches Water & Sanitation Co. v. Ariz. Corp. Comm'n*, 195 Ariz. 574, 576 n.2, 991 P.2d 804, 806 n.2 (App. 1999). The rate of return is then applied to the rate base to establish rates. *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 534, 578 P.2d 612, 615 (App. 1978).

¶3 Prior to filing the application for a rate increase, Gold Canyon had been expanded and upgraded from a capacity of 1 million gallons per day (mgd) to 1.9 mgd. In the test year ending October 31, 2005, Gold Canyon had an FVRB/OCRB of \$15,742,719. Intervenor-appellee Residential Utility Consumer

Office ("RUCO")<sup>3</sup> argued that the FVRB/OCRB rate base should be adjusted downward because the treatment plant upgrade resulted in excess capacity-- specifically that available plant capacity that exceeded the amount necessary to serve its existing customers. While agreeing that Gold Canyon's decision to expand the plant to 1.9 mgd was prudent and appropriate based on growth projections at the time, RUCO contended that that portion of the plant that was not used and useful should not be included in the rate base for ratemaking purposes. RUCO sought a reduction of \$2,789,016 of the FVRB/OCRB rate base to \$13,983,602.

¶4 In Decision No. 69664, the Commission rejected RUCO's proposal, finding that, if the decision to upgrade to 1.9 mgd was prudent, Gold Canyon should not be subject to the decrease. The Commission noted that the minimum expansion that Gold Canyon could have implemented was 0.5 mgd to a total capacity of 1.5 mgd and that adding the additional 0.4 mgd was more economical than incremental upgrades, with the 0.4 mgd costing less than \$1,000,000. The Commission further observed that, had Gold Canyon expanded the plant in smaller increments to avoid the excess capacity disallowance, it would have needed to start planning another incremental expansion almost immediately to

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<sup>3</sup> RUCO is a statutorily created office "established to represent the interests of residential utility consumers in regulatory proceedings involving public service corporations before the corporation commission." Ariz. Rev. Stat. ("A.R.S.") § 40-462 (2001).

meet ongoing demand increases, which would have resulted in higher costs to customers and the inconvenience to customers of ongoing construction activity.

¶15 The Commission adopted the recommendation of the Commission Utilities Division ("Staff") of a somewhat reduced rate base of \$15,725,787. With respect to the cost of capital determination, Staff and Gold Canyon proposed a 100 percent equity capital structure based on Gold Canyon's actual capital structure. RUCO proposed a hypothetical capital structure of forty percent debt and sixty percent equity. RUCO expert William Rigsby testified that the adoption of the hypothetical capital structure was appropriate because Gold Canyon's actual capital structure resulted in a lower level of risk. Rigsby derived an estimated return on equity of 8.6 percent based on a sample group of companies with a capital structure of approximately fifty percent debt and fifty percent equity. The Commission adopted the 100 percent equity capital structure proposed by Gold Canyon and Staff. The Commission noted, "[Gold Canyon's] actual capital structure is comprised of 100 percent paid in capital. In fact, the plant in Gold Canyon's rate base is financed entirely by equity. Although RUCO's proposed hypothetical capital structure would result in lower rates to customers, that fact does not justify adoption of RUCO's recommendation."

¶16 Staff recommended a cost of equity of 9.2 percent. Staff derived that number by applying two financial models to six sample water companies for an average of 10.2 percent. Staff then adjusted the number down 100 basis points to account for Gold Canyon's "financial risk being less than that of the sample companies," resulting in a proposed cost of equity of 9.2 percent.

¶17 Gold Canyon sought a cost of equity of 10.5 percent using six proxy companies. RUCO advocated a cost of equity of 8.6, also based on a sample group of companies. RUCO argued that the lower rate was reasonable because of the lower risk associated with Gold Canyon's proposed 100 percent equity capital structure, which would require a lower expected return on common equity.

¶18 The Commission adopted the Staff's recommendation of a cost of equity of 9.2 percent, which, because of the 100 percent equity capital structure, also represented a 9.2 percent cost of capital. The Commission found Staff's approach to be reasonable and consistent with prior Commission decisions, noting that the methodologies used by Staff had been used for many years by the Commission. The Commission's finding of a rate base of \$15,725,787 and return of 9.2 percent resulted in a gross revenue increase for Gold Canyon of \$1,798,999.

¶19 Decision No. 69664 was adopted by a vote of three commissioners in favor and two dissenting. RUCO filed an application for rehearing. RUCO argued that the rates approved by the Commission resulted in a 72.02 percent revenue increase, which was unfair to ratepayers. RUCO asserted that the Commission's decision favored Gold Canyon's interest over the interest of ratepayers, and pointed out that Gold Canyon's former president had assured ratepayers that the improvements to the plant would not cause an increase in rates. RUCO argued that the Commission should reconsider RUCO's position that the plant had excess capacity that should be excluded from the rate base. RUCO contended that the question was whether current or future ratepayers should pay for the additional capacity, arguing that under the Commission's decision, current ratepayers would be required to pay for the additional capacity whether it was used or not, burdening current ratepayers with the risk of future growth. RUCO also argued that its proposed hypothetical capital structure would bring Gold Canyon's capital structure in line with the industry average and would result in lower rates for ratepayers. Because Gold Canyon had a capital structure of 100 percent equity, RUCO argued, it had extremely low to no financial risk and would therefore also have a lower expected return on common equity, making adoption of the proposed hypothetical capital structure appropriate. RUCO asserted that

Gold Canyon's and Staff's claim that using a hypothetical capital structure would not allow Gold Canyon an adequate level of income tax expense was disingenuous because the expense typically falls on the ratepayers.

¶10 At an open meeting, the Commission discussed RUCO's application for rehearing and the scope of that rehearing. The Commission granted RUCO's application for rehearing on RUCO's proposed rate base reduction for excess capacity and its proposed hypothetical capital structure including cost of equity. The Commission accepted additional filed testimony and conducted a rehearing.

¶11 The administrative law judge issued a Recommended Opinion and Order ("ROO") affirming Decision No. 69664. One commissioner offered two amendments. The first amendment would disallow \$2.8 million from Gold Canyon's rate base for excess capacity, while recognizing that Gold Canyon would be able to recover a full rate of return on the entire plant once the full plant became "used and useful." The first amendment also provided for the establishment of a depreciation expense account to record the depreciation expenses on the disallowed plant. The second proposed amendment provided for the adoption of RUCO's hypothetical capital structure of forty percent debt and sixty percent equity and cost of equity capital of 8.6 percent.

¶12 At the subsequent open meeting, RUCO argued that, although the excess plant capacity resulted from growth projections that exceeded the actual increase in the number of customers, ratepayers should not bear the entire risk of the erroneous growth projections. RUCO agreed that the decision to expand the plant was prudent, but asserted that prudence and "used and useful" were not synonymous and that the excess capacity was not used and useful. RUCO asserted that the average monthly sewer bill of \$60.55 would decrease by \$5.33 if the Commission approved proposed amendment one and would decrease \$6.71 if the Commission approved proposed amendment two.

¶13 With respect to excess capacity, Gold Canyon argued that its decision to expand the plant as it did was prudent. Gold Canyon noted that when it acquired the plant, it was required to renovate and expand. It noted that the Commission required that it plan five years into the future, and that the Arizona Department of Environmental Quality required that when a sewer company is at eighty percent capacity it must plan renovation and when it is at ninety percent capacity it must be building an expansion. Gold Canyon asserted it had a choice of expanding from 1 mgd to 1.5 mgd for \$11 million, after which it would almost immediately have had to expand again, or it could expand to 1.9 mgd in the first instance for \$11.5 million. Gold

Canyon chose to expand to 1.9 mgd. Gold Canyon argued that it had a right to not only recover the capital expended but to earn a return on its investment. It asserted that prudence and "used and useful" were not different concepts, asserting that "[w]hen you tell a company to plan five years out, then everything that is planned for five years out is used and useful by definition."

¶14 Staff argued that, if the Commission found excess capacity, the excess capacity would be the extra 400,000 gallons per day capacity in building the plant to handle 1.9 mgd instead of 1.5 mgd, and so the rate base should be reduced by less than \$1 million, not the \$2.8 million proposed by RUCO. Staff also argued that reducing the cost of equity by 100 basis points--a Hamada adjustment--achieved the same effect RUCO sought through use of a hypothetical capital structure. Staff further explained that its Hamada adjustment adjusted the return on equity as if Gold Canyon had a capital structure of sixty percent equity and forty percent debt. Staff supported the ROO as presented.

¶15 The Commission adjusted the rate base disallowance for excess capacity from \$2.8 million to \$1 million and passed both amendments. The Commission issued Decision No. 70624, which adopted the hypothetical capital structure of forty percent debt and sixty percent equity and a cost of equity of 8.6 percent, and disallowed \$1,000,000 from Gold Canyon's rate base as excess

capacity. It further ordered Gold Canyon to establish a deferred depreciation expense account to record the depreciation expenses on the disallowed plant.

¶16 After Gold Canyon filed its new schedule of rates, RUCO filed an objection, arguing that Gold Canyon did not account for interest synchronization in its revised rates. RUCO argued that the main benefit to ratepayers of a hypothetical capital structure was that a debt component would result in an interest expense that lowers Gold Canyon's income tax. RUCO argued that its recommendation included the effects of interest and income tax expense and asserted that the Commission clearly intended that the ratepayers receive that benefit. In response, Gold Canyon argued that the Commission had not ordered it to synchronize interest and that RUCO had admitted that use of hypothetical capital structure did not mandate interest synchronization. The Commission scheduled and held a procedural conference to clarify the Commission's intent when it issued Decision No. 70624. Gold Canyon argued that the ordering of the paragraphs of Decision No. 70624 were unclear, pointing out as an example, that the decision did not specify whether the \$1 million reduction was to come from the rate base or plant in service.

¶17 The Commission issued Decision No. 70662 to clarify the language and its intent in Decision No. 70624. The decision stated in part:

IT IS . . . ORDERED THAT Gold Canyon Sewer Company's plant in service . . . be reduced by \$1.0 million . . . . Depreciation on the plant removed from plant in service shall be deferred for recovery in a future rate case and the deferral account shall also include interest calculated using the Company's rate of return authorized in Decision No. 70624.

. . . .

IT IS FURTHER ORDERED that the weighted cost of capital approved in this case shall be 8.54 percent . . . . Gold Canyon Sewer Company's weighted cost of debt is 3.38 percent and the Company's weighted cost of equity is 5.16 percent. The Company will use the weighted cost of debt of 3.38 percent in order to calculate Gold Canyon's test year adjusted level of income tax expense, using the interest synchronization method, to arrive at the revised level of operating revenue that will be generated by the revised rates and charges.

¶18 Gold Canyon filed petitions for rehearing for Decision Nos. 70624 and 70662, which were deemed denied by operation of law. A.R.S. § 40-253(A) (2001). Gold Canyon appealed from both decisions, and we consolidated the appeals. We have jurisdiction pursuant to A.R.S. § 40-254.01(A) (2001).

## DISCUSSION

¶19 The Arizona Constitution gives the Commission "full power" to set just and reasonable rates and requires that, in doing so, the Commission determine and use the fair value of the property of the public service corporation devoted to public use within the state. Ariz. Const. art. 15, §§ 3, 14; *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956); *Ariz. Corp. Comm'n v. Ariz. Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415 (1959); *State v. Tucson Gas, Elec. Light & Power Co.*, 15 Ariz. 294, 297-99, 138 P. 781, 782-83 (1914). In reviewing a decision by the Commission on rate-making issues, this court may vacate, set aside, reverse in part or remand the decision to the Commission if we determine upon a "clear and satisfactory" showing that the decision is "unlawful or unreasonable." A.R.S. § 40-254.01 (A). A "clear and satisfactory" showing is the same standard as a "clear and convincing" showing. *Consol. Water Utils. Ltd. v. Ariz. Corp. Comm'n*, 178 Ariz. 478, 481, 875 P.2d 137, 140 (App. 1993). We do not reweigh the evidence or substitute our judgment for that of the Commission, and may disturb the Commission's decision only if the decision "is not reasonably supported by the evidence, is arbitrary, or is otherwise unlawful." *Tonto Creek Estates Homeowners Ass'n v. Ariz. Corp. Comm'n*, 177 Ariz. 49, 58-59, 864 P.2d 1081, 1090-91 (App. 1993). The party

challenging the decision bears the burden of demonstrating by clear and satisfactory proof that the decision is "arbitrary, unlawful or unsupported by substantial evidence." *Litchfield Park*, 178 Ariz. at 434, 874 P.2d at 991; A.R.S. § 40-254.01(E); *Simms*, 80 Ariz. at 154-55, 294 P.2d at 384;

¶20 Gold Canyon argues that the Commission's decision reducing its plant in service account by \$1 million in Decision 70662 is inconsistent with the findings of fact stated in Decision No. 70624. Gold Canyon quotes extensively from the findings in Decision No. 70624 by which the Commission reiterated its earlier conclusion that the Gold Canyon's decision to upgrade to 1.9 mgd was prudent. Gold Canyon then notes that the decision abruptly finds that it had excess capacity and that \$1 million would be disallowed. Gold Canyon argues that, given the findings that its upgrade of the facility was prudent, the Commission had no factual basis to support a decrease based on excess capacity.

¶21 The seeming inconsistency between the express factual findings and the Commission's conclusion is explained by the fact that the Commission reached a conclusion different from that reached by the administrative law judge who drafted the decision. The amendments adopted by the Commission that changed the conclusion did not provide express factual findings.

Obviously, the better approach would have been to identify those facts on which the Commission based its decision.

¶122 Findings of administrative agencies "must be sufficiently definite and certain to permit a judicial interpretation." *Hatfield v. Indus. Comm'n*, 89 Ariz. 285, 288-89, 361 P.2d 544, 547 (1961). The findings need not be in any particular form so long as a reviewing court can determine how the administrative body reached its decision. *Post v. Indus. Comm'n*, 160 Ariz. 4, 8-9, 770 P.2d 308, 312-13 (1989). The decision may be vacated if the reviewing court cannot determine that the basis for the decision is legally sound. *CAVCO Indus. v. Indus. Comm'n*, 129 Ariz. 429, 435, 631 P.2d 1087, 1093 (1981).

¶123 The Commission expressly stated that it agreed with RUCO that Gold Canyon had excess capacity. RUCO had argued that, although Gold Canyon's upgrade was prudent based on the circumstances at the time, some of the plant was not being used for the benefit of the ratepayers and should not be included in the rate base. RUCO further argued that whether the upgrade was prudent was not the same question as whether the added facility had excess capacity.

¶124 A utility "is entitled to a fair return on the fair value of its properties devoted to the public use, no more and no less." *Ariz. Water Co.*, 85 Ariz. at 203, 335 P.2d at 415;

see also A.A.C. R14-2-103(A)(3)(h) (defining "[o]riginal cost rate base" as amount of depreciated original cost "used or useful"). The Commission has discretion in deciding what should or should not be included when finding fair value. *Ariz. Corp. Comm'n v. Ariz. Pub. Serv. Co.*, 113 Ariz. 368, 370-71, 555 P.2d 326, 328-29 (1976); see also *Consol. Water*, 178 Ariz. at 482-83, 875 P.2d at 141-42 (no error in Commission's excluding anticipated construction work in progress as not "used and useful," although Commission could have considered it in finding fair value).

¶125 The record contains evidence that Gold Canyon has a maximum capacity of 1.9 mgd and that during the test year, it had an average flow rate of 0.708 mgd and peak flow of 1.17 mgd. This evidence alone supports the Commission's finding that a portion of the facility was not being used for the benefit of the public and could be excluded from the rate base. At the open meeting after the rehearing, RUCO argued that ratepayers should not bear the entire burden of the erroneous projections that resulted in the decision to build to 1.9 mgd instead of to 1.5 mgd, until the excess capacity became useful. Staff pointed out that Gold Canyon was required to build to 1.5 mgd, and so any reduction in rate base based on excess capacity should be limited to the cost to upgrade from 1.5 mgd to 1.9 mgd, which Decision 69664 placed at less than \$1 million. The Commission

adopted Staff's argument and imposed a lesser reduction than had been proposed by RUCO, demonstrating that the reduction was not arbitrary but was based on the portion of plant that was not then in service.

¶126 The record and the findings demonstrate the basis of the Commission's decision sufficiently for this court's review, and the decision is supported in the record. Gold Canyon has not shown that the reduction based on the plant not yet being used was arbitrary, capricious, or unlawful.

¶127 Gold Canyon also challenges the Commission's adoption of RUCO's hypothetical capital structure. The Commission had initially adopted Staff's cost of equity, which was determined using sample water utilities and then adjusted downward using the Hamada equation to account for Gold Canyon's lower investment risk arising from its 100 percent equity capital structure. In its application for rehearing, RUCO advocated using a hypothetical capital structure of forty percent debt and sixty percent equity to account for the lower risk and to bring that financial risk in line with the sample utilities. RUCO acknowledged that adjustment to the financial risk could be achieved through either the Staff's direct adjustment by the Hamada equation or by employing a fictional capital structure. However, RUCO also asserted that Staff's use of the Hamada equation was not entirely appropriate, noting that Staff applied

it to both of the mathematical models that Staff had used to determine cost of equity, when the Hamada equation is properly applied to only one those models. Gold Canyon argued that the hypothetical capital structure was another way to do what the Hamada equation had done. Staff advised the Commission that it used the Hamada equation to impute a capital structure of sixty percent equity and forty percent debt. RUCO contended that the Hamada equation did not give ratepayers the benefit of an interest expense deduction that would be the case with a capital structure containing debt.

¶128 Gold Canyon argues that the Commission's decision on rehearing changing its approach from using the Hamada equation to using a hypothetical capital structure is arbitrary and capricious and lacks any explanation.

¶129 In its decision, the Commission explained:

A capital structure comprised of 100 percent equity would be viewed as having little to no financial risk. The proposed capital structure adopted by the Commission will bring the Company's capital structure in line with the industry average and it will result in lower rates for the customers of the system. We therefore adopt a hypothetical capital structure of 40 percent debt and 60 percent equity.

One commissioner, who had originally voted in favor of use of the Hamada equation and who changed his vote, made a specific observation comparing the two approaches:

I agree with RUCO that the adoption of the hypothetical capital structure is appropriate in this case in light of the company's 100 percent capital structure. The adoption of RUCO's proposed capital structure more holistically addresses the concern that the company's overly capitalized capital structure is not in the best interest of its customers.

If a company has too much equity in its capital structure, it harms ratepayers in two ways. First, it raises the cost of capital because equity is generally more expensive than debt. And second, it deprives the company of favorable tax implications of having debt, which ultimately inures to the benefit of the ratepayers.

In this case Staff proposed the Hamada adjustments and, while responding to the first concern, . . . leaves a second category of harm to the ratepayers unaddressed. In contrast RUCO's proposed capital structure addresses both concerns, the artificially high cost of capital and the loss of favorable tax treatment.

The record also shows that some of the commissioners were concerned about what would have been a seventy-two percent increase in rates and desired to lower the rates if legally possible. The Commission's concern for the ratepayers was not improper. The Commission's role is not only to set rates so a utility can earn a fair return, but also to protect the consumers from overreaching utilities. *Ariz. Corp. Comm'n v. State ex rel. Woods*, 171 Ariz. 286, 290, 830 P.2d 807, 811 (1992). The Commission has an obligation to consider the effect

on ratepayers of the rates it sets and to balance the interests of the parties involved. *Ariz. Cmty. Action Ass'n v. Ariz. Corp. Comm'n*, 123 Ariz. 228, 231, 599 P.2d 184, 187 (1979) ("A reasonable rate is not one ascertained solely from considering the bearing of the facts upon the profits of the corporation. The effect of the rate upon persons to whom services are rendered is as deep a concern in the fixing thereof as is the effect upon the stockholders or bondholders. A reasonable rate is one which is as fair as possible to all whose interests are involved.") (quoting *Salt River Valley Canal Co. v. Nelssen*, 10 Ariz. 9, 13, 85 P. 117, 119 (1906)).

¶130 Gold Canyon, like RUCO, acknowledged that employing a hypothetical capital structure and using the Hamada equation were two different approaches that addressed the lack of financial risk in Gold Canyon's 100 percent equity capital structure. Presented with two approaches, it is for the Commission and not this court to determine which is appropriate in any particular circumstance when designing rates. See *Litchfield Park*, 178 Ariz. at 435, 874 P.2d at 992 ("The Commission has discretion in determining a utility's capital structure.") (citation omitted). The Commission's ultimate decision is supported by the record; Gold Canyon has not shown that the Commission's adoption of the hypothetical capital structure was arbitrary, capricious, or unlawful.

¶131 Gold Canyon argues that the Commission deviated from the generally accepted method of accounting for financial risk. Gold Canyon specifically notes that the Commission applied the Hamada equation in Black Mountain Sewer Corporation's rate case, despite that company also having a 100 percent equity capital structure and despite the same arguments by RUCO. Gold Canyon argues that the Black Mountain case involved virtually identical circumstances and that therefore the Commission's use of a hypothetical capital structure in this case was arbitrary.

¶132 We find no basis for concluding that the Commission must be bound to apply in one case the methodology for ratemaking it used in a prior case, so long as its decision is supported by the record before it. Gold Canyon has offered no authority otherwise.

¶133 Gold Canyon argues that the Commission improperly reconsidered the issues of cost of equity capital and operating expenses. Gold Canyon contends that, under A.R.S. § 40-253(C), the Commission may not reconsider issues not raised by a party in an application for rehearing. Gold Canyon argues that RUCO did not raise the issues of cost of equity and adjustments to income tax expense in its application for rehearing and therefore the Commission could not consider them.

¶134 RUCO's application for rehearing did not articulate specific issues to be addressed at a rehearing, but discussed

its position regarding excess capacity and capital structure. In discussing the problems with a 100 percent equity capital structure, RUCO discussed its proposed hypothetical capital structure and the effect on the cost of equity.

The water utilities used in RUCO's sample are representative of the industry and, by comparison to the Company, would be considered as having a higher level of financial risk . . . because of their higher levels of debt. The additional financial risk due to debt leverage is embedded in the cost of equities derived for those companies through the DCF analysis that RUCO performed. Thus, the cost of equity derived in RUCO's DCF analysis is applicable to companies that are more leveraged and . . . riskier than a utility such as Gold Canyon, which has no debt in its capital structure. In the case of a publicly traded company, like those included in RUCO's proxy of companies, a company with Gold Canyon's level of equity would be perceived as having extremely low to no financial risk and would therefore also have a lower expected return on common equity. Because of this, a 60/40 hypothetical capital structure that produces a lower weighted cost of common equity is appropriate for Gold Canyon.

. . . .

The problem concerns an appropriate adjustment to the Company's cost of common equity to bring it in line with sample groups of companies that have capital structures more representative of the industry and face greater financial risk as a result of the level of debt in their capital structures.

RUCO also addressed concerns regarding income tax expense.

The Company and Staff claim, and the Commission apparently believes, that a hypothetical capital structure would not allow the Company an adequate level of income tax expense because of the interest deduction associated with RUCO's recommended level of debt. This argument is disingenuous from the standpoint that the burden of paying higher levels of income tax expense for utilities with Commission-approved hypothetical capital structures containing additional equity always falls on ratepayers. The adoption of a hypothetical capital structure should be a two-way street. It is only just and reasonable that Gold Canyon ratepayers should not bear the burden of paying a higher level of income tax expense in rates simply because the Company has made the decision to adopt a 100 percent equity capital structure, which is clearly out of line with the rest of the industry.

In raising the issue of its proposed hypothetical capital structure, RUCO also raised as related matters the issues of cost of equity and income tax expense. In addition, at an open meeting to consider RUCO's application, the Commission discussed the scope of the rehearing and included cost of equity as part of the issue of capital structure. The issues were adequately raised as part of RUCO's application for rehearing.

¶135 Even if the issues had not been raised, A.R.S. § 40-253(C) would not have precluded the Commission from considering them. In construing a statute, we look first to its plain language as the best indicator of the intent of the legislature. *Canon Sch. Dist. No. 50 v. W.E.S. Constr. Co.*, 177 Ariz. 526,

529, 869 P.2d 500, 503 (1994). If the language is unambiguous, we must give effect to that language. *Janson ex rel. Janson v. Christensen*, 167 Ariz. 470, 471, 808 P.2d 1222, 1223 (1991). Statutory construction is an issue of law, which we review de novo. *Schwarz v. City of Glendale*, 190 Ariz. 508, 510, 950 P.2d 167, 169 (App. 1997).

¶136 Section 40-253(C) states:

C. The application [for rehearing] shall set forth specifically the grounds on which it is based, and no person, nor the state, shall in any court urge or rely on any ground not set forth in the application.

The purpose of the statute is to give the Commission the opportunity to correct any mistakes before the matter is taken to court. *Cogent Pub. Serv., Inc. v. Ariz. Corp. Comm'n*, 142 Ariz. 52, 54, 688 P.2d 698, 700 (App. 1984).

¶137 Nothing in the language of the statute suggests that it precludes the Commission from reconsidering issues not raised in the application. The Commission is not a "court," nor is it a "person" or "the state."<sup>4</sup> In addition, the statute also provides that "after a rehearing and a consideration of all the facts," the Commission can change an order if it "finds that the original order or decision or any part thereof is in any respect unjust or unwarranted, or should be changed." A.R.S. § 40-

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<sup>4</sup> A.R.S. § 40-253(A) authorizes any party "or the attorney general on behalf of the state" to apply for a rehearing.

253(E). The Commission may consider relevant factors in a ratemaking proceeding even if not raised by the parties. See *Turner Ranches*, 195 Ariz. at 579, ¶ 23, 991 P.2d at 809. The Commission did not improperly consider the issues of cost of equity or income tax expenses.

¶138 Gold Canyon also argues that the Commission made no findings to support its adoption of RUCO's 8.6 percent cost of equity and that RUCO presented no credible basis for the Commission's decision. We first note that Gold Canyon seems to assert that RUCO had a burden at the rehearing to demonstrate that the Commission's prior findings and conclusions were erroneous in order to provide a "basis to overturn the findings and conclusions" in the prior decision. Gold Canyon has cited no authority to support such a view. Rather, as noted, after rehearing, the Commission can change a prior decision if the Commission concludes it "should be changed." A.R.S. § 40-253(E).

¶139 In Decision No. 70624 the Commission stated:

We believe that RUCO's recommendation for a 8.60 percent cost of equity capital is appropriate, and will adopt it in this case. RUCO's expert witness relied on a DCF model and a CAPM analysis for calculating his cost of equity capital. We believe that adoption of RUCO's recommendations results in just and reasonable rates and charges for Gold Canyon based on the record of this proceeding. We therefore adopt a cost of equity of 8.60 percent, which also results

in an overall weighted cost of capital of 8.54 percent.

The decision provided no other findings supporting its conclusion. However, because the Commission expressly adopted RUCO's recommendation, this court can determine the basis of the Commission's decision. See *Pinetop Truck & Equip. Supply v. Indus. Comm'n*, 161 Ariz. 105, 107, 776 P.2d 356, 358 (App. 1989) (adopting testimony of claimant constituted adequate findings).

¶140 Rigsby, the public utilities analyst for RUCO, recommended a cost of equity of 8.6 percent and a cost of debt of 8.45 percent, which applied to RUCO's hypothetical capital structure of sixty percent equity and forty percent debt resulted in a weighted cost of debt of 3.38 percent, a weighted cost of common equity of 5.16 percent, and a weighted cost of capital of 8.54 percent. He testified that he derived the cost of equity using the discounted cash flow method ("DCF"), and used the capital asset pricing model ("CAPM") in a supporting role to provide additional information. He testified that he used the same DCF methodology as had a Staff witness in another case, whose cost of equity recommendation had been adopted by the Commission. Both methods involved analyzing data on sample proxy companies.

¶141 Gold Canyon finds fault with the companies RUCO used as its proxy group and in RUCO's reliance on a single DCF model,

noting that Staff had used more companies in its samples and had used two different types of DCF models and a two-part CAPM analysis to determine Gold Canyon's cost of equity. Gold Canyon asserts that the methodologies differed in other respects as well. However, the merits or flaws of the competing approaches are matters for the Commission to resolve. Gold Canyon has not demonstrated clearly and convincingly that the Commission's choice of RUCO's methodology is unlawful, arbitrary, or capricious.

¶42 Gold Canyon also argues that the Commission's order adjusting income tax expense is arbitrary and capricious. The Commission ordered Gold Canyon to use the weighted cost of debt of 3.38 percent to calculate the test year adjusted level of income tax expense, using the interest synchronization method, to obtain the revised level of operating revenue.<sup>5</sup>

¶43 The Commission's order reflects the recommendation of RUCO expert Rigsby, who recommended that the Commission adopt an "interest synchronization adjustment, which produces an income

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<sup>5</sup> As explained by Gold Canyon, "[u]tilities must pay federal and state income taxes based on their taxable income. Consequently, income taxes are an expense that is part of a utility's cost of service. Increased income tax expense results in higher utility rates, unless such tax expense can be offset by deductions. In this case, [Gold Canyon's] actual capital structure does not contain any debt. [Gold Canyon], therefore, does not pay annual interest expense to any debt holder, which means that [Gold Canyon] does not have interest expense that can be used as a deduction to lower income taxes."

tax deduction for interest expense that is the weighted cost of debt times the company's rate base." Rigsby explained that using Staff's methodology employing the Hamada equation

does not produce an appropriate interest deduction that is reflective of a capital structure that contains debt. The use of debt to reduce income taxes is often referred to as a tax shield . . . . [T]he Hamada methodology does not produce a weighted cost of debt that is used to calculate an appropriate interest expense deduction to income taxes. . . . [R]atepayers are harmed from the standpoint that they will have to pay higher rates for a higher level of income tax expense that should be lower as a result of a more balanced capital structure.

Rigsby testified that he derived the cost of debt of 8.45 percent by taking the average of eight publicly traded water companies. The 3.38 percent weighted average cost of debt is the product of the cost of debt and the percentage of debt in the capital structure, which was set at forty percent in RUCO's hypothetical capital structure. Rigsby's testimony supports the Commission's decision to order the calculation of income tax expense.

¶44 In addition, the adoption of a hypothetical interest expense by a utility commission is not without precedent. See *In re Citizens Utils. Co.*, 739 P.2d 360 (Idaho 1987) (commission has power to adopt hypothetical interest expense based upon hypothetical capital structure); *Carnegie Natural Gas Co. v. Pa.*

*Pub. Util. Comm'n*, 433 A.2d 938, 942 (Pa. Commw. Ct. 1981)  
(affirming commission order adopting hypothetical capital structure and hypothetical interest expense and disallowing actual income tax expense).

¶145 We find that Gold Canyon has not demonstrated by clear and convincing proof that the Commission's decisions were arbitrary, capricious, or unlawful. We therefore affirm Decision No. 70624 and Decision No. 70662.

#### CONCLUSION

¶146 We find that Decision Nos. 70624 and 70662 are supported by the record and have not been shown to be arbitrary, capricious, or unlawful. We affirm.

/s/

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JON W. THOMPSON, Judge

CONCURRING:

/s/

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PATRICIA A. OROZCO, Presiding Judge

/s/

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DIANE M. JOHNSEN, Judge

