

ORIGINAL



BEFORE THE ARIZONA CORPORATION C

Arizona Corporation Commission

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COMMISSIONERS

DOCKETED

AUG 21 2006

JEFF HATCH-MILLER - Chairman
WILLIAM A. MUNDELL
MIKE GLEASON
KRISTIN K. MAYES
BARRY WONG

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| DOCKETED BY | NR |
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IN THE MATTER OF THE APPLICATION) DOCKET NO. WS-02987A-04-0288
 OF JOHNSON UTILITIES COMPANY, LLC)
 FOR AN EXTENSION OF ITS)
 CERTIFICATE OF CONVENIENCE AND) **STAFF'S NOTICE OF FILING**
 NECESSITY FOR WATER AND) **TESTIMONY**
 WASTEWATER SERVICE.)
 _____)

Staff of the Arizona Corporation Commission hereby provides notice of filing its Direct Testimony in this Docket. An original and thirteen copies are submitted of the Prefiled Direct Testimony of William F. Haug, in the above-referenced matter.

RESPECTFULLY SUBMITTED this 21st day of August, 2006.

Christopher C. Kempley
 Christopher C. Kempley
 Chief Counsel, Legal Division
 Arizona Corporation Commission
 1200 West Washington
 Phoenix, Arizona 85007
 (602) 542-3402

AN ORIGINAL and thirteen (13) copies were filed this 21st day of August, 2006 with:

Docket Control
Arizona Corporation Commission
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Phoenix, Arizona 85007

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1 COPIES of the foregoing document
was filed this 21st day of August, 2006 to:

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JOHNSON UTILITIES COMPANY

DOCKET NO. WS-0297A-04-0288

DIRECT TESTIMONY

OF

WILLIAM F. HAUG

ON BEHALF OF

COMMISSION STAFF

AUGUST 21, 2006

1 **Q. PLEASE STATE YOUR NAME, OCCUPATION, AND BUSINESS ADDRESS.**

2 A. My name is William F. Haug. I am a Senior Partner in the law firm of JENNINGS, HAUG
3 & CUNNINGHAM, L.L.P. The firm is located at 2800 North Central Avenue, Suite 1800,
4 Phoenix, Arizona 85004.
5

6 **Q. ON WHOSE BEHALF ARE YOU SUBMITTING TESTIMONY IN THIS**
7 **PROCEEDING?**

8 A. I am testifying on behalf of the Staff of the Arizona Corporation Commission.

9 **Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND**
10 **PROFESSIONAL EXPERIENCE.**

11 A. I graduated from law school at the University of Arizona in 1956. I have been a practicing
12 attorney in Arizona for approximately 50 years. My areas of practice have included Lawsuits
13 or Disputes, Real Estate, Construction Law, as well as Fidelity and Surety Law. I have
14 attached to my testimony as Exhibit 1, a resume providing a brief outline of my education
15 and professional experience.
16

17 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

18 A. Commission Staff has contracted with me to provide expert assistance in connection with the
19 Commission's consideration of the relative merits of performance bonds as opposed to letters
20 of credit as a device to ensure that Arizona public service corporations perform their
21 obligations in a manner consistent with the public interest. In particular, I was asked to
22 address the issue raised by Johnson Utilities Company L.L.C. ("JUC") in these dockets, as
23 described in the Procedural Orders issued on August 11, 2006.
24

25 **Q. HAVE YOU CONSIDERED THE ISSUE OF THE RELATIVE MERITS OF A**
26 **LETTER OF CREDIT AS OPPOSED TO A PERFORMANCE BOND, AND HAVE**
27 **YOU ANALYZED JUC'S PROPOSED LETTER OF CREDIT?**
28

1 A. Yes, I have considered the general issue of how the Commission might best ensure utility
2 performance. I have also analyzed JUC's proposed form of letter of credit to determine how
3 effective it might be.

4 **Q. HAVE YOU REDUCED THE OUTCOME OF YOUR ANALYSIS TO WRITING?**

5 A. Yes, I have attached to this testimony Exhibit 2, which is entitled "Declaration of William F.
6 Haug" (the "Declaration"). My Declaration describes many of the concerns I have regarding
7 the efficacy of the Commission's attempt to ensure utility performance by means of either
8 performance bonds or letters of credit. I describe some of the elements which should be
9 considered by the Commission in adopting one of these devices as a mechanism to either
10 protect utility ratepayers from losses or to ensure that utilities provide "adequate" service.

11 **Q. WOULD YOU PLEASE SUMMARIZE YOUR CONCLUSIONS?**

12 A. If adopted with appropriate standards and procedures in place, either a performance bond or a
13 letter of credit can be utilized for the intended purpose. It is not clear to me that all of the
14 necessary requirements to ensure that the surety device is effective have been incorporated
15 into previous Commission Orders. I am also concerned that, because the Commission may
16 not have the authority to receive funds under a surety device and distribute them to
17 customers, it may be difficult for the Commission to accomplish its objective without
18 legislative enactment.

19 Additionally, and in particular, I conclude that the proposed form of letter of credit proffered
20 by JUC will not adequately ensure that the utility provides "adequate" service.

21 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

22 A. Yes.
23
24
25
26
27
28

WS-02987A-04-0288
EXHIBIT 1

William F. Haug
Senior Partner
Phone: 602-234-7806
Facsimile: 602-277-5595
Email: wfh@jhc-law.com
Phoenix

Mr. Haug is an experienced litigator with an extensive background in civil litigation. His trial and litigation experience includes complex construction and fidelity and surety disputes representing all aspects of the construction industry, including both public and private owners, architects and engineers, contractors, subcontractors, material suppliers and sureties.

His experience also includes over 35 years representing his clients in arbitrations and mediations, including serving as an arbitrator and mediator in construction disputes.

EDUCATION

- LLB, University of Arizona, 1956
- B.S. in Business Administration, University of Arizona, 1953
 - Major in Accounting
- B.A. from Phoenix College, 1951

ADMITTED TO PRACTICE

- Arizona
- Arizona Supreme Court
- United States Supreme Court
- United States Court of Claims
- U.S. Court of Appeals, Ninth Circuit
- U.S. District Court, District of Arizona

PROFESSIONAL AFFILIATIONS

- State Bar of Arizona, President (1982-83)
 - Construction Law Section
 - Alternative Dispute Resolution Section
- Maricopa County Bar Association, President (1975)
 - Construction Law Committee
- Arizona Foundation for Legal Services and Education, President (1994)
- American Bar Association
 - Tort and Insurance Trial Practice Section, Past Secretary and Financial Officer
 - Fidelity and Surety Law Committee Chairman (1983-84)
 - Forum on the Construction Industry Hard Hat Case Note Editor (1980s)
- American Bar Foundation, Life Member (1991)
- International Association of Defense Counsel
 - Fidelity and Surety Law Committee
 - Construction Law and Litigation Committee
- Defense Research Institute
- Arizona Association of Defense Counsel

- Surety Association of Arizona, Honorary Member
- American Arbitration Association (Complex Case Panel)

REPRESENTATIVE ENGAGEMENTS

- Served as National Bond Counsel for a Surety Company overseeing surety claims throughout the United States
- Successfully defended sureties on bad faith claims
- Obtained defense judgments in all types of fidelity cases both in State and Federal Courts
- Represented contractor in mechanic lien suit involving a multi-million dollar electric generating plant
- Successfully represented subcontractors in lawsuits involving pay when paid and pay if paid clauses
- Served as Chair of Arbitration panel involving a multi-million dollar claim on a condominium project
- Arbitration panel member on a multi-million dollar dispute involving a huge freeway and drainage project
- Successfully mediated many construction disputes
- Drafted and secured the adoption by the Arizona Legislature of Arizona Public Works bonding statutes, lien release and discharge bond statutes on private projects and bonding provisions in the Arizona Uniform Probate Code

REPRESENTATIVE REPORTED DECISIONS

- *National Bank of Arizona v. St. Paul Fire and Marine Ins. Co.*, 193 Ariz. 581, 975 P.2d 711, Ariz. App. (1999). Suit against insured does not state a claim against Officers and Directors and, therefore, is outside the coverage under the Directors and Officers Liability Policy.
- *Cannon Dist. No. 50 v. W.E.S. Construct. Co., Inc.*, 177 Ariz. 526, 869 P.2d 500 (1994). School District was bound by the arbitration provision in its contract.
- *Dodge v. Fidelity and Deposit Co. of Maryland*, 161 Ariz. 344, 778 P.2d, 1240 (1989). A surety in Arizona is subject to bad faith claims as the surety is regulated by the State Insurance Department under the Insurance Code. Tells sureties what to do to in order to avoid bad faith.
- *Pioneer Roofing Co. v. Mardian Construct. Co.*, 152 Ariz. 455, 733 P.2d, 652 (1986). This case establishes the time when a claim must be brought on Public Works Projects and addresses the pay when paid clause provisions of the contract.
- *Employers' Administrative Services, Inc. v. Hartford Acc. & Indem. Co.*, 147 Ariz. 202, 709 P.2d 559 (1985). This case established the surety's right to assert the alter-ego defense on fidelity bonds.
- *Murdock-Bryant Const., Inc. v. Pearson*, 146 Ariz. 48, 703 P.2d 1197 (1985). This case established that the receipt of benefit by the owner is sufficient to support restitution and a quantum merit recovery where the owner is not a party to the contract.
- *J.R. Norton Co. v. Fireman's Fund Insurance Co.*, 116 Ariz. 427, 569 P.2d 857 (Ariz. at 1977). Where, some loss is shown by the insured, insured can establish its damages through inventory computations or profit/loss computations.
- *U.S. Fidelity & Guaranty Co. v. Christoffel*, 115 Ariz. 507, 566 P.2d, 308 (Ariz. at 1977). The court established that liability on the guardian's bond for a

definite period is limited to the amount of the bond and not cumulative for each year the bond is in effect.

- *Maryland Gas Co. v. Clements*, 15 Ariz. at 216, 487 P.2d, 437 (1971). This case established what constitutes notice of dishonesty so as to terminate liability of the surety for future acts of the employee.
- *Lincoln Technical Institute of Arizona, Inc. v. Federal Ins. Co.*, 927 Supp. 376 (D. Ariz., 1994): An endorsement increasing policy limits applies only to losses after the date of the endorsement.

SELECTED PUBLICATIONS & PRESENTATIONS

- *Surety's Liability: Bonds*, Arizona Construction Law 2d Ed., published by the State Bar of Arizona (1994).
- Authored Arizona's *Little Miller Act*, Mechanics Lien Discharge Bond statutes and the Bond provision in Arizona's Uniform Probate Statutes.
- Co-author "*Bankruptcy 1984 v. Surety's Rights to Contract Proceeds*" 20 Forum 725 (1985).
- "*Dodge vs. Fidelity & Deposit - The Final Chapter*" in Tips Fidelity and Surety Law Committee Newsletter, Spring/Summer (1992).
- "*Decision by Insurer Not to Defend Insured Against Claims Cognizable under Bonds*", 12 Forum 410 (1976).
- "*Financing your 'Solvent' Principal— Success Failure*", Fidelity & Surety Law Committee, San Francisco, CA, January 1996.

AWARDS AND HONORS

- 2001, Martin J. Andrews Award for Lifetime Achievement in Fidelity and Surety Law, presented by the Fidelity & Surety Law Committee of the and Insurance Trial Practice Section of the American Bar Association.
- 2004, "Silver Star Award" from the Governor of Arizona for his involvement in creating the Arizona Foundation for Legal Services and Education, 2004.
- August 2005 Volunteer Lawyer Program, Attorney of the Month for his 50-year ongoing commitment to Pro Bono service.
- 2006, Honored for his 50 years of exemplary services in the field of Construction and Surety by the Construction Law Section of the State Bar Arizona.
- 1998 ISO Silver Award for Excellence in Surety Bond Promotion presented by the Surety Association of Arizona.

COMMUNITY ACTIVITIES

- Maricopa County Bar Association
 - Volunteer Lawyers Program
- Creighton School Board (1966.-.75)
- Phoenix Retriever Club (1970.-.90)

AREAS OF PRACTICE

- Construction Law
- Fidelity & Surety Law
- Litigation
- Arbitration and Mediation

EXHIBIT 2

Declaration of William F. Haug

I am a lawyer admitted to the State Bar of Arizona and have been practicing law for almost 50 years. For most of my practice I have been involved with bonds of all types including performance, utility, license and court bonds, as well as letters of credit. In my practice I have primarily represented sureties. In the issuance of bonds, it is not uncommon for sureties to use letters of credit as security against loss where the principal on the bond might have some credit issues. Although bonds are common in the construction industry, the parties do sometimes use letters of credit in lieu of bonds. In fact, from the obligee's or beneficiaries' standpoint, they may be better than bonds since there is normally no defense available to the bank who must and will pay when the beneficiary draws upon the bank. Sometimes the letter will require other documents to accompany the draft drawn to obtain the bank's funds such as invoices, bills of lading and declarations of default.

Letters of credit accomplish their purpose by substituting the credit of the bank for that of the customer. There are basically two types: commercial and standby. The two letters serve different functions. Commercial letters of credit which have been used for centuries to facilitate payment in international trade is the primary payment mechanism for the transaction. The standby letter of credit serves a completely different function. A bank will issue a standby letter of credit on behalf of a customer to provide assurance of the customer's ability to perform under the terms of a contract with the beneficiary. The parties involved in the transaction do not expect that the letter of credit will ever be drawn upon. The letter of credit at issue here would be a standby in that it is intended to guaranty that the utility company will provide its users with adequate services.

Bonds which provide the same protection are a suretyship obligation. It is a tri-party transaction wherein the surety extends its credit to guaranty that the principal will

fulfill its obligations to the obligee. The surety obligation is secondary and only arises if the principal fails to perform its obligations to the obligee. Under this arrangement the surety, in the event of a default by the principal, can raise not only its own defenses to payment but also any defense that its principal might have.

With that overview, we will now look at Johnson Utilities Company's Performance Bond and its proposed letter of credit which tracks the bond form. Although bonds and letters of credit can accomplish the same thing, that is providing security to the obligee or beneficiary, they are entirely two different types of security devices and cannot be combined as is being attempted here. Under a performance bond, both the principal and surety can raise a defense to making any payment at all. Under the letter of credit, the principal and the bank can raise no defense to the payment to the beneficiary. If the principal believes that the payment should not have been made, then after payment has been made, the principal can take what ever action is appropriate against the beneficiary to get the money back.

The terms of the bonds given to the Arizona Corporation Commission, provide that the bond penalty is to be paid to the users with the consent of the Commission as Trustee. "Trustee" is not an appropriate designation as the Commission never holds anything under the terms of the bond which would make it a trustee because the bond amount is payable to the users. The performance bond is really in the form of a payment bond which although it names the Commission as obligee, it runs to the benefit of the users who are the true obligees, not the Commission, who has no right to receive the bond monies from the surety.

The provisions of the bond are incorporated into the letter of credit without recognizing that it is an entirely different form of security device, even to the extent of using bond terms such as surety, principal and bond. Who is the beneficiary? The bank funds appear to be for the benefit of the users and not the Commission. How do the users draw upon the letter when the bank doesn't know who they are and they do not hold the

original letter of credit? The drafting of this letter of credit evidences a lack of understanding of this security device. Since the beneficiaries are unknown, to whom does the bank send its notice of cancellation? The Commission? The users?

To have a proper letter of credit, the Commission should be the beneficiary to whom the funds would be paid, either for the benefit of the users or as a penalty or fine. The Commission Order granting the Certificate of Convenience and Necessity should spell out the terms of the bond or letter of credit, that is, what is its purpose, what constitutes a default under the security document, and what the Commission is to do with the funds it receives. I have attached sample forms of a letter of credit which the Commission could use in the event it determines that a letter of credit is an appropriate substitution.

In discussion with the Commission's counsel, there appears to be some problem with the Commission receiving the benefits of the letter of credit, unless it constitutes some form of a penalty or fine. I understand that all monies received by the Commission must be paid to the State Fund and would not be available to the users if it was intended to be for their benefit. This might mean there would have to be some legislative changes or at least some rules adopted by the Commission which would provide for a procedure to determine who the users are and the amount of their entitlement.

The bond as currently drafted is of little benefit to the users as their claims are generally so small that it is not worth their effort to try to collect from the bonding company, much less that they even know such bond exists. The surety would probably not pay individual claims because they may not know whether the claims exceed the bond amount. Payment of their claims could cause the surety's liability to exceed the amount of the bond, particularly if the bond amount is relatively small. If the bond proceeds are paid to the Commission, the same problems would exist as with the letter of credit.

If the Commission is legislatively authorized and appropriate rules are established, a letter of credit would be preferable over a bond. However, it could be more expensive to the Commission as it will have to adjust the claims of the users, an expense that would be

incurred by the surety when the bond, as now written, makes the users the beneficiaries. Rules promulgated by the Commission could provide that this expense come out of the bond proceeds or letter of credit before the users are paid.

EXHIBIT 2
ATTACHMENT 1

IRREVOCABLE STANDBY LETTER OF CREDIT NO. _____

Date _____

Arizona Corporation Commission (Beneficiary)
1200 W. Washington Street
Phoenix, AZ 85007

Gentlemen:

At the request of _____ (Requestor), we _____ (Name and Address of Bank) have opened an IRREVOCABLE LETTER OF CREDIT in your favor for \$ _____ (Amount) U.S. Dollars, available by your drafts at sight.

We warrant to you that all your drafts under this IRREVOCABLE LETTER OF CREDIT and a certification of default by the Commission will be duly honored upon presentation of your draft on us at _____ (Address of Bank) on or before the expiration date or on or before any automatically extended date set forth below.

Except as stated herein, this IRREVOCABLE LETTER OF CREDIT is not subject to any condition or qualification and is our individual obligation which is in no way contingent upon reimbursement.

This IRREVOCABLE LETTER OF CREDIT is effective _____, _____ and expires on _____, but will be automatically extended without amendment for successive one-year periods from the current expiration date and any future expiration dates unless at least 60 days prior to expiration date we notify you by registered letter that we elect not to renew for such additional one-year periods. Such notification shall be to the attention of the Bond Department at the above address.

This credit is subject to the Uniform Customs and Practices for Documentary Credits (1983 Revision), International Chamber of Commerce, publication no. 400.

Very truly yours,

(Authorized Signature)

(Title)

(To be prepared on Bank Letterhead)

EXHIBIT 2
ATTACHMENT 2

IRREVOCABLE STANDBY LETTER OF CREDIT NO. _____

Date _____

Arizona Corporation Commission (Beneficiary)
1200 W. Washington Street
Phoenix, AZ 85007

Gentlemen:

At the request of _____ (Requestor), we _____ (Name and Address of Bank) have opened an IRREVOCABLE LETTER OF CREDIT in your favor for \$ _____ (Amount) U.S. Dollars, available by your drafts at sight.

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(Authorized Signature)

(Title)

(To be prepared on Bank Letterhead)