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BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONERS

KRISTIN K. MAYES, Chairman
GARY PIERCE
SANDRA D. KENNEDY
PAUL NEWMAN
BOB STUMP

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IN THE MATTER OF THE APPLICATION OF
SUNRISE WATER CO., AN ARIZONA
CORPORATION, FOR A DETERMINATION OF
THE CURRENT FAIR VALUE OF ITS UTILITY
PLANT AND PROPERTY AND FOR
INCREASES IN ITS RATES AND CHARGES
BASED THEREON FOR UTILITY SERVICE

DOCKET NO. W-02069A-08-0406

**NOTICE OF FILING
SUPPLEMENTAL TESTIMONY**

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Sunrise Water Co. ("Sunrise") hereby files Supplemental Testimony by Ray L. Jones.

RESPECTFULLY SUBMITTED on June 22, 2009.

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By:


Marvin Collins

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KRISTIN K. MAYES, Chairman
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OF
RAY L. JONES
ON BEHALF OF
SUNRISE WATER COMPANY
JUNE 22, 2009**

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1 **EXECUTIVE SUMMARY**

2 Jurisdictions that have discussed the issue have generally allowed LLCs and C-Corps to recover
3 income tax expenses, because these taxes are “inescapable business outlays and are directly
4 comparable with similar corporate taxes.”

5 The Commission has often allowed recovery of income-tax expenses by LLCs and C-Corps,
6 although it has not been consistent on this issue.

7 Staff changed its position on the recoverability of income-tax expenses just before its testimony
8 was due in this case.

9 Sunrise incurred actual income-tax expense in the test year.

10 Sunrise’s request to recover income-tax expense is consistent with good public policy and avoids
11 discrimination in favor of C-Corps and against S-Corps and LLCs.

1 **I INTRODUCTION**

2 **Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND TELEPHONE**
3 **NUMBER.**

4 A. My name is Ray L. Jones. My business address is 25213 N. 49th Dr., Phoenix, Arizona
5 85083, and my business phone is (623) 341-4771.

6 **Q. ARE YOU THE SAME RAY L. JONES WHO PREVIOUSLY SUBMITTED**
7 **DIRECT, REBUTTAL AND REJOINDER TESTIMONY IN THIS DOCKET?**

8 A. Yes.

9 **II PURPOSE OF TESTIMONY**

10 **Q. WHAT IS THE PURPOSE OF YOUR SUPPLEMENTAL TESTIMONY?**

11 A. In my testimony:

- 12 • I discuss the treatment of income tax expense for rate making purposes for utilities
13 operating as something other than a C-Corp in states other than Arizona.
14 • I discuss the Commission's actions regarding recovery of income tax expense generally
15 and with respect to this case.
16 • I update Sunrise's position regarding income tax expense.

17 **Q. IS YOUR DISCUSSION OF OTHER CASES IN OTHER JURISDICTIONS**
18 **INTENDED TO BE COMPREHENSIVE?**

19 A. No, I would characterize my discussion as representative. Because of the expense, our
20 case review was limited, so there may be cases that we have missed. If there are multiple
21 cases from a jurisdiction, I will only discuss one or two of the cases as long as they are
22 representative of the other cases.

1 **III INCOME TAX TREATMENT BY STATES OTHER THAN ARIZONA**

2 **Q. ARE YOU AWARE OF STATES THAT ALLOW INCOME TAX EXPENSE TO**
3 **BE INCLUDED IN THE RATES OF UTILITIES THAT ARE NOT C-CORPS?**

4 A. Yes. Based on my research New Mexico, Texas, Washington, Kansas, Wisconsin,
5 Hawaii, New Jersey and Vermont have allowed income tax expense for utilities
6 organized as Sole Proprietorships, S-Corps, or Limited Liability Companies.

7 **Q. WHAT WERE THE UTILITIES, ORGANIZED AS SOLE PROPRIETORSHIPS,**
8 **S-CORPS OR LIMITED LIABILITY COMPANIES, THAT YOU REVIEWED IN**
9 **DETERMINING THE STATES IN WHICH THEY OPERATE ALLOW THE**
10 **RECOVERY OF INCOME TAX EXPENSE IN RATES?**

11 A. The utilities and their State of operation are summarized as follows:

Company	State	Business Type	Citation
Vernah S. Moyston, d/b/a Hobbs Gas Company	New Mexico	Sole Proprietor	<i>Moyston v. New Mexico Public Service Commission</i> 63 P.U.R.3d 522, 76 N.M. 146, 412 P.2d 840 (1966).
Suburban Utility Corporation	Texas	S-Corp	<i>Suburban Utility Corp. v. Public Utility Com'n of Texas</i> 652 S.W.2d 358 (Tex. 1983).
Rainier View Water Company, Inc.	Washington	S-Corp	<i>Washington Utilities and Transportation Com-mission v. Rainier View Water Co, Inc.,</i> 2002 WL 31432725 (Wash. U.T.C.)
Greeley Gas Company	Kansas	S-Corp	<i>Greeley Gas Co. v. State Corp. Com'n of State of Kan.</i> 15 Kan.App.2d 285, 807 P.2d 167, (Kan.App. 1991).
Home Telephone Company, Inc.	Kansas	S-Corp	<i>Home Telephone Co., Inc. v. State Corp. Com'n of State of Kansas,</i> 31 Kan.App.2d 1002, 76 P.3d 1071 (Kan.App. 2003.).
Madison Telephone, LLC	Kansas	LLC	<i>Re Madison Telephone, LLC,</i> 2007 WL 2126360 (Kan. S.C.C.).

Company	State	Business Type	Citation
CenturyTel of the Midwest-Kendall, Inc.	Wisconsin	LLC	<i>Re CenturyTel of the Midwest-Kendall, Inc.</i> , 2001 WL 1744202 (Wis. P.S.C.).
CenturyTel of Central Wisconsin, LLC	Wisconsin	LLC	<i>Re CenturyTel of Central Wisconsin, LLC</i> , 2002 WL 31970289 (Wis. P.S.C.).
Kukio Utility Company, LLC	Hawaii	LLC	<i>Re Kukio Utility Co., LLC</i> , 2008 WL 435059 (Hawai'i P.U.C.).
Maxim Sewerage Corporation	New Jersey	S-Corp	<i>Re Maxim Sewerage Corp.</i> , 1998 WL 223177 (N.J. B.P.U.).
Shoreham Telephone Company, Inc.	Vermont	S-Corp	<i>Re Shoreham Telephone Company, Inc.</i> 239 P.U.R.4th 380, 2005 WL 27529 (Vt. P.S.B.).

1 **Q. WHAT WERE THE CIRCUMSTANCES OF HOBBS GAS COMPANY**
2 **RECEIVING RECOVERY OF INCOME TAX EXPENSE IN NEW MEXICO?**

3 A. The New Mexico Public Service Commission established rates for Hobbs without any
4 consideration given to income tax expense. Hobbs appealed the New Mexico
5 Commission's order and was ultimately awarded recovery of income tax expense by the
6 New Mexico Supreme Court.

7 **Q. WOULD YOU SUMMARIZE YOUR UNDERSTANDING OF THE NEW**
8 **MEXICO COURT'S FINDINGS?**

9 A. The Court found that rates should include income tax expense in the amount that Hobbs
10 would pay if it were a C-Corp. In reaching its conclusion the Court stated that Hobbs'
11 operations were subjected to income taxes in substantial amounts and that rates which fail
12 to take income taxes into account are unfair, unjust, unreasonable and discriminatory.

13 The Court noted that the income taxes paid by Hobbs at individual rates were higher than
14 those that a C-Corp would pay. The Court disagreed with the Commission's contention
15 that the Company was no different than a shareholder receiving dividends from a C-Corp

1 because Hobbs must pay taxes on 100% of the utility's income, while a stockholder only
2 pays taxes on declared and issued dividends.

3 Finally, the Court noted that if Hobbs was a C-Corp the rates would be confiscatory due
4 to the exclusion in income tax expense. The Court noted that confiscatory regulation is
5 void because it is repugnant to the constitutional guaranties of due process and equal
6 protection of the laws.

7 **Q. WHAT WERE THE CIRCUMSTANCES OF SUBURBAN UTILITY**
8 **CORPORATION RECEIVING RECOVERY OF INCOME TAX EXPENSE IN**
9 **TEXAS?**

10 A. The Public Utility Commission of Texas established rates for Suburban without including
11 income tax expense. Suburban appealed the Texas Commission's order and was
12 ultimately awarding recovery of income tax expense by the Texas Supreme Court.

13 **Q. WOULD YOU SUMMARIZE YOUR UNDERSTANDING OF THE TEXAS**
14 **COURT'S FINDINGS?**

15 A. The Texas Court relied in the New Mexico Court's decision in the Hobbs case. In doing
16 so the Texas Court cited the New Mexico Court's notation that hypothetical tax
17 calculations made for the purpose of allocating income taxes to a public utility "establish
18 that the fundamental inquiry is not limited to technical distinctions, but is determined by
19 practical economic facts." The Court also noted that disallowed expenses may weaken a
20 utility's financial position, negatively affecting its ability to raise financing or attract
21 investors.

22 The Court found that income taxes required to be paid by shareholders of an S-Corp are
23 "inescapable business outlays and are directly comparable with similar corporate taxes"

1 paid by C-Corps. The Court held that Suburban was entitled to recover income tax
2 expenses equal to the lesser of the income taxes actually paid by its shareholders or the
3 tax it would pay if it were a C-Corp.

4 **Q. WHAT WERE THE CIRCUMSTANCES OF RAINIER VIEW WATER**
5 **COMPANY RECEIVING RECOVERY OF INCOME TAX EXPENSE IN**
6 **WASHINGTON?**

7 A. Rainier requested rate relief from the Washington Utilities and Transportation
8 Commission. The Washington Commission issued a rate order which included income
9 taxes. The Commission Staff petitioned for administrative review of the Order resulting
10 in the Commission issuing a second order affirming the initial order with respect to the
11 inclusion of income taxes in the rates of Rainier.

12 **Q. WOULD YOU SUMMARIZE YOUR UNDERSTANDING OF THE**
13 **WASHINGTON COMMISSION'S FINDINGS?**

14 A. The Washington Commission cited the Hobbs case and Suburban case deciding to allow
15 income-tax expense for Rainier. It also noted "that the courts of other jurisdictions had
16 adopted the approach, and that the approach will result in rates that are fair, just, and
17 reasonable and will avoid concerns related to the Constitutionally-mandated opportunity
18 to earn a fair return and concerns about different treatment of fundamentally similar
19 entities." Like the courts in New Mexico and Texas, the Washington Commission
20 concluded that income tax should be imputed at the lower of the personal or corporate
21 rate.

1 **Q. WHAT WERE THE CIRCUMSTANCES OF HOME TELEPHONE COMPANY**
2 **RECEIVING RECOVERY OF INCOME TAX EXPENSE IN KANSAS?**

3 A. The Kansas State Corporation Commission disallowed the inclusion of income tax
4 expense in the rates of Home. Home appealed the Commission's decision and the
5 Appeals Court of the State of Kansas allowed recovery of income tax expense in the rates
6 of Home.

7 **Q. WOULD YOU SUMMARIZE YOUR UNDERSTANDING OF THE KANSAS**
8 **COURT'S FINDINGS?**

9 A. The Kansas Court based its decision on an earlier Appeals Court of the State of Kansas
10 decision pertaining to Greely Gas Company. In the Greely case the Court upheld the
11 Kansas Commission's denial of income tax expense for Greely because Greely had not
12 provided proof that its shareholders had incurred income tax expense on the income of
13 the utility. However, in the Greely case the Court relied on the Suburban case in Texas to
14 establish that S-Corps in Kansas should be allowed to recover income tax expenses when
15 it is proven that the shareholder of the S-Corp actually incurred an income tax expense.
16 Based on past Commission practice, the Kansas court ultimately allowed Home income
17 tax expenses equal to those it would have paid if it were a C-Corp.

18 **Q. WERE THE CIRCUMSTANCES OF MADISON TELEPHONE RECEIVING**
19 **RECOVERY OF INCOME TAX EXPENSE IN KANSAS CONSISTENT WITH**
20 **THE GREELY AND HOME CASES?**

21 A. Yes. Madison requested rate relief from the Kansas State Corporation Commission. The
22 Kansas Commission issued a rate order which included income taxes for the lesser of the
23 actual income tax paid by the members of the LLC or the imputed taxes at the corporate

1 tax rate. The Commission noted that this is consistent with the Greely case, which relied
2 on the Suburban case in Texas.

3 **Q. WHAT WERE THE CIRCUMSTANCES OF CENTURY TEL OF CENTRAL**
4 **WISCONSIN AND CENTURY TEL OF THE MIDWEST-KENDALL**
5 **RECEIVING RECOVERY OF INCOME TAX EXPENSE?**

6 A. Both companies were LLC subsidiaries of Century Tel, Inc., a C-Corp. The Wisconsin
7 Public Service Commission authorized recovery at corporate tax rates for both
8 companies, while acknowledging that LLCs are not directly liable for income taxes.

9 **Q. WHAT WERE THE CIRCUMSTANCES OF KUKIO UTILITY COMPANY**
10 **RECEIVING RECOVERY OF INCOME TAX EXPENSE?**

11 A. Kukio applied to and received recovery of income tax expense from the Hawaii Public
12 Utilities Commission. The order does not provide any discussion of the issue other than
13 to note that the parties agreed upon an effective tax rate of 37.9699%.

14 **Q. WHAT WERE THE CIRCUMSTANCES OF MAXIM SEWERAGE**
15 **CORPORATION RECEIVING RECOVERY OF INCOME TAX EXPENSE?**

16 A. Based on a stipulation agreement, the New Jersey Board of Public Utilities authorized
17 rates for Maxim that included income tax expense. The proposed order in the case noted
18 that Maxim's income tax expense should be based on the C-Corp tax rate since that was
19 lower than the individual rate applicable to Maxim's shareholders.

20 **Q. WHAT WERE THE CIRCUMSTANCES OF SHOREHAM TELEPHONE**
21 **COMPANY RECEIVING RECOVERY OF INCOME TAX EXPENSE?**

22 A. Pursuant to a motion of alter a previous decision of the Vermont Public Service Board,
23 the Vermont Board amended its previous decision denying recovery of income tax

1 expense to allow recovery of income tax expense. The Vermont Commission allowed
2 income tax at the difference of the taxable dividend rate of 15% and the personal rate
3 applicable to Shoreham's shareholders of 25.15%.

4 **Q. ARE YOU AWARE OF STATES THAT HAVE NOT ALLOWED INCOME TAX**
5 **EXPENSE TO BE INCLUDED IN THE RATES OF UTILITIES THAT ARE NOT**
6 **C-CORPS?**

7 A. Yes. Based on my research Indiana, Illinois, New Hampshire, Pennsylvania, Florida and
8 Kentucky have denied income tax expense for utilities organized as S-Corps, or Limited
9 Liability Companies.

10 **Q. WHAT WERE THE UTILITIES, ORGANIZED AS S-CORPS OR LIMITED**
11 **LIABILITY COMPANIES, THAT YOU REVIEWED IN DETERMINING THE**
12 **STATES IN WHICH THEY OPERATE DENIED THE RECOVERY OF INCOME**
13 **TAX EXPENSE IN RATES?**

14 A. The utilities and their State of operation are summarized as follows:

Company	State	Business Type	Citation
South Haven Water Works	Indiana	S-Corp	<i>South Haven Waterworks v. Office of Utility Consumer Counselor</i> 621 N.E.2d 653 (Ind.App. 1993)
Monarch Gas Company	Illinois	S-Corp	<i>Monarch Gas Co. v. Illinois Commerce Comm'n</i> , 366 N.E.2d 945, 51 Ill.App.3d 892, (1977).
Concord Steam Corporation	New Hampshire	S-Corp	<i>Re Concord Steam Corp.</i> , 71 N.H. P.U.C. 667 (1986).

Company	State	Business Type	Citation
Jackson Sewer Corporation	Pennsylvania	S-Corp	<i>Pennsylvania Public Utility Comm'n v. Jackson Sewer Corp.</i> , 96 Pa.P.U.C. 322, 2001 WL 1658672 (Pa. P.U.C.).
Farmton Water Resources	Florida	LLC	<i>Re Farmton Water Resources LLC</i> , 2004 WL 2359423 (Fla. P.S.C.)
Ridgelea Investments, Inc.	Kentucky	S-Corp	<i>Application of Ridgelea Investments, Inc.</i> 2008 WL 4696006 (Ky. P.S.C.)

1 **Q. WHAT WERE THE CIRCUMSTANCES OF SOUTH HAVEN WATER WORKS**
2 **BEING DENIED RECOVERY OF INCOME TAX EXPENSE IN INDIANA?**

3 A. The Indiana Utility Regulatory Commission issued an order denying the recovery of
4 income tax expense in the rates of South Haven Water Works. South Haven appealed the
5 Indiana Commission's order, which was ultimately affirmed by the Court of Appeals of
6 Indiana.

7 **Q. WOULD YOU SUMMARIZE YOUR UNDERSTANDING OF THE INDIANA**
8 **COURT'S FINDINGS?**

9 A. In affirming the Indiana Commission's order, the Court found that South Haven's request
10 to recover income tax expense at the 31% individual tax rate was based on a hypothetical
11 approach and that South Haven had provided no evidence the South Haven's owners paid
12 any income tax. The Court considered South Haven's request speculative, arbitrary,
13 hypothetical and unsupported by the record.

14 **Q. WHAT WERE THE CIRCUMSTANCES OF MONARCH GAS COMPANY**
15 **BEING DENIED RECOVERY OF INCOME TAX EXPENSE IN ILLINOIS?**

16 A. The Illinois Commerce Commission issued an order denying recovery of income tax
17 expense for Monarch Gas Company. Monarch appealed the order to the Appellate Court

1 of Illinois. The Court affirmed the Commission's order, finding that the Commission
2 exercised its discretion by rejecting a claimed expense that was not in fact paid by the
3 company.

4 **Q. WHAT WERE THE CIRCUMSTANCES OF CONCORD STEAM**
5 **CORPORATION BEING DENIED RECOVERY OF INCOME TAX EXPENSE IN**
6 **NEW HAMPSHIRE?**

7 A. The New Hampshire Public Utilities Commission issued an order denying income tax
8 expense to Concord. The order relied upon the Illinois decision pertaining to Monarch in
9 reaching its conclusion.

10 **Q. WHAT WERE THE CIRCUMSTANCES OF JACKSON SEWER**
11 **CORPORATION BEING DENIED RECOVERY OF INCOME TAX EXPENSE IN**
12 **PENNSYLVANIA?**

13 A. Pursuant to request to increase rates, the Pennsylvania Public Utility Commission issued
14 an order denying Jackson recovery of income tax expense. The Commission relied on a
15 previous Pennsylvania Supreme Court decision that standalone tax calculations for a
16 utility participating in a consolidated tax return would not be allowed since the
17 standalone calculation did not consider the tax benefits of the consolidation. The
18 Commission concluded that it did not have the authority to include hypothetical expenses
19 not incurred and established that a utility cannot collect phantom taxes and should only
20 be allowed to collect actual taxes paid.

1 **Q. WHAT WERE THE CIRCUMSTANCES OF FARMTON WATER RESOURCES**
2 **LLC AND RIDGELEA INVESTMENTS, INC. BEING DENIED RECOVERY OF**
3 **INCOME TAX EXPENSE IN FLORIDA AND KENTUCKY, RESPECTIVELY?**

4 A. In both cases the Public Service Commission regulating the utility issued a rate order
5 denying recovery on income tax expense. In both cases there was little discussion of the
6 issue. In the Farmton case, the Florida Commission simply stated that a limited liability
7 company has no income tax expense. In the Ridgelea case, the Kentucky Commission
8 stated that income tax expense was removed because Ridgelea is a S-Corp.

9 **IV THE ARIZONA CORPORATION COMMISSION HAS NOT TAKEN A**
10 **CONSISTENT POSITION CONCERNING RECOVERY OF INCOME TAX**
11 **EXPENSE BY LLCs AND S-CORPS.**

12 **Q. WHAT HAS BEEN THE ARIZONA CORPORATION COMMISSION'S**
13 **POSITION CONCERNING RECOVERY OF INCOME TAX EXPENSE BY LLCs**
14 **AND S-CORPS?**

15 A. The Commission has often allowed recovery of income-tax expense for LLCs and S-
16 Corps.

17 **Q. WHAT EVIDENCE DO YOU HAVE THAT THE COMMISSION HAS OFTEN**
18 **ALLOWED RECOVERY OF INCOME TAX EXPENSE BY LLCs AND S-**
19 **CORPS?**

20 A. First, as I testified earlier, the Commission allowed income-tax expense for Sunrise
21 Water, an S-Corp, in a previous rate case. Second, at the hearing, Sunrise introduced
22 Exhibits A-9 through A-14, which demonstrated that the Commission Staff had
23 recommended and the Commission had approved recovery of income-tax expense for

1 three LLCs: Fisher's Landing Water and Sewer Works; LLC; Winchester Water
2 Company, LLC; and Wickenberg Ranch Water, LLC.

3 **Q. HAVE YOU DISCOVERED ANY OTHER CASES WHERE THE COMMISSION**
4 **HAS ALLOWED RECOVERY OF INCOME TAX EXPENSE BY AN LLC OR S-**
5 **CORP?**

6 A. Yes. I previously discussed the 1997 case of Camp Verde Water System, Inc., Decision
7 No. 60105, dated March 19, 1997. In this case the Commission allowed recovery of
8 income-tax expense by an S-Corp where the bank would not loan funds if income-tax
9 expenses were not allowed. This highlights the economic reality that S-Corps have real
10 income tax expenses. Because the bank's investment would only be repaid with after-tax
11 dollars, it insisted on recovery of income-tax expense in rates. This is what I have been
12 saying all along – If income-tax expenses are not recovered in rates, there are fewer
13 dollars available to fund investments. This would effectively reduce the return on
14 investment.

15 **Q. ARE YOU AWARE OF CASES WHERE THE COMMISSION HAS**
16 **DISALLOWED RECOVERY OF INCOME-TAX EXPENSES BY LLCs?**

17 A. Yes, and I am sure that Staff will cite all these cases. However, this does not change my
18 point, which is that the Commission has not taken a consistent position on this issue.
19 Sometimes Staff recommends and the Commission approves recovery of income-tax
20 expense and sometimes Staff and the Commission take the opposite position.

21 **Q. DO YOU BELIEVE THAT THE STAFF'S INCONSISTENCY ON THIS ISSUE IS**
22 **EVIDENT IN THIS CASE?**

23 A. Yes I do. Marvin Collins and I met with Staff in February 2008, before filing our case in
24 August 2008. The purpose of the meeting was to discuss Staff's expectations for our

1 filing and explore possible issues considering that Sunrise had not filed for rates in
2 approximately 25 years. We discussed a number of issues with Staff, but Staff never
3 raised any issue with income-tax expenses. Over the course of Staff preparing its direct
4 testimony in this case Sunrise discussed many issues, but never discussed income-tax
5 expense. Additionally, the issue never came up during Staff's subsequent data requests
6 or its site audit. The failure of this issue to surface until very late in the processing of this
7 case is indicative of Staff's inconsistency on this issue. If Staff had a clear policy on this
8 issue, the income-tax issue would have most certainly arisen earlier.

9 **Q. WHEN DID SUNRISE FIRST BECOME AWARE THAT STAFF WOULD**
10 **PROPOSE DISALLOWANCE OF INCOME-TAX EXPENSE?**

11 A. I received a phone call from Mr. Igwe on February 24, 2009, just three days before
12 Staff's testimony was due on February 27, 2009. During that call, Mr. Igwe informed me
13 for the first time that Staff was considering opposing recovery of income-tax expense for
14 Sunrise because it was an S-Corp. This was the first time anyone at Sunrise was told that
15 Staff was considering this position.

16 **Q. HAVE ANY OTHER STAFF OR COMMISSION ACTIONS DURING THE**
17 **COURSE OF THIS CASE DEMONSTRATED INCONSISTENCY ON THE**
18 **INCOME TAX ISSUE?**

19 A. Yes. Sunrise filed its application in this docket on August 1, 2008. Just one month later,
20 on September 3, 2008, Staff recommended recovery of income-tax expense for
21 Wickenberg Ranch Water, LLC (Exhibit A-13). The Commission approved Staff's
22 position on February 12, 2009 (Exhibit A-14) only days before Staff's testimony was due
23 in this case.

1 **V SUNRISE'S CURRENT POSITION REGARDING INCOME TAX**

2 **Q. HAS YOUR REVIEW OF THE INCOME TAX TREATMENT OF S-CORPS AND**
3 **OTHER PASS THROUGH ENTITIES CHANGED SUNRISES POSITION**
4 **REGARDING IT REQUESTED INCOME TAX TREATMENT?**

5 A. No. To the contrary, the cases serve to support Sunrise's position and reinforce many of
6 the arguments made by Sunrise supporting its position.

7 **Q. WHY SHOULD THE INCOME TAX LIABILITY CREATED BY SUNRISE BE**
8 **RECOVERED IN RATES?**

9 A. The net income generated by Sunrise through the provision of regulated water services is
10 subject to State and Federal income tax. The passed-through tax liability would not exist
11 absent the provision of regulated water services by Sunrise. Using the words of the
12 Texas Supreme Court, the taxes paid by Mr. Campbell on the income of Sunrise are
13 "inescapable business outlays and are directly comparable with similar corporate taxes."
14 Like any other expense prudently incurred in the operation of a regulated entity, the
15 income tax expense should be recovered in rates of the regulated entity, unless
16 circumstances particular to the regulated entity warrant a disallowance of the income tax
17 expense.

18 **Q. WHY IS STAFF'S POSITION FLAWED?**

19 A. Sunrise has previously testified that Staff's position is discriminatory and unfair. Staff
20 bases its recommendation on a technical distinction, rather than fairly and fully
21 evaluating the effect of income taxes on various forms of legal entities to reach its
22 recommendation regarding income tax treatment. Sunrise agrees with the New Mexico
23 Supreme court that technical distinctions are not sufficient grounds to reject Sunrise's
24 request for income tax expense. Since the Arizona commission uses hypothetical income

1 tax calculations when determining the amount of income tax to include in the expenses of
2 consolidated C-Corps, it has effectively agreed with the New Mexico Supreme Courts
3 statement “that the fundamental inquiry is not limited to technical distinctions, but is
4 determined by practical economic facts.” Sunrise simply requests that it not be
5 discriminated against relative to the numerous C-Corps that are part of consolidated
6 groups receiving income tax recovery in Arizona.

7 **Q. PLEASE SUMMARIZE SUNRISE’S POSITION REGARDING INCOME TAX**
8 **EXPENSE.**

9 A. It is not disputed that the net income generated by Sunrise through the provision of
10 regulated water services is subject to State and Federal income tax. The passed-through
11 tax liability would not exist absent the provision of regulated water services by Sunrise,
12 and is an expense incurred in the provision of water service by Sunrise. Further, if the
13 expense is not recovered, then fewer funds would be available for investment in the
14 business. As such, the income-tax expense should be recovered in rates of the regulated
15 entity.

16 The *pro forma* income-tax expense proposed by Sunrise is calculated consistent with the
17 method used by the Commission for C-Corps that are members of a consolidated group
18 and represents a fair and reasonable level of income tax expense to be included in the
19 rates for Sunrise. Treating Sunrise differently than the APS, Southwest Gas, Arizona-
20 American Water, Arizona Water, Chaparral City Water, and the numerous other C-Corps
21 that are part of consolidated groups is discriminatory and unfair to Sunrise, the
22 consolidated C-Corps, and their respective customers.

23 **Q. SEVERAL OF THE CASES YOU DISCUSSED EARLIER ALLOWED INCOME**
24 **TAX EXPENSE AT THE LOWER OF THE TAX CALCULATED AT THE C-**

1 **CORP RATE OR PERSONAL TAX RATES. IS SUNRISE’S POSITION**
2 **CONSISTENT WITH THIS APPROACH?**

3 A. Yes. Sunrise proposed an alternative way for the Commission to calculate the income tax
4 for an S-Corp. Sunrise proposed that Commission calculate taxes at personal rates as if
5 the S-Corp had just one shareholder that derived all of its income from the regulated
6 utility. The alternative method resulted in an allowed tax liability \$10,150 less than
7 calculating the tax at the C-Corp rate.

8 **Q. SEVERAL OF THE CASES DENYING INCOME TAX EXPENSE RELIED ON A**
9 **FINDING THAT THERE WAS NO EVIDENCE THAT THE SHAREHOLDER**
10 **ACTUALLY PAID INCOME TAX ON THE INCOME OF THE UTILITY. IS**
11 **THIS AN ISSUE IN THIS CASE?**

12 A. No. Several of the jurisdictions asserting the position appear to apply an ‘actual taxes
13 paid’ doctrine. The Commission has not adopted this doctrine, because it allows
14 hypothetical standalone income tax calculation for C-Corps filing consolidated tax
15 returns. It does not require a utility to demonstrate the actual taxes paid by its parent
16 shareholder

17 Even if the Commission did require that a utility demonstrate the actual taxes paid by its
18 parent shareholder, Sunrise would be allowed recovery of income-tax expense. Mr.
19 Campbell paid income taxes on Sunrise’s test year taxable income of \$258,646 at a
20 combined federal and state marginal rate of 32.5% and an overall effective rate of 23.0%.
21 This results in actual taxes paid of \$84,060 using the marginal rate approach and \$59,489
22 using the effective rate approach. Both figures are in excess of the \$55,449 requested by
23 Sunrise in its alternative recommendation.

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

2 A. Yes, it does.