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Arizona Corporation Commission
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BEFORE THE ARIZONA CORPORATION COMMISSION

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

IN THE MATTER OF THE APPLICATION OF JOHNSON UTILITIES, L.L.C., DBA JOHNSON UTILITIES COMPANY FOR AN INCREASE IN ITS WATER AND WASTEWATER RATES FOR CUSTOMERS WITHIN PINAL COUNTY, ARIZONA.	DOCKET NO. WS-02987A-08-0180 **STAFF'S INITIAL POST-HEARING BRIEF**

The Utilities Division of the Arizona Corporation Commission ("Staff") hereby files its closing brief in the above-captioned matter. In this brief, Staff will address the major disputed issues. On any issue not specifically addressed in this brief, Staff maintains its position as presented in its testimony.

I. INTRODUCTION.

Johnson Utilities, L.L.C. ("Johnson" or "Company") is a water and wastewater provider serving portions of Pinal County, Arizona. The Company served approximately 17,541 water customers and 21,525 wastewater customers during the test year, which ended December 31, 2007.

In 1997, Johnson received a certificate of convenience and necessity pursuant to Decision No. 60223. Rates and charges were set by that Decision. The Commission in Decision No. 68235 ordered Johnson to file rate applications for its water and wastewater divisions using a 2006 test year by May 1, 2007. Johnson requested an extension of time for among other things, the filing of a rate application until March 31, 2008, using a 2007 test year. Johnson filed its rate application for its water and wastewater divisions on March 31, 2008.

II. SUMMARY OF POSITIONS.

For its water division, the Company proposes rates that would decrease operating revenue by $2,232,070 to produce operating revenue of $10,940,829 resulting in operating income of $689,198, or a 16.94 percent decrease over test year revenue of $13,172,899. The Company also proposes a fair value rate base ("FVRB") of $6,607,841, which is its original cost rate base, and a 10.43 percent rate of return on the FVRB.

For the water division, Staff recommends rates that would decrease operating revenue by $3,016,800 to produce operating revenue of $10,015,099 resulting in operating income of $1,015,888, or a 22.90 percent decrease over adjusted test year revenue of $13,172,899. As Staff's recommended rate base is negative, Staff recommends an operating margin of 10.00 percent.

For its wastewater division, the Company, in its final schedules, proposes rates that would increase operating revenue by $2,239,804 to produce operating revenue of $13,528,467 resulting in operating income of $1,997,259, or a 19.84 percent increase over test year revenue of $11,288,663. The Company also proposes a fair value rate base ("FVRB") of $19,149,173, which is its original cost rate base ("OCRB"), and a 10.43 percent rate of return on the FVRB.

For the wastewater division, Staff recommends rates that would decrease operating revenue by $895,100 to produce operating revenue of $10,458,914 resulting in operating income of $1,045,913, or a 7.88 percent decrease over adjusted test year revenue of $11,354,014. Staff recommends an operating margin of 10.00 percent.

Among the major contested issues between Staff and the Company are the treatment of affiliate and related party profits, disallowances for excess capacity of water and wastewater plant, disallowance of plant for lack of documentation, the treatment of income taxes and water loss.

III. RATE BASE.

There are a number of contested issues between Staff and the Company regarding rate base adjustments. Staff recommends disallowances for plant that is not used and useful and for plant that was not supported by adequate documentation. Staff also determined that the Company's water and wastewater division plants contained excess capacity. Finally because of the layering of affiliate profit, Staff also recommends a disallowance.

A. Johnson Has Plant That Is Not Used And Useful And Should Be Disallowed.

An inspection of the Company's water system revealed plant that was not serving customers during the test year. Staff therefore disallowed $4,127,019 for the water division and 4,595,298 for the wastewater division.

1. Water Division.

While the Company agreed with Staff on the removal of $3,395,894, the Company disagrees with Staff's disallowance of $731,125 associated with 4 miles of 12 inch mains associated with the Rickee Water Plant.[1] The Company, in the testimony of Thomas Bourassa, admits that this plant is not serving customers, but that the Company was required to build this plant in order to serve a development.[2] The Company argues that because it was obligated to construct the plant and acted prudently in order to provide service that such plant should be included in rate base.[3] Company witness Brian Tompsett provides further background. According to Mr. Tompsett, the water main was constructed and installed to provide water service to a subdivision, Silverado Ranch, pursuant to a Master Utility Agreement dated September 7, 2006.[4] The Company admits that the 4 miles of water mains are not serving any customers. Mr. Tompsett contends that Johnson should not be penalized for the lack of progress at Silverado Ranch.[5] Mr. Tompsett admits that there are not even houses at the development.[6]

2. Wastewater Division.

For its wastewater division, Staff recommended a disallowance of $4,595,298. The Company has agreed with the removal of $2,209,026.[7] However, Johnson disputes the removal of $1,696,086 associated with the Precision wastewater treatment plant, and $690,186 associated with the construction of approximately 4 miles of 8 inch force sewer main to serve the Silverado Ranch development. Company witness Tompsett admits that none of the plant that Staff has recommended for disallowance is serving any customers.[8] The Company argues that the decision to construct Precision was prudent and necessary prerequisite to the approval of additional residential home construction in Johnson Ranch and as such should not be excluded from plant in service.[9] With

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[1] Ex. A-5 at 4.
[2] Ex. A-2, vol II at 11.
[3] Ex. A-5 at 4-5.
[4] Ex A-5 at 4.
[5] Id at 5.
[6] TR 923:5-7.
[7] Ex. A-5 at 37.
[8] Ex. A-5 at 36 for Precision; at 37 for Silverado main.
[9] Id. at 36-37.

respect to Silverado, the Company argues that the construction of the questionable main was pursuant to a Master Utility Agreement and should thus be included in plant in service.[10]

3. Discussion.

It is a well established principal that rates must be determined only on a utility's investment actually providing a service to the ratepayer. The exclusion of property not used and useful from a utility's rates results in an equitable allocation of risks between consumers and investors, and is necessary in order to provide incentives to a utility to operate efficiently. The used and useful test serves to measure precisely how much property is devoted to the public for which a return can be expected. Beginning with *Smyth v. Ames,* 169 U.S. 466 (1898), the Supreme Court found that a utility is entitled to a return upon that property which is used and devoted by it to the public convenience. On the other hand, property which is not used and useful for the public convenience is not to be included as a basis for making rates. *Denver Union Stock Yard Co. v. United States,* 304 U.S. 470, 475 (1938). The used and useful test has been accepted by the vast majority of jurisdictions as a means of distinguishing between property included in rates and property appropriately excluded.

The Company's arguments regarding the prudency of the construction should be disregarded. It has been held that prudently incurred property may be excluded from rates. In *Los Angeles Gas and Electric Corp. v. Railroad Commission of California,* 289 U.S. 287 (1933), the Court considered whether a plant designed to manufacture natural gas which was no longer in use should be included in rate base. The Court noted:

> The time and circumstances of the outlay, and the effect of altered conditions, demand consideration. Even when cost is revised so as to reflect what may be deemed to have been invested prudently and in good faith, the investment may embrace property no longer used and useful for the public. *Id.* at 306.

In this case, the fact that the water and sewer mains were constructed pursuant to a master utility agreement has no bearing on whether the plant items were in use during the test year, or are currently in use.[11] In fact, until Staff finds that a plant item, such as the water and sewer mains at

[10] Ex. A-5 at 37.
[11] Tr.1421:24-1422:4.

issue here, are actually in use, Staff would not have a reason to make a prudency determination.[12] As noted by Mr. Scott in the hearing, once the plant items begin serving customers, nothing would prevent the Company from requesting their inclusion in rate base in a later rate case.[13] The Company has admitted that the plant in question is not serving customers. To include such plant would violate well standing principles of ratemaking. Staff's recommended disallowances should be adopted.

B. <u>The Johnson Systems Contain Excess Capacity And That Capacity Should Not Be Included In Plant In Service.</u>

For the water system, Staff engineering witness, Marlin Scott, determined the Anthem system contains excess capacity. Staff recommends a disallowance of $1,127,065.[14] For the wastewater division, Staff witness Scott testified that half of the Company's San Tan System 2.0 million gallons per day treatment capacity is excess capacity. Staff recommends a disallowance of $5,443,062.[15]

1. Water Division.

The Company disagrees with Staff's analysis of the capacity and the growth of the Anthem System. Company witness Tompsett contends that Staff underestimated the growth projection by using its 185 service connections per year, and believes the Company's growth rate of 366 customers per year should be used to determine the well and storage capacities.[16]

Pursuant to peak demand and growth projections, the Anthem Rancho Sendero Well No. 1, and the Rancho Sendero 0.5 million gallon storage tank, in that pursuant to peak demand and growth projections they will not be needed within five years from the 2007 test year. Excess capacity is that plant, typically treatment plants, wells, or storage facilities, which will not be necessary within a five year period.[17] Extra capacity is that plant which will be necessary within a five year planning period using peak demand factors and growth projections.[18] Arizona Administrative Code ("A.A.C.") R18-5-503 provides:

> A. The minimum storage capacity for a CWS or a non-community water system that serves a residential population or a school shall be equal to the average daily demand during the peak month of the year. Storage capacity may be

[12] Tr. at 1421:20-23.
[13] Tr. 1422:5-10.
[14] Ex. S-37 at 3.
[15] Ex. S-37 at 9.
[16] Ex. A-5 at 7.
[17] Tr. 1423:18-20.
[18] Tr. 1423:14-17.

based on existing consumption and phased as the water system expands.

> B. The minimum storage capacity for a multiple-well system for a CWS or a non-community water system that serves a residential population or a school may be reduced by the amount of the total daily production capacity minus the production from the largest producing well.

Staff recommends removal of the Anthem Rancho Sendero Well No. 1, a 600 gallon per minute well, as excess capacity.[19] Mr. Scott explained that Staff recommended plant allowance allows for customer growth beyond Staff's initial projection:

> Staff acknowledges that it used a growth projection of 185 new service connections per year in its initial system calculation. However, in the conclusion of its system analysis, Staff included two wells, at 600 gallons per minute ("GPM") and 300 GPM, for a total of 900 GPM. This total well capacity of 900 GPM could serve up to 2,571 service connections (900 GPM divided by 0.35 GPM per service connection). If the 2,571 is adjusted to subtract the 857 customer base for the test year, the result is 1,714, which equates to 342 new service connections per year for the next five years. Therefore, as a result, the allowed well capacity of 900 GPM is sufficient to add 342 new service connections per year for a five year period."[20]

Even assuming the Company has growth of over 342 new connections per year, nothing prevents the Company from operating all three wells and in a later rate case requesting inclusion of the Anthem Rancho Sendero Well No. 1 in rate base once it is no longer excess capacity.[21] Furthermore, as noted by Mr. Scott, this case uses a 2007 test year, a year from which Staff's original growth projection was obtained.[22] According to the Company's own proposed 366 new connections per month growth projection, the 300 gallon per minute well is excess capacity.[23] Staff's recommendation to use 342 new connections per month growth projection (157 higher than the 2007 growth projection) is reasonable, and the Anthem-Rancho Sendero Well No. 1 should be determined to be excess capacity. Additionally, the 0.5 million gallon storage tank in the Anthem water system is excess capacity and will not be needed in the five year planning period.[24] Applying A.A.C. R18-503(B), only 714,800 gallons per day is necessary for the five year planning period.[25] Therefore, the 1 million gallon storage tank is more than sufficient water storage for the Anthem water system.

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[19] Ex. S-36 at 12; Ex. S-37 at 4; Tr 1464:21-24; Tr 1468:14-21.
[20] Ex. S-37 at 4:6-14.
[21] Tr. 1424:12-21 and 1472:14-17.
[22] Tr. 1446:19-21.
[23] Ex. A-5 at 7-9; Tr. 1469:10-18.
[24] Ex. S-37 at 5:1-12.
[25] Ex. S-37 at 5:1-12.

2. Wastewater Division.

The San Tan Wastewater Treatment Plant contains excess capacity because according to the information provided by the Company, Phase II is not needed according to growth projections for the five year planning period.[26] The Company attempts to argue that because it has plans to connect the Pecan wastewater system to the San Tan wastewater system in the third quarter of 2009, that this prospective re-direction of wastewater flow will eliminate the excess capacity at the San Tan Wastewater Treatment Plant.[27] However, as noted by Mr. Scott, "[t]his proposed construction would be almost two years beyond the test year 2007 and would result in completely new flow data that would not match the test year data."[28] Thus, because wastewater flows were not being redirected during the test year, or even at the time of the hearing, the San Tan Wastewater Treatment Plant should be found to have excess capacity in the amount of 1 million gallons.

When that capacity exceeds what is reasonable, ratepayers should not be required to provide a return on such excess. Staff's recommendations regarding the water and the wastewater plant are reasonable and should be adopted.

C. The Company Lacked Adequate Documentation To Support Its Plant Costs And Staff's Disallowance Of 10% Is Reasonable And Should Be Adopted.

Staff is recommending a 10% disallowance of plant for inadequately supported plant costs. Staff's recommends a disallowance of $7,433,707 for water plant and $10,892,391. Staff removed, from plant in service, the excess capacity and used and useful disallowances before applying the 10% disallowance. As a result, Staff made adjustments to accumulated depreciation and depreciation expense to reflect Staff's proposed adjusted plant balance.

The Company argues that the Staff reduction is arbitrary. According to Mr. Tompsett, the Company provided "contracts, invoices, cancelled checks and/or main extension agreements in support of all but $885,064.[29] Despite the fact that the Company submitted voluminous documents (see generally Exhibit A-69), Staff's audit and analysis could not verify the Company's claims. The audit process was difficult and was compounded by the lack of timeliness of the response of the

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[26] Tr. 1424:22-1425:11.
[27] Ex. A-5 at 38-40.
[28] S-37 at 10:15-18; *see also* Tr. at 1515:10-22.
[29] Ex. A-5 at 12.

Company as well as the failure of the Company to keep its records in accordance with the NARUC Uniform System of Accounts and Commission rules.[30]

Mr. Tompsett claims that the Company provided more than enough documentation to support its plant costs. But quantity does not equal quality. The failure of the Company to respond on a timely basis severely hampered Staff's analysis of the Company's application. Staff propounded numerous data requests to the Company. And as shown by the testimony, the Company responded, in one instance, after the deadline for Staff's surrebuttal testimony. In a letter dated April 21, 2009[31], the Company supplemented its response to a Staff data request, a data request that was issued in August 2008. Staff's surrebuttal testimony was due March 31, 2009. The hearing in this matter commenced April 23, 2009. As Mr. Michlik testified, despite the fact the Company was late he, nevertheless, attempted to review the provided documents.[32]

The Company testified that it provided cancelled checks to support its plant costs.[33] The problem with cancelled checks, as noted by Staff witness Michlik, is that it shows the amount paid but not the actual cost of the asset.[34] The Company also contends that its Advances in Aid of Construction ("AIAC") agreements provide further support of its plant costs. These agreements are main extension agreements, which are governed by A.A.C. R14-2-406. This rule also provides that the Commission must approve all such agreements. The agreements submitted by the Company pertained to years 2000-2007, yet most were filed in 2008.[35] However, most of these agreements are with affiliates of Johnson and Johnson did not maintain complete invoices and records to support these transactions with its affiliates.

The Company provided voluminous documentation and presented such at the hearing. But the Company failed to supply documentation in accordance with the NARUC Uniform System of Accounts ("USOA") and Commission rules. The Company's documentation was by project, which could span several years. The USOA requires plant to be kept by plant account, which the Company

[30] Ex. S-38 at 13.
[31] Ex. S-46.
[32] TR 1712:22-25; 1713:1-7.
[33] Ex. A-5 at 14.
[34] Ex. S-38 at 11.
[35] Ex. S-38 at 12.

did not do consistently. Staff's audit process is necessary and appropriate for verifying operating expenses and rate base costs. Staff's audit process and requirements for reviewing supporting documentation is required by Arizona Administrative Code ("A.A.C.") § R14-2-610 D.1. This rule states in part: "Each utility shall keep general and auxiliary accounting records reflecting the *cost of its properties*… and all other accounting and statistical data *necessary to give complete and authentic information as to its properties*…" (emphasis added). Brian Tompsett testified that he familiarized himself with the rules pertaining to rate applications.[36] Company witness Thomas Bourassa, the Company's witness who prepared the Company's rate schedules and Cost of Capital testimony, admits that he has testified numerous times on behalf of utilities, that he is familiar with what is required by the USOA and Commission rule.[37] The Company knows the rules; it simply has not complied with them.

Staff's recommendation is consistent with other dockets in which the same recommendation was made. *In the matter of Groom Creek Water Users Association*,[38] Staff recommended the disallowance of test year plant where the utility lacked the documentation to support the plant. Decision No. 70627 adopted Staff's recommendation with respect to the disallowance of test year plant.[39] *In the matter of Cordes Lakes Water Company*, Staff recommended the disallowance of plant where the utility lacked the documentation. The Commission, in Decision No. 70170, adopted Staff's recommendation.

As Mr. Michlik testified, Staff's typical range of disallowance for unsubstantiated plant ranges from 10 to 100 percent. Staff determined that only a minimal 10 percent disallowance was warranted in the case.[40]

D. <u>The Company's Request To Include Post-Test-Year Plant Is Inconsistent With The Commission's Normal Treatment Of Post-Test-Year Plant.</u>

The Company has sought the inclusion of post-test-year plant in the amount of $3,222,495 for its wastewater division for plant associated with the Hunt Highway South Force Main project, the

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[36] TR 923:17-25

[37] TR 1384:1-25, 1385:1-11.

[38] Docket No. W-01865A-07-0385 et. al.

[39] Decision No. 70627, FOF 54, 57.

[40] Ex. S-38 at 14.

Queen Creek leach field and the Parks lift station. Staff has recommended a disallowance of the entire amount requested by the Company. The inclusion of post-test-year plant violates principals of ratemaking and results in a mismatch of that plant with the revenues, expenses, and rate base of the test year.

Commission rules require the end of the test year, which is the one-year historical period used in determining rate base, operating income and rate of return, to be the most recent practical date available prior to the filing.[41] Compliance with Commission rules and recognition of Commission policy on appropriate test year selection requires a utility to choose a test year that includes all major rate base and operating income items needed to support its rate application, and to include pro forma adjustments to its chosen test year that are consistent with past Commission action under similar circumstances.

While the Commission has allowed the inclusion of post-test-year plant in rate base, as Staff witness Michlik testified, Staff has traditionally recognized two such scenarios: (1) when the magnitude of the investment relative to the utilities total investment is such that not including the post-test-year plant in the cost of service would jeopardize the utility's financial health, and (2) when conditions such as the following exist: (a) the cost of the post-test-year plant is significant and substantial, (b) the net impact on revenue and expenses for the post-test-year plant is known and insignificant or is revenue-neutral, and (c) the post-test-year plant is prudent and necessary for the provision of services and reflects appropriate, efficient, effective, and timely decision-making.[42] It is the Company's burden to show that the post-test year plant is revenue neutral.

The Company argues that that pro forma adjustments as defined by A.A.C. R14-2-103(A)(3)(i) are "adjustments to actual test year results and balances to obtain a more normal relationship between revenues, expenses and rate base" and its request for the inclusion of post test year plant is a pro forma adjustment to reflect the reality during the period the rates will be in effect.[43] According to Staff, with the absence of reliable cost documentation, it is difficult to determine whether such pro forma adjustments to rate base also include known and measurable changes to

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[41] *See* A.A.C. R14-2-103(A)(3)(p).
[42] Ex. S-44 at 9.
[43] Ex. A-2 vol 3 at 15.

revenues and expenses.[44] Staff contends that the Company has failed to quantify the effects of post-test year plant on revenues and concluded that the plant in question is for expansion.[45] The Company offered no evidence that it was having difficulty providing service to its customers. Johnson attempts to bolster its position by citing several previous Commission decisions involving water companies where post-test plant was allowed into rate base. Those decisions are distinguishable from the instant case. For example, Johnson cites Decision No. 68176 as supportive of their position.[46] In *Chaparral City Water Company*, Chaparral City Water Company ("Chaparral") was seeking recovery of an expansion of a water treatment plant used to treat Central Arizona Project water. Construction of the plant in question was commenced in 2003 and completed in March 2004, three months after the end of the test year. During the test year in that matter, Chaparral peak demand exceeded 10 million gallons per day, but it only had the capacity to treat 8 million gallons per day. The Commission found that Chaparral needed the plant to serve existing customers during the summer, when demand peaks. The Commission was also persuaded by the fact that the plant was placed into service shortly after the end of the test year. In this instance, Chaparral also needed the capacity to aid in its maintenance and provide a safety operating margin.[47] The situation faced by Chaparral is far different that the situation faced by Johnson. Johnson provided no credible evidence, other than conclusory statements that the Park Lift Station was necessary or resolve "potential problems".[48]

It is the Company's burden to show that the post-test year plant will not add to revenues. The Company has not substantiated its claim that the additions are revenue neutral and the request to include post test year plant should be denied.

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[44] Ex. S-44 at 9.
[45] Id.
[46] In The Matter of The Application of Chaparral City Water Company, Docket No. W-02113A-04-0616
[47] Decision No. 68176 at 5.
[48] Ex. A-5 at 34.

E. <u>Affiliate Profit.</u>

Johnson has used affiliates for substantially all of its plant construction. The Company has indicated that affiliates have provided other services to the utility. Staff has recommended a 7.5 percent reduction of plant in service as disallowance for affiliate profit. A discussion of the inter-relationship between the Company and its affiliates is illustrative of the need for closer scrutiny.

1. Corporate and affiliate structure.

Johnson has listed as it members, the George Johnson Revocable Trust, George and Jana Johnson co-trustees, and Connorg, LLC ("Connorg"). The members of Connorg are Brian Tompsett and Susan Tompsett.[49]

In response to a Staff data request, the Company indicated that for the years 1998-2003 construction of water and wastewater plant was done by an affiliate, Boulevard Contracting Company Inc.[50] The Company indicated that the owner was George Johnson. Records from the Commission's Corporation Division indicated that Boulevard's date of incorporation was December 18, 1998 and list George Johnson as President and Chief Executive Officer, and Jana Johnson as secretary. Corporation Division records also indicated that Boulevard has been administratively dissolved for failure to file it annual report.

The Company has identified Central Pinal Contracting, LLC ("CPC") as the entity that provided the construction work after 2003. According to records from the Commission's Corporation Division, from 2003 to 2008, the manager of CPC was Atlas Southwest, Inc., and the member was Crisbar, LLC.[51] The Company indicated in response to a Staff data request, that Mr. Tompsett was also an owner.[52]In April 2008, CPC's ownership changed. Currently the managers are Barbara A. Johnson and Christopher Johnson. The managers are the son and daughter of George Johnson. The member of CPC is the Roadrunner Trust, Barbara A. Johnson and Christopher Johnson, co-trustees. Because of this change in ownership, the Company maintains that CPC is no longer an affiliate and

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[49] Ex. SF-1
[50] Ex. S-20
[51] Ex. S-3; Ex. S-4
[52] Ex. S-20

thus any transaction are not required to be reported pursuant to the Commission's affiliated interest rules.[53]

The Company has indicated that the construction affiliates were not formed solely to provide services to the Company, but did not produce any other agreements with non-affiliated entities.[54]

The Company has indicated that there other affiliates who provide services to the utility. Shea Utility Services Company, Inc. ("Shea"). According to Mr. Tompsett, Shea provides management services and operations to the Company.[55] Other officers were identified as George Johnson and Jana Johnson[56]. The Johnsons ceased being officers of Shea in 2007. Current officers are Christopher and Barbara Johnson. In 2004, Mr. Tompsett was listed in Shea's annual report as an Executive Vice President of Shea.[57] Mr. Tompsett was also an executive of the Company. Mr. Tompsett received compensation for his role at Shea and he also received a distribution for his role with the Company.[58] His dual roles cause Staff to question the arm's length nature of transactions between Shea and the Company.

Another Johnson affiliate that provided services to the Company was Specific Engineering LLC ("Specific"). In March 2008, the Roadrunner Trust, Barbara and Christopher Johnson co-trustees. From 2004 through 2008, the member and manager of Specific was Atlas Southwest. Again, the Company contends that it is not required to disclose any transactions with Specific because in 2008, Specific ceased being an affiliate of Johnson.

2. Discussion.

The Commission rule governing affiliate transactions is A.A.C. R-14-2-801 *et seq*. A.A.C. R-14-2-804(A) provides:

> A utility will not transact business with an affiliate unless the affiliate agrees to provide the Commission access to the books and records of the affiliate to the degree required to fully audit, examine or otherwise investigate transactions between the public utility and the affiliate. In connection therewith, the Commission may require production of books, records, accounts, memoranda and other documents related to these transactions.

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[53] Id.; TR 857:2-9.
[54] TR 1207:1-7
[55] TR 864:10-18
[56] Ex. S-13.
[57] Ex. S-12.
[58] TR 865:5-12

State commissions have historically reviewed affiliate costs and profits with greater scrutiny than other utility costs.

In *U.S. West Communications v. the Arizona Corporation Commission*, 185 Ariz. 277, 915 P.2d 1232 (App. 1996), the Arizona Court of Appeals held that the "Commission has broad powers to scrutinize transactions between a regulated company and its unregulated affiliates" and disallow excessive costs.[59] In *General Telephone Co. of Upstate New York v. the Public Service Commission of New York*, 17 N.Y.2d 373 (N.Y. 1966), the Court of Appeals of New York held that:

> When such materials and services are obtained through contracts which are the result of arm's length bargaining in the open market, the contract price is usually accepted as the proper cost. However, when a utility and its suppliers are both owned and controlled by the same holding company, the safeguards provided by arm's length bargaining are absent, and ever present is the danger that the utility will be charged exorbitant prices which will, by inclusion in its operating costs, become the predicate for excessive rates.[60]

Finally, in *Turpen v. Oklahoma Corporation Commission*, 769 P.2d 1309 (Okla. 1989), the Supreme Court of Oklahoma held that:

> The utility's burden of proving that payments to affiliates are reasonable includes both a burden of production and of persuasion. The utility has the initial burden of producing evidence to show *prima facia* the reasonableness of its payments to affiliates-a mere showing of the expenses' incurrence will not suffice. The utility must produce evidence, *for example, that it charged affiliates the same amount as it did arms-length buyers.* Unless the utility meets this affirmative duty of showing the reasonableness of payments to affiliates, no such expenses may be allowed.[61]

As the *Turpen* court noted, "a mere showing of the expenses' incurrence will not suffice. The utility *must* produce evidence."[62] The *Turpen* court also held that affiliate costs must be the same as non-affiliates would receive from arms-length negotiations.[63] In *Phelps Dodge Corp. v. Arizona Electric Power Co-op, Inc.*,[64] the Arizona Court of Appeals held that the Commission may not allow the competitive market to set rates. The Commission has a "duty to set *just* and reasonable rates that

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[59] 185 Ariz. at 282, 915 P.2d at 1237 (citations omitted).
[60] 17 N.Y.2d at 378.
[61] 769 P.2d at 1323 (citations omitted; emphasis added).
[62] *Turpen.*, 769 P.2d at 1323 (citations omitted; emphasis added).
[63] *Id.*
[64] 207 Ariz. 95, 108, 83 P.3d 573, 586 (App.2004).

provide for the needs of all whose interests are involved, including public service corporations and *the consuming public*."[65]

Even accepting the Company's contention that CPC, Shea, and Specific are no longer affiliates because of the change in ownership, the family relationships make any transactions between the Company and these entities, related party transaction, and thus should be subject to greater scrutiny.

Related party transactions are governed by certain accounting standards such as Financial Accounting Standards Board ("FASB") 57, Related Party transactions.[66] The son and daughter of the owner and founder of Johnson, are owners of the entity that provides construction services to the Company, and as such are related parties. By their very nature, related party transactions require closer scrutiny. Although a transaction between related parties is not *per se* unreasonable, it is the utility's burden to prove that its costs are reasonable. *Florida Power Corp. v. Cresse*, 413 So. 2d at 1191. The Company has denied that it has engaged in any related party transactions.[67]

Staff would argue that part of the duty and responsibility of a regulated utility is to serve its public in a fair and equitable manner. A utility cannot overcharge customers or buy services from related entities at extravagant prices and expect its ratepayers to pay for it. A utility has an obligation to get the best price for services to customers. This includes the obligation not to promote profitability for the Company or another interested company in a transaction that may not be at arm's length to the detriment of its customers.

Staff could not determine whether the transactions between Johnson and its affiliates were at arm's length. The Company claims that it competitively bid its construction projects but did not retain those bids, so Staff could not conduct an audit. As Mr. Michlik testified, fair competitive bids protect ratepayers from being charged too much for plant.[68] As the testimony shows, Mr. Tompsett

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[65] *Id.* (emphasis added).
[66] FASB 57 states that examples of related party transactions include transactions between (a) a parent company and its subsidiaries; (b) subsidiaries of a common parent; (c) an enterprise and trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of the enterprise's management; (d) an enterprise and its principal owners, management, or members of their immediate families; and (e) affiliates.
[67] Ex. S-18; TR 897:7-25; 898:1-10.
[68] Ex. S-38 at 12.

was a part owner of CPC and at the same time, an executive of the Company. Although he indicates that he did not participate in the bidding and the review process of the bids, his role as an owner of the construction affiliate and an executive in the Company appear to be in conflict.

The Company argues that Staff's recommended disallowance of 7.5 percent is grossly overstated and has recommended 1.75 percent.[69] The Company also argues that such a disallowance should only apply to base contract costs.[70] In its review of the cancelled checks provided by the Company, Staff found that such checks indicated that payments for construction of plant were made to Johnson affiliates.[71] Staff found that some of the documentation provided by the Company conflicted with responses to Staff data requests.[72] In its review of the agreements provided by the Company some had a mark-up of 10%; only a few contained a mark-up of 5%.[73]

The Company could have done much more to gather sufficient, competent and reliable evidence to meet its burden of production. Some independent standard must be used to determine the reasonableness of affiliate costs. In an open, competitive market, it may be reasonable to assume that contract prices reflect market prices. Nevertheless, under *Phelps Dodge* market prices may be unjust and unreasonable for utility ratepayers.

For example, in *Washington Utilities & Transportation Commission v. Washington Water Power Company*, 24 P.U.R. 4th 427 (1978), the Washington Utilities and Transportation Commission held that "the only method of determining the *fairness* and reasonableness of [affiliate costs] is to determine the reasonableness of the return to the [utility] on their property used and useful in the business."[74] In rejecting related companies' ability to earn a "double profit,"[75] the Washington Commission concluded that:

> [A] company enjoying the immunities of a public utility has no right to impose upon the consumers a heavier burden than that which would be justly borne, and that will produce a proper rate of return, considering the

[69] Ex. A-2 vol. 2 at 6.
[70] Ex. A-2 vol 3 at 6.
[71] Ex. S-39 at 8.
[72] Id.
[73] Id. at 10.
[74] (publication pages not available, page reference is to Westlaw printout) (citing *Wichita Gas Co. v. Kansas Pub. Service Commission,* 2 F Supp 792 (DC Kan 1933) (emphasis added).
[75] *Id.*

> value of the property devoted to this public service and to the risks involved.[76]

The Commission has addressed the issue of affiliate profit in two decisions, Black Mountain Sewer and Gold Canyon Sewer Company.[77] In both those decisions, the Commission disallowed of both capitalized costs and expenses by the affiliate companies profits. The Commission, in Black Mountain, found it had broad authority to scrutinize transactions between a regulated company and its unregulated affiliates, and to disallow excessive costs.[78] Staff's recommendations are in line with previous Commission decisions and should be adopted.

F. <u>Unexpended Contributions in Aid of Construction ("CIAC")Should Not Be Removed From Rate Base.</u>

At the end of the test year, the Company's balance for CIAC was $31,935,899 for the water division, and $48,931,950 for the wastewater division. The Company proposed to remove $6,931,078 from its water balance because it was unexpended. The Company proposed to remove $16,505 from its wastewater balance because it was unexpended.

The Company's removal of those amounts is contrary to the Commission rules on the treatment of CIAC. Staff has proposed increasing CIAC to reflect the actual test year-end balance.

Staff contends that the treatment accorded to funds contributed by others, does not depend on whether the funds are unexpended. As Staff Witness Michlik explains the removing of unexpended CIAC from the CIAC account is inconsistent with the NARUC USOA.[79] NARUC USOA states the following regarding CIAC:

> 271. Contributions in Aid of Construction
>
> A. This account shall include:
>
> 1. Any amount or item of money, services or property received by a utility from any person or governmental agency, any portion of which is provided at no cost to the utility, which represents an addition or transfer to the capital of the utility, and which is utilized to offset the acquisition, improvement to offset the utility's property, facilities or equipment used to provide utility services to the public.

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[76] *Id.* at 14.
[77] In re Black Mountain Sewer Corporation, Decision No. 69164; In re Gold Canyon Sewer Company, Decision No. 69664.
[78] Decision No. 69164 at 12.
[79] Ex. S-38 at 18.

The unexpended CIAC are funds that can be used by the Company, thus the Company's rate base should be reduced by the CIAC.[80] Reducing rate base by CIAC preserves the ratemaking balance and removes the possibility of the Company earning an excess.

The Company argues that the Staff recommendation would create a mismatch and that existing customers receive a windfall.[81] The Company acknowledges that it method of collecting hook up fees is atypical.[82] It is precisely the atypical method that the Company uses to collect hook up fess that has created the balances of the magnitude that are seen in the instant case. As Mr. Michlik explains, under the typical approach, a utility builds capacity in advance and then collects hook up fees individually upon each new connection.[83] However, Johnson collects hook-up fees well in advance of providing service to the customers for whom the hook-up fee is credited.

The Commission has addressed the issue of unexpended advances in Decision No. 70011 and Decision No. 70360.[84] In both those cases, the utilities contended that it would be unfair to exclude advances from rate base if plant associated with the advance was not in service during the test year. The Commission rejected the utilities arguments. The Company has not advanced any compelling argument to warrant a departure from normal rate making treatment.

Because of the magnitude of the CIAC balances, Staff recommends that the hook-up fee be discontinued. Staff found that there was little equity in the Company's capital structure. While Staff is supportive of the use of hook-up fees, there should be a balance between the amount of equity the Company is investing in plant and what customers are investing in plant through hook-up fees.[85] Staff's recommendations regarding the unexpended hook-up fees and the discontinuance of the hook-up fee tariff are reasonable and should be adopted.

[80] Ex. S-38 at 18-19.
[81] Ex. A-2 vol III at 21-22.
[82] Id. at 24.
[83] Ex. S-39 at 5.
[84] UNS Electric, Docket No. E-04204A-06-0783; UNS Gas Docket No. G-04204A-06-0463.
[85] Ex. S-38 at 35.

IV. REVENUE REQUIREMENT.

A. Operating Margin.

Because the rate base for the water division is negative and the rate base for the wastewater division is relatively small, a rate of return on rate base cannot be used. Staff utilized operating margin to determine the revenue requirement. Staff recommends an operating margin of 10%.[86]

The Company presented testimony regarding cost of capital and is recommending a cost of equity of 12%.[87] Staff would note that in a recent Commission decision for a water utility, the Commission has authorized a cost of equity of 9.9%[88]in a range of x-y.

B. The Commission Should Not Allow Johnson To Recover Its Income Tax Expense.

The Company seeks to include $330,522 in its wastewater division and for income tax expense. Staff recommends the removal of all income tax expense. [89] Johnson is a limited liability company and does not pay taxes at the corporate level. These taxes are passed through to the owners of the Company and accounted for when the individual owners file their tax returns. Johnson has an agreement by which it reimburses the member owners that all tax liabilities attributed and arising from Johnson must be paid by Johnson.[90] The Company argues that it should not be treated differently than a C-Corp and that such treatment is somehow unfair. For Johnson to be awarded income tax expense when it does not pay income tax is unfair.

Johnson attempts to characterize its tax status as similar to an entity that is consolidated and thus does not file tax returns because the parent files.[91] In the instance of a consolidated entity that pays income tax, such an entity is a C-Corp. If the C-Corp's subsidiaries were stand alone entities, those entities would file tax returns and pay income taxes. But Johnson fails to understand that it is an LLC and should be treated as such for income tax expense purposes. Johnson's arguments are not persuasive.

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[86] Ex S-38 at 31.
[87] Ex. A-4 vol 1 at 2.
[88] Decision No. 71308.
[89] Ex. S-44 at 27.
[90] Ex. A-2 vol III at 28.
[91] TR 1393:4-5.

VI. Staff's Recommends The Company Be Allowed To Recover Central Arizona Groundwater Replenishment District Use Fee Through An Adjuster Mechanism.

Staff recommends that the Company be allowed to recover from its customers the Central Arizona Groundwater Replenishment District ("CAGRD") fees through the implementation of an adjuster mechanism, subject to specific enumerated conditions. Although Commission Decision No. 64598 temporarily denied the Company's request to collect a CAGRD tax from its customers, the decision also adopted Staff's recommendation that the issue be determined in the Company's next full rate case.[92] As Mr. Michlik explained, Staff believes that the CAGRD assessment is more properly classified as an adjuster and not a pass-through tax:

> A true pass-through, like a sales tax for example, is one which is known and measurable and easily calculated and assigned. The CAGRD assessment fee, on the other hand, entails a complicated calculation involving several variables which are based on prior years' data. Also more like an adjustor, the assessment represents a significant annual expense for the Company, which is anticipated to progressively increase. In order to keep its membership in CAGRD, the Company must pay this fee.[93]

Furthermore, as explained by Mr. Tompsett, one benefit of a utility being a designated water provider, as opposed to each development receiving a 100-year assured water supply, is that it allows for more efficient regional planning (with the Commission, Dept. of Water Resources, and ADEQ) than can be achieved by smaller, individual developments.[94] Because it is beneficial to the Company's ratepayers and the general public, Staff believes it is appropriate for the Company to be allowed to recover its membership fees from its ratepayers.

Staff recommends that the CAGRD adjustor mechanism only be authorized with the following attached conditions:

1. The initial adjuster fee shall apply to all water sold after the date new rates from this case become effective. In order to calculate this initial fee, the Company shall submit the 2008 data, as per condition No. 7 below, within 30 days of the date of the final order in this matter.
2. The Company shall, on a monthly basis, place all CAGRD monies collected from customers in a separate, interest bearing account ("CAGRD Account").
3. The only time the Company can withdraw money from the CAGRD Account is to pay the annual CAGRD fee to the CAGRD, which is due on October 15th of each year.

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[92] Ex. R-4, TR. at 1162:14-1169:17.
[93] Ex. S-43 at 1:20-25.
[94] TR. at 1201:13-22.

4. The Company must provide to Staff a semi-annual report of the CAGRD Account and CAGRD use fees collected from customers and paid to the CAGRD, with the reports due during the last week of October and the last week of April of each year.

5. The Company must provide to Staff, every even-numbered year (first year being 2010) by June 30th, the new firm rates set by the CAGRD for the next two years.

6. The CAGRD adjustor fees shall be calculated as follows: The total CAGRD fees for the most current year in the Phoenix AMA shall be divided by the gallons sold in that year to determine a CAGRD fee per 1,000 gallons. Similarly, the total CAGRD fees for the most current year in the Pinal AMA shall be divided by the gallons sold in that year to determine a CAGRD fee per 1,000 gallons.

7. By August 25th of each year, beginning in 2010, the Company shall submit for Commission consideration its proposed CAGRD adjustor fees for the Phoenix and Pinal AMAs, along with the calculations and documentation from the relevant state agencies to support the data used in the calculations. Failure to provide such documentation to Staff shall result in the immediate cessation of the CAGRD adjustor fee. Commission-approved fees shall become effective on the following October 1st.

8. If the CAGRD changes its current method of assessing fees (i.e. based on the current volume of water used by customers) to some other method, such as, but not limited to, future projection of water usage, or total water allocated to the Company, the Company's collection from customers of CAGRD fees shall cease."

9. As a compliance item, the Company shall submit a new tariff reflecting the initial adjustor fee as per Condition No. 1 above and shall annually submit a new tariff reflecting the reset adjustor fee prior to the fee becoming effective.[95]

The Company's requested modifications to Staff's recommended conditions should be disregarded. Regarding Staff recommendation No. 3, the Company states, "Johnson Utilities believes that it should be permitted to withdraw funds from the CAGRD account as necessary to comply with any and all conditions of membership in the CAGRD, as those conditions exist now or as they may be modified in the future."[96] The Company should not be allowed to spend funds in the CAGRD account for any purpose other than the CAGRD expense item that they have been designed to recover. Should events arise in the future that would require the Company to pay additional fees associated with their membership, that are unforeseen at this time, the Company has the ability to request their inclusion in a future rate case or other such proceeding. Staff recommends that the Commission not allow the Company to spend the CAGRD Account funds on anything other than the annual CAGRD membership fee that has been analyzed in this proceeding.

[95] Ex. S-43 at 4.
[96] Ex. A-16 at 3:7-15.

Johnson also opposes Staff's condition No. 4 that the Company be required to file semi-annual reports of the CAGRD Account and CAGRD use fees collected from customers.[97] By requiring the Company to file bi-annually, the Commission and Staff have the important ability to more closely monitor the Company's collection of CAGRD fees from ratepayers as well as the state of the CAGRD Account.[98] Likewise, Johnson opposes Staff's condition No. 5. The Company states:

> The Company believes that it would be more efficient for Staff to obtain this information directly from CAGRD, rather than have the Company act as a go-between to communication the information. As I testified above, compliance with regulatory conditions adds costs which are ultimately borne by the Company's rate payers. Thus, regulatory conditions should not be casually imposed, but only as necessary to achieve important regulatory objectives.[99]

However, the rates established by the CAGRD involve calculations with many variables that may or may not be easily accessible or publicly available on the CAGRD's website now, or in the future. Because the Company will be in possession of this information as a part of their own record keeping and compliance requirements, the Company will be in the best position to provide Staff and the Commission with the information.

Johnson opposes Staff's condition No. 7. [100] Condition No. 7 is an important condition because (1) it allows the Company to receive the required documentation first from CAGRD and (2) Staff and Commission must have the ability to review the calculations and documentation, including the CAGRD invoice.[101] Furthermore, the language "for Commission consideration" should not be changed. This is standard language and Staff continues to recommend it because it allows the Commission to monitor and ultimately approve the exact adjuster fee charged to customers.

Lastly, Staff continues to recommend condition No. 8. The Company opposes this condition and states, "[i]n the unlikely event that CAGRD changes the way in which it currently assesses fees, Johnson Utilities would work with Staff to modify the proposed adjuster in an equitable manner consistent with the new CAGRD assessment methodology."[102] It is also unlikely that CAGRD would change the assessment methodology without notice. Furthermore, if the assessment methodology

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[97] Ex. A-16 at 3:16-25.
[98] TR at 912.
[99] Ex. A-16 at 4:1-10.
[100] Ex. A-16 at 4:13-26 and 5:1-11.
[101] TR. at 916:17-22.
[102] Ex. A-16 at 5:12-20.

were changed, the Company would have the option to request a modification of the approved methodology. Without implementation of the preceding nine conditions, Staff does not support implementation of the adjuster mechanism fee.

VII. RATE DESIGN.

Staff recommends the rate designs included in Staff's final schedules submitted in this matter for the Company's water and wastewater systems.[103] Under Staff's proposed rate design, the average 3/4 inch meter water customer with monthly water use of 6,931 gallons would see at $12.84 or 30.15% decrease. Similarly, the median water customer with a monthly water consumption of 6,000 gallons would see a rate decrease of $12.95 or 31.98%.[104] Staff is recommending an inverted three-tiered rate design for the Company's 3/4 and 5/8 inch meter residential customers and an inverted two-tiered rate design for all other customers.[105]

Staff is recommending a single monthly minimum charge for the Company's wastewater customers based on meter size for all zones and classes.[106] For the Company's wastewater 5/8 inch meter customers Staff recommends a monthly minimum charge of $32.31 and $35.543 for 3/4 inch meter customers.[107] Staff recommends an effluent purchase charge of $.5724 per 1,000 gallons and $184.64 per acre food.[108] Staff's recommended rate designs are reasonable and should be adopted.

VIII. WATER LOSS.

Staff recommends that the Company be ordered to conduct a twelve month water loss monitoring exercise for the Johnson Ranch water system including monitoring and reporting water gallons sold, gallons pumped, and gallons purchased per month.[109] The information initially provided by the Company to Staff regarding water loss showed that water loss for the Johnson Ranch water system for 2007 was 19.4%.[110] Subsequently, Mr. Scott made the following standard recommendation:

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[103] *See* final schedules.
[104] *See* final schedule JMM-W27 ('Typical Bill Analysis').
[105] *See* final schedule JMM-W26.
[106] *See* final schedule JMM-WW24.
[107] *Id.*
[108] *Id.*
[109] Tr. 1425:11-1426:14.
[110] Ex. S-36 at 8; Ex. S-37 at 6:14-22; Tr. at 1456:7-15.

> For the Johnson Ranch System, Staff recommends that the Company begin a 12-month monitoring exercise of this water system. Staff further recommends that the Company docket the results of the system monitoring as a compliance item in this case by May 1, 2011. If the reported water loss for the period from April 1, 2010 through April 1, 2011, is greater than 10%, the Company shall prepare a report containing a detailed analysis and plan to reduce water loss to 10% or less. If the Company believes it is not cost effective to reduce water loss to less than 10%, it should submit a detailed cost benefit analysis to support its opinion. This report shall be docketed as a compliance item for this proceeding for review and certification by Staff. The report or cost benefit analysis, if required, shall be docketed by June 30, 2011. In no case shall water loss be greater than 15%. If water loss is not reduced to less than 15 percent by May 1, 2011, Staff may initiate an Order to show Cause against the Company.[111]

The Company then responded by stating that the number of gallons the Company reported sold was inaccurate because it did not include construction water sales and irrigation water sales.[112] Because the Company did not provide sufficient support for this claim, including "a breakdown of the gallons sold per month[]" as requested by Staff, our recommendation remains the same.[113]

IX. ADEQ COMPLIANCE.

Staff recommends that any increases in rates and charges authorized by the Commission in this matter not go into effect until the Company comes into full compliance with the Arizona Department of Environmental Quality ("ADEQ") by resolving all outstanding Notices of Violation ("NOV"), including, but not limited to, the outstanding NOV associated with the Pecan, San Tan, and Section 11 Wastewater treatment plants.[114] However, if a rate decrease is authorized by the Commission in this matter, as recommended by Staff, such decrease should not be postponed until the Company comes into full compliance with ADEQ. (Tr. at 1520:8-1521:5).

X. SWING FIRST ALLEGATIONS.

Although Staff does not support the recommendations made by Swing First Golf, LLC ("Swing First") through its witness Sonn Rowell, Staff does note that Swing First's intervention in this matter has helped bring to Staff's attention certain irregular billing practices and other customer service issues.[115] Because Staff was made aware of the Company's practice of under-billing at Oasis

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[111] Ex. S-36 at 8-9; Tr. at 1419:1-22.
[112] Ex. S-37 at 6:19-22.
[113] Tr. at 1457:3-5; Ex. S-37 at 7:1-6.
[114] Tr. at 1430:2-16.
[115] Ex. SF-40 at 9:1-20; Tr. at 584-590; Ex. A-6 at 16:12-17.

Golf Course, Staff was able to make an adjustment for this.[116] Staff recommends that the remaining customer service related issues Swing First has alleged, be adjudicated and resolved in the pending complaint, Docket No. WS-02987A-08-0049.

X. CONCLUSION.

For the foregoing reasons, Staff respectfully requests the Commission to adopt its recommendations in this proceeding.

RESPECTFULLY SUBMITTED this 20th day of November, 2009.

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[116] Ex. SF-38 at 15:24-26; Tr. at 473:11-474:12, 1704:23-25.

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