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BEFORE THE ARIZONA CORPORATION COMMISSION
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COMMISSIONERS

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ARIZONA CORP COMMISSION
DOCKET CONTROL

IN THE MATTER OF THE APPLICATION OF FARMERS 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 FOR UTILITY SERVICE.

DOCKET NO. W-01654A-08-0502
**FARMERS WATER CO.'S
CLOSING BRIEF**

Arizona Corporation Commission
DOCKETED

DEC 11 2009

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I. INTRODUCTION.

On September 29, 2008, Farmers Water Co. (“Farmers” or “Company”) filed an application with the Arizona Corporation Commission (“Commission”) for a rate increase. Farmers is a Class “C” utility pursuant to A.A.C. R14-2-103(A)(3)(q). The test year used by Farmers is the 12-month period which ended September 30, 2007, the end of the Company’s fiscal year for 2007.

Farmers was ordered to file a rate case in Decision No. 68920 (Docket W-01654A-05-0845) dated August 29, 2006, a decision which granted an extension of the Company’s Certificate of Convenience and Necessity. Decision No. 68920 specified that the Company use a 2007 test year. On June 16, 2008, the Company applied for a 90-day extension of time, until September 29, 2008, to file its rate case. In Decision 70473 (September 3, 2008), the Commission granted the Company’s request.

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1 The Company's present rates were approved in Decision 63749 (June 6, 2001).
2 The prior case test year was the 12 months ending September 30, 1999. Since that time
3 the Company has grown from approximately 912 service connections and now serves
4 approximately 2,240 service connections. (Exhibit A-1 at 4).

5 The Company is requesting an increase in revenues of \$196,121, an increase of
6 34.82% for a total revenue requirement of \$759,404. (Exhibit A-4 at 1). The Company
7 proposes a 10% operating margin as the Company's rate base is negative and a rate of
8 return approach would not be meaningful. (Exhibit A-4 at 2). Farmers' Original Cost
9 Rate Base ("OCRB") and Fair Value Rate Base ("FVRB") is \$(748,646). (*Id.*). The
10 Company requests that its OCRB be treated as its FVRB. (*Id.*).

11 **II. REVENUE REQUIREMENT.**

12 The proposed revenue requirements and proposed rate increases are as follows:

	<u>Revenue Requirement</u>	<u>Revenue Increase</u>	<u>% Increase</u>
15 Company	\$759,404	\$196,121	34.82%
16 Staff	\$726,887	\$163,604	29.04%

17 The primary difference between Staff and the Company with respect to the revenue
18 requirement is that the Company includes income taxes in the revenue requirement and
19 Staff does not. (*Id.*). The Company is proposing an operating margin of 10.00%. (Exhibit
20 A-2 at 3). This is at the low end of the range (10% to 20%) typically recommended by
21 Staff in cases where an operating margin approach is utilized to determine the revenue
22 requirement. (*Id.*). Staff also proposes a 10% operating margin. (Exhibit S-3 at 4).

23 **A. Operating Margin.**

24 The Company is proposing an operating margin of 10%. (Exhibit A-4 at 2). A
25 10% operating margin is at the low end of the range (10% to 20%) typically
26 recommended by Staff in cases where an operating margin approach is utilized to
27 determine the revenue requirement. (Exhibit A-3 at 3). (Staff also proposes a 10%
28 operating margin. (Exhibit S-3 at 4). It is important to note that the Company's

1 recommendation for a 10.00% operating margin is at the very minimum of what it should
2 be. (Tr. at 34-35 [Bourassa]). If the Commission excludes income taxes the operating
3 margin will fall below that amount because the Company will reimburse shareholders for
4 the tax liability. (*Id.*). (See Section IV.C. below).

5 **III. RATE BASE.**

6 The rate bases proposed by each party in the case are as follows:

	<u>OCRB</u>	<u>FVRB</u>
7		
8		
9	Company	\$(748,646)
10	Staff	\$(748,646)

11 Staff has not proposed any adjustments to the Company's OCRB. (Exhibit A-4 at 3).
12 Both the Company and Staff are in agreement on the rate base. (*Id.*).

13 **IV. INCOME STATEMENT.**

14 **A. Undisputed Items.**

15 **a. Depreciation Rates.**

16 Depreciation expense has decreased from the Company's direct filing reflecting a
17 correction to the amortization of contributions-in-aid of construction ("CIAC") based on
18 the Staff testimony.¹ Both Staff and the Company propose the same level of depreciation
19 expense and both Staff and the Company recommend the same depreciation rates.
20 (Exhibit A-2 at 4).

21 **b. Property Taxes.**

22 The Company and Staff are in agreement on the method of computing property
23 taxes. (Exhibit A-2 at 5).

24 **c. Water Testing Expense.**

25 The Company has adopted Staff's proposed adjustment to increase water testing
26 expense to minimize disputes between the parties. (*Id.*).²

27 ¹ Exhibit S-3 at 7.

28 ² *Id.* at 6.

1 **d. Repair and Maintenance**

2 The Company has adopted Staff's proposed 3-year historical average to compute
3 the level of repairs and maintenance expense to minimize disputes between the parties.
4 (Id.).³

5 **e. Salaries and Wages.**

6 In its Surrebuttal testimony, Staff testified that it no longer proposes a downward
7 adjustment of \$14,589 to salaries and wages. (Exhibit S-4 at 3). Both Staff and the
8 Company now agree on the level of salaries and wages expense of \$180,508. (Exhibit A-4
9 at 4).

10 **B. Rate Case Expense**

11 Although the Company and Staff are in agreement as to the amount of rate case
12 expense (\$100,000), Staff asserts that rate case expense should be "normalized". (Exhibit
13 A-2 at 8).⁴ In other words, if a utility expends \$150,000 for rate case expense, the
14 expense is normalized to \$30,000 annually using a 5-year normalization period, and the
15 utility files for rate relief before the end of the 5-year period; the utility forfeits the amount
16 of rate case expense that it did not recover through rates. (Id.). The normalization
17 approach penalizes the Company for seeking new rates before the end of the
18 normalization period. (Id.).

19 Rate case expense is incurred outside the test year, paid for by the utility up-front
20 for the specific purpose of obtaining rate relief, and is a non-typical or non-recurring
21 expense. (Id.). As a consequence, rate case expense should be treated like a deferred
22 regulatory asset. (Id.). In fact, this is how rate case expense has been treated by Staff and
23 the Commission in the past. (Id.). Like other regulatory assets (e.g., plant-in-service), the
24 costs of deferred regulatory assets are recovered over time. (Id.). Presumably, if the
25 amortization period for rate case expense (as with depreciation expense for plant-in-
26 service) approximates the time between when new rates are set, the utility will recover the

27 ³ Id. at 7.

28 ⁴ Exhibit S-3 at 9.

1 expense in full with neither an over collection nor under collection of the expense. (*Id.*).
2 If the Commission is concerned about over or under collection of rate case expense, it
3 could approve a rate case expense surcharge which would cease when the utility fully
4 recovers its expense. (*Id.*).

5 **C. Income Taxes.**

6 Staff proposes to exclude income taxes from the determination of the revenue
7 requirement because Farmers is a Sub-Chapter "S" corporation and is a pass-through entity
8 for income tax purposes. (Exhibit A-2 at 9).⁵ Staff's argument rests on the fact that
9 Farmers itself does not pay income taxes at the company level, rather the taxable income
10 and tax liability passes through to its shareholders who must pay the tax. (*Id.*). While it
11 may be true that the Company itself does not pay taxes, the basis for Staff's exclusion of
12 income taxes is without merit. (*Id.*).

13 The income tax liability arises from the taxable income of Farmers and it is directly
14 attributable to Farmers. (*Id.*). And while the tax liability flows through to the
15 shareholders, the Company still pays the tax by reimbursing the shareholder for the tax
16 that must be paid. (*Id.*). In fact, there exists an agreement between Farmers and its
17 shareholders that an amount that is at least equal to the sum of (a) a percentage of its
18 earnings and profits (as determined for Federal Income tax purposes) that is the same as
19 the highest Federal and Arizona income tax rate on ordinary income for individuals and
20 (b) a percentage of its net long-term capital gains and net gains for the sale or exchange of
21 assets, the gain from which are taxable under Code Section 1231, which is the same as the
22 highest Federal and Arizona income tax rate on such gains for individuals attributed and
23 arising from Farmers must be paid by Farmers. (Exhibit A-2 at 9-10; *see also* Exhibit A-
24 5). As a result, under the shareholder agreement, the Company must pay a dividend to its
25 shareholder each year for the federal and Arizona income tax rates for ordinary income
26 that is produced by the Company. (Tr. at 64 [Triana]; *see also* Exhibit A-5). As explained
27 by the Company witness:

28 ⁵ *Id.* at 8; Exhibit S-4 at 3.

1 *[t]here is an income tax payment that is at the corporate level that the*
2 *Company pays. There is also income tax that are responsible to be paid at*
3 *the shareholder level. The Company is - - that is why we have this*
4 *paragraph 5 within the shareholder agreement, to fund the shareholders to*
5 *be able to make those payments.*

6 *Then we do have states where we do composite returns, where the Company*
7 *actually files on behalf of all shareholders and we pay those returns out of*
8 *the Company's funds on behalf of the shareholders.*

9 (Tr. at 70 [Triana]).

10 In explaining why the Company has income tax expense at the corporate level even
11 though Farmers Investment Co. and Farmers Water Co. are both S-Corps, the Company
12 witness testified:

13 *When you become an S Corporation there is a ten-year period that certain*
14 *built in gains are attributed to the C-Corporation. So until that ten-year*
15 *period is up, there may be tax that is based at the corporate level.*

16 (*Id.*). The 10-year period ends October 1, 2015. (Tr. at 71 [Triana])

17 Furthermore, the required operating income for a tax pass-through entity such as an
18 S-Corp is not the same as that for a C-Corp under Staff recommendation resulting in an S-
19 Corp's being treated differently when there is no sound justification to do so. (Exhibit A-2
20 at 10). Under Staff's proposal, an S-Corp would receive a lower revenue requirement and
21 operating income than a C-Corp resulting in inequities because payment for the tax must
22 come from somewhere. (*Id.*). Ultimately the tax payment comes from the S-Corp itself
23 because shareholders insure their taxes are paid by the entities that generate them. (*Id.*).
24 In fact, the situation is analogous to a subsidiary C-Corp utility of a parent holding
25 company whose tax return is consolidated with the parent. (*Id.*). The individual C-Corp
26 utility does not file a separate tax return, yet this Commission has traditionally allowed
27 income taxes of the utility to be computed on a stand-alone basis and included in the
28 revenue requirement. (*Id.*).

29 In addition, under Staff's proposal, rate payers would receive an unjustified
30 windfall from the lower revenue requirement and operating income when income taxes
31 are excluded. (*Id.*). Moreover, rate making should be applied in a manner which produces
32 reasonable, realistic and non-discriminatory results no matter what the legal form of the

1 utility. (*Id.*). Inclusion or exclusion of income taxes should not be limited to technical
2 distinctions; rather it should be based on whether it is fair and does not discriminate. (*Id.*).
3 The income taxes required to be paid by shareholders of an S-Corp on a utility's income
4 are inescapable business outlays that are directly attributed to the utility and are directly
5 comparable with similar taxes paid by C corporations. (*Id.*).

6 Rather than providing testimony that refutes the merits of inclusion of income taxes
7 in the instant case as set forth in the Company's rebuttal testimony, Staff's response was
8 merely to cite a court case (*Consolidated Water Utilities v. ACC* 178 Ariz. 478,875 P. 2d
9 137, Ariz. Ct.app 1993) which affirms that the Commission has the authority to *allow or*
10 *disallow* income taxes. (Exhibit A-4 at 4). However, the Company has never taken the
11 position that the Commission lacked any authority to allow or disallow income taxes.
12 (Exhibit A-4 at 4-5). The Company's position has always been that rate making should be
13 applied in a manner which produces reasonable, realistic and non-discriminatory results
14 no matter the legal form of the utility. (Exhibit A-4 at 5).

15 It is undisputed that the Commission is constitutionally endowed with very broad
16 power to prescribe classifications and to establish categories to consider in setting rates
17 for public service corporations, which includes authority to consider classification for
18 income tax expenses. A.R.S. § 40-254.01, subd. E; A.R.S. Const. Art. 15, §§ 1 *et seq.*, 14.
19 *Consolidated Water Utilities, Ltd. v. Arizona Corp. Comm'n*, 178 Ariz. 478, 484, 875 P.2d
20 137, 143 (App. 1993). As such, the Commission has the authority to allow the recovery
21 of income tax expense on a case by case basis. In *Consolidated Water Utilities, Ltd. v.*
22 *Arizona Corp. Comm'n*, the Arizona Court of Appeals ruled as follows:

23 *In Arizona, the decision to allow or disallow that tax expense is to be made*
24 *by the Commission, not the courts. See also Tucson Gas, 15 Ariz. at 306,*
25 *138 P. at 786 (the Commission has exclusive power over rate cases, and this*
"exclusive field may not be invaded by either the courts, the legislative or
executive.").

26 (*Id.*).

27 State Commissions vary as to whether income taxes for pass-through entities are
28 allowed in cost of service. Although the Company has not conducted an exhaustive

1 search, Johnson Utilities has identified cases in Florida,⁶ Indiana,⁷ Kentucky,⁸ Vermont,⁹
2 and Wisconsin,¹⁰ where the public service commissions in those jurisdictions have
3 disallowed income tax recovery for pass-through entities. However, Johnson Utilities has
4 identified cases in California,¹¹ Kansas,¹² Michigan,¹³ New Jersey,¹⁴ New Mexico,¹⁵ South
5 Carolina,¹⁶ Texas,¹⁷ Washington,¹⁸ and again Wisconsin,¹⁹ where the state commissions
6 have allowed income tax recovery for pass-through entities.

7 The best rationale for the allowance of income tax recovery for pass through

8 ⁶ See for example: *In Re: Proposed Revisions to Rules 25-30.020, . . . , Pertaining to Water and*
9 *Wastewater Regulation*, Docket No. 911082-WS (1993 WL 590740 (Fla.P.S.C)); see also *Re B&*
10 *C Water Resources, L.L.C.* Docket No. 080197-WU (2008 WL 3846530 (Fla.P.S.C.); and see
11 also *Re Anglers Cove West, Ltd.* Docket No. 070417-WS (2008 WL 3846530 (Fla.P.S.C.)).

12 ⁷ See *In re Pioneer Village Water, Inc.*, (1998 WL 999991 (Ind. U.R.C. 1998)).

13 ⁸ See *In the Matter of: An Application of Ridge-Lea Investments, Inc. for an Adjustment of Rates*
14 *Pursuant to the Alternative Rate Filing Procedure for Small Utilities*, Docket 2008-00364 (2008
15 WL 4696006 (Ky.P.S.C.)).

16 ⁹ See *Re Shoreham Telephone Company Inc.*, Docket No. 6914 (2004 WL 2791514 (Vt.P.S.B.),
17 181 Vt. 57, 915 A.2d 197 (2006)); see also *Re Vermont Electric Power Company, Inc.* Docket
18 No. 7174 (251 P.U.R.4th 331, 2006 WL 1714971 (Vt.P.S.B.)).

19 ¹⁰ See *Re St. Croix Valley Natural Gas, Inc.*, Docket No. 5230-GR-104 (2006 WL 707437
20 (Wis.P.S.C.)).

21 ¹¹ California has included an allowance for income tax expenses as part of rates when evaluating
22 utilities that are organized as limited partnerships. See *ARCO Products Co. v. SFPP, L.P.*, 81
23 CPUC2d 573 at 16 (1998).

24 ¹² See *Re Madison Telephone, L.L.C.*, Docket No. 07—MDTT-195-AUD (2007 WL 2126360
25 (Kan.S.C.C.)).

26 ¹³ See *Re Detroit Thermal, L.L.C.*, Case No. U-13691 (2005 WL 2230278 (Mich.P.S.C.)).

27 ¹⁴ See *Re Maxim Sewerage Corporation BPU*, Docket No. WR97010052 (1998 WL 223177
28 (N.J.B.P.U.)).

¹⁵ The New Mexico Supreme Court found that a sole proprietorship may include income tax
expenses in rate base in “an amount equal to the tax the Company would pay if incorporated” as a
standard C corporation. *Moyston v. New Mexico Public Serv. Comm’n*, 63 P.U.R. 3d 522, 412
P.2d 840, 851 (1966).

¹⁶ See *Re Madera Utilities, Inc.*, Docket No. 2003-368-S (2004 WL 1714912 (S.C.P.S.C.), see
also *Re Development Services, Inc.*, Docket No. 2004-212-S (2005 WL 712315 (S.C.P.S.C.)).

¹⁷ “The income taxes required to be paid by shareholders of a Subchapter S corporation on a
utility’s income are inescapable business outlays and are directly comparable with similar
corporate taxes which would have been imposed if the utility operations had been carried on by a
corporation.” *Suburban Utility Corp. v. Public Utility Comm’n of Texas*, 652 S.W. 2d 358, 364
(1983). Accordingly, the Texas Supreme Court held that the S corporation was “entitled to a
reasonable cost of service allowance for federal income taxes actually paid by its shareholders on
[the company’s] taxable income or for taxes it would be required to pay as a conventional
corporation, whichever is less.” *Id.*

¹⁸ See *Washington Utilities and Transportation Commission v. Rainer View Water Company, Inc.*,
Docket No. UW-010877 (2002 WL 31432725 (Wash.U.T.C.)).

¹⁹ See *Re CenturyTel of the Midwest-Kendall, Inc.*, Docket No. 2815-TR-103 (2001 WL 1744202
(Wis.P.S.C.) see also *Re CenturyTel of Central Wisconsin, L.L.C.*, Docket No. 2055-TR-102
(2002WL 31970289 (Wis.P.S.C.)).

1 entities was set forth in *ExxonMobil Oil Corp. v. Federal Energy Regulatory Comm'n*, 487
2 F.3d 945, 376 U.S.App.D.C. 259, (D.C. Cir. 2007). In that case, the Federal Energy
3 Regulatory Commission (“FERC”) adopted a policy of full income tax allowances for
4 limited partnerships. (*Id.* at 952) (Emphasis added). FERC determined that income taxes
5 paid by partners on their distributive share of the pipeline's income are “just as much a
6 cost of acquiring and operating the assets of that entity as if the utility assets were owned
7 by a corporation.” (*Id.*) (Emphasis added). Consistent with the evidence presented by the
8 Company in support of allowing income tax expense for pass-through entities, FERC
9 found no good reason to limit the income tax allowance to corporations, given that “both
10 partners and Subchapter C corporations pay income taxes on their first tier income.” (*Id.*).
11 Moreover, FERC determined that income taxes paid on the partners' distributive share of
12 the pipeline's income were properly “attributable” to the regulated entity because such
13 taxes must be paid regardless of whether the partners actually receive a cash distribution.
14 See *United States v. Basye*, 410 U.S. 441, 453, 93 S.Ct. 1080, 35 L.Ed.2d 412 (1973)
15 (“[I]t is axiomatic that each partner must pay taxes on his distributive share of the
16 partnership's income without regard to whether that amount is actually distributed to
17 him.”). (*Id.*). Based on this aspect of partnership law, FERC concluded that income taxes
18 paid by investors in a limited partnership are “first-tier” taxes that may be allocated to the
19 regulated entity's cost-of-service. (*Id.*).

20 In *ExxonMobil*, the petitioners argued that these taxes are ultimately paid by
21 individual investors-not the pipeline-and thus it was improper for FERC to allow income
22 tax as an expense to the regulated entity. (*Id.*). However, FERC reasonably addressed this
23 concern, explaining:

24 *Because public utility income of pass-through entities is attributed directly*
25 *to the owners of such entities and the owners have an actual or potential*
26 *income tax liability on that income, the Commission concludes that its*
27 *rationale here does not violate the court's concern that the Commission had*
28 *created a tax allowance to compensate for an income tax cost that is not*
actually paid by the regulated utility.

(*Id.*). (Emphasis added). FERC also emphasized that “the return to the owners of pass-

1 through entities will be reduced below that of a corporation investing in the same asset if
 2 such entities are not afforded an income tax allowance on their public utility income.”
 3 (*Id.*). FERC determined that “termination of the allowance would clearly act as a
 4 disincentive for the use of the partnership format,” because it would lower the returns of
 5 partnerships vis-à-vis corporations, and because it would prevent certain investors from
 6 realizing the benefits of a consolidated income tax return. (*Id.* at 952-953, 376
 7 U.S.App.D.C. at 266-267).

8 Farmers’ submits that it is better policy for the Commission to allow the inclusion
 9 of income tax expense in the Company's revenue requirement. In addition, as set forth
 10 above, the Company’s recommendation for a 10% operating margin is at the very
 11 minimum of what it should be. (Tr. at 34-35 [Bourassa]). If the Commission excludes
 12 income taxes the operating margin will fall below that amount because the Company will
 13 reimburse shareholders for the tax liability. (*Id.*). According to the testimony of Thomas
 14 Bourassa, the Company has an operating income of \$75,000. (Tr. at 34 [Bourassa]). The
 15 Company is going to pay to its shareholders the tax liability. (*Id.*). This will result in the
 16 Company’s cash flow being reduced to under \$50,000, thereby reducing the operating
 17 margin below 10%. (*Id.*).

18
 19 **V. RATE DESIGN.**

20 The monthly charges at proposed rates are listed below.

<u>All Classes</u> <u>Meter</u> <u>Size</u>	<u>Monthly</u> <u>Minimum</u>	<u>Gallons included</u> <u>in Monthly Minimum</u>
5/8	\$ 8.26	0
3/4	\$ 8.26	0
1	\$ 10.32	0
1 1/2	\$ 20.64	0
2	\$ 33.02	0
3	\$ 66.04	0

1	4	\$ 103.19	0
2	6	\$ 206.38	0

3 The Company's proposed commodity charges and tiers by meter size are:

4	Meter		Charge
5	<u>Size</u>	<u>Tier (gallons)</u>	<u>per 1,000 gallons</u>
6	5/8 and 3/4 Residential	1 to 4,000	\$1.45
7		4,001 to 10,000	\$1.92
8		Over 10,000	\$2.49
9	5/8 and 3/4 Commercial, Industrial and Irrigation		
10		1 to 10,000	\$1.92
11		Over 10,000	\$2.49
12	1	1 to 12,500	\$1.92
13		Over 12,500	\$2.49
14	1 1/2	1 to 25,000	\$1.92
15		Over 25,000	\$2.49
16	2	1 to 40,000	\$1.92
17		Over 40,000	\$2.49
18	3	1 to 80,000	\$1.92
19		Over 80,000	\$2.49
20	4	1 to 125,000	\$1.92
21		Over 125,000	\$2.49
22	6	1 to 250,000	\$1.92
		Over 250,000	\$2.49

23 Standpipe minimums are by meter size.

24 The proposed standpipe rate and bulk water rate is \$2.49 per 1,000 gallons.

25 (Exhibit A-4 at 5-7).

26 **VI. MISCELLANEOUS ISSUES.**

27 **A. Customer Deposit Interest.**

28 Staff is recommending that deposit interest of 6% while the Company's rebuttal

1 recommendation is to lower it to 2%. (Exhibit A-3 at 14). The Company believes a 6%
2 rate is too high given the low interest rates currently provided by banks on certificates of
3 deposits ("CD") and money markets. (*Id.*). For example, the current annual yield on: a 5-
4 year CD is 2.66% (Wall Street Journal, September 3, 2009); on a 6-month CD, 0.36%
5 (Federal Reserve, September 1, 2009; and on the money market, 1.16% (Wall Street
6 Journal, September 3, 2009). (*Id.*). In any event, the Company did not include the
7 customer deposit expense as an operating expense on the income statement in its rate
8 application. (Tr. at 17 [Bourassa]).

9 RESPECTFULLY SUBMITTED this 11th day of December, 2009.

10 SNELL & WILMER L.L.P.

11
12 By 

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20 filed this 11th day of December , 2009, with:

21 Docket Control
22 Arizona Corporation Commission
23 1200 West Washington Street
24 Phoenix, AZ 85007

25 COPY of the foregoing hand-delivered on
26 this 11th day of December , 2009, to:

27 Steve Olea, Director
28 Utilities Division
ARIZONA CORPORATION COMMISSION
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