OPEN MEETING AGENDA ITEM

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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, LLC, 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

JOHNSON UTILITIES' REPLY TO AFFIDAVITS OF STAFF AND RUCO

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I. INTRODUCTION.

On June 4, 2010, Utilities Division Staff ("Staff") filed the Affidavit of Jeffrey M. Michlik and the Residential Utility Consumer Office ("RUCO") filed the Affidavit of Rodney L. Moore, each providing schedules regarding different operating margin percentages for Johnson Utilities, LLC, dba Johnson Utilities Company ("Johnson Utilities" or the "Company"). While the schedules of Staff and RUCO correctly calculate the various operating margin percentages based upon their respective rate case recommendations (which the Company opposes), Johnson Utilities strongly urges the Arizona Corporation Commission ("Commission") to reject the recommendation of a negative rate base and operating margin for Johnson Utilities, a class "A" utility. Rather, the Company urges the Commission to adopt a positive rate base and apply a reasonable rate of return, as supported by the evidence in this case. Alternatively, if the Commission adopts a negative rate base and operating margin, then the operating margin should be no less than 10%, consistent with the Staff recommendation.

At the Open Meeting, the Commissioners deferred a decision on the Recommended Opinion and Order ("ROO") until the June 29, 2010, Open Meeting, and Chairman Mayes requested that the parties supplement the record under affidavit with the following information:

> I would like the parties to compare results under various scenarios for using the operating margin as a rate-setting tool. I'm interested in a 3, 5, and 7 percent operating margin as compared to the suggested 8 and 10 percent we've discussed already.
>
> As an alternative, the company could come in also and say that it would like to argue for a rate base and that, for instance it should be the same as RUCO's weighed average cost of capital if it believes that would result in just and reasonable rates and if it wants to continue to argue for a rate base.[1]

Johnson Utilities interpreted this request to allow the Company to choose to provide a rate of return analysis instead of an operating margin analysis. Since the Company prepared its case under a rate of return analysis and provided cost of capital testimony and evidence to support its analysis, the Company provided only modified rate of return scenarios to include each party's proposal as applied to rate base.

II. A NEGATIVE RATE BASE CREATES A "BLACK HOLE" WHICH IS DETRIMENTAL TO A CLASS A UTILITY.

At the May 26, 2010, Open Meeting to discuss the ROO in this case, Utilities Division Director Steve Olea correctly observed the following: "But I can tell you that setting rates for a company this size on operating margin is not the way you want to set rates."[2] Counsel for RUCO stated similarly that "it sets a course that I don't think the Commission wants to go on, and that's our concern."[3] Moreover, Chairman Mayes

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[1] Reporter's Transcript of Proceedings, Agenda item No. U-11 (Vol. I) (May 26, 2010) at 67, lines 4-14 (emphasis added).
[2] Reporter's Transcript of Proceedings, Agenda Item U-11, Vol. I at 37 (May 26, 2010) (emphasis added).
[3] *Id.* at 22.

stated that she is "very uncomfortable with having a Class A utility with a negative rate base" and that in her seven years at the Commission, she has never been asked to adopt an operating margin for a Class A utility.[4] Johnson Utilities also strongly opposes the adoption of a negative rate base and operating margin.

In an affidavit dated June 4, 2010, and filed the same day in this docket, accounting expert Tom Bourassa explained the tremendous detriments of a negative rate base and operating margin for a utility the size of Johnson Utilities, which include the following:

- A negative rate base will make it difficult or likely impossible for Johnson Utilities to attract additional equity in the future, either from current members/shareholders or from future outside investors. Such a lack of access to additional equity would relegate the Company to reliance upon advances-in-aid-of-construction and/or contributions-in-aid-of-construction to fund future growth, which would do little to increase equity in Johnson Utilities.

- A negative rate base will make it difficult or impossible for Johnson Utilities to borrow money because lenders are generally unwilling to loan money to a utility with negative equity. Even if the Company could find a willing lender, it is virtually certain that such a lender would require a higher interest rate to cover the substantial risk associated with lending to a company with negative equity.

- The elimination of $37,643,787 in rate base substantially reduces depreciation expense, thereby decreasing operating cash flow. The reduction of operating cash flow will make it much more difficult for Johnson Utilities to fund plant replacement in the future.[5]

Mr. Bourassa further testified that the adopting of the Staff adjustments for (i) alleged inadequately supported plant, (ii) affiliate profit, and (iii) unexpended hook-up fees will almost certainly guarantee that Johnson Utilities will have a negative rate

[4] *Id.* at 20-21.
[5] Affidavit of Thomas J. Bourassa at 3-4 (June 4, 2010).

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base far into the future, thereby locking the Company into operating margins.[6] For these reasons, it is not good policy for this Commission to adopt a ROO which establishes a negative rate base and operating margin for a water and wastewater company the size of Johnson Utilities.

In a rate case involving *Dupage Utility Company*,[7] a water and wastewater company with a negative rate base, the Illinois Commerce Commission correctly characterized a negative rate base as a <u>black hole</u>:

> [T]he negative rate base creates a black hole into which new investment in plant immediately disappears for ratemaking purposes. The existence of a black hole resulting in the instantaneous total depreciation of new investment effectively removes any incentive for shareholder investments for new plant, because no opportunity exists for a return on that investment.[8]

Johnson Utilities faces just such a black hole if the three major Staff adjustments to rate base are adopted. As Mr. Bourassa explained in his affidavit:

> If the three Staff adjustments are adopted, the members/shareholders will lose 100% of the $28,608,166 in equity which existed at the end of the test year, together with the opportunity to earn a return on that investment. Further, the current members/shareholders or any future outside investors would be required to invest an additional $9,035,621 just to eliminate the negative equity, with no opportunity to ever earn a return on this additional investment. <u>Under these circumstances, it is difficult to imagine a scenario in which anyone would be willing to invest additional capital in Johnson Utilities</u>.[9]

Thus, if the Commission adopts a negative rate base at this time, then in all likelihood, Johnson Utilities will be facing operating margins in future rate cases for many years. This will benefit neither the Company nor its customers.

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[6] *Id*. at 4.
[7] *Dupage Utility Company*, Proposed General Increase in Sewer Rates, 1987 WL 1376876 (Jan. 21, 1987).
[8] *Id*.
[9] Affidavit of Thomas J. Bourassa at 3 (June 4, 2010) (emphasis added).

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At the May 26, 2010, Open Meeting, Mr. Olea acknowledged the unprecedented situation created by Staff's rate base adjustments:

> And I think you [Chairman Mayes] stated it earlier that there's never been an A-sized company that we've had to do this with. I was trying to recall in my time here if there was one, and I cannot recall a company of this size that had little to no rate base.[10]

There is simply no legitimate reason to create a black hole of negative rate base in this case because the evidentiary record does not support a negative rate base.[11]

To address the issues raised regarding inadequately supported plant and affiliate profit, Johnson Utilities presented two alternative rate base calculations that are attached to Mr. Bourassa's affidavit that was docketed on June 4, 2010, and either of these alternatives results in a positive rate base. For the Commission's convenience, Johnson Utilities has attached hereto Johnson Utilities Proposed Amendment No. 11 which modifies the ROO be incorporating the Company's Alternative 1 with an 11.89% rate of return. The proposed amendment assumes the adoption of Mayes Proposed Amendment #2 regarding an adjuster mechanism to pass through the costs of the Central Arizona Groundwater Replenishment District.

The two alternatives proposed in the earlier filing by JU are based on the evidence in the record that the company has an owner's equity amount of $28 million. The company's suggestion is to take the owner's equity amount and reduce it by Staff's disallowances (10% and 7.5% for unsupported and affiliate profit respectively) and then apply an appropriate rate of return. The company has provided details regarding RUCO's rate of return (8.18%), the proposed company rate of return (11.89%) and a rate

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[10] Reporter's Transcript of Proceedings, Agenda Item U-11, Vol. I at 35 (May 26, 2010).

[11] As an example of Johnson Utilities investment for which they would not be able to recover a return on their investment, the following recent major plant improvements were funded by Johnson Utilities with equity: Pecan WWTP Phase 2: $7,348,275, Anthem WWTP: $10,410,332, Anthem water plant : $1,551,847, and the Morning Sun Farms Water plant and Well #2: $744,101.

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of return that is an approximate middle point between RUCO and the Company (10%).

Under Alternative 1, customers will experience: a -23.38% adjustment to water rates and a 6.86% adjustment to the wastewater rates for a combined **-9.38%** adjustment using a rate of return of 11.89%; a -23.93% adjustment to water rates and a 4.04% adjustment to the wastewater rates for a combined **-10.98%** adjustment using a rate of return of 10.00%; and a -24.46% adjustment to water rates and a 1.33% adjustment to the wastewater rates for a combined **-12.52%** adjustment using a rate of return of 8.18%.

Under Alternative 2, customers will experience: a -24.78% adjustment to water rates and a 3.06% adjustment to the wastewater rates for a combined **-11.89%** adjustment using a rate of return of 11.89%; a -25.16% adjustment to water rates and a 0.65% adjustment to the wastewater rates for a combined **-13.21%** adjustment using a rate of return of 10.00%; and a -25.52% adjustment to water rates and a -1.68% adjustment to the wastewater rates for a combined **-14.48%** adjustment using a rate of return of 8.18%. This method, while not the normal approach to a rate case, is an acceptable and effective method to accomplish the goals of the Commission, while maintaining significant rate decreases under each scenario.

III. IF THE COMMISSION ADOPTS AN OPERATING MARGIN, THE MINIMUM OPERATING MARGIN SHOULD BE 10%.

In setting an operating margin, the Commission has traditionally adopted a rate in the range of 10% to 20%. At the May 26, 2010, Open Meeting, Mr. Olea stated as follows:

> Normally what we do, operating margin for small companies, we pick a range of somewhere between 10 to 20 percent. We said, you know, Johnson [Utilities], we're going to go on the low end. Let's go to 10 percent.
>
> And if you're wondering who just whispered to me, this is where we have the engineers have some disagreements with the auditors, but where Staff in the accounting section really likes to use between 10 and 15 percent.

When you have the small mom-and-pop companies, I have a tendency to, you know, give them the benefit of the doubt, so my range is 10 to 20. <u>But regardless if you use 10 to 15 or 10 to 20, the bottom is 10, and so we went with the bottom, 10 percent</u>.[12]

The range given by Mr. Olea is consistent with the range of operating margins adopted by the Commission in recent rate cases for water and wastewater utilities:

AUTHORIZED OPERATING MARGINS				
DECISION	**DATE**	**COMPANY NAME**	**CLASS**	**OPERATING MARGIN**
71693	May 3, 2010	Pineview Water Company	C	12.18%
71505	March 17, 2010	Ehrenberg Improvement Association (non-profit)	C	18.33%
71504	March 17, 2010	DS Water Company	D	10.00%
71482	February 3, 2010	Valley Utilities Water Company	B	10.00%
71478	February 3, 2010	Community Water Company of Green Valley (non-profit)	B	15.00%
71446	December 23, 2009	Utility Systems, LLC, dba Christopher Creek Haven Water Co.	E	20.89%
71414	December 8, 2009	H20, Inc.	B	10.00%
71317	October 30, 2009	Montezuma Rimrock Water Co. LLC	D	12.75%
71234	August 6, 2009	Wilhoit Water Company Inc.	D	15.02%
71236	August 6, 2009	Appaloosa Water Co.	C	17.13%

[12] Reporter's Transcript of Proceedings, Agenda Item U-11, Vol. I at 36 (May 26, 2010).

DECISION	DATE	COMPANY NAME	CLASS	OPERATING MARGIN
71231	August 6, 2009	Fisher's Landing Water & Sewer Works, LLC	D	28.09%
71181	June 30, 2009	Ash Fork Development Association, Inc. (non-profit)	C	10.88%
71173	June 30, 2009	Walnut Creek Water Co. Inc.	D	16.33%
71110	June 5, 2009	Orange Grove Water Co.	D	12.95%
70977	May 5, 2009	ICR Water Users Association (non-profit)	C	11.00%
70954	April 7, 2009	Mountain Glen Water Service	D	15.00%
70741	February 12, 2009	Wickenburg Ranch Water LLC	C	10.81%
70651	December 17, 2008	Sheppard Water Co. Inc.	D	26.16%
70622	November 19, 2008	Oak Creek Water Co.	C	11.00%

Thus, if the Commission determines that an operating margin is appropriate for Johnson Utilities, then the Commission should adopt Staff's recommendation for a rate of 10%, which is consistent with the Commission's prior practice in Arizona.

IV. CONCLUSION.

For the reasons set forth herein, Johnson Utilities urges the Commission to adopt the Company's proposed rate base, rate of return and revenue requirement for its water and wastewater divisions as set forth in its final post-hearing schedules filed October 30, 2009, and its Closing Brief filed November 20, 2009. Alternatively, Johnson Utilities urges the Commission to adopt Alternative 1, as set forth in the Affidavit of Thomas J.

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Bourassa dated June 4, 2010 and filed that day in this docket, with a rate of return of 11.89%. This will produce a positive rate base for both the water and wastewater divisions, and will result in rates and charges that are just and reasonable.

RESPECTFULLY SUBMITTED this 11th day of June, 2010.

SNELL & WILMER L.L.P.

By Jeffrey W. Crockett

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JOHNSON UTILITIES PROPOSED AMENDMENT NO. 11

**** THIS PROPOSED AMENDMENT IS BASED UPON JOHNSON UTILITIES ALTERNATIVE 1.**

**** THIS PROPOSED AMENDMENT ASSUMES THE ADOPTION OF MAYES PROPOSED AMENDMENT #2.**

DELETE the following:

Page 8, line 12 through page 9, line 19.

INSERT the following at page 8, line 12:

"It is incumbent upon all regulated utilities to keep the records necessary to demonstrate the actual cost of its properties in a form that provides complete and authentic information. The evidence in this case demonstrates that the Company has not fully complied with regulatory accounting requirements, and has not fully met its burden of proof regarding the actual cost of its properties. The Company's balance sheet shows member equity of $28,608,166 at of the end of the test year. Staff's recommended adjustment of 10% for inadequately supported plant costs would result in a disallowance of $18,326,088, or approximately 64% of the Company's total equity. Such a disallowance is too large under the circumstances of this case, and when combined with other disallowances recommended by Staff, would result in a negative rate base for the Company. Nevertheless, the Commission finds that an adjustment is warranted, and will make a disallowance equal to 10% of the Company's test year-end equity. Thus, the Company's plant-in-service will be reduced by $2,860,817. For the reasons discussed below, we will not make a corresponding deduction to AIAC or CIAC for this disallowance, so the entire $2,860,817 will come out of member/shareholder equity in the Company.

It is reasonable and in the public interest to require the Company to keep its records in accordance with the NARUC USOA and Commission rules in a manner that will support its filings with the Commission. In future proceedings, if the Company again fails to produce adequate records demonstrating the cost of plant additions, it may be reasonable to consider a greater disallowance than that adopted in this case or a penalty for noncompliance with Commission rules and Orders."

DELETE the following:

Page 14, lines 5-19.

INSERT the following at page 14, line 5:

"We find that $2,201,386 of plant was properly reclassified by the Company as test year plant and should be included in test year plant in service. However, we will not include the remaining $1,021,108 of post test year items in plant in service. The Company will have an opportunity to request inclusion of this plant in its next rate case."

DELETE the following:

Page 25, line 3, beginning with the word "However" through the end of the sentence on line 6.5.

DELETE the following:

Page 25, line 10, beginning with the word "The" through the word "1998" on line 11.

DELETE the following:

Page 31, line 1, beginning with the word "which" through the word "parties,".

DELETE the following:

Page 31, line 23.5, beginning with the word "After" through the end of the sentence on line 26.

INSERT the following at page 31, line 23.5, following the word "adjustments":

> "After considering all the evidence presented, we find that an adjustment to remove affiliate profit is necessary and reasonable in order to exclude excessive plant costs from the Company's rate base and to achieve just and reasonable rates for the Company and its ratepayers. However, Staff's recommended adjustment of 7.5% applied to all plant (including plant constructed by non-affiliates of the Company) would result in a disallowance of $12,370,116, or approximately 43% of the Company's total member equity of $28,608,166 at of the end of the test year. Such a disallowance is too large under the circumstances of this case, and when combined with other disallowances recommended by Staff, would result in a negative rate base for the Company. The Company presented testimony and evidence at the hearing that its affiliate-constructed plant totaled $26,847,516 for the water division and $45,724,508 for the wastewater division, for a combined total of $72,572,024 in affiliate-constructed plant.[1] Thus, we will make an adjustment to remove affiliate profit, as discussed below, but will only apply that adjustment to the Company's affiliate-constructed plant."

DELETE the following:

Page 33, line 3, beginning with the word "We" through the end of the sentence on line 5.5.

INSERT the following at page 33, line 3, following the word "reasonable":

> "We will adopt the Company's recommendation to apply a 1.75% reduction to the Company's plant in service balances, net of other plant in service adjustments, in order to disallow from rates excessive costs associated with affiliate/related party transactions. Thus, the Company's plant-in-service will be reduced by $1,270,011. We will not make a corresponding deduction to AIAC or CIAC for this disallowance, so the entire $1,270,011 will come out of member/shareholder equity in the Company."

---

[1] Company's Final Schedules Water B-2, at page 3.1, and Wastewater B-2, at page 3.1.

DELETE the following:

Page 36, line 6.5, through the end of the sentence on line 17.

INSERT the following at page 36, line 6.5:

"We are persuaded by the Company's arguments based upon the facts and circumstances of this case. Adopting the recommendation of Staff and RUCO to remove include CIAC in rate base will result in a substantial negative rate base for the Company's water division. Thus, we will exclude unexpended HUFs from rate base in the amount of $6,931,078 for the water division and $16,505 for the wastewater division."

DELETE AND REPLACE the following:

Page 36, line 20, delete the figure "($13,682,831)" and replace with "$3,725,208", and delete the figure "$136,562" and replace it with "$16,572,869."

DELETE the following:

Page 50, line 12, through the end of the sentence on page 51, line 12.

INSERT the following at page 50, line 12:

"The Company's FVRB for its water division is $3,725,208 and the FVRB for its wastewater division is $16,572,869. We will adopt the Company's recommended WACC of 11.89% to be used as the Company's rate of return to be applied to the FVRB to compute the Company's required operating income. By adopting a positive FVRB, we avoid the significant detriments associated with a negative rate base and operating margin for a utility the size of the Company. For example, a negative rate base could make it difficult or even impossible for the Company to attract additional equity in the future, either from current members/shareholders or from future outside investors. A lack of ready access to additional equity could render the Company dependent upon AIAC and/or CIAC to fund future growth, which would negatively impact the Company's ability to build equity over time. In addition, a negative rate base could make it difficult or even impossible for the Company to borrow money, or at a minimum, would increase the Company's borrowing costs to address the additional risk associated with the Company's negative rate base."

DELETE the following:

Page 51, line 15.5, through the end of the sentence on line 19.

INSERT the following at page 51, line 15.5:

"The adjusted test year operating income for the water division was $3,523,166. An 11.89% rate of return on the Company's FVRB for its water division of $3,725,208 results in an operating income of $442,927 and a revenue requirement of $10,092,660."

DELETE the following:

Page 51, line 21.5, through the end of the sentence on line 25.

INSERT the following at page 51, line 21.5:

"The adjusted test year operating income for the wastewater division was $1,191,497. An 11.89% rate of return on the Company's FVRB for its wastewater division of $16,572,869 results in an operating income of $1,970,514 and a revenue requirement of $12,133,031."

DELETE AND REPLACE the following:

Page 67, line 26, delete the figure "($13,682,831)" and replace with "$3,725,208".

DELETE AND REPLACE the following:

Page 67, line 28, delete the figure "$11,769,046" and replace with "$9,649,732".

DELETE AND REPLACE the following:

Page 68, line 1, delete the figure "$1,403,853" and replace with "$3,523,166".

DELETE the following:

Page 68, line 6, through the end of the sentence on line 14.

INSERT the following at page 68, line 6:

"The Company's adjusted FVRB for is water division is $3,725,208. Using an 11.89% rate of return applied to the FVRB for the water division to set fair and reasonable rates produces a decrease in the revenues from $13,172,899 to $10,092,660, or $3,080,239, a decrease of 23.38%

DELETE AND REPLACE the following:

Page 68, line 15, delete the figure "$98,522" and replace with "$3,080,239".

DELETE AND REPLACE the following:

Page 69, line 2, delete the figure "$136,562" and replace it with "$16,572,869".

DELETE AND REPLACE the following:

Page 69, line 5, delete the figure "$9,432,270" and replace with "$10,162,517", and delete the figure "$1,921,744" and replace it with "$1,191,497".

DELETE the following:

Page 69, line 10, through the end of the sentence on line 18.

INSERT the following at page 69, line 10:

"The Company's adjusted FVRB for is wastewater division is $16,572,869. Using an 11.89% rate of return applied to the FVRB for the wastewater division to set fair and reasonable rates produces a increase in the revenues from $11,354,014 to $12,133,031, or $779,017, an increase of 6.86%."

DELETE the following:

Page 71, line 11, through the end of the sentence on line 13.

INSERT the following at page 71, line 11:

"The fair value of the Company's water division rate base is $3,725,208. Authorizing a rate of return of 11.89% on the Company's FVRB produces rates and charges that are just and reasonable."

DELETE the following:

Page 71, line 14, through the end of the sentence on line 16.

INSERT the following at page 71, line 14:

"The fair value of the Company's wastewater division rate base is $16,572,869. Authorizing a rate of return of 11.89% on the Company's FVRB produces rates and charges that are just and reasonable."

DELETE the following **ORDERING PARAGRAPH**:

Page 73, line 7, through the end of the sentence on line 11.

MAKE ALL CONFORMING CHANGES, INCLUDING PARAGRAPHS 95, 96, 101 AND 102 OF THE RECOMMENDED OPINION AND ORDER.

11620543.1