BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

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

SWING FIRST GOLF LLC
RESPONSE TO COMMISSIONER PIERCE'S LETTER

Swing First Golf LLC ("Swing First") hereby responds to Commissioner Pierce's August 4, 2010, letter to the parties.

1. Discussion

Swing First notes that Johnson Utilities, LLC ("Utility") has no one else but itself to blame for its current situation. Utility would not find itself with an overall negative rate base except for the following reasons described in the Recommended Opinion and Order ("ROO"):[1]

1. Utility did not keep its books in conformance with NARU and Commission requirements;
2. Utility substantially overbuilt capacity;
3. Utility violated the Commission's rules by using affiliates to construct plant without completive bidding, and proper documentation of plant costs; and
4. Utility collected Hook-up fees from customers far in advance of when the associated plant would be needed to provide service.

Because Utility has a negative rate base for its water operations and essentially a zero rate base for its wastewater operations, traditional rate-of-return ratemaking cannot be applied.

[1] The ROO concludes that Utility's water rate base is ($13,682,831) and its wastewater rate base is $136,562. (ROO at 36:19-20)/

Instead the ROO would provide Utility a ten-percent operating margin, although Judge Jibilian was clearly troubled by this approach:

1. "Authorizing an operating margin for a utility the size of the Company is problematic"[2]
2. "[A]uthorizing an operating margin when there is no rate base investment has the potential of allowing the utility to realize a profit without making any investment, creating a windfall for the utility, without the utility having put any capital at risk.[3]
3. "In the absence of a FVRB, the Arizona Constitution does not require the Commission to authorize rates to allow the Company to collect any revenue in addition to its operating expenses.[4]

A ten-percent operating margin would be an enormous windfall for Utility. The ROO would provide Utility operating income (profit) of $1,307,438 for its water division and $1,045,913 for its wastewater division.[5] Just as acknowledged in the ROO, this would allow Utility to make a windfall profit—provided by its customers—of over $2.3 million, without having any significant capital at risk.

Further, as calculated by Swing First in its Exceptions, providing Utility a ten-percent operating margin would be equivalent to adding $30,924,320 of plant back to Utility's combined rate base.[6] This would essentially negate most of the ROO's careful plant disallowances.

As evidenced by the discussions at previous Open Meetings and by the various amendments filed in this docket, the Commissioners are clearly concerned with balancing the interests of customers and Utility. Through no fault of its customers, Utility is the first Class-A utility in Arizona with no rate base. The Commission wants to set rates high enough to cover

[2] ROO at 50:14-15.
[3] *Id.* at 50:19-22.
[4] Id. at 50, n. 317.
[5] *Id.* at 51:16-24.
[6] Exceptions of Swing First Golf LLC, dated May 17, 2010, at 4.

expenses, contingencies, and to encourage future investments, without penalizing customers through excessive rates.

2. Swing First's Recommendation and Proposed Amendment

As discussed in Swing First's Exceptions, the ROO does not sufficiently try to remedy Utility's other shortfalls: its abominable environmental record; its blatant disregard for the Commission's orders; and its atrocious treatment of its customers. The Commission should not require Utility's customers to provide any more than a minimal bailout unless there is some mechanism in place to encourage Utility to satisfy its fundamental public-service obligations.

Swing First suggests that the Commission approve just a minimal level of operating margin for Utility. The Commission has historically provided operating margin relief only for small utilities to allow them to fund needed capital expenditures. As noted in the ROO, this is an extraordinary remedy, not required by the Constitution. There is no record evidence that a ten-percent operating margin is required for Utility "to build its equity investment."[7] Nor does the ROO identify any plant investment that the windfall operating income could fund. Even worse, the ROO does not even require that the bonus operating income stay in the company. George Johnson could simply dividend all the customer-provided funds to himself and other Utility owners.[8] Given these circumstances, Swing First recommends an operating margin of zero, but would not object to providing Utility an operating margin of up to three percent.

Swing First suggests that the Commission then provide Utility an opportunity to earn an increased operating margin of up to seven percent if it can demonstrate that it has markedly changed its behavior. This would require Utility to submit evidence that:

1. Utility has a plan to increase equity investment by existing owners, and to restrict dividends so as to increase retained earnings to a level needed to fund additional investments and to provide funds for contingencies;
2. Utility is in full compliance with the Arizona Department of Environmental Quality;

[7] *Id.* at 51:4.
[8] As discussed below, Utility's retained earnings balance is zero. This is compelling evidence that all previous earnings have been distributed to Utility's owners.

3. Utility is fully in compliance with NARUC accounting and record-keeping requirements; and

4. Utility has resolved its billing and customer service issues, including customer complaints.

Swing First has attached a suggested amendment, which is based on Mayes Revised Proposed Amendment 4.

3. <u>Specific Responses to Commissioner Pierce</u>

Swing First relies on the expertise of Staff and RUCO to correctly fill in the blanks in Commissioner Pierce's matrix. Swing First next will state its position on each of the amendments so far suggested by the Commissioners, Hearing Division, and Utility's proposed Amendment 12. Finally, Swing First will rank the options identified by Commissioner Pierce.

<u>Mayes 1</u>. Swing First supports Mayes 1.

<u>Mayes 2</u>. Swing First opposes Mayes 2. As the ROO forcefully states:

> The Company has not demonstrated the record keeping ability necessary to administer a CAGRD adjustor mechanism. The record in this case is replete with evidence of the Company's demonstrated inability to produce documentation in the standard format required for a regulated utility during the processing of a rate case. In addition, the Company has very clearly expressed an unwillingness to comply with the requirements necessary for proper administration and oversight of the proposed CAGRD adjustor mechanism. The Company's stated unwillingness, coupled with the Company's shoddy record keeping behavior to date, demonstrate that it would not be wise at this time to grant the Company authority to implement a complex adjustor mechanism.[9]

Swing First's suggested amendment would allow Utility to subsequently implement a CAGRD adjustor mechanism if it complies with the conditions set forth in the amendment.

<u>Mayes 3</u>. Swing First opposes Mayes 3. This amendment would require customers to support a fictitious rate base and would disregard Staff's careful solutions for Utility's slovenly record keeping, illegal affiliate transactions, and enormous overbuilding. If Utility were to appeal an Order incorporating this amendment, a reviewing court might find that it was arbitrary to set rate bases to zero. Swing First recognizes that Mayes 3 results in the lowest overall rates,

[9] *Id.* at 45:4-13.

but submits that a modified Mayes 4 would better balance the interests of customers, the Commission, and Utility.

Mayes 4. As discussed above, Swing First would support a modified version of Mayes 4.

Pierce 1. Swing First opposes Pierce 1. It is contrary to prior, recent Commission precedent. Unless the Commission were to allow similar, retroactive, treatment for other utilities taking the form of an LLC or Subchapter S corporation, it would be discriminatory to allow Utility to recover income-tax expense through rates.

Pierce 2. Swing First opposes Pierce 2. It is contrary to prior, recent Commission precedent. Unless the Commission were to allow similar, retroactive, treatment for other utilities with HUF balances not offset by rate-based plant, it would be discriminatory to ignore these balances just for Utility. Swing First notes that Utility could have resolved this issue by returning these funds to the developers who paid them or placing them in an escrow account. Then when the associated plant was included in rate base, Utility could receive the funds as a rate base offset.

Hearing Division 1. Swing First supports Hearing Division 1. This amendment best balances the interests of Utility and its customers. In accordance with Commission precedent, it normalizes test-year CAGRD expense to known-and measurable levels.

Hearing Division 2. Swing First supports Hearing Division 2.

Hearing Division 3. Swing First supports Hearing Division 3.

Utility 12. Swing First opposes Utility's Proposed Amendment 12. It improperly seeks to recapture the plant disallowances that Staff and the ROO so carefully analyzed and justified. Utility also argues that approval of either Mayes 3 or Mayes 4 "would almost certainly necessitate the immediate filing of an emergency rate case for both the water and wastewater divisions."[10] This is clearly just blustering, as Utility's own schedule demonstrates. It shows that Utility's overall operating-income deficiency would be ($3,552,191) if Utility 12 were

[10] Johnson Utilities' Comments on Mayes Amendments, dated July 26, 2010, at 2:13-14.

approved.[11] As discussed at the Commission's July 28, 2010, Open Meeting, if Mayes 3 were adopted, Utility's overall operating-income deficiency would be ($3.97 million) and if Mayes 4 were adopted, Utility's overall operating-income deficiency would be ($3.54 million). There is hardly any difference in the overall operating-income deficiencies between Mayes 3 and Utility 12, while Mayes 4's operating-income deficiency is virtually identical to that of Utility 12.

Utility's Proposed Amendment 12 would also hurt wastewater customers, many of whom are not water customers. Under either Mayes 3 or Mayes 4, wastewater customers would see significant rate decreases. By contrast, Utility 12 would provide wastewater customers almost no rate relief.

Utility also attached copies of income statements for 2007 and 2009, which purportedly supported its position that Mayes 3 and Mayes 4 were two draconian. First, the Commission should disregard these documents. Although Utility states that these were previously filed with the Commission, the statement is not correct. These statements purport to be for the entire Johnson Utilities, LLC. Utility does not file financial statements for the combined entity. Utility actually filed separate financial statements for its water and sewer divisions.

In fact, what the actual annual report financial statements show is that Utility was generating huge profits in the 2007 test year - $5,570,210.[12] This is an amazing profit for a company that only received its CC&N in 1997. In just ten years, though high initial rates and developer funding, Utility created a money machine.

The enormous profit in the 2007 test year should be no mystery. As the evidence in this case shows, Utility's rates were far too high in 2007. The prohibition on retroactive ratemaking does not allow the Commission to make refunds retroactive to that year. However, if the Commission wants to provide a remedy for these excessive profits, one of Swing First's proposed amendments (Exhibit 4 to its Exceptions) would at least provide Utility's customers some relief. It would make refunds retroactive to the date that new rates should have gone into

[11] *Id.* at Attachment 4.

[12] In the 2007 Annual Reports, Utility reported annual income of $2,519,180 for its water division and $3,051,030 for its sewer division.

effect if Utility had not defied the Commission's Order in Decision No. 68235 that it file a rate case in 2007, based on a 2006 test year.

The actual 2009 financial statements filed with the Commission also show what has happened to Utility's enormous profits. After years of huge earnings, as of year-end 2009, Utility still had **zero** retained earnings on the balance sheets for both of its water and wastewater division. The retained earnings account shows the cumulative amount of net income that has been retained by the corporation rather than distributed to its owners as dividends. Because it has distributed all of its net income over the years to its owners, Utility has zero retained earnings after 13 years of operations. Nothing was left for future investment or contingencies.

Utility's zero retained earnings balance is yet another reason that the Commission should be very careful about providing Utility operating margin relief. If its owners had not looted it, Utility would have a healthy retained earnings balance to fund future investment and cover contingencies. It is time for its owners to put some of these funds back in Utility. Customers should not be required to refill the tank that the owners sucked dry.

Pierce Modified Utility 12. For the reasons just given, Swing First also opposes Commissioner Pierce's modification of Utility 12.

4. Ranking the Options

Swing First believes that its proposed option best balances the interests of customers and Utility. For the various options outlined in Commissioner Pierce's letter, Swing First ranks them as follows (from least bad to worst):

Least Bad

- Option 7 -- Adopt Mayes 4 and Hearing 1.
- Option 6 -- Adopt Mayes 3 and Hearing 1.
- Option 1 -- Adopt the ROO and Hearing 1.
- Option 2 -- Adopt the ROO and Mayes 2.
- Option 3 -- Adopt the ROO, Mayes 2, and Pierce 1.
- Option 5 -- Adopt the ROO, Mayes 2, and Pierce 2.
- Option 4 -- Adopt the ROO, Mayes 2, and Pierce 1 & 2.
- Option 9 -- Adopt a Modified Johnson 12 (as described above) & Mayes 2.
- Option 8 -- Adopt Johnson Utilities 12 & Mayes 2.

Worst

5. Conclusion

Swing First asks the Commission to amend the ROO by:

1. Approving Hearing Division 1;
2. Approving Hearing Division 2;
3. Approving Hearing Division 3;
4. Approving Mayes 1;
5. Approving Swing First's attached amendment.

The combination of these amendments balances the interests of the customers and Utility, does not discriminate against other utilities, and provides Utility an opportunity to demonstrate to the Commission that it has reformed and deserves a higher operating margin.

RESPECTFULLY SUBMITTED on August 9, 2010.

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EXHIBIT 1

SWING FIRST'S PROPOSED AMENDMENT (BASED ON MAYES REVISED PROPOSED AMENDMENT 4)

Page 51, line 1 through line 3,

DELETE:

"Therefore, in order to protect the Company's customers, we will adopt Staffs recommendation to authorize an operating margin: of 10 percent for both its water and wastewater divisions."

AND REPLACE WITH:

"We believe that an operating margin of 10 percent is too generous and would be a windfall for the Company and results in unreasonably higher rates for its customers. On the other hand, no allowance for an operating margin (a margin set to zero) would reduce cash flow for contingencies, and could place the Company's customers in harm's way. Accordingly, in weighing the interests of the Company and its customers we consider the range of possible operating margins between 10 percent and zero that could be authorized based upon this record. In our consideration, we also note:

1. The absence of existing equity investment by the Company;
2. The Company's deplorable environmental record, as evidenced by both the quantity of and seriousness of its unresolved NOVs;
3. The Company's failure to comply with basic NARUC accounting and record-keeping requirements;
4. The Company's numerous billing and customer service issues; and
5. The Company's failure to comply with prior Commission Orders, including the Order in Decision No. 68235 (requiring the Company to file a rate case for its water and wastewater divisions by May 1, 2007, using a 2006 test-year), and the Order in Decision No. 70849, (requiring the Company to file by December 31, 2009, evidence that it has closed all NOVs associated with its Pecan Water Reclamation Plant and that the Plant is in full compliance with ADEQ).

In light of these factors and the record, we find that an operating margin of 3 percent for both its water and wastewater divisions is reasonable. Therefore, we determine a 3 percent operating margin for the water and wastewater divisions is appropriate and in the public interest.

However, we do wish to afford the Company an opportunity to demonstrate to the Commission that it has resolved the concerns that require us today to set its operating margin at the low-end of the range between zero and 10 percent. Accordingly, we will authorize the Company to file, no later than June 30, 2011, an application, based on the fair value rate finding in this case, to increase rates to support a higher operating margin, not to exceed 7 percent. In its application, the Company may also file for approval of a CAGRD adjustor mechanism.

To justify a higher operating margin, the Company's application should include the following items:

EXHIBIT 1

SWING FIRST'S PROPOSED AMENDMENT (BASED ON MAYES REVISED PROPOSED AMENDMENT 4)

1. A plan to increase the Company's equity investment by existing owners, and to restrict dividends so as to increase retained earnings to a level needed to fund additional investments and to provide funds for contingencies;
2. Documentation that the Company is in full compliance with the Arizona Department of Environmental Quality;
3. A report by an independent auditor, not a witness in this case, that the Company is fully in compliance with NARUC accounting and record-keeping requirements; and
4. A report on the status and substance of current billing and customer service issues, including customer complaints.

In its determination whether to increase rates to support a higher operating margin, the Commission will carefully evaluate each of these sections of the application.

Page 51, line 7.5 through line 12, DELETE:

"If, in the Company's next rate filing, the Company still has a negative rate base such that authorizing an operating margin in lieu of a rate of return calculation would be necessary in order to prevent operating losses, we will closely examine and give great consideration to the strength of the Company's efforts to improve its rate base prior to again using an operating margin to determine the revenue requirement."

Page 51, line 15.5 through line 19, DELETE:

"The adjusted test year operating income for the water division was $1,403,853. A 10 percent operating margin for the Company's water division results in operating income of $1,307,438. Based on our findings herein, we determine that the Company's gross revenue for its water division should decrease by $98,522."

AND REPLACE WITH:

"The adjusted test year operating income for the water division was $2,664,888. A 3 percent operating margin for the Company's water division results in operating income of $______. Based on our findings herein, we determine that the Company's gross revenue for its water division should decrease by $__________."

Page 51, line 21.5 through line 25, DELETE:

"A 10 percent operating margin for the Company's wastewater division results in operating income of $1,045,913. Based on our findings herein, we determine that the revenues for the Company's wastewater division should decrease by $895,100.

AND REPLACE WITH:

EXHIBIT 1

SWING FIRST'S PROPOSED AMENDMENT (BASED ON MAYES REVISED PROPOSED AMENDMENT 4)

"A 3 percent operating margin for the Company's wastewater division results in operating income of $_______. Based on our findings herein, we determine that the revenues for the Company's wastewater division should decrease by $_________."

INSERT NEW ORDERING PARAGRAPH:

"IT IS FURTHER ORDERED THAT the Company is authorized to file, no later than June 30, 2011, an application, based on the fair value rate findings in this case, to increase rates to support a higher operating margin, not to exceed 7 percent. In its application, the Company may also file for approval of a CAGRD adjustor mechanism. To justify a higher operating margin, the Company's application should include the following items:

1. A plan to increase the Company's equity investment by existing owners, and to restrict dividends so as to increase retained earnings to a level needed to fund additional investments and to provide funds for contingencies;
2. Documentation that the Company is in full compliance with the Arizona Department of Environmental Quality;
3. A report by an independent auditor, not a witness in this case, that the Company is fully in compliance with NARUC accounting and record-keeping requirements; and
4. A report on the status and substance of current billing and customer service issues, including customer complaints.

In its determination whether to increase rates to support a higher operating margin, the Commission will carefully evaluate each of these sections of the application."

Make all conforming changes necessary in the Findings of Fact, Conclusions of Law and Ordering Paragraphs to carry out these changes in the ROO.