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AZ CORP COMMISSION
DOCKET CONTROL

IN THE MATTER OF THE APPLICATION
OF SAHUARITA WATER COMPANY, LLC
FOR A RATE INCREASE.

DOCKET NO. W-03718A-09-0359

STAFF'S REPLY BRIEF

The Utilities Division of the Arizona Corporation Commission ("Staff") hereby replies to the Post-Hearing Initial Brief of Sahuarita Water Company, LLC ("Sahuarita" or "Company") filed on September 15, 2010. This Reply only addresses new issues and new arguments raised by the Company in its Initial Brief that Staff has not already addressed in its Closing Brief. The mere fact that an issue or argument was raised in Staff's Closing Brief, but not this Reply does not mean that Staff has conceded that particular issue or argument.

I. WELL NO. 23 WAS NOT USED AND USEFUL DURING THE TEST YEAR (OR NOW) AND THEREFORE SHOULD NOT BE INCLUDED IN RATE BASE.

A. Well Capacity Factor of 0.30 gpm/unit¹ and a Peak Hourly Demand Factor of 0.25 Should Be Used in Determining the Company's Well and Storage Capacity Requirements.

Staff mostly concurs with the Accepted Values in the Company's Areas of Agreement Table. However, the Peak Daily Demand (PDD) of 0.47 gpm/unit utilized in the Company's Opening Brief² is inconsistent with the Company's pre-filed rejoinder testimony.³ In the Company's Rejoinder, Mr. Taylor used a 0.30 gpm/unit factor to evaluate the well capacity in his Exhibit A Well 14 Outage Example.⁴ Based on this 0.30 gpm/unit calculation use, Staff understood that the Company accepted 0.30 gpm/unit as the well capacity factor. However, in the Company's Post-Hearing Initial Brief, it

¹ gpm/unit: gallons per minute per unit.
² Company Opening Brief at 5:23-6:1.
³ Ex. A-13, Rejoinder Testimony of Mark F. Taylor, Exhibit A.
⁴ Ex. A-13, Rejoinder Testimony of Mark F. Taylor, Exhibit A.

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1 appears that the Company is now proposing an unsubstantiated 0.47 gpm/unit well capacity factor.⁵
2 This new factor is calculated from the Peak Daily Demand (PDD) of 427 gpd/unit⁶ x 1.6 producing a
3 new Peak Hourly Demand (PHD) of 683 gpd/unit or 0.47 gpm/unit.⁷ The Company states that it
4 takes its 1.6 ratio factor from the Company's 2007 Water System Master Plan.⁸ Further deviating
5 from pre-filed testimony, the Company is now adopting an estimated Peak Hourly Demand factor of
6 1.6 from an outdated 2007 Water System Master Plan in its attempt to argue that the water system has
7 a well capacity deficiency without well no. 23.⁹

8 1. STAFF'S DIRECT TESTIMONY SYSTEM ANALYSIS.

9 As explained by Staff in pre-filed direct testimony, Staff used the Company's actual water use
10 data from the Water Use Data Sheet to calculate the well (0.31 gpm per connection) and storage (358
11 gpd per connection) capacity factors.¹⁰ To calculate these factors, Staff used the average daily
12 demand during the peak month of the year of 48,746,000 gallons (June 2008) / 30 days / 4,539
13 connections = 358 gpd per connection.¹¹ 358 gpd per connection was used to evaluate the storage
14 capacity.¹² Staff used the 358 gpd per connection multiplied by 1.25 (PHD factor) to come up with
15 447 gpd per connection or 0.31 gpm per connection.¹³ This 0.31 gpm per connection was used to
16 evaluate the well capacity.¹⁴ The actual water use data for the Water Use Data Sheet, and a 25% well
17 capacity factor, should be used in the water system analysis, not the Company's estimated 2007 plan
18 projection capacity ratio factor of 1.6.¹⁵

19 To summarize Staff's pre-filed direct testimony, using Staff's initial 0.31 gpm per connection
20 well capacity factor, Staff determined that:

- 21 • For informational purpose, the 2008 test year customer base was approximately 4,670
22 connections.¹⁶

23 ⁵ Company Opening Brief at 5:25-6:1.

24 ⁶ gpd/unit: gallons per day per unit.

24 ⁷ Company Opening Brief at 5:25-6:1.

25 ⁸ Company Opening Brief at 5:15-6:4.

25 ⁹ Company Opening Brief at 5:21-23.

26 ¹⁰ Ex. S-1, Direct Testimony of Marlin Scott Jr., Exhibit MSJ at 7 of 40; Tr. at 395:1.

26 ¹¹ Ex. S-1, Direct Testimony of Marlin Scott Jr., Exhibit MSJ at 7 of 40.

27 ¹² Ex. S-1, Direct Testimony of Marlin Scott Jr., Exhibit MSJ at 7 of 40.

27 ¹³ Tr. at 395:7-10.

27 ¹⁴ Ex. S-1, Direct Testimony of Marlin Scott Jr., Exhibit MSJ at 7 of 40.

28 ¹⁵ Tr. at 394:20-395:2.

28 ¹⁶ Ex. S-1, Direct Testimony of Marlin Scott, Jr., Exhibit MSJ at 7 of 40.

- The well capacity totaling 3,250 GPM (=Well No. 14 at 1,750 + Well No. 18 at 1,500) could adequately serve approximately 10,480 connections (=3,250 / 0.31).¹⁷ 10,480 connection is clearly much more than the test year customer base of 4,670 connections and Staff's estimated growth projection to 8,000 total connections by December 2013.¹⁸
- Well No. 14 at 1,750 GPM alone could serve 5,645 connections (=1,750 / 0.31) which is more than the 4,670 test year number of customer connections.¹⁹
- Well No. 18 at 1,500 GPM alone could serve approximately 4,838 connections (=1,500 / 0.31) which is again more than the 4,670 test year number of customer connections.²⁰

As explained in Staff's direct testimony, the Company's test year well capacity of 3,250 gpm and storage capacity of 2,550,000 gallons is adequate to serve the present customer base and growth within a five year period.²¹ For this reason, the new Well #23 is not needed at this time.

2. STAFF'S UPDATED SYSTEM ANALYSIS USING THE COMPANY'S UPDATED REJOINDER WELL PRODUCTION AND STORAGE CAPACITY NUMBERS.

In response to the Company's rejoinder reduced well production and storage capacity numbers, Staff presented Exhibit S-4 which analyzes the Company's well production and storage capacity requirements using the Company's updated rejoinder well production and storage capacity numbers.²² Using the Company's updated 0.30 gpm per connection for the well capacity evaluation, Staff determined that the combined-operating well capacity totaling 2,800 GPM (=Well No. 14 at 1,550 + Well No. 18 at 1,250) could adequately serve approximately 9,333 connections (=2,800 / 0.30).²³ Additionally, Staff found that Well No. 14 at 1,750 GPM alone could serve 5,833 connections (=1,750 / 0.30), and Well No. 18 at 1,450 GPM alone could serve approximately 4,833 connections (=1,450 / 0.30).²⁴ Wells No. 14 and 18 are adequate to serve and exceed the test year customer base of 4,670 connections and anticipated customer growth within a five year period.²⁵

¹⁷ Ex. S-1, Direct Testimony of Marlin Scott, Jr., Exhibit MSJ at 7 of 40.

¹⁸ Ex. S-1, Direct Testimony of Marlin Scott Jr., Exhibit MSJ at 7 of 40 and 17 of 40.

¹⁹ Ex. S-1, Direct Testimony of Marlin Scott, Jr., Exhibit MSJ at 7 of 40.

²⁰ Ex. S-1, Direct Testimony of Marlin Scott, Jr., Exhibit MSJ at 7 of 40.

²¹ Ex. S-1, Direct Testimony of Marlin Scott, Jr., Exhibit MSJ at 7 of 40.

²² Tr. at 398:10-25.

²³ Ex. S-4, Staff's System Analysis using Company's Rejoinder Numbers.

²⁴ Ex. S-4, Staff's System Analysis using Company's Rejoinder Numbers.

²⁵ Ex. S-4, Staff's System Analysis using Company's Rejoinder Numbers.

1 **B. The minimum storage standards contained in R18-5-503(A) and (B) are**
2 **appropriate for determining what plant is “used and useful” for rate making**
3 **purposes.**

4 Staff uses R-5-503(A) and (B) minimum storage requirements because customers should not
5 be required to pay for more plant than is necessary to adequately serve them during the test year.

6 The Company’s attempt to show that Staff erroneously analyzed the Company’s minimum
7 storage requirements ignores important elements in the calculation.²⁶ The Company incorrectly
8 attempts to demonstrate in its Opening Brief that Staff’s methodology for determining the minimum
9 storage requirements results in a negative storage capacity requirement.²⁷ Unlike Staff’s analysis, the
10 Company fails to consider fire flow requirements. Taking fireflow requirements of 480,000 gallons
11 into consideration, a minimum storage capacity requirement of 63,860²⁸ would be necessary using the
12 Company’s methodology.

13 The Company appears to argue that because its 2007 Water System Master Plan includes well
14 No. 23, that the well should be included in ratebase.²⁹ However, the Company’s 2007 Water System
15 Master Plan is based on projected water usage. Staff’s water system analysis is based on actual water
16 usage numbers.³⁰ The Company also relies on a letter from Pima County Department of
17 Environmental Quality Water/Waste Programs Manager for the proposition that “Staff’s exclusive
18 reliance upon A.A.C. R18-5-503(A) and (B) produces an aberrational and unsustainable result with
19 respect to SWC’s storage capacity.”³¹ However, the Pima County Department of Environmental
20 Quality’s statements regarding system design are not contrary to Staff’s assertion that customers
21 should not be required to pay for plant that is not needed to adequately serve them during the test
22 year. The Department of Environmental Quality, unlike the Commission, does not have the
23 responsibility of setting rates that are fair and reasonable not only to the Company but to its
24 customers. While it may make sense from a planning standpoint to over build, test year customers
25 should not be required to pay for plant that is not yet necessary to serve them.

26 _____
26 ²⁶ Company Opening Brief at 4:15-5:12.
27 ²⁷ Company Opening Brief at 4.
28 ²⁸ $2,151,860 / (480,000 + 1,671,860 - 2,088,000) = 63,860$ gpd.
27 ²⁹ Company Opening Brief at 5:15-4, and fn. 6.
30 ³⁰ Ex. S-1, Direct Testimony of Marlin Scott Jr., Exhibit MSJ at 7 of 40; Tr. at 395:1; See also Ex. S-4, Staff’s
28 ³¹ System Analysis using Company’s Rejoinder Numbers.
 ³¹ Company Opening Brief at 6:12-7:10.

1 Lastly, the Company argues that the Commission should consider both the age and condition
2 of its wells in its used and useful analysis. This is not the Commission's practice. Following the
3 Company's proposal in this case would require to Commission to analyze the age and condition of
4 every plant item (including all mains, wells, pumps, tanks, vehicles, etc.) in every rate case. This is
5 impractical and contrary to long-established Commission practice. The Company will have the
6 ability to recover, in rates, the costs associated with Well No. 23 in a later rate case when Well No.
7 23 becomes necessary to serve the Company's customers. Until such time, Well No. 23 should not
8 be included in rate base.

9 **II. CUSTOMER DEPOSITS ARE PROPERLY TREATED AS A REDUCTION TO**
10 **RATEBASE.**

11 These funds are "a source of non-investor supplied capital" that the Company ultimately has
12 available for use in support of its rate base investment.³² The Company argues that the deposits are
13 intended to ensure the payment for water service, and to minimize exposure to bad debt, and further
14 that it established a bank account to preserve the identity of those funds.³³ The Company also claims
15 that it pays interest on customer deposits at the rate of six percent per annum.³⁴ However, it is not
16 disputed that the customer deposits are initially deposited in the operating account with money from
17 other sources, and that the customer deposit account is only reconciled at the end of each month.³⁵
18 Further, the Company claims it pays six percent interest on customer deposits that is accomplished by
19 means of a credit to the water bill of the customer in question along with the refunded deposit. While
20 this may indeed be the case, the Company did not present any evidence regarding the amount of
21 interest that it credited to customer accounts for refunded deposits during the test year.

22 The Company's assertion that it should be entitled to an amount of interest expense based on
23 six percent of the customer deposits is flawed. The amount of interest expense accrued or paid
24 during the year is not tied to the customer deposits balance existing on the last day of the test year.
25 Since the customer deposit balance can vary considerably during the year, it is appropriate to base
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27 ³² Ex. S-7 at 10.

28 ³³ Post-Hearing Initial Brief at 10.

³⁴ *Id.*

³⁵ Tr. at 351.

1 this calculation on an average, in addition to auditing deposits received and refunds and interest
2 paid.³⁶ The Company nonetheless acknowledges that it did not produce this information despite
3 knowing Staff's recommendation regarding this issue and that Staff would entertain the inclusion of
4 interest expense with proper support.³⁷ Staff urges the Company to provide this information in its
5 subsequent rate application filings.

6 In the mean time, it is not disputed that the Company has access to these non-investor
7 supplied funds for use in its operations³⁸, and as such it should not be entitled to earn a return on
8 these deposits. Staff's recommendation is in accord with NARUC, and recent decisions by the
9 Commission.³⁹ Staff continues to recommend that the Commission treat Company's customer
10 deposits of \$96,204 as a reduction to rate base.

11 **III. SAHUARITA IS NOT ENTITLED TO INCLUDE INCOME TAX EXPENSE AS AN**
12 **OPERATING EXPENSE FOR RATEMAKING PURPOSES.**

13 **A. Any Income Tax Expense for Sahuarita is Hypothetical.**

14 The Company sets forth a key distinction in its Post-Hearing Brief. Specifically, the
15 Company indicates that "[t]here is no dispute between SWC and the Commission's Staff as to
16 whether SWC's water utility operations during the calendar 2008 test period generated income
17 attributable to SWC for which SWC's members incurred federal and state income tax liability."⁴⁰
18 Staff does not dispute that the Company generated income from water utility operations during the
19 2008 test year. However, the Company did not pay any taxes on that income because it is a limited
20 liability company and therefore does not generate taxable income to itself. Further, while Staff does
21 not believe the issue is relevant, the Company did not demonstrate that each of its members actually
22 incurred federal and state tax liability. In fact, Sahuarita is comprised of three members (Interchange
23 Opportunity Fund LLLP, Mission Peaks 4000 LLC, Sharpe and Associates, Inc.) all of which are also
24 pass-through entities and pay no taxes.⁴¹

25
26 ³⁶ Tr. at 517.

27 ³⁷ Tr. at 153, Ex. S-9 at 4.

28 ³⁸ Tr. at 155.

³⁹ See Decision Nos. 71845, 70628, and 71623.

⁴⁰ Post-Hearing Initial Brief at 13.

⁴¹ Tr. at 114.

1 While the Company did attempt to “calculate” the taxable income of Sahuarita, it is not clear
2 how the Company arrived at this figure.⁴² The Company also attempted to demonstrate that someone
3 eventually had to pay income tax on their portion of the income from Sahuarita’s water utility
4 operations, but again this individual (Taxpayer X) is not directly a member of Sahuarita. Further the
5 Company acknowledges that it only demonstrated that one or more members paid income taxes, not
6 all of them, and none of them are actually members of Sahuarita.⁴³

7 **B. Limiting the Allowance of Income Tax Expense to Taxable Entities Does NOT**
8 **Result In Discriminatory Ratemaking.**

9 The Company’s claim that the Commission’s policy of limiting the ratemaking recognition
10 and recovery of income tax expense to taxable entities is an example of form over substance is
11 misguided.⁴⁴ In particular, the Company argues that only through equivalent ratemaking recognition
12 and recovery can the owners of an S corporation’s or LLC’s lawful right to fully recover their
13 expenses of ownership be protected.⁴⁵ This argument is misplaced. The important distinction is that
14 while owners of S corporations and LLCs are entitled to a return on their investment, income taxes
15 are not an expense of those entities and therefore should not be included in the revenue requirement
16 determination. Providing income taxes to owners of S corporation’s or LLC’s that do not pay income
17 taxes is similar to including in rates the income tax obligations of the individual shareholders of C
18 corporations which do have income tax liabilities. Therefore, contrary to the Company’s assertion,
19 providing recovery of income tax expense to S corporations and LLCs does not result in equivalent
20 ratemaking treatment, and it would serve to provide preferential treatment for S corporations or
21 LLCs. In other words, the Company’s request that the Commission should “follow the income taxes,
22 and ascertain if paid, and by whom” does not make sense. Simply put, Staff’s recommendation is
23 based in large part on the treatment accorded to S corporations and LLCs by the Internal Revenue
24 Service.⁴⁶ While Staff agrees that the federal government does not presume to prescribe, nor does it
25 in fact prescribe, when and how the payment of income taxes should be recognized for ratemaking

26 _____
42 Ex. A-15, Appendix D.

27 43 Ex. A-16 at 1.

28 44 Post-Hearing Initial Brief at 14.

45 *Id.*

46 S-9 at 20.

1 purposes⁴⁷, “. . . the decision to allow or disallow . . . tax expense is to be made by the
2 Commission.”⁴⁸ Since it has long been the Commission’s policy not to allow recovery of
3 hypothetical income tax expenses for S corporations and LLCs, it should not allow it in this case.
4 Ultimately, the Company has not proffered any evidence that should cause the Commission to deviate
5 from this clear policy.

6 **C. It is Irrelevant that Income Attributable to Sahuarita’s Utility Activities Was**
7 **Reported to Its Members and that Federal and State Income Taxes Were Paid on**
8 **a Portion of that Income.**

8 Staff believes the Company’s interpretation of Sunrise Water Decision No. 71445 is flawed.
9 Staff acknowledges that the Commission appears to indicate in this Decision that part of its reason for
10 disallowing income tax expense was because there was no documentary evidence in the record that
11 income taxes were passed through and further that the sole member actually paid taxes on that
12 income. Although Staff does not believe the analysis should go further than determining whether the
13 entity is taxable according to the Internal Revenue Service, the Company has nonetheless failed to
14 demonstrate that the members of Sahuarita actually paid income tax on the income generated from
15 utility service. While the Company did attempt to demonstrate that one of its “taxable members” did
16 in fact pay income tax on the income generated by Sahuarita, in Staff’s opinion it resulted in a rather
17 convoluted machination that does not truly reflect the income tax expense of Sahuarita.⁴⁹
18 Additionally, the Company only attempted to demonstrate this issue with one taxpayer, and not all
19 taxpayers.

20 **D. Sahuarita Has the Option of Converting to a C Corporation.**

21 The Company in effect argues that the Commission is indirectly dictating to owners of public
22 service corporations what type of business structure they should adopt.⁵⁰ While Staff does not speak
23 for the Commission, this is an incongruous argument. Public Service Corporations can certainly
24 choose their business structure. In fact, the Company indicated that there are in fact advantages being
25 a pass-through entity such as an LLC. For example a shareholder in an S Corporation and a member

26 ⁴⁷ Initial Post-Hearing Brief at 15.

27 ⁴⁸ *Consolidated Water Utilities v. Ariz. Corp. Comm’n*, 178 Ariz. 478, 484, 875 P.2d 137, 143 (1993).

28 ⁴⁹ It is important to note that none of the members of Sahuarita are taxable entities. Taxpayer X is apparently member of two trusts and Sharpe and Associates. Ex. A-15 at 4.

⁵⁰ Initial Post-Hearing Brief at 18.

1 of an LLC both avoid double taxation that C Corporations do not avoid. Further, the members and
2 shareholder can take advantage of tax losses immediately. Ultimately what it boils down to is that
3 the owners of the public service corporation have to weigh the advantages and disadvantages of each
4 business structure and choose the one that best suits their needs. These owners simply have to be
5 aware that if they choose to form a pass-through entity they will not be entitled to income tax
6 expense. Staff continues to recommend the disallowance of the Company's proposed hypothetical
7 income tax expense.

8 **IV. SAHUARITA DID NOT MEET ITS BURDEN OF PROOF FOR THE INCLUSION OF**
9 **AFFILIATE NON-DEDICATED EMPLOYEE SALARIES.**

10 \$100,831 should be removed from affiliate salaries.⁵¹ The Company failed to keep adequate
11 records of its affiliate non-dedicated employee costs. Pursuant to statute and Commission rules,
12 water utilities, such as the Company, are required to maintain their books and records in accordance
13 with the NARUC Uniform System of Accounts.⁵² "NARUC directs that, to the maximum extent
14 practicable, in consideration of administrative costs, costs should be collected and classified on a
15 direct basis for each asset, service or product provided."⁵³ Such costs include detailed records of
16 services provided.⁵⁴ NARUC also provides that: "Generally, the price for services, products and the
17 use of assets provided by a non-regulated affiliate to a regulated affiliate should be at the lower of
18 fully allocated cost or prevailing market prices."⁵⁵ Further, according to ARS § 40-221(C), "It shall be
19 unlawful for any such corporation to keep any accounts, records or memoranda other than those
20 prescribed by the commission[.]"

21 While admitting that it failed to keep adequate records to support their affiliate, non-dedicated
22 employee salary costs,⁵⁶ the Company argues that because it has provided Staff with (1) testimony
23 regarding the services provided by the non-dedicated affiliate employees, (2) percentage estimates of
24

25 ⁵¹ Final Schedule JMM-11.

26 ⁵² ARS § 40-221(A); A.A.C. R14-2-411(D)(2).

27 ⁵³ Ex. S-9, Surrebuttal Testimony of Jeffrey M. Michlik at 12:14-16.

28 ⁵⁴ Ex. S-9, Surrebuttal Testimony of Jeffrey M. Michlik at 12:19-20.

⁵⁵ NARUC Guidelines for Cost Allocations and Affiliate Transactions, (D)(2)

[http://www.naruc.org/Publications/Guidelines%20for%20Cost%20Allocations%20and%20Affiliate%20Transact
ions.pdf](http://www.naruc.org/Publications/Guidelines%20for%20Cost%20Allocations%20and%20Affiliate%20Transactions.pdf).

⁵⁶ Company Opening Brief at 22:20-23.

1 time and salary allocation of non-dedicated affiliate employees, and (3) salary surveys that are both
2 non-industry specific and non-region specific, that it has met its burden of proof for inclusion of
3 estimated non-dedicated affiliate salaries into ratebase.⁵⁷

4 The Company's testimony regarding various non-dedicated affiliate employee tasks is not a
5 substitute for the detailed record of accounts it is required to keep. As stated by Mr. Seamans and
6 Ms. Homiak, as utility managers, they would not pay for professional services without detailed
7 itemized invoices.⁵⁸ Rate payers should also not have to pay for such unsubstantiated costs.

8 The salary surveys (American Water Works Association and New York Times) are not a
9 substitute for a competitive bidding process and accurate detailed record keeping. The Company
10 states "the compensation paid by the Management Company to such employees is quite comparable
11 to and in-line with the prevailing industry compensation standards reflected in the AWWA and New
12 York Times surveys for comparable positions."⁵⁹ However, as noted above, such compensation costs
13 provided by non-regulated affiliates should be lower than fully allocated cost or prevailing market
14 prices. Additionally, as noted in Staff's Closing Brief, the New York Times survey is not industry
15 specific and the American Water Works Association survey does not address regional differences.⁶⁰

16 The Company's comparison of operating costs to other Arizona utilities also does not provide
17 adequate support for the Company's claimed affiliate non-dedicated employee costs because, (1) "the
18 comparison includes utilities that vary in size from the Company"⁶¹, and (2) "several of the
19 companies illustrated have no salary information, and the cost at issue relates specifically to salaries,
20 not to operating costs in general."⁶²

21 The Company also states that Staff's recommendation to deny recovery of non-dedicated,
22 unsubstantiated, affiliate salaries "is contrary to law, and ill-advised as a matter of logic."⁶³
23 However, it is the Company that has not kept its records in accordance with Arizona law and
24

25 ⁵⁷ Company Opening Brief at 20:11-25:13.

26 ⁵⁸ Tr. at 320:5-20 and 364:8-365:2.

27 ⁵⁹ Exhibit A-14 at 7:14-8:14.

28 ⁶⁰ Ex. S-9, Surrebuttal Testimony of Jeffrey M. Michlik at 7:1-12; Ex. A-14, Rebuttal Testimony of Marian Homiak at 7:20-23.

⁶¹ Ex. S-9, Surrebuttal Testimony of Jeffrey M. Michlik at 7:20.

⁶² Ex. S-9, Surrebuttal Testimony of Jeffrey M. Michlik at 7:21-22.

⁶³ Company Opening Brief at 25:12-13.

1 NARUC accounting standards which does not permit allocation based upon estimates or in an
2 arbitrary fashion.⁶⁴ Thus by its own admission that “it made a mistake of not keeping time sheets”
3 the Company has failed to meet its burden to prove the accuracy of its claimed costs for non-
4 dedicated affiliate employee salary costs.

5 The Commission has a duty to establish just and reasonable rates not only for utilities
6 operating in Arizona but also for its captive ratepayers.⁶⁵ The Company did not utilize a competitive
7 bidding process prior to contracting with the affiliate Management Company. Without (1) a bidding
8 process to ensure reasonable costs, and (2) detailed invoices describing the work actually provided by
9 the non-dedicated affiliate employees, the Commission has a duty to protect ratepayers from
10 potentially increased costs charged by non-regulated affiliate companies such as the Management
11 Company. Here it would be unjust to allow the Company to recover unsubstantiated, affiliate, non-
12 dedicated employee salary cost estimates from its captive ratepayers. The Company has failed to
13 keep maintain records of its affiliate non-dedicated employee salaries in accordance with NARUC
14 standards and Commission regulations, and failed to provide adequate support for such salary costs.

15 **V. SAHUARITA’S PROPOSED THREE YEAR AMORTIZATION OF RATE CASE**
16 **EXPENSE IS NOT REASONABLE GIVEN THE COMPANY’S HISTORY.**

17 The Company’s claim that “normalization” would deny Sahuarita full recovery of the rate
18 case expense associated with the instant proceeding is flawed. Rate case expense is an operating
19 expense that is included in rates at a “normal” level for the test year. Just as with any other
20 “normalized” expense, it would be reassessed in a subsequent rate filing to reflect the normal amount
21 in rates. Contrary to what the Company is asserting it is not a regulatory asset that is recovered over
22 a specified time period. Since the Company does not have a track record of filing rate applications at
23 regular intervals, let alone any track record, Staff believes that an amount that assumes a 5-year
24 period between rate filings is appropriate in this case. While the Company did provide guesstimates
25 and speculation regarding future capital expenditures and operating expenses it has already incurred
26 or will be incurring, it did not provide any particularized evidence for Staff’s consideration prior to

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28 ⁶⁴ National Association of Regulatory Utility Commissioners, Uniform System of Accounts for Class B Water
Utilities, Accounting Instructions, page 16.

⁶⁵ Arizona Constitution, Article 15, Section 3.

1 the hearing. Further Staff does not believe that the anecdotal testimony provided by the Company
2 justifies the Commission adopting a shorter 3 year time period. The risk of adopting this shorter time
3 period is that Sahuarita may not file another rate application within 3 years, and could therefore over
4 recover its rate case expense. Staff therefore continues to recommend \$45,000 (\$225,000/5) as a
5 normalized amount of rate case expense based on its reasonable estimation of a 5-year interval
6 between rate filings.

7 **VI. STAFF'S RECOMMENDED 9.2 PERCENT OVER ALL RATE OF RETURN AND**
8 **10.3 PERCENT COST OF EQUITY ARE REASONABLE AND ALLOW THE**
9 **COMPANY TO RECOVER ITS COSTS.**

9 The Company should not be granted a higher cost of capital if Well No. 23 is not included in
10 rate base. The Company should only be allowed to earn a return on its investments in plant necessary
11 (or used and useful) to serve its test year customers and reasonable growth.⁶⁶ Furthermore, "The
12 return should be reasonably sufficient to assure confidence in the financial soundness of the utility
13 and should be adequate, *under efficient and economical management*, to maintain and support its
14 credit and enable it to raise the money necessary for the proper discharge of its public duties."⁶⁷

15 As explained by the Arizona Supreme Court:

16 The amount of capital invested is immaterial. Under the law of fair value, a
17 utility is not entitled to a fair return on its investment; it is entitled to a fair return
18 on the fair value of its properties devoted to the public use, no more and no less.⁶⁸

19 Furthermore, as noted in the Black Mountain Sewer Corporation Commission Decision No. 69164,
20 "In determining just and reasonable rates, the Commission has broad discretion subject to the
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22
23

24 ⁶⁶ *Arizona Corp. Commission v. Arizona Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415 (Ariz.1959); cited by
25 *City of Tucson v. Citizens Utilities Water Company*, 17 Ariz. App. 477, 482, 498 P.2d 551, 556 (Ariz. App.
26 1972); *Bluefield Waterworks & Imp. Co. v. Public Service Commission of W. Va.* 262 U.S. 679, 692-693, 43
27 S.Ct. 675, 679 (U.S.1923)(holding that A public utility is entitled to such rates as will permit it to earn a return
28 on the value of the property which it employs for the convenience of the public); Ex. S-1, Direct Testimony of
Marlin Scott, Jr. at Exhibit MSJ at 2; Ex. S-2 at 2:10-4:6.

⁶⁷ *Bluefield Waterworks & Imp. Co. v. Public Service Commission of W. Va.*, 262 U.S. 679, 692-693, 43 S.Ct. 675,
679 (U.S.1923)(emphasis added).

⁶⁸ *Arizona Corp. Commission v. Arizona Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415 (Ariz.1959); cited by
City of Tucson v. Citizens Utilities Water Company, 17 Ariz. App. 477, 482, 498 P.2d 551, 556 (Ariz. App.
1972).

1 obligation to ascertain the fair value of the utility's property, and establishing rates that 'meet the
2 overall operating costs of the utility and produce a reasonable rate of return.'"⁶⁹

3 Citing to the *Hope* and *Bluefield* decisions the Company argues that, "Commission adoption
4 of Commission Staff's cost of capital, income tax and Well #23 recommendations would deny to
5 SWC the ability to adequately service that capital already committed to the provision of water utility
6 service to SWC's customers."⁷⁰ However, the Company is not entitled to earn a return on
7 investments in plant that are not used and useful. Well no. 23 is not used and useful, thus the
8 Company should not earn a return on this item. Furthermore, the Company's decision to invest in a
9 well that is not needed at this time is not "efficient and economical management" as contemplated in
10 the *Bluefield*'s statement regarding utility returns. Therefore, *Bluefield* does not require that the
11 Company be allowed to earn a return on unnecessary plant items such as Well No. 23.

12 Likewise, as a non-taxable business entity, taxes are not a cost that the Company should
13 recover from its customers. Following Staff's recommendation to deny the Company's requested
14 income tax adjustment does not increase the Company's cost of equity. As noted in Staff's Closing
15 Brief, the Company's status as an LLC means that it is not subject to the 'double taxation' of C
16 corporations and is thus actually less risky than a C corporation or other taxable entity.⁷¹ The
17 Company should not be granted a higher cost of equity if the Commission denies the non-taxable
18 Company an adjustment to allow for recovery of its members personal income tax liability.

19 Staff recommends that the Commission adopt its well supported and well reasoned overall
20 rate of return of 9.2 percent based on Staff's recommended 10.3 percent cost of equity and 4.2
21 percent cost of debt.

22 **VII. STAFF RECOMMENDS ADOPTION OF THE CAGR D ADJUSTOR, BUT ONLY IF**
23 **THE COMMISSION ADOPTS ALL OF STAFF'S CONDITIONS.**

24 Staff continues to recommend approval of the Company's proposed adjustor mechanism for
25 recovery of the CAGR D fees, but only if the Commission approves all of Staff's recommended
26 conditions, as modified in Staff's Closing Brief. It appears that only Condition 8 is in dispute

27 ⁶⁹ quoting *Scates, et al. v. Arizona Corp. Comm'n*, 118 Ariz. 532, 534, 578 P.2d 612 (Ariz. App. 1978).

28 ⁷⁰ Company Opening Brief at 30:25-31:2.

⁷¹ Tr. at 474:2-22, 479:19-22, 484:21-24, and 485:4-6.

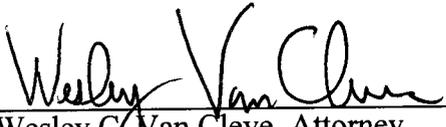
1 between the Company and Staff. Condition 8, as recommended by Staff, is necessary in the event the
2 CAGRD changes its current method of assessing fees.

3 The Company's concern seems to be that there could be a gap between when the Company is
4 required to cease collecting fees from its customers, due to a change in methodology by the CAGRD,
5 and when it would be able to resume collecting fees under the new methodology.⁷² The Company by
6 its own admission acknowledges that it is unlikely that the CAGRD would suddenly change the way
7 it assesses fees.⁷³ The Company would therefore have ample time to make a filing with the
8 Commission for the approval of a new adjustor fee that reflects the CAGRD's changed methodology.
9 In the unlikely event that the CAGRD does make an abrupt change to its current method for
10 calculating and assessing fees, Staff would work with the Company. It is important to Staff that these
11 conditions be standardized among Companies that are seeking an adjustor mechanism to recover
12 CAGRD fees. As noted in Staff's Closing Brief, the Commission recently approved an adjustor
13 mechanism with these same conditions. Staff does not believe that the Company in this case has
14 offered any evidence that warrants deviating from Staff's conditions.

15 **VIII. CONCLUSION.**

16 Staff respectfully requests that the Commission adopts its recommendations on the disputed
17 issues for the reasons stated above, in its Closing Brief, and the testimony Staff provided in this case.

18 RESPECTFULLY SUBMITTED this 30th day of September, 2010.

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28 ⁷² Ex. A-10 at 3.

⁷³ Tr. at 321.

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3 **30th day of September, 2010, with:**

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