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BEFORE THE ARIZONA CORPORATION COMMISSION

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ARIZONA CORPORATION COMMISSION
DOCKET CONTROL

Arizona Corporation Commission

DOCKETED

JAN 7 2011

DOCKETED BY

IN THE MATTER OF THE APPLICATION OF
SUNRISE 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
BASED THEREON FOR UTILITY SERVICE

DOCKET NO. W-02069A-08-0406

**APPLICATION ASKING THE
COMMISSION TO AMEND
DECISION NO. 71445**

1 Pursuant to A.R.S. § 40-252, Sunrise Water Company (“Sunrise”) hereby asks the
2 Arizona Corporation Commission (“Commission”) to amend Decision No. 71445 entered
3 December 23, 2009 (the “Decision”), so as to allow Sunrise to recover income-tax expense as
4 part of its cost of service.

5 Sunrise understands that the Commission intends to use a workshop process to consider
6 the appropriate methodology for S-Corporations and LLCs to recover income-tax expenses on a
7 going-forward basis. Sunrise welcomes this process. However, because of the Decision Sunrise
8 has been unable to recover income-tax expenses—a legitimate, verifiable cost of service—for
9 over a year. It would be unjust to require Sunrise to wait until the end of a workshop process,
10 one that will consider many other issues, before it can begin to recover income-tax expenses.

11 There is no way for Sunrise to make up for the lost revenue that it should have been
12 provided over the last year to recover its legitimate income-tax expense. By amending Decision
13 No. 71445, the Commission can at least halt any further unjust revenue loss.

14 **DISCUSSION**

15 The Decision disallowed income-tax expense for Sunrise. Continued disallowance of
16 income-tax expense for S-Corporations and LLCs would be poor public policy.

1 The Commission should not discriminate against S-Corps or LLCs by disallowing their
2 recovery of demonstrated income-tax expense, when it allows subsidiaries or operating divisions
3 of C-Corps to recover income-tax expense. The equities are identical. In each case, the
4 regulated entity is not the entity that pays the allowed income-tax expense; rather, the regulated
5 entity passes income-tax liability on to the ultimate taxpayer, who must make the required
6 income-tax payments.

7 In the case of either an S-Corp or a C-Corp that is part of a holding company (as most are
8 in this state), it is the ultimate shareholder that pays the taxes. The Commission does not
9 calculate the actual tax liability as part of a rate case. Rather, the Commission calculates
10 hypothetical tax liability as if the entity were a stand-alone company. There is no justifiable
11 reason that the Commission should allow APS, Southwest Gas, Arizona-American Water, or
12 Tucson Electric to recover hypothetical tax expense and to deny Sunrise such recovery.

13 As recognized by many other courts and commissions, income-tax expense is a genuine
14 cost of doing business as a regulated utility. The Commission came to this same conclusion in
15 the 1997 case of Camp Verde Water System, Inc., Decision No. 60105, dated March 19, 1997.
16 In this case the Commission allowed recovery of income-tax expense by an S-Corp, where the
17 bank would not loan funds if income-tax expenses were not allowed.

18 The Camp Verde case highlights the economic reality that S-Corps have real income tax
19 expenses. Because the bank's investment would only be repaid with after-tax dollars, it insisted
20 on recovery of income-tax expense in rates. The Commission acknowledged economic reality
21 and allowed Camp Verde to recover expected income-tax expense.

22 Put another way, only the funds left over after paying taxes and other business expenses
23 are available to fund additional plant investment. If income-tax expense were not recoverable,
24 the effect would be to reduce the allowed return on equity and diminish the funds available for
25 plant investment.

26 As the Commission is well aware, small water companies, many of which are LLCs or S-
27 Corps, are struggling to raise the funds they require to invest in new infrastructure. Disallowing

1 legitimate expenses, such as income-taxes, only reduces the amount of funds these companies
2 would have available for new investments.

3 The record shows that Mr. Campbell, Sunrise's shareholder, did pay income taxes on
4 Sunrise's test-year taxable income.

5 Mr. Campbell paid income taxes on Sunrise's test year taxable income of
6 \$258,646 at a combined federal and state marginal rate of 32.5% and an overall
7 effective rate of 23.0%.¹

8 Many LLCs and Subchapter S corporations have *de minimus* or even negative rate bases
9 for ratemaking purposes. For these entities with inadequate rate bases, the Commission typically
10 sets rates so as to provide at least a 10-percent operating margin. At the other extreme, larger
11 entities, which are almost always Subchapter C-corporations, have rates set using traditional rate-
12 of-return ratemaking, including recovery of income-tax expense. The Decision places Sunrise in
13 a gray area between the operating-margin and rate-of-return ratemaking (with income-tax
14 recovery) methodologies. The result is that Sunrise is being treated worse than it would be under
15 either of the Commission's traditional ratemaking methodologies.

16 Unlike many other Arizona water-utility investors, Mr. Campbell has provided Sunrise
17 the funds needed to invest in water infrastructure, including construction of facilities to address
18 arsenic levels above the Federal drinking water standards. As a result, Sunrise has a substantial
19 rate base and, although it was under-earning, it was able to generate verifiable taxable income in
20 the test-year. Yet, the Decision would provide Sunrise an operating margin of just 7.43 percent,
21 much worse than the minimum 10-percent operating margin provided for utilities even with
22 negative rate bases and no taxable income in the test year.²

23 **REQUESTED RELIEF**

24 Sunrise asks the Commission to amend Decision No. 71445 entered December 23, 2009
25 so as to allow Sunrise to recover income-tax expense as part of its cost of service. Exhibit A is a

¹ Ex. A-15 at 16:18-20.

² Operating Margin = Operating Income/Revenue Requirement, or $\$104,020 \div \$1,399,237 = 7.43\%$. See Decision at 40:20-23.

1 proposed amendment to that effect. Exhibit A is based on Chairman Pierce's proposed Open
2 Meeting Amendment No. 1.

3 RESPECTFULLY SUBMITTED on January 7, 2011.
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6

7 *Craig A. Marks by Marvin Collins*
8 Craig A. Marks
9 Craig A. Marks, PLC
10 10645 N. Tatum Blvd
11 Suite 200-676
12 Phoenix, Arizona 85028
13 (480) 367-1956
14 Craig.Marks@azbar.org
15 Attorney for Sunrise Water Company

Original and 13 copies **filed**
on January 7, 2011, with:

Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Copies of the foregoing **delivered** on
January 7, 2011, to:

Wesley C. Van Cleve
Attorney, Legal Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Steve Olea
Director; Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Sarah N. Harping
Administrative Law Judge
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

By:

Marvin Collins
Marvin Collins

**REQUESTED AMENDMENT
TO DECISION NO. 71445**

Page 32, Line 2,

DELETE last sentence of paragraph 81.

Page 36, Line 9,

DELETE paragraph 88 and REPLACE with the following paragraphs:

88. In this case, the Commission is faced with the issue of whether a Class A or B water utility, which is also an S corporation, should be allowed to recover income-tax expense.¹ On balance we are persuaded that, based on the facts of this case, Sunrise should be allowed to recover this expense and that its revenue requirement should be grossed up for the effect of income taxes. It is true that Sunrise does not directly pay income taxes, but this is equally true, for example, for Arizona Public Service Company (corporate subsidiary) and for Arizona-American Water Company's Sun City Water Division (operating division). In each case, income-tax liability is passed on to the ultimate owner for payment. Further, Sunrise has demonstrated that it generated income-tax liability in the test year and that Mr. Campbell was responsible for the resulting income taxes.² Finally, Sunrise has a positive rate base that is sufficient for traditional ratemaking, as long as income-tax expense is recognized.³ Given these circumstances, it is appropriate for Sunrise to recover income-tax expense and to gross up its revenue requirement for the effect of income taxes.

89. We will approve Sunrise's alternate methodology for computing income-tax expense. This method assumes that the S corporation had just one shareholder (which it does), who filed a return as married filing jointly and derived all of his or her income from the regulated utility. The results is a lower income-tax expense than if we computed the taxes as if Sunrise were a stand-alone taxable entity. In addition, as proposed by Sunrise and recommended by

¹ The *Camp Verde* case appears to have involved a Class C utility.

² Ex. A-15 at 16:18-20.

³ Absent recovery of income-tax expense, this order would only provide Sunrise an operating margin of 7.43%, which is substantially less than that provided for water utilities with minimal or negative rate bases.

**REQUESTED AMENDMENT
TO DECISION NO. 71445**

Staff, we will allow recovery of accumulated deferred income tax (“ADIT”) as an addition to rate base. However, we will calculate ADIT using the combined federal and state effective tax rate of 30.0791% from Sunrise’s alternate methodology, rather than the corporate tax rate recommend by Sunrise and Staff. This results in the addition of \$99,891 in ADIT rather than the \$143,632 proposed by Sunrise and Staff. The resulting income-tax expense is \$49,045

RENUMBER subsequent paragraphs.

Page 38, Line 21,

DELETE last sentence of existing Paragraph 91.

Page 40, Line 9,

DELETE first sentence of existing paragraph 98 and REPLACE with the following sentence:

We find the Sunrise’s OCRB is \$1,140,093, calculated by modifying Staff’s recommended OCRB of \$1,183,834 to exclude \$43,741 in ADIT.⁴

Page 40, line 12,

DELETE the last sentence of paragraph 98 and REPLACE with the following sentence:

Thus, we find that Sunrise’s FVRB is equivalent to its OCRB of \$1,140,093.

Page 40, Lines 20 through 22,

DELETE first sentence of existing paragraph 101 and REPLACE with the following sentence:

⁴ \$43,741 is the difference between \$143,632 in ADIT recommended by Staff and \$99,891 allowed herein.

**REQUESTED AMENDMENT
TO DECISION NO. 71445**

Based on the adjustments made herein, we find that Sunrise should be permitted to recover operating income of \$114,009 and total operating expenses of \$1,344,262, for an overall revenue requirement of \$1,458,272.

Page 40, line 27,

DELETE paragraph 102 and REPLACE with the following paragraph:

We find that it is appropriate to adopt Staff's recommended monthly usage charges and Staff's recommended commodity rate tier break-over points. However the overall revenue requirement established herein necessitates commodity rates higher than those recommended by Staff. With the rates adopted herein, the monthly bill for a customer served by a ¾" meter with average consumption will be increased from \$62.68 to \$64.09, representing an increase of \$1.41, or approximately 2.25 percent over current rates.

Page 43, line 15-16

Change the date from January 1, 2010, to February 1, 2011.

Page 44, Lines 9 through 21,

In each place in which the figures appear:

REPLACE "\$1.75" with "\$1.83"

REPLACE "\$2.50" with "\$2.66"

REPLACE "\$3.15" with "\$3.31"

Make all other conforming changes