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BEFORE THE ARIZONA CORPORATION COMMISSION

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**COMMISSIONERS**

GARY PIERCE, Chairman  
BOB STUMP  
SANDRA D. KENNEDY  
PAUL NEWMAN  
BRENDA BURNS

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

**STAFF'S RESPONSE TO  
PETITION TO AMEND**

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") files its response to the Petition to Amend Decision No. 71854 ("Petition") filed by Johnson Utilities, LLC ("Johnson" or "Company") on February 28, 2011. With the exception of Johnson's request to change the late fee for its sewer customers, Staff urges this Commission to deny Johnson's Petition. Staff would further urge that the proper way to address the Company's concerns would be in the Company's next rate case.

**I. THE SETTING OF JUST AND REASONABLE RATES.**

**A. The Commission's Constitutional Authority.**

Article 15, Section 3, of the Arizona Constitution provides, in relevant part, that the Commission "shall have full power to, and shall, prescribe just and reasonable classifications to be used and just and reasonable rates and charges to be made and collected by public service corporations within the State for service rendered therein." In determining just and reasonable rates, the Commission has broad discretion, subject to the obligation to ascertain the fair value of the utility's property and to establish rates that "meet the overall operating costs of the utility and produce a reasonable rate of return."<sup>1</sup> Under the Arizona Constitution, a utility company is entitled to a fair rate of return on the fair value of its properties, "no more and no less."<sup>2</sup> Arizona law does not

<sup>1</sup> *Scates, et al. v. Arizona Corp. Comm'n*, 118 Ariz. 531, 534, 578 P.2d 612 (App. 1978).

<sup>2</sup> *Litchfield Park Service Co. v. Arizona Corp. Comm'n*, 178 Ariz.45 I, 434, 854 P.2d 988 (App. 1994) (citing *Arizona Corp. Comm'n v. Citizens Utilities Co.*, 120 Ariz. 184 (App. 1978)).

1 mandate that the Commission (1) follow a particular method in its rate making determinations or (2)  
2 exclude consideration of relevant factors.<sup>3</sup>

3 The Commission not only sets just and reasonable rates for public service corporations, but  
4 also sets rates to protect ratepayers from overreaching by those very corporations.<sup>4</sup> It is the second  
5 prong, the protection of ratepayer interest that appears to be lost on Johnson. The Company's  
6 singular focus is its rights as a utility, neglecting to factor in the rights of its captive ratepayers. "The  
7 jurisprudence of our state made it plain long ago that the interests of the public service corporation  
8 stockholders must not be permitted to overshadow those of the public served."<sup>5</sup> The Company's  
9 arguments are no more than an attempt to undermine the Commission's responsibility of balancing of  
10 customer and utility interests at the expense of ratepayers. Protecting ratepayers, however, is part of  
11 the balancing in the public interest performed by the Commission.

12 **B. Decision No. 71854 is supported by the evidence.**

13 Contrary to the assertions of the Company, the record in this matter is replete with evidence to  
14 support the Commission's Decision. A decision supported by substantial evidence is not arbitrary,  
15 illegal, capricious, or an abuse of discretion and is thus valid.<sup>6</sup>

16 The Company appears to assert that the Commission may only consider the evidence  
17 presented by the parties as well as the authorities and precedent supporting the parties' position.<sup>7</sup>  
18 This is a narrow and strained view of the Commission's plenary rate making authority. The  
19 Commission may exercise its own independent judgment and expertise in the setting of rates.<sup>8</sup> The  
20 Commission considered a complete record including exhibits, testimony, and a transcript of all the  
21 proceedings. The Commission also exercised its judgment and expertise in crafting a Decision that

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23 <sup>3</sup> *Simms v. Round Valley Light & Power Company*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956).

24 <sup>4</sup> *Scates v. Arizona Corp. Comm'n*, 188 Ariz. 531, 534, 578 P.2d 612 (App. 1978).

25 <sup>5</sup> *Ariz. Community Action Ass'n v. Ariz. Corp. Comm'n*, 123 Ariz. 228, 231, 559 P.2d 184, 187(1979); *Ariz. Corp. Comm'n v. Woods*, 171 Ariz. 286, 296, 830 P.2d 807, 817 (1992) ("The Commission was not designed to protect public service corporations and their management, but rather, was established to protect our citizens from the results of speculation, mismanagement and the abuse of power.").

26 <sup>6</sup> *See Nutek Information Systems v. Arizona Corp. Comm'n*, 194 Ariz. 104, 107-08 ¶ 15, 977 P.2d 826, 829-30 (App. 1998); *Arizona Corp. Comm'n v. Citizens Utilities Company*, 120 Ariz. 184, 187, 584 P.2d 1175, 1178 (App. 1978); *Porter v. S.C. Pub. Serv. Comm'n*, 507 S.E.2d 328, 332 (S.C. 1998) (holding that "the possibility of drawing two inconsistent conclusions from the evidence does not prevent a court from concluding that substantial evidence supports an administrative agency's finding")

27 <sup>7</sup> Petition at 5.

28 <sup>8</sup> *See. Citizens*, 120 Ariz. 184, 190, 584 P.2d 1175, 1181 (1978).

1 balances the needs of the Company, protects the Company's ratepayers and comports with the  
2 requirements of the state Constitution. The Commission is the ultimate arbiter of the record  
3 presented and renders its decision accordingly. The Commission did so in this case.

4 **II. RESPONSE TO THE COMPANY'S REQUESTED AMENDMENTS.**

5 **A. Johnson requests to modify the \$40 late fee in the sewer tariff.**

6 Staff supports the Company's request to modify the \$40 late fee to be consistent with the  
7 water division late charge of 1.5 percent of the past due balance per month. However, if the  
8 Commission does not wish to re-open this case even for this limited reason, Staff would not object to  
9 leaving the \$40 late fee as is since the unintended consequence of this fee has been a substantial  
10 reduction in late sewer bill payments.

11 **B. The Commission should reject the Company's request to add \$10,892,391 back**  
12 **into rate base for inadequately supported plant.**

13 The Company continues to argue that the Staff reduction is arbitrary. According to Company  
14 witness Tompsett, the Company provided "contracts, invoices, cancelled checks and/or main  
15 extension agreements in support of all but \$885,064".<sup>9</sup> Despite the fact that the Company submitted  
16 voluminous documents (see generally Exhibit A-69), Staff's audit and analysis could not verify the  
17 Company's claims. The audit process was difficult and was compounded by the lack of timeliness of  
18 the response of the Company as well as the failure of the Company to keep its records in accordance  
19 with the National Association of Utility Commissioners ("NARUC") Uniform System of Accounts  
20 ("USOA") and Commission Rules.<sup>10</sup> The Commission's Decision is consistent with prior orders and  
21 is not arbitrary.

22 Staff's conclusion regarding the inadequacy of the Company's documentation is corroborated  
23 by a similar conclusion reached in the 2006 audit report prepared by Henry & Horne. The report  
24 stated:

25 Because of the inadequacy of accounting records for the years prior to 2006, we were  
26 unable to form an opinion regarding the amounts at which utility plant in service and  
27 accumulated depreciation are recorded in the accompanying balance sheet at

28 <sup>9</sup> Ex. A-5 at 12.

<sup>10</sup> Ex. S-38 at 13.

1 December 31, 2006, (stated at \$168,974,434 and \$8,930,075 respectively), or the  
2 amount of depreciation expense from the year then ended (stated at \$1,799,271).<sup>11</sup>

3 The Company continues to shift the focus away from its failure to comply with Commission  
4 rules and Commission decisions; by its constant reiteration that adequate documentation was  
5 provided. It was uncontroverted that the Company failed to keep its books and records in accordance  
6 with Commission rules<sup>12</sup> and in accordance with the NARUC Uniform System of Accounts.<sup>13</sup> The  
7 evidence was uncontroverted that Johnson failed to comply with the very Commission Decision that  
8 granted Johnson's certificate of convenience and necessity.<sup>14</sup>

9 While the Company continues to maintain that it provided Staff continually with documents  
10 to support its plant, it was not always timely. In a letter dated *April 21, 2009*, the Company  
11 supplemented its response to a Staff data request, a data request that *was issued in August 2008*. This  
12 information was provided a mere **two** days before the commencement of the hearing. It is  
13 unreasonable to require Staff to audit those records on the eve of trial. But despite the lateness of the  
14 responses Staff, nevertheless, attempted to review the provided documents.<sup>15</sup>

15 In its Petition, Johnson states that it retained Waterworks Engineers to prepare a replacement  
16 costs new ("RCN") and a replacement costs less depreciation ("RCND) Study. While RCN/RCND  
17 studies are helpful in determining plant values, such studies do not determine whether such plant was  
18 the subject of investment by a utility or whether such plant was paid for or installed by customers or  
19 developers. Plant that is contributed is plant that should not be placed into rate base and thus earn a  
20 return.

21 In a recent Commission decision regarding Arizona-American Water Company, a Class A  
22 utility, the Commission disallowed over \$2,015,170 in plant for inadequate documentation.<sup>16</sup>  
23 Arizona-American argued that it had engineering estimates for the plant and that the plant was  
24 providing service and that it would be punitive to exclude the estimated unsupported costs. The

25 <sup>11</sup> Ex. S-45 at 15.

26 <sup>12</sup> Arizona Administrative Code ("A.A.C.") § R14-2-610 D.1. This rule states in part: "Each utility shall keep general and  
27 auxiliary accounting records reflecting the *cost of its properties...* and all other accounting and statistical data *necessary*  
28 *to give complete and authentic information as to its properties...*" (emphasis added).

<sup>13</sup> NARUC USOA 13.

<sup>14</sup> Decision No. 60223 (May 27, 1997) at 14-15.

<sup>15</sup> Tr. 1713:22-25; 1714:1-7.

<sup>16</sup> Decision No. 71410 (December 8, 2009).

1 Commission disagreed with the Arizona-American arguments and adopted Staff's recommended  
2 disallowance, which was 100% for the plant is question.

3 Decision No. 71854 is in line with other Commission decisions on the inadequacy of  
4 documentation. The Company's request should be denied.

5 **C. Affiliate Profits were properly deducted.**

6 As the Company acknowledges,<sup>17</sup> the Commission has the authority to exclude affiliate profit  
7 from plant in service. The Commission rule governing affiliate transactions is A.A.C. R-14-2-801 *et*  
8 *seq.* A.A.C. R-14-2-804(A) provides:

9 A utility will not transact business with an affiliate unless the affiliate agrees to provide  
10 the Commission access to the books and records of the affiliate to the degree required to  
11 fully audit, examine or otherwise investigate transactions between the public utility and  
12 the affiliate. In connection therewith, the Commission may require production of books,  
13 records, accounts, memoranda and other documents related to these transactions.

14 This Commission, as well as other state commissions, has historically reviewed affiliate costs  
15 and profits with greater scrutiny than other utility costs.

16 In *U.S. West Communications v. Arizona Corp. Comm'n*, 185 Ariz. 277, 915 P.2d 1232 (App.  
17 1996), the Arizona Court of Appeals held that the "Commission has broad powers to scrutinize  
18 transactions between a regulated company and its unregulated affiliates" and disallow excessive  
19 costs.<sup>18</sup>

20 It is part of the duty and responsibility of a regulated utility to serve its public in a fair and  
21 equitable manner. A utility cannot overcharge customers or buy services from related entities at  
22 extravagant prices and expect its ratepayers to pay for it. A utility has an obligation to get the best  
23 price for services to customers. This includes the obligation not to promote profitability for the  
24 Company or another interested company in a transaction that may not be at arm's length to the  
25 detriment of its customers.

26 Staff could not determine whether the transactions between Johnson and its affiliates were at  
27 arm's length. Johnson had a number of affiliates that provided services to the utility. The Company  
28 indicated that for the years 1998-2003 construction of water and wastewater plant was done by an

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<sup>17</sup> Petition at 8.

<sup>18</sup> 185 Ariz. at 282, 915 P.2d at 1237 (citations omitted).

1 affiliate, Boulevard Contracting Company Inc.<sup>19</sup> The Company indicated that the owner was George  
2 Johnson. Records from the Commission's Corporation division indicated that Boulevard's date of  
3 incorporation was December 18, 1998 and list George Johnson as President and Chief Executive  
4 Officer, and Jana Johnson as secretary. Corporation division records also indicated that Boulevard  
5 has been administratively dissolved for failure to file its annual report.

6 The Company has identified Central Pinal Contracting, LLC ("CPC") as the entity that  
7 provided the construction work after 2003. According to records from the Commission's Corporation  
8 division, from 2003 to 2008, the manager of CPC was Atlas Southwest, Inc., and the member was  
9 Crisbar, LLC.<sup>20</sup> The Company indicated in response to a Staff data request, that Brian Tompsett was  
10 also an owner.<sup>21</sup> In April 2008, CPC's ownership changed. Currently the managers are Barbara A.  
11 Johnson and Christopher Johnson. The managers are the son and daughter of George Johnson. The  
12 member of CPC is the Roadrunner Trust, Barbara A. Johnson and Christopher Johnson, co-trustees.  
13 Because of this change in ownership, the Company maintains that CPC is no longer an affiliate and  
14 thus any transaction are not required to be reported pursuant to the Commission's affiliated interest  
15 rules.<sup>22</sup>

16 The Company indicated that the construction affiliates were not formed solely to provide  
17 services to the Company, but did not produce any other agreements with non-affiliated entities.<sup>23</sup>

18 The Company claims that it competitively bid its construction projects but did not retain those  
19 bids, so Staff could not conduct an audit. As Staff testified, fair competitive bids protect ratepayers  
20 from being charged too much for plant.<sup>24</sup> As the testimony shows, Mr. Tompsett was a part owner of  
21 CPC and at the same time an executive of the Company.<sup>25</sup> Although he indicates that he did not  
22 participate in the bidding and the review process of the bids, his role as an owner of the construction  
23 affiliate and an executive in the Company appear to be in conflict.

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26 <sup>19</sup> Ex. S-20.

<sup>20</sup> Ex. S-3; Ex. S-4.

27 <sup>21</sup> Ex. S-20.

<sup>22</sup> *Id.*; TR 857:2-9.

<sup>23</sup> Tr. 1207:1-7.

28 <sup>24</sup> Ex. S-38 at 12.

<sup>25</sup> The Company has informed Staff that Mr. Tompsett is no longer with Johnson Utilities.

1 The Company complains that the adjustment is overstated because Staff “improperly assumed  
2 that all plant recorded on the Company’s books was constructed by affiliates.”<sup>26</sup> The Company  
3 provided Staff with a copy of an external audit of its financial statements conducted by the public  
4 accounting firm of Henry & Horne. The audit was conducted in conjunction with the proposed sale of  
5 assets by Johnson to the Town of Florence.<sup>27</sup> Note 3 to the financial statements regarding related  
6 parties stated that the affiliate contracts to perform substantially all of the water and sewer system  
7 construction for the Company.<sup>28</sup> Further in Staff’s review of canceled checks and bank statements  
8 submitted by the Company in support of payments made for plant, Staff’s review noted payments to a  
9 Company affiliate.<sup>29</sup> The bank records did not indicate payments made to any other construction  
10 entity other than an affiliate. Staff selected the midpoint (7.5) of the range of 5% to 10% mark-up  
11 range found in the documentation provided to Staff by the Company.<sup>30</sup>

12 With respect to the wastewater division, the Company claims that it provided evidence and  
13 testimony that affiliate-constructed wastewater plant totaled only \$45,724,508.<sup>31</sup> However, Staff’s  
14 audit of the Company’s bank records was unable to verify this amount.<sup>32</sup>

15 **D. Unexpended Water Hook-up fees were properly deducted from Rate Base.**

16 Johnson’s method for collecting hook-up fees is not typical, which the Company even  
17 acknowledges.<sup>33</sup> Johnson collects hook-up fees well in advance of providing service to the customers  
18 for whom the hook-up fee is credited. Under a typical approach, a utility builds capacity in advance  
19 and then collects hook-up fees individually upon each new connection.<sup>34</sup>

20 Staff contends that the treatment accorded to funds contributed by others does not depend on  
21 whether the funds are unexpended. The characterization of hook-up fees ( or CIAC) does not hinge  
22 upon whether the fees are spent or unexpended but whether or not the funds were: (i) provided by  
23 someone other than the Company’s owner/investor; (ii) is non-refundable; and (iii) whether the

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25 <sup>26</sup> Company Closing Brief at 4; 15.

26 <sup>27</sup> Docket No.WS-02987A- 07-0203.

27 <sup>28</sup> Ex. S-45 at 14.

28 <sup>29</sup> *Id.* at 11.

29 <sup>30</sup> *Id.* at 13.

30 <sup>31</sup> Company Closing Brief at 17.

31 <sup>32</sup> Ex. S-45 at 12.

32 <sup>33</sup> Ex. A-2, Vol. II at 18.

33 <sup>34</sup> Ex. S-39 at 5.

1 purpose of the CIAC is to fund the plant. Further, the removal of unexpended CIAC from the CIAC  
2 account is inconsistent with the NARUC USOA.<sup>35</sup> NARUC USOA states the following regarding  
3 CIAC:

4 271. Contributions in Aid of Construction

5 A. This account shall include:

- 6 1. Any amount or item of money, services or property received by a utility  
7 from any person or governmental agency, any portion of which is  
8 provided at no cost to the utility, which represents an addition or  
9 transfer to the capital of the utility, and which is utilized to offset the  
acquisition, improvement or construction costs of the utility's property,  
facilities or equipment used to provide utility services to the public.

10 The unexpended CIAC are funds that can be used by the Company, thus the Company's rate  
11 base should be reduced by the CIAC.<sup>36</sup> Reducing rate base by CIAC preserves the ratemaking  
12 balance and removes the possibility of the Company earning an excess.

13 The Company argues that the Staff recommendation would create a mismatch and that  
14 existing customers receive a windfall.<sup>37</sup> It is precisely the non-typical method that the Company uses  
15 to collect hook-up fees that has created the balances of the magnitude that are seen in the instant case.

16 The Commission has addressed the issue of unexpended advances in Decision No. 70011 and  
17 Decision No. 70360.<sup>38</sup> In both those cases, the utilities contended that it would be unfair to exclude  
18 advances from rate base if plant associated with the advance was not in service during the test year.  
19 The Commission rejected the utilities' arguments. The Company has not advanced any compelling  
20 argument to warrant a departure from normal rate-making treatment.

21 **E. The Hook-up Fee was properly discontinued.**

22 Because of the magnitude of the CIAC balances, Staff recommends that the hook-up fee be  
23 discontinued. Staff found that there was little equity in the Company's capital structure. While Staff  
24 is supportive of the use of hook-up fees, there should be a balance between the amount of equity the  
25 Company is investing in plant and what customers are investing in plant through hook-up fees.<sup>39</sup> The

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27 <sup>35</sup> Ex. S-38 at 18.

<sup>36</sup> *Id.* at 18-19.

28 <sup>37</sup> Ex. A-2, Vol III at 21-22.

<sup>38</sup> UNS Gas, Docket No. G-04204A-06-0463; UNS Electric, Docket No. E-04204A-06-0783.

<sup>39</sup> Ex. S-38 at 35.

1 Decision properly discontinued its use. There is nothing to preclude the Company from seeking a  
2 hook-up fee tariff at a later date or from requesting one in its next rate case.

3 **F. The Company's request of a rate of return should be rejected.**

4 The Company has requested a rate of return in the range of 8.18% to 11.89%. Staff did not  
5 recommend a rate of return because the Company, under Staff's recommendation, had a negative rate  
6 base for both water and sewer; Staff set rates based on an operating margin.

7 To determine the cost of capital, the Commission must first determine the appropriate capital  
8 structure, i.e., the ratio of debt and equity which finances the company's investments.<sup>40</sup>

9 The Commission has discretion in determining a utility's capital structure.<sup>41</sup> Once the  
10 appropriate capital structure for rate-making purposes is ascertained, the costs of each component  
11 must be determined.<sup>42</sup> The cost of debt is usually readily determined, as it generally reflects the  
12 prevailing market interest rate.<sup>43</sup> The determination of the cost of equity is more difficult; this  
13 determination involves the judgment of the Commission in determining the appropriate cost of equity  
14 capital.<sup>44</sup>

15 Ratepayers benefit from financially sound utilities. However, ratepayers can also be  
16 unnecessarily burdened when a capital structure is too equity rich for setting just and reasonable  
17 rates.

18 The Company's capital structure is heavily laden with equity (2.79% long-term debt and  
19 97.21 percent equity). RUCO recommended that the Commission impute a hypothetical capital  
20 structure composed of 40 percent long term debt and 60 percent equity.<sup>45</sup> Should the Commission  
21 grant the Company's request, Staff would urge the adoption of a hypothetical capital structure as  
22 proposed by RUCO. However, the Decision was correct and the Company's request should be  
23 rejected.

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25  
26 <sup>40</sup> *Litchfield Park* 178 Ariz. at 434-35, 874 P.2d at 991-92.

27 <sup>41</sup> *See Citizens* 120 Ariz. at 190, 584 P.2d at 1181; *Litchfield Park*. 178 Ariz. at 435, 874 P.2d at 992.

28 <sup>42</sup> *Litchfield Park* 178 Ariz. at 435, 874 P.2d at 992.

<sup>43</sup> *Id.*

<sup>44</sup> *Litchfield Park* 178 Ariz. at 435, 874 P.2d at 992, citing *Sun City Water Company*, 26 Ariz. App. at 309, 547 P.2d at 1109.

<sup>45</sup> Ex. R-9 at 3.

1           **G. Post Test Year Plant for the Wastewater Division was properly excluded.**

2           As the Company notes in its Petition, it “discovered” that \$2,201,386 (Hunt Highway) of  
3 plant originally classified at post test year plant and booked to plant in 2008 was actually placed into  
4 service in 2007. That this plant was “discovered” at the time of the Company’s filing of its rebuttal  
5 testimony, almost one year from the filing of its application and supports the Staff’s position that the  
6 Company failed to keep its books and records properly, which also lends further support to Staff’s  
7 recommended disallowance. The Company also seeks to include in rate base \$1,021,076 of post-test  
8 year plant for the Parks Lift Station and the Queen Creek Leach Field project.

9           Commission rules require the end of the test year, which is the one-year historical period used  
10 in determining rate base, operating income and rate of return, to be the most recent practical date  
11 available prior to the filing.<sup>46</sup> Compliance with Commission rules and recognition of Commission  
12 policy on appropriate test year selection requires a utility to choose a test year that includes all major  
13 rate base and operating income items needed to support its rate application, and to include pro forma  
14 adjustments to its chosen test year that are consistent with past Commission action under similar  
15 circumstances.

16           While the Commission has allowed the inclusion of post-test-year plant in rate base, Staff has  
17 traditionally recognized two such scenarios: (1) when the magnitude of the investment relative to the  
18 utilities total investment is such that not including the post-test-year plant in the cost of service would  
19 jeopardize the utility’s financial health, and (2) when conditions such as the following exist: (a) the  
20 cost of the post-test-year plant is significant and substantial, (b) the net impact on revenue and  
21 expenses for the post-test-year plant is known and insignificant or is revenue-neutral, and (c) the  
22 post-test-year plant is prudent and necessary for the provision of services and reflects appropriate,  
23 efficient, effective, and timely decision-making.<sup>47</sup> It is the Company’s burden to show that the post-  
24 test-year plant is revenue neutral. The Company failed to meet this burden.

25           The Company, contrary to its assertions in its Petition, provided no credible evidence, other  
26 than conclusory statements that the Park Lift Station was necessary to resolve “potential problems”.<sup>48</sup>

27 \_\_\_\_\_  
28 <sup>46</sup> See A.A.C. R14-2-103(A)(3)(p).

<sup>47</sup> Ex. S-44 at 9.

<sup>48</sup> Ex. A-5 at 34.

1 Further, the Company did not provide any evidence that the additions were revenue neutral. It  
2 is the Company's burden to show that the post-test-year plant will not add to revenues.

3 The Company, in its Petition, cites to several past Commission decisions in support of its  
4 position to include post-test-year plant, all of which are distinguishable from this case.

5 **H. The Decision properly excluded income tax expense.**

6 The Company is seeking recovery of \$1,185,679 as income tax expense and continues to  
7 argue that it should be allowed to recover income tax expense even though it is organized as a limited  
8 liability company and does not pay income tax. The following exchange between RUCO's attorney  
9 and Company witness Thomas Bourassa illustrates the position of the Company:

10 Q. (Mr. Pozefsky): Would it be fair to say, Mr. Bourassa that the company is asking to  
11 recover income tax that the company itself did not pay to the State or to the IRS?

12 A. (Mr. Bourassa): You are making a technical distinction.

13 Q. What's the answer?

14 A. The answer is no. The LLC or the partnership doesn't pay the taxes directly on their  
15 returns.<sup>49</sup>

16 While the Company claims it is a "technical" distinction, the Company is asking for recovery  
17 of taxes that it does not pay, and it admits that it does not pay taxes. Further the Company elected a  
18 form of business to take advantage of the benefits of being an LLC, such as the avoidance of double  
19 taxation that exists for C-corporations.<sup>50</sup> Johnson elected to organize itself as an LLC, which is a  
20 pass-through entity for purposes of income tax liability.

21 Notwithstanding Johnson's status as a tax pass-through entity, the Company also claims that  
22 Staff's proposed treatment is somehow unfair, and continues to compare itself to a C-corporation  
23 subsidiary of a holding company. The Company argues that its situation is analogous to a subsidiary  
24 C-Corp utility of a parent holding company whose tax return is consolidated with the parent.<sup>51</sup> But  
25 what the Company fails to acknowledge is that, in that scenario there is usually evidence of the tax  
26 rate. There is no such evidence in this case. The Company failed to provide any evidence regarding  
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28 <sup>49</sup> Tr. 1357.

<sup>50</sup> Tr. 1350:3-24.

<sup>51</sup> Company Closing Brief at 32.

1 the tax rates of its members or that its members even paid any taxes. Further, Mr. Bourassa testified  
2 that the basis for the Company's request is an agreement between Johnson and its members to  
3 reimburse for the tax liability.<sup>52</sup> The ratepayers are not parties to such an agreement. Staff was not  
4 provided a copy of this agreement to verify the nature of the arrangement.

5 In support of its position, the Company in its closing brief cites decisions from several  
6 jurisdictions which indicate a split; some jurisdictions allow income tax expense for pass-through  
7 entities and others do not.<sup>53</sup> For example, in *Re Shoreham Telephone Company Inc*, 2004 WL  
8 2791514 (Vt.P.S.B.), the Vermont Public Services Board denied recovery, stating:

9 We recognize that Shoreham's owners as individuals, and like many other investors,  
10 will pay income tax on earnings and distributions from the Company. Under federal  
11 and state tax law, these sources of income are taxed at the owners' personal income tax  
12 rate. This is a direct corollary of Shoreham's internal decision to choose a Subchapter  
13 S corporate form and enjoy its attendant benefits. These tax obligations are not,  
14 however, expenses that Shoreham (as an incorporated entity) itself must pay. In  
15 essence they are an additional form of compensation to investors (who also happen to  
16 be employees). In some future case Shoreham might (or might not) be able to justify  
such payments as a form of employee compensation, or as a necessary payment for  
capital. However, in this case Shoreham claimed compensation for these costs as  
income taxes, which they are not. Thus, they cannot be included among the  
Company's recognized costs of service.

17 Contrast this Vermont decision to one from Wisconsin. In *Re CenturyTel of Midwest-Kendall,*  
18 *Inc*, 2001 WL 1744202 (Wis.P.S.C.), the Wisconsin Public Service Commission allowed recovery.  
19 Century Tel-Kendall was an LLC that had previously been a corporation and was now requesting  
20 income taxes as part of its revenue requirement. Century Tel-Kendall paid taxes to its ultimate parent,  
21 and the parent filed a consolidated return for all of its affiliates and subsidiary. The Wisconsin Public  
22 Service Commission found that there was evidence in the record of the corporate tax rate and  
23 acknowledged that the operations of Century Tel-Kendall generated taxable income and thus allowed  
24 recovery. In the instant case, Johnson is not a subsidiary of a parent who files consolidated returns.

25 To bolster its argument regarding the allowance of income tax expense the Company cites  
26 *ExxonMobil Oil Corp. v. Federal Energy Regulatory Comm'n* 487 F.3d 945, 376 U.S.App.D.C. 259  
27 (D.C. Cir. 2007), as support for the allowance of income tax recovery for pass-through entities.

28 <sup>52</sup> Tr. 1352:16-21.

<sup>53</sup> Company Closing Brief at 34.

1 However, its reliance on *ExxonMobil*<sup>54</sup> is misplaced and is distinguishable from the instant case. The  
2 decision by FERC to allow recovery of income tax expense did not come easy and FERC's process of  
3 developing an allowance policy has a "tortuous history".<sup>55</sup> FERC determined that it would permit an  
4 income tax allowance for all entities or individuals owning public utility assets provided that an entity  
5 or individual has an actual or potential income tax liability to be paid on that income from those  
6 assets.<sup>56</sup> In the instant case, there is no record of tax liability of the members of Johnson. The  
7 potential for tax liability is negated by the agreement for reimbursement between the Company and  
8 its members.

9 The Commission is the body empowered by the Constitution and by the people to regulate  
10 public service corporations.<sup>57</sup> As such, the Commission, in the exercise of its ratemaking authority  
11 has the power to disallow the recovery of income tax expense for pass-through entities. The Arizona  
12 Court of Appeals, in the *Consolidated Water Utilities v. Ariz. Corp. Comm'n* case made it clear that it  
13 is within the discretion of the Commission allow or disallow income tax expense.<sup>58</sup> There, the Court  
14 held that "the decision to allow or disallow . . . tax expense is to be made by the Commission, and not  
15 the Courts."<sup>59</sup>

16 The Commission agreed to examine the income tax issue in a series of workshops.<sup>60</sup> A  
17 Commission policy statement regarding the imputation of income tax expense is expected sometime  
18 in the future.

### 19 **III. CONCLUSION.**

20 There are a myriad of problems associated with amending the Decision, starting with  
21 adjusting rates in 2011 based on a 2007 test year. The Company has met with Staff to discuss its  
22 record keeping plan. With the proper procedures and a robust record keeping plan, hopefully the  
23 problems identified by the Commission will be eliminated, or at least diminished. Many of the  
24

25  
26 <sup>54</sup> *ExxonMobil Oil Corp. v. Federal Energy Regulatory Comm'n* 487 F.3d 945, 376 U.S.App.D.C. 259 (D.C. Cir. 2007).

27 <sup>55</sup> *Id.* at 948.

28 <sup>56</sup> *Id.* at 950.

<sup>57</sup> See Article 15, Section 3 Arizona Constitution.

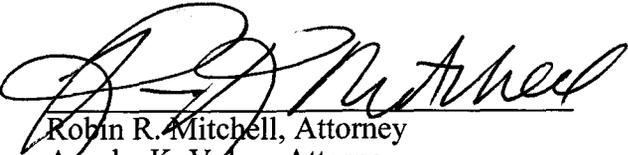
<sup>58</sup> 178 Ariz. 478, 875 P.2d 137 (1993).

<sup>59</sup> *Id.* at 484, 143.

<sup>60</sup> See Decision No. 72177; also Docket No. W-00000C-06-0149.

1 Company's issues can be resolved in the Company's next rate case. Staff would urge the  
2 Commission to deny the Company's requests and leave Decision No. 71854 undisturbed.

3 RESPECTFULLY SUBMITTED this 1st day of June, 2011.

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7 Robin R. Mitchell, Attorney  
8 Ayesha K. Vohra, Attorney  
9 Arizona Corporation Commission  
10 1200 West Washington Street  
11 Phoenix, AZ 85007  
12 (602) 542-3402

13 Original and thirteen (13) copies  
14 of the foregoing were filed this  
15 1<sup>st</sup> day of June, 2011, with:

16 Docket Control  
17 Arizona Corporation Commission  
18 1200 West Washington Street  
19 Phoenix, Arizona 85007

20 Copy of the foregoing mailed and/or  
21 e-mailed this 1<sup>st</sup> day of June, 2011, to:

22 Jeffrey W. Crockett  
23 BROWNSTEIN HYATT FARBER SCHRECK, LLP  
24 40 North Central Avenue, 14<sup>th</sup> Floor  
25 Phoenix, Arizona 85004  
26 Attorney for Johnson Utilities, LLC  
27 [jcrockett@bhfs.com](mailto:jcrockett@bhfs.com)

28 Craig A. Marks  
29 CRAIG A. MARKS, PLC  
30 10645 North Tatum Blvd., Suite 200-676  
31 Phoenix, Arizona 85028  
32 [Craig.marks@azbar.org](mailto:Craig.marks@azbar.org)  
33 Attorney for Swing First Golf, LLC

34 Daniel Pozefsky, Chief Counsel  
35 RESIDENTIAL UTILITY CONSUMER OFFICE  
36 1110 West Washington Street, Suite 220  
37 Phoenix, Arizona 85007-2958  
38 [dpozefsky@azruco.gov](mailto:dpozefsky@azruco.gov)

1 James E. Mannato, Town Attorney  
TOWN OF FLORENCE  
2 P.O. Box 2670  
775 North Main Street  
3 Florence, Arizona 85232-2670  
James.mannato@florenceaz.gov  
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*Ashtley Hodge*