

ARIZONANS FOR RESPONSIBLE WATER POLICY



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Arizona Corporation Commission

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Chairman Gary Pierce
Bob Stump, Commissioner
Sandra Kennedy, Commissioner
Paul Newman, Commissioner
Brenda Burns, Commissioner
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007

In Re: Chairman Pierce's Proposed Policy for Income Tax Recognition, Docket No. W-00000C-06-0149

Dear Chairman and Commissioners:

Simply put, there is no reason for the Commissioners to delay a decision on the issue of whether or not to recognize income tax expense for water companies that use either the S Corp or LLC structure. Both of those structures are legal, both have certain advantages for new utilities, and the Commission itself used to allow that expense but changed course many years ago (over Staff's objections as Staff used to believe that allowing the expense was fair and efficient.)

While some argue that anything that raises rates is bad for customers, that view does not reflect the reality of the economic and environmental intersection that exists in reality in Arizona's infrastructure, investment, Constitution, and the Court decisions which hold that the Commissioners' job is to balance the interests of shareholders and customers and evaluate the tradeoff between economics and environmental concerns.

Commissioners have a very hard job that requires them to balance the interests and take a longer view - they must look at whether a policy or decision is better over the long haul because it: a) creates healthier utilities that can withstand economic and environmental challenges, b) protects Arizona's economic and natural resources, and c) leads to a more sustainable future.

The discrimination in rates that currently exists is obvious - a water utility using a legal, sanctioned, and beneficial corporate structure is subject to a ratemaking process that simply does not exist for other utilities. Interestingly, in the Pima Utility hearings, Staff asked whether a water company that had an affiliate in the real estate business should be allowed to recover income tax expense if their real estate affiliate had losses.

What is fascinating about that question is that it completely ignores the fact that Arizona's largest utility, Arizona Public Service, had that precise situation for several of the past few years as its affiliate, SunCor, generated net operating losses from real estate activities that offset Pinnacle

West's actual tax expense. Not once did the Commission change its position allowing APS to recover income tax expense because of that fact, nor should it have: APS incurs income tax expense because of its utility operations and it should be, and was, allowed to recover that expense without regard to SunCor.

Affiliate losses do not eliminate water utility tax expense. To the extent the need to make a tax payment in a given year is eliminated by an affiliate loss, it is because a tax asset (the affiliate's loss) was used to satisfy the payment obligation. The water utility tax expense is not eliminated - only the cash payment is avoided. The cash payment is avoided, not because there is no utility tax expense, but because the utility owner used a tax asset (generated by an affiliate), rather than cash, to satisfy the utility tax liability. The use of the affiliate's tax asset is a real expense to the utility owner because the tax asset is no longer available to offset future tax expense generated by the affiliate.

Some have argued that if the Commission is to recognize tax expense for S Corps and LLCs, it should base tax expense on shareholder taxes, and should evaluate actual tax expenses in the years following a rate case. First of all, that approach is completely unfounded: *"The amount that a firm reports as income before income taxes for financial reporting usually differs from the amount of taxable income that appears on its income tax return."*¹

Secondly, an annual tax audit of S Corps and LLCs would simply replace the current discriminatory policy with a new discriminatory policy. And finally, a *post hoc* review that "claws back" income tax expense based on year by year analyses of post-rate case tax events is not only at odds with the Commission's treatment of C Corps, but would in itself be a punitive policy leading to massive uncertainty and creating a level of regulation never before seen at this or any other Commission I have encountered.

In case anyone suggests that a new "claw back" policy could avoid its inherent discrimination by applying it to all utilities, i.e., all C Corps, S Corps, and LLCs: It should be patently obvious that such a decision would have a massive, negative, and instant effect on Arizona utilities and their customers. Bond ratings agencies, equity investors, analysts, and hedge funds would *immediately* increase their regulatory risk rating for Arizona and the costs of capital in Arizona would soar overnight.

In the end, the choice is clear: Should the Commission adopt a policy based on its view of fairness between utility shareholders and utility customers - a policy that treats all utilities the same in that it allows income tax recognition?

The policy drafted by Chairman Pierce is not arbitrary; it mirrors the FERC policy, and it returns Arizona to the policy it had in the past (a time when many of the affected S Corps and LLCs were formed.) Each Commissioner should evaluate that policy and its effect on its own merits and the Commissioners should decide what the policy should be in Arizona.

¹ Financial Accounting: An Introduction to Concepts, Methods, and Uses; Clyde P. Stickney, Dartmouth College and Roman L. Weil, University of Chicago; 9th Edition, Pg. 547

There are several policies that the Commission should evaluate with regard to the water sector – income tax expense is but the first of those choices and more recommendations from the water sector will be presented to the Commission in the very near future. Whatever the Commissioners decide on income tax and other policies will be matters for voters to evaluate, as long as the Commissioners themselves take the burden of office and set the course.

Respectfully yours,

/s/ Paul Walker

Paul Walker
Chairman, Arizonans for Responsible Water Policy