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BEFORE THE ARIZONA CORPORATION COMMISSION

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8 IN THE MATTER OF THE APPLICATION OF
9 PIMA UTILITY COMPANY, AN ARIZONA
10 CORPORATION, FOR A DETERMINATION OF
11 THE FAIR VALUE OF ITS UTILITY PLANT AND
12 PROPERTY AND FOR INCREASES IN ITS
13 WATER RATES AND CHARGES FOR UTILITY
14 SERVICE BASED THEREON.

Docket No. W-02199A-11-0329

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16 PIMA UTILITY COMPANY, AN ARIZONA
17 CORPORATION, FOR A DETERMINATION OF
18 THE FAIR VALUE OF ITS UTILITY PLANT AND
19 PROPERTY AND FOR INCREASES IN ITS
20 WASTEWATER RATES AND CHARGES FOR
21 UTILITY SERVICE BASED THEREON.

Docket No. SW-02199A-11-0330

Arizona Corporation Commission
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RUCO'S REPLY BRIEF

22 The Residential Utility Consumer Office ("RUCO") hereby files its Reply Brief on the
23 matters raised in Pima Utility Company's ("Pima" or the Company") and Staff's Opening
24 Briefs.

1 **I. THE RECOVERY OF INCOME TAX EXPENSE**

2 **A. THE EVIDENCE DOES NOT SUPPORT THE COMPANY'S CONTENTION**
3 **THAT THE COMMISSION'S CURRENT POLICY DETERS INVESTMENT**
4 **AND IS HENCE BAD PUBLIC POLICY**

5 The Company holds fast to its recommendation that the Commission recognize an
6 income tax allowance for Pima. The Company's arguments are mainly mischaracterizations
7 of RUCO and Staff's positions and are unsupported by the evidence. Reading Pima's Brief,
8 it is easy to lose sight of what really lies at the heart of the issue – the fact that Pima, an S
9 corporation, does not pay income tax. The Company is asking to recover from Pima's
10 ratepayers, the personal income tax that Pima's shareholders may pay related to Pima's
11 income. As discussed later in the Brief, Pima has failed to provide any evidence that
12 personal income taxes were actually paid. In the Company's mind, RUCO is not concerned
13 with the Company financial well-being, but "just about lower rates" and the fact that RUCO
14 likes the Commission's current policy and does not want to see it changed. Company Brief
15 at 29.

16 In truth, RUCO, and Staff for that matter, do like the Commission's current policy.
17 The Commission's current policy makes sense, is good public policy, and does not violate
18 the Commission's constitutional obligation to prescribe just and reasonable rates.
19 Nonetheless, Pima complains that the current policy promotes tax inefficiency and is
20 therefore bad public policy. Pima Brief 22-27. But Pima fails to provide a persuasive case
21 to support a change in the current policy.

22 Pima admits that S corporation status is "the most tax efficient strategy for their
23 company." Company Brief at 23. According to Pima, the benefits Pima enjoy as an S
24 corporation include a "lower ultimate tax rate, reduced administrative burden, and the

1 avoidance of double taxation on both income generated from operations and liquidation of
2 assets.” Pima Brief at 23. These benefits explain why Pima elected S corporation status in
3 1986 and has not changed since.

4 Pima could have changed its organizational status at any time if it felt disadvantaged
5 in any way¹ but the fact is that Pima has not. The Company cannot even say conclusively
6 that it will change back to C status if the Commission denies its request. All the Company
7 will say is that if its request is denied, it will “go back and evaluate staying an S corporation.”
8 Company Brief at 30. Pima has not been disadvantaged by the Commission’s policy – its
9 action (or lack of action) is proof that the Commission’s current policy has not, and will not
10 deter investors from seeking S corporation status.

11 The Company’s support for its argument centers on the FERC policy. Company Brief
12 at 29-30. The Company notes that the FERC policy emanated out of a concern for much-
13 needed pipeline infrastructure. Company Brief at 30. RUCO pointed out in its Opening Brief
14 that the circumstances that led to the FERC policy are different than the circumstances in
15 this case. Here, the Company is built out so infrastructure investment is not a concern.
16 RUCO Brief at 10 – 11. Here, the concern appears to be paying the shareholder’s personal
17 income taxes, not desperately needed gas pipelines. Id.

18 There is also no evidence in the present case that the Commission’s current policy
19 has pushed utilities organized as C corporations in Arizona. Again, Mr. Spitzer, the
20 Company’s witness testified that most new entities are formed as pass-through LLCs.

21
22 ¹ Pima is a Class B Arizona public service corporation currently organized as an S corporation under Subtitle
23 A, Chapter 1, Subchapter S of the Internal Revenue Code. R-9 at 2. S corporations elect to pass corporate
24 income, losses, deductions and credits through to their shareholders for federal tax purposes. Id. at 3.
Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and

1 Transcript at 186. Mr. Spitzer testified that at the time he was an Arizona Commissioner, the
2 ratio was approximately 100 to 1 and has probably gotten larger. Tr. at 186. When asked if
3 he was aware of any entities organized as a C corporation because of the Commission's
4 policy he testified that he was not aware of any. Tr. at 186-187. Staff's witness, Darren
5 Carlson, corroborated Mr. Spitzer's testimony. Tr. at 308. There is no evidence in the
6 record to support the contention that the Commission's policy is deterring investment in
7 infrastructure and/or "pushing" companies to organize as C corporations in Arizona.

8 In 1986, Pima's shareholders elected to change from C to S corporate status. (Tr. at
9 390) Under the Internal Revenue Code, all shareholders must elect to make this change.
10 (26 USC §1362(a) (2)) One reason for this organizational change was the sweeping tax
11 reforms of the federal Tax Reform Act of 1986. Id. RUCO notes that Pima's shareholders
12 continued to believe that Subchapter S status was the most beneficial organizational form
13 throughout the following years even though the Commission has not allowed Pima to
14 recover personal income tax liability in rates.

15 The shareholders of Pima Utility are highly sophisticated men and woman who
16 undoubtedly receive excellent legal and tax advice. Pima technically has 20 shareholders.
17 Among its shareholders is "John D. Doe"² A second shareholder is "John D. Doe
18 Subchapter S Trust". A-14. A third shareholder is "John D. Doe 1997 Irrevocable
19 Subchapter S Trust". Id. Also, there is a shareholder named "Jane R. Doe". Id. And there is
20 another shareholder named "Jane R. Doe 2006 Irrevocable Trust". Id. There is a shareholder
21 named "Tom S. Doe" and another shareholder named "Tom S. Doe Subchapter S Trust". Id.
22 There is a shareholder named "Mary A. Doe" and another named "Mary A. Doe 2006

23 are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on
24 the corporate income. Id.

1 Irrevocable Trust". Id. Finally, there is a shareholder named "James E. Doe" and another
2 named "James E. Doe 2006 Irrevocable Trust". Id. The creation of these multiple trusts
3 indicates a high level of financial sophistication as well as an adept understanding of the tax
4 implications.

5 The shareholders have chosen to organize as a Subchapter S business because it is
6 in their interest to do so. If it weren't then they could have moved back to C corporation
7 status at any time over the last few decades, but have chosen not to do so. By organizing as
8 an S corporation, the shareholders unanimously elected to avoid corporate income tax.
9 Subchapter S status avoids double taxation. Subchapter S and C corporations are different
10 - trying to equate the two is trying to fit a square peg in a round hole. By having ratepayers
11 cover their personal income tax liability, Pima is asking that shareholders avoid all taxation.

12 **B. THE CONSTITUTION'S DIRECTIVE TO SET JUST AND REASONABLE
13 RATES PRECLUDES THE INCLUSION OF UTILTY EXPENSES THAT DO
14 NOT EXIST.**

15 The Company claims that the inclusion of a personal income tax allowance is legal.
16 Company Brief at 26. RUCO, according to the Company, agrees that an income tax
17 allowance is within the Commission's discretion and that no law prevents the Commission
18 from approving a tax allowance. Id. In support, the Company refers to the following
19 testimony offered by Mr. Rigsby on the witness stand:

20 Q. But you are not aware of any Arizona law, federal law, rule
21 or regulation of the Commission that precludes the Commission
22 from including an allowance for income taxes for pass-through
23 entities?

24 A. No. Again, that would be up to the Commission to make that
25 decision.

² Although the real names of the shareholders are listed in Exhibit A-14, RUCO uses pseudonyms to protect the shareholders' privacy.

1 Company Brief at 26. Mr. Rigsby is a financial analyst and not a lawyer. Besides, not being
2 "aware" of any law is different than agreeing that no law prevents a tax allowance and it is
3 improper for the Company to draw the conclusion that they are the same.

4 The Company's conclusion that RUCO agrees that no law prevents the Commission
5 from approving the Company's recommendation is even more troubling given RUCO's
6 Opening Statement. In relevant part, RUCO's counsel, who is a lawyer, stated:

7 In Arizona, the Arizona State Constitution requires that the
8 Commission approve rates that are just and reasonable, simple
9 edict, whose application on this particular issue should also be
10 simple. You cannot have rates that are just and reasonable that
11 include the recovery of income tax that the utility does not pay.

12 Transcript at 15. The Company's characterization of RUCO's position is not correct.

13 RUCO believes that the Commission is prohibited by the Arizona Constitution from
14 setting rates that include shareholders' personal income tax liability. Pima does not pay
15 income taxes. Setting rates based on an operating expense that does not exist will not result
16 in just and reasonable rates. See RUCO's Opening Brief at 13-16. The Commission is
17 required to set just and reasonable rates under the Arizona Constitution. Ariz. Const. Art.
18 15, § 3. The Company's proposal violates Arizona's Constitutional requirement to set just
19 and reasonable rates.

20 In its Brief, the Company praises Staff's vision in *The Application of Consolidated*
21 *Water Utilities for an Increase in Water Rates*.³ Company Brief at 25-26. The 1986 rate
22 case the Company references concerns Consolidated's Parker, Palm Springs and Circle
23 City Systems. This particular case is noteworthy, for among other things, it is when the

24 ³ *In the Matter of Consolidated Water Utilities*, Docket Nos. E-1009-86-216, E-1009-86-217, E-1009-86-332.

1 Commission "reversed" its policy on the recovery of a tax allowance for pass-through
2 entities to its current policy. See Decision No. 55839, January 8, 1988, Company Brief at
3 26. In that case, Staff supported Consolidated's request to include personal income tax
4 expense in rates.

5 In Decision No. 55839 (Docketed January 8, 1988), the Commission rejected both
6 Consolidated and Staff's arguments and concluded:

7 In our analysis, we cannot rationally allow expenses for income
8 taxes in any form which are not actually paid by the operating entity
9 that controls the water utilities. In this case, Consolidated will pay
10 no taxes on the income it generates from the rates which are
11 authorized hereinafter. Therefore, we will not allow any income tax
12 expense to be charged to its ratepayers.

13 Decision No. 55839 at 4.

14 Approximately, two and one half years later Consolidated tried again to recover a tax
15 allowance in a rate case involving its Apache Junction and Colorado River Divisions.⁴ This
16 time, Staff's vision took Staff in a different direction as Staff (and RUCO) disallowed the
17 Company's pro-forma income tax adjustment. Decision No. 57666 at 15. The Commission,
18 in Decision No. 57666 (docketed December 19, 1991) agreed with Staff and RUCO
19 concluding:

20 We concur with RUCO and Staff. As we discussed in the
21 previous rate case, Applicant will pay no taxes on the income which
22 it generates from the rates authorized hereinafter. Accordingly, we
23 shall not allow income tax expense to be charged to its ratepayers.

24 Decision No. 57666 at 15.

⁴ *In the Matter of Consolidated Water Utilities*, Docket Nos. E-1009-90-115, E-1009-90-116.

1 Consolidated appealed Decision No. 57666 relying on the *Moyston v. New Mexico*
2 *Pub. Serv. Comm'n*, 76 N.M. 146, 412 P.2d 840 (1966) and the *Suburban Util. Corp v.*
3 *Public Util. Comm'n*, 652 S.W.2d 358 (Tex. 1983) cases. The Arizona Court of Appeals
4 rejected Consolidated's arguments and upheld the Commission's decision on this issue.
5 See *Consolidated Water Utilities, Ltd. v. Arizona Corp. Com'n*, 178 Ariz. 478, 484, 875 P.2d
6 137, 143, Ariz.App. Div. 1, 1993 (September 07, 1993).

7 The Commission hit the nail on the head in the *Consolidated* cases. The Arizona
8 Court of Appeals agreed. The Court's decision made it clear that Arizona is not bound to
9 follow FERC or any state for that matter on the issue. The Court held that the Commission
10 set just and reasonable rates when it excluded recovery of personal tax expense. The
11 Company is now asking the Commission to look at the same issue and decide it differently.
12 The Company has not presented one new argument why the Commission should decide this
13 issue differently. The Commission, consistent with its prior decisions as well as the Arizona
14 Court of Appeals decision, should reject the Company's recommendation.

14 **C. PIMA CANNOT PROVE SHARHOLDERS ACTUALLY PAID TAXES.**

15 The Company devotes most of its Brief to its contention that the Commission should
16 focus on the income that arises from the operation of the utility. Company Brief at 25. The
17 argument goes that if the Commission recognizes the Company's income then income tax
18 liability is a byproduct thereof. Id. at 25-29. For the most part RUCO has addressed, at
19 length the arguments raised in the Company's Brief. RUCO Brief at 2-17. However, there
20 are a few areas that need to be addressed at the risk of being repetitive.

21 **1) The Company's recommendation will have unintended consequences**

22 The Company's argument, if approved would have unintended consequences. The
23 mainstay of the Company's argument is that the personal income taxes its shareholders pay
24 are the consequence of the income produced by the Company. However, extending that

1 logic, personal income (and the corresponding tax liability) of shareholders of corporations is
2 also the consequence of the function of the Subchapter C utility. For example, are the
3 ratepayer's next going to be held responsible for the personal income tax associated with the
4 income produced by utilities organized as C corporations? There is no line of reasoning that
5 would distinguish such a request if the Company's recommendation is approved.

6 Staff, in its Supplemental Staff Report in the pending Generic Docket⁵, noted that
7 approving the Company's recommendation would be:

8 "... analogous to including in rates the income taxes borne by
9 shareholders of C Corporation for receipt of dividends. Such
10 treatment effectively increases the rate of return to investors in
11 excess of the stated, or intended, authorized rates. As a result, the
12 authorized rate of return would neither be representative of the
13 actual authorized return nor comparable to other utilities with similar
14 risk. The resulting rates would place an unfair burden on the
15 ratepayers and may not meet the fair and reasonable standard,
16 since ratepayers will be expected to pay more without any
17 incremental demonstrable benefits to them."

18 Staff Report at 3.

19 Under Pima's treatment of personal income taxes, shareholders of C corporations
20 would still be subject to taxation while shareholders of S corporations would be subject to
21 effectively no taxation. The shareholders of the C Corporation would be treated differently.
22 The shareholders of the C Corporation, like the S corporation also pay personal income tax.
23 It would not be long before utilities organized as C corporations would request the same
24 treatment. If the liability for S corporation shareholders is a legitimate utility expense
because the earnings are the consequence of utility operation then the tax liability of C
corporation shareholders must also be considered a legitimate expense. RUCO cannot

⁵ In the Matter of the Arizona Corporation Commission – Generic Investigation, Docket No. W-00000C-06-0149 – Report Dated June 27, 2012 ("Staff Report").

1 support Pima's logic and the natural (and obvious) extension of it. It would be unfair for the
2 Commission to treat the shareholders of pass-through entities differently than the
3 shareholders of Company's that pay corporate income tax.

4 Another unintended consequence not addressed by the company concerning the
5 calculation of a theoretical tax allowance concerns Accumulated Deferred Income Tax
6 ("ADIT"). When a C corporation comes in for rate relief, there is an ADIT calculation
7 associated with the corporate income tax. ADIT, which typically is booked as a liability, is
8 also a deduction to ratebase. A deduction to ratebase benefits the ratepayers. With S
9 corporations, an ADIT calculation is not necessary since there is no corporate income tax.
10 The Company's proposal of imputing an income tax based on the shareholder's personal
11 income tax ignores ADIT⁶ as the calculation is made solely for the purpose of ascertaining
12 the shareholder's recovery of personal income tax from ratepayers and not to ascertain
13 corporate income tax liability. Ratepayer's get the short end of the stick again.

14 Regardless of the Commission's policy, the tax laws allow the Company to change its
15 corporate status in a manner that provides the most benefit. The Commission should not
16 take action which interferes with the purpose and the intent of the tax code.

17 **2. Who pays the taxes makes a big difference.**

18 The Company sees no distinction between the Company paying corporate income
19 tax or the shareholder paying personal income tax on the Company's income. Company
20 Brief at 28-29. According to the Company, it is the income that the Company generates and
21 not who pays the income that is the concern. Id. The Company's argument is misplaced. It
22 bears repeating that the Company does not pay income tax. It does not pay corporate
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1 income taxes because the shareholders have unanimously chosen not to be subject to
2 corporate income tax. (26 USC §1362(a)(2)). Since shareholders may have different
3 individual tax rates and different offsets, any rate the Commission sets would be arbitrary.

4 RUCO Brief at 16.

5 The Commission should reject the Company's proposal. It violates Arizona's
6 Constitution and would result in poor public policy.

7 **3. The Company's refusal to show what taxes were actually paid is**
8 **problematic and inconsistent with the weight of authority in other states and**
9 **the Commission's position on this issue.**

10 The Company has not presented any evidence showing that any taxes were actually
11 paid by the shareholders. Pima has not provided the shareholders actual tax returns or
12 even their Schedule K-1 forms. An S corporation issues a K-1 to each shareholder so the
13 shareholder may report his share of the S corporation's income, losses, and deductions.
14 And any credits on his personal income tax return. R-10 at 8 and Exhibit 2. The Company
15 has presented a proposed income tax allowance which differs from the FERC methodology.
16 Company Brief at 33-34. The Company's proposal involves the computation of "individual
17 effective tax rates (both federal and state)." Id. at 34. The Company believes that looking at
18 individual shareholders returns would be "ludicrous." In short, the Company's methodology
19 is guaranteed to recover an amount that will be different than the income taxes actually paid
20 by the Company's shareholders. Therefore, any rate the Commission sets would be
21 arbitrary and would result in rates that are not reasonable. See RUCO Brief at 16-17.

22 The Company's proposed methodology for calculating the tax allowance is not only
23 inconsistent with FERC it is contrary to the weight of authority in the few states that have

24 ⁶ The ADIT calculation applies prospectively since the Company has not collected any income taxes in

1 authorized an income tax allowance for pass through entities. Ironically, it was not Staff but
2 the Commission who argued before the Arizona Court of Appeals in the *Consolidated* case
3 that "The issue of taxes that are actually paid dominates in states which have authorized
4 inclusion of income taxes even for entities that do not directly incur income taxes."⁷ The
5 Commission made this argument to show that a theoretical tax allowance, such as what the
6 Company is proposing in the current case, would be arbitrary and inappropriate.

7 In its Answering Brief in *Consolidated*, the Commission distinguished other states (in
8 particular New Mexico and Texas) that have approved a tax allowance:

9 The Moyston court recognized that it was deciding a case of
10 first impression and imposed what it recognized to be a
11 hypothetical tax based on its understanding that an actual tax was
12 paid, 412 P.2d at 850. The Suburban Court notes that Moyston is
13 the only decision of a court of last resort on the issue. After noting
14 that the Public Utility Commission had recently approved the
15 imputation of federal income tax liability for a Subchapter S utility,
16 the Suburban court held "...that Suburban is entitled to a
17 reasonable cost of service allowance for federal income taxes
18 actually paid by its shareholders on Suburban's taxable income or
19 for taxes it would be required to pay as a conventional corporation,
20 whichever is less. " 652 S.W.2d at 363, 364 (emphasis added).

21
22
23 While the Suburban case remains valid law in Texas, its
24 effects have been somewhat mitigated. In Southern Union Gas
Company v. Railroad Commission of Texas, 701 S.W.2d 277
(Tex.App. 3 Dist. 1985), the Texas Court of Appeals refined the
Suburban doctrine somewhat, noting "... the Commission did not
abuse its discretion in disallowing "theoretical" income tax liability
for rate making purposes." 701 S.W.2d at 279. The Southern
Union decision is cited approvingly by the Texas Supreme Court in
Public Utility Commission of Texas v. Houston Lighting & Power

rates in the past as an S corporation. Nonetheless, it is still remains a valid concern

⁷ See Appellee Arizona Corporation Commission's Answering Brief at 29-33, *Consolidated Water Utilities, Ltd. v. Arizona Corp. Com'n*, 178 Ariz. 478, 875 P.2d 137 Ariz.App. Div. 1, 1993, (September 07, 1993), 1 CA-CC 92-0002. The relevant excerpt of the Answering Brief is attached hereto as Attachment 1.

1 Company, 748 S.W.2d 439 (Tex. 1987), in which theoretical income
2 tax liability is also disapproved.

3 The most recent word on the topic of taxes actually paid is
4 found in Kansas and it is particularly apposite in the current
5 situation. In Greeley Gas Co. v. State Corporation Commission,
6 807 P. 2d 167 (Kan.App. 1991), the Kansas Court of Appeals, while
7 noting that Suburban appeared to still be good law in Texas,
8 affirmed the Kansas Corporation Commission's disallowance of
9 income taxes based on the utility's failure to produce the taxpayer's
10 income tax returns to demonstrate what income taxes were actually
11 paid, if any, noting that the individual shareholders particular
12 situation could cause the tax rate to vary across the various tax
13 brackets that exist, 807 P.2d at 169, 170. ... (Emphasis added in
14 the original)

15 Id. at 30-32.

16 As the Commission argued in the *Consolidated* appeal, the issue of theoretical income
17 taxes in the current case is "squarely joined." Id. at 32. In the current case, not only has Pima
18 failed to provide satisfactory evidence of income tax amounts actually paid⁸, the Company
19 believes that requiring individual returns to provide such evidence is "ludicrous". Company
20 Brief at 34. The Commission, at least in the past, has clearly recognized that a theoretical tax
21 allowance such as the Company proposes is arbitrary and has taken a position at the Court
22 of Appeals against such a methodology as well as the tax allowance. The Company's
23 disdain for the Commission's previous concern regarding a tax allowance calculation is yet
24 further reason for rejecting the Company's recommendation.

⁸ Pima has not provided income tax statements and/or K-1's of its shareholders.

1 **II. OTHER OPERATING EXPENSE ISSUES**

2 **A. DEPRECIATION EXPENSE – WATER DIVISION**

3 RUCO incorporates the arguments made in its Opening Brief and has nothing
4 additional to add. RUCO Brief at 17.

5 **B. SALARY AND WAGE EXPENSE WATER AND WASTEWATER
6 DIVISION**

7 The Company argues that RUCO has not met its burden of proof to support its
8 recommendation. Company Brief at 15. RUCO, however, is not requesting recovery of the
9 salary expense – the Company is making the request. As the Company itself notes it is the
10 Company that bears the burden of proof on its recommendations. Company Brief at 15, See
11 generally, *State ex. Rel. Corbin v. Ariz. Corp. Comm'n*, 143 Ariz. 219, 223-24, 693 P. 2d
12 362, 366-67 (App. 1984). The Company mistakenly believes that it has met its burden if
13 RUCO does not or cannot dispute the Company's testimony. Company Brief at 15. The
14 Company's misguided interpretation of the standard of proof is not recognized by Arizona
15 law and/or precedent.

16 The Commission addressed the subject issue⁹ in the recent *Sahuarita Water*
17 *Company* ("SWC") case (Docket No. W-03718A-09-0359, Decision No. 72177, Docketed
18 February 11, 2011). In *Sahuarita*, SWC was seeking to recover the payroll and other
19 associated expenses for services provided by its affiliates. SWC argued that the estimated
20 times and duties of its non-dedicated affiliate employees was sufficient to meet the
21 Company's burden of proof. Decision No. 72177 at 18.

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⁹ While the fact pattern may differ, the subject matter and the Commission's reasoning are applicable in the present case.

1 SWC, like Pima¹⁰, did not keep time sheets and claimed that the employees in
2 question were salaried. Decision No. 72177 at 14-15, Pima Brief at 13. SWC, like Pima,
3 also argued that the absence of timesheets does not mean that there was no evidence of the
4 services provided or time dedicated. Decision No. 72177 at 15. Both SWC and Pima claim
5 that it is not the hours but the "value" of the services the employee brings. Company Brief at
6 12, Decision 72177 at 15. SWC, like Pima did not offer first-hand testimony but rather the
7 testimony of other employees of their respective company to make its case. Id. Finally,
8 SWC, like Pima, argued that Staff's concerns, including Staff's argument that there was a
9 possible duplication of duties¹¹ was irrational and punitive.

10 In *Sahuarita*, the Commission rejected SWC's arguments and concluded the
11 Company had not met its burden of proof. Transcript at 18. The Commission concluded;

12 Without time records, the Commission cannot evaluate the
13 accuracy of the estimates or determine whether the activities of
14 these employees did not duplicate the activities of the full-time
15 employees.

16 Because of the lack of reliable evidence, SWC has not
17 shown that its allocations are reasonable and therefore has not met
18 its burden of proof on this issue. Consequently, we accept Staff's
19 adjustment to remove the costs of the non-dedicated employees.

20 Decision No. 72177 at 18-19.

21 In Pima, the Company has backed off any showing of proof to validate and/or even
22 support its request and is now simply asking for the recovery of Mr. Robson's salary
23 awarded in the Company's last rate case trued up for inflation. The Company has not

24 _____
¹⁰ With Pima, oddly enough, the Company did keep time sheets for its other employees and even
claimed initially that Mr. Robson worked 56.68 hours per division. Transcript at 56

1 presented any proof to show the “value” of Mr. Robson’s services and how these services
2 are distinguished from services provided to the other utilities that Mr. Robson operates.
3 Notably, Mr. Robson, himself did not testify. The Company has failed to meet its burden,
4 and the Commission should reject the Company’s recommended salary and wage expense
5 for Mr. Robson.

6 RUCO’s recommendation of a salary of \$7,085 per Division has solid support in the
7 record. RUCO’s use of an hourly rate of \$125 is reasonable as it is based on a comparable
8 CEO of a Class A Water Company within the local area (Arizona Water Company in 2008).
9 R-4 at 18, Transcript at 145. RUCO’s recommendation is fair, is supported by the evidence
10 and should be adopted.

11 C. RATE CASE EXPENSE

12 Pima remains confused on its legal burden of proof. Pima believes that it has met its
13 burden based on what Pima believes is RUCO’s failure to meet its burden. See Pima Brief
14 at 17-18. Again, it is Pima that is requesting the recovery of its rate case expense and it is
15 Pima who has the burden of showing that it is entitled to the level of expense it is requesting.
16 See generally, *State ex. Rel. Corbin v. Ariz. Corp. Comm’n*, 143 Ariz. 219, 223-24, 693 P. 2d
17 362, 366-67 (App. 1984).

18 Pima argues that RUCO has not met its burden and therefore it should be awarded its
19 requested amount of rate case expense. Pima discounts RUCO’s argument primarily
20 because it “... involves a comparison of Pima’s “proposed” amount of rate case expense to
21 “other” rate cases before the Commission.” Pima Brief at 17. Pima is correct - RUCO did
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23
24 ¹¹ In Pima, the issue does not involve affiliate transactions, but Staff has the same concern about the
duplication of services as Mr. Robson is the principal in several other utilities. Transcript at 67-68, 84)

1 support its recommendation by comparing other, similar rate cases which is what the
2 Commission typically does when deciding the issue.

3 Incredibly, making comparisons to other rate cases is exactly how the Company came
4 up with its recommendation. The Company's witness, Thomas Bourassa, testified as
5 follows:

6
7 **Q. PLEASE CONTINUE WITH YOUR DESCRIPTION OF
THE INCOME STATEMENT ADJUSTMENTS.**

8 A. Adjustment 3 shows the rate case expense estimated by the
9 Company. The Company estimates rate case expense for the
10 Water Division of \$200,000, which is half of the total amount
11 requested. The Company proposes that rate case expense be
12 recovered over four years because it believes a four-year cycle for
future rate cases is reasonable given this utility's circumstances.
While the Company's last rate case was eighteen years ago, the
Company intends to file cases on a more regular basis.

13 **Q. WHY DO YOU BELIEVE THIS IS A REASONABLE
ESTIMATE OF RATE CASE EXPENSE FOR THIS RATE CASE?**

14 A. Because it is based on what I have seen in other rate cases.
15 The best recent example I know is Chaparral City Water Company.
16 The Commission granted rate case expense of \$280,000 in that
17 case. Chaparral City Water Company is about 2000 customers
18 larger than either of Pima's divisions. So, I took that number and
19 multiplied it by 1.5, on the assumption that we would achieve about
20 50 percent economies of scale in total for the whole case (both
21 divisions). Thus, each division is allocated \$200,000 of rate case
22 expense. I believe these amounts are also consistent with other
23 water company cases like *Arizona Water Company- Western
Group*, Decision No. 68302 (November 14, 2005) and *Chaparral
City Water Company*, Decision No. 71308 (October 21, 2009), in
24 which the utilities were awarded \$250,000 and \$280,000,
respectively. Another recent example that is relevant is the recent
rate case for Litchfield Park Service Company ("LPSCs"), (Decision
72026, December 10, 20 10) in which both water and wastewater
division rate applications were filed simultaneously. LPSCo incurred
over \$500,000 and was granted \$420,000 of rate case expense.
While LPSCo is a somewhat larger utility and the issues between
the parties may not be the same, in my view the level of outside

1 resources required to prepare the rate case and defend the
2 Company during the course of this proceeding are similar. These
3 cases, among the many others I have worked on, formed the basis
4 for my estimate.

5 A-6 at 12 – 13.

6 Not only did the Company rely on a comparison of other rate cases to support its
7 recommendation, the Company even compared at least one rate case that RUCO used to
8 support its recommendation (AWC Western Group). RUCO-5 at 23. Yet, the Company
9 criticizes RUCO for using AWC as a comparable. Company Brief at 18.

10 The Company argues that RUCO did not consider the significant difference between
11 the Company and the two companies RUCO used as comparables - AWC and UNS Gas.
12 Company Brief at 18. The Company considered AWC in support of its recommendation so
13 attempting to discount that comparison works against the Company and is absurd. Mr.
14 Coley testified to the following regarding UNS gas:

15 In the pending UNSG rate case, UNSG requested a total rate
16 case expense of \$700,000. UNSG is a Class A public service
17 corporation that serves far more customers over a much larger
18 service territory than Pima. UNSG's rate case is much bigger,
19 involved more parties and also deals with more complex
20 ratemaking issues such as decoupling. Both ACC Staff and RUCO
21 are recommending that UNSG's requested level of expense be
22 reduced to \$400,000, which is the same amount that Pima is
23 requesting for the Company's Water and Wastewater Divisions
24 combined.

25 RUCO-5 at 24. Once again, the Company's argument is simply wrong – RUCO did consider
26 the differences in its comparisons and compensated for them accordingly. Based on those
27 comparisons RUCO believes that its \$300,000 recommended level of rate case expense is
28 reasonable and should be adopted by the Commission.

1 **III. CONTESTED RATE BASE ADJUSTMENTS**

2 **A. CONVERSION OF ADVANCES IN AID OF CONSTRUCTION (“AIAC”) TO**
3 **CONTRIBUTIONS IN AID OF CONSTRUCTION (“CIAC”)**

4 RUCO has nothing further to add and incorporates the arguments made in its
5 Opening Brief. RUCO Brief at 23-25.

6 **IV. COST OF CAPITAL**

7 The Company complains that RUCO’s ROE is too low and suggests that RUCO has
8 not done a sanity check on its results. Company Brief at 42. The Company argues that
9 RUCO should consider the inputs used and the results obtained. Id.

10 RUCO’s 9.4% ROE recommendation is the same as Staff’s recommended ROE and
11 only 10 basis points lower than the 9.50% Value Line projection for the water utility industry
12 as a whole. R-10 at 15. Sanity check complete – RUCO and Staff’s ROE recommendation
13 of 9.40% is sane by comparison to Value Line’s analysis of the water utility industry.

14 Additional support for RUCO and Staff’s recommended 9.4% ROE includes the fact
15 that the Federal Reserve has not made any recent changes to its current policy to keep
16 interest rates low for an extended period of time. Id. at 14. Moreover, RUCO’s 9.40% ROE
17 is more than double the Company’s proposed cost of debt, which is more than enough to
18 compensate investors for any perceived business or financial risk that might exist. Id. at 16.

19
20
21 **V. RATE DESIGN**

22 RUCO has nothing further to add and incorporates the arguments made in its
23 Opening Brief. RUCO Brief at 27.

1 **VI. CONCLUSION**

2 For the reasons discussed above and in RUCO's Opening Brief, RUCO recommends
3 the Commission adopt its position in this case, and reject the positions of Staff and the
4 Company, to the extent they conflict.

5 RESPECTFULLY SUBMITTED this 27th day of July, 2012.

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7 
8 Daniel W. Pozefsky
9 Chief Counsel

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ATTACHMENT 1

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obtain service from a public service corporation. The very orders on which the appellant relies address the issue.

Appendix "X" to appellant's opening brief is Commission Decision No. 56510, which is a Commission decision approving a main extension agreement for Metropolitan Water Company. Appellant asserts that the approval of this main extension, for an unrelated and entirely separate company, on unknown facts, supports appellant's contention that it is entitled to recover income taxes in the calculation of its rates. However, appellant apparently failed to read the Commission's order. At page 4 of Decision No. 56510, the final ordering paragraph provides:

IT IS FURTHER ORDERED that approval of allowance for personal income taxes in extension agreements for utilities organized as S-Corporations, partnerships and proprietorships does not constitute recognition of personal taxes for owners of these utilities for the purposes of establishing just and reasonable rates.

Thus, there is no reason to believe that the Commission ever issued a generic order that committed itself to the treatment of income taxes that appellant asserts. In fact, the Commission has denied recovery of income taxes as operating expenses to entities that do not actually incur income taxes since at least appellant's last prior rate proceeding, as appellant admits.

3. The weight of authority supports Commission denial of recovery of income taxes in this case.

The appellant suggests, at pages 36-39 of its opening brief, that courts in other jurisdictions have allowed partnerships and S-Corporations to recover income taxes in rates. In support of this proposition, appellant cites Moyston v. New Mexico Public

Service Corporation, 412 P.2d 840 (N.M. 1966) and Suburban Utility Corp. v. Public Utility Commission of Texas, 652 S.W.2d 358 (Tex. 1983). In addition, appellant notes that in its previous rate case, the Staff of the Commission supported allowing income taxes, although it correctly points out that no income tax allowance was made by the Commission in the previous case.

At the outset, it should be noted that neither of the cited cases is binding authority in Arizona. While this point may appear to belabor the obvious, it is of some consequence that the Arizona courts have declared that the Arizona Constitution gives the Commission more power and broader jurisdiction than other state commissions, see, Arizona Corporation Commission v. State of Arizona, 111 Ariz. Adv. Rep. 5, 8 (1992), State v. Tucson Gas, Elec. Light & Power Co., 15 Ariz. 294, 138 P. 781 (1914). The decisions of Texas and New Mexico courts, while interesting, are not particularly persuasive in this instance. Of more relevance is the fact that in the appellant's previous rate case, the Commission decided the issue in precisely the same manner as it was decided in the current case. The Commission's decision on the same issue, with the same relevant facts, is either res judicata as to this appellant, or, in any event, this appellant is collaterally estopped from pursuing the issue in this later appeal, see, Arizona Public Service Company v. Southern Union Gas Company, 76 Ariz. 373, 377, 265 P.2d 435 (1954).

But even if some weight is given to the decisions of other state courts, the weight of authority still does not support appellant in this case, on this record. The Moyston court recognized that it was deciding a case of first impression and

imposed what it recognized to be a hypothetical tax based on its understanding that an actual tax was paid, 412 P.2d at 850. The Suburban court notes that Moyston is the only decision of a court of last resort on the issue. After noting that the Public Utility Commission had recently approved the imputation of federal income tax liability for a Subchapter S utility, the Suburban court held "...that Suburban is entitled to a reasonable cost of service allowance for federal income taxes actually paid by its shareholders on Suburban's taxable income or for taxes it would be required to pay as a conventional corporation, whichever is less." 652 S.W.2d at 363, 364 (emphasis added).

The issue of taxes that are actually paid dominates in states which have authorized inclusion of income taxes even for entities that do not directly incur income taxes. While the Suburban case remains valid law in Texas, its effects have been somewhat mitigated. In Southern Union Gas Company v. Railroad Commission of Texas, 701 S.W.2d 277 (Tex.App. 3 Dist. 1985), the Texas Court of Appeals refined the Suburban doctrine somewhat, noting "...the Commission did not abuse its discretion in disallowing "theoretical" income tax liability for rate making purposes." 701 S.W.2d at 279. The Southern Union decision is cited approvingly by the Texas Supreme Court in Public Utility Commission of Texas v. Houston Lighting & Power Company, 748 S.W.2d 439 (Tex. 1987), in which theoretical income tax liability is also disapproved.

The most recent word on the topic of taxes actually paid is found in Kansas and it is particularly apposite in the current situation. In Greeley Gas Co. v. State Corporation Commission, 807

P.2d 167 (Kan.App. 1991), the Kansas Court of Appeals, while noting that Suburban appeared to still be good law in Texas, affirmed the Kansas Corporation Commission's disallowance of income taxes based on the utility's failure to produce the taxpayers income tax returns to demonstrate what income taxes were actually paid, if any, noting that the individual shareholders particular situation could cause the tax rate to vary across the various tax brackets that exist, 807 P.2d at 169, 170. In the current case, the issue of theoretical income taxes is squarely joined. Appellant asserts that their rebuttal evidence before the Commission provided evidence of an actual income tax obligation, Appellant's opening brief at page 39. Appellant also asserts that the witness upon whose testimony the income tax disallowance was based admitted that he would have allowed income taxes had Appellant been a corporation, Appellant's opening brief at page 33, citing TR. 446.

Appellant fails to do at least two things, however. First, appellant fails to provide clear and satisfactory evidence of income tax amounts actually paid. The testimony cited by appellant indicates a calculation of income tax attributable to the operation of the utility. Without evidence of the actual payments made by the partners, no clear and satisfactory showing of unreasonableness of the Commission's order has been made, see Greeley, supra. Secondly, in addition to failing to demonstrate the actual amounts paid, appellant has not addressed the theoretical nature of the calculation of income tax it offered. Appellant mentioned the testimony at page 446 of the transcript on the topic of whether the witness would have allowed income taxes if it had been a corporation. Appellant failed to address the

continuing testimony of that same witness at pages 447-451 of the transcript, in which the witness explained his rationale for not allowing income taxes for appellant.

Indeed, appellant's presentation on income tax exclusion presents an ideal setting for consideration of the burden which appellant must meet in order to set aside a Commission decision. As has been mentioned above, appellant cites a single transcript reference in support of the premise that the participants in this limited partnership would necessarily incur income tax expenses as a result of its utility operations. In addition to the fact that appellant ignored the further explanation offered by the witness, as mentioned in the previous paragraph, appellant also ignored the detailed explanations offered on the record which support denying income tax expense to this entity. The court is directed to the portion of the record entitled "Exhibits", more particularly to the exhibits tabbed as Exhibit R-1, at pages 30-31 and Exhibit R-3 at pages 1-6. Each of these exhibits is the prefiled testimony of witness James Armstrong. The cited passages contain his explanations of the factual basis for denying income tax expenses to this partnership in this case. That testimony plainly constitutes substantial evidence in the record in support of the Commission's determination to disallow income taxes as an element of rates for appellant. Appellant's citation to the record does not obviate the substantial evidence that exists and, therefore, appellant fails to sustain the burden required to set aside the Commission's order.

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. . .

appellant to adopt temporary rates, even if the Commission's decision is set aside.

VI. CONCLUSION.

For all the foregoing reasons, the court is respectfully requested to issue its judgment affirming Commission Decision No. 57666 in its entirety.

RESPECTFULLY SUBMITTED this 24th day of August, 1992.



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