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AZ CORP COMMISSION
DOCKET CONTROL

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION
OF PIMA UTILITY COMPANY, AN
ARIZONA CORPORATION, FOR A
DETERMINATION OF THE FAIR VALUE
OF ITS UTILITY PLANTS AND
PROPERTY AND FOR INCREASES IN
ITS WATER RATES AND CHARGES FOR
UTILITY SERVICE BASED THEREON.

DOCKET NO: W-02199A-11-0329

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OF PIMA UTILITY COMPANY, AN
ARIZONA CORPORATION, FOR A
DETERMINATION OF THE FAIR VALUE
OF ITS UTILITY PLANTS AND
PROPERTY AND FOR INCREASES IN
ITS WASTEWATER RATES AND
CHARGES FOR UTILITY SERVICE
BASED THEREON.

DOCKET NO: SW-02199A-11-0330

Arizona Corporation Commission

DOCKETED

JUL 27 2012

DOCKETED BY

PIMA UTILITY COMPANY

REPLY CLOSING BRIEF

July 27, 2012

TABLE OF CONTENTS

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

I. THE LEGAL FRAMEWORK FOR ARIZONA RATEMAKING 1

II. REPLY ON RATE BASE ISSUES 4

 A. Excess Capacity (Wastewater)..... 4

 1. Staff’s Engineer Admitted That 1.6 MGD Is Not Enough Treatment Capacity 4

III. REPLY ON INCOME STATEMENT ISSUES 5

 A. Salary and Wages (Water & Wastewater) 5

 1. Staff Doesn’t Offer Substantial Evidence..... 5

 2. RUCO Has No Basis to “Question” Mr. Soriano’s Testimony 6

 B. Rate Case Expense 8

 1. Amount of Rate Case Expense – RUCO Has Not Met Its Burden of Proof 8

 2. Method of Recovery – The Past Is Not Indicative of the Future..... 8

 3. Staff Agrees a Surcharge Is Lawful..... 9

 C. Income Tax Expense..... 9

 1. It Is Undisputed that Pima “Does not Pay Income Taxes Itself” 10

 2. It Is Undisputed that Pima’s “Shareholders Took Advantage of the Tax Benefits Realized by the Federal Tax Reform Act of 1986 (‘TRA 86’).” 10

 3. It Is Undisputed that No Entity Appears to Have Converted to a C Corporation Because of the Current Commission Policy Against Tax Recovery for Pass-throughs 11

 4. It Is Undisputed that FERC’s Current Policy Is to Allow Tax Allowances to Pass-throughs 12

 5. It Is Undisputed that “Arizona Should Not Adopt a Policy Just Because the Federal Government Has Chosen to Do So. The Policy Must Make Sense for Arizona” 13

 6. It Is Disputed (with RUCO) that the ACC Cannot Legally Base Rates on Operating Costs that Do Not Exist..... 13

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

7. It Is Disputed that the Income Tax Allowance Creates a Potential for Unjust Enrichment 14

8. It Is Disputed that Some Review of Individual Income Tax Returns Will Be Needed 16

9. Conclusion 17

IV. REPLY ON COST OF CAPITAL AND RATE OF RETURN ISSUES 18

V. REPLY ON RATE DESIGN AND OTHER TARIFF CHANGES 19

A. Rate Design 19

B. BMPs 19

1. Reply to Staff – Will the Commission Continue to Duplicate Regulation? 19

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
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24
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TABLE OF ABBREVIATIONS AND CONVENTIONS

Pima Utility Company uses the following abbreviations in citing to the pre-filed testimony and hearing transcripts in this brief. Other documents that were admitted as exhibits during the hearing are cited by hearing exhibit number. Final schedules were filed on June 26, 2012. Other citations to testimony and documents are provided in full, including (where applicable) the Corporation Commission’s docket number and filing date.

Other Abbreviations

Full term	Abbreviation
Pima Utility Company	Pima
Residential Utility Consumer Office	RUCO
Arizona Corporation Commission Staff	Staff
Administrative Law Judge	ALJ
Arizona Corporation Commission	ACC
Arizona Department of Environmental Quality	ADEQ
Arizona Department of Water Resources	ADWR
Best Management Practice	BMP
Capital Asset Pricing Model	CAPM
Discounted Cash Flow	DCF
Federal Energy Regulatory Commissions	FERC
Johnson Utilities Company	JUC
Line Extension Agreement	LXA
Millions of Gallons per Day	MGD
National Association of Regulatory Utility Commissioners	NARUC
Tucson Electric Power	TEP
Weighted Average Cost of Capital	WACC

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Pima Pre-Filed Testimony

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Ray Jones Direct Testimony	A-1	Jones Dt.
Ray Jones Rebuttal Testimony	A-2	Jones Rb.
Ray Jones Rejoinder Testimony	A-3	Jones Rj.
Steven Soriano Direct Testimony	A-4	Soriano Dt.
Steven Soriano Rebuttal Testimony	A-5	Soriano Rb.
Thomas J. Bourassa Direct Testimony (Rate Base, Income Statement and Rate Design)	A-6	Bourassa Dt.
Thomas J. Bourassa Direct Testimony (Cost of Capital)	A-7	Bourassa COC Dt.
Thomas J. Bourassa Rebuttal Testimony (Rate Base, Income Statement and Rate Design)	A-8	Bourassa Rb.
Thomas J. Bourassa Rebuttal Testimony (Cost of Capital)	A-9	Bourassa COC Rb.
Thomas J. Bourassa Rejoinder Testimony (Rate Base, Income Statement and Rate Design)	A-10	Bourassa Rj.
Thomas J. Bourassa Rejoinder Testimony (Cost of Capital)	A-11	Bourassa COC Rj.
Marc L. Spitzer Rebuttal Testimony	A-12	Spitzer Rb.
Marc L. Spitzer Rejoinder Testimony	A-13	Spitzer Rj.

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Staff Pre-filed Testimony

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Darron Carlson Surrebuttal Testimony	S-4	Carlson Sb.
Crystal Brown Direct Testimony	S-5	Brown Dt.
Marlin Scott Jr. Direct Testimony	S-6	Scott Dt.
Marlin Scott Jr. Surrebuttal Testimony	S-7	Scott Sb.
John Cassidy Direct Testimony	S-8	Cassidy Dt.
John Cassidy Surrebuttal Testimony	S-9	Cassidy Sb.
Crystal Brown Surrebuttal Testimony	S-10	Brown Sb.

RUCO Pre-filed Testimony

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Robert B. Mease Direct Testimony	R-3	Mease Dt.
Robert B. Mease Surrebuttal Testimony	R-4	Mease Sb.
Timothy J. Coley Direct Testimony	R-5	Coley Dt.
Timothy J. Coley Surrebuttal Testimony	R-6	Coley Sb.
William Rigsby Direct Testimony	R-9	Rigsby Dt.
William Rigsby Surrebuttal Testimony	R-10	Rigsby Sb.
William Rigsby Direct Testimony (Cost of Capital)	R-14	Rigsby COC Dt.

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Other Portions of the Record

	Hearing Exhibit	Abbreviation
Pima Utility Company Ownership Schedule	A-14	
List of Board of Directors for Robson Affiliated Companies	A-15	
Bourassa Table A-1, Comparison Between C and S Corporations	A-16	
Excerpt of Poulos Direct Testimony from SW-02199A-98-0578	A-17	
Bourassa Table A-2, Further Comparison	A-18	
Data Request Response to CSB 1-12	S-1	
Decision No. 72498 (Las Quintas Serenas Water Company)	S-2	
Form S-4 Registration Statement for Meritage Homes	S-3	
Revised Rate Design for Sewer Division	S-11	
Data Request Response CSB 1-1 (General Ledger Excerpt)	R-1	
Data Request Response CSB 1-29, 5.2, 5.9	R-2	
Excerpt from BP West Coast Products v. FERC Decision (374 F.3d 1263 (D.C. Cir. 2004))	R-7	
Excerpt from ExxonMobil v. FERC Decision (487 F.3d 945 (D.C. Cir. 2007))	R-8	
Excerpts of Annual Reports of Various Companies	R-11	

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Other Portions of the Record

	Hearing Exhibit	Abbreviation
Agreement relating to Extension of Water Distribution Facilities (between Pima Utility Company and Hancock-MTH Builders, Inc.	R-15	
Time Business Article re Taxes	R-16	
Pima's Notice of Filing Late Filed Exhibits (June 20, 2012)		Pima's Late Filed Exhibits
RUCO's Notice of Filing Revised Schedules (June 28, 2012)		RUCO Revised Schedules

7102400.5/075040.0025

1 Pima Utility Company (“Pima” or the “Company”) hereby replies to the closing
2 briefs filed by Staff and RUCO in this rate case.¹ At this stage of the proceeding, these
3 specific issues remain in dispute: (1) excess wastewater treatment capacity; (2) CEO
4 salary; (3) rate case expense; (4) income tax allowance; (5) cost of equity; and (6) BMPs.
5 Pima’s reply on each of these issues follows after a brief discussion of the legal
6 framework governing ratemaking in Arizona.

7
8 **I. THE LEGAL FRAMEWORK FOR ARIZONA RATEMAKING**

9 Because RUCO has now challenged the constitutionality of authorizing an income
10 tax allowance,² a discussion of the legal framework within which rates are set in Arizona
11 is warranted. In the end, the Company and Staff agree on one thing very clearly—this
12 Commission has the legal authority to include an income tax allowance in the
13 determination of the revenue requirement.³

14 In Arizona, the Commission is responsible for setting “just and reasonable” rates
15 and charges for utility services furnished by utilities.⁴ The process followed by the
16 Commission in setting “just and reasonable” rates has been summarized as follows:

17 The general theory of utility regulation is that total revenue, including
18 income from rates and charges, should be sufficient to meet a utility’s
19 operating costs and to give the utility and its stockholders a reasonable rate
20 of return on the utility’s investment. To achieve this, the Commission must
21 first determine the “fair value” of a utility’s property and use this value as
22 the utility’s rate base. The Commission then must determine what the rate

23 ¹ In this reply brief, Pima uses the same citation format, abbreviations and conventions as utilized in its
24 initial closing brief dated July 3, 2012. Additionally, the parties’ closing briefs will be identified as “Staff
25 Br.,” “RUCO Br.,” and “Company Br.,” respectively.

26 ² RUCO Br. at 13:4 – 17:2.

³ Staff Br. at 14:4-19.

⁴ See Ariz. Const. art. 15, § 3.

1 of return should be, and then apply that figure to the rate base in order to
2 establish just and reasonable tariffs.⁵

3 Nearly 100 years of decisions by Arizona courts have required the Commission to
4 set rates that will produce sufficient revenue to allow the utility to recover its costs of
5 service, including a reasonable rate of return on the fair value of its property devoted to
6 public service.⁶ As the Arizona Court of Appeals explained in *Scates*:

7 [T]he rates established by the Commission should meet the overall operating
8 costs of the utility and produce a reasonable rate of return. It is equally clear
9 that the rates cannot be considered just and reasonable if they fail to produce
a reasonable rate of return or if they produce revenue which exceeds a
reasonable rate of return.⁷

10
11 The starting point of a permanent rate application is the test year. However, those
12 results must be adjusted to obtain a normal and more realistic relationship between rate
13 base, revenue, and expenses that will be representative of the period when the new rates
14 are in effect.⁸ The process and procedures that the Commission follows to gather and
15 consider evidence in setting rates are quasi-judicial in character. A clear statement of the
16 process is found in *State ex rel. Corbin v. Arizona Corporation Commission*, which
17 explained:

18 [A proceeding to fix rates] carries with it fundamental procedural
19 requirements. There must be a full hearing. There must be evidence
20 adequate to support pertinent and necessary findings of fact. Nothing can be
treated as evidence which is not introduced as such. . . . Facts and
circumstances which ought to be considered must not be excluded. Facts

21 ⁵ *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (App. 1978) (citations
22 omitted). See also *U.S. W. Commc'ns., Inc. v. Ariz. Corp. Comm'n*, 201 Ariz. 242, 245, 34 P.3d 351, 354,
23 ¶ 13 (2001) (The "fair value [of the utility's plant and property] has been the factor by which a reasonable
rate of return [is] multiplied to yield, with the addition of operating expenses, the total revenue that a
corporation could earn.") ("US West") (citing *Scates*, 118 Ariz. at 533-34, 578 P.2d at 614-15).

24 ⁶ See *US West*, 201 Ariz. at 246, 578 P.2d at 355, ¶ 18 ("a line of cases nearly as old as the state itself has
sustained the traditional formulaic approach" to setting rates).

25 ⁷ *Scates*, 118 Ariz. at 534, 578 P.2d at 615.

26 ⁸ A.A.C. R14-2-103(A)(3)(i) (defining pro forma adjustments).

1 and circumstances must not be considered which should not legally
2 influence the conclusion. Findings based on the evidence must embrace the
basic facts which are needed to sustain the order. . . .

3 A proceeding of this sort requiring the taking and weighing of evidence,
4 determinations of fact based upon the consideration of the evidence, and the
5 making of an order supported by such findings, has a quality resembling that
6 of a judicial proceeding. Hence it is frequently described as a proceeding of
7 a *quasi-judicial* character. The requirement of a "full hearing" has obvious
8 reference to the tradition of judicial proceedings in which evidence is
9 received and weighed by the trier of the facts. The "hearing" is designed to
afford the safeguard that the one who decides shall be bound in good
conscience to consider the evidence, to be guided by that alone, and to reach
his conclusion uninfluenced by extraneous considerations which in other
fields might have play in determining purely executive action. The
"hearing" is the hearing of evidence and argument.

10 It follows that it is not enough for RUCO to merely assert, as it does, that "the [utility]
11 bears the burden of proof."¹⁰ All parties bear the same burden to provide substantial
12 evidence in support of their recommendations because, absent substantial evidence, the
13 Commission cannot sustain its own decisions.¹¹

14 While the Commission is legally bound to act upon substantial evidence, what it
15 does with such evidence is within admittedly broad discretion. The breadth of the
16 Commission's discretion over rates is perhaps best summed-up by RUCO in this
17 representation to the Arizona Court of Appeals:

18 This Court's interpretation of the Commission's discretionary authority is
19 consistent with the recognition that other Arizona courts have given
20 regarding the Commission's constitutional ratemaking authority. The
21 Commission's authority over ratemaking is plenary and cannot be interfered
with by the legislature, the courts, or the executive branch. Even if this
Court were to review and reweigh the evidence as suggested by the

22 ⁹ 143 Ariz. 219, 223-24, 693 P.2d 362, 366-67 (App. 1984) (quoting *Morgan v. United States*, 298 U.S.
468 (1936)).

23 ¹⁰ See, e.g., RUCO Br. at 18:11-13.

24 ¹¹ E.g., *Consol. Water Utils, Ltd. v. Ariz. Corp. Comm'n*, 178 Ariz. 478, 481, 875 P.2d 137, 140 (App.
1993) (citing *Tucson Elec. Power Co. v. Ariz. Corp. Comm'n*, 132 Ariz. 240, 243, 645 P.2d 231, 234;
25 *Ariz. Corp. Comm'n v. Citizens Utils. Co.*, 120 Ariz. 184, 190 n. 5, 584 P.2d 1175, 1181 n. 5 (App. 1978)
26 (court's review is limited to a determination of whether the Commission's order is supported by
substantial evidence and therefore not arbitrary).

1 Appellant, and come to a contrary result, it would not be a sufficient basis
2 for reversal of the Commission's decision unless the Commission's decision
is determined to be unlawful or unreasonable. (footnotes omitted).¹²

3 Or this statement, also made by RUCO to the appellate court:

4 The Arizona Constitution vests the Arizona Corporation Commission with
5 full and exclusive power to fix rates, charges, and classifications for public
6 utilities. *State v. TEP*, 15 Ariz. 294 (1914). The Commission's authority
7 over ratemaking is plenary and cannot be interfered with by the legislature,
the courts or the executive branch. This authority includes "all powers
which may be necessary or essential in connection with the performance of
its duties." (footnotes omitted).¹³

8
9 In the second of these two rate case appeals, RUCO specifically argued that the
10 Commission's broad discretion over rates included the power to impute hypothetical
11 components into the determination of the revenue requirement.¹⁴ There is no material
12 difference between the imputation of a tax expense and the imputation of a higher debt
13 amount and non-existent interest deduction into a revenue requirement save one; as
14 Mr. Spitzer explained numerous times, the tax is real.¹⁵ Both lie within the broad
15 discretion afforded the Commission under Arizona law.

16
17 **II. REPLY ON RATE BASE ISSUES**

18 **A. Excess Capacity (Wastewater)**

19 1. Staff's Engineer Admitted That 1.6 MGD Is Not Enough Treatment
20 Capacity

21 Staff admits that its analysis of excess capacity is limited to a review of test year

22
23 ¹² Brief of Intervenor-Appellee at 7, *Chaparral City Water Co. v. Ariz. Corp. Comm'n*, No. 08-0002 (Ariz.
Ct. App. Apr. 6, 2009).

24 ¹³ Brief of Intervenor-Appellee at 8, *Gold Canyon Sewer Co. v. Ariz. Corp. Comm'n*, No. 09-0001 (Ariz.
Ct. App. Jun. 17, 2009) ("Intervenor-Appellee Brief in Gold Canyon appeal").

25 ¹⁴ *Id.* at 23 – 28.

26 ¹⁵ *E.g.*, Spitzer Rb. at 14:5-9; Spitzer Rj. at 3:3 – 5:5; Tr. at 190:18-22.

1 flows.¹⁶ From this test year data, Staff concludes that the Company “has more than
2 enough capacity at 1.6 MGD.”¹⁷ “Enough” for what? More than 3,000 homes would not
3 be there today if 1.6 MGD was “more than enough.” Mr. Scott did not dispute this fact.¹⁸
4 There’s also ADEQ’s “80-90” rule.¹⁹ The Company’s peak flows exceeded 85 percent of
5 capacity in the test year, and exceeded 95 percent the year after. Under ADEQ’s
6 requirements, if Pima didn’t already have more than 1.6 MGD of wastewater treatment
7 capacity, the Company should have already been building more capacity.²⁰ Staff’s
8 engineering witness admitted this as well.²¹ Fortunately, Pima already has the capacity
9 built at a very reasonable cost, it is already in service and used, useful and necessary
10 serving current customers. For these reasons, Staff’s disallowance should not be adopted.

11

12 **III. REPLY ON INCOME STATEMENT ISSUES**

13 **A. Salary and Wages (Water & Wastewater)**

14 **1. Staff Doesn’t Offer Substantial Evidence**

15 Staff’s entire argument is that the Company has not complied with NARUC and,
16 therefore, Staff’s unexplained and unsupported salary allocation should stand.²² But, as
17 Staff pointed out, the Commission previously looked at the issue of whether the salary is
18 set properly in light of the role Mr. Robson also plays for the other Robson utilities.
19 That’s why the Commission directed the wage study that Ms. Brown claimed she had not

20

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¹⁶ Staff Br. at 3:23 – 4:2.

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¹⁷ Staff Br. at 4:6-7.

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¹⁸ Tr. at 415:6-13

24

¹⁹ Tr. at 424:7-16.

25

²⁰ *Id.*

26

²¹ *Id.*

²² Staff Br. at 6:7-13.

1 seen.²³ But it was filed.²⁴ Thereafter, the Commission set a salary for Mr. Robson for
2 ratemaking, the same salary the Company used as a starting point to propose a salary level
3 in this case.

4 If the Commission wants the Company to do another “wage study” or look at how
5 Mr. Robson’s or any other expense is allocated, it should direct the Company to do so in
6 its next rate case. For the present, however, Staff’s recommended salary expense of just
7 over \$27,000 (for both divisions) annually is unreasonably low and shouldn’t be adopted;
8 certainly not because of something Pima was ordered to do and did to the Commission’s
9 satisfaction over a decade ago. Staff simply does not offer any substantial evidence on
10 this issue.

11 2. RUCO Has No Basis to “Question” Mr. Soriano’s Testimony

12 Mr. Soriano took the witness stand and testified under oath that the hours reported
13 for Mr. Robson in a data request response were in error and had no relationship to what he
14 actually did for the Company.²⁵ RUCO “questions the ‘mistake.’”²⁶ It would appear that
15 RUCO actually believes that the Company made up a story to evade the impact of a
16 number RUCO considers “oddly precise” and “based on something.”²⁷ Either way, under
17 RUCO’s reasoning in this rate case, once a mistake is made, the witness, the information,
18 and any related information, are so tainted as to render the party unable to sustain its
19 burden on the issue.

20 The reality is that mistakes happen. Most recently, RUCO had to correct several of
21 its final schedules.²⁸ Earlier in this case, Mr. Bourassa found that Staff’s direct rates

22 ²³ Tr. at 466:2-6.

23 ²⁴ Ex. A-17.

24 ²⁵ Tr. at 57:5-20, 60:4-7, 63:22 – 64:15.

25 ²⁶ RUCO Br. at 18:15.

26 ²⁷ RUCO Br. at 18:15-17.

²⁸ See RUCO Revised Schedules.

1 produced too much revenue (nearly \$140,000 too much²⁹) and RUCO's direct rates
2 produced too little (about \$90,000 too little³⁰). Staff and RUCO corrected these mistakes
3 at the next opportunity.³¹ Pima didn't seize upon Staff's error and argue that the
4 Company was entitled to \$140,000 more revenue under Staff's analysis, or that Staff
5 cannot meet its burden on any rate design issue because it made a revenue proof error.
6 That's simply not how it works.

7 The Company realized its error when Staff and RUCO relied upon it. The
8 Company explained where the number came from, why it was included and why
9 Mr. Robson did not record time like the others.³² RUCO's witness admitted under cross-
10 examination that he had no basis to dispute Mr. Soriano's explanation of the "mistake"
11 and no information on how many hours Mr. Robson worked. He also testified that he had
12 no basis to question the veracity of the information regarding any other employee and
13 actually admitted that the other numbers reconciled to the GL.³³ Given these facts, RUCO
14 has no basis to "question" the Company's explanation. RUCO is free to reject the
15 Company's recommended expense level and try to support its own. But RUCO still has to
16 meet its burden of proof. On this issue, it is Pima that has produced credible and
17 substantial evidence and met its burden of proof, not RUCO. RUCO's mere doubts or
18 suspicions are not substantial evidence and do not sustain RUCO's burden of proof.

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23 ²⁹ See Bourassa Rb. at 34:14-19

24 ³⁰ Bourassa Rb. at 41:3-7.

25 ³¹ Brown Sb. at 21:4-6; Coley Sb. at 18:10-16.

26 ³² Tr. at 57:5-20, 60:4-7, 63:22 – 64:15; Soriano Rb. at 8:25 – 9:1.

³³ Tr. at 147:8-14, 154:19 – 155:2.

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B. Rate Case Expense

1. Amount of Rate Case Expense – RUCO Has Not Met Its Burden of Proof

RUCO’s entire argument is that the Company’s requested rate case expense is “excessive” compared to recent rate cases for Arizona Water and UNS Gas, both larger utilities.³⁴ Of course, Pima’s being smaller than Arizona Water and UNS Gas doesn’t change the fact that Pima still has to participate in discovery, five rounds of pre-filed testimony, hearings, two rounds of briefing, public comment sessions and open meeting. Moreover, Arizona Water and UNS Gas have in-house rate staff and legal counsel. Mr. Coley admitted that this impacts comparison of rate case expense,³⁵ yet RUCO makes no effort at reconciliation. RUCO didn’t look at any of the evidence of other comparables provided by the Company either.³⁶ RUCO simply points at two other utilities, literally ignoring every other piece of evidence in the record. This is not substantial evidence and RUCO has fallen well short of meeting its burden of proof.

2. Method of Recovery – The Past Is Not Indicative of the Future

RUCO continues to assert that history normally repeats itself, meaning Pima will stay out a long time between rate cases.³⁷ Again, RUCO simply ignores all of the evidence that suggests Pima will have to file for new rates in no more than five years— because it is building plant, because it will have to refinance debt, and because the community is built out, meaning growth will no longer mask increases in expenses as it

³⁴ RUCO Br. at 20:7 – 21:7. RUCO actually mistakenly identified the water utility as “American Water Company” at line 10 on page 20, not Arizona Water, the one discussed by its witnesses. Tr. at 345:23 – 346:20, 347:16-18. Pima understands this was a “mistake” and does not question that RUCO made an error but still intends to compare to Arizona Water, not American, a comparison that is flawed for other reasons besides this mistake.

³⁵ Tr. at 347:19 – 348:8.

³⁶ Tr. at 348:15-17.

³⁷ RUCO Br. at 21:20-22.

1 did between this rate case and the prior ones.³⁸ RUCO even ignores its own “grave”
2 concern and recommends a typical four-year normalization of rate case expense.³⁹
3 Fortunately, the Company’s recommended rate case surcharge addresses all of RUCO’s
4 concerns, a fact that its witness readily admitted.⁴⁰ As such, there is no reason to penalize
5 Pima with RUCO’s preferred 10-year amortization alternative.⁴¹

6 **3. Staff Agrees a Surcharge Is Lawful**

7 Staff doesn’t say much on this issue, although Staff’s brief does point out that some
8 jurisdictions have used rate case expense surcharges, and Staff agrees that the
9 Commission can do so in this case.⁴² Staff actually asserts that all expenses could be
10 surcharged.⁴³ The Company does not know whether that’s true, but that isn’t the point.
11 Rate case expense is not like other expenses and has no impact on the matching of plant,
12 expenses/revenues and customers.⁴⁴ A surcharge is fair and balanced.

13 **C. Income Tax Expense**

14 There are essentially eight assertions made by and critical to Staff’s and/or
15 RUCO’s strenuous opposition to income tax recovery for Pima and other pass-throughs.
16 These assertions and Pima’s reply are discussed below. Notably, five of these eight
17 assertions are undisputed.

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19

³⁸ See Soriano Rb. at 2:23 – 3:14; Bourassa Rj. at 17:12-19.

20 ³⁹ RUCO Br. at 21:12-13.

21 ⁴⁰ Tr. at 349:24 – 350:2.

22 ⁴¹ RUCO Br. at 22:20-21. There is no dispute rate case expense is largely incurred before new rates go
23 into effect. See Coley at Sb. at 10:15-20. Thus, RUCO’s 10 year recovery period would require the
Company to wait at least 10 years to recover, without carrying costs, costs it has already incurred. Soriano
Rb. at 4:11-13; Bourassa Rj. at 17:4-9.

24 ⁴² Staff Br. at 7:3-7.

25 ⁴³ Staff Br. at 7:11-13.

26 ⁴⁴ See Bourassa Rb. at 13:11-18; Bourassa Rj. at 15:9-18.

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1. It Is Undisputed that Pima “Does not Pay Income Taxes Itself”⁴⁵

As stated in its brief, “Pima does not remit a tax payment; instead it files an informational return with the IRS and issues K-1s to its shareholders. The K-1s reflect the tax liability generated by the Company’s provision of utility services and each shareholder’s allocation of that income or loss for tax purposes. Each shareholder must report that tax liability.”⁴⁶ The Company went on to assert—“It is just a simple ‘but for’ test. ‘Either the income arises from the operation of the utility or it doesn’t.’ If it does, then income tax liability is a cost of service and ‘an entity, pass-through entity, C entity, whatever’ should be allowed to recover the cost of that tax liability.”⁴⁷ That Pima does not pay taxes itself has never been in dispute. It is, however, equally undisputed that the income tax liability arises from utility service.

2. It Is Undisputed that Pima’s “Shareholders Took Advantage of the Tax Benefits Realized by the Federal Tax Reform Act of 1986 (‘TRA 86’)”⁴⁸

It is a good thing that Pima’s shareholders take advantage of tax benefits available to it. Those tax benefits, i.e., lower taxes, are the reason Congress amended the tax code.⁴⁹ Limited liability companies, the most common form of pass-throughs today, didn’t even exist before then.⁵⁰ But more importantly for this issue, no evidence has been offered and no allegation has been made that the shareholders are realizing the benefits of the 1986 Tax Code at the expense of the ratepayers. If a business decision is no worse

⁴⁵ Staff Br. at 7:16-18; RUCO Br. at 7:2.
⁴⁶ Company Br. at 24:12-15 (citing Tr. at 178:22 – 179:5, 179:12, 231:14-16).
⁴⁷ Company Br. at 25:18-21 (citing Soriano Rb. at 7:6-12; Tr. at 236:20-22, 238:15-19).
⁴⁸ RUCO Br. at 7:16-17.
⁴⁹ Spitzer Rb. at 6:4-22 (discussing changes made to tax code and why it compelled formation of pass-through entities). *See also* Spitzer Rb. at 10:17-24 (1986 changes in the tax code were about shaping the economy, not just funding government operations).
⁵⁰ The ALJ is asked to take administrative notice that Arizona’s Limited Liability Company Act, A.R.S. § 29-601 *et seq.*, was adopted in 1992. It would appear that the first state to authorize LLCs was Wyoming in 1988. W.S. § 17-29-101 *et seq.*

1 than neutral to customers, why does RUCO care? All things being equal, why would
2 RUCO want Pima to operate as a C corporation, an entity that pays the highest rate on
3 taxes, rather than as a more efficient pass-through? Efficiency is good, whether it be
4 regarding taxes or power, pensions and paperclips.

5 And, just maybe, paying less tax on Pima's operations really does make Pima a
6 more attractive investment, which makes an investment in Pima more competitive with
7 alternative investments like an investment in a publicly traded utility company. Pima's
8 becoming a more attractive investment would also be a good thing for the current and
9 future ratepayers living in Sun Lakes because the community's infrastructure is starting to
10 age and will need repair and replacement going-forward.⁵¹ Of course, all things are not
11 equal today. It is not a simple choice of avoiding the highest tax rates for lower tax rates.
12 It is the 41.5 percent or none.⁵² RUCO and Staff like zero tax recovery because it is a
13 windfall for ratepayers of utilities that took advantage of the intended benefits of "TRA
14 86." The Company does not believe that strikes a fair balance.

15 3. It Is Undisputed that No Entity Appears to Have Converted to a
16 C Corporation Because of the Current Commission Policy Against
Tax Recovery for Pass-throughs⁵³

17 RUCO may be correct that the current policy has not yet "pushed" an entity to
18 change its corporate structure. Although Pima changed to a C corporation in the late
19 1970s, when it was more tax efficient to do so, since 1986 it has continued to voluntarily
20 elect S corporation status. But this is also the first and only time since 1986 that Pima has
21 asked for an income tax allowance to be included in its revenue requirement. Before that,
22 it appears that the Commission did include the allowance for S corporations and
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⁵¹ Soriano Rb. at 3:11-13.

25 ⁵² See Tr. at 86:25 – 87:3; Staff Br. at 14:15-19; RUCO Br. at 17:3-8.

26 ⁵³ RUCO Br. at 10:3 – 11:18.

1 partnerships.⁵⁴ Pima's request is made at a time when several other water utilities are
2 requesting similar treatment, and the Commission is actively engaged in reassessing its
3 current policy regarding income taxes for pass-throughs.⁵⁵ If the request is denied, Pima
4 has said it will have to go back and look at the cost of operating as a tax efficient entity.⁵⁶
5 Other pass-throughs might as well, as any investor-owned entity is constantly
6 re-evaluating the returns from its assets, particularly in light of current economic
7 conditions. RUCO may believe history will repeat itself and it may even have a crystal
8 ball. On the other hand, the economy isn't what it used to be. Money supplies are tight
9 and investors are more wary. Another denial of a tax allowance for a pass-through entity
10 will send a clear signal that the Commission will never change and utilities should convert
11 their corporate structure to a C corporation.

12 4. It Is Undisputed that FERC's Current Policy Is to Allow Tax
13 Allowances to Pass-throughs⁵⁷

14 FERC spent roughly a decade reversing a prior policy that denied income tax
15 allowance to pass-throughs. In creating the current policy, FERC "grappled with the
16 'phantom income' argument advanced by Mr. Johnston and relied upon by" RUCO.⁵⁸
17 Ultimately, FERC rejected the argument that income tax allowances should be denied to
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19 ⁵⁴ *Consolidated Water*, 178 Ariz. 478, 875 P.2d 137; Tr. at 289:7-17, 312:10-13.

20 ⁵⁵ *In the Matter of the Application of Johnson Utilities, L.L.C., dba Johnson Utilities Company for an*
21 *Increase in Its Water and Wastewater Rates for Customers within Pinal County, Arizona*, Docket No. WS-
22 *02987A-08-0180*; *In the Matter of the Commission's Generic Evaluation of the Regulatory Impacts from*
23 *the Use of Non-Traditional Financing Arrangements by Water Utilities and Their Affiliates*, Docket No.
24 *W-00000C-06-0149*; 6/19/12 Staff Mtg.

25 ⁵⁶ Tr. at 394:14 – 395:7.

26 ⁵⁷ Staff Br. at 10:19 – 11:18; RUCO Br. at 6:2-3.

⁵⁸ Spitzer Rj. at 6:7 – 7:3. It is noted that while RUCO and Mr. Rigsby rely heavily on Mr. Johnston (e.g.,
RUCO Br. at 3:1 – 4:10; Rigsby Dt. at 13:7 – 14:8 and Exhibit 1), Mr. Johnston has not testified in this
proceeding and has not been qualified as an expert by RUCO. At best, Mr. Johnston's comments appear
to constitute little more than strongly biased public comment by a very vocal barnstorming lobbyist
singularly focused on this issue.

1 pass-throughs because the tax is not paid at the utility level, Tier 1. FERC reasoned that
2 the tax liability is “real” and is a cost of service so long as the tax paying entities, Tier 2,
3 have an “actual or potential income tax liability.”⁵⁹ FERC voted to change its policy and
4 allow recovery of an income tax allowance to promote tax efficiency and as an effort to
5 spur investment in infrastructure.⁶⁰ Like this Commission, FERC has its own mandate to
6 balance the interests of shareholders and ratepayers in establishing “just and reasonable”
7 rates.⁶¹

8 5. It Is Undisputed that “Arizona Should Not Adopt a Policy Just
9 Because the Federal Government Has Chosen to Do So. The
10 Policy Must Make Sense for Arizona”⁶²

11 Pima agrees.⁶³ The Company hired Mr. Spitzer to explain FERC’s decision and
12 reasoning so that the Commission could understand how another agency addressed the
13 matter. The Company has asserted that a similar policy in Arizona to allow pass-through
14 entities to recover an income tax allowance would promote efficiency, provide equal
15 treatment on recovery of costs of service, and encourage investment in water and sewer
16 infrastructure in the State. If the Commission agrees, it should change its policy.

17 6. It Is Disputed (with RUCO) that the ACC Cannot Legally Base
18 Rates on Operating Costs that Do Not Exist⁶⁴

19 This is a desperate and disingenuous assertion and it should be rejected. First, the
20 tax liability is real.⁶⁵ Second, as discussed in Section I, the Commission has broad

21 ⁵⁹ Spitzer Rb. at 17:9 – 18:17, 21:1-22.

22 ⁶⁰ Tr. at 183:16-21, 188:3-19 (discussing the thinking behind and success of FERC’s policy change).

23 ⁶¹ Spitzer Rb. at 15:21 – 16:2 (citing *In re Permian Basin Area Rate Cases*, 390 U.S. 747 (1968) and *Fed.*
Power Comm’n v. Hope Natural Gas Co., 320 U.S. 591 (1944)).

24 ⁶² RUCO Br. at 4:19-21. *See also* Staff Br. at 9:16-20.

25 ⁶³ Spitzer Rj. at 6:7-25. *See also* Tr. at 188:23 – 189:4.

26 ⁶⁴ RUCO Br. at 15:13-16.

⁶⁵ Spitzer Rb. at 14:5-9; Spitzer Rj. at 3:3 – 5:5; Tr. at 190:18-22.

1 discretion in setting rates. RUCO knows this, and its own witness agreed that this
2 discretion includes the power to include an income tax allowance in the revenue
3 requirement.⁶⁶ Third, as noted in the legal discussion at the outset of this brief, RUCO has
4 previously asserted that this broad discretion specifically includes the authority to
5 consider truly non-existent expenses (hypothetical interest deductions) in the
6 determination of a revenue requirement.⁶⁷ Fourth, the courts have already determined that
7 it is within the Commission's discretion to include an income tax allowance in the revenue
8 requirement.⁶⁸ As noted, before *Consolidated Water*, the Commission allowed
9 S corporations to recover income taxes, apparently without legal challenge by RUCO. In
10 summary, RUCO waited until after trial to assert for the first time that the Commission
11 cannot include income tax expense in the revenue requirement determined in this rate
12 case.⁶⁹ But RUCO is wrong. The Commission can include the requested income tax
13 allowance if it believes, based on substantial evidence, that doing so results in just and
14 reasonable rates.

15 7. It Is Disputed that the Income Tax Allowance Creates a Potential
16 for Unjust Enrichment⁷⁰

17 Pima acknowledges the shareholders will use gains and losses from other business
18 activities to offset income from Pima. Pima also agrees that such offset makes it unlikely

19 ⁶⁶ Tr. at 289:20-25. Although Mr. Rigsby is not an attorney and was not offered by RUCO as a legal
20 expert, Mr. Rigsby's testimony contains significant discussion of legal authorities governing ratemaking in
21 Arizona. *See, e.g.*, Rigsby COC Dt. at 7 – 8, 19, 54. Of course, in this instance, Mr. Rigsby also happens
to be correct.

22 ⁶⁷ Intervenor-Appellee Brief in Gold Canyon appeal at 23 – 28.

23 ⁶⁸ Staff Br. at 14:12-15 (citing *Consolidated Water*, 178 Ariz. at 484, 875 P.2d at 143).

24 ⁶⁹ As stated, the Company specifically asked Mr. Rigsby and he agreed the Commission could grant the
25 requested relief. Tr. at 312:2-5. It is also noteworthy that RUCO did **not** raise "constitutionality" as a
concern when it opposed the requested income tax allowance in the Johnson rate case. *See, e.g.*, RUCO's
Opening Brief, filed Nov. 20, 2009 in Docket No. WS-02987A-08-0180, at 7 – 8; RUCO's Reply Brief,
filed Dec. 11, 2009 in Docket No. WS-02987A-08-0180, at 4 – 5.

26 ⁷⁰ RUCO Br. at 11:21 – 12:3.

1 that the income tax allowance approved for ratemaking will exactly match the actual tax
2 payments. That is why Pima has consistently made two points. First, all of the expenses
3 included in the revenue requirement are estimates.⁷¹ If a C corporation utility makes less
4 revenue than anticipated, the amount of taxes included in the revenue requirement will be
5 higher than the taxes actual paid. Under RUCO's reasoning, that extra tax money would
6 be a windfall. The utility wouldn't likely agree. The point is, there are no post-rate case
7 true-ups for any operating expense—not on power, pensions, paperclips or taxes.

8 Second, the use of offsets for pass-throughs is no different than the use of offsets
9 by the C corporation parent. Again, there is no post-rate case true-up. The Commission
10 does not look at the parent corporation's income and deductions to see if the set level of
11 tax expense is the amount actually paid. And RUCO's contention that "excess funds stay
12 with the [C corporation] utility" is wrong, as a matter of tax law, and as a matter of utility
13 regulation.⁷² On the tax side, while RUCO seems to concede there is always a delta
14 between what a utility recovers in rates and pays in tax (even as to a C corporation), it
15 fails to comprehend the fundamental distinction between the accrual of an income tax
16 liability and payment of income taxes. The annual nature of income tax for public
17 companies, whether utilities or not, involves ongoing income tax audits and adjustments
18 among and between taxable years, carrybacks, carryforwards, bonus depreciation, etc.,
19 meaning that what a utility recovers in rates for income taxes each year and what it pays
20 in taxes will never match.⁷³ But there is no principle of tax or regulatory law requiring the

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22 ⁷¹ See Bourassa Rb. at 22:9-17; Bourassa Rj. at 18:1-6; Tr. at 126:21 – 127:1.

23 ⁷² RUCO Br. at 12:18 – 13:3. RUCO apparently means "excess funds" to be net income that is greater
24 than what was expected in the rate case. But net income can increase as a result of efficiency, unexpected
25 revenue growth, tax law changes, or a host of other reasons – each of which can also work the other way
26 and create a shortfall in income. This is no new issue or fact; it's simply a phrase that tries to make the
normal seem abnormal.

⁷³ Tr. at 124:1 – 127:1. See also Bourassa Rb. at 22:9-17; Bourassa Rj. at 18:1-6.

1 utility to reinvest increased net income (what RUCO calls “excess funds”) in the utility.⁷⁴
2 Earned money can be invested or spent, or distributed or retained within the utility’s
3 management’s discretion.

4 This leads to the regulatory flaw in RUCO’s argument. Utilities deploy capital
5 from whatever source derived (including “excess funds” from an income tax allowance)
6 and such investments can be deemed imprudent or mandated by Commission order.
7 A utility (C corporation or S corporation) will invest funds in utility operations under
8 regulatory principles. Utility customers are not being cheated if a utility does not deploy
9 net income derived from rates back into utility operations—no matter what kind of entity.
10 If the Commission found that net income greater than expected had to be reinvested, it
11 would increase the cost of capital by imposing a hard cap on earnings, and it would
12 eliminate any incentive to seek efficiency in an attempt to increase net income. Non-tax
13 principles, such as the attraction of capital, govern whether the S corporation reinvests or
14 distributes such funds or whether a C corporation reinvests or simply declares an
15 increased dividend. In practice, an income tax allowance for a pass-through works just
16 like an income tax allowance for a C corporation with a parent.

17 8. It Is Disputed that Some Review of Individual Income Tax Returns
18 Will Be Needed⁷⁵

19 For starters, Pima’s shareholders have not been asked for their individual tax
20 returns in this case. In any event, looking at individual tax returns in a given year will not
21 provide a sound basis upon which the effective tax rate should be based. The tax paid in
22 any given year is dependent upon other income and deductions available to the owners.
23 These vary significantly from year to year, which also means the effective tax rates can
24 vary significantly from year to year. This is why the Commission doesn’t look at

25 ⁷⁴ See RUCO Br. at 12:18-21. RUCO offers no citation to the record for this proposition.

26 ⁷⁵ Staff Br. at 13:17-19.

1 individual tax returns for C corporations to determine the effective tax rate. Looking at
2 other income and deductions of the shareholder could result in cross-subsidization. For
3 example, why should ratepayers receive the benefit of a lower tax rate from losses
4 incurred by a non-regulated company also owned by the shareholder or the parent
5 company of a C corporation (e.g., APS and Suncor)? The opposite is also true—why
6 should ratepayers pay higher taxes because additional non-regulated income received by
7 the shareholder or the parent company of a C corporation bumps the shareholder or parent
8 into a higher tax bracket? The method used by Mr. Bourassa is not perfect, but the
9 premise, like that of the FERC method, is that over time the shareholders of the
10 S corporation will incur on average the taxes allowed on the utility income passed to
11 them.⁷⁶ This, the “stand-alone” method, is used for APS and other C corporations that are
12 part of a consolidated structure, and it treats income taxes in the same manner as most
13 other utility revenues and expenses. That is, both revenues and expenses are estimated
14 and not trued-up in later rate cases. In other words, what Mr. Bourassa proposes is
15 consistent with standard ratemaking principles, whereas Staff’s call for individual tax
16 returns is not. For these reasons, individual tax returns are not necessary and should not
17 be required for determining the appropriate effective tax rate to be used for a tax pass-
18 through entity.

19 9. Conclusion

20 The fact that so much is undisputed reflects that this issue comes down to a policy
21 decision for the Commission. The Company has tried, and believes it has succeeded, in
22 making a record and offering argument that supports an income tax allowance for Pima.
23 Like FERC, the Commission should take a long view, not a view limited to rates today.

24
25 ⁷⁶ Because neither Staff nor RUCO agree with any tax recovery, there is no evidence before the
26 Commission to suggest Mr. Bourassa’s methodology is flawed or unfair or results in an expense level that
is unreasonable if the expense is going to be allowed.

1 As Mr. Spitzer explained, FERC took that view and rates went down.⁷⁷ FERC's
2 reasoning in reaching its own decision to reverse course and allow income tax recovery
3 through rates (no matter the type of entity as long as the owners have an actual or
4 potential tax liability) and Mr. Bourassa's use of reasoned calculation methods to reach a
5 reasonable tax rate, illuminates for the Commission that it can make a rational decision to
6 change its policy. It is now up to the Commission to decide how to exercise its discretion
7 on the issue.

8
9 **IV. REPLY ON COST OF CAPITAL AND RATE OF RETURN ISSUES**

10 RUCO adopts the Company's pro forma capital structure with its low 4.25 percent
11 cost of debt.⁷⁸ RUCO then argues that its recommended 9.4 percent cost of equity (which
12 fails to recognize a 13 percent increase in debt level⁷⁹) "if anything, is fair and reasonable"
13 but it could have been lower.⁸⁰ While RUCO accepts that Pima has taken on more
14 financial risk to benefit the ratepayers through lower cost of capital, RUCO "rewards" the
15 utility with a lower cost of equity, decreased salary for its CEO, less rate case expense,
16 and asks the shareholders to absorb the taxes that are part of the utility's cost of service.
17 This treatment belies RUCO's lack of understanding that investors have alternative
18 investment options and that investors will not invest merely because they are captives of
19 their CC&N. This myopic view will lead to higher costs of service in the future as Sun
20 Lakes ages and infrastructure has to be replaced. The Company is asking the Commission

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⁷⁷ Tr. at 245:6 – 246:8.

23 ⁷⁸ RUCO Br. at 26:7-9.

24 ⁷⁹ Mr. Rigsby recommended 22.53 percent debt level in his direct testimony. Rigsby COC Dt. at 6:10-13.
25 All parties are now recommending a debt level of 35.4 percent. Company Final Schedules D-1 (water)
and D-1 (wastewater); Cassidy Sb. at Schedule JAC-1; RUCO Final Schedules RBM-19 (water) and TJC-
18 (wastewater). The difference is 12.9 percent.

26 ⁸⁰ RUCO Br. at 27:3-5.

1 to look down the road and see the bigger picture in terms of planning for the future of the
2 utility customers.

3 Staff's cost of capital, although not so result driven as RUCO's, is also 9.4 percent,
4 also fails the same reasonableness tests, and should also be rejected.⁸¹ Whatever the
5 result, on this record in this case, Pima respectfully submits the number is north of
6 9.4 percent ROE.

7
8 **V. REPLY ON RATE DESIGN AND OTHER TARIFF CHANGES**

9 **A. Rate Design**

10 Neither Staff nor RUCO raise concern with the Company's rate designs or address
11 the rate design "concerns" discussed in the Company's brief.⁸² Therefore, there is nothing
12 for Pima to reply to on rate design.

13 **B. BMPs**

14 1. Reply to Staff – Will the Commission Continue to Duplicate
15 Regulation?

16 Staff never explains why it is necessary to order Pima to have more BMPs and to
17 make BMP filings with the Commission. Staff's whole argument is that others have been
18 ordered to do it.⁸³ That does not justify excessive and duplicative regulation. Pima
19 already has BMPs and already files reports with ADWR. Absent substantial evidence that
20 the additional layer of regulation is necessary, "it has been done before" is not a rational
21 basis to order the additional BMP requirements in this case.

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25 ⁸¹ Bourassa COC Rj. at 2:17-19, 6:16 – 7:6.

26 ⁸² Company Br. at 44 – 45.

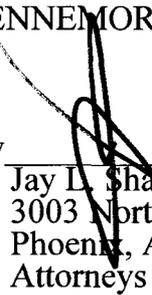
⁸³ See Staff Br. at 17 – 18.

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RESPECTFULLY SUBMITTED this 27th day of July, 2012.

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