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BEFORE THE ARIZONA CORPORATION COMMISSION

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ARIZONA CORPORATION COMMISSION
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IN THE MATTER OF THE APPLICATION OF CLEAR SPRINGS UTILITY COMPANY, INC. FOR AUTHORITY TO INCUR LONG-TERM DEBT.

DOCKET NO. W-01689A-11-0401

IN THE MATTER OF THE APPLICATION OF CLEAR SPRINGS UTILITY COMPANY, INC. FOR A RATE INCREASE.

DOCKET NO. WS-01689A-11-0402

STAFF'S CLOSING BRIEF

At the hearing held on August 6, 2012, the Administrative Law Judge ("ALJ") assigned to these consolidated matters directed the Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") to file a closing brief on the issues of whether Staff's recommendation that the Clear Springs Utility Company, Inc. ("Company" or "Clear Springs") record the Debt Service Reserve Fund as a regulatory liability is lawful, and if so, the manner in which that recommendation could be accomplished. Staff hereby provides the following response.

I. BACKGROUND.

Staff recommends in these consolidated matters that the Company be authorized to incur debt from the Water Infrastructure Finance Authority of Arizona ("WIFA") in the amount of \$426,249 to finance capital improvements and replacements ("WIFA loan"). Staff also recommends that Commission authorize the Company to collect a surcharge from ratepayers because the Company needs additional funds to meet all obligations associated with the WIFA loan.

WIFA contractually requires debtors to submit payment equal to twenty (20) percent of the debt service (principal and interest) payment for the sixty (60) monthly payments beginning with the seventh monthly payment and ending with the sixty-seventh monthly payment.¹ These payments are

¹ Beginning with the sixty-eighth monthly payment and continuing for the term of the loan, WIFA also requires the borrower to make monthly deposits to a Repair and Replacement Fund equal to 20 percent of the monthly debt service payment. These funds are held by the borrower, and they may be used to repair and maintain the assets acquired with the loan proceeds.

1 held by WIFA in a Debt Service Reserve Fund (“DSRF”). WIFA uses the DSRF as security in the
2 event of untimely payments by the borrower. At the end of the loan term, WIFA applies the funds in
3 the DSRF to pay off the remaining balance on the loan. In this regard, the DSRF is essentially a
4 savings account that accumulates to the direct benefit of the utility owners.

5 In this case, the Company’s ratepayers would fund the DSRF under Staff’s recommended
6 infrastructure surcharge. Since ratepayers should not be required to provide funds for utility owners
7 to accumulate savings, any additional funds collected from ratepayers to satisfy the cash flow
8 requirement of the DSRF should be treated as a regulatory liability. The Commission could then
9 determine at a future date (e.g., in a future rate case) the amount and manner in which that regulatory
10 liability should benefit ratepayers (e.g., refunds, rate base reductions, operating expense reductions,
11 etc.). Accordingly, Staff recommends that the Company record a regulatory liability for any
12 infrastructure surcharge collected by the Company for the DSRF and the associated property and
13 income taxes.

14
15 **II. IT IS LAWFUL FOR THE COMPANY TO COLLECT A SURCHARGE, DEPOSIT**
16 **THE PROCEEDS IN A DEBT SERVICE RESERVE FUND AND RECORD AN**
17 **AMOUNT EQUAL TO THE DEPOSIT AS A REGULATORY LIABILITY.²**

18 For accounting purposes, the Commission requires the Company to comply with the Uniform
19 System of Accounts established by the National Association of Regulatory Utility Commissioners
20 (“NARUC”). The Company is also required to comply with applicable tax law with its state and
21 federal tax return filings.³

22 Under Staff’s recommendation, the Company would record the surcharge collected for the
23 debt service reserve fund as a regulatory liability. For purposes of state and federal income tax
24 filings, these collections would be recognized as revenues and would create a tax obligation in the
25 year of collection. In the future, as the Company returns the funds to ratepayers as directed by the
26 Commission, the Company would deduct the refunds as an expense in the calculation of its income

27 ² The foregoing analysis is for informational purposes only and should in no way or manner be construed as legal advice.

28 ³ Staff notes that the Company is not publicly traded and therefore does not need to comply with the accounting rules and regulations of the Securities and Exchange Commission.

1 tax liability reversing the timing difference and eliminating the regulatory liability (this is the same
2 treatment used to recognize over-collections when a utility has a purchased gas or fuel adjustment
3 clause).

4 Generally accepted accounting principles require recording accumulated deferred income
5 taxes for book-tax timing differences, i.e., when revenues and expenses are recognized in different
6 periods for ratemaking and tax purposes. Recognition of deferred income taxes in the ratemaking
7 process is referred to as "normalization." Normalization can be full or partial. The Internal Revenue
8 Code does not require full normalization, i.e., recognition of all book-tax timing differences in rates,
9 and full normalization is not normally adopted by the Commission for water utilities. The Internal
10 Revenue Code does establish minimum normalization requirements for regulated utilities. Under
11 these minimum requirements, accumulated deferred income taxes resulting from use of different
12 depreciation methods and different asset lives for depreciable assets for books and taxes must be
13 recognized in rates. The Internal Revenue Service could revoke the Company's authorization to use
14 accelerated depreciation for tax purposes for failure to record deferred income taxes, i.e., for not
15 complying with minimum normalization requirements. Deferred income taxes are computed as the
16 tax effect of a timing difference, i.e., by multiplying the current effective tax rate by the amount of
17 the revenue or expense that represents the timing difference. Accumulated deferred incomes taxes
18 are recognized in rates as a component of rate base.

19 Since the refund of the surcharge collections treated as a regulatory liability will result in
20 future deductible amounts for tax purposes, a deductible temporary difference exists. Since this
21 temporary difference results neither from use of a different depreciation method nor a different asset
22 life, the Internal Revenue Code does not require normalization of this temporary difference.
23 However, normalization of this temporary difference is allowed. In this instance, if the regulatory
24 liability is deducted in the calculation of rate base, the normalization process makes the Company
25 whole for any income taxes paid on surcharge collections treated as a regulatory liability since the
26 income taxes paid on the receipt of these funds are treated as an Accumulated Deferred Income Tax
27 Debit, an addition in the calculation of rate base, for ratemaking purposes. Alternately, if the
28

1 regulatory liability is not included in the calculation of rate base, normalization of the related
2 accumulated deferred assets is inappropriate. Regardless of its rate base treatment, the surcharge
3 collected for the debt service reserve fund can be lawfully treated as a regulatory liability and
4 recorded in accordance with the NARUC Uniform System of Accounts and applicable tax law.⁴

5 The Company wrongly asserts that Commission decisions need be subjugated to accounting
6 principles. To the contrary, Commission decisions should not be predicated on accounting principles
7 as suggested by the Company. Instead, accounting principles and regulations impact the proper
8 accounting for transactions lawfully authorized or directed by the Commission as exemplified by
9 normalization as described above.

10 **III. CONCLUSION.**

11 Staff's recommendation that the Company record a regulatory liability for the surcharge
12 collected for the debt service reserve fund is consistent with the NARUC Uniform System of
13 Accounts and can lawfully be accomplished.

14
15 RESPECTFULLY SUBMITTED this 21st day of August, 2012.

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19 _____
20 Scott M. Hesla
21 Staff Attorney, Legal Division
22 Arizona Corporation Commission
23 1200 West Washington Street
24 Phoenix, Arizona 85007
25 (602) 542-3402

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27 Original and thirteen (13) copies
28 of the foregoing were filed
this 21st day of August, 2012, with:

24 Docket Control
25 Arizona Corporation Commission
26 1200 West Washington Street
27 Phoenix, Arizona 85007

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⁴ See Exhibit S-8 (Late-Filed) for an illustration presenting an example of the relevant journal entries for recording surcharge collections for the debt service reserve fund as a regulatory liability as recommended by Staff.

1 Copies of the foregoing were mailed this
2 21st day of August, 2012, to:

3 Steve Wene, Esq.
4 MOYES SELLERS & HENDRICKS LTD.
5 1850 N. Central Avenue, Suite 1100
6 Phoenix, Arizona 85004

7 Clear Springs Utility Company, Inc.
8 Attn: Bonnie O'Connor
9 Southwestern Utility Management
10 P.O. Box 85160
11 Tucson, Arizona 85754

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