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IN THE MATTER OF THE APPLICATION OF JOHNSON UTILITIES, LLC FOR AN INCREASE IN ITS WATER AND WASTEWATER RATES FOR CUSTOMERS WITHIN PINAL COUNTY, ARIZONA.

Docket No. WS-02987A-08-0180

RUCO'S APPLICATION FOR REHEARING OF DECISION NO. 73992

Pursuant to A.R.S. § 40-253, the Residential Utility Consumer Office ("RUCO") requests that the Arizona Corporation Commission ("Commission") rehear Decision No. 73992 docketed July 16, 2013. Decision No. 73992 approved Johnson Utilities ("Johnson" or "Company") Petition to Amend Decision No. 71854 to impute income tax expense.

BACKGROUND

On September 15, 2011, the Commission issued Decision No. 72579, which established the current rates for Johnson.[1] This Decision amended the rates that had been set for Johnson in Decision No. 71854, issued August 25, 2010. Decision No. 72579 also provided that Johnson could seek an allowance for income taxes generated as a result of its operations if the

[1] For the most part RUCO agrees with the background set forth in Decision No. 71854 which is followed here.

Commission changed its policy regarding the treatment of income taxes for subchapter S corporations.

On February 21, 2013, in Decision No. 73739, the Commission adopted a policy allowing every utility entity, other than subchapter C corporations and tax-exempt entities, to seek to include in its cost of service an income tax allowance based on the lower of comparable subchapter C corporate income tax expense, or the combined personal income tax obligation created by the distribution of the utility's profits.

On March 8, 2013, the Company filed a petition to amend Decision No. 71854 pursuant to Arizona Revised Statutes ("A.R.S.") § 40-252. The increase to the revenue requirement for water customers is $125,071, or an increase of 0.95 percent, and the increase to the revenue requirement for wastewater customers is $747,274, or an increase of 6.58 percent.

In its filing, the Company is not proposing any changes to its fair value rate base, which is negative $2,414,613 for its water division and $17,270,553 for its wastewater division. Adopting the increases proposed by the Company would increase the Company's revenue requirements to $9,899,013 and $12,339,134 for its water and wastewater divisions, respectively. For the water division, there is no impact to the fair value rate of return ("FVROR") because the fair value rate base is negative, i.e., the revenue requirement is based on an operating margin. The impact to rates is *de minimis* because the amount of the increase is so small. For the wastewater division, the FVROR remains at 8.0 percent, or may become 12.33 percent, depending on the ratemaking classification for the income tax issue, The Company's current rates, based on a 2007 test year, were approved in Decision No. 71854, as amended by Decision No. 72579. In that case, the Company requested recognition of income tax expense in its application, but it was disallowed as the Commission's policy at that time did not recognize

income tax for pass-through entities that had no income tax liability. However, also at that time, the Commission was in the process of evaluating changes to this policy, which ultimately resulted in Decision No. 73739. The matter was heard at the Open Meeting held on June 27, 2013 and on July 16, 2013; the Commission docketed Decision No. 73992. Decision No. 73992 approved Johnson Utilities ("Johnson" or "Company") Petition to Amend Decision No. 71854 to impute income tax expense.

1) THE COMMISSION VIOLATED THE CONSTITUTIONAL REQUIREMENT TO PRESCRIBE JUST AND REASONABLE RATES BY PERMITTING THE A UTILITY ORGANIZED AS AN LLC TO COLLECT IMPUTED INCOME TAX .

a. The Company's proposal violates Arizona's Constitution because the Commission's process does not properly consider fair value.

The Commission is prohibited from opening up a rate case that was decided over two years ago with a 2007 test year for the purpose of increasing rates based on a new expense without a meaningful fair value analysis. The Arizona Corporation Commission is established by Article 15, Section 1 of the Arizona Constitution. The Commission's authority is derived from Article 15, Section 3, which provides, in relevant part, that the Commission "shall have full power to, and shall, prescribe just and reasonable classifications to be used and just and reasonable rates and charges to be made and collected, by public service corporations within the State for service rendered therein." Ariz. Const. Art. 15, § 3.

Although the Commission's authority to prescribe rates is plenary, Tucson Elec. Power v. ACC, 132 Ariz. 240, 242, the Commission's rate-making authority is not unlimited and is subject to the "just and reasonable" clauses of Article 15, Section 3 of the Arizona Constitution. The Constitution obligates the Commission to consider and protect the ratepayers' interests when determining "just and reasonable rates."

The Commission was created by the states Founding Fathers to shield the ratepayers against overreaching by public service corporations. Deborah Scott Engleby, "The Corporation Commission: Preserving its Independence," (20 Ariz. St. L.J. 241, 242 (1988)). At the time of Arizona's Constitutional Convention, there was such a feeling of mistrust of government, including future legislatures, that the delegates, in order to guarantee "the people security against the dominance of corporate and corrupt control of public affairs..." safeguarded against any legislative encroachment by giving the Legislature authority to enlarge the Commission's powers, but no authority to diminish them. Id. at 244. The result was a public service commission with more power than any other state at the time. State v. Tucson Gas, 15 Ariz. 294, 300, 138 P. 781, 783 (1914).

The Arizona courts have long since recognized the Commission's constitutional obligation to protect the financial interest of the consumer. See for example Southern Pac. Co. v. Arizona Corp. Comm'n, 98 Ariz. 339, 342, 404 P.2d 692, 694 (1965), and also Cogent Public Service v. Ariz. Corp. Comm'n., 142 Ariz. 52, 56, 699 P.2d 698, 02 (App. 1984) ("It has long been the policy of our courts to recognize that the setting of utility rates must take into account the interests of utility customers as well as utility shareholders."). The Arizona Supreme Court has even said that the people of Arizona created the Commission primarily for the interests of the consumer.

> "All persons agree that the capital invested in public service should receive reasonable remuneration, and that the services rendered should be efficient and practicable and to all patrons upon equal terms and conditions. With a full knowledge that these things had not been accomplished under the laws heretofore existing in this and other jurisdictions, the people in their fundamental law created the Corporation Commission, and clothed it with full power to investigate, hear, and determine disputes and controversies between public utility companies and the general public. This was done primarily for the

> interest of the consumer." (Tucson Gas, supra at 307-308, 138 P. 781-786)

Clearly and without question the Commission was given unique and extensive powers primarily to protect the consumers' financial interests.

In order to prescribe rates that are just and reasonable and protect the consumer's financial interests, Arizona's Supreme Court has held that when setting rates for public utilities, the Commission must find the fair value of the property.

> The "fair value of the property" of public service corporations is the recognized levels upon which rates and charges for services rendered should be made, and it is made the duty of the Commission to ascertain such value ...for its own use, in arriving at just and reasonable rates... 80 Ariz. At 151 (citation omitted)
>
> ...the Commission is required to find the fair value of the company's property and use such finding as a rate base for the purpose of calculating what are just and reasonable rates. 80 Ariz. at 151.
>
> The reasonableness and justness of the rates must be related to this finding of fair value. 80 Ariz. At 151 (emphasis added)

Decision No. 71854 was docketed on August 25, 2010 and based on a 2007 test year. The Company filed a petition pursuant to A.R.S. § 40-252 to amend Decision No. 71854 on March 8, 2013. Now, more than two years after the rate case was decided and more than five years from the end of the test year, the Commission seeks to open the rate case for the purpose of raising the ratepayer's rates to include an imputed income tax expense and without considering the Company's current fair value rate base. There is no question of an adjustor nor is there a question of emergency rates. This is simply an extraordinary ratemaking measure implemented in a manner to side-step Arizona's fair value requirement.

There is nothing exceptional about this case that warrants extraordinary ratemaking. The Commission has recently changed its policy to allow for the recovery of income tax expense for pass-through entities. The previous policy was in place since the mid-1980s. While the shareholders of the utility would like to recover their personal income taxes paid as soon as possible, this is hardly a pressing matter that could not wait until the Company files its next rate case. In a rate case all of the Company's expenses and other rate case elements would be considered and there would be a meaningful fair value determination.

Instead, the only expense being considered in the current process is the imputed income tax. In Scates *v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 535, 578 P.2d 612, 616 (App. 1978), Mountain States Telephone and Telegraph Company applied for an increase in rates. The Commission approved the increase without any examination of the costs of the utility apart from the affected services, without any determination of the utility's investment, and without any inquiry into the effect of this substantial increase upon Mountain States' rate of return on that investment. The Court held that the Commission's action was in violation of Arizona's constitutional provisions regarding rate making. *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 533, 578 P.2d 612, 614 (App. 1978). The *Scates* court further went on to note that such a piecemeal approach to ratemaking is fraught with potential abuse. *Scates,* 118 Ariz. at 534, 578 P.2d 612, 615. The Court's reasoning is applicable here. Perhaps even more alarming in the subject case is the length of time between the test year and the time considered for the tax imputation – over five years. Such a difference guarantees no relationship between the variables used to consider the Company's rate base in the rate case and the tax calculation in this case.

b. ALLOWANCE OF AN INPUTED INCOME IMPACTS THE COMPANY'S RATE OF RETURN

The allowance of pass-through income tax simply permits the Company to gain an additional profit from its customers under the guise of recovering operating expenses. The impact is that the Company is allowed a higher return than what the Commission approved in the underlying rate case. Staff alluded to it in its report and Decision 73992 even acknowledges it to some extent in paragraphs 14 – 16. According to Staff (and the Decision), a change in the regulatory classification of the expense could result in a FVROR of 12.33 percent. The Decision classifies the expense differently than what is stated in the Commission's policy in order to avoid impacting the FVROR which is the "intent of the Commission's policy." In other words, the intent of the Commission's policy is different than what the policy states.

While Staff believes the classification of the expense determines the impact on the FVROR, it is elementary that increasing the Company's revenues to make up for an expense that does not exist, will result in an increase to the Company's net income, which in turn will increase the Company's ROR.

Nonetheless, the Commission's decision to impute income tax expense is particularly egregious in this case because the Company's limited liability partners have not invested equity capital in the utilities. The Company's FVRB for its water division is negative and the FVRB for its wastewater division is $136,562. Rewarding the Company's limited liability partners with a return on a non-existent investment via imputation of non-existent tax expense is unfair and unreasonable

2) BECAUSE SHAREHOLDERS MAY HAVE DIFFERENT INDIVIDUAL TAX RATES AND DIFFERENT OFFSETS, ANY RATE THE COMMISSION SETS WOULD BE ARBITRARY, CAPRICIOUS AND AN ABUSE OF DISCRETION.

The imputation of non-existent income tax expense in the manner that the Commission has proposed in this case is arbitrary, capricious and an abuse of discretion. The Commission imputed an amount of income tax expense that is not based on the shareholder's actual income tax, therefore, guaranteeing that the shareholders will recover an amount that is not based on their actual income taxes. The Commission could have easily required the shareholder's to produce their actual income tax records in order to recover the expense. The Commission's imputation methodology in this case is arbitrary, capricious and, therefore, an abuse of discretion.

The calculation of corporate income tax and personal income tax are completely different. Taxable income for a C corporation for example is based on the net income from the business. Taxable income for the individual is based on the transfer of income in any number of ways including salaries, interest, dividends, supplemental income, etc. The individual income tax rate will be the same for all of those income sources with no preferential tax treatment for any source in particular. There is no fair way to reconcile the shareholder's personal income tax with a corporate income tax rate that will guarantee that ratepayers will pay an appropriate and fair amount of income tax. About the best that can be done is to "damage" the ratepayer as little as possible.

The Commission is obligated to set rates that are just and reasonable. The Commission must base those rates on the Company's operating costs. The Commission cannot legally base rates on operating costs that do not exist. The Company's proposal violates Arizona's law.

3) THE COMMISSION'S METHODOLOGY FOR IMPUTING TAXES IS CONTRARY TO THE WEIGHT OF AUTHORITY IN OTHER STATES.

The issue of whether the Commission can allow or disallow income tax expense is not a case of first impression in Arizona. The Court of Appeals, in *Consolidated Water Utilities, Ltd. v. Arizona Corp. Com'n*, 178 Ariz. 478, 484, 875 P.2d 137, 143, Ariz.App. Div. 1, 1993 (September 07, 1993) determined that the decision to allow or disallow tax expense for pass-through entities "... is to be made by the Commission, not the courts." Because the Court upheld the Commission's decision to disallow the expense, the Court did not decide and did not rule on the method of imputation proposed in that case. The Commission's methodology for calculating the tax allowance in this case is not only inconsistent with FERC it is contrary to the weight of authority in the few states that have authorized an income tax allowance for pass through entities. Ironically, it was the Commission who argued before the Arizona Court of Appeals in the *Consolidated* case that "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." [2] The Commission made this argument to show that a theoretical tax allowance, such as what the Commission has approved in the current case, would be arbitrary and inappropriate.

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

> 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

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[2] 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.

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).

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 taxpayer's 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. ... (Emphasis added in the original)

As the Commission argued in the *Consolidated* appeal, the issue of theoretical income taxes in the current case is "squarely joined." The Commission, at least in the past, has clearly recognized that a theoretical tax allowance such as that which the Commission has approved here is arbitrary in the case of pass through entities and has taken a position at the Court of Appeals against such a methodology as well as the tax allowance

4) AS A MATTER OF PUBLIC POLICY, ALLOWING A LIMITED LIABILITY COMPANY OR A SUBCHAPTER S CORPORATION TO RECOVER INCOME TAX FROM RATEPAYERS IS POOR PUBLIC POLICY.

RUCO objects to Johnson's request to impute income tax expense for all of the reasons cited in the underlying case as well as Commissioner Brenda Burn's Dissenting Opinion to the Commission's Policy Statement dated February 21, 2013. To the extent applicable, RUCO incorporates all of the arguments it made in the underlying docket as well as in the recent Pima Utility case (Docket Nos. W-02199A-11-0329 and Docket No. SW-02199A-11-0330). Requiring Johnson's ratepayers to pay for a "phantom tax" which Johnson as a corporate entity itself does not pay is not only unfair, it is wrong and will result in unfair and unreasonable rates based on poor public policy.

5) CONCLUSION

For the above reasons, RUCO respectfully requests that the Commission rehear Decision No. 73992.

RESPECTFULLY SUBMITTED this 31st day of July, 2013.

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