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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
JOHNSON UTILITIES, LLC, DOING
BUSINESS AS JOHNSON UTILITIES
COMPANY, FOR APPROVAL OF SALE AND
TRANSFER OF ASSETS AND
CONDITIONAL CANCELLATION OF ITS
CERTIFICATE OF CONVENIENCE AND
NECESSITY.

Docket No. WS-02987A-13-0477

ORIGINAL

TESTIMONY OF STEVE PRATT

Q. Name, address, and purpose for testimony.

A. My name is Steve Pratt. My wife and I own a home on MaCaw Ct. in Johnson Ranch. Johnson Utilities provides our house water and wastewater services. Along with three other customers (Todd Hubbard, Alden Weight, and Karen Christian), we intervened in this proceeding to speak to our concerns with the potential transfer of assets to the Town of Florence (TOF). Incidentally, we prefer the term "customer" to "ratepayer" as "ratepayer" sounds too much like a person whose only value is to pay whatever rate is demanded while customers receive "customer service" in return. At the request of Johnson Utilities we have consolidated comments so as not to unnecessarily add redundancy to the proceeding.

Q. What are your concerns?

A. If the asset transfer takes place, we want assurance that safe, adequate, and reliable service will be provided at rates that will forever be "just and reasonable". Neither

1 myself nor the other customer-interveners are attorneys and any reference we make to
2 rules, regulations, or statutes are not intended to reflect conclusions of law or legal or
3 professional opinions. Our analysis and comments are simply "the common sense way we
4 see it" as customers. I will give our perspective on what we, as customers, consider to be
5 the attributes of "just and reasonable" rates, how the Arizona Corporation Commission
6 might view its role in this docket, and offer a potential path forward.

6 **Q. Are you concerned that "just and reasonable" rates might not result if the
7 TOF acquires the assets of JU under the terms of the draft Purchase Agreement?**

8 A. Yes. Our analysis indicates that the total revenue necessary to provide adequate
9 service post-sale will be significantly higher than the revenue necessary to provide
10 adequate service if the assets are not sold. In addition, in a presentation to the TOF
11 Council on March 26, one of the major benefits to the town mentioned by the firm which
12 helps Florence set rate policy was "Annual financial contribution from acquired utility to
13 General Fund, thus limiting need for additional taxes."

13 The firm's representative also presented a Revenue and Cost of Service projection chart, a
14 copy of which is reproduced on Attachment I to this testimony. That chart indicates an
15 expectation that the TOF, once out from under ACC oversight, could choose to take
16 advantage of an opportunity to annually and exponentially increase revenue above Cost of
17 Service for the foreseeable future. If I read the chart correctly, this might generate \$10
18 Million in revenue above Cost of Service in 2025 and \$30 Million in 2033. These were
19 labeled "conservative" estimates because, according to the consultant, there is room to
20 increase revenue even faster.

20 **Q. What is the problem with generating revenue above Cost of Service?**

21 A. To us, San Tan Valley customers, rates generating revenue above Cost of Service
22 are not "just and reasonable" as we believe the ACC requires just and reasonable rates to
23 produce revenue that is no higher than Cost of Service. It appears that TOF intends on
24 using utility revenue exceeding Cost of Service to subsidize city services.

1 Customers within TOF might pay the same rates as San Tan Valley customers, but would
2 receive an offsetting benefit from lower taxes relative to the services they receive.
3 Customers outside the TOF would simply pay the increased bill and not receive either the
4 associated tax relief or city-provided services they would be paying for.

5 A major concern of ours, therefore, is the lack of independent, well-funded, professional
6 oversight. Who decides what "just and reasonable" rates are? Will the ACC "just and
7 reasonable" standards apply? What recourse do we have if rates are not just and
8 reasonable? Will this require a court challenge? Where will the resources come from to
9 contest a "just and reasonable" finding by TOF? It appears to us that the TOF, or at least
10 its rate consultant, believes the TOF can race down the revenue road with the throttle wide
11 open, at ever increasing speeds, with no traffic cops in sight. "Whatever the market will
12 bear" might be TOF's "just and reasonable" standard, which does not seem either fair or
13 appealing to us.

12 **Q. Do you have assurance that, after the sale, service will be safe, adequate, and
13 reliable?**

14 A. No. It is unclear whether correctly calculated just and reasonable rates will produce
15 enough revenue to adequately maintain the system under the terms of the draft Purchase
16 Agreement included in Mr. Hodges' testimony. It seems to us this question must be asked,
17 analyzed, and answered by the ACC. Perhaps this is an area of inquiry that the ACC and
18 its Staff can take up as part of its mandate in this particular asset transfer request, and
19 perhaps generically the ACC should adopt a policy to do so whenever it is tasked with
20 assessing whether or not an asset transfer that involves regulatory regime change is in the
21 public interest.

20 **Q. What do you mean by "regulatory regime change"?**

21 A. In preparation for this case I reviewed the draft Purchase Agreement, as well as
22 decisions and some (but not near all for Heaven's sake) documents in Docket WS-
23 02987A-08-0180, Johnson Utilities' (JU's) last rate case. I also reviewed some applicable
24

1 statutes and ACC regulations. The ACC applied various standards of review to ultimately
2 arrive at JU's existing rates.

3 Based on my review, it appears that the ACC employs an exquisitely complex regulatory
4 process to ensure that fair, just and reasonable outcomes are offered to balance the
5 interests of customers and state-sanctioned-monopoly service providers. An army, or at
6 least a large platoon, of attorneys, consultants, accountants, engineers and a professional
7 regulatory staff participate to achieve the desired public interest balance. On March 8,
8 2013 Johnson Utilities submitted a document indicating it did not expect the need to
9 change rates until at least July 1, 2019. I suspect, therefore, that the utility believes
10 current rates produce revenue that is at least sufficient to provide safe, reliable, and
11 adequate service until at least 2019.

12 On the other hand, we are unsure what standards or formulas will be used to establish
13 revenue under the TOF regulatory regime, or whether TOF will attempt to increase rates
14 prior to July 1, 2019. Apparently, this is an unknown, if internal secret, at the TOF.
15 Certainly the process will be not anywhere near as intricate as that used by the ACC. The
16 difference between these two processes is what I mean by "Regulatory Regime Change".
17 An increase in rates or revenue necessary to provide safe, adequate, and reliable service
18 due solely to a change in asset ownership does not seem reasonable or fair to us.

19 **Q. What factors are you concerned with in different rate-setting approaches?**

20 A. Primarily factors related to investment, although some questions linger about how
21 affiliated interest transactions will be scrutinized under the proposed management
22 agreement. In the Docket above, Decision 73992, page 2, paragraph 6, the Commission
23 notes that JU did not dispute a fair value rate base determination of \$14,855,940. My
24 understanding of fair value rate base is that this is the amount of investment that the
owner-investors have in JU and the amount they are entitled to earn a fair, just and
reasonable return on. I believe the company was allowed to earn a rate of return of 8% on
its \$15 Million investment. As far as I can tell, the formula for determining the just and
reasonable amount of money the company can collect from customers is something like:

1 [Operating Expenses + Required Line Extension Refunds + [8%*\$14,855,940]]

2 Doing the arithmetic:

3 [Operating Expenses + Required Line Extension Refunds + \$1,188,475]

4 In the formula, I use "Required Line Extension Refunds" in place of "Depreciation" that
5 appears in some of the documents because it appears that the vast majority of JU's
6 depreciable plant was originally paid for pursuant to Line Extension Agreements that are
7 subject to refund. Understanding how those agreements are treated in the revenue
8 determination of the two regulatory regimes is one of the key items we, consumer-
9 interveners, are scratching our heads over. I believe the balance owing was over \$106
10 Million at year-end 2012 (2012 Balance Sheet – Advances in Aid of Construction).

11 **Q. Might the Town of Florence use a different formula?**

12 A. They have not indicated how they would determine how much revenue they want to
13 raise, just that revenue is expected to exceed Cost of Service by increasing amounts each
14 year. However, in 2012 the Town of Florence conducted a rate study which I reviewed
15 and, to best of my knowledge and belief, set rates based on cash flow needs, rather than a
16 rate of return on investment, similar to this formula:

17 [Operating Expenses + Debt Service]

18 **Q. Why would it be a problem if this were the formula Florence uses to set rates?**

19 A. The TOF might, on a cash basis, attempt to charge us, customers, for operating
20 expenses, PLUS debt service on the \$121 Million loan used to purchase the assets, PLUS
21 add enough cash to make Line Extension Agreement payments since the TOF has agreed
22 under the Purchase Agreement to take over those payments. Debt service on the \$121
23 Million loan in the Purchase Agreement seems to be in the neighborhood of \$11 Million per
24 year, so the new revenue required from rates for the TOF would be approximately:

[Operating Expenses + Line Extension Refunds + \$11,000,000]

1 \$11 Million is significantly more than \$1,188,475 so we, as consumers, see a big problem
2 down the TOF revenue road: Increased rates or required revenue solely as a result of the
3 transfer of assets to TOF and regulatory regime change does not seem fair to us. This
4 seems inevitable if TOF seeks to include the full purchase price in rates.

5 **Q. Why does this seem unfair to you?**

6 A. Since we – the consumers – would be asked to pay off the \$121 Million loan used to
7 purchase the assets PLUS pay off the line extension agreements used to originally
8 purchase the same assets, it seems to us that customers are being asked to pay twice for
9 the same assets. In fact, consumers and homeowners, i.e. us, the customer-interveners
10 and our neighbors, have, in the past, directly or indirectly, also dutifully paid our “hook-up”
11 fees to connect to the system. As I understand it, these are reflected in the 2012 JU
12 Annual Report as \$87 Million as “Contributions in Aid of Construction”. It looks to us, as
consumers, like we paid for assets that we will now be asked to pay for again which we do
not consider to be fair.

13 **Q. What is the depreciated original cost of the fixed assets of Johnson Utilities in**
14 **the 2012 Annual Report submitted to the ACC?**

15 A. The total net fixed assets is \$189,103,285.

16 **Q And what do you believe total payments might be that customers are asked to**
17 **make for these \$189,103,285 in assets under the draft Purchase Agreement,**
18 **excluding interest on the \$121 Million loan?**

19 A. If I understand the accounting correctly, that would be:

20 Loan Amount	\$121,000,000
21 Future Line Extension Agreement Refunds (Advances in Aid)	106,191,515
22 Unamortized Hook-up fees (Contributions in Aid)	<u>69,981,225</u>
23 Total	\$276,172,740

1 I do not know how the accounting would work, but if this same transaction were to take
2 place between JU and another private entity on the open market, I believe the ACC might
3 require an acquisition adjustment to the books of approximately \$100 Million.

4 **Q. To your knowledge, has the ACC addressed inclusion of acquisition
5 adjustments in rates?**

6 A. Yes. In my research I discovered that in Decision No. 63584, April 24, 2001 the
7 ACC stated:

8 "Arizona-American is cautioned that the Commission will require Arizona-
9 American to demonstrate that clear, quantifiable and substantial net
10 benefits to ratepayers have resulted from the acquisition of Citizens'
11 systems that would not have been realized had the transaction not
12 occurred before the Commission will consider recovery of any acquisition
13 adjustment in a future rate proceeding."

13 **Q. Are you concerned with the financing terms included in the draft Purchase
14 Agreement?**

15 A. Yes. Under the draft Purchase Agreement, the TOF will purchase the assets for
16 \$121 Million and compensate the owner with 30 year tax-free revenue bonds that carry
17 interest-only payments of 6.625% for the first 5 years and 8% thereafter. TOF planning
18 documents and news reports indicate it can sell revenue bonds for 4.5%. Over the life of
19 the bonds, we, the customers, might be asked to pay more than \$100,000,000 over what
20 we would consider "just and reasonable" finance charges. We don't think this is fair.

20 **Q. How would you approach establishment of just and reasonable rates if the
21 sale is consummated?**

21 A. As a customer, it seems that a just and reasonable net investment on which debt
22 service can be included in the rates needs to be consistent with Title 12 of Arizona
23 Revised Statutes, specifically 12-1122 which requires the value of assets acquired to be
24 determined by ascertaining the most probable price that the property would bring if

1 exposed to the open market. The lawyers can argue about that – it is simply my plain
2 reading.

3 Since it is my understanding that the ACC regulatory regime allows JU to generate cash
4 flow of 8% from approximately \$15,000,000 in investment, this seems to me to be a
5 reasonable place to begin to estimate what the assets might fetch on the open market by
6 an investor seeking a similar market-based rate of return. But I am no expert here and I
7 am not trying to value the assets. Given the intricacies of ACC processes, I suspect highly
8 specialized people would need to be employed to determine value. It is unclear whether or
9 not TOF had a business valuation done that would comply with Title 12. Nevertheless, the
10 gulf between \$15 Million and \$121 Million, and our belief that we are paying more than
11 once for the same assets, gives us pause and greatly concerns us.

12 **Q. Should the ACC concern itself with whether or not the purchase price is fair?**

13 A. I have no opinion on whether or not the ACC should concern itself with the
14 purchase price, but I believe the ACC should be greatly concerned with any situation in
15 which revenue produced by “just and reasonable” rates and revenue required to provide
16 safe, reliable, and adequate service are mutually exclusive. That could be the case here
17 and that could endanger the public.

18 **Q. Explain.**

19 A. If just and reasonable revenue includes debt service on just \$15 Million @ 4.5% and
20 the financial structure of the utility enterprise requires revenue sufficient to service \$121
21 Million @ 8%, it is highly likely that the enterprise will not have sufficient funds to provide
22 adequate service. As customers, we find this a bad situation. In this case, the TOF has
23 publicly indicated that it does not intend to use general tax revenue to assist in paying off
24 the bonds for revenue shortages, so it is unclear how service needs would continue to be
met. The result would mean that our stated goal as customers would not be met. To
repeat: **We want assurance that safe, adequate, and reliable service will be provided
at rates that will forever be “just and reasonable.”**

1 **Q. How might the ACC determine just and reasonable revenue, not for the**
2 **purpose of actual rate-making, but for the purposes of running the public interest**
3 **test?**

4 A. I would recommend a principle stating that revenue required to operate the utility
5 should not be increased simply as a result of the transfer of assets to a new owner with a
6 different regulatory regime. In this case, potential irreparable harm is possible – either the
7 ability to provide safe, adequate, and reliable service might be jeopardized or a
8 requirement to illegally increase revenue levels above just and reasonable levels to
9 provide adequate service is required. This is simply because of the change in regulatory
10 regime. If a private owner were acquiring JU assets we likely would not be having this
11 conversation because the regulatory regime would not change. Why should we, the
12 customers, be penalized financially because of a decision we had no authority over?

13 **Q. How should we proceed?**

14 A. One way to proceed is for the parties to view the assets from the standpoint of what
15 I will refer to as the Original Position.

16 **Q. Describe the Original Position?**

17 A. JU has been operational since 1997. Since that time it has had one rate case –
18 beginning in 2008 - and anticipates it may have another in 2019. It is regulated by the
19 ACC with all of its fancy rules, regulations, methods, and decisions. It is a known quantity
20 and investments have been made by the utility using both its own capital (about
21 \$15,000,000) and customer financed capital (about \$200 Million). Customers built houses,
22 took out mortgages, paid hook-up fees and paid rates in amounts sufficient to pay Line
23 Extension refunds relying on the protections and assurance of the ACC in making sure
24 they would be treated fairly and only paying once for the original cost of assets used to
provide service. There was a Regulatory Compact that balanced the interests of the
customer and monopoly service provider.

Now the Town of Florence wishes to take over the assets of the company and provide
water and wastewater service. From the standpoint of the Original Position, ask yourself

1 what a just and reasonable investment would look like had the TOF been the owner of the
2 assets all along. Had this been the case, the customers would have perhaps paid utility
3 revenue bonds to build plant, made Contributions in Aid of Construction to build the plant,
4 or had developers provide line extensions which would be paid back through customer
5 service charges. Or some combination of all three.

6 However, in neither case above, under a constant regulatory regime, would customers be
7 asked to pay twice for the same assets – in other words they would never be asked to take
8 out revenue bonds to pay for all of the assets of the system PLUS make contributions to
9 pay for the same assets PLUS reimburse developers for Line Extension costs of the same
10 assets. A just and reasonable revenue requirement should include debt service no higher
11 than that which would exist had the TOF owned the facilities all along. To argue otherwise
12 is to argue that asset transfers among entities can be utilized to artificially inflate the
13 original cost of facilities when first dedicated to public service which is the ONLY cost
14 customers should be responsible for. As customers, we do not believe this is fair.
15 Regime change should not harm customers.

16 **Q. Please summarize your testimony.**

17 **A.** As customers, we are participating in this proceeding out of concern for our
18 community. We are not compensated for these efforts other than the desire to provide
19 thoughtful, useful input to the ACC as it seeks to fulfill its constitutional and statutory
20 mandates on behalf of the people of the State of Arizona; in particular, we hope you will
21 consider the position we find ourselves in and help us seek out fair outcomes.

22 We are customer-interveners. We don't know much about Arizona regulatory practices or
23 the internal workings of Johnson Utilities or the Town of Florence or the Arizona
24 Corporation Commission. If we have not interpreted the regulatory, economic, accounting,
or engineering landscape correctly, we simply ask that others who work on these matters
professionally let us know the error of our ways and address our concerns.

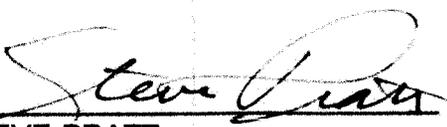
1 It seems to us that some obligatory, independent oversight of the transaction and resulting
2 revenue requirement determinations must be possible under the current statutory scheme.
3 The Commission's regulations under R14-2-402(D) and R14-2-602(D) must serve some
4 purpose other than as a box check-off exercise. In fact, it appears the boxes in these
5 regulations have yet to be checked off and no waiver has, to our knowledge, been granted
6 by the ACC. The regulation requiring disclosure of the impact on customers should
7 include, as discussed above, a discussion of the impact of regulatory rate setting regime
8 changes.

9 It is our understanding that state law exempts municipalities such as Florence from ACC
10 oversight while at the same time imposes on municipalities a rigorous "just and
11 reasonable" standard, the same standard used by the ACC. While we are not lawyers and
12 have not researched the legislative history, we believe the intent of state law is to be more
13 than a paper tiger. It must have some meaningful and substantive effect unless one were
14 to believe, which we cannot, that the Arizona State Legislature intended the people of San
15 Tan Valley should become road kill on a municipality's highway to fiscal prosperity.

16 **Q. Does this complete your testimony?**

17 **A. Yes, it does. Thank you for allowing the consumer-interveners to participate.**

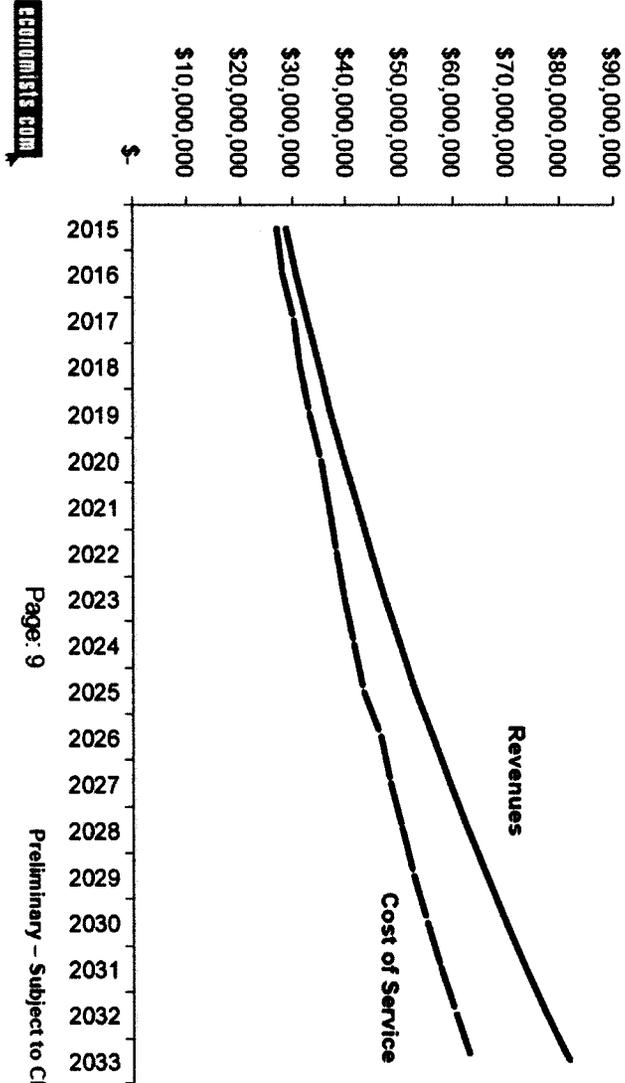
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RESPECTFULLY SUBMITTED this 8th day of May, 2014


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Year 1-20 Financial Forecast 3.0% Annual Rate Adjustments



Revenues are forecast to be sufficient to fund all acquisition and operating costs



Economists.com

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Preliminary - Subject to Change

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