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IN THE MATTER OF THE COMMISSION'S GENERIC EVALUATION OF THE REGULATORY IMPACTS FROM THE USE OF NON-TRADITIONAL FINANCING ARRANGEMENTS BY WATER UTILITIES AND THEIR AFFILIATES.	Docket No. W-00000C-06-0149

RESIDENTIAL UTILITY CONSUMER OFFICE'S COMMENTS

The Residential Utility Consumer Office ("RUCO") submits these comments regarding the possible vote on the adoption of a Policy Statement regarding the treatment of income tax expenses for tax pass-through entities.

SUMMARY

RUCO submits that the Commission should not consider a Policy Statement until the Pima Utility rate case has concluded. The proposed Policy Statement[1], acknowledges the pending Pima Utility rate case[2] ("Pima") where this very issue is in contention. Presently, the hearing in Pima has concluded and the parties are briefing the matter. The next step will be the recommended Order of the Administrative Law Judge ("ALJ") and an Open Meeting where

[1] Proposed policy statement docketed on June 15, 2012 Docket No. W-00000C-06-0149.
[2] Docket Nos. W-02199A-11-0329, W-02199A-11-0330.

the Commission will consider the ROO, any Exceptions, amendments and comments from the public and the parties.

This docket contains numerous regulatory proposals and has been open since 2006. The Open Meeting Agenda for July 18-19 was amended on Friday, July 13, to include this item. Nothing in this docket requires an expedited vote on a Policy Statement. Regardless of which way the Commission decides the issue in the Pima case, there simply is no reason why the Commission cannot vote on a Policy Statement after the Pima case is decided.

A vote on a Policy Statement would improperly influence the Administrative Law Judge and may foreclose the Commissioners' minds to evidence in the Pima docket.

The Commission's administrative process is designed to ensure that decisions are fair, unbiased, and afforded due process. The Commission has adopted Rules pursuant to ARS § 40-243 to govern its process.[3] Those Rules contain provisions whose purpose is to avoid "... the possibility of prejudice, real or apparent, to the public interest in proceedings before the Commission..."[4] It is important that the Commission maintain the integrity of its process and that the public also maintain faith in the process.

The ALJ is an intricate part of the Commission's process. The ALJ makes a recommendation based on the record before her and presents it to the Commission for a final vote. The ALJ's recommendation must be unbiased and unprejudiced.

Likewise, the Commissioners' final decision on the issue should be made at Open Meeting on the merits of the evidence in the record. The Commissioners do not have the full record of the Pima case before it since closing Briefs have not been filed, the ALJ has not

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[3] See Jenney v. Arizona Exp., Inc. (1961) 89 Ariz. 343, 362 P.2d 664.
[4] See for example A.A.C.14-3-113

written the ROO, Exceptions have not been filed and any amendments have not been docketed for the Commissioners' consideration. A vote on a Policy Statement at this time could have the effect of foreclosing the consideration of any information, public sentiment or legal argument that may still come in the Pima case.

The main contention in the Pima case is the question of the treatment of income tax expenses for tax pass-through entities. The proposed Policy Statement, if passed at Open Meeting, will decide the issue before the ALJ's recommendation. In part, the Policy provides:

> Based upon the evidence and testimony which has been presented in the recent rate cases before this Commission as well as in the generic docket, we are persuaded that a tax pass-through entity should be allowed to recover income tax expense as part of its cost of service and that its revenue requirement should be grossed up for the effect of income taxes. We are persuaded that the failure to include income tax expense needlessly discriminates against tax pass-through entities and creates an artificial impediment to investment in utility infrastructure. [5]

The ALJ and the Commission are still in the process of weighing the evidence in the Pima docket. The time for the final decision on this matter is the Open Meeting to vote of the Pima Utility Recommended Order and Opinion.

A recent article appeared in the Tucson Sentinel[6] entitled: "Keeping Tabs on the Fourth Branch of Government: Az Corporation Commission Wields Largely Unaccountable Power. " Among the many comments in the article:

> Established in the Progressive Era state constitution, the ACC was intended as an independent check and regulator on businesses that affect the common good...This is a tremendous amount of largely unaccountable power vested in one body that is rarely covered by the media...The Sun Lakes case, which almost sneaked in without any coverage, is an instructive example...The Robson case is unique in its sweep. But the problem of accountability is widespread. Readers

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[5] Pierce proposed policy statement at 2.
[6] See attached article dated July 10, 2012.

> regularly send me complaints about little-known water companies tied to developers (some to very big developers) and the favorable treatment they receive on rates and mergers.

The Commission should not vote on a Policy Statement at this time. All of the stakeholders as well as the public have an interest in the integrity of the Commission's process. To preserve the integrity of the process, a vote on a Policy Statement should be delayed until the Commission has ruled on the Pima rate case.

If the Commission votes, the Commission should reject the policy

If the Commission chooses to go forward and vote on the proposed Policy Statement, RUCO recommends that the Commission reject it. RUCO contends the inclusion of the personal tax liability of shareholders in utility rates is both poor public policy and unlawful. Attached to this filing is an excerpt from the Opening Brief RUCO filed in the Pima case that explains in detail the reasons why RUCO believes that the Commission should not impute income tax expense for pass-through entities in Arizona.

RESPECTFULLY SUBMITTED this 16th day of July, 2012.

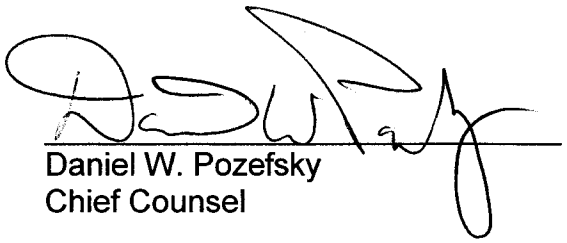

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EXHIBIT 1

News from TucsonSentinel.com:
http://www.tucsonsentinel.com/opinion/report/071012_corp_comm_op/keeping-tabs-fourth-branch-government/

Rogue Columnist

Keeping tabs on the fourth branch of government

Az Corporation Commission wields largely unaccountable power

Posted Jul 10, 2012, 11:12 am

Jon Talton Rogue Columnist

You might be tempted to pass on a story (http://www.azcentral.com/business/articles/20120705arizona-utility-who-must-pay-taxes.html) in Sunday's *Arizona Republic* with the process-y headline, "Case Asks Who Must Pay Taxes for Utility." Don't.

Ably reported by Ryan Randazzo, the article lays out a controversy in Sun Lakes. The small company that provides water for the "active living retirement community" wants a rate increase of about $6 a month from residents, the first such hike since 1994. Sounds reasonable. But it wants more: "About 40 percent of the increase would pay the utility owners' income taxes." The Residential Utility Consumer Office contends that the water company's "shareholders might have other business interests that lose money, and if they combine the tax credits of those operations with the tax liability from the water utility, they might not pay taxes at all, even though the customers would be paying a 'phantom tax.' 'When this happens, this is essentially free money for the shareholders paid by the ratepayers who receive no benefit from these payments,' RUCO wrote in a brief for the case."

This is about more than Sun Lakes. My sympathy is limited for people who want to buy houses in a leapfrogged, 98-percent white development with streets named after Michigan, Minnesota and Indiana, profaning our desert. But the case is a rare window into how power and influence work in the state. Power, especially, at what insiders call "the fourth branch of government," the Arizona Corporation Commission.

Outlanders, and even many natives, assume it is simply a public utilities commission. It appears in the news rarely, and when it does the coverage is limited to a utility rate increase. Yet the commission is so much more. Established in the Progressive Era state constitution, the ACC was intended as an independent check and regulator on businesses that affect the common good. At the time, that especially meant railroads. But its powers are much more far-reaching, ranging from securities to pipeline safety. When I was licensed as an emergency medical technician back in the 1970s, the regulatory agency wasn't the health department but the ACC. More importantly, the five elected commissioners are not merely regulators. They act in executive, legislative and judicial capacities. This is a tremendous amount of largely unaccountable power vested in one body that is rarely covered by the media. And needless to say, it long ago was co-opted by the powerful interests it was established to oversee.

The Sun Lakes case, which almost sneaked in without any coverage, is an instructive example. Sun Lakes was begun 40 years ago by Ed Robson, a hard-scrabble, old-school Arizona developer. When we would run ambulance calls there in the late '70s, it was far away and bleak. Now metro sprawl has reached it. Robson and his family own Pima Water Co., the monopoly that supplies Sun Lakes. If the case is decided in his favor, he will have essentially found a way to charge his own personal salary, profits and *personal* income taxes to his customers through the arcane rate-making process of the Arizona Corporation Commission. It's also a neat bit of estate planning for his family. You can say the boobs from the Midwest deserve it. But it would also reverse long-standing commission rules and have wide-ranging implications.

If I read the briefs and testimony correctly, Robson has come well-armed. For example, Mark Spitzer testified for approving Robson's request. Spitzer is a former commissioner himself (and served as chairman), as well as a former state senator and Bush appointee to the Federal Energy Regulatory Commission. In January, he joined the well-connected law firm of Steptoe & Johnson. There's nothing necessarily unseemly about this. Spitzer is a nice guy. But the Sun Lakes customers can't nearly match such high-profile lobbying firepower.

If Robson succeeds, the precedent will be used by developer/monopoly water providers around the state to get richer. If you live within the Salt River Project, good for you. But Arizona has some 200 small, private water companies. They are already "lightly regulated," to put it nicely. The state's water ownership is full of complexity and intrigue. The developer-connected water companies (the Johnson interests come to mind) know how to work the system with "ins" that the rest of us don't have. And the broader consequences for land use, water resources and sustainability are swept under a very crowded rug.

Thanks to air conditioning, Arizona leapfrog retirement developments made some people very rich in the second half of the 20th century. They were able to unload the externalities, such a traffic congestion, inadequate infrastructure, pollution, disrupted ecosystems, loss of farm land and the local heat island, onto the public. Most of those costs have still not been paid (e.g. the disaster along Hunt Highway). In some cases, freeways, flood control and wider highways were publicly financed to make otherwise worthless land valuable to well-connected players, no matter the damaging effect to the public good.

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It's an open question whether the Ponzi scheme can return after the Great Recession. Too many in the target demographic were financially ruined. Debt and leverage is heavy for the Real Estate Industrial Complex. Tastes are changing, too, with many baby boomers seeking "active retirement living" in vibrant cities. At least a stopgap measure for the players who survived the crash would be padding profits from the captive audience of house buyers at existing developments, such as Sun Lakes, by changing the rules. In theory, if you clone the retirement "community" model to many locations, as well as ownership of the utility companies serving those developments, and finally you get house owners to pay your salaries and income taxes on a continuing and forward basis, this is nearly a no-cost business model that would accrue to the developer and his family for generations. This is not the "free market," but a market fixed by public policy, set by an obscure governmental entity of great and quiet power.

It's a model that requires the right influence. The ordinary small-business owner needn't apply.

The Robson case is unique in its sweep. But the problem of accountability is widespread. Readers regularly send me complaints about little-known water companies tied to developers (some to very big developers) and the favorable treatment they receive on rates and mergers. One customer wrote, "We have communicated with the five ACC Commissioners about these issues and have participated as a community in the rule-making processes. Throughout the years I have been struck by the non-responsiveness of the ACC Commissioners (except one) and the insulated role they occupy." Phrases such as "the fix was in" and "behind-the-scenes deal" are common.

The commission is holding a hearing on the Robson case 10 a.m. Tuesday at the Sun Lakes Country Club's Navajo Room, 25601 N. Sun Lakes Blvd. Yes, Arizonans should vote in greater numbers, paying more attention to the ACC. But we also need a press that is a consistent watchdog over the fourth branch of government, the commissioners and the many ways the system can be gamed.

Jon Talton is a fourth-generation Arizonan who runs the blog Rogue Columnist (http://roguecolumnist.typepad.com) . He is a former op-ed and business columnist of the Arizona Republic and now is economics columnist of the Seattle Times.

- 30 -
have your say

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There are no comments yet. Why don't you get the discussion going?

EXHIBIT 2

violates the constitutional requirement that the Commission set rates that are just and reasonable. (AZ Const. Art. XV, Sec. 3) It is neither just nor reasonable for ratepayers to pay an expense of the utility that does not exist. Whether for policy or legal reasons, the Commission should reject Pima's request to increase rates to cover the tax liability of the earnings for Pima's investors.

I. THE RECOVERY OF INCOME TAX EXPENSE

A. AS A MATTER OF PUBLIC POLICY, ALLOWING A SUBCHAPTER S CORPORATION TO RECOVER INCOME TAX FROM RATEPAYERS IS POOR PUBLIC POLICY.

1. Recovery of personal income taxes is a substantial portion of the requested rate increase.

RUCO questions how the utility can explain to its customers why over 50% of its requested wastewater and 30% of its requested water increase is to pay for taxes – an expense the utility does not pay. It is blatantly unfair to require Pima's customers, most of whom are retirees, to pay the personal income taxes of Pima's shareholders, most of whom are family trusts.

The Company argues that the Commission should adopt a policy of imputing income taxes because FERC has adopted this policy. A-12 at 16-18. However, FERC policy is not controlling precedent in Arizona.

FERC's new policy, not surprisingly, has met some due criticism. David Cay Johnston, a *Tax Analysts'* columnist, said the following about FERC's policy in his column entitled, "Master Limited Partnerships; Paying Other Peoples Taxes[4]."

> Wouldn't it be fantastic if someone else paid your income taxes for you? Imagine all that extra money in your bank account. You could pay off your debts, save, and even splurge.
>
> Of course, for the person who paid your income taxes it would be awful. They would have to pay their own income taxes and then, out of what was left, pay yours.
>
> Congress would never enact such a law, right?
>
> The good news is that Congress has not enacted such a law. The bad news is that buried deep in the fine print of the *Federal Register* is a regulatory rule that has the same effect.
>
> The requirement that forces you to pay the personal income taxes of others applies -- for now -- only to owners of rate-regulated pipelines organized as master limited partnerships, or MLPs.
>
> It is not surprising if you have never heard about this tax-shifting rule. Unless you dig into the inordinately arcane proceedings of the Federal Energy Regulatory Commission (FERC), a small government agency that wields enormous economic power, you would be in the dark. The commission gets almost no news coverage. The very few, and brief, news reports on the cases related to the MLP charge missed the tax issue. [5]

With regard to FERC's new policy and its cost to ratepayers, Mr. Johnston reported the following:

> The math here is stunning. When rates include a tax that does not exist, the investors make out like, well, bandits. Investors in an

---

[4] The FERC policy and the Circuit Court cases mentioned above which address the policy dealt with Master Limited Partnerships, which like S corporations and LLC's are pass-through entities for tax purposes. The resulting FERC policy, however, addresses pass-through entities including LLCs.

[5] RUCO-9, Exhibit 1.

> MLP pocket 75 percent more in after-tax profits than they would if they invested in a traditional corporation owning a pipeline.
>
> You will not find this math in Judge Sentelle's 2007 decision. Had he done the math, would the outcome have been different?
>
> .....
>
> The tax shifted to consumers looks to be as much as $1.6 billion a year for gas pipelines and $1.3 billion more for petroleum pipelines. Industry data show oil pipeline profits are an eye-popping 42 percent of revenues, more than four times the margin for the 12,000 largest corporations.
>
> This estimate has to be heavily hedged because, amazingly, FERC does not issue any statistical reports on either the cost of this tax transfer or of the underlying data from which a solid estimate could easily be calculated. A new law requiring either truth, or at least transparency, in regulations that shift tax burdens would help here, but the Wall Street-friendly Obama administration seems unlikely to take up such a cause. (RUCO-9, Exhibit 1)

a. Arizona is not bound to follow FERC

Arizona has always been proud of its independence. Arizona also has different policy and legal considerations than does the federal government, or Texas, or other states that have adopted some variation of the FERC policy. Arizona's Constitution, for example, is different than the federal model in many ways[6]. It is no surprise that many of Arizona's Founding Fathers were "very much opposed to putting in the constitution of Arizona things that we have simply gathered from other constitutions." John D. Leshy, "The Making of Arizona Constitution", (20 Ariz. St. L.J., 1, 99 (1988)). Arizona should not adopt a policy just because the federal government has chosen to do so. The policy must make sense for Arizona.

b. Other states reject FERC policy

Perhaps these same flaws explain why there is no support for the policy among the eastern commissions.[7] In fact, it appears that few states have adopted this policy.[8] Closer to home, the California Public Utilities Commission, on June 1, 2011, denied Santa Fe Pacific Pipeline, L.P. ("SFPP") recovery of imputed tax. The California PUC noted that it only provides an allowance where the utility expects to incur an expense:

> " If for example, SFPP were suddenly able to conduct business entirely without paper, solely using electronic communications, there would no longer be a need to purchase paper, ink, pens, postage, storage boxes, file cabinets, etc. No one would reasonably argue that SFPP should still have a theoretical allowance for paper and pens, and related items included in its expense forecast. If there is no likely expense, there should be no expense forecast in rates.
>
> ---
>
> ...if there is no taxation on earnings while the earnings are still within the operating control of SFPP, there is no income tax obligation to recognize as a utility operating expense in rates."[9]

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[6] For example, special controls on the legislative process, Ariz. Const., Art. IV, part 2, §§13,14,20, and line-item executive veto, Id. Art. V, §7

[7] Florida: *Re Farmton Water Resources LLC,* 2004 WL 2359423 (Fla. P.S.C.), Indiana: *South Haven Waterworks v. Office of Utility Consumer Counselor,* 621 N.E.2d 653 (Ind.App. 1993), Illinois: *Monarch Gas Co. v. Illinois Commerce Comm'n*, 366 N.E.2d 945, 51 Ill.App.3d 892, (1977), Kentucky: *Application of Ridgelea Investments, Inc.* 2008 WL 4696006 (Ky. P.S.C.), New Hampshire: *Re Concord Steam Corp.,* 71 N.H. P.U.C. 667 (1986), Vermont: *Re: Existing Rates of Shoreham Telephone Company, Inc.*, 181 Vt. 57, 915 A.2d 197 (2006).

[8] Some states have adopted variations of the FERC policy – see for example Kansas: Must present "substantial competent evidence of ... the shareholders' actual income tax liability" – no hypothetical tax recovery.
Greeley Gas Co. v. State Corp. Com'n of State of Kan., 15 Kan.App.2d 285, 807 P.2d 167, (Kan.App. 1991); *Home Telephone Co., Inc. v. State Corp. Com'n of State of Kansas*, 31 Kan.App.2d 1002, 76 P.3d 1071 (Kan.App. 2003). New Mexico – the "New Mexico Rule" - "[A]n amount equal to the tax the Company would pay, if incorporated, is a reasonable and realistic amount to be deducted from the Company's taxable income for rate making purposes." *Moyston v. New Mexico Public Service Commission,* 63 P.U.R.3d 522, 76 N.M. 146, 412 P.2d 840 (1966). Texas – followed the New Mexico rule - *Suburban Utility Corp. v. Public Utility Com'n of Texas* 652 S.W.2d 358 (Tex. 1983). The Texas Court held that Suburban was entitled to recover income tax expenses equal to the lesser of the income taxes actually paid by its shareholders or the tax it would pay if it were a C-Corp.

[9] ARCO Products, Mobil Oil and Texaco vs. Santa Fe Pacific Pipeline, Dec. No. 11-05-045 (Case 97-04-025 at p. 21)

c. FERC Policy was reluctantly upheld by the federal court

It is true that from what can only be described as a long and tortured history, FERC's current policy is to impute income tax to pass-through entities at the top marginal tax rate. It is also true, as the Company points out, that the District of Columbia Court of Appeals has upheld FERC's policy. A-12 at 16-20. However, it is the same court that, in 2004, struck down FERC's attempt to "...create a phantom tax in order to create an allowance to pass-through to the ratepayer."[10] While the court later upheld FERC's new policy based on the ground that FERC had "justified its new policy with reasoning sufficient to survive our review," it is hardly a glowing endorsement or even support for FERC's new policy of imputing income taxes at the maximum marginal tax rate[11]. The Court deferred on the wisdom of the policy itself. "We need not decide whether the Commission has adopted the best possible policy as long as the agency has acted within the scope of its discretion and reasonably explained its actions."[12]

The Court recognized that the question was clearly a policy choice which is FERC's responsibility and not the Court's, and the Court is limited to ensuring that FERC's decision making is "...reasoned, principled and based upon the record."[13]

Neither the Company nor the industry has shown why it makes sense for ratepayers to pay Pima shareholders' personal income tax when the utility itself has chosen not to pay income taxes. The Commission should reject the Company's recommendation.

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[10] *BP West Coast Products v. FERC*, 374 F.3d 1263, 1291, 362 U.S. App. D.C. 438, 466, 160 Oil & Gas Rep. 703 (2004).
[11] *See Exxon Mobil Oil Corp. v. F.E.R.C*, 487 F.3d 945, 948, 376 U.S. App. D.C. 259, 262, 166 Oil & Gas Rep. 230, 233. (2007)
[12] *Id. at* 955.
[13] *Id. at 953.*

2. Ratepayers should only pay expenses incurred by the utility.

It cannot be stressed enough – **the S corporation does not pay income tax.** Ratepayers should only pay for expenses incurred by the utility. Nonetheless, the Company argues that there is no such thing as a phantom income tax. A-12 at 8. The Company claims that income determines tax liability and Pima generates taxable income, and therefore, income tax liability. Id. The fact that an S corporation does not pay income tax, according to the Company is a mere "technical distinction." Id. at 7. However, it is more than a technical distinction. Pima shareholders pay personal income taxes, not corporate taxes. The shareholder's income tax filings are not subject to the federal or state codes pertaining to corporate income tax. R-10 at 5. The Company's shareholders receive their pro-rata share of earnings, losses, and credits which are treated as personal income for income tax purposes. Id. at 5-6. These earnings or losses are subject to the shareholder's individual tax rates. Id. The difference between individual and corporate income taxes is great – there is far more than a mere technical distinction involved here.

By choosing to distribute utility revenues and realize the income earned, the shareholders took advantage of the tax benefits realized by the federal Tax Reform Act of 1986 ("TRA 86"). TRA 86 had a large effect on those corporations eligible to elect Subchapter S status. Shareholders of C corporations could now switch to Subchapter S status to take advantage of the lower individual income rates and subsequent reduced tax liability.

Pima converted to Subchapter S status in 1986. Transcript at 389. Now, despite the preferential tax treatment Pima receives pursuant to the reforms of TRA 86, it wishes its

shareholders to be relieved of ***all*** tax liability since their tax liability would be covered by ratepayers. Simply put, this is a money grab that should be denied.

B. PIMA'S ARGUMENTS IN SUPPORT OF A HYPOTHETICAL TAX ARE UNPERSUASIVE.

1. The failure to include phantom income tax expense does not create an artificial impediment to invest in utility infrastructure in Arizona.

This argument lacks merit. Its premise has no support because Arizona utilities have not migrated to C corporation status in order to eliminate any alleged "impediments" to infrastructure investment. To the contrary, since the 1980s when the Commission established its policy to deny recovery of personal income taxes of shareholders of S corporations, there has been an increase in the number of utilities switching to or organizing as S corporations or LLCs. Particularly after the passage of TRA 86, utilities have chosen to take advantage of the tax benefits afforded by S corporations and LLCs.

Arizona water/wastewater utilities have experienced phenomenal customer growth in the last few decades. The need for additional infrastructure has been a challenge. Additionally, water utilities have had to comply with the federal Safe Drinking Water Act, the Arizona Groundwater Code, and tougher EPA arsenic standards. Utilities, like Pima, have risen to the challenge and have done so without changing their corporate status. Now that Pima is built out, it is difficult for RUCO to appreciate the argument that allowance of recovery of personal income taxes will incent needed infrastructure when Pima was able to meet the infrastructure demands when the challenge was the greatest without choosing to change its corporate status.

The Commission's policy will not spur investment in Arizona. The S corporation status allows utilities to avoid double taxation – paying corporate income taxes on revenues and also personal income taxes on the after-tax dividends. It allows start ups, as the Company even admits, to raise capital and lower its capital needs. R-9 at 5. These benefits are the attraction of organizing as an S corporation.

a. Pima chose S corporation status in 1986

Ironically, the Company is perhaps the best example of an entity that has changed its organizational status on several occasions to the advantage of its shareholders. Initially, the Company represented that it was originally formed as an S corporation. Upon questioning by RUCO, the Company admitted its mistake and testified that it was originally formed as a C corporation in 1972. Transcript at 388. In 1973, the Company elected to change to an S corporation. Id. In 1979, after a change in ownership, the Company converted back to a C corporation. Id. at 389. In 1986, perhaps because of changes in the federal tax code, the Company changed back to an S corporation which it has been ever since. Id.

b. Commission's long standing policy has not motivated Pima to reorganize as a C corporation in the last 26 years.

The Company's own history demonstrates that the Commission's policy on taxes had nothing to do with the Company's many elections. The Company has remained a Subchapter S corporation since 1986 despite the fact that it was precluded from recovering shareholder personal taxes in rates. Why has the Company not changed its organizational status from an S corporation since 1986 given the Commission's current policy? The answer is simple - Pima benefits from S corporation. There is an old adage – "actions speak louder than words". The Company's actions and those of other pass-through regulated

entities in this state show that the Commission's current policy does not impede investment in Arizona.

2. There is no evidence that utilities will reorganize as C corporations unless S corporations and LLCs can impute recovery of shareholder personal tax liability into rates.

During the hearing, Chairman Pierce and the Company's witness, Marc Spitzer discussed the notion that non-recovery of taxes penalizes S corporations and is "pushing folks" into C corporation status. Transcript at 260 – 265.

Pima contends that if utility customers do not cover the personal tax liability of S corporation shareholders, then the shareholders may elect to reorganize as a C corporation. The maximum corporate income tax rate is higher than the maximum individual income tax rate. A C corporation is subject to corporate income tax. Corporate income tax is an identified expense of the utility and is recoverable in rates. And since the maximum corporate income tax rate is higher than the individual income tax rate, the ratepayers, Pima argues, would pay even higher rates if the rates included recovery for corporate income taxes rather the personal income taxes. The argument is that the additional $235,132 (water) and $255,017 (wastewater) Pima is asking for in rates to cover the personal tax liability of Pima's shareholders actually saves the customers money because it stops Pima from reorganizing as a C corporation. RUCO rejects this argument.

a. Commission need not change its policy to attract investors.

On the FERC level, Mr. Spitzer noted that the gas pipelines were desperately needed throughout the country, and the investment community had made it clear that they did not want to invest in the C corporations - they wanted to invest in the pass-through corporations.

Id. at 262. FERC's intent was to encourage investment in desperately needed gas pipelines. Id.

Here, there is a completely different set of circumstances. First, the Company is built out so infrastructure investment is not a concern. Second, with FERC the question centered on desperately needed gas pipelines. Here, the concern is water, not gas pipelines, and there is no air of desperation. Finally, there is no evidence that the Commission's current policy has pushed investors to C corporations. In fact, according to Mr. Spitzer, the evidence would indicate otherwise. Mr. Spitzer testified that most new entities are formed as pass-through LLCs. At the time Mr. Spitzer was an Arizona Commissioner, he testified that the ratio was approximately 100 to 1 and has probably gotten larger. Tr. at 186. When asked if he was aware of any entities organized as a C corporation because of the Commission's policy he testified that he was not aware of any. Tr. at 186-187.

Mr. Spitzer's testimony is consistent with Staff's witness, Mr. Carlson who also testified that he had no knowledge of utilities converting to C corporations because of the Commission's long standing policy and could not even recall a single entity organized as an S corporation that converted to a C corporation. Tr. at 308. There is no evidence in the record to support the contention that the Commission's policy is "pushing" companies to organize as C corporations in Arizona.

3. Increasing rates to cover shareholders' personal income tax liability may result in an unjust enrichment to shareholders if no taxes are actually owed.

Since shareholders may offset tax liability for income earned from Pima with losses from other S corporations or other investments as well as other deductions, credits and exemptions, it is quite possible that monies collected for the shareholders'

tax liability exceed the amount of tax actually owed. When this happens, this is essentially free money for the shareholders paid by the ratepayers who receive no benefit from these payments.

Pima dismisses the important fact that the shareholder can avoid paying taxes by claiming losses from other investments. For example, a shareholder of a profitable S corporation utility who also realized losses from ownership of a real estate development business can apply those losses to offset earnings derived from the utility. Additionally, a shareholder can apply numerous exemptions, deductions and tax credits that are available to the individual taxpayer but not to a corporation. Examples include exemptions for minor children, deductions for health savings accounts, moving expenses, student loan interest, child tax credit, dependent care tax credit, residential energy credits, and retirement savings credit.

Pima argues that it does not matter if the tax rate set in rates does not exactly match the taxes actually paid by the shareholder. After all, argues the Company, most times the amount collected to pay the corporate income tax liability of a utility organized as a C corporation does not match the amount of taxes actually paid by the utility.

RUCO disagrees with this logic. There is a big difference between the possibility of excess funds collected to pay corporate income taxes and to pay personal income taxes. Even if a C corporation utility paid less in taxes than what was recovered in rates, those excess funds stay with the utility. Those funds are available for use for utility purposes. And in a test year, that revenue collected that exceeded the tax bill is calculated into the utility's test year operating income and will offset a rate

increase. With the S corporation, the monies that the customers would pay for income tax would go straight into the shareholders' pockets, and any difference is not retained by the Company for the benefit of the utility and ultimately the ratepayer.[14]

C. ALLOWING A SUBCHAPTER S CORPORATION TO RECOVER INCOME TAX FROM RATEPAYERS WOULD VIOLATE THE COMMISSION'S CONSTITUTIONAL OBLIGATION TO PRESCRIBE JUST AND REASONABLE RATES.

1. The Company's proposal violates Arizona's Constitution because the Company does not pay income tax and, therefore, income tax is not part of the Company's operating costs.

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,

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[14] RUCO recognizes that shareholders may elect not to take the full distribution of income earned by the Company, but is still liable for the taxes on the full amount. However, this decision of the amount of the

"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)

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distribution is made solely by the shareholders in the full discretion.

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 should focus on the principle that "total revenue, including income from rates and charges, should be sufficient to meet a utility's operating costs and to give the utility and its stockholders a reasonable rate of return on the utility's investment." Simms v. Round Valley Light & Power Co., 80 Ariz. 145, 153, 294 P.2d. 378, 383 (1956), Scates v. Arizona Corp. Comm'n, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (App.1978). Arizona's Courts have made it clear that a predicate for determining just and reasonable rates is the Company's operating costs. The amount of revenue awarded should be sufficient to meet the utility's operating costs. Id.

The Company's proposal violates Arizona's Constitution because the Company does not pay income tax, and therefore income tax is not part of the Company's operating costs. Setting rates based on an operating expense that does not exist will not result in just and reasonable rates and is therefore unconstitutional.

Since the Company does not pay income tax, there are several reasons why the Company's proposal does not protect, but actually hurts, the ratepayers' financial interests. First, If the Company is allowed to recover from ratepayers the phantom income tax, not only would the Company avoid paying corporate income tax, the Company's shareholder's would essentially not have to pay personal income tax on the income revenues received from their investment in the utility. By no means could this type of ratemaking be considered balancing

the interests of both the ratepayer and the shareholder – it only considers the shareholder's interest. The rates that would result from such ratemaking could not be just or reasonable.

2. Since shareholders may have different individual tax rates and different offsets, any rate the Commission sets would be arbitrary.

There is no manner in which a system could be developed that would guarantee that ratepayers would pay the appropriate amount of income tax. In other words, the amount of tax recovered would be arbitrary and therefore, not just and reasonable. Staff's witness, Darron Carlson points out that the calculation of corporate income tax and personal income tax are completely different. Tr. at 307. Taxable income for a C corporation for example is based on the net income from the business. Id. Taxable income for the individual is based on the transfer of income in any number of ways including salaries, interest, dividends, supplemental income, etc. Id. 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. Id. at 307-308. 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. As Mr. Carlson notes, about the best we can do is "damage" the ratepayer as little as possible[15]. Id. at 326 – 327.

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

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[15] Mr. Carlson testified that even on the FERC level the FERC drove down to the taxpayer level and determined the weighted cost. Id. at 326. On the taxpayer level, the Commission would require the shareholder's personal tax return. Id. The logistics of obtaining those returns, assuming the shareholders would voluntarily produce them, would be nothing short of a nightmare and truly burdensome on an already overburdened Commission Staff.

cannot legally base rates on operating costs that do not exist. The Company's proposal violates Arizona's law.

RELIEF REQUESTED: The Commission should adopt RUCO's recommendation to reject the Company's proposal to recover $235,132 in income tax expense for Pima's Water Division, and $255,017 in income tax expense for the Company's Wastewater Division. The Commission should also adopt RUCO's adjustments which remove Company-proposed adjusted test year income tax expense levels for both the Water Division and the Wastewater Division.

II. OTHER OPERATING EXPENSE ISSUES

A. DEPRECIATION EXPENSE – WATER DIVISION

RUCO made a minor adjustment of $550 which centers around the appropriate plant classifications for plant that was originally recorded as expenses. Transcript at 142. RUCO recorded the plant based on information in responses to the Company's data requests. Id. at 143.

RELIEF REQUESTED: The Commission should adopt RUCO's $550 adjustment, which is included in RUCO's depreciation expense adjustment of $1,939, and approve RUCO's recommended level of depreciation expense of $688,936.

B. SALARY AND WAGE EXPENSE WATER AND WASTEWATER DIVISION

At issue is the salary of the Company's Chairman of the Board of Directors, Mr. Robson. Originally, the Company requested $90,294 for Mr. Robson in salary for each