

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 KRISTIN K. MAYES
CHAIRMAN

3 GARY PIERCE
COMMISSIONER

4 SANDRA D. KENNEDY
COMMISSIONER

5 PAUL NEWMAN
COMMISSIONER

6 BOB STUMP
COMMISSIONER

7
8 IN THE MATTER OF THE APPLICATION OF
9 JOHNSON UTILITIES, LLC FOR AN
10 INCREASE IN ITS WATER AND
WASTEWATER RATES FOR CUSTOMERS
WITHIN PINAL COUNTY, ARIZONA.

Docket No. WS-02987A-08-0180

11 **RUCO’S OPENING BRIEF**

12
13 **INTRODUCTION**

14 The Residential Utility Consumer Office (“RUCO”) submits this Brief in response to
15 Johnson Utility, LLC’s (“Johnson or the Company”) request that the Arizona Corporation
16 Commission (“Commission”) authorize a rate decrease of \$2,233,479 for its Water Division
17 and a rate increase of \$2,239,804 for its Wastewater Division.

18 At the hearing, RUCO presented ample evidence to authorize a rate decrease of
19 \$2,233,479 for its Water Division and a rate increase of \$2,239,804 for its Wastewater
20 Division. Aside from the traditional ratebase, operating expense and operating income
21 issues, this rate case involved two other heavily contested matters. The first involves Swing
22 First Golf, LLC’s (“Swing First”) claim that the Company overbilled Swing First for effluent and
23 Central Arizona Project (“CAP”) water. This was a contentious matter and a lot of time was
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1 spent in the hearing on it. RUCO has considered all of the evidence of record and does not
2 believe Swing First has made an adequate showing of the amount it is claiming it was
3 overbilled. It is clear from the evidence that there were some billing discrepancies. The
4 Company admits as much, and appears to have made several credits to Swing First's
5 account. Swing First denies that any credits were made to its accounts.¹ Transcript at 582.
6 At present, Swing First has a "\$100,000 plus ... back balance"² but how much of this, if any,
7 is actually owed by Swing First to the Company is unclear from the evidence. Transcript at
8 582. Swing First claims that the entire balance is not owing, but has not shown that to be the
9 case based on the record. Transcript at 583. Nor has the Company accounted for the entire
10 balance owing. It appears that an overwhelming amount of the balance is related to late
11 charges, which may or may not be justified. A further analysis is necessary in the context of
12 a complaint proceeding.

13 Swing First has also made the allegation that Johnson's customers have been
14 overbilled. Swing First has not identified the customers who still have a claim, nor has there
15 been a showing by these customers that they were, in fact, overbilled. To the extent Swing
16 First wishes to pursue its billing claim, RUCO believes the more appropriate place for
17 resolution of this issue would be in the complaint docket.

18 The second issue that was raised by Swing First involves the Company's alleged
19 violations of the State's environmental laws and the Arizona Department of Environmental
20 Quality's ("ADEQ") rules and regulations. Swing First is claiming that the Company has
21 acted in a manner that places the public health and safety at issue. For reasons more fully

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23 ¹ For ease of reference, trial exhibits will be identified similar to their identification in the Transcript of
Proceedings. The transcript volume number will identify references to the transcript.

24 ² The September 2009 billing invoice shows a previous balance for water service of \$103,381.58. A-32.

1 set forth in Section V below. RUCO believes that the evidence in the record supports a
2 finding that the Company has acted in a manner which places the public's health and safety
3 in jeopardy and believes that the Commission should take measures to monitor the Company
4 more closely to ensure the public's health and safety.

5 **I. NON-CONTESTED ISSUES**

6 **Sludge Removal Expense**

7 This is a conforming adjustment to reflect the Company's adoption of Staff's
8 wastewater district operating income adjustment 2, which disallows sludge removal expenses
9 that occurred outside the test year in 2008.

10 **Miscellaneous Expenses**

11 This is a conforming adjustment to reflect the Company's adoption of RUCO's direct
12 recommendation.

13 **Purchased Power Expenses**

14 This is a conforming adjustment to reflect the Company's adoption of RUCO's and
15 Staff's reinstatement of purchase power to include:

- 16 1. An accounting error by the Company whereby it had credited meter deposit
17 refunds to the purchased power account;
- 18 2. A reduction for purchased power costs of an affiliate; and
- 19 3. An increase in purchased power costs for a known and measurable contractual
20 agreement.

1 **Revenue Annualization**

2 This is a conforming adjustment to the Wastewater District to correct an oversight
3 where the Company had failed to charge for the effluent a golf course was receiving.

4
5 **II. CONTESTED RATE BASE ISSUES**

6 **Plant-In-Service**

7 RUCO accepted the Commission Staff's ("Staff") findings with respect to its analysis of
8 the Company's infrastructure and Staff's conclusion that the Company has requested a
9 portion of its plant be placed in rate base that is not used and useful, and/or provides excess
10 capacity and/or is improperly booked. R-2 at 4-5. RUCO's adjustment is consistent with
11 Staff's for each district.

12 **RELIEF REQUESTED:** The Commission should remove \$5,254,084 in plant for the
13 Company's water district and \$9,547,463 in plant for the wastewater district.

14 **Post Test-Year Plant**

15 This is a conforming adjustment which corrects the calculation of post test-year plant
16 for the wastewater division based on the Company's rebuttal testimony.

17 **RELIEF REQUESTED:** The Commission should decrease the adjusted test year rate
18 base by \$490,896.

19 **Contributions in Aid of Construction ("CIAC") and the Accumulated**
20 **Amortization Associated with the CIAC**

21 The Company proposed to remove the unexpended CIAC from ratebase, as well as
22 accumulated amortization associated with the unexpended CIAC. R-1 at 10-11. RUCO
23 disagrees with this treatment. Normally, contributions are booked as CIAC when they are
24 received and treated as a deduction to rate base. Id. at 10. RUCO's recommendation

1 affords the Company the same rate base treatment for CIAC that every other Arizona utility is
2 afforded. Id.

3 **RELIEF REQUESTED:** The Commission should adopt RUCO's adjustment to
4 decrease the CIAC account by \$6,931,078 for the water district and by \$16,505 for the
5 wastewater district and increase the amortization associated with the CIAC by \$310,570 for
6 the water district and \$1,058,281 for the wastewater district.

7 **Accumulated Depreciation**

8 RUCO's plant-in-service analysis for both districts mirrored the Company's filing from
9 1997-2007. R-1 at 9. RUCO made adjustments for two entries in the Company's
10 accumulated depreciation accounts for the Company's water district totaling \$436,975.

11 **RELIEF REQUESTED:** The Commission should decrease the adjusted test year rate
12 base by \$4,584.

14 **Allowance for Materials and Supplies**

15 The Company did not perform a complete working capital analysis. RUCO-2 at 7.
16 RUCO does not believe it is appropriate to allow the Company or any utility for that matter to
17 pick and choose which elements will comprise its working capital allowance. Id. The end
18 result of such a practice will never be fair to ratepayers, and will almost certainly work to the
19 shareholder's benefit. In this case, the Company did not perform a complete working capital
20 analysis to compute the test year level of all the elements. Id. In particular, the Company
21 excluded the material and supply elements in its working capital analysis. Id. Accordingly,
22 RUCO recommends a disallowance for the Company's proposed recovery of the materials
23 and supplies working capital elements only.

1 **RELIEF REQUESTED:** The Commission should reduce the total allowance for
2 working capital to zero by an adjustment for the material and supplies for the water division
3 for \$(348,852).

4 **Service Line and Meter Charges**

5 This adjustment affects the water district only and corrects an accounting error which
6 misidentified an account. Id. at 8.

7 **RELIEF REQUESTED:** The Commission should move \$6,779,771 from the
8 “customer security deposits” account to the “service line and meter charges’ account. Since
9 there was already a balance in the security deposit account of \$378,138, the actual net
10 transfer would be $\$6,779,771 - \$378,138 = \$6,401,633$.

11
12 **III. Contested Operating Income Issues**

13 **Depreciation Expense**

14 This is a conforming adjustment to reflect RUCO’s end of test year depreciation
15 expense.

16 **RELIEF REQUESTED:** The Commission should decrease adjusted test year
17 operating expenses for the water district by \$398,648; and wastewater district by \$362,533.

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19 **Property Tax Expense**

20 This is a conforming adjustment to reflect RUCO’s proposed annual revenue.

21 **RELIEF REQUESTED:** The Commission should increase adjusted test year
22 operating expenses for the water district by \$46,019; and decrease operating expenses for
23 the wastewater district by \$55,085.

1 **Rate Case Expense**

2 RUCO does not argue with the Company proposed rate case expense of \$200,000
3 (\$100,000 for each District). RUCO, however, believes that given the Company’s propensity
4 of not filing timely rate applications, an amortization period of five years as opposed to the
5 Company recommended three year period is appropriate. R-1 at 23, Bourassa Direct at 9.

6 **RELIEF REQUESTED:** The Commission should decrease each Districts adjusted
7 test-year expenses by \$13,333 to reflect a five-year amortization of rate case expense.

8 **Income Taxes**

9 Johnson Utilities was organized as a Limited Liability Company (“LLC”). R-1 at 18.
10 For income tax purposes, an LLC does not pay income taxes and its earnings and/or losses
11 are assigned to individual shareholders on a pro rata basis. Id., Bourassa rebuttal at 23. The
12 Company chose this form of corporate status when it organized as opposed to a “C”
13 Corporation that pays income taxes prior to the distribution of any profits (i.e. dividends) to its
14 shareholders. R-1 at 18. The obvious benefit to the shareholder of the LLC structure is the
15 avoidance of double taxation. Bourassa rebuttal at 25.

16 Nonetheless, even though the Company does not pay income tax and its shareholders
17 avoid double taxation by its corporate status choice, the Company still seeks to recover from
18 ratepayers the income tax its shareholders pay. The Company claims that it reimburses its
19 members for the taxes its members pay as part of an agreement the Company has with its
20 members. Bourassa Rebuttal at 24. Similar to its corporate status election the agreement to
21 repay the shareholders is voluntary. There is no basis for ratepayers to essentially reimburse
22 the shareholders for their individual income tax obligations.

23 The Company analogizes the situation to a subsidiary C Corporation utility of a parent
24 holding company whose tax return is consolidated with the parent. Rebuttal at 24. However,
this argument is really not analogous since the Company is not a subsidiary of a parent who
files a consolidated return. Moreover, the obligation of a parent company for income taxes is
not comparable to the personal obligation of an individual shareholder. Corporate and

1 personal tax obligations are computed and treated completely different under the tax code.
2 The Company's recommendation to recover income tax expense should be rejected.

3 **RELIEF REQUESTED:** The Commission should reject the Company's request and
4 decrease adjusted test year operating expenses for income taxes for the Water District by
5 \$1,185,679 and decrease operating expenses for the Wastewater District by \$330,522.

6 **The Central Arizona Groundwater Replenishment District ("CAGR")**

7 The issue here does not concern the recovery of the CAGR expense but the manner
8 of recovery. The Company proposes that the CAGR assessment be passed through to
9 customers on their monthly bill. A-5 at 19. Staff recommends that the CAGR assessment
10 be classified as an adjustor. S-43 at 1. RUCO recommends the CAGR assessment be
11 treated as an expense. Transcript at 169. RUCO, however, recommends a pro-forma
12 adjustment which will allow the Company to collect all of the assessments to normalize this
13 expense over three years on a forward-looking basis through 2010 since these costs are
14 known and measurable. Transcript at 205. The collection of the assessment through 2010 is
15 three years beyond the test year. Should the Company under-earn on its level of expense
16 beyond 2010, it always has the option of filing for another rate case. RUCO's proposal is the
17 best option for the following reasons.

18 As discussed below, the CAGR is not a tax that can be passed through pursuant to
19 the Administrative Code. It is not a volatile fee. And it is not the most significant annual
20 expense. Further, an adjustor during these trying economic times injects instability in the
21 residential ratepayer's family budget at a time when rate stability is highly valued. Finally, the
22 creation of an adjustor for a traditional and regular expense only serves to create more work
23 for an already over-burdened Commission Staff.

24 The Company's proposal to treat the assessment as a pass through is similar to the
proposal the Company made in 2001 when it filed with the Commission a request for a
clarification of the ratemaking treatment for the CAGR assessment. R-4 at 1. The
Commission Staff's analysis of the Company's proposal in 2001 led it to conclude that the "...

1 GRD taxes cannot be treated as a pass-through tax within the Arizona Administrative Code
2 R14-2-409.D.5 because it is not a “privilege, sales or use tax” since GRD taxes are not
3 based on sales revenue. Therefore GRD taxes do not fall within the scope of the Company’s
4 current tariff.” R-4 at 2. Decision No. 64598 at 2. The Commission denied Johnson Utilities’
5 request to treat the CAGR D tax assessment as a pass through cost to its water and effluent
6 customers concluding that the CAGR D tax “... is not the type of tax that can be passed
7 through within Arizona Administrative Code, R-14-2-409.D.5 and is, therefore, not included in
8 the Company’s current tariff.” Id. at 1-2. Decision No 64598. The Commission did, however,
9 adopt Staff’s recommendation that the CAGR D assessment issue be addressed again in the
10 Company’s next rate case. Id. at 2.

11 Fast forward to the Company’s next rate case, the present case, and nothing has
12 changed with regard to the nature of the assessment. It is still not a privilege, sales or use
13 tax or the type of tax contemplated by the Commission’s Rules. R-5 at 2. Even the
14 Company admits that the CAGR D assessment is based on the volume of water consumed.
15 Transcript at 499. It is not based on revenues like a privilege, sales or use tax. Arguably, it is
16 not a tax but a fee for the provision of service.

17 Privilege, sales and use taxes are also not voluntary. They are mandatory taxes
18 based on revenues. On the other hand, membership in the CAGR D, as the Company also
19 admits is not mandatory. Transcript at 501. There are other alternatives that the Company
20 can partake to meet its assured water supply. Id. In sum, the Company has not shown, nor
21 is there any legal or other basis for treating the CAGR D assessment the same as a privilege,
22 sales or use tax and allowing for a pass through.

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1 The Staff proposes to treat the CAGR assessment as an adjustor. S-43 at 1. It is
2 worth noting the path that Staff took to get to its final recommendation. In the 2001
3 proceeding, Staff had determined that the CAGR assessment could not be treated as a
4 pass through tax. R-4 at 2. In this case, Staff originally recommended that the CAGR
5 assessment be treated as a cost of doing business and included in purchase water expense.
6 S-38 at 25. Thereafter, Staff had a change of heart and proposed to treat the CAGR
7 assessment as a pass through tax, completely counter to Staff's view of the assessment
8 back in 2001. S-41 at 1. More than three months later, Staff changed its recommendation
9 again and sought recovery of the CAGR assessment as an adjustor. S-43 at 1. According
10 to Staff, it took that length of time to reach the determination that the CAGR assessment
11 meets the criteria for the application of an adjustor mechanism. Transcript at 1538-1539.

12 According to Staff "...the assessment represents a significant annual expense for the
13 Company, which is anticipated to progressively increase." S-43 at 1. Apparently, Staff has
14 relaxed the criteria that it views necessary for the application of an adjustor mechanism. In
15 Decision No. 68302, (In the Matter of Arizona Water's rate application for its Western Group,
16 Docket No. W-01445A-04-0650, docketed on November 14, 2005), the Commission noted
17 that

18 Staff states that adjustment mechanisms have traditionally
19 been used to mitigate the regulatory lag for volatile, very large
20 expense items, and are useful when a commodity constitutes a
21 utility's largest expense, such as for electric utilities where purchased
22 power is the utility's single largest expense (Ludders at 7-8; Ludders
23 Sb. At 6). Decision No. 68302 at 44, R-15 at 2.

22 At issue in the Arizona Water case was the Company's proposed continuance of an
23 adjustor mechanism to recover the cost for power provided to Arizona Water from APS. Id.
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1 The Commission denied the Company's request noting that APS' adjuster had numerous
2 safeguards designed to limit volatility and the evidence in that case did not support a finding
3 that the company's power costs were subject to such a degree of price volatility or
4 uncertainty that it justified an adjustor mechanism. Id. at 46. The Commission further
5 concluded, undoubtedly based in part on Staff's conclusions in that case, that consistent with
6 numerous prior and subsequent Commission decisions:

7 There is a danger of piecemeal regulation inherent in adjustment
8 mechanisms. Because they allow automatic increases in rates
9 without a simultaneous review of a utility's unrelated costs,
10 adjustment mechanisms have a built-in potential of allowing a
11 utility to increase rates based on certain isolated costs when its
12 other costs are declining, or when overall revenues are
13 increasing faster than costs due to customer growth. Adjustment
14 mechanisms should therefore be used only in extraordinary
15 circumstances to mitigate the effect of uncontrollable price
16 volatility or uncertainty in the marketplace. Id. at 45-46.

17 Staff also rejected the use of an adjustor mechanism in a recent Chaparral City Water
18 application. Docket No. W-02113A-04-0616, Decision No. 68176 docketed September 30,
19 2005). In Chaparral the company proposed an adjustor for its purchased water and
20 purchased power expenses that even the Commission determined were significant. Decision
21 No. 68176 at 32-33.

22 Staff does not believe that the incremental cost level or volatility
23 associated with possible rate increases or decreases associated
24 with the Company's water supply are significant enough to justify
a purchased water adjustment mechanism in this case, and
recommends denial of the Company's request. Regarding
purchased sewer expense, Staff does not disagree that
purchased power expense is a significant cost for Chaparral City,
but points out that the issue to be considered in implementing an
adjustment mechanism is not merely whether the cost is
significant, but whether the incremental cost level, or volatility,
associated with possible rate increases or decreases is
significant. Staff asserts that future rate increases the Company
projects from SRP and APS do not constitute a level of volatility

1 great enough to warrant the need for a purchased power
2 adjustment mechanism. In particular, Staff differentiates the
3 possible increases in Chaparral City's purchased power expense
4 from the volatility; of APS' constantly changing fuel and
5 purchased power costs, which led to the Commission's recent
6 approval of a Power Supply Adjustor for APS. Id.

7 The Commission agreed with Staff and RUCO that the expenses do not rise to a
8 "...level of volatility that would justify the extraordinary ratemaking treatment..." of an adjustor
9 mechanism. Id. at 33. The Commission concluded:

10 As we stated in Decision No. 56450, there is a danger of
11 piecemeal regulation inherent in adjustment mechanisms.
12 Because adjustor mechanisms allow automatic increases in
13 rates without simultaneous review of a Company's unrelated
14 costs, an adjustment mechanism has a built-in potential of
15 allowing a Company to increase rates based on certain isolated
16 costs when its other costs are declining, or when overall
17 revenues are increasing faster than costs due to customer
18 growth. Such circumstances can result in increases to
19 ratepayers through adjustors even when the Company's level of
20 earnings would not warrant a rate increase, such that the utility's
21 net income is increased outside a rate case. In addition, as we
22 stated in Decision No. 66849 (March 19, 2004), adjustment
23 mechanisms may also provide a disincentive for a utility to obtain
24 the lowest possible cost commodity because the costs are simply
passed through to ratepayers. For these reasons, adjustment
mechanisms should be implemented only under very special
circumstances. Based on the evidence in this proceeding,
circumstances do not exist in this case to justify the risks of
piecemeal regulation inherent in adjustment mechanisms, and
we will not approve the Company's requests. Id.

19 The circumstances in this case do not warrant an adjustor mechanism. The CAGR
20 assessment is not a unique or an unusual expense. When asked on cross-examination, the
21 Company's witness, Brian Tompsett admitted that the assessment was a routine yearly
22 expense. Transcript at 737. Routine yearly expenses like the CAGR assessment do not
23 warrant extraordinary ratemaking treatment. Moreover, the CAGR may be a significant
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1 expense but by no means is it the Company's largest expense. The Company's income
2 statement shows the test year CAGR assessment was \$1.29 million. R-10, Transcript at
3 735. The test year depreciation expense amount listed by the Company was \$1.31 million
4 and outside service expense was \$5.58 million. The CAGR is not the Company's largest
5 expense as Staff has required before recommending adjustors in the past.

6 The CAGR assessment can hardly be called volatile. Staff even admits as much –
7 the assessment is expected to “progressively” increase. S-43 at 1. The Company has
8 provided a table of the CAGR assessment rates. A-5 at 21. The table shows the actual
9 rate through the 2009/2010 year and the projected or advisory rates through 2013/2014. Id.
10 Staff is correct; the table shows progressive increases in the rates from year to year. Id.
11 There are no decreases, and the increases are by no stretch volatile. As Staff concluded in
12 the Chaparral case, the CAGR assessment here does not raise to the “...level of volatility
13 that would justify the extraordinary ratemaking treatment...” of an adjustor mechanism.
14 Decision No. 68176 at 32-33.

15 Historically, the CAGR fee has been treated as a normal expense and included in
16 base rates. Typically, expenses like the CAGR assessment are reflected in base rates. If
17 the CAGR assessment is to be treated as an adjustor, it should be taken out of base rates
18 and moved to the adjustor. Base rates should therefore be lower to reflect the removal of the
19 CAGR assessment. Nowhere in Staff's rate design does it show a decrease in the base
20 rates resulting from the corresponding removal of the CAGR assessment. S-38, Schedule
21 JMM-W27, S-43.

22 The Commission should reject the request for an adjustor mechanism and treat the
23 assessment as an expense. One of the features of an adjustor is that residential ratepayer's
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1 rates change when the adjustor adjusts. With the current economy ratepayers value rate
2 stability. Rate stability helps families plan their family budget. Familiarity with rates and the
3 ability to budget is a critical concern to most if not all of Arizona's ratepayers at a time when
4 every dollar matters. The use of an adjustor should only be allowed in the most extraordinary
5 of circumstances.

6 An adjustor would also create extra work for the Commission's Staff. Among other
7 things the adjustor would require the Commission's Staff and the Commissioners to review
8 the Company's adjustor filings. See S-43 at 2-3. It is no secret that the state is facing a
9 critical budget deficit and all state agencies, including the Commission have budgets that are
10 and will be affected by the state's budget deficit. The Commission Staff's resources are
11 stretched pretty thin as it is now, and Staff should not have to use critical resources where it
12 is unnecessary and inappropriate.

13 Finally, treating the assessment as an expense will allow the Company to recover the
14 assessment through 2010. Transcript at 205. The Company has indicated that it plans on
15 filing a new rate case every three years. Id. In this case the test year used was 2007 which
16 would suggest a 2010 test year for the Company's next rate case. RUCO's adjustment
17 should provide for the complete recovery of the expense without violating the notion of fair
18 value and requiring extraordinary ratemaking treatment for such a routine cost.

19 **RELIEF REQUESTED:** The Commission should increase the Water Districts adjusted
20 test-year expenses by \$1,295,895 to reflect the CAGR assessment.

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1 **IV. Cost of Capital**

2 RUCO is recommending a negative rate base for the Water Division and is
3 recommending an operating margin of 8.18 percent for the Water Division. R-9 at 3. The
4 following analysis on cost of capital applies to the Company's Wastewater Division. RUCO
5 recommends a hypothetical capital structure composed of 40% long-term debt, and 60%
6 common equity. R-9 at 3. The Company proposes to use its actual capital structure of
7 2.79% long-tem debt and 97.21% common equity. Id. RUCO and the Company agree on
8 the cost of long-term debt of 8.00%. Id. at 4. RUCO further recommends a cost of equity of
9 8.31 and the Company believes its 12.00% cost of equity recommendation is fair and
10 reasonable. Finally, RUCO recommends an overall cost of capital of 8.18%, and the
11 Company recommends 11.89%. Id. at 5.

12 **A. The Commission should reject the Company's use of its actual capital**
13 **structure.**

14 The Company has a capital structure that is almost all equity. Since equity costs
15 more than debt, the Company's capital structure results in a higher cost of capital which
16 translates to a higher revenue requirement. The Company's choice of a capital structure that
17 is so heavy in equity is imprudent and counter to the best interests of ratepayers.
18 Accordingly, consistent with what the Commission's past practice when a Company proposes
19 an imprudent capital structure, RUCO's recommended hypothetical capital structure.
20 RUCO's proposed hypothetical capital structure is also consistent with what RUCO has
21 recommended in the past and what the Commission has generally considered appropriate for
22 Company's with imprudent capital structures.

1 **B. RUCO’s use of a historic market risk premium to determine its CAPM cost**
2 **of equity capital was appropriate.**

3 In calculating a cost of equity, both the Company and RUCO, among other models,
4 used the Capital Asset Pricing Model (“CAPM”). The CAPM is a mathematical model
5 developed during the early 1960’s by William F. Sharpe, the Timken professor Emeritus of
6 Finance at Stanford University. R-8 at 29. CAPM is used to analyze the relationships
7 between rates of return on various assets and the risk as measured by beta. Id. The
8 underlying theory behind the CAPM states that the expected return on a given investment is
9 the sum of a risk-free rate of return plus a market risk premium that is proportional to the
10 systematic, non-diversifiable risk, associated with that investment. Id. at 30.

11 The Company arrived at its CAPM cost of equity capital of 12.1% by averaging a
12 CAPM historical market risk premium of 10.8% and a 13.4% current market risk premium.
13 A-1, Direct Testimony of Thomas Bourassa, Schedule D 4.13. RUCO did not use a current
14 market risk premium. RUCO derived a CAPM cost of equity capital based on a historic
15 market risk premium. RUCO calculated a range for its CAPM cost of equity capital between
16 7.72%-8.74% for its water sample and 5.68%-6.70% for its natural gas proxy. R-8, Schedule
17 WAR-7.

18 The Company claims that RUCO’s CAPM analysis is not reliable because it is based
19 on a historic market risk premium and ignored the current market risk premium. A-3 at 11.
20 The use of a historic market risk premium to derive a CAPM cost of equity capital is
21 appropriate. R-9 at 11-12. Reliance on past performance as an indicator of future
22 performance is sounder than reliance on analyst’s projections of market return and treasury
23 yields. An analysis based on past performance is surely more reliable than an analysis

1 based on projections. The use of an historic market premium is more reliable than a current
2 market premium and should be given greater weight.

3 The main difference, however, between RUCO and the Company's CAPM results is
4 attributable to the selection of U.S. Treasury instruments used as inputs for the risk-free rate
5 of return and the time period that has expired since Mr. Bourassa filed his direct testimony.
6 R-8 at 62. The interest rates on U.S. Treasury instruments have fallen over the past year as
7 a result of the Fed's rate cutting actions. Id. Moreover, the Company relies on longer term
8 maturities greater than five years that are unrealistic proxies when one takes into account
9 that utilities generally file for new rates every three to five years. Id.

10 Using the Company's CAPM analysis, RUCO updated the inputs based on data for
11 the week ended January 23, 2009 (obtained in a Federal Reserve Statistical Release dated
12 February 2, 2009). Id. The average yield of the 5, 7 and 10-year U.S. treasury instruments
13 was 2.04 percent as opposed to the average yield of 3.40 percent that Mr. Bourassa used as
14 the risk free rate in his historical market risk premium CAPM model. Id. The yield on the 30-
15 year rate was 3.17 percent as opposed to the 4.70 percent rate that Mr. Bourassa used in his
16 current market risk premium CAPM model. Id.

17 The Company's use of out dated data is also apparent in the Beta inputs that the
18 Company used. At the hearing of this matter, the Company's cost of capital witness was
19 cross-examined on this issue. In the Company's direct case the Company determined the
20 average beta of 0.98 for the company's used in Johnson's proxy. Transcript at 1362. The
21 Company's surrebuttal average beta for the proxy changed to 0.93 based on the Value Line
22 Investment Analyzer Data for February 2008. R-12. Updating the average beta of the same
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1 proxy using the Value Line data for July 24, 2009 results in an average beta of 0.82. R-12.
2 Transcript at 1362-1364.

3 Yet despite an economy that on the whole the Company admits has worsened over
4 the past year, the Company's cost of equity recommendation has increased from 10.5% in its
5 direct case filed on March 8, 2008 to 12% in its rebuttal case filed on March 10, 2009.
6 Transcript at 1358-1359. In response, Mr. Bourassa claims, at least in part that "...other
7 components of the CAPM have also changed." Transcript at 1364. As mentioned above,
8 another component of the CAPM is the market risk premium which when using updated
9 information should be going down because of the lower bond yields. Using the current
10 market risk premium input, however, the Company's market premium recommendation went
11 from 8.9% in its direct case to a whopping 21.3% in its rebuttal case and has not changed to
12 account for the lower yields. Transcript at 1365. These other components may be changing
13 as Mr. Bourassa claims; however, the change should be producing the opposite results of
14 what the Company is recommending.

15 It is often said that cost of capital is more of an art than a science. It is for this reason
16 that it is advisable to check with the industry to test the sanity of cost of capital results. In this
17 case, RUCO offered an exhibit of a publication, entitled "Valuation Measuring and Managing
18 the Value of Companies" by Tim Koller, Marc Goedhart, David Wessels, John Wiley and
19 Sons Inc., to provide a sanity check on the Company's market risk premium
20 recommendation³. R-13. According to this publication which appears to be generally
21 accepted in the industry:

22
23 ³ The Company's witness relied on this publication in another case for its cost of capital analysis for a reason
24 other than to show market risk premium. R-14.

1 Although many in the finance profession disagree about how to
2 measure the market risk premium, we believe 4.5 to 5.5 percent is
3 an appropriate range. Historical estimates found in most textbooks
4 (and locked in the mind of many), which often report numbers near 8
5 percent, are too high for valuation purposes because they compare
6 the market risk premium versus short-term bonds, use only 75 years
7 of data, and are biased by the historical strength of the U.S. market.

8 R-13 at 306. The Company's 21.3% market risk premium makes no sense and quite frankly
9 is absurd.

10 In conclusion, the Company's cost of equity recommendation does not pass the sanity
11 check. At a time when the economy is weak, and the financial risk associated with utilities
12 has decreased, the Company has simply chose to ignore the changes in the current
13 economy and make its CAPM recommendation based on stale Beta and other inputs. The
14 Company also ignored the change in the current economic environment in its risk premium
15 analysis, recommending a risk premium four times greater than what the industry believes is
16 appropriate. Finally, the Company's 12% cost of equity recommendation is significantly
17 higher than what the Commission has awarded similar utilities in the recent past, and there is
18 nothing extraordinary or unusual about this Company that would warrant a higher cost of
19 equity.

20 **REQUESTED RELIEF:** The Commission should approve RUCO's hypothetical
21 capital structure composed of 40% long-term debt, and 60% common equity. The
22 Commission should also approve RUCO's cost of equity of 8.31% and weighted average
23 cost of capital of 8.18%.

1 **V. ENVIORNMENTAL ISSUES**

2 There is a significant amount of evidence in this record concerning the Company's
3 alleged environmental violations. The alleged violations were lodged against the Company
4 by ADEQ. Swing First Golf Club, LLC, ("Swing First") a customer of the Company, is the
5 party in this proceeding that has presented the majority of the evidence. Swing First's
6 purpose for bringing this to the Commission's attention is not exactly clear. However, RUCO
7 believes that the evidence presented in this record presents a public health and safety
8 concern. The basis for RUCO's belief and RUCO's recommendations are more fully set forth
9 as follows.

10 **A. The Commission has jurisdiction over utility matters that affect the**
11 **public's health and safety.**

12 The Commission has both constitutional and statutory authority to regulate public
13 service corporations in matters that concern the public's safety and health. The Commission
14 has full power to, and

15 *"shall * * * make and enforce reasonable rules, regulations and orders for the*
16 *convenience, comfort, and **safety**, and **the preservation of the health**, of the employees*
17 *and patrons of [public service] corporations." (Emphasis added). Ariz. Const. Article 15,*
18 *Section 3.*

19 The Legislature has also expressly mandated the following:

20 The Commission may, by order, rule or regulation:

21 "require every public service corporation to maintain and operate its line, plant,
22 system, equipment, and premises *in a manner which will **promote and safeguard the***
23 ***health and safety of its employees, passengers, customers and the public,**" and to*
24 "prescribe the installation, use, maintenance and operation of appropriate safety or other

1 devices or appliances . . . , establish uniform or other standards of equipment, and require
2 the performance of any other act *which health or safety requires.*” (Emphasis added).”

3 **A.R.S. §40-361(B).**

4 “When . . . *the equipment, appliances, facilities or service* of any public service
5 corporation, or the methods of manufacture, distribution, transmission, storage or supply
6 employed by it, *are unjust, unreasonable, unsafe, improper, inadequate or insufficient,* the
7 commission **shall** determine what is just, reasonable, **safe,** proper, **adequate** or **sufficient**
8 and **shall** enforce its determination by order or regulation.” (Emphasis added). **A.R.S. § 40-**
9 **321(A).**

10 “When . . . *additions or improvements to or changes in the existing plant* or physical
11 properties of a public service corporation *ought reasonably to be made,* or that a new
12 structure or structures should be erected, **to promote the security** or *convenience* of its
13 employees or the public, the commission **shall** make and serve an order directing that such
14 changes be made or such structure be erected in the manner and within the time specified in
15 the order.” (Emphasis added). **A.R.S. §40-33 1(A).**

16 The Commission has authority to “supervise and regulate every public service
17 corporation in the state and do all things, whether specifically designated in this title or in
18 addition thereto, necessary and convenient in the exercise of that power and jurisdiction.”

19 **A.R.S. §40-202(a).**

20 “Every public service corporation **shall** *furnish and maintain such service, equipment*
21 *and facilities as will promote the safety, health, comfort and convenience of its patrons,*
22 **employees and the public,** and *as will be in all respects adequate, efficient and*
23 *reasonable.*” (Emphasis added). **A.R.S. §40-361(B).**

24 The foregoing authority confirms that the Commission has regulatory powers
which allow it to make orders respecting the public’s health and safety. The

1 legislature has also mandated that the Commission take action when needed to
2 provide for the public's health and safety. Finally, the legislature also requires public
3 service corporations furnish and maintain service, equipment and facilities that will
4 promote the safety, health, comfort and convenience of its patrons, employees and
5 the public and be in all respects adequate, efficient and reasonable;

6 The Commission clearly has authority over Johnson's provision of water and
7 wastewater service and has discretion in what measures it may take to assure
8 Johnson provides that service in a manner that does not place the public health and
9 safety at risk.
10

11 **B. Johnson has failed and continues to fail in providing wastewater**
12 **service in a safe and reliable manner, putting the public's health and**
13 **safety at risk.**

14 In total ADEQ has issued fourteen Notice of Violations ("NOVs" or "violations")
15 against the Company dating back to September 2004. SF-9. More recently, five of
16 the NOVs were issued in 2008 and two were issued in 2009. Id. Most of the older
17 violations have been closed and most of the more recent violations remain open.
18 Transcript – page 85 – 117. The number and the nature of the violations are
19 disconcerting.

20 ADEQ is the state agency responsible for enforcing Arizona's environmental
21 laws. ARS §49-103. Among its many powers and duties, ADEQ shall formulate
22 policies, plans, programs and implement rules to carry out its duties to protect the
23 environment. ARS §49-103 (A) (1), (B) (11) (12) and (13). The rules, policies plans
24

1 and programs shall apply to the supply, transmission and disposal of water,
2 wastewater and sewage. Id. ADEQ issues NOVs when it has reason to believe that
3 a Company has violated a rule, statute, order or civil judgment. SF-9. The
4 Company's understanding is that the NOV is just allegations that could possibly lead
5 to a violation of the law. Transcript at 81.

6 The role of ADEQ and the Commission should not be duplicative. ADEQ's role
7 is to prosecute what it perceives as environmental violations for the purpose of
8 protecting the environment. ADEQ has its own procedures and processes for
9 prosecuting its cases. The Commission's role is to assure the provision of safe and
10 reliable water and wastewater services in a manner that does not place the public's
11 health and safety at risk. In determining whether or not the Company is acting in a
12 manner that places the public's safety and health in jeopardy, the Commission's
13 process only requires a finding based on the preponderance of the evidence. If the
14 Commission finds that the Company's provision of service jeopardizes the public's
15 safety and health, its remedies cannot be punitive as might be the case with ADEQ,
16 but rather must focus on remedying the situation so that the public's health and safety
17 are not in jeopardy.
18

19 In this case, there was a significant amount of testimony regarding the
20 Company's alleged violations. When asked, the Company admitted to some of the
21 allegations which clearly place the public's health and safety at risk, denied others,
22 and claimed to be unaware of other potential violations. This is perhaps most evident
23 with unannounced inspections performed by ADEQ on the Company's Section 11
24

1 Wastewater Treatment Plant (“WWTP”). The inspections were made on September
2 25, 2008 and October 7, 2008. Id. The results of the inspection serve the basis for
3 the thirteen allegations that the Company had unlawfully disposed of sewage, sludge
4 and/or biosolids. SF-11, SF-9, Case ID # 103357. The NOV is dated October 20,
5 2008. SF-9, Case ID # 103357.

6 The site inspections mostly centered on the east side of the plant. SF-11 at
7 page 5 of 8. The September 25, 2008, inspection revealed a significant amount of
8 biosolids observed and scattered on a surface area of 750 x 50 feet (“disposal area”).
9 Id. The disposal area contained a large open area (“pit”) and when the ADEQ staff
10 walked into the pit they were standing on top of biosolids that were covered with 2-3
11 inches of topsoil. Id. The ADEQ staff also noted two additional pits in the disposal
12 agree where biosolids had been buried. Id.

14 The biosolids were dry on the surface area but beneath the surface area the
15 biosolids were moist and very odorous. Id. Thereafter, the ADEQ inspectors dug six
16 borings with an auger device. Id. Three of the borings contained a strong sewage
17 odor and were black in color. Id. at 6. The Company’s employees then excavated
18 several trenches where the biosolids were located in the pit. Id. The samples were
19 very moist and odorous and the surface areas were very unstable. Id. On several
20 occasions according to the ADEQ report the ground surface collapsed and the
21 inspectors sank below the surface. Id.

23 Ultimately, the ADEQ inspectors concluded that the Company’s officials were
24 burying unknown quantities of biosolids on the east side of the property during what

1 was believed to be the spring and summer of 2008. Id. At 7 of 8. The Company
2 admits there were biosolids on the surface at the time of the visit. Transcript at 108.
3 The Company also admits there was a large pit that contained biosolids in it. Id. at
4 109. The Company arranged for the biosolids to be transported to the WWTP by the
5 Roadrunner Transport Company. Id. at 111 -112.

6 The Company was less clear about other observations in the ADEQ inspection
7 report. For instance, when asked about whether the areas inspected appeared
8 unstable and actually collapsed, Brian Tompsett, the Company's Executive Vice
9 President claimed he was not at the inspection site but assumed "that it is possible"
10 based on the fact that it was in the inspection report. Id. at 113.
11

12 The ADEQ inspectors did a follow up inspection on October 7, 2008 and the
13 entire disposal area had been excavated and the biosolids were gone. SF-11 at 7 of
14 8. When asked where the biosolids went, the Company's representative responded
15 "what material". Id. This type of response shows a callous disregard for the truth and
16 an effort to downplay or deflect responsibility for what is otherwise a very serious
17 situation. This attitude appears to be prevalent as concerns the environmental
18 issues.
19

20 When asked in general why the Company has received so many Notices of
21 Violations, Mr. Tompsett responded as follows:

22 Q. What about 2009? It doesn't seem like the company is off to a good start
23 in 2009. Any particular reason there have been these violations in 2009?
24

1 A. Well, I guess the most accurate way to describe that is we have an
2 ongoing dispute with ADEQ over the issuance of notices of violations to
3 Johnson Utilities in particular. It is our opinion that they make a special
4 effort to issue violations, and selectively issue violations to our company
5 rather than others.

6
7 Q. So does the Company feel that it is being treated unfairly by ADEQ?

8 A. Short answer would be yes.

9
10 Q. Do you know why the company – why ADEQ may be singling Johnson
11 Utilities out for these violations?

12 A. Well, it is our opinion that they are selectively enforcing more stringently
13 against Johnson Utilities than they do against other companies across
14 the state. And we have done FOIA requests with that in mind, and the
15 evidence that has been presented by ADEQ seems to suggest that that is
16 in fact the case. Transcript at 740-741.

17
18 The Company did present an e-mail between the attorney generals office and
19 ADEQ which tends to support the Company argument. A-34, Transcript at 763 – 766.
20 However, the point is insignificant because even the Company admits to unsafe
21 conditions and environmental infractions. And even giving the Company the benefit
22 of the doubt that ADEQ's approach may be selective, it is because the Company
23 appears to be violating the agency's rules and the law. The Company's unfair
24

1 persecution theory is nothing more than an excuse for its unwillingness to take
2 responsibility for its unsafe actions.

3 This attitude can also be seen in a response by Mr. Tompsett to a question of
4 whether Mr. Tompsett thought that the Commission should be concerned with all of
5 the NOV's issued to the Company. Mr. Tompsett's response:

6 A. I think the Commission should be more concerned with the fact that a
7 sister agency, in our opinion, is not evenhandedly regulating the state.

8 There are many, many other examples in this record which show that the
9 Company has acted in a manner that places the public's health and safety in
10 jeopardy. For example, the Company was issued a NOV for two sanitary overflows
11 with a combined total of 10,000 gallons of untreated water sewage at the Pecan
12 Water Reclamation Plant. SF-9, Case # 97512. The sanitary sewer overflow ("SSO")
13 occurred during the weekend of May 17-18, 2008. Id. ADEQ's investigation into that
14 matter determined that there were elevated levels of e. coli in the Queen Creek wash
15 where the sewage had leaked several months after the initial overflow. SF-9, 14.
16 Regarding the pending status of this NOV, the Company claims that "... the consent
17 order that was associated with this has been closed in the fall of last year, 2008, but
18 the NOV is still open." Transcript at 101. More recently, during April 2009,
19 approximately 9,000 gallons of effluent leaked out of a holding area into a retention
20 basin at the Company's Pecan Water Reclamation Plant. SF-14, Transcript at 118.
21 ADEQ has not issued an NOV on this incident yet. Transcript at 118. Prior to that, in
22 February 2009, the Company also dealt with a 9,000 gallon sewage leak in the
23
24

1 Cambrilla Ocotillo neighborhood caused by clogged sewer lines. SF-14. The
2 Company was not cited by ADEQ for that incident. Id.

3 Other "alleged" violations date back to 2004. During the second quarter of
4 2004, the Company was alleged to have exceeded the acceptable level of fecal
5 Coliform on 58 occasions. SF-9. According to the Company, fecal Coliform is found
6 in any warm-blooded animal waste. Transcript at 86. ADEQ issued an NOV and the
7 matter has since been closed. Transcript at 86. Thereafter, during the third quarter of
8 2004, the Company again exceeded the acceptable level of fecal Coliform on 29 more
9 occasions. A NOV was issued and has since been closed. Transcript at 87, SF-9.

10
11 While the Company admits that there is validity to ADEQ's NOV's, it maintains
12 that the Company has never engaged in a practice that was unsafe to the public's
13 health and safety when providing water and/or wastewater service. Mr. Tompsett was
14 asked about the NOV's in general and if there was any validity to them. Transcript at
15 743. Mr. Tompsett's response:

16 Q. So do you think there is any validity to any of them?

17 A. The letter of the law citing specific statutes, yes, there will be some
18 validity to some of the statutes that are quoted. But I don't think all of the
19 statutes that are alleged, the alleged violations are valid, no.

20
21 When asked whether the Company ever engaged in an unsafe practice when
22 providing water or wastewater service, Mr. Tompsett responded as follows:

23 Q. In your opinion, Mr. Tompsett, has the company ever engaged in an
24 unsafe practice whether providing water and/or wastewater service?

1 A. Define unsafe. I am not sure what you mean.

2 Q. Well, unsafe to the public health and safety to the customers.

3 A. No, in my opinion, no, not that I can think of.

4 Transcript at 751. Given the evidence in this record, this statement is remarkable and
5 sums up the reason why RUCO believes it is necessary for the Commission to take
6 further action to assure the public's safety.

7
8 **C. The Commission, at the very least, should monitor the company**
9 **more closely.**

10 The evidence in this case supports a finding that the Company has violated the
11 state's environmental statutes and on numerous occasions and has placed the
12 public's health and safety in jeopardy. RUCO believes that more regulatory oversight
13 would be appropriate in this situation. It is not clear from the evidence in the record
14 what type of reporting requirements the Company is under.

15 RUCO would recommend that the Company be required to provide the
16 Commission twice a month or no less than monthly, confirmation that it is in
17 compliance with all rules and regulations of ADEQ and notice of any new alleged
18 violations whether written or oral. As part of that filing, the Company should include
19 all correspondence, oral and written that the Company has with ADEQ during the time
20 period. The Company should be ordered to report any leaks, overflows or any other
21 incidents no matter how minor to the Commission immediately after they occur. The
22 Commission should, resources permitting, put into place both scheduled and
23 unannounced visits by its Staff to the Company's service area for the purpose of on-
24

1 site inspections. The Commission Staff should file with the Commission with copies
2 to the parties reports of any inspection made.

3 The above requirements should remain in place for a minimum of six months
4 but not be removed until the Company can prove that all of the open NOVs are
5 closed. RUCO is very concerned about the public's health and safety and the
6 Company's attitude towards this subject. The Commission should take the above
7 action at a minimum to ensure the public's health and safety.
8

9 **VI. CONCLUSION**

10 RUCO recommends that the Commission should authorize a rate **decrease** of
11 \$2,233,479 for its Water Division and a rate **increase** of \$2,239,804 for its Wastewater
12 Division based on the above discussion and as reflected in its final schedules. RUCO
13 recommends an operating margin of 8.18 percent for the Water Division and an 8.31% return
14 on equity for the Wastewater District. RUCO further recommends an 8.18% percent FVROR
15 for the wastewater district. RUCO recommends that the Commission adopt RUCO's rate
16 design and recommendation to monitor the Company more closely as set forth above on the
17 environmental issues which RUCO believes place the public's health and safety at risk.
18

19
20 RESPECTFULLY SUBMITTED this 20th day of November, 2009.

21
22 _____
Daniel W. Pozefsky
23 Chief Counsel
24

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