IN THE SUPREME COURT

STATE OF ARIZONA

JOHNSON UTILITIES, LLC, an Arizona Limited Liability Company, Petitioner/Appellant, v. ARIZONA CORPORATION COMMISSION; and TOM FORESE, BOB BURNS, ANDY TOBIN, BOYD W. DUNN and JUSTIN OLSON, in their official capacities as members of the Arizona Corporation Commission, Respondents/Appellees.	Arizona Supreme Court Case No. CV-19-0105-PR Court of Appeals, Division One Case No. 1 CA-CV 18-0197 Arizona Corporation Commission Docket No. WS-02987A-18-0050

RESPONDENTS/APPELLEES ARIZONA CORPORATION COMMISSION ET AL.'S SUPPLEMENTAL BRIEF

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TABLE OF CONTENTS

I. INTRODUCTION 1

II. THE CONCURRENT OR PERMISSIVE CONSTITUTIONAL AUTHORITY OF ARTICLE 15, SECTION 3 OF THE ARIZONA CONSTITUTION PERMITS THE APPOINTMENT OF AN INTERIM MANAGER 3

III. THE COMMISSION'S APPOINTMENT OF AN INTERIM MANAGER IS ALSO CONSISTENT WITH ITS RATEMAKING AUTHORITY UNDER ARTICLE 15, SECTION 3 7

IV. THE MANAGEMENT INTERFERENCE DOCTRINE DOES NOT ACT AS A BAR TO THE COMMISSION'S AUTHORITY TO ACT TO APPOINT AN INTERIM MANAGER FOR JOHNSON..... 10

V. THE INTERIM MANAGER REMEDY LONG PRE-DATES JOHNSON UTILITIES 12

VI. REVERSAL OF THE COURT OF APPEALS' OPINION WOULD HAVE A FAR-REACHING IMPACT ON THE COMMISSION'S ABILITY TO EFFECTIVELY REGULATE PUBLIC SERVICE CORPORATIONS 15

VII. CONCLUSION..... 17

TABLE OF AUTHORITIES

CASES

Arizona Corporation Commission v. State ex rel. Woods, 171 Ariz. 286, 830 P.2d 807 (1992) ..... PASSIM

Ariz. Eastern R. Co. v. State, 19 Ariz. 409, 171 P. 906 (1921) 3, 4

Arizona Corporation Commission v. George M. Papa d.b.a George M. Papa Water Company, , Case No. CV97-00039 (Navajo County Superior Court (1998)).....12

Arizona Corp. Commission v. Palm Springs Utility Co., Inc., 24 Ariz. App. 124, 536 P.2d 245 (App. 1975) 4, 5

Carondelet Health Servs., Inc. v. Ariz. Health Care Cost Containment Sys. Admin., 182 Ariz. 221, 895 P.2d 133 (App. 1994) 4

Corporation Commission, et al. v. Pacific Greyhound Lines, 54 Ariz. 159, 94 P.2d 443 (1942) 4, 5, 6

Johnson Utilities L.L.C. v. Ariz. Corp. Comm'n, 246 Ariz. 287, 438 P.3d 656 (App. 2019).....2, 11, 12

Litchfield Park Serv. Co v. Arizona Corp. Comm'n, 178 Ariz. 431, 874 P.2d 988 (App. 1994) 8, 9

Pac. Gas & Elec. Co. v. State, 23 Ariz. 81, 201 P. 632 (1921).....4

Phelps Dodge v. Ariz. Elec. Power Co-op., Inc., 207 Ariz. 95, 83 P.3d 573 (App. 2004).....12

Scates v. Ariz. Corp. Comm'n, 118 Ariz. 531, 578 P.2d 612 (App. 1978) 7, 8

US W. Communications, Inc. v. Ariz. Corp. Comm'n, 185 Ariz. 277, 915 P.2d 1232 (App. 1996) 8

US W. Communications, Inc. v. Ariz. Corp. Comm'n, 201 Ariz. 242, 34 P.3d 351 (2001) 8, 9

CONSTITUTION

Arizona Constitution, article XV, § 3 ..... PASSIM

REGULATIONS

A.A.C. R14-2-103(B)(1).....8

STATUTES

A.R.S. § 40-422.....13

ARIZONA CORPORATION COMMISSION DECISIONS

Decision No. 59952, *Arizona Corporation Commission, Complainant, vs. George M. Papa DBA George Papa Water Company, Respondent Docket No. U-01894-96-0490 (January 6, 1997)*.....12, 13

Decision No. 76785, *In the matter of the Commission's investigation of the billing and water quality issues of Johnson Utilities, LLC Docket No. WS-02987A-18-0050 (July 24, 2018)* 1, 9

OTHER

Charles F. Phillips, Jr., *The Regulation of Public Utilities*, 177, 3d, PUR 1993.....8

I. INTRODUCTION.

The Arizona Corporation Commission ("Commission") is obligated to protect the public interest and ensure that the public service corporations it regulates provide safe and reliable service. As noted by the Arizona Supreme Court, "[t]he Commission was not designed to protect public service corporations and their management but, rather, was established to protect our citizens from the results of speculation, mismanagement, and abuse of power." *Ariz. Corp. Comm'n v. State ex rel. Woods*, 171 Ariz. 286, 296, 830 P.2d 807, 817 (1992). After determining that Johnson Utilities, L.L.C. ("Johnson") had provided service and equipment that was unsafe, unjust, and unreasonable, the Commission authorized the appointment of an interim manager. Pet. Ex. A at 307:17-25; Decision No. 76785 at 305:17-25 ("Decision"). Since the Decision's issuance, Johnson has subjected the Commission to a barrage of litigation challenging the Commission's authority to appoint an interim manager rather than turn its focus on solving the serious public health and safety issues identified in the Decision.

Johnson is asking this Court to restrict the Commission's authority in a way that prevents the Commission from fulfilling, arguably, its most important constitutional obligation: to protect the convenience, comfort, safety, and health of employees and patrons of a public service corporation. Johnson's arguments must be rejected. As explained in Section II, *infra*, any such restrictions would leave the

customers of public service corporations at risk to suffer from low quality service and could ultimately lead to higher rates.

The Court of Appeals correctly found that the Commission possesses both the statutory and constitutional authority to appoint an interim manager under the appropriate circumstances. Admittedly, the appointment of an interim manager is an extraordinary remedy that has been used sparingly by the Commission. Nonetheless, it is for the Commission, in the exercise of its constitutional and statutory authority, to determine when this extraordinary remedy should be used.

The Court of Appeals, in finding authority for the Commission's actions under article 15, section 3 of the Arizona Constitution, noted in a footnote that "there has been little case law on what the Court denotes as the 'fourth clause' which gives the Commission broad authority to make and enforce orders affecting public welfare." *Johnson Utilities L.L.C. v. Ariz. Corp. Comm'n*, 246 Ariz. 287, ¶ 11 n.2, 438 P.3d 656, 659 n.2 (App. 2019), *rev. granted* (Aug. 27, 2019). The permissive authority found in section 3 provides that the Commission "may make and enforce reasonable rules, regulations, and orders for the convenience, comfort, and safety, and the preservation of the health, of the employees and patrons" of public service corporations. This permissive authority supports the Commission's authority to appoint an interim manager for Johnson.

Any determination that the Commission lacks the authority to appoint an interim manager when a public service corporation provides unsafe, unreliable and inadequate service will have far-reaching and devastating impacts beyond this matter. Such a determination would moreover restrict the Commission in its ability to respond to future crises involving utility behavior that threatens the public and health and safety. The Court of Appeals' Opinion should be affirmed.

II. THE CONCURRENT OR PERMISSIVE CONSTITUTIONAL AUTHORITY OF ARTICLE 15, SECTION 3 OF THE ARIZONA CONSTITUTION PERMITS THE APPOINTMENT OF AN INTERIM MANAGER.

The Commission's constitutional authority is not limited to its exclusive ratemaking authority. The Commission also has "permissive" or "concurrent" authority. This permissive language of article 15, section 3 states:

> The Corporation Commission . . . may . . . make and enforce reasonable rules, regulations, and orders for the convenience, comfort, and safety, and the preservation of the health, of the employees and patrons of such corporations . . . .

The above portion of article 15, section 3 gives the Commission authority to enforce rules and regulations for public service corporations and other authority in areas that are not specifically related to ratemaking, where the legislature may also act. This authority includes, where appropriate, the appointment of interim managers. *Arizona Corporation Commission v. State ex rel. Woods*, 171 Ariz. 286, 292, 830 P.2d 807, 813 (2015), *summarizing Arizona Eastern R. Co.* v. *State*, 19

Ariz. 409, 413-16, 171 P. 906, 908-09 (1918) ("From the later, permissive language of section 3, the court [in *Arizona Eastern*] seemingly determined that the Commission and the legislature have concurrent jurisdiction to regulate public service corporations in areas other than ratemaking."); *Pac. Gas & Elec. Co. v. State*, 23 Ariz. 81, 84-85, 201 P. 632, 634 (1921).[1]

The Commission's permissive authority has not received as much analysis as the Commission's exclusive ratemaking authority. Where the permissive authority clause has been analyzed, however, demonstrates that the Commission can respond to public health and safety issues and make orders addressing the adequacy and reasonableness of service. In *Arizona Corp. Commission v. Palm Springs Utility Co., Inc.*, 24 Ariz. App. 124, 536 P.2d 245 (App. 1975), the Court of Appeals found the Commission can address service quality issues by fashioning remedies the Commission determines appropriate:

> When problems arise in a particular case which the agency could not reasonably foresee, or the problem is so specialized and varying in nature as to be impossible to capture within the boundaries of a general rule, then the agency has the power to deal with the problem on a case-to-case basis so long as there is a reasonable statutory or constitutional basis for its action.

Carondelet Health Servs., Inc. v. Ariz. Health Care Cost Containment Sys. Admin., 182 Ariz. 221, 229, 895 P.2d 133, 141 (App. 1994) (discussing the holding

[1] Although *Pacific Gas* may have been criticized by the Supreme Court in *Corp. Commission v. Pacific Greyhound Lines*, 54 Ariz. 159, 94 P.2d 443 (1939), *Pacific*

of *Palm Springs*). The permissive authority clause also provides the Commission with authority to ensure the financial health of a utility by virtue of its dealings with affiliates because of the effect such financial health has on ratemaking. *Woods*, 171 Ariz. at 287, 830 P.2d at 808 ("[A]rticle 15, section 3 of the Arizona Constitution gives the Commission power to require a public service corporation to report information about, and obtain permission for transactions with, its parent, subsidiary, and other affiliated corporations.")

Johnson relies on *Corp. Commission v. Pacific Greyhound Lines*, 54 Ariz. 159, 94 P.2d 443 (1939), for the proposition that the Commission has no constitutional authority beyond its exclusive ratemaking authority. Johnson overlooks the facts of *Pacific Greyhound,* which addressed whether the *exclusive* language of article 15, section 3 vests *all state police power* related to public service corporations with the Commission. *Pac. Greyhound*, 54 Ariz. at 176-77, 94 P.2d at 450. The Court in *Pacific Greyhound* held that the Commission's *plenary and exclusive* constitutional authority is limited to ratemaking. *Id.* at 176-77, 94 P.2d at 450. In so holding, the Court did not address the scope of the *permissive* authority section of article 15, section 3.

Although the *Woods* Court acknowledged the ambiguity created by *Pacific Greyhound,* it analyzed the rules before it as if the Commission's constitutional

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Gas does not appear to have been overruled.

authority were limited to ratemaking, concluding that this doctrine was "apparently established" by *Pacific Greyhound.* The Court noted, however, that *Pacific Greyhound* is not clear:

> We use the term 'apparently established' because the language of *Pacific Greyhound* is less than clear. The court [in *Pacific Greyhound*] holds that the legislature has the 'paramount power' to regulate in areas other than those concerned with ratemaking. It does not state whether 'paramount power' means 'exclusive power,' or 'concurrent power' with a 'power to override' Commission regulations. Because of our view of the nature of the regulations in question, . . . we need not resolve this ambiguity at this time.

Woods, 171 Ariz. at 294 n.8, 830 P.2d at 815 n.8 (citations omitted). The scope of the permissive language of article 15, section 3 was therefore not an issue in either *Woods* or *Pacific Greyhound.*

Finally, to the extent there is a concern that *Pacific Greyhound* effectively limited all of the Commission's authority to that of ratemaking, it is factually distinguishable from the present case. *Pacific Greyhound* has a very narrow holding. In *Pacific Greyhound,* there was a conflict between a specific Commission order and a statute, so it was necessary to determine which branch of government held controlling authority. 54 Ariz. at 167, 94 P.2d at 446. In other words, the restriction placed on the Commission's authority by the *Pacific Greyhound* Court only applies when there is competing authority between the Commission and the legislature. Here, by contrast, there is no competing statutory scheme that conflicts with the Commission's authority to appoint interim

managers; therefore, there is no compelling reason to determine whether this authority falls within the Commission's ratemaking authority or not.

In sum, in addition to the constitutional and statutory bases underlying the Court of Appeals' opinion, another sufficient basis for the appointment of an interim manager is the Commission's broad constitutional authority under the permissive authority language of article 15, section 3.

III. THE COMMISSION'S APPOINTMENT OF AN INTERIM MANAGER IS ALSO CONSISTENT WITH ITS RATEMAKING AUTHORITY UNDER ARTICLE 15, SECTION 3.

Arizona courts have construed the Commission's ratemaking authority as an exclusive and plenary grant of power with which neither the legislature nor the judiciary may interfere. This exclusive jurisdiction extends beyond the setting of actual rates to matters that are necessary to the ratemaking process. *See Woods*, 171 Ariz. at 294.

Arizona has a monopoly market structure for water and wastewater public service corporations. The rates that ratepayers ultimately pay are based upon the costs incurred by the utility in order to provide service. *See Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 534, 578 P.2d 612, 615 (App. 1978). To set rates for monopoly utilities, the Commission generally uses the following formula:

(Rate Base x Rate of Return) + Reasonable and Prudent Expenses = Revenue Requirement.

US W. Communications, Inc. v. Ariz. Corp. Comm'n, 201 Ariz. 242, 245, 34 P.3d 351, 354 (2001); *Litchfield Park Serv. Co. v. Ariz. Corp. Comm'n*, 178 Ariz. 431, 434-35, 874 P.2d 988, 991-92 (App. 1994).

"Rate Base" is the dollar value of the physical assets prudently acquired and used and useful in the provision of utility service. *Scates*, 118 Ariz. at 534, 578 P.2d at 615. The "Rate of Return" is the authorized return on the Company's rate base, which is generally viewed as the Company's investment. *Id.* "Expenses" are the reasonable and prudent costs of service that cannot be capitalized, such as salaries or taxes. A.A.C. R14-2-103(B)(1) (copy attached as Exhibit "A"); *see also* Charles F. Phillips, Jr., THE REGULATION OF PUBLIC UTILITIES 177 (Public Utilities Reports, Inc., 3d., 1993) (copy attached as Exhibit "B"). Finally, the "Revenue Requirement" is the amount of money that the utility will be authorized to collect from ratepayers through rates. *Scates*, 118 Ariz. at 534; *US W. Communications, Inc. v. Ariz. Corp. Comm'n*, 185 Ariz. 277, 279, 915 P.2d 1232, 1234 (App. 1996).

From this formula, one can readily see the importance of the "Rate Base" and "Expense" elements in the rate setting process. When determining rates, the Commission must determine the value of the utility's rate base. *US W. Communications, Inc. v. Ariz. Corp. Comm'n*, 201 Ariz. 242, 245, 34 P.3d 351,

354 (2001); *Litchfield Park Serv. Co v. Arizona Corp. Comm'n*, 178 Ariz. 431, 435, 874 P.2d 988, 992 (App. 1994).

In this case, the Commission determined that more than half of Johnson's revenues were being paid to an affiliate, and that arrangement made it difficult for Johnson to manage its rates and ensure that enough cash is reinvested in its systems. Pet., Ex. A at 306:18-21; Decision No. 76785 at 304:18-21. The Commission further determined that because of the amount of the utility's revenue going to the affiliate, Johnson had not adequately maintained and repaired its systems and had not sufficiently reinvested in its systems. *Id.*

These financial arrangements and failures by Johnson directly impact its rates. Because of Johnson's imprudent management decisions, Johnson was incapable of making the necessary repairs and upgrades needed to provide safe and reliable service. If the Commission were limited in remedying Johnson's failures to an order that the utility charge customers the necessary funds to upgrade the systems, the unfortunate effect would be a sharp, immediate increase in rates. Moreover, the customers would be paying for the rebuilding of a system that they had *already* paid for with funds that should have been used to maintain and extend the life of the equipment in the first place.

The authorization and ultimate appointment of an interim manager was thus done, in part, to prevent the subsidization of Johnson by its' customers in the form

of higher rates to effect repairs and to ensure the setting of just and reasonable rates and restoring the provision of safe and reliable service to Johnson's customers. It was moreover necessary to impose a third-party manager to identify the needed repairs and the extent of Johnson's financial misconduct because of ownership's refusal to acknowledge its wrongdoing and the dire state of its infrastructure on its own. The remedy is thus integral in a situation involving a utility that is providing inadequate service in a way that ultimately implicates customer rates.

IV. THE MANAGEMENT INTERFERENCE DOCTRINE DOES NOT ACT AS A BAR TO THE COMMISSION'S AUTHORITY TO ACT TO APPOINT AN INTERIM MANAGER FOR JOHNSON.

The inquiry is not simply whether the Commission interfered with management. The inquiry is whether the Commission impermissibly interfered with management based on the specific actions taken. For example, the Commission properly invades the function of the utility's management when it exercises its power to determine the kind and character of facilities and equipment of a public utility. Such an invasion is not unlawful; it is justified to ensure that the utility can provide safe and reliable service.

The management interference doctrine serves as a check on the Commission's power so that the Commission will be prevented from becoming the *de facto* manager of public service corporations instead of taking actions to control rates or address public health and safety problems. Johnson asks for an overly-

broad interpretation of this doctrine that would preclude the Commission from acting within its constitutional and statutory authority to authorize an interim manager under the appropriate circumstances. Such a determination would be made to the detriment of the public Johnson serves.

More importantly, the limit to the Commission's authority is the doctrine itself. This doctrine is a valid tool in balancing the tension between private utility owners and regulators. The Commission submits that it would not be in the public interest to interpret this policy too broadly because such an interpretation could prevent the Commission from carrying out its constitutional mandate of ensuring that public service corporations charge ratepayers reasonable rates and provide adequate service. The Commission may therefore interfere with the decisions of utility management if the facts and circumstances warrant and as long as it has a legitimate regulatory reason for doing so, namely, the controlling of rates and protecting the health and safety of customers.

As noted by the Court of Appeals, the distinction between Commission rules that attempt to control rates, which are within the power of the Commission, and rules that attempt to control the corporation, which are not permissible, "focuses on what the Commission intends to achieve, and courts have likewise framed their analysis in terms of the Commission's attempted goal or aim". *Johnson Utilities L.L.C. v. Ariz. Corp. Comm'n*, 246 Ariz. 287, ¶15, 438 P.3d 656, 661 (App. 2019),

citing Phelps Dodge v. Ariz. Elec. Power Co-op., Inc., 207 Ariz. 95, 113-114 ¶ 65, 83 P.3d 573, 591-92 (App. 2004). The Commission's goal was to protect the public health and safety, thus, appointing an interim manager to take on the task that Johnson failed to do. It is illogical to argue that the Commission could do nothing but sit idly by while a public service corporation it regulates chronically endangers the public and fails to adequately maintain its facilities and operate as the public good requires. The Commission determined in this matter, based on the facts and circumstances, the appointment of an interim manager was necessary.

V. THE INTERIM MANAGER REMEDY LONG PRE-DATES JOHNSON UTILITIES.

In its Opinion, the Arizona Court of Appeals indicates that "no Arizona court has explicitly reviewed the legality of imposing a third-party interim manager to run a public service corporation . . . ." *Johnson Utilities*, 246 Ariz. 287, ¶ 12, 438 P.3d at 659. Although there is no Arizona Supreme Court or Court of Appeals opinion addressing the Commission's sources of authority to appoint interim managers, the Navajo County Superior Court addressed that very issue in *Arizona Corporation Commission v. George M. Papa d.b.a George M. Papa Water Company*, Case No. CV97-00039 (Navajo County Superior Court, Aug. 13, 1998) (attached hereto as Exhibit "C").

In that case, the Commission issued Decision No. 59952 ordering Mr. George Papa, a water utility owner, to (among other things) open a bank account in

which to deposit revenues from the water company. Commission Decision No. 59952 (attached hereto as Exhibit "D"). The Commission ordered that the utility's revenues could not be spent without the countersignature of Commission officials. *Id.* at 12:10-18. Further, the Commission ordered Commission Staff to seek a Superior Court Order removing Mr. Papa without pay if he did not perform any one of the required steps set forth in the Decision. *Id.* at 12:19-23. Ultimately, Mr. Papa failed to create a bank account for the deposit of company funds and failed to change the utility's billing notices and procedures, as directed. Minute Entry Navajo County Superior Court Minute Entry, June 22, 1998, p. 2, attached hereto as Exhibit "E". In response to this failure, the Commission filed a complaint in Navajo County Superior Court pursuant to A.R.S. § 40-422 seeking to enforce the Commission's directive in Decision No. 59952 to appoint an interim manager. Comm. - Complaint; Motion for Summary Judgment (attached hereto as Exhibits "F" and "G," respectively). Following briefing by both parties regarding the scope of the Commission's authority, the Navajo County Superior Court found the Commission had the jurisdiction to order the removal of Mr. Papa and the installation of an interim manager under the circumstances that were present in that case. Specifically, the superior court determined that

> [t]he constitutional provision (Article XV §3), by which the Arizona Corporation Commission is granted power and authority in the area of regulating public service corporations with the goal of being to further the comfort, safety and the reservation of the health of the employees

> and patrons of public service corporations, as well as the statutes which have been enacted to implement that constitutional power and authority, including A.R.S. § 40-321(A), A.R.S. § 40-361(B) and A.R.S. § 40-202(A), provide sufficient authority to the Arizona Corporation Commission to enable the Commission to enter the Order being sought by these proceedings to be enforced, *i.e.* the removal of Mr. Papa as manager of the water company and the installation of an interim manager.
>
> *See* Exhibit C at 1.

The superior court disagreed with Mr. Papa's position that his forced removal would constitute an unwarranted interference with the utility's management. The Judge opined that Mr. Papa's removal was determined by the Commission to be necessary for the public good, based on Mr. Papa's refusal to follow the Orders of the Commission. Exhibit C at 2. *See also* Navajo County Superior Court Judgment, September 30, 1998 (copy attached hereto as Exhibit "H").

In this matter, the Commission decided that the problems plaguing Johnson were both operational and financial, and that the utility's ownership furthermore refused to acknowledge and remedy those problems. The Commission therefore determined that the appointment of an interim manager for Johnson was necessary and justified to restore Johnson's systems to an acceptable level of service.

VI. REVERSAL OF THE COURT OF APPEALS' OPINION WOULD HAVE A FAR-REACHING IMPACT ON THE COMMISSION'S ABILITY TO EFFECTIVELY REGULATE PUBLIC SERVICE CORPORATIONS.

The Commission, in the Decision, determined that Johnson's service was not adequate, safe or reliable, and that to protect the public health and safety, an interim manager should be appointed. A finding that the Commission lacks the legal authority to appoint an interim manager for a troubled utility, such as Johnson, will have a devastating practical impact that reaches far beyond this particular case.

As noted in the Commission's "Response to Petition for Special Action" filed in the Court of Appeals, the Commission has authorized the appointment of interim managers for public service corporations sparingly over the course of the Commission's history.[2] Specifically, the Commission has only used the appointment of an interim manager in those circumstances where public, health, and safety of the customers and the employees of a public service corporation are at risk.

If this Court determines the Commission lacks the authority to appoint interim managers, the Commission would be required to terminate the interim manager agreement with EPCOR Water Arizona, Inc. and return management to

[2] *See* Arizona Corporation Commission's Resp. to Pet. for Special Action at 23-29.

the owner of Johnson. Currently, Johnson is out of compliance with Commission rules and regulations requiring the provision of safe, reliable, and adequate service. Further, Johnson is currently out of compliance with the Arizona Department of Environmental Quality, the agency charged with ensuring the provision of safe drinking water and proper disposal of wastewater. These are significant problems that required the extraordinary remedy of authorizing the appointment of an interim manager. Absent an interim manager, it is likely that these matters will not be adequately addressed, and the approximately 25,000 water and 35,000 wastewater customers of Johnson will be the ones that suffer.

The Commission has appointed interim managers for six small water utilities for substantively the same reasons.[3] The Commission determined these utilities suffered from financial and operational mismanagement that directly impacted the ability of the utilities to provide safe and reliable service to their customers. The Commission determined the status quo presented a danger to the public health and safety, and thus appointed an interim manager to preserve the convenience, comfort, safety, and health of the customers of these utilities. If this Court were to determine the Commission lacks the authority appoint interim managers, these utilities, like Johnson, would be returned to owners (if they can be located) that

[3] *See* attached list of water utilities wherein Commission has appointed interim managers that are currently managing and operating the public services corporations (copy attached hereto as Exhibit "I").

have demonstrated an inability to provide safe and reliable service to their customers.

V. CONCLUSION.

The Commission must be allowed to act in order to protect the public from utilities where their service has been found to be woefully inadequate and customers are suffering from such inadequate service. The Court of Appeals' opinion should be affirmed.

RESPECTFULLY SUBMITTED this 16th day of September 2019.

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