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Arizona Corporation Commission

DOCKETED

AZ CORP COMMISSION  
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MAR - 5 2004

DOCKETED BY

**BEFORE THE ARIZONA CORPORATION COMMISSION**

6 IN THE MATTER OF THE APPLICATION  
7 OF PINE WATER COMPANY FOR A  
8 DETERMINATION OF THE CURRENT  
9 FAIR VALUE OF ITS UTILITY PLANT  
10 AND PROPERTY AND FOR INCREASES  
11 IN ITS RATES AND CHARGES BASED  
12 THEREON FOR UTILITY SERVICE AND  
13 FOR APPROVAL TO INCUR LONG-  
14 TERM DEBT

DOCKET NO: W-03512A-03-0279

**NOTICE OF FILING SUMMARIES  
OF WITNESSES' PRE-FILED  
TESTIMONY**

11 Pine Water Company hereby files summaries of the pre-filed testimony of its  
12 witnesses, Robert T. Hardcastle and Thomas J. Bourassa. Collectively, Pine Water's  
13 witnesses support the Company's application for adjustments to its rates and charges for  
14 water utility service provided by the Company.

15 At present, Pine Water serves approximately 1900 customers. The Company's  
16 present rates and charges for utility service were approved in Decision No. 62400 (E&R  
17 Water Co., Inc.) on March 28, 2000 and went into effect on April 1, 2000, and Decision  
18 No. 62363 (Williamson Waterworks, Inc.) on March 6, 2000 and went into effect on  
19 April 1, 2000.<sup>1</sup> Revenues from the Company's utility operations are presently inadequate  
20 to provide Pine Water a reasonable rate of return and the Company is requesting rate  
21 adjustments that will produce a revenue increase of approximately \$87,900, which  
22 amounts to an increase of approximately 13.5 percent. In addition, Pine Water is  
23 requesting approval to continue the Commission approved Water Augmentation  
24

25 <sup>1</sup> A few years ago, Pine Water's shareholder, Brooke Utilities, reorganized some seven separate water  
26 companies and systems it acquired in 1996 into five separate subsidiaries, including Pine Water and  
Strawberry Water. See Decision No. 60972 (July 1998).

1 Surcharge Tariff, and to modify said tariff to include additional costs associated with  
2 water supply augmentation, including costs associated with purchasing water from  
3 Strawberry Water Company and delivery of such water by Brooks Utilities through  
4 Project Magnolia.

5 RESPECTFULLY SUBMITTED this 5<sup>th</sup> day of March, 2004.

6 FENNEMORE CRAIG

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8  
9 By \_\_\_\_\_

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14 Original and 13 copies were filed  
15 this 5<sup>th</sup> day of March, 2004, to:

16 Docket Control  
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18 1200 West Washington  
19 Phoenix, Arizona 85007

20 A copy of the foregoing  
21 hand-delivered this 5<sup>th</sup> day  
22 of March, 2004, to:

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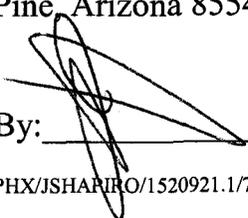
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26 PHX/JSHARIRO/1520921.1/75206.006

**SUMMARY OF**

**ROBERT T. HARDCASTLE**

**PRE-FILED**

**TESTIMONY**

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## **PINE WATER COMPANY**

**Docket No. W-03512A-03-0279**

### **SUMMARY OF ROBERT T. HARDCASTLE PRE-FILED TESTIMONY**

Mr. Hardcastle is the President of Brooke Utilities, Inc. ("Brooke") and Brooke is the sole shareholder of the Applicant, Pine Water Company, Inc. ("Pine Water" or the "Company"). Mr. Hardcastle prepared direct, rebuttal and rejoinder testimony in support of the Company's applications for rate increases and certain financing approvals. Mr. Hardcastle's pre-filed testimony focuses primarily on plant, operational, water supply and customer service issues. In addition, Mr. Hardcastle's pre-filed testimony addresses a number of issues raised by intervenor Pine-Strawberry Water Improvement District ("District"). Finally, in his rejoinder testimony, Mr. Hardcastle responds to questions posed by Commissioner Hatch-Miller and members of the public as a result of public comment sessions in Pine and Phoenix, Arizona.

On the whole, Mr. Hardcastle's pre-filed testimony supports the clear need for rate relief. Pine Water is presently able to operate because its shareholder is subsidizing operating expenses, a situation that is unlikely to continue, nor should it. For many of the reasons discussed in Mr. Hardcastle's pre-filed testimony, Pine Water seeks to recover its reasonable operating expenses and an opportunity to earn a fair return on the property devoted to public service. Absent such relief, Mr. Hardcastle testifies, the Company's ability to continue furnishing water service to approximately 1900 customers in Pine, Arizona is in serious jeopardy.

A summary of the key issues addressed in Mr. Hardcastle's pre-filed direct, rebuttal and rejoinder testimony follows:

#### **1. Ownership of Project Magnolia.**

Project Magnolia is a 10,800-foot pipeline connecting the Pine Water system to the water system of Strawberry Water Company, which is also owed by Brooke. The pipeline was built in 2000-2001 and can transport up to 750,000 gallons of water per day between the two systems. As Mr. Hardcastle's testimony explains, Brooke began exploring the idea of building a pipeline connecting the two water systems in late 1997 when it commissioned a cultural resource study. In August 1998, Brooke entered into a Memorandum of Understanding with the United States Forest Service. In early 2000, the Forest Service and the Arizona Department of Transportation issued use permits. Project Magnolia became a reality, however, when construction of the pipeline began later that year. The pipeline was completed in February 2001 and water deliveries between the Pine and Strawberry Water systems started immediately. Today, Pine Water has a wheeling agreement ("Agreement") with Brooke regarding the transportation of water purchased from Strawberry Water for delivery into the Pine Water system. During the test year, approximately 1 million gallons per month was delivered into the Pine Water system

Mr. Hardcastle testifies that Brooke owns Project Magnolia, testimony challenged by both Commission Staff ("Staff") and the District. In response, Mr. Hardcastle testifies to Brooke's exploration of a possible pipeline project between the two systems and preliminary

efforts to obtain the requisite approvals during the late 1990's. However, during that time frame it had not yet been determined whether the pipeline, if built, would be owned by the regulated utility, then E&R Water Company ("E&R") (Pine Water's predecessor), a third party or by Brooke and costs incurred in connection with exploring a pipeline project were frequently paid through E&R. Consequently, when the Company filed for rate relief in early 1999 using a June 30, 1998 test year, some of the costs that had been incurred by Pine Water (then E&R) were picked up and included in the Company's schedules.

That rate case was decided in March 2000, still before a final decision had been made whether to build the pipeline and, if built, regarding its ownership. No cost recovery associated with the project was authorized in the Commission's decision. Thereafter, Mr. Hardcastle testifies, it was decided that Project Magnolia would be built, owned and operated by Brooke based, in large part, on the substantial risk associated with a pipeline project that might never be used as intended. Such risks, Brooke concluded, would not be afforded an adequate return under the regulatory framework in which Pine Water operates.

After construction of the pipeline commenced in mid to late 2000, Brooke paid the costs of construction. Mr. Hardcastle further testifies that Brooke has paid all of the costs associated with Project Magnolia's operation since the pipeline went into operation in February 2001. In addition, due to Pine Water's poor financial condition, Pine Water has not been able to pay Brooke for the costs associated with wheeling water through the pipeline. Nor, for that matter, has the Company been able to pay for the water purchased from Strawberry Water for delivery through Project Magnolia. Instead, as Mr. Hardcastle testifies, Brooke has subsidized this water augmentation service to the benefit of the Company's ratepayers for more than three years.

## **2. Payment for Water Deliveries Through Project Magnolia.**

As mentioned above, Pine Water is required to pay Brooke \$15 per 1,000 gallons delivered through Project Magnolia, which is separate from the cost of the water the Company purchases from Strawberry Water. As Mr. Hardcastle explains, the wheeling charge was set utilizing a market based pricing concept taking into account the fact that Project Magnolia is the only alternative to trucking water when the sources of water supply in Pine Water's CC&N are inadequate. The cost of trucking water, exclusive of the cost of the water itself, ranges from \$38 to \$45 per thousand gallons. Accordingly, Brooke determined that the \$15 per thousand wheeling charge was reasonable, providing Pine Water a substantial savings (as much as 250%) when compared to the costs of hauling alternatives, while at the same time providing Brooke with a return on its investment commensurate with the substantial risks associated with the project. Of course, as also noted above, Mr. Hardcastle testifies that Pine Water has been unable to pay any of the costs associated with deliveries of water through Project Magnolia to date.

Mr. Hardcastle expresses the Company's recognition that the Commission has the power to determine the amount Pine Water should be allowed to recover from ratepayers for water transportation expense and he provides further testimony in support of the reasonableness of the \$15 per thousand wheeling charge. For example, using a traditional cost based analysis, test year transportation expense, the cost of deliveries through Project Magnolia would be \$12.37 per 1,000 gallons, an amount that simply fails to provide an adequate return given the substantial risk associated with the pipeline's construction and operation. When compared to the costs of

obtaining water under intervenor John Breninger's \$4 million deep well drilling project in the Strawberry Valley, the wheeling charge is roughly 1/5 the cost.

In summary, Mr. Hardcastle's pre-filed testimony clearly supports full cost recovery by Pine Water for transportation services provided by Brooke. This is true whether the Commission were to adopt the Company's initial proposal to include the test year level of transportation expenses in the determination of the revenue requirement, or as explained in the Company's rejoinder filing by Company witness Thomas J. Bourassa, the proposal to amend the existing Water Augmentation Surcharge Tariff to cover all water augmentation costs, whether for Project Magnolia water or hauled water. Pine Water believes, however, that the latter alternative is preferable because it takes into account the ever-changing water supply in the Pine-Strawberry region and would ensure that Pine Water does not under or over recover water augmentation costs. In either case, however, Mr. Hardcastle's pre-filed testimony urges the Commission to provide cost recovery to Pine Water associated with Project Magnolia because it is simply not financially feasible for Brooke to continue subsidizing water service to the Company's ratepayers.

### 3. Water Supply.

As Mr. Hardcastle's pre-filed testimony illustrates, every issue impacting Pine Water begins and ends with the chronic water supply shortages that, for decades, have plagued the area in which the Company operates. As a consequence, Pine Water and Brooke are constantly undertaking new efforts to protect existing water supplies and/or locate additional water sources. Since acquiring this system in 1996, a number of new wells have been drilled, additional storage has been constructed and existing water infrastructure has been repaired to minimize water loss from the antiquated and poorly maintained system Brooke inherited from the prior owner. In addition, Mr. Hardcastle's pre-filed testimony contains, pursuant to Commission order, a Water Augmentation Plan that addresses some alternatives for further enhancement of available water supplies. Nevertheless, Pine Water and its ratepayers continue to face problems associated with the water supplies available within the Company's CC&N.

Mr. Hardcastle also testifies regarding the recent comprehensive water availability study commissioned by and prepared for the District. This study concludes that the aquifer systems in Pine, Arizona are inadequate to support "existing or future water demands." See Investigation of Groundwater Availability at 9. He further provides that these inadequacies are a hydrological reality due to the physical properties of the aquifers and do **not** result from management of the water delivery system by Pine Water. Indeed, Mr. Hardcastle testifies that the District's report flatly contradicts the speculative testimony of the District's surrebuttal witness, Michael Ploughe, who claims that water is available in aquifers below Pine.

Mr. Hardcastle provides further testimony regarding some of the alternatives for enhancing the Company's existing water supply. For example, the District's study concludes there is a possibility of finding water north of Pine in the Strawberry Valley at depths between 1,500 and 2,000 feet. As Mr. Hardcastle explains, however, not only is it uncertain whether such water supplies are available – a concern echoed by Staff engineer Marlin Scott, Jr. – but such a resolution may be well beyond the financial reach of Pine Water and its customers. There are substantial costs associated with drilling for water at such depths, pumping it from such depths

and delivering it into the Pine system through pipelines similar to Project Magnolia. Similarly, Mr. Hardcastle's testifies concerning the District's proposal that Pine Water build a million gallon storage tank. Besides concerns over the costs, roughly \$1 million, Mr. Hardcastle identifies the major problem with the million gallon storage tank - it is unlikely that adequate water supplies will ever be available to make such a tank a viable alternative to existing infrastructure.

In fact, regarding water supply matters, Mr. Hardcastle's testimony reflects the Company's uncertainty and general concern over financial viability. For example, Mr. Hardcastle questions whether it is reasonable to expect Pine Water to spend several hundreds of thousands to several million dollars looking for water in the Strawberry Valley that may not be found, even if found, may not be feasibly delivered into the Pine Water system. What if, Mr. Hardcastle asks, after a protracted legal battle with SRP, a production test well, estimated to cost as much as \$870,000 by Staff engineer Marlin Scott, Jr., is drilled and no water is found? Are Pine Water and its shareholder, Brooke, expected to absorb such cost with no recovery? Although the Company initially proposed a Water Exploration Surcharge intended to help defray the costs and risks associated with exploring for such water resources, this proposal was vehemently opposed by the other parties and ratepayers. As a result, the Company withdrew the request, but these questions remain. As Mr. Hardcastle testifies, the Company needs Commission guidance on just what is reasonable and prudent when it comes to obtaining additional water supplies for its customers in an area where there are few answers and certainly no inexpensive solutions.

#### **4. The District.**

Mr. Hardcastle joins intervenor, Pine Water customer and District member, John Breninger, in expressing concern that Gila County has "hijacked" the District for its own purposes, which include, among other things, diminishing the value of Pine Water's assets in contemplation of condemnation. It was not until the former board of directors of the District resigned, and Gila County put its County administrator, Mr. John Nelson, in a position of running the District, that it moved to intervene based on a County resolution executed solely by Supervisor Ron Christianson. Moreover, the District's witnesses have publicly expressed their opinion that the Company's assets, including its CC&N, should belong to the "citizenry." Mr. Hardcastle's pre-filed testimony reflects the Company's plea that the Commission not allow the District to misuse this rate case.

Mr. Hardcastle's pre-filed testimony also responds to the District's position that the Company should be denied all rate relief because its application is incomplete and/or accurate. Staff found that the Company's application -- one that the Commission ordered the Company to file -- met the Commission's sufficiency requirements. Perhaps even more importantly, Mr. Hardcastle questions whether such a recommendation could possibly serve the public interest. The Company's poor financial condition is well established and, absent rate relief, the Company's financial integrity will worsen and threaten the viability of water utility service to roughly 1900 customers in Pine, Arizona. While this may be the very result sought by the District, which is already circulating petitions to condemn Pine Water's assets, the Company's desire to obtain rate relief so that it can operate in a manner that provides it a recovery of its

operating expenses, and an opportunity to earn a just and fair return on the property it devotes to public utility service.

Mr. Hardcastle's pre-filed testimony exposes the inadequacy of the District's claims. For example, the District asserts that the Commission-imposed Curtailment Tariff is *prima facie* evidence that Pine Water is an inadequate service provider. Pine Water was, however, ordered by the Commission to file the Curtailment Tariff and the Company is not the only entity operating under such water use restrictions. There is simply no basis to penalize the Company for operating consistent with Commission orders.

Nor are the District's claims regarding improper affiliate relationships between Brooke, Strawberry Water and Pine Water valid, as Mr. Hardcastle testifies. The Company accepts that transactions between its affiliates are appropriate for Commission scrutiny -- even heightened scrutiny -- to ensure that all such transactions are reasonable and prudent. Towards that end, the Company has provided substantial information to the other parties through the discovery process regarding affiliate transactions, including the Company's purchase of water from Strawberry Water and the provision of delivery services through Project Magnolia by Brooke. Mr. Hardcastle has taken issue, however, with the District's repeated attempts through pre-filed testimony to assert that all of Brooke's books and records should be "opened up" for view by the Commission in order to ensure that Brooke can keep Pine Water "afloat." Fortunately, the presiding Administrative Law Judge has agreed and rejected the District's request for such wholesale discovery, which efforts, Mr. Hardcastle testifies, have done little more than exacerbate the Company's rate case expense.

Regarding the District's attempts to paint the Company as an inadequate operator, Mr. Hardcastle points out that, not only does the District lack competent evidence to support its outlandish claims, but the evidence actually reflects compliance with all regulations governing its operations. Similarly, Mr. Hardcastle questions the validity of the District's calculations of water loss for the Company and, instead, points to the water loss calculations presented by Staff engineer Marlin Scott, Jr. As between District witness Harry Jones, a part time consultant with no ratemaking or utility experience whatsoever, and Mr. Scott, who has analyzed literally hundreds of utility operations, Mr. Hardcastle suggests that Mr. Scott's testimony regarding water loss should be given the greatest weight possible.

Mr. Hardcastle's pre-filed testimony also addresses the District's claim that water supplies can be augmented for an additional \$10 per month. As Mr. Hardcastle explains, the Company's estimates of additional hundreds of dollars per month in rates is not intended as a "scare tactic," but merely a reflection of the economic reality that would occur if Pine Water were to invest millions of dollars to provide additional water to a customer base of less than 2,000 connections. Unlike the District's estimates, the Company's are supported by evidence and schedules reflecting the necessary ratemaking treatment that would be afforded such massive investment. It is for this reason, as discussed above, that Mr. Hardcastle urges the Commission to provide guidance regarding what is reasonable and prudent with respect to additional capital investment to search for and, if located, provide additional water for its customers.

## 5. Customer Comment Issues.

Mr. Hardcastle testimony also addresses several issues raised during the Commission's public comment sessions in this proceeding, including, most specifically, a December 9, 2003 letter from Commissioner Hatch-Miller to the Company asking eight separate questions. For instance, in answering the Commissioner, Mr. Hardcastle explains the Company's history of operating under Commission imposed moratoriums, including the recent decision by the Commission in January 2002 to modify the moratorium in response to pressure from the community and Gila County because the Commission-imposed moratorium was inhibiting growth. Mr. Hardcastle similarly answers Commissioner Hatch-Miller by explaining why all customers pay a base monthly charge, which reflects the fact that a utility's water system infrastructure must be adequate to meet peak water demand, not simply minimum demand, and that base rates are usually set to cover a portion of the Company's fixed costs. For similar reasons, all customers in the service area must pay non-discriminatory rates.

In further response to Commissioner Hatch-Miller's questions, Mr. Hardcastle discusses the manner in which the Company communicates the status of its water supply and water supply limitations to its customers, including a substantial electronic mailing list, sign postings throughout the community, a toll free number, a call center and mailing of notices to customers under appropriate circumstances. However, while the Company can provide such information, it cannot make its customers, or other interested parties in the region, utilize such information in a manner that enhances the Company's ability to provide service despite limited water supplies.

Mr. Hardcastle also responds to questions by Commissioner Hatch-Miller regarding additional well drilling and additional storage capacity. Regarding well drilling, as also discussed above, Mr. Hardcastle's testifies to the considerable risks, which include the possibility that viable sources of additional water will not be found despite the expenditure of substantial capital. Regarding additional storage, Mr. Hardcastle's indicates that additional storage capacity would not necessarily alleviate water supply problems because the problem faced by Pine Water is a lack of water production, not storage. It does not matter how much water storage is present if sufficient water production is not available to fill the tanks, because, in large part, stored water must be cycled or turned over. Indeed, Mr. Hardcastle testifies that, if sufficient water production were available, the question of additional water storage would be moot. Nevertheless, Pine Water continues to explore more storage as well as the availability of additional water supplies, ever mindful of hydrologic and economic reality in the Pine-Strawberry, Arizona region.

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**SUMMARY OF**

**THOMAS J. BOURASSA**

**PRE-FILED**

**TESTIMONY**

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## PINE WATER COMPANY

### SUMMARY OF THOMAS J. BOURASSA PRE-FILED TESTIMONY

Mr. Bourassa is a Certified Public Accountant providing various accounting and consulting services to regulated businesses, including utilities. In the rate application for Pine Water Company ("Pine Water" or "Company"), Mr. Bourassa was responsible for preparing and is sponsoring Schedules A through H of the standard filing requirements for Class C water utilities as set forth in A.A.C. R14-2-103, and for the overall development of the revenue requirement for the Company. Mr. Bourassa is also the primary witness supporting the Company's concurrent financing application.

Mr. Bourassa filed direct, rebuttal and rejoinder testimony, which generally addresses the following aspects of Pine Water's rate application:

- (1) Revenue Requirement
- (2) Rate Base
- (3) Financing Application for Conversion of Inter-Company Payable to Debt and Equity
- (4) Revenues and Expenses (including depreciation and taxes)
- (5) Cost of Capital
- (6) Rate Design
- (7) Water Augmentation Surcharge

Mr. Bourassa's pre-filed testimony also addresses several issues in dispute with Staff and/or the Pine Strawberry Water Improvement District ("District"). A summary of key issues addressed by Mr. Bourassa follows:

#### **I. Revenue Requirement.**

Mr. Bourassa testifies that the Company's requested increase as of the hearings in this docket is approximately \$87,900, or approximately 13.5% over adjusted test year revenues. Notably, the Company's direct and rebuttal revenue increase requests were approximately \$269,000 or 41%, and approximately \$266,000 or 40.8%, respectively. However, as Mr. Bourassa noted in his rejoinder testimony, the revised recommended revenue increase is significantly lower due to the Company's (1) proposal to remove transportation costs (i.e., Project Magnolia wheeling fees) from the test year operating expenses; and (2) acceptance of Staff's post test year plant additions. Instead, regarding transportation expense, the Company now proposes that "actual" wheeling fees be recovered along with other water augmentation costs via the Company's Water Augmentation Surcharge Tariff, which Staff and the Company agree should be made permanent in this proceeding.

## **II. Rate Base.**

The Company proposes that its original cost rate base ("OCRB") be used as the fair value rate base ("FVRB") in this proceeding. Mr. Bourassa testifies that the Company's OCRB is approximately \$590,700. The rate base proposed in Mr. Bourassa's direct and rebuttal testimonies was \$680,032 and \$665,500, respectively, and the reduction is primarily due to Pine Water's acceptance of Staff's proposed post test year plant amounts.

Mr. Bourassa also explains the differences between the Company and Staff's proposed rate bases. The Company's rate base includes deferred taxes of \$369,000, while Staff's does not. These deferred taxes are comprised of three components: (1) taxes paid on contributions-in-aid of construction; (2) book and tax depreciation differences; and (3) loss carry forwards. Mr. Bourassa testifies that the recording of deferred taxes was proper, consistent with generally accepted accounting principles, and while attributed primarily to its predecessor, E&R Water Company, properly included on Pine Water's books.

Mr. Bourassa also testified that Project Magnolia ("PM") plant costs are not included in the Company's rate base, whereas Staff includes PM costs. As Mr. Bourassa testifies, PM is owned by Brooke Utilities, Inc. ("BUI"), Pine Water's parent, and should not be included in the Company's rate base. Staff's claim that the Company owns the pipeline rests almost entirely on PM construction work-in-progress ("CWIP") of approximately \$334,000 that was proposed in Pine Water's predecessor's (E&R Water Company) 1999 rate application. However, CWIP was disallowed in the prior case and PM costs have never been given rate base treatment or included in Pine Water's rates. The District agrees with Staff to include PM in rate base, but without any independent analysis.

## **III. Financing Application.**

Mr. Bourassa explains the Company's proposal to convert the \$533,000 inter-company payable on the books at the end of the test year to equity (\$369,000) and long-term debt (\$164,000). Mr. Bourassa testifies that the long-term debt and equity is essentially for plant installed since 2000 and plant added in 2003. Although Staff insists that such amounts are being financed for operating expenses, Mr. Bourassa's testimony reflects that Pine Water was essentially unable to pay many of its bills, and that BUI not only paid much of the operating expenses but paid for all capital improvements without reflecting any paid-in capital. As Mr. Bourassa testifies, the situation is no different than in CC&N applications where operating expenses exceed cash flows during the initial years and additional equity infusions may be required to fund operations. In short, as Mr. Bourassa's testimony shows, it is unfair to now characterize what was clearly shareholder investment in a manner that evaporates the investment by BUI. In fact, doing so would further damage Pine Water's already precarious financial condition.

Mr. Bourassa further testifies that the interest rate should be 10 percent for a term of 5 years. Pine Water is not credit worthy, and therefore, it is unlikely that a third party lender would be willing to lend money to Pine Water, even at a 10 percent interest rate. Moreover, Pine Water has not paid the inter-company payable for some time, and Mr. Bourassa testified that a term of more than 5 years would be punitive to BUI because BUI would ultimately have to wait 8 to 9 years for repayment (of only a portion of the total \$533,000), while not earning any interest for at least 3 years.

#### **IV. Revenues and Expenses.**

Mr. Bourassa testifies concerning the Company's proposed adjustments to the test year in order to normalize revenues and expenses to reflect known and measurable changes. There are several areas of agreement with respect to revenues and expenses in this case. Both Staff and the Company agree on the revenue annualization, removal of water hauling costs from purchased water expense, and the adjustment to normalize legal expense. The Company has also accepted Staff's adjustments to sales tax expense and purchased water. Interest expense was adjusted to reflect interest synchronization with rate base, consistent with Staff's proposal. Finally, both Staff and the Company agree to removal of transportation expense from operating expenses. The notable difference, however, is that the Company proposes to collect PM wheeling fees through modification of the Water Augmentation Surcharge Tariff.

Mr. Bourassa also testifies concerning several areas of disagreement between the Company and Staff with respect to operating expenses. In particular, there is disagreement concerning: (1) the level of materials and supplies expense; (2) the amortization period for rate case expense; and (3) the revenue components to be used in the determination of property taxes. There is also disagreement in the level of depreciation expense, but only because Staff includes depreciation from PM.

Mr. Bourassa explains that Staff elected to use a three year historical average to determine its proposed level of materials and supplies expense. However, the Company's proposed level more accurately reflects these expenses on a going-forward basis. In support of this assertion, Mr. Bourassa testifies that the actual expenses for the year immediately following the test year were higher than Staff's proposal by over \$21,000 and even \$3,000 higher than the Company's proposal.

Staff's amortization period for rate case expense is 4.5 years, yet, as Mr. Bourassa testifies, no legitimate support for this amortization period is offered beyond this being the approximate time interval between prior rate filings. As Mr. Bourassa testifies however, given the demand of customers that Pine Water address the chronic water problems and the potential for massive capital infusion to do so, the next rate proceeding will likely be brought in far less than 3 years.

With respect to property taxes, Mr. Bourassa explains that the Company uses two years of adjusted revenues and one year of proposed revenues for the revenue components following the Arizona Department of Revenue formula, exactly as Staff

proposed in the pending Arizona-American rate proceeding. In that case, Staff proposes using an average of three years of historical revenues plus Staff's proposed revenue increase. Mr. Bourassa also responds to allegations by the District that errors in recording property tax expenses impact the determination of property tax expense in this rate case. As Mr. Bourassa testifies, the District's position reflects a misunderstanding of rate making, in this particular instance, the manner in which property tax expenses are determined. Under the Department of Revenue methodology, which the Commission adheres to for determining the manner in which a proper level of property tax expense, past property tax payments are entirely immaterial. Instead, property taxes will, during the time the rates established in this proceeding are in effect, be based on the Company's level of revenue and should be set in this proceeding accordingly.

Further concerning the District, Mr. Bourassa explains that the District has challenged virtually every accounting entry made by Pine Water for the past several years, yet has not provided any specific recommendations and/or schedules regarding income statement issues. Mr. Bourassa further testifies that the District has not identified a single error that has materially changed the Company's or Staff's conclusions and recommendations in this proceeding.

#### **V. Cost of Capital.**

Mr. Bourassa recommends an overall return of 10.99 percent on fair value rate base based on a recommended cost of equity of 12 percent. Mr. Bourassa's cost of equity recommendation is based on the use of financial models, including the DCF model, and a comparable earnings analysis. As Mr. Bourassa testifies, 12% is the minimum cost of equity for a company with similar risks to Pine Water.

Staff's recommendation to base the revenue requirement on a 10 percent operating margin translates to an 11 percent return on Staff's proposed rate base. In the alternative, Staff provides cost of capital testimony in which Staff witness Joel M. Reiker concludes that the cost of capital should be 8.7%, a difference of 229 basis points from the Company's recommendations. The District offers no testimony on cost of capital or rate of return.

Mr. Bourassa noted that Staff's 11 percent rate of return (based on operating margin) translates to a 14.45 percent cost of equity, yet, Staff's alternative cost of equity is 9 percent. Mr. Bourassa also testifies that 9 percent is roughly the same cost of equity recently recommended by Staff in the Arizona-American, Arizona Water and Arizona Public Service rate proceedings, reflecting that Staff's cost of capital recommendations are generic and fail to consider the risks and operating characteristics of Pine Water. Pine Water is not comparable to the nationally traded companies in all respects other than they are all regulated utilities and, as Mr. Bourassa explained, any cost of capital recommendation should provide for a return sufficient to maintain the financial integrity of Pine Water, maintain and support its credit, attract capital, and be comparable to other firms with corresponding risks. Staff's alternative cost of capital does none of these things. Nor, Mr. Bourassa testifies, would an investor in Pine Water ignore the financial

and operating characteristics of Pine Water before investing in the Company, as Mr. Reiker suggests in his testimony.

Staff also proposes that Pine Water be authorized to issue long-term debt in the amount of \$149,979 (with an interest rate of 8 percent and a repayment period of 15 years) and additional equity of \$299,619 to finance PM. In response, Mr. Bourassa testifies that Staff's proposed debt and equity financing is astonishing given that Staff has proposed financing for the purchase of an asset that is not for sale, and based on the implicit presumption that BUI is willing to lend Pine Water an additional \$149,979 when it is already owed several hundred thousand dollars. As Mr. Bourassa notes, there is no credible evidence that any creditor would lend funds to Pine Water under these circumstances, particularly if Staff's rate of return recommendation were adopted as the Company would not have sufficient cash flows to service the debt and repay the inter-company payable loan.

#### **VI. Rate Design.**

Mr. Bourassa supports the Company's proposed rate design, a two-tier design, as is Staff's. However, the Company's proposal allows for more gallons in each tier for 1 inch and larger meters, while Staff's proposed design is a "one size fits all" approach. Mr. Bourassa testifies that both the Company's and Staff's proposed designs should promote conservation, but the Company's provides a greater incentive for larger meter ratepayers to reduce their average use below the higher cost tiers because the tiers for the larger meters are attainable, under Staff's design, this will not likely occur.

#### **VII. Water Augmentation Surcharge.**

Mr. Bourassa explains that the Company's proposal to make permanent the Water Augmentation Surcharge Tariff approved in Decision No. 65914 (May 16, 2004). In addition, the Company proposes to modify the Water Augmentation Surcharge Tariff to allow for the recovery of the costs of purchasing water from Strawberry Water Company as well as the costs for delivery of such water by BUI through PM. As Mr. Bourassa testifies, this proposal, an alternative to inclusion of approximately \$180,000 of test year transportation expense, advantages both the Company and ratepayers because its ratepayers will only be responsible for paying costs actually incurred by the Company to augment water supply in this fashion.

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