

ORIGINAL



0000023804

Brooke Utilities, Inc.

Customer Call Center P.O. Box 9000 • San Dimas, California 91773-9016 • (800) 270-6084
P.O. Box 82218 • Bakersfield, California 93380-2218

RECEIVED

2005 JUL -8 A 8: 36

AZ CORP COMMISSION
DOCUMENT CONTROL

ROBERT T. HARDCASTLE
(661) 633-7526
Fax (781) 823-3070
RTH@brookeutilities.com

June 1, 2005

Docket No. W-03512A-03-0279

James Richey
P.O. Box 2379
Pine, AZ 85544

Re: Alternative JB6 Study, Pine Water Co., Inc., Pine, AZ

Dear Mr. Richey,

Thank you for your effort on the above referenced study dated April 14, 2005. It is clear that your analysis and interest in this topic substantiates the importance of future additional water supplies for the communities of Pine and Strawberry. As you are aware this has been a long standing problem that is related to numerous exhaustive water studies of the area that date as early as the 1960's. Virtually every water study conducted since that time has concluded the same result: that Pine does not have a sufficient source of groundwater to meet its current or future year-round needs.

At your request I have reviewed the above referenced document (hereafter the "JB6 Proposal") in some detail. For many years Brooke Utilities ("Brooke") has argued that a hydrological solution to the area's water problems which is supplanted by an equivalent or more serious, economic problem is no solution at all. Thus, in our view any solution to the local water problem *must* be inextricably linked to a reasonable economic approach that provides for affordably delivered water supplies. If cost was unimportant the water supply problem in the local area probably could have been resolved some time ago using various different means. However, a failed water solution that includes high risk and high cost has the potential for deterring other solutions for many years or decades. It is very important to make our best collective effort the first time. The JB6 Proposal identifies one of many possible future solutions. I commend you for your effort.

For many years Brooke has explained the complexity of the problem to the community with many disbelievers. For this reason we have advocated, since 1998, a detailed examination of every possible alternative solution to the problem. We believe every conventional, unconventional, reasonable, and unreasonable alternative should be considered and prioritized in descending order of risk (defined as likelihood of success) and cost. After many years of advocating this position to everyone from community members to regulatory officials to Gila County representatives, Brooke is pleased to finally see an organized and professional approach to the problem largely void of bickering, suspicion, personal agendas, and accusations of conspiracy.

Brooke Water L.L.C. Circle City Water Co. L.L.C. Strawberry Water Co., Inc. Pine Water Co., Inc.
Payson Water Co., Inc. Navajo Water Co., Inc. Tonto Basin Water Co., Inc.

James Richey
Alternative JB6 Study
June 1, 2005

During a recent hearing at the Arizona Corporation Commission (the "Commission") I recall evidentiary statements made by a member of the local community. His interest was to expose Brooke as a "conspirator" only interested in knowingly withholding huge volumes of water supply from the community for the purpose of driving the cost per customer to the highest possible level. Of course, these unsupported and preposterous statements are false and universally recognized as such by the growing body of people interested in this issue. In fact, the regulatory officials genuinely interested in the solution of Pine's water supply problems recognize that such people and statements retard the opportunity for a solution. Worst of all these people, and their statements, have nearly destroyed the creditability of the concerned people of Pine and Strawberry at the regulatory functions that control this process. I think most people in attendance at the hearing were embarrassed for the person making the statements.

Long ago Brooke has considered every reasonable and unreasonable resolution to the Pine water supply problem we could think of. That doesn't mean that we have considered every possible alternative. We have traveled far down the road of numerous proposals. We have less explored others. We have prioritized the alternatives in terms of risk and cost. We have discussed these alternatives and reported same to the Commission on numerous occasions. As it relates to the current discussion there is very little new information that hasn't been previously considered. That, also, doesn't mean that further discussion isn't warranted or necessary. But, the more people that consider the complexities of this situation ultimately come to three facts that will be related to any future solution:

- First, any solution to the water source and supply problem will mean a higher cost of water in the future.
- Second, any solution to the water source and supply problem will probably come from outside of the area.
- Third, any solution to the water source and supply problem will probably have a legislative component steering the outcome.

Some people see these facts are discouraging. Others see these facts as encouraging. Brooke views these facts as the reality. Brooke has asked the Commission for "guidance" on the proper course of the numerous alternatives for our future consideration. The regulatory scheme requires our "reasonable and prudent" consideration of any proposal to expend investment capital toward such a solution. Unfortunately, the Commission has declined to provide the "guidance" we seek. The Commission's declination to become involved has, in our opinion, further deterred a solution as well. Thus, we don't have the luxury of capital intensive experimentation through incremental progress. Brooke is no different than any business charged with the responsibility to expend capital to improve business operations in the most efficient manner possible. In the case of solving Pine's water supply problems the most preferred capital expenditure is, unfortunately, much more difficult to identify and the consequences of erroneous solution identification can be far more expensive than members of the local community realize.

James Richey
Alternative JB6 Study
June 1, 2005

It is important to for you to realize that there is an important regulatory component to *everything* Pine Water Co. does. Regulatory financial analysis, accounting, capital expenditures, return on investment, rates of return, and almost every other water business consideration is much different than the standard business environment. *Every* business decision made by Pine Water Co. and Brooke must carefully consider the effect of the regulatory environment and, in some cases, project regulatory treatment of future issues. It provides an additional element of concern, frequently referred to as "regulatory risk" that most businesses do not have to consider. The regulatory environment can be very challenging and disappointing. In the case of the most recent Pine Water Co. rate application approximately \$500,000 was spent by the Company and the opposing interveners in the regulatory application process. Most disappointing is that these funds were necessarily spent reaching a settlement conclusion that was largely proposed by the Commission's Staff in the first few weeks of the case. Unfortunately, the attorneys enjoyed the process immensely. But the community lost the exploratory ability of this largely wasted capital expenditure. Unfortunately, Pine Water Co. will only be allowed to capitalize \$200,000 of this expense over a period of four years. All of this capital, which is ultimately repaid by community rate payers inclusive of an approved rate of return, could have been much better spent exploring for water sources. Thus, the regulatory process is a *very* important component of anything done by Pine Water Co. and one that cannot be considered lightly.

The JB6 Proposal

The concept of the JB6 Proposal has been previously considered by Brooke. In our view the JB6 Proposal is flawed in at least the following areas:

- (a) a constant, reliable source of re-filling the storage tanks does not exist
- (b) the capital cost is dramatically understated and comparatively very high
- (c) the positive effect of "resting" Pine wells is speculative at best
- (d) business model foundational facts are seriously inaccurate

Accordingly, I have provided some brief argument in support our conclusions in the form of the statements below.

Source of Supply

The JB6 Proposal correctly identifies the period between Memorial Day and Labor Day annually as the most challenging. For clarification purposes, Brooke refers to this period as the "100 Day War".

Unfortunately, the JB6 Proposal relies on water from Pine Creek as the source of supply for the retrofitted storage tanks (the "Pine Creek Tanks"). Traditionally, and with rare exceptions, the period during the "100 Day War" provides for little or no surface flow available for re-supply of the storage tanks. Thus, at best, a single cycle of 800,000 gallons would be available for introduction into Pine Water Co.'s water system during periods of

James Richey
Alternative JB6 Study
June 1, 2005

deficient supply most likely during the long 4th of July holiday weekends. Once used this additional water supply would be unavailable until the next available surface flow through Pine Creek. That may, or may not, be during the immediately subsequent winter months. For the period 1996-2004 the average peak customer month of July demanded 5,855,000 gallons of water. This monthly demand translates to approximately 195,000 gallons per day for the entire month. Most troubling issue is the fact that customer daily demand during a long 4th of July weekend can approach 900,000 gallons. As can easily be seen from this data the additional supply represented by one cycle of the Pine Creek Tanks does little to resolve the water supply shortage in the area. Further, once expended this additional source of water cannot be retrieved until the next available water flow through Pine Creek. The surface flow of Pine Creek only marginally supported the needs of a 140 person population in 1967 with very little potential for development of a higher utilization.¹ That much additional water might avert a one-time disastrous situation but will not eliminate a water source deficiency problem.

There are additional problems related to the use of Pine Creek water flow as well. These issues include entering into an exchange arrangement with Salt River Project ("SRP") to exchange surface water supplies from Pine Creek with SRP access to water from the Central Arizona Project ("CAP"). The likelihood of entering into such an arrangement is currently better than has existed for some time. However, before such an arrangement could be completed with SRP a settlement agreement with all downstream claimants and bona fide rights holders would be necessary before water could be extracted from Pine Creek. It should be anticipated that non-bona fide water rights holders would strenuously argue as to their prioritized position for rights to the water flow as well. This settlement process will also include an environmental review in the form of a Categorical Exclusion or Environmental Assessment. It was Brooke's experience during the development and construction of the Project Magnolia pipeline project that an Environmental Assessment can cost more than \$125,000 and require almost two years before being completed. The business and regulatory risk associated with these advance expenditures, in light of unknown future water flows through Pine Creek, can be very high if not regulatorily deemed "reasonable and prudent". Of course any negative Commission ruling would come after the expenditure of the capital. This regulatory risk of this result was the primary reason for Pine Water Co. previously seeking regulatory "guidance" in this matter. As stated above, unfortunately, this "guidance" was not proffered by the Commission.

The JB6 Proposal accurately concludes that the project can be completed inclusive of all of the additional components discussed above. However, the additional costs of this process must be included as part of the development cost and risk of recovering these costs is unknown.

¹ Investigation of Groundwater Availability for the Pine/Strawberry Water Improvement District, August 2003, Preface, item 1, Comment 1A, page vii.

Cost of Capital

The JB6 Proposal dramatically understates the financial issues related to the project. The financial analysis of the JB6 Proposal is seriously flawed, not because of inaccurate financial analysis, but because the requirements of the regulatory process have not been accurately considered.

For Commission rate making purposes the allowable returns are applied on a "net" basis. In other words, only "net profits" are computed when considering the return on investment period or the rate of return. "Net profits" are those applied *after* all expenses related to a project. Likewise, a net present value ("NPV") analysis is frequently utilized by regulatory authorities as a normalizing mechanism to assure regulators that sufficient future water company cash flow exists to meet the requirements of the project. Thus, recurring operational costs must be included as part of the project. In the section above I have explained the effect of additional costs related to an exchange agreement with SRP. In addition to the additional infrastructure costs not considered by the JB6 Proposal we estimate the revised capital costs of the project to be approximately \$1,511,700. The "net" regulatory effect of these costs must also include "grossed up" income taxes, depreciation, amortization, regulatory costs, and the approved Pine Water Co. rate of return of approximately 11.41%². Therefore, the adjusted approximate cost of the JB6 Proposal is \$2,524,500 and must be recovered through additional customer rate adjustments.

Brooke's perspective is that such a small incremental solution to a problem that has dubious applicability, because of the seasonal unpredictable availability of Pine Creek water flow, demands strong consideration of other more productive and less economically burdensome alternatives.

"Resting" Water Wells

The JB6 Proposal concludes that the "supplemental storage system would reduce the strain on the Pine and Strawberry wells during the winter months" by utilizing surface water flowing through Pine Creek. This water flow is proposed to be collected through constructed intake infrastructure and stored in the "Pine Creek Tanks". The JB6 Proposal concludes that higher utilization of the surface water sources decreases the utilization of water wells in Pine and Strawberry and, as a result, allows increased availability of groundwater supplies for future use during the "100 Day War". The JB6 Proposal provides no supporting documentation of this conclusion whatsoever.

Brooke believes the "resting" conclusion reached by the JB6 Proposal is speculative, at best, and does not provide a sufficient basis to meet the "reasonable and prudent" regulatory standard, discussed herein, to justify substantial capital investment of the type

² Arizona Corporation Commission, Decision No. 67166, page 8, at line 7.

and nature of the JB6 Proposal. Further, there are several previously developed water supply studies conducted since the 1960's concluding that sub-surface water flow, if not used, is lost to a downstream water source user. Therefore, the increased peak-period performance of water wells in the Pine and Strawberry areas is unproven because customer demand conditions throughout off-peak periods have never been afforded the luxury of providing a data basis to determine the speculative nature of this argument.

Foundation Facts

The economic premise of JB6 Proposal is entirely based on the converted use of capital used to pay for transported water from outside the Pine area. Instead, this capital would be used to fund the investment capital necessary to construct the supplemental water storage facility.³ The JB6 proposal calculates that 2003 water hauling transportation costs totaling \$344,540 as defined by Pine Water Co.'s income statement. This amount is represented to be the sum of "Purchased Water" and "Transportation Expense".

The JB6 Proposal is in error in this conclusion. Pine Water Co., as well as all of Brooke's water companies, utilizes the uniform system of accounts as adopted by the National Association of Regulatory Commissioners ("NARUC")⁴ and as required by the Commission.⁵ As defined therein the expenses related to "Purchased Water" and "Transportation Expense" is not only inclusive of water transportation expenses. In fact, these account descriptions include various different expenses unrelated to water transportation expenses. Therefore, a computation made from the aggregated account summaries of Pine Water Co.'s income statement would be hugely inaccurate.

Since 1998 Brooke's various water companies have contracted with a single source vendor to provide water transportation services. These services include the transportation of wholesale purchased water for Pine Water Co. For the periods described below the aggregate annual water transportation costs paid for the services are as follows:

- Year 2003 \$62,505
- Year 2004 \$38,611

Either of these years' costs is substantially less than the \$344,540 premised by the JB6 Proposal. The same water transportation services contractor has quoted Brooke a cost of \$250 per truck load of water hauled from the Starlight Pines water source in Coconino

³ *Alternative JB6 Study*, page 10: "The proposed supplemental system would be paid for by utilizing the dollars that are currently spent for water that is being purchased outside the Strawberry system through the trucking effort. Operating costs for the buying and trucking additional water could be converted to capital costs, which would pay for the supplemental storage (i.e. Pine Creek Tanks) system within five years."

⁴ *Accounting for Public Utilities*, 1999 updated 2004, Chapter 11, sections 11.01 through 11.03.

⁵ *Arizona Corporation Commission, Decision No. 67166*, page 6, lines 16-17

James Richey
Alternative JB6 Study
June 1, 2005

County to Pine Water Co.'s storage tanks in 2005⁶. This unit price compares favorably to the same \$243 unit price of 2003 and 2004. Indisputably, the 2003 unit cost divided into amount described by the JB6 Proposal⁷ would have computed a total of 1,417 loads of water or approximately 9,216,000 gallons of transported water. That is far more water than was actually transported.

The business model premise of the JB6 Proposal must, therefore, be more closely scrutinized. At the same rate of water transportation expense occurrence in future years as that actually incurred in 2004 it would require Pine Water Co. more than 65 years to break even on the same value investment while not considering the time value of money for the same period. Clearly, such a business investment alternative is preposterous and inconceivable.

The JB6 Proposal error related to not fully understanding the nature of regulatory accounting is understandable. It is an error frequently made. The regulatory business is unique from any other type of business transaction and, therefore, requires any exterior analysis to be firmly rooted in the regulatory nature of the business before embarking on a detailed analysis of the type represented by the JB6 proposal.

It is Brooke's perspective that the business model premise of the JB6 Proposal, based entirely on paying for the Pine Creek Tanks with converted operating capital, easily fails to justify itself on the erroneous foundation facts alone without considering any of the other equally persuasive flaws discussed above. In the opinion of Brooke the errors cited by this section should have been readily detectable to the individual attributions referenced on page 10 of the JB6 Proposal.

Conclusion

Brooke sincerely believes that you should be commended for the serious effort put forth in the JB6 Proposal. The concept of the JB6 Proposal is logical and valid. The analysis is consistent with that performed by business leaders throughout industry. The nature of the utility regulatory environment is, however, much different than any other business form known by myself. Brooke has insisted that all of its managers, operational superintendents, and others attend a special utility school to better understand these conceptual differences. This is another reason why it is so hazardous for untrained community members to suggest logical options that, upon closer examination, do not survive the regulatory analysis scheme.

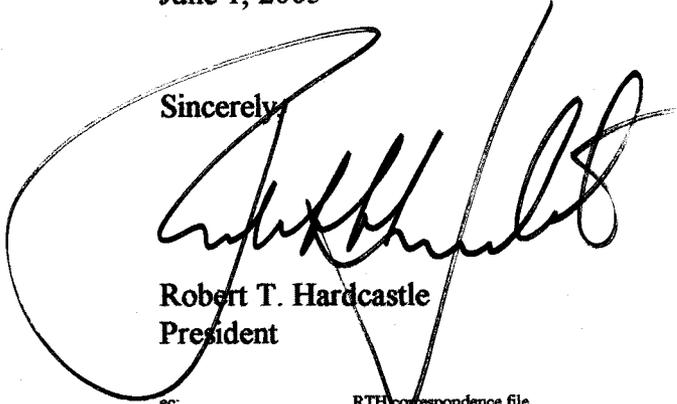
Thank you, again, for your interest and effort.

⁶ Water transportation costs will be adjusted by as much as \$.18 per mile as a fuel surcharge cost.

⁷ Alternative JB6 Study, page 8.

James Richey
Alternative JB6 Study
June 1, 2005

Sincerely,



Robert T. Hardcastle
President

cc:

RTH correspondence file
.MI, ME, DS, JS