



IN THE MATTER OF THE APPLICATION OF
MOUNTAIN PASS UTILITY COMPANY
FOR APPROVAL OF FINANCING,
DOCKET NO. SW-03841A-01-0166

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ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF
PICACHO SEWER COMPANY
FOR APPROVAL OF FINANCING,
DOCKET NO. SW-03709A-01-0165

IN THE MATTER OF THE APPLICATION OF
PICACHO WATER COMPANY
FOR APPROVAL OF FINANCING,
DOCKET NO. W-03528A-01-0169

EXCEPTIONS

The following exceptions to the Recommended Opinion and Order in the aforementioned matters are set forth by Applicants, Mountain Pass Utility Company, Picacho Water Company, and Picacho Sewer company:

Applicant objects to the recommendation for Mountain Pass Utility to issue up to \$5,700,000 in stock equity and to construct the initial collection system with advances in aid of construction ("AIAC"). Applicant seeks approval of stock equity in the amount of \$7,200,000, which includes the initial collection system.

Applicant objects to the recommendation for Picacho Sewer Company to issue up to \$6,200,00 in stock equity and to construct the initial system with AIAC's. Applicant seeks approval of stock equity in the amount of \$7,700,000, which includes the initial collection system.

Applicant objects to the recommendation for Picacho Water Company to issue up to \$4,700,00 in stock equity and to construct the initial system with AIAC's. Applicant seeks approval of stock equity in the amount of \$5,700,000, which includes the initial distribution system.

The principal objection of the Applicants to the proposal in the Recommended Opinion and Order to use AIAC's to construct the initial water and sewer lines is that the Commission has established and maintained a policy over 10 years that the stockholders of the utility provide the funds through equity for the initial water and sewer facilities for service to customers. It is also the expectation of the customers in the developments served by the Applicant that all of the water and sewer infrastructure has been installed and paid for by the utility. The public interest is not served when the customers become aware that not only are the utility's water and sewer lines not paid for by the utilities, but that as ratepayers they have to pay for them in their rates. What will be even more unsettling to the ratepayers is when they discover that the payments for the unpaid water and sewer lines are made to the developer.

The specific exceptions to the recommendation that AIAC's be used to finance the initial construction of the water and sewer lines instead of equity are:

Arizona Corporation Commission

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THE COMMISSION HAS ESTABLISHED AND MAINTAINED A POLICY WHEREBY THE SHAREHOLDERS OF THE UTILITY PROVIDE THE FUNDS FOR THE INITIAL FACILITIES FOR SERVICE TO CUSTOMERS.

- In all financing applications of every affiliate of the Applicants, the Commission has ordered that equity be used to construct the initial water and sewer lines. These orders are:
 - Pima Utility Company, Decision No. 57645 dated November 27, 1991 (2,356,100 total equity financing approved),
 - Pima Utility Company, Decision No. 59130 dated June 27, 1995 (\$5,338,468 total equity financing approved),
 - SaddleBrooke Utility Company, Decision No. 59134 dated June 27, 1995 (\$2,444,198 total equity financing approved),
 - Lago Del Oro Water Company, Decision No. 60227 dated June 5, 1997 (\$2,894,529 total equity financing approved), and
 - Lago Del Oro Water Company, Decision No. 62845 dated August 24, 2000 (\$1,500,000 total equity financing approved).(Source: Applicants' Exceptions to Staff Report, p. 3)

- The Staff Witness in these proceedings, Mr. Joel M Reiker, is the same staffperson who recommended that equity be used to construct all of the water lines in Lago Del Oro Decision No. 62845 less than two years ago. (Oral Testimony, Staff Witness Reiker). Mr. Reiker offered no explanation why he completely reversed his position less than two years later by recommending the use of AIAC's to construct all of the water and sewer lines in this proceeding.

- The Applicants believe that its shareholders should furnish the funds for the initial facilities that provide service to customers (Direct testimony of Applicant Witness Poulos, p. 2), and the Commission has never ordered any affiliate of the Applicants to use AIAC's (Applicants' Exceptions to Staff Report, p. 3).

- The Commission's policy that authorizes equity to construct the initial facilities including the water and sewer lines was established in Pima's Decision No. 57645 in 1991. Prior to that time, Pima had elected to construct all of its water and sewer lines with AIAC's. However, Pima accumulated significant arrearages on its AIAC's because for many years it could not repay the annual refund obligations on the AIAC's (Applicants' Exceptions to Staff Report, p. 2). Decision No. 57645 authorized \$2,356,100 in equity in lieu of the AIAC's that Pima had been using in order to repay arrearages that had accumulated on the AIAC's and to construct the water and sewer lines in the new development area based on Staff's analysis that:

"Growing and expanding companies are heavy users of cash, so Pima needs to preserve its internally generated cash to finance expanding operations rather than having to use it to pay AIAC refunds. Staff believes that future capital improvements in the development area (including water and sewer lines) should be financed with equity capital."

(This portion of page four of the Staff Report in Decision No. 57645 was read into the record by Applicant Witness Poulos.)

- The Commission has established the policy that if one customer is receiving service from a water or sewer line, the entire line is considered used and useful (Oral Testimonies of RUCO Witness Rigsby and Applicant Witness Poulos). This policy has evolved over many years of used and useful evaluations and engineering analysis. The Applicant is unwilling to commit to making a non-used and useful adjustment (Recommended Opinion and Order, p. 7, line 6 and 7) because it does not adhere to Commission policy and it is inconsistent with proper engineering standards. Moreover, Commission policy should not be modified by a company witness in a hearing on financing matters.

THE USE OF AIAC'S FOR WATER AND SEWER LINES HAS RESULTED IN RATE INCREASES TO THE RATEPAYERS.

- Prior to 1991, Pima elected to use AIAC's to construct all of its water and sewer lines (Applicants' Exception to Staff Report, p. 2). The Recommended Opinion and Order in this proceeding proposes that Pima be required to use AIAC's to construct all of its water and sewer lines (Recommended Opinion and Order, p.12, lines 22-28 and p. 13, lines 1-7).
- The refunds on the AIAC's are based on a percentage of the revenues generated from the customers receiving service from the water and sewer lines (Applicants' Exceptions to Staff Report, p. 2). However, there is no provision in rates for the repayment of AIAC obligations (Oral Testimonies Staff Witness Reiker, RUCO Witness Rigsby and Applicant Witness Poulos).
- Pima could not pay the annual refunds under its AIAC obligations, (Applicants' Exceptions to Staff Report, p. 3).
- Pima, was serving nearly 5,000 water and 5,000 sewer customers during the time period when it could not pay the annual refund obligations under the AIAC's (Oral Testimony of Applicant Witness Poulos).
- It took three rate increases and \$2,356,100 in equity over a five-year period for Pima to generate the cash flow that enabled it to pay the arrearages and to meet its annual refund obligations under the AIAC's (Applicants' Exceptions to Staff Report, p. 2).
- The Recommended Opinion and Order on page 6, line 23 which states that Pima's refund amounts were based on a five-year recovery is incorrect. None of the recovery periods in Pima's AIAC's were five years; all AIAC's were either ten or fifteen year repayment schedules (see attached copies of Pima water and sewer AIAC's). The shortened recovery period that was incorrectly identified is not a reason for Pima's inability to meet its annual refund obligations as the Recommended Opinion and Order suggests. Pima used the standard refund period for water AIAC's and obtained variances for every sewer contract to match the payment schedules in the water AIAC's (generally, a 10-year period, Recommended Opinion and Order, p. 6, line 26).
- The Recommended Opinion and Order on page 6, line 22 which states that during this time period 70% of the financing was attributable to AIAC's is incorrect in that this ratio was the result of a unique circumstance rather than a reflection of ongoing conditions. When Pima was unable to pay its annual refund obligations, which included only partial payments in some years and no payments in either 1989, 1990 or 1991, the 70% financing attributable to AIAC's represented the peak ratio of AIAC's to total plant, which included the accumulation of unpaid AIAC's in arrears. Had the AIAC's in arrears been paid as the obligations became due, the ratio of AIAC's to total plant would have been much less. To illustrate, after the \$2,356,100 in equity approved in Decision No. 57645 was issued and the arrearages that had accumulated under the AIAC's were repaid, the financing at Pima that was attributable to AIAC's was below 30%. However, even with the significant reduction in the financing attributable to the AIAC's, Pima became current on the annual refund obligations only when the AIAC payments were included in rates. Rates were increased in Decision No. 57645 in November 1991 and again in Decision No. 58743 in August 1994, and in both of these rate cases the refund obligations under the AIAC's were included in rates (Applicants' Exceptions to Staff Report, p. 2).
- The inclusion of the annual AIAC refund obligations in Pima's rates and the corresponding rate increases resulted in the ratepayers of Pima paying the initial costs of the water and sewer lines instead of the shareholders of the utility (Oral Testimony of Applicant Witness Poulos).
- In Lago Del Oro Decision No. 60227 [Company Exhibit No. 18 in this proceeding], 32% of Lago's overall plant in 1995 was financed with AIAC's and the Company could not make payments of \$44,913 on its total refund obligations of \$51,443 (Decision No. 60227, p.7, lines 8-14). What makes this more significant is that the refund obligations were based on AIAC's for water lines that served only the first 500 customers, whereas Lago was actually serving over 2,600 customers in 1995. In other words, although Lago was generating revenue from 2,600 customers, it could

only pay a fraction (12%) of its AIAC obligations that year which were generated from water lines that served only the first 500 customers.

- What is more revealing is that even though the financing for nearly \$6,000,000 in facilities was approved in Decision No. 60227 in 1997, those facilities that were already providing service to the balance of the 2,600 customers in 1995. Had the cost of those facilities been included in plant in 1995, the ratio of AIAC's to total plant would have dropped to 8% which is well below the 19%-21% that the Recommended Opinion and Order believes is acceptable. Yet, Lago still was only able to refund a fraction (12%) of its annual AIAC refund obligations with only a very small proportion of its actual plant in service financed with AIAC's. This clearly illustrates the Applicants' position that AIAC refund obligations cannot be paid without an increase in rates.

THE APPLICANTS CANNOT MEET THE ANNUAL REFUND OBLIGATIONS UNDER THE AIAC'S.

- The residential lots in the development are high density and the historically have been sold very rapidly in similar developments which results in the refund obligations under the AIAC's accumulating quickly and the contracts being repaid in full (Oral Testimony Applicant Witness Poulos).
- There is no provision in rates for the repayment of AIAC obligations (Oral Testimonies Staff Witness Reiker, RUCO Witness Rigsby, Applicant Witness Poulos).
- Applicants will not have sufficient cash flow, particularly in their incipient years, to service debt (Direct Testimonies of Staff Witness Reiker, p. 3 and Applicant Witness Poulos, p. 2). AIAC's are a form of debt because they require a repayment of the obligations generated thereunder.
- Staff has not conducted any financial analysis to determine whether Applicant can meet the annual refund obligations under the AIAC's (Oral Testimony Staff Witness Reiker).
- The Applicant's inability to meet the annual refund obligations under the AIAC's is exacerbated because there are presently no customers served, and in the incipient years there is an insufficient amount of revenue from the few customers to cover even the fixed costs of operations. As a result, there will not be any funds available to meet the annual refund obligations and the Applicants will be in arrears on the refund obligations on the AIAC's from the beginning. (Oral Testimony Applicant Witness Poulos).
- If the annual refund obligations cannot be paid, the only way to repay them is to increase rates or raise equity capital (Oral Testimony RUCO Witness Rigsby).
- If rates need to be increased in order to meet the refund obligations under the AIAC's as testified to by RUCO Witness Rigsby, the ratepayers will bear the cost of the initial construction of the water and sewer instead of the shareholders, which is unacceptable to the ratepayers and is also inconsistent with Commission policy (Applicants' Exceptions to Staff Report, p. 2 and 3).
- If additional equity capital is needed in order to refund the AIAC obligations under the AIAC's as testified to by RUCO Witness Rigsby, the enormous cost of litigation will be passed on to the ratepayers (Recommended Opinion and Order, p. 5, lines 2 through 5). The costs of such litigation and the resulting increase in rates to the ratepayers can be avoided if the required equity is approved in this proceeding as requested by the Applicants (Applicants' Exception to Staff Report, p. 3).

THE RISKS AND COSTS OF INSTALLING THE INITIAL WATER AND SEWER LINES IN THE DEVELOPMENT SHOULD NOT BE BORNE BY THE RATEPAYERS.

- The evidence submitted by the Applicant is unequivocal that the costs of the water and sewer lines are not included in the price of the homes because they are provided by the utility and not by the developer (Recommended Order and Opinion, p. 6, lines 3 through 8).
- The Commission's policy and the Applicant's belief is that the shareholders should provide the funds to construct utility facilities that provide service to customers (Direct Testimony Poulos, p. 2 and 3).
- The Commission has adopted and consistently maintained this policy (Applicants' Exceptions to Staff Report, p.3). In addition, there is no evidence that the developer is recovering the cost of the water and sewer lines from the customers in the price of the homes because the utility is providing this infrastructure for service to customers. The notion that the developer could change its policy to include the water and sewer lines in the price of the homes is based solely on speculation and not on any existing evidence. Therefore, it should not be factored into this decision. Although the Commission has no recourse against the developer (Recommended Opinion and Order, p. 7, line 28), the Commission always has recourse against the utility (Oral Testimony Applicant Witness Poulos).
- Commission rules do not mandate the use of AIAC's (Recommended Opinion and Order, p. 8, line 8). AIAC's are intended to be used only when facilities are required exclusively for a new service or when the cost of facilities are disproportionate. When facility costs are uneven among customers, the AIAC's are utilized so that the individual customer who benefits from the facilities pays the disproportionate costs instead of the general body of ratepayers. The residential lots in the development to be served by the Applicants are situated and sized uniformly and are constructed sequentially within the development; i.e. there are no disproportionate costs among the general body of ratepayers within the communities. AIAC's are not mandated, and also will be misused if they are required to construct the initial the water and sewer lines in the developments served by the Applicants as proposed in the Recommended Opinion and Order (Applicants' Exceptions to Staff Report, p. 4).
- The use of AIAC's does not shift the risk to the developer as suggested in the Recommended Opinion and Order. Conversely, because rates have to be increased in order to meet the annual refund obligations, the risk of using AIAC's transfers to the ratepayers who will have to pay for the construction of the initial facilities in their water and sewer rates (Applicants' Exception to Staff Report, p. 3).

PIMA UTILITY COMPANY

AGREEMENT RELATING TO EXTENSION OF WATER DISTRIBUTION FACILITIES

THIS AGREEMENT, made and entered into this 31st day of December, 1982, by and between PIMA UTILITY COMPANY, an Arizona corporation, (hereinafter referred to as the "Company"), and SUN LAKES MARKETING, an Arizona limited partnership, address 25612 E. J. Robson Blvd., Sun Lakes, Arizona 85224, (hereinafter referred to as the ("Customer")), WITNESSETH:

In consideration of the services to be performed by the Company and the sums of money to be advanced by the Customer, it is agreed as follows:

1.) The Company will construct an extension to its Sun Lakes water distribution facilities as a continuation of its present facilities as follows:

Install water mains and services to 204 lots in the Sun Lakes Subdivision, Unit 14.

2.) The Customer will pay to the Company upon signing this Agreement the total sum of Fifty-Six Thousand Seven Hundred Thirteen and 71/100 Dollars (\$56,713.71), receipt of which is hereby acknowledged by the Company, which represents:

(a) \$56,713.71 refundable advances in aid of construction for 8960 feet of 10, 8, 6, and 4 inch distribution main, as described above in paragraph 1.

3.) The Company agrees to refund to the Customer 10% of the total annual gross revenue from water sales to each new bona fide customer in a new subdivision, tract, development or project, or located on a single parcel or lot for a period of 10 years beginning the first day of January, 1983, provided that in any event if all refundable advances made pursuant to this contract have not been refunded prior to the end of the 10 year period, then in such event the balance of the advances made hereunder shall be non-refundable in accordance with the Arizona Corporation Commission General Order No. U-41.

The refund period is to begin on the first day of January, 1983, and refunds shall be made by the Company on or before the 31st day of January of each calendar year covering any refunds owing from water revenues received during the preceding January 1st to December 31st period.

The aggregate refunds made hereunder shall in no event exceed the total of the advance in aid of construction made pursuant to this Agreement; it is further understood that no interest will be paid by the Company on advances received under this Agreement.

The Company shall make no refunds from any revenue received from any lines, other than the customer service line, leading up to or taking off from the particular main or line extension as described above by this Agreement, whether the same have been previously installed or may be installed in the future.

The Company may, upon the approval of the Commission, terminate its obligation to refund a percentage of gross revenue from the line extension as described above by accord and satisfaction of its obligations under this Agreement.

4.) All pipe lines, valves, fittings, wells, meters, tanks or other facilities installed under this Agreement, shall be the sole property of the Company, and the person making advances in aid of

PIMA UTILITY COMPANY

AGREEMENT RELATING TO EXTENSION OF SEWAGE DISTRIBUTION FACILITIES

THIS AGREEMENT, made and entered into this 31st day of December, 1982, by and between PIMA UTILITY COMPANY, an Arizona corporation, (hereinafter referred to as the "Company"), and SUN LAKES MARKETING, an Arizona limited partnership, address 25612 E. J. Robson Blvd., Sun Lakes, Arizona 85224, (hereinafter referred to as the ("Customer")), WITNESSETH:

In consideration of the services to be performed by the Company and the sums of money to be advanced by the Customer, it is agreed as follows:

1.) The Company will construct an extension to its Sun Lakes sewage treatment facilities as a continuation of its present facilities as follows:

Install sewer mains and services to 204 lots in the Sun Lakes Subdivision, Unit 14.

2.) The Customer will pay to the Company upon signing this Agreement the total sum of Seventy-Nine Thousand Six Hundred Seventy-Two and 91/100 Dollars (\$79,672.91), receipt of which is hereby acknowledged by the Company, which represents:

(a) \$79,672.91 refundable advances in aid of construction for 17,056 feet of 8 and 4 inch distribution main, as described above in paragraph 1.

3.) The Company agrees to refund to the Customer 10% of the total annual gross revenue from sewage service sales to each new bona fide customer in a new subdivision, tract, development or project, or located on a single parcel or lot for a period of 10 years beginning the first day of January, 1983, provided that in any event if all refundable advances made pursuant to this contract have not been refunded prior to the end of the 10 year period, then in such event the balance of the advances made hereunder shall be non-refundable in accordance with the Arizona Corporation Commission General Order No. U-41.

The refund period is to begin on the first day of January, 1983, and refunds shall be made by the Company on or before the 31st day of January of each calendar year covering any refunds owing from water revenues received during the preceding January 1st to December 31st period.

The aggregate refunds made hereunder shall in no event exceed the total of the advance in aid of construction made pursuant to this Agreement; it is further understood that no interest will be paid by the Company on advances received under this Agreement.

The Company shall make no refunds from any revenue received from any lines, other than the customer service line, leading up to or taking off from the particular main or line extension as described above by this Agreement, whether the same have been previously installed or may be installed in the future.

The Company may, upon the approval of the Commission, terminate its obligation to refund a percentage of gross revenue from the line extension as described above by accord and satisfaction of its obligations under this Agreement.

4.) All pipe lines, man holes, clean outs, sewage treatment facilities or other facilities installed under this Agreement, shall be the sole property of the Company, and the person installing same in aid