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Naco Water Company, LLC
PO Box 85160
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520-623-5172

October 2, 2006

Arizona Corporation Commission
Utilities Division
Docket Control
1200 West Washington Street
Phoenix, Arizona 85007

AZ CORP COMMISSION
DOCUMENT CONTROL

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RECEIVED

Re: Docket No. W-02860A-06-0002 / W-02860A-05-0727

This correspondence will serve to document the response of Naco Water Company, LLC (NWC) to Arizona Corporation Commission (ACC) staff direct testimony filed on September 1, 2-6 regarding ACC Docket # W-02860A-06-0002.

Please be advised that it is the unequivocal opinion of NWC that a rate increase which only authorizes a \$450,000.00 Water Infrastructure Finance Authority (WIFA) loan is completely insufficient to address the ongoing and worsening drinking water supply condition within the NWC system.

MULTIPLE RATE INCREASE APPLICATIONS ARE NOT NECESSARY

Additionally, we feel it is not cost effective for this already financially-troubled company to file multiple new finance and rate applications for each phase of the required future system upgrade construction. NWC believes our customers and our company will be much better served if ACC approves a rate increase order stating that when one phase of system upgrade construction is complete, an additional system user surcharge would be authorized to then finance the next phase of required system upgrade construction, at some future certain date prescribed by the ACC.

Please note that this rate increase structuring concept was in-fact the specific suggestion made by Staff during a meeting held at ACC offices on 12 April 2006. During that meeting with ACC staff and WIFA staff, ACC staff specifically directed NWC to prepare one rate increase and finance application which contained ALL required system upgrade construction. ACC staff also indicated that ACC staff would provide recommendations to the ACC for the timing and formula regarding amounts of those future system user rate increases to be phased-in over time

Arizona Corporation Commission
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Please understand that it was only at the specific recommendation of ACC staff that NWC incurred the significant expense associated with preparing a comprehensive system upgrade construction cost estimate and rate increase application. It appears as if ACC staff has provided direct testimony which contradicts their previous direction to NWC. When and how will NWC ever recapture the value lost in preparing the comprehensive cost estimate and rate increase application which ACC staff previously directed but now rejects?

PHELPS DODGE FINANCIAL SETTLEMENT HAS NO CERTITUDE

Within its direct testimony, ACC staff assumes that Phelps Dodge Corporation will provide financial assistance to help NWC mitigate groundwater contamination impacts associated with Phelps Dodge mine tailing pile. ACC staff has made these assumptions despite the fact that Phelps Dodge has never at any time made a legally binding commitment to provide this financial assistance; and Phelps Dodge may possibly never contribute any financial assistance to NWC. Under such a scenario, problems within the NWC system will continue to worsen to the point when some customers will be without drinking water in the very near future.

As we have stated before, if Phelps Dodge does indeed contribute financial assistance to replace or deepen contaminated supply wells, or to replace distribution lines required to relocate contaminated wells, NWC would in-turn not borrow funds from WIFA to replace threatened drinking water supply wells. Because WIFA only requires repayment of funds actually borrowed, and there would be no need for further rate increases to repay WIFA loans associated with relocating contaminated wells, those potential rate increases could then be forfeited.

HYDROGEOLOGIC ASSESSMENT IMPERATIVE FOR PHELPS DODGE SETTLEMENT

It is absolutely imperative, under any scenario, that the ACC approve a rate increase which will fund completion of the Southern Upper San Pedro River Hydrogeologic Assessment (SUSPRHA). ACC staff has testified against funding the SUSPRHA within the recommended rater increase (Dorothy Hains direct testimony Exhibit 1, page 16).

The SUSPRHA is absolutely essential to NWC if it is ever going to enter into fair and equitable negotiations with Phelps Dodge. The SUSPRHA will provide the first comprehensive independent assessment NWC has ever made regarding the impacts of Phelps Dodge groundwater contamination; and the SUSPRHA is absolutely essential to determining if and where NWC might hope to relocate its impacted drinking water supply wells.

Without the SUSPRHA, NWC cannot even begin to negotiate settlement with Phelps Dodge. This will in-turn cause more eventual cost increases to NWC and its system users; and will completely invalidate ACC staff assumptions regarding a Phelps Dodge financial settlement.

In short, ACC staff cannot base its rate increase recommendations on the assumption that Phelps Dodge will reach a financial settlement with NWC, while at the same time denying NWC the very tools it requires to reach that financial settlement.

NWC urges the Commission to approve a rate increase order stating that costs associated with the SUSPRHA are to be included in the total WIFA funding package finally approved for NWC.

ACC DEBT AUTHORIZATION IS NOT CONSISTENT WITH WIFA LENDING

ACC staff has recommended a rate increase which supports a \$450,000 WIFA loan, and an additional \$300,000 WIFA loan if WIFA commits to a zero interest rate. Beside the fact that this potential \$750,000 WIFA loan financing is still much less than the amount that will ultimately be required to complete the entire system upgrade project, WIFA will not commit to loaning any funds at any interest rate until the total amount of financing is approved by the Commission. After approval of the entire \$750,000 (\$450,000 plus \$300,000) the application will be taken to the Board at WIFA and only then can the negotiations for lower interest rates be reviewed.

WIFA has in place rules for special circumstances such as deprived areas, of which Naco certainly is, which may qualify for low or zero percent interest loans (See attached Exhibit A). But, once again, the WIFA Board will not commit to any interest rate before it receives Commission approval of the total amount to be financed.

ACC rules require ACC approval before a privately held water system can receive any WIFA loan financing. Therefore, how can we negotiate a WIFA loan rate without first having ACC approval?

Furthermore, WIFA lending rules only require a debt service coverage (DSC) ratio of 1.20 to facilitate WIFA lending, yet Staff appears to be imposing the standard upon NWC of maintaining a DSC ratio of 1.53 (Staff direct testimony page 14, line 1). Why is Staff imposing a higher DSC ratio upon NWC than DSC ratio which is actually required by the lender who will be providing financing to NWC?

NWC urges the Commission to approve a rate increase order stating that WIFA can loan any funds to NWC at the interest rate WIFA chooses, so long as the DSC ratio meets WIFA's lending requirements to maintain a DSC ratio equal to 1.20; with the total loan amount and lending rate to be determined by WIFA based upon achieving a 1.20 DSC ratio.

Letter to ACC Utility Division Docket Control
Re: Docket No. W-02860A-06-0002 (dated Oct. 2, 2006)

PHYSICAL PLANT DEPRECIATION ISSUES

In regard to amounts removed from plant and depreciation by Staff (page 4, Item 16), we would like to interject that Well #3 was drilled in 1930 according to Arizona Department of Water Resources records.

It is reported that Staff adjusted the plant value according to the Handy-Whitman Index to calculate the cost of drilling the well in 1950.

Well #3 was purchased as part of a land purchase and we have no record of this ever being put into the plant account.

Also, the old Well #4 was a leased well from the Southern Pacific Railroad June 8, 1964. The well was never put into plant therefore cannot be taken out as NWC did not own the well.

Well #5, though drilled in 1960, was also purchased with a piece of land by Mr. Salim Dominguez, Sr. in 1969. As before, we have no record of this purchased land ever being put into plant.

Thank you for your time and consideration in these matters. If you should have any questions, or require any additional information, please feel free to contact me at (520)623-5172.

Regards;

*J. DAN KELLEY, P.E. for
Bonnie O'Connor*

Bonnie O'Connor

For

Salim S. Dominguez, Jr.

Owner - Naco Water Company LLC

cc: Salim S. Dominguez, Jr.

NACO WATER COMPANY
EXHIBIT A - DOCKET No. W-02860A-06-0002
Hardship Community – Drinking Water Systems

WIFA Policy #: 1.012

Purpose:

Outline the criteria to designate drinking water systems as a Hardship Community and define the additional benefits available to Hardship Communities.

Policy:

Section 1: Hardship Community Designations for Drinking Water Systems

The Board may designate an applicant as a Hardship Community if the applicant fails to meet the applicable WIFA Financial Capability Requirements as defined by WIFA Policy 1.007 or WIFA Policy 1.008 and satisfies one of the following:

1. the Applicant meets the criteria outlined in Section 2 below,
2. the Applicant is designated an action plan community through the Governor's Community Action Plan,
3. The Community is a designated "Colonias" Community through the federal government.

Section 2: Criteria

Unless an applicant is designated as an action plan community through the Governor's Community Action Plan, an applicant must meet the following criteria:

- The applicant's project is above the 50 percentile on the DWRP Project Priority List;
- WIFA awarded the applicant 50 or more Local Fiscal Capacity points on the DWRP Project Priority List; and
- The water system must serve fewer than 10,001 people.

Section 3: Hardship Community Financing Options

After the Board designates a drinking water system a Hardship Community, WIFA may reduce the Combined Interest and Fee Rate (CIFR), reduce coverage requirements, and award a Hardship Grant, if appropriated and available, in accordance with the financing options listed below. WIFA may reduce the CIFR calculated in accordance with WIFA Procedure A.004.2 at the time of loan closing. The Hardship Community financing options include:

Option 1: WIFA may reduce the CIFR to a rate which permits the Hardship Community to obtain the required debt service coverage.

Option 2: If the Hardship Community cannot obtain the required debt service coverage under Option 1, WIFA may reduce the CIFR to a minimum of 0% and reduce the debt service coverage requirement.

Option 3: If the Hardship Community cannot obtain the required debt service coverage under Option 2, WIFA may reduce the CIFR to a minimum of 0%, extend the term to a maximum of 30 years, if not being funded by a federal capitalization grant, and reduce the debt service coverage requirement.

Section 4: Security Levels

WIFA may require Hardship Community Applicants to execute additional levels of security as follows:

<u>Borrower Type</u>	<u>Security Type</u>
Governmental	
City or Town	General Obligation
Community Facility District	General Obligation
Domestic Water Improvement District	Special Assessments
Municipal Improvement District	Not Applicable
Non-Governmental	
Association/Cooperative/Non-Profit	Liens on Personal Property
Privately/Investor Owned	Personal Guarantee

The Board may, if justified by the Hardship Community applicant, waive the additional security levels.

Section 5: CIFR Adjustments

Unless justified by the Hardship Community Borrower and waived by the Board, WIFA will adjust the CIFR as follows:

<u>Year of Loan Term</u>	<u>Amount Added to CIFR</u>
Start of Year 6	25% of the difference between the Standard and Reduced CIFR
Start of Year 11	50% of the difference between the Standard and Reduced CIFR
Start of Year 16	75% of the difference between the Standard and Reduced CIFR
Start of Year 21	If applicable, 100% of the difference between the Standard and Reduced CIFR

Responsibility: Chief Financial Officer

Statutory Reference: ARS 49, Article 2

Rule Reference: R18-15-103, 104, 105, and 106

Originator: Julie Peru, Finance Director

Original Issue Date: January 11, 2000

Most Recent Amendment Date: February 15, 2006

Most Recent Amendment By: Jay R. Spector, Executive Director

Approval: The Board of Directors approved this policy on the date shown below.

Executive Director

Date