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**MEMORANDUM**  
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Arizona Corporation Commission  
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TO: Docket Control 2006 NOV -9 P 2: 39

FROM: Ernest G. Johnson  
Director  
Utilities Division  
AZ CORP COMMISSION  
DOCUMENT CONTROL

DATE: November 9, 2006

RE: COMPLIANCE ITEM - STAFF AUDIT IN THE MATTER OF EMERGENCY INTERIM RATE RELIEF FOR:

- Miracle Valley Water Company, Inc., Docket No. W-01646A-06-0010
- Cochise Water Company, Docket No. W-01868A-06-0010
- Horseshoe Ranch Water Company, Docket No. W-02235A-06-0010
- Crystal Water Company, Docket No. W-02316A-06-0010
- Mustang Water Company, Docket No. W-02230A-06-0010
- Coronado Estates Water Company, Docket No. W-01629A-06-0010
- Sierra Sunset Water Company, Docket No. W-02240A-06-0010

**Introduction**

In Decision No. 68667 (April 20, 2006), the Arizona Corporation Commission ("Commission") approved emergency interim rate relief for Miracle Valley Water Company, Inc., Cochise Water Company, Horseshoe Ranch Water Company, Crystal Water Company, Mustang Water Company, Sierra Sunset Water Company and Coronado Estates Water company, previously owned by Johnny A. McLain (collectively the "McLain Systems"). The relief was a System Improvement Surcharge ("SIS") of \$9.00 per meter per month. The McLain System was being operated by a Commission appointed interim manager, Arizona Small Utilities Association ("ASUA"). On September 19, 2006, Algonquin Water Resources of America, Inc. was appointed interim manager.

The Decision requires the interim manager to maintain a separate bank account in which it must deposit and withdraw all funds received pursuant to the SIS. The interim manager must also file monthly reports with Docket Control, in Docket No. W-01642A-06-0010, as a compliance item in this matter, detailing how the SIS funds were spent, on which of the seven systems the money was spent, and a report of the remaining amounts due on accounts payable. The Decision also required Staff to conduct an audit of the SIS fund expenditures on an annual basis beginning April 1, 2007.

The purchase of the McLain Systems by Algonquin Water Resources of America, Inc. ("Algonquin") is currently pending before the bankruptcy court. The proposed sale has been approved by the Commission in Decision No. 68826. It is currently anticipated that the sale can

be finalized in the near future. Decision No. 68826 also requires that the SIS terminate the first day of the month after Algonquin has filed notification that the sale of the McLain Systems has closed.

Because of these changes, and to assist the transition from ASUA to Algonquin, Staff is preparing the required monthly SIS reports for ASUA. The reports are being prepared by Staff in connection with a monthly audit of ASUA SIS activity rather than waiting until April 1, 2007, as provided in Decision No. 68667. Staff has thus far prepared three audit reports covering transactions through September 21, 2006.

### **Interim Manager Change**

On August 10, 2006, ASUA submitted a thirty day notice indicating that it will discontinue its services as interim manager for the McLain systems effective September 18, 2006. On September 19, 2006, Algonquin Water Services, Inc. entered into an Interim Management Agreement with the Commission and is the current interim manager of the systems.

### **Interim Management Fees**

This report will address the issue of under collected interim management fees by ASUA. A summary of the under collected fees, as requested by ASUA, is attached as Exhibit A. The Interim Management Agreement between ASUA and the Utilities Division of the Commission provided that<sup>1</sup>:

“If the funds and payments received from customers of any of the Water Companies during any month are insufficient to recoup the monthly management fee noted above, the deficit shall be considered a debt of the appropriate company separate and apart from the other companies (i.e. debts of Cochise shall be paid from the customers funds collected by customers of Cochise). ASUA shall be entitled to collect any unpaid monthly management fee through future rates collected on behalf of the appropriate water system”.

Staff has evaluated ASUA’s request and notes the following matters:

1. ASUA failed to account for its revenues and costs on a separate company basis (i.e. revenues and expenses for Cochise Water Company, Miracle Valley Water Company, etc.) during the time period it operated the seven water systems. Therefore, Staff will consider the above provision to apply to the combined McLain Systems. To the best of Staff’s knowledge, requiring a separation of the total revenues and cost for each individual system most likely would not reveal significant variations among each system. ~~To require significant accounting effort to separate such costs now would be time~~

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<sup>1</sup> Interim Management Agreement dated May 6, 2004.

consuming and would likely reveal no significant information. Therefore, Staff will apply the provision noted above on a consolidated basis.

2. ASUA failed to request timely rate increases which could have ameliorated the cash shortfall and compensated ASUA for its interim management fees on a current basis. See Schedule JJD-1 for a summary of additional cash flow based on timely filing for an emergency interim rate increase in July, 2004 and Commission approval in October, 2004, effective November, 2004.
3. ASUA incurred \$271,601 in salaries from July, 2004 through August, 2006 of which \$50,553 was paid to ASUA employees. ASUA agrees that the amounts paid to ASUA employees should be excluded as they are duplicative of the interim management fees.
4. Of the \$271,601 in wages, \$70,304 was paid to Johnny McLain who was paid at the rate of \$26.00 per hour and time and a half for overtime hours.
5. For the 27 months ended August 31, 2006, the water revenues totaled \$951,727 and total expenditures were \$924,357. See JJD-2.
6. As of September 21, 2006, the SIS account had received deposits totaling \$60,048.07 and disbursements totaling \$51,366.18.

#### **Interim Management Fee Reimbursement Considerations**

Staff acknowledges that assumption of interim management duties for several water systems that are in disrepair poses numerous operating challenges and may require a disproportionate amount of supervision. Typically, the labor cost associated with the operation of a water system on an interim basis is usually covered by the interim operator fee. ASUA agreed to a fee of \$10.50.

However, ASUA incurred \$271,601 in direct labor costs which did not include the labor costs of two ASUA individuals who spent numerous hours managing the operations of the systems. The labor cost of those two individuals was born by ASUA and was not charged to the McLain system costs.

Staff believes and ASUA acknowledges that certain ASUA management decisions were not prudent. Hiring Johnny McLain at \$26 per hour and paying for substantial amounts of overtime was too high a price to pay for the services rendered, although McLain had substantial knowledge of the system. McLain was paid approximately \$10,000 per month for the seven months he was employed. That amount is roughly equal to the monthly interim management fee.

ASUA also admits that it had occasional lapses in supervising workers which may have led to more costly and less timely system repairs. It also agrees that the emergency rate relief

should have been requested much earlier in its tenure. Also, ASUA could have more timely filed information regarding the lack of collection of its interim management fees with the bankruptcy court.

Staff acknowledges ASUA's efforts during the difficult transition period for these water systems. Although it had considered terminating its contract with the Commission much earlier than it did, ASUA continued to provide service until a replacement could be found. ASUA states that it did its best to maintain service during a very trying period.

Staff recognizes that ASUA could have requested an increase given the difficulties encountered with the McLain systems. Also, ASUA has not requested compensation for the time value of money. ASUA has borrowed funds from its national organization to maintain its cash flow during its interim management time period.

### **Recommended Interim Management Fee Reimbursements**

ASUA has estimated that it is owed \$207,126.42. Pursuant to the provisions of the interim management agreement, Staff is recommending a reimbursement of \$134,536.20. Staff's recommendation took into account the factors noted above. ASUA's request could have been increased by requesting a higher monthly fee and reimbursement for the time value of money. ASUA's request would be moot had it timely filed an emergency rate request. Staff's recommendation could have been lower if it treated the interim management fee as being paid in lieu of any labor charges.

The reduced recommendation is partly premised on a disallowance of 75 percent of the wages paid to Johnny McLain. The high hourly rate and extensive overtime were the result of ASUA's poor control in the early stages of the transition to interim manager. Staff is also disallowing the travel expenses<sup>2</sup> incurred for training. The interim management fee is to compensate qualified operators, not operators who need training.

Staff has concerns that the interim management agreement provision could be interpreted to mean that all costs incurred by interim managers are considered prudent and will serve to enrich interim operators regardless of their behavior or qualification. Staff does not believe poor or imprudent behavior on the part of an interim manager should be rewarded just because the monthly cash flow does not permit payment of interim management fees.

Staff's recommendation is not intended to punish ASUA but takes into account that certain ASUA management decisions resulted in unnecessary or inappropriate costs.

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<sup>2</sup> Account 886 at Schedule JJD-2 for \$6,123.

**Conclusion**

Staff recommends that in the final accounting of ASUA's tenure as interim manager, it be paid a total of \$134,536.20 for the unpaid portion of its interim management fees.

Such fees will first be paid from any remaining cash in the general checking account, if any. If there are any unspent funds in the SIS account, they may be used to pay the fees. The balance shall also be reduced by any funds obtained at the close of the bankruptcy proceedings. Then, if an unpaid balance still remains, it will become a liability to be paid as part of the transition costs authorized in Commission Decision No 68826.<sup>3</sup> The amount shall be prorated between Northern Sunrise Water Company and Southern Sunrise Water Company on a per customer basis.

Staff will conduct an audit of the final trial balance and the SIS account to determine if all funds have been properly recorded. ASUA has indicated that such trial balance should be available in mid-November, 2006.

EGJ:JJD:CCK:tdp

Originator: James J. Dorf

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<sup>3</sup> Northern Sunrise Water Company and Southern Sunrise Water Company, Docket Nos. W-20453A-06-0247 & W-20454A-06-0248.

Service List for: McClain Systems  
Docket Nos. W-01646A-06-0010 et al

Mr. Flavio Gonzalez  
Arizona Small Utilities Association  
210 North Central Avenue, Suite 6B  
Avondale, Arizona 85323-0000

Mr. Christopher C. Kempley  
Chief, Legal Division  
Arizona Corporation Commission  
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Mr. Ernest G. Johnson  
Director, Utilities Division  
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1200 West Washington Street  
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Ms. Lyn Farmer  
Chief, Hearing Division  
Arizona Corporation Commission  
1200 West Washington Street  
Phoenix, Arizona 85007

McLain Systems  
Docket No. W-01646A-06-0010 et al  
Emergency Rate Increase

Schedule JJD-1

<u>Month</u>	<u>Number of Customers</u>	<u>Additional Revenue</u>
11/2004	1,153	10,377
12/2004	1,147	10,323
1/2005	1,140	10,260
2/2005	1,188	10,692
3/2005	1,193	10,737
4/2005	1,225	11,025
5/2005	1,225	11,025
6/2005	1,215	10,935
7/2005	1,225	11,025
8/2005	1,228	11,052
9/2005	1,277	11,493
10/2005	1,289	11,601
11/2005	1,301	11,709
12/2005	1,300	11,700
1/2006	1,305	11,745
2/2006	1,294	11,646
3/2006	1,302	11,718
2/2006	1,319	11,871
3/2006	1,331	11,979
4/2006	1,350	12,150
		<u>225,063</u>

McLain Systems  
Docket No. W-01646A-06-0010 et al

Schedule JJD-2

Arizona Rural Utility Services, Inc.  
As of August 31, 2006

			Total for 27 Months
1	610	Water Revenue	(951,727)
2	620	Professional Inc	(6,039)
3			(957,766)
4			
5	612	Credit Card fees	1,570
6	615	Refunds	3,534
7	807	Bank Charges	6,129
8	812	Contract Labor	21,543
9	816	Depreciation	133
10	836	Insurance	42,646
11	840	Interest	2,036
12	845	Licences & Fees	6,867
13	846	Management Fees	101,067
14	847	Mileage Reimbursement	20,970
15	850	Office Expense	11,571
16	852	Postage	6,321
17	855	Professional Fees	20,367
18	856	Supplies	51,948
19	860	Rent	3,390
20	862	Repairs & Maintenance	143,560
21	870	Salaries	271,601
22	880	Payroll Taxes	24,828
23	882	Sales Tax	31,538
24	885	Telephone	17,278
25	886	Travel	6,123
26	888	Utilities	123,458
27	934	Other Expenses	5,876
28			<u>924,357</u>

McLain Systems  
Docket No. W-01646A-06-0010 et al  
Interim Management Fee

Schedule JJD-3

	Per ASUA	Per Staff
Estimated Cumulative Management Fees	352,908.50	352,908.50
Amount Previously Collected	(101,067.00)	(101,067.00)
Less ASUA Administrative Cost Already Paid	<u>(44,715.08)</u>	<u>(54,420.30)</u>
Amount Due ASUA	<u><b>207,126.42</b></u>	197,421.20
Less Disallowance of Imprudent Costs		<u>(62,885.00) *</u>
Revised Amount Due ASUA		<u><b>134,536.20</b></u>

* Payroll Disallowance	52,728
Related Payroll Taxes	4,034
Travel Disallowance	6,123
	<u>62,885</u>

McCLAIN WATER SYSTEMS

INTERIM MANAGEMENT FEES FOR ARIZONA RURAL UTILITY SERVICES, INC.

EXHIBIT A

MONTH	COCHISE	CORONADO	CRYSTAL	HORSESHOE	MIRACLE	MUSTANG	SIERRA	Connection n # per mo	Connection s X \$10.50	Management Fees Collected	Minus Adminstratio n Fees Paid	Difference not Collected
Jul-04	362	183	60	200	253	66	29	1153	\$12,106.50	\$10,000.00		
Aug-04	362	183	60	200	253	66	29	1153	\$12,106.50	\$10,000.00		
Sep-04	362	183	60	200	253	66	29	1153	\$12,106.50	\$10,000.00		
Oct-04	362	183	60	200	253	66	29	1153	\$12,106.50	\$10,000.00		
Nov-04	362	183	60	200	253	66	29	1153	\$12,106.50	\$10,000.00		
Dec-04	362	183	60	199	248	66	29	1147	\$12,043.50	\$10,000.00		
Jan-05	363	179	58	198	249	66	27	1140	\$11,970.00	\$10,000.00		
Feb-05	383	189	61	207	262	68	18	1188	\$12,474.00	\$7,920.00		
Mar-05	384	191	62	207	264	67	18	1193	\$12,526.50	\$7,408.00		
Apr-05	390	197	65	210	269	67	27	1225	\$12,862.50	\$7,893.60		
May-05	396	194	65	203	271	69	27	1225	\$12,862.50	\$7,847.40		
Jun-05	381	193	66	202	277	69	27	1215	\$12,757.50	\$0.00		
Jul-05	389	196	63	204	277	69	27	1225	\$12,862.50	\$0.00		
Aug-05	389	188	64	208	283	69	27	1228	\$12,894.00	\$0.00		
Sep-05	396	206	62	221	296	69	27	1277	\$13,408.50	\$0.00		
Oct-05	404	211	63	216	298	71	26	1289	\$13,534.50	\$0.00		
Nov-05	413	209	63	220	299	71	26	1301	\$13,660.50	\$0.00		
Dec-05	413	209	63	214	301	74	26	1300	\$13,650.00	\$0.00		
Jan-06	417	209	65	217	299	73	25	1305	\$13,702.50	\$0.00		
Feb-06	419	211	65	219	284	70	26	1294	\$13,587.00	\$0.00		
Mar-06	425	213	62	219	286	71	26	1302	\$13,671.00	\$0.00		
Apr-06	430	216	65	218	291	73	26	1319	\$13,849.50	\$0.00		
May-06	433	216	62	216	305	73	26	1331	\$13,975.50	\$0.00		
Jun-06	440	216	65	221	308	74	26	1350	\$14,175.00	\$0.00		
Jul-06	437	217	65	217	305	73	26	1340	\$14,070.00	\$0.00		
Aug-06	428	211	63	217	304	70	25	1318	\$13,839.00	\$0.00		
Sep-06								Estimated	\$14,000.00	\$0.00	44715.08	
									<u>\$352,908.50</u>	<u>\$101,067.00</u>	<u>44715.08</u>	<u>\$207,126.42</u>