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MEMORANDUM

TO: Docket Control

FROM: Ernest G. Johnson 
Director
Utilities Division

DATE: September 24, 2007

RE: STAFF REPORT FOR THE WATCO, INC. FINANCING APPLICATION
DOCKET NOS. W-20475A -06-0357 AND W-20475A -06-0550

Attached is the Staff Report for the Watco, Inc. financing application. Staff recommends approval of the requested financing authorization.

Any party to this procedure who wishes may file comments to the Staff Report with the Commission's Docket Control by 4:00 p.m. on or before October 9, 2007.

EGJ:PMC:tdp

Originator: Pedro M. Chaves

Arizona Corporation Commission
DOCKETED

SEP 24 2007

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KK	ne

AZ CORP COMMISSION
DOCKET CONTROL

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Service List for: WATCO, INC.
Docket Nos. W-20475A-06-0357 and W-20475A -06-0550

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

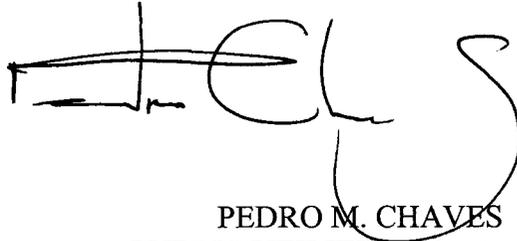
**WATCO, INC.
DOCKET NOS. W-20475A-06-0357 and
W-20475A -06-0550**

APPLICATION FOR FINANCING

SEPTEMBER 24, 2007

STAFF ACKNOWLEDGMENT

The Staff Report for Watco, Inc. Docket Nos. W-20475A -06-0357 and W-20475A-06-0550 is the responsibility of the Staff members listed below: Pedro M. Chaves is responsible for the review and financial analysis of the Company's application. Katrin Stukov is responsible for the engineering analysis.

A handwritten signature in black ink, appearing to read 'P. M. Chaves', with a large, stylized flourish extending from the end.

PEDRO M. CHAVES
PUBLIC UTILITIES ANALYST II

A handwritten signature in black ink, reading 'Katrin Stukov' in a cursive script.

KATRIN STUKOV
UTILITIES ENGINEER

EXECUTIVE SUMMARY
WATCO, INC.
DOCKET NOS. W-20475A-06-0357 AND W-20475A-06-0550

Silverwell Service Corporation (“Silverwell”), a Class “D” Arizona Public Service Corporation organized under subchapter “S” of the United States Treasury regulations with its business office in Show Low, Arizona, filed a financing application with the Arizona Corporation Commission (“Commission”) on May 30, 2006.

On August 31, 2006, Silverwell and Watco, Inc. (“Watco” or “Company”) filed an application with the Commission for approval of the sale of Silverwell’s assets and transfer of its Certificate of Convenience and Necessity (“CC&N”) to Watco (Watco was created to be successor of Silverwell and at that time did not have a CC&N). Commission Decision No. 69391, dated March 22, 2007, approved the CC&N transfer from Silverwell to Watco. Also on August 31, 2006, Watco filed an application for approval of a permanent increase in its water rates and charges under Docket No. W-20475A -06-0550.

On June 6, 2007, a procedural order changed the docket number for the financing application from Docket No. W-01979A -06-0357 to Docket No. W-20475A-06-0357.

The Company requests Commission authorization to borrow \$600,000 from the Water Infrastructure Finance Authority of Arizona (“WIFA”) in order to partially fund various improvement projects.

At December 31, 2005, the Company’s capital structure consisted of 0.0 percent short-term debt, 0.0 percent long-term debt, and 100.0 percent equity. Staff’s pro forma capital structure for the Company reflecting issuance of a \$600,000 20-year amortizing loan at 6.30 percent is comprised of 2.2 percent short-term debt, 81.2 percent long-term debt and 16.7 percent equity.

Staff typically recommends that debt funding not exceed 60 percent of total capitalization (long-term debt, short-term debt and common equity) for private and investor owned utilities. Issuance of the proposed financing would result in an overly leveraged financial position. However, there are no other known options to finance the proposed capital improvements.

Pro forma times interest earned (“TIER”) and debt service coverage (“DSC”) ratios based on Staff’s recommended rates in Docket No. W-20475A-06-0550 yield a 1.40 TIER and a 1.29 DSC. The DSC results show that cash flow from operations would be sufficient to cover all obligations if Staff’s recommended rates are adopted.

Staff concludes that issuance of the proposed debt financing for the purposes stated in the application is within Watco’s corporate powers and would be compatible with the public interest, consistent with sound financial practices and would not impair its ability to provide services if Staff’s rates are adopted.

Staff recommends that the Commission authorize Watco's request to borrow an amount not to exceed \$600,000 in new funds from WIFA for the purposes described herein subject to the condition that the rates adopted in the Company's permanent rate case proceeding provide debt service coverage comparable with Staff's pro forma DSC calculations using Staff's recommended rates.

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Introduction

On May 30, 2006, Silverwell Service Corporation ("Silverwell") filed a financing application with the Arizona Corporation Commission ("Commission") under Docket No. W-01979A -06-0357 ("Financing Proceeding").

On August 31, 2006, Silverwell and Watco, Inc. ("Watco" or "Company") filed an application with the Commission for approval of the sale of Silverwell's assets and transfer of its Certificate of Convenience and Necessity ("CC&N") to Watco (Watco was created to be successor of Silverwell and at that time did not have a CC&N). On that same date, Watco filed an application for approval of a permanent increase in its water rates and charges under Docket No. W-20475A-06-0550 ("Rate Case Proceeding").

On November 13, 2006, Silverwell and Watco filed a motion to consolidate all of the above referenced dockets. A procedural order dated November 30, 2006, consolidated the Rate Case and the Financing proceedings and suspended the time clock rules.

Commission Decision No. 69391, dated March 22, 2007, approved the CC&N transfer from Silverwell to Watco.

On June 6, 2007, a procedural order changed the docket number for the Financing Proceeding from Docket No. W-01979A-06-0357 to Docket No. W-20475A-06-0357.

Public Notice

On May 5, 2006, the Company published notice of its financing application in the *White Mountain Independent*. The *White Mountain Independent* is a semi-weekly newspaper of general circulation published in the City of Show Low, County of Navajo, Arizona. The affidavit of publication is attached along with a copy of the notice.

Background

The Company is a Class "D" Arizona Public Service Corporation organized under subchapter "S" of the United States Treasury regulations with its business office in Show Low, Arizona, and is primarily engaged in the business of providing water utility service to approximately 290 customers in its certificated area in portions of Navajo County, Arizona.

Purpose of the Requested Financing

The Company requests Commission authorization to borrow \$600,000 from the Water Infrastructure Finance Authority of Arizona ("WIFA") for the purpose of partially funding the construction and installation of a 500,000 gallon storage tank, a tie-line between the Silver Lake Estates and Bourdon Ranch Estates Systems and continuation of a meter replacement program. The cost of these improvements is estimated by the Company to total \$876,590.

Description of the Requested Financing

The Company anticipates a \$600,000 WIFA loan with a 20-year amortization at 6.30 percent. The WIFA loan requires encumbrance of Watco's assets as collateral.

Watco is currently placed sixth in WIFA's priority list for the drinking water revolving fund.¹

Financial Analysis

Staff's analysis is illustrated on Schedule PMC-1. Column [A] reflects Watco's historical financial information for the Rate Case Proceeding test year ended December 31, 2005. Column [B] presents financial information that modifies Column [A] to reflect Staff's adjust test year with present rates in the Rate Case Proceeding. Column [C] presents financial information that modifies Column [B] to reflect Staff recommended rates in the Rate Case Proceeding and issuance of a \$600,000 WIFA loan assuming a 20-year amortizing loan at 6.30 percent.

TIER and DSC

Times interest earned ratio ("TIER") represents the number of times earnings cover interest expense on short-term and long-term debt. A TIER greater than 1.0 means that operating income is greater than interest expense. A TIER less than 1.0 is not sustainable in the long-term but does not mean that debt obligations cannot be met in the short-term.

Debt service coverage ratio ("DSC") represents the number of times internally generated cash will cover required principal and interest payments on short-term and long-term debt. A DSC greater than 1.0 indicates that cash flow from operations is sufficient to cover debt obligations. A DSC less than 1.0 means that debt service obligations cannot be met by cash generated from operations and that another source of funds is needed to avoid default.

Schedule PMC-1, Column [C] shows that under the scenario described above for Column [C] Watco would have a 1.40 TIER and a 1.29 DSC if Staff's recommended rates are adopted in the Rate Case Proceeding. The DSC results show that Watco would be able to meet all obligations with cash generated from operations.

Capital Structure

At December 31, 2005, Watco's capital structure consisted of 0.0 percent short-term debt, 0.0 percent long-term debt, and 100.0 percent equity (Schedule PMC-1, Column [A]). Issuance of the requested \$600,000 WIFA loan results in a pro forma capital structure composed of 2.2 percent short-term debt, 81.2 percent long-term debt and 16.7 percent equity (Schedule PMC-1, Column [C]).

¹ Response to Staff's second set of data requests, Attachment A.

As evident in Column [C], inclusion of the requested WIFA loan results in an overly leveraged financial position. However, there is no other known option to finance the proposed capital improvements.

Engineering Analysis

Staff Engineering Report is attached. Staff reviewed the material cost estimate of the proposed improvements. Staff concludes that the proposed improvements and estimated costs appear to be reasonable and appropriate. Staff makes no “used and useful” determination in this proceeding, and no conclusions should be inferred for rate-making or rate base purposes.

Compliance

There are no compliance issues with Watco, Inc.

Conclusion and Recommendations

Staff concludes that issuance of the proposed debt financing for the purposes stated in the application is within Watco’s corporate powers and would be compatible with the public interest, consistent with sound financial practices and would not impair its ability to provide services if Staff’s recommended rates are adopted in the Rate Case Proceeding.

Staff recommends that the Commission authorize Watco’s request to borrow an amount not to exceed \$600,000 in new funds from WIFA for the purposes described herein subject to the condition that the rates adopted in the Company’s permanent rate case proceeding provide debt service coverage comparable with Staff’s pro forma DSC calculations using Staff’s recommended rates.

Staff further recommends that the Commission authorize Watco to encumber its assets in connection with the WIFA loan.

Staff further recommends that one copy of the executed loan documents be filed with Docket Control within 60 days of execution.

FINANCIAL ANALYSIS

Select Financial Information

	[A] <u>12/31/2005</u>		[B] <u>2005 Pro Forma</u>		[C] <u>Pro Forma</u>	
1 Operating Income	\$ (20,026)		\$ 2,383		\$ 52,163	
2 Depreciation & Amortization	17,174		15,790		15,790	
3 Income Tax Expense	-		-		-	
4						
5 Interest Expense	-		-		37,358	
6 Repayment of Principal	-		-		15,479	
7						
8						
9 TIER						
10 [1+3] ÷ [5]	N/M *		N/M		1.40	
11 DSC						
12 [1+2+3] ÷ [5+6]	N/M		N/M		1.29	
13						
14						
15						
16						
17						
18 Short-term Debt	\$ -	0.0%	\$ -	0.0%	\$ 15,479	2.2%
19						
20 Long-term Debt	-	0.0%	-	0.0%	584,521	81.2%
21						
22 Common Equity	119,876	100.0%	119,876	100.0%	119,876	16.7%
23						
24 Total Capital	\$ 119,876	100.0%	\$ 119,876	100.0%	\$ 719,876	100.0%
25						
26						

27 * N/M: Not Meaningful

28 Column [A]: Test year ended December 31, 2005, as provided by the Company under Docket No. 06-0550.

29 Column [B]: Staff adjusted present rates (Schedule CSB-1 under Docket No. 06-0550).

30 Column [C]: Staff recommended rates (Schedule CSB-1 under Docket No. 06-0550). Includes a \$600,000 WIFA loan assuming
31 20-year amortization at 6.30 percent.

PRINTERS

PUBLISHERS

INVOICE

White Mountain Publishing Co.

White Mountain Independent • Wampum Saver • Mountain Skies • White Mountain Realty Guide
 Offices in Show Low, Springerville and St. Johns
 P.O. Box 1570 • Show Low, Arizona 85902 • (928) 537-5721

(Please Include Account Number on Payment)

WATCO, INC.
 P.O. Box 1270
 Show Low, AZ 85902
 Attn: Thomas

ACCOUNT # [REDACTED]
 LEGAL # 8152
 Date: MAY 9, 2006
 Last Run Date: May 5, 2006

Equipment to do Fine Printing – Craftsmen who do it

Serving Navajo and Apache Counties

QUANTITY	DESCRIPTION	PRICE
Re:Public Notice - Application for an Order...Issuance of WIFA		
1 run @ 4"	Legal Publication @ \$ 7.61 per inch	\$ 30.44
	Tax	.61
	Total	\$ 31.05

Thank you for ordering this legal advertising inserted in The White Mountain Independent.
 Affidavits of publication will be sent upon receipt of your remittance.

Date Invoice Mailed 5/9
 Date Affidavits* Mailed 6-13

PAID
 CK. NO. 3197
 DATE 6-2-06

*There will be a \$20 charge (for 2) additional or replacement affidavits

State of Arizona)
)
County of Navajo)

ss.

Affidavit of Publication

White Mountain Independent

PUBLIC NOTICE
OF
AN APPLICATION FOR AN ORDER
AUTHORIZING THE ISSUANCE OF WIFA (security)
BY Watco Inc. (Company)
Watco Inc. (Company) filed an Application with the Arizona Corporation Commission (Commission) for an order authorizing Applicant to issue \$600,000.00 (gross proceeds) of WIFA (security) to be issued. The application is available for inspection during regular business hours at the office of the Commission in Phoenix, Arizona, and the Company's offices in Show Low, Arizona. Intervention in the Commission's proceeding on the application shall be permitted to any person entitled by law to intervene and having a direct substantial interest in this matter. Persons desiring to intervene must file a Motion to Intervene with the Commission which must be served upon applicant and which, in its caption, shall contain the following information:

1. The name, address and telephone number of the proposed intervenor and of any person upon whom service of documents is to be made if different than the intervenor.
 2. A short statement of the proposed intervenor's interest in the proceeding.
 3. Whether the proposed intervenor desires a formal evidentiary hearing on the application and the reasons for such a hearing.
 4. A statement certifying that a copy of the Motion to Intervene has been mailed to Applicant.
- The granting of Motions to Intervene shall be governed by A.A.C. R14-3-105, except that all Motions to Intervene must be filed on or before the 15th day after this notice.

Published in the White Mountain Independent May 5, 2006
WMI 8152 N. 3x, 50505

I, Diane R. Janot, being first duly sworn, depose and say: I am the agent of the White Mountain Publishing Company, publisher of the White Mountain Independent, a semi-weekly newspaper of general circulation published at Show Low, County of Navajo, Arizona and that the copy hereto attached is a true copy of the advertisement as published in the White Mountain Independent on the following dates:

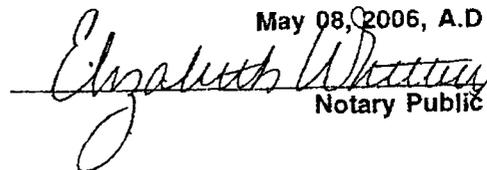
May 05, 2006

White Mountain Independent

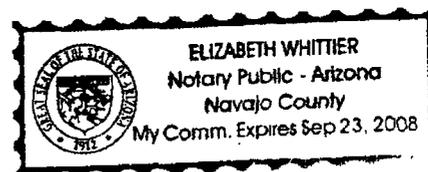


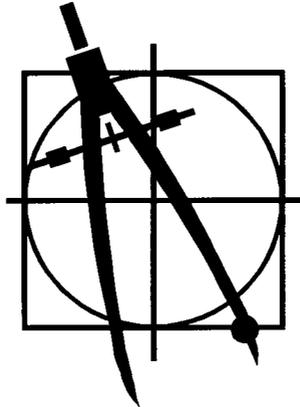
Sworn to me this day of

May 08, 2006, A.D.



Notary Public



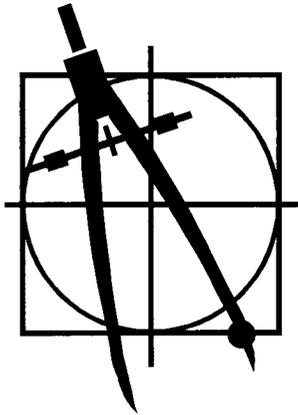


**Engineering Report
For
WATCO, Inc. ("Company")**

**Docket No. W-20475A-06-0357 (Financing)
Docket No. W-20475A-06-0550 (Rates)**

**By: Katrin Stukov
Utilities Engineer**

August 28, 2007



**Engineering Report
For
WATCO, Inc. ("Company")**

**Docket No. W-20475A-06-0357 (Financing)
Docket No. W-20475A-06-0550 (Rates)**

**By: Katrin Stukov
Utilities Engineer**

August 28, 2007

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CONCLUSIONS

1. The Silver Lake water system has water loss of 14.5% and the Bourdon Ranch water system has a water loss of 4.8%. If systems are considered as interconnected, the combined system would have a water loss of 13.5%.
2. The Silver Lake water system has adequate storage, but lacks adequate well capacity to serve the present customer base, and the Bourdon Ranch water system has adequate well and storage capacities to serve the present customer base and reasonable growth. If these two systems are interconnected, the combined system's production and storage capacity could adequately serve the existing customer base and reasonable level of growth.
3. Both the Company's water systems have arsenic concentration of less than 10 parts per billion and are currently meeting the new arsenic standard.
4. The Arizona Department of Environmental Quality ("ADEQ") has determined that both water systems are currently in full compliance with ADEQ requirements and delivering water that meets the water quality standards required by Arizona Administrative Code, Title 18, Chapter 4.
5. The Company is not located in an Active Management Area and therefore is not subject to Arizona Department of Water Resources ("ADWR") reporting and conservation requirements.
6. A check with the Utilities Division Compliance Section showed that there is one delinquency for the Company. As part of Decision No. 69391 the Commission ordered the following: That Watco file, by August 1, 2007, with the Commission's Docket Control, as a compliance in this docket, a copy of the ADEQ Approval to Construct ("ATC") or a letter that an ATC is not required from ADEQ for the interconnection of the Silver Lake and Bourdon Ranch systems.
7. The Company has a curtailment plan tariff that became effective on November 20, 2002, per Decision No.65416.
8. The Company has an approved backflow prevention tariff that became effective on January 27, 2003, per Decision No.65549.
9. A Financing Application for the proposed Phase 1 improvements and estimated costs appear to be reasonable and appropriate. However, approval of this Financing Application does not imply any particular future treatment for rate. No "used and useful" determination of the proposed plant was made, and no conclusions should be inferred for rate making or rate base purposes.

RECOMMENDATIONS

1. The Silver Lake water system has water loss of 14.5%. Staff recommends that the Company continue to monitor its system and, in compliance with Decision No.66175 dated August 13, 2003, annually report to the ACC the number of meters replaced and the water loss data including quantity of water pumped, gallons sold and water loss percentage for each month. The Company shall file its first report with Docket Control, as a compliance item in this docket, within six month of the effective date of the decision in this case. The Company shall reduce its water loss to 10% or less by December 31, 2009.
2. Staff recommends that any decision granting the new rates and charges in this proceeding should not become effective until the Company file with Docket Control, as a compliance item in this docket, a copy of the ADEQ Approval to Construct ("ATC") or a letter that an ATC is not required from ADEQ for the interconnection of the Silver Lake and Bourdon Ranch systems, as ordered in Decision No. 69391 dated March 22, 2007.
3. Staff recommends that in compliance with Decision No.69391 dated March 22, 2007, the Company file, by June 1, 2008, with Docket Control, as a compliance item in this docket, a copy of the ADEQ Approval of Construction ("AOC") for the interconnection of the Silver Lake and Bourdon Ranch systems.
4. Staff recommends its estimated annual water testing expense of \$1,821 be used for purposes of setting rates in this proceeding.
5. Staff recommends that the Company continue using depreciation rates by individual NARUC category as delineated in Exhibit 3.
6. The Company has proposed to reduce its 5/8 X 3/4 meter and service line installation charge to \$0.00. All other charges would remain the same. Staff separated service line and meter installation charges and recommends that charges listed in the right-hand column in Table 'C' be adopted (See Section K – Service Line and Meter Installation Charges for further discussion).
7. Staff recommends Commission approval of the Financing Application for Phase 1 improvements be conditional on the Company filing with Docket Control, as a compliance item in this docket, a copy of the ADEQ ATC for the proposed storage tank by June 1, 2008.

A. INTRODUCTION AND LOCATION OF COMPANY

On August 31, 2006 WATCO, Inc. ("WATCO" or "Company") filed a rate application with the Arizona Corporation Commission ("ACC" or "Commission"). WATCO consists of two separate water systems: Silver Lake and Bourdon Ranch. The Company's CC&N covers an area roughly 3.1 square miles in size and is located about 6 miles northeast of Show Low. The Silver Lake

system serves approximately 258 customers in section 35, and the Bourdon Ranch system serves approximately 29 customers in section 25. The water systems are not currently interconnected. Exhibit 1 describes the certificated area of the water company within Navajo County.

B. DESCRIPTION OF THE WATER SYSTEMS

The plant facilities were visited on December 7, 2006, by Katrin Stukov in the accompaniment of Thomas Grapp, the Company's representative.

The two systems follow typical configurations found in small water systems. Each system consists of a well, which pumps into a storage tank, followed by booster pumps and a pressure tank. Exhibit 2 provides a process schematic for the water system.

Table 'A' below shows the plant facilities summary (as reported by the Company).

Table A. Well Data & Plant Summary

		Silver Lake	Bourdon Ranch
ADWR ID No.		55-603156	55-506606
Casing Size		8 inch	6 inch
Casing Depth		538 ft	440 feet
Pump Type		Submersible	Submersible
Pump Size		10 Hp	5 Hp,
Pump Yield		58 gallon per minute (GPM)	31 GPM
Storage		100,000 gallons	25,000 gallons
Booster Pumps		Four 2 HP, two in series	Two 2 HP
Pressure Tanks		One 10,000 gallons	One 3,000 gallons
Fire Hydrants (standard)		One	N/A
Structures		23'x 20' building	12'x 30' building
Other		Fencing	N/A
Distribution Mains			
Size (in inches)	Material	Length (in feet)	Length (in feet)
4	AC/PVC	33,872	-
6	PVC	4,286	4,480
Meters			
Size (in inches)		5/8 x 3/4	5/8 x 3/4
Quantity		258	29

C. ARSENIC

The U.S. Environmental Protection Agency has reduced the arsenic maximum contaminant level ("MCL") in drinking water from 50 parts per billion ("ppb") to 10 ppb.

The Company reported arsenic concentrations less than 1 ppb for the Silver Lake well and 2 ppb for the Bourdon Ranch well. Based on this data, both water systems are in compliance with the new arsenic MCL.

D. ADEQ COMPLIANCE

The ADEQ has determined that both water systems (the Bourdon Ranch Estates PWS # 09-027 & the Silver Lake PWS # 09-049) are in full compliance with ADEQ requirements and delivering water that meets water quality standards required by Arizona Administrative Code, Title 18, Chapter 4.

E. ACC COMPLIANCE

A check with the Utilities Division Compliance Section showed that there is one delinquency for the Company¹. As part of Decision No. 69391 the Commission ordered the following: that Watco file, by August 1, 2007, with the Commission's Docket Control, as a compliance in this docket, a copy of the ADEQ Approval to Construct ("ATC") or a letter that an ATC is not required from ADEQ for the interconnection of the Silver Lake and Bourdon Ranch systems.

On August 28, 2007 the Company has informed Staff that its Engineer is preparing a filing with ADEQ to obtain the ATC it needs to comply with Decision No. 69391. Staff believes that the Company should have taken action sooner to obtain the ATC from ADEQ.

F. ADWR COMPLIANCE

The Company is not within an Active Management Area, and consequently is not subject to ADWR reporting and conservation requirements.

G. WATER TESTING EXPENSE

The Company is subject to mandatory participation in the Monitoring Assistance Program ("MAP"). Participation in the MAP program is mandatory for water systems, which serve less than 10,000 persons (approximately 3,300 service connections).

For the Test Year ended December 31, 2005, the Company reported its water testing expense at \$302 for both systems (excluding \$1,223 in MAP fees). Staff has estimated testing expense at \$1,821 total for both systems including \$1,223 in MAP fees (\$1,222 for the Silver Lake system and \$599 for the Bourbon Ranch system).

¹ Per ACC Compliance status check dated August 28, 2007.

Table 'B' below shows Staff's annual monitoring expense estimate for each system with participation in the MAP.

Table B. Water Testing Cost

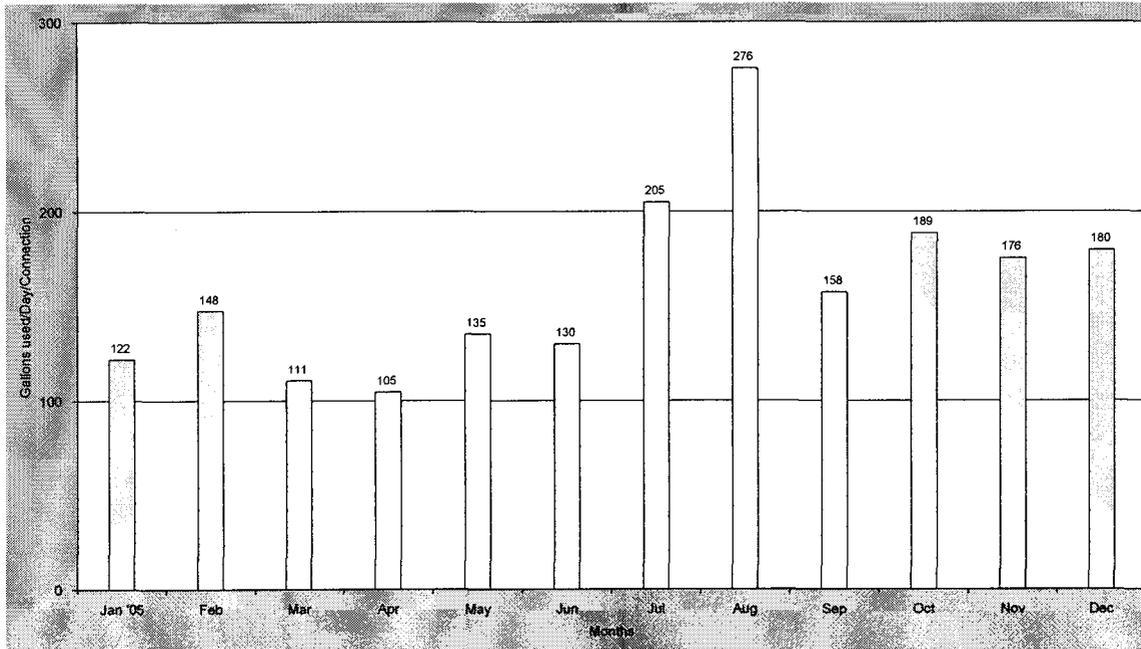
Monitoring	Cost per test	No. of tests per year for each system	Silver Lake Annual Cost	Bourdon Ranch Annual Cost
Total coliform – monthly	\$17	12	\$204	\$204
Inorganics – Priority Pollutants	MAP	MAP	MAP	MAP
Radiochemical – per 4 years	MAP	MAP	MAP	MAP
Phase II and V:				
Nitrate – annual	\$20	1	\$20	\$20
Nitrite – once per period	MAP	MAP	MAP	MAP
Asbestos – per 9 years	MAP	MAP	MAP	MAP
MAP – IOCs, SOCs, & VOCs	MAP	MAP	*\$898	*\$325
Lead & Copper – per 3 years	\$30	10/3- yrs & 5/3-yrs.	\$100	\$50
Total			\$1,222	\$599

*Note: ADEQ - MAP invoices for the 2006 Calendar Year are \$898 & \$325.

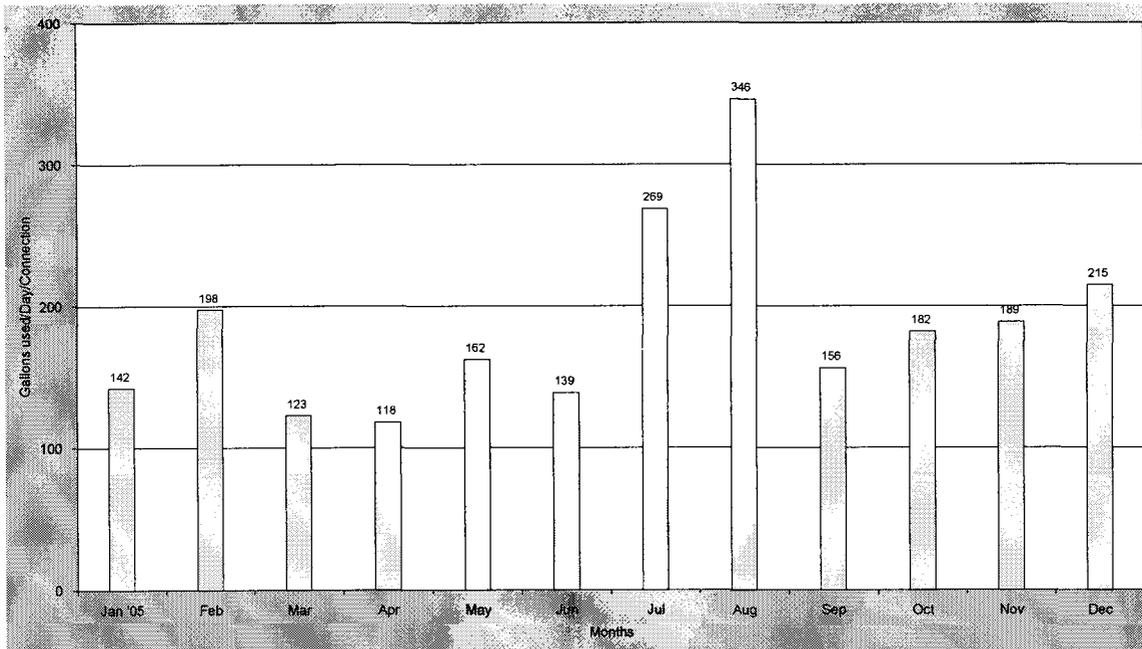
H. WATER USE

Water Sold

Based on the information provided by the Company, water use for the year 2005 is presented below. For Silver Lake, the high water use was 276 gallons per day (“GPD”) per connection in August, and the low water use was 105 GPD per connection in April. The average annual use was 161 GPD per connection. For Bourdon Ranch, the high water use was 346 GPD per connection in August, and the low water use was 118 GPD per connection in April. The average annual use was 187 GPD per connection.



Silver Lake Water Use



Bourdon Ranch Water Use

Non-account Water

Non-account water should be 10% or less. It is important to be able to reconcile the difference between water sold and the water produced by the source. A water balance will allow a water company to identify water and revenue losses due to leakage, theft, and flushing. Non-account water for the Company was calculated to be 14.5% at Silver Lake and 4.8% at Bourdon Ranch during 2005. If systems are considered as interconnected, the combined system would have a water loss of 13.5%.

The Company believes that much of the water loss at the Silver Lake is attributable to aging water meters and approximately 60 feet of water line that contained three leaks. According to the Company, this water line was replaced in February of 2006. The Company plans continuation of an ongoing water meter replacement program.²

Staff recommends that the Company continue to monitor its system and, in compliance with Decision No.66175 dated August 13, 2003, annually report to the Commission the number of meters replaced and the annual water loss data including quantity of water pumped, gallons sold and water loss percentage for each month. The water loss reports shall continue until the water loss is less than 10%. The Company shall reduce its water loss to 10% or less by December 31, 2009.

Existing Systems Analysis

1. Bourdon Ranch System.

The system's current well capacity of 31 GPM and storage capacity of 25,000 gallons could adequately serve approximately 43 connections. Staff concludes that the existing system has adequate production and storage capacity to serve the existing 29 connections.

2. Silver Lakes System

The system's current well capacity of 58 GPM and storage capacity of 100,000 gallons could adequately serve approximately 242 connections. Staff concludes that this system has adequate storage but lacks adequate well production capacity to serve the existing 258 connections.

3. Proposed interconnection of the two systems³.

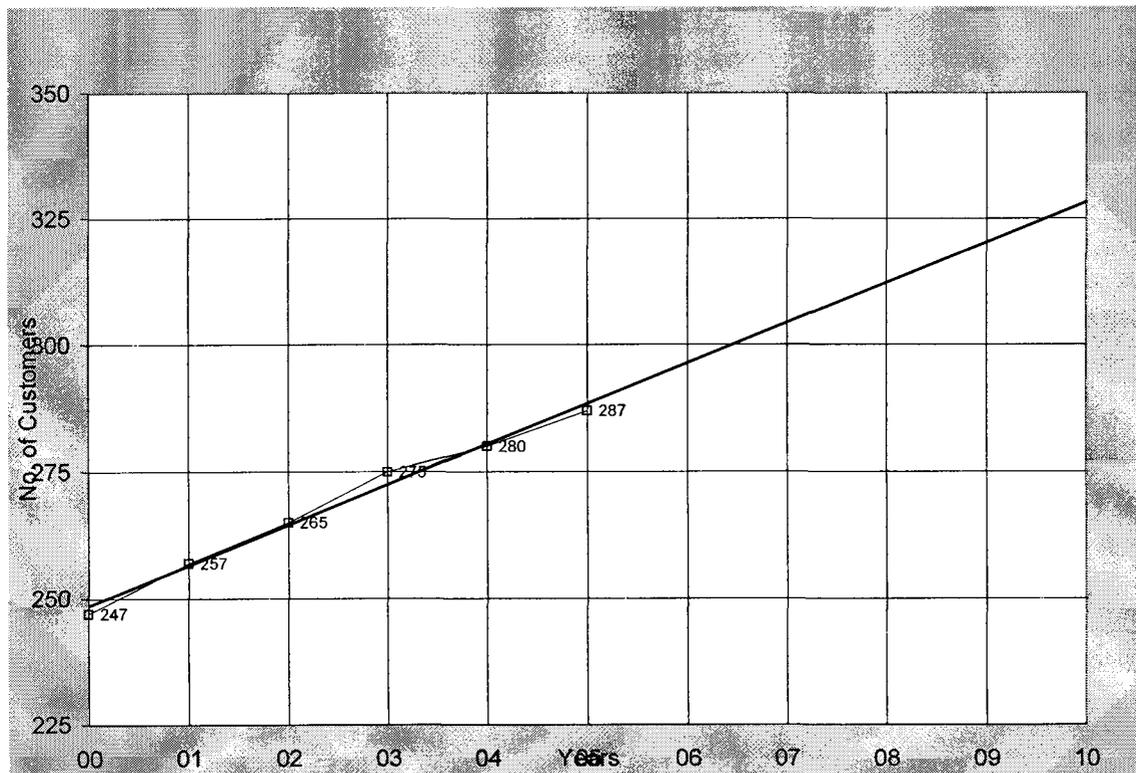
The Company is in process of obtaining a loan to finance the construction of the interconnection of the Silver Lake and Bourdon Ranch systems, in compliance with Decision No.68657 dated April 12, 2006. Staff concludes that if these two systems are interconnected, the combined system's production and storage capacity could adequately serve the existing customer base and a reasonable level of growth.

² See Section 'L' (Financing) in this report for more details.

³ See Sections 'E' (ACC Compliance) and 'L' (Financing) in this report for more details.

I. GROWTH

Based on customer data obtained from the Company's Annual Reports, it is projected that the Company could have over 330 customers by 2010. The figure below depicts actual growth from 2000 to 2005 and projects an estimated growth for the next five years using linear regression analysis.



J. DEPRECIATION RATES

The Company has been using Staff's recommended depreciation rates per National Association of Regulatory Utility Commissioners ("NARUC") plant category. These rates are presented in Exhibit 3 and it is recommended that the Company continue using these depreciation rates by individual NARUC category.

K. OTHER ISSUES

1. Service Line and Meter Installation Charges

The Company has proposed to reduce its 5/8 x 3/4 meter and service line installation charge to \$0.00. All other charges would remain the same. The Company has told Staff that it would prefer not to charge for the 5/8 meter because the administrative cost of refunding outweighs any

benefit especially for the standard meter. The Company's existing charges for the larger size meters are substantially below what is typically charged but the Company believes the amounts will be sufficient to cover material costs and the Company will provide the labor. These charges are refundable advances. The Company would like to keep yearly refunds to a minimum which it believes will create less of a financial burden for it. Staff separated service line and meter charges and recommends that charges listed below in the right-hand column in Table 'C' be adopted.

Table C. Service Line and Meter Installation Charges

Meter Size	Company Current Charges	Company Proposed Charges	Staff's Recommendations		
			Service Line Charge	Meter Charge	Total Charge
5/8 x 3/4-inch	\$290	\$0	\$0	\$0	\$0
3/4-inch	\$320	\$320	\$220	\$100	\$320
1-inch	\$370	\$370	\$245	\$125	\$370
1-1/2-inch	\$545	\$545	\$275	\$270	\$545
2-inch	\$750	\$750	\$300	\$450	\$750
3-inch	\$980	\$980	\$340	\$640	\$980
4-inch	\$1,820	\$1,820	\$600	\$1,220	\$1,820
6-inch	\$3,920	\$3,920	\$1,060	\$2,860	\$3,920

2. Curtailment Plan Tariff

The Company has an approved curtailment tariff that became effective on November 20, 2002, per Decision No.65416.

3. Backflow Prevention Tariff

The Company has an approved backflow prevention tariff that became effective on January 27, 2003, per Decision No.65549.

L. FINANCING

On May 30, 2006, WATCO filed a financing application with ACC. As part of this financing application, the Company submitted a Design Report ("the Report") prepared by Mark Fleetwood, professional engineer. The Report outlined the proposed improvements which include the interconnection of the Silver Lake and Bourdon Ranch systems, the completion of a water meter replacement program, the replacement of an old 100,000 gallon storage tank which is in need of major repairs and the addition of fire protection capacities. The addition of fire protection will require installation of a larger storage tank (located on a high point near both subdivisions), a water line connecting the new tank to existing distribution system (a tie line), fire hydrants and upgrades to the

existing distribution system. The Report, also, indicates that in the future, if the existing wells cannot produce required flows, another well will need to be drilled.

Sizing of the proposed storage tank

The ADEQ drinking water rules require at least one day's storage based on the average daily demand during the peak month of the year. The Company indicated that extra storage will provide sufficient time to respond should a major outage occur (such as, a well pump replacement, which has typically taken 2-3 days). The Company proposed to install a 500,000 gallon storage tank. This will provide sufficient storage capacity for a pump outage and fire flow capacity.

Phasing of construction

The Company is planning to construct the proposed improvements in the following two phases:

Phase 1 (proposed) will include permanent interconnection of the Silver Lake and Bourdon Ranch water systems, installation of a 500,000 gallons storage and tie line, and completion of a meter replacement program.

Phase 2 (future) will include an upgrade of water distribution lines and installation of fire hydrants to facilitate fire flow throughout the Company's service area.

Cost Associated with Phase 1

The Company's financing application is requesting approval for a Water Infrastructure Finance Authority ("WIFA") loan in the amount of \$600,000. This WIFA loan will be supplemented with In-House funds to cover the estimated cost of the proposed Phase 1 improvements which will total \$876,590. Staff concludes that the proposed Phase 1 improvements and estimated costs appear to be reasonable and appropriate. However, approval of this Financing Application does not imply any particular future treatment for rate base. No "used and useful" determination of the proposed plant was made, and no conclusions should be inferred for rate making or rate base purposes.

EXHIBIT 1

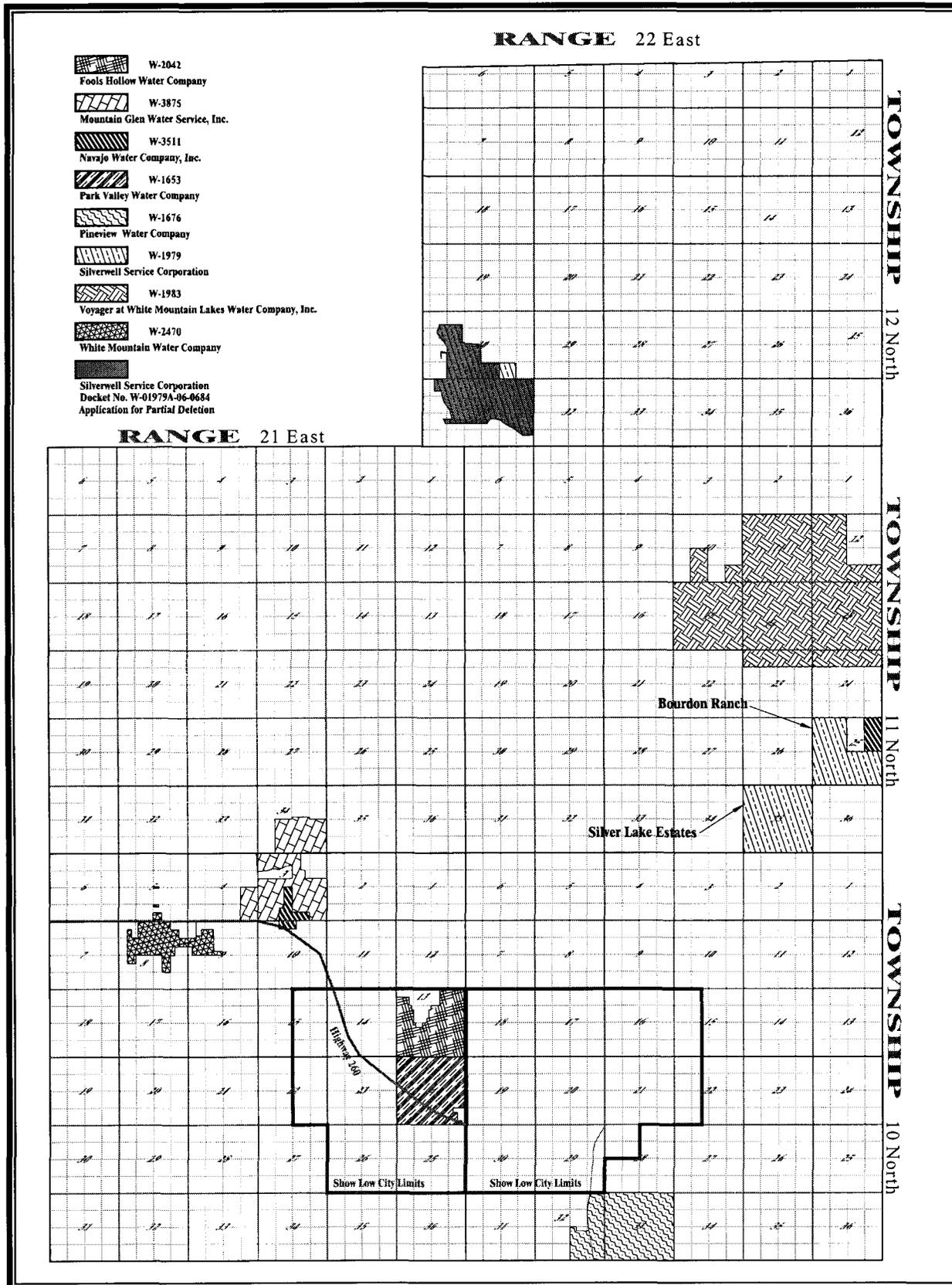
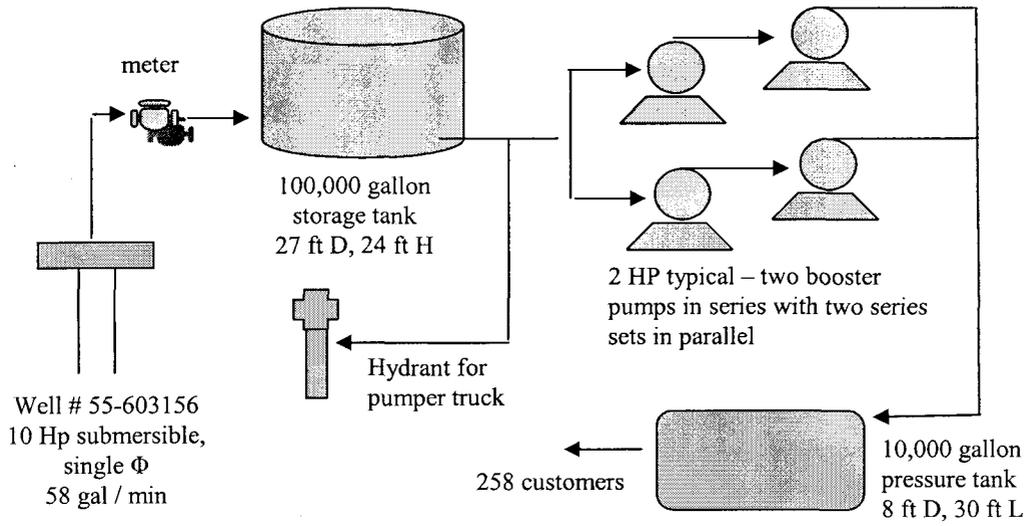
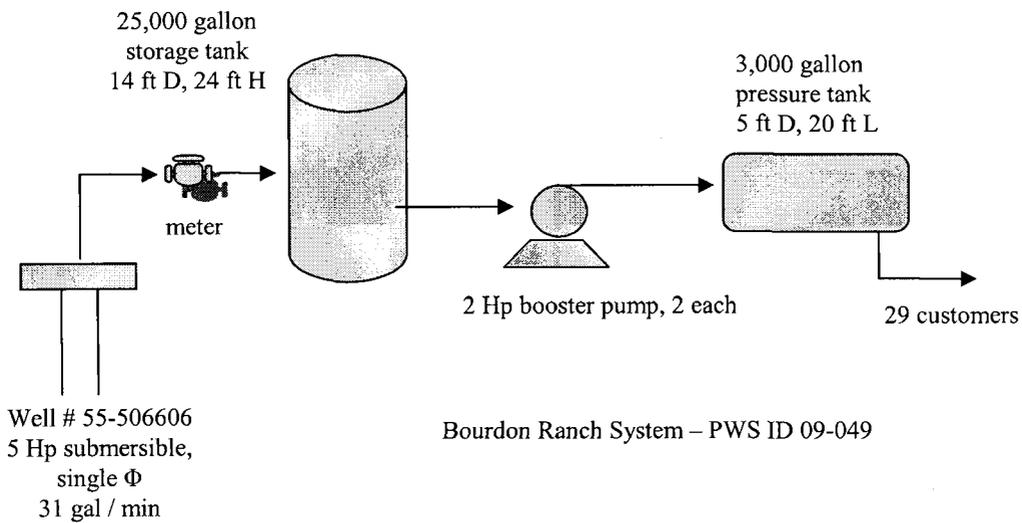


EXHIBIT 2

WATCO, Inc.
Process Schematics



Silver Lake Estates System – PWS ID 09-027



Bourdon Ranch System – PWS ID 09-049

EXHIBIT 3
TYPICAL DEPRECIATION RATES FOR WATER COMPANIES

NARUC Account No.	Depreciable Plant	Average Service Life (Years)	Annual Accrual Rate (%)
304	Structures & Improvements	30	3.33
305	Collecting & Impounding Reservoirs	40	2.50
306	Lake, River, Canal Intakes	40	2.50
307	Wells & Springs	30	3.33
308	Infiltration Galleries	15	6.67
309	Raw Water Supply Mains	50	2.00
310	Power Generation Equipment	20	5.00
311	Pumping Equipment	8	12.5
320	Water Treatment Equipment		
320.1	Water Treatment Plants	30	3.33
320.2	Solution Chemical Feeders	5	20.0
330	Distribution Reservoirs & Standpipes		
330.1	Storage Tanks	45	2.22
330.2	Pressure Tanks	20	5.00
331	Transmission & Distribution Mains	50	2.00
333	Services	30	3.33
334	Meters	12	8.33
335	Hydrants	50	2.00
336	Backflow Prevention Devices	15	6.67
339	Other Plant & Misc Equipment	15	6.67
340	Office Furniture & Equipment	15	6.67
340.1	Computers & Software	5	20.00
341	Transportation Equipment	5	20.00
342	Stores Equipment	25	4.00
343	Tools, Shop & Garage Equipment	20	5.00
344	Laboratory Equipment	10	10.00
345	Power Operated Equipment	20	5.00
346	Communication Equipment	10	10.00
347	Miscellaneous Equipment	10	10.00
348	Other Tangible Plant	----	----

NOTES:

- These depreciation rates represent average expected rates. Water companies may experience different rates due to variations in construction, environment, or the physical and chemical characteristics of the water.
- Acct. 348, Other Tangible Plant may vary from 5% to 50%. The depreciation rate would be set in accordance with the specific capital items in this account.