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BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONERS

BOB STUMP- CHAIRMAN  
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BRENDA BURNS  
BOB BURNS  
SUSAN BITTER SMITH

IN THE MATTER OF THE APPLICATION OF  
VALLEY UTILITIES WATER COMPANY,  
INC., AN ARIZONA CORPORATION, FOR A  
DETERMINATION OF THE FAIR VALUE OF  
ITS UTILITY PLANT AND PROPERTY AND  
FOR AN INCREASE IN ITS RATES AND  
CHARGES FOR UTILITY SERVICE BASED  
THEREON.

DOCKET NO. W-01412A-12-0195

**STAFF'S NOTICE OF FILING  
SURREBUTTAL TESTIMONY**

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby files Surrebuttal Testimonies of John Cassidy and Marlin Scott, Jr. in the above-referenced docket. Staff will be filing the Surrebuttal Testimony of Brendan Aladi on February 11, 2013. Staff has conferred with the counsel for Valley Utilities Water Company, Inc. ("Company"), and the Company has no objection to this modification. The Company will in turn file Rejoinder Testimony on February 20, 2013.

RESPECTFULLY SUBMITTED this 8<sup>th</sup> day of February, 2013.

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Arizona Corporation Commission  
1200 West Washington Street  
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**Original and thirteen (13) copies of  
the foregoing filed this 8<sup>th</sup> day of  
February, 2013, with:**

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

1 **Copy of the foregoing mailed this**  
2 **8<sup>th</sup> day of February, 2013, to:**

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**BEFORE THE ARIZONA CORPORATION COMMISSION**

**BOB STUMP**  
Chairman  
**GARY PIERCE**  
Commissioner  
**BRENDA BURNS**  
Commissioner  
**BOB BURNS**  
Commissioner  
**SUSAN BITTER SMITH**  
Commissioner

IN THE MATTER OF THE APPLICATION ) DOCKET NO. W-01412A-12-0195  
OF VALLEY UTILITIES WATER )  
COMPANY, INC., AN ARIZONA )  
CORPORATION, FOR A DETERMINATION )  
OF THE FAIR VALUE OF ITS UTILITY )  
PLANT AND PROPERTY AND FOR AN )  
INCREASE IN ITS RATES AND CHARGES )  
FOR UTILITY SERVICE BASED THEREON. )

**SURREBUTTAL**

**TESTIMONY**

**OF**

**JOHN A. CASSIDY**

**PUBLIC UTILITIES ANALYST**

**UTILITIES DIVISION**

**ARIZONA CORPORATION COMMISSION**

**FEBRUARY 8, 2013**

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**EXECUTIVE SUMMARY  
VALLEY UTILITIES WATER COMPANY, INC.  
DOCKET NO. W-01412A-12-0195**

The Surrebuttal Testimony of Staff witness John A. Cassidy addresses the following issues:

Capital Structure – Staff recommends that the Commission adopt a capital structure for Valley Utilities Company (“Company”) for this proceeding consisting of 87.1 percent debt and 12.9 percent equity.

Cost of Equity – Staff recommends that the Commission adopt a 9.1 percent return on equity (“ROE”) for the Company. Staff’s estimated ROE for the Company is based on the average of its discounted cash flow method (“DCF”) and capital asset pricing model (“CAPM”) cost of equity methodology estimates for the sample companies of 8.2 percent for the CAPM and 8.8 percent for DCF. Staff’s recommended ROE includes an upward economic assessment adjustment of 60 basis points.

Cost of Debt – Staff recommends that the Commission adopt a 5.8 percent cost of debt for the Company.

Overall Rate of Return – Staff recommends that the Commission adopt a 6.5 percent overall rate of return. Staff’s recommended overall rate of return includes a 30 basis point upward rate of return adjustment.

Mr. Jones’ Rebuttal Testimony – The Staff-recommended 6.5 percent overall rate of return is equal to the 6.5 percent (rounded to a single decimal point) rate of return proposed by the Company; however, the Commission should reject the Company’s proposed 11.0 percent ROE for the following reasons:

Mr. Jones’ proposed cost of equity continues to be unsupported by any formal market based cost of equity estimation analysis, and inappropriately includes a significant risk premium intended to compensate the Company for a deteriorating financial condition, negative cash flow and a highly leveraged capital structure.

1 **I. INTRODUCTION**

2 **Q. Please state your name, occupation, and business address.**

3 A. My name is John A. Cassidy. I am a Public Utilities Analyst employed by the Arizona  
4 Corporation Commission (“Commission”) in the Utilities Division (“Staff”). My business  
5 address is 1200 West Washington Street, Phoenix, Arizona 85007.

6  
7 **Q. Are you the same John A. Cassidy who filed direct testimony in this case?**

8 A. Yes, I am.

9  
10 **Q. What is the purpose of your surrebuttal testimony in this rate proceeding?**

11 A. The purpose of my Surrebuttal testimony is to report on Staff’s updated cost of capital  
12 analysis with its recommendations regarding Valley Utilities Water Company’s (“VUWC”  
13 or “Company”) cost of capital, and to respond to the cost of capital rebuttal testimony of  
14 Company witness, Ray L. Jones (“Mr. Jones’ Rebuttal”).

15  
16 **Q. Please explain how Staff’s surrebuttal testimony is organized.**

17 A. Staff’s Surrebuttal testimony is presented in four sections. Section I is this introduction.  
18 Section II discusses Staff’s updated cost of capital analysis. Section III presents Staff’s  
19 comments on the rebuttal testimony of the Company’s cost of capital witness, Mr. Jones.  
20 Lastly, Section IV presents Staff’s recommendations.

21  
22 **II. COST OF EQUITY AND OVERALL RATE OF RETURN**

23 **Q. Is Staff recommending a different capital structure for VUWC in its surrebuttal  
24 testimony than it did in direct testimony?**

25 A. No. Staff continues to recommend a capital structure consisting of 87.1 percent debt and  
26 12.9 percent common equity.

1 **Q. Has Staff updated its analysis concerning the Company's cost of equity ("COE")**  
2 **since filing direct testimony in this proceeding?**

3 A. Yes. Staff updated its analysis to include more recent market data.  
4

5 **Q. What is Staff's updated estimate for the COE?**

6 A. Staff's updated estimate for the COE is 8.5 percent. This figure is derived from cost of  
7 equity estimates which range from 8.8 percent for the discounted cash flow ("DCF")  
8 method to 8.2 percent for the capital asset pricing model ("CAPM") estimation  
9 methodologies, as shown in Surrebuttal Schedule JAC-3. In direct testimony, Staff's  
10 preliminary COE estimate was 8.8 percent.  
11

12 **Q. In its surrebuttal testimony, does Staff continue to recommend the 60 basis point (0.6**  
13 **percent) upward economic assessment adjustment to VUWC's cost of equity that it**  
14 **recommended in its direct testimony?**

15 A. Yes.  
16

17 **Q. Did Staff give consideration to allowing the Company an upward financial risk**  
18 **adjustment as part of its cost of equity recommendation?**

19 A. Yes. However, for the reasons stated in Staff's direct testimony, Staff does not consider  
20 such an adjustment to COE to be warranted. Instead, Staff elects to make an upward  
21 adjustment to the Company's overall rate of return, as explained below.  
22

23 **Q. What COE is Staff recommending for VUWC?**

24 A. Staff recommends a 9.1 percent COE. This figure represents Staff's updated 8.5 percent  
25 COE, derived from updated cost of equity estimates ranging from 8.8 percent for the  
26 discounted cash flow ("DCF") method to 8.2 percent for the capital asset pricing model

1 (“CAPM”) estimation methodologies, and includes Staff’s 60 basis point economic  
2 assessment adjustment.

3  
4 **Q. Did Staff update its analysis concerning the Company’s overall rate of return?**

5 A. Yes, the updated analysis is supported by Surrebuttal Schedules JAC-1 to JAC-9.

6  
7 **Q. Does Staff’s updated cost of equity analysis result in a change to Staff’s weighted  
8 average cost of capital?**

9 A. No. Based upon its updated cost of equity analysis, Staff’s weighted average cost of  
10 capital remains at 6.2 percent, the same overall rate of return recommended by Staff in  
11 Direct testimony. However, as noted above, Staff elects to make an upward adjustment to  
12 the Company’s overall rate of return.

13  
14 **Q. What upward adjustment is Staff recommending for VUWC’s overall rate of return?**

15 A. Staff recommends a 30 basis point upward adjustment to the weighted average cost of  
16 capital resulting in a 6.5 percent overall rate of return.

17  
18 **Q. What is Staff’s updated overall rate of return?**

19 A. Staff’s updated overall rate of return is 6.5 percent. As shown in Surrebuttal Schedule  
20 JAC-1, Staff made a 30 basis point upward adjustment to the 6.2 percent weighted average  
21 cost of capital resulting from its model resulting in an updated overall rate of return of 6.5  
22 percent. Staff’s updated overall rate of return is equal to the 6.5 percent<sup>1</sup> overall rate of  
23 return requested by the Company.

24  

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<sup>1</sup> The Company’s rebuttal actually proposes a 6.45 percent overall rate of return. Staff normally rounds the rate of return to one decimal point.

1 **Q. What overall rate of return is Staff recommending for VUWC?**

2 A. Staff recommends a 6.5 percent overall rate of return. Staff's recommendation is based on  
3 a COE of 9.1 percent, a cost of debt of 5.8 percent, a 30 basis point upward rate of return  
4 adjustment, and a capital structure consisting of 87.1 percent debt and 12.9 percent  
5 common equity, as shown in Surrebuttal Schedule JAC-1.

6  
7 **III. STAFF RESPONSE TO COMPANY'S COST OF CAPITAL WITNESS MR. RAY**  
8 **L. JONES**

9 **Q. What is Staff's response to the Company's cost of capital witness?**

10 A. Although VUWC needs to continue improving its equity position, Staff agrees with Mr.  
11 Jones' overall assessment that the Company's gain in equity since the prior rate case is  
12 significant and shows a commitment to comply with the Commission's directive in  
13 Decision No. 71482<sup>2</sup> to continue improving its equity position. Accordingly, Staff  
14 recommends a 30 basis point upward adjustment to the weighted average cost of capital.  
15 Adding 30 basis points to Staff's 6.2 percent weighted average cost of capital results in a  
16 6.5 percent overall rate of return which is the same overall rate of return requested by the  
17 Company. Mathematically, the same overall rate of return resulting from a 30 basis point  
18 upward adjustment to the weighted average cost of equity could be achieved by increasing  
19 the COE by an even greater amount. However, Staff recommends the former in order to  
20 avoid adoption of a specific COE that could be viewed as being unpalatable to ratepayers  
21 and to the general public if taken out of the context of a full understanding of financial  
22 concepts and the actual facts and circumstances in this case.

23  

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<sup>2</sup> Page 35, Finding of Fact No. 93.

1 **IV. STAFF RECOMMENDATIONS**

2 **Q. What are Staff's recommendations for VUWC's cost of capital?**

3 A. Staff recommends the following for VUWC's cost of capital:

4 1. A capital structure of 87.1 percent debt and 12.9 percent equity.

5 2. A 5.8 percent cost of debt.

6 3. A 9.1 percent cost of equity.

7 4. A 6.2 percent weighted average cost of capital.

8 5. A 30 basis point upward adjustment to the weighted average cost of capital resulting in  
9 a 6.5 percent overall rate of return.

10

11 **Q. Does this conclude your Surrebuttal testimony?**

12 A. Yes, it does.

**Valley Utilities Cost of Capital Calculation  
Capital Structure  
And Weighted Average Cost of Capital  
Staff Recommended and Company Proposed**

[A]	[B]	[C]	[D]
<u>Description</u>	<u>Weight (%)</u>	<u>Cost</u>	<u>Weighted Cost</u>
Staff Recommended Structure			
Debt	87.1%	5.8%	5.0%
Common Equity	12.9%	9.1%	<u>1.2%</u>
Weighted Average Cost of Capital			6.2%
Rate or Return Adjustment			<u>0.3%</u>
Recommend Overall Rate of Return			<b>6.5%</b>
Company Proposed Structure			
Debt	87.1%	5.8%	5.0%
Common Equity	12.9%	11.0%	<u>1.4%</u>
Weighted Average Cost of Capital			<b>6.5%</b>

[D] : [B] x [C]  
Supporting Schedules: JAC-3 and JAC-4.

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Valley Utilities Cost of Capital Calculation  
Average Capital Structure of Sample Water Utilities

[A]	[B]	[C]	[D]
<u>Company</u>	<u>Debt</u>	Common <u>Equity</u>	<u>Total</u>
American States Water	46.0%	54.0%	100.0%
California Water	53.3%	46.7%	100.0%
Aqua America	53.9%	46.1%	100.0%
Connecticut Water	57.1%	42.9%	100.0%
Middlesex Water	43.3%	56.7%	100.0%
SJW Corp	<u>55.7%</u>	<u>44.3%</u>	<u>100.0%</u>
Average Sample Water Utilities	<b>51.6%</b>	<b>48.4%</b>	<b>100.0%</b>
Valley - Actual Capital Structure	<b>87.1%</b>	<b>12.9%</b>	<b>100.0%</b>

Source:  
Sample Water Companies from Value Line

Valley Utilities Cost of Capital Calculation  
 Growth in Earnings and Dividends  
 Sample Water Utilities

[A] Company	[B] Dividends Per Share 2003 to 2012 <u>DPS<sup>1,2</sup></u>	[C] Dividends Per Share Projected <u>DPS<sup>1,3</sup></u>	[D] Earnings Per Share 2002 to 2011 <u>EPS<sup>1</sup></u>	[E] Earnings Per Share Projected <u>EPS<sup>1</sup></u>
American States Water	3.9%	5.9%	5.1%	4.7%
California Water	1.2%	3.4%	6.2%	8.6%
Aqua America	7.7%	4.5%	7.3%	5.6%
Connecticut Water	1.7%	3.5%	0.4%	9.1%
Middlesex Water	1.7%	1.9%	2.4%	8.3%
SJW Corp	<u>4.4%</u>	<u>3.0%</u>	<u>3.7%</u>	<u>5.5%</u>
Average Sample Water Utilities	<b>3.4%</b>	<b>3.7%</b>	<b>4.2%</b>	<b>7.0%</b>

1 Value Line

2 Value Line -- Ten-year historical dividend growth updated from 2003-2012 as it is known and measurable.

3 Value Line -- Projected DPS growth covers the four-year period, 2012-2016.

Valley Utilities Cost of Capital Calculation  
Sustainable Growth  
Sample Water Utilities

[A]	[B]	[C]	[D]	[E]	[F]
Company	Retention Growth 2002 to 2011 <u>br</u>	Retention Growth Projected <u>br</u>	Stock Financing Growth <u>vs</u>	Sustainable Growth 2002 to 2011 <u>br + vs</u>	Sustainable Growth Projected <u>br + vs</u>
American States Water	3.6%	5.3%	2.5%	6.1%	7.8%
California Water	2.2%	4.8%	2.2%	4.4%	7.0%
Aqua America	4.4%	5.2%	2.3%	6.7%	7.6%
Connecticut Water	2.2%	No Projection	1.0%	3.2%	No Projection
Middlesex Water	1.3%	3.3%	3.7%	5.0%	7.0%
SJW Corp	<u>3.7%</u>	<u>3.2%</u>	<u>0.1%</u>	<u>3.8%</u>	<u>3.3%</u>
Average Sample Water Utilities	<b>2.9%</b>	<b>4.4%</b>	<b>2.0%</b>	<b>4.9%</b>	<b>6.5%</b>

[B]: Value Line  
[C]: Value Line  
[D]: Value Line and MSN Money  
[E]: [B]+[D]  
[F]: [C]+[D]

Valley Utilities Cost of Capital Calculation  
 Selected Financial Data of Sample Water Utilities

[A]	[B]	[C]	[D]	[E]	[F]	[G]
Company	Symbol	Spot Price 1/23/2013	Book Value	Mkt To Book	Value Line Beta $\beta$	Raw Beta $\beta_{raw}$
American States Water	AWR	51.03	22.26	2.3	0.70	0.52
California Water	CWT	19.35	11.40	1.7	0.65	0.45
Aqua America	WTR	26.99	9.49	2.8	0.60	0.37
Connecticut Water	CTWS	29.76	13.67	2.2	0.75	0.60
Middlesex Water	MSEX	19.52	11.97	1.6	0.70	0.52
SJW Corp	SJW	26.77	15.36	1.7	0.85	0.75
Average				2.1	0.71	0.53

[C]: Men Money

[D]: Value Line

[E]: [C] / [D]

[F]: Value Line

[G]: (-0.35 + [F]) / 0.67

Valley Utilities Cost of Capital Calculation  
 Calculation of Expected Infinite Annual Growth in Dividends  
 Sample Water Utilities

[A]	[B]
<u>Description</u>	<u>g</u>
DPS Growth - Historical <sup>1</sup>	3.4%
DPS Growth - Projected <sup>1</sup>	3.7%
EPS Growth - Historical <sup>1</sup>	4.2%
EPS Growth - Projected <sup>1</sup>	7.0%
Sustainable Growth - Historical <sup>2</sup>	4.9%
<u>Sustainable Growth - Projected<sup>2</sup></u>	<u>6.5%</u>
Average	<b>5.0%</b>

<sup>1</sup> Schedule JAC-5

<sup>2</sup> Schedule JAC-6

Valley Utilities Cost of Capital Calculation  
Multi-Stage DCF Estimates  
Sample Water Utilities

[A] Company	[B] Current Mkt. Price (P <sub>0</sub> ) <sup>1</sup> 1/23/2013	[C] d <sub>1</sub>	[D] d <sub>2</sub>	[E] d <sub>3</sub>	[F] d <sub>4</sub>	[H] Stage 2 growth <sup>3</sup> (g <sub>n</sub> )	[I] Equity Cost Estimate (K) <sup>4</sup>
American States Water	51.0	1.31	1.37	1.44	1.51	6.5%	9.0%
California Water	19.4	0.66	0.69	0.73	0.76	6.5%	9.8%
Aqua America	27.0	0.67	0.70	0.74	0.77	6.5%	8.9%
Connecticut Water	29.8	0.98	1.03	1.08	1.14	6.5%	9.7%
Middlesex Water	19.5	0.75	0.79	0.83	0.87	6.5%	10.2%
SJW Corp	26.8	0.75	0.78	0.82	0.86	6.5%	9.2%

$$P_0 = \sum_{t=1}^n \frac{D_t}{(1+K)^t} + \frac{D_n(1+g_n)}{K-g_n} \left[ \frac{1}{(1+K)} \right]^n$$

Average **9.5%**

Where : P<sub>0</sub> = current stock price

D<sub>t</sub> = dividends expected during stage 1

K = cost of equity

n = years of non - constant growth

D<sub>n</sub> = dividend expected in year n

g<sub>n</sub> = constant rate of growth expected after year n

1 [B] see Schedule JAC-7

2 Derived from Value Line Information

3 Average annual growth in GDP 1929 - 2011 in current dollars.

4 Internal Rate of Return of Projected Dividends

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DOCKET NO. W-01412A-12-0195

**SURREBUTTAL**

**TESTIMONY**

**OF**

**MARLIN SCOTT, JR.**

**UTILITIES ENGINEER**

**UTILITIES DIVISION**

**ARIZONA CORPORATION COMMISSION**

**FEBRUARY 8, 2013**

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**SURREBUTTAL TESTIMONY  
VALLEY UTILITIES WATER COMPANY, INC.  
DOCKET NO. W-01412A-08-0586**

1. Staff still recommends the Post-Test Year – drainage improvement project not be included in this proceeding because this project was not completed in a timely manner.
2. Staff considers Well #4 not used and useful and recommends that Well #4 be removed from rate base for this case.

1 **I. INTRODUCTION**

2 **Q. Please state your name, place of employment and job title.**

3 A. My name is Marlin Scott, Jr. My place of employment is the Arizona Corporation  
4 Commission ("Commission"), Utilities Division, 1200 West Washington Street, Phoenix,  
5 Arizona 85007. My job title is Utilities Engineer.

6

7 **Q. Are you the same Marlin Scott, Jr. who submitted Direct Testimony on behalf of the**  
8 **Utilities Division?**

9 A. Yes.

10

11 **Q. What was the purpose of that testimony?**

12 A. My Direct Testimony provided the Utilities Division Staff's ("Staff") engineering  
13 evaluation of Valley Utilities Water Company, Inc. ("Company") for this proceeding.

14

15 **Q. What is the purpose of your Surrebuttal Testimony?**

16 A. To provide Staff's response to the Company's Rebuttal Testimony on the issue of Plant-  
17 in-Service Adjustments for one post-test year ("PTY") plant item and one not used &  
18 useful plant item.

19

20 **II. POST-TEST YEAR PLANT**

21 **Q. Have you reviewed the rebuttal testimony of Ray Jones regarding PTY plant?**

22 A. Yes.

23

24 **Q. What were Mr. Jones' comments regarding PTY plant?**

25 A. The Company submitted two PTY plant projects: 1) pump replacement on Well #6A and  
26 2) drainage improvement at the Bethany Hills Site. In its Direct Testimony, Staff

1 recommended a PTY plant adjustment for Well #6A and did not recommend a PTY plant  
2 adjustment for the drainage improvement. Mr. Jones stated that the Company did not  
3 agree with Staff's recommendation for the drainage improvement because the drainage  
4 project was completed in December 2012 at a cost of \$82,118 and therefore should be  
5 included in this proceeding.

6  
7 **Q. What is Staff's response?**

8 A. During Staff's field inspection on September 7, 2012, Staff noted that the construction of  
9 the drainage project had not commenced and therefore was not completed. On this same  
10 inspection date, Staff also informed the Company that if and when this drainage project is  
11 completed, the Company should contact Staff for a follow-up inspection of this drainage  
12 project. The Company never contacted Staff about the completion of this project.

13  
14 **Q. Based on the Company's rebuttal Testimony regarding the PTY plant, does Staff  
15 make any changes to its recommendation?**

16 A. No, Staff still recommends that this PTY – drainage improvement project not be included  
17 in this proceeding because this project was not completed and reported in a timely manner  
18 to make any PTY adjustment.

19  
20 **III. NOT USED AND USEFUL PLANT**

21 **Q. Have you reviewed the rebuttal testimony of Mr. Jones regarding not used and  
22 useful plant that needs to be retired?**

23 A. Yes.

1 **Q. What were Mr. Jones' comments regarding plant retirements?**

2 A. Staff made retirement adjustment amounts for Wells #2 and #4. For issues regarding Well  
3 #2, I will defer to Staff Witness Brendan Aladi. As for Well #4, Mr. Jones stated that the  
4 Company did not believe Well #4 should be retired because the well will be placed back  
5 into service during 2013.

6  
7 **Q. What is Staff's response?**

8 A. As stated in Staff's Direct Testimony, Well #4 was taken out-of-service in 2007 and was  
9 still out-of-service during Staff's field inspection on September 7, 2012, for a continuing  
10 duration reaching over five years. In addition, Staff also noted that in the prior rate case  
11 under Docket No. 08-0586, with a test year ending June 2008, this Well #4 was noted as  
12 being out-of-service for maintenance. For this reason, Staff recommended that this Well  
13 #4 be retired.

14  
15 **Q. Based on the Company's rebuttal Testimony regarding the retirement of Well #4,  
16 does Staff make any changes to its recommendation?**

17 A. Staff considers Well #4 not used and useful and recommends that Well #4 be removed  
18 from rate base for this case.

19  
20 **Q. Does this conclude your Surrebuttal Testimony?**

21 A. Yes, it does.