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BEFORE THE ARIZONA CORPORATION CC

COMMISSIONERS

BOB STUMP, CHAIRMAN  
GARY PIERCE  
BRENDA BURNS  
BOB BURNS  
SUSAN BITTER SMITH

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Arizona Corporation Commission  
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JUN 11 2013

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IN THE MATTER OF THE APPLICATION OF FAR WEST WATER AND SEWER, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS WASTEWATER RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE.

DOCKET NO. WS-03478A-12-0307

**STAFF'S INITIAL BRIEF**

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby submits its post-hearing brief in the above captioned matter.

**I. INTRODUCTION.**

On July 6, 2012, Far West Water & Sewer Company, Inc. ("Far West" or "Company") filed an application with the Commission to increase its rates for wastewater service. Far West is an Arizona public service corporation authorized to provide water and wastewater service within portions of Yuma County, Arizona. Far West was issued a Certificate of Convenience and Necessity ("CC&N") on April 8, 1998, in Decision No. 60799, which also authorized the transfer of the CC&N held by H&S Developers, Inc. dba Far West Water Company and Far West Sewer Company to Far West.<sup>1</sup> According to the Company, the sewer division currently serves approximately 7,067 residential waste water customers, 44 commercial waste water customers and 4 recreational vehicle parks.<sup>2</sup> Further, Far West's water division currently serves approximately 15,500 customers.<sup>3</sup>

The Company is proposing a rate increase of \$3,482,612 over the Company's adjusted test year revenues of \$2,231,115 for a total revenue requirement of \$5,713,727. This would result in an

<sup>1</sup> Jones Direct, Ex. A-1 at 3.

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

1 operating income of \$1,518,726 or a 7.4 percent rate of return on its original cost rate base of  
2 \$20,523,327.<sup>4</sup>

3 Staff recommends a rate increase of \$3,284,021 over the Staff's adjusted test year revenues of  
4 \$2,231,115 for a total revenue requirement of \$5,515,136.<sup>5</sup> This results in an operating income of  
5 \$1,422,238 or a 7.4 percent rate of return on its original cost rate base of \$19,219,435. The revenue  
6 requirement that Staff is recommending is \$198,591 less than what the Company is proposing.

7 As of the conclusion of the hearing in this matter, there were no income statement  
8 adjustments in dispute, three rate base adjustments in dispute, and agreement regarding rate design  
9 between the Company and Staff. The Company and Staff are also in agreement regarding the capital  
10 structure of the Company and the cost of capital. Further, Far West has agreed to certain but not all  
11 conditions prior to and subsequent to the implementation of the rates that are ultimately authorized in  
12 this matter.

13 **II. REVENUE REQUIREMENT.**

14 As indicated above, Staff recommends a total revenue requirement of \$5,515,136. This  
15 represents about a 147 percent increase over the Staff's adjusted test year revenues of \$2,231,115.  
16 Staff's recommendation results in a 7.4 percent rate of return.<sup>6</sup>

17 Far West proposes a total revenue requirement of \$5,713,727. This represents an increase of  
18 approximately 156 percent over adjusted test year revenues of \$2,231,115. This also would result in  
19 a 7.4 percent rate of return.<sup>7</sup>

20 Interestingly, RUCO is proposing a total revenue requirement of \$4,985,381. This represents  
21 an increase of approximately 123 percent over adjusted test year revenues of \$2,231,115. This would  
22 result in a 7.24 percent rate of return.<sup>8</sup>

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27 <sup>4</sup> Far West Final Schedule A-1.  
28 <sup>5</sup> Staff Final Schedules GWB-1.  
<sup>6</sup> *Id.*  
<sup>7</sup> Far West Final Schedules A-1.  
<sup>8</sup> RUCO Final Schedules TJC-1.

1           **A.     Income Statement Adjustments.**

2           Staff and the Company are in agreement regarding all income statement adjustments in this  
3 case as of the conclusion of the hearing, except for those resulting from disputed rate base items such  
4 as depreciation expense.

5           **B.     Rate Base Adjustments.**

6           There are three rate base adjustments that are still in dispute between Staff and the Company.  
7 First, there is a dispute regarding the Zenon plant that was located at the Del Oro wastewater  
8 treatment plant (“WWTP”) during the test year.<sup>9</sup> Second, there is a dispute between the Company and  
9 Staff regarding the proper calculation of the allowance for funds used during construction  
10 (“AFUDC”) related to the Section 14 and Del Oro WWTPs.<sup>10</sup> Third, Staff is recommending the  
11 disallowance of management fees that were paid to Andrew Capestro that were only necessary as a  
12 result of a delay in the construction that was caused by the Company.<sup>11</sup> Finally, although not a  
13 dispute with the Company, both Staff and the Company take issue with the methodology that RUCO  
14 used in calculating capacity in this case.

15                   **1.     Zenon Plant.**

16           During its review, Staff determined that the Company had purchased mobile equipment from  
17 Zenon for use at its Del Oro WWTP.<sup>12</sup> Although this plant was in service at the Del Oro location  
18 during part of the test year, the Company acknowledged that it was removed from service at the Del  
19 Oro location in December 2011.<sup>13</sup> The Company asserted in prefiled testimony that the Zenon plant  
20 was only temporarily out of service because it was being relocated from the Del Oro WWTP to the  
21 Seasons WWTP.<sup>14</sup> However, the plant was still out of service when Staff performed its inspection of  
22 Far West’s facilities on January 9, 2013. Although the Company indicated during the hearing in this  
23 matter that the Zenon plant was placed in service on April 16, 2013, this is almost 1 ½ years outside  
24 of the test year in this matter.<sup>15</sup> It is Staff’s position that this plant should not be included in rate base

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26 <sup>9</sup> Jones Rebuttal, Ex. A-2 at 12.  
27 <sup>10</sup> Becker Direct, Ex. S-5 at 8.  
28 <sup>11</sup> Becker Direct, Ex. S-5 at 16.  
<sup>12</sup> Becker Direct, Ex. S-5 at 6.  
<sup>13</sup> *Id.* at 7.  
<sup>14</sup> Jones Rebuttal, Ex. A-2 at 12.  
<sup>15</sup> Tr. Vol. I at 50.

1 because this plant item was removed from service during the test year, and was not placed back in  
2 service until almost 1 ½ years after the end of the test- year which was well after Staff performed its  
3 inspection of the Company's facilities in this case.

4 **2. Allowance for Funds Used During Construction ("AFUDC").**

5 This dispute relates to Staff's recommended disallowance of Allowance for Funds Used  
6 During Construction ("AFUDC") that the Company included in Utility Plant in Service ("UPIS").  
7 Although the dispute regarding this issue has been significantly narrowed, there is still a dispute  
8 regarding how much AFUDC should be allowed. In order to understand this dispute it is important to  
9 understand a little of the history of Far West.

10 On March 13, 2006 and October 31, 2006, Far West entered into two consent orders with  
11 ADEQ that required the Company to make certain improvements to its wastewater systems by certain  
12 dates. In order to make the required improvements, the Company sought and obtained authorization  
13 from the Commission to incur indebtedness of up to \$25,215,000.<sup>16</sup> However, during the course of  
14 having the required improvements made, Far West was unable to complete the projects using the  
15 funds obtained through the financing approved in Decision No. 69950.<sup>17</sup> As a result, the Company  
16 was unable to pay its bills on time, and incurred significant late fees, legal expenses, and debt  
17 restructuring costs. Although the Company initially sought recovery of these costs, it has since  
18 removed them from its request.<sup>18</sup> The unpaid bills related to major capital additions to Section 14  
19 WWTP, the Palm Shadows Force Main and Lift Station and the Del Oro WWTP.<sup>19</sup> In particular, Far  
20 West's failure to pay its bills to Zenon Environmental Corporation ("Zenon") resulted in Zenon  
21 refusing to allow Far West to exercise operational control of the Section 14 and Del Oro WWTP's  
22 until payment arrangements had been made.<sup>20</sup> Once the Company made payment arrangements with  
23 Zenon, Section 14 WWTP was placed in service on August 24, 2011, Palm Shadows Lift Station and  
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26 <sup>16</sup> Becker Direct, Ex. S-5 at 8.

27 <sup>17</sup> *Id.* At 9.

<sup>18</sup> Jones Rebuttal, Ex. A-2 at 6.

28 <sup>19</sup> Becker Direct, Ex. S-5 at 9.

<sup>20</sup> *Id.*

1 Force Main were placed in service on October 1, 2011, and the Del Oro WWTP was placed in service  
2 on December 22, 2011.<sup>21</sup>

3 Initially, Far West recorded AFUDC for this plant through the date when it was placed in  
4 service, however, as of the conclusion of the hearing, the Company agrees with Staff's recommended  
5 18 month cutoff period for how long the construction of the plant should have taken but for the  
6 delays in payment to Zenon.<sup>22</sup> The remaining point of contention between Staff and the Company is  
7 that the Company asserts the construction work in progress balances should have been higher during  
8 that 18 month period because Staff did not include all of the construction costs, and therefore the  
9 AFUDC balances are lower than they should have been.<sup>23</sup> The Company did not provide adequate  
10 support that justifies the inclusion of additional AFUDC.

11 The Company acknowledges that the construction period was excessive. The Company  
12 ultimately bears the responsibility of providing services, including the proper estimation of  
13 construction costs for needed improvements. This problem was exacerbated by the Company's  
14 decision to use approximately \$1.9 million of the loan proceeds for its Water Division.<sup>24</sup> Finally, Far  
15 West is a poorly capitalized company, but had indicated in a prior case it would be making steady  
16 steps to increase its equity, and while it has not done so to date, Staff believes because of their  
17 ownership interests in many affiliates, the owners of Far West are very capable of infusing capital.<sup>25</sup>  
18 This capital could have been used to avoid this issue from the outset. Ultimately, Company did not  
19 provide any sort of pro forma AFUDC calculation to support its position.<sup>26</sup> Staff continues to  
20 recommend disallowance of \$1,473,172.<sup>27</sup>

### 21 3. Management Fees.

22 This issue is related to Staff's recommended disallowance of AFUDC discussed above.  
23 Coriolis was retained by Far West to provide comprehensive engineering services for the construction  
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26 <sup>21</sup> Becker Direct, Ex. S-5 at 10.

<sup>22</sup> Tr. Vol. I at 198.

<sup>23</sup> Tr. Vol. I at 198-199.

<sup>24</sup> Becker Direct, Ex. S-5 at 11.

<sup>25</sup> *Id.* at 11-12.

<sup>26</sup> Tr. Vol. I at 199.

<sup>27</sup> Staff Final Schedules GWB-7.

1 of the facilities discussed above, including construction management services.<sup>28</sup> Far West terminated  
2 Coriolis in April 2009,<sup>29</sup> at approximately the same time that Staff asserts the Company should have  
3 completed the construction of the improvements to its WWTP's.<sup>30</sup> The Company paid Andrew  
4 Capestro, the husband of one of the owners of the Company, \$210,000 to perform construction  
5 management services. The fees to Mr. Capestro were paid during 2010 and 2011 long after the date  
6 when the plant could have been in service if the Company had paid its bills on time.<sup>31</sup> The Company  
7 initially sought to capitalize and include \$201,562 in its Utility Plant in Service. However, as of the  
8 Company's rebuttal testimony the Company modified its position by reducing the amount it sought to  
9 include in UPIS to \$100,782.<sup>32</sup> The Company asserts that Mr. Capestro did not duplicate the services  
10 of Coriolis, and that he provided services that Coriolis would have provided if the Company had not  
11 terminated their services.<sup>33</sup> However, even to the extent Mr. Capestro's services were not duplicative  
12 of those provided by Coriolis; they nonetheless would not have been necessary if the construction  
13 projects had not been delayed for nonpayment.<sup>34</sup> Staff therefore continues to recommend  
14 disallowance of the inclusion of any of the management fees paid to Mr. Capestro in UPIS.

15  
16 **III. COST OF CAPITAL.**

17 Staff recommends a return on common equity of 10 percent, a cost of debt of 6.7 percent, and  
18 an overall rate of return of 7.4 percent for the sewer division of Far West in this case.<sup>35</sup> Although  
19 there initially was some dispute between Staff and the Company regarding cost of capital, with  
20 adjustments that Staff made in surrebuttal testimony, the Company ultimately agreed with Staff's cost  
21 of capital analysis in rejoinder testimony.<sup>36</sup>

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23 ...

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25 <sup>28</sup> Tr. Vol. I at 201.

26 <sup>29</sup> Jones Rebuttal, Ex. A-2 at 7.

27 <sup>30</sup> Becker Direct, Ex. S-5 at 13.

28 <sup>31</sup> *Id.* at 16.

29 <sup>32</sup> Jones Direct, Ex. A-2 at 7.

30 <sup>33</sup> *Id.* at 7.

31 <sup>34</sup> Becker Direct, Ex. S-5 at 16.

32 <sup>35</sup> Cassidy Surrebuttal, Ex. S-4 at 6.

33 <sup>36</sup> Jones Rejoinder, Ex. A-4 at 13.

1           **A. Capital Structure.**

2           Staff initially recommended a capital structure in this case comprised of 72.3 percent debt and  
3 27.7 percent common equity.<sup>37</sup> Staff, in direct testimony, provisionally disallowed \$1,732,342 in  
4 short term debt pending additional discovery.<sup>38</sup> Based on the Company's responses to data requests  
5 that Staff issued in the interim, Staff has reversed this disallowance to include the \$1,732,342 as short  
6 term debt in the Company's capital structure.<sup>39</sup> Second, Staff initially converted the Company's  
7 \$1,942,448 long-term debt related to Zenon/Liberation Capital to paid in capital.<sup>40</sup> Subsequent to  
8 filing direct testimony Staff determined that the proceeds associated with the Zenon/Liberation  
9 Capital loan were not of an equity character and therefore is more appropriately treated as debt.<sup>41</sup>  
10 Ultimately, Far West has essentially agreed with Staff's final recommendation of 79.2 percent debt  
11 and 20.8 percent equity.<sup>42</sup> The debt component of the capital structure is comprised of 74.23 percent  
12 long-term debt and 4.95 percent short-term debt.<sup>43</sup>

13           **B. Cost of Debt.**

14           Staff is recommending an overall cost of debt of 6.7 percent.<sup>44</sup> This recommendation is  
15 comprised of a cost of long-term debt of 6.66 percent and a cost of short-term debt of 7.51 percent.<sup>45</sup>  
16 Although the Company and Staff were initially in disagreement regarding the cost of debt, once Staff  
17 reinstated the short term debt into Far West's capital structure, the Company agreed with Staff's  
18 recommendations in its rejoinder testimony.<sup>46</sup> However, it is important to note that Staff did not  
19 simply adopt the cost of debt proposed by Far West for each of its short-term debt obligations once it  
20 recommended reinstating the short-term debt as discussed above.<sup>47</sup> In particular, the Company was  
21 seeking a 12 percent cost of debt for a \$175,000 debt incurred to Scott Spencer and \$36,837 incurred  
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23 <sup>37</sup> Cassidy Surrebuttal, Ex. S-4 at 2.

24 <sup>38</sup> Cassidy Direct, Ex. S-3 at 10.

25 <sup>39</sup> Cassidy Surrebuttal, Ex. S-4 at 2.

26 <sup>40</sup> Cassidy Direct, Ex. S-3 at 9.

27 <sup>41</sup> Cassidy Surrebuttal, Ex. S-4 at 4.

28 <sup>42</sup> Jones Rejoinder, Ex. A-4 at 13. The Company carries its percentages to two decimal places, whereas Staff rounds to one decimal place.

<sup>43</sup> Staff Final Schedules JAC-10.

<sup>44</sup> Staff Final Schedules JAC-1.

<sup>45</sup> Staff Final Schedules JAC-10.

<sup>46</sup> Jones Rejoinder, Ex. A-4 at 13.

<sup>47</sup> Cassidy Surrebuttal, Ex. S-4 at 2.

1 to Gallagher & Kennedy.<sup>48</sup> The proceeds borrowed from Scott Spencer were used to fund a liability  
2 that the Company owed to the Arizona Department of Environmental Quality ("ADEQ") for a  
3 suspended civil penalty. Further the Gallagher & Kennedy debt was incurred to finance an accounts  
4 payable incurred for legal services relating to legal action that ADEQ had taken against Far West.<sup>49</sup>  
5 Staff believes that ratepayers should be held harmless from the Company's incurrence of penalties  
6 and from Far West's inability to pay ongoing business expenses as they come due.<sup>50</sup> However,  
7 simply removing these debt obligations from the Company's capital structure would have the  
8 unintended effect of increasing the equity percentage in the capital structure which would lead to a  
9 higher weighted cost of capital and ultimately a slightly higher annual revenue requirement.<sup>51</sup> Instead  
10 Staff assigned a cost of 7.4 percent to each of these short-term debt obligations, which is equal to the  
11 weighted average cost of capital that Staff is recommending in this case.<sup>52</sup> This will in effect hold the  
12 ratepayers harmless from these debt obligations.

13 **C. Cost of Equity.**

14 The Company agrees with Staff's recommended return on equity number of 10 percent.<sup>53</sup>

15 **IV. RATE DESIGN.**

16 In this case all of the parties are proposing the same basic rate structure with a flat rate for  
17 residential customers, and a flat rate by meter size for commercial customers. Further, the parties are  
18 in general agreement with the Company's proposed RV park rate structure consisting of a flat rate  
19 base charge for common facilities and a flat rate for each RV space. Further, all parties recommend  
20 billing for effluent on a commodity charge basis.

21 In fact the only material disagreements that existed between Far West and Staff as of the  
22 beginning of the hearing in this matter were the phase in of the rates, differences in the meter  
23 multipliers for the 5/8" x 3/4", 1 1/2" and 2" meters for commercial customers, and the effluent rate.<sup>54</sup>

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25 \_\_\_\_\_  
26 <sup>48</sup> *Id.*

<sup>49</sup> Cassidy Surrebuttal, Ex. S-4 at 3.

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> Jones Rebuttal, Ex. A-2 at 23.

<sup>54</sup> Jones Rejoinder, Ex. A-4 at 16.

1 As of the conclusion of the hearing in this matter, the Company agreed to the phase in of the  
2 rates in this matter with 50 percent being implemented once the rates are authorized in this case, and  
3 the phasing in of the remaining 50 percent 6 months later.<sup>55</sup> Further, the Company has agreed to  
4 forgo recovery of lost revenue or interest associated with the phase in.<sup>56</sup> Additionally, Staff and the  
5 Company, as of the conclusion of the hearing in this matter, agree to an effluent rate of not less than  
6 \$0.25 per 1,000 gallons.<sup>57</sup>

7 Finally, Staff and the Company are in agreement with the following meter multipliers for  
8 commercial customers<sup>58</sup>:

9

|                      |       |
|----------------------|-------|
| 10 Commercial - 5/8" | 1.50  |
| Commercial - 3/4"    | 1.50  |
| 11 Commercial - 1"   | 2.60  |
| Commercial - 1 1/2"  | 5.20  |
| 12 Commercial - 2"   | 8.20  |
| Commercial - 3"      | 16.00 |
| 13 Commercial - 4"   | 25.00 |
| 14 Commercial - 6"   | 50.00 |

15 **V. INTERIM MANAGER AND OTHER STAFF RECOMMENDATIONS.**

16 **A. There is no excess capacity in the Far West treatment facilities.**

17 Both Staff and the Company disagree with RUCO's analysis that there is excess capacity with  
18 the Far West wastewater treatment facilities.<sup>59</sup> During the test year, Far West operated six  
19 wastewater treatment facilities.<sup>60</sup> None of the facilities are interconnected.<sup>61</sup>

20 RUCO asserts that in determining whether there is excess capacity in the Far West treatment  
21 facilities, it is appropriate to conduct a system-wide capacity analysis based on a treatment plant  
22 design capacity of 2,332,500 gallons per day ("GPD").<sup>62</sup> This calculation is in excess of the total  
23 planned capacity of Far West's wastewater system.<sup>63</sup>

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25 <sup>55</sup> Tr. Vol II at 294.

<sup>56</sup> *Id.*

<sup>57</sup> See Staff Final Schedule Rate Design GWB-1 and Far West Final Schedule RLJ-Final Schedule H-4.

26 <sup>58</sup> Tr. Vol. V at 1047.

<sup>59</sup> Liu Surrebuttal, Ex. S-2 at 3; Jones Rebuttal, Ex. A-2 at 14.

27 <sup>60</sup> Jones Direct, Ex. A-1 at 3.

<sup>61</sup> Jones Rebuttal, Ex. A-2 at 14.

28 <sup>62</sup> Duffett Direct, Ex. R-9 at 3; Tr. Vol. III at 486-487.

<sup>63</sup> Duffett Direct, Ex. R-9 at 6.

1 According to Staff witness Jian Liu, excess capacity is defined as constructed plant facilities  
2 that exceed the system requirements within a reasonable planning period.<sup>64</sup> In determining excess  
3 capacity, Staff will typically use the average daily flow from the peak month of the year as the  
4 requirement and 5 years as a reasonable planning period.<sup>65</sup> Mr. Liu testified that by the end of the  
5 test year, there was no excess capacity in any of the treatment plants.<sup>66</sup> In fact, Mr. Liu determined  
6 that during the test year, four out of the six treatment plants exceeded peak day treatment capacity.<sup>67</sup>  
7 Further, using 5 years as a reasonable planning period, because of the projected growth in the Far  
8 West service, there is no excess capacity.<sup>68</sup> Using the ADEQ 240 GPD per household standard, the  
9 design capacity of the Far West facilities should be 2,160,000 GPD.<sup>69</sup> If Far West completes all  
10 ongoing treatment plant improvements, the design capacity would be 2,285,000 GPD.<sup>70</sup> The resultant  
11 difference, 125,000 GPD, can serve approximately 520 new customers. Given the Company  
12 estimation that it expects to add between 1,100 and 1,200 customers by 2016,<sup>71</sup> the 125,000 GPD  
13 could easily be needed during the planning period.<sup>72</sup> Staff has concluded that the Company's  
14 wastewater treatment plants have no excess capacity and RUCO's adjustment for excess capacity  
15 should be rejected.<sup>73</sup>

16 **B. Staff Investigations.**

17 Previous Commission decisions ordered Staff to investigate a number of issues and formulate  
18 a recommendation in this docket. Staff was ordered to:

- 19 1. Investigate whether it would be in the public interest to appoint an interim manager  
20 for the Company, and any other appropriate recommendations;<sup>74</sup>
- 21 2. Investigate the Company's relationship with and use of affiliates, including whether  
22 there were payment of fees by developer to H&S Developers Inc. associated with  
obtaining utility service;<sup>75</sup>

23 <sup>64</sup> Liu Surrebuttal, Ex S-2 at 1.

24 <sup>65</sup> *Id.*

24 <sup>66</sup> Tr.Vol. IV at 673.

25 <sup>67</sup> *Id.*; Liu Surrebuttal, Ex S-2 at 2.

25 <sup>68</sup> Liu Surrebutal, Ex. S-2 at 3.

26 <sup>69</sup> *Id.*

26 <sup>70</sup> *Id.*

27 <sup>71</sup> Jones Rebuttal, Ex. A-2 at 16.

27 <sup>72</sup> Liu Surrebuttal, Ex. S-2 at 3.

27 <sup>73</sup> *Id.*

28 <sup>74</sup> Decision No. 71447 at 33-34.

28 <sup>75</sup> Decision No. 72594 at 76-77, 82.

- 1 3. Investigate whether the Company was providing service outside of its CC&N;<sup>76</sup>
- 2 4. Investigate whether Far West has violated the Quality of Service Statute, A.R.S. § 40-361 (B);<sup>77</sup>
- 3 5. Investigate whether the failure of Far West to pay refunds to developers as required by the MXAs is a violation of statutes or Commission rules.<sup>78</sup>

4 **1. Interim Manager.**

5 The Commission, in Decision No. 71447, expressed concern regarding the ability of the  
6 Company to manage the construction projects surrounding Section 14 Wastewater Treatment Plant  
7 (“WWTP”) and its compliance issues with ADEQ. As a result of this concern, the Commission  
8 directed Staff to conduct an investigation and formulate a recommendation whether it is in the public  
9 interest to appoint an interim operator. Staff has recommended that an interim manager is not  
10 warranted at this time.<sup>79</sup> In response to a letter from Commissioner Bitter-Smith of April 4, 2013,  
11 Staff reiterated that it would not be appropriate to appoint an interim manager at this time.<sup>80</sup> In its  
12 response, Staff notes that in October 2012, ADEQ issued Compliance Status Reports regarding Far  
13 West’s WWTPs. ADEQ reported that while the Company is not in compliance with the Consent  
14 Judgment CV2008-021676 (“CJ”), ADEQ is encouraged by the progress that Far West has made.  
15 ADEQ is currently amending the CJ to provide future dates for Far West to complete the remaining  
16 tasks required by the CJ. ADEQ anticipates that an amended CJ will be effective by June 2013.

17 The process for the appointment of an interim manager typically starts with the filing by Staff  
18 of a complaint, petition for an order for interim relief.<sup>81</sup> Staff typically initiates such a petition when  
19 Staff has determined that there is a serious potential for harm to the public. Staff’s petition is  
20 supported by affidavits. These affidavits usually state there is a clear and present danger to the public  
21 health and safety requiring the appointment of an interim manager to ensure that the public is  
22 protected. The Commission, at an Open Meeting, then hears Staff’s petition. If the Commission  
23 determines that Staff’s petition merits action, the Commission issues an order, granting Staff’s  
24 petition and ordering Staff to enter into an agreement for an interim manager. The appointment of an  
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26 <sup>76</sup> Decision No. 72594 at 77.

27 <sup>77</sup> *Id.* at 74.

28 <sup>78</sup> *Id.* at 77.

<sup>79</sup> Becker Direct, Ex. S-5 at 28.

<sup>80</sup> Olea Memo, Ex. S-9 at 1.

<sup>81</sup> Olea Memo, Ex. S-9 at 2.

1 interim manager is considered extraordinary relief by the Commission, ordered when no other  
2 options exist.<sup>82</sup> The appointment of an interim manager is a temporary measure used to ensure safe  
3 and reasonable service.

4 *In Utilities Division Staff v. Johnny McClain, et al.*, the Commission issued an order to show  
5 cause (“OSC”) and appointed an interim manager.<sup>83</sup> McClain owned and/or operated water systems,  
6 Miracle Valley, Cochise, Horseshoe Ranch, Crystal Water Company (“Crystal”), Mustang Water  
7 Company (“Mustang”), Coronado Estates Water Company (“Coronado”), and Sierra Sunset. The  
8 OSC found among other things, that the ADEQ NOVs include no microbiological site sampling plan;  
9 insufficient or no storage, no backflow prevention programs, no emergency operating plan, no  
10 approvals to construct and/or no approvals of construction; that McLain is operating Miracle Valley,  
11 Cochise and Horseshoe Ranch without proper certification and that his operation is in violation of  
12 state law and endangering public health, safety or welfare; and that ADEQ issued compliance reports  
13 for all water systems on July 1, 2003 and all the reports note major deficiencies with all seven  
14 systems.<sup>84</sup> In this instance, there was a serious threat to public health and safety that warranted the  
15 imposition of an interim manager.

16 *Staff of the Utilities Division v. American Realty and Mortgage Co., dba Hacienda Acres*  
17 *Water System*,<sup>85</sup> Staff filed a complaint and was granted the authority to appoint an interim manager  
18 because of Hacienda’s numerous violations of Commission orders, failure to provide water during  
19 curtailment and threats to discontinue water service.<sup>86</sup> Shortly after the appointment of the interim  
20 manager, Lee began to dismantle the system, shutting down service to all of Hacienda’s customers  
21 for several days. The Commission filed this complaint in Superior Court to obtain an injunction to  
22 prevent Joseph Lee, owner of Hacienda Acres Water Company, from entering onto the property and  
23 damaging the water system.<sup>87</sup>

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25  
26 <sup>82</sup> Decision No. 66241 at 2.

27 <sup>83</sup> Docket No. W-01646A-03-0601, et al; Decision No. 66241.

28 <sup>84</sup> McClain ultimately filed for bankruptcy and the systems were ultimately acquired by Liberty Water.

<sup>85</sup> Docket No. W-02258A-07-0470.

<sup>86</sup> *Id.*; Decision Nos. 69865, 70609 and 73233.

<sup>87</sup> *See* CV-2007-015778.

1           Reviewing past Commission decisions that ordered the appointment of an interim manager  
2 and comparing those decisions to the facts surrounding Far West, Staff determined that an interim  
3 manager is not needed at this time. However, Staff has recommended that in the event Far West fails  
4 to satisfy the rate increase conditions set forth in Exhibit A-8, Staff is requesting the authorization, in  
5 this case, to appoint an interim manager.<sup>88</sup> It is Staff's position that the request during the  
6 proceedings constitutes the notice and opportunity to be heard by the Company. If Staff's  
7 recommendation is adopted, the decision in this matter would authorize Staff to seek an interim  
8 manager at a point in the future. During the hearing, Staff and the Company attempted to reach  
9 certain agreements regarding when rates would go into effect. Mr. Jones testified to 9 conditions that  
10 were acceptable to the Company.<sup>89</sup> Staff added an additional condition, that an interim manager be  
11 appointed in the event that the 8 conditions set out in Exhibit A-8 were not met. The Company did  
12 not agree to Staff's condition regarding the interim manager.<sup>90</sup> Staff believes that a decision in this  
13 matter authorizing Staff to seek an interim manager for Far West satisfies any notice and opportunity  
14 to be heard issues, because the underlying hearing in this matter offered the Company an opportunity  
15 to present testimony on the propriety of an interim manager appointment. Under Staff's condition,  
16 once it becomes evident that the Company has failed to meet the conditions set forth in Exhibit A-8,  
17 Staff would file a notice in the docket, stating the Company's failure to comply with the conditions  
18 and Staff would proceed to seek out an interim manager.<sup>91</sup>

19                           **2. Far West and Affiliate Transactions.**

20           An overview of the Commission's authority surrounding affiliate transactions would be  
21 instructive.

22           The Commission rule governing affiliate transactions is A.A.C. R-14-2-801 *et seq.* A.A.C. R-  
23 14-2-804(A) provides:

24           A utility will not transact business with an affiliate unless the affiliate agrees to  
25 provide the Commission access to the books and records of the affiliate to the degree  
26 required to fully audit, examine or otherwise investigate transactions between the  
public utility and the affiliate. In connection therewith, the Commission may require

27 <sup>88</sup> Rate Increase Condition #10, Ex S-10; Tr. Vol. IV at 800.

<sup>89</sup> Rate Increase Conditions, Ex. A-8; Tr. Vol. IV at 792.

28 <sup>90</sup> Tr. Vol. V at 1050:25-26-1051:1-2.

<sup>91</sup> Rate Increase condition #10, Ex. S-10.

1 production of books, records, accounts, memoranda and other documents related to  
2 these transactions.

3 State commissions have historically reviewed affiliate costs and profits with greater scrutiny  
4 than other utility costs.

5 In *U.S. West Communications v. the Arizona Corp. Comm'n*, 185 Ariz. 277, 915 P.2d 1232  
6 (App. 1996), the Arizona Court of Appeals held that the "Commission has broad powers to scrutinize  
7 transactions between a regulated company and its unregulated affiliates" and disallow excessive  
8 costs.<sup>92</sup> In *General Telephone Co. of Upstate New York v. the Public Service Comm'n of New York*,  
9 17 N.Y.2d 373 (N.Y. 1966), the Court of Appeals of New York held that:

10 When such materials and services are obtained through contracts which  
11 are the result of arm's length bargaining in the open market, the contract  
12 price is usually accepted as the proper cost. However, when a utility and  
13 its suppliers are both owned and controlled by the same holding company,  
14 the safeguards provided by arm's length bargaining are absent, and ever  
15 present is the danger that the utility will be charged exorbitant prices  
16 which will, by inclusion in its operating costs, become the predicate for  
17 excessive rates.<sup>93</sup>

18 Finally, in *Turpen v. Oklahoma Corp. Comm'n*, 769 P.2d 1309 (Okla. 1989), the Supreme  
19 Court of Oklahoma held that:

20 The utility's burden of proving that payments to affiliates are reasonable  
21 includes both a burden of production and of persuasion. The utility has  
22 the initial burden of producing evidence to show *prima facie* the  
23 reasonableness of its payments to affiliates—a mere showing of the  
24 expenses' incurrence will not suffice. The utility must produce evidence,  
25 *for example, that it charged affiliates the same amount as it did arms-*  
26 *length buyers.* Unless the utility meets this affirmative duty of showing  
27 the reasonableness of payments to affiliates, no such expenses may be  
28 allowed.<sup>94</sup>

As the *Turpen* court noted, "a mere showing of the expenses' incurrence will not suffice. The  
utility *must* produce evidence."<sup>95</sup> The *Turpen* court also held that affiliate costs must be the same as  
non-affiliates would receive from arms-length negotiations.<sup>96</sup> In *Phelps Dodge Corp. v. Arizona*  
*Electric Power Co-op, Inc.*,<sup>97</sup> the Arizona Court of Appeals held that the Commission may not allow

<sup>92</sup> *U.S. West*, 185 Ariz. at 282, 915 P.2d at 1237 (citations omitted).

<sup>93</sup> *General Telephone*, 17 N.Y.2d at 378.

<sup>94</sup> *Turpen*, 769 P.2d at 1323 (citations omitted; emphasis added).

<sup>95</sup> *Id.*

<sup>96</sup> *Id.*

<sup>97</sup> *Phelps Dodge*, 207 Ariz. 95, 108, 83 P.3d 573, 586 (App.2004).

1 the competitive market to set rates. The Commission has a “duty to set *just* and reasonable rates that  
2 provide for the needs of all whose interests are involved, including public service corporations and  
3 *the consuming public.*”<sup>98</sup>

4 Staff would note that while affiliate transactions between a utility and its unregulated affiliate  
5 are not prohibited, these transactions merit more scrutiny, because the safeguards that are present  
6 when two unaffiliated parties negotiate are absent. Against that background, Staff’s goals for its  
7 review of affiliate transaction are to determine if: (1) ratepayers were harmed by the Company’s use  
8 of affiliates and (2) were the transactions between the Company and its affiliates arms-length.

9 The Company has a number of related entities. H&S Developers, Inc. (“H&S”) is owned by  
10 Paula Capestro, wife of Andrew Capestro, and Sandra Braden, who are officers and the sole  
11 shareholders of Far West. H&S operates primarily as a land development company. H&S has main  
12 extension agreements (“MXAs”) with Far West. H&S originally held the certificates of convenience  
13 and necessity now held by Far West. H&S formed Far West as a separate entity pursuant to  
14 Commission direction in Decision No. 60437. H&S also owns and operates Hanks Market &  
15 Butcher Shop, Foothills Mini Mart, Foothills Sand & Gravel.<sup>99</sup> Far West purchases materials and  
16 supplies from those entities at retail prices. H&S is also a Far West water and sewer customer.

17 Other affiliates identified are the Schechert Trust (“Trust”), with Paula Capestro and Sandra  
18 Braden as beneficiaries. The Trust has provided short term financing to Far West and sold land to Far  
19 West. The Trust has provided a line of credit to Far West.<sup>100</sup> There are two golf courses affiliated  
20 with Far West, Las Barrancas Golf Course with is owned by the Trust and operated by H&S and  
21 Foothills Golf Course, owned by the Trust and operated by H&S. Both golf courses are water and  
22 sewer customers and receive effluent.<sup>101</sup>

23 Southwest Land, LLC (“Southwest”) is owned by Paula Capestro and Andrew Capestro.  
24 Southwest rents office space to Far West. El Rancho Encantado, LLC is a residential development  
25 owned by Paula Capestro. El Rancho Encantado, LLC has MXAs with Far West. El Rancho  
26

27 <sup>98</sup> *Id.* (emphasis added).

<sup>99</sup> Becker Direct, Ex. S-5 at 12.

28 <sup>100</sup> Tr. Vol. II at 387.

<sup>101</sup> Jones Rate Design Rebuttal, Ex. A-3 at 12.

1 Encantado has provided short term cash advances to Far West to meet short term operating cash  
2 needs. El Rancho Encantado receives and pays water and sewer bills for their properties. Q-  
3 Mountain Water, Inc. is a small water company partially owned by Paula Capestro, Sandra Braden  
4 and the Schechert Trust. Far West's water division provides administrative services to Q-Mountain  
5 Water, Inc.

6 As Mr. Becker testified, during his investigation he reviewed the Company's transactions  
7 with its affiliates. Staff discovered two areas of concern. First, Staff discovered that the Company  
8 has unpaid receivables from related parties of approximately \$402,000, mostly for effluent sold to  
9 affiliated golf courses.<sup>102</sup> As Mr. Becker testified, providing uncompensated service is inequitable to  
10 the other ratepayers who are required to pay for services and who may indirectly bear the cost of  
11 uncompensated services.<sup>103</sup> Further, had Far West collected those receivables, that money collected  
12 could have been used to pay its unpaid payables, such as its property taxes.<sup>104</sup> Staff has recommended  
13 that Far West collect all amounts owed by related parties no later than 12 months from the date when  
14 Phase I new rates are effective in this proceeding or December 31, 2014, whichever is sooner.<sup>105</sup>

15 Arm's length transaction has been defined as "a transaction negotiated by unrelated parties,  
16 each acting in his or her self-interest; the basis for a fair market value determination; a transaction in  
17 good faith in the ordinary course of business by parties with independent interests."<sup>106</sup> In this instance,  
18 the Company and its affiliates are related, but as noted by the court in *Turpen*: "The utility must  
19 produce evidence, *for example, that it charged affiliates the same amount as it did arms-length*  
20 *buyers.*"<sup>107</sup> Using this as guidance, Staff attempted to determine whether transactions were "arms-  
21 length". This determination was made difficult by the lack of any written agreements with its  
22 affiliates. The only written agreements between Far West and its affiliates are for the lease of its  
23 office space with Southwest and its main extension agreements.<sup>108</sup>

24  
25  
26 <sup>102</sup> Becker Direct, Ex. S -5 at 27.

<sup>103</sup> *Id.* at 28.

<sup>104</sup> *Id.*

<sup>105</sup> Rate Increase Conditions, Ex. A-8 at 1.

<sup>106</sup> Black's Law Dictionary, 109 (6th ed.1990).

<sup>107</sup> *Turpen*, 769 P.2d 1309.

<sup>108</sup> Becker Rate Design Surrebuttal, Ex. S-8 at 5.

1 Further, Staff could not determine with certainty whether the transactions between the  
2 Company and its affiliates concerning construction projects were at arm's length.<sup>109</sup> In response to  
3 Staff data requests, the Company provided bids of H&S for the building that houses the Del Oro  
4 wastewater treatment plant. The Company indicated that it did not seek competitive bids for the work  
5 at Section 14 Wastewater Treatment Plant, but used the bids it received for the Del Oro work to  
6 negotiate contracts for work on Section 14. For certain work on the Del Oro project, Far West did not  
7 solicit bids because for these particular categories of work, the Company asserts that those portions  
8 were less than 1.0% of the project costs and could be provided more efficiently by H&S without  
9 going through the bid process.

10 After reviewing the affiliate transactions to determine if there had been ratepayer harm, Mr.  
11 Becker concluded that with respect to the construction transactions, the costs were reasonable and  
12 thus there was no harm to the ratepayer.<sup>110</sup> However, the Company does not have a formal written  
13 policy regarding competitive bidding. Staff recommends that the Company formulate and adopt a  
14 written policy to demonstrate that its transactions with its affiliates are at arm's length, transparent  
15 and well documented. Staff also recommends that the Company develop a competitive bidding  
16 process and that the Company be required to maintain evidence of competitive biddings for all major  
17 construction projects.<sup>111</sup> The Company is in agreement with the Staff recommendation.<sup>112</sup>

### 18 3. Serving outside of its CC&N.

19 In response to a data request from Staff, the Company indicated that it is serving four small  
20 areas contiguous to the Far West CC&N.<sup>113</sup> Mr. Jones testified that the Company would file for a  
21 CC&N extension regarding those areas.<sup>114</sup>

### 22 4. Quality of Service.

23 Mr. Liu testified that he reviewed whether Far West had violated the statutes on quality of  
24 service. While he noted a large number of complaints opposing the current rate case, he did not find  
25

26 <sup>109</sup> Becker Surrebuttal Rate Design, Ex. S-8 at 5.

27 <sup>110</sup> *Id.* at 6.

28 <sup>111</sup> *Id.* at 7.

<sup>112</sup> *Id.* at 2.

<sup>113</sup> Becker Direct, Ex. S-5 at 25.

<sup>114</sup> Tr. Vol. II at 297-298.

1 any complaints related to quality of service.<sup>115</sup> Mr. Liu also noted that ADEQ in its compliance status  
2 report of October 2012, stated that it was encouraged by the progress being made by Far West  
3 towards compliance with the CJ. Mr. Liu concluded that there was no evidence to demonstrate that  
4 the Company has violated the quality of service statute.<sup>116</sup>

5 **5. Main Extension Agreements (“MXAs”).**

6 Mr. Becker testified that Staff is concerned with unpaid amounts under MXAs.<sup>117</sup> Because of  
7 the unpaid amounts, Staff has recommended that the Company make monthly payments to  
8 developers under the MXAs with the condition that all amounts due be fully paid not later than June  
9 30, 2015.<sup>118</sup>

10 **C. Staff and Company Agreement Regarding Conditions.**

11 Staff and the Company agreed to 9 conditions.<sup>119</sup> However, as Mr. Jones testified, the  
12 Company did not agree with the additional condition proposed by Staff, namely the appointment of  
13 an interim manager should the Company fail to meet the proposed conditions.<sup>120</sup> The conditions are:

- 14 1. ADEQ Compliance. Any increase in rates and charges approved in this proceeding shall  
15 not become effective until Far West files documentation from ADEQ that Far West’s  
16 wastewater treatment plants are in compliance with ADEQ’s Consent Judgment as it may  
17 be amended.
- 18 2. Spartan Homes. Any increase in rates and charges approved in this proceeding shall not  
19 become effective until Far West makes the payments and files the CC&N extension  
20 required by Decision No. 72594.
- 21 3. Rate Phase-In. Any new rates approved in this proceeding will be phased in with 50  
22 percent of the increase becoming effective for bills rendered on or after the first day of the  
23 month after the Company achieves compliance with both Conditions Nos. 1 and 2, above,  
24 with the remaining 50 percent becoming effective six months later. There will be no  
25

26 <sup>115</sup> Liu Surrebuttal, Ex. S-2 at 3.

<sup>116</sup> *Id.* at 6.

27 <sup>117</sup> Becker Direct, Ex. S-5, at 26.

<sup>118</sup> Tr. Vol. II at 293-294; Tr. Vol. IV at 792-795.

28 <sup>119</sup> Rate Increase Conditions, Ex. A-8.

<sup>120</sup> Tr. Vol. V at 1050.

1 recovery of lost revenue or interest associated with the phase-in period.

- 2 4. Property Taxes. Far West shall submit a payment plan for the full payment of all  
3 delinquent property taxes and penalties for years 2008, 2009, 2010, 2011, and 2012 that is  
4 acceptable to Yuma County for Staff review and Commission approval in this docket.
- 5 5. MXAs. Far West will make monthly payments to developers for unpaid amounts due  
6 under Main Extension Agreements with the condition that all amounts due be fully paid  
7 not later than June 30, 2015.
- 8 6. Collections from Related Parties. Far West will collect all amounts owed by related  
9 parties no later than 12 months from the date when Phase I of new rates are effective in  
10 this proceeding, or December 31, 2014, whichever is sooner.
- 11 7. Effluent Rates. Effluent rates should be set at a rate equal to the greater of \$0.25 per  
12 thousand gallons and local market rate.
- 13 8. RV Tariff Language. The following language should be added to Far West's tariff:
- 14 A. *The RV Rate shall apply only to a parcel of land under single ownership on which*  
15 *three (3) or more Recreational Vehicles are occupied as temporary residences,*  
16 *regardless of whether or not a charge is collected for such accommodations (RV*  
17 *Park).*
- 18 B. *A Recreational Vehicle is a vehicle that is built on a single chassis, four hundred*  
19 *(400) square feet or less in size, designed to be self-propelled (motor home) or*  
20 *permanently towed (trailer, fifth wheel, or camper), and designed primarily for use as*  
21 *temporary living quarters for recreational, camping, travel, or seasonal use and not*  
22 *for use as a permanent dwelling. A Recreational Vehicle includes park model*  
23 *trailers, provided that they have not been altered to increase living space beyond 400*  
24 *square feet. Recreational Vehicles do not include Manufactured Homes (a/k/a Mobile*  
25 *Homes).*
- 26 C. *Each RV Park shall be assessed a single base charge for the sewer usage at*  
27 *clubhouses, laundries and other common areas. In addition, a fee shall be paid for*  
28 *each RV Park space whether occupied or not.*

1 D. Combined facilities that include both an R V Park and Manufactured Home Park  
2 shall pay the RV Park rate for the RV Park portion of the facility with the residential  
3 tariff applying to the Manufactured Home spaces within the facility.

4 9. Affiliate Transaction Policy. Far West will formulate and adopt a formal written policy  
5 concerning affiliate transactions. The policy will address the specific steps that Far West  
6 will take to demonstrate that the transactions between Far West and its affiliates and  
7 related parties are arms-length, transparent and well documented. Further, the policies will  
8 include a competitive bidding process and require that Far West maintain evidence of  
9 competitive biddings for all major construction projects. Far West will submit such a  
10 policy for Staffs review and approval.

11 The Company agreed that it would file compliance filings in the docket as the various  
12 milestones are met.<sup>121</sup> As Mr. Becker testified, Staff agrees with the above 9 conditions only if  
13 accompanied by its proposed 10<sup>th</sup> condition,<sup>122</sup> the authority to appoint an interim manager should  
14 Far West fail to meet the proposed conditions.<sup>123</sup>

15 **VI. CONCLUSION.**

16 There are very few areas of disagreement between Staff and the Company. The more  
17 significant disagreement is the appointment of an interim manager. Staff recommends that in  
18 addition to the conditions set forth in Ex. A-8 that the Commission also adopt Staff's additional  
19 condition as found in Exhibit S-10.

20 RESPECTFULLY SUBMITTED this 11<sup>th</sup> day of June, 2013.

21  
22   
23 Wesley C. Van Cleve  
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27 1200 West Washington Street  
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<sup>121</sup> Tr. Vol. V at 1047.

<sup>122</sup> Rate Increase Condition #10, Ex. S-10.

<sup>123</sup> Tr. Vol. IV at 800-801.

1 **Original and thirteen (13) copies of**  
2 **the foregoing filed this 11<sup>th</sup> day of**  
3 **June, 2013, with:**

3 Docket Control  
4 Arizona Corporation Commission  
5 1200 West Washington Street  
6 Phoenix, Arizona 85007

6 **Copy of the foregoing mailed this**  
7 **11<sup>th</sup> day of June, 2013, to:**

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