

COMMISSIONERS
MIKE GLEASON - Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE



BRIAN C. McNEIL
Executive Director

ARIZONA CORPORATION COMMISSION

DATE: SEPTEMBER 5, 2008

DOCKET NO: W-03512A-07-0362

TO ALL PARTIES:

Enclosed please find the recommendation of Administrative Law Judge Dwight D. Nodes. The recommendation has been filed in the form of an Opinion and Order on:

PINE WATER COMPANY
(FINANCE)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and ten (10) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00** p.m. on or before:

SEPTEMBER 15, 2008

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Working Session and Open Meeting to be held on:

SEPTEMBER 23, 2008 AND SEPTEMBER 24, 2008

For more information, you may contact Docket Control at (602) 542-3477 or the Hearing Division at (602) 542-4250. For information about the Open Meeting, contact the Executive Director's Office at (602) 542-3931.

A handwritten signature in black ink, appearing to read "Brian C. McNeil".

BRIAN C. McNEIL
EXECUTIVE DIRECTOR

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 COMMISSIONERS

3 MIKE GLEASON, Chairman
4 WILLIAM A. MUNDELL
5 JEFF HATCH-MILLER
6 KRISTIN K. MAYES
7 GARY PIERCE

8 IN THE MATTER OF THE APPLICATION OF
9 PINE WATER COMPANY FOR APPROVAL TO
10 (1) ENCUMBER A PART OF ITS PLANT AND
SYSTEM PURSUANT TO A.R.S. §40-285(A);
AND (2) ISSUE EVIDENCE OF INDEBTEDNESS
PURSUANT TO A.R.S. §40-302(A).

DOCKET NO. W-03512A-07-0362

DECISION NO. _____

OPINION AND ORDER

11 DATE OF HEARING: December 4, 2007 (Public Comment – Pine, Arizona)
12 December 12, 2007

13 PLACE OF HEARING: Phoenix, Arizona

14 ADMINISTRATIVE LAW JUDGE: Dwight D. Nodes

15 IN ATTENDANCE: Mike Gleason, Chairman
16 William A. Mundell, Commissioner
17 Kristin K. Mayes, Commissioner
Gary Pierce, Commissioner

18 APPEARANCES: Mr. Jay L. Shapiro, FENNEMORE CRAIG, on behalf
of Pine Water Company;

19 Mr. John G. Gliege, GLIEGE LAW OFFICES, PLLC,
20 on behalf of Intervenors Fred Krafczyk and Michael
Greer; and

21 Ms. Janet Wagner, Assistant Chief Counsel, Legal
22 Division, on behalf of the Utilities Division of the
Arizona Corporation Commission.

23 **BY THE COMMISSION:**

24 On June 11, 2007, Pine Water Company (“PWC” or “Company”) filed with the Arizona
25 Corporation Commission (“Commission”) an application seeking approval to (1) encumber a part of
26 its plant and system pursuant to A.R.S. §40-285(A); and (2) issue evidence of indebtedness pursuant
27 to A.R.S. §40-302(A).
28

1 The Company's application is related to a Joint Well Development Agreement ("Joint
2 Agreement" or "Agreement") entered into between PWC and the Pine-Strawberry Water
3 Improvement District ("PSWID" or "District"). According to the application, the Agreement
4 provides, among other things, that PWC would enter into a contingent indebtedness with PSWID in
5 the amount of \$300,000, for costs related to drilling a deep test well at the K2 well site, and that
6 PWC's assets would be encumbered in a like amount.

7 A number of public comment letters have been filed in this docket, mostly concerning
8 opinions about the K2 well site.

9 On July 12, 2007, Commissioner Mayes filed a letter in the docket stating that a hearing
10 should be held on PWC's application.

11 On August 22, 2007, Commissioner Mayes filed a second letter suggesting that a public
12 comment hearing should be scheduled in the Pine or Strawberry communities regarding the K2 well
13 proposal.

14 On September 7, 2007, the Commission's Utilities Division Staff ("Staff") filed a Staff Report
15 recommending approval of the application.

16 By Procedural Order issued September 14, 2007, a hearing was scheduled for October 15,
17 2007, and the Company was directed to mail and publish notice of the hearing.

18 On September 18, 2007, PWC filed a Request to Change Schedule due to unavailability of the
19 Company's counsel on the scheduled hearing date.

20 On September 19, 2007, a Procedural Order was issued rescheduling the hearing for October
21 26, 2007, and directing the Company to amend the public notice accordingly.

22 On September 26, 2007, PWC filed its Response to Staff Report.

23 On October 18, 2007, the Commission issued notice of a Special Open Meeting to be held
24 December 4, 2007, in Pine, Arizona, for the purpose of taking public comments regarding this matter.

25 On October 22, 2007, Staff filed an Addition to Staff Report.

26 On October 23, 2007, a Procedural Order was issued directing the Company to mail notice to
27 each customer of the Special Open Meeting and to publish notice in a newspaper of general
28 circulation.

1 On October 26, 2007, public comment was taken regarding the application and the evidentiary
2 hearing was rescheduled to commence on December 12, 2007. During the October 26, 2007 public
3 comment hearing, intervention was granted to Fred Krafczyk and Michael Greer (“intervenors”), and
4 dates were established for filing of pre-filed testimony by the Company, Staff, and intervenors.

5 PWC filed the Direct Testimony of Robert Hardcastle on November 7, 2007.

6 On November 19, 2007, the intervenors filed the Direct Testimony of Mr. Krafczyk and
7 Mr. Greer.

8 On November 21, 2007, Staff filed the Responsive Testimony of Pedro Chaves and
9 Marlin Scott, Jr.

10 On December 5, 2007, PWC filed the Rebuttal Testimony of Mr. Hardcastle.

11 The Special Open Meeting was held in Pine on December 4, 2007, as scheduled, during
12 which additional public comment was received.

13 The evidentiary hearing was held on December 12, 2007, as rescheduled. At the conclusion
14 of the hearing, late-filed exhibits were ordered to be filed, with post-hearing briefs and reply briefs
15 due by January 9 and January 18, 2008, respectively.¹

16 On January 2, 2008, Pine Water filed a Request to Modify Current Procedural Schedule and
17 to Schedule a Status Conference. The Company requested that the briefing schedule be vacated; that
18 late-filed exhibits be filed by January 11, 2008; and that a telephonic status conference be scheduled
19 during the week of January 21, 2008.

20 On January 3, 2008, a Procedural Order was issued vacating the briefing schedule, extending
21 the late-filed exhibit date to January 11, 2008, and scheduling a telephonic procedural conference for
22 January 22, 2008.

23 On January 11, 2008, PWC filed Late-Filed Exhibits requested at the hearing. The Company
24 filed an Errata to the Late-Filed Exhibits on January 15, 2008.

25 The telephonic procedural conference was conducted, as scheduled, on January 22, 2008.
26 During the conference, the parties agreed on a revised briefing schedule with initial briefs due on

27 ¹ At the hearing, Commissioner Mayes requested that the parties brief the issues of the Commission’s authority over the
28 effects of the K2 well on neighboring wells and the constitutionality under the Arizona Constitution of the Joint
Agreement between the PSWID and PWC.

1 February 15, 2008 and reply briefs to be filed by February 29, 2008.

2 On February 20, 2008 and March 3, 2008, PWC filed additional Late-Filed Exhibits.

3 Initial Briefs were filed on February 15, 2008 by PWC and Staff, and on February 19, 2008
4 (mailed February 15, 2008) by the intervenors.

5 Reply Briefs were filed on February 29, 2008 by PWC and Staff, and on March 3, 2008
6 (mailed February 29, 2008) by the intervenors.

7 * * * * *

8 Having considered the entire record herein and being fully advised in the premises, the
9 Commission finds, concludes, and orders that:

10 **FINDINGS OF FACT**

11 Description of Application

12 1. On June 11, 2007, PWC filed an application seeking approval to (1) encumber a part
13 of its plant and system pursuant to A.R.S. §40-285(A); and (2) issue evidence of indebtedness
14 pursuant to A.R.S. §40-302(A). According to the Company’s application, its request for approval in
15 this proceeding is related to the Agreement entered into between PWC and the PSWID providing that
16 PWC would enter into a contingent indebtedness with PSWID in the amount of \$300,000, for costs
17 related to drilling a deep test well at the K2 well site, and that PWC’s assets would be encumbered in
18 a like amount.

19 2. The Company claims that its filing for approval under the above-cited statutes is not a
20 typical financing application because the K2 well site does not contain any necessary facilities, the
21 K2 well does not yet exist, and PWC has no obligation to return the PSWID investment in the project
22 until the Commission approves inclusion of the project’s cost in the Company’s rate base. PWC
23 characterizes its application as an “abundance of caution” filing that is being made before the
24 requirements for approval are ripe.

25 Joint Well Development Agreement

26 3. The Joint Agreement between PWC and the PSWID provides a mechanism whereby
27 the District agreed to provide a capital investment of \$300,000 for purposes of drilling a test well at
28 the K2 well site, located in Strawberry, Arizona within the service area of Strawberry Water

1 Company ("SWC"), an affiliate company of PWC. The PWC and SWC systems are connected by
2 the "Project Magnolia" pipeline.

3 4. The PSWID is a water improvement district that is considered a political subdivision
4 of the State of Arizona, pursuant to A.R.S. §48-901 *et seq.*, and thus is not subject to the
5 Commission's jurisdiction.

6 5. The Agreement provides that the District's \$300,000 investment, which is the
7 estimated cost of drilling the K2 test well, will be repaid to the PSWID over 36 months, at 6 percent
8 interest, if the test well produces a sustainable yield of at least 150 gallons per minute ("gpm"). Upon
9 meeting the 150 gpm yield requirements, PWC is obligated to finance the remaining cost of
10 developing the K2 well. The additional estimated cost of the well is \$981,700. In addition, PWC is
11 required to encumber its assets pertaining to the K2 well as security for the District's \$300,000
12 investment. (Ex. S-1, at 2)

13 Standard for Commission Approval of Finance Applications

14 6. A.R.S §40-285(A) provides, in relevant part:

15 A public service corporation shall not sell, lease, assign, mortgage or
16 otherwise dispose of or encumber the whole or any part of its railroad, line
17 plant, or system necessary or useful in the performance of its duties to the
18 public, or any franchise or permit or any right thereunder, nor shall such
19 corporation merge such system or any part thereof with any other public
20 service corporation without first having secured from the commission an
21 order authorizing it to do so.

22 7. A.R.S. §40-302(A) provides, in part, that:

23 Before a public service corporation issues stocks and stock certificates,
24 bonds, notes and other evidences of indebtedness, it shall first secure from
25 the commission an order authorizing such issue and stating the amount
26 thereof, the purposes to which the issue or proceeds thereof are to be
27 applied, and that, in the opinion of the commission, the issue is reasonably
28 necessary or appropriate for the purposes specified in the order...and that,
except as otherwise permitted in the order, such purposes are not, wholly
or in part, reasonably chargeable to operative expenses or to income.

29 8. Based on the applicable statutes and Commission precedent, PWC contends that the
30 Commission's analysis of the application should be limited to whether the encumbrance would

1 impair the Company's ability to provide service; whether the financing is for a lawful purpose; and
2 whether PWC's revenues are sufficient to support its repayment obligations under the Agreement.
3 PWC concedes that the Commission must be satisfied that the requested approval is in the public
4 interest, but the Company claims that the public interest is satisfied by PWC's exploration for
5 additional water sources in Pine.

6 PWC's Ability to Repay the Obligation

7 9. In its Staff Report, Staff stated that PWC's current capital structure consists of 100
8 percent equity, with no long-term or short-term debt. Staff indicated that inclusion of the \$300,000
9 contingent obligation to the PSWID, plus the additional estimated \$981,000 cost of the well
10 development, would result in the Company's capital structure consisting of 77.3 percent equity, 7.1
11 percent short-term debt, and 15.6 percent long-term debt. (Ex. S-1, at 3)

12 10. Staff pointed out, however, that if Advances in Aid of Construction ("AIAC") and
13 Contributions in Aid of Construction ("CIAC") are considered, the Company's current balance of
14 equity is only 9.9 percent, compared with 2.9 percent AIAC and 87.2 percent CIAC. Staff indicated
15 that it typically recommends that combined AIAC and CIAC not exceed 30 percent of total capital.
16 If the requested \$300,000 debt is combined with a paid-in capital investment of \$981,000, however,
17 Staff stated that PWC's capital structure would be comprised of 60.1 percent equity, 5.5 percent
18 short-term debt, 12.1 percent long-term debt, 0.7 percent AIAC, and 21.5 percent CIAC, thereby
19 satisfying Staff's typical capital structure criteria (*Id.*).

20 11. Staff's analysis also included a calculation of PWC's pro forma times interest earned
21 ratio ("TIER") and debt service coverage ("DSC") ratio.² Staff determined that, based on the
22 \$300,000 debt obligation and \$981,000 paid-in capital assumptions, PWC would have pro forma
23 TIER and DSC ratios of 13.79 and 2.41, respectively. Based on these results, Staff concluded that
24

25 ² The TIER represents the number of times earnings will cover interest expense on short-term and long-term debt. A
26 TIER greater than 1.0 means that operating income is greater than interest expense. A TIER of less than 1.0 is not
27 sustainable in the long term but does not necessarily mean that debt obligations cannot be met in the short term. The DSC
28 ratio represents the number of times internally generated cash will cover required principal and interest payments on long-
term debt. A DSC ratio greater than 1.0 means that operating cash flow is sufficient to cover debt obligations. A DSC
less than 1.0 means that debt service obligations cannot be met from operations and that another source of funds is needed
to avoid default.

1 PWC would have sufficient operating income to cover interest expense on the short-term loan
2 obligation to the District, and would be able to meet all obligations with cash generated from
3 operations. (*Id.*)

4 Intervenors' Position

5 12. With respect to the issue of the Commission's authority to consider the impact of the
6 K2 well on other area wells, the intervenors contend that the Commission may consider all evidence
7 presented and the Commission is not limited by any actions of the legislature. The intervenors claim
8 that the Commission has exclusive power regarding regulations pertaining to public service
9 corporations and the Commission must consider, first and foremost, the effect of a regulated utility
10 company's actions on the public interest. The intervenors argue that the Commission has an
11 obligation to protect the public interest by considering the impact on wells in the Strawberry area and
12 there is no constitutional provision, statute, or legal precedent that precludes the Commission from
13 doing so.

14 13. The intervenors also assert that the Commission should consider whether PWC may
15 act under the Joint Agreement because, according to the intervenors, there has been no judicial
16 determination regarding the District's capacity to enter into the Agreement.

17 14. The intervenors further contend that PWC may not be permitted to encumber a portion
18 of its assets (*i.e.*, the K2 well site), because the property is owned by SWC, and that PWC should not
19 be permitted to issue evidence of indebtedness because of the intervenors' claim that the District
20 lacks the legal capacity to enter into the Agreement and the indebtedness would violate the Arizona
21 Constitution (see discussion below).

22 15. The intervenors argue that PWC has presented an unconstitutional contract with a
23 party (the District) that lacks the capacity to enter into the Agreement. According to the intervenors,
24 the Joint Agreement between PWC and the District violates Article 9, Sections 7 and 10, of the
25 Arizona Constitution. Article 9, Section 7, provides, in relevant part:

26 Neither the state, nor any county, city, town, municipality, or other
27 subdivision of the state shall ever give or loan its credit in the aid of, or
28 make any donation or grant, by subsidy or otherwise, to any individual,
association, or corporation....

1 The intervenors assert that, although there are exceptions for the use of certain types of funding
2 related to public-private partnerships, in this case the District would be taking money from its general
3 fund, raised through taxes on residents, and using the District funds to pay for the drilling of a test
4 well for PWC, with only a possibility that the funds would be returned if the test well proves to be
5 successful. The intervenors argue that, under the balancing test established by the Arizona Supreme
6 Court in *Wistuber v. Paradise Valley Unified School District*, 141 Ariz. 346 (1984), the governmental
7 authority (*i.e.*, the District) must be paid reasonable compensation for its investment. The intervenors
8 claim that the Agreement with PWC fails to meet that balancing test. The intervenors cite *State ex*
9 *rel. Corbin v. Superior Court*, 159 Ariz. 307 (App. 1988) for the same proposition. The intervenors
10 cite *Arizona Center for Law in the Public Interest v. Hassell*, 172 Ariz. 356, 367 (App. 1992),
11 wherein the Court of Appeals, citing to the *Wistuber* court's analysis of the Gift Clause, stated:

12 First, the reviewing court must be satisfied that a dispensation of public
13 funds or property serves a public purpose. Second, the reviewing court
14 must be satisfied that the dispensing public entity has received
15 “‘consideration’ which is not ‘so inequitable and unreasonable that it
16 amounts to an abuse of discretion,’ thus providing a subsidy to the private
17 entity.” 141 Ariz. at 349 (quoting *City of Tempe v. Pilot Properties, Inc.*,
18 22 Ariz. App. 356 (1974)).

16 16. The other constitutional provision cited by the intervenors is Article 9, Section 10,
17 which provides:

18 No tax shall be laid or appropriation of public money made in aid of any
19 church, or private or sectarian school, or any public service corporation.

20 The intervenors argue that this section of the Arizona Constitution prohibits the Agreement between
21 PWC and the District because drilling of the K2 well would benefit PWC by providing up-front
22 funding that would only be recovered if the test well is successful. However, if the well is
23 unsuccessful, the District would receive only the well site. The intervenors contend that the Joint
24 Agreement is a clear violation of the Constitution, and the Commission may therefore not approve
25 the Agreement.

26 17. The intervenors' next argument is that the Joint Agreement would cause “double
27 taxation” of the residents of Pine, and result in taxation of Strawberry residents without providing a
28 benefit. The rationale offered in support of this claim is that, because the money raised through taxes

1 by the District would benefit only customers within the PWC CC&N area, those people outside the
2 CC&N area receive no benefit from the taxation. With respect to the residents located within the
3 CC&N area, the intervenors contend that in addition to paying taxes to the District, they would also
4 be required to pay higher utility rates once the costs of the well are included in PWC's rate base.

5 18. The intervenors also assert that the Joint Agreement provides for an unlawful financial
6 transaction for the District because it requires the District to place public funds into an escrow
7 account, but release of the escrow funds are subject approval of PWC. The intervenors contend that
8 this provision of the agreement is contrary to A.R.S. §48-901, which establishes the County Treasurer
9 as the District's Treasurer. The intervenors argue that, pursuant to A.R.S. §48-952, the County
10 Treasurer may only pay out obligations of the District for specified purposes, which do not include
11 payment into an escrow account or for the purpose of drilling a test well.

12 19. The intervenors raise several other ancillary issues related to the K2 well project.
13 They claim that the size of the well site is inadequate for drilling the well; that PWC is having
14 easement problems that will affect access to the well site; that the K2 well is a high risk project that
15 would not be undertaken without the up-front investment provided by the District; and that two
16 former members of the District's Board, John Breninger and Jim Richie, had conflicts of interest due
17 to business dealings with PWC and therefore additional questions are raised regarding the validity of
18 the Agreement between PWC and the District.

19 Staff's Position

20 20. Staff recommends that the financing application submitted by PWC should be
21 approved subject to the conditions set forth in the Staff Report. In its brief, Staff summarized the two
22 applicable statutes, A.R.S. §§40-302(A) and 40-301(C), as requiring that the Commission consider
23 whether the proposed request is:

- 24 1. reasonably necessary for the purposes in the order;
- 25 2. for lawful purposes;
- 26 3. within the applicant's corporate powers;
- 27 4. compatible with the public interest;
- 28 5. compatible with sound financial practices;
6. compatible with proper performance as a public service corporation; and
7. will not impair the applicant's ability to perform that service.

1
2 21. According to Staff, the application submitted by PWC satisfies these statutory
3 requirements. Staff claims that the record supports the need for additional water resources in the
4 Pine/Strawberry area; that the K2 well would benefit both communities; and a deep well, such as K2,
5 is a potential answer to the need for more water in the area. Staff asserts that the Joint Agreement
6 between PWC and the District provides a benefit to both the Company and the customers of PWC
7 because it mitigates the risk of undertaking the deep well project and therefore provides PWC a
8 greater incentive to pursue the additional water source. Staff indicates that the application meets the
9 criteria listed above because: PWC reasonably needs approval of the financing to pursue the project;
10 the deep well exploration is for a lawful purpose, within the Company's corporate powers, and is a
11 proper function of a public water utility; financing of the well project is within PWC's proper
12 performance as a public service corporation, given the Commission's prior admonishment to the
13 Company to seek additional water sources; and the project will not impair PWC's ability to serve its
14 customers. Staff cites to Steve Olea's testimony at the hearing that, if successful, the water attained
15 from the K2 well could be sufficient to eliminate water hauling surcharges, which have caused a
16 number of complaints by customers over the past several years. Given these factors, Staff concluded
17 that the proposed financing arrangement is in the public interest and should be approved.

18 22. Staff also asserts that the validity of the agreement between PWC and the District is
19 not within the Commission's jurisdiction because all disputes regarding contract law are properly
20 raised through an action in Superior Court. Staff contends that it is not the actions of PWC that are
21 being challenged by the intervenors, but rather the actions of the District. According to Staff, the
22 intervenors are seeking to have the Commission invalidate an agreement that is beneficial to PWC,
23 and ultimately its customers, by asking the Commission to find that the District's actions, authorized
24 by its duly elected Board, are unlawful. Staff argues that an attempt by the Commission undertake
25 the actions suggested by the intervenors would be difficult for the Commission to defend.

26 23. Regarding the arguments raised by the intervenors with respect to Article 9, Section 7,
27 of the Arizona Constitution, Staff points out that the section cited by intervenors is not applicable to
28 political subdivisions, such as the District. Article 13, Section 7, of the Constitution states, in

1 relevant part:

2 [T]ax levying *public improvement districts*...shall be political
3 subdivisions of the State, and vested with all the rights, privileges and
4 benefits, and entitled to the immunities and exemptions granted
5 municipalities and political subdivisions under this Constitution or any
6 law of the State or of the United States; but all such districts *shall be
7 exempt from the provisions of sections 7 and 8 of Article IX of this
8 Constitution.* (emphasis added)

9 Staff states that the intervenors' arguments ignore this exemption and the intervenors' arguments on
10 this issue should be disregarded.

11 24. As indicated above, Article 9, Section 10, of the Arizona Constitution states that "[n]o
12 tax shall be laid or appropriation of public money made in aid of ...any public service corporation."

13 Staff agrees that PWC is a public service corporation, and that the funds to be fronted by the District
14 under the agreement were likely raised through the District's taxing powers. Staff states that the
15 issues to be considered are whether the money being provided by the District constitutes an
16 appropriation of "public money"; and whether the manner in which the District's funds are to be used
17 constitute "aid" to a public service corporation.

18 25. Staff does not appear to dispute that, although not specifically defined, tax revenues
19 collected by the District would meet the definition of public money. Staff cites to *Kotterman v.*
20 *Killian*, 193 Ariz. 273, 285 (1999), wherein the Arizona Supreme Court, relying on a definition found
21 in Black's Law Dictionary, found that public money is "[r]evenue received from federal, state, and
22 local governments from taxes ...etc."

23 26. With respect to the second question, whether the District's agreement to provide
24 contingent funding for drilling of the K2 test well constitutes unconstitutional "aid" to PWC, Staff
25 cites *Community Council v. Jordan*, 102 Ariz. 448 (1967), for the Arizona Supreme Court's
26 definition under both Article 2, Section 12, and Article 9, Section 10. In *Community Council*, the
27 court upheld the constitutionality of the State's partial reimbursement of a non-profit religious
28 organization's provision of emergency assistance services to individuals in need. The court stated
that "[t]he 'aid' prohibited in the constitution of this state is, in our opinion, assistance in any form
whatsoever which would encourage the preference of one religion over another, or religion per se

1 over no religion.” *Id.* at 454. Staff contends that, under the holding of the *Community Council*
 2 decision, the agreement between the District and PWC does not violate Article 9, Section 10, because
 3 the “aid” provided to PWC in the form of an advance for drilling the test well would not encourage or
 4 tend to encourage a preference for PWC over any other public service corporations. Staff argues that,
 5 under the agreement, PWC does not control the funds placed into escrow³ but is simply a business
 6 partner in a venture under which the District would be repaid with interest if the well is successful, or
 7 the District would obtain ownership of the well site if the test well does not produce at a specified
 8 capacity. Staff asserts that the transaction between the District and PWC does not violate the Arizona
 9 Constitution because any “aid” received by PWC does not cause a preference to PWC.

10 27. Regarding the Commission’s authority to protect neighboring well owners if
 11 production drops due to the K2 well, Staff states that the Commission likely has authority under
 12 Article 15, Section 3⁴, of the Arizona Constitution and A.R.S. §40-331⁵ to require changes to the K2
 13 well in order to protect the public interest. In its Supplemental Staff Report, Staff stated that it would
 14 require certain specific information about the K2 well before the well is placed in the Company’s rate
 15 base, including a letter from ADWR regarding the long-term, continuous capacity of the well (Ex. S-
 16 3). At the hearing, Mr. Olea stated that ADWR’s testing would occur after the test well is completed,
 17 but before the production well is drilled, and that Staff would provide the ADWR information to the
 18 Commission that would include an assessment of whether the K2 well is drawing water from the
 19 same area as the existing wells. (Tr. 276-80)

20 PWC’s Position

21 28. PWC contends that its application, and the requested approval by the Commission, are
 22 limited to whether, pursuant to A.R.S. §40-285(A), the Company should be authorized to encumber a

23 ³ In its reply brief, PWC states that the District chose to approve the “Escrow Instructions” and waive receipt of
 24 Commission approvals prior to investing funds in escrow. According to PWC’s brief, the District determined that a delay
 25 in funding the test well would undermine the possibility of obtaining additional water supplies in the summer of 2008
 (PWC Reply Brief at 3-4).

26 ⁴ Article 15, Section 3, provides in part that: “The Corporation Commission shall have full power to, and shall ... make
 27 reasonable rules, regulations, and orders, by which such [public service] corporations shall be governed ... and make and
 28 enforce reasonable rules, regulations, and orders for the convenience, comfort, and safety, and the preservation of the
 health, of the employees and patrons of such corporations”

⁵ A.R.S. §40-331(A), states in relevant part that: “When the commission finds that ... changes in the existing plant or
 physical properties of a public service corporation ought reasonably to be made ... to promote the security or convenience
 of ... the public, the commission shall make and serve an order directing that such changes be made”

1 well and well site by executing a lien to secure the District's interest in the K2 well and well site
2 under the Joint Well Development Agreement; and whether, pursuant to A.R.S. §40-302(A), PWC
3 should be permitted to issue evidence of indebtedness.

4 29. With respect to the proposed security interest and lien in favor of the District, PWC
5 claims: there is no evidence that the proposed lien would impair the Company's ability to serve its
6 customers; the evidence of indebtedness of \$300,000 (plus 6 percent interest) is within PWC's ability
7 to repay, as shown by Staff's TIER and DSC calculations; the evidence of indebtedness is being
8 undertaken for a lawful purpose (*i.e.*, finding more water); and the financing approvals sought by the
9 application are entirely consistent with the public interest.

10 30. Regarding the Commission's jurisdiction over the validity of the Joint Agreement,
11 PWC argues that the District, a political subdivision, is represented by separate legal counsel who
12 represented that the District had legal authority to contract with PWC, which representation was
13 sufficient for the Company to enter into the Agreement. The Company asserts that it is beyond the
14 Commission's authority to rule on the validity of the Joint Agreement because, as stated by the
15 Arizona Supreme Court in *Trico Electric Cooperative v. Ralston*, 67 Ariz. 358, 363 (1948), "[n]o
16 judicial power is vested in or can be exercised by the corporation commission unless that power is
17 expressly granted by the constitution." The court held that none of the Commission's constitutionally
18 vested powers "confer upon the commission the jurisdiction to pass upon the construction and
19 validity of contracts." *Id.*

20 31. PWC also claims that, even if the Commission could rule on the validity of the Joint
21 Agreement, the Agreement is consistent with the Arizona Constitution because it furthers the public
22 purpose of seeking additional water sources for the District's members. Consistent with Staff's
23 arguments, PWC states that the intervenors' reliance on Article 9, Section 7, is misplaced because
24 Article 13, Section 7, expressly exempts the District from the "Gift Clause" prohibitions set forth in
25 Article 9, Section 7.

26 32. PWC concedes that the District is subject to Article 9, Section 10 ("Aid Clause"),
27 which precludes use of public money to aid churches, private or sectarian schools, or public service
28 corporations. PWC contends that there is little case law regarding this clause of the constitution, and

1 no cases addressing “aid” to public service corporations. However, according to PWC, Article 9,
2 Section 10, does not stand for the proposition that no public funds may be channeled to public service
3 corporations, in accordance with *Community Council, supra*, which, as discussed previously, found
4 that public money could be used to reimburse a religious organization as long as the state funding did
5 not provide a preference for one religion over another.

6 33. Although the Gift Clause provision of the constitution (Article 9, Section 7) is not
7 applicable to the District, PWC claims that case law addressing that clause is useful for guidance
8 regarding Section 10, given the dearth of jurisprudence addressing the Aid Clause. PWC cites *State*
9 *v. Northwestern Mutual Ins. Co.*, 86 Ariz. 50, 53 (1959), in which the Arizona Supreme Court held
10 (with respect to whether the Gift Clause precluded a school district from contracting for fire
11 insurance) that “the evil to be avoided was the depletion of the public treasury or inflation of public
12 debt by engagement in non-public enterprises. But it was never thought that the state and local
13 governments should be prohibited from dealing with private enterprises” PWC contends that this
14 is especially true regarding special districts, such as irrigation districts, that are primarily commercial
15 in nature.

16 34. PWC states that the test established by the Arizona Supreme Court in *Wistuber*,
17 regarding whether use of public money violates the Gift Clause, is that: “a use of public money or
18 property will not violate the Gift Clause if, taking a ‘panoptic’ view of the transaction in question, a
19 court concludes that (1) the use is for a public purpose, and (2) the value of the public money or
20 property is not so much greater than the value of the benefit received by the public that the exchange
21 of the one for the other is disproportionate.” *Maricopa County v. State*, 187 Ariz. 275, 279-80 (App.
22 1996). The court added that “[a] use of public funds or property that meets both these criteria will
23 not contravene the Gift Clause even though particular persons or organizations benefit specially from
24 such use.” *Id.* at 280.

25 35. PWC argues that, although District is not subject to the Gift Clause, the case law
26 addressing that provision of the Arizona Constitution provides useful guidance with respect to the
27 “public interest” standard employed by the courts. PWC points out that the District was formed in
28 order to find additional water in the Pine/Strawberry area, and its decision to provide up-front capital

1 for drilling a test well is consistent with that purpose. According to PWC, a successful K2 test well
2 would result in a return of the District's investment, as well as requiring another entity (Pine Water)
3 to invest an additional amount of approximately \$1 million to complete the production well.

4 36. PWC also contends that the District's actions are authorized by state statutes. The
5 Company cites A.R.S. §48-909(A)(6), which PWC claims authorizes the District's Board to acquire,
6 construct, reconstruct, or repair a well, and A.R.S. §48-909(B)(1), under which the District is allowed
7 to "[a]cquire, by gift, purchase, condemnation or otherwise in the name of the district and own,
8 control, manage and dispose of any real or personal property or interest in such property necessary or
9 convenient for the construction, operation and maintenance [of the well]." PWC also cites to the
10 District's authority to join with any person in the construction, operation, or maintenance of a well,
11 pursuant to A.R.S. §48-909(B)(2), and to A.R.S. §48-909(B)(4), which permits the District to "[s]ell,
12 lease or otherwise dispose of any property of the district or interest in such property when the
13 property is no longer required for the purposes of the district" PWC asserts that the District is
14 engaging in the activities that are consistent with its mission to find additional water sources, and
15 which are consistent with constitutional and statutory requirements.

16 37. With respect to the impact of the K2 well on other wells in the Strawberry area, PWC
17 asserts that ADWR, and not the Commission, has the power to regulate groundwater and the
18 Commission is not empowered by the Arizona Constitution or state statute to stop public service
19 corporations from undertaking lawful activities. The Company claims that the Groundwater Code
20 (A.R.S. §45-103 *et seq.*) grants ADWR general control and supervision over groundwater and,
21 because PWC's CC&N is outside of an Active Management Area ("AMA"), there are no restrictions
22 on well placement or groundwater pumping in the event of impacts to surrounding wells.

23 38. PWC also contends that there is no evidence that the K2 well would have an impact on
24 neighboring wells because all existing wells are drilled to shallow depths in pockets of fractured rock,
25 whereas the K2 well is expected to be drilled to a depth approximately 1,700 feet into a distinct deep
26 aquifer (R-aquifer). PWC claims that if any de-watering of adjacent shallow wells were to occur, the
27 Company intends to seal the K2 well off from the shallower "C-aquifer." The Company argues that
28 it has a significant incentive to ensure there are no detrimental impacts to existing wells because

1 PWC and SWC own many of the shallow wells in the Strawberry area where the K2 well is to be
2 drilled.

3 39. Regarding the alleged easement problems, PWC claims that it is working to obtain the
4 necessary easements and expects a successful conclusion to those efforts. The Company states that if
5 it is unable to secure the necessary easements, the well would not be drilled and no approvals would
6 be needed. However, PWC argues that the need for easements has nothing to do with whether the
7 requested financing approval should be granted.

8 Discussion and Resolution

9 40. There is no dispute that the Pine/Strawberry area has long suffered from severe
10 shortages of water, which shortages have often led to the need for water hauling and associated
11 hauling surcharges, primarily during summer months. The Commission has admonished PWC on a
12 number of occasions to investigate ways to increase the availability of water during peak periods.
13 Primarily based on the long-held belief of most experts that the area's hydrology was limited to
14 production from shallow wells sunk into fractured rock, no real progress was made in finding
15 solutions to the chronic shortages. In recent years, however, the drilling of several deep wells by
16 private individuals appears to have altered the conventional wisdom regarding groundwater in the
17 Pine area.

18 41. Against this backdrop, PWC entered into a Joint Well Development Agreement with
19 the Pine Strawberry Water Improvement District as a means of providing an opportunity for PWC to
20 drill a deep well in the Strawberry area, at a site now owned by PWC⁶. Although the application filed
21 in this case seeks only approval, pursuant to A.R.S. §§40-285 and 40-302, of PWC's ability to incur
22 \$300,000 of indebtedness to the District, and to encumber the well site and well assets in favor of the
23 District, a number of other issues have been raised with respect to the application.

24 42. Based on a review of all of the relevant facts and legal arguments presented in this
25 proceeding, we believe that the financing application submitted by PWC should be approved. In
26

27 ⁶ The K2 well site was transferred to PWC from SWC on February 7, 2008 by Special Warranty Deed (February 20, 2008
28 Late-filed Exhibit). Staff witness Steve Olea stated at the hearing that Staff did not believe the transfer between sister
companies required Commission approval because he assumed "it [the K2 well site] is not providing use to Strawberry or,
if it is, that use would still be available to Strawberry even after the transfer" (Tr. 273).

1 reaching this conclusion we agree with the Company and Staff that the issues presented for our
2 review are relatively narrow. Consistent with a long line of decisions addressing financing
3 applications, our review of such requests is generally limited to a determination of whether the
4 requested financing is for a lawful purpose, consistent with sound financial practices, compatible with
5 the public interest and the applicant's proper performance as a public service corporation, and is
6 within the applicant's corporate powers; whether the applicant's revenues are adequate to support its
7 repayment obligations; and whether the financing will impair its ability to provide service to its
8 customers.

9 43. As described by Staff, PWC's TIER and DSC ratios are well within the limits
10 typically required by Staff and the Commission to ensure repayment of the proposed financing, and
11 there is no evidence that the proposed debt would impair the Company's ability to provide service to
12 its customers. The incurrence of the debt obligation and encumbrance of assets are within PWC's
13 corporate powers as a provider of water utility service, are consistent with sound financial practices,
14 and are for a lawful purpose, seeking an additional source of water. As a result, we believe that the
15 requested financing approval is in the public interest.

16 44. The intervenors seek to employ the "public interest" requirement as a catch-all to vest
17 the Commission with nearly limitless authority over any and all matters related to public service
18 corporations. The intervenors cite *Arizona Corporation Comm'n v. State ex rel. Woods*, 171 Ariz.
19 286 (1992), for the proposition that the Commission should use its public interest authority as a
20 means of reviewing a wide range of topics, including the validity of the Joint Agreement, whether the
21 District exceeded its authority by entering into the Agreement, whether the K2 well site is large
22 enough to drill a well, whether necessary easements have been obtained, and whether certain District
23 Board members had a conflict of interest when the Joint Agreement was negotiated.

24 45. We agree that the Commission has a broad range of powers granted by the Arizona
25 Constitution and a number of statutes; however, our jurisdiction is not limitless. Underlying the
26 intervenors' arguments in this case is an attempt to question and/or undo a number of decisions made
27 by the District's duly elected Board. We wish to make clear that we have no jurisdiction to make
28 findings as to the propriety of the District's actions, including the validity of the underlying

1 Agreement, given the District's status as a political subdivision of the State of Arizona. *See, Trico*
2 *Electric Cooperative, 67 Ariz. at 363.* If the intervenors wish to raise issues related to alleged
3 improprieties by the District's Board, they may do so through an action in a court of competent
4 jurisdiction. Indeed, pursuit of a remedy through a court action has been available for many months
5 and could have been employed to address the issues raised by the intervenors in this proceeding
6 regarding the District.

7 46. Although we agree with Staff and PWC that it is not the Commission's role to make
8 determinations regarding the constitutionality or legality of the District's decisions or contracts, we
9 will briefly address the alleged constitutional violations raised by the intervenors. First, as was
10 pointed out by both Staff and the Company, the intervenors' reliance on Article 9, Section 7, of the
11 Arizona Constitution is misplaced, given the District's exemption from that provision under Article
12 13, Section 7. With respect to Article 9, Section 10, the intervenors claim that the prohibition of
13 using public money to aid churches and public service corporations is absolute. However, as the
14 Arizona Supreme Court held in *Community Council, supra*, public funds may be used to reimburse a
15 sectarian organization for expenses incurred to provide assistance to those in need, as long as the
16 public funds were not used to provide a preference of one religion over another. 102 Ariz. at 4.
17 Although *Community Council* did not deal with "aid" to a public service corporation, it clearly shows
18 that the "Aid Clause" does not constitute an absolute prohibition.

19 47. Given the lack of case law addressing Article 9, Section 10, as it applies to public
20 service corporations, it is instructive to look to court decisions addressing public/private ventures
21 under the Gift Clause (Article 9, Section 7). In *Wistuber*, the Arizona Supreme Court found that the
22 Gift Clause may be violated if the value to be received by the public is far exceeded by the
23 consideration being paid by the public, but in making such a determination "the courts must not be
24 overly technical and must give appropriate deference to the findings of the governmental body." 141
25 Ariz. at 349. As PWC points out, the District's \$300,000 investment is directed to finding water in
26 the Pine area, the primary purpose for which the District was formed. If the K2 well is successful,
27 not only does the District receive a return of its investment, plus interest, but the Agreement requires
28 PWC to invest an additional estimated amount of \$1 million to complete the well and put it into

1 production. The benefit to the District and its members would appear to be significant to the extent
2 that the District does not have to invest the full amount necessary to place the deep production well
3 into place. In making these observations, we wish to make clear that we are not rendering an opinion
4 as to whether the District's actions violate the Arizona Constitution. Such issues may be presented to
5 a court with jurisdiction to consider constitutional arguments.

6 48. A number of other issues raised by the intervenors are not properly before us in this
7 case. For example, the intervenors' "double taxation" claim, the level of risk being undertaken by the
8 District, the District's control over escrow funds, and alleged conflicts of interest by District Board
9 members, are all matters that may be presented to a court with jurisdiction to consider actions taken
10 by the District and its Board.

11 49. In addition, we make no finding regarding the validity of the Joint Agreement or the
12 future recoverability through rates of costs associated with the K2 well, or any other well. Those
13 decisions are reserved for a rate case in which the Company will bear the burden of proving the
14 prudence of its decisions, and the reasonableness of the costs incurred, based on facts that were
15 known or should have been known at time such decisions were made.

16 50. With respect to the effect of the K2 well on neighboring wells, we do not believe it is
17 necessary, at this time, to address the Commission's authority to order corrective actions. Rather, it
18 is sufficient to direct Staff to provide to the Commission the results of ADWR's analysis of the test
19 well results, and whether neighboring wells would be affected by a production well at the K2 well
20 site, in accordance with Staff's recommendation in this case. Once that information is received, the
21 Commission can assess whether some further action should be taken regarding the affected wells.

22 CONCLUSIONS OF LAW

- 23 1. PWC is a public service corporation within the meaning of Article XV of the Arizona
24 Constitution and A.R.S. §§ 40-285 and 302.
- 25 2. The Commission has jurisdiction over PWC and the subject matter of the application.
- 26 3. Notice of the application was given in accordance with the law.
- 27 4. Staff's recommendations are reasonable and should be adopted.
- 28

1 IT IS FURTHER ORDERED that the financing approved herein shall not guarantee or imply
2 any specific treatment of any capital additions for rate base or rate making purposes.

3 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

4 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

5
6
7 CHAIRMAN

COMMISSIONER

8
9 COMMISSIONER

COMMISSIONER

COMMISSIONER

10 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive
11 Director of the Arizona Corporation Commission, have
12 hereunto set my hand and caused the official seal of the
13 Commission to be affixed at the Capitol, in the City of Phoenix,
14 this ____ day of _____, 2008.

15 _____
16 BRIAN C. McNEIL
17 EXECUTIVE DIRECTOR

18 DISSENT _____

19
20 DISSENT _____
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1 SERVICE LIST FOR: PINE WATER COMPANY

2 DOCKET NO.: W-03512A-07-0362

3 Jay L. Shapiro
4 Patrick J. Black
5 FENNEMORE CRAIG, PC
6 3003 North Central Avenue, Suite 2600
7 Phoenix, Arizona 85012
8 Attorneys for Pine Water Company

9 William P. Sullivan
10 CURTIS, GOODWIN, SULLIVAN,
11 UDALL & SCHWAB, P.L.C.
12 501 East Thomas Road
13 Phoenix, Arizona 85012-3205
14 Attorneys for Pine-Strawberry Water Improvement District

15 John G. Gliege
16 GLIEGE LAW OFFICES, PLLC
17 P.O. Box 1388
18 Flagstaff, Arizona 86002-1388
19 Attorney for Intervenors

20 Janice Alward, Chief Counsel
21 Legal Division
22 ARIZONA CORPORATION COMMISSION
23 1200 West Washington Street
24 Phoenix, Arizona 85007

25 Ernest G. Johnson, Director
26 Utilities Division
27 ARIZONA CORPORATION COMMISSION
28 1200 West Washington Street
Phoenix, Arizona 85007