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MEMORANDUM

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TO: Docket Control

FROM: Ernest G. Johnson
Director
Utilities Division

DATE: October 4, 2004

RE: STAFF REPORT FOR ARIZONA WATER COMPANY (DOCKET NO. W-01445A-04-0498) APPLICATION FOR AN ACCOUNTING ORDER AUTHORIZING THE DEFERRAL OF CAPITAL COSTS AND EXPENSES INCURRED BY ITS WESTERN GROUP SYSTEMS RELATED TO ARSENIC TREATMENT

Attached is the Staff Report for Arizona Water Company's application for an accounting order authorizing the deferral of capital costs and expenses incurred by its Western Group systems related to arsenic treatment.

EGJ:DRR:cal

Originator: Dennis R. Rogers

Attachment: Original and Thirteen Copies

Arizona Corporation Commission

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STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION

ARIZONA WATER COMPANY
DOCKET NO. W-01445A-04-0498

APPLICATION FOR
AN ACCOUNTING ORDER AUTHORIZING THE
DEFERRAL OF CAPITAL COSTS AND EXPENSES
BY ITS WESTERN GROUP SYSTEMS RELATED TO
ARSENIC TREATMENT

October 4, 2004

**EXECUTIVE SUMMARY
ARIZONA WATER COMPANY
DOCKET NO. W-01445A-04-0498**

Arizona Water Company ("Company") provides water service to approximately 26,000 customers in its Western Group systems, which are the Casa Grande, Coolidge, White Tank, Stanfield and Ajo systems. The Company seeks an accounting order authorizing it ". . . to record and defer for recovery under the terms of an approved Arsenic Cost Recovery Mechanism ("ACRM") for the Western Group all arsenic treatment costs and expenses deemed recoverable under the ACRMs the Commission approved in Arizona Water Company's Northern and Eastern Group cases . . ."

An accounting order is the rate-making mechanism whereby the Commission provides specific authorization, as permitted under the National Association of Utility Regulatory Commissioners ("NARUC") Uniform System of Accounts ("USOA"), to treat costs in a manner that is different than under generally accepted accounting principles.

In this case, the Company seeks an accounting order authorizing it to (1) defer recognition of the purchase cost of arsenic treatment facilities or the lease capital cost for leased facilities in the usual manner until an ACRM is authorized for the Western Group and (2) defer up to twelve months of recoverable operation and maintenance expenses for inclusion in an ACRM.

The Company requests authorization in this case to defer in its Western Group essentially the same types of costs that the Commission authorized for inclusion in ACRMs in its Northern Group and its Eastern Group. This request for an accounting order is distinguished from the previously authorized ACRMs in that the ACRMs provide a method for recovery of costs whereas an accounting order only allows costs to be deferred so that the Commission may consider authorization for recovery at a future date. The Company's filing anticipates that an ACRM will be established in conjunction with a rate case proceeding which it filed on September 7, 2004.

The Company's application states that it projects a \$13.6 million cost to purchase arsenic treatment facilities for the Western Group systems and \$2.1 million annual operating and maintenance costs for arsenic treatment for the affected Western Group systems. Arsenic treatment is required to reduce water arsenic levels to less than 10 parts per billion ("ppb") maximum contaminant level ("MCL") by January 2006, as mandated by the United States Environmental Protection Agency.

Contrary to the Northern and Eastern Groups where the Commission rendered rate decisions and established ACRMs prior to arsenic treatment plant construction and initial operations, the Company anticipates that it will incur all of the Western Group's arsenic treatment facilities capital costs before an ACRM is authorized. The timing difference for completion and initiation of operations between the Western Group and the Northern and Eastern

Groups is significant in that arsenic treatment capital and operating costs will be incurred before these costs can be considered for inclusion in rates or an ACRM. Under generally accepted accounting and ratemaking principles the Company will have no opportunity to recover arsenic removal costs that are incurred by the Western Group before such costs are recognized in rates unless the Commission issues an accounting order authorizing the deferral of these costs for future consideration of recovery. The magnitude of the costs incurred for arsenic MCL compliance may be sufficient to affect the Company's financial integrity if not recovered.

Staff recommends issuance of an Accounting Order authorizing the Company to defer certain capital and operations and maintenance arsenic removal costs similar to the costs the Commission authorized for inclusion in the ACRMs for the Company's Northern and Eastern Groups.

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STAFF ACKNOWLEDGMENT

The Staff Report for Arizona Water Company, Docket No. W-01445A-04-0498 was the responsibility of the Staff member Dennis R. Rogers, who was responsible for the review and analysis of the Company's application for an Accounting Order Authorizing the Deferral of Capital Costs and Expenses Incurred by its Western Group Systems Related to Arsenic Treatment.



Dennis R. Rogers
Public Utilities Analyst IV

Introduction and Background

On July 8, 2004, Arizona Water Company ("Company") filed an application with the Arizona Corporation Commission, ("Commission") for an Accounting Order authorizing the deferral of capital costs and expenses incurred by its Western Group systems related to arsenic treatment.

The Company has 18 systems configured in three groups. The Commission authorized an Arsenic Treatment Cost Recovery Mechanism ("ACRM") for its Northern Group in rate case Decision No. 66400, dated October 14, 2003, and for its Eastern Group in Decision No. 66849, dated March 19, 2004. The Company filed a general rate case application for its Western Group on September 7, 2004.

The United States Environmental Protection Agency has reduced the arsenic maximum contaminant level ("MCL") from 50 parts per billion ("ppb") to 10 ppb. The date for compliance with the new MCL is January 23, 2006. The Company projects actual capital costs at \$13.6 million and annual operating and maintenance costs of \$2.1 million for its Western Group systems. The Company seeks an accounting order authorizing the deferral of certain capital costs and expenses it expects to incur in its Western Group systems for arsenic treatment before those costs can be recognized in rates.

Arizona Water Company was formed in 1955. The Company obtained a Certificate of Convenience and Necessity issued by the Commission in Decision No. 28794, dated March 23, 1955. The Company's Western Group current rates were authorized on December 23, 1992, in Decision No. 58120.

Staff Analysis

The Company's application seeks, "Approval of an Accounting Order to record and defer for recovery under the terms of an approved ACRM for the Western Group all arsenic treatment costs and expenses deemed recoverable under the ACRMs the Commission approved in Arizona Water Company's Northern and Eastern Group cases."¹ The Company also proposes "to record the actual cost to purchase arsenic treatment facilities or the actual lease capital costs (standby fee) for leased facilities in a deferred debit account until an ACRM is authorized for the Western Group. The Company would not earn a return on the actual cost to purchase arsenic treatment facilities while they are deferred nor recognize any depreciation expense on them."²

An accounting order is the rate-making mechanism whereby the Commission provides specific authorization, as permitted under the National Association of Regulatory Utility Commissioners ("NARUC") Uniform System of Accounts ("USOA"), to treat costs in a manner that is different than under generally accepted accounting principles.

¹ Docket No. W-01445A-04-0498, page 4, lines 8 through 10.

² Id. page 4, lines 15 through 19.

Decision No. 66400, dated October 14, 2003, defined the arsenic treatment costs and expenses that were to be included in the ACRMs as follows:

- (1) Capital costs expended to construct arsenic treatment plant
- (2) Leased equipment whose payments must be broken out as follows:
 - a. The lessor's equipment construction costs
 - b. Recoverable operation and maintenance ("O&M") costs
 - c. Other O&M costs.

The lessor will also be required to identify the interest rate embedded in the lease payment.³

Recoverable O&M costs were defined as "media replacement or regeneration costs, media replacement or regeneration service costs, and waste media or regeneration disposal costs"⁴

Decision No. 66400 also specifically denied recovery of certain other costs stating:

"Arizona Water will not be entitled to recover interest or financing charges associated with the deferred balance."⁵

". . . property taxes should not be included in the Company's ACRM filings."⁶

Contrary to the Northern and Eastern Groups where the Commission rendered rate decisions and established ACRM mechanisms prior to arsenic treatment plant construction and initial operations, the Company anticipates that it will incur all of the Western Group's arsenic treatment facilities capital costs before an ACRM is authorized. The timing difference for completion and initiation of operations between the Western Group and the Northern and Eastern Groups is significant in that arsenic treatment capital and operating costs will be incurred before these costs can be considered for inclusion in rates or an ACRM. Under generally accepted accounting and ratemaking principles the Company will have no opportunity to recover arsenic removal costs that are incurred by the Western Group before such costs are recognized in rates unless the Commission issues an accounting order authorizing the deferral of these costs for future consideration of recovery.

A primary factor underlying Staff's recommendations for authorizing ACRMs for the Northern and Eastern Groups was the potential for arsenic removal costs to have detrimental financial effects to the Company. Likewise, the magnitude of the capital investment and projected annual arsenic operation and maintenance costs for the Western Group warrants consideration for unusual treatment such as deferral of these costs. Since deferral of these costs is not the normal treatment under the National Association of Regulatory Utility Commissioners Uniform System of Accounts, the Company cannot defer these costs unless the Commission issues an accounting order authorizing the deferrals. Normally plant and expenses are recorded in the period they are incurred. Authorizing deferrals is a mechanism the Commission can use to

³ Decision No. 66400, page 6, lines 19 through 22.

⁴ Id. page 6, lines 1 and 2.

⁵ Id. page 7, lines 2 and 3.

⁶ Id. page 16, lines 20 and 21.

allow the Company to request recovery of the deferred costs in the future. An ACRM is one way the arsenic treatment costs could be recognized in rates. The Company anticipates that recovery will take the form of an ACRM authorized by the Commission in its pending rate case.

The purpose of any authorized accounting order would be to allow the Company to defer arsenic treatment costs for future consideration by the Commission to authorize recovery, not to provide for recovery. The Company's proposal to record purchased arsenic treatment facilities in a deferred debit account effectively provides for authorization of recovery, not simply deferral for future consideration of recovery, of depreciation expense on the arsenic treatment facilities incurred during the deferral period. Accordingly, the Company's proposal regarding deferrals for purchased arsenic treatment facilities is inappropriate. An alternative method of deferring costs related to purchased arsenic treatment facilities is to defer the depreciation expense on those facilities.

Staff Recommendations

Staff recommends issuing an accounting order authorizing the Company to defer arsenic treatment costs incurred in its Western Group for future Commission consideration for recovery as follows:

1. Depreciation expense for the actual cost to purchase each arsenic treatment facility may be deferred for a period not to exceed twelve months.
2. The actual lease capital costs (standby fee) for each leased arsenic treatment facility may be deferred for a period not to exceed twelve months.
3. Leased capital costs must meet the following criteria to be eligible for deferral:
 - a. The costs recorded for leased equipment must be broken out by payment into the following three separate components: a) the lessor's equipment construction costs; b) recoverable O&M costs (as defined below); and c) other O&M costs, and
 - b. The lessor's embedded interest rate is stated.
4. Operation and Maintenance expenses eligible for deferral are limited to the following:
 - a) media replacement or regeneration costs; b) media replacement or regeneration service costs; and c) waste media or regeneration disposal costs for each of the systems for a period up to twelve months.
5. No property taxes associated with arsenic recovery plant shall be deferred.
6. No deferrals shall be recorded after January 2007.