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IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR AUTHORITY TO IMPLEMENT ARSENIC COST RECOVERY MECHANISMS FOR ITS AGUA FRIA WATER, SUN CITY WEST WATER, HAVASU WATER, AND TUBAC WATER DISTRICTS	DOCKET NO. W-1303A-05-0280
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS SUN CITY WEST WATER AND WASTEWATER DISTRICTS.	DOCKET NO. WS-01303A-02-0867
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS MOHAVE WATER DISTRICT AND ITS HAVASU WATER DISTRICT.	DOCKET NO. W-1303A-02-0869 **ARIZONA-AMERICAN WATER COMPANY'S CLOSING BRIEF**

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS ANTHEM WATER DISTRICT, ITS AGUA FRIA WATER DISTRICT, AND ITS ANTHEM/AGUA FRIA WASTEWATER DISTRICT.	DOCKET NO. WS-01303A-02-0870

ARIZONA-AMERICAN WATER COMPANY'S
CLOSING BRIEF

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I. INTRODUCTION[1]

Arizona-American Water Company ("Arizona-American" or the "Company") is an Arizona corporation engaged in the business of providing water and wastewater utility service to customers in its various water and wastewater districts located in portions of Maricopa, Mohave, and Santa Cruz counties in Arizona under authority granted by the Commission. Arizona-American is a wholly-owned subsidiary of American Water Works, Inc. Arizona-American's ultimate parent is RWE AG.

The federal Environmental Protection Agency has promulgated new water quality regulations that reduce the allowable concentration of arsenic in drinking water from 50 to 10 parts per billion ("ppb"), effective January 23, 2006.

In Decision No. 66400 dated October 14, 2003, the Commission approved an Arsenic Cost Recovery Mechanism ("ACRM") for Arizona Water Company's Northern Division. In this case Arizona-American is asking approval of an ACRM—essentially identical to the mechanism approved in Decision No. 66400—for three of its Water Districts: Aqua Fria; Sun City West; and Havasu.

The Company's only additional request is for a new hook-up fee for its Havasu Water District, to be effective upon an order in this proceeding. The purpose of this request is to offset capital costs associated with arsenic remediation, which will reduce the magnitude of the necessary surcharge.

Consistent with Decision No. 66400, Arizona-American will subsequently make a series of filings for each district for specific ACRM surcharge step increases based on actual capital costs and recoverable deferred and recurring operating and maintenance expenses. Eligible capital costs include depreciation expense, and gross return.

[1] This section is based generally on Broderick Direct, pp. 1-3.

Presently, Arizona-American delivers water in each of these three districts at levels below the current arsenic standard but in excess of the new standard. The construction of the new arsenic-removal facilities in these three districts will require approximately $22 million in capital investment. Arizona-American estimates that average monthly ACRM surcharges for capital costs and recurring O&M will range from $5.61 to $18.06, depending on the water district.

In 2004, Arizona-American earned less than its authorized return in all three of these districts and earnings will further erode in 2005 and beyond. ACRMs can slow the pace of this erosion.

II. PROCEDURAL HISTORY

On December 17, 2001, Arizona-American filed an application with the Commission requesting a Commission declaration that the Commission's Public Utility Holding Companies and Affiliated Interests Rules, A.A.C. R14-2-801, et seq. ("Affiliated Interests Rules") were not applicable to the transaction described in the application, or alternatively, requesting a limited waiver of the requirements of the Affiliated Interests Rules with respect to the described transaction. The Commission issued Decision No. 65453 in that docket on December 12, 2002.

On November 22, and December 13, 2002, Arizona-American filed with the Commission applications for rate increases in all of its water and wastewater districts with the exception of its Paradise Valley Water District. The Commission issued Decision No. 67093 in those dockets on June 30, 2004.

On December 15, 2004, Arizona-American filed a request to: 1) reopen the record in Decision No. 67093 for the limited purpose of serving as the evidentiary basis for future Arsenic Cost Recovery Mechanism ("ACRM") filings for the concerned Arizona-American water

districts, and 2) waive Condition No. 15 in Decision No. 65453 for Arizona-American' s Paradise Valley Water District. Condition 15 in Decision No. 65453 had prohibited the Company from filing any new rate cases for any of its districts for three years from the date the RWE purchase of American Water Works closed—until January 10, 2006.

On February 15, 2005, the Commission issued Decision No. 67593 in the above-captioned dockets, granting Arizona-American's requests, expressly conditioned on dismissal of Arizona-American's pending appeals of Decision No. 67093 and Decision No. 65453 within 30 days of the Decision. Arizona-American and Commission Staff ("Staff") executed stipulations to dismiss these appeals, which were approved by the courts.

As required by the March 29, 2005, Procedural Order in this case, Arizona-American filed on April 15, 2005, an application for authority to implement ACRMs for its Agua Fria Water, Sun City West Water, Havasu Water, and Tubac Water Districts, together with direct testimony in support of the application.[2]

On May 4, 2005, the Company filed a Motion to Delete Tubac Water District from Application.[3] This Motion was granted by a Procedural Order dated May 6, 2005. On June 8, 2005, Arizona-American filed the Direct Testimony of Joseph E. Gross P. E. [Revised June 8, 2005]; and the Direct Testimony of Thomas M. Broderick [Revised June 8, 2005]. The Company's revised testimony deleted all references to the Tubac Water District.

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[2] The Company has separately requested an ACRM to recover the costs associated with arsenic remediation for its Paradise Valley Water District in Docket No. W-01303A-05-0405.

[3] The Motion stated that in response to its customers' desires, the Company is evaluating another arsenic-remediation technology for the Tubac Water District, and has asked the Arizona Department of Environmental Quality for a 12-month delay for compliance with the new federal requirements for that system to allow time for the evaluation. The Motion requested leave for the Company to amend its application to delete the requested relief concerning its Tubac Water District, and stated that counsel for Staff and RUCO have indicated to the Company that neither party has any objection to the request.

On July 1, 2005, Staff filed the Direct Testimony of Crystal S. Brown. RUCO filed that same date, the Direct Testimony of Marylee Diaz Cortez. On July 19, 2005, Arizona-American filed the Responsive Testimony of Thomas M. Broderick.

The hearing was held as scheduled on July 26, 2005, before Assistant Chief Administrative Law Judge Dwight Nodes. At the hearing, Judge Nodes set August 29, 2005, as the date for the parties to submit closing briefs. The Company submits this closing brief in accordance with that order.

III. ARSENIC REMEDIATION FACILITIES

Arizona-American provided two witnesses to testify about the arsenic remediation facilities the Company is building to satisfy the new federal standard of no more than 10 ppb. The first witness was Fredrick K. Schneider, who adopted the pre-filed direct testimony of Joseph E. Gross (Exhibit A-1) and the three exhibits attached to Mr. Gross' testimony (Exhibits A-2, A3, and A4). Mr. Schneider's examination appears at Tr. 8-30. The Company's second witness concerning its arsenic remediation facilities was Peter J Keenan, whose examination appears at Tr. 86-111.

Fredrick K. Schneider is employed by American Water Works Service Company as the director of engineering for American Water's Western Region. Tr. at 9. He is responsible for overseeing the capital planning and engineering activities for the entire Western Region, including regulated operations in Arizona, California, Hawaii, New Mexico, and Texas. Tr. at 9-10. Mr. Schneider is a registered professional engineer in Arizona and holds Grade 3 certificates from the Arizona Department of Environmental Quality. Tr. at 10. Joseph E. Gross, who originally sponsored Exhibits A-1 through A-4, is the engineering manager for Arizona, New Mexico, and Texas, and reports directly to Mr. Schneider. *Id.*

Mr. Schneider testified that Arizona-American's overall arsenic-remediation program will consist of eight treatment facilities in five Arizona-American districts. Gross Direct at 3. Three facilities will be required in the Company's Agua Fria Water District, two in the Sun City West Water District, one in the Havasu Water District, one in the Tubac Water District, and one in the Paradise Valley Water District. *Id.* Exhibit A-2 is a map that shows the location of each facility. *This case concerns only the six facilities in the Company's Agua Fria Water, Sun City West Water, and Havasu Water Districts. Id.*

For six of the Arizona facilities, the Company selected a granular-iron media-adsorption process as the most cost-effective method for arsenic remediation. Gross Direct at 4. As the incoming water passes through the contactor vessels, the arsenic ions are chemically attracted to the ferric ions and therefore adhere to the iron-based media. *Id.* Water with very low levels of arsenic then flows out of the vessels for blending with other water sources, chlorination, and distribution. *Id.* To insure a cost-effective process, only 60-70% of the influent water is actually treated. *Id.* The treated water, containing very low levels of arsenic, is then blended with other source water; with the resultant arsenic level maintained at or below eight ppb. *Id.* The Company used a competitive-bid process to select the manufacturer of the treatment vessels and awarded the contract to Severn Trent, Inc. *Id.*

Another advantage of how Arizona-American has designed the six granular-iron facilities, is that the vessels can be used with different media, should technology improve in the future.

> [W]e chose the facilities and sized them appropriately so as that, as technology came out more advanced and more cost efficient, as that media is exhausted, we are able to swap that media out and maybe put a different type of media back in to make sure we stay on top of any new emerging technologies that may become available. Tr. at 17-18.

The Sun City West No. 1 site will utilize a coagulation-filtration process, where the arsenic ions are attracted by a ferric chloride solution added to the incoming water.[4] Gross Direct at 4. The combined iron/arsenic precipitate is then removed via filtration, dewatered, and deposited in a landfill as non-hazardous material. *Id.* The treated water proceeds to blending with other water sources, chlorination, and distribution. *Id.* The blending process is the same as described above, which minimizes actual treatment costs. *Id.* For facilities treating larger volumes of water, such as the Sun City West No. 1 site and the Paradise Valley site, this procedure is more cost-effective than the granular-iron process. *Id.* at 4-5.

Exhibit A-3 describes each location where treatment is needed, discusses the technology selected, and provides a cost estimate for each treatment facility.

Mr. Schneider explained that drilling new wells was not a reasonable option to treating existing water supplies for arsenic. Tr. at 21-26. First, land in most of the areas is in short supply, so even acquiring a new well site would cost $150-200,000. Tr. at 22. Second, drilling and outfitting a new well would cost in the range of $1.2 to $1.4 million. *Id.* Third, there would be no guarantee that the new well would satisfy the arsenic standard without treatment. *Id.* Fourth, a new well may not supply as much water as a proven production well, or could have other water quality issues. *Id.* at 23. Drilling pilot wells can somewhat reduce the risk, but does not ensure against poor, expensive outcomes once the well is actually drilled and outfitted. *Id.* at 24-26.

To insure compliance with the new arsenic standard, each construction contract contains specifications requiring startup procedures and testing to insure arsenic levels do not exceed eight ppb, two ppb below the EPA's maximum contaminant level. Gross Direct at 5. The Company targets a slightly lower arsenic level in the blended water to provide a margin of safety

[4] This same technology will be used for arsenic remediation at the Company's Paradise Valley treatment facility.

for compliance. *Id.* To insure initial and continued compliance, samples will be taken at intervals specified by EPA and analyzed by a certified commercial-testing laboratory. *Id.* Additionally, the Company will daily monitor various online instrument readings to insure proper operation of the facilities. *Id.* If necessary, because of fluctuations in influent arsenic or other water quality parameters, the Company can readily adjust the percentage of the total flow to satisfy the internal eight ppb standard. *Id.*

Arizona-American has awarded construction contracts for each project. Gross Direct at 6. The Company used a competitive-bid process to select the construction contractors, based upon qualifications and low bids. *Id.* For the coagulation-filter project at Sun City West No. 1, the Company analyzed proposals submitted by four firms and then awarded a design-build contract for to D. L. Norton Company. *Id.*

The remaining projects all used a construction-manager-at-risk approach. *Id.* Contractors were chosen based upon bids submitted by firms after examination of 30% plans. *Id.* The design contracts for these projects were awarded after examination of cost and scope proposals by three qualified construction firms. *Id.* After reviewing these criteria, Arizona-American selected Garney Construction as the contractor for the remaining sites in Maricopa County and for the Havasu Water District project. *Id.*

Arizona American has had extensive experience with the selected contractors, D.L. Norton and Garney Construction. Tr. at 26. Although neither has built arsenic projects for the Company, they have successfully completed booster facilities, storage tanks, wastewater treatment plant expansions, and other projects. *Id.* As discussed above, the granular-iron media-adsorption facilities will use Severn Trent's pre-manufactured treatment vessels. Therefore, Garney Construction's role will be to perform the general types of construction it has previously

performed for Arizona-American, for example "electrical, grading, concrete work, building, piping, and then installing the [pre-manufactured] vessels." Id. at 27.

Each of the selected contractors will submit monthly invoices, which an Arizona-American project manager will examine for accuracy and completeness of work. Gross Direct at 6. Upon approval, invoices will be submitted to the corporate accounting office for payment. *Id.* To insure satisfactory completion, the Company will withhold a ten-percent retainage from each invoice, payable only when the project has been completed, inspected, and accepted. *Id.*. The ten-percent retainage is a standard practice for Arizona-American on all but the smallest construction projects. *Id.* at 6-7.

The final subject in Mr. Schneider's direct testimony was a forecast of the new dedicated operation and maintenance costs associated with arsenic-remediation facilities. Gross Direct at 7. The costs of ferric chloride and other chemicals, and the media used in the treatment process, are currently not used anywhere else in Arizona American's system and are unique to the treatment process. *Id.* Exhibit A-4 summarizes these costs. Consistent with the Commission's approved ACRM for Arizona Water Company's Northern and Eastern Districts, the O&M forecast in Exhibit A-4 does not include the costs of additional, non-dedicated, staffing, or the costs of the increased power needed to operate these facilities. *Id.*

Neither Staff nor RUCO presented any direct testimony concerning the actual facilities Arizona-American is constructing or the initial choice of media to be used in the granular-iron treatment vessels. However, Judge Nodes did obtain some testimony on these subjects from Staff engineering witness John Chelus.

Before briefly discussing Mr. Chelus' testimony, it is important to establish what is relevant in this case. Consistent with the Arizona Water precedent, once arsenic remediation

facilities for a district are completed, the Company will be making a Step One filing to implement a surcharge to recover the capital costs associated with the facility. The capital costs include for each facility the vessel and an initial load of media needed to reduce the arsenic content of the water. See Exhibit A-3. Replacement media costs will be part of recoverable O&M, which can only be considered as part of a Step Two filing. The Company's filing is based on this understanding of the Arizona Water precedent and neither Staff nor RUCO has suggested any other process.

Mr. Chelus observed the following concerning the Company's arsenic-remediation facilities.

- He would have like to have seen pilot testing at each site, before a particular media was selected, particularly as to pH affects. Tr. at 79-80.
- The vessels from Severn Trent that the Company is installing could be used for "all different kinds of media," so that "the plant costs probably aren't going to change that much." Tr. at 80
- He expects that Staff would want to ensure that the most cost effective media was chosen. Tr. at 82.
- He endorsed the ACRM process, but not necessarily the specific details of construction and operation. Tr. at 83-84.
- He agreed that evaluating the choice of media at a facility would be based on what was known at the time. Tr. at 86.
- He mentioned as an alternative to pilot testing, "bench scale pilot studies" that a professor at Arizona State University was developing. Tr. at 87.

- He acknowledged that Staff had sent a significant number of data requests to the Company concerning the facilities, that the Company had timely replied to each request, and that the Company had provided Staff "a lot of information" in its responses. Tr. at 88.

In response to Mr. Chelus' testimony, Arizona-American put Peter John Keenan on the stand. Mr. Keenan is employed by American Water Works Service Company as the technical services manager for American Water's Northeast Region. Tr. at 97. Before that time, he was employed as a senior design engineer for American Water Works Service Company; working on the Arizona arsenic project was one of his responsibilities. *Id.* Mr. Keenan has a bachelor's degree in civil engineering from Villanova University and a master's degree in environmental engineering from the University of Massachusetts. *Id.*

Mr. Keenan discussed his extensive role in the Arizona arsenic-remediation projects:

> [M]y role was to manage the up-front preliminary design work, the evaluation of alternatives, the selection of the alternative or recommendation to Arizona-American and then develop the design concept and work with the detailed design engineers through the design process to complete the design work. Tr. at 98.

Mr. Keenan was involved in the selection of the media for the vessels, which was finalized in June 2004. *Id.* He explained why the media had to be selected over one year ago: "We needed to make that decision at that time to have enough time to complete the design of those facilities, procure the equipment, and complete the construction by the January '06 deadline." Tr. at 98-99.

Mr. Keenan next provided several reasons why it was unnecessary to perform pilot testing at each facility site before selecting the appropriate media. First, the Company had already performed several tests and had the benefit of extensive literature review.

At the time in June of '04 when we finalized our selection, and that date might be off by a little bit but that was generally the time period, we did have the benefit of the pilot work that was actually done in Sun City West. We also had pilot data from an American Water system in California where we tested two granular iron medias, a Severn Trent product and U.S. Filter's product, on water of similar quality. And there is also a lot of published data at that point that we had from other water systems around Arizona and elsewhere in the western region and work we had done. We had done a pilot test in New Jersey with granular ferric hydroxide, a U.S. Filter's product.

So comparing the water quality for the Arizona-American supplies to both what is in Sun City West as well as those other systems, we felt we had adequate information to make an educated decision on how the media would perform. Tr. at 99-100.

Second, unnecessary pilot testing is expensive.

Typically the manufacturers will charge you a fee to provide a pilot unit and provide their media. There is sampling that needs to be done to test the performance of the unit. Lab tests tend to be fairly expensive. So it is difficult to quantify, but we have seen prices in the range of $10,000, you know, plus or minus for a given media. And if you are doing multiple media, then that just gets multiplied. There is an economy to doing side by side, where the setup and so on is less expensive. But we would expect, if you ran multiple parallel pilot tests, you know, you can easily get up into the 20 - $30,000 range. Tr. at 100-101.

Third, extra pilot testing takes time, which would delay completion of the facilities.

I mean you have to run them for several weeks to several months to evaluate the data. Typically for this media, what you are looking for is when does the media get exhausted and how quickly, so you have to run it for several weeks to several months to see that pattern occur. Tr. at 101.

Fourth, to protect its customers, Arizona American is purchasing media with performance guarantees.

We went out to Severn Trent and U.S. Filter and McFee Environmental Supply who has an iron exchange base absorptive media, they all gave us performance guarantees and said we will treat this much water before you have to change out this media. And on that basis, we picked the one that had the best value on the O&M side and also had the financial backing where, if it didn't perform, we would get a prorated share back from the manufacturer. So we were able to protect our customers, you know, from selecting media that didn't perform as expected. Tr. at 109.

Finally, by purchasing the same media from the same vendor (with performance guarantees), the Company was able to get much better pricing than if it had purchased specific media for each facility.

> The other important consideration or strategy we used in our approach was to bid the granular iron media for all of the sites together to take advantage of the economy of scale. We felt there was tremendous value in going out to the suppliers rather than picking one type of media for one site and another media system for another site which might -- granted one might outperform one slightly at one site versus the other, but we felt that would have been less cost effective to try to take advantage of those savings as compared to taking advantage of doing a bulk purchase of I think what amounted to 25 or 20 some odd vessels for the five or six sites that we were procured for, and in the bulk purchase of the media itself as well. Tr. at 107-108

Mr. Keenan was quite familiar with the bench pilot testing discussed by Mr. Chelus,[5] but explained that this option was not available at the time the Company had to make its media purchases.

> Mr. Chelus mentioned that Dr. Westerhoff at ASU, I believe it is, is performing a test called the rapid small scale column test. And American Water actually is using that on one of our systems from California. We have engaged Dr. Westerhoff to do that test.
>
> However, at the time we made this decision, that test had not yet been fully developed and wasn't an accepted method. And at this point, we are still not certain how it compares since that work has not been compared to actual full scale performance data. We are not certain that it really will tell us whether one media is particularly more effective than another in a full scale application. Tr. at 102-103.

Mr. Keenan also didn't believe that Staff, or anyone else, could evaluate media performance at the time Staff evaluates the completed capital projects.[6] When asked this question he replied:

> I don't think so. I mean our expectation is that any absorbent media with, you know, initially at the start-up of operation will remove the bulk of the

[5] Tr. at 87.
[6] After the Company's Step One filing.

> arsenic. It takes, in this case it will take several weeks to several months before we even start to see a breakthrough occur where you can start to project out, you know, down the road when the media would have to be replaced. So I think that would be difficult. Tr. at 101-102.

This means that media performance should not be an issue until at least Arizona-American's Step Two filing.

IV. ACRM PROCEDURE

1. ARIZONA-AMERICAN'S REQUEST

In his Direct Testimony, Thomas M. Broderick presented the Company's proposed arsenic cost recovery mechanism and the procedure for its use. Exhibit A-5. Other than the proposed hook-up fee for the Havasu Water District, there were ultimately no disagreements between the parties.

Mr. Broderick is the Manager, Government & Regulatory Affairs, for American Water's Western Region. Broderick Direct at 1. In this capacity, he is responsible for Arizona American's day-to-day relations with the Commission and for community relations in Arizona. He also supports regulatory activities in Arizona and occasionally in other jurisdictions. *Id.* Mr. Broderick has over 20 years experience in the electric-utility industry with responsibilities for regulatory and government affairs, corporate economics, planning, load forecasting, finance and budgeting with Arizona Public Service Company, PG&E National Energy Group, PG&E Energy Services, and the United States Agency for International Development. *Id.* He earned a Masters in Economics from the University of Wisconsin – Madison and a Bachelor in Economics from Arizona State University. *Id.* at 2.

Mr. Broderick set forth Arizona-American's request in this proceeding:

> Arizona American Water requests Commission approval by August 31, 2005, of an Arsenic Cost Recovery Mechanism ("ACRM") for its Agua Fria, Havasu, and Sun City West Water Districts. This request includes both the mechanism and the procedure for its use. Once approved,

> Arizona American will subsequently make a series of filings for each district for specific ACRM surcharge step-increases based on actual capital costs and recoverable deferred and recurring operating and maintenance expenses. Eligible capital costs include depreciation expense and gross return. *Id.*

Other than the requested hook-up fee for Havasu Water, Arizona-American's request is essentially identical to what the Commission approved for Arizona Water Company's Northern Division in Decision No. 66400, dated October 14, 2003.

> 1. The ACRM is based solely on actual costs and costs eligible for recovery are depreciation, gross return, and recoverable O&M.
>
> 2. Actual rate recovery via the ACRM commences after new arsenic facilities are in service and are in compliance with the new US EPA standard for arsenic.
>
> 3. Establishment of deadlines for filing the next rate cases for these districts, without limit on Arizona American's ability to file earlier as per existing Commission orders.
>
> 4. An ACRM rate design composed of a 50/50 split of the recovery between monthly minimum charges and volumetric charges.
>
> 5. A financial presentation composed of ten standard schedules for each of the districts with the ACRM.
>
> 6. Recoverable O&M costs include only media replacement or regeneration, media replacement or regeneration service, and waste disposal.
>
> 7. A deferral for future recovery of up to 12 months of recoverable O&M without return commencing with the in-service of facility(s) within each district.
>
> 8. Two step-rate increases in each district with an ACRM.
>
> 9. No true-up of the ACRM for over or under collection.
>
> 10. Gross return included in the ACRM based upon earlier rate of return and return on equity findings (for Arizona American this is Commission Decision No 67093 dated June 30, 2004, which authorized a 9% ROE).
>
> Broderick Direct at 4-5.

The Company's arsenic-remediation facilities will be financed through internal borrowing at a rate of 70 basis points above Treasury rates, which is a significantly lower rate than would be available to any stand-alone Arizona water utility or from the Water Infrastructure Finance Authority ("WIFA"). Broderick Direct at 5-6. Further, because of Arizona-American's current poor earnings, Mr. Broderick did not believe that the Company could qualify for WIFA financing. *Id.* at 6.[7]

Mr. Broderick attached Schedules 1 through 11 to his testimony. These were admitted as Exhibit A-7. Schedules 1-10 provide the required information in the format approved for Arizona Water's Northern Division in Decision No. 66400. *Id.* The Company will re-submit Schedules 1-10 each time it makes an ACRM filing. *Id.* at 6-7. This will amount to up to six more submittals (three water districts with two step increases each). *Id.* at 7. They use actual 2004 data and the Company's estimated cost estimates in Exhibits A-3 and A-4.

A list of the ten ACRM schedules follows:[8]

- Schedule 1: Arizona American's most recent balance sheet at the time of a filing for an ACRM step increase.
- Schedule 2: The most recent income statement for Arizona American and for those districts the Company is requesting an ACRM step increase.
- Schedule 3: An earnings test schedule for each district where the Company is requesting an ACRM step increase. The earnings test will reflect the Company's most recent financial data.
- Schedule 4: A rate review schedule for each district showing the incremental and pro forma effects of the rate increase associated with arsenic removal capital and recoverable O&M costs on the financial data provided in Schedules 2 and 3.

[7] Mr. Broderick presented actual 2004 returns on equity for the three subject water districts as follows: Havasu - (4.48) %, Sun City West - 1.26 %, and Agua Fria - 6.77 %. Broderick Direct at 10.

[8] Schedule 11 relates to the Havasu hook-up fee.

- Schedule 5: A revenue requirement schedule showing the calculation of the required rate increase related to arsenic removal capital and recoverable recurring O&M costs for each district. The schedule will also indicate the current, incremental increase, and proposed commodity rates and monthly minimums for a 5/8-inch equivalent meter.

- Schedule 6: A schedule showing the surcharge calculation for arsenic removal capital and recurring recoverable O&M costs for each district. Fifty percent of the total capital and recurring recoverable O&M costs will be in the form of a monthly minimum surcharge and fifty percent will be in the form of a commodity surcharge. The monthly minimum surcharge will be scaled to each customer class based on the current approved ratio between monthly meter size minimum. The schedule will also provide information related to number of customers by meter size and number of gallons sold. When the Company seeks recovery of deferred recoverable O&M costs, a similar schedule will be provided showing the calculation of the 12-month deferred recoverable O&M surcharge, calculated in the same manner as the recurring recoverable O&M surcharge.

- Schedule 7: A rate base schedule for each district showing the rate base determined in Decision No. 67093 as well as the most recent rate base calculated as of the date of the information provided in Schedules 1 and 2, both adjusted to reflect the inclusion of completed and in-service facilities related to arsenic treatment.

- Schedule 8: A CWIP Ledger showing monthly charges related to the construction of arsenic removal facilities by project.

- Schedule 9: A schedule showing the calculation of the Company's four-factor allocation methodology, similar to the three-factor ratios provided by Arizona Water Company in Docket No. 01445A-00-0962, at the request of Commission Staff.

- Schedule 10: A bill analysis comparing typical bills for customers on a 5/8-inch meter under present and proposed rates.

To avoid any misunderstandings and delays to the actual filings, Arizona-American wanted all parties to know the anticipated amount of the ACRM surcharges. Broderick Direct at 9. Mr. Broderick estimated total ACRM monthly surcharges for the average residential 5/8-inch equivalent meter customer bill before taxes as follows (Broderick Direct at 9-10):

District	Present Rates	Proposed Rates	ACRM Increase
Havasu	$ 21.67	$ 39.73	$ 18.06
Sun City West	$ 22.71	$ 31.68	$ 8.97
Agua Fria	$ 20.78	$ 26.39	$ 5.61

Because of Arizona-American's current low or even negative equity returns for these three districts, and because of the $22 million investment that had to be made to comply with the new federal arsenic standards, it is critical that the ACRM procedure be put into place for the Company and then that Staff and other parties diligently participate in the process. To that end, Mr. Broderick outlined a timeline for the ACRM procedure.[9]

> 1) Arizona American compiles Schedules 1-10 using actual data and files them at the Commission on January 23, 2006, requesting a specific step 1 ACRM rate increase in that district. Step 1 does not include recoverable O&M. Rather, recoverable O&M for up to the first 12 months is deferred.
>
> 2) The parties review the filing and at an Open Meeting in late February 2006 the Commission approves a specific ACRM surcharge for that district which is effective on customer bills in March 2006.
>
> 3) Arizona American again compiles Schedules 1-10 using actual data and files them at the Commission on January 23, 2007, requesting a specific step 2 ACRM rate increase in that district. The step 2 increase includes recoverable O&M, both the deferred and recurring. Again, the amount of recurring O&M included in the mechanism is identical to the amount deferred, as set forth in the Arizona Water ACRM case. Like that case, recovery of the O&M deferral will occur via a separate line within the ACRM on customers' bills.
>
> 4) The parties review the filing and later at an Open Meeting in late February 2007 the Commission approves a step 2 specific ACRM surcharge for that district which is effective on customer bills in March 2007.
>
> 5) Next, after one year (March 2008), recovery of the deferred O&M will be complete, the separate line item for this recovery will disappear, and

[9] The timeline assumes that facilities are in service by January 23, 2006. The actual filing date will depend on the date the facilities are completed and placed in service.

the total ACRM surcharge will decrease by this amount. The Company will continue to recover the recurring O&M and capital costs.

6) The ACRM surcharge will then remain on customer bills until the effective date of new permanent rates in that district, at which time the ACRM will end. It is possible that the effective date of new rates may happen in some instances during the timeframe outlined above.

2. RUCO RESPONSE

With the exception of the proposed Havasu hook-up fee, RUCO recommended approval of Arizona-American's requested ACRM. Dias Cortez Direct at 3. The Havasu hook-up fee will be discussed below in Section V.

3. STAFF RESPONSE

Staff presented its case through the testimony of Crystal S. Brown. Ms. Brown accepted Arizona-American's proposed ACRM and procedure, with ten recommendations. In his Responsive Testimony (Exhibit A-6), Mr. Broderick addressed each of Staff's recommendations. The following table lists each recommendation and Mr. Broderick's response.

Number	Staff Recommendation	Arizona-American Response	Citation
1	Authorization of the requested ACRM.	Accepted.	Broderick Rebuttal at 2.
2	Arizona-American file a plan with the Commission's Docket Control by December 31, 2005, that describes how the Company will attain and maintain a capital structure (equity, long-term debt and short-term debt) with equity representing between 40 percent and 60 percent of total capital. Staff will address the plan in the Company's Paradise Valley Water Company rate proceeding (Docket No. W-O1303A-O5-0405).	The Company agrees to file this plan. The Company shares Staff's goal of reaching an equity ratio of at least 40 percent and will file a capital-structure plan by December 31, 2005. The Company is presently in the midst of a capital-intensive, multi-year expenditure program in Arizona, of which arsenic removal is but one component. Arizona American Water summarized its capital expense program in our recent Paradise Valley rate-case filing, so it is sensible for the Commission to	*Id.* at 2-3.

Number	Staff Recommendation	Arizona-American Response	Citation
		further address a capital-structure plan in that case. The Company's plan will, of course, comply with Condition No. 12 in Decision No.65453 (RWE acquisition case), which requires the Company to maintain a minimum common equity ratio of 35 percent or restrict dividends, and if the ratio falls below 30%, then infuse capital.	
3	The Company should file by April 1st each year subsequent to any year that it has ACRM collections a report with the Utilities Division Director showing its ending capital structure (equity, long-term debt, and short-term debt) by month for the prior year.	Accepted.	*Id.* at 4.
4	The rate base calculation (Schedule 7) for the Havasu water district be modified to explicitly show a deduction for Arsenic Impact Fee collections.	The Company accepts this recommendation. Attached are revised illustrative Schedules 3, 5, 6, and 7 for the Havasu Water District reflecting that and all other revisions to schedules recommended by Commission Staff (and RUCO for that matter). These include deducting from rate base in Schedule 7 actual amounts collected via the Havasu Arsenic Impact Fee, and modifying and better identifying adjustments to actual period financial results in Schedule 3, the earnings test schedule. The actual Step 1 filings in 2006 will reflect these changes. Please note that the Company made a correction to rate base to reflect three years amortization of regulatory contributions and advances as per Decision No. 63584. The earlier Schedules erred by containing only two	*Id.* at 5.

Number	Staff Recommendation	Arizona-American Response	Citation
		years.	
5	The Earnings Test schedule filed in support of the ACRM should incorporate adjustments conforming with Decision No. 67093. For example, the acquisition adjustment should be removed from rate base and the amortization of the adjustment should be removed from the income statement. The actual period results, adjustments, and adjusted period should be clearly shown on each Earnings Test Schedule. The earnings test places a cap on the ACRM surcharge based on the existing authorized rate of return.	The Company accepts this recommendation. Please note, however, that the "acquisition premium" cited by Ms. Brown was not included in rate base amounts in the schedules filed on April 15, 2005. However, amortization of the utility plant acquisition adjustment was included in expenses, but has now been removed in Schedule 3-Revised, which depicts how this Schedule will appear at the time of Step 1 filings.	*Id.* at 5-6
6	Microsoft Excel or compatible electronic versions of the filings and all work papers be concurrently provided to Staff with all ACRM filings.	Accepted.	*Id.* at 6.
7	The Company should file the schedules discussed in its application except as modified in the above recommendations. In addition, Staff reserves the right for further discovery as it deems necessary related to the ACRM filings.	The Company accepts this recommendation. Furthermore, to facilitate any additional pre-review, during the period leading up to our Step 1 filings we will timely respond to any additional data requests concerning any facility, despite the July 19, 2005, deadline for discovery in this case.	*Id.* at 6-7.
8	The Company should file an application for a permanent rate increase for its Agua Fria, Sun City West and Havasu water districts no later than April 30, 2008, using 2007 as the test year.	The Company accepts this recommendation, clarified as follows: the Company accepts Commission Staff's recommendation that the Havasu rate application shall also be filed on or before April 30, 2008. However, the Company seeks clarification . . . . The Company believes that this means it can file	*Id.* at 7-8.

Number	Staff Recommendation	Arizona-American Response	Citation
		these three rate cases on the same or different dates, so long as each case is filed before April 30, 2008. **Staff accepted this clarification.** Tr. at 93-94.	
9	Approval of Havasu's Arsenic Impact Fee ("AIF") Tariff as modified by Staff and reflected in Staffs attached Tariff Schedule - Arsenic Impact Hook-up Fee.	The Company accepts this recommendation. However, Staff is silent as to the effective date of this tariff. The Company requests that this tariff be effective immediately upon an order in this hearing.	*Id.* at 8.
10	Havasu be required to file a calendar year status report each January 31st with Docket Control for the prior twelve (12) month period, beginning January 31, 2006, until the AIF Tariff is no longer in effect. This status report should contain a list of all customers that have paid the AIF Tariff, the amount each has paid, the amount of money spent from the account, the amount of interest earned on the AIF Tariff account, and a list of all facilities that have been installed with the AIF Tariff funds during the 12 month period.	Accepted.	*Id.* at 8.

4. ACCEPTABLE CONDITIONS

Based on Staff's recommendations, the following conditions are acceptable to the Company.

1. Arizona-American shall file a plan with the Commission's Docket Control by December 31, 2005, that describes how the Company will attain and maintain a capital structure (equity, long-term debt, and short-term debt) with equity representing between 40 percent and 60

percent of total capital. Staff will address the plan in the Company's Paradise Valley Water Company rate proceeding (Docket No. W-O1303A-O5-0405).

2. The Company shall file by April 1st each year subsequent to any year that it has ACRM collections a report with the Utilities Division Director showing its ending capital structure (equity, long-term debt, and short-term debt) by month for the prior year.

3. The Earnings Test schedule filed in support of the ACRM should incorporate adjustments conforming with Decision No. 67093. For example, the acquisition adjustment should be removed from rate base and the amortization of the adjustment should be removed from the income statement. The actual period results, adjustments, and adjusted period should be clearly shown on each Earnings Test Schedule. The earnings test places a cap on the ACRM surcharge based on the existing authorized rate of return.[10]

4. With all ACRM filings, the Company will provide to Staff Microsoft Excel or compatible electronic versions of the filings and all work papers.

5. Staff may conduct further discovery as it deems necessary related to the ACRM filings. The Company will timely respond to such discovery.

6. The Company shall file applications for permanent rate increases for its Agua Fria, Sun City West, and Havasu water districts, with each application filed no later than April 30, 2008.

7. The Company shall file for its Havasu Water District a calendar year status report each January 31st with Docket Control for the prior 12-month period, beginning January 31, 2006, until the AIF Tariff is no longer in effect. This status report should contain a list of all customers that have paid the AIF Tariff, the amount each has paid, the amount of money spent

[10] In his Responsive Testimony, Mr. Broderick did revise his schedules to conform with this recommendation.

from the account, the amount of interest earned on the AIF Tariff account, and a list of all facilities that have been installed with the AIF Tariff funds during the 12 month period.

V. HAVASU HOOK-UP FEE

The estimated average ACRM surcharge for the Company's Havasu Water District is $18.06 per customer per month. Broderick Direct at 9. This is over twice the expected average surcharge for Sun City West Customers and more than three times the expected average surcharge for Agua Fria Customers. *Id.* at 9-10. To fairly allocate the amount of the surcharge, Arizona-American has proposed a new hook-up fee for the Havasu Water District. In Schedule 11 of Exhibit A-7, Mr. Broderick derives the surcharge amounts. For a new residential customer with a 5/8 inch meter, the proposed hook-up fee would be $781. *Id.* at 13. To raise the maximum amount of funds to offset the surcharge, Arizona-American requests that the hook-up fee go into effect immediately after a final order in this phase of the case. *Id.*

The idea for the new hook-up fee came from Havasu customers who hoped that the funds from the fee could help reduce the amount of the ACRM surcharge. Broderick Direct at 15. Staff supports the hook-up fee. Brown Direct at 12. Staff's recommended hook-up fees by meter size are set forth in Table 1 of Ms. Brown's testimony. *Id.* at 13. The Company accepts these amounts.

Arizona-American proposed some language to be added to the Havasu Water Tariff, which the Company believes, after some hearing room discussion and modification, is now acceptable to Staff:

> **Use and Accounting for Arsenic Treatment Facilities Hook-up Fee**
>
> All funds collected by the company pursuant to the hookup fee shall be treated as an offset to the costs of arsenic treatment facilities (including engineering and design costs for such facilities) in the ACRM step one and step two increases and in rate base in any future ratemaking proceeding. The company shall maintain on its books an accounting of the arsenic

> treatment facilities hookup fees collected pursuant to this tariff and an accounting of the arsenic treatment facilities constructed subsequent to adoption of this tariff.

This language is modeled on language in the tariff for the Arizona-American's Agua Fria Water District so-called water facility hookup fee, WHU-1. Tr. at 36.

RUCO opposes the hook-up fee because the "arsenic plant is not growth related . . . ." Diaz Cortez Direct at 5. RUCO was also concerned that the hook-up fee would not reduce the ACRM through rate-base reductions. *Id.* at 4.

Mr. Broderick responded to RUCO's concerns. He revised Schedule 7 of Exhibit A-7, to show the reduction to the ACRM surcharge as a result of the hook-up fee. Broderick Response, at 10. He noted that the Commission has recently approved a similar hook-up fee to offset arsenic-treatment costs.[11] *Id.* Finally, he explained that the price of new homes is soaring in the Company's Havasu Water District. *Id.* at 11. The most significant area for new home growth in the District is a new development called the Refuge, where home prices range from $250,000 to $1,000,000. *Id.* The impact of a small hook-up fee on the ultimate price of these homes is negligible. *Id.* By contrast, the median price for existing homes in Lake Havasu City was only $98,500 in 2000. *Id.* For all these reasons, it is fair to have wealthier new customers pay a small hook-up fee to slightly offset the burden on new customers.

VI. CONCLUSION

1. THE ACRM PROCESS SHOULD BE APPROVED

With the conditions set forth in IV.4, above the parties agree that the ACRM should be approved and on the process to be followed in future filings. However, it is extremely important that the process move quickly, or the benefits of an ACRM will become outweighed by the burdens of the procedure.

[11] Decision No. 67669, dated March 9, 2005 (Valley Utilities Water Company, Inc.).

2. THE ACRM PROCESS SHOULD PROCEED QUICKLY AND PREDICTABLY

Arizona-American's customers benefit tremendously from the Company's ability to borrow from its corporate parent at very low cost – 70 basis points over treasury rates. Broderick Direct at 6. If it were a stand-alone company, it would not have access to this low cost debt, so customer rates would have to rise to compensate the company for its higher borrowing costs. Further, at present earnings levels, a stand-alone Arizona-American would not even be able to qualify for WIFA financing. *Id.* at 6.

Mr. Broderick discussed the tremendous financial challenges already faced by Arizona-American, even without having to invest up to $45 million for arsenic-remediation facilities in the Havasu, Sun City West, Agua Fria, Tubac, and Paradise Valley Water districts to satisfy an unfunded federal mandate to reduce arsenic levels below 10 ppb. Actual 2004 returns on equity for the three subject water districts were dismal. Havasu Water's return was a negative 4.48 %, while Sun City West's earnings were barely positive at 1.26 %, and Agua Fria's were only 6.77 %. Broderick Direct at 10. If the anticipated $45 million arsenic-remediation investment were subject to normal regulatory procedures, earnings erosion would escalate.

By significantly reducing regulatory lag ACRMs can help stem earnings erosion, at least on the capital investments and recoverable O&M. "Absent the approval of the ACRM, our financial integrity will rapidly erode until new permanent rates can be established in two to three years." Broderick Direct at 3.

However, if the ACRM procedure drags out, then the ACRM's advantages evaporate. Rate cases will be still necessary to adjust the authorized return on equity and recover many of the increased O&M costs associated with arsenic treatment, such as new media, electricity, and labor. If each step of the ACRM process were to require evidentiary hearings, along with an

already required full rate case to incorporate the ACRM surcharge into base rates, then regulatory lag could actually increase and the traditional rate-case approach would be superior. "To help halt destruction of equity, the ACRM must be successfully implemented." Broderick Response at 3.

3. THE HAVASU HOOK-UP FEE SHOULD BE APPROVED AND IMMEDIATELY IMPLEMENTED

For the reasons given in Section V, above, the Commission should approve the Havasu hook-up fee at the levels set forth in Table 1 of Ms. Brown's testimony. Brown Direct at 13. Arizona-American's Havasu Water tariff should also include the new hook-up fee charges and the language set forth in Section V concerning the use of and accounting for the funds raised by the hook-up fee. Finally, in order for the fee to generate as much as possible, and thereby reduce the amount of the ACRM surcharge as much as possible, the hook-up fee should be implemented as soon as possible after the Commission's initial order in this case.

RESPECTFULLY SUBMITTED on August 29, 2005.

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