

OPEN MEETING ITEM



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COMMISSIONERS
JEFF HATCH-MILLER - Chairman
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ARIZONA CORPORATION COMMISSION

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DATE: October 3, 2005
DOCKET NO: W-01303A-05-0280
WS-01303A-02-0867
TO ALL PARTIES: WS-01303A-02-0869
WS-01303A-02-0870

AZ CORP COMMISSION
DOCUMENT CONTROL

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

ARIZONA-AMERICAN WATER COMPANY
(ARSENIC COST RECOVERY MECHANISM)

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 thirteen (13) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00 p.m.** on or before:

OCTOBER 12, 2005

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 Open Meeting to be held on:

OCTOBER 18 AND 19, 2005

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

BRIAN C. McNEIL
EXECUTIVE DIRECTOR

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 COMMISSIONERS

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

8 IN THE MATTER OF THE APPLICATION OF
9 ARIZONA-AMERICAN WATER COMPANY,
10 INC., AN ARIZONA CORPORATION, FOR
11 AUTHORITY TO IMPLEMENT ARSENIC COST
12 RECOVERY MECHANISMS FOR ITS AGUA
13 FRIA WATER, SUN CITY WATER WEST,
14 HAVASU WATER AND TUBAC WATER
15 DISTRICTS.

DOCKET NO. W-01303A-05-0280

16 IN THE MATTER OF THE APPLICATION OF
17 ARIZONA-AMERICAN WATER COMPANY,
18 INC., AN ARIZONA CORPORATION, FOR A
19 DETERMINATION OF THE CURRENT FAIR
20 VALUE OF ITS UTILITY PLANT AND
21 PROPERTY AND FOR INCREASES IN ITS
22 RATES AND CHARGES BASED THEREON FOR
23 UTILITY SERVICE BY ITS SUN CITY WEST
24 WATER AND WASTEWATER DISTRICTS.

DOCKET NO. WS-01303A-02-0867

25 IN THE MATTER OF THE APPLICATION OF
26 ARIZONA-AMERICAN WATER COMPANY,
27 INC., AN ARIZONA CORPORATION, FOR A
28 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-01303A-02-0869

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, ITS AGUA FRIA WATER BY
ITS ANTHEM WATER DISTRICT, AND ITS
ANTHEM/AGUA FRIA WASTEWATER
DISTRICT.

DOCKET NO. WS-01303A-02-0870

DECISION NO. _____

OPINION AND ORDER
PHASE II (ARSENIC TREATMENT
COST RECOVERY MECHANISM)

1 DATE OF HEARING: July 26, 2005
 2 PLACE OF HEARING: Phoenix, Arizona
 3 ADMINISTRATIVE LAW JUDGE: Dwight D. Nodes
 4 APPEARANCES: Mr. Craig A. Marks, on behalf of Applicant;
 5 Mr. Daniel Pozefsky, on behalf of RUCO;
 6 Mr. Timothy Sabo, Staff Attorney, Legal
 7 Division, on behalf of the Utilities Division of
 the Arizona Corporation Commission.

8 **BY THE COMMISSION:**

9 **INTRODUCTION**

10 On November 22 and December 13, 2002, Arizona-American Water Company, Inc.
 11 (“Arizona-American” or “Company”) filed applications with the Arizona Corporation Commission
 12 (“Commission”) for fair value determinations of its utility plant and for permanent rate increases for
 13 five of its districts (Sun City West Water and Wastewater, Sun City Water and Wastewater, Havasu
 14 and Mohave Water, Agua Fria Water and Wastewater, and Tubac Water). On June 30, 2004, the
 15 Commission issued Decision No. 67093 establishing permanent rate increases for these five districts.

16 On December 17, 2004, Arizona-American filed a motion requesting that the Commission
 17 reopen the record in the dockets underlying Decision No. 67093. Reopening the record in those
 18 dockets was deemed necessary to allow consideration of a request for imposition of an Arsenic Cost
 19 Recovery Mechanism (“ACRM”) within the context of the fair value rate base findings of the rate
 20 case dockets.

21 On February 15, 2005, the Commission issued Decision No. 67593 granting the Company’s
 22 request to reopen the record in Decision No. 67093 for the limited purpose of serving as the
 23 evidentiary basis for future ACRM filings for the affected Arizona-American water districts.
 24 Decision No. 67593 was conditioned on dismissal of Arizona-American’s pending appeals of
 25 Decision No. 67093 and 65453 within 30 days of the Decision. The appeals were subsequently
 26 dismissed.

27 By Procedural Order issued March 29, 2005, Arizona-American was directed to file a new
 28 application indicating the relief sought regarding the ACRM, and to consolidate the new application

1 with those existing dockets from Decision No. 67093 that would be affected by the specific relief
2 requested in its filing.

3 On April 15, 2005, Arizona-American filed the above captioned application (Docket No. W-
4 01303A-05-0280) for authority to implement ACRMs for its Agua Fria Water, Sun City West Water,
5 Havasu Water, and Tubac Water Districts. As directed by the March 29, 2005 Procedural Order, the
6 Company also filed direct testimony in support of the application, and a proposed form of public
7 notice.

8 A Procedural Conference was conducted on May 2, 2005 to discuss the procedural schedule
9 for the proceeding, as well as the proposed form of notice.

10 On May 4, 2005, the Company filed a Motion to Delete the Tubac Water District from its
11 Application. The Motion stated that, in response to its customers' desires, Arizona-American is
12 evaluating an alternative arsenic remediation technology for the Tubac District, and has asked the
13 Arizona Department of Environmental Quality ("ADEQ") for a 12-month delay for compliance with
14 the new federal maximum contaminant level ("MCL") for arsenic in drinking water.

15 By Procedural Order issued May 6, 2005, the Company's request to delete the Tubac Water
16 District from its application was approved, a hearing was scheduled for July 26, 2005, mailing and
17 publication of notice of the ACRM proposal were ordered, and various other procedural filing
18 deadlines were established.

19 On June 8, 2005, Arizona-American submitted proofs of mailing and publication in
20 accordance with the May 6, 2005 Procedural Order.

21 On June 8, 2005, Arizona-American filed the Revised Direct Testimony of Thomas Broderick
22 (Ex. A-5) and Joseph Gross (Ex. A-1).

23 On July 1, 2005, Staff filed the Direct Testimony of Crystal Brown (Ex. S-1) and the
24 Residential Utility Consumer Office ("RUCO") filed the Direct Testimony of its witness, Marylee
25 Diaz Cortez (Ex. R-1).

26 On July 20, 2005, Arizona-American filed the Responsive Testimony of Mr. Broderick (Ex.
27 A-6).

28 The hearing was held as scheduled on July 26, 2005 before a duly authorized Administrative

1 Law Judge of the Commission. No public comment was received at the hearing.

2 Closing Briefs were filed by the Company, RUCO and Staff on August 29, 2005 by
3 agreement of the parties.

4 * * * * *

5 The Commission, having reviewed the record of this proceeding in its entirety and being fully
6 advised in the premises, hereby issues findings, conclusions, and orders.

7 **FINDINGS OF FACT**

8 **Arizona-American’s ACRM Proposal**

9 1. Arizona-American’s request for recovery of arsenic treatment costs arises from rules
10 established by the United States Environmental Protection Agency (“EPA”) that require MCL for
11 arsenic in potable water to be reduced from 50 parts per billion (“ppb”) to 10 ppb, effective January
12 23, 2006. An ACRM is a mechanism that was first approved for Arizona Water Company’s Northern
13 Group in Decision No. 66400 (October 14, 2003) to allow “interim” (*i.e.*, prior to a permanent rate
14 case filing) rate relief for capital investment and “recoverable operation and maintenance”¹
15 (“recoverable O&M”) costs associated with construction and operation of arsenic treatment facilities
16 mandated by the new federal arsenic MCL standard.

17 2. Arizona-American is seeking approval in this proceeding of an ACRM for its Agua
18 Fria, Havasu, and Sun City West Districts. The Company projects that construction of arsenic
19 treatment facilities in these three districts will require approximately \$22 million in capital
20 investment, plus ongoing operation and maintenance (“O&M”) costs. According to Mr. Broderick,
21 absent approval of an ACRM for these districts, the Company’s financial integrity will rapidly erode
22 until new permanent rates could be put in place to recover the additional investment costs associated
23 with arsenic treatment facilities (Ex. A-5, at 3).

24 3. Although the application initially sought to include the Tubac District, the Tubac
25 request was subsequently withdrawn. In addition, as stated above, the Company’s ACRM request for
26 its Paradise Valley District is being considered separately in the pending rate case for that district
27

28 ¹ Recoverable O&M costs are “media [filter] replacement or regeneration costs, media replacement or regeneration service costs, and waste media or regeneration disposal costs” (Decision No. 66400, at 6).

1 (Docket No. W-01303A-05-0405). Arizona-American's Sun City Water District is not affected by
2 the new arsenic MCL standard because it has available water sources that are currently in
3 compliance.

4 4. Arizona-American provides potable water, irrigation water, and wastewater services to
5 approximately 115,000 customers in portions of Maricopa, Mohave, and Santa Cruz counties in
6 Arizona. The Company serves approximately 23,000 customers in the Agua Fria Water District,
7 14,500 customers in the Sun City West Water District, and 1,100 customers in the Havasu Water
8 District. Arizona-American is a wholly owned subsidiary of American Water Works, Inc. Arizona-
9 American's ultimate parent company is RWE AG.

10 5. In support of its application, Arizona-American provided testimony by Fredrick
11 Schneider, American Water's Director of Engineering for the Western Region, who adopted the pre-
12 filed Direct Testimony of Mr. Gross. According to his testimony, Arizona-American's arsenic
13 remediation program will consist of eight treatment facilities in the five districts that are affected by
14 the new standard. Three facilities will be installed in the Agua Fria District, two in the Sun City West
15 District, one in the Havasu District, and one in the Paradise Valley District. The Tubac District will
16 also require arsenic remediation (which may be accomplished by a form of point-of-use technology).
17 The application in this proceeding, however, now involves consideration only of the six planned
18 facilities for the Agua Fria (3), Sun City West (2), and Havasu (1) districts (Ex. A-1, at 3).

19 6. With the exception of the Sun City West No. 1 and Paradise Valley sites, the
20 Company selected a granular-iron media absorption process for the facilities as the least cost method
21 of compliance. Under this process, incoming water passes through contactor vessels where arsenic
22 ions adhere to the iron-based media. After passing through the filters, water with low arsenic levels
23 would then flow out of the vessels for blending with other water sources, chlorination, and
24 distribution. In order to keep costs down, only 60 to 70 percent of the raw water is treated and
25 blended, in order to achieve an overall arsenic content level of 8 ppb or below. The Company's
26 witness stated that the Company used a competitive bid process to select the manufacturer of the
27 treatment vessels and, based on the bids received, selected Severn Trent, Inc. According to the
28 Company's witness, the granular-iron vessels can be used with different types of media, thereby

1 providing additional flexibility if technology changes in the future (*Id.* at 4).

2 7. For the facilities treating larger volumes of water (*i.e.*, Sun City West No. 1 and
3 Paradise Valley), Arizona-American intends to utilize a coagulation-filtration process where arsenic
4 ions are attracted by a ferric chloride solution added to the incoming water. The combined
5 iron/arsenic precipitate would be removed via filtration, dewatered, and deposited in a landfill as non-
6 hazardous material. Under this process, the water would then be blended in the same format as
7 described above for the granular-iron treatment. The Company claims that the coagulation-filtration
8 process is more cost-effective for treatment of larger volumes (*Id.* at 4-5).

9 8. On cross-examination, Mr. Schneider explained that drilling new wells was not a cost-
10 effective option to installing facilities for arsenic treatment. He stated that scarcity and cost of land
11 for drilling in the relevant areas, costs of drilling, and the unknown quality of water that would be
12 obtained from new well sources are all factors contributing to the Company's decision to pursue
13 installation of treatment facilities (Tr. 21-26).

14 9. Arizona-American has awarded construction contracts for each of the projects after
15 employing a competitive bid process. For the coagulation-filter technology being used at the Sun
16 City West No. 1 site, Arizona-American analyzed four proposals and awarded a design-build contract
17 to D.L. Norton Company. The other projects will use a "construction manager at risk" approach,
18 under which the contractor performs general construction including installation of electrical, grading,
19 concrete, building, piping, and installing the pre-manufactured vessels that are obtained from Trent
20 Severn. The Company's witness testified that three proposals were evaluated and Garney
21 Construction Company was chosen for the sites not awarded to D.L. Norton. Arizona-American
22 indicated that it has extensive experience with both contractors regarding construction of booster
23 facilities, storage tanks, wastewater treatment facilities, and other projects (Tr. 26-27; Ex. A-1, at 6).

24 10. Arizona-American's ACRM proposal is essentially identical to the ACRM approved
25 for Arizona Water's Northern Group in Decision No. 66400, and subsequently for Arizona Water's
26 Eastern Group in Decision No. 66849 (March 19, 2004), with one exception. The exception is the
27 Company's request to impose a hook-up fee on new customers in the Havasu District as a means of
28 partially offsetting the arsenic compliance costs in that district. The proposed Havasu hook-up fee

1 issue is discussed in more detail below.

2 11. In all other respects, Arizona-American states that its proposed ACRM is identical to
3 the mechanism approved for Arizona Water, including the following:

- 4 1. The ACRM is based solely on actual costs and costs eligible for
5 recovery (depreciation, gross return, and recoverable O&M);
- 6 2. Actual rate recovery via the ACRM commences after new arsenic
7 facilities are in service and are in compliance with the new EPA
8 standard for arsenic;
- 9 3. Establishment of deadlines for filing the next rate cases for the
10 three districts, but without limiting the ability of those districts to
11 file for permanent rate relief sooner, if necessary;
- 12 4. An ACRM rate design composed of a 50/50 split of the recovery of
13 costs between monthly minimum charges and commodity charges;
- 14 5. A financial presentation (filing) composed of ten standard
15 schedules for each of the districts covered by the ACRM;
- 16 6. Recoverable O&M costs would include only media replacement or
17 regeneration, media replacement or regeneration service, and
18 waster disposal;
- 19 7. A deferral for future recovery of up to 12 months of recoverable
20 O&M, without return, commencing with the in-service date of the
21 facilities within each district;
- 22 8. Two step-rate increases for each district covered by the ACRM;
- 23 9. No true-up of the ACRM for over or under collection; and
- 24 10. Gross return would be included in the ACRM based upon the rate
25 of return and return on equity established in Decision No. 67093
26 (June 30, 2004) (*i.e.*, a 9 percent return on equity) (Ex. A-5, at 4-
27 5).

28 12. Arizona-American witness Broderick testified that the arsenic remediation facilities
will be financed through internal borrowing at a rate of 70 basis points above Treasury rates, which
he claims is a significantly lower rate than would otherwise be available to any stand-alone Arizona
water utility or from the Water Infrastructure Finance Authority ("WIFA"). Mr. Broderick indicated
that it is unlikely that Arizona-American could qualify for a WIFA loan due to the Company's current

1 poor earnings (Ex. A-5, at 6).

2 13. Mr. Broderick described the mechanics and timing of the ACRM filings and what
3 costs would be recoverable in each step of the ACRM as follows:

- 4 a) In the step one filing, which would be filed at any time after
5 January 23, 2006 and would include the 10 schedules of
6 information specified in Decision No. 66400, the Company could
7 seek rate recovery of capital costs for arsenic treatment facilities
8 that are *up and running*, and could begin deferral of recoverable
9 O&M costs related to those facilities;
- 10 b) The Company anticipates that the parties (Staff and RUCO) would
11 then have an opportunity to review the filed information for each
12 district for which the schedules are submitted, and the Commission
13 would issue an Order approximately one month later approving a
14 specific ACRM surcharge for that particular district;
- 15 c) In the second step filing, which would be filed after January 23,
16 2000 and would again include the 10 schedules of information
17 specified in Decision No. 66400, the Company could seek
18 recognition of the prior 12 months of deferred O&M costs, as well
19 as ongoing O&M costs;
- 20 d) The parties would again have an opportunity to review the second
21 step filings, and the Company anticipates that a Commission Order
22 would be issued approximately one month later approving the Step
23 2 surcharge for arsenic treatment facilities;
- 24 e) Approximately one year later (*i.e.*, March 2008), the recovery of
25 the *deferred* O&M costs would automatically cease and the
26 separate line item for that charge would disappear. However, the
27 Company would continue to recover the recurring recoverable
28 O&M expenses authorized in Step 2; and
- f) The ACRM surcharge would remain on customer bills until the
effective date of new permanent rates for the relevant district, at
which time the ACRM would cease. Under Staff's
recommendation, Arizona-American would be required to file the
permanent rate case resulting in elimination of the ACRM by no
later than April 30, 2008, based on a 2007 test year (Tr. 48-49; Ex.
A-5, at 11-13).

14. Mr. Broderick testified that the capital costs alone for the three affected districts in this
proceeding are estimated to total \$22.0 million based on the following cost projections: Havasu \$1.7
million; Sun City West \$10.3 million; and Agua Fria \$10.0 million. Mr. Broderick also provided an

1 estimate of the potential rate impact of the future rates associated with the ACRM. For an average
 2 usage residential 5/8-inch meter customer, the Company projects the following monthly rate impacts:
 3 Havasu – current \$21.67 would increase to \$39.73 (\$18.06 increase); Sun City West – current \$22.71
 4 would increase to \$31.68 (\$8.97 increase); and Agua Fria – current \$20.78 would increase to \$26.39
 5 (\$5.61 increase) (Ex. A-5, at 9-10). Mr. Broderick stated that these rate projections are based on the
 6 expected impact at a hypothetical point “in-between” the Step 1 and Step 2 ACRM adjustments, and
 7 that “our actual step one filing would be for an amount somewhat less than what is displayed ... [and]
 8 step two would then be an amount that is somewhat higher than is displayed in my testimony” (Tr.
 9 49). As a result, the rates described above do not reflect the full rate impact that the Company
 10 expects will occur after the second step is implemented under the ACRM.

11 Staff Recommendations

12 15. Based on its analysis of the Company’s application, and supporting testimony and
 13 exhibits, Staff witness Crystal Brown made the following recommendations:

- 14 a) The requested ACRM should be approved;
- 15 b) Arizona-American should be required to file a plan with Docket
 16 Control by December 31, 2005 that describes how the Company
 17 expects to attain and maintain a capital structure (equity, long-term
 18 debt, and short-term debt) with equity representing between 40 and
 60 percent of total capital²;
- 19 c) The Company should be required to file, by April 1st of each year
 20 subsequent to any year in which it collects surcharges under an
 21 ACRM, a report with the Utilities Division Director showing the
 22 Company’s ending capital structure by month for the prior year;
- 23 d) The rate base calculation for the Havasu Water District should be
 24 modified to explicitly show a deduction for Arsenic Impact Fee
 25 collections [see discussion below of Havasu hook-up fee issue];
- 26 e) The Earnings Test schedule filed in support of the ACRM should
 27 incorporate adjustments conforming to Decision No. 67093. As an
 28 example, Staff states that the acquisition adjustment should be

² According to Staff, as of December 31, 2004, Arizona-American’s capital structure consisted of \$23,803 in short-term debt, \$198,772,252 in long-term debt, and \$115,410,355 in equity. This results in a capital structure consisting of 63.3 percent debt and 36.7 percent equity. If CIAC is included in the capital structure analysis, the equity component is reduced to 34.45 percent equity (Ex. S-1, at 11).

1 removed from rate base and the amortization of the adjustment
 2 should be removed from the income statement. The actual period
 3 results, adjustments, and adjusted period should be clearly shown
 on each Earnings Test Schedule, because the Earnings Test places
 a cap on the ACRM surcharge based on the existing rate of return;

- 4 f) Microsoft Excel or compatible electronic versions of the filings
 5 and all work papers should be filed concurrently with all ACRM
 filings;
- 6 g) Arizona-American should be required to file the schedules
 7 discussed in its application, as modified above. Staff reserves the
 8 right to seek additional discovery related to the ACRM filings;
- 9 h) The Company should be required to file permanent rate case
 10 applications for the Agua Fria, Sun City West, and Havasu districts
 by no later than April 30, 2008 [although not necessarily all at the
 11 same time], using a 2007 test year;
- 12 i) The Havasu District Arsenic Impact Fee ("AIF") Tariff, as
 13 modified in Staff's Tariff Schedule attached to Ms. Brown's
 testimony, should be approved³; and
- 14 j) For the Havasu District, the Company should be required to file
 15 with Docket Control by January 31st of each year, an annual
 16 calendar year status report, until the AIF Tariff is no longer in
 17 effect. Staff states that the status report should contain a list of all
 18 customers that have paid the AIF, the amount each customer has
 paid, the amount of money spent from the AIF account, the amount
 of interest earned on the AIF account, and a list of all facilities that
 have been installed with funds from the AIF Tariff during the 12-
 month period (Ex. S-1, at 4-5).

19 **Proposed Havasu Hook-Up Fee**

20 16. Arizona-American proposed a new hook-up fee that would be applicable only to new
 21 connections in the Havasu District, and would be treated as a contribution in aid of construction
 22 ("CIAC"). Mr. Broderick stated that the fee is based on "the estimated cost of the arsenic facilities
 23 and the existing and maximum number of water connections" (Ex. A-5, at 13). For 5/8 inch
 24 residential customers, the proposed hook-up fee is \$781 (*Id.*). Mr. Broderick indicated that the hook-
 25 up fee proposal came about as a result of suggestions from existing Havasu customers made at
 26 community outreach meetings conducted in March 2005 (*Id.* at 14).

27 _____
 28 ³ At the hearing, Arizona-American proposed additional language for the AIF Tariff modeled on the Agua Fria Water
 District's existing water facility hook-up fee tariff (Tr. 35-36), which the Company believes is acceptable to Staff.

1 17. Staff supports the proposed hook-up fee, which it labels an Arsenic Impact Fee
2 (“AIF”), but recommends higher charges than those suggested by the Company. For 5/8 inch
3 residential customers, Staff’s recommended AIF would be \$870 (Ex. S-1, at 12-13). Higher AIF
4 charges would apply to new customers with larger meters (*Id.*).

5 18. Although RUCO does not oppose approval of the ACRM, it opposes the proposed
6 hook-up fee. RUCO witness Marylee Diaz Cortez stated that it is inappropriate to use a hook-up fee
7 as a source of funding for arsenic treatment plant because hook-up fees are generally used “as a
8 method of funding plant that is related to growth” (Ex. R-1, at 5). Ms. Diaz Cortez testified that
9 arsenic treatment plant is not “growth related” because the plant would still need to be built even if
10 growth remains static. She claims that imposition of the hook-up fee on new customers only would
11 be discriminatory because such customers would be required to pay both the hook-up fee and the step
12 increases under the ACRM (*Id.*).

13 19. As the Company points out, the hook-up fee was requested by a number of existing
14 Havasu customers as a means of mitigating the expected burdens associated with complying with a
15 federal mandate. In addition, the Commission has previously approved a similar hook-up fee to
16 provide funds for arsenic remediation compliance. *See, Valley Utilities Water Co., Inc.*, Decision No.
17 67669 (March 9, 2005). We believe that the proposed hook-up fee, as set forth in Staff’s AIF Tariff
18 (and as modified at the hearing), represents a reasonable means of providing at least some offset to
19 the significant burden that is expected to be imposed on Havasu customers as a result of arsenic
20 compliance measures. The AIF Tariff will therefore be approved.

21 **Discussion and Resolution**

22 20. The parties are in agreement that a streamlined cost recovery mechanism is
23 appropriate to enable Arizona-American to recover costs associated with arsenic treatment
24 compliance. Staff recognizes that the EPA’s new MCL standard will require Arizona-American, as
25 well as other affected water companies, to incur significant costs to come into compliance with the
26 revised standard. Although RUCO opposed parts of the Arizona Water ACRM approved in Decision
27 No. 66400, it does not dispute the proposed ACRM in this proceeding except for the hook-up fee
28 discussed above.

1 21. Regarding the economic burden of arsenic-related costs and their potential impact on
2 Arizona-American, the Company estimates that the arsenic remediation capital costs alone for the
3 three districts will be approximately \$22 million. These estimated costs point out the magnitude of
4 the problem that faces Arizona-American with respect to compliance with the new arsenic MCL
5 requirements. There is no debate by the parties that an abbreviated form of cost recovery is justified
6 given the extraordinary nature of the expected costs, and in order to ensure that the arsenic treatment
7 compliance costs do not compromise the Company's financial integrity and ongoing viability.

8 22. Although the Sun City West and Agua Fria districts will incur higher overall costs
9 (\$10.3 million and \$10.0 million, respectively), the greater rate impact will be on the Havasu District
10 customers, who have only 1,100 customers over which to spread the projected \$1.7 million in capital
11 costs. When the additional O&M costs are added to the capital costs of compliance, the effect on
12 customers is troubling. The projected monthly rate increases for Havasu of \$18.06; for Sun City
13 West of \$8.97; and for Agua Fria of \$5.61 are significant, and as noted above they do not reflect the
14 full impact that is expected to be experienced by the affected customers. Unfortunately, the only
15 alternative to recovery by Arizona-American of arsenic-related costs would be non-compliance with
16 federal regulations.

17 23. Therefore, after considering all of evidence presented in this proceeding, we believe
18 the ACRM proposed herein provides the only viable resolution of arsenic remediation requirements
19 imposed on the Company by the new arsenic MCL standard. In addition to providing a mechanism
20 for recovery of capital costs incurred by Arizona-American, the ACRM offers the Company an
21 opportunity to recover limited verifiable O&M costs in a timely manner. However, as explained
22 above, the recovery of O&M expenses is confined to specific and narrowly defined costs in order to
23 enable Staff and other parties to more easily audit expenditures incurred by the Company for the
24 treatment facilities.

25 24. The two step increases allowed under the ACRM prior to the Company's filing of a
26 full rate case in 2008 should be sufficient to allow Arizona-American an opportunity to recover a
27 significant percentage of the arsenic treatment costs it expects to incur over the next three years.
28 However, the ACRM process is not a substitute for a full rate review which will be conducted after

1 all of the Company's arsenic treatment costs are known and measurable. The Company also retains
2 the opportunity to file a general rate application in the interim.

3 25. We wish to make clear that the parties to this proceeding have not waived their right to
4 address relevant issues that may arise in the course of any future step increase filing. We agree that
5 any party has the right to request intervention in a subsequent step increase "phase" of this
6 proceeding and to assert all rights afforded to an intervenor. Parties should have the ability to
7 analyze thoroughly all schedules submitted by the Company in connection with its ACRM step
8 requests, and to seek additional relevant information related to the filing. However, we do not expect
9 that parties should be entitled to relitigate the issues that have been decided in this Decision. In other
10 words, the subsequent step increase filings should not be considered an opportunity to make a
11 collateral attack on this Decision.

12 26. Arizona-American expressed its belief that the review of ACRM filings by Staff and
13 RUCO, as well as the Commission's Decision on the Company's filings, should take only 30 days.
14 Although we expect the review and resolution of the filings to be completed in an expedited manner,
15 we make no commitment regarding the length of any such review. Staff should undertake a thorough
16 review of the Company's filings including, if necessary, conducting discovery regarding the ACRM
17 application. If necessary, a hearing may be required to examine unresolved issues. If no hearing is
18 held, Staff will issue a recommendation for the Commission's consideration. If a hearing is
19 conducted by the Hearing Division, a Recommended Order will be issued by an Administrative Law
20 Judge for the Commission's consideration.

21 27. Our approval of the ACRM process, as outlined in this Order, recognizes that Arizona-
22 American faces significant costs in the next several years to comply with the U.S. EPA's new arsenic
23 MCL standards. The impact on Arizona-American, as well as many other smaller water companies,
24 will be significant, as has been recognized by both Staff and RUCO. Absent the implementation of
25 an ACRM mechanism, the only viable alternative would be a series of rate applications and the
26 possibility that interim rate relief would be required to maintain the Company's financial integrity
27 until rate relief could be granted.

28 28. Because an allowance for the property tax expense of Arizona-American is included in

1 the Company's rates and will be collected from its customers, the Commission seeks assurances from
 2 the Company that any taxes collected from ratepayers have been remitted to the appropriate taxing
 3 authority. It has come to the Commission's attention that a number of water companies have been
 4 unwilling or unable to fulfill their obligation to pay the taxes that were collected from ratepayers,
 5 some for as many as twenty years. It is reasonable therefore, that as a preventive measure Arizona-
 6 American shall annually file, as part of its annual report, an affidavit with the Utilities Division
 7 attesting that the company is current in paying its property taxes in Arizona.

CONCLUSIONS OF LAW

8
 9 1. Arizona-American is a public service corporation within the meaning of Article XV of
 10 the Arizona Constitution and A.R.S. §§40-250 and 40-251.

11 2. The Commission has jurisdiction over Arizona-American and of the subject matter of
 12 the issues raised in the Company's ACRM proposal and request for rate consolidation.

13 3. Notice of the application was provided in the manner prescribed by law.

14 4. Approval of step increases under the Arsenic Cost Recovery Mechanism, as described
 15 herein, is consistent with the Commission's authority under the Arizona Constitution, ratemaking
 16 statutes, and applicable case law.

17 5. Staff's recommendations described above are reasonable and should be approved.

18 6. Approval of the ACRM is specifically conditioned on compliance with the Staff
 19 recommendations discussed above and approved herein.

ORDER

20
 21 IT IS THEREFORE ORDERED that Arizona-American Water Company's application for
 22 authority to implement an Arsenic Cost Recovery Mechanism is approved, to the extent described
 23 herein.

24 IT IS FURTHER ORDERED that the Havasu District Arsenic Impact Fee Tariff, as modified
 25 in Staff's AIF Tariff Schedule, and as further modified at the hearing, shall be approved.

26 IT IS FURTHER ORDERED that Arizona-American Water Company shall comply with all
 27 requirements discussed in this Order as a condition of approval of the Arsenic Cost Recovery
 28 Mechanism.

1 IT IS FURTHER ORDERED that Arizona-American Water Company shall file a plan with
2 Docket Control by December 31, 2005 that describes how the Company expects to attain and
3 maintain a capital structure (equity, long-term debt, and short-term debt) with equity representing
4 between 40 and 60 percent of total capital.

5 IT IS FURTHER ORDERED that Arizona-American Water Company shall file, by April 1st
6 of each year subsequent to any year in which it collects surcharges under an ACRM, a report with
7 the Utilities Division Director showing the Company's ending capital structure by month for the
8 prior year.

9 IT IS FURTHER ORDERED that Arizona-American Water Company shall modify the rate
10 base calculation for the Havasu Water District to explicitly show a deduction for Arsenic Impact Fee
11 collections.

12 IT IS FURTHER ORDERED that, as part of the Earnings Test schedule filed in support of the
13 ACRM, Arizona-American Water Company shall incorporate adjustments conforming to Decision
14 No. 67093.

15 IT IS FURTHER ORDERED that Arizona-American Water Company shall file the schedules
16 discussed in its application, as modified by Staff's recommendations herein. Microsoft Excel or
17 compatible electronic versions of the filings and all work papers should be filed concurrently with all
18 ACRM filings.

19 IT IS FURTHER ORDERED that Arizona-American Water Company shall file permanent
20 rate applications for its Sun City West, Agua Fria, and Havasu districts by no later than April 30,
21 2008, based on a 2007 test year.

22 IT IS FURTHER ORDERED that, for the Havasu District, Arizona-American Water
23 Company shall file with Docket Control by January 31st of each year, an annual calendar year status
24 report, until the AIF Tariff is no longer in effect. The status report shall contain a list of all
25 customers that have paid the AIF, the amount each customer has paid, the amount of money spent
26 from the AIF account, the amount of interest earned on the AIF account, and a list of all facilities
27 that have been installed with funds from the AIF Tariff during the 12-month period

28 IT IS FURTHER ORDERED that Arizona-American Water Company shall file the schedules

1 and information described above, as well as any additional relevant data requested by Staff, as part of
2 any request for an Arsenic Cost Recovery Mechanism step increase.

3 IT IS FURTHER ORDERED that Arizona-American Water Company shall annually file as
4 part of its annual report, an affidavit with the Utilities Division attesting that the Company is current
5 in paying its property taxes in Arizona.

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

7 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

8
9

CHAIRMAN

COMMISSIONER

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COMMISSIONER

COMMISSIONER

COMMISSIONER

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15 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive
16 Director of the Arizona Corporation Commission, have
17 hereunto set my hand and caused the official seal of the
18 Commission to be affixed at the Capitol, in the City of Phoenix,
19 this ____ day of _____, 2005.

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28
BRIAN C. McNEIL
EXECUTIVE DIRECTOR

DISSENT _____

DISSENT _____

1 SERVICE LIST FOR: Arizona-American Water Company, Inc.
2 DOCKET NOS.: W-01303A-05-0280, WS-01303A-02-0867, W-01303A-
3 02-0869, WS-01303A-02-0870,

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