**OPEN MEETING ITEM**

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COMMISSIONERS
JEFF HATCH-MILLER - Chairman
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

**ARIZONA CORPORATION COMMISSION**

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

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

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EXECUTIVE DIRECTOR

**BEFORE THE ARIZONA CORPORATION COMMISSION**

COMMISSIONERS

JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

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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 WATER WEST, HAVASU WATER AND TUBAC WATER DISTRICTS. | DOCKET NO. W-01303A-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-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<br><br>DECISION NO. _____<br><br>**OPINION AND ORDER PHASE II (ARSENIC TREATMENT COST RECOVERY MECHANISM)** |

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

**BY THE COMMISSION:**

## INTRODUCTION

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

* * * * * * * * * *

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

## FINDINGS OF FACT

**Arizona-American's ACRM Proposal**

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

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

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

[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).

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

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

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

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

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

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

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

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

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

issue is discussed in more detail below.

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

1. The ACRM is based solely on actual costs and costs eligible for recovery (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 EPA standard for arsenic;

3. Establishment of deadlines for filing the next rate cases for the three districts, but without limiting the ability of those districts to file for permanent rate relief sooner, if necessary;

4. An ACRM rate design composed of a 50/50 split of the recovery of costs between monthly minimum charges and commodity charges;

5. A financial presentation (filing) composed of ten standard schedules for each of the districts covered by the ACRM;

6. Recoverable O&M costs would include only media replacement or regeneration, media replacement or regeneration service, and waster disposal;

7. A deferral for future recovery of up to 12 months of recoverable O&M, without return, commencing with the in-service date of the facilities within each district;

8. Two step-rate increases for each district covered by the ACRM;

9. No true-up of the ACRM for over or under collection; and

10. Gross return would be included in the ACRM based upon the rate of return and return on equity established in Decision No. 67093 (June 30, 2004) (*i.e.*, a 9 percent return on equity) (Ex. A-5, at 4-5).

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

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

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

a) In the step one filing, which would be filed at any time after January 23, 2006 and would include the 10 schedules of information specified in Decision No. 66400, the Company could seek rate recovery of capital costs for arsenic treatment facilities that are *up and running*, and could begin deferral of recoverable O&M costs related to those facilities;

b) The Company anticipates that the parties (Staff and RUCO) would then have an opportunity to review the filed information for each district for which the schedules are submitted, and the Commission would issue an Order approximately one month later approving a specific ACRM surcharge for that particular district;

c) In the second step filing, which would be filed after January 23, 2000 and would again include the 10 schedules of information specified in Decision No. 66400, the Company could seek recognition of the prior 12 months of deferred O&M costs, as well as ongoing O&M costs;

d) The parties would again have an opportunity to review the second step filings, and the Company anticipates that a Commission Order would be issued approximately one month later approving the Step 2 surcharge for arsenic treatment facilities;

e) Approximately one year later (*i.e.*, March 2008), the recovery of the *deferred* O&M costs would automatically cease and the separate line item for that charge would disappear. However, the Company would continue to recover the recurring recoverable 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

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

**Staff Recommendations**

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

a) The requested ACRM should be approved;

b) Arizona-American should be required to file a plan with Docket Control by December 31, 2005 that describes how the Company expects to attain and maintain a capital structure (equity, long-term debt, and short-term debt) with equity representing between 40 and 60 percent of total capital[2];

c) The Company should be required to file, by April 1st of each year subsequent to any year in which it collects surcharges under an ACRM, a report with the Utilities Division Director showing the Company's ending capital structure by month for the prior year;

d) The rate base calculation for the Havasu Water District should be modified to explicitly show a deduction for Arsenic Impact Fee collections [see discussion below of Havasu hook-up fee issue];

e) The Earnings Test schedule filed in support of the ACRM should incorporate adjustments conforming to Decision No. 67093. As an 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).

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, because the Earnings Test places a cap on the ACRM surcharge based on the existing rate of return;

f) Microsoft Excel or compatible electronic versions of the filings and all work papers should be filed concurrently with all ACRM filings;

g) Arizona-American should be required to file the schedules discussed in its application, as modified above. Staff reserves the right to seek additional discovery related to the ACRM filings;

h) The Company should be required to file permanent rate case applications for the Agua Fria, Sun City West, and Havasu districts by no later than April 30, 2008 [although not necessarily all at the same time], using a 2007 test year;

i) The Havasu District Arsenic Impact Fee ("AIF") Tariff, as modified in Staff's Tariff Schedule attached to Ms. Brown's testimony, should be approved[3]; and

j) For the Havasu District, the Company should be required to file with Docket Control by January 31st of each year, an annual calendar year status report, until the AIF Tariff is no longer in effect. Staff states that the status report should contain a list of all 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).

**Proposed Havasu Hook-Up Fee**

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

[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.

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

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

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

**Discussion and Resolution**

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

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

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

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

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

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

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

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

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

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

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

## CONCLUSIONS OF LAW

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

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

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

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

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

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

## ORDER

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

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

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

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

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

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

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

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

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

IT IS FURTHER ORDERED that, for the Havasu District, Arizona-American Water Company shall file with Docket Control by January 31st of each year, an annual calendar year status report, until the AIF Tariff is no longer in effect. The status report shall contain a list of all 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

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

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

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

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

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN COMMISSIONER

COMMISSIONER COMMISSIONER COMMISSIONER

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

BRIAN C. McNEIL
EXECUTIVE DIRECTOR

DISSENT _____

DISSENT _____

SERVICE LIST FOR: Arizona-American Water Company, Inc.

DOCKET NOS.: W-01303A-05-0280, WS-01303A-02-0867, W-01303A-02-0869, WS-01303A-02-0870,

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