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WILLIAM A. MUNDELL
CHAIRMAN
JIM IRVIN
COMMISSIONER
MARC SPITZER
COMMISSIONER



BRIAN C. McNEIL
EXECUTIVE SECRETARY

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ARIZONA CORPORATION COMMISSION

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DATE: AUGUST 14, 2001

AZ CORP COMMISSION
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DOCKET NO: W-01303A-00-0929

TO ALL PARTIES:

Enclosed please find the recommendation of Administrative Law Judge Philip Dion. The recommendation has been filed in the form of an Order on:

ARIZONA-AMERICAN WATER COMPANY, INC.
(FINANCING)

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

AUGUST 23, 2001

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

AUGUST 28, 2001 AND AUGUST 29, 2001

For more information, you may contact Docket Control at (602)542-3477 or the Hearing Division at (602)542-4250.

Arizona Corporation Commission

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BRIAN C. McNEIL
EXECUTIVE SECRETARY

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 WILLIAM A. MUNDELL
CHAIRMAN
3 JIM IRVIN
COMMISSIONER
4 MARC SPITZER
COMMISSIONER
5

6 IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY,
7 INC., AN ARIZONA CORPORATION, FOR
AUTHORITY TO ISSUE SHORT-TERM AND
8 LONG-TERM DEBT INSTRUMENTS IN
CONNECTION WITH FINANCING THE
9 ACQUISITION OF THE WATER AND
WASTEWATER UTILITY PLANT AND ASSETS
10 OF CITIZENS COMMUNICATIONS.

DOCKET NO. W-01303A-00-0929

DECISION NO. _____

ORDER

11 Open Meeting
August 28 and 29, 2001
12 Phoenix, Arizona

BY THE COMMISSION:

13 On November 15, 2000, Arizona-American Water Company (“Arizona-American” or “the
14 Company”) filed an application with the Arizona Corporation Commission (“Commission”)
15 requesting authority to issue short-term and long-term debt in an aggregate principal amount not to
16 exceed \$180.0 million and to assume certain industrial development revenue bonds (“IDRBs”) in the
17 amount of \$10,635,000. The proposed debt will be used to finance the acquisition of the Arizona
18 water and wastewater utility plant and assets of Citizens Communications Company (“Citizens”).
19 The assumption of the revenue bonds would also be accomplished in connection with the acquisition
20 of Citizens’ assets.

21 On December 29, 2000, Arizona-American filed an Affidavit of Publication indicating compliance
22 with the Commission’s notice requirements. On May 25, 2001, the Commission’s Utilities Division
23 Staff (“Staff”) filed its Staff Report in the matter, recommending approval of the application without
24 a hearing.

25 **DISCUSSION**

26 **Introduction**

27 Arizona-American (formerly Paradise Valley Water Company) serves approximately 4,700
28

1 customers in portions of the Town of Paradise Valley, the City of Scottsdale and certain
2 unincorporated areas in Maricopa County, Arizona. It has been in the utility business since 1950.
3 The parent of Arizona-American, American Water Works Company, Inc. ("AWW"), is the largest
4 privately-owned water utility system in the United States, providing water, wastewater and other
5 water resource management services to approximately 3 million customers in 23 states. Citizens
6 currently serves about 160,000 customers in the state of Arizona.

7
8 **Purpose of Financing**

9 The short-term and long-term debt requested by Arizona-American will be used for the sole
10 purpose of financing the acquisition of the water and wastewater utility plant and assets of Citizens in
11 the state of Arizona. On March 24, 2000, Citizens and Arizona-American jointly filed an application
12 with the Commission requesting authority to transfer the Arizona water and wastewater assets and the
13 Certificates of Convenience and Necessity of Citizens to Arizona-American. A hearing was held on
14 that application on September 27, 2000, and the Commission approved the transfer in Decision No.
15 63584 (April 24, 2001).

16 Citizens' and Arizona-American's compliance with the Arizona Department of
17 Environmental Quality ("ADEQ") requirements was addressed in the sale and transfer application
18 proceeding. Both companies were found to be in compliance with all ADEQ requirements. ADEQ
19 indicated that Arizona-American was in total compliance and delivering water that does not exceed
20 any maximum contaminant level and meets the water quality standards of the Safe Drinking Water
21 Act. All of the Citizens water companies were either in total or substantial compliance and all were
22 delivering water that does not exceed any maximum contaminant level and meets the water quality
23 standards of the Safe Drinking Water Act. The Citizens wastewater treatment plants were in total
24 compliance with ADEQ rules.

25 The purchase price to be paid by Arizona-American to Citizens is \$231,310,000, subject to
26 adjustment at closing. The purchase price includes the assumption of IDRBS in the amount of
27 \$10,635,000. Under the purchase agreement between Arizona-American and Citizens, a post-closing
28 adjustment to the purchase price will be made to reflect changes in Citizens' net assets occurring after
June 30, 1999. Arizona-American anticipates that the purchase price will increase, based on

1 increased investment in new plant to support growth occurring in Citizens' service territories.
2 Arizona-American expects to pay approximately \$71,000,000 over book value for Citizens' assets.

3 Although Arizona-American is requesting approval of up to \$180,000,000 of long-term debt,
4 all the projections, supplied to Staff indicate an initial issuance of \$132,000,000. None of the
5 projections though 2005 indicate the issuance of more than a total of \$134,900,000 in long-term debt.

6 Arizona-American currently has a capital structure consisting of approximately 53 percent
7 debt and 47 percent common equity. Arizona-American intends to maintain a capital structure
8 consisting of 60 to 55 percent debt and 40 to 45 percent equity following the completion of the
9 Citizens' acquisition. In order to achieve this capital structure, approximately 40 percent of the
10 purchase price for Citizens' water and wastewater assets will be financed by an infusion of paid-in
11 capital provided by AWW, with the balance of the purchase price financed by a combination of short-
12 term debt and the assumption of the IDRBS. The short-term debt will then be refinanced and
13 converted to long-term debt within 12 months from the date of closing.

14 At December 31, 2000, AWW's consolidated capital structure consisted of approximately 59
15 percent debt, 1 percent preferred stock and 40 percent common equity. AWW also reported
16 consolidated net utility plant of \$5.20 billion and operating revenues of \$1.35 billion as of such date.

17 **American Water Capital Corp.**

18 The debt financing will be provided to Arizona-American by American Water Capital Corp.
19 ("Capital Corp."), which is also a subsidiary of AWW. Capital Corp. serves as the primary funding
20 vehicle for all of AWW's utility subsidiaries. By combining the short and long-term debt
21 requirements of AWW's utility subsidiaries, Capital Corp. is able to issue bonds, commercial paper
22 and other securities in the public markets. This combined borrowing power should result in lower
23 transaction costs and increased borrowing efficiency. Capital Corp. carries strong corporate credit
24 ratings from Standard and Poor's and Moody's rating services of A- and Baa1, respectively.

25 Arizona-American has previously entered into a Financial Services Agreement with Capital
26 Corp.¹ Under this agreement, Capital Corp. will provide short and long-term loans and cash

27 _____
28 ¹ See Decision No. 63586 (April 24, 2001) (approving short-term debt to be provided by Capital Corp. for miscellaneous capital projects).

1 management services to Arizona-American. This agreement requires Arizona-American to reduce
2 the balance of its short-term debt owed to Capital Corp. by the excess of any cash not required to pay
3 daily disbursements.

4 Terms of the Proposed Debt

5 Initially, Arizona-American will borrow up to \$180.0 million from Capital Corp. on a short-
6 term basis. This debt will be unsecured and will be issued at prevailing interest rates. Arizona-
7 American expects that the short-term debt will carry an interest rate no greater than 50 basis points
8 over the London Interbank Offer Rate ("LIBOR"). LIBOR is the British Banker's Association
9 average of interbank offered rates for dollars deposited in the London market and is based on
10 quotations at 16 major banks. As of May 18, 2001, the one-year LIBOR rate was 4.44 percent, which
11 is nearly equal to the rate on U.S. Treasury bonds maturing in two years.

12 Within 12 months from the date of the transfer of the assets, Arizona-American will refinance
13 and replace the short-term debt with long-term debt issued through Capital Corp. Although the
14 precise terms of the debt have not yet been determined, Arizona-American has committed in its
15 application to limit the interest rate to a level no greater than 250 basis points over Treasury bonds of
16 similar maturities. Arizona-American expects that the long-term debt will have a maturity between 5
17 and 30 years, but most likely will be issued with maturities in the 7 to 10-year range. Staff indicated
18 that 7 and 10-year Treasury bonds currently carry interest rates between 5 percent and 5.5 percent.
19 Adding 250 basis points results in a range of 7.5 percent to 8.0 percent.

20 Assumption of IDRBS

21 Under the terms of the asset purchase agreement with Citizens, Arizona-American agreed to
22 assume a portion of Citizens' IDRBS in the amount of \$10,635,000. Capital Corp. will initially be
23 the assuming entity. Capital Corp. will then enter into a matching loan, containing terms identical to
24 those of the IDRBS, with Arizona-American, at which time the debt will be reflected in the capital
25 structure of Arizona-American.

26 The IDRBS mature on September 1, 2028. These bonds are floating rate bonds, similar to
27 commercial paper, with the interest rate changing daily with each remarketing of the bonds. Staff
28 indicated that the most recent rate paid by Citizens on the IDRBS was 4.25 percent.

1 **Arizona-American's Ability to Repay the Proposed Debt**

2 Staff utilized pro forma financial information and conducted an analysis of Arizona-
3 American's ability to repay the proposed debt following the acquisition of Citizens' water and
4 wastewater utility assets. Staff's projections and analysis are based upon the assumption that the new
5 short-term debt issued to finance the purchase of Citizens' assets is immediately converted to long-
6 term debt. Another assumption adopted by Staff was Arizona-American's projection that the new
7 debt would not have principal payments until maturity.

8 Staff's projections show that with the proposed debt, Arizona-American would have a Times
9 Interest Earned Ratio ("TIER") ranging from 1.05 to 0.83 and a Debt Service Coverage ratio ("DSC")
10 ranging from 1.62 to 1.21, depending on the amount of debt actually issued and future ratemaking
11 treatment of the acquisition premium that will be paid for Citizens' assets.² Based on the company's
12 financial statements ending December 31, 2000, Arizona-American had a TIER of 2.19 and a DSC of
13 3.49. As indicated by Staff, while the ratios based on the new debt issuances do not reflect robust
14 financial health, they indicate that Arizona-American should generate sufficient earnings and cash
15 flow to make principal and interest payments on its current and proposed debt.

16 **Impact on Capital Structure and Cost of Capital**

17 In Arizona-American's most recent rate proceeding, the Commission, in Decision No. 61831
18 (July 20, 1999), used a capital structure consisting of 45.0 percent long-term debt with a cost of 7.3
19 percent, and 55.0 percent common equity at a cost of 11.0 percent, resulting in a weighted cost of
20 capital of 9.3 percent. Staff evaluated the impact of the proposed debt issuance of approximately
21 \$132,000,000 and the assumption of \$10,635,000 of Citizens' IDRBS on Arizona-American's capital
22 structure. Staff's pro forma capital structure for Arizona-American consists of 59.4 percent long-
23 term debt at a cost of 7.4 percent, and 40.6 percent common equity at a cost of 11.0 percent, resulting
24 in a weighted cost of capital of 8.9 percent. This pro forma capital structure reflects the assumption
25 that AWW would invest additional paid-in capital (equity) of approximately \$92.5 million, which
26 would constitute an increase in equity of approximately \$0.70 for every dollar of new debt issued.

27 ²If the Company assumes Citizens' IDRBS and issues \$132,457,390 of acquisition debt, the projected TIER and DSC are
28 .95 and 1.62, respectively. If the Company is allowed to issue \$180,000,000 in long-term debt, the projected TIER and
DSC are .83 and 1.21, respectively.

1 Staff expressed concern that if the entire \$180.0 million of debt is issued, the percentage of
2 debt in Arizona-American's capital structure would increase to more than 65 percent, while the
3 percentage of equity in the Company's capital structure would decrease to less than 35 percent. Staff
4 indicates that these ratios would not be comparable to those of healthy, publicly-traded water utilities.
5 Moreover, Staff believes that if the entire \$180.0 million of debt is issued without any additional
6 equity infusion, Arizona-American's coverage ratios may not reach 1.0. This capital structure is
7 likely to result in a higher cost of equity as a result of the additional financial risk associated with
8 repayment of interest, thereby requiring a higher return on equity.

9 Staff's concerns about the capital structure that may result from the issuance of additional
10 debt in connection with acquiring Citizens' assets are legitimate. However, in its application,
11 Arizona-American has stated that it intends to achieve and maintain a capital structure containing
12 between 60 percent and 55 percent debt and between 40 percent and 45 percent equity following the
13 acquisition. In accordance with Arizona-American's application and the recommendations of Staff,
14 this Decision will require Arizona-American to increase its equity by at least \$0.69 for each dollar of
15 acquisition debt issued by Arizona-American to ensure that Arizona-American's capital structure
16 remains reasonably balanced.

17 Additional Staff Recommendations

18 In the Staff Report, the Staff recommends approval of a total of \$180.0 million of new debt
19 for the purpose of financing the acquisition of Citizens' assets. Based on Arizona-American's
20 application, the Company intends to borrow up to \$180.0 million on a short-term basis in order to
21 complete the acquisition, and to refinance and replace this short-term debt with long-term debt within
22 12 months from the closing. Therefore, Arizona-American is seeking authority to borrow a total of
23 \$180.0 million (exclusive of the financing relating to assumption of Citizens' IDRBS), and our
24 approval is accordingly limited to that total amount of debt.

25 Staff also recommends that Arizona-American perform an analysis that shows the savings
26 resulting from having Capital Corp. provide financing compared to Arizona-American procuring
27 financing from a non-affiliate. This analysis would be filed at the time of Arizona-American's next
28 rate case. Because Capital Corp. is an affiliate of Arizona American, and because of the magnitude

1 of the debt financing and its potential impact on Arizona-American's cost of capital, we concur with
2 this recommendation.

3 Finally, Staff recommends that any matching loans made by Capital Corp. to Arizona-
4 American relating to the assumption of Citizens' IDRBs carry terms that are no less favorable to
5 Capital Corp. than those presently associated with the IDRBs. We also concur with this
6 recommendation.

7 Based on the above, Staff believes that approval of the application will be compatible with the public
8 interest, with sound financial practices, and with the proper performance by Arizona-American of
9 service as a public service corporation and will not impair its ability to perform that service. We
10 concur with Staff, and believe that it is appropriate to approve Arizona-American's application
11 without a hearing, subject to the conditions indicated above.

12 * * * * *

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

15 **FINDINGS OF FACT**

16 1. Arizona-American is an Arizona corporation that provides water utility service to
17 approximately 4,700 customers in portions of the Town of Paradise Valley, the City of Scottsdale and
18 other unincorporated areas within Maricopa County, Arizona.

19 2. On November 15, 2000, Arizona-American filed an application with the Commission
20 requesting authority to issue short-term and long-term debt in an aggregate principal amount not to
21 exceed \$180.0 million and to assume certain IDRBs in connection with financing the acquisition of
22 Citizens' Arizona water and wastewater utility plant and assets.

23 3. On December 29, 2000, Arizona-American filed an Affidavit of Publication indicating
24 compliance with the Commission's notice requirements.

25 4. On May 25, 2001, Staff filed its Report on Arizona-American's application.

26 5. The parent of Arizona-American, AWW, is the largest privately-owned water utility
27 system in the United States, providing water, wastewater and other water resource management
28 services to approximately 3 million customers in 23 states.

1 6. The short-term and long-term debt that will be issued by Arizona-American will be
2 used for the sole purpose of financing the acquisition of Citizens' assets.

3 7. Citizens and Arizona-American received authorization from the Commission for the
4 transfer of Citizens' water and wastewater assets and Citizens' Certificates of Convenience and
5 Necessity to Arizona-American in Decision No. 63584.

6 8. The purchase price to be paid by Arizona-American to Citizens is \$231,310,000,
7 subject to adjustment at closing to reflect changes in Citizens' net assets occurring after June 30,
8 1999. The purchase price includes the assumption of IDRBs in the amount of \$10,635,000.

9 9. The debt financing will be provided to Arizona-American by Capital Corp., which
10 serves as the primary funding vehicle for all of AWW's utility subsidiaries.

11 10. Capital Corp. carries strong corporate credit ratings from Standard and Poor's and
12 Moody's rating services of A- and Baa1, respectively.

13 11. Initially, Arizona-American will borrow up to \$180.0 million from Capital Corp. on a
14 short-term basis. This debt will be unsecured and is expected to have an interest rate no greater than
15 50 basis points over the LIBOR.

16 12. Within 12 months of the date of the transfer of the assets, Arizona-American will
17 refinance and replace the short-term debt with long-term debt issued through Capital Corp., which is
18 expected to have an interest rate no greater than 250 basis points over U.S. Treasury bonds of similar
19 maturities.

20 13. Capital Corp. will initially act as the assuming entity with respect to Citizens' IDRBs.
21 Capital Corp. will enter into a matching loan, containing terms identical to those of the IDRBs, with
22 Arizona-American, at which time the debt will be reflected in Arizona-American's capital structure.

23 14. Arizona-American currently has a capital structure consisting of approximately 53
24 percent debt and 47 percent common equity.

25 15. Arizona-American intends to achieve and maintain a capital structure containing
26 between 60 percent and 55 percent debt and between 40 percent and 45 percent equity following its
27 acquisition of Citizens' assets.

28 16. Staff's analysis of the effect of the proposed financing indicates that Arizona-

1 American would have a TIER ranging from 1.05 to 0.83 and a DSC ranging from 1.62 to 1.21,
2 depending on the amount of debt actually issued and future ratemaking treatment of the acquisition
3 premium that will be paid for Citizens' assets.

4 17. Staff recommends that Arizona-American be required to increase its equity by at least
5 \$0.69 for each dollar of acquisition debt issued by Arizona-American to ensure that Arizona-
6 American's capital structure remains reasonably balanced and its coverage ratios remain acceptable.

7 18. Staff also recommends that this Decision approve a total of up to \$180.0 million of
8 new debt for the purpose of financing the purchase of Citizens' assets to ensure that there is no
9 possibility that Arizona-American would issue combined long- and short-term debt exceeding that
10 amount. In its application, Arizona-American has indicated that it understands this limitation.

11 19. Staff also recommends that Arizona-American be required to perform an analysis that
12 shows the savings resulting from having Capital Corp. provide financing compared to Arizona-
13 American procuring financing from a non-affiliate. This analysis should be filed at the time of
14 Arizona-American's next rate case.

15 20. Staff also recommends that the terms of any matching loan made by Capital Corp. to
16 Arizona-American relating to the assumption of Citizens' IDRBs carry terms that are no less
17 favorable to Capital Corp. than those presently associated with the IDRBs.

18 21. Subject to the foregoing conditions, Staff believes that the proposed financing is for
19 lawful purposes, consistent with sound financial practices, and is in the public interest.

20 22. Staff recommends that the proposed financing be approved without a hearing.

21 CONCLUSIONS OF LAW

22 Arizona-American is a public service corporation within the meaning of Article XV of the
23 Arizona Constitution and A.R.S. §§ 40-281 and 40-282.

24 2. The Commission has jurisdiction over Arizona-American and the subject matter of
25 this application.

26 3. Notice of the application was given in accordance with the law.

27 4. The financing approved herein is for lawful purposes within Arizona-American's
28 corporate powers, is compatible with the public interest, with sound financial practices, and with the

1 proper performance by Arizona-American of service as a public service corporation, and will not
2 impair Arizona-American's ability to perform that service.

3 5. The financing approved herein is for the purposes stated in the application and is
4 reasonably necessary for those purposes, and such purposes are not, wholly or in part, reasonably
5 chargeable to operating expenses or to income.

6 6. Staff's recommendations in Findings of Fact Nos. 17 through 20 are reasonable and
7 should be adopted.

8 **ORDER**

9 IT IS THEREFORE ORDERED that the application of Arizona-American Water
10 Company for authority to issue promissory notes and other evidence of indebtedness in a total
11 aggregate principal amount not to exceed \$180.0 million, exclusive of the financing relating to the
12 assumption of Citizens' IDRBs, on the terms and conditions set forth hereinabove shall be and the
13 same is hereby approved.

14 IT IS FURTHER ORDERED that Arizona-American Water Company shall secure long-term
15 debt financing within 12 months of obtaining the short-term debt. The long-term debt shall be used
16 to repay the principal and interest owed under the short-term financing, and at such time the
17 authorization for the short term financing contained in this Order shall terminate.

18 IT IS FURTHER ORDERED that Arizona-American Water Company's request to incur
19 additional long-term indebtedness, and to issue a promissory note payable to American Water Capital
20 Corp. in consideration for American Water Capital Corp.'s assumption of Citizens Communications
21 Company's industrial development revenue bonds totaling \$10,635,000 on terms that are no less
22 favorable than the terms of the revenue bonds being assumed, shall be and the same is hereby
23 approved.

24 IT IS FURTHER ORDERED that Arizona-American Water Company is hereby authorized to
25 issue and deliver promissory notes and other instruments evidencing said short-term and long-term
26 indebtedness consistent with the foregoing approvals and to execute and deliver any additional
27 documents necessary to effectuate the authorization granted hereinabove.

28 IT IS FURTHER ORDERED that Arizona-American be required to increase its equity by at

1 least \$0.69 for each dollar of acquisition debt issued by Arizona-American to ensure that Arizona-
2 American's capital structure remains reasonably balanced and its coverage ratios remain acceptable.

3 IT IS FURTHER ORDERED that Arizona-American shall comply with Staff's
4 recommendations as set forth in Findings of Fact Nos. 17 through 20.

5 IT IS FURTHER ORDERED that the authorization granted hereinabove is expressly
6 contingent upon Arizona-American Water Company's use of the proceeds for the purposes set forth
7 in its application.

8 IT IS FURTHER ORDERED that approval of the financing set forth above does not
9 constitute or imply approval or disapproval by the Commission of any particular expenditure of the
10 proceeds derived for purposes of establishing just and reasonable rates.

11 IT IS FURTHER ORDERED that Arizona-American Water Company shall file copies of all
12 executed financing documents setting forth the terms and conditions of the financing with the
13 Compliance Section of the Commission's Utilities Division within 30 days of execution of said
14 documents.

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1 IT IS FURTHER ORDERED that Arizona-American Water Company shall perform an
2 analysis that shows the savings resulting from having American Water Capital Corp. provide the new
3 debt financing, as provided hereinabove, as compared to obtaining financing from a non-affiliated
4 lender, and shall file such analysis in conjunction with Arizona-American Water Company's next
5 general rate proceeding.

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

7 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.
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9

10 CHAIRMAN COMMISSIONER COMMISSIONER
11

12
13 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive
14 Secretary of the Arizona Corporation Commission, have
15 hereunto set my hand and caused the official seal of the
16 Commission to be affixed at the Capitol, in the City of Phoenix,
17 this ____ day of _____, 2000.

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19 _____
20 BRIAN C. McNEIL
21 EXECUTIVE SECRETARY

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1 SERVICE LIST FOR: ARIZONA-AMERICAN WATER COMPANY

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3
4 Norman D. James
5 FENNEMORE CRAIG
6 3003 N. Central Avenue, Suite 2600
7 Phoenix, Arizona 85012-2913
8 Attorneys for Arizona-American Water Company

9 Christopher C. Kempley, Chief Counsel
10 Legal Division
11 ARIZONA CORPORATION COMMISSION
12 1200 West Washington
13 Phoenix, AZ 85007

14 Steve Olea, Acting Director
15 Utilities Division
16 ARIZONA CORPORATION COMMISSION
17 1200 West Washington
18 Phoenix, AZ 85007

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