ORIGINAL

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MEMORANDUM

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TO: Docket Control

FROM: Ernest G. Johnson
Director
Utilities Division

DATE: February 10, 2006

RE: STAFF REPORT FOR ARIZONA-AMERICAN WATER COMPANY, INC. FOR APPROVALS ASSOCIATED WITH A PROPOSED TRANSACTION WITH MARICOPA COUNTY MUNICIPAL WATER CONSERVATION DISTRICT NUMBER ONE TO ALLOW THE CONSTRUCTION OF A SURFACE WATER TREATMENT FACILITY - DOCKET NO. W-01303A-05-0718

Attached is the Staff Report for Arizona-American Water Company, Inc. ("Company") application for approvals associated with a proposed White Tanks surface water treatment facility. Staff typically does not recommend approval of agreements between private parties and does not in this case. Staff recommends approval of the Company's request to issue evidence of indebtedness in amount equal the capital lease asset of approximately $37.4 million, subject to conditions. Staff also comments on the accounting and ratemaking treatment for the proposed capital lease. Staff recommends the sale and transfer of certain assets. Staff recommends an increase in the Company's Water Facilities Hook-up Fee. Staff generally agrees with the Company's proposed regulatory process and timing.

EGJ:JJD:red

Originator: James J. Dorf

Attachment: Original and sixteen copies

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Service List for: Arizona-American Water Company, Inc.
Docket No. W-01303A-05-0718

Mr. Scott Wakefield
1110 West Washington Street, Suite 220
Phoenix, Arizona 85007

Mr. Craig Marks
Arizona-American Water Company, Inc.
101 Corporate Center
Phoenix, Arizona 85024

Mr. Christopher C. Kempley
Chief Counsel, Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Mr. Ernest G. Johnson
Director, Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Ms. Lyn Farmer
Chief Administrative Law Judge, Hearing Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION

ARIZONA-AMERICAN WATER COMPANY, INC.

DOCKET NO. W-01303A-05-0718

APPLICATION FOR APPROVALS ASSOCIATED WITH A PROPOSED TRANSACTION WITH MARICOPA COUNTY MUNICIPAL WATER CONSERVATION DISTRICT NUMBER ONE TO ALLOW THE CONSTRUCTION OF A SURFACE WATER TREATMENT FACILITY

FEBRUARY 10, 2006

STAFF ACKNOWLEDGMENT

The Staff Report for Arizona-American Water Company, Inc. ("Company"), Docket No. W-01303A-05-0718, was the responsibility of the Staff members listed below. James J. Dorf was responsible for the review and analysis of the Company's application. Jian Liu was responsible for the engineering and technical analysis. John La Porta was responsible for reviewing the Commission's records on the Company, and reviewing customer complaints filed with the Commission.

James J. Dorf
Chief Accountant

Jian Liu
Staff Engineer

John La Porta
Public Utilities Consumer Analyst I

EXECUTIVE SUMMARY
ARIZONA-AMERICAN WATER COMPANY, INC.
DOCKET NO. W-01303A-05-0718

Arizona-American Water Company ("Company") is a public service corporation engaged in providing water and wastewater services in portions of Maricopa, Mohave, and Santa Cruz Counties, Arizona. The Company currently serves approximately 97,000 water customers and 47,000 wastewater customers. The Company is the largest investor-owned water and wastewater utility in Arizona.

The Company is requesting certain approvals associated with a proposed transaction with Maricopa County Municipal Water Conservation District Number One ("MWD"). The Company and MWD have executed a Memorandum of Understanding ("MOU") that outlines the framework under which MWD will finance, build, and own a White Tanks surface water treatment facility. The facility will treat Central Arizona Project ("CAP") surface water for three or more entities, one of which is the Company.

The Company is requesting the Arizona Corporation Commission's ('Commission") authorization to enter into a capital lease with MWD for its portion of the treatment plant capacity, approximately 55 percent of the initial plant capacity. Specifically, the Company requests Commission approval of the following:

1. Approval to enter into agreements as contemplated in the MOU.
2. Authorization to issue evidence of indebtedness in an amount equal to a capital lease asset and determined consistent with the formula set forth in the agreement.
3. Authorization of the transfer of assets owned by the Company to MWD.
4. Authorize the rate making treatment of the capital lease.
5. Authorize a revision to the current water facilities and CAP hook-up fees.
6. Approve a regulatory process.

The project offers the following benefits:

1. It makes possible the construction of a "regional" surface water facility.
2. Treatment of the Company's CAP allocation can satisfy the demands of its rapidly growing Agua Fria District.
3. A regional treatment plant utilized by several water providers is a least cost solution for treating CAP water.
4. It will preserve groundwater resources throughout the region and the Company's Agua Fria District.

Staff typically does not recommend approval of agreements between private parties and does not in this case. Staff recommends approval of the Company's request to issue evidence of indebtedness in amount equal the capital lease asset of approximately $37.4 million, subject to conditions. Staff recommends the sale and transfer of certain assets. Staff also comments on the accounting and ratemaking treatment for the proposed capital lease. Staff recommends an

increase in the company's Water Facilities Hook-up Fee. Staff generally agrees with the Company's proposed regulatory process and timing.

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Introduction

Arizona-American Water Company, Inc. ("Arizona-American" or "Company") is a public service corporation engaged in providing water and wastewater services in portions of Maricopa, Mohave, and Santa Cruz Counties, Arizona pursuant to various certificates of public convenience and necessity granted by the Arizona Corporation Commission ("Commission"). The Company currently serves approximately 97,000 water customers and 47,000 wastewater customers. The Company is Arizona's largest investor owned water and wastewater utility.

The Company is requesting certain approvals associated with a proposed transaction with Maricopa County Municipal Water Conservation District Number One ("MWD"). The Company and MWD have executed a Memorandum of Understanding ("MOU") that outlines the framework under which MWD will finance, build, and own a White Tanks surface water treatment facility. The facility will treat Central Arizona Project ("CAP") surface water for three or more entities, one of which is the Company.

The treated surface water will be used by the Company to serve its Agua Fria Water District which is located in the West Phoenix suburbs (north of I-10, between the White Tank Mountains and the 101 Expressway). The Company's Agua Fria Water District currently has approximately 25,000 customers and is adding about 4,000 new water customers each year.

The Company is requesting several approvals including approval of the transaction with MWD and authorization to issue debt in the form of a capital lease of approximately $37,413,874.

Project Overview

The basic framework under which MWD will build, finance, and own the White Tanks Treatment Plant ("WTTP" or "plant") is summarized in the MOU between the MWD and the Company. An affiliate of Arizona-American is anticipated to be the operator of the facility.

The plant will be located at Cactus and Perryville Roads, will be constructed in phases, and is capable of expanding its capacity to treat up to 80 million gallons per day ("mgd"). The plant will ultimately treat water for other municipal and private water companies in the region.

The first phase (Phase 1a) will initially treat 13.5 mgd and construction is anticipated to begin in the spring of 2006 and be completed and operational by the summer of 2008. The Company will lease 7.5 mgd of that capacity. The City of Goodyear and Arizona Water Company are expected to contract for the remaining 6 mgd of treatment capacity.

Phase 1b will be constructed in 2010 and add an additional 6.5 mgd of which the Company intends to lease 4.0 mgd. The current estimate of the cost to construct the facilities is $67,344,973 for Phase 1a and $7,500,000 for Phase 1b. Three additional phases of 20 mgd each will eventually be added, for a total treatment capacity of 80 mgd.

The Company's proportionate share of each phase is $37,413,874 for Phase 1a and $4,615,385 for Phase 1b for a total of $42,029,259.

Project Benefits

The Company proposes that the project is in the public interest by providing the following benefit to the White Tanks region:

1. It makes possible the construction of a regional surface water facility to be owned by MWD.

2. Treatment of the Company's CAP allocation can satisfy the demands of it rapidly growing Agua Fria District.

3. A regional treatment plant utilized by several water providers is a least cost solution for treating CAP water.

4. It will preserve groundwater resources throughout the Company's Agua Fria District.

Requested Approvals

The Company is requesting the following Commission approvals, each of which are discussed below:

1. Approval to enter into agreements as contemplated in the MOU.

2. Authorization under A.R.S. §40-301 to issue evidence of indebtedness in an amount equal to the capital lease asset and determined consistent with the formula set forth in the agreement.[1]

3. Authorization of the transfer of assets by the Company to MWD.

4. Authorize the rate making treatment of the capital lease.

5. Authorize a revision to the current water facilities and CAP hook-up fees.

6. Approve a regulatory process that includes:

    a. Approval of the items requested herein in the first quarter of 2006, if the 2008 deadline is to be met.

[1] Attachment B to the filing.

b. The filing of an Agua Fria District rate application in early 2007 with a 2006 test year.

c. An application, filed in 2008, for recovery of the actual plant construction and operating costs using a method similar to the two step Arsenic Cost Recovery Mechanisms ("ACRM") as approved in other Commission Decisions.[2]

1. Approval to Enter into Agreements

Background

As outlined in the Company's application, a number of western Maricopa County municipalities and private water companies holding CAP allocations formed WESTCAPS to develop cooperative regional solution to effectively use existing CAP allocations and other renewable water resources.

A study completed in 2001 by WESTCAPS warned that continued reliance on groundwater to support new development would cause groundwater levels to decline and accelerate land-subsidence problems. The study concluded that the region's water suppliers should maximize their use of CAP and other surface water resources.

Arizona-American Involvement

The Company holds a CAP subcontract for 11,093 acre-feet per year that is currently being used by MWD as part of its aquifer recharge program. Such CAP water requires treatment before it can be delivered to customers. The MOU provides for MWD to deliver treated CAP water to the Company's Agua Fria District.

The Company purchased, in 2002, a 45 acre parcel of land at the site identified in the WESTCAPS study for a regional treatment facility. The Company believed it could obtain financing to design, build, and operate a large treatment facility, although it was ultimately unable to do so. The Company also signed contracts to design, engineer and construct the facility. As of October, 2005, the design and permitting portions for Phase 1a were 95 percent complete.

MWD Involvement

The Company was approached by MWD about investing in, then ultimately owning the facilities. The negotiations led to the execution of the MOU with MWD taking responsibility for financing, building and owning the White Tank treatment facilities and an agreement to have an affiliate of the Company responsible for operating the plant.

[2] Such as Decision No. 68310, Arizona-American Water Company.

MWD is striving to have the treatment plant in service by the summer of 2008. The Company predicts that it will be short of water by the summer of 2007. Another benefit of the MOU is that, if the Commission approves the transaction, MWD will connect three mgd of interim well capacity to the Company in 2007. This will prevent the drilling of additional wells in the region.

Comparison to Alternatives

An analysis of two alternatives was made and compared to Company's cost of drilling new wells to meet customer demand. The first alternative is an estimate of the cost for the Company to build and operate its own water treatment facility to treat CAP water. The second alternative is the proposed regional MWD facility.

The analysis estimates the cost per 1,000 gallons as follows[3]:

Drill New Wells with Arsenic Treatment	$2.74
Stand Alone CAP Treatment Facility	$3.18
White Tanks Regional Treatment Facility	$2.55

Also, to the extent that the treatment facilities operate at costs lower than initially estimated, MWD residents will receive annual credits on their water bills.

Staff Analysis

Staff does not typically recommend approval of agreements to which it is not a party and will not do so in this case. However, Staff recognizes the benefits derived from a regional solution which helps to preserve groundwater resources, reduces the potential from ground subsidence, and encourages the use of CAP surface water. Cost effective development of the regions water resources is in the public interest. Additionally, the economies of scale achieved by a regional approach are clearly in the public interest. Other benefits include acceleration of the Company's CAP water usage and connection to three mgd MWD well capacity to bridge potential gap in the Company's production capacity which will eliminate the need to drill new wells. Another unique feature is the potential for customer credits if the treatment facility's actual operating costs are lower than estimated.

[3] Attachment C to the Company's filing.

2. Authorization to Issue Evidence of Indebtedness in an Amount Equal to a Proposed Capital Lease

Company Proposal for a Capital Lease

If approved by the Commission, the Company will enter into a capital lease with MWD for a term of forty years. The Company's estimate of the useful life of the plant for accounting purposes is 38 years. The lease has been structured to comply with the requirements of Financial Accounting Standards ("FAS") No. 13[4] wherein it qualifies for treatment as a *capital* lease rather than an *operating* lease.[5] Capital leases require that the net present value of the minimum lease payments be recorded as both the asset value and the lease obligation amounts at inception. Typically, under the criteria met by the Company, the asset is depreciated over the asset's estimated useful life, rather than the life of the lease.

The National Association of Regulatory Commissioner's ("NARUC") Uniform System of Accounts ("USOA") permits capital lease accounting for transaction complying with FAS No. 13. However, based on facts specific to individual decisions, the Commission has required that some capital leases be accounted for as operating leases. The Company has requested that the Commission permit it to record the lease transaction as a capital lease under FAS 13 and as permitted by the USOA.

The lease term is forty years with the right to renew for an additional 40 years. The estimated useful life of the plant is 38 years and will be depreciated at 2.63 percent per year.

Company Indebtedness

Based upon the capital lease formula outlined in the MOU, the estimated indebtedness for the Phase 1a capital lease is $37,413,874 and calls for payments of $3,210,504 per year for 25 years and a $1 per year thereafter. The estimated interest rate is 7.0 percent interest rate but will be established based upon MWD actual incurred borrowing rate. The Company's capital structure as of September 30, 2005, consisted of 3.4 percent short-term debt, 70.6 percent long-term debt and 26.0 percent common equity. The Company has indicated that it plans on adjusting its capital structure upon consummation of the lease by making a common equity infusion of approximately 40.0 percent of the lease indebtedness or an approximate equity infusion of $15 million.[6]

Staff has applied the additional common equity and lease indebtedness to the September 30, 2005 capital structure. The resulting pro forma capital structure would consist of 3.0 percent

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[4] Financial Accounting Standards Board, Financial Accounting Standards No. 13, issued November, 1977, as amended.

[5] The FAS requires, among other criteria, that "the lease term is equal to 75 % or more of the estimated useful life of the leased property" and/or "the present value of the minimum lease payments is equal to 90% of the fair value of the leased property". The lease meets both of these requirements.

[6] $37,413,874 x 40 % = $14,965,550.

of short-term debt, 63.2 percent of long-term debt, 7.5 percent of capital lease obligations, and 26.2 percent of common equity.

The Company has submitted to the Commission an equity improvement plan which indicates that the Company may reach the 40 percent equity level, but will have trouble achieving that ratio through 2009 given its estimated capital expenditures.[7] The Company is pursuing approval from its Board of Directors for an equity infusion of $35 million in the first quarter of 2006. This would increase its equity position to approximately 31.4 percent based upon the September 30, 2005 balances. If the Company were to maintain this equity level through June, 2008, and at that time infuse an additional $15 million of common equity and enter into the capital lease, the pro-forma equity balance would approximate 31.1 percent. See Schedule JJD-1.

Staff Analysis

Staff commends the Company for addressing its relatively low equity balance and taking steps to improve its position through means other than retained earnings. Staff is, however, concerned that the addition of over $37 million in capital lease obligations, without an equity infusion, will seriously compromise the Company's financial health. Additionally, absent the significant potential benefits offered by the subject transaction, Staff would recommend even greater equity infusion or equity balance improvement prior to recommending approval.

Staff will recommend approval of the authorization to issue evidence of indebtedness in an amount equal to the capital lease asset as determined consistent with the formula set in the agreement. However, Staff recommends that the authorization be subject to the following three conditions:

1. In any event, the Company is required to make an equity infusion of an amount equal to at least 40 percent of the capital lease obligation.

2. Immediately after recognizing the capital lease, the Company's common equity balance shall not be below 30 percent of total capital.

3. The Company's Step 1 Water Treatment Plant filing (as discussed later) must demonstrate that after including the effects of the capital lease, the Company's times interest earned ratio will be at least 1.25 and the Company debt service coverage ratio shall be at least 1.25.

The Times Earned Interest Ratio ("TIER") represents the number of times earnings will cover interest expense on long-term debt. A TIER greater than 1.0 means that operating income

[7] Compliance Filing, dated November 30, 2005, in Docket Nos. W-01303A-05-0280, WS-01303A-02-0867, and WS-01303A-02-0869.

is greater than interest expense. A TIER less than 1.0 is not sustainable in the long term but does not necessarily mean that debt obligations cannot be met in the short term.

The Debt Service Coverage ratio ("DSC") represents the number of times internally generated cash will cover required principal and interest payments on long-term debt. A DSC greater than 1.0 indicates that operating cash flow is sufficient to cover debt obligations.

Staff has estimated the cash flows associated with its estimated hook-up fees (see hook-up fee discussion below) and the Company's estimated capital and operating expenses through the end of 2009. See Schedule JJD-6. Because of the proposed early collection of hook-up fees, the Company could have substantial positive cash flow related to the capital lease that may extend for several years. This could relieve some pressure on the Company' TIER and DSC by the assumption of debt in the form of a capital lease. Staff will recommend that the Company provide a comprehensive cash flow analysis when filing its Step 1 water treatment surcharge (discussed below) filing to permit evaluation based on more current financial results.

3. Authorize Asset Transfers to MWD

Proposed Asset Transfers

The Company proposes to sell the following assets to MWD:

1. The 45 acre site previously identified for the treatment plant. The purchase price will be the lesser of the appraised value or $30,000 per acre. If sold at $30,000 per acre, the Company anticipates proceeds of $1,350,000. The land has a current book value of $555,902.[8] Staff will recommend that the after tax gain of approximately $341,330[9] be shared between ratepayers and shareholders. The ratepayer's share of $170,665 should be used to reduce the cost of land when the capital lease is accounted for by the Company.

2. Design/Build Agreement. Approximately $5,492,538 has been spent by the Company related to the design and engineering for the project. If approved by the Commission, the Company will bill MWD the total costs incurred to that date. These costs include all external and internal engineering costs, including Company labor, expenses, overheads and an Allowance for Funds Used During Construction ("AFUDC").

3. Sale of a water trunk line. This trunk line is anticipated to be completed in the first quarter of 2006 with an estimated construction cost of $9,037,357. The trunk line is used to deliver treated water from the treatment plant to the Company, the City of Goodyear, and Arizona Water Company distribution systems.

[8] Response to Staff Data Request No. JJD-2.
[9] The Company used a revenue conversion factor of 1.62863 which equates to a combined federal and state income tax rate of 38.5989 percent ($1,350,000 – $555,902 =$794,098 -$214,572 [$555,902 x 38.5989] = $341,330).

4. Design documents for an additional trunk line segment. MWD will purchase the design costs for a section of the trunk line not yet completed. The estimated cost to complete this segment is $1,347,747.[10]

Items 2, 3, and 4 above are being sold to MWD at the Company's then existing accumulated costs. There is no profit to the Company for these elements.

Staff Analysis

Staff's analysis concludes that the sale of the above assets to MWD is reasonable and in the public interest. The sales will give MWD control over facilities being used to serve multiple private and public water customers and are appropriate to properly and efficiently operate its treatment facilities.

Staff, therefore recommends that the proposed asset sales and transfers be approved by the Commission.

4. Authorize the Proposed Ratemaking Treatment of the Capital Lease

Company Proposal

The Company has proposed to account for the transaction as a capital lease and receive regulatory approval to have similar treatment for ratemaking purposes. Capital leases are recorded as an obligation and an asset equal to the present value of the minimum lease payments during the term of the lease, not to exceed the fair value of the leased property.

The Company intends to finance the transaction with an equity infusion of approximately $15 million. The Company estimates the interest rate on debt will be approximately 7.0 percent. However, the actual rate will be determined once MWD actually funds the transaction. The Company will include this debt in its overall capital structure, which will be addressed in its 2007 Agua Fria rate case (discussed below).

The Company proposes that the treatment plant costs be recovered in a manner similar to Arsenic Cost Recovery Mechanisms ("ACRM") approved by the Commission.[11] The Water Treatment Surcharge Mechanism ("WTSM") can be implemented in two phases. The first phase will permit recovery of the initial capital cost (Step 1 filing for water treatment plant) and the Step 2 filing will permit recovery of related operating and maintenances ("O&M") costs.

The Company has estimated the rate impact on customers by calculating a surcharge using the same methodology as is used for ACRMs.[12] It estimated the accumulated water

[10] Response to Staff Data Request No. JJD-14.
[11] Arizona-American Water Company, Inc. Decision No. 68310 and Arizona Water Company Decision Nos. 66400 and 66849.
[12] Company Attachments D & E to its filing.

treatment hook-up fee collections of $11,178,740 using its existing fees and $23,188,760 using the Company's proposed hook-up fees. See Schedule JJD-4. It then used the accumulated hook-up fees to reduce the estimated rate base for the capital lease. The Company's calculations resulted in per month per customer charges ranging from a high of $10.26 to a low of $3.00 per month through the year 2018. Staff then utilized a ten year average to levelize the rates over that period of time and calculated an average rate of $4.25.[13] See Schedule JJD-7.

Staff notes that the rates calculated by the Company did not account for hook-up fee collections after 2008. The revenue requirement calculation did not provide for accumulated deferred income taxes or the substantial cash flow in the early years of the capital lease. Staff will recommend that the Company address these issues when making its Step 1 water treatment filing.

Staff Analysis

Staff agrees that the Company may propose that the transaction be accounted for as a capital lease and that it should be accounted for as provided for in FAS 13 and NARUC Accounting Instruction 22, given the proposed lease terms. However, Staff will make a final determination based upon the facts in evidence in the Company's rate application for it WTSM. Staff will also evaluate the estimated useful life and the depreciation rate in the 2007 Agua Fria rate filing.

However, the appropriate process for establishing the Company's capital lease rate treatment is in the context of a general rate filing. The Company has proposed that it will file a general rate application for the Agua Fria District in 2007 with 2006 test year. That will be the appropriate forum for determining the proper rate treatment. Additionally, the Commission is not required to follow generally accepted accounting principles or the USOA. With some exceptions, if Staff agrees with an ACRM methodology during the 2007 rate filing, a WTSM may be appropriate for the Company to recover costs associated with the water treatment plant including the following:

1. The surcharge is based solely on the actual costs eligible for recovery (depreciation, gross return, fixed and variable O & M charged by MWD).

2. Gross return will be based on the return authorized in its pending rate application for its Paradise Valley District and adjusted based upon the return authorized in the next Agua Fria rate case.

3. A required equity infusion of approximately 40.0 percent of the final Phase 1a capital lease obligation.

4. Actual rate recovery commences after the water treatment facilities are in service.

[13] Not adjusted for the time value of money.

5. A water treatment surcharge rate design composed of a separate commodity rate that is updated annually for any new capital leases, updated billing determinants and hook-up fees.

6. A deferral for future recovery of up to 12 months of fixed and variable O & M, without return, commencing with the in-service date of the water treatment facilities.

7. A financial presentation (filing) composed of ten standard schedules.

5. Authorize Revisions to Hook-Up Fees

The Company is currently collecting two hook-up fees in the Agua Fria District. A CAP Hook-up Fee whereby developers pay $257.00 per residential building and $150 per equivalent residential unit for commercial buildings. The funds collected are treated as contributions in aid of construction ("CIAC") and are non-refundable. The fee is increased for each increased meter size. The Company anticipates that these fees will no longer be necessary by the end of the second quarter of 2006 when it will be ended.

The Company also has a Water Facilities Hook-up Fee that is intended to offset the costs of new water facilities needed to serve new customers. The funds collected are also treated as ("CIAC") and are non-refundable.

The Company proposes to discontinue the Water Facilities Hook-up Fee, extend the CAP Hook-up Fee and increase it to $1,800. See Schedule JJD-4 for a summary of existing and proposed fees. The proposed fees, if approved would go into effect starting in May, 2006. The Company estimates that $23,188,760 will be collected through June 30, 2008.

Staff Analysis

Water Facilities Hook-up Fee ("WFHUF): Staff is recommending retention of the WFHUF with a $250 increase for 5/8" x 3/4" meters. Staff's estimates that, with a $250 increase, the excess[14] hook-up fees collected as of June 30, 2008 will approximate $22,692,000. See Schedules JJD-4 and JJD-5. This is close to the amount used by the Company ($23,188,790) for its estimates of the per-meter per –month analysis. It should be noted that the Company reduced its estimated excess hook-up fees by estimated construction expenditures accruing after June 30, 2008, through December 31, 2010 (approximately $7 million).

Staff notes that the Company's Water Facilities Hook-up Fee WHU-1 tariff, Sheet 9, has a definition for "Off-Site Facilities" which included "treatment facilities" as an appropriate use for funds collected under the tariff. See Attachment 2. The funds collected are only to be used to make capital lease payments. The funds may not be used to pay operating and maintenance

[14] The estimated cumulatively collected WFHUFs less the estimated cumulative related capital expenditures.

costs of the water treatment facilities. Operating and maintenance cost can be evaluated in the Company's rate application in 2007.

CAP Hook-up Fee: The CAP fee is recovering certain carrying costs associated with previously paid CAP M&I charges. The Company estimates that the charges will be fully collected in 2006. Staff recommends that the Company continue to collect the CAP fees and terminate the tariff once the total has been fully collected.

Staff recommends increasing the WFHUF tariff (Sheet 9a) to $1,400 for the 5/8" x 3/4" meters and graduated for other meter sizes as indicated in Staff Schedule JJD-4. The CAP Hook-up Fee Tariff should remain in effect until fully collected and then be terminated.

6. Approve a Regulatory Process

The Company is requesting approval of the following regulatory process that includes:

1. Approval of the items requested herein in the first quarter of 2006.

2. Filing an Agua Fria District rate application in early 2007 with a 2006 test year.

3. An application, filed in 2008, for recovery of the actual plant construction and operating costs using a method similar to the two step Arsenic Cost Recovery Mechanisms ("ACRM") as approved in other Commission Decisions.[15]

Staff Analysis

Staff concurs with the regulatory process and timing as suggested by the Company. The regulatory objectives and timing appear to be realistic. However, Staff makes no recommendation at this time with respect to the Company's proposed cost recovery method for the water treatment facility. The Company is free to propose an ACRM type recovery mechanism in its rate application in 2007, but there can be no assurance as to the nature of the Commissions approval(s). See Staff's recommendations below regarding the requested approvals and requested regulatory process.

Engineering Analysis

Staff Engineering has reviewed the application and concluded that a regional water treatment plant is the favored option and is reasonable. However, no "used and useful" determination of the proposed project has been made. See attached Engineering report.

[15] Such as Decision No. 68310, Arizona-American Water Company.

Notifications

The Company provided a Confirmation of Mailing and Affidavit of Publishing to Docket Control on January 23, 2006. The public notice was sent to each of the Company's customers and published in the Arizona Republic and Arizona Business Gazette.

Compliance

The Company has no compliance items at this time.

Staff Recommendations

Staff makes the following recommendations.

1. Staff does not typically recommend approval of agreements to which it is not a party and will not do so in this case. However, Staff recognizes the benefits derived from a regional solution which helps to preserve groundwater resources, reduces the potential from ground subsidence, and encourages the use of CAP surface water.

2. Staff recommends approval of the authorization to issue evidence of indebtedness in an amount equal to the capital lease asset as determined consistent with the formula set in the agreement. However, Staff recommends that the authorization be subject to the following three conditions:

    a. In any event, the Company is required to make an equity infusion of an amount equal to at least 40 percent of the capital lease obligation.

    b. Immediately after recognizing capital lease, the Company's common equity balance shall not be below 30 percent of total capital.

    c. The Company's Step 1 Water Treatment Plant filing must demonstrate that after including the effects of the capital lease, the Company's times interest earned ratio will be at least 1.25 and the Company debt service coverage ratio shall be at 1.25.

3. Staff recommends that the proposed asset sales and transfers be approved by the Commission.

4. The appropriate process for establishing the Company's capital lease rate treatment is in the context of a general rate filing. The Company has proposed that it will file a general rate application for the Agua Fria District in 2007 with 2006 test year. Staff recommends that the efficacy of establishing a WTSM be determined at that time.

5. Staff recommends increasing the WFHUF tariff (Sheet 9a) to $1,400 for the 5/8" x 3/4" meters and graduated for other meter sizes as indicated in Staff Schedule JJD-4. The CAP Hook-up Fee Tariff should remain in effect until fully collected and then be terminated. A revised WFHUF tariff should be submitted to Docket Control, as a compliance item in this matter, within 30 days of a decision in this case.

6. Staff concurs with the regulatory process and timing as suggested by the Company. The regulatory objectives and timing appear to be realistic. However, there can be no assurance as to the nature of the Commissions approval(s).

CAPITAL STRUCTURE ANALYSIS

Selected Financial Data
Showing Pro Forma Effects of the Proposed Lease

		[A] 12/31/2004		[B] Pro Forma		[C] Pro Forma	
15	Short-term Debt	$15,143,305	3.4%	$15,143,305	3.2%	$15,143,305	2.8%
16							
17	Long-term Debt	$314,177,766	70.6%	$314,177,766	65.5%	$314,177,766	59.0%
18							
19	Capital Lease Obligation	$0	0.0%	$0	0.0%	$37,413,871	7.0%
20							
21	Common Equity	$115,420,371	26.0%	$150,420,371	31.4%	$165,420,371	31.1%
22							
23	Total Capital	$444,741,442	100.0%	$479,741,442	100.0%	$532,155,313	100.0%

[A] Balances as of September 30, 2005.
[B] Pro Forma September 30, 2005 with an Equity Infusion of $35 million.
[C] Pro Forma September 30, 2005 with an Equity Infusion of $50 million.

24	Total Construction Cost Phase 1a	$67,344,973
25	*Proportionate Share of Construction (7.5 / 13.5)*	$37,413,836
26	Approximate Equity Infusion ($37,413,836 @ 40 percent)	$15,000,000

Arizona-American Water Company, Inc.
W-01303A-05-0718
Capital Lease with Maricopa Water District

Schedule JJD-2

CAPITAL LEASE PAYMENTS

	CAPITAL LEASE PAYMENT FORMULA	COMMENT
CAPITAL PAYMENT	**Fixed Capital Lease Payments:** [PMT] / 12 where PMT = $A[r/(1-(1+r)^{n})]*f/h$ *r is calculated using an appropriately termed treasury bond + a Corporate Spread of 275 basis points.*	A= Original Cost of WTP & delivery assets *r*= interest rate n= Amortization period *f*= AAW's subscripted capacity *h*= Total subscribed plant capacity
O & M PAYMENT	**Operation & Maintenance Payments**:** Composed of Fixed and Variable O&M. F= (m) / 12 x f / h V= n x r	(m)= budgeted annual fixed costs f= AAW's subscripted capacity h= Total subscribed plant capacity n= user's monthly measured flow (in 000) r= q / annual estimated flow($ per 000) q= budgeted annual variable O&M

COSTS INCLUDED IN THE ANNUAL O & M CHARGE

Maintenance Investment: Post Implementation Facility Assets less than $50,000*	These costs are charged as part of the fixed O & M charge
Administrative Fee: Equals 10% of ***projected*** fixed and variable O&M costs except for R & R costs	A provision for MWD administrative costs as set forth in its annual budget

OTHER POTENTIAL LEASE PAYMENTS

Repair & Replacement Investment ("R & R): Post Implementation Facility Assets over $50,000*	Requires new capital lease when it aggregates $500,000 or every fifth year
Payment After Initial Amortization Period: Assumes the lease will be extended beyond 40 years.	The "n" factor in the lease formula will become $1 for any periods beyond the current 40 year term
Facility Repurchase Price:	Provides a complex formula wherein the Company can purchase capacity from

* subject to an annual inflation adjustment.
** subject to an annual true up to actual costs for the variable component.

ARIZONA-AMERICAN WATER COMPANY
Docket No. W-01303A-05-0718

Schedule JJD-3

CAPITAL LEASE AMORTIZATION

	Amount Financed	Annual Payment	Principal	Interest	Outstanding Balance
1	37,413,874	3,210,504	591,533	2,618,971	36,822,341
2		3,210,504	632,940	2,577,564	36,189,401
3		3,210,504	677,246	2,533,258	35,512,155
4		3,210,504	724,653	2,485,851	34,787,502
5		3,210,504	775,379	2,435,125	34,012,123
6		3,210,504	829,655	2,380,849	33,182,468
7		3,210,504	887,731	2,322,773	32,294,737
8		3,210,504	949,872	2,260,632	31,344,865
9		3,210,504	1,016,363	2,194,141	30,328,502
10		3,210,504	1,087,509	2,122,995	29,240,993
11		3,210,504	1,163,634	2,046,870	28,077,359
12		3,210,504	1,245,089	1,965,415	26,832,270
13		3,210,504	1,332,245	1,878,259	25,500,025
14		3,210,504	1,425,502	1,785,002	24,074,523
15		3,210,504	1,525,287	1,685,217	22,549,236
16		3,210,504	1,632,057	1,578,447	20,917,179
17		3,210,504	1,746,301	1,464,203	19,170,878
18		3,210,504	1,868,542	1,341,962	17,302,336
19		3,210,504	1,999,340	1,211,164	15,302,996
20		3,210,504	2,139,294	1,071,210	13,163,702
21		3,210,504	2,289,045	921,459	10,874,657
22		3,210,504	2,449,278	761,226	8,425,379
23		3,210,504	2,620,727	589,777	5,804,652
24		3,210,504	2,804,178	406,326	3,000,474
25		3,210,504	3,000,471	210,033	3
26		1	1		
27		1	1		
28		1	1		
29		1	1		
30		1	1		
31		1	1		
32		1	1		
33		1	1		
34		1	1		
35		1	1		
36		1	1		
37		1	1		
38		1	1		
39		1	1		
40		1	1		
	Total payments		37,413,886	42,848,729	

Arizona America Water Company
Docket No. W-03510A-05-0145
All Amounts In Thousands

Schedule JJD-4

SUMMARY OF PROJECTED CAPITAL EXPENDITURES AND HOOK-UP FEES

	2005	Jan-April 2006	May-Dec 2006	2007	Jan-Jun 2008	Jul-Dec 2008	2009	2010
CAPITAL EXPENDITURES								
1 Estimated Capital Expenditures*	155	1,562	76	1,288	3,000	3,014	2,112	2,000
2 Cummulative Capital Expenditures	4,689	6,251	6,327	7,615	10,615	13,629	15,741	17,741
HOOK-UP FEES								
3 Existing Cummulative HUF	5,202	8,313	14,557	24,094	28,844	33,593	42,881	52,169
4 Proposed Cummulative HUF**	5,202	8,719	18,492	33,420	40,584	48,018	62,556	77,129
5 Current Cummulative Excess HUF (L3-L2)***		2,062	8,230	16,479	***18,229***	19,964	27,140	34,428
6 Proposed Cummulative Excess (L5-L2)***		2,468	12,165	25,805	***29,969***	34,389	46,815	59,388
7 Staff Recommended Excess (JJD-5 Line 19)			9,677	19,910	***22,692***			

Company Estimated HUF Contribution Offset with no Increase at 6/30/2008	11,179	Attachment D, Company Filing.
Company Estimated HUF Contribution Offset with an Increase at 6/30/2008	23,189	Attachment E, Company Filing.

PROPOSED HOOK-UP FEES

	Existing Hook-Up Fees			Company		Staff Recommended	
	WFHUF	CAP	Total	Increase	Proposed	Increase	WFHUF
5/8 x 3/4 Inch	1,150	150	1,300	500	1,800	250	1,400
3/4 Inch	1,725	225	1,950	750	2,700	375	2,100
1 Inch	2,875	375	3,250	1,250	4,500	625	3,500
1.5 Inch	5,750	750	6,500	2,500	9,000	1,250	7,000
2 Inch	9,200	1,200	10,400	4,000	14,400	2,000	11,200
3 Inch	18,400	2,400	20,800	8,000	28,800	4,000	22,400
4 Inch	28,750	3,750	32,500	12,500	45,000	6,250	35,000
6 Inch	57,500	7,500	65,000	25,000	90,000	12,500	70,000
8 Inch	115,000	15,000	130,000	50,000	180,000	25,000	140,000

* Only capital expenditures related to the water facility hook-up fee, from Schedule D, Company Application.
** Assumes implementation in second quarter of 2006
*** Amount of cummulative HUFs in excess of cummulative construction expenditures.

Arizona-American Water Company, Inc.
Docket No. W-01303A-05-0718

Schedule JJD-5

STAFF RECOMMENDED HOOK UP FEE IMPACT

		Staff Increase	May-06 to Dec-06	2007	Jan-08 to Jun-08	Jul-08 to Dec-08	2009	2010
1	Number of Meters							
2	5/8 x 3/4 Inch	$250	325	338	169	169	185	131
3	3/4 Inch	$375	1,463	2,252	1,131	1,131	2,159	2,175
4	1 Inch	$625	932	1,461	732	732	1,482	1,503
5	1.5 Inch	$1,250	71	113	55	55	116	117
6	2 Inch	$2,000	28	45	20	20	46	45
7								
8	Hook-up Fees Collected							
9	5/8 x 3/4 Inch		$81,250	$84,500	$42,250	$42,500	$46,250	$32,750
10	3/4 Inch		$548,625	$844,500	$424,125	$424,125	$809,625	$815,625
11	1 Inch		$582,500	$913,125	$457,500	$457,500	$926,250	$939,375
12	1.5 Inch		$88,750	$141,250	$68,750	$68,750	$145,000	$146,250
13	2 Inch		$56,000	$90,000	$40,000	$40,000	$92,000	$90,000
14	WTHUF for the period		$1,357,125	$2,073,375	$1,032,625	$1,032,875	$2,019,125	$2,024,000
15	Cummulative WFHUF Increase		$1,357,125	$3,430,500	$4,463,125	$5,496,000	$7,515,125	$9,539,125
16	Existing HUF Cumm.*		$14,556,975	$24,094,500	$28,843,712			
17	Staff HUF Cumm (L15 + L16)		$15,914,100	$27,525,000	$33,306,837			
18	Less Cumm. Capital Exp.		$6,237,316	$7,614,956	$10,614,956			
19	Staff Excess WFHUF		$9,676,784	$19,910,044	***$22,691,881***			

* Attachment D, Company Filing

Arizona America Water Company
Docket No. W-03510A-05-0145

Schedule JJD-6

ESTIMATED CASH FLOW*
In Thousands

1	Excess Hook-up fees collected through June 30, 2008**		$ (18,892)
2	Activity July 1, 2008 to December 31, 2008		
3	Lease Payments	1,605	
4	Operation and Maintenance	223	
5	Additional Hook-up fees collected	(4,749)	
6	Capital Expenditures	3,014	
7	Net Activity for the Period		93
8	December 31,2008 balance		(18,799)
9	Activity in 2009		
10	Lease Payments	3,210	
11	Operation and Maintenance	446	
12	Additional Hook-up fees collected	(9,288)	
13	Water Treatment Surcharge Collections*	2,112	
14	Net Activity for the Period		(3,520)
15	December 31, 2009 Balance		$ (22,319)

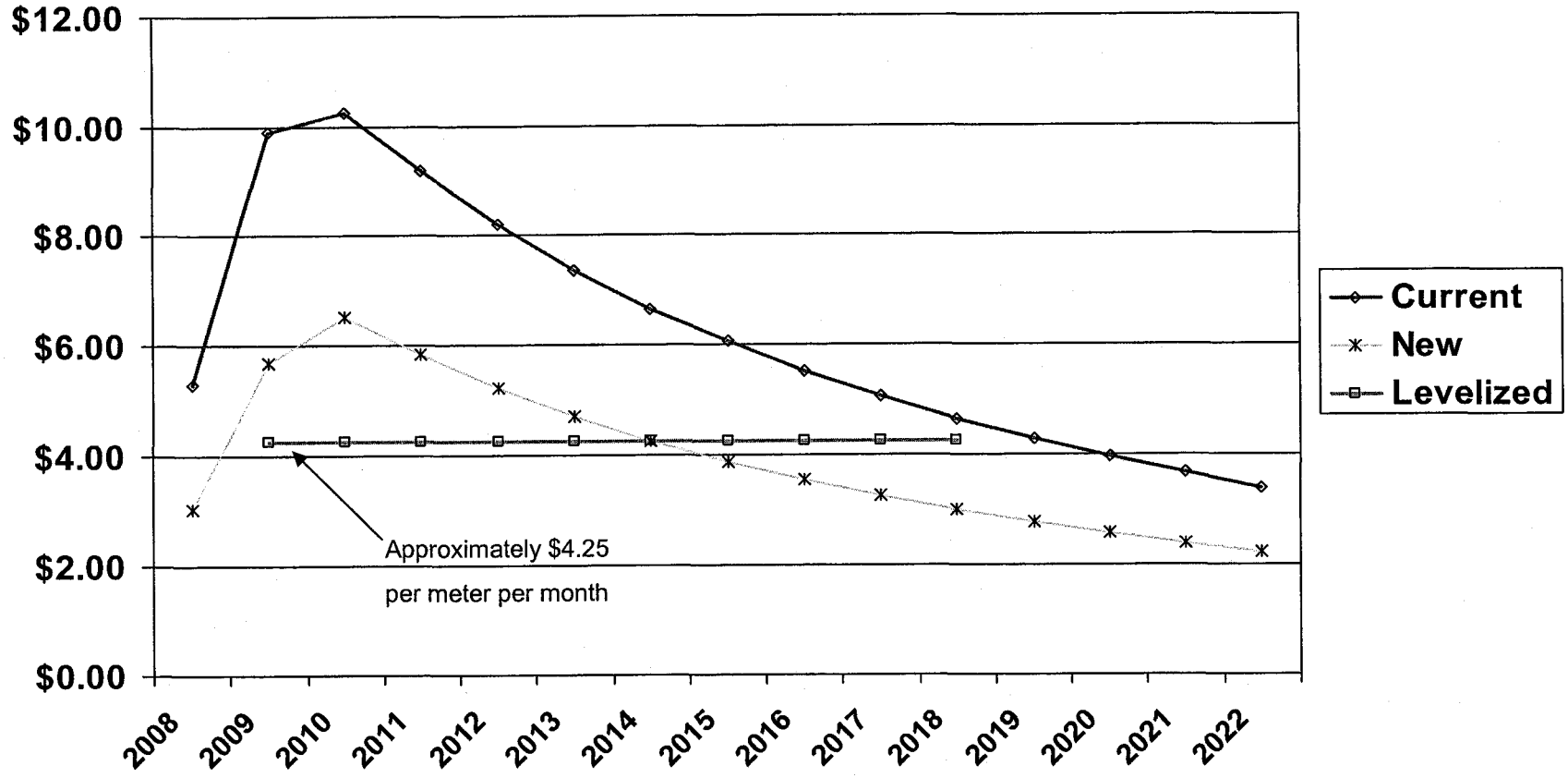
* Based on Company existing WFHUF estimates, Attachment D, Company Filing
** Schedule JJD-4, Line 5.

Arizona-American Water Company

Docket No. W-01303A-05-0718

Schedule JJD-7

WHITE TANK TREATMENT PLANT SURCHARGE PER CUSTOMER PER MONTH COST ESTIMATE



Source- Attachments D & E,
Company filing.

ATTACHMENT A

MEMORANDUM

DATE: December 9, 2005

TO: James Dorf
Chief Accountant
Utilities Division

FROM: Jian W. Liu
Utilities Engineer
Utilities Division

RE: Arizona–American Water Company
Docket No. W-01303A-05-0718 (Financing)

Introduction

Arizona–American Water Company ("Arizona–American" or "Company") presently provides utility service to approximately 97,000 water customers and 47,000 sewer customers in Arizona. The Company's Agua Fria District is located in the rapidly developing western Phoenix suburbs, where Arizona–American currently has about 25,000 water customers and is adding approximately 4,000 new water customers per year.

Financing Application

The Company and Maricopa County Municipal Water Conservation District Number One ("MWD") have executed a Memorandum of Understanding (MOU). MWD will build and own a regional water treatment facility known as the White Tanks Plant. Arizona–American intends to contract for 7.5 million gallons per day (mgd) of Phase 1A (13.5mgd) and 4.0 mgd of Phase 1B (6.5 mgd) of the White Tanks Plant capacity. The White Tanks Plant will be ultimately expandable to a total capacity of 80 mgd. The major benefits from the MOU and associated agreements are:

1. It will make possible the construction of a regional surface-water treatment facility known as the White Tanks Plant, to be owned and operated by MWD;
2. Arizona–American will be able to use its share of the treatment capacity at the White Tanks Plant to treat its entitlement to Colorado River water delivered through facilities of the Central Arizona Project (CAP);
3. It will preserve groundwater resources throughout the Company's Agua Fria District by significantly reducing anticipated groundwater usage.

Arizona–American is requesting to issue an evidence of indebtedness in an amount equal to the capital lease asset, and implement revised hook-up fees to reduce the rate impact of the proposed capital lease. MWD will purchase the plant site, plant design documents and a recently constructed trunk pipeline from Arizona–American.

Capital Lease - Alternatives Considered

The Company researched and evaluated two other options. One option was the Company would continue to rely on existing and new wells to meet its demands. The expected cost of this option was slightly higher than the White Tanks Plant option. But this option would be contrary to public policy, that is, to encourage the use of renewable surface water resources and to discourage groundwater usage, which would increase the possibility of land subsidence and reduce the water table. The other option would be for Arizona–American to build its own water treatment facility. However, without other partners, this option would be significantly more expensive. Based on the Company's consultant Ray L. Jones, the standalone water treatment plant option is 24.9% more expensive than leasing treatment capacity in MWD's White Tanks Plant.

Maricopa County Environmental Services Department (MCESD) Compliance

The MCESD reported no major system deficiencies and has determined the water system is currently delivering water that meets water quality standards required by Arizona Administrative Code, Title 18, Chapter 4 (Reported on Nov. 22, 2005).

Proposed Revised CAP Hook-up Fee

Arizona–American is asking to revise its existing water hook-up fees for the Agua Fria Water District so that growth can help raise additional funds to reduce the rate impact of the White Tanks Capital Lease. Arizona–American currently collects two water related hook-up fees in the Agua Fria Water District. The first is the CAP Hook-up Fee, and the second is the Water Facilities Hook-up Fee. Total Hook-up Fee in its present form is $1,300.00 for 5/8 x 3/4" Meter Size. Arizona–American proposes to discontinue the Water Facilities Hook-up Fee, and extend the CAP Hook-up Fee with modifications. The revised CAP Hook-up Fee will be $1,800.00 for 5/8 x 3/4" Meter Size. Without these changes, Arizona-American projects the rate increase would be approximately $10.00/customer/month for Phase 1A of the MWD Capital Lease. Arizona–American proposes revised hook-up fees so the projected rate increase would be reduced to approximately $6.00/customer/month.

Conclusion

Staff concludes that leasing treatment capacity in MWD's White Tanks Plant is the favored option and is reasonable. However, no "used and useful" determination of the proposed project item was made and no particular treatment should be inferred for rate making or rate base purposes in the future.

ATTACHMENT B

ORIGINAL

Water Facilities Hook-Up Fee WHU – 1

Applicability

Applicable to all new potable water Service Connections within the Company's CC&N, except those potable water Service Connections constructed pursuant to a Line Extension Agreement executed prior to November 10, 2003 that required the developer to fun or install the Off-Site Facilities necessary for Company to provide potable water service to the potable water Service Connection, provided, however, that the necessary Off-Site Facilities have actually been funded or instatlled.

Purpose

The purpose of the hook-up fee pursuant to this tariff is to equitably apportion the costs of constructing additional facilities to provide water production, treatment, transmission, storage, pressure and flow among all new Service Connections.

Definitions

Unless the context otherwise requires, the definitions set forth in Rule No. 1 shall apply in interpreting this tariff schedule. The following additional definitions apply to this tariff schedule only.

"Main Extension Agreement" means any agreement whereby an Applicant agrees to advance the costs of the installation of on-site water facilities (including distribution mains, valves, fittings, hydrants and other improvements in accordance with Rule No. 5) to the Company to serve new service connections, or install on-site water facilities to serve new service connections and transfer ownership of such water facilities to the Company, which agreement shall require the approval of the Arizona Corporation Commission (same as line *extension agreement*).

"Off-Site Facilities" means treatment facilities, wells, transmission lines, storage tanks and related appurtenances necessary for proper operation, including engineering and design costs. Off-site facilities may also include booster pumps, pressure tanks, distribution mains and related appurtenances necessary for proper operation, if these facilities are not for the exclusive use of the applicant but rather those facilities will provide regional or system wide benefits.

"Service Connection" means and includes all service connections for residential, commercial, industrial, or other uses, regardless of meter size.

APPROVED FOR FILING

DECISION #: 67093

ORIGINAL

Water Facilities Hook-Up Fee WHU – 1 (continued)

Rates

Each new service connection shall pay the Water Facilities Hook-up Fee indicated below based on the meter size to be installed:

Water Facilities Hook-Up Fee		
Meter Size	Factor	Total Hook-Up Fee
⅝" x ¾"	1.0	$1,150.00
¾"	1.5	$1,725.00
1"	2.5	$2,875.00
1½"	5.0	$5,750.00
2"	8.0	$9,200.00
3"	16.0	$18,400.00
4"	25.0	$28,750.00
6"	50.0	$57,500.00
8"	100.0	$115,000.00

Special Conditions

Assessment of One Time Hook-Up Charge: The hook-up fee may be assessed only once per Service Connection, or residential lot within a platted subdivision (similar to meter and service line installation charges). However, this provision does not exempt from the hook-up fee, any newly created parcel(s) resulting from further subdivision of a lot or land parcel and which do not have a Service Connection.

2. Time of Payment:

   a. In the event that the Applicant is required to enter into a Main Extension Agreement payment of the charges required hereunder shall be made by the Applicant when operational acceptance is issued for the on-site water facilities constructed to serve the improvement.

   b. In the event that the Applicant is not required to enter into a main extension agreement, the charges hereunder shall be due and payable at the time a meter is requested to be set for service to the property.

3. Failure to Pay Charges; Delinquent Payments: Under no circumstances will the Company set a meter or otherwise allow service to be established if the Applicant has not paid in full all charges as provided by this Water Facilities Hook-Up Fee tariff.

4. Off-Site Hook-Up Fees In Addition to Other Charges: The off-site hook-up fees shall be in addition to any costs associated with a main extension agreement for on-site facilities, and are in addition to the amounts to be paid pursuant to charges authorized under other tariffs.

APPROVED FOR FILING

DECISION #: 67093

ORIGINAL

Water Facilities Hook-Up Fee WHU – 1 (continued)

5. Use of and accounting for Water Facilities Hook-up Fee: Proceeds from the hook-up fee shall be accounted for as a contribution in aid of construction. As such, they will be treated as an offset to the cost of Off-Site Facilities included in rate base in any future ratemaking proceeding. The Company shall maintain on its books an accounting of the Water Facilities Hook-up Fees collected pursuant to this tariff and an accounting of the Off-Site Facilities constructed subsequent to adoption of this tariff.

6. Disposition of Excess Funds: After all necessary and desirable Off-Site Facilities are constructed or the Water Facilities Hook-Up Fee has been terminated by order of the Arizona Corporation Commission (Commission), any Water Facilities Hook-Up Fees collected in excess of the total amount expended by the Company for construction of Off-Site Facilities shall be refunded. The Commission shall determine the manner of the refund at the time a refund becomes necessary.

   Sizing of Water Meters: Residential water meters through 1" in size shall be sized in accordance with Company requirements as detailed in the most recent version of the Company's Development Guide. Large residential and all commercial water meters shall be sized in accordance with the Uniform Plumbing Code, latest edition.

APPROVED FOR FILING

DECISION #: 67093