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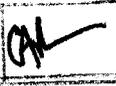
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Arizona Corporation Commission

**DOCKETED**

APR 17 2003

DOCKETED BY 

Attorneys for Arizona Water Company

## BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION  
OF ARIZONA WATER COMPANY, AN  
ARIZONA CORPORATION, FOR  
ADJUSTMENTS TO ITS RATES AND  
CHARGES FOR UTILITY SERVICE  
FURNISHED BY ITS NORTHERN GROUP  
AND FOR CERTAIN RELATED  
APPROVALS.

Docket No. W-01445A-00-0962  
(Phase 2 – Arsenic Cost Recovery)

**ARIZONA WATER COMPANY'S  
EXCEPTIONS TO RECOMMENDED  
DECISION AND ORDER  
[CORRECTED]**

### I. INTRODUCTION.

Arizona Water Company (“Arizona Water” or “the Company”) hereby submits its exceptions to the recommended form of Opinion and Order (“Recommended Order”) in the second phase of this general rate proceeding (“Phase 2”). Phase 2 deals with two interrelated issues: (1) approval of a procedure for Arizona Water to recover costs incurred to comply with the new Maximum Contaminant Level (“MCL”) for arsenic, imposed by the U.S. Environmental Protection Agency (“EPA”) under the Safe Drinking Water Act, and (2) consolidation of rates and charges for water service by Arizona Water’s Northern Group systems, as authorized in Decision No. 64282 (Dec. 28, 2001).

1 While the Recommended Order approves an arsenic cost recovery mechanism  
2 ("ACRM") allowing Arizona Water to recover a portion of its costs to construct and  
3 operate arsenic treatment facilities, the ACRM in the Recommended Order is inadequate  
4 to maintain the Company's financial integrity. The Recommended Order, while  
5 acknowledging that operation and maintenance costs ("O&M") for arsenic treatment are  
6 likely to be significant (Recommended Order at page 6, line1), does not include arsenic-  
7 related O&M costs in the ACRM. The effect of this recommendation is to deny recovery  
8 of annual O&M expenses until such time as a general rate case decision is issued. Based  
9 upon the timing of the rate application contemplated in this Recommended Order, that  
10 could be as late as September 2008. This recommendation, if adopted, will undermine the  
11 effectiveness of the ACRM and likely force Arizona Water to seek general rate increases  
12 as the Company's earnings will immediately be reduced to unacceptable levels.

13 In addition, the Proposed Order adopts Staff's proposal for recovering 50 percent  
14 of the capital costs through a surcharge on the monthly minimum rate and the other 50  
15 percent by a surcharge on the commodity rate. The Staff's proposal did not contemplate a  
16 consolidation of the Sedona and Rimrock systems for ratemaking purposes as  
17 recommended in the Proposed Order and did not address how the commodity rates would  
18 be modified to generate the other 50 percent of the capital costs. (Would there be a single  
19 commodity surcharge applied to both systems or individual commodity surcharges for  
20 Rimrock and Sedona?) The Company's proposal avoids these issues by recovering the  
21 capital costs via a monthly minimum surcharge and the incremental arsenic-related O&M  
22 expenses via a commodity surcharge. Other flaws in the recommended rate design are  
23 discussed below.

24 We have prepared proposed amendments for the commissioner's convenience  
25 which are attached.

26

1 **II. THE FINANCIAL IMPACT OF THE NEW ARSENIC MCL ON ARIZONA**  
2 **WATER DICTATES THE NEED FOR A STREAMLINED COST RECOVERY**  
3 **PROCEDURE THAT INCLUDES O&M EXPENSES.**

4 As indicated in the Recommended Order, the Utilities Division (“Staff”),  
5 intervenor Residential Utility Consumer Office (“RUCO”) and Arizona Water generally  
6 agree that approval of a streamlined procedure that will allow Arizona Water to recover  
7 costs associated with arsenic treatment without having to file a general rate case is  
8 necessary and appropriate. The parties recognize that the EPA’s new MCL for arsenic  
9 requires Arizona Water to incur extraordinarily high costs to comply and will likely have  
10 adverse impacts on Arizona Water. For example, the Staff accounting witness, in his pre-  
11 filed testimony, explained:

12 The potential magnitude of arsenic removal costs could harm  
13 the financial integrity of water utilities. A large number of  
14 Arizona water utilities are affected by the arsenic MCL  
15 requirements. Accordingly, a large number of rate and  
16 financing applications are likely to result. *A stream-lined  
17 procedure for recovering arsenic removal costs is important  
18 to efficiently preserve the financial integrity of water  
19 utilities.* Staff, RUCO, and Arizona Water (“parties”) agree  
20 that a stream-lined procedure could reduce the overwhelming  
21 administrative preparation and processing anticipated by the  
22 normal rate case and financing cases anticipated by the EPA’s  
23 10 parts per billion (“ppb”) MCL standard.

24 Fox Dir. at 3-4 (emphasis added).<sup>1</sup> During the hearing, Mr. Olea, the Assistant Director of  
25 the Commission’s Utilities Division, testified that “Staff believes that the costs that are  
26 going to be incurred are not going to be your normal, everyday costs. It’s going to be  
extremely expensive to treat arsenic whatever method you use.” Tr. at 268.

The evidence presented by Arizona Water clearly establishes the magnitude of the  
financial impacts that will result from complying with the new MCL. The Company

<sup>1</sup> The transcript of the October 3 and 18, 2002, hearing (which is numbered consecutively) will be cited as “Tr.” The pre-filed testimony of the Company’s witness, Mr. Kennedy, will be cited as “Kennedy Dir.” The testimony of Staff’s witnesses, Mr. Fox, Mr. Scott and Mr. Olea, will be cited as “Fox Dir.,” “Scott Dir.” and “Olea Dir.,” respectively. The testimony of RUCO’s witness, Ms. Diaz Cortez, will be cited as “Diaz Cortez Dir.”

1 presented two different exhibits depicting the estimated capital costs and expenses on a  
 2 Company-wide basis and for the Northern Group. These expenses include operations and  
 3 maintenance expenses, income taxes related to the revenue increase, and depreciation and  
 4 property taxes associated with the new plant.

5 In the case of the Northern Group, estimated capital costs (i.e., the cost to construct  
 6 new facilities to treat arsenic) will be approximately \$3.7 million. Exhibit RJK2-6  
 7 (hearing exhibit A-2). By comparison, the rate bases authorized in Phase 1 of this  
 8 proceeding are approximately \$6.3 million and \$1 million for the Sedona (including  
 9 Valley Vista) and Rimrock systems, respectively.

	<u>Arsenic Treatment Plant</u>	<u>Authorized Rate Base</u>
11 Sedona	\$2,413,008	\$6,275,320
12 Rimrock	\$1,287,441	\$1,020,731
13 <b>Total</b>	<b>\$3,700,749</b>	<b>\$7,296,051</b>

14 Decision No. 64282, Exhibit A; Exhibit RJK2-6 (hearing exhibit A-2).

15 Unfortunately, the revenue requirements resulting from the costs of constructing  
 16 the arsenic treatment facilities are only approximately half of the total amount that  
 17 Arizona Water will require to comply with the new arsenic MCL. The costs of operating  
 18 and maintaining these facilities ("O&M expenses") for the affected Northern Group  
 19 systems are expected to exceed \$1 million annually. As shown below, this amounts to  
 20 one-third of the combined revenues of the Sedona and Rimrock systems. Comparing the  
 21 O&M expenses to the systems' operating income authorized in the first phase of this  
 22 docket clearly shows the financial crisis that will occur if O&M expenses are excluded  
 23 from the ACRM, Decision No. 64282, Exhibit C; Exhibit RJK 2-6 (hearing exhibit A-2).

24 \

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	<u>Annual Arsenic O&amp;M Expenses</u>	<u>Annual Revenues</u>	<u>Operating Income</u>
Sedona	\$544,364	\$2,618,125	\$604,706
Rimrock	\$531,068	\$394,459	\$98,360
<b>Total</b>	<b>\$1,075,432</b>	<b>\$3,012,584</b>	<b>\$703,066</b>

Thus, for the Sedona system (including the Valley Vista system<sup>2</sup>), estimated O&M expenses associated with the arsenic treatment facilities are \$544,364 – 90 percent of the required operating income. The anticipated impact on the Rimrock system is even more dramatic: Estimated O&M expenses associated with arsenic treatment are \$531,068 – more than 5 times the required operating income. While these amounts are estimates, the parties agree that these estimates are reasonable. Tr. at 252-256. *See also* Direct Testimony of Marlin Scott, Jr. (filed in Phase 1 of this docket) at 5-6 and 7 (discussing the Company’s cost estimates and concluding that “using an EPA publication as the basis for projecting the treatment and removal costs for arsenic is reasonable”).

Moreover, the foregoing costs pertain only to the Northern Group. The estimated capital costs that will be incurred by the Northern Group systems that will be required to treat for arsenic (Sedona, Valley Vista and Rimrock) comprise only 13 percent of the estimated company-wide arsenic capital costs. Kennedy Dir. at 7-9 and Exhibits RJK2-3 & RJK2-4; Tr. At 25-28. In addition, Arizona Water faces company-wide increases in arsenic O&M expenses that total \$16.8 million over the next four years. The ACRM approved in this docket will apply only to the Northern Group's Rimrock And Sedona systems, which account for \$4.3 million of the four year total.

The Recommended Order recognizes the need for innovative procedures to address the impact on Arizona Water resulting from EPA’s mandate, and generally recommends

<sup>2</sup> The Sedona and Valley Vista water systems are already consolidated for regulatory accounting and ratemaking purposes. Rimrock, however, is not currently consolidated.

1 approval of an ACRM. Under the ACRM proposed by Arizona Water, the Company will  
2 be required to prepare and file summary schedules based on the actual cost of constructing  
3 arsenic treatment facilities and actual expenses related to the operation of those facilities,  
4 together with appropriate supporting documentation. Increases would be authorized only  
5 to the extent that the return on rate base of the affected systems does not exceed 9.64  
6 percent – the authorized return on “fair value” rate base approved in Decision No. 64282.  
7 Accordingly, as discussed in the Recommended Order, the ACRM satisfies the  
8 requirements of *Residential Utility Consumer Office v. Ariz. Corp. Comm.*, 199 Ariz. 588,  
9 20 P.3d 1169 (App. 2001), and *Scates v. Ariz. Corp. Comm.*, 118 Ariz. 531, 578 P.2d 612  
10 (App. 1978).

11 Unfortunately, the ACRM as recommended fails to allow Arizona Water to recover  
12 \$4.3 million of O&M expenses over the next four years. This recommendation, if  
13 adopted, will undermine the effectiveness of the ACRM, intensify financial risk and likely  
14 force Arizona Water to seek general rate increases with their overwhelming administrative  
15 preparation and processing. As explained below, Arizona Water submits that there is no  
16 basis for excluding O&M expenses.

17 **III. RECOVERY OF O&M EXPENSES RELATED TO ARSENIC TREATMENT**  
18 **SHOULD BE AUTHORIZED.**

19 Although the Recommended Order recognizes the significance of the additional  
20 O&M expenses that Arizona Water will incur (see pp. 3-4), it nevertheless would deny  
21 Arizona Water the ability to recover these expenses through the ACRM. The rationale  
22 given for refusing to allow recovery of O&M expenses is that it would make the ACRM  
23 process too complicated: “Although O&M costs for these facilities are likely to be  
24 significant, we are not persuaded that the expedited process envisioned by the parties  
25 would accommodate inclusion of O&M costs without adding significant complexity.”  
26 Recommended Order at 6, ls. 1-3. While some additional work would be required, the

1 concerns expressed by Staff and RUCO on this point are exaggerated and certainly do not  
2 support excluding \$4.3 million of the Company's arsenic O&M costs from the ACRM.

3 As proposed by the Company, the ACRM would permit the Company to recover  
4 only its actual, recorded arsenic O&M expenses or lease costs. These expenses will  
5 consist of either the expenses for operating and maintaining arsenic treatment facilities  
6 that the Company constructs or, alternatively, the capital and operating payments required  
7 under a binding lease with a third-party contractor, who will design, build and own the  
8 facilities. In either case, the Company will have to maintain appropriate records that  
9 accurately segregate the specific incremental arsenic expenses from the Company's  
10 general operating expenses. The Company will have the burden of submitting schedules  
11 and supporting documentation establishing the amount of these incremental arsenic  
12 expenses. It will certainly be much easier for Staff and RUCO to review and audit these  
13 limited accounting records, than to review and audit all of the Company's books and  
14 records in connection with a general rate proceeding, in which the parties are required to  
15 verify all operating expenses, in addition to all of the Company's total plant and other rate  
16 base items, cost of capital and rate design and other matters at issue in a general rate case.  
17 More importantly, there simply isn't enough time for the Company to rely on general rate  
18 cases to maintain its financial integrity.

19 Assuming it were possible for the Company to prepare and submit an ACRM filing  
20 within 30 days following year-end and that the Commission authorized an increase to be  
21 effective within 60 days of the filing date, it would nevertheless take the Company 12  
22 additional months to recover the arsenic O&M expenses included in its filing. In other  
23 words, even under the most optimistic assumptions, the O&M expenses actually incurred  
24 during the prior year would not be fully recovered until 15 months after the year they were  
25 incurred. During this 15-month period the Company would continue to incur additional  
26 and increasing amounts of incremental arsenic O&M expenses that would never be

1 recovered.

2 In addition, the exclusion of O&M expenses from the ACRM will discourage the  
3 leasing of arsenic treatment facilities. As stated, the Company is currently engaged in  
4 discussions with independent contractors who would design, build and own the arsenic  
5 treatment facilities under a lease arrangement with Arizona Water. This type of lease  
6 arrangement may well be the most cost-effective approach for complying with the new  
7 arsenic MCL. It reduces the financing burden on the utility by eliminating the need to  
8 obtaining financing from a lender and places the risk of treatment method and plant  
9 obsolescence on the contractor/lessor. Under this type of arrangement, however, Arizona  
10 Water would not directly incur normal capital costs, but would instead be required to  
11 make regular payments to the lessor for capital and operating costs. If O&M expenses are  
12 excluded from the ACRM, these payments – which can easily be tracked and verified –  
13 could not be recovered outside a general rate case. At a minimum, the ACRM should  
14 include the capital costs included in the costs of leasing arsenic treatment facilities from  
15 an independent third party.

16 In short, there is no legitimate basis for excluding O&M expenses from the ACRM.  
17 There is no dispute that approximately half of the costs associated with complying with  
18 the new MCL for arsenic will be O&M expenses. Arizona Water is proposing to recover  
19 those expenses as part of the ACRM, but only after the Company has been operating the  
20 arsenic treatment facilities or the O&M expenses are known and measurable under a third  
21 party lease agreement. Given the magnitude of the O&M expenses, excluding them  
22 would defeat the very purposes of the cost recovery procedure: to maintain the financial  
23 integrity of water utilities faced with extraordinary capital and operating expense impacts  
24 from the new arsenic MCL without overwhelming the Staff with general rate increase  
25 applications.

26

1 **IV. ARSENIC CAPITAL COSTS SHOULD BE RECOVERED THROUGH THE**  
2 **MINIMUM CHARGE.**

3 The Company's capital costs associated with the construction of arsenic treatment  
4 plant are fixed and do not vary with the quantity of water that a customer uses each  
5 month. The new plant must be designed and constructed to treat water on the basis of  
6 peak system capacity, not on the annual gallons sold. \. In other words, Arizona Water  
7 must have treatment capacity to handle the system's peak day demand to ensure that all  
8 water is properly treated. The quantity of water a particular customer uses in a given  
9 month does not effect the peak demand or fixed capital costs.<sup>3</sup> Under the Recommended  
10 Order, however, 50% of the Company's capital costs would be recovered through the  
11 commodity rate. This rate design penalizes the desirable, high-load factor customer. This  
12 design also fails to recognize the fixed nature of the Company's capital costs, subsidizes  
13 low-load factor customers and will result in greater revenue instability and adversely  
14 impact cost recovery.

15 Recovering capital costs through a surcharge based on equivalent 5/8" meters  
16 properly recognizes the demand that each class of meters places on the system, as  
17 illustrated on Exhibit RJK 2-5. For example, a 5/8" meter has a maximum capacity of 20  
18 gallons per minute ("gpm") while a 2" meter has a capacity of 160 gpm. Under the  
19 Recommended Order, which would adopt Staff's proposed rate design, customers with a  
20 5/8" meter and a high load factor, i.e. their water use is relatively constant throughout the  
21 year, will be paying more than their share of the capital costs. Conversely a customer  
22 with a 2" meter and low load factor would be paying less than his share of capital costs.  
23 Recovering all of the capital costs through an equivalent 5/8" meter charge, as proposed

24 <sup>3</sup> In contrast, O&M expenses have both fixed and variable components. Some expenses, such as  
25 power and chemicals, will change depending on monthly usage levels. Other O&M expenses  
26 such as rents or fixed lease payments are a fixed cost that do not vary with usage. The majority of  
O&M expenses, however, are variable. Therefore, Arizona Water has proposed that all O&M  
expenses be recovered by means of the commodity rate.

1 by Arizona Water, would produce a uniform 5/8" meter arsenic surcharge of \$5.22 per  
2 month and a 2" surcharge of \$32.31 per month. Under the Company's rate design each  
3 different meter class would be responsible for its potential contribution to the system peak  
4 demand. If 50% of the capital costs are to be recovered through the commodity cost as  
5 Staff proposed, the ACRM revenue will be more volatile, and the Company is more likely  
6 to over or under collect the required amount. This is not an appropriate rate design.

7 Shifting recovery of 50% of the Company's capital costs to the commodity rate  
8 will also cause problems in consolidating the Sedona and Rimrock rates. The  
9 Recommended Order adopts the Company's two-step rate consolidation proposal for the  
10 Rimrock and Sedona systems to mitigate the impact of arsenic treatment costs on the  
11 Rimrock system. The existing Rimrock and Sedona minimum charges are within \$0.40  
12 (2.5%) of each other. However, the existing commodity rates are more divergent: the  
13 Sedona system's commodity rate is \$1.66 per 1,000 gallons, while the Rimrock system's  
14 commodity rate is \$2.50 per 1,000 gallons – a 50% difference. Recovering half of the  
15 capital costs through each system's commodity rate will increase this divergence and  
16 make the second consolidation step, which will not take place until the Northern Group's  
17 next general rate case, more disruptive to customers.

18 Finally, Staff has never explained how the Sedona and Rimrock commodity rates  
19 would be modified to generate the additional 50% of the arsenic capital costs. It is  
20 unclear whether there would be a single, uniform commodity surcharge, or different  
21 commodity charges for the two systems. Consequently, if the Recommended Order is  
22 adopted, it is unclear what rate design is actually being approved. This conflicts with the  
23 Recommended Order's finding that rate design should be determined now and not  
24 relitigated as part of the ACRM process. Recommended Order at 14. If different  
25 commodity surcharges are in fact what Staff intends to propose, this would make  
26 consolidation of the Sedona and Rimrock systems more difficult by increasing the

1 differences between the two systems' rates.

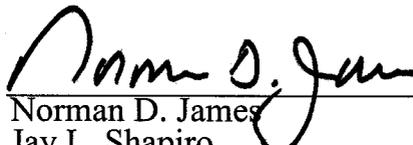
2 **V. IN CONCLUSION, THE RECOMMENDED ORDER SHOULD BE AMENDED**  
3 **TO INCLUDE O&M EXPENSES IN THE ACRM, RECOVER ALL CAPITAL**  
4 **COSTS IN THE MINIMUM AND CLEARLY STATE THE MANNER IN WHICH**  
5 **THE SEDONA AND RIMROCK SYSTEMS WILL BE CONSOLIDATED.**

6 This has been a lengthy and difficult proceeding. While the parties were able to  
7 reach agreement on a number of issues, significant issues remained unresolved. The  
8 Recommended Order addressed these issues thoughtfully but, unfortunately, does not  
9 fully accomplish the Commission's stated objective for this phase of the proceeding,  
10 which is to ensure that Arizona Water will have the ability to recover the costs associated  
11 with arsenic treatment so that it can maintain its financial integrity while meeting the new  
12 arsenic MCL in a streamlined and efficient manner.

13 The magnitude of O&M expenses in relation to the Rimrock and Sedona systems'  
14 recently authorized operating income compels inclusion of these expenses in the ACRM.  
15 The capital cost portion of the ACRM should be recovered through the minimum and the  
16 O&M portion should be recovered through the commodity charge as clearly set forth in  
17 the Company testimony and Exhibit RJK 2-5. Finally the two-step process of  
18 consolidating the Rimrock and Sedona systems to reduce the rate impact of arsenic  
19 treatment on Rimrock customers should be clearly stated. The attached amendments to the  
20 Recommended Order are therefore proposed.

21 RESPECTFULLY SUBMITTED this 17th day of April, 2003.

22 FENNEMORE CRAIG

23 By 

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2 foregoing was delivered this 17 day of  
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5 Arizona Corporation Commission  
6 1200 West Washington  
7 Phoenix, AZ 85007

8 A copy of the foregoing  
9 was delivered this 17 day of  
10 April, 2003 to:

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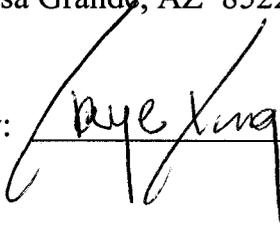
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By:  \_\_\_\_\_

## ARIZONA WATER COMPANY

### AMENDMENTS TO RECOMMENDED ORDER

AGENDA ITEM NO. 8

DOCKET NO. W-014445A-00-0962

OPEN MEETING DATE: April 22 and 23, 2003

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#### AMENDMENT 1 – RECOVERY OF EXPENSES

**Page 5, line 27, through page 6, line 18:** delete existing paragraphs and substitute:

“We agree with the Company that the ACRM process should include O&M expenses, in the event the arsenic treatment facilities are constructed and owned by the Company, and the cost of leasing arsenic treatment facilities, in the event the Company enters into a lease with a third party that will build and own the facilities. There is no dispute that O&M expenses are likely to comprise more than half of the costs associated with complying with the new MCL for arsenic. Consequently, the omission of these expenses from the ACRM process would defeat the purpose of the cost recovery procedure and discourage its use. Although we acknowledge the concerns of Staff and RUCO that the inclusion of these expenses in the ACRM will lead to some additional complexity, the ACRM process will still be far less complicated than a general rate case. Further, the Company will be required to maintain appropriate records that accurately segregate arsenic treatment expenses from the Company’s general operating expenses. The Company will also have the burden of submitting schedules and supporting documentation establishing the amount of these expenses in order to recover them under the ACRM.”

**Page 8, lines 21-22:** delete first sentence of paragraph.

**Page 17, lines 17-19:** make conforming amendment to Finding of Fact 8.

#### AMENDMENT 2 – RATE DESIGN

**Page 8, lines 22-24:** delete sentence that begins on line 22 and substitute:

“We believe that the Company’s proposed rate design appropriately allocates the cost of service among customer classes.”

**Page 9, lines 2-4:** delete sentence beginning on line 2, and substitute:

“Accordingly, the Company’s recommendation that capital costs be recovered through a monthly surcharge based on meter size and that O&M expenses and, if applicable, payments required under an operating lease be recovered through a commodity surcharge should be adopted in the implementation of the ACRM approved in this proceeding.”

**Page 17, lines 24-26:** make conforming changes to Finding of Fact 11.

### **AMENDMENT 3 – DESCRIPTION OF RATE CONSOLIDATION**

**Page 11, line 13:** add the following after the word “purposes.”:

“The first step in consolidating the Sedona and Rimrock systems is the adoption of a single set of monthly minimum charges for the two systems as part of the ACRM process. The same ACRM surcharge would then be applied to both systems’ common monthly minimum charge to recover 100% of the arsenic capital costs. The remaining costs would be recovered through a uniform commodity surcharge applicable to both systems. The final rate consolidation step for the Sedona and Rimrock systems will occur in the Company’s next general rate case, when a single commodity rate will be developed for the Sedona and Rimrock systems.”