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Arizona Corporation Commission

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11 **BEFORE THE ARIZONA CORPORATION COMMISSION**

12 IN THE MATTER OF THE APPLICATION
13 OF ARIZONA WATER COMPANY, AN
14 ARIZONA CORPORATION, FOR
15 ADJUSTMENTS TO ITS RATES AND
16 CHARGES FOR UTILITY SERVICE
AND FOR CERTAIN RELATED APPROVALS.

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

**ARIZONA WATER COMPANY'S
CLOSING BRIEF**

17 Arizona Water Company (“Arizona Water” or “the Company”) hereby submits its
18 closing brief concerning the limited issue presently before the Administrative Law Judge:
19 whether costs associated with leasing arsenic treatment facilities, and related operations
20 and maintenance (“O&M”) expenses, should be recovered under the arsenic cost recovery
21 mechanism (“ACRM”) under consideration in this phase of Arizona Water’s rate
22 proceeding for its Northern Group water systems. Arizona Water submits that the
23 modifications to the ACRM jointly proposed by the Utilities Division (“Staff”) and
24 Arizona Water should be adopted and approved. Under these modifications, direct costs
25 associated with media replacement or regeneration, media replacement or regeneration
26 service and waste media or regeneration disposal (but no other O&M expenses) will be

1 recovered in the ACRM. In addition, if treatment facilities are leased from a third-party
2 contractor, rather than constructed and owned by Arizona Water, a portion of the leasing
3 costs will be recovered. These modifications will afford greater protection to Arizona
4 Water by allowing recovery of some (although not all) O&M expenses in the ACRM,
5 while placing leased treatment facilities on an equal footing with Company owned
6 treatment facilities, without complicating the ACRM process.

7 Conversely, if the modifications proposed by Staff and Arizona Water are not
8 approved, the ACRM will allow only recovery of certain capital-related costs,
9 undermining the effectiveness of the ACRM in maintaining the Company's financial
10 viability. Moreover, exclusion of O&M expenses from the ACRM will undermine the
11 attractiveness of leasing facilities from a third-party contractor as an option for arsenic
12 treatment because under that option, no costs would be recovered.

13 For these reasons, Arizona Water submits that the portion of the Recommended
14 Opinion and Order ("ROO"), filed April 8, 2003, addressing recovery of O&M expenses
15 (pages 4-6) should be revised to incorporate the ACRM modifications proposed by Staff
16 and Arizona Water.

17 **A. Overview of Prior Proceedings.**

18 The procedural background relating to this phase of Arizona Water's rate
19 proceeding for its Northern Group is set forth on pages 1 through 3 of the ROO. In
20 summary, the original parties to this rate proceeding, Arizona Water, Staff and the
21 Residential Utility Consumer Office ("RUCO"), agreed to a separate phase of this
22 proceeding to develop an appropriate methodology for recovery of costs to comply with
23 the new maximum contaminant level ("MCL") for arsenic, established by the United
24 States Environmental Protection Agency pursuant to the federal Safe Drinking Water Act
25 and its implementing regulations. Following various meetings and discussions between
26 the parties, thereafter a hearing was conducted on October 3 and 18, 2002, and a single set

1 of simultaneous briefs was filed on December 6, 2002, by Arizona Water, Staff and
2 RUCO. On April 8, 2003, the ROO was issued by the Administrative Law Judge, to
3 which Arizona Water filed exceptions on April 17, 2003. The matter was then considered
4 by the Commissioners at an Open Meeting on April 22, 2003.

5 There is no dispute that the O&M expenses are expected to constitute more than
6 half of the total amount that Arizona Water will be required to spend to comply with the
7 new arsenic MCL. The O&M expenses for the affected Northern Group systems (Sedona
8 and Rimrock) are expected to exceed \$1 million annually, and on a company-wide basis,
9 O&M expenses for arsenic treatment are expected to exceed \$16 million over the next
10 four years. Accordingly, Arizona Water has consistently maintained that to be effective,
11 the ACRM should include both capital-related costs¹ and O&M expenses. *See, e.g.,*
12 *Arizona Water Company's Closing Brief on Phase 2 at 12-15 (filed Dec. 6, 2002);*
13 *Arizona Water Company's Exceptions to Recommended Opinion and Order at 6-8 (filed*
14 *April 17, 2003).* Indeed, the significance of the additional O&M expenses for arsenic
15 treatment is specifically recognized in the ROO. ROO at 3-4. However, both Staff and
16 RUCO opposed recovery of O&M expenses, including amounts paid to a third-party
17 contractor under a lease or similar contractual arrangement. *E.g., Transcript (Oct. 18,*
18 *2002) at 289-290 (testimony of Steven M. Olea); Transcript (Oct. 3, 2002) at 125-127*
19 *(testimony of Marylee Diaz Cortez).*

20 During the discussion at the Open Meeting, however, the Commissioners had
21 reservations about limiting the ACRM to only capital-related costs. In particular, the
22 Commissioners expressed concern that the exclusion of O&M expenses would discourage
23 leasing of treatment facilities. As Staff representatives acknowledged at the Open

24 _____
25 ¹ The specific capital-related costs that would be recovered under the ACRM are the return on the
26 original (actual) cost of constructing the treatment facilities, additional federal and state income
taxes relating to the additional revenue requirement, depreciation expense associated with the new
plant and property taxes. ROO at 4 n. 3.

1 Meeting, payments made to a third-party contractor under a lease are treated for
2 accounting and ratemaking purposes as operating expenses rather than capital costs. As a
3 result, exclusion of O&M expenses from the ACRM would effectively preclude any cost
4 recovery if Arizona Water were to lease treatment facilities. In addition, exclusion of
5 O&M expenses from the ACRM would effectively eliminate the Water Infrastructure
6 Financing Authority of Arizona (“WIFA”)² as a possible financing alternative because
7 WIFA requires coverage of operating expenses in its evaluation of loan applications. Mr.
8 Gordon Fox, the Staff’s primary accounting witness in this phase of the proceeding,
9 argued to the Commissioners that if the ROO were amended to allow only recovery of
10 leasing costs, Arizona Water (and other water utilities subject to similar treatment
11 requirements) would be encouraged to lease treatment facilities rather than constructing
12 and operating them.

13 Given the confusion over this issue, the Commissioners directed the Hearing
14 Division to conduct additional proceedings to consider the need to include leasing costs in
15 the ACRM.³ Thereafter, on April 25, 2003, the Administrative Law Judge issued a
16 procedural order, directing the parties to engage in settlement discussions about recovery
17 of leasing costs and setting a hearing for June 26, 2003, in the event the parties were
18 unable to reach agreement. The deadline to complete settlement discussions was
19 subsequently extended through June 9, 2003 to allow the parties additional time to explore
20 settlement.

21 Arizona Water and Staff were able to agree on proposed modifications to the
22 ACRM to allow recovery of leasing costs and allow limited recovery of certain O&M

23 ² WIFA is an independent agency of the state authorized to finance the construction, rehabilitation
24 and/or improvement of drinking water, wastewater, wastewater reclamation, other water quality
facilities/projects, which was established by statute ARS § 49-1202.

25 ³ The Commission also directed Arizona Water to investigate the availability of grants and low-
26 cost loans that may be available for financing the construction of arsenic treatment facilities. This
issue is briefly addressed in the concluding section of this Closing Brief.

1 expenses if treatment facilities are constructed and operated by Arizona Water so costs
2 recovered under either approach will be comparable. Intervenor Arizona Utility Investors
3 Association, Inc. ("AUIA")⁴, in its pre-filed testimony, stated its support for the
4 modifications agreed to by Staff and Arizona Water. RUCO, however, continues to
5 oppose recovery of any O&M expenses, including costs associated with leasing treatment
6 facilities.⁵

7 **B. The Proposed Modifications to the ACRM.**

8 The modifications to the ACRM proposed by Staff and Arizona Water establish a
9 balanced cost recovery mechanism that does not favor owning arsenic treatment facilities
10 over leasing arsenic treatment facilities. These modifications are described in the pre-
11 filed testimony of Ralph J. Kennedy (Hearing Exhibit A-3), and an example of how the
12 modified ACRM will operate is set forth in Exhibit RJK-1, attached to that pre-filed
13 testimony. Staff has agreed that Mr. Kennedy's description of the modifications and the
14 example set forth in his exhibit are correct. Transcript (June 26, 2003) at 410. The
15 specific modifications to the ACRM are as follows:

16 **1. Limited O&M Expense Recovery.**

17 Regardless of whether treatment facilities are leased or owned by Arizona Water,
18 three specific types of O&M expenses will be subject to recovery: (1) media replacement
19 or regeneration costs; (2) media replacement or regeneration service costs; and (3) waste
20 media or regeneration disposal costs ("Recoverable O&M Expenses"). Recoverable
21 O&M Expenses will result from services provided by a third-party contractor, who will

22 ⁴ The AUIA was granted leave to intervene at this stage of the proceeding based on its concern
23 that the ACRM ultimately approved by the Commission may be used as a template for subsequent
24 cases involving the recovery of arsenic treatment costs. See Procedural Order (filed June 6,
2003).

25 ⁵ The remaining intervenor, the City of Casa Grande, did not file any testimony on this issue, and
26 during the hearing, the City did not present any witnesses nor did its counsel make an opening
statement. Consequently, the City has not expressed a position on the modifications Staff and
Arizona Water jointly propose.

1 bill Arizona Water for these services. Kennedy Testimony at 7; Transcript (June 26,
2 2003) at 362-364, 374. None of these services are currently being provided to the
3 Company, and, consequently, these expenses are not reflected in the Company's current
4 rates. *Id.* Further, Arizona Water intends to contract for these services because of their
5 technical nature and to avoid the potential liability and additional regulatory requirements
6 associated with handling and disposing of hazardous wastes. Transcript (June 26, 2003)
7 at 373-374.

8 Although other expenses will be incurred in connection with operating and
9 maintaining the treatment facilities (e.g., electrical power, labor and chemicals), those
10 expenses will not be recoverable under the ACRM. By limiting the recovery of expenses
11 in this manner, it will be relatively easy to isolate and audit expenses as part of the ACRM
12 process while ensuring that there will be no "double recovery" of expenses. *See*
13 Transcript (June 26, 2003) at 397-400 (testimony of Gordon Fox).

14 **2. Recovery of Lease Payments.**

15 In order to place the costs of leased treatment facilities on an equal footing with
16 Company constructed and owned treatment facilities, Staff proposed, and Arizona Water
17 agreed, that lessors must provide a breakdown identifying three separate components that
18 comprise the lease payment: (1) the lessor's construction-related costs; (2) Recoverable
19 O&M Expenses (as defined above); and (3) other costs and expenses. In addition, the
20 lessor will be required to provide the interest rate (finance charge) embedded in the lease
21 payment. If a prospective lessor declines to provide this information to Arizona Water,
22 that lessor will be disqualified. Kennedy Testimony at 7. By requiring the lessor to
23 separately identify these components of the lease payments, the same cost recovery
24 mechanism may be used regardless of whether the treatment facilities are leased or owned
25 by Arizona Water.

26

1 **3. Deferred and Ongoing Recoverable O&M Expenses.**

2 Recoverable O&M Expenses will be treated the same whether the arsenic treatment
3 facility is leased or owned. Two categories of Recoverable O&M Expenses are eligible
4 for recovery through the ACRM: (1) costs that have been incurred and deferred in the 12
5 months prior to the ACRM filing, and (2) costs that will continue to be incurred after the
6 ACRM filing. Deferred costs will be recovered through a twelve-month surcharge, while
7 recurring costs will be recovered through an adjustment in base rates consistent with the
8 rate design discussed on pages 8 and 9 of the ROO. Arizona Water will not be allowed to
9 recover interest or any other type of financing charge on the deferred balance of the
10 expenses. Kennedy Testimony at 8-9; Fox Testimony at 3-5. *See also* Transcript (June
11 26, 2003) at 363-364, 375-377. Exhibit RJK-1, attached to Mr. Kennedy's pre-filed
12 testimony, provides an example of the computation of Recoverable O&M Expenses and
13 capital-related costs under the modified ACRM.

14 The deferral of Recoverable O&M Expenses will begin upon operation of the
15 arsenic treatment facility. Recoverable O&M Expenses shall be deferred until such time
16 as an ACRM filing is made in which recovery is sought for the deferred Recoverable
17 O&M Expenses. This addresses Staff's concerns that Recoverable O&M Expenses must
18 not be estimates and must be known and measurable. In addition, the Company agrees to
19 limit the deferral period to a twelve-month period that begins at the later of either the in-
20 service date of the arsenic treatment facility or the twelve-month period prior to the month
21 in which the ACRM request is filed. The deferral period would be determined on an
22 individual arsenic treatment facility basis. The Company can choose when to request
23 recovery of each individual arsenic treatment facility's deferred Recoverable O&M
24 Expenses through an ACRM step filing. As in the ROO, however, there can only be two
25 ACRM filings per water system before the next general rate proceeding for the Northern
26 Group systems.

1 The second expense category, recurring Recoverable O&M Expenses, would also
2 be considered at the same time that recovery of the deferred Recoverable O&M Expenses
3 is requested through an ACRM filing. However, after recurring Recoverable O&M
4 Expenses are determined, these expenses would be recovered through an increase in base
5 rates. The Company could choose when to request recovery of each individual arsenic
6 treatment facility's Recoverable O&M Expenses through an ACRM step filing, but once
7 the prospective level of Recoverable O&M Expenses has been established for a specific
8 treatment facility, they would remain at that level until new rates are established in the
9 next general rate proceeding.

10 **4. Number of ACRM Rate Adjustments.**

11 Arizona Water will be permitted two rate adjustments per water system under the
12 ACRM (*see* ROO at 6-7), but will only be permitted to seek recovery of Recoverable
13 O&M Expenses on one occasion per treatment facility. Fox Testimony at 3-4. However,
14 due to variations in the timing of construction and other circumstances that will cause
15 specific treatment facilities to be placed in service at different times, Arizona Water will
16 not be able to recover all of its Recoverable O&M Expenses. *See* Transcript (June 26,
17 2003) at 362-364. As explained above, only Recoverable O&M Expenses incurred within
18 12 months prior to the Company's ACRM filing will be eligible for recovery. If a
19 particular treatment facility has only been in service for six months prior to the
20 Company's ACRM filing, Recoverable O&M Expenses for that facility will be limited to
21 expenses incurred during the six-month in-service period. Conversely, if a particular
22 treatment facility was placed in service 16 months prior to the Company's ACRM filing,
23 any expenses incurred prior to the twelve-month period immediately preceding that filing
24 will not be recovered. *See* Transcript (June 26, 2003) at 363, 374-377.

25 **5. Recovery of Capital-Related Costs.**

26 The modifications to the ACRM proposed by Staff and Arizona Water will have no

1 effect on the manner in which capital-related costs will be recovered. Those costs will be
2 recovered, along with recurring Recoverable O&M Expenses, through an increase in the
3 base rates, as provided in the ROO.⁶

4 **6. Rate Design for ACRM.**

5 As indicated above, the pre-determined rate design described in the ROO at pages
6 8 and 9 will not be modified. Arizona Water's base rates will be adjusted to allow
7 recovery of both capital-related costs and recurring Recoverable O&M Expenses in the
8 manner described in the ROO, i.e., ACRM costs will be allocated equally between the
9 monthly minimum charge and the commodity charge, with increasing responsibility based
10 on meter size. Deferred Recoverable O&M Expenses recovered by means of the twelve-
11 month surcharge would be allocated between the monthly minimum charge and the
12 commodity charge in the same manner. The adjustments to base rates and the twelve-
13 month surcharge to recover deferred expenses will be calculated using the same billing
14 determinants. This will simplify the ACRM process and allow the Company's filing to be
15 quickly processed.

16 **7. Other Costs and Expenses.**

17 As indicated above, only the identified capital-related costs and Recoverable O&M
18 Expenses are eligible for recovery under the modified ACRM. Other types of costs and
19 expenses may only be recovered following a general rate proceeding. Additionally, as
20 previously noted, some amount of Recoverable O&M Expenses will not be recovered.
21 Arizona Water will be required to construct multiple facilities to treat water from twelve
22 different wells within its Sedona and Rimrock systems. Transcript (June 26, 2003) at 379.
23 Consequently, treatment facilities will be constructed and placed in service at various

24 ⁶ Staff has proposed an additional modification to the ROO that would exclude property taxes
25 from the capital-related costs to be recovered under the ACRM. Arizona Water disagrees with
26 this recommendation, which is predicated on a misunderstanding of the computational and billing
cycle for property taxes, while ignoring the lag inherent in the ratemaking process. See Transcript
(June 26, 2003) at 385-386 (testimony of Gordon Fox).

1 times over the next two years. This will result in timing difficulties, preventing full
2 recovery of Recoverable O&M Expenses.

3 **C. RUCO's Opposition to the Modified ACRM is Not Supported by the**
4 **Record and Contrary to Arizona Law.**

5 RUCO offers no compelling reason to reject the modifications proposed by Staff
6 and Arizona Water. RUCO continues to argue that including any O&M expenses in the
7 ACRM will greatly complicate the ACRM process. However, that argument is
8 contradicted by the testimony of Staff's primary accounting witness, Mr. Fox, who
9 testified that the review required to include Recoverable O&M Expenses in the ACRM
10 "will be minimal." Transcript (June 6, 2003) at 398. Mr. Fox's conclusion is supported
11 by common sense: Recoverable O&M Expenses will be evidenced by either invoices
12 reflecting direct payments to a contractor retained to service and replace the filter media
13 or payments made to a lessor that owns and may operate the treatment facility. In either
14 case, the scope of review will be limited, and it will not be necessary to audit any other
15 Company O&M expenses in order to segregate and verify specific costs.

16 RUCO also continues to suggest that the inclusion of Recoverable O&M Expenses
17 in the ACRM creates legal questions. However, there is simply no legal basis for that
18 argument. The Commission is authorized to approve automatic adjustment mechanisms
19 in the context of a general rate proceeding under which a utility is allowed to recover
20 specific, narrowly defined operating expenses. *See, e.g., Scates v. Arizona Corp.*
21 *Comm'n*, 118 Ariz. 531, 535-536, 578 P.2d 612, 616-617 (App. 1978). The court
22 explained that adjustment mechanisms have been upheld

23 . . . because the clauses are initially adopted as part of the
24 utility's rate structure in accordance with all statutory and
25 constitutional requirements and, further, because they are
26 designed to insure that, through the adoption of a set formula
geared to a specific readily identifiable cost, the utility's
profit or rate of return does not change.

1 *Id.* at 535, 578 P.2d at 616.

2 The ACRM under consideration in this case satisfies the requirements set forth in
3 *Scates*, as this adjustment mechanism is being approved in the context of a general rate
4 proceeding accompanied by finding of the “fair value” of the Company’s utility plant and
5 property, and the expenses that will be recovered pursuant to the adjustment mechanism
6 are limited to certain narrowly defined expenses resulting from direct payments to third-
7 party contractors for the maintenance and replacement of arsenic treatment filter media.
8 Moreover, due to the timing difficulties discussed above, Arizona Water will not recover
9 all of its Recoverable O&M Expenses even under the modified ACRM. Consequently,
10 and contrary to RUCO’s suggestion, it is perfectly appropriate to include Recoverable
11 O&M Expenses in the ACRM under Arizona law. Therefore, RUCO’s argument should
12 be rejected.

13 The modifications to the ACRM proposed by Staff and Arizona Water constitute a
14 reasonable and balanced compromise. The modifications will allow Arizona Water to
15 recover a portion of the additional O&M expenses that will result from constructing and
16 operating the arsenic treatment facilities, which will help in maintaining its financial
17 integrity. The expenses that will be recoverable under the ACRM will be limited to
18 Recoverable O&M Expenses (i.e., direct costs associated with maintaining and replacing
19 arsenic treatment filter media), which can be easily isolated from other O&M expenses
20 and audited without complicating the ACRM process. *See* Transcript (June 26, 2003) at
21 397-400 (testimony of Gordon Fox). In addition, the modifications will allow comparable
22 cost recovery regardless of whether Arizona Water owns or leases treatment facilities.
23 Therefore, the ACRM, as modified, will not favor one approach over the other, satisfying
24 the Commissioners’ concerns, and should be approved.

25 **D. Availability of Grants and Loans for Arsenic Treatment Facilities.**

26 The Commissioners also requested that Arizona Water investigate the availability

1 of grants and low-cost loans for financing the construction of arsenic treatment facilities.⁷
2 Pursuant to that instruction, Arizona Water conducted an investigation through searches of
3 information on the websites of government authorities and a meeting with representatives
4 of WIFA. Kennedy Testimony at 11-12. Attached to Mr. Kennedy's pre-filed testimony
5 as Exhibit RJK-2 is a summary of various low-cost funding options. Although WIFA
6 identified eight sources of funding, seven of the eight funding sources impose restrictions
7 (e.g., population size, geographic location and income restrictions) that prevent Arizona
8 Water from being eligible.

9 Arizona Water is eligible to apply for a loan from WIFA, the eighth funding source
10 identified by WIFA. However, as explained in Mr. Kennedy's pre-filed testimony, WIFA
11 loans are evaluated and provided on a basis that is inconsistent with Arizona Water's
12 organization and capital structure. Kennedy Testimony at 12. For example, WIFA
13 normally provides loans to single-system utilities (both municipal and private) for a
14 specific project, and requires that rates that will support repayment of the loan be in place
15 before the loan is approved. This requirement may also require all arsenic-related O&M
16 expenses to be recovered through rates. Arizona Water, in contrast, has 18 water systems
17 with individual rate structures, and obtains financing for capital projects on a Company-
18 wide basis. Arsenic treatment facilities will be constructed for nine of those 18 systems.
19 The estimated construction costs (assuming Arizona Water constructs and owns the
20 treatment facilities) for the Sedona and Rimrock systems comprise only 13 percent of the
21 total construction costs. *See* Direct Testimony of Ralph J. Kennedy (filed Aug. 23, 2002),
22 Exhibit RJK 2-3.

23 ⁷ As explained in Mr. Kennedy's testimony at page 11, Arizona Water's application to participate
24 in the Environmental Protection Agency's treatment technology research demonstration program
25 has been approved. Under this program, 12 full-scale demonstration plants will be constructed on
26 a nationwide basis, and two of the first phase demonstration plants will be built in the systems
included in the Company's Northern Group. At the conclusion of the demonstration project, the
Company will be allowed to acquire these facilities at a significant cost savings. Kennedy
Testimony at 11.

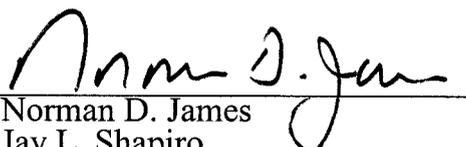
1 In short, while it appears that Arizona Water might be eligible for WIFA loans,
2 additional investigation is needed to determine if Arizona Water can satisfy WIFA's
3 eligibility criteria and whether WIFA's conditions and requirements are workable given
4 the Company's large financing requirements, its geographic diversity, the number of
5 individual treatment facilities to be constructed by the Company and other specific
6 circumstances. Without recovery of some O&M expenses related to arsenic treatment,
7 however, the Company would most likely not meet the operating criteria.

8 **E. Conclusion and Relief Requested.**

9 For the foregoing reasons, Arizona Water urges approval of the modifications to
10 the ACRM proposed by Staff and Arizona Water. Approval of the ACRM with these
11 modifications will ensure that the ACRM process remains streamlined and
12 straightforward. At the same time, the ACRM will more effectively maintain the financial
13 integrity of the Company, which is facing significant increases in both O&M expenses
14 and capital (construction) costs as a result of the new MCL for arsenic, by allowing
15 recovery of some (but not all) of the Company's additional O&M expenses. Conversely,
16 if the modifications are not approved, the ACRM's effectiveness will be undermined
17 because it will not allow any recovery of O&M expenses, which comprise over half of the
18 total costs Arizona Water must incur to comply with the new MCL. Ignoring half of
19 Arizona Water's costs, as RUCO proposes, is inconsistent with the purpose of the ACRM
20 and, clearly, not in the public interest.

21 RESPECTFULLY SUBMITTED this 15th day of August, 2003.

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