

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Illinois-American Water Company, :  
Citizens Utilities Company of Illinois and :  
Citizens Lake Water Company :  
 : 00-0476  
Petition for Approval of Proposed :  
Reorganization and Affiliated Interest :  
Agreements, Issuance of Common Stock :  
and Debt Securities and Assumption :  
of Affiliated Interest.

**REPLY BRIEF ON EXCEPTIONS TO  
THE HEARING EXAMINERS' PROPOSED ORDER**

Now comes the Staff of the Illinois Commerce Commission ("Staff") through its attorneys, and submits this Reply Brief on Exceptions ("RBOE") regarding the Proposed Order issued by Hearing Examiners' ("HEPO"). Staff will limit its RBOE to the Brief on Exceptions ("BOE") filed by Illinois American Water Company. ("IAWC" or "Company")

The Company argues essentially the same points, in the same manner, they argued in their previously submitted Initial Brief ("I B") and Reply Brief ("R B"). Having already responded to the arguments, Staff does not wish to waste more of its or the Commission's resources on the topics. Accordingly, Staff hereby adopts by reference its responsive arguments as previously set forth.

**I. TREATMENT OF CONTRIBUTIONS IN AID OF CONSTRUCTION/ADVANCES**

IAWC continues to propose improper accounting treatment for contributions in aid of construction ("CIAC"). (IAWC BOE, pp. 42-43) The Proposed Order has rightly rejected the Company's proposal and the Commission should give no weight to the Company's exception.

In effect, IAWC argues that for this transaction, proper and normal accounting treatment should be ignored. (IAWC BOE, p. 41) This is a claim that is totally without merit. Staff has repeatedly provided sufficient arguments to refute the Company's position. (Staff I B, p. 44)

IAWC erroneously implies that Accounting Instruction 21 does not offer instruction to the purchaser of the utility plant. Id. However Instruction 21 states:

The amount of contributions in aid of construction applicable to the property acquired, and which the purchaser may be required to record, shall be charged to account 104-Utility Plant Purchased or Sold, and concurrently credited to account 271-Contributions in Aid of Construction.

IAWC says that there is no balance of CIAC/Advances to record under the Uniform System of Accounts ("USOA"). IAWC's implication is not correct. The contributions and advances would not exist but for the related assets.

IAWC in its BOE admits that it recognizes that "when utility plant is purchased or sold, both buyer and seller ... must make appropriate accounting entries under the USOA".

**A. "Recording" CIAC/Advances only for Ratemaking Purposes**

The Company's proposed treatment of only reflecting CIAC in rate cases for ratemaking purposes does not satisfy Staff's concerns. This is simply another attempt by the Company to restructure the rules for their own self-serving interest and use, in effect, by having two different sets of accounting records. This type of accounting treatment for CIAC/Advances is contrary to traditional regulatory accounting principles. (See Staff I B, p. 44 and Staff R B, p. 45)

**B. Arizona Commission Decision**

The Company requested that the Commission take administrative notice to provide “new” information regarding a settlement decision by another state public utility commission. The Company requested that the Commission take administrative notice of Arizona Corp. Commission April 18, 2001. 83 Ill. Adm. Code 200.640 states that the Commission may take administrative notice of matters of which the circuit courts of this state may take judicial notice. However, it should be noted that 83 Ill. Adm. Code 200.640 also discourages the use of administrative notice by the Commission. In support of its request, IAWC has attached to its BOE incomplete and misleading sections of the Settlement Agreement. On page 4 of the Settlement Agreement, it states:

8. Compromise; No Precedent. This Settlement Agreement represents a compromise in the positions of the parties hereto. By entering into this Settlement Agreement, neither Staff nor Arizona-American acknowledges the validity or invalidity of any particular method, theory or principle of regulation, or agrees that any method, theory or principle of regulation employed in reaching a settlement is appropriate for resolving any issue in any other proceeding, including (without limitation) any issues that are deferred to a subsequent rate proceeding. Except as specifically agreed upon in this Settlement Agreement, nothing contained herein will constitute a settled regulatory practice or other precedent.

By attempting to establish the Arizona decision as a precedent here in Illinois, it would appear that Arizona American Water Company through its parent American Water Works Company (“AWW”) is in violation of its settlement.

Moreover, even if the parties had not agreed that the settlement would not be used as precedent, a decision in Arizona does not bind this Commission to accept Arizona’s decision, as the Company seems to suggest in its BOE. This Commission is not bound to follow decisions made in other jurisdictions. In fact, IAWC’s parent, American Water

Works Company, Inc. recognizes on page 31 of its 2000 Annual Report to Shareholders that “The jurisdiction exercised by each commission is prescribed by state legislation and therefore varies from state to state.”

If the Commission were to take administrative notice of the Arizona opinion, which it should not, Staff believes that the complete documents be provided to the Commission. Hence, Staff has attached to this Reply BOE the Arizona Commission order and Settlement Agreement between Arizona Corporation Commission Staff and the Arizona American Water Company.<sup>1</sup>

IAWC’s attempts to introduce unnecessary confusion into this docket by submitting the Arizona settlement. The substance of the Arizona settlement is that Contributions in Aid of Construction will be recorded and amortized above the line in the records which form the basis of regulating Arizona American Water Company’s rates. The Arizona settlement also notes that the treatment of contributions authorized by the Arizona Commission will be for ratemaking purposes. (IAWC BOE, Attachment 3, p. 3) This is neither surprising, nor contrary to the authority of the ICC. It is appropriate that the Commission rule that the IAWC record Contributions in Aid of Construction and Customer Advances in accordance with the Uniform System of Accounts. This treatment of Contributions and Advances would result in reductions of rate base and depreciation expense for ratemaking purposes. There is no need for the Commission to rule on the treatment of Contributions and Advances for financial reporting purposes. This is because financial accounting rules are a matter for the Securities and Exchange Commission and

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<sup>1</sup> If the Commission chooses not to take administrative notice of the material provided by the Company, Staff would have no objection to the striking of the material attached to this RBOE.

IAWC's public accounting firm. However, IAWC's Annual Report to the Commission should record Contributions and Advances in a manner which is consistent with the rules contained in the Commission's Uniform System of Accounts.

Staff continues to oppose the treatment of CIACs and Advances offered by IAWC and rejected by the HEPO.

### **C. Understated Acquisition Adjustment**

The position claimed by the Company regarding contributions and advances only serves to demonstrate that the Company had understated its acquisition adjustment in this proceeding. The Company has admitted that the acquisition premium will increase by \$60,340,639 if contributions and advances are improperly included in IAWC's accounts. Staff finds it hard to accept that IAWC, the "finest quality water provider in America" (IAWC BOE, p. 9), as well as all of the Company's hired experts, failed to recognize this early in the proceeding when they filed documents claiming the acquisition adjustment was only \$66,615,818. IAWC erroneously claims that the proper accounting and ratemaking treatment of contributions and advances will "unnecessarily increase the level of the Acquisition Adjustment". (IAWC BOE, p. 2) IAWC has tried throughout this proceeding to understate the true acquisition adjustment to make it appear more reasonable. If the Commission were to adopt IAWC's position, the true acquisition adjustment is \$126,956,456. The Commission should not expose ratepayers to such an overwhelming liability through the Savings Sharing Proposal ("SSP").

**D. Contributions and Advances are not Separable from the Related Assets**

IAWC is also proposing the idea that the contributions and advances which gave rise to the very assets that the Company is purchasing are separable from those assets. The Company fails to provide the support for this proposition.. When this acquisition was negotiated, apparently IAWC failed to consider that under the Uniform System of Accounts, and ratemaking theory. The customers should not be required to pay, through the SSP, either a return of, or a return on, their contributed investment in the utility property. (HEPO, p. 45) IAWC cannot simply wish away because the Company “is not acquiring any CIAC or advances...” (IAWC BOE, p. 41) The contributions and advances automatically come with the related assets. Under the Company’s proposal, the customers who provided those assets would simply be out of luck and be required to pay twice.

IAWC incorrectly cites IAWC Exhibit 2.0R, page 13 for the proposition that “the refund obligation remains with [Citizens Utility Company of Illinois (“CUCI”)]”. (IAWC BOE, p. 41) However, no mention is made of the refund obligation remaining with CUCI at page 13. Instead, Mr. Ruckman refers to the testimony of Mr. Hamilton. Mr. Hamilton states “How CUCI financed its water and wastewater utility assets is irrelevant from Illinois-American’s point of view...” (IAWC Ex. 7.0R, p. 10) How CUCI financed its water and wastewater utility assets is relevant from the point of view of Staff and the USOA. IAWC is attempting to alter the facts of record by backing into a position that mirrors the Arizona decision. CUCI has not provided any testimony regarding this matter. Neither CUCI nor IAWC has identified a mechanism for providing customers any refund. An obligation that only exists because of the related asset remains with the asset when it is sold. The obligation only

exists in relation to the asset that gave rise to it. As explained in Staff's Initial Brief, failure to transfer the CIAC to IAWC along with the assets will harm customers, because the customers will then have to pay a return on property which they donated to Citizens. (Staff I B, p. 44)

For all the foregoing reasons, the Commission should reject the Company's exception and alternative language regarding the contributions in aid of construction and customer advances.

## **II. SECTION 7-204(C) - PURCHASE PRICE**

In response to the HEPO finding that the SSP should be rejected, IAWC argues repeatedly that the purchase price for the Utility Assets was developed through arm's-length negotiations. (IAWC BOE, pp. 2, 5, 10, 11, 23, and 25)<sup>2</sup> To the contrary, the record shows that IAWC was not involved in the negotiations for the Utility Assets. (IAWC I B, p. 72) Rather, the purchase price for the Utility Assets is a proportion of the Project purchase price, which was negotiated by AWW and Citizens Utilities Company ("CUC"), and was allocated by AWW to IAWC based on Gross property, plant and equipment ("Gross PP&E").<sup>3</sup> Further, Sections 6.1.4, 6.1.7 and 6.2.7 of the Asset Purchase Agreement affirm that the purchase of the Utility Assets by IAWC is contingent upon approval of the purchase of all the CUC water and wastewater assets. This makes the purchase price of individual companies irrelevant to CUC. (Staff R B, pp. 4-5)

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<sup>2</sup> The term "Utility Assets" refers to the assets of Citizens Utilities Company of Illinois ("CUCI") used exclusively in providing water or wastewater service and the assets of Citizens Business Services Company that relate primarily to the business operations of CUCI (ICC Staff Ex. 3.0 Proprietary, p. 1).

<sup>3</sup> The term "Project" refers to the acquisition of all of the Citizens Utilities Company subsidiaries to be acquired by American Water Works Company, Inc. (ICC Staff Ex. 3.0 Proprietary, Schedule 5, p. 8).

According to IAWC, “[t]he evidence in this case is overwhelming that the purchase price is fair, reasonable, and reflects fair market value.” (IAWC BOE, p. 23) To demonstrate such, IAWC presented an acquisition analysis by Mr. Bharani Bobba and a discounted cash flow (“DCF”) analysis by Mr. Joseph F. Hartnett, Jr. For the reasons summarized below, Staff found that both analyses fail to demonstrate that the purchase price is fair or reasonable.

IAWC relies, in part, upon the acquisition multiples presented by Mr. Bobba to demonstrate that the purchase price for the Utility Assets is reasonable. (IAWC BOE, p. 5) Acquisition multiples alone do not demonstrate the effects of the Utility Assets’ purchase price with respect to subsidization of non-utility activities and adverse rate impacts on retail customers. (Staff R B, p. 7; Staff I B, pp. 31-33) On this basis, Mr. Bobba’s acquisition multiple analysis is insufficient to satisfy the very specific legal requirements of Section 7-204(b) of the Public Utilities Act (“Act”).

Moreover, IAWC’s BOE reveals that the purchase price for the Utility Assets, when properly adjusted for the \$60 million CIAC liability, is approximately \$280 million, compared to the Company’s original testimony which indicated a purchase price of approximately \$220 million. (IAWC IB, p. 8) Specifically, the BOE states, “[a]s shown on Late-Filed Exhibit 1, the effect of the recording of CIAC is to increase the Acquisition Adjustment from \$66,615,818 to \$126,956,456.” (IAWC BOE, at 43). Under IAWC’s proposal, Mr. Bobba’s acquisition multiple analysis, Company Exhibit 6.3, is no longer valid because it is based on the wrong purchase price. Assuming a purchase price of \$220 million, the asset valuation for the Acquisition is below the average for four of the five

acquisition multiples. (Staff I B, p. 31)<sup>4</sup> However, at the actual purchase price of \$280 million, the asset valuation for the Acquisition is above the average for three of the five acquisition multiples and above the high for two of the five acquisition multiples, as shown below:<sup>5</sup>

	<b>RATIO OF ASSET VALUE TO:</b>				
	<b>LTM Revenues</b>	<b>LTM EBITDA</b>	<b>LTM EBIT</b>	<b>Net PP&amp;E</b>	<b>Customers</b>
<b>HIGH</b>	7.4X	19.0X	27.4X	2.3X	\$5,054
<b>AVERAGE</b>	6.1X	16.6X	22.5X	2.2X	\$3,905
<b>LOW</b>	3.4X	13.4X	17.6X	1.9X	\$2,309
<b>UTILITY ASSETS' VALUE:</b>					
<b>\$220 Million</b>	7.6X	15.6X	20.2X	1.5X	\$3,097
<b>\$280 Million</b>	9.7X	19.9X	25.7X	1.9X	\$3,903

IAWC also relies upon a DCF analysis presented by Mr. Hartnett to demonstrate that the purchase price for the Utility Assets is reasonable. (IAWC BOE, p. 23) Not only does IAWC persist in misrepresenting Staff's testimony regarding the tax benefits related

<sup>4</sup> The term "Acquisition" refers to the acquisition transaction in which IAWC has entered into an asset purchase agreement with AWW, CUC, CUCI and certain other affiliates of CUC under which IAWC will purchase from CUCI the Utility Assets.

<sup>5</sup> Asset value equals equity value of transaction plus book liabilities; "LTM" refers to last twelve months; "EBITDA" refers to earnings before interest, taxes, depreciation and amortization; "EBIT" refers to earnings before interest and taxes; and, "Net PP&E" refers to net property, plant and equipment. All of the information, except the ratios relating to the \$280 million purchase price, is taken from Company Exhibit

to the transaction (IAWC BOE, p. 23; IAWC I B, p. 17) but the Company failed to supply the updated DCF analysis to Staff until December 15, 2000, despite several Staff data requests seeking such analyses prior to December 2000. (Staff R B, pp. 7-9; Staff I B, pp. 28-34) Regardless, the DCF analysis estimated a market value of \$221 million for the Utility Assets, which is dwarfed by the actual \$280 million purchase price. Moreover, Staff demonstrated that even at \$220 million, IAWC is attempting to charge Illinois ratepayers a disproportionate share of the total purchase price of the Project. Under IAWC's proposal, Illinois ratepayers would pay 99.5% of the market value of the Utility Assets while AWW would pay only 93.3% of the market value of the Project. (Staff R B, pp. 39-40)

The Company's arguments in favor of the SSP are also contradictory. Company witness Mr. Henry Mülle testified that, "...shareholders will balk at making otherwise desirable and economic combinations of operating properties if there is a lack of incentive and they are required to bear the entire burden of the disposition of the Acquisition Adjustment." However, IAWC's BOE also notes that, under the SSP, the present value of savings allocated to shareholders is a negative \$12 million. (IAWC BOE, pp. 15 and 27) IAWC's own testimony suggests that either the Company has a propensity for risk since it strongly recommends approval of the SSP -- a plan that promises Company shareholders savings equal to negative \$12 million (on a present value basis) -- or that the Company has understated the benefits of the Acquisition and the SSP to shareholders. Thus, Company claims of harm without approval of the SSP should be discounted.

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6.3. The acquisition multiples at a \$280 million purchase price equal the multiples at a \$220 million purchase price times (\$280 million / \$220 million).

### III. SECTION 7-204(C) SAVINGS

IAWC asserts that they have provided “extensive evidence” of the measurement of savings in this proceeding. (IAWC BOE, p. 43) Staff has repeatedly stated that the documents provided by the Company do not constitute sufficient evidence of a workable plan to measure savings. The HEPO is correct in concluding that the evidence submitted in this proceeding was not sufficient to approve its use in determining savings amounts. Since IAWC, in this proceeding, has not presented a specific methodology for quantifying Acquisition savings, the Commission should require the Company to provide in the upcoming proceeding, more specific information than was provided in this proceeding about how the Company will demonstrate that a given level of savings in the test year has resulted from the acquisition. The petition seeking approval of specific methodology for quantifying acquisition savings should address, among other things, the following:

- 1) identification of the cost and expense components that will be components of the savings calculations,
- 2) descriptions of the specific methods by which savings will be calculated,
- 3) identification of specific documents to be used to calculate savings,
- 4) the method of calculating the rate case test year. (e.g. Citizen’s on a stand alone basis following merger with 50% of savings added to the test year; or Citizens on a stand alone basis assuming no merger, subtracting total savings to arrive at a test year on a stand alone basis following merger, and adding back 50% of savings.)

### **A. IAWC's Pump Example**

IAWC claims that the HEPO's treatment disallowing the SSP is analogous to a company prudently purchasing a new energy efficient pump and being denied the opportunity to recover the cost, while being forced to pass on the savings to ratepayers. (IAWC BOE, p. 14) There are several differences between a prudently purchased energy efficient pump and the acquisition adjustment proposed in this docket. First of all, the purchase price of the pump is readily ascertainable, supported by invoices, and not subject to much dispute. Next, the prudence of a piece of new equipment purchased can be ascertained by its proven energy efficiency. The Company has not proven that its proposed acquisition adjustment recovery will provide benefits for the ratepayers. Next, a newly purchased energy efficient pump, like the assets purchased in the present transaction, would be recorded at original cost, not at an amount more than original cost. With this proper ratemaking treatment, the shareholders will be entitled to earn a return on that prudently incurred pump investment, not denied any recovery as IAWC suggests.

In reality, the Company's example supports the HEPO's position, to wit, utility companies are entitled to recover original cost and a fair return thereon. An example which is more analogous to the SSP would be to increase the cost of the pump to be included in rate base to an amount which equals original cost plus half of the savings which the customers will receive plus the difference between the pump that the company is purchasing and the cost of a more expensive pump which the Company decides would be imprudent to purchase. The Company's argument is without merit and should be rejected by the Commission.

**B. Savings Continue into Perpetuity**

The Company's BOE claim that, "...the Proposed Order fails to recognize the fact that savings continue, not just for forty years, but into perpetuity." IAWC BOE, p 27 This is a misleading characterization of the HEPO's proposal. The rates established in any rate case filed in the three year period could remain effective into perpetuity. While it might be reasonable to assume that the rates will actually be in effect for only 20 years. (By way of example, CILCO has not filed for a general change in its electric rates in about 20 years.) Given that assumption, Illinois-American could continue to earn revenues in excess of its actual expenses for up to 20 years beyond its three year window of opportunity.

The Company's Exhibit 3.5 R, Column (1), Year 5 identifies \$4,990,013 of savings. If 50% of that savings, or \$2,495,007, were included in a test year filed in 2004 and Illinois-American did not file a new rate case for the Citizens Division until 2024, then Illinois-American would recover \$49,900,140 (\$2,495,007 times 20 years), (plus any additional savings occurring after the 2004 test year<sup>6</sup>) above its actual cost of providing service to its customers.

**C. Acquisition Adjustment is a Transaction Cost**

The Company's BOE emphasizes technical form, rather than the substance of this issue. At one point IAWC emphasizes the word expense when arguing that the acquisition adjustment is not a transaction cost. (IAWAC BOE, p 20) At another point the Company argues that because various examples of transaction costs are properly recorded in plant account 301, the acquisition adjustment is not a transaction cost because it is not properly

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<sup>6</sup> Schedule 3.5R reflects that IAWC anticipates that savings will continue to increase. IAWC projected annual savings of \$12,567,750 by year 25. (IAWC Ex. 3.5R)

recorded in account 301. (IAWC BOE, pp. 22-23) These arguments are artful at best. Whether the Acquisition cost can be recorded in one particular account rather than in another particular account does not determine the nature of the acquisition adjustment. The fact is, the acquisition adjustment will not, and can not, exist unless the transaction occurs. The Adjustment which would result from this Acquisition transaction is by definition a transaction cost. (See Staff R B, pp. 9-10)

#### **IV. THE ALTERNATIVE PROPOSAL**

Should the SSP be rejected by the Commission, IAWC presents an alternative proposal (IAWC BOE, 36). The alternative proposal improperly places all of the risk related to realizing acquisition-related savings on ratepayers. (ICC Staff Ex. 9.0 Proprietary, p. 17) Therefore, Staff recommends that the alternative proposal be rejected. (Staff R B, p. 45; Staff I B, p. 33)

#### **V. SECTION 7-204(B) OF THE ACT**

##### **A. Section 7-204(b)(2)**

The Company's proposal does not satisfy the requirement of Section 7-204(b)(2) of the Act. If the Acquisition Adjustment is included in rates, allocating too much of the Project purchase price to IAWC would result in IAWC ratepayers subsidizing non-utility operations inside and outside of Illinois. Allocating the Project purchase price according to Gross PP&E is problematic for several reasons, the most critical being that if the SSP is approved, Illinois ratepayers would be forced to pay a greater proportion of the Utility Assets' value that AWW authorized for the entire Project. Worse, no single allocation method was used to allocate the purchase price among the transactions occurring in the Illinois jurisdiction. Finally, the acquisition multiples are insufficient to demonstrate that the

purchase price is reasonable and the Illinois DCF analysis is neither a reliable nor accurate measure of the market value of the Utility Assets. (Staff R B, pp. 7-9, 39-40; Staff I B, pp. 28-33) On the other hand, if the Commission rejects the SSP and the alternative proposal, the reorganization would not violate Section 7-204(b)(2) of the Act.

**B. Section 7-204(b)(4)**

IAWC wrongly claims that the decline in the referenced financial ratios from ICC Staff Exhibit 10.0, Schedule 10.1 represents a clear and significant impairment of IAWC's financial condition. (IAWC BOE, pp. 41-42) The record clearly shows that IAWC's financial strength will not decline below the investment grade level. As such, IAWC's financial impairment would not be significant under the terms set forth in Section 7-204(b)(4) of the Act. (See Staff R B, pp. 42-44)

IAWC suggests that there is no basis to believe that the financial ratios in Staff Exhibit 10.0, Schedule 10.1 would change significantly in the event that revenue and cost data from Docket No. 00-0340 were reflected. (IAWC BOE, p. 40) However, the data shown on ICC Staff Exhibit 10.0, Schedule 10.1, reflect IAWC rates that were set in 1997 and CUCI rates that were set in 1995, but reflect 1999 costs for both IAWC and CUCI. (Staff R B, pp. 43-44). Notwithstanding these mismatched costs and expenses, again, IAWC's finances will not be significantly impaired.

IAWC again advances the myth that under cross-examination, Mr. Hardas changed his position, admitting that the financial integrity of IAWC would be impaired if it completed the Acquisition without recovery of the of the Acquisition Adjustment. (IAWC BOE, pp. 41-42) Mr. Hardas' direct testimony clearly states that IAWC's financial condition, under the

circumstances above, would be impaired, but not significantly. (Staff R B, p.42) Mr. Hardas confirmed that position during cross-examination. IAWC incorrectly claims that its ability to raise necessary capital on reasonable terms and its ability to maintain a reasonable capital structure will be significantly impaired if the SSP is not approved. However, as demonstrated throughout this docket, and specifically through Mr. Hardas' testimony, IAWC's alleged impairment will not be significant.

**C. Section 7-204(b)(7)**

The SSP also fails to satisfy the requirement of Section 7-204(b)(7) of the Act. Staff strongly disagrees with IAWC's claim that there is no risk of an adverse rate impact under the SSP. (IAWC BOE, p. 5) Under the SSP, IAWC proposes to recover the Acquisition Adjustment portion of the purchase price for the Utility Assets, which may be more than the merger premium paid for the Utility Assets. If this occurs, IAWC would recover a "pre-merger" merger premium, which is independent from the amount of savings IAWC expects to realize from the Acquisition. This would likely result in a spiral of increasing market values, purchase prices, and merger premiums, in future acquisitions. (Staff R B, pp. 5-6; Staff I B, pp. 22-26, 34-35 and 38-40) On the other hand, If the Commission rejects the SSP and the alternative proposal, the reorganization would not violate Section 7-204(b)(7) of the Act.

**VI. CONCLUSION**

For the foregoing reasons, the Staff of the Illinois Commerce Commission respectfully requests that the Commission order reflect Staff's recommendations.

Respectfully submitted,

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Illinois Commerce Commission

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BEFORE THE ARIZONA CORPORATION COMMISSION  
DOCKETED

APR 24 2001

1  
2 WILLIAM A. MUNDELL  
CHAIRMAN  
3 JIM IRVIN  
COMMISSIONER  
4 MARC SPITZER  
COMMISSIONER  
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6 IN THE MATTER OF THE JOINT  
7 APPLICATION OF CITIZENS UTILITIES  
8 COMPANY; AGUA FRIA WATER DIVISION  
9 OF CITIZENS UTILITIES COMPANY;  
10 MOHAVE WATER DIVISION OF CITIZENS  
11 UTILITIES COMPANY; SUN CITY WATER  
12 COMPANY; SUN CITY SEWER COMPANY;  
13 SUN CITY WEST UTILITIES COMPANY;  
14 CITIZENS WATER SERVICES COMPANY  
15 OF ARIZONA; CITIZENS WATER  
16 RESOURCES COMPANY OF ARIZONA;  
17 HAVASU WATER COMPANY AND TUBAC  
18 VALLEY WATER COMPANY, INC., FOR  
19 APPROVAL OF THE TRANSFER OF THEIR  
20 WATER AND WASTEWATER UTILITY  
21 ASSETS AND THE TRANSFER OF THEIR  
22 CERTIFICATES OF PUBLIC CONVENIENCE  
23 AND NECESSITY TO ARIZONA-  
24 AMERICAN WATER COMPANY AND FOR  
25 CERTAIN RELATED APPROVALS.

DOCKET NOS. W-01032A-00-0192  
W-01032B-00-0192  
W-01032C-00-0192  
S-02276A-00-0192  
WS-02334A-00-0192  
WS-03454A-00-0192  
WS-03455A-00-0192  
W-02013A-00-0192  
W-01595A-00-0192  
W-01303A-00-0192

DECISION NO. 63584

OPINION AND ORDER

17 DATE OF HEARING: September 27, 2000  
18 PLACE OF HEARING: Phoenix, Arizona  
19 PRESIDING ADMINISTRATIVE  
20 LAW JUDGE: Karen E. Nally'  
21 IN ATTENDANCE: Chairman William A. Mundell and  
Commissioner Jim Irvin  
22 APPEARANCES: Mr. Michael M. Grant, GALLAGHER &  
23 KENNEDY, and Mr. Craig Marks, Associate  
24 General Counsel, on behalf of Citizens  
25 Communications Company;

26 <sup>1</sup> This Recommended Opinion and Order was prepared by Administrative Law Judge Marc E. Stern upon review of the testimony and exhibits admitted into evidence in the proceeding.

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Mr. Norman D. James, FENNEMORE CRAIG, on behalf of Arizona-American Water Company;

Mr. Daniel W. Pozefsky, Staff Attorney, on behalf of Residential Utility Consumer Office;

Mr. Bill Meek on behalf of the Arizona Utility Investors Association; and

Ms. Teena Wolfe, Staff Attorney, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

**BY THE COMMISSION:**

On March 24, 2000, Citizens Utilities Company, now known as Citizens Communications Company, together with its Agua Fria Water Division, Mohave Water Division, Sun City Water Company, Sun City Sewer Company, Sun City West Utilities Company, Citizens Water Services Company of Arizona, Citizens Water Resources Company of Arizona, Havasu Water Company and Tubac Valley Water Company (collectively "Citizens"), and Arizona-American Water Company ("Arizona-American") filed with the Arizona Corporation Commission ("Commission") a Joint Application to Transfer Assets and Related Approvals ("Application") of Citizens' water and wastewater utility assets in Arizona including Citizens' Certificates of Convenience and Necessity ("Certificates") held by Citizens to Arizona-American.

On May 17, 2000 and on June 1, 2000, the Residential Utility Consumer Office ("RUCO") and the Arizona Utility Investors Association ("AUIA") filed applications for leave to intervene. Subsequently, intervention was granted to RUCO and to AUIA.<sup>2</sup>

On May 30, 2000, by Procedural Order, a hearing was scheduled on the above-captioned matter for September 27, 2000. Citizens and Arizona-American caused public notice of the Application and hearing thereon to be published in various newspapers throughout Arizona. In

<sup>2</sup> On April 10, 2000, Mr. Marvin Lustiger filed an application to intervene in the above-captioned matter. However, by subsequent filing, Mr. Lustiger clarified that he was only interested in electric or telephone service in Mohave County, and therefore, Mr. Lustiger's request to intervene was deemed to have been withdrawn.

1 addition, Citizens notified all its customers of the Application by means of a written bill insert.

2 On September 14, 2000, a formal public comment session was held in Sun City.

3 On September 26, 2000, the Commission's Utilities Division ("Staff") filed a Settlement  
4 Agreement ("Agreement") marked Exhibit A which is incorporated by reference and attached  
5 hereto.

6 On September 27, 2000, a full public hearing took place at the offices of the Commission  
7 in Phoenix, Arizona. Citizens, Arizona-American, RUCO, AUIA and Staff were present with  
8 counsel. Following the presentation of evidence, Citizens and RUCO submitted written briefs on  
9 the issue of whether Citizens should be required to pay a portion of the gain resulting from the  
10 sale of its utility assets to Citizens' customers. The matter was then taken under advisement  
11 pending submission of a recommended Opinion and Order to the Commission.

12 **DISCUSSION**

13 **Parties to the Transaction**

14 Citizens, through its various divisions and subsidiaries, provides water, wastewater,  
15 electric, natural gas and telecommunications services to approximately 1.8 million customers in  
16 22 states, including in excess of 100,000 customers in Arizona. Citizens' current business  
17 strategy is to focus on the provision of telecommunications services and the expansion of those  
18 operations through the acquisition of wire centers and access lines from other providers,  
19 primarily in rural areas, as was the case in the recently approved transfer of rural wire centers by  
20 Qwest Corporation to Citizens Utilities Rural Company, Inc.

21 In connection with this business strategy, Citizens intends to sell its water, wastewater,  
22 electric, and natural gas utilities and to apply the proceeds to finance acquisitions and other  
23 business activities in the telecommunications area. In April 2000, Citizens also announced the  
24 sale of its Louisiana natural gas operations for \$375 million.

25 The Commission granted Arizona-American a Certificate of Convenience and Necessity  
26 to provide water service to approximately 4,600 customers in portions of the Town of Paradise

1 Valley, the City of Scottsdale and certain unincorporated portions of Maricopa County. Arizona-  
2 American is a wholly owned subsidiary of American Water Works Company, Inc. ("AWW")  
3 which is the largest privately-owned water utility system in the United States, providing water,  
4 wastewater and other water resource management services to approximately 3 million customers  
5 in 23 states, and with a reported consolidated net plant of \$5.1 billion and operating revenues of  
6 \$1.26 billion. AWW's December 31, 1999, balance sheet reflected a capital structure of 58.4  
7 percent long-term debt, 2.3 percent preferred stock and 39.3 percent common equity.

8 In 1999, AWW's subsidiaries invested \$467 million in improving and upgrading their  
9 facilities, and for the past several years, AWW has made similar expenditures averaging nearly  
10 \$400 million per year. According to AWW witnesses, AWW's acquisition policy is motivated,  
11 at least in part, by anticipated capital expenditures resulting from new regulatory requirements  
12 and programs and the need to replace or upgrade aged infrastructure to maintain high quality  
13 service. With the additional water and wastewater systems, AWW and its subsidiaries hope to  
14 obtain economies of scale and to strengthen their financial capability by expanding their  
15 customer base.

16 The Transaction

17 On October 15, 1999, Citizens, Arizona-American and AWW entered into an agreement  
18 under which Arizona-American is to acquire the water and wastewater assets and the Certificates  
19 held by Citizens in Arizona ("the Acquired Assets") for approximately \$231 million, subject to  
20 adjustment at the time of closing. The purchase price will be increased based on utility plant  
21 added by Citizens after June 30, 1999, and will be reduced based on plant retirements occurring  
22 after such date. The Acquired Assets include all utility plant, property and interests relating to  
23 Citizens' water and wastewater operations in Arizona, with certain exceptions, including assets  
24 commonly used by Citizens in connection with other utility operations, cash and cash  
25 equivalents, and assets related to benefit plans. Citizens will also retain certain liabilities,  
26 including obligations for taxes payable, obligations relating to employee compensation and

1 benefits, and refunds of certain advances in aid of construction. Arizona-American will assume  
2 and be liable for all contracts and permits assigned at closing, certain Industrial Development  
3 Revenue Bonds ("IDRBs"), and unperformed obligations.

4 Arizona-American will finance the purchase of the Acquired Assets by a combination of  
5 debt and equity. AWW has recently formed a new subsidiary, American Water Capital  
6 Corporation ("AWCC"), that will provide loans and other financial services to AWW  
7 subsidiaries. Initially, Arizona-American will borrow funds from AWCC on a short-term basis,  
8 and receive additional funds in the form of common equity directly from AWW. Within 12  
9 months, the short-term debt will be converted to long-term debt with a planned capital structure  
10 which will contain 55 to 60 percent debt and 45 to 40 percent common equity, including  
11 Arizona-American's existing debt and equity capital and the Citizens' IDRBs that will be  
12 assumed.<sup>3</sup>

### 13 The Position of Staff and the Staff Settlement Agreement

14 Staff generally supported the application, and recommended that the transfer of the  
15 Acquired Assets to Arizona-American be approved, subject to several conditions.

16 First, Staff recommended that the Commission defer any decision on the ratemaking  
17 treatment of an acquisition adjustment, deferred taxes, excess deferred taxes, and investment tax  
18 credits until a future rate proceeding.

19 Second, Staff recommended that the decision to allow recovery of an acquisition  
20 adjustment be based on Arizona-American's ability to demonstrate that clear, quantifiable and  
21 substantial net benefits have been realized by ratepayers, which would not have been realized  
22 had the transaction not occurred.

23 Third, Staff recommended that Arizona-American should be ordered to file, 13 months  
24

25 <sup>3</sup> Arizona-American has filed an application for authority to issue short-term and long-term debt in  
26 connection with financing the purchase of the Acquired Assets, which is pending in Docket No. W-  
01303A-00-0929.

1 after the closing of the transaction, a report comparing the number of complaints received by the  
2 Commission prior to and after the transaction. The report should provide an explanation of any  
3 significant changes in the number and importance of the complaints. Staff would then review  
4 this report and, if necessary, make a recommendation to the Commission of any further action to  
5 be taken.

6 Fourth, Staff recommended that an imputation of the benefits related to advances in aid  
7 of construction ("AIAC") and contributions in aid of construction ("CIAC") received by  
8 Arizona-American be made in subsequent rate proceedings for each former Citizens' system.  
9 The purpose of the imputation would be to recognize those portions of the Acquired Assets that  
10 were financed by AIAC and CIAC which Arizona-American will not be assuming. Staff also  
11 recommended that imputed AIAC be amortized over a period of 10 years, while imputed CIAC  
12 would be amortized below the line in the same manner as would have otherwise occurred.

13 Fifth, Staff recommended that Arizona-American be required to seek Commission  
14 approval of any amendments to, or transfers of agreements relating to the purchase of water,  
15 such as Citizens' Central Arizona Project ("CAP") water subcontracts.

16 Finally, Staff recommended that the Commission order Arizona-American to charge  
17 ratepayers for services based on the rates, charges, and service tariffs in effect at the time of  
18 closing in each Citizens service territory, until such time as Arizona-American files general rate  
19 proceedings for each service territory.

20 In its rebuttal filing, Arizona-American indicated that it would stipulate to the conditions  
21 recommended by Staff, including the deferral of a decision concerning the recognition of an  
22 acquisition adjustment and the conditions under which an acquisition adjustment would be  
23 recognized, and would adopt and utilize the rates and charges for service, and all other service  
24 tariffs currently in effect in each of the affected Citizens service territories. However, Arizona-  
25 American disagreed with imputing Citizens' AIAC and CIAC to Arizona-American.

26

1 Subsequently, Staff and Arizona-American entered into the Agreement, which resolved  
2 all areas of disagreement relating to the terms and conditions under which the Acquired Assets  
3 would be transferred to Arizona-American.

4 Pursuant to the terms of the Agreement, Citizens' AIAC and CIAC will be imputed to  
5 Arizona-American for ratemaking purposes. This adjustment will reduce rate base. The amount  
6 of the AIAC and CIAC to be imputed to Arizona-American for ratemaking purposes will be  
7 based on the actual balances shown on Citizens' regulatory books as of the date of the transfer of  
8 the Acquired Assets, adjusted as follows: an amount equal to 5 percent of Citizens' AIAC  
9 balance at the time of the transfer will be reclassified as CIAC and added to the CIAC balance,  
10 and the same amount will be deducted from Citizens' AIAC balance. The adjusted amount of  
11 AIAC will be amortized below the line (i.e., no impact on expenses) over a period of 6.5 years,  
12 with the amortization period beginning on the day on which the transfer takes place. The  
13 adjusted amount of CIAC will be amortized above the line (i.e., as a reduction to depreciation  
14 expense that would otherwise be recoverable in rates) over a period of 10 years, with the  
15 amortization period beginning on the day on which the transfer takes place. The imputation of  
16 AIAC and CIAC to Arizona-American is solely for ratemaking purposes, and not for financial  
17 accounting or any other purpose.

18 In addition to agreeing to the imputation of AIAC and CIAC, Arizona-American agreed  
19 that the Commission may adopt Staff's remaining conditions concerning the sale and transfer of  
20 the Acquired Assets. Staff and Arizona-American also agreed that Arizona-American's request  
21 for an accounting order to establish the amortization method for any acquisition adjustment  
22 resulting from the transaction should be deferred until a future rate case.

23 Based on these agreements by Arizona-American, Staff is recommending that the  
24 Commission should approve the transfer of the Acquired Assets to Arizona-American and should  
25 not impose any additional terms, conditions or requirements on Arizona-American.  
26

1 During the hearing, Staff and Arizona-American voiced their support of the Agreement,  
2 believing that its terms are reasonable and in the public interest. AUIA also expressed its  
3 support for the Agreement. However, the remaining party to the proceeding, RUCO, objects to  
4 the approval of the Agreement and to the transaction generally, as discussed below.

5 Position of RUCO

6 RUCO maintains the proposed transaction believing that it is not in the public interest  
7 and should not be approved unless it is restructured. RUCO argued that the transaction could  
8 possibly, in the future, impact on ratepayers. While RUCO did not disagree that consideration of  
9 an acquisition adjustment should be deferred until a future ratecase, RUCO argued that the gain  
10 resulting from the sale of the Acquired Assets received by Citizens, i.e., the difference between  
11 the net book value of the Acquired Assets and the purchase price being paid by Arizona-  
12 American, should be shared equally between Citizens stockholders and the ratepayers. RUCO  
13 further argued that the Commission should adopt a set of criteria to determine what, if any,  
14 acquisition adjustment should be allowed in a future rate proceeding. RUCO also suggested that  
15 to make this transaction in the public interest, among other things, the transaction should be  
16 contingent upon Arizona-American's Board of Director's approving a letter pledging to invest no  
17 less than 15 percent of the purchase price in acquisitions and capital improvements of "resources  
18 stressed" water and/or wasterwater utilities in Arizona no later than 72 months after the date the  
19 Commission authorizes the transaction.

20 Analysis of Disposition of Gain Issue

21 RUCO contended that fundamental principles of fairness support sharing the gain in this  
22 case. RUCO maintained that ratepayers have shared in the risk associated with the operation of  
23 the utility assets and that it necessarily follows that ratepayers should share in the gain realized  
24 from the sale of those assets. According to RUCO, this risk sharing results from the accounting  
25 treatment provided in the National Association of Regulatory Utility Commissioners  
26 ("NARUC") Uniform System of Accounts when an asset is retired prematurely, i.e., before a

1 utility fully recovers its original cost via depreciation. RUCO also stated that prior Commission  
2 decisions support gain sharing.

3 In response, Citizens argued that ratepayers have assumed no risk in connection with the  
4 operation of Citizens' water and wastewater utility business. Investors have provided the  
5 utility's capital and bear the financial risks associated with its operations. Therefore, the  
6 investors should be entitled to receive any gain resulting from the transaction. As to prior  
7 Commission decisions, Citizens cited three analogous cases involving a sale of an entire line of  
8 utility business in which the Commission did not order gain sharing.<sup>4</sup> Citizens also cited  
9 Decision No. 60167 (April 17, 1997) in which a utility's natural gas business was sold at a loss.  
10 In that case, the Commission did not order the customers to share in the loss.<sup>5</sup>

11 This proceeding is similar to the three cases cited earlier by Citizens since it is selling its  
12 entire business and will have no further water and wastewater operations in Arizona. The  
13 Commission has never required gain sharing under these circumstances. In the Contel of the  
14 West matter, in which Citizens was authorized to acquire all of Contel's telephone properties in  
15 Arizona, Staff urged that the gain resulting from the sale be shared equally with ratepayers.  
16 However, the Commission rejected gain sharing in that case.

17 We also do not believe that ratepayers bear a substantial risk by virtue of receiving utility  
18 service in this case. The particular accounting treatment for depreciable plant provided under the  
19 Uniform System of Accounts does not shift risk to customers, but rather prescribes particular  
20 accounting adjustments to properly reflect rate base before and after the retirement of a plant  
21 item. The utility's owners, i.e., its shareholders, ultimately bear the risks associated with the  
22 utility's business. While regulation may reduce those risks relative to most non-regulated  
23

24 \_\_\_\_\_  
25 <sup>4</sup> Citizens/Southern Union, Decision No. 57647 (December 2, 1991); Contel/Citizens, Decision No. 58819,  
(October 17, 1994); and GTE/Citizens, Decision No. 62648 (June 13, 2000).

26 <sup>5</sup> Ajo Improvement Company/Southwest Gas, Decision No. 60167 (April 17, 1997).

1 businesses, regulation does not shift that risk to ratepayers, who are entitled to receive utility  
2 service at rates set by the Commission.

3 Accordingly, we do not find it appropriate under the circumstances in this case to require  
4 Citizens to share with ratepayers any part of the gain it receives from the sale of the Acquired  
5 Assets to Arizona-American. However, this will not preclude the Commission from protecting  
6 the ratepayers in the future. In any claim for an acquisition adjustment in a future rate case, the  
7 Commission can strictly scrutinize the foundation of the claim and determine what amount, if  
8 any, should be approved.

9 Analysis of Remaining RUCO Recommendations

10 RUCO's other recommendations pertained to the structure of the transaction and  
11 RUCO's concerns that this structure could lead to rate increases in the future. RUCO's concern  
12 primarily relates to the fact that Arizona-American will not be assuming all of Citizens'  
13 liabilities associated with AIAC and CIAC, which totaled approximately \$80.8 million and \$4.7  
14 million, respectively, at December 31, 1999. According to RUCO, the structure of the  
15 transaction will result in the elimination of AIAC and CIAC as reductions from rate base, which  
16 will in turn result in an increase in rate base and, eventually, to rate increases.

17 We believe that the Agreement appropriately deals with this issue. Citizens' AIAC and  
18 CIAC will be recognized for ratemaking purposes by Arizona-American, even though Arizona-  
19 American is not assuming those liabilities. By virtue of this imputation, the impact of the  
20 structure of the transaction will be ameliorated. Based on the evidence and the testimony, the  
21 approach utilized in the Agreement is reasonable.

22 Further, the evidence indicates that the transaction between Citizens, Arizona-American  
23 and AWW was the product of arms-length negotiations that occurred after Citizens had adopted  
24 its current business strategy of focusing on telecommunications services and divesting itself of  
25 its water and wastewater systems, as well as its electric and natural gas systems throughout the  
26

1 country. This is not a transaction between affiliated companies. The payment by Arizona-  
2 American will constitute an investment in the Acquired Assets.

3 RUCO also expressed concern regarding the impact of the transaction on Citizens'  
4 accumulated deferred income taxes ("ADITs"), which totaled approximately \$5.2 million as of  
5 December 31, 1999, and Citizens' investment tax credits ("ITCs"), which totaled approximately  
6 \$2.2 million as of the same date. Under the Agreement, any decision on the treatment of ADITs  
7 and ITCs will be deferred until Arizona-American seeks new rates in a future proceeding.  
8 Staff's recommendation is appropriate under the circumstances herein.

9 Next, RUCO questioned the approach proposed by Arizona-American and Staff, as  
10 adopted in the Agreement, for dealing with the possible future recognition of an acquisition  
11 adjustment in rates. RUCO agreed with Arizona-American and Staff that it is appropriate to  
12 defer consideration of any acquisition adjustment resulting from the transaction until a future rate  
13 proceeding, in order to afford Arizona-American an opportunity to demonstrate that the  
14 acquisition has provided a net benefit to ratepayers by virtue of improved operating efficiencies,  
15 economies of scale and other synergies. However, RUCO's witnesses also contended that the  
16 Commission should adopt a set formula that would be used in connection with any future  
17 determination of the amount of the acquisition adjustment.

18 We have concerns about the adoption of a set, mechanical formula to quantify a future  
19 acquisition adjustment. We believe that such a determination should be made at the time all the  
20 facts and circumstances are known. Staff's recommendation concerning the basis on which the  
21 Commission will allow the recovery of an acquisition adjustment is reasonable and in the public  
22 interest. Arizona-American is cautioned that the Commission will require Arizona-American to  
23 demonstrate that clear, quantifiable and substantial net benefits to ratepayers have resulted from  
24 the acquisition of Citizens' systems that would not have been realized had the transaction not  
25 occurred before the Commission will consider recovery of any acquisition adjustment in a future  
26 rate proceeding.

1 RUCO was also critical of Arizona-American's failure to assume all of Citizens' IDRBs.  
2 As stated, Arizona-American will assume certain IDRBs, which total approximately \$10.6  
3 million. The IDRBs that will be assumed constitute low-cost capital. The average cost of the  
4 IDRBs that will be assumed by Arizona-American was 3.55 percent per annum during 1999.  
5 RUCO believes that there may be three additional Citizens bond issues, representing low-cost  
6 capital, that will not be assumed in connection with the transaction.

7 Arizona-American, in its testimony, has acknowledged that other bonds have been issued  
8 by Citizens. The evidence indicates, however, that in contrast to the IDRBs that will be  
9 assumed, the other bonds would require unanimous consent from all bond holders in order to be  
10 assumed, which would be administratively difficult, if not impossible, to accomplish within the  
11 time frame of the transaction. The additional costs to Arizona-American to replace these low-  
12 cost IDRBs with alternative forms of financing was not ascertained.

13 We find that it would not be feasible for Arizona-American to assume the remaining  
14 bonds and it would not be reasonable to impute these bonds to Arizona-American's capital  
15 structure. The remaining bonds will continue to be an obligation of Citizens and will continue to  
16 be included in Citizens' capital structure in its ongoing telecommunications business.

17 Finally, RUCO recommends that authorization of the transaction be made contingent on  
18 Arizona-American pledging to invest not less than 15 percent of the purchase price for the  
19 Acquired Assets, or approximately \$35 million, in acquisitions and capital improvements of  
20 "resource stressed" water and/or wastewater utilities in Arizona. These acquisitions and capital  
21 improvements would have to be made within 72 months from the date on which the Commission  
22 approves the transaction.

23 The Commission recognizes that there are small water and wastewater utilities in Arizona  
24 that may need technical and financial assistance. Indeed, the Commission has provided such  
25 assistance to small water and wastewater utilities through workshops and the development of  
26 policies aimed at improving their financial viability. However, it is not reasonable to compel a

1 private utility to spend in excess of \$35 million to solve these problems, nor is it clear that the  
2 Commission has the authority to do so.

3 Arizona-American has indicated its willingness to work with the Commission in  
4 developing solutions to service problems being experienced by small, troubled utilities. By  
5 virtue of acquiring Citizens' systems in Arizona, Arizona-American will be in closer proximity  
6 to a number of these systems, and the Commission would expect Arizona-American, as  
7 circumstances warrant, to seriously consider acquiring these systems or otherwise provide  
8 technical or financial assistance. For these reasons, we do not believe it is appropriate to impose  
9 such a mandate on Arizona-American.

10 \* \* \* \* \*

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

13 **FINDINGS OF FACT**

14 1. Pursuant to authority granted by the Commission, Citizens provides public water,  
15 wastewater, electric, natural gas and telecommunications services in various parts of Arizona.

16 2. Pursuant to authority by the Commission, Arizona-American, a wholly owned  
17 subsidiary of AWW, provides public water service to approximately 4,600 customers in the  
18 Town of Paradise Valley, the City of Scottsdale and in certain unincorporated portions of  
19 Maricopa County, Arizona. Arizona-American is presently classified as a Class B water utility.

20 3. On March 24, 2000, Citizens and Arizona-American filed an Application  
21 requesting approval of the sale and transfer of Citizens' water and wastewater utility assets in  
22 Arizona together with the transfer of Citizens' Certificates to Arizona-American.

23 4. RUCO and the AUIA were granted intervention in this Docket.

24 5. Public notice of the Application and hearing thereon was published in various  
25 newspapers throughout Arizona within and in the vicinity of Citizens' and Arizona-American's  
26 certificated service areas.

1 6. Customers of Citizens were also notified of the Application by means of a written  
2 bill insert.

3 7. Citizens' current business strategy is to focus on the provision of  
4 telecommunication services and to expand its telecommunications subsidiaries' operations  
5 through the acquisition of wire centers and access lines from other providers, primarily in rural  
6 areas.

7 8. In the furtherance of this business strategy, Citizens is selling its water,  
8 wastewater, electric and natural gas utilities and applying the proceeds to finance acquisitions  
9 and other business activities in the telecommunications industry.

10 9. AWW and its subsidiaries, including Arizona-American, are the largest privately-  
11 owned water utility system in the United States, providing water, wastewater and other water  
12 resource management services to approximately three million customers in 23 states.

13 10. AWW is financially sound, and has the experience, expertise and resources to  
14 assume and perform Citizens' public service obligations.

15 11. On October 15, 1999, Citizens, Arizona-American and AWW entered into an  
16 asset purchase agreement under which Arizona-American will acquire all of the water and  
17 wastewater utility assets together with the requisite Certificates held by Citizens in Arizona.

18 12. Arizona-American will pay a purchase price of approximately \$231 million which  
19 includes the assumption of approximately \$10.6 million of existing debt in the form of  
20 outstanding IDRBS. The purchase price is subject to adjustment either higher or lower based on  
21 plant additions and retirements occurring after June 30, 1999.

22 13. Arizona-American will finance the transaction through a combination of debt and  
23 equity, resulting in Arizona-American having a capital structure of 55 to 60 percent debt and 45  
24 to 40 percent common equity. This debt to equity ratio is comparable to the capital structures of  
25 most large, publicly-traded water utilities.

26

1           14. Staff is recommending that the Application be approved for the sale and transfer  
2 of Citizens' water and wastewater utility assets including the Certificates to Arizona-American  
3 subject to the following conditions:

- 4           • that any decision on the ratemaking treatment of an acquisition adjustment,  
5 deferred taxes, excess deferred taxes and investment tax credits be deferred until a  
6 future rate proceeding;
- 7           • that if recovery of any acquisition adjustment is authorized in the future it should  
8 be based on Arizona-American's ability to demonstrate that clear, quantifiable  
9 and substantial net benefits have been realized by ratepayers in the affected areas,  
10 which would not have been realized had the transaction not occurred;
- 11           • that Arizona-American file, 30 days after the first anniversary of the transaction, a  
12 report which compares the number of complaints received by the Commission  
13 under Citizens' ownership and under Arizona-American's ownership and provide  
14 an explanation of any significant changes in the number and importance of the  
15 complaints received. Staff should review the data and, if necessary, make a  
16 recommendation to the Commission of any further action to be taken;
- 17           • that an imputation of the benefits related to AIAC and CIAC received by Arizona-  
18 American should be made in subsequent rate proceedings for each former  
19 Citizens system as recommended by Staff in its direct testimony;
- 20           • that Arizona-American shall be required to secure prior Commission approval of  
21 any amendments to, or transfers of agreements relating to the purchase of water,  
22 such as Citizens' CAP water subcontracts; and
- 23           • that Arizona-American shall charge ratepayers for services based on the rates,  
24 charges, and service tariffs in effect at the time of closing in each Citizens service  
25 territory, until such time as Arizona-American files general rate proceedings for  
26 each service territory.

19           15. On September 26, 2000, Staff filed the Agreement that is marked Exhibit A. The  
20 Agreement resolves all issues relating to the terms and conditions under which the Acquired  
21 Assets may be sold and transferred to Arizona-American.

22           16. In the Agreement, Arizona-American acknowledged that it will follow Staff's  
23 recommendations if they are adopted by the Commission.

24           17. While RUCO did not oppose the treatment of the acquisition adjustment in a  
25 future rate proceeding, it neither joined in signing the Agreement nor suggested a workable  
26

1 alternative approach to that agreed upon by Arizona-American and Staff in the Agreement in this  
2 instance based on our prior treatment of similar transactions.

3 18. Arizona-American is a fit and proper entity to acquire Citizens' utility assets and  
4 Certificates and to assume Citizens' public service obligations for the operation of the utility  
5 systems in Arizona.

6 19. Staff and Arizona-American believe that the approval of the Agreement attached  
7 hereto as Exhibit A is in the public interest.

8 20. Based on our review of the evidence, Staff's recommendations in Findings of Fact  
9 No. 14 and the Agreement are reasonable and in the public interest. Therefore, the transfer of  
10 Citizens' water and wastewater utility assets and Certificates to Arizona-American should be  
11 approved.

12 **CONCLUSIONS OF LAW**

13 1. Citizens and Arizona-American are public service corporations within the  
14 meaning of Article XV of the Arizona Constitution and A.R.S. §§ 40-281, 40-282 and 40-285.  
15

16 2. The Commission has jurisdiction over Citizens and Arizona-American and over  
17 the subject matter of the Application.

18 3. Citizens and Arizona-American provided notice of this proceeding in accordance  
19 with the law.

20 4. There is a continuing need for public water and wastewater service in the  
21 certificated service areas of Citizens.  
22

23 5. Arizona-American is a fit and proper entity to receive the Certificates of Citizens.

24 6. The Application of Citizens and Arizona-American, the Agreement and the  
25 conditions recommended by Staff in Findings of Fact No. 14 should be approved.  
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**ORDER**

IT IS THEREFORE ORDERED that the Joint Application for Approval to Transfer the Assets and Certificates of Convenience and Necessity of Citizens Utilities Company, now known as Citizens Communications Company, together with its Agua Fria Water Division, Mohave Water Division, Sun City Water Company, Sun City Sewer Company, Sun City West Utilities Company, Citizens Water Services Company of Arizona, Citizens Water Resources Company of Arizona, Havasu Water Company and Tubac Valley Water Company, to Arizona-American Water Company be, and is hereby, approved.

IT IS FURTHER ORDERED that Arizona-American Water Company shall comply with the terms, conditions and requirements as set forth in the Staff Settlement Agreement, attached hereto as Exhibit A, and with Staff's recommendations in Findings of Fact No. 14 hereinabove.

IT IS FURTHER ORDERED that Arizona-American Water Company shall file, within 30 days from the date on which the acquisition has been completed, with the Director of the Commission's Utilities Division, appropriate documentation evidencing its acquisition of the Citizens Utilities Company now known as Citizens Communications Company's Arizona water and wastewater utility assets.

IT IS FURTHER ORDERED that Arizona-American Water Company shall notify its customers of the effective date of the transfer of the utility assets and of its assumption of the obligation to provide water and wastewater utility services at the existing rates by means of an insert in its first regular monthly billing or by other appropriate means immediately following the date it files the documentation with the Director of the Utilities Division.

IT IS FURTHER ORDERED that Arizona-American Water Company shall file, within 15 days of the date it files the documentation with the Director of the Utilities Division, a copy of the notice it provides its customers.

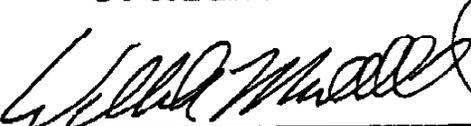
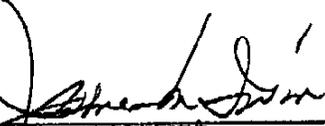
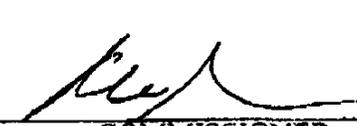
1 IT IS FURTHER ORDERED that Arizona-American Water Company shall continue to  
2 charge the existing rates and charges of the transferred utility companies until further Order by  
3 the Commission.

4 IT IS FURTHER ORDERED that Arizona-American Water Company shall continue to  
5 file all periodic reports, and comply with all outstanding compliance matters previously required  
6 of Citizens Utilities Company, now known as Citizens Communications Company relative to the  
7 acquired water and wastewater operations.

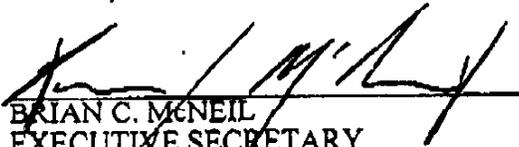
8 IT IS FURTHER ORDERED that Citizens Utilities Company shall maintain its books  
9 and records for the transferred utility companies for a period of 5 years from the effective date of  
10 this Decision.

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

12 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

13   
14    
15 CHAIRMAN COMMISSIONER COMMISSIONER

16 IN WITNESS WHEREOF, I, BRIAN C. McNEIL,  
17 Executive Secretary of the Arizona Corporation  
18 Commission, have hereunto set my hand and caused the  
19 official seal of the Commission to be affixed at the Capitol,  
20 in the City of Phoenix, this 24<sup>TH</sup> day of  
April, 2001

21   
22 BRIAN C. McNEIL  
23 EXECUTIVE SECRETARY

24 DISSENT \_\_\_\_\_

25  
26

1 SERVICE LIST FOR: CITIZENS COMMUNICATIONS COMPANY  
 ET AL.  
 2 DOCKET NOS.: W-01032A-00-0192; W-01032B-00-0192; W-  
 3 01032C-00-0192; S-02276A-00-0192; WS-  
 4 02334A-00-0192; WS-03454A-00-0192; WS-  
 5 03455A-00-0192; W-02013A-00-0192; W-01595A-  
 00-0192; and W-01303A-00-0192

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25 3099-0035/898296

26

1 CARL J. KUNASEK  
 CHAIRMAN  
 2 JIM IRVIN  
 COMMISSIONER  
 3 WILLIAM A. MUNDELL  
 COMMISSIONER

4 BEFORE THE ARIZONA CORPORATION COMMISSION

5 IN THE MATTER OF THE JOINT  
 6 APPLICATION OF CITIZENS UTILITIES  
 COMPANY; AGUA FRIA WATER  
 7 DIVISION OF CITIZENS UTILITIES  
 COMPANY; MOHAVE WATER DIVISION  
 8 OF CITIZENS UTILITIES COMPANY; SUN  
 CITY WATER COMPANY; SUN CITY  
 9 SEWER COMPANY; SUN CITY WEST  
 UTILITIES COMPANY; CITIZENS WATER  
 10 SERVICES COMPANY OF ARIZONA;  
 CITIZENS WATER RESOURCES  
 11 COMPANY OF ARIZONA; HAVASU  
 WATER COMPANY AND TUBAC VALLEY  
 12 WATER COMPANY, INC., FOR  
 APPROVAL OF THE TRANSFER OF THEIR  
 13 WATER AND WASTEWATER UTILITY  
 ASSETS AND THE TRANSFER OF THEIR  
 14 CERTIFICATES OF PUBLIC CONVENIENCE  
 AND NECESSITY TO ARIZONA-  
 15 AMERICAN WATER COMPANY AND FOR  
 CERTAIN RELATED APPROVALS.

DOCKET NOS. W-01032A-00- 0192  
 W-01032B-00- 0192  
 W-01032C-00- 0192  
 S-02276A-00- 0192  
 WS-02334A-00-0192  
 WS-03454A-00-0192  
 WS-03455A-00-0192  
 W-02013A-00- 0192  
 W-01595A-00- 0192  
 W-01303A-00- 0192

SETTLEMENT AGREEMENT BETWEEN  
 ARIZONA CORPORATION  
 COMMISSION STAFF AND ARIZONA-  
 AMERICAN WATER COMPANY

17 On March 24, 2000, Citizens Utilities Company (now known as Citizens"  
 18 Communications Company), its Agua Fria Water Division, its Mohave Water  
 19 Division, Sun City Water Company, Sun City Sewer Company, Sun City West,  
 20 Utilities Company, Citizens Water Services Company of Arizona, Citizens Water  
 21 Resources Company of Arizona, Havasu Water Company and Tubac Valley Water  
 22 Company (collectively, "Citizens") and Arizona-American Water Company  
 23 ("Arizona-American") filed with the Arizona Corporation Commission  
 24 ("Commission") a joint application for the approval of the sale and transfer of  
 25 Citizens water and wastewater utility plant, property and assets in Arizona,  
 26 including transfer of Citizens' certificates of convenience and necessity

1 ("Certificates"), to Arizona-American pursuant to A.R.S. § 40-285.

2 The Commission's Utilities Division Staff ("Staff") has investigated the  
3 application and has recommended that the application be approved by the  
4 Commission, subject, however, to certain conditions and requirements, which are  
5 set forth in the Direct Testimony of Linda A. Jaress, filed in this docket on August  
6 14, 2000, at pages 18-19 ("Staff Recommendations"). Arizona-American has  
7 indicated that it is willing to accept the Staff Recommendations, with the exception  
8 of the recommendation that Citizens' advances in aid of construction ("AIAC") and  
9 contributions in aid of construction ("CIAC") be imputed to Arizona-American.

10 Representatives of Staff and Arizona-American have had discussions  
11 concerning the matters in dispute with respect to the application and have reached  
12 a settlement. The purpose of this Settlement Agreement is to memorialize the  
13 agreement that has been made by and among Staff and Arizona-American, which  
14 resolves all areas of disagreement relating to the terms and conditions under which  
15 Citizens' Arizona water and wastewater assets and Citizens' Certificates may be  
16 transferred to Arizona-American.

17 1. AIAC Imputation; Amortization. As of December 31, 1999, Citizens'  
18 AIAC balance was \$80,818,669. Citizens' AIAC balance as of the date on which  
19 Citizens' water and wastewater assets and Certificates are transferred to Arizona-  
20 American and Arizona-American becomes responsible for the provision of water  
21 and wastewater services will be imputed to Arizona-American. Such imputation  
22 shall be solely for ratemaking purposes. The total amount of AIAC imputed will be  
23 adjusted as more particularly provided below. The adjusted amount of AIAC will be  
24 amortized below the line (i.e., no impact on expenses) over a period of 6.5 years,  
25 with the amortization period beginning on the day on which the transfer takes  
26 place.

1           2.    CIAC Imputation: Amortization. As of December 31, 1999, Citizens'  
 2 CIAC balance was \$4,734,430. Citizens' CIAC balance as of the date on which  
 3 Citizens' water and wastewater assets and Certificates are transferred to Arizona-  
 4 American and Arizona-American become responsible for the provision of water and  
 5 wastewater services will also be imputed to Arizona-American. Such imputation  
 6 shall be solely for ratemaking purposes. The total amount of CIAC to be imputed  
 7 to Arizona-American will also be adjusted as provided below. The adjusted CIAC  
 8 balance imputed to Arizona-American will be amortized above the line (i.e., as a  
 9 reduction to depreciation expense) over a period of 10 years, with the amortization  
 10 period beginning on the day on which the transfer takes place.

11           3.    Adjustment to Recorded AIAC and CIAC Balances. The amounts of  
 12 AIAC and CIAC to be imputed to Arizona-American for ratemaking purposes will be  
 13 based on the actual balances shown on Citizens' regulatory books as of the date of  
 14 the transfer, adjusted as follows: An amount equal to five percent (5%) of  
 15 Citizens' AIAC balance at the time of the transfer will be reclassified as CIAC and  
 16 added to the CIAC balance, and the same amount will be deducted from Citizens'  
 17 AIAC balance in computing the amounts to be imputed to Arizona-American for  
 18 ratemaking purposes hereunder.

19           4.    Adoption of Remaining Staff Recommendations. Arizona-American  
 20 agrees that the Commission may adopt the remaining Staff Recommendations, as  
 21 set forth in the Direct Testimony of Linda A. Jaress.

22           5.    Deferral of Determination of Amortization Method. The parties agree  
 23 that Arizona-American's request for an accounting order to establish the  
 24 amortization method for any acquisition adjustment resulting from the transaction  
 25 should be deferred until a future rate case.

26           6.    Transfer in the Public Interest. Based on the foregoing agreements

1 and understandings, Staff agrees that Arizona-American is a fit and proper entity to  
2 acquire the Certificates and that the Commission should authorize and approve the  
3 transfer of Citizens' Arizona water and wastewater assets to Arizona-American on  
4 the terms set forth herein. No additional terms, conditions or requirements are  
5 necessary or appropriate.

6 7. Support and Defend. This Settlement Agreement will be introduced as  
7 an exhibit during the hearing on the application, presently set for September 27,  
8 2000. Arizona-American and Staff will jointly request that the Settlement  
9 Agreement be received into evidence, and agree to support and defend this  
10 Settlement Agreement and the transfer of Citizens' water and wastewater assets  
11 and the Certificates to Arizona-American on the terms set forth herein as just,  
12 reasonable and appropriate based on the particular circumstances presented in this  
13 application.

14 8. Compromise; No Precedent. This Settlement Agreement represents a  
15 compromise in the positions of the parties hereto. By entering into this Settlement  
16 Agreement, neither Staff nor Arizona-American acknowledges the validity or  
17 invalidity of any particular method, theory or principle of regulation, or agrees that  
18 any method, theory or principle of regulation employed in reaching a settlement is  
19 appropriate for resolving any issue in any other proceeding, including (without  
20 limitation) any issues that are deferred to a subsequent rate proceeding. Except as  
21 specifically agreed upon in this Settlement Agreement, nothing contained herein  
22 will constitute a settled regulatory practice or other precedent.

23 9. Privileged and Confidential Negotiations. All negotiations and other  
24 communications relating to this Settlement Agreement are privileged and  
25 confidential, and no party is bound by any position asserted during the  
26 negotiations, except to the extent expressly stated in this Settlement Agreement.

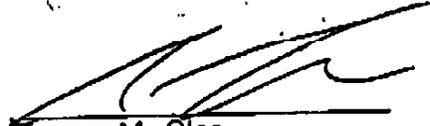
1 As such, evidence of statements that were made or other conduct occurring during  
2 the course of the negotiation of this Settlement Agreement is not admissible in any  
3 proceeding before the Commission or a court.

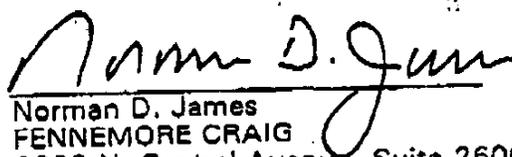
4 10. Complete Agreement. This Settlement Agreement represents the  
5 complete agreement of the parties with respect to its subject matter. There are no  
6 understandings or commitments other than those expressly set forth herein.

7 DATED this 26 day of September, 2000.

8 ARIZONA CORPORATION  
9 COMMISSION STAFF

ARIZONA-AMERICAN WATER COMPANY

10 By:   
11 Steven M. Oles  
12 Acting Director, Utilities Division  
13 Arizona Corporation Commission  
1200 West Washington Street  
Phoenix, Arizona 85007

By:   
Norman D. James  
FENNEMORE CRAIG  
3003 N. Central Avenue, Suite 2600  
Phoenix, Arizona 85012-2913  
Attorneys for Arizona-American  
Water Company

14 An original and 10 copies of the  
15 foregoing was delivered this  
16 \_\_\_ day of September, 2000, to:

17 Docket Control  
18 Arizona Corporation Commission  
1200 West Washington  
Phoenix, AZ 85007

19 A copy of the foregoing  
20 was delivered this \_\_\_ day of  
September, 2000, to:

21 Karen E. Nally  
22 Assistant Chief Administrative  
Law Judge  
23 Hearing Division  
Arizona Corporation Commission  
24 1200 West Washington  
Phoenix, AZ 85007

25  
26

1 A copy of the foregoing  
2 was telecopied/delivered and mailed this \_\_\_  
3 day of September, 2000, to:

3 Daniel W. Pozefsky  
4 Staff Attorney  
5 Residential Utility Consumer Office  
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7 Suite 1200  
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9 (602) 285-0350  
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9 Craig A. Marks  
10 Associate General Counsel  
11 Citizens Communications Company  
12 2901 N. Central, Suite 1660  
13 Phoenix, AZ 85012  
14 (602) 265-3415

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

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