



BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK Arizona Corporation Commission
Chairman
JIM IRVIN
Commissioner
WILLIAM A. MUNDELL
Commissioner

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IN THE MATTER OF THE JOINT)
APPLICATION OF CITIZENS UTILITIES)
COMPANY; AGUA FRIA WATER DIVISION)
OF CITIZENS UTILITIES COMPANY;)
MOHAVE WATER DIVISION OF CITIZENS)
UTILITIES COMPANY; 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, INC., FOR APPROVAL)
OF THE TRANSFER OF THEIR WATER)
AND WASTEWATER UTILITY ASSETS)
AND THE TRANSFER OF THEIR CERTIFI-)
CATES OF PUBLIC CONVENIENCE AND)
NECESSITY TO ARIZONA-AMERICAN)
WATER COMPANY AND FOR CERTAIN)
RELATED APPROVALS.)

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Staff of the Arizona Corporation Commission hereby files the testimony of Linda A. Jares, Acting Chief of Accounting and Rates, Utilities Division, in the above-referenced dockets:

RESPECTFULLY SUBMITTED this 14th day of August, 2000.

for Christopher C. Kempsey
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Attorney, Legal Division
Arizona Corporation Commission
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**DIRECT
TESTIMONY OF**

LINDA A. JARESS

**DOCKET NOS. W-01032A-00-0192
W-01032B-00-0192**

August 14, 2000

BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK

Chairman

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Commissioner

WILLIAM A. MUNDELL

Commissioner

IN THE MATTER OF THE JOINT APPLICATION) DOCKET NOS. W-01032A-00-0192
OF CITIZENS UTILITIES COMPANY; AGUA) W-01032B-00-0192
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UTILITIES COMPANY; MOHAVE WATER)
DIVISION OF CITIZENS UTILITIES)
COMPANY; SUN CITY WATER COMPANY;)
SUN CITY SEWER COMPANY; SUN CITY)
WEST UTILITIES COMPANY; CITIZENS)
WATER SERVICES COMPANY; CITIZENS)
WATER RESOURCES COMPANY OF)
ARIZONA; HAVASU WATER COMPANY AND)
TUBAC VALLEY WATER COMPANY, INC., FOR)
APPROVAL OF THE TRANSFER OF THEIR)
WATER AND WASTEWATER UTILITY ASSETS)
AND THE TRANSFER OF THEIR CERTIFICATES)
OF PUBLIC CONVENIENCE AND NECESSITY TO)
ARIZONA-AMERICAN WATER COMPANY AND)
FOR CERTAIN RELATED APPROVALS)

DIRECT

TESTIMONY

OF

LINDA A. JARESS

ACTING CHIEF OF ACCOUNTING AND RATES
UTILITIES DIVISION

AUGUST 14, 2000

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1 **INTRODUCTION**

2 Q. Please state your name and business address.

3 A. My name is Linda A. Jaress. My business address is 1200 West Washington, Phoenix,
4 Arizona 85007.

5
6 Q. Please state your educational background and professional experience.

7 A. I received a Bachelor of Arts Degree from Michigan State University and a Master of
8 Business Administration Degree from the University of Hawaii. I was employed as a
9 Research Analyst for the Hawaii Trucking Association from 1977 through 1978 and as a
10 Financial Analyst for the State of Hawaii, Division of Consumer Advocacy from 1980
11 through 1985. In 1985, I was employed by the Arizona Corporation Commission
12 ("Commission") as a Senior Rate Analyst and received a promotion to Manager,
13 Financial Analysis in 1991. I also served as the Acting Chief of the Accounting and
14 Rates Section for six months in 1997 and from May 30, 2000 to the present.

15
16 Q. Please list your duties and responsibilities as Acting Chief of Accounting and Rates.

17 A. I supervise approximately twelve analysts and accountants. I am responsible for all cases
18 assigned to the Accounting and Rates section including rate and financing cases, mergers
19 and acquisitions, and tariff filings. I am also responsible for preparing and presenting
20 testimony and Staff Reports on various finance-related issues such as mergers, asset
21 purchases, Affiliated Interest Rule filings and applications for approval of financing.

22
23 Q. What is the purpose of your testimony?

24 A. The purpose of my testimony is to present Staff's analysis and recommendations
25 regarding the proposed sale of Arizona water and wastewater assets of Citizens
26 Communications, Inc. ("Citizens") to Arizona-American Water Company ("Arizona-

27 ...

28 ...

1 American”) for \$231.3 million and the transfer of all related certificates of convenience
2 and necessity (“CC&Ns”). Arizona-American provides water utility service to 4,568
3 customers in Arizona. The Citizens' water and wastewater assets in Arizona are used to
4 serve approximately 158,364 customers.

5
6 Q. Has Citizens Utilities Company recently changed its name?

7 A. Yes, it has. On May 19, 2000 Citizens Utilities Company changed its name to Citizens
8 Communications, Inc.. Upon what standards are you basing your recommendations?

9 A. The transfer of the assets of Citizens to Arizona-American must be in the public interest
10 and Arizona-American must be a fit and proper entity to acquire the CC&N of Citizens in
11 the areas at issue.

12
13 Q. Briefly summarize Staff's recommendation regarding the proposed transaction between
14 Arizona-American and Citizens.

15 A. Staff is recommending that the Commission approve the proposed sale of assets subject
16 to several conditions.

17
18 **PARTIES TO THE TRANSACTION**

19 Q. Please describe Citizens.

20 A. Citizens provides, through its division and subsidiaries, regulated and competitive
21 communications services, water and wastewater, electric and natural gas service to
22 approximately 1.8 million customers in twenty-two states including Arizona.

23
24 Q. How large are Citizens' Arizona water and wastewater operations?

25 A. The Arizona water and wastewater operations serve approximately 158,364 customers in
26 various locations throughout Arizona. The number of customers served by the various
27 Citizens' entities at issue are listed on Exhibit LAJ-1.

28 ...

1 Q. Please describe American Water Works.

2 A. American Water Works, the parent of Arizona-American, is the largest water utility in
3 the United States, providing water, wastewater and other water resource management
4 services to approximately 2,516,000 customers in twenty-three states. The majority of
5 the customers served are located in the states of Pennsylvania, Missouri and New Jersey.
6 American Water Works is a publicly-traded holding company whose consolidated net
7 plant of \$5.1 billion generated revenues of \$1.26 billion during the year 1999.

8
9 AWW is currently in an acquisition mode. In 1998 and 1999, it spent \$46.2 million and
10 \$41.8 million respectively on acquisitions of other water and wastewater operations. In
11 late 1999, along with the agreement to acquire the Citizens water and wastewater assets,
12 AWW announced an agreement to acquire all of the common stock of SJW Corp., the
13 parent of San Jose Water. SJW is a publicly-traded holding company providing water
14 service to 216,000 customers in and around San Jose, California.

15
16 Q. Approximately how much of AWW's business is devoted to wastewater operations?

17 A. Although AWW subsidiaries provide utility wastewater service in seven states, the vast
18 majority of AWW's customers are water customers. At year-end 1999, AWW and its
19 subsidiaries served 2.7 million water customers and 189,366 wastewater customers. For
20 1999, \$24.5 million, or only 2.0 percent of total AWW revenues were generated by
21 wastewater operations.

22
23 Q. Please describe AWW's financial health.

24 A. AWW is financially sound. On December 31, 1999 its balance sheet reflected a capital
25 structure of 58.4 percent long-term debt, 2.3 percent preferred stock and 39.3 percent
26 common equity. These ratios are similar to the composite capital structure ratios of the

27 ...

28 ...

1 six publicly-traded water companies followed by Value Line Investment Survey of 56.9
2 percent debt, 3.4 percent preferred stock and 39.7 percent common equity. AWW's
3 shareholders have experienced uninterrupted increases in dividends per share since at
4 least 1989.

5
6 According to the May 5, 2000 issue of Value Line Investment Survey ("Value Line"),
7 "American is in the midst of a massive capital spending phase. Last year, the Company
8 invested \$467 million in improving and upgrading its facilities; and management
9 estimates that \$2.2 billion will be spent on capital improvements over the next five years.
10 It anticipates that the expenditures will be substantially paid for by regulatory decisions."
11 The common shares of American received the highest Safety Rank from Value Line.

12
13 Q. How does the bond rating of AWW compare to that of Citizens?

14 A. Standard and Poor's (S&P) has rated Citizens' corporate bonds at A+, recently
15 downgraded from AA-. According to S&P the downgrade reflects increased concern
16 about Citizens' prospective financial policy, in light of its accelerated pace of
17 acquisitions. Moreover, the accelerated expansion of the company's competitive local
18 exchange carrier network increased financial risk. The debt rating by Moody's Investors
19 Service ("Moody's") for Citizens is A2 and has not been recently lowered

20
21 AWW, as a holding company, does not issue bonds. However, several of its subsidiaries
22 have issued bonds that are rated by Standard and Poor's. The bonds of two of those
23 subsidiaries are rated A- and the third subsidiary's bonds are rated A.

24
25 Recently, AWW formed a new subsidiary, American Water Capital Corp. ("American
26 Capital"), a special purpose subsidiary that serves as the primary funding vehicle for
27 AWW and its other subsidiaries. Standard & Poor's and Moody's assigned bond ratings
28 of A- and Baa1, respectively to the new entity's bonds. According to an AWW press

1 release dated June 26, 2000 announcing the formation of the new subsidiary, "The
2 corporate ratings reflect the consolidated credit strength of American Water Works
3 derived from its geographic diversity, stable customer base, supportive regulatory
4 climate, high quality operations, and experienced management."

5
6 Q. Does this mean that the new financing subsidiary of American Water Works, which will
7 raise the capital needed for Arizona-American, will have a higher cost of debt than
8 Citizens?

9 A. Initially, it may. However, it should be remembered that Citizens intends to soon become
10 exclusively a communications company which will significantly increase its exposure to
11 risks related to competition. The recognition of those risks is apparent in Citizens' recent
12 downgrade by the bond-rating agency mentioned above. In contrast, American Water
13 Works provides primarily utility service in the water and wastewater industries that could
14 be considered pure monopolies in which there is de minimus or no competition. It is not
15 inconceivable that eventually, the bond ratings of American Water Capital Corp. will
16 become higher than those assigned to Citizens as Citizens divests itself of its less risky
17 water and wastewater subsidiaries.

18
19 Q. Please Describe Arizona-American, the company that will directly own the Citizens
20 water and wastewater assets.

21 A. Arizona-American's predecessor, Paradise Valley Water Company, was incorporated on
22 December 30, 1949. On December 3, 1969 it was purchased by AWW and on January 1,
23 2000 its name was changed to Arizona-American. Arizona-American provides service to
24 4,568 customers in portions of Scottsdale and the Town of Paradise Valley. Of American
25 Water Works' total customers at December 31, 1999, 0.15 percent were Arizona-
26 American customers.

27 ...

28 ...

1 Q. Please describe the financial health of Arizona-American.

2 A. According to its Annual Report to the Commission for the twelve months ending
3 December 31, 1999 Arizona-American generated net income of \$619,192 on net plant of
4 \$22,942,912. Of the net plant, \$9.2 million was either advanced or contributed by other
5 parties. Although, according to the Annual Report, net income relative to invested plant
6 was less than superior, Arizona-American has never hesitated to apply for rate increases
7 to maintain a healthy level of earnings.

8
9 The Company's capital structure is indicative of a healthy company at 49.9 percent long-
10 term debt and 50.1 percent common equity. To this analyst's knowledge, Arizona-
11 American has never experienced difficulty in securing external financing.

12
13 **REASONS FOR THE SALE**

14 Q. How will Arizona-American and its parent benefit from the purchase of the water and
15 wastewater assets of Citizens?

16 A. According to the testimony of Arizona-American witness Kelleher, the companies will
17 benefit from economies of scale and increased shareholder return. Another benefit of the
18 transaction is better geographic balance resulting in less vulnerability to local or regional
19 factors such as the weather.

20
21 Q. Please describe Citizens current corporate vision and business strategy, the actions taken
22 to effectuate that strategy and how this transaction is part of that strategy.

23 A. Citizens' current business strategy is to divest itself of all non-communications business
24 and use the funds from those sales to expand its communications sector. It has entered
25 several agreements to effectuate that strategy including large purchases of
26 telecommunications assets from Qwest, Inc. and GTE. In February 2000, Citizens

27 ...

28 ...

1 announced the sale of its electric businesses for \$535.0 million and on April 13, 2000,
2 Citizens Communication announced the sale of its Louisiana Gas operations for \$375.0
3 million.

4
5 The transaction at issue is part of a large sale of Citizens water and wastewater businesses
6 for \$835.0 million. The purchase price for the Arizona water and wastewater assets at
7 June 30, 1999 was expected to be \$231.3 million.

8
9 **THE TRANSACTION**

10 Q. Please describe the Arizona transaction.

11 A. The sale of assets will be a cash purchase transaction set forth in the Asset Purchase
12 Agreement dated October 15, 1999 and signed by representatives of Citizens, American
13 Water Works and Arizona-American. The assets purchased will include all assets,
14 property and interests relating to the water and wastewater operations of Citizens in
15 Arizona with some exclusions. Among the assets retained by Citizens will be all assets
16 commonly used in the water/wastewater, gas, electric or communications businesses,
17 cash and cash equivalents and assets related to benefit plans. Among the liabilities
18 Citizens will retain are the obligations for taxes payable, obligations with respect to
19 compensation and employee benefits and all refunds of advances at the time of closing.
20 Arizona American will assume the liabilities for all contracts and permits assigned to
21 them, certain Industrial Development Authority bonds ("IDRBs") and unperformed
22 service obligations.

23
24 Q. How will the transaction be financed by Arizona-American?

25 A. Initially, the transaction will be financed by short-term debt acquired by American
26 Capital. Later, a mix of debt and equity will be issued to refund the short-term debt.

27 ...

28 ...

1 **ADVANCES AND CONTRIBUTIONS**

2 Q. Will Arizona-American assume the refund obligations related to advances received for
3 construction of facilities?

4 A. No. Citizens is retaining the obligation to pay the refunds.

5
6 Q. Will Arizona-American's books and records reflect the contributions Citizens received
7 from developers on its books and records after the sale?

8 A. No. The Sales Agreement does not indicate that these liabilities will transfer to Arizona-
9 American. Advances and contributions are accounted for as liabilities on the books and
10 records of the companies that receive them.

11
12 Q. At December 31, 1999 what were the total advances and contributions on the books and
13 records of Citizens Arizona water and wastewater operations?

14 A. The 1999 Annual Reports to the Commission for the Citizens entities at issue reflected
15 advances of \$80.8 million and contributions of \$4.7 million for a total of \$85.6 million.

16
17 Q. How are advances and contributions normally treated for ratemaking purposes?

18 A. Advances are deducted from rate base because they represent plant financed by cost-free
19 capital usually received from real estate developers. The developers advance only the
20 amount necessary to pay for the plant required. No interest or other cost of capital is
21 included in the amount of the advance.

22
23 Q. If Arizona-American were to complete the purchase the Citizens assets and immediately
24 file an application for a rate increase, what effect would the absence of the advances and
25 contributions have on revenue requirements?

26 A. Using the rate of return allowed by the Commission in Arizona-Americans last rate case
27 of 9.33 percent, the impact would be a \$12.8 million increase in revenue requirements
28 (\$85,553,049 X 9.33% X 1.6).

1 Q. What is Staff's recommendation regarding the retention of these liabilities by Citizens?

2 A. The retention by Citizens of the liabilities related to advances and contributions will have
3 a significant impact on the rates of the former Citizens customers. Staff recommends that
4 an imputation of the benefits related to advances be made in the rate cases for each
5 former Citizens entity being sold. The imputation for each year should be reduced by
6 10.0 percent in a manner similar to that which would have been performed had the
7 advances been transferred to Arizona-American. The imputation to recognize the
8 foregone contributions should be reduced by the below-the-line amortization of the
9 contributions which would have otherwise occurred.

10

11 **WATER SUPPLY CONTRACTS**

12 Q. Which of the Citizens entities being transferred have entered into subcontracts for CAP
13 water?

14 A. In total, the Citizens entities hold four subcontracts for CAP water. Sun City Water holds
15 two subcontracts totaling 4,189 acre-feet per year. The subcontract for the Agua Fria
16 Division totals 11,093 acre-feet and the fourth contract for 2,372 acre-feet belong to Sun
17 City West Utilities Company.

18

19 Q. Are those CAP allocations being used?

20 A. Yes. All of Citizens' systems holding CAP subcontracts are currently using their CAP
21 allocations.

22

23 Q. Have any of Citizens' Arizona water companies entered other contracts for water?

24 A. Yes. Citizens is purchasing water for the Anthem service territory under an agreement
25 with Del Webb Corporation ("Del Webb"). Del Webb is entitled to the water under an
26 Option and Lease Agreement with the United States of American and the Ak-Chin Indian
27 Community ("Ak-Chin"). In 1999, Anthem received 1,851 acre-feet under these
28 agreements.

1 Q. Will the CAP subcontracts and the agreement with Del Webb be transferred to Arizona-
2 American?

3 A. Yes.
4

5 Q. Will Arizona American have the ability to transfer the CAP subcontracts to other parties
6 within or outside of Arizona?

7 A. Yes, the subcontracts appear to be transferable without restriction on the location of the
8 parties involved. However, the transfer, sale or other relinquishment of the CAP
9 subcontracts are subject to the policies established by the Arizona Department of Water
10 Resources and the Central Arizona Water Conservation District.
11

12 Q. Will Arizona-American have the right to transfer any Ak-Chin water from Anthem?

13 A. Per the agreement with Del Webb, Arizona-American will not have the right to transfer
14 any Ak-Chin water from Anthem.
15

16 Q. What is your recommendation regarding the CAP and Ak-Chin water?

17 A. Although there currently is no apparent reason for Arizona-American to relinquish any of
18 its future rights under the CAP subcontracts and Del Webb agreement, court cases and
19 legislation regarding water and water rights are ongoing and could conceivably effect
20 these agreements. Therefore, I recommend that Arizona-American be ordered to seek
21 Commission approval of any amendment to, or transfer of agreements to purchase and
22 use water.
23 ...
24 ...
25 ...
26 ...
27 ...
28 ...

1 **CAPITAL EXPENDITURE BUDGETS**

2 Q. What are Citizens capital expenditure budgets for the years 2001 and 2002 for the water
3 and wastewater companies being sold?

4 A. For the year 2001, Citizens projected to spend \$21.8 million on the water and wastewater
5 operations, \$11.2 million of which would be financed by advances and contributions. For
6 2002, the budget reflected expenditures of \$26.3 million, \$17.5 million of which would
7 be financed by advances and contributions. Due to the contemplated sale of the Arizona
8 systems, Citizens has cautioned that the budget projections for 2001 and 2002
9 represented only amounts to maintain current operations and meet firm developer
10 commitments.

11
12 Q. What is Arizona-American's planned capital budget for the new territory?

13 A. Arizona-American has budgeted \$37.5 million for the year 2001 to be partially financed
14 by \$24.0 million of advances and contributions, and for 2002 has budgeted \$49.4 million,
15 \$40.2 million of which will be financed by advances and contributions. This illustrates a
16 continued reliance upon cost-free capital to fund the capital improvements.

17
18 **RATES**

19 Q. Will any rate or charge be immediately affected by the proposed sale?

20 A. Arizona-American's application indicates that it will adopt all of the rates and charges
21 currently in effect in the certificated areas being purchased.

22
23 Q. Has Arizona-American indicated when it will request the first rate increase after the
24 purchase of the Citizens assets?

25 A. In response to a data request, Arizona American indicated that "...increases and/or
26 decreases will depend on the costs to provide service, including customer growth,
27 planned related investments, inflation and other projected factors." However, the

28 ...

1 financial model provided by Arizona-American projected rate increases for both the
2 current Arizona-American operations and for the customers acquired from Citizens
3 beginning in 2002.

4
5 **CUSTOMER SERVICE**

6 Q. Please describe the history of complaints received by the Commission's Consumer
7 Services Section for the Citizens water and wastewater operations and for Arizona-
8 American.

9 A. In 1998, for the entire Citizens water and wastewater operations, the Commission
10 received 11 complaints and in 1999, 10 complaints. For the year 2000, by July 3rd the
11 Commission had received 3 complaints.

12
13 Arizona-American's record was 3 complaints in 1998, 4 in 1999 and 3 for the period
14 January 1 to July 3, 2000.

15
16 Q. What are Arizona-American's plans for providing customer service? Specifically, how
17 will the former Citizens customers receive answers to billing questions and whom will
18 they contact in emergencies?

19 A. An Arizona-American data response to similar questions indicated that "The structure
20 and location of the American System's Customer Care organization is currently under
21 review....After the sale, a customer...will call a toll free phone number which will be
22 provided on bills ...and which will be listed in local phone directories." Arizona-
23 American did not indicate where the Customer Care personnel will be located but did
24 commit to meeting with customers in person, when necessary, or arrange to meet them at
25 Arizona-Americans' local office.

26 ...

27 ...

28 ...

1 Arizona-American also responded that customers who need emergency service will call a
2 toll free phone number and technicians will be dispatched from Arizona-American's
3 "local office".
4

5 Q. What is Staff's recommendation regarding customer service?

6 A. Arizona-American's responses indicate that several fundamental decisions have not yet
7 been made regarding customer service. Staff believes that the customers should be no
8 worse off under Arizona-American's ownership of the assets and that Arizona-American
9 should not change the location or number of any customer service representatives or
10 technicians until it determines that such changes will not affect the quality of service to
11 all of its customers.
12

13 To guard against any reduction in customer service levels, Staff recommends that 13
14 months after the closing of the transaction, Arizona-American file a report comparing the
15 number of complaints received by the Commission under their ownership compared to
16 the complaints received under Arizona-American's ownership and provide explanations
17 for any significant changes in the number and importance of the complaints. Staff will
18 review the report and, if necessary, provide a recommendation to the Commission.
19

20 **ACQUISITION PREMIUM**

21 Q. Please explain what an acquisition adjustment is.

22 A. An acquisition adjustment is the difference between the purchase price and the net book
23 value of the asset (i.e. the original cost of the asset less accumulated depreciation). A
24 utility that acquires assets for a price above net book value often requests recovery of
25 the acquisition adjustment, or premium, in rates. If approved, all else held constant, rates
26 will be higher than before the purchase.
27 ...
28 ...

1 Q. What is the acquisition premium that Arizona American will record on its books in this
2 case?

3 A. The acquisition premium is subject to change because it will be computed from the book
4 value of the assets on the date of closing. As of June 30, 1999, the purchase price,
5 including the assumption of \$10.x million of debt by Arizona-American, was \$231.3
6 million. The book value of the assets being purchased was \$160.2 million. The
7 acquisition premium paid then, would be the difference, or \$71.2 million.

8
9 Q. Is Arizona-American requesting ratemaking treatment of the acquisition premium in this
10 proceeding?

11 A. No. However, Arizona-American witness Dave Stephenson included an exhibit in his
12 testimony illustrating a method of amortizing the acquisition adjustment that Staff has
13 never before encountered. Normally, acquisition adjustments are amortized equally over
14 a long period of time. He suggests the use of a mortgage amortization method under
15 which smaller amounts are amortized over the early years and larger amounts during the
16 later years, similar to the amortization of principal in a home mortgage. He also presents
17 an exhibit illustrating that the synergies related to the merging of operations will increase
18 over time. The mortgage method of amortizing the acquisition adjustment combined
19 with the growing synergies would, according to Mr. Stephenson, result in the generations
20 customers receiving the greatest synergies shouldering the greatest burden of the
21 acquisition adjustment.

22
23 Q. Do you agree with Mr. Stephenson's analysis?

24 A. No. I do not. While on the surface the matching of benefits and costs appears reasonable
25 there are significant flaws in his analysis. First, the assumption that the Commission
26 would allow recovery of any amount of the acquisition premium is open to question.
27 Second, Mr. Stephenson has estimated synergies over the next 40 years, a humbling task
28 even for the most seasoned economist. The margin of error in such a forecast is great.

1 Third, and most importantly, Mr. Stephenson has neglected to include any offset to the
2 synergies for the increases in revenue requirement due to the \$92.0 million of additional
3 rate base which could be experienced because of the retention by Citizens of the advances
4 and contributions and the non-transferability of the deferred tax balances.

5
6 Q. What is Mr. Stephenson requesting regarding this matter?

7 A. Mr. Stephenson is requesting that the Commission authorize a 40-year amortization
8 period and use of a mortgage amortization method for the acquisition premium.

9
10 Q. Do you recommend that the Commission consider Mr. Stephenson's analysis?

11 A. No. Staff recommends that the Commission withhold any judgement on the amortization
12 period or method until a future rate case where actual costs and benefits may be
13 examined.

14
15 Any decision to allow the recovery of an acquisition premium in rates should be based on
16 Arizona-American's demonstration that clear, quantifiable and substantial net benefits or
17 savings occurred to ratepayers that would not have been realized absent the transaction
18 as structured. This would include types of benefits that would result from the structural
19 advantages of Arizona-American (i.e. economies of scale or other unique synergies that
20 would not have been available to Citizens).

21
22 **DEFERRED INCOME TAXES**

23 Q. What are deferred income taxes?

24 A. Deferred income taxes arise because of timing differences in the way in which revenues
25 and expenses are recognized on a utility's books for regulatory purposes, as opposed to
26 the way in which they are recognized for income tax reporting purposes. These
27 differences are primarily due to the use of straight-line depreciation for regulatory
28 purposes and accelerated depreciation for income tax purposes.

1 Q. What is the proper ratemaking treatment for accumulated deferred taxes and what effect
2 do deferred taxes have on utility rates?

3 A. Accumulated deferred income taxes represent a cost-free source of funds provided by
4 ratepayers to the utility. Thus, they are treated as a deduction to rate base. This results in
5 a lower rate base for the utility and lower rates for the utility's customers.

6
7 Q. What effect will the proposed transaction between Citizens and Arizona-American have
8 on any existing deferred taxes and how will it impact ratepayers?

9 A. The deferred income taxes related to the assets being sold would be included in the
10 calculation of any taxable gain that is realized by Citizens when the sale of the assets to
11 Arizona-American is completed. Because Arizona-American's books will not reflect the
12 accumulated deferred taxes related to the exchanges they are purchasing, the deduction of
13 the deferred tax balance from rate base would no longer occur. However, as Arizona-
14 American increases its investment in plant in the exchanges, "new" deferred taxes will be
15 accumulated.

16
17 Q. What about "excess" deferred taxes and unamortized Investment Tax Credits?

18 A. These also represents amounts paid by rate payers in excess of income taxes actually paid
19 by Citizens and are also deducted from ratebase.

20
21 Q. What are the total ITCs and deferred taxes currently on the books of Citizens related to
22 the Arizona operations being sold?

23 A. The total is \$7.3 million. Because these balances will not transfer to Arizona-American,
24 the immediate impact will be to increase the ratebase by \$7.3 million.

25
26 Q. What is your recommendation regarding deferred taxes and excess deferred taxes?

27 A. A future rate case proceeding will be the appropriate forum in which to determine the
28 recognition of these liabilities.

1 **BENEFITS OF THE TRANSACTION**

2 Q. What benefits might accrue to the former Citizens customers under the ownership of
3 Arizona-American?

4 A. The combination of the Citizens water and wastewater operations in Arizona with
5 Arizona-American may result in operating efficiencies. These efficiencies and synergies
6 are addressed in the direct testimony of Arizona-American witness Daniel Kelleher and
7 the corrected direct testimony of David Stephenson. Efficiencies expected by the two
8 witnesses include savings from the enhanced ability of Arizona-American and American
9 Water Works to enter into operations and maintenance contracts and access to a
10 nationwide pool of trained water and wastewater professionals. More specifically, Mr.
11 Stephenson expects savings in management fees, group insurance, pension, customer
12 accounting, rent and capital investments.

13
14 Q. What do you believe the benefits to the transaction to be?

15 A. From responses to data requests, it is apparent that the charges from the American Water
16 Work's service corporation will be lower than those currently charged by Citizens. Also,
17 American Water Works, being considerably larger than Citizens, may be able to
18 consolidate larger financing arrangements and achieve some savings in that area.

19
20 It can also be expected that benefits will be experienced by the Arizona customers related
21 to the focus of the entire American Water Works organization on water and wastewater
22 operations. Investment decisions may not be clouded by conflicting demands of other
23 lines of business. For example, as previously mentioned, Citizens' business strategy is
24 focused on communications and not water and wastewater operations. American Water
25 Works is focused on providing water and wastewater services. Other potential
26 purchasers could also have a less narrow focus.

27 ...

28 ...

1 **CONCLUSIONS AND RECOMMENDATIONS**

2 Q. What conclusions have you drawn from this application and the responses to data
3 requests?

4 A. Citizens' corporate focus has moved from a diversified utility company to
5 communications and telecommunications. The focus of Arizona-American and its parent
6 is water and wastewater operations. Arizona-American and its sister subsidiaries of
7 American Water Works have acquired technical expertise through their many years of
8 experience operating water and wastewater operations across the country, are financially
9 sound and are fit and proper entities to acquire Citizens' Arizona assets.

10
11 Q. What is Staff's recommendation in this case?

12 A. Staff believes that approval of the sale and transfer, under Staff's recommended
13 conditions will be in the public interest.

14
15 A. What conditions are you recommending?

16 A. Staff recommends that the Commission defer any decision on the treatment of an
17 acquisition premium, deferred taxes, excess deferred taxes, investment tax credits until a
18 future rate case proceeding.

19
20 Staff further believes that any decision to allow the recovery of an acquisition adjustment
21 should be based on Arizona American's ability to demonstrate that clear, quantifiable and
22 substantial net benefits have occurred to the benefit of ratepayers in the affected areas,
23 that would not have been realized had the transaction not occurred.

24
25 Staff is concerned about Arizona-American's lack of a specific plan for customer service
26 issues and operations. To guard against any reduction in customer service, Staff
27 recommends that 13 months after the closing of the transaction, Arizona-American file a
28 report comparing the number of complaints received by the Commission under their

1 ownership compared to the complaints received under Arizona-American's ownership
2 and provide explanations for any significant changes in the number and importance of the
3 complaints. Staff will review the report and, if necessary, provide a recommendation to
4 the Commission.

5
6 The retention by Citizens of the liabilities related to advances and contributions will have
7 a significant impact on the rates of the former Citizens customers. Staff recommends that
8 an imputation of the benefits related to advances be made in the rate cases for each
9 former Citizens entity being sold. The imputation for each year should be reduced by
10 10.0 percent in a manner similar to that which would have been performed had the
11 advances been transferred to Arizona-American. The imputation to recognize the
12 foregone contributions should be reduced by the below-the-line amortization of the
13 contributions which would have otherwise occurred.

14
15 Staff further recommends that Arizona-American be required to seek Commission
16 approval of any amendment to, or transfer of agreements to purchase and use water.

17
18 Finally, Staff recommends the Commission order Arizona American to charge the
19 customers rates, charges and all tariffs currently in effect in each respective service
20 territory until Arizona American files general rate case for those territories.

21
22 Under Staff's recommended conditions, Arizona-American will be a fit and proper entity
23 to acquire the CC&N of Citizens in the service territories at issue and the transfer of the
24 Arizona water and wastewater assets of Citizens will be in the public interest.

25
26 Q. Does this conclude your direct testimony?

27 A. Yes, it does.

**Citizens Communications, Inc.
Water & Wastewater Operations in Arizona**

Name	Type of Utility	Area Served	County	Number of Customers	Basic Monthly Charge for 3/4" meter	Charge per 1,000 Gal.
Sun City Water Company	Water	Sun City & Vicinity	Maricopa	30,315	\$5.00	\$0.73 to 8,000 gal \$0.92 over 8,000 gal
Sun City Sewer Company	Sewer	Sun City & Vicinity	Maricopa	29,618	\$12.87	
Sun City West Utilities Water Division	Water	Sun City West & Vicinity	Maricopa	34,026	\$5.00	\$0.93 to 8,000 gal \$1.12 over 8,000 gal
Sun City West Utilities Wastewater Division	Sewer	Sun City West & Vicinity	Maricopa	34,026	\$16.24	
Agua Fria Water Division of Citizens Utilities	Water	Surprise & Vicinity	Maricopa	8,776	\$10.00	\$1.78 to 8,000 gal \$2.24 over 8,000 gal
Mohave Water Division of Citizens Utilities	Water	Bullhead City & Vicinity	Mohave	14,471	\$8.65	\$1.48 over 1,000 gal
Citizens Water Services Company of Arizona	Water and Sewer	Anthem Community, North of Phoenix	Maricopa	974	water-\$16.00 sewer-\$16.00	water-\$2.00 sewer-\$2.00 to 7,000 gal
Citizens Water Resources Company of Arizona	Water and Sewer	Anthem Community, North of Phoenix	Maricopa	27	sewage treatment for residential effluent	residential customers/sell treated effluent
Havasus Water Company	Water	Lake Havasu City Western Arizona	Mohave	1,078	\$10.00	\$1.31 over 1,000 gal Nov-Apr \$1.42 over 1,000 gal May-Oct
Tubac Valley Water Company Inc.	Water	Tubac Valley Southern Arizona	Santa Cruz	485	\$15.35	\$1.66 to 8,000 gal \$2.04 over 8,000 gal
Paradise Valley Water Company	Water	Paradise Valley & Scottsdale	Maricopa	4,568	\$8.74	\$0.73 to 25,000 gal \$1.68 for 25,001-80,000 gal \$2.17 over 80,000 gal