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Arizona Corporation Commission

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

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AZ CORP COMMISSION
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BEFORE THE ARIZONA CORPORATION COMMISSION

5 IN THE MATTER OF THE JOINT
6 APPLICATION OF CITIZENS UTILITIES
7 COMPANY; AGUA FRIA WATER
8 DIVISION OF CITIZENS UTILITIES
9 COMPANY; MOHAVE WATER DIVISION
10 OF CITIZENS UTILITIES COMPANY; SUN
11 CITY WATER COMPANY; SUN CITY
12 SEWER COMPANY; SUN CITY WEST
13 UTILITIES COMPANY; CITIZENS WATER
14 SERVICES COMPANY OF ARIZONA;
15 CITIZENS WATER RESOURCES
16 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.

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

NOTICE OF FILING
REBUTTAL TESTIMONY

17 Arizona-American Water Company hereby files the Rebuttal Testimony of
18 Daniel L. Kelleher and the Rebuttal Testimony of David P. Stephenson in support of
19 the Joint Application in the above-entitled docket.

20 DATED this 5th day of September, 2000.

FENNEMORE CRAIG

21
22 By
23 Norman D. James
24 3003 N. Central Avenue, Suite 2600
25 Phoenix, AZ 85012
26 (602) 916-5346
Attorneys for Arizona-American Water
Company

1 An original and 10 copies of the
2 foregoing and the rebuttal testimony
3 described above was delivered this
4 5th day of September, 2000, to:

5 Docket Control
6 Arizona Corporation Commission
7 1200 West Washington
8 Phoenix, AZ 85007

9 A copy of the foregoing and the
10 rebuttal testimony described above
11 was delivered this 5th day of
12 September, 2000, to:

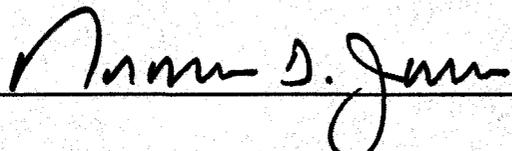
13 Karen E. Nally
14 Assistant Chief Administrative
15 Law Judge
16 Hearing Division
17 Arizona Corporation Commission
18 1200 West Washington
19 Phoenix, AZ 85007

20 Teena Wolfe
21 Attorney, Legal Division
22 Arizona Corporation Commission
23 1200 West Washington
24 Phoenix, AZ 85007

25 Daniel W. Pozefsky
26 Staff Attorney
Residential Utility Consumer Office
2828 North Central Avenue
Suite 1200
Phoenix, AZ 85004

27 A copy of the foregoing and the
28 rebuttal testimony described above
29 was mailed this 5th day of September,
30 2000, to:

31 Walter W. Meek, President
32 Arizona Utility Investors Association
33 P. O. Box 34805
34 Phoenix, AZ 85067

35 By: 

1 CARL J. KUNASEK
CHAIRMAN
2 JIM IRVIN
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3 WILLIAM A. MUNDELL
COMMISSIONER
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13 TRANSFER OF THEIR WATER AND
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14 THE TRANSFER OF THEIR
CERTIFICATES OF PUBLIC
15 CONVENIENCE AND NECESSITY TO
ARIZONA-AMERICAN WATER
16 COMPANY AND FOR CERTAIN
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21 **REBUTTAL TESTIMONY OF DANIEL L. KELLEHER**
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September 5, 2000

REBUTTAL TESTIMONY OF DANIEL L. KELLEHER

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- Q. Please state your name and business address.
- A. My name is Daniel L. Kelleher. My business address is 1025 Laurel Oak Road, Voorhees, New Jersey.
- Q. By whom are you employed and in what capacity?
- A. I am employed by American Water Works Service Company, Inc. ("Service Company") as Senior Vice President. I am responsible for the regulated utility businesses owned by American Water Works Company, Inc. ("AWW") and for the engineering, water quality, operations and regulatory programs' support services available to those utilities from the Service Company.
- Q. Have you submitted testimony in this proceeding previously?
- A. Yes. I have prepared and submitted direct testimony in support of the application in this case.
- Q. What is the purpose of your rebuttal testimony?
- A. The purpose of this testimony is to address certain recommendations made by Residential Utility Consumer Office ("RUCO") witness Gordon Fox concerning conditions to be imposed on the approval of the acquisition by Arizona-American Water Company ("Az-Am") of the water and wastewater assets of Citizens Telecommunications Company's ("Citizens") divisions and subsidiaries in Arizona. Specifically, at pages 26 and 27 of his testimony, Mr. Fox discusses his views on the public service obligations of water and wastewater utilities. At lines 21 through 24 on page 27, he states, "It seems appropriate that along with the opportunity to acquire prime Arizona utilities comes the obligation to acquire some resource challenged utilities to improve the overall quality of service in Arizona." At pages 31 through 34, Mr. Fox proposes conditions to be attached to approval of the transaction by

1 the Arizona Corporation Commission ("the Commission"). Among those
2 conditions, one proposed requirement is that Az-Am's Board of Directors
3 approve a letter pledging to invest no less than 15 percent of the purchase
4 price paid by Az-Am in this transaction in acquisitions and capital
5 improvements of "resource stressed" water and/or wastewater utilities in
6 Arizona no later than 72 months after the date this transaction is authorized
7 by the Commission.

8 Q. Do you agree that the transfer of Citizens' assets should be subject to this
9 requirement?

10 A. No. As I indicated in my direct testimony, once this transaction is
11 completed, Az-Am will have sufficient size, financial capacity and resources
12 to assist in the resolution of structural problems in the water industry in
13 Arizona. In fact, our subsidiaries in other states have a track record of
14 providing such assistance and have cooperated with state and local
15 governments to craft creative solutions to water service problems. We have
16 the expertise and resources, as well as a commitment to effective water
17 resource management. We are certainly willing to work with the
18 Commission and with local governments here in Arizona, as we have in other
19 states, to deal with particular problems in the water industry. In fact, by
20 virtue of acquiring Citizens' water and wastewater assets in Arizona, we will
21 be in closer proximity to troubled systems in Arizona which will make it
22 easier for us to provide assistance should circumstances warrant.
23 Assistance to these systems can take many forms, such as the provision of
24 technical or operating advice and expertise, outright acquisition or other
25 partnering arrangements. Our ability to provide that assistance, however,
26 depends on a number of factors, including proximity to the troubled system

1 and reasonable regulatory treatment of the costs and capital investment that
2 may be required.

3 Q. What sort of regulatory treatment does Mr. Fox recommend in connection
4 with proposing that the acquisition of Citizens' assets in Arizona be
5 conditioned on Az-Am's investment of 15% of the purchase price in troubled
6 Arizona water systems?

7 A. That's part of the problem with Mr. Fox's recommendation. In his direct
8 testimony, Mr. Fox does not explain what sort of regulatory treatment Az-
9 Am would receive under his recommendation. In fact, in a data request, Az-
10 Am asked RUCO to specify the particular regulatory treatment that Az-Am
11 would receive in connection with acquiring "resource stressed" Arizona
12 water and/or wastewater utilities. In response, RUCO simply indicated that
13 each acquisition "should be evaluated on an individual basis." In other
14 words, while Mr. Fox proposes that Az-Am commit to spend nearly \$35
15 million over the next six years, RUCO is unable to provide any insight into the
16 regulatory treatment to which Az-Am would be entitled in making such
17 investments.

18 Q. What would be the impact of Mr. Fox's recommendation if it were to be
19 adopted by the Commission?

20 A. The effect of Mr. Fox's proposal would be to create substantial disincentives
21 for the provision of assistance to, or the acquisition of, small, troubled water
22 systems. As explained in more detail in Mr. Stephenson's rebuttal
23 testimony, the combined impact of all of Mr. Fox's proposals would
24 undermine the economics of the transaction that we have negotiated with
25 Citizens. Ignoring for the moment his recommendation regarding Az-Am's
26 investment in troubled water systems, Mr. Fox's other proposals would

1 virtually assure that Az-Am would not be provided with an opportunity to
2 earn a reasonable rate of return on its investment in the water and
3 wastewater assets of Citizens. The imposition of a further condition under
4 which Az-Am would be required to pay an additional 15% of the purchase
5 price, or approximately \$35 million, for the purposes Mr. Fox indicates is akin
6 to imposing a penalty on Az-Am.

7 Q. Are there other problems with Mr. Fox's proposal?

8 A. Yes. His proposal to effectively impose a \$35 million penalty on Az-Am
9 contains no details whatsoever. For example, Az-Am asked RUCO to
10 disclose the identities of water and wastewater utilities that may be possible
11 candidates for assistance or acquisition. In response to that data request,
12 RUCO was unable to identify a single utility, further indicating that this
13 proposal is intended to act as a penalty or, perhaps, a deterrent in order to
14 prevent the acquisition. Similarly, in response to a data request, RUCO was
15 unable to provide the approximate number of water and wastewater utilities
16 that may be subject to acquisition under Mr. Fox's recommendation. I
17 suspect that an investment of \$35 million would roughly equate to all Class
18 D and E companies in Arizona.

19 When carefully considered, it is uncertain how Mr. Fox's
20 recommendation would even work. For example, it is unclear whether some
21 sort of fund would be established and, if so, how it would be administered,
22 and by whom. It is also uncertain what systems would be eligible to receive
23 assistance, standards for eligibility, the amount of potential assistance,
24 whether the assistance constitutes a loan or gift, provisions for repayment if
25 not a gift, staffing requirements and costs to administer this assistance and
26 any repayments or collections, enforcement of any terms or conditions of

1 such assistance and so on. Perhaps most importantly, Mr. Fox does not
2 address the legal authority and constitutionality of forcing an entity which is
3 purchasing the assets of a utility to provide a subsidy of this nature to third
4 parties as a precondition to authorizing the transfer of assets.

5 Q. What is your recommendation with regard to Mr. Fox's proposal?

6 A. The Commission should reject this proposal. To do otherwise would be
7 detrimental to this transaction and to the goal of providing assistance to
8 small, troubled water systems by imposing substantial disincentives on the
9 acquisition of water systems in Arizona. Our subsidiaries have been
10 interested and actively involved in solving water service problems and
11 assisting financially and operationally-troubled water utilities without being
12 ordered to do so. Such programs are most successful when there is a
13 conducive environment, which is reasonable for all involved and is not, in
14 effect, a penalty on acquisitions that are otherwise in the public interest.

15 The Commission can count on our willingness to assist in solutions to
16 pressing problems relating to water and wastewater infrastructure and
17 operations in Arizona. Our ability to fulfill that commitment, however,
18 depends on the environment created by public policy as it relates to
19 recognition of legitimate investments, as well as costs of doing business, in
20 creatively attacking the problems associated with small "resource
21 challenged" water and wastewater utilities. The financial conditions RUCO
22 would attach to this transaction are so extreme as to make it unlikely that
23 anyone would be able to provide assistance in solving critical water service
24 problems.

25 Q. Does that conclude your rebuttal testimony?

26 A. Yes.

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21 **REBUTTAL TESTIMONY OF DAVID P. STEPHENSON**

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26 **September 5, 2000**

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I. SUMMARY OF ARIZONA-AMERICAN'S POSITION 1

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1 **REBUTTAL TESTIMONY OF DAVID P. STEPHENSON**

2 Q. State your name and business address.

3 A. My name is David P. Stephenson. I am employed by American Water Works
4 Service Company, Inc., 880 Kuhn Drive, Chula Vista, California 91914.

5 Q. Have you previously provided testimony in this matter.

6 A. Yes, I provided direct testimony in support of the joint application of Arizona-
7 American Water Company ("Arizona-American") and Citizens Communications,
8 Inc. (formerly Citizens Utilities Company) and Citizens' various Arizona water
9 and wastewater subsidiaries (collectively, "Citizens") for authority for Citizens
10 to transfer its water and wastewater utility plant, property and Certificates of
11 Public Convenience and Necessity ("CC&Ns") to Arizona-American. The
12 application was filed on March 24, 2000 (the "Joint Application").

13 Q. Please state the purpose of your rebuttal testimony.

14 A. The purpose of my rebuttal testimony is to state, on behalf of Arizona-
15 American, my agreements or disagreements with the Direct Testimony of
16 Arizona Corporation Commission ("Commission") Staff witness Linda A. Jaress
17 and Residential Utility Consumer Office ("RUCO") witness Gordon Fox. They
18 have both provided direct testimony in this matter containing various
19 recommendaitons regarding the Joint Application.

20 **I. SUMMARY OF ARIZONA-AMERICAN'S POSITION.**

21 Q. Please briefly summarize your agreements with Ms. Jaress and Mr. Fox.

22 A. I agree with both witnesses that this Joint Application should be approved, that
23 Arizona-American is a suitable owner-operator for the affected Citizens'
24 systems and that the rate-making and regulatory accounting treatment afforded
25 to Arizona-American for any acquisition adjustment should be deferred until the
26 first rate increase application for one of the affected systems.

1 Q. Briefly summarize your disagreements with Ms. Jaress and Mr. Fox.

2 A. Both witnesses have proposed conditions on the transfer of the utility plant and
3 assets with which I disagree. Put simply, if approved, those conditions would
4 materially alter the agreement that Arizona-American and Citizens have
5 negotiated. I will address these proposed conditions and explain why the
6 Commission should disregard them.

7 Q. Please state the organization of the remainder of your testimony.

8 A. My testimony is organized in three sections. I will first respond specifically to
9 the recommendations of Ms. Jaress, the Commission's witness in this matter.
10 Next I will respond specifically to the recommendations of Mr. Fox, RUCO's
11 witness in this matter. Finally, I will state the rebuttal position of Arizona-
12 American as it relates to this Joint Application.

13 **II. REBUTTAL TO COMMISSION STAFF.**

14 Q. Please state the conditions concerning the transfer of the Citizens' utility plant
15 and assets proposed by Ms. Jaress with which you agree.

16 A. Ms. Jaress has recommended six conditions that should be placed on the
17 transfer of Citizens' utility plant and assets to Arizona-American: 1) that the
18 Commission defer any decision on the treatment of an acquisition adjustment,
19 deferred taxes, excess deferred taxes and investment tax credits until a future
20 rate proceeding; 2) that the decision to allow the recovery of any acquisition
21 adjustment should be based on Arizona-American's ability to demonstrate that
22 clear, quantifiable and substantial net benefits exist; 3) that Arizona-American
23 should file a report comparing the number of customer complaints received by
24 the Commission under its ownership 13 months after the closing; 4) that
25 Citizens' advances and contributions in aid of construction, which Citizens will
26 retain, should be imputed to Arizona-American; 5) that Arizona-American be

1 required to seek Commission approval of any amendment to, or transfer of the
2 agreements for the purchase of Colorado River water, and 6) that Arizona-
3 American adopt and utilize the rates and charges and all tariffs currently in
4 effect in each of the affected Citizens service areas. I agree with all of Ms.
5 Jaress's conditions except for condition 4. I do not believe that the
6 Commission should impute Citizens' advances and contributions to Arizona-
7 American, artificially reducing rate base, when Citizens will remain responsible
8 for refunding pre-existing advances.

9 In addition, I would like to note that our agreement to defer any decisions
10 on certain issues until Arizona-American seeks new rates in a future proceeding,
11 does not mean that we agree with these conditions. For example, we believe
12 that imputing the deferred income taxes and investment tax credits of a prior
13 owner to Arizona-American in a future rate proceeding would result in a
14 violation of IRS normalization rules. Nonetheless, we agree with Staff that the
15 issue can be addressed in the next rate proceeding.

16 Q. Please explain why you believe the Commission should not impute Citizens'
17 advances and contributions in aid of construction to Arizona-American.

18 A. As I stated in response to RUCO data request 1.10, Arizona-American is
19 purchasing all the water and wastewater assets of Citizens in Arizona. Arizona-
20 American is not assuming any of the liabilities of Citizens related to these
21 assets, except for one series of Industrial Development Revenue Bonds
22 ("IDRBs"). The agreement between Citizens and Arizona-American was based
23 on arms-length negotiations, taking into account market conditions for the value
24 of the assets. Arizona-American believes that it should be allowed to earn a fair
25 return on its investment in those assets.

26

- 1 Q. Do you agree with Ms. Jaress' contention that rates will increase significantly if
2 Citizens' advances and contributions are not recognized by Arizona-American?
- 3 A. No. The flaw in Ms. Jaress' contention is that she is considering only the effect
4 of one aspect of the transaction while ignoring other significant aspects. A
5 utility's rates are set in a case-by-case basis, based on the utility's "fair value"
6 rate base, operating expenses, capital costs and other circumstances during an
7 historic test year, with appropriate proforma adjustments. When Arizona-
8 American seeks new rates in a future rate proceeding, those rates will
9 necessarily depend on a number of different factors. The impact of eliminating
10 Citizens' advances and contributions may be offset by changes in operating
11 expenses, capital costs and other operating efficiencies, as well as changed
12 circumstances and regulatory developments. It is overly simplistic to assume
13 that rates will automatically increase, as Ms. Jaress has done.
- 14 Q. If the Commission were to agree with Ms. Jaress that some imputation of
15 advances and contributions should be made, do you agree with Ms. Jaress's
16 recommendation that the advances in aid of construction be amortized over a
17 10-year period?
- 18 A. No. I believe that Ms. Jaress has failed to consider all the related facts
19 regarding Citizens' advances. Ms. Jaress has based her recommendation on the
20 fact that many main extension agreements in Arizona use 10 years as the
21 refund period, based on the minimum requirement in A.A.C. R14-2-406.
22 However, the contracts related to the advances Citizens has received have been
23 in place for varying periods of time and have varying terms and conditions.
24 Some of these contracts have refund periods that will expire in one year and
25 others may have just been executed and the refund period will not expire for 10
26 years.

1 Q. How would you recommend that the amortization period be determined?

2 A. I believe that the amortization period should be determined based on a weighted
3 average of the remaining refund period under the contracts that Arizona-
4 American will not assume.

5 Q. Have you estimated that weighted average?

6 A. Yes. The weighted average remaining life for the current advance contracts as
7 of June 30, 2000 is approximately 6.5 years. Therefore, I believe that the
8 appropriate period that should be used is 6.5 years.

9 Q. What amortization period does Ms. Jaress propose for contributions in aid of
10 construction?

11 A. With respect to contributions, Ms. Jaress proposes an amortization period equal
12 to the remaining period used for depreciation purposes, i.e., the asset's
13 remaining useful life. Given that the imputation proposed by Ms. Jaress is
14 intended to artificially reduce Arizona-American's rate base, notwithstanding our
15 actual investment in Citizens' utility plant and assets, I see no reason not to use
16 the same amortization period for contributions – 6.5 years.

17 Q. Does this complete your rebuttal to Staff?

18 A. Yes, it does.

19 **III. REBUTTAL TO RUCO.**

20 Q. Please state the conditions concerning the transfer of Citizens' utility plant and
21 assets proposed by Mr. Fox.

22 A. Mr. Fox has proposed seven conditions that should be placed on the transfer of
23 Citizens' assets to Arizona-American: 1) that the transaction be made
24 contingent on restructuring the agreement negotiated between Citizens and
25 Arizona-American to "compensate" ratepayers fully for the loss in economic
26 value due to the "loss" of advances and contributions; 2) that the transaction

1 be contingent on restructuring the agreement negotiated between Citizens and
2 Arizona-American to compensate ratepayers fully for the "loss" in economic
3 value due to the retention by Citizens, if applicable, of any low-cost debt, i.e.,
4 Citizens' IDRBs; 3) that the gain on sale received by Citizens be divided equally
5 between the ratepayers and Citizens; 4) that the amount of any acquisition
6 adjustment be determined and authorized in the context of Arizona-American
7 next general rate proceeding and that this adjustment to rate base be based on
8 a formula (to which he refers in his recommendations); 5) that Arizona-
9 American be required to invest no less than 15% of the final purchase price paid
10 to Citizens in "resource stressed" water and/or wastewater utilities in Arizona;
11 6) that Arizona-American and Citizens jointly file documentation for various
12 items once the transaction has closed, and 7) that Arizona-American's request
13 for an Accounting Order approving an amortization method for any acquisition
14 premium be denied. I fully agree with condition 6, and partially agree with
15 conditions 4 and 7.

16 Q. Please state your partial agreements with his fourth and seventh conditions.

17 A. I agree that the rate-making treatment of the acquisition adjustment should be
18 determined in Arizona-American's next rate proceeding. I do not agree with his
19 suggested formula, or even with the concept that a specific formula should be
20 established in this proceeding. With respect to Mr. Fox's seventh condition, I
21 agree that the Commission should not, in this proceeding, approve a specific
22 amortization method of the acquisition adjustment. However, the request
23 should not be denied. It should instead be deferred until Arizona-American's
24 next rate proceeding.

25 Q. Please state your disagreement with Mr. Fox's condition 1.
26

1 A. Mr. Fox believes Citizens' sale of its assets should be conditioned on what he
2 terms full ratepayer "compensation" for the economic "loss" resulting from
3 Citizens' retention of advances and contributions in aid of construction.
4 However, he has not considered impact of the repayment stream for the
5 advances that would have normally occurred had the advances been assumed
6 by Arizona-American. In addition, he has not considered any impacts that
7 retention of the advances and contributions by Citizens will have on future
8 deferred taxes. He has also not recognized the potential synergies that Arizona-
9 American may provide to customers, except in his proposed formula. Again, as
10 stated above, Arizona-American is purchasing the utility plant and assets of
11 Citizens in Arizona based on a contract negotiated in good faith based on
12 current market conditions.

13 Like Ms. Jares, Mr. Fox seems to be ignoring the nature of the underlying
14 transaction. In summary, Citizens has decided to divest itself of all of its utility
15 systems and operations except for telecommunications. Citizens therefore
16 placed its utility plant, assets and property on the market. Arizona-American, in
17 an arms-length transaction, has agreed to purchase those assets on terms and
18 conditions that were negotiated between the parties. When the transaction
19 closes, Arizona-American will pay Citizens approximately \$230 million for
20 Citizens' water and wastewater plant, assets and other property in Arizona.
21 Arizona-American's investment in that plant will therefore be approximately
22 \$230 million. This is not a situation in which affiliated entities are transferring
23 the ownership of property in order to inflate rate base. Arizona-American will
24 have a real investment in that plant, and it is entitled to a return on that
25 investment.

26

1 Q. Doesn't Mr. Fox maintain that the transaction is not in the "public interest"
2 because Arizona-American's rate base will not be the same as Citizens' current
3 rate base?

4 A. Yes. However, I believe Mr. Fox's analysis is erroneous. In effect, what he
5 argues is that Arizona-American's future rate base is likely to be greater than
6 Citizens' historic, recorded rate base and, therefore, rates are likely to increase.
7 According to Mr. Fox, if the acquiring entity is likely to have a higher rate base
8 and, as a result, rates may increase in the future, then the transaction is not in
9 the "public interest" and should not be approved. Mr. Fox has provided no
10 authority for this position in his testimony, nor did RUCO provide any authority
11 in response to data requests that we served.

12 The relevant statute, A.R.S. § 40-285, requires that a public service
13 corporation - a utility - obtain Commission approval prior to selling,
14 encumbering or otherwise transferring utility plant or property that is used or
15 necessary for the provision of service. This statute appears to be intended to
16 ensure that the ability of the transferring utility to furnish service is not
17 impaired. It does not indicate that future changes in a utility's rate base should
18 be a determining factor, particularly when, as in this case, the utility has
19 decided to sell all of its utility plant. Arizona-American's rate base, including
20 any acquisition adjustment, should be determined during its next rate case, and
21 not in this proceeding.

22 Q. Does Mr. Fox contend that Arizona-American is incapable of providing safe,
23 adequate and reliable water and wastewater service if the transaction is
24 approved?

25 A. No, nor could he. Arizona American has the experience, expertise and
26 resources to satisfy Citizens' public service obligations.

1 Q. Applying Mr. Fox's analysis, what would happen if Citizens elected to sell a
2 portion of its utility plant to a municipality?

3 A. I assume that RUCO would urge the Commission to disapprove the transaction
4 unless the same terms and conditions Mr. Fox has proposed in this case were
5 applied to that transaction.

6 Q. Are you aware of any case in which the Commission has imposed conditions
7 and requirements like those recommended by Mr. Fox on a municipality's
8 acquisition of a private utility's plant and system?

9 A. No. I should note that in a data request, we asked RUCO to explain the basis
10 on which the Commission may refuse to allow a public service corporation to
11 sell its utility plant to a municipality. RUCO refused to answer that data request
12 on the grounds that it was not necessarily calculated to lead to the discovery of
13 admissible evidence.

14 Q. On page 7 of his direct testimony, Mr. Fox accuses Arizona-American of
15 deliberately structuring the transaction to eliminate advances, increase rate
16 base, and increase rates, thereby causing customers to subsidize "non-
17 economical development" and to "pay twice" for plant financed by advances.
18 Is this testimony accurate?

19 A. No. First, as I have already explained, the terms of the purchase agreement
20 were the product of arms-length negotiations between unrelated entities. Mr.
21 Fox's suggestion that Arizona-American deliberately structured the transaction
22 to increase rate base is absurd. Again, Arizona-American will invest
23 approximately \$230 million in purchasing the utility plant and assets from
24 Citizens. Under fundamental rate-making principles, a utility is entitled to earn a
25 reasonable return on its investment. This is not some sort of phantom
26

1 transaction intended to artificially inflate rate base, as Mr. Fox erroneously
2 suggests.

3 Second, his contention that existing customers are "paying twice" for plant
4 originally financed by advances is wrong. Mr. Fox apparently assumes that all
5 amounts advanced by a developer are automatically passed through to new
6 home buyers in the form of higher home prices. However, this view is overly
7 simplistic, and may or may not be accurate depending on a variety of
8 circumstances. Ultimately, the price of a home depends on any number of
9 market-driven factors. Assuming, for the sake of argument, that a component
10 of the price of the home, say \$1,000, is attributable to advances in aid of
11 construction paid by a developer to Citizens, it is erroneous to argue that the
12 home buyer is "paying" for utility plant – he is simply buying a home at a price
13 based on the current market for homes in that area.

14 Q. Accepting Mr. Fox's erroneous premise for the moment, it would seem that the
15 home buyer will eventually be re-paid that \$1,000, plus a return on his
16 investment.

17 A. If one accepts Mr. Fox's premise, that is correct. If Mr. Fox purchases a home
18 in 1990 for \$100,000 and then sells the home in 2000 for \$150,000, he has
19 received a return of \$50,000 in his investment, a portion of which return would
20 be attributable to the \$1,000 for advances that the developer included in the
21 original price of Mr. Fox's home. Mr. Fox is not required to share the return
22 with the developer or with the utility.

23 This example highlights the fundamental problem with Mr. Fox's argument.
24 The infrastructure and other improvements installed or paid for by a developer
25 may affect the price of a home, but also increase the home's value and
26 marketability. A home located in an unimproved area, with gravel roads, no

1 sidewalks, no parks and other amenities, and no water and wastewater services
2 is likely to be less expensive than a home in, for example, Sun City Grand or
3 Anthem. By the same token, a home in Anthem may well appreciate in value
4 far more quickly and ultimately provide its owner a higher return on his
5 investment than a home in an unimproved area. Mr. Fox's oversimplistic
6 analysis ignores this aspect of the real estate market.

7 Q. Are there any other flaws in Mr. Fox's analysis?

8 A. Yes. His contention that customers are somehow "paying twice" is
9 inconsistent with fundamental rate-making principles. Advances and
10 contributions in aid of construction are excluded from a utility's rate base
11 because the utility has not made an investment in those facilities. In other
12 words, if the cost of constructing a main is paid by a developer, the utility has
13 no investment in that main and, therefore, is not entitled to earn a return on the
14 main. Advances and contributions in aid of construction are thus deducted
15 from rate base because the utility has no investment in the plant financed by
16 means of advances and contributions, in contrast to plant financed by debt or
17 equity. Advances and contributions are not deducted based on the belief that
18 customers might "pay twice" because the sales price of a house may reflect the
19 developer's infrastructure costs.

20 In this case, Arizona-American will have an investment in utility plant and
21 property equal to approximately \$230 million. As stated, this is a real
22 investment resulting from an arms-length transaction. It will be financed initially
23 by short-term debt and, ultimately, by a mixture of long-term debt and equity.
24 Arizona-American should be allowed to earn a return on that investment.

25 Q. Are there other areas in Mr. Fox's analysis of the effects of Citizens retaining
26 the advances and contributions with which you disagree.

1 A. Yes. Mr. Fox in his Direct Testimony has calculated a revenue impact related to
2 the elimination of Citizens advances and contributions from rate base. I believe
3 that he has made mistakes in both his calculations and the assumptions he has
4 used. First, he has assumed a depreciation rate of 4% on plant financed by
5 advances and contributions. When asked to provide the basis for that assumed
6 depreciation rate, RUCO simply stated that it was an assumption, i.e., no basis
7 exists. Given the type of utility plant normally constructed under a main
8 extension agreement, the use of a 4% depreciation rate is excessive.

9 Second, Mr. Fox has miscalculated the gross-up factor related to operating
10 income. He has assumed a gross-up factor of 1.5, again without any
11 explanation or support for that figure.

12 Lastly, Mr. Fox has not considered the gross-up effect on the accumulated
13 deferred taxes related to the advances and contributions. The accumulated
14 deferred tax needs to be deducted from the total advances and contributions
15 before calculating the revenue requirement.

16 Q. Please state your disagreement with Mr. Fox's condition 2.

17 A. Mr. Fox has recommended that the transaction be made contingent on the
18 recognition of the "loss" in economic value due to Citizens retention of the low-
19 cost IDRBs. This recommendation is illogical. Arizona-American will finance
20 this entire transaction with the lowest cost capital structure available.
21 However, the IDRBs that Arizona-American will not assume are bonds that
22 require unanimous consent for a transfer. The bonds that Az-Am will assume
23 are re-marketed on a weekly basis, so it is easy to accumulate all the bonds in
24 the hands of one investment banker on a particular re-marketing date. The
25 banker, as the bondholder, would then vote in favor of the assumption, and re-
26 market the bonds on the next day. However, the fixed rate bonds that Citizens

1 is retaining do not provide for weekly re-marketing and would require us to
2 contact every bondholder to obtain unanimous consent, which would be
3 administratively difficult, if not impossible, within the timeframe of the
4 transaction.

5 Q. Please state whether you agree with Mr. Fox's condition 3.

6 A. No, I do not. The formula Mr. Fox has proposed for recognition of the
7 acquisition adjustment contains a sharing proposal. The formula would provide
8 the ratepayers with 50% of any allowed acquisition premium. In addition, Mr.
9 Fox also proposes that 50% of Citizens' gain from the sale of its property be
10 refunded to ratepayers. This does not make any economic sense. It is Citizens
11 and Arizona-American who are at risk in this matter for recovery of their past
12 and future investments. The ratepayers bear no risk for the investments made
13 by others to provide service. Corporations rely on their ability to pay a
14 reasonable return to their investors, and that includes a return for the past
15 investment and past risks for investing in the utility. Divestiture of holdings
16 provides the investors with recovery of past forgone returns and the loss of
17 future possible earnings.

18 Q. Please state your disagreement with Mr. Fox's formula as stated in his
19 recommendations as part of condition 4.

20 A. I have serious concerns about Mr. Fox's formula. First, as stated in my
21 response above, Mr. Fox not only has requested that any proven synergy
22 savings be shared with ratepayers, but he has recommended that the gain on
23 sale as recognized by Citizens be shared with the ratepayers. This would
24 provide the ratepayers with a substantial windfall which could possibly exceed
25 the total gain.
26

1 Second, the formula does not consider synergies that are unrelated to raw
2 changes in expenses. The formula proposed by Mr. Fox only considers savings
3 that can be proven relative to historic expenses. Rates that customers must
4 pay are driven not only by reasonable operating expenses, but also by the
5 utility's investment in utility plant to serve the customers. Mr. Fox, in his
6 proposed formula, does not provide any recognition of the savings that may be
7 realized through lower costs of capital and for savings resulting from Arizona-
8 American's ability to construct plant at a lower cost. Savings in construction
9 costs directly reduce rate base.

10 Third, Mr. Fox has not considered the effects of refunds that will be made
11 by Citizens regardless of this transaction. Mr. Fox has proposed to use the
12 balance of Citizens' advances and contributions as they existed at December
13 31, 1999, ignoring the fact that as refunds are made, advances are reduced and
14 rate base increases. Thus, he overstates the future ratepayer benefit associated
15 with plant funded by advances and contributions. This proposed treatment of
16 advances and contributions would impair Arizona-American's future earnings
17 potential on these assets.

18 Finally, Mr. Fox has not considered any of the impacts of inflation or
19 mandated changes in operation that would cause changes in expenses
20 regardless of who operates the water and wastewater systems. Mr. Fox has
21 proposed that test year expenses be compared to Citizens' recorded 1999
22 expenses. The only variance that he proposes is for customer growth. There
23 are far too many variables to compare only recorded expense levels. For
24 example, if the EPA imposes new guidelines on the level of a certain
25 contaminant (e.g., arsenic or radon) and the removal of that contaminant causes
26 increases in operating expenses, Mr. Fox's proposed formula would not consider

1 those circumstances. His proposed formula would consider the new expense to
2 be a negative synergy caused by Arizona-American's acquisition of the Citizens'
3 water and wastewater assets, which would clearly not be the case.

4 Q. Do you have any other comments about Mr. Fox's statements concerning an
5 acquisition adjustment?

6 A. Yes. Mr. Fox has said he is relying on FAS 71 in stating that Arizona-American
7 should immediately expense any acquisition adjustment. This interpretation of
8 FAS 71 is incorrect. FAS 71 basically states that the accounting for any asset,
9 deferred or otherwise, must be viewed in the context of a possible impairment.
10 In the case of an acquisition adjustment, the National Association of Utility
11 Regulatory Commissioners (NARUC) Uniform System of Accounts requires that
12 an acquisition adjustment be recorded in the utility books and records. FAS 71
13 would only require different accounting treatment if the asset was deemed to be
14 impaired in accordance with generally accepted accounting principles for
15 enterprises in general. Mr. Fox is correct in his statement that to record a
16 deferred asset related to an expense, the utility must have probable assurance
17 that the public utility commission will allow the recovery of the asset in rates.
18 However, an acquisition adjustment is not an expense: it is an investment in the
19 utility.

20 Q. Please state your disagreement with Mr. Fox's condition 5.

21 A. This item will be addressed in the rebuttal testimony of Mr. Daniel Kelleher.

22 Q. Please state your disagreement with Mr. Fox's condition 7.

23 A. As noted above, I agree that this item should be deferred until Arizona-
24 American's first rate case, but it should not be denied at this time. If the
25 Commission defers consideration of the appropriate treatment of the acquisition
26 adjustment until a general rate proceeding, as both Staff and RUCO recommend,

1 then determination of the amortization method for that adjustment should also
2 be deferred.

3 Q. Is Arizona-American withdrawing its request that the Commission approve a
4 mortgage amortization method of accounting?

5 A. No, but we agree that accounting consideration should be postponed until
6 Arizona-American's first rate case.

7 Q. Have you estimated the financial effects of RUCO recommendations in this
8 case?

9 A. I have made a very rough estimate based on the cursory explanations Mr. Fox
10 has provided in its testimony. I have based my estimate on a sales price of
11 \$231 million, net plant of \$168 million, deferred taxes of \$5 million, AIAC and
12 CIAC of \$86 million, ITC of \$2 million, \$4 million in expense synergies, \$8
13 million in annual capital synergies and a requirement for Arizona-American to
14 invest \$35 million in "resource stressed" utilities. Based on these facts, the
15 ratepayers would: 1) receive a cash rebate of \$78 million, 2) have rates
16 reduced by the expense reduction of \$4 million, and 3) have rates annually
17 reduced by \$1.2 million due to the revenue requirement on the annual capital
18 savings of \$8 million. Citizens would have \$55 million less in cash to invest in
19 rural telecommunications systems in Arizona. Arizona-American would: 1) be
20 forced to earn on a rate base of \$75 million (approximately one-third of its
21 actual investment), 2) have to invest approximately \$6 million annually for six
22 years in troubled utilities with little chance of any return, and 3) receive no
23 credit for expenses saved or any capital savings provided to customers. In
24 total, Arizona-American would be earning on a rate base that may be as little as
25 30% of its actual investment, which may not be high enough to cover its debt
26 service requirements. I have not considered the effects of RUCO's imputation

1 of the IRDB's into the capital structure. The imputation would further reduce
2 Arizona-American's net income and coverages.

3 Q. In your opinion, who would benefit by RUCO's recommendations?

4 A. No one would benefit from a transaction that would result in negative net
5 income for Arizona-American. In reality, ratepayers would be harmed in the
6 long run because they would be served by a financially-impaired utility.

7 Q. Does this conclude your rebuttal to the RUCO?

8 A. Yes it does.

9 **IV. RECOMMENDATIONS.**

10 Q. What are your recommendations in this matter.

11 A. I recommend that the Commission approve the transfer of Citizens' water and
12 wastewater utility plant, assets and CC&Ns to Arizona-American. The transfer
13 should be based on the following conditions:

- 14 (1) That the Commission should address the regulatory treatment of Arizona-
15 American's acquisition adjustment, deferred taxes, excess deferred taxes
16 and investment tax credits in a future rate proceeding.
- 17 (2) That the decision to allow the recovery of any acquisition adjustment
18 should be based on Arizona-American's ability to demonstrate that clear,
19 quantifiable and substantial net benefits exist, as recommended by Staff.
- 20 (3) That Arizona-American should file a report comparing the number of
21 customer complaints received by the Commission under their ownership to
22 those received by Citizens prior to the transaction 13 months after the
23 transaction is concluded, as recommended by Staff.
- 24 (4) That Arizona-American should be required to seek Commission approval of
25 any amendment to, or transfer of, agreements to purchase Colorado River
26 water, as recommended by Staff.

1 (5) That Arizona-American should be authorized to charge the rates and
2 charges, and to provide service under the Citizens' tariffs currently in effect
3 in each of the affected service areas.

4 (6) That Arizona-American and Citizens should be required to jointly file
5 documentation of the final purchase price, net book value of the assets
6 sold at the time of the transaction, the amount of the gain/premium, the
7 date of the transfer, and supporting documents, as recommended by Staff.

8 (7) That Arizona-American's request for an accounting order to establish the
9 amortization method for the acquisition adjustment should be deferred until
10 Arizona-American's first general rate case.

11 Q. Does that conclude your rebuttal testimony?

12 A. Yes, it does.

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