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Arizona Corporation Commission

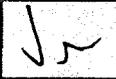
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3 WILLIAM A. MUNDELL
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AZ CORP COMMISSION
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BEFORE THE ARIZONA CORPORATION COMMISSION

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.

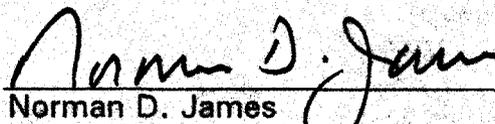
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**ARIZONA-AMERICAN WATER
COMPANY'S NOTICE OF FILING
SUMMARIES OF PRE-FILED
TESTIMONY**

17 Arizona-American Water Company hereby files its summaries of the pre-filed
18 testimony of Daniel L. Kelleher, Joseph F. Hartnett, Jr., and David P. Stephenson
19 in support of the Joint Application in the above-entitled docket.

20 DATED this 25th day of September, 2000.

21 FENNEMORE CRAIG

22 By 
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Attorneys for Arizona-American Water
Company

1 An original and 10 copies of the
2 foregoing and the summaries
3 described above was delivered this
4 20th 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 summaries described above
11 was delivered this 21st day of
12 September, 2000, to:

13 Carl J. Kunasek, Chairman
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9 A copy of the foregoing and the
10 summaries described above
was telecopied and mailed this 25th
day of September, 2000, to:

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26

**ARIZONA-AMERICAN WATER COMPANY AND
CITIZENS COMMUNICATIONS COMPANY**

**JOINT APPLICATION FOR TRANSFER OF ASSETS
DOCKET NOS. W-01032A-00-0192, ET AL.**

**SUMMARY OF PRE-FILED TESTIMONY OF ARIZONA-AMERICAN WATER
COMPANY'S WITNESSES**

1. Daniel L. Kelleher.

Daniel L. Kelleher has submitted both direct and rebuttal testimony on behalf of Arizona-American Water Company ("Arizona-American") in support of the application. Mr. Kelleher is Senior Vice President of American Water Works Service Company, Inc., and is 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 provided to the subsidiaries and affiliates of AWW, including Arizona-American.

Direct Testimony. In his direct testimony, Mr. Kelleher generally describes the nature of the transaction between Citizens Communications Company (formerly known as Citizens Utilities Company) and Arizona-American, as well as the general business and operations of AWW, which currently has 23 subsidiaries operating in 22 states that serve approximately 10 million people. Mr. Kelleher also discusses AWW's acquisition strategy and the rationale behind that strategy, including the challenges currently facing the water industry in the United States. These challenges include the need for massive investment in water and wastewater infrastructure over the next 20 years as a consequence of aging plant and the imposition of new regulatory requirements under the Safe Drinking Water Act, Clean Water Act and other government programs. Mr. Kelleher also explains that the water industry is both highly fragmented and is capital intensive. These conditions result in severe pressure on the water industry to increase its ability to attract capital at a reasonable cost as well as the industry's technical and operating capabilities.

Mr. Kelleher also discusses, in his direct testimony, AWW's policy of pursuing consolidation through mergers and acquisitions, which is an integral part of AWW's long-term, strategic planning, and how the acquisition of Citizens' water and wastewater assets are integral to AWW's strategic planning. Mr. Kelleher then addresses the benefits that are anticipated to result from the acquisition of Citizens' water and wastewater assets, which include:

- Long-term cost savings through the achievement of improved economies of scale and operating efficiencies.
- A consolidated management structure.
- A combined entity that will be in a better position to participate in the ongoing water industry consolidation.

- An enhanced ability to attract capital at a reasonable cost.
- The combined entity will be better equipped to handle emergencies and other circumstances requiring substantial resources and expertise.
- The combined entity will focus solely on providing water and wastewater services, with a commitment to provide high-quality service at a reasonable cost.

Mr. Kelleher concludes his direct testimony by discussing the substantial level of investment that AWW and its subsidiaries have made in water utility plant during the past decade, including, for example, more than \$467 million in construction expenditures in 1999 alone. AWW is committed to making the investments necessary to provide quality water and wastewater service that complies with all applicable regulatory requirements.

Rebuttal Testimony. Mr. Kelleher's rebuttal testimony addresses RUCO's recommendation that approval of the transfer of Citizens' water and wastewater assets in Arizona be conditioned on Arizona-American's Board of Directors approving a letter pledging to invest an amount not less than 15 percent of the purchase price for Citizens' assets in acquisitions and capital improvements of "resource stressed" water and/or wastewater utilities no later than 72 months after the date the transaction is authorized. In his rebuttal testimony, Mr. Kelleher explains why this recommendation is inappropriate and should not be adopted. Among other things, Mr. Kelleher points out that RUCO's proposal is extremely vague and fails to provide any detail regarding how it would actually work. The regulatory treatment that Arizona-American would receive under this recommendation is not explained, nor are any examples of "resource stressed" utilities that may be appropriate candidates provided. Given the extremely vague and uncertain nature of how this proposal would work, it appears that it is intended by RUCO to operate as a penalty that would create substantial disincentives to the acquisition and consolidation of water systems in Arizona. Mr. Kelleher also reiterates Arizona-American's willingness to work with the Commission and with local governments in Arizona, as other subsidiaries of AWW have done in other states, to deal with particular problems and issues. Unfortunately, the financial conditions that RUCO would attach to this transaction are so extreme that water industry consolidation and assistance to smaller companies would be discouraged.

2. **Joseph F. Hartnett, Jr.**

Joseph F. Hartnett, Jr., has submitted direct testimony on behalf of Arizona-American in support of the application. Mr. Hartnett is employed by American Water Works Service Company ("Service Company") as Vice President – Finance. He also serves as the Treasurer of AWW.

Direct Testimony. In his direct testimony, Mr. Hartnett describes the process that led to AWW's decision to purchase all of the water and wastewater utility plant, property and related assets of Citizens, which began in May 1999, after Citizens disclosed, in a filing with the Securities and Exchange Commission, that they planned to sell their public service businesses, including their water and wastewater utility assets, and to concentrate on telecommunications.

Mr. Hartnett summarizes the discussions and negotiations that took place between representatives of AWW and Citizens, explaining that these negotiations were at arm's-length. Both parties relied on their own financial and legal advisors, and there are no pre-existing business relationships between Citizens and AWW. The purchase price for all of the water and wastewater assets to be acquired from Citizens is \$835 million, of which approximately \$231 million is the purchase price for the water and wastewater assets being acquired in Arizona.

3. **David P. Stephenson.**

David P. Stephenson has submitted both direct and rebuttal testimony on behalf of Arizona-American in support of the application. Mr. Stephenson is employed by American Water Works Service Company, Inc., as the Director of Rates and Revenues for the Western Region of AWW. The Western Region is comprised of water and wastewater utilities located in Arizona, California, Hawaii and New Mexico, including Arizona-American. Mr. Stephenson also serves as Assistant Treasurer for Arizona-American, and has testified on a number of occasions in proceedings before the Commission as well as proceedings before public utility commissions in other states.

Direct Testimony. In his direct testimony, Mr. Stephenson provides a brief overview of the transaction between Citizens and AWW, and explains the method of allocating the purchase price to be paid for all of the water and wastewater assets being acquired by the AWW operating utilities in the six states that are involved in the transaction and the methodology used to account for the difference between the purchase price to be paid by Arizona-American for the water and wastewater assets being acquired in Arizona and the book value of those assets.

Mr. Stephenson also discusses the treatment of the difference between the purchase price to be paid for the water and wastewater assets and the asset balances, as shown on Citizens' combined balance sheet for its operating divisions and subsidiaries in Arizona. Arizona-American will record an acquisition adjustment in accordance with the Uniform System of Accounts. However, Arizona-American is not requesting any recognition of this acquisition adjustment in rate base or other recovery of the adjustment in rates at this time. Instead, Arizona-American is requesting that the determination of the appropriate treatment of the acquisition adjustment for ratemaking purposes be deferred until Arizona-American's next general rate proceeding, in accordance with the Commission's normal practice. Mr. Stephenson also discusses Arizona-American's proposed amortization of the acquisition adjustment, including its request that a forty-year amortization period be utilized and that a "mortgage" method of amortization be used rather than a straight-line method.¹

Finally, Mr. Stephenson discusses the preliminary analysis of the savings expected to result from Arizona American's acquisition of Citizens' water and wastewater assets and Arizona-American's subsequent operation of Citizens' water and wastewater systems in Arizona ("the Synergy Analysis"). Mr. Stephenson explains that Arizona-American estimates total synergy savings of approximately \$960 million over a forty-year period, and further anticipates

¹ In his rebuttal testimony (summarized below), Mr. Stephenson has indicated, on behalf of Arizona-American, that the determination of the appropriate amortization method should also be deferred until Arizona-American's next general rate proceeding.

that those savings will exceed the impact on rates resulting from the recovery of the acquisition adjustment over of the same forty-year period. Mr. Stephenson notes that the Synergy Analysis is based on the latest information available and that actual savings will be more fully developed and quantified after the transaction is closed and Arizona-American is able to fully integrate the Citizens' water and wastewater assets into its operations. It will necessarily take time to realize the full savings potential, as integration of Citizens' systems and operations into AWW takes place. However, as explained by Mr. Stephenson, Arizona-American believes that, on a cumulative basis, the projected synergy savings will ultimately be realized.

Rebuttal Testimony. Mr. Stephenson's rebuttal testimony addresses the recommendations made by the Utilities Division of the Commission ("Staff") as well as RUCO pertaining to the application in their respective direct testimony. With respect to the direct testimony of Staff, Arizona-American has agreed to accept all of the recommendations made by Staff, with the sole exception that all of Citizens' advances and contributions in aid of construction should be artificially imputed to Arizona-American. Under the transaction between Arizona-American and Citizens, Citizens will remain responsible for refunding all pre-existing advances in aid of construction – they will not be assumed by Arizona-American. The purchase price that will be paid by Arizona-American is based on Citizens remaining obligated for those advances. While the elimination of advances in aid of construction from rate base will impact Arizona-American's rate base, it is overly simplistic to assume today that Arizona-American's rates will increase as a result. A utility's rates are set on a case-by-case basis, based on the utility's "fair value" rate base, operating expenses, capital costs and other circumstances. The impact of eliminating Citizens' advances may well be offset by changes in operating expenses, capital costs and other operating efficiencies, as well as changed circumstances and regulatory developments, as Mr. Stephenson explains. Mr. Stephenson also testifies that the ten-year amortization period proposed by Staff is excessive given the fact that the remaining life of Citizens' outstanding main extension agreements and similar contracts is approximately 6.5 years. Accordingly, in the event that Citizens' outstanding advances are imputed to Arizona-American, notwithstanding the fact that Citizens will remain liable to pay refunds on those contracts, a shorter amortization period should be utilized.

Mr. Stephenson's rebuttal testimony also addresses proposals made by RUCO, the bulk of which are unacceptable and would undermine the economics of the transaction. Mr. Stephenson explains why RUCO's extreme and one-sided recommendations are illogical and are unsupported by authority. Mr. Stephenson also explains the errors that are contained in a formula proposed by the RUCO witness regarding the recognition of the acquisition adjustment in future rates. As noted by Mr. Stephenson, the RUCO formula is extremely simplistic and would ignore a variety of factors, such as synergies that are unrelated to raw changes and expenses, the impacts of inflationary forces, and mandated changes in operation and new regulatory requirements. Ultimately, as explained by Mr. Stephenson, the position taken by RUCO would, if approved, result in a substantial windfall for utility customers while forcing Arizona-American to earn on a rate base that may be as little as 30% of its actual investment. In the long run, RUCO's recommendations would harm ratepayers by impairing the ability of Arizona-American to provide safe and reliable utility service.