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AZ CORP COMMISSION
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BEFORE THE

CARL J. KUNASEK
CHAIRMAN
JIM IRVIN
COMMISSIONER
WILLIAM A. MUNDELL
COMMISSIONER

Arizona Corporation Commission
DOCKETED

OCT 11 2000

DOCKETED BY

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
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
W-01656B-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

**CITIZENS COMMUNICATIONS
COMPANY'S POST-HEARING BRIEF**

The Administrative Law Judge has left this docket open for two weeks to receive a post-hearing brief on the subject of whether gain related to the excess of Citizens' sale price over net-book value should be shared with customers. The Residential Utility Consumer Office ("RUCO") maintains that gain-sharing is appropriate. This is not a trivial claim. RUCO would wrongly extract \$35.6 million from shareholders.

In fact, Commission precedent, precedent from other commissions, and sound public policy reasons all controvert RUCO's position. The Commission's policy is that when an entire line of utility business is sold to another entity that continues the business, the seller is entitled to 100% of any gain.

1 **A. None of RUCO's Precedent Concerns Sales of Businesses**

2 Around the Country, there have been hundreds of cases where utility
3 commissions have been asked to approve sales of jurisdictional utilities, generally
4 at prices well above book value. Yet, RUCO has failed to cite a single case, either
5 here or in any other jurisdiction, where a commission has required gain sharing
6 as a condition of approving a sale. The ALJ can reasonably infer from this that
7 precedent supports the opposite view.

8 Sherlock Holmes solved a case by grasping the significance of silence. In
9 *Silver Blaze*,¹ the key clue noted by Holmes was that a stable dog did not bark
10 when it should have.

11 I had grasped the significance of the silence of the dog, for one true
12 inference invariably suggests others. The Simpson incident had shown me
13 that a dog was kept in the stables, and yet, though some one had been in
14 and had fetched out a horse, he had not barked enough to arouse the two
15 lads in the loft. Obviously the midnight visitor was some one whom the dog
knew well.² (Emphasis added).

16 This inference allowed Holmes to reason that the horse Silver Blaze had in fact
17 been stolen by the putative murder victim, John Straker, the horse's trainer.

18 Citizens cannot be certain that there is no precedent supporting RUCO's
19 position; proving a negative is always difficult. However, given the rapid pace of
20 utility sales and consolidations in the last ten years, especially in the telephone
21 and electric industries, and the absence of cited precedent, it is reasonable to
22 infer that requiring gain sharing is indeed rare.

23 **B. The Corporation Commission Allocates All Gain to Shareholders**

24 The Commission's policy is that when an entire line of utility business is
25 sold to another entity that continues the business, the seller is entitled to 100%
26 of any gain. The Commission has a different policy where a gain results from
27

28
29 ¹ Doyle, Sir Arthur Conan, Memoirs of Sherlock Holmes, Adventure 1, public domain,
<http://www.inform.umd.edu/EdRes/ReadingRoom/Fiction/Doyle/Memoirs/silver-blaze>.

² *Id.*, no page number available (emphasis added).

1 sales of discrete assets that are then removed from rate base. In that case, the
2 Commission believes that gain-sharing is appropriate.

3 In the cases cited by RUCO in this docket, and in the testimony of Marylee
4 Diaz Cortez in the Qwest asset sale docket,³

- 5 • the sales were of discrete utility assets to a non-utility entity;
- 6 • the assets did not represent a complete business;
- 7 • the assets would no longer be used or necessary in connection with
8 the provision of regulated utility service; and
- 9 • the seller utility was not disposing of its associated service territory in
10 conjunction with the asset sale.⁴

11 In this instance, the assets being sold by Citizens to Arizona American
12 represent a complete line of business, and they will continue to be used and
13 useful by Arizona American in the provision of regulated water and sewer service.
14 Moreover, Citizens will no longer be operating these businesses in the State of
15 Arizona. These facts are totally different from those in the transactions where
16 the Commission has required gain to be shared with utility customers.

17 The Commission does not require the sharing of gains on the sale of a
18 business. Focusing just on Citizens, there have been at least three cases where
19 there have been gains associated with Citizens' purchase of complete businesses.

20 In July 1991, Citizens and Southern Union Gas Company ("Southern
21 Union") signed an agreement under which Citizens purchased all of Southern
22 Union's natural gas transmission and distribution system assets in Arizona.⁵ At

23
24 ³ In The Matter Of The Joint Application Of Us West Communications, Inc. And Citizens
25 Utilities Rural Company, Inc. For Approval Of The Transfer Of Assets In Certain Telephone Wire
26 Centers To Citizens Rural And The Deletion Of Those Wire Centers From Us West's Service
27 Territory, Docket Nos. T-01051B-99-0737 and T-01954B-99-0737.

28 ⁴ The APS streetlight sale was arguably the closest circumstantially to the Citizens sale.
29 However, there were significant differences. The street lights were removed from the regulated
rate base and not included in any other rate base. Although a municipality was buying the lights,
it was not in turn offering tariffed lighting service. Residents would just get light as part of living
in the City. Further, APS would continue to sell electricity to the City to power the lights.
Effectively, APS was still providing lighting service, but without the streetlight assets.

⁵ *Joint Application of Southern Union Gas Company and Citizens Utilities Company*, Decision
No. 57647, December 2, 1991. Copy attached as Appendix A.

1 the conclusion of that transaction, Southern Union retained no further business
2 interests in the State.

3 The purchase price was reported as \$46 million, less certain working capital
4 liabilities assumed and certain pro-rations after the closing. The net book value
5 of the assets acquired was approximately \$27.6 million, producing a gain on the
6 sale of some \$17 million. The asset purchase was approved by the Commission
7 in Decision No. 57847 issued on December 2, 1991. No portion of the gain
8 realized by Southern Union was required to be shared.

9 In May 1993, Citizens and Contel of the West ("Contel") signed an
10 agreement under which Citizens purchased all of Contel's telephone properties
11 and assets located in Arizona. At the conclusion of that transaction, Contel had
12 no further telephone operations in the State. The purchase agreement contained
13 a sales price of approximately \$88.6 million, which produced a gain for Contel on
14 the transaction of approximately \$45 million. In the hearing that was conducted
15 before the Commission in response to the parties' application for approval of the
16 transaction, the Commission Staff recommended a 50-50 sharing of the gain
17 between customers and investors. According to the Staff, such sharing was
18 consistent with what it believed was the Commission's policy with respect to gains
19 realized on the sale of utility property.

20 The Commission rejected gain-sharing,⁶ referencing Contel's testimony.
21 Contel had stated that:

22 It is Contel, not the ratepayers, that is the legal owner of the tangible
23 and intangible assets being sold, and therefore, requiring Contel to
24 rebate 50% of the gain to ratepayers would constitute a
25 governmental confiscation of private property and a violation of the
constitution.

26 and
27
28

29 ⁶ *Joint Application of Contel of the West and Citizens Utilities Company*, Decision No. 58819,
October 17, 1994. Copy attached as Appendix B.

1 The Commission policy in transactions involving the sale of the
2 complete businesses, where the selling utility is exiting the state
3 subsequent to consummation of the transaction, has been to allow
4 the selling company to retain 100% of the gain.

5 Finally, in June 1999, GTE California and Citizens Utilities Rural Company
6 signed an agreement under which Citizens purchased the remaining GTE
7 telephone assets in the State of Arizona. The Commission approved the
8 transaction and did not require any gain to be shared.⁷

9 Commission precedent is that a selling utility is entitled to all gain
10 associated with the sale of an entire business to another entity that will continue
11 to use the assets to provide utility service. Mr. Dabelstein, the former Director of
12 Utilities for the Commission testified that this is the Commission's practice. RUCO
13 has offered nothing to the contrary.⁸

14 **C. The Commission does not Require Customers to Share Losses on**
15 **Sales of Assets**

16 If customers were somehow entitled to share in gain, then it would make
17 sense that customers should also share in any loss associated with the sale of a
18 utility business. But this is also not the Commission's policy.

19 In Decision No. 60167, the Commission approved the sale of Ajo
20 Improvement Company's gas business to Southwest Gas Corporation.⁹ Assets
21 with a net book value of \$1,985,517 were sold for \$700,000 -- a net loss of
22 \$1,285,517. Ajo had 828 customers. If 50% of the loss had been allocated per
23 customer, the average customer would have owed Ajo approximately \$776.¹⁰ In
24 contrast to its position in this case, RUCO did not suggest that customers had any
25 rights or responsibility concerning Ajo's loss -- the difference between the sale
26 price and net-book value.

27
28 ⁷ *Joint Application of GTE California, Inc. and Citizens Utilities Company*, Decision No. 62648,
29 June 13, 2000. Copy attached as Appendix C.

⁸ Dablestein Rebuttal Testimony, p. 9.

⁹ Copy attached as Appendix D.

¹⁰ $(\$1,285,517 / 2) / 828 = \776.28 .

1 In accordance with Commission policy, the seller, Ajo, absorbed the entire
2 loss. If Ajo had been fortunate enough to find a buyer willing to pay more than
3 book value, Commission policy would also have supported Ajo's retention of the
4 entire gain. In the sale of a utility business there is simply no nexus between a
5 seller's gain or loss and the seller's customers.

6 **D. Other Commissions also Allocate All Gain to Shareholders**

7 California has a long-standing, explicit policy -- gain on the sale of a
8 business belongs to shareholders. For example, the California Public Utilities
9 Commission ("CalPUC") recently approved the sale of the Ambler Park Water
10 Utility ("Ambler") to California-American Water Company ("CalAm").¹¹ The
11 CalPUC referenced its long-standing policy and allowed Ambler to keep all the
12 gain on the transaction:

13 Finally, we will discuss the issue of gain on sale. As discussed
14 above, Ambler's owners will receive \$55,279 above Ambler's
15 ratebase of \$276,398, i.e., the owners of Ambler will realize a
16 gain on sale of \$55,279.

17 As to the treatment of gain on sale, the Commission in D.89-07-
18 016 . . . stated that gain on sale of utility plant shall accrue to
19 the shareholders to the extent that the remaining ratepayers are
20 not adversely affected when the sale is to a public entity. That
21 same policy applies when the sale is to other than a public entity
22 "when the conveying utility was relieved of its public utility
23 obligation to serve the geographic region being conveyed." . . .
24 In this situation, the entire Ambler system is being transferred
25 and there will be no remaining ratepayers. Accordingly, the
26 entire gain on sale will be retained by Ambler's owner.¹²
27 (Citations omitted).

28 Four years earlier, the CalPUC approved the purchase by Citizens of 5000
29 access lines from GTE California, Inc. ("GTE").¹³ The CalPUC stated its rule

11 *Application of Ambler Park Water Utility and California-American Water Company*, 1998
Cal. PUC LEXIS 936 (1998). Copy attached as Appendix E.

12 *Id.*, pp. 12-13.

13 *Application of Citizens Utilities Company of California and GTE California Incorporated*,
1994 Cal. PUC LEXIS 663; 56 CPUC2d 539 (1994). Copy attached as Appendix F.

1 concerning gain on sale as follows:

2 100% of the gain accrues to shareholders in the event part or all
3 of the utility's operating system, which was formerly in ratebase,
4 is sold to a municipality or other public entity concurrent with the
5 utility being relieved of and the municipality or other agency
6 assuming the public utility obligations to the customers within
7 the areas served by the system.¹⁴

8 Unlike Citizens in this case, GTE was not subject to rate-base regulation, but was
9 instead operating under incentive, price-cap regulation. Therefore, the CalPUC
10 modified its rule so that GTE was entitled to retain all of the gain, unless the gain
11 pushed its rate of return over its 15.5% cap. In that case (deemed unlikely by
12 the CalPUC), customers would get 100% of the excess gain that caused the
13 return to exceed 15.5%.¹⁵

14 In 1992, the Illinois Commerce Commission approved the sale of Union
15 Electric Company's ("Union Electric") Iowa service area to Iowa Electric Light &
16 Power Company.¹⁶ Union Electric was allowed to retain all the gain on sale.

17 Finally, in 1983, the Missouri Public Service Commission considered the
18 gain-on-sale issue in the context of a Missouri Cities Water Company rate case.¹⁷
19 In 1982, the utility had sold of its water businesses within certain cities. The
20 issue of gain sharing was then raised in the subsequent rate case. In that case,
21 the Missouri Commission allocated all the gain to the utility's shareholders.

22 RUCO may cite a recent New York Court of Appeals case involving New York
23 Telephone Company's sale of its share of a subsidiary business, BellCore.¹⁸
24 BellCore was the former Bell Labs and was created as a result of the 1984 break-
25 up of AT&T into seven Regional Bell Operating Companies ("RBOCs"). Each of the

26 ¹⁴ *Id.*, pp. 17-18. This also applies when the purchaser is a regulated utility.

27 ¹⁵ *Id.*, p. 25.

28 ¹⁶ *Petition of Union Electric Company*, 1992 Ill. PUC Lexis 427 (1992). Copy attached as
Appendix G.

29 ¹⁷ *Application of Missouri Cities Water Company*, 1983 Mo. PSC Lexis 53, 26 Mo. P.S.C. (N.S.)
1 (1983). Copy attached as Appendix H.

¹⁸ *New York Telephone Co. v. Public Service Comm. of New York*, 731 N.E.2d. 1113 (2000).

1 RBOCS had a share of BellCore. The RBOCs decided to dispose of BellCore and
2 New York Telephone applied to the New York Public Service Commission ("PSC")
3 for approval of the disposition.

4 The New York PSC held, and the Court of Appeals ultimately upheld, that
5 customers were entitled to the intrastate portion of the gain associated with the
6 sale. Their reasoning was that New York customers had paid rates to New York
7 Telephone that were functionally equivalent to rates that would have resulted
8 from having the BellCore assets in rate base and associated expenses recovered
9 through rates. Because they were effectively being removed from rate base, the
10 New York PSC reasoned that customers should receive the gain associated with
11 the sale of the "assets." Again, this is distinguishable from our case. Nothing is
12 being removed from rate base as a result of the sale.

13 Citizens' search for state utility commission decisions on the issue of gain
14 on sale has not been exhaustive. But what is perhaps most surprising from even
15 a limited but diligent search -- given the huge number of recent utility business
16 sales -- is how rarely the issue actually comes up. The logical inference is that
17 the applicants routinely ask for and are allowed to retain 100% of the gain.
18 Because the utilities contributed the capital that created the assets, the result is
19 good policy and expected. Further, when the issue has been raised by
20 commission staffs or intervenors, the commissions have followed the California
21 rule: "100% of the gain accrues to shareholders in the event part or all of the
22 utility's operating system, which was formerly in ratebase, is sold to a
23 municipality or other public entity [or to a regulated entity]."¹⁹

24 **E. Customer Rates Should be Unaffected by the Sale of a Business**

25 The sale or premature retirement of a discrete asset from rate base means
26 that the asset will no longer be available to serve customers. In contrast, the
27 sale of a business means that the assets are still in service. The same pipes,
28

29 ¹⁹ *Application of Citizens Utilities Company of California and GTE California Incorporated*,
1994 Cal. PUC LEXIS 663; 56 CPUC2d 539 (1994), pp. 17-18.

1 meters, and stations will be providing customer service the day after the
2 transaction closes, as were in service the day before. Rate base for the acquiring
3 utility should be exactly the same the day after a sale closes as the day before.

4 Market value for a company's assets is always likely to be different than
5 rate base. Market value is based upon a willing buyer's perception of the present
6 value of expected net revenues to be generated by the acquired assets. These
7 forecasted revenues will be received, to the extent reality matches expectations,
8 from future customers. Present customers have no vested interest in those
9 future revenue opportunities.

10 Market value may be more or less than rate base, but it is irrelevant to rate
11 making. Arizona rates are constitutionally based on fair value, which is unrelated
12 to market value. In rate cases, rate base is neither marked up to reflect
13 increases in market value, nor marked down to reflect decreases. If RUCO were
14 consistent, it would have to agree that customers should compensate the selling
15 utility if it were to sell its business for less than book value. As shown in Section
16 C, above, RUCO has not been consistent. Apparently RUCO's position is that if
17 there is a gain, customers should get one-half, but if there is a loss, the selling
18 utility should absorb it all. This is tails-I-win, heads-you-lose, thinking.

19 **F. Gain-Sharing is not in the Public Interest**

20 The North Carolina Utilities Commission at one time required customers to
21 receive a portion of the gain associated with the sale of a utility business. That
22 commission recently reversed this position purely for public policy reasons.²⁰

23 In 1990, the North Carolina Commission adopted a policy that gain should
24 be split between the selling utility and its customers.²¹ In 1995, the North
25 Carolina Commission considered the application of Carolina Water Service to sell
26 its water-utility business to the City of Charlotte, North Carolina. The North
27

28 ²⁰ *North Carolina Utilities Commission and Carolina Water Service, Inc. of North Carolina v.*
29 *Public Staff of North Carolina Utilities Commission*, 472. S.E.2d 193 (NC App, 1996). Copy
attached as Appendix I.

²¹ *Id.*, p 196.

1 Carolina Commission reconsidered and reversed its former policy as being
2 "contrary to the public interest."

3 Events occurring since the Commission initially established its gain
4 splitting policy in 1990 indicate that such policy, contrary to the public
5 interest, serves as a disincentive to sell and may thereby discourage and
6 impede beneficial sales to municipal and other government-owned
7 entities. . . .With the benefit of hindsight, the Commission can now see that
8 the policy to split gains or losses on sales of water and/or sewer systems
9 has had a negative impact on the public good.²²

10 ...

11 If economic incentives are removed so that this succession of
12 ownership becomes inadvisable, customers are denied those benefits. If
13 companies like CWS are prevented from retaining the gain on sale in North
14 Carolina, a substantial incentive is removed for those companies to buy
15 systems from developers or small, undercapitalized operators in the first
16 instance. Likewise, a substantial incentive is removed to negotiate to sell
17 systems to municipal or governmental entities. At a minimum, the sale
18 price is artificially increased above the fair market based price to adjust for
19 the payment of part of the gain to customers. The result is harm to
20 consumers because the natural progression of transfer of ownership to the
21 most efficient provider is disrupted. These harmful consequences are
22 clearly not in the public interest. . . .²³

23 In summary, the North Carolina Commission found a number of reasons
24 why gain sharing was not in the public interest.

- 25 • It removes an incentive for small water companies to sell to larger,
26 more efficient water companies.
- 27 • It discourages water companies from selling to municipal utilities.
- 28 • It leads to higher selling prices to compensate the selling utility for
29 having to share gain.

30 These reasons are equally compelling for this Commission. Gain-sharing is not in
31 the public interest.

32 ²² *Id.*, pp. 196, 197.

33 ²³ *Id.*, p. 197.

1 **G. Customers Obtain No Right to Share Gain By Paying Rates**

2 RUCO witness Gordon Fox argues that by paying rates customers have
3 shared in the risk of those assets and deserve compensation through gain-
4 sharing when those assets are sold.²⁴ This argument is unsupported.

5 It is not clear to what risk Mr. Fox refers. It may be the risk of early
6 retirement, where an asset would be removed from rate base before it was fully
7 depreciated. However, as Mr. Dabelstein testified, this risk is balanced by the
8 offsetting reward when assets outlast their depreciable lives.²⁵ Over time Mr.
9 Dabelstein stated that the differences would balance out.²⁶ Therefore, this
10 alleged shareholder risk does not require compensation in any way.

11 Mr. Fox also suggests that the Uniform System of Accounts of the National
12 Association of Regulatory Utility Commissioners provides some relevant guidance
13 concerning gain associated with the sale of a utility business. But the example he
14 provides is off point and would not be controlling even if it were relevant.

15 Mr. Dabelstein explained that the Uniform System of Accounts does not
16 control ratemaking:

17 Although the Commission requires the utilities under its jurisdiction to
18 follow the Uniform Systems of Accounts, it has long held that such
19 requirements are for regulatory accounting and reporting purposes
20 only, and do [not] necessarily dictate ratemaking policies.
21 Accordingly, any accounting practice associated with the sale of assets
22 that is contained in the USofA is not obligatory on this Commission for
23 ratemaking or asset sale approval purposes.²⁷

24 As has been already established, the Commission's policy is that all gain
25 associated with the sale of a utility business belongs to the seller, just as all
26 losses associated with a sale would be the seller's responsibility. Any allegedly
27 contrary accounting is not germane.

28 ²⁴ Fox Direct Testimony, pp. 9-10; Fox Surrebuttal, pp. 4-7.

29 ²⁵ Dablestein Rebuttal Testimony, p. 9.

²⁶ *Id.*, pp. 9-10.

²⁷ *Id.*, pp. 8-9.

1 Further, even if Mr. Fox' accounting example controlled ratemaking, the
2 example would still be irrelevant to this transaction. Mr. Fox' example concerned
3 the early retirement of an asset from ratebase. That is not the case for this
4 transaction. No assets are being retired; the same assets will serve the
5 customers after closing as before.

6 Boiled down to its essential, RUCO seems to be arguing that simply by
7 paying rates, customers obtain some kind of claim to gain if a business is sold.
8 This is baseless. A tenant gets nothing when a landlord sells the apartment
9 building at a profit. A cable-television subscriber gets nothing if the local provider
10 sells out to Cox or Time-Warner. A Microsoft licensee (which almost all of us are)
11 does not share in Microsoft's stock-price appreciation, unless he or she has been
12 prescient enough to have purchased the stock. Similarly, paying rates does not
13 entitle a utility customer to share in an increase in the market value of a
14 business.

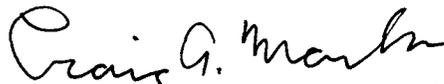
15 **H. Conclusion**

16 There is no basis for RUCO's position that a utility should share any gain
17 associated with the sale of a utility business with its customers. Commission
18 precedent and practice is to the contrary – a utility is entitled to all such gain.
19 Nor does the Commission require customers to share losses associated with sales
20 of businesses. The Commission's policy is consistent with precedent from other
21 commissions around the United States. It is also consistent with Arizona's
22 Constitutional fair-value ratemaking requirement – market value is irrelevant to
23 Arizona ratemaking. Further, the North Carolina Utilities Commission has
24 articulated several compelling reasons why gain-sharing is not in the public
25 interest. Finally, RUCO has failed to identify any specific risk that customers
26 share that should entitle them to any share of gain.

27
28
29

1 In her proposed order, the ALJ should reject gain-sharing.

2 RESPECTFULLY submitted on October 11, 2000.

3
4 

5
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11 Original and ten copies filed on
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By


Joann Zychlewicz

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APPENDIX A

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APPENDIX B

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APPENDIX C

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APPENDIX D

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APPENDIX E

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APPENDIX F

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APPENDIX G

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APPENDIX H

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APPENDIX I

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APPENDIX A

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BEFORE THE ARIZONA CORPORATION COMMISSION

RENZ D. JENNINGS
CHAIRMAN
MARCIA WEEKS
COMMISSIONER
DALE H. MORGAN
COMMISSIONER

Arizona Corporation Commission
DOCKETED

DEC 02 1991

DOCKETED BY *[Signature]*

IN THE MATTER OF THE JOINT)
APPLICATION OF SOUTHERN UNION GAS)
COMPANY, A DIVISION OF SOUTHERN)
UNION COMPANY, AND CITIZENS)
UTILITIES COMPANY FOR APPROVAL OF)
THE TRANSFER AND ASSIGNMENT OF THE)
ASSETS OF AND CERTIFICATES OF)
CONVENIENCE AND NECESSITY COMPRISING)
SOUTHERN UNION COMPANY'S NORTHERN)
ARIZONA GAS TRANSMISSION AND)
DISTRIBUTION SYSTEM TO CITIZENS)
UTILITIES COMPANY AND FOR APPROVAL)
OF ASSET PURCHASE AGREEMENT DATED)
JULY 3, 1991.)

DOCKET NO. E-1032-91-248
DOCKET NO. U-1240-91-248

DECISION NO. 57647

OPINION AND ORDER

DATE OF HEARING: October 28, 1991
PLACE OF HEARING: Phoenix, Arizona
PRESIDING OFFICER: Lyn Farmer
IN ATTENDANCE: Chairman Renz D. Jennings
Commissioner Marcia Weeks

APPEARANCES: BROWN & BAIN, P.A., by Mr. Lex J. Smith
and Mr. Terence W. Thompson, Attorneys, on
behalf of Joint Applicants, Southern Union
Gas Company and Citizens Utilities;
Mr. Roger A. Schwartz, Chief Counsel, on
behalf of Intervenor, Arizona Residential
Utility Consumer Office; and
Mr. Stephen J. Burg and Ms. Elizabeth A.
Kushibab, Staff Attorneys, Legal Division,
on behalf of the Arizona Corporation
Commission Staff.

BY THE COMMISSION:

On July 12, 1991, Southern Union Gas Company, a division of
Southern Union Company ("Southern Union") and Citizens Utilities
Company ("Citizens") filed with the Arizona Corporation Commission

1 ("Commission") a Joint Application for Approval of the Transfer and
2 Assignment of Assets and Certificates of Convenience and Necessity
3 ("Certificates") comprising Southern Union's Northern Arizona Gas
4 Transmission and Distribution System ("system") to Citizens, and for
5 approval of the Asset Purchase Agreement dated July 3, 1991.

6 On August 7, 1991, the Residential Utility Consumer Office
7 ("RUCO") filed an Application to Intervene which was granted on
8 August 19, 1991.

9 On September 4, 1991, the Commission issued a Procedural Order
10 setting dates and locations of public comment hearings. The public
11 comment hearings were held as scheduled in Show Low, Flagstaff,
12 Prescott, and Kingman, Arizona.

13 On September 6, 1991, the Commission issued a Procedural Order
14 setting the matter for hearing on October 28, 1991 at 1:30 p.m. in
15 Phoenix, Arizona. The hearing was held as scheduled.

16 DISCUSSION

17 In accordance with A.R.S. § 40-285, Southern Union and Citizens
18 request approval of the sale and transfer transaction contained in
19 the Asset Purchase Agreement ("Agreement") entered into on July 3,
20 1991. Under the terms of the Agreement, Citizens will pay Southern
21 Union approximately \$46 million in cash, less the net working
22 capital liabilities, and subject to an adjustment for certain
23 prorations after the closing. Southern Union will transfer to
24 Citizens all of the assets comprising the system and all related
25 Certificates and franchises. Citizens will assume all the
26 obligations and liabilities arising under contracts, leases,
27 easements, franchises, licenses and permits related to the assumed
28

1 assets. The terms of the Agreement require the closing to take
2 place on or before December 31, 1991.

3 Mr. Charles Aldrich, President and General Manager of Louisiana
4 Gas Service Company ("LGS"), a division of Citizens, and Vice-
5 President of Citizens, testified on behalf of Citizens. LGS is a
6 stand-alone division of Citizens which manages Citizens' natural gas
7 business segment and will manage the system upon purchase from
8 Southern Union. Mr. Aldrich identified the benefits in Arizona
9 arising from this transaction as follows:

- 10
- 11 • the system will be acquired by a company with significant
 - 12 financial wherewithal and an experienced management team;
 - 13 • Citizens will study growth communities to determine whether
 - 14 system extensions are economical;
 - 15 • Citizens' financial strength is a significant advantage and a
 - 16 benefit that over time will allow it to finance the capital
 - 17 investment necessary to keep up with growth on a lower overall
 - 18 cost basis than would Southern Union;
 - 19 • LGS will introduce advanced technologies to the system which
 - 20 will result in better customer service and more stable and
 - 21 efficient cost of service;
 - 22 • the acquisition will provide opportunity for economies of scale
 - 23 and more efficient cost of service;
 - 24 • LGS has an outstanding record and has won numerous awards in
 - 25 all areas of its operations relating to safety and training;
 - 26 • Citizens has effectively and efficiently used low cost tax free
 - 27 industrial revenue bond financing for plant additions;
 - 28

- 1 • the acquisition will increase opportunities for demand side and
2 cost side management; and
3 • because of its size, Citizens can and does view its investment
4 in Arizona from a longer term perspective.

5 Dr. Robert E. Johnston, [Ph.D.,] a consultant, also testified
6 on behalf of Citizens concerning the benefits of the transaction.
7 Dr. Johnston prepared exhibits showing the cost of capital savings
8 to ratepayers, and agreed that RUCO Ex. R-2 accurately represented
9 those savings to be \$133,697 annually. He testified that since the
10 rate base is growing, the present and future savings will be
11 greater.

12 Mr. Randall W. Sable testified on behalf of the Commission's
13 Utilities Division Staff ("Staff") concerning the proposed
14 transaction. Staff recommended that the Commission approve the
15 acquisition subject to the following conditions:

- 16 • that the ratemaking treatment of an acquisition adjustment be
17 deferred until a future rate proceeding and that an adjustment
18 be allowed only if Citizens proves benefits exceeding the
19 acquisition costs or benefits that would not have occurred
20 without the transfer;
21 • that ratepayers will be held harmless from any cost associated
22 with pipe/system replacement and/or repair that was the result
23 of Southern Union's faulty or improper installation or poor
24 workmanship to the extent the cost is not recovered by Citizens
25 from Southern Union;
26 • that Citizens submit a long-term plan of at least 10 years to
27 the Director of the Utilities Division concerning extension of
28 service in the certificated area acquired, within 1 year of the
effective date of this Decision;
• that Citizens cooperate with Staff regarding evaluations of
pipeline safety and other matters pertaining to the quality,
condition, and capacity of service;
• that Citizens work with Staff and within 6 months provide data
on its electric and gas customers and prices to allow Staff to
analyze the cross-elasticity of demand for gas and electricity;

- 1 • that Citizens' marketing expenses recovered through rates be
2 limited to safety, informational and conservation messages in
3 areas where it provides both gas and electric service;
- 4 • that Citizens submit a draft of its cost allocation procedures
5 for review prior to filing its next general rate case;
- 6 • that Citizens extend service to areas where it is economically
7 feasible to do so;
- 8 • that Citizens agree not to file for increased rates in the
9 northern Arizona gas properties any earlier than January 1,
10 1993;
- 11 • that Citizens file with the Director of the Utilities Division
12 a list of all refunds assumed by Citizens, within 30 days of
close of escrow; and
- 13 • that Citizens notify the customers of the northern Arizona gas
14 properties of the transfer of ownership within 15 days of the
15 close of escrow, and file a copy of the notice with the
16 Director of the Utilities Division.

17 Mr. James R. Dittmer, a consultant, testified on behalf of
18 RUCO. Although Mr. Dittmer does not oppose the acquisition, he
19 testified that from a financial standpoint, there has not been a
20 showing made that ratepayers will benefit or not be detrimented by
21 the transfer, and that therefore, from a cost-to-ratepayer
22 standpoint, the application can be viewed as deficient. He made
23 four recommendations:

- 24 • Citizens should provide an estimate of savings from structural
25 cost advantages;
- 26 • Citizens should acquire and retain all historical operating
27 data for Southern Union's Arizona properties for a 5 to 10-
28 year period;
- Citizens should assure the Commission that it will not seek
recovery of the premium over net depreciated original cost
paid; and

1 • the Commission should advise Citizens that at the next rate
2 case Citizens must prove that the rates are lower than they
3 would have been if Citizens had not acquired the system and
4 that any acquisition adjustment recovery will be limited to
5 some portion of the savings stemming from structural
6 differences between Southern Union and Citizens
7 ownership/management.

8 The benefits identified by Citizens and Southern Union which
9 would occur as a result of this acquisition are difficult to
10 quantify. Citizens performed no studies measuring possible
11 operational efficiencies and has not finalized any plans on changes
12 to the existing operating structure of the Southern Union system.
13 Citizens did quantify the potential cost of capital savings to
14 ratepayers.

15 The potential disadvantages identified by Staff include the
16 possibility of increased allocation of costs to Arizona as a result
17 of an additional corporate layer via Citizens structure; the
18 possibility that Citizens may prefer the energy utility with the
19 higher profit margin, at the expense of the other utility; the
20 possibility that Citizens would request higher rate increases as a
21 result of its paying a price for the system above net book value;
22 and the possibility that the benefits identified by Citizens would
23 not be realized.

24 Based upon the record evidence compiled in this proceeding, the
25 Commission finds that Citizens' financial strength, its willingness
26 to extend the system where it is economically feasible, the tangible
27 short-term benefit to ratepayers of rate stability, and the
28

1 potential for economies of scale and more efficient cost of service
2 make it within the public interest to approve the acquisition.

3 Citizens has offered not to file a rate application until
4 January 1, 1993 with the provision that a final order would be
5 issued by the Commission no later than September 30, 1993. Delaying
6 the filing is reasonable and appropriate because it will allow
7 Citizens time to gain familiarity with the gas operations; to
8 implement the cost efficiencies and savings Citizens claims will
9 result; to experience at least one heating season with the increased
10 rates granted in June 1991 and determine how the rates affect demand
11 through the winter; and will provide some rate stability to the
12 ratepayer. As a condition to approving this application, we will
13 require Citizens to delay filing a rate application until January 1,
14 1993, and with regard to this rate moratorium, note that the
15 Utilities Division Staff has proposed time guidelines for processing
16 rate applications. Citizens' rate application will be processed
17 under those rules as ultimately adopted. We believe that this will
18 alleviate Citizens' concern over the issuance of timely rate relief
19 and that providing a date for a final order is unnecessary.

20
21 Citizens has not made the transfer contingent upon obtaining an
22 acquisition adjustment, but has indicated that in its next rate
23 proceeding it will request recognition of such an adjustment.
24 Citizens must be reminded that Arizona allows for a return on
25 invested plant, not on the sale price paid for the utility.

26 For the reasons discussed above, we also do not accept RUCO's
27 recommendation to require Citizens to assure the Commission that it
28 will not seek recovery of an acquisition premium. While we are not

1 inclined to permanently prohibit Citizens from seeking recovery of
2 an acquisition premium, we are concerned with the issue of
3 determining whether ratepayers are receiving any benefits from the
4 transaction. For this reason, we believe RUCO's recommendation that
5 Citizens acquire and retain Southern Union's historical operating
6 data is reasonable and appropriate.

7
8 We are, furthermore, concerned that in the next rate case, even
9 with the retention of Southern Union's records, it will be difficult
10 with the passage of time to determine whether ratepayers have truly
11 benefitted from the transaction. If individual cost components
12 increase subsequent to the purchase, there will be an incentive for
13 Citizens to claim the increases to be unavoidable -- even if
14 Southern Union had retained ownership. Conversely, it is reasonable
15 to assume that Citizens will desire to claim any declining cost
16 components as merger-related -- which should be utilized to fund in
17 whole or in part an acquisition premium. Citizens should be advised
18 that we expect a demonstration of clear and quantifiable ratepayer
19 savings related only to the acquisition in the next rate case.

20 We are in agreement with RUCO's recommendation that if an
21 acquisition premium recovery is granted, it should be limited to
22 some portion of savings stemming from structural advantages (i.e.,
23 economies of scale) which are afforded by the transaction. Savings
24 which could have and should have been achieved under Southern Union
25 ownership clearly should not be considered when determining the
26 level of acquisition premium for recovery.

27 We decline to adopt Staff's recommendation limiting the type of
28 marketing expenses that can be recovered through rates at this time.

1 The issue is more appropriate in the context of a rate hearing,
2 where the parties can present evidence and arguments concerning the
3 appropriate treatment for specific types of expenses.

4 Staff's recommendation that ratepayers be held harmless for
5 costs associated with pipe/system replacement and/or repair is
6 premature. Citizens has indicated that it is its position that
7 reasonable costs associated with system repair or replacement should
8 be recovered in rates. This Commission must remind Citizens that no
9 matter the warranties of the seller, the burden for system quality
10 is Citizens'. Citizens would do well to familiarize itself with
11 Decision No. 57075 issued in Southwest Gas Corporation's previous
12 rate case which addresses similar issues.

13 Staff modified its recommendation to allow the long-term plan
14 for extension of service to cover a period of at least 3-5 years.
15 We believe that a long-term plan of at least 5 years is appropriate.

16 The remaining Staff recommendations were not opposed and should
17 be adopted.

18 * * * * *

19 Having considered the entire record herein and being fully
20 advised in the premises, the Commission finds, concludes, and orders
21 that:

22 FINDINGS OF FACT

23 1. Southern Union Company is a Delaware corporation
24 authorized to do business and doing business in the State of Arizona
25 through its operating division, Southern Union Gas Company.
26 Southern Union is certificated by the Commission to provide public
27 utility natural gas service in portions of the State of Arizona,
28

1 namely the Counties of Mohave, Coconino, Yavapai, Navajo and Apache.
2 Southern Union filed a copy of its certificate of good standing with
3 the Commission.

4 2. Citizens Utilities Company is a Delaware corporation
5 authorized to do business and doing business in the State of Arizona
6 and provides public utility gas, electric, telecommunications, water
7 and wastewater service in Arizona in various locations throughout
8 the state pursuant to Certificates issued by the Commission.
9 Citizens filed a copy of its certificate of good standing with the
10 Commission.

11 3. Citizens and Southern Union are requesting Commission
12 approval of the Asset Purchase Agreement and authority to transfer
13 the assets and Certificates relating to Southern Union's northern
14 Arizona gas transmission and distribution system to Citizens.

15 4. Citizens will pay \$46 million cash, which will be offset
16 by the net working capital liabilities, and subject to an adjustment
17 for certain prorations after the closing.

18 5. According to Southern Union's response to Staff's data
19 request, the current net gas plant in service is approximately \$27.6
20 million.

21 6. Neither Staff nor RUCO oppose[s] the application, but both
22 believe the public interest would be served only if certain
23 conditions are adopted by the Commission.

24 7. The Commission finds that the following conditions to the
25 transfer, as recommended by Staff and RUCO, are reasonable,
26 appropriate, and necessary to protect the public interest:
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- 1 • Citizens shall submit a long-term plan of at least 5 years to
- 2 the Director of the Utilities Division concerning extension of
- 3 service in the certificated area acquired, within 1 year of the
- 4 effective date of this order;
- 5 • Citizens shall cooperate with Staff regarding evaluations of
- 6 pipeline safety and other matters pertaining to the quality,
- 7 condition, and capacity of service;
- 8 • Citizens shall work with Staff and within 6 months of the
- 9 effective date of this order, provide data on its electric and
- 10 gas customers and prices to allow Staff to analyze the cross-
- 11 elasticity of demand for gas and electricity;
- 12 • Citizens shall submit a draft of its cost allocation procedures
- 13 for review prior to filing its next general rate case;
- 14 • Citizens shall extend service to areas where it is economically
- 15 feasible to do so;
- 16 • Citizens shall not file for increased rates in the northern
- 17 Arizona gas properties any earlier than January 1, 1993;
- 18 • Citizens shall file with the Director of the Utilities Division
- 19 a list of all refunds assumed by Citizens, within 30 days of
- 20 close of escrow;
- 21 • Citizens shall notify the customers of the northern Arizona gas
- 22 properties of the transfer of ownership within 15 days of the
- 23 close of escrow, and file a copy of the notice with the
- 24 Director of the Utilities Division; and
- 25 • Southern Union shall provide Citizens all historical operating
- 26 data for Southern Union's Arizona properties for the last 5
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1 years, and Citizens shall retain the data for a 10-year
2 period.

3 8. The ratemaking treatment of marketing expenses and any
4 acquisition adjustment will be deferred until a future rate
5 proceeding.

6 9. Citizens has the responsibility to investigate the
7 condition of the system and be cognizant of Commission policy in
8 previous Decisions concerning pipe or system replacement and repair.

9 CONCLUSIONS OF LAW

10 1. Southern Union and Citizens are public service
11 corporations within the meaning of Article XV of the Arizona
12 Constitution and A.R.S. § 40-281, et seq.

13 2. The Commission has jurisdiction over Southern Union and
14 Citizens and of the subject matter of the application.

15 3. Notice of the application was given in accordance with the
16 law.

17 4. There is a continuing need for natural gas utility service
18 in Southern Union's certificated area.

19 5. Citizens is a fit and proper entity to receive the
20 Certificates.

21 6. Subject to the conditions discussed in Finding of Fact No.
22 7, hereinabove, the transfer of the Certificates and assets of
23 Southern Union to Citizens is in the public interest and should be
24 approved.

25 ORDER

26 IT IS THEREFORE ORDERED that the joint application of Southern
27 Union Gas Company and Citizens Utilities Company for approval of the
28

1 transfer and assignment of the assets and certificates of Southern
2 Union's northern Arizona gas transmission and distribution system to
3 Citizens and for approval of the Asset Purchase Agreement is hereby
4 granted.

5 IT IS FURTHER ORDERED that Citizens Utilities Company shall
6 charge Southern Union's gas customers the existing rates and charges
7 for the system until a change in those rates and charges is
8 authorized by the Commission.

9 IT IS FURTHER ORDERED that Citizens Utilities Company shall
10 submit a long-term plan of at least 5 years to the Director of the
11 Utilities Division concerning extension of service in the
12 certificated area within 1 year of the effective date of this
13 Decision.

14 IT IS FURTHER ORDERED that Citizens Utilities Company shall
15 cooperate with Staff regarding evaluations of pipeline safety and
16 other matters concerning the quality, condition, and capacity of
17 service.

18 IT IS FURTHER ORDERED that Citizens Utilities Company shall
19 cooperate with Staff and provide data within 6 months of the
20 effective date of this Decision on its electric and gas customers
21 and prices to allow Staff to analyze the cross-elasticity of demand
22 for gas and electricity.

23 IT IS FURTHER ORDERED that Citizens Utilities Company shall
24 submit a draft of its cost allocation procedures for review prior to
25 filing its next general rate case.

1 IT IS FURTHER ORDERED that Citizens Utilities Company shall
2 extend gas service to areas where it is economically feasible to do
3 so.

4 IT IS FURTHER ORDERED that Citizens Utilities Company shall not
5 file a general rate case until January 1, 1993.

6 IT IS FURTHER ORDERED that Citizens shall abide by all terms
7 and conditions imposed upon Southern Union concerning the Purchased
8 Gas Adjustor reporting requirements established by Decision No.
9 57396.

10 IT IS FURTHER ORDERED that Southern Union Gas Company shall
11 provide Citizens Utilities Company all historical operating data for
12 its Arizona properties for the last 5 years, and Citizens shall
13 retain the data for a 10-year period.

14 IT IS FURTHER ORDERED that Citizens Utilities Company shall
15 file a list of all customer refunds it has assumed with the Director
16 of the Utilities Division within 30 days of the completion of the
17 transfer.

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1 IT IS FURTHER ORDERED that Citizens Utilities Company shall
2 notify the customers of the northern Arizona gas system that
3 ownership of the system has changed and how to contact Citizens'
4 customer service department. The notice shall be given by bill
5 insert beginning within 15 days of the completion of the transfer
6 and Citizens shall file a copy of the notice with the Director of
7 the Utilities Division.

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

10 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

11
12
13 CHAIRMAN

COMMISSIONER

COMMISSIONER

14 IN WITNESS WHEREOF, I, JAMES MATTHEWS, Executive
15 Secretary of the Arizona Corporation Commission, have
16 hereunto set my hand and caused the official seal of
17 this Commission to be affixed at the capitol, in the
18 City of Phoenix, this 2nd day of
19 December, 1991.

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Paul A. Bellis for
JAMES MATTHEWS
Executive Secretary

DISSENT
LF:dmr

APPENDIX B

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APPENDIX A

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1 ("Certificate") by Contel West to Citizens.

2 Intervention in this matter was granted to the Residential
3 Utility Consumer office ("RUCO") on September 13, 1993.

4 By Procedural Order issued February 9, 1994 the hearing in this
5 matter was scheduled to commence on May 19, 1994. By Procedural Order
6 dated May 25, 1994, the hearing was rescheduled to commence on June 8,
7 1994. A public comment session was held in Phoenix, Arizona on May 19,
8 1994.

9 The hearing was held as scheduled and concluded on June 9, 1994.
10 At the hearing, Citizens, Contel West, RUCO, and Staff were
11 represented by counsel and presented testimony. At the conclusion of
12 the hearing, the matter was taken under advisement by the Hearing
13 Officer pending submission of a Recommended Opinion and Order to the
14 Commission and the parties were given leave to file closing briefs in
15 lieu of closing arguments.

16 DISCUSSION

17 Contel West is an Arizona corporation engaged in the business of
18 providing telecommunications service to the public within portions of
19 Apache, Coconino, Gila, Greenlee, and Navajo Counties Arizona,
20 pursuant to authority granted by the Commission. Joint applicant,
21 Citizens, is a Delaware corporation certificated by the Commission to
22 provide telecommunications, electric, gas, water, and wastewater
23 service in Arizona. Citizens currently serves approximately 58,700
24 telecommunications customers in Mohave County, Arizona.

25 Citizens and Contel West entered into an Asset Purchase Agreement
26 ("Agreement") on May 18, 1993, whereby Contel West's Arizona telephone
27 properties and related assets will be sold to Citizens at a purchase
28 price of approximately \$88.6 million. Citizens will acquire marketable

1 title to the telephone plant free of any liens or security interest,
2 and will acquire the contracts, rights, and business records
3 associated with such telephone properties. This transaction is part of
4 an agreement between Contel West's parent corporation, GTE Corporation
5 ("GTE"), and Citizens for the sale and purchase of approximately
6 500,000 access lines in ten states for a total purchase price of \$1.1
7 billion. Citizens and Contel West have also executed an Employee
8 Transfer Agreement to govern the transition of employment and employee
9 benefits. The parties anticipate a September 30, 1994 closing date
10 for the Arizona telephone properties.

11 The Contel West telephone properties which are the subject of the
12 Agreement include approximately 27,700 (as of June 1993) access lines
13 in the following exchanges: Alpine, Cibeque, Greer, Hawley Lake,
14 Heber, Holbrook, McNary, Pinedale, Pinetop, Pinetop Country Club, Show
15 Low, Snowflake, Springerville, St. Johns, and Whiteriver. Citizens
16 intends to operate the acquired properties under the name "Citizens
17 Telecommunications Company of Arizona", which will be distinct from
18 its Arizona Mohave telecommunications service. However, Citizens does
19 intend to establish a centralized services location in Dallas, Texas,
20 which will provide service to both of Citizens' local telephone
21 operations. Mr. Robert S. Crum testified on behalf of Citizens that
22 Citizens and Contel West are negotiating a Continuation Services
23 Agreement wherein GTE will provide financial, accounting, billing,
24 data processing, and administrative services to ensure an orderly and
25 "seamless" transition of service providers. Contel West and Citizens
26 contend that approval of the sale of the telephone properties and
27 transfer of the attendant Certificates is in the public interest.
28 Citizens submits that the proposed transaction should be

1 unconditionally approved by the Commission since the joint applicants
2 have, at a minimum, shown that the proposed sale and transfer is not
3 detrimental to the public interest.

4 Staff indicated that from a technical and operational standpoint
5 the current Contel West ratepayers will not be detrimentally affected
6 by Citizens' acquisition. However, from an economic perspective, Staff
7 and RUCO are concerned that the transaction exposes current Contel
8 West ratepayers to potential new costs and/or detrimental financial
9 implications which may result in increased rates. Accordingly, both
10 RUCO and Staff believe that the sale is generally in the public
11 interest, provided that certain conditions are imposed upon the
12 Commission's approval of the acquisition. Staff has also recommended
13 five technical and administrative recommendations to be adopted by the
14 Commission in order for Citizens' acquisition of these telephone
15 properties to be in the public interest. It is the imposition of
16 these conditions by Staff and RUCO that requires further discussion.

17 REALIZATION OF GAIN

18 The transaction is characterized as a sale "with traffic",
19 meaning "with customers," and includes the associated revenue streams
20 and the right to net operating income in the future. The gain to be
21 realized by Contel from the sale is the difference between the net
22 book value¹ of the depreciable physical assets and the sales price
23 less transaction costs. It is with respect to the treatment of the
24 gain that Staff and GTE/Contel West have disagreed. RUCO did not
25 present any testimony concerning this issue.

26 Staff recommended that any gain realized by GTE on the sale
27

28 ¹ The net book value is represented by the original cost of
the tangible physical asset less accumulated depreciation.

1 should be equally divided between ratepayers and shareholders, and
2 that ratepayers receive a one-time credit from Contel on their last
3 bill. Staff believes that ratepayers should be allocated 50% of the
4 gain since the value associated with revenue streams and future net
5 operating income is derived from the ratepayers. According to Staff,
6 its recommendation is generally consistent with the Commission's
7 policy regarding gains realized on sales of utility property. The
8 specific mechanism recommended by Staff to rebate a portion of the
9 gain to customers was chosen since Contel West will no longer have a
10 presence in the State and, therefore, will not have utility property
11 in which to invest the gain. Staff noted that although the ratepayers
12 did not assume the risk of the initial investment in the assets, the
13 shareholders of Contel West have been insulated from competition
14 within their certificated service territory as a public service
15 corporation and, therefore, should not receive 100 percent of the gain
16 which is attributable to the revenue stream from ratepayers.

17 Contel West characterizes the transaction with Citizens as a sale
18 of a complete business, or a sale of plant "with traffic," and not the
19 sale of individual depreciable tangible assets in the ordinary course
20 of doing business. Contel West believes that its gain in the
21 transaction should not be shared with, or rebated to, ratepayers for
22 the following reasons:

- 23 ♦ It is Contel, and not the ratepayers, that is the legal
24 owner of the tangible and intangible assets being sold, and
25 therefore, requiring Contel to rebate 50% of the gain to
26 ratepayers would constitute a governmental confiscation of
27 private property and a violation of the Constitution.
- 28 ♦ Staff's recommendation is contrary to regulatory treatment

1 accorded similar transactions by the Commission, contrary to
2 case law from virtually every other jurisdiction, violates
3 the law prohibiting "piecemeal ratemaking,"² and burdens
4 interstate commerce.

5 ♦ The Uniform System of Accounts, adopted by the Commission,
6 and Part 32 of the Rules and Regulations of the Federal
7 Communications Commission, provide that gains and losses
8 incurred in the sale of assets with traffic are "below-the-
9 line" items which would flow directly to the Company and not
10 the ratepayers.

11 ♦ The gain increment above net book value is attributed to the
12 worth of the intangible assets associated with Contel's
13 Arizona telephone operations and ratepayers bear none of the
14 risk associated with the Company's intangible assets.

15 ♦ The Commission policy in transactions involving the sale of
16 the complete business where the selling utility is exiting
17 the state subsequent to consummation of the transaction has
18 been to allow the selling company to retain 100% of the
19 gain.³ Consequently, the Commission has focused instead on
20

21 ² Contel explains in its brief that providing a credit on
22 customers bills to reflect a portion of the gain is equivalent to a
23 rate reduction based solely upon this transaction, and therefore, is
24 contrary to the prohibition against single-issue ratemaking in the
Arizona Constitution. Contel further argues that if the gain
sharing is labeled a rebate, rather than a rate reduction, Arizona
law still prohibits a rebate of tariffed charges.

25 ³ Contel's brief states that three recent opinions of the
26 Commission allowed the selling company to retain one hundred percent
27 (100%) of the gain where the transaction involved the sale of a
28 going concern with the utility exiting the state at the close of the
transaction. The cases cited were Southern Union Gas Company,
Decision No. 57647 (December 2, 1991); Chronicle Publishing Company,
Decision No. 58450 (November 3, 1993); and Rio Utility Company,
Inc., Decision No. 58639 (May 27, 1994).

1 the purchasing utility's treatment of the acquisition
2 adjustment treatment.

3 Although the Commission shares Staff's concern that ratepayers
4 not be placed at risk for paying for the gain realized by Contel West
5 when Citizens requests ratemaking treatment of the acquisition
6 adjustment, we agree with Contel that Staff's "gain sharing"
7 recommendation is not appropriate in the instant transaction. Nor do
8 we believe that the Commission should adopt Staff's recommendation
9 just to ensure that ratepayers receive a tangible benefit from the
10 transaction. Staff's "gain sharing" recommendation is not mandated by
11 previous Commission decisions and the Commission will continue to
12 decide this issue on a case-by-case basis.

13 ACQUISITION ADJUSTMENT

14 Although Citizens agreed with Staff's recommendation that the
15 ratemaking treatment of an acquisition adjustment be deferred until a
16 future rate proceeding, Citizens opposed the criteria recommended by
17 Staff to determine whether an acquisition adjustment will be
18 recoverable in the future. The acquisition adjustment is the
19 difference between the total cost to Citizens of the utility plant
20 acquired in excess of the net depreciated original cost value of the
21 plant acquired. Although the total purchase price cannot be precisely
22 determined at this time, it is estimated that the acquisition
23 adjustment will approximate \$45 million.

24 Staff's witness, Mr. David Daer, testified that the explicit
25 standards for recovery of an acquisition premium established in the
26 matter of Citizens' acquisition of the former Southern Union Gas
27 Company ("SUG"), Decision No. 57647 (December 2, 1991), are also
28 applicable to this transaction. Pursuant to Decision No. 57647, an

1 acquisition premium recovery will be recognized if the acquiring
2 utility can demonstrate clear, quantifiable and substantial benefits
3 to ratepayers related only to the acquisition. According to Staff, at
4 the time of seeking ratemaking treatment of the acquisition
5 adjustment, Citizens has the burden of proving savings stemming from
6 structural advantages which are afforded by the acquisition and
7 showing that there are savings beyond what could have or should have
8 been realized under continued Contel West ownership. Citizens opposes
9 this standard as unreasonable since it is based solely on quantifiable
10 cost savings and ignores non-quantifiable benefits which will be
11 provided to customers. RUCO recommended that the Commission prohibit
12 Citizens from future rate recovery of the acquisition adjustment in
13 this transaction. RUCO believes that the opportunity for the possible
14 recovery of the acquisition premium was provided to Citizens in
15 Decision No. 57647, since there was an expectation that Citizens would
16 be able to provide benefits to ratepayers that could not have been
17 attained under SUG's continued ownership. Mr. Smith testified that no
18 similar expectation in this matter was proven by Citizens and,
19 therefore, the Commission's denial of any recovery of the acquisition
20 premium is not inconsistent with Decision No. 57647.

21 RUCO believes that denial of recovery is consistent with the
22 Commission's observation in Decision No. 57647 that "Citizens must be
23 reminded that Arizona allows for a return on invested plant, not on
24 the sale price paid for the utility." In the alternative, RUCO
25 recommends that should the Commission not prohibit recovery of the
26 acquisition premium, then Staff's recommendation to utilize the
27 criterion established in Decision No. 57647 regarding the recovery of
28 an acquisition premium also be adopted in this proceeding.

1 Citizens believes that consideration of the recovery of the
2 acquisition adjustment should be deferred to future rate proceedings
3 and recommended that: the acquisition premium be recorded in FCC
4 Account 2005, Telephone Plant Acquisition Account, until such time as
5 Citizens seeks Commission approval to include all or some of the
6 acquisition adjustment in rates; and that to determine the amount of
7 the acquisition adjustment allowable in rates, the Commission should
8 compare the total operating expenses per access line for the test year
9 in the rate case to the average operating expenses per access line for
10 the last two years prior to Citizens' ownership of these properties.
11 Mr. Daer correctly points out that this comparison would not be
12 meaningful without attributing proper consideration and weight to the
13 current cost reduction trend established by Contel West with reference
14 to its Arizona properties. RUCO indicates that this recommendation
15 would permit Citizens to carry the balance in Account 2005
16 indefinitely, without any requirement for amortizing the balance of
17 the account below the line over a specified number of years. This,
18 according to RUCO, would place ratepayers at risk for the rate
19 inclusion of the acquisition premium for an indefinite period of time.

20 In order to protect the public interest and assure that
21 ratepayers are not harmed by the Citizens' acquisition, we will
22 prohibit Citizens from including any part of the acquisition
23 adjustment from this transaction into rates.

24 DEFERRED INCOME TAXES

25 Upon consummation of the sale to Citizens, all of Contel West's
26 deferred income taxes ("DIT") and investment tax credits ("ITC")
27 applicable to the Arizona properties will become due and payable, and
28 therefore, DIT will no longer function as an offset to rate base and

1 ITC will no longer reduce income tax expense. However, Mr. Daer
2 observed that Citizens would build up DIT subsequent to the sale and
3 prior to its first rate proceeding, therefore the actual effect or
4 impact on future rates attributable to the loss of Contel's DIT
5 offsets is presently unknown. Accordingly, Mr. Daer recommended, and
6 Citizens agreed, that: a ratemaking adjustment be deferred to a future
7 rate proceeding; and that for the remaining life of the assets being
8 purchased by Citizens, ratepayers should be at least as well off under
9 Citizens' ownership as they would under the continued ownership by
10 Contel West. However, Citizens agreed to defer the ratemaking
11 adjustment provided that the adjustment does not violate the
12 normalization provisions of the Federal Tax Code. According to Staff,
13 this ratemaking adjustment would be based upon the difference between
14 rate base under Citizens' ownership compared to what the rate base
15 would be under Contel West's ownership.

16 RUCO recommended that as a precondition to Commission approval
17 of the acquisition, Citizens be prohibited from challenging a future
18 ratemaking adjustment for lost DIT or ITC on certain specified
19 grounds. Additionally, RUCO recommended that the Commission order
20 Citizens to make available at the next rate case detailed accounting
21 and tax information, as well as knowledgeable personnel to answer
22 questions concerning this data during discovery. Citizens objected to
23 RUCO's requirement since the availability of knowledgeable Contel West
24 personnel at a future proceeding is unknown at this time.

25 We find Staff's recommendation is consistent with the
26 Commission's policy that ratepayers should be at least as well off
27 under Citizens' ownership as they would have been under the continued
28 ownership by Contel West. We believe that it is unnecessary to adopt

1 in this proceeding RUCO's recommendations pertaining to the conduct of
2 discovery proceedings involving DIT and ITC which may occur in a
3 future rate proceeding. Accordingly, we concur with Staff and Citizens
4 that the ratemaking treatment of DIT and ITC should be deferred to a
5 future rate proceeding.

6 DATA RETENTION

7 Staff recommended that Citizens acquire and retain historical
8 operating and financial data relating to the Contel West properties
9 for the past five years and that GTE/Contel West be required to assist
10 Citizens with the preparation of data requests in future rate
11 proceedings. RUCO generally supports Staff's recommendations, but
12 suggests that GTE/Contel West should be required, for a period of five
13 years after the closing, to make available to Citizens persons who are
14 knowledgeable concerning the interpretation of the accounting records.
15 Mr. Barry Johnson, testifying on behalf of GTE, indicated that a
16 continuation of services agreement being negotiated with Citizens
17 would include a provision for providing assistance with data
18 responses. Mr. Johnson, however, stated that even without that
19 agreement GTE would provide assistance to Citizens in the preparation
20 of data responses provided an appropriate compensation agreement
21 existed to compensate GTE.

22 Citizens objects to Staff's recommendation since GTE may not have
23 information for years prior to the merger of GTE and Contel in 1991
24 and argues that, the relevance of this information to a rate case
25 which cannot be filed until 1996 is suspect. With respect to the
26 availability of documents, GTE's witness stated that GTE maintained in
27 its possession all documents which it is obligated to keep pursuant to
28 the retention of records requirements of Part 42 of the FCC Rules and

1 Regulations. Additionally, Contel West agreed to provide Citizens with
2 all operating and financial data for GTE West-Arizona, for the time
3 prior to and subsequent to the merger, which is in its possession as
4 of the date of the closing.

5 Citizens also objected to Staff's recommendation which would
6 require GTE to assist in the preparation of data responses in future
7 rate proceedings since the availability of knowledgeable GTE/Contel
8 West personnel when discovery occurs in a future rate proceeding is
9 unknown. Citizens suggests that if this recommendation is adopted,
10 then the Commission should allow Citizens, for ratemaking purposes,
11 full recovery of all costs incurred in utilizing GTE/Contel West
12 personnel to comply with the Commission's order. However, we believe
13 that Citizens' request for the Commission's pre-approval of
14 speculative costs is inappropriate in this proceeding and should be
15 deferred to a future proceeding where recovery is actually being
16 sought by Citizens.

17 We find that Staff's recommendations are appropriate considering
18 the discovery problems encountered by Citizens in the first rate
19 proceeding following its acquisition of the Northern Arizona Gas
20 Division from Southern Union Gas. Staff's recommendations provide a
21 practical solution to avoid a situation wherein Citizens is unable to
22 provide meaningful answers to data responses which may require the
23 assistance of GTE or Contel West personnel. We also accept RUCO's
24 recommendation that GTE/Contel West should be obligated to provide
25 Citizens with knowledgeable personnel to interpret the data for a
26 period of five years after the sale, however, the compensation of
27 GTE/Contel West for this service is a matter to be negotiated between
28 the parties as a part of the overall purchase agreement, and will not

1 be determined by the Commission. Contrary to Citizens' objection, the
2 financial and historical data relating to the acquired Arizona
3 telephone properties may be relevant to evaluations to be performed in
4 future proceedings, and we believe that the recommendations of Staff
5 and RUCO will help to insure that relevant data is preserved and that
6 support is available to assist Citizens' ability to interpret the
7 data. Accordingly, we will adopt the recommendations of Staff and RUCO
8 as described herein.

9 COST ALLOCATION

10 Citizens did not oppose Staff's recommendation to require
11 Citizens to submit a draft of its cost allocation procedures prior to
12 filing its next general rate case. We concur with Staff's
13 recommendation.

14 RATES AND CHARGES

15 In its application Citizens indicated that it will adopt the
16 current rates, charges, terms and conditions for service found in the
17 existing Contel West tariffs. Staff has recommended that Citizens
18 agree not to file for a rate increase for at least two years from the
19 effective date of an order approving the transaction. Staff's
20 recommendation for a stay-out period was based upon Citizens'
21 testimony that an evaluation of the customer benefits to be derived
22 from combining the Contel West operations with Citizens existing
23 Mohave County telephone operations and/or its Arizona Gas Division
24 ("AGD") operations would not be completed for a "couple of years"
25 after the acquisition.

26 Citizens agreed to Staff's recommendation for a two-year rate
27 moratorium effective from the date of this Decision with the following
28 qualifications: that the Commission authorize the deferral of the

1 Transition Costs⁴ until after the moratorium period and thereafter
2 amortize the costs over a three year period; and, that the ratemaking
3 treatment of the Transition Costs be determined in a future
4 proceeding, provided however, that these costs are not included with
5 either the acquisition adjustment or the transaction costs in this
6 proceeding. Although Staff does not oppose Citizens' proposal to
7 defer and amortize the Transition Costs, Staff believes that the
8 appropriate ratemaking treatment of these Transition Costs should be
9 deferred to a future rate case. Accordingly, Staff also deferred to a
10 future rate proceeding a determination of whether the Transition Costs
11 should be included with the acquisition adjustment or the transaction
12 costs associated with the acquisition. Staff, however, did not oppose
13 Citizens proposal to allow new tariffs to be filed within the two year
14 moratorium period, provided other certificated telecommunications
15 companies have the ability to file for tariff changes and the proposed
16 tariff changes do not result in an increase in the rate of return for
17 the Contel West telephone properties.

18 RUCO opposes Citizens proposed treatment of Transition Costs and
19 recommends that the Commission defer ratemaking treatment of these
20 costs, along with other acquisition related costs, to a future rate
21 proceeding. According to RUCO, the Commission should reject Citizens'
22 proposal for deferral and amortization of the Transition Costs since
23 Citizens' request requires the Commission to approve in this
24

25 ⁴ Transition Costs were described by Mr. O'Brien as costs
26 Citizens has or will incur in reorganizing and expanding the
27 administrative and operational infrastructure as a result of the
28 acquisition of the GTE telephone properties. Citizens has incurred
these costs since August 1993 and estimates the amount to be
allocated to Arizona operations at approximately \$600,000 or
\$200,000 per year based upon a proposed three year amortization.
(Exhibit A-4, pp. 20-21, O'Brien Rebuttal)

1 proceeding the inclusion of Transition Costs into future rates. RUCO,
2 however, would not object to the Commission authorizing a deferral and
3 amortization of the Transition Costs, provided any such order contains
4 an explicit statement that the Commission is taking no position at
5 this time regarding the probability of future rate recovery. The order
6 should also require clear proof of structural cost savings resulting
7 from Citizens' ownership before including these costs in rates.

8 We believe that a two year rate moratorium is appropriate because
9 it will allow Citizens adequate time to gain familiarity with the
10 operation of the Contel West system and to evaluate possible operating
11 synergies and cost efficiencies to be derived from combining
12 operations with its Mohave County telephone operations and AGD
13 operations. Citizens agreed that two years was an appropriate period
14 of time in which to complete this evaluation. Accordingly, to permit
15 Citizens to increase rates prior to two years after the acquisition of
16 the Contel West properties would be contrary to the public interest.
17 This is consistent with the Commission's policy that ratepayers should
18 not be worse off from an economic standpoint as a result of this
19 transaction.

20 We also agree with Staff and RUCO that the determination of
21 future ratemaking treatment of Transition Costs should be deferred
22 until the next rate case and, therefore, will not agree at this time
23 to Citizens' request to exclude Transition Costs from the acquisition
24 adjustment or the transaction costs in this proceeding. We also
25 concur with RUCO that to the extent that these costs may be
26 recoverable, Citizens will have the burden of establishing that
27 quantifiable cost savings to ratepayers have been achieved beyond what
28 could have or should have been realized under continued GTE/Contel

1 West ownership. Although Citizens may elect to defer and amortize
2 Transition Costs, we will defer any ratemaking treatment of these
3 costs to a future rate case. We will also adopt the proposal
4 concerning the filing of new tariffs as agreed upon by Staff and
5 Citizens.

6 TARGET EXCELLENCE

7 RUCO's witness, Mr. Ralph Smith, believes that ratemaking
8 treatment of Target: Excellence costs should be established in this
9 proceeding and recommends that the Commission order Citizens to
10 maintain detailed accounting records of Target: Excellence program
11 costs for the acquired properties and to limit recovery of such costs
12 to proven savings. Citizens believes that the ratemaking treatment of
13 Target: Excellence costs is not a relevant issue in this proceeding
14 since no request was made in their application for any recovery of
15 these costs in current rates. In fact, Citizens has agreed to charge
16 Contel West's currently approved rates and to not file a rate case
17 during a two year stay-out period.

18 We agree with Citizens that the ratemaking treatment of Target:
19 Excellence costs should be deferred to a future rate case where
20 Citizens is seeking the inclusion of these costs in rates.
21 Accordingly, we will not adopt RUCO's recommendations as a pre-
22 condition to the approval of Citizens acquisition.

23 CUSTOMER BILLING SERVICES

24 Mr. Mark Shine testified that Citizens is negotiating to purchase
25 billing services from GTE's Customer Billing and Services System
26 ("CBSS") and characterizes the CBSS as a "world class system." (Ex.
27 A-3A, p. 17) Mr. Shine also testified that it is common practice in
28 the telecommunications industry to contract for billing services. RUCO

1 argued that ratepayers will not be better off after the acquisition as
2 it relates to billing services since Citizens has not demonstrated
3 that ratepayers will not be charged more for the CBSS system under
4 Citizens ownership, rather than Contel West's continued ownership.
5 Therefore, RUCO recommended that as a precondition to approving the
6 acquisition, the Commission should require GTE to provide cost data on
7 the billing services so that Citizens' CBSS billing costs could be
8 measured for ratemaking purposes.

9 Although we cannot determine in this proceeding whether Citizens
10 costs to utilize the CBSS billing system will be equal, greater or
11 less than, the costs under continued GTE ownership, we can determine
12 that ratepayers will maintain a similar level or quality of billing
13 services under Citizens ownership if the CBSS system is also utilized
14 by Citizens. We are not, however, determining that the CBSS system
15 must be used by Citizens or that the price paid to GTE for the service
16 is reasonable. Accordingly, we will not adopt RUCO's recommendation
17 and will defer the issue of the reasonableness of these costs and
18 their ratemaking treatment to a future rate case when Citizens seeks
19 to include these costs in rates.

20 GTE'S NONREGULATED AFFILIATES

21 RUCO recommends that the Commission require GTE to provide full
22 details concerning charges and rates of return of two of GTE
23 nonregulated affiliates, GTE Supply ("GTES") and GTE Data Services,
24 Inc. ("GTEDS"), as well as the rates of return earned by the
25 affiliates, as a precondition to approval of the acquisition.
26 According to RUCO, the data should be maintained by Citizens for
27 future rate proceedings.

28 GTE's witness, Mr. Johnson, testified that the FCC audit into

1 GTE's affiliated charges, and the subsequent FCC Consent Decree Order
2 AAD 95-35, covered a period of time prior to the Contel/GTE merger in
3 1991. Mr. Johnson opposed RUCO's recommendation since Contel West's
4 present rates were approved prior to the merger in 1991, GTE's
5 affiliates provided no services to Contel West prior to the 1987 test
6 year used in the last rate case, and, therefore, the existing Contel
7 West's rates do not include any GTED or GTES supply charges. Mr.
8 Johnson further states that RUCO's recommendation to analyze financial
9 data related to GTE's affiliates would be more appropriate in a rate
10 proceeding.

11 Since both parties agree that no overcharges from GTE affiliates
12 have been included in existing rates and that Citizens is required to
13 continue to charge these rates during the moratorium period, we agree
14 with GTE that to the extent financial data concerning these affiliated
15 entities is relevant, the issue should be deferred to the next rate
16 case. However, we also believe that GTE should provide to Citizens at
17 the time of closing all data in their possession relating to any
18 business dealings subsequent to the merger between the GTE affiliates
19 and the Contel West-Arizona properties. This data should include
20 details concerning the returns earned by GTES and GTEDS on their
21 transactions with Contel-West Arizona for the years that operation was
22 under GTE ownership. As previously discussed concerning data
23 retention, GTE should also be required to provide to Citizens,
24 knowledgeable personnel for five years after the closing to assist
25 Citizens with the interpretation of this data in future rate
26 proceedings.

27

28

TECHNICAL AND ADMINISTRATIVE RECOMMENDATIONSMAPS AND DESCRIPTIONS

Citizens agrees to Staff's recommendation that Citizens file maps and descriptions of the service territory that are identical to the maps and descriptions found in the Contel West tariff. Citizens agrees to amend any inaccurate maps and legal descriptions which were filed with their application in this matter. Accordingly, we concur with Staff and will adopt its recommendation.

UPGRADING SERVICE

Staff recommended that: Citizens undertake a study to determine the economic feasibility of upgrading the Greer and Hawley Lake exchanges from analog to digital switching; and, that Citizens conduct an engineering study of service improvements in the Blue River Valley and Richville areas, with the results to be reported within ninety days after completion of the transaction. Citizens does not oppose Staff's recommendations⁵. Although we adopt these recommendations, we will not give ratemaking treatment in this proceeding to the costs of the studies or analysis to be undertaken by Citizens. Ratemaking treatment is deferred to a future proceeding where Citizens is requesting inclusion of these costs into rates.

APPROVAL OF FRANCHISES

Citizens did not object to the following Staff recommendations: that the transfer not take place until necessary franchises are approved; and, that a conditional Certificate issue requiring Citizens to obtain the necessary franchises within one year from the effective date of this Decision. We concur with Staff's recommendation.

⁵ Citizens filed exceptions to the Proposed Order and requested 180 days in which to submit the results of its study.

1 REFUNDS AND NOTICES

2 Staff recommended that Citizens file with the Director of the
3 Utilities Division a list of all refunds assumed by Citizens due for
4 meter installations, security deposits, or main extension agreements.
5 Staff does not oppose Citizens' request that it be allowed sixty to
6 ninety days from the close of escrow to file that information. We will
7 adopt Staff's recommendation and permit Citizens ninety days from the
8 close of escrow to file the information with the Utilities Division.

9 Staff also recommended that Citizens provide notice to the
10 affected customers of Contel West concerning the change in ownership
11 at least fifteen days following the close of escrow, along with the
12 name, address, and telephone number of Citizens' customer service
13 department. However, Mr. Daer indicated that this recommendation would
14 not prohibit Citizens from notifying customers of the transition in
15 ownership prior to the close of escrow. Consequently, Citizens did not
16 oppose Staff's recommendation and agreed to file a copy of the notice
17 with the Director of the Utilities Division. Accordingly, we will
18 adopt Staff's recommendations.

19 * * * * *

20 Having considered the entire record herein and being fully
21 advised in the premises, the Commission finds, concludes, and orders
22 that:

23 FINDINGS OF FACT

24 1. Contel West is an Arizona corporation engaged in the
25 business of providing telecommunications service to the public within
26 portions of Apache, Coconino, Gila, Greenlee, and Navajo Counties
27 Arizona, pursuant to authority granted by the Commission.

28 2. Citizens is a Delaware corporation certificated by the

1 Commission to provide telecommunications, electric, gas, water, and
2 wastewater service in Arizona.

3 3. Citizens currently serves approximately 58,700
4 telecommunications customers in Mohave County, Arizona.

5 4. On June 30, 1993, Contel West and Citizens filed a joint
6 application for approval of the sale of certain telephone properties
7 in Arizona and for approval of the transfer of the attendant
8 Certificate by Contel West to Citizens.

9 5. The proposed sale to Citizens of Contel West's Arizona
10 telephone properties includes approximately 27,700 access lines in the
11 following exchanges: Alpine, Cibeque, Greer, Hawley Lake, Heber,
12 Holbrook, McNary, Pinedale, Pinetop, Pinetop Country Club, Show Low,
13 Snowflake, Springerville, St. Johns, and Whiteriver.

14 6. On May 18, 1993, Contel West and Citizens entered into an
15 Asset Purchase Agreement which established the purchase price for the
16 acquisition as \$88 million, subject to adjustments pursuant to the
17 Agreement.

18 7. The gain to be realized from the sale to Citizens is the
19 difference between the net book value of the depreciable physical
20 assets and the sales price, less Transaction Costs.

21 8. Contel West proposes to allow its shareholders to retain all
22 of the gain resulting from the sale of the Arizona telephone
23 properties to Citizens.

24 9. Neither Staff nor RUCO oppose the application, but both
25 believe the public interest would be served only if certain conditions
26 are adopted by the Commission.

27 10. The Commission finds that the following conditions to the
28 transfer are reasonable, appropriate, and necessary to protect the

1 public interest:

2 ♦ Contel West may retain 100% of the gain to be realized from
3 Citizens acquisition of its Arizona telephone properties.

4 ♦ For ratemaking purposes, we shall prohibit Citizens from
5 including any part of the acquisition adjustment for this
6 transaction into rates.

7 ♦ The ratemaking treatment of deferred income taxes and
8 investment tax credits be deferred to a future rate
9 proceeding and any adjustment would be based upon the
10 difference between rate base under Citizens' ownership
11 compared to what rate base would be under Contel West's
12 continued ownership.

13 ♦ For the remaining life of the assets being purchased from
14 Contel West by Citizens, the ratepayers should be at least
15 as well off under Citizens' ownership as they would be under
16 the continued ownership by Contel West.

17 ♦ Citizens shall acquire and retain historical operating and
18 financial data relating to Contel West properties for the
19 five years prior to the sale, GTE/Contel West shall assist
20 Citizens with the preparation of data responses in future
21 rate proceedings, and GTE/Contel West shall provide Citizens
22 with knowledgeable personnel to interpret the data for a
23 period of five years after the sale.

24 ♦ Citizens shall submit a draft of its cost allocation
25 procedures for review prior to filing its next rate case.

26 ♦ Citizens shall not file for increased rates for the acquired
27 Contel West telephone properties any earlier than two years
28 from the effective date of this Decision.

1 ♦ Citizens may file new tariffs and revise existing tariffs
2 relating to the acquired Contel West properties, to the
3 extent that other certificated telecommunications companies
4 in Arizona have the ability to file for tariff changes,
5 provided that the proposed tariff changes do not result in
6 an increase in the rate of return applicable to the newly
7 acquired properties.

8 ♦ Citizens shall file maps and descriptions of the service
9 territory that are identical to the maps and descriptions
10 found in the Contel West tariff.

11 ♦ Citizens shall undertake a study to determine the economic
12 feasibility of upgrading the Greer and Hawley Lake exchanges
13 from analog to digital switching, but ratemaking treatment
14 attributable to the costs of the studies is deferred to a
15 future rate proceeding where Citizens is requesting
16 inclusion of these costs into rates.

17 ♦ Citizens shall conduct an engineering study of service
18 improvements in the Blue River Valley and Richville areas,
19 and shall report the results of this study to the Director
20 of the Utilities Division within ninety days after
21 consummation of the closing. The ratemaking treatment
22 attributable to the costs of this study are deferred to a
23 future rate proceeding where Citizens is requesting
24 inclusion of these costs into rates.

25 ♦ The transfer between Contel West and Citizens not take place
26 until all necessary franchises needed prior to approval are
27 obtained.

28 ♦ Citizens shall receive a conditional Certificate of

1 Convenience and Necessity requiring Citizens to obtain all
2 necessary franchises within one year from the effective date
3 of this Decision.

4 ♦ Citizens shall file with the Director of the Utilities
5 Division a list of all refunds assumed by Citizens due for
6 meter installations, security deposits, or main extension
7 agreements, within ninety days of close of escrow.

8 ♦ Citizens shall notify affected Contel West telephone
9 customers of the transfer of ownership, along with the name,
10 address, and telephone number of Citizens' customer service
11 department, not later than 15 days of the close of escrow,
12 and file a copy of the notice with the Director of
13 Utilities.

14 ♦ Ratemaking treatment of Citizens Target: Excellence costs
15 should be deferred to a future rate proceeding where
16 Citizens is seeking inclusion of these costs in rates.

17 ♦ Ratemaking treatment for the purchase of billing services
18 from GTE's Customer Billing and Services System will be
19 deferred to a future rate proceeding when Citizens seeks to
20 include these costs into rates.

21 ♦ GTE shall provide Citizens at the time of closing all
22 historical financial data in its possession concerning
23 charges and rates of return of GTE Supply and GTE Data
24 Services relevant to any business transactions subsequent to
25 the merger of GTE and Contel West in 1991. For a period of
26 five years after the close of escrow, GTE shall make
27 available to Citizens, knowledgeable personnel to assist in
28 the interpretation of this data in future rate proceedings.

CONCLUSIONS OF LAW

1
2 1. Contel West and Citizens are public service corporations
3 within the meaning of Article XV of the Arizona Constitution and
4 A.R.S. §§40-281, 40-282 and 40-285.

5 2. The Commission has jurisdiction over Contel West and
6 Citizens and of the subject matter of the application.

7 3. There is a continuing need for the provision of telephone
8 service to the public in Contel West's certificated service area.

9 4. Citizens is a fit and proper entity to receive the assets
10 and Certificate of Contel West.

11 5. Notice of the application was given in the manner prescribed
12 by law.

13 6. Subject to the conditions discussed in Finding of Fact No.
14 10, hereinabove, the transfer of the Certificate and assets of Contel
15 West to Citizens is in the public interest and should be approved.

16 ORDER

17 IT IS THEREFORE ORDERED that the joint application of Contel of
18 the West, Inc. and Citizens Utilities Company for approval of the sale
19 of assets and transfer of Certificates of Contel West's Arizona
20 telephone properties to Citizens is hereby granted.

21 IT IS FURTHER ORDERED that Citizens Utilities Company shall
22 charge Contel of the West, Inc.'s telephone customers the existing
23 rates and charges authorized by the Commission until a change in those
24 rates and charges is authorized by the Commission.

25 IT IS FURTHER ORDERED that Citizens Utilities Company shall not
26 file a general rate case requesting an increase in rates any earlier
27 than two years from the effective date of this Decision.

28 IT IS FURTHER ORDERED that Citizens Utilities Company may file

1 new tariffs and revise existing tariffs relating to the telephone
2 properties acquired from Contel of the West, Inc., to the extent that
3 other certificated telecommunications companies in Arizona have the
4 ability to file for tariff changes, provided that the proposed tariff
5 changes do not result in an increase in the rate of return applicable
6 to the acquired properties.

7 IT IS FURTHER ORDERED that for ratemaking purposes, we shall
8 prohibit Citizens Utilities Company from including any part of the
9 acquisition adjustment for this transaction into rates.

10 IT IS FURTHER ORDERED that GTE shall provide Citizens Utilities
11 Company at the time of close of escrow all historical financial data
12 for its Contel of the West, Inc. Arizona telephone properties for the
13 last five years, and Citizens shall retain the data for a five year
14 period. GTE shall also make available to Citizens Utilities Company
15 for a period of five years after close of escrow, knowledgeable
16 personnel to assist in the interpretation of the data and in the
17 preparation of data responses in future rate proceedings.

18 IT IS FURTHER ORDERED that GTE shall provide to Citizens
19 Utilities Company, at the time of close of escrow, all historical
20 financial data in its possession relating to charges and rates of
21 return of GTE Supply and GTE Data Services relevant to any business
22 transactions with Contel of the West, Inc. subsequent to the merger of
23 GTE and Contel of the West, Inc. GTE shall also, for a period of five
24 years after the close of escrow, make available to Citizens Utilities
25 Company knowledgeable personnel to assist in the interpretation of
26 this data and in the preparation of data responses in future rate
27 proceedings. This data should include details concerning the returns
28 earned by GTEs and GTEs on their transactions with Contel-West

1 Arizona for the years that operation was under GTE ownership.

2 IT IS FURTHER ORDERED that Citizens Utilities Company shall
3 submit a draft of its cost allocation procedures for review prior to
4 filing its next general rate case.

5 IT IS FURTHER ORDERED that Citizens Utilities Company shall file
6 a list of all customer refunds it has assumed with the Director of the
7 Utilities Division within 90 days of the completion of the transfer.

8 IT IS FURTHER ORDERED that Citizens Utilities Company shall
9 notify the affected Contel West telephone customers of the transfer of
10 ownership and shall also provide the customers with the name, address,
11 and telephone number of Citizens' customer service department. The
12 notice shall be mailed to customers not later than 15 days of the
13 completion of the transfer by close of escrow and Citizens shall file
14 a copy of the notice with the Director of the Utilities Division.

15 IT IS FURTHER ORDERED that Citizens Utilities Company shall file
16 maps and descriptions of the service territory that are identical to
17 the maps and descriptions found in the Contel of the West, Inc.
18 tariff.

19 IT IS FURTHER ORDERED that Citizens Utilities Company shall
20 undertake a study to determine the economic feasibility of upgrading
21 the Greer and Hawley Lake exchanges from analog to digital switching.

22 IT IS FURTHER ORDERED that Citizens Utilities Company shall
23 conduct an engineering study of service improvements in the Blue River
24 Valley and Richville areas, and shall report the results of this study
25 to the Director of the Utilities Division within 180 days after the
26 completion of the transfer by close of escrow.

27 IT IS FURTHER ORDERED that Citizens Utilities Company is granted
28 a conditional Certificate of Convenience and Necessity which requires

1 Citizens Utilities Company to obtain all necessary franchises within
2 365 days of the effective date of this Decision.

3 IT IS FURTHER ORDERED that approval of the transfer is
4 conditioned upon Citizens Utilities Company filing with the Commission
5 all necessary franchises within 365 days of the effective date of this
6 Decision.

7 IT IS FURTHER ORDERED that the ratemaking treatment of Target:
8 Excellence costs shall be deferred until a future rate proceeding for
9 Citizens Utilities Company.

10 IT IS FURTHER ORDERED that the ratemaking treatment of billing
11 services leased from GTE's Customer Billing and Services System shall
12 be deferred until a future rate proceeding for Citizens Utilities
13 Company.

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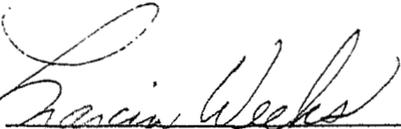
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1 IT IS FURTHER ORDERED that the ratemaking treatment of deferred
2 income taxes and investment tax credits shall be deferred until a
3 future rate proceeding for Citizens Utilities Company.

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

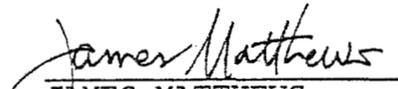
6 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

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8 
9 CHAIRMAN

10
11 COMMISSIONER

12 
13 COMMISSIONER

14 IN WITNESS WHEREOF, I, JAMES MATTHEWS, Executive
15 Secretary of the Arizona Corporation Commission, have
16 hereunto set my hand and caused the official seal of the
17 Commission to be affixed at the Capitol, in the City of
18 Phoenix, this 17 day of October, 1994.

19
20 
21 JAMES MATTHEWS
22 EXECUTIVE SECRETARY

23
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26
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28
DISSENT _____
RB

1 SERVICE LIST FOR:

CONTEL OF THE WEST, INC. and
CITIZENS UTILITIES COMPANY

2 DOCKET NO.:

U-1514-93-169 and E-1032-93-169

3
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21 Gary Yaquinto, Director
22 Utilities Division
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23 1200 West Washington Street
Phoenix, Arizona 85007

25

26

27

28

APPENDIX C

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BEFORE THE ARIZONA CORPORATION COMMISSION

RECEIVED

DOCKETED

CARL J. KUNASEK
CHAIRMAN

JIM IRVIN
COMMISSIONER

WILLIAM A. MUNDELL
COMMISSIONER

JUN 16 2000

JUN 13 2000

CITIZENS
PHOENIX ADM. OFFICE

DOCKETED BY



IN THE MATTER OF THE JOINT APPLICATION
OF GTE CALIFORNIA INCORPORATED AND
CITIZENS UTILITIES RURAL COMPANY, INC.
FOR APPROVAL OF THE SALE OF ASSETS
AND TRANSFER OF THE CERTIFICATE OF
CONVENIENCE AND NECESSITY OF GTE
CALIFORNIA INCORPORATED TO CITIZENS
UTILITIES RURAL COMPANY, INC.

DOCKET NO. T-01954B-99-0511
T-01846B-99-0511

DECISION NO. 62648

OPINION AND ORDER

DATE OF HEARING: April 10, 2000
PLACE OF HEARING: Phoenix, Arizona
PRESIDING OFFICER: Karen E. Nally
APPEARANCES: Mr. Craig A. Marks, on behalf of Citizens Utilities Rural Company, Inc.;
Mr. Jeffrey W. Crockett, SNELL & WILMER, L.L.P., on behalf of GTE California, Inc.; and
Ms. Maureen A. Scott, Staff Attorney, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

BY THE COMMISSION:

On September 10, 1999, GTE California Incorporated ("GTE") and Citizens Utilities Rural Company, Inc. ("Citizens Rural") filed a joint application, based on an Agreement for Purchase and Sale of Telephone Exchanges dated June 16, 1999, for approval of the Sale of Assets and Transfer of the Certificate of Convenience and Necessity of GTE to Citizens Rural.

On October 19, 1999, the Arizona Payphone Association ("APA") filed an Application to Intervene.

Our November 29, 1999 Procedural Order granted APA's Application to Intervene.

On February 7, 2000, the Utilities Division of the Arizona Corporation Commission ("Staff") filed a Request for Procedural Order ("Request").

Our February 23, 2000 Procedural Order set forth the preparation and conduct of this

1 proceeding.

2 GTE filed an Affidavit of Publication reflecting that notice was published on March 6, 2000.

3 Our Procedural Order of February 29, 2000 reset the hearing for April 10, 2000 due to GTE
4 and Citizens Rural stating that they had a conflict regarding the hearing date of April 13, 2000.

5 **DISCUSSION**

6 GTE provides service to approximately 8,600 access lines in the State of Arizona with
7 approximately 6,100 residential lines and 2,500 business lines. The six exchanges are Bouse, Cibola,
8 Ehrenberg, Parker, Parker Dam, and Poston.

9 GTE announced a plan to sell its Arizona switched access lines among other
10 properties. This repositioning was intended to position GTE in markets that offer greater efficiencies
11 in operations and higher growth opportunities. Citizens Rural submitted the winning bid by
12 committing to retain all employees directly supporting the purchased exchanges, by assuming any
13 bargaining unit agreement in effect for the sold exchanges, by providing evidence of financial
14 viability, and by the ability to successfully operate the property and obtain necessary regulatory
15 approvals.

16 According to GTE, the sale to Citizens Rural is in the public interest because Citizens Rural is
17 experienced in telecom operations, especially rural exchanges. The sale allows both companies to
18 meet their objectives while continuing the high level of service currently enjoyed by the customers
19 located in the exchange areas. GTE states that the transaction should result in a seamless transition
20 for the customers. Citizens Rural has committed to continue to provide 911 and E-911 services so
21 there will not be a disruption or change in the provision of emergency services as a result of these
22 sales. Additionally, Citizens Rural will continue to provide the Extended Area Service ("EAS")
23 routes that are currently in place.

24 According to Citizens Rural, its initial funding of the property acquisition will be funded from
25 the Citizens Rural's cash and investment portfolio or from short-term borrowings. Citizens Rural
26 also has the ability to borrow the necessary funds either by issuing commercial paper or by drawing
27 on a \$3 billion bank credit facility obtained for the purpose of providing funding for property
28 acquisitions. Permanent funding for the acquisitions will be provided from Citizens Rural cash and

1 investment portfolio and the proceeds from the sale of Citizens Rural's Public Services' businesses.
2 Therefore, Citizens Rural anticipates that the subsidiaries' capital structure will be 100% equity.

3 Citizens Rural will adopt GTE's retail local service rates and charges that are in effect at the
4 time of the closing and GTE's intrastate tariff rates in effect at the time of the closing. Citizens Rural
5 will also negotiate interconnection agreements with all telecommunication service providers that
6 currently have interconnection agreements with GTE and for which GTE currently provides
7 interconnection services in the acquired exchanges. Until a new agreement is reached, Citizens Rural
8 will provide interconnection services to that provider according to the existing interconnection
9 agreement.

10 Citizens Rural is also asking to be designated an Eligible Telecommunications Carrier
11 ("ETC") under Section 214 of the Telecommunications Act of 1934 as amended because any carrier
12 seeking Universal Service Funding must be designated as such by the state commission. GTE has
13 been so designated for the wire centers being acquired. As Citizens Rural will provide the same
14 services as GTE after the acquisition, Citizens Rural requests the Commission grant it the same ETC
15 status that GTE possessed prior to the acquisition. Additionally, Citizens Rural has stated that it does
16 not need an FCC study area waiver at this time.

17 Citizens Rural also will continue to provide the same products and services to
18 customers that GTE provides in the subject exchanges. Citizens Rural will also be able to offer both
19 intraLATA and interLATA interexchange services. Over a three and a half to four year period,
20 Citizens Rural also plans to invest between \$4.4 to \$4.5 million for routine maintenance, switch
21 upgrades, and software additions for potential new services.

22 On April 10, 2000, Staff, GTE, and Citizens Rural entered into a Settlement Agreement
23 ("Agreement") which requested the Commission approve the Joint Stipulation to expedite the
24 Commission's approval of the Joint Application, subject to certain conditions in the Agreement. We
25 will approve the Agreement and enact its terms.

26 * * * * *

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

FINDINGS OF FACT

1
2 1. On September 10, 1999, GTE and Citizens Rural filed a joint application, based on an
3 Agreement for Purchase and Sale of Telephone Exchanges dated June 16, 1999, for approval of the
4 Sale of Assets and Transfer of the Certificate of Convenience and Necessity of GTE to Citizens
5 Rural.

6 2. On October 19, 1999, the APA filed an Application to Intervene.

7 3. Our November 29, 1999 Procedural Order granted APA's Application to Intervene.

8 4. On February 7, 2000, Staff filed a Request for Procedural Order.

9 5. Our February 23, 2000 Procedural Order set forth the preparation and conduct of this
10 proceeding.

11 6. GTE filed an Affidavit of Publication reflecting that notice was published on March 6,
12 2000.

13 7. Our Procedural Order of February 29, 2000 reset the hearing for April 10, 2000 due to
14 GTE and Citizens Rural stating that they had a conflict regarding the hearing date of April 13, 2000.

15 8. On April 10, 2000, GTE submitted on behalf of the APA, a letter that stated that the
16 APA did not oppose the Agreement.

17 9. GTE provides service to approximately 8,600 access lines in the State of Arizona with
18 approximately 6,100 residential lines and 2,500 business lines.

19 10. The six exchanges are Bouse, Cibola, Ehrenberg, Parker, Parker Dam, and Poston.

20 11. GTE announced a plan to sell its Arizona switched access lines among other
21 properties.

22 12. According to GTE, the sale to Citizens Rural is in the public interest because Citizens
23 Rural is experienced in telecom operations, especially rural exchanges.

24 13. Citizens Rural has committed to continue to provide 911 and E-911 services so there
25 will not be a disruption or change in the provision of emergency services as a result of these sales.

26 14. Citizens Rural will continue to provide the EAS routes that are currently in place.

27 15. Citizens Rural anticipates that the subsidiaries' capital structure will be 100% equity.

28 16. Citizens Rural will adopt GTE's retail local service rates and charges that are in effect

1 at the time of the closing and GTE's intrastate tariff rates in effect at the time of the closing.

2 17. Citizens Rural will also negotiate interconnection agreements with all
3 telecommunication service providers that currently have interconnection agreements with GTE and
4 for which GTE currently provides interconnection services in the acquired exchanges.

5 18. Until agreement is reached, Citizens Rural will provide interconnection services to
6 that provider according to the existing interconnection agreement.

7 19. Citizens Rural is also asking to be designated an ETC under Section 214 of the
8 Telecommunications Act of 1934 as amended because any carrier seeking Universal Service Funding
9 must be designated as such by the state commission.

10 20. As Citizens Rural will provide the same services as GTE after the acquisition, Citizens
11 Rural requests the Commission grant it the same ETC status that GTE possessed prior to the
12 acquisition.

13 21. Additionally, Citizens Rural has stated that it does not need a FCC study area waiver
14 at this time.

15 22. Citizens Rural also will continue to provide the same products and services to
16 customers that GTE provides in the subject exchanges.

17 23. Over a three and a half to four year period, Citizens Rural also plans to invest between
18 \$4.4 to \$4.5 million for routine maintenance, switch upgrades, and software additions for potential
19 new services.

20 24. On April 10, 2000, Staff, GTE, and Citizens Rural entered into an Agreement, which
21 requested the Commission approve the Joint Stipulation to expedite the Commission's approval of
22 the Joint Application, subject to certain conditions in the Agreement.

23 25. Pursuant to the Agreement, Staff, GTE and Citizens Rural have agreed as follows:

24 **Rates and Charges.** Citizens Rural agrees that it will adopt GTE California's existing
25 local service rates and charges for each of the six exchanges it is acquiring from GTE
26 California. Citizens Rural also agrees that it will charge the same rates and charges
27 currently in effect for all other intrastate services in each of the six exchanges it is
28 acquiring from GTE California. Such local service rates and other intrastate rates and
charges shall remain in effect in the exchanges until such time as Citizens Rural receives
authorization from the Commission to increase or decrease its local service rates and

1 other intrastate rates and charges.

2 **Availability of Services and Filing of Tariffs.** Citizens Rural agrees to provide the
3 same products and services to customers in each of the six exchanges it will be acquiring
4 that GTE California currently provides to its customers. Both GTE California and
5 Citizens Rural agree that the provision of public safety services such as 911 shall
6 continue to be provided in the same manner, and without interruption, to all customers in
7 the affected exchanges. Citizens Rural also agrees that it will file new intrastate tariffs
8 with the Commission, which mirror GTE California's tariffs currently on file at the
9 Commission for each of the six exchanges, which will be subject to Staff review and
10 approval.

11 **Completion of Planned Upgrades.** Citizens Rural agrees that it will complete the
12 following projects that GTE California has planned for the calendar year 2000:

- 13 (a) Cable Replacement and Pedestal Rehabilitation Estimated to Cost
14 \$35,000. To the extent not completed by GTE California as of the date of
15 closing, Citizens Rural will complete this cable replacement and pedestal
16 rehabilitation.
- 17 (b) Outside Plant Cable Reinforcement Estimated to Cost \$126,708. To the
18 extent not completed by GTE California as of the date of closing, Citizens
19 Rural will complete the outside plant cable reinforcement.
- 20 (c) Placement of Pair Gain Device Estimated to Cost \$101,169. To the extent
21 not completed by GTE California as of the date of closing, Citizens Rural
22 will complete the placement of this pair gain device.

23 Citizens Rural agrees that the above-described projects will be completed no later than
24 year-end 2000. Citizens Rural agrees to undertake plans to modernize and upgrade plant
25 in the affected exchanges over the next four years. Citizens Rural also agrees to make
26 available to Staff its plans when completed which will identify where network
27 improvements and reinforcements will be made and the projected date of those
28 improvements and reinforcements.

Interconnection Agreements. Citizens Rural agrees to abide by the terms and
conditions of GTE's existing interconnection and inter-carrier agreements until it is able
to renegotiate new agreements with the affected providers. All interconnection and inter-
carrier agreements between Citizens Rural and telecommunications services providers in
the acquired wire centers will be submitted to the Commission for approval as required
by law or regulation.

Eligible Telecommunications Carrier Status. In order to be designated an Eligible
Telecommunications Carrier ("ETC") in the six GTE California exchanges it is acquiring,
Citizens Rural agrees to: (A) offer the services that are supported by Federal universal
service support mechanisms under section 254(c), either using its own facilities or a
combination of its own facilities and resale of another carrier's services (including the
services offered by another eligible telecommunications carrier); and (B) advertise the

1 availability of such services and the charges therefore using media of general distribution.
2 The Commission Staff agrees that Citizens Rural should be entitled to any waivers, if
3 any, currently in effect for GTE California for the full term of the waiver. Citizens Rural
4 also agrees to offer Lifeline and Link Up Service on the same terms and conditions as
5 currently available to GTE California subscribers in each of the six exchanges it will be
6 acquiring and that it will advertise the availability of Lifeline and Link Up service as
7 required under federal and state law.

8 **GTE California Provision of Support Services.** In accordance with Exhibit E of the
9 Citizens Rural and GTE California Agreement, GTE California agrees to provide such
10 support services as necessary to ensure continued and unimpeded service to all customers
11 in the six exchanges it is acquiring, including but not limited to, operator services,
12 directory assistance, SS7 services and supply services.

13 **Publication of Directories.** Citizens Rural's Directory Services Company will provide
14 white and yellow page directories in the exchanges acquired from GTE California similar
15 to those directories that are currently provided by GTE California.

16 **Acquisition Adjustment.** In this proceeding, Citizens Rural has not requested that the
17 Commission establish the ratemaking treatment for the difference between the book
18 value of the properties purchased from GTE California and the purchase price paid.
19 While Citizens Rural intends to record the consideration paid over the book value of the
20 net assets acquired from GTE California in accordance with FCC Part 32 Accounting
21 Rules, Citizens Rural agrees that the recognition of such premium for regulatory
22 purposes, including but not limited to, ratemaking or fair value rate base determination
23 purposes, shall not be allowed without the prior authorization of the Commission.
24 Citizens Rural acknowledges that the Commission Staff generally opposes the recovery
25 of such an acquisition premium in rates, but that the Staff has agreed to defer the issue to
26 Citizens Rural's next rate case, or until such time, if ever, as Citizens Rural seeks
27 recovery of such acquisition adjustment.

28 **Deferred Taxes and Investment Tax Credits.** The Commission Staff has not analyzed
whether any deferred income taxes and/or income tax credits will exist on the date of
closing which should be deducted from rate base or refunded to ratepayers. The Parties
agree to defer the issue of the existence, quantification and treatment of any deferred
income taxes and/or investment tax credits to Citizens Rural's next rate case proceeding,
or any future proceeding where this issue may be relevant.

Study Area Waiver. Citizens Rural has stated that it may petition the Federal
Communications Commission ("FCC") for a study area waiver in order to remove the
cap that will be placed upon the amount of federal Universal Service Funds available to
Citizens Rural after acquisition of the GTE California exchanges. Citizens Rural agrees
to provide the Commission Staff with a copy of such petition prior to filing for its review.

Notice to Customers. Citizens Rural and GTE California agree to notify customers by
bill insert or separate mailing of the changes in ownership once the Commission
approves the transaction. The Notice shall inform customers, among other things, (1) that
existing rates will not change, (2) that Citizens Rural will assume the responsibility of

1 GTE as intraLATA carrier and (3) of a phone number where customers can call to have
2 any questions they may have answered. Citizens Rural and GTE California shall submit
their proposed Notice to the Commission Staff for review and approval prior to mailing.

3 **Notice to Commission.** Citizens Rural and GTE California both agree to file with the
4 Commission, a joint written notice of closing of the transaction within five days of
5 formal closing. Citizens Rural and GTE California also agree to provide the
Commission with written notice of all other approvals or authorizations required for
6 consummation of the transfer.

7 **Contingency of Joint Stipulation.** This Joint Stipulation is contingent upon
8 Commission approval of the Joint Stipulation in its entirety and without modification
9 pursuant to a final and non-appealable order. Each provision of this Joint Stipulation is
10 in consideration and support of all the other provisions, and expressly conditioned upon
11 acceptance by the Commission without change. In the event that the Commission fails to
adopt this Joint Stipulation according to its terms by May 31, 2000, this Joint Stipulation
shall be deemed withdrawn and of no further force or effect and the Parties shall be free
to pursue their respective positions in these proceedings without prejudice.

12 **Positions Not Prejudiced, Limited or Waived.** None of the Parties by their execution
13 of this Agreement shall be deemed to have accepted, agreed to, or conceded to any
14 particular ratemaking or legal principle underlying this Stipulation. With respect to
those matters deferred to a future rate case proceeding as set forth herein, acceptance of
this Joint Stipulation does not prejudice, limit or waive any position that Citizens Rural
or Staff may desire to assert in such rate case proceeding.

15 26. On April 10, 2000, a hearing was held on this matter at the Commission's offices in
16 Phoenix, Arizona.

17 27. On April 13, 2000, Staff, with the concurrence of GTE and Citizens Rural, filed an
18 erratum to the Agreement to correct the first sentence of paragraph 4 on page 3.

19 **CONCLUSIONS OF LAW**

20 1. Citizens Rural and GTE are public service corporations within the meaning of Article
21 XV of the Arizona Constitution and A.R.S. §§ 40-281, 40-282, and 40-285.

22 2. The Commission has jurisdiction over Citizens Rural, GTE, over the subject matter of
23 this proceeding, and over the Agreement.

24 3. Citizens Rural and GTE provided notice of this proceeding in accordance with law.

25 4. The Agreement resolves all matters contained therein in a manner which is just and
26 reasonable, and which promotes the public interest.

1 SERVICE LIST FOR:

GTE CALIFORNIA INCORPORATED and CITIZENS
UTILITIES RURAL COMPANY, INC.

2
3 DOCKET NOS.:

T-01954B-99-0511 and T-01846B-99-0511

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25 1200 West Washington Street
26 Phoenix, Arizona 85007

27 Deborah Scott, Director
28 Utilities Division
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1200 West Washington Street
Phoenix, Arizona 85007

EXHIBIT A

IN THE MATTER OF THE JOINT APPLICATION OF GTE CALIFORNIA
INCORPORATED AND CITIZENS UTILITIES RURAL COMPANY, INC., FOR
APPROVAL OF THE SALE OF ASSETS AND TRANSFER OF THE
CERTIFICATES OF CONVENIENCE AND NECESSITY OF GTE CALIFORNIA
INCORPORATED TO CITIZENS UTILITIES RURAL COMPANY, INC.
(DOCKET NOS. T-01954B-99-0511 AND T-01846B-00-0511)

JOINT STIPULATION

THIS JOINT STIPULATION is entered into this 10th day of April, 2000, between GTE California Incorporated ("GTE California"), Citizens Utilities Rural Company ("Citizens Rural") and the Arizona Corporation Commission Utilities Division Staff ("Commission Staff"). GTE California, Citizens Rural, and the Commission Staff are collectively referred to herein as the "Parties".

RECITALS

On August 27, 1999, GTE California and Citizens Rural filed a Joint Application with the Arizona Corporation Commission seeking approval of the sale of certain telephone properties in Arizona and the transfer of the Certificates of Convenience and Necessity ("CC&N") from GTE California to Citizens Rural. Specifically, the telephone properties to be transferred are the Cibola, Ehrenberg, Bouse, Parker, Parker Dam and Poston Exchanges located in La Paz County, Arizona.

On October 19, 1999, the Arizona Payphone Association ("APA") filed a motion to intervene in this proceeding, which motion was subsequently granted without objection by the Commission. Other than filing its application to intervene (which neither expressed a position on nor requested any relief concerning the proposed sale), the APA has not filed testimony, conducted discovery, or otherwise participated in this proceeding. There were no other intervenors in this proceeding.

On February 28, 2000, GTE California and Citizens Rural each filed direct testimony addressing the transfer of exchanges from GTE California to Citizens Rural. On March 24, 2000, Staff filed testimony recommending approval of the transfer subject to certain conditions and recommendations set forth therein. Prior to filing its testimony, Staff conducted discovery regarding the proposed transfer of exchanges, requesting and receiving information from both GTE California and Citizens Rural. In its testimony, Staff concluded that Citizens Rural is a fit and proper entity to receive the CC&N of GTE California, and that the transfer of exchanges from GTE California to Citizens Rural is in the public interest, subject to certain conditions and recommendations set forth in the testimony.

GTE California and Citizens Rural have reviewed the Staff testimony, and each agrees with the conditions and recommendations contained therein. There being no areas of disagreement between the Parties, the Parties desire to enter into this Joint Stipulation

to expedite the Commission's approval of the Joint Application, subject to the conditions set forth hereinafter.

NOW THEREFORE, the undersigned parties stipulate and agree as follows in connection with the Joint Application filed with the Commission by GTE California and Citizens Rural in Docket Nos. T-01954B-99-0511 and T-01846B-99-0511.

AGREEMENT

1. Rates and Charges

Citizens Rural agrees that it will adopt GTE California's existing local service rates and charges for each of the six exchanges it is acquiring from GTE California. Citizens Rural also agrees that it will charge the same rates and charges currently in effect for all other intrastate services in each of the six exchanges it is acquiring from GTE California. Such local service rates and other intrastate rates and charges shall remain in effect in the exchanges until such time as Citizens Rural receives authorization from the Commission to increase or decrease its local service rates and other intrastate rates and charges.

2. Availability of Services and Filing of Tariffs

Citizens Rural agrees to provide the same products and services to customers in each of the six exchanges it will be acquiring that GTE California currently provides to its customers. Both GTE California and Citizens Rural agree that the provision of public safety services such as 911 shall continue to be provided in the same manner, and without interruption, to all customers in the affected exchanges. Citizens Rural also agrees that it will file new intrastate tariffs with the Commission, which mirror GTE California's tariffs currently on file at the Commission for each of the six exchanges, which will be subject to Staff review and approval.

3. Completion of Planned Upgrades

Citizens Rural agrees that it will complete the following projects that GTE California has planned for the calendar year 2000:

- (a) Cable Replacement and Pedestal Rehabilitation Estimated to Cost \$35,000. To the extent not completed by GTE California as of the date of closing, Citizens Rural will complete this cable replacement and pedestal rehabilitation.
- (b) Outside Plant Cable Reinforcement Estimated to Cost \$126,708. To the extent not completed by GTE California as of the date of closing, Citizens Rural will complete the outside plant cable reinforcement.

- (c) Placement of Pair Gain Device Estimated to Cost \$101,169. To the extent not completed by GTE California as of the date of closing, Citizens Rural will complete the placement of this pair gain device.

Citizens Rural agrees that the above-described projects will be completed no later than year-end 2000. Citizens Rural agrees to undertake plans to modernize and upgrade plant in the affected exchanges over the next four years. Citizens Rural also agrees to make available to Staff its plans when completed which will identify where network improvements and reinforcements will be made and the projected date of those improvements and reinforcements.

4. Interconnection Agreements

Citizens Rural agrees to abide by the terms and conditions of GTE's existing interconnection and inter-carrier agreements until it is able to renegotiate new agreements with the affected providers. All interconnection and inter-carrier agreements between Citizens Rural and telecommunications services providers in the acquired wire centers will be submitted to the Commission for approval as required by law or regulation.

5. Eligible Telecommunications Carrier Status

In order to be designated an Eligible Telecommunications Carrier ("ETC") in the six GTE California exchanges it is acquiring, Citizens Rural agrees to: (A) offer the services that are supported by Federal universal service support mechanisms under section 254(c), either using its own facilities or a combination of its own facilities and resale of another carrier's services (including the services offered by another eligible telecommunications carrier); and (B) advertise the availability of such services and the charges therefore using media of general distribution. The Commission Staff agrees that Citizens Rural should be entitled to any waivers, if any, currently in effect for GTE California for the full term of the waiver. Citizens Rural also agrees to offer Lifeline and Link Up Service on the same terms and conditions as currently available to GTE California subscribers in each of the six exchanges it will be acquiring and that it will advertise the availability of Lifeline and Link Up service as required under federal and state law.

6. GTE California Provision of Support Services

In accordance with Exhibit E of the Citizens Rural and GTE California Agreement, GTE California agrees to provide such support services as necessary to ensure continued and unimpeded service to all customers in the six exchanges it is acquiring, including but not limited to, operator services, directory assistance, SS7 services and supply services.

7. Publication of Directories

Citizens Rural's Directory Services Company will provide white and yellow page directories in the exchanges acquired from GTE California similar to those directories that are currently provided by GTE California.

8. Acquisition Adjustment

In this proceeding, Citizens Rural has not requested that the Commission establish the ratemaking treatment for the difference between the book value of the properties purchased from GTE California and the purchase price paid. While Citizens Rural intends to record the consideration paid over the book value of the net assets acquired from GTE California in accordance with FCC Part 32 Accounting Rules, Citizens Rural agrees that the recognition of such premium for regulatory purposes, including but not limited to, ratemaking or fair value rate base determination purposes, shall not be allowed without the prior authorization of the Commission. Citizens Rural acknowledges that the Commission Staff generally opposes the recovery of such an acquisition premium in rates, but that the Staff has agreed to defer the issue to Citizens Rural's next rate case, or until such time, if ever, as Citizens Rural seeks recovery of such acquisition adjustment.

9. Deferred Taxes and Investment Tax Credits

The Commission Staff has not analyzed whether any deferred income taxes and/or income tax credits will exist on the date of closing which should be deducted from rate base or refunded to ratepayers. The Parties agree to defer the issue of the existence, quantification and treatment of any deferred income taxes and/or investment tax credits to Citizen's next rate case proceeding, or any future proceeding where this issue may be relevant.

10. Study Area Waiver

Citizens Rural has stated that it may petition the Federal Communications Commission ("FCC") for a study area waiver in order to remove the cap that will be placed upon the amount of federal Universal Service Funds available to Citizens Rural after acquisition of the GTE California exchanges. Citizens Rural agrees to provide the Commission Staff with a copy of such petition prior to filing for its review.

11. Notice to Customers

Citizens Rural and GTE California agree to notify customers by bill insert or separate mailing of the changes in ownership once the Commission approves the transaction. The Notice shall inform customers, among other things, (1) that existing rates will not change, (2) that Citizens Rural will assume the

responsibility of GTE as intraLATA carrier and (3) of a phone number where customers can call to have any questions they may have answered. Citizens Rural and GTE California shall submit their proposed Notice to the Commission Staff for review and approval prior to mailing.

12. Notice to Commission

Citizens Rural and GTE California both agree to file with the Commission, a joint written notice of closing of the transaction within five days of formal closing. Citizens Rural and GTE California also agree to provide the Commission with written notice of all other approvals or authorizations required for consummation of the transfer.

13. Contingency of Joint Stipulation

This Joint Stipulation is contingent upon Commission approval of the Joint Stipulation in its entirety and without modification pursuant to a final and non-appealable order. Each provision of this Joint Stipulation is in consideration and support of all the other provisions, and expressly conditioned upon acceptance by the Commission without change. In the event that the Commission fails to adopt this Joint Stipulation according to its terms by May 31, 2000, this Joint Stipulation shall be deemed withdrawn and of no further force or effect and the Parties shall be free to pursue their respective positions in these proceedings without prejudice.

14. Positions Not Prejudiced. Limited or Waived

None of the Parties by their execution of this Agreement shall be deemed to have accepted, agreed to, or conceded to any particular ratemaking or legal principle underlying this Stipulation. With respect to those matters deferred to a future rate case proceeding as set forth herein, acceptance of this Joint Stipulation does not prejudice, limit or waive any position that Citizens Rural or Staff may desire to assert in such rate case proceeding.

DATED as of the date first written above.

GTE CALIFORNIA INCORPORATED-

By: Jeffrey W. Cuth

Its: Attorney

CITIZENS UTILITIES RURAL COMPANY

By: [Signature]

Its: VICE PRESIDENT - REGULATORY & GOVERNMENT AFFAIRS

ARIZONA CORPORATION COMMISSION
UTILITIES DIVISION STAFF

By: Barbara Wytaste

Its: Assistant Director

APPENDIX D

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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission
DOCKETED

APR 17 1997

CARL J. KUNASEK
CHAIRMAN
JIM IRVIN
COMMISSIONER
RENZ D. JENNINGS
COMMISSIONER

DOCKETED BY *cm*

IN THE MATTER OF THE APPLICATION OF)
OF AJO IMPROVEMENT COMPANY AND)
SOUTHWEST GAS CORPORATION)
FOR APPROVAL OF THE SALE OF THE)
NATURAL GAS ASSETS AND THE TRANSFER)
OF THE CERTIFICATE OF PUBLIC)
CONVENIENCE AND NECESSITY OF AJO)
IMPROVEMENT COMPANY TO SOUTHWEST)
GAS CORPORATION.)

DOCKET NO. E-1025-96-473

DOCKET NO. U-1551-96-473

DECISION NO. 60167

OPINION AND ORDER

DATE OF HEARING: January 9, 1997 & March 13, 1997
PLACE OF HEARING: Tucson, Arizona
PRESIDING OFFICER: Jane L. Rodda
APPEARANCES: Mr. Lex Smith, BROWN & BAIN, PA, on behalf of Ajo Improvement Company;
Mr. Thomas Sheets, Vice President and General Counsel, on behalf of Southwest Gas Corporation;
Mr. James Beene, on behalf of Residential Utilities Consumer Office, intervenor; and
Mr. Christopher Kempley, Assistant Chief Counsel, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

BY THE COMMISSION:

On August 30, 1996, Ajo Improvement Company ("AIC") and Southwest Gas Corporation ("Southwest Gas") filed with the Arizona Corporation Commission ("Commission") a joint application for the approval of the sale of assets and transfer of Certificate of Public Convenience and Necessity ("Certificate") associated with the natural gas distribution system of AIC to Southwest Gas. On September 20, 1996, the Commission granted intervention to the Residential Utility Consumer Office. The Commission's Utilities Division Staff ("Staff") filed its Staff Report in this matter on October 16, 1996, recommending approval after a hearing.

By Procedural Order dated October 23, 1996, the Commission set a hearing for January 9, 1997

1 in Tucson, Arizona. On December 18, 1996, Southwest Gas requested a 60 day continuance to afford
2 AIC and Southwest Gas additional time to resolve issues relating to the transfer. Neither RUCO nor Staff
3 opposed the continuance, although Staff requested that in light of the delay, the Commission consider
4 returning AIC's over collected Purchased Gas Adjuster ("PGA") bank balance to customers as soon as
5 possible. The Commission continued the evidentiary portion of hearing on the sale and transfer of assets
6 until March 13, 1997, but convened on January 9, 1997, for the purpose of taking public comment and
7 discussing how to refund the over collected PGA bank balance. Neither AIC nor Southwest Gas opposed
8 the Commission taking action to return the over collected bank PGA balance to customers prior to the
9 March hearing date. As a result, on February 3, 1997, the Commission issued Decision No. 60053,
10 ordering AIC to refund the over collected PGA bank balance to its customers by the end of February
11 1997. AIC complied with the Commission's order.

12 The hearing reconvened before a duly authorized Hearing Officer on March 13, 1997 in Tucson,
13 Arizona. Mr. John Zamar testified on behalf of AIC; Messrs Dennis Holden and Roger Montgomery,
14 testified on behalf of Southwest Gas; and Ms. Linda Jaress testified for Staff.

15 DISCUSSION

16 Introduction

17 AIC owns and operates a natural gas distribution system, and electric, water and wastewater
18 utilities within and around the town of Ajo in Pima County, Arizona. Phelps Dodge Corporation
19 ("Phelps Dodge"), owner of a copper mine near Ajo, is the parent of AIC. AIC's gas operations serve
20 approximately 828 customers. Phelps Dodge is selling the gas system because "[t]he changes in
21 regulations and requirements to operate and maintain the gas system have become too burdensome...and
22 it was determined that it would not be prudent to continue to operate the system."

23 Southwest Gas provides gas transportation and distribution service to approximately 1,028,000
24 customers in three states, including 590,900 customers in Arizona. Southwest Gas serves approximately
25 1,000 customers in the area completely surrounding AIC.

26 Purchase Price

27 AIC and Southwest Gas negotiated a purchase price of \$700,000. On August 5, 1996, Southwest
28 Gas paid \$140,000 to AIC as a deposit and will pay AIC an additional \$560,000 at closing. The purchase

1 price is below the book value of the assets being transferred, which on December 31, 1995 was
2 \$1,985,517. Southwest Gas requested that the Commission authorize it to exclude the unamortized
3 balance of the negative acquisition adjustment from rate base in its pending rate case. Exclusion of the
4 unamortized balance from rate base would allow Southwest Gas to earn a return on the \$1,985,517 book
5 value of the acquired assets rather than on just the \$700,000 it paid for them. Southwest Gas also
6 requested authorization to use the unamortized balance of the acquisition adjustment as an offset to
7 reduce the amount of any acquisition adjustment related to future, above-book purchases. At the hearing
8 on this matter, Southwest Gas requested that a decision on the treatment of the negative acquisition
9 adjustment be determined as part of this proceeding rather than deferred to Southwest Gas' pending rate
10 case.

11 In its Staff Report, Staff took no position regarding the treatment of the negative acquisition
12 adjustment, stating that Southwest Gas' pending rate case was the appropriate forum for deciding the
13 issue. However, at the hearing, Staff stated that it was recommending that the negative acquisition
14 adjustment be treated in the method Southwest Gas proposed. Staff took no position, however, on
15 whether the treatment of the negative acquisition adjustment should be adjudicated as part of this
16 proceeding.

17 RUCO supports Staff's original position concerning the acquisition adjustment. RUCO learned
18 of Staff's decision to support the negative acquisition adjustment immediately prior to the hearing and
19 did not have adequate time to analyze the issue. Consequently, in a pleading filed with the Commission
20 on March 24, 1997, RUCO opposed having the treatment of the acquisition adjustment determined in this
21 proceeding.

22 We concur with RUCO. Southwest Gas' pending rate case, where the effect on rate payers can
23 be thoroughly analyzed, is the proper forum for determining the treatment of the acquisition adjustment.

24 Effect of Transfer on AIC Customers

25 Currently, AIC maintains a staff of five customer service representatives and service technicians
26 in an office in Ajo. The staff is cross trained to provide services to the various utility services. One
27 employee is dedicated to the gas system, although he also performs work for the other utility services.

28 After the sale, AIC customers can contact Southwest Gas for 24 hour emergency service and

1 normal customer service through an "800" number. A service technician, stationed in Gila Bend, who
2 currently provides service to Southwest Gas' customers around Ajo, will provide service to the former
3 AIC customers. Southwest Gas' Casa Grande District has 41 employees who will be available to perform
4 construction and maintenance activities not performed by the Gila Bend service technician. Southwest
5 Gas expects to provide repair service to former AIC customers as quickly as AIC.

6 In addition to paying by mail, current AIC gas customers may pay their bills at the Arizona Public
7 Service Company ("APS") office and at the Phelps Dodge Mercantile store. After the sale, the customers
8 may continue to pay at the APS office indefinitely, but may only pay at the Mercantile store for the
9 immediate 6 month period following the transfer.

10 Southwest Gas offers several customer service programs not offered by AIC that will be available
11 to former AIC customers immediately after the transfer, including the Low Income Ratepayer Assistance
12 Program, Automatic Payment Plan, Equal Payment Plan, Third Party Alert Plan, equipment marking for
13 visually impaired customers, services for hearing and speech-impaired customers, a language bank
14 service, and a seniors weatherization program.

15 Rates

16 AIC's rates include a lower monthly service charge than Southwest Gas's Central Division rates,
17 however, AIC has a higher per therm charge than Southwest Gas. Consequently, the impact of the
18 transfer on customer bills will depend on usage. Not only do the total rates per therm of the two
19 companies differ, the components (i.e., margin, gas cost and purchased gas adjusters) of those rates also
20 differ significantly. Based on historical usage, on average, customers who would be classified as
21 residential by Southwest Gas would experience a slight increase in their bills and those classified as small
22 commercial would experience a slight decrease in their bills if Southwest gas' rates applied.

23 Staff notes that in comparing rates, one should consider that AIC's rates were set before the 1994
24 replacement of the distribution system and some of the costs reflected in AIC's rates may be significantly
25 lower than the real costs of serving AIC customers which may have contributed to AIC's 1995 operating
26 loss of \$110,000.

27 Staff recommends that for the period between the closing of the transaction and the effective date
28 of Southwest Gas' new rates, Southwest Gas should continue to charge AIC customers the current AIC

1 rates. Staff further recommends that upon the final disposition in Southwest Gas' rate case, Southwest
2 Gas should true-up the former AIC gas cost and adjuster to Southwest Gas' cost. A true up would consist
3 of applying Southwest Gas' gas cost and adjuster to the former AIC customers' usage and refunding any
4 positive difference. Staff believes this procedure would reduce the rate shock which customers would
5 experience if the tariffed rates were lowered at closing and then possibly raised at the conclusion of the
6 Southwest Gas rate case. Southwest Gas did not oppose Staff's recommendation concerning rates. We
7 concur that Staff's proposal is reasonable.

8 * * * * *

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

11 **FINDINGS OF FACT**

12 1. On August 30, 1996, AIC and Southwest Gas (collectively "Applicants") filed with the
13 Commission a joint application for the approval of the sale of assets and the transfer of the Certificate
14 associated with the natural gas distribution system of AIC to Southwest Gas.

15 2. The Commission granted intervention to RUCO on September 20, 1996.

16 3. Phelps Dodge owns AIC which owns and operates a natural gas distribution system, as
17 well as electric, water and wastewater utilities in and around Ajo in Pima County.

18 4. Southwest Gas provides gas transportation and distribution service to approximately
19 1,028,000 customers in three states, including approximately 590,900 customers in Arizona. Southwest
20 Gas serves approximately 1,000 customers in the area completely surrounding AIC.

21 5. Staff issued its Staff Report on October 16, 1996, and recommended approval of the
22 transaction after a hearing.

23 6. By Procedural Order dated October 23, 1996, the Commission set the hearing on this
24 matter for January 9, 1997.

25 7. On December 3, 1996, AIC filed a Certification of Mailing of Public Notice with the
26 Commission, certifying that it mailed notice of the hearing to its customers.

27 8. On December 18, 1996, Southwest Gas requested that the hearing be continued for 60
28 days to provide the parties additional time to work out details of the transaction.

1 9. No parties objected to a continuance, although Staff expressed concern that a continuance
2 would delay the refund of AIC's overcollected PGA bank balance to its customers.

3 10. On January 9, 1997, the hearing convened for the purpose of taking public comment and
4 to discuss the procedure for refunding AIC's over-collected Purchased Gas Adjuster balance account.
5 The Hearing Officer continued the evidentiary portion of the hearing until March 13, 1997.

6 11. On February 6, 1997, the Commission issued Decision No. 60053 which ordered AIC to
7 refund the over-collected purchase gas adjuster bank balance during the last week of February 1997. AIC
8 complied with Decision No. 60053.

9 12. The hearing reconvened on March 13, 1997 as scheduled.

10 13. AIC and Southwest Gas negotiated a purchase price for the system of \$700,000, which
11 is below the book value of the system of \$1,985,517 as of December 31, 1995.

12 14. Southwest Gas has requested authorization to exclude the unamortized balance of the
13 negative acquisition adjustment from rate base in future general rate cases and to use the unamortized
14 balance of the acquisition adjustment as an offset to reduce the amount of any acquisition adjustment
15 related to future, above-book purchases. At the hearing, Southwest Gas requested that the Commission
16 adjudicate the treatment of the acquisition adjustment in this proceeding rather than defer the issue to
17 Southwest Gas' pending rate case.¹

18 15. Staff recommended that the unamortized acquisition adjustment be deducted from rate
19 base. Staff did not take a position whether the issue should be determined in the current proceeding or
20 deferred to Southwest Gas' rate case.

21 16. RUCO opposed determining the treatment of the acquisition adjustment in this proceeding
22 and recommended that the pending rate case was the appropriate forum.

23 17. The Commission will defer this issue to the pending rate case.

24 18. At the time of the hearing, AIC and Southwest were in compliance with the Commission's
25 Pipeline Safety regulations.

26 19. Southwest Gas has the financial and technical ability to operate the AIC gas distribution
27

28 ¹ On December 5, 1996, Southwest Gas filed an application for rate increase which is currently pending before the Commission.

1 system.

2 20. Staff recommended that for the period between the closing of the transaction and the
3 effective date of Southwest Gas' new rates, Southwest Gas should continue to charge AIC customers
4 current AIC rates.

5 21. Staff further recommends that Southwest Gas provide notice of its rate case to AIC gas
6 customers; that when Southwest Gas' new rates go into effect, Southwest Gas should true-up the
7 revenues received from the AIC gas cost and purchased gas adjuster rates to those which reflect the
8 Southwest gas cost and refund any difference to the former AIC customers.

9 22. Although claiming it would be under-earning on the AIC assets, Southwest Gas agreed
10 to accept Staff's recommendation concerning rates.

11 23. The transfer of AIC's Pima County-based natural gas properties to Southwest Gas is in
12 the interest of the Ajo community as a whole because the consolidation with Southwest Gas' current
13 customer base in Ajo should result in overall system cost savings due to efficiencies and economies of
14 scale and all of the residents in the Ajo community should benefit from Southwest Gas' safety related
15 and other customer service programs.

16 **CONCLUSIONS OF LAW**

17 1. Applicants are public service corporations within the meaning of Article XV of the
18 Arizona Constitution and A.R.S. §§40-281, 40-282, 40-301 and 40-302.

19 2. The Commission has jurisdiction over Applicants and the subject matter of the
20 Application.

21 3. Notice of the hearing was given in accordance with the law.

22 4. Southwest Gas is a fit and proper entity to receive the natural gas distribution assets and
23 Certificate of AIC.

24 **ORDER**

25 IT IS THEREFORE ORDERED that the joint application of Ajo Improvement Company and
26 Southwest Gas Corporation for approval of the sale of gas distribution assets and transfer of Certificate
27 of Convenience and Necessity associated with the natural gas distribution system of Ajo Improvement
28 Company to Southwest Gas Corporation is approved.

1 IT IS FURTHER ORDERED that Ajo Improvement Company and Southwest Gas Corporation
2 are authorized to execute the legal documents necessary to effectuate the transaction.

3 IT IS FURTHER ORDERED that Southwest Gas Corporation shall charge Ajo Improvement
4 Company's current rates and charges to Ajo Improvement Company's customers until further order of
5 the Commission and to comply with Staff's recommendations set forth in Finding of Fact No. 20.

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

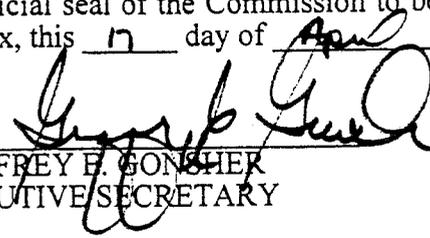
7 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

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11 CHAIRMAN

COMMISSIONER


COMMISSIONER

12
13 IN WITNESS WHEREOF, I, GEOFFREY E. GONSHER, Executive Secretary
14 of the Arizona Corporation Commission, have hereunto set my hand and caused
15 the official seal of the Commission to be affixed at the Capitol, in the City of
16 Phoenix, this 17 day of April, 1997.

17 
18 GEOFFREY E. GONSHER
19 EXECUTIVE SECRETARY

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1 SERVICE LIST FOR: AJO IMPROVEMENT COMPANY and SOUTHWEST GAS
2 CORPORATION

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APPENDIX E

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In the Matter of the Application of Ambler Park Water Utility, a California corporation, and California-American Water Company (U 210 W), a California Corporation for an order authorizing (A) Ambler Park Water Utility to sell and transfer and California-American Water Company to purchase and receive the water utility assets of Ambler Park Water Utility, including the properties used in its water utility business, and (B) Ambler Park Water Utility to withdraw from the water utility business, and (C) California-American Water Company, Monterey Division, to engage in and carry on the water utility business of Ambler Park Water Utility, and (D) the commencement of service in the Ambler Park Water Utility service area by California-American Water Company, and (E) California-American Water Company, Monterey Division, to amortize the acquisition adjustment by reason of this transaction pursuant to the methodology authorized previously by the Commission for the California-American Water Company

Decision No. 98-09-038, Application No. 97-07-058 (Filed July 31, 1997)

California Public Utilities Commission

1998 Cal. PUC LEXIS 936

September 3, 1998

CORE TERMS: service area, water, water system, acquisition, customer, environmental review, water supply, mutual, transfer of ownership, required to provide, public utility, ratebase, plant, condition of approval, rate structure, rate case, completion, reflecting, recording, relieved, effective date, moratorium, premium, acquire, proposed decision, rate of return, formation, condemnation, stand-alone, transferred

PANEL: [*1] Richard A. Bilas, President, P. Gregory Conlon, Jessie J. Knight, Jr., Henry M. Duque, Josiah L. Neeper, Commissioners

COUNSEL: Lawrence D. Foy; Steefel, Levitt & Weiss by Lenard G. Weiss, Attorney at Law; Dave Stephenson for California-American Water Company; and Con Cronin, for Ambler Park Water Utility, applicants.

Mike Weaver, for Highway 68 Coalition; Gerri Bolles, for Corral De Tierra Villa Homeowners' Association; David Dillworth, for Responsible Consumers of Monterey Peninsula; and Richard Hughett, for himself, interested parties.

Raymond A. Charvez, for Water Division.

OPINION

Summary of Decision

This decision authorizes Ambler Park Water Utility (Ambler) to sell its water system to California American Water Company (CalAm) and to be relieved of its public utility responsibility. Ambler and CalAm are jointly referred to as applicants.

Background

Ambler serves approximately 390 customers in an unincorporated area of Monterey County near the City of Salinas. Ambler's service territory includes Ambler Park subdivision, Rim Rock subdivision, and Rancho El Toro Country Club.

Ambler was incorporated in July 1975. It is regulated by the Commission as a Class D water utility.

CalAm [*2] is a Class A water utility serving various districts in Northern and Southern California, including, in its Monterey Division, the cities of Monterey, Pacific Grove, Carmel-by-the-Sea, Del Rey Oaks, Sand City, portions of Seaside, and certain unincorporated portions of Monterey County.

CalAm was incorporated in December 1965 for the purpose of acquiring the water system of California Water and Telephone Company. The Commission approved the acquisition by Decision (D.) 70418, 65 CPUC 281. Subsequently, CalAm has acquired various small water utilities.

CalAm is currently providing meter reading and customer billing services to Ambler for which CalAm is being reimbursed by Ambler. Ambler's customers remit their payment for water services to Ambler, not to CalAm. CalAm has been providing this service to Ambler since 1996 pursuant to an agreement.

On March 28, 1996, CalAm and Ambler entered into an agreement for the purchase of the assets of Ambler by CalAm (Agreement). The Agreement is attached to the application as Exhibit 1. According to the Agreement, CalAm will pay Ambler \$276,398 (Ambler's ratebase as of December 31, 1991) plus a premium of \$55,279 or a total sum of \$331,677 [*3] for Ambler's water utility assets.

Although Ambler's water system is not interconnected with the Monterey Division system, after the acquisition by CalAm, Ambler's water system will become a part of CalAm's Monterey Division. Applicants state that CalAm will operate the Ambler water system as a stand-alone system, and that it will not be connected to the Monterey Division water system.

Requested Relief

Applicants filed this application requesting an ex parte order authorizing:

- a. CalAm to acquire Ambler's water system assets pursuant to the Agreement,
- b. CalAm to serve Ambler's service area;
- c. CalAm to amortize the \$55,279 premium it is paying over rate base for Ambler's system; and
- d. Ambler to be relieved of its public utility obligations.

Applicant's Proposed Ratemaking Treatment for the Acquisition of Ambler's System

As stated earlier, CalAm has agreed to pay \$55,279 in excess of ratebase for Ambler's water system. This premium will be treated as an acquisition adjustment. CalAm proposes to amortize this acquisition adjustment below the line over 25 years, the remaining tax life of the property to be acquired. CalAm states that the tax saving resulting from amortization [*4] of the acquisition adjustment will be reflected for book purposes.

CalAm plans to continue to charge, until January 1, 2000, Ambler's current rates, which were authorized in D.96-12-004 for the service it will provide in Ambler's service area. The rates authorized in D.96-12-004 were based on a rate of return on ratebase of 13.25% which is an appropriate rate of return for a Class D water utility. CalAm recognizes that it should earn a return on ratebase in Ambler's service area at a rate more appropriate for a Class A water utility. However, CalAm believes that the rates for Ambler's service area should not be reduced at acquisition because CalAm plans to invest approximately \$100,000 to bring Ambler's system into compliance with the health and safety standards. CalAm's planned system improvements are included in Exhibit 9 attached to the application. According to CalAm's calculation, the system improvements to Ambler's system would increase the ratebase for the system and reduce the rate of return to 9.25%.

Request for Hearing

On August 24, 1997, Mike Weaver, Chairman of the Highway 68 Coalition, requested a hearing in this proceeding. In his request for hearing, Weaver [*5] requested that:

1. The Commission allow the customers of Ambler an opportunity to explore the possibility of forming a mutual water company.
2. The Commission not allow CalAm to apply to Ambler's customers the graduated rate structure which is currently used by CalAm's Monterey Division.
3. As a condition of approval of the requested transfer of ownership, the Commission impose a limit on the number of service connections in Ambler's service area to the current level of 387 connections.
4. The Commission require an environmental review of the proposed transfer under the California Environmental Quality Act.

Also, by a letter dated September 15, 1997, several customers of Ambler requested the Commission to hold a hearing in this application.

Hearings

A duly-noticed prehearing conference was held on November 13, 1997, before Administrative Law Judge Garde in Ambler's service area. The prehearing conference was followed by a public participation hearing (PPH).

An evidentiary hearing in the matter was held in Monterey on February 5, 1998. The matter was submitted on March 27, 1998, upon receipt of concurrent briefs.

At the PPH, several customers praised the service provided [*6] by Ambler. The customers, however, were concerned that CalAm would divert the water supply in Ambler's service area to CalAm's service area in Monterey through an interconnection and that certain water production costs for service in the Monterey Bay Area, including the cost of construction of the proposed Carmel Dam, would be charged to Ambler's current customers.

CalAm stated that it was not going to interconnect Ambler's service area with its current Monterey Division service area. CalAm also stated that it would operate the Ambler service area on a stand-alone basis and that no water production cost from the Monterey Division would be transferred to Ambler's customers.

Ratepayer Representation Branch's Report

The Ratepayer Representation Branch (RRB) of the Commission's Water Division made its analysis of the proposed relief sought by applicants. RRB concluded that the proposed transfer will not have an adverse impact on Ambler's customers. RRB recommends that the proposed transfer be approved subject to the following conditions:

1. CalAm should be required to provide RRB by December 31, 1998, a report on the additional plant improvements, including the capital expenditures [*7] related to the plant improvements, which are put in place to bring Ambler service area into compliance with health and safety standards.
2. CalAm should be required to provide RRB within six months of transfer, the system journal entries reflecting the recording of the acquisition adjustment.
3. CalAm should be required to propose in its next general rate case application for the Monterey Division a rate design for the Ambler service area.
4. CalAm should be required to address Highway 68 Coalition's request to form a mutual water company.

Discussion

We will address each issue raised by Highway 68 Coalition and RRB.

Formation of a Mutual Water Company

Highway 68 Coalition requests that this proceeding be delayed to allow the formation of a mutual water company. RRB supports Highway 68 Coalition's position.

While we are not necessarily opposed to the formation of mutual water company by Ambler's customers, we note that Con Cronin, the current owner of Ambler, testified that he intended to honor his agreement with CalAm to sell his water system to CalAm. Cronin also testified that he did not intend even to discuss the sale of his system to Highway 68 Coalition.

Public [*8] Utilities Code Section 851 provides that a sale of a public utility, in whole or in part, may be made only with consent of the Commission. In *Hanlon v. Eshleman* (1915) 169 Cal 200, 203, the California Supreme Court stated:

The provision that an owner may not sell without the consent of the commission implies that there must be an owner ready to sell and seeking authority to do before the commission is called upon to act.

Based on the testimony of Cronin, there is no willing seller. Thus, the Commission could not require Cronin to sell to a mutual water company. (*Alan and Allan Corp.* (1976) 81 CPUC 24.)

Given Cronin's position, Ambler's customers can only form a mutual water company by exercising eminent domain or condemnation powers. We see no reason to delay the transfer of the system to CalAm because Ambler's customers could exercise their condemnation power against CalAm just as it could have over Ambler. We will deny Highway 68 Coalition's request to delay the transfer of Ambler's system to CalAm.

Rate Structure

Highway 68 Coalition requests that the graduated rate structure which is currently used for CalAm's Monterey Division not be applied to Ambler's [*9] customers.

In addition, RRB requests that CalAm be required to propose a rate design for the Ambler service area in its next general rate case application for the Monterey Division.

CalAm proposes no changes to Ambler's rate structure until January 1, 2000. CalAm plans to file a general rate case application for its Monterey Division requesting rate changes effective January 1, 2000. The issue of rate design will be addressed in that proceeding.

Moratorium on New Connections

Highway 68 Coalition requests that as a condition of approval of the requested transfer of ownership, the Commission impose a moratorium on new service connections in the Ambler service area. According to Highway 68 Coalition, CalAm's proposed acquisition has a hidden agenda to enlarge Ambler's service area to include the nearby, extensive undeveloped acreage owned by Bollenbacher and Kelton, Inc.

Highway 68 Coalition states that water supply in Ambler's service area is limited and that addition of new customers may result in the system running out of water.

Applicants disagree with Highway 68 Coalition's position about the water supply situation in Ambler's service area. Applicants cite the Hydrologic [*10] Update Study conducted by FugroWest, Inc. for the Monterey County Water Resources Agency (Ref. Item F). The study concluded that there is adequate water supply in Ambler's service area.

Also, while Highway 68 Coalition contends that Ambler's water supply is limited, its witness Weaver conceded during cross-examination that Ambler has never run out of water, even during the last drought. Since CalAm does not plan to interconnect Ambler's service area with its service area in the Monterey region, there is little possibility of water supply problems in Ambler's service area.

Next, we will consider Highway 68 Coalition's concern about expansion of Ambler's service area to the property owned by Bollenbacher and Kelton, Inc. Highway 68 Coalition is surmising that CalAm has a hidden agenda to expand its service area. It has not provided any basis to lead us to the same conclusion. However, even if Highway 68 Coalition's assumption regarding service area expansion is correct, CalAm will still have to seek approval of the Commission for expansion of its service through an advice letter. Adequacy of water supply would be one of the factors considered by the Commission before authorizing the [*11] expansion of the service area. We will not adopt Highway 68 Coalition's recommendation regarding placing a moratorium on service connections as a condition of approving the transfer of the water system.

RRB's Request for Reports

RRB requests that CalAm be required to provide RRB with reports on the treatment of acquisition adjustment and system improvements to bring Ambler's service area into compliance with health and safety standards.

In its application, CalAm states that it will perform certain plant improvements within three months of acquiring Ambler's system. The proposed plant improvements are listed in Exhibit 9 attached to the application.

We expect CalAm to complete the proposed improvements within three months of the completion of the transfer. Within 45 days upon completion of the proposed improvements, CalAm should provide a report to the Director of the Water Division on the system improvements put in place. The report should include the actual costs of the improvements made. If the improvements are not put in place within three months of the effective date of this order, CalAm's report should also include an explanation for the delay.

As to the proposed treatment [*12] of the acquisition adjustment, we note that it is consistent with the treatment approved by the Commission in D.70418 which authorized the acquisition of the water system of California Water and Telephone Company by CalAm. As requested by RRB, we will require CalAm to provide journal entries reflecting the recording of the Ambler acquisition adjustment to the Director of the Water Division within six months of the effective date of this order.

Finally, we will discuss the issue of gain on sale. As discussed above, Ambler's owners will receive \$55,279 above Ambler's ratebase of \$276,398, i.e., the owners of Ambler will realize a gain on sale of \$55,279.

As to the treatment of gain on sale, the Commission in D.89-07-016 (Re Ratemaking Treatment on Capital Gains (Appendix A) 32 CPUC2d at pp. 240-242) stated that gain on sale of utility plant shall accrue to the shareholders to the extent that the remaining ratepayers are not adversely affected when the sale is to a public entity. That same policy applies when the sale is to other than a public entity "when the conveying utility was relieved of its public utility obligation to serve the geographic region being conveyed." California [*13] Water Service Company (1994) 56 CPUC2d 4, 12-13; California Water Service Company (1993) 47 CPUC2d 580, 599. In this situation, the entire Ambler system is being transferred and there will be no remaining ratepayers. Accordingly, the entire gain on sale will be retained by Ambler's owner.

Environmental Review

Highway 68 Coalition requests that an environmental review under CEQA of the proposed transfer be performed.

The application before us concerns only the transfer of ownership of Ambler's facilities to CalAm. Although the Commission has in certain circumstances decided that an environmental review must be performed when utility assets are transferred, we do not believe that an environmental review is either warranted or required in this case under either CEQA or Rule 17.1 of the Commission's Rules of Practice and Procedure. This case is logically similar to D.97-07-019, where we concluded that a transfer of utility facilities was not a "project" as defined in CEQA. Today's decision does not identify any issues that might trigger an environmental review. CalAm will continue to operate Ambler as a stand-alone system, current rates will remain in effect until the year [*14] 2000, and water supply sources will not change.

Future proposals that may have an environmental effect will require separate action by the Commission or other agencies, and those events may require separate evaluation under CEQA. Highway 68's claims that CalAm's acquisition will result in an expansion of the current Ambler service territory is speculative, and in any event any such expansion

would likely require separate Commission approval. CalAm does plan system improvements to Ambler's service area, and those improvements, depending on their nature, may require separate Commission approval. However, as currently described by CalAm, those improvements would be exempt from environmental review pursuant to Class 2 exemptions included in Rule 17.1(h).

We conclude that this application involves a change in ownership that does not constitute a project under CEQA. Our determination here is similar to our decisions in other applications for changes in ownership of utility property approved by the Commission in the past (See for example D.94-04-042, D.94-04-083, D.95-10-045).

Commission Policy

In 1979, the Commission adopted a policy of encouraging the acquisition of small water [*15] companies by larger water companies. The Commission reiterated this policy in D.92-03-093, 43 CPUC2d 589. The proposed transfer of ownership of a Class D water company to a Class A water company is consistent with that policy.

CalAm is a Class A water company in good standing with the Commission for reasons stated earlier. CalAm's ownership of Ambler is not adverse to public interest. We will approve the transfer.

Comments on ALJ's Proposed Decision

ALJ proposed decision was filed and mailed to the parties on May 28, 1998. Highway 68 Coalition and Richard Hughett have filed comments on the proposed decision. CalAm filed reply comments. After reviewing the comments, we believe that only one issue needs to be addressed.

Richard Hughett points out that during the public participation hearing, Larry Foy, Vice-President of CalAm, stated that:

"...And we have agreed with the individuals with that concern and request that the Commission place as part of this purchase that condition, the water will not be exported from this operating system." (Tr. PHC p. 2)

Richard Hughett requests, among other things, that as a condition of approval of the transfer of ownership of Ambler's [*16] water system, the Commission prohibit any interties between Ambler's water system and CalAm's other water systems.

We have verified Richard Hughett's assertion and have added the appropriate Finding of Fact and Ordering Paragraph to prohibit interties between Ambler's water system and CalAm's other water systems.

We have also elaborated upon the applicability of the need for environmental review of the transfer. Other than the changes discussed above, we are issuing the decision as proposed.

Findings of Fact

1. CalAm and Ambler seek an ex parte order of the Commission granting authorization for:
 - a. CalAm to acquire Ambler's assets;
 - b. CalAm to serve Ambler's service area;
 - c. CalAm to amortize the \$55,279 premium it is paying over rate base for Ambler's system; and
 - d. Ambler to be relieved of its public utility obligations.
2. Highway 68 Coalition requests that the Commission delay its action in the matter to allow Ambler's customers to form a mutual water company.
3. The owner of Ambler is not willing to sell the system to the yet-to-be-formed mutual company.

4. Given the position of Ambler's owner regarding the sale of the system to a mutual water company, Ambler's [*17] customers could only acquire Ambler's system through eminent domain.

5. Ambler's customers could exercise their powers of condemnation over CalAm just as well as they could have over Ambler.

6. Highway 68 Coalition requests that CalAm not be allowed to apply to Ambler's customers the graduated rate structure which is currently used for CalAm's Monterey Division.

7. CalAm does not propose to modify rates for Ambler's customers until January 1, 2000, when it files a general rate case application for its Monterey Division.

8. Highway 68 Coalition requests that as a condition of approval of the requested transfer of ownership, the Commission impose a moratorium on new service connections in the Ambler service area.

9. Highway 68 Coalition contends that CalAm's proposed acquisition of Ambler's system has a hidden agenda to enlarge Ambler's service area to include the nearby, extensive undeveloped acreage owned by Bollenbacher and Kelton, Inc.

10. The Hydrologic Update Study conducted by FugroWest, Inc. for the Monterey County Water Resources Agency concludes that there is adequate water supply in Ambler's service area.

11. Highway 68 Coalition requests that an environmental review of the [*18] proposed transfer be performed.

12. The proposed transfer is not a project under CEQA.

13. CalAm's proposed treatment of acquisition adjustment is consistent with the treatment approved by the Commission in D.70418 which authorized the acquisition by CalAm of California Water and Telephone Company.

14. RRB requests that CalAm be required to provide journal entries reflecting the recording of the Ambler acquisition adjustment.

15. Requiring CalAm to provide RRB journal entries regarding Ambler's acquisition adjustment will enable RRB to ensure that the acquisition adjustment is being recorded correctly.

16. Within three months of the completion of the transfer of the system, CalAm proposes to make certain system improvements in Ambler's service area.

17. RRB requests that in order to ensure that CalAm has made the necessary system improvements, CalAm be required to provide a report on the system improvements in place.

18. The proposed transfer of Ambler's system is consistent with the Commission's policy of promoting acquisition of small water systems by large water companies.

19. As a condition of approval of the proposed transfer of ownership of Ambler's water system, CalAm has agreed [*19] not to intertie Ambler's water system to any other water system of CalAm.

Conclusions of Law

1. The proposed transfer of Ambler's water system to CalAm should be approved.

2. Highway 68 Coalition's requests should be denied.

3. CalAm should be required to provide RRB journal entries reflecting the recording of Ambler's adjustment.

4. CalAm should be required to file a report on the planned system improvements to Ambler's system.
5. The rates in Ambler's service area should not be reconsidered until the Commission reviews the January 1, 2000 general rate case application for CalAm's Monterey Division.
6. An environmental review under CEQA of the proposed transfer of ownership is not required.
7. Any proposal by CalAm to expand the Ambler service area will require the Commission's approval and a separate CEQA evaluation.
8. This order should be made effective immediately to enable CalAm to acquire and operate Ambler's water system expeditiously.
9. Where the utility operations are to be sold to a nongovernmental buyer but the seller will no longer remain in the utility business, the gain on sale belongs to the shareholders of the seller.

ORDER

IT IS ORDERED that:

1. Within [*20] 180 days of the effective date of this order, Ambler Park Water Utility (Ambler) may transfer its water system to California American Water Company (CalAm) in accordance with the Agreement for Purchase included in Exhibit 1 attached to the application.
2. Within ten days of the transfer, Ambler shall write to the Commission stating the date of transfer and attach a copy of the transfer document.
3. Within ten days of the transfer, Ambler shall remit to the Commission all user fees collected up to the time of transfer.
4. Upon compliance with this order, Ambler shall be relieved of its public utility designation.
5. Within six months of the effective date of this order, CalAm shall file with the Director of the Commission's Water Division, journal entries reflecting the recording of Ambler's acquisition adjustment.
6. Within 45 days of the completion of the proposed plant improvements listed in Exhibit 9, CalAm shall file with the Director of the Commission's Water Division a report on the system improvements made to Ambler's water system since the transfer.
7. Within 30 days of the completion of the transfer, CalAm shall file, with the Commission, tariff schedules and service area [*21] map for its Monterey Division. The filing shall be in accordance with the Commission's General Order 96-A.
8. The rates for water service in Ambler's service area shall not be revised until January 1, 2000.
9. CalAm is prohibited to intertie Ambler's water system to any other water system of CalAm.
10. This proceeding is closed.

This order is effective today.

Dated September 3, 1998, at San Francisco, California.

APPENDIX F

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Application of Citizens Utilities Company of California (U 87 C) ("CUCC"), GTE California Incorporated (U 1002) ("GTEC"), for authority under Section 851 for GTEC to sell to CUCC certain of its property, in accordance with an Asset Transfer Agreement dated as of May 18, 1993

Decision No. 94-09-080, Application No. 93-07-039 (Filed July 22, 1993)

California Public Utilities Commission

1994 Cal. PUC LEXIS 663; 56 CPUC2d 539

September 15, 1994

CORE TERMS: phase, transferred, ratepayers, shareholders, customer, purchase price, gain-on-sale, telephone, acquisition, interim, plant, earnings, book value, ratemaking, notice, accounting, rate of return, seal, effective, depreciation, billing, public interest, effective date, settlement, refund, public utility, municipality, calculation, residential, allocated

PANEL: [*1]

Daniel Wm. Fessler, President; Norman D. Shumway, P. Gregory Conlon, Jessie J. Knight, Jr., Commissioners

INTERIM OPINION

This decision resolves Phase I of the application of Citizens Utilities Company of California (Citizens) and GTE California Incorporated (GTEC), for authority under Section 851 for GTEC to sell to Citizens certain of its property.

I. Factual Background

Citizens and GTEC jointly seek authority for GTEC to sell to Citizens certain of its telephone plant, contracts, books and records, and Federal Communications Commission (FCC) licenses and non-FCC authorizations associated with five specific telephone exchanges and unregulated services. The five exchanges to be conveyed consist of approximately 5,000 access lines, which represent significantly less than 1% of GTEC's existing access lines. The exchanges are located in Clarksburg, Courtland, Isleton, Meadowville, and Walnut Grove and are strategically located close to Citizens' present service territories in Elk Grove and Rio Vista, located south of Sacramento.

Pursuant to the Agreement, Citizens will buy from GTEC telephone plant associated with the five exchanges, related contracts, books and records, [*2] FCC licenses, and non-FCC authorizations to the extent assignable. The telephone plant consists of real property, machinery, equipment, vehicles, and all other assets and properties used, or held for future use, in connection with the conduct of the business within the five exchanges. This includes all improvements, plants, systems, structures, construction work in progress, telephone cable, microwave facilities, telephone line facilities, telephones, machinery, furniture, fixtures, materials, supplies, tools, implements, conduits, stations, substations, equipment (including central office equipment, subscriber's station equipment, and other equipment in general), telephone numbers and listings, telephone directories, instruments, house wiring connections, and all other equipment of every nature and kind owned by GTEC and used in connection with the five telephone exchanges.

This asset sale is part of a series of acquisitions by Citizens Utilities Company (CUC), the parent company of Citizens, and its subsidiaries which involve the assets of GTE Corporation's (GTE) telephone operating subsidiaries in ten states. The sale of the assets is governed by the terms and conditions of [*3] an asset purchase agreement between CUC, GTEC, and GTE dated as of May 18, 1993 (Agreement). A copy of the Agreement and all schedules were provided to the Commission under seal, pursuant to administrative law judge (ALJ) ruling, as Exhibit A to the

application. CUC assigned its rights and privileges under the Agreement as to California assets to Citizens in an assignment entered into as of July 15, 1993 (Assignment), filed as Exhibit B to the application.

CUC and Citizens do not contemplate any changes to GTEC's existing policies with respect to rates, operations, maintenance, accounting, finances or management immediately after the close of the acquisition. Citizens intends to initially adopt GTEC's current rates and tariffs so that Citizens' new customers in the five exchanges will not face unexpected changes in either charges or quality of service. Citizens has negotiated a transition service agreement (Transition Contract) with GTEC, filed pursuant to ALJ Ruling under seal, to manage the five exchanges for an interim period and perform all billing functions for the customers in the five transferred exchanges. Only after interim rates are issued in Citizens' currently pending [*4] general rate case (GRC) (Application (A.) 93-12-005), will the former GTEC customers in the five exchanges be switched to Citizens' rates.

Also as part of the transaction, the applicants have negotiated an employee transfer agreement (Schedule 12.1 to the Agreement) so that all present GTEC employees in the five purchased exchanges will be guaranteed continued employment with Citizens. Applicants allege that the benefit packages available to the employees in the aggregate are comparable between the two companies.

GTEC wishes to sell the exchanges in order to focus more on core markets and achieve greater operating synergies. These exchanges are relatively isolated from the remainder of GTEC's operations in California but are contiguous to Citizens' territory in Elk Grove and Rio Vista. The exchanges fit in with Citizens' business strategy to acquire and operate local exchange companies in small- and medium-sized cities and towns which are experiencing above-average economic growth. Citizens will, at a minimum, maintain the current level of services provided by GTEC and is committed to enhancing telephone services through state-of-the-art technology. The five exchanges are all [*5] digital and have SS7 capability, as do all of Citizens' existing California exchanges. Citizens forecasts operating and economic efficiencies to the benefit of all of its customers as a result of the purchase of the five exchanges. Throughout the new service area, Citizens intends to implement its quality management program, "target-excellence" to further enhance telephone services and efficiency.

Citizens has filed a map depicting its existing exchanges along with a list of those exchanges as Exhibit C to the application. Exhibit G to the application includes a map of GTEC's California exchanges as well as a map of the five exchanges sought to be transferred.

A copy of Citizens' income and balance sheet as of December 31, 1992 was filed as Exhibit D to the application. A copy of GTEC's balance sheet and income statement as of December 31, 1992 was filed as Exhibit E to the application.

Filed as Exhibit H to the application is a statement of the book value of the five exchanges to be conveyed. Exhibit H discloses total regulated and deregulated PP&E, at December 31, 1992, with an investment of \$30,521,776, a depreciation reserve of negative \$13,318,914, and a net book value [*6] of \$17,202,862. As of that date, regulated investment was \$30,013,874 with a depreciation reserve of negative \$13,315,717 and a net book value of \$16,698,157. Nonregulated assets at that date were an investment of \$20,440 with a depreciation reserve of a negative \$3,197 and a net book value of \$17,243.

II. Procedural History

Although not required by Section 851 or our Rules of Practice and Procedure, the applicants served a copy of the application upon approximately 81 competitors. Notice of the application appeared in the Commission Daily Calendar on July 26, 1993. On August 25, 1993, the Commission's Division of Ratepayer Advocates (DRA) filed a protest to the application. No other protests were filed. However, on August 25, 1993, AT&T Communications of California moved to intervene in the case.

On November 5, 1993, a prehearing conference (PHC) was held by ALJ Watson. On November 19, 1993, she issued her ruling on the first PHC directing that certain filings be made under seal, setting the second PHC, and ruling that Rule 24 notice was not required in this proceeding since no rate changes would occur as a result of this closing. She also found that the [*7] gain-on-sale issues raised by DRA could be appropriately addressed as a matter of law, absent DRA's identification at the second PHC of factual issue(s) impacting the application of gain-on-sale precedents. The ALJ also ruled that the Agreement's choice of New York law was appropriate since one party thereto was a New

York corporation and transactions in states other than California were involved. However, the ALJ stated she would consider any legal arguments as to the appropriateness of New York law governing the Assignment by which Citizens acquired the right to all of the California exchanges from its parent CUC. Applicants were directed to provide to DRA a full description of the property being transferred and more details regarding the purchase price, by way of either pro formas, or if reasonably calculable prior to the second PHC, the final purchase price. Finally, the ALJ ruled that under a Section 851 transfer proceeding, full-blown cost/benefit analyses, as requested by DRA, were not required. However, applicants were directed to detail for DRA the operating efficiencies generally described in the application. At the PHC, AT&T was permitted to intervene.

On February [*8] 10, 1994, DRA filed a motion to consolidate the instant application with Citizens' pending GRC, A.93-12-005, assigned to ALJ Mattson. The applicants timely responded thereto. A second PHC was held on February 22, 1994.

On March 1, 1994, ALJ Watson and ALJ Mattson issued a joint ruling granting in part and denying in part DRA's motion to consolidate A.93-07-039 with A.93-12-005. The ALJs ruled that A.93-07-039 would be divided into two phases and granted the motion to consolidate Phase II of the instant application with the pending GRC, A.93-12-005. They denied the motion as to Phase I of A.93-07-039.

The ALJs ruled that Phase I of the instant application should resolve all issues under Public Utilities (PU) Code § 851 except the issues as to the effects of the transaction upon Citizens' ratepayers, and whether any gain-on-sale exists. Phase I would resolve the proper method for allocation of the gain-on-sale, if any is found to accrue in Phase II of the proceeding. Phase I would also resolve the issues surrounding the interim rates to be charged under the Transition Contract, prior to implementation of the Commission's decision in the GRC on new Citizens' rates.

Phase II [*9] will address the revenue requirement and ratemaking effects on Citizens of the acquisition of the five exchanges. Phase II will also determine the amount of the gain-on-sale, if any, and any necessary adjustments to GTEC rates, by applying the allocation method determined in Phase I. Finally, the ALJs noted that the Commission's decision on Phase I may permit closing of the asset transfer to occur subject to conditions such as those set forth in In the Matter of the Joint Application of GTE Corporation and Contel Corporation, 39 CPUC 2d 480, Decision (D.) 91-03-022. (March 13, 1991.)

The ALJ issued her ruling on the second PHC on March 1, 1994 and ordered Rule 24 customer notice, regarding Citizens' rate proposals and restructuring in the GRC, to be given promptly by Citizens to the GTEC customers in the five GTEC exchanges sought to be purchased. The ALJ ruled that the notice should direct that any comments regarding the rate restructure be directed to the GRC rate and clarify that, during the period after the closing of the purchase through the implementation of the Commission decision on rates in A.93-12-005, the customers would continue to be charged GTEC rates. The ALJ [*10] also mandated that the notice be as explicit as possible about the differences in GTEC's and Citizens' rates and the changes in rates that might occur due to Citizens' pending GRC. The content of the notice was made subject to review and approval by both ALJ Watson and ALJ Mattson. ALJs Watson and Mattson subsequently reviewed and approved the notice.

ALJ Watson also ruled that if DRA, Citizens, and GTEC did not execute and file a stipulation as to the valuation of the access lines being transferred by March 21, 1994, then Citizens would be required to audit the purchased assets and enter the results of the audit in evidence in Phase II of the proceeding. Citizens would be required to furnish a copy of the audit to DRA promptly after its completion. Applicants were directed to supplement the instant application by filing a copy of the Transition Contract under seal. The parties were directed to address in their briefs possible methods to hold ratepayers harmless if GTEC's rates became higher than Citizens' during the interim period under the Transition Contract.

As to DRA's objection to the Agreement's term which permits the parties to adjust the purchase price within 90 days [*11] after closing, the ALJ ruled that the decision on Phase I would require the purchase price adjustments to occur prior to hearings in the GRC and on the schedule directed by ALJ Mattson. The applicants were directed to furnish DRA the final purchase price information promptly upon its completion. Applicants were also required to promptly file, as an exhibit to the Agreement, under seal, the final purchase price information as a supplement to the instant application in Phase II.

The ALJ noted that due to the post-closing adjustment period for the purchase price, the factual determination of whether any gain-on-sale actually exists would be deferred to Phase II of the proceeding. However, the parties were directed to brief the proper standard of allocation of gain-on-sale in Phase I.

In response to DRA's concerns over proper and timely access to documents and persons within the possession and control of applicants, applicants were directed to cooperate with DRA and make available to it all information pertinent to the issues in Phase I no later than March 21, 1994. DRA was given 15 days to make a filing in this docket to propose any further conditions it felt necessary to protect [*12] the public's interest as to Phase I issues. n1 Applicants' response thereto was permitted to be included in their opening brief.

n1 No such filing was made by DRA.

On March 21, 1994, DRA and GTEC filed, under seal, a stipulation regarding the evaluation of the assets to be transferred.

Concurrent opening briefs were filed on April 22, 1994. Concurrent reply briefs were filed April 29, 1994.

III. Discussion

A. Valuation of Assets

The property will be sold at the purchase price set forth in Section 3.1 of the Agreement, which has been filed under seal but disclosed to the Commission, the ALJ, and DRA. The purchase price will be paid in cash. Section 3.2 provides for certain adjustments to the purchase price regarding damaged property, assumed liability, customer deposits and construction advances, and access lines. Within 90 days following the effective date of the sale, the final calculation of the purchase price, adjusted pursuant to Section 3.2, is to be delivered by Citizens to GTEC, which shall have 30 days to notify Citizens of any objection thereto. If GTEC objects to any calculation, the parties have agreed in good faith to resolve the dispute within [*13] 30 days after the notice of objection but thereafter shall refer any unresolved disputes to the accounting firm of Deloitte and Touche whose calculations shall be binding upon GTEC and Citizens. The Agreement will terminate, under its Section 15.1(g), if closing does not occur by December 31, 1994.

DRA and the applicants have stipulated to the valuation of the assets proposed to be transferred in the stipulation filed under seal on March 21, 1994. The stipulation as to the estimated amount of the average net book value of the GTEC property is an average of the January 1, 1994 net book value of GTEC's plant and the projected December 31, 1994 net book value of the transferred plant. However, the parties have also agreed that the calculation of the final purchase price under the terms of the Agreement will include the actual net book value at closing rather than the estimated average value of the net plant. DRA has agreed to use the estimated average value of the net plant to estimate any potential gain-on-sale or good will and revenue requirements effects resulting from the transfer until such time as the actual net book value of the property is determined after closing.

A review [*14] of the stipulation as to the estimated net book value in conjunction with the financial data on GTEC and Citizens, appended as Exhibits D and E to the application, discloses that the purchase price is adequate and in the public interest, and that Citizens possesses sufficient financial ability to close the sale and support the telephone plant. However, the impact of the purchase on Citizens' ratepayers shall be determined in Phase II of this proceeding before ALJ Mattson.

B. Positions of the Parties on Disputed Issues

1. GTEC and Citizens

GTEC and Citizens contend that any gain-on-sale should go entirely to GTEC's shareholders. GTEC and Citizens also believe that no mechanism should be required to handle a potential rate differential that might arise during the Transition Contract's term.

GTEC asserts that based on the Commission decision adopting the Uniform System of Accounts (USOA) for jurisdictional local exchange telephone companies, n2 allocation of the gain-on-sale, if any, arising from the sale of the

five exchanges should go only to its shareholders. GTEC proposes to record the gain in accordance with 47 CFR 32.7350 Gains or losses from the disposition [*15] of certain property. Citizens would observe the rules found at 47 CFR 32.2000(b) Telecommunications plant acquired. GTEC also contends that under *In re Ratemaking Treatment of Capital Gains Derived from the Sale of a Public Utility Distribution System Serving an Area Annexed by a Municipality or Public Entity*, (1989) 32 CPUC 2d 233, D.89-07-016 "Redding II", this sale qualifies as a partial liquidation requiring all gain to be distributed to the shareholders.

n2 *In re Uniform System of Accounts for Telephone Companies* (1987) 26 CPUC 2d 349, D.87-12-063. The Federal Communications Commission (FCC) adopted a revised version of the USOA to be effective January 1, 1988. The USOA appears at 47 Code of Federal Regulations (CFR) Chapter 1; it is also commonly referred to as "Part 32". By D.87-12-063, the USOA was adopted for the operations of local exchange carriers subject to CPUC jurisdiction.

2. DRA

As a result of settlement discussions with applicants and a review of the voluminous responses to data requests, DRA does not oppose the application subject to the following conditions:

"(a.) GTEC should refund revenues equivalent to 50% of any gain-on-sale [*16] resulting from this transaction to its ratepayers in a form of a surcredit.

"(b.) GTEC should refund revenues equivalent to 50% of any revenue requirement decreases resulting from this transaction to its ratepayers in the form of a surcredit.

"(c.) [Citizen's] ratepayers should not be required to pay for any of [Citizen's] transaction costs and revenue requirement increases resulting from this transaction." n3 (Concurrent Opening Brief DRA at page 1.)

n3 This condition is to be considered in Phase II of this proceeding.

Additionally, DRA contends that under the Transition Contract, customers in the five transferred exchanges should be charged GTEC's rates only until they exceed Citizens', at which time, Citizens' rates should be utilized.

DRA argues that under the new regulatory framework (NRF) for GTEC and Pacific Bell, the USOA decision is no longer applicable and instead the Commission should look to Application of GTE California for Review of Operations of the Incentive Based Regulatory Framework (1993) CPUC 2d , D. 93-09-038 (GTEC's NRF 92 Review), particularly page 11, mimeo, for the precedents on gain-on-sale. n4 DRA contends that GTEC misconstrues Redding [*17] II, which in any event, is not applicable to the facts of this case. DRA contends that an equitable distribution of the gain-on-sale would be a 50-50 sharing between shareholders and ratepayers.

n4 D.93-09-038 found two partial settlements in A.92-05-002 (Application of GTE California Incorporated for Review of the Operations of the Incentive-Based Regulatory Framework Adopted in Decision 89-10-031) to be in the public interest. These settlements included provisions governing the gain-on-sale of land. However, by its express terms, the GTEC settlement "shall not be applied to any alleged or actual gain on sale of land arising from a sale, exchange or other disposal of GTEC serving territory or exchanges." (D. 94-06-011, Appendix B, par. 12.)

C. Gain on Sale

GTEC relies on D.93-01-025, *In the Matter of the Application of California Water Service Company* (CPUC 2d , "CalWater") as authority for allocating 100% of the gain to its shareholders. There, the water utility argued that the Redding II rule should apply. Under Redding II, 100% of the gain accrues to shareholders in the event part or all of the utility's operating system, which was formerly [*18] in ratebase, is sold to a municipality or other public entity concurrent with the utility being relieved of and the municipality or other agency assuming the public utility obligations to the customers within the areas served by the system. n5 Even though the sale was to another water utility, and not "a municipality or some other public or governmental entity, such as a special utility district" as stipulated in the Redding II conditions, the Commission decided to apply the "partial liquidation" theory and awarded the gain to CalWater's shareholders. DRA has failed to distinguish this proceeding from the CalWater case.

n5 Redding II further requires that gain may accrue to shareholders only to the extent that the remaining ratepayers on the selling utility's system are not adversely affected, and the ratepayers have not contributed capital to the distribution system.

The instant transaction would satisfy the Redding II rule, except for the fact that the purchaser is not a municipality but Citizens, a public utility. CalWater appears to indicate that it would be proper to allocate all of the gain to shareholders in this case. However, the transaction in [*19] CalWater involved two water utilities, both subject to rate of return regulation. Here, the seller is GTEC, a telephone utility which has enjoyed the regulatory flexibility of NRF since January 1, 1990. As explained below, this distinction is dispositive of this proceeding.

GTEC claims that 47 CFR 32.2000 subsection (d) directs it to record the gains from the sale below the line, and therefore all gains should go to its shareholders. That section of the USOA consists of instructions for "telecommunications plant retired". Subparagraph (5) states, "When the telecommunications plant is sold together with traffic associated therewith, . . . the difference, if any, (between the original cost and accumulated depreciation) and the consideration received . . . for the property shall be included in Account 7350, Gains and Losses from Disposition of Certain Property. . . ." Account 7350 is recorded under "nonoperating income and expense", that is, its entries are made below the line for regulatory purposes.

As we have in previous decisions, we reject any argument that the USOA alone should direct the Commission's allocation of gain between shareholders and ratepayers. While GTEC's [*20] interpretation of the accounting rules is correct, accounting practices do not drive ratemaking nor will we base our decision solely on the principles set forth in the USOA. (See, In the Matter of the Application of Suburban Water Systems (1994) D.94-01-028 mimeo. at 14 (" . . . ratemaking controls accounting, not vice versa").) Therefore, if there is reason to believe the accounting treatment for gain-on-sale is inappropriate for ratemaking purposes, accounting and ratemaking need not go hand-in-hand. (Id.)

When it adopted the USOA in 1987, the Commission stated, "Part 32 . . . reflects a financial based accounting system to facilitate the monitoring of revenues, expenses, and investments by product, service, purpose and type; facilitate management reporting data for cost of service and the separations and settlement process; and to accommodate generally accepted accounting principles. . . ." (Re Uniform System of Accounts for Telephone Companies (1987) 26 CPUC 2d 349, 353.)

When it adopted the NRF for local exchange carriers in 1989, the Commission observed that ". . . (U)nder traditional rate-of-return regulation, the agency determines a reasonable revenue level [*21] based on its examination of the utility's business; revenue is set at a level aimed at allowing the utility to recover reasonable operating costs and to earn a reasonable profit on its investment." (33 CPUC 2d 43, 130; D.89-10-031, In the Matter of Alternative Regulatory Frameworks for Local Exchange Carriers, "NRF Decision"). GTEC, however, is no longer subject to rate of return regulation. Rather, it is subject to a price-cap model, where revenues or rates are obtained by multiplying the prior year's revenues or rates by a factor which nets inflation against a productivity adjustment, subject to Z factor adjustment. (32 CPUC 2d at 216 (Finding of Fact 35).)

It is clear that under NRF, the USOA is of limited value in determining the allocation of gains between ratepayers and consumers. The Commission intended that its benchmark shareable earnings mechanism operate as the mechanism to allocate earnings between shareholders and ratepayers. This is illustrated by the following finding of fact: "We will not entertain applications from Pacific or GTEC seeking ratemaking adjustments based on accounting changes to, for example, reduce the so-called reserve deficiency or shorten [*22] amortization periods, which could whittle away at shareable earnings." (D.89-10-031, Finding of Fact 53.)

Operational income and expense flows into the revenue stream subject to the sharing mechanism unless the income or expense qualifies as a "Z" factor. As GTEC observed, ". . . cost changes arising as a result of GTEC's selling of the five exchanges would not qualify for Z factor treatment because such decision was made by GTEC management." (GTEC Response to Opening Brief of DRA, p. 4.)

We concur with GTEC that the decision to convey the exchanges to Citizens is just the kind of management activity we intended to encourage by the adoption of the NRF. Since the gain from that sale is not a Z factor, it should be considered the same as any other positive or negative cash flow to GTEC under the new regulatory framework. It would be inappropriate to single out this transaction from any other management decision to allocate, deploy, convey,

or alienate utility resources. n6 The net proceeds of the transaction should be booked as miscellaneous operating revenue realized during the 1993-94 fiscal year; its contribution to earnings may be retained by management, subject to the earnings [*23] ceiling adopted in GTEC's NRF 92 Review.

n6 Our decision in GTEC's NRF 92 Review approved a settlement which allocated gain on the sale of land to ratepayers and shareholders based on (a) the relative amount of time the property had been in rate base before and after the effective date of NRF, and (b) whether the sale occurred before or after the effective date of NRF. The settlement does not apply here, under the express terms of the parties. Moreover, the property being conveyed here is not primarily land, but telecommunications equipment and hardware. Thus, it is apparent that this transaction can be treated like any other management decision to allocate utility resources under NRF.

GTEC's assertion that its shareholders are immediately entitled to all of the financial gain resulting from management action, such as the instant transaction, is misguided. The Commission did not declare that shareholders exclusively should benefit from management decision-making. After all, management compensation is included in the NRF start up revenue requirement. The 100% allocation to shareholders of earnings up to the 15.50% ceiling rate of return is the adopted mechanism for granting [*24] investors the benefit of management acumen. Indeed, in GTEC's NRF 92 Review, we eliminated the original NRF requirement that 50% of the earnings between the benchmark rate of return and the ceiling rate of return be returned to ratepayers. The straightforward allocation of all earnings below the ceiling to shareholders is a substantial and sufficient reward for management's decision to convey the exchanges to Citizens. The claim that in the post-NRF world, gains should be allocated 100% to shareholders is inconsistent with NRF. n7

n7 In the pre-NRF world, the gain from the sale of these exchanges might have been allocated to ratepayers.

DRA believes that any gain-on-sale from the transfer of assets which is allocated to ratepayers should be paid in the form of a Tariff-A38(a) surcredit, to be included as part of GTEC's October 1, 1995 price cap filing, to be implemented January 1, 1996. If, as recommended by DRA, the surcredit is applied to all of GTEC's rates and charges for Category I services and nonflexibly priced Category II services, and to caps on rates and charges for flexibly priced Category II services, a portion of the gain will be diverted from the shareable [*25] earnings calculation and allocated directly to ratepayers.

We do not approve the position of either DRA or GTEC; neither ratepayers nor shareholders should directly receive any portion of the gain. The effect of the transaction may contribute to earnings. Shareholders retain 100% of earnings up to a ceiling of 15.5% rate of return. It is conceivable, though not likely, that the incremental effect of this transaction could boost GTEC's rate of return over 15.5%. At that point, the gain would be realized 100% by ratepayers.

GTEC is likely to experience a reduction in both costs and revenues due to the sale of these five exchanges. No separate flow through of these impacts should be authorized whether in the form of a surcredit as advocated by DRA or otherwise, is authorized.

D. Cost to be Booked to Citizens' Revenue Requirement

The application for authority to transfer the five exchanges is consolidated with the application of Citizens for a general rate increase and to adopt a new regulatory framework (NRF). Cost based ratemaking is being used as the foundation for Citizen's post-NRF revenue requirement. Thus, the Commission is still concerned about the rate impact of [*26] Citizen's acquisition of the exchanges upon its customers.

Citizens has indicated that it will observe the provisions of 47 CFR 32.2000 paragraph (b) in accounting for its purchase. That section states, "(1) Property, plant and equipment acquired from an entity, whether or not affiliated with the accounting company, shall be accounted for at original cost, except that property, plant and equipment acquired from a nonaffiliated entity shall be accounted for at acquisition cost if the purchase price is (minimal)."

We have expressed concern that ratepayers whose service will now be provided by the acquiring utility should not be harmed by the transaction. "In the case of a transfer from one regulated privately-owned utility to another, our policy has been clear: the assets in question continue in the rate base at their previously-determined value without any consideration for a premium above book value that might have been paid in the acquisition." (Redding II, 32 CPUC 2d 233, 235.) Therefore, any premium paid by Citizens for the property being acquired should be amortized below the line

over the remaining life of the asset. For ratemaking purposes, we recognize no exception [*27] from the original cost rule for minimal purchases. To the extent the USOA is inconsistent with our rule, Citizens should not record this transaction in accordance with 47 CFR 32.2000 paragraph (b).

E. Transition Contract

The Transition Contract calls for GTEC to perform the billing functions on the five transferred exchanges for an interim period. The initial term of the Agreement runs until December 31, 1994, but may be extended pursuant to Article XV of the contract. The parties were requested to address in briefs methods to hold harmless the new Citizens' ratepayers in the five exchanges from GTEC rate increases during the interim period covered by the Transition Contract. Citizens intends to initially adopt GTEC's current rates and charges so that the customers in the transferred exchanges will not face unexpected changes in either charges or quality of service. DRA has stated that as long as GTEC's rates remain at their current levels, it has no objections to Citizens' adoption of GTEC's rates pending implementation of new rates under Citizens' pending GRC. However, should GTEC's rates become higher than Citizens' rates in the interim period, DRA recommends that [*28] the customers in the five exchanges be charged Citizens' then existing rates and charges.

Citizens believes that any possible harm to ratepayers is so de minimis, that it does not justify developing an elaborate mechanism to hold the ratepayers harmless. Citizens notes that its current charge for monthly flat residential service is \$14.45 n8 whereas GTEC's current rate is \$9.75, plus a 14.9% surcharge for an effective monthly rate of \$11.20. In the now rescinded decision on IRD, GTEC's rates were set at \$17.80, effective January 1, 1994. GTEC had proposed an IRD rate of \$15.55 for residential basic service in that proceeding. Citizens believes that it is premature to implement a refund mechanism when the potential rate differential is speculative and probably minimal. Citizens states that if the ultimately adopted IRD decision retains the \$17.80 basic service rate for GTEC, the differential will be merely \$3.35 more per month than Citizens' current rate. Were the Commission to adopt GTEC's proposed IRD rate, the differential between Citizens' current rate and the IRD rate for GTEC would drop to \$1.10 per month. Citizens argues that events beyond its control create [*29] uncertainty as to whether ratepayers in the five transferred exchanges will experience any significant bill impact at all. Citizens cites uncertainty as to the date of the decision on this application, the level of Citizens' new GRC rates on an interim and final basis, the effective date of new GTEC rates under a revised IRD decision, and the level of the GTEC rates under IRD. Citizens also notes that, even if GTEC's basic residential rates were to increase post-IRD, the intraLATA toll rates would decrease. Therefore, it argues that customers in the transferred exchanges may in fact experience an overall reduction in their monthly bills. And, Citizens asserts, until the IRD decision is adopted and effective, the customers in the five exchanges paying GTEC's current basic residential rate of \$9.75 are actually paying \$4.70 less per month than if they had been converted immediately to Citizens' current rates. Therefore, Citizens argues this benefit outweighs any speculative negative rate impact that might occur when GTEC's IRD rate design is implemented.

n8 This rate is for Citizens' residential basic service for Elk Grove. Citizens' basic service rate for Rio Vista is only \$13.60. [*30]

We believe that the uncertainties associated with the implementation of the new IRD GTEC rates coupled with the fact that the Transition Contract will result in a \$3.25 savings per month for the customers in the transferred exchanges, warrants no refund design mechanism at this time. It is our hope that a new IRD decision should be issued in sufficient time this year to permit an effective date of January 1, 1995. In A.93-12-005, ALJ Mattson has set a schedule to establish interim rates for Citizens under its pending GRC to be effective January 1, 1995. Additionally, the Transition Contract calls for termination on December 31, 1994 unless extended. Therefore, it is probable that the customers in the five exchanges will, in fact, suffer no harm by remaining at GTEC's rates rather than Citizens until the end of 1994. However, as soon as interim rates under Citizens' GRC become effective, the customers in the transferred exchanges should be transferred to Citizens' billing and collection system at Citizens' then effective interim rates. This may well coincide with the effective date for new GTEC IRD rates. However, should the actual time frame not fit the parameters set forth [*31] in this decision, DRA may petition to modify this portion of the decision based on a showing that the \$3.25 per month savings has been offset by a period of higher GTEC post-IRD bills.

F. Adjustment to GTEC's Billing Base

GTEC's transfer of exchanges will result in a reduction of approximately 5,000 access lines and associated revenue. The revenue reduction will impact the billing base, which is used to calculate the surcharge adjustments which implement GTEC's annual price cap filing. To ensure that the surcharge adjustments are as accurate as possible, GTEC should revise its billing base to reflect this sale by advice letter no later than 30 days after the consummation of the transaction.

IV. Conditions to Closing of the Transaction

In this Phase I decision, we find that sale of the five exchanges is not adverse to the public interest pursuant to PU Code § 851. However, issues concerning rate impacts and gain-on-sale remain to be determined in Phase II, which has been consolidated with Citizens' GRC. The applicants wish to close the transaction prior to the final decision in Phase II, at their own risk. The applicants were put on notice by ALJ Watson that any [*32] decision in Phase I of the proceeding could contain the types of conditions on closing found In the Matter of the Joint Application of GTEC Corporation and Contel Corporation D.91-03-022 (1990). Therefore, we approve the closing of the acquisition prior to the issuance of the final decision in Phase II of this proceeding subject to the following conditions. Until the decision in Phase II is final, Citizens shall:

1. Maintain separate books and records on the five transferred exchanges.
2. Maintain separate management and other personnel.
3. Maintain separate offices.
4. Maintain the services presently provided by GTEC in the five exchanges pursuant to the Transition Contract.
5. Refrain from using any of the assets of the five transferred exchanges for the benefit of CUC or of CUC's subsidiaries or affiliates, other than Citizens in the ordinary course of business.
6. Refrain from selling, transferring, disposing of, encumbering, or otherwise impairing the marketability or viability of any of the assets within the five transferred exchanges, except in the ordinary course of business.
7. Refrain from commingling any of the assets within the transferred exchanges [*33] with those of Citizens or its other subsidiaries or affiliates.
8. Take all of the reasonable and necessary steps to maintain the five transferred exchanges and their related assets and operations as separate and independent entities so that Citizens could readily divest itself of the transferred exchanges if the Commission should impose rate impacts or conditions in Phase II which are unacceptable to GTEC or Citizens.
9. Not reduce the levels of employment within the five transferred exchanges pending completion of Phase II of this proceeding.

Applicants shall also complete all adjustments to the final purchase price prior to September 30, 1994. n9 Applicants shall furnish to DRA the final purchase price information not later than two business days after its completion. Applicants shall also file, as an exhibit to the Agreement, under seal, the final purchase price information as a supplement to the application in Phase II. To the extent that this condition requires modification of the time periods set forth in Section 3.2 of the Agreement, the parties should either amend the Agreement or perform thereunder according to the condition set by the Commission.

n9 This includes the period for GTEC's objection to the final purchase price and refund to Deloitte and Touche. [*34]

Applicants may proceed to closing, subject to determination of reasonableness of the revenue requirement and rates in Phase II and the conditions set forth above. Should applicants make the business decision to close prior to Phase II, at the risk of their shareholders, Citizens shall acquire the public utility obligation associated with the five transferred exchanges upon such closing and may not be divested of such obligation absent prior Commission approval. GTEC

shall be relieved of its public utility obligation as to the five exchanges, post-closing, subject to the final Commission decision on the revenue requirement and rates in Phase II.

Summary

After careful review of the record in this proceeding, the Commission has determined that the acquisition of the Clarksburg, Courtland, Isleton, Meadowville, and Walnut Grove exchanges of GTEC by Citizens is sound and reasonable economically (only as to reasonableness issues considered in Phase I) and operationally, and that it will not be adverse to the public interest. Therefore, the Commission will grant all authorizations sought in A.93-07-039, subject to the conditions set forth herein and determination of the issues [*35] deferred to Phase II of this application.

Findings of Fact

1. Notice of the filing of the application appeared in the Commission's Daily Calendar on July 26, 1993. DRA filed its protest on August 25, 1993.
2. On March 1, 1994, this application was phased and Phase II was consolidated with Citizens pending GRC, A.93-12-005. All issues remaining in Phase I were determined to be legal, rather than factual, and were to be adjudicated based on the parties' briefs.
3. The acquisition by Citizens of the five GTEC exchanges in Courtland, Clarksburg, Isleton, Meadowville, and Walnut Grove is sound and reasonable economically (only as to reasonableness issues considered in Phase I) and operationally and will not be adverse to the public interest.
4. Prior Commission precedents on gain-on-sale, which predated NRF, are no longer directly applicable to post-NRF sales by telephone utilities subject to NRF.
5. GTEC's sale of exchanges to Citizens was subject to management discretion and control, so it is not entitled to "Z factor" treatment.
6. The gain on sale should be treated as miscellaneous operating income by GTEC.
7. The allocation of all earnings between the earnings [*36] floor of 7.75% rate of return and 15.50% rate of return is substantial and sufficient reward to GTEC's shareholders for the gain on sale of these exchanges.
8. Phase I of the proposed transaction will not be adverse to the public interest, as long as the closing is conditioned as set forth in Section IV of this decision.
9. No refund mechanism for GTEC's customers in the five exchanges should be implemented at this time under the Transition Contract.
10. Principles of cost of service ratemaking, which apply to Citizens at this time, require that the property being acquired by Citizens be recorded at its original cost with related downward adjustments for accumulated depreciation and contributions in aid of construction; premiums for acquisition are not recoverable in rates.
11. GTEC's transfer of exchanges will impact the billing base, which is used to calculate the surcharge adjustments which implement GTEC's annual price cap filing.

Conclusions of Law

1. Authority should be granted to consummate the acquisition by Citizens of the five GTEC exchanges in Courtland, Clarksburg, Isleton, Meadowville, and Walnut Grove under the terms and conditions of the Agreement attached [*37] as Exhibit A to the application, the Assignment attached as Exhibit B to the application, and the Transition Contract, filed as a schedule to Exhibit A, all as modified by this decision.
2. A public hearing is not necessary.

3. The disposition of GTEC's gain on sale of exchanges to Citizens should be governed by the principles of the new regulatory framework (NRF) for local exchange telephone companies, as modified by GTEC's NRF 92 Review decision.

4. The principles of cost of service ratemaking still apply to Citizens at this time; therefore, it should record its acquisitions at original cost with related downward adjustments for accumulated depreciation and contributions in aid of construction; any acquisition premium paid is not recoverable in rates, and should be amortized below the line over the remaining life of the assets.

5. Since time is of the essence and because all conditions to closing of the transaction contemplated in the Agreement have occurred, this order should be effective immediately.

INTERIM ORDER

IT IS ORDERED that:

1. Phase I of Application 93-07-039 filed by Citizens Utilities Company of California (Citizens) and GTE California Incorporated [*38] (GTEC) for authority under Section 851 of the Public Utilities Code for GTEC to sell to Citizens certain of its property in accordance with an asset transfer agreement dated as of May 18, 1993 is granted on an interim basis as conditioned herein.

2. In the event that the Commission imposes rate impacts or conditions in this application's Phase II which either GTEC or Citizens is unwilling to accept, Citizens shall proceed with divestiture as required by this interim decision.

3. Within 10 days of the transfer, Citizens shall write the Commission stating the date of transfer. A copy of the transfer documents shall be attached.

4. Citizens is authorized to record this transaction at original cost with downward adjustments for accumulated depreciation and contributions in aid of construction; any acquisition premium paid is not recoverable in rates, and shall be amortized below the line over the remaining life of the assets.

5. GTEC is authorized to book the gain on sale arising from this transaction pursuant to 47 CFR 32.7350 Gains or losses from the disposition of certain property.

6. GTEC shall treat the gain on sale arising from this transaction as miscellaneous operating [*39] income for ratemaking purposes.

7. Pending final resolution of Phase II of this proceeding, GTEC shall be relieved of, and Citizens shall acquire, the public utility obligation for the five transferred exchanges after closing of the transaction as it is authorized and conditioned herein.

8. Should GTEC's rates increase before the transferred customers come under Citizens' interim rates in its pending GRC, DRA may petition to modify this portion of the decision based on a showing that the \$3.25 monthly savings has been offset by a period of higher GTEC post-IRD bills.

6. GTEC should revise its billing base to reflect this sale by filing an advice letter no later than 30 days after the consummation of the transaction.

9. This order shall become effective immediately, but, unless exercised, any authority herein granted shall expire on December 31, 1994.

10. If for any reason GTEC and Citizens agree to cancel the transaction contemplated by the application, the parties shall notify the Commission of such fact within 5 days.

This order is effective today.

Dated September 15, 1994, at San Francisco, California.

APPENDIX G

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Union Electric Company Petition for an order authorizing the sale, transfer and assignment of certain assets, real estate, leased property, easements and contractual agreements to Iowa Electric Light & Power Company and, in connection therewith, certain other related transactions

92-0084

ILLINOIS COMMERCE COMMISSION

1992 III. PUC LEXIS 427

October 28, 1992

CORE TERMS: electric, wholesale, retail, customers, territory, generating, northern, peak, Public Utilities Act, petitioner filed, service area, real estate, reallocation, transmission, reduction, modified, plant, capital structure, preferred stock, leases, hydroelectric, modification, accounting, ratepayers, long-term, easements, emissions, savings, prudent

OPINION: [*1]

ORDER

By the Commission:

On March 12, 1992, Union Electric Company ("Petitioner" or "UE") filed a verified petition with the Illinois Commerce Commission ("Commission") requesting approval for the sale, transfer and assignment of certain assets, real estate, leased property, easements and contractual agreements to Iowa Electric Light & Power Company ("Iowa Electric") and for certain other related transactions pursuant to Section 7-102 of the Public Utilities Act. On May 15, 1992, Petitioner filed a motion to supplement its petition to include an amendment to an Electric Service Agreement between it and Iowa Electric. The motion to supplement the petition is granted.

Pursuant to proper legal notice, hearings were held in this matter before a duly authorized Hearing Examiner of the Commission at its offices in Springfield, Illinois on July 13 and July 14, 1992. Appearances were entered by counsel on behalf of Petitioner and by members of the Commission's Public Utilities Division ("Staff"). Petitioner presented evidence in support of the petition, and at the conclusion of the hearing on July 14, 1992, the record was marked "Heard and Taken."

Petitioner filed a draft order. [*2] Staff filed comments on the draft order. Petitioner filed an amended draft order.

The Hearing Examiner's proposed order was served on the parties. No briefs on exceptions were filed.

Petitioner provides retail electric service to customers in Missouri, Illinois and Iowa and also serves 19 wholesale electric customers, 18 of which are located in Missouri and one in Iowa. As of December 31, 1991, Petitioner provided retail electric service to approximately 1,008,000 customers in the State of Missouri, 68,000 customers in the State of Illinois, and 17,000 in the State of Iowa.

The Agreement for Which Approval is Sought

Petitioner seeks approval to perform an "Agreement for Purchase and Sale of Certain Assets and Real Estate and Assignment of Easements, Leases and Licenses (the "Agreement") dated March 4, 1992, as modified on April 21, 1992, which it entered into with Iowa Electric. The Agreement was admitted into evidence as Schedule 1 to UE Exhibit 1. The modification to the Agreement was admitted into evidence as UE Exhibit 2. The modification amends Exhibit J to Schedule 1, which is a 25 Hertz Wholesale Electric Service Agreement between Petitioner and Iowa Electric. [*3]

Gary L. Rainwater, Petitioner's General Manager of Corporate Planning, testified concerning the general terms of the Agreement. The Agreement provides for the sale of Petitioner's Iowa service area to Iowa Electric. Petitioner's Iowa service territory is a 566 square mile area located in Lee, Henry, Des Moines and Van Buren Counties. It includes approximately 17,000 customers, five of which are served with non-standard 25 Hz power. The area's 60 Hz firm peak demand is approximately 130 MW and the 25 Hz peak demand is approximately 45 MW. Almost all of the 25 Hz power supply is interruptible.

Pursuant to the Agreement, Iowa Electric will pay \$58.75 million for UE's Iowa retail and wholesale electric business, which includes distribution facilities, vehicles, equipment, franchises, leases, easements, permits, real estate and certain transmission lines. UE's Keokuk, Iowa hydroelectric generating plant and its associated transmission facilities are excluded from the sale. The sales price is subject to certain adjustments at the closing. The Agreement also includes two wholesale contracts under which Iowa Electric will purchase wholesale power from UE.

The sales prices was [*4] arrived at through a competitive bidding process. Mr. Rainwater testified that Iowa Electric's offer was the best offer and met UE's criteria for the sale of the area. He indicated that UE determined the value of its Iowa service area on the basis of its future earnings potential. UE assumed an 8.12% return on rate base, which was the average rate of return for Iowa during the nine quarters prior to October 1991.

Benefits from the Sale

Mr. Rainwater testified that two factors were involved in UE's decision to sell its Iowa service area. First, the sale will reduce UE's regulatory costs and allow its management to focus its attention on its Missouri and Illinois businesses. UE's Iowa business accounts for only about 2.5% of its total revenues. UE determined that a disproportionate amount of its management's time was spent on its Iowa operations. Second, the sale of the Iowa area will reduce UE's peak demand by 130 MW and delay the need for its next generating unit by about two years or until the year 2000.

Mr. Rainwater testified that UE's Illinois ratepayers will benefit from the sale. He indicated that the sale will result in the reallocation of certain system expenses [*5] to Illinois, which would increase revenue requirements for Illinois customers. He indicated, however, that this cost reallocation is more than offset by cost reductions resulting from the sale. He noted that the reduction of UE's peak demand by about 130 MW will reduce UE's future generating plant requirements by about 150 MW. Mr. Rainwater testified that the reallocation of vintage existing generating capacity from Iowa to Illinois is less costly to Illinois ratepayers than the building of new capacity. He also noted that the reduced energy requirements on UE's system will result in a reduction in sulfur dioxide emissions. He stated that the reduced emissions will reduce UE's costs to comply with the *Clean Air Act Amendments of 1990*.

In Docket No. 92-0123, UE is seeking Commission approval of the sale of its northern Illinois service territory to Central Illinois Public Service Company. Mr. Rainwater testified that an analysis performed by UE indicates that the sale of the Iowa and northern Illinois service areas will result in net present value savings in 1992 dollars of approximately \$200 million for its Missouri and remaining Illinois customers. That analysis, summarized [*6] in UE Exhibit 4, covers the period from 1992 through 2021. Mr. Rainwater testified that approximately 15% of those savings are attributable to the sale of the northern Illinois service territory and 85% are attributable to the sale of the Iowa service territory (Tr., p. 13-14).

UE's Proposed Use of Proceeds from the Sale and Proposed Journal Entries to Record the Sale

David L. Wucher, Manager of Petitioner's Plant and Regulatory Accounting Department, sponsored exhibits which indicate the impact of the proposed sales of its Iowa and northern Illinois service territories on its financial statements (Schedule 1 and 2 to UE Exhibit 3) and its proposed journal entries to record the sales (Schedule 3 to UE Exhibit 3). Mr. Wucher testified that the before-tax gain on the sales would be \$34,057,000, and that the tax on the gain would be \$19,292,000 (Tr. pp. 45-46). He indicated that the gain will be recorded below-the-line in Account 421.1. He stated that shareholders are entitled to any gain on the sales since they are the owners of UE's properties.

Mr. Wucher testified that the proceeds from the sales of the Iowa and northern Illinois service territories will be used for UE's [*7] ongoing operating and to reduce existing debt (Tr., p. 45). UE's response to a Staff data request, admitted into evidence as Staff Cross Exhibit 1, indicates that UE's capital structure as of December 31, 1991 consists

of long-term debt 46%, preferred stock 5% and common equity 49%. Giving effect to the sales, UE projects a capital structure that consists of long-term debt 45%, preferred stock 5% and common equity 50%.

At the hearing on July 14, 1992, Peter Lazare, a member of the Rate Design Department of the Commission's Public Utilities Division, stated that Staff recommends that the relief requested by Petitioner be granted.

The Commission, having considered the entire record, is of the opinion and finds that:

(1) Petitioner is a Missouri corporation engaged, among other things, in the business of providing electric and gas service to the public in Illinois, and is a public utility within the meaning of the Public Utilities Act;

(2) the Commission has jurisdiction over Petitioner and the subject matter hereof;

(3) the statements of fact set forth in the prefatory portion of this Order are supported by the record and are hereby adopted as findings of fact;

(4) the consent [*8] and approval of the Commission for the sale of Petitioner's Iowa retail and wholesale electric business to Iowa Electric pursuant to the Agreement admitted into evidence as Schedule 1 to UE Exhibit 1, as modified by UE Exhibit 2, may reasonably be granted and the public will be inconvenienced thereby;

(5) the consideration to be paid by Iowa Electric and received by Petitioner pursuant to the Agreement is reasonable and prudent;

(6) Petitioner's proposed accounting treatment for the sale of its Iowa retail and wholesale electric business is reasonable and should be approved.

IT IS THEREFORE ORDERED that consent and approval of the Commission is granted for the performance by Union Electric Company of the Agreement admitted into evidence as Schedule 1 to UE Exhibit 1, as modified by UE Exhibit 2.

IT IS FURTHER ORDERED that Union Electric Company is hereby authorized to sell, transfer and assign to Iowa Electric Light & Power Company its wholesale and retail electric systems located in the State of Iowa (excluding its hydroelectric generating plant and related transmission facilities near Keokuk, Iowa), as more particularly described in the Agreement, that are necessary or useful [*9] in the performance of Union Electric Company's duties with respect to the provision of retail and wholesale electric service in Iowa.

IT IS FURTHER ORDERED that the consideration to be received by Union Electric Company from Iowa Electric Light & Power Company pursuant to the Agreement is hereby approved as reasonable and prudent.

IT IS FURTHER ORDERED that Union Electric Company's proposed accounting treatment for the sale of its Iowa retail and wholesale electric business to Iowa Electric Light & Power Company is hereby approved.

IT IS FURTHER ORDERED that Union Electric Company is hereby authorized to execute and perform in accordance with the terms of all other documents reasonably necessary and incidental to the performance of the transactions which are the subject of the Agreement.

IT IS FURTHER ORDERED that subject to the provisions of Section 10-113 of the Public Utilities Act and 83 Ill. Adm. Code 200.880, this Order is final; it is not subject to the Administrative Review Law.

Commissioner Kretschmer dissents; a written opinion will be filed.

APPENDIX H

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In the matter of the joint application of Missouri Cities Water Company and the City of Northmoor, Missouri, for authority authorizing Missouri Cities Water Company to sell, transfer and convey to the City of Northmoor the water distribution system and related property serving residents within the City of Northmoor. *

In the matter of the joint application of Missouri Cities Water Company and the City of St. Charles, Missouri, acting on behalf of the Board of Public Works of said City, for authority authorizing Missouri Cities Water Company to sell, transfer and convey to the City of St. Charles the water distribution system and related property serving an area commonly referred to as the Cole Creek area.

In the matter of Missouri Cities Water Company of St. Charles, Missouri, for authority to file tariffs increasing rates for water service provided to customers in the Missouri service area of the Company.

In the matter of Missouri Cities Water Company of St. Charles, Missouri, for authority to file tariffs increasing rates for sewer service provided to customers in the Missouri service area of the Company.

* The Commission in an order issued June 5, 1983, denied a rehearing in this case.

Case Nos. WM-82-147, WM-82-192, WR-83-14 and SR-83-15

PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

1983 Mo. PSC LEXIS 53; 26 Mo. P.S.C. (N.S.) 1

May 2, 1983

CORE TERMS: staff, water, customer, rate base, ratepayer, accounting, tariff, leveraging, rate of return, investor, double, earnings, sewer, sewage, working capital, subsidiary, dividend, plant, capital structure, rate case, infiltration, recommended, coverage, storm, depreciation, expenditure, ratemaking, consolidated, normalization, sanitary

HEADNOTES: [*1] Return §§ 34, 55, 61.1. Water § 18. A "double leverage" adjustment may be made to the capital structure of a utility company which is a wholly-owned subsidiary of another corporation, resulting in a lower return on the subsidiary's equity, where the equity of the relevant parent corporation has a clearly identifiable cost.

Return §§ 34, 55, 61.1. Water § 18. A "double leverage" adjustment to the capital structure of a utility company which is a wholly-owned subsidiary of another corporation recognizes that the subsidiary's equity is made up entirely of the components of the capital structure of the parent corporation, and that the parent's purchase of the equity of the subsidiary is "leveraged" by lower-cost debt included in the parent's capital structure.

Return §§ 34, 55, 61.1. Water § 18. Where a utility company has more than one parent company, the double leveraging concept should be applied to the senior parent company whose common equity costs are specifically identifiable, ideally one whose stock is market-traded.

Return §§ 34, 55, 61.1. Water § 18. A double leverage adjustment will be rejected when purely mechanical and no valid and reliable theoretical or [*2] practical basis is discernible from the record; where there is no showing of the double leveraging effects on the company's parent or the parent's parent; and where the effects of double (or triple or quadruple) leveraging are speculative because the market-traded senior parent is operating under Chapter XI Reorganization and has recently experienced negative earnings.

Accounting §§ 9, 45. Speculation, expectation and possibility that certain expenses will occur in the future fail to meet burden of proof.

Accounting §§ 15, 32, 44, 45. Limitation of maintenance expenditures because of a cash-flow crisis points up the wisdom of using a multi-year average to develop a normalized level of expenses, since such an average evens out irregularities of any particular year.

Accounting §§ 15, 29, 45. The cash-flow test for determining whether normalization treatment should be authorized for the tax-timing differences considers two primary factors: a utility's internally generated funds as a percentage of construction expenditures, and the utility's interest coverage.

Accounting §§ 15, 29, 44, 45. Full normalization will not be allowed when a company's interest coverage and internally [*3] generated funds as a percentage of construction expenditures are adequate.

Accounting §§ 38, 44, 45. The Commission traditionally has not included security retirements in its consideration of the normalization issue.

Accounting §§ 15, 45. Rate case expenses are not extraordinary expenses which should be amortized but are ordinary expenses which should be included in a company's cost of service at a reasonable level calculated upon historic data, adjusted if necessary for known and measurable changes.

Accounting §§ 29, 45. The interest amount used in establishing a subsidiary's rates should reflect the overall capital that the parent has employed in its investment in the subsidiary.

Accounting §§ 1, 45. Discounted cash flow (DCF) analyses are appropriate for determining a rate of return on equity. DCF is considerably more systematic and allows the Commission to treat all utilities it regulates in a consistent manner.

PANEL: Shapleigh, Chm., McCartney, Fraas, Dority, Musgrave, CC.

COUNSEL: APPEARANCES: Charles G. Siebert, Attorney at Law, Schlafly, Griesedieck, Ferrell & Toft, 314 North Broadway, St. Louis, Missouri 63102, for the Missouri Cities Water Company.

Jeremiah D. [*4] Finnegan, Attorney at Law, Suite 101, 4225 Baltimore Avenue, Kansas City, Missouri 64111, for the Cities of Weatherby Lake, Riverside, Parkville, Houston Lake, Platte Woods, Lake Waukomis; and Platte County Water District No. 6.

Michael C. Pendergast, Assistant Public Counsel, 1014 Northeast Drive, Jefferson City, Missouri 65101, for the Office of the Public Counsel and the public.

Martin C. Rothfelder, Assistant General Counsel, Post Office Box 360, Jefferson City, Missouri 65102, for the Staff of the Missouri Public Service Commission.

OPINION: REPORT AND ORDER

Procedural Background:

On June 11, 1982, Missouri Cities Water Company (hereinafter, "Company" or "Missouri Cities") filed tariff sheets with this Commission by which the Company proposed a general increase in rates for water and sewer services provided to customers in its Missouri service areas. The proposed tariffs bore a requested effective date of July 15, 1982. On July 14, 1982, the Commission suspended those tariffs until November 12, 1982. On November 4, 1982, the Commission further suspended the proposed effective date of the tariffs until May 12, 1983. Also on November 4, 1982, the Commission [*5] approved a form of notice to be given by the Company to its customers concerning the proposed rate increases in this case.

A timely application to intervene in this case was filed on behalf of the Missouri Cities of Weatherby Lake, Riverside, Parkville, Houston Lake, Platte Woods, and Lake Waukomis, and on behalf of Platte County Water Supply District No. 6, (hereinafter, "City Intervenors"). The City of Mexico, Missouri, also filed an application to intervene in Case No. WR-83-14. These applications to intervene were granted by Commission order of September 28, 1982.

The Company filed its prepared direct testimony and exhibits in this case on October 4, 1982.

On December 1, 1982, the Office of the Public Counsel (hereinafter, "Public Counsel") filed a "Request for Local Hearings" in this case. On December 10, 1982, the Commission issued its "Order Setting Local Public Hearing". Such local public hearing was held as scheduled on Saturday, January 15, 1983 in the cafeteria/gymnasium of the Willie Harris Elementary School, 1025 Country Club Road, St. Charles, Missouri. The transcript of that local public hearing is a part of the evidentiary record of this case, and all of the [*6] competent and substantial evidence contained therein has been considered by the Commission in reaching its Findings and Conclusions herein.

On December 21, 1982, the Commission issued its "Interim Rate Order" in response to an application for same filed for the Company on or about November 16, 1982, authorizing the Company to use the accelerated cost recovery system for calculating depreciation for income tax purposes and to use a normalization method of accounting as defined and prescribed in the Economic Recovery Tax Act of 1981, and as defined and prescribed in any rulings or regulations which might be promulgated to further explain or define the provisions of that Act.

On January 6, 1983, the prepared direct testimony and exhibits of the Commission Staff (hereinafter, "Staff") were filed in this case.

On January 17, 1983, the prehearing conference in this case was convened in Jefferson City, Missouri. On January 25, 1983, the hearing of this matter commenced in the Commission's hearing room in Jefferson City. The hearing concluded on January 27, 1983. The reading of the record by the Commission pursuant to Section 536.080, RSMo 1978, has not been waived. Briefs [*7] have been filed by all parties except the City of Mexico, Missouri, which did not participate in the prehearing conference or in the hearing.

On January 24, 1983, the Staff filed a "Motion to Exclude Consideration of the Mexico Well Issue." This motion was briefed by the parties, and by Commission order issued February 17, 1983, was granted by the Commission. For the reasons stated in that order, the issue designated in the Hearing Memorandum in this case as the "Mexico Well" Issue (Exhibit 1, Page 8, Section IX) has not been considered by the Commission on its merits in this case.

On February 4, 1983, the Commission issued its "Order of Consolidation" consolidating the instant cases with Cases No. SM-81-217, WM-82-147, and WM-82-192. On February 18, 1983, the Commission granted a further order re-separating Case No. SM-81-217 from the other four (4) cases for decision by the Commission, since that case is not yet ready for a decision. These cases are discussed further below under Section V (A) and Section VI (B), "Gain on Sales."

Findings of Fact

I. The Company:

Missouri Cities Water Company is a utility company engaged in providing water supply and sewer services in [*8] Missouri to approximately 23,571 water customers and 4,478 sewer customers. The Company provides water service through five (5) operating divisions: Brunswick, Mexico, Parkville, Warrensburg and St. Charles County. In addition, the Company provides sewer service in Parkville and St. Charles County. The Company's rates are set separately for water and sewer service and for each division.

For the year ended December 31, 1981, the Company derived ninety (90) percent of its revenue from water operations and ten (10) percent from its sewer operations. The majority of its water industrial customers are in the Mexico and Warrensburg divisions, and the Company also sells water wholesale in the Brunswick, Mexico, Parkville and Warrensburg divisions.

The Company has 47 employees. Its principal office is located in St. Charles, Missouri, in which is located its engineering, accounting, administrative and other general office personnel. The Company is a wholly-owned subsidiary of Consolidated Water Company, a holding company which has other operating subsidiaries in Florida, Indiana, Ohio and Michigan. The offices of Consolidated Water Company are located in Coral Gables, Florida.

[*9] Missouri Cities Water Company is a water corporation and a sewer corporation, and a public utility, within the meaning and scope of Chapters 386 and 393, RSMo 1978, and as such is within the jurisdiction of this Commission.

II. Elements of Cost of Service:

The Company's authorized rates are generally based on its cost of service, or "revenue requirement". As elements of its revenue requirement, the Company is authorized to recover all of its reasonable and necessary operating expenses and, in addition, a reasonable rate of return on the value of its property used in public service (rate base). It is necessary, therefore, to establish the value of the Company's rate base and to establish a reasonable rate of return to be applied thereto which, when added to reasonable operating expenses, results in the total revenue requirement of the Company. By calculating the Company's reasonable level of revenues (earnings), it is possible to determine the existence and extent of any deficiency between the present earnings and the revenue requirement found reasonable in any rate proceeding.

III. Test Year and True-Up:

The purpose of using a test year is to construct a reasonably [*10] expected level of revenues, expenses and investment during the future period for which the rates to be determined herein will be in effect. Aspects of the test year operations may be adjusted upward or downward in order to arrive at a proper allowable level of all of the elements of the Company's operations.

The Company's original filing in this case was based on a test year ending December 31, 1981. However, the Company and all other parties have now agreed to use the Staff's historical test year ending September 30, 1982, adjusted for known and measurable changes. No true-up of rate base or expense items has been requested or made.

IV. Contested Issues:

The Commission hereinbelow sets out its findings as to those issues presented to it for decision in the Hearing Memorandum in this case (Joint Exhibit 1), which were not resolved by the parties in prehearing conference.

V. Net Operating Income:

Several adjustments to the Company's operating revenues and expenses have been proposed in this case. Generally, adjustments to operating revenues and expenses found to be proper represent a reduction of or addition to the Company's net operating income, after giving effect [*11] to income tax liability.

A. Gain On Sales.

During 1982, the Company sold its Northmoor water distribution system to the City of Northmoor, and its Cole Creek water distribution system to the City of St. Charles, pursuant to Commission authorization. These transactions are described in more detail below in Section VI. B., "Gain On Sales". City Intervenors and Public Counsel propose that the sale proceeds from those sales in excess of the net depreciated book value of the transferred systems be credited respectively to the Parkville and St. Charles districts' revenue requirements. If this position were adopted, the net operating income available to the Company would be increased, and the Company's revenue requirement in this case

would be decreased. The Staff recommends that the net gain of the sales be subtracted from the Company's rate base, as discussed below.

For reasons discussed below in Section VI. B., the Commission determines that the adjustment to net operating income proposed by the City Intervenors and Public Counsel should not be approved in this case.

B. Maintenance Accrual Account.

The Company accrues projected maintenance expense on normally [*12] recurring expenditures depending on the nature of the item, and then performs the necessary maintenance with funds already provided. The timing of the accrual and maintenance is at the discretion of Company officials. In this case, the Company proposes to include \$72,600 in its cost of service, representing what Company alleges is its normal cost of maintaining wells, pumps and reservoirs.

Staff proposes to include \$52,000 in the Company's cost of service for maintenance accruals. Staff's proposed figure is the average of the Company's actual maintenance expenditures for the five (5) years ending September 30, 1982. It is Staff's opinion that the Company's method of projecting maintenance accrual causes customers to contribute to future maintenance costs, rather than paying for actual maintenance as incurred.

The items covered by the Company's maintenance accrual account are generally large cash outlays which occur periodically and cover the painting of storage tanks; maintenance on wells, pumps and motors; and maintenance on high-service pumps. The maintenance accrual account is made up of five (5) separate accruals representing the five (5) divisions of the Company. In the [*13] Brunswick Division, the Company has had to acidize the wells each year. However, with the addition of a new well in 1982 which will permit lower levels of pumpage from existing wells, the necessity of acidizing in the Brunswick Division should be reduced from every year to every five (5) years. Acidizing the wells in the Mexico and Platte County Divisions is on a seven (7) to eight (8) year cycle, and in Warrensburg is on a ten (10) year cycle. Major maintenance for pumps and motors generally is incurred every seven to ten years, and the painting of the inside of water tanks in four (4) of the Company's divisions is on a seven (7) year cycle.

The Company's proposed maintenance accrual account level in this case is based upon projected maintenance procedures and the projected costs thereof, considering the dates when specific maintenance items were last undertaken. The maintenance actually scheduled under the Company's data in this case would not reach the \$72,600 level that the Company is requesting as a "normal" maintenance expense, until 1987.

As stated previously in this Report and Order (See Section III., above), the purpose of using a test year is to construct a reasonably [*14] expected level of revenues, expenses and investment during the future period for which the rates to be determined herein will be in effect. The Commission finds and concludes that the Company has not met its burden of proving that its proposed level of maintenance expenses can be reasonably expected to be incurred during the future period for which the rates set in this case will be in effect. The expectation that maintenance expenses will reach \$72,600 in 1987 is not sufficient to meet the Company's burden of proof. The possibility that maintenance expenses other than those included in that \$72,600 amount could occur prior to 1987 is too speculative to be relied upon.

The Commission determines that Staff's actual five-year average is the more reasonable method of calculating the level of maintenance expenses which should be included in the Company's cost of service in this case. The Company is critical of the Staff's approach because it includes the first nine (9) months of 1982, in which the Company asserts that it severely limited its maintenance expenditures because of a cash-flow crisis. Actually, that circumstance points up the wisdom of using a multi-year average [*15] to develop a normalized level of expenses, since such an average evens out the irregularities of any particular year.

Staff's proposal is adopted.

C. Full Normalization.

The Company proposes that it be authorized to normalize the timing differences between book and tax treatments relating to payroll expenses, transportation, interest and similar items related to construction, and to defer the differences of the income tax effects by setting up a separate account, Account Number 283-Accumulated Deferred Income Taxes. On the other hand, Staff proposes to flow-through those tax-timing differences to the Company's

ratepayers. The timing differences arise from the capitalization of the items on the accounting books of the Company and the expensing of such items in computing income taxes. This treatment increases internally generated funds and reduces rate base because deferred taxes is a rate base deduction. The effect of the Company's proposal is to increase test year expense by \$16,620, and to decrease rate base by the same amount.

The Commission has consistently utilized a "cash-flow test" for determining whether normalization treatment should be authorized for the tax-timing [*16] differences of particular utilities. Under its "cash-flow test", the Commission considers two primary factors: the Company's internally generated funds as a percentage of construction expenditures, and the Company's interest coverage. It is Staff's evidence in this case that if internally generated funds as a percentage of construction expenditures is at a level of thirty (30) percent or lower, and interest coverage is 1.5 percent or lower, then the Company would be experiencing significant cash-flow problems such that full normalization should be allowed.

The competent and substantial evidence upon the record of this case demonstrates that the after-tax interest coverages of Missouri Cities Water Company have been at levels between 1.62 and 2.09 from 1977 through 1981, inclusive; that the Company's test year-unadjusted after-tax interest coverage is 1.92; and that the Company's test year-adjusted after-tax interest coverage is 1.72. In addition, internally generated funds as a percentage of construction have ranged between 57 percent and 78 percent for this Company between 1977 and 1981, inclusive, and are 87.53 percent for the test year in this case. The Commission finds that [*17] Staff's position on this issue is just and reasonable, and should be adopted. Therefore, the Commission finds and concludes that the Company's interest coverage and internally generated funds as a percentage of construction expenditures are adequate, and that full normalization should not be allowed in this case.

The Commission notes that the Company's calculations of internally generated funds as a percentage of construction expenditures included internal cash supporting the retirement of internal debt and preferred stock, in addition to cash supporting construction. The Commission traditionally has not included security retirements in its consideration of the normalization issue, and is not persuaded upon the record herein that it should do so in this case.

The Commission notes that it has opened a generic docket (PSC Case No. 00-83-220) for further study of the issue of normalization of tax-timing differences. However, upon the record in this case and for the reasons stated herein, Company's proposal of full normalization of tax-timing differences will not be adopted.

D. Rate Case Expense.

The Company proposes that the rates resulting from this case include [*18] rate case expenses equal to one-half the cost of the Company's last rate case (\$35,600), plus the entire estimated cost of the present rate case (\$52,000), or a total amount of \$87,000. Company alleges that it is amortizing the expenses of its 1981 rate case over a two-year period on its books, and that such amortization only came into effect with the rates resulting from that rate case, which was settled, in approximately February, 1982.

The Staff contends that the amount of rate case expense which should be allowed in the Company's rates should equal the amount of the estimated expenses of the instant rate case, which is \$52,000. The Company asserts that the Staff's approach would deprive the Company of the opportunity to recover its past rate case expenses of \$35,600, being the last half of its expenses from the 1981 rate case. The Company plans to file additional rate cases in 1983, 1984 and 1985.

As stated previously in this Report and Order (Section III., above), the purpose of using a test year is to construct a reasonably expected level of revenues, expenses and investment during the future period for which the rates to be determined herein will be in effect. Rate case [*19] expenses are not extraordinary expenses which should be amortized, but are ordinary expenses which should be included in a Company's cost of service at a reasonable level calculated upon historic data, adjusted if necessary for known and measurable changes. The Commission finds and concludes that the reasonable level of rate case expenses which should be included in the Company's cost of service in this case is \$52,000, as proposed by the Staff. To provide for the recovery of past rate case expenses, as proposed by the Company, could constitute retroactive ratemaking, which is prohibited by State ex rel. Utilities Consumer Council of Missouri v. Public Service Commission of Missouri, 585 S.W.2d 41, 59 (Mo. en banc 1979). See also Re: Martigney Creek Sewer Company, Mo. PSC Case No. SR-83-166 (Report and Order issued March 4, 1983).

Staff's proposed level of rate case expenses is hereby approved.

E. Income Tax Credit for Parent Interest Payments.

The Company's filing in this case credited the Company's income tax liability by a pro rata share of the tax savings from the interest payments by Consolidated Water Company, the parent company of Missouri Cities [*20] Water Company. The amount of this income tax credit, calculated by the Company based upon its filing test year of December 31, 1981, was \$15,000. Based upon the agreed test year in this case ending September 30, 1982, Company computes the credit to be \$13,247.

City Intervenors and Public Counsel agree with the Company that there should be an income tax credit for interest payments by the Company's parent corporation, but calculate the credit to be \$25,206 rather than \$13,247. This calculation is based upon a gross interest payment amount for Consolidated Water, rather than a net interest amount.

Staff opposes the additional interest deduction. Staff asserts that its methodology in this case synchronizes the interest deduction with the rate base and capital structure utilized by the Staff, thereby allowing as a deduction only that interest that would be paid through rates. Staff asserts that the Company, City Intervenor and Public Counsel proposals would reduce revenue requirement with a Company investor's tax deductions, rather than those of the Company itself which are paid in rates.

Upon the record in this case, the Commission determines that the interest amount used in [*21] establishing the Company's rates should reflect the overall capital that Consolidated Water Company has employed in its investment in Missouri Cities. Each month, Consolidated Water takes the total interest it pays or accrues and the total interest received from all sources, principally its subsidiaries, and nets the difference. The net difference is allocated monthly to the subsidiaries based on Consolidated Water Company's investment in its respective subsidiaries. This procedure of Consolidated and the Company has been followed consistently since the mid-1960's and has been used by the Company in all of its rate case filings since that time.

The Commission finds and concludes that the Company has met its burden of proving that its proposed income tax credit for parent interest payments is just and reasonable, and should be approved.

F. Net Operating Income-Summary.

After adjustments made on the basis of the contested issues discussed above, the Commission finds the Company's net operating income under present rates to be \$1,256,291.

VI. Rate Base:

A. Negative Working Capital.

The Company did not include any cash working capital in its proposed rate base in [*22] this case. Staff, however, proposes that the Company's rate base be decreased by \$80,152, representing a negative cash working capital component.

Cash working capital is the amount of cash required to pay the day-to-day expenses incurred by the Company to provide service to the ratepayer. Cash working capital is supplied by the shareholder (investor) and the ratepayer. When an expenditure by the Company to provide service to the ratepayer precedes the collection from the ratepayer for such service, the cash working capital must be provided by the investor. The ratepayer provides cash working capital when the reverse is true; collection for services rendered by the Company precedes the payment by the Company for the goods or services necessary to provide that utility service. The investor or the ratepayer, as appropriate, is compensated for the cash working capital provided to the Company by adjusting the Company's rate base. The investor-supplied cash working capital funds increase rate base, while ratepayer-supplied cash working capital funds reduce rate base.

The Staff determined its proposed negative working capital adjustment in this case by the use of a lead-lag [*23] study. The Commission has consistently accepted the lead-lag methodology for the determination of cash working capital requirements. See, for example, Re: Kansas City Power & Light Company, MoPSC Case No. ER-78-52, 28

PUR 4th 398 (1979); Re: Kansas City Power & Light Company, MoPSC Case No. ER-81-42 (Report and Order issued June 17, 1981); and Re: Continental Telephone Company of Missouri, MoPSC Case No. TR-82-223 (Report and Order issued January 26, 1983).

Staff's lead-lag study in the instant case developed and compared a revenue lag and an expense lag for the Company. A revenue lag is the amount of time between the provision of service by the Company and the receipt of payment for that service. The revenue lag consists of three components: usage, billing and collection lags. The expense lag describes the amount of time between the receipt of goods or services by the Company and the subsequent payment by the Company for those goods and services, which are used in providing utility service to the ratepayer. When the revenue lag exceeds the expense lag, the cash working capital is provided by the investor. When the expense lag exceeds the revenue lag, the cash [*24] working capital is provided by the ratepayer.

The Company performed no lead-lag study in this case. The Company opposes the Staff's proposed negative working capital adjustment on the basis of the Company's allegation that its credit has been deteriorating and its earnings have been substandard, asserting that the cash balance which the Company maintains, its investment in unamortized plant abandonment losses and its preliminary engineering expenditures demonstrate that Staff's negative working capital adjustment should be disapproved. These arguments of the Company are irrelevant to a determination of the Company's cash working capital, as defined herein.

Staff's lead-lag study in the instant case demonstrates that, in the aggregate, the ratepayer provides cash working capital to the Company. The Commission finds and concludes that the Staff's lead-lag study is reasonable and should be relied upon in this case. As a result, the Company's rate base should be reduced by the amount of the negative cash working capital requirement, which is \$80,152.

B. Gain On Sales.

On December 11, 1981, Missouri Cities Water Company and the City of Northmoor, Missouri, filed a joint application [*25] with this Commission seeking authority for the Company to sell, transfer and convey to Northmoor the water distribution system and related property serving Northmoor. The application was assigned PSC Case No. WM-82-147.

The Company had been providing water service to the residents of Northmoor since the year 1960, pursuant to a Certificate of Convenience and Necessity granted by this Commission in PSC Case No. 14,550. The distribution system was part of the Company's Parkville division, and served approximately 130 customers. The City of Northmoor decided to purchase the water distribution system so that it could upgrade that system to meet the fire standards required by Kansas City, Missouri, in order that the residents of Northmoor could receive fire protection from Kansas City.

The Company and Northmoor agreed to a cash sale price of \$28,000. The original cost of the Northmoor distribution system was determined to be \$18,793, arrived at pursuant to an original cost study ordered by the Commission in Case No. 15,946. The sale price of \$28,000 is asserted to represent the replacement value of the system, less depreciation.

On February 19, 1982, the Commission entered [*26] an order in Case No. WM-82-147 requiring the Company to send notice of the application to its affected customers and setting an intervention deadline in that case of April 9, 1982. No applications to intervene were filed.

On February 8, 1982, the Company and the City of St. Charles, Missouri, filed a joint application with this Commission seeking authority for the Company to sell, transfer and convey to St. Charles the water distribution system and related property serving an area commonly referred to as the Cole Creek area. This application was assigned PSC Case No. WM-82-192.

The Company had been providing water service to approximately 60 residential customers, 25 commercial customers, 11 multi-family customers and 1 industrial customer in the Cole Creek area pursuant to a Certificate of Public Convenience and Necessity granted by this Commission in Case Nos. 15,032 and 15,593. The Cole Creek area is part of the Company's St. Charles Division. A portion of the Cole Creek area is located within the corporate limits of the City of St. Charles and an additional portion of the Cole Creek area may be annexed by the City of St. Charles in the near future. The Company and the City [*27] of St. Charles agreed to a sale price of \$140,000, which is asserted to

represent the replacement value of the system, less depreciation. The Company determined that the original cost of the property to be sold to the City of St. Charles, less accumulated depreciation, amounted to \$52,060.

On March 1, 1982, the Commission issued an order in Case No. WM-82-192 requiring the Company to send notice of the application to its affected customers, and set an intervention deadline in that case of April 15, 1982. No applications to intervene were filed.

On June 10, 1982, the Commission issued its "Order Setting Hearing" in Case Nos. SM-81-217, WM-82-147 and WM-82-192. Case No. SM-81-217 involves the application of the Company for authority to (1) enter into an agreement with the City of St. Peters for sewage treatment and (2) to abandon its Steeplechase sewage treatment plant and recover the unamortized loss on the abandonment thereof over a ten-year period. A hearing on the consolidated cases took place as scheduled on June 11, 1982 at the Commission's offices in Jefferson City, for the purpose of answering questions of the Commission regarding the propriety of severing the [*28] question of the appropriate accounting entries to be made as a result of the transactions contemplated by those cases, from the Commission's determination to authorize the underlying transactions. On July 2, 1982, the Commission issued its "Order and Notice of Hearing" in the three cases, in which it denied motions filed by the Company for an order approving transfer of the utility property, consolidated all three cases for determination of the accounting issues raised therein, set a deadline for the filing of the Company's direct testimony and exhibits and scheduled a hearing to be held on August 13, 1982. Company filed direct testimony in accordance with that order, and the Commission's Staff also prefiled testimony in Case Nos. WM-82-147 and WM-82-192.

On July 23, 1982, the Commission issued its Interim Report and Order in Case No. SM-81-217, approving a Stipulation and Agreement entered into by the parties to that case, thereby approving the agreement between the Company and the City of St. Peters, Missouri, for the treatment of sewage in the area served by the Company's Steeplechase sewage treatment plant, and approving the abandonment of the Steeplechase sewage treatment [*29] plant and amortization of the remaining undepreciated plant resulting therefrom over a ten-year period. Pursuant to the Stipulation and Agreement, the Commission deferred a decision as to the proper accounting and ratemaking treatment to be afforded to the proceeds of any sale of the land upon which the abandoned sewage treatment plant was situated. On July 27, 1982, the Commission issued an order in each of Case Nos. WM-82-147 and WM-82-192 approving the transfers requested in those cases, but reserving ruling on the appropriate accounting treatment to be afforded to the gain realized by the Company on those sales.

An evidentiary hearing on the contested accounting issue in Cases No. WM-82-147 and WM-82-192 was held as scheduled on August 13, 1982 in the Commission's hearing room in Jefferson City. Because no sale of the remaining land related to the abandoned Steeplechase sewage plant had occurred, the parties agreed that the proper accounting treatment of such a sale in Case No. SM-81-217 was not ripe for hearing before the Commission. Company and Staff filed initial briefs and reply briefs in Case Nos. WM-82-147 and WM-82-192.

In Case Nos. WR-83-14 and SR-83-15, City Intervenors [*30] propose that the gain experienced by the Company on the sale of the Northmoor water system should be amortized over a two-year period and thereby offset against the rates to be paid by the remaining customers of the Parkville Division of the Company. Public Counsel supports the City Intervenors as to the proposed treatment on the Northmoor sale, and further proposes that consistent treatment be afforded the Cole Creek sale. The Commission Staff proposes that the gain on these sales should be deducted from the Company's rate base, and contends that its proposed rate base treatment is supported by the Uniform System of Accounts. The Company opposes all of the above proposals and asserts that gains and losses from the sale of operating units should be afforded "below the line" accounting and ratemaking treatment.

On February 4, 1983, the Commission issued its "Order of Consolidation" in Case Nos. SM-81-217, WM-82-147, WM-82-192, WR-83-14 and SR-83-15, consolidating those cases for decision by the Commission. On February 18, 1983, the Commission issued another order in those five cases, called "Order Separating Case No. SM-81-217," separating Case No. SM-81-217 from the [*31] other four cases for decision by the Commission, since Case No. SM-81-217 involves vacant land rather than a distribution system and since no sale of that land has actually been accomplished.

Therefore, the Commission has before it in the instant case the question of the appropriate accounting and ratemaking treatment to be afforded to the gains realized by the Company from the sale of its Northmoor and Cole Creek water distribution systems.

The gain realized by the Company on the Cole Creek sale, net of taxes and expenses, is \$54,911.33. The gain realized by the Company on the Northmoor sale, net of taxes and expenses, is \$2,705.39. If Staff's rate base proposal were approved, the Company's net original cost rate base in this case would be reduced by \$57,616.72 on a total Company basis (rounded to \$57,616 by the parties in the reconciliation in this case, attached to Joint Exhibit No. 1). If the Commission were to adopt the proposal of the City Intervenors and Public Counsel, the net gain proceeds would be amortized over two years, thereby reducing the revenue requirement to be established in this case by \$28,808.36 (rounded to \$28,808 in the Joint Hearing Memorandum). [In its [*32] brief, the Public Counsel recommends that the gain on the Cole Creek sale be amortized over a ten year period rather than over two years as proposed by the City Intervenors as to the gain on the Northmoor sale.] The adoption of the Company's proposal to treat the net gain as "below the line" income would have no effect on the Company's rates or rate base.

The Commission has adopted the Uniform System of Accounts (USoA) for Class A and B water utilities published by the National Association of Regulatory Utility Commissioners, as the standard for accounting for regulated water utilities. 4 CSR 240-50.030.

Instruction 5-F of the Uniform System of Accounts states the following:

5. Utility Plant Purchased or Sold.

F. When utility plant constituting an operating unit or system is sold, conveyed, or transferred to another by sale, merger, consolidation, or otherwise, the book cost of the property sold or transferred to another shall be credited to the appropriate utility plant accounts, including amounts carried in account 114, Utility Plant Acquisition Adjustments, and the amounts (estimated if not known) carried with respect thereto in the accounts for accumulated provision [*33] for depreciation and amortization and in account 252, Advances for Construction, and account 271, Contributions in Aid of Construction, shall be charged to such accounts and the contra entries made to Account 106, Utility Plant Purchased or Sold. Unless otherwise ordered by the Commission, the difference, if any, between (a) the net amount of debits and credits and (b) the consideration received for the property (less commissions and other expenses of making the sale) shall be included in account 422, Gains (Losses) From Disposition of Property. (See account 106, Utility Plant Purchased or Sold.)

Note: In cases where existing utilities merge or consolidate because of financial or operating reasons or statutory requirements rather than as a means of transferring title or purchased properties to a new owner, the accounts of the constituent utilities, with the approval of the Commission, may be combined. In the event original cost has not been determined, the resulting utility shall proceed to determine such cost as outlined herein.

Company asserts that Instruction 5-F clearly applies where an operating system and its connected customers are transferred, and the system [*34] continues to be utilized by the purchaser to serve the same customers. Company asserts that the Northmoor and Cole Creek systems which were sold by the Company are "utility plant constituting an operating unit or system" within the meaning of Instruction 5-F, so that the gain on the sales of those systems should be recorded "below the line," in account 422, Gains (Losses) From Disposition of Property. It is Company's position that this treatment of the gain is reasonable, since the investor is the one who runs the risk of the gain or loss on the partial liquidation of the Company's business. Included in that risk of loss, in the Company's view, is the recovery in real purchasing power of less than the initial investment. Company states that in an original cost State such as Missouri, the customer never pays for cost of service based upon depreciation computed on a replacement value of the asset, but rather pays depreciation based upon the original book value, so that the customer never faces the risk of inflation in relation to depreciation.

Company asserts that its proposed accounting and ratemaking treatment of the gains in question is supported by the Commission's decision [*35] in Re: Kansas City Power & Light Company, Case No. ER-77-118. In that case, Kansas City Power & Light Company (KCP&L) sold certain electric distribution properties to the Kansas City Board of Public Utilities, and at the same time sold a 69 KV transmission line to the City of Independence, Missouri. The proceeds received by KCP&L from those sales resulted in a gain over net original cost, and the Company proposed that these

gains should be recorded "below the line" for accounting purposes. In its Report and Order approving this accounting treatment, the Commission stated at Page 42:

It is the Commission's position that ratepayers do not acquire any right, title and interest to Company's property simply by paying their electric bills. It should be pointed out that Company investors finance Company while Company's ratepayers pay the cost of financing and do not thereby acquire an ownership position. Therefore, the Commission finds that the disposal of Company property at a gain does not entitle its ratepayers to benefit from that gain nor does the disposal of Company property at a loss require that Company's ratepayers absorb that loss.

The Staff asserts that another provision [*36] of the Uniform System of Accounts may be applied to the gains in question as an alternative to Instruction 5-F, and that the Commission should weigh the equities involved and then determine which of the alternative sections of the USoA should be applied. The alternative provision referred to by the Staff is Instruction 10-B(2), which provides as follows:

(2) When a retirement unit is retired from utility plant, with or without replacement, the book cost thereof shall be credited to the utility plant account in which it is included, determined in the manner set forth in paragraph D, below. If the retirement unit is of a depreciable class, the book cost of the unit retired and credited to utility plant shall be charged to the accumulated provision for depreciation applicable to such property. The cost of removal and the salvage shall be charged or credited, as appropriate, to such depreciation account.

The USoA also includes the following definitions related to Instruction 10-B(2):

21. "Property retired," as applied to utility plant, means property which has been removed, sold, abandoned, destroyed, or which for any cause has been withdrawn from service.

22. "Replacing" [*37] or "replacement," when not otherwise indicated in the context, means the construction or installation of utility plant in place of property retired, together with the removal of the property retired.

25. "Retirement units" means those items of utility plant which, with or without replacement, are accounted for by crediting the book cost thereof to the utility plant account in which included.

26. "Salvage value" means the amount received for property retired, less any expenses incurred in connection with the sale or in preparing the property for sale, or, if retained, the amount at which the material recoverable is chargeable to materials and supplies, or other appropriate account.

Staff asserts that Instruction 10-B(2) can be applied to the instant factual situation, since the Northmoor and Cole Creek operating systems have been "sold" and "withdrawn from service" and are therefore "property retired" within the USoA definitions. Since, in Staff's view, either Instruction 5-F or Instruction 10-B(2) may be applied to the instant facts, the decision should be based upon a weighing of the equities involved. That weighing process, according to the Staff, results in the conclusion [*38] that the Company's ratepayers should be entitled to the benefit of the gain on sales of the Northmoor and Cole Creek facilities.

Staff asserts that the investor's legally protected interest resides in the capital he invests in the utility, rather than in the items of property which are purchased with that capital for the provision of utility service. As the basis of this proposition, staff cites *Southwestern Bell Telephone Company v. Missouri Public Service Commission*, 262 U.S. 276 (1923), and *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Area Transit Commission*, 485 F. 2d 786 (D.C. cir. 1973), cert. denied sub. nom. *Transit System, Inc. v. Democratic Central Committee*, 415 U.S. 935 (1974). In the latter case, (hereinafter referred to as the DCC case), the Court concluded that the allocation of appreciation in value of utility assets while in operating status depends on two principles: (1) the right to capital gains on utility assets is tied to the risk of capital losses (principle of "gain follows loss"); and (2) he who bears the financial burden of particular utility activity should also reap the resulting benefit (principle [*39] of "benefit follows burden"). Based upon a detailed analysis in that case, the Court concluded that ratepayers of the Washington Metropolitan Area Transit Commission had borne substantial risks of loss and financial burdens associated with the assets employed in the utility's business, and were entitled to the benefit of the gain realized by the sale of certain appreciable assets.

Based upon these principles, Staff asserts that the recovery by Missouri Cities' investors of the proceeds of the sale of appreciated utility properties should be limited to the amount of their original investment. Applying the two underlying principles of the DCC case, Staff asserts that the application of both principles to the instant facts should result in the conclusion that the ratepayers of Missouri Cities Water Company should receive the benefit of the gains from the Northmoor and Cole Creek sales. First, Staff asserts, it is clear that the ratepayer bears the risk of capital losses. Staff points to the Commission's decisions in Re: Missouri Edison Company, PSC Case No. ER-79-120 (Report and Order issued September 25, 1979), in which the Commission allowed the utility to amortize, [*40] over a period of time, extraordinary expenses resulting from a major ice storm during the test year; Re: St. Joseph Light and Power Company, PSC Case No. 18,448 (Report and Order issued July 30, 1975), where the Commission authorized the utility to increase rates to cover purchased power costs amounting to \$1,350,000 necessitated by damage to a generating facility caused by explosion, extreme heat and fire; and Re: Missouri Public Service Company, PSC Case No. ER-81-85 (Report and Order issued May 27, 1981), in which the Commission authorized the utility to amortize extraordinary purchased power costs and extraordinary maintenance costs associated with an outage at a generating facility caused by a defective turbine.

Concerning the "benefit follows burden" principle, Staff asserts that it is equally clear that the ratepayer bears the expense of ordinary operation, maintenance and depreciation, as well as absorbing investment losses brought on by functional obsolescence and the exhaustion of depletable assets. In Staff's view, the Company's shareholders have already received their original cost investment through the depreciation expense which is included in the Company's [*41] rates, and have received a return on that investment. Having received their full legally protectable interest in those assets, Staff believes that the Company's investors cannot be heard to complain that they have not received their just due. Therefore, it is Staff's position that this weighing of the equities demonstrates that the Company's ratepayers are entitled to the benefit of the gain on the sales of the Northmoor and Cole Creek operating facilities.

The Company asserts that Instruction 10-B(2), relied upon by the Staff, does not apply to the sale of used and useful operating systems and the transfer of the customers related to those systems. The Company alleges that a reading of Instructions 5-F and 10-B(2) together leads to the conclusion that the method proposed by the Staff is properly applied where retirement units are sold or disposed of or abandoned owing to obsolescence or due to newer facilities, and where the customers affected by the disposition of the retirement units remain customers of the utility in question. On the other hand, Company avers, when a utility sells utility property to another utility or municipality, as here, and withdraws from the [*42] business of serving the customers who are thereafter served by the purchaser, the accounting treatment in respect to the proceeds received by the selling utility are properly accounted for by Instruction 5-F. Company points out (and Staff's witness agreed) that if the Company sold all of its utility business, all of the gain or loss on that sale would inure to the investors of the Company and not to the ratepayers. It is therefore consistent, says the Company, to treat a partial liquidation of the Company's business, by the sale of a distribution system and the transfer of its customers, in the same manner, i.e., "below the line".

In addition, the Company argues that the DCC case, relied upon by the Staff, is inapposite, since it involved the sale of improved real estate pursuant to a conversion of the utility from a streetcar-bus system to an all-bus system and did not involve a sale of an operating system or transfer of customers to a purchasing utility. Also, the Court in the DCC case found no uniform accounting rule or other well established principle to govern the situation, and said that if there were a general rule applicable, it should be given great deference, particularly [*43] in an accounting proceeding.

Company also argues that its customers, by the payment of their utility bills, do not acquire any right, title or interest in the property of the Company; and that the proposals of City Intervenors, Public Counsel and Staff would take the Company's property without fair compensation and would deprive the Company of substantive and procedural due process of law, in violation of the applicable provisions of the Constitutions of the United States and of the State of Missouri.

The City Intervenors assert that the sale of the Northmoor system by the Company will result in an increase in rates to the remaining customers in the Platte County Division of the Company, since the loss of the Northmoor customers will result in the fixed costs for that division being spread over fewer customers. City Intervenors seek the amortization of the gain on the Northmoor sale over a two-year period in order to cushion the impact of the loss of the Northmoor system and customers on the remaining ratepayers in the Platte County Division. As previously stated, Public Counsel supports the City Intervenors as to the gain on the Northmoor sale and proposes that consistent treatment [*44] be afforded the Cole Creek sale, recommending in his brief that the gain on the Cole Creek sale be amortized over a ten-

year period against the rates in the St. Charles County Division. No provision of the Uniform System of Accounts or Commission precedent is cited in support of the City Intervenor-Public Counsel proposal.

In deciding this issue, the Commission is not bound by the Uniform System of Accounts. Commission Rule 4 CSR 240-50.030(4) states:

In prescribing these systems of accounts the Commission does not commit itself to the approval or acceptance of any items set out in any account for the purpose of fixing rates or determining other matters before the Commission.

The Commission also notes that Instruction 5-F of the USoA, relied upon by the Company, provides for "below the line" treatment of gains or losses to which that Instruction applies, "unless otherwise ordered by the Commission."

The Commission does, however, find Instruction 5-F of the USoA persuasive on this issue. The Commission's reading of Instructions 5-F and 10-B(2) of the USoA lead it to the determination that Instruction 5-F is more appropriately applied to the instant transactions. The [*45] Northmoor and Cole Creek operating systems were not retired for obsolescence or some other cause, nor abandoned or destroyed. Rather, they were operating systems which were sold to another, within the meaning of Instruction 5-F.

The Company's ratepayers have paid depreciation and maintenance expenses, and a rate of return, based upon the transferred property. In turn, the ratepayers have received utility service from the Company by the use of that property. It can be argued that the Company's ratepayers had no reasonable expectation of benefit from those Company assets other than the receipt of utility service. In addition, the decisions of this Commission cited by the Staff concerning the bearing by the ratepayer of extraordinary expenses caused by damage to utility plant do not involve losses on the sale of utility property.

Of the options presented to the Commission upon the record of this case, the Commission determines that the Company's proposal is the most reasonable, and should be approved.

The Commission is of the opinion that it would be possible to develop additional alternative treatments of gains on the sale of appreciated utility assets, for ratemaking purposes, [*46] in addition to those presented in this case. Such alternatives might include returning to the ratepayer through amortization the depreciation expense which the ratepayer has paid to the Company on the assets which are sold, and allowing the Company to treat the remainder of the gain "below the line"; or returning to the ratepayer a percentage of the net gain equal to the percentage of the Company's capital structure which is non-equity, and allowing the Company to treat "below the line" the percentage of the gain representing the percentage of the Company's capital structure which is equity. These alternatives would permit a sharing of the benefit of gains on appreciated utility assets between the ratepayer and the shareholder. It is possible that such alternatives would prevent the possibility of a multiple recovery by the Company's investors for particular utility plant (through the recovery of depreciation expense in rates, and then again through an appreciated sale price); and would, on the other hand, still provide an incentive to the Company and its shareholders to invest in property which may appreciate in value to the benefit of the Company. The options before the Commission [*47] upon the instant record, however, are "all-or-nothing" options; under the Company's proposal, the gain on sales inures entirely to the benefit of the shareholder; while under the Staff, City Intervenor and Public Counsel proposals, the gain on sales accrues entirely to the ratepayer.

For these reasons, the Commission is limiting its decision on this issue to the facts and record of this case. Although the Commission is not strictly bound by the principles of stare decisis and res judicata, the Commission nonetheless wishes to emphasize that its authorization of "below the line" treatment of the gain on the sales of the Northmoor and Cole Creek systems by Missouri Cities Water Company is not necessarily indicative of a general policy of the Commission to treat the gain on sale of utility property in this same manner as to other utilities in future cases, for accounting or ratemaking purposes. The instant decision is not binding upon the Commission or the parties in future cases involving similar issues.

For purposes of this case and upon the record herein, the Commission finds and concludes that the gain on the sale by Missouri Cities Water Company of its Northmoor [*48] and Cole Creek operating systems should be treated "below the line" in accordance with Instruction 5-F of the Uniform System of Accounts, for accounting and ratemaking

purposes. Therefore, no adjustment to Company's net operating income or rate base shall be made as a result of those sales in this case.

C. Mexico Well Issue.

In its prepared direct testimony and exhibits in this case, the Company proposed that it be authorized to implement a supplemental rate of \$.105/CCF as an additional consumption charge for the Mexico Division, to be collected when a new well which is planned for the Division is completed and placed in service. This proposal was set out in the Hearing Memorandum in this case (Joint Exhibit No. 1). On January 24, 1983, the Staff filed a "Motion to Exclude Consideration of the Mexico Well Issue," and a Memorandum in support of that motion, asserting that the Commission was without authority to grant the Company's proposed Mexico Well rate increment since it was not requested by the Company's proposed tariffs filed in this case on June 11, 1982. On February 9, 1983, Company and Public Counsel filed briefs in response to the Staff's motion and memorandum. [*49]

On February 17, 1983, the Commission issued its "Order Granting Staff Motion" in this case, thereby excluding consideration of the Mexico Well Issue in this case.

D. Original Cost Rate Base.

Upon the competent and substantial evidence in this case, and adjusting for the determinations reached on rate base issues above, the Commission finds and concludes that the Company's net original cost rate base is \$12,504,700.

VII. Capital Structure and Rate of Return:

A. Double Leveraging.

The Commission hereby overrules the Company's objection to certain testimony of City Intervenors' witness Dittmer on this issue. (Transcript, Pages 279-280).

Since the Company is a wholly-owned subsidiary of Consolidated Water Company, City Intervenors and Public Counsel propose that Missouri Cities' capital structure should be adjusted to recognize the fact that the Company's equity is composed entirely of the components of the capital structure of Consolidated Water Company. The capital structure of Consolidated is comprised in part of lower cost (and tax deductible) debt and lower cost preferred stock, and in part of higher cost common equity. This lower cost debt and preferred [*50] stock has, in the view of City Intervenors and Public Counsel, been used by Consolidated to finance the acquisition of the common stock of Missouri Cities. Therefore, it is argued, Consolidated employs financial leverage at the parent level in the same manner that the subsidiary Company (Missouri Cities) achieves leverage by issuing its own debt. Under such "double leveraging," the holder of Consolidated's common equity would earn a return in excess of the return on common equity authorized by this Commission, it is asserted. To avoid such a result, City Intervenors and Public Counsel propose a "double leveraging" adjustment to be applied to the Staff's proposed capital structure, designed to reduce the Staff's low recommended return on rate base as follows:

Staff's low recommended rate of return	11.08%
Less effect of double leverage	.29%
Rate of return using double leverage	10.79%

City Intervenors and Public Counsel allege that the cost of the long-term debt and preferred stock portions of Consolidated Water Company's outstanding securities are significantly less than the cost of common equity as recommended in this case by either Company or Staff. City Intervenors [*51] and Public Counsel assert that integrating this lower cost debt and preferred stock into Missouri Cities' capital structure, as they propose by their adjustment, merely recognizes that Consolidated has employed this financial leverage at the parent level in order to acquire and maintain its common equity investment in Missouri Cities. The absence of such adjustment, it is asserted, will have the inevitable effect of authorizing Consolidated, as the immediate investor in Missouri Cities, to earn a rate of return in excess of that finally approved by the Commission in this proceeding. City Intervenors and Public Counsel

cite several Commission precedents for the adoption of a double leveraging adjustment, including Re: Southwestern Bell Telephone Company, Case Nos. TR-81-208 and TR-82-199; Re: Continental Telephone Company, Case No. TR-82-223; and Re: Missouri Power & Light Company, Case Nos. HR-82-178, ER-82-180 and GR-82-181.

The Company opposes the proposal of City Intervenors and Public Counsel because it does not believe that the double leverage theory is consistent with proper ratemaking concepts. Company asserts that it has designated certain property to the public [*52] service, and it is that property on which the Company is entitled to earn a fair return. The identity of a regulated utility's investors, whether corporate or individual, and how they acquired or financed their capital for investment in the utility, should have no effect on the level of rates paid by that utility's customers, in the Company's view.

The Staff does not oppose the use of a double leveraging adjustment as a matter of ratemaking principle, and has supported such an adjustment in cases such as the Southwestern Bell rate cases cited above. However, Staff contends that the double leveraging adjustment is inappropriate in the instant case. Staff asserts that this Commission's use of the double leveraging adjustment has only involved parent corporations whose equity has clearly identifiable cost. See Re: Missouri Power & Light Company, Case Nos. HR-82-178, ER-82-180 and GR-82-181 (Report and Order issued October 29, 1982); Re: Southwestern Bell Telephone Company, Case No. TR-82-199 (Report and Order issued December 30, 1982). Staff argues that if the double leveraging concept is to be applied, it should be carried to its logical conclusion and applied [*53] to the senior parent company whose common equity costs are specifically identifiable (ideally, one whose stock is market traded). However, Consolidated Water Company (the parent corporation of Missouri Cities Water Company) is a wholly-owned subsidiary of Avatar Utilities, Inc., which in turn is a wholly-owned subsidiary of Avatar Holdings, Inc., which is a market-traded company. Therefore, says the Staff, City Intervenors and Public Counsel should have started by identifying the capital costs of the parent which is market traded (Avatar Holdings, Inc.), and then worked down to Missouri Cities, which would have required quadruple leveraging. However, the evidence in this case shows that Avatar Holdings, Inc. filed for reorganization under Chapter XI of the Bankruptcy Act in January of 1976, subsequently reorganized, and recently has showed negative earnings. Based on these facts, the Staff avers that setting a rate of return based upon the equity of Avatar Holding, Inc. would be speculative and inappropriate.

In addition, Staff alleges that the City Intervenors' adjustment constitutes merely a mechanical adjustment without a sound basis either presented on the record or inferable [*54] from the record. That adjustment simply adjusts Staff's low end of its range of recommended rates of return on equity, to Consolidated Water Company's equity, without defined theoretical or practical basis.

City Intervenors indicate in their initial brief in this case that quadruple leveraging from the publicly traded parent company (Avatar Holdings, Inc.) would result in a lower rate of return than double leveraging from the immediate parent (Consolidated). The evidence in the record of this case, however, sheds no light whatever on the rate of return which would result from triple or quadruple leveraging. City Intervenors also argue in their reply brief that it is "inexplicable" that the Staff should suggest that quadruple leveraging could be appropriate for this Company, but then argue against the application of double leveraging. City Intervenors' argument on this point is obviously based on the assumption just recited, that quadruple leveraging would result in a lower rate of return than double leveraging, which is not supported by the evidence herein.

Upon the evidence before it, the Commission cannot find that the double leveraging adjustment proposed by City Intervenors [*55] and Public Counsel would more accurately reflect the cost of equity capital of Missouri Cities. No valid and reliable theoretical or practical basis for the proposed adjustment is discernible from the record of this case. The Commission cannot accept the purely mechanical adjustment proposed herein.

In addition, this Commission's use of the double leveraging adjustment has generally involved ultimate parent corporations (not parents who are themselves subsidiaries) whose equity has a specifically identifiable cost. Re: Southwestern Bell Telephone Company, supra; Re: Continental Telephone Company, supra; and Re: Missouri Power & Light Company, supra. The effects of parental capital structures cannot be assessed absent a showing of the leveraging effects of Avatar Utilities, Inc. upon that of Consolidated Water Company, or of the capital structure of Avatar Holdings, Inc. on that of Avatar Utilities, Inc. Further, even if that data were a part of the instant record, the Commission would have to conclude on the evidence before it that the effects of quadruple leveraging are too

speculative to be relied upon, due to the fact that the market-traded "ultimate" parent [*56] (Avatar Holdings, Inc.) is operating under Chapter XI reorganization and has recently experienced negative earnings.

For these reasons, the double leveraging adjustment proposed by the City Intervenors and Public Counsel must be rejected in this case.

B. Rate of Return:

The Company proposes that a fair cost of equity capital to the Company would be not less than 18.5 percent. This would result in an overall rate of return on original cost rate base of 12.75 percent. Staff asserts that the Company should earn in a range of 13.5 to 14.5 percent on equity, which would result in an overall rate of return on original cost rate base in a range from 11.08 percent to 11.41 percent. City Intervenors and Public Counsel support the Staff's low return on equity (13.5 percent), but propose an overall rate of return on original cost rate base of 10.79 percent based on a double leveraging adjustment (See Section VII. A., "Double Leveraging", above).

As of the end of the test year in this case (September 30, 1982), the capital structure of the Company was as follows:

	Amount	Percent of Capitalization
Common Stock	\$ 4,075,817	33.34
Preferred Stock	562,200	4.60
Long-term Debt	7,588,188	62.06
	\$12,226,205	100.00%

[*57]

Company asserts that a reduction of debt leverage through the expansion of the equity base is desirable, but states it is difficult in today's market to attract equity capital that earns only 8 to 10 percent. The Company points out that a financial summary of investor-owned water companies in 1980 prepared by the National Association of Water Companies shows that longterm debt averaged 45.7 percent for companies in the \$1 million to \$1.5 million revenue range, 48.2 percent for companies in the \$5 million to \$10 million revenue range, and 53.6 percent for companies with revenues in excess of \$10 million. Company asserts that the common stockholder of Missouri Cities Water Company has supplied approximately 1/3 of the capital requirements of the Company in the last six years, and has earned from 7.3 percent to 10.7 percent on equity (or an average of 8.6 percent) from 1977 through 1981, inclusive. The pay-out of earnings averaged 59 percent during that period. The Company considers these earnings on equity to be substandard, so that new equity capital will be difficult to attract without a significant increase in the Company's rate of return on equity.

In arriving at [*58] his recommended level of return on equity of 18.5 percent, the Company's witness testified that he had considered the size of the construction program of the Company, the percentage of funds generated internally, the cost of alternative securities such as bonds and common stock, the size of the companies, the economic conditions in which the Company operates, and the legal criteria of the decisions of the United States Supreme Court in *Federal Power Commission v. Hope Natural Gas*, 320 U.S. 591, 64 S.Ct. 281 (1944), and *Bluefield Waterworks v. Public Service Commission of West Virginia*, 262 U.S. 679, 43 S.Ct. 675 (1923). In *Bluefield Waterworks*, the Supreme Court stated the following:

A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. [*59] The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable

at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally.

In the Hope Natural Gas case, the Supreme Court provided this additional guidance:

[I]t is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock . . . By that standard the return to the equity owner should be commensurate with risks on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

Company asserts that its sixty-two percent (62%) debt level approaches the upper limit allowed by its Indenture, and that [*60] its pro forma earnings have been such that its interest coverage ratio has been deteriorating over the last seven years to a perilous level. Company's witness also presented a "risk spread analysis" showing that the risk spread between debt and equity capital on electric companies has varied from 3 percent to 5.8 percent, and asserted that the interest rate to the Company on its debt generally parallels the trend in Baa-rated bonds.

Company asserts that its stock carries an additional risk which the Company designates as a "liquidity risk," because an investor purchasing that stock cannot readily take his capital back out of the business, in contrast to an investor who buys the equity of a publicly traded company. Company states that over the next several years it will be required to attract \$500,000 per year of outside capital to finance construction but will probably not be able to attract equity capital on reasonable terms because of its low level of earnings. The Company also has sinking funds and maturity schedules for 1983 through 1987 requiring an additional funding of \$2,144,000. The interest rates which will be required to attract capital for such refunding [*61] under today's economic conditions will be significantly higher than the rates of the outstanding debt, Company argues.

The Company's average equity ratio for the period of February 1979 through September 1982 was 33.18 percent, which was similar to the majority of the Company's included in an industry composite consisting of nine market-traded water companies for the years 1979 through 1981, studied by the Staff.

The Staff's rate of return on equity proposal is based on a Discounted Cash Flow Model (DCF), which is a theoretical representation of an investor's view of future cash flows which the investor expects to receive from ownership of a company's common stock. The model states that the value of a given share of common stock is based upon the amount of the expected future cash flows and upon the riskiness of the expected future cash flows. The amount of expected cash flows consists of dividends to be received and/or growth of the stock which will result in capital gains. The cost rate of common equity is, therefore, the discount rate which equates the present value of these cash flows to the current market price of the common stock.

The DCF model is expressed by the following [*62] equation:

$$k = D / P + g$$

where "k" represents the investor's required rate of return or discount rate; "D" represents indicated dividends per share; "P" represents the market price per share of common stock; and "g" represents the growth rate in dividends per share and earnings per share. The

D / P

part of the formula represents the market dividend yield; and "g" represents the percentage growth the investor expects the dividend to have continuously into the future. Thus, Staff identifies this model as the "continuous growth form" of the DCF model. This form of the DCF model includes the following assumptions: (1) perpetual life of the Company; (2) constant required rate of return over time (i.e., constant "k"); (3) constant growth in cash dividends (i.e., constant "g"); and (4) identical growth rates for cash dividends, earnings and common stock prices. Additionally, it is implied in these assumptions that there is a constant dividend pay-out ratio and a constant price/earnings multiple over time.

Since neither Missouri Cities Water Company nor its parent, Consolidated Water Company, are market-traded, the Staff selected data for nine market-traded companies for use in the [*63] DCF model. Staff studied the dividend yields of the nine water companies from 1977 through 1982. The annual composite averages of those yields grew from 8.25 in 1977 to 11.52 in 1981, retreating in 1982 to 10.98. However, the composite monthly yields steadily declined in July through December of 1982 from 11.37 to 10.03. Staff studied the approximate daily composite stock yields of its test companies from October 1 through December 31, 1982, and observed that stock prices were rising from October 1 to October 18 (as evidenced by declining yields), but that the average yields stabilized at about 9.9 percent through the remainder of October and all of November. The December yields reflect further consolidation and are influenced upward by slow market adjustment to dividend increases by two of the study companies. In Staff's view, December yields are also influenced upward by the market's tendency for profit-taking prior to year end.

Based on its study of this data, the Staff determined that the late October through November, 1982, average yields of 9.9 percent should constitute the mid-point for the range of yields to be used in Staff's DCF model. Allowing for the possibility [*64] of continued gentle rise, or of continued decline, from that mid-point, Staff set a range of 9.6 to 10.2 percent.

In establishing its growth rate (element "g") for the DCF model, Staff evaluated both the dividends per share and the earnings per share for the nine market-traded water companies in its study. Staff analyzed 10-year Trend-Line growth rates of both earnings and dividends per share for the nine companies from 1977 through 1982. The average dividend growth rates for each year exceeded average earnings growth. Staff observes that if this trend continues, payments of dividends will eventually represent a return of owners' equity.

Staff's approach was to average several years of growth rates together due to the vacillation which occurs in earnings per share from year to year. Based on its study data, the 1977 through 1982 average of earnings growth was 4.28 percent. The Staff eliminated Hackensack Water Company (one of the study companies) from this computation of earnings growth, because earnings data for both 1981 and 1982 for that company was affected by severe water restrictions prompted by the 1980 drought.

Staff's witness next analyzed a series of economic indicators, [*65] including expansion of the gross national product and of the money supply, interest rate and stock market trends, and fiscal and monetary actions of the federal government. Based upon these indicators and the views of leading economists and analysts, Staff's witness estimated a growth range based upon his expectation of movement of the economy into a period of sustained and controlled moderate economic growth. Staff's witness concluded that the 4.28 percent average earnings growth of the nine study companies analyzed by the Staff would represent the high end of the growth rate spectrum. Staff's witness further determined the low end of the growth rate range should be 3.945 percent, developed from the average of earnings growth for the four-year period 1977 through 1980. Staff asserts that this analysis is consistent with the concept that water utilities are not generally considered to be companies whose stock price, earnings, or dividend increases are classified as high-growth. Rounded to the nearest 1/10 of 1 percent, Staff's recommended range of growth rates for inclusion in its DCF model is from 3.9 to 4.3 percent.

Inserting the ranges derived for market dividend [*66] yield and expected growth into the DCF model formula results in the following range of Staff's recommended rate of return on equity for the Company:

$$k = 9.6 + 3.9 = 13.5$$

$$k = 10.2 + 4.3 = 14.5$$

Staff concludes that investors' required return on equity for the nine market-traded water companies, using Staff's DCF model, is between 13.5 and 14.5 percent, inclusive. Staff also calculated pro forma after-tax interest coverages for Missouri Cities Water Company based upon the range of returns on equity determined by Staff's DCF, and those interest coverages were from 1.73 to 1.78 times. The Company's existing bond issues are safeguarded by an Indenture of Mortgage dated June 1, 1956, which requires annual interest coverage after taxes of 1.5 times, and limits the amount of total debt to 66-2/3 percent of net plant less contributions in aid of construction. Staff's recommended returns on equity will allow additional debt financing up to the 66-2/3 percent limit and still meet the interest coverage requirement under the Indenture.

Staff's recommended range of rates of return on equity would result in an overall rate of return of 11.08 to 11.41 percent on the Company's original cost [*67] rate base.

Based upon the record in this case, the Commission finds and concludes that the Company has failed to meet its burden of proving that a rate of return on equity of 18.5 percent is just and reasonable. First, Company's analysis relies upon economic data from mid-1982 and earlier and does not reflect the significant changes in the financial markets that began to become evident in mid-August of 1982, including substantial declines in interest rates and record-setting increases in stock prices. For example, Company's witness relied upon interest rates for long-term U.S. Government bonds and Baarated utility first mortgage bonds of 12.2 percent and 16.0 percent, respectively. As of the time of the hearing in this case, interest rates on those bonds had dropped to 10.0 percent and 13 percent, respectively. Also, unlike the DCF model utilized by the Staff, Company's analysis of rate of return on equity is highly subjective and does not present a technique or model which can be applied by the Commission to this or other utilities in a systematic manner. For example, Company's witness asserted that one of the considerations in his determination of a recommended rate of return [*68] on equity was the size of the construction budget. However, no discernible standard for analyzing the impact of such construction budgets upon the Company's cost of equity capital was offered. In addition, the Company presented evidence of a "risk spread" of 3.0 percent to 5.8 percent for electric utilities, but presented no evidence that the risks and risk premium of the electric utilities studied are the same for water companies.

The Commission has consistently found Discounted Cash Flow (DCF) analyses to be appropriate for determining a rate of return on equity. As stated by the Commission in its Report and Order in Re: Continental Telephone Company, PSC Case No. TR-82-223 (Report and Order issued January 26, 1983), "[t]his is because it is relatively simple to apply and measures investor expectations for a specific company." (Id., at Page 18). As acknowledged by the Commission in Re: Missouri Public Service Company, PSC Case No. 18,181, 20 Mo. PSC (N.S.) 57, (1975), the DCF analysis is "considerably more systematic and allows this Commission to treat all utilities it regulates in a consistent manner."

Company is critical of Staff's DCF result because [*69] it conflicts with what the Company refers to as the "risk premium confirmation test." This test, Company argues, is based upon the financial principle that a purchaser of common stock of a Company has greater risk in relation to return of his principal investment and to earnings than does the purchaser of the debt security of the same company. This is due to the fact that the purchaser of the debt security has a claim on the assets and earnings of the Company which is prior to claims of the shareholders. As a result, the equity purchaser will demand a higher return than the debt purchaser. Staff's witness agreed on cross-examination that a risk premium exists under normal market conditions.

Upon the evidence in the record of this case, the Commission finds and concludes that the Staff's DCF analysis is reasonable and should be relied upon. The Commission further finds and concludes that the existence of "risk premium" compels the use of the high end of Staff's recommended range for rate of return on equity. Having considered the totality of the competent and substantial evidence before it in this case, the Commission finds that the appropriate and necessary return on common [*70] equity to be allowed Company is 14.5 percent. Applying this figure to the capital structure set out hereinabove results in an overall rate of return of 11.41 percent on the Company's net original cost rate base.

VIII. Fair Value Rate Base:

The Commission finds and concludes that the Company's fair value rate base is \$12,504,700.

IX. Revenue Requirement (Revenue Deficiency):

Based upon the findings and conclusions of the Commission herein, the total net operating income requirement of Missouri Cities Water Company is \$1,426,786. The net operating income available for purposes of this proceeding is \$1,256,291, leaving a net operating income deficiency of \$170,495. After applying a factor for income tax, the Commission finds that the gross revenue deficiency of Missouri Cities Water Company in this proceeding is \$324,705.

X. Service Issues:

Several service problems involving the Company were raised at the local public hearing in this case on January 15, 1983 in St. Charles, Missouri. Staff and Company presented evidence at the hearings in Jefferson City on these, and

related, service problems, and Company also filed a late-filed exhibit (Exhibit No. 23) setting [*71] out the results of its follow-up on certain service issues.

Testimony was adduced at the local public hearing concerning accumulations of water at the entrance to Sunnydale Mobile Home Park in St. Charles, causing ice on the streets at freezing temperatures. Staff investigated the problem and found that any such accumulation of water was not related to the master water meter at the mobile home park, and found no evidence that it was related to the sewage lift station which is located at the entrance of the mobile home park. Therefore, this problem is apparently not related to the Company's operations.

A recurring problem relates to the Sunny Meadows Subdivision in St. Charles County. At least three homes on Carpenter Drive in that subdivision experience sewage backups into the basements of the homes during heavy rains. The Company has begun an investigative and repair program concerning this problem. These sewage backups appear to be caused by "infiltration" of storm water into the sanitary sewer system of the Company. Storm water can infiltrate into the sanitary sewage system from foundation drains along the foundation of homes which, in turn, are connected to the [*72] service lateral on the customer's premises and therefore to the sanitary sewage system; from outside stairwell drains ("catch basins") on a customer's premises which are connected to the service lateral; and from other sources, including leaking manholes or leaking joints on sanitary sewer facilities. The infiltration at Sunny Meadows appears to be due in large part to catch basins connected to the service laterals.

Sewer backup problems have also been occurring in the Warsen Hills Subdivision in St. Charles County, and are also believed to be caused or aggravated by storm water infiltration into the sanitary sewage system. Apparently a number of homes in Warsen Hills were constructed some years ago with foundation drains and other storm water drains connected to the sanitary sewage system. The Company has done a significant amount of investigative and repair work in these two subdivisions over the past two and one half (2 1/2) years, including smoke tests and television inspections, and has been reporting the results of these tests and of the repair work to the Staff. The Staff is of the opinion that the Company has been adequately handling these infiltration problems with respect [*73] to Company-owned facilities at Warsen Hills.

The Company's tariffs on file with this Commission include rules stating the following:

Rule 5(a) . . . The Company shall deny service where footing drains, down spouts, or other sources of uncontaminated water are permitted to enter the system through either the inside piping or through the building sewer.

Rule 6(b) . . . No person shall discharge or cause to be discharged, any storm water, surface water, ground water, roof runoff, sub-surface drainage, cooling water or unpolluted industrial process waters to any Company's mains.

A reading of Rule 5 of the Company's tariffs, including Rule 5(j), makes it clear that the customer is to construct and maintain the service sewer (service lateral), including the connection to the Company's collecting sewer.

Based upon these provisions of the Company's tariffs, the Staff recommends that the Company enforce its tariffs by requiring the disconnection of any storm water drainage facilities on a customer's premises from the Company's sanitary sewage system, at risk of disconnection of sewage service to the customer. By letter dated March 23, 1982, Staff recommended to the Company that [*74] it proceed to notify customers who are known to be in violation of the Company's tariffs concerning infiltration of storm water. The Company had not, however, given any written notification to those customers as of the time of the hearing in this case.

The Staff witness testified that customer violations are difficult to deal with because the customer is required to spend a substantial amount of money to repair his facilities, and that notification to these customers often generates complaints to the Company and/or to the Commission and Public Counsel. However, in Staff's view, the customers experiencing sewage backup as a result of storm water infiltration will not see their problem resolved regardless of what action the Company takes on its own system unless customer violations are found and required to be corrected.

Since the Company is obtaining wholesale sewage treatment services from the City of St. Peters, its ratepayers are paying for treatment of all the water that goes through the metering facility of the St. Peters plant. As a result, reducing the amount of storm water which is infiltrated into the sewage system from the Sunny Meadows Subdivision will have cost-related [*75] benefits to the Company and its ratepayers.

As to the Sunny Meadows Subdivision, Staff has also recommended an interim measure to protect the homes on Carpenter Drive from sewage backups while the investigation and long-range repairs in the subdivision are being performed. In response to that recommendation, the Company installed back-flow prevention devices (check valves) in the service laterals on the premises of the five homes located on Carpenter Court. This device allows sewage flows to pass from the customer's lateral into the Company's collection system, but will not allow flows to enter the customer's lateral from the collection system beyond the location of the valve. The Commission was advised by the Company's late-filed Exhibit No. 23 that installation of these devices was completed on February 4, 1983. The homeowners involved all agreed to the installation of those valves, in writing.

The back-flow devices cost approximately \$400 to \$550 each, installed. Company does not propose (nor has Staff recommended) this interim solution for the Warsen Hills Subdivision because Company believes that the primary infiltration problem at Warsen Hills is foundation drains, which [*76] catch significantly more water per unit than the catch basins on Carpenter Court do. Therefore, the back-flow devices would cause the water which is running into the foundation drains to come back into the customer's basement.

Company's witness also testified that the Company is now planning to mail notices to customers in Sunny Meadows and Warsen Hills Subdivisions who are known to be in violation of the Company's tariffs respecting storm water infiltration. The Company will send these letters to the Staff for review before sending them to customers. Company's witness testified that the Company had agreed with the Staff to allow customers until August of 1983 to come into compliance with the Company's infiltration tariffs.

Before connecting service to any new customer, the Company now inspects the sanitary sewage system on the premises to insure that it is a fully enclosed system and is not subject to storm water or other infiltration. The homes in Sunny Meadows Subdivision and Warsen Hills Subdivision which are believed to have infiltration problems were apparently constructed before the sanitary sewage system serving those homes became part of the Company's system. [*77]

Staff recommends that the Commission order the Company to install backup devices protecting the five homes on Carpenter Court. However, since the Commission has been advised by the Company that those devices have already been installed, the Commission determines that such an order is not necessary. The Staff is free to, and should, verify that these devices have been installed.

Staff also recommends that the Company be required to file two reports concerning its investigation and repair of its own system as it relates to the Sunny Meadows Subdivision. The first report would detail the Company's program in Sunny Meadows for investigation and elimination of infiltration sources and would include a tentative schedule of repairs through the remainder of 1983. The second report would describe actions actually taken as of that time, and the Company's plans for further action.

In addition, Staff recommends that the Commission order the Company to file two reports concerning its efforts to bring about compliance by customers with its tariff provisions concerning infiltration of storm water into the sewage system. The first of these reports would include information for both Sunny [*78] Meadows and Warsen Hills Subdivisions concerning the number of customers contacted, and copies of the type or types of notices sent to customers. The second report would detail, for both subdivisions, the status of the programs to bring customers into compliance, the number of customers involved, the number of customers brought into compliance, the number of customers facing disconnect and the number of customers which are disconnected due to the program. The second report would also detail the procedures used by the Company to locate customers with service sewers in violation of the Company's tariffs and the Company's plans for locating such customers in the future.

The Commission determines that the Staff's recommendation concerning continued investigation, repair and compliance actions by the Company, and for filing reports with the Commission on those matters, is reasonable, and should be approved, as ordered below.

Testimony was also received at the local public hearing, and additional testimony adduced at the hearings in Jefferson City, concerning an allegation that six fire hydrants in St. Charles Hills Subdivision in the Company's service area could

not be opened. The [*79] Company inspects fire hydrants annually and lubricates or otherwise maintains them as necessary upon such inspections.

Hearsay evidence indicates that the hydrants complained of had been painted during the summer of 1982 and the man who was painting them could not open them. Captain McWilliams from the St. Charles Fire Protection District was contacted, and he opened the hydrants although three of them opened with difficulty.

There is also hearsay evidence in the record indicating that the Company was notified of the problems concerning these six hydrants sometime between the summer of 1982 and January of 1983. It cannot be determined with certainty from the competent and substantial evidence in this case whether those problems were in fact reported to the Company. At hearing, the Company's vice president testified that the Company would visually inspect any hydrant reported to the Company as not working properly. While the Commission has insufficient evidence before it upon which to base any findings of fact regarding this alleged incident, the Commission does expect the Company to promptly investigate any reports of malfunctioning fire hydrants and to take all necessary [*80] steps to assure that such hydrants are in proper working order at all times.

Certain other alleged service problems were testified to which have been investigated by the Staff, Public Counsel and/or the Company, and which do not present issues which the Commission need resolve in this case.

Conclusions

The Public Service Commission of Missouri reaches the following conclusions:

The Company is a public utility subject to the jurisdiction of this Commission pursuant to Chapters 386 and 393, RSMo. 1978.

The Company's tariffs which are the subject matter of this proceeding were suspended pursuant to authority vested in this Commission by Section 393.150, RSMo. 1978.

The burden of proof to show that the proposed increased rates are just and reasonable is upon the Company.

The Commission, after notice and hearing, may order a change in any rate, charge or rental, and any regulation or practice affecting a rate, charge or rental, of the Company, and may determine and prescribe the lawful rate, charge or rental and the lawful regulation or practice affecting said rate, charge or rental thereafter to be observed.

The Commission may consider all facts which, in its judgment, have any [*81] bearing upon a proper determination of the price to be charged with due regard, among other things, to a reasonable average return upon the capital actually expended and to the necessity of making reservations out of income for surplus and contingencies.

This Commission has general supervisory power over the Company and may take such action as is reasonably necessary to assure the provision of safe and adequate service by the water and sewer companies it regulates. Section 393.140, RSMo 1978.

The order of this Commission is based upon competent and substantial evidence upon the whole record.

The Company's existing rates and charges for water and sewer service are insufficient to yield reasonable compensation for water and sewer services rendered by it in this state and, accordingly, revisions in the Company's applicable water and sewer tariff charges, as herein authorized, are proper and appropriate and will yield the Company a fair return on the net original cost rate base or the fair value rate base found proper herein. Water and sewer rates resulting from the authorized revisions will be fair, just, reasonable and sufficient and will not be unduly discriminatory or [*82] unduly preferential.

For ratemaking purposes, the Commission may accept a stipulation in settlement of any contested matter submitted by the parties. The Commission is of the opinion that the matters of agreement between the parties in this case are reasonable and proper and should be accepted.

All motions not heretofore ruled upon are denied and all objections not heretofore ruled upon are overruled.

The Company should file, in lieu of the proposed revised water and sewer tariffs filed and suspended in this case, new tariffs designed to increase gross water and sewer revenues by approximately \$324,705 exclusive of gross receipts and franchise taxes.

It is, therefore,

ORDERED: 1. That the proposed revised water and sewer tariffs filed by Missouri Cities Water Company in Case Nos. WR-83-14 and SR-83-15 are hereby disapproved, and the Company is authorized to file in lieu thereof, for approval by this Commission, permanent tariffs designed to increase gross revenues by approximately \$324,705 on an annual basis, exclusive of gross receipts and franchise taxes.

ORDERED: 2. That Missouri Cities Water Company shall file the water and sewer tariffs in compliance with this [*83] Report and Order on or before May 9, 1983, for review by the Commission.

ORDERED: 3. The rates established and the tariffs authorized herein may be effective for water and sewer service rendered on and after the 12th day of May, 1983.

ORDERED: 4. That Missouri Cities Water Company be, and is hereby, ordered and directed to continue its investigation and repair of its own system serving the Sunny Meadows Subdivision, as discussed hereinabove, and provided further, that the Company shall file a report with the Commission's Staff on or before May 25, 1983 detailing its program in Sunny Meadows Subdivision for investigation and elimination of infiltration sources, including a tentative schedule of repairs through the remainder of 1983; and on or before September 1, 1983, the Company shall file a report with the Commission's Staff detailing actions actually taken in regard to such investigation and elimination and detailing the Company's plans for continuation of the investigation and repair process.

ORDERED: 5. That Missouri Cities Water Company be, and is hereby, ordered and directed to take actions specifically designed to require compliance by its customers in Sunny Meadows [*84] and Warsen Hills Subdivisions with the Company's tariff provisions prohibiting infiltration of storm water into the Company's sanitary sewage system; provided further, that the Company shall file a report with the Commission's Staff on or before May 25, 1983 setting out, for both of said subdivisions, the number of customers contacted by the Company concerning tariff compliance, and copies of the type or types of notices sent to customers, if any; and the Company shall file a report with the Commission's Staff on or before September 1, 1983 detailing, for both of said subdivisions, the status of the programs to bring customers into tariff compliance, the number of customers involved, the number of customers actually brought into compliance, the number of customers facing disconnect for non-compliance, and the number of customers actually disconnected for non-compliance. The latter report shall also detail the procedures used by the Company to locate customers with service sewers in violation of the Company's tariffs and the Company's plans for locating such customers in the future.

ORDERED: 6. That this Report and Order shall become effective on the 12th day of May, [*85] 1983.

Shapleigh, Chm., McCartney, Fraas, Dority and Musgrave, CC., Concur and certify compliance with the provisions of Section 536.080 RSMo, 1978.

APPENDIX I

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STATE OF NORTH CAROLINA ex rel. UTILITIES COMMISSION; and CAROLINA WATER SERVICE, INC. OF
NORTH CAROLINA, APPLICANT APPELLEES v. PUBLIC STAFF - NORTH CAROLINA UTILITIES
COMMISSION, INTERVENOR APPELLANTS
No. COA95-27

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COURT OF APPEALS OF NORTH CAROLINA

123 N.C. App. 43; 472 S.E.2d 193; 1996 N.C. App. LEXIS 583

October 5, 1995, Heard In The Court Of Appeals
July 2, 1996, Filed

PRIOR HISTORY: [***1] From the North Carolina Utilities Commission Docket No. W-354, Sub 133 Docket No. W-354, Sub 134. Appeal by intervenor-appellant from orders entered 7 September 1994 and 14 November 1994 by the North Carolina Utilities Commission.

DISPOSITION: Affirmed.

CORE TERMS: splitting, water, shareholder, customer, ratepayers, public interest, municipal, split, sewer, arbitrary and capricious, whole record, substantial evidence, purchase price, beneficial, harmful, reasonable mind, undercapitalized, privately, assigning, smaller, assign, careful consideration, relevant evidence, material evidence, evidence showed, water system, public funds, public good, sales price, new policy

COUNSEL: Hunton & Williams, by Edward S. Finley, Jr. and James L. Hunt, Raleigh, NC, for applicant-appellee Carolina Water Service, Inc. of North Carolina.

Public Staff, Robert P. Gruber, Executive Director, by Antoinette R. Wike, Chief Counsel, and Paul L. Lassiter, Staff Attorney, Raleigh, NC, for intervenor-appellant Public Staff - North Carolina Utilities Commission.

JUDGES: McGEE, Judge, Judges MARTIN, John C., and JOHN concur.

OPINION BY: McGEE

OPINION:

[*45] [*195] McGEE, Judge.

The only statutory grounds argued by Public Staff in its brief for reversing the decision to assign 100 percent of the gain from the sales of the two systems to CWS' shareholder are that the order was arbitrary and capricious and not supported by competent, material and substantial evidence. Further, Public Staff argues the Commission's announcement that in the future it would assign 100 percent of the gain or loss on the sale of utilities to the utility shareholders violated due process. However, as set forth below, this last issue is not properly before us.

After reviewing the record, we affirm the order of the [***5] Commission.

On appeal, a rate decision, rule, regulation, finding, determination, or order made by the Commission is deemed prima facie just and reasonable. N.C. Gen. Stat. § 62-94(e). "Judicial reversal of an order of the Utilities Commission is a serious matter for the reviewing court which can be properly addressed only by strict application of the [statutory] criteria which circumscribe [*196] judicial review." Utilities Comm. v. Oil Co., 302 N.C. 14, 20, 273 S.E.2d 232, 235 (1981). Appellate review of an order of the Commission is governed by subsections (b) and (c) of N.C. Gen. Stat. § 62-

94. State ex rel. Utilities Comm. v. Southern Bell, 88 N.C. App. 153, 165, 363 S.E.2d 73, 80 (1987). "Where the Commission's actions do not violate the Constitution or exceed statutory authority, appellate review is limited [*46] to errors of law, arbitrary action, or decisions unsupported by competent, material and substantial evidence." Utilities Comm. v. Springdale Estates Assoc., 46 N.C. App. 488, 494, 265 S.E.2d 647, 651 (1980). In determining whether to uphold the Commission's actions, the appellate court shall review the whole record. N.C. Gen. Stat. § 62-94(c). When applying the [***6] whole record test, the court may not replace the Commission's judgment with its own when there are two reasonably conflicting views of the evidence. See White v. N.C. Dept. of E.H.N.R., 117 N.C. App. 545, 547, 451 S.E.2d 376, 378, disc. review denied, 340 N.C. 263, 456 S.E.2d 839 (1995).

Public Staff argues the Commission incorrectly determined that it was in the best interest of the consuming public to implement a policy whereby 100 percent of the gains and losses on sale will be distributed to utility shareholders. Public Staff contends the better policy would be to allow ratepayers who share the risk of loss to also share in capital gains upon the sale of utilities. However, it is not and should not be this Court's role to determine the merits of policy positions adopted or rejected by the Commission. "[The reviewing court's] statutory function is not to determine whether there is evidence to support a position the Commission did not adopt. We ask, instead, whether there is substantial evidence, in view of the entire record, to support the position the Commission did adopt." State ex rel. Utilities Comm. v. Eddleman, 320 N.C. 344, 355, 358 S.E.2d 339, 347 (1987). [***7] The General Assembly has given the Commission, not the courts, the authority to regulate the operations of public utilities. N.C. Gen. Stat. § 62-2. Therefore, if the findings and conclusions of the Commission are supported by competent, substantial and material evidence, this Court must affirm the decision even if we might have reached a different determination upon the evidence. Utilities Comm. v. Telephone Co., 281 N.C. 318, 336-37, 189 S.E.2d 705, 717 (1972).

Public Staff contends the Commission's order is not supported by competent, substantial, and material evidence and is arbitrary and capricious. We disagree. When addressing a question of the sufficiency of the evidence, this Court has described the proper standard of review from a decision of the Commission as follows:

The Commission's order [is] to be affirmed if, upon consideration of the whole record as submitted, the facts found by the Commission are supported by competent, material and substantial evidence, taking into account any contradictory evidence or [*47] evidence from which conflicting inferences could be drawn. "Substantial evidence" is such relevant evidence as a reasonable mind might accept as adequate [***8] to support a conclusion.

Springdale Estates, 46 N.C. App. at 490-91, 265 S.E.2d at 649 (citations omitted). Upon review of the whole record, we find it contains relevant evidence which "a reasonable mind might accept as adequate" to support the Commission's decision.

To support its decision, the Commission made, among others, the following findings and conclusions:

Events occurring since the Commission initially established its gain splitting policy in 1990 indicate that such policy, contrary to the public interest, serves as a disincentive to sell and may thereby discourage and impede beneficial sales to municipal and other government-owned entities. . . .

CWS provided evidence that shows that action has been taken in response to the Commission's decision in past dockets to split the gain that is harmful to the public interest and that such developments exemplify why the Commission's gain splitting policy can be detrimental and should be revised. CWS states further that through written statements in the past Orders, upon which the Public Staff relies, certain members of the Commission have questioned [**197] the wisdom and appropriateness of the past [***9] decisions to equally split gains. Through these written statements, those Commissioners have suggested that the issue should be revisited and that the ramifications to the public good of the decision to split the gains should be taken into account. Based on those statements, CWS argues that the Public Staff's reliance on the past holdings equally splitting gains is inappropriate and not in the public interest.

With the benefit of hindsight, the Commission can now see that the policy to split gains or losses on sales of water and/or sewer systems has had a negative impact on the public good. For example, the proposed sale of the Beatties Ford system from CWS to CMUD in 1990 was renegotiated after this Commission ruled to split the gain. That resulted in the Charlotte-Mecklenburg taxpayers and ratepayers spending more on the acquisition of the Beatties Ford system

than they would have spent if this Commission's ruling had been to flow the gain to stockholders only. Furthermore, the Farmwood "B" contract between CWS and [*48] CMUD contains a provision wherein the price to CMUD escalates in proportion to the portion of any gain that is flowed to CWS's remaining customers. In addition, [***10] all involved parties know that CWS chose not to sell its Riverbend utility system as a result of the Commission's ruling in Docket No. W-354, Sub. 88.

These facts, consequences of the Commission's decisions in the prior CWS and [Heater Utilities, Inc. ("Heater")] dockets, suggest that the Commission's gain splitting policy is contrary to the public interest. A policy of gain splitting for sales of water and/or sewer systems may undermine the achievement of economies of scale and encourage inefficient operations. That result is clearly not in the public interest. Moreover, with respect to Beatties Ford, the sales price for Beatties Ford, paid from public funds, was artificially increased. The sales price for [the Genoa subdivision water system] was reduced to the detriment of CWS. The beneficial sale of [the Riverbend subdivision water system] to [the City of] New Bern fell through. None of those harmful consequences would have taken place but for the Commission's decision to split the gain. On balance, the marginal benefit to remaining ratepayers of the gain splitting policy is outweighed by the harmful consequences of such policy. . . . The Commission should not[***11] impose economic barriers to the orderly transfer of water systems to municipal entities, as was inadvertently done in the Riverbend situation.

If economic incentives are removed so that this succession of ownership becomes inadvisable, customers are denied those benefits. If companies like CWS are prevented from retaining the gain on sale in North Carolina, a substantial incentive is removed for those companies to buy systems from developers or small, undercapitalized operators in the first instance. Likewise, a substantial incentive is removed to negotiate to sell systems to municipal or governmental entities. At a minimum, the sale price is artificially increased above the fair market based price to adjust for the payment of part of the gain to customers. The result is harm to consumers because the natural progression of transfer of ownership to the most efficient provider is disrupted. These harmful consequences are clearly not in the public interest. . . .

The detrimental effect of the Commission's gain splitting policy as it pertains to the sale of water and/or sewer systems is reflected in the transactions at issue in this case. The purchase [*49] price for[***12] the Farmwood "B" system increases by \$58,000 if the Commission requires CWS to split 50% of the gain with the remaining [ratepayers.] This is an added taxpayer expense that is inconsistent with the public interest. It appears that this provision would not have been included in the CWS-CMUD contract except in response to the Commission's gain splitting policy.

These findings and conclusions support the Commission's decision that CWS should retain 100 percent of the gain on sale of the water systems, and we determine that the [**198] record contains substantial, material, competent evidence to support the findings.

The order states these findings were based on evidence "found in the applications and the testimony of [CWS] witness Daniel and Public Staff witnesses Rudder and Fernald." Carl Daniel, vice president of CWS, testified that a policy of splitting the gain on sale acted as a disincentive for privately held utilities to sell facilities to municipalities. Daniel testified this adversely impacted consumers because additional public funds would have to be expended. If CWS did not sell its facilities, CMUD, whose charter requires it to provide service to Farmwood B and Chesney[***13] Glen, would be forced to incur the additional expense of completely duplicating the existing facilities. Customers would have to pay tap-on fees of several thousand dollars to fund these duplication costs. Daniel also testified customers benefit by transferring to a municipal utility because of better fire protection, lower homeowners insurance premiums, better system reliability, lower usage rates, and improved water taste. He further testified that a policy of allowing the shareholder to keep 100 percent of the gain on sale would encourage CWS to continue to purchase smaller utility companies that may be having problems in serving their customers. Daniel also testified, and the record contains a copy of the contract, that CMUD's purchase price for the Farmwood B system would be \$58,000 higher if the Commission allowed CWS to retain only 50 percent of the gain on sale as opposed to 100 percent.

Katherine Fernald, water supervisor in the accounting division of Public Staff, testified on cross-examination that CWS negotiated a higher price with CMUD for its Beatties Ford facilities and that a deal to sell the Riverbend system to the City of New Bern fell through after the Commission[***14] announced its policy of splitting gains between the shareholder and ratepayers. Fernald testified the ratepayers within the Riverbend system wanted the system sold and preferred to have service provided by a municipality. She also testified that by selling [*50] facilities, CWS reduces its customer base and loses economies of scale.

We conclude that a reasonable mind would regard the testimony of Daniel and Fernald, along with the other materials contained in the record, to adequately support a conclusion that the best interests of the public would be served by allowing CWS to keep 100 percent of the gain on sale of the Farmwood B and Chesney Glen systems. The evidence showed a policy of equally splitting gains on sale would result in a higher purchase price for the Farmwood B system, causing a greater burden for Charlotte-Mecklenburg taxpayers. Also, the contract stated that if CWS was required to share more than 50 percent of the gain with the ratepayers, then the sale could be called off. The evidence also showed the beneficial transfers of privately held utilities to municipal systems had been hampered by a policy of splitting gain on sale. In this case, if CWS had refused to sell the[***15] facilities, CMUD would have been forced to duplicate the existing facilities at a high cost. Further, a policy of assigning 100 percent of the gain to the shareholder encourages CWS to make further investments in other smaller water systems, some of which may be undercapitalized or poorly run.

We also disagree with Public Staff's contention that the Commission's order was arbitrary and capricious.

The arbitrary and capricious standard is a difficult one to meet. Agency actions have been found to be arbitrary and capricious when such actions . . . "indicate a lack of fair and careful consideration; [and] when they fail to indicate 'any course of reasoning and the exercise of judgment.'"

White, 117 N.C. App. at 547, 451 S.E.2d at 378 (citations omitted). Here, a review of the order and record shows the Commission gave fair and careful consideration to the issues before it, and that the Commission's final decision was the product of reasoning and the exercise of its judgment.

We agree with Public Staff that several of the Commission's findings and conclusions appear to be improperly based upon the Commission's knowledge of events and evidence outside of this record. [***16] See *Utilities Commission v. Coach Co.*, 261 N.C. 384, 391, 134 S.E.2d 689, 695 [**199] (1964)("The Commission's knowledge, however expert, cannot be considered by us on appeal unless the facts embraced within that knowledge are in the record."). Also, the Public [*51] Staff's argument that the record needed additional evidence on certain issues is well taken. For example, although one could conclude that the higher renegotiated price for the Beatties Ford System and the failure to complete the Riverbend sale directly resulted from the Commission's gains splitting policy, the record contains no direct testimony or evidence that the policy was the sole cause of these changes nor any evidence concerning whether other circumstances may also have been involved. However, we find the evidence that is contained in the record to be sufficient to support the Commission's order that CWS retain all of the gain on sale of the Farmwood B and Chesney Glen systems.

Lastly, Public Staff assigns as error the Commission's statement that "In future proceedings, the Commission will follow a policy, absent overwhelming and compelling evidence to the contrary, of assigning 100% of the gain or loss on the sale of water[***17] and/or sewer utility systems to utility company shareholders." However, this issue is not properly before this Court and we need not decide it.

Public Staff argues the Commission violated due process by announcing this policy without holding a hearing before all interested parties. However, Public Staff cited no authority for this proposition and this argument is deemed abandoned. N.C.R. App. P. 28(b)(5). Further, an appellate court will not consider constitutional questions, such as a violation of due process, when they are "not necessary to the decision of the precise controversy presented in the litigation before it." *Nicholson v. Education Assistance Authority*, 275 N.C. 439, 447, 168 S.E.2d 401, 406 (1969). By its language, the policy pronouncement complained of by Public Staff applies to future cases before the Commission. It is prospective in nature and had no bearing upon this case. As such, the issue is not ripe for determination.

Therefore, we decline to decide whether the Commission's new policy concerning the future assignment of gain or loss upon the sales of water and/or sewer utilities complies with due process.

For the reasons stated, the order of the Commission[***18] is affirmed.

Affirmed.

Judges MARTIN, John C., and JOHN concur.