BEFORE THE ARIZONA CORPORATION COMMISSION

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

IN THE MATTER OF THE JOINT APPLICATION BETWEEN CITIZENS UTILITIES COMPANY AND CAP ROCK ENERGY CORPORATION FOR THE APPROVAL OF THE SALE OF CERTAIN ELECTRIC UTILITY PROPERTIES IN ARIZONA AND THE TRANSFER OF THE CERTIFICATE OF CONVENIENCE AND NECESSITY FROM CITIZENS TO CAP ROCK.

Docket No. E-01032A-00-0163
Docket No. E-01032B-00-0163
Docket No. E-01032C-00-0163
Docket No. E-03851A-00-0163

NOTICE OF FILING

The Residential Utility Consumer Office ("RUCO") hereby provides notice of filing the redacted Direct Testimony of Gordon Fox, in the above-referenced matter. An unredacted copy is being provided to the Hearing Officer under seal.

RESPECTFULLY SUBMITTED this 2nd day of August, 2000.

Daniel W. Pozefsky
Attorney, RUCO

AN ORIGINAL AND TEN COPIES
of the foregoing filed this 2nd day
of August, 2000 with:

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CAP ROCK ENERGY CORPORATION

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DIRECT TESTIMONY

OF

GORDON FOX

(redacted)

ON BEHALF OF

THE

RESIDENTIAL UTILITY CONSUMER OFFICE

AUGUST 2, 2000

TABLE OF CONTENTS

INTRODUCTION

Q. Please state your name and business address.

A. My name is Gordon L. Fox. My business address is 2828 North Central Avenue, Suite 1200, Phoenix, AZ 85004.

Q. By whom are you employed and in what capacity?

A. The Residential Utility Consumer Office (RUCO) employs me in the position of Utilities Chief Rate Analyst.

Q. Briefly summarize your educational and professional credentials related to your work in the field of utility regulation.

A. I have Master and Bachelor of Science Degrees in Accounting. I have earned the following professional accounting and finance certifications: Certified Public Accountant (CPA); Certified Management Accountant (CMA); and Certified in Financial Management (CFM). My utility experience includes three years in my current position, seven years in various auditing and rate analyst positions with the Arizona Corporation Commission and four years with a cable TV utility with responsibility for preparing and presenting rate applications before jurisdictional authorities.

Q. Please state the purpose of your testimony.

A. The purpose of my testimony is to present findings and recommendations resulting from my review and analysis of the joint application of Citizens

Utilities Company, Inc. (Citizens) and Cap Rock Energy Corporation (Cap Rock) for the sale of essentially all of Citizens' Arizona Electric Division (AED) assets and the transfer of the certification of convenience and necessity (CC&N) to Cap Rock.

CITIZENS

Q. Please provide a brief description of Citizens and the AED.

A. In 1998 Citizens Utilities Company (Citizens) served 1,820,444 customers in 22 states with gas, electric, water, wastewater, and telecommunications services. Citizens provides all of these services in Arizona. In 1998 Citizens had total assets of $5.293 billion, generated revenues of $1.542 billion and earned a net income of $57.1 million. In October 1999, Citizens announced the sale of its water and wastewater utilities for $835 million and of its electric utilities for $535 million. Citizens is also in the process of divesting of its gas distribution utilities. The proceeds of these divestitures are being used to acquire telecommunications assets. Citizens Communications was adopted as the corporation's new name on May 18, 2000, to reflect the new focus of business operations. Citizens' common stock is traded on the New York Stock Exchange under the symbol CZN.

According to the Annual Report to the Arizona Corporation Commission, the AED provided electrical distribution service to 67,153 customers at the end of 1999 (approximately 80 percent in Mohave County and 20 percent in Santa Cruz County) and had total assets of $343.3 million. In 1999 the AED generated operating revenues of $98.8 million and earned a net income of $7.1 million.

CAP ROCK

Q. Please provide a brief description of Cap Rock Energy Corporation (Cap Rock).

A. Cap Rock is currently a wholly owned subsidiary of Cap Rock Electric Cooperative (Co-op). Co-op is organized as a not-for-profit cooperative association headquartered in Midland, Texas. The management of Co-op has received authorization from the owner-members to proceed with a plan to transfer Co-op's assets to Cap Rock. Stock in Cap Rock will be issued to Co-op members who elect to take stock based on each member's outstanding equity credit balance in Co-op. Cap Rock is incorporated in Delaware and has Subchapter C corporate status under the Internal Revenue Code.

Co-op operates the Hunt-Collin, Lone Wolf, Stanton, and McCulloch Divisions, all in Texas. The Lone Wolf, Hunt-Colin, and McCulloch Divisions resulted from mergers with other cooperatives that currently have 3,200; 2,700; and 5,600 customers, respectively. A pending merger with Lamar County Electric Cooperative, Inc., when complete, will increase the total customer base for Co-op to 44,000. Cap Rock has also entered into an agreement with Citizens to purchase the properties of Citizens' Vermont Electric Division with approximately 21,000 customers. In addition, Cap Rock has a number of non-regulated affiliates engaged in real estate, gas and oil mineral rights, financing, management services, and other activities. Cap Rock will operate its regulated utility operations as divisions, not as separate subsidiary entities. Ownership in Cap Rock is not publicly traded at this time.

In 1999 Co-op had total assets of $163.0 million, generated revenues of $55.3 million and incurred a net loss of $1.1 million.

SALE AND TRANSFER TRANSACTION - PROPOSED

Q. Please describe the proposed sale and transfer transaction between Citizens and Cap Rock.

A. On February 11, 2000, Citizens and Cap Rock entered into a Purchase and Sale Agreement (Agreement). The agreement sets forth the terms and conditions for the transfer of Citizens' AED assets, rights, and obligations, with specified exceptions, and for the transfer of Citizens' Certificate of Convenience and Necessity (CC&N) to Cap Rock.

Q. Please explain Citizens motivation for this transaction.

A. According to Citizens' 1999 annual report, the Company has made a strategic change in operations to divest of its public utility operations (water, wastewater, gas, and electric) and to invest the proceeds in telephone access lines. Citizens' management noted two reasons for this strategic change in focus. First, ". . . approximately 2 million telephone access lines in the rural and suburban areas that are Citizens' market focus came available for acquisition." Second, "Doubt-digit multiples of cash flow in contrast to the single-digit multiples of cash flow utility companies traded at in public markets." In other words, Citizens' management opined that at this time investments in the telecommunications industry provide better opportunities than investments in public utilities to enhance stockholder value, and that suitable telecommunications properties were available for purchase.

Q. Please explain Cap Rock's motivation for this transaction.

A. Cap Rock management issued "Performance Review '99 (Review)," an overview of the Company's operations, mergers/acquisitions, alliances, government relations, planning, organizing, marketing, financial, achievements, mission/goals, and other activities. The message set forth in the Review and the 2000 Annual Report projects the aggressive and progressive attitude of management. Cap Rock's mission statement is:

> "Cap Rock Energy will be the recognized leader in providing local communities throughout North America with Energy and other related, value-enhanced services that simplify people's lives while creating value for its customers, employees and shareholders."

Cap Rock management is focused on growth, primarily via acquisitions and mergers. Page 5 of the Review states, "[T]he importance of growth was at the forefront of our plans." Page 26 of the Review states, "We need to be growing 100,000 meters at a time – not the 5,000 to 10,000 meters at a time that our current approach is gaining." Page 113 of the Review further states:

> "Our mission is to grow Cap Rock Electric Cooperative, Inc. from a Texas electric cooperative to a community owned stock company providing services to at least three hundred thousand customers across North America. This will be done by merging, acquiring, or combining with other electric cooperatives, municipal systems and rural and suburban portions of investor-owned utilities."

In short, Cap Rock believes its survival is dependent upon increasing efficiencies via economies of scale provided by growth. The joint application asserts that electric distribution in rural areas is the Company's core competency. Accordingly, acquisition of Citizens AED is a natural extension of Cap Rock's core business.

However, Cap Rock's focus on growth extends beyond electrical distribution. Page 50 of the review states:

> "In our merger & acquisition plan, there are two entities to be considered: (1) Cap Rock Energy (CRE) and (2) New West Resources. Mergers with Cap Rock Energy will be electric utility distribution systems only, with emphasis on electric cooperatives interested in a conversion to a stock company corporate structure.
>
> On the other hand, New West Resources requires our efforts be focused on minerals and /or mineral companies; real estate through Grandview Property Management that fits our plan of 18% rate of return and short payback with upside flip or get a multiple via a REIT, and other ownership interests where we can be a silent majority partner that has a market multiple with management and leadership that we trust and like."

New West Resources, Inc. is a wholly owned subsidiary of Co-op, that owns real estate, has investments in real estate trusts, and owns oil and gas mineral and royalty interests.

The marketing plan on page 12 of the Review states:

> "We expect to make mistakes in identifying new products or services, as this is a new endeavor for Cap Rock, and one in which our experience is lacking. But we do expect to gain at least 20 percent of our company revenue from new products/services by the year 2000."

The 1999 Annual Report states:

> "Where we expect to add value for our shareholders will be in the unregulated side of our business. We believe we will be able to realize a higher rate of return in our subsidiary companies than we will realize in the electric side, which will be our transmission and distribution assets. In that area, we will simply be receiving a fixed rate of return. That rate of return may be even lower than it has been in the past. But the unregulated subsidiary companies, offering new products

> and services, as well as revenue sources, is where we think we will gain value."

In summary, Cap Rock is motivated by management's belief that growth is necessary to enhance efficiency and that efficiency gains are necessary for Cap Rock's survival. Acquisition of the AED assets is a logical step for Cap Rock in that it expands Cap Rock's operations in the area of its core competency, rural electric power distribution.

Q. What is the purchase price for the AED assets?

A. The exact purchase price will not be determined until the transaction is completed because the Agreement provides for adjustments in changes to net plant, accounts receivable, accrued revenue, inventory, account payable, customer deposits, customer advances, capital expenditures, etc. Ignoring the affects of these adjustments, the purchase price is $210,000,000.

Q. Is the book value of the AED assets equal to the purchase price?

A. No. The revised financial statements provided by Cap Rock in response to RUCO data request 1.7 show the net plant in service at December 31, 1999 as *** **Confidential** **Confidential** ***. Thus, the excess of Cap Rock's cost over book value, i.e., the premium paid, is estimated at *** **Confidential** **Confidential** ***. This premium (acquisition adjustment) is further discussed later is this testimony.

Q. How does Cap Rock plan to finance the transaction?

A. Cap Rock anticipates financing the entire purchase price by issuing long-term debt in the amount of ***__Confidential__ __Confidential__ *** and preferred stock in the amount of *** **Confidential** **Confidential** ***. The anticipated long-term debt is *** **Confidential** . **Confidential** ***

Q. What other capital has Cap Rock arranged related to the acquisition?

A. Cap Rock has arranged for the following additional capital:

a. A letter of credit in the face amount of up to *** **Confidential** **Confidential** *** as earnest money. Any amount drawn on this letter of credit must be repaid in full within 12 months of the date of the draw.

b. Long-term debt not to exceed *** **Confidential** **Confidential** *** for capital additions made within three years of the acquisition. This is a *** **Confidential** **Confidential** *** loan.

c. A *** **Confidential** **Confidential** *** revolving line of credit.

Q. Has the prospective lender placed any conditions on closing of the acquisition, capital additions, and revolving line of credit particular to the Commission's approval of the transaction?

A. Yes. The document from the prospective lender regarding the commitment states:

*** **Confidential**

Confidential ***

ISSUES

Capital Structure and Financial Risk

Q. What capital structure is Cap Rock Proposing?

A. Cap Rock will experience an initial transition period during which loans are executed and preferred stock issued. The loans and preferred stock will provide a capital structure consisting of *** **Confidential** **Confidential** *** percent debt and *** **Confidential** **Confidential** *** percent preferred stock. This transition period will end when Co-op exchanges its assets for Cap Rock stock. After this conversion is complete, the capital of Co-op and Cap Rock will merge as one.

Q. What is Cap Rock's projected capital structure subsequent to the conversion?

A. Cap Rock's projected, consolidated financial statements show long-term debt of *** **Confidential** **Confidential** *** and equity of *** **Confidential** **Confidential** *** at December 31, 1999. The existing equity in Co-op will be distributed to Co-op's members as Cap Rock common stock based on each member's outstanding equity credit balance in Co-op. Combining this existing capital with the proposed new issuances of debt and preferred stock provides a projected capital structure with *** **Confidential**

Confidential ***

Q. Is this capital structure consistent with Cap Rock's target long-term capital structure?

A. No. In response to RUCO data request 3.10, Cap Rock asserted that its long-term capital structure " . . . is expected to be 70% debt, 10% preferred stock, and 20% common equity."

Q. How does Cap Rock plan to bridge the common equity deficiency between its initial and target capital structure?

A. In response to RUCO data request 1.19(n), Cap Rock provided the following response.

*** **Confidential**

Confidential ***

Q. How much equity capital will Cap Rock need to issue to achieve its target capital structure?

A. Using a 1999 projected total capital structure of *** **Confidential** **Confidential** *** (i.e., assuming no growth in assets after 1999), Cap Rock would need *** **Confidential** **Confidential** *** of common equity to achieve its target of *** **Confidential** **Confidential** *** percent of total capital. Assuming there is no change in common equity between 1999 and 2002, Cap Rock would need to issue additional common stock in the amount of *** **Confidential** . **Confidential** ***

Q. What level of earnings would be required to support an *** **Confidential** **Confidential** *** issuance of common stock and total common stock equity of *** **Confidential** **Confidential** ***?

A. Assuming that the cost of equity capital is 10.7 percent as authorized by Decision No. 59951, AED's prior rate case, the earnings available to common stockholders would need to be *** **Confidential** . **Confidential** ***

Q. Will all of Cap Rock's earnings be available to common stockholders?

A. No. Preferred stockholders will have claim to some of Cap Rock's earnings. Using Cap Rock's projected cost rate of *** **Confidential** **Confidential** *** percent on *** **Confidential** **Confidential** *** of preferred stock, preferred stockholders will have claim to *** **Confidential** **Confidential** *** of after tax earnings.

Q. What level of earnings is necessary to support *** **Confidential** **Confidential** *** of preferred stock and *** **Confidential** **Confidential** *** of common stock?

A. An after-tax earnings of *** **Confidential** **Confidential** *** is required.

Q. Do Cap Rock's earnings projections show sufficient earnings to support a *** **Confidential** **Confidential** *** common stock issuance?

A. Cap Rock's earnings projections for AED and Texas operations are $2.9 million and $1.7 million, respectively, for a total of $4.6 million. Thus, the projected income is *** **Confidential** **Confidential** *** less than required to support a stock issuance of *** **Confidential** . **Confidential** ***

Q. Cap Rock has projected earnings through 2005. Do the projected earnings for any of these years approach *** **Confidential** ? **Confidential** ***

A. No. Cap Rock's projected earnings for the years 2003, 2004, and 2005 are *** **Confidential** , **Confidential** *** respectively.

Q. Did you ask Cap Rock the basis for its assertion that Cap Rock would be in a good position to make a common stock offering 18 to 24 months following the transaction?

A. Yes. In response to RUCO data request 5.6, Cap Rock stated,

> "Based on the forecasts provided, Cap Rock should see pre-tax earnings of approximately *** **Confidential** **Confidential** *** in 2002, exclusive of the effects of Vermont and the pending merger. After backing out the preferred return in

> Arizona, this leaves *** **Confidential Confidential** *** in return on common equity. Assuming a 12% return on equity, this would support a common equity level of approximately *** **Confidential Confidential** ***."

Q. Is there a significant error in the calculation Cap Rock made to estimate that its 2002 earnings will support an equity issuance of *** **Confidential Confidential** ***?

A. Yes. Cap Rock's calculation erroneously assumed that preferred stock dividends are paid with pre-tax earnings.

Q. Have you recalculated the amount of common equity that would be supported treating preferred stock dividends correctly, i.e., as being paid from after-tax earnings?

A. Yes. Using Cap Rock's assumptions, the correct calculation shows that year 2002 projected earnings will support a total of *** **Confidential Confidential** *** of common equity. Since the outstanding common stock in 1999 is *** **Confidential Confidential** ***, Cap Rock's projected earnings will only support an additional common stock issuance of about *** **Confidential Confidential** ***.

Q. Did you ask Cap Rock to identify the errors, if any, in your corrected calculation?

A. Yes. I made that inquiry in RUCO data request 7.2 and received the following response:

***** Confidential**

Confidential ***."

Q. Has any evidence been presented to suggest to you that these items will significantly increase the ability or the amount of common stock Cap Rock can issue?

A. No.

Q. Did you review Cap Rock's and AED's actual and Cap Rock's projected financial statements and make inquiries as to operating changes or new service opportunities that could significantly increase the attractiveness of a Cap Rock stock offering?

A. Yes. Nothing in my inquiry and review revealed any operating or financial information that attribute a significant intangible value that would enhance Cap Rock's attractiveness to investors. That is, there is no reason to believe Cap Rock will provide new services that sufficiently increase profit potential nor are there any extraordinary gains/losses to be considered that would support a stock offering approaching $66.8 million.

Q. Are there any reasons why Cap Rock needs to immediately achieve its long-term target of having 20 percent common equity in its capital structure?

A. Yes. First, the *** **Confidential** **Confidential** *** is the only potential lender that has committed to providing debt funding. *** **Confidential** **Confidential** *** commitment includes the following covenants:

*** **Confidential** "

" **Confidential** ***

Under these covenants, Cap Rock's ability to issue stock or obtain additional debt funding at reasonable rates will be critically hindered if equity falls below *** **Confidential** **Confidential** *** percent of total assets.

Q. How does *** **Confidential** **Confidential** *** consider preferred stock in its determination of minimum equity requirements?

A. In response to RUCO data request 10.4, a representative on behalf of *** **Confidential** **Confidential** *** provided the following response:

> *** **Confidential** " "
>
> **Confidential** ***

Q. If the preferred stock Cap Rock is proposing to issue is considered as *** **Confidential** , **Confidential** *** what percentage of Cap Rock's projected capital structure will be equity after the conversion of Co-op's assets to Cap Rock?

A. Using this treatment, equity will be approximately *** **Confidential** **Confidential** *** percent of total asset after the conversion.

Q. Assuming that Cap Rock can attain an initial equity balance equal to *** **Confidential** **Confidential** *** percent of total assets, how will potential investors perceive this achievement?

A. Potential investors will recognize the onerous restrictions on dividend distributions for falling below that percentage of equity. This substantial risk will deter investors and significantly increase the cost of equity capital needed to attract investors until the percentage of equity is comfortably above *** **Confidential Confidential** *** percent. Also, the relatively small margin of equity will be perceived as additional risk by potential lenders causing the cost of debt to increase.

Q. How does Cap Rock's target capital structure compare with Citizens' historical capital structure?

A. According to Citizens' 1999 annual report, Citizens has been maintaining common equity as a percentage of total capital between 45 percent and 49 percent in the past three years. Preferred stock was approximately five percent of total capital for each year. Long-term debt was between 45 percent and 50 percent of total capital for each year.

Q. What level of debt to total capitalization is typical of electric utilities with outstanding investment grade bonds?

A. The average or typical electric utility with an "A" (medium-grade)," "AA" (high-grade), or "AAA" (highest grade) has a debt to total capitalization rate of about 50 percent.

Q. Why have these electric utilities limited their debt to total capital ratios to approximately 50 percent?

A. As noted above, these are investment grade bonds. The interest rate on a bond is inversely related to its investment rating. Utilities can obtain higher bond ratings and lower financial risk by limiting the amount of debt in their capital structure. Unlike common stock, bonds have fixed charges for interest and principal payments. Failure to make timely payment of these fixed charges can lead to insolvency and receivership. Fixed charge obligations also limit a utility's ability to attract additional capital for replacements, improvements, and expansion. Equity investors will also require a higher return for taking the additional financial risk presented by a highly leveraged utility.

Q. Has Cap Rock recognized that its proposed capital structure will result in high capital costs?

A. Yes. In response to RUCO data request 8.1, Cap Rock asserted that based on negotiations that had taken place, the cost of its preferred stock is expected to be 12 percent per annum. Twelve percent is higher than the rate the Commission has authorized for common stock for Citizens. Since preferred stockholders are in a preferential position regarding priority of a company's assets, preferred stock of a company is less costly than common equity.

Q. Is there a relationship between the interest rate of debt and the amount of debt that can be carried?

A. Yes. As the cost of debt financing increases, the amount of debt that can be carried decreases. It should be obvious that a company can carry more debt at five (5) percent than at ten (10) percent. Debt service coverage and interest coverage ratios that lenders use as minimum coverage requirements reflect the inverse relationship between the cost of debt and the amount of debt that can be carried (i.e., interest expense is a component of the denominator of these ratios).

Q. What implication does this inverse relationship between cost of debt and the amount of debt that can be carried have on a company's capital structure?

A. A company with a high cost of debt should carry less debt and more equity than a company with a lower cost of debt.

Q. How does Cap Rock's projected cost of debt compare to Citizens'?

A. In response to RUCO data request 3.11, Cap Rock asserted that the most probable annual interest rate on its acquisition and capital improvement debt issuances is *** **Confidential Confidential** *** percent. Citizens' 1999 annual report shows the following debt:

1. Debentures $1.0 billion @ 7.34%

2.	IDRB	$353 million @	5.39%
3.	Senior unsecured notes	$361 million @	6.25%
4.	ELI bank credit facility	$260 million @	6.63%
5.	RUS Loan Contracts	$87 million @	5.85%
6.	Other Debt	$45 million @	8.86%

Thus, Cap Rock's projected cost of debt is significantly higher than Citizens'. This result is expected and at least partially due to Citizens' balanced capital structure versus the debt laden capital structure proposed by Cap Rock.

Q. Do the projected earnings Cap Rock used to calculate its ability to issue common stock include any identifiable major assumptions that should be noted to place the projections in proper perspective?

A. Yes. First, Cap Rock's earnings are based on the unknown assumption that the Commission will authorize an *** **Confidential** **Confidential** *** percent rate increase that will in be in effect for the entire year of 2002. Second, Cap Rock has assumed that its annual administrative and general costs will be $3.1 million less than Citizens'.

Q. Assuming that Cap Rock can operate with administrative and general expenses that are $3.1 million less than Citizens', will this necessarily result in $3.1 million in additional earnings for Cap Rock?

A. No. In AED's prior rate case, Decision No. 59951, the Commission disallowed $927,285 of administrative and general expenses. Cap Rock's $3.1 million cost savings was calculated using Citizens actual cost, not the amount allowed for recovery in rates. Thus, even if Cap Rock's $3.1 million cost savings estimate is correct, the benefit to Cap Rock may be considerable less.

Q. What are some other significant concerns about Cap Rock's projected earnings?

A. The actual interest rates on the proposed debt are unknown at this time. The projected earnings reflect interest rates that are significantly lower than the rates Cap Rock was projecting as the most probable in response to RUCO data request 3.8. Due to the magnitude of the proposed debt, even small changes in the interest rate will have a significant affect on Cap Rock's earnings. Also, in response to RUCO data request 7.3, Cap Rock stated that it did not know how much of the projected revenue represents recovery of purchased power costs. Without knowing the amount of purchased power included in revenue, Cap Rock could not have properly adjusted for the difference between the actual cost of gas and the amount included in revenue. This omission will cause an error in the calculated pre-tax income by the amount of this difference.

Q. What other concerns do you have regarding Cap Rock's projections for administrative and general expenses, purchased power cost, and interest expense?

A. Since interest rates are constantly changing, Cap Rock's failure to continually update its financial projections for interest rate changes is reasonable and expected. However, failure to recognize Commission disallowances of administrative and general expenses of nearly a million dollars and not adjusting revenue to reflect recovery of actual purchase power cost implies that meaningful inquiry, scrutiny and preparation of the financial projections is absent. Accordingly, the reasonable accuracy and value of these projections is in question.

Q. Do the concerns you have raised regarding Cap Rock's projected earnings and ability to issue common stock also have ramifications that apply to preferred stock?

A. Yes. Cap Rock has not yet issued the preferred stock and there is no certainty that investors for the preferred stock can be found. Potential preferred stock investors will recognize the additional financial risk presented by Cap Rock's plan for a capital structure that is heavily debt laden, and errors in earnings projections will affect the cash available to pay preferred stock dividends.

Q. How important to Cap Rock's acquisition plans is its ability to issue preferred stock?

A. As discussed previously, preferred stock is one of the two sources of funds Cap Rock is anticipating to use to finance the purchase price with debt being the other source. Since the anticipated debt issuance will not provide sufficient funds for the purchase, the preferred stock issuance is a critical component of Cap Rock's acquisition plan.

Q. Will Cap Rock's capital needs be fully satisfied by the 1999 level of capitalization?

A. No. Cap Rock is projecting capital improvements for the years 2000, 2001, and 2002 of $23.6 million, $29.4 million, and $15.1 million, respectively, for a total of $68.1 million. Additional capital will be needed to finance these capital improvements.

Q. Has Cap Rock arranged for this additional capital?

A. Partially. As noted previously, Cap Rock has obtained a commitment for a *** **Confidential** **Confidential** *** -year loan not to exceed ***

Confidential **Confidential** *** for capital additions made within three years of the acquisition.

Q. How does Cap Rock plan to finance the remaining *** **Confidential** **Confidential** *** needed for capital improvements?

A. In response to RUCO data request 3.8(e), Cap Rock stated, *** **Confidential** " " **Confidential** ***

Q. What type of capital would be available from *** **Confidential** **Confidential** ***?

A. Cap Rock would be obtaining additional debt.

Q. Does Cap Rock have a commitment from *** **Confidential** **Confidential** *** to provide additional funding?

A. No. In response to RUCO data request 4.2, Cap Rock stated,

> "It is our understanding that our relationship with *** **Confidential** **Confidential** *** in the future (for both Texas and Arizona) will be much the same as it has been with *** **Confidential** **Confidential** *** in the past. Under that relationship, which is governed by a 100% mortgage arrangement, *** **Confidential** **Confidential** *** has a process under which Cap Rock would apply for a loan to cover the next two years' anticipated capital funding. The process starts far enough in advance (and it is initiated by Cap Rock) that the funding can be approved, subject to any terms and conditions, and in place

> available to draw against by the start of the first calendar year in the two-year period. Although we have nothing in writing from *** **Confidential** **Confidential** *** to document the assertion above, we are currently a borrower in good standing and eligible to apply for additional credit from *** **Confidential** . **Confidential** ***

Q. Assuming that Cap Rock could obtain *** **Confidential** **Confidential** *** of additional debt funding for capital additions, how would this affect Cap Rock's capital structure?

A. Cap Rock's capital structure would shift away from Cap Rock's target capital structure by becoming more debt laden. Cap Rock would need to obtain additional equity in order to maintain its existing capital structure.

Q. Will Cap Rock's creditors and investors expect earnings to increase to support the additional debt and equity capital used to finance capital improvements?

A. Yes. All equity investors will expect their required cost of capital and creditors will require debt service coverage requirements to be maintained.

Q. Do Cap Rock's earnings projections show sufficient earnings to support the additional debt and equity needed for the projected plant improvements and to achieve Cap Rock's target capital structure?

A. As discussed previously, Cap Rock's projected earnings fail to support the issuance of any meaningful level of equity even at the year 1999 level of capital. Thus, Cap Rock's projected earnings will not support additional equity capital and achieve the target capital structure.

Q. Does Cap Rock have an accurate estimate of the cost of AED's capital improvement needs?

A. No. In response to RUCO data request 3.11, Cap Rock asserted that it was not in a position to provide an accurate estimate of capital expenditure requirements. Cap Rock based its projections on figures provided by Citizens. Thus, Cap Rock may have a different assessment after obtaining direct operational experience with AED.

Q. What has Cap Rock offered to support its target long-term capital structure?

A. In response to RUCO data request 3.10, Cap Rock offered the following rationale for not targeting a capital structure similar to most investor owned utilities.

> "There are two reasons for Cap Rock's assertions. The first is that as a "wires company" Cap Rock will not have the capital risk associated with base load generation plants or major bulk transmission lines. The other reason is that the "wires" business will remain regulated. Both of these reasons reduce risk to the company and should allow for the use of higher leverage."

Q. Has Cap Rock conducted an analysis to determine an appropriate capital structure?

A. No. In response to RUCO data request 4.3 which asked Cap Rock for the information used to conclude that its target long-term capital structure is appropriate for a "wires company," the following response was provided.

> "The conclusions reached by Cap Rock are based on our conversations with CFC personnel, other bankers and financial advisors. We have not done a detailed study to determine if our target capital structure will indeed attract the needed capital. However, our conversations with bankers suggests that they appreciate the reduced risk for a wires only company and are willing to finance, as debt, a larger percentage [of] Cap Rock's requirements."

Q. Please address Cap Rock's claims that as a wires and regulated business a larger amount of debt in its capital structure is appropriate.

A. Historically, most investor owned electric utilities have been regulated in not only the wires portion of their business but also in their generation and transmission operations. Thus, Cap Rock's status as a regulated "wires" utility is not a valid reason for a more highly leveraged capital structure when compared to the traditional capital structures of investor owned utilities. Although it is a fair assessment that the capital structure of a wires only utility will generally be able to support some degree of debt over that of an integrated electric utility, there is no basis to assume that the amount of that additional debt is of the magnitude proposed by Cap Rock.

Q. How do plans for growth generally affect capital structure?

A. Growth requires capital, involves start-up costs, and increases risk. Accordingly, a company with significant growth plan should maintain a higher level of equity capital than a comparable company in a maintenance or low growth situation.

Q. What are Cap Rock's plans for growth?

A. As discussed previously, Cap Rock has aggressive growth plans in utility and non-utility operations. Cap Rock's mission is to grow its utility operations via large acquisitions and mergers. However, Cap Rock expects to add value for shareholder via unregulated operations where the Company expects to gain 20 percent of revenue in the year 2000. Cap Rock recognizes that since it seeks to provide new products and services, it will make mistakes. Cap Rock and its affiliates have operations in real estate, gas and oil mineral rights, finance, management services and other activities.

Q. What affect do these unregulated operations have on an investor's perception of Cap Rock's risk?

A. Cap Rock's unregulated activities will almost certainly increase an investor's risk assessment. This risk is reflected in Cap Rock's 1999 operating results where the aggregate unregulated operations incurred a net loss in excess of $4 million.

Q. How does the additional risk of Cap Rock's unregulated operations affect the determination of an appropriate capital structure?

A. The amount of debt that can safely be carried in the capital structure is inversely related to risk. Therefore, the additional risk resulting from the unregulated operations reduces the amount of debt that is appropriate for Cap Rock's capital structure.

Q. What impact does Cap Rock's inauguration as an investor owned utility have on investors' perceived risk?

A. Investors will recognize an increase in risk due to the inexperience of Cap Rock's management controlling a stock corporation. In addition, since Cap Rock has never issued stock, there is a question as to whether Cap Rock's stock will be accepted by investors. Again, this is additional risk that will reduce the amount of debt that is appropriate in the capital structure.

Q. Please explain Cap Rock's common stock distribution plan.

A. Cap Rock's plan is to focus the distribution on the local and community investors in the communities served. Management's representations in "Performance Review '99" include, "[I]t is the hope of Cap Rock's Board and Management that there will be enough local interest to make a market for our stock regionally, if not locally, without having to be traded initially on a major stock exchange. But our plans are to become a community-owned stock company (p. 4)" and "[T]he longer we can keep our stock off Wall Street, the longer we can keep local control and ownership. Further, locals are less likely to exert the same level of pressure in the short run as to yields, P/E ratios, dividends, etc (p.44)." According to Cap Rock, this stock distribution method will allow avoidance of investment banker fees. Cap Rock believes that since the initial investors will be former members of Co-op, their expectations for profits and dividends will be lower, at least initially, than other investors. Cap Rock expects Co-op member investors to prefer Cap Rock stock to patronage capital in Co-op because the stock is more liquid than patronage capital.

Q. Please provide an assessment of Cap Rock's proposed common stock distribution plan.

A. Cap Rock's plan has the positive attribute that at least some investment banker fees may successfully be avoided. However, Cap Rock cannot operate outside of the fundamentals of the market economy. Cap Rock must compete on a market basis for equity capital. The reason investors prefer the liquidity of stock over patronage capital is to allocate their investments in a manner that is most appropriate for their circumstances. There is no reason to believe that investors in the communities served by Cap Rock will expect anything less than a market return on their capital. If an investment in Cap Rock does not provide the best choice for these investors, they will invest their capital elsewhere. Local and regional demand for Cap Rock stock may not be sufficient to provide the Company's equity capital needs. In fact, there may not be sufficient demand of Cap Rock stock even without the Company's restricted distribution plan. One of the benefits of securing the services of an investment banker that underwrites a stock issuance is that the stock sale is guaranteed at a minimum price.

Cap Rock's stock distribution plan reflects a reluctance to break away from its cooperative method of organization. There is a fundamental difference between cooperatives and investor owned utilities. In a cooperative the customers are also the investors and appropriately participate in the risk of ownership. However, in an investor owned utility, business and financial risks are the responsibility of the stockholders, not the customers. Stockholders' equity capital provides customers with a degree of security from the risks and consequences of operating losses and defaults on debt obligations and covenants. For example, if rates are increased to support capital improvements or to achieve minimum debt service requirements because a fair return on Cap Rock's meager equity capital is insufficient, stockholders will have passed the risk and consequences of ownership to customers. Therefore, a utility must maintain an adequate amount of capital to protect ratepayers from assuming the risks of stockholders. Cap Rock's conversion from a cooperative to an investor owned utility must be complete. The capitalization of a cooperative is incompatible with that of an investor owned utility. In addition, unlike a cooperative, it is essential for an investor owned utility to maintain an adequate level of equity capital to attract additional capital for plant replacement and expansion.

Further, Cap Rock's intention to maintain local control and ownership is inconsistent with the Company's plans for rapid growth in non-regulated businesses. As Cap Rock's non-regulated businesses grow, the former Co-op owner-customers will hold a smaller portion of the outstanding stock. This dilution of the holding by former Co-op owner-customers will quickly dispense the low cost of equity Cap Rock has assumed these local investors will accept.

Industrial Development Revenue Bonds (IDRB)

Q. Please define an IDRB.

A. Each year the U.S. Congress establishes a total amount of debt that can be issued by nonprofit Industrial Development Authorities (IDA) in each county in the United States. The amount of debt issuing authority attributed to each county is determined by its population. IDAs have authority established by the U.S. Congress in the Tax Reform Act of 1986 to issue bonds on behalf of third parties engaged in certain, usually construction, activities that are deemed to be in the public interest. The

IDAs enter into agreements to loan the proceeds to entities such as Citizens that will use the funds for the public good.

Q. Do IDRBs have any particular benefit to utilities and ratepayers?

A. Yes. Generally, IDRBs are exempt from federal income taxation. The tax-exempt feature of IDRBs makes them more attractive to potential buyers of bonds than taxable bonds. Thus, bond buyers are willing to accept a lower interest earnings rate. The lower interest rate reduces interest expense to the issuing utility. In turn, the reduced interest expense is passed on to ratepayers in the form of a lower cost of capital in rate proceedings.

Q. What is the outstanding balance of AED's IDRBs?

A. In response to RUCO data request 3.15, Citizens provided a schedule showing outstanding principal of IDRBs in the amount of $149,931,799. This total consists of fixed and variable interest obligations of $98,563,042 and $51,368,757, respectively. The composite rate of interest as of March 31, 2000 was 5.77 percent for an annual interest expense of $8,648,577.

Q. When will the IDRBs be repaid?

A. There are 12 separate IDRB loan agreements with separate maturity dates. The maturity dates fall between the dates August 1, 2020 and May

1, 2032, inclusive. Thus, the remaining loan periods vary between 20 and 32 years.

Q. How will the IDRBs be treated under the terms of the Agreement?

A. In response to RUCO data request 3.15, Citizens stated, "[I]n accordance with the sale agreement, Citizens Utilities shall continue to be and shall remain the primary obligor with respect to all IDRB Indebtedness outstanding immediately after the closing date."

Q. Is the treatment of IDRBs in accordance with the Agreement neutral to the Citizens and ratepayers?

A. No. The proposed treatment is favorable to Citizens and detrimental to ratepayers.

Q. How can retention of the obligation to repay bonds be favorable to Citizens?

A. The obligation to repay IDRBs in and of itself is not favorable; however, the repayment is not the only consideration. If Citizens were not retaining the IDRB obligation, the purchase price Cap Rock would be willing to pay would fall to compensate for assuming the $149.9 million IDRB obligation belonging to Citizens. Citizens would then have $149.9 million less cash to invest in telephone access lines. Citizens would have to replace this capital by issuing new debt at the current market rate. Thus, by retaining the IDRB obligations, Citizens has obtained $149.9 million of capital at 5.77 percent, a considerable saving over the current market rate. Over the remaining 20 to 32 year term of the IDRBs, the savings in capital costs to Citizens is likely to be $50 million to $100 million.

Q. How are ratepayers harmed by Citizens' retention of the IDRB obligations?

A. IDRBs provide low-cost (currently 5.77 percent) capital. If Cap Rock was assuming the IDRB obligations, this low-cost capital would be included in Cap Rock's cost of capital in rate cases for the next 20 to 32 years. Instead Cap Rock must issue new debt at the estimated most probable rate of *** **Confidential** **Confidential** *** percent. The annual incremental interest expense Cap Rock will incur by having to obtain new capital instead of assuming the IDRB obligations is the difference between the current rates for new debt and the existing rates for IDRBs multiplied by the outstanding IDRB balance (*** **Confidential** **Confidential** ***). Over the remaining 20 to 32 year term of the IDRBs, the additional interest costs to Cap Rock that will be passed on to ratepayers is likely to be *** **Confidential** . **Confidential** ***

Q. Please explain why the potential savings to Citizens is not equal to the incremental costs to Cap Rock.

A. These amounts would be equal if Citizens' and Cap Rock had the same cost of capital. The difference is due to differing assumptions regarding the cost of capital for the two companies, i.e., the assumption that Citizens' cost of issuing new debt is less than Cap Rock's cost of issuing new debt.

Q. Could you provide an analogy to explain from the ratepayer's perspective the impact of Citizens retaining the IDRB obligations?

A. Yes. Assume a homeowner (ratepayer) has an existing 30-year, $149,900, 5.77 percent per annum mortgage (IDRB) on a home with a lender in Stamford, CT (Citizens). The homeowner decides to refinance the same amount with another 30-year loan (*** **Confidential** **Confidential** ***) at *** **Confidential** **Confidential** *** percent with a lender in Midland, TX (Cap Rock). Except for the difference in interest rates the terms and conditions of the two loans are identical.

Q. Would any reasonable homeowner refinance under these conditions?

A. No.

Accumulated Deferred Income Tax Credits

Q. What are Accumulated Deferred Income Taxes (ADIT) and how do they affect rates?

A. ADIT is the net amount of Deferred Income Tax Expense accumulated for prior years. Deferred Income Tax Expense results from timing differences in the recognition of revenues and expenses for the differing purposes of calculating income tax liability and revenue requirements in ratemaking. ADIT credits represent a utility's collection of revenues from ratepayers in years prior to making remittances to state (Arizona Department of Revenue) and federal (U.S. Treasury) authorities. That is, ADIT credits represent payments ratepayers have made in advance for future income tax liabilities. ADIT is cost-free capital that reduces rate base, and accordingly, rates.

Q. What amount of ADIT credit was recognized as a reduction to rate base in AED's prior rate case?

A. In Decision No. 59951, dated January 3, 1997, the Commission recognized a reduction of $5,009,283 in the determination of rate base related to ADIT credits.

Q. What amount of ADIT credit is shown in AED's 1999 annual report to the Commission?

A. AED's 1999 annual report to the Commission shows a credit balance for ADIT of $3,286,778.

Q. Will these ADIT credits transfer to Cap Rock?

A. No. The sale of AED's assets is a taxable event that will cause the deferred taxes to become due and payable. That is, Citizens will have to pay the income taxes collected in advance from ratepayers to the tax collection authorities.

Q. Will Citizens' be harmed or receive benefits directly related to the payment of these taxes collected in advance?

A. No. Citizens will no longer have the advanced capital, however, there will no longer be a reduction to the ratebase upon which Citizens can earn. These items are offsetting.

Q. Will ratepayers receive any benefit directly related to Citizens' payment of the ADITs that were collected in advance?

A. No.

Q. Will ratepayers be harmed by Citizens' payment of the ADITs that were collected in advance?

A. Yes. Since the ADIT will not transfer to Cap Rock, Citizens' ADIT credits will no longer be used in the calculation of rate base. Accordingly, rates will increase. Thus, the ADIT consequences of the sale neither harm nor benefit Citizens, however there is a direct benefit to the tax collection authorities at the expense of ratepayers.

Citizens' Gain/Cap Rock's Premium

Q. Under terms of the Agreement will Cap Rock purchase AED's assets for more than book value?

A. Yes. As discussed previously, the Agreement provides for certain adjustments to the base purchase price of $210,000,000. Based on the most recent information provided in Cap Rock's projected financial statements for AED prepared June 5, 2000, the acquisition adjustment or premium is *** **Confidential** **Confidential** ***. That is, Citizens' gain and Cap Rock's premium payment in excess of book value are estimated at approximately *** **Confidential** **Confidential** ***. The actual premium is likely to increase by the time the transaction is complete.

Q. How does Citizens' plan to treat the gain?

A. In response to RUCO data request 1.2, Citizens stated, "Citizens does not intend to share any portion of any gain on the sale with customers."

Q. How has the Commission traditionally treated gains on the sale of assets?

A. The Commission treats each sale on an individual basis. According to the National Association of Regulatory Utility Commissioners (NARUC) Uniform System of Accounts (USOA) for electric utilities that the Commission has adopted, gains on the sale of assets are treated as operating or non-operating, as approved by the Commission. My understanding is that the Commission normally provides for a sharing between shareholders and ratepayers, i.e., the gain is divided and partially recognized as operating and partially as non-operating. In my opinion, a sharing of the gain is the correct treatment in normal circumstances.

Q. Why is sharing the gain between shareholders and ratepayers the correct treatment in normal circumstances?

A. The parties that share in the risks related to utility assets should be entitled to share in the gain on the sale of those utility assets. Using the accounting treatment prescribed in the USOA, when an asset is retired before a utility fully recovers its original cost via depreciation, accumulated depreciation is debited (reduced). The effect of the USOA treatment is to make the utility whole, i.e., the utility does not recognize a loss on the early retirement and rate base is preserved at the pre-retirement level. This treatment transfers the risk of assets becoming obsolete or wearing out prematurely from the utility to the ratepayers. Further, ratepayers pay a return on the assets on an on-going basis. Thus, ratepayers participate in the risks of asset ownership with the utility, and accordingly, are entitled to share in gains from the sale of those assets as directed by the Commission and in accordance with the USOA allowed treatments.

Q. How is Cap Rock proposing to treat the premium?

A. In response to RUCO data request 5.1, Cap Rock stated:

> "Cap Rock does not seek an "acquisition adjustment" in this proceeding. Instead it asks that the difference between purchase price and net plant as of the date of the purchase and sale agreement be placed in a deferral account for future regulatory treatment. Cap Rock refers to this amount as the "acquisition differential." Cap Rock understands that the usual treatment before the ACC is for "acquisition differentials" to be placed in a deferral account and to be subject to future regulatory treatment. If the purchasing utility is subsequently able to demonstrate that structural changes have resulted in reductions in expense, then the purchasing utility may recapture as an acquisition adjustment (and thus reduce the deferral account) an amount equal to the expense savings associated with the structural changes."

Q. Do you agree with Cap Rock's proposal to address this issue in the context of a future regulatory proceeding?

A. Yes. Due to the particular circumstances in this case, treatment of the premium can be effectively addressed is a subsequent regulatory proceeding.

CONCLUSION AND RECOMMENDATIONS

Q. How is your analysis above to be applied?

A. My analysis is presented as a basis for determining whether the proposed transaction is in the public interest. Stated alternately, my analysis can be used to determine whether the transaction is in the public interest.

Q. Please provide an overview of your findings.

A. My analysis of Citizens' sale of assets and transfer of CC&N to Cap Rock, as proposed in the joint application, shows that there are three major consequences and one lesser but still significant consequence that have potential detrimental impacts for ratepayers. The three major reservations I have are in regard to: (1) the capitalization of Cap Rock; (2) Citizens' retention of the Industrial Revenue Development Bonds; and (3) Citizens' proposal to keep all of the gain for shareholders. In addition, the transaction, if approved, would cause a significant detrimental financial impact on ratepayers by eliminating accumulated deferred income tax credits.

Q. What are the fundamental problems with Cap Rock's capitalization?

A. The fundamental problem with Cap Rock's capitalization is a deficiency in equity capital. A deficiency of equity capital provides the foundation for many other problems including: an increase in the cost of equity; an increase in the cost of debt; a reduction in cash flow; an increase in the risk of default on debt obligations; a reduction in the ability to issue additional capital; a reduction in growth prospects; an upward influence on rates; and increases in the risks of insolvency and bankruptcy, as well as the Company's viability as a going concern.

Q. Please succinctly explain the effects of Citizens' proposal to retain the IDRB obligations?

A. Cap Rock ratepayers will incur substantial and long-term (20 to 32 years) economic harm if Citizens retains the IDRB obligations. Cap Rock will have to replace the low cost of capital provided by the IDRBs with alternate and more expensive capital causing upward pressure on rates.

Q. What is your opinion of Citizens' proposal to keep 100 percent of the gain for shareholders?

A. Citizens' proposal is one-sided, unfair, fails to recognize the risk ratepayers have incurred related to the assets, and is inconsistent with the Commission's normal treatment as allowed by the NARUC USOA.

Q. Based on your analysis, is the transaction as proposed in the public interest?

A. No. Based on my analysis, there are two major consequences resulting from the transaction as proposed. First, a company (Citizens) with a balanced and financially stable capital structure is being replaced by a neophyte investor-owned utility with woefully inadequate equity financing (Cap Rock). Citizens is much better suited to provide for AED's continuing financial needs. Second, Cap Rock's incremental capital costs, loss of IDRB financing, and loss of ADIT credits present incremental costs that Cap Rock is unlikely to overcome by any potential savings in Administrative and General and Income Tax Expenses. Accordingly, I believe substantial changes are warranted to prevent this transaction from being a detriment to the public interest.

Q. In order to make this transaction in the public interest, what changes do you recommend?

A. I recommend that authorization of the transaction be made contingent upon Cap Rock issuing sufficient common stock, so that on a consolidated basis subsequent to the issuance, common stock represents no less than 45 percent of total outstanding capital (common stock, preferred stock, and long-term debt).

Further, I recommend that authorization of the transaction be made contingent upon Cap Rock's Board of Directors approving a letter pledging that it will not enter into any merger or acquisition, issue any debt, retire or purchase common stock, issue any cash dividends, or engage in any other transaction that, subsequent to such transaction, results in common stock being less than 40 percent of the total outstanding capital, unless, prior to taking such action, the Company has received express written approval of the Commission.

Further, I recommend that authorization of the transaction be made contingent upon Cap Rock's Board of Directors approving a letter pledging to limit the non-regulated utility operations to 20 percent or less of total assets unless the Company obtains prior express written approval of the Commission.

Further, I recommend that authorization of the transaction be made contingent upon Cap Rock's Board of Directors approving a letter pledging to notify the Director of the Utilities Division in writing within 15 days of the Company becoming aware that common equity is less than 30 percent of the total outstanding capital.

Further, I recommend that authorization of the transaction be made contingent upon Cap Rock's Board of Directors approving a letter pledging to sell the AED's assets subject to the Commission's approval within 24 months of the occurrence of common equity becoming less than 25 percent of total outstanding capital unless a waiver of this provision is granted by the Commission.

Further, I recommend that the Commission include language in the order to comply with the prospective lender's condition of closing of the loans that the Commission recognize that Cap Rock must maintain an MDSC of *** **Confidential** **Confidential** *** along with qualifying language noting that rates for Arizona public service companies are based on the fair value of the assets committed to public service and that recognition of loan conditions provides no assurance regarding debt service coverage levels and no direct effect on the rates to be established.

Further, I recommend that authorization of the transaction be made contingent upon a restructuring or other change in the transaction to compensate ratepayers fully for the loss in economic value due to the retention by Citizens of the low-cost IDRB capital.

Further, I recommend that the gain on the sale be divided in equal amounts between Citizens and ratepayers. That is, ratepayers should receive one-half of the gain.

Further, I recommend that the treatment of the acquisition adjustment be determined in the context of the next rate case proceeding.

Further, I recommend that the Cap Rock and Citizens jointly file documentation of the final purchase price, net book value of assets sold at the time of the transaction, the amount of the gain/premium, date of the transfer, and supporting documentation.

Q. Does this conclude your direct testimony?

A. No. I have prepared the testimony above based on Citizens' and Cap Rock's joint filing and the Companies' data responses; however, neither Company has yet filed direct testimony. I reserve the opportunity to file additional direct testimony as may be necessary to address issues in the Companies' direct testimonies.