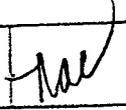




BEFORE THE ARIZONA CORPORATION COMMISSION  
DOCKETED

1  
2 WILLIAM A. MUNDELL  
CHAIRMAN  
3 JIM IRVIN  
COMMISSIONER  
4 MARC SPITZER  
COMMISSIONER  
5

DEC 12 2002

DOCKETED BY 

6 IN THE MATTER OF THE APPLICATION OF  
ARIZONA-AMERICAN WATER COMPANY,  
7 INC. FOR A LIMITED WAIVER OF THE  
REQUIREMENTS OF A.A.C. R14-2-801, ET SEQ.,  
8 AND CERTAIN RELATED RELIEF.

DOCKET NO. W-01303A-01-0983  
DECISION NO. 65453

**OPINION AND ORDER**

9 DATE OF HEARING: August 8, 2002  
10 PLACE OF HEARING: Phoenix, Arizona  
11 ADMINISTRATIVE LAW JUDGE: Teena Wolfe  
12 APPEARANCES: Mr. Norman D. James and Mr. Jay L. Shapiro,  
FENNEMORE CRAIG, on behalf of Applicant  
13 Arizona-American Water Company; and  
14 Ms. Janet Wagner, Attorney, Legal Division, on behalf  
of the Utilities Division of the Arizona Corporation  
15 Commission.

16 **BY THE COMMISSION:**

17 On December 17, 2001, Arizona-American Water Company, an Arizona corporation  
18 ("Arizona-American"), filed an application with the Arizona Corporation Commission  
19 ("Commission") requesting a Commission declaration that the Commission's Public Utility Holding  
20 Companies and Affiliated Interests Rules, A.A.C. R14-2-801, *et seq.* ("Affiliated Interests Rules") do  
21 not apply to the transaction described in the application, or alternatively, requesting a limited waiver  
22 of the requirements of the Affiliated Interests Rules, solely with respect to the described transaction  
23 ("Application"). The transaction described in the Application consists of the proposed merger of  
24 Arizona-American's parent, American Water Works Company, Inc., a Delaware corporation  
25 ("American Water Works") with a subsidiary of RWE AG ("RWE"), a company organized under the  
26 laws of the Federal Republic of Germany. The described transaction includes the acquisition of  
27 American Water Works' outstanding shares of stock.

28 On January 15, 2002, at the request of the Commission's Utilities Division Staff ("Staff"), the

1 Commission suspended the Application for a period of 120 days.

2 On April 22, 2002, Arizona-American filed an amendment to the Application to include a  
3 Notice of Intent to Reorganize, pursuant to Section 803(A) of the Affiliated Interests Rules.<sup>1</sup> By its  
4 Application and subsequent amendment, Arizona-American requests either: 1) a declaration that the  
5 Commission lacks jurisdiction over the transaction; or 2) a waiver from the Affiliated Interests Rules  
6 with respect to the proposed transaction pursuant to A.A.C. R14-2-806; or 3) approval of the  
7 transaction as a reorganization of a holding company pursuant to A.A.C. R14-2-803.

8 On May 10, 2002, Staff requested that a hearing be held on this matter. Arizona-American  
9 consented to the procedural dates proposed by Staff, and by Procedural Order dated May 14, 2002,  
10 this matter was set for hearing.

11 Arizona-American provided public notice of the hearing as required by the May 14, 2002  
12 Procedural Order. No requests for intervention were received.

13 A public hearing was held as scheduled on August 8, 2002, before a duly authorized  
14 Administrative Law Judge of the Commission. Arizona-American and Staff appeared through  
15 counsel and presented evidence. No members of the public appeared to provide public comment.  
16 Following the hearing, on September 6, 2002, Arizona-American and Staff submitted closing briefs,  
17 and the matter was taken under advisement.

## 18 DISCUSSION

### 19 **A. The Proposed Transaction**

20 The transaction underlying Arizona-American's Application is an agreement by American  
21 Water Works with RWE and Thames Water Aqua Holdings GmbH, a wholly-owned subsidiary of  
22 RWE ("Thames Holdings"). Pursuant to the agreement, all of American Water Works' issued and  
23 outstanding common stock will be acquired by Thames Water Aqua U.S. Holdings, a recently formed  
24 Delaware corporation and a wholly-owned subsidiary of Thames Holdings. Thames Water Aqua  
25 U.S. Holdings will be an American holding company, serving as a single "umbrella" company under  
26 which RWE plans to place all of its American water and wastewater assets. The acquisition of  
27

28 <sup>1</sup> Arizona-American states that its amendment of the Application to include the Notice of Reorganization should not be construed as a waiver of its right to seek alternative relief, as may be appropriate.

1 American Water Works' common stock will be accomplished by means of a merger in which Apollo  
2 Acquisition Company, also a Delaware corporation controlled by Thames Holdings, will be merged  
3 with and into American Water Works, with American Water Works surviving the merger as a wholly  
4 owned subsidiary of Thames Water Aqua U.S. Holdings. In conjunction with the merger, Thames  
5 Water Aqua U.S. Holdings will purchase all of the issued and outstanding shares of American Water  
6 Works' common stock at \$46.00 per share. Shareholder approval was obtained at a special meeting  
7 on January 17, 2002.

8 RWE, Germany's fifth largest industrial group, is an international multi-utility service  
9 provider with its core businesses in electricity, water, gas, waste management and other utility-related  
10 services.<sup>2</sup> Thames Holdings serves as a holding company for the water and wastewater operations  
11 under the RWE corporate umbrella. As stated above, Thames Water Aqua U.S. Holdings has been  
12 formed as the holding company for all of the water and wastewater operations in the United States.  
13 RWE has delegated the management of its various water operations worldwide to Thames Water  
14 PLC ("Thames Water"), a corporation organized under the laws of England and Wales and  
15 headquartered in London, which will be a sister affiliate of Thames Water Aqua U.S. Holdings.  
16 Thames Water is presently the third largest private water company in the world.<sup>3</sup>

17 Following the completion of the proposed transaction, American Water Works' shares of  
18 common stock would no longer be publicly traded, but would be held by Thames Water Aqua U.S.  
19 Holdings. American Water Works would remain in existence and become responsible for managing  
20 the Americas region (North and South America) of Thames Water, and would continue to be  
21 headquartered in Voorhees, New Jersey. Arizona-American would continue to be a wholly-owned  
22 subsidiary of American Water Works.

23 Arizona-American asserts that as a result of the proposed transaction, Arizona-American's  
24 local and regional management will not change, there will be no reduction in Arizona-American's  
25

26 <sup>2</sup> RWE has a business presence in more than 120 countries on six continents. RWE and its subsidiaries employ some  
170,000 people, more than one-third of whom work outside of Germany, including more than 16,000 employees in the  
27 United States.

28 <sup>3</sup> Thames Water provides drinking water and wastewater treatment services to over 43 million people worldwide,  
including 12 million people in and around the City of London. In the United States, Thames Water has 880 employees  
staffing operations or offices in Houston, Pittsburgh, Cincinnati, Westfield, New Jersey, and Puerto Rico.

1 local staffing, there will be no changes in Arizona-American's rates and charges for service, and  
 2 Arizona-American's capital structure will not change. Arizona-American's witness testified that  
 3 there will be no request to recover any acquisition premium or any other costs associated with the  
 4 proposed transaction, and that the proposed transaction will not cause any additional layer of  
 5 management overhead to be allocated to Arizona-American. In addition, Arizona-American asserts  
 6 that there will not be any cross-subsidization of any affiliates, and any transactions between Arizona-  
 7 American and any "affiliate," as such term is defined in A.A.C. R14-2-801, will continue to be  
 8 subject to the Affiliated Interests Rules and other regulatory requirements of the Commission.

9 Arizona-American believes that the proposed transaction is likely to generate benefits for  
 10 Arizona-American and its utility customers. Arizona-American states that in addition to potential  
 11 reductions in the cost of capital, Thames Water's extensive experience in managing water and  
 12 wastewater operations throughout the world, when combined with the existing expertise of American  
 13 Water Works' management, should enhance the quality of service provided to Arizona-American  
 14 utility customers. Arizona-American states in support of this assertion that Thames Water, which  
 15 manages water operations on six continents, has considerable experience in operating water systems  
 16 in regions where security has been a significant concern for decades, and that Thames Water has an  
 17 outstanding track record in terms of the quality of utility service it provides. Arizona-American  
 18 claims that American Water Works and its subsidiaries, including Arizona-American, will benefit by  
 19 becoming a part of an organization with significant expertise, greater access to capital, and greater  
 20 economies of scale.

21 **B. Conditions Proposed by Staff**

22 Staff has recommended approval of the transaction pursuant to A.A.C. R14-2-803, subject to  
 23 the following fifteen conditions:

- 24
- 25 #1 Arizona-American shall not seek recovery of any excess of cost over book value  
 paid pursuant to the reorganization at any time in the future from this Commission.
- 26 #2 Arizona-American shall not seek recovery of any costs associated with the  
 27 reorganization, including internal corporate costs, in any future Arizona rate  
 28 proceeding.

- 1 #3 Arizona-American and its affiliates shall provide their books and records, upon  
2 request, in the Phoenix metropolitan area. Arizona-American and its affiliates  
3 shall also provide access to their books and records where such documents are  
4 maintained.
- 4 #4 Arizona-American shall not adjust any existing account amounts as a result of the  
5 reorganization. Arizona-American may make normal accounting adjustments that  
6 would have occurred absent the reorganization.
- 6 #5 In future rate proceedings filed after the effective date of the reorganization,  
7 Arizona-American shall have the burden of demonstrating that any cost overhead  
8 allocations and direct charges resulting from the reorganization including, but not  
9 limited to, the addition of layers of management, are reasonable and provide a net  
10 benefit to Arizona-American and/or its customers.
- 10 #6 Arizona-American shall not allow the reorganization to diminish local (Arizona)  
11 staffing that would result in service degradation.
- 11 #7 Arizona-American shall not allow its quality of service to diminish, the number of  
12 service complaints should not increase, the response time to service complaints  
13 should not increase, and service interruptions should not increase as a result of the  
14 reorganization.
- 14 #8 Arizona-American shall continue to maintain its business headquarters in Arizona  
15 and fully operational local (Arizona) field offices, as appropriate to maintain the  
16 quality of its service.
- 16 #9 If Arizona-American ever plans to share with affiliates, or other entities, any  
17 information made available to Arizona-American solely by virtue of the  
18 company/customer relationship, such as billing information and services received  
19 by a customer, it shall notify the Commission at least 180 days in advance. Such  
20 notice shall, at a minimum, identify the intended use of the information. Arizona-  
21 American shall also, at the time of the filing of the 180-day notice, file a tariff  
22 setting forth appropriate customer notification procedures to inform customers  
23 about the sharing.
- 22 #10 If Arizona-American ever shares any customer information with affiliates, or other  
24 entities, it shall maintain accurate records of revenues earned as a result and make  
25 those records available to Staff upon request with ten days' notice. For the  
26 purposes of this condition and Condition Nine above, customer information that is  
27 prohibited from disclosure does not include a customer's name, address or service  
28 location, and telephone number.
- 26 #11 Arizona-American shall not use any utility plant or other property, that is used or  
27 necessary for the provision of utility service, for any unregulated activity unless  
28 Arizona-American maintains appropriate books and record of account detailing the  
nature of such unregulated activity and providing appropriate allocations between

1 activities relating to Arizona-American's provision of utility service and the  
 2 unregulated activity. Arizona-American's books and records concerning all  
 3 unregulated activities shall be subject to the Commission's review and shall be  
 made available in the Phoenix metropolitan area or, at the Commission's request,  
 where the records are maintained, on ten days' notice.

4 #12 Arizona-American shall maintain a minimum common equity ratio of 35 percent  
 5 of total capital. Arizona-American's total capital is defined as common equity,  
 6 preferred equity, and long-term debt. Arizona-American shall not make  
 7 remittances or pay dividends to American Water Works unless Arizona-  
 8 American's common equity is at least 35 percent of total capital. If Arizona-  
 9 American's common equity falls to 30 percent of total capital, American Water  
 10 Works shall provide a cash infusion of equity sufficient to bring Arizona-  
 American's common equity ratio back to a minimum of 35 percent of total capital.  
 Arizona-American shall not be prohibited from requesting that the foregoing  
 equity percentages be decreased based on changes to capital markets or other  
 conditions that make it prudent to alter Arizona-American's capital structure.

11 #13 The cost of debt issued after the closing date of the reorganization, for purposes of  
 12 setting rates in Arizona-American's rate proceedings, filed within ten years from  
 13 the effective date of the reorganization, shall reflect a rating of A- (S&P) / Baa1  
 (Moody's) or higher.

14 #14 Arizona-American and its affiliates agree that in future Commission proceedings,  
 15 they shall not seek a higher cost of capital than that which Arizona-American  
 16 would have been authorized as a stand-alone entity. Specifically, no capital  
 financing costs (either debt or equity) should increase by virtue of the  
 reorganization.

17 #15 Arizona-American shall refrain from filing any non-emergency rate increase  
 18 requests for one year from the closing date of the reorganization; however,  
 19 Arizona-American may file rate increase requests prior to the reorganization's  
 20 closing date, and any such requests shall not be subject to the conditions set forth  
 herein.

21 **C. Conditions in Dispute**

22 Arizona-American and Staff both stated at the hearing that the fifteen conditions  
 23 recommended by Staff, that are set forth above, are the result of attempts by Arizona-American and  
 24 Staff to resolve the parties' differences regarding the necessity of conditions on Commission approval  
 25 of the proposed transaction. The parties are not in complete agreement on the language of Staff's  
 26 recommended Conditions Five and Eight, and are in substantial disagreement on the substance of  
 27 Conditions Three and Thirteen. Arizona-American believes that Staff's recommended Conditions  
 28 Three and Thirteen are unnecessary.

1           1.     Condition Three

2           In lieu of the Condition Three proposed by Staff, Arizona-American proposes a Condition  
3 Three as follows:

4           (Arizona-American)

5           Three.     Arizona-American and its affiliates will comply with R14-2-801, *et seq.*,  
6           pertaining to affiliated interests, or seek Commission authorization for any  
7           waivers thereof, including the provisions of R14-2-804 relating to the  
8           transaction of business with and access to the books and records of any  
9           affiliate, including the production of records at Arizona-American's local  
10          business headquarters and elsewhere.

11          For purposes of comparison, Staff's proposed Condition Three is as follows:

12          (Staff)

13          Three.     Arizona-American and its affiliates shall provide their books and records, upon  
14          request, in the Phoenix metropolitan area. Arizona-American and its affiliates  
15          shall also provide access to their books and records where such documents are  
16          maintained.

17          Arizona-American believes that the language Staff proposes for Condition Three goes beyond  
18          what is already required under the Affiliated Interests Rules. Arizona-American believes there is no  
19          reason to grant Staff *carte blanche* to examine the books and records of all RWE affiliates throughout  
20          the world, without regard to whether that affiliate has business dealings with Arizona-American.  
21          Arizona-American states that it is already prohibited, by A.A.C. R14-2-804(B), from transacting any  
22          business with an affiliate "unless the affiliate agrees to provide the Commission access to the books  
23          and records of the affiliate to the degree required to fully audit, examine or otherwise investigate  
24          transactions between the public utility and the affiliate." Arizona-American believes that the  
25          Commission may only regulate transactions between public utilities and their affiliates.

26          Staff argues that Arizona-American's proposal is not sufficient because it does not cover the  
27          other possible situations in which Staff may need access to the books and records of one of the  
28          Company's affiliates. Staff believes that there might be a need to look at the books and records of an  
29          affiliate that doesn't do business directly with Arizona-American, because Staff might perceive that  
30          the affiliate is causing costs to fall unfairly on Arizona-American's ratepayers.

31          We believe that, without provision of affiliate books and records to the Commission for

1 review, upon request, the Commission has no means of verifying whether transactions between a  
2 regulated public utility and its affiliate have occurred, and of thereby assessing possible ratemaking  
3 effects. The public interest requires that the Commission have access to such information. As Staff  
4 points out, Arizona-American's proposed Condition Three fails to recognize that the Commission's  
5 ratemaking authority extends beyond the requirements of the Affiliated Interests Rules. The  
6 Commission's constitutional ratemaking authority allows it to obtain information about a public  
7 service corporation's affiliates in order to be prepared to take action to prevent any negative  
8 consequences of intercompany transactions significantly affecting a public service corporation's  
9 structure or capitalization. This authority includes requiring access to a utility affiliate's books and  
10 records when such access is necessary for effective ratemaking. As a condition of approval of the  
11 proposed transaction, Arizona-American should be required to abide by Condition Three as proposed  
12 by Staff.

13           2.     Condition Five

14           Staff proposes Condition Five as follows:

15           Five.       In future rate proceedings filed after the effective date of the reorganization,  
16                       Arizona-American shall have the burden of demonstrating that any cost overhead  
17                       allocations and direct charges resulting from the reorganization including, but not  
18                       limited to, the addition of layers of management, are reasonable and provide a net  
                     benefit to Arizona-American and/or its customers.

19           Arizona-American has stated that it is willing to accept Condition Five based on its  
20 understanding that the term "net" is intended to indicate only that Arizona-American must benefit in  
21 some respect from the service being provided, without a quantifiable dollar amount being associated  
22 with the benefit. Staff believes, however, that the crucial question is whether the cost of a transaction  
23 is reasonable in relation to the benefit to Arizona-American and its customers. Staff believes that the  
24 term "net" implies a comparison, though not necessarily a numerical one. Both Arizona-American  
25 and Staff agree that a benefit must be shown. We believe that in the future rate proceedings referred  
26 to in this condition, in order for Arizona-American to recover any cost overhead allocations and  
27 direct charges resulting from the reorganization, Arizona-American should have the burden of  
28 demonstrating that such costs are reasonable in relation to the benefits conferred on Arizona-

1 American and its customers. We find that no change to the language recommended by Staff is  
2 required.

3       3.     Condition Eight

4       Staff proposes Condition Eight as follows:

5       Eight.     Arizona-American shall continue to maintain its business headquarters in Arizona  
6                 and fully operational local (Arizona) field offices, as appropriate to maintain the  
7                 quality of its service.

8       Arizona-American proposed at the hearing that a second sentence be added to Condition  
9       Eight, as follows: "However, Arizona-American is not precluded from making local operational  
10       changes in connection with integrating the water and wastewater systems acquired from Citizens  
11       Communications and any future acquisitions into Arizona-American's local operations." Staff stated  
12       at the hearing that elimination of the second sentence did not affect the meaning of Condition Eight.  
13       Arizona-American believes that Staff's testimony at the hearing clarified that the second sentence is  
14       not necessary to allow Arizona-American to make operational changes in connection with integrating  
15       the water and wastewater systems acquired from Citizens earlier this year, or other operational  
16       changes that relate to the provision of local services and are unconnected to the reorganization.  
17       Arizona-American states that it can agree to Condition Eight, based on Staff's testimony. We agree  
18       that the language of the first sentence does not preclude Arizona-American from making such  
19       changes, and will adopt the language of Condition Eight as recommended by Staff.

20       4.     Condition Thirteen

21       Staff proposes Condition Thirteen as follows:

22       Thirteen.     The cost of debt issued after the closing date of the reorganization, for purposes of  
23                     setting rates in Arizona-American's rate proceedings, filed within ten years from  
24                     the effective date of the reorganization, shall reflect a rating of A- (S&P) / Baa1  
                      (Moody's) or higher.

25       Arizona-American proposes that Condition Thirteen remain in effect for a period of three  
26       years, as opposed to the ten year period proposed by Staff.

27       Arizona-American objects to this condition because credit ratings involve subjective  
28       determinations made by investment services. Arizona-American states that its credit rating may be

1 affected by changes in regulatory requirements or other factors affecting the water utility industry or  
2 the economy generally, regardless of the business activities of RWE or its subsidiaries. Arizona-  
3 American therefore believes that Arizona-American should not be required to guarantee a minimum  
4 debt cost. In addition, Arizona-American states that Condition 13 could weaken it financially and  
5 lead to more frequent rate increase applications to maintain cash flows and debt service coverages.  
6 Further, Arizona-American believes that its acceptance of Condition Fourteen eliminates the  
7 possibility that an adverse credit rating will cause Arizona-American's cost of debt in a future rate  
8 proceeding to exceed the market cost of debt for a business organization comparable to Arizona-  
9 American.<sup>4</sup>

10 Staff states that although Arizona-American has suggested that the proposed transaction may  
11 benefit Arizona-American by lowering its cost of capital, such a benefit cannot be quantified and may  
12 not materialize, so Staff proposed Condition Thirteen to address the issue. Staff argues that  
13 Condition 13 is necessary to protect ratepayers from the potential of increased rates due to any  
14 possible downgrading in Arizona-American or its affiliates' bond ratings, and that its proposed ten-  
15 year protection period is a relevant time frame that provides better protection to Arizona ratepayers  
16 than Arizona-American's proposal of three years.

17 While we agree with Staff that the ratepayers should be protected from possible rate increase  
18 that may result from a possible downgrade of Arizona-American or its affiliates, we also recognize  
19 the subjective nature of determinations made by investment services and the possibility that the entire  
20 industry may suffer from a poor economy and/or volatile nature of today's capital markets. Further,  
21 we also recognize that Arizona-American could be subject to possible credit downgrade absent this  
22 merger, and that no protection for ratepayers currently exists to offset this possibility.

23 Based on the above, we find that Arizona-American's proposal to guarantee its credit rating  
24 for three years from the effective date of the reorganization is reasonable and shall adopt it for  
25 purposes of Condition 13.

26 <sup>4</sup> Staff proposes Condition Fourteen as follows:

27 Fourteen. Arizona-American and its affiliates agree that in future Commission proceedings, they shall not  
28 seek a higher cost of capital than that which Arizona-American would have been authorized as a stand-  
alone entity. Specifically, no capital financing costs (either debt or equity) should increase by virtue of the  
reorganization.

1 **D. Rate Increase Moratorium**

2 Condition 15 proposed by Staff would require Arizona-American to refrain from filing any  
3 non-emergency rate increase requests for one year from the closing date of the reorganization. We  
4 believe that increasing this moratorium from one year to three years is appropriate, as it would  
5 provide increased protection to Arizona-American's ratepayers. We will therefore amend Condition  
6 15 as proposed by Staff to require that Arizona-American refrain from filing any non-emergency rate  
7 increase requests for three years from the closing date of the reorganization.

8 **E. Conclusion**

9 Staff and Arizona-American agree that as a result of the proposed transaction, Arizona-  
10 American may benefit from the lower cost of capital that RWE enjoys as compared to that of  
11 Arizona-American's affiliate, American Water Capital Corp., which currently provides debt capital to  
12 Arizona-American through its parent, American Water Works. Because RWE's credit ratings are  
13 superior to those of American Water Capital Corp. at the present time, and RWE has a substantially  
14 larger market capitalization than that available to Arizona-American through American Water Works  
15 and American Water Capital Corp., RWE currently has greater equity and debt financing capability  
16 than American Water Works and American Water Capital Corp.

17 Precise quantification of benefits to Arizona-American resulting from RWE's lower cost of  
18 capital is difficult, however, due to factors such as the maturity dates of existing debt, uncertainty  
19 concerning future levels of capital expenditures and associated financing requirements, and changes  
20 in interest rates and potential future changes in credit ratings. Utility rates can be impacted by  
21 holding company structure and capitalization, and we believe that utility ratepayers should not be  
22 required to bear the burden of financial risk resulting from holding company diversification.  
23 Understanding this, Staff has proposed fifteen conditions that it recommends we place upon our  
24 approval of the transaction. Staff believes its proposed conditions will provide Arizona-American's  
25 ratepayers with protection from the possible adverse effects of the reorganization. Arizona-American  
26 disagrees with certain of those conditions. We believe, however, that the public interest requires that  
27 the Commission apply the Affiliated Interests Rules in a manner that will maximize protection to  
28 ratepayers, and for the reasons stated above, we believe that approval of the transaction proposed in

1 the application should be made subject to the conditions as proposed by Staff and as amended herein.

2 \* \* \* \* \*

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

5 **FINDINGS OF FACT**

6 1. Arizona-American is an Arizona corporation that has provided water utility service in  
7 portions of the Town of Paradise Valley, the City of Scottsdale and certain unincorporated portions of  
8 Maricopa County for many years.<sup>5</sup>

9 2. All of Arizona-American's common stock was purchased by American Water Works  
10 in the late 1960s. Since that time, Arizona-American has been a wholly-owned subsidiary of  
11 American Water Works.  
12

13 3. American Water Works is a Delaware corporation with headquarters located in  
14 Voorhees, New Jersey. American Water Works is a publicly-traded company, whose shares of  
15 common stock are traded on the New York Stock Exchange.<sup>6</sup>  
16

17 4. In January 2002, Arizona-American completed the acquisition of the water and  
18 wastewater utility systems and assets of Citizens Communications Company in Arizona. As a result  
19 of that transaction, approved by the Commission in Decision No. 63584 (April 4, 2001), Arizona-  
20 American currently provides water and wastewater service to approximately 140,000 customers in  
21 Arizona. Consequently, Arizona-American is a Class A water utility, and is subject to the  
22 Commission's Affiliated Interests Rules.  
23

24 5. On September 16, 2001, American Water Works entered an agreement with RWE to  
25 merge with one of RWE's subsidiaries. On January 17, 2002, at a special meeting, American Water  
26

27 <sup>5</sup> Arizona-American was originally named Paradise Valley Water Company. The Company's name was changed to  
Arizona-American Water Company in January 2000.

28 <sup>6</sup> At present, there are approximately 100 million shares of American Water Works common stock issued and outstanding.  
American Water Works has more than 60 subsidiaries (both regulated and unregulated), which collectively have a

1 Works' shareholders approved Thames Water Aqua U.S. Holdings' purchase of all of the issued and  
2 outstanding shares of American Water Works' common stock at \$46.00 per share, in conjunction  
3 with the merger.

4 6. On December 17, 2001, Arizona-American filed the Application with the  
5 Commission.

6 7. On January 15, 2002, at the request of Staff, the Commission issued Decision No.  
7 64362, which suspended the Application for a period of 120 days.

8 8. On April 22, 2002, Arizona-American filed an amendment to the Application that  
9 contained the information required for a notice of intent to reorganize pursuant to A.A.C. R14-2-  
10 803(A). By its Application and the subsequent amendment, Arizona-American requests either: 1) a  
11 declaration that the Commission lacks jurisdiction over the transaction; or 2) a waiver from the  
12 Affiliated Interests Rules with respect to the proposed transaction pursuant to A.A.C. R14-2-806; or  
13 3) approval of the transaction as a reorganization of a holding company pursuant to A.A.C. R14-2-  
14 803.  
15

16 9. On May 10, 2002, Staff filed a Request for Procedural Order, requesting that deadlines  
17 be established for the filing of written testimony, the commencement of the hearing and certain other  
18 procedural matters. Arizona-American consented to the dates proposed by Staff.  
19

20 10. The Commission issued a Procedural Order on May 14, 2002, setting this matter for  
21 hearing on August 8, 2002, and establishing the agreed-upon procedural deadlines.

22 11. On July 11, 2002, Arizona-American caused public notice of the hearing to be  
23 published in The Arizona Republic, a newspaper of general circulation within the State of Arizona.

24 12. The Commission received no intervention requests.

25 13. A public hearing was held on the Application on August 8, 2002. Arizona-American  
26  
27

28 business presence in 27 states and 3 Canadian provinces.

1 and Staff appeared through counsel and presented evidence. No persons appeared to provide public  
2 comment at the hearing.

3 14. Written public comments that advocated a thorough review of the application were  
4 filed in the docket on September 3, 2002.

5 15. The parties filed closing briefs on September 6, 2002.

6 16. The transaction described in the discussion above would result in a holding company  
7 structure that can be summarized as follows:  
8

9 RWE AG, a company organized under the laws of the Federal Republic of Germany

↓

10 Thames Water Aqua Holdings GmbH, a holding company  
11 organized under the laws of the Federal Republic of Germany  
(wholly-owned by RWE AG)

↓

12 Thames Water Aqua U.S. Holdings, a Delaware Corporation  
13 (wholly-owned by Thames Water Aqua Holdings GmbH)

↓

14 American Water Works Company, Inc., a Delaware Corporation  
15 (wholly-owned by Thames Water Aqua U.S. Holdings)

↓

16 Arizona-American Water Company, Inc., an Arizona Corporation  
17 (wholly-owned by American Water Works Company, Inc.)

18 17. American Water Capital Corp. ("AWCC"), another American Water Works  
19 subsidiary, currently provides debt capital and financial management services to American Water  
20 Works and its utility subsidiaries, including Arizona-American.

21 18. Both Staff and Arizona-American agree that Arizona-American may benefit from the  
22 lower cost of capital that RWE enjoys as compared to AWCC. RWE's credit ratings are superior to  
23 those of AWCC at the present time, and RWE has a substantially larger market capitalization than  
24 that available to Arizona-American through American Water Works and AWCC. RWE therefore has  
25 greater equity and debt financing capability than American Water Works and AWCC. RWE also has  
26 access to the European capital market as well as the United States domestic market.  
27  
28

1 19. Precise quantification of benefits to Arizona-American resulting from RWE's lower  
2 cost of capital is difficult, due to factors such as the maturity dates of existing debt, uncertainty  
3 concerning future levels of capital expenditures and associated financing requirements, and changes  
4 in interest rates and potential future changes in credit ratings.

5 20. The credit rating of a parent company can positively impact the cost of capital of a  
6 utility affiliate, but it can also negatively impact it. If RWE's ratings were to fall in the future, the  
7 positive benefits that Arizona-American anticipates could fail to materialize and be replaced by  
8 negative ones.

9 21. Staff recommends that the Commission condition the approval of this transaction upon  
10 the following fifteen conditions:  
11

- 12
- 13 #1 Arizona-American shall not seek recovery of any excess of cost over book value  
paid pursuant to the reorganization at any time in the future from this Commission.
- 14 #2 Arizona-American shall not seek recovery of any costs associated with the  
15 reorganization, including internal corporate costs, in any future Arizona rate  
16 proceeding.
- 17 #3 Arizona-American and its affiliates shall provide their books and records, upon  
18 request, in the Phoenix metropolitan area. Arizona-American and its affiliates  
shall also provide access to their books and records where such documents are  
19 maintained.
- 20 #4 Arizona-American shall not adjust any existing account amounts as a result of the  
21 reorganization. Arizona-American may make normal accounting adjustments that  
would have occurred absent the reorganization.
- 22 #5 In future rate proceedings filed after the effective date of the reorganization,  
23 Arizona-American shall have the burden of demonstrating that any cost overhead  
24 allocations and direct charges resulting from the reorganization including, but not  
25 limited to, the addition of layers of management, are reasonable and provide a net  
benefit to Arizona-American and/or its customers.
- 26 #6 Arizona-American shall not allow the reorganization to diminish local (Arizona)  
staffing that would result in service degradation.
- 27 #7 Arizona-American shall not allow its quality of service to diminish, the number of  
28 service complaints should not increase, the response time to service complaints.

1 should not increase, and service interruptions should not increase as a result of the  
2 reorganization.

3 #8 Arizona-American shall continue to maintain its business headquarters in Arizona  
4 and fully operational local (Arizona) field offices, as appropriate to maintain the  
5 quality of its service.

6 #9 If Arizona-American ever plans to share with affiliates, or other entities, any  
7 information made available to Arizona-American solely by virtue of the  
8 company/customer relationship, such as billing information and services received  
9 by a customer, it shall notify the Commission at least 180 days in advance. Such  
10 notice shall, at a minimum, identify the intended use of the information. Arizona-  
11 American shall also, at the time of the filing of the 180-day notice, file a tariff  
12 setting forth appropriate customer notification procedures to inform customers  
13 about the sharing.

14 #10 If Arizona-American ever shares any customer information with affiliates, or other  
15 entities, it shall maintain accurate records of revenues earned as a result and make  
16 those records available to Staff upon request with ten days' notice. For the  
17 purposes of this condition and Condition Nine above, customer information that is  
18 prohibited from disclosure does not include a customer's name, address or service  
19 location, and telephone number.

20 #11 Arizona-American shall not use any utility plant or other property, that is used or  
21 necessary for the provision of utility service, for any unregulated activity unless  
22 Arizona-American maintains appropriate books and record of account detailing the  
23 nature of such unregulated activity and providing appropriate allocations between  
24 activities relating to Arizona-American's provision of utility service and the  
25 unregulated activity. Arizona-American's books and records concerning all  
26 unregulated activities shall be subject to the Commission's review and shall be  
27 made available in the Phoenix metropolitan area or, at the Commission's request,  
28 where the records are maintained, on ten days' notice.

#12 Arizona-American shall maintain a minimum common equity ratio of 35 percent  
of total capital. Arizona-American's total capital is defined as common equity,  
preferred equity, and long-term debt. Arizona-American shall not make  
remittances or pay dividends to American Water Works unless Arizona-  
American's common equity is at least 35 percent of total capital. If Arizona-  
American's common equity falls to 30 percent of total capital, American Water  
Works shall provide a cash infusion of equity sufficient to bring Arizona-  
American's common equity ratio back to a minimum of 35 percent of total capital.  
Arizona-American shall not be prohibited from requesting that the foregoing  
equity percentages be decreased based on changes to capital markets or other  
conditions that make it prudent to alter Arizona-American's capital structure.

#13 The cost of debt issued after the closing date of the reorganization, for purposes of  
setting rates in Arizona-American's rate proceedings, filed within ten years from

1 the effective date of the reorganization, shall reflect a rating of A- (S&P) / Baa1  
2 (Moody's) or higher.

3 #14 Arizona-American and its affiliates agree that in future Commission proceedings,  
4 they shall not seek a higher cost of capital than that which Arizona-American  
5 would have been authorized as a stand-alone entity. Specifically, no capital  
6 financing costs (either debt or equity) should increase by virtue of the  
7 reorganization.

8 #15 Arizona-American shall refrain from filing any non-emergency rate increase  
9 requests for one year from the closing date of the reorganization; however,  
10 Arizona-American may file rate increase requests prior to the reorganization's  
11 closing date, and any such requests shall not be subject to the conditions set forth  
12 herein.

13 22. Arizona-American proposes that the Commission adopt its version of Condition #3  
14 and Condition # 13 as opposed to Staff's version.

15 23. In order to provide greater protection to Arizona-American's ratepayers, we will  
16 amend Condition 15 as proposed by Staff, to require that Arizona-American refrain from filing any  
17 non-emergency rate increase requests for three years from the closing date of the reorganization.

18 24. We find that Arizona-American's proposal to guarantee that the cost of debt issued  
19 after the closing date of the reorganization, for purposes of setting rates in Arizona-American's rate  
20 proceedings, filed within three years from the effective date of the reorganization, shall reflect a  
21 rating of A- (S&P) / Baa1 (Moody's) or higher is reasonable, and we shall adopt it for purposes of  
22 Condition 13.

23 25. For the reasons set forth herein, it is in the public interest to attach the conditions as  
24 proposed by Staff, with the amendments to Conditions 13 and 15 described in Findings of Fact Nos.  
25 23 and 24 above, to Commission approval of the transaction proposed in the Application.

### 26 CONCLUSIONS OF LAW

27 1. Arizona-American is a public service corporation within the meaning of Article 15,  
28 Section 3 of the Arizona Constitution and Title 40 of the Arizona Revised Statutes.

2. The Commission has jurisdiction over the transaction proposed in the Application  
pursuant to Article 15, Section 3 of the Arizona Constitution and the Commission's Affiliated  
Interests Rules, A.A.C. R14-2-801 through -806.

1 3. It is not in the public interest to grant Arizona-American's request for a waiver from  
2 Commission review of the proposed transaction.

3 4. The public interest requires that the Commission apply the Affiliated Interests Rules in  
4 a manner that will maximize protection to ratepayers.

5 5. Utility rates can be impacted by holding company structure and capitalization.

6 6. Utility ratepayers should not be required to bear the burden of financial risk resulting  
7 from holding company diversification.

8 7. Approval of the transaction proposed in the Application would serve the public  
9 interest only if conditions are imposed to provide adequate protection to ratepayers.

10 8. The public interest requires that the transaction proposed in the Application be  
11 approved, subject to the conditions as recommended by Staff, set forth in Findings of Fact No. 21  
12 above, with the amendments to Conditions 13 and 15 described in Findings of Fact Nos. 23 and 24  
13 above.

14 **ORDER**

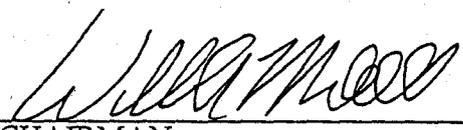
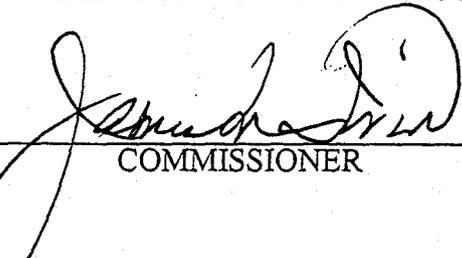
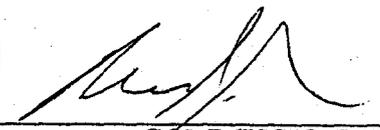
15 IT IS THEREFORE ORDERED that Arizona-American Water Company's request for a  
16 waiver from Commission review of the transaction proposed in the Application, pursuant to A.A.C.  
17 R14-2-806, is hereby denied.

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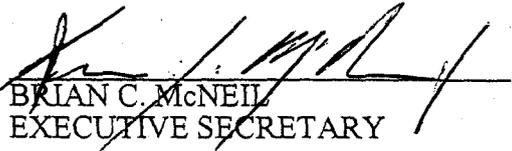
1 IT IS FURTHER ORDERED that the transaction proposed by Arizona-American Water  
2 Company in the Application is hereby approved, as a reorganization of a holding company pursuant  
3 to A.A.C. R14-2-803, subject to the conditions recommended by Staff as set forth in Findings of Fact  
4 No. 21 above, with the amendments to Conditions 13 and 15 described in Findings of Fact Nos. 23  
5 and 24 above.

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

7 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

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9   
10 CHAIRMAN  COMMISSIONER  COMMISSIONER  
11

12 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive  
13 Secretary of the Arizona Corporation Commission, have  
14 hereunto set my hand and caused the official seal of the  
15 Commission to be affixed at the Capitol, in the City of Phoenix,  
16 this 12<sup>th</sup> day of December, 2002.

17   
18 BRIAN C. McNEIL  
19 EXECUTIVE SECRETARY

20 DISSENT \_\_\_\_\_

21 TW:mlj

1 SERVICE LIST FOR: ARIZONA-AMERICAN WATER COMPANY, INC.

2 DOCKET NO. W-01303A-01-0983

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