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Arizona Corporation Commission

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6 **BEFORE THE ARIZONA CORPORATION COMMISSION**

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

DOCKET NO. W-01303A-01-0983

**ARIZONA-AMERICAN WATER
COMPANY'S EXCEPTIONS TO
RECOMMENDED OPINION AND ORDER**

13 Arizona-American Water Company, an Arizona corporation (hereinafter "Arizona-
14 American" or "the Company"), hereby submits its Exceptions to the recommended form of
15 opinion and order filed by the Administrative Law Judge ("the Recommended Order") in the
16 above-entitled application.

17 For the reasons set forth hereinafter, Arizona-American respectfully disagrees with
18 the Administrative Law Judge's recommendations with respect to the imposition of
19 "Condition Thirteen." This condition, which would be imposed on Arizona-American as a
20 condition to approval of the subject transaction under A.A.C. R14-2-803, would effectively
21 require Arizona-American to guarantee a maximum cost of debt for a period of 10 years
22 after the transaction has closed. For the reasons set forth below, Arizona-American believes
23 that this condition is not only unreasonable and unwarranted, but is also unprecedented.
24 Arizona-American respectfully requests that the Commission approve the Recommended
25 Order, but with an amendment to Condition Thirteen limiting the time period during which
26 the Company is required to guarantee its cost of debt to no more than three years.

1 **A. Background and Overview of the Company's Application.**

2 The Recommended Order provides a detailed and accurate discussion of the
3 background concerning both the subject transaction and the proceedings that have
4 occurred to date before the Commission. Very simply, Arizona-American is an Arizona
5 corporation that currently provides water and wastewater services in Maricopa, Mohave
6 and Santa Cruz Counties. Arizona-American is a wholly-owned subsidiary of American
7 Water Works Company, Inc., a Delaware corporation ("AWW"). AWW is a publicly-
8 traded company, whose shares of common stock are traded on the New York Stock
9 Exchange, headquartered in Voorhees, New Jersey. It has more than 60 subsidiaries (both
10 regulated and unregulated), which collectively have a business presence in 27 states and
11 three Canadian provinces, including regulated water utilities in over 20 states. Turner
12 Reb. at 4.¹

13 As explained in the Recommended Order, the subject transaction concerns an
14 agreement made by AWW with RWE AG, a company organized under the laws of the
15 Federal Republic of Germany ("RWE"), and Thames Water Aqua Holdings GmbH, a
16 company organized under the laws of the Federal Republic of Germany and a wholly-
17 owned subsidiary of RWE ("Thames Holdings"). Turner Reb. at 5.² Under this
18 agreement, all of AWW's issued and outstanding common stock will be acquired by
19 Thames Water Aqua U.S. Holdings, a Delaware corporation and a wholly-owned
20 subsidiary of Thames Holdings. Tr. at 74-78. The acquisition of AWW's common stock
21 will be accomplished by means of a merger in which Apollo Acquisition Company, also a

22 ¹ Citations to the record will be abbreviated as follows: the transcript of the August 8,
23 2002 hearing will be cited as "TR." The rebuttal testimony of the Company's witnesses,
24 Mr. Turner and Mr. McGivern, will be cited as "Turner Reb." and "McGivern Reb." The
direct testimony of Staff's witnesses, Mr. Carlson, Mr. Reiker and Mr. Chelus, will be
cited as "Carlson Dir.," "Reiker Dir." and "Chelus Dir.," respectively.

25 ² A complete copy of the agreement made between AWW, RWE and Thames Holdings is
26 attached to Arizona-American Application, which was filed in the docket of this matter on
December 17, 2001.

1 Delaware corporation controlled by Thames Holdings, will be merged into AWW, with
2 AWW surviving the merger. *Id.*; *see also* McGivern Reb. at 3-4. In conjunction with the
3 merger, the issued and outstanding shares of AWW's common stock will be purchased at
4 an agreed price of \$46.00 per share. *Id.*

5 As explained in the Recommended Order, both RWE and Thames Holdings are
6 large industrial concerns, with business operations throughout the world, including
7 extensive water and wastewater utility operations. *See* Recommended Order at 3 and ns. 2
8 & 3. Following the completion of the transaction, AWW will remain in existence as a
9 wholly-owned subsidiary of Thames Water Aqua U.S. Holdings, and be responsible for
10 managing the Americas region (North and South America) of Thames' utility operations.
11 Arizona-American will continue to be a wholly-owned subsidiary of AWW and will
12 continue to provide water and wastewater utility services in Arizona under the
13 Commission's jurisdiction. Tr. at 91-92; McGivern Reb. at 4; Turner Reb. at 6. As
14 explained by James McGivern, the Managing Director of Thames Water's Americas
15 business operations, during the hearing in this docket:

16 [T]he people making the decisions today will be the same
17 people making the decisions tomorrow and into the future of
18 the acquisition. That is the intention. It's not meant to have
any change in that respect.

19 Tr. at 92. Local and regional management will not change, and there will be no reduction
20 in Arizona-American's local staffing as a result of the transaction. *Id.* at 95; McGivern
21 Reb. at 4.

22 In addition, there will be no changes in Arizona-American's rates and charges for
23 service as a result of the transaction. Arizona-American's capital structure will not
24 change. Turner Reb. at 6. There will be no request to recover any acquisition premium or
25 any other costs associated with the transaction. Tr. at 16-17, 91-92; McGivern Reb at 4-5;
26 Turner Reb. at 6-7. There will not be any cross-subsidization of any affiliates, and any

1 transactions between Arizona-American and any "affiliate," as such term is defined in
2 A.A.C. R14-2-801, will continue to be subject to the Affiliated Interests Rules and other
3 regulatory requirements of the Commission. Turner Reb. at 8. Put simply, the transaction
4 will be "transparent" to Arizona-American and its utility customers. Turner Reb. at 7.
5 There is simply no evidence in the record of any adverse impact on Arizona-American's
6 customers from the transaction.

7 **B. Summary of the Parties' Positions.**

8 In its application and subsequent amendment, Arizona-American has maintained
9 that it is entitled to a waiver from the Commission's Affiliated Interests Rules, A.A.C.
10 R14-2-801, *et seq.*, with respect to the transaction pursuant to R14-2-806 or, in the
11 alternative, to a declaration that the Commission lacks jurisdiction over the transaction
12 because the transaction does not directly involve Arizona-American, but instead involves
13 Arizona-American's parent, AWW, whose publicly-traded common stock is being
14 acquired by means of a merger with a foreign (i.e., non-Arizona) corporation.
15 Alternatively, Arizona-American has requested approval of the transaction as a
16 "reorganization of a holding company" pursuant to R14-2-803.

17 The Commission's Utilities Division ("Staff") has recommended approval of the
18 transaction pursuant to R14-2-803, subject, however, to a series of 15 conditions.
19 Ultimately, Arizona-American, seeking a cooperative resolution, and Staff reached
20 agreement on 13 of the conditions (although several conditions required clarification, as
21 indicated in the Recommended Order). However, the parties disagreed on the language of
22 two of Staff's proposed conditions, including Condition Thirteen.

23 Under the Recommended Order, Staff's version of those conditions would be
24 adopted and imposed on Arizona-American, in addition to the conditions the parties
25 agreed on. Based specifically on the discussion of Condition Three found on pages 7 – 8
26 of the Recommended Order, Arizona-American will accept that condition. Consequently,

1 the only condition that remains in dispute is Condition Thirteen. For the reasons
2 explained below, Condition Thirteen is excessive and unreasonable, and should be
3 removed or limited in duration to no more than three years.

4 **C. The Transaction Satisfies the Criteria Set Forth in R14-2-803 Without**
5 **the Conditions.**

6 R14-2-803 requires any utility or affiliate intending to reorganize an existing public
7 utility holding company to notify Staff in writing at least 120 days prior to the
8 reorganization, and to provide certain specified information. A.A.C. R14-2-803(A).³
9 Following receipt of the notice of intent, Staff must notify the applicant of any questions it
10 may have concerning the notice, following which the Commission, within 60 days from
11 the receipt of the notice of intent, must decide whether to hold a hearing or approve the
12 reorganization without a hearing. A.A.C. R14-2-803(B). Although the Commission may
13 reject the proposed reorganization of the holding company, it may do so only on one or
14 more of three specific grounds:

- 15 (1) The transaction would impair the financial status of the public utility;
16 (2) The transaction would prevent the public utility from attracting capital at fair
17 and reasonable terms; or
18 (3) The transaction would impair the ability of the public utility to provide safe,
reasonable and adequate service.

19 A.A.C. R14-2-803(C).

20 In this case, the evidence plainly shows that each of the three criteria is satisfied.
21 First, there is no evidence that the transaction “would impair the financial status” of
22 Arizona-American. The evidence shows that Arizona-American’s capital structure will
23 not change as a result of the transaction, nor will any expenses associated with the
24 transaction be passed on to Arizona-American. Arizona-American will continue to exist

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26 ³ Under the definitions provided in the Affiliated Interests Rules, AWW is a holding
company because it is an “affiliate that controls a public utility.” A.A.C. R14-2-801(4).

1 as a wholly-owned subsidiary of AWW and effectively operate as a stand-alone entity
2 subject to this Commission's jurisdiction. Presumably, for these reasons, none of Staff's
3 witnesses expressed any concern about the impact of the transaction on Arizona-
4 American's financial status. See Carlson Dir. at 4-5; Reiker Dir. at 2-6.

5 The second criterion is also satisfied. There is simply no evidence that the
6 transaction would prevent Arizona-American "from attracting capital at fair and
7 reasonable terms." In fact, Staff acknowledged that to the extent the transaction affects
8 Arizona-American's ability to attract capital at all, that impact will be *positive* based on
9 RWE's superior credit ratings, RWE's access to international capital markets and RWE's
10 larger market capitalization. See Reiker Dir. at 3-4. Staff's financial analyst testified that
11 "RWE's favorable bond ratings may flow through to AWCC, lowering the cost of debt to
12 AWCC and ultimately, Arizona-American. Assuming all other things are held constant, a
13 lower cost of debt to Arizona-American would result in a lower overall cost of capital in
14 future rate cases." Reiker Dir. at 5.

15 Finally, there was no dispute that the third criterion in the rule is satisfied. The
16 Staff engineering witness investigated the impact of the transaction on Arizona-
17 American's ability to "provide safe, reasonable and adequate service," and concluded that
18 he foresees no adverse impact as a result of the transaction. Chelus Dir. at 4. He also
19 testified, based on his investigation, that local management and staffing levels will not
20 change as a result of the transaction, which was confirmed by Mr. McGivern at the
21 August 8 hearing. See Chelus Dir. at 3-4; Tr. at 91-92.

22 In short, there is no evidence that would allow the proposed reorganization to be
23 rejected under the criteria established by the Commission in R14-2-803(C). Therefore,
24 there is no basis for any of the conditions Staff recommended and which the
25 Recommended Order would impose.

26

1 **D. Arizona-American's Final Position Regarding the Conditions**
2 **Recommended by Staff Should Be Adopted by the Commission.**

3 Despite Staff's general agreement that the criteria set forth in R14-2-803(C) have
4 been satisfied, Staff nevertheless urged approval of the reorganization subject to 15
5 separate conditions. Carlson Dir. at 6-7. The legal basis for imposing these conditions in
6 light of the plain language of R14-2-803 has never been explained (and, as explained
7 above, does not exist). The pre-filed testimony of the key Staff witness, Mr. Carlson, is
8 cryptic at best, and expressed only a vague concern that the "acquisition may present the
9 opportunity for [Arizona-American] to share customer data" with affiliates. Carlson Dir.
10 at 5. Obviously, this is not one of the Commission's three criteria in R14-2-803.⁴ It
11 appears that Staff may maintain that there are additional, unstated requirements inherent in
12 the rule, which allow conditions and requirements to be imposed on the local utility, even
13 if the test in subpart (C) of the rule has been satisfied.

14 Despite the lack of credible evidence,⁵ the Recommended Order would adopt
15 Staff's position on the basis of the "public interest." *See, e.g.*, Recommended Order at 11,
16 ls. 15-20. R14-2-803 contains no such standard, which would open the door to imposing
17 conditions and requirements without regard to the plain language of the Commission's
18 rule and without regard to the limits on the Commission's jurisdiction. *See, e.g., Ariz.*
19 *Corp. Comm'n v. State ex rel. Woods*, 171 Ariz. 286, 297-98, 830 P.2d 807, 818-19 (1992)
20 (the Affiliated Interests Rules "apply *only* to public utilities subject to the Commission's
21 jurisdiction," and "*only* regulate transactions between those utilities and their affiliates";
22 italics supplied). No court would approve such an open-ended standard for agency

23 _____
24 ⁴ However, this concern is addressed in Conditions Nine and Ten, which Arizona-
American has agreed to accept.

25 ⁵ The Staff witness chiefly responsible for sponsoring Staff's recommended conditions
26 was unable to explain the requirements already imposed on Arizona-American by the
Affiliated Interests Rules. Tr. at 138-142.

1 decision-making.

2 In order to cooperate with Staff, and without waiving its jurisdictional arguments,
3 Arizona-American has agreed to a modified version of the conditions recommended by
4 Staff. *See* Turner Dir. at 15; Tr. at 14. As discussed above, the only condition that
5 remains in dispute is Condition Thirteen. Arizona-American maintains that this condition,
6 as proposed by Staff, is unnecessary and unfairly burdensome to the Company. However,
7 the Administrative Law Judge has recommended that Staff's version of Condition
8 Thirteen be adopted and imposed on Arizona-American. For the reasons explained below,
9 Arizona-American maintains this is inappropriate.

10 **E. Staff's Version of Condition Thirteen Is Unreasonable and Unfair to the**
11 **Company.**

12 Condition Thirteen, as proposed by Staff, provides:

13 The cost of debt issued after the closing date of the
14 reorganization for purposes of setting rates in AAWC's rate
15 proceedings, filed within *ten years* from the effective date of
the reorganization, shall reflect a rating of A- (S&P) / Baa1
(Moody's) or higher. [Italics supplied.]

16 The credit ratings contained in this condition are the current credit ratings of American
17 Water Capital Corp. ("AWCC"), which is a subsidiary of AWW and provides debt capital
18 and financial management services to AWW and its utility subsidiaries, including
19 Arizona-American. This condition effectively guarantees a maximum interest rate (cost)
20 for any debt that is issued for a period of 10 years after the transaction has closed,
21 regardless of any other factors, including changes that may occur in the capital markets or
22 otherwise (e.g., concerns about the impact of new water quality standards or similar
23 requirements affecting the water industry).

24 This condition is both unprecedented and inappropriate. *See* Tr. at 27-30. The
25 basic justification for the condition is that RWE's credit ratings are superior to those of
26 AWCC and may ultimately translate to a lower debt cost and an overall decrease in

1 Arizona-American's cost of capital. See Reiker Dir. at 3-4. While RWE's favorable
2 credit ratings may flow through to AWCC and, ultimately, to Arizona-American, Staff is
3 concerned that the reverse could also occur, *i.e.*, RWE's credit ratings could be
4 downgraded in the future, resulting in a higher cost of debt. Thus, by using AWCC's
5 current credit ratings to set a ceiling on the cost of future debt for Arizona-American, Staff
6 hopes to reap the benefit of RWE's superior credit ratings, while eliminating any
7 downside.

8 This condition also ignores the fact that credit ratings involve subjective
9 determinations made by investment services. Tr. at 28. For example, AWCC's current
10 credit rating from Standard and Poor's, A-, is one notch greater than Moody's current
11 rating, Baa1. See Reiker Dir. at 4 and Exhibit JMR-1. Moreover, credit ratings can be
12 driven by a number of different factors that are beyond the control of RWE, Thames
13 Water or AWW. Thus, the credit rating of AWCC may be affected by changes in
14 regulatory requirements or other factors affecting the utility industry or the economy
15 generally, regardless of the business activities of RWE or its subsidiaries. Tr. at 28-30.

16 The Staff finance witness acknowledged this situation at the hearing:

17 Q. [By Mr. James] And bond ratings can be influenced by
18 a variety of factors, some of which are outside the
control of the company, correct?

19 A. [By Mr. Reiker] That is correct.

20 Q. So it's conceivable that the bond rating of American
21 Water Capital Corporation, the current lender for the
22 local affiliate here, could deteriorate for conditions that
have nothing to do with Thames' operations or RWE's
business activities, correct?

23 A. That is certainly possible.

24 Tr. at 165. Because credit ratings by investment services are subjective and are impacted
25 by circumstances beyond the company's control, it is inappropriate to force Arizona-
26

1 American to guarantee a particular minimum debt cost as a condition of the
2 reorganization. Further, as Mr. Turner testified, this condition could weaken Arizona-
3 American financially and lead to more frequent rate increase applications to maintain cash
4 flows and debt service coverages. Tr. at 29-30.

5 Finally, Arizona-American has agreed to accept Condition Fourteen, under which
6 Arizona-American agrees that in any future Commission proceedings, it will not seek a
7 higher cost of capital than that which Arizona-American would have been authorized as a
8 stand-alone entity. As clarified by the Staff finance witness during the hearing, the
9 interest rate and other terms of any debt provided by AWCC (or any other affiliate) will be
10 compared to the interest rate and other terms that could be obtained by Arizona-American
11 from a third-party lender in the marketplace. Tr. at 161-164. Consequently, Arizona-
12 American's cost of capital (including debt) can never be greater than the cost for Arizona-
13 American to obtain debt and equity financing on its own. Thus, Condition Fourteen
14 eliminates the possibility that an adverse credit rating will cause Arizona-American's cost
15 of debt in a future rate proceeding to exceed the current market cost of debt for a business
16 organization comparable to Arizona-American.

17 Despite these serious problems, Arizona-American has agreed to Condition
18 Thirteen, but only if this condition remains in effect for a period of *no more than three*
19 years from the effective date of the transaction, as opposed to 10 years as recommended
20 by Staff and the Administrative Law Judge. For the reasons set forth above, any guarantee
21 concerning future debt costs is unreasonable and may ultimately punish Arizona-American
22 based on circumstances beyond its control and the control of RWE and its affiliates. If a
23 condition like Condition Thirteen is imposed at all, the term of such condition should be
24 no more than three years.

25

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1 **F. Conclusion.**

2 It is undisputed that the transaction will have no adverse effect on Arizona-
3 American. Arizona-American will still be a wholly-owned subsidiary of AWW, its local
4 management and staffing will not change, its capital structure will not change and no costs
5 or expenses associated with the transaction will be pushed down to Arizona-American. In
6 addition, even Staff acknowledges that Arizona-American is likely to benefit by becoming
7 part of a larger, financially stable business organization with a substantially larger market
8 capitalization and access to international capital markets, as well as the expertise of
9 Thames Water, which manages water systems on six continents. Finally, Arizona-
10 American will remain subject to the Commission's regulatory jurisdiction and
11 requirements, including the Affiliated Interests Rules, which already impose stringent
12 requirements on Arizona-American's dealings with affiliates. *See* A.A.C. R14-2-804.

13 Without waiving its jurisdictional and other arguments, Arizona-American has, in
14 good faith, agreed to the treatment of its application as an application for approval of the
15 reorganization of a public utility holding company pursuant to R14-2-803. As explained,
16 there are three criteria set forth in subpart (C) of that rule on which the Commission may
17 reject the proposed reorganization. The evidence shows that each of those criteria are
18 satisfied in this case, and, consequently, there is no basis to reject Arizona-American's
19 application. The conditions proposed by Staff, therefore, constitute a "belt-and
20 suspenders" approach that goes well beyond the rule's requirement and, as the record
21 shows, is unsupported by competent evidence.

22 The foregoing notwithstanding, in order to reach a compromise with Staff,
23 Arizona-American has agreed to the imposition of the conditions set forth on pages 4
24 through 6 of the Recommended Order, as clarified during the hearing. With respect to
25 Condition Thirteen, however, Arizona-American respectfully submits that the
26 Recommended Order goes well beyond what is reasonable and necessary under the

1 Affiliated Interests Rules or otherwise. Arizona-American therefore requests that
2 Condition Thirteen either be eliminated or that its duration be shortened to not more than
3 three years, and that the transaction be approved subject to that condition.

4 RESPECTFULLY SUBMITTED this 13th day of November, 2002.

5 FENNEMORE CRAIG, P.C.

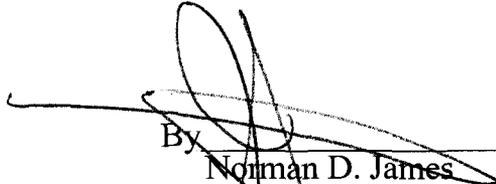
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12 13th day of November, 2002, to:

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