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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission

COMMISSIONERS

DOCKETED

JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MIKE GLEASON
KRISTIN K. MAYES
BARRY WONG

AUG 29 2006

DOCKETED BY nr

IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY FOR
AN AFFILIATE AGREEMENT WITH
AMERICAN WATER RESOURCES, INC.

DOCKET NO. WS-01303A-05-0170

DECISION NO. 68916

OPINION AND ORDER

DATE OF HEARING: August 10, 2005

PLACE OF HEARING: Phoenix, Arizona

ADMINISTRATIVE LAW JUDGE: Dwight D. Nodes¹

APPEARANCES: Mr. Craig A. Marks, on behalf of Applicant; and
Mr. Timothy J. Sabo, Staff Attorney, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

BY THE COMMISSION:

On March 9, 2005, Arizona-American Water Company ("Arizona-American") filed with the Arizona Corporation Commission ("Commission") an Agreement For Support Services Between American Water Resources, Inc. ("AWR") and Arizona-American.

On June 9, 2005, Arizona-American and the Commission's Utilities Division ("Staff") filed a Stipulation setting forth a proposed procedural schedule.

On June 10, 2005, a procedural order was issued setting the matter for hearing on August 10, 2005 and establishing a procedural schedule.

On June 14, 2005, Arizona-American and Staff filed a Stipulation requesting that the procedural schedule established by the June 10, 2005 procedural order be changed.

On June 17, 2005, a procedural order was issued with the requested changes to the schedule

¹ Administrative Law Judge Dwight Nodes conducted the hearing in this matter. Administrative Law Judge Amy Bjelland drafted the Recommended Opinion and Order.

1 and retaining the original hearing date.

2 On June 24, 2005, Staff filed its Notice of Filing the Direct Testimony of Linda A. Jaress.

3 On July 22, 2005, Arizona-American filed the Joint Direct Testimony of Clifford C. Groh and
4 Brian K. Biesemeyer.

5 On August 5, 2005, Staff filed its Notice of Filing the Rebuttal Testimony of Linda A. Jaress.

6 On August 10, 2005, the hearing was held as scheduled before a duly authorized
7 Administrative Law Judge of the Commission. Both parties were represented by counsel. The matter
8 was taken under advisement pending submission of late-filed exhibits and closing briefs.

9 On September 9, 2005, Arizona-American filed two late-filed exhibits.

10 On September 23, 2005, Arizona-American and Staff filed simultaneous Closing Briefs.

11 * * * * *

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

14 **FINDINGS OF FACT**

15 1. Arizona-American provides water and/or sewer service to over 121,000 customers in
16 Arizona. Arizona-American and AWR are both subsidiaries of American Water Works Company,
17 whose ultimate parent is RWE AG, a company organized under the laws of the Federal Republic of
18 Germany. The merger of Arizona-American's parent company, American Water Works Company,
19 Inc., with a subsidiary of RWE was approved by Decision No. 65453 (December 12, 2002) ("RWE
20 Acquisition Order").

21 2. Arizona-American wishes to enter into an affiliate agreement with AWR to provide
22 programs wherein Arizona-American customers would be given the opportunity to subscribe with
23 AWR for water and sewer line insurance programs. AWR has similar water and sewer line
24 insurance programs in eleven other states. The program is similar to Qwest Corporation's Linebacker
25 program, except that AWR, Arizona-American's unregulated affiliate, would administer the program.

26 3. Linda Jaress, Executive Consultant III for the Commission's Utilities Division, stated
27 that Staff does not believe that Arizona-American has shown that the Agreement is in the public
28 interest and therefore Staff recommended rejection of the Agreement; however, in the event the

1 agreement is accepted by the Commission, Staff recommended various conditions attendant thereto.
2 Arizona-American maintains that the Agreement is in the public interest, and is willing to accept
3 several of Staff's recommendations in the event the Agreement is approved.

4 **The Proposed Protection Programs**

5 4. Water and sewer line customers own the service lines on their property. In the case of
6 a water line, the customer owns the line from the water meter to the shut-off valve outside the house;
7 in the case of a sewer line, the customer owns the line from the property line to the house. The
8 customer is responsible for correcting problems arising with those areas of the line(s), whether caused
9 by tree-root incursions, seasonal soil subsidence, aging, or other normal wear and tear.

10 5. AWR's Water Line Protection Program and Sewer Line Protection Program
11 (collectively, the "Programs") are for residential customers who wish to purchase insurance against
12 leaks and breaks in the water or sewer lines that belong to the customer. For an annual fee, AWR
13 would provide for the repair of the line(s), including obtaining permitting, site restoration, and
14 provision of independent licensed contractors². The annual fee for the Water Line Protection
15 Program would be \$60 to cover the cost of repair for damage resulting from "normal wear and tear"
16 up to \$4,000 per occurrence. The annual fee for the Sewer Line Protection Program would be \$109
17 to cover the cost of repair for damage, again from "normal wear and tear," as well as for clog
18 removal, up to \$4,000 per occurrence, subject to a \$50 fee for service each time an independent
19 contractor is dispatched to the customer's home.

20 6. Under the terms of the proposed Agreement, Arizona-American would distribute
21 AWR informational and promotional materials, and from time to time, customer satisfaction surveys
22 regarding the Programs, to Arizona-American customers. AWR would be responsible for all
23 associated costs. The Agreement provides for repair service coordination by allowing an Arizona-
24 American employee who becomes aware of damage to a customer's line(s), and knows that the
25 customer is enrolled in the applicable Program, to notify AWR. Billing for either or both Programs
26 would be done via the customer's water or sewer bill issued by Arizona-American, which would then
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28 ² No Arizona-American or AWR employees would make service line repairs.

1 forward the funds to AWR.

2 **Compensation for Services and Other Alternative Staff Recommendations**

3 7. The fee to be paid Arizona-American by AWR for services rendered pursuant to the
4 Agreement would be the greater of 115 percent of fully distributed costs incurred by Arizona-
5 American in providing the services, or the market price for the services if one is ascertainable.
6 However, the Agreement provides that billing and collection services would be \$0.10 per customer
7 per monthly billing.

8 8. If the Commission rejects Staff's primary recommendation to deny the application in
9 its entirety, Staff recommends that the Agreement be modified to indicate that Arizona-American
10 should be compensated for its services, including billing and collection services, at 115 percent of
11 fully allocated costs or prevailing market prices, whichever is higher, and that in its next rate case,
12 Arizona-American should provide information and workpapers showing the calculation of the market
13 price and fully allocated costs. Staff observed that the companies' objection does not appear to be
14 due to unsoundness of the recommendation, but rather because they believe it to be impractical.

15 9. Arizona-American argued that the \$0.10 amount should be approved, as it would be a
16 windfall to Arizona-American because the actual cost to provide the service is negligible and consists
17 only of providing an additional line to reflect the monthly fee for the Programs onto the customer's
18 monthly water or sewer bill.

19 10. Mr. Groh testified that:

20
21 [t]he 10-cent per bill amount was developed in the Fall of 2001 via
22 negotiations between AWR and its affiliate New Jersey American Water
23 Company (NJAM) to enter into an Agreement for Support Services for the
24 Programs. At that time, NJAM determined that its cost for imprinting on a
customer's water bill a single line item charge for the Program and a
separate line item charge for applicable New Jersey state sales tax would
be pennies per month.³

25 Also, during the testimony of Mr. Brian K. Biesemeyer, Arizona-American's Network General
26 Manager, the \$0.10 charge was characterized as financial "gravy"⁴ for Arizona-American.

27 _____
28 ³ Tr. at 51.

⁴ *Id.* at 54.

1 **Potential Customer Confusion and Costs**

2 11. Staff concluded that the promotional materials initially provided by Arizona-
3 American, which are in use in New Jersey, where AWR offers the Programs, could lead to customer
4 confusion.

5 12. The Commission previously addressed the shared use of utility names and logos with
6 competitive affiliates in Decision No. 62416 (April 3, 2000), wherein the Commission approved
7 Arizona Public Service's ("APS") Code of Conduct for use in competitive activities. The Code of
8 Conduct prohibited the shared use of the APS name and logo by its competitive affiliates. The
9 Commission approved similar language for Tucson Electric Power in Decision No. 62767 (August 2,
10 2000).

11 13. With respect to the Programs proposed in this proceeding, Staff expressed its concern
12 that "the language of the promotional materials, as in most advertisement, is given to hyperbole and
13 written to stir the emotions."⁵

14 14. Staff also stated that, if approved, the Programs would affect the Commission and
15 Commission Staff because the Commission's name, address and telephone number appears on all of
16 Arizona-American's bills, wherein charges for the Programs would appear. The Commission's
17 Consumer Services Section currently receives calls and complaints regarding disputes over the
18 Linebacker program offered by Qwest Corporation, which is somewhat similar to the Programs.
19 Therefore, Staff expects an increase in the number of calls taken by Commission Staff; however, the
20 Commission's Compliance Division Staff would be unable to assist in resolving complaints regarding
21 the unregulated affiliate's activities. Further, if the Programs and Agreements are approved subject
22 to certain conditions, the Commission's Compliance Section will also be involved.

23 15. Staff stated that Arizona-American's rate cases would also be complicated by the
24 addition of the Programs and could result in higher rate case expenses, which are recovered through
25 rates to customers. Staff noted that Arizona-American's typical rate case expenses are significant and
26 cited Decision No. 67093 (June 30, 2004), wherein the Commission approved recovery of \$418,941
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28 ⁵ Direct Testimony of Linda Jaress, p. 16.

1 of rate case expenses.

2 **Potential Customer Benefits**

3 16. Staff stated that the primary beneficiary of the Programs would be the unregulated
4 affiliate, AWR, which stands to reap substantial profit. However, Staff conceded that Arizona-
5 American's rate payers could benefit from successful Programs if the price for all the services
6 Arizona-American provides to AWR is set at a level equal to Arizona-American's fully allocated cost
7 plus 15 percent, or market, whichever is higher, and if the net income from those services is included
8 above-the-line for ratemaking purposes, the Programs could result in a lower revenue requirement in
9 Arizona-American's next rate case, which translates into lower rates for customers. Additionally, for
10 customers who enroll in the Programs who have a coverable claim for water or sewer line leaks or
11 breaks, the Programs could be worthwhile.

12 17. Mr. Biesemeyer testified at hearing that there is a great benefit to the consumer that
13 has a coverable claim in that Arizona-American would refer that customer immediately to AWR,
14 which would then immediately arrange for the necessary repairs.⁶ Mr. Biesemeyer testified that
15 Arizona-American does not give referrals to plumbers or contractors to its customers, so customers
16 without Program subscriptions would have to engage a plumber or contractor on their own.⁷

17 **Profitability**

18 18. Arizona-American provided confidential responses to Staff regarding profitability
19 under the Programs for Arizona-American. Mr. Clifford C. Groh, Director of Business Development
20 and Operations for AWR, testified under seal to confidential information regarding profitability under
21 the Programs for AWR. Arizona-American expects a low level of net income from providing
22 services to AWR as specified in the Agreement; AWR expects to reap substantial revenue by the
23 fourth year of the Programs.

24 19. From the confidential information provided, Staff gave a range of estimates of
25 revenues that could be generated by the Programs. If five percent of Arizona-American's 121,000
26 customers enroll in both Programs, AWR's revenues would be approximately \$1.0 million. If 20

27 ⁶ Tr. at 55 and 56.

28 ⁷ *Id.*

1 percent enroll, revenues for AWR would be over approximately \$4.0 million.

2 20. At hearing, Mr. Groh suggested that AWR would be willing to share 50 percent of its
3 profits with Arizona-American only if Arizona-American were also willing to take 50 percent of the
4 risk or losses associated with the Programs.⁸ Mr. Groh testified that AWR “would consider [sharing
5 profit with Arizona-American] but I think it would need to be balanced also with the willingness of
6 Arizona-American Water to share the losses as well if any.”⁹

7 **Privacy Concerns**

8 21. During the discovery process, Staff requested that both Arizona-American and AWR
9 provide their policies with regard to the dissemination of customer-specific information such as
10 name, address, telephone number, usage, bill payment history, etc. Arizona-American does not have
11 a written policy, but informed Staff that “[e]xcept in response to a request from a police agency or to
12 a subpoena, the company never provides usage or bill payment history to any party.” Customer
13 names, addresses, and telephone numbers would be shared with AWR or with any non-affiliate
14 offering services similar to AWR’s Programs.

15 22. AWR informed Staff that while it does not share customer-specific information with
16 non-affiliated companies, it does share such information with an external marketing agency that helps
17 AWR “develop promotional materials, conduct marketing campaigns and provide analyses of
18 campaign results.” AWR stated that it uses a formal agreement with its external marketing agency to
19 maintain the confidentiality of this customer-specific information; however, AWR did not provide the
20 agreement it currently uses because it is in the process of negotiating a new marketing agreement.
21 Based on the new, unsigned agreement that was provided to Staff by AWR, Staff concluded that
22 although one section purports to protect against the distribution of customer-specific information, the
23 last phrase of the section reads “...unless otherwise specifically authorized in writing by the
24 Company”, indicating to Staff that currently there is no agreement between AWR and its marketing
25 agency(ies) that protects customer-specific information of Arizona-American’s customers.
26 Therefore, Staff recommended that the Commission condition any approval of the Agreement upon
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28 ⁸ Tr. at 44.

⁹ *Id.* at 45.

1 the filing of a signed contract between AWR and its marketing agency that prohibits the
2 dissemination of the customer-specific information that AWR receives from Arizona-American.

3 23. Staff further recommended that the Commission require Arizona-American, before
4 disseminating customer-specific information to an affiliate or non-affiliate, to inform the customer
5 regarding what information would be released and for what purpose. The customer must
6 affirmatively respond before such information is disseminated. Non-response by the customer should
7 not be considered consent. This requirement should not apply to requests from police agencies or
8 subpoenas.

9 **Action in Other Jurisdictions**

10 24. Staff stated that its research indicates that similar programs are common in other
11 states, especially in the northeast where freezing temperatures may reduce the life of a service line.
12 Staff provided examples of similar programs and their costs, which ranged from \$1.99 per month to
13 \$210 per year.

14 25. AWR indicated that it provides similar Programs in 11 other states. Only four states,
15 Pennsylvania, Virginia, West Virginia, and Illinois required approval for the affiliated utility to
16 institute the Programs through an affiliate agreement. Although Pennsylvania and Virginia approved
17 the applications for provision of water and sewer line insurance programs by AWR, Virginia required
18 removal of and changes to contract language that related to pricing and to commission approval of
19 future changes in the Programs or contract. Virginia also limited the approval to five years.

20 26. The West Virginia Public Service Commission Staff presented testimony expressing
21 its concerns over the cost allocations included in the agreement. West Virginia-American eventually
22 withdrew its application after testimony was filed and a hearing was held.

23 27. The Illinois Commission denied the application based upon "...the open ended nature
24 of the amended affiliate agreement...[and] the absence of any substantive evidence demonstrating
25 that the [Program] is properly priced or is even legitimately necessary"¹⁰.

26 28. Although AWR was ultimately able to institute the Programs in Illinois and West
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28 ¹⁰ Illinois Order Docket No. 02-0101 (September 16, 2003).

1 Virginia, the Programs were implemented without the assistance of the affiliated utilities.

2 **Affiliated Interest Rules Issue Raised by Staff**

3 29. The Commission's Affiliated Interests rules, R14-2-801 *et seq.*, apply to all Class A
4 investor-owned utilities under the jurisdiction of the Commission. Arizona-American is a Class A
5 investor-owned utility. Under the rules, a utility such as Arizona-American is prohibited from
6 conducting business with an affiliate unless the affiliate agrees to provide the Commission access to
7 its records for the purposes of auditing or investigating transactions between the utility and affiliate.

8 30. During the course of its investigation in this matter, Staff indicated that pursuant to the
9 Affiliated Interests rules, RWE AG is both a public utility holding company and an affiliate of
10 Arizona-American, and therefore must file a notice with the Commission when it intends to perform
11 a reorganization.¹¹

12 31. Staff stated that because neither RWE nor Arizona-American has ever filed for any
13 form of waiver from the Affiliated Interests Rules other than the requested waiver from the Rules
14 when RWE acquired American Water Works, Arizona-American should file for an appropriate
15 waiver from the Rules to clarify the type of transaction for which its parent, American Water, and its
16 ultimate parent, RWE, would need to file notice with this Commission of organizations and
17 reorganizations of the public utility holding company. Ms. Jaress testified at hearing that:

18 RWE is a public utility holding company and it's been making
19 transactions, mergers, divestitures without filing for approval or waivers.
20 I thought it would be appropriate if not necessary for the company to file,
21 make some kind of filing that would clear up any transactions that may
have required approval or notice that weren't approved or explain why
they didn't require notice or approval.¹²

22 When asked whether "every time RWE acquires a new affiliate or divests an affiliate that it should
23 come to the Commission for some sort of a waiver of the rules?"¹³ Ms. Jaress replied, "I'm
24 suggesting that the Commission should make that decision whether or not any or all of those
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26 ¹¹ Pursuant to A.A.C. R14-2-801, reorganization is the "acquisition or divestiture of a financial interest in an affiliate or a
27 utility, or reconfiguration of an existing affiliate or utility's position in the corporate structure or the merger of
consolidation of an affiliate or a utility."

28 ¹² *Id.* at 120.

¹³ *Id.* at 121.

1 transactions need approval.”¹⁴

2 32. Arizona-American and AWR stated in their response to the direct testimony of Ms.
3 Jaress that they object to this recommendation because they do not understand its necessity. Arizona-
4 American further argued that such a filing would not be necessary in this docket, nor would it be
5 appropriate for the Commission to impose such a requirement where Staff did not specifically
6 identify activities of specific affiliates that would require such a waiver.

7 33. We agree with Staff that the Commission must make the decision whether any or all of
8 the transactions of RWE need approval. The obligation is upon the regulated entity to ensure
9 compliance with all Commission rules, and therefore we will order Arizona-American to either
10 request a waiver of the rules with regard to the various transactions that give rise to an affiliated-
11 interests issue, or to seek approval.

12 **Discussion and Conclusion**

13 34. Although the proposed Programs may allow Arizona-American’s customers to
14 ultimately realize some minimal benefits through revenues derived from the company’s unregulated
15 affiliate, we believe the potential costs outweigh any such speculative benefits. Even if additional
16 qualifying language were to be included on customer bills explaining the distinction between
17 Arizona-American and AWR, the fact that customers would be billed for the insurance services on
18 utility bills would undoubtedly lead to customer confusion regarding the provider of the services, and
19 customers could believe that such services are regulated by the Commission. Moreover, Staff cited to
20 the additional costs that are likely to be incurred by the Commission due to calls and complaints
21 received by the Consumer Services Section related to the proposed Programs. Of further concern is
22 the fact that Consumer Services Staff would be unable to resolve complaints regarding the
23 unregulated affiliate’s activities.

24 35. In addition, the limited revenues that would be received by Arizona-American through
25 the Programs, and thus the ultimate benefit accruing to ratepayers, would in all probability be offset
26 by the additional time and expenditure of Staff resources associated with auditing the Programs’
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28 ¹⁴ *Id.*

1 expenses and revenues, as well as the additional rate case expenses incurred by the company to
2 support the reasonableness of the Programs costs. Thus, after considering all aspects of Arizona-
3 American's proposal, we conclude that the Programs as proposed are not in the public interest and the
4 application should therefore be denied.

5 36. In denying the application, we wish to make clear that AWR, as an affiliate
6 unregulated by the Commission, is free to undertake selling its Programs pursuant to all applicable
7 insurance laws and regulations governing such activities. However, AWR may not use Arizona-
8 American's name and resources in marketing or promoting its Programs. As pointed out above,
9 AWR implemented its insurance products in Illinois and West Virginia without the assistance of the
10 regulated utility companies in those states, and it may decide to operate in a similar manner in
11 Arizona.

12 **CONCLUSIONS OF LAW**

13 1. Arizona-American is a public service corporation within the meaning of Article XV of
14 the Arizona Constitution and A.R.S. §40-281 *et seq.*

15 2. The Commission has jurisdiction over Arizona-American and the subject matter of the
16 docket.

17 3. Staff's recommendation to deny the application is reasonable and should be adopted.

18 4. Staff's recommendation to require Arizona-American to file either for an appropriate
19 waiver from the Rules, or approval of appropriate transaction(s), is reasonable and should be adopted.

20 **ORDER**

21 IT IS THEREFORE ORDERED that the application of Arizona-American Water Company
22 for an affiliate agreement with American Water Resources, Inc., shall be, and hereby is, denied.

23 ...
24 ...
25 ...
26 ...
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28 ...

1 IT IS FURTHER ORDERED that Arizona-American Water Company shall file either for an
2 appropriate waiver from the Rules to clarify the type of transaction for which its parent, American
3 Water Resources, Inc., and its ultimate parent, RWE AG, must file notice with this Commission or
4 for approval of appropriate transaction(s).

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

6 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

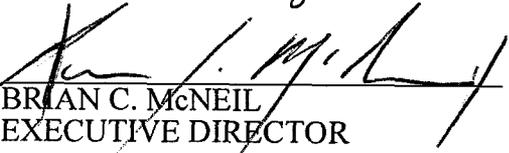
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 9 CHAIRMAN COMMISSIONER

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 11 COMMISSIONER COMMISSIONER COMMISSIONER

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13 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive
14 Director of the Arizona Corporation Commission, have
15 hereunto set my hand and caused the official seal of the
16 Commission to be affixed at the Capitol, in the City of Phoenix,
17 this 29th day of August, 2006.

18 
19 BRIAN C. McNEIL
20 EXECUTIVE DIRECTOR

21 DISSENT _____

22 DISSENT _____

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1 SERVICE LIST FOR: ARIZONA-AMERICAN WATER COMPANY
2 DOCKET NO.: W-01303A-05-0170
3 Craig A. Marks
Corporate Counsel
4 Arizona-American Water Company
19820 N. 7th Street, Ste. 201
5 Phoenix, AZ 85024
6 Christopher Kempley, Chief Counsel
Legal Division
7 ARIZONA CORPORATION COMMISSION
1200 West Washington Street
8 Phoenix, AZ 85007
9 Ernest G. Johnson, Director
Utilities Division
10 ARIZONA CORPORATION COMMISSION
1200 West Washington
11 Phoenix, AZ 85007

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