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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

Arizona Corporation Commission

DOCKETED

FEB 20 2007

JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MIKE GLEASON
KRISTIN K. MAYES
GARY PIERCE

DOCKETED BY
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IN THE MATTER OF ARIZONA-AMERICAN
WATER COMPANY, INC., FOR A FINDING OF
NO JURISDICTION, OR FOR A WAIVER OF THE
AFFILIATED INTERESTS RULES PURSUANT
TO A.A.C. R14-2-806, OR, IN THE
ALTERNATIVE, FOR APPROVAL OF AN
AFFILIATED INTERESTS TRANSACTION
PURSUANT TO A.A.C. R14-2-801 *et seq.*

DOCKET NO. SW-01303A-06-0274
W-01303A-06-0274
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DECISION NO. 69344

OPINION AND ORDER

DATE OF HEARING: November 29, 2006
PLACE OF HEARING: Phoenix, Arizona
ADMINISTRATIVE LAW JUDGE: Dwight D. Nodes
IN ATTENDANCE: Commissioner Mike Gleason
Commissioner Kristin K. Mayes
APPEARANCES: Mr. Thomas H. Campbell and Mr. Michael T. Hallam,
LEWIS AND ROCA, LLP, on behalf of Arizona-
American Water Company, Inc.; and
Ms. Janice Alward, Assistant Chief Counsel, Legal
Division, on behalf of the Utilities Division of the
Arizona Corporation Commission.

BY THE COMMISSION:

On April 25, 2006, Arizona-American Water Company, Inc. ("Arizona-American" or "Company") filed with the Arizona Corporation Commission ("Commission") an application for a finding of no jurisdiction or for a waiver of the Commission's Affiliated Interests Rules, pursuant to Arizona Administrative Code ("A.A.C.") R14-2-806 or, in the alternative, for approval of an affiliated interests transaction pursuant to A.A.C. R14-2-801, *et seq.* ("Application"). The Application states that Arizona-American's immediate parent, American Water Works Company, Inc. ("American Water") intends to merge with a subsidiary of RWE Aktiengesellschaft ("RWE") (the ultimate parent) and, upon completion of an initial public offering, American Water would return

1 to being a publicly traded company as it was prior to American Water's acquisition by RWE in 2003.

2 On July 28, 2006, the Commission issued Decision No. 68856, which suspended Commission
3 action on the filing.

4 On September 29, 2006, the Commission's Utilities Division Staff ("Staff") filed its Staff
5 Report in this matter recommending approval of an affiliated interests transaction, pursuant to A.A.C.
6 R14-2-803(A), subject to certain conditions.

7 By Procedural Order issued October 13, 2006, this matter was scheduled for hearing,
8 procedural filing deadlines were established, and the Company was directed to publish notice of the
9 Application and the hearing date.

10 On November 3, 2006, Arizona-American filed the Direct Testimony of John R Bigelow,
11 Paul Townsley, and Thomas Broderick in support of the Application.

12 On November 17, 2006, Staff filed the Rebuttal Testimony of James J. Dorf¹, reiterating the
13 Staff positions set forth in the Staff Report.

14 On November 28, 2006, the Company filed Affidavits of Publication in compliance with the
15 October 13, 2006 Procedural Order. No requests for intervention were received.

16 The hearing was held as scheduled on November 29, 2006 before a duly authorized
17 Administrative Law Judge. At the conclusion of the hearing, the matter was taken under advisement
18 pending submission of a late-filed exhibit and issuance of a Recommended Opinion and Order.

19 On December 13, 2006, Arizona-American submitted a late-filed exhibit in the form of a
20 letter outlining its agreement with Staff regarding the ongoing applicability of certain conditions
21 imposed by a prior Commission Decision.

22 * * * * *

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

25 **FINDINGS OF FACT**

26 1. As described in the Application and the Company's testimony, the proposed merger
27

28 ¹ Staff witness Gordon Fox adopted Mr. Dorf's testimony and testified at the hearing regarding Staff's position.

1 transaction is a two-step process. In the first step, Thames Water Aqua U.S. Holdings, Inc.
2 (“TWAUSHI”) would be merged with and into American Water, with America Water being the
3 surviving corporation. Upon completion of that transaction, Thames Water Aqua Holdings GmbH
4 (“Thames GmbH”)² would sell up to 100 percent of the common stock of American Water through
5 an initial public offering (“IPO”). In the event less than 100 percent of the shares are sold through
6 the IPO, due to market conditions, subsequent public offerings would be made to sell the remaining
7 shares of American Water stock (Ex. A-3, at 3-4).

8 2. RWE is a stock corporation incorporated under the laws of Germany, with
9 headquarters in Essen, Germany. Through various subsidiaries, RWE controls and operates
10 businesses engaged in electric power generation, trading, transmission and distribution of electric
11 power, natural gas and crude oil exploration and production (as well as natural gas transmission and
12 distribution), and water and wastewater related services. According to Company witness John
13 Bigelow, RWE is one of Europe’s leading integrated electric and gas companies, with operations
14 stretching from the United Kingdom to Eastern Europe (*Id.* at 5).

15 3. Thames GmbH is also a German corporation with headquarters in Essen, Germany.
16 Thames GmbH is wholly owned by RWE and is the intermediate holding company for most of
17 RWE’s water and wastewater operations. Thames GmbH owns 100 percent of the shares of
18 TWAUSHI but does not have any employees of its own (*Id.*).

19 4. TWAUSHI is a Delaware corporation headquartered in Voorhees, New Jersey.
20 TWAUSHI is the intermediate holding company for all of RWE’s water and wastewater businesses
21 in the United States, and is the direct parent of American Water (*Id.* at 5-6).

22 5. American Water is also a Delaware corporation based in Voorhees, New Jersey.
23 American Water’s principal business is investing in and owning the stock of water and wastewater
24 utility companies, such as Arizona-American. American Water and its operating subsidiaries have
25 approximately 6,000 employees and provide services to approximately 18 million people in 29 states
26 and three Canadian Provinces³. Prior to 2003, when it was acquired by RWE, American Water was

27 ² Thames GmbH is a 100 percent owned subsidiary of RWE.

28 ³ Arizona-American serves approximately 97,000 water customers and 47,000 wastewater customers in portions of Maricopa, Mohave, and Santa Cruz counties in Arizona (Ex. A-1, at 4).

1 one of the largest publicly traded water companies in the United States (*Id.*).

2 6. American Water Capital Corporation ("AWCC") is a direct subsidiary of American
3 Water which provides cash management and debt funding services for the American Water
4 subsidiaries. According to Mr. Bigelow, no changes will occur in the relationships between AWCC
5 and the American Water subsidiaries as a result of the RWE divestiture of American Water (*Id.* at 6-
6 7).

7 7. Prior to the American Water IPO, a registration statement must be filed with the
8 Securities and Exchange Commission ("SEC"). The registration statement will include a prospectus,
9 audited financial information, and risks associated with the investment offering. The Company
10 expects that the registration statement will be filed sometime after the first quarter of 2007,
11 whereupon the SEC will offer comments and American Water will file an amended registration
12 statement to address the SEC's comments. Assuming the SEC issues are resolved, and approval is
13 gained from the required state regulatory agencies, marketing of the IPO would ensue followed by a
14 request for the SEC to approve the registration statement. Upon approval, the offering's underwriters
15 and Thames GmbH would agree on a price per share for the IPO. Mr. Bigelow claims that RWE
16 does not intend to permit any person or entity to acquire a controlling interest in American Water
17 through the public offering, and American Water will include in the prospectus a statement that no
18 investor is permitted to acquire control of American Water without gaining necessary regulatory
19 approvals (*Id.* at 8-10).

20 8. According to the Company, RWE seeks to divest its water and wastewater businesses
21 to concentrate on its European power and energy markets, which are its core businesses. Mr.
22 Bigelow stated that RWE's decision to divest itself of American Water was based on RWE's need to
23 respond to fierce competition in its energy and power markets, growing customer needs, and rising
24 costs for energy production facilities (*Id.* at 10).

25 9. Arizona-American cited a number of benefits that it claims will be derived from
26 American Water returning to being a publicly traded company. The alleged benefits include being
27 subject to federal securities laws and stock exchange regulations, which the Company claims will
28 impose obligations on American Water related financial reporting, accounting, internal controls,

1 general business disclosures, corporate governance, executive compensation reporting, issuance of
2 securities and related financial and business matters. The Company also claims benefits related to
3 compliance with generally accepted accounting principles ("GAAP") in the United States, audit
4 requirements of American Water and its subsidiaries, and the transparency associated with required
5 SEC filings (including Sarbanes-Oxley compliance) (*Id.* at 11-12).

6 10. Mr. Bigelow stated that as a publicly traded company, American Water would have
7 access to public equity and debt capital markets in the United States, thereby enabling the Company
8 to raise capital to replace aging infrastructure and comply with increasingly stringent water quality
9 standards. He also indicated that American Water would have greater control of its own destiny and
10 would no longer have to compete for capital and management attention with other international
11 divisions of RWE. Currently, AWCC receives its debt financing from RWE, through the European
12 capital markets. Following the IPO, AWCC would acquire debt and equity from capital markets in
13 the United States.

14 11. Mr. Bigelow testified that, as of December 31, 2005, the total amount of AWCC
15 borrowing from RWE was \$2,438,586,000, of which \$2,030,286,000 will become due between June
16 2006 and June 2007. The balance of the debt maturing after June 2007 (\$408,300,000) will be called
17 early by RWE as a result of the proposed divestiture, as permitted under the terms of the loans.
18 \$25,000,000 of the long term debt provides funding to Arizona-American (*Id.* at 15). According to
19 Mr. Bigelow, a prior \$550,000,000 revolving line of credit from RWE has been replaced by a new
20 \$800,000,000 credit facility at terms similar to those previously provided by RWE (*Id.* at 16; Tr. 75-
21 76).

22 12. The Company does not expect that the proposed transaction will have any long-term
23 effects on American Water's credit rating, although Standard & Poor's placed both American Water
24 and AWCC on CreditWatch with negative implications in November 2005 (*Id.*, Ex. A). Mr. Bigelow
25 stated that RWE is committed to making sure American Water has an equity ratio of 45 to 55 percent
26 at the time of the IPO (Tr. 65).

27 13. With respect to Arizona-American's 2005 Equity Improvement Plan, which created a
28 minimum equity ratio target of 40 percent by 2010, Company witness Paul Townsley stated that the

1 40 percent equity target was achieved temporarily in 2006, but it would be difficult to maintain that
 2 level given the capital costs associated with known future developments⁴ (Ex. A-1, at 10). Company
 3 witness Thomas Broderick stated that Arizona-American remains committed to the 2005 Equity
 4 Improvement Plan's goal of reaching a 40 percent equity ratio. Mr. Broderick indicated that when
 5 the Company's \$25 million debt to AWCC (sourced from RWE) is terminated as a result of the
 6 transaction, he expects a portion of the \$25 million replacement financing will be infused as equity to
 7 avoid erosion of the equity ratio (Ex. A-2, at 5-6).

8 14. Mr. Townsley also testified that the proposed transaction would not affect staffing
 9 levels for Arizona-American, and that employees have increased significantly over the past several
 10 years in Arizona due to growth in the state (Ex. A-1, at 7-8).

11 15. As stated above, Arizona-American requested in its application that the Commission
 12 make a finding of no jurisdiction over the proposed transaction, or for a waiver of the Commission's
 13 Affiliated Interests Rules, pursuant to A.A.C. R14-2-806 or, in the alternative, for approval of an
 14 affiliated interests transaction pursuant to A.A.C. R14-2-801, *et seq.* Staff recommended that the
 15 Commission assert jurisdiction over the proposed transaction, but that the Commission approve the
 16 application, subject to certain conditions, pursuant to A.A.C. R14-2-803(A), which provides as
 17 follows:

18 Any utility or affiliate intending to organize a public utility company or
 19 reorganize⁵ an existing public utility holding company will notify the
 Commission's Utility Division in writing at least 120 days prior thereto.

20 16. In its Staff Report, Staff indicated that its primary concerns in reviewing the proposed
 21 transaction were: "American Water's ability to maintain a sound capital structure, retain its ability to
 22 attract equity and debt capital, continue to adequately serve Arizona ratepayers, and maintain its
 23 current support for Arizona-American and future planned Arizona infrastructure" (Ex. S-2, at 5).
 24 Benefits of the transaction noted by Staff are: greater corporate transparency; a greater corporate
 25

26 ⁴ Examples cited by Mr. Townsley include refund obligations to Del Webb of \$25 to \$ 30 million in 2007 and 2008, a \$50
 27 million surface water treatment plant project in the Agua Fria District, and other capital intensive infrastructure projects
 that could affect the Company's equity ratio on a short-term basis (Tr. 39-40).

28 ⁵ A.A.C. R14-2-801(5) defines "reorganize" as "[t]he acquisition or divestiture of a financial interest in an affiliate or a
 utility, or reconfiguration of an existing affiliate or utility's position in the corporate structure or the merger or
 consolidation of an affiliate or a utility."

1 focus on water and wastewater operations in the United States; continuation of services provided to
2 Arizona-American by the parent American Water, and access to capital through AWCC; no effect on
3 Arizona-American's rates or operations; the ability of Arizona-American customers and employees to
4 invest in a local utility company by purchasing American Water stock; the agreement to maintain
5 current Arizona offices and the likelihood of increases in local employment opportunities; and the
6 agreement by the Company not to seek recovery of any transactional costs associated with the
7 transaction. Staff concluded that the proposed transaction would provide benefits to Arizona
8 ratepayers; would not impair the financial status of Arizona-American or prevent the Company from
9 attracting capital at fair and reasonable terms; and would not impair the Company's ability to provide
10 safe, reasonable and adequate service. Staff therefore found that the application is in the public
11 interest and should be approved, subject to certain conditions described below (*Id.* at 6).

12 17. Staff stated that, in developing its proposed conditions, it recognized that American
13 Water's (and thus Arizona-American's) financial capabilities would be evaluated thoroughly by
14 analysts and investors as part of the IPO process. Based on its analysis of the application and
15 associated documents, Staff made the following recommendations:

- 16 a) Arizona-American shall not allow the transaction to diminish local
17 (Arizona) staffing that would result in service degradation;
- 18 b) Arizona-American shall continue to maintain its business
19 headquarters in Arizona and fully operational local field offices, as
20 appropriate to maintain the quality of service;
- 21 c) Arizona-American shall not seek regulatory recovery in a future
22 rate proceeding of the costs incurred to implement the proposed
23 transaction;
- 24 d) Arizona-American shall not change its equity improvement plan;
- 25 e) Arizona-American and its affiliates shall provide access to their
26 books and records, upon request, where such documents are
27 maintained;
- 28 f) Arizona-American shall make available during the Company's
general rate application(s) subsequent to completion of the
proposed transaction, information related to the financing and
administration of Arizona-American in order to permit a review of
the reasonableness of any cost allocations among its affiliates;
- g) Upon completion of the transaction, Arizona-American shall
provide reasonable notice regarding the IPO, and any subsequent
offering, within 90 days thereof (*Id.* at 7-8).

1 18. In the Staff Report, Staff pointed out that several conditions had previously been
2 imposed on the Company by Decision No. 65453 related to affiliate transaction concerns, including
3 prohibitions on sharing of customer information. Staff stated that it believes the existing affiliated
4 interest rules, as set forth in A.A.C. R14-2-802, *et seq.*, are adequate to provide oversight of future
5 affiliate transactions (*Id.* at 8).

6 19. At the conclusion of the hearing, the Company requested that the conditions proposed
7 by Staff in this proceeding supersede any prior conditions imposed in Decision No. 65453 (Tr. 93-
8 98). Staff responded that the Company had not presented testimony on the issue of prior conditions.
9 Due to this dispute, the parties were directed to submit a late-filed exhibit outlining their agreement,
10 or disagreement, with respect to the ongoing applicability of the prior conditions. In a letter filed by
11 Arizona-American on December 13, 2006, the Company indicated that although it does not believe
12 any conditions are necessary, following discussions with Staff it would accept imposition of the
13 following requirements from Decision No. 65453 (as modified) as a condition of approval of the
14 proposed transaction:

- 15 a) If Arizona-American ever plans to share with affiliates, or other
16 entities, any information made available to Arizona-American
17 solely by virtue of the company/customer relationship, such as
18 billing information and services received by a customer, it shall
19 notify the Commission at least 60 days in advance. Arizona-
20 American shall also, at the time of the 60-day notice, file a tariff
21 setting forth appropriate customer notification procedures to
22 inform customers about the sharing;
- 23 b) If Arizona-American ever shares any customer information with
24 affiliates, or other entities, it shall maintain accurate records of
25 revenues earned as a result and make those records available to
26 Staff upon request with ten days' notice. For the purposes of this
27 condition and condition (a) above, customer information that is
28 prohibited from disclosure does not include a customer's name,
address or service location, and telephone number; and
- c) Arizona-American shall not use any utility plant or other property,
that is used or necessary for the provision of utility service, for any
unregulated activity unless Arizona-American maintains
appropriate books and records of account detailing the nature of
such unregulated activity and providing appropriate allocations
between activities relating to Arizona-American's provision of
utility service and the unregulated activity. Arizona-American's
books and records concerning all unregulated activities shall be

made available in the Phoenix metropolitan area or, at the Commission's request, where the records are maintained, on ten days' notice.

20. For the reasons described herein, we find that Arizona-American's application is in the public interest and should be approved, subject to compliance with the conditions set forth in the Staff Report and in the Company's December 13, 2006, late-filed letter.

CONCLUSIONS OF LAW

1. Arizona-American is a public service corporation within the meaning of Article 15, 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.

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

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

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

6. The public interest requires that the transaction proposed in the Application be approved subject to the conditions recommended by Staff, as well as the conditions set forth in the Company's December 13, 2006, late-filed letter, as described above.

ORDER

IT IS THEREFORE ORDERED that Arizona-American Water Company's request for a waiver from Commission review of the transaction proposed in the Application, pursuant to A.A.C. 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, subject to the conditions recommended by Staff, as
3 well as the conditions set forth in the Company's December 13, 2006, late-filed letter, as described
4 above.

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

6 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

7

8 Jeffrey W. Hatch-Miller William Miller
 9 CHAIRMAN COMMISSIONER

10 Lawrence L. Pearson Debra M. ... Gary J. ...
 11 COMMISSIONER COMMISSIONER COMMISSIONER

12

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 20th day of Feb., 2007.

18 Brian C. McNeil
19 BRIAN C. McNEIL
20 EXECUTIVE DIRECTOR

21 DISSENT _____

22 DISSENT _____

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