

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE JOINT APPLICATION FOR APPROVAL OF)
THE ACQUISITION BY PHILADELPHIA) CASE NO. 2002-00384
SUBURBAN CORPORATION OF THE STOCK OF)
AQUASOURCE UTILITY, INC.)

ORDER

Philadelphia Suburban Corporation (Philadelphia), AquaSource, Inc. (AquaSource), and AquaSource Utility, Inc. (AquaSource Utility) (collectively Joint Petitioners) have applied for Commission approval of the transfer of control of AquaSource Utility to Philadelphia. At issue is whether Philadelphia has the managerial, technical, and financial ability to provide reasonable utility service and whether the proposed transfer of control is in the public interest. We find in the affirmative on the former issue, but conclude that the proposed transaction is in the public interest only if certain conditions are met.

PROCEDURE

On October 22, 2002, the Joint Applicants filed their application for Commission approval of the proposed transfer of control. The Attorney General (AG) subsequently moved for and was granted leave to intervene in this matter. Following discovery by the AG and Commission Staff, we ordered that any party wishing a hearing on the

application to formally request such hearing. No party has requested such hearing. This matter stood submitted for decision as of December 18, 2002.¹

PROPOSED TRANSACTION: AN OVERVIEW

AquaSource Utility, a corporation organized under the laws of Texas and headquartered in Pennsylvania, owns and operates sewage treatment facilities in Franklin County, Kentucky that serve approximately 429 customers for compensation in the Coolbrook Subdivision of Franklin County, Kentucky.² In addition to these facilities, which it acquired in 2000,³ it owns and operates water and wastewater systems in 12 other states.

AquaSource, a corporation incorporated under the laws of Delaware, owns all outstanding shares of AquaSource Utility. AquaSource is a subsidiary of DQE, a holding company with holdings in the energy, telecommunications, financial services and water and wastewater sectors.

Philadelphia, a corporation organized under the laws of Pennsylvania, is the second largest investor-owned water utility holding company in the United States. It has operating subsidiaries⁴ that serve approximately two million persons in Pennsylvania,

¹ KRS 278.020(5) requires the Commission to complete any review of any application for transfer of control of a utility within 60 days of the application's filing unless good cause requires an extension of the review period. In our Order of December 5, 2002, we found that the Joint Applicants' request for additional time to respond to discovery requests required such extension and we directed that the statutory review period be extended to 90 days.

² Annual Report of AquaSource Utility, Inc. to the Public Service Commission of Kentucky for Calendar Year ending December 31, 2001 at 12.

³ Case No. 2000-00130, Application of AquaSource Utility, Inc. for all Approvals Necessary for the Sale and Purchase of the Coolbrook Sanitation Division 4-Way Enterprises, Inc. Wastewater System (Ky.PSC May 15, 2000).

⁴ These subsidiaries include: Pennsylvania Suburban Water Company, Consumers Applegrove Water Company, Consumers Illinois Water Company, Consumers Indiana Water Company, Consumers Maine Water Company, Consumers Ohio Water Company, Consumers New Jersey Water Company, Consumers Pennsylvania Water Company, and Hydraulics, Ltd.

Ohio, New Jersey, North Carolina, Illinois and Maine. Its headquarters and principal business office are located in Bryn Mawr, Pennsylvania.

On July 29, 2002, AquaSource, DQE, Philadelphia and Aqua Acquisition Corporation executed an agreement under which Philadelphia would acquire 90 percent of the issued and outstanding stock of AquaSource Utility and all of the issued and outstanding stock of Reynolds Group, Inc.⁵ and AquaSource Development Company.⁶ This agreement provides for a base purchase price of \$205 million. This price, however, is subject to adjustment based upon AquaSource Utility's achievement of certain performance measures involving revenue, rate base and projected customer connections. Depending upon AquaSource Utility's performance, the final purchase may increase by \$10 million or decrease by \$25 million.

STANDARD OF REVIEW

KRS 278.020 requires Commission review and approval of any change in or transfer of control⁷ of a utility. KRS 278.020(4) provides:

No person shall acquire or transfer ownership of, or control, or the right to control, any utility under the jurisdiction of the commission by sale of assets, transfer of stock, or otherwise, or abandon the same, without prior approval by the commission. The commission shall grant its approval if the person acquiring the utility has the financial, technical, and managerial abilities to provide reasonable service.

⁵ Reynolds Group, Inc., is a water utility holding company that is organized under the laws of Indiana. It does not conduct any business in Kentucky.

⁶ AquaSource Development Company, a Texas corporation, is a subsidiary of AquaSource that develops new water supply and wastewater projects. It does not conduct any business in Kentucky.

⁷ KRS 278.020(5) defines control as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a utility, whether through the ownership of voting securities, by effecting a change in the composition of the board of directors, by contract or otherwise.

KRS 278.020(5) provides in part:

No individual, group, syndicate, general or limited partnership, association, corporation, joint stock company, trust, or other entity (an acquirer), whether or not organized under the laws of this state, shall acquire control, either directly or indirectly, of any utility furnishing utility service in this state, without having first obtained the approval of the commission. Any acquisition of control without prior authorization shall be void and of no effect. . . .The commission shall approve any proposed acquisition when it finds that the same is to be made in accordance with law, for a proper purpose and is consistent with the public interest.

Our review of any proposed transfer of control must address two issues. First, we must determine whether the party acquiring control has the requisite abilities to provide reasonable utility service. Second, we must determine whether the proposed transfer is consistent with the public interest.

KRS 278.020 does not define public interest. In Case No. 2002-00018, we found that a transfer is in the public interest if it does not adversely affect the existing level of utility service or rates or that any potentially adverse effects can be avoided through the Commission's imposition of reasonable conditions on the acquiring party.⁸ We further found that the acquiring party should also demonstrate that the proposed transfer is likely to benefit the public through improved service quality, enhanced service reliability, the availability of additional services, lower rates, or a reduction in utility expenses to provide present services. Such benefits, however, need not be immediate or readily quantifiable.⁹

⁸ Case No. 2002-00018, Application for Approval of the Transfer of Control of Kentucky-American Water Company to RWE Aktiengesellschaft and Thames Water Aqua Holdings GmbH (Ky.PSC May 30, 2002) at 7.

⁹ Id. See also Case No. 2000-00129, Joint Application of NiSource, Inc., New NiSource, Inc., Columbia Energy Group, and Columbia Gas of Kentucky for Approval of a Merger (Ky. P.S.C. June 30, 2000).

ANALYSIS

Provision of Reasonable Utility Service

Based upon the evidence of record, the Commission finds that Philadelphia has the financial, managerial, and technical abilities to provide reasonable utility service to AquaSource Utility's present customers. Philadelphia has operated as a public water utility since 1886. For the year ending December 31, 2001, Philadelphia had total assets of \$1,560,339,000 and provided water or wastewater services to approximately 602,000 customers.¹⁰ In addition, it provided water and wastewater services to approximately 35,000 persons through operation and maintenance contracts with municipal authorities and other parties.¹¹ Philadelphia has represented to the Commission that it intends to retain the current management and staffing levels of its operations in Kentucky. We are aware of no administrative or regulatory complaints or proceedings regarding the operation of its water and wastewater facilities. While Philadelphia has not received a credit rating from any credit rating entity, several of its subsidiaries have received generally acceptable credit ratings from such entities.¹²

Public Interest Question

The Commission finds that the proposed transfer of control is generally in the public interest. Philadelphia has retained AquaSource Utility's present management and will retain current staffing levels for its Kentucky operations. The proposed transaction,

¹⁰ Philadelphia Suburban 2001 Annual Report at 1, *available at* http://media.corporate-ir.net/media_files/NYS/PSC/ar01/2001_ar.pdf (Jan. 17, 2003).]

¹¹ *Id.* at 6.

¹² Joint Applicants' Final Answers to Commission Staff's First Set of Interrogatories and Requests for Production of Documents, Item 18.

therefore, will not result in any diminution or reduction in the quality of service and will not result in any immediate increase in rates for wastewater service.

Moreover, the certain characteristics of Philadelphia's operations are likely to result in greater efficiencies and improvement of service quality. Unlike DQE and AquaSource, Philadelphia has focused its corporate efforts solely on the water and wastewater sector. Philadelphia has been involved in water and wastewater operations for a significantly longer period of time and has greater experience in the operation of such utilities. Philadelphia's size will allow AquaSource Utility to benefit from increased economies of scale and enhanced purchasing power through lower purchasing costs and reduction of administrative costs.

The Commission finds that the proposed transaction will not be in the public interest unless certain conditions are imposed to protect AquaSource Utility's customers from incurring any costs associated with the proposed transaction. Accordingly, we have conditioned our approval upon Philadelphia and AquaSource Utility not using any form of push down accounting to require AquaSource Utility customers to pay any acquisition costs or any premium that Philadelphia may have paid for AquaSource Utility's stock.

We further find that the proposed transaction is in the public interest only if Philadelphia and AquaSource Utility adequately fund and maintain AquaSource Utility's treatment and collection system. Given the relative small size of AquaSource Utility's operations in Kentucky, we are concerned that the needs of these operations will be ignored or fail to receive the appropriate attention. To ensure that these needs are adequately met, we further find that AquaSource Utility should be required to submit its 2-year capital and operations and maintenance budget and an explanation of any

reduction in that budget that exceeds 10 percent of the prior year's budgeted expenditure.

The AG has expressed concern about the Commission's ability to enforce the provisions of this Order against Philadelphia. He has noted that Philadelphia does not transact business in the Commonwealth and that any attempt to obtain service of process upon it will be difficult. Sharing this concern, we find that the public interest requires that Philadelphia be required to appoint an agent for service of process for any action that the Commission may bring to enforce the provisions of this Order.

Finally, we place AquaSource Utility and Philadelphia on notice that any cost allocations that are made between Philadelphia and AquaSource Utility and between AquaSource Utility's central operations and its Kentucky operations will be closely scrutinized. The proposed transaction represents the second transfer of control of the facilities serving the Coolbrook Subdivision in 3 years. Despite AquaSource Utility's assurances of lower rates and improved service when it applied for approval of the transfer of control, it subsequently sought significant increases in rates based in large measure on allocated costs not directly associated with its Kentucky operations. It subsequently withdrew this application when it was unable to adequately document these expenses or its allocations. To avoid a repetition of this event, we expect any future rate application to contain extensive documentation of these costs.

SUMMARY

After considering the evidence of record and being otherwise sufficiently advised, the Commission finds that:

1. Philadelphia and AquaSource Utility will, after the consummation of the proposed transfer of control, have the financial, technical, and managerial abilities to provide reasonable utility service.

2. Philadelphia's proposed acquisition of AquaSource Utility is in accordance with law and for a proper purpose; it will, however, be consistent with the public interest only under the conditions set forth in Appendix A to this Order.

3. Philadelphia will not, by reason of its ownership of all outstanding shares of common stock of AquaSource Utility, be a utility as defined in KRS 278.010(3).

IT IS THEREFORE ORDERED that:

1. The transfer of control of AquaSource Utility from DQE and AquaSource to Philadelphia is approved subject to the conditions set forth in Appendix A of this Order. The proposed transfer of control shall not proceed unless, within 7 days of the date of this Order, written acknowledgements on behalf of Philadelphia and AquaSource Utility by each entity's chief executive officer accepting and agreeing to be bound by these conditions are filed with the Commission.

2. Philadelphia shall not impair AquaSource Utility's capacity to meet its obligations to provide adequate, efficient, and reasonable utility service.

3. AquaSource Utility is prohibited from guaranteeing the debt of Philadelphia or any of its affiliates or subsidiaries without the prior approval of the Commission.

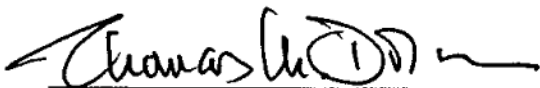
4. The Joint Applicants shall file with the Commission a copy of the final decision or order or other forms of regulatory notification regarding the proposed merger that each state regulatory authority with jurisdiction over the proposed merger issues within 20 days of the issuance of such order or notification.

5. Within 5 days of the consummation of the proposed acquisition, Philadelphia and AquaSource Utility shall file a written notice setting forth the date of the acquisition.

Done at Frankfort, Kentucky, this 21st day of January, 2003.

By the Commission

ATTEST:

A handwritten signature in black ink, appearing to read "Thomas H. O'Donnell", written over a horizontal line.

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2002-00384 DATED January 21, 2003

The proposed acquisition agreement between AquaSource, DQE, Philadelphia and Aqua Acquisition Corporation and the transfer of control of AquaSource Utility from AquaSource to Philadelphia are approved upon the following conditions:

1. AquaSource Utility and those customers served through its Kentucky operations shall not incur, directly or indirectly, any additional costs, liabilities, or obligations in conjunction with Philadelphia's acquisition of AquaSource.

2. AquaSource Utility shall not incur any additional indebtedness, issue any additional securities, or pledge any assets to finance any part of the purchase price paid by Philadelphia for the AquaSource stock.

3. The payment for the AquaSource stock shall be recorded on Philadelphia's books and shall not be recorded in AquaSource Utility's books.

4. The premium that Philadelphia pays for AquaSource stock, as well as any other associated costs, shall not be pushed down to AquaSource Utility or those customers served through AquaSource Utility's Kentucky operations.

5. All costs related to Philadelphia's acquisition of AquaSource Utility, including the cost of purchase and the premium paid for AquaSource Utility, shall not be considered in any rate-making proceeding regarding the rates for sewer service provided by AquaSource Utility's operations in Kentucky.

6. No change of control payments will be allocated to customers served through AquaSource Utility's Kentucky operations.

7. No costs associated with the early termination of any member of senior management of AquaSource or AquaSource Utility shall be allocated to customers served through AquaSource Utility's Kentucky operations.

8. Customers served through AquaSource Utility's Kentucky operations shall experience no material adverse change in utility service due to the proposed transaction.

9. Philadelphia and AquaSource Utility shall adequately fund and maintain AquaSource Utility's sewage treatment and collection systems within Kentucky to comply with all applicable Kentucky statutes and administrative regulations and to supply the service needs of the customers of those systems.

10. Beginning with calendar year 2003 and for the following 4 years, AquaSource Utility shall submit to the Commission its 2-year capital and operations and maintenance budgets for its Kentucky operations when submitting its annual report for those operations for the prior calendar year with an explanation of any capital budget item that changes more than 10 percent from the prior year.

11. Philadelphia shall appoint an agent in Kentucky for the limited purpose of accepting the service of process of any action that the Commission may bring to enforce the provisions and conditions set forth in this Order.