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MEMORANDUM

TO: Docket Control

FROM: Ernest G. Johnson EGJ
Director
Utilities Division

DATE: April 19, 2004

RE: STAFF REPORT FOR DIAMOND VALLEY WATER USERS CORPORATION AS ORDERED BY DECISION NO. 66733 (DOCKET NO. W-03263A-00-0470)

Attached is the Staff Report to comply with Decision No. 66733, dated January 20, 2004, that ordered the Utilities Division to conduct an audit of Diamond Valley Water Users Corporation's 2003 revenues and expenses and file a report within 90 days of the effective date of that Decision to "address whether the rates charged for public water utility service are being charged reasonably and that the expenses of the utility are being paid in a lawful manner". Staff concludes that the expenses of the utility are being properly paid and that the Company is charging rates in accordance with its filed tariffs and that continued operating results similar to those experienced in 2003 are inadequate to sustain operations in the long term.

EGJ:JRM:rdp

Originator: Jamie Ryan Moe

Attachment: Original and fourteen copies

Arizona Corporation Commission
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Service List for: Diamond Valley Water Users Corporation
Docket No. W-03263A-00-0470

Diamond Valley Water Users Corporation
4754 East Donna Drive
Prescott, Arizona 86301

Bradshaw Management Corporation
Post Office Box 20939
Sedona, Arizona 86341

Kevin Greif
1140 North Opal Drive
Prescott, Arizona 86303

Christopher C. Kempley, Esq., Chief Counsel
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Ernest G. Johnson, Esq., Director
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Lyn Farmer, Esq., Chief Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION

DIAMOND VALLEY WATER USERS CORPORATION

DOCKET NO. W-03263A-00-0470

RATES AND EXPENSE EXAMINATION

APRIL 2004

STAFF ACKNOWLEDGMENT

The Staff Report for Diamond Valley Water Users Corporation, Docket No. W-03263A-00-0470, was the responsibility of the Staff member listed below. Jamie R. Moe was responsible for the rates and expense examination.

Jamie R. Moe
Public Utilities Analyst III

EXECUTIVE SUMMARY

Diamond Valley Water Users Corporation ("DVWUC" or "Respondent" or "Company") provides public water service to more than 500 customers in various parts of Yavapai County, Arizona. The Company's present rates were approved by Decision No. 60125, dated March 19, 1997.

On July 11, 2000, Mr. Kevin Greif ("Complainant") filed with the Arizona Corporation Commission ("Commission") a Complaint against DVWUC. In the interim, while Mr. Greif's Complaint was pending, the Commission issued Decision No. 63587, dated April 4, 2001, in which the Commission's Utilities and Legal Divisions were authorized to take all lawful action necessary to engage a qualified management entity to operate the utility. The Company is currently under the interim management of Bradshaw Management Corporation ("Bradshaw") which is operated by Mr. Tim Kyllo.

Mr. Greif's initial Complaint, a billing dispute, had been resolved by Bradshaw prior to the Complaint hearing. However, at the hearing Mr. Greif expressed additional concerns that had occurred subsequent to Decision No. 63587. As an outgrowth of those concerns, the Commission ordered, in Decision No. 66733 dated January 20, 2004, "that the Utilities Division of the Arizona Corporation Commission shall conduct and complete, within 90 days of the effective date of the Decision, an audit of the Diamond Valley Water Users Corporation finances and file a report in this Docket with a copy to the Complainant, based on Diamond Valley Water Users Corporation's calendar year revenues and expenses for the year 2003 which shall address whether the rates charged for public water utility service are being charged reasonably and that the expenses of the utility are being paid in a lawful manner."

Staff concludes that the expenses of the utility are being properly paid and that the Company is charging rates in accordance with its filed tariffs.

Staff also concludes that continued operating results similar to those experienced in 2003 are inadequate to sustain operations in the long term.

During the course of its examination of revenues and expenses, it came to Staff's attention that the Company is neither recording service line and meter installation charges to the Advances-in-Aid-of-Construction account nor refunding these advances. Staff recommends that the Company record and refund Advances-in-Aid-of-Construction in accordance with Arizona Administrative Code ("A.A.C.") Rule R14-2-405.B.2.

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Introduction

The Utilities Division ("Staff") prepared this Staff Report to comply with Decision No. 66733 that ordered "the Utilities Division of the Arizona Corporation Commission shall conduct and complete, within 90 days of the effective date of the Decision, an audit of the Diamond Valley Water Users Corporation finances and file a report in this Docket with a copy to the Complainant, based on Diamond Valley Water Users Corporation's calendar year revenues and expenses for the year 2003 which shall address whether the rates charged for public water utility service are being charged reasonably and that the expenses of the utility are being paid in a lawful manner." Decision No. 66733 addresses the Complaint filed on July 11, 2000, by Mr. Kevin Greif ("Complainant") with the Arizona Corporation Commission ("Commission") against DVWUC.

Background

In October of 1994, Diamond Valley Water Users Corporation, a non-profit corporation, acquired the water utility after the utility's former operator filed for Chapter 7 bankruptcy proceedings in the United States Bankruptcy Court for the District of Arizona. In order to provide water utility service to an area between Prescott Valley and Prescott, Arizona, the Commission granted approval of the purchase of the utility assets and transfer of the Certificate of Convenience and Necessity ("CC&N") from the former owner in Decision No. 60125, dated March 19, 1997. Decision No. 60125 also approved continuance of the tariff structure as well as a re-stated water service agreement with Prescott Valley Water Company ("PVWC").

On July 11, 2000, Mr. Kevin Greif filed a Complaint with the Commission against Diamond Valley Water Users Corporation. Mr. Greif's Complaint was filed along with a number of other Complaints filed by other customers involving billing disputes or claims of mismanagement of DVWUC. The Respondent failed to file an answer to any of the Complaints. While the Complaint was pending, the Commission issued Decision No. 63587 dated April 4, 2001, in which the Commission's Utilities and Legal Divisions were authorized to take all lawful action necessary to engage a qualified management entity to operate the utility. The Respondent is presently under the interim management of Bradshaw Management Corporation ("Bradshaw"), which is operated by Mr. Tim Kyllo.

On July 27, 2003, Staff filed a memorandum requesting that certain of the outstanding Complaints which had been filed against the Respondent be administratively closed because they had been resolved through arbitration proceedings conducted by Staff. The customer billings and earlier issues relating to billing problems had been resolved through the placement of Bradshaw as management of all operations for DVWUC. Mr. Greif did not want his Complaint to be dismissed or administratively closed, although his initial Complaint with respect to a billing dispute had been resolved by the placement of Bradshaw as management of DVWUC. His concerns had progressed to the ownership of the utility's assets, what happens if Bradshaw terminated its services and whether Bradshaw properly collects, spends and accounts for revenues.

The Company purchases the entirety of its water supply from PVWC. DVWUC pays three types of fees to PVWC under the water purchase agreement. The Company pays $2.25 per 1,000 gallons purchased, a basic service charge of $4.60 per DVWUC customer per month, and a $1,200 one-time fee for each new DVWUC customer connection. The basic service charge is in the final year of a temporary reduction agreement, and it will increase to $5.60 beginning in January 2005.

The Company has several outstanding debts that were incurred prior to Bradshaw taking over as interim management. The Company had outstanding balances as of December 31, 2003 to PVWC and the Fain Family in the amounts of $95,288 and $6,619, respectively, for a total of $101,907. The Company also had unpaid Yavapai County property taxes including interest of $54,576 at March 31, 2004, related to the years 1994 to 2000. The Company is contesting these unpaid taxes which it claims were improperly assessed. The Company has paid its property tax assessments subsequent to 2000.

Examination and Financial Analysis

Staff performed audit procedures to examine DVWUC's 2003 revenues and expenses. Schedule JRM-1, attached, presents the results. The Company generated operating revenues of $264,736 and incurred operating expenses of $266,268 to provide an operating loss of $1,532 for a negative operating margin of 0.58 percent. The operating income and operating margin results provide a good indication regarding the reasonableness of rates. However, an examination of cash flows provides a more detailed understanding of on-going conditions because certain cash flows that are not reflected in revenues and expenses can affect a utility's ability to meet its financial obligations. For example, DVWUC charges $1,650 for service line and meter installation for a 5/8 x ¾-inch meter customer. The Company generated $52,800 from these charges by connecting 32 new customers in 2003. Service line and meter installation charges are recorded as advances; therefore, the cash flows they generate are not recognized in operating revenue. Schedule JRM-2 presents DVWUC's sources and uses of cash in 2003.

An analysis of DVWUC's 2003 cash flows reveals that the Company increased its cash balance by deferring payment of current obligations. Specifically, the Company increased cash by $38,425 to $53,963 during the year primarily by increasing unpaid obligations to Bradshaw Management by $46,545 and to PVWC by $19,850. The Company cannot continue to generate cash by postponing payment of operating expenses and other current liabilities since these obligations will eventually have to be paid.

DVWUC cannot rely on customer growth to generate cash for other purposes. Although the Company generated $52,800 from service line and meter installations in 2003, the cost of new customer connections exceeded the amount generated by $23,512. The Company incurred $37,912 to construct service lines and install meters to service the new customers and incurred $38,400 of obligations to PVWC for connecting new customers for a total of $76,312. Thus, customer growth has a negative immediate effect on the Company's cash flow. The cash flow analysis shows that the Company could not satisfy its cash needs even if customer growth did not have a negative effect on cash flow. This can be determined by noting that the cash flow generated by deferring payment to Bradshaw Management and PVWC exceeds the net cash used to connect new customers.

Schedule JRM-2 shows that the Company invested $47,181 in new plant and reduced debt by $37,400 in 2003. The Company's ability to continue meeting plant improvement and debt service requirements is dependent upon its ability to obtain capital and to generate cash from operating activities. The operating results for 2003 are inadequate for the Company to continue meeting its obligations in the long-term. The Company needs to increase revenues and/or decrease expenses to sustain its operations. An unfavorable ruling on the Company's contested Yavapai County property taxes would increase it cash requirements.

Staff reviewed the prudence of operating expenses and capital improvements and deemed them appropriate.

Other Issues

During the course of its examination of revenues and expenses, it came to Staff's attention that the Company is neither recording service line and meter installation charges to the Advances-in-Aid-of-Construction account nor refunding these advances in accordance with A.A.C. Rule R14-2-405.B.2. Refunding advances places additional demands on cash flow.

Conclusion and Recommendations

Staff concludes that the expenses of the utility are being properly paid.

Staff also concludes the Company is charging rates in accordance with its filed tariffs.

Staff also concludes that continued operating results similar to those experienced in 2003 are inadequate to sustain operations in the long term.

Staff recommends that the Company take the following actions for its own benefit: (1) conduct an assessment of whether the 2003 operating results are representative of on-going operations; (2) evaluate the potential to reduce expenses without detriment to service quality, and (3) conduct an assessment of a need to make a rate filing.

Staff further recommends that the Company record and refund Advances-in-Aid-of-Construction in accordance with A.A.C. Rule R14-2-405.B.2.

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Complaint

Schedule JRM-1

Statement of Operating Income and Expenses

Operating Revenues	
Metered Water Revenue	$ 257,103
Other Operating Revenues	7,633
Total Revenues	264,736
Operating Expenses	
Salaries and Wages	-
Purchased Water	141,122
Purchased Power	11,444
Chemicals	-
Repairs and Maintenance	27,924
Office Supplies and Expense	1,349
Outside Services	68,625
Water Testing	169
Rents	-
Transportation Expenses	-
Insurance - General Liability	2,750
Insurance - Health and Life	
Regulatory Commission Expense - Rate Case	
Misc. Expense	1,884
Depreciation Expense	3,222
Taxes other Than Income	
Property Taxes	7,728
Income Tax	50
Total Expenses	266,268
Operating Income/(Loss)	$ (1,532)
Operating Margin	-0.58%

Diamond Valley Water Users Corporation
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Schedule JRM-2

Cash Flow Analysis

Cash flows from operating activities		
Net Income/(Loss)		$ (1,532)
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$ 3,222	
Interest Expense paid out	(45)	
Back taxes for property paid out	(2,808)	
Increase in customer security deposits	4,344	
Non-cash Blue Stake adjustment	631	
Increase in accounts payable - PVWC hookup charges	19,850	
Increase in accounts payable - Bradshaw Management	46,546	$ 71,740
Net cash provided by operating activities		$ 70,208
Cash flows from investing activities		
Plant additions - Pumping Equipment	(6,527)	
Plant additions - Distribution Mains	(2,742)	
Plant additions - Meters	(1,046)	
Plant additions - Services	(36,866)	
Net cash used by investing activities		$ (47,181)
Cash flows from financing activities		
Increase in AIAC - Service Line & Meter Charges	52,800	
Decrease in assumed debt - Fain Family	(7,500)	
Decrease in assumed debt - PVWC	(29,900)	
Net provided by investing activities		$ 15,400
Net increase in cash		$ 38,426
Cash at beginning of year per books		$ 15,537
Cash at end of year		$ 53,963