ORIGINAL

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MEMORANDUM

TO: Docket Control

FROM: Ernest G. Johnson EGJ
Director
Utilities Division

DATE: October 18, 2004

RE: STAFF REPORT FOR KEATON DEVELOPMENT COMPANY APPLICATION FOR FINANCING AUTHORIZATION DOCKET NO. W-02169A-04-0363

Attached is the Staff Report for Keaton Development Company application for a financing authorization. Staff recommends denial.

EGJ: JHJ: red

Originator: J. H. JOHNSON

Attachment: Original and sixteen copies

Service List for: Keaton Development Company, Inc.
Docket No. W-02169A-04-0363

Keaton Development Company
P.O. Box 905
Salome, Arizona 85348

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Chief Counsel, Legal Division
Arizona Corporation Commission
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Director, Utilities Division
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STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION

KEATON DEVELOPMENT COMPANY

DOCKET NO. W-02169A-04-0363

APPLICATION FOR A
FINANCING AUTHORIZATION

OCTOBER 2004

STAFF ACKNOWLEDGMENT

The Staff Report for Keaton Development Company, Docket No. W-02169A-04-0363 was the responsibility of the Staff members listed below: J. H. Johnson was responsible for the review and financial analysis of the Company's application. Dorothy Hains was responsible for the engineering and technical analysis.

J. H. JOHNSON
PUBLIC UTILITIES ANALYST III

Dorothy Hains

DOROTHY HAINS
UTILITIES ENGINEER (WATER/WASTEWATER)

EXECUTIVE SUMMARY

Keaton Development Company ("Keaton" or "Company") filed an application on May 13, 2004 with the Arizona Corporation Commission ("Commission" or "ACC") requesting authorization to incur $40,000 of long-term debt. Keaton also submitted an application for financing with the Water Infrastructure Finance Authority ("WIFA").

Keaton is an Arizona for-profit corporation which owns and operates a public service corporation and holds a Certificate of Convenience and Necessity ('CC&N") authorizing it to provide water service in La Paz County, Arizona. Keaton's headquarters are in Salome, Arizona. Keaton provides water service to 429 connections as of the date of the application and has three employees.

Keaton is owned by William Scott, age 61, of Blythe, California, who bought the Company on March 4, 2003. Mr. Scott subsequently took Keaton into Chapter 11 bankruptcy as the result of inability to make refunds of Advances in Aid of Construction to KRC Company, Inc.

Keaton proposes to use the loan proceeds for the following purposes: (1) Develop a master plan for the expansion needed in the near future; (2) Upgrade the chlorination system; (3) Develop information on existing ground storage reservoirs; and (4) Provide back up electrical power for electricity outages.

The Company proposes to borrow $40,000 from WIFA at an expected interest rate of 5.5 percent per annum with a twenty-year term and a monthly payment of $275.17.

Staff reviewed the financial information submitted with the application and the Company prepared updated projections for the second half of 2004. The projections show a return to profitability and a positive equity position. However, issuing debt so soon after a Chapter 11 bankruptcy (Final Decree has not been filed) with no documented history of profitability is ill advised. An alternative to issuing additional debt to finance the proposed expenditures is to infuse equity capital.

Staff concludes that Keaton is not a viable candidate for more long-term debt. Its negative equity, operating losses and a pro forma debt service coverage ratio of 1.15 that is below WIFA's minimum requirement of 1.20 are not compatible with issuing additional debt.

Staff recommends denial of the applicant's request for authorization to incur $40,000 of debt financing.

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ENGINEERING REPORT

NOTICE

Introduction

Keaton Development Company ("Keaton" or "Company") filed an application on May 13, 2004, with the Arizona Corporation Commission ("Commission" or "ACC") requesting authorization to incur $40,000 of long-term debt. Keaton also submitted an application for financing with the Water Infrastructure Finance Authority ("WIFA").

Notice

The Company published a notice of an application for an order authorizing the issuance of long-term debt in the *Parker Pioneer* on April 14, 2004. An affidavit of publication is attached to this report.

Background

Keaton is an Arizona for-profit corporation which owns and operates a public service corporation and holds a Certificate of Convenience and Necessity ("CC&N") authorizing it to provide water service in La Paz County, Arizona. Keaton's headquarters are in Salome, Arizona. Keaton provides water service to 429 connections as of the date of the application and has three employees.

Keaton expects many additional customers in the next few years from development of new RV parks, mobile home parks, and additional lots in the KRC development.

Keaton is owned by William Scott, age 61, of Blythe, California, who bought all the outstanding shares of common stock of the Company on March 4, 2003. Mr. Scott subsequently took Keaton into Chapter 11 bankruptcy as the result of inability to make refunds of Advances in Aid of Construction to KRC Company, Inc.

Purpose of Financing

Keaton proposes to use the loan proceeds for the following purposes: (1) Develop a master plan for the expansion needed in the near future; (2) Upgrade the chlorination system; (3) Develop information on existing ground storage reservoirs; and (4) Provide back up electrical power for electricity outages.

Description of Proposed Financing

The Company proposes to borrow $40,000 from WIFA at an expected interest rate of 5.5 percent per annum with a twenty-year term and a monthly payment of $275.17.

Financial Analysis

Staff used financial information from the financial statements provided with the application for the year ended December 31, 2003, to prepare Schedule JHJ-1, attached, and as the basis for its analysis. Schedule JHJ-1 presents operating income, times interest earned ratio ("TIER"), debt service coverage ("DSC"), and capital structure data. Staff also used expected terms and conditions from WIFA as outlined in the application. Specifically, Staff's analysis is based on a 20-year amortization at 5.5 percent per annum and a sinking fund requirement equal to one year's payments to be collected over the first five years of the loan.

The Company reports revenue of $151,525 for the fiscal year ending December 31, 2003. Expenses exceeded revenues resulting in an operating loss for the year of $16,228.

Schedule JHJ-1, column B, reflects 2003 financial results with pro forma adjustments to reflect the proposed loan. The pro forma information shows a negative 1.70 TIER and a 1.15 DSC. These ratios indicate that Keaton's cash flows are marginally sufficient to service the proposed $40,000 debt and other existing debt in the short-term, but has insufficient earnings to sustain debt service in the long-term. The DSC is below WIFA's minimum requirement of 1.20.

The TIER represents the number of times earnings will cover interest expense on long-term debt. A TIER ratio greater than 1.0 means that operating income is greater than interest expense.

The debt service coverage ratio represents the number of times internally generated cash will cover required principal and interest payments on long-term debt. A DSC ratio greater than 1.0 indicates that operating cash flow is sufficient to cover debt obligations.

Schedule JHJ-1 also shows that Keaton's existing capital structure is completely comprised of debt due to the negative equity position. The proposed debt would exacerbate the already excessively leveraged capital structure.

Keaton is not a viable candidate for the proposed long-term debt due to its negative equity, operating losses and insufficient DSC. Keaton's balance sheet problems should be addressed by improving its equity balance through equity infusion and improved operating results.

Staff also reviewed the Company's updated projections for the second half of 2004. The projections show a return to profitability and a positive equity position. However, the projections are insufficient to support the proposed debt in the absence of a documented history of profitability so soon after a Chapter 11 bankruptcy (Final Decree has not been filed). Infusion of equity capital is an alternative to debt issuance for funding the proposed expenditures.

Compliance

The Utilities Division Compliance Section reports that there are no outstanding compliance issues.

Engineering Analysis

The Engineering Report concludes that there is adequate storage and production capacity to serve 3,200 customers and the water being delivered meets water quality standards required by the Arizona Administrative Code, Title 18, Chapter 4. Staff further concludes that the projects that are the subject of the proposed financing application are appropriate and the Company's cost estimates are reasonable.

Staff Conclusions and Recommendations

Staff concludes that the issuance of debt in the amount of $40,000 on the terms described is for lawful purposes and within the corporate powers of the applicant.

Staff further concludes that the issuance of any additional debt is not compatible with the public interest and not compatible with sound financial practices due to the applicant's marginal ability to service debt and its excessively leveraged financial position.

Staff recommends denial of the applicant's request for authorization to incur $40,000 of debt financing.

Staff recommends, as outlined in greater detail in the attached Engineering Report, that the Company file quarterly reports with the Utilities Division Director showing monthly water pumped and sold until notified otherwise by the Utilities Division Director. The quarterly report should also summarize actions taken to reduce system water loss.

Staff recommends that the Company file a curtailment tariff as soon as possible, but no later than forty-five days after the effective date of the final Decision and Order in this matter. The tariff shall be docketed as a compliance item under this docket number for the review and certification of the Utilities Division Director. The tariff shall further generally conform to the sample tariff found on the Commission's web site at www.cc.state.az.us. Staff recognizes that the Company may need to make minor modifications according to their specific management, operational, and design requirements as necessary and appropriate.

Keaton Development Company
Docket No. W-02169A-04-0363
Application For Financing

Schedule JHJ-1

FINANCIAL ANALYSIS

Selected Financial Data
Including Immediate Effects of the Proposed Debt

		[A] *12/31/2003*		[B] *Pro Forma*	
1	Operating Income	$ (16,228)		$ (16,228)	
2	Depreciation & Amort.	23,596		23,596	
3	Income Tax Expense	0		0	
4					
5	Interest Expense	3,840		6,012	
6	Repayment of Principal	2,340		5,642	
7					
8					
9	**TIER**				
10	[1+3] ÷ [5]	-3.23		-1.70	
11	**DSC**				
12	[1+2+3] ÷ [5+6]	1.20		1.15	
13					
14					
15					
16					
17					
18	Short-term Debt	$2,340	N/M	$5,642	N/M
19					
20	Long-term Debt	$42,804	N/M	$79,502	N/M
	Other Long Term Debt	$128,822	N/M	$128,822	N/M
21					
22	Common Equity	($162,813)	N/M	($162,813)	N/M
23					
24	Total Capital	$11,153	N/M	$51,153	N/M
25					
26					
27					

MEMORANDUM

DATE September 8, 2004

TO: James Johnson, Auditor III

FROM: D. Hains, Utilities Engineer

RE: **Keaton Development Company – Financing Application (Docket No. W-02169A-04-0363)**

Introduction

Keaton Development Company ("Keaton" or "Company"), which provides water service to the Town of Salome in La Paz County, has filed a financing application for approval to obtain a loan in the amount of $40,000. The loan will be used for (1) the development of a master plan, (2) to complete an engineering evaluation of the Company's existing chlorination system, (3) to complete an engineering evaluation of the Company's existing storage system, and (4) to pay for the purchase of an on-site emergency generator. The need for each of these projects is discussed below. In 2002, Keaton was sold to a new owner.

System Analysis

I. Capacity

The Company owns and operates a water system that contains two wells, three storage tanks, and a distribution system serving 399 metered customers in a certificated area of approximately three square miles. This system has a 1,100 gallon per minute ("GPM") production rate and 48,000 gallons of storage capacity. There is adequate storage and production capacity in the system to serve approximately 3,200 customers.

According to Mr. William S. Scott (the new owner of Keaton), important records regarding storage tank specifications, repairs and improvements, and other storage tank modifications were not provided by the previous owner. The new owner has expressed concern about the operating condition of the existing tanks and believes there may be a need for additional storage capacity. It appears that the Company has not been operating the tanks at full capacity. Therefore, the Company plans to hire an engineering consultant to evaluate the system and recommend any changes that are needed.

II. Water Treatment

The Company has received several complaints recently from customers regarding water odor and taste quality. The Company suspects that the chlorine treatment device is not functioning properly or is not functioning at all. The Company plans to hire an engineering consultant to evaluate the chlorine treatment system and determine if the existing chlorinator can be repaired or if a new unit is needed.

III. Emergency Generator

The Company has experienced service related problems (i.e., low water pressure, or no water) when commercial power has been interrupted for any significant period of time. These interruptions, which in recent years have declined, have typically occurred during the monsoon season when high winds and lightening have damaged APS electric facilities[1]. Recently, the Company purchased an on-site generator which can be used to restore power to the well pumps and other equipment in the event commercial power is interrupted for a significant period of time.

IV. Water Loss

A. Prior Years Reporting

In Decision No. 64176, effective November 2001, the Company was ordered to file quarterly reports showing monthly water pumped and water sold data for a period of one year. At the end of the one year reporting period, the Company was experiencing an average monthly water loss of 16.74 percent.

B. January 2003 through February 2004

The Company's water loss situation appears to be worsening, for January 2003 through February 2004 the Company experienced an average monthly water loss of 24.34 percent which far exceeds Staff's recommended water loss threshold of 10 percent. Staff recommends that the Company be required to file quarterly reports showing monthly water pumped and water sold data until it is notified otherwise by the Director of the Utilities Division. The quarterly report should also include a summary of the actions taken during that quarter to reduce system water loss. These reports shall be docketed as a compliance item under this docket number for the review of the Utilities Division Director. Staff further recommends that the Company reduce its water loss to less than 10 percent within eighteen months after the effective date of the Decision in this matter. If after eighteen months of the effective date of the Decision in this matter the Company has failed to reduce its non-account water below 15 percent, Staff further

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[1] APS is the electric utility that provides service in the Salome area. Service to the area is provided via a radial line. Due to the nature of a radial line service arrangement, when the line is damaged service is interrupted until repairs can be made. Recent improvements made by APS to this line appear to have reduced the frequency of Salome outages.

recommends that any new Main Extension Agreements submitted by the Company shall be denied until the Company shows that average water loss for two consecutive quarters is below 15 percent.

If the Company finds that water loss can only be reduced to less than 15 percent, but not less than 10 percent within eighteen months after the effective date of the Decision in this matter, the Company shall submit a detailed cost analysis and explanation demonstrating why a water loss reduction to less than 10 percent is not cost effective.

The financing, in part, will be used to fund the development of a master plan. The company has been operating without records/maps which show the location of existing underground facilities (i.e., main lines, distribution lines, service lines, control valves and meters). A master plan will create a record of the existing system which will enable the Company to locate leaks and other problems and improve its system management. A comprehensive master plan is an important tool that the Company needs to efficiently manage its system and to reduce water loss.

Arizona Department of Environmental Quality ("ADEQ") Compliance

Staff received an ADEQ water quality compliance status report dated May 19, 2004, for Keaton's water system (Public Water System No. 15-029). In this report, ADEQ stated that it has determined that this system is currently delivering water that meets water quality standards required by Arizona Administrative Code, Title 18, Chapter 4.

Arizona Department of Water Resources ("ADWR") Compliance

The system is not within any ADWR Active Management Area.

ACC Compliance

A check with the Utilities Division Compliance Section showed there are no outstanding compliance issues.

Other Issues:

I. Arsenic

The U.S. Environmental Protection Agency ("EPA") has reduced the arsenic maximum contaminant level ("MCL") in drinking water from 50 micrograms per liter ("μg/l") to 10 μg/l. The date for compliance with the new MCL is January 23rd, 2006. Recent lab test results indicate that the Company is delivering water that meets the new arsenic standard.

II. Detailed Cost Analysis

The itemized costs are listed below:

Project Description	Estimated Cost ($)
A. Master Plan	
Field investigation	14,500
Mapping of mains, Well inventory & Water quality testing	4,500
Computer modeling	14,000
Contingencies (16% of the project cost)	5,266
subtotal	**23,766**
B. Reservoirs Investigation	
Field investigation & Recommendation	6,000
subtotal	**6,000**
C. Upgrading Chlorination Project	
Field investigation, Field sampling & testing, Design chemical feed pump, design control device & research a suitable chlorinator	3,800
Subtotal	**3,800**
D. Purchase an on-site generator	
Diesel generator (125KW, 3 Ø, 480v)	23,000
Subtotal	**23,000**
Total	**57,566**

With the exception of cost listed for the emergency generator, purchased in March 2004, the estimates above reflect the costs the Company expects to incur to hire engineering firm(s) to conduct the required analysis. Staff believes that the Company's estimated costs to complete the four projects that are the subject of the proposed financing are reasonable.

III. Curtailment Tariff

A curtailment tariff is an effective tool to allow a water company to manage its resources during periods of shortages due to pump breakdowns, droughts, or other unforeseeable events. Since the Company does not have a curtailment tariff, this application provides an opportune time to prepare and file such a tariff. Staff recommends that the Company file a curtailment tariff as soon as possible, but no later than forty-five days after the effective date of the final Decision and Order in this matter. The tariff shall be docketed as a compliance item under this docket number for the review and certification of the Utilities Division Director.

Staff further recommends that the tariff shall generally conform to the sample tariff found on the Commission's web site at www.cc.state.az.us. Staff recognizes that the Company may need to make minor modifications according to their specific management, operational, and design requirements as necessary and appropriate.

Summary

I. Recommendations:

1. Staff recommends that the Company be required to file quarterly reports showing monthly water pumped and water sold data until it is notified otherwise by the Director of the Utilities Division. The quarterly report should also include a summary of the actions taken during that quarter to reduce system water loss. These reports shall be docketed as a compliance item under this docket number for the review of the Utilities Division Director. Staff further recommends that the Company reduce its water loss to less than 10 percent within eighteen months after the effective date of the Decision in this matter. If after eighteen months of the effective date of the Decision in this matter the Company has failed to reduce its non-account water below 15 percent, Staff further recommends that any new Main Extension Agreements submitted by the Company shall be denied until the Company shows that average water loss for two consecutive quarters is below 15 percent.

   If the Company finds that water loss can only be reduced to less than 15 percent, but not less than 10 percent within eighteen months after the effective date of the Decision in this matter, the Company shall submit a detailed cost analysis and explanation demonstrating why a water loss reduction to less than 10 percent is not cost effective.

2. Staff recommends that the Company file a curtailment tariff as soon as possible, but no later than forty-five days after the effective date of the final Decision and Order in this matter. The tariff shall be docketed as a compliance item under this docket number for the review and certification of the Utilities Division Director.

   Staff further recommends that the tariff shall generally conform to the sample tariff found on the Commission's web site at www.cc.state.az.us. Staff recognizes that the Company may need to make minor modifications according to their specific management, operational, and design requirements as necessary and appropriate.

II. Conclusions:

1. There is adequate storage and production capacity in the system to serve 3,200 customers.

2. ADEQ has determined that this system is currently delivering water that meets water quality standards required by Arizona Administrative Code, Title 18, Chapter 4.

3. The system is not within any ADWR Active Management Area.

4. A check with the Utilities Division Compliance Section showed there are no outstanding compliance issues.

5. Staff concludes that the projects that are the subject of this proposed financing application are appropriate and that the Company's cost estimates to complete the four projects are reasonable. However, Staff has not made a determination of the capital improvements as "used and useful" at this time, but defers this determination until the Company files its next rate application.

AFFIDAVIT OF PUBLICATION

STATE OF ARIZONA

COUNTY OF LA PAZ, ss

Alice Opie

Alice Ople

of said county, being duly sworn, deposes and says: that he/she is and at all times herein mentioned was a citizen of the United States, over the age of twenty-one years, and is competent to be a witness on the trial of the above entitled action, and that he/she is not a party to, nor interested in the above entitled matter.

That he/she is the Advertising Agent for the:

PARKER PIONEER

(published weekly) and which is a weekly newspaper of general circulation, published and circulated in the said County of La Paz, and is published for the dissemination of local news and intelligence of a general character, and has a bona fide subscription list of paying subscribers, and said newspaper has been established and published in the City of Parker, County of La Paz, State of Arizona, for at least one year before the publication of the first insertion of this notice and said newspaper is not devoted to the interests of, or published for the entertainment of any particular class, profession, trade, calling, race or denomination, or any number thereof.

That the:

APPLICATION FOR AN ORDER
Long Term Debt
Keaton Development Co., Inc.

of which the annexed is a printed copy, was published in said newspaper at least 1 times, commencing on the 14th day of April, 2004, and ending on the 14th day of April, 2004, all above days inclusive, and in the regular and entire issue of said newspaper proper, and not in a supplement and said notice was published therein on the following dates, to-wit:

April 14, 2004

PUBLIC NOTICE OF AN APPLICATION FOR AN ORDER AUTHORIZING THE ISSUANCE OF Long Term Debt

BY Keaton Development Co., Inc.

Keaton Development Co. filed an Applicatio with the Arizona Corporation Commision (Commission) for an order authorizing Applicant to issue $40,000.00 of Long Term Debt. The application is available for inspection during regular business hours at the office of the Commission in Phoenix, Arizona, and the Company's offices in Salome, Arizona.

Intervention in the Commission's proceedings on the application shall be permitted to any person entitled by law to intervene and having a direct substantial interest in this matter. Persons desiring to intervene must file a Motion to Intervene with the Commission which must be served upon applicant and which, at a minimum, shall contain the following information:

1. The name, address and telephone number of the proposed intervenor and of any person upon whom service of documents is to be made if different than the intervenor.
2. A short statement of the proposed intervenor's interest in the proceeding.
3. Whter the proposed intervenor desires a formal evidentiary hearing on the application and the reasons for such a hearing.
4. A statement certifying that a copy of the Motion to Intervene has been mailed to Applicant.

The granting of Motions to Intervene shall be governed by A.A.C. R14-3-105, except that all Motions to Intervene must be filed on, or before, the 15th day after this notice.

PUBLISH: Aug. 14, 2004 7757

Subscribed and sworn to before me this 15th day of April, 2004.

Sandra K Griffin

Notary Public in and for the County of La Paz, State of Arizona.

My Commission Expires:

OFFICIAL SEAL
SANDRA K. GRIFFIN
Notary Public - State of Arizona
MOHAVE COUNTY
My Comm. Expires July 24, 2004