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MEMORANDUM

TO: Docket Control

FROM: Deborah R. Scott  
Director  
Utilities Division

DATE: April 18, 2001

RE: STAFF REPORT FOR THE APPLICATION OF DIVERSIFIED WATER UTILITIES, INC., AN ARIZONA CORPORATION, FOR AUTHORITY TO ISSUE DEBT (DOCKET NO. W-02859A-00-0964)

Attached is the Staff Report for the application of Diversified Water Utilities, Inc., for approval to issue long-term debt for the purpose of financing the purchase and installation of water utility plant. Staff recommends approval of the request without a hearing.

DRS:LAJ:jbc

Originator: Linda A. Jaress

Attachment: Original and eleven copies

Arizona Corporation Commission

DOCKETED

APR 20 2001

DOCKETED BY	
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STAFF REPORT  
UTILITIES DIVISION  
ARIZONA CORPORATION COMMISSION

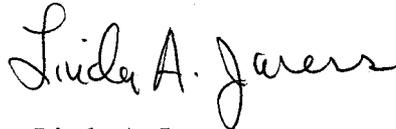
DIVERSIFIED WATER UTILITIES, INC.  
DOCKET NO. W-02859A-00-0964

APPLICATION  
FOR AUTHORITY TO ISSUE LONG-TERM DEBT

APRIL 2001

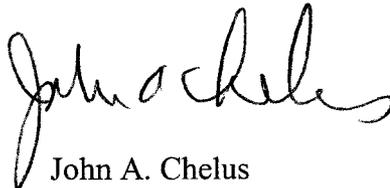
STAFF ACKNOWLEDGMENT

The financial analysis contained in the Staff Report for Diversified Water Utilities, Inc., Docket No. W-02859A-00-0964, was prepared by Linda A. Jaress.

A handwritten signature in cursive script that reads "Linda A. Jaress".

Linda A. Jaress  
Executive Consultant 111

The engineering analysis contained in the Staff Report was prepared by John A. Chelus, Utilities Engineer.

A handwritten signature in cursive script that reads "John A. Chelus".

John A. Chelus  
Utilities Engineer

On November 22, 2000 Diversified Water Utilities, Inc. ("Diversified" or "the Company"), filed an application for approval to issue debt in the amount of \$58,428.30 to Skyline Vista Ranch, L.L.C. ("Skyline" or "the Developer") and \$378,900 to the Water Infrastructure Financing Authority ("WIFA").

### Background

Diversified currently serves approximately 177 customers in Pinal County. Diversified's current rates were set pursuant to Decision No. 60219, dated May 27, 1997, based on a 1995 test year when the company served 43 customers. The rates were set at \$27.50 per month and \$3.65 per 1,000 gallons for a 5/8 x 3/4 meter customer. The Company was also granted an \$850 refundable Service Line and Meter Installation Charge for the same customer class.

On March 15, 1999, in Decision No. 61580, Diversified was granted an Off-site Facilities Hook-up Fee Tariff that instituted hook-up fees ranging from \$850 for a 5/8 x 3/4 inch meter to \$34,000 for a 6-inch meter. At that time, the Company had recently added 50 customers. The purpose of the hook-up fee as set forth in the Decision was to put the Company "in a much better position to add the required backbone plant to serve this relatively large amount of growth."

### Arizona Department of Environmental Quality (ADEQ) Compliance

ADEQ has determined that Diversified is currently delivering water that does not exceed any maximum contaminant levels and meets the Safe Drinking Water Act quality requirements.

### Arizona Department of Water Resources Compliance

Diversified is located in the Phoenix Active Management Area ("AMA") and is in compliance their regulations.

### The Purpose of the Debt

The funds from the proposed debt would be used to make improvements to the system. Diversified's water system consists of one 120 gallons per minute well, one 5,000 gallon pressure tank, two 10 horsepower booster pumps and one 20,000 gallon storage tank. According to Diversified, the system has adequate well capacity at the present time, but lacks necessary storage capacity. The proposed debt will finance the purchase and installation of a 250,000 gallon storage tank, a new well, pressure tank, booster pumps and a new 12-inch diameter distribution line.

Engineering Staff has reviewed the application and considers the proposed projects and the associated costs reasonable.

### The Proposed Skyline Debt

The loan from Skyline will be used to partially fund a twelve-inch and an eight-inch interconnection and line extension. The total cost of the extension will be \$131,109. As part of the settlement of a complaint filed with the Commission, the Company and the developer agreed that Diversified would pay the cost of materials and labor related to replacing or paralleling existing lines and necessary to increase the size of the line. The developer agreed to pay all other labor, equipment and material costs.

The result of the settlement is that Skyline would advance \$72,681, or approximately 55.0 percent of the cost of the line extension, and the remaining \$58,428 would be loaned to Diversified by Skyline. The terms of the Skyline loan consist of an interest rate of 8.0 percent and a maturity of five years.

### The WIFA Debt

Diversified is within WIFA's fundable range for a loan of up to \$378,900. The funds from the WIFA loan would be used to purchase and install the well and a storage tank. Although the final terms and conditions will not be known until the time the loan is funded, it is anticipated that the term will be twenty years with an interest rate equal to 70.0 percent of the prime rate. The current prime rate is 8.5 percent resulting in an estimated interest rate on the WIFA loan of 6.0 percent.

### The Ability of Diversified to Service the Proposed Debt

Diversified supplied "compiled" 1999 financial statements as Exhibit D, to the application. According to the Company's auditors, compiled financial statements are limited to presenting "information that is the representation of management" and they had neither audited nor reviewed the financial statements. Compiled financial statements are often necessary because of the prohibitive cost of audited financial statements.

Attached as Exhibit 1 is relevant financial information taken from Diversified's compiled financial statements for the years ending December 31, 1999 and 2000. The 1999 financial statements reflect a company in poor financial health. The Company owed approximately \$100,000 in debt and had negative equity of \$22,000. The Company also suffered a net loss of \$1,700 for the year. Staff's initial analysis of the financial statements found that the Company did not have sufficient funds to make timely principal, interest and reserve payments on the total amount of the proposed debt.

Staff requested more information from the Company including an explanation of how the Company would have the means to make timely payments on the proposed debt. The Company responded that it would rely on the \$850 "connection fee" to generate the funds and, if necessary, the Company President was willing to "continue deferring payment of salary."

Soon thereafter, the Company supplied compiled financial statements for the year 2000. These statements reflect a company in better financial health than in 1999. Positive net income of \$15,319 was generated and equity increased from negative \$22,000 to positive \$33,000. This was accomplished by an increase in revenues of approximately \$10,000, a \$3,000 reduction in expenses, and the elimination of certain salaries and payables to shareholders.

The abbreviated financial statements and debt service analysis for Diversified are attached as Exhibit 1. It can be seen that \$55,000 of cash is required each year to service the proposed additional debt of \$437,438, while the Company is only generating approximately \$22,000 of cash. Staff contacted the Company regarding this deficiency. The Company contends that the funds generated by the hook-up fee will be sufficient to make up the difference between cash uses and cash sources.

The Company has provided Staff with a copy of a written request for service sent by a representative of Skyline to Diversified, Salt River Project, Qwest, the City of Mesa and Cox for planning purposes. Skyline expects to build three phases of a subdivision "as soon as they obtain all of the required approvals." Diversified expects that within one year, it will receive \$91,800 in hook-up fees from the three phases of the Skyline subdivision. If the customers materialize, diversified will also experience increased revenues.

Staff suggested that the Company apply for a rate increase to assure cash flow necessary for debt service. The Company expressed great reluctance to increase rates for this purpose. It will rely upon revenues and hook-up fees from the new subdivisions for those funds.

Staff believes there is some risk, as is common in the real estate industry, that some or all of the planned subdivision will not materialize and that current customers, under current rates, may not generate sufficient revenues to adequately cover debt service related to the proposed debt. However, due to the Company's reluctance to raise rates, Staff recommends an alternative solution.

Staff recommends that the Company file a cash flow statement in the docket on July 31, 2002, for Staff's review. Staff also recommends that the Commission approve the total amount of debt requested by the Company with the additional condition that if Diversified does not generate positive cash flow by June 30, 2002, that the Company file for a rate increase by September 30, 2002. These conditions should reduce the risk of financial harm that the Company would experience if the additional customers do not materialize.

Conclusions and Recommendations

Staff recommends approval of Diversified's application for approval to issue debt in the amount of \$58,428.30 to Skyline Vista Ranch, L.L.C., and \$378,900 to the Water Infrastructure Financing Authority.

The terms of the Skyline loan will be five years at 8.0 percent interest. The WIFA terms will be determined at the time the loan is drawn.

Staff believes the debt is for utility purposes and the projects and their estimated costs are reasonable.

Staff recommends that the Company file a cash flow statement in the docket on July 31, 2002, for Staff's review.

Staff further recommends that if Diversified does not generate positive cash flow, including principal and interest payments on the proposed debt by June 30, 2002, that the Company file for a rate increase by September 30, 2002.

Under these conditions, Staff believes that the proposed debt is in the public interest, is compatible with sound financial practices and should be approved.

**DIVERSIFIED WATER UTILITIES, INC.**  
Years Ending December 31, 1999 and 2000

*Abbreviated Income Statement*

	<u>1999</u>	<u>2000</u>
Revenue	\$ 93,988	\$ 102,606
Depreciation	\$ 7,908	\$ 20,154
Op. Expenses	<u>\$ 82,431</u>	<u>\$ 67,207</u>
Total Op. Expenses	\$ 90,339	\$ 83,157
Op. Income	<u>\$ 3,649</u>	<u>\$ 19,449</u>
Interest Exp. Net	\$ 5,360	\$ 4,130
Net Income	<u>\$ (1,711)</u>	<u>\$ 15,319</u>

*Abbreviated Balance Sheet*

<b>Assets:</b>		
Net Plant	\$ 167,636	\$ 574,317
Current assets	\$ 15,911	\$ 24,978
<b>Liabilities:</b>		
Current Liabilities	\$ 136,737	\$ 61,437
Meter deposits	\$ 68,542	\$ 92,229
Advances-in-aid	-	290,439
Contributions	-	19,373
Long term debt	45,922	25,039
Equity	<u>\$ (21,731)</u>	<u>\$ 32,747</u>
Total Capital	\$ 24,191	\$ 459,827

*Cash Available for Debt Service on Proposed Debt*

Depreciation	\$ 20,154
Net Income	<u>\$ 15,319</u>
Subtotal	<u>\$ 35,473</u>
less;	
Principal/Harris Trust note	\$ 5,424
Meter Deposit Refunds	\$ 7,853
Total Cash available for debt service on new debt	<u>\$ 22,196</u>
Debt Service for proposed debt of \$437,328.	<u>\$ 55,378</u>
Difference between Debt Service and Cash Flow	<u>\$ (33,182)</u>

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