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BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL
CHAIRMAN
JIM IRVIN
COMMISSIONER
MARC SPITZER
COMMISSIONER

Arizona Corporation Commission
AZ CORP COMMISSION
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IN THE MATTER OF THE) DOCKET NO. W-02859A-00-0964
APPLICATION OF DIVERSIFIED)
WATER UTILITIES, INC., AN) **DIVERSIFIED WATER UTILITIES,**
ARIZONA CORPORATION, FOR) **INC.'S EXCEPTIONS TO THE**
AUTHORITY TO ISSUE DEBT) **RECOMMENDED ORDER**

Diversified Water Utilities, Inc. ("Diversified") hereby respectfully submits exceptions to the recommendations submitted by the Administrative Law Judge ("ALJ") in the above-captioned matter pursuant to A.A.C. R14-3-110(B) and requests the Commission adopt the recommendation of Staff and approve the financing in full and reject the ALJ's Recommendation. In particular, Diversified takes exception to the Recommended Order's failure to approve the \$58,428.30 loan to Skyline Vista Ranch, L.L.C. and its approval of the \$353,900 WIFA loan "only if Diversified Water Utilities, Inc. infuses the company with at least \$58,428.30 in equity by funding its portion of the agreement with Skyline."

I. THE NATURE OF THE FINANCING

Briefly, Diversified seeks \$353,900 from the Water Infrastructure Financing Authority ("WIFA") payable over 20 years at an interest rate of approximately 6% or less. The funds will be used to fund a pressure tank, a 200,000 gallon storage tank, upgrade an existing well and obtain a second production well system. This additional plant is necessary and appropriate to serve Diversified's existing customers, as well as the growth

1 that is reasonably anticipated within its certificated area. In fact, in order to comply with
2 Arizona Department of Environmental Quality guidelines and to avoid water shortages
3 during peak demand times, Diversified's Shareholder secured and paid for a 200,000
4 gallon storage tank so that it could be installed prior to the summer. This was done as a
5 short-term bridge, pending Commission and WIFA approval of this financing application.

6
7 The second component of this financing is a \$58,428.30 loan at 8% interest
8 over five years from Skyline Vista Ranch, L.L.C. ("SVR"). The SVR loan is the result of
9 a settlement between Diversified and a lot split development group ("Developer") caused
10 by a Formal Complaint captioned James Marchant vs. Diversified Water Utilities, Inc.,
11 Docket No. W-02859A-97-0268 Number 63015. The Developer developed a 160-acre
12 wildcat subdivision ("Development") that required a main transmission line to the
13 Development. Diversified and the Developer disagreed as to the type of project being
14 developed, the facilities needed and who was responsible for installing the facilities
15 needed. As a compromise, after discussions, and in settlement, Diversified and the
16 Developer agreed upon \$131,109.30 worth of system of improvements. The parties
17 further agreed that \$72,681 would be deemed an advance-in-aid-of-construction. The
18 remaining sum, \$58,428.30, would be the responsibility of Diversified. SVR, comprised
19 in part of the Developers, provided the funds as a five-year loan at an 8% annual interest
20 rate. SRV and the Developers were informed and understood that the loan would have to
21 be approved by the Commission to be enforceable. With this understanding, the facilities
22 were installed. The sum allocated to the Company represents the materials used to
23 installing an 8-inch and 12-inch main transmission line to the Development. Diversified
24 desires to abide by the settlement and supports paying SVR the funds, as a loan.
25
26

1 Diversified, however, opposes paying SVR in a lump sum as proposed by the ALJ or
2 conditioning the WIFA loan on such payment. Such action constitutes a windfall for SVR
3 and the Developer.

4 **II. THE ALJ'S CONCERN REGARDING CAPITAL STRUCTURE IS**
5 **MISPLACED**

6 **A. Cash Flow is No Longer an Issue.**

7
8 Initially the ALJ expressed concern regarding the ability of Diversified to
9 cash flow the loan. Diversified appreciates that concern. However, Diversified has fully
10 addressed this concern. The annualized year to date financials reflects that Diversified's
11 operating revenues will increase by approximately 70% from \$102,606 for the year 2000
12 to \$175,000. Net income will increase from \$15,319 to \$74,486. From a situation where
13 the debt service would exceed available cash by \$24,882, the projected statement for 2001
14 shows the debt service can be easily satisfied. Diversified's updated Abbreviated Income
15 Statement for 1999, 2000 and 2001 (annualized based upon the six months ending July 31,
16 2001), is attached as Exhibit A. In fact, the data demonstrates Diversified's cash flow has
17 increased by approximately \$65,000 and that it can anticipate \$87,562 in cash flow from
18 operations available to finance the \$47,078 needed to service its proposed debt.

19
20 Furthermore, Diversified has demonstrated that its historical growth for the
21 past three years is 30 to 45 customers. A chart reflecting the number of identifiable lots
22 within its Diversified's certificated area, the number that are occupied and the number that
23 are yet to be developed is attached hereto as Exhibit B. The chart demonstrates that out of
24 1,089 potential developable lots currently within Diversified's certificated area, 890
25 remain to be developed. Diversified is authorized to collect \$850 for each new connection
26

1 to assist financing of backbone plant. Thus, the 890 unoccupied lots represent a potential
2 of \$756,500 in funds to be generated to assist in the payment of the indebtedness before
3 the Commission. Diversified is currently experiencing approximately 3 to 4 customer
4 hookups per month or 36 to 48 customers per year. Thus, in addition to the cash flows
5 now being generated by the Company, the Company can reasonably expect at least
6 \$30,000 per year in connection fees.

7
8 **B. Debt to Equity Ratios are Meaningless for Small Water
9 Companies.**

10 The proposed Amendment filed by the Hearing Division recognizes that the
11 information provided after the filing of the proposed order "predicts that [the Company]
12 will be able to service the entire debt." However, the ALJ continues to decline to
13 recommend authorization of the indebtedness to Skyline Vista Ranch, L.L.C. because "the
14 Commission is concerned that, if the entire amount of the debt were approved, the
15 Company's capital structure would be approximately 93% debt and 7% equity" has not
16 been addressed. Currently Diversified's capital structure is 23% debt and 77% equity.
17 However, it is not uncommon for a small utility to be almost 100% debt financing,
18 especially where they are undergoing significant plant improvements or expansions. Here,
19 the debt represents a 70% growth in total fixed assets (\$412,328.30 versus current fixed
20 assets of \$587,440.40). To consider debt/equity ratios for a small utility is unproductive
21 and not a normal practice of this Commission. In fact, capital structures are seldom, if
22 ever, examined in rate cases for companies with revenues under \$250,000. When you are
23 dealing with small dollars, any significant indebtedness will cause significant shifts in the
24 debt to equity ratio. The issue is, can the Company cash flow the debt? In fact, WIFA's

25
26 ///

1 purpose is to provide low cost highly leveraged debt to small utilities so they are
2 encouraged to make appropriate improvements.

3 The Company, until last year, suffered operating losses since the new
4 owners took over in 1994. As a result, the Company, until last year, had a negative
5 retained earnings. The negative retained earnings reflect that there have been no profits to
6 invest in the Company. Under such circumstances, it is unrealistic to expect the Company
7 to have a significant level of equity at this time.

8
9 **III. DIVERSIFIED'S SOLE SHAREHOLDER HAS DEMONSTRATED**
10 **AN ABILITY AND WILLINGNESS TO SUPPLY CAPITAL WHEN**
11 **NECESSARY**

12 Prior to the acquisition by its current shareholder, Mr. Gray, the utility was
13 under an Arizona Department of Environmental Quality Cease and Desist Order and was
14 delinquent in property taxes. To address the problems, Mr. Gray personally guaranteed a
15 \$40,000 loan to Diversified from Harris Trust (and it is possible WIFA will require a
16 similar personal guarantee). These funds were used to improve Diversified's system and
17 to remedy the Cease and Desist Order. Additionally, in order to minimize operating
18 expenses, Mr. Gray performs appropriate hands-on construction improvements, performs
19 some minor repairs and otherwise contributes his labor to the Company. Mr. Gray, who
20 also acts as the officer and general manager, as well as field laborer for the Company, is
21 currently drawing a *de minimis* salary from Diversified. Obviously, the Company has
22 never paid a dividend. In fact, until last year, the Company had not shown any positive
23 income. Yet, Diversified's system and service keeps improving.

24 ///

25 ///

26

1 The efforts of the Company are starting to show fruition. The net plant of
2 the Company has increased from approximately \$35,000 at the end of 1995 to \$587,440 as
3 of July 31, 2001. The \$40,000 debt has been paid down to \$20,597. The negative retained
4 earnings of \$22,019 as of December 31, 1999 is now a positive \$30,757. Where the
5 Company had a negative equity of \$21,731 as of December 31, 1999, it now has a positive
6 equity of \$69,990 as of July 31, 2001; a \$90,000 increase in equity over just a two and
7 one-half year period.

8
9 As the system improves, moderate growth will continue. As a result, gross
10 revenues will continue to increase. The plant encompassed by this financing is necessary
11 and appropriate in order to sustain this growth and to provide its existing customers
12 reliable water service.

13 **IV. THE DEBT TO EQUITY RATIO WILL LIKELY NEVER REACH**
14 **THE 97/3 LEVEL**

15 The WIFA financing has not yet been approved. Further, it is not
16 anticipated that the WIFA loan will be fully funded for a 12 to 18 month period,
17 depending on how quickly construction of the needed improvements can proceed.
18 Therefore, upon approval of financing by this Commission, Diversified will immediately
19 commence paying the Skyline Vista Ranch, L.L.C. debt and will continue to pay the
20 Harris Trust loan. By the time the WIFA loan is actually fully funded these debts will
21 have been paid down and the equity to debt ratio will never reach the levels projected by
22 the ALJ.

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WHEREFORE, it is respectfully requested that the Commission amend the Recommended Order and approve the full financing application as recommended by Staff.

Respectfully submitted this 7th day of September, 2001.

MARTINEZ & CURTIS, P.C.



William P. Sullivan, Esq.
Paul R. Michaud
2712 North Seventh Street
Phoenix, Arizona 85006-1090
Attorneys for Diversified Water Utilities, Inc.

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**PROOF OF SERVICE AND
CERTIFICATE OF MAILING**

I hereby certify that on this 7th day of September, 2001, I caused the foregoing document to be served on the Arizona Corporation Commission by hand-delivering the original and ten (10) copies of said document to:

Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

With copies of the foregoing mailed/hand-delivered this 7th day of September, 2001 to:

Philip J. Dion, III, Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

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

Steve Olea, Acting Director
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007


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EXHIBIT A

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

Abbreviated Income Statement

	<u>1999</u>	<u>2000</u>	<u>2001</u> (Projected based on 7/3/01 date)
Revenue	\$ 93,988	\$ 102,606	\$ 175,000
Depreciation	\$ 7,908	\$ 20,154	\$ 26,676
Op. Expenses	<u>\$ 82,431</u>	<u>\$ 67,207</u>	<u>\$ 77,014</u>
Total Op. Expenses	\$ 90,339	\$ 83,157	\$ 103,690
Op. Income	<u>\$ 3,649</u>	<u>\$ 19,449</u>	<u>\$ 78,340</u>
Interest Exp. Net	\$ 5,360	\$ 4,130	\$ 3,854
Net Income	<u>\$ (1,711)</u>	<u>\$ 15,319</u>	<u>\$ 74,486</u>

Abbreviated Balance Sheet

Assets:			
Net Plant	\$ 167,636	\$ 574,317	\$ 587,440
Current assets	\$ 15,911	\$ 24,978	\$ 43,186
Liabilities:			
Current Liabilities	\$ 136,737	\$ 61,437	\$ 133,376
Meter deposits	\$ 68,542	\$ 92,229	\$ 116,444
Advances-in-aid	-	\$ 290,439	\$ 290,439
Contributions	-	\$ 19,373	\$ 34,000
Long term debt	\$ 45,922	\$ 25,039	\$ 20,597
Equity	<u>\$ (21,731)</u>	<u>\$ 32,747</u>	<u>\$ 69,990</u>
Total Capital	\$ 24,191	\$ 459,827	

Cash Available for Debt Service on Proposed Debt

Depreciation		\$ 20,154	\$ 26,676
Net Income		<u>\$ 15,319</u>	<u>\$ 74,486</u>
Subtotal		\$ 35,473	\$ 101,162
less;			
Principal/Harris Trust note		\$ 5,424	\$ 5,600
Meter Deposit Refunds		\$ 7,853	\$ 8,000
Total Cash available for debt service on new debt		<u>\$ 22,196</u>	<u>\$ 87,562</u>
Debt Service for proposed debt of \$412,328.		<u>\$ 47,078</u>	<u>\$ 47,078</u>
Difference between Debt Service and Cash Flow		<u>\$ (24,882)</u>	<u>\$ 40,484</u>

EXHIBIT B

**CURRENT STATUS OF ACTIVE DEVELOPMENT WITHIN
DIVERSIFIED WATER UTILITIES, INC.'S CERTIFICATED AREA**

	Identification of Area	Total Developable Lots	Connections	Lots Left to be Developed
1.	Quail Hollow Subdivision	120	37	83
2.	Valley of the Sun Subdivision	441	59	382
3.	Skyline Vista Subdivision	144	15	129
4.	North Wildcat Area	Approx. 256	18	238
5.	South Wildcat Area	Approx. 128	70	58
	TOTAL	1,089	199	890

EXCEPTION

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BEFORE THE ARIZONA CORPORATION COMMISSION

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1
2 **WILLIAM A. MUNDELL**
3 **Chairman**

Arizona Corporation Commission

DOCKETED

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3 **JIM IRVIN**
4 **Commissioner**

SEP 07 2001

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4 **MARC SPITZER**
5 **Commissioner**

DOCKETED BY	<i>me</i>
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6 **IN THE MATTER OF THE APPLICATION)**
7 **OF DIVERSIFIED WATER UTILITIES,)**
8 **INC., AN ARIZONA CORPORATION, FOR)**
9 **AUTHORITY TO ISSUE DEBT.)**

Docket No. W-02859A-00-0964

**STAFF'S EXCEPTIONS TO THE
ADMINISTRATIVE LAW JUDGE'S
PROPOSED ORDER**

10 Diversified Water Utilities, Inc. ("Diversified") has filed a financing application,
11 seeking the Commission's approval to obtain a WIFA loan. The Administrative Law Judge has
12 issued a Proposed Order, approving the application but requiring Diversified to obtain additional
13 equity before it may draw funds from the WIFA loan. Staff respectfully disagrees with this
14 requirement for three reasons: 1) it may discourage small water companies from availing
15 themselves of WIFA loans, 2) it places too much emphasis on the Company's capital structure,
16 and 3) it treats Diversified differently than other utilities.

17 First, if the Commission requires water companies that have negative equity --and there
18 are many-- to infuse equity before drawing funds from WIFA loans, the companies may hesitate
19 or completely avoid availing themselves of WIFA funds. To the owners, such a requirement
20 would drive up the "cost" of any loan.

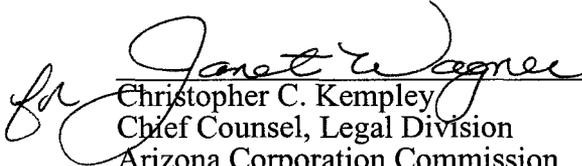
21 Second, the Proposed Order indicates that requiring the owners to infuse equity in the
22 Company will enhance the Company's likelihood of obtaining the WIFA loan because the capital
23 structure will be stronger. WIFA's primary interest, as is any bank's, is the Company's ability to
24 service the debt, not the Company's capital structure. This is based on the fact that a company's
25 capital structure reflects its entire financial history rather than only current financial health. To
26 illustrate how little significance this Commission and lending institutions have placed on capital
27 structure, Tucson Electric Power Company, Arizona Electric Power Cooperative, Graham
28 County Utilities, Dragoon Water Company, Cienega Springs Water Company, and Shepard

1 Water Company, among many others, have obtained debt at reasonable terms, as well as
2 Commission approval of that debt, when their capital structures were comprised of negative
3 equity and over one-hundred percent debt.

4 Third, and finally, the Proposed Order may ultimately result in higher rates. Although
5 the Proposed Order concludes that infusing equity in place of an equal amount of debt will
6 reduce the impact on rates, this conclusion implies that equity carries a zero cost. This
7 Commission has long recognized the financial precept that the cost of equity is higher than the
8 cost of debt. Depending on how the Commission sets rates in Diversified's next rate case, an
9 infusion of equity could result in a higher cost of capital and higher rates.

10 Staff believes that its recommendation that Diversified file a cash flow statement in July
11 2002, and a subsequent rate case if cash flow is shown to be insufficient, provides enough
12 protection to the ratepayers' interests and the Company's financial health. Staff continues to
13 support its recommendations as filed and incorporated into the attached amendments.

14 RESPECTFULLY SUBMITTED this 7th day of September, 2001.

15
16 
17 Christopher C. Kempley
18 Chief Counsel, Legal Division
19 Arizona Corporation Commission
1200 W. Washington Street
Phoenix, Arizona 85007
Telephone: (602) 542-3402
Facsimile: (602) 542-4870

20 Original and ten copies of the foregoing
21 were filed this 7th day of September, 2001 with:

22 Docket Control
23 Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

24 Copies of the foregoing were mailed and/or
25 hand-delivered this 7th day of September,
26 2001, to:

27 William P. Sullivan
28 MARTINEZ & CURTIS, P.C.
2712 North 7th Street
Phoenix, Arizona 85006-1090

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Steve Olea
Acting Director
Utilities Division
Arizona Corporation Commission
1200 W. Washington St.
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Philip Dion
Administrative Law Judge
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Phoenix, Arizona 85007

Monica A. Martinez
Legal Assistant to Christopher C. Kempley
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UTILITIES DIVISION PROPOSED AMENDMENT 1

TIME/DATE PREPARED: September 7, 2001

COMPANY: DIVERSIFIED WATER UTILITIES, INC.

AGENDA NO.: U-9

DOCKET NO.: W-02859A-00-0964

OPEN MEETING DATE: September 11,2001

Page 1, Line 28: **INSERT:**

After the filing of the proposed Order in this matter, the Company filed two letters, one on August 24, 2001 and the other on August 31, 2001, regarding the Company's current financial status.

Page 6, Line 17 **INSERT:**

Based on increased revenues since January 1, 2001 and the Company's projections of future revenues, the Company believes it can now support the entire debt service requirements without reliance on hook-up fees.

After receiving and reviewing the Company's August 24th and August 31st letters, Staff has not changed its recommendations.

Page 6, Line 17 through page 7 line 25 **DELETE.**

Page 10, line 14 **DELETE:** the word "not"

Page 10, Line 15, **DELETE:** the word "not"

Page 10, Lines 17 through 12 **DELETE**

Page 10, Lines 28 through Page 11, Line 5 **DELETE**

Page 11, Line 22 **DELETE:** (,) after "draw". **Insert** (,) after "draw".

Page 11, Line 22. through 26 **DELETE:** "only" through and including "purpose"

Page 11, Line 22 **INSERT:**

IT IS FURTHER ORDERED that Diversified Water Utilities, Inc. is hereby authorized to obtain \$58,428 in unsecured long-term financing from Skyline Vista Ranch, L.L.C. at terms of 8.0 percent interest with repayment over five years.