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Arizona Corporation Commission  
BEFORE THE ARIZONA CORPORATION COMMISSION

**DOCKETED**

OCT - 3 2001

1  
2 WILLIAM A. MUNDELL  
3 CHAIRMAN  
4 JIM IRVIN  
5 COMMISSIONER  
6 MARC SPITZER  
7 COMMISSIONER

DOCKETED BY *sd*

8 IN THE MATTER OF THE APPLICATION OF  
9 DIVERSIFIED WATER UTILITIES, INC., AN  
10 ARIZONA CORPORATION, FOR AUTHORITY  
11 TO ISSUE DEBT.

DOCKET NO. W-02859A-00-0964

DECISION NO. 64061

**ORDER**

12 Open Meeting  
13 September 13, 2001  
14 Phoenix, Arizona

15 **BY THE COMMISSION:**

16 On November 27, 2000, Diversified Water Utilities, Inc. ("Diversified", "Applicant" or  
17 "Company") filed an application for debt financing with the Arizona Corporation Commission  
18 ("Commission") requesting authorization to issue long-term debt in the amount of \$378,900 to the  
19 Water Infrastructure Financing Authority ("WIFA") and to issue short-term debt in the amount of  
20 \$58,428.30 to Skyline Vista Ranch, L.L.C. ("Skyline" or "Developer"). The total amount of debt in  
21 the original application was \$437,328.30.

22 On April 18, 2001, Staff filed its Staff Report in the matter, recommending approval of the  
23 application without a hearing.

24 On April 26, 2001, Diversified filed an affidavit indicating it provided notice of its application  
25 on April 17, 2001, through a direct mailing to each of its customers.

26 In June 2001, Diversified notified the Commission's Utilities Division Staff ("Staff") that the  
27 amount of debt financing it needed would be reduced. Diversified now requests authorization to  
28 issue long-term debt in the amount of \$353,900 to WIFA and to issue short-term debt in the amount  
of \$58,428.30 to Skyline. The new total amount of debt requested in this application is \$412,328.30.

On July 20, 2001, Staff filed an amended Staff Report ("Amended Report") in the matter,  
again recommending approval of the application without a hearing. The Amended Report was  
generated to update the docket regarding the change in the WIFA portion of the financing.

1 The Arizona Department of Environmental Quality ("ADEQ") has determined that  
2 Diversified is currently delivering water that does not exceed any maximum contaminant levels and  
3 meets the Safe Drinking Water Act quality requirements. Diversified is located in the Phoenix  
4 Active Management Area and is in compliance with its regulations.

## 5 DISCUSSION

### 6 Introduction

7 Diversified provides water utility service to approximately 177 customers in Pinal County.  
8 Diversified's Certificate of Convenience and Necessity ("CC&N") was originally granted to  
9 Ellsworth Land and Livestock, Inc. in Decision No. 33633-A (January 30, 1962). It was  
10 subsequently transferred to Diversified in Decision No. 59133 (June 27, 1995). Diversified's current  
11 rates were approved in Decision No. 60219 on May 27, 1997, based on a 1995 test year when  
12 Diversified only served 43 customers. If Diversified's historical growth rate continues, it could have  
13 355 customers by the end of 2005.

14 In Decision No. 60219, Diversified was ordered to reduce unaccounted water loss to 15  
15 percent or less by its next rate filing. Staff Engineering indicated that based on data provided by  
16 Diversified, the unaccounted water loss on the system for the year 2000 was at 15 percent.  
17 Engineering Staff states that this level is still too high, but also notes that "good progress" is being  
18 made.

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

### 24 Purpose of Financing

#### 25 A. The Proposed WIFA Debt

26 Diversified is within WIFA's fundable range for a loan up to \$378,900. Initially, the funds  
27 from the WIFA loan would be used to make improvements on the system including the purchase and  
28 installation of a 250,000-gallon storage tank, a well, a pressure tank, booster pumps and a 12-inch



1 Report, the prime rate was 8.5 percent. Therefore, the estimated interest rate on the WIFA loan was  
2 assumed to be 6.0 percent.

3 B. The Proposed Skyline Debt

4 The amount of the proposed Skyline debt is \$58,428.30. The terms of the Skyline loan  
5 consist of an interest rate of 8.0 percent and a maturity date of five years. The short duration of the  
6 loan and its associated loan payment would substantially impact the Company's cash flow. The loan  
7 agreement was negotiated between the parties at arms length, and Diversified is not affiliated with,  
8 nor is it a subsidiary of Skyline.

9 **Capital Structure and Financial Impact**

10 Diversified supplied "compiled" 1999 financial statements with the application. According to  
11 Diversified's auditors, compiled financial statements are limited to presenting "information that is the  
12 representation of management" and they had neither audited, nor reviewed the financial statements.  
13 Compiled statements are used because of the prohibitive cost of audited financial statements.

14 According to the Staff Report, the 1999 compiled financial statements reflect a company in  
15 poor financial health. Diversified owed approximately \$100,000 in debt and had negative equity of  
16 (\$22,000). Diversified also suffered a net loss of (\$1,700) for the year.

17 Subsequently, Diversified supplied Staff with compiled financial statements for the year 2000.  
18 These statements reflect a company in better financial health than in 1999. Equity increased from a  
19 negative (\$22,000) to a positive \$33,000. Net income increased from a loss of (\$1,700) to a positive  
20 \$15,319. An increase in revenues of approximately \$10,000, and the elimination of certain salaries  
21 and payables to shareholders accomplished this turnaround.

22 Based on the new information in the Amended Report, Staff estimated that Diversified needs  
23 approximately \$47,000 a year for the first five years to service the proposed additional debt of  
24 \$412,328.30. After five years, the Skyline loan will have been paid off and therefore, only  
25 approximately \$30,000 per year will be required to service the WIFA loan.

26 Currently, Diversified is only generating \$22,000 in cash per year that can be applied for debt  
27 service towards the proposed debt. Staff was concerned about the ability of Diversified to service the  
28 proposed debt. Staff requested more information from Diversified including an explanation of how

1 Diversified would have the means to make timely payments on the proposed debt. Diversified  
2 responded that it would rely on the \$850 "connection fee" to generate the funds and, if necessary, the  
3 President of Diversified was willing to "continue deferring payment of salary." Diversified stated the  
4 growth in its area will generate new hook-up fees and revenues that will be sufficient to make up the  
5 difference between cash uses and cash sources.

6 Diversified provided Staff with a copy of a written request for service sent by a representative  
7 of Skyline to Diversified, Salt River Project, Qwest, the City of Mesa and Cox, for planning  
8 purposes. Skyline expects to build three phases of a subdivision "as soon as they obtain all of the  
9 required approvals." Diversified also supplied Staff with information that it has averaged 35 to 45  
10 new 5/8-inch by 3/4-inch meter connections per year. Diversified expects this trend to continue  
11 because of the new Skyline subdivision. Therefore, Diversified states it expects to generate between  
12 \$29,750 to \$38,250 in connection fees per year for the foreseeable future. Although hook-up fee  
13 revenues have historically been used by the Company for system upgrades, those funds will now be  
14 needed to help service the proposed debt. If the new subdivision materializes, Diversified will  
15 experience increased revenues from hook-up fees and new customer usage.

16 As a measure of financial soundness, Staff examined the effects of the proposed debt in  
17 relation to Diversified's Debt Service Coverage ("DSC") ratio. That ratio measures the number of  
18 times cash flow will cover principal and interest payments. In 2000, Diversified's DSC was 4.5.

19 Under the Company's proposal, the anticipated annual principal and interest payment related  
20 to the debt for the first year would be \$47,000 and the projected DSC ratio is 0.70. That number is  
21 below 1.00, indicating that Diversified may not be able to service the proposed debt.

22 Diversified's 2000 year-end capital structure was approximately 43 percent total debt and 57  
23 percent equity. The addition of the proposed debt would raise the percentage of total debt from 43  
24 percent to 93 percent and lower equity from 57 percent to 7 percent.

25 Staff suggested that Diversified apply for a rate increase to assure cash flow necessary for  
26 debt service. Diversified expressed great reluctance to increase rates for this purpose. It prefers to  
27 rely upon hook-up fees and usage revenues from the new connections for those funds.

28 Although recognizing Diversified's reluctance to raise rates, Staff believes there is some risk,

1 as is common in the real estate industry, that some or all of the planned subdivision will not  
 2 materialize and that current customers, under current rates, may not generate sufficient revenues to  
 3 adequately cover debt service related to the proposed debt. However, since the current rates paid by  
 4 Diversified's customers are significant, and due to Diversified's reluctance to raise rates, Staff  
 5 recommended an alternative solution.

6 Staff recommended that Diversified file a cash flow statement in the docket by July 31, 2002,  
 7 for Staff's review. Staff also recommended that the Commission approve the total amount of debt  
 8 requested by Diversified with the additional condition that, if Diversified does not generate sufficient  
 9 positive cash flow to service its debt by June 30, 2002, it will file for a rate increase by September 30,  
 10 2002. Staff indicates these conditions should reduce the risk of financial harm that Diversified would  
 11 experience if the additional customers do not materialize.

12 Based on the above conditions, Staff recommended approval of Diversified's application for  
 13 approval to issue long-term debt in the amount of \$353,900 to the Water Infrastructure Financing  
 14 Authority and short-term debt in the amount of \$58,428.30 to Skyline Vista Ranch, L.L.C. Staff  
 15 believes that the proposed debt is in the public interest, is compatible with sound financial practices  
 16 and should be approved without a hearing.

17 **Subsequent Information Filed by the Company**

18 After the filing of the proposed Order in this matter, the Company filed two letters, one on  
 19 August 24, 2001 and the other on August 31, 2001, regarding the Company's current financial status.  
 20 Those letters state that, due to the Company's increased revenues since January 1, 2001 and the  
 21 Company's projections of future revenues, the Company can now support the entire debt and the  
 22 associated payments even without reliance on hook up fees. Based on the Company's unaudited  
 23 numbers, the Company predicts that it will be able to service the entire debt. The Company argues  
 24 that based upon this new information the Commission should approve the entire debt in its  
 25 application.

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Analysis

If the Company assumes the entire amount of the proposed debt, its capital structure would be approximately 93 percent debt and 7 percent equity. Those figures are not representative of a Company with a healthy capital structure. At the Open Meeting held on this date, Diversified agreed to withdraw the portion of its application regarding the proposed Skyline debt without prejudice. The Company is free to reapply for the Skyline debt, if it so chooses.

With the withdrawal of the proposed Skyline debt and associated payments, the number of new hook-ups and the associated fees and revenues needed to cover the approved WIFA debt payments will likely be obtainable based upon past, current and predicted future growth in Diversified's service area. Moreover, if Diversified does not experience the type of growth to allow it to pay for this debt, and a rate case is subsequently filed, any impact on rate payers will be significantly less than under the scenario proposed by the Company. Therefore, we find that the Company shall be allowed to proceed with the WIFA loan.

In this Order, the Commission has tried to balance the needs of the Company to accommodate the growth in its service area, the financial impact to the Company of acquiring debt to pay for plant additions, the reluctance of Diversified to file a rate case, the impact of a rate case on current customers of Diversified and who should bear the risk that future development does not occur as expected. The Commission, in formulating this Order, has tried to balance all of those competing interests.

Accordingly, we will approve the WIFA financing in the amount of \$353,900 and grant Diversified's motion to withdraw the portion of its application regarding the Skyline debt without prejudice.

\* \* \* \* \*

Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

FINDINGS OF FACT

1. Diversified Water Utilities, Inc. is water company that serves approximately 177 customers in Pinal County.

1           2.       On November 27, 2000, Diversified filed an application for debt financing with the  
2 Commission requesting authorization to issue long-term debt in the amount of \$378,900 to the Water  
3 Infrastructure Financing Authority and to issue short-term debt in the amount of \$58,428.30 to  
4 Skyline Vista Ranch, L.L.C. The total amount of debt in the original application was \$437,328.30.

5           3.       In June 2001, Diversified notified Staff that the amount of debt financing it needed  
6 would be reduced. Diversified now requests authorization to issue long-term debt in the amount of  
7 \$353,900 to WIFA and to issue short-term debt in the amount of \$58,428.30 to Skyline. The new  
8 total amount of debt requested in this application is \$412,328.30.

9           4.       On April 26, 2001, Diversified filed an affidavit indicating it provided notice of its  
10 application on April 17, 2001, through a direct mailing to each of its customers.

11          5.       On April 18, 2001, Staff filed its Staff Report in the matter, recommending approval  
12 of the application without a hearing.

13          6.       On July 20, 2001, Staff filed an amended Staff Report in the matter, again  
14 recommending approval of the application without a hearing. The Amended Report was generated to  
15 update the docket regarding the WIFA portion of the financing.

16          7.       The Arizona Department of Environmental Quality has determined that Diversified is  
17 currently delivering water that does not exceed any maximum contaminant levels and meets the Safe  
18 Drinking Water Act quality requirements. Diversified is located in the Phoenix Active Management  
19 Area and is in compliance with its regulations.

20          8.       Based on the Amended Report, the funds from the WIFA loan would be used to pay  
21 for improvements on the system including the purchase and installation of a 200,000-gallon storage  
22 tank, a well, a pressure tank, booster pumps and a 12-inch distribution line.

23          9.       Engineering Staff predicts that Diversified will have a serious water shortage crisis in  
24 less than five years if the current growth rate continues and the Company does not expand its system  
25 in the near future. Engineering Staff has reviewed the WIFA application and, based on Diversified's  
26 current growth rate, considers the proposed projects and the associated costs reasonable.

27          10.       The loan from Skyline would be used to partially fund a 12-inch and 8-inch  
28 interconnection and line extension. The total cost of the project will be \$131,109.30. Diversified and

1 Skyline entered into an agreement in which Skyline will advance \$72,681, or 55 percent of the cost of  
2 the project, as an aid to construction. The remaining \$58,428.30 would be loaned to Diversified by  
3 Skyline. Engineering Staff has reviewed the Skyline application and considers the proposed projects  
4 and the associated costs reasonable.

5 11. The project will help Diversified meet expected future growth of customers, improve  
6 existing reliability and increase system service.

7 12. Based on the Amended Report, the WIFA loan is for an amount of up to \$353,900.  
8 Although the final terms and conditions of the WIFA loan will not be known until the time the loan is  
9 funded, it is anticipated that the term of the loan will be twenty years with an interest rate equal to  
10 70.0 percent of the prime rate. At the time of the Staff Report, the current prime rate was 8.5 percent.  
11 Therefore, the estimated interest rate on the WIFA loan was assumed to be 6.0 percent.

12 13. The amount of the proposed Skyline debt is \$58,428.30. The terms of the Skyline  
13 loan consist of an interest rate of 8.0 percent and a maturity date of five years.

14 14. Based on the new information in the Amended Report, Staff estimated that Diversified  
15 needs approximately \$47,000 a year for the first five years to service the proposed additional debt of  
16 \$412,328.30.

17 15. The Staff Report indicates Diversified is only generating \$22,000 in cash per year that  
18 can be applied for debt service towards the proposed debt. Diversified has filed subsequent  
19 information indicating it can service the entire debt.

20 16. Diversified stated the growth in its area will generate new hook-up fees and revenues  
21 that will be sufficient to make up the difference between cash uses and cash sources.

22 17. Diversified expects to generate between \$29,750 and \$38,250 in connection fees per  
23 year for the foreseeable future. Although hook-up fee revenues have historically been used by the  
24 Company for system upgrades, those funds will now be needed to help service the proposed debt.

25 18. There is some risk, as is common in the real estate industry, that some or all of the  
26 projected growth in Diversified's service area, and the associated hook-up fees and revenues, will not  
27 materialize.

28 19. The Company's current DSC is 4.5.

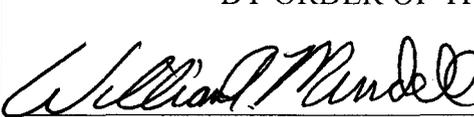
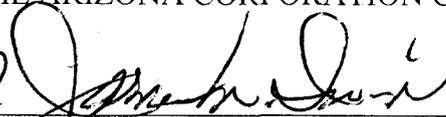
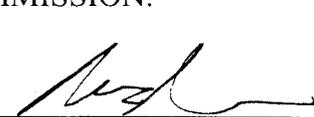




1 such financing.

2 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

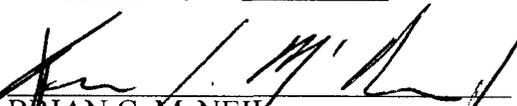
3 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

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5 CHAIRMAN COMMISSIONER COMMISSIONER

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7 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive  
 8 Secretary of the Arizona Corporation Commission, have  
 9 hereunto set my hand and caused the official seal of the  
 10 Commission to be affixed at the Capitol, in the City of Phoenix,  
 11 this 3rd day of October, 2001.

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13 BRIAN C. McNEIL  
 14 EXECUTIVE SECRETARY

15 DISSENT: \_\_\_\_\_

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1 SERVICE LIST FOR: DIVERSIFIED WATER UTILITIES, INC.

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

3  
4 William P. Sullivan  
MARTINEZ & CURTIS, P.C.  
2712 North 7<sup>th</sup> Street  
5 Phoenix, Arizona 85006-1090

6 Christopher Kempley, Chief Counsel  
Legal Division  
7 ARIZONA CORPORATION COMMISSION  
1200 West Washington Street  
8 Phoenix, Arizona 85007

9 Steve Olea, Acting Director  
Utilities Division  
10 ARIZONA CORPORATION COMMISSION  
1200 West Washington Street  
11 Phoenix, Arizona 85007

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