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MEMORANDUM

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AZ CORP COMMISSION
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TO: Docket Control
FROM: Ernest Johnson *EGJ*
Director
Utilities Division

DATE: January 25, 2002

RE: STAFF REPORT FOR ARIZONA WATER COMPANY'S APPLICATION FOR AN ORDER AUTHORIZING THE EXECUTION OF A LOAN AGREEMENT AND THE DELIVERY OF A PROMISSORY NOTE IN CONNECTION THEREWITH. (DOCKET NO. W-01445A-01-0408)

Attached is the Staff Report for Arizona Water Company's application for an order authorizing the execution of a loan agreement and the delivery of a promissory note in connection therewith. Staff further recommends that a hearing not be held in this matter.

EGJ:CSB:rdp

Originator: Crystal S. Brown

Attachment: Original and eleven copies

Arizona Corporation Commission

DOCKETED

JAN 28 2002

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| DOCKETED BY | <i>Adm</i> |
|-------------|------------|

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Docket No. W-01445A-01-0408

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

ARIZONA WATER COMPANY

DOCKET NO. W-01445A-01-0408

**APPLICATION FOR AN
ORDER AUTHORIZING
THE EXECUTION OF A LOAN AGREEMENT AND THE
DELIVERY OF A PROMISSORY NOTE IN CONNECTION THEREWITH**

JANUARY 2002

STAFF ACKNOWLEDGMENT

The Staff Report for Arizona Water Company, Docket Number W-01445A-01-0408, was the responsibility of the Staff members listed below. Crystal S. Brown was responsible for the review and analysis of the Company's application for authorization to execute a loan agreement. Marlin Scott, Jr. was responsible for the engineering and technical analysis.



Crystal S. Brown
Public Utilities Analyst V



Marlin Scott, Jr.
Public Utilities Engineer

**EXECUTIVE SUMMARY
ARIZONA WATER COMPANY
DOCKET NO. W-01445A-01-0408**

Arizona Water Company requests authority to execute a loan agreement with Bank of America ("Bank") to extend Arizona Water Company a line of credit in an amount not to exceed \$5 million.

The purpose of the financing is to reimburse the Company for actual monies spent for capital improvements and additions and to pay Utility Investment Company for short-term debt that may be outstanding on or after the effective date of the New Amendments as discussed later in this report.

Staff recommends approval of the Company's application for authorization to enter into a loan agreement with Bank of America Arizona for a line of credit not to exceed \$5 million.

Staff further recommends approval of this financing application without a hearing.

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Engineering Memorandum

Introduction

Arizona Water Company ("Arizona Water" or "Company") is a type "C" Arizona corporation which owns and operates eighteen (18) separate water systems in Cochise, Coconino, Gila, Maricopa, Navajo, Pima, Pinal and Yavapai Counties in Arizona. Arizona Water is a wholly owned subsidiary of Utility Investment Company, which is a wholly owned subsidiary of United Resources, Inc. Arizona Water charges rates approved in Decision Nos. 58120 and 64281. As of December 31, 2000, Arizona Water provided water service to approximately 60,000 customers.

On May 11, 2001, Arizona Water filed an application with the Arizona Corporation Commission ("Commission") requesting authorization to execute a loan agreement with Bank of America ("Bank") to extend Arizona Water a line of credit in an amount not to exceed \$2 million. On June 1, 2001, the Company filed a certification of publication for its financing application.

On December 7, 2001, the Company filed an amendment to its financing application. The amendment increased the \$2 million line of credit requested in the original application to \$5 million.

Background

On July 30, 1997, Arizona Water entered into a Business Loan Agreement (the "1997 Loan Agreement") with Bank of America that established a line of credit in an amount not to exceed \$9 million. The Commission approved the 1997 Loan Agreement in Decision No. 60272, dated July 2, 1997. Additionally, the Commission approved eight amendments to the 1997 Loan Agreement during the period of 1998 through 2000. This application seeks approval for a ninth amendment to the 1997 Loan Agreement.

In Decision No. 62844, dated August 24, 2000, the Commission ordered that the Company's next financing be in the form of equity or long-term debt. Accordingly, on April 12, 2001, the Company issued and sold \$15 million of its General Mortgage Bonds, Series K, to Pacific Life & Annuity Company. One of the purposes of the bond issue was to reduce the Company's short-term debt. The Company had no short-term debt balance as of April 13, 2001.

Purpose of the Financing

The purpose of the financing is to reimburse the Company for actual monies spent for capital improvements and additions and to pay Utility Investment Company for short-term debt that may be outstanding on or after the effective date of the New Amendments as discussed later in this report. Also, the Company indicated that additional monies for short-term borrowings are needed because of lower actual net income and advances in aid of construction than originally forecasted.

Staff Engineering has examined Arizona Water's 2000 construction budget and found the projects to be both reasonable and appropriate as shown in the attached engineering memorandum.

Terms of the Debt

Arizona Water seeks the Commission's authority to extend its short-term debt, a revolving line of credit, with the Bank of America to an amount not to exceed \$5 million. The line of credit will be effective from the date of a signed Commission order and expire on May 31, 2002. One of the conditions to obtain the line of credit from the Bank is the execution of one or more amendments (the "New Amendments") to the 1997 Loan Agreement between the Bank and the Company. The New Amendments will retain the same terms and conditions of the 1997 Loan Agreement.

The line of credit provides Arizona Water the choice of three rates depending on the timing and amount of the draws. Arizona Water may choose between 1) the Bank's Reference Rate, 2) a fixed rate to be determined by the Bank, or 3) an interest rate computed using a formula based on the London Interbank Offered Rate ("LIBOR"). As of October 3, 2001, the rates under the options were as follows:

1. Option 1: Reference Rate: $5.50 - 0.25 = 5.25$
2. Option 2: Fixed Rate (On amounts not less than \$500,000)
 - 30 Day: $2.53 + 1.00 = 3.53$
 - 90 Day: $2.43 + 1.00 = 3.43$
 - 120 Day: $2.41 + 1.00 = 3.41$
3. Option 3: LIBOR Rate
 - 30 Day: $2.53 + 1.00 = 3.53$
 - 90 Day: $2.43 + 1.00 = 3.43$
 - 120 Day: $2.41 + 1.00 = 3.41$

Financial Impact of the Proposed Financing

Schedule CSB-1 presents the Company's operating income, debt service coverage ("DSC") ratio, times interest earned ratio ("TIER"), and capital structure. Schedule CSB-2 presents Staff's loan amortization schedule for the proposed debt.

Arizona Water had operating income of \$7 million for the year ending December 31, 2000. Staff's analysis indicates that Arizona Water's capital structure consisted of 19 percent short-term debt, 13 percent long-term debt, and 68 percent equity at December 31, 2000. Staff's pro forma analysis shows that if Arizona Water was to draw the entire \$5 million of short-term debt available under the proposed financing, the impact on the capital structure would not be

significant.¹ The long-term debt component would rise to 18.74 percent, while the equity component would fall to 63.51 percent.

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

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

Arizona Water had a TIER of 7.24 and a DSC of 7.33 as of December 31, 2000. The pro forma effect of the proposed \$5 million line of credit fully drawn will decrease the Company's TIER to 6.55 and DSC to 1.91. The pro forma TIER and DSC ratios exceed the preferred level of 1.25 showing that Arizona Water will have adequate cash flow to make interest payments on the proposed loan. The interest rate used for short-term debt in Staff's projection was 5.25 percent. This rate was chosen as the highest and most conservative interest rate option available under this short-term line of credit agreement.

Conclusions and Recommendations

Staff Engineering reviewed the projects for which the Company proposes to be reimbursed and found them to be reasonable and appropriate.

Staff concludes that the proposed financing is for lawful purposes, within the corporate powers of Arizona Water, is compatible with the public interest, sound financial practices and proper service performance by Arizona Water as a public service corporation, and will not impair the Company's ability to perform that service.

Therefore, Staff recommends approval of the Company's application for authorization to enter into a loan agreement with Bank of America Arizona for a line of credit not to exceed \$5 million.

Staff further recommends approval of this financing application without a hearing.

¹ Staff included the entire short-term loan in the analysis of Arizona Water's capital structure because the loan will either be refinanced or converted to long-term debt.

FINANCIAL ANALYSIS

Selected Financial Information
Pro forma Includes Immediate Effects of the Proposed Line of Credit

| | [A] <u>12/31/2000</u> | | [B] <u>Pro Forma</u> | | |
|----|--------------------------|--------------|-------------------------|--------------|--------|
| 1 | Operating Income | \$ 7,059,938 | | \$ 7,059,938 | |
| 2 | Depreciation & Amort. | 3,504,370 | | 3,504,370 | |
| 3 | Income Tax Expense | 2,682,630 | | 2,682,630 | |
| 4 | Interest Expense | 1,344,874 | | 1,488,199 | |
| 5 | Repayment of Principal | 461,768 | | 5,461,770 | |
| | TIER | | | | |
| 6 | [1+3] ÷ [5] | 7.24 | | 6.55 | |
| | DSC | | | | |
| 7 | [1+2+3] ÷ [5+6] | 7.33 | | 1.91 | |
| 8 | Short-term Debt | \$13,400,000 | 19% | \$13,400,000 | 17.75% |
| 9 | Long-term Debt | \$9,142,535 | 13% | \$14,142,535 | 18.74% |
| 10 | Common Equity | \$47,937,149 | 68% | \$47,937,149 | 63.51% |
| 11 | Total Capital | \$70,479,684 | 100% | \$75,479,684 | 100.0% |

Arizona Water Company
Docket No. W-01445A-01-0408
Application For Financing

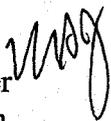
| | | | |
|-----------------------|-------------|----------------------|-------|
| Loan Amount Requested | \$5,000,000 | | |
| Down Payment: | \$0 | | |
| Amount Financed: | \$5,000,000 | | |
| Number of years: | 1 | Compounding Periods: | 12 |
| Interest rate (r): | 5.25% | APR: | 5.38% |

LOAN AMORTIZATION SCHEDULE

| Period | Loan payment (1) | Beginning- of-month principal (2) | Payments | | End-of-month principal [(2) - (4)] (5) | Annual Interest (6) | Annual Principal (7) | Annual Debt Payment (8) |
|--------|------------------------|--|-------------------------------|---------------------------------|---|---------------------------|----------------------------|-------------------------------|
| | | | Interest [r * (2)] (3) | Principal [(1) - (3)] (4) | | | | |
| 1 | \$428,610.62 | \$5,000,000.00 | \$21,875.00 | \$406,735.62 | \$4,593,264.38 | | | |
| 2 | 428,610.62 | 4,593,264.38 | 20,095.53 | 408,515.08 | 4,184,749.30 | | | |
| 3 | 428,610.62 | 4,184,749.30 | 18,308.28 | 410,302.34 | 3,774,446.96 | | | |
| 4 | 428,610.62 | 3,774,446.96 | 16,513.21 | 412,097.41 | 3,362,349.55 | | | |
| 5 | 428,610.62 | 3,362,349.55 | 14,710.28 | 413,900.34 | 2,948,449.22 | | | |
| 6 | 428,610.62 | 2,948,449.22 | 12,899.47 | 415,711.15 | 2,532,738.06 | | | |
| 7 | 428,610.62 | 2,532,738.06 | 11,080.73 | 417,529.89 | 2,115,208.18 | | | |
| 8 | 428,610.62 | 2,115,208.18 | 9,254.04 | 419,356.58 | 1,695,851.60 | | | |
| 9 | 428,610.62 | 1,695,851.60 | 7,419.35 | 421,191.27 | 1,274,660.33 | | | |
| 10 | 428,610.62 | 1,274,660.33 | 5,576.64 | 423,033.98 | 851,626.36 | | | |
| 11 | 428,610.62 | 851,626.36 | 3,725.87 | 424,884.75 | 426,741.61 | | | |
| 12 | 428,610.62 | 426,741.61 | 1,866.99 | 426,743.62 | (2.02) | 143,325.37 | 5,000,002.02 | 5,143,327.39 |

MEMORANDUM

TO: Crystal Brown
Senior Rate Analyst
Utilities Division

FROM: Marlin Scott, Jr. 
Utilities Engineer
Utilities Division

DATE: October 5, 2001

RE: ARIZONAWATER COMPANY
APPLICATION FOR AUTHORITY TO EXECUTE LOAN AGREEMENT AND
DELIVER PROMISSORY NOTE
DOCKET NO. W-01445A-01-0408 (Financing)

Arizona Water Company (Company) filed this financing application on May 11, 2001 to extend its line of credit and will utilize for, 1) payment for construction of improvements and additions to the Company's utility plant located in the State, 2) the reimbursement of monies actually expended from monies in the Company's treasury for such purposes, and 3) payment to Utility Investment Company of the short-term indebtedness.

Staff Engineering has reviewed the Company's construction budgets for the years 1999, 2000 and 2001 and their specific projects in order to evaluate the construction/projects for this financing request. These projects and their budgets appear to be reasonable and appropriate. Staff Engineering also recommends the acceptance of this Company's projections and analysis.

MSJ:msj

cc: Engineering file