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MEMORANDUM RECL...

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TO: Docket Control
FROM: Ernest G. Johnson
Director
Utilities Division

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AZ CORP COMMISSION
DOCUMENT CONTROL

DATE: February 17, 2006

RE: STAFF REPORT FOR THE ABRA WATER COMPANY, INC. APPLICATION
FOR AUTHORIZATION FOR FINANCING DOCKET NO. W-01782A-05-
0236

Attached is the Staff Report for ABRA Water Company, Inc.'s application for authorization for financing. Staff recommends approval with conditions.

EGJ:DTZ:red

Originator: Daniel Zivan

Attachment: Original and fourteen copies

Service List for: ABRA Water Company, Inc.
Docket No. W-01782A-05-0236

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

ABRA WATER COMPANY, INC.

DOCKET NO. W-01782A-05-0236

**APPLICATION FOR AUTHORIZATION
FOR FINANCING**

FEBRUARY 17, 2006

STAFF ACKNOWLEDGMENT

The Staff Report for ABRA Water Company, Inc., Docket No. W-01782A-05-0236 is the responsibility of the Staff members listed below: Daniel Zivan is responsible for the review and financial analysis of the Company's application. Dorothy Hains is responsible for the engineering and technical analysis.



DANIEL ZIVAN
PUBLIC UTILITIES ANALYST III



DOROTHY HAINS
UTILITIES ENGINEER

EXECUTIVE SUMMARY
ABRA WATER COMPANY, INC.
DOCKET NO. W-01782A-05-0236

ABRA Water Company, Inc. ("ABRA" or "Company") filed an application requesting authorization for financing with the Arizona Corporation Commission ("Commission") on April 1, 2005. ABRA is an Arizona for-profit corporation that serves approximately 450 customers and is located in Paulden, Arizona.

ABRA proposes to obtain a 20-year amortizing loan not to exceed \$250,000 from the Water Infrastructure Financing Authority ("WIFA"). ABRA proposes to use the funds to install an arsenic treatment facility that it estimated to cost \$250,000. This facility is necessary to comply with the Safe Drinking Water Act which requires that arsenic levels be reduced to 10 particles per billion ("ppb") by January 23, 2006. Staff has determined that the actual amount that ABRA will incur to construct the proposed arsenic removal facility could be over \$263,000.

The pro forma times interest earned ratio ("TIER") and debt service coverage ratio ("DSC") resulting from the issuance of long-term debt in the amount of \$250,000 are 1.25 and 1.42, respectively. The pro forma capital structure resulting from the issuance of \$250,000 of long-term debt consists of 2.0 percent short-term debt, 73.9 percent long-term debt and 24.1 percent equity. Staff concludes that financing the proposed capital improvements entirely with debt would result in an excessively leveraged capital structure. ABRA should maintain a capital structure with equity representing no less than 30 percent in the short-term and have a plan to increase equity to at least 40 percent in the long-term.

Staff prefers issuance of \$226,634 of long-term debt and an equity infusion of \$37,000 which provides a pro forma capital structure composed of 1.9 percent short-term debt, 68.1 percent long-term debt and 30.0 percent equity. The pro forma TIER and DSC resulting from issuance of \$226,634 of long-term debt and a \$37,000 equity infusion are 1.33 and 1.51, respectively. These ratios indicate that ABRA would have sufficient cash flow to service all present obligations and proposed long term-debt.

However, the Company is responding to a federally mandated regulation and has limited financial alternatives to raise sufficient funds for compliance. Accordingly, the Company should make use of WIFA as a low cost lender. The authorization of a loan in excess of \$226,634 will cause the Company's equity ratio to fall below 30 percent and is not considered sound financial practice. However, the Company's resulting TIER and DSC will be adequate to service its loans even if it borrows \$250,000.

In recognition of the Company's limited access to capital and the need to promptly provide safe drinking water to ABRA's customers, Staff concludes that authorization to issue \$250,000 of long-term debt and issuance of equity capital to the extent that the arsenic treatment facility costs exceed \$250,000 is appropriate.

Staff also concludes that ABRA should have a plan to build equity greater than or equal to 40 percent of total capital. Staff recommends approval of the request for authorization to incur long-term debt in the amount of \$250,000 subject to the condition that the Company also be ordered to file a capital plan acceptable to Staff.

Staff further recommends authorization to issue common stock in the amount that the arsenic treatment facility cost exceeds \$250,000.

Staff further recommends that within 120 days of a Decision in this matter, the Company file with Docket Control, as a compliance item in this Docket, a detailed plan demonstrating how the Company will reduce its water loss to less than 10 percent, but in no case more than 15 percent. If the Company finds that reduction of water loss to less than 10 percent is not cost-effective, the Company shall submit a detailed cost analysis and explanation demonstrating why a water loss to less than 10 percent is not cost-effective.

Staff further recommends that within eighteen months of the effective date of a Decision in this matter, the Company file with Docket Control, as a compliance item in this Docket, a plan showing how it plans to expand system capacity to meet the anticipated growth.

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ENGINEERING REPORT

Introduction

ABRA Water Company, Inc. ("ABRA" or "Company"), an Arizona "C" Corporation located in Paulden, Arizona, filed an application requesting authorization for financing with the Arizona Corporation Commission ("Commission") on April 1, 2005.

Notice

Notice of a financing application was published in *The Courier*, a newspaper of general circulation in Chino Valley and Prescott Valley.

Background

ABRA is an Arizona for-profit corporation that serves approximately 450 customers and is located in Paulden, Arizona. ABRA's current rates were approved in Decision No. 65917, dated May 16, 2003.

Purpose of the Financing

ABRA proposes to install an arsenic treatment facility ("project") that it estimated to cost \$250,000. This facility is necessary to comply with the Safe Drinking Water Act which requires that arsenic levels be reduced to 10 particles per billion ("ppb") by January 23, 2006.

Description of Proposed Financing

ABRA proposes to obtain a 20-year amortizing loan from the Water Infrastructure Financing Authority ("WIFA") not to exceed \$250,000. WIFA's interest rate for ABRA represents the current prime rate (7.50 percent as of February 15, 2006) plus 200 basis points multiplied by .80. Staff has determined that the actual amount that ABRA will incur to construct the proposed arsenic removal facility could be over \$263,000.

Financial Analysis

Schedule DTZ-1 presents historical financial information for the year ended December 31, 2004 in column A. Column B is the same as Column A modified to reflect financing the \$250,000 cost of the proposed capital improvements with debt (calculated at 8.00 percent and amortized over 20 years). Column C is the same as Column A modified to reflect Staff's preference for issuance of \$226,634 debt (calculated at 8.00 percent and amortized over 20 years) and a \$37,000 equity infusion.

Schedule DTZ-1, column A shows that ABRA currently has a times interest earned ratio ("TIER") of 4.09 and a debt service coverage ratio ("DSC") of 3.83 before recognition of any additional debt. Schedule DTZ-1, column B shows that the pro forma effect of a \$250,000 long-term debt issuance is to reduce TIER to 1.25 and DSC to 1.42. Schedule DTZ-1, column C

shows that the pro forma effect of a \$226,634 long-term debt issuance and a \$37,000 equity infusion is to reduce TIER to 1.33 and DSC of 1.51. The pro forma DSC results indicate that ABRA would be able to meet all current obligations and service either a \$226,634 or a \$250,000 long-term debt issuance.

TIER represents the number of times earnings cover interest expense on long-term debt. A TIER greater than 1.0 means that operating income is greater than interest expense. A TIER less than 1.0 is not sustainable in the long term but does not mean that debt obligations cannot be met in the short term.

DSC represents the number of times internally generated cash will cover required principal and interest payments on long-term debt. A DSC greater than 1.0 indicates that operating cash flow is sufficient to cover debt obligations. A DSC less than 1.0 means that debt service obligations cannot be met by cash generated from operations and that another source of funds is needed to avoid default.

ABRA's capital structure currently consists of 2.0 percent short-term debt, 54.3 percent long-term debt and 43.7 percent equity (Schedule DTZ-1, Column A). The pro forma capital structure resulting from the issuance of \$250,000 of long-term debt consists of 2.0 percent short-term debt, 73.9 percent long-term debt and 24.1 percent equity is excessively leveraged (Schedule DTZ-1, Column B). The pro forma capital structure resulting from the issuance of Staff's preferred \$226,634 long-term debt and a \$37,000 equity infusion consists of 1.9 percent short-term debt, 68.1 percent long-term debt and 30.0 percent equity (Schedule DTZ-1, Column C).

Staff concludes that financing the proposed capital improvements entirely with debt would result in an excessively leveraged capital structure. ABRA should maintain a capital structure with equity representing no less than 30 percent in the short-term and have a plan to increase equity to at least 40 percent in the long-term. An excessively leveraged capital structure restricts a utility's ability to obtain additional debt financing, places upward pressure on rates and may result in less favorable terms for future financing.

However, the Company is responding to a federally mandated regulation and has limited financial alternatives to raise sufficient funds for compliance. Accordingly, the Company should make use of WIFA as a low cost lender. The authorization of a loan in excess of \$226,634 will cause the Company's equity ratio to fall below 30 percent and is not considered sound financial practice. However, the Company's resulting TIER and DSC will be adequate to service its loans even if it borrows \$250,000.

In recognition of the Company's limited access to capital and the need to promptly provide safe drinking water to ABRA's customers, Staff concludes that authorization to issue \$250,000 of long-term debt and issuance of equity capital to the extent that the arsenic treatment facility costs exceed \$250,000 is appropriate. Staff also concludes that ABRA should have a plan to build equity greater than or equal to 40 percent of total capital.

Compliance

There are no compliance issues with ABRA Water Company, Inc.

Engineering Analysis

The Staff Engineering Report is attached. Staff reviewed the material cost estimates of the proposed plant improvements. Staff concludes that the actual amount that ABRA will incur to construct the proposed arsenic treatment facility could be over \$263,000. Staff makes no "used and useful" determination in this proceeding. Treatment of the proposed plant improvements for rate-making purposes is deferred to a future rate proceeding.

Conclusion and Recommendations

Staff concludes that the proposed plant improvements are appropriate.

Staff concludes that the proposed use of funds is appropriate and that authorization to incur an amount not exceeding \$250,000 of long-term debt for those purposes is lawful and within the corporate powers of the applicant, would be compatible with the public interest, and not impair ABRA's ability to provide service. However, issuance of debt in excess of \$226,623 is not consistent with sound financial practice and should be mitigated by the Company preparing a capital plan, acceptable to Staff, to increase equity to 40 percent of total capital.

Staff recommends granting authorization to borrow an amount not to exceed \$250,000 under the terms and conditions proposed and for the purposes described in this application subject to the condition that the Company also be ordered to file a capital plan acceptable to Staff.

Staff further recommends approval of granting liens in favor of the lender as required to secure the borrowings authorized.

Staff further recommends authorizing ABRA to engage in any transactions and to execute any documents necessary to effectuate the authorizations granted.

Staff further recommends that the Commission order the Company to file a capital plan that is satisfactory to Staff, within 90 days of the decision in this matter, to increase its equity to 40 percent of total capital.

Staff further recommends that one copy of executed loan documents be filed with Docket Control, as a compliance item, within 90 days of the decision in this matter.

Staff further recommends granting authorization to issue common stock in the amount that the arsenic treatment facility cost exceeds \$250,000.

Staff further recommends that within 120 days of a Decision in this matter, the Company file with Docket Control, as a compliance item in this Docket, a detailed plan demonstrating how the Company will reduce its water loss to less than 10 percent, but in no case more than 15 percent. If the Company finds that reduction of water loss to less than 10 percent is not cost-effective, the Company shall submit a detailed cost analysis and explanation demonstrating why a water loss to less than 10 percent is not cost-effective.

Staff further recommends that within eighteen months of the effective date of a Decision in this matter, the Company file with Docket Control, as a compliance item in this Docket, a plan showing how it plans to expand system capacity to meet the anticipated growth.

FINANCIAL ANALYSIS

	[A]		[B]		[C]		
	Year Ended 12/31/2004		Pro Forma With \$250,000 LT Debt		Pro Forma With \$226,634 LT Debt and \$37,000 Equity Infusion		
1	Operating Income	\$ 35,522	\$ 35,522		\$ 35,522		
2	Depreciation & Amort.	21,070	21,070		21,070		
3	Income Tax Expense	55	55		55		
4							
5	Interest Expense	8,700	28,509		26,658		
6	Repayment of Principal	6,100	11,384		10,890		
7							
8							
9	TIER						
10	[1+3] + [5]	4.09	1.25		1.33		
11	DSC						
12	[1+2+3] + [5+6]	3.83	1.42		1.51		
13							
14							
15							
16							
17							
18	Short-term Debt	\$6,100	2.0%	\$11,384	2.0%	\$10,890	1.9%
19							
20	Long-term Debt	\$167,386	54.3%	\$412,102	73.9%	\$389,230	68.1%
21							
22	Common Equity	\$134,513	43.7%	\$134,513	24.1%	\$171,513	30.0%
23							
24	Total Capital	\$307,999	100.0%	\$557,999	100.0%	\$571,633	100.0%
25							
26							
27							

[A] 2004 actual financial information

[B] Column A adjusted to reflect issuance of \$250,000 of long-term debt

[C] Column A adjusted to reflect issuance of \$226,634 of long-term debt and a \$37,000 equity infusion

MEMORANDUM

DATE February 17, 2006

TO: Daniel Zivan, Public Utility Auditor

FROM: D. Hains, Utilities Engineer

RE: **Abra Water Corporation – Financing Application**
(Docket No. W-01782A-05-0236)

Introduction

Abra Water Company (“Abra” or “Company”) has filed a financing application to obtain a \$250,000 loan. According to the Company, it will use this loan to install an arsenic removal treatment facility. Arsenic levels in both of the Company’s wells exceed the new arsenic standard of 10 $\mu\text{g}/\text{l}$ that became effective January 23, 2006.

System Analysis

I. Capacity

The Company owns and operates a water system that contains two wells, one storage tank and a distribution system to serve approximately 490 customers. The gravity fed system has a 455 gallon per minute (“GPM”) production rate and 250,000 gallons of storage capacity. The system has adequate storage and production capacity to serve over 700 with both wells running. However, only the major production well produces water to meet demand, in that case the system has adequate production and storage to serve an additional 100 customers.

II. Arsenic Levels

The table below lists the arsenic level and flow rate of each well.

Well No. (ADWR #)	Arsenic Level ($\mu\text{g}/\text{l}$)	Flow (GPM)
55-561786	16	270
55-619178	30	180

Because the wells are located at separate well sites, approximately three miles apart, the Company has decided to only treat the water produced by the larger of the two wells, Well No. 55-561786. The Company does not plan to use Well No.

55-619178 in the future, therefore, no arsenic removal plant will be installed at this well site.

III. The Proposed Arsenic Treatment Plant

The Company proposes to install a McPhee Environmental Supply, LLC ("McPhee") manufactured arsenic removal device with ArsenX media¹. The proposed plant includes four vessels, each vessel has 55 cubic feet of volume and is capable of treating 500 GPM and is designed to reduce arsenic concentration levels to almost 1 µg/l. The Company plans to treat 57% of the raw groundwater produced to 1 µg/l and then blend this treated water with the remaining water needed to meet a 7.5 µg/l arsenic concentration in the water delivered to customers.

IV. Water Loss

Based on the water usage data between January 2004 and January 2005, the calculated non-accountable water loss in the system is 15.14%. Non-account water should be 10% or less and never more than 15%. Since the water loss is only slightly over the recommended threshold, Staff recommends that within 120 days of a Decision in this matter, the Company file with Docket Control as a compliance item in this Docket a detailed plan demonstrating how the Company will reduce its water loss to less than 10% but in no case no more than 15%. If the Company finds that reduction of water loss to less than 10% is not cost-effective, the Company shall submit a detailed cost analysis and explanation demonstrating why a water loss reduction to less than 10% is not cost effective.

IV. Growth

Historically, the growth rate in this system has been 37 new connections per year. The capacity of the existing system will be exhausted in less than three years if this growth rate continues unchanged. Because the Company only proposes to treat one of its wells, the Company may have to upgrade its well pump and storage system to meet the demand in the near future, or in the alternative, install arsenic treatment plant for the backup well. Staff recommends that within eighteen months of the effective date of a Decision in this matter, the Company file with Docket Control as a compliance item in this Docket a plan showing how it plans to expand system capacity to meet the anticipated growth.

Arizona Department of Environmental Quality ("ADEQ") Compliance

Staff received a water quality compliance status report for Public Water System #13-001 from ADEQ dated March 18, 2005. In this report, ADEQ stated that it

¹ ArsenX is a new hybrid arsenic removal media that utilizes nano-particle technology to combine iron and plastic bead durability.

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 no outstanding compliance issues.

Analysis & Detailed Costs

Although the Company has estimated its total construction cost to be \$250,000 in the application, the itemized costs are more than the requested amounts. The itemized costs are listed below:

Description	Quantity	Cost (\$)
Treatment Plant (supplied by McPhee)		
Design & permitting	1	12,988
Treatment Equipment (including four of 55 ft ³ vessels)	4	100,816
Media (220 ft 3/vessel) Yard piping	4	79,860
Subtotal		193,664
 Plumbing to connect the treatment plant with existing plants	 1	 11,792.76
 Building ¹ (a 30’x 24’ x 14’ Building) with electric wiring, metal entrance doors	 1	 42,350.00
 Pump		
60-HP, 500 GPM , 3Ø pump	1	10,500
Control (3Ø)	1	3,450
labor		1,000
tax		878
subtotal		15,828
 Total		 263,634

Note 1: To prevent winter frost, the treatment plant will be enclosed in the proposed building.

Staff believes that these estimated costs are reasonable and the proposed plant improvement appropriate. 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.

Curtailment Tariff

The Company has had an approved Curtailment Tariff in effect since April 1, 2003.

Summary

I. Recommendations:

1. Staff recommends that within 120 days of a Decision in this matter, the Company file with Docket Control as a compliance item in this Docket a detailed plan demonstrating how the Company will reduce its water loss to less than 10% but in no case no more than 15%. If the Company finds that reduction of water loss to less than 10% is not cost-effective, the Company shall submit a detailed cost analysis and explanation demonstrating why a water loss reduction to less than 10% is not cost effective.
2. Staff recommends that within eighteen months of the effective date of a Decision in this matter, the Company file with Docket Control as a compliance item in this Docket a plan showing how it plans to expand system capacity to meet the anticipated growth.

II. Conclusions:

1. Staff concludes that the estimated costs and proposed plant improvements to be financed are reasonable and appropriate. 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.
2. ADEQ has determined that the Company's system is currently delivering water that meets water quality standards required by Arizona Administrative Code, Title 18, Chapter 4
3. The Company is not in any ADWR Active Management Area.
4. A check with the Utilities Division Compliance Section showed no outstanding compliance issues.