

ORIGINAL



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MEMORANDUM

TO: Docket Control  
FROM: Ernest G. Johnson  
Director  
Utilities Division  
DATE: October 2, 2007

*EA for EGJ*

RE: STAFF REPORT FOR SONOITA VALLEY WATER COMPANY;  
APPLICATION FOR APPROVAL OF DEBT DUE TO SONOITA VALLEY  
WATER COMPANY'S NEED TO BORROW FUNDS TO MAINTAIN AND  
REPAIR THE SYSTEM (DOCKET NO. W-20435A-07-0143)

Attached is the Staff Report for Sonoita Valley Water Company's application for approval of debt due to Sonoita Valley Water Company's need to borrow funds to maintain and repair its water system. Staff recommends denial of the request.

EGJ:SPI:red

Originator: Steve Irvine

Attachment: Original and sixteen copies

Arizona Corporation Commission  
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OCT -2 2007

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Service List for: Sonoita Valley Water Company  
Docket No. W-20435A-07-0143

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**STAFF REPORT  
UTILITIES DIVISION  
ARIZONA CORPORATION COMMISSION**

**SONOITA VALLEY WATER COMPANY  
DOCKET NO. W-20435A-07-0143**

**APPLICATION FOR APPROVAL OF DEBT**

**OCTOBER 2, 2007**

## STAFF ACKNOWLEDGMENT

The Staff Report for Sonoita Valley Water Company, Docket No. W-20435A-07-0143 is the responsibility of the Staff members listed below. Steve Irvine is responsible for the financial review and analysis. Katrin Stukov was responsible for the Engineering memorandum.



Steve Irvine  
Public Utilities Analyst IV



Katrin Stukov  
Utilities Engineer Water / Wastewater

**EXECUTIVE SUMMARY**  
**SONOITA VALLEY WATER COMPANY**  
**DOCKET NO. W-20435A-07-0143**

Sonoita Valley Water Company ("Sonoita" or "Company") filed an application with the Arizona Corporation Commission ("Commission") on March 7, 2007, requesting authorization of \$121,000 of new debt. Sonoita recently acquired the assets and Certificate of Convenience and Necessity ("CC&N") for Southern Water Corporation ("Southern") in Decision No. 69259 of January 19, 2007.

The owner and president of Sonoita is Mr. E. H. Lewis. Mr. Lewis is also the president, CEO and a director of Lewis Development Corporation. The application states that Mr. Lewis has provided \$121,000 to Sonoita and Southern either personally or from Lewis Development Corporation as a result of the need for plant additions, repairs and maintenance for the water systems. The water systems have issued promissory notes in exchange for the funds. Commission approval of the transaction was not sought prior to the transfer of funds and issuance of the promissory notes. Sonoita now seeks retroactive authorization from the Commission to treat the funds provided by Mr. Lewis and Lewis Development Corporation as debt.

Mr. Lewis and Lewis Development Corporation had funds available to make the equity infusions at the time funds were provided to the water systems. Sonoita did not apply for Commission authorization to incur debt before receiving funds from Mr. Lewis and Lewis Development Corporation as required by A.R.S. §40-301.

Staff finds that authorization for issuance of debt would serve to weaken Sonoita's financial position by introducing more debt in the capital structure and exposing the Company to increased financial risk. Classification of the proceeds from Mr. Lewis and Lewis Development Corporation as debt would create a highly leveraged capital structure. Should the Commission authorize the loans, the combined capital structure of Sonoita and Southern would be approximately 110.8 percent short-term debt and negative 10.8 percent equity. Given retroactive authorization of \$121,000 in new debt, the Company's pro forma times interest earned ratio ("TIER") is negative 7.94 and the debt service coverage ratio ("DSC") ratio is negative 0.18.

Staff concludes that issuance of new debt by Sonoita is inappropriate at this time as the Company would have an excessively high proportion of debt in its capital structure and does not presently have the ability to service debt payments. Staff recommends denial of Sonoita's application for authorization to issue \$121,000 in new debt and classification of the funds as "Other Paid-In Capital."

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Customer Service Memorandum

Engineering Memorandum

Public Notice

### **Introduction**

Sonoita Valley Water Company (“Sonoita” or “Company”)<sup>1</sup> filed an application with the Arizona Corporation Commission (“Commission”) on March 7, 2007, requesting authorization of \$121,000 of new debt.

### **Public Notice**

Sonoita’s application included an affidavit attesting that notice of the financing application was mailed to all of Sonoita’s customers on March 6, 2007. A copy of the notice is attached.

### **Compliance**

Sonoita has no outstanding Commission compliance issues.

### **Background**

Sonoita is an Arizona for-profit corporation serving customers in Santa Cruz County, Arizona. Sonoita presently provides service to approximately 79 residential customers and 19 commercial customers. Sonoita recently acquired the assets and Certificate of Convenience and Necessity (“CC&N”) for Southern Water Corporation (“Southern”) in Decision No. 69259 of January 19, 2007. The acquisition added 39 residential and 19 commercial customers to Sonoita’s customer base.

### **Purpose of the Financing Application**

The owner and president of Sonoita is Mr. E. H. Lewis. Sonoita recently acquired Southern’s assets and CC&N. Mr. Lewis is also the president, CEO and a director of Lewis Development Corporation. The application states that Mr. Lewis has provided \$121,000 to Sonoita and Southern either personally or from Lewis Development Corporation as a result of the need for plant additions, repairs and maintenance for the water systems. Of the total funds provided to the water systems, \$40,200 was provided by Mr. Lewis personally and \$80,800 was provided by Lewis Development. The water systems have issued promissory notes in exchange for the funds. The promissory notes stipulate repayment within one year. Commission approval of the transaction was not sought prior to the transfer of funds and issuance of the promissory notes. Sonoita now seeks retroactive authorization from the Commission to treat the funds provided by Mr. Lewis and Lewis Development Corporation as debt.

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<sup>1</sup> Sonoita is an Arizona corporation which was granted a CC&N by the Commission in Decision No. 68823.

**Financial Analysis****Capital Structure**

Mr. Lewis and Lewis Development Corporation had funds available to make the equity infusions at the time funds were provided to the water systems. Sonoita did not apply for Commission authorization to incur debt before receiving funds from Mr. Lewis and Lewis Development Corporation as required by A.R.S. §40-301.

Sonoita does not have access to capital markets as it is not a publicly traded company. As Sonoita lacks access to capital markets it is appropriate that Sonoita have as much equity as possible in order to reduce financial risk. Accordingly, Staff finds that authorization for issuance of debt would serve to further weaken Sonoita's financial position by introducing more debt in the capital structure and exposing the Company to increased financial risk.

Classification of the proceeds from Mr. Lewis and Lewis Development Corporation as debt would create a highly leveraged capital structure. For a utility with access to the capital markets, Staff typically recommends a capital structure with a minimum of 40 percent equity of total capital (short-term debt plus long-term debt plus common equity) as appropriate to provide a balance of cost and financial health. Absent access to the capital markets, a privately owned for-profit regulated utility should incur debt primarily as a last resort. Should the Commission authorize the loans, the combined capital structure of Sonoita and Southern would be approximately 110.8 percent short-term debt and negative 10.8 percent equity. Should the Commission not authorize the loans, effectively considering the funding an equity infusion, the combined capital structure would be 7 percent short-term debt and 93 percent equity. A table demonstrating the respective capital structures is shown below. The table is based on the consolidated 2006 financials included in the application.

	Funding Approved as Debt		Funding as an Equity Infusion	
Short-Term Debt	\$129,218	110.8%	\$ 8,218	7%
Equity	\$ -12,630	-10.8%	\$108,370	93%
Total	\$116,588	100%	\$116,588	100%

**TIER and DSC**

Staff prepared Schedule SPI-1 using the financial information included in Sonoita's application. Column A depicts the consolidated financial information as of December 31, 2006. The information depicted in Column A assumes that the \$121,000 in payments to the Company are an equity infusion as these payments have not been authorized as debt. The pro forma information in Column B shows the impact of authorizing the \$121,000 payments as debt. Given retroactive authorization of \$121,000 in new debt, the Company's pro forma times interest earned ratio ("TIER") is negative 7.94 and the debt service coverage ratio ("DSC") is negative 0.18. Sonoita's negative 0.18 pro forma DSC and negative 7.94 pro forma TIER are a result of having negative operating income.

DSC represents the number of times internally generated cash will cover required principal and interest payments on short-term and long-term debt. A DSC less than 1.0 indicates that operating cash flow is insufficient to cover debt obligations.

TIER represents the number of times earnings will cover interest expense on short-term and 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 necessarily mean that debt obligations cannot be met in the short term.

### **Engineering Analysis**

Staff's Engineering Report is attached. Sonoita submitted to Staff descriptions and costs of projects associated with the request to incur debt. Staff reviewed these project descriptions and costs and concludes that they appear to be reasonable and appropriate. Staff makes no "used and useful" determination of the proposed plant and no particular future treatment should be inferred for rate-making or rate base purposes.

### **Conclusion and Recommendations**

Staff concludes that issuance of new debt by Sonoita is inappropriate at this time as the Company would have an excessively high proportion of debt in its capital structure and does not presently have the ability to service debt payments.

Staff recommends denial of Sonoita's application for authorization to issue \$121,000 in new debt.

Staff further recommends classification of the \$120,000 as "Other Paid-In Capital" instead of debt in accordance with the National Association of Regulatory Utility Commissioners Uniform System of Accounts.

**FINANCIAL ANALYSIS**

Selected Financial Data  
Including Immediate Effects of the Proposed Debt

	[A] <u>12/31/2006</u>		[B] <u>Pro Forma</u>		
1	Operating Income	\$ (26,468)	\$ (26,468)		
2	Depreciation & Amort.	4,088	4,088		
3	Income Tax Expense	45	45		
4					
5	Interest Expense	24	3,326		
6	Repayment of Principal	0	121,000		
7					
8					
9	<b>TIER</b>				
10	[1+3] + [5]	-1,090.51	-7.94		
11	<b>DSC</b>				
12	[1+2+3] + [5+6]	-921.79	-0.18		
13					
14					
15					
16					
17					
18	Short-term Debt*	\$8,218	7.0%	\$129,218 110.8%	
19					
20	Long-term Debt	\$0	0.0%	(\$0) 0.0%	
21					
22	Common Equity*	\$108,370	93.0%	(\$12,630) -10.8%	
23					
24	Total Capital	\$116,588	100.0%	\$116,588 100.0%	
25					
26					
27	The \$121,000 paid into company is reflected as Common Equity in column A and as Short-term Debt in column B.				

## MEMORANDUM

DATE: September 13, 2007

TO: Steve Irvine  
Public Utilities Analyst

FROM: Katrin Stukov *KS*  
Utilities Engineer

RE: Sonoita Valley Water Company  
Financing Application  
Docket No. W-20435A-07-0143

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### **Introduction**

Sonoita Valley Water Company (the "Company") has filed an application with the Arizona Corporation Commission ("ACC") requesting authorization to incur \$121,000 in debt due to the need to borrow funds to maintain, repair and improve the Company's two water systems from 2005 to 2007.

### **Construction Projects and Costs**

The Company submitted spreadsheets with the project descriptions and a breakdown of costs as summarized below:

<b>Capital Improvements</b>	<b>Cost</b>
Intangibles	\$199
Franchise	\$1,368
Wells	\$27,825 <sup>1</sup>
Pumping Equipment	\$37,968
Dist. Reservoirs	\$934
TD Mains	\$26,481
Services	\$1,497
Meters	\$3,371
Sub Total	<b>\$99,643</b>
<b>Operating Expenses</b>	
Hauled Water (when the well down)	\$2,475
Maintenance & Operations	\$18,882
Sub Total	<b>\$21,357</b>
Total	<b>\$121,000</b>

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<sup>1</sup> This amount includes a \$18,000 down payment for a new well.

Staff has reviewed the above financing request and determined that the above listed Capital Improvements projects and costs appear to be reasonable and appropriate. However, this does not imply any particular future treatment for rate base. No "used and useful" determination of the proposed plant was made, and no conclusions should be inferred for rate making or rate base purposes.

### **Water Quality Compliance**

The Arizona Department of Environmental Quality ("ADEQ") regulates the water systems operated by the Company. ADEQ has determined that these water systems are in full compliance and delivering water that meets water quality standards required by Arizona Administrative Code, Title 18, Chapter 4.<sup>2</sup>

### **ACC Compliance Status**

A check of the compliance database indicated that there were no delinquencies for the Company.<sup>3</sup>

### **Curtailment Tariff**

The Company has an approved curtailment tariff.

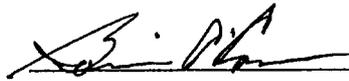
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<sup>2</sup> Status reports dated August 1, 2006 and March 9, 2007 were used to determine compliance for some systems.

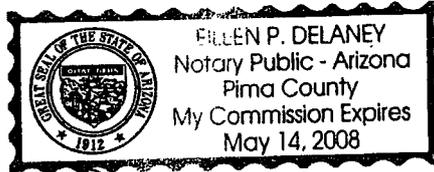
<sup>3</sup> Per compliance check dated September 12, 2007.

**AFFIDAVIT OF PUBLICATION**  
**SONOITA VALLEY WATER COMPANY**  
**PUBLIC NOTICE OF AN APPLICATION FOR**  
**FINANCING APPROVAL**

I, Bonnie L. O'Connor, Secretary Treasurer of Sonoita Valley Water Company hereby certify that the customers notification attached to this affidavit was provided to all customers of Sonoita Valley Water Company/Southern Water Co. by U.S. Mail on the 6<sup>th</sup> day of March, 2007.

 DATE: 3/06/07

COUNTY OF PIMA        )  
                                  )SS  
STATE OF ARIZONA    )



SIGNED BEFORE ME THIS 6<sup>th</sup> DAY OF March, 2007.

  
Notary Public

MY COMMISSION EXPIRES: May 14, 2008

PUBLIC NOTICE  
FINANCE APPLICATION

PUBLIC NOTICE OF AN APPLICATION FOR AN ORDER TO AUTHORIZE THE  
ISSUANCE OF DEBT BY SONOITA VALLEY WATER

SONOITA VALLEY WATER COMPANY (APPLICANT) HAS FILED AN APPLICATION WITH THE ARIZONA CORPORATION COMMISSION (COMMISSION) FOR AN ORDER AUTHORIZING THE APPLICANT TO RECORD FINANCING APPROVAL. THE PRESENT RATES HAVE BEEN IN EFFECT SINCE MARCH 1, 1991. THE AMOUNT OF FINANCING WILL BE FOR \$ 121,000.00 THE APPLICANT HAS HAD TO BORROW MONEY FOR REPAIRS AND MAINTENANCE AND MUCH NEEDED UPGRADES OF THE AGING SYSTEM OF SONOITA VALLEY WATER CO., AS WELL AS THE SYSTEM FORMERLY KNOWN AS SOUTHERN WATER COMPANY. THE MERGING OF THE TWO COMPANIES HAS BEEN APPROVED BY THE ARIZONA CORPORATION COMMISSION PER DOCKET #W-20435a-06-0410 & #W-2435a-06-0411, DECISION #69259.

THE APPLICATION IS AVAILABLE FOR INSPECTION DURING REGULAR BUSINESS HOURS AT THE OFFICE OF THE COMMISSION IN TUCSON, ARIZONA, 400 W. CONGRESS, ROOM 218, 85701 AND APPLICANT'S OFFICE AT 2102 N. FORBES, BLVD. SUITE 107, TUCSON, AZ 85745.

INTERVENTION IN THE COMMISSION'S PROCEEDING ON THE APPLICATION SHALL BE PERMITTED TO ANY PERSON ENTITLED BY LAW TO INTERVENE AND HAVING A DIRECT SUBSTANTIAL INTEREST IN THE MATTER. PERSONS DESIRING TO INTERVENE MUST FILE A MOTION TO INTERVENE WITH THE COMMISSION WHICH MUST BE SERVED UPON APPLICANT AND WHICH, AT A MINIMUM, SHALL CONTAIN THE FOLLOWING INFORMATION:

- 1) NAME, ADDRESS AND TELEPHONE OF THE PROPOSED INTERVENER AND OF ANY PERSON UPON WHOM SERVICE OF DOCUMENTS IS TO BE MADE IF DIFFERENT THAN THE INTERVENER.
- 2) A SHORT STATEMENT OF THE PROPOSED INTERVENER'S INTEREST IN THE PROCEEDING.
- 3) WHETHER THE PROPOSED INTERVENER DESIRES A FORMAL EVIDENTIARY HEARING ON THE APPLICATION AND THE REASON FOR SUCH A HEARING.
- 4) A STATEMENT CERTIFYING THAT A COPY OF THE MOTION TO INTERVENE HAS BEEN MAILED TO THE APPLICANT.

THE GRANTING OF MOTIONS TO INTERVENE SHALL BE GOVERNED BY A.A.C. R14-3-105, EXCEPT THAT ALL MOTIONS TO INTERVENE MUST BE FILED ON, OR BEFORE, THE 15<sup>TH</sup> DAY AFTER THIS NOTICE.