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MEMORANDUM

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AZ CORP COMMISSION
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TO: Docket Control

FROM: Ernest G. Johnson
Director
Utilities Division

DATE: November 14, 2007

RE: STAFF REPORT FOR VALLEY UTILITIES WATER COMPANY'S APPLICATION FOR AN EMERGENCY RATE INCREASE AND AUTHORITY TO IMMEDIATELY IMPLEMENT A WELL SURCHARGE (DOCKET NO. W-01412A-07-0560)

STAFF REPORT FOR VALLEY UTILITIES WATER COMPANY'S APPLICATION FOR AN APPROVAL OF A $250,000 LINE OF CREDIT AND AUTHORITY TO ISSUE LONG-TERM PROMISSORY NOTES OR BONDS AND OTHER EVIDENCE OF INDEBTEDNESS AS PERMANENT REFINANCING OF THAT LINE OF CREDIT (DOCKET NO. W-01412A-07-0561)

Attached is the Staff Report for Valley Utilities Water Company's ("Company") applications for an emergency rate increase and a financing approval. Staff recommends denial of the $250,000 revolving line of credit and its related surcharge. Staff recommends approval of the $250,000 loan through the Water Infrastructure Finance Authority ("WIFA"). Further, Staff recommends that the surcharge go into effect after the WIFA loan has closed and the Company has drawn on the loan. Staff recommends the Company file a full rate case by no later than June 1, 2008, using a 2007 test year.

Any party who wishes may file comments to the Staff Report with the Commission's Docket Control by 4:00 p.m. on or before November 26, 2007.

EGJ:CSB:red

Originator: Crystal S. Brown

Attachment: Original and sixteen copies

Arizona Corporation Commission
DOCKETED

NOV 14 2007

DOCKETED BY

Service List for: Valley Utilities Water Company
Docket Nos. W-01412A-07-0560 & W-01412A-07-0561

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STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION

VALLEY UTILITIES WATER COMPANY

DOCKET NOS. W-01412A-07-0560
&
W-01412A-07-0561

APPLICATION FOR AN
EMERGENCY RATE INCREASE AND
AUTHORITY TO IMMEDIATELY
IMPLEMENT A WELL SURCHARGE

APPLICATION FOR AN APPROVAL
OF A $250,000 LINE OF CREDIT AND
AUTHORITY TO ISSUE LONG-TERM
PROMISSORY NOTES OR BONDS AND
OTHER EVIDENCE OF INDEBTEDNESS AS
PERMANENT REFINANCING OF THAT LINE OF CREDIT

NOVEMBER 14, 2007

STAFF ACKNOWLEDGMENT

The Staff Report for Valley Utilities Water Company, Docket Nos. W-01412A-07-0560 & W-01412A-07-0561, was the responsibility of the Staff members listed below. Crystal Brown was responsible for the financial review and analysis of the Company's application. Marlin Scott, Jr. was responsible for the engineering and technical analysis. Guadalupe Ortiz was responsible for reviewing the Commission's records on customer complaints filed with the Commission.

Crystal Brown

Crystal Brown
Public Utilities Analyst V

Marlin Scott

Marlin Scott, Jr.
Utilities Engineer

Guadalupe Ortiz

Guadalupe Ortiz
Public Utilities Consumer Analyst I

EXECUTIVE SUMMARY
VALLEY UTILITIES WATER COMPANY
DOCKET NOS. W-01412A-07-0560 AND W-01412A-07-0561

On October 1, 2007, Valley Utilities Water Company ("Valley Utilities" or "Company") filed an application for emergency rates and a financing application. The Company's rate application asserts that a sudden and unexpected well failure and problems with other wells has resulted in production levels that are too low to meet its 2008 summer peak demand for its 1,400 customers.

Recommendations

Emergency Rate Surcharge

Staff recommends approval of Staff's recommended emergency rate surcharges as shown on Schedule CSB-3.

Staff further recommends that the monthly surcharge rate be conditional upon Staff's recommended cost of the well.

Staff further recommends that the surcharge be implemented only after the Company closes on the loan and has drawn funds to begin construction of the plant.

Staff further recommends that if the Company has not drawn funds from the loan within one year of the date of the Decision resulting from this proceeding, that approval of the loan and surcharge be rescinded.

Staff further recommends that the Company post a bond in an amount of $1,500[1] prior to implementing the emergency rate increase authorized in this proceeding.

Staff further recommends that the emergency rate increase be interim.

Staff further recommends that the Company be directed to file within 30 days of the Order a revised rate schedule reflecting the emergency rate increase with Docket Control, as a compliance item in this docket.

Staff further recommends that the Company notify its customers of the revised rates, and its effective date, in a form acceptable to Staff, by means of an insertion in the Company's next regularly scheduled billing.

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[1] Decision No. 67990, dated July 18, 2005, required a bond from Sabrosa Water Company in the amount of $3,000. The amount was approximately 5 percent of the annual increase in the emergency rate application. Staff's recommended bond amount for Valley Utilities is equal to approximately 5 percent of the $30,369 annual increase in revenue.

Staff further recommends that the Company file a full rate case by no later than June 1, 2008, using a 2007 test year.

Financings

Staff recommends denial of the Company's $250,000 revolving line of credit. Staff recommends approval of the Company's application for authority to issue debt to the Water Infrastructure Finance Authority not to exceed $250,000.

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Introduction

On October 1, 2007, Valley Utilities Water Company ("Valley Utilities" or "Company") filed an application for emergency rates and a financing application. Also, concurrently with the emergency rate and financing applications, the Company filed a Motion to Consolidate. On October 17, 2007, the Company's request to consolidate the applications was approved by Procedural Order.

Valley Utilities' rate application asserts that a sudden and unexpected well failure and problems with other wells has resulted in production levels that are too low to meet its 2008 summer peak demand for its 1,400 customers. The Company has concluded that the only remedy for this urgent problem is to begin drilling a replacement well as soon as possible. Consequently, it has requested an emergency rate increase and authority to immediately implement a two-phased well surcharge.

The Company proposes that the first phase of the well surcharge will recover only the interest expense on a revolving $250,000 line of credit that will be used to construct the new well. The line of credit will be from a commercial bank and the $250,000 balance is intended to be temporary.

Once the Company can refinance the $250,000 line of credit through WIFA[2] (which the Company anticipates will be within one year), then the second phase would be implemented. The second phase surcharge, under the Company's proposal, would recover the principal, interest, annual debt reserve payment, and income taxes on the $250,000 WIFA loan. The terms and conditions of both loans are discussed in greater detail in the "Financing" section of this Report.

Background

Valley Utilities is an Arizona class B utility engaged in the business of providing potable water service to a community located within a County strip, just east of Luke Air Force Base in Maricopa County, Arizona. Valley Utilities provides service to over 1,400 customers of which just over half (i.e., 795) are serviced by 3/4-inch meters. The current rates were authorized in Decision No. 68309, dated November 14, 2005.

Engineering Analysis

Introduction

Valley Utilities Water Company, Inc. ("Company") has submitted emergency rates and financing applications to drill a new well at a cost of $250,000. The Company operates a water system in the Phoenix West Valley in Maricopa County.

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[2] Water Infrastructure Finance Authority of Arizona ("WIFA")

Existing Water System

The Company's system serves a community located within a County strip, just east of Luke Air Force Base and consists of seven wells (totaling 1,655 gallons per minute ("GPM")), five storage tanks (totaling 1,060,000 gallons), four booster stations and a distribution system serving 1,422 service connections as of August 2007.

Company's Application Filings

Emergency Rates

In August 2007, Well No. 6 was taken out of service due to loss of production. Due to Well No. 6's production of 425 GPM removed from the Company's operation, the total well production of 1,655 GPM has decreased to 1,230 GPM (See section entitled Staff's Analysis below for further discussion of this reduced well production impact).

Financing

The Company is requesting financing approval for a $250,000 loan from the WIFA. This loan is needed to finance the construction of a replacement well for Well No. 6. According to the application, a bid from a well drilling company estimated the cost of a new well at approximately $200,000, with the remaining $50,000 to cover undetermined contingency costs associated with drilling and equipping the new well. As stated in the application, the well driller's bid will be filed as a late-filed exhibit.

Staff's Analysis

According to the Water Use Data Sheet submitted by the Company, the Company has six operating wells producing a total of 1,230 GPM, 1,060,000 gallons of storage capacity, and a distribution system serving 1,422 service connections as of August 2007. Using the historical growth rates, it is projected that the existing service area could grow to approximately 1,520 connections by mid 2008.

Based on the existing six well production and storage tank capacities, the system cannot adequately serve its over 1,400 service connections.

Maricopa County Environmental Services Department ("MCESD") Compliance

MCESD regulates the water system under Public Water System No. 07-079. Based on compliance information provided by the MCESD, the system has no deficiencies and MCESD has determined that this system is currently delivering water that meets water quality standards required by Arizona Administrative Code, Title 18, and Chapter 4.

Conclusions

The existing six well production and storage tank capacities cannot adequately serve the existing service connections. As of August 2007, the Company was serving 1,422 service connections. Therefore, the construction of the replacement well for Well No. 6 is needed.

Compliance

The Utilities Division Compliance Section reports the following.

> *According to Decision #68309, the Company was ordered to:*
>
> *The Company will file with Docket Control an application for approval of an arsenic removal surcharge tariff, if a surcharge is necessary to allow the Company to meet its principal and interest obligations on the amount of the WIFA loan and income taxes on the surcharges.*

Compliance with this Decision is contingent upon the Company having drawn on the loan and its ability to repay the loan. The Company has not made a filing regarding this matter. Further, Staff is not aware, at this time, of any monies being drawn on the loan.

The MCESD regulates the water system under Public Water System No. 07-079. Based on compliance information provided by the MCESD, the system has no deficiencies and MCESD has determined that this system is currently delivering water that meets water quality standards required by Arizona Administrative Code, Title 18, and Chapter 4.

Consumer Services

A review of the Consumer Services Section database from January 1, 2004 to October 10, 2007 showed the following:

2004 - three complaints (one billing, one rates/tariffs, one construction costs) and two inquiries were reported,

2005 - two complaints (both billing) and two inquires were reported,

2006 - two complaints (one billing and one service) and two inquiries were reported,

2007 - one inquiry was reported. There were no complaints or opinions.

All complaints and inquiries have been resolved and closed.

Conditions Necessary for Emergency Rate Relief

General conditions necessary for interim emergency rates[3] include:

1. A sudden change that causes hardship to a company
2. A company is insolvent, and
3. A company's ability to maintain service (pending a formal rate determination) is in serious doubt.

According to the Company's application, a sudden well failure and the Company's impending shortage of water production capacity are the conditions that comprise the emergency. Further, Mr. Robert L. Prince, the President of Valley Utilities Water Company, indicated that if the Company did not have a new well in service by early spring 2008, the Company's storage tanks would go dry and the Company would not be able to serve any of its customers (page 7 of Exhibit 2, Direct Testimony of Robert L. Prince, lines 11-13). Staff does not agree with this statement.

Conclusion

Staff concludes, based on review of the Company's unaudited application, that Valley Utilities' condition satisfies the third criteria to qualify for emergency rates listed above. Based on review of the information provided by the Company, it will not be able to provide proper and adequate service during peak periods without additional water source.

Positive Equity Position Plan

Decision No. 68309, dated November 14, 2005, ordered Valley Utilities to file and implement a plan to improve its equity position. The Decision stated on page 11, line 21 the following:

> Staff recommended that the Company be required to institute a plan that would produce a positive equity position by December 31, 2010, such plan to be filed with Docket Control within 90 days from the date of the Commission's Decision. The Company's FVRB in its last rate case was negative $292,898 (see Decision No. 62908, p.11), and in this case, has deteriorated further, to negative $539,804. As stated at page 4 above, we are concerned that this Company continues to operate the utility in such a way that although equity is not being invested, ratepayers are required to generate cash sufficient to show an operating income.

[3] According to Attorney General Opinion No. 71-17, interim or emergency rates are proper when either all or any of the following conditions occur: when sudden change brings hardship to a Company; when the Company is insolvent; or when the condition of the Company is such that its ability to maintain service pending a formal rate determination is in serious doubt.

On February 13, 2006, in compliance with Decision No. 68309, the Company filed its Positive Equity Position Plan. The plan listed seven steps the Company would take to build positive equity as follows:

1. File a request for an accounting order authorizing the Company to defer any and all arsenic operating and maintenance expense for recovery in future rate proceedings.

2. Attempt to maintain the operating margin authorized by the Commission by filing new rate applications as often as necessary.

3. File a new rate application using a 2007 test year.

4. File emergency rate applications in order to maintain its authorized operating margin.

5. Reinvest available operating income in new plant and equipment.

6. Apply for accounting orders as necessary, to defer expenses for consideration of recovery in subsequent rate cases.

7. Continue to suspend paying dividends.

Rescinded $452,080 Loan (Decision No. 62908, Dated 9/18/2000)

On January 11, 2000, Valley Utilities requested approval for two items of long-term debt: $452,080 from WIFA and $289,675 from Robert Prince, President and CEO of Valley Utilities and Barbara Prince, Secretary and Treasurer of Valley Utilities. Staff recommended denial of the proposed Prince loan of $289,675 because the Company had negative equity of $264,404 and the approval of the Prince loan would be detrimental to the Company's capital structure. Staff recommended that the Company's shareholders finance the remaining projects with equity. At the hearing, the Company had no objection to Staff's recommendation. Staffs recommendations were approved in Decision No. 62908, dated September 18, 2000. Decision No. 62908 also authorized a $6.35 monthly customer surcharge to service the $452,080 WIFA loan.

The loan and the related $6.35 surcharge were later rescinded in a subsequent rate proceeding as discussed below.

Existing $1.92 Million Loan (Decision No. 68309, Dated 11/14/2005)

Decision No. 68309, dated November 14, 2005, rescinded approval of the $452,080 WIFA loan because the Company had never drawn on it. At the same time, the Decision authorized approval of a $1.92 million WIFA loan to construct arsenic treatment plant. Further, the Decision ordered the Company to file an application for an arsenic removal surcharge tariff if a surcharge is necessary to allow the Company to pay the debt.

Additionally, the Decision ordered the Company to file a report on the $6.35 surcharge that it had begun collecting in the year 2000. In compliance with Decision No. 68309, the Company filed a report of the activity and balance of the WIFA set aside. The balance at the November 30, 2005 was $101,725. While this fund was meant only to service the WIFA debt, Staff notes that the Company used funds from this account to pay general operating expenses as follows:

10/9/2003	$10,000	To fund payroll cash shortfall
10/15/2003	$12,000	LX Payback
11/17/2003	$10,000	To fund accounts payable cash shortfall
4/2/2004	$20,000	To fund accounts payable cash shortfall
5/2/2004	$ 5,000	To fund payroll cash shortfall
2/10/2005	$10,000	To fund payroll cash shortfall
3/11/2005	$10,000	To fund payroll and income tax cash shortfall
3/28/2005	$20,000	To pay for insurance, liability, vehicle, and well repair
4/6/2005	$10,000	To fund payroll cash shortfall

Financing Application

Introduction

On October 1, 2007, Valley Utilities filed an application with the Commission requesting authorization (1) to obtain a $250,000 revolving line of credit from a commercial bank and (2) to later refinance the $250,000 revolving line of credit to a fixed rate, fixed term loan with WIFA.

Public Notice

Per Procedural Order issued October 18, 2007, a copy of the Public Notice shall be mailed to each customer and published in a newspaper of general circulation in the Company's service area on or before November 5, 2007. The Company filed the Affidavit of Publication on November 9, 2007.

Purpose and Terms of the Proposed Financing

The purpose of the $250,000 revolving line of credit is to provide the initial funds to drill the new well. The Company anticipates that the line of credit will be temporary and will be converted to fixed rate, fixed term debt once it can be refinanced with WIFA. The Company expects that the rate for the revolving line of credit will be nine percent.

Under the Company's proposal, the purpose of the long-term debt is to refinance the $250,000 revolving line of credit with a fixed rate, fixed term loan through WIFA. Under Staff's proposal, the purpose of the long-term WIFA debt is to reimburse funds to the water system for drilling a new well. The Company proposed financing is a 20-year amortizing loan at a 6.00[4] percent interest rate.

Financial Analysis and Recommendation for $250,000 Revolving Line of Credit

For financial analysis purposes, Staff considers the $250,000 revolving line of credit to be long-term debt because its repayment term is greater than one year. Staff does not recommend approval of the $250,000 revolving line of credit and recommends that the Company obtain the initial funds for the well construction with a cash infusion from the shareholders. This action would be consistent with item number five of the Company's "Positive Equity Position Plan" as discussed earlier. The investment in plant would move the Company's negative rate base in a positive direction.

As an alternative to the line of credit, the Company can obtain short-term debt that does not exceed seven percent of total capitalization in accordance with Arizona Revised Statute 40-302 D. Staff's analysis, based on unaudited information provided by the Company, shows that Valley Utilities has sufficient cash flow to pay for such debt. At December 31, 2006, the Company reported $88,824 in operating income and $172,644 in depreciation expense resulting in a positive cash flow of over $255,000 as shown on Schedule CSB-1. Also, for the year ended December 31, 2006, the Company reported a cash balance of $794,000.

Financial Analysis of $250,000 WIFA Loan

Staff's analysis is based on Valley Utilities' unaudited financial statements dated December 31, 2006. The financial analysis shown on Schedule CSB-1 presents selected financial information from the financial statements and the pro forma effect of the proposed $250,000 loan. Schedule CSB-1 also shows the capital structure and debt service coverage ("DSC") and times interest earned ("TIER") ratios.

Capital Structure

Staff's capital structure analysis includes advances in aid of construction ("AIAC") and contributions in aid of construction ("CIAC"). At December 31, 2006, Valley Utilities' capital structure consisted of no debt[5]; 86.65 percent AIAC, 22.52 percent CIAC, and a negative 9.17 percent equity. Valley Utilities' drawing the entire proposed loan of $250,000 would result in a pro forma capital structure comprised of 0.14 percent short-term debt, 5.25 percent long-term

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[4] The Company's application stated a 6.66% interest rate. However, the Company used a 6.00 percent rate in its surcharge calculation as shown on "Attachment Three" of the Company's application. Further the Company stated that the WIFA subsidy rate was 85 percent but used 75 percent in its surcharge calculation. Staff used 75 percent in its calculation in order to be conservative.

[5] Staff did not include the Company's proposed $28,237 in long-term debt as it was not Commission authorized. Also, Staff did not include the Company's $1.92 million WIFA loan because the Company had not drawn any funds as of 12/31/2006 and the Company will obtain a surcharge to pay for the debt service payments for the loan.

debt, 81.98 percent AIAC; 21.31 percent CIAC, and a negative 8.67 percent equity as shown on Schedule CSB-1.

Capital structure is an indicator of financial soundness. Valley Utilities has no equity and its over-reliance on AIAC and CIAC to fund plant construction has resulted in a negative rate base. As discussed previously, Decision No. 68309 stated ". . .we are concerned that this Company continues to operate the utility in such a way that although equity is not being invested, ratepayers are required to generate cash sufficient to show an operating income and customers were required to pay an operating income when the shareholders had no investment in plant." The same concern remains in the instant proceeding. Therefore, Staff continues to recommend that the shareholders infuse equity into the water company and follow its "Positive Equity Position Plan" discussed earlier.

Interest and Debt Service Coverage

Staff also examined the effects of the proposed financing on the Company's TIER and DSC.

DSC represents the number of times internally generated cash (i.e., earnings before interest, income tax, depreciation and amortization expenses) covers required principle and interest payments on debt. A DSC greater than 1.0 means operating cash flow is sufficient to cover debt obligations.

TIER represents the number of times earnings before income tax expense covers interest expense on 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.

Valley Utilities' TIER and DSC resulting from its 2006 Staff adjusted financial statements are not meaningful as the Company had no debt. Including Staff's recommended revenue requirement and fully drawing the proposed $250,000 loan results in a pro forma TIER and DSC of 7.45 and 13.13, respectively. The pro forma TIER and DSC show that Valley Utilities would have adequate cash flow to meet all Commission authorized obligations including the proposed debt.

Conclusions and Recommendations

WIFA Loan

Staff concludes that the project the Company proposes to construct and the $250,000 in long-term debt from WIFA is reasonable and appropriate.

Staff concludes that the proposed financing is within Valley Utilities' powers as a corporation, is compatible with the public interest and would not impair its ability to provide public service.

Therefore, Staff recommends approval of the Company's application for authority to issue debt to WIFA not to exceed $250,000.

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

Staff further recommends that one copy of executed loan documents be filed with Docket Control, as a Compliance item, within 60 days of the execution of any transactions.

Company Proposed Emergency Rate Surcharge

The Company has requested an emergency rate of $0.89 per month surcharge for each 5/8 x 3/4-inch meter; $1.34, 3/4-inch; $2.23, 1-inch; $4.45, 1.5-inch; $7.13, 2-inch; $14.25, 3-inch; $22.27, 4-inch; $44.54, 6-inch; $71.27, 8-inch; $102.45, 10-inch; $191.53, 12-inch, as shown on Schedule CSB-3.

Staff Adjustments to the Emergency Rate Surcharge

Decision No. 68309 authorized an arsenic remediation surcharge mechanism ("ARSM") for Valley Utilities. The ARSM prescribes a methodology to calculate a surcharge for arsenic treatment plant that was financed through a WIFA loan. The Company has modified the Commission approved methodology to calculate the surcharge for the new well. The Company proposes to add $4,539 for the annual WIFA debt reserve payment.

Staff has reviewed the Company's calculation and recommends two changes. First, Staff recommends removal of the $4,539 for the annual WIFA debt reserve payment. WIFA requires a monthly or quarterly payment into a debt reserve account to ensure payments on loans. The debt reserve account is similar to a forced savings account. It is an asset to the borrower and interest on the reserve accrues to the borrower. There is a very high likelihood that all payments will be made because of the Staff recommended surcharge and the Company's operating income. Consequently, when the loan is fully paid, the cash in the reserve account will become available to shareholders as equity. Therefore, Staff's methodology removes the reserve component from the surcharge and allows only the principal and interest on the loan amount to be recovered from customers.

Second, Staff recommends removal of the income taxes from the surcharge calculation. The ARSM, which includes income taxes, was designed to recover extraordinary costs of plant needed to comply with federally mandated drinking water standards. The cost of the new well for which the Company seeks recovery is routine in nature. Therefore, recovery of income taxes is inappropriate. Normal approvals for financings by this Commission do not include an allowance for income taxes.

Staff's adjustments decreased the emergency surcharge by $0.25, from $0.89 to $0.64 for the 5/8-inch x 3/4-inch metered customer. Staff recommends approval of Staff's recommended emergency rate surcharges as shown on Schedule CSB-3.

Staff further recommends that the monthly surcharge be conditional upon Staff's recommended cost of the well.

Staff further recommends that the surcharge be implemented only after the Company closes on the loan and has drawn funds to begin construction of the plant.

Staff further recommends that if the Company has not drawn funds from the loan within one year of the date of the Decision resulting from this proceeding, that approval of the loan and surcharge be rescinded.

Staff further recommends that the Company post a bond in an amount of $1,500[6] prior to implementing the emergency rate increase authorized in this proceeding.

Staff further recommends approval of the emergency rate increase sought by Valley Utilities Water Company.

Staff further recommends that the emergency rate increase be interim, subject to "true up" at the Company's next full rate case.

Staff further recommends that the Company be directed to file within 30 days of the Order a revised rate schedule reflecting the emergency rate increase with Docket Control, as a compliance item in this docket.

Staff further recommends that the Company notify its customers of the revised rates, and its effective date, in a form acceptable to Staff, by means of an insertion in the Company's next regularly scheduled billing.

Staff further recommends that the Company file a full rate case by no later than June 1, 2008, using a 2007 test year.

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[6] Decision No. 67990, dated July 18, 2005, required a bond from Sabrosa Water Company in the amount of $3,000. The amount was approximately 5 percent of the annual increase in the emergency rate application. Staff's recommended bond amount for Valley Utilities is equal to approximately 5 percent of the $30,369 annual increase in revenue.