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MEMORANDUM

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AZ CORP COMMISSION
DOCKET CONTROL

TO: Docket Control
FROM: Steven M. Olea
Director
Utilities Division

JS
60m

DATE: September 17, 2009

RE: STAFF REPORT IN THE MATTER OF THE APPLICATION OF YARNELL WATER IMPROVEMENT ASSOCIATION, INC. AN ARIZONA NON-PROFIT CORPORATION, FOR AUTHORITY (1) TO ISSUE EVIDENCE OF INDEBTEDNESS IN AN AMOUNT NOT TO EXCEED \$767,000.00 IN CONNECTION WITH (A) THE CONSTRUCTION OF WATER SYSTEM INFRASTRUCTURE IMPROVEMENTS AND (B) REPAYMENT OF EXISTING DEBT; AND (2) TO ENCUMBER ITS REAL PROPERTY INTERESTS AND WATER SYSTEM INFRASTRUCTURE AS SECURITY FOR SUCH INDEBTEDNESS (DOCKET NO. W-02255A-09-0258)

Attached is the Staff Report for Yarnell Water Improvement Association, Inc.'s application for authority to issue long-term indebtedness. Staff recommends approval.

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 September 28, 2009.

SMO:JCM:tdp

Originator: Juan C. Manrique

Attachment: Original and thirteen copies

Arizona Corporation Commission
DOCKETED

SEP 17 2009

DOCKETED BY	<i>MM</i>
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Service List for: Yarnell Water Improvement Association, Inc.
Docket No. W-02255A-09-0258

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

**YARNELL WATER IMPROVEMENT ASSOCIATION, INC.
DOCKET NO. W-02255A-09-0258**

**APPLICATION FOR AUTHORITY TO ISSUE
LONG-TERM INDEBTEDNESS**

SEPTEMBER 17, 2009

STAFF ACKNOWLEDGMENT

The Staff Report for Yarnell Water Improvement Association, Inc. Docket No. W-02255A-09-0258 is the responsibility of the Staff members listed below. Juan C. Manrique is responsible for the financial analysis. Dorothy Hains is responsible for the engineering review.



JUAN C. MANRIQUE
PUBLIC UTILITIES ANALYST I



DOROTHY HAINS
UTILITIES ENGINEER – WATER/WASTEWATER

EXECUTIVE SUMMARY
YARNELL WATER IMPROVEMENT ASSOCIATION, Inc.
DOCKET NO. W-02255A-09-0258

On May 22, 2009 Yarnell Water Improvement Association, Inc. ("Yarnell" or "Company") filed an application with the Arizona Corporation Commission ("Commission") asking for authorization to issue evidence of indebtedness through the United States Department of Agriculture, Rural Development ("USDA-RD") and to encumber its real property interests and water system infrastructure as security for such indebtedness.

The U.S. Congress enacted the American Recovery and Reinvestment Act of 2009 ("ARRA") on February 17, 2009.

Yarnell is a non-profit Class "C" Arizona public service corporation that owns and operates a public water utility in Yavapai County, Arizona. The Company seeks a loan administered by USDA-RD on behalf of Rural Utilities Service ("RUS") in an amount not to exceed \$1,300,000. The Company anticipates \$533,000 of the loan will be designated as forgivable principal reducing the expected repayable indebtedness to \$767,000. The forgivable principal is contingent upon compliance with ARRA and USDA-RD requirements. The Company expects a 40-year amortizing loan at 3.75 percent per annum. The purpose of Yarnell's request for indebtedness is to pay for the cost of improvements to its existing water system and to pay the balance of the existing debt that funded the original construction of the water system in 1974 and 1975.

Commission Decision No. 70698, dated January 20, 2009, established Yarnell's present rates based on a 2006 test year to provide an operating income of \$61,344. As of December 31, 2006, Yarnell's capital structure consisted of 7.4 percent short-term debt, 46.5 percent long-term debt, and 46.1 percent equity. Staff calculated a pro forma capital structure reflecting issuance of a \$767,000 40-year amortizing loan at 3.75 percent per annum, and it is composed of 1.2 percent short-term debt, 83.9 percent long-term debt and 15.0 percent equity. Staff also calculated a pro forma debt service coverage ("DSC") ratio of 1.41 using the \$61,344 operating income authorized in Decision No. 70698. The DSC results show that cash flow from operations is sufficient to cover all obligations.

Staff concludes that the Company's proposed capital projects are appropriate and that the related cost estimates are reasonable. However, no "used and useful" determination of the proposed project item was made and no particular treatment should be inferred for rate making or rate base purpose in the future.

Staff further concludes that issuance of the proposed debt financing for the purposes stated in the application is within Yarnell's corporate powers, is compatible with the public interest, is consistent with sound financial practices and will not impair its ability to provide services.

Staff recommends authorization to incur a 38-to-42 year amortizing loan in an amount not to exceed \$1,300,000 pursuant to a loan agreement administered by USDA-RD on behalf of RUS that provides for \$533,000 of the principal amount to become forgiven upon compliance with the American Recovery and Reinvestment Act of 2009 and USDA-RD.

Staff further recommends that the Commission authorize Yarnell to pledge its assets in the State of Arizona pursuant to A.R.S. § 40-285 in connection with the USDA-RD/RUS loan.

Staff further recommends that Yarnell use best efforts and act in good faith to comply with all the requirements of the American Recovery and Reinvestment Act of 2009 and all requirements of USDA-RD/RUS in order to obtain the \$533,000 of forgivable principal.

Staff further recommends that the Commission take the regulatory measures it deems appropriate due to any detrimental consequences to ratepayers that may result from Yarnell's failure to use best efforts and act in good faith to comply with the American Recovery and Reinvestment Act of 2009 that results in a reduction in the amount of the loan that would otherwise qualify as forgivable principal.

Staff further recommends that any authorization to incur debt granted in this proceeding terminate on December 31, 2012.

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

Staff recommends that the Company file with Docket Control as a compliance item in this docket by December 31, 2012, copies of the Arizona Department of Environmental Quality ("ADEQ") Certificates of Approval of Construction ("AOC") for Project No. 1 (repair and replace valves), Project No. 2 (replace fire hydrants), Project No. 3 (reline storage tanks), and Project No. 5 (replace water lines).

Staff further recommends that one copy of executed loan documents be filed with Docket Control, as a compliance item in this case, within 60 days of the execution of any financing transaction authorized herein.

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Introduction

On May 22, 2009 Yarnell Water Improvement Association, Inc. ("Yarnell" or "Company") filed an application with the Arizona Corporation Commission ("Commission") asking for authorization to issue evidence of indebtedness through the United States Department of Agriculture, Rural Development ("USDA-RD") and to encumber its real property interests and water system infrastructure as security for such indebtedness.

Public Notice

On July 8, 2009, the Company filed an affidavit of publication verifying public notice of its financing application. The Company published notice of its financing application in the *Courier* on June 20, 2009. The *Courier* is a daily newspaper of general circulation in the City of Prescott, County of Yavapai, Arizona. The affidavit of publication is attached along with a copy of the Notice.

Background

The U.S. Congress enacted the American Recovery and Reinvestment Act of 2009 ("ARRA") on February 17, 2009. USDA-RD's website shows that ARRA authorizes it to provide an additional subsidy on loans. In addition, the website asserts that projects that receive ARRA funds will need to be capable of moving forward rapidly; hence, expedited regulatory consideration is appropriate.

Yarnell is a non-profit Class "C" Arizona public service corporation located in Yarnell, Arizona. Yarnell owns and operates a public water utility in Yavapai County, Arizona.

On January 20, 2009, the Commission issued Decision No. 70698 establishing the Company's present rates based on a 2006 test year to provide an operating income of \$61,344.

Compliance

Decision No. 70698, dated January 20, 2009, established new rates and directed Yarnell to file, as a compliance item with Docket Control, a revised rate schedule setting forth its new rates and charges. Commission records show that the Company filed a schedule of its rates and charges on September 9, 2009. Staff is currently reviewing the filing.

Purpose and Description of the Requested Approval

The purpose of Yarnell's request for indebtedness is to pay for the cost of improvements to its existing water system and to pay the balance of the existing debt that funded the original construction of the water system in 1974 and 1975.

The Company requests that the Commission authorize it to secure financing in an amount not to exceed \$1,300,000 administered by USDA-RD on behalf of Rural Utilities Service ("RUS"). The Company anticipates \$533,000 of the loan will be designated as forgivable principal reducing the expected repayable indebtedness to \$767,000. The forgivable principal is contingent upon compliance with ARRA and USDA-RD requirements. The Company expects a 40-year amortizing loan at 3.75 percent per annum.

Engineering Analysis

The Staff Engineering Memorandum is attached. Staff reviewed the material cost estimates of the Company's proposed capital improvements. Staff concludes that Yarnell's cost estimates in the project budget seem reasonable and appropriate. Staff makes no "used and useful" determination of the proposed improvements and no conclusions are made for rate base or ratemaking purposes.

Financial Analysis

Staff's analysis is illustrated on Schedule JCM-1. Column [A] reflects operating results and financial information consistent with Decision No. 70698 based on the test year ended December 31, 2006. Column [B] presents pro forma financial information that modifies Column [A] to reflect issuance of a 40-year, \$1,300,000 amortizing loan at 3.75 percent per annum, repayment of the balance of the existing debt that funded the original construction of the water system in 1974 and 1975¹ and equity at December 31, 2008.

DSC

Debt service coverage ratio ("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 greater than 1.0 indicates that cash flow from operations 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.

Schedule JCM-1, Column [A] shows a 1.68 DSC with the Company's existing debt, and a pro forma 1.41 DSC under the scenario described above for Column [B] above. The pro forma DSC results show that cash flow from operations is sufficient to cover all obligations with the Company's proposed debt issuance and use of funds.

Capital Structure

At December 31, 2006, the Company's capital structure consisted of 7.4 percent short-term debt, 46.5 percent long-term debt and 46.1 percent equity (Schedule JCM-1, Column [A], lines 19-25). Issuance of the proposed \$1,300,000, 40-year amortizing loan would result in a

¹ The Company's December 31, 2008, balance sheet shows an outstanding balance of \$268,931.

capital structure composed of 1.2 percent short-term debt, 83.4 percent long-term debt and 15.0 percent equity (Schedule JCM-1, Column [B], lines 19-25).

Staff typically recommends that non-profit water utilities maintain capital structures with a minimum of 30 percent equity as appropriate to provide a balance of cost and financial risk for regulated utilities and ratepayers. Staff concludes that the proposed capital improvements and the forgivable principal opportunity warrant authorization of the proposed debt despite the resulting highly leverage capital structure.

Capital Structure inclusive of AIAC and CIAC

At December 31, 2006, the Company's capital structure, inclusive of Advances In Aid of Construction ("AIAC") and Net Contributions In Aid of Construction ("CIAC")², consisted of 7.4 percent short-term debt, 46.5 percent long-term debt, 46.1 percent equity, 0.0 percent AIAC and 0.0 percent CIAC (Schedule JCM-1, Column [A], lines 30-40).

Encumbrance

A.R.S. § 40-285 requires public service corporations to obtain Commission authorization to encumber certain utility assets. The statute serves to protect captive customers from a utility's act to dispose of any of its assets that are necessary for the provision of service, thus, it serves to preempt any service impairment due to disposal of assets essential for providing service. Pledging assets as security typically provides benefits to the borrower in the way of increased access to capital funds or preferable interest rates, and it is often an unavoidable condition for procurement of funds for small or financially stressed entities.

Conclusion and Recommendations

Staff concludes that the Company's proposed capital projects are appropriate and that the related cost estimates are reasonable. However, no "used and useful" determination of the proposed project item was made and no particular treatment should be inferred for rate making or rate base purpose in the future.

Staff further concludes that issuance of the proposed debt financing for the purposes stated in the application is within Yarnell's corporate powers, is compatible with the public interest, is consistent with sound financial practices and will not impair its ability to provide services.

Staff recommends authorization to incur a 38-to-42 year amortizing loan in an amount not to exceed \$1,300,000 pursuant to a loan agreement administered by USDA-RD on behalf of RUS that provides for \$533,000 of the principal amount to become forgiven upon compliance with the American Recovery and Reinvestment Act of 2009 and USDA-RD.

² Contributions in Aid of Construction less Amortization of Contributions in Aid of Construction.

Staff further recommends that the Commission authorize Yarnell to pledge its assets in the State of Arizona pursuant to A.R.S. § 40-285 in connection with the USDA-RD/RUS loan.

Staff further recommends that Yarnell use best efforts and act in good faith to comply with all the requirements of the American Recovery and Reinvestment Act of 2009 and all requirements of USDA-RD/RUS in order to obtain the \$533,000 of forgivable principal.

Staff further recommends that the Commission take the regulatory measures it deems appropriate due to any detrimental consequences to ratepayers that may result from Yarnell's failure to use best efforts and act in good faith to comply with the American Recovery and Reinvestment Act of 2009 that results in a reduction in the amount of the loan that would otherwise qualify as forgivable principal.

Staff further recommends that any authorization to incur debt granted in this proceeding terminate on December 31, 2012.

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

Staff recommends that the Company file with Docket Control as a compliance item in this docket by December 31, 2012, copies of the Arizona Department of Environmental Quality ("ADEQ") Certificates of Approval of Construction ("AOC") for Project No. 1 (repair and replace valves), Project No. 2 (replace fire hydrants), Project No. 3 (reline storage tanks), and Project No. 5 (replace water lines).

Staff further recommends that one copy of executed loan documents be filed with Docket Control, as a compliance item in this case, within 60 days of the execution of any financing transaction authorized herein.

FINANCIAL ANALYSIS

Selected Financial Information

	<u>[A]¹</u> <u>Decision No. 70698</u>		<u>[B]²</u> <u>Pro Forma</u>		
1	Operating Income	\$61,344	\$61,344		
2	Depreciation & Amort.	\$35,393	\$35,393		
3	Income Tax Expense	\$0	\$0		
4					
5	Interest Expense	\$19,091	\$50,889		
6	Repayment of Principal	\$38,399	\$17,825		
7					
8					
9					
10					
11	DSC				
12	[1+2+3] ÷ [5+6]	1.68	1.41		
13					
14					
15					
16					
17	Capital Structure				
18					
19	Short-term Debt	\$38,399	7.4%	\$17,825	1.2%
20					
21	Long-term Debt	\$241,409	46.5%	\$1,296,589	83.9%
22					
23	Common Equity	\$239,741	46.1%	\$231,088	15.0%
24					
25	Total Capital	\$519,549	100.0%	\$1,545,502	100.0%
26					
27					
28	Capital Structure (inclusive of AIAC and Net CIAC)				
29					
30	Short-term Debt	\$38,399	7.4%	\$17,825	1.2%
31					
32	Long-term Debt	\$241,409	46.5%	1,296,589	83.9%
33					
34	Common Equity	\$239,741	46.1%	\$231,088	15.0%
35					
36	Advances in Aid of Construction ("AIAC")		0.0%	\$0	0.0%
37					
38	Contributions in Aid of Construction ("CIAC") ³		0.0%	\$0	0.0%
39					
40	Total Capital (Inclusive of AIAC and CIAC)	\$519,549	100.0%	\$1,545,502	100.0%
41					
42					
43	AIAC and CIAC Funding Ratio⁴		0.0%		0.0%
44	(36+38)/(40)				
45					
46					

¹ Column [A] reflects operating results and financial information consistent with Decision No. 70698, dated January 20, 2009, for test year 2006.

² Column [B] reflects the issuance of a \$1,300,000, 40-year amortizing loan at 3.75 percent and equity at December 31, 2008.

³ Net CIAC balance (i.e. less: accumulated amortization of contributions).

⁴ Staff typically recommends that combined AIAC and Net CIAC funding not exceed 30 percent of total capital, inclusive of AIAC and Net CIAC, for private and investor owned utilities.

MEMORANDUM

DATE September 14, 2009

TO: Juan Manrique
Public Utility Analyst

FROM: Dorothy Hains, P. E. *DH*
Utilities Engineer

RE: **In the matter of the application of Yarnell Water Improvement Association, Inc. for approval to (1) issue evidence of indebtedness in an amount not to exceed \$767,000.00 in connection with (A) the construction of water system infrastructure improvements and (B) repayment of existing debt; and (2) to encumber its real property interests and water system infrastructure as security for such indebtedness.**
Docket No. WS-01303A-09-0258

Introduction and Background

On May 22, 2009, Yarnell Water Improvement Association ("Yarnell" or "the Company") filed with the Arizona Corporation Commission ("ACC") a financing application requesting ACC approval to incur long-term debt in the amount of 767,000 dollars to (1) repair and replace valves; (2) replace fire hydrants (3) reline storage tanks; (4) install on-site generator; (5) replace water lines and (6) replace telemetry system.

On September 9, 2009, the Company filed a supplemental exhibit to the application stating that the Company awarded JWJ Design Builders, Inc. a contract worth \$446,200 to construct the water system improvements listed above.

Location of System

The Company is located near the Town of Congress, 30 miles southwest of the City of Prescott in Yavapai County. Attached Exhibits 1 and 2 detail the location of the service area in relation to other Commission-regulated companies in Yavapai County and in the immediate area. The Company serves an area approximately five square miles in size that includes a portion of Sections 12, 14 and 15, of Township 10 North, Range 5 West, and Sections 1, 2, 10 and 11 of Township 10 North, Range 5 West.

System Analysis

The Company owns and operates a water system that consists of two wells (having a combined well capacity of 470 gallons per minute ("GPM"), three storage tanks (having a capacity of 540,000 gallons), seven pressure relief valves and a distribution system. The Company serves approximately 600 metered customers, the majority of which are residential. Based on water usage data in the Company's 2008 Annual Report, Yarnell has adequate production and storage to serve its existing customers plus reasonable growth. Lost water for Yarnell was calculated to be 18 percent which exceeds acceptable limits of 10 per cent. In Decision No. 70698, dated January 20, 2009, the Commission ordered the Company to continue to reduce its water loss. A water loss reduction report or detailed cost benefit analysis must be filed as a compliance item within 13 months of the effective date of Decision No. 70698. Proceeds from this loan are needed to complete the improvements listed above, which in part are needed to address the Company's ongoing water loss issue.

Arizona Department of Environmental Quality ("ADEQ") Compliance Status

Staff received a compliance status report from ADEQ dated June 3, 2009, in which ADEQ stated that the system (ADEQ Public Water System Identification #13-057) has no major deficiencies. ADEQ has determined that the 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 Status

The Company is not in any ADWR Active Management Area ("AMA"). Staff received a Compliance Status Report from ADWR related to Yarnell on June 1, 2009 stating that ADWR has determined that the Company is currently in compliance with departmental requirements governing water providers and/or community water systems.

ACC Compliance Status

A check of the Utilities Division Compliance database showed there were no delinquent compliance items for the Company.

Cost

A general description and breakdown of the funding required is as follows:

Project Description	Estimated Cost (\$)
Project No. 1 Repair and Replace Valves	
Remove & Replace 4 pressure reducing valves (@ \$8,390/unit)	33,560
Relocate Pressure reducing valves (@ \$13,508/unit)	13,508
Remove & Replace 2 check valves ((@ \$12,936/unit)	25,872
Two signs (one @ well site and another @ HWY 89 per USDA requirement (@ \$1,500/unit)	3,000
Subtotal	75,940
Project No. 2 Replace Fire Hydrants	
Traffic control	5,500
Replace 67 fire hydrants (@ \$2,350/unit)	157,450
Testing/disinfection	5,000
Subtotal	167,950
Project No. 3 Reline Storage Tanks	
Earthwork for install a Loomis 10,000 gallon storage tank	5,000
Install a 10,000 gallon storage tank (@ \$13,050) @ well site	13,050
Replace the water level on existing 40,000 gallon tank (@ \$5,100/unit)	5,100
Reline one 250,000 gallon tank (@\$29,706/tank)	29,706
Reline one 40,000 gallon tank (@\$12,960/tank)	12,960
Subtotal	65,816
Project No. 4 Install On-site Generator	
Install a 55 kW, 60 Hz generator (@ \$41,171/unit)	41,171
Subtotal	41,171
Project No. 5 Replace Water Lines	
Cleaning site	2,500
Dust control (including purchasing water)	21,000
Erosion Control	2,350
Remove & salvage pump station	9,000
Install 61' of 4" PVC pipes (@ \$43.00/ft)	2,623
Install two 4" Tee with Thrust Block (@ \$650/unit)	1,300
Install four 4" gate valves with thrust block (@ \$700/unit)	2,800
Install eight 4" 45° Elbow with thrust block (@ \$200/unit)	1,600
Install 82' of 6" PVC pipeline with trace wire (@ \$75/unit)	6,150
Install two tapping sleeves (@ \$1,500/unit)	3,000

Install one 6" 45° elbow (@ \$300/unit)	300
Install two 6" valves (@ \$950/unit)	1,900
Subtotal	54,523
Project No. 6 Replace Telemetry System	
Replace telemetry system	40,800
Subtotal	40,800
Total	446,200

Staff concludes that the proposed projects are appropriate and the cost estimates presented above are reasonable for purposes of this financing request. However, no "used and useful" determination of the proposed project item was made and no particular treatment should be inferred for rate making or rate base purpose in the future.

Approval of Construction ("AOC")

Staff recommends that the Company file with Docket Control as a compliance item in this docket by December 31, 2012, copies of the ADEQ Certificates of AOC for Project No. 1 (repair and replace valves), Project No. 2 (replace fire hydrants), Project No. 3 (reline storage tanks), and Project No. 5 (replace water lines).

Summary

I. Conclusions

1. ADEQ stated that the Company's water system has no major deficiencies. ADEQ has determined that the system is currently delivering water that meets water quality standards required by Arizona Administrative Code, Title 18, Chapter 4.
2. ADWR has determined that the Company is currently in compliance with departmental requirements governing water providers and/or community water systems.
3. A check of the Utilities Division Compliance database showed there were no delinquent compliance items for the Company.
4. Staff concludes that the proposed project is appropriate and the cost estimates presented herein are reasonable for purposes of this financing request. However, no "used and useful" determination of the proposed project item was made and no particular treatment should be inferred for rate making or rate base purpose in the future.

5. The Yarnell water system currently has adequate storage and well production to serve its existing base of customers plus reasonable growth.

II. Recommendations

1. Staff recommends that the Company file with Docket Control as a compliance item in this docket by December 31, 2012, copies of the ADEQ Certificates of AOC for Project No. 1 (repair and replace valves), Project No. 2 (replace fire hydrants), Project No. 3 (reline storage tanks), and Project No. 5 (replace water lines).

