

ORIGINAL



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MEMORANDUM  
RECEIVED

2012 FEB -1 P 3:38

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

AZ CORP COMMISSION  
DOCKET CONTROL

DATE: February 7, 2012

RE: STAFF REPORT FOR PIMA UTILITY COMPANY'S APPLICATION FOR AUTHORITY TO (1) ISSUE EVIDENCE OF INDEBTEDNESS IN AN AMOUNT NOT TO EXCEED \$8,370,000 IN CONNECTION WITH (A) INFRASTRUCTURE IMPROVEMENTS TO THE UTILITY SYSTEM AND (B) PURCHASE OF EQUITY; AND (2) ENCUMBER REAL PROPERTY AND PLANT AS SECURITY FOR SUCH INDEBTEDNESS FOR ITS WATER AND WASTEWATER SYSTEMS. (DOCKET NOS. W-02199A-11-0403 AND SW-02199A-~~0404~~) 11-0404

Attached is the Staff Report for the Pima Utility Company's application for authority to borrow funds. 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 February 17, 2012.

SMO:JAC:kdh

Originator: John A. Cassidy

Arizona Corporation Commission  
DOCKETED

FEB - 7 2012

DOCKETED BY *[Signature]*

Service List for: Pima Utility Company  
Docket Nos.: W-02199A-11-0403 and SW-02199A-11-0404

Mr. Steve Soriano  
Vice President and General Manager  
Pima Utility Company  
9532 E. Riggs Road  
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Phoenix, Arizona 85012  
Attorney for Pima Utility Co.

**STAFF REPORT  
UTILITIES DIVISION  
ARIZONA CORPORATION COMMISSION**

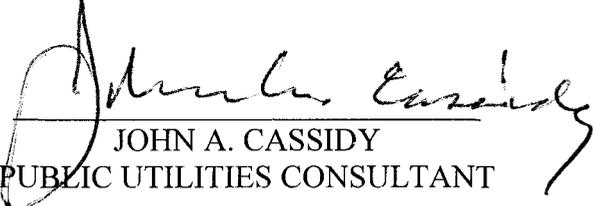
**PIMA UTILITY COMPANY  
DOCKETS NOS. W-02199A-11-0403 & SW-02199A-11-0404**

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

**FEBRUARY 7, 2012**

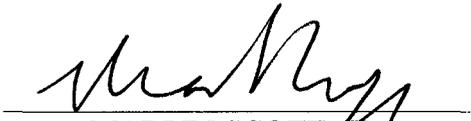
## STAFF ACKNOWLEDGMENT

The Staff Report for Pima Utility Company, Dockets No. W-02199A-11-0403 and SW-02199A-11-0404, is the responsibility of the Staff members listed below. John A. Cassidy is responsible for the financial analysis. Marlin Scott, Jr. is responsible for the engineering review.



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JOHN A. CASSIDY  
PUBLIC UTILITIES CONSULTANT



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MARLIN SCOTT, JR.  
UTILITIES ENGINEER

**EXECUTIVE SUMMARY  
PIMA UTILITY COMPANY  
DOCKETS NOS. W-002199A-11-0403 & SW-02199A-11-0404**

On November 8, 2011, Pima Utility Company, ("Pima" or the "Company"), filed identical applications for its water and wastewater divisions with the Arizona Corporation Commission ("Commission") requesting authorization to issue debt and pledge its assets and revenue as security. Wells Fargo Bank, National Association ("Wells Fargo" or the "Bank") is the anticipated lender. On January 6, 2012, the Company filed an amendment to the application.

Pima is a Subchapter "S" Corporation and a Class "B" Arizona public service corporation that provides water (10,175 connections) and wastewater (10,050 connections) utility services in portions of Maricopa County, Arizona. The Company requests authorization to issue debt in an amount not to exceed \$8,370,000 in the form of a 15-year amortizing loan with a 5-year maturity at a rate not to exceed 5.5 percent per annum. The terms of the anticipated loan provide for encumbrance of all the Company's assets and revenues. The Company proposes to use the proceeds of the debt financing for three purposes:

1. \$1,500,000 to fund force main replacement projects in the sewer system and the refurbishing of certain outdated sewer facilities;
2. \$4,370,000 to refinance existing Industrial Development Authority ("IDA") bonds at a lower interest rate; and
3. \$2,500,000 to rebalance the capital structure by replacing equity with debt.

As of December 31, 2010, Pima's capital structure consisted of 2.0 percent short-term debt, 22.0 percent long-term debt, and 76.0 percent equity. Staff calculated a pro forma capital structure reflecting issuance of an \$8,370,000 5-year amortizing loan at 5.5 percent per annum, a \$2,500,000 equity buy back and a \$1.755 million 2011 IDA debt repayment not financed by the proposed loan and it is composed of 5.9 percent short-term debt, 27.2 percent long-term debt and 66.9 percent equity. This scenario presents a stringent test of the Company's debt service capacity. For this scenario, Staff calculated a pro forma 1.30 debt service coverage ratio ("DSC"). This pro forma DSC shows that cash flow from operations is sufficient to cover all obligations. The Company has no existing unused authorizations to issue indebtedness.

Staff concludes that the Company's proposed capital improvement projects are appropriate and that the related \$1,500,000 cost estimate is reasonable.

Staff further concludes that the Company's proposal to refinance \$4,370,000 of existing IDA bonds at a lower interest rate is appropriate and that its proposal to rebalance its capital structure by replacing \$2,500,000 of equity with debt is reasonable.

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

Staff recommends:

- Granting authorization to incur a 15-year amortizing loan in an amount not to exceed \$8,370,000 with a 5- to 7-year maturity date at an interest rate not to exceed 5.5 percent per annum for the purposes stated in the Company's application.
- That the Commission authorize Pima to pledge its assets in the State of Arizona pursuant to A.R.S. § 40-285 in connection with any indebtedness authorized in this proceeding.
- That any unused authorization to incur debt granted in this proceeding expire on December 31, 2013.
- Authorizing Pima to engage in any transaction and to execute any documents necessary to effectuate the authorizations granted.
- That Pima file with Docket Control, as a compliance item in this matter, a copy of the loan documents, within 60 days of the execution of any financing transaction authorized herein.
- That the Company file with Docket Control, as a compliance item in this docket, by June 30, 2013, a copy of the Arizona Department of Environmental Quality/Maricopa County's Certificate for Approval to Construct for the Hunt Highway-Price Road Sewer Force Main Improvement Project.

**TABLE OF CONTENTS**

	<b><u>PAGE</u></b>
INTRODUCTION .....	1
PUBLIC NOTICE .....	1
BACKGROUND.....	1
COMPLIANCE .....	1
PURPOSE AND DESCRIPTION OF THE REQUESTED FINANCING.....	1
ENGINEERING ANALYSIS.....	2
FINANCIAL ANALYSIS .....	2
DEBT SERVICE COVERAGE .....	2
CAPITAL STRUCTURE .....	3
CAPITAL STRUCTURE INCLUSIVE OF AIAC AND CIAC .....	3
ENCUMBRANCE .....	3
CONCLUSION AND RECOMMENDATIONS.....	3

**SCHEDULES**

FINANCIAL ANALYSIS .....	JAC-1
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**ATTACHMENTS**

ENGINEERING MEMORANDUM.....	A
AFFIDAVIT OF PUBLICATION .....	B

## INTRODUCTION

On November 8, 2011, Pima Utility Company, (“Pima” or the “Company”), filed identical applications for its water and wastewater divisions with the Arizona Corporation Commission (“Commission”) requesting authorization to issue debt and pledge its assets and revenue as security. On January 6, 2012, the Company filed an amendment to the application.

## PUBLIC NOTICE

On December 22 2011, the Company filed an affidavit of publication verifying public notice of its financing application. The Applicant published notice of its financing application in the *Arizona Business Gazette* on November 24, 2011. The *Arizona Business Gazette* is a weekly newspaper of general circulation in the county of Maricopa, State of Arizona. The affidavit of publication is attached along with a copy of the Notice.

## BACKGROUND

Pima is a Subchapter “S” Corporation and a Class “B” Arizona public service corporation that provides water (approximately 10,175 connections) and wastewater (approximately 10,050 connections) utility services in portions of Maricopa County, Arizona.

On August 29, 2011, Pima filed separate general rate applications for its water<sup>1</sup> and wastewater<sup>2</sup> divisions. These rate cases were consolidated by Procedural Order dated September 30, 2011, and currently remain pending before the Commission.

## COMPLIANCE

A check of the compliance database indicates that there are currently no delinquencies for Pima.

## PURPOSE AND DESCRIPTION OF THE REQUESTED FINANCING

The Company proposes to use the proceeds of the debt financing for three purposes:

1. \$1,500,000 to fund force main replacement projects in the sewer system and the refurbishing of certain outdated sewer<sup>3</sup> facilities;
2. \$4,370,000 to refinance existing Industrial Development Authority (“IDA”) bonds at a lower interest rate; and
3. \$2,500,000 to rebalance the capital structure by replacing equity with debt.

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<sup>1</sup> Docket No. W-02119A-11-0329.

<sup>2</sup> Docket No. SW-02119A-11-0330.

<sup>3</sup> On January 19, 2012, the Company filed a Notice of Errata to reflect that sewer facilities, not water facilities as stated in the initial application, are to be refurbished.

The Company requests authorization to issue debt in an amount not to exceed \$8,370,000 in the form of a 15-year amortizing loan with a 5-year maturity<sup>4</sup> at a rate not to exceed 5.5 percent per annum. The terms of the anticipated loan provide for encumbrance of all the Company's assets and revenues. Wells Fargo Bank, National Association ("Wells Fargo" or the "Bank") is the anticipated lender.

## **ENGINEERING ANALYSIS**

The Staff Engineering Memorandum is attached. Staff reviewed the Company's proposed Hunt Highway-Price Road Sewer Force Main Improvement project and concludes that the project is appropriate and that its \$1,500,000 cost estimate is reasonable. Staff makes no "used and useful" determination pertaining to the proposed capital improvements nor does it make any conclusions for rate base or ratemaking purposes.

## **FINANCIAL ANALYSIS**

Staff's analysis is presented in Schedule JAC-1. Column [A] of the schedule reflects the Company's historical financial information for the year ended December 31, 2010, and Column [B] presents pro forma financial information that modifies Column [A] to reflect issuance of an \$8,370,000, 15-year amortizing loan at 5.5 percent per annum, a \$2,500,000 equity buy back and a \$1.755 million 2011 IDA debt repayment not financed by the proposed loan. Column [C] presents pro forma financial information that modifies Column [B] to reflect full amortization of the proposed loan over a 5-year term versus a 15-year amortization.

### *Debt Service Coverage*

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 JAC-1, Column [A] shows a 2.68 DSC for the year ended December 31, 2010. A pro forma 3.04 DSC results for the scenario described above for Column [B], and a pro forma 1.30 DSC results for the scenario described above for Column [C]. The scenario for Column [C] represents a stringent test of the Company's debt service capacity. Staff calculated a pro forma 1.30 DSC for this scenario. This pro forma DSC shows that cash flow from operations is sufficient to cover all obligations. The Company has no existing unused authorizations to issue indebtedness.

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<sup>4</sup> On January 6, 2012, the Company filed an amended term sheet revising the anticipated maturity date to 5 years from 5-year and 7-year alternatives and showing the offered interest rate (5-year London Interbank Offer Rate ("LIBOR") plus 2.00 percent) at 3.65 percent.

### *Capital Structure*

As of December 31, 2010, Pima's capital structure consisted of 2.0 percent short-term debt, 22.0 percent long-term debt, and 76.0 percent equity (Schedule JAC-1, Column [A], lines 19-25). Staff calculated a pro forma capital structure for the scenario described above for Column [B], which represents the Company's proposal, and it is composed of 1.5 percent short-term debt, 31.6 percent long-term debt and 66.9 percent equity (Schedule JAC-1, Column [B], lines 19-25). Under the Company's proposal, \$2,500,000 of the debt issuance will be used to buy back equity to provide a capital structure that remains equity-rich, but to a lesser degree than its current capital structure. Due to Pima's otherwise strong balance sheet, historically good operating results, continuing equity-rich capital structure and professional financial management; Staff concludes that the proposed capital structure rebalancing is reasonable.

### *Capital Structure inclusive of AIAC and CIAC*

As of December 31, 2010, the Applicant's capital structure, inclusive of Advances-In-Aid-of-Construction ("AIAC") and Net Contributions-In-Aid-of-Construction ("CIAC")<sup>5</sup> consisted of 1.9 percent short-term debt, 21.2 percent long-term debt, 73.4 percent equity, 2.5 percent AIAC and 1.0 percent CIAC (Schedule JAC-1, Column [A], lines 30-40).

### *Encumbrance*

The terms of the anticipated loan provide for encumbrance of all the Company's assets and revenues. 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 improvement projects are appropriate and that the related \$1,500,000 cost estimate is reasonable.

Staff further concludes that the Company's proposal to refinance \$4,370,000 of existing IDA bonds at a lower interest rate is appropriate and that its proposal to rebalance its capital structure by replacing \$2,500,000 of equity with debt is reasonable.

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<sup>5</sup> Contributions in Aid of Construction less Accumulated Amortization of Contributions in Aid of Construction.

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

Staff recommends:

- Granting authorization to incur a 15-year amortizing loan in an amount not to exceed \$8,370,000 with a 5- to 7-year maturity date at an interest rate not to exceed 5.5 percent per annum for the purposes stated in the Company's application.
- That the Commission authorize Pima to pledge its assets in the State of Arizona pursuant to A.R.S. § 40-285 in connection with any indebtedness authorized in this proceeding.
- That any unused authorization to incur debt granted in this proceeding expire on December 31, 2013.
- Authorizing Pima to engage in any transaction and to execute any documents necessary to effectuate the authorizations granted.
- That Pima file with Docket Control, as a compliance item in this matter, a copy of the loan documents within 60 days of the execution of any financing transaction authorized herein.
- That the Company file with Docket Control, as a compliance item in this docket, by June 30, 2013, a copy of the Arizona Department of Environmental Quality/Maricopa County's Certificate for Approval to Construct for the Hunt Highway-Price Road Sewer Force Main Improvement Project.

**FINANCIAL ANALYSIS**

Selected Financial Information

	[A] <sup>1</sup> 12/31/2010		[B] <sup>2</sup> Pro Forma		[C] <sup>3</sup> Pro Forma	
1 Operating Income	\$ 1,314,000		\$ 1,314,000		\$ 1,314,000	
2 Depreciation & Amort.	1,180,000		1,180,000		1,180,000	
3 Income Tax Expense	0		0		0	
4						
5 Interest Expense	461,000		451,127		423,025	
6 Repayment of Principal	470,000		369,552		1,495,496	
7						
8						
9						
10						
11 <b>DSC</b>						
12 [1+2+3] + [5+6]	2.68		3.04		1.30	
13						
14						
15						
16						
17 <b>Capital Structure</b>						
18						
19 Short-term Debt	505,000	2.0%	369,552	1.5% <sup>4</sup>	1,495,496	5.9% <sup>4</sup>
20						
21 Long-term Debt	5,620,000	22.0%	8,000,448	31.6%	6,874,504	27.2%
22						
23 Common Equity	19,432,000	76.0%	16,932,000	66.9%	16,932,000	66.9%
24						
25 Total Capital	\$25,557,000	100.0%	\$25,302,000	100.0%	\$25,302,000	100.0%
26						
27						
28 <b>Capital Structure (inclusive of AIAC and Net CIAC)</b>						
29						
30 Short-term Debt	505,000	1.9%	369,552	1.4%	1,495,496	5.7%
31						
32 Long-term Debt	5,620,000	21.2%	8,000,448	30.5%	6,874,504	26.2%
33						
34 Common Equity	19,432,000	73.4%	16,932,000	64.5%	16,932,000	64.5%
35						
36 Advances in Aid of Construction ("AIAC")	660,000	2.5%	660,000	2.5%	660,000	2.5%
37						
38 Contributions in Aid of Construction ("CIAC") <sup>5</sup>	274,000	1.0%	274,000	1.0%	274,000	1.0%
39						
40 Total Capital (Inclusive of AIAC and CIAC)	\$26,491,000	100.0%	\$26,236,000	100.0%	\$26,236,000	100.0%
41						
42						
43 <b>AIAC and CIAC Funding Ratio</b> <sup>6</sup>	3.5%		3.6%		3.6%	
44 (36+38)/(40)						
45						

46 <sup>1</sup> Column [A] is based on financial information for the year ended December 31, 2010.

47 <sup>2</sup> Column [B] is Column [A] modified to reflect issuance of the proposed \$8,370,000 debt financing maturing in 5 years, and amortized for 15 years at 5.5 percent per annum, \$1.755 million IDA payments in 2011 not financed by the proposed loan, \$4.37 million in IDA Bond repayments and \$2.5 million in equity buy back.

48 <sup>3</sup> Column [C] is Column [B] modified to reflect full amortization of the proposed \$8,370,000 loan over its 5-year term versus a 15-year amortization.

49 <sup>4</sup> Pro Forma Short-term Debt represents the first year principal repayment on the proposed loan.

50 <sup>5</sup> Net CIAC balance (i.e. less: accumulated amortization of contributions).

51 <sup>6</sup> 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: January 11, 2012

TO: John Cassidy  
Contractor  
Utilities Division

FROM: Marlin Scott, Jr.   
Utilities Engineer  
Utilities Division

RE: Pima Utility Company – Water Division, Docket No. W-02199A-11-0403  
(Financing) and Wastewater Division, Docket No. SW-02199A-11-0404  
(Financing)

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**Introduction**

On November 8, 2011, Pima Utility Company – Water and Wastewater Divisions (“Company”), Docket Nos. 11-0403 and 11-0404, respectively, submitted financing applications for authority to issue evidence of indebtedness from Wells Fargo Bank in an amount not to exceed \$8,370,000. Roughly, \$4,370,000 of this new debt will be used to replace existing debt at a reduced interest rate, \$1,500,000 will be used to fund wastewater system improvements, and the remaining \$2,500,000 will be used to rebalance the Company’s capital structure to reflect a higher amount of debt. This engineering report will only address the \$1,500,000 related to the funding for the wastewater system improvement identified as the Hunt Highway-Price Road Sewer Force Main Improvement.

**Existing Wastewater System**

The Company has a wastewater system consisting of a Water Reclamation Facility (“WRF”), reuse system, and collection system. The operation of the WRF consists of a 2.4 million gallon per day (“MGD”) sequential batch reactor (“SBR”) treatment plant and wastewater collection system consisting of 15 collection lift stations, and approximately 99.6 miles of wastewater mains serving approximately 10,050 service laterals as of December 2010. Effluent from the WRF is recycled by direct delivery of reclaimed water to the Oakwood Golf Course. The effluent reuse system includes five recharge/recovery wells. The recharge and recovery wells are used to deliver recovered effluent to the Oakwood Golf Course and to a Home Owners Association for landscape watering.

### **Proposed Improvement Project**

In its financing applications, the Company provided a letter from B&R Engineering, Inc. showing a cost breakdown for the Hunt Highway--Price Road Sewer Force Main Improvement as follows:

1. Piping	\$ 865,259
2. Valve/Fittings	\$ 201,365
3. Lift station improvements	\$ 375,000
4. Pavement replacement	\$ 25,698
5. Traffic control	\$ 50,000

=====  
Total: \$1,517,322 (Rounded to \$1,500,000)

In Staff's Data Request MSJ – 3.3, Staff requested a more detailed breakdown of costs for the above project components. The Company responded by providing the attached spreadsheet, Exhibit RLJ – 3.3A, and also provided additional information by stating that the project consists of re-routing flows from four existing lift stations to a new major lift station and force main system for direct delivery to the WRF. The project will improve wastewater collection efficiency and ease the burden on the remaining downstream lift stations and lines, some of which are operating in excess of their intended capacity. The project also abandons an existing force main that has reached the end of its useful life.

Staff has reviewed the improvement project and concludes that the project is appropriate and the cost estimate totaling \$1,500,000 is reasonable.

### **Compliances**

On December 12, 2011, the Arizona Department of Environmental Quality (“ADEQ”) reported the Company's WRF, Inventory No. 100557 was in compliance with ADEQ regulations.

On January 4, 2012, the Utilities Division Compliance Section indicated that the Company had no delinquent ACC compliance issues.

### **Conclusions/Recommendation**

The Company is in compliance with ADEQ and ACC regulations.

Staff concludes that the improvement project is appropriate and the cost estimate totaling \$1,500,000 is reasonable. No “used and useful” determination of the proposed project items were made and no particular treatment should be inferred for rate making or rate base purposes in the future.

John Cassidy  
January 11, 2012  
Page 3

Staff recommends that the Company file with Docket Control, as a compliance item in the docket, by June 30, 2013, a copy of the ADEQ/Maricopa County Certificate for Approval to Construct for the Hunt Highway-Price Road Sewer Force Main Improvement Project.



Reference/PO #  
19

SANDRA BAKER

# Arizona Business Gazette

The business resource

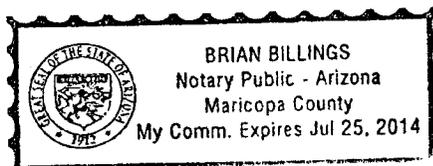
PO BOX 194  
Phoenix, Arizona 85001-0194  
(602) 444-7315 FAX (602) 444-7364

STATE OF ARIZONA }  
COUNTY OF MARICOPA } SS.

Manny Vargas, being first duly sworn, upon oath deposes and says: That he is the Legal Ad Rep of the Arizona Business Gazette, a newspaper of general circulation in the county of Maricopa, State of Arizona, published weekly at Phoenix, Arizona, and that the copy hereto attached is a true copy of the advertisement published in the said paper on the dates indicated.

11/24/2011

Sworn to before me this  
24TH day of  
NOVEMBER 2011

  
Notary Public

PUBLIC NOTICE OF AN APPLICATION FOR AN ORDER FOR AUTHORITY TO (1) SUSPEND EVIDENCE OF INDEBTEDNESS IN AN AMOUNT NOT TO EXCEED \$200,000 IN CONNECTION WITH THE CONSTRUCTION OF IMPROVEMENTS TO THE WATER SYSTEM AND (2) THE PURCHASE OF EQUITABLE AND OTHER INTERESTS IN REAL PROPERTY AND PLAN AS SECURITY FOR SUCH INDEBTEDNESS. PIMA UTILITY COMPANY, AN ARIZONA CORPORATION, is applying for an order of the Arizona Commission on Public Utilities. The application shall contain the following information: (a) the name of the applicant and the proposed project; (b) a description of the project; (c) the estimated cost of the project; (d) the estimated amount of the indebtedness; (e) the estimated amount of the security; (f) the estimated amount of the improvements; (g) the estimated amount of the water system; (h) the estimated amount of the water system; (i) the estimated amount of the water system; (j) the estimated amount of the water system; (k) the estimated amount of the water system; (l) the estimated amount of the water system; (m) the estimated amount of the water system; (n) the estimated amount of the water system; (o) the estimated amount of the water system; (p) the estimated amount of the water system; (q) the estimated amount of the water system; (r) the estimated amount of the water system; (s) the estimated amount of the water system; (t) the estimated amount of the water system; (u) the estimated amount of the water system; (v) the estimated amount of the water system; (w) the estimated amount of the water system; (x) the estimated amount of the water system; (y) the estimated amount of the water system; (z) the estimated amount of the water system. Published Nov. 24, 2011.