

ORIGINAL



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MEMORANDUM

TO: Docket Control 2012 AUG 24 P 12: 52

FROM: Steven M. Olea
Director
Utilities Division

DATE: August 24, 2012

RE: **SUPPLEMENTAL STAFF REPORT – FOR COMPLIANCE FILING IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY FOR A WAIVER UNDER A.A.C. R14-2-806 OR, IN THE ALTERNATIVE, NOTICE OF INTENT TO REORGANIZE UNDER A.A.C. R14-2-803 (DOCKET NO. W-01303A-11-0101)**

On November 17, 2011, the Arizona Corporation Commission (“Commission”) issued Decision No. 72668 which approved the transfer of ownership of Arizona-American Water Company (“AAWC”) to Epcor Water (USA) Inc. and granted authority for AAWC to incur certain long term debt at terms that were “substantially identical to or better than those reflected in existing debt between AAWC and American Water Capital Corp.” The Decision also ordered “that within 90 days of AAWC’s filing of the details of the replacement of current short term debt with new long term debt, the Commission’s Utilities Division shall file a Staff Report and Recommendation for Commission consideration regarding the replacement long term debt.” Pursuant to Decision No. 72668, on March 22, 2012 and July 9, 2012, Epcor Water Arizona Inc. (“EWAZ”) made its compliance filing on behalf AAWC.

Attached is the Staff Report, pursuant to the compliance filing ordered in the above-named docket, that discusses Staff’s analysis of EWAZ/AAWC’s compliance filing.

Staff concludes that replacement of debt formerly held by American Capital Corporation with debt held by Epcor has not harmed the Company’s ratepayers. No further analysis or action is warranted at this time.

SMO:GWB:red/CHH

Originator: Gerald W. Becker

Arizona Corporation Commission

DOCKETED

AUG 24 2012

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Docket No. W-01303A-11-0101

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

**STAFF REPORT – FOR COMPLIANCE FILING IN THE MATTER OF THE
APPLICATION OF ARIZONA-AMERICAN WATER COMPANY FOR A WAIVER
UNDER A.A.C. R14-2-806 OR, IN THE ALTERNATIVE, NOTICE OF INTENT TO
REORGANIZE UNDER A.A.C. R14-2-803**

DOCKET NO. W-01303A-11-0101

AUGUST 24, 2012

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INTRODUCTION

On November 17, 2011, the Arizona Corporation Commission (“Commission”) issued Decision No. 72668 which approved the transfer of ownership of Arizona-American Water Company (“AAWC”) to Epcor Water (USA) Inc. and granted authority for AAWC to incur certain long term debt at terms that were “substantially identical to or better than those reflected in existing debt between AAWC and American Water Capital Corp.” The Decision also ordered “that within 90 days of AAWC’s filing of the details of the replacement of current short term debt with new long term debt, the Commission’s Utilities Division shall file a Staff Report and Recommendation for Commission consideration regarding the replacement long term debt.” Pursuant to Decision No. 72668, on March 22, 2012 and July 9, 2012, Epcor Water Arizona Inc. (“EWAZ”) made its compliance filing on behalf AAWC (collectively described herein as “Company”).

STAFF ANALYSIS

Staff has reviewed the Company’s filing of March 22, 2012, along with its supplemental filing of July 9, 2012, and agrees with the Company’s representation that “... the replacement debt’s terms are slightly better than those existing prior to the acquisition.”¹

The primary focus of Staff’s analysis in this filing is to provide an “apples to apples” comparison of the effective interest rate of the certain debt instruments before and after the sale to EPCOR in order to provide any potential ratemaking implications in future rate proceedings. To this end, Staff has revisited the Company’s Response to the Residential Utility Consumer Office (“RUCO”) Data Requests 2.1 and 2.2 and compared the average interest rate of certain instruments before and after the transaction.

As indicated on Attachments A, the Company reported the existence of 12 debt instruments numbered 1-12 that were outstanding prior to the sale. As shown on Attachment B, Staff has compiled the pre-transfer data provided per RUCO Data Requests 2.1 and 2.2 along with the post-transfer data provided by the Company in its filings of March 22, 2012 and July 9, 2012. As indicated on both attachments, the Company had a total indebtedness of \$253.1 million consisting of 12 debt instruments. Except for items 6 and 7 consisting of a Water Infrastructure Finance Authority (“WIFA”) loan of approximately \$809,000 and a Tolleson obligation of approximately \$8.56 million², respectively, the original debt of approximately \$243.8 million³ was retired and essentially re-financed by EWAZ with a combination of long term, intermediate term, and short term debt. Further, coinciding with the retirement of \$243.8 million of debt was

¹ Application dated March 22, 2012, 1 at 18-9.

² The WIFA loan and the Tolleson obligation remain as outstanding obligations of EWAZ.

³ As indicated on the Company’s filing of March 22, 2012 and its supplemental filing of July 6, 2012, the post transfer debt of the applicable debt is \$244.8 million but Staff believes that this was a typographical error and that the applicable, post transfer debt is \$243.8 million. This consists of the pre transfer debt of items 1-5 and 8-12 per Attachment B which were redeemed/ refinanced.

its replacement with approximately \$240.2 million of debt that indicates a reduction in debt of approximately \$3.6 million of indebtedness for the Company.

As indicated on Attachment B, the debt instruments that were refinanced were those listed as items 1-5 and 8-12 with a total outstanding balance of approximately \$243.8 million and annual interest expense of approximately \$10.8 million for an effective annual interest rate of 4.417 percent. This debt was replaced with total debt of \$240.2 million classified as \$98 million of long term debt with an interest rate of 5.00 percent, \$133 million of intermediate term debt with an interest rate of 3.74 percent, and \$9.2 million of short term debt with an interest rate of 0.35 percent, for an overall interest expense of approximately \$9.91 million for an effective weighted interest rate of 4.124 percent without amortization of certain debt issuance costs. Considering the annual amortization of issuance costs of approximately \$38,000 as shown on Attachment B, total interest expense and the effective weighted interest rate increase to approximately \$9.94 million and 4.139 percent respectively, which compare with interest expense and an effective interest rate of approximately \$10.8 million and 4.417 percent, respectively, on the \$243.8 million⁴ of indebtedness prior to the sale.

CONCLUSIONS AND RECOMMENDATIONS

Staff concludes that replacement of debt formerly held by American Capital Corporation with debt held by Epcor has not harmed the Company's ratepayers. No further analysis or action is warranted at this time.

⁴ The 243.8 million is less than the total pre-sale indebtedness of \$253.1 million.

COMPANY
DOCKET NO:ARIZONA-AMERICAN WATER COMPANY
W-01303A-11-0101Response provided by: Greg Barber
Title: Finance DirectorAddress: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027**Company Response Number:** RUCO 2.1

Q. Debt Replacements Please refer to lines 18 through 20 of page 8 of AAWC's Application which states the following: "As part of this transaction, at closing, EPCOR will replace the existing Arizona-American debt extended by American Water with debt extended by EPCOR under comparable terms ("Debt Replacements")." In regard to this statement, please provide an itemized list of the debt obligations that will be replaced by EPCOR at the time of the proposed transaction closes that includes the following information:

- (a) name of debt issuances/loans
- (b) name of lenders (if applicable)
- (c) maturity date of debt issuances/loans
- (d) stated interest rate on debt issuances/loans
- (e) original amount financed through debt issuances/loans
- (f) current balance on debt issuances/loans

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ARIZONA-AMERICAN WATER COMPANY
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Response provided by: James McKee
Title: Director, Business Process Management
EPCOR Water Services, Inc
Address: 9469 Rossdale Road
Edmonton, Alberta Canada T5K 0A5

Company Response Number: RUCO 2.2

- Q.** Debt Replacements In regard to the itemized list requested in RUCO 2.1, please identify which specific Arizona-American debt issuance/loans will be replaced by EPCOR.
- A.** Items #1 through #5 will be replaced by EPCOR. It is likely that American Water will pay off items #9 through #12 at the time of Closing. However, to maintain the existing capital structure, EPCOR will need to issue new debt to replace these items.

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A. See chart below for outstanding debt obligations.

	(a)	(b)	(c)	(d)	(e)	(f)
1.	5.39%Series A	Internal	12/21/2013	5.39%	\$24.7M	\$24.7M
2.	5.52% Series B	Internal	12/21/2016	5.52%	\$11.2M	\$11.2M
3.	5.62% Series C	Internal	12/21/2018	5.62%	\$123.1M	\$123.1M
4.	144A Bonds	Internal	10/15/2037	6.593%	\$16.45M	\$16.45M
5.	Short Term Debt	Internal	N/A	Approx. .40% to .79% based on actual and budgeted information for 2011	N/A	Approx. \$57.6M
6.	WIFA American Recovery and Reinvestment Loan	WIFA	11/1/2029	3.938%	\$839,726	\$809,219
7.	Tolleson Muni Refunding Bond (Guarantee by American Water)	Tolleson	5/1/2015	Variable	\$8.56M	\$8.56M
8.	Tax Exempt AMT Bonds Issued by the IDA of Maricopa, AZ	IDA	9/1/2028	5.25%	\$10.635M	\$10.635M

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	(a)	(b)	(c)	(d)	(e)	(f)
9.	Neighborhood Installment Agreement-- Monterrey		8/1/2012	6.26%	\$114,503	\$15,712
10.	Neighborhood Installment Agreement-- Rosalee		8/1/2013	5.76%	\$80,891	\$11,668
11.	Neighborhood Installment Agreement-- TO Development		8/1/2015	7.18%	\$69,278	\$28,453
12.	Neighborhood Installment Agreement-- Montex		8/1/2015	7.18%	\$55,050	\$24,372

Line No.	Item No.	Descriptor	Original Debt ----->			Replacement Debt ----->		
			[A]	[B]	[C]	[D]	[E]	[F]
			Principal	Rate	Interest Expense	Principal	Rate	Interest Expense
1	1	Intermediate Term	\$ 24,700,000	5.390%	\$ 1,331,330	\$ 98,000,000	5.000%	\$ 4,900,000
2	2		\$ 11,200,000	5.520%	\$ 618,240	\$ 133,000,000	3.740%	\$ 4,974,200
3	3		\$ 123,100,000	5.620%	\$ 6,918,220	\$ 9,246,000	0.350%	\$ 32,361
4	4	Total Int. Term	\$ 159,000,000	5.577%	\$ 8,867,790	\$ 240,246,000	4.124%	\$ 9,906,561
5	4	Long Term	\$ 16,450,000	6.593%	\$ 1,084,549			
7	5	Short Term	\$ 57,600,000	0.400%	\$ 230,400			
8	1-5	Total Items Above	\$ 233,050,000	4.369%	\$ 10,182,739			
9						Per Company		9,944,664
10	6	WIFA Item 6	\$ 809,219	3.938%	\$ 31,867	Amort. of		
11	7	Tollson Obligation	\$ 8,560,000	0.34%	\$ 29,104	Issue Costs		38,103
12	8	AMT bonds	\$ 10,635,000	5.45%	\$ 579,608			
13	9	Monterrey Agreement	\$ 15,127	6.26%	\$ 947			
14	10	Rosalee Agreement	\$ 11,668	5.76%	\$ 672			
15	11	Devepment Agreement	\$ 28,453	7.18%	\$ 2,043			
16	12	Montex Agreement	\$ 24,372	7.18%	\$ 1,750			
17			\$ 253,133,839	4.278%	\$ 10,828,729			
18								
19								
20								
21	21	Total Items 1-5 above	\$ 233,050,000	4.369%	\$ 10,182,739			
22	22	Total Items 8-12 above	\$ 10,714,620	5.460%	\$ 585,019			
23	23		\$ 243,764,620	4.417%	\$ 10,767,758			
24								
25	25	Items 6-7	\$ 9,369,219	0.651%	\$ 60,971			
26	26	Total (all items 1-12)	\$ 253,133,839	4.278%	\$ 10,828,729			

Column:

- [A] Item number per Co. response to RUCO 2.1
- [B] Classification based on maturity dates as shown in col. (c) in Co. response to RUCO 2.1
- [C] The remaining principal outstanding as of the Co. response to RUCO 2.1, col. (f)
- [D] Interest rates as either per the Co. response to RUCO 2.1, col. (d), or
- [D] Line 13, updated rate per recent communication by the Co to Staff as recalculated by Staff, on line nos. 4, 10,19, 21-23, 25-26
- [E] Annual Interest Expense as recalculated by Staff
- [F] Per Co. filing of March 22, 2012
- [G] Per Co. filing of March 22, 2012
- [G] Lines 10 and 12, as recalculated by Staff
- [H] Annual Interest Expense as recalculated by Staff on lines 4-10
- [H] Line No. 12, Per Company data
- [H] Line No. 14, line 10 minus line 12