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MEMORANDUM RECEIVED

2014 FEB 10 P 3:01

TO: Docket Control

AZ CORP COMMISSION
DOCKET CONTROL

FROM: Steven M. Olea
Director
Utilities Division

DATE: February 10, 2014

ORIGINAL

RE: STAFF REPORT IN THE MATTER OF THE APPLICATION OF LAGO DEL ORO WATER COMPANY, AN ARIZONA CORPORATION, FOR AUTHORITY TO: (1) ISSUE EVIDENCE OF INDEBTEDNESS IN AN AMOUNT NOT TO EXCEED \$3,900,000 IN CONNECTION WITH THE PURCHASE OF EQUITY; AND (2) ENCUMBER REAL PROPERTY AND PLANT AS SECURITY FOR SUCH INDEBTEDNESS. (DOCKET NO. W-01944A-13-0242)

Attached is the Staff Report in the matter concerning Lago Del Oro Water Company's application for authority to incur long-term indebtedness. Staff recommends conditional 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 14, 2014.

SMO:JAC:tdp\RRM

Originador: John A. Cassidy

Arizona Corporation Commission
DOCKETED

FEB 10 2014

DOCKETED BY 

Service List for: Lago Del Oro Water Company
Docket No.: W-01944A-13-0242

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

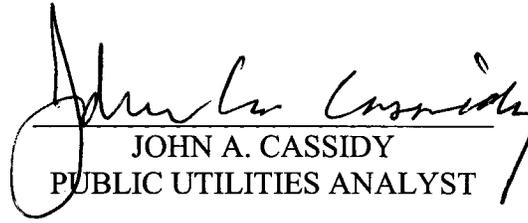
**LAGO DEL ORO WATER COMPANY
DOCKET NO. W-01944A-13-0242**

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

FEBRUARY 10, 2014

STAFF ACKNOWLEDGMENT

The Staff Report for Lago Del Oro Water Company, Docket No. W-01944A-13-0242 is the responsibility of the Staff member listed below.



JOHN A. CASSIDY
PUBLIC UTILITIES ANALYST

EXECUTIVE SUMMARY
LAGO DEL ORO WATER COMPANY
DOCKET NO. W-01944A-13-0242

On July 10, 2013, Lago Del Oro Water Company (“LDO” or “Company”) filed a financing application with the Arizona Corporation Commission (“Commission”) requesting authorization to incur indebtedness in an amount not to exceed \$3,900,000 and to encumber its real property and plant as security for such indebtedness. On October 9, 2013, the Company filed an amendment to the application modifying the terms of its proposed financing.

Staff concludes that the proposed debt financing and rebalancing of the Company’s capital structure, as modified by Staff with the loan principal not to exceed the net book value of the plant assets purchased, is reasonable and appropriate.

Staff further concludes that issuance of the proposed indebtedness, as adjusted by Staff, is compatible with the public interest, consistent with sound financial practices, and will not impair LDO’s ability to provide services.

Staff recommends:

- Approval of LDO’s request to issue long-term debt, on condition that the principal of the loan not exceed \$2,751,411, in the form of a secured, 7-year loan amortized over a 7-year period at an interest rate of 4.57 percent per annum, but subject to change, an effective interest rate not to exceed 6.0 percent.
- That the proceeds of the borrowing authority authorized herein be used to reimburse equity shareholders for the paid in capital used to purchase the subject plant, as described in the application.
- That any unused authority to issue long-term debt granted in this proceeding expire on December 31, 2014.
- Authorizing LDO to engage in any transaction and to execute any documents necessary to effectuate the authorizations granted.
- That LDO file as a compliance item in this matter, one copy of the loan documents with the Utilities Division Compliance Section and a letter of confirmation with Docket Control, within 60 days of the execution of any financing transaction authorized herein.

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INTRODUCTION

On July 10, 2013, Lago Del Oro Water Company (“LDO” or “Company”) filed a financing application with the Arizona Corporation Commission (“Commission”) requesting authorization to incur indebtedness in an amount not to exceed \$3,900,000 and to encumber its real property and plant as security for such indebtedness. On October 9, 2013, the Company filed an amendment to the application modifying the terms of its proposed financing.

PUBLIC NOTICE

On December 20, 2013, 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 Daily Star* on October 4, 2013, and in the *San Manuel Miner* on October 9, 2013. The *Arizona Daily Star* is a newspaper of general circulation in the County of Pima, State of Arizona. The *San Manuel Miner* is a legal newspaper published weekly in the County of Pinal, State of Arizona. The affidavits of publication are attached along with copies of the Notice.

BACKGROUND

LDO is a for profit “C” Corporation and a Class “B” Arizona public service corporation providing water utility service to metered customers in portions of Pima and Pinal Counties, Arizona, pursuant to certificates of convenience and necessity granted by the Commission. During 2012 the Company served approximately 6,400 connections.

The Company’s current rates were approved in Decision No. 56464 (dated April 26, 1989).

On June 27, 2013, LDO filed a rate application with the Commission requesting an increase to its authorized tariff rates for water utility service. The Company’s rate case is currently pending before the Commission.¹

COMPLIANCE

As of February 3, 2014, a check of the compliance database indicates that there are currently no delinquencies for LDO.

¹ Docket No. W-01944A-13-0215.

PURPOSE AND DESCRIPTION OF THE REQUESTED FINANCING

In December 2012, the Company purchased a significant portion of its water system from Saddlebrooke Development (“Saddlebrooke”), an LDO affiliate for \$3,887,998.² As contemplated in the application, proceeds from the proposed \$3.9 million debt financing will be used to return the paid in equity capital provided by shareholders for this plant acquisition and to rebalance the Company’s present 100.0 percent equity capital structure. The proposed financing will leave LDO with a rebalanced capital structure consisting of 59.79 percent equity and 40.21 percent debt, one more favorable to rate payers as the cost of debt is less than the cost of equity.

As originally proposed, the financing terms called for a loan maturity not to exceed 5 years at an interest rate not to exceed 6.0 percent. As amended, the proposed terms call for a loan maturity of 7 years, with monthly payments based on a 10-year amortization period and a balloon payment due at maturity, at a fixed interest rate not to exceed 6.0 percent. The anticipated lender for the proposed financing is Wells Fargo Bank.

Pursuant to the Wells Fargo preliminary term sheet accompanying LDO’s amended filing, the 7-year term loan to be made available carries a variable interest rate of Prime plus 0.25%, or LIBOR plus 2.25 percent. LDO may acquire a variable-to-fixed interest rate swap to hedge the variable interest expense of this credit facility, and doing so would result in a fixed all-in rate of 4.57 percent per annum over the life of the loan.³ Based on an interest rate of 4.57 percent per annum, the balloon payment of principal owing at the end of year seven on a 7-year loan amortized over ten years is \$960,706.

The fact that the interest rate contained in the Wells Fargo term sheet is variable suggests that the actual interest rate could change by the time this financing application is approved by the Commission. Staff believes that the Commission should authorize LDO to complete this financing as long as the final effective interest rate, after giving consideration to the factors identified in the term sheet discussion in the preceding paragraph immediately above, does not exceed 6.0 percent.

The \$3,887,998 actual cost figure of the plant assets acquired by LDO from its affiliate represents Saddlebrooke’s original cost basis in those assets. However, the plant purchased by LDO had previously been placed in service by the affiliate, and LDO’s proposed financing gives no consideration to the level of accumulated depreciation that would, or should, have been recorded between the time the various plant assets were originally placed in service by Saddlebrooke and subsequently purchased by LDO. Accordingly, Staff considers approval of the financing to be appropriate on condition that the loan principal of the proposed debt not

² Exhibit 2 of the Company’s original financing application contains a schedule showing the assets purchased from Saddlebrooke. The date January 1, 2012 appearing at the top of the schedule refers to the date at which LDO placed these assets on the Company’s books; however, the actual purchase of the assets from the LDO affiliate did not take place until December 2012.

³ This rate was based on market conditions as of September 16, 2013.

exceed \$2,751,411, a figure representing the original cost of the assets (\$3,887,998), net of accumulated depreciation (\$1,136,587).⁴

FINANCIAL ANALYSIS

Staff's analysis is presented in Schedule JAC-1. Column [A] of the schedule reflects LDO's historical financial information for the year ended December 31, 2012, and Column [B] presents pro forma financial information modifying Column [A] to reflect issuance of the Staff adjusted \$2,751,411 proposed debt at an interest rate of 4.57 percent per annum having a 7 year maturity and amortized over 10 years. Column [C] presents pro forma financial information that modifies Column [A] to reflect issuance of the Staff adjusted \$2,751,411 proposed debt at an interest rate of 4.57 percent per annum having a 7 year maturity and amortized over 7 years.

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] does not reflect a DSC for the year ended December 31, 2012, due to LDO having a 100.0 percent equity capital structure. A pro forma 2.24 DSC results for the scenario described above for Column [B], and a pro forma 1.67 DSC results for the scenario described above for Column [C]. As evidenced by the above, LDO presently has cash flows from operations sufficient to meet all on-going debt service obligations, and would continue to do so under either of the two pro forma scenarios depicted in Columns [B] and [C]. Staff prefers approval of the loan scenario calling for full amortization of the loan principal in seven years, as it eliminates the need for a lump sum payment of principal at the end of year seven as required under a 10-year loan amortization period.⁵ The Company has no existing unused authorizations to issue indebtedness.

Capital Structure

As of December 31, 2012, LDO's capital structure consisted of 0.0 percent short-term debt, 0.0 percent long-term debt, and 100.0 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], and it is composed of 2.3 percent short-term debt, 26.6 percent long-term debt and 71.0 percent equity (Schedule JAC-1, Column [B], lines 19-25). For the scenario described

⁴ For details of Staff's adjustment to plant, See: Docket No. W-01944A-13-0215, Direct testimony of Staff witness, Mary Rimback.

⁵ To confirm the feasibility of Staff's preferred loan terms calling for full amortization of the loan principal over a 7-year period but at an interest rate of 6.0 percent per annum, Staff performed the same strenuous pro forma test as that depicted in Column [C] of Schedule JAC-1, and this test resulted in a DSC of 1.59.

above for Column [C], Staff calculated a pro forma capital structure composed of 3.6 percent short-term debt, 25.4 percent long-term debt and 71.0 percent equity (Schedule JAC-1, Column [C], lines 19-25).

Capital Structure inclusive of AIAC and CIAC

As of December 31, 2012, the Applicant's capital structure, inclusive of Advances-In-Aid-of-Construction ("AIAC") and net Contributions-In-Aid-of-Construction ("CIAC")⁶ consisted of 0.0 percent short-term debt, 0.0 percent long-term debt, 93.3 percent equity, 2.9 percent AIAC and 3.8 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 proposed debt financing and rebalancing of the Company's capital structure, as modified by Staff with the loan principal not to exceed the net book value of the plant assets purchased, is reasonable and appropriate.

Staff further concludes that issuance of the proposed indebtedness, as adjusted by Staff, is compatible with the public interest, consistent with sound financial practices, and will not impair LDO's ability to provide services.

Staff recommends:

- Approval of LDO's request to issue long-term debt, on condition that the principal of the loan not exceed \$2,751,411, in the form of a secured, 7-year loan amortized over a 7-year period at an interest rate of 4.57 percent per annum, but subject to change, an effective interest rate not to exceed 6.0 percent.

⁶ Contributions in Aid of Construction less Accumulated Amortization of Contributions in Aid of Construction.

- That the proceeds of the borrowing authority authorized herein be used to reimburse equity shareholders for the paid in capital used to purchase the subject plant, as described in the application.
- That any unused authority to issue long-term debt granted in this proceeding expire on December 31, 2014.
- Authorizing LDO to engage in any transaction and to execute any documents necessary to effectuate the authorizations granted.
- That LDO file as a compliance item in this matter, one copy of the loan documents with the Utilities Division Compliance Section and a letter of confirmation with Docket Control, within 60 days of the execution of any financing transaction authorized herein.

FINANCIAL ANALYSIS

Selected Financial Information

	[A] ¹		[B] ²		[C] ³
	<u>12/31/2012</u>		10-Year Amortization <u>Pro Forma</u>		7-Year Amortization <u>Pro Forma</u>
1 Operating Income	\$ (44,520)		\$ (44,520)		\$ (44,520)
2 Depreciation & Amort.	827,650		827,650		827,650
3 Income Tax Expense	(14,956)		(14,956)		(14,956)
4					
5 Interest Expense	0		121,124		118,648
6 Repayment of Principal	0		222,173		341,368
7					
8					
9					
10					
11 DSC					
12 [1+2+3] + [5+6]	#DIV/0!		2.24		1.67
13					
14					
15					
16					
17 Capital Structure					
18					
19 Short-term Debt	0	0.0%	222,173	2.3% ⁴	341,368
20					
21 Long-term Debt	0	0.0%	2,529,238	26.6%	2,410,043
22					
23 Common Equity	9,699,341	100.0%	6,740,138	71.0%	6,740,138
24					
25 Total Capital	\$ 9,699,341	100.0%	\$ 9,491,549	100.0%	\$ 9,491,549
26					
27					
28 Capital Structure (inclusive of AIAC and Net CIAC)					
29					
30 Short-term Debt	0	0.0%	222,173	2.2%	341,368
31					
32 Long-term Debt	0	0.0%	2,529,238	24.8%	2,410,043
33					
34 Common Equity	9,699,341	93.3%	6,740,138	66.2%	6,740,138
35					
36 Advances in Aid of Construction ("AIAC")	297,640	2.9%	297,640	2.9%	297,640
37					
38 Contributions in Aid of Construction ("CIAC") ⁵	396,418	3.8%	396,418	3.9%	396,418
39					
40 Total Capital (Inclusive of AIAC and CIAC)	\$ 10,393,399	100.0%	\$ 10,185,607	100.0%	\$ 10,185,607
41					
42					
43 AIAC and CIAC Funding Ratio ⁶	6.7%		6.8%		6.8%
44 (36+38)/(40)					
45					

¹ Column [A] is based on financial information for the year ended December 31, 2012.

² Column [B] is Column [A] modified to reflect issuance of the Staff adjusted \$2,751,411 debt financing maturing in 7 years, amortized for 10 years at 4.57 percent per annum, and a \$2,751,411 equity draw down to rebalance the capital structure, net of an anticipated \$207,792 operating loss.

³ Column [C] is Column [B] modified to reflect full amortization of the Staff adjusted \$2,751,411 loan over a 7-year period at 4.57 percent per annum.

⁴ Pro Forma Short-term Debt represents the first year principal repayment on the proposed loan.

⁵ Net CIAC balance (i.e. less: accumulated amortization of contributions).

⁶ 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.

ARIZONA DAILY STAR

Tucson, Arizona

STATE OF ARIZONA)
COUNTY OF PIMA)

Debbie Capanear, being first duly sworn deposes and says: that she is the Advertising Representative of **TNI PARTNERS**, a General Partnership organized and existing under the laws of the State of Arizona, and that it prints and publishes the Arizona Daily Star, a daily newspaper printed and published in the City of Tucson, Pima County, State of Arizona, and having a general circulation in said City, County, State and elsewhere, and that the attached ad was printed and

Legal Notice

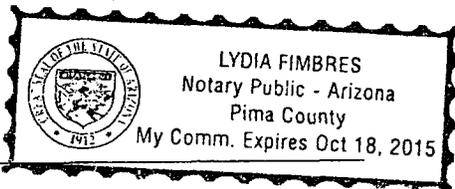
published correctly in the entire issue of the said Arizona Daily Star on each of the following dates, to-wit:

OCTOBER 4, 2013

Debbie Capanear

Subscribed and sworn to before me this 18 day of October, 2013

Lydia Fimbres
Notary Public



My commission expires

AD NO. 8095859

PUBLIC NOTICE OF AN APPLICATION FOR AN ORDER
Docket No: SW-01944A-13-024Z

AUTHORIZING THE ISSUANCE OF \$3,900,000 BY LAGO DEL ORO WATER COMPANY

Lago Del Oro Water Company ("Company") filed an Application with the Arizona Corporation Commission ("Commission") for an order authorizing the Company to issue indebtedness in an amount not to exceed \$3,900,000. The application is available for inspection during regular business hours at the office of the Commission in Phoenix, Arizona, and the Company's offices, 3352 E. Riggs Road, Sun Lakes, Arizona 85248 and 40004 S. Ridgeview Blvd., Tucson, AZ 85739.

Intervention in the Commission's proceedings on the application shall be permitted to any person entitled by law to intervene and having a direct substantial interest in this matter. Persons desiring to intervene must file a Motion to Intervene with the Commission which must be served upon the Company and which, at minimum, shall contain the following information:

1. The name, address and telephone number of the proposed intervenor and of any person upon whom service of documents is to be made if different than the intervenor.
2. A short statement of the proposed intervenor's interest in the proceeding.
3. Whether the proposed intervenor desires a formal evidentiary hearing on the application and the reasons for such a hearing.
4. A statement certifying that a copy of the Motion to Intervene has been mailed to the Company.

The granting of Motions to Intervene shall be governed by A.A.C. R14-3-105, except that all Motions to Intervene must be filed on, or before, the 15th day after this notice.

Publish October 4, 2013
Arizona Daily Star

Public Notice

PUBLIC NOTICE OF AN APPLICATION FOR AN ORDER Docket No. SW-01944A-13-0242 AUTHORIZING THE ISSUANCE OF \$3,900,000 BY LAGO DEL ORO WATER COMPANY

Lago Del Oro Water Company ("Company") filed an Application with the Arizona Corporation Commission ("Commission") for an order authorizing the Company to issue indebtedness in an amount not to exceed \$3,900,000. The application is available for inspection during regular business hours at the office of the Commission in Phoenix, Arizona, and the Company's offices, 9352 E. Riggs Road, Sun Lakes, Arizona 85248 and 40004 S. Ridgeview Blvd., Tucson, AZ 85739.

Intervention in the Commission's proceedings on the application shall be permitted to any person entitled by law to intervene and having a direct substantial interest in this matter. Persons desiring to intervene must file a Motion to Intervene with the Commission which must be served upon the Company and which, at minimum, shall contain the following information:

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2. A short statement of the proposed intervenor's interest in the proceeding.
3. Whether the proposed intervenor desires a formal evidentiary hearing on the application and the reasons for such a hearing.
4. A statement certifying that a copy of the Motion to Intervene has been mailed to the Company.

The granting of Motions to Intervene shall be governed by A.A.C. R14-3-105, except that all Motions to Intervene must be filed on, or before, the 15th day after this notice.
MINER Legal 10/9/13

State of Arizona
County of Pinal

AFFIDAVIT OF PUBLICATION

Annette Barajas being first duly sworn deposes and says that she is a representative of the *San Manuel Miner*, a legal newspaper published weekly at San Manuel, in the County of Pinal, State of Arizona that the legal entitled, **PUBLIC NOTICE OF AN APPLICATION FOR AN ORDER Docket No. SW-01944A-13-0242 AUTHORIZING THE ISSUANCE OF \$3,900,000 BY LAGO DEL ORO WATER COMPANY**, a printed copy of which is hereto attached, has been or will be published in all the regular weekly editions of said newspaper (and not a supplement thereof) for ONE week, the date of publication being as follows, to-wit:

10/9/13

Annette Barajas
Representative

Subscribed and sworn to before me this

11th DAY OF October, 2013

Gayle Ann Carnes
Notary Public

