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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

DOCKETED

APR 18 2014

- BOB STUMP - Chairman
- GARY PIERCE
- BRENDA BURNS
- BOB BURNS
- SUSAN BITTER SMITH

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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

DECISION NO. 74450

ORDER

Open Meeting
 April 8 & 9, 2014
 Phoenix, Arizona

BY THE COMMISSION:

* * * * *

Having considered the entire record herein and being fully advised in the premises, the Arizona Corporation Commission ("Commission") finds, concludes, and orders that:

FINDINGS OF FACT

Procedural History

1. On July 10, 2013, Lago Del Oro Water Company ("LDO" or the "Company") filed an Application with the Commission for authority to: (1) issue evidence of indebtedness in an amount not to exceed \$3,900,000; and (2) encumber its real property and utility plant as security for such indebtedness ("Finance Application").

2. On June 27, 2013, LDO filed a rate application with the Commission requesting a rate increase ("Rate Application" or "Rate Case").¹ The Rate Case is set for hearing to commence on April 3, 2014.

3. On October 9, 2013, LDO filed an Amendment to the Application which attached an

¹ Docket No. W-01944A-13-0215.

1 updated Preliminary Term Sheet from Wells Fargo Bank.

2 4. On December 20, 2013, LDO filed an affidavit of publication verifying that it had
3 notice of its Finance Application published in the *Arizona Daily Star* on October 4, 2013, and in the
4 *San Manuel Miner* on October 9, 2013.

5 5. On February 10, 2014, the Commission Utilities Division (“Staff”) filed a Staff Report
6 in which Staff recommends conditional approval of the financing request.

7 6. On February 14, 2014, LDO filed a Response to Staff Report in which LDO states that
8 it is in full agreement with Staff’s recommendations and respectfully requests that the matter go
9 before the Commission as soon as possible in order to obtain the financing at the currently low
10 interest rates.

11 7. Given the interconnection of capital structure and cost of capital addressed in the
12 Finance Application, and the rates to be determined in the Rate Case, by Procedural Order dated
13 February 26, 2014, the parties were directed to file position statements on whether the Finance
14 Application and Rate Application should be consolidated by March 7, 2014.

15 8. On March 7, 2014, LDO filed its Position Statement Regarding Consolidation and
16 argues that consolidation is not warranted. LDO states that its request for financing would rebalance
17 its capital structure from 100 percent equity to one including an amount of debt that more closely
18 resembles the capital structures of the cost of capital proxy companies, represents good business
19 practice and is appropriate, whether or not LDO increases rates. The Company asserts that by not
20 consolidating and proceeding with the financing request immediately, the capital structure will be
21 easier to determine in the Rate Case because once the Company obtains the loan, the cost of debt and
22 weighted average cost of capital will be known. The Company states that if the cases were
23 consolidated, the Company could not complete the financing until after the issuance of an Order in
24 the Rate Case which could result in a mismatch between the pro forma interest rate and actual interest
25 rate. In addition, the Company believes that there is a significant risk of interest rate increases if
26 there is a delay in closing the loan, which could detrimentally impact rates. Furthermore, the
27 Company asserts that it and Staff are in agreement concerning the value of the plant that was
28 purchased, and there is no linkage between the plant’s net value and the Finance Application that

1 needs to be addressed in a consolidated docket.

2 9. Staff filed its Response to the February 26, 2014 Procedural Order, on March 7, 2014.
3 Staff does not believe that consolidation is warranted because Staff's analysis indicates that
4 additional rate relief is not needed for the Company to meet the debt servicing requirements
5 associated with the new debt. Staff asserts that allowing the Rate Case docket to proceed without
6 consolidating it with the Financing Application will allow LDO to obtain the financing sooner, which
7 may serve to reduce LDO's cost of debt. Staff also believes that "the risk and potential higher costs
8 associated with possible interest rate increases more than offsets any application processing
9 efficiencies that might result from consolidation and concurrent processing of both applications."

10 10. Although there are natural connections between the Finance Application and the
11 pending Rate Case, the circumstances of this financing request, in which: 1) the debt is reimbursing
12 shareholders for plant that is already in service and there is no dispute between the parties in the Rate
13 Case over the value of the that plant; 2) there is no dispute whether the addition of the proposed debt
14 benefits the Company and ratepayers; 3) there is a risk that waiting until the conclusion of the Rate
15 Case may increase the cost of debt; and 4) completing the financing prior to the completion of the
16 Rate Case would avoid using a pro forma cost of debt, merit proceeding with the Finance Application
17 and not consolidating the matters.

18 **Background**

19 11. LDO is a for-profit "C" Corporation, and a Class "B" Arizona public service
20 corporation, providing water utility service to customers in portions of Pima and Pinal Counties.
21 During 2012, LDO served approximately 6,400 connections.

22 12. Staff reports that as of February 3, 2014, the Commission's compliance database
23 indicates that LDO had no delinquencies.

24 13. LDO's current rates were approved in Decision No. 56464 (April 26, 1989).

25 **Finance Request**

26 14. In December 2012, LDO purchased a significant portion of its water system from
27 Saddlebrooke Development ("Saddlebrooke"), an affiliate of LDO, for a purchase price of
28 \$3,887,998.

1 15. As contemplated in the Finance Application, LDO will use the proceeds of the loan to
2 repay shareholders for the plant purchased from Saddlebrooke, and thereby “rebalance” the
3 Company’s capital structure, which currently consists of 100 percent equity.

4 16. The proposed financing as presented in the Finance Application would result in a
5 capital structure consisting of 59.79 percent equity and 40.21 percent debt, which the Company
6 promotes as being more favorable to ratepayers given the lower cost of debt than equity.

7 17. The terms of the proposed financing, as amended, call for a loan from Well Fargo
8 Bank with a seven year maturity, and monthly payments based on a 10 year amortization schedule
9 with a balloon due at maturity, at a fixed interest rate not to exceed 6.0 percent. The Wells Fargo
10 preliminary term sheet indicates a 7-year term loan with a variable interest rate of prime plus 0.25
11 percent, or LIBOR plus 2.25 percent. LDO has indicated that it may acquire a variable-to-fixed
12 interest rate swap to hedge the variable interest expense, which would result in a fixed “all-in” rate of
13 4.57 percent per annum over the life of the loan.² Based on an interest rate of 4.57 percent per annum,
14 a seven-year term and 10-year amortization, the balloon payment at the end of the term would be
15 \$960,706.³

16 18. Staff recognizes that the variable interest rate contained in the Well Fargo term sheet
17 means the actual interest rate could change by the time the Commission is able to approve the
18 request. Staff recommends that the Commission authorize LDO to complete the financing as long as
19 the effective interest rate, after giving consideration to the factors identified in the term sheet, does
20 not exceed 6.0 percent.

21 19. LDO acquired the assets at Saddlebrooke’s original cost basis of \$3,887,998, which
22 does not reflect the accumulated depreciation on the assets that accrued from the time that they were
23 placed into service and the date of purchase. Staff recommends that the Commission approve a loan
24 amount not to exceed \$2,751,411, which is the original cost of the assets less accumulated
25 depreciation of \$1,136,587.⁴

26 _____
27 ² Updated Wells Fargo Preliminary Term Sheet.

³ Staff Report at 2.

28 ⁴ Staff calculated the plant value in the pending Rate Case. See Docket No. W-01944A-13-0215 (Direct Testimony of Mary Rimback).

1 20. In the year ended December 31, 2012, LDO had a capital structure that consisted 100
2 percent of common equity. Inclusive of Advances in Aid of Construction (“AIAC”) and net
3 Contributions in Aid of Construction (“CIAC”), as of December 31, 2012, LDO’s capital structure
4 consisted of 0.0 percent short-term debt, 0.0 long-term debt, 93.3 percent equity, 2.9 percent AIAC,
5 and 3.8 percent CIAC.

6 21. Staff analyzed the proposed transaction assuming the issuance of \$2,751,411 of new
7 debt, with a term of seven years and an amortization schedule of 10 years, at an interest rate of 4.57
8 percent. Staff’s analysis indicates a pro forma capital structure consisting of 2.3 percent short-term
9 debt, 26.6 percent long-term debt and 71.0 percent equity. Assuming the same loan amount, and
10 interest rates, but a seven year term and seven year amortization, results in a pro forma capital
11 structure composed of 3.6 percent short-term debt, 25.4 percent long-term debt and 71.0 percent
12 equity.

13 22. Staff’s pro forma analysis indicates that as of December 31, 2012, under current rates,
14 and assuming a \$2,751,411 loan, an interest rate of 4.57 percent, a ten year amortization period, and
15 seven year term, LDO would have a Debt Service Coverage (“DSC”) ratio of 2.24.⁵ Assuming a
16 principal balance of \$2,751,411, an interest rate of 4.57 percent, and a seven year amortization period
17 and term, as of December 31, 2012, LDO would have a DSC of 1.67.⁶

18 23. The terms of the anticipated loan provide for the encumbrance of all the Company’s
19 assets and revenues. Arizona Revised Statutes (“A.R.S.”) §40-285 requires public service
20 corporations to obtain Commission authorization to encumber certain utility assets. The statute serves
21 to protect captive customers from a utility disposing of assets that are necessary to provide service,
22 and thus, attempts to preempt any service impairment resulting from the disposal of such assets.

23 24. Staff states that pledging assets as security typically provides benefits to the borrower
24 in the way of increased access to capital funds or preferable interest rates, and it is often an
25 unavoidable condition of procuring funds.

26 ⁵ DSC represents the number of times internally generated cash will cover required principal and interest payments on
27 short-term and long-term debt. A DSC greater than 1.0 indicates that cash flow from operations is sufficient to cover debt
28 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.

⁶ Staff Report at Schedule JAC-1.

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

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

7 27. Staff recommends:

8 (a) Approving LDO's request to issue long-term debt, on condition that the principal
9 of the loan not exceed \$2,751,411, in the form of a secured, 7-year loan amortized over a 7-year
10 period, at an effective interest rate not to exceed 6.0 percent;⁷

11 (b) That the proceeds of the borrowing authorized herein be used to reimburse equity
12 shareholders for the paid in capital used to purchase the utility plant, as described in the Finance
13 Application;

14 (c) That any unused authority to issue long-term debt granted herein expire on
15 December 31, 2014;

16 (d) Authorizing LDO to engage in any transaction and to execute any documents
17 necessary to effectuate the authorizations granted; and

18 (e) That LDO, as a compliance item in this docket, file one copy of the loan
19 documents with the Utilities Division Compliance Section and a letter of confirmation with Docket
20 Control, within 60 days of the execution of any financing transaction authorized herein.

21 28. LDO agrees with all of Staff's recommendations.

22 **Resolution**

23 29. We conclude that the proposed financing, as modified by Staff, is in the public interest
24 as it does not impair the operations of the utility and provides a more balanced capital structure.

25 ...

26 ...

27
28 ⁷ Under Staff's proposal there is no balloon payment at the end of the loan term.

CONCLUSIONS OF LAW

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2 1. LDO is a public service corporation within the meaning of Article XV of the Arizona
3 Constitution and A.R.S. §§ 40-285, 40-301, 40-302, and 40-303.

4 2. The Commission has jurisdiction over LDO and of the subject matter of the Finance
5 Application.

6 3. Notice of the Finance Application was given in accordance with the law.

7 4. The financing approved herein is for lawful purposes within LDO's corporate powers,
8 is compatible with the public interest, with sound financial practices, and with the proper
9 performance by LDO of service as a public service corporation, and will not impair LDO's ability to
10 perform the service.

11 5. The financing approved herein is for the purposes stated in the Finance Application, is
12 reasonably necessary for those purposes and such purposes may not be reasonably chargeable to
13 operating expenses or to income.

14 **ORDER**

15 IT IS THEREFORE ORDERED that Lago Del Oro Water Company is hereby authorized to
16 obtain a secured loan in an amount not to exceed \$2,751,411, for a term and amortization period of
17 seven (7) years, at an effective interest rate not to exceed 6.0 percent.

18 IT IS FURTHER ORDERED that such finance authority shall be expressly contingent upon
19 Lago Del Oro Water Company's use of the proceeds for the purposes stated in its Finance
20 Application and approved herein.

21 IT IS FURTHER ORDERED that any unused authority to incur long-term debt granted in this
22 proceeding shall terminate on December 31, 2014.

23 IT IS FURTHER ORDERED that Lago Del Oro Water Company is authorized to engage in
24 any transactions and execute any documents necessary to effectuate the authorizations granted herein.

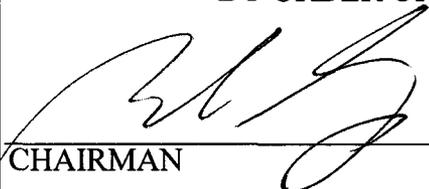
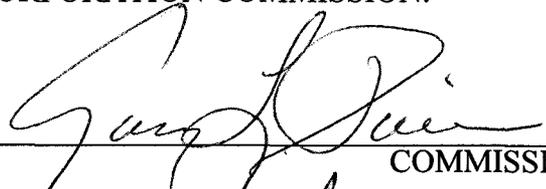
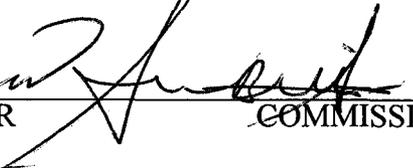
25 IT IS FURTHER ORDERED that Lago Del Oro Water Company shall file with the Utilities
26 Division Compliance Section a copy of any executed financing documents related to this authority,
27 and shall file a letter of confirmation with Docket Control, as a compliance item in this Docket,
28 within 60 days after the date of execution.

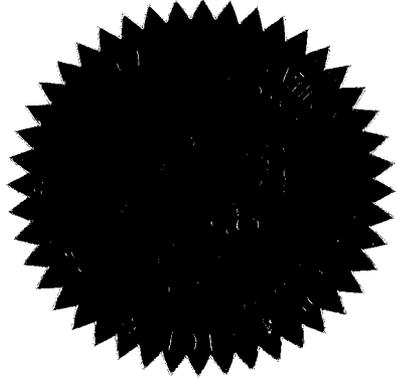
1 IT IS FURTHER ORDERED that Lago Del Oro Water Company is authorized to pledge its
2 assets in the State of Arizona pursuant to A.R.S. §40-285 in connection with any indebtedness
3 authorized in this Decision.

4 IT IS FURTHER ORDERED that approval of the financing set forth hereinabove does not
5 constitute or imply approval or disapproval by the Commission of any particular expenditure of the
6 proceeds derived thereby for purposes of establishing just and reasonable rates.

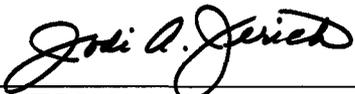
7 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

8 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

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10
11  CHAIRMAN  COMMISSIONER
12
13  COMMISSIONER  COMMISSIONER  COMMISSIONER
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15 IN WITNESS WHEREOF, I, JODI JERICH, Executive
16 Director of the Arizona Corporation Commission, have
17 hereunto set my hand and caused the official seal of the
18 Commission to be affixed at the Capitol, in the City of Phoenix,
19 this 18th day of April 2014.

20 
21 JODI JERICH
22 EXECUTIVE DIRECTOR

23 DISSENT _____

24 DISSENT _____
25 JR:ru
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27
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1 SERVICE LIST FOR: LAGO DEL ORO WATER COMPANY

2 DOCKET NO.: W-01944A-13-0242

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