

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

In the Matter of Lake Region Water and Sewer)
Co. for Authority to Borrow up to \$2,000,000 in) **File No. WF-2013-0118**
Long-Term Secured Debt)

STAFF RECOMMENDATION

COMES NOW the Staff of the Missouri Public Service Commission (Staff), by and through its attorney, and states the following for its *Staff Recommendation* to the Missouri Public Service Commission (Commission):

1. On September 26, 2012, Lake Region Water and Sewer Company (Lake Region or Company) filed an *Application* for Authority to Borrow up to \$2,000,000 in Long-Term Secured Debt. (*Application*).
2. On December 17, 2012, the Commission issued an *Order Granting Request for Extension of Time*, which gave Staff until January 15, 2013, to file its recommendation. This pleading complies with that order.
3. Upon reviewing the Company's *Application* and conducting an investigation, Staff recommends a conditional approval of the *Application*, as supported by the Memorandum attached and incorporated herein by reference as Appendix A.

WHEREFORE, the Staff respectfully submits this *Staff Recommendation Update* to the Commission for its information and consideration and respectfully requests the Commission grant the *Application* with the conditions included in Appendix A.

Respectfully submitted,

/s/ Rachel M. Lewis

Rachel M. Lewis
Deputy Counsel
Missouri Bar No. 56073

Attorney for the Staff of the
Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102
(573) 526-6715 (Telephone)
(573) 751-9285 (Fax)
rachel.lewis@psc.mo.gov

CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed or hand-delivered, transmitted by facsimile or electronically mailed to all counsel of record on this 15th day of January, 2013.

/s/ Rachel M. Lewis

MEMORANDUM

TO: Missouri Public Service Commission
Official Case File Case No. WF-2013-0118

FROM: Zephania Marevangeo, Financial Analysis Unit

/s/ Zephania Marevangeo 01/15/13 /s/ Rachel Lewis 01/15/13
Project Coordinator/Date Staff Counsel's Office/Date

SUBJECT: Staff's Recommendation to Conditionally Approve Lake Region Water and Sewer Company's ("Lake Region" or "Company") Application for Authority to Borrow Up to \$2,000,000 in Long-term Secured Debt.

DATE: January 15, 2013

1. (a) **Type of Issue:** Long-term Secured Debt.
- (b) **Amount:** Total not to exceed \$2,000,000 of long-term indebtedness.
- (c) **Rate:** The higher of the Prime Rate as published in the "Money Rates" section of *The Wall Street Journal* or five percent (5%) per annum
- (d) **Other Provisions:** Further terms and provisions including provisions for prepayment and redemption will be determined at the time of issuance.

2. **Proposed Date of Transaction:** \$1,400,000 immediately and \$600,000 whenever Lake Region determines that the plant investments are necessary to provide safe and adequate service.

3. (a) **Statement of Purpose of the Issuances:** According to Lake Region's response to Staff's Data Request Nos. 1 and 2, (1) \$1,400,000 to buy back the owners' equity interest in Lake Region, and (2) \$600,000 for certain anticipated improvements to the system. The anticipated improvements consist of (a) expanding the treatment plant on Shawnee Bend (\$250,000), (b) a new well on Shawnee Bend (\$250,000) and (c) a new water storage facility on Shawnee Bend (\$500,000).

(b) **From a financial perspective, does Staff deem this purpose reasonable?**

Yes, assuming the Commission orders compliance with all proposed listed conditions.

4. **Copies of executed instruments defining terms of the proposed securities:**

— (a) If such instruments have been previously filed with the Commission, a reference to the Case Number in which the instruments were furnished.

X (b) If such instruments have not been executed at the time of filing, a statement of the general terms and conditions to be contained in the instruments which are proposed to be executed.

— (c) If no such instruments are either executed or to be executed, a statement of how the securities are to be sold.

5. **Certified copy of resolution of the directors of applicant, or other legal documents authorizing the issuance of the securities reviewed:**

Yes X No

6. Pro-forma Balance Sheet and Income Statement reviewed:

Yes X No

7. Capital expenditure schedule reviewed:

Yes X No

8. Journal entries are required to be filed by the Company to allow for the Fee Schedule to be applied:

Yes X No

(Note: Fee schedule would not apply to the repayment of existing debt.)

9. Recommendation of the Financial Analysis Department:

 Grant by session order (see Comments)

X Conditional Approval granted pending receipt of definite terms of issuance (see Comments)

 Require additional and/or revised data before approval can be granted (see Comments)

 Formal hearing required (see Comments)

 Recommend dismissal (see Comments)

COMMENTS:

Company History:

Lake Region is a public regulated utility engaged in providing water and sewer services to members of the public located in an unincorporated area of Camden County, Missouri.

Lake Region is equally owned by RPS Properties, Inc. and Sally Stump. RPS Properties, Inc. is a partnership for the Schwermann family, and Robert Schwermann is the general partner.

Robert Schwermann and Sally Stump also have a 51.76 percent and 48.24 percent ownership interest in North Suburban Public Utilities, Inc., respectively. North Suburban Utilities, Inc. wholly owns Ozark Shores Water Company, which is another entity the Commission regulates.

Sally Stump and RPS Properties, Inc. have equal ownership interest in Lake Region. Staff understands that Sally Stump does not have an active role in the management or operations of the Company, however, RPS Properties, Inc. is active in the management of Lake Region's assets and ensuring safe and adequate service.

During the Company's meeting with Staff on November 14, 2012, the Company indicated that RPS properties, Inc. engages in other unregulated activities that are not related to the regulated utility business.

Case Background:

On September 26, 2012, Lake Region filed, Case No. WF-2013-0118, pursuant to Sections 393.190 and 393.200 RSMo, and Commission Rules 4 CSR 240-2.060 and 3.220, an Application with the Commission for authority to issue up to \$2,000,000 in Long-Term Secured Debt ("proposed debt").

Company's Intent

The Company stated the uses of the proceeds as follows, on page three (3) of its *Application*:

11. Lake Region intends to apply the net proceeds from the Financing for the acquisition of property, the construction, completion, extension or improvements or additions to its facilities, other capital investments, all of which shall be necessary and proper for the rendition of public water supply and wastewater service, the improvement or maintenance of its service, the discharge or lawful refunding of indebtedness outstanding and to reimburse its treasury for any costs heretofore incurred.

Because Lake Region's stated uses of the proceeds from the proposed debt financing were quite vague, Staff issued several data requests and met with the Company to gain a better understanding of the Company's intended use of the proceeds. Based on the responses to Staff Data Requests Nos. 1 and 2, Staff now understands that the Company's primary intent for the proposed financing is to (1) use proceeds from the \$1,400,000 debt issuance to buy back the owners' "equity" interest in Lake Region and (2) use proceeds from the \$600,000 debt issuance for certain anticipated improvements to the system. The anticipated improvements consist of (a) expanding the treatment plant on Shawnee Bend (\$250,000), (b) a new well on Shawnee Bend (\$250,000) and (c) a new water storage facility on Shawnee Bend (\$500,000).

Based on responses to Staff Data Request No. 1, the Company discussed the need for some of these improvements with members of Staff's Water and Sewer Unit. The Company also expressed that \$600,000 of the proposed debt issuance would fund sixty (60) percent of the projected costs for certain anticipated improvements to the system. Thus the improvements will be financed by sixty (60) percent debt and forty (40) percent equity.

Background of Debt Issued at Shareholder Level and Proposed Debt at Company Level

Staff is aware that Lake Region's owners obtained loans of approximately \$2,700,000 in 2004 and used the proceeds to acquire, among other things, equity interest in Lake Region ("acquisition debt").

Staff submitted data requests related to the acquisition debt in the Company's most recent rate case, WR-2010-0111. Staff specifically asked the purpose for which the proceeds from the acquisition debt were used in Staff's Data Request No. 61 in that rate case. In response, the Company stated that it used the proceeds to acquire equity interest in Lake Region.

Because Lake Region's owners acknowledged that this debt could just as easily been issued at Lake Region and the cost of debt was based on the risks associated with Lake Region's assets, Staff recommended and the Commission later approved, in Case No. WR-2010-0111, a rate

making capital structure that classified the entire balance of acquisition debt issued on October 8, 2004 as Lake Region's long-term debt. Not only did the Company not object to Staff's recommendation to include this acquisition debt, and its cost, in Lake Region's rate making capital structure, but it affirmed Staff's capital structure position. Company witness John R. Summers indicated the following in his Rebuttal Testimony, page 8, lines 22 through 23: "I believe the approach proposed by Staff most accurately reflects the costs of the capital employed in the Company's operation." Consequently, even though Lake Region did not directly issue this debt, the Company appropriately recognized that this was the actual capital supporting Lake Region's operations.

To date, the current balance on the acquisition loan has increased and is slightly over \$2,700,000, and is secured by the equity interest in Lake Region; and Staff understands that the owners' equity interests in Lake Region are first in line should a default occur, though Staff recognizes that there is other collateral now attached to that debt.

Capital Structure

In response to Staff Data Request No. 9, the Company provided Lake Region's 2011 calendar year-end financial statements and projected financial statements for 2013. The projected financial statements illustrate the expected impact of the proposed \$2,000,000 debt issuance on Lake Region's current capital structure and credit metrics.

Currently, Lake Region's balance sheet implies 99.3 percent equity and 0.7 percent debt. Assuming Lake Region issues the entire \$2,000,000 of debt proposed in its *Application*, Lake Region's balance sheet, should imply 24.6 percent equity and 76.6 percent debt. According to the Company's response to Staff Data Request No. 18, Lake Region suggests that it is the Company's intent to introduce additional debt to benefit rate payers through a lower cost of capital.

In general, Staff agrees that the low-risk nature of regulated utility operations allows owners to use more leverage to lower the cost of capital and, therefore, create additional shareholder

value. However, there are means in which this can be done without the debt showing up on Lake Region's financial statements, as demonstrated by Lake Region's most recent rate case. Therefore, Staff does not endorse and will not prematurely comment on the Company's opinion as it relates to possible benefits the pro forma capital structure may confer on the ratepayers. Staff notes that it is beyond the scope of this recommendation to determine whether Lake Region's proposed financing in this case will translate into a capital structure that will benefit ratepayers. An analysis of a capital structure that may benefit ratepayers is more appropriately addressed in the context of a rate case. As a result of the last rate case, the Company will file its next rate case in 2013 and Staff will provide a detailed analysis and recommendation regarding Lake Region's capital structure and any effect on the Company's ratepayers at that time.

Staff's scope and Impact of the Proposed Debt Issuance

Scope

Given the intricacy of the processes that Staff went through in establishing a fair and reasonable ratemaking capital structure for Lake Region in Case No. WR-2010-0111, Staff has noted that some of Lake Region's data request responses in this case seem to be an attempt to have Staff, and the Commission, validate Lake Region's current opinion that its financing request creates a capital structure that is appropriate for purposes of ratemaking. However Staff's scope in this financing case is limited to assessing the ability of the Company to absorb the proposed debt issuance on its balance sheet on a stand-alone basis without causing a financial strain that might be detrimental to ratepayers. Staff's position is that a full analysis of the Company's capital structure is more appropriately discussed in the context of a rate case.

Staff will discuss in the following section the impact of the proposed debt issuance (\$2,000,000) on specific aspects of the Company's financial statements based on the 2011 year-end audited financial statements. Staff will also explain its analysis of the capital structure and the Company's financial ratios or credit metrics. The credit metrics reviewed

include: (1) Debt to Equity Ratio, (2) Funds From Operations (FFO) to Total Debt, and (3) Interest Coverage.

Impact of the Proposed Debt Issuance

Based on the Company's audited financial statements provided in response to Staff Data Request No. 9, Lake Region's balance sheet currently implies a capital structure of 99.3 percent equity and 0.7 percent debt, FFO to Total Debt of 562.7 percent and Interest Coverage of 22x. A \$2,000,000 debt issuance, as reflected in the Company's pro forma statements, will result in an implied capital structure of 24.4 percent equity and 76.6 percent debt, FFO to Total Debt of 3.5 percent and Interest Coverage of 3x.

A capital structure of 24.4 percent equity and 76.6 percent debt or Debt to Capital ratio of 76.6 percent simply indicates that the Company's Capital Structure is financed by 76.6 percent debt and 24.4 percent equity. Based on Standard and Poor's financial benchmarks, this capital structure is considered to be "Highly Leveraged," which is the highest financial risk categorization under S&P's criteria. Although this capital structure would be viewed as extremely leveraged in context of larger-publicly trade utility companies, there is more confidence in the reliability of the financial statements of publicly-traded companies than for smaller regulated utilities that are privately held.

FFO to Debt indicates the amount of leverage the given company has as it relates to cash flows. According to Standard and Poor's financial risk benchmarks, a ratio of less than twelve (12) percent is considered highly-leveraged and a ratio greater than sixty (60) percent is considered minimal financial risk. Financial risk is simply the possibility that a given company will default on its debt. Therefore, the lower the FFO to Debt ratio, then the higher the financial risk. Lake Region's pro forma statements indicate an FFO to Total Debt ratio of 3.5 percent, which implies a highly levered capital structure for the Company.

Interest Coverage ratio measures the number of times the Company's Earnings Before Interest, Tax, Depreciation and Amortization (EBITDA) for a given time period can pay the

interest due in that same given time period. The Company's ratio of three (3) indicates that the Company's available cash or EBITDA is three (3) times the size of its interest obligation.

During discovery conducted in this rate case, WF-2013-0111, the Company represented that the acquisition debt was obtained and priced based on Lake Region's risk profile. The owners represented that they issued this debt at the partnership level rather than at Lake Region for their own personal reasons. The owners represented that the full amount of this debt could have been issued just as easily at Lake Region.

Therefore, based on the information provided and communicated by the Company, Staff asserts Lake Region can issue the \$2,000,000 proposed debt and still have additional debt capacity to ensure safe and adequate service. Staff's discovery in the Company's most recent rate case found that the Lake Region's properties were able to support at least \$2,700,000 of debt, even though it was issued at the owners' level and with ownership interest in Lake Region pledged as collateral. If the owners of Lake Region were to default on the shareholder loan, the lender (Altera Bank) may become the owner of Lake Region if it chose to foreclose on the owners' equity interest in the Company. If there is a default on the debt proposed in the *Application*, the lender's foreclosure on Lake Region's assets may have the same effect on ownership.

Staff's Concerns:

If Lake Region and its owners are allowed to directly and indirectly create and/ or maintain a highly leveraged capital structure, the risk of default and subsequent transfer of control of Lake Region's operations to the lender would increase. If this results in an inability for the Company to attract additional capital, this would cause a risk to safe and adequate service. While Staff recognizes owners of utility properties have pledged their equity interest in Lake Region as collateral for debt without Commission approval, in this instance Staff is concerned that the owners' financial management plans might increase both the owners' and Lake Region's financial risk profile and, in turn, the risk of default, which can jeopardize safe and adequate service.

Staff is aware that Lake Region's owners are responsible for the debt incurred at the ownership level; and likewise Lake Region is responsible for debt incurred at the Company level. However, when the owners of Lake Region and Lake Region both hold levels of debt that far exceed the owners' total investment in the Company, Staff becomes concerned because, as the Company has noted in its objections to certain Staff Data Requests, the Company's owners can make financial management decisions without Commission approval and such decisions may cause an increased risk of foreclosure on Lake Region's assets and therefore its operations.

Debt Issuance and Due Diligence:

The Long-Term Secured Debt, pursuant to standard banking terms over a period not to exceed thirty (30) years, will be provided by Altera Bank, 11120 West 135th Street, Overland Park, Kansas. Interest will be set at the rate of the higher of the Prime Rate as published in the "Money Rates" section of *The Wall Street Journal* or 5 (five) percent per annum.

Staff submitted Data Request Nos. 3 and 4 to the Company, requesting information regarding the due diligence performed by Lake Region before settling for an agreement that will offer an interest rate floor of 5 (five) percent- *especially given the prevailing very low interest rate environment* - over the life of the debt. Lake Region's response indicated that the Company was unable to garner a bid for fixed rate financing.

Besides Altera Bank, Lake Region contacted Central Bank of the Lake of Ozarks, Bank Star One, U S Bank, Bank of America, Commerce Bank and Bank of Missouri. Of those banks, Bank of Missouri was the only bank, other than Altera Bank, to offer financing to Lake Region. Bank of Missouri offered a Small Business Administration_(SBA) loan with a term of fifteen (15) years and an interest rate based on Prime plus 2.75 percent, adjusted quarterly, with a 6 (six) percent floor. Altera Bank's terms were the most competitive of the two banks that offered financing.

Conclusion:

Staff has expressed its concern over the Company owners' financial management decisions. Staff believes Lake Region's request to issue \$2,000,000 at Lake Region in addition to the \$2,700,000 acquisition debt that already exists at the ownership level amounts to a direct and indirect increase in financial risk exposure and chances of default to the Company. Staff understands that the owners' interest in equity interest in Lake Region stand first in line should a default occur. Considering Staff's scope was limited to whether Lake Region's ability to attract additional capital would be impaired, not rate case issues, such as an appropriate ratemaking capital structure, Staff recommends the Commission approve Lake Region's request to issue the financing proposed in its Application.

As a result of its investigation, Staff recommends approval of this *Application* with the following conditions:

1. That the Company shall file with the Commission, within 30 days from the transaction date, all final terms and conditions of the proposed financing, including, but not limited to, the aggregate proceeds received, price information, and estimated expenses.
2. That nothing in the Commission's order shall be considered a finding by the Commission of the value of this transaction, including, but not limited to, Lake Region's capital structure for ratemaking purposes, and that the Commission reserves the right to consider the ratemaking treatment of these financing transactions and their effect on cost of capital in any later proceeding.

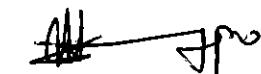
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Lake Region Water and)
Sewer Co. for Authority to Borrow Up to) Case No. WF-2013-0118
\$2,000,000 in Long-Term, Secured Debt)

AFFIDAVIT OF ZEPHANIA MAREVANGEPO

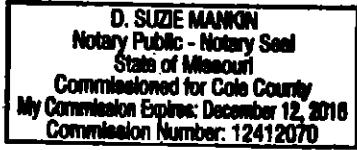
STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Zephania Marevangepo, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Recommendation in memorandum form, to be presented in the above case; that the information in the Staff Recommendation was developed by him; that he has knowledge of the matters set forth in such Staff Recommendation; and that such matters are true and correct to the best of his knowledge and belief.



Zephania Marevangepo

Subscribed and sworn to before me this 15th day of January, 2013.



D. Suzie Mankin
Notary Public