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MEMORANDUM

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Arizona Corporation Commission
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TO: Docket Control

FROM: Deborah R. Scott
Director
Utilities Division

DATE: November 17, 2000

RE: STAFF REPORT FOR ARIZONA ELECTRIC POWER COOPERATIVE, INC.'S REQUEST FOR AUTHORIZATION TO INCUR LONG-TERM DEBT AND ISSUE LIENS IN ITS PROPERTY TO FINANCE ITS CONSTRUCTION WORK PLAN (DOCKET NO. E-01773A-00-0227)

Attached is the Staff Report for Arizona Electric Power Cooperative's application to issue long-term debt in the amount of $21,510,515. Staff recommends approval of the application, subject to Commission approval. Staff further recommends that a hearing not be held in this matter.

DRS:WAR:jbc

Originator: William A. Rigsby

Attachment: Original and Eleven Copies

STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION

ARIZONA ELECTRIC POWER COOPERATIVE, INC.
DOCKET NO. E-01773A-00-0227

APPLICATION
TO ISSUE LONG-TERM DEBT
AND ISSUE LIENS IN PROPERTY
TO FINANCE A CONSTRUCTION
WORK PLAN

NOVEMBER 2000

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SCHEDULES

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STAFF ACKNOWLEDGMENT

The Staff Report for Arizona Electric Power Cooperative, Inc., Docket No. E-01773A-00-0227, was the responsibility of the Staff members listed below. William A. Rigsby was responsible for the review and financial analysis of the Cooperative's application to issue long-term debt in the amount of $21,510,515. Asher Emerson was responsible for the engineering analysis of the proposed project.

William A. Rigsby

William A. Rigsby
Senior Rate Analyst

Asher Emerson

Asher Emerson
Utilities Engineer (Electrical)

Introduction

On April 7, 2000, Arizona Electric Power Cooperative, Inc. ("AEPCO" or "the Cooperative"), a Class A[1] non-profit generation and transmission cooperative located in Benson, Arizona, filed an application requesting approval of $21,510,515 in long-term debt through the Rural Utilities Service ("RUS") - Federal Financing Bank ("FFB") guaranteed loan program.

AEPCO provides wholesale electricity to six Class A member cooperatives[2], two Class B members[3] and, one Class C member[4] (collectively known as "Members"). AEPCO's members are located in Arizona and in parts of New Mexico and California. Through the Cooperative's member utilities, AEPCO provides electrical power to approximately 105,000 residential and business customers in the aforementioned three-state area.

The proposed long-term debt was authorized by AEPCO's board of directors at their annual meeting in Benson on February 9, 2000. AEPCO'S present rates and charges were approved by the Arizona Corporation Commission ("ACC" or "Commission") in Decision No. 58405, dated September 3, 1993.

Purpose of the Debt

The $21,510,515 in proceeds from the RUS-FFB loan will finance the following transmission and generation projects valued at $14,360,920 and $7,149,595 respectively:

Transmission

- Transmission lines valued at a cost of $944,160,
- New substations and switching stations at a cost of $5,775,385,
- Line and station changes at a total cost of $4,052,197,

[1] Based on information contained in AEPCO'Ss 1999 Annual Report to the Utilities Division of the Arizona Corporation Commission, the Cooperative had total operating revenues of $163,141,948.

[2] AEPCO's Class A members include Duncan Valley Electric Cooperative, Duncan, AZ; Graham County Electric Cooperative, Pima, AZ; Sulphur Springs Valley Electric Cooperative, Willcox,AZ; Trico Electric Cooperative, Tucson, AZ; Mohave Electric, Bullhead City, AZ; and Anza Electric, Anza, CA.

[3] AEPCO's Class B members are comprised of the City of Mesa Electric Utility, which purchases approximately fifty percent of its power from AEPCO, and Morenci Water and Electric Company.

[4] AEPCO's sole Class C member is Salt River Project ("SRP") which signed a 20-year 100 megawatt firm power contract in 1988.

- Other transmission items with a cost of $1,971,746, and

- Ordinary replacements on lines and substations totaling $1,617,432.

Generation

- New and replacement generation assets that include, among other additions, a cooling tower, various types of scrubbers, a generator relay and a coal loader for a cost of $7,149,595.

A review of the above listed projects is contained in the Staff Engineering memorandum that appears in Attachment 1 of this report.

Terms of the Debt

As noted earlier, AEPCO intends to finance the aforementioned $21,510,515 of capital improvements by obtaining a twenty-year loan from the RUS-FFB guaranteed loan program. Because the actual rate of interest will not be known until the loan contract between RUS-FFB and AEPCO is finalized, only an estimate of the actual annual fiscal impact on the Cooperative can be made at this time (according to RUS, loans are presently being made at 6.22 percent). AEPCO has estimated that the Cooperative's RUS draws will be in the form of fixed rate notes with a rate of 6.25 percent based on an analysis of current yield curves. Staff calculates that the annual debt service associated with the loan will range from $1,849,299 to $1,924,520 based on interest rates of 6.00 percent and 6.50 percent respectively.

Existing Long-Term Debt and Capital Structure

As of December 31, 1999, AEPCO had long-term debt totaling $318,505,317. AEPCO's capital structure during this operating period is exhibited in Schedule 1 of this report. The RUS-FFB debt made up 65.7 percent of the total debt. Loans through the Central Bank for Cooperatives, the Rural Electrification Administration ("REA"), and the National Rural Utilities Cooperative Finance Corporation ("CFC"), comprised 14.0 percent, 3.7 percent and 1.1 percent of the total amount of debt outstanding. The remainder of the Cooperative's long-term debt was made up of pollution control bonds, 6.3 percent, and solid waste disposal revenue bonds, 9.0 percent. AEPCO's capital structure is comprised almost entirely of long-term debt. During the Cooperative's 1999 operating period, AEPCO recorded negative equity of $4,099,373.

Financial Analysis

Commission Staff's ("Staff") financial analysis of AEPCO is exhibited in Schedule 1 of this report and is divided into two different sections. The upper section of Schedule 1 presents a comparison of the financial information presented in AEPCO'S application (Column A), with pro forma figures developed by Staff (Columns B and C). The figures provided by the Cooperative in Column A reflect the results of the 1999 operating period. The figures exhibited in Columns B and C reflect the additional interest and principle that would result from the Cooperative-proposed loan at interest rates ranging from 6.00 percent to 6.50 percent.

Schedule 1 also presents the results of Staff's Times Interest Earned Ratio ("TIER") and Debt Service Coverage ("DSC") ratio analysis that examined the effect that the Cooperative-proposed debt will have on AEPCO. These ratios measure the number of times that earnings will cover interest payments ("TIER") and the number of times cash flow will cover principal and interest payments ("DSC"). Generally speaking, a TIER of 1.50 and a DSC ratio of 1.25 are preferred.

Staff's pro forma operating figures in Column B, which include the effects of the proposed debt, yield a TIER of 1.21 and a DSC ratio of 0.94. Staff's pro forma operating figures in Column C yield a TIER of 1.20 and a DSC ratio of 0.94. Although the ratios would indicate a less than satisfactory ability to maintain debt service coverage, Staff believes that AEPCO's past performance proves otherwise. Based on its analysis of prior operating periods, from 1991 through 1999. Staff observed that AEPCO was able to handle an even larger amount of long-term debt with lower TIER and DSC ratios during the Cooperative's 1995 operating year[5].

AEPCO's balance sheet for 1999 reflected that the Cooperative had unrestricted cash and cash equivalents of $15,490,868 or approximately 8.05 times the amount of increased debt service that the Cooperative would be obligated to pay if the proposed loan were approved at a 6.50 percent rate of interest. In addition to this, AEPCO recorded $28,200,000 in the Cooperative's Investments account during the same operating period. In short, Staff believes that, based on the strength of the Cooperative's balance sheet, AEPCO has the ability to meet its debt obligations despite the lower TIER and DSC ratios.

The lower section of Schedule 1 presents a comparison of AEPCO'S December 31, 1999, capital structure with a pro forma capital structure that takes into consideration the Cooperative-proposed loan. As illustrated in Schedule 1, the level of long-term debt being proposed by AEPCO results in a capital structure of 101.2 percent debt and negative 1.2 percent equity regardless of the rate of interest.

AEPCO's negative equity position resulted primarily from write offs, in 1987, of certain deferrals and the loss of Members' high demand customers in the late 1980's, and early 1990's. The negative equity has steadily declined from negative equity of $49.4 million in 1992, to the current level of $4.1 million.

[5] During the period ended December 31, 1995, AEPCO had long-term debt of $369,066,271. The Cooperative's TIER and DSC ratios for the same period were 0.85 and 0.79 respectively.

The aforementioned decrease in negative equity is largely attributed to improved retained earnings, which resulted from positive net margins that were realized during 1991 to 1994 and 1996 to 1999. Staff believes that this trend of positive net margins will continue despite the fact that the Cooperative's operating revenues fell 5.0 percent from $171,129,553, in 1998, to $163,363,610 in 1999. This drop in operating revenue was the net result of the expiration of three sales contracts with Phelps Dodge Corporation, Inc. during 1998 and the commencement of a sales contract with Morenci Water and Electric Company also during 1998. Furthermore, AEPCO's negative equity position has never significantly impeded AEPCO's access to debt financing. Staff believes that AEPCO's current negative equity position should not prevent approval of the proposed debt.

Engineering Analysis

Staff Engineering has reviewed AEPCO's application and believes that the proposed projects are reasonable and should be approved by the Commission.

Conclusions and Recommendations

Given the Cooperative's cash and investment position, Staff believes that the proposed financing is for lawful purposes, consistent with sound financial practices and is in the public interest.

Staff further recommends approval without a hearing.

Arizona Electric Power Cooperative, Inc. Schedule 1
Docket No. E-01773A-00-0227
Operating Period Ended December 31, 2000

FINANCIAL ANALYSIS

DECEMBER 31, 1999 AND PRO FORMA 1999 FINANCIAL INFORMATION

	A	B	C
		Pro Forma	Pro Forma
		@ 6.00%	@ 6.50%
	1999	1999	1999
Net margin (a)	$4,777,085	$4,003,312	$3,928,091
Depreciation (b)	$10,477,485	$10,477,485	$10,477,485
Interest Expense (c)	$18,606,775	$19,380,548	$19,455,769
Principal Repayment (d)	$15,414,308	$16,489,834	$16,489,834
Times Interest Earned Ratio (TIER) (a + c) ÷ c	**1.26**	**1.21**	**1.20**
Debt Service Coverage Ratio (DSC) (a + b + c) ÷ (c + d)	**1.00**	**0.94**	**0.94**

DECEMBER 31, 1999 AND PRO FORMA 1999 CAPITAL STRUCTURE INFORMATION

	A	B	C	D	E	F
			Pro Forma		Pro Forma	
			@ 6.00%		@ 6.50%	
	1999	%	1999	%	1999	%
RUS-FFB Debt	$209,369,655		$230,880,170		$230,880,170	
REA Debt	$11,920,668		$11,920,668		$11,920,668	
Pollution Control Bonds	$20,090,000		$20,090,000		$20,090,000	
Solid Waste Disposal Revenue Bonds	$28,800,000		$28,800,000		$28,800,000	
Central Bank for Cooperatives Debt	$44,719,000		$44,719,000		$44,719,000	
CFC Debt	$3,605,994		$3,605,994		$3,605,994	
Total Long-Term Debt	$318,505,317	101.3%	$340,015,832	101.2%	$340,015,832	101.2%
Margins & Equities	($4,099,373)	-1.3%	($4,099,373)	-1.2%	($4,099,373)	-1.2%
Totals	**$314,405,944**	**100.0%**	**$335,916,459**	**100.0%**	**$335,916,459**	**100.0%**

MEMORANDUM

TO: William A. Rigsby, Senior Rate Analyst

FROM: Asher Emerson, Utilities Engineer

THRU: Del Smith, Utilities Engineer Supervisor

DATE: November 15, 2000

RE: AEPCO FINANCING- E-01773A-00-0227

Staff Engineering ("Staff") reviewed the above referenced application, which was submitted by the Arizona Electric Power Cooperative, Inc. ("AEPCO"). AEPCO seeks $21,510,515 in financing approval to construct multiple projects. Staff reviewed the construction plan in order to evaluate the projects. The brief project descriptions and Staff's recommendations are as follows:

The AEPCO financing request is broken into the 5 categories shown below. The details of the projects are shown on the 2 spreadsheets, provided by AEPCO in the financing application.

New Transmission Line - $944,160.

This new transmission line is a purchase of a portion of a new SRP line, which allows AEPCO to obtain additional wheeling service to meet load growth at Mohave Electric.

New Substations/Switching Stations - $5,775,385.

Two additional substations are needed, one to meet TRICO's load growth and the other to meet Mohave Electric Coop's load growth.

Existing Line and Station Changes - $4,052,197.

This category consists of projects to:

Provide flood protection of transmission lines
Upgrade a substation due to Graham County load growth
Provide a second feed to Duncan Valley Electric Coop
Replace a 26-year-old transmission line
Replace a 40-year-old transformer
Replace faulted PCB contaminated capacitor bank

Other Transmission Items

Telecommunication Upgrade, for $1,971,746, to install digital microwave radio and multiplex equipment to replace aging and non-supported equipment in operation.

Transmission Replacements, for $1,617,432, to replace deteriorated wood poles that are more than 20 years old.

Generation Upgrades/Replacements - $7,149,595

This item consists of 36 projects required for safety, equipment replacement, maintenance, statutory requirements and productivity enhancements.

The individual projects are reasonable, as are the costs and payback periods. It is not unexpected that a power plant of this age would require significant expenditures in order to maintain operating capacity factor exceeding 90%.

RECOMMENDATION:

It is recommended that AEPCO's financing request be approved.