EXCEPTION

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BEFORE THE ARIZONA CORPORATION COMMISSION

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Chairman
KRISTIN K. MAYES
Commissioner
JEFF HATCH-MILLER
Commissioner
WILLIAM MUNDELL
Commissioner
MIKE GLEASON
Commissioner

Arizona Corporation Commission
DOCKETED
OCT 25 2004
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IN THE MATTER OF THE APPLICATION OF TRICO ELECTRIC COOPERATIVE, INC., AN ARIZONA NONPROFIT CORPORATION, FOR AUTHORITY TO BORROW THE ADDITIONAL SUM OF $57,992,000 FROM, OR GUARANTEED BY, THE UNITED STATES OF AMERICA (RUS) AND TO EVIDENCE SAID LOAN BY THE EXECUTION OF A LOAN AGREEMENT, PROMISSORY NOTE AND SECURITY DOCUMENTS REQUIRED BY THE LENDER.

Docket No. E-01461A-04-0299

EXCEPTIONS TO RECOMMENDATIONS OF THE CHIEF ADMINISTRATIVE LAW JUDGE TO THE COMMISSIONERS

TRICO ELECTRIC COOPERATIVE, INC., the Applicant in the above entitled proceedings, pursuant to A.A.C. R R14-3-110(B), files the following Exceptions to the Chief Administrative Law Judge's Recommendations in the form of an Opinion and Order dated October 20, 2004, on the following grounds and for the following reasons:

Trico has two primary exceptions, one dealing with the requirement that Trico file a capital improvement plan no later than December 31, 2004, which will demonstrate how Trico will improve or maintain its equity position to not less than 30 percent of total capital by December 31, 2009, and the other with Trico's capital credit refunds. (References below are to the proposed Opinion and Order and the Transcript of the hearing held October 1, 2004.)

I. THE 30% EQUITY PLAN

Findings of Fact Nos. 15, 19 and 20 state that on August 18, 2004, Trico filed a rate application requesting a rate increase of 5.13% with a Times Interest Earned Ratio ("TIER") of 1.5 and a Debt Service Coverage ("DSC") of 1.75, both the TIER and DSC exceeding RUS and CFC minimum requirements of 1.25. In addition, Trico intends to file another application for an additional 5% rate increase in 2010.

Exhibit A-2 in evidence, lines 1, 2, 3 and 14, deals with Trico's equity, TIER, DSC and rate increase over present rates if Trico's pending rate application is granted and if the proposed additional 5% rate increase in 2010 is approved.

Exhibit A-8 in evidence, Finding of Fact No. 30, sets forth comparable information, but setting forth the effects on rates of a capital improvement plan increasing Trico's equity in 2009 to 30%. Such effect is as follows:

Year	Rate Increase over Present Rates
2005	9.45%
2006	10.48%
2007	11.91%
2008	12.37%
2009	12.45%

Clearly, this more than doubles the rate increase of 5.13% Trico requests in its pending rate case.

RUS and CFC, Trico's two lenders, are the most directly affected by Trico's economic condition. Neither makes the requirement of the 30% equity level by 2009 as set forth in the recommendations.

RUS' policy concerning the equity of its borrowers is set forth in Exhibit A-7 in evidence, which is an email from Larry McGraw, RUS' general field representative in Trico's service area, Transcript 55/7-16, to Kevin Ritter, Trico's Manager of Finance and Corporate Services. Mr. McGraw states therein:

> "[The loan contract between RUS and Trico] provides that a borrower ... may retire capital credits equal to 25 percent of the prior year's net margin when the equity is between 20 and 30 percent of total assets.
>
> ***Borrower must have prior RUS approval to retire capital credits when the equity is less than 20 percent of total assets or to exceed 25 percent of the prior year's net margin when the equity is between 20 and 30 percent of total assets.***
>
> ***Otherwise, RUS does not have an equity requirement.***" (Emphasis supplied.

Kevin Ritter's testimony sets forth CFC's equity policy that CFC requires a minimum 20% equity. Tr. 56/15-23.

Neither of these policies are set forth in the Recommendations.

Trico's Board of Directors, which more than any other entity, is responsible for Trico's financial condition, has carefully considered Trico's equity in its current period of rapid growth. As set forth in Finding of Fact No. 26, Trico has adopted a strategic position that a 25% equity level is reasonable for the foreseeable future and it is reasonable to allow equity to drop slightly below the 25% level (as long as an annual TIER is above 1.25) to avoid excessive rate increases.

Trico believes the equity level, considered by itself, is not a true indication of the financial health of the corporation. All financial factors must be considered as a total picture. The Commission Staff's concern regarding equity was not mentioned during the Commission Staff's discussions with Trico's staff after the Application was filed or in any of the Commission Staff's data requests to Trico. Trico was not aware of the equity recommendation until it received the Staff Report on September 24, 2004. Had Trico been apprised of such recommendation at an earlier date, it would have promptly raised its objections thereto.

The Commission takes judicial notice of its records. Arizona Electric Power Cooperative, Inc. ("AEPCO"), Trico's wholesale supplier, from 1980 through 1999 has had a ***negative equity.*** Yet the Commission approved 12 loans during that time period.[1] AEPCO remains financially a healthy, viable corporation to this date.

Finding of Fact 28 refers to Trico's last rate case in 1992 and Trico's 1996 loan proceedings in which higher equity levels and a higher cash reserve were adopted as Trico's board policies at those times. The Finding of Fact concludes:

> "... However, despite the testimony of Trico's witness at hearing that the change of opinion is due to Trico's rapid growth, it is not clear why that opinion has changed, as Trico was in 1996, and continues to be, in a period of rapid growth."

To the contrary, Kevin Ritter clearly testified that Trico's present growth is much more rapid than in 1996, CFC has changed its policy regarding the equity level of its borrowers and circumstances have changed so that high equity levels and high cash reserves are no longer appropriate in light of Trico's current rapid growth without seriously impacting rates. Tr. 73/16 – 76/22. Attached as <u>Exhibit A</u> to these Exceptions is a copy of that portion of the Transcript. [The answers therein are by Kevin Ritter.]

There is no evidence in the record that supports Finding of Fact No. 16, which states that as of December 31, 2002, Trico's capital structure consisted of 64.5 percent debt and 35.5 percent equity. Exhibit A-2, page 1, line 1 sets forth Trico's equity as 31.08%.

In Findings 27 and 29 it is stated, in effect, that Trico can improve its capital structure other than by increasing rates. That should be determined in Trico's rate case rather than in this

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[1] See Decision Nos. 52394, 53168, 54772, 55594, 55793, 55887, 56151, 57548, 57848, 58378, 58485, 60041.

loan proceedings. Most of Trico's expenses are fixed and cannot be reduced. The reduction of other expenses undoubtedly would result in the reduction of the quality of Trico's service to its consumers. While such statements in the Recommendations may be theoretically correct, in actual practice the increase in equity set forth in the Recommendations cannot be achieved without raising rates substantially.

Accordingly, the capital improvement plan requiring the attainment of an equity level of 30% by 2009 is not supported by the record and evidence. Furthermore, in the event the Recommendations are accepted by the Commission, Trico's request of a 5.13% increase in its pending rate case will be preempted and the Commission will be required to approve an increase in rates more than double that requested over the 2005-2009 time period. The matter of Trico's equity level should be addressed in the rate case, not in this loan proceeding, as Trico has argued on numerous occasions. Tr. 43/4-8, 45/4-12.

II. CAPITAL CREDIT REFUNDS

Finding of Fact No. 29 states in part:

> "... Trico's witness acknowledged that in 2003 it was in violation of its mortgage requirements with RUS when it retired over a million dollars of capital credits, stating that 'it was a mistake on our part'. RUS requires that when the Cooperative has between 20 and 30 percent equity, the Cooperative must limit its retirement of capital credits to no more than 25 percent of its net margin ... We believe that Trico must also look at means other than merely raising rates to address its soon to be highly leveraged capital structure, and will approve this financing with the condition that Trico not retire capital credits in excess of 25 percent of its net margins when its capital structure is between 20 and 30 percent, and no retirement when equity is 20 percent or less. This is in accordance with the existing mortgage requirements of RUS ..."

Conclusion of Law No. 6 provides:

> "It is reasonable and in the public interest to authorize Trico to borrow $57,992,000 from RUS at an interest rate of 5 percent on the condition that Trico not retire capital credits in excess of 25 percent of its net margins when its capital structure is between 20 and 30 percent equity, and no retirement when equity is 20 percent or less."

The second Ordering paragraph states:

> "IT IS ORDERED that Trico Electric Cooperative, Inc. shall not retire capital credits in excess of 25 percent of its net margins when its capital structure is between 20 and 30 percent equity, and no retirement shall occur when equity is 20 percent or less."

RUS' and CFC's policies concerning capital credit refunds are set forth above in Exhibit A-5 in evidence and Kevin Ritter's testimony.

RUS' policy is that capital credit refunds can exceed 25% of the prior year's net margin when equity is between 20% and 30%, ***with RUS' prior approval.*** Finding of Fact No. 29, Conclusion of Law No. 6 and the second Ordering paragraph do not accurately set forth RUS' policy by omitting the right to exceed 25% of the prior year's net margin ***with RUS' prior approval.*** These provisions in the proposed Opinion and Order should be changed to accurately reflect RUS' equity requirements.

Mr. Ritter also testified that Trico could exceed the 25% capital credit refund limitation by obtaining RUS approval. Tr. 67/18 – 68/1. He further testified to why Trico considered refunding capital credits vital to its business as a cooperative. Tr. 69/2-14. Attached hereto as Exhibit B to these Exceptions is a copy of that portion of the Transcript. [The question is by the Chief Administrative Law Judge. The answer is by Kevin Ritter.]

Finding of Fact No. 29 incorrectly states that Trico's capital credit refund in 2003 "was a mistake on [Trico's] part." Kevin Ritter did not testify that that refund was a mistake, instead he testified that the failure to obtain RUS' approval in exceeding the 25% limitation was an inadvertent mistake. Tr. 66/17-67/16.

Trico did not receive Staff's Report dated September 22, 2004 until September 24. The Chief Administrative Law Judge on September 28 issued her Procedural Order setting a hearing on the loan application at 10:00 a.m. Friday, October 1. The Staff Report did not mention Trico's capital credit refunds and, accordingly, it did not mention a restriction thereon contrary to RUS' and CFC's equity policies. It did set forth its 30% equity condition. Therefore, Trico was not prepared to offer documentary evidence as to why it inadvertently failed to obtain RUS' required prior consent of its 2003 capital credit distribution.

Attached hereto as Exhibit C is a copy of a letter from RUS to Trico's President dealing with such consent in response to Trico's letter advising RUS of the error. Transcript 67/11-16. The letter states that had Trico made the request for approval before the distribution, such request would likely have been approved.

Trico's Board of Directors approved the 2003 capital credit distribution in August 2003. The latest monthly financial report at that time was as of June 30, 2003, which showed that Trico's equity was 30.24%. On July 31, 2003, it was 30.70%. On November 30, 2003, the last date that an equity was determined prior to the distribution, the equity was 30.35%. Trico's staff projections indicated that the distribution would not reduce its equity below 30%. Since RUS does not require its prior consent to exceed the 25% distribution when the equity is 30% or more and Trico's equity previously exceeded such threshold, the error was understandable and certainly not intentional.

By failing to provide in her Recommendations that capital credit refunds can be increased over 25% if Trico's equity is between 20% and 30% with RUS' prior approval, the Chief Administrative Law Judge has imposed restrictions on capital credit refunds that are contrary to Trico's lenders' policies. These lenders meticulously examine Trico's financial condition constantly. They are in a much better position to regulate capital credit refunds than the Commission.

III. CONCLUSION

Based upon the foregoing Exceptions to the Recommendation, Trico urges that the Commission amend the Recommendations as follows:

A. Findings of Fact:

1. Strike Finding 16 and renumber the following Findings.

2. Amend Finding 28 by striking the last sentence on lines 4-6, page 6.

3. Strike Finding 29 and renumber Finding 30.

B. Conclusions of Law:

1. Amend Conclusion 6 by striking "on the condition" to the end of the Conclusion, lines 15-17, page 7.

2. Strike Conclusion 8.

C. Order:

1. Strike the second Ordering paragraph lines 26-28, p. 8.

2. Strike the last Ordering paragraph lines 12-14, p. 9.

RESPECTFULLY SUBMITTED this 22 day of October, 2004.

WATERFALL ECONOMIDIS CALDWELL
HANSHAW & VILLAMANA, P.C.

By Russell E. Jones
Russell E. Jones
D. Michael Mandig
Attorneys for Trico Electric Cooperative, Inc.

ORIGINAL and 13 copies of the foregoing filed this 22 day of October, 2004, with:

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EXHIBIT A

Q. And there was some discussion in there about financial ratios. And I wanted to kind of see because it has been awhile since you have been in for a rate case.

A. Yes, since '92.

Q. And in looking at the discussion in there, at that time you requested a TIER of 2.02. And this is on page 11 of that Decision 57915. And I will read this sentence. It begins on page 10, line 28.

In conjunction with its TIER level, the

company-requested increase was driven by a goal of achieving a 35 percent equity ratio. The company indicated that the CFC has recommended that all cooperatives take steps to obtain a minimum equity ratio of 40 percent.

Can you explain what has happened since then that would now lead your board to want to have a minimum equity ratio of 25 percent?

A. I think that's a multi-pronged answer. So let me try to address it at least in general terms.

I think one issue is some of CFC's recommendations are driven by their ability to obtain funds on the lender's market. And so they make those recommendations depending on that market. That has some impact on it.

I believe just in general terms there was some, a general trend at that point in time for cooperatives to raise their equity and maintain a higher equity. However, over the ensuing years, I think they found that it has been very difficult for many co-ops to do that, and especially co-ops the size of Trico who are fast growing and have very high capital needs, to generate the kinds of revenue that you need to maintain an equity of that level in that high a growth scenario. It pushes your rates up to an unacceptable level.

So they backed away from it over the previous 12 years. And now I think the focus is more on looking at the co-ops individually and, in our particular scenario, what makes sense as a reasonable equity level, balancing the rate impact to your membership, CFC's ability to borrow funds and to fund the cooperatives. And so you have seen a change I think in the philosophies over that period of time.

Q. Okay. I also pulled out a financing decision. It is Decision 59941 from December of 1996. And this looks like it was when you were requesting to borrow about 15 million from RUS and CFC and I think you ended up getting 11.3 million.

In that decision, there is again some discussion about the financial ratios. And page 3, there is a sentence stating: Trico management testified that their board of directors has determined that $7 million is an appropriate minimum cash reserve level. In general, Trico tries to maintain a cash reserve equivalent to 8 percent of its utility plant, plus one month's purchase power expense with a minimum of 7 million.

And concluding that paragraph, it says: Trico's management testified that Trico's board has determined that large cash reserves are prudent during the current period of rapid growth and given the uncertainties associated with retail competition.

Is that still true today?

A. No. I believe that's another area that has been re-evaluated by the board. And again I think it is probably predominant because of the growth, capital needs.

If you look at the work plans of those areas versus the work plans today, the project requirements are just substantially more. And so we have backed away from that.

And I believe that on the bottom of the Exhibit A-2, it lists some of the criteria for the forecast. And it talks about the fact that the cash levels, the board has re-evaluated what they feel is a reasonable cash level, 2 percent of utility plant with a maximum of 5 million to be achieved by 2012.

And I think they strategically decided that because they have seen over the ensuing years since that time the difficulties in maintaining those high cash levels, particularly in terms of rates and the impact on the membership. So it is a strategic decision by our board to bring things down to a much more, what we feel, reasonable level in order to maintain reasonable rates.

EXHIBIT B

Q. I am just curious, if you are, you testified that you had an expectation of cash needs this year, why the co-op would be continuing to pay out capital credits.

A. I believe the answer to that would be that that's one of the things that our board feels is extremely important as a cooperative. That's one of the things that makes us a cooperative, makes us who we are. And they would like to continue that program as long as possible. And as long as we can maintain our financial position and do so even, you know, obviously we are in for a rate increase to keep ourselves healthy, but it is a very important issue to the cooperative, to our board in

EXHIBIT C

USDA

United States Department of Agriculture
Rural Development

Rural Business–Cooperative Service • Rural Housing Service • Rural Utilities Service
Washington, DC 20250

JUN 04 2004

Mr. George P. Davies
President
Trico Electric
Cooperative, Inc.
P.O. Box 930
Marana, Arizona 85653

Dear Mr. Davies:

The Rural Utilities Service (RUS) has received your request dated April 19, 2004, regarding a Patronage Capital Retirement amounting to 25 percent of the prior year's margins. Based upon your letter the Patronage Capital Retirement (retirement) has already been disbursed. RUS has reviewed your request and considered the limitations provided in 7 CFR 1718, Subpart C, Appendix A, Section 6.8, Limitations on Distributions:

A borrower may make distributions to its members, stockholders, or consumers if:

(a) Equity above 30 percent. If, after giving effect to any such distribution, the Equity of the borrower shall be greater than or equal to 30 percent of its Total Assets; or

(b) Equity above 20 percent. If, after giving effect to any such Distribution, the equity of the borrower shall be greater than or equal to 20 percent of its Total Assets and the aggregate of all Distributions during the calendar year when added to such Distribution shall be less than or equal to 25 percent of the prior year's margins.

If we had reviewed your application when it was originally submitted it is very likely that we would have recommended that it be approved even though it would have fallen outside the guidelines. RUS does not grant post approval to actions taken by borrowers. However, since the retirement has already occurred RUS will not take any action with respect to this retirement. In the future, if you have any questions, you can contact the General Field Representative, Mr. Larry W. McGraw, at 505-892-0353 or RUS in Washington, D.C. at 202-720-0848.

Sincerely,

ROBERT O. ELLINGER
Director
Southern Regional Division