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MEMORANDUM

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FROM: Ernest G. Johnson
EGJ Director
Utilities Division

AZ CORP COMMISSION
DOCUMENT CONTROL

DATE: August 9, 2005

RE: STAFF REPORT FOR THE SOUTHWEST TRANSMISSION COOPERATIVE,
INC. APPLICATION FOR AUTHORIZATION TO APPLY THE PROCEEDS
OF PREVIOUSLY AUTHORIZED INDEBTEDNESS TO A DIFFERENT
PURPOSE (DOCKET NO. E-04100A-05-0151)

Attached is the Staff Report for Southwest Transmission Cooperative, Inc.'s application for authorization to apply the proceeds of previously authorized indebtedness to a different purpose. Staff recommends conditional approval.

EGJ:DTZ:red

Originator: Daniel Zivan

Attachment: Original and sixteen copies

Service List For: SOUTHWEST TRANSMISSION COOPERATIVE, INC.
Docket No. E-04100A-05-0151

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

SOUTHWEST TRANSMISSION COOPERATIVE, INC.

DOCKET NO. E-04100A-05-0151

**APPLICATION FOR AUTHORIZATION
TO APPLY THE PROCEEDS OF PREVIOUSLY AUTHORIZED INDEBTEDNESS
TO A DIFFERENT PURPOSE**

AUGUST 2005

STAFF ACKNOWLEDGMENT

The Staff Report for Southwest Transmission Cooperative, Inc., Docket No. E-04100A-05-0151 is the responsibility of the Staff members listed below: Daniel Zivan is responsible for the review and financial analysis of the Company's application. Prem Bahl is responsible for the engineering and technical analysis.



DANIEL ZIVAN
PUBLIC UTILITIES ANALYST



PREM BAHL
UTILITIES ENGINEER

EXECUTIVE SUMMARY
SOUTHWEST TRANSMISSION COOPERATIVE, INC.
DOCKET NO. E-04100A-05-0151

Southwest Transmission Cooperative, Inc. ("SWTCO" or "Cooperative"), an Arizona non-profit cooperative located in Benson, Arizona, filed an application for authorization to apply the proceeds of previously authorized debt to a different purpose with the Arizona Corporation Commission ("Commission") on March 4, 2005. SWTCO proposes to use the funds to build a transmission substation, the Sandario Project ("Project"), with an estimated cost of \$6,099,956. The Project would improve reliability in the service area served by Trico Electric Cooperative, Inc. ("Trico"), one of its Class A members. A major portion, 71 percent, of the Project will be a direct assignment facility ("DAF") to Trico causing Trico to compensate SWTCO for costs pertaining to its portion of the Project.

Staff finds the proposed use of funds appropriate and necessary for reliable operation of the electrical transmission system. Further, the projected costs are found to be reasonable and typical for similar facility improvements made by other transmission providers.

SWTCO's existing capital structure is excessively leveraged consisting of 7.7 percent short term debt, 87.1 percent long term debt and 5.2 percent equity. SWTCO's highly leveraged capital structure restricts its ability to obtain additional debt financing, may result in less favorable terms for future financing and places upward pressure on rates. Issuance of the entire proposed \$6,099,956 debt would slightly exacerbate SWTCO's leverage resulting in a capital structure consisting of 7.5 percent short term debt, 87.6 percent long term debt and 4.9 percent equity.

The times interest earned ratio ("TIER") and debt service coverage ratio ("DSC") for the year ended December 31, 2004 are 1.11 and 1.01, respectively, showing virtually no margin for a negative variance in operating results to meet all obligations. Issuance of the proposed debt would reduce the TIER and DSC to 1.05 and 0.98, respectively. A DSC of 0.98 demonstrates that SWTCO would not be able to meet debt obligations with its existing rates. Adoption of Staff's recommended rates in SWTCO's pending rate case (Docket No. E-04100A-04-0527) would increase the TIER and DSC with the proposed debt to 1.40 and 1.11, respectively. The aforementioned TIER and DSC resulting from the issuance of the proposed debt include a Direct Assignment Facility payment from Trico of approximately 71 percent of the monthly loan payment related to the new debt.

Staff concludes that issuance of the proposed debt financing for the purposes stated in the application is lawful and within SWTCO's corporate powers, compatible with the public interest, consistent with sound financial practice and will not impair its ability to provide services only if an operating income no less than recommended by Staff in the pending rate case is adopted and that SWTCO adheres to its filed plan to improve its equity to 30 percent of total capital.

Accordingly, Staff recommends approval of the request for authorization to borrow funds contingent upon the Commission authorizing an operating income no less than recommended by

Staff in SWTCO's pending rate case and the Cooperative adhering to the capital improvement plan it submitted December 23, 2002.

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SCHEDULES

FINANCIAL ANALYSIS	SCHEDULE DTZ -1
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ATTACHMENTS

ENGINEERING REPORT

Introduction

Southwest Transmission Cooperative, Inc. ("SWTCO" or "Cooperative"), an Arizona non-profit cooperative located in Benson, Arizona, filed an application for authorization to apply the proceeds of previously authorized debt to a different purpose with the Arizona Corporation Commission ("Commission") on March 4, 2005. In effect, the Cooperative is requesting authorization to incur \$6,099,556 of long-term debt.

Notice

Notice of a financing application was published in *The Kingman Daily Miner* on July 7, 2005 and in *The Arizona Daily Star/Tucson Citizen* on July 1, 2005. *The Kingman Daily Miner* is a newspaper of general circulation in the City of Kingman, County of Mohave, Arizona and *The Arizona Daily Star/Tucson Citizen* is a newspaper of general circulation in the County of Pima, Arizona. The affidavit of publication is attached along with a copy of the Notice.

Background

SWTCO is a non-profit, member-owned cooperative that provides transmission service to its six Class A members and three Class B members. Class A members include Anza Electric, Duncan Valley Electric, Graham County Electric, Mohave Electric, Sulphur Springs Valley Electric and Trico Electric. Class B members include Arizona Electric Power Cooperative, Sierra Southwest Cooperative Services, Inc. and Morenci Water & Electric. SWTCO is headquartered in Benson, Arizona and was spun off from Arizona Electric Power Cooperative, Inc. in August, 2001.

Purpose of Financing

SWTCO plans to build a transmission substation, known as the Sandario Project ("Project"). The Commission approved a certificate of environmental capability ("CEC") for the Project in Decision No. 67432, dated December 3, 2004. The Project would improve reliability in the service area served by Trico Electric Cooperative, Inc. ("Trico"), one of its Class A members.

Description of Financing

The Commission authorized SWTCO to incur up to \$30,853,000 in debt to finance certain capital improvements in Decision No. 65473, dated December 19, 2002. SWTCO secured a loan for that amount from the Rural Utility Service/Federal Financing Bank ("RUS/FFB"), however, those capital improvements required less than the total loan amount. If approved, SWTCO proposes to draw the estimated \$6,099,956 cost of the Project from the under-drawn portion of the existing RUS/FFB loan. The existing note has a provision stating that the last day for an advance is December 31, 2007 and has a final maturity of December 31, 2035. At the final maturity date, any unpaid principal balance will become due. The interest rate

shall be equal to the Federal Financing Bank ("FFB") 30 year note, which was 4.72 percent as of April 5, 2005. Advances are amortized on a quarterly basis and the interest rate is determined by the FFB rate at the time of advance.

Financial Analysis

Schedule DTZ-1, Column A presents historical financial information for the year ended December 31, 2004. Column B presents 2004 actual financial information reflecting the proposed debt and Direct Assignment Facility ("DAF") revenues from Trico. Column C presents pro forma financial information reflecting Staff's recommended operating income in the pending rate case, issuance of the proposed debt and DAF revenues from Trico. A major portion, 71 percent, of the Project will be a DAF to Trico causing Trico to compensate SWTCO for costs pertaining to its portion of the Project. Staff used an interest rate of 5.00 percent for analysis purposes.

The times interest earned ratio ("TIER") and debt service coverage ratio ("DSC") for the year ended December 31, 2004 are 1.11 and 1.01, respectively, showing virtually no margin for a negative variance in operating results to meet all obligations (Schedule DTZ-1, column A). Issuance of the proposed debt would reduce the TIER and DSC to 1.05 and 0.98, respectively (Schedule DTZ-1, column B). A DSC of 0.98 demonstrates that SWTCO would not be able to meet its debt obligations with its existing rates. Adoption of Staff's recommended rates in SWTCO's pending rate case (Docket No. E-04100A-04-0527) would increase the TIER and DSC with the proposed debt to 1.40 and 1.11, respectively (Schedule DTZ-1, column C). The aforementioned TIER and DSC resulting from the issuance of the proposed debt include a DAF payment from Trico of approximately 71 percent of the monthly loan payment related to the new debt.

TIER represents the number of times earnings cover interest expense on long-term debt. A TIER greater than 1.0 means that operating income is greater than interest expense. A TIER less than 1.0 is not sustainable in the long term but does not mean that debt obligations cannot be met in the short term.

DSC represents the number of times internally generated cash will cover required principal and interest payments on long-term debt. A DSC greater than 1.0 indicates that operating cash flow 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 DTZ-1 shows SWTCO's existing and pro forma capital structure including the issuance of the proposed debt. SWTCO's existing capital structure is highly leveraged and consists of 7.7 percent short term debt, 87.1 percent long term debt and 5.2 percent equity. SWTCO's pro forma capital structure reflecting the issuance of the proposed debt is 7.5 percent short term debt, 87.6 percent long term debt and 4.9 percent equity. SWTCO continues to be a highly leveraged entity despite the Commission requiring the Cooperative, in Decision No.

64991, dated June 26, 2002, to file a capital plan to increase its equity position to 10 percent by December 31, 2006, 15 percent by the end of 2010 and 30 percent by the end of 2015.

SWTCO filed, as required by Decision No. 64991, a capital plan with the Commission on December 23, 2002. The plan included a financial forecast approved by SWTCO's board of directors projecting equity positions by year as follows:

2002	4.35 percent
2003	5.94 percent
2004	7.56 percent
2005	10.07 percent
2006	12.94 percent
2007	16.46 percent
2008	19.75 percent
2009	23.56 percent
2010	26.48 percent
2011	28.74 percent

The pro forma capital structure including the issuance of the \$6,099,956 of new debt would result in SWTCO having only 4.9 percent equity in its overall capital structure. This pro forma equity percentage is significantly lower than what SWTCO projected to achieve in its equity improvement plan.

Staff concludes that approval of the request for authorization to borrow funds should be contingent upon the Commission authorizing an operating income no less than recommended by Staff in SWTCO's pending rate case and the Cooperative adhering to a plan to improve its equity to 30 percent of total capital by December 31, 2015.

Compliance

There are no compliance issues with Southwest Transmission Cooperative, Inc.

Engineering Analysis

The Staff Engineering report is attached to this report. Staff reviewed the material cost estimates to construct the Project. Staff concludes that SWTCO's \$6,099,956 cost estimate for the Project appears reasonable. Staff makes no "used and useful" determination in this proceeding. Treatment of the Sandario Project for rate-making purposes is deferred to a future rate proceeding.

Staff Conclusions and Recommendations

Staff concludes that the Sandario project is appropriate and that the estimated costs are reasonable.

Staff concludes that the proposed use of funds is appropriate and that authorization to incur up to \$6,099,956 of long term debt for those purposes is lawful and within the corporate powers of the applicant, would be compatible with the public interest, consistent with sound financial practices, and not impair SWTCO's ability to provide service if the Commission authorizes an operating income no less than recommended by Staff in SWTCO's pending rate case and the Cooperative adheres to a plan to increase equity as a percentage of total capital to 30 percent no later than the end of 2015.

Staff recommends granting authorization to borrow an amount not to exceed \$6,099,956 under the terms and conditions proposed and for the purposes described in this application contingent upon the Commission approving an operating income no less than recommended by Staff in the pending rate proceeding and the Cooperative adhering to a plan to increase equity as a percentage of total capital to 30 percent no later than the end of 2015.

Staff further recommends approval of granting liens in favor of the lender as required to secure the borrowings authorized.

Staff further recommends authorizing the Company to engage in any transactions and to execute any documents necessary to effectuate the authorizations granted.

FINANCIAL ANALYSIS

Selected Financial Data
Including Immediate Effects of the Proposed Debt

	[A] <u>12/31/2004</u>		[B] <u>12/31/2004 with Debt</u>		[C] <u>Pro Forma Revenue and Debt</u>	
1 Operating Income	\$ 5,162,576		\$ 5,162,576		\$ 6,832,344	
2 Depreciation & Amort.	7,021,968		7,021,968		7,021,968	
3 Income Tax Expense	0		0		0	
4						
5 Interest Expense	4,634,452		4,894,270		4,894,270	
6 Repayment of Principal	7,460,268		7,542,929		7,542,929	
7						
8						
9 TIER						
10 [1+3] + [5]	1.11		1.05		1.40	
11 DSC						
12 [1+2+3] + [5+6]	1.01		0.98		1.11	
13						
14						
15						
16						
17						
18 Short-term Debt	\$7,460,268	7.7%	\$7,745,307	7.5%	\$7,745,307	7.5%
19						
20 Long-term Debt	\$84,595,191	87.1%	\$90,410,108	87.6%	\$90,410,108	87.6%
21						
22 Equity	\$5,025,614	5.2%	\$5,025,614	4.9%	\$5,025,614	4.9%
23						
24 Total Capital	\$97,081,073	100.0%	\$103,181,029	100.0%	\$103,181,029	100.0%
25						
26						
27						

[A] 2004 Actual financial information

[B] 2004 Actual financial information including the proposed debt and DAF revenue from Trico

[C] Pro Forma information including Staff's recommended operating income from the pending rate case, issuance of the proposed debt and DAF revenue from Trico

COPY

MEMORANDUM

TO: Daniel Zivan
Public Utility Analyst I
Utilities Division

FROM: Prem Bahl *Prem*
Electric Utilities Engineer
Utilities Division

DATE: April 5, 2005

SUBJECT: SOUTHWEST TRANSMISSION COOPERATIVE, INC.'S
APPLICATION DATED MARCH 4, 2005; (DOCKET NO. E-04100A-
05-0151)

Southwest Transmission Cooperative, Inc. ("SWTC") submitted an application to the Arizona Corporation Commission ("Commission") for authorization to include the Sandario Project ("Project") as an authorized use of Rural Utility Service ("RUS") approved loan funds. The Commission previously approved loan funds up to \$30,853,000 for construction projects, pursuant to the Decision No. 65743. SWTC has revised its 2004-2007 Construction Work Plan ("Work Plan") to include the Project. This revision has not resulted in any increase in the overall funding of the Work Plan, because other projects in the revised Work Plan have been constructed for a lower cost than originally estimated.

The Commission issued a Certificate of Environmental Compatibility ("CEC") for the Project via Decision No. 67432 dated December 3, 2004.

Staff has reviewed the cost estimates of the materials to be utilized in the construction of the Project. It is Staff's conclusion that the attached list of materials for the Project and the cost estimates of the materials (\$6,099,956), provided by the Applicant, appear to be reasonable. No particular treatment of this plant for rate making purposes should be assumed due to Staff's conclusions in this proceeding.

cc: List of Sandario Project Materials

MATERIAL DESCRIPTION	UNIT COST	CONSTRUCTION		RETIREMENT TO STOCK	
		QUANTITY	AMOUNT	QUANTITY	AMOUNT
Transformer 115/24.9 50 MVA	\$700,000	1	\$700,000.00		
Power Circuit Breaker 115 kV	50,000	3	150,000.00		
Disconnect Switch 115kV	7,000	12	84,000.00		
Potential Transformer 115Kv 550BIL	9,000	9	81,000.00		
Motor Operator 125V DC	5,000	1	5,000.00		
Lightning Arrester 115 kV	2,000	6	12,000.00		
Structural Steel 115 kV Side	180,000	1	180,000.00		
Insulators, Al. Bus & Fittings	55,000	1	55,000.00		
Relay & Metering Panels	40,000	3	120,000.00		
Control Building	60,000	1	60,000.00		
Microwave System	100,000	1	100,000.00		
Station Service Transformer 25 kVA	800	1	800.00		
Control Cable	40,000	1	40,000.00		
RTU & HMI	25,000	1	25,000.00		
Grounding	45,000	1	45,000.00		
Battery Bank & Charger	20,000	1	20,000.00		
Pre-Fab Cable Trench	35,000	1	35,000.00		
Chain Link Fence	30,000	1	30,000.00		
AC & DC Distribution Panels	7,000	1	7,000.00		
Capacitor Bank 115 kV, 19.2 MVAR	70,000	2	140,000.00		
Power circuit breaker 115 kV	50,000	2	100,000.00		
Disconnect switch 115 kV	7,000	2	14,000.00		
Structual steel	22,000	1	22,000.00		JUNKED
Insulators, buswork & fittings	18,000	1	18,000.00		
RTU upgrade	2,000	1	2,000.00		
control wiring	5,000	1	5,000.00		
relay panel	40,000	1	40,000.00		
cable trench extension	5,000	1	5,000.00		
Reactor	30,000	1	30,000.00		
Plays & controls	20,000	1	20,000.00		
Cable & conduit	6,000	1	6,000.00		
Subtotal			2,151,800.00		
Stores Expense (5%)			107,590.00		
TOTAL MATERIAL COST			\$2,259,390.00		

REMARKS New Sandario Substation 115/24.9 kV 50 MVA substation	LABOR :	Engineering	\$105,000.00
		Operations	50,015.00
	TOTAL		\$155,015.00
	OUTSIDE SERVICES:		
		Construction	\$320,000.00
		Inspection	45,000.00
		Environmental	100,000.00
	TOTAL		\$465,000.00
	MISCELLANEOUS:		
		Transportation	\$25,000.00
	Travel & Lodging	25,000.00	
	Land	143,554.00	
TOTAL		\$193,554.00	

Tax	\$15,114
Labor Overhead	\$51,155
IDC	\$55,367
Contingency (10%)	\$293,306
Grand Total	\$3,487,900

