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MEMORANDUM

TO: Docket Control

FROM: Ernest G. Johnson, Esq.
Director
Utilities Division

DATE: October 30, 2001

RE: STAFF REPORT FOR ARIZONA ELECTRIC POWER COOPERATIVE, INC. APPLICATION FOR FINANCING APPROVAL, DOCKET NO. E-01773A-01-0701

Attached is the Staff Report for Arizona Electric Power Cooperative, Inc., application for financing approval. Staff recommends approval. Staff further recommends that a hearing should not be held in this matter.

EGJ:JHJ:rdp

Originator: J. H. Johnson

Attachment: Original and ten copies

Arizona Corporation Commission
DOCKETED

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DOCKETED BY

RDP109SR

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Docket No. E-01773A-01-0701

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STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION

ARIZONA ELECTRIC POWER COOPERATIVE, INC.
DOCKET NO. E-01773A-01-0701

APPLICATION FOR
FINANCING APPROVAL

OCTOBER 2001

Rdp109SR

STAFF ACKNOWLEDGMENT

The Staff Report for Arizona Electric Power Cooperative, Inc., Docket No. E-01773A-01-0701, was the responsibility of the Staff members listed below. J. H. Johnson was responsible for the review and financial analysis of the Company's application. Jerry Smith was responsible for the engineering and technical analysis.

J. H. JOHNSON
AUDITOR III

JERRY SMITH
UTILITIES ENGINEER

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SCHEDULE

Attachment

Introduction

Arizona Electric Power Cooperative, Inc. ("AEPCO" or the "Cooperative") filed an application on September 4, 2001, for authorization to borrow $30,000,000 for up to 30 years under interim and permanent financing arrangements. AEPCO operates as an electricity power wholesaler and has no consumer customers to be notified of its request for financing. AEPCO seeks Arizona Corporation Commission ("ACC") approval at a November 2001, Open Meeting to allow for purchase and delivery of a power unit by May 15, 2002.

AEPCO is a non-profit cooperative owned by its members. Membership consists of six Class A members who are provided power on an all requirements basis. The Class A members include Anza Electric Cooperative, Duncan Valley Electric Cooperative, Graham County Electric Cooperative, Mohave Electric Cooperative, Sulphur Springs Electric Cooperative, and Trico Electric Cooperative. Class B members include Morenci Water and Electric Company and the City of Mesa. The sole Class C member is the Salt River Project. AEPCO did not renew its contract with the City of Mesa for 2001, freeing up 17 MW of power for other uses.

AEPCO produces much of the power it sells at the Apache Generating Station located southwest of Willcox, Arizona on Highway 191. The Apache Generating station includes steam-fired boilers (coal or natural gas fuel) and three existing gas turbine (natural gas or distillate fuel) generating units. All units are over 20 years old. Purchased power makes up any shortfalls and the Cooperative provides power to members when maintenance is scheduled for its generating units.

AEPCO had been a non-taxable entity until fiscal year 2000. AEPCO lost its non-taxable status when power sales to non-members exceeded 15 percent of revenues. AEPCO anticipates regaining a non-taxable status for the fiscal year 2001.

Purpose of Financing

AEPCO requires additional electric plant to meet anticipated shortfalls in capacity through 2004. AEPCO is anticipating a shortage of generating capacity by the summer of 2002, unless the Cooperative can purchase and install a General Electric 38 MW aero-derivative gas turbine. AEPCO has contracted with General Electric to purchase equipment to meet the forecast shortage in generating capacity. The anticipated total cost of the unit, installation, and other related equipment is $30,000,000. To date, payments totaling $6,291,052 have been made out of cash balances to General Electric under the agreed-upon progress payment schedule.

The proposed financing will reimburse AEPCO for funds expended under the progress payment schedule and provide funds to complete the purchase and installation of the gas turbine.

Proposed Debt

AEPCO requests authority to issue debt twice in its application: (1) interim financing; and, (2) long-term permanent financing.

Interim Financing

AEPCO proposes to borrow interim funds through one of the following sources:

1. Cooperative Finance Corporation ("CFC") interim financing or,
2. CFC/RUS Fast Track A financing.

The CFC and RUS are both part of the U.S. Department of Agriculture and were established to provide financial resources to rural utilities who may have no other way to borrow funds for plant. The interim financing rate is expected to be 6.20 percent based on CFC's published rates as of September 17, 2001. The anticipated maturity is unknown but AEPCO anticipates paying off the interim financing by the fourth quarter of 2002, or the first quarter of 2003.

Permanent Financing

AEPCO's permanent financing is expected to come from the Federal Financing Bank ("FFB"). The FFB, established by Congress in 1973, borrows funds from the U. S. Treasury and aids agencies in issuing obligations. AEPCO intends to arrange the FFB financing based upon a 30-year note with quarterly debt service payments. FFB financing rates, as of September 20, 2001, were 5.69 percent. The CFC will likely require that AEPCO provide up to 12.5 percent of the loan amount requested be invested in loan capital term certificates. A loan capital term certificate is essentially a reserve fund to protect the creditor.

Financial Analysis and Staff Concerns

Staff analyzed the application and is concerned with AEPCO's highly leveraged capital structure and interest coverage ratios (TIER and DSC). Therefore, Staff recommends below that the approximate $23,700,000 remaining balance to complete the project be financed with debt and the progress payments made to date come from membership capital (equity).

Staff's analysis is based on a long-term loan of $23,700,000 at 6.20 percent. Staff's pro-forma TIER is 1.62 and its pro-forma DSC is 1.17 (shown on Schedule JHJ) for the year 2000. TIER and DSC are measures of ability to satisfy interest and principal payments as they become due. TIER represents the number of times earnings will cover interest expense. DSC represents the number of times cash available will cover required debt payments including interest and principal. Staff's pro-forma TIER and DSC indicate the Cooperative's ability to incur the new debt. AEPCO is required under the loan covenants of previous financing with RUS and the CFC to maintain a minimum TIER of 1.05 and DSC of 1.0.

The Cooperative's pro-forma capital structure for 2000 had membership capitalization of 2.1 percent. AEPCO's membership capitalization has been improving in recent years through retained margins. The equity position is marginal. Staff is concerned that AEPCO increase its equity position. Schedule JHJ also shows the annual equity percentages from December 31, 1998, to December 31, 2000. AEPCO's existing loan covenants prohibit it from distributing patronage dividends when the membership capital is below 40 percent. As of June 30, 2001, AEPCO had unrestricted cash on hand of $25,199,999 to meet normal operating expenses and make progress payments until financing is finalized.

Engineering Analysis

The Engineering Staff report provides the following findings for AEPCO:

1. The need for additional generating capacity is documented,
2. Cost-effective purchase power alternatives are not available,
3. Transmission line constraints that impede delivery or purchase of power have been documented.

The Engineering Staff Report, attached to this report, finds no technical flaws in AEPCO's application for financing and finds that the cost estimate of the proposed project is consistent with the cost of similar facilities constructed by others.

Conclusions and Recommendations

AEPCO needs additional generating capacity by the summer of 2002 to meet increasing demands for electrical energy by its member cooperatives. The Cooperative has explored alternatives to additional generating capacity and has found them not feasible.

Staff has concerns over AEPCO's marginal equity position.

Staff finds that the issuance of debt in the amount of $23,700,000 is for lawful purposes, within the corporate powers of the applicant, compatible with the public interest, compatible with sound financial practices, and will not impair its ability to perform service.

Staff recommends approving the applicant's request for financing, limited to the amount of $23,700,000, on an interim basis from either CFC or CFC/RUS Fast Track A Financing.

Staff further recommends authorization of long-term financing, limited to the amount of $23,700,000, from the Federal Financing Bank.

Staff further recommends an 8 percent interest rate cap to insure that debt issuance remains consistent with sound financial principles.

Staff further recommends authorizing AEPCO to grant liens on its property as required in order to secure the borrowings.

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

Staff further recommends that AEPCO be required to submit a capital plan to the Arizona Corporation Commission by December 31, 2002, to increase AEPCO's membership capital (equity) position to 30 percent by December 31, 2006, and further increase AEPCO's equity position to 35 percent by December 31, 2009.

Staff recommends approval without a hearing.

Arizona Electric Power Cooperative, Inc. Schedule JHJ
Docket No. E-01773A-01-0701
Application for Financing

Selected Financial Data

LINE NO.	DESCRIPTION		Year 1998		1999		2000
1	Revenues	$	171,129	$	163,364	$	238,444
2	O & M Expenses	$	128,266	$	128,518	$	195,850
3	Depreciation	$	10,591	$	10,477	$	11,224
4	Operating Inc. (L1-L2-L3)	$	32,272	$	24,369	$	31,370
5	Interest Expense	$	19,982	$	19,569	$	19,328
6	Principal Repayment	$	14,836	$	16,192	$	16,993
7	TIER (L4/L5)		1.62		1.25		1.62
8	DSC (L4+L3)/(L5+L6)		1.23		0.97		1.17
	AEPCO Calculated DSC		N/A		1.00		1.23
9	Equity Percentages		-2.3%		-1.1%		2.1%

Staff calculations on line eight include present and proposed debt.

Memorandum

To: Jim Johnson, Auditor III, Utilities Division
From: Jerry D. Smith, Electric Utilities Engineer, Utilities Division JDS
Thru: Del Smith, Engineering Supervisor, Utilities Division
Date: October 2, 2001

Subject: AEPCO Financing Application, Docket No. E-01773A-01-0701

Arizona Electric Power Cooperative ("AEPCO") filed an application on September 4, 2001, for authority to incur debt and secure liens on its property for the financing of a new Combustion Turbine Unit 4. AEPCO proposes to borrow an amount not to exceed $30 million from either the National Rural Utilities Cooperative Finance Cooperative and/or the Rural Utilities Service. Engineering Staff ("Engineering") has reviewed the most recent AEPCO financing application and AEPCO's response to Commission Staff data requests. Engineering offers the following assessment.

AEPCO first documented its inability to meet it generating reserve requirements beginning in 2001, at the ACC Energy Workshop 2001-2002, held on February 16, 2001. The generating reserves deficiency is further substantiated by Section 8, of AEPCO's Fast Track A Materials for RUS/CFC. AEPCO has documented the need for the proposed 38 MW combustion turbine generator very effectively in Section 3, of the same RUS/CFC material. In fact, AEPCO documents that it was unable to arrange cost-effective purchase power alternatives from the new Calpine South Point Power plant or the new Griffith Power Plant because of their intent to sell only at the commodity price (spot market).

AEPCO also provided excellent documentation in Sections 17 and 18, of its RUS/CFC material of its fuel supply / delivery arrangements and its commitment to appropriate emission control technology. In Section 19, AEPCO documents the various transmission line constraints that impede its ability to purchase or deliver to others. Engineering concludes AEPCO is pursuing the only option available to meet its short-term generation reserve requirements. AEPCO's documentation serves as a good model of what Engineering would appreciate seeing in large power plant Certificate of Environmental Compatibility applications regarding project need, adequate and reliable transmission capacity and fuel supply / delivery capability.

Engineering finds no technical flaws in AEPCO's application for financing of a 38 MW combustion turbine generator. The cost estimate of the proposed project is consistent with cost of similar facilities constructed by others.

JDS:jbc

CC: Steve Olea, Acting Director, Utilities Division