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ORIGINAL

MEMORANDUM

30A

TO: Docket Control

FROM: Ernest G. Johnson
 Director
 Utilities Division

DATE: January 30, 2006

RE: AMENDED STAFF REPORT FOR SOUTHWEST TRANSMISSION COOPERATIVE, INC. REQUEST FOR AUTHORIZATION TO APPLY THE PROCEEDS OF PREVIOUSLY AUTHORIZED INDEBTEDNESS TO A DIFFERENT PURPOSE IN DOCKET NOS. E-04100A-00-0227 AND E-01773A-00-0227

Attached is the Amended Staff Report for Southwest Transmission Cooperative, Inc. request for authorization to apply the proceeds of previously authorized indebtedness to a different purpose in Docket Nos. E-04100A-00-0227, E-01773A-00-227 and E-04100A-02-0261. The amended report deletes Staff's "contingent upon the Cooperative adhering to the capital improvement plan it submitted December 23, 2002" and substitutes the following language pursuant to Decision No. 68072: "contingent upon the Cooperative adhering to the requirement in Decision No. 68072 to submit a capital improvement plan by March, 31, 2006." Staff recommends conditional approval.

EGJ:JJD:red

Originator: James J. Dorf

Attachment: Original and sixteen copies

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Service List for: Southwest Transmission Cooperative, Inc.
Docket No. E-04100A-00-0227 et al

Mr. Michael M. Grant
Gallagher & Kennedy
2575 East Camelback Road
Phoenix, Arizona 85016-9225

Mr. Christopher C. Kempley
Chief Counsel, Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Mr. Ernest G. Johnson
Director, Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Ms. Lyn Farmer
Chief Administrative Law Judge, Hearing Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

**AMENDED STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

SOUTHWEST TRANSMISSION COOPERATIVE, INC.

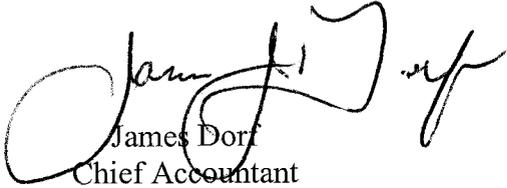
DOCKET NOS. E-04100A-00-0227 & E-01773A-00-227

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

JANUARY, 2006

STAFF ACKNOWLEDGMENT

The Amended Staff Report for Southwest Transmission Cooperative, Inc., Docket Nos. E-04100A-00-0227 and E-01773A-00-0227 was the responsibility of the Staff member listed below. James Dorf was responsible for the review and financial analysis of the Company's application.



James Dorf
Chief Accountant

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**AMENDED EXECUTIVE SUMMARY
SOUTHWEST TRANSMISSION COOPERATIVE, INC.
DOCKET NOS. E-04100A-00-0227 AND E-01773A-00-227**

Southwest Transmission Cooperative, Inc. ("SWTCO" or "Cooperative"), an Arizona non-profit cooperative located in Benson, Arizona, filed a request for authorization to apply the proceeds of previously authorized debt to a different purpose with the Arizona Corporation Commission ("Commission") on December 12, 2005. SWTCO proposes to use the funds to upgrade its mobile radio system, implement a remedial action scheme and upgrade the San Xavier area communication equipment. The projects have already been completed at a total cost of \$1,488,329. The projects improve the Cooperative's communication capabilities and improve system reliability in its service area.

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.

The proposed projects had been previously approved under a different loan application (the B8 Loan Authorizations). The interest and principal payments for the proposed debt have only a minor negative effect on the Cooperative's times interest earned and debt service cost ratios.

The Cooperative has informed the Rural Utility Service ("RUS") that approximately \$1.5 million in A8 Loans have not yet been drawn. It recommends that funds for projects it has approved as part of the B8 Loan Authorization be drawn instead under its A8 Loan Authorization. This recommendation has been made by RUS since the last day to encumber funds on the A8 Loan Authorization is March 31, 2006. If the funds are not drawn by that date, the encumbrance will lapse.

Staff concludes that issuance of the proposed debt financing for the purposes stated in the request 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 SWTCO adheres to a plan to improve its equity to 30 percent.

Accordingly, Staff recommends approval of the request for authorization to borrow funds contingent upon the Cooperative adhering to the requirement in Decision No. 68072 to submit a capital improvement plan by March, 31, 2006.

Because the projects noted herein and borrowing levels were previously approved by the Commission and appropriate notice previously provided to customers, Staff recommends approval without a hearing or further notice to the Cooperative's customers.

Introduction

Southwest Transmission Cooperative, Inc. ("SWTCO" or "Cooperative"), an Arizona non-profit cooperative located in Benson, Arizona, filed a request for authorization to apply the proceeds of previously authorized debt to a different purpose with the Arizona Corporation Commission ("Commission") on December 12, 2005. In effect, the Cooperative is requesting authorization to incur \$1,488,329 of long-term debt.

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.

Prior Approvals

In Decision No. 64991, Docket No. E-04100A-00-0227, the Commission authorized SWTCO to borrow up to \$14,360,920 from Rural Utility Service ("RUS") and Federal Financing Bank ("FFB") for transmission related projects referred to as the "A8 Loan Authorization."

In Decision No. 65473, Docket No. E-04100A-0261, the Commission authorized SWTCO to borrow \$30,853,000 from RUS/FFB to finance its construction work plan referred to as the "B8 Loan Authorization."

RUS has informed SWTCO that approximately \$1.5 million in A8 Loans have not yet been drawn. It recommends that funds for projects it has approved as part of the B8 Loan Authorization be drawn instead under its A8 Loan Authorization. This recommendation has been made by RUS since the last day to encumber funds on the A8 Loan Authorization is March 31, 2006. If the funds are not drawn by that date, the encumbrance will lapse and RUS will have to go through another Congressional budget process to re-encumber the monies.

Purposed Projects

SWTCO has proposed that the following three projects be moved from the B8 Loan Program to the A8 Loan Program:

Apache Remedial Action Upgrade	\$ 173,676.00
Mobile Radio System Upgrade	\$ 219,682.60
San Xavier Area Communication Upgrade	<u>\$1,094,970.74</u>
	<u>\$1,488,329.74</u>

Staff Engineering has reviewed the projects and finds the proposed use of the funds appropriate and necessary for reliable operation of the electrical transmission system. Further, the projects have already been completed and the costs incurred are found to be reasonable and typical for similar facility improvements made by other transmission providers.

Financial Analysis

SWTCO recently received approval, in Decision No. 68175 dated September 30, 2005, for a similar authorization to use funds from the B8 Loan Authorization. The amount of the loan authorization was estimated to be \$6,099,956. SWTCO also received approval of new rates in Decision No. 68072 which were effective on September 1, 2005. A second phased increase is effective January 1, 2006.

Staff's analysis for that authorization was based upon December 31, 2004 financial data and pro forma data was used assuming that the then pending rate increase would be approved. The pro forma analysis found that SWTCO's times interest earned ratio ("TIER") was 1.40 and the debt service coverage ratio ("DSC") was 1.11.¹ Adding an additional \$75,000 to interest expense and \$75,000 in principal payments for the new loan will decrease the TIER to 1.38 and the DSC to approximately 1.10.

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.

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, a capital plan with the Commission on December 23, 2002.

Staff has reviewed the Cooperatives' financial statements through November 30, 2005. The Cooperative continues to be highly leveraged. The issuance of an additional \$1,488,329 in debt will continue to erode the capital structure. However, the recent rate increases should provide some improvement to the Cooperative's TIER and DSC.

¹ Staff Report, Schedule DTZ-1 in Docket No. E-04100A-05-0151.

Staff concludes that approval of the request for authorization to borrow funds should be contingent upon the Cooperative adhering to the requirement in Decision No. 68072 to submit a capital improvement plan by March, 31, 2006.

Compliance

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

Staff Conclusions and Recommendations

Staff concludes that the projects proposed to be transferred from the B8 Loan Authorization to the A8 Loan Authorization are appropriate and that the costs are reasonable.

Staff concludes that the proposed use of funds is appropriate and that authorization to incur up to \$1,488,329.34 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 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 \$1,488,329.34 under the terms and conditions proposed and for the purposes described in this application contingent upon the Cooperative adhering to the requirement in Decision No. 68072 to submit a capital improvement plan by March, 31, 2006.

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

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