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GALLAGHER & KENNEDY
P.A.
ATTORNEYS AT LAW

MICHAEL M. GRANT
DIRECT DIAL: (602) 530-8291
E-MAIL: MMG@GKNET.COM

0000054831

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2575 EAST CAMELBACK ROAD
PHOENIX, ARIZONA 85016-9225
PHONE: (602) 530-8000
FAX: (602) 530-8500
WWW.GKNET.COM

June 15, 2006

HAND DELIVERED

Docket Control
Arizona Corporation Commission
1200 W. Washington
Phoenix, AZ 85007

Re: *Southwest Transmission Cooperative, Inc. Equity Improvement Analysis; Decision No. 68072; Docket Nos. E-04100A-04-0527 and E-01773A-04-0528*

Dear Sir/Madam:

Pursuant to the third ordering paragraph at page 11 of Decision No. 68072, enclosed are the original and 15 copies of the Equity Improvement Analysis of Southwest Transmission Cooperative, Inc. The date for filing the report was extended from March 31, 2006 to June 16, 2006 by Procedural Orders dated April 6 and June 13, 2006.

Very truly yours,

GALLAGHER & KENNEDY, P.A.

Michael M. Grant

By:
Michael M. Grant

MMG/plp
15169-9/1378912
Attachment

Original and 15 copies filed with Docket Control this 15th day of June, 2006.

cc (w/attachment): Dirk Minson
Gary Pierson

Equity Improvement Analysis

Southwest Transmission Cooperative, Inc.

Introduction

Southwest Transmission Cooperative, Inc. ("SWTC" or the "Cooperative") is a non-profit transmission cooperative owned by its members. There are six Class A member distribution cooperatives and two Class B members. Representatives from each Class A member and an elected representative of the Class B members comprise SWTC's Board of Directors which governs its operations. The Class A members are Anza Electric Cooperative, which serves electricity at retail in south-central California; and Duncan Valley Electric Cooperative, Graham County Electric Cooperative, Mohave Electric Cooperative, Sulphur Springs Valley Electric Cooperative and Trico Electric Cooperative—all of which serve electricity at retail in rural areas of Arizona. The Class B members are the Arizona Electric Power Cooperative, Inc. ("AEPCO") and Sierra Southwest Cooperative Services, Inc.

SWTC was formed in 1999 in anticipation of AEPCO restructuring into three separate non-profit cooperative corporations. The Commission approved the restructuring in Decision No. 63868. As of August 1, 2001, SWTC commenced operations and purchased the transmission business of AEPCO, including the transmission facilities and assets and rights to transmission capability under various agreements.

The Cooperative owns and operates a delivery system which schedules power into the areas served by its member cooperatives in Arizona, New Mexico and southern California. It may also provide transmission service to patrons and other users who may not become members, but who privately contract with SWTC for wholesale transmission service.

SWTC's current rates were established in Decision No. 68072 dated August 17, 2005 (the "Decision"). During the rate case leading to the Decision, there was discussion about the Cooperative's equity levels. (Decision, pp. 11-14, Findings 31-39.) Citing, among other things, prior financing Decision No. 64227, Staff urged the Commission to set an equity goal for SWTC of 30% by 2015. While SWTC agreed with Staff that an equity analysis should be filed, the Cooperative responded that a 30% equity goal was excessive for a transmission cooperative and argued that no equity goal should be established because an inflexible target could leave both it and the Commission in the position of requesting and setting unnecessarily high rates in the future. Mohave Electric Cooperative ("MEC") supported the Cooperative's position that the equity level recommended by Staff is excessive, but in briefing suggested that AEPCO's equity filing also examine differences in benefits, if any, which partial- versus all-requirements members receive from an improved AEPCO equity position.[1]

The Commission resolved these issues in Finding 39 of the Decision as follows:

> We believe that SWTC should update its December 2002 Capital Improvement Plan, with updated assumptions and provide an analysis of the rates that would be required to achieve an equity level of 30 percent, within ten years, or 2015. <u>We do not adopt a requirement now, nor do we read Decision No. 64227 as requiring, that SWTC achieve any specific equity goal</u>. We do adopt the rates herein with the expectation that SWTC will be able to build much needed equity. Because we are requiring SWTC to file another rate case in no

[1] The AEPCO and SWTC rate cases were consolidated, heard jointly and MEC filed a single brief stating its positions on both cases on May 9, 2005. Unlike AEPCO, SWTC does not have partial-requirements members. Thus, although the reference to MEC's partial-requirements position is contained in this Decision, there is nothing to analyze on this issue for SWTC because the Class A partial/all-requirements membership distinction does not exist in SWTC.

> more than five years, in any case, adopting an ultimate goal of 30 percent at this time is not necessary. We concur with Mohave that the equity improvement plan should also address an analysis of the effect of the equity improvement on partial [as] well as full requirements members.[2] Our decision not to accept a 30 percent equity goal at this time should not be interpreted as a finding on any particular ultimate equity requirement. (Emphasis supplied.)

The final Ordering Paragraph on page 11 of the Decision instructed the Cooperative to file an equity analysis by March 31, 2006. Procedural Orders dated April 6 and June 13, 2006 extended that date to June 16, 2006.

Equity Analysis

Executive Summary

SWTC used its 2005 Financial Forecast in preparing this update of its December 2002 filing. Consistent with the equity analysis performed in relation to AEPCO, SWTC first developed a "base case" which assumed no further rate increases for the period 2008-2015 after the phased rates approved in the Decision take effect in 2006 and 2007. In this case, not unexpectedly, the equity level as a percentage of assets begins to decline in 2009 and by 2015 reaches a negative 12%.

In order to produce an SWTC equity level of 30% by the year 2015, revenue increases of 24% and 5% would be required in 2008 and 2012, respectively. Both the base case and 30% equity case results, of course, are premised on all of the updated assumptions in the financial forecast holding true over the ten-year forecast period. To place the 30% equity level in context, the 2004 G&T Trend Analysis prepared by the CFC indicated a median equity level as a percentage of assets for G&Ts nationwide of just under 15.5%.

[2] See prior footnote. This issue is discussed in the AEPCO equity analysis. SWTC has no partial-requirements members.

SWTC, unlike AEPCO, has no partial-requirements members. To the extent that increases in SWTC's equity level improve its balance sheet and credit strength, all SWTC members benefit equally from that improvement.

Equity Requirements and History

As a borrower from the Rural Utilities Service ("RUS") which is a division of the United States Department of Agriculture, SWTC is subject to RUS' regulation. Neither the RUS nor the Cooperative's other primary source of borrowed funds, the National Rural Utilities Cooperative Finance Corporation ("CFC"), impose equity level or equity management requirements on transmission borrowers such as SWTC. Further, neither the RUS nor CFC "rate" the debt which they guarantee or provide to SWTC, i.e., charge different interest rates based on the borrower's credit characteristics or equity levels.

RUS regulations and mortgage covenants do require that cooperatives like SWTC generate sufficient margins to maintain a Times Interest Earned Ratio ("TIER") of 1.05 and a Debt Service Coverage ratio ("DSC") of 1.0. Prospective TIER and DSC standards require the Cooperative to design and implement rates to provide sufficient revenue to (1) pay all fixed and variable expenses, (2) provide and maintain reasonable working capital and (3) maintain, on an annual basis, the TIER and DSC margin requirements. Retrospectively, the average TIER and DSC levels achieved in the two best out of the three most recent calendar years must meet the levels of 1.05 and 1.0, respectively.

As part of the AEPCO restructuring, SWTC assumed a percentage of AEPCO's then outstanding RUS/Federal Financing Bank and other long-term debt in order to pay for the transmission business it received as part of the restructuring. It also was allocated a portion of total membership capital. As of December 31, 2001—the close of the Cooperative's first partial year of operations—its balance sheet reflected a total of approximately $97.9 million in total assets and membership capital of slightly more than $1.8 million.

Having completed only four full years of operations, SWTC obviously has minimal equity history to report. Equity was approximately 2.4% at the end of 2002; 4.3% at the end of 2003; 5.01% at the end of 2004; but fell to 1.21% at the end of 2005. The 2005 decline in equity level was primarily attributable to the loss of a large amount of transmission service revenues from Morenci Water & Electric Company. It bypassed SWTC's system, directly connected to the TEP transmission system and cancelled its firm transmission service agreement with the Cooperative in late 2004. The more than $5 million dollar loss in firm and non-firm revenues was the primary driver of the 2005 losses and the phased rate increases authorized last year by the Commission in the Decision.

<u>The Financial Forecast</u>

The financial forecast used as the basis for this analysis was approved by SWTC's Board of Directors at its October 11, 2005 meeting and, as required by the Decision, updates the assumptions used in the December 2002 filing. Although financial forecasts are prepared annually to guide the Cooperative on various operational and financial matters, RUS Rule 7 CFR 1710.300(b) requires a long-range financial forecast be prepared in conjunction with

SWTC's currently pending 2005-2008 Construction Work Plan loan request (the "2005 Forecast").[3]

As with any forecast, a number of assumptions must be made concerning a variety of different factors. The 2005 Forecast represents the Cooperative's best current judgment as to what is likely to happen in relation to these factors over the next ten years. These include member and other firm and contingent load growth; operating expenses; required future borrowings and associated interest and principal expense; and labor costs. To the extent that actual experience differs from the projections, both the forecast results and this equity analysis will be impacted accordingly.

The more significant assumptions built into the 2005 Forecast are:

- Load forecasts are based primarily upon the medium economic scenario in the 2004 Load Forecast Study.
- Operating expenses are based on the 2005 annual operating plan and the base amount is escalated at 3% throughout the study period. The most significant variable expense is the other power supply/wheeling expense.
- The 2005-2008 Construction Work Plan ("CWP") and the Long Range Plan ("LRP") are used to determine plant additions reflected in the financial forecast.
- A general inflation rate of 3% is used for the base case, including labor costs.

[3] This financing request is currently pending in Docket No. E-04100A-06-0058.

Rates Required for 30% Equity By 2015

The Decision instructed SWTC to "provide an analysis of the rates that would be required to achieve an equity level of 30 percent, within ten years, or 2015."[4] To develop a "base case" and consistent with the AEPCO equity analysis, using the 2005 Forecast, SWTC also looked at the projected equity results for 2015 based on the phased rates approved in the Decision and assuming no further rate adjustments for the period 2008-2015.

Attached as Exhibit A is a Balance Sheet 2005-2015 demonstrating the effects of the rates approved in the Decision on SWTC's equity level and assuming no further rate adjustments through 2015. As the schedule indicates, equity levels as a percentage of total assets increase to approximately 4.4% in 2008 as a result of the phased rates approved in the Decision, including the small step increases in September of 2006 and 2007. Provided that all assumptions in the 2005 Forecast hold true, without any further rate adjustments the equity level begins to decline in 2009 and by 2015 reaches approximately a negative 12%.

In order to analyze the rates required to produce an SWTC equity level of 30% by the year 2015, two rate cases were assumed with revenue increases taking effect in 2008 of 24% and 2012 of 5%. Attached as Exhibit B is a Balance Sheet demonstrating the results of that analysis and those assumed rate increases. As the schedule indicates, assuming all assumptions in the 2005 Forecast hold true, those revenue increases in those years would produce an equity level of just over 30% in 2015.

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[4] Decision, Finding 39, p. 9.

Analysis of the Effect of Equity Improvement on Partial- and Full-Requirements Members

The second issue discussed in the Decision was "an analysis of the effect of the equity improvement on partial as well as full requirements members."[5] SWTC, however, does not have any partial-requirements members.

MEC is a partial-requirements member of AEPCO. Sulphur Springs Valley Electric Cooperative, Inc. is also in the process of converting its member relationship with AEPCO from all- to partial-requirements status. SWTC provides transmission service to MEC pursuant to an agreement at Commission-approved rates. We believe this statement inadvertently was included in the SWTC rate Decision because the AEPCO and SWTC rate cases were consolidated and MEC presented its equity concerns regarding its partial-requirements member status with AEPCO in a single brief covering both cases. In any event, each of SWTC's Class A members including MEC benefit equally from improvements in SWTC's overall equity position.

Conclusion

While SWTC agrees that equity is an important consideration in assessing its overall financial profile, it is only one of many relevant considerations. For example, the CFC regularly monitors more than 30 key financial indicators of generation and transmission cooperatives operating nationwide. The CFC's G&T Trend survey for 2004—the most recent year for which data is available—indicated a median equity level for all G&Ts nationwide of 15.47% (excluding four systems which failed to make scheduled debt service payments or which are operating under a debt restructure agreement). SWTC does not believe that any equity target or goal should be established and 30% is unnecessarily high.

[5] Decision, Finding 39, p. 9.

The phased rate increases for 2005-2007 which the Commission approved in the Decision will allow the Cooperative to resume its gradual equity improvement over the next few years. SWTC and its Board of customer representatives will continue to monitor its progress and work with the Commission to assure that adequate rate levels sufficient for safe, reliable and adequate service are maintained.

EXHIBIT A

Southwest Transmission Cooperative, Inc.
2006 Equity Plan Base Case
Based on 2005 Financial Forecast

Balance Sheet

Liabilities and Other Credits	2005 Actuals	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Capitalization											
Memberships	$1	$1	$1	$1	$1	$1	$1	$1	$1	$1	$1
Patronage Capital	$5,025	$2,784	$2,784	$2,784	$2,784	$2,784	$2,784	$2,784	$2,784	$2,784	$2,784
Operating Margins Current and Prior Years	-$4,397	-$2,455	-$2,638	-$3,408	-$4,647	-$5,513	-$10,036	-$14,549	-$19,802	-$25,335	-$30,954
Non Operating Margins	$607	$4,181	$5,380	$6,875	$7,442	$7,999	$8,599	$9,188	$9,851	$10,451	$11,089
Total Margins_Equities	$1,236	$4,511	$5,527	$6,251	$5,580	$5,271	$1,348	-$2,576	-$7,167	-$12,099	-$17,080
Long Term Debt											
LTD RUS	$1,533	$1,109	$705	$325	$52	$0	$0	$0	$0	$0	$0
LTD FFB	$71,904	$75,741	$81,687	$95,162	$105,516	$101,668	$97,727	$99,783	$101,324	$110,029	$112,062
LTD Other	$22,645	$21,164	$19,187	$18,081	$16,836	$15,445	$13,925	$12,258	$10,480	$8,516	$6,646
Total Long Term Debt	$96,082	$98,014	$101,579	$113,568	$122,404	$117,114	$111,651	$112,041	$111,804	$118,545	$118,708
Accum Operating Provisions	$0	$71	$71	$71	$71	$71	$71	$71	$71	$71	$71
Total Non Current Liabilities	$96,082	$98,085	$101,649	$113,639	$122,475	$117,185	$111,722	$112,112	$111,875	$118,616	$118,779
Current Liabilities											
Notes Payable		$5,078	$11,654	$15,324	$5,635	$7,802	$17,638	$20,237	$30,538	$27,143	$32,716
Accts Payable	$2,610	$4,510	$7,132	$3,909	$3,962	$4,021	$4,074	$4,127	$4,171	$4,219	$4,276
Taxes Accrued	$901	$1,246	$1,742	$2,049	$2,357	$2,892	$3,367	$3,463	$3,401	$3,404	$3,433
Interest Accrued	$426	$745	$727	$706	$684	$659	$630	$598	$561	$520	$481
Other Current Liabilities	$407	$620	$620	$620	$620	$620	$620	$620	$620	$620	$620
Total Current Liabilities	$4,344	$12,199	$21,875	$22,608	$13,260	$15,995	$26,330	$29,045	$39,292	$35,907	$41,527
Deferred Credits	$188	$184	$184	$184	$184	$184	$184	$184	$184	$184	$184
Total Liabilities	$101,850	$114,979	$129,236	$142,682	$141,499	$138,635	$139,584	$138,764	$144,184	$142,608	$143,410
Equity as a Percentage of total assets	1.21%	3.92%	4.28%	4.38%	3.94%	3.80%	0.97%	-1.86%	-4.97%	-8.48%	-11.91%

EXHIBIT B

Southwest Transmission Cooperative, Inc.
Equity Plan - 30% by 2015
(Based on 2005 Financial Forecast)

Balance Sheet

Liabilities And other Credits

	2005 Actuals	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Capitalization											
Memberships	$1	$1	$1	$1	$1	$1	$1	$1	$1	$1	$1
Patronage Capital	$5,025	$2,784	$2,784	$2,784	$2,784	$2,784	$2,784	$2,784	$2,784	$2,784	$2,784
Operating Margins Current and Prior Years	-$4,397	-$2,455	-$2,638	$2,825	$8,311	$14,313	$17,377	$21,933	$26,443	$31,137	$36,052
Non Operating Margins	$607	$4,181	$5,380	$6,875	$7,570	$8,641	$9,834	$11,122	$12,587	$14,328	$16,585
Total Margins_Equities	$1,236	$4,511	$5,527	$12,484	$18,666	$25,739	$29,995	$35,840	$41,815	$48,250	$55,421
Long Term Debt											
LTD RUS	$1,533	$1,109	$705	$325	$52	$0	$0	$0	$0	$0	$0
LTD FFB	$71,904	$75,741	$81,687	$95,162	$105,516	$101,668	$97,727	$99,783	$101,324	$110,029	$112,062
LTD Other	$22,645	$21,164	$19,187	$18,081	$16,836	$15,445	$13,925	$12,258	$10,480	$8,516	$6,646
Total Long Term Debt	$96,082	$98,014	$101,579	$113,568	$122,404	$117,114	$111,651	$112,041	$111,804	$118,545	$118,708
Accum Operating Provisions	$0	$71	$71	$71	$71	$71	$71	$71	$71	$71	$71
Total Non Current Liabilities	$96,082	$98,085	$101,649	$113,639	$122,475	$117,185	$111,722	$112,112	$111,875	$118,616	$118,779
Current Liabilities											
Notes Payable		$5,078	$11,654	$9,633	$0	$0	$0	$0	$0	$0	$0
Accts Payable	$2,610	$4,510	$7,132	$3,909	$3,962	$4,021	$4,074	$4,127	$4,171	$4,219	$4,276
Taxes Accrued	$901	$1,246	$1,742	$2,049	$2,357	$2,892	$3,367	$3,463	$3,401	$3,404	$3,433
Interest Accrued	$426	$745	$727	$706	$684	$659	$630	$598	$561	$520	$481
Other Current Liabilities	$407	$620	$620	$620	$620	$620	$620	$620	$620	$620	$620
Total Current Liabilities	$4,344	$12,199	$21,875	$16,917	$7,624	$8,193	$8,691	$8,808	$8,754	$8,763	$8,812
Deferred Credits	$188	$184	$184	$184	$184	$184	$184	$184	$184	$184	$184
Total Liabilities	$101,850	$114,979	$129,236	$143,224	$148,950	$151,300	$150,593	$156,944	$162,627	$175,812	$183,196
Equity as a Percentage of total assets	1.21%	3.92%	4.28%	8.72%	12.53%	17.01%	19.92%	22.84%	25.71%	27.44%	30.25%