ORIGINAL

30

MEMORANDUM

2003 MAR -3 A 11:00

AZ CORP COMMISSION
DOCUMENT CONTROL

Arizona Corporation Commission
DOCKETED

MAR 0 3 2003

DOCKETED BY

TO: Docket Control

FROM: Ernest Johnson
Director
Utilities Division

DATE: January 21, 2003

RE: STAFF REPORT FOR GRAHAM COUNTY ELECTRIC COOPERATIVE, INC.'S APPLICATION FOR APPROVAL OF LONG-TERM DEBT (DOCKET NO. E-01749A-02-0926)

Attached is the Staff Report for Graham County Electric, Inc.'s application for authorization to incur long-term debt. Graham County Electric Cooperative, Inc. requests authority to borrow $10.8 million from the National Rural Utilities Cooperative Finance Corporation ("CFC"). Staff recommends granting Graham Electric authority to borrow an amount not to exceed 7.0 million from the CFC.

EJ:CSB:rdp

Originator: Crystal S. Brown

Attachment: Original and sixteen Copies

Service List for: Graham County Electric Cooperative, Inc.
Docket No. E-01749A-02-0926

Mr. Russ Barney
Graham County Electric Cooperative, Inc.
Post Office Box Drawer B
Pima, Arizona 85543

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

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

Ms. Lyn Farmer
Director, Hearing Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION

GRAHAM COUNTY ELECTRIC COOPERATIVE, INC.

DOCKET NO. E-01749A-02-0926

APPLICATION FOR APPROVAL OF LONG-TERM DEBT

FEBRUARY 2003

STAFF ACKNOWLEDGMENT

The Staff Report for Graham County Electric Cooperative, Inc., Docket Number E-01749A-02-0926, was the responsibility of the Staff members listed below. Crystal S. Brown was responsible for the review and analysis of the Cooperative's application for authorization to execute a loan agreement. Prem Bahl was responsible for the engineering and technical analysis.

Crystal S. Brown
Public Utilities Analyst V

Prem Bahl
Utilities Engineer

EXECUTIVE SUMMARY
GRAHAM COUNTY ELECTRIC COOPERATIVE, INC.
DOCKET NO. E-01749A-02-0926

Graham County Electric Cooperative, Inc. requests authority to borrow $10.8 million from the National Rural Utilities Cooperative Finance Corporation ("CFC"). Staff recommends granting Graham Electric authority to borrow an amount not to exceed 7.0 million from the CFC.

The purpose of the loan is to finance the Cooperative's five-year capital additions and improvements construction plan. The proposed construction will help insure that Graham Electric's capacity is sufficient to meet its current and future demands and will provide upgrades to its aging system.

TABLE OF CONTENTS

SCHEDULE

ATTACHMENT

Introduction and Background

Graham County Electric Cooperative, Inc. ("Graham Electric" or "Cooperative") was formed in 1944 and is a certificated Arizona-based non-profit rural electric distribution cooperative. Graham Electric provides electric service to approximately 8,700 customers in Graham County, Arizona.

On December 24, 2002, Graham Electric filed an application for approval to borrow $10.8 million in long-term debt from the National Rural Utilities Cooperative Finance Corporation ("CFC"). Graham Electric published notification of the financing application on December 18, 2002.

Graham Electric has seven outstanding loans from the CFC totaling $9.65 million obtained with the Commission's authorization. These loans mature on various dates from 2029 to 2033. The loan proceeds were used to finance capital additions and improvements, and to replenish the Cooperative's working capital.

Graham Electric has a contract with Graham County Utilities, Inc. ("Graham Utilities") to manage and operate Graham Utilities' water and gas divisions. Graham Electric is the guarantor of Graham Utilities' $2.79 million mortgage note.[1] Additionally, Decision No. 60472, dated November 25, 1997, authorized Graham Electric to extend a $150,000 short-term line of credit to Graham Utilities to cover temporary cash shortfalls Graham Utilities may experience.

Graham Electric filed an application for a permanent rate increase on September 13, 2002. Staff filed a letter finding the application sufficient on November 22, 2002,

Terms and Purpose of the Proposed Financing

Graham Electric proposes to borrow $10,813,368 from the CFC for a period of 35 years at the interest rate prevailing at the time the funds are borrowed (7.0 percent as of January 27, 2003). The purpose of the loan is to finance the Cooperative's five-year Construction Work Plan.[2]

Staff examined Graham Electric's 2002-2006 Construction Work Plan and found the projects to be both reasonable and appropriate as discussed in the attached Engineering Memorandum.

[1] As of September 30, 2001, the principal balance owed on the note was $2.24 million.
[2] The five-year Construction Work Plan was filed with the application.

Financial Analysis

Staff's analysis is based on the Cooperative's financial statements dated September 30, 2002. The attached Financial Analysis Schedule CSB-1 presents selected financial information from the financial statements and the pro forma effects of $10.8 million and $7.0 million, 35-year loans. Schedule CSB-1 also shows the capital structure and ratios for debt service coverage ("DSC"); times interest earned ("TIER"); and earnings before interest, income tax, depreciation and amortization expenses to interest expense ("EBITDA-I").

The DSC represents the number of times internally generated cash (i.e. earnings before interest, income tax, depreciation and amortization expenses) covers required principle and interest payments on long-term debt. A DSC greater than 1.0 means that operating cash flow is sufficient to cover debt obligations.

The TIER represents the number of times earnings before income tax expense cover interest expense on long-term debt. A TIER greater than 1.0 means that operating income is greater than interest expense.

The EBITDA-I represents the number of times internally generated cash (i.e. earnings before interest, income tax, depreciation and amortization expenses) covers interest expense on long-term debt. An EBITDA-I greater than 1.0 means that operating cash flow is greater than interest expense.

For the period ended September 30, 2002, Graham Electric experienced a $20,069 operating loss after interest payments of $647,905. Graham Electric's capital structure consisted of 0.62 percent short-term debt, 56.10 percent long-term debt, and 43.28 percent equity. Drawing down a $10.8 million loan in its entirety would result in a capital structure consisting of 0.65 percent short-term debt, 72.78 percent long-term debt, and 26.57 percent equity as shown on the Financial Analysis Schedule. The pro forma effect of drawing down a $10.8 million loan is a DSC of 1.28. The covenants of the Cooperative loans require a minimum DSC of 1.35. Therefore, a $10.8 million loan is not consistent with sound financial practices.

The Cooperative needs capital to begin work on projects included in its five-year Construction Work Plan prior to the resolution of its pending rate proceeding. The Cooperative can borrow $7.0 million and not fall below the minimum DSC requirement of 1.35. Granting the Cooperative authorization to incur $7.0 million of debt would allow it to proceed with its capital projects without interruption. Drawing down a $7.0 loan would result in a capital structure consisting of 0.64 percent short-term debt, 68.60 percent long-term debt, and 30.76 percent equity as shown on the Financial Analysis Schedule. The pro forma effect of drawing down a $7.0 million loan is a DSC of 1.36[3], a TIER of 0.98, and an EBITDA-I ratio of 1.54. A DSC of

[3] Staff's DSC calculation is conservative and yields a smaller result than the CFC's calculation because Staff's method does not include non-operating margin in the numerator of the DSC ratio.

1.36 means that internally generated cash flow is sufficient to pay principal and interest payments on the $7.0 million loan.

The Cooperative will need to increase its earnings to increase its TIER from 0.98 to at least 1.00 in order to maintain its equity capital. Staff anticipates that the Cooperative's TIER will be positively affected by the outcome of its pending rate proceeding. Therefore, based on this finding and that the DSC and EBITDA-I are acceptable, Staff's opinion is that the TIER of 0.98 is compatible with sound financial practice.

Conclusions and Recommendations

Staff concludes that the projects the Cooperative proposes to finance are reasonable and appropriate.

Staff concludes that the debt recommended by Staff is for lawful purposes, within the corporate powers of Graham Electric, compatible with the public interest, compatible with sound financial practices, compatible with its proper performance as a public service corporation and will not impair its ability to perform that service.

Staff recommends approval of $7.0 million of Graham Electric's $10.8 million request for authorization to borrow from the National Rural Utilities Cooperative Finance Corporation for a period of 35 years at the interest rate prevailing at the time the funds are borrowed and on the other terms and conditions described in the application.

Staff further recommends that Graham Electric be ordered to file copies of all executed financing documents setting forth the terms of the financing as soon as practicable after they become available.

Graham County Electric Cooperative, Inc.
Docket No. E-01749A-02-0926
Application For Approval of Long-term Debt

Schedule CSB-1

FINANCIAL ANALYSIS

Selected Financial Information
Pro forma Includes Immediate Effects of the Proposed Debt

		[A] Actual Results at *9/30/2002*		[B] Cooperative Proposed $10.8 Million *Pro Forma*		[C] Staff Recommended $7.0 Million *Pro Forma*	
1	Oper. Inc. After Intr. Exp on L.T. Debt	(20,069)		(20,069)		(20,069)	
2	Depreciation & Amortization Expense	642,794		642,794		642,794	
3	Income Tax Expense	0		0		0	
4							
5	Interest Expense on L.T. Debt	647,905		1,421,645		1,155,541	
6	Repayment of Principal	101,989		176,393		150,154	
7							
8							
9	**TIER**						
10	[1+3+5] ÷ [5]	0.97		0.99		0.98	
11	**DSC**						
12	[1+2+3+5] ÷ [5+6]	1.69		1.28	Note A	1.36	
13	**EBITDA-I**						
14	[1+2+3+5] ÷ [5]	1.96		1.44		1.54	
15							
16							
17							
18	Short-term Debt	$106,700	0.62%	$181,104	0.65%	$154,865	0.64%
19							
20	Long-term Debt	$9,651,255	56.10%	$20,390,219	72.78%	$16,603,090	68.60%
21							
22	Common Equity	$7,444,439	43.28%	$7,444,439	26.57%	$7,444,439	30.76%
23							
24	Total Capital	$17,202,394	100.00%	$28,015,762	100.00%	$24,202,394	100.00%

Note A: The CFC requires a minimum DSC ratio of 1.35.

MEMORANDUM

TO: Crystal Brown
Public Utilities Analyst V
Utilities Division

FROM: Prem Bahl
Electric Utilities Engineer
Utilities Division

THRU: Del Smith
Engineering Supervisor
Utilities Division

DATE: January 29, 2003

RE: Engineering Report for Graham County Electric Cooperative, Inc.
Application for Approval of Long-Term Debt
Docket No. E-01749A-02-0701 (Financing)

Graham County Electric Cooperative ("Graham" or "Cooperative") filed with the Arizona Corporation Commission its financing application on December 24, 2002, for authorization to borrow $10,813,368 from National Rural Utilities Cooperative Finance Corporation to complete a new five (5) year (2002-2006) construction work plan (CWP). Major elements of the work plan include Members' line extensions, distribution system equipment, additions, upgrades and replacements. The following Table summarizes the 2002-2006 CWP expenditures.

Member Extensions	Distribution	Distribution Replacements	Transmission	Totals
$5,400,131	$1,592,750	$3,307050	$858,500	$11,158,431

NEW LOAD GROWTH

Graham's load (coincident peak) is forecasted to grow from 30.7 MW in 2001 to 35.8 MW in 2006, which amounts to 3.3% load growth per year. The number of customers is projected to increase by 782 from 7579 to 8361 in the same five-year period. That amounts to approximately 2.1% per year increase in customer growth. Therefore, new distribution facilities and improvements are needed to meet Graham's new load growth.

The CWP includes provision for completing construction of two distribution circuits from the San Jose Substation, one them being ten miles long. This will enable

Graham to meet its projected load in this area in a reliable manner. Nearly 20 miles of existing circuits will be upgraded to a higher size conductor as detailed in the 5-year CWP.

SYSTEM RELIABILITY

To improve reliability of the system, Graham is proposing to install new voltage regulators, sectionalizing switches, and shunt capacitors throughout its system.

LOSSES

Graham's total system losses averaged 8.72% over a five-year period from 1997-2001. RUS Bulletin 45-4, "Guidelines for Distribution System Energy Losses," indicate permissible average system losses of 8.5%. That shows that Graham's distribution losses are only slightly higher than the RUS guidelines. It is expected that Graham's system losses would be reduced as a result of building a section of a new line and reconductoring certain line segments with a higher size conductor in the proposed current work plan. Losses would also be reduced as the system power factor improves by installing new shunt capacitors.

WOODEN POLE REPLACEMENT PROGRAM

On my recent visit to Graham's service area, I found a number of wooden poles needing replacement as they had outlived their useful lives. Graham has a program of replacing approximately 450 wooden poles per year in the CWP, which will give an approximately 40-year rotational cycle for all pole replacements. The average life of a treated wooden pole is approximately 40 years.

CONCLUSION

Engineering Staff has reviewed Graham's construction budgets for the years 2002-2006 and their specific projects in evaluating this financing request. Based on the aforementioned review of Graham's five-year Construction Work Plan and annual budgets for the said period, and inspection of the distribution system, it is Engineering Staff's conclusion that all the system additions and improvements, as included in the CWP, are appropriate and their cost estimates reasonable. However, this does not imply a specific treatment for rate base or rate making purposes.