

ORIGINAL



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MEMORANDUM

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TO: Docket Control
Arizona Corporation Commission

FROM: Ernest G. Johnson *EA for EGJ*
Director
Utilities Division

DATE: October 11, 2006

RE: STAFF REPORT FOR THE ARIZONA ELECTRIC POWER COOPERATIVE,
INC. APPLICATION FOR AUTHORIZATION TO INCUR DEBT AND
SECURE LIENS IN ITS PROPERTY TO FINANCE ITS CONSTRUCTION
WORK PLAN. (DOCKET NO. E-01773A-06-0084)

Attached is the Staff Report for Arizona Electric Power Cooperative, Inc.'s application for authorization to incur debt and secure liens in its property to finance its construction work plan. Staff recommends approval of the proposed financing.

EGJ:PMC:tdp

Originator: Pedro M. Chaves

Arizona Corporation Commission
DOCKETED

OCT 11 2006

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Docket No. E-01773A-06-0084

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

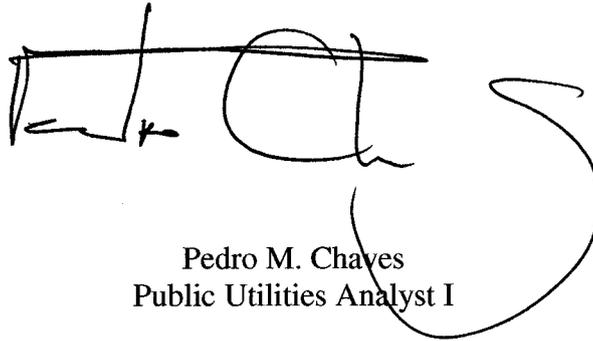
**ARIZONA ELECTRIC POWER COOPERATIVE, INC.
DOCKET NO. E-01773A-06-0084**

**APPLICATION FOR AUTHORIZATION
TO INCUR DEBT AND SECURE LIENS IN ITS PROPERTY TO FINANCE ITS
CONSTRUCTION WORK PLAN**

OCTOBER 11, 2006

STAFF ACKNOWLEDGMENT

The Staff Report for Arizona Electric Power Cooperative, Inc., Docket No. E-01773A-06-0084 is the responsibility of the Staff members listed below: Pedro M. Chaves is responsible for the review and financial analysis of the Company's application. Prem Bahl is responsible for the engineering and technical analysis.

A handwritten signature in black ink, appearing to read 'Pedro M. Chaves', with a large, stylized flourish extending to the right.

Pedro M. Chaves
Public Utilities Analyst I

A handwritten signature in black ink, appearing to read 'Prem Bahl', written in a cursive style.

Prem Bahl
Utilities Engineer

EXECUTIVE SUMMARY
ARIZONA ELECTRIC POWER COOPERATIVE, INC.
DOCKET NO. E-01773A-06-0084

Arizona Electric Power Cooperative, Inc. ("AEPCO" or "Cooperative"), an Arizona class "A" utility and non-profit cooperative located in Benson Arizona, filed an application for authorization to incur debt and secure liens in its property to finance its construction work plan ("CWP").

The Cooperative asks that the Commission authorize it to secure interim CWP financing in an amount not to exceed \$29.2 million from the National Rural Utilities Cooperative Finance Corporation ("CFC") and to secure a permanent loan in an amount not to exceed \$29.2 million from the Rural Utilities Service/Federal Financing Bank ("RUS/FFB") long-term loan program. In addition, the Cooperative asks the Commission to authorize it to change the specific facilities to be financed in the CWP without the necessity of filing an amended application so long as the total amount financed remains below the requested financing amount.

AEPCO's existing capital structure is highly leveraged consisting of 7.7 percent short term debt, 87.0 percent long term debt, and 5.3 percent equity. Issuance of the proposed debt would further exacerbate AEPCO's overly leveraged financial position resulting in a capital structure composed of 7.3 percent short-term debt, 87.8 percent long-term debt and 5.0 percent equity by the year end 2006.

Staff's pro forma times interest earned ("TIER") and debt service coverage ("DSC") ratios that reflect authorized phased in rate increases for 2006 and 2007 show TIER results sufficient to meet loan covenants and DSC results hovering at or near 1.00. These results suggest that projected operating results are barely sufficient to meet all obligations.

Staff concludes that issuance of the proposed debt financing for the purposes stated in the application is within AEPCO's corporate powers, is compatible with the public interest, consistent with sound financial practices and will not impair its ability to provide services.

Staff recommends that the Commission authorize AEPCO's request to obtain interim CWP financing from CFC in an amount not to exceed \$29.2 million. Staff further recommends that the Commission authorize the Cooperative to secure a permanent loan in an amount not to exceed \$29.2 million from RUS/FFB to repay and replace the interim CFC loan.

Staff further recommends that the Commission deny the Cooperative's request for authorization to change the specific facilities to be financed in the CWP without the necessity of filing an amended application.

TABLE OF CONTENTS

	<u>PAGE</u>
INTRODUCTION	1
PUBLIC NOTICE	1
BACKGROUND	1
PURPOSE OF THE FINANCING.....	1
DESCRIPTION OF PROPOSED FINANCING.....	2
FINANCIAL ANALYSIS.....	2
CAPITAL STRUCTURE.....	3
TIER AND DSC	3
COMPLIANCE.....	4
CONCLUSION AND RECOMMENDATIONS	4

SCHEDULES

FINANCIAL ANALYSIS.....	PMC-1
-------------------------	-------

Attachments

ENGINEERING REPORT	A
NOTICE	B

Introduction

On February 10, 2006, Arizona Electric Power Cooperative, Inc. ("AEPCO" or "Cooperative") filed an application with the Arizona Corporation Commission ("Commission") requesting authorization to incur debt and secure liens in its property to finance its construction work plan for 2005 - 2008 ("CWP").

Public Notice

On March 14, 2006, the Cooperative filed an affidavit of publication verifying public notice of its financing application. The Cooperative published notice of its financing application in *The Kingman Daily Miner* on February 23, 2006, and in *The Arizona Daily Star/Tucson Citizen* on the same date. *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

AEPCO is an Arizona non-profit, member-owned cooperative located in Benson, Arizona. AEPCO provides power and energy at wholesale primarily to its six Class A member distribution cooperatives—Anza Electric Cooperative, Duncan Electric Cooperative, Graham County Electric Cooperative, Mohave Electric Cooperative, Sulphur Springs Valley Electric Cooperative and Trico Electric Cooperative—under the terms of all-requirements or partial-requirements capacity and energy agreements. AEPCO also provides service to the City of Mesa as a Class B member under the terms of a capacity and energy agreement. In addition, AEPCO provides service to the Salt River Project Agriculture Improvement District as a Class C member under the terms of a capacity and energy agreement. AEPCO's current rates, and two additional phases to become effective in September of the years 2006 and 2007, were approved in Decision No. 68071, dated August 17, 2005.

Purpose of the Financing

The Cooperative asks that the Commission authorize it to secure interim CWP financing in an amount not to exceed \$29.2 million from the National Rural Utilities Cooperative Finance Corporation ("CFC") and to secure a permanent loan in an amount not to exceed \$29.2 million from the Rural Utilities Service/Federal Financing Bank ("RUS/FFB") long-term loan program when available to repay and replace the CFC interim financing. In addition, AEPCO asks authorization from the Commission to change the specific facilities to be financed in the CWP without the necessity of filing an amended application so long as the total amount financed remains below the requested financing amount.

Description of Proposed Financing

The Cooperative requests to secure interim CWP financing from CFC and to secure a permanent loan from RUS/FFB to repay and replace the CFC interim financing.

The Cooperative has requested loan terms from the CFC with a final maturity of December 31, 2035. The current interest rate for a CFC loan is 7.15 percent. No pre-payment penalties apply to this proposed interim CFC financing.

The Cooperative has requested RUS/FFB loan terms with a final maturity date of December 31, 2035. The United States Treasury establishes daily the interest rate that is applicable to draws on RUS/FFB loans for that date. The current interest rate for a 30-year RUS/FFB loan is 5.19 percent.

AEPCO expects to receive RUS/FFB approval of the loan application by the third quarter of this year. The applicable interest rate on the RUS/FFB loan will be fixed at the time that each advance is made and AEPCO would be able to draw down on the loan as needed to proceed with the Cooperative's CWP.

The Cooperative also requests that the Commission authorize it to change the specific facilities to be financed in the CWP without the necessity of filing an Amended Application so long as the total amount financed remains below \$29.2 million.

Engineering Analysis

Staff Engineering Report is attached. Staff reviewed the material cost estimates of the proposed plant improvements. Staff concludes that AEPCO's \$29.2 million cost estimate for the proposed CWP appears reasonable. Staff makes no "used and useful" determination in this proceeding. Treatment of the proposed plant improvements for rate-making purposes is deferred to a future rate proceeding.

Financial Analysis

Staff's analysis is illustrated in Schedule PMC-1. Column [A] reflects AEPCO's financial information for the year ended December 31, 2005. Column [B] presents 2006 pro forma financial information that modifies Column [A] to reflect the annual operating margin contemplated to result from implementation of the second phase rates¹ authorized in Decision No. 68071. Column [B] also recognizes repayment of debt scheduled through the end of 2006 and assumes additional draws to fully utilize the debt authorized in Decision No. 68065. Column [C] is the same as Column [B], modified to reflect debt repayments scheduled for the year 2007. Column [D] modifies Column [C] to reflect the annual operating margin

¹ Phase two rates become effective September 1, 2006.

contemplated to result from implementation of the third and final phase rates² authorized in Decision No. 68071. Column [D] also recognizes debt repayments scheduled through the end of 2008.

Capital Structure

AEPCO's existing capital structure is highly leveraged. At December 31, 2005, AEPCO's capital structure consisted of 7.7 percent short term debt, 87.0 percent long term debt and 5.3 percent equity. The 2006 pro forma reflects that issuance of the proposed debt would further exacerbate AEPCO's overly leveraged capital structure and would result in a capital structure composed of 7.3 percent short-term debt, 87.8 percent long-term debt and 5.0 percent equity. AEPCO's 2008 pro forma capital structure consists of 8.5 percent short-term debt, 85.7 percent long-term debt and 5.9 percent equity.

TIER and DSC

Times interest earned ratio ("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.

Debt service coverage ratio ("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.

The 2006 pro forma TIER and DSC for AEPCO's proposed debt are 1.60 and 1.00, respectively, showing that operating results are barely sufficient to meet all obligations. The 2007 pro forma TIER and DSC for AEPCO's proposed debt are 1.71 and 0.99, respectively, indicating that for the year 2007 the Cooperative's operating results will not be sufficient to meet all obligations. The 2008 pro forma TIER and DSC for AEPCO's proposed debt are 2.01 and 1.12, respectively. The latter calculations indicate that AEPCO's operating results will be sufficient to meet all obligations after all authorized phases of the rate increase become effective.

RUS has a coverage ratio requirement that requires AEPCO to achieve a minimum TIER and DSC of 1.00 in two out of three years. The RUS has found AEPCO in non-compliance with this requirement. The rates authorized in Decision No. 68071 should improve AEPCO's future TIER and DSC results.

Although the pro forma TIER and DSC results of Column [C], Schedule PMC-1, indicate that AEPCO would not be able to meet all short-term and current obligations if AEPCO were to

² Phase three rates become effective September 1, 2007.

incur the entire proposed \$29.2 million long-term debt issuance, there are two mitigating factors to consider. First, Staff utilized the current CFC interest rate for all of its calculations. RUS/FFB loans bear lower interest rates than CFC loans, e.g., the respective current rate differential is 1.96 (7.15% - 5.19%) percent. Second, the Cooperative will not draw the entire \$29.2 million immediately after the loan is approved.

Compliance

There are no compliance issues with Arizona Electric Power Cooperative, Inc.

Conclusion and Recommendations

Staff concludes that the estimated costs associated with the CWP appear to be reasonable.

Staff concludes that issuance of the proposed debt financing not to exceed \$29,200,000 for the CWP is within AEPCO's corporate powers, is compatible with the public interest, is consistent with sound financial practices, and will not impair its ability to provide services.

Staff recommends that the Commission authorize AEPCO to incur debt and secure liens in its property to finance its CWP for \$29.2 million.

Staff recommends that the Commission authorize AEPCO's request for authorization to obtain interim CWP financing from CFC in an amount not to exceed \$29,200,000.

Staff further recommends that the Commission authorize the Cooperative to secure a permanent loan in an amount not to exceed \$29,200,000 from RUS/FFB to repay and replace the interim CFC loan.

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

Staff further recommends that one copy of the executed loan documents be filed with Docket Control, as a compliance item in this docket, within 30 days of execution.

Staff recommends that the Commission deny the Cooperative's request for authorization to change the specific facilities to be financed in the CWP without the necessity of filing an amended application.

FINANCIAL ANALYSIS

	[A] 12/31/2005	[B] 2006 Pro forma	[C] 2007 Pro Forma	[D] 2008 Pro Forma
1 Operating Income	\$ 9,610,701	\$ 22,472,487	\$ 22,472,487	\$ 23,784,761
2 Depreciation & Amort.	8,432,257	8,432,257	8,432,257	8,432,257
3 Income Tax Expense	0	0	0	0
4				
5 Interest Expense	12,941,363	14,049,471	13,145,349	11,857,173
6 Repayment of Principal	16,766,941	16,874,253	17,925,430	16,858,451
7				
8				
9 TIER¹				
10 [1+3] + [5]	0.74	1.60	1.71	2.01
11				
12 DSC				
13 [1+2+3] + [5+6]	0.61	1.00	0.99	1.12
14				
15				
16				
17				
18 Short-term Debt	\$16,766,941	\$ 16,874,253	\$ 17,925,430	\$ 16,858,451
19				
20 Long-term Debt	\$188,590,441	\$203,341,658	\$185,779,385	\$169,310,925
21				
22 Common Equity	\$11,474,569	\$11,474,569	\$11,474,569	\$11,474,569
23				
24 Total Capital	\$216,831,951	\$231,690,481	\$215,179,384	\$197,643,945
25				
26				
27				
28 [A]: Based on 2005 audited financial statements.				
29 [B]: Operating income reflects phase I and II fully into effect.				
30 [C]: Operating income includes phase I and II fully into effect. Phase III is not included since it becomes effective on September 2007.				
31 [D]: Operating income includes all phases fully into effect.				

MEMORANDUM

TO: Pedro Chaves
Public Utility Analyst III
Utilities Division

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

THRU: Del Smith *DS*
Engineering Supervisor
Utilities Division

DATE: September 22, 2006

SUBJECT: ARIZONA ELECTRIC POWERCOOPERATIVE, INC.'S AMENDED
FINANCING APPLICATION DATED FEBRUARY 10, 2006; DOCKET NO. E-
01773A-06-0084

On February 10, 2006, the Arizona Electric Power Cooperative, Inc. ("AEPCO" or "Cooperative") submitted an application to the Arizona Corporation Commission ("Commission") for authorization to borrow \$29.2 million from the Rural Utilities Service/Federal Financing Bank. The purpose of this loan is to provide financing for AEPCO's 2005-2008 Construction Work Plan ("CWP" or "Plan" or "Work Plan"). This loan amount will enable AEPCO to invest in the generating plant equipment in terms of necessary improvements, upgrades and replacements to meet the projected demand and energy requirements of AEPCO's Class A member distribution cooperatives.

Utility Background

In 2001, Arizona Electric Power Cooperative, the Generation & Transmission ("G & T") Cooperative, was split into three separate organizations: AEPCO, the generation cooperative; Southwest Transmission Cooperative ("SWTC"), the transmission cooperative, and Sierra Southwest ("SSW" or "Sierra"), the staffing and human resources cooperative. AEPCO is owned by its six (6) Class A Member Cooperatives, which include Anza Electric, Duncan Valley Electric, Graham County Electric, Mohave Electric, Trico Electric and Sulphur Springs Valley Electric., and one (1) Class B Member, City of Mesa, and one (1) Class C Member, Salt River Project.

Stationed in Benson, Arizona, AEPCO is a non-profit corporation that provides the generation needs of the member distribution cooperatives serving customers in Arizona, as well as small areas of California and New Mexico. As reported by the Cooperative, AEPCO also sold the following capacity to non-Class A Members in 2005:

Salt River Project (SRP):	100 MW
Electrical District #2 (ED-2):	8 MW
City of Mesa:	15 MW

AEPCO's Apache Station is located in Cochise, Arizona, and consists of seven (7) generating units with a total generating capacity of approximately 600 MW. The power generated at the Apache Station is transmitted through the transmission services provided by SWTC over a 613-mile, high voltage and extra high voltage transmission system. AEPCO's Class A member systems' simultaneous coincident peak demand in 2005 was 548 MW.

2005-2008 Construction Work Plan

AEPCO's original 2005-2008 Work Plan consisted of projects with a total expenditure of \$36,544,173. The total of the current project list provided in response to Staff's Data Request PB 4.2 amounts to \$29,201,061, which is the amount requested for approval in AEPCO's application in this proceeding. According to AEPCO, "The reason for the difference is two projects have already been approved for funding in Decision No. 68065. The existing Ash/Scrubber pond closure (\$4,295,858) is being funded through CFC financing as authorized at page 4, the first ordering paragraph of that Decision. The second project is the new Low Flow Impoundment Pond (\$3,047,254), which was approved at pages 4 and 5, the second and third ordering paragraphs of Decision No. 68065 and is currently in interim CFC financing."

Staff has reviewed AEPCO's current list of projects in the CWP totaling \$29.2 million, which is spread over the Plan period in Table 1 as follows:

Table No. 1
Arizona Electric Power Cooperative, Inc.
Distribution of 2005-2008 Construction Work Plan (Dollars)

2005	2006	2007	2008	TOTAL
\$136,261	\$6,435,570	\$7,350,827	\$15,278,403	\$29,201,061

Staff finds the items included in the list of capital projects are appropriate to meet new load growth of the member cooperatives and will enable AEPCO to operate and maintain the generating plant at the Apache Station in a safe and reliable manner. Staff also finds the expenditure amounts associated with these projects reasonable.

Conclusions

Based on the review of AEPCO's 2005-2008 Work Plan, it is Staff's conclusion that the projects included in the Plan are appropriate, and the costs associated with these projects are reasonable. However, this does not imply a specific treatment for rate base or rate making purposes in the Cooperative's future rate filings.

GALLAGHER & KENNEDY

P.A.

ATTORNEYS AT LAW

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March 14, 2006

HAND DELIVERED

MAR 14 2006

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

Re: *Affidavits of Publication on the AEPSCO Application for Finance Approval;*
Docket No. E-01773A-06-0084

Dear Sir/Madam:

Enclosed are the original and 13 copies of the Affidavits of Publication concerning notice of the above-captioned matter. Your assistance is appreciated.

Very truly yours,

GALLAGHER & KENNEDY, P.A.



By:

Michael M. Grant

MMG/plp
10421-44/1343976

Enclosures

Original and 13 copies filed with Docket Control this 14th day of March, 2006.

cc (w/enclosures): David Ronald, Legal Division (delivered)
Pedro Chaves, Utilities Division (delivered) ✓
Gary Pierson

AFFIDAVIT OF PUBLICATION

Kingman Daily Miner

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STATE OF ARIZONA)
County of Mohave) ss.

I, **Ulli Schneider**, being first duly sworn on her oath says:
That she is the Legals Clerk of **THE KINGMAN DAILY MINER**
An Arizona corporation, which owns and publishes the Miner,
a Daily Newspaper published in the City of Kingman, County of Mohave,
Arizona; that the notice attached hereto, namely,

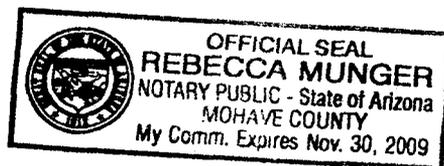
**PUBLIC NOTICE
NO. 3417**

Has, to the personal knowledge of affiant, been published in the news-
paper aforesaid, according to law, from the **22 day of February, 2006**
to the **22 day of February, 2006**, inclusive without change, interruption or
omission, amounting in **1** insertion, made on the following date:
2/22, 2006.

By: Ulli Schneider
Legal Clerk, 23 Day of February, 2006

By: Rebecca Munger
Notary Public

My commission expires: 11/30/2009



PUBLIC NOTICE
AN APPLICATION FOR AN ORDER
APPROPRIATE TO THE
DEVELOPMENT OF A PROJECT
BY THE AZEP/AS ELECTRIC POWER
AND GAS INC.
The Arizona Electric Power Cooperative, Inc. (AZEP/AS) has filed an application with the Arizona Corporation Commission for an order authorizing it to borrow up to \$200 million to fund its proposed \$2.2 billion in transmission and Construction Work Plan. The application is available for inspection during regular business hours at the offices of the Commission in Phoenix and Tucson, Arizona, and AEP/AS, 1000 South Highway 80, P.O. Box 1000, Kingman, Arizona 86401. Intervention in the Commission's proceedings on the application shall be permitted to any person entitled by law to intervene and having a direct and substantial interest in the matter. Persons desiring to intervene shall file a Motion to Intervene with the Commission which must be served upon AEP/AS and which, as a minimum, shall contain the following information:
1. The name, address and telephone number of the proposed intervenor and of any person upon whom service of documents may be made as representative of the intervenor.
2. A short statement of the proposed intervenor's interest in the proceeding.
3. Whether the proposed intervenor desires a formal evidentiary hearing on the application and the reasons for such a hearing.
4. A statement certifying that a copy of the Motion to Intervene has been mailed to AEP/AS.
The granting of Motions to Intervene shall be governed by A.A.C. R14-3-305.
Published: February 22, 2006
Ad No. 3417

CITIZEN PUBLISHING COMPANY

Tucson, Arizona

STATE OF ARIZONA)
COUNTY OF PIMA)

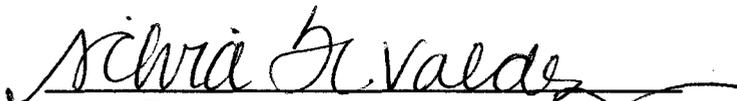
Arianne Semar, being first duly sworn deposes and says: that she is the Legal Advertising Representative of the **CITIZEN PUBLISHING COMPANY**, a corporation organized and existing under the laws of the State of Arizona, and that the said **CITIZEN PUBLISHING COMPANY** prints and publishes the Tucson Citizen, a daily newspaper printed and published in the City of Tucson, Pima County, State of Arizona, and having a general circulation in said City, County, State and elsewhere, and that the attached

Legal Notice

was printed and published correctly in the entire issue of the said Tucson Citizen on each of the following dates, to-wit: *February 23, 2006*



Subscribed and sworn to before me this 13 day of
March, 2006


Notary Public



SILVIA H VALDEZ
Notary Public - Arizona
Pima County
Expires 12/15/09

My commission expires _____

TNI AD NO. 4542342

