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MEMORANDUM

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TO: Docket Control
FROM: Ernest G. Johnson
Director
Utilities Division

Arizona Corporation Commission

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DATE: October 22, 2002

RE: STAFF REPORT FOR SOUTHWEST TRANSMISSION COOPERATIVE, INC.,
APPLICATION FOR FINANCING APPROVAL (DOCKET NO. E-04100A-02-
0261)

Attached is the Staff Report for Southwest Transmission Cooperative, Inc., application for approval to incur debt and secure liens on its property to finance its construction work plan. Staff recommends approval.

EGJ: JHJ: rdp

Originator: J. H. Johnson

Attachment: Original and fifteen copies

Service List for Southwest Transmission Cooperative, Inc.
Docket No. E-04100A-02-0261

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

SOUTHWEST TRANSMISSION COOPERATIVE, INC.

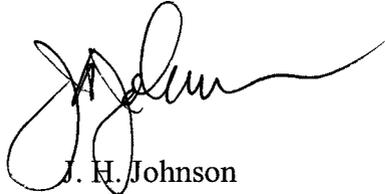
DOCKET NO. E-04100A-02-0261

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

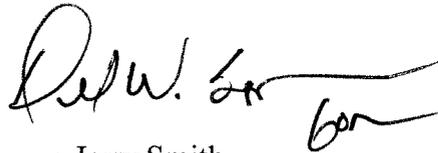
OCTOBER 2002

STAFF ACKNOWLEDGMENT

The Staff Report for Southwest Transmission Cooperative, Inc., Docket No. E-04100A-02-0261, was the responsibility of the Staff members listed below. J. H. Johnson was responsible for the financial review and analysis. Jerry Smith was responsible for the engineering and technical analysis.



J. H. Johnson
Public Utilities Analyst III



Jerry Smith
Utilities Engineer (Electrical)

EXECUTIVE SUMMARY

Southwest Transmission Cooperative, Inc. ("STC" or "Company") filed an application April 4, 2002, with the Arizona Corporation Commission, for authorization to incur debt of \$30,853,000 and pledge assets to secure the debt.

STC serves mostly Southern Arizona from Wilcox to areas surrounding Tucson. It is a non-profit 501-(3) (C) Arizona Corporation created from transmission assets divested by Arizona Electric Power Cooperative, Inc. ("AEPSCO") as of August 1, 2001.

The loan proceeds will fund capital improvements to the existing electrical transmission system. Transmission service is primarily provided between AEPSCO, the generation source, and the retail electrical sale cooperatives that are members and owners of STC.

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 of cost for similar facility improvements made by other transmission providers.

Staff has concerns about the financial condition of the Company and its ability to service debt as actual TIER and DSC for the first five months of its corporate existence are .70 and .92, respectively. Staff also has reservations because membership capitalization is currently only 2.0 percent and will decline as additional debt is incurred. Staff's concerns are only mitigated by Decision No. 63305 that requires the Company to submit a capital plan by December 31, 2002, which will eventually raise membership capital levels to 30 percent.

Staff recommends approval of the request for authorization to borrow funds.

TABLE OF CONTENTS

	<u>PAGE</u>
INTRODUCTION	1
PURPOSE OF FINANCING	1
PROPOSED DEBT	1
FINANCIAL ANALYSIS	1
ENGINEERING ANALYSIS	3
STAFF RECOMMENDATIONS	3

SCHEDULES

Selected Financial Data.....	Schedule JHJ - 1
Pro-forma Data.....	Schedule JHJ - 2

Attachment

Engineering Report

RUS Letter

Introduction

Southwest Transmission Cooperative, Inc. ("STC", or "Company") filed an application with the Arizona Corporation Commission ("ACC" or "Commission") on April 4, 2002. The application asks for authorization to incur debt and secure liens on its property in the amount of \$30,853,000 to finance its construction work plan.

STC is an Arizona non-profit corporation headquartered in Benson, Arizona, and owned by its Class A members. Owners are cooperatives selling electricity to retail consumers primarily in southern Arizona. Arizona Electric Power Cooperative, Inc. ("AEPSCO") at the Apache Station generation complex near Willcox, Arizona produces much of the electricity transmitted by the Company. AEPSCO and STC have a common board of directors. Transmission lines operated by the Company transmit electricity from the generating station to the purchasing cooperatives and some non-member purchasers.

STC was created on August 1, 2001, as a separate entity in a spin-off from AEPSCO on August 1, 2001. STC received all of the transmission assets and a share of AEPSCO's debt in the spin-off.

Purpose of Financing

The Company proposes borrowing funds to complete its 2001-2004 work plan which consists principally of individual projects including the Apache-Winchester 230 KV line and substation which is to improve transmission system reliability in southeast Arizona. This project contemplates replacing 23 miles of Apache to Hayden 115 KV transmission line with a double circuit 230 KV and 115 KV line. The project resolves system overloads as further discussed in the attached Staff Engineering Memorandum.

Proposed Debt

The Company proposes to borrow a total of \$30,853,000 from the Rural Utilities Service/Federal Financing Bank ("RUS") long-term guaranteed loan program. Terms expected are 35 years and an interest rate of 5.710 percent per annum. Advances are to be made through 2004 when the work plan is completed.

RUS has approved the loan transaction as evidenced in the attached letter signed by the Assistant Administrator of the Electric Program. The U.S. Government is guaranteeing the \$30,853,000 loan that will be advanced by the Federal Financing Bank.

Financial Analysis

Staff's analysis of the Company's financial strength is based on financial statements for the five months ending December 31, 2001, the entity's period of existence since its spin-off

from AEPCO. The five-month statements were audited by the Dallas, Texas office of Arthur Andersen, LLP, and are presented on an unqualified basis.

The results of operations for the first five months of existence as a separate entity as measured by the time's interest earned ratio ("TIER") and debt service ratio ("DSC") are inadequate to satisfy the normal requirements by RUS. The annualized TIER, DSC, and the Cash Coverage Ratio ("CCR") for the first five months of existence, (Schedule JHJ-1, attached) are .70, .92, and 1.01 respectively. These ratios reflect a \$243,000 adjustment to operating income, to remove non-recurring expenses.

TIER represents the number of times earnings will cover interest expense on long-term debt.

DSC represents the number of times internally generated cash will cover required principal and interest payments on long-term debt.

CCR represents the number of times internally generated cash will cover required interest payments on debt. A CCR of greater than 1.0 means that operating cash flow is greater than interest expense. CCR is equal to EBITDA (earnings before interest, taxes, depreciation, and amortization) divided by interest expense.

Schedule JHJ-2, attached, presents the Company's projections for the fiscal years 2001 through 2011. These projections reflect new rates presented and recommended to the board by the Company's management at STC's June 2002 board meeting. The proposed rates are projected to produce sufficient revenues to provide a DSC of 1.0 and a TIER of at least 1.26 through fiscal 2010. These rates have been approved by the Company's board but not by the ACC or FERC. The Company needs higher rates in 2002 and beyond to meet the RUS minimum requirements for a 1.05 TIER and a 1.00 DSC. The Company has filed an Open Access Transmission Tariff ("OATT") application with the Commission.

The Company was thinly capitalized at December 31, 2001, with a member's equity percentage of 2.0. Member's equity will decline to 1.5 percent after the proposed debt is incurred. In Decision No. 63305, dated June 26, 2002, the Commission ordered STC to file a capital plan no later than December 31, 2002, to increase membership capital to 10 percent by December 31, 2006, to 15 percent by the end of 2010, and to 30 percent by the end of 2015.

Development of a capital plan to comply with the requirements of Decision No. 63305 is necessary for STC to conform with the "sound financial practices" requirement for Commission approval found in the Arizona Revised Statutes.

Engineering Analysis

The Staff Engineering Memorandum dated August 2, 2002, attached, concludes that the proposed capital improvements are appropriate and necessary for reliable operation of the system. The Staff Engineering Report further concludes that cost estimates are reasonable, and are typical of costs for similar facility improvements made by other transmission providers.

The Company has complied with requirements that transmission plans for the next ten years be filed with the Commission.

Staff Recommendations

Staff concludes that the issuance of debt in the amount of \$30,853,000 on the terms described is for lawful purposes, within the corporate powers of the applicant, compatible with the public interest, compatible with sound financial practice, and will not impair its ability to perform service, provided that the Company complies with the capital plan requirements established by Decision No. 63305, dated June 26, 2002.

Staff recommends the approval of the applicant's request for authorization to obtain financing on the terms and conditions described in the application in the amount of \$30,853,000.

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

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

Staff further recommends that the Company be ordered to file copies of all executed financing documents with the Commission within 30 days after they become available.

FINANCIAL ANALYSIS

Selected Financial Information
Reflecting the Immediate Effects of the Proposed Debt

	[A] 12/31/2001		[B] Pro Forma		
1	Operating Income	\$ (599)		\$ (599)	
2	Depreciation & Amort.	2,611		2,611	
3	Income Tax Expense	0		0	
4					
5	Interest Expense	1,992		2,167	
6	Repayment of Principal	2,383		5,719	
7					
8					
9	TIER¹				
10	[1+3+5] + [5]	0.70		0.72	
11	DSC				
12	[1+2+3+5] + [5+6]	0.92		0.53	
13	Cash Coverage Ratio				
14	[1+2+3] + [5]	1.01		0.93	
15					
16					
17					
18	Short-term Debt	\$0	0%	\$0	0.0%
19					
20	Long-term Debt	\$87,494,000	98%	\$90,504,000	98.0%
21					
22	Common Equity	\$1,813,000	2%	\$1,813,000	2.0%
23					
24	Total Capital	\$89,307,000	100%	\$92,317,000	100.0%
25					
26					
27					

1. Proposed debt includes all amounts to be drawn by 2004. Additional borrowings of \$27,843,000 will occur in 2003 and 2004.

Income Statement

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Operating Revenues											
Network Revenues	18,684	19,008	20,185	21,375	22,283	22,730	23,170	22,719	23,620	23,443	26,773
Point to Point Firm Revenues	7,546	10,061	9,650	9,777	9,990	9,990	9,985	9,610	8,997	8,675	3,810
Point to Point Non Firm Revenues	26	26	26	26	26	26	26	26	26	13	13
Total Electric Revenues	26,256	29,095	29,861	31,178	32,299	32,746	33,180	32,355	32,644	32,131	30,597
Other Operating Revenue and Income	3,555	3,555	3,555	3,555	3,555	3,555	3,555	3,555	3,555	3,555	3,555
Total Operating Revenues	29,811	32,650	33,416	34,733	35,854	36,301	36,735	35,910	36,199	35,686	34,152
Operating Expenses											
Other Power Supply	3,589	3,644	3,699	3,754	3,811	3,869	3,927	3,987	4,047	4,108	4,170
Operating Expense Admin & General	7,285	7,395	7,507	7,620	7,735	7,852	7,971	8,091	8,213	8,337	8,463
	2,882	2,925	2,970	3,014	3,060	3,106	3,153	3,201	3,249	3,298	3,348
Total Operation Expense	13,756	13,964	14,176	14,388	14,606	14,827	15,051	15,279	15,509	15,743	15,981
Maintenance Expenses											
Maintenance Expense General Plant	2,074	2,105	2,137	2,170	2,202	2,236	2,269	2,304	2,338	2,374	2,410
	1,218	1,237	1,255	1,274	1,293	1,313	1,333	1,353	1,373	1,394	1,415
Total Maintenance Expense	3,292	3,342	3,392	3,444	3,495	3,549	3,602	3,657	3,711	3,768	3,825
Other Expenses											
Depr & Amort Expense	3,615	3,606	4,177	4,444	4,418	4,493	4,548	4,602	4,698	4,770	4,765
Other Deductions	2,499	2,508	2,518	2,528	2,538	2,549	2,558	2,566	2,577	2,577	2,537
Taxes	1,860	1,860	1,803	1,824	2,225	2,194	2,193	2,149	2,072	1,995	1,999
Interest-Ltd	5,903	5,829	5,787	6,165	6,431	6,230	5,984	5,564	5,254	4,969	4,739
Other Interest Expense	0	0	248	163	0	0	0	0	0	0	0
Total Other Expenses	13,877	14,003	14,533	15,124	15,612	15,466	15,283	14,871	14,591	14,311	14,040
Total Cost-Electric Service	30,925	31,309	32,101	32,956	33,713	33,842	33,936	33,807	33,811	33,822	33,846
Operating Margins	-1,114	1,341	1,315	1,777	2,141	2,459	2,789	2,103	2,388	1,864	306
Interest Income	448	416	40	244	468	545	677	765	743	814	951
Aludc	97	133	538	72	25	25	12	12	50	0	0
Other Nonoperating Income -Net	94	94	94	94	94	94	94	94	94	94	94
Net Margins	-475	1,984	1,987	2,187	2,728	3,123	3,582	2,974	3,275	2,772	1,351
Debt Service (Principal & Interest Payments)	\$13,224	\$13,477	\$14,071	\$14,830	\$15,449	\$15,719	\$15,987	\$15,002	\$15,086	\$14,370	\$12,648
Net Margin	-5475	\$1,984	\$1,987	\$2,187	\$2,728	\$3,123	\$3,582	\$2,974	\$3,275	\$2,772	\$1,351
LTD Interest Expense + Other Deduction Interest	\$7,762	\$7,688	\$7,893	\$8,186	\$8,290	\$8,089	\$7,843	\$7,409	\$7,099	\$6,814	\$6,533
Depreciation	\$3,615	\$3,806	\$4,177	\$4,444	\$4,418	\$4,493	\$4,548	\$4,602	\$4,698	\$4,770	\$4,765
Margin+Interest+Depreciation	\$10,902	\$13,478	\$14,057	\$14,817	\$15,436	\$15,705	\$15,973	\$14,985	\$15,072	\$14,356	\$12,649
(Net Margin+Interest Exp+Depreciation)/Debt Service*(AFUDC)	0.82	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
LTD Interest Expense + Other Deduction Interest	\$7,762	\$7,688	\$7,846	\$8,024	\$8,290	\$8,089	\$7,843	\$7,423	\$7,113	\$6,828	\$6,598
Net Margin	-5475	\$1,987	\$2,187	\$2,728	\$3,123	\$3,582	\$2,974	\$3,275	\$2,772	\$2,351	\$1,351
	\$7,287	\$9,672	\$9,633	\$10,211	\$11,018	\$11,212	\$11,425	\$10,397	\$10,388	\$9,600	\$7,949
TIER**	0.94	1.26	1.26	1.27	1.33	1.39	1.46	1.40	1.46	1.41	1.20
**((Net Margin+Interest Expense)/Interest Expense)											

Memorandum

To: Jim Johnson, Auditor III, Utilities Division
From: Jerry D. Smith, Electric Utilities Engineer, Utilities Division
Thru: Del Smith, Engineering Supervisor, Utilities Division *DS*
Subject: Southwest Transmission Coop. Financing Application, Docket No. E-01773A-02-0261
Date: August 2, 2002

Southwest Transmission Cooperative ("TRANSCO") filed an application on April 4, 2002, for authority to incur debt and secure liens on its property for the financing of necessary improvements to its transmission system. TRANSCO proposes to borrow funds not to exceed \$30,853,000 from the Rural Utilities Service ("RUS") guaranteed Federal Financing Bank ("FFB"). Engineering Staff ("Engineering") has reviewed the TRANSCO financing application and offers the following technical assessment.

Engineering has reviewed TRANSCO's revised 2001-2004 Construction Work Plan filed with its financing application. The work plan contains all capital improvements upon which the loan is based. A summary of the proposed work is provided in Table 1.

Table 1: Summary of Work Plan

RUS 740c Code	Construction Category	Amount
800	Transmission Lines	9,890,000.
900	New Substations, Switching Stations	9,841,683.
1000	Line and Station Changes	7,181,690.
1101	Communication/Supervisory Control And Data Acquisition	2,083,491.
1102	Ordinary Line and Substation Replacement	1,857,060.
TOTAL		\$30,853,924.

One major project, the Winchester Project, represents approximately \$21 million in the work plan. This project is an exception to TRANSCO's normal work plan. The project consists of replacing 23 miles of Apache to Hayden 115 kV transmission line with a double circuit 230 kV and 115 kV line. The new 230 kV line connects Apache Substation with a new Winchester 345 kV Substation on TEP's 345 kV Greenlee to Vail transmission line.

The Winchester project is needed to resolve system overloads for single contingency outages. The project will also decrease TRANSCO's need for remedial action schemes ("RAS") for multiple contingency outages. The project provides TRANSCO a third transmission interconnection point to the Arizona Extra High Voltage ("EHV") System. The project is expected to increase TRANSCO's import/export capability by approximately 400 MW. TRANSCO filed with the Commission a copy of a report entitled "Winchester Interconnect Project Report" with its ten-year plans in January 2002. The project has also been modeled and studied as part of the Central Arizona Study ("CATS").

The remaining approximately \$10 million of the work plan consists of routine and customary improvements. New substation and substation transformers for TRANSCO's member Distribution Cooperatives represents approximately \$6 million and the remaining \$4 million is for Communication and Supervisory Control And Data Acquisition ("SCADA") improvements and Ordinary Replacements. Need for the new substations and transformers for member Distribution Cooperatives was validated this summer when Trico experienced substation transformer overloads that resulted in several consecutive days of customer outages. Several of the proposed transformer additions are slated for Trico's service area.

Conclusions

Engineering finds the capital improvements proposed in TRANSCO's financing application to be appropriate and necessary for reliable operation of its system. TRANSCO has complied with its requirements to file transmission plans for the next ten years with the Commission by the end of January of each year. The most recent filing properly included technical studies supporting the planned transmission improvements. Cost estimates of the proposed projects are reasonable and are typical of cost for similar facility improvements made by other transmission providers. However, Engineering defers judgement of all proposed improvements as "used and useful" until such time that TRANSCO applies for a rate adjustment. A more thorough review of transmission facilities will be undertaken at that time.

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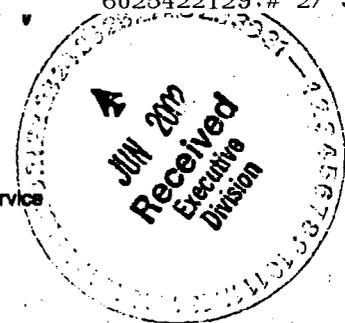
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CC: Steve Olea, Assistant Director, Utilities Division



United States Department of Agriculture  
Rural Development

Rural Business-Cooperative Service • Rural Housing Service • Rural Utilities Service  
Washington, DC 20250



JUN 19 2002

Mr. Donald W. Kimball  
Executive Vice President and  
Chief Executive Officer  
Southwest Transmission Cooperative, Inc.  
P. O. Box 2195  
Benson, Arizona 85602

Dear Mr. Kimball:

We are pleased to advise you that a loan guarantee commitment in the amount of \$30,853,000 has been approved for Southwest Transmission Cooperative, Inc. (SWTC), by the Rural Utilities Service (RUS). Under this commitment, the Government will guarantee a loan of \$30,853,000 to SWTC pursuant to a contract of guarantee, satisfactory to RUS, among the Government, SWTC, and the Federal Financing Bank (FFB).

The proceeds of the guaranteed loan, designated "B8", are to be used to finance additional transmission and substation facilities.

Advances will be made on the "B8" loan only after the conditions outlined below have been met:

1. The RUS has entered into a contract of guarantee with SWTC, and the FFB has agreed, with RUS approval, to make SWTC a guaranteed loan of \$30,853,000 to finance the projects included in the "B8" loan;
2. SWTC has submitted evidence, in form and substance satisfactory to the Administrator, that the conditions in the contract of guarantee have been satisfied to the extent and in the manner prescribed by the Administrator; and
3. SWTC has submitted evidence, in form and substance satisfactory to the Administrator, that it has duly authorized, executed, and has delivered to the Administrator the FFB Note and the Reimbursement Note in the manner prescribed by the Administrator.

Mr. Donald W. Kimball

2

The loan agreement and other documents will be forwarded in the near future for execution. This loan is approved with the understanding that the loan agreement will be authorized and executed by your organization and returned to us by the date, which will be set forth in the letter transmitting the loan agreement.

Sincerely,



BLAINE STOCKTON  
Assistant Administrator  
Electric Program