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MEMORANDUM

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TO: Docket Control

FROM: Steven M. Olea
Director
Utilities Division

2013 OCT 29 PM 3 03

DATE: October 29, 2013

RE: STAFF REPORT IN THE MATTER OF THE APPLICATION OF DUNCAN VALLEY ELECTRIC COOPERATIVE, INC. FOR APPROVAL OF A LOAN (DOCKET NO. E-01703A-13-0272)

Attached is the Staff Report for Duncan Valley Electric Cooperative, Inc.'s ("DVEC") application requesting authorization to borrow funds to finance DVEC's prepayment of a portion of its future pension funding obligation to the National Rural Electric Cooperative Association. Staff recommends approval of the requested authorization.

Any party to this procedure who wishes may file comments to the Staff Report with the Commission's Docket Control by 4:00 p.m. on or before November 08, 2013.

SMO:JAC:tdp|WVC

Originator: John A. Cassidy

Arizona Corporation Commission

DOCKETED

OCT 29 2013

DOCKETED BY

Service List for: Duncan Valley Electric Cooperative, Inc.
Docket No. E-01703A-13-0272

Mr. Michael Pearce
Duncan Valley Electric Cooperative, Inc.
379597 AZ 75
P.O. Box 440
Duncan, Arizona 85534

Mr. John V. Wallace
Grand Canyon State Electric Cooperative Association, Inc.
2210 South Priest Drive
Tempe, Arizona 85282

**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

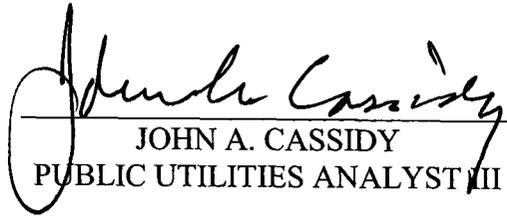
**DUNCAN VALLEY ELECTRIC COOPERATIVE, INC.
DOCKET NO. E-01703A-13-0272**

**APPLICATION
FOR
APPROVAL OF A LOAN**

OCTOBER 29, 2013

STAFF ACKNOWLEDGMENT

The Staff Report for Duncan Valley Electric Cooperative, Inc., Docket No. E-01703A-13-0272 is the responsibility of the Staff members listed below: John A. Cassidy is responsible for the review and financial analysis of the Cooperative's application.


JOHN A. CASSIDY
PUBLIC UTILITIES ANALYST III

EXECUTIVE SUMMARY
DUNCAN VALLEY ELECTRIC COOPERATIVE, INC.
DOCKET NO. E-01703A-13-0272

On August 8, 2013, Duncan Valley Electric Cooperative, Inc. (“DVEC” or “Cooperative”), an Arizona class “A” public service corporation and non-profit, member-owned cooperative located in Duncan, Arizona, filed an application requesting authorization to borrow funds to make its accelerated funding payment to the National Rural Electric Cooperative Association (“NRECA”) Retirement Security Plan (“RSP”).

DVEC requests Commission authorization to borrow \$475,099 from the National Rural Utilities Cooperative Finance Corporation (“CFC”) in the form of an 11-year amortizing loan at a fixed interest rate of 2.95 percent to finance the prepayment of a portion of DVEC’s future funding obligations to the NRECA RSP.

As of December 31, 2012, DVEC’s capital structure consisted of 0.3 percent short-term debt, 2.8 percent long-term debt, and 96.9 percent equity. Issuance of the proposed financing debt results in a pro forma capital structure composed of 0.8 percent short-term debt, 8.2 percent long-term debt and 91.0 percent equity. Staff calculated a pro forma debt service coverage (“DSC”) ratio of 2.55. The pro forma DSC results show the Cooperative has sufficient funds to pay all obligations.

Staff concludes that issuance of the proposed debt financing for the purposes stated in the application is within DVEC’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 authorizing DVEC to borrow up to \$475,099 in the form of an 11-year amortizing loan at 2.95 per cent per annum from CFC to finance the prepayment of a portion of DVEC’s future pension obligations, as described in its Application.

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

Staff further recommends that the Cooperative provide to the Utilities Division Director, a copy of the loan documents executed pursuant to the authorizations granted herein, within 30 days of the execution of the loan, and also file a letter in Docket Control verifying that such documents have been provided to the Utilities Division.

Staff further recommends that any authorization to incur debt granted in this proceeding terminate by December 31, 2014.

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INTRODUCTION

On August 8, 2013, Duncan Valley Electric Cooperative, Inc. (“DVEC” or “Cooperative”), an Arizona class “A” public service corporation and non-profit, member-owned cooperative located in Duncan, Arizona, filed an application requesting authorization to borrow funds to make its accelerated funding payment to the National Rural Electric Cooperative Association (“NRECA”) Retirement Security Plan (“RSP”).

PUBLIC NOTICE

On September 4, 2013, the Cooperative filed an affidavit of publication verifying public notice of its financing application. DVEC published notice of its financing application in *The Copper Era* on August 28, 2013. *The Copper Era* is a weekly newspaper of general circulation published in the County of Greenlee, Arizona. The affidavit of publication is attached (Attachment A) along with a copy of the Notice.

BACKGROUND

DVEC is a member-owned, non-profit rural electric distribution cooperative¹ which provides electric and natural gas service to approximately 1,700 members in portions of southeastern Arizona and southwestern New Mexico.²

DVEC’s current rates were approved in Decision No. 67433, dated December 3, 2004.³

PURPOSE AND DESCRIPTION OF THE FINANCING

DVEC requests Commission authorization to borrow up to \$475,099 from the National Rural Utilities Cooperative Finance Corporation (“CFC”) in the form of an 11-year amortizing loan at an interest rate of 2.95 percent to finance the prepayment of a portion of DVEC’s future funding obligations to the National Rural Electric Cooperative Association (“NRECA”) Retirement Security Plan (“RSP”).⁴

¹ DVEC is one of five Class “A” member distribution cooperatives who purchase all or most of its electric power from Arizona Electric Power Cooperative, Inc. (“AEPSCO”).

² In the Application, DVEC makes reference to the number of members it serves, while the Annual Report filed with the Commission provides statistical information on the number of customers served. In response to a data request issued by Staff, DVEC indicated that for 2012, the Cooperative had 1,661 total members (1,468 in Arizona and 193 in New Mexico) and 3,043 total customers (in Arizona, 1,974 electric and 732 gas; in New Mexico, 337 electric). DVEC defines a member as “a consumer or group of consumers who jointly hold a membership in the cooperative for one or more services.”

³ Docket No. E-01703A-03-0904.

⁴ Although the Application requests Commission authority for a loan in the amount of \$475,099, the Cooperative’s Board of Directors, in a meeting held March 18, 2013, approved a Resolution allowing DVEC to borrow from CFC an aggregate amount not to exceed \$478,156 (See Application, Exhibit A). In response to Staff data request JAC-1.1, DVEC provided a schedule from NRECA showing what the Cooperative’s accelerated funding payment to RSP would be if paid as of a certain date. The larger \$478,156 figure authorized by DVEC’s Board comports to the amount owing if paid by April 30, 2013, while the \$475,099 loan figure for which DVEC requests Commission

DVEC estimates that by prepaying a portion of its RSP payments, the Cooperative will experience retirement expense savings of \$67,485 over the 11-year loan period, based upon an assumed 3.0 percent annual increase in base salary, with the savings potential being higher should DVEC base salary increase by more than 3.0 percent.⁵ When estimated over a 20-year period, DVEC anticipates retirement expense savings of approximately \$750,000.⁶ The Cooperative asserts that the benefit of all savings realized due to prepayment will accrue to DVEC members in the form of a lower cost of service.

STAFF ANALYSIS

Staff's analysis is illustrated on Schedule JAC-1. Column [A] reflects the Cooperative's historical financial information for the year ended December 31, 2012. Column [B] presents pro forma financial information that modifies Column [A] to reflect the repayment of principal associated with a capital lease obligation entered into by DVEC in 2012. Though this capital lease principal payment is not scheduled to be made until the year 2013, Staff elected to include Column [B] in its analysis in order to more accurately gauge the Cooperative's current financial position prior to consideration of the proposed debt financing. Lastly, Column [C] presents pro forma financial information that modifies Column [B] to reflect the proposed \$475,099, eleven-year amortizing loan at an interest rate of 2.95 percent per annum.

Debt service coverage ratio ("DSC")

DSC represents the number of times operating income will cover required principal and interest payments on short-term and long-term debt. A DSC greater than 1.0 indicates that cash flow from operations 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 may be needed to avoid default under certain conditions.

As shown in Schedule JAC-1, Column [A], for the year ended December 31, 2012, DVEC had a DSC of 23.29. The pro forma DSC for the Cooperative under the scenario described above for Column [B] is 5.22. Lastly, the pro forma DSC for the Cooperative under the scenario described above for Column [C] is 1.85. Thus, the pro forma DSC results indicate that DVEC has sufficient operating cash flows to meet the debt service obligations associated with the proposed financing.

authorization in this docket comports to the accelerated funding payment due RSP if paid by March 31, 2013. In response to Staff data request JAC-1.2, DVEC indicated that its Board directed management to make the RSP prepayment by March 31, 2013.

⁵ In response to Staff data request JAC-1.5, over the 6-year period, 2007-2012, DVEC experienced an average annual increase in base salary of 4.40 percent.

⁶ As shown in Exhibit B of the Application, in the year 2032 DVEC estimates cumulative savings to be \$754,336.

Capital Structure

As of December 31, 2012, as shown in Column [A] of schedule JAC-1, DVEC's capital structure consisted of 0.3 percent short-term debt, 2.8 percent long-term debt, and 96.9 percent equity. As shown in Column [B], the Cooperative's capital structure consisted of 0.4 percent short-term debt, 2.5 percent long-term debt, and 97.2 percent equity. As shown in Column [C], issuance of the proposed debt results in a pro forma capital structure composed of 0.8 percent short-term debt, 8.0 percent long-term debt and 91.2 percent equity.

Encumbrance

Arizona Revised Statutes ("A.R.S.") § 40-285 requires public service corporations to obtain Commission authorization to encumber certain utility assets. The statute serves to protect captive customers from a utility's act to dispose of any of its assets that are necessary for the provision of service; thus, it serves to preempt any service impairment due to disposal of assets essential for providing service. Pledging assets as security typically provides benefits to the borrower in the way of increased access to capital funds or preferable interest rates, and it is often an unavoidable condition for procurement of funds for small or financially stressed entities.

The Cooperative conveyed to Staff that the proposed financing does not involve an encumbrance.

Proper Use of Funds

Staff concludes that the prepayment of pension contributions using the currently available low interest rates is a proper use of funds, and it is in the public interest.

COMPLIANCE

As of October 11, 2013, a check of the Commission's compliance database indicated there were no unresolved compliance issues with DVEC.

CONCLUSION AND RECOMMENDATIONS

Staff concludes that issuance of the proposed debt financing for the purposes stated in the application is within DVEC'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 authorizing DVEC to borrow up to \$475,099 in the form of an 11-year amortizing loan at an interest rate of 2.95 percent per annum from CFC to finance the prepayment of a portion of DVEC's future funding pension contributions, as described in the Application.

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

Staff further recommends that the Company provide to the Utilities Division Director, a copy of the loan documents executed pursuant to the authorizations granted herein, within 30 days of the execution of the loan, and also file a letter in Docket Control verifying that such documents have been provided to the Utilities Division.

Staff further recommends that any authorization to incur debt granted in this proceeding terminate by December 31, 2014.

FINANCIAL ANALYSIS

Selected Financial Information

	[A] ¹ <u>12/31/2012</u>		[B] ² <u>Pro Forma</u>		[C] ³ <u>Pro Forma</u>
1 Operating Income	\$ (137,665)		\$ (137,665)		\$ (137,665)
2 Depreciation & Amort.	282,632		282,632		282,632
3 Income Tax Expense	0		0		0
4					
5 Interest Expense	6,224 ⁴		6,224		19,740
6 Repayment of Principal	0		21,549 ⁵		58,662
7					
8					
9					
10					
11 DSC					
12 [1+2+3] + [5+6]	23.29		5.22		1.85
13					
14					
15					
16					
17 Capital Structure					
18					
19 Short-term Debt	21,549 ⁶	0.3%	25,933 ⁷	0.4%	63,046 ⁸ 0.8%
20					
21 Long-term Debt	203,901 ⁹	2.8%	182,352	2.5%	620,338 8.0%
22					
23 Common Equity	7,111,723	96.9%	7,111,723	97.2%	7,111,723 91.2%
24					
25 Total Capital	\$7,337,173	100.0%	\$7,320,008	100.0%	\$7,795,107 100.0%
26					
27					

¹ Column [A] is based on financial information for the year ended December 31, 2012, as reported in the Cooperative's audited financial statements.

² Column [B] is Column [A] modified to reflect the repayment of principal associated with a Capital lease obligation, the payments of which are not scheduled to begin until 2013.

³ Column [C] is Column [B] modified to reflect issuance of the proposed \$475,099 debt amortized over a period of 11 years at an interest rate of 2.95 percent per annum.

⁴ Interest expense associated with a Capital lease obligation.

⁵ Principal repayment is associated with a Capital lease obligation, the payments of which are not scheduled to begin until 2013.

⁶ Current portion of Capital lease obligation in year 2012.

⁷ Current portion of Capital lease obligation in year 2013.

⁸ Current portion of Capital lease obligation from Column [B] plus current portion owing on the proposed debt.

⁹ Long-term debt associated with the capital lease obligation, as reported on the Cooperative's 2012 Balance Sheet.

