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MEMORANDUM

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FROM: Tom M. Broderick *Tom M. Broderick*
Director
Utilities Division

AZ CORP COMMISSION
DOCKET CONTROL

DATE: January 25, 2016

RE: STAFF REPORT FOR ARIZONA ELECTRIC POWER COOPERATIVE, INC.
FOR AUTHORIZATION TO INCUR DEBT AND SECURE LIENS IN ITS
PROPERTY TO FINANCE ITS CONSTRUCTION WORK PLAN (DOCKET
NO. E-01773A-15-0389)

Attached is the Staff Report for Arizona Electric Power Cooperative's application for authorization to incur debt and secure liens on its property to finance its construction work plan. 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 February 4, 2016.

TMB:PNT:red\CHH

Originator: Phan Tsan

Arizona Corporation Commission

DOCKETED

JAN 25 2016

DOCKETED BY *AK*

Service List for: Arizona Electric Power Cooperative, Inc.
Docket No. E-01773A-15-0389

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

ARIZONA ELECTRIC POWER COOPERATIVE, INC.

DOCKET NO. E-01773A-15-0389

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

JANUARY 25, 2016

STAFF ACKNOWLEDGMENT

The Staff Report for Arizona Electric Power Cooperative, Inc., Docket No. E-01773A-15-0389 is the responsibility of the Staff members listed below. Phan Tsan is responsible for the financial review and analysis of the Cooperative's application. Ray Williamson is responsible for the engineering and technical analysis.



PHAN TSAN
PUBLIC UTILITIES ANALYST



RAY WILLIAMSON
UTILITIES ENGINEER

EXECUTIVE SUMMARY
ARIZONA ELECTRIC POWER COOPERATIVE, INC.
DOCKET NO. E-01773A-15-0389

On November 13, 2015, Arizona Electric Power Cooperative, Inc. ("AEP" or "Cooperative"), a not-for-profit, member-owned electric generation cooperative located in Benson, Arizona, filed an application with the Arizona Corporation Commission ("Commission") requesting authorization to obtain long-term debt from the Rural Utilities Services/Federal Financing Bank ("RUS/FFB") guaranteed loan program to finance its 2015-2017 Construction Work Plan ("CWP") in an amount not to exceed \$31,167,500.

AEP also requests authorization, consistent with that granted in Decision Nos. 71111 (December 4, 2008) and 73728 (May 25, 2012), to change the specific facilities to be financed in the Cooperative's CWP without the necessity of filing an amended application so long as the total amount financed does not exceed \$31,167,500.

AEP's capital structure, as of December 31, 2014, consisted of 5.69 percent short-term debt, 54.51 percent long-term debt, and 39.80 percent equity. A pro forma capital structure reflecting issuance of a 20-year \$31,167,500 amortizing loan at 2.39 percent per annum is composed of 5.52 percent short-term debt, 58.50 percent long-term debt and 35.98 percent equity.

Staff's pro forma times interest earned ratio ("TIER") and debt service coverage ("DSC") ratios are 1.37 and 1.20, respectively. These results suggest that projected operating results are sufficient to meet all obligations and covenants.

Staff concludes that the CWP projects are appropriate and the related cost estimates are reasonable.

Staff concludes that issuance of the proposed debt financing for the purposes stated in the application is within AEP'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:

- Granting AEP authorization to incur long-term debt from the RUS/FFB to finance its 2015-2017 CWP in an amount not to exceed \$31,167,500.
- That such finance authority shall be expressly contingent upon AEP's use of the proceeds for the purposes stated in its application and approved herein.
- That any unused authorizations to issue debt granted in this proceeding terminate within five years of a decision in this docket.
- Authorizing AEP to change the specific facilities to be financed in the CWP without necessity of filing an amended application conditioned upon the following: 1) the total amount financed remains below the financing amount authorized; 2) that

AEPCO file in this docket a description of any proposed modifications to the CWP which cost more than \$500,000, and that such modifications substantially conform to the purposes of the 2015-2017 CWP; 3) that Staff has not filed an objection to the proposed modification within 60 days of the date AEPCO files the proposed changes; and 4) that the proposed modification be deemed approved for financing purposes only.

- Authorizing AEPCO to engage in any transaction and to execute any documents necessary to effectuate the authorization herein granted.
- That AEPCO 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.
- Authorizing AEPCO to pledge its assets in the State of Arizona pursuant to A.R.S §40-285 in connection with any indebtedness authorized in this proceeding.

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INTRODUCTION

On November 13, 2015, Arizona Electric Power Cooperative, Inc. ("AEP" or "Cooperative"), a not-for-profit, member-owned electric generation cooperative located in Benson, Arizona, filed an application with the Arizona Corporation Commission ("Commission") requesting authorization to obtain long-term debt from the Rural Utilities Services/Federal Financing Bank's ("RUS/FFB") guaranteed loan program to finance its 2015-2017 Construction Work Plan ("CWP") in an amount not to exceed \$31,167,500.

AEP also requests authorization, consistent with that granted in Decision Nos. 71111 and 73728, to change the specific facilities to be financed in the Cooperative's CWP without the necessity of filing an amended application so long as the total amount financed does not exceed \$31,167,500.

NOTICE

On December 2, 2015, AEP filed an affidavit of publication verifying public notice of its financing application. The Cooperative published notice of its financing application in *The Arizona Daily Star* and *The Kingman Daily Miner* on November 23, 2015. *The Arizona Daily Star* is a newspaper of general circulation in the county of Pima, Arizona, and *The Kingman Daily Miner* is a newspaper of general circulation in the City of Kingman, County of Mohave, Arizona. The affidavit of publication is attached along with a copy of Notice.

COMPLIANCE

As of December 15, 2015, a check of the Compliance Database indicates AEP is currently in Compliance with the Compliance database.

BACKGROUND

AEP provides power and wholesale energy primarily to six Class "A" member distribution cooperatives-Anza Electric Cooperative¹, Duncan Valley 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. Also, Valley Electric Association ("VEA") is a Class "D" member. VEA does not have either a partial or all-requirements contract with AEP, but has an agreement with AEP whereby AEP provides scheduling and trading services as well as economy energy purchases.

AEP's current rates were approved in Decision No.74173, dated October 25, 2013².

¹ Anza Electric Cooperative is a distribution cooperative located in California.

² Docket No.E-01773A-12-0305.

AEPCO currently has two financing approvals from the Commission that remain in effect. Decision No. 73728³ approved permanent financing not to exceed \$32,042,700 and interim financing not to exceed \$38,907,400. As of October 31, 2015, AEPCO had drawn \$13,000,000 under the permanent financing facility. AEPCO expects to utilize the full amount approved to finance the projects identified in its 2012-2014 CWP. Decision No. 74447⁴ (April 18, 2014) approved two unsecured, committed revolving lines of credit not to exceed the combined amount of \$10,000,000. As of October 31, 2015, \$5,000,000 had been drawn.

PURPOSE AND DESCRIPTION OF THE PROPOSED FINANCING

The Cooperative's application requests authorization to obtain long-term financing in an amount not to exceed \$31,167,500 from RUS/FFB's guaranteed loan program to finance its 2015-2017 CWP.

AEPCO is not requesting approval for interim financing because, pursuant to the Commission's authorization in Decision No. 74447, AEPCO has two unsecured, committed revolving lines of credit sufficient to provide interim funding.

AEPCO also requests authorization, consistent with that granted in Decision No. 71111 and 73728, 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 does not exceed \$31,167,500.

AEPCO expects RUS/FFB loan terms will reflect a final maturity date of December 31, 2034. As of January 13, 2016, the current interest rate for a 20-year RUS/FFB loan is 2.39 percent.

The applicable interest rate on the RUS/FFB loan will be fixed at the time that each advance is made based on treasury rates then in effect.

ENGINEERING ANALYSIS

Staff's Engineering Report is attached as Attachment A. Staff concludes that the projects included in the proposed CWP are appropriate and their associated costs appear to be reasonable. Staff makes no "used and useful" determination in this proceeding. Staff's conclusions in this Docket do not imply a specific treatment for rate base or for rate making purposes in any of AEPCO's future rate filings.

FINANCIAL ANALYSIS

Staff's analysis is illustrated on Schedule PNT-1. Column [A] reflects the Cooperative's audited financial information for the year ended December 31, 2014. Column [B] represents pro forma financial information that reflects issuance of the proposed \$31,167,500 debt financing amortized over 20 years at 2.39 percent.

³ Docket No. E-01773A-12-0192

⁴ Docket No. E-01773A-14-0019

Capital Structure

As of December 31, 2014, AEPCO's capital structure consisted of 5.69 percent short-term debt, 54.51 percent long-term debt, and 39.80 percent equity. A pro forma structure reflecting issuance of a 20-year \$31,167,500 amortizing loan at 2.39 percent per annum is composed of 5.52 percent short-term debt, 58.50 percent long-term debt and 35.98 percent equity.

Debt Service Coverage ratio ("DSC")

DSC represents the number of times internally generated cash 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.

Schedule PNT-1, column [A] shows that for the year ended December 31, 2014, AEPCO's DSC was 1.32. The pro forma DSC for the Cooperative under the scenario described above for Column [B] is 1.20. The pro forma DSC results show AEPCO has sufficient funds to meet all debt obligations and meets the minimum 1.0 DSC covenant required by RUS.

Times Interest Earned Ratio ("TIER")

TIER represents the number of times operating income covers interest expense on short-term and 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.

Schedule PNT-1, column [A] shows that for the year ended December 31, 2014, AEPCO's TIER was 1.49. The pro forma TIER for the Cooperative under the scenario described above for Column [B] is 1.37. The pro forma TIER results show the Cooperative has sufficient funds to meet all debt obligations, and meets the minimum 1.05 TIER covenant required by RUS.

Encumbrance

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.

CONCLUSION AND RECOMMENDATIONS

Staff concludes that the CWP projects are appropriate and the related cost estimates are reasonable.

Staff concludes that issuance of debt financing for the purposes stated in the application 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:

- Granting AEPCO authorization to incur long-term debt from the RUS/FFB to finance its 2015-2017 CWP in an amount not to exceed \$31,167,500.
- That such finance authority shall be expressly contingent upon AEPCO's use of the proceeds for the purposes stated in its application and approved herein.
- That any unused authorizations to issue debt granted in this proceeding terminate within five years of a decision in this docket.
- Authorizing AEPCO to change the specific facilities to be financed in the CWP without necessity of filing an amended application conditioned upon the following: 1) the total amount financed remains below the financing amount authorized; 2) that AEPCO file in this docket a description of any proposed modifications to the CWP which cost more than \$500,000, and that such modifications substantially conform to the purposes of the 2015-2017 CWP; 3) that Staff has not filed an objection to the proposed modification within 60 days of the date AEPCO files the proposed changes; and 4) that the proposed modification be deemed approved for financing purposes only.
- Authorizing AEPCO to engage in any transaction and to execute any documents necessary to effectuate the authorization herein granted.
- That AEPCO 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.
- Authorizing AEPCO to pledge its assets in the State of Arizona pursuant to A.R.S §40-285 in connection with any indebtedness authorized in this proceeding.

FINANCIAL ANALYSIS

December 31, 2014 Income Statement and Capital Structure and Pro Forma
Including Immediate Effects of the Proposed Debt

		[A] ¹		[B] ²	
		<u>12/31/2014</u>		<u>Pro Forma</u>	
1	Operating Margin	\$ 12,812,572		\$ 12,812,572	
2	Depreciation & Amort.	13,073,564		13,073,564	
3	Income Tax Expense	0		0	
4					
5	Interest Expense	8,613,178		9,344,661	
6	Repayment of Principal	10,938,471		12,168,896	
7					
8					
9	TIER				
10	[1+3] ÷ [5]	1.49		1.37	
11	DSC				
12	[1+2+3] ÷ [5+6]	1.32		1.20	
13					
14					
15					
16					
17					
18	Short-term Debt ³	\$16,694,824	5.69%	\$17,925,249	5.52%
19					
20	Long-term Debt	\$160,044,618	54.51%	\$189,981,693	58.50%
21					
22	Common Equity	\$116,840,842	39.80%	\$116,840,842	35.98%
23					
24	Total Capital	\$293,580,284	100.00%	\$324,747,784	100.00%
25					
26					

27 ¹ Column [A] is based on audited financial information of the year ended December 31, 2014.

28 ² Column [B] represents pro forma amounts to reflect the issuance of the \$31,167,500,
29 20-year amortizing loan at 2.39 percent annum.

30 ³ Short-term Debt inclusive of member advances and other investments,
31 current maturities of capital lease obligation, and current maturities of long-term debt.

MEMORANDUM

TO: Phan Tsan
Public Utilities Analyst I
Utilities Division

FROM: Ray T. Williamson *RTW*
Utilities Engineer
Utilities Division

THRU: Del Smith
Engineering Supervisor
Utilities Division

DATE: January 13, 2016

RE: IN THE MATTER OF THE APPLICATION OF ARIZONA ELECTRIC
POWER COOPERATIVE, INC. FOR AUTHORIZATION TO INCUR DEBT
AND SECURE LIENS IN ITS PROPERTY TO FINANCE ITS
CONSTRUCTION WORK PLAN (DOCKET NO. E-01773A-15-0389)

On November 13, 2015, Arizona Electric Power Cooperative, Inc. ("AEPSCO") submitted an Application ("Application") requesting authorization to incur debt and secure liens on its property to finance its Construction Work Plan for 2015-2017 ("CWP").

The CWP indicates necessary upgrades, improvements, and replacements to AEPSCO's generation plant that are anticipated to be needed over the next several years. Attached to the Application is Exhibit A, which provides the details of the facilities in the CWP that are included in this financing request, which will be referred to as the T-8 loan. The estimated total cost of the facilities proposed is \$31,167,500.

Engineering Review

The Engineering Staff has reviewed the application and, in particular, the list of projects outlined in Exhibit A which will be funded by the T-8 loan. Staff notes that over half of the \$31,167,500 cost will be utilized for NO_x reduction upgrades, NO_x¹ compliance upgrades, and mercury control.

Staff has reviewed the costs proposed in the Application and believes that the costs are appropriate. Staff further believes that the projects listed in Exhibit A are reasonable for AEPSCO to meet environmental compliance and to provide the services required to meet its customers' needs.

¹ NO_x is a generic term for nitric oxide and nitrogen dioxide (NO and NO₂). NO_x emissions are regulated under the Clean Air Act Amendments of 1990.

However, no "used and useful" determination of the proposed project items was made and no particular treatment should be inferred for ratemaking or rate base purposes in the future.

Conclusions

Based on Engineering Staff's review of the Application, Staff believes that AEPCO's request, for authorization to incur debt and secure liens to finance \$31,167,500 is appropriate and the cost estimates are reasonable.