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Gallagher&Kennedy

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Jennifer A. Cranston
Attorney
Direct: (602) 530-8191
Email: jennifer.cranston@gknet.com

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July 8, 2016

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

Re: *Credit Rating Report Compliance Filing; Decision No. 74591; Docket Nos. E-01773A-14-0018 & E-04100A-14-0018*

Dear Sir or Madam:

Pursuant to the Second Ordering Paragraph on page 11 of Decision No. 74591, enclosed are the original and 15 copies of Arizona Electric Power Cooperative, Inc.'s investment grade credit rating report issued by Fitch, dated June 2, 2016.

Thank you for your assistance with this matter.

Sincerely,

GALLAGHER & KENNEDY, P.A.

By: Jennifer A. Cranston

JAC/plp
Enclosure
5494570v1/10421-0069

cc (w/o enclosure): William P. Sullivan, Attorneys for MEC *(mailed)*
Michael W. Patten, Attorneys for Trico *(mailed)*

Original and 15 copies filed with Docket Control this 8th day of July, 2016.

Arizona Corporation Commission
DOCKETED

JUL 08 2016

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Arizona Electric Power Cooperative, Inc.

Revenue Bonds and Senior Unsecured Obligations
Full Rating Report

Ratings

Solid Waste Disposal Revenue Bonds (underlying)	A–
Implied Senior Unsecured Obligations	A–

Rating Outlook

Stable

Key Utility Statistics

Fiscal Year Ended 12/31/15

System Type	Wholesale Electric
NERC Region	WECC
No. of Class A Members	6
Primary Fuel Source	Coal

Related Research

Fitch Rates Arizona Electric Power Cooperative, AZ's Obligations 'A–'; Outlook Stable (May 2016)

Analysts

Matthew Reilly, CFA
+1 415-732-7572
matthew.reilly@fitchratings.com

Kathy Masterson
+1 512-215-3730
kathryn.masterson@fitchratings.com

Key Rating Drivers

Sound Cooperative Fundamentals: Arizona Electric Power Cooperative, Inc. (AEPCO) provides wholesale power to six rural electric distribution cooperatives under joint and several, take-or-pay contracts that extend through Dec. 31, 2035. Members are served under both all-requirements and partial requirements power sales agreements.

Solid Financials Underpin Rating: Consolidated financial metrics are sound and remain generally in line with rating category medians. Debt service coverage was 1.28x in 2015 and overall liquidity, which has increased significantly over the past few years, was strong at 264 days. Financial projections show modest weakening for both coverage and liquidity through 2018 before rebounding to around 2015 levels in 2019.

State Regulatory Oversight: The Arizona Corporation Commission (ACC) regulates the rates and financing plans of most Arizona-based electric utilities, including AEPCO and five of its members. While rate regulation is uncommon for public power utilities and raises some concerns regarding rate flexibility, this risk is partially addressed by the ACC's recent adoption of a streamlined rate process for cooperatives and historically supportive treatment of AEPCO.

Flexible Rate Structure: AEPCO's rate structure, approved by the ACC, is a credit positive and offsets some concerns regarding the rate-regulated environment. Rate adjustors are in place to recover costs related to purchased power and fuel, environmental compliance, and transmission costs, reducing potential lags in recovering costs.

Coal Based Power Supply: AEPCO is heavily dependent on its two coal-fired load-following units at the Apache Power Generation Station (Apache), which are increasingly pressured by environmental regulations. These units plus entitled hydro capacity provide baseload power to all members while the all-requirement members' peaking needs are met through AEPCO's natural gas-fired generation or economic power purchases.

Environmental Regulation Compliance Costs: Capital compliance costs required to meet the Environmental Protection Agency's (EPA) haze emissions standards are manageable, although power costs are expected to rise as one of AEPCO's primary coal-fired units is permanently switched to natural gas by the end of 2017. The EPA's Clean Power Plan could present challenges to AEPCO and its continued reliance on the remaining coal-fired unit.

Relatively Low Debt Burden: Debt metrics compare favorably to similarly rated entities. Debt levels are projected to remain relatively low, as management plans to gradually reduce overall debt over the next several years.

Rating Sensitivities

Failure to Sustain Metrics: AEPCO's rating could be negatively affected if they are unable to sustain metrics consistent with 'A' rating category medians as a result of environmental cost pressures, less supportive rate regulation, or a significant drop in energy sales.

Rating History

Rating	Action	Outlook/ Watch	Date
A–	Assigned	Stable	5/23/16

Credit Profile

AEPCO is a wholesale generation and transmission cooperative that serves six member-owners located throughout Arizona and parts of California and New Mexico. Members are retail distribution rural electric cooperatives that serve a largely residential and non-concentrated customer base with a combined meter count of approximately 151,672. Member power sales contracts are joint and several, take-or-pay contracts that extend to Dec. 31, 2035.

Governance and Management Strategy

Organizational Structure and Trust Indenture Process

AEPCO's organizational structure recently changed when AEPCO formally merged its generation operations with its related, stand-alone transmission provider, Southwest Transmission Cooperative (SWTC), effective March 1, 2016. The combined entity will operate under the AEPCO name. The merger effectively reversed the cooperative's actions in 2001, undertaken to prepare for potential industry deregulation, to separate the organization into three entities based on business operation. The third entity, Sierra Southwest Cooperative Services (Sierra), which provided the staffing and administrative services to the other business, remains a separate entity but all staffing agreements have been terminated and all employees have been transferred to AEPCO. AEPCO, in its current form, and Sierra, along with the three previous entities, are referred to as the Arizona Generation and Transmission Cooperatives (Arizona's G&T Cooperatives or the cooperatives).

The cooperatives elected to pursue the merger in conjunction with their participation in the Rural Utility Services (RUS) trust indenture process. Management expects that the merger will benefit members due to the increased size and asset base, enhanced efficiency of operations, and more timely and effective decision making from the single, unified board. Adoption of the RUS trust indenture, to replace their more traditional RUS loan contracts and mortgages, will also benefit the cooperative by providing wider access to capital, including nongovernmental lenders and public capital markets. The indenture was formally recognized and established on March 1, 2016 in conjunction with the merger.

Leadership and Management

AEPCO is governed by a single board of directors with equal representation from all Class A members. Daily operations are under the direction of CEO Patrick Ledger. Mr. Ledger was appointed CEO in early 2011 by the boards of AEPCO, SWTC, and Sierra after serving in various management roles for the three cooperatives since 2002. Mr. Ledger is joined by an 11-member management team. Fitch Ratings views AEPCO's management team positively given its significant cumulative experience, tenure with the organization, and the demonstrated improvements in working relationships with the cooperative's members.

Related Criteria

Revenue-Supported Rating Criteria (June 2014)

U.S. Public Power Rating Criteria (May 2015)

AEPCO's Members

AEPCO has six class A member-owners and three class D members. The class A members all have joint and several, take-or-pay power sales agreements with AEPCO that expire on Dec. 31, 2035. Each of these members has an allocated capacity in AEPCO's base generation resources that was established to facilitate the movement of certain members to partial-requirements from all-requirements power sales agreements. The individual members are listed in the *AEPCO's Class A Members* table on page 3.

AEPCO's Class D members, Valley Electric Association, Central Arizona Water Conservation District, and Southwest Public Power Agency, do not have power sales agreements with AEPCO but instead receive scheduling and trading services along with economic energy purchases. Contracts extend for a minimum of two years and are renewed annually until terminated by either party with six months' notice.

AEPCO's Class A Members

Member	Partial or All Requirements	Allocated Capacity (%)	Primary Service Territory
Anza Electric Cooperative (Anza)	All Requirements	2.5	Riverside County, California
Duncan Valley Electric Cooperative (DVEC)	All Requirements	1.3	Graham and Greenlee Counties, Arizona & Grant and Hidalgo Counties, New Mexico
Graham County Electric Cooperative (GCEC)	All Requirements	7.6	Graham County, Arizona
Mohave Electric Cooperative (MEC)	Partial Requirements	35.8	Mohave, Coconino, and Yavapai Counties, Arizona
Sulphur Springs Valley Electric Cooperative (SSVEC)	Partial Requirements	31.7	Cochise, Graham, Pima, and Santa Cruz Counties, Arizona
Trico Electric Cooperative (TEC)	Partial Requirements	21.1	Pima, Pinal, and Santa Cruz Counties, Arizona

Source: AEPCO.

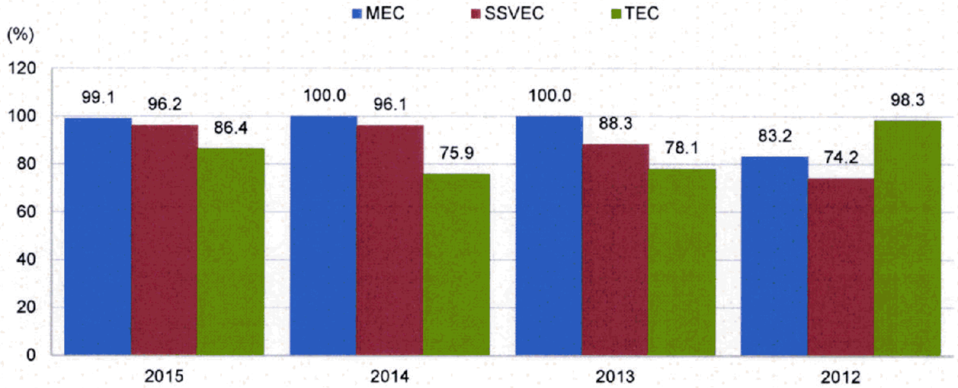
AEPCO provides scheduling and trading services to all of its class A and D members through its equity ownership in ACES. ACES's regional headquarters is co-located with AEPCO. Fitch views AEPCO's participation with ACES's positively given the level of risk management, trading control, portfolio modeling, and other services provided by the organization.

Movement to Partial Requirements

AEPCO's three largest members negotiated changes in their power sales agreements to partial requirements from all requirements to take advantage of more economic sources of power. The first member to do so was Mohave Electric Cooperative (MEC, 2001), followed by Sulphur Springs Valley Electric Cooperative (SSVEC, 2008) and Trico Electric Cooperative (TEC, 2011). However, business relations with the partial requirements members remain sound and all three have returned to AEPCO for scheduling and trading services.

AEPCO has primarily focused on maintaining its current asset base following the movement of some members to partial requirements. The relatively stable load profile of the remaining all-requirement members, together with the limited obligation to meet the needs of partial requirements members, has reduced the need for additional generation resources. AEPCO continues to provide the majority of its partial requirements members' power supply.

Percentage of kWhs Provided by AEPCO to Partial Requirement Members



Source: AEPCO, Fitch Ratings.

New Resources to be Project Based

The restructured power sales contracts include provisions that allow AEPCO to acquire additional resources following approval from a super-majority of the board of directors (75%) and approval from either 75% or 100% of the class A members, depending on the projected impact of the new resource on AEPCO's equity and credit commitment. All class A members will have the ability to participate in new resources at an amount of their discretion and will not be bound by their allocated base capacity amounts. This project-based model provides members and AEPCO with additional flexibility to tailor resources to match particular needs.

Future resource development and acquisition will be guided by AEPCO's recently completed strategic resource plan. While no major new resources are envisioned in the immediate future, management stated that a solar project — 6 MW–12 MW depending on member participation and approval — may be developed on permitted land in close proximity to Apache station. Additionally, attractive opportunities to acquire already built and operational generation assets could be acted upon, pending member approval and interest.

Customer Profile and Service Area

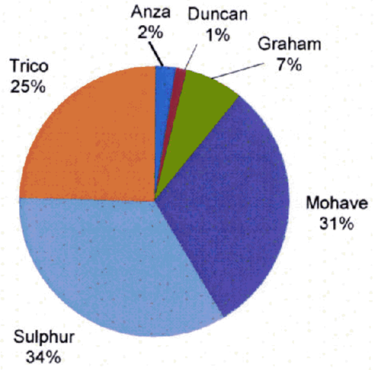
AEPCO's sales are largely to member-owners, which accounted for 79% and 84% of MWh sales in 2015 and 2014, respectively. While not reliant on wholesale sales, AEPCO sells into the market when opportunities are available with members receiving a credit for the margin earned. Sales statistics measure AEPCO's sales under each member's allocated capacity, and do not include purchases to meet partial requirement member needs in excess of their allocated capacity. The three partial requirements members account for the vast majority of AEPCO's load and revenues.

Sales Information

(%)	2015	2014	2013	2012
Total Electric Sales (MWh)	3,061,910	3,192,218	2,726,675	2,277,773
Member Sales as Percentage of Total Sales	82	86	93	96
Total Sales Growth	(4.1)	17.1	19.7	(7.2)
Sales to Members Growth	(8.7)	8.5	16.5	(6.5)

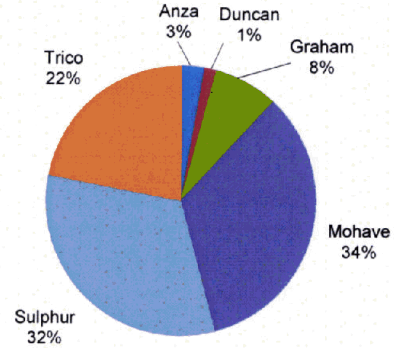
Source: AEPCO.

AEPCO's 2015 Electric MWh Sales By Class A Member



Source: AEPCO, Fitch Ratings.

AEPCO's 2015 Electric Revenues By Class A Member



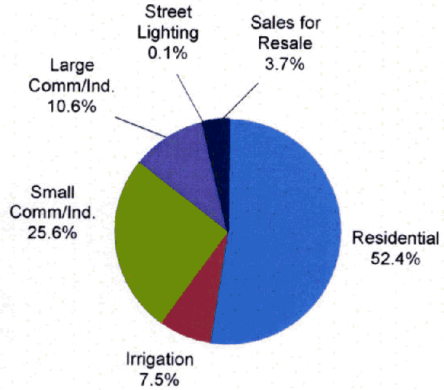
Source: AEPCO, Fitch Ratings.

Member Profile

AEPCO provides wholesale electric service to six distribution cooperatives located throughout Arizona and in portions of California and New Mexico. The six cooperatives serve a large and disperse geographical area and provide retail electric service to approximately 151,672 meters. The distribution cooperatives' customer base is mostly residential, accounting for approximately 88% of total meters in 2015. However, energy sales and revenues are more evenly split by the various customer categories. Positively, the residential customer class makes up the majority of MWh sales (52.4%) and revenues (57.3%) among the members.

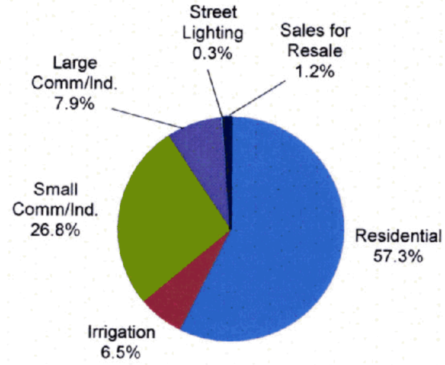
Member cooperatives largely serve rural to semi-urban areas, which are likely to lag behind regional metro centers in terms of economic growth and activity. Current and future load growth is expected to largely occur within the service territories of the partial requirements members.

MWh Sales by Customer Class
(2015)



Source: AEPCO, Fitch Ratings.

Revenues by Customer Class
(2015)



Source: AEPCO, Fitch Ratings.

Assets and Operations

Power Supply

AEPCO's total summertime capacity of 794.8 MW (2015) is sufficient to serve the system's peak demand of 552.2 MW (2015). Generation resources consist of both directly owned capacity and resources contracted through long-term purchase power agreements, particularly in the summer months when AEPCO's load experiences a sharp peak. AEPCO actively purchases power against its owned capacity when economically advantageous.

Base resources, which supply power to all class A members, consist of AEPCO's two largest generating units, ST2 and ST3, and federal hydropower agreements. ST2 and ST3, which are located at Apache, are capable of running on both coal and natural gas but have largely run on coal since their construction. Both units are considered to be aging, having been built in the late 1970s, but have maintained solid operating performance as shown in the *Apache Operating Performance* table below.

Apache Operating Performance

Unit	Year Built	Net Capacity (MW)	Fuel	Equivalent Availability Factor 2015	Net Capacity Factor 2015
ST1	1963	72	Gas	99.8	2.7
ST2	1978	175	Coal/Gas	87.5	55.0
ST3	1979	175	Coal/Gas	92.7	63.0
GT1	1964	10	Gas	48.6	1.1
GT2	1972	20	Gas/Oil	99.9	0.0
GT3	1975	65	Gas	96.9	0.7
GT4	2002	38	Gas/Oil	78.1	7.1

Source: AEPCO.

AEPCO's contracted power supply from federal hydro resources includes two contracts with the Western Area Power Administration (Western). Capacity and energy under the contracts vary by year and season, with increased allocations during the summer months relative to winter. The first contract, which entitles AEPCO to capacity and energy from the Parker and Davis Dams on the lower Colorado River, expires at the end of September 2024. The second entitles AEPCO to capacity and energy from the Salt Lake City Integrated Projects and expires at the end of September 2028.

Non-base resources largely consist of AEPCO's directly owned natural gas peaking units and purchase power agreements. These resources primarily serve to meet all-requirement members' peaking needs.

AEPCO participates in the Southwest Reserve Sharing Group to meet WECC-established reserve requirements. The group provides sufficient capacity and energy to cover the potential loss of either ST2 or ST3 for the first hour following an outage.

Fuel Purchases and Hedging

AEPCO's purchases the bulk of its expected coal needs through three-year rolling contracts, although some spot purchases are conducted when needed or when conditions are favorable.

AEPCO hedges the expected gas supply needs for its all-requirements members and will also hedge the expected needs of its partial-requirements members on a pass-through basis, if requested. Gas needs following the permanent conversion of ST2 are expected to be met through supply obtained from the nearby El Paso natural gas pipeline. The contract with El Paso for gas transportation lasts for 10 years, expiring in November 2024. AEPCO has 14 agreements in place for physical gas purchases and four ISDA agreements in place for financial gas hedging.

EPA Haze Regulation

The EPA approved AEPCO's revised plan to comply with haze emission regulations affecting Apache in 2015. The plan, which was developed through significant negotiations with the EPA, requires AEPCO to make approximately $23.6 million in capital compliance investments and convert ST2 to run solely on natural gas by the end of 2017. Although the plan is likely to result in increased operating and power costs, Fitch views the accepted plan and related costs as manageable.

Clean Power Plan

The EPA's Clean Power Plan and Arizona's state implementation plan could have significant effects on AEPCO and the cost of power to its members. Management stated that discussions have been positive with both EPA and Arizona Department of Environmental Quality with both parties reportedly receptive to options for accommodating smaller, rural utilities like AEPCO and its members.

Cost and Rate Structure

Rate Regulation

The ACC regulates the rates and financings of AEPCO and five of the cooperative's six members. AEPCO's relationship with the elected, five-member ACC is reportedly productive and the most recent rate case, which proposed a rate decrease, was approved by the commission in 2013.

Rate regulation is uncommon for public power utilities and Fitch views the additional level of review and approval cautiously as delays or unfavorable rulings could limit the utility's ability to recapture costs in a full and timely manner. Positively, the ACC appears to be moving toward greater support of cooperatives, as it adopted a new rate streamlining process for utility cooperatives in 2013 that is expected to provide a quicker and less costly means to incrementally raise rates (up to 6%) between major rate cases.

AEPCO's Rate Structure

AEPCO's wholesale rates are broken down into fixed charges, operations and management (O&M) charges, a base energy rate, and other energy charges. Fixed and O&M costs are assigned based on each Class A member's allocated capacity. Energy rates are determined by the Class A member's participation in the respective resources, with the base energy rate including generation from AEPCO's coal fired resources and allocated energy from Western and the other energy rate including AEPCO's non-base resources. The base and other energy rates include fuel cost adjustors that are adjusted semiannually. The ACC has a 30-day period to review adjustments. Management reports that the ACC has not challenged the adjustment in at least the last seven years.

Power sales contracts with all-requirements and partial requirements members include provisions for an unlimited step-up in the event of another member's payment default. The nonpayment amount would be included in future O&M charges, to the extent the nonpayment amount corresponded to O&M expenses, and the remainder — including energy charges — would be included as a fixed charge and apportioned to the remaining members based on their allocated capacity.

Environmental Compliance Adjustment Rider

The ACC approved AEPCO's request to apply a surcharge to members to recoup environmental related costs, including capex and ongoing operations costs required to meet the environmental mandates. The surcharge, called the Environmental Compliance Adjustment Rider, is viewed as a credit strength given the potential costs of complying with current and future environmental mandates.

Rate Competitiveness

Management's future rate plans are uncertain given the unknown outcome of the Clean Power Plan.

Member's retail rates are notably higher than AEPCO's wholesale rates, reflecting the costs of serving less populated, rural areas. The *Average Retail Rate for AEPCO Members and Arizona* table below provides the average residential price (cents/kWh) for AEPCO's members in 2014.

Average Retail Rate for AEPCO Members and Arizona

MEC	Arizona State Average	SSVEC	TEC	GVEC	Anza	DVEC
9.75	9.91	11.78	12.93	11.47	17.98	11.3

MEC – Mohave Electric Cooperative. SSVEC – Sulphur Springs Valley Electric Cooperative. TEC – Trico Electric Cooperative. GVEC – Graham County Electric Cooperative. Anza – Anza Electric Cooperative. DVEC – Duncan Valley Electric Cooperative.
Source: EIA, AEPCO.

Financial Performance

Management provided a pro forma of AEPCO's and SWTC's historical financial performance on a consolidated basis. Financial metrics are generally in line with similarly rated wholesale utilities, including generation and transmission cooperatives. Debt service coverage exhibits some annual volatility, with a recent low of 1.28x in 2015 and a high of 1.50x in 2013, but has averaged a sound 1.38x from 2011 to 2015.

Liquidity levels are solid as management has made increasing cash and obtaining additional lines of credit part of its cash flow management strategy. At the end of 2015, AEPCO and SWTC's consolidated balance sheet reported 83 days cash on hand, marking a significant increase from 29 days in 2011 and reflecting improved operating margins, reduced capital spending and fuel purchases, and unspent loan proceeds. In addition, the ACC approved AEPCO's request to enter into two separate bilateral committed lines of credit for $50 million each with CoBank and CFC, of which $15 million was outstanding at the end of 2015. AEPCO and SWTC's consolidated liquidity levels rise to approximately 264 days in 2015 including lines of credit.

AEPCO and SWTC's Consolidated Financial Metrics

	2011	2012	2013	2014	2015
Days Cash on Hand	29	21	96	78	83
Debt Service Coverage (x)	1.4	1.4	1.5	1.3	1.3

Source: AEPCO, Fitch Ratings.

Current financial projections reflect an anticipated decrease in debt service coverage over the next several years to around 1.20x, which is comparatively low, but acceptable for the current rating.

Debt and Capital Structure

AEPCO and SWTC's consolidated equity/capitalization ratio has been steadily increasing over the past five years, rising to 31% in 2015 compared with 21.9% in 2010. Management's financial projections show this trend continuing through 2021 when equity/capitalization is expected to reach 42.8%.

AEPCO and SWTC's total outstanding debt has fluctuated over the past five years, but shows a gradual downward trend with approximately $267.4 million outstanding at the end of 2015. Of that amount, approximately 10.8% was unhedged, variable rate debt. Leverage ratios are relatively low for the rating and are projected to remain low as management increasingly funds capital spending with cash and gradually reduces its debt load.

The utility's capital improvement plan for 2016–2022 totals $81.8 million. Environmental compliance costs, generation maintenance and renewal, and transmission improvements are the most significant expenses. Approximately 87% of the capital plan is expected to be debt-financed. However, debt issuances are expected to be less than annual retirements, resulting in a net decrease in leverage. The outcome of the EPA's Clean Power Plan and Arizona's state implementation plan could significantly alter the capital investment program, but the impact is unknown.

Member Cooperatives

The consolidated financial profile of AEPCO's class A members has incrementally improved over the past several years and is viewed as supportive of AEPCO's rating. Consolidated net operating margins were $13.7 million in 2015 on revenues of $281.2 million, resulting in debt service coverage of 1.80x. Liquidity levels have remained relatively low, but stable with an ending 2015 balance of $11.7 million or 17.5 days cash on hand. Equity levels have improved, rising to 49.1% in 2015 compared with 41.1% in 2010. Consolidated results over the past five years are presented in the *Aggregated Financial Metrics of AEPCO Members* table below.

Aggregated Financial Metrics of AEPCO Members

($ 000)	2015	2014	2013	2012	2011
Operating Revenues	281,233	306,011	304,999	300,082	298,454
Net Operating Margin	13,678	19,444	9,164	9,920	5,473
Debt Service Coverage (x)	1.80	2.07	1.66	1.72	1.58
Long-term Debt	345,795	354,544	365,929	353,637	345,368
Equity/Capitalization (%)	49.1	46.8	43.9	43.5	42.1
Available Cash	11,742	18,396	10,494	10,641	12,189
Days Cash on Hand	17.5	25.4	14	14.4	16.3

Source: AEPCO, Fitch Ratings.

The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.