MEMORANDUM

To: Utah Public Service Commission

From: Division of Public Utilities

Thad LeVar, Acting Director
Artie Powell, Manager, Energy Section
Charles Peterson, Technical Consultant
Douglas D. Wheelwright, Utility Analyst

Subject: Application of Garkane Energy Cooperative, Inc. for Authority to Issue Securities, Docket No. 10-028-02.

Date: December 23, 2010

RECOMMENDATIONS (Approval)

The Division recommends that the Commission authorize Garkane to issue securities in the form of a Secured Promissory Note in the amount of $15,000,000 and to execute a Loan Agreement with the National Rural Utilities Cooperative Finance Corporation ("CFC") as requested.

ISSUE

Garkane Energy Cooperative, Inc. (Garkane, or the Company) requests authorization to issue securities in the form of a Secured Promissory Note and Loan Agreement. The aggregate commitment amount with CFC is $15,000,000 and represents a long term financing facility for financing a portion of the Company's capital improvements. Within the aggregate commitment amount, the Company may execute one or more Notes, each representing a separate loan with CFC. Each advance under the loan facility may be structured with either a fixed or variable interest rate and may have a maturity date of up to forty (40) years. The commitment allows for individual notes to be requested for five years from the date of approval (Draw Period) and will be used to facilitate future long-term financing needs for capital projects. The Loan Facility will be secured by a first-lien mortgage on the Company's electric system assets. A similar request was approved by the Commission November 2, 2007, under Docket No. 07-028-01. With the recent addition of the customers in Colorado City, this request is also being submitted to the Arizona Commission for approval.

DISCUSSION

This $15 million commitment is a request for additional debt with CFC. The Company has utilized this type of financing with CFC and funded $6.4 million in new loans during 2007, $6.0 million in 2008 and $3.0 million in 2009. For the period 2007 through October 2010, the Company added $13.5 million to the Net Plant & Equipment but only added $6.5 million to its total long term debt obligations. The Company has existing long term debt obligations of $32.5 million represented by 32 individual notes financed with CFC. The board of directors of the Cooperative reviewed and approved the transaction in a meeting held November 29, 2010.

Information used in the Division's analysis included the Application and Attachments 1 – 4, filed with the Commission, along with the audited annual financial reports for Garkane Energy Cooperative, Inc. for 2005 through 2009 and interim financial information through October 2010. In addition, the Company provided the 2010 Work Plan Project Summary which identified 22 capital projects to be completed in the next few years. The Division has had discussions with Stan Chappell, Finance Manager, for Garkane Energy regarding certain details of the application and questions concerning the financial statements of the Company.

<u>Historical Results</u>

A summary of Garkane's financial results for January 2005 through October 2010 along with the calculated financial ratios are presented in Exhibit 1. The Company struggled in 2008 with lower margins and high maintenance expenses but responded with rate increases in August 2008 and July 2009. The historical income statements on page 1 indicate an average increase in total revenue of 9.55% annually from $14.4 million in 2005 to $20.7 million in 2009. Operating expenses have grown at a slower rate than revenues, rising from $12.3 million in 2005 to $17.0 million in 2009, for an 8.39% annual growth rate. This can be partially attributed to reduced costs for propane and lower transmission and distribution maintenance expenses.

Earnings from operations increased at 15.85% annually for the period under review. Net margin before any return of patrons' capital showed a dramatic increase of 32.54%. This is due primarily to the $1.7 million gain on the sale of assets in 2009. This was a one-time event that resulted from the sale of a transmission line that runs from Colorado City to Hurricane to PacifiCorp. Excluding this one item, the net margin grew at an annual rate of 15.30%, which is consistent with the operational growth rate and historical averages.

The balance sheet information on page 2 shows that net plant and equipment has been increasing each year since 2005 at an average annual rate of 12.16% and stands at $56.8 million. Additional plant assets are primarily from distribution and transmission upgrades. Construction on some of these projects is slow and is being delayed due to environmental issues in the national parks and on federal lands. The 2010 Work Plan identifies 22 individual projects with an estimated remaining cost of $11.5 million and will be spread over several years. The Cash and Equivalents account is down as of year-end 2009 but has returned to historical levels in 2010. Total Current assets have been increasing at an average annual rate of 4.79%. In July 2009 the Company completed the purchase of the Twin Cities Power System (Colorado City and Hilldale) for $3.0 million. In September the Company sold a portion of the 69kv line acquired to Rocky Mountain Power for $3.1 million but retained the other purchased assets. This transaction resulted in a gain of $1.7 million since only a portion of the assets were sold. The acquisition added approximately 1,100 retail customers and resulted in a significant increase in Accounts Receivable. The purchase of these assets was approved by the Commission in June 2009 (Docket No. 09-028-03).

Total equity has increased at a slower rate than total assets with an annual growth rate of 7.67%, while long-term debt grew at 12.71%. Current maturities of long-term debt showed a 20.29% increase from $0.6 million in 2005 to $1.3 million in 2009. Total liabilities grew from $24.9 million to $41.2 million for an annual increase of 13.33%. The Company did not refund patrons capital in 2008 or 2009 but has approved a refund of $500,000 for 2010.

Page 4 of Exhibit 1 sets forth financial ratios for 2006 through 2010. The Long-term Solvency ratios for year end 2009 remain strong and are near the historical averages. Profitability and margin ratios are distorted due to the large gain on the sale of assets mentioned above. Excluding that event from the calculations, the net margin and profitability ratios are above the historical averages. The revised Net Margin is calculated at 10.86% compared to the average of 8.16%. The revised Return on Total Capital was 7.26%, up from the historical average of 6.62%. The revised Debt Service ratio is calculated at 2.15 down slightly from the 2.21 average, but is substantially higher than the 1.35 required by the CFC Loan Agreement. The Capital Structure was not affected by the gain and indicates Long-Term Debt at 55.85% and Equity at 44.15%.

It appears that the Company has been able to meet its current obligations and is generally healthy. The proposed loan request will allow the Company to fund a portion of its planned capital improvements. The Company has been able to meet this obligation in the past and should be able to do so in the future. Exhibit 2 is a five year forecast that includes the additional capital improvements along with the additional debt.   Based on the projections, it appears that the Company will be able to meet its debt obligations and maintain ratios similar to historical levels.

CONCLUSIONS

The Division has not attempted to evaluate the reasonableness of the legal terms and conditions of the financial transaction. The Division bases its recommendation for approval on the following factors.

1. The Board of Directors approved the application during the November 29, 2010 meeting.
2. Garkane's use of loan funds has been for lawful purposes consistent with the executed loan documents.
3. The Company has the ability to raise customer charges, if necessary, in order to meet its financial obligations.
4. Based upon the historical financial statements it appears that Garkane has been financially stable for the past five years and has been able to meet its obligations.
5. Projections identified in Exhibit 2 indicate that the Company has the ability to service the proposed additional debt.

Based upon these considerations, the Division recommends that the Commission approve the Application of Garkane Energy Cooperative, Inc. for Authority to Issue Securities, Docket No. 10-028-02.

cc: Carl R. Albrecht, CEO, Garkane Energy Cooperative, Inc.
Stan Chapell, Finance Manager, Garkane Energy Cooperative, Inc.
Michelle Beck, Committee of Consumer Services
Cheryl Murray, Committee of Consumer Services