State of Utah
Department of Commerce
Division of Public Utilities

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MEMORANDUM

To: Utah Public Service Commission

From: Division of Public Utilities

Chris Parker, Director
Artie Powell, Manager, Energy Section
Charles Peterson, Technical Consultant
Douglas D. Wheelwright, Utility Analyst

Subject: Application of Empire Electric Association, Inc. for Authority to Issue Securities, Docket No. 11-025-01.

Date: January 19, 2011

RECOMMENDATIONS (Approval)

The Division recommends that the Commission approve the request and authorize Empire to issue securities in the form of $42,174,000 in additional debt obligations. The new debt will be financed with the Federal Financing Bank ("FFB") with the guarantee of the Rural Utility Services ("RUS").

ISSUE

Empire Electric Association, Inc. (Empire, or the Company) requests authorization for authority to issue securities in the form of a secured debt obligation. The amount to be financed is $42,174,000 which will be used for the construction of transmission and distribution facilities and for a new headquarters facility. The new debt will be issued by the Federal Financing Bank ("FFB") with the guarantee of the United States of America, acting by and through the Administrator of the Rural Utility Services ("RUS"). The new credit facility will allow the

Company to obtain financing for capital improvement projects until November 1, 2015. Individual notes can be structured with either fixed or variable interest rates with repayment terms of up to 34 years. The loan will be secured under a supplemental Mortgage dated November 10, 2010 in supplement to the Restated Mortgage and Security Agreement dated August 1, 2007.

DISCUSSION

Information used in the Division's analysis included the Company's application with exhibits 1 – 6, along with the audited annual financial reports for Empire Electric Association, Inc. for 2004 through 2009. In addition, the Company provided the current RUS Form 7, which included interim financial information through November 2010. The Company has provided additional cost estimates and loan budget information for the proposed projects along with a 4 year work plan. The Division has had discussions with Mary Thiesing, Accounting Manager of Empire, regarding certain details of the prospective loan, questions regarding the historical financial statements and the projections included in the application. The proposed loan was approved by the board of directors on November 19, 2010, under Resolution 13-2010. A copy of the board meeting minutes has been included with this analysis.

The proposed loan will be used to finance a number of identified projects included in the 4 year work plan and the RUS Cost Estimate and Loan Budget. In general, the $42.2 million will be used as follows; $27.3 million in distribution projects, $12.7 million for a new Company headquarters facility and $2.2 million for transmission projects. Information on the new headquarters facility is preliminary and the Company is reviewing possible changes that could reduce the total project cost.

The proposed loan facility will allow the Company to make multiple draw requests and can be structured with multiple notes of various maturities and interest rates. The draw period will be open until November 2015 to allow for individual project funding. Individual notes can be structured with repayment terms up to 34 years.

Exhibit 5 of the application is a forecast completed by SGS Engineering and was prepared to determine the Company's ability to service the existing and the proposed debt. This forecast includes financial projections through 2019 and makes a number of assumptions for expected revenue and expenses. While most of the assumptions used in the analysis appear to be consistent with historical information, a few concerns have been noted. For example, Line 14 assumes a rate increase every year beginning in 2011. This does not appear to be consistent with historical information and is not consistent with anticipated rate increases discussed with the Company. While it is likely a rate increase will be needed in future years, it is not anticipated that rate increases will take place every year . Additionally, Capital Credit retirement is projected to be 25% of the prior year margins and averages $1.2 million per year through 2019. This amount is almost twice as large as the 5 year historical average of $746 thousand and is more than the annual amount budgeted by the Company.

The proposed debt will have a significant impact on the balance sheet and the income of the Company. If the loan is fully funded, long term debt could increase from $30.7 million to approximately $70.0 million and could more than double the interest expense. The proposed loan would significantly change the capital structure and reduce common equity from 54.8% to 44.7% based on the projections provided. While this is a significant change, it is within the lending guidelines and required loan covenants.

<u>Historical Results</u>

Empire Electric's 3,410 square-mile service territory includes all of Montezuma County and parts of Dolores and San Miguel counties in Colorado and part of San Juan County in Utah. Empire distributes electricity purchased from Tri-State Generation and Transmission Association, a not-for-profit cooperative. Tri-State also generates and transmits power for 43 other member cooperatives scattered across the states of Colorado, Nebraska, New Mexico, and Wyoming.

Exhibit 1 is a summary of the audited financial results for 2006 through 2009 and interim financial results through November 2010. Audited financial information for 2010 will not be available until approximately April 2011.

The income statement on page 1 indicates that total revenue increased 11.28% annually from $30.1 million in 2005 to an estimated $54.4 million in 2010. Operating expenses have grown at a faster rate than revenues, rising from $27.7 million in 2005 to an estimated $44.1 million for 2010, for an 11.69% annual increase. This increase is driven primarily by an increase in the cost of purchased power, which has increased at 13.5% annually. The Company indicated that the increase in cost is due to increased load requirements from their largest customer, Kinder Morgan, and is not due to a rate increase by Tri-State Generation. The Operating Margin before Capital Credits showed an increase of 6.3% and has averaged $1.5 million for the previous 5 years under review. Capital Credits received primarily from Tri State have averaged $3.9 million for the previous 5 years and are estimated to be $2.9 million for 2010. Including the Capital Credits, the net margin grew from $2.4 million to $2.9 million for a 7.29% annual increase.

The balance sheet information on page 2 shows that the Cash and Equivalents account has averaged $2.6 million for the 5 years under review and stands at $2.3 million for 2010. Total current assets have seen a slight increase of 3.46% with the largest increase noted in Accounts Receivable which grew at 12.24%. Receivables have come down from $4.4 million in 2009 to $3.7 million in 2010. Net plant and equipment has been increasing each year since 2005 at an average annual rate of 7.89% from $31.6 to $46.2 million. Additional plant assets are coming from replacement of existing overhead lines with underground lines and the replacement of older equipment. Equities in other organizations increased from $20.1 to $34.7 million and represent 39.4% of the total Company assets. The majority of these equities consist of Capital Credits from Tri-State G & T Association, Inc. for $29.6 million, $2.6 million in PathNet Fiber Network and $0.8 million in FastTrack Communications. The investments represent minority interest in the two communication companies and shared ownership of Tri-State with other utilities.

While Total Assets grew at 8.83%, Long-term debt grew at a slower rate of 4.72% and total liabilities at 4.52%. Contributed Patrons Capital increased from $26.2 million in 2005 to $48.4 million in 2010 for a 13.05% annual increase. Due to the strong cash and equity position, the Company was able to refund capital to members in each of the years under review. For 2009, the Company refunded $735,502 and has approved a $900,000 refund for 2010.

Page 3 of Exhibit 1 sets forth financial ratios for 2006 through 2010. The Long-term Solvency and Profitability ratios for 2010 remain strong and are near historical averages. Net Operating Margin stands at 3.32%, down slightly from the average of 3.55%. However, Net Margin including Capital Credits is 13.37% compared to the 12.40% average. Return on Equity is strong at 12.96% for 2010, down from the 14.27% 5 year average. The Capital Structure calculates Long-Term Debt at 38.47% and Equity at 61.53%. The Operating Debt Service Covenant ratio (ODSC) is calculated at 3.21 for 2010 and compares favorably to the historical average of 1.98 and is above the 1.1 required in the loan covenants. The Operating Times Interest ratio (OTIER) is calculated at 2.07 for 2010 and is above the historical average of 1.96 and the 1.25 required in the loan covenants.

Exhibit 2 is the projected income statement and balance sheet calculations which are based on the historical financial information and include the proposed loan and capital improvements. The projections assume a general rate increase in 2012 and have been included to coincide with the anticipated rate increase from Tri-State Generation. Return of Patronage Capital has been projected at $1.0 million per year and matches the maximum amount budgeted by the Company. Capital expenditures and debt obligations have been included based on the 4 year work plan provided by the Company.

Based on the historical information, it appears that the Company is generally healthy and has been able to meet its current obligations. The projections indicate that the Company should be able to meet its future debt obligations including the proposed loan and should be able to stay within the loan covenants required by the lender.

CONCLUSIONS

The Company, which has total access to financial information about its operations and budgets, has conducted an evaluation and concluded that this transaction is beneficial. The lender, FFB has conducted an evaluation and concluded that the collateral is acceptable and the cash flow is adequate to service the additional debt obligation. The Division has not attempted to evaluate the reasonableness of the terms and conditions of financial transaction and has based its recommendation for approval on the following factors.

1. The Board of Directors has approved the proposed transaction during the November 19, 2010 meeting.

2. Empire's use of loan funds will be 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. Attached as Exhibit 1, are financial statements of the Company for the years 2006 through November 2010. Based upon these financial statements it appears the Empire has been financially stable for the past five years and has been able to meet its financial obligations.

Based upon these considerations, the Division recommends that the Commission approve the Application of Empire Electric Association, Inc. for Authority to Issue Securities, Docket No. 11-025-01.

cc: Neal E. Stephens, General Manager, Empire Electric Association, Inc.
Mary Thiesing, Accounting Manager, Empire Electric Association, Inc.
Michelle Beck, Committee of Consumer Services
Cheryl Murray, Committee of Consumer Services