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Division of Public Utilities

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MEMORANDUM

To: Utah Public Service Commission

From: Division of Public Utilities

Philip J. Powlick, Director
Artie Powell, Manager, Energy Section
Marlin Barrow, Technical Consultant
Charles Peterson, Technical Consultant
Kasi Boede, Intern

Subject: Application of Deseret Generation & Transmission Co-Operative for Authority to Issue Securities in the Form of Secured Promissory Note to National Rural Utilities Cooperative Finance Corporation, Docket No. 09-506-01.

Date: June 2, 2009

ISSUE

Deseret Generation & Transmission Co-Operative (DG&T, Deseret, or the Company) requests authorization for authority to issue securities in the form of a promissory note to the National Rural Utilities Cooperative Finance Corporation (CFC) for approximately $10 million pursuant to R746-110.

RECOMMENDATION (APPROVE)

The Division recommends that the Commission authorize Deseret the authority to issue securities in the form of a promissory note to the CFC for approximately $10 million dollars.

DISCUSSION

Information used in the Division's analysis included: Annual Reports of Deseret for years ending December 31, 2005 through December 31, 2008; financial statements of the Company for the three months ending March 30, 2009; attachments filed by the Company with the Application including "Schedule 1" (details of loan), "Funds Requisition Statement" and "Secured Promissory Note" as well as the Company's forecasting model "Model 62.1.". The Division issued several data requests that were answered either through e-mail or through conference calls primarily with Robert Dalley, the Company's CFO.

<u>Background</u>

Deseret has faced severe financial difficulties in the past, leading to a series of arrangements for restructuring and recapitalizing the Company's indebtedness. The last such restructuring occurred within the 1996 to 1998 time frame and resulted in an agreement with CFC known as the Obligations Restructuring Agreement (ORA). Deseret depends on CFC as a primary source of financial support. The CFC is structured as a co-op. Deseret is one of several hundred members of CFC. The structure of CFC directly relates to its reliance on capital from its members for its financing.

Due to the current economic downturn, CFC has called on its members for support in strengthening its balance sheet through the issuance of subordinated member certificates that will count as equity on its balance sheet. According to Robert Dalley, these certificates are similar to preferred stock in a regular, for-profit corporation. Deseret has elected to support CFC by purchasing these member securities. In order to replace the cash used to purchase the CFC certificates, Deseret has chosen to finance the purchase of these member certificates through a promissory note to CFC instead of using cash on hand in order to maintain liquidity and flexibility for anticipated future cash needs. The financing is via a promissory note in the amount of $10 million with a maturity date of December 31, 2025. Deseret can decide between fixed and variable interest rates. The Division has assumed the current fixed rate offered by CFC for a seventeen year loan in its analyses.

The Company has significant cash balances totaling about $64 million as of March 31, 2009. However, much of this cash is restricted, and the Company will be needing cash for its May 2009 overhaul of its Bonanza plant, upgrades on its transmission line and equipment for its coal mine in Colorado. In addition, Deseret anticipates that it will be required to contribute significant sums for work done on its 25 percent owned Hunter II plant. The Company also believes it is prudent to hold cash balances for unforeseen events as well as day-to-day operations.

Historical Financial Results

Exhibit 1 sets forth the audited consolidated historical financial results for 2005 through 2008 for the income statement and balance sheet. First quarter ended March 31, 2009 data are also included.

The income statement shows revenues on average increased by 7.92% from $215,084,261 in 2005 to $270,371,704 in 2008. Operating expenses grew from $192,324,727 in 2005 to $239,199,803 in 2008, which results in 7.54% growth. This shows that for the historical period examined, revenues grew at a higher rate than expenses. Interest expense declined at a rate of -7.46% annually over 2005 to 2008. This was due to a decrease in long-term debt from $326,347,462 in 2005 to $285,644,886 in 2008. Net income had a fluctuating trend that resulted from the 2-year cycle of maintenance expense and nonmember revenues. Net income increases from ($4,957,859) in 2005 to $10,839,905 in 2006, then decreases to ($9,743,591) in 2007 and increases to $7,816,259 in 2008.

The balance sheet information shows that the Cash and Equivalents have increased dramatically from 2005 to 2008 going from $24,009,879 to $64,967,922. This is due to the sale of SO_2 allowances of over $25 million and undistributed members' funds that are being held at the Company. However, total current assets have increased by only ten percent annually from 2005 to 2008. The heavy increase in cash was counteracted by a decrease in all other current assets.

Net plant and equipment remained fairly constant from 2005 to 2008, increasing 0.90%. Total assets decreased by over three and a half percent annually from 2005 to 2008.

Current liabilities decreased, as opposed to growth in current assets, at a little over 2 percent annually. Long-term debt at the same time has shown a significant decrease at an average annual rate of -4.34%. Total liabilities declined at a yearly rate of -3.88% from 2005 to 2008. Patronage equity increased at an average rate of 0.20% during the 2005 to 2008 period, climbing to a balance of nearly $93.3 million; the March 31, 2009 patronage capital balance increased to $107.2 million primarily due to the relatively large net income amount reported. Patronage equity includes retained earnings and additional capital contributions from patrons less return of capital to patrons.

The Company's current ratio[1] has varied annually, but overall increased from 2005 to 2008 from 2.84 to 4.02 respectively. The Company's quick ratio[2] averaged 2.58 in the given time period. Long-term solvency ratios appear to have generally been flat or slightly improving throughout the time period examined. Times interest earned alternated during the 2005 to 2008 period starting at 0.65, increasing to 1.40, then declining to 0.54, and ending at 1.56 for 2008. Aside from sales-to-cash ratio, asset utilization ratios appear to have been increasing between 2005 and 2008.

However, profitability ratios follow the same 2-year fluctuating cycle as net income.
They drop off in 2007 compared to 2006, then improve significantly for 2008, but worsen in the annualized March 2009 data. One reason the Company keeps relatively high cash balances is to cover these maintenance cycles.

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[1] Current ratio is current assets divided by current liabilities. It is a measure of a company's ability to satisfy its cash needs over the coming twelve months.
[2] Quick ratio is cash plus accounts receivable divided by current liabilities. It is a more stringent measure of a company's ability to satisfy its cash needs over the coming twelve months.

Financial statement data for the first quarter ending March 2009 were also considered. Annualizing the income statement suggests that total revenues for 2009 will drop to $253.3 million compared to more than $270.3 million in 2008. Operating expenses also decrease in 2009, which will cause annualized earnings from operations to increase to about $41.0 million in 2009 compared with $31.2 million in 2008. Perhaps more significant is that the annualized net income for 2009 amounts to $55.7 million. This annualized net income, which would be significantly higher than the net income of the recent past if it actually occurs, is driven by higher operating margins and a significant increase in equity in the income of DG&T's mining subsidiary. However, at this time the Division views this annualized 2009 income to be unlikely given the historical patterns, and the Company's own Model 62 forecast[3]. The balance sheet for March 31, 2009 shows nothing remarkable in comparison with previous years except for a transfer of cash to other current assets and construction work in progress.

The above historical analysis is limited and covers primarily only the most recent four complete years and the first three months of 2009. Based upon this information, Deseret appears to have been a barely profitable company. By structure DG&T is a not-for-profit co-op and is "upstream" from its six owner/members, which are also not-for-profit co-op electric power retailers. The revenues received from its member co-ops can be controlled according to Deseret's cash flow needs, therefore it is likely that over a period of several years, the Company will cover its operating and debt service cash flow needs and show little net profit. Therefore, the Division believes that Deseret should be able to maintain the cash flow and minimal profitability it needs, and by doing so, it appears that the Company would be able to issue $10 million in securities in the form of secured promissory notes, while simultaneously investing in interest-paying CFC capital securities which should cover most of the additional interest expense of the loan.

[3] Model 62 (or Model 62.1) has its origins in the financial restructurings of the late 1990s. The model's primary purpose is to show the CFC that Deseret will likely be able to continue to meet its debt obligations. The model was last updated in February 2008, and is consequently somewhat outdated now.

Forecast 2009 to 2018

The Division prepared forecasts based on historical data from 2005 to 2008. It also utilized annualized data from March 2009 financial statements and the Model 62.1 forecast given to the Division by the Company. In the future (see Model 62.1), the Company anticipates a number of likely developments that will require additional cash to pay for construction work in progress. The Quadra Mines, served by Deseret member Wells Rural Electric are expected to be depleted in about eight years resulting in a drop in demand for power from Deseret. In 2011, Chevron has indicated to Moon Lake Electric, one of Deseret's members that it expects operations to decline, which could also result in a loss of revenues to the Company. This information was used in creating this year's forecasts along with the 2008 information from the Company.

To better look at the impact of future financial possibilities and the $10 million proposal, the Division prepared two financial forecasts. The first forecast assumes that Deseret remains as it is and does not issue $10 million in securities. This "status quo" forecast is shown in Exhibit 2. The second forecast, shown in Exhibit 3, assumes the $10 million in securities are issued in the form of a secured promissory note. In Exhibit 3, $10 million was added as promissory note debt, and about $862,000 for interest expense calculated by using the CFC fixed interest rate of 8.50%[4] for 17 year loan. However, it was countered with $10 million in CFC certificates, and $750,000 in expected interest based on the CFC member capital securities rate of 7.5%.

Because of the recent recession and future slowing economy, the Division adjusted revenues, cost of purchased power, and operating and maintenance expenses. Operating and maintenance expenses were also adjusted by alternating +/- $5,000,000 for the 2-year maintenance cycle. The Division also added $6,000,000 to other expenses to offset the reported equity earnings reported for the 1st quarter. The Company already has a surplus of cash, therefore cash and equivalents were assumed to stay constant. Plant and service was adjusted in 2011 for the prospective Hunter II upgrade. The Company lumps current portion of LTD with long-term debt, so there is

[4] CFC offers fixed rates on loans based upon a 360-day year; variable rates on loans are calculated on a 365-day year.

no current portion shown. The Division has assumed that the Company's forecast and rates reported by CFC are accurate as of the dates given.

Based on these assumptions, the forecast indicates that Deseret should be able to handle the $10 million promissory note to issue securities. Both forecasts indicate a positive net income for every year except for 2009 and 2012. Profitability ratios are positive, fairly stable, and differ little in both forecasts. For example, the average return on equity for the entire forecast period is 4.43 percent in Exhibit 2, the case without the loan, and 4.34 percent in Exhibit 3, the scenario with the loan.

The Division has not attempted to evaluate the reasonableness of the terms and conditions of the financial transaction. The Division relied upon the company's own analysis and the analysis of the lender CFC. The Division based its recommendation for approval on the following factors:

A. While the Deseret has not demonstrated an absolute need for the loan, the Division believes that it is reasonable and in the public interest, especially in this time of financial and economic uncertainty, for the Company to help sustain the balance sheet of its primary lender of which the Company is also a member-owner. Consequently, the purchase of the CFC capital certificates is in the interest of the Company and in the public interest generally. Deseret is maintaining its near-term liquidity and flexibility by taking out a loan simultaneous with the purchase of the CFC member certificates. The net financial effect of this transaction appears to be minimal to the Company.

B. The Company, which has total access to financial information about its operations and budgets has conducted an evaluation in Model 62.1 and concluded that in a reasonable timeframe the promissory note can be paid in full.

C. The Company can use the interest earned on the CFC certificates to pay over 87% of the promissory note interest payments. Furthermore, the Company has ample cash on hand to make the payments to CFC

D. Attached as Exhibit 1, in 5 pages, are financial statements of the Company for the years 2005 through 2008. These financial statements are supplied to the Division on an annual basis. The Division has not performed a detailed financial analysis of the Company.

E. The two forecasts prepared by the Division suggest that the Company should be able to handle the $10 million promissory note, given that CFC certificates are purchased.

Based upon these considerations, the Division recommends that the Commission approve the Application of Deseret Power for authority to issue securities in the form of a secured promissory note to CFC for $10 million, Docket No. 09-506-01.

cc: David F. Crabtree, General Counsel, Deseret Generation & Transmission
Robert Dalley, Chief Financial Officer, Deseret Generation & Transmission
Michele Beck, Director, Office of Consumer Services