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

Philip J. Powlick, Director
Artie Powell, Manager, Energy Section
Marlin Barrow, Technical Consultant
Charles Peterson, Technical Consultant
Douglas D. Wheelwright, Utility Analyst

Subject: Application of Empire Electric Association, Inc. for Authority to Issue Securities, Docket No. 10-025-01.

Date: August 26, 2010

ISSUE

Empire Electric Association, Inc. (Empire, or the Company) requests authorization for authority to issue securities to refinance an existing debt obligation. The amount to be refinanced is $1,060,340 and is a portion of the outstanding long term debt to Rural Utility Services (RUS). The purpose of the refinance is to reduce the interest rate on this portion of the Company debt from 5.0% to 3.94%. It is estimated that this action will result in a reduction in interest costs of approximately $62,586 over the term of the loan.

RECOMMENDATIONS (Approval)

The Division recommends that the Commission authorize Empire to issue securities in the form of a nine year term note with National Rural Utilities Cooperative Finance Corporation (CFC) to refinance the existing debt obligation.

DISCUSSION

Information used in the Division's analysis included the filed application with exhibits 1 – 4, along with the audited annual financial reports for Empire Electric Association, Inc for 2004 through 2009. The Division has had discussions with Mary Thiesing, Accounting Manager of Empire, regarding certain details of the prospective loan and questions regarding the financial statements of the Company. The proposed refinance was approved by the board of directors on August 20, 2010. While it was not available as of the filing date, and a copy of the resolution has been provided by the Company and has been included with this analysis.

The existing loan was funded by the Federal Rural Utilities Service, Federal Financing Bank which is an agency of the U.S. Department of Agriculture and does not have any restrictions or prepayment penalties. This loan has been in place with RUS for approximately 15 years and was not part of the new debt to RUS that was approved by the Commission in 2007. The interest rate on the current debt obligation is 5.0%.

The Company was approached by CFC and offered a new loan with a fixed rate of 3.94%. The difference in the interest rate will result in a cost savings of $62,586 over the life of the loan with an additional $17,156 in patronage credits with CFC. Including the patronage credits, the Company has calculated the effective interest rate to be 3.69%. Item #3 on page 1 of the application incorrectly states that this refinance will reduce the cost by approximately $73,000 "**per year**" and should read "**over the term of the loan**". The proposed loan will require a new Promissory Note and will be secured under the Restated Mortgage and Security Agreement dated August 1, 2007.

Historical Results

Exhibit 1 is a summary of the audited financial results for 2005 through 2009 along with the calculated financial ratios. The income statement on page 1 indicates that total revenue increased 11.39% annually from $30.1 million in 2005 to $50.5 million in 2009. Operating expenses have grown at a faster rate than revenues, rising from $27.7 million in 2005 to $47.4

million in 2009, for a 12.15% annual growth rate. This increase is driven primarily by an increase in the cost of purchased power, which has increased at 14.09% annually. The Company indicated that the increase in cost is due to increased load requirement 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 a slight decrease of .96% but remained strong at $1.5 million for 2009. Capital Credits increased 22.75% during the period under review and grew from $2.2 million in 2005 to $4.5 million in 2009. Including the Capital Credits, the net margin grew at a faster rate than total revenue increasing from $3.4 million to $6.2 million for a 13.89% annual increase.

The balance sheet information on page 2 shows that the Cash and Equivalents account has been relatively steady and stands at $3.1 million as of December 2009. Overall, current assets have been increasing at an average annual rate of 8.0% with the largest increase noted in Accounts Receivable which grew at 15.21%. While the balance has increased, the Company has been successful in collecting the accounts with 29 days receivable in 2009 compared to the historical average of 27 days. Net plant and equipment has been increasing each year since 2005 at an average annual rate of 7.68% and stands at $44.4 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 total $35.0 million and represent 39.7% of the total 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 but shared ownership of Tri-State with other utilities.

Long-term debt grew at 4.63% and total liabilities at 5.34%. Contributed Patrons Capital increased from $26.2 million in 2005 to $47.7 million in 2009 for a 14.85% 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 and refunded $735,502 in 2009.

Page 3 of Exhibit 1 sets forth financial ratios for 2005 through 2009. The Long-term Solvency and Profitability ratios for year end 2009 remain strong and are near the historical averages. Net Operating Margin stands at 3.01%, down from the average of 3.90%. However, Net Margin including Capital Credits is 12.21% compared to the 12.00% average. Return on Equity is strong at 12.79% for 2009, down slightly from the 13.48% average. The Capital Structure indicates Long-Term Debt at 39.28% and Equity at 60.72%. The Debt Service Covenant ratio is calculated at 3.36 as of 2009 and above the 3.17 average. This is substantially higher than the 1.35 required by the CFC Loan Agreement.

It appears that the Company has been able to meet its current obligations and is generally healthy. The proposed loan will not add to the existing debt obligation and will slightly reduce the required interest payment. Since the Company has been able to meet this obligation in the past, they should be able to pay this obligation in the future.

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 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 August 20, 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, virtually at will in order to meet its financial obligations.

4. Attached as Exhibit 1, are financial statements of the Company for the years 2005 through 2009. The audited financial statements used to prepare this analysis are supplied to the Division on an annual basis. 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. 10-025-01.

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