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 Garkane Energy Cooperative, Inc. for Authority to Issue Securities, Docket No. 10-028-01.

Date: October 21, 2010

RECOMMENDATIONS (Approval)

The Division recommends that the Commission authorize Garkane to issue securities in the form of a Substituted Secured Promissory Note and an Amended and Restated Loan Agreement with 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 Substituted Secured Promissory Note and an Amended Loan Agreement. This request is related to a $4,500,000 long-term loan arrangement with National Rural Utilities Cooperative Finance Cooperative ("CFC") that was approved by the Commission January 27, 2000. (Docket No. 99-028-01) The original approval included a guarantee of payment by the Rural Utilities Service of the U. S. Department of Agriculture ("RUS"). This loan has four individual notes at 4.65% fixed interest with a current outstanding balance of $3.6

million. In 2009, Garkane requested and received approval from CFC to release RUS from its obligation. All advances were completed prior to the date of this modification and there was no change to the current interest rate or maturity. The Company did not bring this matter to the Commission and executed the Substitute Note and Amended Loan Agreement on April 22, 2009. This application seeks to rectify the oversight.

DISCUSSION

The Company has total debt obligations of $32.5 million represented by 32 individual notes financed with CFC. The $4.5 million loan being considered is the only portion that has the RUS guarantee and has been paid down to $3.6 million. While this loan represents only a small portion of the total debt, it creates an extra level of approval for all the debt. Any modifications to existing debt or requests for new financing must to be approved by RUS, even if it is not the guarantor.

The modification to the loan agreement and the release of the RUS guarantee was approved by the Garkane board of directors on April 22, 2009. Approval for the modification was not submitted to the Commission since the transaction was previously approved in 2000 and because there were no changes to the interest rate or loan amount. CFC has required that this modification be approved by the Commission so that it may be fully enforceable without being subject to any appeal or protest.

The Company has recently made application to CFC for an additional $15.0 million. It is anticipated that if this issue is approved, an application for the $15 million request will be submitted to the Utah and Arizona Commissions.

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. The Division has had discussions with Stan Chappell and David Crabtree from Garkane Energy regarding certain details of the application and questions concerning the financial statements of the Company.

<u>Historical Results</u>

Exhibit 1 is a summary of the audited financial results for 2005 through 2009 along with the calculated financial ratios. 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, indicates 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 to PacifiCorp of a transmission line that runs from Colorado City to Hurricane. 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 the net plant and equipment has been increasing each year since 2005 at an average annual rate of 12.16% and stands at $55.1 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 Cash and Equivalents account is down in 2009 but 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 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 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 13.64%. 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 is anticipated to resume payments in 2010.

Page 4 of Exhibit 1 sets forth financial ratios for 2005 through 2009. 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 modification and release of the RUS guarantee will not add to the existing debt obligation or change the interest rate. The Company has been able to meet this obligation in the past, and should be able to do so in the future. The Amended and Restated Loan Agreement and Substitute Promissory Note should have no effect on ratepayers and will not increase the interest cost to the Company.

CONCLUSIONS

CFC and the Company have negotiated and signed an agreement to maintain the current loan terms and release the RUS guarantee. 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. There has been no material change to the terms of the loan approved by the Commission January 27, 2000.
2. The Board of Directors approved the modification during the April 22, 2009 meeting.
3. The modified loan agreement was approved by the Company and CFC.
4. Garkane's use of loan funds has been for lawful purposes consistent with the executed loan documents.
5. The Company has the ability to raise customer charges, if necessary, virtually at will in order to meet its financial obligations.
6. Attached as Exhibit 1, are financial statements of the Company for the years 2005 through 2009. Based upon these financial statements it appears the Garkane 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 Garkane Energy Cooperative, Inc. for Authority to Issue Securities, Docket No. 10-028-01.

cc: Carl R. Albrecht, CEO, Garkane Energy Cooperative, Inc.
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Michelle Beck, Committee of Consumer Services
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