

**Financial Market and Capital Structure
Considerations In
Public Power Pricing Decisions**

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For

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Introduction

As the Salt River Project Agricultural Improvement and Power District (“SRP”) Board of Directors and Management approach the upcoming 2019 Price Process, they must again balance the desire to maintain SRP’s favorable electric prices, with the dual goals of preserving SRP’s financial strength and ensuring that future SRP customers continue to benefit from affordable, reliable electric energy. One of the primary challenges involved in establishing optimal pricing for electric energy has always been that of striking the balance between near-term customer affordability and long-term financial viability. Historically, this challenge has involved the tradeoff between the need for price increases that ensure financial strength against the desire to limit the effect of the price increases on customers.

Over the past four years, SRP has kept the base component of its pricing structure stable, while passing along fuel cost savings through temporary decreases in the Fuel and Purchased Power Adjustment Mechanism (“FPPAM”). In 2018, SRP’s Board of Directors approved two temporary FPPAM decreases: an \$18.8 million decrease that was effective for the 2018 May through October billing cycles, and an additional \$24.2 million decrease that became effective for the November 2018 through April 2019 period. Together, these temporary decreases were equivalent to an overall annual 1.5 percent system average decrease in bills.

For the 2019 Price Process, SRP management is proposing an overall 2.2 percent net decrease effective May 2019 for the beginning of SRP’s Fiscal Year 2020. The proposal retains and adds to the annual 1.5 percent temporary decrease approved for the Fiscal Year 2019 (May 2018 through April 2019). The proposed prices for Fiscal Year 2020 will be 3.7 percent lower than the prices approved by the Board during the last price process in Fiscal Year 2015 and 2.2 percent lower than the prices customers were charged in Fiscal Year 2019. The net 2.2 percent price decrease is the combinations of two components: a 1.7 percent base price increase, and a 3.9 percent FPPAM decrease. The base price increase and FPPAM decrease listed above are the percentage changes for those components relative to the total prices currently in effect. The numbers do not reflect the restructuring of the Environmental Programs Cost Adjustment Factor (“EPCAF”) which is being redistributed between the base price and FPPAM. This redistribution does not impact overall prices. The structure and amount of the

overall price decrease reflect: (1) a base price increase to partially pay for capital expenditures to keep up with economic growth and maintain reliability, and (2) a FPPAM decrease driven primarily by lower natural gas prices.

Utility Industry Change

An overall price decrease is a new and recent event for an SRP Price Process. However, the combination of higher base prices and lower fuel costs is contributing to lower overall prices for several utilities across the country. The decline in natural gas prices has enabled a subset of utilities, with access to gas-fired generation, to utilize the tailwinds of lower fuel prices to allow them to implement the base price increases needed to continue to recover fixed costs and retain financial strength.

Even though the 2019 Price Process results in an overall net decrease in prices, the “customer affordability versus financial viability” tradeoff remains an important factor in SRP’s Price Process decision. However, the 2019 Price Process will also have to consider the impact of several new utility industry trends and developments that have occurred since the last Price Process in 2015. The utility industry is very different than it was four years ago. Most industry experts expect as much or more change in the near future. The Price Process must take into account this change, and serve as a tool to ensure that SRP and its customers are positioned to take advantage of sweeping industry change.

Perhaps the most pervasive recent change in the utility industry has been the declining use, and reduced perceived value, of traditional baseload generating resources. The reasons for this change are multi-faceted and well-publicized. They include:

- The sharp and unrelenting national decline in load growth, even in otherwise healthy, fast-growing areas of the country,
- Uncertainty regarding the future of carbon emitting resources, as exemplified by the passage of SB100 in California that calls for an eventual transition to a net zero carbon electric utility industry in that State,
- Continued mandates and economic incentives for the deployment of non-dispatchable, intermittent renewable resources like wind and solar,
- The economic headwinds against coal-fired generation caused by lower pricing for gas-fired and renewable generation,
- Ongoing advances in battery storage technology, and
- Improving economic viability of behind-the-meter distributed generation and micro-grid technology.

For most of the nation's largest utilities – both investor-owned and public power – traditional central station generating assets have been a core component of their balance sheets for decades. As the perception and value of traditional utility assets changes rapidly, so does the concept of the optimal utility balance sheet. In the past, conventional utility assets were expected to have economic useful lives of 30 to 40 years. Utility assets were virtually assured of producing, transmitting and distributing energy for decades. They could be safely financed with long-term debt that was scheduled to be repaid over the full useful life of the assets. Most investor owned utilities (“IOUs”) would fund roughly half of their capital costs with debt. Municipal utilities enjoyed very low-cost, tax-exempt debt and often had balance sheets with well over 50% debt.

Utility Industry Response to Change

The dramatic change in the perceived value of traditional generating assets, and the industry-wide transition toward less carbon-intensive alternatives, have led many utilities to revise their historic approach to managing their balance sheets. Prudent financial management has always dictated that utility managers align their financial structures to their business dynamics and operating environments. Historically, the utility industry had an accepted financial model of funding long-term assets with a substantial amount of long-term debt. Debt retirement and debt service payments were typically structured to reflect the long-term value and use of the assets.

Most public power utilities employed a “mortgage style” debt service structure in which principal and interest were scheduled to produce roughly level annual total debt service payments. The result was that principal repayment in the early years was lower than in the later years, with annual principal payments increasing slowly over time as debt was paid off and interest payments declined and allowed for more principal repayment. Public power utilities typically use straight-line depreciation for large generating assets. This meant that roughly equal portions of the asset were depreciated and expensed each year. In the early years of an asset's life, the annual depreciation exceeded the annual principal payments. The asset book value would decline more quickly than debt was retired. All else equal, in the early years of an asset's life, the debt to assets ratio (debt divided by total assets) would increase as the depreciation exceeded debt repayment and asset value declined faster than debt was paid down. Typically, there is a crossover point in an asset's life when the annual principal payment catches up with the annual depreciation amount. This crossover point is often around 15-20

years into an asset's expected life. Many utilities have reached this point for a significant portion of their assets. The fact that principal payments have begun to exceed depreciation has allowed debt ratios to decline naturally – especially since there have not been significant amounts of new capital spent on large assets for many years. There are limited numbers of newer projects in the earlier stages of their life cycles that would counterbalance the older assets and their inherent declining debt ratios. This is one of the reasons we see a general decline in debt ratios in public power.

Another reason for declining debt ratios is that utilities are taking specific action with respect to certain of their assets whose value has declined even more quickly than their original depreciation schedules would have suggested. These utilities are revising and accelerating their debt repayment schedules to keep pace with declining asset values. Several public power entities have recognized the changing market value of their generating assets and revised their depreciation schedules for certain units. These utilities include Omaha Public Power District and JEA (formerly Jacksonville Electric Authority) who have closed some of their largest baseload generating facilities and taken significant write-downs on the value of those assets. In March 2017, SRP took a series of actions to address the uncertainty around the expected life of SRP's coal-fired facilities, and to transition to a more sustainable resource portfolio. The depreciable life of Springerville 4 and Coronado Generating Stations were shortened to 2030 and 2025, respectively, in order to facilitate a path toward a less carbon-intensive resource mix that will include more renewables supported by natural gas generating facilities. Shortening the expected useful lives of the generating units increased the annual depreciation expense for those generating units by approximately \$50 million per year. SRP's remaining coal assets, including Hayden, Craig and Four Corners Generating Stations, all have depreciable lives ending no later than 2025.

Following this decision, in November of 2017, SRP accelerated the retirement of debt associated with its coal-fired resources to better align the remaining outstanding debt with the decreasing book value of the assets. Action was taken to transfer \$25 million in funds from SRP's General Fund to an escrow account to provide for calling certain bonds at their earliest call date on January 1, 2019. Similarly, action was taken in Fiscal Year 2019 to repay just over \$9 million of outstanding bonds associated with the Navajo Generating Station with funds from SRP's General Fund. These actions move SRP toward maintaining a more prudent balance between assets and debt on SRP's balance sheet.

The debt ratio is one of the most commonly followed measures of public power financial health – with lower debt ratios seen as a sign of credit strength. Public power financial managers typically look to keep their debt ratios as low as they can “afford” within their available revenues. Debt ratios improve when there are sufficient customer revenues to pay down bond principal. Financial managers need to balance the prices paid by electric customers with the desire to have a balance sheet that is “attractive” to bond market investors and credit rating agencies. This traditional “tug of war” between the forces of near-term price competitiveness and long-term financial health has now been joined by the new dimension and forces of dramatic industry change. This change is affecting how utilities perceive debt and how they manage their balance sheets.

In addition to a long-standing desire to preserve and improve financial strength, many utilities are looking to the future and aligning their financial structures with the drastically changing nature of the utility industry. The change toward reduced reliance on traditional generating assets has led many utilities to explore ways to reduce the debt associated with these older assets. The energy needs previously satisfied by carbon-based generation are increasingly met by renewable resources, and these resources are increasingly obtained through power purchase agreements instead of asset ownership. Public power utilities are sourcing most of their new wind and solar resources through long-term Power Purchase Agreements (“PPAs”) with private developers who are better able to benefit from the Federal tax credits available for renewable owners. The tax credits enable private, for-profit renewable owners to bid aggressively on renewable requests for proposals issued by public power and convey some of the tax benefits to public power utilities via lower bid prices.

These PPAs are the predominate means by which public power utilities acquire low-cost and low-risk renewable resources. PPAs allow utilities to avoid the asset ownership and debt issuance associated with renewable resources. However, credit rating agencies and investment analysts recognize that PPA’s carry with them “debt-like” payment obligations that must be paid as an operating expense, and as an operating expense their payments are senior in priority to debt repayment. The PPAs are often “take and pay” in that if the power/energy is available from the resource, the purchaser must take and pay for the power/energy, even if it is not needed. In order to account for the debt-like nature of PPAs, certain of the credit rating agencies calculate a portion of the PPA payments and include them as debt and debt service when they calculate financial ratios. This debt-like treatment of PPA payments is relatively

new. Both Fitch Ratings and Standard & Poor's published new public power rating methodologies in the past year that include a portion of PPA payments in their debt metrics. Fitch treats roughly 30% of some PPA payments as debt-like. Standard & Poor's treats roughly 50% of PPA payments as debt-like. Neither Fitch nor S&P have applied their new methodology to a public credit rating of SRP. Based upon SRP projections provided to PFM, over the next several years SRP could accumulate annual PPA payments approaching \$300 million that could be incorporated into SRP's debt metrics by the rating agencies. The present value of these payments, assuming an average contract term of 20 years, would approach \$4 billion.

To the extent that either 30% or 50% of this \$4 billion amount is considered debt-like, it could add either \$1.3 billion or \$2.0 billion to the rating agencies' imputed debt balance for SRP. These figures would represent either 27% or 42%, respectively of SRP's current \$4.74 fiscal year end 2018 debt balance. That is not to say that SRP should consider these PPA payments to be debt, but it is important to note that financial analysts at the rating agencies are taking note of the magnitude of PPA payments that utilities are assuming, and how these contracts could affect bondholders who are in line behind PPAs in payment priority.

The combination of reduced investment in traditional generating assets, and the off-balance sheet acquisition of renewables, has led to a noticeable deleveraging of public power balance sheets across the country. The debt ratio for most large integrated (generation, transmission and distribution) public power utilities is declining. To demonstrate this fact, PFM has selected the following Peer Group of utilities for which to provide debt related data for comparison with SRP:

- Los Angeles (CA) Department of Water and Power – Power System (“LADWP”)
- City Public Service of San Antonio (TX) (“CPS”)
- Long Island Power Authority (NY) (“LIPA”)
- Omaha Public Power District (NE) (“OPPD”)
- JEA (formerly Jacksonville Electric Authority FL)
- Colorado Springs (CO) Utilities (“CSU”)
- Austin (TX) Energy (“AE”)
- Sacramento (CA) Municipal Utility District (“SMUD”)
- Orlando (FL) Utilities Commission (“OUC”)

These nine utilities, together with SRP, make up the ten largest fully integrated public power systems in the United States. There are many historical and situational differences between these utilities, such that their absolute levels of debt and debt ratios are quite different.

However, all but one share the fact that they have reduced their debt ratios over the past several years.

The following table provides asset, debt and the debt to asset percentages for SRP's large public power Peer Group. SRP's data is shown at the top of the table, with the nine Peer Group members listed after SRP in order of the amount by which their debt ratios declined in recent years.

Examples of Changing Debt Ratios Among Major Public Power Utilities

Salt River Project	<u>4/30/2014</u>	<u>4/30/2015</u>	<u>4/30/2016</u>	<u>4/30/2017</u>	<u>4/30/2018</u>	<u>Change</u>
Total Assets	11.42	11.78	12.38	12.66	13.13	
Debt and Leases	4.41	4.27	4.58	4.47	4.74	
Debt to Assets	38.6%	36.2%	37.0%	35.3%	36.1%	-2.5%
Sacramento Muni Util Dist	<u>12/31/2013</u>	<u>12/31/2014</u>	<u>12/31/2015</u>	<u>12/31/2016</u>	<u>12/31/2017</u>	<u>Change</u>
Total Assets	5.34	5.36	5.89	5.67	5.79	
Debt and Leases	3.08	2.88	2.67	2.67	2.47	
Debt to Assets	57.7%	53.7%	45.3%	47.1%	42.7%	-15.0%
JEA (Jacksonville, FL)	<u>9/30/2014</u>	<u>9/30/2015</u>	<u>9/30/2016</u>	<u>9/30/2017</u>	<u>9/30/2018</u>	<u>Change</u>
Total Assets	5.14	5.28	5.31	5.19	4.74	
Debt and Leases	3.43	3.19	3.05	2.75	2.45	
Debt to Assets	66.7%	60.4%	57.4%	53.0%	51.7%	-15.0%
Omaha Pub Pow Dist	<u>12/31/2013</u>	<u>12/31/2014</u>	<u>12/31/2015</u>	<u>12/31/2016</u>	<u>12/31/2017</u>	<u>Change</u>
Total Assets	4.45	4.91	5.43	5.44	5.50	
Debt and Leases	2.33	2.14	2.37	2.34	2.13	
Debt to Assets	52.4%	43.6%	43.6%	43.0%	38.7%	-13.6%
Orlando Util Comm	<u>9/30/2013</u>	<u>9/30/2014</u>	<u>9/30/2015</u>	<u>9/30/2016</u>	<u>9/30/2017</u>	<u>Change</u>
Total Assets	3.26	3.32	3.36	3.69	3.62	
Debt and Leases	1.58	1.58	1.63	1.57	1.48	
Debt to Assets	48.5%	47.6%	48.5%	42.5%	40.9%	-7.6%
Colorado Springs Util	<u>12/31/2013</u>	<u>12/31/2014</u>	<u>12/31/2015</u>	<u>12/31/2016</u>	<u>12/31/2017</u>	<u>Change</u>
Total Assets	4.31	4.44	4.55	4.55	4.61	
Debt and Leases	2.39	2.36	2.34	2.34	2.26	
Debt to Assets	55.4%	53.1%	51.5%	51.5%	49.1%	-6.3%
Austin Energy	<u>9/30/2013</u>	<u>9/30/2014</u>	<u>9/30/2015</u>	<u>9/30/2016</u>	<u>9/30/2017</u>	<u>Change</u>
Total Assets	3.85	3.86	4.23	4.40	4.47	
Debt and Leases	1.37	1.28	1.44	1.37	1.32	
Debt to Assets	35.6%	33.2%	34.0%	31.1%	29.5%	-6.1%
Long Island Power Auth	<u>12/31/2015</u>	<u>12/31/2016</u>	<u>12/31/2017</u>	<u>12/31/2018</u>	<u>12/31/2019</u>	<u>Change</u>
<i>LIPA restructured and moved several billion dollars of debt to a debt securitization affiliate. LIPA has since tracked debt to capitalization ratio. 2018 and 2019 are projected figures.</i>						
Debt to Capitalization	95.4%	91.1%	91.1%	91.2%	90.2%	-5.2%
Los Angeles Dept W&P	<u>6/30/2014</u>	<u>6/30/2015</u>	<u>6/30/2016</u>	<u>6/30/2017</u>	<u>6/30/2018</u>	<u>Change</u>
Total Assets	14.49	16.71	16.86	17.96	17.90	
Debt and Leases	7.94	8.67	8.94	9.27	9.51	
Debt to Assets	54.8%	51.9%	53.0%	51.6%	53.1%	-1.7%
San Antonio City Pub Serv	<u>1/31/2014</u>	<u>1/31/2015</u>	<u>1/31/2016</u>	<u>1/31/2017</u>	<u>1/31/2018</u>	<u>Change</u>
Total Assets	10.72	10.59	10.59	10.57	10.95	
Debt and Leases	5.49	5.50	5.77	5.54	5.64	
Debt to Assets	51.2%	51.9%	54.5%	52.4%	51.5%	0.3%

As the table indicates, almost every member of the public power Peer Group has reduced the amount of outstanding debt relative to its overall asset base. That average debt ratio reduction for the group is 7.2%. The asset-weighted average decline of the group is a debt ratio reduction of 5.3% over the period. SRP's debt ratio decline of 2.5% is roughly one-third that of the group average and roughly one-half that of the asset-weighted group average. The data and averages listed above do not prescribe a preferred "right amount" of debt reduction, or even imply that debt reduction is the right approach for every utility. It is, however, an interesting indicator of what has been occurring in the industry.

There are multiple factors that contribute to the nearly universal trait of declining debt ratios among the group. First, there is their position in the "debt amortization versus depreciation life cycle", and the fact that many utilities have reached the crossover point where debt retirement is exceeding depreciation on their older generating assets. Secondly, most of these utilities are also sourcing a meaningful amount of new energy through renewable Power Purchase Agreements as opposed to relying solely on building their own new generating assets.

Lastly, several of these utilities and others, have accelerated the pace of debt retirement beyond what they had expected five to ten years ago. They are doing this in response to specific assets that are no longer operating or whose value has declined, and to prepare for a future when their customers desire greater flexibility in their energy choices. SRP is one of several major public power utilities that are consciously reducing reliance on debt in reaction to the new utility market dynamics. The trend toward debt reduction is not only a reaction to recent developments, it is also an expectation that industry change will continue and perhaps accelerate.

SRP's 2019 Proposed Price Changes and Impacts

The overall 2.2 percent proposed reduction in prices will allow SRP to maintain its strong financial position and enhance its financial flexibility. In order to highlight the incremental impact of the 1.7 percent base price increase, SRP management has provided projections for two pricing scenarios – one in which there is no base price increase and only an FPPAM reduction of 3.9 percent, and the other in which the FPPAM reduction is accompanied by the 1.7 percent base price increase. The tables below provide the projected results for certain key financial metrics under each of these two scenarios.

Base Price Remains Unchanged, FPPAM Declines 3.9 %				
(\$ MILLIONS)	2019	2020	2021	2022
Combined Net Revenues	116	(53)	4	55
Funds Available for Corporate Purposes	674	500	578	645
Capital Expenditures	864	694	772	880
Debt Issuance	171	0	196	272
Debt Ratio	48.0%	47.4%	47.0%	46.9%
Debt Service Coverage Ratio	4.12 X	3.46 X	3.74 X	3.84 X

Base Price Increases 1.7% and FPPAM Declines 3.9% for 2.2% Net Decrease				
(\$ MILLIONS)	2019	2020	2021	2022
Combined Net Revenues	116	(2)	59	114
Funds Available for Corporate Purposes	674	550	632	703
Capital Expenditures	864	694	772	880
Debt Issuance	171	0	92	214
Debt Ratio	48.0%	47.2%	45.9%	45.3%
Debt Service Coverage Ratio	4.12 X	3.64 X	3.96 X	4.10 X

It is important to note that the debt ratio figure tracked by SRP is the Debt to Capitalization Ratio. It is a measure of Debt divided by Debt plus Net Capital, as opposed to the Debt to Total Assets Ratio that is calculated for the Peer Group comparison provided earlier in this Report. Neither ratio is necessarily better than the other. They both track debt as compared to the general size of the balance sheet. Any change over time for the Debt to Capitalization Ratio could be expected to be roughly equal to the change in Debt to Assets Ratio.

With SRP's proposed combined pricing action of 1.7 percent base price increase for a 2.2 percent overall net decrease, debt service coverage is projected to decline slightly, then return to current levels over the next several years. Projected debt service coverage would decline from 4.12X in FY 2019, to 3.64X in FY 2020, and then return to near current levels. Without any change in the base price, and only a 3.9 percent FPPAM decrease, SRP's debt service coverage would decline to 3.46X in FY 2020, and stay below current levels for the foreseeable future. The debt ratio would continue to decline under both scenarios, but predictably goes lower with the base price increase. Without the base price increase, the debt ratio is projected to go to 46.9% at the end of 2022. With the base price increase, that figure is slightly lower at 45.3%.

Neither of the scenarios outlined above presents the picture of a financially "troubled" utility. SRP's financial condition remains strong under either scenario. The proposed price increase, and the resulting favorable financial metrics will again send the message to the financial community that SRP continues to value credit strength and ratings. PFM expects that the

resulting metrics should be sufficient to preserve SRP's credit ratings, and its position as one of the premier credits in the tax-exempt bond market. With this, SRP can expect to continue to borrow at the lowest rates available to any municipal utility system.

Benefits of Declining Debt Ratios and Continued Credit Strength

SRP's current customers have affordable energy today because SRP has a history of making responsible decisions that strike the appropriate balance between competing near-term price pressures and long-term cost management. SRP has always funded its capital needs with a conservative balance of customer revenue and external debt financing; providing for the continued expectation of low prices and financial flexibility. Current customers derive the benefits of SRP's conservative debt management in multiple ways. The most obvious results of reduced reliance on debt in the past are SRP's reduced debt service obligations in the present. In addition, reduced debt translates to stronger financial metrics (e.g. liquidity, cash flow, debt ratios) that are carefully followed by credit rating analysts and investors. These metrics are the most important factors in determining a utility's credit ratings, and thus interest rate costs. SRP's interest rates on its prior financings were typically the lowest rates available at the time to any governmental utility borrower in the United States. SRP also has very low-cost revolving credit agreements to support its commercial paper program. Credit enhancement fees are a direct function of a utility's credit strength and ratings. SRP's current customers pay low rates today because previous pricing decisions have left SRP with less debt, and lower cost debt than other utilities.

SRP's 2019 Price Process will again have a direct impact on current customers. The 2019 Price process will also have a major impact on future customers. SRP has one of the largest projected capital plans of any public power utility – with over \$2.3 billion projected in the upcoming three year period between 2020 and 2022, and similar amounts likely after this period. SRP also has roughly \$2.5 billion of outstanding bonds that can be refinanced when they are eligible in the future to be called away from investors and potentially refinanced at lower rates. The bond series and the amounts of callable refinancing candidates are listed below. We have also provided an estimate of annual interest cost savings if the bonds could be refinanced at an average interest rate of 3.5%:

Series	Refundable Amount	Call Date	Est. Annual Interest Savings at 3.5%
2009B	\$ 4,925,000	1/1/2019	\$ 68,950
2010B	85,250,000	12/1/2020	1,193,500
2011A	321,295,000	12/1/2021	4,498,130
2012A	236,186,000	6/1/2022	3,306,604
2015A	172,035,000	12/1/2024	2,408,490
2015A	695,250,000	6/1/2025	9,733,500
2016A	530,735,000	1/1/2027	7,430,290
2017A	481,095,000	1/1/2028	6,735,330
Total	\$ 2,526,771,000		\$ 35,374,794

The average coupon on these outstanding bonds is close to 5.0%. Current market rates for comparable bonds are closer to 3.5%. If interest rates stay below 5%, and SRP maintains favorable credit ratings, there will be considerable refunding activity during the projection period. The future savings on these refinancing candidates will be a function of SRP's ability to preserve its credit strength and achieve favorable borrowing costs. SRP's pricing decisions can; (1) bolster its long-standing credit strength and deliver lower future capital costs and greater future refunding savings, and (2) position SRP's balance sheet to facilitate flexibility in preparation of further industry change.

Debt minimization and credit rating maximization are important, but they are not the most important objectives in SRP's pricing decisions. There are lesser-rated utilities that function adequately through a range of credit market conditions. It is likely that SRP could maintain its historically favorable credit ratings and be well-positioned to access the capital markets at very favorable interest rates under either of the pricing process scenarios detailed above. However, further debt reduction made possible by the 2019 Price Plan will position SRP to respond to ongoing industry change, and allow customers to benefit from innovation as opposed to being burdened by an outdated financial structure.

In the past, preserving and building credit strength has traditionally been a "defensive" strategy to preserve access to low-cost capital during even the most challenging market conditions. Capital market access is not the primary driving force behind the debt reduction strategies being employed by many major public power utilities. The reduced reliance on debt is more a

recognition that traditional asset values have declined considerably, and these assets are unlikely to be able to support large debt balances in the future. Financial managers are aligning debt to assets. They are looking to a future where change is expected to continue and financial flexibility afforded by lower debt balances will be an important factor in adapting to this change.

SRP and other utilities also face an industry transformation that could make it increasingly difficult to recover existing fixed costs – including debt service costs. Conservation and distributed/renewable generation technologies are changing the way utilities bring value to a growing number of customers. For many customers, the local utility will be supplying fewer kilowatt hours, yet still providing capacity and distribution services that are 100% essential to achieving the policy and economic objectives that are driving utility industry transformation. If SRP defers debt retirement, and continues to bear a high fixed cost burden associated with debt, the need to recover these costs may prevent customers from accessing new, “greener” and lower cost technologies.

Other Price Process Considerations

In December 2000, the SRP Board adopted five Pricing Principles that have guided the pricing of SRP’s electric service. Two of these Pricing Principles - Gradualism and Equity - relate directly to the task of balancing customer interests with the desire to maintain financial strength.

Gradualism recognizes the desire on the part of customers to have consistent, stable prices. There will be situations where unexpected, isolated costs arise – such as those related to a plant outage – and it will be reasonable for a utility to absorb these costs in the short run and allow financial metrics to deteriorate temporarily. The unexpected cost could be recovered over time with a slight adjustment, as opposed to a short-term, sharp price increase. Conversely, a permanent, systemic cost increase – for example, a carbon tax – may be more appropriate for immediate and full recovery via a price adjustment. Delaying the recovery would only require a more severe, or less gradual, price adjustment in the future.

The principle of Equity applies both to fairness between customer classes (e.g., residential vs. industrial), and to fairness between customer generations (past, present and future). SRP’s Board is tasked with protecting the value of SRP’s considerable resources and the low cost power they provide. SRP’s current competitive prices are a function of these valuable assets and the manner in which they have been financed over the years. SRP’s prices are competitive today because there was not a disproportionate reliance on debt to fund prior resource

investments. In the same fashion, future prices will reflect current resource and capital structure decisions. A good definition of Equity or fairness between past, present and future customers would appear to be preservation of SRP's balance sheet and its hard-earned capital structure. Today's customers benefit from a capital structure that was built by prices paid by past customers. The Pricing Principle of Equity would argue for pricing decisions that preserve SRP's balance sheet and capital strength so that future customers will benefit from a similarly competitive SRP pricing structure.

Based on PFM's review of SRP's Proposed Adjustments to SRP's Standard Electric Price Plans Dated December 20, 2018, it appears that the overall price adjustments will adequately recover costs and preserve SRP's capital strength and credit ratings. PFM recommends that SRP continue to emphasize the principles of Gradualism and Equity and maintain the capital strength you have built over many decades.

Conclusions

The proposed base price increase of 1.7 percent, and overall price decrease of 2.2 percent under consideration by SRP should preserve SRP's credit strength and provide SRP the financial flexibility to respond to the dramatic changes underway in the utility industry. SRP and its customers will be positioned to benefit from the recent and future changes. The proposed price increase will provide cash flow to cover debt service, contribute to SRP's considerable capital improvement program, and retire debt. The pricing action will send a message to the financial community that SRP is making decisions that will balance the needs of current customers with the goal of maintaining its strong financial condition.

PFM supports the price increase recommended by SRP Management. We further believe that adherence to the Pricing Principles is in SRP's long term best interests and will maintain SRP's position within the investment community and with the rating agencies. It will also provide future SRP customers an opportunity to benefit from the same comparative pricing advantage that SRP's current customers experience today.

PFM Financial Advisors as Provider of the Report

PFM Financial Advisors (“PFM”) provides a full range of financial and investment advisory services to state and local government entities throughout the United States. For the past five years, PFM has served as advisor on a larger par amount of debt financing for United States governmental entities than any other financial institution. PFM has roughly 650 employees in over 30 offices throughout the country. Ten of these professionals spend nearly all their time providing financial advice to electric utilities that are either owned, controlled, or somehow affiliated with state or local governmental jurisdictions. PFM currently provides financial advisory services to roughly 60% of the 50 largest public power utilities in the country, and to eight utilities in the 10 member Public Power Peer Group covered in the financial comparison. The following chart provides an indication of PFM’s position in the public power financial advisory sector.

50 Largest Public Power Entities by MWH Sold (2016) with PFM Clients Highlighted					
Rank	Public Power Entity	State	Rank	Public Power Entity	State
1	New York Power Authority	NY	26	Orlando Utilities Commission	FL
2	Salt River Project	AZ	27	Florida MPA	FL
3	CPS Energy	TX	28	North Carolina Eastern MPA	NC
4	Santee Cooper	SC	29	North Carolina MPA No. 1	NC
5	Los Angeles DWP	CA	30	Tacoma Public Utilities	WA
6	Nebraska Public Power District	NE	31	Indiana Municipal Power Agency	IN
7	Omaha Public Power District	NE	32	WPPI Energy	WI
8	Long Island Power Authority	NY	33	EPB -Chattanooga Electric Power Board	TN
9	Puerto Rico Electric Power Authority	PR	34	Knoxville Utilities Board	TN
10	Lower Colorado River Authority	TX	35	Clark Public Utilities	WA
11	Chelan County PUD No 1	WA	36	Missouri Joint Municipal Electric Commission	MO
12	Austin Energy	TX	37	Huntsville Utilities	AL
13	American Municipal Power, Inc	OH	38	PUD No 1 of Cowlitz County	WA
14	JEA	FL	39	Colorado Springs Utilities	CO
15	Memphis Light, Gas and Water	TN	40	California Department of Water Resources	CA
16	MEAG Power	GA	41	Lincoln Electric System	NE
17	Seattle City Light	WA	42	PUD No. 1 of Douglas County	WA
18	Sacramento Municipal Utility District	CA	43	Eugene Water & Electric Board	OR
19	Southern California Public Power Authority	CA	44	Illinois Municipal Electric Agency	IL
20	Nashville Electric Service	TN	45	Platte River Power Authority	CO
21	Energy Northwest	WA	46	City of Garland	TX
22	PUD No 2 of Grant County	WA	47	City Utilities of Springfield	MO
23	Grand River Dam Authority	OK	48	Northern California Power Agency	CA
24	PUD No 1 of Snohomish County	WA	49	Silicon Valley Power	CA
25	Intermountain Power Agency	UT	50	Imperial Irrigation District	CA

Source: 2018 American Public Power Association Public Power Annual Directory & Statistical Report

Definitions of Various Financial Metrics

Total Assets

Total Assets listed are generally for the most recent full fiscal year. The Total Assets figure provides a measure by which to compare the overall size of various utilities. In most cases, the major asset classes include; net plant, current assets (cash and receivables) and investments. In some cases there are utilities with “regulatory” or “recoverable” assets, which represent a valuation for the expectation of future revenues.

Long Term Debt

This category includes all debt expected to be repaid in more than one year. It includes conventional long-term debt, variable-rate debt, senior and subordinated debt. In some cases a utility will include capital lease obligations and other “debt-like” obligations.

Net Position

This “equity” measure for public power utilities is typically presented as accumulated net revenues or retained earnings in financial statements. It represents “profits” over time.

Debt to Asset Ratio

This figure is the percentage obtained by dividing the Debt number described above by the utility’s Assets. This is a good relative measure of leverage in comparing public power systems.

Debt to Capitalization Ratio

For this measure, Debt is divided by total Capitalization. Total Capitalization is defined as Debt plus the Net Position figure. The primary purpose of utilizing this measure, in addition to the Debt to Assets figure, is to adjust for accounting differences between utilities.

Debt Service Coverage

This is generally a measure of annual free cash flow available to cover annual debt service payments. Operating expenses are deducted from total revenue to arrive at an amount often referred to as Net Revenues. Net Revenues are divided by annual debt service to arrive at the amount by which Net Revenues “cover” annual debt service payments. It is perhaps the single most important metric by which the rating agencies measure year-to-year financial strength.