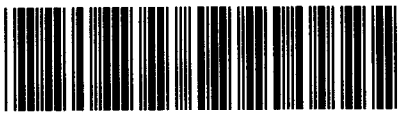


Control Number: 41527

Item Number: 2

Addendum StartPage: 0

DOCKET NO. 41527

APPLICATION OF SOUTH TEXAS ELECTRIC COOPERATIVE, INC. TO CHANGE RATES FOR WHOLESALE TRANSMISSION SERVICE (NON-IOU)	§ § § § §	PUBLIC UTILITY COMMISSION OF TEXAS

STATEMENT OF INTENT AND PETITION TO CHANGE SOUTH TEXAS ELECTRIC COOPERATIVE, INC.'S RATE FOR WHOLESALE TRANSMISSION SERVICE

MAY 30, 2013

DOCKET NO. 41527

APPLICATION OF SOUTH TEXAS ELECTRIC COOPERATIVE, INC. TO CHANGE RATES FOR WHOLESALE TRANSMISSION SERVICE (NON-IOU)	§ § § § §	PUBLIC UTILITY COMMISSION OF TEXAS

INDEX

VOLUME 1: PETITION AND TESTIMONY

VOLUME 2: NON-IOU TCOS RATE FILING PACKAGE

RATE FILING PACKAGE

WORKPAPERS

DOCKET NO. 41527

APPLICATION OF SOUTH TEXAS ELECTRIC COOPERATIVE, INC. TO CHANGE RATES FOR WHOLESALE TRANSMISSION SERVICE (NON-IOU)	§ § § § §	PUBLIC UTILITY COMMISSION OF TEXAS

STATEMENT OF INTENT AND PETITION OF
SOUTH TEXAS ELECTRIC COOPERATIVE, INC.
TO CHANGE ITS WHOLESALE TRANSMISSION RATES

Comes Now South Texas Electric Cooperative, Inc. (STEC) and files this Statement of Intent and Petition to Change its Wholesale Transmission Rates. In support thereof, it respectfully shows as follows:

I.

The Public Utility Commission of Texas (Commission) has exclusive original jurisdiction over the subject matter of this proceeding in accordance with the Public Utility Regulatory Act Chapter 35, Subchapter A.

II.

SUPPORTING APPLICATION AND TESTIMONY

In support of its Petition, STEC includes a completed NON-IOU Transmission Cost of Service Rate Filing Package's (TCOS RFP's) schedules and workpapers and the testimonies of Frances J. Nitschmann, Daniel M. Walker, and Cory J. Allen. The Application, schedules, workpapers, testimonies and exhibits fully support STEC's request for a change in its transmission rates.

III.

FACTUAL STATEMENT

In its Application, STEC seeks authority to increase its rate for wholesale transmission service within the Electric Reliability Council of Texas (ERCOT).

The proposed transmission rate will result in an increase to test year revenues of $13,113,641, an increase of 37.94% over the revenues approved in Docket 38509 in an interim rate filing in August, 2010. The current access-fee is $0.568/kw-per-year; the requested access-fee will be $0.722285/kw-per-year, a 27.16% increase.

STEC seeks to decrease its rate for distribution-level wholesale transmission service. Its current rate is $1.58/kw-per-month; the proposed new rate is $1.26429/kw-per-month, a decrease of 19.98%.

STEC also seeks to make changes to its tariff. The proposed tariff reflects the joining of Magic Valley Electric Cooperative and Medina Electric Cooperative as members of STEC and the affect their joining has on the counties STEC serves, STEC's offices, and the description of its system. It also includes updated rules and regulations governing STEC's service including a new Line and Service Extension Policy approved by the STEC Board Of Directors, which includes members representing each of its member distribution cooperatives.

The rate increase for wholesale-transmission service will affect all distribution service providers in ERCOT who pay transmission charges pursuant to the Commission's Substantive Rules. STEC's last transmission rate was approved in Docket No. 38569 in an interim rate filing in August 2010.

IV.

NOTICE TO AFFECTED PARTIES

STEC is providing notice of its Application to all transmission and distribution service providers listed on the Commission's transmission matrix in Docket No. 40946, *Commission Staff's Application to Set 2013 Wholesale*

Transmission Charges for the Electric Reliability of Texas. A copy of STEC's proposed Notice is appended hereto as Attachment A and a list of those entities served with notice is appended as Attachment B.

V.

STEC's designated representative for service of pleadings, orders and other correspondence is:

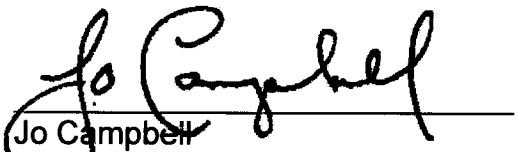
Jo Campbell
P.O. Box 154415
Waco, Texas 76715
jocampbell@stec.org
(254)-799-2978 (telephone)
(254) 799-2217 (fax)

VI.

CONCLUSION

Based on its Application and Supporting evidence, STEC respectfully requests its proposed TCOS, and the resulting rates and tariff be approved.

Respectfully submitted,



Jo Campbell
Attorney for STEC
State Bar No. 03707800
PO Box 154415
Waco, Texas 76715
(254) 799-2978
(254) 799-2217 (facsimile)
E-mail: jocampbell@stec.com

DOCKET NO. 41527

APPLICATION OF SOUTH TEXAS ELECTRIC COOPERATIVE, INC. TO CHANGE RATES FOR WHOLESALE TRANSMISSION SERVICE (NON-IOU)	§ § § § §	PUBLIC UTILITY COMMISSION OF TEXAS

NOTICE OF RATE CHANGE REQUEST

South Texas Electric Cooperative, Inc. (STEC) hereby provides notice that on May 30, 2013 it filed with the Public Utility Commission of Texas (Commission) its Petition and Statement of Intent to Change its Wholesale Transmission Rates, along with a completed Transmission Cost of Service Rate Filing Package (Application).

In its Application, STEC is proposing to increase its test year transmission revenues by $13,113,641, an increase of 37.94% over the revenues approved in Docket No. 38569 in an interim-rate filing in August 2010. STEC's transmission-access-fee within ERCOT will increase from $0.568/kw-per-year to $0.722285/kw-per-year. STEC seeks to decrease its rate for distribution-level wholesale transmission service. Its current rate is $1.58/kw-per-month; the proposed rate is $1.26429/kw-per-month, a decrease of 19.98%. The Application is based on the test year ending December 31, 2012.

Person's wishing to intervene or to comment on the Petition and Application should notify the Commission by July 15, 2013, which is the intervention deadline in this proceeding. A request to intervene should be mailed to the Public Utility Commission of Texas, P.O. Box 13326, Austin, Texas 78711-3326.

The Application can be inspected at the Commission's office, and may also be reviewed online on the Commission's website (www.puc.texas.gov). Further information may be obtained by calling the Commission's Office of Customer Protection at (512) 936-7120 or (888) 782-8477. Hearing and speech-impaired individuals with text telephones (TT&) may contact the Commission at (512) 936-7136.

A copy of this notice is being served on all transmission and distribution service providers listed on the Commission's transmission matrix in Docket No. 40946, *Commission Staff's Application to Set 2013 Wholesale transmission Service Charges for the Electric Reliability Council of Texas.*

DOCKET NO. 41527

APPLICATION OF SOUTH TEXAS ELECTRIC COOPERATIVE, INC. TO CHANGE RATES FOR WHOLESALE TRANSMISSION SERVICE (NON-IOU)	§ § § § § § §	PUBLIC UTILITY COMMISSION OF TEXAS

SERVICE LIST FOR NOTICE

Centerpoint Energy Houston Electric LLC
PO Box 4567
Houston, TX 77210-4567

Oncor Electric Delivery Cooperative. LLC
1601 Bryan Street, Suite 2305C
Dallas, TX 75201

Texas-New Mexico Power Co.
225 E. John Carpenter Fwy.
Suite 1500
Irving, TX 75062-2282

AEP Texas Central Company
225 E. John Carpenter Fwy Ste 1500
Irving, TX 75062-2282

AEP Texas North Company
1603 Laurie St.
Vernon, TX 76384-3907

Bandera Electric Cooperative Inc.
PO Box 200
Bartlett, TX 76511-0200

Bartlett Electric Cooperative Inc.
27492 Texas 97
Bartlett, TX 76511

Big Country Electric Cooperative Inc.
PO Box 518
Roby, TX 79543-0518

Bluebonnet Electric Cooperative Inc.
PO Box 729
Bastrop, TX 78602

Brazos Electric Power Cooperative Inc.
28015 West Highway84
McGregor, TX 76657

Central Texas Electric Cooperative Inc.
PO Box 553
Fredericksburg, TX 78624-0553

City of Bastrop
PO Box 427
Bastrop, TX 78602-9427

City of Bellville
30 South Holand
Bellville, TX 77418

City of Boerne
PO Box 1677
Boerne, TX 78006-6677

City of Brenham
PO Box 1059
Brenham, TX 77834

City of Bridgeport Municipal Electric System
900 Thompson Street
Bridgeport, TX 76426

City of Burnet
PO Box 1369
Burnet, TX 78611-1369

City of Cuero
PO Box 660
Cuero, TX 77954-0660

City of Flatonia
PO Box 329
Flatonia, TX 78941-0329

City of Fredericksburg
126 West Main Street
Fredericksburg, TX 78624

City of Georgetown
PO Box 409
Georgetown, TX 78627-0409

City of Giddings
118 East Richmond Street
Giddings, TX 78942

City of Goldthwaite
PO Box 450
Goldthwaite, TX 76844-0450

City of Gonzales
PO Box 547
Gonzales, TX 78629-0547

City of Hallettsville
101 North Main Street
Hallettsville, TX 77964

City of Hempstead
1125 Austin Street
Hempstead, TX 77445

City of LaGrange
155 E. Colorado St.
LaGrange, TX 78945

City of Lampasas
312 East Third Street
Lampasas, TX 76500

City of Lexington
PO Box 56
Lexington, TX 78947-0056

City of Llano
301 West Main
Llano, TX 78643

City of Lockhart
PO Box 239
Lockhart, TX 78644-0239

City of Luling
PO Box 630
Luling, TX 78648-0630

City of Mason
PO Box 68
Mason, TX 76856-0068

City of Moulton
PO Box 369
Moulton, TX 77975-0369

City of San Marcos
630 E. Hopkins
San Marcos, TX 78666

City of San Saba
PO Box 788
San Saba, TX 76877

City of Sanger
502 Elm
Sanger, TX 76266

City of Schulenburg
PO Box 8
Schulenburg, TX 78956

City of Seguin
205 N. River Street
Seguin, TX 78156

City of Seymour
201 N. Washington St.
Seymour, TX 76380

City of Shiner
802 N. Avenue E
Shiner, TX 77984-0802

City of Smithville
PO Box 449
Smithville, TX 78957

City of Waelder
PO Box 427
Waelder, TX 78959

City of Weimar
PO Box 427
Waelder, TX 78959

City of Whitesboro
PO Box 340
Whitesboro, TX 76273

City of Yoakum
PO Box 738
Yoakum, TX 77995

Coleman County Electric
Cooperative Inc.
PO Box 860
Coleman, TX 76834-0860

Comanche Electric Cooperative
Association
PO Box 720
Comanche, TX 76442

Concho Valley Electric Cooperative
Inc.
PO Box 3388
San Angelo, TX 76902

Cooke County Electric Cooperative
Association
PO Box 530
Muenster, TX 76352-0530

Deep East Texas Electric
Cooperative Inc.
PO Box 736
San Augustine, TX 75972

Denton County Electric Cooperative
dba Coserv Electric
7701 S. Stemmons Corinth
Denton, TX 76210

Fannin County Electric Cooperative
Inc.
1530 Silo Road
Bonham, TX 75418

Farmers Electric Cooperative Inc.
dba FEC Electric
PO Box 6037
Greenville, TX 75403

Fayette Electric Cooperative Inc.
357 N. Washington
LaGrange, TX 78945

Fort Belknap Electric Cooperative
Inc.
PO Box 486
Olney, TX 76374-0486

Granbury Municipal Utilities
116 W. Bridge St.
Granbury, TX 76048

Grayson Collin Electric Cooperative
Inc
PO Box 548
Van Alstyne, TX 75495

Guadalupe Valley Electric Cooperative Inc.
PO Box 118
Gonzales, TX 78629

Hamilton County Electric Cooperative
PO Box 753
Hamilton,TX 76531

Hillco Electric Cooperative Inc.
PO Box 127
Itasca, TX 76055-0127

Houston County Electric Cooperative
PO Box 52
Crockett, TX 75835

J A C Electric Cooperative Inc.
PO Box 278
Bluegrove, TX 76352-0278

Jasper Newton Electric, Cooperative Inc.
812 South Marharet Avenue
Kirbyville, TX 75956

Kerrville Public Utility Board
PO Box 911
Kerrville, TX 78029-0911

Lamar County Electric Cooperative dba LEC
PO Box 580
Paris, TX 75461-0580

Lighthouse Electric Cooperative
PO Box 600
Floydada, TX 79235-0600

Lyntegar Electric Cooperative Inc.
PO Box 970
Tahoka, TX 79373

Magic Valley Electric Cooperative Inc.
PO Box 267
Mercedes, TX 78570-0267

Mid South Electric Cooperative Association
7625 Hwy 6
Navasota, TX 77868-7478

Navarro County Electric Cooperative Inc.
PO Box 616
Corsicana, TX 75151-0616

Navasota Valley Electric Cooperative Inc.
PO Box 848
Franklin, TX 77856-0848

New Braunfels Utilities
PO Box 310289
New Braunfels, TX 78131-0289

Pedernales Electric Cooperative Inc.
PO Box 467
Johnson City, TX 78636-0467

Sam Houston Electric Cooperative Inc.
PO Box 1121
Livingston, TX 77351

San Bernard Electric Cooperative
PO Box 1208
Bellville, TX 77418-1208

South Plains Electric Cooperative Inc.
4727 S. Loop 289 Ste. 200
Lubbock, TX 79424

Southwest Texas Electric Cooperative Inc.
PO Box 677
El Dorado, TX 76936-0677

Tri County Electric Cooperative Inc.
600 NW Parkway
Azle, TX 76020

Trinity Valley Electric Cooperative
PO Box 888
Kaufman, TX 75142-0370

United Electric Cooperative Services Inc.
PO Box 16
Cleburne, TX 76033

Wise Electric Cooperative
1900 N. Trinity
Decatur, TX 76234

Brownsville Public Utilities Board
PO Box 3270
Brownsville, TX 78523-3270

Bryan Texas Utilities
PO Box 8000
Bryan, TX 77805

Cherokee County Electric Cooperative Association
11022 State Hwy. 64
Tyler, TX 75707-3437

City of Austin dba Austin Energy
721 Barton Springs Road
Austin, TX 78704-1194

City of Bowie
PO Box 1677
Bowie, TX 76230

City of Brady
PO Box 351
Brady,TX 76825

City of Coleman
PO Box 592
Coleman, TX 76834-0592

City of College Station
PO Box 9960
College Station, TX 77842-9960

City of Garland
200 N. 5th Street
Garland, TX 75040

City of Goldsmith
520 N. Goldsmith St.
Goldsmith, TX 79741-0629

City of Hearne Municipal Electric System
209 Cedar St.
Hearne, TX 77859

City of Robstown Utility System
101 E. Main Avenue
Robstown, TX 78380

CPS Energy
PO Box 1771
San Antonio, TX 78296

Denton Municipal Electric
215 E. McKinney St.
Denton, TX 76201

Geus
2810 Western Street
Greenville, TX 75401

Jackson Electric Cooperative Inc.
PO Box 1189
Edna, TX 77957-1189

Karnes Electric Cooperative Inc.
PO Box 7
Karnes City, TX 78118

Medina Electric Cooperative Inc.
PO Box 370
Hondo, TX 78861-0510

San Miguel Electric Cooperative Inc.
PO Box 280
Jourdanton, TX 78026-0280

San Patricio Electric Cooperative
6200 FM 3387
Christine, TX 78012

Sharyland Utilities LP
4403 W. Military Hwy.
McAllen, TX 78503-8837

South Texas Electric Cooperative Inc.
PO Box 19
Nursery, TX 77979

Victoria Electric Cooperative Inc.
PO Box 2178
Victoria, TX 77902

Weatherford Municipal Utility System
303 Palo Pinto Street
Weatherford, TX 76086

Wharton County Electric Cooperative Inc.
PO Box 31
El Campo, TX 77437

Rusk County Electric Cooperative
PO Box 1169
Henderson, TX 75653-1169

Hamilton County Electric Cooperative
PO Box 753
Hamilton, TX 76531

Taylor Electric Cooperative Inc.
Abilene
PO Box 250
Merkel, TX 79536

Rio Grande Electric Cooperative
PO Box 1509
Bracketville, TX 78832

Western Farmers Electric Cooperative
701 NE 7th
Anadarko, OK 73005

Houston County Electric Cooperative
TXU
PO Box 52
Crockett, TX 75835

Nueces Electric Cooperative Inc.
PO Box 1032
Robstown, TX 78380-1032

Wood County Electric Cooperative Inc.
PO Box 1827
Quitman, TX 75783

Cherokee County Electric Cooperative Association
(Coral Power As QSE)
PO Box 257
Rusk, TX 75785

Heart of Texas Electric Cooperative Inc.
PO Box 357
McGregor, TX 76657-0357

Trinity Valley Electric Cooperative
PO Box 888
Kaufman, TX 75142

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing Notice of Rate Change Request was served on all transmission and distribution service providers listed on the Commission's transmission matrix in Docket No. 40946 by first-class mail on this 30th day of May, 2013.

Becky Loredo

Becky Loredo
Secretary

GLOSSARY OF TERMS

4CP	The average of the highest ERCOT peak intervals in June, July, August, and September
A&G	Administrative and General
C361	Functionalization factor used to assign a portion of account 361 depreciation to transmission
C362	Functionalization factor used to assign a portion of account 362 depreciation to transmission
CFC	National Rural Utilities Cooperative Finance Corporation, a cooperative financing resource
CFR 1767	Code of Federal Regulations part; "Accounting Requirements for RUS Electric Borrowers"
CoBank	A national cooperative bank
DSC	Debt Service Coverage, a multiplying ratio used in calculating the rate-of-return
DWS	Distribution Level Wholesale Transmission Rate, the distribution rate schedule in STEC's tariff
ERCOT	Electric Reliability Council of Texas
FERC	Federal Energy Regulatory Commission
FFB	Federal Financing Bank, a US government corporation that provides financing
Fitch	Fitch Ratings, Inc., a financial rating agency
G&T	Generation and Transmission Cooperative
GNLPLT-N	Functionalization factor used to assign a portion of general plant maintenance to transmission
IOU	Investor-owned Utility
kV	kilovolt, 1 kV = 1,000 volts
Members	The eight electric distribution cooperatives that are represented on STEC's Board of Directors
Moody's	Moody's Investors Service, Inc., a financial rating agency
MW	megawatt
NCP	Non-coincident peak
NERC	North American Electric Reliability Corporation
O&M	Operations and Maintenance
PAYROLL	Functionalization factor used to assign a portion of payroll to transmission; not used by STEC
PAYXAG	Functionalization factor used to assign a portion of the administrative and general expenses to transmission

PLTSVC-N	Functionalization factor used to assign a portion of insurance cost to transmission
PLTSVC-NX	Functionalization factor used to assign a portion of property tax to transmission
PLTXGNL-N	Functionalization factor used to assign a portion of general plant to transmission
RUS	Rural Utility Services, a division of the US Department of Agriculture
S&P	Standard & Poor's Financial Services LLC, a financial rating agency
Schedules	Spreadsheet forms showing costs and expenses
STEC	South Texas Electric Cooperative, Inc.
TOMXFP	Functionalization factor used to assign a portion of general expenses to transmission
TCOS	Transmission Cost of Service
TCOS-RFP	Transmission Cost of Service Rate Filing Package for Non-Investor Owned Transmission Service Providers in the Electric Reliability Council of Texas
TIER	Times Interest Earned Ratio
TOTREV	Functionalization factor use to assign a portion of account 928 to transmission
Workpapers	Spreadsheets and other documents supporting the Schedules
WTS	Wholesale Transmission Service, the transmission rate schedule in STEC's tariff

DOCKET NO. 41527

APPLICATION OF SOUTH TEXAS ELECTRIC COOPERATIVE, INC. TO CHANGE RATES FOR WHOLESALE TRANSMISSION SERVICE (NON-IOU)	§ § § § § § §	PUBLIC UTILITY COMMISSION OF TEXAS

DIRECT TESTIMONY

OF

FRANCES J. NITSCHMANN

ON BEHALF OF

SOUTH TEXAS ELECTRIC COOPERATIVE, INC.

May 30, 2013

DOCKET NO. 41527

APPLICATION OF SOUTH TEXAS ELECTRIC COOPERATIVE, INC. TO CHANGE RATES FOR WHOLESALE TRANSMISSION SERVICE (NON-IOU)	§ § § § § § §	PUBLIC UTILITY COMMISSION OF TEXAS

DIRECT TESTIMONY

OF

FRANCES J. NITSCHMANN

ON BEHALF OF SOUTH TEXAS ELECTRIC COOPERATIVE, INC.

TABLE OF CONTENTS

DIRECT TESTIMONY

OF

FRANCES J. NITSCHMANN

ON BEHALF OF SOUTH TEXAS ELECTRIC COOPERATIVE, INC.

I.

POSITION AND QUALIFICATIONS

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Frances Nitschmann. I am the Chief Financial Officer ("CFO") for South Texas Electric Cooperative Inc. ("STEC") of 2849 Farm Road, 447 P.O. Box 119, Nursery, Texas 77976.

Q. PLEASE SUMMARIZE YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND.

A. I received a Bachelor of Science in Business Administration in accounting from University of Houston, Victoria, Texas in 1980. I worked for a local Public Accounting firm for sixteen years, worked for a municipality for four years, and then went to work for STEC as an accountant. I have spent 12 years at STEC and as the CFO I supervise all accounting and finance personnel efforts.

Q. HAVE YOU TESTIFIED BEFORE THIS COMMISSION?

A. No.

Q. ARE YOU A CERTIFIED PUBLIC ACCOUNTANT?

A. Yes. I am a Certified Public Accountant in the state of Texas, Certificate No. 27836.

II.

PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to present STEC's cost of service for the historical test year ending December 31st, 2012. I explain the manner in which STEC's service costs are accounted, how functionalization factors are developed, STEC's finances and debt service, depreciation expenses, and the requested rates for transmission and distribution services. I explain the schedules and work papers of the TRANSMISSION COST OF SERVICE RATE FILING PACKAGE FOR NON-INVESTOR OWNED TRANSMISSION SERVICE PROVIDERS IN THE ELECTRIC RELIABILITY COUNCIL OF TEXAS ("TCOS-RFP").

III.

TCOS-RFP SCHEDULES

Q. WHAT IS THE SOURCE OF THE DATA USED TO DEVELOP THE SCHEDULES?

A. The financial data came from the accounting books and records of STEC. All accounting costs from the books and records of STEC are accounted for in accordance with generally accepted accounting principles. Bumgardner Morrison & Company, LLP, STEC's external auditor, has expressed an unqualified opinion that STEC's financial statements for the fiscal years ended December 31, 2012 and 2011 are presented fairly.

Q. DOES STEC ADHERE TO THE FERC UNIFORM SYSTEM OF ACCOUNTS?

A. STEC utilizes the Uniform System of Accounts of the Code of Federal Regulations Part 1767 ("CFR 1767"). There are few differences between it and the FERC system of accounts. STEC is an electric cooperative so revenues in excess of expenses are returned to the Members as capital credits rather than paying dividends to shareholders and the CFR 1767 account definitions reflect that characteristic. The definitions associated with account numbers 200 through 219 are titled "Margins and Equities" in CFR 1767 and "Proprietary Capital" in the FERC system. Patronage capital, gains, and margins are mentioned prevalently in the CFR 1767 account definitions rather than the FERC system definitions' references to stocks and earnings.

Q. WHAT TEST YEAR IS STEC'S TCOS-RFP BASED UPON?

A. The test year is January 2012 through December 2012.

Q. WHAT TEST YEAR WAS USED IN STEC'S LAST TRANSMISSION COST OF SERVICE ("TCOS") FILING? WHAT WAS THE DOCKET NUMBER?

A. January 1st, 2008 to December 31st, 2008 was the test year in STEC's rate filing of Docket No. 37535.

Q. HAS STEC FILED AN INTERIM UPDATE SINCE THAT LAST TCOS FILING? IF SO, WHEN AND WHAT DOCKET NUMBER?

A. Yes, STEC filed an interim update of its transmission expenses in August, 2010 that was approved in PUC Docket No. 38569.

Q. WHAT IS STEC'S REQUESTED TCOS AMOUNT AND FEE AND HOW DO THEY COMPARE TO THOSE PREVIOUSLY APPROVED?

A. The TCOS requested is $47,681,204 with an annual Access Fee of $0.722285 per KW. The requested TCOS is an increase of $13,113,641 over the $34,567,563 previously approved in Docket No. 38569.

Q. WHEN WAS THE PREVIOUS STEC TCOS FILING?

A. STEC's last TCOS-RFP was Docket No. 37535 approved in January of 2010. An interim filing to adjust capital investments was approved in Docket No. 38569 in November of 2010.

Q. IS STEC PROPOSING ANY ACCOUNT RECLASSIFICATIONS IN ITS TCOS-RFP?

A. No, it is not.

Q. IS STEC PROPOSING ANY ADJUSTMENTS IN ITS TCOS-RFP?

A. No.

Q. WERE THE SCHEDULES DEVELOPED CONSISTENT WITH THE REQUIREMENTS OF THE TCOS-RFP?

A. Yes, they were.

Q. WERE THE SCHEDULES PREPARED BY YOU OR UNDER YOUR DIRECT SUPERVISION?

A. Yes, they were.

Q. ARE THE SCHEDULES AND WORKPAPERS TRUE AND CORRECT TO THE BEST OF YOUR KNOWLEDGE?

A. Yes, they are.

Q. WHAT SCHEDULES IN THIS TCOS-RFP DO YOU SPONSOR?

A. I sponsor all schedules in STEC's TCOS-RFP.

Q. FOR ANY SCHEDULE IN THE TCOS-RFP INSTRUCTIONS THAT DOES NOT APPLY, PLEASE EXPLAIN WHY.

A. The following schedules do not apply because STEC is not including related amounts in its TCOS-RFP.

Schedule B-4, Unbundled Construction Work in Progress

Schedule B-6, Unbundled Plant Held for Future Use

Schedule B-7, Unbundled Accumulated Provision Balance

Schedule B11, Unbundled Other Rate Base

Schedule B-12, Unbundled Regulatory Assets

Schedule C-1, Rate of Return Method

Schedule C-3, Cash Flow Method

Schedule C-4, Times Interest Earned Ratio

Schedule E-3, Federal Income Taxes

Schedule E-4, Other Expenses

Schedule E-6, Wheeling Revenue Under Existing Contracts

Q. IS STEC PROVIDING WORKPAPERS IN SUPPORT OF THE TCOS-RFP SCHEDULES? IF SO, WERE YOU INVOLVED IN THEIR DEVELOPMENT AS WELL?

A. Yes, there are workpapers supporting several of the schedules. Most were developed by me or by personnel under my supervision. The exceptions are those workpapers that are copies or excerpts of supporting documents.

Q. HAVE YOU PROVIDED EXPLANATIONS FOR THE WORKPAPERS?

A. Yes. Each workpaper referenced by the schedules as a source of applicable costs includes explanatory statements. The statements are located near the bottoms of the workpaper pages.

Q. PLEASE PROVIDE EXPLANATIONS FOR THE WORKPAPERS THAT ARE NOT PART OF THE TCOS-RFP SPREADSHEET.

A. The workpapers that do not have explanations are copies or excerpts of documents that support STEC's TCOS-RFP. These include:

- Workpaper WP/C-2/3.1 - National Rural Utilities Cooperative Finance Corporation ("CFC") Consolidating Loan
  Excerpt: The minimum Debt Service Coverage ratio ("DSC") of 1.0x is indicated by paragraph B.
- Workpaper WP/C-2/3.2 - Indenture Rate Covenant Excerpt: Section 14.14 requires a minimum margin for Interest Ratio of 1.10x. This agreement securitizes all STEC secured debt.
- Workpaper WP/C-2/3.3 - First Supplement to Indenture Excerpt: This is an excerpt from the first supplemental agreement to the indenture showing that STEC is required to meet certain principal payments terms.
- Workpaper WP/C-2/3.4 - Revolving Credit Facility Excerpt: Section 6.07(a) of STEC's credit agreement dated 2011 requires a minimum margin for Interest Ratio of 1.10x.

- Workpaper WP/C-2/3.5 - Bond Purchase Agreement Excerpt: This is an excerpt from the bond purchase agreement defining STEC's obligations to make certain payments on the 2009 bonds.
- Workpaper WP/C-2/3.6 - Second Supplemental to Indenture Excerpt: This excerpt shows STEC's obligation to make certain payments on the 2009 bonds.
- Workpaper WP/C-2/4 - STEC Board of Directors Resolution: This is a copy of the resolution passed by STEC's Board of Directors.
- Workpaper WP/C-2/5 - 2012 Audit Report: A full copy of the audit report for the test year.

IV.

STEC'S FINANCES

Q. PLEASE DESCRIBE STEC'S FINANCES.

A. At present STEC has secured financing with CFC and have outstanding private placement bonds and most of its unsecured financing with a consortium of twelve (12) banks in the amount of $350 million dollars through August 4, 2016. STEC has an indenture in place which secures our debt. Future long term financing is expected to be through the bond market and loans from various banks. STEC uses its unsecured line of credit to finance its capital projects on an on-going basis. STEC plans to periodically reimburse its line of credit with funds from bond sales.

Q. WHAT ARE STEC'S DEBT OBLIGATIONS?

A. STEC has debt obligations in the form of private placement bonds issued November 2009 and a combination of secured and unsecured loans from CFC. STEC also has an unsecured line of credit with a consortium of twelve banks. Excerpts of the agreements related to minimum financial ratios and other related STEC responsibilities are included in the workpapers as previously discussed.

Q. HAS STEC RECENTLY MADE CHANGES IN HOW IT SECURES FINANCING? IF SO, PLEASE EXPLAIN HOW STEC HISTORICALLY OBTAINED FINANCING AND WHAT IT HAS DONE RECENTLY.

A. Yes, STEC recently made changes in how it secures financing. STEC refinanced its Rural Utility Service ("RUS"), the successor of "REA", and effectively "bought out" of RUS in 2007. Prior to that time, all of STEC's loans were from RUS and CFC. Since that time STEC has twice secured long term financing from the sale of private placement bonds and has also continued to borrow from CFC. STEC has established short term financing through an unsecured line of credit which is periodically reimbursed with funds from the bond sales.

Q. WHAT IS STEC'S PERCENT EQUITY LEVEL AND WHAT ARE NEAR TERM PROJECTIONS?

A. STEC's percent equity as a percent of capitalization at December 31, 2012 is 17.26%. It is expected to decrease to 14.58% in the next year due to capital investments financed with debt.

V.

CHANGES SINCE STEC'S LAST TCOS FILING

Q. HOW MUCH HAS STEC'S TCOS INCREASED?

A. STEC has added facilities in its efforts to continue to provide reliable service to its members and to improve transmission service of the ERCOT grid. STEC's TCOS has increased from $34,567,563 to $ 47,681,204, an increase of $13,113,641 since its last TCOS-RFP filing.

Q. WHAT FACTORS CONTRIBUTED TO STEC'S INCREASE IN TCOS?

A. STEC's TCOS increases are due to:

- Net additions for transmission facilities that occurred after the STEC TCOS Docket No. 38569. Docket No. 38569 covered STEC plant additions through April 30, 2010. Facilities were added from May 1, 2010 through December 31, 2012.
- Updated accumulated depreciation for all transmission facilities for the same time period
- Depreciation expense on the net additions to the transmission facilities
- Property taxes on the net additions to the transmission facilities
- Updated operations and maintenance expenses required by the increased facilities primarily due to the assets transferred to STEC from Medina Electric Cooperative and Magic Valley Electric Cooperative.

Q. WERE THERE ANY COSTS FOR 2012 THAT ARE NON-RECURRING OR EXTRAORDINARY THAT SHOULD BE REMOVED OR NORMALIZED?

A. No, there were not.

VI.

TRANSMISSION RATE BASE AND EXPENSES

Q. PLEASE EXPLAIN THE TRANSMISSION RATE BASE.

A. The various components of rate base are presented by Schedules B-1 through B-12, and summarized on Schedule B. STEC's transmission rate base components are net-plant-in-service and working capital. Schedule B shows the total transmission rate base as of December 31, 2012 is $269,477,821.

Q. DID YOU MAKE ANY POST-TEST YEAR ADJUSTMENTS?

A. No.

Q. DID YOU FUNCTIONALIZE ANY PURCHASED POWER EXPENSE TO TRANSMISSION?

A. No purchased power expense was functionalized to transmission.

Q. HOW DID YOU CALCULATE CASH WORKING CAPITAL?

A. As shown in Schedule B-9, cash working capital was calculated as one-eighth of annual Operation and Maintenance ("O&M") expenses excluding fuel and purchased power as prescribed by P.U.C. SUBST. R. 25.231.

Q. HOW DID YOU DETERMINE O&M EXPENSES ASSIGNED TO THE TRANSMISSION FUNCTION?

A. The O&M expenses assigned to the transmission function are shown on Schedule D-1. These O&M expenses include a direct assignment of the expenses in transmission O&M accounts (560 – 573).

VII.

FUNCTIONALIZATION FACTORS

Q. PLEASE EXPLAIN THE DEVELOPMENT OF THE FUNCTIONALIZATION FACTORS USED IN THE TCOS.

A. The costs and rate base items are assigned to the transmission, generation, and distribution in accordance with the three-step process and P.U.C. SUBST. R. 25.192. The factors are shown on Schedules F-1 through F-4.

Schedule F-1 develops STEC's PAYXAG allocation factor, payroll excluding Administrative and General ("A&G") expenses. Schedule F-1 also develops the PAYROLL allocation factor which includes all payroll, including A&G.

Schedule F-2 develops functionalization factors using actual operations and maintenance charges to produce TOMXFP, total operations and maintenance excluding fuel and purchased power. Schedule F-3 develops net plant functionalization factors using the gross plant less accumulated depreciation that is specifically functionalized to produce PLTXGNL-N, the net utility plant less net general plant. It also develops GNLTLP-N allocation factor by taking the gross general plant less applicable accumulated depreciation as allocated to function either

specifically or in the proportion as the PLTXGNL-N allocation for plant not specifically allocated. PLTSVC-NX allocation factor plant is the total of the PLTXGNL-N and GNLPLT-N by percentage. "Net Utility Plant excluding General Plant, Intangible Plant" is the above plus the allocated intangible plant percentages.

Schedule F-4 allocates total rate base, the TRB Allocation Factor. It also develops TOTREV allocation factor by using the other revenue which has been allocated by function. This schedule develops DISTOPX using the distribution operations charges for 2012. Total distribution maintenance charges excluding account 590 and 588 for 2012 are the source of the DISTMAX allocation factor.

Schedule F-4 includes C361 and C362 allocation factors using the allocation by substation of structures and improvements and station equipment that was developed by the performance of a substation by substation analysis to determine the transmission and distribution portion of the facilities.

Q. HOW ARE THE AMOUNTS ASSOCIATED WITH TRANSMISSION FACILITIES DETERMINED FOR EACH SUBSTATION INCLUDED IN THE 360, 361, AND 362 ACCOUNTS?

A. STEC performed a substation-by-substation analysis to determine the transmission portion of the substation facilities. The calculation of the functionalization of Accounts 360 through 362 is provided in the workpapers WP/B-1/1, WP/B-1/1.1 and WP/B-1/1.1.1.

Q. HOW ARE THE COMMON COSTS OF EACH SUBSTATION DETERMINED?

A. The common costs are determined as any costs not specifically identified as transmission or distribution in accordance with P.U.C. SUBST. R. 25.192.

Q. HOW ARE THE SUBSTATION COMMON COSTS ACCURATELY ASSIGNED TO TRANSMISSION?

A. These common costs are allocated in the same proportion as the directly assignable costs relate to the total directly assignable costs. This is done on a per substation basis as shown by WP/B-1/1.1.1.

Q. DO THE FUNCTIONALIZED AMOUNTS REMAIN THE SAME FOR THE LIFE OF THE STATION? IF NOT, WHY WOULD THEY CHANGE?

A. No, the functionalized amounts may change in a substation as additions or retirements occur.

Q. HOW WERE A&G EXPENSES FUNCTIONALIZED?

A. STEC's A&G expenses were functionalized pursuant to the General Instruction 11(c) in the TCOS-RFP and allocated according to the functionalization factors as shown on Schedule D-2.

- Accounts 920, 921, 925, 926, and 931 were allocated based on total payroll excluding administration and general and excluding contract labor (PAYXAG).
- Account 923 and 930 were allocated based on company operations and maintenance excluding fuel and purchased power (TOMXFP).
- Account 924 was allocated based on net utility plant (PLTSVC-N).

- Account 928 was allocated based on total other revenue (TOTREV).
- Account 932 was allocated based on net general plant (GNLPT-N).

Q. DOES STEC ALLOCATE THE PAYROLL TAXES, RETIREMENT, AND VARIOUS INSURANCE PREMIUMS THROUGH THE PAYROLL?

A. Yes. STEC allocates these costs to the appropriate account. STEC allocates umbrella insurance, Director and Officer insurance, workman's compensation, general liability, long and short term disability insurance, 24-hour accident insurance, major medical insurance, life insurance, 401K and defined benefit retirement plans, federal and state payroll taxes and social security taxes every month based on the dollars charged on payroll to capital, generation, transmission, distribution, retail and A&G related accounts.

Q. HOW DID YOU FUNCTIONALIZE PROPERTY TAXES?

A. Property taxes were allocated based on net utility plant less intangible plant (PLTSVC-NX) from Schedule F-3.

VIII.

OTHER REVENUES

Q. DID STEC INCLUDE ANY EXPENSES ASSOCIATED WITH ITS COMPETITIVE RETAIL FUNCTION IN ITS REQUESTED TCOS?

A. No. STEC provides the back office support and billing functions and directly assigns all of the costs to Nueces Electric Cooperative, Inc. ("NEC"). Although the costs and revenues are included in STEC's

financial records, STEC has excluded these costs and revenues from its TCOS. The details are shown on workpaper WP/D-2/2. STEC also excluded from TCOS the plant and accumulated depreciation associated with the competitive retail function. The details are shown on workpaper WP/B-2.

Q. WHAT EXPENSES ARE EXCLUDED FROM THE TCOS DETERMINATION?

A. Costs of dues paid by STEC to Texas Electric Cooperatives, Inc. included percentages used for Legislative Advocacy, Social/Recreation, and Political. These costs have been excluded as reflected on WP/D-5. Dues paid to the National Rural Electric Cooperative Association ("NRECA") include a percentage used for Legislative Advocacy. This has also been excluded as reflected on WP/D-5.

Q. IDENTIFY THE UTILITY REVENUES FROM AFFILIATES OR THIRD-PARTIES FOR USE OF TRANSMISSION FACILITIES FOR ANY TYPE OF COMMUNICATION SYSTEM (CELL, INTERNET, CABLE). HOW DOES STEC ACCOUNT FOR THESE REVENUES IN THE TCOS RFP?

A. The following are rents for 2012 that are included in account no. 454 and are shown on workpaper WP/E-5:

AT&T	(pole attachment)	$144.00
Suddenlink	(pole attachment)	$170.00
Jackson County Sheriff	(radio tower rent)	$4,800.00
777 Operating Company	(radio tower rent)	$2,400.00

The total rents of 2012 is $7,514.

Schedule E-5 also shows $7,200 in account 456 which is reimbursement by three of the distribution cooperatives for their share of joint internet service costs.

IX.

TARIFF RATES

Q. WHAT RATES ARE INCLUDED IN THE TARIFF FILED BY STEC?

A. The tariff reflecting the TCOS requested by STEC is included as Exhibit CJA-6 to the testimony of Cory J. Allen who is also filing in support of STEC's TCOS-RFP. The tariff includes two schedules with increased rates, one for the Wholesale Transmission Service ("WTS") and one for the Distribution Level Wholesale Transmission Service ("DWS").

Q. WHAT IS STEC'S REQUESTED TRANSMISSION ACCESS FEE AND HOW IS IT APPLIED?

A. STEC's access fee, the Wholesale Transmission Rate, is calculated on Schedule A to be $0.722285 per kW-Year. It is applied to the eligible customers' average system demands coincident with the average of ERCOT's system peak demand of June, July, August, and September, the 4CP, of the preceding calendar year.

Q. HOW IS THIS CALCULATED?

A. It is calculated as STEC's TCOS of $47,681,204 divided by the 2012 4CP of 66,014,376 kW. The load responsibility data was obtained from Docket

40946, *Commission Staff's Application to set 2013 Wholesale Transmission Service Charges for the Electric Reliability Council of Texas.*

Q. WHAT METHOD IS USED TO DETERMINE STEC'S REQUESTED RATE OF RETURN?

A. The method uses DSC as is discussed in the TCOS-RFP instructions related to Schedule C-2.

Q. WHAT NET INCOME PER REVENUE DOLLAR IS EXPECTED IF THE 1.50x DSC IS USED?

A. If 1.50x DSC is used the expected net income per revenue dollar is $0.19.

Q. WHAT DWS RATE RESULTS FROM 2012 YEAR END DATA?

A. The distribution rate base of $108,196,980 (Schedule B) is multiplied by the rate-of-return 8.0799%. This amount, shown on Schedule B, is added to the distribution expense less interest to result in the Total Distribution Cost. To calculate the distribution expense, account 565 expenses and the Revenue Credits of $9,506 (Schedule A, from accounts 454 and 456) are subtracted from the Total Operating Expense (Distribution) of $15,153,676 (Schedule A). The distribution expense totals $8,561,300 so the Total Distribution Cost is $17,303,507.

The average of the 2010, 2011, and 2012 billing units of non-coincident peak demands at all delivery points is 13,686,308.

The Total Distribution Cost divided by the billing units equals the DWS of $1.26429 per kW per month at each delivery point.

Q. IN YOUR OPINION, IS THE TCOS STEC IS REQUESTING REASONABLE? ARE STEC'S RATES REASONABLE?

A. Yes. STEC's requested TCOS of $47,681,204 is reasonable. STEC has followed the appropriate requirements as specified in the applicable P.U.C. Substantive Rules and the TCOS-RFP. The facilities included in STEC's TCOS meet the requirements for wholesale transmission service and are reasonable to be included in STEC's TCOS. STEC's transmission and distribution rates are reasonable.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes, it does.

DOCKET NO. 41527

APPLICATION OF SOUTH TEXAS ELECTRIC COOPERATIVE, INC. TO CHANGE RATES FOR WHOLESALE TRANSMISSION SERVICE (NON-IOU)	§ § § § §	PUBLIC UTILITY COMMISSION OF TEXAS

DIRECT TESTIMONY

OF

DANIEL M. WALKER

ON BEHALF OF

SOUTH TEXAS ELECTRIC COOPERATIVE, INC.

MAY 30, 2013

DOCKET NO. 41527

APPLICATION OF SOUTH TEXAS ELECTRIC COOPERATIVE, INC. TO CHANGE RATES FOR WHOLESALE TRANSMISSION SERVICE (NON-IOU)	§ § § § §	PUBLIC UTILITY COMMISSION OF TEXAS

DIRECT TESTIMONY

OF

DANIEL M. WALKER

ON BEHALF OF SOUTH TEXAS ELECTRIC COOPERATIVE, INC.

TABLE OF CONTENTS

EXHIBITS

DIRECT TESTIMONY

OF

DANIEL M. WALKER

ON BEHALF OF SOUTH TEXAS ELECTRIC COOPERATIVE, INC.

I.

INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Daniel M. Walker. I am an advisor on cooperative finance. My business address is 7106 University Drive; Richmond, VA 23229.

Q. PLEASE DESCRIBE YOUR RELEVANT EXPERIENCE AND EDUCATIONAL BACKGROUND.

A. I hold a Bachelor's degree from Appalachian State University and a Master of Business Administration degree from the University of Richmond. I have published articles on regulation in the College of William & Mary Business Review, EPRI Research Journal, and Public Utilities Fortnightly. I have served as Director of Public Utility Accounting and Finance for the Virginia State Corporation Commission. As a public utility consultant, I have testified in civil and administrative cases in Virginia, Florida, Kentucky, Ohio, Arizona, and Alaska. In addition, I served as the Chief Financial Officer ("CFO") for Old Dominion Electric Cooperative for 21 years. In that capacity, I was directly responsible for the issuance of approximately $3 billion of capital market financings. I

have testified on behalf of Old Dominion and its members before the Virginia State Corporation Commission, the Maryland Public Service Commission, the Delaware Public Service Commission, and the Federal Energy Regulatory Commission. As an advisor, I have assisted Generation and Transmission Cooperatives ("G&Ts") across the country in placing over $3 billion of financing in the capital markets. Also, as a financial advisor, I have testified on behalf of G&Ts and distribution cooperatives before public service commissions in Kentucky, Alaska, and Virginia.

Q. HAVE YOU TESTIFIED BEFORE THE PUBLIC UTILITY COMMISSION OF TEXAS?

A. No.

II.

PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to support the Transmission Cost of Service ("TCOS") filing of South Texas Electric Cooperative, Inc. ("STEC"), to describe STEC's financial framework, its financial requirements and to discuss the importance of using the debt service coverage ratio to set transmission rates.

Q. PLEASE SUMMARIZE YOUR TESTIMONY AND RECOMMENDATIONS.

A. When STEC first exercised the PUC open access transmission rules to set its transmission rates, STEC operated under the rules, regulations, and mortgage of the Rural Utility Service ("RUS"). Under RUS, the key financial matrix to determine financial performance and the adequacy of rates to repay debt service was Times Interest Earned Ratio ("TIER"). Financial requirements since then have changed for STEC. STEC has paid off its RUS mortgage and refinanced its debt in the capital markets, the same capital markets that also provide debt financing for investor-owned utilities ("IOUs"). The key financial ratio for cooperatives that finance in the capital markets is Debt Service Coverage ("DSC"). To be able to attract capital, STEC needs to use DSC to set transmission rates. The appropriate DSC level for STEC is 1.50x.

III.

HOW G&T COOPERATIVES FINANCE

Q. WOULD YOU GIVE AN OVERVIEW OF HOW G&T COOPERATIVES TYPICALLY FUND THEIR CAPITAL NEEDS?

A. Twenty years ago G&T cooperatives enjoyed relatively easy access to capital through the Federal programs such as the Rural Electric Administration ("REA") - the renamed Rural Utility Service ("RUS"). While this capital was less expensive than that available in the capital markets, these government financing applications required between twelve and twenty-four months to process and loan conditions had to be

met in order to have access to loan funds. This low cost capital allowed G&T's to build large generation units and thus achieve efficiencies to assist in the development of rural economies.

Q. DO G&T'S HAVE THE SAME ACCESS TO CAPITAL TODAY TO FUND THEIR CAPITAL NEEDS?

A. No. The financing landscape for G&T's has become very complex.

Q. WOULD YOU EXPLAIN?

A. Because of political pressure and fiscal concerns, timely direct loans from the RUS, especially for base load generation, have become difficult to obtain. As a result, certain G&T's with base load requirements have retired their RUS mortgages and refinanced their debt with "market-friendly" indentures in order to borrow directly from the capital markets. This gave G&T's like STEC greater access to capital. STEC adopted a capital market indenture in 2009.

Q. HAS ADOPTING A MARKET FRIENDLY INDENTURE IMPROVED THE ABILITY OF G&T COOPERATIVES TO ATTRACT CAPITAL?

A. In general, yes; however, to gain access to the capital markets, a G&T must maintain good credit quality.

Q. WHY IS MAINTAINING GOOD CREDIT QUALITY SO IMPORTANT?

A. In the past, utilities were considered a safe haven for both long term bondholders and commercial banks for short term credit. Enron and World Com proved to the financial community that utilities were no longer safe havens. As a CFO operating in the capital market during

that time, I learned first-hand how difficult attracting capital for a cooperative can be. Bondholders, commercial banks, National Rural Utilities Cooperative Finance Corporation ("CFC") and CoBank began to focus on a cooperative's credit profile. Emphasis on credit quality was intensified even further during the recent credit crisis that started in 2008.

Q. WHY IS CREDIT QUALITY IMPORTANT TO COOPERATIVES?

A. Both the short term and long term capital markets are very competitive. Lenders have many choices on how they deploy their available funds. For example, lenders like insurance companies (a favorite lender to cooperatives) allocate available funds based on credit quality. As such, cooperatives with a strong credit profile (rating in the "A" category) qualify for a larger "pot" of funds than cooperatives at the "BBB" level of credit ratings. In some situations capital is either not available for cooperatives with low ratings or is very expensive. This is not necessarily true for IOUs.

Q. WOULD YOU EXPLAIN WHY COOPERATIVE FINANCINGS ARE DIFFERENT THAN THOSE OF IOU'S IN THE CAPITAL MARKETS?

A. Cooperatives have considerably less market liquidity than IOUs. IOUs issue billions of dollars in the capital market while cooperatives, by comparison, issue very little debt in the capital markets. As such, commercial bankers and bondholders devote most of their attention to IOUs rather than cooperatives. In other words, cooperatives have to

work harder to assure they can attract capital regardless of their ratings. A cooperative with weak credit has a much higher hill to climb and, consequently, it generally incurs both higher costs of financing and has less financing funds available.

IV.

STEC FINANCIAL HISTORY

Q. PLEASE BRIEFLY DISCUSS THE REASONS STEC DECIDED IT MUST OBTAIN FINANCING FROM SOURCES OTHER THAN THE FEDERAL FINANCE BANK AND RUS?

A. STEC operated under an RUS mortgage until 2007. At that time, STEC was planning to invest in the Coleto Creek coal fired generation project. It became clear to STEC that they could not depend on RUS to fund its future capital needs.

Q. WHAT STEPS DID STEC THEN TAKE TO SECURE ITS FINANCIAL FUTURE?

A. In 2007, STEC decided to refinance all of its mortgage notes payable to the RUS and FFB. FFB debt of $154.2 million and RUS debt of $19.6 million were replaced with a bridge loan of $209.5 million from the National Rural Utilities Cooperative Finance Corporation ("CFC"). At that time, STEC's assets were pledged to CFC as security for this debt. During 2009, STEC completed a new market indenture, refinanced a portion of the CFC debt, and financed transmission line investment and

its Pearsall Power Plant project by issuing $320 million in the capital markets. The remaining secured CFC debt was $324.9 million.

Q. HOW DOES A G&T COOPERATIVE POSITION ITSELF TO ATTRACT CAPITAL?

A. To attract capital, cooperatives must maintain a solid credit profile and, as a regulated utility, earn their cost of capital.

V.

STEC'S COST OF CAPITAL AND FAIR RATE OF RETURN

Q. HOW DO YOU DEFINE THE REQUIRED RATE OF RETURN OR COST OF CAPITAL USED TO SET RATES FOR A COOPERATIVE?

A. In the regulatory arena the cost of capital is a measure of a "fair" rate of return.

> "At a minimum a public utility must be afforded the opportunity not only of assuring its financial integrity so that it can maintain its credit standing and attract additional capital as needed, but also of achieving earnings (margins) comparable to those of other companies having corresponding risk."[1]

This is a fundamental principle of finance whether the utility is regulated or unregulated. For a cooperative using DSC to set rates, the rate of return is the margin left over after covering all costs including debt service, both principal and interest, expressed as a ratio of margin to debt service. In determining a rate level, the ability to attract adequate capital is properly considered a basic test of a fair return. A utility must

[1] Charles Phillips, Jr., "The Regulation of Public Utilities," Public Utilities Reports, Inc., p. 331.

be able to attract capital at a reasonable cost in order to build and maintain physical plants and to meet its public service obligations. Failure to maintain the financial integrity of a cooperative is contrary to the interest of its members as well as the providers of capital.

Q. HOW DO YOU DETERMINE THE APPROPRIATE RISK PARAMETERS?

A. The most important sources of an independent evaluation of risk and credit are the three major rating agencies: Standard & Poor's ("S&P"), Moody's Investors Service ("Moody's"), and Fitch. It is fundamental that expected returns are directly related to the perceived risk of an investment. It follows that if the risk of investing in a particular cooperative is similar to that of other like-rated cooperatives, their respective costs of capital should be similar. In most cases, to determine the cost of capital for a cooperative one would compare its financial performance with cooperatives of similar risk as determined by credit ratings from two or three of the major rating agencies. In other words, to attract capital it is reasonable to assume the lenders would expect cooperatives with similar risk to have similar financial performance.

Q. IS STEC CURRENTLY RATED?

A. Yes. STEC is rated "A-" by Fitch and S&P.

Q. COULD YOU BRIEFLY EXPLAIN WHAT FACTORS ARE CONSIDERED IMPORTANT BY THE RATING AGENCIES IN ASSESSING A COOPERATIVE'S RISK?

A. While each of the rating agencies has a different rating methodology, they tend to concentrate their evaluation of cooperatives in several areas. A "credit negative" in one agency may also be a credit concern in the other agencies. General areas of evaluation are:

- Financial Performance
- Flexibility to Change Rates/Regulatory Environment
- Long-Term Wholesale Contract with Members
- Member Profile
- Size

The above list is ranked in the general order of importance given by the rating agencies' committees in developing credit ratings. I discuss each of these criteria below.

Financial Performance

The bottom line indicator of how well a cooperative has dealt with its risk is the financial results of its operations. The agencies analyze a variety of indicators and ratios to measure the ability to cover fixed and variable obligations. The key ratios analyzed are debt service coverages, liquidity, and equity. The rating agencies also apply stress to financial results to test the ability of cooperatives to deal with uncertainties in their financial operations. The reason financial performance is given the most