

NUMBER: RR-2724
DATE: May 14, 2013
MAIL LOG No.: 146790, 147165

TO: W. Kevin Hughes, Chairman
Harold D. Williams, Commissioner
Lawrence Brenner, Commissioner
Kelly Speakes-Backman, Commissioner

FROM: Anthony Myers, Assistant Executive Director

RE: Southern Maryland Electric Cooperative, Inc. Has Filed an Application for Authority to Borrow Approximately \$15 Million and Issue Promissory Notes on behalf of SMECO Solar LLC.

Description of Application:

By letter dated April 17, 2013, Southern Maryland Electric Cooperative (“SMECO” or “the Cooperative”) has filed an application for authority to issue notes of indebtedness up to the amount of \$14,565,000. SMECO also requested expedited authorization for this request by the Commission.

Parties which should receive a copy of Staff Recommendations:

Mark A. MacDougall, Southern Maryland Electric Cooperative, Inc.
Paula Carmody, Maryland Office of People’s Counsel

Recommended Action (Including Conditions):

Staff recommends that the Commission grant SMECO's request to borrow from the Federal Financing Bank up to \$14,565,000 and that SMECO be authorized to execute the Rural Utilities Service Loan Contract and the Federal Financing Bank Note with a maximum principal amount of \$14,565,000. Additionally, SMECO should be directed to file reports as necessary to comply with COMAR 20.07.04.02.C. Staff also recommends that SMECO be provided three true test copies of the signed Order approving this request.

Phillip E. VanderHeyden
Director, Electricity Division

Leslie M. Romine
Chief Staff Counsel

Commission Action on _____:

Approved __ Disapproved __ Accept for Filing __

Comments of the Electricity Division (RR-2724)

RE: Southern Maryland Electric Cooperative, Inc. has Filed an Application

For Authority to Guarantee Indebtedness for Approximately \$14 million and Issue Promissory Notes on Behalf of SMECO Solar LLC.

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Summary of Filing

By letter dated April 17, 2013, SMECO filed an application for authority to issue notes of indebtedness up to the amount of \$14,565,000 to finance the construction of the 5.5 MW Herbert Farm Solar Project. SMECO will use these funds to pay down the bridge loan it acquired in October 2011 with the Commission's approval.¹ SMECO acquired the bridge loan to fund the construction of its 5.5 MW solar facility. Per Sections 5-203, 6-101, and 6-102 of the Public Utilities Article ("PUA") SMECO requested the Commission to authorize the Cooperative to guarantee this loan on behalf of the SMECO Solar LLC to borrow money from the Federal Financing Bank ("FFB"). This loan will be guaranteed as to payment by the United States of America, acting through the Administrator of the Rural Utilities Service ("RUS").

SMECO requested expedited authorization for this request by the Commission. SMECO also requested three true test copies of the Order because the Cooperative needs to provide one signed copy to the lender.

Applicable Law

Public Utilities Article ("PUA") § 5-203(b)(2) states:

Except as provided in paragraph (5) of this subsection, without prior authorization of the Commission, a public service company may not: (i) assume or guarantee an obligation or liability with respect to stocks, bonds, securities, notes, or other evidence of indebtedness that is payable as a whole or in part to any person more than 12 months after the date of issuance;

PUA § 6-101(a)(2) states:

Except as provided in paragraph (4) of this subsection, a public service company shall obtain authorization from the Commission before the public service company: (i) assumes or guarantees an obligation or liability with respect to stocks, bonds, securities, notes, or other evidence of indebtedness of any person that is payable wholly or partly more than 12 months after the date of the assumption or guarantee; [or] issues stocks, bonds, securities, notes, or other evidence of indebtedness that is payable wholly or partly more than 12 months after the date issued;

¹ See ML No.134380.

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PUA § 6-101(b)(1) states, “Subject to the requirements of subsection (c) of this section, the Commission may authorize an act described under subsection (a)(2) of this section if the Commission finds that the act is consistent with the public convenience and necessity.”

PUA § 6-102(b) states:

The Commission shall authorize a public service company to issue stocks, bonds, securities, notes, or other evidence of indebtedness, payable wholly or partly more than 12 months after the date of issuance, if the Commission finds that the issuance is reasonably required for the public service company to:

- (1) acquire property;
- (2) construct, complete, extend, or improve its facilities;
- (3) discharge or lawfully refund its obligations;
- (4) maintain or improve service; or
- (5) reimburse money, not secured by or obtained from the issuance, that is expended for a purpose described in item (1), (2), or (3) of this subsection within 5 years before the filing of an application with the Commission for the reimbursement.

PUA § 6-102(d)(1) states, “An authorization by the Commission under subsection (b) . . . of this section shall be by order. PUA § 6-102(d)(2)(i-ii) requires the order to specify the amount of the issuance authorized; and the purpose under subsection (b) or (c) for which the issuance reasonably required.

COMAR 20.07.04.01A-I sets forth the required information that must be provided, when applicable, regarding a public service company’s financial condition.

COMAR 20.07.04.02A(1-12) sets forth the required content of an application for authorization to issue any stock bonds, notes or other evidences or indebtedness shall include.

COMAR 20.07.04.02B states:

Within 2 weeks of the filing of an application, and for the next succeeding week, the public service company shall give notice of the filing of an application under §A of this regulation with the Commission by publishing an advertisement in a newspaper of general circulation in each county in the distribution territory served by the company.

COMAR 20.07.04.02C states:

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An order of the Commission granting an application, or any part of it, shall:

- (1) Prescribe the purpose for which the proceeds of the security or obligation shall be used;
- (2) Direct the applicant to report to the Commission under oath the sale or other disposition of the securities or obligations authorized, the terms and conditions of them, and the amount realized from them;
- (3) Require the applicant to make a report at least once every 6 months showing in detail the use and application by it of the money so realized, until the moneys shall have been fully expended; and
- (4) Contain such other provisions as the Commission may deem necessary or appropriate in each case.

Background

On September 28, 2011 SMECO filed an application seeking loan approvals to establish an affiliate known as SMECO Solar LLC for the purpose of constructing and operating a 5.5 MW solar generating facility on SMECO property.² The Commission, in its Order dated October 28, 2011, granted SMECO's request for waivers regarding the construction of the facility owned and operated by SMECO Solar LLC with the following conditions:

- (1) SMECO Solar LLC will not engage in other solar projects beyond the projects at issue today without further approval from the Commission;
- (2) Waivers contingent on the understanding that all of the output from the projects will be sold to the Southern Maryland Electric Cooperative ("Cooperative"). If there is any selling of the output to another party, all waivers are removed; and
- (3) That the Cooperative and SMECO Solar LLC will fully and properly allocate for all the costs.³

Upon receiving Commission's approval, SMECO Solar LLC completed the construction of the solar generation facility in November 2012. The Cooperative representatives explained to Staff in e-mail correspondence that the Cooperative did not plan to sell any portion of the output produced in the solar facility per Commission's Order dated October 28, 2011. SMECO representatives concluded that in the unlikely event that all of SMECO customers switched to an alternate energy supplier⁴ the Cooperative would have to ask the PSC for

² See ML No.134380.

³ See #23, 10/26/2011 AM; ML#134380, S-1251.

⁴ PUA 7-703 requires that SMECO, as a Cooperative, has an obligation to obtain at least 0.20% of its energy supply from solar energy in 2013. SMECO Solar LLC was initially built to meet SMECO's requirement for renewable energy supply. If a substantial portion of SMECO customers switch to alternate sources for energy supply SMECO's requirement for renewable energy may also diminish.

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authorization to sell the minor amount of power generated by the solar facility into the market.

On April 17, 2013 SMECO filed for Commission's approval to guarantee a loan on behalf of SMECO Solar LLC in the amount of \$14,565,000 from FFB to refinance the costs of the construction for SMECO Solar's new facility. SMECO provided the detailed engineering specifications outlining the cost of the now completed and inspected construction project as required by COMAR 20.07.04.02. A(3). SMECO Solar LLC applied for and received a 1603 Treasury Grant in the amount of \$5,921,036 upon completion of the new solar facility.⁵ This loan request applies to the remaining \$14,565,000 needed to pay off the bridge loan. Since loan funds from RUS are not normally disbursed until the construction is completed and the project has been inspected⁶, the Cooperative asked for and received approval from the Commission for the construction loan that was used to fund the project originally.⁷ The construction is now complete and the Cooperative would like to borrow the permanent loan from RUS for the construction costs after subtracting the amounts received from the 1603 Treasury Grant. SMECO will pay off the construction loan it acquired using the funds from the notes of indebtedness and the federal grant it received in 2012. SMECO expects that the interest rate on the notes of indebtedness (approximately 2.70% for 20 years) will most likely be much lower than the loan it currently has that funded the solar project (about 2.29% for 36 months).

Under the FFB note, FFB will make an advance to SMECO Solar LLC upon written request, and SMECO Solar LLC will select the maturity date of the advance. While the final maturity date is specified as December 31, 2033, the date can not be less than one calendar year after the requested advance date. The interest rate for the advance will also be established by the FFB at the time of the advance. Therefore SMECO prepared a breakdown of costs and payments of the 20-year loan based on 5.5% and 7.5% interest rates. Additionally SMECO provided a financial breakdown of the costs of the loan if the Herbert Solar project produces at 90% capacity. SMECO representatives explained that while all of these scenarios are unlikely, these scenarios were required by the RUS representatives for the loan application and represent higher than expected interest rate scenarios.⁸

⁵ SMECO representatives stated that the total grant money they received was \$5,948,756.

⁶ SMECO provided this information in an e mail upon Staff's data request.

⁷ See ML No. 134380, S-1251. The construction was completed using a bridge loan which was approved by the Commission on October 28, 2011.

⁸ This information was obtained from SMECO representatives via e mail and phone correspondence between April 29th and May 2nd 2013.

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SMECO provided the breakdown of the cost of completing the Herbert Solar Farm in the form of a sworn affidavit by its planning engineer.⁹ A summary of the cost breakdown is presented in the following table:

Construction of a 5,500 KW (AC), 6,602.4 KW (DC) Solar Photovoltaic facility located on the Herbert Farm Site in Charles County, MD – Cost Breakdown

Materials	\$ 14,494,967
Labor and Installation Services	\$ 2,771,825
EPC ¹⁰ Fees	\$ 947,979
Engineering, Permitting & Insurance	\$ 870,934
Additional Misc. Costs	\$ 1,229,314
<u>Total:</u>	<u>\$ 20,315,019¹¹</u>

In addition to the engineering affidavit outlining the actual cost of the Herbert Solar Project SMECO filed the following documents with its filing:

- RUS Loan Contract
- Federal Financing Bank Note
- Affidavit of Directors
- Outstanding Long-Term Debt as of February 28, 2013
- 2013 Audited Financial Statements and Independent Auditors Report
- USDA-RUS Cost Estimates and Loan Budget
- USDA-RUS Ten Year Financial Forecast
- Guarantee Agreement.

Staff reviewed each of the documents filed with the Commission and corresponded with the Cooperative to gather additional information which is included in its analysis.

⁹ See Exhibit 1 -- Engineering affidavit as to the Construction Costs.

¹⁰ EPC stands for Engineering, Procurement, and Construction.

¹¹ This amount includes the total estimated construction costs per the affidavit signed by the SMECO engineer and excludes the federal grant SMECO applied for and received in the amount of \$5,921,036.

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Analysis

Staff reviewed SMECO's filings and confirmed that COMAR and PUA requirements were met. The following table summarizes the documentation SMECO provided to Staff and corresponding law and/or regulation to which it corresponds:

<u>SMECO Documentation</u>	<u>Requirement</u>
Exhibit 6 -- Outstanding Long-Term Debt as of February 28, 2013.	COMAR 20.07.04.01.D, F, and G
Exhibit 1 -- Engineering Affidavit as to the Construction Costs	COMAR 20.07.04.02. A(3)
Request for Guarantee of Debt on Behalf of SMECO Solar LLC.	COMAR 20.07.04.02 A (1) & (2), PUA 6-102(d)(1), & COMAR20.07.04.02 C.
Credit Agreement for the Bridge Loan ¹²	COMAR 20.07.02.A (5)
Exhibit 4. Affidavit of Directors	COMAR 20.07.01 A.(7), (11), & (12)
ML No. 147165 Copies of Advertisements filed by SMECO	COMAR 20.07.04.02.B
Exhibit 2.RUS Loan Contract, Exhibit 3. Federal Financing Bank Note, Exhibit 9. Guarantee Agreement Exhibit 7. USDA-RUS Cost Estimates and Loan Budget Exhibit 8. USDA-RUS Ten Year Financial Forecast	COMAR 20.07.04.02 A. (9)
Exhibit 5. 2012 Audited Financial Statements and Independent Auditors Report	COMAR 20.07.04.02.A.(6)

Staff reviewed the construction costs of the newly constructed Herbert Solar Facility as well as the affidavit of the SMECO directors stating that the proceeds of the proposed notes will be used to finance the construction costs of the Herbert Solar Project. Additionally Staff reviewed the list of outstanding long term debts in conjunction with the Cooperative's Audited Financial Statements as of December 31, 2012. Staff also reviewed SMECO's 2013 Audited Financial Statements and Independent Auditors Report completed by a third party independent business consultant. The result of this annual audit revealed that SMECO

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complied with the specific RUS provisions.^{13,14} Finally the independent auditors pointed out that the Cooperative's consolidated financial statements were adequately prepared to present its financial position fairly as of December 31, 2012. In conclusion the auditors did not report any concerns with SMECO's financial information for the period ending December 31, 2012.¹⁵

Staff also reviewed SMECO's Financial Statement to verify that the financial conditions of the Cooperative can fully support the requirements of this new loan agreement with RUS. RUS sets financial coverage ratios for "distribution borrower" cooperatives such as SMECO to ensure that their debt service obligations can be fully maintained. RUS also sets financial coverage ratios for transmission and generation borrowers such as SMECO Solar LLC. These ratios are summarized below:

<u>RUS Coverage Ratios¹⁶</u>	<u>SMECO Requirements¹⁷</u>	<u>SMECO Solar LLC Req.¹⁸</u>
TIER	1.25	1.05
DSC	1.25	1.00
OTIER	1.1	--
ODSC	1.1	--

RUS financial requirements are defined for TIER ("Times Interest Earned Ratio"), OTIER ("Operating Times Interest Earned Ratio"), DSC (Debt Service Coverage), and ODSC (Operating Debt Service Coverage). The OTIER and ODSC ratios are not defined for Transmission and Generation Borrowers such as SMECO Solar LLC. Staff noted that RUS did not specify these coverage ratios for SMECO Solar LLC in its Loan Contract. SMECO representatives explained that since SMECO is acting as the guarantor of this loan and SMECO already has two loans approved with RUS and therefore has to file these coverage ratios on annual basis, RUS did not specify revised ratios as a result of this loan in the new contract. Nonetheless Staff requested these values from the Cooperative and summarized them below to ascertain that the Cooperative can in fact serve as a guarantor for this new loan.

¹³ See Exhibit 6 2012 Audited Financial Statement and Independent Auditors Report. Independent Auditors' Management Letter for Electric Borrowers.

¹⁴ The RUS Loan requirements refer to the TIER, OTIER, DSC, and the ODSC requirements defined earlier.

¹⁵ Exhibit 6, 2012 Audited Financial Statements and Independent Auditors Report, Page 2.

¹⁶ These ratios are defined in Mortgage Security Agreement, and Financing Statement supplied by SMECO upon Staff's data request.

¹⁷ SMECO is qualified as a Distribution Borrower.

¹⁸ SMECO Solar LLC is qualified as a Power Supply Borrower.

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These values are summarized as follows:

Times Interest Earned Ratio (TIER)^{19,20,21}	2013	2012
<u>Total Accrual Margins + Interest on LTD</u>	<u>\$34,973,706</u>	<u>\$28,957,679</u>
Interest on LTD	\$15,903,019	\$16,098,719
	2.199	1.799

Operating Times Interest Earned Ratio (OTIER)		
Patronage Capital & Margins +		
<u>Other Capital Credits + Interest on LTD</u>	<u>\$30,400,259</u>	<u>\$24,346,578</u>
Interest on LTD	\$15,903,019	\$16,098,719
	1.912	1.512

Debt Service Coverage Ratio (DSC)		
Total Accrual Margins + Interest on LTD +		
<u>Depreciation and Amortization Expense</u>	<u>\$61,015,880</u>	<u>\$55,386,585</u>
Total Debt Service Billed	\$31,384,416	\$31,838,137
	1.944	1.741

Operating Debt Service Coverage Ratio (ODSC)		
Patronage Capital & Operating Margin +		
<u>Interest on LTD + Deprec. & Amortizn. Expense.</u>	<u>\$56,442,433</u>	<u>\$50,775,484</u>
Total Debt Service Billed	\$31,384,416	\$31,808,137
	1.798	1.596

The data above show that SMECO's TIER, OTIER, DSC, and ODSC values as of March 31, 2013 exceed the RUS thresholds for loan qualifications. SMECO's TIER as of March 31, 2013 was 2.2, this means that after paying for expenses, besides interest for its current long term debt, SMECO had enough earnings to pay 2.2 times its current interest payments. SMECO currently has an authorized TIER of 1.95.²²

The Ten Year Forecast²³ also provided detailed yearly breakdown of principal payments based on 5.5% interest ("Base Case"), 7.5% interest ("High Interest Scenario"), and Low Output Scenario (90%). These different scenarios were provided because the interest rate

¹⁹ The factor components that are used to determine the coverage ratios are determined by RUS, and are specified in the Mortgage Security Agreement and Financing Statement. While these are not specified in the current RUS Loan Contract prepared for SMECO and SMCEO Solar LLC, SMECO files these with RUS on an annual basis. RUS reserves the right to modify how these coverage ratios are to be calculated.

²⁰ For convenience, Long Term Debt is abbreviated as LTD.

²¹ These values are calculated as 12 months ending December 31, 2012 and March 31, 2013 respectively.

²² See Case No. 9234, Item 32.

²³ See Exhibit 8 – USDA – RUS Ten Year Financial Forecast prepared and submitted by SMECO.

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will not be determined until the loan is approved. However SMECO and SMECO Solar LLC expect that the interest rate will be lower than the lowest interest rates calculated within the Exhibit 8. These calculations are prepared with the assumption that SMECO Solar LLC will not go below a TIER of 1.1 and DSC of 1.0 which comply with the RUS requirements stated earlier. While SMECO Solar LLC is the official borrower of the loan, SMECO, the parent company, is the guarantor of the loan. SMECO Solar LLC will finance the loan through the proceeds of energy generated and sold directly to its parent company SMECO.²⁴ All of the energy output, attributes, and capacity rights of the Herbert Solar Project will be sold to SMECO only, with an initial term of 20 years. The contract price for the energy generated has been set but may escalate as necessary to recover SMECO Solar LLC's expenses and debt service and generate a TIER ratio of at least 1.1.

Staff has verified the calculations using the data provided by the Cooperative. Staff verified that the TIER and DSC ratios do not go below the thresholds set forth by RUS. Staff reviewed SMECO's instant filing in light of the COMAR regulations and the PUA articles that are relevant to this filing and are listed under the Applicable Law Section. Finally Staff also confirmed with SMECO that per COMAR 20.07.04.02B the Cooperative informed general public of its filing by publishing advertisements in newspapers in its distribution territory.²⁵ Staff did not identify any issues with SMECO's request to issue papers of indebtedness.

In conclusion, Staff finds that SMECO has fully complied with PUA and COMAR requirements presented under the Applicable Law Section of this document. Having reviewed the application in conjunction with additional information provided by SMECO to Staff's data requests, Staff concludes that SMECO's request for authority to issue additional debt from RUS meets the statutory and regulatory requirements.

²⁴ See ML# 134380, S-1251.

²⁵ See ML# 147165

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Recommendation:

Staff recommends that the Commission grant SMECO's request to borrow from the Federal Financing Bank up to \$14,565,000 and that SMECO be authorized to execute the Rural Utilities Service Loan Contract and the Federal Financing Bank Note with a maximum principal amount of \$14,565,000. Additionally, SMECO should be directed to file reports as necessary to comply with COMAR 20.07.04.02C. Staff also recommends that SMECO be provided three true test copies of the signed Order approving this request.

Özlen D. Luznar
Regulatory Economist
Electricity Division

cc: H. Robert Erwin, Jr., General Counsel
David J. Collins, Executive Secretary
Terry J. Romine, Chief Public Utility Law Judge
Odogwu Obi Linton, Director, Office of External Relations
Regina Davis, Communications Director