PFM Report
for the Salt River Project
Price Process

Financial Market and Capital Structure Considerations In Public Power Pricing Decisions

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Introduction

- SRP price process has historically included a Report on the financial impacts of pricing proposals
  - *Analyzing financial metrics, credit ratings and investor reactions*
- Public Financial Management ("PFM") has delivered the Report for the prior two price processes
  - *PFM serves as advisor to over half of the 50 largest public power systems*
- The PFM Report has traditionally focused on the financial impact of SRP price proposals
  - *Incremental impact on key financial metrics*
  - *Expected bond rating agency reactions to metrics and message*
  - *Investor reactions - maintaining SRP's position as a premier credit*
  - *Cash flow impacts on future financings and refinancings*

The Current Price Process

- The current price process is unlike any in the past
  - *The overall price of electricity will **<u>decline</u>** as a result of the process*
- This reflects the industry's unprecedented degree of change since SRP's last price process
- Key elements of change are well documented
  - *Significant and unrelenting decline in load growth*
  - *Uncertainty regarding the future of carbon emitting resources*
  - *Mandates and incentives for non-firm renewable resources*
  - *Economic headwinds for coal-fired generation from lower priced options*
  - *Improved economic viability of distributed generation and micro-grids*

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The Impacts of Industry Change

- Most industry experts would argue that we are closer to the mid-stage than to the end of this transition
  - *No expectation that any of the prior conditions will diminish*

- Changes have been, and will be, good for the consumers; however they could challenge long-term recovery of fixed costs (debt)

- None of these changes are thought to be "credit positive"
  - *They have the potential to:*

reduce sales	**increase costs**
increase prices	**promote competition**
increase volatility	**devalue existing assets**

impose mandates

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The Impacts of Industry Change

- Financial "business as usual" could leave utilities with a lot of debt and too few customers to pay for the debt

- Traditional public power finance was based on long-term debt amortized over the life of very long-term assets
  - *A considerable amount of debt, but confidence in the long-term customer base*
  - *Customers did not expect choice and/ or flexibility/mobility*

- Consumer preference for flexibility/mobility, and industry migration to alternative generation sources, have led to a rapid decline in the <u>perceived</u> value of traditional assets

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The Impacts of Industry Change

- The decline in perceived value has also been accompanied by reductions in asset value on financial statements

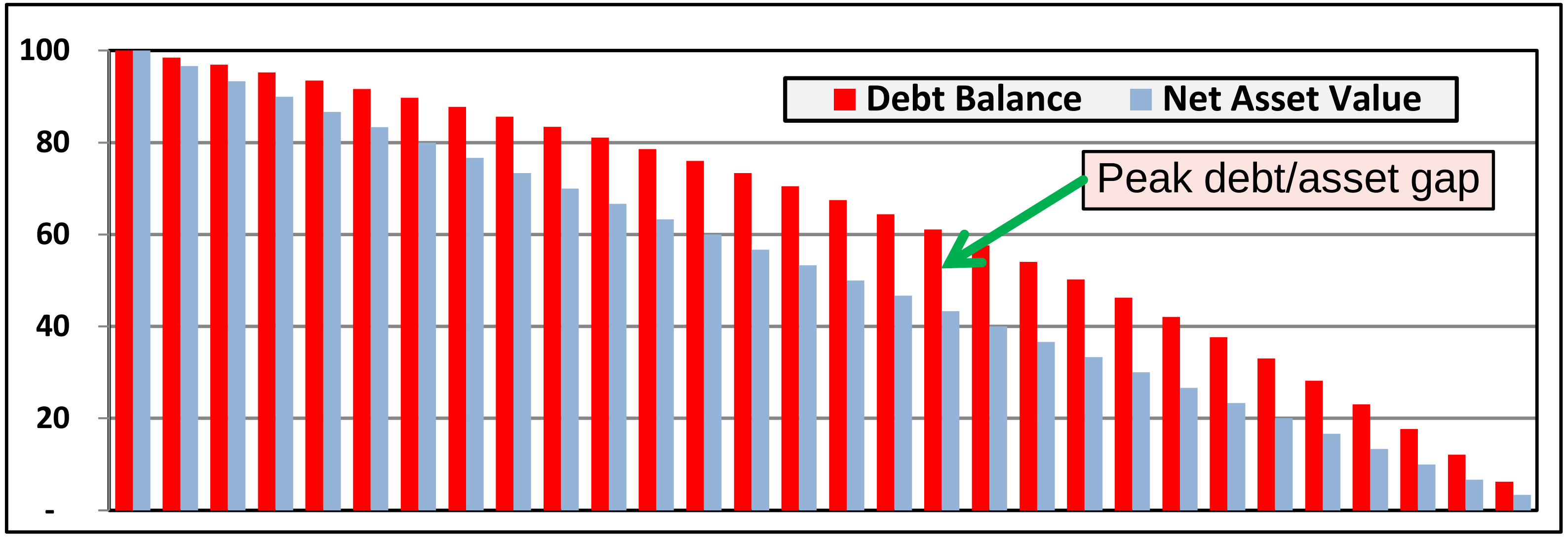
  generation retirement *accelerated depreciation* *plant write-offs*

- Many utilities are halfway through useful lives of generating assets, yet debt amortization doesn't keep pace with depreciation

Depreciated Asset Value versus Debt Balance

Assumes $100MM, 30-yr asset financed with Level debt service, "mortgage-style" amortization

(numbers in $ millions)



The Reaction to Industry Change

- Utilities are also sourcing new generation via power purchase contracts (PPAs) as opposed to on balance sheet debt
  - *PPAs allow for shorter term commitments than asset ownership*
  - *Renewable PPAs pass through a portion of federal tax incentives*
- The asset side of the public power is smaller than it would have been without industry change
- The liability side of the balance sheet (debt) is also changing
- An industry trend to declining debt ratios
  - ***SRP Peer Group Comparison***

Changing Debt Ratios Among Major Public Power Utilities

Debt Ratio History

SRP's Peer Group of the 10 largest load-serving public power utilities

Salt River Project	4/30/2014	4/30/2015	4/30/2016	4/30/2017	4/30/2018	Change
Debt to Assets	**38.6%**	**36.2%**	**37.0%**	**35.3%**	**36.1%**	**-2.5%**
Sacramento Muni Util Dist	12/31/2013	12/31/2014	12/31/2015	12/31/2016	12/31/2017	Change
Debt to Assets	**57.7%**	**53.7%**	**45.3%**	**47.1%**	**42.7%**	**-15.0%**
JEA (Jacksonville, FL)	9/30/2014	9/30/2015	9/30/2016	9/30/2017	9/30/2018	Change
Debt to Assets	**66.7%**	**60.4%**	**57.4%**	**53.0%**	**51.7%**	**-15.0%**
Omaha Pub Pow Dist	12/31/2013	12/31/2014	12/31/2015	12/31/2016	12/31/2017	Change
Debt to Assets	**52.4%**	**43.6%**	**43.6%**	**43.0%**	**38.7%**	**-13.6%**
Orlando Util Comm	9/30/2013	9/30/2014	9/30/2015	9/30/2016	9/30/2017	Change
Debt to Assets	**48.5%**	**47.6%**	**48.5%**	**42.5%**	**40.9%**	**-7.6%**
Colorado Springs Util	12/31/2013	12/31/2014	12/31/2015	12/31/2016	12/31/2017	Change
Debt to Assets	**55.4%**	**53.1%**	**51.5%**	**51.5%**	**49.1%**	**-6.3%**
Austin Energy	9/30/2013	9/30/2014	9/30/2015	9/30/2016	9/30/2017	Change
Debt to Assets	**35.6%**	**33.2%**	**34.0%**	**31.1%**	**29.5%**	**-6.1%**
Long Island Power Auth	12/31/2015	12/31/2016	12/31/2017	12/31/2018	12/31/2019	Change
Debt to Capitalization	**95.4%**	**91.1%**	**91.1%**	**91.2%**	**90.2%**	**-5.2%**
Los Angeles Dept W&P	6/30/2014	6/30/2015	6/30/2016	6/30/2017	6/30/2018	Change
Debt to Assets	**54.8%**	**51.9%**	**53.0%**	**51.6%**	**53.1%**	**-1.7%**
San Antonio City Pub Serv	1/31/2014	1/31/2015	1/31/2016	1/31/2017	1/31/2018	Change
Debt to Assets	**51.2%**	**51.9%**	**54.5%**	**52.4%**	**51.5%**	**0.3%**

Average Debt Ratio decline of 7.3%

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The Reaction to Industry Change

- Credit rating agency analysis adapts to industry change

- Major revisions:

  #1 – Treating Power Purchase Agreements (PPAs) as "debt-like" obligations

  #2 – Emphasis on debt <u>balance</u> versus debt service <u>coverage</u>

- Rating agencies view PPA payments as "debt-like"
  - *Some PPA's are more debt-like than others – length and fixed payments*
  - *Fitch Ratings counts ~30% of some PPA payments as debt service*
  - *Standard & Poor's counts ~50% of PPA payments as debt service*
  - *NPV of PPA "debt service" counted as "real" debt for some metrics*
  - *Why? because many PPAs are "must-pay", and senior to debt payments*

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The Reaction to Industry Change

- SRP's annual PPA payments could approach $300 million
  - *Counting 30% as debt would add ~$1.3bn to SRP's ~$4.7bn debt balance*
  - *Counting 50% would add ~$2.0bn*

- The emphasis on debt balance versus debt service coverage
  - *The most important financial metric has always been DS coverage*
  - *Cash flow available for DS divided by DS*
  - *The "blood pressure" of public power financial health*
  - *But primarily a measure of this year's financial health*

- Fitch Ratings new methodology focuses on debt balances
  - *Key metric is free cash flow divided by debt balance*
  - *A better measure of long-term financial health*

The SRP Price Process

- SRP Management’s Price Process recommendation is:
  - *Reflective of recent and expected industry change*
  - *Consistent with industry debt ratio reduction trends*
  - *Responsive to credit rating analysts’ concerns about balance sheets*
- SRP Debt Ratio will continue to decline
  - *Declining at a slower rate than recent public power industry averages*
  - *But starting from lower (stronger) ratios than industry averages*
- SRP’s balance sheet will accommodate future industry change, promote customer flexibility, and preserve SRP’s position as the premier public power credit