Financial Market and Capital Structure Considerations In Public Power Pricing Decisions

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For

Salt River Project

December 2, 2024

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Introduction

In order to establish the framework for the financial considerations for the 2025 Price Process, it is important to recognize the most prominent financial topic faced by the Salt River Project Agricultural Improvement and Power District ("SRP") – the $12 Billion Capital Improvement Program for the six-year period from 2025 to 2030. This figure is nearly twice SRP's current outstanding debt balance, and nearly equal to the entire existing balance sheet. SRP is not alone in facing formidable capital spending projections. There are several major investor-owned and public power utilities with expected capital expenditures far in excess of their current debt balances. There are two reasons for this seemingly imbalanced relationship between utility capital needs and current balance sheet sizing. First, many utilities are projecting load growth and capital needs which far exceed levels they have experienced in recent decades. Second, many of these same utilities, SRP included, have done an excellent job in recent years of managing debt and strengthening their balance sheets. There has been slower load growth, reduced need for new resources, and a greater use of power purchase agreements to meet new load. As a result, there has been less investment, and often more debt retirement than debt issuance in recent decades. This condition will be changing drastically. Fortunately, many utilities, like SRP, will be heading into a time of significantly increased debt issuance, starting from a very strong financial position. For SRP, this financial strength is the outcome of years of decision-making which has required management and governing bodies to balance the interests of current and future customers; largely by balancing the sources of capital funding between current customer revenue and long-term debt.

As SRP's Board of Directors and Management approach the upcoming 2025 Price Process, they will again balance the desire to maintain SRP's favorable electric prices, with the dual goals of preserving SRP's financial strength and ensuring future SRP customers benefit from clean, affordable, reliable electric energy. One of the primary challenges to establishing optimal pricing for electric energy has 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 adjustments which ensure long-term financial strength against the desire to limit the near-term effect of the price increases on current customers.

SRP customers have experienced very low and stable base rates for an extended period of time. Since 2019, SRP has kept the base component of its pricing structure stable, while passing along increased fuel and purchased power costs through adjustments to the Fuel and Purchased Power Adjustment Mechanism ("FPPAM"). The recent years' overall FPPAM price increases have been as follows:

3.9% effective November 2021
4.7% effective November 2022
4.7% effective November 2023
4.9% additional effective November 2023
3.9% effective November 2024

A portion of these increases have been designed to reimburse under-collected balances resulting from delays in prior FPPAM increase implementation, which delays reflected SRP's desire to mitigate the impact on customers from the COVID-19 pandemic and the related economic downturn. The bulk of the increases reflect the reality of higher costs for fuel and for the purchase of increasing amounts of renewable energy via power purchase contracts and a gas tolling agreement to meet capacity.

For the 2025 Price Process, SRP management is proposing a Base Price increase of 4.0%, and an FPPAM decrease of 1.6%, taking effect in the 2026 fiscal year. The amount and timing of the Base Price action reflects the need to both fund a portion of SRP's significant capital investments, and to pay increasing debt service on the portion of the capital program that will be funded through the issuance of long-term debt.

Utility Industry Change – Load Growth and Resource Needs

Many major electric utilities are facing a degree of load growth which has not been seen in over three decades. The Phoenix area in particular is experiencing load growth driven by population growth, renewed business activity, transportation electrification, a surge in technology manufacturing and of course, spectacular data center growth. This is driving the need for new generating resources at a time when many electric utility constituency groups are calling for the retirement of existing fossil fuel generating units. These forces combine to create the need for substantial amounts of new, less carbon-intensive resources, along with new transmission assets to move energy from where it will be generated to where it is needed. For the past several decades, most utilities had sufficient, or excess, generating capacity. With sufficient capacity, load growth often meant more efficient utilization of existing resources or the ability to achieve scale for new projects. Moderate load growth had historically translated to slower energy price increases and even price decreases for existing customers, as new customers helped absorb existing fixed costs. In this new environment, load growth means new resource needs, with potentially higher cost new resources; such that meeting new load growth could translate to higher energy prices for customers. Growth is no longer a utility's best friend. This new, once in a generation load growth could require higher energy prices in the near future. The big questions about the higher prices are: How much? When? And Who?

The 2025 Price Process will require decisions which allocate the cost burden of long-term utility investments among current and future customers – deciding between how much to rely on near-term price increases to fund capital investment, and how much to rely on the use of long-term debt. An important consideration in these decisions will be their impacts on SRP's financial position and SRP's capacity to borrow the billions of dollars required to fund a significant portion of capital expenditures.

SRP's Current Balance Sheet and Projected Capital Expenditures

At the end of the 2024 fiscal year, SRP had roughly $5.5 billion of long-term debt on its balance sheet, supporting net utility plant of $8.7 billion. When combined with a considerable amount of invested and current assets, this produces an overall balance sheet of $15.1 billion. SRP's Debt Ratio (for which SRP uses the Debt-to-Capitalization Ratio), an important measure of debt or leverage, was 46.1% as of April 30, 2024, and had been as low as 41.7% at the end of FY 2022. SRP's balance sheet and financial strength make it one of the strongest, if not **the strongest**, of all large utility systems in the country. This enviable position is the product of decades of prudent, and often difficult decisions, which have proven to be very beneficial for current customers. However, SRP is now in the early stages of the 6-year, $12.3 billion capital program, which in the absence of any Base Price increases over this period, would be projected to require the issuance of nearly $7.7 billion of additional debt. As shown in the table below, this amount of debt issuance would take SRP's Debt Ratio up to 58.1% by 2030.

Table 1 - SRP Financial Projections Without any Base Price Increases

FP26 Case: No Base Price Increase in FY26 or FY28, 1.6% FPPAM Decrease in FY26							($ Millions)
Fiscal Year end April 30	**2025**	**2026**	**2027**	**2028**	**2029**	**2030**	**6 Yr Total**
Combined Net Revenues	461	264	178	44	241	491	1,679
Funds Avail for Corp Purposes	923	839	814	716	826	1,067	5,185
Capital Expenditures	1,694	1,507	1,733	2,050	2,578	2,750	12,313
Debt Issuance	789	672	1,137	1,437	1,841	1,794	7,670
Debt Ratio	46.6%	47.4%	49.8%	53.2%	56.4%	58.1%	
Debt Service Coverage	3.95 X	3.63 X	3.32 X	2.89 X	2.92 X	3.09 X	

Projections provided by SRP

If SRP's Debt Ratio were to reach 58.1% in 2030, at that point it would be SRP's highest Debt Ratio in 30 years. In the table above, the green highlighted figures show some of SRP's particularly strong near-term financial metrics, while those in yellow indicate the cautionary potential metrics projected to occur in the absence of any Base Price increases. The projections for the "No Increase" scenario would clearly lead to significant financial metric deterioration. The Base Price increase being proposed by SRP Management is designed to mitigate these impacts, without imposing the full burden of capital expenditures on current customers. In order to evaluate the impact of the proposed Base Price increase, it will be helpful to understand SRP's current financial condition relative to other large public power systems.

Public Power Financial Metrics and Comparisons

There are three important general financial metrics analyzed by public power credit rating agencies and investors. They are:

Debt Ratio(s) or Leverage – the ratio of debt to other balance sheet figures, such as assets or capitalization. Capitalization is defined as debt + accumulated net revenues, with net revenues as an equity-type metric for governmental utilities. Lower debt ratios indicate lower debt costs, more flexibility and lower risk.

Debt Service Coverage – the ratio of annual cash flow available to pay debt service relative to the amount of the annual debt service payments. Higher coverage creates more capacity to absorb revenue or expense volatility and still be able to meet debt service payments.

Liquidity – the amount of cash, investments, and short-term borrowing capacity relative to the amount of ongoing operating expenses. Greater liquidity is another metric which indicates better ability to respond to cash flow volatility.

In addition to its strong Debt Ratio, SRP has historically maintained healthy liquidity metrics. SRP has a reasonable targeted $600 million minimum general fund balance, which when combined with other operating funds and segregated funds available for general corporate purposes, provides substantial liquidity to meet unexpected cash flow volatility. SRP has never had to use any of the segregated funds for operating purposes.

SRP's Debt Service Coverage has also been very strong – with cash flow available for debt service averaging roughly 3.7X annual debt service payments over the last ten years. High debt service coverage provides two significant benefits. First, strong coverage provides assurance a utility can absorb revenue or expense volatility and still meet its debt service obligations. Second, the excess cash flow remaining after making debt payments is available to invest in capital assets, thus reducing the ongoing need for additional debt.

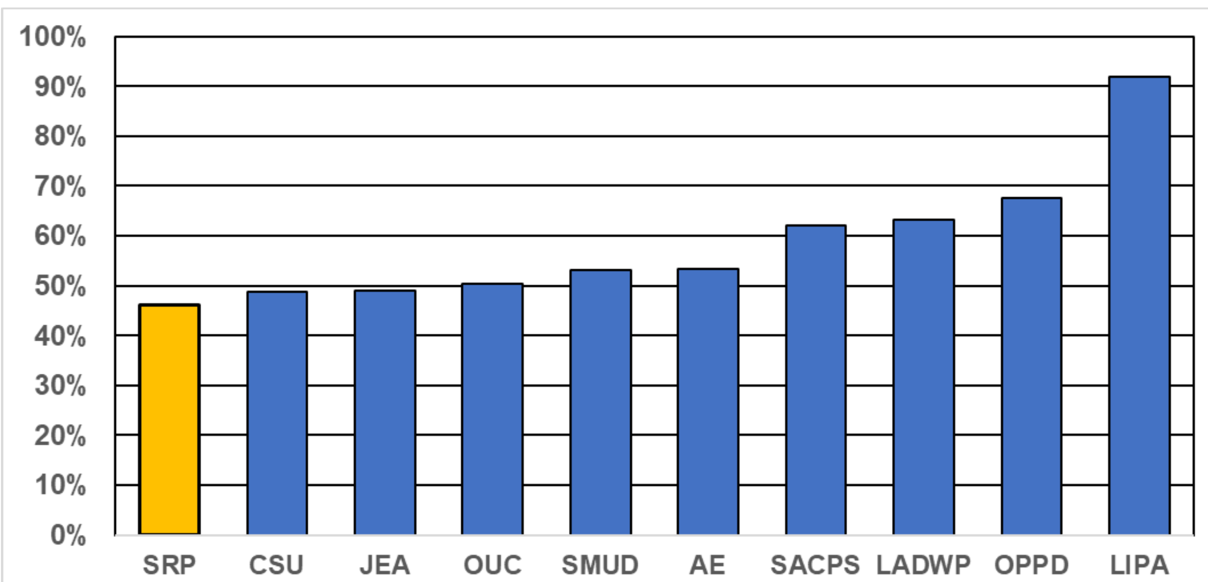
SRP's primary financial metrics position SRP as one of the most financially secure and stable of the larger public power utility systems in the country. The table below provides a comparison of the Debt Ratio (again using Debt-to-Capitalization) for a Peer Group of the ten largest fully integrated (owning generation, transmission, and distribution), load-serving public power utilities in the United States. For this metric, we compare stated Long-Term Debt to the total of Long-Term Debt and Net Position (together labeled Total Capitalization or Capital). We use the figures from each utility's most recent audited financial statements. There are several historical and situational differences between these Peer Group utilities, such that their absolute levels of debt and Debt Ratios vary considerably. However, most have shown stable to slightly improving Debt Ratios in recent years The following table provides Net Position, Long-Term Debt, Total Capital, and Debt Ratio for the 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 their current Debt Ratio – lowest to highest.

Table 2 – Public Power Peer Group Debt and Debt Ratios

Public Power Peer Group Utility		Net Position	Long Term Debt	Total Capital	Debt Ratio	Credit Ratings
Salt River Project	SRP	6,408	5,471	11,879	**46.1%**	**Aa1/AA+/--**
Colorado Springs Utility	CSU	2,526	2,412	4,938	**48.8%**	**Aa2/AA+/--**
JEA (Jacksonville, FL)	JEA	1,484	1,426	2,910	**49.0%**	**A1/A+/AA**
Orlando Utility Commission	OUC	1,695	1,726	3,421	**50.5%**	**--/AA/AA**
Sacramento Muni Utility Dist	SMUD	2,587	2,921	5,508	**53.0%**	**Aa2/AA/AA**
Austin Energy	AE	1,766	2,021	3,787	**53.4%**	**Aa3/AA-/AA-**
San Antonio City Public Service	SACPS	4,364	7,175	11,539	**62.2%**	**Aa2/AA-/AA-**
LA Dept Water & Power (Power)	LADWP	7,027	12,118	19,145	**63.3%**	**Aa2/AA-/--**
Omaha Public Power District	OPPD	1,544	3,205	4,749	**67.5%**	**Aa2/AA/--**
Long Island Power Authority	LIPA	827	9,292	10,119	**91.8%**	**A2/A/A+**

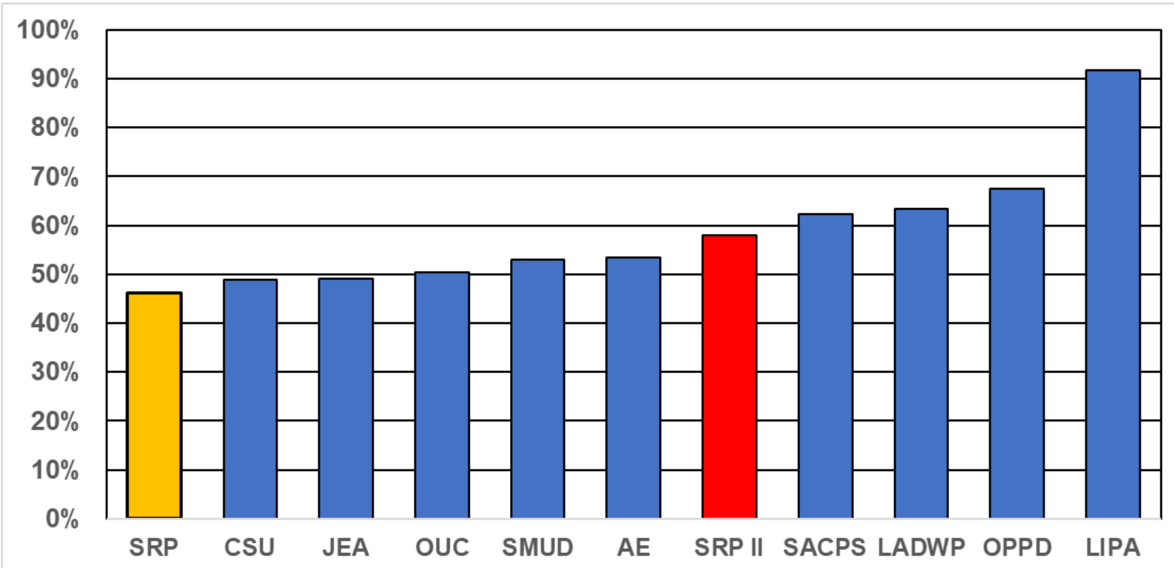
Also shown below is a graph of the Peer Group Debt Ratios, with the abbreviations at the bottom of the graph tracking to those listed in the table above.

Chart 1 – Public Power Peer Group Debt Ratios



The Peer Group comparison demonstrates SRP’s credit strength, and is one of the reasons SRP has the highest average credit ratings of the entire Peer Group. As shown in the Table 1 data provided by SRP, if SRP did not implement any Base Price increase over the next several years, the Debt Ratio is projected to increase materially. SRP’s Debt Ratio would move SRP from the top of the Peer Group down to the mid-range of the group. The following graph adds a data point (SRP II) for the "No Increase" scenario.

<u>Chart 2 – Public Power Peer Group Debt Ratios with SRP II Added</u>



Debt Service Coverage would also decline materially – from the recent ten-year average of over 3.7X, down to below 3.0X. Both of these results would represent a substantial departure from SRP's traditional "Top of Class" financial performance. These metrics would be materially lower than recent numbers, and represent a reversal of SRP's practice of preserving the strong financial position made possible by energy prices paid by customers over the past several decades. SRP's financial strength is very much a legacy built by previous Boards, Management Teams, and Customers. The outcome of the 2025 Price Process will determine the extent to which this tradition is carried forward for future Customers.

SRP's 2025 Proposed Price Changes and Impacts

The proposed 4% Base Price increase, which will be partially offset by the 1.6% FPPAM reduction, will position SRP to reduce the degree of financial metric deterioration which would occur in the absence of any Base Price increase. The proposed Base Price increase will lead to a somewhat higher Debt Ratio than the current 46.1%, but it will generate cash flow to fund more of the capital program and reduce the amount of debt required. SRP management has provided financial projections for the recommended Base Price increase. The projections also include a hypothetical additional 4.0% Base Price increase effective in 2028. ***This additional increase is not a recommendation, but presented only to provide a potential scenario which preserves***

SRP's financial metrics at levels providing a reasonable expectation of maintaining SRP's credit ratings at or near current levels. The table below provides the projected results for the recommended 4% Base Price increase, along with a hypothetical additional 4% increase. Highlighted rows have been added to show the differences in Debt Issuance and Debt Ratio between this scenario and the "No Increase" scenario.

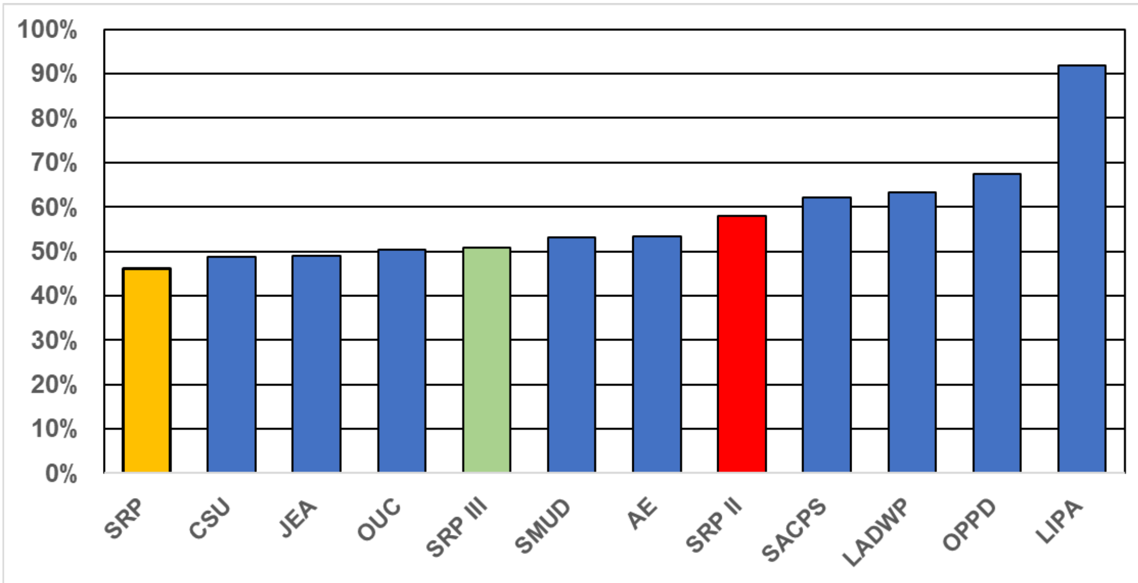
Table 3 - SRP Financial Projections w/ Proposed and Additional 4% Base Price Increases

FP26 Case: 4% Base Price Increase in FY26 & FY28, 1.6% FPPAM Decrease in FY26							($ Millions)
Fiscal Year end April 30	2025	2026	2027	2028	2029	2030	6 Yr Total
Combined Net Revenues	461	335	361	339	700	1,003	3,198
Funds Avail for Corp Purposes	923	911	997	1,011	1,285	1,578	6,704
Capital Expenditures	1,694	1,507	1,733	2,050	2,578	2,750	12,313
Debt Issuance	789	601	954	1,143	1,383	1,282	6,152
Reduction vs No Increase	**0**	**71**	**183**	**294**	**458**	**512**	**1,518**
Debt Ratio	46.6%	46.8%	48.1%	49.9%	51.0%	50.8%	
Improvement vs No Increase	**0.0%**	**0.6%**	**1.7%**	**3.3%**	**5.4%**	**7.3%**	
Debt Service Coverage	3.95 X	3.82 X	3.78 X	3.57 X	3.91 X	4.15 X	

Projections provided by SRP

While it is only the single 4% Base Price increase being recommended currently, in order to develop a meaningful longer-term projection and comparison to the "No Increase" scenario, it is helpful to assume some amount of future increase to generate a meaningful longer-term projection. The "Multiple Increase" scenario still results in a rising Debt Ratio. However, PFM believes it is a scenario which provides a reasonable expectation of preserving SRP's current credit ratings, and provides an indication of what may be required in the future if one of SRP's goals is to maintain its credit ratings. In the following graph, we add another Debt Ratio data point (SRP III) which includes the projected 2030 result of the "Multiple Increase" scenario.

Chart 3 – Public Power Peer Group Debt Ratios with SRP III Added



As Table 3 shows, with SRP management's proposed price changes, along with an additional 4% increase, debt service coverage is projected to decline slightly through 2028, but then return to current levels toward the end of the projection period. Without any change in the Base Price SRP's debt service coverage would decline to below 3.0X. The Debt Ratio would continue to increase under both scenarios, but at a slower pace with Base Price increases. Without Base Price increases, the Debt Ratio is projected to go to 58.1% by the end of 2030. With the increases shown above, that figure is lower at 50.8%. Even with multiple increases, SRP would be borrowing over $6 billion of new debt over six years.

Neither of the scenarios outlined above presents the picture of a financially "troubled" utility. SRP's financial condition remains viable under either scenario. However, the proposed price increase, and the resulting financial metrics will again send the message to the financial community that SRP continues to value credit strength and ratings. PFM expects the proposed Base Price increase, and resulting financial 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. This expectation assumes SRP would maintain the multiple non-financial credit rating criteria at their current levels. With the implementation of the Base Price increase, and preservation of its historically strong financial metrics, PFM believes SRP will continue to borrow at the lowest interest rates available to any municipal utility system.

Benefits of Preserving Debt Ratios and Credit Strength

SRP's current customers have affordable energy today because SRP has a history of making responsible decisions; striking the balance between near-term price pressures and long-term cost management. SRP has 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 historical conservative debt management in multiple ways. The obvious result of reduced reliance on debt in the past is SRP's lower debt service in the present. In addition, reduced debt translates to stronger financial metrics (e.g., liquidity, cash flow, debt ratios) which are carefully followed by credit rating analysts and investors. These metrics are 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 2025 Price Process will again have a direct impact on current customers, as well as a lasting impact on future customers. SRP has one of the largest projected capital plans of any public power utility – with over $12 billion projected between 2025 and 2030, over $6 billion expected to be financed with debt. SRP also has over $2 billion of outstanding bonds which, at current market rates, could be refinanced for savings over the same 2025 to 2030 time period. The potential 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) maintain its long-standing credit strength, (2) deliver lower future capital costs and greater future refunding savings, and (3) 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 possible SRP could maintain solid debt credit ratings and access the capital markets at very favorable interest rates under either of the pricing process scenarios detailed above. However, the lower debt balances made possible by the 2025 pricing proposal provide greater assurance of maintaining SRP's credit strength, and will continue the tradition of far-sighted decision-making aimed at preserving SRP's balance sheet for both current and future Customers.

Other Price Process Considerations

In December 2000, the SRP Board adopted five Pricing Principles which 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, but recover them over a longer period, thus allowing 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 – as we seem to be seeing for sizable resource additions – 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 built in part with energy prices paid by past customers. The Pricing Principle of Equity would argue for pricing decisions which preserve SRP's balance sheet and capital strength and allow future customers to benefit from a similarly competitive SRP pricing structure.

Based on PFM's review of SRP's management's proposed Base Price increase, it appears the price adjustments will adequately recover costs and preserve SRP's capital strength and credit ratings. PFM recommends SRP continue to emphasize the principles of Gradualism and Equity and maintain the capital strength it has built over many decades.

Conclusions

The proposed Base Price increase of 4% under consideration by SRP should preserve SRP's credit strength and provide SRP the financial flexibility to respond to the changes and load growth being experienced in the utility industry. The proposed price increase will provide cash flow to cover debt service, contribute to SRP's considerable capital improvement program, and slow the pace of growth in debt and Debt Ratio. 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 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 which SRP's current customers experience today.

PFM Financial Advisors as Provider of the Report

PFM Financial Advisors LLC ("PFM") provides a full range of financial and investment advisory services to state and local government entities throughout the United States. For the past decade, PFM has served as advisor on a larger par amount of debt financing for United States governmental entities than any other municipal advisor institution. PFM has roughly three hundred employees in over thirty offices throughout the country. Ten of these professionals spend nearly all their time providing financial advice to electric utilities which are either owned, controlled, or somehow affiliated with state or local governmental jurisdictions. PFM currently provides financial advisory services to roughly 70% of the fifty 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, with the shaded names indicating entities for whom PFM has provided financial advisory services.

Largest Public Power Entities by MWH Sold (2020) with PFM Clients Highlighted					
Rank	Public Power Utility	State	Rank	Public Power Utility	State
1	Salt River Project	AZ	26	Orlando Utilities Commission	FL
2	New York Power Authority	NY	27	North Carolina Municipal Power Agency No. 1	NC
3	CPS Energy	TX	28	North Carolina Eastern Municipal Power Agency	NC
4	Santee Cooper	SC	29	Tacoma Public Utilities	WA
5	Los Angeles DWP	CA	30	Intermountain Power Agency	UT
6	Nebraska Public Power District	NE	31	Indiana Municipal Power Agency	IN
7	Long Island Power Authority	NY	32	WPPI Energy	WI
8	Omaha Public Power District	NE	33	Colorado Springs Utilities	CO
9	Puerto Rico Electric Power Authority	PR	34	EPB - Chattanooga Electric Power Board	TN
10	Lower Colorado River Authority	TX	35	Knoxville Utilities Board	TN
11	Austin Energy	TX	36	Clark Public Utilities	WA
12	American Municipal Power	OH	37	Huntsville Utilities	AL
13	Chelan County PUD No. 1	WA	38	Missouri Joint Municipal Electric Utility Comm	MO
14	Memphis Light, Gas and Water Division	TN	39	Platte River Power Agency	CO
15	Sacramento Municipal Utility District	CA	40	Sam Reyburn Municipal Power Agency	TX
16	JEA	FL	41	Douglas County, PUD No. 1	WA
17	Southern California Public Power Authority	CA	42	Cowlitz County, PUD No. 1	WA
18	MEAG Power	GA	43	Eugene Water & Electric Board	OR
19	Seattle City Light	WA	44	Lincoln Electric System	NE
20	Nashville Electric Service	TN	45	Springfield, City Utilities of	MO
21	Grant County, PUD No. 2	WA	46	Silicon Valley Power	CA
22	Energy Northwest	WA	47	Garland, City of	TX
23	Snohomish County, PUD No. 1	WA	48	Illinois Municipal Electric Agency	IL
24	Florida Municipal Power Agency	FL	49	IID Energy	CA
25	Grand River Dam Authority	OK	50	Modesto Irrigation District	CA