Rachel Johnson (00:00):

<Silence> Welcome back to Co-Op Energy Talk. I'm Rachel Johnson, the c e o here at Tray Land Electric Cooperative. And today we are talking about Cherry Land's 2023 kind of into year financial forecast, but more specifically about capital credits and what this means for how we're gonna handle capital credits this year. When you get your power from cherry land, you get more than just clean, affordable, reliable electricity. You also get access to all of the benefits of co-op membership, including Patronage Capital, which is your share of the cooperatives margins at the end of the year, also known as Capital Credits. Since 2009, cherryland has returned about $31.5 million in capital credits to our members. However, this year our board made the very difficult decision not to return any capital credits. And so we thought it makes sense to kind of just take some time in this podcast and explain why and what goes into that decision so that you can kinda understand what it means for the co-op and also what it looks like going forward. And joining me today to discuss Capital Credit retirements is Cherry Land's C f O Mark Wilson, thank you for joining me. Mark. Thank

Mark Wilson (01:13):

You for having me, Rachel. It's a pleasure to be here.

Rachel Johnson (01:15):

I know, and we were just talking about this, I think this is your first time on the podcast, it's time. But you've been at Cherry Lamb for how many years?

Mark Wilson (01:21):

Almost 18 years. Okay.

Rachel Johnson (01:22):

So it took him 18 years to get a seat on the pack. No, I'm just kidding. No. So Mark's been helping kind of guide the financials of the co-op for, you know, almost two decades. So certainly incredibly knowledgeable person to help us talk through all of this. So to kick us off, let's, let's talk through how capital credits work. 'cause I think a lot of people who aren't super familiar with co-ops don't understand it. So why don't you walk us through that lifecycle of a capital credit, that kind of difference between allocation and retirement?

Mark Wilson (01:46):

Sure. When I look at Capital Credits, I look at them as really two parts. There is the allocation of the excess margins, which you talked about, and that happens on an annual basis. So after we have finished our fiscal year end and we have our final audited financial numbers, that's when the allocation takes place to the membership. And there's two components of that allocation. There's the cherry land portion, which is the excess net operating margins that cherry land generates from its core business. And then there's the allocation that we receive from Wolverine Power Cooperative, our, our g and t on their excess margins that they generate and are proportionate share for those margins as well. Those generally show up on your bill as a bill notice, if you will, in either June or July every year.

Rachel Johnson (02:42):

So in June or July of 2024, for example. Correct. It'll show 2020 threes allocation. Correct. So this most recent June or July would've been 2020 twos out? That

Mark Wilson (02:49):

Is correct, yes.

Rachel Johnson (02:50):

Yes. That makes sense.

Mark Wilson (02:51):

And then the second component is the actual retirement of those capital credits. And this is really a board decision based on where we sit financially at the time. And the, it's usually based on what management recommends for the actual retirement to take place for that given year. And it's usually an actual dollar amount that the, the board chooses to retire. What happens is that 75% of that dollar amount goes to the oldest unretired year that's still on the books for for the cooperative mm-hmm. <Affirmative>. And in this particular case for Cherryland, that's 2004.

Rachel Johnson (03:33):

So everything that we had allocated prior to 2004 has been retired. Correct. But we still have allocated margins from 2004 that we've not yet retired and had not fully and had, had we done a capital credit retirement this year, 75% of that, whatever that dollar amount was, would've gone to to the

Mark Wilson (03:50):

2004 helping

Rachel Johnson (03:50):

To retire those. Yep, that's

Mark Wilson (03:51):

Correct. Okay. And then two 5% goes to the most recent year. So if we were to have done the retirement in 2023, that would've been to the 2022 allocation.

Rachel Johnson (04:04):

And what's cool about that breakdown of 75 and 25 is it allows us to kind of share our, our margins, if you will, with both our, our oldest capital capital credits. We haven't retired, but also with some of our newer members who may be just getting to know the cooperative and kind of understand this core part of being a member of a cooperative. Those retirements generally will show up for members in December. So if you are a current member, you would receive that as a credit on your bill. And if you are no longer a current member, so let's say you were a member in 2004 and you now are, you know, off with a lesser utility, obviously <laugh> then you would receive that in a check in the form of a check to whatever address we have on file for you, which is why we always tell people make sure to keep your contact information updated even when you're no longer an active member here. That's correct. 'cause You might still have un unretired, but allocated capital credits.

Mark Wilson (04:51):

Yes.

Rachel Johnson (04:52):

So let's kind of talk through how this, I think it's baffling for people to hear that we still have Unretired capital credits from 2004. So I think it might be helpful if we just take a second and talk through how holding onto that retirement for a while benefits the entire membership and what we use those dollars for. Because what it essentially is, is it's a, a zero interest loan to the co-op from the membership at that time that we then use to invest in the system. That's

Mark Wilson (05:22):

Correct. Yes. And what that does is that it helps us control our own debt service costs that we have with our outside lenders. And it helps keep our rates lower for all the membership. And like you indicated, it's, it's a capital investment for maintaining our poles and wires. And our system, you know, we're very proud of the fact that our reliability is 99.99%, but that takes a lot of effort and a lot of money mm-hmm. <Affirmative> to, to maintain that level. Just for example, our, our right of way maintenance budget alone for 2023 as amended is about two and a half million dollars. So that's a big chunk of money that we allocate for just maintaining the system. Mm-Hmm. <Affirmative>, that doesn't include any system upgrades that we do. Mm-Hmm. <Affirmative> which we budget for roughly about $7 million every year to maintain our 3000 miles of line and upgrade those 3000 miles of line. You know, this co-op started in 1938, so there's some old stuff that's still out there that we have to maintain and, and upgrade and we do an excellent job at of that. Yeah.

Rachel Johnson (06:31):

And we've been very I think aggressive is actually a fair way of describing it. Aggressive with our approach to investing in our system. I mean, you mentioned right of way our tree trimming. We're on a six, six year tree trimming cycle, whereas most utilities across the country might be 10 or even 12 years before they're getting back to a circuit and re trimming trees. But the advantage to our members of that approach is that it has allowed us to have literally state and industry leading reliability numbers where people come to us, other utilities come to us and say, what are you doing? And how do, how do we get to where you're at? And it's because we make those investments, but as you pointed out, they're costly. So talk through what capital credits do in terms of our debt service and kind of where, what, what would it look like if we were just borrowing all that money and every single year we retired a hundred percent of the capital credits that we had?

Mark Wilson (07:20):

Well, our current debt level on a long-term basis and is in excess of about $62 million. So if we were to totally retire capital credits annually every year, in order to fund that, we'd have to borrow money to do that. Mm-Hmm.

Rachel Johnson (07:36):

<Affirmative>

Mark Wilson (07:37):

And borrowing from the membership, if you will, at 0% as you indicated, helps to fray additional borrowing costs, helps to keep rates down and allows us to really operate the co-op in the most efficient manner that we can

Rachel Johnson (07:53):

Mm-Hmm. <Affirmative>.

Mark Wilson (07:55):

And for example, right now, our blended interest rate on all of our long-term debt is about 4.3% mm-hmm.

Rachel Johnson (08:03):

<Affirmative>. So

Mark Wilson (08:04):

If we were to borrow money at today's market, which is in excess of 6%, if not higher, that additional cost to the membership for one year would be an extra six to $700,000 of additional expense. So it's a huge number. And so a lot of factors go into the decision to whether or not we retire capital credits or whether or not we take a pause for a year.

Rachel Johnson (08:37):

Mm-Hmm. <affirmative> and I, I and I, I just wanna put a really fine point on something you said. 'cause I think it's so important. What we're doing as an organization is balancing two different things. And one is a, a desire to keep our rates as affordable as possible, and recognizing that interest is one of our big expenses. And this is a way to balance that expense and keep the day-to-day rates that people pay on their bills a little lower. At the same time, we also recognize we can't hold onto people's money forever. And that's why we have consistently retired capital credits. We're committed to consistently retiring capital credits. We don't, we don't view it as an indefinite loan. It's simply a allows us to, to keep that, to keep that balance of what are we collecting in our rates right now versus how are we offsetting cost with how we do this margin allocation in retirement at the end of every single year.

Rachel Johnson (09:26):

So this year, you know, after basically 14 years, we made the recommendation to the board not to retire Capital Credits. And I just kind of wanna talk through that because it is, it is different than what we've done over the last few years. Let's start by just, and I've, for my loyal listeners, you've heard this on so many board meeting briefs now that it's probably no longer good or fun or new news. The weather has not been our friend this year that it's been so mild. We had a really mild winter. We had a really pretty mild summer, a few hot, you know, a day or two here, but not consistent heat,

Mark Wilson (09:56):

Not consistent. Right.

Rachel Johnson (09:56):

Then we moved into fall. We, the first parts of September were cold and rainy. We got one more week of heat and now we're back to kind of boring, cold and rainy, but not super cold. So what happens is people aren't using their air conditioners or their fans in their heating as much as what we've seen in a normal year. Talk about what that has meant for our sales.

Mark Wilson (10:14):

Yeah. I hate to use the term perfect storm in an electric co-op utility industry, but that's kind of the situation that we face this year. Mm-Hmm. <affirmative>

Mark Wilson (10:25):

Our weather has not been cooperating for us for our industry. And it's not just us alone. I mean, you talk to every other co-op in the state of Michigan and, and they're in the same situation. We are our energy sales are down about a five and a half percent from where they were a year ago through September. You add the inflationary pressures that we're seeing and everybody's seeing mm-hmm.

Rachel Johnson (10:49):

<Affirmative>

Mark Wilson (10:49):

And the interest rates rising and interest costs being higher. We're in a very tough position this year. Mm-Hmm.

Rachel Johnson (10:55):

<Affirmative>

Mark Wilson (10:55):

To the point that we are forecasting that our net operating margins will be negative probably in excess of a million dollars. Mm-Hmm.

Rachel Johnson (11:05):

<Affirmative>.

Mark Wilson (11:05):

So what that means on your allocation for 2023 from the cherry land margin perspective is that it'll be zero. Mm-Hmm.

Rachel Johnson (11:14):

<Affirmative>,

Mark Wilson (11:15):

There will still be an allocation from Wolverine because they're forecasting positive margins for 2023, but cherry land is not. So the allocation that you will likely see on your, on your bill next summer for 2023 from Cherry land will not show anything. Mm-Hmm. <Affirmative> it'll just be a, a line item allocation only from Wolverine for margins. So we

Rachel Johnson (11:39):

Have this dynamic of our sales are down, we're also really trying very hard to manage all of these cost pressures and inflationary pressures from both interest rates, labor costs, supply chain costs, ev there's no, the cost of nothing has gone down. The cost of everything has gone up. Correct. So we, we know that we're going to have to tackle that with rates. But for this year, we also kind of looked at it and when we were thinking through what we would do with capital credit retirements, looking at our equity position, looking at cash flow, it was very, very evident that it would be irresponsible to fund a capital credit retirement this year because we would've had to do all of that through some sort of a debt

somewhere. Right? Correct. Like, whether it's a short term or long term borrowing, we were still gonna have to fund it through debt at high interest rates in a year when we're already going to in the year with negative net operating margins.

Mark Wilson (12:30):

And in addition to that in the past several years, we've received a fairly substantial retirement from, from Wolverine from their margins. And Wolverine has made the decision based on their financial metrics that they're taking a pause on retirement and capital credits as well. So we will not be receiving any retirement funds from Wolverine probably for the next three years mm-hmm.

Rachel Johnson (12:55):

<Affirmative>.

Mark Wilson (12:56):

So if we were to do a retirement, we'd have to borrow money to fund that mm-hmm.

Rachel Johnson (13:01):

<Affirmative>

Mark Wilson (13:01):

And in the financial situation we're in for this current year, it just did not make a whole lot of sense to do that. Yeah.

Rachel Johnson (13:08):

So it's the right decision. It's an, it's a really prudent, I think, approach to managing this, all of these dynamics we've just described. But we also recognize that we're going to go back to retiring capital credits. This is a, this is not a long-term thing. This is a short-term thing then a one

Mark Wilson (13:22):

Thing. It's

Rachel Johnson (13:22):

Yep. That we're looking at it as a one-off. So let's kind of talk through the plans that you and I have been discussing and that we've been discussing as a senior team with our board on how we're gonna get back to healthy margins and back to retiring capital credits and just kind of come up with a long-term strategy for how to manage all these pressures so that we're not having to, you know, at the end of, we don't wanna end multiple years with negative operating margins. That's not a good plan. <Laugh>, correct. Mm-Hmm. <Affirmative>. Correct. so let's, let's kind of talk through some of the things we're doing. One he's not here to discuss it with us, but our engineering and operations manager, Frank Ker, is in the process of finalizing a five-year work plan. That is something we do consistently every five

Mark Wilson (13:57):

Years. Every

Rachel Johnson (13:57):

Five years. Yeah. That's why we call it that. But what that gives us is a really solid and shared understanding of all of our capital investments over the next five years.

Mark Wilson (14:06):

Correct. It's a forecast of, of what we anticipate in system upgrades Yep. Throughout our entire service territory for the next five years.

Rachel Johnson (14:15):

So then once we have that in hand, which we're gonna have by the end of the year, talk about what your team does next in, in terms of saying, okay, well here's what we wanna do.

Mark Wilson (14:22):

Well, we'll take that data and we'll do a, a financial forecast. And we factor in a lot of different assumptions into, into that forecast. The plant upgrades is the biggest because that impacts pretty much everything that we intend to do going forward and how we're gonna fund that. And the forecast calculates that for us we set up certain targets and metrics that we wanna achieve and the forecast will calculate what our revenue requirements will need to be for us to hit those targets. Mm-Hmm.

Rachel Johnson (15:01):

<Affirmative>

Mark Wilson (15:02):

And it'll indicate to us if we need to do a rate increase and when mm-hmm.

Rachel Johnson (15:06):

<Affirmative>

Mark Wilson (15:07):

And the frequency of that rate increase. So we're gonna go into this after we get the update from Frank on the five-year work plan, we'll have a pretty good idea as to where we think 2023 will end up at that point, we'll, at that point probably already have our 2024 budget completed. And so we're gonna hit the ground running with good data. And so what we will do is develop that forecast and that forecast will tell us it's really a 10 year forecast. But once you get out past three or four years, it's kind of meaningless data at that point. 'cause Things change all the time. But it'll tell us exactly the approach that we need to take to get us back on the right footing.

Rachel Johnson (15:51):

So the thing that I really like about the timing of all of this is that we, the last time we did a five-year work plan, we were in a very different environment than we are now. And now we had, to your point, we have better data and I think probably more realistic assumptions about what our costs are gonna be long-term to continue to make the system investments we have to make. 'cause All of this is ultimately about delivering on our promise of reliability to our members. Right? Like they count on us to keep the lights on and the cost of doing that has changed, but we're not gonna back off of keeping the lights on. We're gonna figure out how to plan long-term for those costs. And this puts us in a good position to start doing that next year with the, with the forecasting that your team is gonna do, and then looking

and saying, here's how much revenue we're gonna need over the next few years. Here's the gap between what our current rates can do and where we need to be to continue to be healthy and investing in our system. And so for those of you listening at home, just know we're gonna continue to share that with you. We, we wanna be as transparent as possible about those processes and the insights we're getting to give you long as much long-term certainty as we can about where your rates are heading for us to continue to invest in our system. Anything else on that before we, before we

Mark Wilson (16:57):

Yeah. We're not gonna change our approach to how we operate our business. Yeah. Yeah. We're gonna continue to invest in the system that we always have mm-hmm. <Affirmative> over the last several years, long before I even got here. And just really manage the business as it needs to be managed. Yep. And that's not gonna change. Yeah.

Rachel Johnson (17:18):

And I, and I thank you for saying that. 'cause I think that sometimes people say, well, why don't you just, you know, whatever, pull back on your system maintenance for a year or two, that bill always comes due and it comes due in the form of major outages that impact the businesses and homes we serve. And those are very, very costly to restore as well, so that, that bill will always come, come due. And I, and I think the thing that we all remain committed to is we are, we, this co-op has been in business for 85 years and we're running it as a business that's gonna exist 85 years from now. So always having that kinda long-term focus on the investments we make today benefit today's members and tomorrow's members in the form of reliable electricity, which is, is necessary. Right.

Speaker 3 (17:58):

So,

Rachel Johnson (17:58):

Yeah. Thank you for saying that. So that's kinda where we're at. I have to say, mark, I can't believe we've never had you on the podcast before. 'cause You're such a good podcast. Oh, thank you. You could have a, you could have a little side jam in podcasting. But you, if you have more questions about this, don't hesitate to reach out to me. But also, mark and I both have a column in the November, December issue of country lines talking through this. I kind of talk a little bit about the current financial status of the co-op and what we're doing next year. Mark talks a little bit more about how capital credits work and kind of what goes into the decision surrounding capital credit. So be sure to check that out. I think lots of good information there. And stay tuned over the next year as we work through some of these and come up with some long range planning. Thank you again for joining me, mark.

Speaker 3 (18:36):

It was my pleasure. Thank you for having me.

Rachel Johnson (18:38):

Join us next time for more co-op Energy Talk.