

**BEFORE THE NEW MEXICO PUBLIC REGULATION COMMISSION**

**IN THE MATTER OF THE FILING OF ADVICE            )**  
**NOTICE NO. 69 BY SOCORRO ELECTRIC            )**            **Case No. 18-00383-UT**  
**COOPERATIVE, INC.                                    )**  
**\_\_\_\_\_)**

**ORDER REQUIRING ADDITIONAL SUPPLEMENTAL TESTIMONY FROM  
SOCORRO ELECTRIC COOPERATIVE, INC.**

This matter comes before Carolyn R. Glick, Hearing Examiner for the New Mexico Public Regulation Commission, upon her own motion and pursuant to 1.2.2.35(K) NMAC. The Hearing Examiner **FINDS AND CONCLUDES:**

1. From looking at Schedule D-9.0 (p.69 of 380 of the Cost of Service and Rate Study), the Hearing Examiner is unclear as to what method Socorro Electric Cooperative, Inc. (SEC) used to calculate its revenue requirement. Attached Exhibits 1, 2 and 3 describe methods commonly used by rural electric cooperatives to calculate the revenue requirement, such as debt service coverage and TIER (which can be one of several ratios). These exhibits also describe, in general, the components of the revenue requirement. For example, *Accounting for Public Utilities* describes the debt service coverage approach as:

$$\text{Operating costs} + \text{taxes} + \text{debt service coverage} = \text{revenue requirement}$$

Exh. 1.

2. SEC should file supplemental testimony identifying what method it used to calculate its revenue requirement and identifying the components of the approach it used.

**IT IS THEREFORE ORDERED:**

A. On or before April 5, 2019, SEC shall file Supplemental Testimony answering the following questions:

1. What method did SEC use to calculate its revenue requirement? Debt service coverage approach, TIER method or something else?
2. If SEC used the TIER method:
  - a. What TIER ratio did SEC use? Operating TIER or something else?

b. What TIER level did SEC use and why? (For example, 1.2, 1.5, 2.0 or something else?)

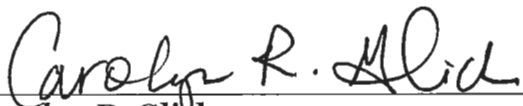
c. Set forth, by component and amount, calculation of the TIER. For example, Exhibit 3 identifies the equation for Net TIER as (net margins + long-term debt expense)/long-term debt expense.

3. Set forth, by general component and amount, calculation of SEC's revenue requirement. For example, see Exhibit 1 at 3-19 (example) and Exhibit 2, p.25.

B. This Order is effective immediately.

Issued at Santa Fe, New Mexico on April 1, 2019.

**NEW MEXICO PUBLIC REGULATION COMMISSION**

  
\_\_\_\_\_  
**Carolyn R. Gliick**  
**Hearing Examiner**

# ACCOUNTING FOR PUBLIC UTILITIES

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## Volume 1

**ROBERT L. HAHNE**

**GREGORY E. ALIFF**  
**DELOITTE & TOUCHE LLP**

*Contributing Authors: The following were the original contributing authors of Accounting for Public Utilities. While much of what these individuals originally wrote has been removed or replaced through the annual update process, we wish to continue to recognize their contributions in the creation of this book.*

**FRANCIS J. ANDREWS, JR.**

**WILLIAM W. EYERS**

**JOHN S. FERGUSON**

**HERNAN GONZALEZ**

**JOHN D. MCCLELLAN**

**RICHARD W. MCCULLOUGH**

**JAMES E. MORRIS**

**RANDALL A. SNOWLING**

**JAN A. UMBAUGH**

**2016**

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factors to produce the allowable rate of return on common equity.

§ 3.04 Revenue Level Adjustments

After the composite cost of capital for the utility under review has been determined and assuming that the composite rate equals the required rate of return (the typical assumption), the earnings deficiencies and the revenue adjustment to correct the problem under test period conditions can be determined. This process can be illustrated by using the preceding financial data (Figures 3-1, 3-2, and 3-3) as follows:

**Example**

|   |                              |
|---|------------------------------|
| Rate Base   | <u>\$750</u>                 |
| Required Rate of Return   | <u>9.60%</u>                 |
| Net Operating Income<br>Required                                | <u>\$ 72</u>                 |
| Test Period Cost of Service Results<br>Deficiency               | <u>\$ 60</u><br><u>\$ 12</u> |
| Revenue Increase (Deficiency adjusted<br>for a 40% tax factor.) | <u>\$20</u>                  |

The rates are then adjusted, based on operations of the test period (i.e., kilowatt-hour sales), to produce an additional \$20, so that the operations will produce revenues at a level adequate to cover the total cost of service as measured under test period conditions. An alternative approach to the same objective is to total the identified cost components to produce total cost of service, which is then compared with test period revenues.

**Example:**

|                                     |              |
|-------------------------------------|--------------|
| <b>Test Period Cost of Service:</b> |              |
| Operation and Maintenance Expenses  | \$180        |
| Depreciation and amortization       | 50           |
| Taxes—Other                         | 5            |
| Income Taxes                        | 27*          |
| Cost of Capital                     | <u>72</u>    |
| Total                               | \$334        |
| Test Period Revenue                 | <u>314</u>   |
| Revenue Increase                    | <u>\$ 20</u> |

\* Result of applying the gross-up for taxes on equity and preferred capital cost recovery (\$72 total cost of capital less debt portion of \$30 [ $\$750 \times .04$ ]  $\times .66$  gross-up at a 40% tax rate).

§ 3.05 Debt Service Coverage Approach

The objective of the debt service coverage approach is to determine the level of revenues necessary to recover the costs incurred in providing service, which is identical to other approaches used to measure revenue requirements. Different cost groupings are used to measure the total cost of service because of the limited, possibly nonexistent, use of equity capital in a capital intensive setting; a condition that

undermines the use of traditional rate of return applications in which equity capital is a major cost source. This approach is typically used in measuring the cost of service for electric cooperatives that are financed primarily with debt capital, supported only by nominal levels of "margin capital" (i.e., the ownership interests of the cooperative members or customers).

Equity capital is normally assigned the role of the primary risk capital in rate of return applications. As the equity component declines as a portion of total capital, the level of equity risk increases. At some point, the risks become such that rational equity cost benchmarks cannot be accessed. At that point, the rate base/rate of return measure becomes useless. It is in these circumstances that an alternative, such as a debt service coverage ratio, is used.

The debt service coverage allowance includes the actual principal and interest payments (i.e., a factor of 1.00) and an "excess" coverage component (e.g., a factor of .20) as an earnings buffer. The 1.00 times basic coverage component is fixed, but the excess coverage component varies with the circumstances. For example, a system with 90 percent debt financing requires a higher excess coverage than a similar system financed entirely by debt. The higher excess coverage is needed because the 90 percent debt financing must also cover the risks, as well as any earnings requirements, associated with the 10 percent of the system financed by margin or equity capital.

This example illustrates the process of fixing revenue requirements using the debt service approach:

**Example:**

|                        |            |
|------------------------|------------|
| Operating Cost         | \$ 180     |
| Taxes                  | 5          |
| Debt Service Coverage* | <u>120</u> |
| Revenue Requirements   | \$ 305     |
| Test period Revenues   | \$ 295     |
| Revenue Increase       | \$ 10      |

\* The debt service coverage amount in this instance assumes principal payments of \$40, interest payment of \$60, and a coverage ratio of 1.2 times. Note that depreciation expenses are not included in the calculation. These expenses are replaced by the provision for debt retirement, assuming \$40 for the payment of principal.

**§ 3.06 Operating Ratio Approach**

In the foregoing discussions, it has been observed that revenues must be adequate to recover the operating costs of the system plus the cost of capital required to support the system. Since operating costs can be identified for the period of operations under review, it is possible to use a target operating ratio result in fixing total revenue requirements by dividing the operating costs (which might or might not include depreciation and taxes—a definitional issue, but one directly affecting the effectiveness of the operating ratio used) by the target operating ratio. The test period cost of service data from the financial statements (Figure 3-1) at the front of this chapter may be used to illustrate the operating ratio approach.

# RATE REGULATON

Presentation to the Georgian National Energy  
and Water Supply Regulatory Commission

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Batumi, Georgia  
August 2011

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*Jeff Derouen, Executive Director*  
*Scott Lawless, Financial Analysis*  
*Quang Nguyen, Legal Division*  
*Kentucky Public Service Commission*



EXHIBIT

2

# Revenue Requirement – Times Interest Earned Ratio (TIER)

$$\text{TIER} = \frac{(\text{Net Margins} + \text{Annual Interest Expense on Long-Term Debt})}{\text{Annual Interest Expense on Long-Term Debt}}$$

TIER is a measure of financial performance developed by the United States Department of Agriculture's Rural Utility Service, the main lender to Rural Electric Cooperatives.

**Electric Cooperatives Using this Method:**  
**2 Generation and Transmission Coops**  
**19 Distribution Coops**

The TIER level allowed by the Commission for Generation and Transmission Coops is determined on a case-by-case basis and is dependent upon the utility's financial position at the time of the Commission's Review.

The TIER allowed for Distribution Coops is usually set at 2.0 but can be higher or lower when warranted by the utility's financial condition.

A 2.0 TIER sets Net Margins at an amount equal to Annual Interest Expense on Long-term Debt.

# Revenue Requirement – TIER

|   |                |
|---|----------------|
| O&M Expenses                                    | \$X,XXX        |
| Plus: Depreciation Expenses                     | XXX            |
| Taxes Other Than Income Taxes                   | XXX            |
| Interest on Long-Term Debt                      | XXX            |
| Interest on Short-Term Debt                     | XXX            |
| Non-Utility Expenses                            | XXX            |
| Margin Required to Attain Allowable TIER        | <u>XXX</u>     |
| Total Revenue Requirement                       | \$X,XXX        |
| Less: Other Operating Revenue                   | (XXX)          |
| Non-Utility Revenues, including Interest Income | (XX)           |
| Patronage Capital Credits from Lenders          | <u>(XX)</u>    |
| <b>Revenue Required from Rates for Service</b>  | <b>\$X,XXX</b> |



# Revenue Requirement – Debt Service Coverage Ratio

Number of Utilities Using this Method:

109 County Water Districts and Associations and  
103 Municipal Water Systems that provide regulated wholesale service.

|  |                       |
|--|-----------------------|
| O&M Expenses   | \$X,XXX               |
| Taxes Other Than Income Taxes  | XXX                   |
| Depreciation   | XXX                   |
| Total Expenses   | X,XXX                 |
| Plus: 3 or 5 year Average Principal and Interest Payments on LTD<br>Debt Coverage Requirement, established by Lender | XXX<br>XX             |
| Total Revenue Requirement  | X,XXX                 |
| Less: Other Operating Revenue  | (XX)                  |
| Non Utility Revenues, Including Interest Income  | (XX)                  |
| <b>Revenue Required from Rates for Service</b>   | <b><u>\$X,XXX</u></b> |



# Setting Rates: Best Practices for Electric Cooperatives

**PART 4**

JULY 18, 2008

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## Methodologies for Determining Revenue Requirements

*Editor’s Note: The first three parts of this series were included in the April 27, 2007, July 27, 2007, and January 4, 2008, issues of Solutions News Bulletin. Additional articles in the series will appear later this year.*

### Overview

This special Solutions insert is the fourth in a series, “Setting Rates: Best Practices for Electric Cooperatives.” The series examines how electric cooperatives can apply best practices when setting rates for their members.

This part discusses the two predominant approaches for determining the revenues required to prudently operate the cooperative, to maintain the desired equity ratio and/or provide for an equity management plan, and to meet the future financial goals of the cooperative. These two approaches are the Coverage Ratio (CR) method and the return on rate base method—also known as the Rate of Return (ROR) method. This part also outlines the benefits and drawbacks associated with each method and includes these sections:

- Introduction
- The CR method
- The ROR method
- Summary
- Glossary
- Additional resources

### Introduction

In setting rates for electric utilities, state regulatory commissions have sought to create a balance between the utility’s financial interests and the consumer’s right to reliable service at reasonable rates.

Investor-owned utilities are owned by stockholders who are largely not customers of the utility. This creates an implicit conflict of interest between customers and stockholders that is usually resolved by rate regulation.

With cooperatives, the same conflict between customers and owners is not present since the customers are the owners of the utility. This situation—coupled with the generally smaller size of cooperatives, the fact that most cooperatives are not-for-profit entities and the remedies customer-owners have against a

cooperative’s board of directors and management—generally provides suitable protection for customers. Most states recognize this and do not regulate distribution cooperatives’ rates. In fact, only about 16 states currently rate regulate distribution cooperatives.

In the absence of formal rate regulation by the state, the cooperative’s board of directors becomes the *de facto* regulator. As such, it must contend with the same fundamental questions that a state regulator would face. One such question is determining the adequate revenues required to meet the distribution cooperative’s financial plan and return patronage capital pursuant to a prudent schedule.

The approach most often used by electric cooperatives is the CR method. Frequently, this refers to the times interest earned ratio (TIER). However, it actually can be one of several ratios, including net or operating TIER, debt service coverage (DSC) ratio or modified DSC ratio. In this paper, TIER is generally used in discussing the CR method.

This method considers the margins plus other factors—e.g., long-term interest expense, depreciation and amortization, non-operating margins (interest) and cash receipts of patronage capital. It directly reflects the revenues and expenses of the cooperative but not the equity costs.

The ROR method provides cooperatives with an alternative approach for determining revenue requirements that has certain benefits, such as a direct relationship between the cost of equity and revenue requirements and the direct inclusion of the net amount of the cooperative’s investment in the determination of revenue requirements. This is also the most widely used method for determining revenue requirements as it is commonly used in the rate proceedings of electric, gas and telephone utilities.

**The Coverage Ratio Method**

The Rural Utilities Service (RUS) and its predecessor, the Rural Electrification Administration, have used TIER to evaluate and regulate cooperatives since the industry was established. In the early years, cooperatives were largely debt financed, with little or no equity. This highly leveraged position made the CR method well suited for cooperatives.

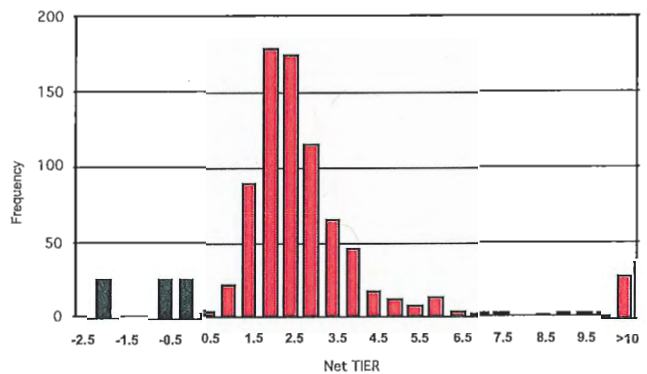
Today, RUS specifies minimum coverage ratios for net TIER, operating TIER, DSC and operating DSC. The equation used to measure actual net TIER is illustrated in Equation 1.

**Equation 1**

$$\text{Net TIER} = (\text{Net Margins} + \text{Long-term Debt Expense}) / \text{Long-term Debt Expense}$$

One theoretical difficulty in setting rates with TIER—or another coverage ratio—is that an optimal TIER is seldom known. In practice, TIER is frequently set to historical norms, such as what other cooperatives have done. Indeed, CFC’s Key Ratio Trend Analysis (KRTA) is frequently used for the purpose of “benchmarking” performance measures, or ratios. However, the question of the appropriate value of TIER is not addressed by benchmarking. Chart 1, which uses information from CFC’s 2006 KRTA database, illustrates a frequency distribution of net TIER for 813 distribution cooperatives.

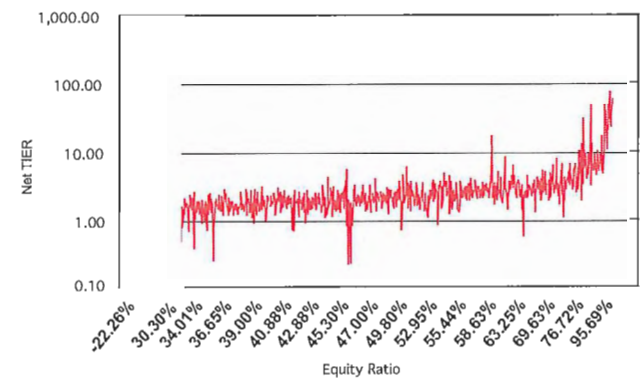
**CHART 1: Distribution Cooperatives’ Net TIER**



Source: CFC’s 2006 KRTA Database

The value of TIER is directly related to the equity ratio as illustrated in Chart 2. Therefore, when deciding on an appropriate TIER, the amount of debt the cooperative has in its capital structure should be considered.

**CHART 2: Relationship Between Net TIER and Equity Ratio**



Source: CFC’s 2006 KRTA Database

Formulas developed to assist cooperatives in managing their equity seek to provide appropriate cost-of-equity guidelines based on various criteria and frequently must be converted to a TIER target.

Once the target TIER has been selected, the increase in revenues can easily be determined by algebraic manipulation of Equation 1, as shown in Equation 2.

**Equation 2**

$$\text{Increase in Revenues} = [(\text{TIER} \times \text{Long-term Interest Expense}) - \text{Long-term Interest Expense}] - \text{Net Margins}$$

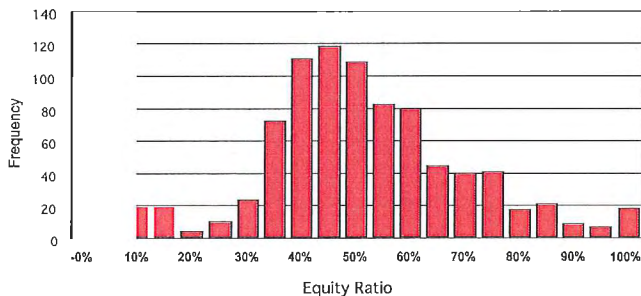
So long as TIER is greater than one, margins are positive. This is not to suggest that low TIER values are adequate for cooperatives. Over the last several decades, cooperatives have rightly sought to increase their equity ratios, which have also increased coverage ratios such as net TIER.

Today, many cooperatives still use the CR method to determine revenue requirements, even though cooperatives generally are not as highly leveraged as those in the early years.

In recent years, cooperatives have grown equity—and consequently, TIER. Equity benefits the modern cooperative by providing a means of growing plant investment and providing a buffer against earnings volatility. Indeed, equity ratios are an appreciable part of the total capitalization of many cooperatives as illustrated in Chart 3, created from CFC’s 2006 KRTA database.

The median value for the 2006 equity ratios illustrated

**CHART 3: Distribution Cooperatives’ Equity Ratios**



Source: CFC’s 2006 KRTA Database

in Chart 3 is 47.27 percent. As the distribution suggests, however, the average value is even higher (50.80 percent). Cooperatives have matured into the well-financed and governed entities we see today.

So, is the use of TIER still appropriate? TIER is still an appropriate means of setting revenue requirements at cooperatives, but there are additional issues to be considered.

**The Rate of Return Method**

Although many electric cooperatives use the CR method, the predominant approach for determining revenue requirements at utilities of all types is the ROR method, which is widely used in rate proceedings of electric, gas and telephone utilities. This approach is more comprehensive than the CR method, but it is also more difficult to use. It measures the

return on the investment in net plant and related items such as inventories, construction work in progress, allowance for funds used during construction and cash working capital. It is illustrated in Equation 3 in simple form.

**Equation 3**

$$\text{Revenue Requirement} = \text{Operating Expenses} + \text{ROR} \times (\text{Rate Base} - \text{Depreciation})$$

Where:

$$\text{ROR} = \text{Rate of Return}$$

(the weighted cost of both debt and equity)

This approach is particularly useful where the debt and equity comprise a significant portion of the cost of providing service. Indeed, the value of the rate base should be close to the value of the capitalization after taking into account subsidiary investments. If not, care should be taken to understand why. Mismatches between financing terms and depreciation may account for some differences.

In the ROR method, the return—which represents investment in net plant, inventories and working capital requirements—represents the weighted cost of debt and equity used to finance the rate base, as shown in Chart 4.

**CHART 4: Capital Structure and Weighted Return on Rate Base Example**

|              | Capitalization Ratio | Cost  | Weighted Cost |
|--------------|----------------------|-------|---------------|
| Debt         | 55%                  | 5.00% | 2.75%         |
| Equity       | 45%                  | 6.50% | 2.92%         |
| <b>TOTAL</b> | <b>100%</b>          |       | <b>5.67%</b>  |

Chart 4 illustrates both the return on rate base (5.67 percent) as well as the return on equity (6.50 percent). By computing the return on rate base, and “back-solving” for the return on equity, the cooperative can compute its “earned return on equity” at existing operating revenues. If the cooperative is computing the return on rate base to determine the desired level of operating revenues, the return on equity must be determined.

Although entire books have been written on the economic and financial theories that govern the cost of equity determination, the cost of equity for a cooperative is reasonably straightforward. CFC has long held that cooperative equity has a cost, and that cost is determined through the application of one or more formulas. This is the root of equity management. The ROR method provides a means for a cooperative to directly apply the cost of equity in the determination of the appropriate level of operating revenues.

On a forward-looking basis, equity costs can be determined by the application of several related formulas. These formulas have been developed over the past 30-plus years. Work by RUS and CFC has resulted in modification of the original formula to reflect a forward-looking analysis. The modified formula is shown as Equation 4.

#### Equation 4

$$Ke = [(1+g)^{n+1} - (1-g)^n] / (1+g)^n - 1$$

Where: Ke = cost of equity

g = growth in total utility plant

n = patronage capital cycle

This formula computes the minimum return required to hold the equity ratio at its present level while growing at a fixed rate of growth (g) with revolving capital credits at a specific cycle (n years). It also implicitly assumes a retirement of patronage capital schedule that grows as margins grow over time. Other methods differ in the way they treat capital credits and equity ratios.

As with the CR method, capital structures heavily skewed to either debt or equity may require adjustments to either the capital structure in the form of a hypothetical capital structure or adjustments to the return on equity to reflect extreme situations.

## Summary

Although most cooperatives use a CR method to determine revenue requirements, there is an alternative approach.

The CR method does provide an easy means by which revenue requirements can be evaluated or set. But CR methods only indirectly reflect the cost of equity. For instance, revenues above a 1.0 TIER are attributable to the equity component, but it is unclear whether the difference in the existing or proposed TIER is truly adequate without first studying the effects of the cooperative's past and future equity ratios, its future growth and its patronage capital return policy.

The limitations associated with the use of a CR method for determining revenue requirements are largely solved by using the ROR method. This method is also more comprehensive and, therefore, more precise. The downside of the ROR method is that it is more difficult to use.

Both methods, if applied diligently, should provide electric cooperatives with useful means of determining revenue requirements or evaluating the adequacy of existing revenues.

## Glossary

**Coverage Ratio:** A ratio that measures interest coverage. TIER, debt service coverage (DSC) ratio and modified DSC ratio are all measures of interest coverage.

**CWIP:** Construction work in progress. A component of rate base.

**Equity Cost:** The annualized cost of equity in percentage terms. For an investor-owned utility, the cost of equity is indirectly measured. It represents the opportunity cost of other investments of similar risk. This cost can be measured by the discounted cash flow method, the comparable earnings approach, the capital assets pricing model or other similar method. For cooperatives, the cost of equity is the cost to return patronage capital pursuant to a specific schedule. Hence, the cost of equity for a cooperative is a more straightforward calculation than for an investor-owned utility.

**Equity Ratio:** Total equity and margins divided by total capitalization of the cooperative. Total capitalization is the sum of total equities and margins and total long-term debt.

**Key Ratio Trend Analysis (KRTA):** A series of ratios and measurements of distribution cooperatives that permits comparisons among companies. The database is compiled annually by CFC.

**Median Value:** The median measures the middle position of a frequency distribution for a group of data.

**Operating Income:** Operating revenues less operating and maintenance expenses, depreciation expense and non-income-related taxes.

**Return on Rate Base:** Operating income divided by the rate base.

**Revenue Requirement:** Minimum revenues required for the prudent operation of the utility.

**Times Interest Earned Ratio (TIER):** A key financial ratio used to measure a cooperative's financial health and its ability to meet interest expense on long-term debt. It compares the cooperative's margins with interest expense.

## Additional Resources

Hahn, Robert L., and Aliff, Gregory E. (October 2003). *Accounting for Public Utilities*.

NARUC Staff Subcommittee on Accounting and Finance (Summer 2003). *National Association of Regulatory Utility Commissioners Rate Case and Audit Manual*.

NRECA Rate Issues Study Committee (January 1989). *Rate Issues And Strategies: A Guide For Rural Electric Policymakers*.

## Setting Rates Series I: Available Online

The first four parts of this series "Setting Rates: Best Practices for Electric Cooperatives" are available on CFC's Extranet and through [cooperative.com](http://cooperative.com).

Go to CFC's home page at [www.nrucfc.coop](http://www.nrucfc.coop) and log into the Extranet. From the Extranet, select Tools & Information and then CFC Library.

The series is also posted on [cooperative.com](http://cooperative.com). Go to: [www.cooperative.com/services/retailrates.htm](http://www.cooperative.com/services/retailrates.htm).

**BEFORE THE NEW MEXICO PUBLIC REGULATION COMMISSION**

IN THE MATTER OF THE FILING OF )  
ADVICE NOTICE NO. 69 BY SOCORRO )  
ELECTRIC COOPERATIVE, INC. ) **Case No. 18-00383-UT**  
)  
SOCORRO ELECTRIC COOPERATIVE, )  
INC., APPLICANT )

**CERTIFICATE OF SERVICE**

I CERTIFY that on this date I sent, to the parties and individuals listed here and in the manners specified below, a true and correct copy of the **Order Requiring Additional Supplemental Testimony from Socorro Electric Cooperative, Inc.** dated April 1, 2019.

Via Email to:

|                          |  |                        |  |
|--------------------------|--|------------------------|--|
| Nann Winter              | <a href="mailto:nwinter@stelznerlaw.com">nwinter@stelznerlaw.com</a> ;           | Davon Murrietta        | <a href="mailto:tiara-jojola@yahoo.com">tiara-jojola@yahoo.com</a> ;                 |
| Keith W. Herrmann        | <a href="mailto:kherrmann@stelznerlaw.com">kherrmann@stelznerlaw.com</a> ;       | Tiara Jojola           | <a href="mailto:itsmevioleta@yahoo.com">itsmevioleta@yahoo.com</a> ;                 |
| Ed Reyes                 | <a href="mailto:Edwin.reyes.jr@comcast.net">Edwin.reyes.jr@comcast.net</a> ;     | Violet Alvarado        | <a href="mailto:Theresarosales22@gmail.com">Theresarosales22@gmail.com</a> ;         |
| Donald Monette           | <a href="mailto:dmonette@socorronm.gov">dmonette@socorronm.gov</a> ;             | Patricia G. Williams   | <a href="mailto:pwilliams@wwwlaw.us">pwilliams@wwwlaw.us</a> ;                       |
| Polo Pineda              | <a href="mailto:ppineda@socorronm.gov">ppineda@socorronm.gov</a> ;               | Lorna Wiggins          | <a href="mailto:lwiggins@wwwlaw.us">lwiggins@wwwlaw.us</a> ;                         |
| Joseph Herrera           | <a href="mailto:jherrera@socorroelectric.com">jherrera@socorroelectric.com</a> ; | Theresa & James Rivera | <a href="mailto:trivera@co.socorro.nm.us">trivera@co.socorro.nm.us</a> ;             |
| Christie Griego          | <a href="mailto:cgriego@wwwlaw.us">cgriego@wwwlaw.us</a> ;                       | Zachery Anaya          | <a href="mailto:zanaya68@gmail.com">zanaya68@gmail.com</a> ;                         |
| Justin Proctor           | <a href="mailto:Justin.proctor@guernsey.us">Justin.proctor@guernsey.us</a> ;     | Maribel Tarango        | <a href="mailto:southernmari2010@yahoo.com">southernmari2010@yahoo.com</a> ;         |
| Rauni Montoya            | <a href="mailto:rmontoya@socorroelectric.com">rmontoya@socorroelectric.com</a> ; | Valen Alonzo           | <a href="mailto:valonzo@socorronm.gov">valonzo@socorronm.gov</a> ;                   |
| Jimmy Capps              | <a href="mailto:jcapps@socorroelectric.com">jcapps@socorroelectric.com</a> ;     | Jim Quaranta           | <a href="mailto:Elkmanjimaz@gmail.com">Elkmanjimaz@gmail.com</a> ;                   |
| Donna Wilkins            | <a href="mailto:donna@socorroelectric.com">donna@socorroelectric.com</a> ;       | Anton Salome           | <a href="mailto:asalome@socorronm.gov">asalome@socorronm.gov</a> ;                   |
| Larry Blank              | <a href="mailto:lb@tahoeconomics.com">lb@tahoeconomics.com</a> ;                 | Sammy Vivian           | <a href="mailto:sammyvirg@live.com">sammyvirg@live.com</a> ;                         |
| Donald J. Steinnerd      | <a href="mailto:reenerd@q.com">reenerd@q.com</a> ;                               | Demecio Silva          | <a href="mailto:openseasongohunt@yahoo.com">openseasongohunt@yahoo.com</a> ;         |
| Mark K. Adams            | <a href="mailto:mkadams@rodey.com">mkadams@rodey.com</a> ;                       | Enrique Trujillo       | <a href="mailto:ultimate_dragon2004@yahoo.com">ultimate_dragon2004@yahoo.com</a> ;   |
| Mayor Ravi Bhasker       | <a href="mailto:RBhasker@socorronm.gov">RBhasker@socorronm.gov</a> ;             | Jerry Griego           | <a href="mailto:dusty418@msn.com">dusty418@msn.com</a> ;                             |
| Donald Monette           | <a href="mailto:Donald@themonettes.com">Donald@themonettes.com</a> ;             | Tony Montoya           | <a href="mailto:tbmontoya@gmail.com">tbmontoya@gmail.com</a> ;                       |
| Leopoldo Pineda, Jr.     | <a href="mailto:pineda@pinedas.net">pineda@pinedas.net</a> ;                     | David Gutierrez        | <a href="mailto:dgutierrezsr85@gmail.com">dgutierrezsr85@gmail.com</a> ;             |
| Rudy L. Chavez           | <a href="mailto:elchavez67@gmail.com">elchavez67@gmail.com</a> ;                 | Sean Standiford        | <a href="mailto:sean.standiford@gmail.com">sean.standiford@gmail.com</a> ;           |
| Carl Lukesh              | <a href="mailto:jlukesh@socorronm.gov">jlukesh@socorronm.gov</a> ;               | Celina Baca            | <a href="mailto:CelinaBaca6@gmail.com">CelinaBaca6@gmail.com</a> ;                   |
| Stephanie Saavedra       | <a href="mailto:ssaavedra@socorronm.gov">ssaavedra@socorronm.gov</a> ;           | Robert Serna           | <a href="mailto:767Serna@gmail.com">767Serna@gmail.com</a> ;                         |
| Arthur P. Gonzales       | <a href="mailto:agonzales@co.socorro.nm.us">agonzales@co.socorro.nm.us</a> ;     | Bradford Borman        | <a href="mailto:Bradford.borman@state.nm.us">Bradford.borman@state.nm.us</a> ;       |
| Abran Baca, Jr.          | <a href="mailto:bongobaca@yahoo.com">bongobaca@yahoo.com</a> ;                   | Milo Chavez            | <a href="mailto:Milo.chavez@state.nm.us">Milo.chavez@state.nm.us</a> ;               |
| Isacc Angel              | <a href="mailto:isaccangel78@yahoo.com">isaccangel78@yahoo.com</a> ;             | Judith Amer            | <a href="mailto:Judith.amer@state.nm.us">Judith.amer@state.nm.us</a> ;               |
| Deanne Aragon            | <a href="mailto:daragon1722@gmail.com">daragon1722@gmail.com</a> ;               | David Ault             | <a href="mailto:David.Ault@state.nm.us">David.Ault@state.nm.us</a> ;                 |
| Catherine Stewart Roache | <a href="mailto:csr1938@sdcc.org">csr1938@sdcc.org</a> ;                         | Mahlon Wigton          | <a href="mailto:Mahlon.Wigton@state.nm.us">Mahlon.Wigton@state.nm.us</a> ;           |
| Nancy Feraldi            | <a href="mailto:nferaldi@gmail.com">nferaldi@gmail.com</a> ;                     | Gabriella Dasheno      | <a href="mailto:Gabriella.Dasheno@state.nm.us">Gabriella.Dasheno@state.nm.us</a> ;   |
| Melissa Salazar          | <a href="mailto:Meliss.salazar@yahoo.com">Meliss.salazar@yahoo.com</a> ;         | Beverly Eschberger     | <a href="mailto:Beverly.Eschberger@state.nm.us">Beverly.Eschberger@state.nm.us</a> ; |
| Johnny Sedillo           | <a href="mailto:sedillojohnny@yahoo.com">sedillojohnny@yahoo.com</a> ;           | Carolyn Glick          | <a href="mailto:Carolyn.Glick@state.nm.us">Carolyn.Glick@state.nm.us</a> ;           |
| Lena Chavez              | <a href="mailto:lena.chavez1981@gmail.com">lena.chavez1981@gmail.com</a> ;       |                        |  |
| Ruby Lopez               | <a href="mailto:rubbyalopez@yahoo.com">rubbyalopez@yahoo.com</a> ;               |                        |  |

Via first-class mail to:

Jerald R. Lopeman  
106 Stallion Circle  
Socorro, NM 87801

Manuel Lara  
802 Texas Avenue  
Socorro, NM 87801

Toby Jaramillo  
815 Calvin Street, NE  
Socorro, NM 87801

John and Barbara Da Costa  
504 Central Avenue  
Socorro, NM 87801

Johnny Valencia  
503 Dolores Drive  
Socorro, NM 87801

Michael P. Gonzales  
804 Texas Ave.  
Socorro, NM 87801

James Padilla  
721 Bagley Street  
Socorro, NM 87801

Joe A. Flores, Jr.  
1107 Vermont  
Socorro, NM 87801

William Wiggins  
Post Office Box 1308  
Albuquerque, NM 87103-1308

Oscar Acosta  
403 A Street  
Socorro, NM 87801

Robert Serna  
511 Calle Bonita  
Socorro, NM 87801

Sebastian A. Hinojosa  
615 Ivy St. Box #B  
Socorro, NM 87801

James Peralta  
301 5<sup>th</sup> Street, #11  
Socorro, NM 87801

**DATED** this April 1, 2019.

**NEW MEXICO PUBLIC REGULATION COMMISSION**

  
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Ana C. Kippenbrock, Law Clerk

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