Chelan County PUD

District-Wide Financial Policies
Recommendations for 2017 and Beyond

Board Presentation

March 6, 2017

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Agenda

- 2017 District Performance Plan goal
- Financial Policy history and current status
- Recommended District-wide financial policies and processes
- Forecast metrics
- Summary and next steps

Information only - no action requested today

Financial Strategy Sessions - Timeline

OBJECTIVE #4 - ENSURE FINANCIAL STABILITY
We will sustain a financial structure that seeks to avoid raising revenue from electric rate increases through the upcoming five-year period (and potentially beyond) under all plausible scenarios and create access to low cost capital when needed.

			2017			
			Q1	**Q2**	**Q3**	**Q4**
4	L.	Conduct series of Board strategy sessions to adjust and affirm long-term financial policies, Integrated Electric business line financial policies, rate philosophies, power contract guidelines, COSA guidelines and internal debt funding philosophies				
4	1.	Review and refresh District Financial Policies by end of Q1				
4	2.	Review, refresh and establish Business Line Financial Policies by end of Q2				
4	3.	Establish long-term rate guidance by 12/1				
4	4.	Establish long-term internal/external debt guidelines by 12/1				

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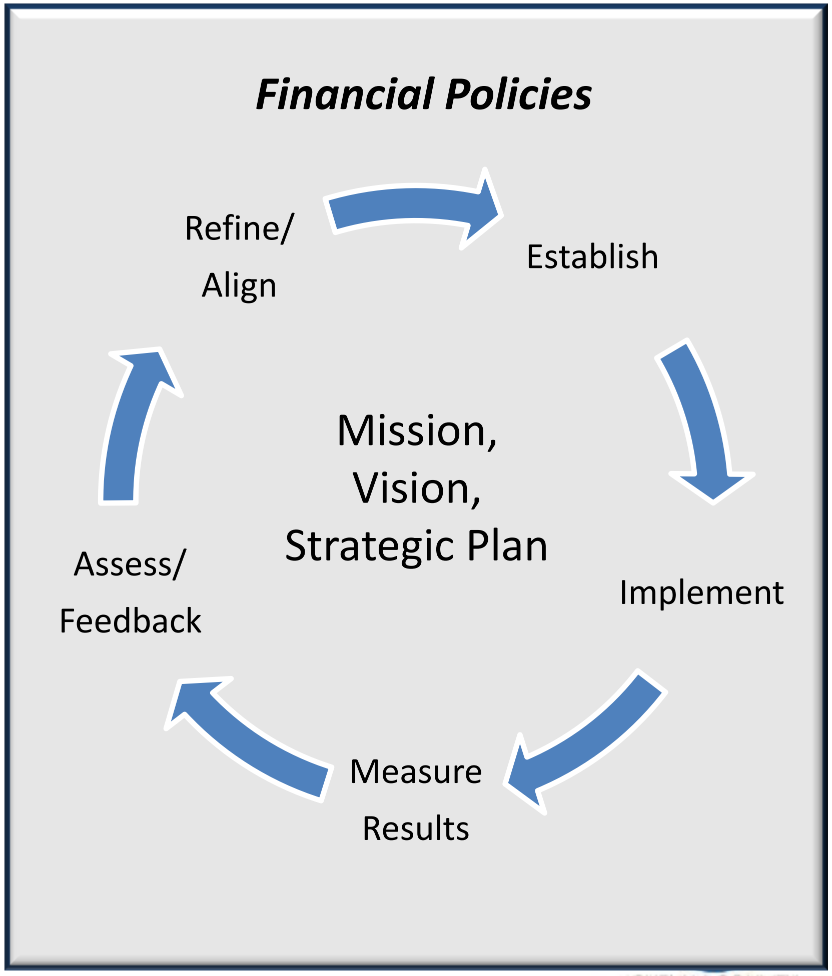
Key Messages

- Stable finances increase our flexibility
- Strong policies support a solid AA credit rating
- Continued stability and improvement of metrics in recent years
- Well ahead of peer averages
- Stability means we can broaden our financial target processes and review

Financial Policies – Continuous Cycle

2015 -2019 District-Wide Financial Policies

- Established in 2010
- Refined and extended in 2014
- Business Line policies in 2015
  - Planned 2017 review of Water, Wastewater and Fiber, development of Integrated Electric
- Align and refine based on strategic plans, customer preferences, financial and operational conditions
- Re-establish: the cycle continues



District-Wide Financial Policies
Guiding Principles

1. **Maintain a strong AA credit rating**

2. **A sustainable long-term plan to inform cohesive decision-making while promoting:**
   - Transparency
   - Achieving strategic objectives
   - Accountability to our customers & customer satisfaction
   - Long-term rate predictability for customers
   - Operational excellence and fiscal health
   - Prudent allocation and recovery of capital costs over time
   - Uninterrupted access to the financial markets at the lowest reasonable cost
   - Maintenance of long-lived, value-adding assets and responsible stewardship of the environment
   - Proactive risk management

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Maintaining Financial Strength

- It is time to re-evaluate our targets and process for the longer-term
- District overall results are in line with highly-rated peers
- Refine Financial Policies to support a sustainable financial path
- Strong liquidity is needed in anticipation of future large expenses

Metric	District Results for 2016	AA Peer Median in 2015	Expectation for AA rated entity *
Financial Liquidity	Very Strong at 518 days	217 days	150 – 249 days
Debt Leverage	Better than median at 43%	48%	26 – 60%
Debt Service Coverage	Strong at 3.22x	2.48x	2.0 – 2.49x
Rate of Return*	Strong at 8.8%		4 – 6%*

* Expectation of AA based on Moody's criteria with exception of Rate of Return, which is based on historical peer utility averages.

Recommended District Financial Policies

- No changes recommended to:
  - Debt Service Coverage
  - Debt Leverage
  - Financial Liquidity
- Recommend replacing Unrestricted Cash target of >$150M with Days Cash on Hand metric of > 250 days
  - Self-adjusting
  - Commonly used and comparable across industry
  - Improved clarity between cash metrics
- Recommend sunset of Rate of Return target after 2019
  - Retained through debt reduction program
  - On a District wide basis, it has served its purpose
  - Shift focus to increased detail at business line level

Recommended District-Wide Financial Policies

Metric	Expectation for AA rated entity *	Current Targets 2014-2019	Recommended Targets 2017+
Financial Liquidity		> $175M or computed methodology	> $175M or computed methodology
Unrestricted Cash		$150M	***Replaced by Days Cash on Hand***
Days Cash on Hand	150 – 249 days (AA) > 250 days (AAA)	***new***	> 250 days (~$150M)
Debt Leverage	26 – 60%	< 60% 2014, < 35% by 2019	< 35% 2019+
Debt Service Coverage	2.0 – 2.49x	> 2.0x	> 2.0x
Rate of Return	4 – 6%	> 4%	> 4% thru 2019**

* Expectation of AA rating based on Moody's criteria with exception of Rate of Return, which is based on peer utility averages.

**Rate of Return will sunset as a District-Wide Financial Metric after 2019.

Recommended Process Updates

- Staff conducts biennial review, or more often if circumstances warrant, and any amendments presented for Board consideration
  - Recommended metrics would not have end dates
  - Requirement establishes periodic review process
- Refined definition of expected and unusual forecast scenarios
  - Clarify that probabilistic net wholesale sales revenue inform scenarios
- Subject to refinement; the unusual case 5 year forecast proposed at 10% accumulated impacts versus prior 5% annual impacts
  - More representative of fundamental shift in wholesale price curve
  - Conservative downside projection as net wholesale sales are primary unusual case variant
  - Lower unusual forecast results, particularly for liquidity

Recommended Metric and Forecast

Financial Liquidity (Expected and Unusual Case)

- No material metric change from current policy
- Maintain Financial Liquidity sufficient to manage to the greater of $175M or the requirements computed in the District combined comprehensive Financial Liquidity Methodology

COMBINED (in millions)*	**2016**	***2017***	***2018***	***2019***	***2020***	***2021***
District Proposed Total Liquidity Targets	**$175**	***$178***	***$175***	***$175***	***$175***	***$199***
Expected (50% probability)	$396	*$359*	*$281*	*$229*	*$226*	*$225*
Unusual (10% probability/accumulated)		*$355*	*$272*	*$213*	*$202*	*$203*
"What-If" - $20 flat market, 82% water, increased costs			*$262*	*$198*	*$176*	*$201*

* 1-31-17 forecast, does not include yet to be decided long range facilities plan; base case includes no new debt; unusual case – accumulated includes ~$18M new debt in 2021, "what-if" case is as of 12-31-16 and includes ~$60M new debt in 2021.

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Recommended Metric and Forecast

Days Cash on Hand (Expected and Unusual Case)

- Refinement to current policy metric from fixed dollar to days cash
- Maintain unrestricted cash greater than 250 Days Cash on Hand
- $150 million is approximately 250 Days Cash on Hand in 2016

COMBINED*	2016	*2017*	*2018*	*2019*	*2020*	*2021*
District Proposed Days Cash on Hand	**$150M**	***250 days***	***250 days***	***250 days***	***250 days***	***250 days***
Expected (50% probability) *Unrestricted balance expectation*	518 $306M	*550* *$304M*	*454* *$263M*	*371* *$218M*	*367* *$218M*	*388* *$225M*
Unusual (10% probability/accumulated) *Unrestricted balance expectation*		*543* *$300M*	*437* *$253M*	*344* *$202M*	*327* *$194M*	*351* *$208M*
"What-If"- $20 flat market, 82% water, increased costs			*426* *$247M*	*330* *$194M*	*296* *$176M*	*374* *$217M*

*1-31-17 forecast, does not include yet to be decided long range facilities plan; base case includes no new debt; unusual case – accumulated includes ~$18M new debt in 2021, "what-if" case is as of 12-31-16 and includes ~$60M new debt in 2021

Recommended Metric and Forecast

Debt Leverage (Expected and Unusual Case)

- No metric change from current policy
- Achieve equity based debt ratio of <35% by 2019 and maintain beyond
- Revisit forecasts annually to confirm additional debt reduction is the best use of cash under then-existing assumptions

COMBINED*	2016	*2017*	*2018*	*2019*	*2020*	*2021*
District Proposed Targets	**<50%****	**<45%****	**<40%****	**<35%**	**<35%**	**<35%**
Outstanding Debt Balance (in millions)	**$590**	***$537***	***$452***	***$368***	***$331***	***$306***
Scheduled Debt Retirements	$23	*$23*	*$24*	*$26*	*$25*	*$26*
Additional Debt Reduction at first call date	$---	*$29*	*$61*	*$60*	*$11*	*$---*
Expected (50% probability)	43%	*38%*	*32%*	*27%*	*24%*	*22%*
Unusual (10% probability/accumulated)		*38%*	*33%*	*27%*	*24%*	*23%*
“What-If” - $20 flat market, 82% water, increased costs			*33%*	*27%*	*25%*	*26%*

*1-31-17 forecast, does not include yet to be decided long range facilities plan; base case includes no new debt; unusual case – accumulated includes ~$18M new debt in 2021, “what-if” case is as of 12-31-16 and includes ~$60M new debt in 2021.

**Interim planning targets, not adopted metrics.

Recommended Metric and Forecast

Debt Service Coverage

- No metric change from current policy
- Expected on combined basis: > 2.00x
- Unusual on combined basis: > 1.25x

COMBINED*	2016	*2017*	*2018*	*2019*	*2020*	*2021*
District Proposed Targets (expected)	**>2.00**	**>2.00**	**>2.00**	**>2.00**	**>2.00**	**>2.00**
District Proposed Targets (unusual)	**>1.25**	**>1.25**	**>1.25**	**>1.25**	**>1.25**	**>1.25**
Expected (50% probability)	3.2	*3.0*	*2.8*	*2.7*	*2.9*	*2.8*
Unusual (10% probability/ accumulated)		*3.0*	*2.7*	*2.6*	*2.7*	*2.5*
"What-If"- $20 flat market, 82% water, increased costs			*2.6*	*2.5*	*2.5*	*2.0*

* 1-31-17 forecast, does not include yet to be decided long range facilities plan; base case includes no new debt; unusual case – accumulated includes ~$18M new debt in 2021, "what-if" case is as of 12-31-16 and includes ~$60M new debt in 2021.

Recommended Metric and Forecast

Rate of Return

- No metric change from current policy except sunset after 2019
- Expected: > 4.0% thru 2019, Unusual: > 2.0% thru 2019
- Business line metrics will include income statement measure of financial health

COMBINED*	2016	*2017*	*2018*	*2019*	*2020*	*2021*
District Proposed Targets (expected)	**> 4%**	**> 4%**	**> 4%**	**> 4%**	***target sunsets***	
District Proposed Targets (unusual)	**> 2%**	**> 2%**	**> 2%**	**> 2%**		
Expected (50% probability) *Bottom-line expectation*	8.8% $96M	*7.8%* *$89M*	*5.9%* *$70M*	*4.9%* *$59M*	*4.1%* *$50M*	*3.8%* *$48M*
Unusual (10% probability/accumulated) *Bottom-line expectation*		*7.5%* *$85M*	*5.4%* *$64M*	*4.3%* *$53M*	*3.5%* *$43M*	*2.6%* *$32M*
"What-If"- $20 flat market, 82% water, increased costs			*4.8%* *$57M*	*3.8%* *$46M*	*2.7%* *$34M*	*1.5%* *$19M*

* 1-31-17 forecast, does not include yet to be decided long range facilities plan; base case includes no new debt; unusual case – accumulated includes ~$18M new debt in 2021, "what-if" case is as of 12-31-16 and includes ~$60M new debt in 2021.

Summary of Recommended Metrics

Existing
New
Sunset after 2019

Debt Leverage

<35% by 2019 and beyond (expected and unusual cases)

Days Cash on Hand

>250 days (expected and unusual cases)

Debt Service Coverage

>2.0x (expected case)
>1.25x (unusual case)

Financial Liquidity

>$175M or computed amount (expected and unusual cases)

Financial Policies

Rate of Return

>4.0% (expected case)
>2.0% (unusual case) through 2019

If projections reflect that future results are less than 110% of the targets, recommended action plans will be presented for Commission consideration.

Summary

- Stable finances increase our flexibility
  - Anticipate maintaining solid financial position (expected case)
  - Able to “weather the storm” (unusual case)
- Strong policies support a solid AA credit rating
  - Well ahead of peer averages
  - Reliable, sustainable future path
- Continue to evolve Financial Policies
  - Listen to our customers
  - Align with financial and operational conditions

Financial Strategy Sessions – Next Steps

Goal: Conduct series of Board strategy sessions to adjust and affirm long-term financial policies, Integrated Electric business line financial policies, rate philosophies, power contract guidelines, COSA guidelines and internal debt funding philosophies

☑ Review and refresh District Financial Policies by the end of Q1	March 6, 2017
❑ Board and customer questions and feedback	March 6-20, 2017
❑ Request Board approval of Resolution	March 20, 2017
❑ Review, refresh and establish Business Line Financial Policies by the end of Q2	Q2 2017
❑ Establish long-term rate guidance by 12/1	Q4 2017
❑ Establish long-term internal/external debt guidelines by 12/1	Q4 2017

Appendix

Financial Policy Definitions and Information

Appendix – Financial Liquidity

- Insufficient liquidity can be disastrous, excess liquidity can be costly
- Cash reserve policies are a best practice and balanced financial liquidity supports:
  - Long-term financial, organizational and operational stability to meet minimum requirements (ensure timely payments, reserve for catastrophic events and ensure funds for system improvements and reliability)
  - Mitigate risks reflecting the scope of operations, risk profile, complexity
- The Financial Liquidity Methodology utilizes a comprehensive computation to determine minimum requirements for known items and potential risks that impact financial stability
  - Computed amounts ensure timely payments for <u>operations and debt service</u> (Operating Requirements), reserve for <u>catastrophic or contingent events</u> (Potential Contingencies) and funds for <u>capital investments</u> (Planned Expenditures) for system improvements and reliability
  - The computation is refreshed quarterly and results are provided during the quarterly financial review
- Sources of Financial Liquidity include
  - **Primary Liquidity -** unrestricted cash and investments that are available for liquidity needs with no limitations on use. Funds restricted solely by board or management policy (Board Designated Funds) may also be included.
  - **Secondary Liquidity** – general bank lines or letters of credit or similar instruments and other internal sources, if available, that could be used to meet short term liquidity needs such as DRC/CRC funds - Cash associated with the Debt Reduction & Capital Recovery charges of the Power Sales Contracts associated only with Rocky Reach and Rock Island. Capital Recovery Charge (CRC) –allows the District to collect additional revenue up to a maximum of 50% (set annually) of a $25M (in 2004 dollars) capital base amount escalated over time. Debt Reduction Charge (DRC) – allows the District to collect additional revenue up to a maximum of 3% (set annually) of the outstanding debt obligations. The accumulated DRC/CRC funds, subject to an aggregate cap over the life of the contract, can be used for purchase, redemption or defeasance of those debt obligations or capital improvements.

Appendix – Days Cash on Hand

- Only includes unrestricted cash and investments (Primary Liquidity) and not funds with uses restricted by agreements or contracts (such as Secondary Liquidity and bond reserves)
- Indicates financial flexibility, specifically cash and short term investments, relative to expenses
- Days Cash on Hand is one of several rating agency key criteria consideration
  - Comparable across entities because it considers cash balances and expenses
  - Greater than 250 Days Cash on Hand is considered very strong
  - For the District, strong cash balances supplements where other key rating criteria are low

$$\frac{\text{Unrestricted Cash and Investments}}{\text{Operating Expense – Depreciation/ Amortization (non cash expenses)}} * 365$$

- Self adjusts as opposed to being a single fixed dollar minimum
  - To meet the same Days Cash on Hand target, higher levels of unrestricted cash are required if operating expenses increase, lower levels of unrestricted cash are required if operating expenses decrease
  - Purchased Power costs are included in operating expenses, therefore some power sales hedging activity (which treatment is determined by specific accounting principles) can impact Days Cash on Hand results and forecasts

Appendix – Debt Leverage

- Leverage ratios help measure debt levels relative to its investment in assets
  - Key rating agency consideration, ratios of less than 50% generally indicate credit strength and support high ratings
  - District currently uses a debt to equity ratio, however the District's "equity" is referred to as **Total Net Position** which is the accumulation of the Change in Net Position or "bottom line" results. "Equity", assets minus liabilities, represents the value of the entity after all the debts are paid.

$$\frac{\text{Outstanding Debt}}{\text{Outstanding Debt + Total Net Position (Equity)}}$$

- Capital-intensive industries or low profitability industries typically have higher leverage ratios
- Reducing debt leverage ratio can be achieved by limiting additional borrowing, paying down debt or accumulating equity
- Very low debt leverage ratios may indicate disparities in intergenerational cost allocation to the customer base

Appendix – Debt Service Coverage

- Bond covenant – an enforceable promise to bondholders
  - One indication of the margin of safety for the payment of debt service
  - Defined by 4 Master Bond Resolutions which are legal document adopted by the Board establishing the terms and conditions for bonds
  - Minimum annual requirement of 1.0x, with inclusion of 'other available funds' 1.15x – 1.25x
- Debt Service Coverage is a commonly used financial metric
  - Measures ability to pay for debt service requirements with cash flow from operations
  - Rating agencies view 2.0x or greater as evidence of credit strength and supportive of higher ratings
  - Higher ratios can lead to lower interest costs on new debt, access to bank liquidity, and more favorable power contract provisions
  - Debt Service Requirement is the amount of money necessary to pay the principal and interest on an outstanding debt in each year

$$\frac{\text{Net Income + Depreciation + Interest Expense}}{\text{Debt Service Requirements}}$$

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Appendix – Rate of Return

- Contributes to recovery of sufficient funds to replace more costly utility assets in the future
  - Assets installed years ago are more expensive to replace today
  - Assets installed today will likely be more expensive to replace tomorrow
  - An appropriate rate of return helps prevent customers today from being subsidized by future customers (or vice versa)
- Rate of Return is the percent of annual return (bottom line) on investments (utility assets)
  - Bottom line or Change Net Position can also be described as the gain or loss result from operations, revenues minus expenses or annual financial results
  - For the District’s Rate of Return calculation, investment in assets is defined as Net Utility Plant (Plant in Service + Construction Work In Progress - Accumulated Depreciation)

$$\frac{\text{Change in Net Position (“Bottom Line”)}}{\text{Net Utility Plant}}$$

- Provides Flexibility
  - Strategic debt reduction opportunities
  - Builds total net position (equity) – ability to pay for capital without borrowing, weather volatility
  - Returns to customer-owners (dividend via low and stable rates)