RESOLUTION NO. 10-13561

A RESOLUTION ADOPTING REGULATORY ACCOUNTING FOR HEDGING AND DERIVATIVE TRANSACTIONS

FACTUAL BACKGROUND AND REASONS FOR ACTION

The Board of Commissioners establishes rates for the PUD that are designed to recover the costs of providing services. The Commission has covenanted in bond resolutions that the District will charge retail rates sufficient to cover costs and maintain certain debt service coverage ratios. On June 21, 2010, the Commission also approved financial policies under resolution 10-13555 which require the District to maintain certain debt service coverage ratios, liquidity targets, debt ratios and rates of return to maintain the long-term financial health of the District. If projections reflect that future results will vary from established targets, recommended corrective action, including potential retail rate actions, will be presented for Commission consideration and action.

As a result, the PUD qualifies for the application of FASB Accounting Standards Codification (ASC) 980, Regulated Operations, (formerly known as SFAS 71 "Accounting for the Effects of Certain Types of Regulation"), which requires that the effects of the rate-making process be recorded in the financial statements. Accordingly, certain expenses and credits, normally reflected in the Change in Net Assets as incurred, may be recognized when included in rates and recovered from, or refunded to, customers. Expenses or credits that may be deferred under ASC 980 include derivative fair value adjustments required under Governmental Accounting Standards Board (GASB) Statement No. 53.

In June 2008, GASB issued Statement No. 53 (GASB 53), "Accounting and Financial Reporting for Derivative Instruments." GASB 53 provides a comprehensive framework for the measurement, recognition and disclosure of derivative instrument transactions for the purpose of enhancing the usefulness and comparability of derivative instrument information reported by state and local governments. GASB 53 is effective for the District beginning in fiscal year 2010, however restatement of prior year results is also required.

GASB 53 requires entities to record the fair value of certain contracts that meet the definition of a derivative. The manner in which changes in fair value are recorded depends on whether the underlying transactions meet criteria under GASB 53 to apply hedge accounting. Hedge accounting treatment depends on the effectiveness of a derivative instrument as a hedge. An effective hedge allows the District to defer such gain or loss resulting from a change in market value to the balance sheet. An ineffective hedge requires the change in fair value to be recognized in the Statement of Revenues, Expenses and Changes in Net Assets in the current period.

Valuation gains or losses on derivative instruments that are held to maturity net to zero over time and result in no net impact to the District's financial position or cash flows. However, the requirements of accounting for ineffective hedges under GASB 53 can result in significant volatility to Changes in Net Assets in any individual year.

ANALYSIS AND STAFF RECOMMENDATION

The District has reviewed its various derivative instruments to determine applicability of the GASB 53 standard. Forward purchases and sales of energy that require physical delivery and which are expected to be used or sold by the reporting entity in the normal course of business are generally considered "normal purchases and normal sales." These transactions are excluded under GASB 53 and therefore are not required to be recorded at fair value in the financial statements. However, some of the other District contractual arrangements fall under the requirements of GASB 53. These include, but are not limited to, some Interest Rate Swap Agreements (IRSA) and forward purchase and sale of investments. Other potential contracts include, but are not limited to, financial energy transactions, energy options, environmental attributes purchases and sales, and variable rate commodity pricing.

In addition to the required implementation of GASB 53, the District may adopt ASC 980 to eliminate the impact of changes in the fair value of derivatives on the District's Statement of Revenues, Expenses and Changes in Net Assets. ASC 980 allows an entity with cost-based rates to capitalize costs or revenues as regulatory assets or liabilities and recognize those costs or revenues when recovered from or refunded to customers. Since the Commission establishes cost-based rates, the District may adopt ASC 980 and defer the fair value adjustments required under GASB 53, as regulatory assets or liabilities.

Implementation of GASB 53 without also adopting ASC 980 could result in significant volatility in the District's financial results. The District's analysis of current contracts indicate that if the requirements of GASB 53 alone had been applied to 2009 financial statements, the District would have incurred additional net losses of approximately $6 million, although that net loss would be reversed in future periods, but not before other fluctuations in the District's earnings are recorded.

The implementation of GASB 53 without also adopting ASC980 would also result in the District's financial statements being inconsistent with the normal practice used by the Commission in setting rates. The District's rates are based on projected purchase and sales contracts at known prices (or interest rates) contained in the contracts for the rate period. The use of fluctuating market prices (or interest rates) rather than embedded contract pricing is not appropriate for setting rates, particularly when the fluctuating market prices have no long term impact on the District's earnings or cash flow. If the District and its counterparties fulfill their obligations under the contracts, any gain or loss recognized under GASB 53 would be reversed with no net unrealized gain or loss, upon settlement of the contract.

Staff has presented the background, requirements and considerations for adopting GASB 53 and ASC 980 at the June 29, 2010, Audit Committee Meeting and July 12, 2010, Commission meeting. District staff recommends that it is in the best interest of the District to adopt Regulatory Accounting (ASC 980) for those contracts that are required to be reflected at fair value by GASB 53 and offset these assets and/or liabilities with a regulatory liability or asset. This would be accomplished by recording regulatory liabilities and assets simultaneously with booking the entries required by GASB 53 so as to result in no impact on the District's Statement of Revenues, Expenses and Changes in Net Assets. This will reduce volatility in the financial statements caused by market fluctuations and better support the rate setting process.

The General Manager and Chief Financial Officer have reviewed this recommendation and concur.

ACTION

IT IS RESOLVED BY THE COMMISSION OF PUBLIC UTILITY DISTRICT NO. 1 OF CHELAN COUNTY, WASHINGTON, as follows:

Section 1. Regulatory Accounting (ASC 980) is hereby adopted for those contracts that are required to be reflected at fair value by GASB 53.

Section 2. This resolution is intended only to clarify and support the appropriate accounting treatment of hedging and derivative activities by the District.

Dated the 26th day of July 2010.

President

ATTEST:

Randy Smith
Vice President

Secretary

Norman Gutzwiler
Commissioner

Commissioner

SEAL

CAW