

RESOLUTION NO. 12-13719

A RESOLUTION TO ADOPT THE STRATEGIC
POLICY DIRECTION OF THE DISTRICT'S FIBER
OPTIC NETWORK BUSINESS

FACTUAL BACKGROUND AND REASONS FOR ACTION

The Board has been engaged in a strategic planning effort with regard to its fiber-optic network business. The Board has received input from its customer-owners at meetings, via surveys, focus groups, interviews, formal and informal discussions, and emails.

The District held a public meeting on February 28, 2012 and considered the reports of several experts retained by the District to provide input on the District's strategic planning effort. Thereafter, several public meetings were held to discuss various options available to the District with regard to the District's fiber optic network business.

The Board recognizes the following stated preferences of the majority of the District's electric customer-owners: keep electric rates low and stable; maintain electric reliability; operate efficiently; keep the District financially stable; and do not use electric revenues to subsidize non-electric businesses.

General Manager John Janney made a recommendation to the Board at a special meeting on April 9, 2012. The presentation, including the recommendation, is attached hereto and incorporated herein as Exhibit A. The General Manager recommended that "alternative 2" as described in the presentation be adopted and steps be taken over time to implement that recommendation.

The Board recognizes there are many steps to be taken and research to be completed before a strategic plan for the fiber optic networks can be fully developed and implemented. However, the Board recognizes the need to provide strategic policy direction at this time.

ACTION

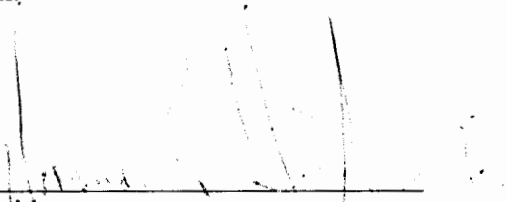
IT IS RESOLVED BY THE COMMISSION OF PUBLIC UTILITY
DISTRICT NO. 1 OF CHELAN COUNTY, WASHINGTON, as follows:

Section 1. The District will keep, improve and operate the existing fiber optic network as a self-sustaining business. This strategic policy direction adopts "alternative 2" as outlined by General Manager Janney's on April 9, 2012.

Section 2. The General Manager and staff are authorized to take such actions and present further plans to implement this strategic policy direction, reporting back to the Board and requesting further Board approval as appropriate or necessary for policy and rate decisions.

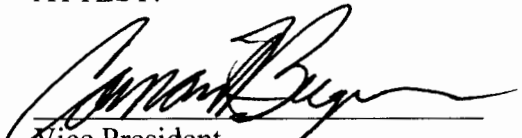
Section 3. This resolution supersedes all prior resolutions and motions that are inconsistent with the provisions of this resolution.

DATED this 16th day of April 2012.



President

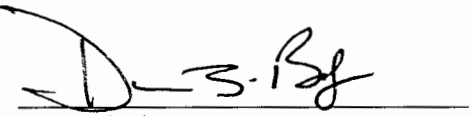
ATTEST:



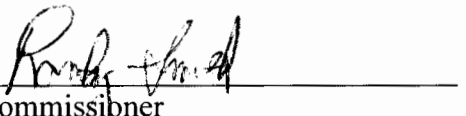
Vice President



Secretary



Commissioner



Commissioner

Seal

Fiber-optic Network Strategic Planning

April 9, 2012



Overview

- Public Process – current status
- Key themes – what we've heard from customer-owners over the past 3 years
- Addressing frequent questions/comments
- Considerations and Alternatives
- Considering additional ideas from customer-owners
- Outlook for PUD fiber and PUD as a whole
- Recommendation
- Next Steps



Process - where we are now

- Input from customer-owners
 - Public meeting Feb. 28 to share fiber reports
 - Meetings the week of Mar. 19 in Wenatchee, Chelan, Leavenworth, Cashmere
 - Email to: Fiberthoughts@chelanpud.org
- GM recommendations to Board on April 9
- We want input on recommendation
 - No PUD decision yet
- Board deliberation and possible decision on April 16 (after public process)

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Key Themes – past 3 years

- Clear preferences from majority of customers
 - Electricity is “Job #1”
 - Keep rates low and stable
 - Maintain reliability
 - Operate efficiently
 - Keep PUD financially stable
 - Don’t subsidize other activities through electric rates

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Common Questions/Comments

- Providing fiber to county residents is the same as rural electrification
 - Similar, but not the same – rural electrification was accompanied by:
 - Vote of the people
 - Monopoly electric service
 - Eminent domain/condemnation authority
 - Rate setting authority to ensure cost recovery
 - New customers often paid full cost to connect
 - Key differences: PUD was assured there would be no competition, could recover full costs of providing service over time

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Common Questions/Comments

- “P” in PUD is for Public – not Private
 - Yes, that is why we are doing what we are doing:
 - Extensive customer outreach/engagement over the past 3 years
 - Adopted a new strategic plan based on what customer-owners want from their PUD
 - Making substantial progress toward meeting Plan goals
 - But we are not done – a continuous process.....
 - We will continue to actively engage all customer-owners via a variety of venues in order to make informed decisions and stay on track with what customer-owners want from their PUD
 - We are obligated to be good stewards of public money and resources

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Common Questions/Comments

- I don't understand the "internal loan thing"
 - PUD has limited access to funding – 4 primary options:
 - Issue bonds to third parties (e.g., revenue bonds)
 - Loans (e.g., bank loans, internal "intra-utility" loans)
 - Grants and other external funding sources
 - Contributions from ISP's and/or end-use customers
 - Except for grants or funding from others, PUD customer-owners are footing the bill



Financial impact of internal loans

With Internal Loan to Fund Fiber System	
Electric System	
Interest expense on external debt (bonds)*	(5.0)
Interest income from internal loan to fiber system	5.0
Net Impact	0.0
Fiber System	
Interest expense on loan from electric system	(5.0)
Depreciation expense	(5.0)
Net Income from operations	2.0
Net Impact	(8.0)
Overall Impact on District as a whole	(8.0)
Without Internal Loan to Fund Fiber System	
Electric System	
Interest expense on external debt (bonds)*	(5.0)
Interest income from internal loan to fiber system	0.0
Net Impact	(5.0)
Fiber System	
Interest expense on loan from electric system	0.0
Depreciation expense	(5.0)
Net Income from operations	2.0
Net Impact	(3.0)
Overall Impact on District as a whole	(8.0)

Same overall financial impact to be recovered through electric rates

*Approximate – money loaned to fiber could have been used to pay down external debt and/or avoid issuing new debt at same rate of interest



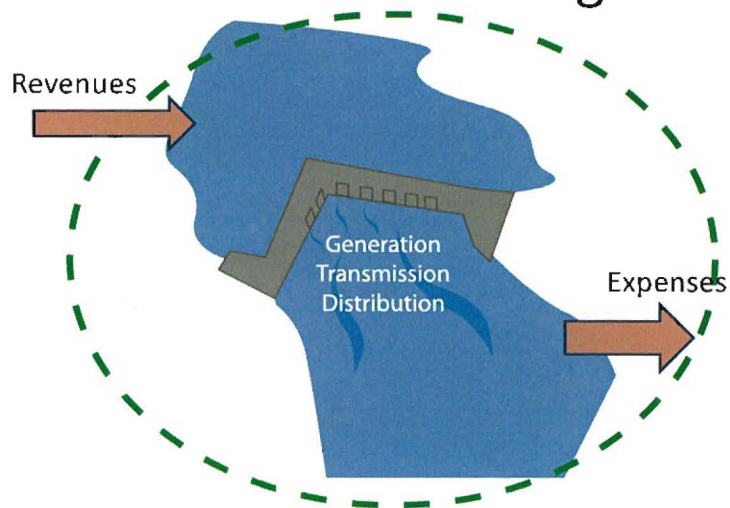
Common Questions/Comments

- Describe how losses in non-electric systems (subsidies) impact my electric rates

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Chelan PUD ... in the beginning

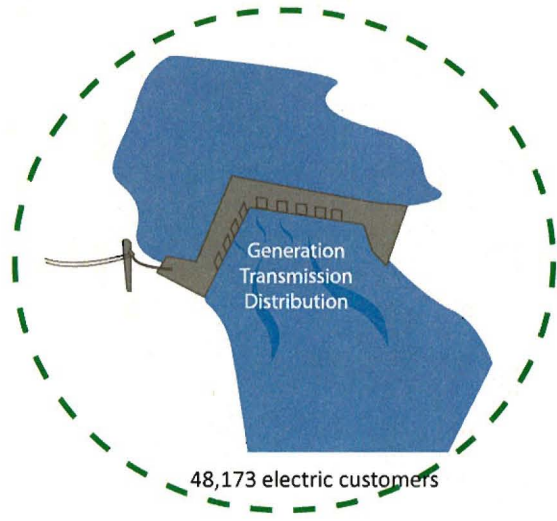


Rates cover costs

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Chelan PUD ... as it is today



Water
5497 customers



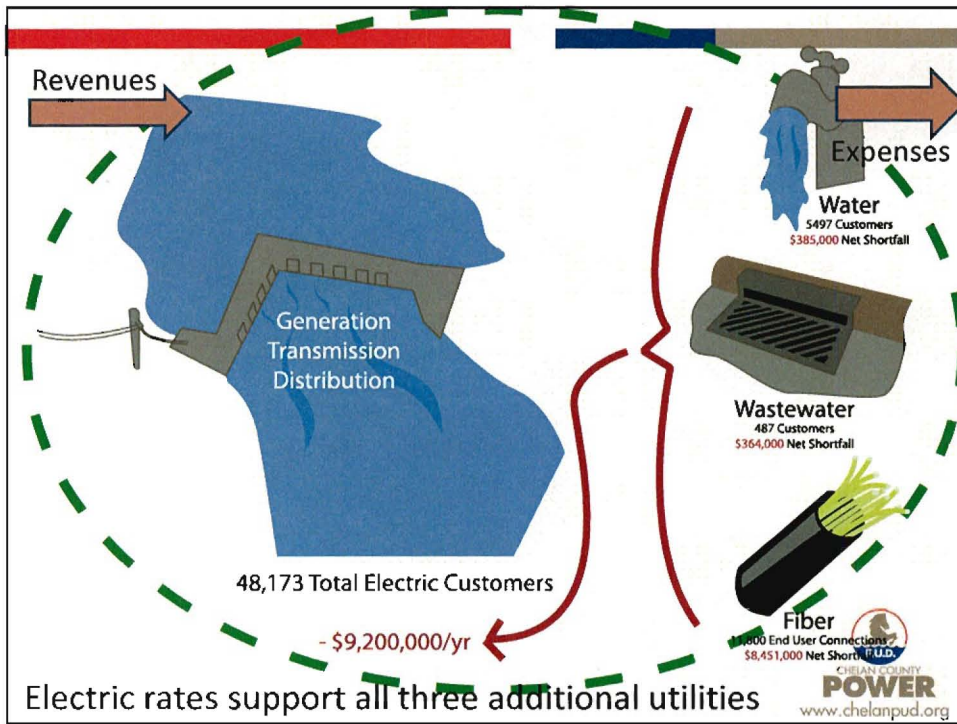
Wastewater
487 customers



Fiber
11,800 end user connections



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Common Questions/Comments

- The PUD made a “commitment” to provide fiber
 - Initial concept – roughly \$80 - \$90 million to complete, fiber revenues would cover costs of service over time
 - As recently as Aug. 2010, we said cost to complete the county-wide build out would be roughly \$33 million
 - Now, estimated cost to complete is multiples of that amount:
 - Roughly \$120 million to provide access to first 70%
 - That much or more to provide access to remaining 30%
 - We have an obligation to be good stewards of public money and resources

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Common Questions/Comments

- Not completing the build-out creates inequities
 - Initial concept – provide access to the entire county, fiber would “stand on its own” financially
 - Fair and equitable because it would be available to everybody who wanted it, those taking service would pay full cost of providing that service – no subsidies
 - Later – started saying less than 100% would have access
 - Introduced “inequity” – some who wanted fiber might not get it
 - Eventually – recognized payback was “never”
 - Ongoing subsidies mean those who don’t want (or can’t get) the service are paying for others to have it
 - This highlights the inherent problem in “cross-subsidization” – which we face with PUD water, wastewater and fiber systems

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Inherent Challenges with Subsidies

- Subsidies, by their very nature, can be unfair to some – particularly where one utility service is subsidizing another
 - Introduces “inequity” issues (previous slide)
 - Because of this, the practice is often prohibited (by regulation or policy) – or allowed only in special circumstances
- Typical justifications for subsidies:
 - For the “greater public good” (social engineering) when the perceived societal benefit outweighs the cost of the subsidy
- Ideally – subsidies would be allowed only on an exception basis when:
 - Cost/benefit is thoroughly analyzed and understood
 - Subsidy is limited as a matter of policy (e.g., specific \$\$ amount)
 - Full, transparent public process precedes decision to grant subsidy taking into account customer-owner priorities, preferences and willingness to bear the cost of the subsidy

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Considerations and Alternatives



Three Alternatives Considered

- As discussed during evening public meetings the week of March 19:
 - 1) Get out of the business - sell to a third party and allow them to operate the fiber network
 - 2) Keep, improve and operate the existing network as a stand-alone, self-sustaining business - provide for limited incremental build-out with surplus funds generated from the fiber network (if any)
 - 3) Continue the fiber network build out to 98% of county homes and businesses, cost paid via higher electric rates

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Additional Customer Feedback

- We've had suggestions from a number of customer-owners during recent public meetings – as well as via email and phone calls – including:
 - Provide options for those outside the existing network footprint, even if customers have to pay the full cost of connecting to the network
 - Allow for more “self build” options
 - Consider other funding sources (e.g., grants)
 - Consider offering “tiered rates” – some without good alternatives would be willing to pay more for fiber
 - Current (and prospective) fiber customers might be willing to bear more of the cost of providing fiber service
 - Provide better information about how to request and receive fiber service

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Outlook for PUD Fiber and PUD as a Whole



Brief History – PUD overall

- Major capital expenditures over past 10 – 15 years
 - Modernizations completed at Rocky Reach and Lake Chelan hydro projects (Rock Island PH #1 underway)
 - Rocky Reach fish bypass facility
 - Federal license implementation costs at Rocky Reach and Lake Chelan
 - Sizeable fish rearing and hatchery expenses
 - Nine figure fiber project
- Borrowed money, increased fixed costs
- Highly dependent on surplus power sales revenues, interest earnings
 - Wholesale power prices and interest rates plunged
 - Snow pack below average
- Lost roughly \$30 million over two year period ('09-'10)
- Implemented 9% temporary surcharge to help mitigate financial impact
- PUD bond ratings put on negative outlook from 2 of 3 independent bond rating agencies



Go-forward challenges for PUD overall

- Current 5-year projections are looking better but longer-term outlook remains uncertain
- Highly dependent on variable revenue sources
 - Power market fundamentals continue to deteriorate
- Increasing regulatory burden – “one size fits all”
- Future “known” expenditures and/or risks
 - Implement 2 recently-approved federal licenses (Lake Chelan and Rocky Reach)
 - Rock Island relicensing (2028)
 - Finish modernization at Rock Island PH #1
 - Plan for eventual modernization at Rock Island PH #2
 - Replace aging transmission/distribution infrastructure
 - Resolution of Columbia River Treaty
 - Operate and maintain water, wastewater and fiber businesses
- Wait and see with rating agencies (negative outlook remains)

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Current Status of PUD Fiber

- Approximately \$120 million invested to date – access provided to roughly 70% of county homes/businesses
- Roughly 2 in 5 homes/businesses with access to fiber are taking service
- Losing money since inception – losses are growing (roughly \$8.5 million last year)
- Cash flow barely covers operating and maintenance expenses, not depreciation or debt service
- Projections are that revenues will never be able to cover interest on internal debt, much less repay principal

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Go-forward challenges for PUD Fiber

- Telecommunications, particularly the part owned/operated by the PUD, is very capital intensive
- Highly competitive marketplace (unlike other PUD businesses)
- Wholesale model makes it difficult to compete
- Changing technology
- Evolving end-user preferences
- Very small network – difficult to achieve economies of scale that larger networks can

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General Manager Recommendation



Considerations:

- Extensive customer engagement over nearly 3-year period
 - Discovered conflicting priorities and preferences
- Comprehensive internal effort from PUD staff
- Solicited advice from several independent experts to:
 - Evaluate cost/benefit trade-offs (economic value)
 - Explore possible exit strategy (sale)
 - Better understand customers' priorities and preferences
 - What people want, what they are willing to pay for it
 - Identify opportunities to improve the business model
- Clearly, no matter what we do, we can't meet the needs of every customer-owner

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Recommendation:

- Alternative #2
 - Consider roughly \$120 million cash investment in PUD fiber to be "sunk cost" – paid for by electric customers
 - Write-off \$99 million internal debt
 - Ignore depreciation on existing fiber assets
 - Develop and implement comprehensive financial policies for fiber business (don't dig another hole)
 - Implement other reasonable and cost-effective recommendations from independent experts
 - Evaluate and implement reasonable and cost-effective ideas we heard from customer-owners and ISP's
 - Develop and implement 5-year business plan
 - Improve communications regarding fiber service, roles and responsibilities of PUD, ISP's and fiber end users
 - Begin search for qualified, executive-level telecommunications expert to lead/manage the PUD fiber business long-term

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Recommendation:

- Alternative #2
 - Develop and implement comprehensive financial policies for fiber business (don't dig another hole)
 - No new subsidies (cash or loans) from other District sources
 - Establish minimum positive cash flow requirements – current and prospective (min. 5-year horizon)
 - Establish and maintain minimum cash reserve level for emergencies, unanticipated expenses or declines in revenue
 - Introduce "savings account" concept to build funds for larger capital expenditures that cannot be covered by current year cash flow (e.g., technology upgrades, expansion)
 - Note: making financial and operational improvements does not guarantee a sustainable business over the long haul – results will be heavily influenced by competition, changes in technology, customer preferences, etc.

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Recommendation:

- Alternative #2
 - Implement other reasonable and cost-effective recommendations from independent experts
 - Market to existing locations with a service drop
 - Shift some responsibilities and costs to retail service providers
 - Restructure wholesale fiber rates and increase over time
 - Reduce expenses to match work load
 - Invest capital wisely to keep reliability high
 - Expand the system only with revenue generated by fiber-optic network

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Recommendation:

- Alternative #2
 - Evaluate and implement reasonable and cost-effective ideas we heard from customer-owners and ISP's
 - Review existing fiber line extension policy to consider:
 - Options for those outside existing footprint
 - Self-build options
 - Fees and charges (e.g., connection fees)
 - Other funding sources (e.g., grants)
 - Further evaluate rates the PUD charges to ISP's
 - Consider charging higher rates to ISP's
 - Tiered rate structure (outlying areas)

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Recommendation:

- Alternative #2
 - Develop comprehensive 5-year business plan
 - Keep, fix, maintain and provide for limited expansion within TBD financial and operational policies/metrics
 - Maintain and enhance operations to ensure appropriate level of reliability, redundancy and customer service
 - Improve performance and efficiency
 - Increase cash flow
 - » Improve efficiency, reduce costs
 - » Provide best mix of products and services (meet demand)
 - » Charge “what the market will bear”
 - Additional cash flow (if any) could be used to maintain higher levels of service and reliability on existing network over time
 - Additional cash flow might also allow for limited potential future expansion over time

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Recommendation:

- Alternative #2
 - Improve communications regarding roles and responsibilities of PUD, ISP's and fiber end users
 - Conduct "focus" group meetings with PUD staff, ISP's and current and prospective fiber customers
 - Redefine and/or clarify roles, responsibilities and expectations of all stakeholders (who does what)
 - Develop clear, concise information and best mediums for which to communicate with all stakeholders
 - Evaluate opportunities for "aggregator" (ISP or 3rd party?) to work with potential fiber end users, ISP's and the PUD to provide cost-effective means to connect new fiber customers

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Financial View



Keep the fiber-optic network and improve the business model

Fiber System Financial Impact Summary

Year	Revenue	Expense	Capital	Cash Impact	Net Income
2013	\$8.4 M	\$4.8 M	\$3.2 M	\$0.3 M	(\$2.3 M)
2014	\$9.1 M	\$5.1 M	\$3.7 M	\$0.2 M	(\$2.0 M)
2015	\$9.7 M	\$5.3 M	\$4.1 M	\$0.4 M	\$1.3 M
2016	\$10.1 M	\$5.5 M	\$2.9 M	\$1.7 M	\$1.3 M
2017	\$10.0 M	\$5.7 M	\$1.2 M	\$3.1 M	\$0.9 M
2018-22	\$50.0 M	\$32.7 M	\$6.3 M	\$11.0 M	(\$0.7 M)
2023-27	\$50.5 M	\$39.7 M	\$10.4 M	\$0.4 M	(\$10.2 M)

Expected case – cash flow look, excludes depreciation and interest expense

Includes depreciation

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Why Option #2?

- Meets priorities and preferences of most customer-owners
 - Customer-owners value the fiber network, Option #2 maintains local control, allows us to keep and potentially improve the network (so, not Option #1)
 - Most customer-owners do not want to raise electric rates to expand it, Option #2 adheres to that (so, not Option #3)
 - May provide limited opportunities for expansion over time with surplus cash generated by the fiber network (if any)
 - May provide opportunities for expansion with funds contributed by others
- Path for fiber must be consistent with overall PUD strategic plan
 - Electric service remains job #1: low and stable rates, reliable service
 - Milestones to a more sustainable Chelan PUD include:
 - Pay down debt
 - Save for a rainy day
 - Catch up on major upgrades and maintenance, provide for future expenditures
 - Once we've achieved these milestones, restored PUD bond ratings and have managed to accumulate dedicated funds for additional discretionary spending, we will have more choices
 - For now, we need to remain disciplined and execute on the plan that our customer-owners helped us set for their PUD

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PUD as economic engine

- PUD has been and can continue to be major economic engine for Chelan county
 - Average savings for PUD electric customers:
 - Approximately \$50 million/year versus regional average rates
 - Roughly \$100 million/year versus national averages
 - Subsidization of non-electric activities puts upward pressure on PUD electric rates – acts like a “tax” on electric customers
 - Funds used for one purpose will limit funds available for other purposes (priorities and trade-offs)
 - Majority of PUD customer-owners have made it clear they want us to maintain low, stable electric rates and reliable service
 - Keeping the PUD financially and operationally strong will ultimately provide more flexibility and options for the future

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Questions, feedback and discussion

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Thank you for coming

Next step - Board meeting on April 16
for board consideration of
recommendation and possible vote

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