

Financial Policies at Chelan PUD

June 7, 2010

Agenda

- ▶ Background and Objectives
- ▶ Financial Policies Overview
- ▶ Target Metrics (“legs of the stool”)
 - ▶ Rate of Return
 - ▶ Debt/Leverage
 - ▶ Debt Service Coverage
 - ▶ Financial Liquidity/Reserves
- ▶ Summary
- ▶ Next Steps

Background

- ▶ Heard from customers via phone surveys and focus group meetings regarding preferences with respect to PUD finances, rates and services
- ▶ Internal working group convened in early April to evaluate financial policy alternatives to promote financial stability, rate stability and reliability
- ▶ Sought out additional business leader, customer and employee feedback throughout May with follow-up in early/mid June
- ▶ Public board meetings – tentative schedule:

<u>Dates</u>	<u>Topic</u>
6/7	Overview of Conceptual Financial Policies (Today)
6/14	Follow-up Meeting – Staff Recommendation
6/21	Adopt Financial Policies

Feedback – Customer Survey*

Summary of Key Finance-Related Responses

- ▶ Customers prefer stability and predictability with regard to rates
 - ▶ Reflect average cost rather than fluctuate from year to year
 - ▶ Smaller rate increases spread out over time as opposed to a big increase all at once
- ▶ Stated priorities for times when revenues exceed costs:
 - ▶ Pay down debt (56%)
 - ▶ Rainy day fund (55%)
 - ▶ Invest in Infrastructure (31%)
 - ▶ Rebates to customers (20%)
 - ▶ Subsidize other services (10%)

*Source – Strategies 360 Report to Commission 12/14/09

Financial Policies – What and Why?

Guidelines designed to promote:

- ▶ Long-term rate stability for customers
- ▶ Operational and fiscal health
- ▶ Prudent allocation and recovery of capital costs over time
- ▶ Uninterrupted access to the bond markets at the lowest reasonable cost

Benefits of prudent Financial Policies:

- ▶ Enables the District to provide high quality services at the lowest possible cost to its customers in the long run

Rate of Return

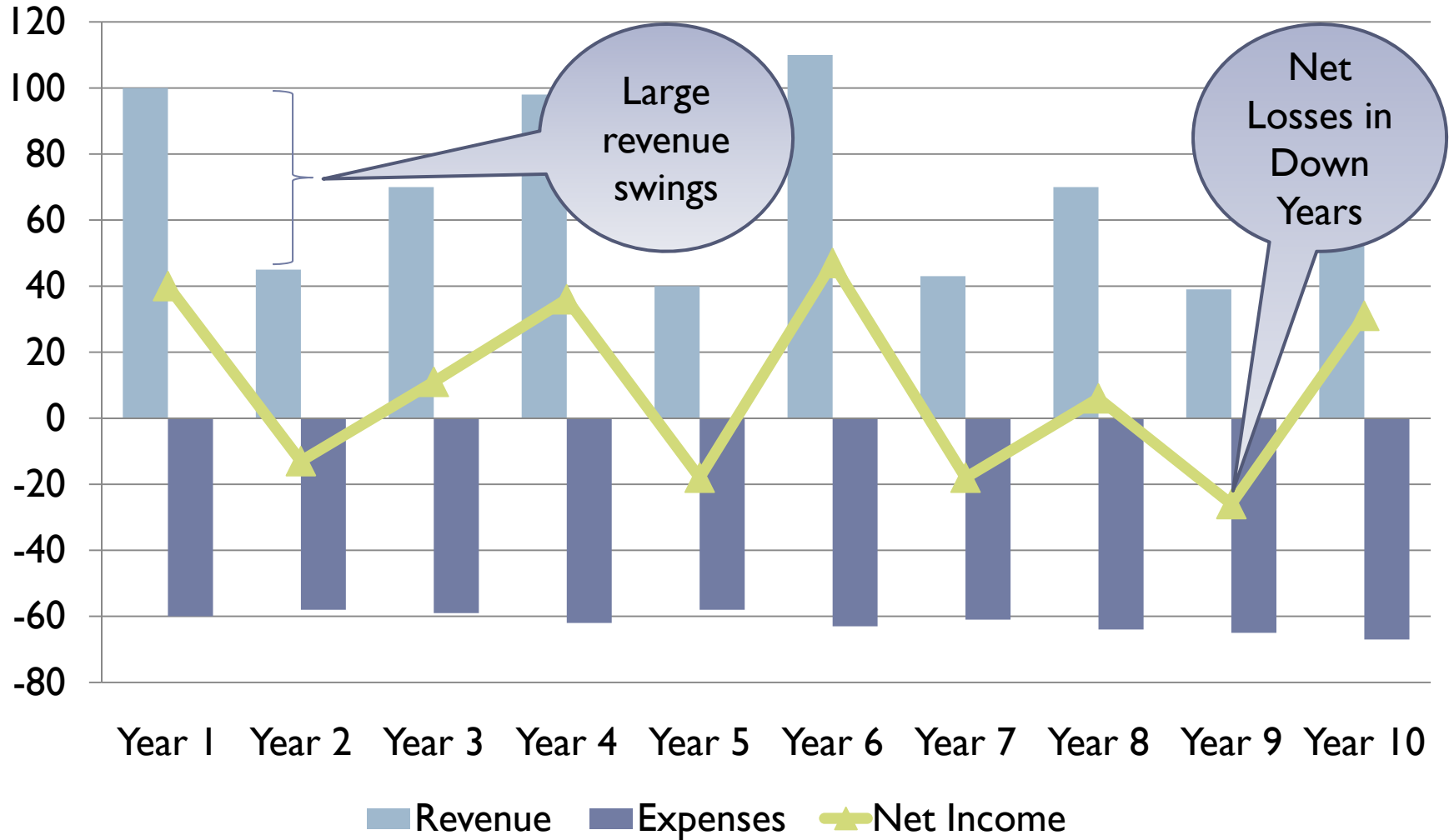


Rate of Return

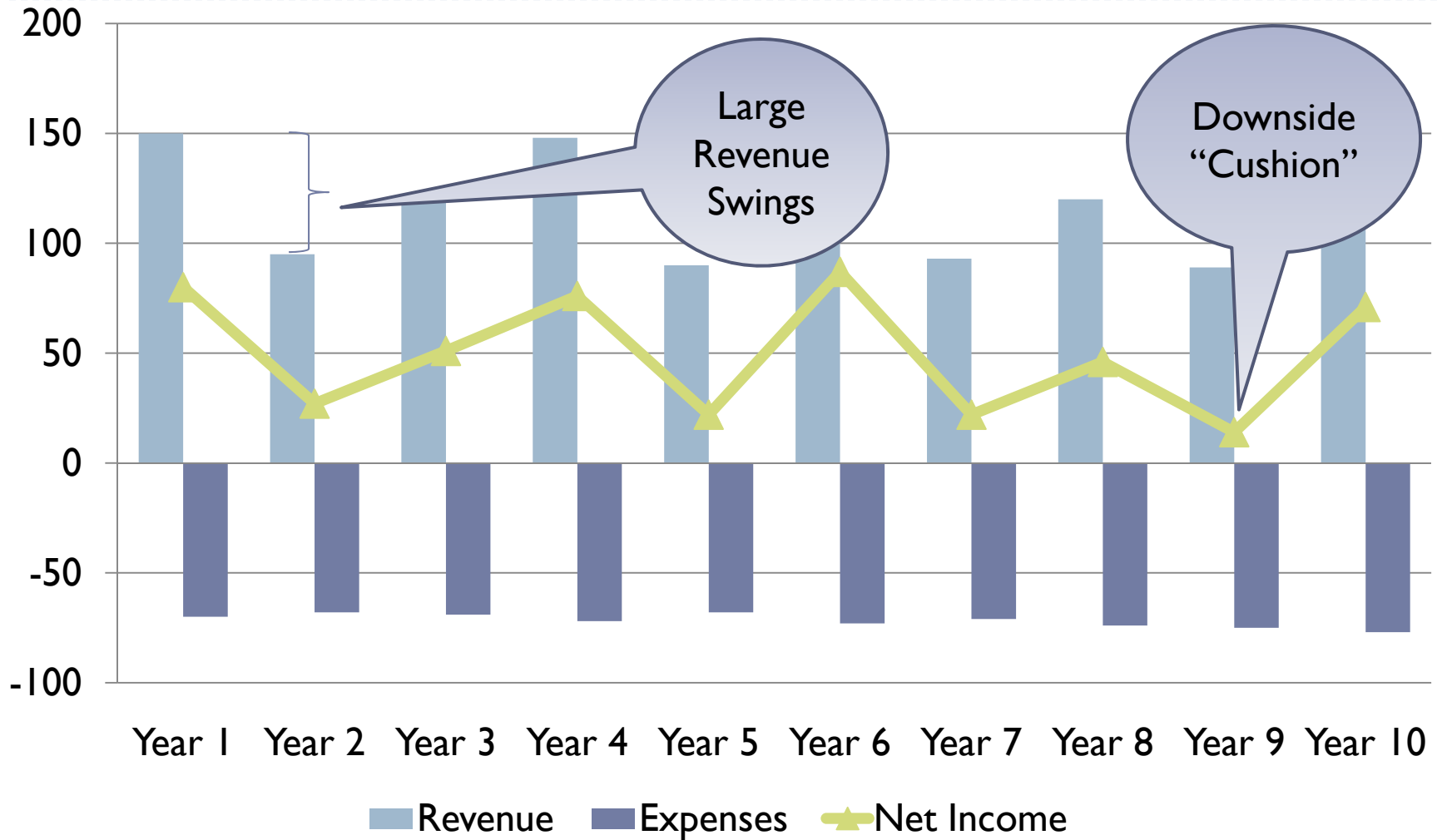
Why do we need a positive return (bottom line)?

- ▶ Assets installed years ago are more expensive to replace today
- ▶ Assets installed today will likely be more expensive to replace tomorrow
- ▶ Rate of return attempts to recover sufficient funds to replace the assets at some point in the future
- ▶ Sufficient income under “expected” conditions (normal years) provides a reasonable cushion for “unexpected” events (e.g., low water/low price years)

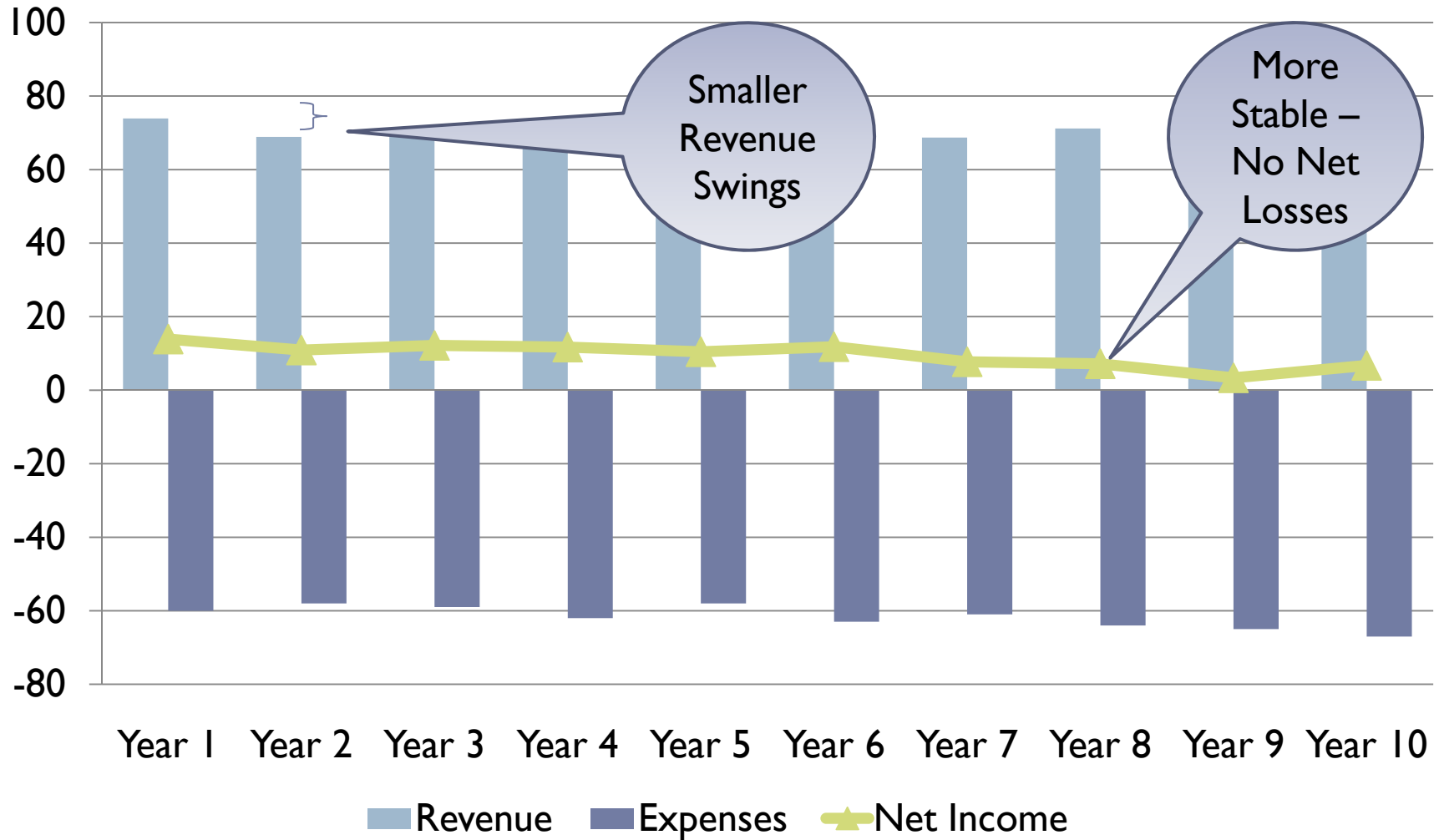
Hypothetical Base Case



Increase Rate of Return

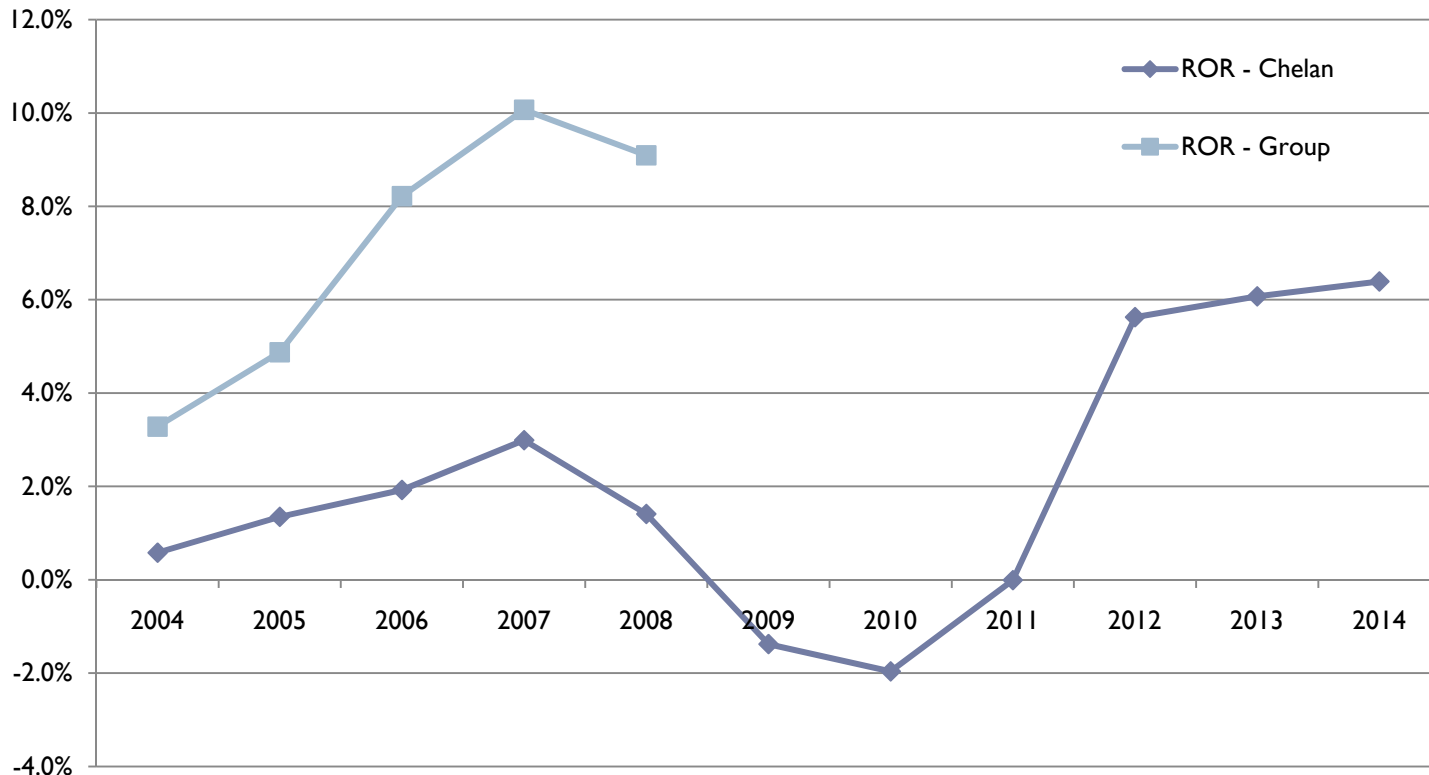


Reduce Revenue Variability (Hedging)



Benchmarking Rates of Return

**Rate Of Return
(Change in Net Assets / Net Utility Plant)**



Peer Group Consists of Comparable Pacific Northwest Public Utilities

Rate of Return Targets

Conceptual Targets for Consideration:

- ▶ **Target Range (expected conditions) = 4% to 6%**
 - ▶ Relatively consistent with peer group
 - ▶ Provides for reasonable levels of revenue generation & reasonable ability to meet other financial targets

- ▶ **Minimum Target (95% confidence interval) = 2%**
 - ▶ Promotes disciplined risk management strategy in order to mitigate downside revenue volatility
 - ▶ Can help mitigate need for large rate surcharges

Conceptual Targets / Current Forecast

Rate of return

- Conceptual Target: 4% - 6% expected conditions, 2% unusual conditions

Combined	2010	2011	2012	2013	2014
Unhedged:					
Base case-expected (50% probability)	(2.0%)	0.0%	5.6%	5.8%	6.2%
Base case-unusual (5% probability)	(2.4%)	(2.0%)	1.0%	0.1%	0.3%
Hedged:					
Hedging plan-unusual (5% probability)	(2.4%)	(2.0%)	4.3%	3.9%	3.5%
Hedging plan-stressed (75% water, \$30 power)	(2.6%)	(2.7%)	4.0%	3.4%	2.9%

X% –results that are below conceptual targets

Note: proposed targets would apply starting in 2012

Balance Sheet Leverage

(a relative measure of debt levels)



District Revenue Bonds Outstanding

- ▶ The District is responsible to bond holders for the payment of all debt
- ▶ A portion of debt is contractually covered by Power Purchasers through the Power Sales Contracts (PSC)
- ▶ The contractual obligation changes with the new PSC post 2011/2012

As of 12/31/09	District	Contract Purchaser	Total
Rocky Reach	48,662,836	272,968,597	321,631,433
Rock Island	251,119,402	251,119,402	502,238,804
Lake Chelan	95,225,251	-	95,225,251
Distribution	84,093,654	-	84,093,654
Networks	25,431,273	-	25,431,273
Water	650,453	-	650,453
Wastewater	-	-	-
Internal Service	10,664,579	-	10,664,579
Treasury Services	4,410,950	-	4,410,950
	<u>520,258,399</u>	<u>524,087,999</u>	<u>1,044,346,398</u>
*Assuming 12/31/09 debt but post 2011/12 % split:	606,354,195	437,992,202	1,044,346,398

Benchmarking Debt/Leverage Measures

- ▶ Debt Ratio: $\text{Total Debt} / (\text{Total Debt} + \text{Net Assets})$
- ▶ Moody's Rating Methodology for Aaa – Aa Rated Entity

Moody's Rating Methodology (select metrics 4/08 report)		Chelan's Metric 2008
Debt Ratio	Less than 60% ; easily manageable capital program	79%

- ▶ Fitch U.S. Public Power Peer Study – June 2009

Entity	Rating	*Applied Moody's Debt Ratio
Chelan PUD	AA+	83.6%
Regional Peers**	Various	61.6%
2008 Median-Retail		54.0%

- ▶ *For consistency with Moody's Debt Ratio rating expectation, used the formula of one minus the Fitch Adjusted Equity/Capitalization = $\text{Total Equity} / (\text{Total Debt} + \text{Total Equity} + \text{Off Balance Sheet Obligations})$ to equate to a comparable Moody's ratio.
- ▶ **Regional Peers in Fitch report (Grant PUD, Snohomish PUD, Eugene Water and Electric Board)

Leverage Targets

- ▶ **Conceptual Target for Consideration:**
 - ▶ Debt ratio of 60% or less
 - ▶ Consistent with comparably-rated peers and investor/rating agency guidelines
 - ▶ Achieve by 2015 and then maintain at those ratios or better in accordance with policy

Conceptual Targets / Current Forecast

Leverage – Debt Ratio - Conceptual Target: 60% by 2015

Combined	2010	2011	2012	2013	2014	2015
Unhedged:						
Base case-expected (50% probability)	74.2%	74.2%	71.1%	68.0%	64.0%	61.2%
Base case-unusual (5% probability)	74.4%	75.5%	73.7%	71.1%	67.0%	64.1%
Hedged:						
Hedging plan-unusual (5% probability)	74.4%	75.5%	71.8%	68.9%	65.1%	62.4%
Hedging plan-stressed (75% water, \$30 pwr)	74.5%	75.9%	72.0%	69.3%	65.6%	63.3%

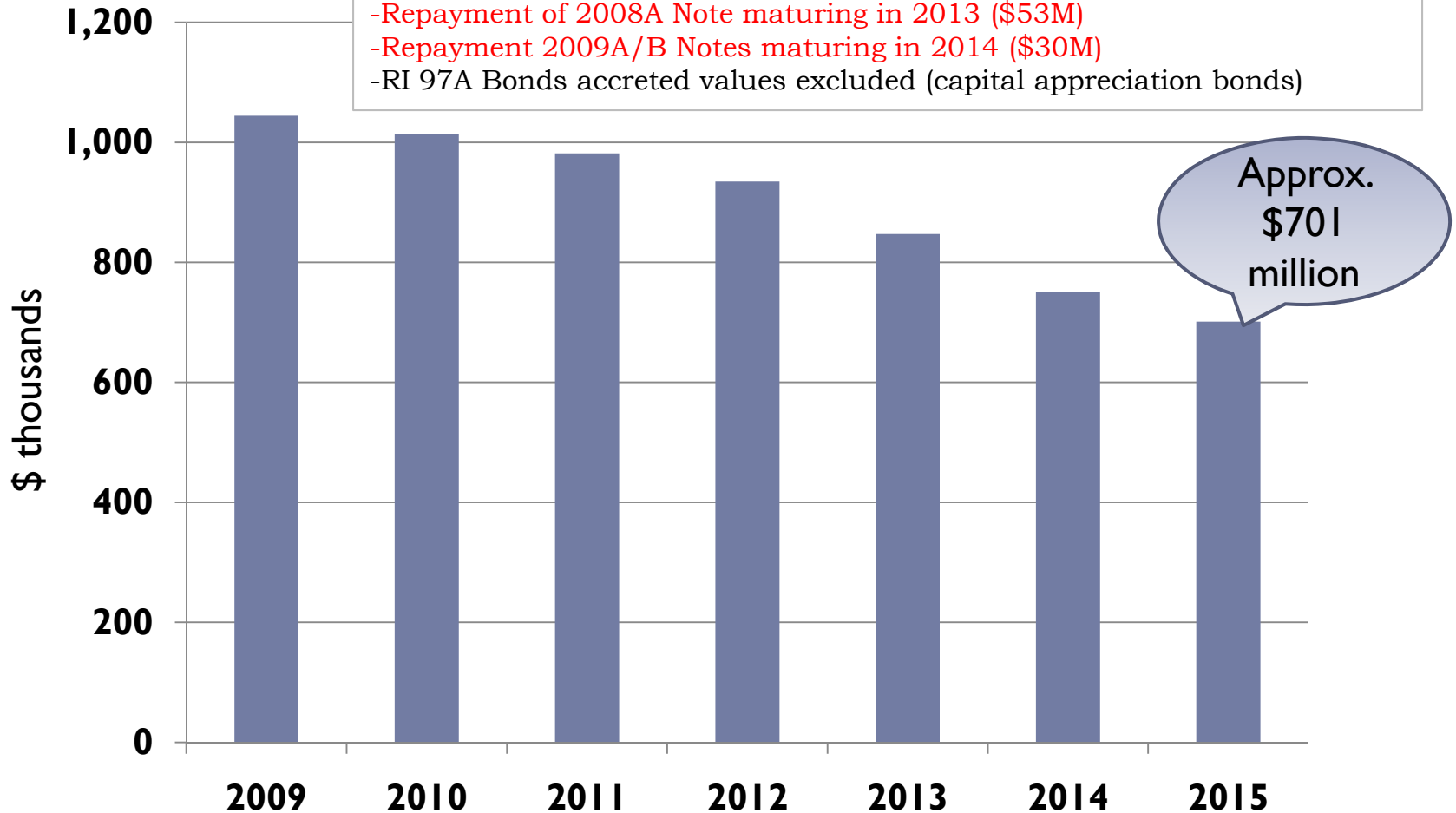
X% –results that are below conceptual targets

Note: if the District pays off approx. \$53 million notes due in 2013, ratio in 2015 drops to slightly below 60% in the “expected” scenario

Revenue Bonds Outstanding

Assumptions:

- Reflects actual principal payments and remarketings
- Assumes no additional new debt
- Repayment of 2008A Note maturing in 2013 (\$53M)
- Repayment 2009A/B Notes maturing in 2014 (\$30M)
- RI 97A Bonds accreted values excluded (capital appreciation bonds)



Debt Service Coverage

Debt Service Coverage - Review

- ▶ Bond covenant – promise to bondholders
- ▶ Represents the ability to cover the year's debt requirements with cash generated from operations
- ▶ Defined by Five Different Master Bond Resolutions
 - ▶ Base (minimum) debt service coverage typically 1.0x
 - ▶ With inclusion of 'other available funds' typically 1.15x
- ▶ Calculated based on assumed ("levelized") basis not actual

$$\frac{\text{Net Revenue} + \text{Depreciation} + \text{Interest Expense}}{\text{("levelized") Debt Service Payments}}$$

- ▶ Higher ratio supports a higher bond rating and lower interest costs on debt

Rating Agencies & Peer Comparisons

▶ Moody's Rating Methodology for Aaa – Aa Rated Entity

Moody's Rating Methodology (select metrics 4/08 report)		Chelan's Metric 2008
Debt Service Coverage	Strong DSC with stable trend; three year average DSC ratio between 2.25-3.00x	1.4x projected 1.04x actual ('09 Senior)

▶ Fitch U.S. Public Power Peer Study – June 2009

Entity	Rating	Adj Debt Service Coverage(x)
Chelan PUD	AA+	1.53
Regional Peers*	Various	2.02
2008 Median-Retail		2.35

- ▶ Adjusted Debt Service Coverage = Funds Available For Debt Service / Total Annual Debt Service
- ▶ * Regional Peers in Fitch Report (Grant PUD, Snohomish PUD, Eugene Water and Electric Board)

Debt Service Coverage Considerations

- ▶ District debt service coverage is low relative to peers (even many of the lower-rated utilities) and rating agency medians
- ▶ Recent years and future projections show a deterioration of coverage to concerning levels
- ▶ Debt Service Coverage ratio can be impacted by changing ‘levers’
 - ▶ Increased Revenue improves ratio
 - ▶ Reduced Operating Expenses improves ratio
 - ▶ Reduced Debt Payments (e.g., lower debt levels) improves ratio
- ▶ Target Objective: develop basic approach that can reasonably be modeled and materially consistent with rating agency methodologies and peer comparisons

Debt Service Coverage Targets

Conceptual targets for consideration:

- ▶ Expected range on combined basis = 2.25x – 2.75x
 - ▶ Consistent with rating agency targets and comparably rated peers
- ▶ Minimum target on combined basis = 1.25x at 95% confidence
 - ▶ Promotes disciplined risk management strategy in order to mitigate downside revenue volatility
 - ▶ Mitigates need for large rate surcharges

Note: we will continue to monitor each of the five actual lien calculations for compliance with bond covenants

Conceptual Targets / Current Forecast

Debt Service Coverage

- ▶ Conceptual Target: 2.25 – 2.75 expected conditions, 1.25, unusual conditions

Senior debt coverage	2010	2011	2012	2013	2014
Unhedged:					
Base case-expected (50% probability)	(0.9)	2.8	18.4	17.5	18.1
Base case-unusual (5% probability)	(1.8)	(1.6)	2.5	(3.0)	(3.4)
Hedged:					
Hedging plan-unusual (5% probability)	(1.8)	(1.6)	13.9	10.7	8.1
Hedging plan-stressed (75% water, \$30 power)	(2.2)	(2.9)	12.6	8.8	5.9

X.X – represents violation of bond covenant

Note: proposed targets would apply starting in 2012

Conceptual Targets / Current Forecast

Debt Service Coverage

- ▶ Conceptual Target: 2.25 – 2.75 expected conditions, 1.25, unusual conditions

Subordinate debt coverage	2010	2011	2012	2013	2014
Unhedged:					
Base case-expected (50% probability)	1.2	1.6	2.5	2.4	2.5
Base case-unusual (5% probability)	1.1	1.1	1.3	0.9	0.9
Hedged:					
Hedging plan-unusual (5% probability)	1.1	1.1	2.1	1.9	1.8
Hedging plan-stressed (75% water, \$30 power)	1.0	0.9	2.0	1.8	1.6

X.X – represents violation of bond covenant

Note: proposed targets would apply starting in 2012

Financial Liquidity

(cash reserves and other sources)



Financial Liquidity/Reserves

- ▶ To ensure the long-term financial, organization and operational stability of the District – (i.e., more stable retail electric rates)
- ▶ Liquidity is necessary to mitigate risk (e.g., unexpected decline in revenue or increased expense) – aka “rainy day fund”
- ▶ Liquidity needs – risk based approach reflecting the District’s
 - ▶ scope of operations
 - ▶ risk profile
 - ▶ complexity
- ▶ Financial Liquidity is a key rating factor - measure of financial flexibility, strength, and stability to manage through risks.

Financial Liquidity/Reserves

- ▶ Days Cash On Hand....one measure of financial liquidity
- ▶ Moody's Rating Methodology for Aaa – Aa Rated Entity

Moody's Rating Methodology (select metrics 4/08 report)		Chelan's Metric 2008
Days Cash on Hand	Greater than 125 days	602

- ▶ Fitch U.S. Public Power Peer Study – June 2009

Entity	Rating	Days Cash on Hand
Chelan PUD	AA+	358
Regional Peers*	Various	252
Fitch 2008 Median-Retail	Various	78

Days Cash on Hand = Unrestricted Cash + Available Lines of Credit / Operating Expenses (Net of Depreciation). Multiplied by 365

* Regional Peers in Fitch Report (Grant PUD, Snohomish PUD, Eugene Water and Electric Board)

- ▶ Days Cash On Hand: Helpful Metric....but it does not take into account unique operational, financial or risk profile of each utility

Financial Liquidity/Reserves

Current Factors Affecting Need For Liquidity/Reserves

- ▶ “Rollover Risk” (debt re-pricing or expiring in near future):
 - \$ 80MM of new short-term notes due 2013/2014
 - \$ 92MM VRDB* liquidity support expires 2013\$172MM Total
- ▶ Additional liquidity may be required to support contingent obligations such as:
 - Potential margin calls and/or termination payments on interest rate swaps (up to \$60MM or more depending on market conditions)
- Pending decisions may require additional liquidity support
 - Refundings & forward starting swaps in 2011 and 2013
 - Post-2012 surplus electricity sales – laddered slices
 - Power Risk Management Policy – short/mid-term hedging

*VRDB = Variable Rate Demand Bonds

Liquidity Considerations

- ▶ Respondents to the District's survey indicate a high preference (55%) for rainy day fund
- ▶ District cash on hand is higher than our peers and strong from a rating agency methodology (not adjusted for risks and complexity)
- ▶ Liquidity adequacy is key – actual requirement will vary based on current and projected business risks, changes in operations, etc.
- ▶ Recent years and future projections show a decline in unrestricted cash (reserves) and increasing needs for higher levels of liquidity

Liquidity/Reserve Target Considerations

- ▶ Reserve development should consider risks and impact to financial stability
- ▶ Risk based 'bucket' methodology

Reserve Bucket	General Purpose	Example Categories - Methodology
Operating	Normal business needs	Working capital – specified months of O&M Revenue Stabilization – Energy – revenue volatility Revenue Stabilization – Interest – interest rate volatility
Contingency	Infrequent or unexpected events	Margin/Collateral calls – exposures relative to power and swap transactions Termination events – exposures relative to swap transactions Counterparty default – exposures relative to power and swap transactions Contingency risk – combination of various uncorrelated risks identified
Planning	Saving for future planned events	Capital Reserves – % of annual capital (future) Bond Maturities – set aside for bond sinking fund/maturity in advance of term

Estimated Liquidity Requirements

\$million	2010	2011	2012	2013	2014
Operating Reserves – Normal Bus Needs	87	87	87	87	87
Contingency Reserves – Infrequent or Unexpected Events	66	66	66	66	66
Planning Reserves – Future Planned Events/Expenses	66	110	154	197	151
Subtotal	219	262	306	350	303
“Portfolio Effect” (not every need will occur at once)	-64	-64	-64	-64	-64
Net Portfolio Reserve Target	155	199	242	286	240

Sources of Liquidity

- ▶ Previous slides covered liquidity needs (what we need)
- ▶ Next We Will Cover Sources of liquidity (what we have)
 - ▶ Primary liquidity – cash and short-term investments
 - ▶ Secondary liquidity
 - ▶ External bank lines
 - ▶ Internal cash sources (e.g., “surplus” cash in Hydro Systems)
- ▶ Secondary Liquidity is new concept
 - ▶ Want to make sure we’re using our entire balance sheet and efficiently using all available sources of internal liquidity
 - ▶ Not having sufficient liquidity can be disastrous, but having too much can be costly
 - ▶ We’re working to strike a reasonable balance between the two extremes – not carry too much or too little

Primary Liquidity

Cash and Investment Balances as of 12/31/09

	<u>\$ million</u>
Total cash and investments	\$435
Less restricted construction funds	(130)
Less bond reserves and related funds	(74)
Less power contract reserve funds	(34)
Less operating funds for Hydro only	(10)
Less self insurance reserves	(5)
Unrestricted funds	<u><u>\$182</u></u>

Secondary Liquidity

- ▶ May use secondary liquidity as “back-up” - standby source
- ▶ For Internal Sources (“from Hydro funds”)
 - ▶ May be cheaper than external bank lines, but.....
 - ▶ Availability will change over time as capital plans, accumulation levels, etc. change
 - ▶ Only a short-term source and must be paid back
 - ▶ Utilization would require agreement from power purchasers

\$million	'09 Bal	2010	2011	2012	2013	2014
Secondary Liquidity*	0	30	42	31	0	0

*Current Estimate – may change from quarter to quarter

Financial Liquidity Targets

Conceptual Targets for Consideration:

- ▶ Adopt minimum financial liquidity target of \$175 million for 2010
 - ▶ Max \$25 million of “internal” secondary liquidity to count towards target

- ▶ Continue analysis to evaluate additional options/decisions that will impact financial liquidity in subsequent periods:
 - ▶ Timing for resumption of fiber build out (currently slated to resume in 2012)
 - ▶ Timing for AMR project (currently slated for 2012 and 2013)
 - ▶ Cost/benefit and feasibility of:
 - ▶ Reissuing \$53 million short term notes due in 2013
 - ▶ Reissuing \$30 million short term notes due in 2014
 - ▶ External line(s) of credit with Bank(s)
 - ▶ Options in new power contracts – optimal usage of Debt Reduction and Capital Recovery components
 - ▶ Etc.

Projected Sources vs. Anticipated Needs

	2010	2011	2012	2013	2014
Anticipated Liquidity Needs	155	199	242	286	240
Projected Sources of <u>Primary</u> Liquidity					
Unhedged:					
Base case-expected (50% probability)	170	166	195	211	208
Base case-unusual (5% probability)	166	143	142	142	136
Hedged:					
Hedging plan-unusual (5% probability)	166	143	180	190	180
Hedging plan-stressed (75% water, \$30 power)	163	136	175	182	167

XX – projected sources are below anticipated needs

Note: see prior slide for additional options/decisions that may influence outcomes

Projected Sources vs. Anticipated Needs

	2010	2011	2012	2013	2014
Anticipated Liquidity Needs	155	199	242	286	240
Projected Sources of <u>Total</u> Liquidity					
Unhedged:					
Base case-expected (50% probability)	200	208	226	211	208
Base case-unusual (5% probability)	196	185	173	142	136
Hedged:					
Hedging plan-unusual (5% probability)	196	185	211	190	180
Hedging plan-stressed (75% water, \$30 power)	193	178	206	182	167

Projected sources < anticipated needs

= or > \$175 proposed min target for 2010

Note: see prior slide for additional options/decisions that may influence outcomes

Summary of Benchmarking Results

▶ Key Financial Targets versus Rating Agency/Peer Metrics:

	Chelan Relative Ranking
Rate of Return	Weaker
Debt/Leverage	Weaker
Debt Service Coverage	Weaker
Liquidity/Reserves	Stronger

- ▶ Proposed financial policies/targets are designed to strengthen the District's overall financial position
- ▶ Too much reliance on one "leg of the stool" can limit the District's ability to provide consistent and reliable services while maintaining low, stable rates over the long run

Actionable Policies

(actions required when targets are violated)



Actions When Targets are Violated

- ▶ **Results are worse than targets:**
 - ▶ Squeeze out additional downside exposure (e.g., tighter hedging targets), where possible
 - ▶ **Cost Control Measures**
 - ▶ Stop “discretionary” projects
 - ▶ Reduce/defer O&M Expenses
 - ▶ Defer capital expenditures and major maintenance projects
 - ▶ Reduce pace of build-outs and multi-year projects
 - ▶ Increase rates with enough lead time to allow for smaller, incremental rate adjustments

Actions When Targets are Violated

- ▶ **Results are better than targets:**
 - ▶ Catch up on deferred maintenance and critical capital projects
 - ▶ Replenish “Rainy Day” funds
 - ▶ Establish Planning Reserves for planned future expenses
 - ▶ Discretionary projects with positive returns
 - ▶ Pay down debt
 - ▶ Debt avoidance (more pay-as-you-go)
 - ▶ Pay down existing debt before final maturity
 - ▶ Reduce rates/rebates to customers

Summary

- ▶ The actionable targets and policies we discussed today are designed to put the District on a reliable, sustainable path for the future
- ▶ If we adopt these metrics and action plans, we expect that our financial position will improve over the next several years
- ▶ We heard from our customers about managing debt, saving for a “rainy day” and avoiding large rate increases all at once and these policies are designed to help us do that
- ▶ Our surplus power sales present a great opportunity – if we manage according to our plan, we should be able to mitigate much of the downside risk and still capture the benefits

Comments or Questions?

