RESOLUTION NO. 10-13555

A RESOLUTION RESTATING AND REVISING LONG RANGE FINANCIAL POLICIES FOR THE DISTRICT WHICH AMENDS AND SUPERSEDES PRIOR RESOLUTIONS PERTAINING TO SUCH MATTERS, INCLUDING RESOLUTION NO. 08-13377

FACTUAL BACKGROUND AND REASONS FOR ACTION

Starting in 2001, the District has become increasingly reliant on revenues derived from the sale of surplus generation to balance its budget. Prior to this time, retail rate revenues were generally sufficient to cover the District's costs of providing reliable utility services. Over the past decade, the District has invested hundreds of millions of dollars to upgrade aging utility plant and comply with licensing obligations associated with its hydro projects. During this same period, the District invested over $100 million in a new competitive wholesale telecommunications business. Increasing regulatory mandates for renewable energy, conservation, grid reliability and environmental programs are also having an impact on the District's operations. Meanwhile, one 5% retail electric rate increase in 2008 provided only a partial offset to the increasing cost pressures described above.

Leading up to 2009, aided in part by a 1974 contract with Puget Sound Energy which allowed the District to take back an increasing share of output (from 0% to a 50% share) of the Rock Island Powerhouse II output between 2000 and 2006, relatively favorable hydrologic and energy market conditions, the District's revenues from the sale of surplus generation were generally increasing at a rate sufficient to cover the increasing cost pressures without resorting to larger retail rate increases. Except for the 2000/2001 western energy crisis – which generally benefited the District on the upside – the District experienced a period of relatively stable and increasing revenue that tended to mask the inherent volatility associated with the increasing reliance on this revenue source.

For years, the District has been anticipating the expiration of several long-term power sales contracts in 2011 and 2012. All but one of these contracts expires during 2011 and 2012. Douglas PUD will receive 5.54% of the output of Rocky Reach after 2011. The District recently entered into two new long term contracts with Puget Sound Energy and Alcoa for a portion of the output of the combined Rocky Reach and Rock Island systems under more favorable terms than the expiring contracts. After accounting for Puget's and Alcoa's 25% and 26% respective shares of Rocky Reach and Rock Island output and Douglas PUD's 5.54% share of Rocky Reach, the District's total share of the output from its three hydro projects will increase from roughly 30% today to close to 48% in 2012. With this new mix, the

District will also benefit from a larger share of output from its lowest cost resource, the Rocky Reach Project.

In 2012, the District's increased share of hydro project output is expected to add roughly 200 average MW of surplus generation under expected conditions (50% probability). Until the new Alcoa and Puget Sound Energy contracts expire in 2028 and 2031, respectively, the District's share of the output from its three hydro projects is static. Even modest load growth over that period will begin to erode the amount of surplus the District has to sell into the market and, unless wholesale electricity prices rise to compensate for the declining volumes, the District's wholesale revenue stream will begin to erode as well. Higher than expected load growth would tend to further reduce surplus volumes and associated revenues.

Assuming the District's local retail load will grow over time as the economy grows and surplus sales volumes diminish, it is likely that the District's costs to provide stable and reliable utility services will increase and gradually erode the financial performance of the District. At some point, additional retail rate increases will be required to maintain financial stability. Rigorous financial planning and prudent Financial Policies, and the discipline they promote, should help to delay the time when significant retail rate increases may be required.

ANALYSIS AND STAFF RECOMMENDATION

As part of a strategic planning effort that began in August 2006, the General Manager and District staff conducted comprehensive financial analyses and discussed Financial Policies with the Commission during a series of public meetings. The information, analyses, and discussions identified a series of financial challenges for the District through 2011 and established that a surcharge on retail electric rates was an appropriate risk mitigation tool. This effort culminated on June 11, 2007 when the Commission passed a motion establishing a set of governing Financial Policies designed to guide the District's financial course through 2011. The motion was ratified with Resolution 08-13377.

During 2009, the District experienced a material drop in revenue due primarily to poor economic conditions, abnormally low river flows and depressed wholesale electric prices. To compensate, the District took a series of measures including: over $20 million in budget reductions (capital and O&M), mandatory furloughs for all employees, a salary freeze for non-bargaining unit employees, a voluntary headcount reduction program and other measures to reduce costs. These steps were not enough to balance the budget and on April 27, 2009, the Commission approved a 9% temporary surcharge on the District's retail electric customers effective May 1, 2009 for up to 12 months. Even after these actions (absent a potentially much larger electric rate surcharge), the District remained at risk of meeting a key covenant with bondholders on its outstanding Senior Consolidated System Debt and, as a precautionary step to ensure technical compliance, the District deposited into escrow an amount sufficient to meet the debt service coverage requirement on the Senior Consolidated System Debt for both 2009 and 2010.

After adopting a 2010 budget with spending slightly below the reduced 2009 budget – an unsustainable level over the long run if the District expects to maintain its strong service and reliability levels – the District is again experiencing lower than expected revenues. After extending the 9% surcharge for up to 12 more months on April 5, 2010, the District continues to draw on cash reserves to fill the remaining budget gap.

District staff and the Commission recognize the costs associated with making such course corrections and the urgent need to ensure a greater level of financial stability and associated retail rate stability. At the July 20, 2009 Commission meeting, the General Manager proposed a new Strategic Planning effort focused beyond 2011. To date, with assistance provided by a third party consulting firm with focused expertise in the areas of quantitative and qualitative research, the District reached out to customers, business leaders, employees and others to determine customer preferences with regard to PUD finances, rates and services. The result of these efforts pointed to a number of preferences, including: a strong desire for a financially stable utility, more stable and predictable rates (smaller incremental rate adjustments as opposed to large one-time adjustments), debt reduction and building and maintaining sufficient financial reserves.

In early 2010, the General Manager and the Commission President appointed a Financial Policy Subcommittee consisting of two Commissioners, the senior management team of the District and other District staff. This subcommittee held a series of meetings beginning in early April to evaluate various Financial Policy options that would be responsive to the preferences outlined by the various stakeholders noted above – and also meet the needs of various other stakeholders who have a vested interest in the financial health of the District. These financial stakeholders include the District's current and prospective bondholders, bond rating agencies, various banks that provide services to the District and other entities that have material business relationships with the District. Throughout the process, key employees and a group of business leaders from the communities we serve were engaged to solicit feedback and provide direction to develop a comprehensive set of Financial Policy options.

Staff's financial modeling incorporated current revenue and expense forecasts based on expected operations and market conditions, as well as a multitude of additional probabilistic and "what if" scenarios. This analysis highlighted one thing very clearly: the additional surplus energy the District expects to sell into the wholesale market beginning in late 2011 provides a great opportunity for the District. The additional revenue from surplus sales under expected conditions will help fill the gaps between operating costs and retail revenues. This opportunity also poses an enormous challenge in that the District will be relying more on a volatile revenue source to meet its financial obligations and balance the budget each year. Staff's analysis identified various scenarios where the District would fall short of meeting its annual financial obligations (e.g., debt service coverage) unless actions are taken to manage the downside variability of wholesale revenues.

Staff has previously presented to the Commission various options and programs designed to stabilize wholesale revenues and this analysis confirms the expectation that these programs, if they can be implemented as currently contemplated, can help the District maintain financial stability throughout expected and unusual hydrological and market conditions, at least in the short run. In the event longer-term influences and pressures begin to put additional strain on the District's finances, it is the intent of these Financial Policies and the associated processes and forecasting tools to anticipate such pressures in advance. In most cases, assuming appropriate financial discipline is followed, this process should allow for needed course corrections and any necessary rate adjustments to be anticipated in advance and implemented incrementally over time.

The financial analyses, risk evaluations, benchmarking results and customer and employee feedback were all incorporated into staff's recommendations, outlined below. These recommendations are designed to refine the existing Financial Policies to further promote long term rate stability and predictability for customers, reduced debt levels over time, prudent levels of financial liquidity/reserves and uninterrupted access to financial markets at the lowest reasonable costs.

Staff presented a conceptual set of Financial Policy options for consideration and discussion at the June 7, 2010 regular Commission meeting. After obtaining additional input, staff presented their final recommendations at public meetings on June 14, 2010 and June 21, 2010.

District staff recommends that it is in the best interest of the District to amend the District's Financial Policies to the following:

1. **Rate of Return** – The District's Rate of Return would be calculated as the change in net assets divided by net utility plant on a combined basis. The targeted range is 4% - 6% under expected conditions (50% confidence) with a minimum of 2% under unusual conditions (95% confidence) by 2012. The targeted range is relatively consistent with peer group performance and would provide for reasonable levels of revenue generation and ability to meet other financial targets. The minimum threshold promotes a disciplined risk management strategy in order to mitigate downside revenue volatility which helps reduce the need for large rate surcharges.

2. **Debt Ratio** - The District's Debt Ratio would be calculated as total debt divided by total debt plus net assets on a combined basis. The target is to achieve a Debt Ratio of 60% or less by 2015 and then maintain that ratio or better in accordance with policy. This target is consistent with comparably-rated peers and investor/rating agency guidelines.

3. **Debt Service Coverage Ratio** – The Debt Service Coverage Ratio would be calculated on a District combined basis and in accordance with the District's bond covenants. The calculation would also be performed on each individual lien in accordance with the specific bond indenture requirements. The Debt Service Coverage Ratio on the combined basis would be a target range of 2.25x – 2.75x under expected conditions (50% confidence) and a minimum of 1.25x under unusual conditions (95% confidence) by 2012. The target range is consistent with rating agency targets and comparably-rated peers. The minimum threshold promotes a disciplined risk management strategy in order to mitigate downside revenue volatility which helps reduce the potential for large rate surcharges.

4. **Financial Liquidity** – Financial Liquidity would include primary liquidity such as unrestricted cash and investments and secondary liquidity including general bank lines or similar instruments and other internal sources (e.g., excess Hydro system funds), if available, that could be tapped to meet short-term liquidity needs. The minimum Financial Liquidity target is $175 million for 2010 which may include up to a maximum of $25 million of liquidity provided by secondary internal sources, if available. The Financial Liquidity target is intended to provide adequate liquidity to support operating reserves for normal business needs, contingency reserves for infrequent or unexpected events and planning reserves for future planned events. Staff will continue to analyze liquidity needs for 2011 and beyond and provide a recommendation to the Commission in a subsequent action.

Staff will monitor the District's financial performance in relation to the Financial Policies as stated in this Resolution and report to the Commission on a quarterly basis or more frequently if conditions warrant.

The Financial Policies will be reviewed and updates will be proposed for Commission consideration, as needed, on a periodic basis in accordance with the ongoing strategic planning cycle.

The General Manager has reviewed these Financial Policies and recommends that they be approved and adopted by the Commission.

ACTION

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

Section 1. In order to comply with RCW 54.24.080, the Commission recognizes the obligation to maintain and collect rates or charges for electric energy, water, wastewater, wholesale telecommunications and other services, facilities and commodities sold, furnished or supplied by the District. The rates and charges must be adequate to provide revenues sufficient for payment of the principal and interest on revenue bond obligations and all payments which the District is obligated to set aside in any special fund or funds created for such purpose, and for the proper operation and maintenance of the public utility and all necessary repairs, replacements and renewals thereof.

Section 2. The Commission also recognizes the need for rigorous financial planning to anticipate and respond to changes in the business climate and economic environment in order to maintain long term rate stability and adequate operating funds. Prudent Financial Policies enable the District to provide stable, reliable and responsive utility services at the lowest possible cost to its customer-owners over the long run.

Section 3. The Commission restates and revises the District's Financial Policies as follows:

1. Maintain a Rate of Return in a targeted range of 4% - 6% under expected conditions (50% confidence) with a minimum of 2% under unusual conditions (95% confidence) by 2012.
2. Achieve a Debt Ratio of 60% or less by 2015.
3. Maintain Debt Coverage Ratios on a combined basis of 2.25x – 2.75x under expected conditions (50% confidence) with a minimum of 1.25x under unusual conditions (95% confidence) by 2012.
4. Establish a minimum Financial Liquidity target for 2010 of $175 million that includes up to a maximum of $25 million provided by secondary internal sources, if available.

Section 4. The Commission hereby directs the General Manager to submit annual budgets and five-year financial plans to the Commission for consideration and approval as part of the District's typical budget cycle (generally adopted in December). The Commission further directs the General Manager to take appropriate actions to maintain compliance with these Financial Policies including cost effective measures to stabilize revenues and/or prudent and sustainable cost reductions, where feasible. To the extent Policy actions or retail rate actions are required to maintain compliance with these Financial Policies, the General Manager will present appropriate recommendations to the Commission for consideration and adoption.

Section 5. The District's Executive Manager of Finance/Chief Financial Officer/Chief Risk Officer or designee shall report compliance with such Financial Policies to the Commission on a quarterly basis. If projections reflect that future results will vary from established targets, the recommended corrective action will be presented for Commission consideration and action.

Section 6. Resolution No. 08-13377 is hereby amended and superseded. To the extent additional prior resolutions of the District impose limitations or directions which are being amended or superseded by this Resolution and which are inconsistent with this Resolution, said prior resolutions are hereby rescinded and amended to the extent they conflict with this Resolution.

DATED this 21st day of June 2010.

President

ATTEST:

Vice President

Secretary

Commissioner

Commissioner

SEAL

CAW