RESOLUTION NO. 11 - 13648

A RESOLUTION ADOPTING REGULATORY ACCOUNTING FOR TERMINATION OF INTEREST RATE SWAP AGREEMENTS

FACTUAL BACKGROUND AND REASONS FOR ACTION

The Board of Commissioners ("Commission") establishes rates for the District that are designed to recover the costs of providing services. The Commission has covenanted in bond resolutions that the District shall fix, establish, maintain and collect rates and charges to provide revenues sufficient to cover costs and maintain certain debt service coverage ratios. 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 District qualifies for the application of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 980, Regulated Operations, 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 that may be deferred under ASC 980 include Interest Rate Swap Agreement (Swap) termination payments.

Application of ASC 980 requires Commission approval for each type of cost or revenue deferred. Examples of items the board has previously approved the application of Regulatory Accounting for include: Resolution No. 10-13561-derivative fair value adjustments, Resolution No. 10-13572-significant contributions and Resolution No. 10-13573-conservation expenditures. These deferrals are fully disclosed in the audited financial statements.

On March 10, 2011, the District terminated the 2008 Swap and paid termination fees in the amount of $7,038,500 based on the fair market value at that time. The termination fees paid are expected to be recovered through reduced interest expense over the next few years. The District is currently evaluating whether to terminate the 2011 Swap. The potential termination payment amount fluctuates based on market conditions and is currently estimated between $11 million - $15 million. A decision whether to terminate the 2011 Swap will be made prior to its effective date of June 1, 2011. Any 2011 Swap termination fees are expected to be recovered through interest expense savings as a result of the 2011 bond refinancing.

Without adopting Regulatory Accounting, the Swap termination payments would be expensed as incurred, however, the benefit of these expenditures (through interest savings) would be recognized over multiple years in the future. Consequently, without adopting Regulatory Accounting, there would be a mismatch between when the expense is recognized and when the benefit is received and reflected in rates.

ANALYSIS AND STAFF RECOMMENDATION

ASC 980 allows an entity with cost-based rates to capitalize costs as Regulatory Assets and recognize those costs when recovered from customers. Since the Commission establishes cost-based rates, the District may adopt ASC 980 and defer the Swap termination payments as Regulatory Assets and recognize them when recovered effectively through rates.

Terminating the Swaps without also adopting ASC 980 could result in significant volatility in the District's financial results and result in the District's financial statements being inconsistent with the normal practice used by the Commission in setting rates. The District's cost-based rates include interest expense savings obtained through debt refinancing, therefore it is reasonable to defer upfront Swap termination payments and recognize them when recovered through rates, i.e. over the interest expense savings period.

Staff has presented the background, requirements and considerations for adopting Regulatory Accounting in general and for other matters at prior Board meetings. Staff presented the background, requirements and considerations for adopting Regulatory Accounting for Swap termination payments at the April 25, 2011 meeting. District staff recommends that it is in the best interest of the District to also adopt Regulatory Accounting (ASC 980) for Swap termination payments. This will be accomplished by recording Regulatory Assets simultaneously with expensing the termination costs so as to result in no impact on the District's Statement of Revenues, Expenses and Changes in Net Assets. The Regulatory Asset will be amortized, and included in rates, over the benefit period or as reasonably determined by Accounting. This will reduce volatility in the financial statements caused by Swap termination payments and better support the financial policies and 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 Interest Rate Swap Agreement (Swap) termination payments.

Section 2. This resolution is intended to clarify and support the appropriate accounting treatment of Swap termination payments made by the District.

11-13648

Dated the 2nd day of May 2011.

President

ATTEST:

Vice President

Secretary

Commissioner

Commissioner

SEAL

CAW