District-Wide Financial Policies

Information Only

No Action Requested Today

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CHELAN COUNTY P.U.D.

What We Will Cover Today

- Financial Policy
  - Principles and process
  - Current status
  - Forecast metrics
- Recommended financial policy refinements
- Summary and next steps

Financial Policy Guiding Principles

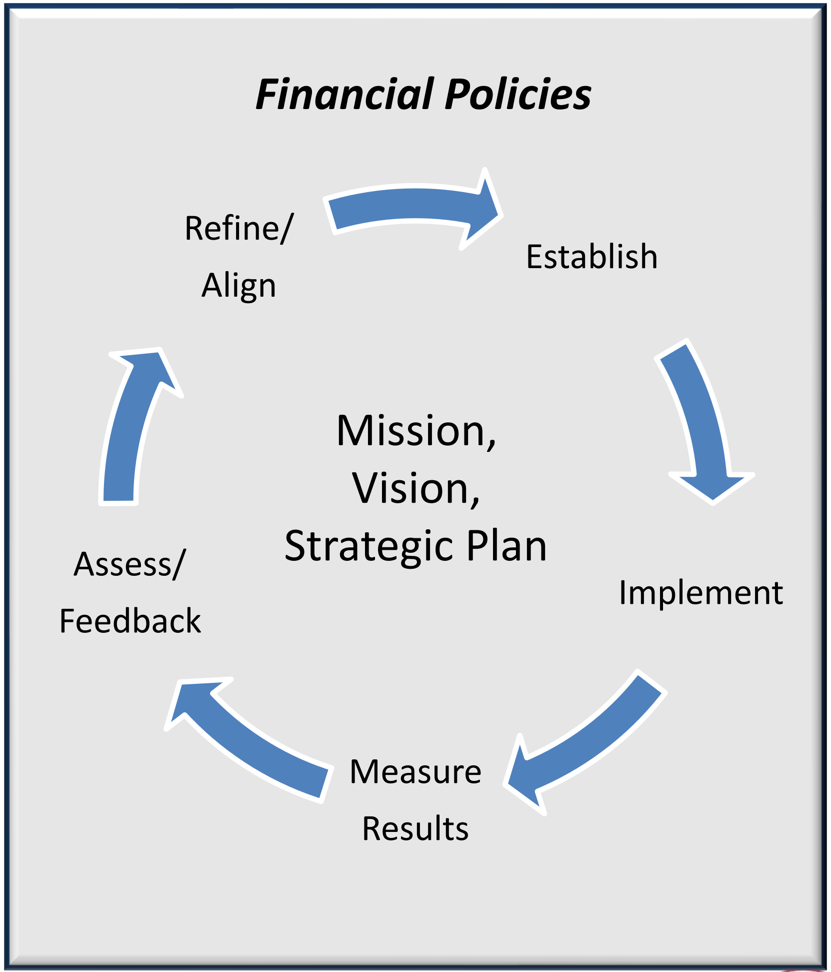
- Stable finances increase our flexibility
  - Anticipate maintaining solid financial position (expected case)
  - Able to weather the storm (unusual case)
  - Capacity to respond to opportunities and threats
- Strong policies support
  - Cohesive decision-making to achieve strategic objectives
  - Early indicators for proactive rather than reactive course corrections
  - Transparency and accountability to our customer owners
  - Prudent allocation and recovery of capital costs over time
  - Long-term rate predictability for customers
  - A solid AA credit rating, uninterrupted access to the financial markets at the lowest reasonable cost
  - Favorable contract terms
  - Proactive risk management

Continuous Cycle Process

- District-Wide Financial Polices
  - Modern structure established 2010
  - Refined in 2014 & 2017
  - Reported quarterly
  - Benchmarked annually

- *Align and refine based on strategic plans, customer preferences, financial and operational conditions*

- Re-establish: the cycle continues



Current District-Wide Financial Policies

- Policies adopted in 2017 extend indefinitely but reviewed annually with the objective to ensure a long-term sustainable financial path
  - Five-year forecast reported quarterly to Board
  - Expected and unusual cases
  - Corrective action plan if results are within 10% of any policy metric (which may include stay the course for temporary or isolated challenges)

Debt Ratio
Target
<35%

Combined Cover
Target
>2.0x

Days Cash
Target
>250

Financial Liquidity
Target
>$175M*

*Liquidity target is the greater of $175M or methodology calculation.
Liquidity target for 2024 is $240M as of the Q2 2024 forecast.

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Current Comparative Results

- District overall results are strong for both debt and cash metrics
- We are performing favorably compared to highly-rated peers
- We are meeting or exceeding Rating Agency expectations

Metric	District Results for 2023	AA Peer Median in 2023*	Expectation for AAA/AA rated entity**
Debt Leverage	16%	~40%	<35% / 35 – 60%
Debt Service Coverage	4.9x	2.3x	>2.5x / 2.0 – 2.5x
Days Cash on Hand	363 days	251 days	>250 / 150 – 250 days
Financial Liquidity	$424M	not comparable across entities	

* Based on Fitch Ratings' US Public Power Peer Study and peer entity financial statements
**Based on Moody's criteria, however debt leverage results do not reflect Moody's pension obligation adjustment factors

Forecast Results (Q2 2024)

District Combined	2024	2025	2026	2027	2028
Debt Ratio (Expected case <35%)	13.1%	10.5%	8.9%	7.5%	6.0%
Debt Ratio (Unusual case <35%)		10.6%	9.8%	10.7%	9.2%
Combined Debt Cover (Expected case > 2.00x)	3.72	5.37	5.69	6.71	7.25
Combined Debt Cover (Unusual case >1.25x)		4.90	4.82	4.84	4.99
Days Cash on Hand (Expected case >250)*	321	280	281	282	313
Days Cash on Hand (Unusual case > 250)*		259	251	276	260
Liquidity (Calculated min $240M-$291M, Expected)	$363M	$313M	$295M	$300M	$339M
Liquidity (Calculated min $240M-$291M, Unusual)		$290M	$263M	$293M	$282M

* Excludes proposed internal loans under consideration in September 2024
Excludes potential increases in future purchased power costs

The information in this schedule contains forward-looking information and projections. Such projections are necessarily subject to various risks and uncertainties. Actual results could, and likely will, differ materially from those projected, in part as a result of differences between assumptions utilized in making such projections and actual outcomes and certain other risks.

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Trends Since 2017 Policy Refinements

- Historically, high levels of Days Cash on Hand was needed as an offset for a variety of factors that have now positively evolved
- Substantial improvement in debt metrics
  - Debt leverage target of < 35% is achieved, not aspirational
  - Debt service coverage target of > 2.0x is consistently exceeded
- Mature power sales hedging program
  - Consistent execution of market-based slice contracts and new long-term contracts with credit worthy counterparties
- Multi-year rate plans adopted
  - Demonstrated action with small incremental increases

The District's operational and financial condition supports more balanced Debt and Cash metrics

Recommended Policy Refinements

- No changes recommended to Debt metrics (Leverage & Cover)
- Recommend increasing Financial Liquidity target floor to $225M
  - Better aligns with methodology
  - Recognize cumulative impact of inflation on O&M and Capital
  - Future: review and adjust if warranted during annual benchmarking and inform Board via quarterly financial report
- Recommend decreasing Days Cash on Hand metric to > 150 days
  - Low end of AA range per rating agency
  - Recognize long-term, demonstrated financial stability
  - Improved balance between cash and debt metrics
  - For long-term planning strategies, will not be driver of assumed borrowing actions

Reduced Days Cash Target

PROS

- Better balance of debt and cash metrics, reflecting more resilient financial condition
- Aligned with expectations for AA rated utility, many peers
- Supports more flexible decision making by focusing future debt issuance decisions on District specific Financial Liquidity
- Prevents holding cash in excess of prudent planning needs, potentially reducing costs

CONS

- Should current strengths deteriorate, high levels of days cash may not be available to mitigate perceived risk increase

Refined Metrics

Days Cash on Hand

>150 days
(expected and unusual cases)

Debt Leverage

<35%
(expected and unusual cases)

- Existing
- Increase
- Decrease

Financial Liquidity

>$225M or computed amount
(expected and unusual cases)

Financial Policies

Debt Service Coverage

>2.0x (expected case)
>1.25x (unusual case)

If projections reflect that future results are within 10% of the targets, recommended action plans will be presented for Commission consideration

Key Takeaways

- Stable finances increase our flexibility
  - Anticipate maintaining solid financial position (expected case)
  - Able to "weather the storm" (unusual case)
- Strong policies support a solid AA credit rating
  - Favorable comparison to expectations and peers
  - Reliable, sustainable future path
- Continue to evolve Financial Policies
  - Listen to our customers
  - Align with financial and operational conditions
  - Balanced policies to support informed decision making

Next Steps

Sept 16	Resolution to approve refined Financial Policy metrics
Nov 2024	Q3 Financial Review, including refined metrics
2025+	Refinement cycle continues: Annual review and benchmarking, Board communication if liquidity floor adjusted

Appendix

Financial Policy Definitions

Appendix – Debt Leverage

- Leverage ratios help measure debt levels relative to its investment in assets
  - Key rating agency consideration, ratios of less than 50% generally indicate credit strength and support high ratings
  - District currently uses a debt-to-equity ratio; however, the District's "equity" is referred to as **Total Net Position** which is the accumulation of the Change in Net Position or "bottom line" results. "Equity", assets minus liabilities, represents the value of the entity after all the debts are paid.

$$\frac{\text{Outstanding Debt}}{\text{Outstanding Debt} + \text{Total Net Position (Equity)}}$$

- Capital-intensive industries or low profitability industries typically have higher leverage ratios
- Reducing debt leverage ratio can be achieved by limiting additional borrowing, paying down debt or accumulating equity
- Very low debt leverage ratios may indicate disparities in intergenerational cost allocation to the customer base

Appendix – Debt Service Coverage

- Bond covenant – an enforceable promise to bondholders
  - One indication of the margin of safety for the payment of debt service
  - Defined by four Master Bond Resolutions which are legal document adopted by the Board establishing the terms and conditions for bonds
  - Minimum annual requirement of 1.0x, with inclusion of ‘other available funds’ 1.15x – 1.25x
- Debt Service Coverage is a commonly used financial metric
  - Measures ability to pay for debt service requirements with cash flow from operations
  - Rating agencies view 2.0x or greater as evidence of credit strength and supportive of higher ratings
  - Higher ratios can lead to lower interest costs on new debt, access to bank liquidity, and more favorable power contract provisions
  - Debt Service Requirement is the amount of money necessary to pay the principal and interest on an outstanding debt in each year

$$\frac{\text{Net Income + Depreciation + Interest Expense}}{\text{Debt Service Requirements}}$$

Appendix – Days Cash on Hand

- Only includes unrestricted cash and investments (Primary Liquidity) and not funds with uses restricted by agreements or contracts (such as Secondary Liquidity and bond reserves)
- Indicates financial flexibility, specifically cash and short-term investments, relative to expenses
- Days Cash on Hand is one of several rating agency key criteria consideration
  - Comparable across entities because it considers cash balances and expenses
  - Greater than 150 Days Cash on Hand is considered strong
  - For the District, strong cash balances supplements where other key rating criteria are low

$$\frac{\text{Unrestricted Cash and Investments}}{\text{Operating Expense – Depreciation/ Amortization (noncash expenses)}}$$

- Self adjusts as opposed to being a single fixed dollar minimum
  - To meet the same Days Cash on Hand target, higher levels of unrestricted cash are required if operating expenses increase, lower levels of unrestricted cash are required if operating expenses decrease
  - ***Purchased Power costs are included in operating expenses, therefore some power sales hedging activity (which treatment is determined by specific accounting principles) can impact Days Cash on Hand results and forecasts***

Appendix – Financial Liquidity

- Insufficient liquidity can be disastrous, excess liquidity can be costly
- Cash reserve policies are a best practice and balanced financial liquidity supports:
  - Long-term financial, organizational and operational stability to meet minimum requirements (ensure timely payments, reserve for catastrophic events and ensure funds for system improvements and reliability)
  - Mitigate risks reflecting the scope of operations, risk profile, complexity
- The Financial Liquidity Methodology utilizes a comprehensive computation to determine minimum requirements for known items and potential risks that impact financial stability
  - Computed amounts ensure timely payments for <u>operations and debt service</u> (Operating Requirements), reserve for <u>catastrophic or contingent events</u> (Potential Contingencies) and funds for <u>capital investments</u> (Planned Expenditures) for system improvements and reliability
  - The computation is refreshed quarterly, and results are provided during the quarterly financial review
- Sources of Financial Liquidity include
  - **Primary Liquidity -** unrestricted cash and investments that are available for liquidity needs with no limitations on use. Funds restricted solely by board or management policy (Board Designated Funds) may also be included.
  - **Secondary Liquidity** – general bank lines or letters of credit or similar instruments and other internal sources, if available, that could be used to meet short term liquidity needs such as DRC/CRC funds - Cash associated with the Debt Reduction & Capital Recovery charges of the Power Sales Contracts associated only with Rocky Reach and Rock Island. Capital Recovery Charge (CRC) –allows the District to collect additional revenue up to a maximum of 50% of the capital base amount, which escalates over time due to inflation. Debt Reduction Charge (DRC) – allows the District to collect additional revenue up to a maximum of 3% of the outstanding debt obligations. The accumulated DRC/CRC funds, subject to an aggregate cap over the life of the contract, can be used for purchase, redemption or defeasance of those debt obligations or capital improvements.