Risk Management Committee
Meeting March 20, 2017 with Finance Committee review of Forecast and Budget

Red Lodge Office 2:00 – 5:00

Attending
Committee Members: Frank Willett, Judith Gregory, Bill Pascoe, Dick Nolan, Julie Lindgren, Arleen Boyd. Board and staff: Dan Dutton, Brad Prophet
Via Telephone: Legal Counsel Larry Martin
Video connection: Manager Jim Webb, District Manager Angie Jennings
Presenters: Gail Tabone, EES Consulting; Eric Anderson, NRUCFC

Cost of Services Update with EES Analyst Gail Tabone – Gail walked through an overview of updates to results of the February 2016 COSA report from EES Consulting. She noted the need for rate stability (no unanticipated rate increases following a decrease) and justifiable revenue projections. EES updated revenue and cost numbers using 2016 budgeted costs and rates in place now. She did not directly address the assumptions in the current standalone forecast scenarios indicating that a rate decrease producing 5% revenue reduction in July 2017 is financially sound and sustainable. Her quick update showed a 3.8% revenue surplus for 2017. "My update is not appropriate to determine the level of the overall rate decrease since it did not account for added kWh in 2017 or changes to the budget of costs. Financial forecasts used to develop the 2017 budget for both expected revenues and expenses would be a better source for evaluating the level of the rate decrease."

The report (included in board packet) examines revenue-to-cost ratios for the different classes of BEC consumers and advises considering adjustments to bring small commercial and irrigation consumers closer to a 100% contribution of revenue to address their cost of service if a rate decrease is implemented. Small commercial customers are above that contribution level and irrigation consumers are below. The EES report outlines three options for implementing a rate decrease and notes the need to balance COSA results with other considerations to determine the appropriate level of rate decrease for each customer class.

The group discussed making changes to rate design to address seasonal residents, distributed generation and other emerging issues. Gail reported that utilities have the best data for that analysis approximately a year after installing new meters that provide detailed information about demand and cost of service.

Recommendation – With a new BEC manager planned for mid 2017 and new meters scheduled to be installed in 2018 and 2019 the committee recommends planning for comprehensive rate design analysis (establishing classes of customers and setting rates to ensure that each class contributes fairly to cover as close to 100% of its cost of service as possible) by 2020.

NRUCFC preview of equity management presentation to BEC Board -- Eric Anderson presented an overview of issues related to margins and equity management that he will discuss with the board on March 28. He noted the differences between BEC and other co-ops when looking at standard financial metrics – particularly the fact that BEC is one of only two Montana co-ops not associated with a generation and transmission cooperative. The differences should be considered when evaluating BEC financial analysis results, particularly TIER which in most cases includes calculation of G&T credits that may not result in actual paid revenue.

Eric suggested 40% as a safe equity level goal, emphasized the important tie of margins to equity and outlined two short calculations for estimating margin requirements. BEC has no equity policy to provide a benchmark for management. Eric mentioned a 1/8 of one percent discount to co-ops with 40% or higher equity. That discount and others are available only to 100% NRUCFC borrowers.

With a fast look at the BEC forecast numbers Eric applied a shortcut for estimating margin requirements and raised questions about reconciling the result with the Scenario 4 Forecast. After looking at BEC Forecast numbers Eric sent the following comments and description of the short calculations.

"FYI the math that I was using as an example at a high level to help assist with determining margin requirements were the following.
Rule 1:
If you plan to grow TUP at 3%
And
If you plan to retire capital credits at 3%
Then as a rule of thumb you would need to generate a margin equal to 6% of equity just to maintain your current equity level.

Rule two:
Assuming equity is 37% you would need to generate a margin equal to 37% of the capital budget plus 100% of capital credit retirements, just to maintain your current equity level.

The math behind both of these rules equals the same margin requirement. This is at a very high level and other unique characteristics need to be considered before drawing any conclusions, and these simple high level models are not intended to replace your financial forecast."

Frank Willett presented Scenario #4 of the Standalone Forecast Model that included provisions discussed at last month's BEC board meeting. This scenario began with the" Baseline to Budget Scenario #1" modified to add these assumptions:

- A 5% reduction in total revenue effective July 1, 2017.

- Capital credits paid on a 25-year rotation with 4% of the outstanding balance being retired during each year of the forecast.
- Borrowing that includes $1.9M for meter replacement and 30% of planned expenditures for distribution and general plant additions ($2.2M) for a total borrowing during the forecast period of $4.1M.
- No assumed minimum cash balance

Frank reported: The 5% rate reduction brings bottom line margins down into a more reasonable range averaging $527K per year over the life of the forecast. Equity ends up at 44% in the last year of the forecast. Everything looks good. Cash is a good problem/opportunity -- n each of the seven years of the forecast cash ends up averaging about $1.2M. This is not a realistic number for cash on-hand for BEC to carry. This does not argue for a second rate reduction which the model shows would bring operating margins down to zero. At this point BEC has two options for reducing the high projected cash levels: reducing borrowing or paying more in capital credit retirements.

After the committee meeting Frank and Kim Mikkelson reviewed the data used for payment and amortization of the debt for meter replacement and made adjustments to the report. The revised report is included in the board packet. Kim reported, "Because the period where interest changes to the model covers about 4.5 years, the difference was not appreciable. There is a decline in the cash ending balance of approximately $250,000 by the final forecast year, but margins hold fairly consistent. The model still supports a $450,000 rate reduction."

Recommendations: The committee and board members present agreed to recommend that based on the results of running Scenario 4 and the COSA update from EES BEC proceed with review and planning for a rate reduction amounting to a 5% decrease in revenue to be implemented July, 2017. The finance and risk management committees recommended updating the 2017 budget to reflect the rate decrease, the expenses estimated for standalone operations in the forecast (page 3), deletion of expenses for merger communications and addition of estimated cost ($80,000) for the manager search. Jim Webb and Brad Prophet agreed to prepare the changes for board review.

Power Supply – Bill Pascoe looked at the TEA report relative to BEC plans. The report agrees with other industry analyses that note the connection between natural gas prices and power generation costs. The current state of the natural gas market is low with flat gas prices due to supply that is greater than demand. Bill reported that he would recommend talking with suppliers and asking our supplier about potential prices for power after the scheduled expiration of our contract in 2022. Jim will initiate conversations and Jim and Bill report to the board and committee.

Transition Planning -- Larry reported that, responding to a request from Jim Webb, he had prepared a contract with provisions Jim and Richard Peck had defined for Richard to address during the BEC transition from LVE management to independent operation under a new manager. Jim said that the board would review the intent and provisions at the March 28 meeting and decide how to proceed.