

KMPUD Proposal for Establishing Initial Electricity and Propane Rates
Energy Finance Subcommittee on Rates
(March 15, 2011)

This document explains the objectives and approach for establishing electricity and propane rates to become effective after KMPUD completes its purchase of Mountain Utilities and becomes the supplier of electricity and propane on or before July 1, 2011.

Objective

Our objective is to meet the needs of the Kirkwood community for reliable and affordable power. Since we are assuming a significant amount of debt, we also need to reduce risk for the buyers of our debt (bonds) so we can sell our bonds at the lowest possible interest rate. Lastly, we need to establish rates for In-Valley electricity that will enable us to finance the Out-valley project. The proposed rates are 49.5 cents/kilowatt-hour (kwh) for electricity and 8.2 cents/cubic foot for propane. These rates are about 3 cents higher for electricity than the average for the last year from Mountain Utilities and about 1 cent lower for propane. The rates will vary with the cost of diesel and propane as we discuss below. The rates are based on February 2011 fuel prices.

Components of the rates

The rates for electricity and propane include two major components:

1. Capital costs – The cost of the capital needed to build the In-valley operations. This consists of:
 - a. Capital expenditures and capitalized interest during construction –Since we need the capital before we have revenues from operations, we have expanded the bond offering by borrowing funds to cover three years’ interest payments.
 - b. Debt service – The rates include the first of a two-step rate adjustment plan designed to produce sufficient funds to make long-term debt amortization payments.
2. Operations costs – The total costs to deliver energy to a Kirkwood resident or business
 - a. Operations costs – The fixed and variable costs of providing power including labor, distribution, etc
 - b. Fuel costs – Diesel or propane variable cost based on usage

Bond offering

The first bond anticipation notes (BANs) or bond will be sold at the end of April. We project a need of \$2,900,000 in taxable bonds for purchase of MU and \$18,300,000 in tax- exempt bonds for construction of In-valley, refinancing of existing bond anticipation notes that have paid for In-valley, Out-valley and other KMPUD needs to date. The

BANs are expected to pay interest only and have a three year maturity date. The buyers of KMPUD bonds need to assess the risk that KMPUD has the ability to make the semi-annual interest payments (if interest is not capitalized) and access the bond market to pay off the BANs in three years by issuing new, long-term bonds.

We are eliminating the risk of making the bond interest payments by initially putting all the funds needed to make those payments in a protected account held by the “Trustee” bank. This “capitalized interest” requires us to borrow the money for the interest payments (an additional \$3,400,000), but we know it will make the BANs more saleable and allow a slightly lower interest rate. The capitalized interest adds about 1.6 cents to the electricity rates.

The second risk potential bond-buyers will assess is whether we can pay off the BANs in three years through a new, long-term bond financing. One way we demonstrate the ability to access the long-term capital market is to show two things: (1) that the rates include enough cash flow to fund operations plus the money needed to make the future, semi-annual bond payments; and (2) that the rates allow us to build a reserve of 20% of the annual debt service (see Rate Stabilization Fund below). The District will do this in two steps because we don’t know what interest rates will be when we do the long-term bond financing.

The District’s initial rate plan is to start at 49.5 cents/kilowatt-hour (kwh) for electricity and 8.2 cents/cubic foot for propane. The initial rates assume that long-term debt financing will be 6.5% for tax-exempt and 7.5% for taxable bonds. This is optimistic in today’s bond market but within historical ranges. When we do the long-term bond financing in one to three years, we will need to make a rate adjustment to make sure we meet the debt service requirement. The actual bond interest rates may be higher at that time.

Rates charged will produce excess cash that will be deposited in a “Rate Stabilization Fund” (“RSF”) held by the Trustee bank. The RSF is pledged to make debt payments but it also can be used to keep the utility rates consistent by absorbing temporary fluctuations in costs. By setting rates to fund the RSF now:

1. We demonstrate our ability to support the debt payments for the long-term,
2. We build up cash over the next three years (because we make the actual debt payments from the capitalized interest),
3. We establish the 20% reserve requirement for the long-term financing; and
4. We are in a good position to complete the next financing.

Alternatively, money collected for bond debt service can be applied to pay current interest on the BANs resulting in a smaller amount collected in the RSF.

The District also proposes to establish a Fuel Adjustment Charge as part of electric and propane rates. This separate line item on customer billings can be adjusted as frequently

as monthly to reflect differences in the cost of diesel or propane from the budgeted price. See “Rate Calculations” below for details.

Allocation of Cost Across Businesses

The cost of the borrowing needs to be allocated between In-valley electricity, propane, Out-valley and KMPUD other costs. We do this by computing how much of the borrowing each of the four categories uses. This results in the following:

Business	Total expenses	Percentage
In-valley electricity	\$11,993,000	64%
Propane	\$ 2,119,000	11%
Out-valley expenses	\$ 4,004,000	21%
KMPUD	\$ 744,000	4%

In-valley and Propane businesses need to cover their costs through the revenues collected in the rates. Out-valley and KMPUD costs are paid for by existing property taxes (about \$400,000/year). When Out-valley is ready for construction, we will issue another bond to cover those costs. When Out-valley is completed, the additional debt repayment costs will be included in the rates and diesel fuel expense will be replaced by lower priced power from the grid.

Rate Calculations

To calculate rates, we need to allocate the costs across the total amount of energy sold. To do this we assume that 6.8 million kwh of electricity and 19.1 million cubic feet of propane will be sold on an average year. Each District customer will be charged two separate rates for both electric and propane service. The District will charge a fixed rate comprised of operating costs and the Rate Stabilization Fund, as well as a variable rate. The fixed rate for electricity will be approximately 28.5 cents per kilowatt-hour used, while the fixed rate for propane will be approximately 3.2 cents per cubic foot.

The variable rate charged for electricity and propane will fluctuate monthly depending on the current cost of fuel. The variable rate will be based on the District’s total cost of fuel consumed per month divided by the District’s total production. For example: If the District purchased and consumed \$53,000 worth of fuel in March and produced a total of 250,000 kwh that same month. The \$53,000 cost of fuel divided by the 250,000 kwh produced makes the March variable rate 21 cents per kwh. We currently estimate variable rates of 21 cents/kwh for electricity and 5 cents/cubic foot for propane.

Total Costs for Electricity and Propane

Based on recent estimates that are subject to change the total costs for electricity are as follows:

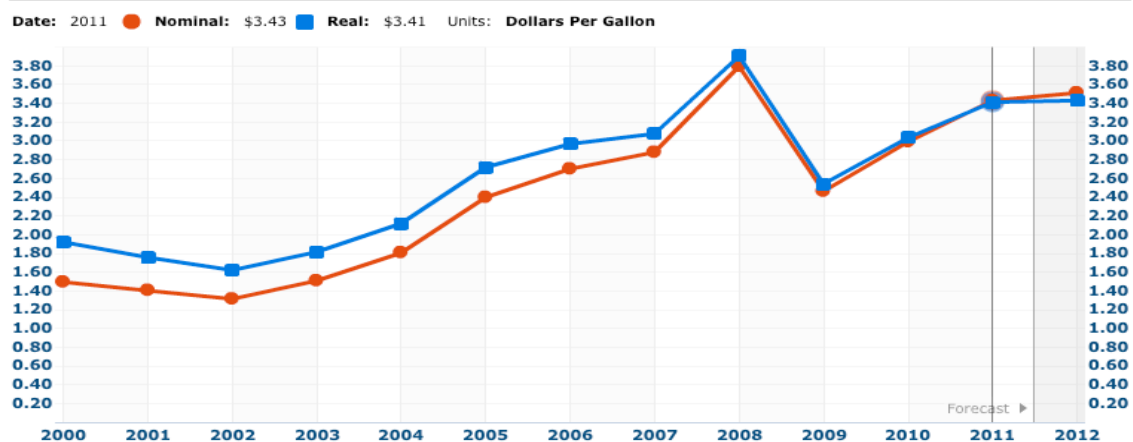
Item	Cents/kwh
Rate Stabilization Fund	14.7 cents
Operating costs	13.8 cents
Fuel costs	21 cents
Total	49.5 cents

The total costs for propane are as follows:

Item	Cents/cubic foot
Rate Stabilization Fund	1 cent
Operating costs	2.2 cents
Fuel costs	5 cents
Total	8.2 cents

Additional Considerations

Diesel costs have been slowly increasing over the last two years and experienced a jump in the last month due to instability in the Middle East and North Africa. The chart below shows the average national cost of diesel over the last decade. Note that our cost is lower because we do not pay the road taxes included in the chart below and associated with diesel sold for transportation at the pump:



Fuel Adjustment Charge. To address this variation in diesel and propane costs, the District is planning on periodically adjusting the rates in response to changes in diesel and propane prices. The Fuel Adjustment Charge on customer billings can be changed as frequently as monthly upon action of the Board. It is designed to collect the actual cost of diesel and propane and not under or over collect for more than one month.

The increasing cost of diesel is a reminder of why we want to connect to the grid and get to a more stable, regulated, and lower price. While it will take many years, when we pay off the debt, Kirkwood electricity prices should be similar to average prices in Northern California. We are currently approximately three times more expensive.

Our energy project will also serve properties that have not yet been built. We need to evaluate how to make sure that new properties pay their fair share of the costs.

We also need to evaluate trade-offs between paying all the debt through the electricity rates vs. a combination of electricity rates and property taxes if that results in lower overall costs for the Kirkwood community residents and businesses.

The proposed plan puts all costs into the electric and propane rates. An alternative approach that will be considered in the future is to have a fixed monthly payment that reflects some or all of the fixed costs plus a variable payment based on the actual amount of energy consumed. In fact, this is how the District currently bills for water.

Finally, the largest long-term component of our electricity rates is the amount of borrowing and the interest rate of that borrowing. We need to address this in two ways. The first is to continue to examine all expenses and reduce the total amount of capital expenditures. The second is to improve our credit rating (currently our debt is “unrated”) so we can lower the amount of interest we need to pay to attract buyers for our bonds.

We can significantly lower our long-term interest rates by moving from an unrated bond to an investment grade rated bond. To accomplish this, we need to build our financial strength and demonstrate a successful operating history. This initial rate proposal starts us on that path. The other significant bond security feature to accomplish an investment grade credit rating is to evaluate pledging to lenders KMPUD’s ability to assess property taxes in the event that electric or propane revenues are insufficient to maintain bond debt service payments.

Summary

In summary our objective of meeting the needs of the Kirkwood community for reliable and affordable power is achievable. The plan presented here keeps electricity costs similar to current costs and lowers the cost of propane. It puts KMPUD on a stronger financial footing and gives us the access to the bond market we need to finance our short-term and long-term needs.