PUBLIC UTILITY DISTRICT NO. 1 OF COWLITZ COUNTY

2012 BUDGET

To: ***Cowlitz PUD Board of Commissioners***
From: ***Brian Skeahan, General Manager***
Re: ***2012 Budget Transmittal Memo***
Date: ***December 22, 2011***

With this memo I am submitting for your consideration and approval the Cowlitz PUD budget for 2012. This budget provides financial resources necessary to:

- Meet the power supply needs of the service territory,
- Recognizes a much different power supply environment arising from the passage of Initiative 937, (the first step of that law which goes into effect in 2012), and the new BPA contract which went into effect on October 1st, 2011, along with an associated 7.8% rate increase.
- Implements another significant reduction in our capital improvements program previously adopted by the Board, while maintaining at least minimum necessary momentum on needed system improvements and updates
- Continues implementation of key hardware and software initiatives of Project Focus and AMI
- Reflects the general direction given by the Board in our strategic planning process, and
- Generally meets the requirements of the Board's financial policy, but falls short of our desired targets in certain areas.

This budget assimilates the rate increase previously adopted by the Board which goes into effect on November 1, 2011. There is no increase assumed in 2012, but it is anticipated we will next look at rate requirements for 2013 based on 2012 slice/block net power costs, non firm sales revenues from our Swift project, and revenues from the White Creek and Harvest projects not used to meet our 2012 I-937 requirements.

After a period of modest but not inconsequential load and customer growth Cowlitz County and the PUD have been hard hit by the economic downturn that began in earnest in late 2008 and continued through 2011. This budget and the forecasts that are its essential underpinnings reflect an expectation that the weak local economy will continue in 2012. We saw load declines across all classes of customers and saw the largest load declines in our industrial class in 2009 and 2010. In 2011 the loads in all classes have been slightly above forecast. In anticipation of a continued slow economy we have included less than 1% load growth in the forecast, after removing the impact of additional Fibre load due to their election to sell their generation and place additional load on BPA, as compared to the loads contained in the 2011 budget.

Perhaps the most significant aspect of the 2012 budget is on the revenue side. In late 2011 it became evident that the California PUC was not going to approve a portion of payments we expected to see from wind sales in 2010 and 2011. The California Legislature also passed a law clearly intended to encourage California utilities to acquire renewable resources from in state projects. However the definitions contained in the law are ambiguous and the PUC is currently performing rulemaking to provide greater certainty. The result of these events has been the termination of back to back contract with Shell and PG&E, and the near complete absence of a market in California pending resolution of the rulemaking. These events resulted in an operating loss for 2011, and were a significant driver in the recently adopted 17.5% rate increase.

The output of our share of the White Creek and Harvest projects is assumed to be sold in the spot market as it is generated at current market forecast price. We are also assuming a $10 REC price. I should note that at this time we are not receiving this price for RECs and our ability to do so is somewhat contingent upon if our resources are categorized as “bucket one” resources in the CPUC rulemaking. This is one assumption that could offset our otherwise conservative assumptions noted below. Wholesale wind sales will represent $7.33 million, REC revenues of $2.57 million, for a total of $9.90 million of operating revenues, and $20.59 million of operating expenditures, including debt service. The expected net cash generated by the projects is -$10.7 million. This is solely wholesale revenue, not factoring in any application of the wind resources to retail load as is now required by I-937.

As is our standard practice the 2012 Budget contains several conservative assumptions. We are assuming no non-firm sales revenue from the Swift project. Essentially this is a critical water forecast, and should the water year be better our net financial position will be improved. Just as we plan on critical water for Swift, we are assuming wind generation at the “P-95” level. This represents a level of generation output that we believe we will meet or exceed 95 percent of the time. This is our first year under the slice / block contract, and at the Board’s direction we forecast at the P-75 level, i.e. we expect that financial outcome or better in three out of four years. However, the slice block contract presents a more variable cost of BPA power on an annual basis that did the load following contract. For 2012 we will be taking actions in our management of the slice product to enhance the probability of meeting our budgeted net power cost.

Our cash reserves at 2011 year end will again be a lower than our desired level heading into the Slice contract. This results primarily from the CPUC action and continued soft retail sales. We expect, even on a critical water / P-95 basis to eventually rebuild those reserves to an acceptable level over the next couple of years. Should we get average to better than average water and wind over the coming year those reserves will obviously rebuild more quickly than predicted. Such a scenario in 2012 under our new slice contract would result in an even more rapid accumulation of necessary reserves. However at this point it looks like low market power prices, driven by low gas costs will more than offset what initially appears to be a probably average to better water year.
As in the case of virtually every electric utility, the overwhelming majority of expenditures are directly associated with the cost of generating or purchasing electric power and energy. Approximately 68 percent of total District expenditures are for power supply.

A significant change to this budget is the funding of the Capital Improvement Plan previously adopted by the Board. In adopting that plan the Board laid out a series of challenges to staff, including stepping up renewal and replacement activities such as underground cable replacement, substation improvements and reliability enhancement projects. The continued slow economy, and the associated reduction in customer driven work, coupled with the less than expected net revenues and the has resulted in a reduction in the capital budget. The 2012 capital budget is $12.4 million, down from $17.2 million in 2011, $40.2 million in 2010, and $35.2 million in 2009 and $25.4 million in 2008. This is a prudent move given the District’s financial circumstances. The budget continues to fund Project Focus activities, maintains underground cable replacement and substation work, albeit at a much slower pace, and continues AMI related work. Achieving the correct balance will be a future challenge.

The operating budget also reflects implementation of Board directed initiatives, including holding the line on staffing levels and total compensation. Overall FTE is expected to be minus 1 compared to the 2011 budget, down 9 from our 2010 and 2009 budget, and down 3 from out 2008 budget. Our total labor and benefit expenses are 3.24 percent less than the 2011 budget. With this budget our labor costs have been essentially flat for three consecutive years, and are up less than 4.5% since the 2009 budget. As the Board is aware the District has experienced and assimilated a significant level of “baby boom” retirements and associated staffing impacts. I see our FTE levels slightly declining from current levels upon completion of Project Focus, particularly if customer driven work remains slow and the capital budget remains at approximately 2012 levels. I anticipate these reductions can largely be obtained through attrition.

Regulatory requirements are placing increasing demands on the District. WECC related requirements account for over $546,320 in O&M costs and approximately $5,400 in capital expenditures. The District will continue its emphasis of the PUD as an environmentally responsible organization through continuation of recent initiatives and involvement in the development of possible amendments to I-937 and State and Federal climate policy deliberations. We anticipate continuing PCB testing and a targeted removal of PCB equipment, an effort that is beginning to near completion. We are also preparing for an increase in our energy efficiency efforts in 2012 and in future years.

Funds have again been set aside for targeted work with the Cowlitz EDC but at a slightly reduced level compared to past years. We will again be working with EDC to do our part in creating additional jobs in our communities. The District believes it is particularly important to be a good partner with other County entities in this area given concerns about the current economy.

The 2012 budget is less than our targeted debt service coverage level established by policy (no lower than 1.5 times; we project 1.35 times with this budget). We will need to strive to increase our DSC in 2013.

This is the seventh year of budgeting under our current format, with improvements and refinements evident over the past several years. While the process has improved we anticipated further improvements after the implementation of the new financial package. That is still a work in progress and I would like to commend the staff in working with new tools this year as part of the Cayenta system that performed less well than anticipated. Rectifying that will be a priority before next budget year.

This document is intended to provide Commissioners with a good understanding of not only what is being spent but the major projects and initiatives being supported by the budget. The narrative is intended to provide a summary of 2011 activities and activities planned and previously directed by the Board for 2012 at a department and division level. The document also contains some charts and graphs to provide the Board with a good summary overview. I hope the document continues to meet your needs.

To: Brian Skeahan, General Manager
From: Trent Martin, Director of Accounting and Finance
Re: 2012 Electric Utility Budget Summary
Date: December 9, 2011

I am pleased to submit for your review a summary of the District's proposed 2012 budget.

2012 Projected Loads, Revenues and Power Costs:

As you know, retail sales for 2009 and 2010 were substantially less than forecasted, particularly for industrial and major industrial customers. For 2011, loads have been ahead of forecast for all classes. The projection for 2012 is modest increases in residential and general service, a decrease in industrial and an increase in major industrial largely due to the addition of 30aMW for Fibre. With the new agreements reached with the major industrial customers, they are contributing more to cover associated costs; however, as in the past because so much of our net margin from these customers is derived "up front", fluctuations from their projected loads have little effect on our bottom line. Fluctuations in loads for residential, general service and other industrial revenues greatly affect net margin.

In January 2011 the District implemented an approximate 9% rate increase with another approximate 17.5% increase implemented in November 2011. These rate increases were driven by rising power and conservation costs, including impacts of I-937 and loss of Grant PUD resources, reduced wind revenue and the need to achieve a minimum debt service coverage ratio in order to comply with bond covenants. The total projected cost increase is approximately $21 million.

The reduction in net wind results is projected to be approximately $11 million and is a result primarily of lower wholesale market prices, including REC's. The decline in prices is due to a decline in demand, market swings (such as the price of natural gas) and legislative action in California requiring more in-state renewable generation to meet RPS requirements. This situation has been further exacerbated as the stored and shaped component of our contract with Shell was not approved by the CPUC resulting in a loss of $9.22 million in revenue through October 2011.

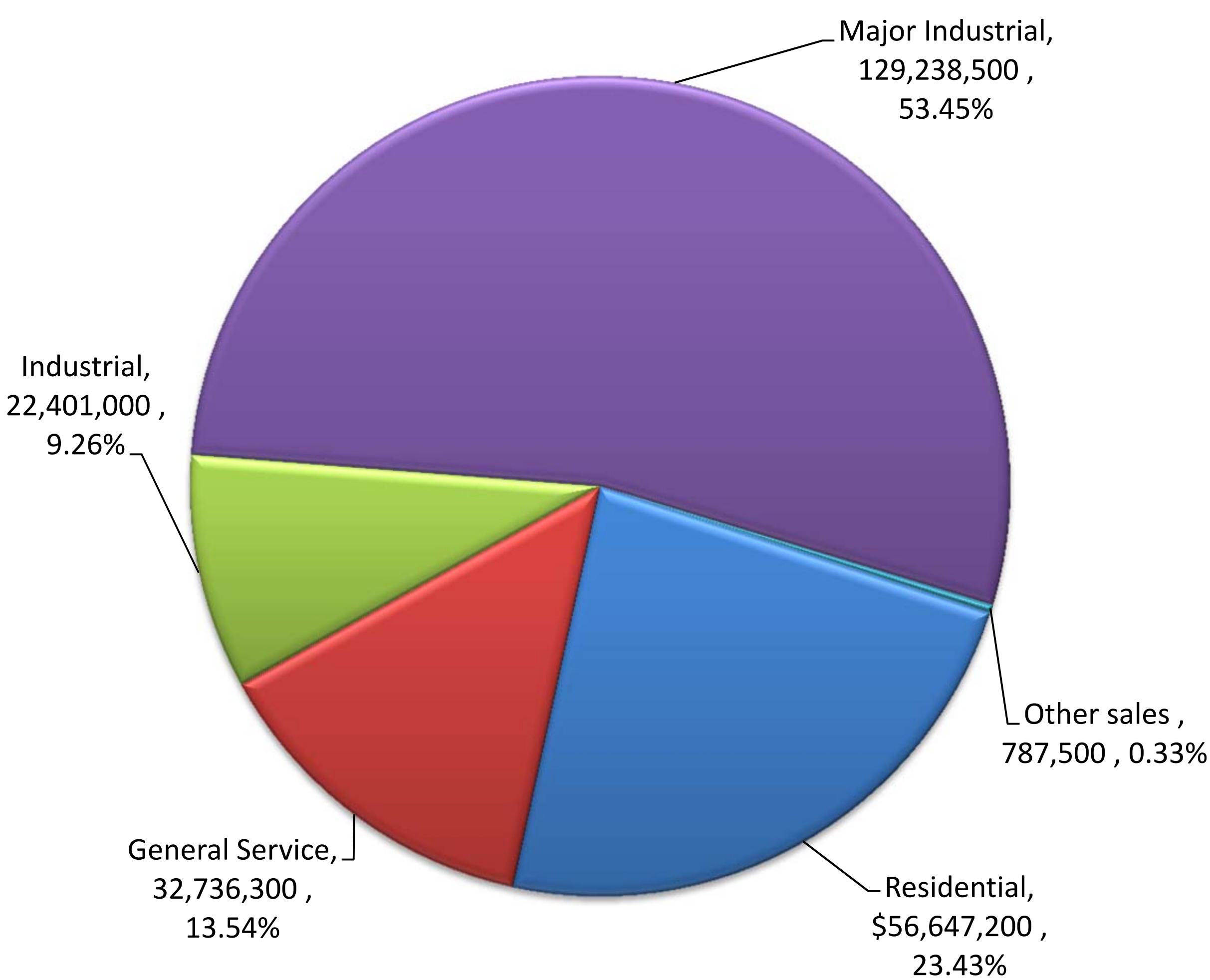
In October 2011, the District began operations under a 20-year Net Requirements Power Sales Contract (PSC) with BPA that was executed in 2008 and is set to expire in 2028. The Net Requirements contract consists of a fixed block amount of power, as well as, a variable amount of Slice power based on the actual output of the Federal Base System (FBS). This form of contract requires the District to balance its loads and resources each hour or be subject to BPA's energy imbalance charges. The FBS resources are dispatched to meet District load or regional sales in combination with the balance of the District's power resource portfolio, i.e. Swift No. 2, Wanapum, Priest Rapids, White Creek Wind, Harvest Wind and Nine Canyon Wind. The current BPA Regional Dialogue, Block/Slice Contract requires the District to be proactive in resource development to serve load growth and variations in consumption. BPA is by far the most significant element of the District's power supply portfolio, serving about 90% of District load.

Our overall assumptions for power supply include P-75 for BPA and critical (P-95) for both Swift and the wind projects. "P-95" represents a level of generation output that we believe we will meet or exceed 95 percent of the time.

A summary of anticipated operating revenues is found on the following page.

Sales:	2012 Budget	2011 Budget	Difference	Percent
Retail:				
Residential	$ 56,647,200	$ 46,758,700	$ 9,888,500	21.15%
General Service	32,736,300	26,919,600	5,816,700	21.61%
Industrial	22,401,000	22,060,500	340,500	1.54%
Major Industrial	129,238,500	98,992,600	30,245,900	30.55%
Other	787,500	675,800	111,700	16.53%
Total Retail Sales	241,810,500	195,407,200	46,403,300	23.75%
Wholesale:				
Wind	-	20,355,000	(20,355,000)	-100.00%
Total Sales	241,810,500	215,762,200	26,048,300	12.07%
Other Operating Revenues	2,258,300	2,164,000	94,300	4.36%
Total Operating Revenues	$ 244,068,800	$ 217,926,200	$ 26,142,600	12.00%

2012 Budgeted Retail Sales by Classification



2012 Projected Expenditures:

Below is a brief discussion of expenditures, excluding power:

Labor:

Combined labor and benefits are projected to decrease compared to 2011 budgeted amounts. Labor is impacted by reductions in workforce, retirements, new hires, step, merit and COLA increases and a projected increase in overtime. The estimated reduction in benefits largely relates to a refinement in the budget process; however, as we are self-insured for health insurance this number will fluctuate from year to year.

The overall staffing levels for 2012 are expected to be down from that of 2011. Below is a summary:

Department	2011 Budget	2011 Actual	2012 Budget
Commissioners	3.00	3.00	3.00
Administrative Services	11.00	11.00	11.00
Power Management	9.50	9.50	10.00
Engineering	28.40	30.00	29.02
Operations	62.00	62.00	61.29
Accounting	8.30	7.00	7.50
Information Services	11.50	10.00	11.00
Customer Services	29.75	30.50	29.50
Total	163.45	163.00	162.31

Other Expenses:

In addition to power costs as discussed above, notable changes in other expenses include:

Outside Professional Services – Continued focus to reduce the use of outside consultants.

Taxes – Correlates to the increase in revenues resulting from the rate increases noted above.

Training and Education – Focusing more on in-house and web-based training.

Conservation Incentives and Expenses – The District continues its conservation commitment to comply with Washington State Initiative 937. Different from the past is BPA has reduced its reimbursement resulting in an estimated levelized increase of $2 million annually.

Building & Grounds – Postponing and reducing certain activities.

Brushing – Reducing one crew.

A summary of 2012 operating expenditures is found below.

PURPOSE CODE	PURPOSE DESCRIPTION	2012 ELECTRIC BUDGET	2011 ELECTRIC BUDGET	$ DIFFERENCE	% DIFFERENCE
LABOR					
93	Regular Wages	$ 12,726,439	$ 12,411,300	$ 315,139	2.54%
94	Overtime Wages	842,146	728,300	113,846	15.63%
95	Taxes & Benefits	3,709,522	4,716,400	(1,006,878)	-21.35%
	Total Labor	17,278,107	17,856,000	(577,893)	-3.24%
OTHER EXPENSES					
1	Materials & Supplies	280,275	326,700	(46,425)	-14.21%
2	Equipment	99,781	113,800	(14,019)	-12.32%
3	Outside/Prof Services	3,325,938	3,517,600	(191,662)	-5.45%
4	Advertising	95,300	86,800	8,500	9.79%
5	Miscellaneous	18,500	12,500	6,000	48.00%
6	Freight	1,000	1,000	-	0.00%
7	Small Tools	84,000	75,200	8,800	11.70%
8	Business Exp/Travel	190,560	112,400	78,160	69.54%
9	Utilities	36,000	36,000	-	0.00%
11	Dues & Prof Org	614,565	597,100	17,465	2.92%
12	Rentals & Lease	62,425	54,600	7,825	14.33%
13	Taxes	13,262,000	10,706,000	2,556,000	23.87%
14	Power Supply	186,045,027	166,634,000	19,411,027	11.65%
15	Insurance	568,000	517,000	51,000	9.86%
16	Property Damage Pmt	1,000	1,000	-	0.00%
17	Licenses, Fees & Permits	30,300	52,300	(22,000)	-42.07%
18	Publications	25,700	26,900	(1,200)	-4.46%
19	Postage	394,500	348,100	46,400	13.33%
20	Telephone	139,740	124,700	15,040	12.06%
21	Training/Education	184,800	275,900	(91,100)	-33.02%
22	Employee Relations	35,750	20,000	15,750	78.75%
23	Community Relations	121,800	118,300	3,500	2.96%
24	Maintenance Contracts	720,303	649,300	71,003	10.94%
26	Equipment Maintenance	79,800	22,500	57,300	254.67%
27	Safety Expenses	65,820	36,400	29,420	80.82%
28	Material & Equip Testing	57,250	41,500	15,750	37.95%
32	Scada Maintenance	-	-	-	0.00%
33	Conservation Incentives (1)	13,131,764	11,271,400	1,860,364	16.51%
34	Conservation Expense	2,000,000	-	2,000,000	0.00%
35	Regulatory Compliance	362,000	438,500	(76,500)	-17.45%
41	Bldgs/Grnds Maintenance	272,000	400,000	(128,000)	-32.00%
51	Brushing	1,000,000	1,308,000	(308,000)	-23.55%
52	Excavation Services	75,000	75,000	-	0.00%
56	Overhead Line Material	30,000	20,000	10,000	50.00%
57	Underground Line Material	30,000	25,000	5,000	20.00%
81	Bad Debt Expense	250,000	300,000	(50,000)	-16.67%
96	Transportation	683,400	716,600	(33,200)	-4.63%
	Total Operating Expense	224,374,298	199,062,100	25,312,198	12.72%
	TOTAL LABOR & EXPENSES	$ 241,652,405	$ 216,918,100	$ 24,734,305	11.40%

(1) Conservation Incentives will be Fully Reimbursed by BPA

Capital Budget:

During the 2012 budget discussions, considerable time was devoted to re-evaluating the capital plan and timing in light of other cost pressures, economic downturn, capacity, etc. The District is continuing with its long range plan to replace underground, upgrade from 69 kv to 115 kv, upgrade substations and automated metering infrastructure but has tempered the rate resulting in a $14 million plan for 2012 (difference from the below detail is capitalized labor).

Capital costs are summarized below:

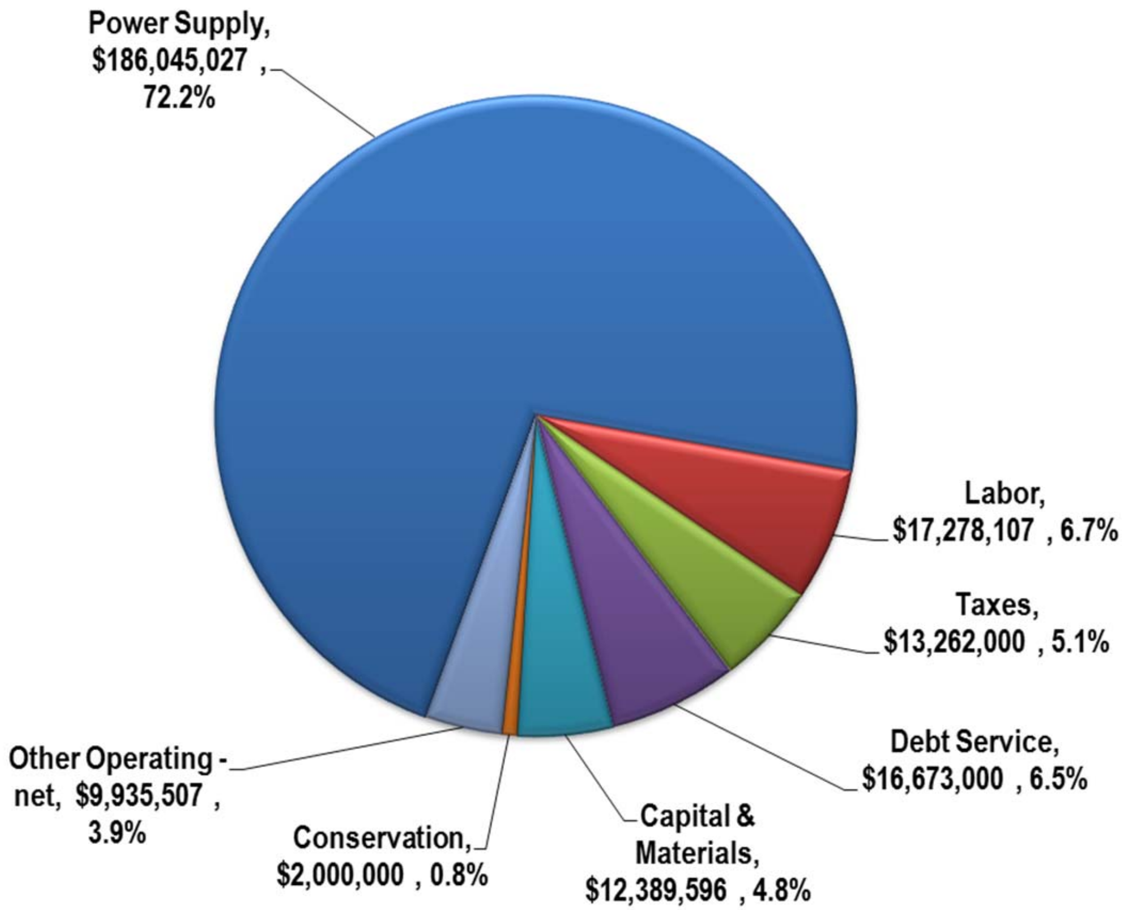
PURPOSE CODE	PURPOSE DESCRIPTION	2012 ELECTRIC BUDGET	2011 ELECTRIC BUDGET	$ DIFFERENCE	% DIFFERENCE
1	Materials	414,000	166,500	247,500	148.65%
2	Equipment	2,679,996	3,219,200	(539,204)	-16.75%
3	Contracted Services	1,581,200	2,902,200	(1,321,000)	-45.52%
12	Leased/Rented Equipment	6,000	3,000	3,000	100.00%
17	Licenses, Fees & Permits	65,000	70,000	(5,000)	-7.14%
50	Substations	1,585,000	2,625,200	(1,040,200)	-39.62%
52	Excavation Services	800,000	750,000	50,000	6.67%
54	Vehicle Replacement	470,000	270,000	200,000	74.07%
55	Automated Meter Infrastructure	550,000	1,500,000	(950,000)	-63.33%
56	Overhead Line Material	1,000,000	1,900,000	(900,000)	-47.37%
57	Underground Line Material	1,200,000	1,700,000	(500,000)	-29.41%
58	Overhead Transformers	600,000	300,000	300,000	100.00%
59	Underground Transformers	800,000	700,000	100,000	14.29%
60	Meters	100,000	360,000	(260,000)	-72.22%
96	Transportation	538,400	548,400	(10,000)	-1.82%
79	Preliminary Investigation	-	150,000	(150,000)	-100.00%
	TOTAL CAPITAL COSTS	$ 12,389,596	$ 17,164,500	$ (4,774,904)	-27.82%

Debt Service:

Electric System debt service costs consist of principal and interest payments made on the capital construction bonds issued in 2006, 2007 and 2010. Debt service also includes repayment of a loan from the District's Production System that was used to prepay for energy from the White Creek Wind Project. Debt service requirements are summarized below:

PURPOSE CODE	PURPOSE DESCRIPTION	2012 ELECTRIC BUDGET	2011 ELECTRIC BUDGET	$ DIFFERENCE	% DIFFERENCE
82	Interest	8,653,578	9,771,000	(1,117,422)	-11.44%
83	Principal	8,019,422	7,015,000	1,004,422	14.32%
	TOTAL DEBT SERVICE	$ 16,673,000	$ 16,786,000	$ (113,000)	-0.67%

2012 Projected Expenditures by Type
(Excludes Conservation Incentives Fully Reimbursed by BPA and Debt Expense Allocations to Power Costs - Includes Amortization of Prepaid Power Costs)



Compliance with Policy and GAAP Presentation:

The 2012 budget is in compliance with the debt service coverage level established by bond covenants. However, as noted in the calculations below, compliance with the coverage ratio may require rate action depending on 2012 sales and expenditure levels.

To save a substantial amount of money and expense by not issuing taxable bonds, the District used cash reserves to fund the White Creek Wind and Harvest Wind projects and borrowed 100% of our three-year capital improvement program in 2007 and 2010. Consequently, in 2008 - 2013 it is not necessary to fund 60% of capital requirements from rates as prescribed by policy. Instead, surplus cash generated by rates for each year will be used to replenish cash reserves. Below is a summary of the calculation, which is followed by the presentation on a GAAP basis.

2012 Electric Utility Budget Summary - Ratio Calculations

	2012 Budget	2011 Budget	% Change
Sales at Present Rates	$ 241,810,500	$ 215,762,200	12.07%
Rate Adjustment [(1)]	-	5,100,000	-100.00%
Misc. Operating Revenues	2,258,300	2,164,000	4.36%
Total Operating Revenues	244,068,800	223,026,200	9.44%
Operating Expenses			
Power Management	189,633,032	168,510,100	12.54%
Engineering	3,939,168	4,166,400	-5.45%
Operations	10,045,990	10,431,400	-3.69%
Customer Services	4,457,680	4,350,900	2.45%
Commissioners & Admin. Services	3,242,483	3,301,200	-1.78%
Accounting & Information Services	3,850,265	4,042,500	-4.76%
Environmental Services	90,023	138,200	-34.86%
Taxes	13,262,000	10,706,000	23.87%
Duplicated Fleet Charges [(2)]	(388,300)	(375,400)	3.44%
Capitalized Labor	(2,477,900)	(3,997,800)	-38.02%
Total Operating Expenses	225,654,441	201,273,500	12.11%
Net Operating Revenue	18,414,359	21,752,700	-15.35%
Other Income	250,000	500,000	-50.00%
Amortization of Prepaid Power	4,320,000	4,320,000	
Available for D.S.& Cap. Add.	22,984,359	26,572,700	-13.50%
Less Debt Service [(3)]	16,481,878	16,460,600	0.13%
Available for Capital Additions [(5)]	**$ 6,502,481**	**$ 10,112,100**	-35.70%
Initial Capital Request [(4)]	**$ 12,389,596**	**$ 17,164,500**	-27.82%
Equity percentage	**52.48%**	**58.91%**	
Debt Service Coverage Ratio	**1.39**	**1.61**	

[(1)] Potential Rate Action in 2011

[(2)] Fleet Costs included in Transportation Expenses

[(3)] As defined by Bond Covenants

[(4)] Excludes Preliminary Investigation

[(5)] Reconciliation to Net Margins:

	2012	2011
Available for Capital Additions	$ 6,502,481	$ 10,112,100
BABs Subsidy	1,018,300	1,018,300
Subordinated Debt	(1,209,422)	(1,343,700)
Amortization of Prepaid Power	(4,320,000)	(4,320,000)
Depreciation	(11,000,000)	(7,915,800)
Principal on Long-term Debt	8,019,422	7,015,000
Net Margins	$ (989,219)	$ 4,565,900

2012 GAAP Based Electric Utility Budget

	Budget 2012	Budget 2011	Actual 2010
Operating Revenues:			
Retail Sales:			
Residential	$ 56,647,200	$ 46,758,700	$ 42,711,581
General Service	32,736,300	26,919,600	24,986,825
Industrial	22,401,000	22,060,500	19,991,272
Major Industrial	129,238,500	98,992,600	101,828,599
Other Sales	787,500	675,800	676,666
Rate Adjustment	-	5,100,000	-
Total Retail Sales	241,810,500	200,507,200	190,194,943
Wholesale:			
Wind Sales [(1)]	-	20,355,000	16,880,915
Total Sales	241,810,500	220,862,200	207,075,858
Other Operating Revenues	2,258,300	2,164,000	1,301,643
Total Operating Revenues	244,068,800	223,026,200	208,377,501
Operating Expenses:			
Cost of Power	186,045,027	166,634,000	163,929,993
Operations & Maintenance	11,118,958	10,224,600	7,954,828
Customer Accounts	4,457,680	4,350,900	4,021,083
Customer Service & Informational	2,996,219	671,200	219,705
Administrative & General	7,774,557	8,686,800	8,415,975
Depreciation	11,000,000	7,915,800	8,586,799
Taxes	13,262,000	10,706,000	9,308,643
Interest and Amortization	8,653,578	9,771,000	7,435,874
Total Operating Expenses	245,308,019	218,960,300	209,872,900
Net Operating Margins	(1,239,219)	4,065,900	(1,495,399)
Nonoperating Revenues-(Expenses):			
Interest Revenue	250,000	500,000	89,210
Other	-	-	(159,412)
Total Nonoperating Revenues-(Expenses)	250,000	500,000	(70,202)
Net Margins-(Loss)	$ (989,219)	$ 4,565,900	$ (1,565,601)

[(1)] Netted with cost of power in 2012.