



Report of Independent Auditors and
Combined Financial Statements for

**Public Utility District No. 1 of
Klickitat County**

December 31, 2012 and 2011

MOSS-ADAMS_{LLP}

Certified Public Accountants | Business Consultants

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REPORT OF INDEPENDENT AUDITORS

The Board of Commissioners
Public Utility District No. 1 of Klickitat County

Report on Financial Statements

We have audited the accompanying combined financial statements of Public Utility District No. 1 of Klickitat County (the District), which comprise the combined statements of net position as of December 31, 2012 and 2011 and the related combined statements of revenues, expenses, and changes in net position and cash flows for the years then ended, and the related notes to the combined financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these combined financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of combined financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these combined financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the combined financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the combined financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the combined financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the combined financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the combined financial statements.

We believe that the audit evidence obtained is sufficient and appropriate to provide a basis for our audit opinion.

REPORT OF INDEPENDENT AUDITORS (continued)

Opinion

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the financial position of the District as of December 31, 2012 and 2011 and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matter

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 4 through 12 be presented to supplement the basic combined financial statements. Such information, although not a part of the basic combined financial statements, is required by the Government Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic combined financial statements in an appropriate operational, economic or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic combined financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Moss Adams LLP

Portland, OR
September 9, 2013

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY -
MCAG No. 1785
DIRECTORY OF OFFICIALS**

<u>Office</u>	<u>Official</u>	<u>Term</u>	<u>Term Expiration</u>
Board of Commissioners			
President	Randy L. Knowles	6 years	December 2018
Vice President	Dan G. Gunkel	6 years	December 2014
Secretary	Ray A. Mosbrucker	6 years	December 2016
Appointed Officials			
General Manager	James R. Smith	1313 S. Columbus	
Chief Financial Officer/Auditor	Shannon N. Crocker	Goldendale, WA 98620	
Attorney	Pacifica Law Group LLP	1191 2nd Avenue, Suite 2100 Seattle, WA 98101	

PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY – MCAG No. 1785 MANAGEMENT’S DISCUSSION AND ANALYSIS

This section provides an overview and analysis of key data presented in the basic combined financial statements for the years ended December 31, 2012 and 2011. Information within this section should be read in conjunction with the basic combined financial statements and accompanying notes.

Overview of the Combined Financial Statements

Public Utility District No. 1 of Klickitat County (the District) consists of the electric system, eight water systems and five wastewater systems. The District’s service area covers approximately 1,680 square miles in Klickitat County. The District also serves small areas in the surrounding counties of Yakima, Skamania, and Benton. As of December 31, 2012 the District had 12,253 electric, 1,123 water, and 1,173 wastewater customers. The District’s wholesale activity is a significant part of the electric system business lines. Wholesale revenues are generated from the sale of the output from the Landfill Gas Project, a 36.5 MW facility, and from the White Creek Wind I power purchase contract, which the District owns 13% of the generated output from the 205 MW project.

The financial statements of the District report the self-supporting, proprietary activities of the District funded primarily by the sale of power, water and wastewater services. The District reports these business-type activities in a manner similar to private sector business enterprises, using the accrual basis of accounting, in accordance with accounting principles generally accepted in the United States of America.

The Statement of Net Position presents information on the District’s assets and liabilities, with the difference between the two reported as net position, and provides information regarding the nature and amount of resource investment (assets) and obligations incurred in the pursuit of such resources. This statement also provides a vehicle for evaluating the capital structure of the District and assessing liquidity and financial flexibility of the District.

The Statement of Revenues, Expenses, and Changes in Net Position reports revenues and expenses as well as change in net position for this period. This statement provides a measurement of the District’s operations, helps to evaluate the level of cost recovery from charges for products and services, and can be used as a partial determinant of creditworthiness.

The Statement of Cash Flows provides information concerning cash receipts and disbursements during the reporting period resulting from operating, financing, and investing activities. This information provides insight into the District’s ability to generate net cash flows to meet obligations, as they become due, and is an important indicator of the District’s liquidity and financial strength.

The Notes to Financial Statements provide additional information that is essential to a full understanding of the financial statements, as described above, including significant accounting policies, commitments, obligations, risks, contingencies and other financial matters of the District.

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY –
MCAG No. 1785
MANAGEMENT’S DISCUSSION AND ANALYSIS**

Financial Highlights – 2012 to 2011

- For the year ended December 31, 2012 the District met its compliance obligations with a debt service coverage ratio that exceeded 1.0.
- In January 2012, the District experienced a severe ice storm which involved the reconstruction of several miles of line across the entire county and totaled \$1.66 million. The District was eligible for reimbursement from FEMA which resulted in a combined Federal and State funds of \$1.452 million.
- On August 28, 2012, the District’s Commissioners adopted a 12.0% Electric Rate Increase to be implemented in two phases, 7.0% as of October 1, 2012 and 5.0% as of April 1, 2013.
- Customer growth in 2012 was fairly flat with little to no change.
- On July 10, 2012, the District’s Commissioners adopted a resolution to integrate the Cliff’s Water System into the Electric System to provide benefit to the entire county.
- In 2012 the District capitalized an additional \$22.0 million of the Land Fill Gas II (LFG II) project. The LFG II project is a 26.0 MW gas-fired combustion turbine and steam recovery generating facility located at the Roosevelt landfill.
- The District receives transmission revenues for providing transmission services for the White Creek Wind I project, Harvest Wind, Tuolumne, Windy Flats, Linden Farms, Windy Point, and from the Goldendale Energy Center, a 248 MW natural gas-fired combined cycle combustion turbine electric generating facility owned and operated by Puget Sound Energy. The revenue received from this business-line was approximately \$5,387,192.
- In 2012 the District took its final draw of \$158,605 on the Drinking Water State Revolving Fund Loan for the Glenwood Water System. The District expended a total of \$792,443 of the approved \$1,175,566, resulting in a 32% savings vs. budget. The project replaced distribution lines and developed an additional water source for the Glenwood Water System, lifting moratoriums on new connections due to undersized distribution lines.
- Staff worked with each local community in which the District serve either water or wastewater or both to review operations, rates and projected future projects. Rate increases were adopted for those systems based on cash flow and cash reserves for future projects.

Financial Highlights – 2011 to 2010

- The year ended December 31, 2011 financial results recorded a \$570,704 change in net position. The District was in compliance with its debt service coverage covenant at year-end.
- In 2011, the District completed a \$13.61 million bond sale to fund Electric Distribution capital construction and redeem a bond anticipation note.

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY –
MCAG No. 1785
MANAGEMENT’S DISCUSSION AND ANALYSIS**

- On October 1, 2011, the District imposed a 9.8% Electric Rate Increase.
- In 2011 the District capitalized 71.8% of the Land Fill Gas II (LFG II) project equating to \$51.2 million. LFG II is a 26.0 MW gas-fired combustion turbine and steam recovery generating facility located at the Roosevelt landfill.
- The District receives transmission revenues for providing transmission services for the White Creek Wind I project, Harvest Wind, Tuolumne, Windy Flats, Linden Farms, Windy Point, and from the Goldendale Energy Center, a 248 MW natural gas-fired combined cycle combustion turbine electric generating facility owned and operated by Puget Sound Energy. The revenue received from this business-line was approximately \$5,238,469.
- Customer growth was near 0.6% in 2011, which is slightly below the past 5 years.
- In 2011 the District took its second draw of \$401,589 on the Drinking Water State Revolving Fund Loan of \$1,175,566 for Glenwood’s Water System. The project will replace distribution lines and develop an additional water source for the Glenwood Water System, lifting moratoriums on new connections due to undersized distribution lines.
- Staff worked with each local community in which we serve either water or wastewater or both to review operations, rates and projected future projects. Rate increases were adopted for those systems based on cash flow and reserves for future projects.

Condensed Comparative Financial Information

Combined balance sheet

Capital assets	\$ 222,303,198	\$ 227,511,508	\$ 222,592,618
Current, restricted, and other assets and deferred outflow of resources	<u>61,539,759</u>	<u>65,301,286</u>	<u>65,613,629</u>
Total assets	<u>\$ 283,842,957</u>	<u>\$ 292,812,794</u>	<u>\$ 288,206,247</u>

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY –
MCAG No. 1785
MANAGEMENT’S DISCUSSION AND ANALYSIS**

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Long-term liabilities and deferred inflow of resources	\$ 138,794,547	\$ 140,591,635	\$ 130,292,057
Current liabilities	<u>9,978,351</u>	<u>12,390,980</u>	<u>18,654,715</u>
Total liabilities	<u>148,772,898</u>	<u>152,982,615</u>	<u>148,946,772</u>
Invested in capital assets, net of related debt	86,660,452	94,217,644	91,370,913
Restricted - bond funds	12,155,694	12,503,086	11,761,136
Restricted - rate stabilization fund	2,400,000	2,387,624	1,966,887
Unrestricted	<u>33,853,913</u>	<u>30,721,825</u>	<u>34,160,539</u>
Total net position	<u>135,070,059</u>	<u>139,830,179</u>	<u>139,259,475</u>
Total liabilities and net position	<u>\$ 283,842,957</u>	<u>\$ 292,812,794</u>	<u>\$ 288,206,247</u>

Capital activity

2012 to 2011

Net utility plant for the District increased \$5.2 million during 2012. In early 2012 the District experienced a severe ice storm; as a result multiple capital improvements for effected distribution lines were executed. In addition, the District completed several other large projects which included the Glenwood Water System, Timber Road Radio Site, and Fisher Hill Bridge. The District also capitalized an additional portion of the LFG II generation facility equating to \$22.0 million during 2012. The project is on schedule for final completion of the permanent gas cleaning system in 2013.

2011 to 2010

Net utility plant for the District increased \$5.0 million during 2011. Some of the large projects completed to plant in 2011 were White Creek to Roosevelt Transmission, Roosevelt Substation Upgrade, John Day Substation Upgrade, and Glenwood Substation Upgrade. The District is in the process of finalizing the construction of our LFG II facility and capitalized 71.8% of the project in 2011 equating to \$51.2 million.

Debt activity

2012 to 2011

The District took a final draw of \$158,605 on the Drinking Water State Revolving Fund Loan and completed the Glenwood Water project.

2011 to 2010

The District issued \$13,610,000 in electric system revenue bonds in December 2011. The proceeds are being used to fund Electric Distribution capital construction and redeem a bond anticipation note.

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY –
MCAG No. 1785
MANAGEMENT’S DISCUSSION AND ANALYSIS**

Current, restricted, and other activity

2012 to 2011

The District expended \$5.6 million of the construction funds in 2012 on electric capital projects. The remaining \$1.5 million balance of the 2011 capital construction bond proceeds will be fully utilized in 2013.

2011 to 2010

Current, restricted, and other assets recognized \$7.1 million in construction funds due to capital construction bond proceeds. This was partially offset by the utilization of the 2009 capital construction bond proceeds being fully exhausted in 2011 along with the continued amortization of White Creek Wind I purchase power agreement.

Overall results of operations

2012 to 2011

The District’s 2012 results are a reflection of economic conditions in a diversified utility. The District’s wholesale segment is subject to external pricing impacts, whereas the retail segment is less cyclical. The District met 2012 forecast targets by implementing rate increases and managing operational expenses.

2011 to 2010

The District’s 2011 results are slightly better than 2010 and continued their trend of positive operating income recording net operating income of \$1,208,286.

Electric system operating results

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Operating revenues	\$ 37,086,740	\$ 32,239,253	\$ 33,631,876
Operating expenses	<u>40,403,375</u>	<u>30,967,006</u>	<u>28,467,883</u>
Operating income	(3,316,635)	1,272,247	5,163,993
Net non-operating revenue (expense)	(5,332,970)	(1,633,256)	(3,513,666)
Capital contributions	<u>2,720,574</u>	<u>947,114</u>	<u>20,504,483</u>
Change in net position	<u>\$ (5,929,031)</u>	<u>\$ 586,105</u>	<u>\$ 22,154,810</u>

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY –
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MANAGEMENT’S DISCUSSION AND ANALYSIS**

Operating revenues

2012-2011

The Electric System recognized a 15.0% increase in operating revenues between 2012 and 2011. The majority of this increase is attributed to additional wholesale sales through the LFGII Project and the first full year of the Slice contract. Retail electric rates increased 7.0%, effective October 1, 2012 with a scheduled 5.0% increase effective April 1, 2013.

2011 to 2010

The Electric System recorded a 4.1% decrease in operating revenues in 2011 vs. 2010 mainly attributed the end of a 3 year contract for White Creek Wind Generation and the continued decline in wholesale market prices for Landfill Gas and White Creek Wind Generation projects that are located within Klickitat County. These were partially offset by a 9.8% electric rate increase that went into effect on October 1, 2011.

Operating expenses

2012 to 2011

Operating expenses increased 30.5% in 2012. This is mainly attributed to a \$5.2 million increase in depreciation expense for the \$73.2 million Landfill Gas Phase II project. Operation Expense also reflected a full year of BPA rate increase that went into effect October 2011, an increase of 17.0% due to the operation of the LFG II project for a full year; however, the District did experience some offset to these increases through Maintenance and Administrative and General expenses which decreased 14.9% as a result of continued efforts to control spending through constant evaluation of expenditures, elimination of cost-of-living increases, and a reduction of force.

2011 to 2010

Operating expense increased by 8.8% in 2011. This is mainly attributed to a 47.4% increase in depreciation expense from the 71.8% capitalization of the Landfill Gas Phase II Project. Power Generation costs were up 2.9% vs. 2010 due to the continued increase in generation from the LFG II project. SG&A expenses were down in 2011 by 3.7% vs. 2010 mainly attributed to the continued focus the District has placed on controlled spending and re-evaluating of expenses as it continues to work on focusing its efforts on finalizing the HW Hill Landfill Gas Project.

Non-operating revenue/(expense)

2012 to 2011

Non-operating expenses increased by \$3.7 million mainly due to the capitalization of plant which reduced capitalizing interest associated with construction.

2011 to 2010

Non-operating expense decreased by \$1,880,410 which equates to 53.5% over 2010. This change is mainly attributed to additional capitalization of interest expense primarily due to the LFG II project.

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY –
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MANAGEMENT’S DISCUSSION AND ANALYSIS**

Capital contributions

2012 to 2011

Capital contributions for the District in 2012 increased \$1.8 million. This is largely due to an early 2012 ice storm, which was deemed a FEMA disaster. As a result multiple capital improvements for effected distribution lines were completed and reimbursed by FEMA equating to \$1.5 million.

2011 to 2010

Capital contributions for the District in 2011 were \$947,114, a significant decreased compared to 2010. The capital contributions in 2010 were above normal contributions for a given year due to an \$18.4 million contribution of plant assets from the District’s agreements with Harvest Wind, Windy Flats and Linden Farms to maintain and operate transmission and substation equipment.

Legal settlement

There were no legal issues during 2012 or 2011 where the District received or disbursed a settlement.

Water and wastewater systems operating results

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Operating revenues	\$ 1,501,866	\$ 1,396,608	\$ 1,351,946
Operating expenses	<u>640,297</u>	<u>1,460,569</u>	<u>1,317,348</u>
Operating income (loss)	861,569	(63,961)	34,598
Net non-operating revenue/(expense)	(17,999)	18,574	15,515
Capital contributions and grants	<u>325,341</u>	<u>29,986</u>	<u>62,827</u>
Change in net assets (net income)	<u>\$ 1,168,911</u>	<u>\$ (15,401)</u>	<u>\$ 112,940</u>

Operating revenues

2012 to 2011

The District Water/Waste Water operating revenues recorded an increase of 7.5% in 2012.

2011 to 2010

The District Water/Waste Water revenues recorded an increase of 3.3% in 2011.

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY –
MCAG No. 1785
MANAGEMENT’S DISCUSSION AND ANALYSIS**

Operating expenses

2012 to 2011

The District Water/Waste Water operating expenses decreased by 56.2% in 2012 due to allocations and capital projects.

2011 to 2010

The expenses to operate the Water/Waste Water systems were up 10.9% or \$143,221 in 2011 compared to a 2010. This increase in operating expenses can be attributed to increased preventative maintenance schedules for all water/waste water facilities to avoid failures.

Non-operating revenue/(expense)

2012 to 2011

The District Water/Waste Water non-operating expense increased by \$36.5 thousand in 2012.

2011 to 2010

Non-operating revenue increased by 19.7% primarily due to new service connection charges for the Dallesport Sewer system during 2011.

Capital contributions and grants

2012 to 2011

The District Water/ Waste Water received capital contributions in 2012 for the Roosevelt well in the amount of \$300,000. This project is on schedule for completion in 2013.

2011 to 2010

Capital contributions were in line with expectations during 2011 as no significant LUD’s were established.

The District looking forward 2013

As of the end of 2012, the District had \$1.486 million remaining of the 2011 Bond Funds for capital improvements and plans to fully expend this fund in 2013.

The District will continue to utilize The Energy Authority (TEA), who manages its day to day marketing and purchasing functions, to evaluate the District’s Risk Management hedging strategies and power sale contracts through 2016 with continued focus on maximizing the value of our day-ahead and month-ahead surplus and deficits based on prior year learning’s and best practices. In addition, BPA released its Slice Optimization Application in October 2012 and the District and TEA are taking advantage of the ability to control its share of the BPA System output.

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY -
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MANAGEMENT'S DISCUSSION AND ANALYSIS**

The District will also be completing final improvements on the HW Hill Landfill Gas generation facility, in conformance with the contract as the contractor is not performing. The District is working with a contractor who has yet to meet all the requirements of their supply and construction contract, which has taken focus from the District. The plant has been operating since October, 2011. The final improvements will reduce the current costs being incurred by the temporary system by \$400 thousand and place these costs in line with the original scope of the project.

The District does not anticipate further 230 kV transmission business line constructions in 2013 due to the current electric and Renewable Energy Credit marketplace. The District does however; anticipate interconnection work in the coming years as those conditions change.

The District will also be continue to review operating and capital costs throughout 2013 and evaluate how to best utilize our cash flow. Part of the initial evaluation will involve the restructuring of the management team to include a Chief Operating Officer. This position will have the ability to manage and utilize all engineering, construction and maintenance resources in the most effective and efficient manner and ensure we continue to provide long-term availability and safety within a strict budget.

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**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY -
MCAG No. 1785
COMBINED STATEMENTS OF NET POSITION**

	ASSETS	
	December 31,	
	2012	2011
CURRENT ASSETS		
Cash and cash equivalents	\$ 10,290,717	\$ 9,952,816
Notes receivable	175,918	164,495
Accounts receivable, net	779,750	1,295,620
Unbilled revenue	1,613,067	1,640,269
Other receivables	4,497,925	2,872,923
Materials and supplies	1,761,438	1,621,313
Prepayments	696,654	308,701
Current portion of prepaid power contract	1,180,359	1,180,359
	<u>20,995,828</u>	<u>19,036,496</u>
RESTRICTED CASH EQUIVALENTS		
Special deposits	-	400
Construction funds	1,486,603	7,147,975
Special funds	15,167,025	15,454,649
	<u>16,653,628</u>	<u>22,603,024</u>
CAPITAL ASSETS		
Total plant in service	290,128,259	262,543,537
Construction work in progress	3,797,441	25,246,775
	<u>293,925,700</u>	<u>287,790,312</u>
Total utility plant	293,925,700	287,790,312
Accumulated provision for depreciation	(71,622,502)	(60,278,804)
	<u>222,303,198</u>	<u>227,511,508</u>
OTHER ASSETS		
Other investments and transmission deposits	1,794,435	2,195,740
Other assets and prepaid power contract	20,279,515	21,466,026
Derivative asset	1,222,465	-
	<u>23,296,415</u>	<u>23,661,766</u>
DEFERRED OUTFLOWS OF RESOURCES		
Accumulated decrease in fair value of hedging derivatives	593,888	-
	<u>593,888</u>	<u>-</u>
Total assets	<u>\$ 283,842,957</u>	<u>\$ 292,812,794</u>

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY -
MCAG No. 1785
COMBINED STATEMENTS OF NET POSITION**

LIABILITIES AND NET POSITION

	December 31,	
	2012	2011
CURRENT LIABILITIES		
Accounts payable	\$ 2,991,204	\$ 5,232,347
Current portion of long-term debt	3,517,909	3,432,579
Consumers deposits	351,434	277,032
Other current and accrued liabilities	3,117,804	3,449,022
Total current liabilities	9,978,351	12,390,980
NONCURRENT LIABILITIES		
Compensated absences	143,839	190,434
Long-term debt	136,834,355	140,401,201
Derivative liability	593,888	-
Total noncurrent liabilities	137,572,082	140,591,635
DEFERRED INFLOWS OF RESOURCES		
Accumulated increase in fair value of hedging derivatives	1,222,465	-
Total liabilities	148,772,898	152,982,615
NET POSITION		
Net investment in capital assets	86,660,452	94,217,644
Restricted - bond funds	12,155,694	12,503,086
Restricted - rate stabilization fund	2,400,000	2,387,624
Unrestricted	33,853,913	30,721,825
Total net position	135,070,059	139,830,179
Total liabilities and net position	\$ 283,842,957	\$ 292,812,794

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY -
MCAG No. 1785
COMBINED STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION**

	Years Ended December 31,	
	2012	2011
OPERATING REVENUES		
Electric system		
Sales to retail customers	\$ 23,200,123	\$ 21,513,337
Sales to wholesale and transmission customers	13,845,508	10,725,916
Water/wastewater systems	1,542,975	1,396,608
Total operating revenues	<u>38,588,606</u>	<u>33,635,861</u>
OPERATING EXPENSES		
Power expense	10,026,127	8,571,212
Operations expense	11,120,075	8,193,639
Maintenance expense	2,444,687	3,313,267
Administrative and general expense	4,083,952	4,362,118
Depreciation expense	11,804,653	6,642,815
Tax expense	1,564,178	1,344,524
Total operating expenses	<u>41,043,672</u>	<u>32,427,575</u>
OPERATING (LOSS) INCOME	<u>(2,455,066)</u>	<u>1,208,286</u>
NON-OPERATING REVENUE/(EXPENSE)		
Interest income	160,418	183,497
Other non-operating revenues	1,215,324	1,290,175
Interest expense	(6,547,673)	(2,928,854)
Amortization expense	(169,920)	(159,500)
Other expense	(9,118)	-
Total non-operating expense	<u>(5,350,969)</u>	<u>(1,614,682)</u>
LOSS BEFORE CAPITAL CONTRIBUTIONS AND GRANTS	(7,806,035)	(406,396)
CAPITAL CONTRIBUTIONS AND GRANTS	<u>3,045,915</u>	<u>977,100</u>
CHANGE IN NET POSITION	<u>(4,760,120)</u>	<u>570,704</u>
NET POSITION, beginning of year	<u>139,830,179</u>	<u>139,259,475</u>
NET POSITION, end of year	<u>\$ 135,070,059</u>	<u>\$ 139,830,179</u>

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY –
MCAG No. 1785
COMBINED STATEMENTS OF CASH FLOWS**

	Years Ended December 31,	
	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts from customers	\$ 37,571,907	\$ 34,472,566
Payments to suppliers for goods and services	(22,763,561)	(18,101,535)
Payments to employees for services	(6,963,749)	(6,660,894)
Taxes paid	(1,525,377)	(1,363,726)
Net change in cash flows from operating activities	<u>6,319,220</u>	<u>8,346,411</u>
CASH FLOWS FROM NON-CAPITAL FINANCING ACTIVITIES		
Proceeds from BPA transmission deposits	401,305	256,113
Other non-operating income	1,215,324	1,290,175
Net change in cash flows from non-capital financing activities	<u>1,616,629</u>	<u>1,546,288</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Principal payments on long-term debt	(3,441,909)	(8,392,009)
Issuance of long-term debt	158,605	14,011,589
Bond issuance costs	-	(207,520)
Interest payments	(6,698,892)	(3,142,014)
Capital contributions and grants	3,045,915	977,100
Other assets - preliminary engineering	(163,768)	(2,567)
Capital expenditures	(6,605,461)	(11,561,710)
Net change in cash flows from capital and related financing activities	<u>(13,705,510)</u>	<u>(8,317,131)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Interest received	158,166	186,613
Net change in cash flows from investing activities	<u>158,166</u>	<u>186,613</u>
NET CHANGE IN CASH AND CASH EQUIVALENTS	(5,611,495)	1,762,181
CASH AND CASH EQUIVALENTS, beginning of year	32,555,840	30,793,659
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 26,944,345</u>	<u>\$ 32,555,840</u>

**PUBLIC UTILITY DISTRICT NO. 1 OF KCLICKITAT COUNTY -
MCAG No. 1785
COMBINED STATEMENTS OF CASH FLOWS**

	Years Ended December 31,	
	<u>2012</u>	<u>2011</u>
RECONCILIATION OF OPERATING INCOME TO NET CASH FROM OPERATING ACTIVITIES		
OPERATING (LOSS) INCOME	<u>\$ (2,455,066)</u>	<u>\$ 1,208,286</u>
ADJUSTMENTS TO RECONCILE OPERATING INCOME TO NET CASH FROM OPERATING ACTIVITIES		
Depreciation expense	11,804,653	6,642,815
Amortization of prepaid power contract	1,180,359	1,180,359
CHANGES IN OPERATING ASSETS AND LIABILITIES		
Receivables and unbilled revenue	(1,091,101)	841,267
Materials and supplies	(140,125)	(91,598)
Prepayments	(387,953)	(64,141)
Accounts payable	(2,241,143)	(1,558,862)
Customer deposits	74,402	(4,562)
Other current and accrued liabilities	(378,211)	273,067
Compensated absences	(46,595)	(77,009)
Deferred credits and other liabilities	-	(3,211)
Total adjustments	<u>8,774,286</u>	<u>7,138,125</u>
Net cash from operating activities	<u>\$ 6,319,220</u>	<u>\$ 8,346,411</u>

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY –
MCAG No. 1785
NOTES TO COMBINED FINANCIAL STATEMENTS**

Note 1 – Organization and Significant Accounting Policies

Organization and combined financial statements – Public Utility District No. 1 of Klickitat County, Washington (the District) is a municipal corporation governed by an elected three-person Board of Commissioners. The District’s reporting entity is comprised of the combined electric system, eight water systems and five wastewater systems. All significant intercompany balances and transactions have been eliminated from the combined amounts reported. The District has no component units. The District’s service area covers approximately 1,680 square miles in Klickitat County. The District also serves small areas in the surrounding counties of Yakima, Skamania, and Benton. As of December 31, 2012 the District had 12,253 electric, 1,123 water, and 1,173 wastewater customers. The District’s wholesale activity is a significant part of the electric system business lines. Wholesale revenues are generated from the sale of the output from the Landfill Gas project, and from the White Creek Wind I power purchase contract. The District owns 13% of the generated output from the White Creek Wind I 205 MW project.

Basis of accounting and presentation – The accounting policies of the District conform to generally accepted accounting principles (GAAP) as applicable to proprietary funds of governments using the full accrual basis of accounting. The Governmental Accounting Standards Board (GASB) is the accepted standard setting body for establishing governmental accounting and financial reporting principles. Accounting records are maintained in accordance with methods prescribed by the State Auditor under the authority of Chapter 43.09 RCW, the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission (FERC) for the Electric System and the Uniform System of Accounts for Class A & B Water Utilities prescribed by the National Association of Regulatory Utility Commissioners for the Water System.

Cash equivalents – The District considers all highly liquid investments (including restricted assets) with a maturity of three months or less to be cash equivalents. Assets in the Local Government Investment Pool (LGIP) are considered cash equivalents as they can be converted to cash within one day.

Accounts receivable and allowance for uncollectible accounts – Accounts receivable are recorded when invoices are issued and are written off when they are determined to be uncollectible. The allowance for uncollectible accounts includes amounts estimated through an evaluation of specific accounts, based on the best available facts and circumstances, of customers that may be unable to meet their financial obligations, and a reserve is recorded based on historical experience. The allowance for uncollectible accounts at December 31, 2012 and 2011 was \$596,201 and \$33,538, respectively.

Other receivables – Other receivables consists of amounts due from customers for small material purchases, certain aid in construction billings, repairs to damaged plant and equipment from accidents caused by others, funding requests to granting or loaning agencies, customers who take primary electric service from the District or have a power sales contract, and other miscellaneous items that may require invoicing that would not normally be entered into the customer service billing system.

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY –
MCAG No. 1785
NOTES TO COMBINED FINANCIAL STATEMENTS**

Note 1 – Organization and Significant Accounting Policies (continued)

Materials and supplies – Materials and supplies provide for additions, maintenance and repairs to utility plant and are stated at average cost.

Restricted assets – In accordance with bond resolutions and certain related agreements, separate restricted funds are required to be established. Cash held in these funds are restricted for specific uses, including construction, debt service and other special reserve requirements.

Capital assets (utility plant) – Utility plant is stated at original cost, contract price or fair value if donated (see Note 3). Costs include labor, materials and related indirect costs, such as engineering, transportation and allowance for funds (i.e. interest) used during construction. Additions, renewals and betterments with a minimum cost of \$500 per item are capitalized. Repairs and minor replacements are charged to operating expenses. In the case of disposals, unless there is a major retirement or a general plant asset is retired, the cost of property and any removal cost less salvage are charged to accumulated depreciation when property is retired. Depreciation is computed using straight-line group rates; 3% for distribution plant, 2.75% for transmission plant, and 1.67% to 2.5% for generating plant. Depreciation of water and wastewater plant has been computed over useful lives of 25 to 40 years. General plant composite rates range from 2.2% to 14.4%.

Derivative instruments – The District has adopted GASB Statement No. 53, Accounting and Financial Reporting for Derivative Instruments. Subject to certain exceptions GASB Statement No. 53 requires every derivative instrument be recorded on the statement of net position as an asset or liability measured at its fair value, and changes in the derivative’s fair value to be recognized in earnings unless such derivatives meet specific hedge accounting criteria to be determined as effective.

It is the District’s policy to document and apply as appropriate the normal purchase and normal sales exception under GASB Statement No. 53. The District has reviewed its various contractual arrangements to determine applicability of these standards. Purchases and sales of forward electricity and option contracts that require physical delivery and which are expected to be used or sold by the reporting entity in the normal course of business are generally considered “normal purchases and normal sales.” These transactions are excluded under GASB Statement No. 53 and therefore are not required to be recorded at fair value in the financial statements. Certain put and call options and financial swaps for electricity are considered to be derivatives under GASB Statement No. 53, and do not generally meet the “normal purchases and normal sales” criteria. See Note 8 for further discussion of the District’s derivative instruments and risk management.

Unamortized debt expense and premium – Bond issue costs are amortized to expense using the straight-line method over the term of the bonds. Bond premiums are amortized to interest expense, using the weighted average method over the term of the bonds.

PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY –
MCAG No. 1785
NOTES TO COMBINED FINANCIAL STATEMENTS

Note 1 – Organization and Significant Accounting Policies (continued)

Other investments – Consists of investment in White Creek Public LLC, carried on the equity basis of accounting.

Transmission deposits – Consists of deposits for certain transmission services paid to Bonneville Power Administration (BPA).

Unamortized prepaid power contract – Consists of prepaid power amortized using the straight-line method over the term of the contract (see Note 4).

Compensated absences – Compensated absences are absences for which employees will be paid, such as vacation and sick leave. The District records compensated absences as an expense and liability when earned. Vacation pay and sick leave pay policies were superseded by a Personal Time Off (PTO) policy in 2008. District employees are entitled to time off based upon length of continuous service which is payable upon resignation, retirement or death. There is a 700-hour cap on PTO accrual, determined according to the employees' anniversary dates. After the annual transfer of PTO hours into Volunteer Employee Beneficiary Association (VEBA) or deferred comp, any hours over the 700-hour cap will be forfeited. At separation, if an employee is not eligible to retire, they may cash out their PTO bank at a schedule governed by years of service.

Fair value of financial instruments – The carrying amounts of current assets, including restricted cash, and current liabilities approximate fair value due to the short-term maturity of those instruments.

Net position – Net position consist of:

- **Net investment in capital assets** – This component of net position consists of capital assets, net of accumulated depreciation, and unspent bond proceeds less outstanding balances of any bonds and other borrowings that are attributable to the acquisition, construction, or improvement of those assets.
- **Restricted** – This component consists of net position on which constraints are placed as to their use. Constraints include those imposed by creditors (such as through debt covenants), contributors, or laws or regulation of other governments or constraints imposed by law through constitutional provisions or through enabling legislation.
- **Unrestricted** – This component of net position consists of net position that does not meet the definition of “restricted” or “net investment in capital assets.”

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY –
MCAG No. 1785
NOTES TO COMBINED FINANCIAL STATEMENTS**

Note 1 – Organization and Significant Accounting Policies (continued)

Revenues and expenses – Operating revenues and expenses result from providing services and producing and delivering goods in connection with the District’s principal ongoing operations. Operating revenues are recognized when billed and expenses are recognized when incurred. In addition, the District recognizes unbilled revenue, revenues from services provided, but not yet billed. The principal operating revenues of the District are charges to customers for electric, water and wastewater service. Operating expenses for the District include the cost of sales and services, maintenance, administrative expenses, depreciation on capital assets and taxes. All revenues and expenses not meeting this definition are reported as non-operating revenues and expenses.

The credit practices of the District require an evaluation of each new customer’s credit worthiness on a case-by-case basis. Based on policy, a deposit may be obtained from the customer. Concentrations of credit risk with respect to receivables for residential customers are limited due to the number of customers comprising the District’s customer base. Credit losses have been within management’s expectations. Similar to its evaluation of residential, commercial and industrial customers’ credit reviews, the District continually evaluates its wholesale power customers by reviewing credit ratings and financial credit worthiness of existing and new customers.

Capital contributions – Capital contributions are District-mandated customer connection charges used to fund construction of system properties necessary to extend service to a new customer.

Use of estimates – The preparation of combined financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the combined financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates in the District’s financial statements include the allowance for doubtful accounts, bad debt expense, useful lives of plant and related depreciation expense.

Significant risks and uncertainties – The District is subject to certain business risks that could have a material impact on future operations and financial performance. These risks include, but are not limited to, weather and natural disaster related disruptions; collective bargaining labor disputes; fish and other Endangered Species Act issues; Environmental Protection Agency regulations; federal government regulations or orders; deregulation of the electric industry; and market risks inherent in the buying and selling of power, a commodity with inelastic demand characteristics and minimal storage capability.

Interest rate risk – The District’s investment policy limits investment maturities to less than five years from the date of purchase unless authorized by the General Manager and Chief Financial Officer for a specific purpose. During 2012 and 2011 investments were in the State Treasurer’s LGIP, which has a weighted average portfolio maturity of less than 90 days and beginning December 2012 added the ability to invest in a Bank of the West Money Market Plus Public Funds account.

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY –
MCAG No. 1785
NOTES TO COMBINED FINANCIAL STATEMENTS**

Note 1 – Organization and Significant Accounting Policies (continued)

Credit risk – In accordance with the Revised Code of Washington, District bond resolutions and District internal investment policies, all investments are direct obligations of the U.S. Government, deposits in the LGIP, or deposits with financial institutions recognized as qualified public depositories of the State of Washington. The District’s cash deposits are covered by federal depository insurance or protected against loss by deposit with financial institutions recognized as qualified public depositories of the State of Washington. The District intends to hold deposits and securities until maturity.

Concentration of credit risk – District policies allow the entire portfolio to be invested in direct United States Government guaranteed obligations or in the LGIP. No other investment may exceed half of portfolio market value. The LGIP, a 2a7-like pool as defined by GASB Statement No. 31 and the Securities and Exchange Commission, invests in high quality, short-term investments; all LGIP money market securities must be rated A-1 by Standard & Poor’s Corporation or P1 by Moody’s Investor Services, Inc. The LGIP weighted average maturity must not exceed 90 days and no single investment may exceed 762 days in maturity. Withdrawals in excess of \$10 million are available on a one day notice. The LGIP Annual Report is available on the Washington State Treasurer’s website.

Reclassification – Changes have been made to prior year account classifications as needed to conform to the current year presentation format.

Note 2 – Deposits and Investments

Cash and cash equivalents consist of the following at December 31:

	Restricted Cash Equivalents	Unrestricted Cash and Cash Equivalents	Total 2012	Total 2011
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Construction funds	\$ 1,486,603	\$ -	\$ 1,486,603	\$ 7,147,975
Special funds	15,167,025	-	15,167,025	15,454,649
Cash – general funds	-	10,290,717	10,290,717	9,952,816
Special deposits	-	-	-	400
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Totals	<u>\$ 16,653,628</u>	<u>\$ 10,290,717</u>	<u>\$ 26,944,345</u>	<u>\$ 32,555,840</u>

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY –
MCAG No. 1785
NOTES TO COMBINED FINANCIAL STATEMENTS**

Note 3 – Capital Assets (Utility Plant)

The following are changes in capital assets for the year ended December 31, 2012:

Description	Balance 01/01/2012	Additions	Retirements and Transfers	Balance 12/31/2012
Capital assets not being depreciated				
Organization	\$ 14,767	\$ -	\$ -	\$ 14,767
Franchises and consents	211,427	-	-	211,427
Land and land rights	1,456,352	197,644	941	1,653,055
Construction work in progress	25,246,775	6,047,181	27,496,515	3,797,441
	<u>26,929,321</u>	<u>6,244,825</u>	<u>27,497,456</u>	<u>5,676,690</u>
Capital assets being depreciated				
Electric plant				
Distribution plant	103,123,511	5,112,235	497,765	107,737,981
Transmission plant	52,853,501	603,014	56,670	53,399,845
Generating plant	76,283,227	21,047,928	-	97,331,155
Water and wastewater plant	18,760,321	947,106	-	19,707,427
General plant	9,840,431	233,246	1,075	10,072,602
	<u>260,860,991</u>	<u>27,943,529</u>	<u>555,510</u>	<u>288,249,010</u>
Total capital assets	287,790,312	34,188,354	28,052,966	293,925,700
Accumulated depreciation	<u>(60,278,804)</u>	<u>(11,843,909)</u>	<u>500,211</u>	<u>(71,622,502)</u>
Net capital assets	<u>\$ 227,511,508</u>	<u>\$ 22,344,445</u>	<u>\$ 27,552,755</u>	<u>\$ 222,303,198</u>

Note 4 – Other Assets and Prepaid Power Contract

Other assets and prepaid power contract as of December 31, consist of the following:

	2012	2011
Prepaid power contract, net of current portion	\$ 16,525,044	\$ 17,705,400
Unamortized debt issuance expense	3,222,915	3,391,941
Preliminary investigation charges	531,556	368,685
	<u>\$ 20,279,515</u>	<u>\$ 21,466,026</u>

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY –
MCAG No. 1785
NOTES TO COMBINED FINANCIAL STATEMENTS**

Note 4 – Other Assets and Prepaid Power Contract (continued)

Prepaid power contract – The District entered into a 20-year Energy Purchase Agreement for the White Creek Wind I Facility, which became effective January 1, 2008. Under this Agreement, the District had rights to 26% of the output from the 205 MW facility and was obligated to pay the same percentage of the reimbursable operating expenses. In June 2008, the District completed a transaction with Lewis PUD to sell 10% of the 26% share of the White Creek Wind I project power output. In December 2008, the District also sold 3% of the remaining 16% share of the White Creek Wind I project power output to Benton PUD. The gain on the sale of White Creek power rights was \$23,678,404. The remaining portion of the project is amortized on a straight-line basis over the remaining term of the contract.

Note 5 – Long-Term Debt

The following are changes in long-term debt for the year ended December 31, 2012:

	Balance 01/01/2012	Additions	Payments/ Amortization	Balance 12/31/2012	Due Within One Year
Electric revenue bonds	\$ 139,235,000	\$ -	\$ 3,240,000	\$ 135,995,000	\$ 3,325,000
Unamortized bond premium	2,403,782	-	198,212	2,205,570	-
W/WW revenue bonds	227,500	-	32,000	195,500	23,000
W/WW loans	1,967,498	158,605	169,908	1,956,194	169,909
Total long-term debt	<u>\$ 143,833,780</u>	<u>\$ 158,605</u>	<u>\$ 3,640,120</u>	<u>\$ 140,352,264</u>	<u>\$ 3,517,909</u>

Substantially all electric revenues are pledged as security for the electric revenue bonds and substantially all water/wastewater revenues are pledged as security for the water/wastewater revenue bonds. Water/wastewater loans are secured by water/wastewater assets. Electric revenue bonds carry fixed and variable interest rates ranging from 2.030% to 6.680%, for the years ended December 31, 2012 and 2011. The water/wastewater revenue bonds have a 5.0% fixed rate. The loans from the Public Work Trust Fund (PWTF) carry fixed rates from 0.0% to 3.0% and the State Revolving Fund (SRF) loans have fixed rates of 0.0% to 1.0%. Electric revenue bonds mature through December 1, 2031, water/wastewater bonds mature through September 1, 2021 and the PWTF and SRF loans mature through October 1, 2028. There is \$14,253,628 as of December 31, 2012, in restricted assets of the District representing revenue bond reserve requirements, construction funds and debt service accounts for the various indentures. There are a number of other limitations and restrictions contained in the various bond indentures.

**PUBLIC UTILITY DISTRICT NO. 1 OF KCLICKITAT COUNTY -
MCAG No. 1785
NOTES TO COMBINED FINANCIAL STATEMENTS**

Note 5 - Long-Term Debt (continued)

Future maturities are as follows as of December 31, 2012:

Electric Revenue Bonds			
Year(s)	Principal	Interest	Totals
2013	\$ 3,325,000	\$ 7,254,090	\$ 10,579,090
2014	3,430,000	7,148,389	10,578,389
2015	3,565,000	7,017,534	10,582,534
2016	3,710,000	6,869,052	10,579,052
2017	5,405,000	6,694,883	12,099,883
2018-22	35,250,000	28,663,278	63,913,278
2023-27	45,575,000	17,886,320	63,461,320
2028-31	35,735,000	5,393,602	41,128,602
	<u>\$ 135,995,000</u>	<u>\$ 86,927,148</u>	<u>\$ 222,922,148</u>

Water/Wastewater Revenue Bonds			
Year(s)	Principal	Interest	Totals
2013	\$ 23,000	\$ 9,775	\$ 32,775
2014	23,000	8,625	31,625
2015	26,000	7,475	33,475
2016	29,000	6,175	35,175
2017	29,000	4,725	33,725
2018-21	65,500	5,575	71,075
	<u>\$ 195,500</u>	<u>\$ 42,350</u>	<u>\$ 237,850</u>

Water/Wastewater PWTF & SRF Loans			
Year(s)	Principal	Interest	Totals
2013	\$ 169,909	\$ 7,693	\$ 177,602
2014	169,909	7,195	177,104
2015	169,909	6,697	176,606
2016	169,909	6,198	176,107
2017	124,996	5,700	130,696
2018-22	624,979	21,027	646,006
2023-27	481,406	9,035	490,441
2028	45,177	452	45,629
	<u>\$ 1,956,194</u>	<u>\$ 63,997</u>	<u>\$ 2,020,191</u>
Total	<u>\$ 138,146,694</u>	<u>\$ 87,033,495</u>	<u>\$ 225,180,189</u>

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY –
MCAG No. 1785
NOTES TO COMBINED FINANCIAL STATEMENTS**

Note 5 – Long-Term Debt (continued)

At December 31, 2012, the District's 2001 Electric Revenue Bonds in the amount of \$1,252,200 were considered defeased. This refunded bond constitutes a contingent liability of the District only to the extent that cash and investments presently in the control of the refunding trustees are not sufficient to meet debt service requirements, and are therefore excluded from the combined financial statements because the likelihood of additional funding requirements is considered remote.

Note 6 – Retirement Benefits

1. Pension plan

Substantially all of the District's full-time and qualifying part-time employees participate in one of the statewide retirement systems administered by the Washington State Department of Retirement Systems, under cost-sharing multiple-employer public employee defined benefit and defined contribution retirement plans. The Department of Retirement Systems (DRS), a department within the primary government of the State of Washington, issues a publicly available comprehensive annual financial report (CAFR) that includes financial statements and required supplementary information for each plan.

The DRS CAFR may be obtained by writing to: Department of Retirement Systems, Communications Unit – PO Box 48380 – Olympia WA 98504-8380. The following disclosures are made pursuant to GASB Statement 27, Accounting for Pensions by State and Local Government Employers.

Public Employees' Retirement System (PERS) Plans 1, 2, and 3

Plan description – PERS is a cost-sharing multiple-employer retirement system comprised of three separate plans for membership purposes: Plans 1 and 2 are defined benefit plans and Plan 3 is a defined benefit plan with a defined contribution component.

Membership in the system includes elected officials; state employees; employees of the Supreme, Appeals and Superior courts (other than judges in a judicial retirement system); employees of legislative committees, community and technical colleges, college and university employees not participating in national higher education retirement programs; judges of district and municipal courts; and employees of local government.

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY –
MCAG No. 1785
NOTES TO COMBINED FINANCIAL STATEMENTS**

Note 6 – Retirement Benefits (continued)

PERS participants who joined the system by September 30, 1977 are Plan 1 members. Those who joined on or after October 1, 1977 but before either, February 28, 2002 for state and higher education employees, or August 31, 2002 for local government employees, are Plan 2 members unless they exercise an option to transfer their membership to Plan 3. PERS participants joining the system on or after March 1, 2002 for state and higher education employees, or September 1, 2002 for local government employees have the irrevocable option of choosing membership in either PERS Plan 2 or PERS Plan 3. The option must be exercised within 90 days of employment. An employee is reported in Plan 2 until a choice is made. Employees who fail to choose within 90 days default to PERS Plan 2.

PERS defined benefit retirement benefits are financed from a combination of investment earnings and employer and employee contributions. PERS retirement benefit provisions are established in state statute and may be amended only by the State Legislature.

Plan 1 members are vested after the completion of five years of eligible service. Plan 1 members are eligible for retirement at any age after 30 years of service, or at the age of 60 with five years of service, or at the age of 55 with 25 years of service. The annual benefit is two percent of the average final compensation per year of service, capped at 60 percent. The average final compensation is based on the greatest compensation during any 24 eligible consecutive compensation months. Plan 1 retirements from inactive status prior to the age of 65 may receive actuarially reduced benefits. The benefit is actuarially reduced to reflect the choice of a survivor option. A cost of living allowance (COLA) is granted at age 66 based upon years of service times the COLA amount, increased by three percent annually. Plan 1 members may also elect to receive an additional COLA amount (indexed to the Seattle Consumer Price Index), capped at three percent annually. To offset the cost of this annual adjustment the benefit is reduced.

Plan 2 members are vested after the completion of five years of eligible service. Plan 2 members may retire at the age of 65 with five years of service, or at the age of 55 with 20 years of service, with an allowance of two percent of the average final compensation per year of service. The average final compensation is based on the greatest compensation during any eligible consecutive 60 month period. Plan 2 retirements prior to the age of 65 receive reduced benefits. If retirement is at age 55 or older with at least 30 years of service, a three percent per year reduction applies; otherwise an actuarial reduction will apply. The benefit is also actuarially reduced to reflect the choice of a survivor option. There is no cap on years of service credit; and a cost of living allowance is granted (indexed to the Seattle Consumer Price Index), capped at three percent annually.

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY –
MCAG No. 1785
NOTES TO COMBINED FINANCIAL STATEMENTS**

Note 6 – Retirement Benefits (continued)

Plan 3 has a dual benefit structure. Employer contributions finance a defined benefit component, and member contributions finance a defined contribution component. The defined benefit portion provides a benefit calculated at one percent of the average final compensation per year of service. The average final compensation is based on the greatest compensation during any eligible consecutive 60 month period. Effective June 7, 2007, Plan 3 members are vested in the defined benefit portion of their plan after ten years of service; or after five years of service, if twelve months of that service are earned after age 44; or after five service credit years earned in PERS Plan 2 prior to June 1, 2003. Plan 3 members are immediately vested in the defined contribution portion of their plan. Vested Plan 3 members are eligible to retire with full benefits at age 65, or at age 55 with 10 years of service. Retirements prior to age 65 receive reduced benefits. If retirement is at age 55 or older with at least 30 years of service, a three percent per year reduction applies; otherwise an actuarial reduction will apply. The benefit is also actuarially reduced to reflect the choice of a survivor option. There is no cap on years of service credit and Plan 3 provides the same cost of living allowance as Plan 2.

The defined contribution portion can be distributed in accordance with an option selected by the member, either as a lump sum or pursuant to other options authorized by the Employee Retirement Benefits Board.

There are 1,184 participating employers in PERS. Membership in PERS consisted of the following as of the latest actuarial valuation date for the plans of January 1, 2011:

Retirees and beneficiaries receiving benefits	\$ 82,242
Terminated plan members entitled to but not yet receiving benefits	30,515
Active plan members vested	106,317
Active plan members non-vested	<u>44,273</u>
Total	<u><u>\$ 263,347</u></u>

**PUBLIC UTILITY DISTRICT NO. 1 OF KLICKITAT COUNTY –
MCAG No. 1785
NOTES TO COMBINED FINANCIAL STATEMENTS**

Note 6 – Retirement Benefits (continued)

Funding policy – Each biennium, the state Pension Funding Council adopts Plan 1 employer contribution rates, Plan 2 employer and employee contribution rates, and Plan 3 employer contribution rates. Employee contribution rates for PERS Plan 1 are established by statute at 6 percent for state agencies and local government unit employees, and at 7.5 percent for state government elected officials. The employer and employee contribution rates for Plan 2 and the employer contribution rate for Plan 3 are developed by the Office of the State Actuary to fully fund Plan 2 and the defined benefits portion for Plan 3. All employers are required to contribute at the level established by the Legislature. Under PERS Plan 3, employer contributions finance the defined benefit portion of the plan, and member contributions finance the defined contribution portion. The Employee Retirement Benefits Board sets Plan 3 employee contribution rates. Six rate options are available ranging from 5 to 15 percent; two of the options are graduated rates dependent on the employee’s age. The methods used to determine the contribution requirements are established under state statute in accordance with chapters 41.40 and 41.45 RCW.

The required contribution rates expressed as a percentage of current year covered payroll, as of December 31, 2012, were as follows:

	<u>PERS Plan 1</u>	<u>PERS Plan 2</u>	<u>PERS Plan 3</u>
Employer*	7.21%**	7.21%**	7.21%***
Employee	6.00%****	4.64%****	*****

* The employer rates include the employer administration expense fee currently set at 0.16%.

** The employer rate for state elected officials is 10.80% for Plan 1, 7.25% for Plan 2 and Plan 3.

*** Plan 3 defined benefit portion only.

**** The employee rate for state elected officials is 7.50% for Plan 1, and 4.64% for Plan 2.

***** Variable from 5% to 15% maximum based on rate selected by the PERS3 member.

Both the District and the employees made the required contributions. The District’s required contributions for the years ended December 31 were as follows:

	<u>PERS Plan 1</u>	<u>PERS Plan 2</u>	<u>PERS Plan 3</u>
2012	\$ 5,087	\$ 404,638	\$ 24,320
2011	9,522	655,744	35,680
2010	8,678	537,268	34,399

**PUBLIC UTILITY DISTRICT NO. 1 OF KLUCKITAT COUNTY –
MCAG No. 1785
NOTES TO COMBINED FINANCIAL STATEMENTS**

Note 6 – Retirement Benefits (continued)

2. Post employment benefits plan other than pensions

Plan description – In addition to pension benefits, the District provides post employment health care benefits. District members are eligible for retiree medical benefits after becoming eligible for service retirement pension benefits under Plan 2 of the PERS (age 65 with 5 years of service; age 55 with 20 years of service). Currently former members who are entitled to a deferred vested pension benefit are not eligible to receive medical benefits after pension benefit commencement. Survivors of members who die are not eligible for medical benefits.

Funding policy – The funding policy is based upon the pay-as-you-go financing requirements.

Annual OPEB cost and net OPEB obligation – The District’s annual other postemployment benefit (OPEB) cost is based upon the annual required contribution (ARC), an amount actuarially determined in accordance with the parameters of GASB 45. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover the normal cost each year and amortize any unfunded actuarial liabilities over a period of thirty years as of January 1, 2011.

The District’s annual OPEB cost, the percentage of annual OPEB cost contributed to the plan, and the net OPEB obligation for years ended December 31 were as follows:

<u>Fiscal Year Ended</u>	<u>Annual OPEB Cost</u>	<u>Cost Contributed</u>	<u>Net OPEB Obligation</u>
12/31/2012	\$ 101,310	143.45%	\$ 581,727
12/31/2011	102,491	195.76%	625,745
12/31/2010	413,230	43.30%	723,886

Funding status and funding progress – As of January 1, 2011, the most recent valuation date, the plan was 0% funded. The accrued liability for benefits was \$1.3 million, and the actuarial value of assets was \$0, resulting in a UAAL of \$1.3 million.

The following table presents a schedule of funding progress for the District’s OPEB Plan:

<u>Valuation Date</u>	<u>Actuarial Value of Assets</u>	<u>Accrual Accrued Liability</u>	<u>Unfunded Actuarial Accrued Liabilities (UAAL)</u>	<u>Funded Ratio</u>	<u>Covered Payroll</u>	<u>UAAL as a Percentage of Covered Payroll</u>
1/1/2008	\$ -	\$ 4,784,699	\$ 4,784,699	0%	N/A	N/A
1/1/2011	\$ -	\$ 1,291,085	\$ 1,291,085	0%	N/A	N/A

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Note 6 – Retirement Benefits (continued)

Actuarial valuations involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality, and the healthcare cost trend. Amounts determined regarding the funded status of the plan and the annual required contributions of the employer are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future.

Note 7 – Segment Information – Enterprise Funds

The District operates an electric, eight water, and five wastewater utilities which are primarily financed by user charges. The key financial data for the years ended December 31, 2012 and 2011 is as follows:

Condensed statement of net position:

	Electric System	Water- Wastewater Systems	Total 2012	Total 2011
Assets				
Current, restricted, and other assets	\$ 57,322,885	\$ 4,216,874	\$ 61,539,759	\$ 65,301,286
Capital assets	<u>206,565,274</u>	<u>15,737,924</u>	<u>222,303,198</u>	<u>227,511,508</u>
Total assets	<u>\$ 263,888,159</u>	<u>\$ 19,954,798</u>	<u>\$ 283,842,957</u>	<u>\$ 292,812,794</u>
Liabilities				
Current liabilities	\$ 9,698,142	\$ 280,209	\$ 9,978,351	\$ 12,390,980
Noncurrent liabilities	<u>136,834,705</u>	<u>1,959,842</u>	<u>138,794,547</u>	<u>140,591,635</u>
Total liabilities	<u>146,532,847</u>	<u>2,240,051</u>	<u>148,772,898</u>	<u>152,982,615</u>
Net position				
Net investment in capital assets	73,175,672	13,484,780	86,660,452	94,217,644
Restricted	14,555,694	-	14,555,694	14,890,710
Unrestricted	<u>30,864,994</u>	<u>2,988,919</u>	<u>33,853,913</u>	<u>30,721,825</u>
Total net position	<u>118,596,360</u>	<u>16,473,699</u>	<u>135,070,059</u>	<u>139,830,179</u>
Total liabilities and net position	<u>\$ 265,129,207</u>	<u>\$ 18,713,750</u>	<u>\$ 283,842,957</u>	<u>\$ 292,812,794</u>

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Note 7 – Segment Information – Enterprise Funds (continued)

Condensed statements of revenues, expenses, and changes in net position:

	Electric System	Water- Wastewater Systems	Total 2012	Total 2011
Operating revenues	\$ 37,086,740	\$ 1,501,866	\$ 38,588,606	\$ 33,635,861
Operating expenses	29,163,079	75,940	29,239,019	25,784,760
Depreciation	11,240,296	564,357	11,804,653	6,642,815
Operating income	(3,316,635)	861,569	(2,455,066)	1,208,286
Non-operating revenues (expenses)				
Interest income	128,529	31,889	160,418	183,497
Interest expense	(6,502,164)	(45,509)	(6,547,673)	(2,928,854)
Other non-operating revenue (expense), net	1,040,665	(4,379)	1,036,286	1,130,675
Capital contributions and grants	2,720,574	325,341	3,045,915	977,100
Change in net position	(5,929,031)	1,168,911	(4,760,120)	570,704
Net position, beginning of year	123,799,509	16,030,670	139,830,179	139,256,475
Net position, end of year	\$ 117,870,478	\$ 17,199,581	\$ 135,070,059	\$ 139,827,179

Note 8 – Power Risk Management

As of December 31, 2012, the District had the following derivative instruments outstanding:

	Changes in Fair Value		Fair Value at December 31, 2012		Notional
	Classification	Amount	Classification	Amount	
Cash Flow Hedges:					
Financial Swap Forward	Deferred Inflow	\$1,222,465	Derivative Asset	\$1,222,465	169,335 MWH
	Deferred Outflow	\$593,888	Derivative Liability	\$593,888	169,335 MWH

The fair values of the financial swap contracts were based on the futures price curve for the Mid-Columbia Intercontinental Exchange for electricity.

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Note 8 – Power Risk Management (continued)

Objective and strategies – The District enters into derivative energy transactions to hedge its known or expected positions within its approved Risk Management Policy. Decisions are made to enter into forward transactions to protect its financial position specifically to deal with long and short positions as determined by projected load and resource balance positions. Generally, several strategies are employed to hedge the District’s resource portfolio, including:

- *Surplus Purchased Power Resources* – the District hedges projected surpluses in future periods by selling power or by purchasing put options. Surplus power is generally sold forward at a fixed-price, either physically or financially, when the probability of surplus is very high; surplus power is hedged through the purchase of physical or financial put options when the projected surplus is less certain, but nevertheless expected to be available under expected scenarios. From time to time the District will sell physical power forward in the next calendar month at a price based on the Mid-Columbia index to perfect financial forward sales while settle based on the same index.

Credit Risk – The District has developed a credit policy that establishes guidelines for setting credit limits and monitoring credit exposure on a continuous basis. The policy addresses frequency of counterparty credit evaluations, credit limits per specific counterparty and counterparty credit concentration limits. Commodity transactions, both physical and financial, are entered into only with counterparties approved by the District’s Risk Management Committee for creditworthiness. The District had 5 counterparties with approved credit limits for electric power sales and purchases as of December 31, 2012. Counterparty credit limits are based on The Energy Authority’s (TEA) (See Note 12) proprietary credit rating system and other factors. Credit ratings for counterparties range from “not-rated” to AAA, with a majority of counterparties rated between BBB- and AA.

Basis Risk – The District proactively works to eliminate or minimize basis risk on energy transactions by entering into derivative transactions that settle pursuant to an index derived from market transactions at the point physical delivery is expected to take place. There are no derivative transactions outstanding that carry basis risk as of December 31, 2012. As applicable, all power related transactions are to be settled on the relevant Mid-Columbia index, and all gas transactions are to be settled on the relevant Sumas/Huntingdon index. The District has ready access to electric transmission and natural gas transportation capacity at those respective trading points.

Termination Risk – Hedging derivative contracts may be terminated by mutual agreement of the Board and the counterparty, or upon the occurrence of a termination event. Termination events include non-payment, non-delivery, deterioration of creditworthiness, or other material adverse changes. During the year ended December 31, 2012, there were no terminations.

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Note 9 – Risk Management and Self Insurance

Unemployment insurance – The District maintains insurance against most normal hazards, except for unemployment insurance, where the District has elected to become self-insured for all losses. The District reimburses the State Employment Security Department for actual costs upon receipt of any claim. The District does not estimate any future liability as the amount is not significant.

Public utility risk management services – The District, along with seventeen other public utility districts and one joint operating agency, is a member of the Public Utility Risk Management Services self-insurance fund. The program provides members with various liability, property, and health insurance coverage in three separate pools.

The District has not accrued a liability for any outstanding claims of the self-insured pools, including incurred-but-not-reported health and welfare claims, as the amount cannot be reasonably estimated. Management believes the claims, for those that are successful, will not have a significant impact on the financial position of the District.

The District is a participant in the liability pool, which maintains a base self-insured retention level of \$1,000,000, funded reserves ranging from \$1,500,000 to \$2,000,000, and individual member deductibles of \$250. The liability pool provides the District with shared excess coverage of \$60,000,000 general liability, \$10,000,000 professional liability, and \$10,000,000 per occurrence Directors and Officers liability.

The District is also a participant in the property pool, which maintains a self-insured retention level of \$250,000, funded reserves ranging from \$500,000 to \$750,000, and varying deductibles of \$250 on most property and \$75,000 on the H. W. Hill Landfill Gas project. The property pool provides the District with \$175,000,000 shared excess coverage, attaching at the self-insured retention level for all property risks excepting flood and earthquake, which attach at 2% of total insured value. Any gap between the self-insured level and excess insurance is funded half by the property pool and half by the affected member.

The District also participates in the health and welfare pool. Participating members are billed each month for shared costs (administration costs to operate the pool, mail order prescription plan costs, and stop loss carrier costs), claims by the members covered employees and dependents, and any shared claims for members who exceeded stop loss limits.

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Note 10 – Joint Ventures

Conservation and Renewable Energy System (CARES) – The District, along with seven other public utility districts, is a member of CARES, a municipal corporation and joint operating agency of the State of Washington. CARES was formed pursuant to RCW Chapter 43.52. The purpose of CARES is to develop and acquire conservation, renewable and high efficiency resources consistent with the Northwest Conservation and Electric Power Plan. CARES issued Conservation Project Revenue Bonds which are tax-exempt and unconditionally guaranteed by the BPA. The District has not contributed any money to CARES for several years. The District has no equity interest or liability for CARES operations.

McNary North Fishway Hydroelectric Project – On August 14, 1995, the District and Northern Wasco County PUD entered into an Ownership Agreement to jointly construct and operate the McNary North Fishway Hydroelectric Project. The project was completed in September 1997 and is generating approximately ten megawatts (10 MW) of electricity. Both the District and Northern Wasco County PUD share equally in the output, as well as the construction and operation costs of the Project. In 2012 and 2011 the District contributed \$450,000.

Last Mile Electrical Cooperative (LMEC) – The District, along with seven other public utility districts and two other organizations, is a member of LMEC, a non-profit cooperative. LMEC was formed pursuant to RCW Chapter 24.06. The purpose of LMEC is to develop wind and other renewable energy projects. At this time, LMEC has not issued any debt and is solely funded by its members. The District has no equity interest or liability for the LMEC operations at this time.

White Creek Public, LLC & White Creek Project, LLC – The District, along with Cowlitz PUD, formed White Creek Public, LLC to participate in White Creek Project, LLC which also includes as members Tanner Electric Co-op and Lakeview Light & Power. Early development of the project was done by the utilities involved, but prior to the end of 2007 the project was sold to Prudential and Lehman Brothers. Energy purchase agreements were signed by the utilities for 20 years of power that began commercial operation on November 21, 2007 (see Note 4). The percentage owned by each utility was determined based upon their contribution made during the original development stage. Phases 1 and 2 of White Creek Wind I have a total of 89 2.3 MW wind turbines for an anticipated output of 205 MW. Both phases were in production as of November 21, 2007. In 2012 and 2011, the District's investment in the project of \$11,317 and \$14,988, respectively, consisted of a share of the remaining assets. These amounts have been shown on the balance sheet as other investments and transmission deposits.

Note 11 – Contingencies

Lawsuits – The District is a defendant in various lawsuits. Although the outcome of these lawsuits is not presently determinable, it is the opinion of District management that resolution of these matters will not have a material adverse effect on the financial condition of the District.

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Note 11 – Contingencies (continued)

Construction financing – On April 17, 2001 the District entered into a thirty (30) year agreement with the Goldendale Energy, Inc. in order to provide for the transmission of the electric energy to be produced at Goldendale Energy Inc. generating facility from the E.E. Clouse Substation to Bonneville's Harvalum Substation. The generating facility was sold through bankruptcy auction in February 2007 to Puget Sound Energy. The District established a new letter of credit for the transmission line service, which the District built and operates for the generation facility. The letter of credit covers the net present value of the remaining contract amount including the debt outstanding.

Grants – Grants received by the District are subject to audit by the granting agency and may result in certain costs being disallowed and required to be returned. Management believes it has complied with grant guidelines and the likelihood of disallowed costs is remote.

Note 12 – Power Contracts

The District purchased power from BPA under a partial requirement contract which expired on September 30, 2011. Under this contract the District served a portion of customer load with existing generation from the McNary Fishway Project, approximately 5 MW. The balance of the District's load requirement is supplied by BPA at the public preference customer rate.

Effective October 1, 2011, the District entered into a Slice/Block Agreement with the BPA. The provisions of this agreement establishes the terms under which the District is committed to purchase its power for a period of seventeen years. The Slice/Block Agreement specifies that BPA rates are variable and includes provisions for various adjustments depending on actual load and BPA costs. In addition, the Slice portion of the agreement includes a true-up provision that allows BPA to recover Slice costs not previously recovered during the fiscal year. BPA assesses this true up on an annual basis. The true up is paid, or refunded if a credit, during the next fiscal year.

The Slice portion of the agreement commits the District to purchase a certain fixed percentage of BPA generation which varies depending on the available water and may result in power that is surplus to the District's needs and which the District intends to sell on the open market. The Block portion of the agreement specifies a specific amount of MWs BPA will supply to the district. This amount is adjusted per the contract on a yearly basis.

The White Creek Wind I facility energy purchase agreement for 13% of the 205 MW project was sold under contract to other utilities through March 2011. The output for the remainder of the year went to market (see Note 4).

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Note 13 - Generation Assets

H. W. Hill Landfill Gas project is rated a 26.0 MW plant that takes methane gas from the regional landfill and produces electricity from five 2.1 MW reciprocating combustion engines. 2.0 MW's of the output from this project is sold to a public utility and the balance sold on the spot market.

McNary Dam Hydroelectric project is a 10 MW plant that the District shares joint ownership with Northern Wasco Peoples Utility District in The Dalles, Oregon. The facility is located on the north shore fish bypass area of McNary Dam and received a 50-year license on September 30, 1991. Of the 5 MW's the District receives, 4.5 MW's are declared to load.

Note 14 - Union Contracts

The District has a contract with the International Brotherhood of Electrical Workers which covers the electrical line workers employed by the District. The District signed a new contract with the union which was executed beginning June 1, 2011 for a three year period.