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# Report of the Blue Ribbon Panel to the Chugach Electric Association Board of Directors

November 2007

The Chugach Electric Association (CEA) Board of Directors established a Blue Ribbon Panel (Panel) though resolutions on May 16, 2007, and June 20, 2007.

The purpose of the Panel is described in the May 16th resolution:

"As a first step, it's time to reach out to community leaders and appoint a small group of corporate executives with expertise to make a high level assessment of Chugach Electric and make recommendations. This group will be known as the Blue Ribbon Panel for Chugach Electric Association.

"The Review Panel will:

A. Review high-level performance measures and finances.
B. Make recommendations as to whether there should be a more detailed outside review, investigation and/or management audit undertaken.
C. Review Chugach Electric communications on the issues most important to its members and the business community.
D. If indicated, recommend how Chugach should restructure to deliver value in line with national economic performance standards for electrical utilities.
E. Make recommendations in other areas that it deems appropriate or that arise as it undertakes its review."

The members of the Panel were unanimously approved at the June , 2007, Board meeting.

Panel members

David Gottstein, President, Dynamic Capital Management
Robert Hickel, President, Hickel Investment Company
Loren Lounsbury, Former APUC Commissioner and Commerce Commissioner
Richard Lowell, President, Ribelin Lowell & Co. Insurance Brokers (retired)
John Wanamaker, Vice President, Seattle-Northwest Securities Corporation
Facilitator: William Noll, former Commissioner of Commerce, Community and Economic Development

Copies of these resolutions and biographies of the Panel members are at Tab 3.

The following report is respectfully submitted to the CEA Board by its duly appointed Panel.

Although the report is comprised of recommendations based on the review of a necessarily complex group of management factors, the Panel recommends the following three overarching guiding principles to the Board.

**The first guiding principle is to take all steps necessary to deliver the lowest possible long-term cost and rate structure for CEA's customers, coupled with the long-term viability and financial health of the utility.** Cost management and control should become a integral part of the CEA culture.

Not connected to America's national energy grid, getting electricity and power to Alaskans once was a challenge even in Anchorage. Because of the vital importance of providing power, reliability was given the highest priority.

It is therefore with justifiable pride that CEA points to performance records of very few power outages and a very high degree of reliability for its residential and business customers. CEA management presented the Panel with a statistic showing that CEA's power was on 99.98% of the time, which is a great achievement. Most Railbelt Alaskans by and large enjoy reliable and stable power supplies after a long history of no such reliability, a great tribute to CEA and the efforts of a long line of current and past employees.

On the other hand, a nationally recognized benchmarking firm reported to the Panel that CEA's distribution rates could be as much as 60% higher than those of utilities with similar customer density. Other analysts state that CEA has cost components that are twice national norms. This and other evidence suggests that CEA has several major and systemic deficiencies in its cost and delivery structure and operations, including among its collective bargaining units.

**The second guiding principle is the need for long-term planning on many levels, but particularly in terms of power generation and financial matters.**

The Panel recognizes the excellence of CEA management's presentations to the Panel. The quality of that input speaks well of the experience and know-how of the CEA management team.

**The Panel recommends that strategic planning in five-year, ten-year and longer increments needs to be done and updated annually.**

Particular attention should be in power generation and financial areas. There should be a clearly written and well-understood debt plan. Those plans should be well understood and communicated on several levels: by CEA Board and staff; to CEA Co-op membership; and to energy customers of the Railbelt.

**The third guiding principle is the need to eliminate the co-op as the business model and concentrate on other models to achieve a more efficient, cost effective and financially healthy utility.**

Some of the reasons for this are: no one acts as owners; only about 15-20% of CEA members bother to vote; management and labor are often stalemated; risk capital management is not properly motivated to take or mitigate investment risk, resulting in a climate where both management and labor cannot optimize their performance for the long-term financial health of CEA.

CEA and ML&P merger discussions should continue. The Panel also feels that Railbelt-wide joint discussions need to be front and center for the good of the utilities and, more importantly, for the good of the Railbelt consumers.

**Therefore, the Panel recommends that planning for mergers or some other sort(s) of coordinated effort, including but not limited to privatization, in Railbelt power generation, transmission and distribution needs to receive a very high priority. The CEA Board needs to undertake a serious initiative to separate Generation & Transmission from Distribution.**

## Management and Governance Segments

The balance of this report is broken down into several segments.

The Panel recognizes that its recommendations will lead to two categories of action: those that CEA can accomplish on its own, such as costs of certain operations; and those that can be achieved by some combination of efforts, such as with its sister utilities or the Regulatory Commission of Alaska (RCA).

## Financing

*The financing segment contains three areas of concern. The first is that hundreds of millions of dollars of balloon debt is coming due within the next several years in early 2011 and 2012, without a sophisticated and interest rate sensitive plan of re-finance in place (or at least one that has been adequately conveyed to this Panel or to CEA's Board). This occurs during the period where CEA's two largest customers, Matanuska Electric and Homer Electric Associations, may look to other sources of power. (This should not be confused with the additional need to have a broad based long-term financial plan.)*

*Secondly, the fact that the debt coming due represents unamortized costs of generation assets that have passed their useful life means that the utility is faced with paying for the past from the future and is looking to rely on increased generation efficiencies and population growth in order to fund it.*

*Thirdly, unless CEA is able to normalize its relationship and costs with its operational units, and cost-optimize the generation, transmission, and distribution of electricity for itself and other utilities within the Railbelt, it will either face having to pass unjustified costs onto the rate payers, or will face financial decay and or future crisis.*

The Panel recommends that CEA should develop a more comprehensive plan of finance within the next 60-90 days, with particular attention to debt management. The Board should authorize management to retain qualified advisors and/or institutions to assist in the development of such a plan.

The Panel feels that CEA must maintain and expand contacts with financing institutions and rating agencies to provide the best financing possible. Strong improvement in cost controls and the bottom line must become priority goals for CEA. As part of any internal assessment and restructuring opportunities, the Board should have an appraisal done of CEA by an appropriate contractor.

The following are some specific suggestions that should appear in the debt and financial plans.

(1) The useful lives of CEA's assets should be matched, in the least case, with debts associated with those assets. For example, if an asset has a remaining

useful life of fifteen years (sometimes irrespective of its book-assigned remaining depreciable life), then the debt should at least be paid off by the time the asset needs to be replaced.

(2) Have near, mid and far range debt plans that demonstrate the debt allocation that will bring the best average or blended cost of funds (i.e., the mix of fixed rate, variable rate, amortizing debt, and bullet debt).

(3) Test the debt plan against the market on a regular basis. Having a Financial Advisor would help CEA Management with this task. The Financial Advisor would constantly stay abreast of the market rates, liquidity, and financial instruments that may be used by CEA.

(4) Long-term debt should be paid on a fully amortized basis or have the flexibility (without penalty) to pre-pay principal payments prior to maturity on interest-only debt. The existing bond/debt covenants should be reviewed as to their flexibility in early pre-payment and/or refinancing of existing debt. Seeking longer amortization schedules with no pre-payment penalties or "factored in" pre-payment penalties needs to be reviewed periodically.

## Labor

*On the one hand, management and the Board recognize and appreciate the value and importance that both its union and non-union employees contribute to the delivery of CEA's reliable energy service. However, as a result of political action efforts on the part of Labor, coupled with a non-active co-op membership, the natural balance between the board/management and labor has been compromised. The result is often fractured and volatile management direction, and a labor cost structure that cannot be justified.*

*A lack of transparency and the lack of proper management tools such as benchmarking, detailed internal data, and others results in a significant lack of up-to-date critical management data. Cost comparisons should be able to be made and benchmarked against similar utility services. The lack of transparency has kept hidden the need for better and up-to-date tools and information.*

The Panel offers several recommendations, the first of which is that CEA must work hard towards positioning itself so that it can't be held hostage by any collective bargaining unit in CEA's duty to deliver reliable 24/7 electrical service to all its customers. It must be able to bargain from a position of strength, not weakness. It must have the management tools so that it knows, and reports to all, including to the union, what its costs are.

The Board should take direct positive steps to re-establish and maintain a productive balance between CEA management and the collective bargaining units. This might include public disclosure of benchmarking, to the degree that labor costs are a bargaining chip in this effort. This also affects CEA governance, including the review of labor funding of Board candidates' campaigns. Transparency is an important factor in all of this. Management should have the full confidence of the Board and should represent CEA customers at the bargaining table, with only policy and direction from the Board.

CEA management stated that there is a national shortage of linemen and other electrical skills. There are statutory and contractual obstacles in making certain that adequate skilled labor is available. CEA should establish a company-sponsored training program to train potential employees in the skill areas needed. This can be done in cooperation with other employers needing the same skills. Look for cooperation and co-funding opportunities from the Federal and

State Departments of Labor. Both urban and rural training centers could be contemplated.

CEA must develop contingency plans for a strike or, for that matter, the loss of workmen for any other emergency situation, such as epidemics or terrorist acts.

At least one study shows wages higher than average. If there is not an active Compensation Committee, then form one, and meet at least once a year. Review the establishment of a CEA productivity incentive program.

CEA should establish the cost per hour for CEA labor by adding all cost factors such as wages and fringe benefits, then dividing by hours worked. Further study should be done for "wrench time," which refers to the actual hours of work performed by an employee for the same time period. Thirdly, do an analysis of the work product for each actual hour worked to arrive at the total cost per unit of production. The results should be benchmarked with utilities nationwide, with appropriate adjustments for COLA, etc. This benchmarking should be performed by an independent company and should be made public in accordance with the principle of transparency.

## Benchmarking

***Benchmarking is a catch-all term used to describe an ability to compare macro and micro sales and cost components against an external group of entities delivering like products and services. It is a critically important tool in the management and cost containment program of any utility.***

The Panel recommends that benchmarking be kept up-to-date with at least a major study every five years, with updates annually. Benchmarking is a powerful tool to identify areas of strength and, more importantly, opportunities for improvement. In keeping with the principle of transparency, benchmarking results should be made public. CEA does some benchmarking now, but it is inadequate. Benchmarking should be comprehensive and cover <u>all</u> CEA activities, not just select favorites. Distribution costs are high at CEA. Generation and transmission have not been benchmarked at the macro-level.

Here is an example of the value of benchmarking. The Blue Ribbon Panel commissioned the national benchmarking firm of UMS to report to the Panel on CEA through the year 2006. UMS reported to the Panel that CEA was off the charts in the cost of delivery compared to the norm for utilities of similar density. UMS says that CEA has a very inefficient distribution cost structure. Refer to UMS's report at Tab 10 of this report.

The CEA Board needs to direct management to take immediate remedial action.

## Governance

*Swings in the CEA Board's balance of power are unhealthy for consistency of message to management. Changing Board members and goals affects management motivation in deleterious ways. The Board needs to relate with management through the CEO. The Board should not be involved with matters properly handled by management.*

*It is inappropriate for Board members to have any agenda outside their fiduciary responsibility for direct or indirect benefits to the ratepayers, and the long-term health of the Co-op.*

*There appears not to be an ongoing program for new director Board orientation and continuing training.*

*CEA lacks an information strategy and communication campaign.*

The Panel makes the following recommendations. Change the bylaws to increase the size of the board to not less than nine members, making three-year terms for each Board member. This action will tend to slow the swing in any balance of power.

The Panel recommends naming three designated seats on the Board, mandating that at least one Board member be an engineer, one be a CPA, and one be a businessperson.

Ensure that there are active Audit and Compensation Committees.

The Board should provide a thorough orientation, especially for newly elected members. New Board members need to be briefed on all historical matters, including benchmarking and financial information as mentioned above. Board members should be provided an on-going training program during their term in office.

CEA needs to design and deliver an information campaign to its employees, members, and other local and Railbelt residents. This strategy should bring honest information on where the utility is now, not only in terms of reliance but also in its quest to deliver the lowest possible rates to its customers, demonstrating where CEA meets the performance of its peers, where it is lacking and how it is working to improve.

The Board needs to be careful that management's implementation of this strategy conforms to the Board's vision of transparency and dedication to an open process, which are stepping stones to a fully informed membership and public, which in turn leads to the most efficient and cost effective system possible.

## Structure

*There are a number of questions and problems that have arisen during the course of the Panel's listening and deliberating. Some, if not all, have been addressed in some fashion above. However, this is the last segment of the Panel's recommendations to the Board, so the Panel chooses to make a statement of the whole on the subject of structure.*

*Statements that our Railbelt power system is broken ring true. It at least appears to be far from optimal. Those elements that worked so well in developing reliable power during earlier years seem now to clash, and that works against the consumers' best interests in any manner you define them.*

*There is an issue about fair representation for members of wholesale customers such as MEA, HEA and Seward.*

The co-op model system is broken and obsolete. What shall the replacement look like? Replacement models include privatization, more municipal ownership or involvement, a Unified System Operator, an Investor Owned Utility, or some other form, including any hybrid of the aforementioned.

**The Board should direct a thorough review as to what structure provides the best opportunity to provide the lowest cost and most efficient and reliable long-term electrical power to Railbelt consumers in general, and to CEA members in particular.**

The Panel has spoken above on the leadership role CEA should play in addressing these questions and deciding the answers. To this end, the Panel highly commends the Board for taking the bold step of asking for outside recommendations from the Panel members. The Panel thanks the Board for the opportunity to provide its input.

The Panel strongly urges that CEA Board members start now to work cooperatively together. CEA should move aggressively with its sister utilities, the Regulatory Commission of Alaska (RCA), and the Alaska Energy Authority (AEA) on the subject of Railbelt rationalization. (In the business world "rationalization" means to align and deploy assets in the most economic and efficient manner.)

The Board should consider making use of the opportunity presented by Matanuska Electric Association's recent RCA filing to flesh out this subject.

The $800,000 appropriated to AEA for a Unified System Operator (USO) study should be tapped for this and other planning purposes. Given its size and importance to the Railbelt, CEA can become the *de facto* leader on this initiative.

Summary

1. **The Panel recommends that the Board immediately engage in an all-out effort to rationalize the Railbelt utilities, considering whatever form or combination of forms benefits the rate payers the most.**
2. **Take all steps necessary to deliver the lowest possible long-term cost and rate structure for CEA's customers.**
3. **Strengthen planning on many levels, but particularly in terms of power generation and financial matters.**
4. **Take action to eliminate the co-op as the business model and concentrate on other models to achieve a more efficient, cost effective and financially healthy utility.**
5. **Take steps to normalize relations between CEA management and labor.**
6. **Comprehensive benchmarking in all CEA activity areas must be kept up to date, with at least a major study every five years and updates annually.**
7. **Transparency must be an integral part of CEA's agenda. As a part of that, CEA should improve its internal and external information and communication strategies.**

Leadership for these recommendations and initiatives should start with the CEA Board.

**The Panel recommends that the CEA Board should initiate the Panel's recommendations immediately. Start the leadership process with that which it can and does control: transparency, planning, benchmarking, labor and structure.**

CEA should use its powers of communication and advocacy and work zealously for the benefit of its members. Today, frankly, CEA does not give forth that image. It seems reactive rather than proactive, perhaps a product of the long struggle for delivery of reliable energy, but no longer acceptable.