

Use of Derivatives

- *Derivatives* is a generic term for a variety of financial instruments that derive their value from other financial instruments
 - Usually a contract rather than an asset
 - Essentially a promise to convey change in value of the asset, rather than the asset itself
 - Payments may be made regularly (in the case of interest rate swaps) or at end of the contract (in the case of rate locks) based on the face amount of the contract (“notional amount”) and the change in value
 - Requires little or no initial investment
 - In the event both parties are obligated to make payments (in the case of interest rate swaps), the contract provides for “net settlement” of payments
 - Often can be terminated at the prevailing market price or “replacement value”
- Primarily used as tools, within a debt portfolio, to manage risks and exposures
 - Hedge against future changes in interest rates
 - To convert interest rate exposure from variable rate to fixed rate, or vice versa
- Rules governing derivative accounting promulgated in 1998
 - FAS 133 – Accounting for Derivative Instruments and Hedge Activities
 - Amended by SFAS 137 – Deferral of Effective Date of FAS 133 and SFAS 138 – Accounting for Certain Derivative Instruments and Certain Hedge Activities
 - Requires all derivative instruments be recorded in the financial statements at “fair value”
 - Requires that the gain or loss due to changes in fair value depends on whether the instrument qualifies as a hedge
 - If a hedge, accounting varies based on the type of risk being hedged
 - If not a hedge, gains and losses must be reported when they occur
 - FAS 71, Accounting for the Effects of Regulation, also impacts Chugach and requires that financial reporting for derivatives follow regulatory treatment
- In 1999, interest rates were low and were expected to rise. Chugach had three options for managing the refinancing risk associated with the Series 1992A Bonds, which were first callable in 2002.
 - Ignore risk
 - Do not hedge and take a chance on interest rates in 2002

- Incur substantial cost to lock-in prevailing rates
 - Issue refunding bonds in 1999 and carry the added cost (i.e. create a second mortgage while still paying first mortgage for three more years)
- Create an “insurance policy” to minimize future impact of interest rate changes in 2002
 - Use a treasury rate-lock to manage risk exposure
- How the Rate Lock Worked
 - Basis of contract: Derived its value from a combination of the 10-year Treasury security and 30-year Treasury security to replicate the average life of the Series 1992A Bonds
 - Final Maturity: The rate lock termination coincided with the first call date of the Series 1992A Bonds (March 2002)
 - Valuation: Depending upon market movement from 1999 (date of execution) through termination of contract in 2002
 - Terms: Chugach could optionally terminate the contract prior to 2002 at market value
- Results
 - Interest rates had declined at termination of the Rate Lock relative to 1999 interest rate levels
 - This rate lock terminated in stages by end of 2001
 - Settlement payment of \$7 million recorded as a “regulatory asset” under FAS 71 and is currently being amortized to interest expense because Chugach is recovering the cost of the rate lock through rates
 - Chugach entered into a short term rate lock prior to the 2002 call date on the Series A bonds
 - Chugach received a \$1.2 million payment upon termination of this rate lock which was recorded to reduce the “regulatory asset” above and is currently being amortized to interest expense and recovered through rates
 - Series 1992A bonds were refinanced at the call date from 9.14% in two tranches, one at a fixed rate of 6.20% and the other at a variable rate that has averaged 1.66% since inception
 - The increased savings resulting from waiting until 2002 to undertake the refinancing *combined with* the termination value of the Rate Lock resulted in lower net interest expense than if Chugach had refinanced in 1999