STANDARD & POOR'S

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February 14, 2008

Chelan County Public Utility District No.1, Washington; Retail Electric; Wholesale Electric

Primary Credit Analyst:
Peter V Murphy, New York (1) 212-438-2065; peter_murphy@standardandpoors.com

Secondary Credit Analyst:
Ian Carroll, San Francisco (1) 415-371-5060; ian_carroll@standardandpoors.com

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Credit Profile		
US$40. mil cons sys rev rfdg bnds (taxable) ser 2008A due 07/01/2024		
Long Term Rating	AA/Stable	New
Chelan Cnty Pub Util Dist #1 hydro-elec (Rock Island) (MBIA)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Chelan Cnty Pub Util Dist #1 (Chelan Hydroelec Cons Sys) Sr lien		
Long Term Rating	AA/Stable	Affirmed
Chelan Cnty Pub Util Dist #1 (Rocky Reach Hydroelec Sys) Sr lien		
Long Term Rating	AA/Stable	Affirmed
Chelan Cnty Pub Util Dist #1 (Chelan Hydroelec Cons Sys) (FGIC)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services assigned its 'AA' rating, and stable outlook, to Chelan County Public Utility District No. 1, Wash.'s series 2008A consolidated system revenue bonds (subordinate lien). At the same time, Standard & Poor's affirmed its 'AA' long-term rating and 'AA' underlying rating (SPUR), with a stable outlook, on Chelan's existing bonds.

The series 2008A bonds are being sold in fixed-rate mode and are taxable, while an upcoming series 2008B bond issue will be sold as variable-rate demand bonds.

The 'AA' rating reflects the strong business profile and modest financial risk of the district's consolidated system, which includes its electric, water, and wastewater utility; telecommunications unit; and the Lake Chelan hydroelectric project. The consolidated system is the ultimate obligor for the district's various utility systems and hydroelectric projects issuing debt through the consolidated system's bond resolution. As with the issuance of several series of bonds in 2007, Chelan has covenanted that it will not issue debt with a lien prior to the lien on the series 2008 bonds, which effectively closes what is the current senior lien. In addition, under the new subordinate-lien resolution, legal protections have improved slightly. Consequently, Standard & Poor's does not distinguish between the two liens.

As of Dec. 31, 2007, the district had $658 million in hydroelectric consolidated system debt and $297 million in project debt at its Rocky Reach and Rock Island hydroelectric projects, although more than half of this combined debt burden is serviced by hydroelectric project offtakers under long-term, take-or-pay, cost-of-service contracts.

The rates and charges of the retail utilities, as well as certain intersystem loan payments from the district's two large hydroelectric systems, secures the consolidated system bonds.

The district, established in 1936, owns and operates an electric distribution system, a telecommunications system, three major hydroelectric power generating projects (Rocky Reach, Rock Island, and Lake Chelan), and a small water and wastewater system. The district issues debt primarily through its consolidated systems bond resolution, a financing vehicle created in 1987, for issuing tax-exempt debt on behalf of both the retail utilities and the hydroelectric projects from which the district derives most of its power. As of 2007, the district rescinded the consolidation of the Rocky Reach and Rock Island projects in order to preserve the flexibility in hydroelectric project financing arrangements.

Chelan's strong business profile ('3' on Standard & Poor's 10-point scale, with '1' as the strongest) is characterized by the district's rate-setting ability, extremely low-cost power supply, moderate asset and resource concentration, and a low degree of merchant risk-related nonfirm surplus sales. The district's low-cost power supply is derived from its three hydroelectric plants, which produced power at an average $18 per megawatt-hour (MWh) in 2007. The cost is projected to increase modestly each year to about $21 by 2010, assuming average hydrological conditions. The hydroelectric projects are competitive even under very low stream-flow conditions, as demonstrated most recently during the extreme 2000-2001 winter drought (the second-worst on record), when the production costs averaged a still-competitive $17 per MWh. Chelan officials estimate that under critical water conditions, project costs would remain below $25 per MWh, well below the likely market price in the region under such a scenario. The district has surplus power during nearly all months of the year. The sale of surplus power subsidizes retail rates.

Like its mid-Columbia neighbors, Grant County Public Utility District (A+/Stable) and Douglas County Public Utility District (AA/Stable), Chelan sells far more power to contractual offtakers and the wholesale market than it does to its own retail system. Chelan's distribution system currently takes about a third of the aggregate output from its Lake Chelan, Rocky Reach, and Rock Island projects and sells the remainder of the output to other utilities in the region through long-term, take-or-pay contracts that expire by 2012. The power sales contracts permit Chelan to charge offtakers for their allocable shares of operating and debt service costs, plus 15% rolling coverage on interest payments. Chelan's distribution system still has surplus capacity in nearly all months, even under very low water conditions. Short-term and market sales of this surplus capacity, including sales to Alcoa Inc. and the Douglas County district, accounted for a significant portion of operating revenues at the retail system and an even larger percent of net revenues, given that margins on these sales exceed those at the retail level.

Debt service coverage (DSC) ratios at the consolidated system were a strong 1.6x for fiscal 2006. DSC at the retail distribution level remains highly sensitive to wholesale sales not made under long-term contracts. The lower coverage ratio for the consolidated system is indicative of the cost-of-service contracts supporting most of the debt, as explained below.

Outlook

The stable outlook reflects Chelan's strong financial policies regarding DSC and liquidity, as well as the district's low cost power supply. Though concern remains regarding the district's continued reliance on wholesale sales that have generated substantial margins even under adverse stream-flow conditions, Standard & Poor's expects that management and the governing board would take steps to adjust net income under such a scenario.

Stable Economic And Customer Base

Chelan County is located in central Washington. The county's population grew more than 20% during the past decade. The Cascade Mountains, Columbia River, and forests and lakes attract recreation and tourism, second-home development, and retirees. Wenatchee, located 140 miles northeast of Seattle, is Chelan's county seat and largest city. The county has below-average economic characteristics. Agriculture, primarily apple and other fruit production along with related industries, accounted for roughly one-sixth of employment. Services and trade round out the economic base. The unemployment rate (5.2% for the 12 months ending December 2006, the lowest level in six years) is typically above the national average, while household income is 92% of the national average. Leading employers include various medical, educational, and agricultural concerns, as well as local governments and the district itself. Alcoa is also a key employer, producing aluminum at a plant that also generates substantial electric sales.

Chelan serves retail electric service to 45,371 customer accounts, mainly in Chelan County, but also in parts of adjoining counties. Customer growth has averaged 1.7% annually the past four years, indicating the steady pace of the county's economic growth, as well as the manageable level of related capital pressures on the distribution system. Alcoa, which employs 377 workers at its Wenatchee Works smelter, is the distribution division's leading customer, accounting for about 14% of distribution sales.

This concentration is mitigated by provisions in the Alcoa contract that link prices to actual costs of production on a take-or-pay basis. The contract with Alcoa runs through Oct. 31, 2011. Importantly, the district is negotiating an extended long-term contract with Alcoa with favorable economic incentives for that nevertheless will improve the district's financial position, and insulating the district somewhat from capital pressures at its two main hydroelectric projects. In addition, Chelan has contracted to sell 2.77% of its share of hydroelectric production at Rocky Reach and Rock Island to the Douglas County district; the share will increase by an additional 2.77% from 2011 to 2021 and will be subject to renewal in 10-year increments to 2061.

Strong Hydroelectric Assets

The district benefits from an excess of low-cost hydroelectric generation. Energy from the district's three hydroelectric projects cost just $15 per MWh in 2007 and is economical even at near-critical water levels, as was realized in 2001. Including firm purchases, the distribution system's average cost of power was a still-low $18/MWh in 2007.

The district is generally a net seller of power, since its allocation of hydroelectric power is sufficient to meet retail load requirements, except under the most adverse of stream-flow conditions, or on days with exceptionally cold weather in which local demand may exceed supply. As such, the district generally derives a significant amount of its net revenues from wholesale operations, which subsidizes its retail distribution operations. Generation at the district's hydroelectric projects is driven by Columbia River stream flow below the Grand Coulee Dam, which is correlated with stream flow at The Dalles, Ore. (which is also affected by Snake River stream flow), the major pricing hub in the Pacific Northwest.

Low Cost Power Supply, Increased Output

Chelan operates three major hydroelectric projects, which together represent nearly 2,000 MW and generated more than 9.5 million MWh in 2007, up 9.2 million in 2006. Last year was the fourth consecutive year of increasing project output, a trend that is inverse to average cost per unit. A portion of the output from the two leading projects is sold to third parties, pursuant to long-term power supply contracts, which expire in 2011 and 2012. The district has renegotiated a 20-year contract with Puget Sound Energy commencing in 2011, and expects to secure contracts with other purchasers for the post-2011 period in the coming years.

The Rocky Reach system is located on the Columbia River and has a nameplate capacity of 1,300 MW. Its 11 turbine generators provide significant operational flexibility. Average production costs are stable, and including debt service, was $12 per MWh the past two years, and only $14 per MWh in 2001, even though that year's drought suppressed stream flow to "critical water" levels. Chelan's distribution system has a 41% allocation of project output, of which a portion is resold to Alcoa (23%) and the Douglas County district (2.77%, with an option to take an additional 2.77% beginning Nov. 1, 2011). In 2006, the facility provided roughly 49% of the Chelan distribution system's total power supply.

The Rock Island system is located on the Columbia River and has a nameplate capacity of 624 MW, generated by 19 turbines. The average cost of production was roughly $24 per MWh in four of the past five years through 2007. The Rock Island project produced power at $23 per MWh during 2001, under severe drought conditions. As of Dec. 31, 2007, the district's share of the total project output is 50%, after Chelan exercised a series of purchase options to increase its share of project capacity. In 2006, the facility provided approximately 32% of the Chelan distribution system's total power supply.

The Lake Chelan hydroelectric project provided 10% of the Chelan distribution system's total energy requirements in 2006 and 2007 at an average cost of production of about $11 per MWh. The Chelan distribution system receives 100% of the 59 MW hydroelectric plant's output. The district also owns a share of the first two phases of Energy Northwest's 9 Canyon Wind project, totaling about 8 MW of wind energy.

Regulatory Compliance And Relicensing

The current licenses for Rocky Reach expired in July 2006, and Chelan is operating under an annual license while final approvals for a new 50-year license are progressing. Chelan expects a new license to be granted by FERC for Rocky Reach sometime in 2008. The license for Rock Island does not expire until 2028. In November 2007, Chelan received a new 50-year license for Lake Chelan.

At Lake Chelan, the net present value cost of implementing the recently approved 50-year FERC license is projected to be approximately $68 million; the amount includes fish protection, mitigation, and enhancement measures, among other operating and capital costs.

Fifty-Year Habitat Conservation Plan

Chelan has developed a habitat conservation plan (HCP) that outlines the district's efforts for a 50-year period. The plan's goal is to ensure that there is no net affect on fish from the operation of its hydroelectric facilities. The district is responsible for 91% fish passage (survival) at the Rocky Reach and Rock Island projects and 9% compensation from hatcheries and tributary programs. Various interested parties have agreed to be supportive of the district's license applications filed during the 50-year proposed term of the HCP.

In June 2004, FERC approved Chelan's HCP application and amended the Rocky Reach and Rock Island operating licenses to incorporate the plant. Chelan is engaged in full implementation of the HCP programs. At Rocky Reach, Chelan spent approximately $112 million for the juvenile fish bypass system, and its license will require periodic updates using state-of-the-art technology. In 2007, Chelan's management reported that the district will reduce spill at the Rocky Reach and Rock Island dams due to the success of the HCP in fish survival rates, flows through the generators at the projects should increase as a result, leading to increased wholesale sales.

Extremely Low Rates Aid Competitive Position

With extremely low power production costs, the district has very low wholesale and retail rates. Its long-term power sales contracts for Rocky Reach and Rock Island expire in 2011 and 2012, respectively. Chelan's retail customers enjoy what are among the lowest rates in the country, averaging three cents per kilowatt-hour (kWh) in 2007, compared with the average system rate in Washington of about six cents per kWh. Industrial rates are a low 1.9 cents per kWh. Chelan's wholesale generation is also exceptionally competitive, with average production and purchased power costs of just $18 per MWh in 2007, compared with Bonneville Power Administration's priority firm rate of about $30 per MWh. The district expects to maintain a competitive position at both its retail and wholesale operations. Retail rates were increased 5% as of Jan. 1, 2008, the first rate increase since 2000, when rates were raised by a modest 2.5%. Importantly, the district did not raise rates during the lingering drought period earlier this decade, though most other utilities in the region did, some dramatically. At the same time, the district raised water and sewer rates by 9%, and rates for telecommunications services by 2%, as part of a strategy to align revenues with costs for each business unit.

Finances: Strong Debt Service Coverage And Liquidity

DSC of all debt is strong for the consolidated systems, at 1.6x for fiscal 2006. Fixed-charge coverage was a strong 1.5x in 2006. While audited figures for the fiscal year ending Dec. 31, 2007, are not yet available, net income available for debt service in 2007 increased over 2006, based on strong wholesale sales and stable power costs. Annual debt service levels remain dependent upon wholesale sales and margins, and consequently can vary with hydrological conditions and regional power market prices, although the recent retail rate increase will somewhat reduce the affect of volatile hydrology on debt service coverage ratios. Coverage of project revenue bonds is maintained at 1x, with the power purchasers charged just the cost of production, including all debt service, plus an additional 15% rolling coverage on interest.

District management projects solid DSC at the retail level above 1.75x, and unrestricted cash reserves maintained at or above $75 million, keeping with the district's minimum policy targets. Current liquidity levels well exceed the targets, although debt reduction and cash-funding of capital projects reduced the overall level in 2007 to about $140 million. In 2007, the district funded a recently established rate stabilization($50 million) and an operating reserve ($52 million). Management has and will consider temporary rate surcharges if it is determined that financial target performance is threatened, although this was not necessary in 2007.

Chelan has a strong, liquid balance sheet for both the consolidated and distribution systems. Unrestricted cash and investments, which totaled $139 million as of Dec. 31, 2007, are the equivalent of roughly 400 days' expenditures. An equity layer of 25% provides Chelan with significant flexibility for planned additional borrowings.

The district's five-year capital improvement plan (CIP) indicates modest ($103 million) amount of projects for the distribution division, and an additional $50 million for the broadband telecommunications system. However, Chelan projects $142 million of additional debt-funded borrowing and $65 million from inter-system loans for hydroelectric projects during the 2008-2012 period, as part of the projects' estimated $257 million of projects, mostly at the Rock Island dam.

Legal Provisions

The legal provisions for consolidated system revenue bonds are weak overall, due to low coverage tests for the rate covenant and additional bonds test. The senior consolidated system resolution, however, is effectively closed by a new resolution under which the 2007 and 2008 bonds are being issued. The newer resolution has different legal provisions that make some improvements from a credit perspective. These improvements include the addition of flow-of-funds provisions and a rate stabilization fund, as well as tighter language on the additional bonds test and rate covenants. The rate covenant for the consolidated hydroelectric system bonds requires the district to collect revenue that provides annual revenues, together with other unencumbered funds of the district, in an amount sufficient to pay operating expenses of the consolidated system and cover debt service by 1.25x. In addition, distribution system net revenues alone must meet a DSC test of 1x for senior bonds, while the subordinate-lien test allows the use of rate stabilization funds. A debt service reserve is maintained for the consolidated system senior- and junior-lien bonds in the amount of maximum annual interest payable in any future year.

Debt Derivative Profile: Low Risk

The district's consolidated system has been assigned a Standard & Poor's Debt Derivative Profile (DDP) overall score of '1.5' on a scale of '1' to '4', with '1' representing the lowest risk and '4', the highest.

The DDP overall score of '1.5" reflects Standard & Poor's view that Chelan's electric-system-related swap portfolio reflects a very low credit risk at this time due to:

- Highly rated swap counterparties;
- A low degree of involuntary termination risk under the county's swaps due to a wide ratings trigger spread;
- Average economic viability of the swap portfolio over stressful economic cycles, due to the relative long term of the swaps; and
- Strong management practices regarding debt and derivatives.

Chelan has entered five floating- to fixed-rate swaps with a notional amount of roughly $231 million. Two of the swaps, with a notional amount of $93 million, became effective May 31, 2007, and are associated with a like amount of series 2008B refunding bonds. The other three swaps are forward-starting swaps, and will take effect upon the issuance of other refunding bonds, which Chelan expects to issue in 2009, 2011, and 2013. The 2007 swaps are with Bear Stearns Capital Markets Inc. (guaranteed by Bear Stearns Cos. Inc.), and Lehman Brothers Special Financing Inc. (guaranteed by Lehman Brothers Holdings Inc.). The other counterparties are JPMorgan Chase Bank N.A. and Goldman Sachs Mitsui Marine Derivative Products L.P. (guaranteed by The Goldman Sachs

Group Inc.). The documents for the various swaps list the issuer's rating falling below 'BBB' as an additional credit event. This is seen as remote, due to Chelan's consolidated system's strong credit profile. In addition, the swap insurer's rating, currently 'AAA', must fall below 'A-'. Net variable-rate exposure is minimal, as Chelan has swapped most of its variable-rate bonds to a fixed rate. Chelan manages its debt and swap program with an adopted swap and debt management policy. Due to the low degree of termination risk, Standard & Poor's is not factoring in the swaps' value at risk as contingent liabilities for Chelan's consolidated system's revenue bonds.

Ratings Detail (As Of February 14, 2008)		
Chelan Cnty Pub Util Dist #1 chelan hydro cons (AMBAC)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Chelan Cnty Pub Util Dist #1 chelan hydro cons (FSA)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Chelan Cnty Pub Util Dist #1 chelan hydro cons (MBIA)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Chelan Cnty Pub Util Dist #1 cons sys (MBIA)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Chelan Cnty Pub Util Dist #1 elec (XL CAPITAL)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Chelan Cnty Pub Util Dist #1 (Chelan Hydroelec Cons Sys) Jr lien		
Long Term Rating	AA/Stable	Affirmed
Chelan Cnty Pub Util Dist #1 (Chelan Hydroelec Cons Sys) (taxable) Sr lien		
Long Term Rating	AA/Stable	Affirmed

Many issues are enhanced by bond insurance.