STANDARD & POOR'S
PUBLIC FINANCE

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

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Credit Profile

US$147. mil elec rev bnds ser 2004 dtd 03/31/2004 due 03/31/2034
AA
Sale date: 15-APR-2004

AFFIRMED

$143.365 mil. Chelan Cnty Pub Util Dist #1 (Chelan Hydroelec Cons Sys) Sr lien
AA

$28.050 mil. Chelan Cnty Pub Util Dist #1 Chelan hydro cons sys rev bnds ser 1998A dtd 09/01/1998 due 07/01/2028 2030
AAA/AA(SPUR)

$2.250 mil. Chelan Cnty Pub Util Dist #1(Chelan Hydroelec Cons Sys) (taxable) Sr lien
AA

$79.905 mil. Chelan Cnty Pub Util Dist No 1 chelan hydro cons sys rev bnds ser 2002 A&B dtd 12/12/2002 due 07/01/2037
AAA/AA(SPUR)

$30.000 mil. Chelan Cnty Pub Util Dist No 1 chelan hydro cons sys rev bnds ser 2002 C dtd 12/12/2002 due 07/01/2003-2014 2017 2022 2033
AAA/AA(SPUR)

$65.620 mil. Chelan Cnty Pub Util Dist No 1 cons sys rev bnds ser 2001A dtd 03/01/2001 due 01/01/2036
AAA/AA(SPUR)

$28.655 mil. Chelan Cnty Pub Util Dist No 1 hydro cons sys rev bnds ser 2001C dtd 04/01/2001 due 07/01/2032
AAA/AA(SPUR)

$396.225 mil. Chelan Cnty Pub Util Dist No.1 (Chelan Hydroelec Cons Sys) Jr lien
AA

OUTLOOK:
NEGATIVE

Rationale

Standard & Poor's Ratings Services revised its rating outlook to negative from stable on Chelan County Public Utility District (PUD) No. 1, Wash.'s hydroelectric consolidated system revenue bonds. At the same time, Standard & Poor's affirmed the 'AA' rating on the bonds and assigned its 'AA' rating to the district's $147 million electric revenue bonds, series 2004. The rating reflects:

- Very low production costs at the district's three hydroelectric projects, which averaged $17/MWh in 2003, and remained low even under the near "critical" water conditions of 2001;
- Residential retail rates of 3.0 cents per kWh in 2003, which remain among the lowest in the country;
- Strong direct debt service coverage of 2.88x at the distribution system and solid debt service coverage of 1.19x at the consolidated system in 2003;
- Strong liquidity, with unrestricted cash reserves projected to increase to about $81 million from $65 million at fiscal year-end 2003 due to anticipated reimbursement with bond funds; and
- Low-to-moderate adjusted debt leverage of about 50% for Chelan's combined utility system and 68% at the consolidated system for fiscal 2003;

The district's ability to earn wholesale revenues from surplus non-firm hydroelectric generation allows it to maintain strong coverage without a substantial rate increase, although these revenues have been shown to be robust even under low streamflow conditions.

The bonds are secured by revenues of the consolidated system, which includes the Lake Chelan hydroelectric project, the distribution system, and the water and wastewater system, as well as certain intersystem loan payments from the district's two large hydroelectric systems. Standard & Poor's does not make a rating distinction between the closed senior lien and the working junior lien because the senior lien accounts for only 17.4% of total consolidated debt as of Dec. 31, 2003.

The district, established in 1936, owns and operates an electric distribution system, a telecommunications system (as part of its electric distribution system), three major hydroelectric power generating projects--Rocky Reach, Rock Island, and Lake Chelan, a small water system, and a small wastewater system. The consolidated system lien, which includes each of these systems other than the two large hydroelectric systems (Rocky Reach and Rock Island), was created in 1987 as a means to issue tax-exempt debt for both the municipal utilities and the hydroelectric projects from which the district derives most of its power. Chelan has been assigned a business profile of '3' on Standard & Poor's 10-point scale, with '1' being highest.

The district's low cost of power is derived from its hydroelectric plants, which have produced energy at an extremely competitive average cost of $17/MWh or less, including during the 2000-2001 winter drought when water conditions were the second-worst ever recorded. Current take-or-pay contracts with long-term power purchasers for approximately 76% of the Rocky Reach and Rock Island projects' output allow the district to recover only production costs plus 15% rolling coverage on interest. Once these contracts expire in 2011 and 2012, however, the district will be free to negotiate new contracts and/or sell this output at market rates, expected to be well above production costs, which would give the district healthy operating margins. The remaining output of the hydroelectric projects is currently sold to the district's distribution system.

The district has surplus power during most periods of the year. The sale of surplus power during the 2000-2001 winter drought at high market prices more than compensated for high-priced purchases in other periods that were necessitated by the low water levels. The district weathered the severe power crisis in 2001 without rate increases, the need to borrow to fund cash flow deficits, significant power cost increases, or depletion of cash reserves.

Debt service coverages of the distribution system's debt and the consolidated system's debt were strong at 2.88x and 1.19x for fiscal 2003, respectively. The 1.19x coverage ratio for the consolidated system is indicative of the cost-of-service contracts supporting most of the debt, as explained below. Debt leverage remains appropriate for the rating at 68% as of Dec. 31, 2003, and is expected to increase marginally after the sale of the estimated $47 million in series 2004 bonds. However, the increase in debt leverage will be more pronounced at the distribution level, projected to increase from 13% to pre-1999 levels of 25% or more, largely due to the build-out of the district's broadband telecommunications system at an estimated total capital project cost of $86 million through 2012.

Liquidity

Liquidity of the consolidated system is adequate, with unrestricted cash and investments of $65 million (or 137 days of operating expenses) as of Dec. 31, 2003. The reserves, which are distributed among the district's various retail systems, totaled 194 days of cash at the retail level.

Outlook

The negative outlook reflects the potential for declining cash reserves or future debt issuance due to the absence of a planned rate increase, despite significant increases in capital requirements for nearly all segments of the consolidated system, including an aggressive expansion of the district's broadband telecommunications system. While cognizant of the economic development benefits of low-cost broadband connectivity, Standard & Poor's is concerned that the telecommunications expansion as proposed introduces a higher level of business risk to the utility and could weaken the district's historically strong financial profile, in particular its low debt levels, very strong debt service coverage, and strong liquidity. A key consideration for stabilizing the outlook will be the district's ability to achieve direct debt service coverage levels well above 2x on a normalized basis, especially as the district continues to derive substantial revenues from off-system sales of non-firm energy.

Regulation

The utility's regulatory position is above average, given the district's ability to set its own rates and the limited political support for deregulation in Washington. Rate setting is the responsibility of the Board of Commissioners and is not subject to approval by any state or federal authority. The board's willingness to raise rates may be limited over the near term, given a moderate amount of dissatisfaction among certain segments of the customer base. District elections for two of the five board seats are scheduled for November. The board has not approved a retail rate increase since the 2.5% rate increase proposed in 1999 and implemented in 2000, primarily due to better-than-expected financial results. Even if competition is introduced, the district is well poised to compete in wholesale and retail markets with rates that are among the lowest in the country. Its contracts to sell power at cost to third parties expire in 2011 and 2012. The Rocky Reach project comes up for relicensing in 2006. However, relicensing risk has been proactively mitigated by Chelan through its Habitat Conservation Plan, which incorporates the needs of key stakeholders and would be effective for 50 years. This plan will be formally incorporated into the relicensing process.

Markets

Chelan County is located in central Washington. The county's population has grown more than 20% during the last decade. The Cascade Mountains, Columbia River, and forests and lakes attract recreation and tourism, second-home development, and retirees. Wenatchee, 140 miles northeast of Seattle, is Chelan's county seat and largest city (2003 population of 28,470). The county has below-average economic characteristics. Agriculture, primarily apple and other fruit production, along with related industries accounted for 16% of employment in 2000. Services and trade round out the economic base. The unemployment rate (8.6% for the 12 months ending December 2003) is well above the national average, while household income is 92% of the national average.

The distribution system provides power to a predominately residential customer base of 39,383 (2003). The distribution system serves the entire territory within Chelan County with retail service, except Cashmere, which purchases power from the district on a wholesale basis. The district also serves a small area of adjoining Douglas, Okanogan, Kittitas, and King counties. Customer concentration has been low since former top customer Alcoa Power temporarily shut down operations at its aluminum smelter facility operations in July 2001, while continuing to employ substantially all of the local workers. Top customers now include Douglas County PUD (DCPUD; 5.5% of retail revenues), City of Cashmere (2.0%), Stemilt Growers Inc (3.0%), Trout Blue Chelan (1.6%), and Keyes Fiber Inc (1.4%). In the event Alcoa restarts its production facility, the company could again account for large portion of sales. Except for Alcoa, Chelan's retail sales are widely distributed and there is no concentration among customers.

Alcoa, the distribution system's largest customer, received 23% of the output of the Rocky Reach system (296 MW) at cost under a long-term contract and accounted for 19.3% of total distribution system revenues in 2000. In 2001, the district signed a new contract with Alcoa in which Alcoa curtailed its operations and released its rights to purchase power. Chelan sells the power in the market and pays a release fee to Alcoa that funds Alcoa's payroll and maintenance expenses during the shutdown period. In addition to providing proceeds for Chelan from power sales, the contract also assures guaranteed employment levels (about 400 jobs), aiding the local economy. This contract is subject to termination by either party with sixty days of notice; however the district has agreed not to terminate before January 2005. In the event that Alcoa restarts its plant to sufficient operating capacity, the district may lose this revenue stream. In the event of any purchaser default, the current power sales contracts provide for the remaining purchasers to take a 25% step-up in output and corresponding costs.

Wholesale power from the district's hydroelectric projects is distributed throughout the Pacific Northwest by the district's wholesale power purchasers. The district considers regional transmission and distribution facilities to be ample enough to sustain a broad market for the district's surplus power, both now and after the district's wholesale power contracts expire in 2011 and 2012.

Operations

The district benefits from an excess of low-cost hydroelectric generation. Energy from the district's two major hydroelectric projects cost only $17/MWh even at the "critical" water levels experienced in 2001. The district is almost always a net seller of power, since its allocation of hydroelectric power is sufficient to meet retail load requirements, except under adverse of streamflow conditions (in which case the district may be short in November or December). As such, the district generally derives a significant amount of its net revenues from wholesale operations. The district expects to be able to meet substantially all of its load from low-cost hydroelectric power for the foreseeable future.

Chelan's three major hydroelectric projects together represent over 2,000 MW and generated nearly 7.9 million MWh in 2003. The 72.5% output from the two largest projects are sold to third parties pursuant to long term power supply contracts, which expire in 2011 and 2012. The current licenses for the Rocky Reach, Rock Island and Lake Chelan projects expire in July 2006, December 2028, and March 2004 respectively. The PUD will use the alternate licensing process for the current Rocky Reach and Lake Chelan relicensing efforts. In addition, Chelan is in the final stages of developing a habitat conservation plan (HCP), a planning document that outlines the district's efforts for a 50-year period. The commissioners signed off on the HCP in April 2002 and a final FERC order, which will incorporate the HCP in the licensing process, is expected by mid-2004 (versus the end of 2003, as previously expected). The Fish and Wildlife Service is the last federal agency required to sign off on the HCP. The agency is currently assessing the impact of the plan on bull trout, lamprey and sturgeon--species that are not specifically covered by the HCP (which addresses spring and summer Chinook, steelhead, and sockeye salmon stocks).

Rocky Reach system.

Rocky Reach is located on the Columbia River and has a maximum capability of 1,287 MW. Its 11-turbine generators provide significant operational flexibility. The average cost of production, including debt service, was $13/MWh in 2003 and only $14/MWh in 2001, even though that year's drought suppressed streamflow to "critical water" levels. About 59% of the Rocky Reach output is sold to four investor-owned utilities via take-or-pay and cost-of-service contracts: Puget Sound Energy Inc. (39%), Portland General Electric Co. (12%), PacifiCorp (5%), and Avista Corp. (3%). The remaining 41% of the output is sold to the Chelan distribution system, which is allocated to Alcoa (23%) Douglas County PUD (2.77%) and the district (15.13%). Alcoa and Douglas are also take-or-pay purchasers. In 2001, the Rocky Reach output accounted for 25% of distribution system's energy resources, compared with approximately 50% in the past. A long-term agreement with DCPUD currently provides DCPUD with 2.77% of Chelan's share of the Rocky Reach output at a rate equal to Chelan's cost and may have the right to an additional 2.77% beginning Nov. 1, 2011. The contracts with the power purchasers extend through Oct. 31, 2011, at which time the additional power is expected to revert back to the district. In 2003, the facility provided approximately 21% of the Chelan distribution system's total power supply.

The Rock Island system.

Rock Island is located on the Columbia River and has a maximum capability of 660 MW with 19 turbines. The average cost of production was about $25/MWh in 2003, versus $23/MWh during the low water conditions of 2001. Energy available to the district from this project is governed by a power sales contract with Puget Sound Energy Inc., which expires in June 2012. The output is sold to Puget on a take-or-pay basis and cost-of-service basis subject to the right of the district to take certain portions for its own use. The district's share of the first 11 generating units is currently 50% and 25% from the other eight in 2003 for a total of forty percent of the output. In addition, the district has given Puget notice of its intention to commence withdrawing an additional 20% in 2005 and 5% in 2006, at which point its total share will be 50% of the output of the entire system. In 2003, the facility provided approximately 28% of the Chelan distribution system's total power supply.

The Lake Chelan system.

The facility is a small dam with a maximum capability of 59 MW. For the 12 months ended Dec. 31, 2003, the average cost of production was about $11/MWh. The district sells the entire project output through the distribution system. Lake Chelan provided 11% of the distribution system's total energy requirements in 2003. At Lake Chelan, the district expects to spend approximately $30 million in protection, mitigation, and enhancement measures for a proposed 50-year license, which expired in March 2004. As of this printing, the district was awaiting word from the FERC as to whether it would grant a new long-term license or whether the plant would be operated under a license with annual renewal

Wholesale Marketing & Resource Optimization

Chelan has contracted with Avista for scheduling and real time resource optimization services, for which Avista makes periodic payments to the district. Under an operating agreement, Avista receives the use of the district's control area to source and sink energy transactions, which provides Avista the ability to enter an operating day with unbalanced schedules, unlike other power marketers. This access to the real-time market provides Avista a substantial market advantage. The operating agreement with the district and Avista's management of the resources also provide Avista with river operating information that allows it to maximize the value of its own resource portfolio. Avista guarantees an annual minimum payment to the district, in addition to providing real-time scheduling services free of charge. The district does not pay either capacity payments or management fees to Avista, but only payments for energy purchased to balance the district's loads and resources on an hourly basis. Avista sells the energy at its average cost (i.e., same price for sales and purchases that Avista receives for sales and purchases of its own energy onits own behalf) with no mark up or additional charge.

The Distribution System

The hydroelectric projects described above provided over 95% of the distribution system's energy requirements in 2003. Purchases are made in anticipation of native load, and surplus is sold on the market. The district does not purchase power on a speculative basis; its purchases are solely to satisfy power requirements of its retail system. Given the predominance of low-cost hydroelectric resources owned by the district, the average system cost for the distribution system has historically been low. The district is typically a net seller into the market for 60 MW to 80 MW.

The Telecommunications System

The district is provides wholesale access to its fiber optic network and building line extensions to connect customers. The district initially installed the fiber optic "back bone" to facilitate operational control over its projects and its distribution system. The district's board decided at the end of 2002 to proceed with commercial expansion of its wholesale remarketing program over the next 10 years, through which the district serves as a wholesale provider to private retail service providers. By the end of 2003, the district's fiber network had reached over 3,000 premises and had connected 705 users purchasing telephone and Internet services through retail service providers. The buildout plan calls for fiber drops to be installed to 75% of the district's customers by 2008 and 95% by 2012. The system utilizes passive optical network (PON) technology. The district is considering wireless and power line technology to connect the most remote customers, who typically exhibit the highest capital costs. The district had internally funded about $18 million in capital investments as of fiscal year-end 2003 and expects to spend $86 million through 2012. The district will apply $15 million of the series 2004 bond proceeds to reimburse itself for capital costs incurred to date, providing $25 million in bond funds for future capital investment in the system. The district projects that the system will achieve positive operating cash flow are expected by 2005.

Competitive Position

Low production costs are passed on to retail customers of the distribution system. Chelan's customers enjoy what are likely the second-lowest rates in the country. Residential rates are very low, averaging 3.0 cents per kWh in 2003. Industrial rates are also low at 1.9 cents per kWh. In the Pacific Northwest, the average residential rate for 2002 was about 6.6 cents per kWh. Bonneville Power Administration's priority firm rate is about $35/MWh. The district is expected to maintain its competitive position, since the average cost of hydroelectric power is expected to be remain about 20 mills/kWh, or less, even under critical water conditions. The retail customers of the electric distribution system are at very little risk of being enticed away by a lower-cost generation provider.

Management

A five-member commission, elected from commissioner districts, administers the PUD. The senior management team has exhibited a high degree of stability and exhibits a proactive approach to the environmental concerns facing hydroelectric operations on the Columbia River. The district has been responsive to state and federal agencies, Indian tribes, and environmental groups in exploring the available options to protect endangered and threatened species. Lately, the district has pursued an aggressive schedule for building out its broadband telecommunications system.

Legal Provisions

The legal provisions are weak overall and offer limited protection to bondholders. The bonds are secured by revenues of the consolidated hydroelectric system, which include all rates and charges received or accrued by the district for electric power and energy and other services. Revenues specifically include amounts received from payments by the various divisions of the system (distribution division), and on inter-system loans from the two large hydro projects maintained in the district: Rocky Reach and Rock Island.

The district has bonds outstanding under a junior and a senior lien. Standard & Poor's does not make a rating distinction between the closed senior lien and the working junior lien, because bonds are viewed as a system wide obligation and the closure of the senior lien enables the junior lien to be free of risk of dilution by the senior lien. A rate covenant for the consolidated hydroelectric system bonds requires the district to collect revenue for electric power furnished by the consolidated system, which provides annual revenues together with other unencumbered funds of the district, in an amount sufficient to pay operating expenses of the consolidated system. Additionally, distribution system net revenues together with unencumbered funds of the district, and after payment of senior-lien debt service, must be equal to 115% of annual debt service on the outstanding distribution system bonds. A debt service reserve is maintained for the consolidated system junior-lien bonds in the amount of maximum annual interest payable in any future year. The additional bonds test is weak, as it is based on projected revenues; annual operating revenues must be sufficient to meet existing and proposed debt service by 1x. For distribution system bonds, operating revenues, including other available funds, must be sufficient to meet debt service by 1.25x. For hydro bonds, operating revenues, plus available funds, must be sufficient to meet debt service plus 15% of interest coming due in the first full year.

The Rocky Reach system and Rock Island system have project bonds outstanding equal to $14.7 million and $305.3 million, respectively, which are secured by the revenues of those projects. Payments on the project bonds are made prior to the intersystem loan payments made on the consolidated hydroelectric system's senior- and junior-lien obligations. The project bonds are also rated 'AA', based on excellent project economics and solid operations.

Finances

Debt service coverage is strong for both the distribution and consolidated systems, at 2.88x and 1.19x for fiscal 2003, respectively. Fixed-charge coverage and funds from operations coverage of interest stood at 1.08x and 1.12x, respectively. Coverage levels are strong but, as expected, have declined over several years due to net wholesale margins returning to their pre-power crisis levels. Coverage of distribution debt had always been over 2.0x until dipping to 1.9x in 2002. Coverage of project revenue bonds is maintained at 1x, with the power purchasers charged only the cost of production, including all debt service, plus an additional 15% rolling coverage on interest.

Chelan has a strong, liquid balance sheet at both the consolidated and distribution systems. Cash and equivalents total $65 million (including board-designated reserves in the contingency fund and capital fund), or 194 days' operating expenses at the distribution level. Debt leverage is low-to-moderate at 52% for Chelan's combined utility system and 68% at the consolidated system for fiscal 2003. With the sale of the estimated $47 million in new debt as part of the series 2004 bonds (in addition to $100 million in refunding bonds), total debt leverage of the distribution system is projected to increase from 52% to 56% or more, as the district finances build-out of the its broadband telecommunications system at an estimated cost of $86 million through 2012. An equity layer of 32% and the fully funded nature of hydroelectric project capital expenditures over the next few years provide Chelan with significant cushion should additional borrowings be required. The debt absorption capability at the projects is considerable, since an increase in power cost rates by 1 mill/kWh can service about $100 million in debt.

Budgeted capital expenditures for 2004 through 2007 increased from $94.2 million in 2002 to $173.8 million in 2004, driven in part by $39 million in telecommunications infrastructure investment. The district's five-year capital budget for the distribution system and hydro projects is now estimated at $205 million (versus $159 million in 2002), which includes $46 million in telecommunications infrastructure investment.

The district projects solid debt service coverage at the retail level of between 2.5x and 2.8x through 2008 and unrestricted cash reserves maintained at $70 million or higher through 2008. Aside from the aggressive growth expectations regarding telecom net revenues, the forecast assumptions are reasonable for 2004, but less so thereafter: streamflow for 2004 is assumed to be 88% of average, but 100% thereafter. Other key assumptions include energy prices of between $39 and $41 per MWh; 2.5% load growth; and a 6% operations and maintenance escalation factor.