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

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Credit Profile		
US$62.756 mil cons sys subordinate rev notes ser 2008A due 07/01/2013		
Long Term Rating	AA/Stable	New
Chelan Cnty Pub Util Dist #1 (Chelan Hydroelec Cons Sys) sr lien		
Long Term Rating	AA/Stable	Affirmed
Chelan Cnty Pub Util Dist #1 (wrap of insured) (MBIA & BHAC) (SEC MKT)		
Unenhanced Rating	AA(SPUR)/Stable	Rating Assigned

Rationale

Standard & Poor's Ratings Services has assigned its 'AA' rating on Chelan County Public Utility District No. 1 (Chelan or the district), Wash.'s $62.75 million hydroelectric system revenue refunding bonds, series 2008A subordinate revenue notes. At the same time, Standard & Poor's affirmed the 'AA' underlying rating on the district's debt outstanding. The outlook is stable.

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. The $62.75 million 2008A notes mature in 2013. The district is issuing them under a note resolution that subordinates their lien to the recently established subordinate operating lien under which series 2007 and 2008 consolidated system bonds were issued. The resolution that created the operating lien effectively closed what had been the senior lien. In addition, under the recently adopted subordinate operating lien resolution, legal protections have improved slightly. Consequently, Standard & Poor's does not distinguish between the senior and subordinate liens.

As of Dec. 31, 2007, Chelan had $659 million in hydroelectric consolidated system debt and $297 million in project debt at its Rocky Reach and Rock Island hydroelectric projects, although hydroelectric project offtakers under take-or-pay, cost-of-service contracts service more than half of this combined debt burden. In November 2008, the district expects to sell $20 million-$35 million of bonds to fund capital improvements at its Rock Island hydroelectric project, as well as up to $40 million in refunding bonds.

The rates and charges of the retail utilities, as well as certain intersystem loan payments from the district's three 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 to preserve the flexibility in hydroelectric project financing arrangements.

Characterizing Chelan's strong business profile ('3' on Standard & Poor's 10-point scale, '1' as the strongest) are 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 comes from its three hydroelectric plants, which produced power at an average $15 per megawatt-hour (MWh) in 2007. Chelan projects the cost to increase modestly each year to about $18 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 less than $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. Surplus-power sales subsidize 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 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 1.9x in fiscal 2007, up from 1.6x for fiscal 2006, due to stronger market sales activity during the year. DSC at the consolidated level remains highly sensitive to wholesale sales not under long-term contracts.

Outlook

The stable outlook reflects Chelan's strong financial policies regarding DSC and liquidity, as well as the district's low cost power supply. Although we still have concerns 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 in central Washington, with its principal city, Wenatchee, about 140 miles from Seattle. Tourism and agriculture are key industries, with fruit production, especially apples being of particular note. Agriculture provides about one-sixth of employment in the county.

The unemployment rate (4.5% for the 12 months ending December 2007, the lowest level in seven 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 390 workers at its Wenatchee Works smelter, is the distribution division's leading customer, accounting for about 15% 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, but a new contract for the subsequent 17-year period has been entered, and contains provisions that encourage Alcoa to maintain certain production levels at its Wenatchee plant, and also improve the district's financial position, and insulating the district somewhat from capital pressures at its two main hydroelectric projects. In 2006, Chelan had negotiated a similar arrangement with Puget Sound Energy (PSE), although without the production provisions, extending its contract with PSE to 2031. In addition, Chelan has contracted to sell 2.77% of its share of hydroelectric production at Rocky Reach to the Douglas County district; the share will increase by an additional 2.77% from 2011-2021, 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 $19 per MWh in 2007.

The district is generally a net seller of power, because 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 case, local demand could exceed supply). As such, the district generally derives a significant amount of its net revenues from wholesale operations, which subsidizes its retail distribution operations. Driving generation at the district's hydroelectric projects is Columbia River stream flow below the Grand Coulee Dam, which is correlated with stream flow at The Dalles, Ore. (which the Snake River stream flow also affects), the major pricing hub in the Pacific Northwest.

Low Cost Power Supply, And 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 from 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, given the projects' stable operating costs. A portion of the output from the two leading projects is sold to third parties, pursuant to long-term power supply contracts that expire in 2011 and 2012. The district has renegotiated a 20-year contract with PSE starting in 2011, and a 17-year contract with Alcoa. The district could secure contracts with other purchasers for the post-2011 period in coming years.

The Rocky Reach system is 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).

The Rock Island system is on the Columbia River and has a nameplate capacity of 624 MW, generated by 19 turbines. The average cost of production was about $24 per MWh in four of the five years to 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.

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 48 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 license for up to 50 years are progressing. Chelan expects a new license for Rocky Reach sometime in early 2009. The license for Rock Island does not expire until 2028. In November 2006, 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 license is projected to be approximately $72 million; the amount includes fish protection, mitigation, and enhancement measures, among other operating and capital costs.

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 what we consider a low 1.9 cents per kWh. In our opinion, 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 $31 per MWh. The district expects to maintain a competitive position at both its retail and wholesale operations. Retail rates rose 5% as of Jan. 1, 2008, the first increase since 2000 (2.5%). The district did not raise rates during the lingering drought period, although most other utilities in the region did, some dramatically. Also in early 2008, the district raised water and sewer rates by 9%, and rates for telecommunications services 2%, as part of a strategy to align revenues with costs for each business unit. The district is evaluating adjusting water and sewer rates among different customer segments, based on an ongoing cost-of-service study, in a way that will not affect its overall financial position.

Finances: Strong Debt Service Coverage And Liquidity

DSC of all debt is strong for the consolidated systems, at 1.9x for fiscal 2007. Fixed-charge coverage was a strong 1.7x in 2007, with the slight improvement compared with the 1.6x in 2006 mainly attributable to strong off-system sales. Nevertheless, annual debt service levels still depend on wholesale sales and margins and 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. The district's long-term strategy is to continue improving the alignment between its retail system's costs and revenues. Coverage of the district's 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 cash reserves staying at or above $130 million, keeping with Chelan's increased minimum policy target. Current liquidity levels well exceed the targets, although debt reduction and cash-funding of capital projects reduced the overall level of unrestricted funds 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 considered and will consider temporary rate surcharges if it determines 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 $176 million as of Dec. 31, 2007, equal about 400 days' expenditures. The district's five-year capital improvement plan, covering 2008-2012, indicates modest ($100 million) projects for the distribution division, and an additional $50 million for the broadband telecommunications system. However, Chelan projects $200 million of debt-funded borrowing, either through bonds or inter-system loans for hydroelectric projects during the 2008-2012 period, mostly at the Rock Island dam.

Legal Provisions

In our opinion, the debt service coverage levels for the rate covenant and additional bonds test contained in the legal provisions for consolidated system revenue bonds are weak overall. The senior consolidated system resolution, however, is effectively closed by a new resolution under which the district issued bonds in 2007 and 2008. The newer resolution has different legal provisions that make some improvements from a credit perspective. These improvements include new 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 system bonds requires the district to collect revenue that provides annual revenues, together with other unencumbered funds of the district, 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. The district maintains a debt service reserve for the consolidated system senior- and junior-lien bonds in the amount of maximum annual interest payable in any future year. The 2008A notes will be issued on a lien subordinate to the 2007 and 2008 bonds.

Debt Derivative Profile: Low Risk

We have assigned the district's consolidated system 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.

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

- A low degree of involuntary termination risk under the district'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-tofixed-rate swaps with a notional amount of about $231 million. Two of the swaps, with a notional amount of $93 million, took effect 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 district's issuing other refunding bonds, which Chelan expects to do in 2009, 2011, and 2013. One of the 2007 swaps was initially entered into with Bear Stearns Capital Markets Inc. (guaranteed by Bear Stearns Cos. Inc. [AA-/Negative/A-1+]). The counterparties' obligations under that swap have been assumed by J.P. Morgan Chase Bank N.A. (AA/Negative/A-1+). A second swap entered in 2007 is with Lehman Brothers Special Financing Inc. (guaranteed by Lehman Brothers Holdings Inc.). On Oct. 17, 2008, the district terminated the 2008B payment agreement with Lehman Brothers Special Financing and entered a replacement 2008B payment agreement with The Bank of New York Mellon Corp. (AA-/Stable/A-1+). The counterparties for the forward swaps are JPMorgan Chase and Goldman Sachs Mitsui Marine Derivative Products L.P. (AAA/Stable/--; guaranteed by The Goldman Sachs Group Inc. [AA/Negative/A-1+]).

The documents for the various swaps list the rating on the issuer falling below 'BBB' as an additional credit event. We believe this is remote, due to Chelan's consolidated system's strong credit profile. Net variable-rate exposure is minimal, as the district 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 the district's consolidated system's revenue bonds.

Ratings Detail (As Of October 27, 2008)		
Chelan Cnty Pub Util Dist #1 cons sys rev bnds rfdg (AMT) ser 2008B		
Long Term Rating	AA/A-1+/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
Chelan Cnty Pub Util Dist #1 cons sys rev		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Chelan Cnty Pub Util Dist #1 (Chelan Hydroelec Cons Sys) cons sys rev		

Ratings Detail (As Of October 27, 2008) **(cont.)**		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.