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

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Credit Profile

AFFIRMED	
$16.274 mil. Chelan Cnty Pub Util Dist #1 (Rocky Reach Hydroelec 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)
$286.162 mil. Chelan Cnty Pub Util Dist #1 Hydroelec rev rfdg bnds (Rock Island Hydroelec Sys) (taxable) Jr lien	AA
$25.485 mil. Chelan Cnty Pub Util Dist #1 Hydroelec rev rfdg bnds (Rock Island Hydroelec Sys) Jr lien	AA
$143.365 mil. Chelan Cnty Pub Util Dist #1 (Chelan Hydroelec Cons Sys) Sr lien	AA
$2.250 mil. Chelan Cnty Pub Util Dist #1 (Chelan Hydroelec Cons Sys) (taxable) Sr lien	AA
$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)
$78.375 mil. Chelan Cnty Pub Util Dist No 1 cons sys rev bnds ser 2001B 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)
$15.755 mil. Chelan Cnty Pub Util Dist No 1 hydro cons sys rev bnds ser 2001D dtd 05/01/2001 due 06/01/2002-2015	AAA/AA(SPUR)
$396.225 mil. Chelan Cnty Pub Util Dist No.1 (Chelan Hydroelec Cons Sys) Jr lien	AA
OUTLOOK:	STABLE

Rationale

The 'AA' rating on Chelan County Public Utility District No. 1 (Chelan), Wash.'s bonds reflects:

- Very low production costs at the district's three hydroelectric projects, averaging 2.0 cents per kWh to the district even under the exceptionally poor water conditions in 2001;
- Residential retail rates of 30 mills per kWh in 2001, which remain among the lowest in the country;
- The sale of excess power at market rates during periods of surplus; which largely compensated for the higher purchased power costs during the peak season owing to the low water levels;

- Continued strong historical debt service coverage (DSC) on all outstanding obligations reflected in 6.24 times (x) DSC from operations in 2001; and
- A strong, liquid balance sheet with $98 million in cash, $73 million in various bond funds and $155 million to meet future capital expenditures.

The bonds are secured by revenues of the consolidated system, which includes the three hydroelectric projects, the distribution system, and the water and wastewater system. 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 16.5% of total consolidated debt.

The district's low cost of power is derived from its hydroelectric plants, which produced energy at an extremely competitive average cost of 20 mills per kWh in 2001, a year when water conditions were very poor. Current contracts with investor-owned utilities for approximately 63% of the projects' output allow the district to recover only production costs. Once these contracts expire in 2011 and 2012, however, it is expected that the district will be able to negotiate new contracts 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 certain periods of the year. The sale of surplus power during 2001 at high market prices compensated for high-priced purchases in other periods that were necessitated by the low water levels. Debt service of the distribution debt and consolidated system are strong at 6.24x and 1.48x, respectively. With fish-related capital expenditure plans already funded through bonds issued last year and no other significant expenses planned, coverage should remain strong. The balance sheet is liquid with $98 million in cash, which represents 116 days of operations, and should protect against contingencies.

Outlook

The stable outlook reflects the ability of Chelan to manage a severe power crisis--such as that which occurred in 2001--without significant rate increases or a large rise in the district's debt burden, low cost of power resources, and substantial cash reserves. The district should continue to benefit from off-system sales during surplus periods. The stable outlook also reflects increased predictability in environmental expenditure consequent to the habitat conservation plan signed between Chelan and the major stakeholders.

Business Profile

Chelan has been assigned a business profile of '2' on Standard & Poor's 10-point scale, with '1' being highest. This primarily reflects the following factors:

- The highly competitive nature of the Rocky Reach, Rock Island, and Lake Chelan projects, with very low cost of power generation;
- Stable costs associated with environmental compliance; and
- Operation in a state that has not yet passed deregulation legislation.

Regulation

The Washington State legislature has not passed a deregulation bill. Given the happenings in California and the Pacific Northwest, and the Enron bankruptcy, there appears to be limited support for deregulation in the state. Even should competition be 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 retail customers of the electric distribution system are at very little risk of being enticed away by a lower-cost generation provider. 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.

Economy

Chelan County is located in central Washington. The county's population has grown over 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 the county seat and largest city, with a population of 25,620.

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 (9.2% for the 12 months ending December 2001) is well above the national average, while household income is 88% of the national average.

Markets

The distribution system provides power to a predominately residential customer base of about 38,311. The distribution system serves the entire territory within Chelan County with retail service, except Cashmere, Wash., 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.

The five leading customers of the distribution system are Alcoa Power (4.7% of revenues), Douglas County PUD (0.5%), the city of Cashmere (0.2%), Stemilt Growers Inc (0.3%), and Keyes Fiber Inc (0.2%). Alcoa will account for a significantly larger portion of sales should it restart its aluminum smelter in Chelan's territory, which was shut down in June 2001. Except for Alcoa, Chelan's retail sales are widely distributed and there is no concentration among customers.

APG (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 whereby Alcoa curtailed its operations and released its rights to purchase power. Chelan would sell the power in the market and pay 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 assured guaranteed employment levels, aiding the local economy. This contract was extended through at least Feb. 1, 2003 and beyond unless one of the parties terminates the contract with 60 days notice.

Operations

The Rocky Reach system

Rocky Reach is located on the Columbia River and has a maximum capability of 1,287 MW. It has 11-turbine generators, providing significant operational flexibility. The average cost of production, including debt service, is 10 mills per kWh, except in 2001 when the drought raised costs to about 14 mills/kWh.

About 59% of the Rocky Reach output is sold to four investor-owned utilities: Puget Sound Energy Inc. (39%), Portland General Electric Co. (12%), Pacificorp (5%), and Avista (3%) via take-or-pay and cost-of-service contracts. The contracts with the power purchasers extend through Oct. 31, 2011, at which time the additional power will revert back to the district. The district expects to negotiate new contracts and sell energy to the four investor-owned utilities at a rate somewhere between the market rate and the cost of production.

The remaining 41% of the output is sold to the Chelan distribution system, which is allocated to APG (23%), Douglas County PUD (2.77%), and the district (15.13%). In 2001, the Rocky Reach output accounted for 25% of distribution system's energy resources, compared against approximately 50% in the past. A long-term agreement with Douglas County Public Utility District, (DCPUD) currently provides DCPUD with 2.77% of the district's share of the Rocky Reach output at a rate equal to the district's cost, and the right to take an additional 2.77% beginning Nov. 1, 2011.

The Rock Island system

Rock Island is located on the Columbia River and has a maximum capability of 660 MW with 18 turbines. The average cost of production is about 16 mills per kWh, except in 2001 when it rose to 23 mills/kWh.

Energy available to the district from this project is governed by a power sales contract with Puget Sound Energy Inc. that expires in June 2012. The entire 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 10 generating units is currently 50% and 15% from the other eight in 2002. The district has given Puget notice of its intention to commence withdrawing an additional 10% in each year through 2005, and 5% in 2006. In 2001, the facility provided approximately 24% of the Chelan distribution system's total power supply

The Lake Chelan system.

The Lake Chelan facility is a small dam with a maximum capability of 56 MW. For the 12 months ended Dec. 31, 2001, the average cost of production was 19 mills per kWh, up from 10 mills/kWh in 2000. The district sells the entire project output through the distribution system. Lake Chelan provided 7.5% of the distribution system's total energy requirements in 2000

The distribution system.

The hydroelectric projects described above provided about 57% of the distribution system's energy requirements in 2001, a sharp decrease from the 80% in 2000. 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 in its power marketing operations. Given the predominance of low-cost hydroelectric resources owned by the district, the average system cost for the distribution system has historically been low. Average costs for 2001 rose to 74.4 mills/kWh compared to the historical levels of 10-15 mills/kWh. The increase was due to the low water levels in 2001 coupled with high spot prices and also resulted in low net revenues. The district is typically a net seller into the market to the tune of 60-80 MW.

The management acquired 26 diesel generators--with a variable cost of $160/megawatt hour (MWh)--at a cost of $32.3 million in early 2001 when market rates were $450/MWh. The generators produced power valued at approximately $13 million before wholesale electricity prices dropped and they became uneconomical to run. The district wrote down 24 of the 26 diesel generators to $13 million by year-end 2001. They may be sold in the future.

Relicensing.

The current licenses for the Rocky Reach, Rock Island, and Lake Chelan projects expire in July 2006, Dec 2028 and March 2004 respectively. Chelan will use the alternate licensing process for the current Rocky Reach and Lake Chelan relicensing efforts.

Habitat Conservation Plan

Chelan, along with Douglas County PUD, 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 goal of the plan is to ensure no net impact on fish, with 91% fish passage at the Rocky Reach and Rock Island projects, 7% compensation from hatcheries, and 2% compensation for habitat improvements. The interested parties agree to be supportive of the district's license applications filed during the 50-year proposed term of the HCP. Once completed, it is expected that the proposed HCP will satisfy the FERC relicensing requirements along with the Endangered Species Act requirements. It will also be unique in that such a HCP for a hydroelectric project has not been created anywhere in the US thus far. The commissioners signed off on the HCP in April and a final FERC order, incorporating the HCP in the licensing process, is expected by the end of the year.

At Rocky Reach, Chelan will spend approximately $92 million for the juvenile fish bypass system over the next few years. Operating costs of about $70 million over the 50-year life of the plan will be included in future budgets. $36 million will be spent over the 50-year period for habitat improvements and $61 million for hatcheries. At Lake Chelan, approximately $30 million is expected to be spent in protection, mitigation and enhancement measures for a proposed 50-year license.

Competitive Position

Low production costs are passed on to retail customers of the distribution system. Chelan's customers enjoy probably the second-lowest rates in the country. Residential rates are very low, averaging 30 mills per kWh in 2001. Industrial rates are also low at 19 mills per kWh. Chelan's rates are low even by the standards of the Pacific Northwest, where the average residential rate for 2001 was about 55 mills/kWh. The district is expected to maintain its competitive position, since the average cost of hydro power is expected to be only 16-17 mills/kWh even under critical water conditions. The debt absorption capability is great as an increase in rates by 1 mill/kWh can service $100 million in debt.

Management

The district is administered by a five-member commission, elected from commissioner districts. Senior management of the district shows a high degree of stability and exhibits a proactive approach to the environmental concerns facing hydroelectric operations on the Columbia River. An ongoing strategic planning process allows the district to focus on new strategic initiatives each year that are then rolled into operations, maintained as an initiative, or dropped. 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

Legal Provisions

The bonds are secured by revenues of the consolidated hydroelectric system, which includes 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 on intersystem loans from the three projects maintained in the district: Rocky Reach, Rock Island, and Lake Chelan. Overall, legal provisions are weak and offer limited protection to bondholders:

- Covenant requirements are fairly lenient. Net revenues, after paying senior-lien debt service should equal at least annual debt service on the outstanding junior-lien bonds plus 15% of the interest coming due in the next fiscal year.
- The debt service reserve fund is funded at interest only.
- There is no clear flow-of-funds provision.
- The additional bonds test (ABT) is based on projected revenues and allows inclusion of cash reserves..

Chelan County has loans 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 systemwide 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 fourth supplemental resolution created a contingency reserve account in 1998. The account may be funded up to $10 million and may be used for emergency operating conditions, to make intersystem loans, and to provide liquidity for emergency financial situations.

The ABT is weak as it is based on projected revenues. Annual operating revenues must be sufficient to meet existing and proposed debt service 1x. For distribution system bonds, operating revenues, including other available funds, must be sufficient to meet debt service 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 and Rock Island systems have project bonds outstanding equal to $16.2 million and $311.6 million, respectively, that are secured by the revenues of those projects. These existing bonds have a lien on project revenues senior to both the consolidated hydroelectric system's senior- and junior-lien obligations. The project bonds also carry the 'AA' rating, the same rating that the consolidated hydroelectric system bonds carry, since it is Standard & Poor's view that the loan payments made by the two projects to the consolidated hydroelectric system are made as operating expenses as covenanted in the bond documents, and they will always be set sufficient to recover these expenses

Finances

Chelan has weathered the Northwest drought and the power crisis remarkably well. Although the district did incur unusually high purchased power costs during the winter when water flows were low and the district was short power, it also realized substantial revenues from sale of power during the surplus periods. The district also had significant revenues from the new Alcoa contract in 2000.

DSC from operations for the consolidated system remained comfortable at 1.48x. Fixed charge coverage and funds from operations (FFO) coverage of interest stood at 1.12x and 2.61x respectively. These measures compare favorably with historical averages and are expected to decline over the next few years as the effect of the crisis wears out. Non-firm wholesale sales and power purchases are expected to be lower going forward. Chelan also will not rely upon wholesale sales in order to meet covenants or to maintain coverages that meet expectations for the rating.

Coverage of distribution debt has always been over 2.00x and was 6.24x in 2001. Coverage with cash reserves was 24.0x and 19.7x in 2000 and 2001 respectively. Coverage of project revenue bonds is maintained at 1x, with the power purchasers charged only the cost of production, including all debt service.

Chelan has a strong, liquid balance sheet as of year-end 2001. Cash and equivalents total $98 million (including board-designated reserves in the contingency fund and capital fund), or 116 days' operating expenses in 2001, which is very high considering the high power prices. Chelan has $115 million in construction funds from bond proceeds over the last two years. These will be sufficient to finance all fish related capital expenditures to meet the requirements of the HCP. Chelan also has $73 million in various bond funds providing additional bondholder protection. If we include these funds in the DSC, the coverage improves further to 2.59x in 2001.

An equity layer of 28% and the fully funded nature of capital expenditures over the next few years provides Chelan with significant cushion should additional borrowings be required.

Chelan County Public Utility District No. 1 - Financial Performance

Period ended December 31	**1999**	**2000**	**2001**
Operating Revenues ($ 000s)	181,458	283,349	406,824
Net Available ($ 000s)	87,341	129,305	112,026
Debt Service ($ 000s)	67,451	69,549	75,627
Debt Service Coverage (x)	1.29	1.86	1.48
Current Ratio (x)	2.22	1.79	1.82
Quick Ratio (x)	1.63	1.06	1.44
Accts Rec/Oper Revs (%)	9	23	4
Equity/Assets (%)	26	28	28
Days' Cash	225	229	116
Total Debt/Capitalization (%)	72	67	70
Total Debt/Plant (%)	85	82	93

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