Balance 2007 STRATEGIC BUDGET PROCESS

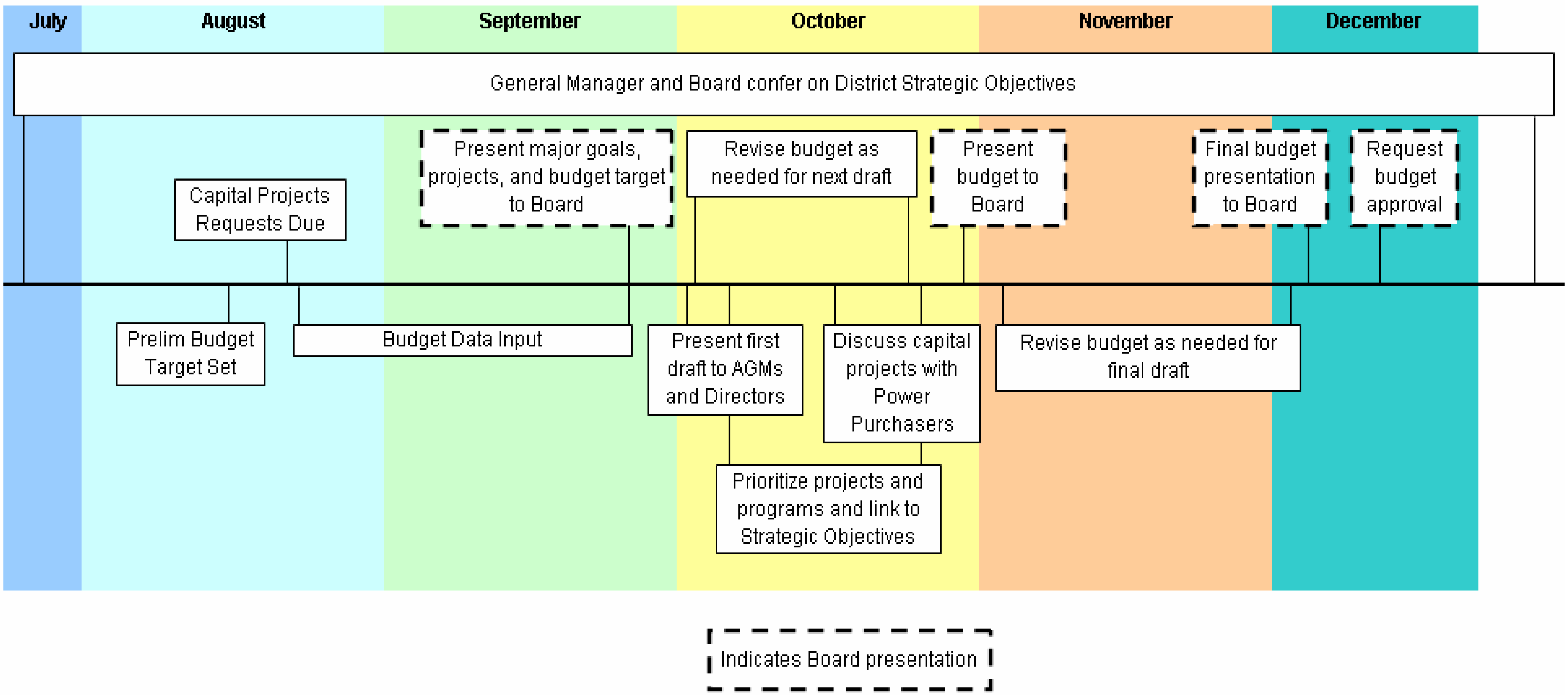
2007 Proposed Budget

December 4, 2006

2007 Budget Highlights

- Target: Hold Operating Expense increase to 5%
- Process to get to current proposed budget
- Current Wholesale Revenue forecast
- Non-Hydro Debt Coverage Ratio Challenge
- Analyze Revenue Options

2007 Budget Timeline



Process to date

- Cross functional Budget Team formed
- Preliminary Budget Targets established
  - No more than 5% growth in O&M (excluding depreciation, net power supply, debt service and taxes)
  - Capital projects in line with 10-year capital plan
- Preliminary Budgets submitted
  - Aligned with Balanced Scorecard
  - Results exceeded Budget Target
- Directors prioritized budgets based on impact on reliability and service levels
- Budget team reviewed and recommended further reductions – 5% target was met (4.5%)
- Proposed Budget results compiled – presenting today

2007 Challenges

- Rocky Reach & Lake Chelan license implementations
- Aging Infrastructure - Hydro facilities, Electric and Water, Hatcheries, Parks
- Benefit cost increases
  - PERS, Healthcare, Retiree Medical (OPEB)
- Materials cost increases – fuel, steel, copper
- Contractor availability
- Wholesale Revenue Volatility

Budget Assumptions

Revenues

District Revenue Assumptions

- Electric Distribution
  - 5.7% load growth
- Networks
  - 2,000 new active connections
- Water/Wastewater
  - 4% customer increase
- Hydros – cost of service based

Wholesale Revenue Drivers

- Water
  - Volume
  - Timing of runoff
- Volatility of Market Prices
  - Natural gas, crude oil
  - Forward market
  - Preschedule market
  - Hourly market
- Structure of Alcoa 95/2000 Power Contract
- Local Average Temperatures
- Local growth

Wholesale Revenue Assumptions

- Retail Load Growth of 5.7%
- Alcoa: Two pot line operation
- 84% water forecasted
- Average flat price of $63/mwh

Water Forecast 2007

- Very little data
- November – more precipitation than normal
- Very mild El Nino
- Requires a contingency plan

Year	Water
2003	86%
2004	84%
2005	89%
2006	102%
2007	84%

Water forecast is very important

Year	Revenue	Sold Forward	Bal aMW	Price	Water
2006	$58.1M	**$24.4M** @ **$63**	45 **125**	$60 **$54** $44	90% **102%**
2007	$ 35.9M	**$12.1M** @ **$66**	30	$63	84%

- Less water to sell forward during budget period
- Also less hedging opportunities during the year
- Market conditions different than 2006 (Record high Natural Gas)
- Alcoa uses more 95/2000 power during low water years

Projected Net Wholesale Revenue

Low	**$30.0 Million**
Budget Estimate	**$35.9 Million**
High	**$40.0 Million**

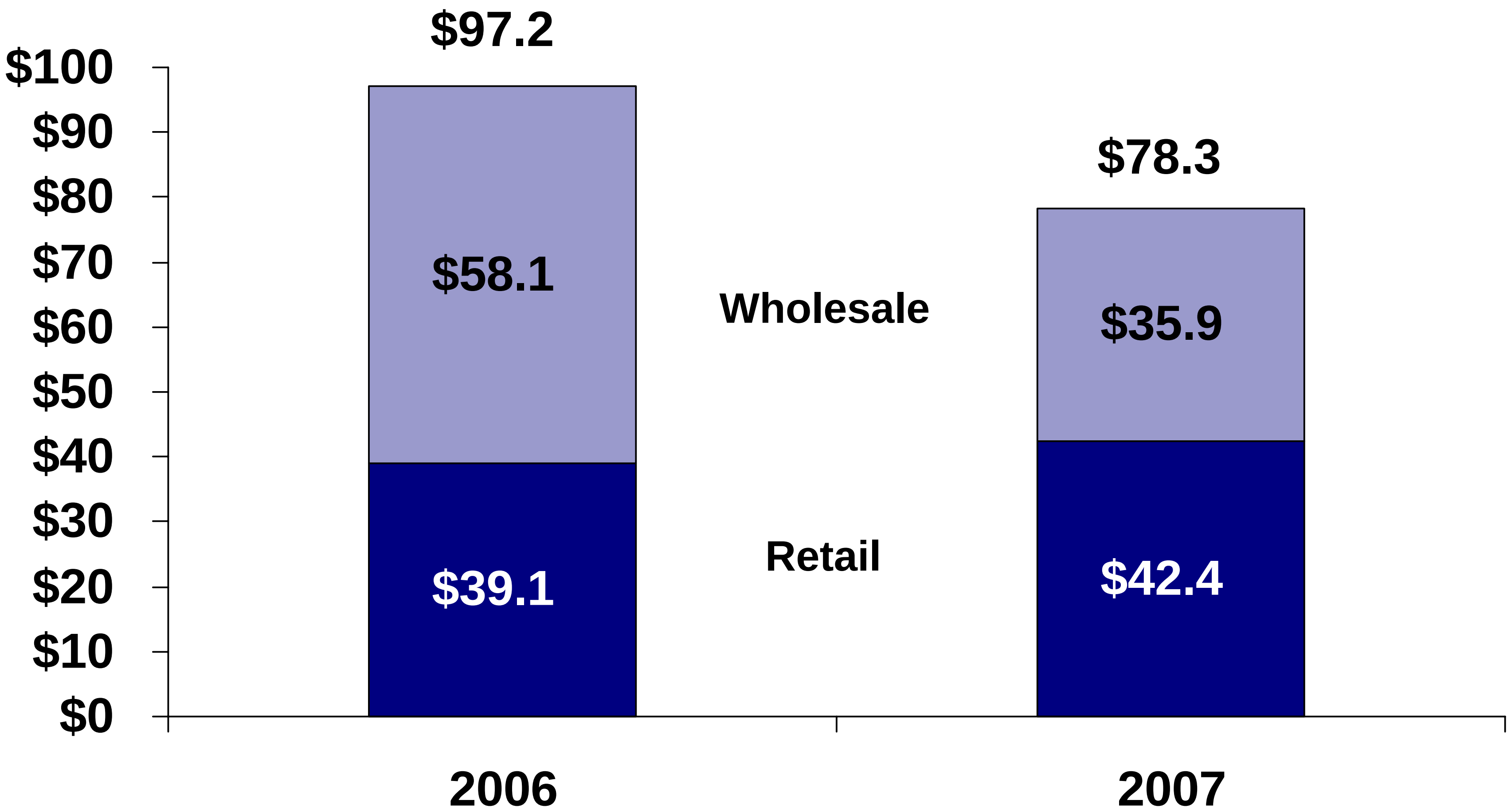
2006 Budget $58.1 Million

Comparison 2006 v 2007

	+/(-)	Balance (Millions of $)
2006 Forecasted Net Wholesale Revenue		**$58.1**
Lower projected water in 2007 (84% vs. 102%)	-17.0	41.1
Higher forward market prices ($63 vs. $44)	9.8	50.9
Lower expected Hedging Optimization ($0.5M vs. $10.1M)	-9.6	41.3
Higher Alcoa consumption at lower water levels (48,800 mwhs)	-1.9	39.4
Local Load Growth (82,344 mwhs)	-3.5	35.9
2007 Budgeted Net Wholesale Revenue		**$35.9**

Wholesale vs. Retail Revenue

(in millions)



Budget Assumptions

Expenses

Labor/Benefit Assumptions

- Bargaining unit wage adjustments
  - 3.69% contractual (6% including promotions, step increases)
- Non Bargaining unit wage adjustments
  - 3.8% pool (4.8% including promotions, market adjustments)
- Benefit cost increases
  - PERS – 3.69% to 5.28% at 1/1, increasing to 6.91% on 7/1
  - Healthcare – 18% effective 8/06, 16% effective 8/07
  - Other Post Employment Benefits (OPEB) - $53k

Magnitude of the change required by OPEB?

- Under current plan, to fully fund the existing liability would cost $14.9M, plus $571k annual service cost
- Fully funding the liability significantly reduces cash
- If unfunded, the liability would be viewed as added debt for bond rating purposes
- The annual service cost is treated as additional O&M expense

Plans to minimize OPEB liability

- Continue retiree medical subsidy only as a bridge to Medicare (age 65)
- Limit retiree medical subsidy to 2006 amounts + inflation adjustment based on CPI-W*
- 2006 Rates:
  - Retiree under 65: Cost = $705.61/mo.; Subsidy = $207.66/mo.
  - Spouse under 65: Cost = $575.61/mo.; Subsidy = $169.40/mo.
- Fund the accrued liability in 2006

*The *Consumer Price Index for Urban Wage Earners and Clerical Workers* (CPI-W) is produced by the Bureau of Labor Statistics (BLS). The CPI-W is used to annually adjust benefits to Social Security beneficiaries.

Positive impact of changes to the District

- Reduces liability from $14.9M to $1.9M
- Reduces annual service cost from $571k to $53k
- Reduces 2007 Operating Expenses by $2.4M

Positive impact of changes to Retirees

- Now eligible for the full range of Medi-Gap plans
- Research shows retirees likely can get comparable coverage at a lower cost than PUD subsidized rate (as low as 1/3 the cost)
- With few exceptions, no pre-existing condition exclusions
- Benefits fair and personal interaction to help post-65 retirees transition

Staffing

- Full Time Equivalents (FTEs)*
  - 2007 Budget - 750
  - 2006 Budget - 769
- Reduce workforce through attrition
- Reduce contingent on-call work force
- New position:
  - Chief Risk Officer/Risk Manager
- 2 Pre-apprentice interns – Energy Technology Certificate Program (1040 hours)

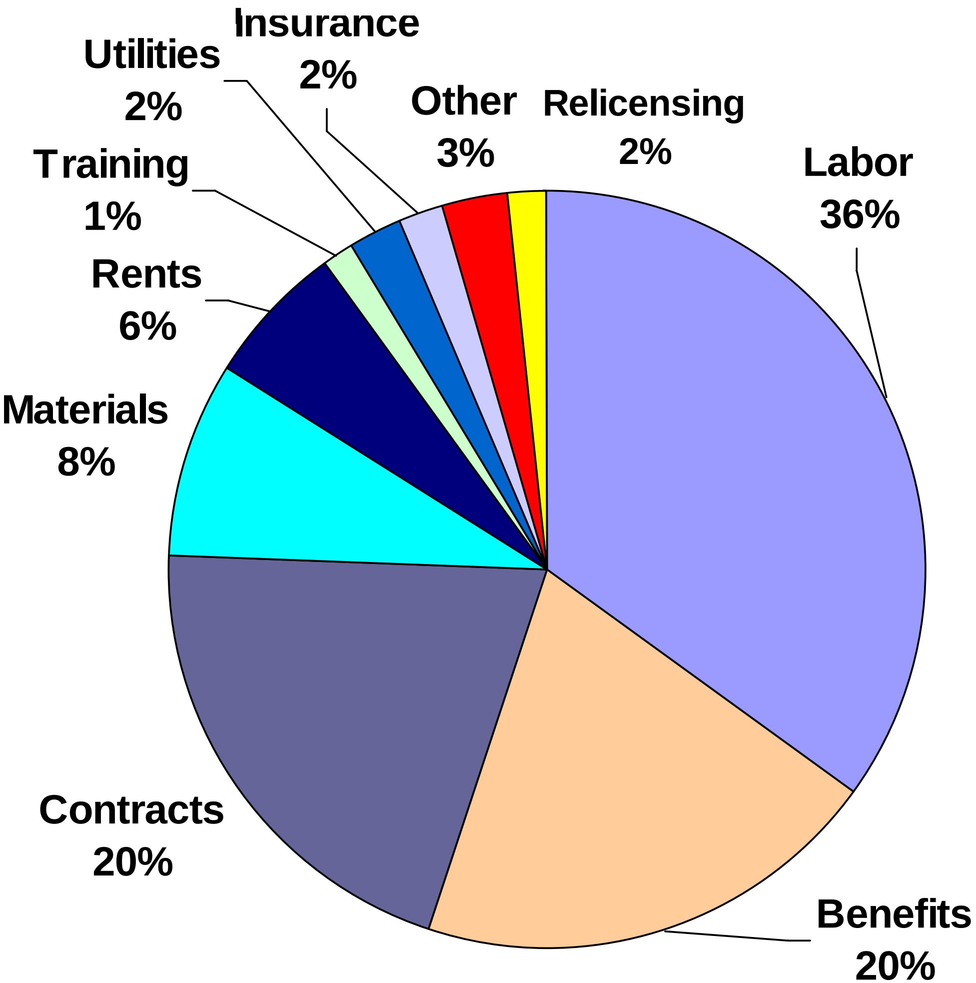
**FTE calculation divides regular hours by 2,080, and is not a "headcount" number. Reductions in FTEs indicate fewer paid hours worked, some of which is the result of retiree separations.*

New Significant Expenses

- Rocky Reach License Implementation
  - Assumes Q2 issuance
    - O&M $1.4M
    - Capital $1.3M
- Lake Chelan License Implementation
    - O&M $910K
    - Capital $4.4M
- Employee Benefit Costs

2007 Operating Expenses

(Excludes Purchased Power, Depreciation, Debt Service)



Operating Expenses

($000s)

	2007 Budget	2006 Budget	Variance
Distribution	25,614	24,396	1,218
Networks	3,948	3,712	236
Water/WW	4,195	3,999	196
Rocky Reach	43,372	39,850	3,522
Rock Island	36,044	37,285	(1,241)
Lake Chelan	5,102	3,951	1,151
Total	118,275	113,193	5,082

Preliminary Budget Results

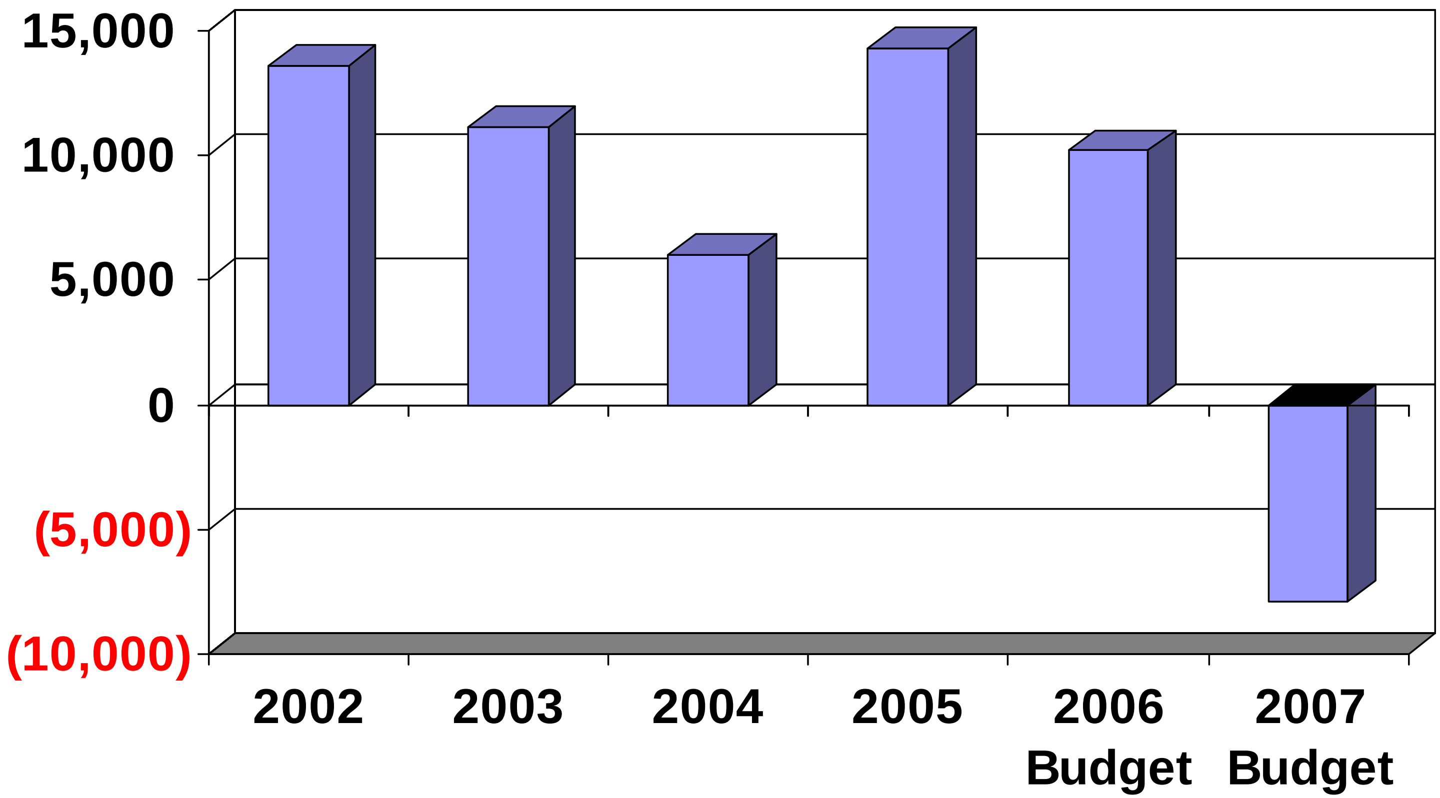
Income Statement

Combined Revenue and Expense

(in millions)

	2007 Budget	2006 Budget	Variance
Operating Revenue	208.3	199.1	4.8%
Operating Expense	118.3	113.2	**4.5%**
Net Power Supply	21.7	(4.8)	---
Deprec/Amort/Taxes	44.5	40.1	10.9%
Non-Operating Expense	36.2	44.5	(18.7%)
Chg in Net Assets Before CIAC	(12.3)	6.1	---
Capital Contributions (CIAC)	4.4	4.1	7.4%
Inc/(Dec) in Net Assets	**(7.9)**	10.2	---

Inc/(Dec) in Net Assets



Electric Distribution

($000s)	2007 Budget	2006 Budget	Variance
Operating Revenue *	43,351	40,604	2,747
Net Power Supply	21,664	(4,805)	26,469
Operating Expenses	25,614	24,396	1,218
Operating Income	(3,927)	21,013	(24,940)
Depreciation/Taxes	11,561	9,800	1,761
Non-Op Exp (Inc)	(6,976)	(2,336)	(4,640)
Cap Contributions	3,468	2,960	508
Inc/(Dec) in Net Assets	(5,044)	16,509	(21,553)

* *Includes other revenues in addition to electric rates*

Networks

($000s)

	2007 Budget	2006 Budget	Variance
Operating Revenue	4,048	3,172	876
Operating Expenses	3,948	3,712	236
Operating Income	100	(540)	640
Depreciation/Taxes	3,944	2,832	1,112
Non-Op Exp (Inc)	4,306	3,240	1,066
Inc/(Dec) in Net Assets	(8,150)	(6,613)	(1,538)

Water

($000s)

	2007 Budget	2006 Budget	Variance
Operating Revenue	3,785	3,515	270
Operating Expenses	3,546	3,366	180
Operating Income	239	149	(90)
Depreciation/Taxes	1,492	1,429	63
Non-Op Exp (Inc)	1,032	722	310
Cap Contributions	861	900	(39)
Inc/(Dec) in Net Assets	(1,424)	(1,102)	(322)

Wastewater

($000s)

	2007 Budget	2006 Budget	Variance
Operating Revenue	400	409	(9)
Operating Expenses	649	633	16
Operating Income	(249)	(224)	(25)
Depreciation/Taxes	381	380	1
Non-Op Exp (Inc)	36	28	8
Cap Contributions	78	245	(167)
Inc/(Dec) in Net Assets	(588)	(387)	(201)

Rocky Reach

($000s)

	2007 Budget	2006 Budget	Variance
Operating Revenue	77,771	73,825	3,945
Operating Expenses	43,372	39,850	3,521
Operating Income	34,399	33,975	424
Deprec/Amort/Taxes	16,624	15,965	659
Non-Op Exp (Inc)	18,146	18,719	(573)
Inc/(Dec) in Net Assets	(371)	(709)	338

Rock Island

($000s)

	2007 Budget	2006 Budget	Variance
Operating Revenue	71,044	70,980	64
Operating Expenses	36,044	37,285	(1,241)
Operating Income	35,000	33,695	1,305
Deprec/Amort/Taxes	9,474	8,661	813
Non-Op Exp (Inc)	23,432	22,852	580
Inc/(Dec) in Net Assets	2,094	2,182	(88)

Lake Chelan

($000s)

	2007 Budget	2006 Budget	Variance
Operating Revenue	7,865	6,554	1,311
Operating Expenses	5,102	3,951	1,151
Operating Income	2,763	2,603	160
Deprec/Amort/Taxes	1,007	1,050	(43)
Non-Op Exp (Inc)	1,557	1,248	309
Inc/Dec in Net Assets	199	305	(106)

Preliminary Budget Results

Balance Sheet

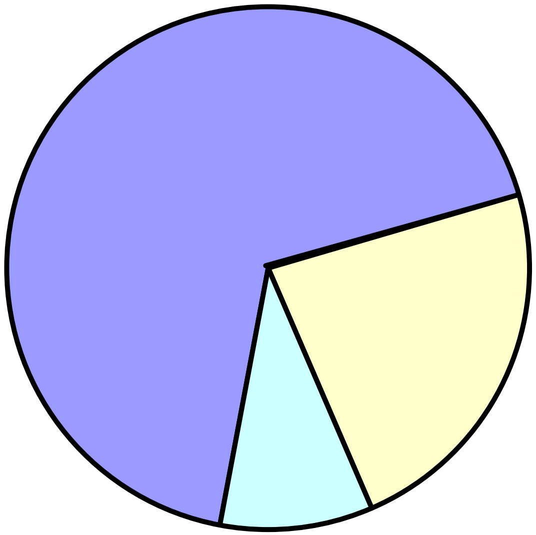
Utility Services Cash Reserves

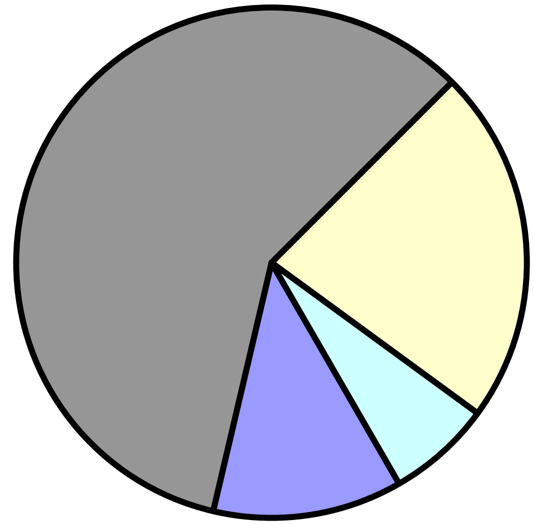
- Projected Ending Balance
  - 12/31/07 - $162.6M
  - 12/31/06 - $190.2M
- Avg. Rate of Return on Investments
  - 5.64% in 2007
  - 3.99% in 2006

Capital Expenditures
($000s)

	2007 Budget	2006 Budget	Variance
Distribution	16,900	18,485	(1,585)
Networks	10,924	11,577	(653)
Water/WW	4,428	4,864	(436)
Rocky Reach	11,991	15,910	(3,919)
Rock Island	30,997	31,634	(637)
Lake Chelan	11,203	3,274	7,929
Internal Service	3,978	4,871	(893)
Total	90,421	90,615	(194)

Hydro Capital Financing (est.)





2006 Forecast

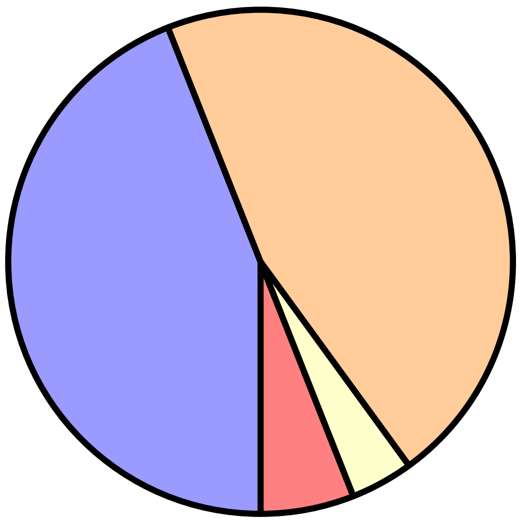
Existing Bonds	$ 30,057
New Bonds	-
Replacement Recovery	$ 10,064
Reserve & Contingency	$ 4,149
Total Hydro Capital 2006	$ 44,270

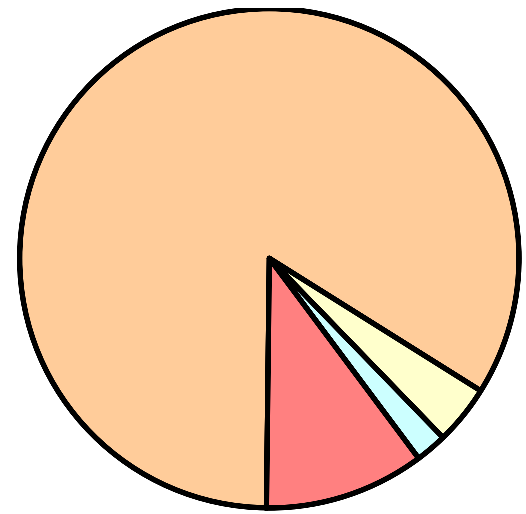
2007 Budget

Existing Bonds	$ 6,500
New Bonds	$ 32,183*
Replacement Recovery	$ 12,075
Reserve & Contingency	$ 3,683
Total Hydro Capital 2007	$ 54,441

**Anticipated new bonds issued in 2007 of $54,000 for $32,183 in 2007 and $21,817 in 2008, excluding reserves and cost of issuance. Options to reduce new external borrowing are still being evaluated.*

Non-Hydro Capital Financing (est.)





2006 Forecast

Existing Bonds	$ 15,019
Cash	$ 15,573
Contributions in Aid	$ 1,400
Internal Service Rents	$ 2,042
New Bonds	$ -
Total Non-Hydro Capital 2006	$ 34,034

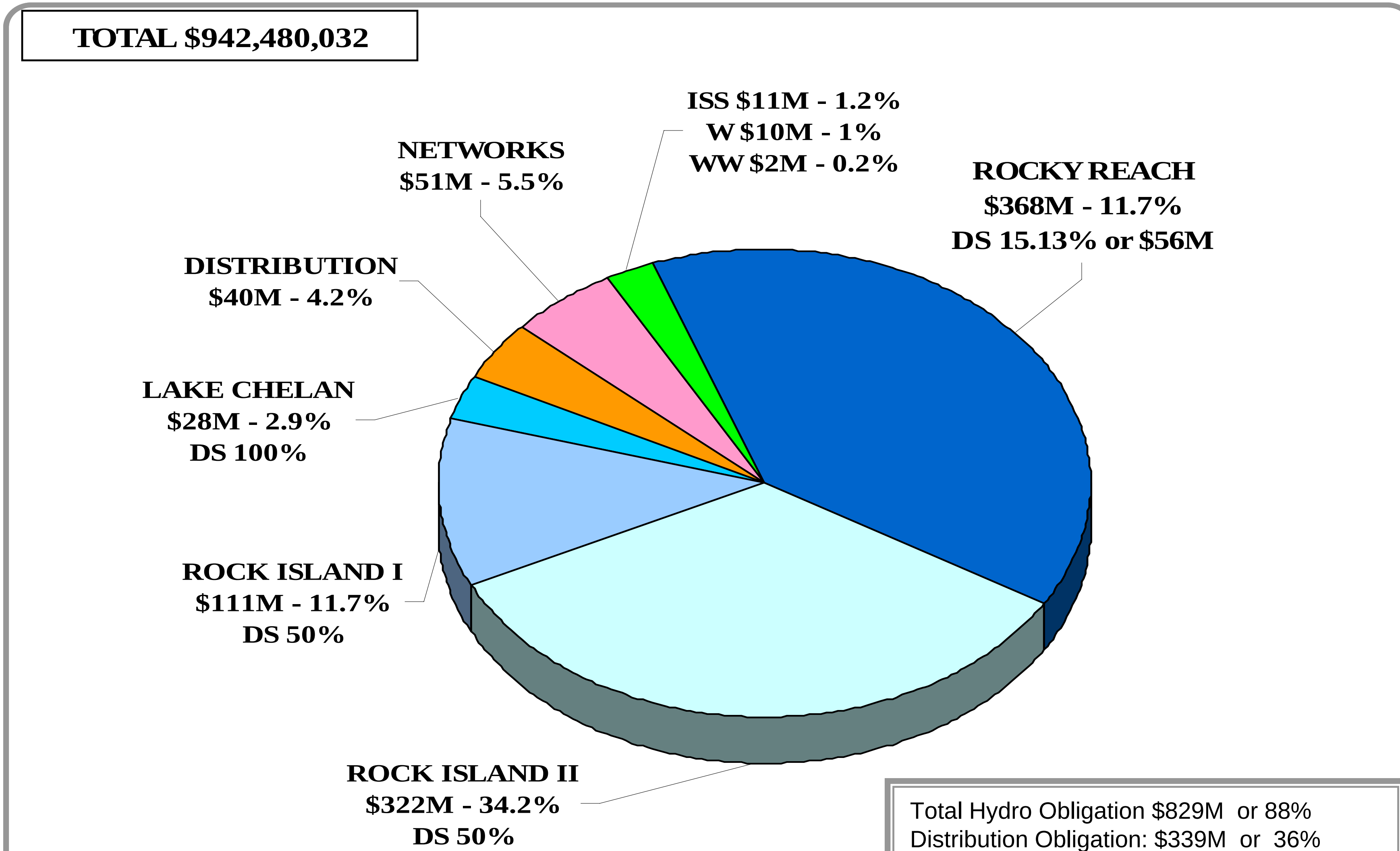
2007 Budget

Existing Bonds	-
Cash	$ 30,226*
Contributions in Aid	$ 1,400
Internal Service Rents	$ 3,729
New Bonds	$ 625**
Total Non-Hydro Capital 2007	$ 35,980

**Excludes capitalized debt service for Networks.*

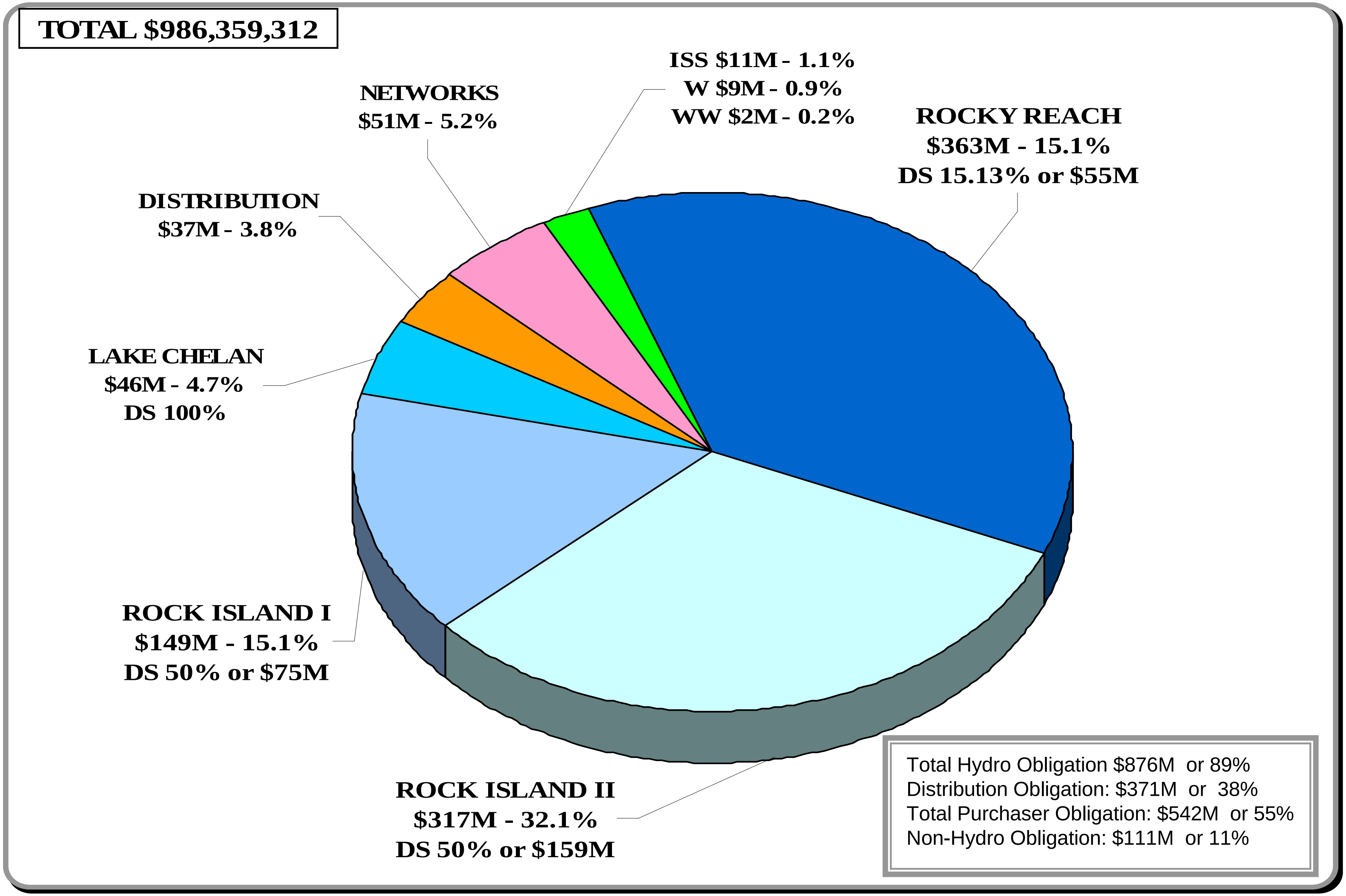
***Anticipated new CREBs bonds issued in 2007 of up to $1,250 for potential Stehekin project pending board approval.*

Revenue Bonds & Related Loans Estimated 12-31-06



Total Hydro Obligation $829M or 88%
Distribution Obligation: $339M or 36%
Total Purchaser Obligation: $529M or 56%
Non-Hydro Obligation: $114M or 12%

Revenue Bonds & Related Loans Estimated 12-31-07



Debt Cover Ratio

- Measure of ability to service debt
- One measure of overall financial health
- Higher is better

- Hydro Debt Coverage Ratio
  - Covenant minimum 1.0x due to cost of service power contracts
- Non-Hydro Debt Coverage Ratio – A Key District Measure
  - 1.00x Covenant Minimum
  - 1.15x Covenant Minimum with Other Available Funds
  - 1.25x to issue new debt
  - 1.75x-2.00x current preliminary target***
- Debt Service Coverage Ratio =

$$\frac{\text{Operating Revenues* – Operating Expenses**}}{\text{Principal and Interest Payments}}$$

* Cash reserves do not count as revenue

** Does not include capital costs nor depreciation expense

***Preliminary target based on current risk profile and projected 2007 financial challenges

2007 Debt Coverage Projection

Retail Revenue	Wholesale Revenue	Debt Coverage	$ for 1.75 coverage
$42.4M	$40M (high)	1.97	-
$42.4M	$35.9M (budget)	1.51	($2.2M)
$42.4M	$30M (low)	0.87	($8.1M)

Budget Reduction Impact on Non-Hydro Debt Coverage

	2006 Budget	2007 as of 9/27/06	2007 as of 10/16/06	2007 as of 10/23/06	2007 as of 11/30/06
Operating Expenses	$113.4M	$125.0M	$123.5M	$119.6M	$118.3M
Net Wholesale Revenue	58.1M	37.3M	36.5M	35.9M	35.9M
Debt Cover	3.18x	1.38x	1.36x	1.34x	1.51x
Net Revenue needed for 1.75	($15.6M)	$3.4M	$3.6M	$3.8M	$2.2M

Items <u>not</u> included in 2007 Budget

- Major O&M reductions
  - Hydro Projects ($4.6M)
  - Delayed Hatchery Work ($695k)
  - Travel and Training ($500k)
  - Tree Trimming/Pole Testing ($485k)
  - RR License Impl moved to 2Q07 ($467k)
  - Delayed Parks Maintenance ($578K)
  - Reduced ResourceSmart ($200k)
- Major Capital deferrals
  - Utility Services land purchase ($6M)
  - Delayed Parks Projects ($1.2M)
  - Electric Automated Meter Reading- *Phase 1* ($1M)
  - Delayed Hatchery Projects ($800k)

Total O&M and Capital Reductions/Deferrals = $27M

Other items not included in 2007 Budget

- Contingency funds for fires/storms
- Monitor water system
- Cashmere electric system
- Full modernization at Stehekin

Potential Risks/Consequences

- Reliability
- Customer Service levels
- Availability
- Forced Outage Rate
- Sustainability

Next Steps

- Final Board review/questions
- Budget approval request: December 11
- Integrate budget into long-term Strategic Planning Sessions and Contingency Plan