Rating agency views on long term take and/or pay contracts
10-24-07

This is a response to a comment made recently at a board meeting, regarding rating agency views on take or pay contracts versus selling power into the wholesale market.

District staff has worked with rating agencies, underwriters, bond counsel and financial advisors to understand the pros and cons of market sales and take or pay contracts.

Rating agencies have been generally positive in their analysis of the district's long term power contracts. By their nature, take or pay contracts require the power purchasers in all circumstances to pay debt service on the outstanding bonds. This provides assurance to investors owning district bonds that there will be a flow of funds for the servicing of debt. Standard and Poor's and Moody's specifically lists the take or pay contracts as a credit strength.

Rating agency reports view our long wholesale position as a strength with the caveat that costs remain under market price and that there is not a regulatory impairment of output. They mention the potential listing of additional endangered species specifically in this regard. I think they would recognize and evaluate the change in risk profile resulting from the district taking an additional 25% of the output to market. Being too reliant on wholesale revenues has been viewed negatively due to the inherent volatility of market price and water availability.

I don't think that taking an additional 25% of the output to market by itself would improve our credit rating and might even lower it. Ratings would be based on how we managed the risk associated with the additional output and what ultimate effect it had on actual financial results and forecasts.

Market sales and take or pay contracts are tools used to achieve different ends. They both are useful as part of the district's revenue portfolio. The key is to find the optimum balance between the two.

Click on the link below to access the most recent rating reports on Chelan PUD. There is also a 2006 S&P report attached to this message as a PDF file that mentions take or pay contracts as a rating strength. You will be provided hard copies of this document and the other referenced documents for your notebooks.

Joe Jarvis

Finance | Chelan County Public Utility District

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RESEARCH

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

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Credit Profile

AFFIRMED	
$16.274 mil. Chelan Cnty Pub Util Dist #1 (Rocky Reach Hydroelec Sys) Sr lien	AA
OUTLOOK:	STABLE

Rationale

The 'AA' rating on Chelan County Public Utility District (PUD) No. 1, Wash.'s Rocky Reach hydroelectric project revenue bonds reflects the project's superior economics, stable financial performance even under poor water conditions, take-or-pay offtaker contracts for 85% of project capacity, and favorable plant attributes and operational practices that substantially mitigate the risk of production curtailment due to unit outage or environmental requirements.

Credit strengths include:

- Historical production costs that are very low, averaging about $13 per megawatt-hour (MWh) in fiscal 2004, and that are expected to remain highly competitive, even after accounting for increasing debt service, gradual cost inflation and potentially poor streamflow conditions;
- The project's strong operating performance and the flexibility afforded by its 11 turbines, which together partially mitigate single asset risk;
- The ability to pass through at least 85% of project costs to offtakers under take-or-pay contracts through October 2011, with all five direct offtakers (including Chelan) subject to a 25% step-up provision;
- The imminent adoption of an innovative agreement with federal and state regulators that should allow the project to comply with federal endangered species laws without significant impacts on project operations or capital requirements; and
- The project's stable financial performance, even under poor water conditions.

The bonds are secured by revenues of the project, which include payments by the four investor-owned utilities and an aluminum smelter that take project power under long-term, take-or-pay contracts. The revenue pledge securing the bonds is senior to the project's payment obligations with respect to Chelan's hydroelectric consolidated system (HCS) bonds, which are rated separately.

Issuer covenants under the master bond resolution provide limited bondholder protection, specifically, a 1x debt service coverage (DSC) additional bonds test based on operating revenues and a 1x DSC rate covenant based on net revenues adjusted for contingency funds withdrawals and deposits.

As of June 30, 2005, the project had approximately $370 million in total debt obligations, including $13 million in senior lien Rocky Reach project revenue bonds, and $357 million in subordinate intersystem loan obligations related to bonds issued under Chelan's Hydroelectric Consolidated System bond resolution.

The Rocky Reach project is a "run-of-the-river" hydroelectric project located on the Columbia River, and has a maximum generating capability of 1,287 MW. The district operates the facility under a long-term license from Federal Energy Regulatory Commission (FERC) that extends to June 30, 2006. Project economics are exceptional. The project's large number of turbine generators, 11 in all, provides significant operational flexibility and enhances project availability. The average cost of production, including debt service, was $13 per MWh in 2004, and only $14 per MWh in 2001, when that year's drought suppressed streamflow to near "critical water" levels.

The superb project economics of the Rocky Reach project provides strong assurance of cost recovery from the project's offtakers. The project's extremely low cost of generation and strong performance history makes it extremely unlikely that Chelan or a project offtaker would default on its payment obligation to the project, even in the event of bankruptcy. Even if a power purchasers were to default, Chelan could easily resell the defaulting participant's allocation of project power to the other purchasers, which have right of first refusal, or to the wholesale market. Current power sales contracts require direct contract offtakers to increase their share of project costs by up to 25% in the event of a default by another participant.

The project's financial profile is adequate. As a cost-based project, participants are billed to essentially meet 1x coverage of cash debt service. Senior debt service coverage was a very high 20x in fiscal 2004, but coverage of both senior and subordinate obligation debt service was only about 1x. Debt levels are moderate at 65% debt to total capital and 72% debt to net plant, although debt per MW installed capacity was a low $255 per MW as of Dec. 31, 2004.

Liquidity

Liquidity was adequate, with restricted cash and investments as of Dec. 31, 2004 of about $35 million, including debt service reserve funds totaling $2 million (the required reserve for the project's outstanding bonds).

In comparison, the project has average annual capital requirements of about $14 million and average annual project debt maturities of about $1 million from 2006 to 2010.

The project's revenue bonds mature as follows:

Table 1 Rocky Reach Hydro Project Outstanding Debt	
Year	**Maturities ($000s)**
2006	973
2007	1,024
2008	1,074
2009	1,125
2010	1,184

Outlook

The stable outlook reflects Standard & Poor's expectation that the project will continue to demonstrate exceptional plant performance and extremely competitive production costs relative to baseload resources and bulk power rates in the region. The outlook also assumes that any future increases in unit production costs, including those anticipated to support capital improvements or regulatory compliance at the project, will not materially weaken the project's competitiveness. A negative outlook, although unlikely, could result if project economics suffer due to sustained and significant increases in production costs, excessive debt leverage, or significant increases in capital requirements. A positive outlook would depend on a clear improvement in project economics, favorable resolution of the relicensing process and offtaker contract negotiations, a high degree of certainty regarding future operating and capital requirements, and possibly reduced debt leverage at the project.

Rating Methodology

The ratings are based on a methodology specific to cost-based, publicly owned wholesale electric systems, which considers a number of factors, including: project economics; the strength of contractual offtakers, if any; and the credit support of or exposure to the public entity that owns the system. The very strong project economics of the Rocky Reach hydroelectric project provide strong assurance of cost recovery, even with weaker-rated offtakers, due to the ability of project owner and operator Chelan to remarket the power originally allocated to the offtaker upon any default. These same project economics provide assurance that Chelan would continue to pay its allocable share of project costs, regardless of its credit position. The presence of contractual offtakers is not a major rating factor at this time, but could become important if the project's strong competitive position was ever compromised.

Project Sponsor

Chelan County PUD, established in 1936, owns and operates a water system, a wastewater system, an electric distribution system, a telecommunications system, and three hydroelectric power generating projects: Rocky Reach, Rock Island, and Lake Chelan. Chelan's retail system and two major hydroelectric projects, Rocky Reach and Rock Island, are able to incur debt by issuing revenue bonds through individual system bond resolutions or through the HCS bond resolution. Under the HCS structure, the projects repay their shares of HCS debt on a levelized basis, even though much of that debt is nonamortizing. Rather than being escrowed, the prepaid principal payments get recycled back to the projects as intersystem loans.

Project Offtakers

The project's output is allocated among several offtakers, including Chelan. About 59% of the Rocky Reach output is sold through long-term, take-or-pay contracts through Oct. 31, 2011, to four investor-owned utilities: Puget Sound Energy Inc. (39%, 'BBB-/Stable'), Portland General Electric Co. (12%, BBB+/Stable/A-2), PacifiCorp (5%, A-/Watch Neg/A-2), and Avista Corp. (3%, BB+/Stable/B-1). Chelan PUD sells a portion of its own 41% allocation of Rocky Reach power to Alcoa Power Generating Inc. (23%, NR), a wholly owned subsidiary of aluminum manufacturer Alcoa Inc. (A-/Negative/A-2), and Douglas County PUD (2.77%, 'AA-/Stable') through take-or-pay, cost-of-service contracts, and uses the remainder for its own electric distribution system.

In December 2005, Chelan County PUD and Puget Sound Energy announced a tentative agreement that extends PSE's participation in the Rocky Reach and Rock Island projects by an additional 20 years through October 2031. The cost-based, take-or-pay agreement calls for Puget to receive 25 percent of the combined output of Chelan PUD's Rocky Reach and Rock Island dams for 20 years, starting in 2011-2012. The contract is subject to approval by the boards of directors for Chelan and PSE, as well as the FERC.

Project Economics

The project economics of the Rocky Reach project are exceptional. Production costs average about $13 per MWh and are still competitive even in years of low streamflow, as demonstrated in 2001 by the $14 per MWh unit cost of production despite extremely poor water conditions. Production costs are expected to remain under $20 per MWh, even under critical water conditions. Plant operating performance is strong, with a 2004 availability factor of about 98%. The project's 11 turbine-generator units operate independently, allowing continued operations even in the event of a forced outage at one of the units.

Project Regulation

Chelan's ability to own and operate the project is dependent on its successful relicensing by FERC. Chelan is currently using the "alternative licensing process" to renew the project license, which expires in June 2006. Federally licensed hydroelectric projects are required to comply with the requirements of the Endangered Species Act, as well as other federal laws. The district has addressed endangered species requirements for a 50-year period at both the Rock Island and Rocky Reach projects through anadromous fish agreements and habitat conservation plans (HCPs), which were approved by FERC and other federal and state agencies in 2004. The district believes the HCPs will significantly reduce risks related to environmental compliance at the projects and provide greater certainty for continued operations of the projects. Several nonanadromous species not covered by the HCP--such as bull trout, Pacific lamprey, and white sturgeon--are being addressed through the Rocky Reach relicensing process.

Financial Policy

Financial policy is characterized by Chelan's ability to pass through project costs on a monthly basis and the maintenance of restricted reserves, including a debt service reserve. Chelan bills its contractual offtakers monthly based on actual operating, maintenance, and debt service costs. Cost recovery is not affected by streamflow, since costs are recovered irrespective of MWh production at the project. The project has historically funded a debt service reserve to be equal to maximum annual interest on the outstanding bonds.

Financial Profile

The project's debt structure is characterized by a high percentage of non-amortizing, long-dated debt and the mismatch of debt maturities with the expiration dates of the project's power sales contracts. In addition to the $13 million in Rocky Reach project debt that amortizes by 2029, the project also had $357 million in subordinate intersystem loan obligations issued through Chelan's HCS bond resolution as of June 30, 2005. In contrast to the direct project debt, the HCS debt consists largely of bullet maturities and is of considerably longer duration, with a weighted average maturity of about 30 years as of Dec. 31, 2004. Neither the use of bullet debt nor the mismatch of bond tenor and power sales contract expiration are rating factors, given the project's competitiveness and the fact that bullet debt rollover risks are manageable to the offtakers, including Chelan.

Accounting

The Rocky Reach project is audited annually, with a fiscal year-end of Dec. 31 as part of Chelan County PUD. Chelan's auditor, Deloitte & Touche, issued an unqualified audit opinion on the district's 2004 annual report. The audit conforms with GAAP accounting and abides by GASB standards.