M E M O R A N D U M

TO: Board of Commissioners

FROM: Power Contract Negotiating Team

RE: Risks Identified Related to the Alcoa Proposed Term Sheet

DATE: October 15, 2007

The Alcoa proposed term sheet represents a take-or-pay, slice proposal for a 25/26% share of the output from Rocky Reach and Rock Island hydroelectric projects. Alcoa will pay the 25/26% share of all costs as defined regardless of the amount of energy actually received. Costs are defined more broadly than the definition in the current contract with the District's wholesale purchasers.

The purpose of this memo is to describe risks that the team has identified regarding the proposed term sheet with Alcoa.

Operational Risks (mitigated)

As noted, Alcoa will receive a percentage of the output actually produced. For example, if a unit goes down, Alcoa would share in that risk by receiving less energy but continuing to pay full costs. If the District were to guarantee a particular amount of energy to be delivered, the operational risks would fall all upon the District and its customer/owners. This type of "slice" contract shares that risk. The District would maintain all operational decision-making and control. Sections 17 and 18.

Environmental Risks (mitigated)

If environmental requirements impose a reduced flow regime or increase the costs of operating Rocky Reach and Rock Island, Alcoa would share in those risks. Alcoa would only be entitled to a percentage share of the actual energy produced from the available water in any given year but will pay the percentage (25/26%) of costs, regardless of what those costs may be in the future.

Cost of production/delivery – risk of increases (mitigated)

We have seen a number of reasons for cost increases for the production and delivery of energy. Environmental regulations represent one. There is also the ever-increasing costs of labor and materials. Under this proposed term sheet, Alcoa is agreeing it would pay its fixed percentage of costs for the operation of the projects and the delivery of the energy to them, regardless of the amount of increases.

Amount and timing of water (mitigated)

Alcoa would be responsible to perform its own forecasting of water and the power to be generated and used at their plant. Section 5.3. Alcoa would make the decision as to operating levels based upon their information and analysis. The District would provide information, but will not be responsible (nor liable) for any forecasting or predictions.

Licensing and relicensing (mitigated)

The costs of licensing requirements for Rocky Reach will increase with the increased costs of material and labor. As noted above, the risks of those cost increases would be shared with Alcoa as a slice purchaser. Further, Rock Island's license expires in 2028. The District will need to start the relicensing process in about 2018-2020. The proposed term sheet specifically includes a provision that on-going relicensing process costs would be paid as incurred and Alcoa will share in those expenses (Section 19 and Appendix A). This is a shared expense even though the contract expires in 2028, when the license expires. Note: There is no commitment to any future contract beyond 2028.

Transmission risks (mitigated)

There are transmission constraints for delivery of energy out of the Mid-C area which could impact the District's ability to sell energy on the market and the price of that energy. A sale of energy to Alcoa, a local user of the energy, avoids these constraint issues. This will need to be a consideration if the Alcoa plant does shut down and the District sells the power.

Further, Alcoa pays for its proportionate share of the transmission system costs within the District's system.

Credit risks (mitigated to extent of collateralization requirement)

Alcoa currently has a credit rating of A2 (Moodys), A- (Fitch) and BBB+ (S&P). Having Alcoa as a counterparty provides diversification of the District's credit exposure and would provide a creditworthy purchaser based on current credit ratings. On the other hand, the proposed term sheet with Alcoa does represent a credit concentration in one counterparty. The credit risk exposure to Alcoa given the amount of energy pursuant to this proposed term sheet and the deferred capacity reservation charge is large. This is particularly true in the early years given the schedule for payment of the deferred capacity reservation charge.

The proposed term sheet includes a mitigation measure regarding this credit risk in terms of a collateralization requirement that is triggered if Alcoa's credit rating drops to below BBB- (below investment grade). The collateralization provisions require the posting of a letter of credit or other collateral satisfactory to the District. Section 28. If collateral is not posted, then the District could declare Alcoa in default of the contract and pursue all available remedies (including termination of the contract).

District Debt (mitigated)

The proposed term sheet includes provisions whereby the District recovers financing costs (principal and interest), including future debt and debt outstanding at the time the agreement is effective in 2011. The District is in control of the financing decisions. Appendix A. Further, there are provisions that can be used by the District to reduce debt and also pay some capital costs on an "as we go" basis instead of borrowing. Those provisions are the Debt Reduction Charge and the Capital Recovery Charge addressed in Section 11 (f), (g) and (h).

Losses or damages to Alcoa's facilities or operations (mitigated)

The District would not be liable to Alcoa for any damages or losses (direct, consequential or otherwise) sustained by Alcoa as a result of the failure to deliver, curtailment, reduction or interruption of Output or any failure of transmission or interconnection equipment. We learned in September 2005 as a result of the McKenzie transformer failure just how valuable this type of provision is to the District given how quickly damage can occur at the Alcoa facility (pots "freezing").

Curtailment and load shedding (mitigated)

The District may interrupt, reduce or suspend delivery of output for any reason, including system emergencies, relocation, repair or maintenance of equipment, operating constraints or regulatory requirements. Section 10. Further, the District would have the right to occasionally curtail deliveries of energy for short period of time to meet local load requirements. Section 12. Neither of these events would subject the District to liability or costs.

Legislative Risks (mitigated)

As discussed, the District is a creature of statute and could be the target of an attempt to "take" our projects. The potential of this risk has been the subject of debate. However, a slice, long-term contract (if approved) would mitigate the risk since any entity that may attempt to "take" the project would be subject to existing contracts that could not be unilaterally abrogated.

Less energy to sell at market prices through 2028 (recognized)

This is a proposed term sheet for a proposed long-term (17) year contract that is based upon costs of operation and delivery. There are payments that go beyond a typical cost-of-service contract (i.e., credit rating premium (Section 11(e)); financing costs as defined; District retains all monies in all accounts at the end of the contract (Section 14); proceeds from surplus sales shared in certain events (Section 5)). This means there will be less energy available to be sold at market. There is a "flip" side of the same risk: volatility. On one hand, this proposed contract would provide the District with assurances and subject the District and its customer/owners to less volatility associated with prices and water. On the other hand, it also represents a potential reduction in revenues that could be obtained if all of this power were sold at market prices. This latter option (selling everything at market) would create another risk which is political in nature.

Amount of energy sold to Alcoa (recognized)

Power adequate to serve two pot lines is currently available to Alcoa. The contract for that power expires in October 2011. Alcoa has maintained that a three pot line operation is needed in the long run to justify continued operation of the Wenatchee Works smelter. Economies of scale by running the plant at a higher capacity support that analysis. Also independent analysis, most recently by CRU Strategies (an international metals consultancy firm) in April 2007, concluded that power supplied by Chelan PUD to run three pot lines would increase the probability that Alcoa would find it economically feasible to operate the Wenatchee Works on a sustained basis over the proposed term (17 years) set forth in the proposed term sheet.