

## **FITCH UPGRADES CHELAN (WA) PUBLIC UTILITY DIST \$1B REV BNDS TO 'AA+'; OUTLOOK STABLE**

Fitch Ratings-New York-24 October 2008: Fitch Ratings upgrades Chelan County Public Utility District No. 1 (the district), Washington's approximately \$1 billion senior and subordinated consolidated system revenue bonds and hydroelectric project revenue bonds to 'AA+' from 'AA'. Fitch also assigns an 'AA+' rating to the district's proposed issuance of up to \$75 million, in aggregate, series 2008A (taxable/AMT) and 2008B (non- AMT) Rock Island and Rocky Reach hydro system revenue/refunding bonds. Fitch further assigns an 'AA+' rating on the district's \$62 million, series 2008A consolidated system subordinated revenue notes, with a shorter term maturity of five years. The Rock Island and Rocky Reach hydroelectric system bonds are directly secured by the net revenues of the respective hydroelectric projects. Consolidated system debt (including the proposed 2008A subordinated notes) is secured by the net revenues of the 'consolidated system', which consists of the district's electric distribution, water, wastewater, telecom, and the Lake Chelan hydroelectric production systems. The Rating Outlook for all debt is Stable.

The 2008A short-term subordinated notes are scheduled to price as early as Oct. 28, 2008. The final maturity of subordinated notes will be determined closer to pricing, but not likely to extend further than five years. The district intends to refinance the subordinated notes at maturity with long-term debt.

The series 2008A and B hydro project system revenue bonds are fixed-rate securities and are scheduled to price in mid November, subject to market conditions. All proceeds will be used to finance a portion of capital expenditures and current refund certain outstanding debt for economic savings.

The district's upgrade to the 'AA+' level reflects steady strengthening of financial metrics over the past five years, very low cost hydroelectric power resources (average cost of power of just 16 mills per kilowatt hour [kwh]), among the lowest retail electric rates both regionally and nationally, and ample cash reserves. Additionally, Chelan has attained federal relicensing of two of its three hydropower projects thus far, extending the operating licenses 40 and 50 years, respectively, for the Rock Island and Lake Chelan hydro projects.

Several positive and recent developments this year include management's completion of their comprehensive strategic plan, which sets out a plan to address the district's reliance on considerable offsystem power sales (70% of distribution system revenues for fiscal year 2007), the establishment of a solid liquidity target (from \$50 million up to \$130 million), and the expected filing within the next few weeks of the final biological opinion (from the U.S. Fish and Wildlife Services) which is the final step necessary for the Federal Energy Regulatory Commission (FERC) to take action on the district's largest hydro facility, the Rocky Reach project. At this point, the district is anticipating attaining the renewed federal operating license for Rocky Reach in early 2009.

Going forward, the district's existing offsystem power contract sales will expire on Oct. 31, 2011 for Rocky Reach and June 7, 2012 for Rock Island. Chelan has renegotiated new long-term power sales agreements with two of the current power purchasers (Alcoa and Puget Sound Energy), which will account for 51% of the district's Rocky Reach and Rock Island hydropower output post 2011/2012. The new power sales contracts contain more favorable terms for the district and will likely boost net margins in years with average hydrological conditions. Finally, since the western energy crisis of 2001 and with the increasing state mandates for more renewable and 'greener' power resources, average wholesale electricity prices will continue to feel upward price pressure for the foreseeable future. The district is favorably poised to benefit from this power market environment given Chelan is a net seller of exceptionally low-cost, renewable and 'green' hydroelectric power.

Credit risks are few and manageable, and aside from obtaining the final approval of FERC's

operating license for the Rocky Reach hydroelectric project, include exposure to varying hydrological conditions in the northwest and their impact on the district's significant net surplus power sales. As the existing hydropower sales agreements terminate in 2011 and 2012, the district's hydropower allocation will grow to 48% of the output from the combined hydro projects in 2012 (from 30% historically). As a result, surplus power sales will grow as well. Resale revenues can be volatile, as they are directly affected by the volume of hydropower produced (which is a function of the water conditions) and the region's wholesale electricity market prices. The district's recently completed strategic plan provides initiatives to partially mitigate the district's dependence on net surplus power sales, including: implementing moderate annual retail rate increases, the ability to impose rate surcharges if necessary, building up of cash reserves, and accelerated paydown of distribution debt (non-hydro project debt).

A final note, despite Chelan's various senior, subordinate, consolidated and project-specific liens, Fitch rates all long-term obligations the same at 'AA+'. While the distribution system and hydro generating projects are accounted for and financed separately, Fitch still views them as an integrated system. The senior consolidated system lien is now closed, and the subordinated consolidated system lien is the operating lien going forward.

Chelan County PUD No. 1 is an integrated electricity provider, with approximately 45,500 retail customers in central Washington. The retail distribution system is part of Chelan's consolidated system and further includes: a small water and wastewater system (5,200 user/460 users), a fiber optics system (6,500 end users), and the Lake Chelan hydroelectric project (48 megawatts). As mentioned above, the district also owns two other large hydroelectric projects, the Rock Island and Rocky Reach projects, which are accounted for separately.

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