Chelan County Public Utility District No. 1, Washington

**Credit Profile**

<table>
<thead>
<tr>
<th>Bond Description</th>
<th>Long Term Rating</th>
<th>Rating Type</th>
<th>New</th>
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</thead>
<tbody>
<tr>
<td>US$93.75 mil Consolidated sys rev bnds ser 2007A dtd 05/31/2007 due 07/01/2032</td>
<td>AA/ Stable</td>
<td>AA/ Stable</td>
<td>New</td>
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<tr>
<td>US$29. mil Consolidated sys rev bnds (Non-AMT) ser 2007C due 07/01/2037</td>
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<tr>
<td>US$8.14 mil Consolidated sys rev bnds (amt) ser 2007B due 07/01/2042</td>
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<td>AA/ Stable</td>
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</tr>
</tbody>
</table>

**Rationale**


At the same time, Standard & Poor’s affirmed its ‘AA’ rating and underlying rating (SPUR), with a stable outlook, on Chelan’s existing bonds.

The 2007A bonds are being sold in auction-rate mode, while series 2007B and 2007C are fixed-rate bonds.

The ‘AA’ rating reflects the strong business profile and modest financial risk of the district’s consolidated system, which includes its electric, water, and wastewater utility; telecommunications unit; and the Lake Chelan hydroelectric project. The consolidated system is the ultimate obligor for the district’s various utility systems and hydroelectric projects issuing debt through the consolidated system’s bond resolution. With the issuance of the 2007 bonds, Chelan has covenanted that it will not issue debt with a lien prior to the lien on the 2007 bonds, which effectively closes the current senior lien. In addition, under the new subordinate
lien resolution, legal protections have improved slightly. Consequently, Standard & Poor’s does not
distinguish between the two liens.

As of Dec. 31, 2006, the district had $636 million in hydroelectric consolidated system debt and
$303 million in project debt at its Rocky Reach and Rock Island hydroelectric projects. The district
estimates that approximately $524 million, or 56%, of this combined debt burden is serviced by
hydroelectric project offtakers under long-term, take-or-pay, cost-of-service contracts, leaving a net
debt burden of $413 million as of Dec. 31, 2006.

The consolidated system bonds are secured by the rates and charges of the retail utilities as well as
certain inter-system loan payments from the district’s two large hydroelectric systems.

The district, established in 1936, owns and operates an electric distribution system, a
telemcommunications system, three major hydroelectric power generating projects (Rocky Reach, Rock
Island, and Lake Chelan), and a small water and wastewater system. The district issues debt primarily
through its consolidated systems bond resolution, a financing vehicle created in 1987 for the purpose of
issuing tax-exempt debt on behalf of both the retail utilities and the hydroelectric projects from which
the district derives most of its power. As of 2007, the district rescinded the consolidation of the Rocky
Reach and Rock Island projects in order to preserve the flexibility in hydroelectric project financing
arrangements.

Chelan’s strong business profile (‘3’ on Standard & Poor’s 10-point scale, with ‘1’ as the strongest) is
characterized by the district’s rate-setting ability, extremely low-cost power supply, moderate asset and
resource concentration, and a low degree of merchant risk-related non-firm surplus sales. The district’s
low cost power supply is derived from its three hydroelectric plants, which produced power at an
average $16 per megawatt-hour (MWh) in 2006; the cost is projected to increase modestly each year to
about $21 by 2010, assuming average hydrological conditions. The hydroelectric projects are
competitive even under very low streamflow conditions, as demonstrated most recently during the
extreme 2000-2001 winter drought (the second-worst on record), when the production costs averaged
a still-competitive $17 per MWh. Chelan officials estimate that under critical water conditions, project
costs would remain below $25 per MWh, well below the likely market price in the region under such a
scenario. The district has surplus power during nearly all months of the year. The sale of surplus power
subsidizes retail rates.

Like its mid-Columbia neighbors, Grant County Public Utility District (A+/Stable) and Douglas
County Public Utility District (AA/Stable), Chelan sells far more power to contractual offtakers and the
wholesale market than it does to its own retail system. Chelan’s distribution system currently takes
about 30% of aggregate output from its Lake Chelan, Rocky Reach, and Rock Island projects and sells
the remaining 70% of the output to other utilities in the region through long-term, take-or-pay
contracts that expire by 2012. The power sales contracts permit Chelan to charge offtakers for their
allocable shares of operating and debt service costs, plus 15% rolling coverage on interest payments.
Chelan’s distribution system still has surplus capacity in nearly all months, even under very low water
conditions. Short-term and market sales of this surplus capacity, including sales to Alcoa Inc. and the
Douglas County district, accounted for a high 50% of operating revenues at the retail system and an
even larger percent of net revenues, given that margins on these sales exceed those at the retail level.

Debt service coverage (DSC) ratios at the consolidated system were a strong 1.75x for fiscal 2006.
DSC at the retail distribution level remains highly sensitive to wholesale sales not made under long-
term contracts. The lower coverage ratio for the consolidated system is indicative of the cost-of-service contracts supporting most of the debt, as explained below.

**Outlook**

The stable outlook reflects Chelan’s strong financial policies regarding DSC and liquidity, as well as the district’s low cost power supply. Though concern remains regarding the district’s continued reliance on wholesale sales that have generated substantial margins even under adverse streamflow conditions, Standard & Poor’s expects that management and the governing board would take steps to adjust net income under such a scenario.

**Economic Base And Markets**

Chelan County is located in central Washington. The county’s population has grown more than 20% during the past decade. The Cascade Mountains, Columbia River, and forests and lakes attract recreation and tourism, second-home development, and retirees. Wenatchee, located 140 miles northeast of Seattle, is Chelan’s county seat and largest city. The county has below-average economic characteristics. Agriculture, primarily apple and other fruit production along with related industries, accounted for roughly one-sixth of employment. Services and trade round out the economic base. The unemployment rate (5.9% for the 12 months ending December 2005, the lowest level in five years) is typically above the national average, while household income is 92% of the national average. Leading employers include various medical, educational, and agricultural concerns, as well as local governments and the district itself. Alcoa is also a key employer, producing aluminum at a plant that also generates substantial electric sales.

Chelan serves retail electric service to 44,431 customer accounts, mainly in Chelan County, but also in parts of adjoining counties. Customer growth has averaged 2.4% annually the past four years, indicating the county’s economic growth, as well as related capital pressures on the distribution system. Alcoa, which employs 377 workers at its Wenatchee Works smelter, is the distribution division’s leading customer, accounting for 15% of distribution sales in 2006. This concentration is mitigated by provisions in the Alcoa contract that link prices to actual costs of the Rocky Reach system on a take-or-pay basis. The contract with Alcoa runs through Oct. 31, 2011. In addition, Chelan has contracted to sell 2.77% of its share of hydroelectric production at Rocky Reach and Rock Island to the Douglas County district; the share will increase by an additional 2.77% from 2011 to 2021 and will be subject to renewal in 10-year increments to 2061.

**Operations**

The district benefits from an excess of low-cost hydroelectric generation. Energy from the district’s two major hydroelectric projects cost just $18 per MWh in 2006 and is economical even at near-critical water levels, as was realized in 2001.

The district is generally a net seller of power, since its allocation of hydroelectric power is sufficient to meet retail load requirements, except under the most adverse of streamflow conditions, or on days with exceptionally cold weather in which local demand may exceed supply. As such, the district generally derives a significant amount of its net revenues from wholesale operations, which subsidizes its retail distribution operations. Generation at the district’s hydroelectric projects is driven by Columbia River streamflow below the Grand Coulee Dam, which is correlated with streamflow at The
Dalles, Oreg. (which is also affected by Snake River streamflow), the major pricing hub in the Pacific Northwest.

**Power Supply**

Chelan operates three major hydroelectric projects, which together represent nearly 2,000 M W and generated more than 9.2 million M W h in 2006, up 9.1% from 2005. A portion of the output from the two leading projects is sold to third parties, pursuant to long-term power supply contracts which expire in 2011 and 2012. The district has renegotiated a 20-year contract with Puget Sound Energy commencing in 2011, and expects to secure contracts with other purchasers for the post-2011 period in the coming years.

The Rocky Reach system is located on the Columbia River and has a nameplate capacity of 1,300 M W. Its 11 turbine generators provide significant operational flexibility. The average cost of production, including debt service, was $12 per M W h in 2006 and just $14 per M W h in 2001, even though that year’s drought suppressed streamflow to “critical water” levels. Chelan’s distribution system has a 41% allocation of project output, of which a portion is resold to Alcoa (23%) and the Douglas County district (2.77%, with an option to take an additional 2.77% beginning Nov. 1, 2011). In 2006, the facility provided roughly 49% of the Chelan distribution system’s total power supply.

The Rock Island system is located on the Columbia River and has a nameplate capacity of 624 M W, generated by 19 turbines. The average cost of production was roughly $24 per M W h in 2006, its best performance since 2002. The Rock Island project produced power at $23 per M W h during 2001, under severe drought conditions. As of Dec. 31, 2006, the district’s share of the total project output is 50%, after Chelan exercised a series of purchase options to increase its share of project capacity. In 2006, the facility provided approximately 32% of the Chelan distribution system’s total power supply.

The Lake Chelan hydroelectric project provided 10% of the Chelan distribution system’s total energy requirements in 2006 at an average cost of production of about $11 per M W h. The Chelan distribution system receives 100% of the 59 M W hydroelectric plant’s output.

**Regulatory Compliance And Relicensing**

The current licenses for Rocky Reach expired in July 2006, and Chelan is operating under an annual license while final approvals for a new 50-year license are progressing. Chelan expects a new license to be granted by FERC for Rocky Reach in late 2007. The license for Rock Island does not expire until 2028. In November 2007, Chelan received a new 50-year license for Lake Chelan.

At Lake Chelan, the net present value cost of implementing the recently approved 50-year FERC license is projected to be approximately $68 million; the amount includes fish protection, mitigation, and enhancement measures, among other operating and capital costs.

**Habitat Conservation Plan**

Chelan has developed a habitat conservation plan (HCP) that outlines the district’s efforts for a 50-year period. The plan’s goal is to ensure that there is no net impact on fish from the operation of its hydroelectric facilities. The district is responsible for 91% fish passage (survival) at the Rocky Reach and Rock Island projects and 9% compensation from hatcheries and tributary programs. Various interested parties have agreed to be supportive of the district’s license applications filed during the 50-year proposed term of the HCP. In June 2004, FERC approved Chelan’s HCP application and
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amended the Rocky Reach and Rock Island operating licenses to incorporate the plant. Chelan is engaged in full implementation of the HCP programs. At Rocky Reach, Chelan spent approximately $112 million for the juvenile fish bypass system, and its license will require periodic updates using state-of-the-art technology. In 2007, Chelan’s management reported that the district will reduce spill at the Rocky Reach and Rock Island dams due to the success of the HCP in fish survival rates, flows through the generators at the projects should increase as a result, leading to increased wholesale sales.

Competitive Position

Although retail competition is unlikely to be introduced in Washington in the foreseeable future, the district is well poised to compete in wholesale and retail markets, with rates that are among the lowest in the country. Its long-term power sales contracts for Rocky Reach and Rock Island expire in 2011 and 2012, respectively. Chelan’s retail customers have little incentive to obtain electricity from any other source. Customers enjoy what are among the lowest rates in the country, averaging three cents per kilowatt-hour (kWh) in 2006, compared with the average system rate in Washington of about six cents per kWh. Industrial rates are a low 1.9 cents per kWh. Chelan’s wholesale generation is also exceptionally competitive, with average production costs of just $16 per MWh in 2006, compared with Bonneville Power Administration’s priority firm rate of about $30 per MWh. The district expects to maintain a competitive position at both its retail and wholesale operations. The most recent rate increase was in 2000, when rates were raised by a modest 2.5%. Importantly, the district did not raise rates during the lingering drought period earlier this decade, though most other utilities in the region did, some dramatically so.

Finances: Strong Debt Service Coverage

DSC of all debt is strong for the consolidated systems, at 1.6x for fiscal 2006. Fixed-charge coverage was a strong 1.5x in 2006. Annual debt service levels remain dependent upon wholesale sales and margins, and consequently can vary with hydrological conditions and regional power market prices. Coverage of project revenue bonds is maintained at 1x, with the power purchasers charged just the cost of production, including all debt service, plus an additional 15% rolling coverage on interest. District management projects solid DSC at the retail level above 1.75x, and unrestricted cash reserves maintained at or above $75 million, keeping with the district’s minimum policy targets. Management is evaluating various strategies to reduce dependence on wholesale profits of power sales to shore up operations, and is willing to address user charges and surcharges in its various systems, including the water and sewer systems.

Chelan has a strong, liquid balance sheet for both the consolidated and distribution systems. Debt is a moderate 72% of capitalization, but is expected to decline as the district funds more capital projects with cash. Unrestricted cash and investments, which totaled $178 million as of Dec. 31, 2006, are the equivalent of roughly 15 months’ expenditures. An equity layer of 25% provides Chelan with significant flexibility should additional borrowings be required.

The district’s five-year capital improvement plan (CIP) indicates modest ($19.9 million) additional borrowing on behalf of the retail system, including the broadband telecommunications system, in the next five years; however, $139 million of additional debt-funded borrowing and $108 million from intersystem loans for hydroelectric projects are projected during the 2007-2011 period. The 2007 new
money bonds (series 2007B and 2007C), along with annual revenues and reserves, are expected to
cover the district’s capital needs for the next two years.

Legal Provisions
The legal provisions for consolidated system revenue bonds are weak overall, due to low coverage tests
for the rate covenant and additional bonds test. The senior consolidated system resolution, however, is
effectively closed by a new resolution under which the 2007 bonds are being issued. The new resolution
has different legal provisions that make some improvements from a credit perspective. These
improvements include the addition of flow-of-funds provisions and a rate stabilization fund, as well as
tighter language on the additional bonds test and rate covenants. The rate covenant for the
consolidated hydroelectric system bonds requires the district to collect revenue that provides annual
revenues, together with other unencumbered funds of the district, in an amount sufficient to pay
operating expenses of the consolidated system and cover debt service by 1.25x. In addition,
distribution system net revenues alone must meet a DSC test of 1x for senior bonds, while the
subordinate lien test allows the use of rate stabilization funds. A debt service reserve is maintained for
the consolidated system senior- and junior-lien bonds in the amount of maximum annual interest
payable in any future year.

Debt Derivative Profile: ‘1.5’
The district’s consolidated system has been assigned a Standard & Poor’s Debt Derivative Profile
(DDP) overall score of ‘1.5’ on a scale of ‘1’ to ‘4’, with ‘1’ representing the lowest risk and ‘4’ the
highest. The overall score of ‘1.5’ reflects Standard & Poor’s view that Chelan’s electric system-related
swap portfolio reflects a very low credit risk at this time due to:
- A low degree of involuntary termination risk under the county’s swaps due to a wide ratings trigger
  spread;
- Average economic viability of the swap portfolio over stressful economic cycles, due to the relative
  long term of the swaps; and
- Strong management practices regarding debt and derivatives.
Chelan has entered five floating-to-fixed-rate swaps with a notional amount of roughly $231 million.
Two of the swaps, with a notional amount of $93 million, will become effective of May 31, 2007, and
are associated with the 2007A refunding bonds. The other three swaps are forward-starting swaps, and
will take effect upon the issuance of other refunding bonds expected to be issued in 2009, 2011, and
2013. The 2007 swaps are with Bear Stearns Capital Markets Inc. (guaranteed by Bear Stearns
Companies Inc.), and Lehman Brothers Special Financing Inc. (guaranteed by Lehman Brothers
Holdings Inc.). The other counterparties are JPMorgan Chase Bank, N.A., and Goldman Sachs M itsui
Marine Derivative Products, L.P. (AAA, guaranteed by The Goldman Sachs Group Inc.). The
documents for the various swaps list the issuer's rating falling below ‘BBB’ as an additional credit event.
This is seen as remote, due to the Chelan’s consolidated system’s strong credit profile; in addition, the
swap insurer’s rating, currently ‘AAA’, must fall below ‘A-’. Net variable-rate exposure is minimal, as
Chelan has swapped most of its variable-rate bonds to a fixed rate. Chelan manages its debt and swap
program with an adopted swap and debt management policy. Due to the low degree of termination
risk, Standard & Poor’s is not factoring in the swaps’ value at risk as contingent liabilities for Chelan’s consolidated system’s revenue bonds.

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<th>Ratings Detail (As Of 30-Apr-2007)</th>
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<td><strong>Chelan Cnty Pub Util Dist #1 (Chelan Hydroelec Cons Sys) Sr lien</strong></td>
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<td><strong>Chelan Cnty Pub Util Dist #1 (Chelan Hydroelec Cons Sys) (taxable) Sr lien</strong></td>
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