Public Power/North America
New Issue

Chelan County Public Utility District No. 1, Wash.

Ratings

New Issue

$134 Million 2007 Series A, B and C Subordinated Consolidated System Revenue Bonds .... AA*

Outstanding Debt

Security Class	Current Rating	Previous Rating	Date Changed
Sr. Consol. Sys. Rev. Bonds**	AA	AA–	9/3/98
Rocky Reach Hydro Sys. Rev. Bonds (1968)	AA	AA–	9/3/98
Rock Island Hydro Sys. Rev. Bonds (1955/1997)	AA	AA–	9/3/98

*Long-term unenhanced rating. **Various series (1996–2005).

Rating Watch...None
Rating Outlook.. Stable

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Profile

Chelan provides electricity to 44,400 retail customers in central Washington. Chelan's consolidated system includes the retail distribution system and a water/wastewater system (5000 users/440 users), a fiber optic network (4800 end-users) and the Lake Chelan hydroelectric facility (48 mw). Chelan also owns two other large hydropower facilities (Rocky Reach and Rock Island), which are accounted for separately.

Key Credit Strengths

- Low-cost hydroelectric resources.
- Solid financial position.
- Very competitive retail rates.
- Attained new federal operating licenses for two of three hydroelectric projects thus far.

Key Credit Concerns

- Largest hydroproject awaiting FERC approval of new operating license.
- Distribution system margins reliant on surplus wholesale power sales.
- Increasing cost pressures for the distribution system.

May 9, 2007

■ Rating Rationale

Chelan County Public Utility District No. 1's (Chelan) high credit quality stems from its considerably low-cost hydroelectric power resources (both on a regional and national basis), very competitive retail rates (average of 3 cents per kilowatt-hour [kwh]), solid financial performance (highlighted by strong cash reserves) and successful federal relicensing of two of its three hydroprojects thus far.

Chelan's low-cost power reflects its ownership of three hydroelectric facilities (Rocky Reach, Rock Island and Lake Chelan), with a combined generating capacity of nearly 2000 megawatts (mw). The average cost of hydro production for these facilities was just $16 per megawatt-hour (mwh) in 2006, which compares very favorably against the Northwest's largest hydroelectric power producer, Bonneville Power Administration, with an average power cost of closer to $30 per mwh for 2006. Given the district's power allocation from its hydroelectric projects, the district's hydroelectric generating resources are more than adequate to meet the distribution system's power needs well into the future, except on the coldest winter days. Chelan's power supply position should remain competitive compared to the Northwest region's wholesale power market, which is increasingly driven by more costly natural gas as well as, to a lesser degree, wind and other renewable resources, on the margin.

Credit risks are few and manageable, including attaining Federal Energy Regulatory Commission (FERC) approval to renew the operating license for Chelan's Rocky Reach hydro project, the distribution system's reliance on net margins (primarily from surplus wholesale sales) and increasing power costs for the distribution system. Additionally, there is the ongoing risk that federal/state fish protection regulations could change, or a new species of fish could be added to the endangered list, which may affect operations at the hydroelectric projects.

■ New Issue Details

Chelan is scheduled to price $93.8 million series 2007A auction-rate subordinated consolidated system revenue bonds on May 10, 2007, and up to $40 million series 2007 B and C fixed-rate subordinated consolidated system revenue bonds on May 30, 2007. Lehman Brothers Inc. will be the sole underwriter for both deals. The 2007A bonds (subject to alternative minimum tax [AMT]) will be used to refund a portion of the outstanding senior consolidated system revenue bonds (series 1996A, B, C, D and 1997A [I-V]). Proceeds from the 2007B (subject to AMT) and 2007C (non-AMT) will finance a portion of the capital expenditures at the district.

The interest rate exposure on the 2007A auction-rate bonds will be swapped to a fixed rate through the final maturity date, with Bear Stearns Capital Markets Inc. (parental guarantee rated 'A+') and Lehman Brothers Special Financing Inc. (parental guarantee rated 'A+') as swap counterparties.

The ratings for the 2007 bonds reflect unenhanced ratings, as all the bonds are expected to be insured by the 'AAA' rated monoline bond insurers, XL Capital Assurance Inc. (series 2007A) and Financial Security Assurance Inc. (series 2007B/C). The 2007 bonds rank subordinate to $636 million in outstanding senior consolidated system revenue bonds (prior to 2007 refunding). Fitch Ratings also rates debt issued separately by Chelan's Rocky Reach ($11.8 million) and Rock Island ($291.3 million) hydroelectric projects at 'AA'.

Security Features

New Subordinated Consolidated System Lien

The 2007 bonds are being issued pursuant to a new subordinated consolidated system master resolution. Under the new subordinated resolution, the district made an effort to tighten bond covenants that were weaker in the senior consolidated lien. The key changes to the resolution, which Fitch views positively include:

- More traditional and conservative rate covenant.
- More traditional additional bonds test (based on historical or projected net revenue calculation).
- Simplified definition of annual debt service, clarifying the assumed amortization of the balloon bonds.
- Creation of a rate-stabilization fund.
- Addition of a traditional flow of funds.
- Closed senior consolidated system resolution.

Despite Chelan's maintenance of senior and subordinate liens, and hydro project versus consolidated system liens, Fitch rates all the obligations the same at 'AA'. While the distribution system and hydro generating projects are accounted for and financed separately, Fitch still views them all as an integrated system. Additionally, the senior consolidated lien is now closed, and there is a cross-default provision in the subordinated consolidated debt resolution that further links certain liens in the unlikely event of default. Also, given the take-or-pay nature of the power sales contracts for the hydroelectric projects, any payment default by the power purchasers would allow the district to remarket that purchaser's hydropower allocation in the wholesale market.

Recent Developments

Lake Chelan License Extended 50 Years

In November 2006, the FERC approved the new operating license for the district's Lake Chelan hydroelectric project (48 mw) to 2056. The district has already begun implementing the license requirements, which are manageable at an estimated cost of $65 million–$70 million over the 50-year period. The plans include the rehabilitation of the hydroproject's two generating units beginning in 2007.

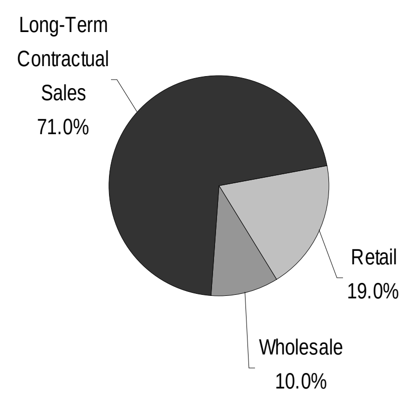
With the successful federal relicensing of the district's Lake Chelan and Rock Island projects thus far, only the Rocky Reach project remains without an approved new federal operating license. Rocky Reach is Chelan's largest hydroelectric facility, with a production capability of 1,300 mw. Rocky Reach's operating license expired in June 2006 but continues to operate normally pursuant to an annually renewed license until the new federal license is approved.

Positively, the district is in the final stages of FERC's review process of the Rocky Reach application and a final decision is anticipated in 2007. To Chelan's management's credit, the development of the habitat conservation plans for Rocky Reach and Rock Island hydroelectric projects not only set a boundary on future fish protection expenditures but also seemed to have helped move the FERC review process along somewhat smoother. FERC's approval of a new operating license for Rocky Reach is favorable, as it ensures the ability to operate the hydro facilities well into the future, beyond the existing life of bonds outstanding.

While Chelan has been successful at attaining the hydro projects' federal relicensing thus far, licensing comes with a long-term cost in the form of license requirements that must be implemented, albeit spread over the 50-year term of the license. Chelan conservatively estimates that the average cost of power from its three hydroelectric projects, at just $16/mwh currently, will increase to $21/mwh by 2011. In critical water years, the average hydropower cost could rise to $25/mwh. However, in those years, the district's power cost should continue to remain competitive relative to others in the Northwest region.

In Fitch's opinion, the projected cost of hydropower will remain competitively well-positioned in comparison to the broader Northwest region, where predominantly higher cost power resources, such as: natural-gas fired, wind and other alternative/renewable resources will likely be added for the foreseeable future. Additionally, the hydroprojects do not emit any greenhouse gases, which is favorable for the district, relative to some other utilities in the region and nationally.

2006 Allocation of Chelen County Public Utility District No. 1's Hydro Resources
(Megawatt-Hours)



Source: Company 2006 audited financial report.

Extended First Power Sales Contract to 2031 with Puget Sound

In January 2006, Puget Sound Energy, Inc. (PSE, not rated by Fitch) was the first Pacific Northwest power company to establish a new power purchase agreement with Chelan. Chelan's hydroelectric output from the Rocky Reach and Rock Island facilities is currently sold at 44% to the district (for distribution system use and sales to Alcoa) and 56% to various Northwest power purchasers (PSE, Avista Corp., PacifiCorp, Portland General Electric Company, Douglas County Public Utility District No. 1). The power is sold directly from the hydroprojects to the investor-owned utilities at cost, pursuant to take-or-pay agreements that expire in 2011/2012. The Rocky Reach power sales agreements contain a 25% step-up provision for the nondefaulting purchasers in the event a purchaser defaults on the hydropower payments. The new power sales agreements (post-2012) preserve most of the key take-or-pay provisions as in the existing power sales contracts. In the extended PSE power sales agreement, Chelen also received an upfront capacity reserve fee of $89 million, which the district is reviewing how best to use those funds for the benefit of its customers.

Given the value of Chelan's low-cost hydropower in the region, the district anticipates continuing to sell approximately 60% of the aggregate output of Rocky Reach and Rock Island to other Northwest power purchasers beyond 2012. For the distribution system, it will maintain 40% of the projects' output for its own use. This level of hydro allocation for the district is adequate to cover the distribution system's power requirements, likely for the next 20 years.

New General Manager and Commissioners

Chelan is governed by five elected commissioners. The commissioners' responsibilities include establishing retail rates and approving budgets, expenditures and utility policies. Chelan is not regulated by any other state or federal utility authority (excluding FERC authority over the hydroprojects' operating licenses). Two of the commissioners were recently elected in 2006, and all five are in their first terms. Thus far, the working relationship has been very cooperative with Chelan's management team. Senior management is striving to keep communication frequent and open to help bring newer members up to date and keep existing members abreast of Chelan's financial and operating status.

In May 2006, the district also hired a new general manager (GM), Rich Riazzi, to replace the prior GM, Charles Hosken, who moved onto a new position at another utility. While Mr. Riazzi has only been at Chelan for less that a year, he comes with more than 25 years of utility experience, most recently as president and CEO of IDACORP Energy, L.P. (power trading arm) and senior vice president of IDACORP, Inc. (the parent company of Idaho Power Co.). Based on his background, Mr. Riazzi is knowledgeable about the Pacific Northwest hydropower industry and should prove to be a valuable asset to Chelan as it faces the challenges ahead, in particular, the effective management of the distribution system's variable and considerable wholesale power sales.

Financial Update

For the separately accounted for hydroelectric projects (Rocky Reach and Rock Island), financial performance is very stable and predictable, as the power is fully contracted for and sold at cost. The take-or-pay nature of the power sales agreements provides for the recovery of all power costs, including debt service, whether or not the hydroelectric projects are operating. Consequently, debt-service coverage remains consistent and close to 1.0 times (x) as per the indenture.

For the distribution system, financial performance has been solid and strengthening since the Western energy crisis in 2000/2001. Chelan weathered the severe drought conditions much better than its peers (due to its ability to offset peak replacement power purchases with off-peak surplus wholesale sales), and the district's financial metrics remained strong. Fitch-calculated debt-service coverage, which incorporates senior and subordinate consolidated debt as well as consolidated bond proceeds loaned to the hydroprojects, has improved to 1.61x for fiscal year-end 2006 from 1.20x in 2002. Unrestricted cash reserves are exceptionally strong, totaling approximately $211.8 million at fiscal year-end 2006, the equivalent of more than 600 days of operating cash.

The district's cash position was significantly bolstered in 2006 by the $89 million capacity payment received from PSE. While the district's current target for unrestricted cash reserves is $75 million, or closer to 130 days of operating cash, that financial target, among other objectives, is currently under review as part of the district's ongoing strategic planning sessions (see New Strategic Planning Process section for more details). Equity-to-total capitalization modestly declined to 28% in 2006 from 31% in 2002 but is still within the range of comparably rated utilities.

Going forward, assuming average Northwest water conditions, reasonable wholesale power prices, 2.5% annual sales growth post-2007 and only modest annual rate increases, total debt-service coverage is projected to range from 1.38x–1.68x through 2011, which is adequate for the rating category, assuming maintenance of solid cash reserves. This base case scenario takes into account that the average cost of power from Chelan's hydroprojects will be increasing prospectively, due to the implementation of the new project operating license requirements and other system upgrades. At the same time, the district will gradually continue to retain more of its hydropower allocation for its own use to meet native load growth (albeit at a lower margin than for wholesale market sales). The combination of these two trends could negatively affect financial protection metrics. In anticipation of these potential consequences, the district expanded its strategic planning process to address and manage these risks going forward.

New Strategic Planning Process

In the past few months, the commissioners and senior management have begun a series of comprehensive strategic planning sessions to update the district's financial targets and address the challenges ahead for Chelan. In particular, a key focus of the planning sessions relates to the distribution system's increasing cost pressures and need to reduce reliance on net margins from surplus wholesale sales, which can vary considerably depending on the wholesale electricity market. A key credit risk for the district is the financial effect of a significant decline in wholesale electricity prices. Fitch looked at stress case scenarios lowering projected wholesale market prices approximately 20% (2009–2012) and determined that the district could offset most of the net loss via manageable rate increases of 5%. The Stable Rating Outlook takes this risk into consideration and assumes that the district would take the necessary actions to maintain adequate financial strength for the 'AA" rating category level.

Water, Wastewater and Fiber Optics Systems

In aggregate, these businesses, which are part of Chelan's consolidated system, accounted for 3.5% of total consolidated revenues for fiscal year-end 2006. The water and wastewater systems and the fiber optic network are not self-supporting systems, and each relies on wholesale net margins. The fiber network generates revenues adequate to cover operating expenses but not capital expenditures and long-term debt payments. While this cash drain on the district is projected to continue until 2012–2013, the net loss is declining and only represents 2% of the district's net assets for 2006.

Financial Summary — Chelan County Public Utility District No. 1

($000s, Fiscal Years Ended Dec. 31)

	2006	2005	2004	2003	2002
Income Statement					
Total Operating Revenues	221,552	220,702	241,217	222,460	186,964
Total Operating Expenses	170,602	166,440	191,627	161,943	135,167
Operating Income	50,950	54,262	49,590	60,517	51,797
Total Assets	1,286,863	1,398,645	1,400,355	1,354,262	1,369,677
Adjustments to Operating Income for Debt-Service Coverage	59,089	45,494	42,777	39,648	37,025
Funds Available for Debt Service	110,039	99,756	92,367	100,165	88,822
Adjusted Funds Available for Debt Service	115,271	109,138	110,444	113,496	95,070
Adjustment for Purchased Power	5,232	9,382	18,077	13,331	6,248
Total Annual Debt Service	68,138	65,633	61,941	74,796	73,737
Selected Balance-Sheet Items					
Unrestricted Funds*	211,825	113,111	93,221	66,216	77,823
Restricted Funds	169,706	209,450	240,970	233,236	272,641
Total Debt	931,091	942,107	958,094	918,000	944,520
Equity and/or Retained Earnings	355,772	456,538	442,261	436,262	425,157
Key Ratios					
Debt-Service Coverage (x)**	1.61	1.52	1.49	1.34	1.20
Coverage of Full Obligations (x)†	1.57	1.45	1.38	1.29	1.19
Days Cash on Hand	605	315	217	183	255
Net Variable-Rate Debt/Total Capitalization (%)	0.7	2.9	0	0	0
Debt/Funds Available for Debt Service	8.5	9.4	10.4	9.2	10.6
Equity-to-Capitalization (%)	28	33	32	32	31
Average Cost of Power ($/mwh)	17	20	25	24	16
Average Columbia River Flow at Rocky Reach (000 cfs)	111	101	94	95	112

*Includes board-restricted assets. **Based on Fitch coverage calculations, not resolution coverage. †Includes taxes/payments in lieu of taxes. Mwh – Megawatt-hour. Cfs – Cubic feet per second. Source: Company reports.