STANDARD & POOR'S PUBLIC FINANCE

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

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Credit Profile

OUTLOOK REVISED
To STABLE
From NEGATIVE

$143.365 mil. Chelan Cnty Pub Util Dist #1 (Chelan Hydroelec Cons Sys) Sr lien
AA
AA

$28.050 mil. Chelan Cnty Pub Util Dist #1 Chelan hydro cons sys rev bnds ser 1998A dtd 09/01/1998 due 07/01/2028 2030
AAA/AA(SPUR)
AA

$2.250 mil. Chelan Cnty Pub Util Dist #1(Chelan Hydroelec Cons Sys) (taxable) Sr lien
AA
AA

$158.160 mil. Chelan Cnty Pub Util Dist No 1 Chelan Hydro Cons Sys rev bnds rfdg (FGIC)
AAA/AA(SPUR)
AA

$79.905 mil. Chelan Cnty Pub Util Dist No 1 chelan hydro cons sys rev bnds ser 2002 A&B dtd 12/12/2002 due 07/01/2037
AAA/AA(SPUR)
AA

$30.000 mil. Chelan Cnty Pub Util Dist No 1 chelan hydro cons sys rev bnds ser 2002 C dtd 12/12/2002 due 07/01/2003-2014 2017 2022 2033
AAA/AA(SPUR)
AA

$65.620 mil. Chelan Cnty Pub Util Dist No 1 cons sys rev bnds ser 2001A dtd 03/01/2001 due 01/01/2036
AAA/AA(SPUR)

Rationale

Standard & Poor's Ratings Services revised its rating outlook to stable from negative on Chelan County Public Utility District No. 1, Wash. Additionally, Standard & Poor's affirmed its 'AA' rating on Chelan's hydroelectric consolidated system (HCS) revenue bonds, reflecting the strong business profile and intermediate financial risk profile of Chelan's combined electric, water, and wastewater utility, which is the ultimate obligor among the various utility systems, and hydroelectric projects that issue debt through the HCS bond resolution. Chelan's electric distribution system, its largest retail utility, is characterized by its extremely low-cost power supply, stable operations, strong debt service coverage, and moderate debt leverage.

Credit strengths include:

- The absence of retail competition and the ability to set retail rates without external oversight;
- Exceptionally low power supply costs, given that the district's three hydroelectric projects are highly economical, even under extremely low streamflow conditions;
- Very low retail rates, including a residential rate of 3.0 cents per kilowatt-hour (kWh) in 2004;
- Strong debt service coverage at the retail system level, with direct debt service of about 3.0x and a fixed charge coverage of about 1.7x in 2004, and adequate 1.5x coverage at the consolidated level; and
- Moderate adjusted debt leverage of about 57% at the retail system and 70% at the consolidated system as of Dec. 31, 2004.

Factors tempering the rating include:

- Reliance on wholesale margins from the sale of surplus hydroelectric generation due to the district's surplus power position in nearly all months, even under extremely low streamflow conditions; and
- Asset and fuel concentration, with complete reliance on just three hydroelectric resources, although the two largest projects exhibit exceptional project economics and operational flexibility due to the presence of multiple, independent turbines at each project.

As of June 30, 2005, Chelan had $652 million in HCS debt and $304 million in project debt at its Rocky Reach and Rock Island hydroelectric projects. The district estimates that approximately $302 million, or 32% of this combined debt burden, is

AA

$78.375 mil. Chelan Cnty Pub Util Dist No 1 cons sys rev bnds ser 2001B dtd 03/01/2001 due 01/01/2036
AAA/AA(SPUR)
AA

$28.655 mil. Chelan Cnty Pub Util Dist No 1 hydro cons sys rev bnds ser 2001C dtd 04/01/2001 due 07/01/2032
AAA/AA(SPUR)
AA

$15.755 mil. Chelan Cnty Pub Util Dist No 1 hydro cons sys rev bnds ser 2001D dtd 05/01/2001 due 06/01/2002-2015
AAA/AA(SPUR)
AA

$29.440 mil. Chelan Cnty Pub Util Dist No 1 hydro cons sys rfdg rev bnds ser 2003A dtd 04/02/2003 due 07/01/2032
AAA/AA(SPUR)
AA

$396.225 mil. Chelan Cnty Pub Util Dist No.1 (Chelan Hydroelec Cons Sys) Jr lien
AA
AA

allocable to its retail utility system, with the balance allocable to the other project offtakers under long-term, take-or-pay, cost-of-service contracts.

The HCS bonds are secured by the rates and charges of the retail utilities as well as certain intersystem loan payments from the district's two large hydroelectric systems. Standard & Poor's does not make a rating distinction between the closed senior lien and the working junior lien because the senior lien is closed and accounts for only 4% of total consolidated debt as of Dec. 31, 2004.

The district, established in 1936, owns and operates an electric distribution system, a telecommunications 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 HCS 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.

Chelan's strong business profile ('3' on Standard & Poor's 10-point scale, where '1' is 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 surplus sales. The district's low-cost power supply is derived from its three hydroelectric plants, which produced power at an average $17 per megawatt-hour (MWh) in 2004. The plants are competitive even under very low streamflow conditions, as demonstrated most recently during the extreme 2000-2001 winter drought (the second-worst on record), during which average production costs remained extremely competitive at $17/MWh or less. The district has surplus power during nearly all months of the year. The sale of surplus power during the 2000-2001 winter drought at high market prices more than compensated for high-priced purchases in other periods that were necessitated by the low water levels.

Like its Mid-Columbia neighbors, Grant County Public Utility District ('A+/Negative') 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 24% of output from its Rocky Reach and Rock Island projects and sells the remaining 76% of the output to other utilities in the region through long-term, take-or-pay contracts that expire in 2011 and 2012, respectively. The contracts permit Chelan to charge offtakers for their allocable shares of operating and debt service costs, plus 15% rolling coverage on interest payments. Even with just 24% of output from the two projects, 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 accounted for a large 69% of operating revenues at the retail system in 2004 and an even larger percentage of net revenues, given that margins on these sales exceed those at the retail level.

Cash flow coverage was adequate as of fiscal 2004. Funds from operations (FFO) to interest coverage was 4x at the consolidated system and 2.2x at the consolidated level in fiscal 2004. This financial metric, while seldom used in public power ratings, is relevant for Chelan, given its very large amount of non-amortizing debt. Debt service coverage ratios at both the distribution and consolidated levels were 3.0x and 1.5x, respectively, for fiscal 2004, although the coverage ratio at the distribution level remains highly sensitive to wholesale margins. The lower coverage ratio for the consolidated system reflects the cost-based debt service payments by the hydro projects to the HCS fund. Fixed charge coverage was 1.7x for the distribution level and 1.3x at the consolidated level.

Debt leverage is moderate at 57% at the distribution level and 71% at the consolidated level as of Dec. 31, 2004, and is expected to increase slightly after the district's 2005 acquisition of an additional 20% of Rock Island Powerhouse No. 2 power from co-participant Puget Sound Energy. The district does not anticipate future borrowings on behalf of the retail system, including the broadband telecommunications system.

Liquidity

Liquidity at the consolidated level included $53.7 million in unrestricted cash, $241.0 million in restricted construction, debt service reserve and revenue funds, plus $39.6 million in restricted long-term investments as of Dec. 31, 2004. Such levels of liquidity compare favorably with debt and capital requirements at the consolidated level, given the district's highest debt maturity of $28.5 million and highest annual capital outlay of $63.7 million through 2009.

Unrestricted cash and investments at the retail system totaled $86.7 million (including board-designated reserves in the contingency fund and capital fund), or 180 days' cash on hand at the retail level. In comparison, the highest debt maturity at the retail system is about $16.8 million through 2009, while the highest annual capital outlay is about $19.9 million over the same period.

As of Dec. 31, 2004, debt maturities are projected as follows:

Table 1 Chelan County Public Utility District No. 1 Debt Maturities

($000s)		
Year	**Chelan**	**Retail Share of HCS & Project Debt**
2005	25,425	13,464
2006	28,519	16,819
2007	26,473	14,040
2008	27,590	14,337
2009	20,796	15,165

Outlook

The stable outlook reflects Chelan's strengthened capital and financing plan, which calls for cash funding of retail system capital requirements for the foreseeable future. The outlook also assumes that Chelan's Rocky Reach and Rock Island projects will remain extremely competitive, that Chelan's capital investment in its wholesale broadband telecommunications system will not increase significantly beyond current projections, and that Chelan will not materially increase its variable-rate and swap exposure to capture the spread between floating or synthetic fixed interest rates on HCS debt and the fixed interest rates charged to the other project offtakers.

Although strong wholesale market prices are likely to support substantial margins on surplus power sales even under the recent below-average streamflow conditions, a sharp decline in wholesale prices could significantly reduce coverage levels to below ranges acceptable for the 'AA' rating. The rating outlook assumes that, in such a scenario, Chelan's management would promptly implement retail rate increases or draw down its cash reserves in a gradual and disciplined fashion that supports credit quality.

Significant delays in addressing coverage deterioration or aggressive expansion of capital and financing requirements at the retail system could result in a negative outlook. In contrast, the consideration of a positive outlook would depend on a significant reduction in debt leverage, a credible and material improvement in district financial policies, and the favorable resolution of relicensing issues, significant capital needs, and power sales contracts at the projects.

Accounting

Chelan is audited annually, with a fiscal year-end of Dec. 31. Deloitte & Touche provided the last audit opinion, which was unqualified, on the project's 2004 annual report. The audit conforms with GAAP accounting and abides by GASB standards, which recognizes FAS 71. As a governmental entity not registered with the SEC, Chelan is not subject to the requirements of Section 404 of the Sarbanes-Oxley Act. Chelan does enter into energy trading contracts, but does not employ mark-to-market accounting. As allowed by GASB Statement No. 20, the district has elected not to implement FASB statements and interpretations issued after Nov. 30, 1989. As a result, accounting pronouncements by FASB do not have a material effect on Chelan's financial results.

Chelan has not reported any operating lease obligations that warrant adjustment of its reported financial information, but Standard & Poor's does calculate adjusted financial ratios to reflect its proportionate share of project debt at the Rocky Reach, Rock Island, and Lake Chelan hydroelectric projects, which are all owned by Chelan.

Rating Methodology

The ratings on the HCS revenue bonds are determined using the rating methodology for public power entities, which evaluates the credit quality of a revenue pledge by a municipal entity as opposed to the consolidated creditworthiness of that entity. In this case, the ratings are based on ability and willingness of Chelan's combined retail utility, which provides electric, telecommunications, and water and sewer services to Chelan County, to meet its obligations, including debt service on the district's bonds. Chelan's retail system serves as the ultimate obligor among the various divisions of the district--namely the retail system, the Rocky Reach hydroelectric project ('AA/Stable'), and the Rock Island hydroelectric project ('AA/Stable')--that issue debt through the HCS bond resolution. Standard & Poor's does not make a rating distinction between the closed senior lien and the working junior lien, because the risk of dilution by the senior lien is negligible, given that the senior lien is closed and accounts for only 4% of total consolidated debt.

Business Description

The district, established in 1936, owns and operates a water system, a wastewater system, an electric distribution system, a telecommunications system, and three major hydroelectric power generating projects: Rocky Reach, Rock Island, and Lake Chelan. Chelan's various systems and hydroelectric projects of the district are able to issue revenue bonds pledged by individual system revenues or through the HCS bond resolutions, which is supported by net revenues of the retail system, plus payments by the hydroelectric projects on intersystem loans made with HCS bond proceeds. The consolidated system, which includes each of these systems, was created in 1987 as a financing vehicle for issuing tax-exempt and taxable debt without restrictions regarding interest rate mode or principal amortization for the various systems and hydroelectric projects of Chelan, including the Rocky Reach and Rock Island hydroelectric projects. 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.

Legal Provisions

The legal provisions are weak overall and offer limited protection to bondholders. A rate covenant for the consolidated hydroelectric system bonds requires the district to collect revenue for electric power furnished by the consolidated system, which provides annual revenues together with other unencumbered funds of the district in an amount sufficient to pay operating expenses of the consolidated system. Additionally, distribution system net revenues together with unencumbered funds of the district, and after payment of senior-lien debt service, must be equal to 115% of annual debt service on the outstanding distribution system bonds. A debt service reserve is maintained for the consolidated system junior-lien bonds in the amount of maximum annual interest payable in any future year. The additional bonds test is weak, as it is based on projected revenues; annual operating revenues must be sufficient to meet existing and proposed debt service by 1x. For distribution system bonds, operating revenues, including other available funds, must be sufficient to meet debt service by 1.25x. For hydro bonds, operating revenues, plus available funds, must be sufficient to meet debt service plus 15% of interest coming due in the first full year.

Business Profile

Chelan County is located in central Washington. Wenatchee, 140 miles east of Seattle, is Chelan's county seat and largest city (2004 population of 28,760). The county has below-average economic characteristics. Agriculture, primarily apple and other fruit production, along with related industries, accounted for 16% of employment in 2000. The unemployment rate (8.8% for the 12 months ended December 2004) is well above the national average, while household income is 92% of the national average. The county's population has grown more than 20% during the last decade.

The utility's regulatory position is above average, given the district's ability to set its own rates and the limited political support for deregulation in Washington. Rate setting is the responsibility of the Board of Commissioners and is not subject to approval by any state or federal authority. The board has not approved a retail rate increase since the 2.5% rate increase proposed in 1999 and implemented in 2000, primarily due to better-than-expected financial results.

The distribution system provided power in 2004 to a predominantly residential customer base of 43,064 retail customers. Customer concentration is moderate since top customer Alcoa Power (approximately 20% of retail revenues) resumed operations at its aluminum smelter facility operations in December 2004. Except for Alcoa, Chelan's retail sales are widely distributed and there is no concentration among customers. In addition to retail sales, Chelan also is a large seller of wholesale power, which accounted for 69% of total retail system revenues in 2004. The district sells a portion of its roughly 41% allocation of hydro project power to a number of wholesale customers through both firm contracts as well as net requirements agreements. Firm power sales are made to aluminum smelter Alcoa (23% of Rocky Reach) and Douglas County Public Utility District (2.77% of Rocky Reach) through cost-of-service contracts.

The district benefits from an excess of low-cost hydroelectric generation. Energy from the district's two major hydroelectric projects cost only $17 per MWh in 2004 and is nearly as economical even at the near "critical" water levels, as evidenced by the $17/MWh unit power cost realized in 2001. Chelan operates three major hydroelectric projects, which together represent more than 2,000 MW of capacity and generated more than 8.1 million MWh in 2004. The output from the two largest projects are sold to third parties pursuant to long-term power supply contracts that expire in 2011 and 2012. The district is almost always 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. Chelan has contracted with Avista for scheduling and real-time resource optimization services, for which Avista makes periodic payments to the district.

The district's ability to own and operate its hydroelectric projects is dependent on its successful relicensing by FERC. The current licenses for the Rocky Reach and Rock Island projects expire in June 2006 and December 2028, respectively. Since the expiration of its FERC license in 2004, the Lake Chelan project has operated under an annual license pending the issuance of a new license. Chelan is using an alternate licensing process for relicensing the Rocky Reach project, as it did with the Lake Chelan project relicensing. FERC and other federal and state agencies approved in 2004 the anadromous fish agreements and habitat conservation plans (HCP). The HCPs are planning documents that outline for the Rocky Reach and Rock Island projects a program for achieving compliance with endangered species laws for a 50-year period. The HCPs will significantly reduce risks related to environmental compliance at the projects and provide greater certainty for continued operation of the projects. Nonanadromous not addressed by the HCP (such as bull trout, lamprey, and sturgeon) are being addressed through the Rocky Reach licensing process.

Chelan's competitive position is exceptionally strong and is expected to remain so, since the average cost of hydroelectric power is expected to be remain about 20 mills/kWh or less, even under critical water conditions. Retail rates are the second lowest in the U.S., averaging 3.0 cents per kWh in 2004, versus the average system rate in Washington of 6 cents per kWh. Industrial rates are also low at 1.9 cents per kWh. Chelan's wholesale generation is also exceptionally competitive, with average production costs of $17 per MWh in 2004, versus Bonneville Power Administration's priority firm rate of about $35/MWh. The district expects to maintain its competitive position at both its retail and wholesale operations, with an average cost of hydroelectric power of less than $21/MWh, even under critical water conditions.

Capital requirements are high, driven primarily by capital needs at the Rock Island hydroelectric project and, to a much lesser degree, by the district's broadband telecommunications expansion. The district currently projects capital expenditures of $81.7 million from 2005 to 2009 at the distribution system (including about $42 million for telecom expansion) and $257 million at the consolidated level.

Diversified Activities

The district operates a fiber-optic telecommunications network that employs passive optical network (PON) technology and provides wholesale telecommunications services for several retail service providers operating in Chelan County. In addition to selling capacity on its fiber optic network, Chelan also builds line extensions to connect customers at the request of retail service providers. Chelan began building out its network in 2003 and expects to complete build-out by 2013. The buildout plan calls for fiber drops to be installed to 75% of the county's customers by 2008 and 95% by 2012. Wireless and power line technology may be used to connect the customers in remote areas where capital costs for connection may be prohibitive. As of October 2005, the district's fiber network has passed 11,325 potential subscribers, of which 2,783 had purchased Internet service and 1,670 had purchased telephone services through retail service providers.

Chelan projects that its telecommunications system will achieve positive operating cash flow in 2006. However, the district expects to continue to provide internal loans to the telecom system with wholesale net margins to cover interest expense through at least 2008 and capital requirements through at least 2012. As of December 2005, the district had debt financed 100% of its roughly $38 million capital investment and about $10 million in operating and interest costs to date, but expects to internally fund the balance of the approximately $60 million in additional capital requirement through 2012.

Financial Policy

Chelan's financial policy suggests a moderate appetite for financial risk. Its debt service coverage target of 1.75x for distribution and non-hydroelectric system debt, which it typically exceeds, provides support for credit quality. However, the robustness of this coverage target is partially offset by Chelan's reliance on somewhat aggressive forecast assumptions of average streamflow and forward market prices, which together determine projected wholesale sales of surplus hydro generation, a primary determinant of debt service coverage. Chelan does not have specified targets for debt leverage, variable-rate debt, or swap exposure, which is a credit concern, given Chelan's ability to assume considerable interest rate and swap risk by issuing variable-rate or synthetic fixed-rate debt through the HCS lien on behalf of the Rocky Reach and Rock island projects, since the other project offtakers are billed on a fixed, level debt service basis.

Financial Profile

Debt service of the distribution debt and consolidated system was strong at 2.95x and 1.70x for fiscal 2004, respectively. FFO interest coverage was 3.97x. Coverage of distribution debt are nearly always higher than 2.0x, with the exception of 2002 when coverage dipped to 1.9x. Coverage of project revenue bonds is maintained at 1x, with the power purchasers charged only the cost of production, including all debt service. The district projects solid debt service coverage at the retail level of well over 2x in 2006 and 2007, although coverage declines in 2008 and 2009 suggest potential financial pressure in the absence of more favorable wholesale prices and/or a retail rate increase. In all years, Chelan projects cash reserves of at least $80 million.

Chelan has a solid, liquid balance sheet at both the consolidated and retail systems. Cash and equivalents total $131.3 million (including board-designated reserves in the contingency fund and capital fund). Adjusted debt leverage was moderate at about 57% as of Dec. 31, 2004, but is expected to increase slightly in 2006 due to Chelan's acquisition of an additional 20% stake in the output of the Rock Island project's powerhouse No. 2. Chelan expects to fund 100% of capital requirements at the distribution and telecommunications systems with internally generated cash. Capital requirements at the hydroelectric projects are projected to be funded with cash restricted as part of the intersystem loan fund, as well as external debt.

Chelan's debt structure includes a relatively high proportion of long-dated, non-amortizing debt. Of the $652 million in HCS debt, about $530 million (or 81%) is in the form of bullet debt, resulting in a weighted average maturity of about 30 years for all HCS bonds. In contrast, the $304 million in Rocky Reach and Rock Island project debt amortizes over 10 and 25 years, respectively. Variable-rate debt represents only 4% of total outstanding debt on a consolidated basis, but 13% of the retail system debt. In addition, the retail system has swap exposure on approximately $97 million in HCS debt, which Chelan plans refinance as synthetic fixed rate debt in 2007 ahead of its remarketing date.

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