

CHUGACH ELECTRIC ASSOCIATION, INC.
ANCHORAGE, ALASKA

February 23, 2009

To: Mike Cunningham, Chief Financial Officer
From: Sherri McKay-Highers, Manager, Budget and Financial Reporting
Subject: 2008 Variance Report

Chugach closed 2008 with Operating Revenues of \$288.3 million, margins of \$6.4 million, a 1.28 Margins for Interest/Interest (MFI/I), a Times Interest Earned Ratio (TIER) of 1.30, current ratio of 1.26:1 and an equity to total capitalization ratio of 30.3%. The budget comparisons discussed below are based on the 2008 budget as approved.

kWh Sales

	<u>2008 Actual</u>	<u>2008 Budget</u>	<u>2007 Actual</u>
Retail kWh Sales	1,205,831,517	1,224,448,270	1,206,037,227
Wholesale kWh Sales	<u>1,323,768,080</u>	<u>1,293,651,350</u>	<u>1,311,306,543</u>
Total Firm kWh Sales	2,529,599,597	2,518,099,620	2,517,343,770
Economy Energy kWh Sales	<u>256,105,420</u>	<u>233,777,000</u>	<u>93,753,230</u>
Total kWh Sales	2,785,705,017	2,751,876,620	2,611,097,000

Firm kWh sales totaled 2,529,599,597 which were 0.5% over budget and 0.5% over 2007. Retail kWh sales were under budget by 1.5%, primarily due to lower residential sales caused by a change in consumer consumption patterns. Wholesale kWh sales were 2.3% over budget. This variance was due to higher than anticipated sales to Homer Electric Association (HEA) primarily caused by higher than anticipated industrial sales. This increase was offset by lower than anticipated sales to Matanuska Electric Association (MEA) and Seward Electric System (SES). Economy energy kWh sales were over budget by 9.6%. The budget variance is the result of higher than anticipated sales to Golden Valley Electric Association (GVEA).

Retail kWh sales did not materially change in 2008 from 2007. Though not a material variance, large commercial sales decreased while residential sales increased in 2008 over 2007. Wholesale kWh sales increased 1.0% in 2008 from 2007. Sales to HEA decreased but was more than offset by an increase in sales to MEA. Economy energy kWh sales increased by 173.2% from 2007. In 2007, Chugach was limited in generating additional output for economy energy sales due to transmission line work and maintenance on several Beluga units.

Energy Revenue (in millions)

	<u>2008 Actual</u>	<u>2008 Budget</u>	<u>2007 Actual</u>
Retail Revenue	\$ 157.6	\$ 154.5	\$ 150.9
Wholesale Revenue	<u>109.4</u>	<u>99.3</u>	<u>97.8</u>
Total Firm Revenue	267.0	253.8	248.7
Economy Energy Revenue	<u>18.5</u>	<u>15.3</u>	<u>5.8</u>
Total Revenue	\$ 285.5	\$ 269.1	\$ 254.5

Revenue from firm sales totaled \$267.0 million in 2008 compared to \$253.8 million in the 2008 budget and \$248.7 million in 2007. Retail revenue increased 2.0% from the budget due to higher fuel costs recovered in revenue through the fuel surcharge mechanism, despite lower than anticipated kWh sales. This increase was offset by a decrease in base rates effective June 1, 2008, as a result of Chugach's 2005 Test Year Rate Case. Wholesale revenue increased 10.2% from budget primarily due to higher fuel expense recovered through the fuel surcharge mechanism. Higher than anticipated sales to HEA and an increase to wholesale base rates, as a result of Chugach's 2005 Test Year Rate Case, also contributed to this variance, which was slightly offset by lower than anticipated kWh sales to MEA. Economy energy revenues increased 20.9% over budget which was attributable to increased sales to GVEA due to the reasons stated above in the 2008 kWh budget to actual discussion.

Retail revenue increased from 2007 to 2008 primarily due to higher fuel expense recovered through the fuel surcharge mechanism in 2008 over 2007. Wholesale revenue increased over 2007 primarily due to higher fuel costs recovered through the fuel surcharge mechanism, as well as increased sales to MEA in 2008 over 2007. Economy energy revenue increased from 2007 due to the reasons stated above in the 2008 kWh budget to actual discussion.

Other Operating Revenue (in millions)

	<u>2008 Actual</u>	<u>2008 Budget</u>	<u>2007 Actual</u>
Other Operating Revenue	\$ 2.8	\$ 2.9	\$ 3.0

Other operating revenue for 2008 totaled \$2.8 million compared to \$2.9 million in the 2008 budget and \$3.0 million in 2007. There was no significant variance from the 2008 budget and other operating revenue decreased in 2008 from 2007 primarily due to a decrease in Bradley Lake wheeling revenue.

Power Production (in millions)

	<u>2008 Actual</u>	<u>2008 Budget</u>	<u>2007 Actual</u>
Operating & Maintenance	\$ 16.7	\$ 16.4	\$ 16.2
Fuel	<u>137.9</u>	<u>121.2</u>	<u>106.0</u>
Total	\$ 154.6	\$ 137.6	\$ 122.2

Power production operating and maintenance expense for 2008 was \$16.7 million compared to \$16.4 million in the 2008 budget and \$16.2 million in 2007. This financial statement category was over budget due primarily to professional services associated with the outages of Beluga Units 7 and 8, as well as higher warehouse and garage expenses. Depreciation also contributed to this variance due to the difference between rates and implementation date of the 2005

depreciation study included in the final 2005 Test Year rate case. The final order from the 2005 Test Year rate case also caused an increase in the amortization of the Beluga River Gas Compression project due to the difference in projected amount and amortization period. Additionally, this financial statement category was over budget due to an Environmental Protection Agency (EPA) settlement, as well as unexpected water purchases required for the new water injection system at the Bernice Lake power plant. These variances were offset by lower labor expense and by the deferral of materials for the Beluga Unit 3 inspection, now projected for 2009.

Power production operating and maintenance expense increased from 2007 to 2008 due primarily to the amortization associated with the Beluga River Gas Compression project, as well as the accelerated amortization of the prior Beluga Unit 8 overhaul caused by a change to the maintenance schedule. These increases were somewhat offset by a decrease in information services allocated costs associated with Sarbanes-Oxley compliance in 2007.

Fuel expense in 2008 was \$137.9 million compared to \$121.2 million in the 2008 budget and \$106.0 million in 2007. The budget variance was primarily caused by more than anticipated MCF purchased due in part to higher than anticipated sales to GVEA and the forced outage of Beluga Unit 8, as well as a higher than anticipated price. Actual fuel purchased in 2008 was 30,792,658 MCF at an average effective price of \$5.13 per MCF, which did not include 3,895,468 MCF of fuel that was recorded as purchased power compared to 29,225,708 MCF in the 2008 budget at an average effective price of \$4.82 per MCF, which did not include 4,085,000 MCF of fuel that was recorded as purchased power.

The increase in fuel expense from \$106.0 million in 2007 to \$137.9 million in 2008 was primarily a result of an increase in MCF used, as a result of higher economy sales, the unavailability of Beluga Unit 8 due to maintenance, and a higher average effective fuel price. The increase was also due in part to the impact of credits received in 2007 for reduced fuel production taxes. In 2008, Chugach used 30,792,658 MCF of fuel at an average effective price of \$5.13 per MCF, which did not include 3,895,468 MCF of fuel that was recorded as purchased power compared to 27,633,963 MCF of fuel used in 2007 at an average effective price of \$4.49 per MCF, which did not include 2,702,879 MCF of fuel that was recorded as purchased power.

Purchased Power (in millions)

	<u>2008 Actual</u>	<u>2008 Budget</u>	<u>2007 Actual</u>
Total Purchased Power	\$ 31.5	\$ 31.1	\$ 33.9

Purchased power cost for 2008 totaled \$31.5 million compared to \$31.1 million in the 2008 budget and \$33.9 million in 2007. Although we experienced lower than anticipated purchases in 2008, that was offset by a higher average effective price. In 2008, Chugach purchased 483,742 MWh of energy at an average effective price of 6.24 cents per kWh compared to 536,807 MCF of energy at an average effective price of 5.58 cents per kWh in the budget.

The decrease in purchased power expense from \$33.9 million in 2007 to \$31.5 million in 2008 was due to less MWh purchased, which was somewhat offset by a higher average effective price caused by higher fuel prices. Transmission line work and other maintenance activities in 2007 limited our generation, resulting in higher purchased power costs in 2007. In 2008, Chugach purchased 483,742 MWh of energy at an average effective price of 6.24 cents per kWh compared to 523,910 MWh of energy at an average effective price of 6.15 cents per kWh in 2007.

Transmission Operations and Maintenance (in millions)

	<u>2008 Actual</u>	<u>2008 Budget</u>	<u>2007 Actual</u>
Total Transmission	\$ 5.8	\$ 6.5	\$ 6.8

Transmission operations and maintenance expense totaled \$5.8 million in 2008 compared to \$6.5 million in the 2008 budget and \$6.8 million in 2007. The budget variance was primarily due to lower substation labor due to the substation department performing more distribution maintenance than anticipated which was recorded to that financial statement category and professional services associated with overhead line clearing. The aforementioned variances were slightly offset by higher helicopter expense. Helicopter services are used to maintain our microwave system at Silvertip, Cooper Mountain and other locations around the system as well as any inaccessible facilities. The fixed costs associated with our helicopter lease was projected to be allocated based on usage, however, lower helicopter usage resulted in a higher percentage of the fixed costs charged to this financial statement category.

The decrease in transmission operations and maintenance expense from 2007 to 2008 was primarily due to lower labor expense related to substation maintenance as well as lower information services allocated compliance costs.

Distribution Operations and Maintenance (in millions)

	<u>2008 Actual</u>	<u>2008 Budget</u>	<u>2007 Actual</u>
Total Distribution	\$ 12.4	\$ 11.7	\$ 13.7

Distribution operations and maintenance expenses totaled \$12.4 million in 2008 compared to \$11.7 million in the 2008 budget and \$13.7 million in 2007. The budget variance was due to higher substation labor due to more distribution maintenance being performed than anticipated as described above, as well as more labor and materials charged to expense which decreased the amount charged to capital. Additionally, the variance was due to labor associated with overhead line and transformer maintenance due to a weather related outage. The variance was also due to costs associated with workers compensation claims and higher warehouse and garage expense caused by an increase in depreciation expense due to the difference between rates and implementation date of the 2005 depreciation study included in the final 2005 Test Year rate case, as well as higher fuel costs associated with vehicles and equipment.

The decrease in distribution expense from 2007 to 2008 was primarily due to lower labor and professional services associated with line maintenance, as well as lower information services allocated compliance costs.

Consumer Accounts (in millions)

	<u>2008 Actual</u>	<u>2008 Budget</u>	<u>2007 Actual</u>
Total Consumer Accounts	\$ 4.8	\$ 5.0	\$ 4.3

Consumer accounts expense totaled \$4.8 million in 2008 compared to \$5.0 million in the 2008 budget and \$4.3 million in 2007. This financial statement category was under budget in 2008 primarily due to lower labor as well as software and labor expense allocated from information services.

The increase in consumer accounts expense from 2007 to 2008 was primarily due to an increase in uncollectible accounts and higher advertising and imaging costs associated with capital credit retirements.

Customer Information (in millions)

	<u>2008 Actual</u>	<u>2008 Budget</u>	<u>2007 Actual</u>
Total Customer Information	\$ 0.6	\$ 0.7	\$ 0.6

Customer information expense totaled \$0.6 million in 2008 compared to \$0.7 million in the 2008 budget and \$0.6 million in 2007. There was no significant variance from the 2008 budget and customer information did not materially change from 2007 to 2008.

Administrative and General (in millions)

	<u>2008 Actual</u>	<u>2008 Budget</u>	<u>2007 Actual</u>
Total Administrative and General	\$ 19.1	\$ 17.7	\$ 20.8

Administrative and general expense totaled \$19.1 million in 2008 compared to \$17.7 million in the 2008 budget and \$20.8 million in 2007. This financial statement category was over budget due to professional services for legal and compliance matters, the preparation and distribution of the annual report and professional services related to board activities. Credit card fees were also over budget due to a change in the cutoff date associated with our credit card program. Labor and indirect labor associated with vacation and cash in lieu also contributed to this variance. These variances were somewhat offset by lower building maintenance and office supplies expense, lower labor costs allocated by information services and lower than anticipated professional services associated with training and regulatory matters. These variances were also offset by lower than anticipated costs associated with gas negotiations which are currently being deferred and not expensed.

Administrative and general expense decreased from 2007 to 2008, due primarily to lower professional services and information services allocated costs associated with Sarbanes-Oxley compliance costs in 2007. The decrease was also due to a decrease in credit card fees in 2008 compared to 2007.

The summary of all the above 2008 operations and maintenance expenses total \$228.8 million compared to \$210.4 million in the 2008 budget and \$202.3 million in 2007.

Depreciation expense totaled \$30.8 million for 2008 compared to \$30.4 in the 2008 budget and \$29.0 million in 2007. The budget variance was due primarily to the difference between rates

and implementation date of the 2005 depreciation study included in the final 2005 Test Year rate case. The variance from 2007 to 2008 was due in part to a change in depreciation rates as a result of Chugach's 2005 Test Year Rate Case, as well as the continued closeout of construction projects.

Tax expense for 2008 totaled \$0.8 million compared to \$0.9 million in the 2008 budget and \$0.8 million in 2007. There were no significant changes or variances from the 2008 budget or 2007 actual expenses.

Long-term interest expense totaled \$21.3 million in 2008 compared to \$23.1 million in the 2008 budget and \$24.2 million in 2007. The budget variance was primarily due to lower than anticipated interest rates and the interest expense associated with the 2002 Series B Bonds which was redeemed using the NRUCFC line of credit. The decrease from 2007 was due to the use of our NRUCFC line of credit to redeem the outstanding principal amount and pay accrued interest on the 2002 Series B Bonds in March of 2008. The decrease was also due to continued principal payments as well as lower interest rates in 2008 compared to 2007.

Interest during construction totaled \$0.4 million compared to \$1.0 million in the budget and \$0.6 million in 2007. This variance was primarily due to a lower than anticipated average Construction Work In Progress, (CWIP) balance caused by less construction activity than anticipated and lower than anticipated interest rates. The variance from 2007 was primarily due to a lower weighted average rate in 2008 of 5.1% compared to 6.3% during 2007.

Other interest expense totaled \$1.7 million compared to \$0.3 million in the 2008 budget and \$0.1 million in 2007. The budget variance was primarily due to the interest expense associated with the NRUCFC line of credit which was utilized to redeem the \$29.6 million outstanding principal amount of the 2002 Series B Bonds. We also utilized our CoBank and NRUCFC lines of credit due to the timing of expenditures, receipt of payment for services and the under-recovery of the prior quarter's fuel and purchased power costs. We had an outstanding balance of \$7.5 million on our CoBank line of credit and utilized an additional \$13.3 million on our NRUCFC line of credit in 2008. The variance from 2007 was primarily due to the use of the NRUCFC line of credit described above and the use of our CoBank line of credit in 2008. This increase is net of the effect of a decrease in interest rates in 2008 compared to 2007.

Other deductions include donations, preliminary survey and investigation charges of abandoned projects and obsolete inventory write-offs. In 2008, other deductions totaled \$0.1 million compared to \$0.3 million in the budget and \$0.2 million in 2007. There was no significant variance from the 2008 budget or from 2007.

All of the foregoing expenses resulted in total cost of electric service in 2008 of \$283.1 million compared to \$264.4 million in the 2008 budget and \$256.1 million in 2007.

Non-operating margins include interest income, Allowance for Funds Used During Construction (AFUDC), capital credit and patronage capital allocations and extraordinary items. In 2008, non-operating margins totaled \$1.2 million compared to \$1.3 million in the budget and \$1.5 million in 2007. While there was no significant overall variance from the 2008 budget, AFUDC was under budget due to a lower than anticipated CWIP balance and a lower average equity balance caused by less than anticipated margin performance in 2007. This variance was offset by higher than anticipated non-operating margins interest which was due to less than anticipated capital spending. The decrease from 2007 was primarily due to a decrease in AFUDC and non-operating margins interest. AFUDC decreased from 2007 for the same reasons stated in the 2008 budget to actual discussion. Non-operating margins interest decreased from 2007 due to more capital spending in 2008 compared to 2007, lower interest rates and a lower average cash balance.

The net result of revenue and expenses in 2008 was margins of \$6.4 million compared to projected margins of \$9.1 million in the 2008 budget and margins of \$2.9 million in 2007. These results gave Chugach an MFI/I of 1.28, a TIER of 1.30 and an equity-to-total-capitalization ratio of 30.3%. The year-end current ratio was 1.26:1.