

Chugach Electric Association, Inc.
Anchorage, Alaska

October 27, 2005

TO: Board of Directors

FROM: Michael R. Cunningham, Chief Financial Officer

THROUGH: William R. Stewart, Interim Chief Executive Officer

SUBJECT: Implementation of 2002 Depreciation Study rates on 2004 financial Records

This is intended to memorialize the decision making process the internal Chugach Electric Association Inc. (Chugach) staff undertook when implementing the recommended depreciation rates resulting from the "Depreciation Study of Electric Plant in Service as of December 31, 2002, update.

Background:

The study is the 2002 update of the original 1991 study. (Updates are conducted every three years, as stipulated to in Docket U-93-1). The 2002 update is based on 2002 financial data, the work was undertaken in 2003, and the consultant's study was received late in 2003.

By that time, Chugach had received the final order in Docket U-01-108 (the 2000 Test Year Rate Case docket), which stated that when filing its next rate case, Chugach should submit a depreciation study update (Chugach, as part of the 2000 Test Year Rate Case had submitted the "Depreciation Study of Plant in Service" as of December 31, 1999). The rates recommended in the 1999 study update were accepted for the most part by the Commission in Docket U-01-108. (U-01-108 involved changes to electric rates). The final orders in the 2000 Test Year Rate Case required Chugach to submit a depreciation study update when filing its next rate case.

Chugach debated internally for nearly six months (from approximately May, 2004, to October, 2004) on whether to file the 2002 update or not. The key issue in that debate was whether Chugach should file the depreciation study update with the Commission to simply request adjustment of the depreciation rates or whether we should request an adjustment to electric rates to reflect the depreciation rate changes. In addition, the debate centered on the Regulatory Commission of Alaska's order stating at our next rate case we should file a Depreciation Study update. However, that filing date was uncertain.

We knew the update recommended changed rates due to plant balances changing and that depreciation reserves may be inadequate to cover the future retirements of plant. We also knew that, while the total change in expense would be de minimus (some \$259,000) between the old rates and the new rates, there were significant changes between G&T and Distribution. We

recognized that the new rates increased Generation depreciation expense and that could potentially impact G&T margin allocations on an unbundled basis.

Implementation of Revised Depreciation Rates:

The question centered on whether the RCA had jurisdiction over new depreciation rates to be used by Chugach on its financial records given that no electric rate change would be implemented with the depreciation rate change. It was recognized on our part that the RCA has jurisdiction of electric rates charged to consumers. However, we believed the statute language was unclear whether the RCA had authority over what depreciation rates were utilized by utility management in its financial records, and that was logically the responsibility of management.

After consultation with our external auditors and in-house counsel regarding the necessity of filing the study with the RCA if no electric rates were to be changed, and that it was within GAAP to implement the new rates as of January 1, 2004, we made that implementation effective.

By letter dated October 4, 2004, I notified the wholesale customers - Homer Electric, Matanuska Electric, and City of Seward - of this action. We also explained that we were filing the study with the RCA but not asking for electric rate changes at the time.

We also explained that if the RCA changed or otherwise did not approve the proposed rates that we would implement the changes on a prospective basis from the date of that determination. If the RCA decision came after we had closed the financial records for 2004, we would implement the changes in a subsequent year.

We closed 2004 with the proposed rates reflected in our financial statement presentation of Depreciation Expense. We disclosed this in our SEC filings at 12/31/04 and in each subsequent filing in 2005.

The Depreciation Study Update filing with the RCA:

The wholesale customers objected to the implementation of the rates at 1/1/04 in filings made to the RCA. The RCA told us to not implement the rates pending their decision. We responded with a proposed implementation schedule for implementing the new depreciation rates once the RCA issued final orders approving of new depreciation rates at the end of the pending depreciation study review.

On March 9, 2005, the RCA issued Order No. 2 requiring Commission approval of depreciation rates before the utility can implement them. However, Order No. 2 did not state how Chugach must implement this decision under Chugach's circumstances. On August 8, 2005, Chugach filed a motion with the RCA requesting approval of its plan for compliance with Order No. 2. On September 21, 2005, the RCA issued "Order No. 8" in which they ordered we adjust the underlying financial records (not reopen the 2004 books – they left that to management's discretion) to reflect the 1999 study depreciation rates.

We have developed a plan to restate the internal unbundled financial statements with the effects of implementing the 1999 rates on the 2004 unbundled financial statements, restate 2005 year-to-

date financial results for the same reason, and disclose these in our September 30, 2005, SEC Form 10Q.

The aggregate impact of these unbundled restatements are expected to be an aggregate addition of \$400,000 of Depreciation Expense as of September 30, 2005.

Impact on previous Securities and Exchange Commission filings:

The impact to of Order No. 8's requirement to reimplement the 1999 approved depreciation rates is considered immaterial to Chugach's financial statements taken as a whole. The RCA did not order Chugach to formally restate its 2004 year-end statements. Their only requirement was that the "underlying financial data reflect the currently approved rates".

Amendment and restatement of prior 2004 SEC filings is not necessary due to the immateriality of the order. Chugach will disclose the contents of Order No. 8 and the 2005 financial statements' impacts in its third quarter SEC Form 10Q filing.