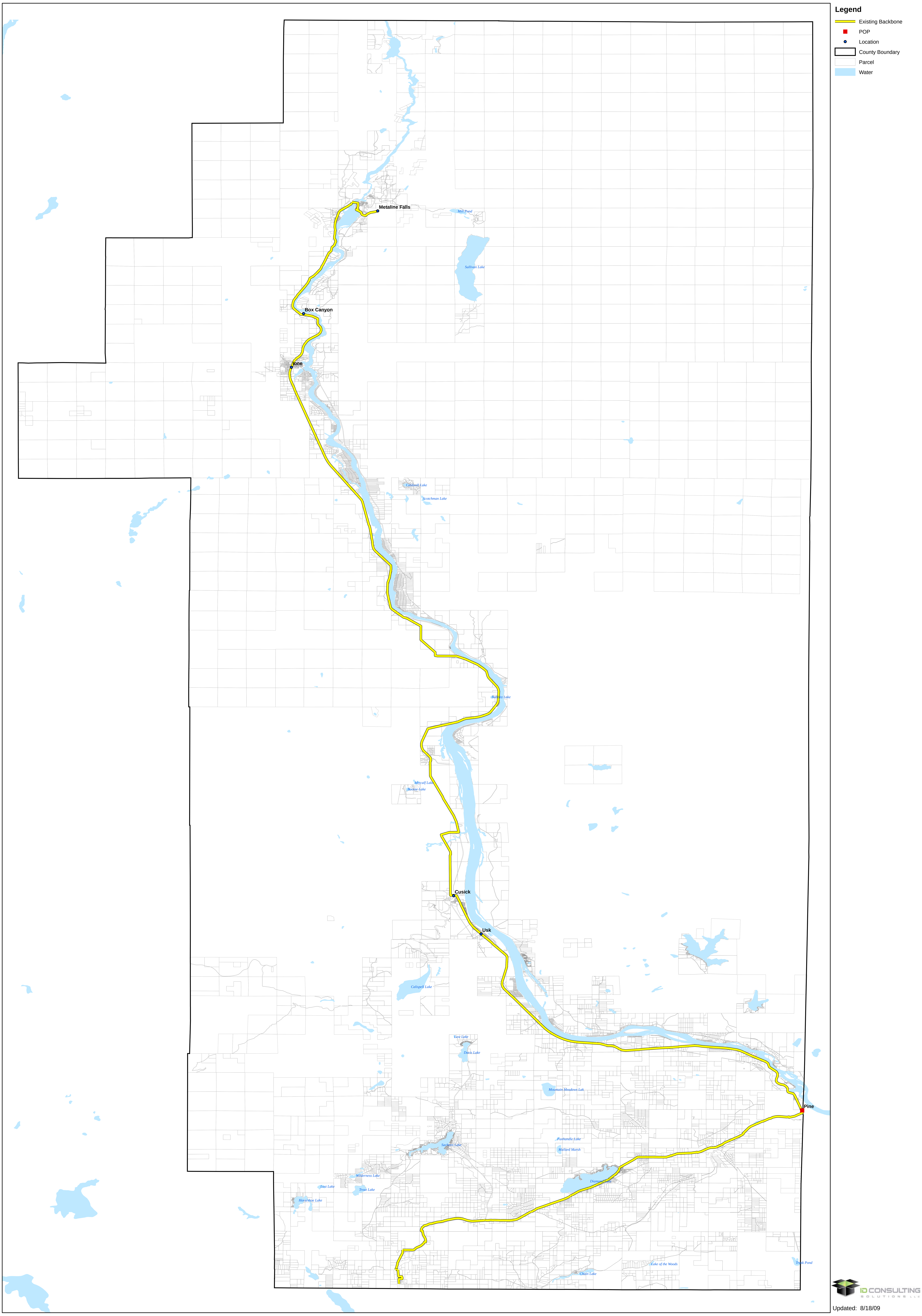
Pend Oreille County PUD Network
Existing Backbone

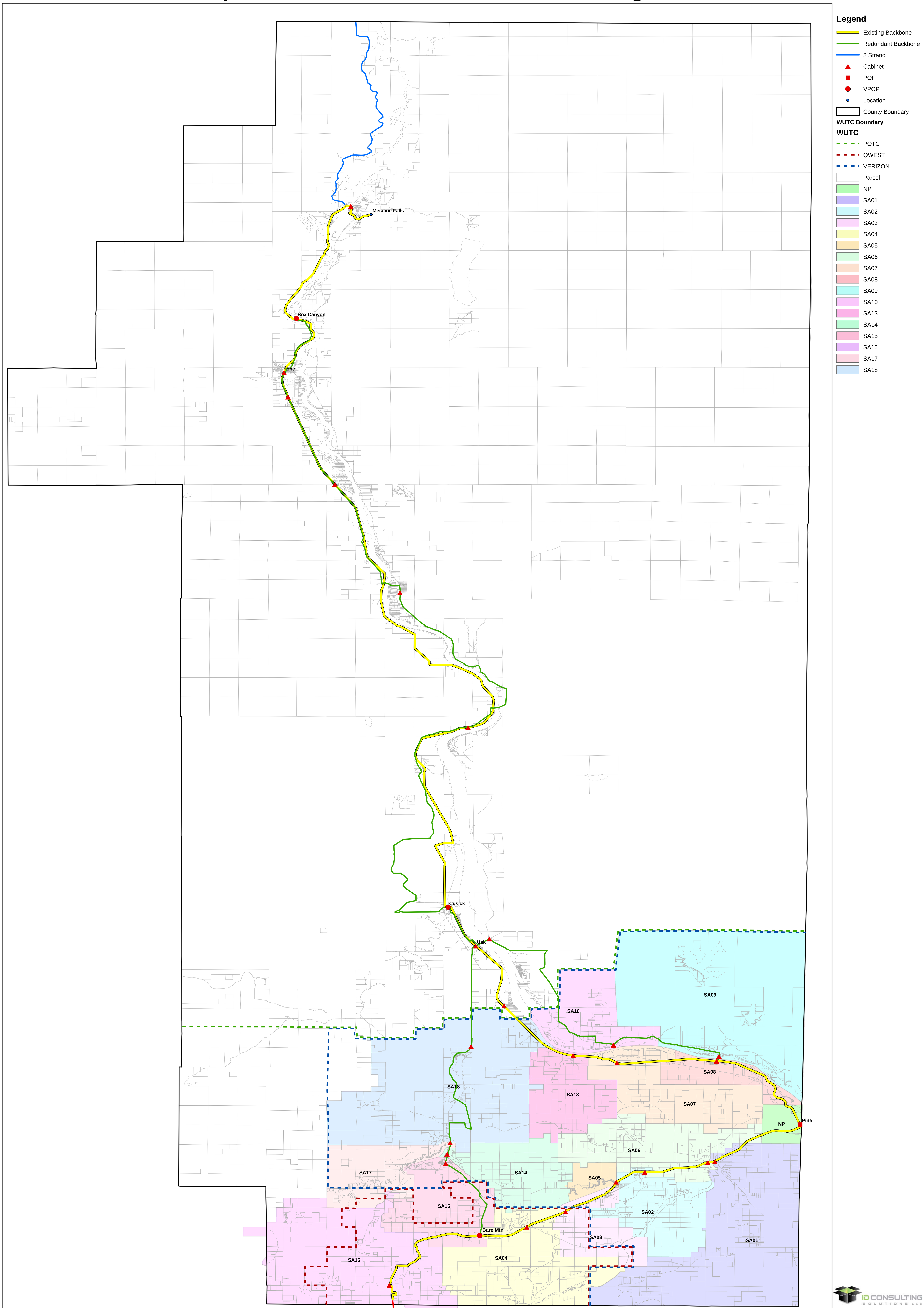


Updated: 8/18/09

Pend Oreille County PUD Network
Proposed Redundant Backbone

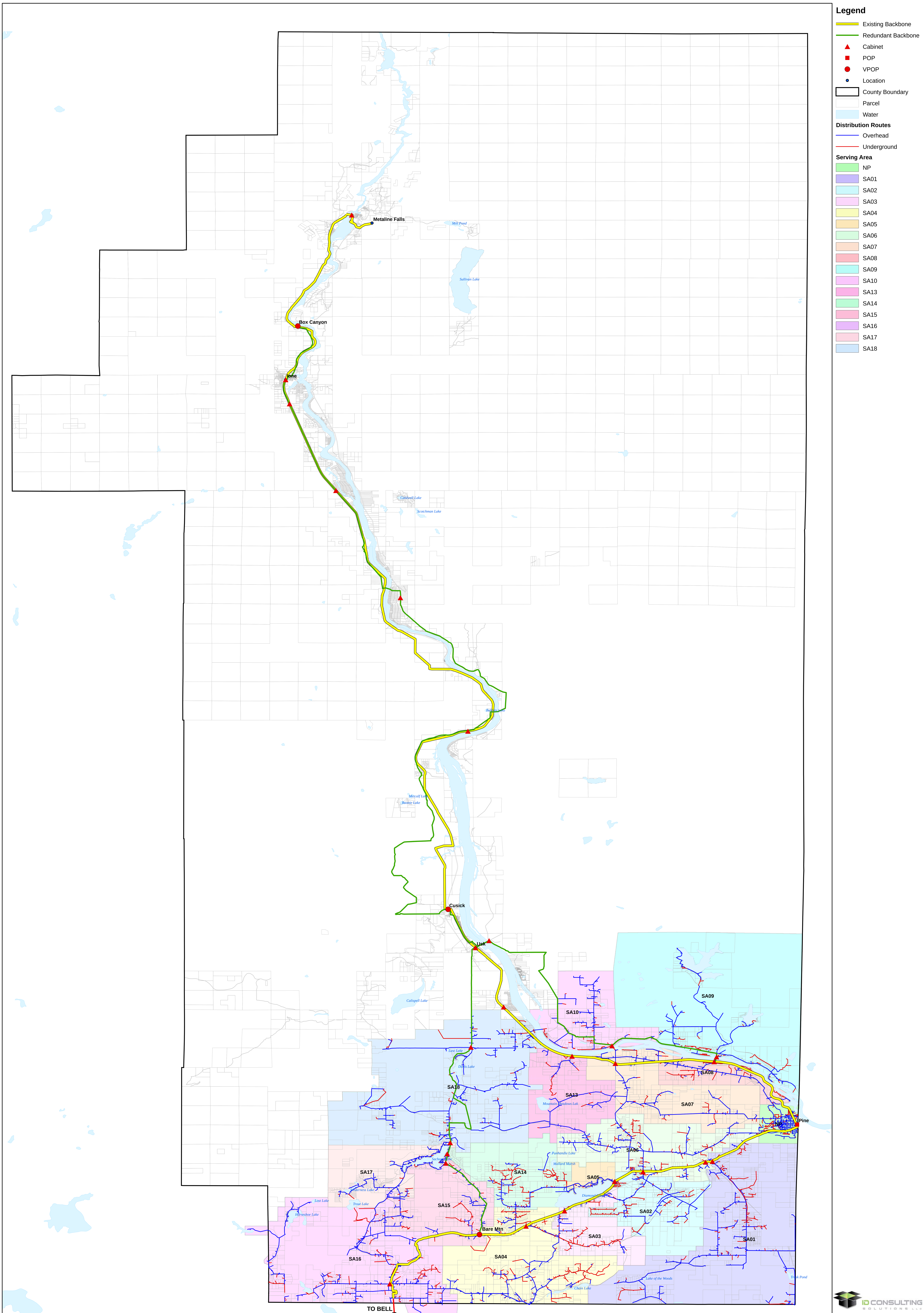
Updated: 8/18/09

Pend Oreille County PUD
Proposed Network Servicing Areas



Updated: 8/18/09

Pend Oreille County PUD Distribution



Updated: 8/18/09

INDEPENDENT AUDITOR'S REPORT

To the Commissioners
Public Utility District No. 1
of Pend Oreille County, Washington

We have audited the accompanying combined balance sheets of Public Utility District No. 1 of Pend Oreille County, Washington (the "District") as of December 31, 2008 and 2007, and the individual balance sheets of the Electric, Box Canyon Production, and Water Systems as of December 31, 2008, and the related combined statements of revenues, expenses, and changes in net assets and cash flows for the years ended December 31, 2008 and 2007, and the related individual statements of revenues, expenses, and changes in net assets and cash flows for the Electric, Box Canyon Production, and Water Systems for the year ended December 31, 2008. These statements are the responsibility of the District's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the District as of December 31, 2008 and 2007, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying management's discussion and analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information as listed in the table of contents is presented for the purposes of additional analysis and is not a required part of the basic financial statements. These schedules are the responsibility of the District's management. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on it.

Moss Adams LLP

Everett, Washington
March 9, 2009

MANAGEMENT'S DISCUSSION AND ANALYSIS
December 31, 2008 and 2007

The financial management of the Public Utility District No. 1 of Pend Oreille County (the District) offers readers of these financial statements this overview and summary analysis of the financial activities of the District for the years ended December 31, 2008 and 2007. This section of the financial report is designed to assist the reader in focusing on significant financial activities and issues, as well as important changes in the District's financial position and results of operations, which may affect the District's ability to address subsequent years' challenges. This discussion and analysis is designed to be used in conjunction with the financial statements and notes, which follow this section.

Overview of the Financial Statements

The financial section of the Annual Report includes the Report of Independent Auditors, Management's Discussion and Analysis, Basic Financial Statements with accompanying notes, and Supplemental Information (unaudited).

The financial statements of the District report the self-supporting, proprietary activities of the District funded primarily by the sale of power and water services. The District reports the business-type activities in a manner similar to private-sector business enterprises, using the accrual basis of accounting, in accordance with accounting principles generally accepted in the United States of America.

The *Combined Balance Sheets* present information on the District's assets and liabilities and provide information regarding the nature and amount of resource investment (assets), and obligations incurred in the pursuit of such resources. This statement also provides a vehicle for evaluating the capital structure of the District and assessing liquidity and financial flexibility of the District.

The *Combined Statements of Revenues, Expenses, and Changes in Net Assets* reports revenues and expenses as well as change in net assets (owners' equity) for this period. This statement provides a measurement of the District's operations, helps to evaluate the level of cost recovery from charges for products and services, and can be used as a partial determinant of creditworthiness.

The *Combined Statements of Cash Flows* provide information concerning cash receipts and disbursements during the reporting period resulting from operational, financing, and investing activities. This information provides insight into the District's ability to generate net cash flows and meet obligations, as they become due, and is an important indicator of the District's liquidity and financial strength.

The *Notes to Combined Financial Statements* provide additional information that is essential to a full understanding of the financial statements, as described above, including significant accounting policies, commitments, obligations, risks, contingencies, and other financial matters of the District.

Financial Highlights

The District serves the approximately 1,400 square miles of land that is Pend Oreille County. Customer growth continued at approximately 2% in 2008, which has been the average customer growth for the last 5 years. Residential energy consumption for 2008 was approximately 7% higher than 2007, slightly more than the 4% average consumption growth for the last 5 years.

The District is continuing its focus on implementing conditions of the FERC license received for the Box Canyon Hydroelectric Project in 2005. Most of the plans have been completed, and now the District is beginning to perform the work laid out in each plan to protect and enhance the environment surrounding the Box Canyon Dam reservoir. A major part of this is the upgrade of the hydroelectric project itself, which entails replacing all four turbines, as well as upgrading most of the components needed to support increased generation within the Project. Our hope in this project is to enable provision of clean, reliable power to the customers of Pend Oreille County for another 50 years.

The following discussion provides analysis of the comparative financial information provided in the following table:

Combined Balance Sheet Information for December 31, 2008, 2007, and 2006

	2008	2007	2006
Assets			
Current Assets	$ 17,506,449	$ 18,103,091	$ 16,073,474
Special Funds	11,807,352	10,924,484	10,119,451
Other Assets	5,434,514	6,214,488	6,029,308
Net Utility Plant	109,240,302	94,828,745	87,423,588
Total Assets	143,988,617	130,070,808	119,645,821
Liabilities			
Current Liabilities	21,914,292	9,565,833	8,340,223
Other Liabilities	9,099,590	9,770,256	9,344,927
Long-Term Debt	22,031,192	24,623,882	24,137,491
Total Liabilities	53,045,074	43,959,971	41,822,641
Net Assets			
Invested in Capital Assets	76,813,413	68,596,653	61,840,215
Restricted	3,880,902	3,791,504	3,628,502
Unrestricted	10,249,228	13,722,680	12,354,463
Total Net Assets	90,943,543	86,110,837	77,823,180
Total Liabilities and Net Assets	$ 143,988,617	$ 130,070,808	$ 119,645,821

After over 50 years of Box Canyon Hydroelectric Project operation, the District decided to upgrade the turbines and modernize the plant. The turbine upgrade, a required part of the District's Federal Energy Regulatory Commission license, will help improve water quality and fish passage, and will result in incremental generation. The total anticipated cost of the turbine upgrade is $100 million with $8.1 million expended as of December 31, 2008. Plant modernization is projected at $25 million with $8.6 million spent as of December 31, 2008. In total, as of December 31, 2008, the District has expended $16.7 million, incurred $10.4 million in outstanding debt financing, and paid the remaining $6.3 million from reserves. The project is scheduled for completion in 2013 and accounts for many of the District's 2008 balance sheet variations as discussed in the following paragraphs.

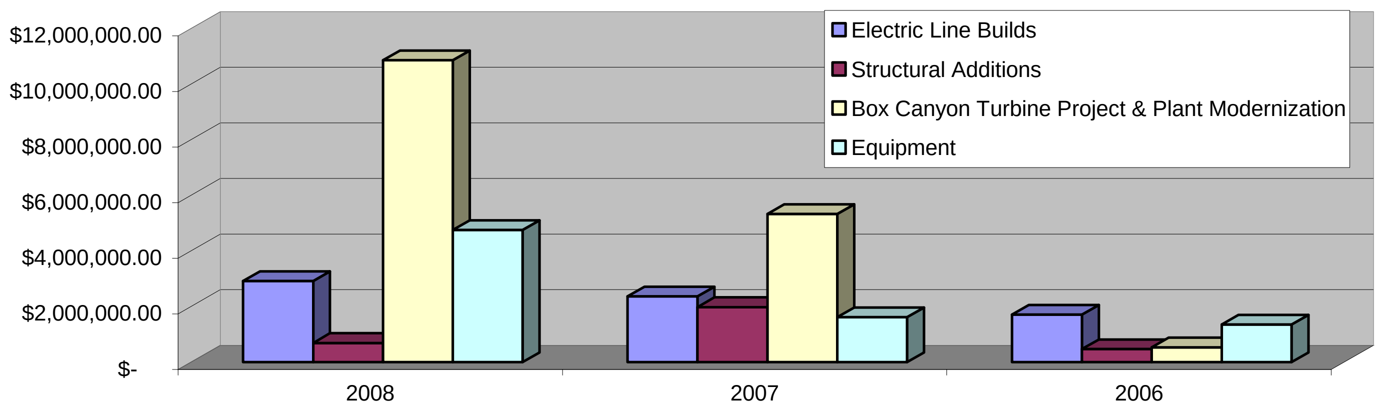
While working capital levels of $7,733,251 for the year ended December 31, 2006 and $8,537,258 for the year ended December 31, 2007 were strong, the District saw a drop in working capital for the year ended December 31, 2008 of $12,945,101. A majority of this change is the result of a line-of-credit for the Box Canyon Production System, which is being used to finance Box Canyon turbine upgrades. The line, which was opened in November 2007, has a balance of $8,546,522 as of December 31, 2008. The District intends to refinance the line-of-credit with either a revenue bond issuance or another line-of-credit during 2009. The District views this line as part of the long-term debt financing of the Box Canyon turbine upgrades, but due to its stated maturity date of December 2009, it is categorized as a current liability, decreasing the District's working capital.

The Electric System saw a decrease in working capital for 2008 of $4,332,549. The District had expected a decrease of approximately $1.5 million due to the planned purchase of a transformer at the District's Metaline Falls substation. $913,000 was expended on the transformer project in 2008. The transformer will allow the District to avoid future wheeling charges and will provide the transport of energy from Boundary Dam. In February 2008, one of the District's Cusick substation transformers failed unexpectedly, forcing the District to purchase and install a new transformer. Costs for the Cusick transformer are expected to be approximately $2.8 million, of which $2.5 million was expended in 2008. Neither project was debt financed during 2008.

Monies held in special funds include capital projects and license condition implementation funds for the Box Canyon Production System, and Bond Reserve and Board Designated Reserve funds for the Electric System. The Board Designated Reserve fund is internally restricted to any authorized purpose of the District and receives regular deposits based on income generated from a mining customer. For the Electric System, the District measures available reserves as working capital plus the Board Designated Fund. Reserves as of December 31, 2008 were $7,123,953, down from $11,137,045 and $11,173,542 as of December 31, 2007 and 2006, respectively.

Other Assets include deferred license costs for Box Canyon's FERC license conditions. Included in the license costs are a number of payments to cities and agencies operating in Pend Oreille County. These payments are intended to be used by these entities to further enhance the environment around the Box Canyon reservoir. Deferred license costs of $5,067,435 in 2008, $5,790,851 in 2007 and $5,516,668 in 2006 represent the present value of these payments that will be made over the license's 50-year life.

Gross utility plant increased $17,794,897 during 2008, a considerable increase over the capital additions of $11,401,088 during 2007 and $4,126,717 in 2006. A majority of this increase relates to the upgrade of Box Canyon Dam, accounting for $10.9 million in 2008 and $5.3 million in 2007. Engineering and model testing of the new turbines are complete, and various parts of the turbines and generator core are currently being manufactured at several facilities around the world. Current work at Box Canyon Dam includes upgrades to support increased generation as well as replacement of aging auxiliary equipment. Other notable additions to utility plant in 2008 include $3.4 million in substation transformers and $2.7 million in customer electric line extensions and distribution line upgrades. A chart comparing utility plant additions is shown below.



Other Liabilities consist of deferred revenue charges for a 30-year right-of-use for fiber optic communications, an approximation of potential license surrender liability for a water storage structure, and deferred FERC license costs for payments to be made to outside agencies per mandatory license conditions. The 6.9% decrease in other liabilities over the 2007 balance is considered a normal variation, as these balances fluctuate slightly with annual amortization and slight changes in estimation factors.

Long-Term Debt at December 31, 2008 is 15% of total assets, down from 19% and 20% as of December 31, 2007 and 2006, respectively. The District repaid over $1.9 million of revenue bond principal during 2008. Electric System revenue bonds consist of two issuances, the 1998 bonds with a balance at December 31, 2008 of $6.4 million and the 2005 bonds with a balance at December 31, 2008 of $15.6 million. The 2005 bonds are a refinancing of bonds issued in 1996 (Note 4). The District's bonds are currently rated through Moody's Investors Service and Fitch Ratings, which gave the District an A3 and A- (stable) rating, respectively. Moody's Investors Service has rated the Electric System bonds as A3 since 1996. Fitch Ratings began rating the District when the 1996 bonds were refinanced in 2005, which rating has remained unchanged since that time.

Total District debt, including the current portion, is 23% of total assets, up from 20% as of December 31, 2007 and 22% as of December 31, 2006. The increase for 2008 reflects additional funds borrowed under the Box Canyon Production System line-of-credit for the turbine upgrade project. The District will continue to borrow on a line-of-credit until revenue bonds are secured for this project.

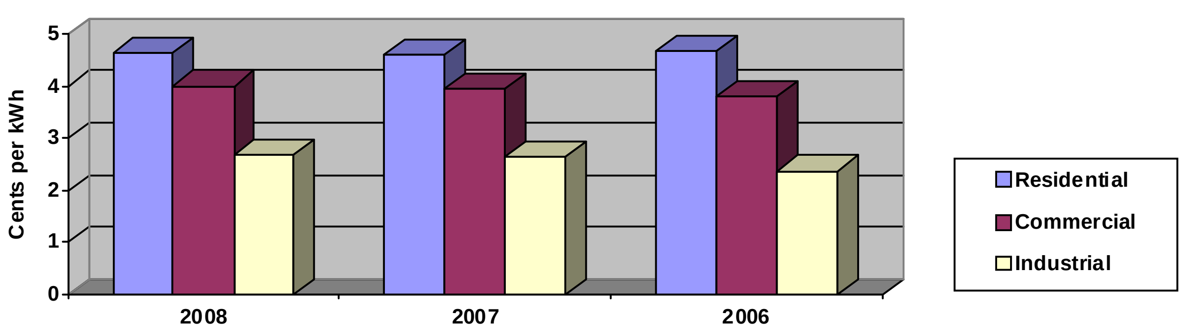
Year-end Net Assets (owner's equity) is 63% of total asset valuation of $143,988,617, compared to 66% and 65% as of December 31, 2007 and 2006, respectively. The lower trend reflects the increase in assets and debt associated with the Box Canyon turbine upgrades and plant modernization.

Electric System Operating Results

	2008	2007	2006
Electric Operating Revenues			
Ponderay Newsprint Company	$18,734,173	$ 18,011,794	$ 16,478,241
Other Retail Customers	11,134,570	10,287,494	9,903,194
Sales to Other Utilities	10,996,408	12,117,878	10,144,370
All Other	3,392,745	1,821,368	2,104,438
Total Operating Revenues	44,257,896	42,238,534	38,630,243
Electric Operating Expenses			
Power Costs	29,639,732	27,003,316	24,715,879
All Other	12,266,338	10,990,120	10,330,854
Total Operating Expenses	41,906,070	37,993,436	35,046,733
Net Operating Revenues	2,351,826	4,245,098	3,583,510
Non-Operating Expenses	748,132	448,689	939,958
Change in Net Assets	$ 1,603,694	$ 3,796,409	$ 2,643,552

The District's largest customer is Ponderay Newsprint Company, which consumed 73% of the District's retail energy usage in 2008. Under terms of the District's contracts with Ponderay Newsprint Company, the customer is billed based on actual costs of service rather than under a rate schedule. All costs and benefits derived from Bonneville Power Administration power products are passed on to this customer, as all Bonneville power is purchased exclusively for Ponderay Newsprint Company. Accordingly, variations in Operating Revenue from Ponderay Newsprint Company can reflect changes in Bonneville Power Administration purchased power costs as well as market resale of this same purchased energy. Operating Revenue from Ponderay Newsprint Company is also dependent on water flows and the cost to produce Box Canyon power, which includes FERC license upgrades.

Other Retail Customers Operating Revenues increased $847,076 in 2008, reflecting a slightly colder than average year. The District did not have a rate increase in 2008, but had a 3% rate increase effective August 1, 2007, and a 15% rate increase effective January 1, 2006. The number of District residential energy customers grew 1.7% in 2008, comparable to 1.8% and 2.0% growth in 2007 and 2006, respectively. The 2008 average usage per residential customer meter, at 19.01 megawatt hours per meter per year, is slightly up from the 2007 and 2006 usage levels of 18.17 and 17.76 megawatt hours per meter each year. District residential energy customers paid an average of 4.64 cents per kilowatt hour consumed in 2008, up slightly from 4.61 cents in 2007. Average residential payment per kilowatt hour consumed in 2006 was 4.67 cents. The following chart compares District historic residential, commercial, and industrial rates. Ponderay Newsprint is included in the industrial rate, and as mentioned previously, this customer's costs can vary from year to year.

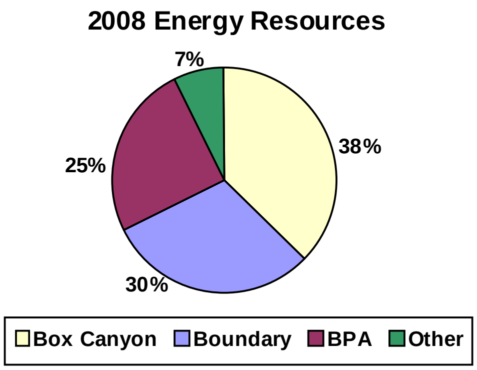


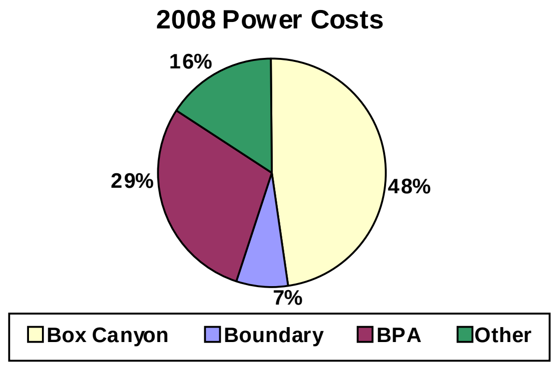
Sales to Other Utilities is primarily associated with the Bonneville Power Administration Block and Slice of the System products (Note 5). The Slice of the System product varies with Columbia River water flows and its resale value moves with power market prices; accordingly, sales to other utilities and power purchases will also vary from year to year. As previously stated, all benefits and risks associated with surplus sales of Bonneville Power Administration power accrue to Ponderay Newsprint Company.

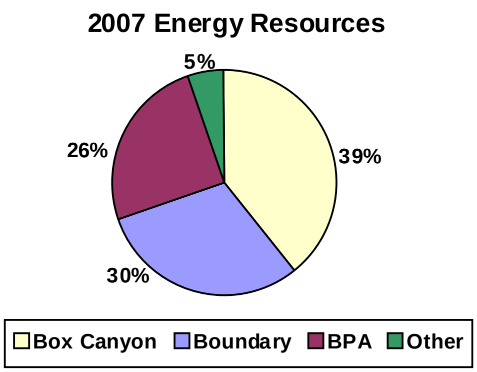
All Other Operating Revenues reflect customer contributed capital for electric line extensions (Note 1), wholesale broadband revenues (Note 10), and miscellaneous revenues, such as timber sales from logging activities on District owned properties.

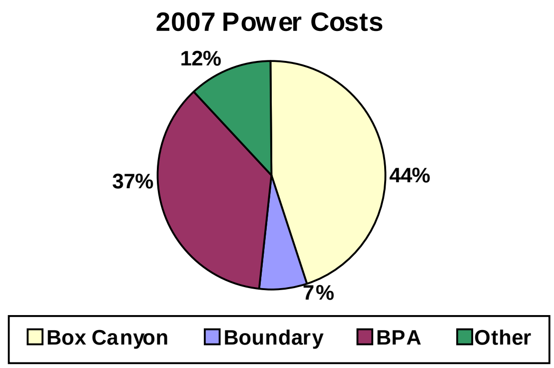
The District has not been immune to the national economic downturn. Pend Oreille County has been historically dependent on the timber and mining industries, which have seen a sharp decline in recent months. In December 2008, the District's second largest customer, Teck, announced that it would be temporarily shutting down its zinc mining operations due to low commodity prices. The customer was billed $1,652,739 and used 51,451 megawatt hours of energy in 2008. Teck's usage is expected to be approximately 25% of these amounts during temporary shut down status, the duration of which is unknown. The District has budgeted for the lost revenues in 2009. Budgeted debt service coverage for 2009 remains above the District's internal goal of 1.75; however, additional economic decline may further negatively impact the District's cash flows.

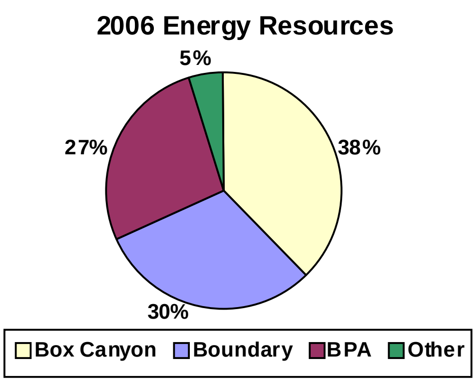
Energy Resources and Related Power Costs

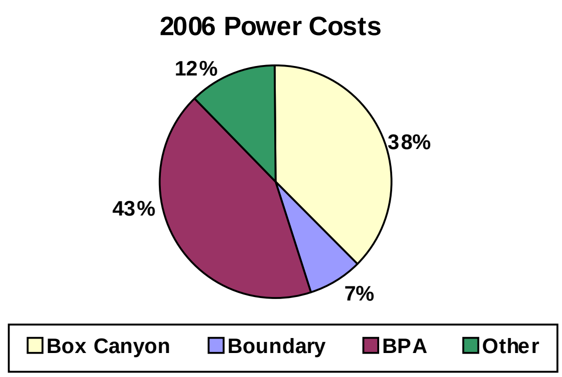












Power Costs increased $2,636,416 in 2008 and $2,287,437 in 2007, and decreased $1,835,042 in 2006. Under the Boundary Hydroelectric project FERC license, the District is eligible to receive Boundary's first 48 megawatts of produced power. At approximately $5.57 per megawatt hour, power received from Boundary Hydroelectric Project is the District's most inexpensive source of power and is a key component of the District's current low power rates. Historically, the District's most expensive source of power has been from Bonneville Power Administration and is a resource that is purchased exclusively for Ponderay Newsprint Company and resold to them at cost. This resource had an average cost of $28 per megawatt hour in 2008, $32 in 2007, and $31 in 2006. Power from Box Canyon Hydroelectric Project was an average of $25 per megawatt hour in 2007, and $20 in 2006, but averaged $31 in 2008 as a result of Box Canyon work being done to prepare for turbine upgrades as well as annual variation in river flows and associated power generation levels. Other Energy Resources include costs to operate the Calispell Powerhouse, which produces less than 1 megawatt per hour, market power purchases, and power marketed for the Kalispel Tribe of Indians. Under a new contract in 2008, the Kalispel Tribe receives a portion of the power Box Canyon produces as rental payment for lands flooded by the Box Canyon Reservoir. The Electric System purchases this power at the monthly market price, at an average cost of $59 per megawatt hour in 2008.

All Other Operating Expenses include operations and maintenance, administrative and general, taxes, and depreciation. Operations and maintenance expenses for the Electric System were $4,630,455 in 2008, up from $3,809,861 and $3,429,582 in 2007 and 2006, rising due to increased fuel and labor costs. Remaining expenses increased slightly due to normal account fluctuations.

Interest income and interest expense are included in Non-Operating Expenses, as well as some small miscellaneous items. Interest rates on the District's primary cash investment averaged 2.68% during 2008, down from 5.09% and 4.90% for 2007 and 2006, respectively. Interest expense decreased $141,999 due to regular payments made on the District's long-term debt.

Box Canyon Production System Operating Results

	2008	2007	2006
Production Operating Revenues			
Sales to the Electric System	$ 14,517,977	$ 11,983,511	$ 9,195,553
All Other	1,725	99,889	1,877
Total Operating Revenues	14,519,702	12,083,400	9,197,430
Production Operating Expenses	11,420,818	8,030,650	8,423,725
Net Operating Revenues	3,098,884	4,052,750	773,705
Non-operating Revenues	151,132	248,407	156,657
Change in Net Assets	$ 3,250,016	$ 4,301,157	$ 930,362

The Box Canyon Production System encompasses costs related to the production of hydroelectric power at Box Canyon Dam. The Production System currently sells all power it produces to the District's Electric System. Sales to the Electric System are priced at the cost to produce the power, including the cost to build or acquire capital assets. The Production System had approximately $11.8 million in capital addition costs during 2008, of which $9.6 million was debt financed (Note 4).

Operating Expenses for the Production System saw a marked increase related to the turbine upgrade project. Operations and maintenance costs for 2008 were up $876,418 over 2007 as the District prepares the plant for the first turbine replacement in the fall of 2009. The District has added staff at the facility in anticipation of increased activity starting in the spring of 2009. Operating expenses were also up for 2008 due to power purchases made to firm up to contractually required levels of production. Firm-up power purchases totaled $3,083,265 in 2008, as compared to $1,337,385 in 2007 and $744,371 in 2006. Firm-up power purchases will vary year to year depending on river flows and Box Canyon generation levels and will not occur in all years.

Water System Operating Results

	2008	2007	2006
Water Operating Revenues			
Sales to Retail Customers	$ 380,864	$ 372,833	$ 350,185
All Other	9,675	9,420	6,851
Total Operating Revenues	390,539	382,253	357,036
Water Operating Expenses	467,459	456,169	455,193
Net Operating Expenses	(76,920)	(73,916)	(98,157)
Non-operating Revenues	55,916	264,007	47,945
Change in Net Assets	$ (21,004)	$ 190,091	$ (50,212)

The District operates nine separate water systems throughout Pend Oreille County. The number of customers in each water system range from 30 to 200, serving approximately 610 customers in total. The District is contractually obligated to maintain separate and distinct rates for each water system which reflect the individual system's costs. Base rates range from $20 to $65 per month for the first 10,000 gallons of water used. Revenues increased $8,031 for the year ended December 31, 2008, compared to $22,648 and $23,621 for the years ended December 31, 2007 and 2006, primarily due to increases in the base rate and weather conditions. Grant revenue of $72,892, $283,077, and $66,334 are included in Non-operating Revenue for the years ended December 31, 2008, 2007, and 2006 respectively, which funds were used to improve the infrastructure of several systems.

Currently Known Facts, Decisions, and Conditions

A description of currently known facts, decisions, and conditions that are expected to have a significant affect on future financial position or results of operations follows.

Ponderay Newsprint Company - The District's single largest customer, Ponderay Newsprint Company, represents 63% of retail energy revenues. District contracts with Ponderay Newsprint Company expire in 2027 and provide for an irrevocable $10 million letter of credit in the event of default. The rate impact from a loss of Ponderay Newsprint Company power sales cannot be accurately forecasted and depends upon the interaction of many factors, including but not limited to, then existing cost of production of Box Canyon Project power, cost of acquisition of Bonneville power, and market or resale value of this power. In a low priced wholesale power market, District rates could be greatly impacted by the loss of this customer (Note 5).

Box Canyon Hydroelectric Project FERC License - The Box Canyon Hydroelectric Project license is discussed in Note 8 to the financial statements. Costs to complete both capital and environmental projects outlined in the license are subject to several variables, including component price fluctuations and changes in engineering specifications. New license conditions may push generation costs high enough to cause the loss of Ponderay Newsprint Company as a customer, possibly affecting the District's current low rate structure.

Sullivan Creek Hydroelectric Project - As discussed in Note 8 to the financial statements, the Sullivan Creek Project's 50-year FERC license expired in 2008. In 2003, the District notified FERC of intent to not relicense. There is substantial uncertainty regarding potential license surrender liability of the current structure. The District recorded a liability estimate and has fully depreciated asset values.

Contacting the District's Financial Management

The financial report is designed to provide interested parties with a general overview of the District's finances and to demonstrate District accountability for the money it receives. If you have questions about this report, or require additional or clarifying financial information, contact the District's financial department as set forth on the last page of this Annual Report under Organizational Information—Corporate Office.

John D. Jordan, CPA
Director of Finance

COMBINED BALANCE SHEETS - ASSETS

	Electric System	Box Canyon Production System	Water System	Combined Total As of December 31, (Note 1) 2008	2007
Current Assets					
Cash and cash equivalents (Note 2)	$ 11,666,234	$ 2,088,475	$ -	$ 13,754,709	$ 13,612,350
Receivables-					
Accounts and contracts, net	760,638	-	10,408	771,046	1,287,425
Other	195,285	-	-	195,285	363,968
Unbilled revenue (Note 1)	871,837	-	-	871,837	726,537
Materials and supplies	1,711,147	-	34,003	1,745,150	1,924,683
Prepaid expenses and other	137,559	30,863	-	168,422	188,128
Due from other systems	214,212	-	-	-	-
Total Current Assets	15,556,912	2,119,338	44,411	17,506,449	18,103,091
Special Funds (Note 2)					
Bond reserve	2,191,728	-	-	2,191,728	2,117,556
Board designated reserve	2,527,343	-	-	2,527,343	2,207,886
Renewal and license:					
Internal restricted funds	-	4,592,434	-	4,592,434	4,128,285
Escrow funds	-	2,394,840	-	2,394,840	2,308,309
Economic Development Fund	101,007	-	-	101,007	162,448
Total Special Funds	4,820,078	6,987,274	-	11,807,352	10,924,484
Other Non-Current Assets					
Contracts and notes receivable	587	-	-	587	12,707
Deferred licensing costs (Note 1)	-	5,067,435	-	5,067,435	5,790,851
Unamortized issue costs	301,545	56,435	8,512	366,492	410,930
Total Other Non-Current Assets	302,132	5,123,870	8,512	5,434,514	6,214,488
Utility Plant (Note 3)					
Land and land rights	1,928,416	784,295	78,981	2,791,692	2,781,082
Hydroelectric plant and equipment	2,464,172	32,509,804	-	34,973,976	31,120,702
Structures, buildings and equipment	89,091,725	-	5,682,563	94,774,288	91,698,649
Intangible assets	178,120	12,365,582	742	12,544,444	12,555,309
Construction work in progress	4,809,511	13,001,215	-	17,810,726	6,944,487
	98,471,944	58,660,896	5,762,286	162,895,126	145,100,229
Less accumulated depreciation and amortization	37,881,128	13,969,917	1,803,779	53,654,824	50,271,484
Net Utility Plant	60,590,816	44,690,979	3,958,507	109,240,302	94,828,745
Total Assets	$81,269,938	$58,921,461	$ 4,011,430	$143,988,617	$ 130,070,808

The accompanying notes are an integral part of these combined financial statements.

COMBINED BALANCE SHEETS -
LIABILITIES AND NET ASSETS

	Electric System	Box Canyon Production System	Water System	Combined Total As of December 31, (Note 1) 2008	2007
Current Liabilities					
Accounts payable and customer deposits	$ 5,613,947	$ 1,993,078	$ -	$7,607,025	$ 3,929,500
Accrued compensation and benefits	1,577,654	14,461	-	1,592,115	1,450,312
Accrued taxes	505,751	100,554	1,510	607,815	671,074
Customer prepayments	731,430	-	1,466	732,896	839,258
Accrued bond interest	401,973	11,245	2,845	416,063	445,880
Current portion of long-term debt (Note 4)	2,075,000	8,642,236	44,953	10,762,189	2,019,140
Current portion of deferred revenue	54,547	-	-	54,547	53,219
Current license costs	-	141,642	-	141,642	157,450
Due to other systems	-	-	214,212	-	-
Total Current Liabilities	10,960,302	10,903,216	264,986	21,914,292	9,565,833
Other Liabilities					
Deferred revenue	1,028,957	-	-	1,028,957	1,078,546
License costs (Note 1)	-	7,320,633	-	7,320,633	7,941,710
License surrender liability (Note 8)	750,000	-	-	750,000	750,000
Total Other Liabilities	1,778,957	7,320,633	-	9,099,590	9,770,256
Long-Term Debt					
Revenue bonds (Note 4)	19,610,692	1,148,572	-	20,759,264	21,583,125
Other long-term debt (Notes 4 and 10)	200,000	621,287	450,641	1,271,928	3,040,757
Total Long-Term Debt	19,810,692	1,769,859	450,641	22,031,192	24,623,882
Total Liabilities	32,549,951	19,993,708	715,627	53,045,074	43,959,971
Commitments and Contingencies (Note 8)					
Net Assets					
Invested in capital assets, net of related debt	39,006,669	34,335,319	3,471,425	76,813,413	68,596,653
Restricted for:					
Economic Development	101,007	-	-	101,007	162,448
Debt service	3,779,895	-	-	3,779,895	3,629,056
Total Restricted	3,880,902	-	-	3,880,902	3,791,504
Unrestricted	5,832,416	4,592,434	(175,622)	10,249,228	13,722,680
Total Net Assets	48,719,987	38,927,753	3,295,803	90,943,543	86,110,837
Total Liabilities and Net Assets	$81,269,938	$58,921,461	$4,011,430	$143,988,617	$130,070,808

The accompanying notes are an integral part of these combined financial statements.

COMBINED STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

	Electric System	Box Canyon Production System	Water System	Combined Total For the year ended December 31, (Note 1) 2008	2007
Operating Revenues					
Sales to retail customers-					
Ponderay Newsprint Company	$18,734,173	$ -	$ -	$18,734,173	$18,011,794
Other retail customers	11,134,570	-	380,864	11,515,434	10,660,327
Sales to other utilities	10,996,408	-	-	10,996,408	12,117,878
Inter-system sales	1,880,701	14,517,977	-	-	-
Contributed capital (Note 1)	779,762	-	5,373	785,135	855,025
Other	732,282	1,725	4,302	594,595	906,024
Total Operating Revenues	44,257,896	14,519,702	390,539	42,625,745	42,551,048
Operating Expenses					
Power costs	29,639,732	3,083,265	-	16,426,572	16,357,190
Operations and maintenance	4,630,455	5,254,043	279,016	10,057,661	8,365,303
Administrative and general	2,744,868	2,056,654	19,159	4,680,567	3,912,486
Taxes	1,542,243	105,143	19,318	1,666,704	1,609,732
Depreciation and amortization	3,348,772	921,713	149,966	4,420,451	4,082,405
Total Operating Expenses	41,906,070	11,420,818	467,459	37,251,955	34,327,116
Net Operating Revenues (Expenses)	2,351,826	3,098,884	(76,920)	5,373,790	8,223,932
Non-Operating Revenues (Expenses)					
Interest income	459,155	197,712	3,068	605,765	1,051,722
Interest on debt	(1,239,366)	(124,623)	(11,427)	(1,375,416)	(1,397,096)
AFUDC interest (Note 3)	60,038	124,259	-	184,297	142,354
Grant revenues (Note 9)	-	-	72,892	43,168	283,077
Other, net	(27,959)	(46,216)	(8,617)	1,102	(16,332)
Total Non-Operating Revenues (Expenses)	(748,132)	151,132	55,916	(541,084)	63,725
Change in Net Assets	1,603,694	3,250,016	(21,004)	4,832,706	8,287,657
Accumulated Net Assets					
Beginning of year	47,116,293	35,677,737	3,316,807	86,110,837	77,823,180
End of year	$48,719,987	$ 38,927,753	$3,295,803	$90,943,543	$86,110,837

The accompanying notes are an integral part of these combined financial statements.

COMBINED STATEMENTS OF CASH FLOWS - OPERATING AND FINANCING ACTIVITIES

	Electric System	Box Canyon Production System	Water System	Combined Total For the year ended December 31, (Note 1) 2008	2007
Cash Flows from Operating Activities					
Receipts from customers	$42,358,172	$ -	$384,698	$ 42,742,870	$ 41,913,301
Receipts from other operating revenues	101,639	14,762	-	116,401	277,748
Payments to suppliers for goods and services	(17,423,794)	(4,292,914)	(187,742)	(21,904,450)	(22,432,993)
Payments to employees for services	(4,008,041)	(2,701,108)	(150,866)	(6,860,015)	(6,389,359)
Payments to (from) other systems	(12,312,580)	12,492,116	(179,536)	-	-
Net cash from operating activities	8,715,396	5,512,856	(133,446)	14,094,806	13,368,697
Cash Flows from Noncapital Financing Activities					
Economic Development Fund					
Transfers & other receipts	25,000	-	-	25,000	25,000
Awarded to grant applicants	(15,934)	-	-	(15,934)	(33,125)
Intersystem financing	21,378	(46,216)	24,838	-	-
Net cash from noncapital financing activities	30,444	(46,216)	24,838	9,066	(8,125)
Cash Flows from Capital and Related Financing Activities					
Acquisition and construction of capital assets	(6,961,127)	(11,621,604)	(64,980)	(18,647,711)	(11,345,208)
Proceeds from grants	-	-	229,962	229,962	96,283
Change of deferred revenue (Note 1)	(48,261)	-	-	(48,261)	(88,078)
Proceeds from issuance of revenue bonds	-	1,305,600	-	1,305,600	2,346,829
Scheduled payments on revenue bonds (Note 4)	(1,980,000)	(95,714)	-	(2,075,714)	(1,895,000)
Interest paid on revenue bonds (Note 4)	(1,095,883)	(503)	-	(1,096,386)	(1,184,951)
Proceeds from issuance of borrowings	-	6,817,410	-	6,817,410	-
Scheduled payments on note payable	-	-	(44,954)	(44,954)	(35,710)
Interest paid on notes payable	-	(105,635)	(11,420)	(117,055)	(12,200)
Net cash from capital and related financing activities	(10,085,271)	(3,700,446)	108,608	(13,677,109)	(12,118,035)

The accompanying notes are an integral part of these combined financial statements.

COMBINED STATEMENTS OF CASH FLOWS -
INVESTING ACTIVITIES AND RECONCILIATIONS

	Electric System	Box Canyon Production System	Water System	Combined Total For the year ended December 31, (Note 1) 2008	2007
Cash Flow from Investing Activities					
Purchases of investments	$(17,678,724)	$ -	$ -	$(17,678,724)	$ (9,736,882)
Sales and maturities of investments	15,753,000	-	-	15,753,000	9,729,475
Interest on investments, contracts and notes	322,476	197,712	-	520,188	1,051,587
Net cash from investing activities	(1,603,248)	197,712	-	(1,405,536)	1,044,180
Net Change in Cash and Cash Equivalents	(2,942,679)	1,963,906	-	(978,773)	2,286,717
Cash and Cash Equivalents (Note 2)					
Beginning of year	17,424,991	7,111,843	-	24,536,834	22,250,117
End of year	$14,482,312	$9,075,749	$ -	$23,558,061	$ 24,536,834
Reconciliation of Net Operating Revenues (Expenses) to Cash Flows from Operating Activities					
Net operating revenues (expenses)	$ 2,351,826	$ 3,098,884	$ (76,920)	$5,373,790	$ 8,223,932
Adjustments to reconcile net operating revenues (expenses) to net cash from operating activities					
Depreciation and amortization	3,348,772	921,713	149,966	4,420,451	4,082,405
Changes in operating assets and liabilities:					
Receivables	500,138	13,037	(2,787)	510,388	(162,361)
Unbilled revenue (Note 1)	(145,300)	-	-	(145,300)	74,572
Due to other systems	162,982	-	(162,982)	-	-
Materials and supplies	170,520	-	9,013	179,533	(237,142)
Prepaid expenses and other current assets	23,151	(3,445)	-	19,706	(21,103)
Deferred charges (Note 1)	-	86,531	-	86,531	120,399
Accounts payable, customer deposits and prepayments	2,042,296	1,397,494	(49,454)	3,390,336	1,217,663
Accrued compensation, benefits and taxes	261,011	(1,358)	(282)	259,371	70,332
Net cash from operating activities	$8,715,396	$ 5,512,856	$(133,446)	$14,094,806	$ 13,368,697

The accompanying notes are an integral part of these combined financial statements.

NOTES TO COMBINED FINANCIAL STATEMENTS
December 31, 2008 and 2007

NOTE 1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Organization - Public Utility District No. 1 of Pend Oreille County, Washington (the District) is a municipal corporation governed by an elected three-person Board of Commissioners. The District's reporting entity is comprised of three primary component units, or operating systems.

The Electric System distributes electricity to residential and other consumers in Pend Oreille County. The Box Canyon Production System produces hydroelectric power from the Box Canyon Hydroelectric Project (Note 8). The Water System consists of nine individual water distribution subdivisions. The District is required by various financing and contractual arrangements to report separately on each system and maintain each system as a separate entity with separate obligations.

The District authorized usage of the name Community Network System (CN System) for the purpose of facilitating access to, and use of, the District's Electric System broadband communication network for the benefit of the people of Pend Oreille County (Note 10) in accordance with state granted wholesale authority. The CN System is an endeavor of the Electric System and is not a separate operating system for reporting purposes.

Basis of Accounting and Presentation - The accounting policies of the District conform to generally accepted accounting principles (GAAP) as applicable to proprietary funds of governments. The Governmental Accounting Standards Board (GASB) is the accepted standard setting body for establishing governmental accounting and financial reporting principles. Accounting records are maintained in accordance with methods prescribed by the State Auditor under the authority of Chapter 43.09 RCW, the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission (FERC) for the Electric System and Box Canyon Production System, and the Uniform System of Accounts for Class C Water Utilities prescribed by the National Association of Regulatory Utility Commissioners for the Water System.

GASB Statement No. 20 requires that the District apply all GASB pronouncements as well as the pronouncements issued on or before November 30, 1989, by the Financial Accounting Standard Board (FASB) and its predecessor organizations, unless those pronouncements conflict with or contradict GASB pronouncements. As provided for in GASB Statement No. 20, the District has elected not to implement FASB Statements and Interpretations issued after November 30, 1989.

System columns presented in the financial statements do not sum to the combined totals due to the elimination of certain inter-system transactions. These transactions relate to inter-system power sales and purchases, loan balances and interest on inter-system loans, and inter-system administrative charges.

A summary of other significant accounting policies utilized in the preparation of the combined financial statements follows.

New Accounting Standards - In November of 2006, the GASB issued GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. This statement addresses accounting and financial reporting standards for potentially detrimental effects of existing pollution. The District adopted this statement for the year ended December 31, 2007, and recorded a $50,000 current liability related to high lead levels discovered during excavation for a water system upgrade. All costs for disposing of contaminated soil were covered by the District's insurance policy during 2008. No further liability for this issue is expected as of December 31, 2008. The District evaluated all current and future environmental projects related to the Box Canyon FERC license, and concluded no projects named in the license are considered pollution remediation. See further discussion of the Box Canyon FERC license at Note 8.

In June of 2007, the GASB issued GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. The objective of this Statement is to establish accounting and financial reporting requirements for intangible assets and is expected to enhance the comparability of the accounting and reporting of such assets among state and local governments. GASB Statement No. 51 is required for financial statements for periods beginning after June 15, 2009. The District has chosen to do early implementation as of December 31, 2008 and has evaluated its intangible assets, including the Box Canyon FERC license and land easements, and has concluded that all assets are properly recorded under GASB Statement No. 51.

Note 1 – Organization and Significant Accounting Policies (continued)

In June of 2008, the GASB issued GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments.* This statement addresses the recognition, measurement, and disclosure of derivative instruments, which are often complex financial arrangements to manage specific risks or to make investments. The statement is effective for periods beginning after June 15, 2009. The District did not elect early adoption of this statement, and will continue to evaluate its applicability to District finances over the next year.

Revenue Recognition - The Electric System and Water System recognize revenue as earned on a monthly basis based on rates established by the District's Board of Commissioners and, for the Electric System, in accordance with power sales contracts with Ponderay Newsprint Company (Note 5). Because Electric System customer meters are read and billed at various times during each month, the District estimates unbilled revenues for energy delivered to customers between their last respective cycle billing date and December 31, and records that amount as unbilled revenue for the current year. The Box Canyon Production System recognizes revenue on a cost-of-service basis from sales to the Electric System.

Allowance for Uncollectible Accounts - Management reviews accounts receivable on a regular basis to determine if any receivables will potentially be uncollectible. The allowance for uncollectible accounts includes amounts estimated through an evaluation of specific accounts, based on the best available facts and circumstances, of customers that may be unable to meet their financial obligations, and a reserve based on historical experience. Management believes that the allowance for uncollectible accounts as of year end is adequate.

Cash and Cash Equivalents - The District records repurchase agreements and other short-term investments, with maturity at date of purchase of three months or less, at cost as cash equivalents.

Special Funds and Investments - Short-term investments with a maturity of between three and twelve months, at date of purchase, are recorded at amortized cost with discount or premium amortized on a straight-line basis over the life of the investments. The District records all other investments at fair value based on quoted market rates, with changes in unrealized gains and losses reported as investment income.

Materials and Supplies - Materials and supplies are recorded at average cost.

Utility Plant - As discussed in Note 3 regarding capitalization, depreciation, and retirement policies.

Contributed Capital - Contributions in Aid of Construction are District-mandated customer connection charges used to fund construction of system properties necessary to extend service to a new customer. The payments are initially recorded as liabilities, then reclassified to operating revenue (contributed capital) when the associated facilities are constructed or acquired.

Deferred Licensing Costs - The FERC issued the District a 50-year operating license for the Box Canyon Hydroelectric Project in July 2005. The license contains environmental studies and projects that the District must complete. Per the license, a Technical Committee, which consists of members of the involved state and federal agencies and the Kalispel Tribe, oversees the implementation of the license requirements in conjunction with District staff.

Certain of the FERC license conditions require payments to various outside entities for projects and operating costs which will not be directed by, or controlled by, the District or the Technical Committee. The District has estimated and present valued these payments over the 50-year license and recorded a deferred asset and license cost liability. The District has not recorded the future costs of the remaining expenses related to license implementation. Costs for these projects will be capitalized or expensed, as may be appropriate, when incurred. The District also maintains license liabilities for escrow funds held per license conditions (Note 2).

Deferred Financing Costs - Bond issue costs, discounts, and premiums are amortized to interest expense, using the effective interest method, over the term of the bonds. The excess of costs incurred over the carrying value of bonds refunded on early extinguishment of debt is amortized to expense over the shorter of the remaining life of the old bonds or the life of the new issue (Note 4).

Deferred Revenue - In August 2000, the District entered into an agreement with Seattle City Light concerning a cost sharing arrangement for building of fiber optic communications capability in Pend Oreille County. Among other terms and conditions, the District retained ownership of all constructed network assets with a commitment to grant Seattle City Light a 30-year right-of-use for 8 to 12 dark fiber strands along the District's network backbone. Seattle City Light made a one-time, lump sum payment of $1,487,650 under the agreement. The District recorded the payment as Electric System deferred revenue and is amortizing the balance to revenue on a straight-line basis over the 30-year life of the agreement.

Restricted Net Assets - Amounts presented as restricted net assets are reserved for specific purposes and cannot be used for normal operations. Balances currently classified as restricted include funds held by the Economic Development Revolving Fund (Note 2) and bond principal and interest due for the upcoming year, less accrued interest, as well as the bond reserve fund.

Compensated Absences - Employees accrue personal leave to be used for vacation, sick, and family leave purposes. Annual leave granted each employee varies in accordance with years of service and may be carried forward from year-to-year, capped at a maximum bank of 1200 hours. The District records the cost of personal leave as earned, not as taken.

Accounting Estimates - The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Significant Risks and Uncertainties - The District is subject to certain business risks that could have a material impact on future operations and financial performance. These risks include weather and natural-disaster-related disruptions; collective bargaining labor disputes; changing local and national economic conditions; fish and other Endangered Species Act issues; Environmental Protection Agency regulations; federal government regulations or orders concerning the operation, maintenance, licensing and license surrender of hydroelectric facilities, including licensing of the Box Canyon Project as discussed in Note 8; the financing and completion of significant capital projects including the Box Canyon Project turbine upgrade and plant modernization; deregulation of the electrical industry; concentration risk in the form of sales to a major customer, Ponderay Newsprint Company and related potential impact on District power contracts (Note 5); and market risks inherent in buying and selling of power, a commodity with inelastic demand characteristics and minimal storage capability.

Reclassifications – Certain reclassifications have been made to the 2007 financial statements presentation to conform to the current year presentation. These reclassifications do not affect the change in net assets as previously reported.

NOTE 2. SPECIAL FUNDS AND INVESTMENTS

The District's investment portfolio consisted of the following cash and cash equivalents and investments:

	Electric System	Box Canyon Production System	Water System	Combined Total As of December 31, 2008	2007
Revenue Funds					
Cash and cash equivalents	$ 9,676,094	$ 2,083,787	$ -	$ 11,759,881	$ 11,661,553
Bond principal and interest	1,990,140	4,688	-	1,994,828	1,950,797
Total Revenue Funds	11,666,234	2,088,475	-	13,754,709	13,612,350
Special Funds					
Bond reserve	2,191,728	-	-	2,191,728	2,117,556
Board Designated reserve	2,527,343	-	-	2,527,343	2,207,886
Renewal and license					
Internal restricted funds	-	4,592,434	-	4,592,434	4,128,285
Escrow funds	-	2,394,840	-	2,394,840	2,308,309
Economic Development	101,007	-	-	101,007	162,448
Total Special Funds	4,820,078	6,987,274	-	11,807,352	10,924,484
Total Special and Revenue Funds	$16,486,312	$ 9,075,749	$ -	$ 25,562,061	$ 24,536,834
Cash and Cash Equivalents, at Cost, Which Approximates Market Value					
Cash deposits	$ 1,132,369	$ 2,394,840	$ -	$ 3,527,209	$ 4,665,022
Local government investment pool	13,349,943	6,680,909	-	20,030,852	19,871,812
Total Cash and Cash Equivalents	$14,482,312	$ 9,075,749	$ -	$ 23,558,061	$ 24,536,834
Investments					
U.S. Treasuries, long-term at market	$ 1,997,724	$ -	$ -	$ 1,997,724	$ -
Accrued interest receivable	6,276	-	-	6,276	
Total Investments	$ 2,004,000	$ -	$ -	$ 2,004,000	$ -
Total Funds	$16,486,312	$ 9,075,749	$ -	$ 25,562,061	$ 24,536,834

Interest Rate Risk. The District's investment policy limits investment maturities to less than five years from the date of purchase unless authorized by the General Manager and Director of Finance for a specific purpose. During 2008 and 2007, excepting the 2005 bond reserve account, all investments were in the State Treasurer's Local Government Investment Pool (LGIP), which has a weighted average portfolio maturity of less than 90 days.

Credit Risk. In accordance with the Revised Code of Washington, District bond resolutions, and District internal investment policies, all investments are direct obligations of the U.S. Government, deposits in the LGIP, or deposits with financial institutions recognized as qualified public depositories of the State of Washington. U.S. Government securities are held by banks or trust companies as the District's agent and in the District's name.

Note 2 – Special Funds and Investments (continued)

The District's cash deposits are covered by federal depository insurance or protected against loss by deposit with financial institutions recognized as qualified public depositories of the State of Washington. The District intends to hold time deposits and securities until maturity.

Concentration of Credit Risk. District policies allow the entire portfolio to be invested in direct United States Government guaranteed obligations or in the LGIP. No other investment may exceed half of portfolio market value. The LGIP, a 2a7-like pool as defined by GASB Statement No. 31 and the Securities and Exchange Commission, invests in high quality, short-term investments; all LGIP money market securities must be rated A-1 by Standard & Poors Corporation or P1 by Moody's Investor Services, Inc. The LGIP weighted average maturity must not exceed 90 days and no single investment may exceed 762 days in maturity. Withdrawals in excess of $10 million are available on a one day notice. The LGIP Annual Report is available on the State Treasurer's website at http://tre.wa.gov/LGIP/lgip.htm.

Bond Reserve, Principal, and Interest Funds - For each debt issue, the District is required by bond resolutions to maintain principal and/or sinking fund and interest accounts within the bond funds to provide for the next semi-annual interest and annual principal/sinking fund payments falling due, which are reported as current assets. All bond funds are restricted by bond resolution to the payment of debt service obligations.

District Electric System revenue bond resolutions require reserve accounts be maintained within the bond funds. The 1998 reserve account requires a deposit equal to the maximum amount of principal and interest falling due in any single bond year, which the District met through the purchase of a surety bond. The 2005 reserve account equals 10% of par amount and premium on the 2005 bonds issued. This $1,934,181 reserve is invested in a forward supply contract with a private third party wherein a series of U.S. Treasury bonds, bills, or notes, of a maturity not to exceed the next scheduled bond interest payment date, will be delivered to the District's trust account. Per agreement with the independent third party, the District receives a pre-determined yield on the investments through the end of the agreement, which expires January 1, 2014.

Board Designated Reserve Fund - The Electric System Board Designated Reserve Fund receives monies from uncertain, non-recurring, or limited duration revenue streams such as surplus sales of District generated power resources, timber sales, and a portion of certain customer revenues associated with mining activities. Disbursements from the fund are allowed for any valid business purpose of the District as specifically authorized by motion of the Board of Commissioners.

Renewal and License Fund - The Renewal and License Reserve Fund is an internally restricted fund, not required by any external agencies or contractual agreements, established to provide for Box Canyon Hydroelectric Project capital additions, renewals and replacements, and for capital expenditures required by terms and conditions of the Box Canyon Project FERC license (Note 8) not otherwise provided for by the District.

Escrow Funds - The Box Canyon Project FERC license stipulates that a Trout Restoration Fund and a Recreation Resources Fund are to be financed by the District. These funds were established through interest bearing escrow accounts with a financial institution and are used at the discretion of the District and Technical Committee members (Note 8) for trout preservation and recreational facility improvements and maintenance. As of December 31, 2008 and 2007, the escrow balance in the Trout Restoration Fund totaled $1,658,832 and $1,646,821 while the balance in the Recreation Resources Fund was $736,008 and $661,488, respectively.

Economic Development Revolving Fund - As allowed by Revised Code of Washington (RCW) 82.16.0491, the District contributes $50,000 annually to the Pend Oreille County Economic Development Revolving Fund and receives a $25,000 matching excise tax credit, resulting in a net cost to the District of $25,000. The District's Board of Commissioners appoints the fund's local board and has currently appointed themselves to three of the five positions. Monies deposited may be used for qualifying economic development projects within the county, as allowed by RCW and approved by the local board. In accordance with the provisions of GASB Statement No. 39, the Economic Development Revolving Fund is recorded as a blended component unit within the Electric System. Further information concerning the Economic Development Revolving Fund may be obtained by contacting the District's financial department as set forth on the last page of this Annual Report under Organizational Information—Corporate Office.

NOTE 3. UTILITY PLANT

Utility plant assets are stated at cost, including an allowance for funds used during construction (AFUDC). For the years ended December 31, 2008 and 2007, the District recorded AFUDC of $184,297 and $142,354, respectively. Betterments and major renewals over $1,000 are capitalized, while maintenance and repairs are charged to operations as incurred.

The District capitalized to Utility Plant costs associated with seeking the new FERC license, including legal fees for continuing litigation of various license conditions, and amortizes the balance over the 50-year term of the license. Capitalized relicensing costs as of December 31, 2008 and 2007 were $12,365,582 and $12,222,367, with accumulated amortization of $836,937 and $589,556, respectively.

During the years ended December 31, 2008 and 2007, the following changes occurred in the District's utility plant:

	2007 Balance	Additions	Retirements/ Transfers	2008 Balance
Land and land rights	$ 2,781,082	$ 810	$ 9,800	$ 2,791,692
Hydroelectric plant and equipment	31,120,702	230,309	3,622,965	34,973,976
Structures, buildings and equipment	91,698,649	757,268	2,318,371	94,774,288
Intangible assets	12,555,309	146,378	(157,243)	12,544,444
Construction work in progress	6,944,487	17,895,051	(7,028,812)	17,810,726
	145,100,229	19,029,816	(1,234,919)	162,895,126
Less accumulated depreciation and amortization	50,271,484	4,621,362	(1,238,022)	53,654,824
Net Utility Plant	$ 94,828,745	$ 14,408,454	$ 3,103	$109,240,302

	2006 Balance	Additions	Retirements/ Transfers	2007 Balance
Land and land rights	$ 2,717,016	$ 64,066	$ -	$ 2,781,082
Hydroelectric plant and equipment	30,448,420	419,408	252,874	31,120,702
Structures, buildings and equipment	86,304,884	1,474,549	3,919,216	91,698,649
Intangible assets	12,262,965	292,344	-	12,555,309
Construction work in progress	1,965,856	9,631,178	(4,652,547)	6,944,487
	133,699,141	11,881,545	(480,457)	145,100,229
Less accumulated depreciation and amortization	46,275,553	4,227,673	(231,742)	50,271,484
Net Utility Plant	$ 87,423,588	$ 7,653,872	$ (248,715)	$94,828,745

Depreciation - Depreciation is determined by the straight-line method over the estimated useful lives of the related assets, which ranges from 7 to 50 years. Composite rates are used for asset groups and, accordingly, no gain or loss is recorded on the disposition of an asset unless it represents a large and unusual retirement. The combined composite depreciation rates are as follows:

	Electric System	Box Canyon Production System	Water System
2008	3.9%	2.3%	2.8%
2007	3.8%	1.0%	2.7%

NOTE 4. LONG-TERM DEBT

In November 1998, the District issued $10 million tax-exempt Electric System revenue bonds to complete certain transmission line and substation capital work. The issue contains $7,770,000 in series bonds maturing in annual installments from December 1, 2001 through 2015, with interest rates ranging from 4.0% to 4.4%. The remaining $2,230,000 is a 4.55% term bond maturing in sinking fund installments from 2016 through 2018. The bonds are reported in the balance sheet net of unamortized discount of $34,315 and $39,347 as of December 31, 2008 and 2007, respectively.

In November 2005, the District issued $13,240,000 Series A (subject to alternative minimum tax) and $5,430,000 Series B (tax exempt) revenue bonds to refund bonds originally issued in 1996. The present value savings at the time of refinancing was estimated at $1,343,710. The Series A bonds accrue interest at 4.00% to 5.00% maturing in annual installments from January 1, 2006 through January 1, 2015. The Series B bonds consist of $1,580,000 in series bonds, maturing in annual installments from January 1, 2006 through January 1, 2014 and accruing interest at 3.25% to 4.00%; $2,420,000 maturing in annual sinking fund installments from January 1, 2015 through January 1, 2017 accruing interest at 4.35%; and $1,430,000 maturing on January 1, 2018 accruing interest at 5.25%. The District recorded a loss from refinancing of $1,470,496, which is amortized using the effective interest method over the life of the 2005 bonds. The bonds are recorded in the balance sheet net of unamortized premium of $330,999 and $428,609 and unamortized loss from refinancing of $680,991 and $876,137 as of December 31, 2008 and 2007, respectively.

In November 2005, the Electric System loaned the Box Canyon Production System $2 million to provide additional liquidity to enable implementation of newly issued FERC license requirements. Interest on the loan accrued at the Electric System's variable opportunity cost of the Washington State Local Government Investment Pool's monthly interest rate which varied in 2007 from 4.5% to 5.2%. The balance of the note was paid in full as of December 31, 2007.

In 2007, the District arranged a $40 million short-term borrowing with a financial institution to finance initial phases of the Box Canyon turbine upgrade and plant modernization projects. The borrowing envisioned four non-revolving $10 million line-of-credits be established, one created each year from 2007 to 2010, subject to the financial institution credit approval at the time each new $10 million line is opened.

In November 2007, the District sold revenue bond anticipation notes to the financial institution establishing the first $10 million line-of-credit, maturing December 1, 2009. Interest is paid quarterly and may be based on either a discounted Prime or LIBOR rate, chosen by the District at the time of each draw. During 2008, the District borrowed $6,207,173 at interest rates varying from 1.24% to 3.84%. The principal balance outstanding at December 31, 2008 is $8,546,522.

In December 2008, the District established the second $10 million line-of-credit, maturing December 1, 2010. Interest is paid quarterly and accrued at a LIBOR based rate, which ranged from 1.74% to 1.76% during December 2008. The line accrues an additional bank fee of 0.10% on the unused portion of the line, which is paid quarterly. The principal balance outstanding as of December 31, 2008 is $621,287.

The financial institution has reserved the right to issue the third and fourth lines, as well as extend the December 2009 due date of the first line-of-credit, based on credit review and economic conditions existing at the time the District requests the lines be opened. There is no firm commitment the additional lines will be issued or maturity date extended. The District intends to repay the lines of credit with proceeds from a revenue bond issuance in 2009 or 2010, depending on market conditions and other factors.

In November 2008, the District issued a $1,340,000 Clean Renewable Energy Tax Credit Bond (CREB) to assist in the financing of the Box Canyon turbine upgrade project. CREB purchasers are eligible for a credit against their federal income tax. The bond carries an interest rate of 1.35% and provides for equal annual principal payments in the amount of $95,714, the first of which was paid in December 2008. The bond matures in December 2021.

In 2000, the Sunvale Subdivision of the Water System received a loan for $189,607 from the State of Washington Department of Community, Trade, and Economic Development to finance the construction of new wells and distribution line. The fixed interest rate is 2.5% for a term of twenty years. Annual principal payments in the amount of $9,979 are due through October 2020.

In 2001, the State of Washington Department of Community, Trade, and Economic Development authorized a $400,070 loan to the Riverbend Subdivision of the Water System, to finance system improvements, with a fixed interest rate of 2.5%. Annual principal payments in the amount of $22,018 are due through October 2020.

Note 4 – Long-Term Debt (continued)

In July 2003, the District executed a State of Washington Public Works Board loan agreement for the Granite Shores subdivision of the Water System enabling a $70,551 loan to be repaid over 20 years at 1% interest. The loan financed certain system improvements, including drilling a new well. Annual principal repayments of $3,713 began in October 2005 and will end in October 2023. Subsequently, in March 2006, the District secured an additional loan with the State of Washington Public Works Board for $35,717 to cover the remaining costs of drilling the new well. The second loan also carries a 1% interest rate. Annual principal payments in the amount of $1,880 are due through October 2026.

In February 2005, the Community Economic Revitalization Board (CERB) awarded the District a $200,000 loan for construction of communication infrastructure projects. This loan carries no interest, and principal payments are deferred for the first five years. Annual principal payments of $13,333 will begin in 2011 and will end in 2026.

In December 2007, the District was awarded a $29,450 loan from the Department of Community, Trade and Economic Development (CTED) for engineering expenses related to upgrading the Metaline Falls Water System (Note 9). Principal payments in the amount of $7,362 began in July 2008 and will end in July 2011. The loan accrues interest at 2.0%.

During the years ended December 31, 2008 and 2007, the following changes occurred in the District's long-term debt:

	2007 Balance	Additions	Reductions	2008 Balance
Revenue bonds, face amount	$ 24,050,000	$ 1,340,000	$ 2,075,714	$ 23,314,286
Unamortized bond premium	428,609	-	97,610	330,999
Unamortized bond discount	(39,347)	-	(5,031)	(34,316)
Loss on refunding	(876,137)	-	(195,146)	(680,991)
Other long-term debt	3,079,897	6,828,460	44,954	9,863,403
Total Debt	$ 26,643,022	$ 8,168,460	$ 2,018,101	$ 32,793,381
Current Portion of Total Debt				10,762,189
Total Long-Term Debt				$ 22,031,192

	2006 Balance	Additions	Reductions	2007 Balance
Revenue bonds, face amount	$ 25,945,000	$ -	$ 1,895,000	$ 24,050,000
Unamortized bond premium	539,990	-	111,381	428,609
Unamortized bond discount	(44,614)	-	(5,267)	(39,347)
Loss on refunding	(1,118,983)	-	(242,846)	(876,137)
Other long-term debt	746,808	2,368,799	35,710	3,079,897
Total Debt	$ 26,068,201	$ 2,368,799	$ 1,793,978	$ 26,643,022
Current Portion of Total Debt				2,019,140
Total Long-Term Debt				$ 24,623,882

Note 4 – Long-Term Debt (continued)

Scheduled maturities and interest on long-term debt are as follows:

	Electric System	Box Canyon Production System	Water System	Combined as of 12/31/08
Principal				
2009	$ 2,075,000	$ 8,642,236	$ 44,953	$ 10,762,189
2010	2,165,000	717,001	44,952	2,926,953
2011	2,288,333	95,714	44,952	2,428,999
2012	2,393,333	95,714	37,591	2,526,638
2013	2,508,333	95,714	37,591	2,641,638
2014-2018	10,746,665	478,570	187,954	11,413,189
2019-2023	66,665	287,146	91,965	445,776
2024-2026	26,671	-	5,636	32,307
	$ 22,270,000	$ 10,412,095	$ 495,594	$ 33,177,689
Interest				
2009	$ 1,001,860	$ 143,239	$ 10,936	$ 1,156,035
2010	903,349	35,756	9,934	949,039
2011	799,449	14,214	8,931	822,594
2012	689,936	12,922	7,927	710,785
2013	574,586	11,630	7,071	593,287
2014-2018	1,247,110	38,764	22,516	1,308,390
2019-2023	-	7,752	3,520	11,272
2024-2026	-	-	113	113
	$ 5,216,290	$ 264,277	$ 70,948	$ 5,551,515

NOTE 5. POWER PURCHASE CONTRACTUAL AGREEMENTS

Ponderay Newsprint Company - In July 1986, the Electric System entered into power sales contracts with Ponderay Newsprint Company to supply power to a fiber mill and paper plant. The District is obligated to provide all power necessary to operate both the fiber mill and paper plant. Power delivery under these contracts expires in 2027. In 2008, approximately 73% of Electric System retail energy deliveries and 63% of retail energy sale revenues were to Ponderay Newsprint Company.

To fulfill this power commitment, the District delivers power from the Box Canyon Project and acquires power at cost from the Boundary Project. The District's rights to acquire power at cost from the Boundary Project are provided for in Article 49 of Seattle City Light's Federal Energy Regulatory Commission license for the Boundary Project. Power is also obtained from the Bonneville Power Administration (BPA) and other suppliers under various power purchase contracts. The cost of all power purchases necessary to fulfill the requirements of the fiber mill and paper plant is charged to Ponderay Newsprint Company based upon the District's actual costs.

The Ponderay Newsprint Company has provided an irrevocable letter of credit for $10 million, which the District may draw upon in the event Ponderay Newsprint Company defaults in its obligations under the contracts. The District believes the letter of credit provides reasonable funds to cover the District's outstanding power purchase commitments and contractual obligations in the event of default by Ponderay Newsprint Company. However, future retail rates of the Electric System may be affected if the District were to no longer provide service to Ponderay Newsprint Company.

The rate impact from a loss of Ponderay Newsprint Company power sales cannot be forecasted accurately; it depends upon the interaction of many factors, including but not limited to, existing cost of production of Box Canyon Project power, cost of acquisition of Bonneville power, and market or resale value of this power.

Seattle City Light - ***Boundary Hydroelectric Project* -** Seattle City Light possesses a FERC license, expiring August 1, 2011, to operate the Boundary Hydroelectric Project in northern Pend Oreille County. This license contains Article 49 granting the District a licensed share of the project, set at 48 MW capacity, with actual energy deliveries not to exceed the District's retail customer load requirements. The District agreed to aid Seattle City Light in the post-2011 relicensing of the Boundary Project. In exchange for District support, Seattle City Light agreed to extend the District's Article 49 rights forward into the new license period and to remove restrictions limiting power deliveries to District service territory load requirements.

The Boundary Project is located immediately downstream from the Box Canyon Project, and as such the reservoir level between Boundary and Box Canyon has a direct relation to the amount of power either Project can produce. Seattle City Light provides the District a monthly payment in lieu of energy to replace lost generation from the impact of the Boundary Project on the Box Canyon Project. The District is acquiring transmission capacity between the Boundary Project and District transmission facilities. Once delivery capacity is acquired, scheduled to occur by October 2009, the District will receive energy deliveries rather than a cash payment. Payments received from City of Seattle in lieu of energy totaled $1,265,357 and $1,355,910 for the years ended December 31, 2008 and 2007, respectively.

Bonneville Power Administration - The District purchases power from the Bonneville Power Administration (BPA) under contracts which expire September 30, 2011. Through agreement with BPA, the District receives a Shaped Block Purchase under which the District will receive 1.8 average megawatts through September 30, 2011. Block deliveries are fixed at a flat rate within each month, but predetermined at different levels each month so as to more closely follow anticipated seasonal load requirements.

Additionally, the District contracts for a Slice of the System under which the District accepts 0.3819% of the output of the base federal system and agrees to pay an equal share of costs as defined under the contract. Under provisions of the Slice contract, the District is subject to federal system generation risks and variability in quantity and cost of power delivered. Daily and monthly deliveries do not match District customer requirements and do not provide for future load growth. The overall contracted percent of the federal base system was set not to exceed forecasted District customer load requirements for the year 2002, based on critical (historically low) Pacific Northwest snow packs and hydrological river flows.

The District has executed a new 20-year BPA power sales contract for deliveries beginning October 1, 2011. While Slice and Block allocations are not yet finalized under the new contract, the District anticipates its Tier 1 allocations will reflect a considerable reduction in Slice deliveries largely offset by an increase in Block purchases.

The District believes the risks and rewards associated with the Slice and Block product pass through to Ponderay Newsprint Company under the terms of the contracts with that customer.

Energy Northwest - The District is a participant in Energy Northwest's (formerly the Washington Public Power Supply System) Nuclear Projects Nos. 1 and 3, both of which have terminated. The District purchased from Energy Northwest, and assigned to BPA, 0.087% of the capability of Project No. 1 and 0.078% of Energy Northwest's 70% ownership share of Project No. 3. Under the agreements, the District is unconditionally obligated to pay Energy Northwest its pro rata share of the total costs of the projects, including debt service, even though the projects are terminated. Under the Net Billing Agreements, BPA is responsible for assuming the District's cost obligation. The District's Electric System revenue requirements are not directly affected by the associated costs; revenue requirements are affected only indirectly to the extent that the costs of the projects result in increases in BPA's wholesale power rates.

NOTE 6. RETIREMENT BENEFIT PLANS

Pension Plans - All full-time, as well as certain part-time, District employees participate in the statewide cost sharing, multiple employer Public Employees Retirement System (PERS). The Washington State Department of Retirement Systems (DRS) issues a publicly available financial report that includes financial statements and required supplementary information for PERS. This report may be found on the DRS web site, located at www.drs.wa.gov.

PERS provides both retirement and disability benefits, established by state statute, based on compensation and length of service. Plans 1 and 2 are defined benefit programs, Plan 3 is a combination defined benefit/defined contribution program. PERS participants joining the system by September 30, 1977 are Plan 1 members. Participants joining the system subsequently, but on or before August 31, 2002, are Plan 2 members unless they make a decision to transition from Plan 2 to Plan 3. Employees hired after August 31, 2002 will be in Plan 3, unless they make a decision to join Plan 2 within 90 days of hire.

Plan 1 employees vest after five years of eligible service and are eligible for retirement at any age after 30 years of service, or at the age of 60 with 5 years of service, or at the age of 55 with 25 years of service. The annual pension is 2% of the average final compensation (greatest compensation during any 24 consecutive eligible months) per year of service, capped at 60%. If qualified, after reaching the age of 66 a cost-of-living allowance is granted based on years of service credit and is capped at 3% annually.

Plan 2 employees vest after five years of eligible service and may retire at the age of 65 with 5 years of service, or at age 55 with 20 years of service. The retirement benefit is based on 2% of average final compensation, per year of service, based on any eligible consecutive 60-month period. Actuarially calculated early retirement penalties apply to retirements prior to the age of 65. With 30 years of service credit, no penalty is calculated if age of retirement is 62 or older, and the penalty is capped at 3% per year if retirement age is between 55 and 62. There is no cap on years of service credit and a cost-of-living allowance is granted, capped at 3% annually.

Plan 3 is a dual benefit structure. Plan 3 members may retire after ten years of service, or five years of service with at least one year after age 54, or five years of service in Plan 2 prior to June 1, 2003. Participant contributions finance a defined contribution component. Employer contributions finance a defined benefit component operating similar to Plan 2, but with the retirement benefit based on 1% of average final compensation per year of service. Early retirement penalty rules similar to Plan 2 apply on the defined benefit component.

Each biennium, the State Pension Funding Council adopts employer contribution rates for all three plans and employee contribution rates for Plan 2. Plan 1 employee contribution rates are set at 6% by State statute and do not vary. Plan 3 employee contribution rates vary from 5% to 15% and are individually set by each employee. The contribution rates following represent both District and employees' full liabilities under PERS.

	2008	2007	2006
Employee contribution %			
Plan 1	6.00%	6.00%	6.00%
Plan 2	4.15% - 5.45%	3.50% - 4.15%	2.25% - 3.50%
Plan 3	5.00% - 15.00%	5.00% - 15.00%	5.00% - 15.00%
Employer contribution %			
Plan 1	6.13% - 8.31%	5.46% - 6.13%	2.44% - 3.69%
Plan 2	6.13% - 8.31%	5.46% - 6.13%	2.44% - 3.69%
Plan 3	6.13% - 8.31%	5.46% - 6.13%	2.44% - 3.69%
Contribution dollars			
Employee	$320,368	$249,113	$190,361
Employer	$457,965	$336,124	$161,868
Total	$778,333	$585,237	$352,229
PERS covered payroll	$6,301,077	$5,783,979	$5,257,975

Other Post-employment Benefits - The District provides reimbursement for healthcare insurance premiums for retired employees. Beginning August 1, 2005, retiring employees who chose to continue medical coverage under the District's plan became eligible to receive $10 per year of service per month toward postemployment medical premiums. The reimbursement begins at the later of the month of retirement or at age 60 and expires when the retiree reaches age 65. The dollar value of the reimbursement originally decreased $1 each year, expiring August 1, 2015, but the expiration date was extended to August 1, 2018 during contract negotiations in the spring of 2008. Employees retiring between August 1, 2007 and July 31, 2011 are eligible for $8 per year of service per month for reimbursement of medical expenses, with the eligible amount decreasing by $1 each year thereafter. The estimated liability for this benefit as of December 31, 2008 and 2007 is $118,578 and $66,096, respectively. The District has elected to finance this plan under a pay-as-you-go method, for which there were no contributions for the year ended December 31, 2008 and 2007. There is no past service cost to be realized in future years as would be calculated under GASB Statement No. 45; all related past service costs were accrued as of December 31, 2008.

The District allows retirees to contribute to life insurance premiums established during employment. Employees retiring after November 1, 2003 pay the full life insurance premium cost. The District currently has five former employees that retired before

Note 6 – Retirement Benefit Plans (continued)

November 2003 and continue to pay the premium in effect at that date. These retirees will continue to pay a reduced rate until December 31, 2010, at which time they will begin to pay the full rate. The District currently pays the remainder of the premium for these former employees and records a liability and expense for the estimated future payments of the District's portion of the premium. The balance of this liability was $7,730 and $12,461 as of December 31, 2008 and 2007.

Savings Plans - In addition to PERS, the District maintains a deferred compensation plan, as well as two defined contribution plans, in accordance with the Internal Revenue Code Sections 457 and 401(a), respectively. All District employees are eligible to participate in the 457 plan and one of the two available 401(a) plans. The 401(a) plans provide for an employer match of 50% of eligible employee deferral of employee straight-time wages, capped at a 2% employer match on a 4% employee deferral. Employer contributions for 2008 and 2007 were $112,034 and $105,294, respectively. All plan assets have been placed into trusts for the exclusive benefit of plan participants and their beneficiaries and are, therefore, not reflected in these balance sheets.

The District maintains a Health Reimbursement Arrangement for employees. Non-bargaining unit employees receive 3.5% of employee base wages paid into individual employer sponsored medical savings accounts to pay for eligible medical expenses, tax-free, whether incurred while employed or after retirement. Bargaining unit employees are eligible for up to 1.0% of employee base wage contributions, and an additional 1.0% if they participate in District sponsored wellness programs.

NOTE 7. SELF-INSURANCE

Public Utility Risk Management Services - The District, along with seventeen other public utility districts and one joint operating agency, is a member of the Public Utility Risk Management Services self-insurance fund. The program provides members with various liability, property, and health insurance coverages in three separate pools.

The District is a participant in the liability pool, which maintains a base self-insured retention level of $3 million, funded reserves ranging from $1.5 million to $2 million, and individual member deductibles of $250. The liability pool provides the District with shared excess coverage of $60 million general liability, $10 million professional liability, and $10 million per occurrence Directors & Officers liability.

The District is also a participant in the property pool, which maintains a self-insured retention level of $250,000, funded reserves ranging from $500,000 to $750,000, and varying deductibles of $250 on most property and $75,000 on the Box Canyon, Sullivan, and Calispel Hydroelectric Projects. The property pool provides the District with $175 million shared excess coverage, attaching at the self-insured retention level for all property risks excepting flood and earthquake, which attach at 2% of total insured value. Any gap between the self-insured level and excess insurance is funded half by the property pool and half by the affected member.

As a member, the District is subject to assessments based on claims submitted by all members. The following assessments were charged during the years ended December 31:

	Liability		Property	
	2008	2007	2008	2007
Electric System	$ 69,805	$ 67,645	$ 23,299	$ 19,787
Box Canyon Production System	20,736	18,763	116,978	110,914
Water System	3,654	3,628	2,383	2,420
Total	$ 94,195	$ 90,036	$ 142,660	$ 133,121

Central Washington Public Utilities - The District, with six other public utility districts, is a member of the Central Washington Public Utilities Unified Insurance Program and Trust, which is a self-insurance program providing medical, dental, life insurance, disability insurance, and similar benefits to member employees and families. Formed by a Declaration of Trust and an Interlocal Agreement under Revised Code of Washington chapter 39.34, the Trust is administered by a Board of Trustees comprised of an appointed Trustee from each of the seven member districts. Further information may be obtained by contacting the District's financial department as set forth on the last page of this Annual Report under Organizational Information—Corporate Office.

NOTE 8. COMMITMENTS AND CONTINGENCIES

Box Canyon Project License - After expiration of the original 50-year license in 2002, the Federal Energy Regulatory Commission issued a 50-year license for the District's Box Canyon Hydroelectric Project on July 11, 2005. The District is now in the process of implementing the conditions of the license which include environmental studies and projects initiated by state and federal agencies and the Kalispel Tribe of Indians. All projects and studies are related to Box Canyon Dam and the reservoir behind it and include the protection, mitigation, and enhancement of fish, wildlife, recreation, erosion, and cultural preservation. Capital projects include replacement of Box Canyon Dam turbines, alteration of spillway gates for total dissolved gas abatement, fish entrapment vessels, and fish passage facilities. Costs for these projects will be capitalized at the time of completion. District directed projects that are non-capital in nature, and are expensed as incurred, include improvement of wildlife and fish habitat, water quality monitoring, erosion mitigation, and environmental studies. The license also includes several payments to agencies that are used at the discretion of the receiving party. These payments are intended for recreation, but the District has no control over the final disposition of the funds. These costs have been estimated over the life of the license and have been recorded as a deferred asset and liability as described in Note 1.

The District has begun work on replacing the Box Canyon turbines. The first turbine will be installed in the fall of 2009, with a turbine replaced each of the next three years thereafter. The project includes installing new four blade Kaplan style turbines, generator rewinds, and upgrades to all auxiliary equipment. Although the contract has been awarded, change orders and fluctuations in price of metals could drive the cost of the project over its current $100 million cost estimate. As of December 31, 2008, the District has expended slightly over $8.1 million on the turbine upgrade project.

Additionally, the District is engaged in a Box Canyon Plant modernization effort driven by the turbine upgrades and associated incremental generation. There are many varied aspects to this effort, including rebuilding cranes, improving cooling systems, replacing transformers and similar work. These projects are estimated to cost approximately $25 million with over $8.6 million expended as of December 31, 2008.

The license includes language authorizing the District to use lands in the Kalispel Indian Reservation. Under a contract signed in 2007, payment to the Kalispel Tribe for use of their lands is based on costs to produce power at Box Canyon Dam. The Kalispel Tribe receives their payment in electrical energy, the amount of which is based upon a formula using Box Canyon Dam production costs. The Kalispel Tribe chooses on an annual basis to either use the energy or require the District to sell the energy to a third party on the Kalispel Tribe's behalf. Payments are subject to a $200,000 floor through 2010, which will accelerate $15,000 in 2011 and every five years thereafter. In 2008, the Kalispel Tribe opted to have the District sell the energy to a third party. Total power sold on their behalf in 2008 was $524,422. An amendment to the previous FERC license established payments for use of this land during 2007 in the amount of $159,048.

Sullivan Creek Project - The Electric System's Sullivan Creek Project is currently licensed for water storage only. In 1992, the District began a process of pursuing a FERC license amendment to rebuild the plant into a 12-megawatt hydroelectric generation facility. In 2002, the District withdrew its license amendment application from FERC. The project is not currently thought to be economically feasible within the in-stream flow operating criteria imposed by the Washington State Department of Ecology (Ecology) and the United States Forest Service (USFS).

The project's 50-year FERC license expired September 2008. The District is currently participating in a license surrender process with several agencies, including USFS, Ecology, Washington State Department of Fish and Wildlife, United States Fish and Wildlife, several organizations and local citizens. Terms and conditions of the license surrender process, currently being negotiated with all concerned parties, must be settled before FERC will release the license for the project. Part of the Sullivan Creek project is located on Forest Service land, and as such the District must obtain a special use permit to keep the project in tact for use as a water storage facility. There is substantial uncertainty regarding the potential liability in the surrender process and obtaining a special use permit; negotiations with the agencies are in initial stages, and no clear direction has emerged. Removal of the plant may or may not occur, but other environmental issues such as fish passage and sediment removal may add substantial cost to the project. Several external funding sources have surfaced in discussions, but the possibility of securing additional funding is uncertain. The District previously recorded an estimated liability of $750,000 based on a probability weighted outcome analysis. There currently is no strong evidence to increase or decrease this liability, and therefore the recorded liability for this issue remains at $750,000 as of December 31, 2008. Asset values of $1,293,818 were fully depreciated as of December 31, 2008.

Note 8 – Commitments and Contingencies (continued)

Rental Agreement - In 1997, the District entered into a rental agreement with the Pend Oreille County Port District for use of their railroad right-of-way related to a 115 kV transmission line project. Under this agreement, the District agreed to pay a consumer price index adjusted $125,000 per year, for a twenty-year period commencing January 1, 1997, subject to termination by the District with a year's notice. The District paid $169,362 and $164,749 under the terms of this agreement for rental for 2008 and 2007, respectively**.**

Power Purchase Contracts - As discussed in Note 5 previous relating to power purchase commitments.

NoaNet - The District is committed to repay its ownership share of NoaNet Revenue Bonds and participate in future assessments as described in Note 10.

Other Contingencies - The District is subject to various claims, possible legal actions, and other matters arising out of the normal course of business. When it is possible to make a reasonable estimate of the District's liability with respect to probable claims, an appropriate provision is made. Although the ultimate outcome of litigation against the District cannot be determined, management intends to continually defend all claims against the District and believes the District is adequately reserved for all known events.

NOTE 9. GRANTS

Federal Emergency Management Agency (FEMA) - In December 2006 a severe storm caused damage to the District distribution lines. The storm was declared a natural disaster by the federal government and the District applied for reimbursement from FEMA for labor and supplies expenses. Total grant revenue received from FEMA for the storm totaled $92,266, of which an estimated $50,000 was recorded in 2006, and an additional $42,266 in grant revenue was recorded in 2007.

Washington State Department of Community, Trade and Economic Development - In June, 2007, the Department of Community, Trade and Economic Development (CTED) awarded the town of Metaline Falls up to $585,000 in Community Development Block Grant (CDBG) funds to upgrade the town's water system including infrastructure for the community of Pend Oreille Village. As owner and operator of the town's water system, including Pend Oreille Village, the District was named the project subrecipient. $265,896 in funds had been expended as of December 31, 2007 on the project. $43,168 in additional funds were expended and reimbursed when the project was completed in 2008.

Economic Development Revolving Fund - During 2008, the Metaline Falls Water System requested two grants totaling $29,724 from the Economic Development Revolving Fund (As discussed in Note 2). The grants were to provide matching funds for Community Devopment Block Grants, a Public Works Trust Fund loan, and a Department of Ecology Metering Grant that the System obtained during 2008. The funds are included as grant revenue, and eliminated in a consolidating entry.

Washington State Department of Ecology, Water Resources Program - In August, 2006, the District was awarded a grant to fund the purchase and installation of water meters for the Sandy Shores, Greenridge, Riverview, Lazy Acres, and Holiday Shores Water Systems. The District was reimbursed the total cost of the project of $9,805 during the year ended December 31, 2007. The District was granted an additional $7,363 to include a metering device for the Metaline Falls Water System in November of 2007, the amount of which is included as grant revenue as of December 31, 2007.

Community Economic Revitalization Board Financial Aid - In February 2005, the District received final approval for a Community Economic Revitalization Board grant and loan package associated with certain Community Network System telecommunication projects as discussed in Note 10 below.

NOTE 10. BROADBAND SERVICES

Community Network System - The District owns a fiber optic backbone extending from Spokane north past Metaline Falls and includes fiber into all District substations. The District built this system primarily for Electric System operation and control, but allows others to use the system and thereby help local residents and businesses as well as develop revenues to offset infrastructure costs.

In 2001, the District authorized use of the name Community Network System (CN System) for the purpose of facilitating access to, and use of, the District's Electric System broadband communication network for the benefit of the people of Pend Oreille County. CN System operations are conducted in accordance with state wholesale laws, which authorize the District to build infrastructure and enable open-access use of that infrastructure to Internet Service Providers and entities authorized to provide retail telecommunications services within the State of Washington, who may then, in turn, provide retail services to customers.

Note 10 – Broadband Services (continued)

As of December 31, 2008 and 2007, the District's communications infrastructure investment totals $6,152,453 and $5,716,530, respectively.

CN System revenues and expenditures are as shown below; this information encompasses most operating costs, including member contributions to NoaNet as discussed below, but does not reflect internal Electric System reallocations for use of poles and rights-of-way or office rent associated with space used by the District's four CN System employees.

	2008	2007
Wholesale operating revenues		
Services to authorized retail providers	$ 235,688	$ 202,872
Services to Internet service providers	88,645	86,370
Services to District	58,800	58,800
Fiber leasing	85,348	86,074
Service & other	2,100	2,100
Contributed capital	7,000	21,410
	477,581	457,626
Operating expenditures		
Operations, excluding depreciation	279,497	242,630
Maintenance	154,880	79,991
NoaNet equity contributions	100,554	120,167
General and administrative	32,453	28,936
Capital spending	433,045	142,231
	1,000,429	613,955
Net spending	$ 522,848	$ 156,329

Northwest Open Access Network - The District, along with 11 other Washington public utility districts and Energy Northwest, is a member of Northwest Open Access Network (NoaNet), a Washington non-profit mutual corporation. NoaNet utilizes a high-speed fiber optic transmission system, largely located within Washington State, to provide Ethernet and other advanced telecommunications services on a wholesale basis to its members and retail telecommunications companies. NoaNet has first right-of-refusal to lease four strands, designated as public purpose, from fiber optic lines the Bonneville Power Administration installed on transmission lines.

NoaNet members have guaranteed a $27 million revenue bond issuance, which accrues interest at rates varying from 5.05% to 7.09% and matures in annual and sinking fund installments through December 2016. The District's 3.91% guarantee share of the $16,550,000 outstanding as of December 31, 2008 is $647,105 with a maximum exposure of $808,964 in the event other members fail to honor their guarantees.

In 2003, NoaNet established a $5 million variable rate, junior lien, non-revolving line-of-credit which has a balance outstanding of $76,923 as of December 31, 2008. While not guaranteed by members, NoaNet has pledged future member assessments to repay the line, if necessary.

In 2006, NoaNet established a $5 million variable rate, junior lien, non-revolving line-of-credit which has a balance outstanding of $2,629,495 as of December 31, 2008. The District has guaranteed its ownership share of this line-of-credit.

In November 2008, NoaNet established a $1.5 million variable rate, junior lien, non-revolving line-of-credit which has a balance outstanding of $1,500,000 as of December 31, 2008. The District has guaranteed its ownership share of this line-of-credit.

Note 10 – Broadband Services (continued)

As of December 31, 2008, the District's ownership interest in NoaNet is 3.94%. In 2007, NoaNet incurred a net loss from operations of $1,205,201, offset by member payments of $3,073,318, resulting in an accumulated members' equity deficit as of December 31, 2007 of $11,947,865.

Under generally accepted accounting principles, the District's Electric System reports no investment or liability account balance reflecting NoaNet membership. The District's share of assessments and related contributions to NoaNet of $100,554 and $120,167 in 2008 and 2007, respectively, have been expensed as incurred.

A NoaNet annual report may be obtained by writing to Northwest Open Access Network, 3511 Norfolk Court, Olympia, WA 98501. A web site is available at www.noanet.net.

INDEPENDENT AUDITOR'S REPORT

To the Commissioners
Public Utility District No. 1
of Pend Oreille County, Washington
Newport, Washington

We have audited the accompanying combined balance sheet of Public Utility District No. 1 of Pend Oreille County, Washington (the "District") as of December 31, 2007 and 2006, and the individual balance sheets of the Electric, Box Canyon Production and Water Systems as of December 31, 2007, the related combined statements of revenues, expenses, and changes in net assets, and cash flows for the years ended December 31, 2007 and 2006, and the individual statements of revenues, expenses, and changes in net assets, and cash flows for the Electric, Box Canyon Production and Water Systems for the year ended December 31, 2007. These statements are the responsibility of the District's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the District as of December 31, 2007 and 2006, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying management's discussion and analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information as listed in the table of contents is presented for the purposes of additional analysis and is not a required part of the basic financial statements. These schedules are the responsibility of the District's management. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on it.

Moss Adams LLP

Seattle, Washington
March 21, 2008

MANAGEMENT'S DISCUSSION AND ANALYSIS
December 31, 2007 and 2006

The financial management of the Public Utility District No. 1 of Pend Oreille County (the District) offers readers of these financial statements this overview and summary analysis of the financial activities of the District for the years ended December 31, 2007 and 2006. This section of the financial report is designed to assist the reader in focusing on significant financial activities and issues, as well as important changes in the District's financial position and results of operations, which may affect the District's ability to address subsequent years' challenges. This discussion and analysis is designed to be used in conjunction with the financial statements and notes, which follow this section.

Overview of the Financial Statements

The financial section of the Annual Report includes the Report of Independent Auditors, Management's Discussion and Analysis, Basic Financial Statements with accompanying notes, and Supplemental Information (unaudited).

The financial statements of the District report the self-supporting, proprietary activities of the District funded primarily by the sale of power and water services. The District reports the business-type activities in a manner similar to private-sector business enterprises, using the accrual basis of accounting, in accordance with accounting principles generally accepted in the United States of America.

The *Combined Balance Sheets* present information on the District's assets and liabilities and provide information regarding the nature and amount of resource investment (assets), and obligations incurred in the pursuit of such resources. This statement also provides a vehicle for evaluating the capital structure of the District and assessing liquidity and financial flexibility of the District.

The *Combined Statements of Revenues, Expenses, and Changes in Net Assets* reports revenues and expenses as well as change in net assets (owners' equity) for this period. This statement provides a measurement of the District's operations, helps to evaluate the level of cost recovery from charges for products and services, and can be used as a partial determinant of creditworthiness.

The *Combined Statements of Cash Flows* provide information concerning cash receipts and disbursements during the reporting period resulting from operational, financing, and investing activities. This information provides insight into the District's ability to generate net cash flows and meet obligations, as they become due, and is an important indicator of the District's liquidity and financial strength.

The *Notes to Combined Financial Statements* provide additional information that is essential to a full understanding of the financial statements, as described above, including significant accounting policies, commitments, obligations, risks, contingencies, and other financial matters of the District.

Financial Highlights

The year ending December 31, 2007 marked another solid financial year for the District. With Electric System reserves at the end of 2007 at $11,137,045 and debt service coverage of 2.70, we outreached our goals of $8,000,000 and 1.75 in these areas, respectively. We did so while completing some larger capital projects during the year, including significant upgrades to both Box Canyon Dam and the Electric System. Our reserves will put us in a better position for the future as we continue to complete major projects, including construction of a 115kv transmission line and the purchase of substation transformers scheduled for 2008.

The District serves the approximately 1,400 square miles of land that is Pend Oreille County. Customer growth continued at approximately 2% in 2007, which has been the average customer growth for the last 5 years. Energy consumption for 2007 was approximately 4% higher than 2006, slightly more than the 3% average growth for the last 5 years.

The District is continuing its focus on implementing conditions of the FERC license received for Box Canyon Dam in 2005. Most of the plans have been completed, and now the District is beginning to perform the work laid out in each plan to protect and enhance the environment surrounding the Box Canyon Dam reservoir. A major part of this is the upgrade of the Hydroelectric project itself, which entails replacing all four turbines, as well as upgrading most of the components needed to support increased generation within the Dam. Our hope in this project is to enable provision of clean, reliable power to the customers of Pend Oreille County for another 50 years.

The following discussion provides analysis of the comparative financial information provided in the following table:

Combined Balance Sheet Information for December 31, 2007, 2006, and 2005

	2007	2006	2005
Assets			
Current Assets	$ 18,103,091	$ 16,073,474	$ 12,290,425
Special Funds	10,924,484	10,119,451	9,868,731
Other Assets	6,214,488	6,029,308	3,149,349
Net Utility Plant	94,828,745	87,423,588	87,218,747
Total Assets	130,070,808	119,645,821	112,527,252
Liabilities			
Current Liabilities	9,565,833	8,340,223	6,866,757
Other Liabilities	9,770,256	9,344,927	5,483,071
Long-Term Debt	24,623,882	24,137,491	25,877,946
Total Liabilities	43,959,971	41,822,641	38,227,774
Net Assets			
Invested in Capital Assets	68,596,653	61,840,215	59,795,197
Restricted	3,791,504	3,628,502	2,284,526
Unrestricted	13,722,680	12,354,463	12,219,755
Total Net Assets	86,110,837	77,823,180	74,299,478
Total Liabilities and Net Assets	$ 130,070,808	$ 119,645,821	$ 112,527,252

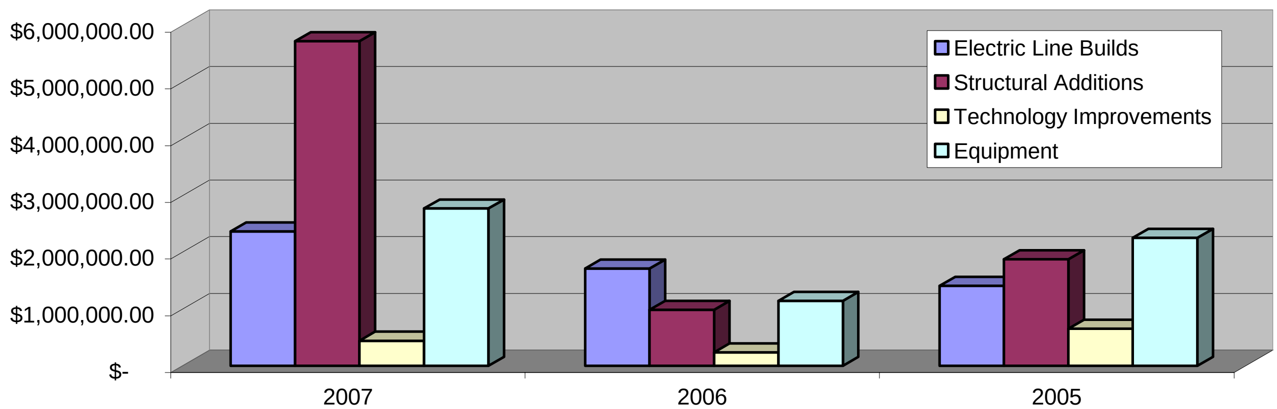
Working capital increased $804,007 during the year ended December 31, 2007, from $5,423,668 in 2005 and $7,733,251 in 2006 to $8,537,258 in 2007. Contributing to the gain in working capital were slightly higher interest rates on investments during 2007 as well as increased electric and water rates during the second half of the year.

Monies held in special funds includes capital projects and license condition implementation funds for Box Canyon Production System, and Bond Reserve and Board Designated Reserve funds for the Electric System. The Board Designated Reserve fund is internally restricted to any authorized purpose of the District and was used during 2007 to construct a $1.4 million addition to the District’s administrative building. The fund was replenished during 2007 through the deposit of $1,155,965 of surplus sales of Box Canyon generation and revenues from an industrial customer.

For the Electric System, the District measures available reserves as working capital plus the Board Designated Fund. Total reserves for the District have grown $7,175,305 over the last 5 years, as the District continues to strive for good financial health and plan for upcoming construction projects.

Other Assets include deferred license costs for Box Canyon Dam’s FERC license conditions. Included in the license are a number of payments to cities and agencies operating in Pend Oreille County. These payments are intended to be used by these entities to further enhance the environment around the Box Canyon Dam reservoir. Deferred license costs of $5,790,851 in 2007 and $5,516,668 in 2006 represent the present value of these payments that will be made over the next 50 years. $11,579,517 in costs to obtain the new license were reclassified to utility plant in 2005 and are being amortized over its 50-year life.

Gross utility plant increased $11,401,088 during 2007, a considerable increase over the capital additions in 2006 of $4,126,717. In 2005, gross utility plant increased $8,454,596, net of the reclassification of license costs noted above. During 2007, notable additions to utility plant include a $1.4 million administration building addition, $2.1 million in customer electric line extensions and distribution line upgrades, and over $5.1 million in upgrades for Box Canyon Dam, including rehab work for the powerhouse crane and engineering work for both new turbines and generator step-up transformers. A chart comparing utility plant additions is shown below.



Other liabilities consists of deferred revenue charges for a 30-year right-of-use for fiber optic communications, an approximation of potential environmental liability for a water storage structure, and deferred FERC license costs for payments to be made to outside agencies per mandatory license conditions. The 4.5% increase in other liabilities over the 2006 balance is expected, as these balances fluctuate slightly with annual amortization and slight changes in estimation factors.

Long-Term Debt at December 31, 2007 is 19% of total assets, down from 20% and 23% as of December 31, 2006 and 2005, respectively. The District repaid over $1.8 million of revenue bond principal during 2007. Revenue bonds consist of two issuances, the 1998 bonds with a balance at December 31, 2007 of $6.95 million and the 2005 bonds with a balance at December 31, 2007 of $17.1 million. The 2005 bonds are a refinancing of bonds issued in 1996 (Note 4). The District's bonds are currently rated through Moody's Investors Service and Fitch Ratings, which gave the District an A3 and A- (stable) rating, respectively. Moody's Investors Service has rated the Electric System bonds as A3 since 1996. Fitch Ratings began rating the District when the 1996 bonds were refinanced in 2005 and have remained unchanged since that time.

Payments of long-term debt were offset by a line of credit opened during 2007 to fund turbine upgrade projects, the balance of which at December 31, 2007 was $2,339,349. The intent of this line of credit is to finance Box Canyon upgrade costs until such time that the District will issue revenue bonds, which is anticipated in the next few years.

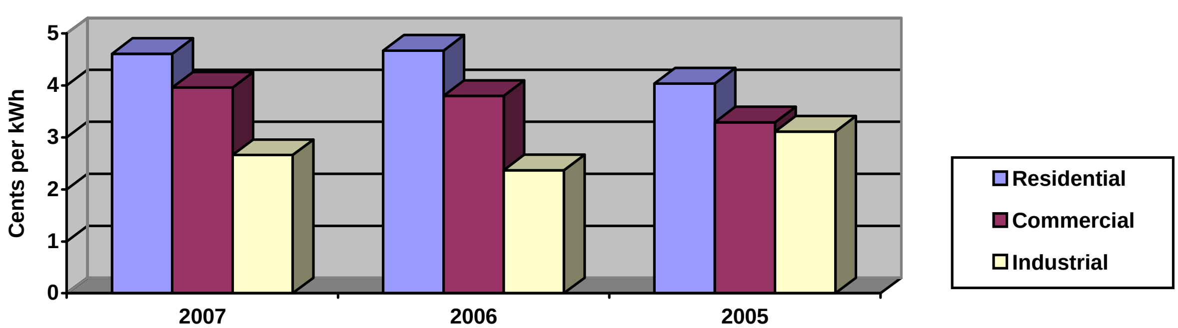
Year end Net Assets (owner's equity) is 66% of total asset valuation of $130,070,808, consistent with 65% and 66% as of December 31, 2006 and 2005, respectively.

Electric System Operating Results

	2007	2006	2005
Electric Operating Revenues			
Ponderay Newsprint Company	$ 18,011,794	$ 16,478,241	$ 23,240,204
Other Retail Customers	10,287,494	9,903,194	8,457,219
Sales to Other Utilities	12,117,878	10,144,370	7,275,949
All Other	1,821,368	2,104,438	1,762,699
Total Operating Revenues	42,238,534	38,630,243	40,736,071
Electric Operating Expenses			
Power Costs	27,003,316	24,715,879	26,550,921
All Other	10,990,120	10,330,854	10,755,513
Total Operating Expenses	37,993,436	35,046,733	37,306,434
Net Operating Revenues	4,245,098	3,583,510	3,429,637
Non Operating Expenses	448,689	939,958	1,104,361
Change in Net Assets	$ 3,796,409	$ 2,643,552	$ 2,325,276

The District's largest customer is Ponderay Newsprint Company, which consumed 73% of the District's energy sales in 2007. Under terms of the District's contracts with Ponderay Newsprint Company, the customer is billed based on actual costs of service rather than under a rate schedule. All costs and benefits derived from Bonneville Power Administration power products are passed on to this customer, as all Bonneville power is purchased exclusively for Ponderay Newsprint Company. Accordingly, variations in Operating Revenue from Ponderay Newsprint Company can reflect changes in Bonneville Power Administration purchased power costs as well as market resale of this same purchased energy. Operating Revenue from Ponderay Newsprint Company is also dependent on water flows and the cost to produce Box Canyon power, which includes FERC license upgrades.

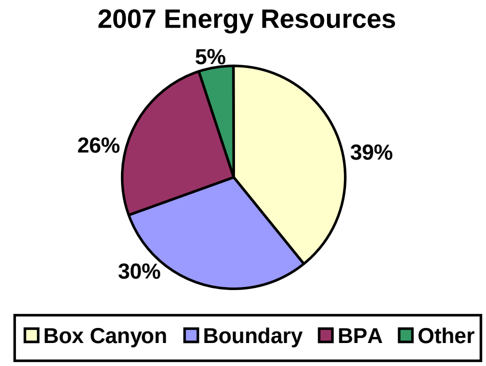
Other Retail Customers Operating Revenues increased $384,300 in 2007, which reflects a 3% rate increase effective August 1, 2007. The $1,445,975 increase for the year ended December 31, 2006 reflects a 15% electric rate increase that went into effect January 1, 2006. The $808,803 increase in 2005 is primarily a result of an industrial customer that ramped up to full production. The number of District residential energy customers grew 1.8% and 2.0% as of December 31, 2007 and 2006, respectively. The 2007 average usage per residential customer meter, at 18.17 megawatts per meter per year, is slightly up from the 2006 and 2005 usage level of 17.76 megawatts per meter each year. District residential energy customers paid an average of 4.61 cents per kWh consumed in 2007, down slightly from 4.67 cents in 2006. Average residential payment per kWh consumed in 2005 was 4.04 cents. A chart comparing District historic residential, commercial, and industrial rates is shown below. Ponderay Newsprint is included in the industrial rate, and as mentioned previously, this customer's costs can vary from year to year.

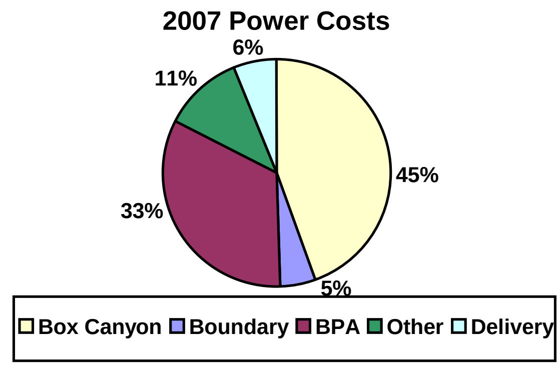


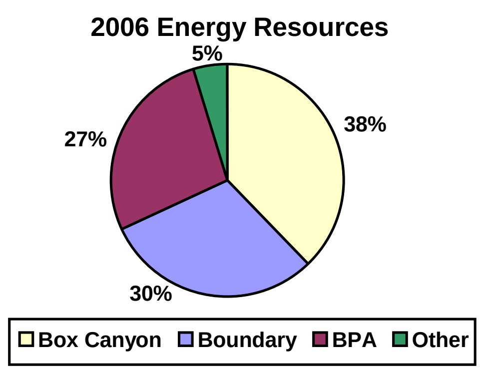
Sales to Other Utilities is primarily associated with the Bonneville Power Administration Block and Slice of the System products (Note 5). The Slice of the System product varies with Columbia River water flows and its resale value moves with power market prices; accordingly, sales to other utilities and power purchases will also vary from year to year. As previously stated, all benefits and risks associated with surplus sales of Bonneville Power Administration power accrue to Ponderay Newsprint Company.

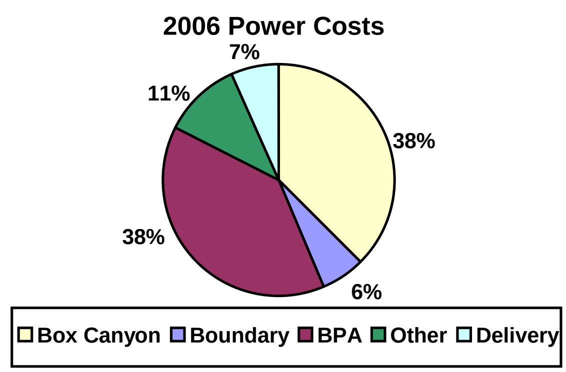
All Other Operating Revenues reflect customer contributed capital for electric and water line extensions (Note 1), wholesale broadband revenues (Note 10), and miscellaneous revenues, such as timber sales from logging activities on District owned properties.

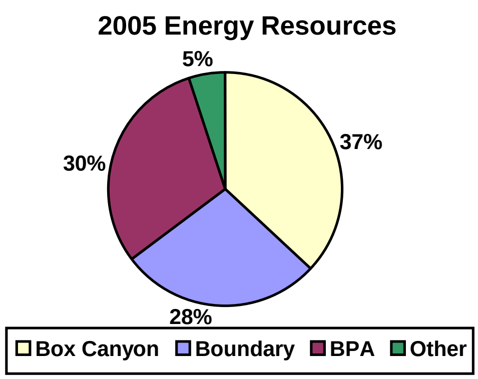
Energy Resources and Related Power Costs

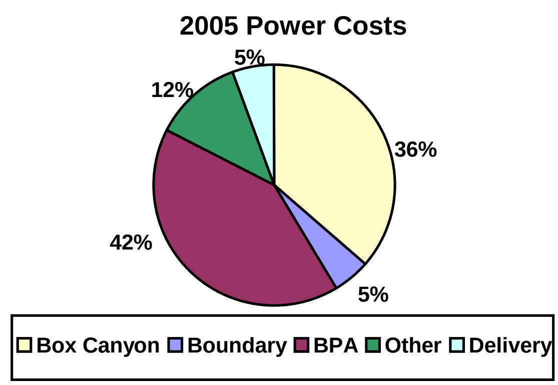












Under the Boundary Hydroelectric project FERC license, the District is eligible to receive Boundary's first 48 megawatts of produced power. At approximately $3.81 per megawatt hour, power received from Boundary Hydroelectric Project is the District's most inexpensive source of power and is a key component of the District's current low power rates. The District's most expensive source of power, from Bonneville Power Administration, had an average cost of $29 per megawatt hour in 2007, as compared to $28 in 2006 and $32 in 2005. This resource is purchased exclusively for Ponderay Newsprint Company and resold to them at cost. Power from Box Canyon Hydroelectric Project was an average of $25 per megawatt hour in 2007, compared to $20 in 2006 and $23 in 2005. FERC license implementation costs will continue to increase, as the District begins to debt finance various capital projects mandated by the license. Other Energy Resources and related Power Costs include costs to operate the Calispell Powerhouse, which produces less than 1 megawatt per hour, and payments to Avista Utilities, which manages the District's control services.

Interest income and interest expense are included in Non-Operating Expenses, as well as some small miscellaneous items. Interest rates on the District's primary cash investment averaged 5.09% during 2007, up from 4.90% and 3.17% for 2006 and 2005, respectively. Interest expense decreased $180,209 due to regular payments made on the District's long-term debt.

Box Canyon Production System Operating Results

	2007	2006	2005
Production Operating Revenues			
Sales to the Electric System	$ 11,983,511	$ 9,195,553	$ 9,780,575
All Other	99,889	1,877	592,878
Total Operating Revenues	12,083,400	9,197,430	10,373,453
Production Operating Expenses	8,030,650	8,423,725	8,249,318
Net Operating Revenues	4,052,750	773,705	2,124,135
Non Operating Revenues	248,407	156,657	111,394
Change in Net Assets	$ 4,301,157	$ 930,362	$ 2,235,529

The Box Canyon Production System encompasses those costs related to the production of hydroelectric power at Box Canyon Dam. During 2007 and 2006, the Production System sold all power it produced to the District's Electric System. In 2005, the District ended a 50-year contract with Seattle City Light in which Seattle City Light was a purchaser of Box Canyon power, which sales are included as All Other revenue in 2005. Sales to the Electric System are priced at the cost to produce the power, including the cost to build capital assets. These costs increased $2,787,958 in 2007, primarily due to capital projects. The Production System had approximately $5.8 million in capital addition costs during 2007, of which $2.3 million was debt financed (See Note 4).

Operating Expenses for the Production System remained fairly consistent, down $393,075 over 2006 and $218,668 over 2005. Operating expenses will fluctuate depending on current projects occurring at the Dam. During 2007, the District capitalized more labor to projects, as noted above, rather than expensing labor to operations.

Water System Operating Results

	2007	2006	2005
Water Operating Revenues			
Sales to Retail Customers	$ 372,833	$ 350,185	$ 326,564
All Other	9,420	6,851	4,164
Total Operating Revenues	382,253	357,036	330,728
Water Operating Expenses	456,169	455,193	438,268
Net Operating Expenses	(73,916)	(98,157)	(107,540)
Non Operating Revenue	264,007	47,945	184,104
Change in Net Assets	$ 190,091	$ (50,212)	$ 76,564

The District operates nine separate water systems throughout Pend Oreille County. The number of customers in each water system range from 31 in the smallest to 199 in the largest, serving approximately 610 customers in total. Base rates range from $20 to $65 per month for the first 10,000 gallons of water used. Revenues increased $22,648 for the year ended December 31, 2007 and $23,621 for the year ended December 31, 2006, primarily due to increases in the base rate. Grant revenue of $283,077, $66,334, and $190,416 are included in Non Operating Revenue for the years ended December 31, 2007, 2006, and 2005 respectively, the funds of which were used to improve the infrastructure of several systems.

Currently Known Facts, Decisions, and Conditions

A description of currently known facts, decisions, and conditions that are expected to have a significant affect on future financial position or results of operations follows.

Ponderay Newsprint Company - The District's single largest customer, Ponderay Newsprint Company, represents 64% of retail energy revenues. District contracts with PNC expire in 2027 and provide for an irrevocable $10 million letter of credit in the event of default. The rate impact from a loss of Ponderay Newsprint Company power sales cannot be accurately forecasted and depends upon the interaction of many factors, including but not limited to, then existing cost of production of Box Canyon Project power, cost of acquisition of Bonneville power, and market or resale value of this power. In a low priced wholesale power market, District rates could be greatly impacted by the loss of this customer. See Note 5 to the financial statements for further information regarding this issue.

Box Canyon Hydroelectric Project FERC License - The Box Canyon Hydroelectric Project license is discussed in Note 8 to the financial statements. The District is currently challenging certain aspects of the license, the outcome of which is unknown. New license conditions may push generation costs high enough to cause the loss of Ponderay Newsprint Company as a customer, possibly affecting the District's current low rate structure.

Sullivan Creek Hydroelectric Project - As discussed in Note 8 to the financial statements, the Sullivan Creek Project's 50-year FERC license expires in September 2008. In 2003, the District notified FERC of intent to not relicense. There is substantial uncertainty regarding potential environmental liability of the current structure. The District recorded a probability weighted environmental liability and is fully depreciating asset values over the remaining life of the license

Contacting the District's Financial Management

The financial report is designed to provide interested parties with a general overview of the District's finances and to demonstrate District accountability for the money it receives. If you have questions about this report, or require additional or clarifying financial information, contact the District's financial department as set forth on the last page of this Annual Report under Organizational Information—Corporate Office.

John D. Jordan, CPA
Director of Finance

Public Utility District No. 1 of Pend Oreille County, Washington

COMBINED BALANCE SHEETS - ASSETS

As of December 31, 2007	Electric System	Box Canyon Production System	Water System	Combined Total As of December 31, (Note 1) 2007	2006
Current Assets					
Cash and cash equivalents (Note 2)	$ 12,937,101	$ 675,249	$ -	$ 13,612,350	$ 12,130,666
Receivables-					
Accounts and contracts, net	1,279,804	-	7,621	1,287,425	832,148
Other	164,137	13,037	186,794	363,968	454,985
Unbilled revenue (Note 1)	726,537	-	-	726,537	801,109
Materials and supplies	1,881,667	-	43,016	1,924,683	1,687,541
Prepaid expenses and other	160,710	27,418	-	188,128	167,025
Due from other systems	377,194	-	-	-	-
Total Current Assets	17,527,150	715,704	237,431	18,103,091	16,073,474
Special Funds (Note 2)					
Bond reserve	2,117,556	-	-	2,117,556	2,026,049
Board designated reserve	2,207,886	-	-	2,207,886	1,901,880
Renewal and license:					
Internal restricted funds	-	4,128,285	-	4,128,285	3,845,992
Escrow funds	-	2,308,309	-	2,308,309	2,187,910
Economic Development Fund	162,448	-	-	162,448	157,620
Total Special Funds	4,487,890	6,436,594	-	10,924,484	10,119,451
Other Non-Current Assets					
Contracts and notes receivable	12,707	-	-	12,707	27,812
Deferred licensing costs (Note 1)	-	5,790,851	-	5,790,851	5,516,668
Unamortized issue costs	379,785	21,970	9,175	410,930	484,828
Total Other Non-Current Assets	392,492	5,812,821	9,175	6,214,488	6,029,308
Utility Plant (Note 3)					
Land and land rights	1,917,806	784,295	78,981	2,781,082	2,717,016
Hydroelectric plant and equipment	2,468,430	40,879,647	-	43,348,077	42,383,451
Structures, buildings and equipment	86,412,639	-	5,286,010	91,698,649	86,304,884
Other utility plant	327,192	-	742	327,934	327,934
Construction work in progress	1,028,878	5,582,636	332,973	6,944,487	1,965,856
	92,154,945	47,246,578	5,698,706	145,100,229	133,699,141
Less Accumulated depreciation and amortization	35,236,522	13,379,749	1,655,213	50,271,484	46,275,553
Net Utility Plant	56,918,423	33,866,829	4,043,493	94,828,745	87,423,588
Total Assets	$79,325,955	$46,831,948	$ 4,290,099	$ 130,070,808	$119,645,821

The accompanying notes are an integral part of these combined financial statements.

Public Utility District No. 1 of Pend Oreille County, Washington

COMBINED BALANCE SHEETS -
LIABILITIES AND NET ASSETS

As of December 31, 2007	Electric System	Box Canyon Production System	Water System	Combined Total As of December 31, (Note 1) 2007	2006
Current Liabilities					
Accounts payable and customer deposits	$ 3,283,916	$ 595,584	$ 50,000	$ 3,929,500	$ 2,522,812
Accrued compensation and benefits	1,435,970	14,342	-	1,450,312	1,389,587
Accrued taxes	567,251	102,031	1,792	671,074	637,081
Customer prepayments	838,338	-	920	839,258	1,052,669
Accrued bond interest	439,297	3,745	2,838	445,880	477,870
Current portion of long-term debt (Note 4)	1,980,000	-	39,140	2,019,140	1,930,710
Current portion of deferred revenue	53,219	-	-	53,219	91,708
Current license costs	-	157,450	-	157,450	237,786
Due to other systems	-	-	377,194	-	-
Total Current Liabilities	8,597,991	873,152	471,884	9,565,833	8,340,223
Other Liabilities					
Deferred revenue	1,078,546	-	-	1,078,546	1,128,135
License costs (Note 1)	-	7,941,710	-	7,941,710	7,466,792
Environmental liability (Note 8)	750,000	-	-	750,000	750,000
Total Other Liabilities	1,828,546	7,941,710	-	9,770,256	9,344,927
Long-Term Debt					
Revenue bonds (Note 4)	21,583,125	-	-	21,583,125	23,426,393
Other long-term debt (Notes 4 and 10)	200,000	2,339,349	501,408	3,040,757	711,098
Total Long-Term Debt	21,783,125	2,339,349	501,408	24,623,882	24,137,491
Total Liabilities	32,209,662	11,154,211	973,292	43,959,971	41,822,641
Commitments and Contingencies (Note 8)					
Net Assets					
Invested in capital assets, net of related debt	33,535,083	31,549,450	3,512,120	68,596,653	61,840,215
Restricted for:					
Economic Development	162,448	-	-	162,448	157,620
Debt service	3,629,056	-	-	3,629,056	3,470,882
Total Restricted	3,791,504	-	-	3,791,504	3,628,502
Unrestricted	9,789,706	4,128,287	(195,313)	13,722,680	12,354,463
Total Net Assets	47,116,293	35,677,737	3,316,807	86,110,837	77,823,180
Total Liabilities and Net Assets	$79,325,955	$46,831,948	$4,290,099	$130,070,808	$119,645,821

The accompanying notes are an integral part of these combined financial statements.

COMBINED STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

For the Year Ended December 31, 2007	Electric System	Box Canyon Production System	Water System	Combined Total For the year ended December 31, (Note 1) 2007	2006
Operating Revenues					
Sales to retail customers-					
Ponderay Newsprint Company	$18,011,794	$ -	$ -	$18,011,794	$16,478,241
Other retail customers	10,287,494	-	372,833	10,660,327	10,253,379
Sales to other utilities	12,117,878	-	-	12,117,878	10,144,370
Inter-System sales	87,492	11,983,511	-	-	-
Contributed capital (Note 1)	854,104	-	921	855,025	512,029
Other	879,772	99,889	8,499	906,024	961,168
Total Operating Revenues	42,238,534	12,083,400	382,253	42,551,048	38,349,187
Operating Expenses					
Power costs	27,003,316	1,337,385	-	16,357,190	15,821,278
Operations and maintenance	3,809,861	4,377,625	268,909	8,365,303	9,077,167
Administrative and general	2,397,010	1,567,959	26,053	3,912,486	3,707,093
Taxes	1,483,442	107,223	19,067	1,609,732	1,539,416
Depreciation and amortization	3,299,807	640,458	142,140	4,082,405	3,945,175
Total Operating Expenses	37,993,436	8,030,650	456,169	34,327,116	34,090,129
Net Operating Revenues (Expenses)	4,245,098	4,052,750	(73,916)	8,223,932	4,259,058
NonOperating Revenues (Expenses)					
Interest income	877,618	248,589	6,052	1,051,722	816,008
Interest on long-term debt	(1,381,365)	(3,745)	(11,986)	(1,397,096)	(1,574,343)
AFUDC interest (Note 3)	70,726	70,800	828	142,354	-
Grant revenues (Note 9)	-	-	283,077	283,077	66,334
Other, net	(15,668)	(67,237)	(13,964)	(16,332)	(43,355)
Total NonOperating Revenues (Expenses)	(448,689)	248,407	264,007	63,725	(735,356)
Change in Net Assets	3,796,409	4,301,157	190,091	8,287,657	3,523,702
Accumulated Net Assets					
Beginning of year	43,319,884	31,376,580	3,126,716	77,823,180	74,299,478
End of year	$ 47,116,293	$ 35,677,737	$ 3,316,807	$86,110,837	$77,823,180

The accompanying notes are an integral part of these combined financial statements.

COMBINED STATEMENTS OF CASH FLOWS - OPERATING AND FINANCING ACTIVITIES

For the Year Ended December 31, 2007	Electric System	Box Canyon Production System	Water System	Combined Total For the year ended December 31, (Note 1) 2007	2006
Cash Flows from Operating Activities					
Receipts from customers	$ 41,534,731	$ -	$ 378,570	$ 41,913,301	$ 39,025,625
Receipts from other operating revenues	189,769	87,979	-	277,748	387,336
Payments to suppliers for goods and services	(18,180,372)	(4,174,876)	(77,745)	(22,432,993)	(23,263,603)
Payments to employees for services	(3,533,513)	(2,680,377)	(175,469)	(6,389,359)	(6,319,998)
Payments to (from) other systems	(12,023,523)	11,811,733	211,790	-	-
Net cash provided by operating activities	7,987,092	5,044,459	337,146	13,368,697	9,829,360
Cash Flows from Noncapital Financing Activities					
Economic Development Fund					
Transfers & other receipts	25,000	-	-	25,000	25,000
Awarded to grant applicants	(33,125)	-	-	(33,125)	(33,900)
Intersystem financing	1,226,001	(1,218,753)	(7,248)	-	-
Net cash provided by (used in) noncapital financing activities	1,217,876	(1,218,753)	(7,248)	(8,125)	(8,900)
Cash Flows from Capital and Related Financing Activities					
Acquisition and construction of capital assets, net of cash contributions	(5,183,104)	(5,754,383)	(407,721)	(11,345,208)	(4,175,016)
Proceeds from grants	-	-	96,283	96,283	66,334
Change of deferred revenue (Note 1)	(88,078)	-	-	(88,078)	(49,588)
Proceeds from issuance of long-term debt	-	2,317,379	29,450	2,346,829	41,701
Scheduled payments and early retirement on revenue bonds (Notes 3 and 4)	(1,895,000)	-	-	(1,895,000)	(687,000)
Interest paid on revenue bonds (Note 4)	(1,184,951)	-	-	(1,184,951)	(921,295)
Scheduled payments on note payable	-	-	(35,710)	(35,710)	(35,710)
Interest paid on notes payable	-	-	(12,200)	(12,200)	(12,666)
Net cash used in capital and related financing activities	(8,351,133)	(3,437,004)	(329,898)	(12,118,035)	(5,773,240)

The accompanying notes are an integral part of these combined financial statements.

COMBINED STATEMENTS OF CASH FLOWS -
INVESTING ACTIVITIES AND RECONCILIATIONS

For the Year Ended December 31, 2007	Electric System	Box Canyon Production System	Water System	Combined Total For the year ended December 31, (Note 1) 2007	2006
Cash Flow from Investing Activities					
Purchases of investments	$ (9,736,882)	$ -	$ -	$ (9,736,882)	$ (21,813,917)
Sales and maturities of investments	9,729,475	-	-	9,729,475	21,823,187
Interest on investments, contracts and notes	802,998	248,589	-	1,051,587	805,099
Net cash provided by investing activities	795,591	248,589	-	1,044,180	814,369
Net Increase in Cash and Cash Equivalents	1,649,426	637,291	-	2,286,717	4,861,589
Cash and Cash Equivalents (Note 2)					
Beginning of year	15,775,565	6,474,552	-	22,250,117	17,388,528
End of year	$17,424,991	$7,111,843	$ -	$ 24,536,834	$22,250,117
Reconciliation of Net Operating Revenues (Expenses) to Cash Flows from Operating Activities					
Net operating revenues (expenses)	$ 4,245,098	$ 4,052,750	$ (73,916)	$ 8,223,932	$4,259,058
Adjustments to reconcile net operating revenues (expenses) to net cash provided by operating activities					
Depreciation	3,299,807	640,458	142,140	4,082,405	3,945,175
Cash provided (used) by changes in operating assets and liabilities					
Receivables	(150,472)	(11,910)	21	(162,361)	867,767
Unbilled revenue (Note 1)	74,572	-	-	74,572	41,047
Due to other systems	(227,639)	-	227,639	-	-
Materials and supplies	(228,114)	-	(9,028)	(237,142)	(103,361)
Prepaid expenses and other current assets	(34,335)	13,232	-	(21,103)	17,726
Deferred charges (Note 1)	-	120,399	-	120,399	501,647
Accounts payable, customer deposits and prepayments	595,626	572,141	49,896	1,217,663	388,497
Accrued compensation, benefits and taxes	412,549	(342,611)	394	70,332	(88,196)
Net cash provided by operating activities	$7,987,092	$ 5,044,459	$ 337,146	$ 13,368,697	$9,829,360

The accompanying notes are an integral part of these combined financial statements.

NOTES TO COMBINED FINANCIAL STATEMENTS
December 31, 2007 and 2006

NOTE 1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Organization - Public Utility District No. 1 of Pend Oreille County, Washington (the District) is a municipal corporation governed by an elected three-person Board of Commissioners. The District's reporting entity is comprised of three primary component units, or operating systems.

The Electric System distributes electricity to residential and other consumers in Pend Oreille County. The Box Canyon Production System produces hydroelectric power from the Box Canyon Hydroelectric Project (Note 8). The Water System consists of nine individual water distribution subdivisions. The District is required by various financing and contractual arrangements to report separately on each system and maintain each system as a separate entity with separate obligations.

The District authorized usage of the name Community Network System (CN System) for the purpose of facilitating access to, and use of, the District's Electric System broadband communication network for the benefit of the people of Pend Oreille County (Note 10) in accordance with state granted wholesale authority. The CN System is an endeavor of the Electric System and is not a separate operating system for reporting purposes.

Basis of Accounting and Presentation - The accounting policies of the District conform to generally accepted accounting principles (GAAP) as applicable to proprietary funds of governments. The Governmental Accounting Standards Board (GASB) is the accepted standard setting body for establishing governmental accounting and financial reporting principles. Accounting records are maintained in accordance with methods prescribed by the State Auditor under the authority of Chapter 43.09 RCW, the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission (FERC) for the Electric System and Box Canyon Production System, and the Uniform System of Accounts for Class C Water Utilities prescribed by the National Association of Regulatory Utility Commissioners for the Water System.

GASB Statement No. 20 requires that the District apply all GASB pronouncements as well as the pronouncements issued on or before November 30, 1989, by the Financial Accounting Standard Board (FASB) and its predecessor organizations, unless those pronouncements conflict with or contradict GASB pronouncements. As provided for in GASB Statement No. 20, the District has elected not to implement FASB Statements and Interpretations issued after November 30, 1989.

System columns presented in the financial statements do not sum to the combined totals due to the elimination of certain inter-system transactions. These transactions relate to inter-system power sales and purchases, loan balances and interest on inter-system loans, and inter-system administrative charges.

A summary of other significant accounting policies utilized in the preparation of the financial statements follows.

New Accounting Standards - In June 2004, the GASB issued GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, to recognize the cost of postemployment benefits in the period the related services are received by the employer, and to provide information for benefit liabilities promised to employees. The District adopted GASB 45 as of December 31, 2005, recognizing the full expected liability and related expense as of that date. See further discussion of other postemployment benefits at Note 6.

In November of 2006, the GASB issued GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. This statement addresses accounting and financial reporting standards for potentially detrimental effects of existing pollution. The District adopted this statement for the year ended December 31, 2007, and recorded a $50,000 current liability related to high lead levels discovered during excavation for a water system upgrade. The liability estimates the cost of disposing the contaminated soil. No other liabilities related to GASB Statement No. 49 are known at this time.

In June of 2007, the GASB issued GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets.* The objective of this Statement is to establish accounting and financial reporting requirements for intangible assets and is expected to enhance the comparability of the accounting and reporting of such assets among state and local governments. GASB Statement No. 51 is required for financial statements for periods beginning after June 15, 2009. The District is currently evaluating the impacts of adopting this statement for the District's financial statements.

Note 1 – Organization and Significant Accounting Policies (Continued)

Revenue Recognition - The Electric System and Water System recognize revenue as earned on a monthly basis based on rates established by the District's Board of Commissioners and, for the Electric System, in accordance with power sales contracts with Ponderay Newsprint Company (see Note 5). Because Electric System customer meters are read and billed at various times during each month, the District estimates unbilled revenues for energy delivered to customers between their last respective cycle billing date and December 31, and records that amount as unbilled revenue for the current year. Estimated unbilled revenue as of December 31, 2007 and 2006 was $726,537 and $801,109, respectively. The Box Canyon Production System recognizes revenue on a cost-of-service basis from sales to the Electric System.

Allowance for Uncollectible Accounts - Management reviews accounts receivable on a regular basis to determine if any receivables will potentially be uncollectible. The allowance for uncollectible accounts includes amounts estimated through an evaluation of specific accounts, based on the best available facts and circumstances, of customers that may be unable to meet their financial obligations, and a reserve based on historical experience. Management believes that the allowance for uncollectible accounts as of year end is adequate.

Management reviews accounts receivable on a regular basis to determine if any receivables will potentially be uncollectible. The allowance for uncollectible accounts includes amounts estimated through an evaluation of specific accounts, based on the best available facts and circumstances, of customers that may be unable to meet their financial obligations, and a reserve based on historical experience. Management believes that the allowance for uncollectible accounts as of year end is adequate.

Cash and Cash Equivalents - The District records repurchase agreements and other short-term investments, with maturity at date of purchase of three months or less, at cost as cash equivalents.

Special Funds and Investments - Short-term investments with a maturity of between three and twelve months, at date of purchase, are recorded at amortized cost with discount or premium amortized on a straight-line basis over the life of the investments. The District records all other investments at fair value based on quoted market rates, with changes in unrealized gains and losses reported as investment income.

Materials and Supplies – Materials and supplies are recorded at average cost.

Utility Plant - See Note 3 regarding capitalization, depreciation, and retirement policies.

Contributed Capital - Contributions in Aid of Construction are District-mandated customer connection charges used to fund construction of system properties necessary to extend service to a new customer. The payments are initially recorded as liabilities, then reclassified to operating revenue (contributed capital) when the associated facilities are constructed or acquired.

Deferred Licensing Costs - The Federal Energy Regulatory Commission issued the District a new 50-year operating license for the Box Canyon Hydroelectric Project in July 2005. The license contains environmental studies and projects that the District must complete. Per the license, a Technical Committee, which consists of members of the involved state and federal agencies and the Kalispel Tribe, oversees the implementation of the license requirements.

The District capitalizes to Utility Plant all costs associated with seeking the new FERC license, including legal fees for continuing litigation of various license conditions and amortizes the balance over the 50-year term of the license. Capitalized relicensing costs as of December 31, 2007 and 2006 were $12,222,367 and $11,932,329 with accumulated amortization of $589,556 and $350,880, respectively.

Certain of the FERC license conditions require payments to various outside entities for projects and operating costs which will not be directed by, or controlled by, the District or the Technical Committee. The District has estimated and present valued these payments over the 50-year license and recorded a deferred asset and license cost liability of $5,790,851 and $5,516,668 as of December 31, 2007 and 2006, respectively. The District can not accurately estimate the future costs of the remaining expenses related to license implementation. Costs for these projects will be capitalized or expensed, as may be appropriate in the future, upon payment for completion of the work. The District also has a license cost liability for escrow funds held per license conditions of $2,308,309 and $2,187,910 as of December 31, 2007 and 2006, respectively. See further discussion of escrow funds at Note 2.

Deferred Financing Costs - Bond issue costs, discounts, and premiums are amortized to interest expense, using the effective interest method, over the term of the bonds. The excess of costs incurred over the carrying value of bonds refunded on early extinguishment of debt is amortized over the term of the new bonds, using the effective interest method.

Deferred Revenue - In August 2000, the District entered into an agreement with Seattle City Light concerning a cost sharing arrangement for building of fiber optic communications capability in Pend Oreille County. Among other terms and conditions, the District retained ownership of all constructed network assets with a commitment to grant Seattle City Light a 30-year right-of-use for 8 to 12 dark fiber strands along the District's network backbone. Seattle City Light made a one-time, lump sum payment of $1,487,650 under the agreement. The District recorded the payment as Electric System deferred revenue and is amortizing the balance to revenue on a straight-line basis over the 30-year life of the agreement.

Restricted Net Assets - Amounts presented as restricted net assets are reserved for specific purposes and cannot be used for normal operations. Balances currently classified as restricted include funds held by the Economic Development Revolving Fund (Note 2) and bond principal and interest due for the upcoming year (less accrued interest) as well as the bond reserve fund.

Compensated Absences - Employees accrue personal leave to be used for vacation, sick, and family leave purposes. Annual leave granted each employee varies in accordance with years of service and may be carried forward from year-to-year, capped at a maximum bank of 1200 hours. The District records the cost of personal leave as earned, not as taken.

Accounting Estimates - The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Significant Risk and Uncertainties - The District is subject to certain business risks that could have a material impact on future operations and financial performance. These risks include weather and natural-disaster-related disruptions; collective bargaining labor disputes; fish and other Endangered Species Act issues; Environmental Protection Agency regulations; federal government regulations or orders concerning the operation, maintenance, and/or licensing of hydroelectric facilities, including licensing of the Box Canyon Project as discussed in Note 8; deregulation of the electrical industry; concentration risk in the form of sales to a major customer, Ponderay Newsprint Company and related potential impact on District power contracts (Note 5); and market risks inherent in buying and selling of power, a commodity with inelastic demand characteristics and minimal storage capability.

Reclassifications - Certain reclassifications were made to the 2006 financial statements presentation to conform to the classifications used in 2007. These reclassifications do not affect the changes in net assets as previously reported.

NOTE 2. SPECIAL FUNDS AND INVESTMENTS

The District's investment portfolio consisted of the following cash and cash equivalents and investments:

As of December 31, 2007	Electric System	Box Canyon Production System	Water System	Combined Total As of December 31, 2007	Combined Total As of December 31, 2006
Revenue Funds					
Cash and cash equivalents	$10,986,304	$ 675,249	$ -	$ 11,661,553	$ 10,211,015
Bond principal and interest	1,950,797	-	-	1,950,797	1,919,651
Total Revenue Funds	12,937,101	675,249	-	13,612,350	12,130,666
Special Funds					
Bond reserve	2,117,556	-	-	2,117,556	2,026,049
Board Designated reserve	2,207,886	-	-	2,207,886	1,901,880
Renewal and license					
Internal restricted funds	-	4,128,285	-	4,128,285	3,845,992
Escrow funds	-	2,308,309	-	2,308,309	2,187,910
Economic Development	162,448	-	-	162,448	157,620
Total Special Funds	4,487,890	6,436,594	-	10,924,484	10,119,451
Total Special and Revenue Funds	$17,424,991	$ 7,111,843	$ -	$ 24,536,834	$ 22,250,117
Cash and Cash Equivalents, at Cost, Which Approximates Market Value					
Cash deposits	$ 2,356,713	$ 2,308,309	$ -	$ 4,665,022	$ 5,021,747
Local government investment pool	15,068,278	4,803,534	-	19,871,812	17,228,370
Total Cash and Cash Equivalents	$17,424,991	$ 7,111,843	$ -	$ 24,536,834	$22,250,117

Interest Rate Risk. The District's investment policy limits investment maturities to less than five years from the date of purchase unless authorized by the General Manager and Director of Finance for a specific purpose. During 2007 and 2006, excepting the 2005 bond reserve account, all investments were in the State Treasurer's Local Government Investment Pool (LGIP), which has a weighted average portfolio maturity of less than 90 days.

Credit Risk. In accordance with the Revised Code of Washington, District bond resolutions, and District internal investment policies, all investments are direct obligations of the U.S. Government, deposits in the LGIP, or deposits with financial institutions recognized as qualified public depositories of the State of Washington. U.S. Government securities are held by banks or trust companies as the District's agent and in the District's name.

The District's cash deposits are covered by federal depository insurance or protected against loss by deposit with financial institutions recognized as qualified public depositories of the State of Washington. The District intends to hold time deposits and securities until maturity.

Note 2 – Special Funds and Investments (Continued)

Concentration of Credit Risk. District policies allow the entire portfolio to be invested in direct United States Government guaranteed obligations or in the LGIP. No other investment may exceed half of portfolio market value. The LGIP, a 2a7-like pool as defined by GASB Statement No. 31 and the Securities and Exchange Commission, invests in high quality, short term investments; all LGIP money market securities must be rated A-1 by Standard & Poors Corporation or P1 by Moody's Investor Services, Inc. The LGIP weighted average maturity must not exceed 90 days and no single investment may exceed 762 days in maturity. Withdrawals in excess of $10 million are available on a one day notice. The LGIP Annual Report is available on the State Treasurer's website at http://tre.wa.gov/LGIP/lgip.htm.

Bond Reserve, Principal, and Interest Funds - For each debt issue, the District is required by bond resolutions to maintain principal and/or sinking fund and interest accounts within the bond funds to provide for the next semi-annual interest and annual principal/sinking fund payments falling due, which are reported as current assets. All bond funds are restricted by bond resolution to the payment of debt service obligations.

District Electric System revenue bond resolutions require reserve accounts be maintained within the bond funds. The 1998 reserve account requires a deposit equal to the maximum amount of principal and interest falling due in any single bond year, and the 2005 reserve account equals 10% of par amount and premium on the 2005 bonds issued. The District met the 1998 bonds reserve requirement through the purchase of a surety bond. The 2005 bond reserve requirement of $1,934,181 is invested in a forward supply contract with a private third party wherein a series of U.S. Treasury bonds, bills, or notes, of a maturity not to exceed the next scheduled bond interest payment date will be delivered to the District's trust account. Per agreement with the independent third party, the District will receive a pre-determined yield on the investments through the end of the agreement, which expires January 1, 2014.

Board Designated Reserve Fund - The Electric System Board Designated Reserve Fund receives monies from uncertain, non-recurring, or limited duration revenue streams such as surplus sales of District generated power resources, timber sales, and a portion of certain customer revenues associated with mining activities. Disbursements from the fund are allowed for any valid business purpose of the District as specifically authorized by motion of the Board of Commissioners.

Renewal and License Fund - The Renewal and License Reserve Fund is an internally restricted fund, not required by any external agencies or contractual agreements, established to provide for Box Canyon Hydroelectric Project capital additions, renewals and replacements, and for capital expenditures required by terms and conditions of the Box Canyon Project FERC license (Note 8) not otherwise provided for by the District.

Escrow Funds - The Box Canyon Project FERC license stipulates that a Trout Restoration Fund and a Recreation Resources Fund are to be financed by the District. In October 2005, the District established interest bearing escrow accounts with a financial institution for the Trout Restoration Fund and the Recreation Resources Fund. The funds will be held in trust by the financial institution and used at the discretion of the District and Technical Committee members (Note 8) for trout preservation and recreational facility improvements and maintenance. As of December 31, 2007 and 2006, the escrow balance in the Trout Restoration Fund totaled $1,646,821 and $1,607,881 while the balance in the Recreation Resources Fund was $661,488 and $580,029, respectively.

Economic Development Revolving Fund - As allowed by Revised Code of Washington (RCW) 82.16.0491, the District contributes $50,000 annually to the Pend Oreille County Economic Development Revolving Fund and receives a $25,000 matching excise tax credit, resulting in a net cost to the District of $25,000 annually. The District's Board of Commissioners appoints the fund's local board and has currently appointed themselves to three of the five positions. Monies deposited may be used for qualifying economic development projects within the county, as allowed by RCW and approved by the local board. In accordance with the provisions of GASB Statement No. 39, the Economic Development Revolving Fund is recorded as a blended component unit within the Electric System. As of December 31, 2007 and 2006, the Electric System holds $162,448 and $157,620 respectively, in trust for future projects as approved by the fund's local board. Further information concerning the Economic Development Revolving Fund may be obtained by contacting the District's financial department as set forth on the last page of this Annual Report under Organizational Information—Corporate Office.

NOTE 3. UTILITY PLANT

Utility plant assets are stated at cost, including an allowance for funds used during construction (AFUDC). During 2007, the District recorded AFUDC of $142,354. No interest was capitalized during 2006. Betterments and major renewals over $1,000 are capitalized, while maintenance and repairs are charged to operations as incurred. During the years ended December 31, 2007 and 2006, the following changes occurred in the District's utility plant:

	2006 Balance	Additions	Retirements/ Transfers	2007 Balance
Land and land rights	$ 2,717,016	$ 64,066	$ -	$ 2,781,082
Hydroelectric plant and equipment	42,383,451	711,752	252,874	43,348,077
Structures, buildings and equipment	86,304,884	1,474,549	3,919,216	91,698,649
Other utility plant	327,934	-	-	327,934
Construction work in progress	1,965,856	9,631,178	(4,652,547)	6,944,487
	133,699,141	11,881,545	(480,457)	145,100,229
Less accumulated depreciation and amortization	46,275,553	4,227,673	(231,742)	50,271,484
Net Utility Plant	$ 87,423,588	$ 7,653,872	$ (248,715)	$ 94,828,745

	2005 Balance	Additions	Retirements/ Transfers	2006 Balance
Land and land rights	$ 2,664,211	$ 52,805	$ -	$ 2,717,016
Hydroelectric plant and equipment	41,619,724	716,991	46,736	42,383,451
Structures, buildings and equipment	84,610,646	1,870,187	(175,949)	86,304,884
Other utility plant	349,088	3,846	(25,000)	327,934
Construction work in progress	328,755	2,794,340	(1,157,239)	1,965,856
	129,572,424	5,438,169	(1,311,452)	133,699,141
Less accumulated depreciation and amortization	42,353,677	4,111,412	(189,536)	46,275,553
Net Utility Plant	$ 87,218,747	$ 1,326,757	$ (1,121,916)	$ 87,423,588

Depreciation - Depreciation is determined by the straight-line method over the estimated useful lives of the related assets, which ranges from 7 to 50 years. Composite rates are used for asset groups and, accordingly, no gain or loss is recorded on the disposition of an asset unless it represents a large and unusual retirement. The combined composite depreciation rates are as follows:

	Electric System	Box Canyon Production System	Water System
2007	3.8%	1.0%	2.7%
2006	3.9%	1.0%	2.8%

NOTE 4. LONG-TERM DEBT

In November 1998, the District issued $10 million tax-exempt Electric System revenue bonds to complete financing of the 115 kV transmission line project and for other capital needs of the District. The issue contains $7,770,000 in series bonds maturing in annual installments from December 1, 2001 through 2015, with interest rates ranging from 4.0% to 4.4%. The remaining $2,230,000 is a 4.55% term bond maturing in sinking fund installments from 2016 through 2018. The bonds are reported in the balance sheet net of unamortized discount of $39,347 and $44,614 as of December 31, 2007 and 2006, respectively.

In November 2005, the District issued $13,240,000 Series A (subject to alternative minimum tax) and $5,430,000 Series B (tax exempt) revenue bonds to refund bonds originally issued in 1996. The present value savings at the time of refinancing was estimated at $1,343,710. The Series A bonds accrue interest at 4.00% to 5.00% maturing in annual installments from January 1, 2006 through January 1, 2015. The Series B bonds consist of $1,580,000 in series bonds, maturing in annual installments from January 1, 2006 through January 1, 2014 and accruing interest at 3.25% to 4.00%; $2,420,000 maturing in annual sinking fund installments from January 1, 2015 through January 1, 2017 accruing interest at 4.35%; and $1,430,000 maturing on January 1, 2018 accruing interest at 5.25%. The District recorded a loss from refinancing of $1,470,496, which is amortized using the effective interest method over the life of the 2005 bonds. The bonds are recorded in the balance sheet net of unamortized premium of $428,609 and $539,990 and unamortized loss from refinancing of $876,137 and $1,118,983 as of December 31, 2007 and 2006, respectively.

In November 2005, the Electric System loaned the Box Canyon Production System $2 million to provide additional liquidity to enable implementation of newly issued FERC license requirements. Interest on the loan accrued at the Electric System's variable opportunity cost of the Washington State Local Government Investment Pool's monthly interest rate which varied in 2007 from 4.5% to 5.2%. The balance of the note was paid in full as of December 31, 2007.

In November 2007, the District sold revenue bond anticipation notes to a financial institution, creating a non-revolving line of credit. The line of credit will not exceed $10 million and will mature on December 1, 2009. Funds will be used to finance Box Canyon Production System capital projects. Interest is paid quarterly and may be accrued at either a discounted Prime Rate or discounted LIBOR rate, with the rate being chosen at the time of each draw. Draws taken during 2007 accrued interest at 3.84%. The principal balance outstanding as of December 31, 2007 is $2,339,349.

In 2000, the Sunvale Subdivision of the Water System received a loan for $189,607 from the State of Washington Department of Community, Trade, and Economic Development to finance the construction of new wells and distribution line. The fixed interest rate is 2.5% for a term of twenty years. Annual principal payments in the amount of $9,979 are due through October 2020.

In 2001, the State of Washington Department of Community, Trade, and Economic Development authorized a $400,070 loan to the Riverbend Subdivision of the Water System, to finance system improvements, with a fixed interest rate of 2.5%. Annual principal payments in the amount of $22,018 are due through October 2020.

In July 2003, the District executed a State of Washington Public Works Board loan agreement for the Granite Shores Subdivision of the Water System enabling a $70,551 loan to be repaid over 20 years at 1% interest. The loan financed certain system improvements, including drilling a new well. Annual principal repayments of $3,713 began in October 2005 and will end in October 2023. Subsequently, in March 2006, the District secured an additional loan with the State of Washington Public Works Board for $35,717 to cover the remaining costs of drilling the new well. The second loan also carries a 1% interest rate. Annual principal payments in the amount of $1,880 are due through October 2026.

In February 2005, the Community Economic Revitalization Board (CERB) awarded the District a $200,000 loan for construction of communication infrastructure projects (Note 10). This loan carries no interest, and principal payments are deferred for the first five years. Annual principal payments of $13,333 will begin in 2011 and will end in 2026.

In December, 2007, the District was awarded a $29,450 loan from the Department of Community, Trade and Economic Development (CTED) for engineering expenses related upgrading the Metaline Falls Water System (Note 9). Principal payments in the amount of $1,550 will begin in July 2008 and will end in July 2026. The loan accrues interest at 0.50%.

Note 4 – Long Term Debt (continued)

	Electric System	Box Canyon Production System	Water System	Combined as of 12/31/07
Principal				
2008	$ 1,980,000	$ -	$ 39,140	$ 2,019,140
2009	2,075,000	2,339,349	39,140	4,453,489
2010	2,165,000	-	39,141	2,204,141
2011	2,288,333	-	39,140	2,327,473
2012	2,393,333	-	39,141	2,432,474
2013-2017	11,036,665	-	195,703	11,232,368
2018-2022	2,271,665	-	131,712	2,403,377
2023-2026	40,004	-	17,431	57,435
	$24,250,000	$ 2,339,349	$ 540,548	$27,129,897
Interest				
2008	$ 1,095,883	$ 89,889	$ 11,420	$ 1,197,192
2009	1,001,860	89,889	10,633	1,102,382
2010	903,349	-	9,771	913,120
2011	799,449	-	8,908	808,357
2012	689,936	-	8,043	697,979
2013-2017	1,748,896	-	27,262	1,776,158
2018-2022	72,801	-	6,470	79,271
2023-2026	-	-	303	303
	$ 6,312,174	$ 179,778	$ 82,810	$ 6,574,762

During the years ended December 31, 2007 and 2006, the following changes occurred in the District's long-term debt:

	2006 Balance	Additions	Reductions	2007 Balance
Revenue bonds, face amount	$ 25,945,000	$ -	$ 1,895,000	$ 24,050,000
Unamortized bond premium	539,990	-	111,381	428,609
Unamortized bond discount	(44,614)	-	(5,267)	(39,347)
Loss on refunding	(1,118,983)	-	(242,846)	(876,137)
Other long term debt	746,808	2,368,799	35,710	3,079,897
Total Debt	$ 26,068,201	$ 2,368,799	$ 1,793,978	$ 26,643,022
Current Portion of Total Debt				2,019,140
Total Long-Term Debt				$ 24,623,882

	2005 Balance	Additions	Reductions	2006 Balance
Revenue bonds, face amount	$ 26,580,000	$ -	$ 635,000	$ 25,945,000
Unamortized bond premium	662,020	-	122,030	539,990
Unamortized bond discount	(49,893)	-	(5,279)	(44,614)
Loss on refunding	(1,439,272)	-	(320,289)	(1,118,983)
Other long term debt	798,801	35,717	87,710	746,808
Total Debt	$ 26,551,656	$ 35,717	$ 519,172	$ 26,068,201
Current Portion of Total Debt				1,930,710
Total Long-Term Debt				$ 24,137,491

NOTE 5. POWER PURCHASE CONTRACTUAL AGREEMENTS

Ponderay Newsprint Company - In July 1986, the Electric System entered into power sales contracts with Ponderay Newsprint Company to supply power to a fiber mill and paper plant. The District is obligated to provide all power necessary to operate both the fiber mill and paper plant. Power delivery under these contracts expires in 2027. In 2007, approximately 73% of Electric System retail energy deliveries and 64% of retail energy sale revenues were to Ponderay Newsprint Company.

To fulfill this power commitment, the District delivers power from the Box Canyon Project and acquires power at cost from the Boundary Project. The District's rights to acquire power at cost from the Boundary Project are provided for in Article 49 of Seattle City Light's Federal Energy Regulatory Commission license for the Boundary Project. Power is also obtained from the Bonneville Power Administration (BPA) and other suppliers under various power purchase contracts. The cost of all power purchases necessary to fulfill the requirements of the fiber mill and paper plant is charged to Ponderay Newsprint Company based upon the District's actual costs.

The Ponderay Newsprint Company has provided an irrevocable letter of credit for $10 million, which the District may draw upon in the event Ponderay Newsprint Company defaults in its obligations under the contracts. The District believes the letter of credit provides reasonable funds to cover the District's outstanding power purchase commitments and contractual obligations in the event of default by Ponderay Newsprint Company. However, future retail rates of the Electric System may be affected if the District were to no longer provide service to Ponderay Newsprint Company.

The rate impact from a loss of Ponderay Newsprint Company power sales cannot be forecasted accurately; it depends upon the interaction of many factors, including but not limited to, existing cost of production of Box Canyon Project power, cost of acquisition of Bonneville power, and market or resale value of this power.

Seattle City Light - ***Boundary Hydroelectric Project* -** Seattle City Light possesses a FERC license, expiring August 1, 2011, to operate the Boundary Hydroelectric Project in northern Pend Oreille County. This license contains Article 49 granting the District a licensed share of the project, set at 48 MW capacity, with actual energy deliveries not to exceed the District's retail customer load requirements. The District agreed to aid Seattle City Light in the post-2011 relicensing of the Boundary Project. In exchange for District support, Seattle City Light agreed to extend the District's Article 49 rights forward into the new license period and to remove restrictions limiting power deliveries to District service territory load requirements.

The Boundary Project is located immediately downstream from the Box Canyon Project, and as such the reservoir level between Boundary and Box Canyon has a direct relation to the amount of power either Project can produce. Seattle City Light provides the District a monthly payment in lieu of energy to replace lost generation from the impact of the Boundary Project on the Box Canyon Project. The District is acquiring transmission capacity between the Boundary Project and District transmission facilities. Once delivery capacity is acquired, scheduled to occur by 2009, the District will receive energy deliveries rather than a cash payment. Payments received from City of Seattle in lieu of energy totaled $1,355,910 and $1,334,063 for the years ended December 31, 2007 and 2006, respectively.

Bonneville Power Administration - The District purchases power from the Bonneville Power Administration (BPA) under contracts which expire September 30, 2011. Through agreement with BPA, the District receives a Shaped Block Purchase under which the District will receive 1.8 average megawatts through September 30, 2011. Block deliveries are fixed at a flat rate within each month, but predetermined at different levels each month so as to more closely follow anticipated seasonal load requirements.

Additionally, the District contracts for a Slice of the System under which the District accepts 0.3819% of the output of the base federal system and agrees to pay an equal share of costs as defined under the contract. Under provisions of the Slice contract, the District is subject to federal system generation risks and variability in quantity and cost of power delivered. Daily and monthly deliveries do not match District customer requirements and do not provide for future load growth. The overall contracted percent of Federal base system was set not to exceed forecasted District customer load requirements for the year 2002, based on critical (historically low) Pacific Northwest snow packs and hydrological river flows.

For the initial Slice contract year ended September 30, 2002, Slice customers exercised audit rights, indicating that Slice customers felt the year-end true-up bill did not follow contract specifications. Audit rights were also extended to the 2003, 2004, and 2005 year-end true-up calculations. In November of 2006, the Slice litigation was settled with its public agency customers, and the District received $443,283, including interest, as settlement for the 2002-2005 Slice payments.

Note 5 – Power Purchase Contractual Agreements (continued)

The District believes the risks and rewards associated with the Slice and Block product pass through to Ponderay Newsprint Company under the terms of the contracts with that customer.

Energy Northwest - The District is a participant in Energy Northwest's (formerly the Washington Public Power Supply System) Nuclear Projects Nos. 1 and 3, both of which have terminated. The District purchased from Energy Northwest, and assigned to BPA, 0.087% of the capability of Project No. 1 and 0.078% of Energy Northwest's 70% ownership share of Project No. 3. Under the agreements, the District is unconditionally obligated to pay Energy Northwest its pro rata share of the total costs of the projects, including debt service, even though the projects are terminated. Under the Net Billing Agreements, BPA is responsible for assuming the District's cost obligation. The District's Electric System revenue requirements are not directly affected by the associated costs; revenue requirements are affected only indirectly to the extent that the costs of the projects result in increases in BPA's wholesale power rates.

NOTE 6. RETIREMENT BENEFIT PLANS

Pension Plans - All full-time, as well as certain part-time, District employees participate in the statewide cost sharing, multiple employer Public Employees Retirement System (PERS). The Washington State Department of Retirement Systems (DRS) issues a publicly available financial report that includes financial statements and required supplementary information for PERS. This report may be found on the DRS web site, located at www.drs.wa.gov.

PERS provides both retirement and disability benefits, established by state statute, based on compensation and length of service. Plans 1 and 2 are defined benefit programs, Plan 3 is a combination defined benefit/defined contribution program. PERS participants joining the system by September 30, 1977 are Plan 1 members. Participants joining the system subsequently, but on or before August 31, 2002, are Plan 2 members unless they make a decision to transition from Plan 2 to Plan 3. Employees hired after August 31, 2002 will be in Plan 3, unless they make a decision to join Plan 2 within 90 days of hire.

Plan 1 employees vest after five years of eligible service and are eligible for retirement at any age after 30 years of service, or at the age of 60 with 5 years of service, or at the age of 55 with 25 years of service. The annual pension is 2% of the average final compensation (greatest compensation during any 24 consecutive eligible months) per year of service, capped at 60%. If qualified, after reaching the age of 66 a cost-of-living allowance is granted based on years of service credit and is capped at 3% annually.

Plan 2 employees vest after five years of eligible service and may retire at the age of 65 with 5 years of service, or at age 55 with 20 years of service. The retirement benefit is based on 2% of average final compensation, per year of service, based on any eligible consecutive 60-month period. Actuarially calculated early retirement penalties apply to all retirements prior to the age of 65, but are capped at 3% per year if age at retirement is 55 or older with 30 years of service credit. There is no cap on years of service credit and a cost-of-living allowance is granted, capped at 3% annually.

Plan 3 is a dual benefit structure. Plan 3 members may retire after ten years of service, or five years of service with at least one year after age 54, or five years of service in Plan 2 prior to June 1, 2003. Participant contributions finance a defined contribution component. Employer contributions finance a defined benefit component operating similar to Plan 2, but with the retirement benefit based on 1% of average final compensation per year of service. Early retirement penalty rules similar to Plan 2 apply on the defined benefit component.

Each biennium, the State Pension Funding Council adopts employer contribution rates for all three plans and employee contribution rates for Plan 2. Plan 1 employee contribution rates are set at 6% by State statute and do not vary. Plan 3 employee contribution rates vary from 5% to 15% and are individually set by each employee. The contribution rates shown below represent both District and employees' full liabilities under PERS.

Note 6 – Retirement Benefit Plans (continued)

	2007	2006	2005
Employee contribution %			
Plan 1	6.00%	6.00%	6.00%
Plan 2	3.50% - 4.15%	2.25% - 3.50%	1.18% - 2.25%
Plan 3	5.00% - 15.00%	5.00% - 15.00%	5.00% - 15.00%
Employer contribution %			
Plan 1	5.46% - 6.13%	2.44% - 3.69%	1.38% - 2.44%
Plan 2	5.46% - 6.13%	2.44% - 3.69%	1.38% - 2.44%
Plan 3	5.46% - 6.13%	2.44% - 3.69%	1.38% - 2.44%
Contribution dollars			
Employee	$249,113	$190,361	$129,340
Employer	$336,124	$161,868	$ 93,223
Total	$585,237	$352,229	$222,563
PERS covered payroll	$5,783,979	$5,257,975	$4,835,674

Other Postemployment Benefits - The District provides reimbursement for healthcare insurance premiums for retired employees. Beginning August 1, 2005, retiring employees who chose to continue medical coverage under the District's plan became eligible to receive $10 per year of service per month toward postemployment medical premiums. The reimbursement begins at the later of the month of retirement or at age 60 and expires when the retiree reaches age 65. The dollar value of the reimbursement was $9 per year of service for employees retiring between August 1, 2006 and July 31, 2007, and will decrease $1 each year until it expires on August 1, 2015. The estimated liability for this benefit as of December 31, 2007 and 2006 is $66,096 and $87,209, respectively. The District has elected to finance this plan under a pay-as-you-go method, for which there were no contributions for the year ended December 31, 2007 and 2006. There is no past service cost to be realized in future years as would be calculated under GASB Statement No. 45; all related past service costs were accrued as of December 31, 2007.

The District allows retirees to contribute to life insurance premiums established during employment. Employees retiring after November 1, 2003 pay the full life insurance premium cost. The District currently has 6 former employees that retired before November 2003 and continue to pay the premium in effect at that date. These retirees will continue to pay a reduced rate until December 31, 2010, at which time they will begin to pay the full rate. The District currently pays the remainder of the premium for these former employees and records a liability and expense for the estimated future payments of the District's portion of the premium. The balance of this liability was $12,461 and $18,060 as of December 31, 2007 and 2006.

Savings Plans - In addition to PERS, the District maintains a deferred compensation plan, as well as two defined contribution plans, in accordance with the Internal Revenue Code Sections 457 and 401(a), respectively. All District employees are eligible to participate in the 457 plan and one of the two available 401(a) plans. The 401(a) plans provide for an employer match of 50% of eligible employee deferral of employee straight-time wages, capped at 7.32% less the required PERS Plan 2 employer contribution percentage net of administrative fees, which is subject to a lock of a 2% cap under certain circumstances. These circumstances were met in 2006 and the cap will remain locked at 2% for future years. Employer contributions for 2007 and 2006 were $105,294 and $134,320, respectively. All plan assets have been placed into trusts for the exclusive benefit of plan participants and their beneficiaries and are, therefore, not reflected in these balance sheets.

The District maintains a Health Reimbursement Arrangement for employees. Non-bargaining unit employees receive 3.5% of employee base wages paid into individual employer sponsored medical savings accounts to pay for eligible medical expenses, tax-free, whether incurred while employed or after retirement. Bargaining unit employees are eligible for up to 1.5% of employee base wage contributions if they participate in District sponsored wellness programs.

NOTE 7. SELF-INSURANCE

Public Utility Risk Management Services - The District, along with seventeen other public utility districts and one joint operating agency, is a member of the Public Utility Risk Management Services self-insurance fund. The program provides members with various liability, property, and health insurance coverages in three separate pools.

The District is a participant in the liability pool, which maintains a base self-insured retention level of $1 million, funded reserves ranging from $1.5 million to $2 million, and individual member deductibles of $250. The liability pool provides the District with shared excess coverage of $60 million general liability, $10 million professional liability, and $10 million per occurrence Directors & Officers liability.

The District is also a participant in the property pool, which maintains a self-insured retention level of $250,000, funded reserves ranging from $500,000 to $750,000, and varying deductibles of $250 on most property and $75,000 on the Box Canyon, Sullivan, and Calispel Hydroelectric Projects. The property pool provides the District with $175 million shared excess coverage, attaching at the self-insured retention level for all property risks excepting flood and earthquake, which attach at 2% of total insured value. Any gap between the self-insured level and excess insurance is funded half by the property pool and half by the affected member.

As a member, the District is subject to assessments based on claims submitted by all members. The following assessments were charged during the years ended December 31:

	Liability		Property	
	2007	2006	2007	2006
Electric System	$ 67,645	$ 75,272	$ 19,787	$ 25,608
Box Canyon Production System	18,763	29,541	110,914	144,150
Water System	3,628	4,597	2,420	3,147
Total	$ 90,036	$109,410	$133,121	$172,905

Central Washington Public Utilities - The District, with six other public utility districts, is a member of the Central Washington Public Utilities Unified Insurance Program and Trust, which is a self-insurance program providing medical, dental, life insurance, disability insurance, and similar benefits to member employees and families. Formed by a Declaration of Trust and an Interlocal Agreement under Revised Code of Washington chapter 39.34, the Trust is administered by a Board of Trustees comprised of an appointed Trustee from each of the seven member districts. Further information may be obtained by contacting the District's financial department as set forth on the last page of this Annual Report under Organizational Information—Corporate Office.

NOTE 8. COMMITMENTS AND CONTINGENCIES

Box Canyon Project License - The Federal Energy Regulatory Commission issued a 50 year license for the District's Box Canyon Hydroelectric Project on July 11, 2005. The District is now in the process of implementing the conditions of the license which include environmental studies and projects initiated by state and federal agencies and the Kalispel Tribe of Indians. All projects and studies are related to Box Canyon Dam and the reservoir behind it and include the protection, mitigation, and enhancement of fish, wildlife, recreation, erosion, and cultural preservation. The license projects can be categorized as either capital, District directed, or Non-District directed expenses. Capital projects include fish bypass and turbine replacement and will be capitalized as construction on these projects is completed. Non-District directed expenses include direct payments to agencies or escrow accounts that are used at the discretion of the receiving party. These costs have been estimated over the life of the license and have been recorded as a deferred asset and liability as described in Note 1. All remaining costs are either performed by District staff or contracted at the District's discretion and will be expensed as incurred.

The District is currently contesting some of the license provisions concerning fish passage and total dissolved gas, which are projects that are scheduled to begin subsequent to 2008. Decisions concerning these issues may have a significant impact on future costs. The District has entered into a contract to construct new turbines for Box Canyon Dam as part of license requirements, with the first turbine installation to occur in 2009. Final costs for these projects may deviate greatly from current estimates.

Note 8 – Commitments and Contingencies (continued)

The license includes language authorizing the District to use lands in the Kalispel Indian Reservation. Under a new contract signed in 2007, payment to the Kalispel Tribe for use of their lands will be based on costs to produce power at Box Canyon Dam. Beginning in 2008, the Kalispel Tribe will receive their payment in electrical energy, the amount of which is based upon a formula using Box Canyon Dam production costs. The Kalispel Tribe may then choose to use the energy or require the District to sell the energy to a third party on the Kalispel Tribe's behalf. Payments are subject to a $200,000 floor through 2010, which will accelerate $15,000 in 2011 and every five years thereafter. An amendment to the previous FERC license established payments for use of this land during 2007 and 2006. Payments to the Department of Interior on behalf of the Kalispel Tribe for use of this land were $159,048 and $155,107 for 2007 and 2006, respectively.

Sullivan Creek Project - The Electric System's Sullivan Creek Project is currently licensed for water storage only. In 1992, the District began a process of pursuing a FERC license amendment to rebuild the plant into a 12-megawatt hydroelectric generation facility. In 2002, the District withdrew its license amendment application from FERC. The project is not currently thought to be economically feasible within the in-stream flow operating criteria imposed by the Washington State Department of Ecology (Ecology) and the United States Forest Service (USFS).

The project's 50-year FERC license No. 2225 expires September 2008. In 2003, the District notified FERC of its intent to not relicense the project.

There is substantial uncertainty regarding the potential environmental liability surrounding the Sullivan Creek Project. The District has recorded an estimated environmental liability of $750,000 as of December 31, 2007. There are no deferred licensing costs associated with this project; license-related costs incurred during the remaining term of the license will be expensed as incurred. Asset values of $1,293,818 and $1,307,496 as of December 31, 2007 and 2006 are being depreciated over the remaining life of the license on a straight-line basis resulting in depreciation charges of $180,771 in 2007 and 2006.

Rental Agreement - In 1997, the District entered into a rental agreement with the Pend Oreille County Port District for use of their railroad right-of-way related to a 115 kV transmission line project. Under this agreement, the District agreed to pay a consumer price index adjusted $125,000 per year, for a twenty-year period commencing January 1, 1997, subject to termination by the District with a year's notice. The District paid $164,749 and $159,640 under the terms of this agreement for rental for 2007 and 2006, respectively.

Power Purchase Contracts - See Note 5 previous relating to power purchase commitments.

NoaNet - The District is committed to repay its ownership share of NoaNet Revenue Bonds and participate in future assessments as described in Note 10.

Other Contingencies - The District is subject to various claims, possible legal actions, and other matters arising out of the normal course of business. When it is possible to make a reasonable estimate of the District's liability with respect to probable claims, an appropriate provision is made. Although the ultimate outcome of litigation against the District cannot be determined, management intends to continually defend all claims against the District and believes the District is adequately reserved for all known events.

NOTE 9. GRANTS

Federal Emergency Management Agency (FEMA) - In January 2006 and again in December 2006, the District sustained damage due to area storms. These storms were declared by the federal government as natural disasters and the District applied for reimbursement from FEMA for labor and supplies expenses. Total grant revenue received from FEMA for the January storm totaled $27,848. The District recorded $50,000 in estimated grant revenue from the December storm in 2006. An additional $42,266 in grant revenue related to these storms was recorded during the year ended December 31, 2007.

Washington State Department of Community, Trade and Economic Development - In June, 2007, the Department of Community, Trade and Economic Development (CTED) awarded the town of Metaline Falls up to $585,000 in Community Development Block Grant (CDBG) funds to upgrade the town's water system including infrastructure for the community of Pend Oreille Village. As owner and operator of the town's water system, including Pend Oreille Village, the District was named the project subrecipient. $265,896 in funds had been expended as of December 31, 2007 on the project, which is expected to be completed in 2008.

Washington State Department of Ecology, Water Resources Program - In August, 2006, the District was awarded a grant to fund the purchase and installation of water meters for the Sandy Shores, Greenridge, Riverview, Lazy Acres, and Holiday Shores Water Systems. The District was reimbursed the total cost of the project of $9,805 during the year ended December 31, 2007. The District was granted an additional $7,363 to include a metering device for the Metaline Falls Water System in November of 2007, the amount of which is included as grant revenue as of December 31, 2007.

Community Economic Revitalization Board Financial Aid - In February 2005, the District received final approval for a Community Economic Revitalization Board grant and loan package associated with certain Community Network System telecommunication projects as discussed in Note 10 below.

NOTE 10. BROADBAND SERVICES

Community Network System - The District owns a fiber optic backbone extending from Spokane north past Metaline Falls and includes fiber into all District substations. The District built this system primarily for Electric System operation and control, but allows others to use the system and thereby help local residents and businesses as well as develop revenues to offset infrastructure costs.

In 2001, the District authorized use of the name Community Network System (CN System) for the purpose of facilitating access to, and use of, the District's Electric System broadband communication network for the benefit of the people of Pend Oreille County. CN System operations are conducted in accordance with state wholesale laws, which authorize the District to build infrastructure and enable open-access use of that infrastructure to Internet Service Providers and entities authorized to provide retail telecommunications services within the State of Washington, who may then, in turn, provide retail services to customers.

As of December 31, 2007 and 2006, the District communications infrastructure investment totals $5,716,530 and $5,469,822, respectively.

CN System revenues and expenditures are as shown below; this information encompasses most operating costs, including member contributions to NoaNet as discussed below, but do not reflect internal Electric System reallocations for use of poles and rights-of-way or office rent associated with space used by the District's four CN System employees.

	2007	2006
Wholesale operating revenues		
Services to authorized retail providers	$202,872	$264,231
Services to Internet service providers	86,370	86,745
Services to District	58,800	58,800
Fiber leasing	86,074	85,898
Service & other	2,100	2,100
	436,216	497,774
Operating expenditures		
Operations, excluding depreciation	242,630	218,525
Maintenance	79,991	105,641
NoaNet equity contributions	120,167	120,136
General and administrative	28,936	24,093
Capital spending, net of contributed capital and Grant revenue	120,821	117,526
	592,545	585,921
Net spending	$156,329	$ 88,147

Note 10 – Broadband Services (continued)

Community Economic Revitalization Board Financial Aid - In February 2005, the Community Economic Revitalization Board (CERB) awarded the District a Conditional Initial Offer of Financial Aid relating to construction of a communications tower, completion of fiber optic connectivity to the Kalispel Tribe Commerce Park, and certain other communication infrastructure projects within Pend Oreille County. The various community projects will be financed with a $265,000 grant, a $200,000 no interest, 20-year loan from the CERB, $207,000 from the District, and $50,000 from the Pend Oreille County Economic Development Revolving Fund (Note 2). $78,289 in grant revenue was recorded on these projects for the year ended December 31, 2005, and $12,343 was expended for the year ended December 31, 2006. There were no expenditures for this project for the year ended December 31, 2007.

Northwest Open Access Network - The District, along with 11 other Washington public utility districts and Energy Northwest, is a member of the Northwest Open Access Network (NoaNet), a Washington non-profit mutual corporation. NoaNet utilizes a high-speed fiber optic transmission system, largely located within Washington State, to provide Ethernet and other advanced telecommunications services on a wholesale basis to its members and retail telecommunications companies. NoaNet has first right-of-refusal to lease four strands, designated as public purpose, from fiber optic lines the Bonneville Power Administration installs on transmission lines.

NoaNet members have guaranteed a $27 million revenue bond issuance, which accrues interest at rates varying from 5.05% to 7.09% and matures in annual and sinking fund installments through December 2016. The District's 3.91% guarantee share of the $20,065,000 outstanding as of December 31, 2006 is $784,542 with a maximum exposure of $980,777 in the event other members fail to honor their guarantees. In January 2003, NoaNet supplemented this financing with a $5 million line of credit, restricted to use for capital purposes. NoaNet pledged future assessments, if necessary, to repay the $5 million line of credit, of which the District would be responsible for its then-current ownership share. As draws are no longer possible on the 2003 line of credit, an additional $5 million line of credit was approved in June 2006.

As of December 31, 2007, the District's ownership interest in NoaNet is 3.94%. In 2006, NoaNet incurred a net loss from operations of $2,046,523, offset by member payments of $3,497,542, resulting in an accumulated members' equity deficit as of December 31, 2006 of $13,815,982.

Under generally accepted accounting principles, the District's Electric System reports no investment or liability account balance reflecting NoaNet membership. The District's share of assessments and related contributions to NoaNet of $120,167 and $120,136 in 2007 and 2006, respectively, has been expensed as incurred.

A NoaNet annual report may be obtained by writing to Northwest Open Access Network, 3511 Norfolk Court, Olympia, WA 98501. A web site is available at www.noanet.net.

INDEPENDENT AUDITOR'S REPORT

To the Commissioners
Public Utility District No. 1
of Pend Oreille County, Washington

We have audited the accompanying combined balance sheet of Public Utility District No. 1 of Pend Oreille County, Washington (the "District") as of December 31, 2006, and the individual balance sheets of the Electric, Box Canyon Production and Water Systems as of December 31, 2006, the related combined statements of revenues, expenses, and changes in net assets, and cash flows for the year ended December 31, 2006, and the individual statements of revenues, expenses and changes in net assets, and cash flows for the Electric, Box Canyon Production and Water Systems for the year ended December 31, 2006. These statements are the responsibility of the District's management. Our responsibility is to express an opinion on these financial statements based on our audit. The accompanying combined balance sheet of the District as of December 31, 2005, and the related combined statements of revenues, expenses and changes in net assets, and cash flows for the year then ended were audited by other auditors, whose report dated March 29, 2006, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the District as of December 31, 2006, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying management's discussion and analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information included on pages 39 through 40 is presented for the purposes of additional analysis and is not a required part of the basic financial statements. These schedules are the responsibility of the District's management. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements and accordingly, we express no opinion on it.

Moss Adams LLP

Seattle, Washington
March 26, 2007

MANAGEMENT'S DISCUSSION AND ANALYSIS
December 31, 2006 and 2005

The financial management of the Public Utility District No. 1 of Pend Oreille County (the District) offers readers of these financial statements this overview and summary analysis of the financial activities of the District for the years ended December 31, 2006 and 2005. This section of the financial report is designed to assist the reader in focusing on significant financial activities and issues, as well as important changes in the District's financial position and results of operations, which may affect the District's ability to address subsequent years' challenges. This discussion and analysis is designed to be used in conjunction with the financial statements and notes, which follow this section.

Overview of the Financial Statements

The financial section of the Annual Report includes Management's Discussion and Analysis, Basic Financial Statements with accompanying notes, Supplemental Information (unaudited), and the Report of Independent Auditors.

The financial statements of the District report the self-supporting, proprietary activities of the District funded primarily by the sale of power and water services. The District reports the business-type activities in a manner similar to private-sector business enterprises, using the accrual basis of accounting, in accordance with accounting principles generally accepted in the United States of America.

The *Combined Balance Sheets* present information on the District's assets and liabilities and provide information regarding the nature and amount of resource investment (assets), and obligations incurred in the pursuit of such resources. This statement also provides a vehicle for evaluating the capital structure of the District and assessing liquidity and financial flexibility of the District.

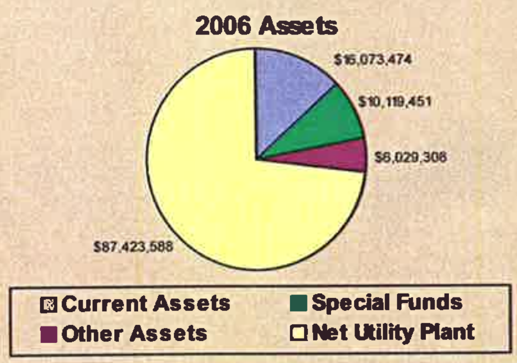
The *Combined Statements of Revenues, Expenses, and Changes in Net Assets* reports revenues and expenses as well as change in net assets (owners' equity) for this period. This statement provides a measurement of the District's operations, helps to evaluate the level of cost recovery from charges for products and services, and can be used as a partial determinant of creditworthiness.

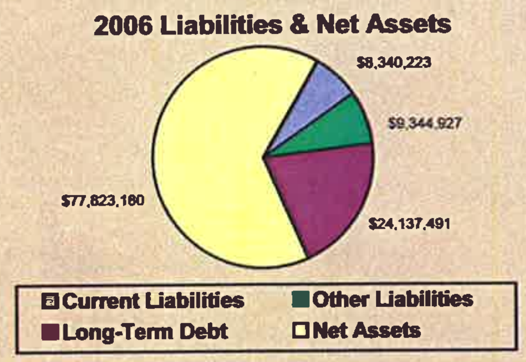
The *Combined Statements of Cash Flows* provide information concerning cash receipts and disbursements during the reporting period resulting from operational, financing, and investing activities. This information provides insight into the District's ability to generate net cash flows and meet obligations, as they become due, and is an important indicator of the District's liquidity and financial strength.

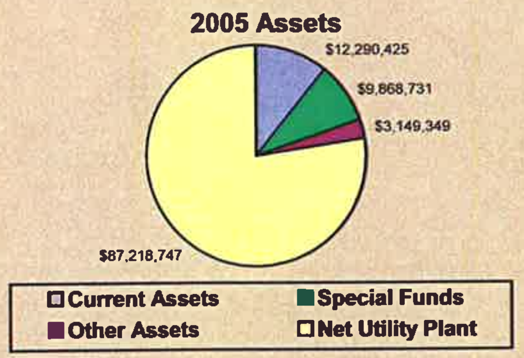
The *Notes to Combined Financial Statements* provide additional information that is essential to a full understanding of the financial statements, as described above, including significant accounting policies, commitments, obligations, risks, contingencies, and other financial matters of the District.

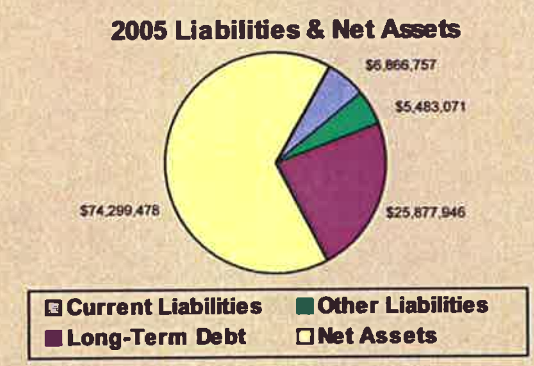
Financial Highlights

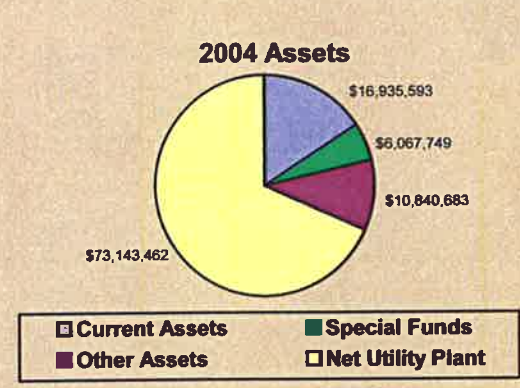
The 2006 financial year dealt with the effects of a number of changes that occurred at the District in 2005. These changes are discussed in further detail below. Comparative graphs depicting the composition of District assets, liabilities and net assets (owner's equity) are:

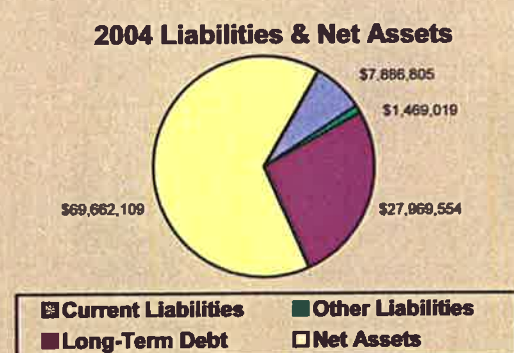












The District experienced a solid financial year in 2006. Total working capital of $7,733,251 as of December 31, 2006 was $2,309,583 over the December 31, 2005 balance of $5,423,668. The District's debt service ratio, a measure of net cash flow from operations in comparison to debt service requirements, calculated to 2.38 for 2006, above 2005 and 2004 results of 2.23 and 2.17, respectively, well above the 1.25 ratio stipulated in bond resolution covenants. Paid Electric System line extensions in 2006 were $944,562, an increase of 176% over 2005's $341,492 and 200% over 2004's $315,027.

For the Electric System, the District measures available reserves as working capital plus the Board Designated Fund. During 2006, Electric System reserves increased to $11,173,542, a $1,925,416 increase over the December 31, 2005 balance of $9,248,126. The December 31, 2004 balance was $7,987,580. The District's Electric System reserves have grown $7,211,802 over the 5 year period beginning December 31, 2002, as the District continues to strive for good financial health and prepares for future capital projects.

Monies set aside in special funds grew slightly in 2006. $479,912 was deposited in 2006 in the Electric System Board Designated Fund, which is internally restricted to any authorized purpose of the District. Expenses of $110,997 from the fund, related to the initial stages of a building addition, resulted in an ending balance of $1,901,880, as compared to $1,532,965 and $290,384 as of December 31, 2005 and 2004, respectively. The District's escrow funds, as required by the Box Canyon Project FERC License (Note 2), which were not yet established in 2004, also increased from $1,686,263 as of December 31, 2005 to $2,187,910 as of December 31, 2006, the increase resulting from both interest earnings and deposits into the fund as required by the FERC License.

In 2005, the District obtained a new license for the Box Canyon Hydroelectric Project from the Federal Energy Regulatory Commission (FERC). The license includes conditions mandating studies and projects to protect, mitigate, and enhance the environment within the Box Canyon Project boundary. Included in Other Assets are deferred licensing costs of $5,516,668 as of December 31, 2006 and $2,505,585 as of December 31, 2005, which include payments to outside entities mandated by the FERC license (Note 1). The $3,011,083 increase in 2006 is due to a change in estimate as a result of court decisions made during 2006.

During 2005, as a result of obtaining a the new FERC license, the District reclassified $11,579,517 of deferred license costs (Note 1) to Utility Plant. Relicensing costs as well as litigation expenses that are continuing on certain license condition requirements are currently included in Utility Plant and totaled $11,932,329 as of December 31, 2006. The balance is being amortized on a straight line basis over the life of the license.

The District repaid almost $2 million of long term debt in 2006. In November 2005, the District issued $18,670,000 in revenue bonds to refund bonds originally issued by the Electric System in 1996. The present value savings of the refinancing was estimated at $1,343,710. Long-term debt at December 31, 2006 is 20% of total assets, down from 23% and 26% as of December 31, 2005 and 2004, respectively.

The change in Electric System current portion of long term debt relates to the debt refinancing that took place in 2005. When the bonds were refinanced, some of the current portion was paid early during the process. Therefore, the balance at December 31, 2005 of $635,000 is significantly lower than the balances of $1,895,000 as of December 31, 2006 and $1,540,000 as of December 31, 2004. Actual debt service payments will be lower than in past years due to refinancing, but a larger portion of each payment will be paying off principal, therefore the current portion of long term debt should continue to increase over the next several years.

The District's bonds are currently rated through Moody's Investors Service and Fitch Ratings, which gave the District a A3 and A- (stable) rating, respectively. Both A3 and A- are considered by their respective companies to be upper medium grade bonds. Moody's Investors Service has rated the Electric System bonds as A3 since 1996, and Fitch Ratings began rating the District when the 1996 bonds were refinanced in 2005 and have remained unchanged since that time.

Year end Net Assets (owner's equity) is 65% of total asset valuation of $119,645,821, consistent with 66% and 65% as of December 31, 2005 and 2004, respectively.

Operating Results

	2006	2005	2004
Operating Revenues			
Ponderay Newsprint Company	$16,478,241	$23,240,204	$19,570,914
Other Retail Customers	10,253,379	8,783,783	7,974,980
Sales to Other Utilities	10,144,370	7,840,844	5,279,662
Contributed Capital	512,029	503,036	401,183
All Other	961,168	640,441	799,864
Total Operating Revenues	38,349,187	41,008,308	34,026,603
Operating Expenses			
Power Costs	15,821,278	18,407,101	15,021,536
All Other	18,268,851	17,151,634	13,660,059
Total Operating Expenses	34,090,129	35,558,735	28,681,595
Net Operating Revenues	4,259,058	5,449,573	5,345,008
Non Operating Expenses	735,356	812,204	1,028,385
Change in Net Assets	$ 3,523,702	$ 4,637,369	$ 4,316,623

In 2006, Ponderay Newsprint Company was able to take advantage of good water flows and favorable markets to resell a higher than average amount of energy received from Bonneville Power Administration. Under terms of the District's contracts with the Ponderay Newsprint Company, the customer is billed based on actual costs of service rather than under a rate schedule. All costs and benefits derived from Bonneville Power Administration power products are passed on to this customer, as all Bonneville power is purchased exclusively for Ponderay Newsprint Company. Accordingly, variations in Operating Revenue from Ponderay Newsprint Company can reflect changes in Bonneville Power Administration purchased power costs as well as market resale of this same purchased energy. The cost of power generated at the Box Canyon Hydroelectric Project, which Ponderay Newsprint Company receives, rose in 2005 due to implementation of terms and conditions of the FERC license requirements. Implementation costs were slightly lower in 2006 in comparison to 2005; however, they are expected to rise in the near future. Overall, Ponderay Newsprint Company's energy consumption dropped 3.4% in 2006 following a drop of 1.4% in 2005 and 1.3% in 2004, which can be considered normal variations as the customer pursues ways to become more energy efficient and lower their operating costs.

The $1,469,596 increase in 2006 Other Retail Customers Operating Revenues primarily reflects a 15% electric rate increase that went into effect January 1, 2006. Due to cash flow concerns related to rising Box Canyon costs, the District's Board of Commissioners felt it prudent to raise electrical rates. The $808,803 increase in 2005 is mostly a result of an industrial customer that ramped up to full production. The number of District residential energy customers grew 2.0% and 2.4% as of December 31, 2006 and 2005, respectively. The 2006 average usage per residential customer meter, at 17.76 megawatts per meter per year, is consistent with 2005 and is slightly up from the 2004 usage level of 17.35 megawatts per meter per year.

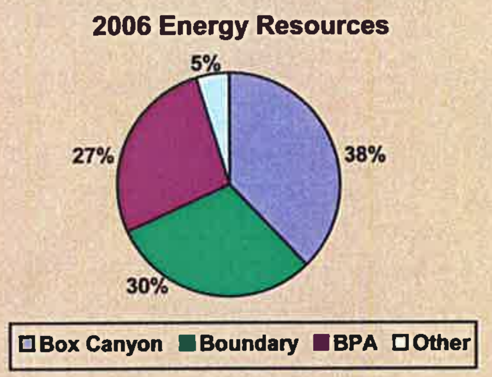
Sales to Other Utilities is primarily associated with the Bonneville Power Administration Block and Slice of the System products (Note 5). The Slice of the System product varies with Columbia River water flows and power market prices, and accordingly, sales to other utilities and power purchases will also vary from year to year. As previously stated, all benefits and risks associated with surplus sales of Bonneville Power Administration power accrue to Ponderay Newsprint Company.

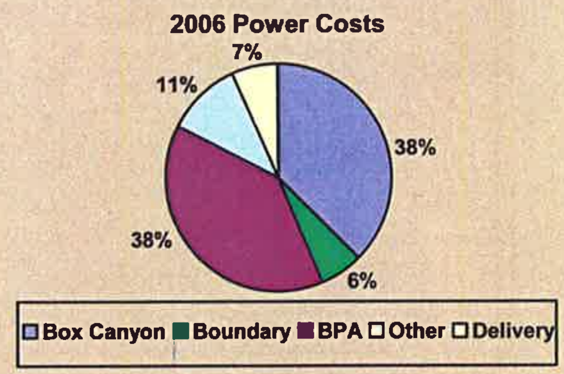
Contributed Capital, representing customer payments for electric and water line extensions, varies from year to year depending on population growth and the length of the season in which crews can work underground. Payments are recorded as revenue when the extension is complete. As previously stated, the District received $944,562 in payments from line extensions in 2006. Extensions totaling $512,029 were completed in 2006 and recorded as revenue; the remaining extensions are scheduled to be completed in 2007. All Other Operating Revenues reflect wholesale broadband revenues (Note 10) as well as miscellaneous revenues, such as timber sales from logging activities on District owned properties.

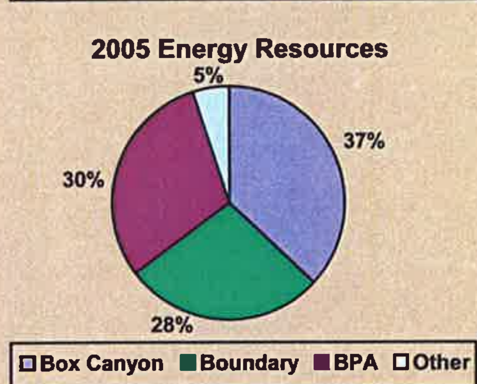
As mentioned above, purchased power costs vary with changes in Bonneville Power Administration energy costs. Overall, the Pacific Northwest experienced favorable water flows during 2006, resulting in lower purchased power costs than in 2005. Box Canyon Project generation costs are reported as operating and maintenance expenses, as they relate to generation costs rather than purchased power. Expenses relating to terms and conditions of the new FERC license began in 2005, resulting in a higher level of Box Canyon generation costs for 2005 and 2006, which will continue into future years.

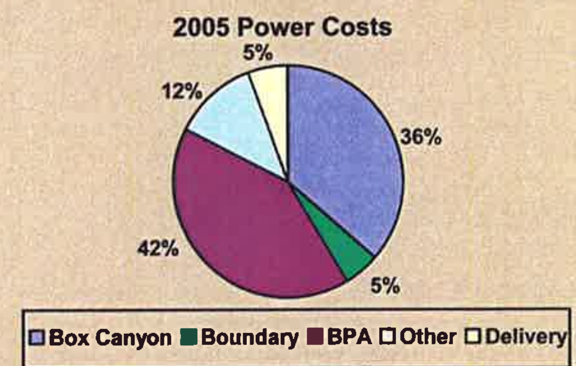
Interest income and interest expense are included in Non-Operating Expenses, as well as some small miscellaneous items. Interest rates on the District's primary cash investment have risen to 5.2% as of December 31, 2006, up from 4.16% and 2.07% as of December 31, 2005 and 2004, respectively. This rise in interest income as well as a decrease in interest expense due to the refinancing of the 1996 bonds as previously discussed, resulted in a 9% drop in Non-Operating Expenses.

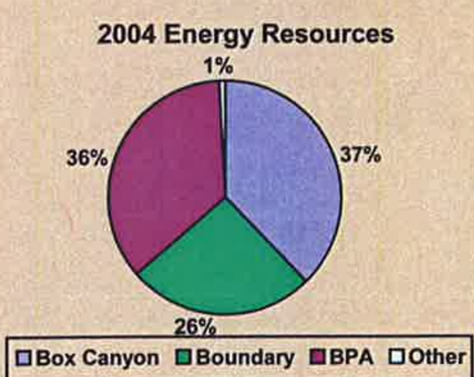
Energy Resources and Related Power Costs

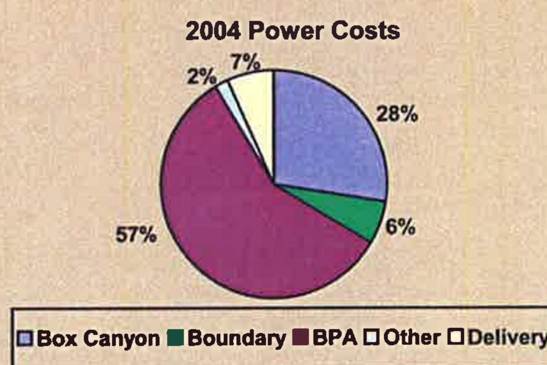








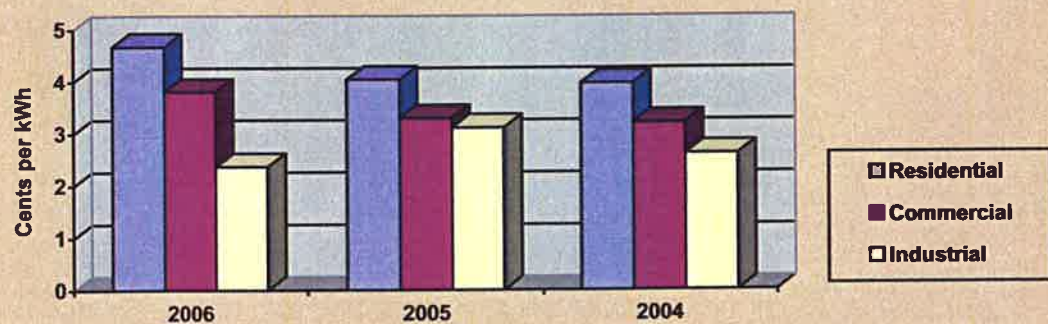




Under the Boundary Hydroelectric project FERC license, the District is eligible to receive Boundary's first 48 average megawatts of power. At approximately $3.92 per megawatt hour, power received from Boundary Hydroelectric project is the District's most inexpensive source of power and is a key component of the District's current low power rates. The District's most expensive source of power, from Bonneville Power Administration, had an average cost of $28 per megawatt hour in 2006, as compared to $32 in 2005 and $30 in 2004. This resource is purchased exclusively for Ponderay Newsprint Company and resold to them at cost. Power from Box Canyon Hydroelectric Project was an average of $20 per megawatt hour in 2006, compared to $23 in 2005 and $13 in 2004. As noted above, expenses incurred under the FERC license implementation have caused Box Canyon power to rise significantly over the past two years. Cost of Box Canyon power is expected to rise higher as FERC license directed projects are addressed. Other Energy Resources and related Power Costs include costs to operate the Calispel Power House, which produces less than 1 megawatt per hour, and payments to Avista Utilities, which manages the District's control services. Contract changes with Avista in 2005 resulted in an increase in Other Energy Resources used by the District.

Rates

Effective January 1, 2006, the District increased electric power rates by approximately 15%. This increase was implemented to increase cash flows to fund projects required by the Box Canyon FERC license. District residential energy customers paid an average of 4.67 cents per kWh consumed in 2006, up slightly from 4.04 and 3.96 cents in each year of 2005 and 2004, respectively. A chart comparing District historic residential, commercial, and industrial rates is shown below. Ponderay Newsprint is included in the industrial rate, and as mentioned previously, this customer's costs can vary from year to year.



Currently Known Facts, Decisions, and Conditions

A description of currently known facts, decisions, and conditions that are expected to have a significant affect on future financial position or results of operations follows.

Ponderay Newsprint Company

The District's single largest customer, Ponderay Newsprint Company, represents 75% of 2006 retail Electric System customer load by megawatt hours and 63% by retail energy revenues. District contracts with PNC expire in 2027 and provide for an irrevocable $10 million letter of credit in the event of default. The rate impact from a loss of Ponderay Newsprint Company power sales cannot be accurately forecast and depends upon the interaction of many factors, including but not limited to, then existing cost of production of Box Canyon Project power, cost of acquisition of Bonneville power, market or resale value of this power, and the ability of the District to retain Boundary generation. In a low priced wholesale power market, District rates could be greatly impacted by the loss of this customer. See Note 5 to the financial statements for further information regarding this issue.

Box Canyon Hydroelectric Project FERC License

The Box Canyon Hydroelectric Project license is discussed in Note 8 to the financial statements. New license conditions are projected to result in generation costs approaching $25 per megawatt hour produced, varying by year, over the next several years. The District is currently challenging certain aspects of the license in court. Absent success of any legal challenge, the generation cost could raise by an additional estimated $5 per megawatt hour somewhere near calendar year 2013. Should the increased costs result in the loss of Ponderay Newsprint Company as a customer, the District's current low rate structure could be greatly affected as discussed previously.

Sullivan Creek Hydroelectric Project

As discussed in Note 8 to the financial statements, the Sullivan Creek Project's 50-year FERC license expires in September 2008. In 2003, the District notified FERC of intent to not relicense. There is substantial uncertainty regarding potential environmental liability of the current structure. The District recorded a probability weighted environmental liability and is fully depreciating asset values over the remaining life of the license.

Contacting the District's Financial Management

The financial report is designed to provide interested parties with a general overview of the District's finances and to demonstrate District accountability for the money it receives. If you have questions about this report, or require additional or clarifying financial information, contact the District's financial department as set forth on the last page of this Annual Report under Organizational Information—Corporate Office.

John D. Jordan, CPA
Director of Finance

COMBINED STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

For the Year Ended December 31, 2006	Electric System	Box Canyon Production System	Water System	Combined Total For the year ended December 31, (Note 1) 2006	2005
Operating Revenues					
Sales to retail customers-					
Ponderay Newsprint Company	$16,478,241	$ -	$ -	$16,478,241	$23,240,204
Other retail customers	9,903,194	-	350,185	10,253,379	8,783,783
Sales to other utilities	10,144,370	-	-	10,144,370	7,840,844
Inter-System sales	557,831	9,195,553	-	-	-
Contributed capital (Note 1)	509,060	-	2,969	512,029	503,036
Other	1,037,547	1,877	3,882	961,168	640,441
Total Operating Revenues	38,630,243	9,197,430	357,036	38,349,187	41,008,308
Operating Expenses					
Power costs	24,715,879	744,371	-	15,821,278	18,407,101
Operations and maintenance	3,429,582	5,500,405	265,192	9,077,167	8,174,667
Administrative and general	2,311,890	1,445,186	28,555	3,707,093	3,638,906
Taxes	1,416,731	104,952	17,733	1,539,416	1,742,273
Depreciation	3,172,651	628,811	143,713	3,945,175	3,595,788
Total Operating Expenses	35,046,733	8,423,725	455,193	34,090,129	35,558,735
Net Operating Revenues (Expenses)	3,583,510	773,705	(98,157)	4,259,058	5,449,573
NonOperating Revenues (Expenses)					
Interest income	705,204	231,811	5,242	816,008	575,173
Interest on long-term debt	(1,561,574)	-	(12,769)	(1,574,343)	(1,651,050)
Grant revenues	-	-	66,334	66,334	268,693
Other, net	(83,588)	(75,154)	(10,862)	(43,355)	(5,020)
Total NonOperating Revenues (Expenses)	(939,958)	156,657	47,945	(735,356)	(812,204)
Change in Net Assets	2,643,552	930,362	(50,212)	3,523,702	4,637,369
Accumulated Net Assets					
Beginning of year	40,676,332	30,446,218	3,176,928	74,299,478	69,662,109
End of year	$43,319,884	$31,376,580	$3,126,716	$77,823,180	$74,299,478

The accompanying notes are an integral part of these combined financial statements.

Public Utility District No. 1 of Pend Oreille County, Washington

COMBINED STATEMENTS OF CASH FLOWS - OPERATING AND FINANCING ACTIVITIES

For the Year Ended December 31, 2006	Electric System	Box Canyon Production System	Water System	Combined Total For the year ended December 31, (Note 1) 2006	2005
Cash Flows from Operating Activities					
Receipts from customers	$38,502,978	$165,646	$357,001	$39,025,625	$38,329,649
Receipts from other operating revenues	384,476	1,877	983	387,336	31,564
Payments to suppliers for goods and services	(18,280,251)	(4,644,941)	(114,411)	(23,039,603)	(22,654,942)
Payments to employees for services	(3,718,407)	(2,423,633)	(177,958)	(6,319,998)	(5,611,012)
Payments to (from) other systems	(8,587,375)	8,553,046	34,329	-	-
Net cash provided by operating activities	8,301,421	1,651,995	99,944	10,053,360	10,095,259
Cash Flows from Noncapital Financing Activities					
Economic Development Fund					
Transfers & other receipts	25,000	-	-	25,000	25,000
Awarded to grant applicants	(33,900)	-	-	(33,900)	(20,318)
Intersystem financing	764,641	(760,601)	(4,040)	-	-
Net cash provided by (used in) noncapital financing activities	755,741	(760,601)	(4,040)	(8,900)	4,682
Cash Flows from Capital and Related Financing Activities					
Acquisition and construction of capital assets	(2,518,219)	(1,776,719)	(104,078)	(4,399,016)	(7,216,786)
Proceeds from sale of capital assets	-	-	-	-	8,512
Proceeds from capital contributions and grants	-	-	66,334	66,334	468,693
Change of deferred revenue (Note 1)	(49,588)	-	-	(49,588)	(49,588)
Proceeds from issuance of long-term debt	6,338	-	35,363	41,701	17,839,453
Scheduled payments and early retirement on revenue bonds (Note 3 and 4)	(635,000)	-	(87,710)	(722,710)	(21,387,711)
Interest paid on revenue bonds (Note 4)	(919,995)	-	(13,966)	(933,961)	(2,078,975)
Net cash used in capital and related financing activities	(4,116,464)	(1,776,719)	(104,057)	(5,997,240)	(12,416,402)

The accompanying notes are an integral part of these combined financial statements.

COMBINED STATEMENTS OF CASH FLOWS - INVESTING ACTIVITIES AND RECONCILIATIONS

For the Year Ended December 31, 2006	Electric System	Box Canyon Production System	Water System	Combined Total For the year ended December 31, (Note 1) 2006	2005
Cash flow from Investing Activities					
Purchases of investments	$(21,813,917)	$ -	$ -	$(21,813,917)	$ (6,218)
Sales and maturities of investments	21,816,969	-	6,218	21,823,187	2,349,218
Interest on investments, contracts and notes	615,095	189,986	18	805,099	1,168,549
Net cash provided by investing activities	618,147	189,986	6,236	814,369	3,511,549
Net Increase (Decrease) in Cash and Cash Equivalents	5,558,845	(695,339)	(1,917)	4,861,589	1,195,088
Cash and Cash Equivalents (Note 2)					
Beginning of year	10,216,720	7,169,891	1,917	17,388,528	16,193,440
End of year	$15,775,565	$6,474,552	$ -	$22,250,117	$17,388,528
Reconciliation of Net Operating Revenues (Expenses) to Cash Flows from Operating Activities					
Net operating revenues (expenses)	$ 3,583,510	$ 773,705	$ (98,157)	$ 4,259,058	$5,449,573
Adjustments to reconcile net operating revenues (expenses) to net cash provided by operating activities					
Depreciation	3,172,651	628,811	143,713	3,945,175	3,595,788
Cash provided (used) by changes in operating assets and liabilities					
Receivables	697,794	165,646	4,327	867,767	(887,791)
Unbilled revenue (Note 1)	41,047	-	-	41,047	(171,373)
Due to other systems	(54,345)	-	54,345	-	-
Materials and supplies	(102,138)	3,332	(4,555)	(103,361)	110,188
Prepaid expenses and other current assets	24,978	(7,252)	-	17,726	26,715
Deferred charges (Note 1)	-	725,647	-	725,647	1,686,263
Accounts payable, customer deposits and prepayments	1,037,201	(648,925)	221	388,497	249,139
Accrued compensation, benefits and taxes	(99,277)	11,031	50	(88,196)	36,757
Net cash provided by operating activities	$ 8,301,421	$ 1,651,995	$ 99,944	$10,053,360	$10,095,259

The accompanying notes are an integral part of these combined financial statements.

NOTES TO COMBINED FINANCIAL STATEMENTS
December 31, 2006 and 2005

NOTE 1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Organization

Public Utility District No. 1 of Pend Oreille County, Washington (the District) is a municipal corporation governed by an elected three-person Board of Commissioners. The District's reporting entity is comprised of three primary component units, or operating systems.

The Electric System distributes electricity to residential and other consumers in Pend Oreille County. The Box Canyon Production System produces hydroelectric power from the Box Canyon Hydroelectric Project (Note 8). The Water System consists of nine individual water distribution subdivisions. The District is required by various financing and contractual arrangements to report separately on each system and maintain each system as a separate entity with separate obligations.

The District authorized usage of the name Community Network System (CN System) for the purpose of facilitating access to, and use of, the District's Electric System broadband communication network for the benefit of the people of Pend Oreille County (Note 10) in accordance with state granted wholesale authority. The CN System is an endeavor of the Electric System and is not a separate operating system for reporting purposes.

Basis of Accounting and Presentation

The accounting policies of the District conform to generally accepted accounting principles (GAAP) as applicable to proprietary funds of governments. The Governmental Accounting Standards Board (GASB) is the accepted standard setting body for establishing governmental accounting and financial reporting principles. Accounting records are maintained in accordance with methods prescribed by the State Auditor under the authority of Chapter 43.09 RCW, the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission (FERC) for the Electric System and Box Canyon Production System, and the Uniform System of Accounts for Class C Water Utilities prescribed by the National Association of Regulatory Utility Commissioners for the Water System.

GASB Statement No. 20 requires that the District apply all GASB pronouncements as well as the pronouncements issued on or before November 30, 1989, by the Financial Accounting Standard Board (FASB) and its predecessor organizations, unless those pronouncements conflict with or contradict GASB pronouncements. As provided for in GASB Statement No. 20, the District has elected not to implement FASB Statements and Interpretations issued after November 30, 1989.

System columns presented in the financial statements do not sum to the combined totals due to the elimination of certain inter-system transactions. These transactions relate to inter-system power sales and purchases, loan balances and interest on inter-system loans, and inter-system administrative charges.

A summary of other significant accounting policies utilized in the preparation of the financial statements follows.

New Accounting Standards

In June 2004, the GASB issued GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, to recognize the cost of postemployment benefits in the period the related services are received by the employer, and to provide information for benefit liabilities promised to employees. The District adopted GASB 45 as of December 31, 2005, recognizing the full expected liability and related expense as of that date. See further discussion of other postemployment benefits at Note 6.

In November of 2006, the GASB issued GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. This statement addresses accounting and financial reporting standards for potentially detrimental effects of existing pollution. Water quality is listed as a potential pollutant, and as such the District may be required to estimate a possible liability associated with water quality. GASB Statement No. 49 is required for financial statements for periods beginning after December 15, 2007. The District is currently evaluating the impacts of adopting this statement for the District's financial statements.

Revenue Recognition

The Electric System and Water System recognize revenue as earned on a monthly basis based on rates established by the District's Board of Commissioners and, for the Electric System, in accordance with power sales contracts with Ponderay Newsprint Company (see Note 5). Because Electric System customer meters are read and billed at various times during each month, the District estimates unbilled revenues for energy delivered to customers between their last respective cycle billing date and December 31, and records that amount as unbilled revenue for the current year. Estimated unbilled revenue as of December 31, 2006 and 2005 was $801,109 and $842,156, respectively. The Box Canyon Production System recognizes revenue on a cost-of-service basis from sales to the Electric System.

Allowance for Uncollectible Accounts

Management reviews accounts receivable on a regular basis to determine if any receivables will potentially be uncollectible. The allowance for uncollectible accounts includes amounts estimated through an evaluation of specific accounts, based on the best available facts and circumstances, of customers that may be unable to meet their financial obligations, and a reserve based on historical experience. Management believes that the allowance for uncollectible accounts as of year end was adequate.

Cash and Cash Equivalents

The District records repurchase agreements and other short-term investments, with maturity at date of purchase of three months or less, at cost as cash equivalents.

Special Funds and Investments

Short-term investments with a maturity of between three and twelve months, at date of purchase, are recorded at amortized cost with discount or premium amortized on a straight-line basis over the life of the investments. The District records all other investments at fair value based on quoted market rates, with changes in unrealized gains and losses reported as investment income.

Materials and Supplies

Materials and supplies are recorded at average cost.

Utility Plant

See Note 3 regarding capitalization, depreciation, and retirement policies.

Contributed Capital

Contributions in Aid of Construction are District-mandated customer connection charges used to fund construction of system properties necessary to extend service to a new customer. The payments are initially recorded as liabilities, then reclassified to operating revenue (contributed capital) when the associated facilities are constructed or acquired.

Deferred Licensing Costs

The Federal Energy Regulatory Commission issued the District a new 50-year operating license for the Box Canyon Hydroelectric Project in July 2005. The license contains environmental studies and projects that the District must complete. Per the license, a Technical Committee, which consists of members of the involved state and federal agencies and the Kalispel Tribe, oversees the implementation of the license requirements.

As a result of obtaining a new license, the District capitalized to Utility Plant accumulated relicensing costs totaling $11,579,517 as of December 31, 2005 and began amortizing the balance over the 50-year term of the new license. Costs attributed to legal fees for continuing litigation of various license conditions have been capitalized during the current year. Capitalized relicensing costs as of December 31, 2006 are $11,932,329 with accumulated amortization of $348,178.

Certain of the FERC license conditions require payments to various outside entities for projects and operating costs which will not be directed by, or controlled by, the District or the Technical Committee. Included in these costs are annual payments to outside organizations as described above. The District has estimated and present valued these payments over the 50-year license and recorded a deferred asset and license cost liability of $5,516,668 and $2,505,585 as of December 31, 2006 and 2005, respectively. Remaining expenses related to license implementation will be recorded as incurred over the 50 year license period, as the District can not accurately estimate the future costs of these projects and will be expensed in the future upon payment for completion of the work.

Deferred Financing Costs

Bond issue costs, discounts, and premiums are amortized to interest expense, using the effective interest method, over the term of the bonds. The excess of costs incurred over the carrying value of bonds refunded on early extinguishment of debt is amortized over the term of the new bonds, using the effective interest method.

Deferred Revenue

In August 2000, the District entered into an agreement with Seattle City Light concerning a cost sharing arrangement for building of fiber optic communications capability in Pend Oreille County. Among other terms and conditions, the District retained ownership of all constructed network assets with a commitment to grant the Seattle City Light a 30-year right-of-use for 12 dark fiber strands along the District's network backbone. Seattle City Light made a one-time, lump sum payment of $1,487,650 under the agreement. The District recorded the payment as Electric System deferred revenue and is amortizing the balance to revenue on a straight-line basis over the 30-year life of the agreement.

Restricted Net Assets

Amounts presented as restricted net assets are reserved for specific purposes and cannot be used for normal operations. Balances currently classified as restricted include funds held by the Economic Development Revolving Fund (Note 2) and bond principal and interest due for the upcoming year (less accued interest) as well as the bond reserve fund.

Compensated Absences

Employees accrue personal leave to be used for vacation, sick, and family leave purposes. Annual leave granted each employee varies in accordance with years of service and may be carried forward from year-to-year, capped at a maximum bank of 1200 hours. The District records the cost of personal leave as earned, not as taken.

Accounting Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Significant Risk and Uncertainties

The District is subject to certain business risks that could have a material impact on future operations and financial performance. These risks include weather and natural-disaster-related disruptions; collective bargaining labor disputes; fish and other Endangered Species Act issues; Environmental Protection Agency regulations; federal government regulations or orders concerning the operation, maintenance, and/or licensing of hydroelectric facilities, including licensing of the Box Canyon Project as discussed in Note 8; deregulation of the electrical industry; concentration risk in the form of sales to a major customer, Ponderay Newsprint Company and related potential impact on District power contracts (Note 5); and market risks inherent in buying and selling of power, a commodity with inelastic demand characteristics and minimal storage capability.

Reclassifications

Certain reclassifications were made to the 2005 financial statements presentation to conform to the classifications used in 2006. These reclassifications do not affect the changes in net assets as previously reported.

NOTE 2. SPECIAL FUNDS AND INVESTMENTS

The District's investment portfolio consisted of the following cash and cash equivalents and investments:

As of December 31, 2006	Electric System	Box Canyon Production System	Water System	Combined Total As of December 31, 2006	2005
Revenue Funds					
Cash and cash equivalent	$ 9,770,365	$ 440,650	$ -	$ 10,211,015	$ 7,161,196
Bond principal and interest	1,919,651	-	-	1,919,651	364,825
Total Revenue Funds	11,690,016	440,650	-	12,130,666	7,526,021
Special Funds					
Bond reserve	2,026,049	-	-	2,026,049	1,952,081
Board Designated reserve	1,901,880	-	-	1,901,880	1,532,965
Renewal and license					
Internal restricted funds	-	3,845,992	-	3,845,992	4,566,811
Escrow funds	-	2,187,910	-	2,187,910	1,686,263
Economic Development	157,620	-	-	157,620	130,611
Total Special Funds	4,085,549	6,033,902	-	10,119,451	9,868,731
Total Special and Revenue Funds	$ 15,775,565	$ 6,474,552	$ -	$ 22,250,117	$17,394,752
Cash and Cash Equivalents, at Cost, Which Approximates Market Value					
Cash deposits	$ 2,752,193	$ 2,269,554	$ -	$ 5,021,747	$ 3,342,754
Local government investment pool	13,023,372	4,204,998	-	17,228,370	14,045,774
Total Cash and Cash Equivalents	15,775,565	6,474,552	-	22,250,117	17,388,528
Investment, short term certificate of deposit, at cost	-	-	-	-	6,224
Total Funds	$ 15,775,565	$ 6,474,552	$ -	$ 22,250,117	$ 17,394,752

Interest Rate Risk. The District's investment policy limits investment maturities to less than five years from the date of purchase unless authorized by the General Manager and Director of Finance for a specific purpose. During 2006 and 2005, excepting the 2006 bond reserve account, all investments were in the State Treasurer's Local Government Investment Pool (LGIP), which has a weighted average portfolio maturity of less than 90 days.

Credit Risk. In accordance with the Revised Code of Washington, District bond resolutions, and District internal investment policies, all investments are direct obligations of the U.S. Government, deposits in the LGIP,or deposits with financial institutions recognized as qualified public depositories of the State of Washington. U.S. Government securities are held by banks or trust companies as the District's agent and in the District's name.

The District's cash deposits are covered by federal depository insurance or protected against loss by deposit with financial institutions recognized as qualified public depositories of the State of Washington. The District intends to hold time deposits and securities until maturity.

Concentration of Credit Risk. District policies allow the entire portfolio to be invested in direct United States Government guaranteed obligations or in the LGIP. No other investment may exceed half of portfolio market value. The LGIP, a 2a7-like pool as defined by GASB Statement No. 31 and the Securities and Exchange Commission, invests in high quality, short term investments; all LGIP money market securites must be rated A-1 by Standard & Poors Corporation or P1 by Moody's Investor Services, Inc. The LGIP weighted average maturity must not exceed 90 days and no single investment may exceed 762 days in maturity. Withdrawals in excess of $10 million are available on a one day notice. The LGIP Annual Report is available on the State Treasurer's website at http://tre.wa.gov/LGIP/lgip.htm.

Bond Reserve, Principal, and Interest Funds

For each debt issue, the District is required by bond resolutions to maintain principal and/or sinking fund and interest accounts within the bond funds to provide for the next semi-annual interest and annual principal/sinking fund payments falling due, which are reported as current assets. All bond funds are restricted by bond resolution to the payment of debt service obligations.

District Electric System revenue bond resolutions require reserve accounts be maintained within the bond funds. The 1998 reserve account requires a deposit equal to the maximum amount of principal and interest falling due in any single bond year, and the 2005 reserve account equals 10% of par amount and premium on the 2005 bonds issued. The District met the 1998 bonds reserve requirement through the purchase of a surety bond. The 2005 bond reserve requirement of $1,934,181 is invested in a forward supply contract with a private third party wherein a series of U.S. Treasury bonds, bills, or notes, of a maturity not to exceed the next scheduled bond interest payment date will be delivered to the District's trust account. Per agreement with the independent third party, the District will receive a pre-determined yield on the investments through the end of the agreement, which expires January 1, 2014.

Board Designated Reserve Fund

The Electric System Board Designated Reserve Fund receives monies from uncertain, non-recurring, or limited duration revenue streams such as surplus sales of District generated power resources, timber sales, and a portion of certain customer revenues associated with mining activities. Disbursements from the fund are allowed for any valid business purpose of the District as specifically authorized by motion of the Board of Commissioners.

Renewal and License Fund

The Renewal and License Reserve Fund is an internally restricted fund, not required by any external agencies or contractual agreements, established to provide for Box Canyon Hydroelectric Project capital additions, renewals and replacements, and for capital expenditures required by terms and conditions of the Box Canyon Project FERC license (Note 8) not otherwise provided for by the District. In 2005, the Electric System loaned the Box Canyon Production System $2 million (Note 4), which was also deposited into this fund.

Escrow Funds

The Box Canyon Project FERC license stipulates that a Trout Restoration Fund and a Recreation Resources Fund are to be financed by the District. In October 2005, the District established interest bearing escrow accounts with a financial institution for the Trout Restoration Fund and the Recreation Resources Fund. The funds will be held in trust by the financial institution and used at the discretion of the District and Technical Committee members (Note 8) for trout preservation and recreational facility improvements and maintenance. As of December 31, 2006 and 2005, the escrow balance in the Trout Restoration Fund totaled $1,607,881 and $1,576,824 while the balance in the Recreation Resources Fund was $580,029 and $109,439, respectively.

Economic Development Revolving Fund

As allowed by Revised Code of Washington (RCW) 82.16.0491, the District contributes $50,000 annually to the Pend Oreille County Economic Development Revolving Fund and receives a $25,000 matching excise tax credit, resulting in a net cost to the District of $25,000 annually. The District's Board of Commissioners appoints the fund's local board and has currently appointed themselves to three of the five positions. Monies deposited may be used for qualifying economic development projects within the county, as allowed by RCW and approved by the local board. In accordance with the provisions of GASB Statement No. 39, the Economic Development Revolving Fund is recorded as a blended component unit within the Electric System. As of December 31, 2006 and 2005, the Electric System holds $157,620 and $130,611 respectively, in trust for future projects as approved by the fund's local board. Further information concerning the Economic Development Revolving Fund may be obtained by contacting the District's financial department as set forth on the last page of this Annual Report under Organizational Information—Corporate Office.

NOTE 3. UTILITY PLANT

Utility plant assets are stated at cost. Betterments and major renewals over $1,000 are capitalized, while maintenance and repairs are charged to operations as incurred. During the years ended December 31, 2006 and 2005, the following changes occurred in the District's utility plant:

	2005 Balance	Additions	Retirements/ Transfers	2006 Balance
Land and land rights	$ 2,664,211	$ 52,805	$ -	$ 2,717,016
Hydroelectric plant and equipment	41,503,533	716,991	(187,953)	42,032,571
Structures, buildings and equipment	84,610,646	1,870,187	(175,949)	86,304,884
Other utility plant	349,088	3,846	(25,000)	327,934
Construction work in progress	328,755	2,794,340	(1,157,239)	1,965,856
	129,456,233	5,438,169	(1,546,141)	133,348,261
Less—accumulated depreciation	42,237,486	3,876,723	(189,536)	45,924,673
Net Utility Plant	$ 87,218,747	$ 1,561,446	$ (1,356,605)	$ 87,423,588

	2004 Balance	Additions	Retirements/ Transfers	2005 Balance
Land and land rights	$ 2,647,298	$ 16,913	$ -	$ 2,664,211
Hydroelectric plant and equipment	27,594,823	11,692,673	2,216,037	41,503,533
Structures, buildings and equipment	80,754,672	1,821,586	2,034,388	84,610,646
Other utility plant	348,487	201	400	349,088
Construction work in progress	582,425	4,288,519	(4,542,189)	328,755
	111,927,705	17,819,892	(291,364)	129,456,233
Less—accumulated depreciation	38,784,243	3,598,988	(145,745)	42,237,486
Net Utility Plant	$ 73,143,462	$ 14,220,904	$ (145,619)	$ 87,218,747

Depreciation

Depreciation is determined by the straight-line method over the estimated useful lives of the related assets, which ranges from 7 to 50 years. Composite rates are used for asset groups and, accordingly, no gain or loss is recorded on the disposition of an asset unless it represents a large and unusual retirement. The combined composite depreciation rates are as follows:

	Electric System	Box Canyon Production System	Water System
2006	3.9%	1.0%	2.8%
2005	3.7%	1.1%	2.8%

Construction Work in Progress

Interest costs incurred to finance major construction projects are capitalized as part of the project cost, net of interest earned on borrowed proceeds. No such costs were capitalized in 2006 or 2005.

NOTE 4. LONG-TERM DEBT

In November 1998, the District issued $10 million tax-exempt Electric System revenue bonds to complete financing of the 115 kV transmission line project and for other capital needs of the District. The issue contains $7,770,000 in series bonds maturing in annual installments from December 1, 2001 through 2015, with interest rates ranging from 4.0% to 4.4%. The remaining $2,230,000 is a 4.55% term bond maturing in sinking fund installments from 2016 through 2018. The bonds are reported in the balance sheet net of unamortized discount of $44,614 and $49,893 as of December 31, 2006 and 2005, respectively.

In November 2005, the District issued $13,240,000 Series A (subject to alternative minimum tax) and $5,430,000 Series B (tax exempt) revenue bonds to refund bonds originally issued in 1996. The present value savings at the time of refinancing was estimated at $1,343,710. The Series A bonds accrue interest at 4.00% to 5.00% maturing in annual installments from January 1, 2006 through January 1, 2015. The Series B bonds consist of $1,580,000 in series bonds, maturing in annual installments from January 1, 2006 through January 1, 2014 and accruing interest at 3.25% to 4.00%; $2,420,000 maturing in annual sinking fund installments from January 1, 2015 through January 1, 2017 accruing interest at 4.35%; and $1,430,000 maturing on January 1, 2018 accruing interest at 5.25%. The District recorded a loss from refinancing of $1,470,496, which is amortized using the effective interest method over the life of the 2005 bonds. The bonds are recorded in the balance sheet net of unamortized premium of $539,990 and $662,020 and unamortized loss from refinancing of $1,118,983 and $1,439,272 as of December 31, 2006 and 2005, respectively.

In November 2005, the Electric System loaned the Box Canyon Production System $2 million to provide additional liquidity to enable implementation of newly issued FERC license requirements. Interest on the loan accrues at the Electric System's variable opportunity cost of the Washington State Local Government Investment Pool's monthly interest rate which varied in 2006 from 4.2% to 5.2%. The principal balance of $1,151,516 and $1,878,788 as of December 31, 2006 and 2005, respectively, is included as an amount due from other systems on the financial statements. Monthly principal payments in the amount of $60,606 began November 30, 2005 and will end July 31, 2008.

The Metaline Falls Subdivision of the Water System revenue bonds, with an outstanding principal balance of $52,000 as of December 31, 2005, were repaid by the District in February 2006.

In 2000, the Sunvale Subdivision of the Water System received a loan for $189,607 from the State of Washington Department of Community, Trade, and Economic Development to finance the construction of new wells and distribution line. The fixed interest rate is 2.5% for a term of twenty years. Annual principal payments in the amount of $9,979 are due through October 2020.

In 2001, the State of Washington Department of Community, Trade, and Economic Development authorized a $400,070 loan to the Riverbend Subdivision of the Water System, to finance system improvements, with a fixed interest rate of 2.5%. Annual principal payments in the amount of $22,018 are due through October 2020.

In July 2003, the District executed a State of Washington Public Works Board loan agreement for the Granite Shores Subdivision of the Water System enabling a $70,551 loan to be repaid over 20 years at 1% interest. The loan financed certain system improvements, including drilling a new well. Annual principal repayments of $3,713 began in October 2005 and will end in October 2023. Subsequently, in March 2006, the District secured an additional loan with the State of Washington Public Works Board for $35,717 to cover the remaining costs of drilling the new well. The second loan also carries a 1% interest rate. Annual principal payments in the amount of $1,880 are due through October 2026.

In February 2005, the Community Economic Revitalization Board (CERB) awarded the District a $200,000 loan for construction of communication infrastructure projects (Note 10). This loan carries no interest and principal payments are deferred for the first five years. Principal payments of $13,333 will begin in 2011 and will end in 2026.

	Electric System	Box Canyon Production System	Water System	Combined as of 12/31/06
Principal				
2007	$ 1,895,000	$ -	$ 35,710	$ 1,930,710
2008	1,980,000	-	37,590	2,017,590
2009	2,075,000	-	37,590	2,112,590
2010	2,165,000	-	37,591	2,202,591
2011	2,288,333	-	37,590	2,325,923
2012-2016	10,251,665	-	187,953	10,439,618
2017-2021	5,436,665	-	155,958	5,592,623
2022-2025	53,337	-	16,826	70,163
	$26,145,000	$ -	$ 546,808	$26,691,808

	Electric System	Box Canyon Production System	Water System	Combined Total as of 12/31/06
Interest				
2007	$ 1,184,952	$ -	$ 12,205	$ 1,197,157
2008	1,095,883	-	11,350	1,107,233
2009	1,001,860	-	10,494	1,012,354
2010	903,349	-	9,639	912,988
2011	799,449	-	8,784	808,233
2012-2016	2,276,327	-	31,075	2,307,402
2017-2021	235,306	-	9,679	244,985
2022-2025	-	-	393	393
	$ 7,497,126	$ -	$ 93,619	$ 7,590,745

During the years ended December 31, 2006 and 2005, the following changes occurred in the District's long-term debt:

	2005 Balance	Additions	Reductions	2006 Balance
Revenue bonds, face amount	$ 27,178,801	$ 35,717	$ 722,710	$ 26,491,808
Unamortized bond premium	662,020	-	122,030	539,990
Unamortized bond discount	(49,893)	-	(5,279)	(44,614)
Loss on refunding	(1,439,272)	-	(320,289)	(1,118,983)
Notes payable	200,000	-	-	200,000
Total Debt	$ 26,551,656	$ 35,717	$ 519,172	$ 26,068,201
Current Portion of Total Debt				1,930,710
Total Long-Term Debt				$ 24,137,491

	2004 Balance	Additions	Reductions	2005 Balance
Revenue bonds, face amount	$ 29,896,512	$ 18,670,000	$ 21,387,711	$ 27,178,801
Unamortized bond premium	-	671,814	9,794	662,020
Unamortized bond discount	(349,248)	-	(299,355)	(49,893)
Loss on refunding	-	(1,470,496)	(31,224)	(1,439,272)
Notes payable	-	200,000	-	200,000
Total Debt	$ 29,547,264	$ 18,071,318	$ 21,066,926	$ 26,551,656
Current Portion of Total Debt				673,710
Total Long-Term Debt				$ 25,877,946

NOTE 5. POWER PURCHASE CONTRACTUAL AGREEMENTS

Ponderay Newsprint Company

In July 1986, the Electric System entered into power sales contracts with Ponderay Newsprint Company to supply power to a fiber mill and paper plant. The District is obligated to provide all power necessary to operate both the fiber mill and paper plant. Power delivery under these contracts expires in 2027. In 2006, approximately 75% of Electric System retail energy deliveries and 63% of retail energy sale revenues were to Ponderay Newsprint Company.

To fulfill this power commitment, the District delivers power from the Box Canyon Project and acquires power at cost from the Boundary Project. The District's rights to acquire power at cost from the Boundary Project are provided for in Article 49 of Seattle City Light's Federal Energy Regulatory Commission license for the Boundary Project. Power is also obtained from the Bonneville Power Administration (BPA) and other suppliers under various power purchase contracts. The cost of all power purchases necessary to fulfill the requirements of the fiber mill and paper plant is charged to Ponderay Newsprint Company based upon the District's actual costs.

The Ponderay Newsprint Company has provided an irrevocable letter of credit for $10 million, which the District may draw upon in the event Ponderay Newsprint Company defaults in its obligations under the contracts. The District believes the letter of credit provides reasonable funds to cover the District's outstanding power purchase commitments and contractual obligations in the event of default by Ponderay Newsprint Company. However, future retail rates of the Electric System may be affected if the District were to no longer provide service to Ponderay Newsprint Company.

The rate impact from a loss of Ponderay Newsprint Company power sales cannot be accurately forecast and depends upon the interaction of many factors, including but not limited to, existing cost of production of Box Canyon Project power, cost of acquisition of Bonneville power, market or resale value of this power, and ability of the District to retain Boundary generation.

Seattle City Light

Boundary Hydroelectric Project

Seattle City Light possesses a FERC license, expiring August 1, 2011, to operate the Boundary Hydroelectric Project in northern Pend Oreille County. This license contains Article 49 granting the District a licensed share of the project, set at 48 MW capacity, with actual energy deliveries not to exceed the District's retail customer load requirements. The District agreed to aid Seattle City Light in the post-2011 relicensing of the Boundary Project. In exchange for District support,Seattle City Light agreed to extend the District's Article 49 rights forward into the new license period and to remove restrictions limiting power deliveries to District service territory load requirements.

The Boundary Project is located immediately downstream from the Box Canyon Project, and as such the reservoir level between Boundary and Box Canyon has a direct relation to the amount of power either Project can produce. Prior to August 2005, Seattle City Light delivered power to the District to replace lost generation from the impact of the Boundary Project on the Box Canyon Project. Seattle City Light and the District drafted a new Agreement for post-2005 providing the District a monthly payment in lieu of energy. The District is acquiring transmission capacity between the Boundary Project and District transmission facilities. Once delivery capacity is acquired, scheduled to occur by 2009, the District will receive energy deliveries rather than a cash payment. Payments received from City of Seattle in lieu of energy totaled $1,334,063 and $776,364 for the year ended December 31, 2006 and 2005, respectively.

Bonneville Power Administration

The District purchases power from the Bonneville Power Administration (BPA) under contracts which expire September 30, 2011. Through agreement with BPA, the District receives a Shaped Block Purchase under which the District will receive 1.8 average megawatts through September 30, 2011. Prior to August 1, 2005, the District received 12.7 average megawatts of Shaped Block Purchase. Block deliveries are fixed at a flat rate within each month, but predetermined at different levels each month so as to more closely follow anticipated seasonal load requirements.

Additionally, the District contracts for a Slice of the System under which the District accepts 0.3819% of the output of the base federal system and agrees to pay an equal share of costs as defined under the contract. Under provisions of the Slice contract, the District is subject to federal system generation risks and variability in quantity and cost of power delivered. Daily and monthly deliveries do not match District customer requirements and do not provide for future load growth. The overall contracted percent of Federal base system was set not to exceed forecasted District customer load requirements for the year 2002, based on critical (historically low) Pacific Northwest snow packs and hydrological river flows.

For the initial Slice contract year ended September 30, 2002 Slice customers exercised audit rights, indicating that Slice customers felt the year-end true-up bill did not follow contract specifications. Audit rights were also extended to the 2003, 2004, and 2005 year-end true-up calculations. In November of 2006, the Slice litigation was settled with its public agency customers. As a result of the litigation, the District received $443,283, including interest, for 2002-2005 Slice payments.

The District believes the risks and rewards associated with the Slice and Block product pass through to Ponderay Newsprint Company under the terms of the contracts with that customer.

Energy Northwest

The District is a participant in Energy Northwest's (formerly the Washington Public Power Supply System) Nuclear Projects Nos. 1 and 3, both of which have terminated. The District purchased from Energy Northwest, and assigned to BPA, 0.087% of the capability of Project No. 1 and 0.078% of Energy Northwest's 70% ownership share of Project No. 3. Under the agreements, the District is unconditionally obligated to pay Energy Northwest its pro rata share of the total costs of the projects, including debt service, even though the projects are terminated. Under the Net Billing Agreements, BPA is responsible for assuming the District's cost obligation. The District's Electric System revenue requirements are not directly affected by the associated costs; revenue requirements are affected only indirectly to the extent that the costs of the projects result in increases in BPA's wholesale power rates.

NOTE 6. RETIREMENT BENEFIT PLANS

Pension Plans

All full-time, as well as certain part-time, District employees participate in the statewide cost sharing, multiple employer Public Employees Retirement System (PERS). The Washington State Department of Retirement Systems (DRS) issues a publicly available financial report that includes financial statements and required supplementary information for PERS. This report may be found on the DRS web site, located at www.drs.wa.gov.

PERS provides both retirement and disability benefits, established by state statute, based on compensation and length of service. Plans 1 and 2 are defined benefit programs, Plan 3 is a combination defined benefit/defined contribution program. PERS participants joining the system by September 30, 1977 are Plan 1 members. Participants joining the system subsequently, but on or before August 31, 2002, are Plan 2 members unless they make a decision to transition from Plan 2 to Plan 3. Employees hired after August 31, 2002 will be in Plan 3, unless they make a decision to join Plan 2 within 90 days of hire.

Plan 1 employees vest after five years of eligible service and are eligible for retirement at any age after 30 years of service, or at the age of 60 with 5 years of service, or at the age of 55 with 25 years of service. The annual pension is 2% of the average final compensation (greatest compensation during any 24 consecutive eligible months) per year of service, capped at 60%. If qualified, after reaching the age of 66 a cost-of-living allowance is granted based on years of service credit and is capped at 3% annually.

Plan 2 employees vest after five years of eligible service and may retire at the age of 65 with 5 years of service, or at age 55 with 20 years of service. The retirement benefit is based on 2% of average final compensation, per year of service, based on any eligible consecutive 60-month period. Actuarially calculated early retirement penalties apply to all retirements prior to the age of 65, but are capped at 3% per year if age at retirement is 55 or older with 30 years of service credit. There is no cap on years of service credit and a cost-of-living allowance is granted, capped at 3% annually.

Plan 3 is a dual benefit structure. Plan 3 members may retire after ten years of service, or five years of service with at least one year after age 54, or five years of service in Plan 2 prior to June 1, 2003. Participant contributions finance a defined contribution component. Employer contributions finance a defined benefit component operating similar to Plan 2, but with the retirement benefit based on 1% of average final compensation per year of service. Early retirement penalty rules similar to Plan 2 apply on the defined benefit component.

Each biennium, the State Pension Funding Council adopts employer contribution rates for all three plans and employee contribution rates for Plan 2. Plan 1 employee contribution rates are set at 6% by State statute and do not vary. Plan 3 employee contribution rates vary from 5% to 15% and are individually set by each employee. The contribution rates shown below represent both District and employees' full liabilities under PERS.

	2006	2005	2004
Employee contribution %			
Plan 1	6.00%	6.00%	6.00%
Plan 2	2.25% - 3.50%	1.18% - 2.25%	1.18%
Plan 3	5.00% - 15.00%	5.00% - 15.00%	5.00% -15.00%
Employer contribution %			
Plan 1	2.44% - 3.69%	1.38% - 2.44%	1.38% - 1.40%
Plan 2	2.44% - 3.69%	1.38% - 2.44%	1.38% - 1.40%
Plan 3	2.44% - 3.69%	1.38% - 2.44%	1.38% - 1.40%
Contribution dollars			
Employee	$ 190,361	$ 129,340	$ 101,578
Employer	$ 161,868	$ 93,223	$ 63,012
Total	$ 352,229	$ 222,563	$ 164,590
PERS covered payroll	$5,257,975	$4,835,674	$4,523,112

Other Postemployment Benefits

The District provides reimbursement for healthcare insurance premiums for retired employees. Beginning August 1, 2005, retiring employees who chose to continue medical coverage under the District's plan became eligible to receive $10 per year of service per month toward postemployment medical premiums. The reimbursement begins at the later of the month of retirement or at age 60 and expires when the retiree reaches age 65. The dollar value of the reimbursement is $9 for employees retiring between August 1, 2006 and July 31, 2007, and will decrease $1 each year until it expires on August 1, 2015. The District recorded a liability and equal expense of $102,495 for these payments as of December 31, 2005. The estimated liability for this benefit as of December 31, 2006 is $87,209. There is no past service cost to be realized in future years as would be calculated under GASB Statement No. 45; all related past service costs are accrued as of December 31, 2006.

The District also allows retirees to continue to contribute to life insurance premiums established during employment. Employees retiring after November 1, 2003 pay the full life insurance premium cost. The District currently has 7 former employees that retired before November 2003 and continue to pay the premium in effect at that date. These retirees will continue to pay a reduced rate until December 31, 2010, at which time they will begin to pay the full rate. Because the District currently pays the remainder of the premium for these former employees, this amount is as a liability and expense for the estimated future payments for the District's portion of the premium was recorded for the year ended December 31, 2006 in the amount of $18,060.

Savings Plans

In addition to PERS, the District maintains a deferred compensation plan, as well as two defined contribution plans, in accordance with the Internal Revenue Code, Sections 457 and 401(a), respectively. All District employees are eligible to participate in the 457 plan and one of the two available 401(a) plans. The 401(a) plans provide for an employer match of 50% of eligible employee deferral of employee straight-time wages, capped at 7.32% less the required PERS Plan 2 employer contribution percentage net of administrative fees, which is subject to a lock of a 2% cap under certain circumstances. These circumstances were met in 2006 and the cap will remain locked at 2% for future years. Employer contributions for 2006 and 2005 were $134,320 and $186,482, respectively. All plan assets have been placed into trusts for the exclusive benefit of plan participants and their beneficiaries and are, therefore, not reflected in these balance sheets.

The District maintains a Health Reimbursement Arrangement for employees. Non-bargaining unit employees receive 3.5% of employee base wages paid into individual employer sponsored medical savings accounts to pay for eligible medical expenses, tax-free, whether incurred while employed or after retirement. Bargaining unit employees are eligible for up to 1.5% of employee base wage contributions.

NOTE 7. SELF-INSURANCE

Public Utility Risk Management Services

The District, along with seventeen other public utility districts and one joint operating agency, is a member of the Public Utility Risk Management Services self-insurance fund. The program provides members with various liability, property, and health insurance coverages in three separate pools.

The District is a participant in the liability pool, which maintains a self-insured retention level of $1 million, funded reserves ranging from $1.5 million to $2 million, and individual member deductibles of $250. The liability pool provides the District with shared excess coverage of $60 million general liability, $10 million professional liability, and $10 million per occurrence Directors & Officers liability.

The District is also a participant in the property pool, which maintains a self-insured retention level of $250,000, funded reserves ranging from $500,000 to $750,000, and varying deductibles of $250 on most property and $75,000 on the Box Canyon, Sullivan, and Calispel Hydroelectric Projects. The property pool provides the District with $175 million shared excess coverage, attaching at the self-insured retention level for all property risks excepting flood and earthquake, which attach at 2% of total insured value. Any gap between the self-insured level and excess insurance is funded half by the property pool and half by the affected member.

As a member, the District is subject to assessments based on claims submitted by all members. The following assessments were charged during the years ended December 31:

	Liability		Property	
	2006	2005	2006	2005
Electric System	$ 75,272	$ 68,864	$ 25,608	$ 24,375
Box Canyon Production System	29,541	24,047	144,150	138,962
Water System	4,597	4,195	3,147	2,811
Total	$109,410	$ 97,106	$172,905	$166,148

Central Washington Public Utilities

The District, with six other public utility districts, is a member of the Central Washington Public Utilities Unified Insurance Program and Trust, which is a self-insurance program providing medical, dental, life insurance, disability insurance, and similar benefits to member employees and families. Formed by Interlocal Agreement under Revised Code of Washington chapter 39.34, the Trust is administered by a Board of Trustees comprised of an appointed Trustee from each of the seven member districts. Further information may be obtained by contacting the District's financial department as set forth on the last page of this Annual Report under Organizational Information—Corporate Office.

NOTE 8. COMMITMENTS AND CONTINGENCIES

Box Canyon Project License

The Federal Energy Regulatory Commission issued a 50 year license for the District's Box Canyon Hydroelectric Project on July 11, 2005. The District is now in the process of implementing the conditions of the license which include environmental studies and projects initiated by state and federal agencies and the Kalispel Tribe of Indians. All projects and studies are related to Box Canyon Dam and the reservoir behind it and include the protection, mitigation, and enhancement of fish, wildlife, recreation, erosion, and cultural preservation. The license projects can be categorized as either capital, District directed, or Non-District directed expenses. Capital projects include fish bypass and turbine replacement and will be capitalized as construction on these projects is completed. Non-District directed expenses include direct payments to agencies or escrow accounts that are used at the discretion of the receiving party. These costs have been estimated over the life of the license and have been recorded as a deferred asset and liability as described in Note 1. All remaining costs are either performed by District staff or contracted at the District's discretion and will be expensed as incurred.

The District is currently contesting some of the license provisions concerning fish passage and total dissolved gas, which are projects that are scheduled to begin subsequent to 2007. Decisions concerning these issues may have a significant impact on future costs. The District is currently negotiating a contract to construct new turbines for Box Canyon Dam as part of license requirements, with the intent to begin construction of the turbines in early 2008. Final costs for these projects may deviate greatly from current estimates.

The new license includes language authorizing the District to use lands in the Kalispel Indian Reservation. An amendment to the previous FERC license established payments for use of this land. Under the new license, the Kalispel Tribe and District may agree on and submit a new payment schedule to FERC; until this schedule is approved, the District will make payments under the old rental agreement. Payments to the Department of Interior on behalf of the Kalispel Tribe for use of this land were $155,107 and $149,984 for 2006 and 2005, respectively.

Sullivan Creek Project

The Electric System's Sullivan Creek Project is currently licensed for water storage only. In 1992, the District began a process of pursuing a FERC license amendment to rebuild the plant into a 12-megawatt hydroelectric generation facility. In 2002, the District withdrew its license amendment application from FERC. The project is not currently thought to be economically feasible within the in-stream flow operating criteria imposed by the Washington State Department of Ecology (Ecology) and the United States Forest Service (USFS).

The project's 50-year FERC license No. 2225 expires September 2008. In 2003, the District notified FERC of an intent to not relicense the project.

There is substantial uncertainty regarding the potential environmental liability surrounding the Sullivan Creek Project. The District has recorded an estimated environmental liability of $750,000 as of December 31, 2006. There are no deferred licensing costs associated with this project; license-related costs incurred during the remaining term of the license will be expensed as incurred. Asset values of $1,307,496 as of December 31, 2006, are being depreciated over the remaining life of the license on a straight-line basis resulting in depreciation charges of $180,771 in 2006 and 2005.

Rental Agreement

In 1997, the District entered into a rental agreement with the Pend Oreille County Port District for use of their railroad right-of-way related to a 115 kV transmission line project. Under this agreement, the District agreed to pay a consumer price index adjusted $125,000 per year, for a twenty-year period commencing January 1, 1997, subject to termination by the District with a year's notice. The District paid $159,640 and $154,391 under the terms of this agreement for rental for 2006 and 2005, respectively.

Power Purchase Contracts

See Note 5 previous relating to power purchase commitments.

NoaNet

The District is committed to repay its ownership share of NoaNet Revenue Bonds and participate in future assessments as described in Note 10.

Other Contingencies

The District is subject to various claims, possible legal actions, and other matters arising out of the normal course of business. When it is possible to make a reasonable estimate of the District's liability with respect to probable claims, an appropriate provision is made. Although the ultimate outcome of litigation against the District cannot be determined, management intends to continually defend all claims against the District and believes the District is adequately reserved for all known events.

NOTE 9. GRANTS

Federal Emergency Management Agency (FEMA) -

In January 2006 and again in December 2006, the District sustained damage due to area storms. These storms were declared by the federal government as natural disasters and the District applied for reimbursement from FEMA for labor and supplies expenses. Total grant revenue received from FEMA for the January storm totaled $27,848. The estimated receivable from FEMA for the December storm is $50,000 and is included as grant revenue for 2006.

Washington State Department of Ecology Emergency Drought Project

In August 2005, the Washington State Department of Ecology awarded the District a grant of $158,000 through the Drought Preparedness Account to provide capital improvements for the Riverbend, Greenridge, and Lazy Acres Subdivisions of the Water System. Capital improvements include an intake structure and increased storage for the Riverbend Subdivision and new wells for the Greenridge and Lazy Acres Subdivisions. In October 2005, the grant amount was increased to $203,875.

Community Economic Revitalization Board Financial Aid

In February 2005, the District received final approval for a Community Economic Revitalization Board grant and loan package associated with certain Community Network System telecommunication projects as discussed in Note 10 below.

NOTE 10. BROADBAND SERVICES

Community Network System

The District owns a fiber optic backbone extending from Spokane north past Metaline Falls and includes fiber into all District substations. The District built this system primarily for Electric System operation and control, but allows others to use the system and thereby help local residents and businesses as well as develop revenues to offset infrastructure costs.

In 2001, the District authorized use of the name Community Network System (CN System) for the purpose of facilitating access to, and use of, the District's Electric System broadband communication network for the benefit of the people of Pend Oreille County. CN System operations are conducted in accordance with state wholesale laws, which authorize the

District to build infrastructure and enable open-access use of that infrastructure to Internet Service Providers and entities authorized to provide retail telecommunications services within the State of Washington, who may then, in turn, provide retail services to customers.

As of December 31, 2006 and 2005, the District communications infrastructure investment totals $5,469,822 and $4,869,868, respectively; the majority of which would have occurred if the District had built the system solely for its own internal use.

CN System revenues and expenditures are as shown below; this information includes most operating costs, including member contributions to NoaNet as discussed below, but do not reflect internal Electric System reallocations for use of poles and rights-of-way or office rent associated with space used by the District's four CN System employees.

	2006	2005
Wholesale operating revenues		
Services to authorized retail providers	$ 264,231	$ 244,404
Services to Internet service providers	86,745	90,920
Services to District	58,800	58,800
Fiber leasing	85,898	84,348
Service & other	2,100	2,600
Operating expenditures		
Operations, excluding depreciation	218,525	204,923
Maintenance	105,641	95,400
NoaNet equity contributions	120,136	120,200
General and administrative	24,093	20,121
Capital spending, net of contributed capital and Grant revenue	117,526	234,889
Net spending	$ 88,147	$ 194,461

Community Economic Revitalization Board Financial Aid

In February 2005, the Community Economic Revitalization Board (CERB) awarded the District a Conditional Initial Offer of Financial Aid relating to construction of a communications tower, completion of fiber optic connectivity to the Kalispel Tribe Commerce Park, and certain other communication infrastructure projects within Pend Oreille County. The various community projects will be financed with a $265,000 grant, a $200,000 no interest, 20-year loan from the CERB, $207,000 from the District, and $50,000 from the Pend Oreille County Economic Development Revolving Fund (Note 2). $78,289 in grant revenue was recorded for this project for the year ended December 31, 2005, and $12,343 was expended for the year ended December 31, 2006.

Northwest Open Access Network

The District, along with 11 other Washington public utility districts and Energy Northwest, is a member of the Northwest Open Access Network (NoaNet), a Washington non-profit mutual corporation. NoaNet utilizes a high-speed fiber optic transmission system, largely located within Washington State, to provide Ethernet and other advanced telecommunications services on a wholesale basis to its members and retail telecommunications companies. NoaNet has first right-of-refusal to lease four strands, designated as public purpose, from fiber optic lines the Bonneville Power Administration installs on transmission lines.

NoaNet members have guaranteed a $27 million revenue bond issuance, which accrues interest at rates varying from 5.05% to 7.09% and matures in annual and sinking fund installments through December 2016. The District's 3.91% guarantee share of the $21,675,000 outstanding as of December 31, 2006 is $847,493 with a maximum exposure of $1,059,366 in the event other members fail to honor their guarantees. In January 2003, NoaNet supplemented this financing with a $5 million line of credit, restricted to use for capital purposes. NoaNet pledged future assessments, if necessary, to repay the $5 million line of credit, of which the District would be responsible for its then-current ownership share. As of December 31, 2006, NoaNet has drawn $2 million on the line-of-credit with $1,000,000 remaining outstanding. An additional $5 million line of credit was approved in June 2006. NoaNet pledged future assessments, if necessary, to repay this line of credit as well. $4.5 million had been withdrawn as of December 31, 2006.

As of December 31, 2006, the District's ownership interest in NoaNet is 3.94%. In 2005, NoaNet incurred a net loss from operations of $3,074,311, offset by member contributions of $3,864,897, resulting in an accumulated members' equity deficit as of December 31, 2005 of $15,267,001. In 2006, members contributed an additional $3,072,550 to finance NoaNet's net operating loss of approximately $2.0 million (unaudited).

Under generally accepted accounting principles, the District's Electric System reports no investment or liability account balance reflecting NoaNet membership. The District's share of assessments and related contributions to NoaNet of $120,136 and $120,201 in 2006 and 2005, respectively, has been expensed as incurred.

A NoaNet annual report may be obtained by writing to Northwest Open Access Network, 3511 Norfolk Court, Olympia, WA 98501. A web site is available at www.noanet.net.