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

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Table Of Contents

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

Credit Profile		
Chelan County Public Utility District #1 con sys		
Long Term Rating	AA/Stable	Affirmed
Chelan Cnty Pub Util Dist #1 (Chelan Hydroelec Cons Sys) jr lien		
Long Term Rating	AA/Stable	Affirmed
Chelan Cnty Pub Util Dist #1 cons sys rev		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services has affirmed its 'AA' rating on Chelan County Public Utility District No. 1, Wash.'s consolidated system revenue senior and subordinate bonds. The district's net revenue pledge secures the bonds. The outlook is stable.

The affirmation reflects our view of Chelan's strong business profile in its consolidated system, which includes its electric, water, and wastewater utility; telecommunications unit; and the Lake Chelan hydroelectric project.

In our opinion, key credit strengths include:

- Chelan's extremely low rates, which are among the lowest in the country at about one-quarter the national average;
- Very low operating costs, in our view, which arise from strong hydroelectric generating assets totaling almost 2,000 megawatts (MW); and
- Good financial management and planning, resulting in a very strong cash position, with more than one year's expenditures held in cash, historically and projected.

In our view, offsetting factors include exposure to variable hydrology, which can affect net wholesale revenues, as happened most recently in 2009 and 2010. The consolidated system is the ultimate obligor for the district's utility systems and hydroelectric projects issuing debt through the consolidated system's bond resolution. The resolution that created the operating lien effectively closed what had been the senior lien. In addition, under the subordinate operating lien resolution, bond protections have improved slightly. Consequently, Standard & Poor's does not distinguish between the two liens.

Supporting Chelan's strong business risk profile ('3' on Standard & Poor's scale from '1' to '10', with '1' the strongest) are the district's rate-setting ability, extremely low-cost power supply, moderate asset and resource concentration, and a low degree of merchant risk-related nonfirm surplus sales. Its low-cost power supply comes from its three hydroelectric plants, which management estimates produced power at an average $15 per megawatt-hour in 2012. District officials project the cost to maintain its competitive advantage in the region, assuming average hydrological conditions. Furthermore, given the size of the district's resources compared to its native load demand, Chelan has surplus power under almost all hydrological conditions. Profits from surplus power sales contribute to the district's very low retail rates.

Chelan sells far more power to contractual off-takers and the wholesale market than to its own retail system. The district's distribution system takes 48% of the aggregate output from its Lake Chelan (59 MW), Rocky Reach (1,300 MW), and Rock Island (629 MW) projects and sells 51% of the output from Rocky Reach and Rock Island to two counterparties in the region through long-term, take-or-pay contracts that expire in 2028 and 2031. Its distribution system has surplus capacity in nearly all months, even under very low water conditions. The district's long-term financial plan includes hedging a sizable portion of its hydrology risk by annually selling slices of its system by auction to various counterparties for up to five years on a rolling basis. We believe this strategy will reduce the negative impacts of low stream flows.

Debt service coverage (DSC) ratios at the consolidated system were low, in our view, at about 1.25x in fiscal years 2009 and 2010, due mainly to declines in off-system sales revenue. Consolidated DSC is sensitive to wholesale sales, including spot market sales not made under long-term contracts. In fiscal years 2009 and 2010, below-average stream flows, combined with low market power prices, led to the lower DSC levels. Improved hydrology and budget adjustments to both revenue and expenditures contributed to much stronger coverage in 2011 (1.6x) and, according to unaudited figures, 1.9x for fiscal 2012 (year ended Dec. 31). Despite a 2.5% rate increase in 2012, the overall retail rate declined 6.5% in 2012 without the surcharge, which was in place for 32 months during fiscal years 2009-2011. The revenue enhancements in the past three fiscal years were in conjunction with other measures management has implemented, including deferring some capital expenditures, unpaid furloughs, wage increase give-backs for executives, and a hiring freeze. In our view, management's responsiveness, when combined with its very strong cash reserves, offset declines in wholesale sales revenues. In addition, with the provisions of two long-term contracts that took effect in 2011 and 2012, and the increased share available for market sales benefiting the consolidated system, a portion of which has been sold via a series of medium-term contracts on a rolling five year basis, we believe the district has hedged a significant portion of its volume and price risk.

Chelan's capital improvement plan for 2012-2016 averages $47 million in annual spending, which is about 25% lower than the previous five-year period. Capital projects planned include distribution, generation, and fiber optic systems. Management expects to fund the plan from available funds, without issuing additional debt. Furthermore, with scheduled maturities and cash defeasances, management's forecasts indicates a significant reduction its debt balances, dropping to about $657 million by 2016 from $923 million currently.

Outlook

The stable outlook reflects our assessment of Chelan's strong financial policies regarding DSC and liquidity, as well as its low-cost power supply. The outlook also reflects our expectation that management's will continue to enact budget measures to counter any revenue shortfalls that would occur in its wholesale operations, to achieve its targeted liquidity levels. We do not expect to raise or lower the rating during our two-year outlook period.

Debt and Utility Structure

As of Sept. 30, 2012, Chelan had $644 million in hydroelectric consolidated system debt and $280 million in project debt at its Rocky Reach and Rock Island hydroelectric projects, although hydroelectric project off-takers under take-or-pay, cost-of-service contracts service more than half of this. The rates and charges of the retail utilities, as well as certain intersystem loan payments from the district's three large hydroelectric systems, secures the consolidated system bonds.

Established in 1936, Chelan owns and operates an electric distribution system, a telecommunications system, three major hydroelectric power generating projects (Rocky Reach, Rock Island, and Lake Chelan), and a small water and wastewater system. The district issues debt primarily through its consolidated systems bond resolution, a financing vehicle created in 1987, for issuing tax-exempt debt on behalf of both the retail utilities and the hydroelectric projects from which it gets most of its power. In 2007, it rescinded the consolidation of the Rocky Reach and Rock Island projects to preserve the flexibility in hydroelectric project financing arrangements.

Bond Provisions

We believe DSC levels for the rate covenant and additional bonds test contained in the bond provisions for consolidated system revenue bonds are weak overall. The senior consolidated system resolution, however, is effectively closed by a new resolution, under which the district has issued bonds since 2007.The newer resolution has different bond provisions that make some improvements from a credit perspective. These improvements include the addition of flow-of-funds provisions and a rate stabilization fund, as well as tighter language on the additional bonds test and rate covenants. The rate covenant for the consolidated system bonds requires Chelan to collect revenue that provides annual revenues, together with other unencumbered district funds, sufficient to pay operating expenses of the consolidated system and cover debt service 1.25x. In addition, distribution system net revenues alone must meet a DSC test of 1x for senior bonds, while the subordinate-lien test allows the use of rate-stabilization funds. The district maintains a debt service reserve for the consolidated system senior- and junior-lien bonds in the amount of maximum annual interest payable in any year.

Related Criteria And Research

USPF Criteria: Electric Utility Ratings, June 15, 2007

Ratings Detail (As Of February 19, 2013)		
Chelan County Public Utility District #1 cons sys ser 2008B		
Long Term Rating	AA/A-1+/Stable	Affirmed
Chelan Cnty Pub Util Dist #1 (Chelan Hydroelec Cons Sys) cons sys rev		
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Many issues are enhanced by bond insurance.