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Rating Update: Moody's maintains Aa3 on Chelan County Public Util. Dist 1, WA's revenues bonds. Outlook is stable.

Global Credit Research - 05 Feb 2015

Approximately $725 million of debt securities outstanding

CHELAN COUNTY PUBLIC UTILITY DISTRICT 1, WA
Electric Distribution and Generation
WA

NEW YORK, February 05, 2015 --Moody's Investors Service is maintaining its Aa3 rating on Chelan County Public Util. Dist 1, WA (Chelan PUD) revenue bonds consisting of the Consolidated System, Chelan Hydro Consolidated, Rock Island, and Rocky Reach revenue bonds. The rating outlook is stable.

SUMMARY RATING RATIONALE

Chelan PUD's Aa3 rating is supported by district's highly competitive hydro generation, strong liquidity position, low retail rates, and long-term contracts for more than 50% of Rocky Reach and Rock Island's output. Additionally, Chelan PUD's ratings are supported by the district's targeted debt reduction to less than $400 million by 2019, forecasted maintenance of strong internal liquidity of 400 to 500 days cash on hand, expected debt service coverage ratios (DSCR) around 2.0 times or higher on average, and the district's continuation of strong risk management since 2010.

The rating also considers the district's considerable long-term exposure to wholesale power prices and hydrology risk, the district's reliance on non-retail revenue to subsidize its retail business, and counterparty concentration with significantly lower rated entities.

Outlook

The stable outlook considers the district's forecast of high liquidity, an expected debt service ratio around 2.0x or higher on average, significant deleveraging over time, and the continuation of its risk management policies including hedging.

What Could Change the Rating - UP

Factors that could improve the district's rating including achievement of substantial debt reduction, maintenance of high liquidity, execution of long term contracts with highly rated counterparties, greater diversification of counterparty credit risk, and increase in DSCR comfortably above 3x on a sustained basis.

What Could Change the Rating - DOWN

Chelan PUD's rating could be downgraded if the district is unable to maintain high liquidity levels and sustain debt service coverage around 2.0x on average. The district's rating could also be negatively affected if the district weakens its risk management approach, incurs major operational problems or is unable to reduce leverage according to expectations.

DETAILED CREDIT DISCUSSION

Chelan PUD operates a utility system that primarily generates and delivers electricity to approximately 48,900 retail customers in Chelan county (not rated), which is located in the central part of Washington state. The district also provides wholesale fiber-optic services, water services, waste water services and generates electricity for sale under either long-term contracts or on a wholesale basis. The district's 2,994 square mile service area is primarily rural and has a population of approximately 74,000 (2013). The major economic activities in the Chelan/Douglas county area are agriculture, agriculture related industries, healthcare, education and manufacturing. The local economy has improved with unemployment averaging 6.3% (preliminary) for 2014 that was an improvement over 7.3% for 2013.

Chelan PUD benefits from ownership of three hydroelectric plants totaling 1,988 MW of capacity. The largest hydro plant is the 1,300 MW Rocky Reach facility followed by the 629 MW Rock Island plant and lastly the 59 MW Lake Chelan plant. The district sells approximately 51% of the combined output of the Rocky Reach and Rock Island plants to Puget Sound Energy, Inc. (PSE: Baa1, stable) and Alcoa Inc (Alcoa: Ba1, stable) under long-term contracts that have take or pay type features. Douglas County Public Utility District 1, WA (Douglas PUD: Aa3, stable) also takes 5.54% of Rocky Reach's output under long-term contract.

The district's governing body is comprised of a five member independent board of commissioners who are elected under staggered four and six year terms. The next election is in 2016 for two commissioner positions.

LEGAL SECURITY:

The Chelan Hydro Consolidated (CHC) System bonds are secured by a senior lien on the net revenues of the CHC system that includes the net revenues of the Electric Distribution System, Lake Chelan Hydro project, Water System and Waste Water System. The CHC system bonds also benefit from a pledge of payments of interest and principal on affiliate debt loaned to Rock Island and Rocky Reach. The rate covenant requires 1.0 times coverage based on CHC's net revenues and 1.15 times coverage including other available funds. Each bond series has its own segregated reserve size to maximum annual interest. CHC lien is now closed and the last of these bonds are expected to be paid off in 2015.

The Consolidated System System (Consolidated System) revenue bonds are secured by a second lien on the net revenues of the Consolidated System, which consists of the same net revenues sources as the CHC system plus the Fiber Optic system. The Consolidated System revenue bonds are subordinate to the senior lien of the CHC System revenue bonds and represent Chelan PUD's primary debt issuing lien. The rate covenant and additional bonds test is 1.00 times based net revenue and 1.25 times including other available funds, respectively. The Consolidated System revenue bonds have a cash funded debt service reserve equal to maximum annual interest.

The Rock Island revenue bonds are secured by a pledge of Rock Island net system revenues. The 2009A series are subordinate to the prior Rock Island bonds, which are closed to new debt issuances but represent nearly all of the debt. The revenue from the sale of output from Rock Island can be commingled with the output from the other electric utility systems of the district. The rate covenant requires 1.0 times coverage and there is no additional bonds test. The debt service reserve requirement is sized to maximum annual interest and is cash funded.

The Rocky Reach System revenue bonds are secured by a pledge of revenues. Pledged revenues include all revenues, rates and charges from the district's operation of the Rocky Reach system; the rate covenant requires a 1.0 times coverage test and each bond series has a cash funded debt service reserve requirement sized to maximum annual interest.

An unusual provision in the 2008 Rock Island and Rocky Reach master resolutions for the 2009 bond series require the Distribution System to pay for its share of the costs only if Rock Island or Rocky Reach provides power. Moody's views this as a weakness though it does not have an impact at this time given the large amount of subordinated affiliate debt and the relatively small amount of debt affected totaling only $14 million at Rocky Reach's debt as of year-end 2014.

INTEREST RATE DERIVATIVES:

None. The district terminated its last three interest rate swaps in 2013 and paid a $15.9 million termination fee.

RATING FACTORS

LOW COST HYDRO SYSTEM LEADS TO VERY LOW RETAIL RATES

A key fundamental credit support factor for the district is Chelan PUD's 1,988 MW low cost hydro system, which reached commercial operations from 1920 to 1970 depending on the unit. The plants have operated well in most years although in March 2013, Chelan PUD discovered a turbine problem at the 1,300 MW Rocky Reach plant that affects four turbines. The district has made interim repairs that allowed the turbines to resume operations in April 2014 and Chelan PUD expects to start permanent repairs in 2015 on a staggered basis. We view the total estimated cost to repair at around $45 million as being manageable before potential insurance recovery and cost sharing with the long term offtakers.

Even with these unexpected outages, the district's overall cost of power remains extremely low at a weighted average cost around $16.4/MWh in 2013 and contributes to very low retail rates that are less than half of the

Washington state average. The low rates have led to increased inquiries by large load customers consisting primarily of data centers resulting in the district placing a temporary moratorium on new large load customers starting in December 2014. We currently incorporate the assumption that Chelan PUD will develop a new policy on large new load customers that will fit with its recently approved financial targets.

In addition to price competitiveness, the district's hydro facilities enjoy environmental benefits since they do not emit greenhouse gases or other major emissions. Thus, the district is likely to benefit over time from more stringent emissions regulations. That said, the district remains exposed to environmental regulations affecting threatened and endangered fish similar to other hydro generator owners in the region. Chelan PUD has a comprehensive Habitat Conservation Plan (HCP) to manage its environmental exposures at both Rocky Reach and Rock Island. The district has already spent substantial capital on a fish by-pass system and continues to expend ongoing funds on fish related environmental costs including the fish hatcheries and fish monitoring.

LONG TERM TAKE OR PAY TYPE CONTRACTS COVER ROUGHLY HALF OF HYDRO SYSTEM'S OUTPUT

Chelan PUD sells 51% of the power output from the combined Rocky Reach and Rock Island plants under long-term, take or pay 'plus' contracts to PSE (25% of allocated capacity) and Alcoa (26% of allocated capacity). The district also sells 5.54% of Rocky Reach's output to Douglas PUD. PSE and Alcoa's contracts mature in 2031 and 2028 while Douglas PUD's contract matures in 2021 with four 10-year extension options. Under the PSE and Alcoa contracts, the off-takers are responsible for its proportionate share of operation and maintenance, assumed debt service payments, and other costs. Chelan PUD can also implement credit, administrative, debt reduction, and capital recovery charges. The latter two charges can be used to reduce debt or pay for capital expenditures. Chelan PUD has decided to charge the maximum debt reduction and capital recovery charge allowed under the contract, which we view as credit supportive. That said, the Alcoa and PSE's payments related to their share of debt service at Rocky Reach and Rock Island follow an assumed debt amortization schedule, which can be different than the actual debt amortization at the two hydro plants. An additional consideration is the reliance on cash flows and revenues from Alcoa (nearly 20% of consolidated revenues) whose rating is below investment grade. Partially offsetting this risk are Chelan PUD's very competitive prices charged for the capacity and energy and posted collateral totaling around $93.8 million as of December 2014.

The remaining 48% of the output is retained by the district and Chelan PUD sells a substantial amount of power into the wholesale energy market.

THE DISTRICT HAS SIGNIFICANT RELIANCE ON PROFITS FROM VOLATILE WHOLESALE MARKET REVENUES

Chelan PUD's share of three hydroelectric projects are sufficient for the district to meet its electric system load requirements under almost all conditions, including the 2000-2001 energy crisis. That said, Chelan PUD has substantial excess power sales and the district significantly relies on wholesale energy sales to mainly subsidize the district's electric distribution system. Chelan PUD's share of the hydro plant's output is a net 48% and under average hydrology, Chelan PUD expects to sell approximately 332 aMW of surplus power in 2015 compared to roughly 193 aMW sold to its retail customers. Wholesale power sales represent over 45% of total operating revenues in 2013 and we consider the district's large wholesale revenue exposure as a credit weakness especially given the high hydro and power price volatility. For example, the power prices fell steeply to below $20/MWh in 2012 compared to nearly $60/MWh in 2007 while regional hydrology has ranged from around 60% to 130% of average since 2000.

Since 2009, Chelan PUD developed and implemented a robust risk management plan to manage wholesale and hydrology exposure described below.

STRONG RISK MANAGEMENT AND FINANCIAL POLICIES REDUCE WHOLESALE REVENUE VOLATILITY AND CONTRIBUTES TO IMPROVED FINANCIAL PERFORMANCE

Chelan PUD's strong risk management program and financial policies implemented since 2009 have resulted in lower revenue volatility and improved financial performance. The district's power hedges consist of firm energy sales and 'slice' auctions of the district's hydro system output on a rolling forward basis. The district's seeks to have less than 5% of the total hydro output completely exposed to price and hydro volatility in the prompt year. While firm energy sales only transfers price risk, 'slice' sales transfer operational, hydrology and price risk to the counterparty resulting in greater cash flow certainty. The district has generally exceeded its minimum hedging objectives and Moody's expects Chelan PUD will continue to hedge through a combination of block and slice products on a rolling basis to ensure greater revenue stability. The extensive hedging has resulted in some counterparty concentration although we derive some comfort from Chelan PUD's monitoring and counterparty collateral posting requirements.

The district's policies and actions also have resulted in continued strong liquidity position, improved consolidated debt service coverage (DSCR) and leverage. Over the last three years, Chelan PUD has typically maintained over 500 days cash on hand and looking forward, we expect 400-500 days cash on hand, which is supported by Chelan's PUD's policy of maintaining minimum $175 million of liquidity of which $150 million consists of unrestricted cash and investments. In addition to liquidity, Chelan PUD's DSCR improved to around 1.90x and 2.2x in 2012 and 2013, respectively compared to around 1.0x in 2010. We estimate 2014's DSCR at over 2.0x excluding bullet maturities and around 1.3x including the bullet maturities. Looking forward, we expect an average DSCR around 2.0 times or higher excluding further optional debt repayments by the district and Chelan PUD's strong cash flow generation should allow the district to internally fund capital expenditures and reduce debt. Chelan PUD has already reduced debt to $725 million at year-end 2014 compared to almost $1.1 billion in 2009. Looking forward, the district expects debt to further reduce to $382 million outstanding by 2019. The overall expected improvement in the financial profile is one of the key factors that supports the district's Aa3 rating compared to the indicated A2 rating under the public power with generation ownership methodology.

HISTORICAL WILLINGESS TO RAISE RATES IS VIEWED AS WEAKER THAN PEERS

While the district's rate process is not regulated by the state regulatory board, Chelan PUD has showed a limited willingness to use its authority to raise retail rates to maintain its financial condition in the past. In April 2009, Chelan PUD elected commissioners approved a temporary 12-month increase in rates by only 9% compared to the 18% rate increase recommended by management and the 38% increase necessary to ensure 'pay as you go' for the retail electric business. The rate increase was necessitated by lower than expected wholesale revenue and lower than expected interest income. Since April 2009, the district has taken extensive efforts to improve communications with its customers and the district's commissioners leading to smoother subsequent rate actions. For example, the 9% rate surcharge was extended through 2011 while the district implemented 5% to 9% rate increase for its water, wastewater, and fiber systems from 2010 through 2014 albeit no net increase for the electric system.

KEY STATISTICS:

Total Restricted and Unrestricted Cash and Investments, 2013: $421 million

Total net MWh produced, 2013: 9.5 million

Aggregate Hydro Capacity (Nameplate): 1,988 MW

Chelan Senior Consolidated System 2013 Debt Service Coverage (per resolution without available funds): 56 times

Subordinate Consolidated System 2013 Debt Service Coverage (per resolution without available funds): 2.9 times

Rock Island System 2013 Debt Service Coverage (per resolution): 1.95 times

Rocky Reach System 2013 Debt Service Coverage (per resolution): 7.16 times

Consolidated Debt Service Coverage Ratio, 2013 (Moody's): 2.2 times

Debt Ratio, 2013: 60%

Days Cash on Hand, 2013: 543

Average Retail Rate, 2013: 3.2 cents/kwh

DEBT STATEMENT AS OF December 31, 2013

Rock Island System Revenue Bonds $252 million

Rocky Reach System Revenue Bonds: $16 million

Chelan Hydro Consolidated System Revenue Bonds: $25 million

Consolidated System Revenue Bonds: $484 million

Consolidated System Revenue Notes: $29 million

OTHER CONSIDERATIONS

Moody's evaluates Chelan PUD under the US Public Power Electric Utilities with Generation Ownership Exposure methodology, and, as depicted below, the grid indicated rating is A2, which is two notches lower than the its Aa3 rating. Chelan PUD's high liquidity position, strong risk management, and expected improvement in financial profile over time are factors that support the Aa3 assigned rating.

The grid is a reference tool that can be used to approximate credit profiles for public power with generation ownership in most cases. However, the grid is a summary that does not include every rating consideration. Please see US Public Power Electric Utilities with Generation Ownership Exposure for more information about the limitations inherent to grids.

Public Power Rating Methodology Factors

1 Cost Recovery Framework (25% weight): (A)

2. Willingness to Recover Costs and Maintain Sound Financial Metrics (25% weight): (A)

3. Management of Generation Risk (10% weight): (A)

4. Rate Competitiveness (10% weight): (Aaa)

5. Financial Strength:

Sub factor a) Adjusted Days Liquidity on Hand (10% weight): (564 3-yr avg) (Aaa)

Sub factor b) Debt Ratio (10% weight): (65% 3-yr avg) (A)

Sub factor c) Adjusted Debt Service Coverage (10% weight): (1.86x 3-yr avg) (A)

Grid Indicated Rating: A2

Notching:

Merchant Exposure: -0.5

Scorecard Indicated Rating: A2

The principal methodology used in this rating was U.S. Public Power Electric Utilities with Generation Ownership Exposure published in November 2011. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

Please see Moody's Rating Symbols and Definitions on the Rating Process page on www.moodys.com for further information on the meaning of each rating category and the definition of default and recovery.

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