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

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Credit Profile		
US$122.3 mil cons sys rfdg bnds ser 2011A due 07/01/2026		
Long Term Rating	AA/Stable	New
US$78.4 mil cons sys rfdg bnds ser 2011B due 07/01/2026		
Long Term Rating	AA/Stable	New
Chelan County Public Utility District #1 con sys		
Long Term Rating	AA/Stable	Affirmed
Chelan Cnty Pub Util Dist #1 (Chelan Hydroelec Cons Sys) cons sys rev		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services has assigned its 'AA' long-term rating to Chelan County Public Utility District No. 1 (Chelan or the district), Wash.'s consolidated system revenue bonds, series 2011 A and B. At the same time, Standard & Poor's affirmed its 'AA' rating on Chelan's consolidated system revenue obligations, both senior and subordinate lien. The outlook is stable.

The district's net revenue pledge secures the 2011 bonds, which will refinance about $200 million senior bonds outstanding.

The ratings reflect our view of the district's strong business risk 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 strengths include:

- Chelan's extremely low rates, which are among the lowest in the country. at about one-fourth of the national average;
- Very low operating costs arising from strong hydroelectric generating assets; and
- A very strong cash position, with more than one year's expenditures held in cash, historically and projected.

We believe offsetting factors include financial challenges associated with low hydrological and price levels in the past two years.

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 profile ('3' on Standard & Poor's scale of '1' to '10', '1' being the strongest) are the district's rate-setting ability, extremely low-cost power supply, moderate asset and resource concentration, and low degree of merchant risk-related nonfirm surplus sales. Chelan's low-cost power supply comes from its three hydroelectric plants, which produced power at an average $21 per megawatt-hour (MWh) in 2010. Officials project the cost to remain at this level through 2015, and to see its competitive advantage in the region increase assuming average hydrological conditions. Furthermore, given the size of its resources in comparison to its native load demand, the district has surplus power under almost all hydrological conditions. Surplus power sales subsidize retail rates.

Like its mid-Columbia neighbors, Grant County Public Utility District (AA-/Stable) and Douglas County Public Utility District (AA/Stable), 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 about a third of the total output from its Lake Chelan, Rocky Reach, and Rock Island projects and sells the remainder to other utilities in the region through long-term, take-or-pay contracts that expire by 2012. The power sales contracts permit Chelan to charge off-takers for their allocable shares of operating and debt service costs, plus 15% rolling coverage on interest payments. The district's distribution system still has surplus capacity in nearly all months, even under very low water conditions. Short-term and market sales of surplus capacity, including sales to Alcoa Inc. and the Douglas County district, accounted for a significant portion of operating revenues at the retail system and an even larger percent of net revenues, given that margins on these sales exceed those at the retail level.

Debt service coverage (DSC) ratios at the consolidated system were about 1.25x in fiscals 2009 and 2010, down from 1.6x in 2008, due mainly to declines in off-system sales revenue. Consolidated DSC remains highly sensitive to wholesale sales not under long-term contracts. In fiscals 2009 and 2010, below-average stream flows and low market power prices lead to the lower DSC. Ordinarily, low stream flows are inversely correlated to market prices, which support greater stability in Chelan's wholesale revenues. In response to fiscal challenges related to a decline in wholesale revenues that began in 2009, the district's board approved a 9% surcharge on its retail rates for up to 12 months. As wholesale revenue shortfalls persisted into 2010, the district's board subsequently extended the surcharge to the end of fiscal 2011. In addition, it has increased electric rates 2% (which it later rescinded), and increased rates in its other smaller segments, such as water, sewer, and telecommunications funds. These revenue enhancements were in conjunction with other measures, including deferring some capital expenditures, unpaid furloughs and wage increase give-backs for executives, and a hiring freeze. In our view, management's responsiveness, combined with its very strong cash reserves, has offset declines in wholesale sales revenues in the past two years. Due to the nature of certain power sales contracts, we expect that Chelan will increase net wholesale revenues by 2012, when its share of the Rocky Reach and Rock Island hydroelectric projects allocated to the consolidated system increases markedly. We view the onset of the new contractual framework as positive.

The district's capital improvement plan for 2011-2015 averages $58.9 million a year, with projects across its distribution, generation, and fiber optic systems. Management expects to fund the five-year plan from available funds, without issuing additional debt. The district plans to reduce debt up to $171 million in the next five years. Furthermore, as of 2011, management does not expect to new debt for capital projects until at least 2020.

We have assigned a Debt Derivative Profile of '1.5' to Chelan's swap portfolio on our scale of '1' to '4', reflecting low risk. We base this assessment on strong counterparties (J.P.Morgan Chase Bank N.A. (AA-/Stable/A-1+), Goldman Sachs Mitsui Marine Derivative Products L.P. (AAA/Negative--), and Bank of NY Mellon Corp. (AA-/Stable/A-1+). The district had four active swap agreements, with a notional amount of $167.9 million. The marked-to-market value of these swaps at fiscal year-end 2010 was negative $23.3 million. Chelan estimates its unhedged variable-rate debt portfolio, after considering the effect of synthetic fixed hedges, to be $90 million. We believe the district's large cash balances offset this exposure.

Outlook

The stable outlook reflects our assessment of Chelan's strong financial policies regarding DSC and liquidity, as well as the district's low cost power supply. The outlook also reflects our expectation that management will continue to counter revenue shortfalls to achieve its targeted liquidity levels.

Debt And Utility Structure

As of Dec. 31, 2010, Chelan had $729 million in hydroelectric consolidated system debt and $300 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 retail utilities' rates and charges, 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.

Regulatory Compliance And Relicensing

In February 2009, the Federal Energy Regulatory Commission extended the Rocky Reach license to 2052. The license for Rock Island expires in 2028. In November 2006, Chelan received a 50-year permit for its smaller Lake Chelan project. At Lake Chelan, the net cost of implementing the license is approximately $72 million; the amount includes fish protection, mitigation, and enhancement measures, among other operating and capital costs.

Bond Provisions

We believe the DSC levels for the rate covenant and additional bonds test in the bond provisions are weak overall. The senior consolidated system resolution, however, is effectively closed by a new resolution under which bonds were issued in 2007, 2008, and 2009. The newer resolution has some improved provisions from a credit perspective. These 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 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 by 1.25x. In addition, nonhydro 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. Chelan 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 April 28, 2011)		
Chelan Cnty Pub Util Dist #1 (Chelan Hydroelec Cons Sys) jr lien		
Long Term Rating	AA/Stable	Affirmed
Chelan County Public Utility District #1 cons sys ser 2008B		
Long Term Rating	AA/A-1+/Stable	Affirmed
Chelan County Public Utility District #1 cons sys (MBIA) (BHAC)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Chelan Cnty Pub Util Dist #1 cons sys rev		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Chelan Cnty Pub Util Dist #1 (Chelan Hydroelec Cons Sys) cons sys rev		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

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