S&P Global
Ratings

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Summary:

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

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Credit Profile		
Chelan Cnty Pub Util Dist #1 WHLELC (Rock Island) (MBIA) (National)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Many issues are enhanced by bond insurance.		

Credit Highlights

- S&P Global Ratings affirmed its 'AA' long-term rating and underlying rating (SPUR) on Chelan County Public Utility District No. 1 (Chelan, or the district), Wash.'s series 1997A senior-lien Rock Island hydroelectric system revenue bonds.
- The outlook is stable.

Security

Securing the bonds are project net revenue from long-term contracts with contracted off-takers as well as payments by project owner Chelan (AA+/Stable consolidated system bonds rating) on behalf of its electric distribution system. Project costs, including debt service, are passed through to Chelan and to the off-takers. Bond provisions under the master bond resolution are weak, in our view, and include a 1x debt service coverage (DSC) additional bonds test based on operating revenue and a 1x DSC rate covenant based on net revenue adjusted for contingency funds withdrawals and deposits. The district is required to fund a debt service reserve at maximum annual interest.

The Rock Island hydroelectric project had approximately $159 million in direct debt outstanding as of Dec. 31, 2021, not including interfund loans due to the consolidated system totaling an additional $195 million.

Credit overview

The rating reflects our view of the project's:

- Extremely low historical production costs at 3.8 cents per kilowatt-hour (kWh) that we expect will remain highly competitive, even in the event of below-average hydrological conditions;
- Strong operating performance and flexibility from its multiple turbines, which together partly mitigate single-asset risk;
- Ability to pass through 100% of costs to off-takers, which have signed take-or-pay contracts; and
- Ability to reassign or remarket surplus energy in the event of payment default by a contractual off-taker.

The Rock Island project is a "run-of-the-river" hydroelectric project on the Columbia River and has a capacity of 629 megawatts. The district operates the facility under a long-term license from the Federal Energy Regulatory Commission that extends to Dec. 31, 2028. We believe its 19 turbine generators provide significant operational

flexibility and enhance project availability. The Rock Island project's strong project economics provide strong assurance of cost recovery from the project's direct off-takers. The average cost of production remains low but rose to 3.8 cents per kWh in 2021 from 2.7 cents per kWh in 2017 as a result of capital improvements. Project availability has ranged from 55% to 62% since 2017 but is down from 82% in 2014 as a result of several units' being out of service for repair or turbine replacement. The project's units operate independently, allowing continued operations even in the event of forced outage at one or multiple units. The project's capacity factor was 46% in fiscal 2021, down from 51% in 2017.

Rock Island has power sales contracts with purchasers as follows:

- Puget Sound Energy Inc. (25% share through 2031); and
- Alcoa (26% share through 2028)

Chelan uses the remaining output in its own retail electric system or sells it into the market, including "slice" sales out up to 15 years with various counterparties that are designed to reduce wholesale revenue volatility and uncertainty.

The contracts with Puget Sound Energy and Alcoa are cost-plus, take-or-pay contracts that recoup operating and debt costs. This provides the district financing flexibility and full operational control. There is a mandatory step-up by purchasers if another defaults. Regardless, should one or more of the power purchasers default, the low-cost power can readily be resold into the wholesale power markets, ensuring adequate funds for debt service. The "plus" components of the contracts include various charges for debt reduction and pay-as-you-go capital.

Alcoa Inc., the former parent company of Alcoa Corp., curtailed operations at Wenatchee Works smelter in December 2015, and about 425 employees were laid off in connection with the shutdown. But Alcoa remains contractually obligated to pay its share of monthly operating costs and debt service, although any revenue from the sale of its share of power by the district is netted against such payments. The district has retained $122 million in net revenue from the sale of unused Alcoa power since the contractual provisions were established. These funds count toward the district's unrestricted cash balance. This does not include an additional $62 million contractual charge collected from Alcoa in 2018, and the district also holds $45 million in collateral from Alcoa for protection against default. The district has the sole right to terminate the contract, and the Alcoa plant remains idle as of this report.

The project's financial profile is solid, in our opinion. DSC treating interfund loans as deductions to net revenue, was 2.50x in fiscal 2021, and DSC for all debt and loans was 1.75x. Although project-specific liquidity balances were a thin $1.9 million, or 12 days' of operations, as of 2021, the project has access to the consolidated system's ample liquidity balances, if needed, and also engages in intersystem loans from the consolidated system.

Debt to capitalization remains moderate at 61% in fiscal 2021 but has improved over the years, from 98% in 2014 and 83% in 2017. Chelan's capital improvement plan indicates an average of $59 million in annual spending at the project during fiscal years 2022 to 2026, a sizable increase from $43 million from 2017 to 2021 as a result of turbine modernization and rehabilitation. The district will fund project capital needs largely from available and recurring net revenue. No additional debt is planned over the next five years.

Environmental, social and governance

We see the district's climate transition risks as having a limited effect on our credit rating analysis based on the power supply almost entirely consisting of non-carbon-emitting resources. Nevertheless, the district, by virtue of operating the project, is subject to fish mitigation regulations that add to costs and modestly reduce net generation.

Social risks are also credit neutral. In our view, the economic effects of the pandemic thus far have not affected the project's financial position given the nature of the power sales contracts. In addition, given the extremely low-cost power produced by the project, social risks are negligible.

We view the utility's governance factors as credit supportive, as they include full rate-setting autonomy, liquidity targets, a long-term capital plan and cybersecurity procedures, and long-term financial forecasting.

Outlook

The stable outlook reflects our view of the project's strong operating performance and low production costs. Long-term contracts provide a stable revenue stream, and strong project economics provide credit stability and mitigate credit risks regarding regulation, environmental mandates, and off-taker credit quality. We anticipate that the project will remain competitive with other generators or resource options in the region, even with high capital investments required over the next five years.

Downside scenario

We do not anticipate lowering the rating over the next two years given the competitive cost of power, but we could do so in the unlikely event that costs become uncompetitive on a sustained basis, such as if market prices in the region continue their decline and materially disrupt project competitiveness.

Upside scenario

Given significant capital needs, which could drive up per unit power costs, and given high debt, we do not anticipate raising the rating during the next two years. Also limiting rating upside is our expectation that DSC is unlikely to materially improve.

Related Research

Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022

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