FITCH AFFIRMS CHELAN COUNTY PUD, WA'S CONSOLIDATED SYS REV BONDS AT 'AA+'; OUTLOOK STABLE

Fitch Ratings-San Francisco-29 September 2017: Fitch Ratings has affirmed the following ratings for Chelan County Public Utility District No. 1 (the district), WA at 'AA+':

--$304.3 million consolidated system revenue bonds;
--$209 million Rock Island Hydroelectric project revenue bonds (separately secured by project revenues only);
--$12.7 million Rocky Reach Hydroelectric project revenue bonds (separately secured by project revenues only).

The Rating Outlook is Stable.

SECURITY

The consolidated system revenue/refunding bonds are secured by a net revenue pledge of the consolidated systems, which includes the electric distribution, water, wastewater and fiber optics systems, and the Lake Chelan hydroelectric project. The senior lien is closed, and the subordinate lien is currently the operating lien.

The Rock Island and Rocky Reach project-specific bonds are secured by a separate net revenue pledge for each project.

KEY RATING DRIVERS

COUNTYWIDE ELECTRIC SERVICE PROVIDER: The district provides electric, water, wastewater, and wholesale telecommunications service to Chelan County. The integrated electric system is the most significant revenue generator for the district, accounting for approximately 96.5% of operating revenues in 2016, and serves as the primary driver of the rating.

VALUABLE HYDROELECTRIC GENERATION RESOURCES: The district's rating reflects its valuable hydropower generation resources at Rocky Reach, Rock Island, and Lake Chelan that provide very low-cost electric power. Recent declines in market prices have eroded the district's advantage relative to the market. However, wholesale demand for the district's hydro power products remains solid and district products sell at a premium to market prices.

SIGNIFICANT WHOLESALE SALES; LARGELY CONTRACTED: Only 18% of the district's ample capacity is used to meet retail needs with the vast majority of the remainder sold to third parties through long or medium-term contracts. Wholesale contracts are designed to insulate the district from price and hydro-variability risks. The district remains exposed to counterparty risks, which are mitigated through contractual step-up provisions, collateral postings, and the ability to remarket power upon counterparty default.

RAPID DEBT REDUCTION: The district is prudently using the extra margin from wholesale sales and surplus cashflow to rapidly decrease leverage through optional and scheduled debt payments. Debt-to-FADS declined to 3.5 times (x) in 2016 from 5.1x in 2012 and is projected to continue declining with no debt issuances forecasted over the next five years and the planned continuation of the optional debt payoff program.

STRONG FINANCIAL PERFORMANCE: The district's financial metrics remain strong with consolidated debt service coverage of 3.26x in 2016 and 562 days cash on hand. Management's financial projections reflect expectations that financial performance will remain supportive of the rating through 2021.

RATING SENSITIVITIES

MANAGEMENT OF WHOLESALE SALES: Chelan County Public Utility District No. 1's rating is supported by its ability to successfully manage its wholesale exposure through long and medium-term contracts that largely reduce district exposure to price and hydro-variability risks. Reduced demand for the district's wholesale products for any reason, including persistently low market prices, could result in negative rating action.

CREDIT PROFILE

The district is an integrated electricity provider, operating since 1947. The district's electric utility operations consist of its retail distribution system (the distribution system) and its hydroelectric projects, which are Rock Island (629 MW generating capacity), Rocky Reach (1,300 MW) and Lake Chelan (59 MW).

The consolidated system includes the district's retail electric system, along with a small water and wastewater utility (1.7% of 2016 operating revenues), a fiber optics system (1.9% of operating revenues) and the Lake Chelan Hydroelectric Project. The current retail electric customer base encompasses around 50,000 users in Chelan County, Washington.

Fitch views the district and its separately secured hydro developments as a single integrated system, given that the distribution system and the hydro developments are managed and operated as an integrated system, with the same management team and loans flowing between the systems.

LARGELY CONTRACTED WHOLESALE SALES

The distribution system meets the majority of its power requirements from its share of the combined output of the three hydroelectric facilities and uses market purchases to smooth load. Native electric load accounts for approximately 18% of combined project output. The remainder of project output is sold through project-specific, long-term contracts (52%) and short- to medium-term block and slice contracts (28%). The balance, approximately 2% of output, is retained by the district to balance power needs and resources and can be sold under short-term arrangements.

The district's long-term contracts with Puget Sound Energy (PSE; BBB-/Stable), Alcoa, Corp (Alcoa; BB+/Stable) entitle the counterparties to 25% and 26%, respectively, of the combined output from Rocky Reach and Rock Island. PSE's contract expires in 2031; Alcoa's expires in 2028. The district's contract with Douglas County Public Utility District (Douglas) entitles Douglas to 5.54% of the output from Rocky Reach and expires in 2021 but is subject to extensions.

ALCOA

In December 2015, Alcoa curtailed its Wenatchee Works smelting facility. Under the power sales contract, Alcoa remains responsible for 26% of the costs at Rocky Reach and Rock Island regardless of the actual amount of power used. District management confirmed that Alcoa has remained current on all payments to date.

While the smelter is curtailed, the district sells off Alcoa's share of the combined output and applies the proceeds against Alcoa's monthly costs. Any shortfalls in revenues generated through the market sales are paid by Alcoa, and any surplus is retained by the district.

The district and Alcoa successfully negotiated an extension that permits Alcoa to continue to curtail smelter operations to June 2018 without triggering additional contractual payments. In exchange, the district received certain funds from Alcoa in addition to the monthly payments. Alcoa's performance under the contract is secured by two letters of credit totaling $83 million, which Fitch views as sufficient to mitigate Alcoa's credit risk. The collateral is sufficient to cover Alcoa's highest consecutive three months of payments ($15 million) plus the amount that would be due if Alcoa remains curtailed beyond June 2018 or shuts down its plant.

In addition to the collateral posting, the district's exposure to either Alcoa or PSE is also reduced by contractual step-ups that are required in the event that either counterparty defaults. For example, if Alcoa defaulted, PSE would be required to take a proportional share of Alcoa's slice contract, while the district's distribution system would retain the remainder.

VALUABLE HYDROELECTRIC GENERATION RESOURCES

The district's generation assets are a credit strength. Even with some operational challenges that have been experienced over the past few years, the district's average hydropower production cost remains competitive with market prices. While the district's advantage relative to the market has diminished significantly in recent years as wholesale power prices in the Northwest have remained persistently low, the district's stable and low production costs remain attractive to counterparties and demand for the district's medium- and long-term slice products has been solid.

STRONG FINANCIAL PERFORMANCE

The district's financial performance remains strong and supportive of the rating. Consolidated debt service coverage and coverage of full obligations were above rating medians at 3.26x and 2.88x, respectively, in 2016. Liquidity levels remain robust with approximately $306.5 million, or 562 days cash on hand, at the end of 2016.

The district's financial projections, which reflect average water year conditions, show healthy financial performance continuing through 2021. Cash balances are projected to remain healthy and above the district's policy target of 250 days cash on hand. Coverage levels are also expected to exceed the district's 2.0x target.

Debt levels have decreased substantially in recent years, as the district is actively paying down its outstanding balances. At its peak at fiscal year-end 2009, outstanding debt totaled $1.04 billion and debt/FADS was a lofty 12.4x. As of year-end 2016, outstanding debt is $596.6 million, a decrease of nearly 43%, and debt/FADS is 3.5x, which is below peer medians.

While the district maintains flexibility to modify its debt reduction and issuance programs to fund future capital, projections show the district will continue accelerating debt repayment, with $161 million in increased principal payments above its amortization schedule through 2021. The optional debt payments along with scheduled amortization and the lack of planned debt issuances are expected to reduce the district's debt/FADS ratio to around 2.6x by 2021.

Contact:

Primary Analyst
Matthew Reilly, CFA
Director

+1-415-732-7572
Fitch Ratings, Inc.
650 California St, 4th Floor
San Francisco, CA 94108

Secondary Analyst
Lina Santoro
Analytical Consultant
+1-212-908-0522

Committee Chairperson
Kathy Masterson
Senior Director
+1-512-215-3730

Media Relations: Alyssa Castelli, New York, Tel: +1 (212) 908 0540, Email: alyssa.castelli@fitchratings.com.

Additional information is available on www.fitchratings.com

Applicable Criteria
Rating Criteria for Public Sector Revenue-Supported Debt (pub. 05 Jun 2017)
https://www.fitchratings.com/site/re/898969
U.S. Public Power Rating Criteria (pub. 18 May 2015)
https://www.fitchratings.com/site/re/864007