FITCH AFFIRMS CHELAN COUNTY PUD (WA) CONSOLIDATED SYS REVENUE BONDS AT 'AA+'; OUTLOOK STABLE

Fitch Ratings-New York-06 October 2015: Fitch Ratings has affirmed the following ratings for Chelan County Public Utility District No. 1 (the district), WA at 'AA+':

--$25.4 million senior consolidated system revenue/refunding bonds;
--$442.2 million subordinate consolidated system revenue/refunding bonds;
--$243.4 million Rock Island Hydroelectric project revenue bonds (separately secured by project revenues only);
--$14.1 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

LOW-COST POWER PROVIDER: The district's strong rating reflects its exceptionally low-cost power resources, which results in very competitive rates for its wholesale hydroelectric projects and its retail distribution system (the distribution system). Production costs are well below the regional average and are projected to remain low for the foreseeable future.

WHOLESALE PROVIDER CHARACTERISTICS: A substantial portion of hydro project generation is sold off-system, as it is surplus to native load requirements that account for just 18% of total generation. The district seeks to mitigate its wholesale exposure through long-, medium- and short-term contract sales (accounting for about 75% of generation over the next five years) with terms that hedge price, water flow and operational risks. Merchant power sales are limited to approximately 7% of output over the next five years.

STRONG FINANCIAL PERFORMANCE: Consolidated financial metrics remain very healthy, after the district implemented favorable changes to its wholesale power sales contracts that include cost-plus pricing and an increased share of hydro project output to the distribution system. Debt service coverage (DSC) dipped in 2014, but only because of higher debt service related to the utility's debt reduction plan.

FAVORABLE DEBT REDUCTION PLAN: Leverage on a consolidated basis has been significantly reduced in recent years, decreasing by almost 30% since 2009. The district anticipates continuing to proactively pay down debt. No additional new money issuance is planned over the near term, which should further benefit the district's leverage position.

SUBSTANTIAL LIQUIDITY: The district maintains ample unrestricted cash reserves on a consolidated basis, equivalent to 419 days cash on hand (DCOH) at year-end 2014. Unrestricted funds are projected to decrease somewhat, as the utility actively pays down debt and internally funds CapEx, but are expected to remain strong for the rating category.

HYDROLOGICAL VARIABILITY SOMEWHAT MITIGATED: The distribution system is a net seller into the wholesale power market, which subjects it to variability in hydrological conditions and market prices. Implementation of a wholesale sales auction process for medium- and short-term slice contracts, which have staggered maturity dates and provide ample margin over cost, has helped to insulate the district from changes in water flow.

UNIFORM RATINGS: Fitch rates all of Chelan's debt obligations the same despite the tiered liens. While the consolidated system and the hydro-generating projects are accounted for and financed separately, they are managed and operated as an integrated system by the same management team and loans flowing between the systems.

RATING SENSITIVITIES

MANAGEMENT OF WHOLESALE SALES: Given Chelan County Public Utility District's reliance on asset performance and variable wholesale sales through an auction process, it is important that these sales and overall operations are managed together with retail electric rates in a way that maintains stable financial performance. A material and sustained decline in wholesale power prices or auction demand that results in diminished financial performance could put downward pressure on the rating.

RETAIL AND WHOLESALE OPERATIONS

The district is an integrated electricity provider, operating since 1947. Operations consist of the district's distribution system and its hydroelectric projects, which are Rock Island (629 megawatt [MW] generating capacity), Rocky Reach (1,300 MW) and Lake Chelan (59 MW). The majority of generation output is sold off-system to a mix of long-, medium- and short-term purchasers.

The distribution system, which accounts for only 18% of generation, includes the retail electric system (12.1% of 2014 consolidated revenues), along with a small water and wastewater utility (1.4% of 2014 consolidated revenues), a fiber optics system (1.6% of consolidated revenues) and the Lake Chelan Hydroelectric Project. The current retail customer base encompasses almost 50,000 users in central Washington.

EXTREMELY LOW-COST POWER RESOURCES

Rocky Reach and Rock Island are stand-alone hydroelectric generation projects that are each accounted for separately. Off-system sales are done through a mix of long-term contracts (52%) and short- to medium-term block and slice contracts (30%). The long-term contracts extend to 2028 and 2031. The distribution system's power requirements are met through its share of the combined output of the three hydroelectric projects, along with market purchases to smooth load.

Project operations have generally been solid since inception, with plant availability factors near or above 90% with the exception of 2013 and 2014. In 2013, Rocky Reach had four of its 11 generating units taken offline for repairs. A crack in an oil delivery rod was discovered in one of the units and three additional units with similar design features were also taken offline. Repairs and usual maintenance on the units are expected to be fully completed in 2020.

2014 generation and availability was lower due to a fracture found at neighboring Grant County Public Utility District's Wanapum Dam. In order to investigate and repair the fracture, water above the Wanapum Dam was lowered below normal operating levels, which affected generation at upstream dams Rocky Reach and Rock Island. The district adjusted operations and generation amounts at its dams to protect equipment reliability.

Repair costs and estimated loss of revenue from the Rocky Reach outages and 2014 water level drawdown is manageable and Fitch does not view the event as a credit concern.

MANAGEMENT OF POWER SUPPLY

New power sales contracts for Rocky Reach and Rock Island went into effect in 2011 and 2012, respectively. The contracts afford the distribution system a slice of the combined output of Rocky Reach and Rock Island, which equates to approximately 200 annual MW of additional energy. Historically, the two projects each had individual power sales agreements, which expired on Oct. 31, 2011 and June 7, 2012, respectively. Fitch views the new contracts positively, as they favorably charge on a 'cost-plus' basis, versus the previous cost of service, and include adders for capex and debt financing costs.

The district updated its power supply management plan in 2010, in order to better manage its increased amount of long capacity. Fitch views the district's current strategy as a credit strength, as it materially reduces the district's exposure to price and hydrological risks. The district uses an auction process to lock in medium-term slice contracts and short-term block contracts for approximately 27% of hydro generation output. In any given prompt year, only approximately 3% of the district's generation capacity is exposed to current market conditions.

STRONG FINANCIAL PERFORMANCE

The district maintains ample liquidity, which Fitch views as an essential credit strength supporting the 'AA+' rating. Unrestricted funds at year-end 2014 totaled $269 million, equivalent to 419 DCOH. Increased 2014 operating expenses stemming from the Wanapum dam fracture resulted in a decrease of DCOH, from 543 DCOH at year-end 2013, even while unrestricted fund balances improved. Unrestricted funds are projected to decrease somewhat, but still remain very strong, as the utility actively pays down debt and internally funds CapEx.

Consolidated DSC has strengthened in recent years, as the district has benefited from the new wholesale contracts implemented in 2011 and 2012 and strong water years. DSC dropped in 2014, from 2.75x in 2013 to 1.42x, primarily due to increased debt service tied to a large payment on maturing debt. Without the increased payment, DSC would have been a strong 1.87x. DSC is projected to increase in 2015 and remain robust, averaging 2.87x through 2019. Additionally, projections show the district will continue to make debt payments above scheduled amortization and markedly reduce its leverage position by year-end 2019.

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Applicable Criteria
Revenue-Supported Rating Criteria (pub. 16 Jun 2014)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=750012
U.S. Public Power Rating Criteria (pub. 18 May 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=864007