MOODY'S
INVESTORS SERVICE

Rating Update: Moody's downgrades Chelan PUD's revenues bonds to Aa3 and subordinated notes to A1; outlook is revised to stable

Global Credit Research - 15 Feb 2013

Approximately $874 million of debt securities affected

CHELAN COUNTY PUBLIC UTILITY DISTRICT 1, WA
Other Special Districts
WA

Opinion

NEW YORK, February 15, 2013 --Moody's Investors Service has downgraded Chelan County Public Utility District (Chelan PUD) No. 1's to Aa3 rating from Aa2 on its Consolidated System, Chelan Hydro Consolidated, Rock Island, and Rocky Reach revenue bonds. Consolidated System Subordinate notes, which are the most junior debt at Chelan PUD, have been downgraded to A1 from Aa3. The rating outlook has been revised to stable from negative.

SUMMARY RATING RATIONALE

The downgrade of Chelan PUD's ratings considers the district's considerable exposure to wholesale power prices and hydrology risk and the district's reliance on non-retail revenue to subsidize its retail business. The downgrade also considers counterparty concentration with significantly lower rated entities and the ongoing execution risk of its financial and hedging objectives under challenging and volatile market conditions.

Factors supporting Chelan's Aa3 on its senior revenue bonds and A1 rating on its subordinated notes are the 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 $700 million by 2016, forecasted maintenance of strong internal liquidity of 600 to 700 days cash on hand, expected debt service coverage ratios in excess of 2 times in most years, and the district's materially improved risk management over the last three years. Chelan PUD's high liquidity position, strong risk management, and expected improvement in financial profile over time are factors that support the Aa3 senior rating compared to the A2 indicated under Moody's Public Power with Ownership Generation methodology.

Moody's also affirmed the VMIG 1 rating assigned to the Series 2008B bonds (2008B Bonds) in connection with the delivery of an alternate standby bond purchase agreement (the SBPA or liquidity facility) to be provided by Union Bank, N.A (the Bank) in substitution for the current SBPA provided by U.S. Bank, National Association. Upon substitution, the short-term rating will be based on the short-term rating of Union Bank, N.A. and the likelihood of early termination of the SBPA without a mandatory tender of the 2008B Bonds. The long term and short term other senior obligation (OSO) ratings of Union Bank, N.A. are A2 and P-1, respectively. Events which would cause the liquidity facility to terminate without a mandatory purchase of the 2008B Bonds are directly related to the credit quality of the district. Accordingly, the likelihood of any such event occurring is reflected in the Aa3 long term rating assigned to the 2008B Bonds.

DETAILED CREDIT DISCUSSION

Chelan PUD operates a utility system that primarily generates and delivers electricity to approximately 48,400 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 73,500. The major economic activities in the Chelan/Douglas county area are agriculture, agriculture related industries, healthcare, education and manufacturing. According to the Washington State Employment Security Department, unemployment was around 8.4% (preliminary) in Chelan County compared to 7.7% (preliminary) for Washington State as of December 2012.

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 (Baa2, stable) and Alcoa (Baa3/under review for downgrade) under long-term

contracts that have take or pay type features. Douglas PUD (Aa3, negative) 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 2014 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 by CHC system to Rock Island and Rocky Reach but not a direct pledge of the net revenues from Rock Island and Rocky Reach system. CHC lien is now closed. The rate covenant requires 1.0 times coverage based on net revenues of the CHC system against debt service of the CHC system excluding debt service for debt funds loaned to the three hydro projects (Lake Chelan, Rock Island, Rocky Reach). An additional rate covenant requires 1.15 times coverage using other available funds and based upon the net revenues of the CHC System. Each bond series has its own segregated reserve and 2004C and 2005B series are backed by $2.2 million in sureties from National Public Finance Guarantee though this modest exposure is manageable given Chelan's strong internal liquidity.

The Consolidated System Subordinate notes and Consolidated System (Consolidated System) revenue bonds are secured by a third lien and second lien, respectively, on the net revenues of the Consolidated System which consists of the same net revenues sources as the CHC system plus Fiber Optic system. The Consolidated System revenue bonds are subordinate to the senior lien of the CHC System revenue bonds and the district has covenanted not to issue additional CHC System bonds. The rate covenant and additional bonds test for the Consolidated System bonds is 1.25 times using other available funds and 1.00 times based only on current revenue excluding other available funds. The Consolidated System revenue bonds have a cash funded debt service reserve equal to maximum annual interest segregated by bond series.

The Rock Island revenue bonds are secured by a pledge of net Rock Island system revenues and are subordinate to the lien on prior Rock Island bonds, which are closed to new debt issuances. Pledged revenues include all revenues, rates and charges from the district's operation of the Rock Island system. 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 bond charge coverage of 1.0 times; there is no additional bonds test; and each bond series has a cash funded debt service reserve requirement sized to maximum annual interest.

The Rocky Reach System revenue bonds are secured by a pledge of revenues and were subordinate to the lien on prior Rocky Reach bonds. The district has covenanted not to issue additional senior lien Rocky Reach bonds and none remain outstanding. 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 bond coverage test and each bond series has a cash funded debt service reserve requirement sized to maximum annual interest.

Moody's notes that the 2008 Rock Island and Rocky Reach master resolutions for the 2008 and 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 $13 million of Rock Island debt and $18 million at Rocky Reach's debt.

INTEREST RATE DERIVATIVES:

The district has three interest rate swaps with a total notional value of $89.5 million with highly rated counterparties with a negative mark to market position of $21.1 million as of December 31, 2012.

SBPA For 2008B Bonds

The obligation of the Bank to purchase tendered 2008B Bonds under the SBPA will immediately and automatically terminate or be suspended: (1) upon the district's failure to make any payment of principal and interest on any

2008B Bonds or parity bonds; (2) if a final non-appealable judgment in excess of $20 million is rendered against the district and remains unsatisfied and unstayed for a period exceeding that permitted by State law; (3) if the district commences a voluntary bankruptcy or similar proceeding or if an involuntary case or bankruptcy is commenced against the district that remains undismissed or unstayed (suspended when commenced, terminated if undismissed or unstayed for a period of 60 days; (4) if any provision of governing documents relating to the payment of principal and interest on the 2008B Bonds or the lien or pledge of revenues securing the 2008B Bonds ceases to be valid and binding on the district or is declared to be null and void by a court or governmental authority or the validity or enforceability of such provision is repudiated or otherwise denied by the district; or (5) a debt moratorium or comparable extraordinary restriction on repayment of debt shall have been declared or announced by the district or a governmental agency with appropriate jurisdiction with respect to the 2008B Bonds or all parity bonds.

The 2008B Bonds will remain in the weekly rate mode with interest payable on the first Wednesday of each month. The 2008B Bonds may be converted in whole or in part to the daily, commercial paper, fixed, or auction rate mode. Upon conversion, the 2008B Bonds being converted will be subject to mandatory tender at a purchase price of par plus accrued interest. In addition, prior to such conversion, the trustee must receive written evidence from Moody's that the rating on the 2008B Bonds will not be reduced or withdrawn as a result of such conversion. The short-term rating will cover 2008B Bonds in the weekly and daily rate modes only.

Purchase price payments for 2008B Bonds tendered but not remarketed will be paid first from district monies, then from remarketing proceeds, and to the extent that such funds are not available, from a draw under the liquidity facility.

Substitution of the liquidity facility is permitted under the Resolution and the 2008B Bonds will be subject to mandatory tender on the business day prior to the effective date of the substitute SBPA. The SBPA terminates on the date the Bank has received a certificate signed by the trustee stating that an alternate letter of credit has been received and it has become effective.

Bondholders may tender their 2008B Bonds during the weekly rate mode on any business day with written notice given to the tender agent with seven days prior written notice. When the 2008B Bonds are in the daily rate mode, Bondholders may tender their 2008B Bonds on any business day with written notice given to the tender agent by 11 a.m. New York time. 2008B Bonds which are purchased by the liquidity provider due to a failed remarketing may not be released until the liquidity facility has been reinstated in the amount drawn for such purchase.

The 2008B Bonds will be subject to mandatory tender upon: (i) each interest rate conversion date; (ii) the first day of a CP term; (iii) one business day prior to the expiration date of the liquidity facility; (iv) one business day prior to the substitution date of the liquidity facility; (v) not later than 15 days following the trustee and tender agent's receipt of notice of an event of default under the liquidity facility; and (vi) the first day on which 2008B Bonds in the weekly, daily or commercial paper rate mode are not in authorized denominations.

The SBPA will cover full principal plus 35 days of interest at 10%, the maximum rate on the 2008B Bonds. The SBPA will be available to pay purchase price to the extent district monies and remarketing proceeds are insufficient. The SBPA provides sufficient coverage for the 2008B Bonds while they bear interest in the weekly and daily rate modes only.

Draws made on the SBPA received at or prior to 12:00 p.m. (New York City time) will be honored by 2:30 p.m. (New York City time) by the Bank on the same day. Draws made under the SBPA will be reinstated upon reimbursement of such drawings.

The SBPA will terminate on the earliest to occur of: (i) March 8, 2016, its stated expiration date ; (ii) the date the Bank receives a certificate signed by the trustee stating: (a) a substitute liquidity facility has been provided and become effective; (b) no 2008 Bonds remain outstanding under the Resolution; or (c) all 2008 Bonds have been converted to a rate mode other than the weekly or daily; (iii) 30 days following the tender agent and trustee's receipt of notice from the Bank of an event of default under the SBPA; or (iv) the date of voluntary termination of the SBPA by the district (as a condition to such termination, the Resolution requires that the trustee has received written evidence from Moody's that the short-term rating on the Bonds will not be reduced or withdrawn as a result of such termination).

RATING FACTORS

LOW COST HYDRO SYSTEM

A key fundamental credit support factor for the district is Chelan PUD's 1,988 MW low cost hydro system, which was built 30 to 50 years ago. The plants have operated well with a weighted average availability around 94% from 2009-2011. In 2012, approximately 10.8 million MWh of power was delivered by the district's facilities at a weighted average cost around $14/MWh. Assuming average water flows, the all-in weighted average production costs are expected to be around $17/MWh by 2016 with the large Rocky Reach plant the cheapest at around $12/MWh. The district's cost of power has historically been well-below regional and national averages though the competitive position has weakened since 2009 due to the substantial drop in 'around the clock' market prices in the Pacific Northwest with a recent low of around $20/MWh in 2012.

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

The district sells 51% of the power output from the district's combined Rocky Reach and Rock Island plants under long term take or pay 'plus' contracts to Puget Sound Energy (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 and other costs. Chelan PUD can also assess credit and administrative charges and debt reduction and capital recovery charges, which can be used to reduce debt or pay for capital expenditures. The district 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), as its Baa3 senior unsecured rating is currently under review for possible downgrade. Partially offsetting this risk are Chelan PUD's very competitive prices charged for the capacity and energy and the district's ability to request collateral sized to 3 months of payments and a sizeable 'shutdown' collateral amount in the event of downgrade to below investment grade, which in aggregate totals around $97 million. The shutdown collateral amount declines over time according to a set schedule.

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

The district'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 subsidize the district's other systems including electric distribution and fiber optic businesses. With the expiration of certain PPAs in 2011 and 2012, Chelan PUD's share of the hydro plant's output is a net 48% and under average hydrology, Chelan PUD expects to sell approximately 330 aMW of surplus power on average over the next 5 years compared to roughly 190 aMW sold to its retail customers. Expected wholesale power sales as a portion of total operating revenues comprises approximately 40% of total operating revenues and is considered a credit weakness given the substantially higher business risks of the wholesale energy business compared to the traditional electric distribution business. The high proportion of wholesale power revenue relative to the retail revenue (around 20% of total revenues) is considered atypical for public power and remains the primary driver of the rating downgrade.

The two primary drivers of wholesale market sales for Chelan PUD are hydro levels and wholesale market prices. Under an 'ordinary' economic environment, lower hydro levels tend to push up wholesale market prices and serve as a partial natural hedge. For example, in 2001, Chelan's wholesale revenues increased compared to 2000 even though Grand Coulee's flow levels were 60% of normal compared to 99% in 2000. However, the power prices have fallen steeply with a recent low of below $20/MWh for 2012 compared to nearly $60/MWh in 2007 due to low natural gas prices, lower demand, and the introduction of wind resources throughout the region. Additionally, regional hydrology has been very volatile with water flows reaching a low of around 60% of average and a high of around 130% of average since 2000.

To manage wholesale and hydrology exposure, the district utilizes a strong risk management program in place.

EXPECTED STRONG FINANCIAL METRICS AND STRONG RISK MANAGEMENT PROGRAM REDUCES THE IMPACT OF WHOLESALE REVENUE VOLATILITY

Key credit strengths are the district's strong liquidity position and the expected improvement in consolidated debt service coverage (DSCR) and leverage. Over the last several years, the district has typically maintained over 500 days cash on hand, and the district forecasts around 600 to 700 days cash on hand which is supported by Chelan's PUD's policy of maintaining minimum $150 million of unrestricted cash and investments. Liquidity is also enhanced by a $50 million 3-year bank credit facility maturing in April 1, 2014. However, Moody's views the bank credit facility as a substantially weaker form of liquidity since it contains restrictive features including a 'no material adverse effect' clause and minimum A3/A-/A- ratings as conditions precedent to funding. Additionally, the bank credit agreement terminates and all advances are immediately due and payable if the district's rating falls to Baa2/BBB/BBB or lower.

In addition to liquidity, Chelan PUD forecasts an improvement in the debt service coverage to above 2.0x in most years compared to an average of around 1.4x from 2009-2011 due to a sizeable revenue increase on both wholesale sales and long term contracts. The cash flow generated from the higher anticipated revenue are expected to fund annual capital expenditures that average $50 million and voluntary debt reduction targets. Based on the district's base case forecast, total debt is expected to decrease to less than $700 million by the end of 2016 compared to almost $1.1 billion in 2009, a credit strength. 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.

Another key support factor is the district's strong risk management program implemented over the last several years. Hedging of wholesale power sales represents a major component of the risk management program. The district's hedges consist of a combination of firm energy sales and auctions of 'slices' of the district's hydro system output on a rolling forward basis with the goal of having less than an equivalent of 5% of the total hydro output merchant in the prompt year and which increases to nearly 20% of the fourth and fifth year. While firm energy sales only transfers price risk, 'slice' sales transfers both hydrology and price risk to the counterparty resulting in greater cash flow certainty. Currently, the district exceeds its minimum hedging objectives and Moody's expects that the district will continue to hedge through a combination of block and slice products on a rolling basis to ensure greater revenue stability.

The combination of Chelan PUD's robust risk management and expected strong financial metrics results in substantial downside protections over the next several years under possible stress scenarios such as a combination of low hydrology conditions, market prices, and major hedge counterparty default. That said, Moody's also recognizes the ongoing execution risk of the District's financial and hedging targets in a volatile market environment especially as forward power prices have been weakening over the last several years. Additionally, counterparty concentration remains a concern though we understand Chelan PUD is monitoring this closely and has counterparty collateral in place to reduce this risk.

IMPROVED RATE MANAGEMENT IS CREDIT POSITIVE THOUGH 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. Prior to 2009, Chelan PUD raised electric rates by 5% in 2008 and 2.5% in 2000. While the district's retail rates are significantly below average compared to other electric utilities in Washington State and remain one of the lowest rates in the US, the risk of a 'rate shock' remains an important factor since retail customers are likely to consider increases relative to their current rates in addition to the absolute rate.

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% surcharge was extended through 2011 while the district implemented 5% to 9% rate increase for its water, wastewater, and fiber systems from 2010 through 2012. For the electric system, a permanent 2.5% rate increase replaced the 9% surcharge in 2012 resulting in a net 6.5% decrease. The improvement is viewed as positive development compared to 2009 and we expect the district to continue to maintain its enhanced communications with its customers and commissioners.

Outlook

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

What Could Change the Rating - DOWN

In light of the recent rating action, the substantial liquidity that exists, and plans to deleverage over time, we believe that Chelan PUD is very well positioned at the current rating. However, 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.

What Could Change the Rating - UP

Given the fundamentally higher business risk profile and customer concentration, the District's rating is unlikely to be upgraded. Over the longer term, factors that could improve the district's rating are substantially lower leverage than the level expected, 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.

KEY STATISTICS:

Total Restricted and Unrestricted Cash and Investments, 2011: $377 million

Total net MWh produced, 2012: 10.8 million

Aggregate Hydro Capacity (Nameplate): 1,988 MW

Chelan Senior Consolidated System 2011 Debt Service Coverage (per resolution without available funds): 5 times without escrow

Subordinate Consolidated System 2011 Debt Service Coverage (per resolution without available funds): 1.9 times

Rock Island System 2011 Debt Service Coverage (per resolution): 1.0 times

Rocky Reach System 2011 Debt Service Coverage (per resolution): 2 times

Consolidated Debt Service Coverage Ratio, 2011 (Moody's): 1.5 times

Debt Ratio, 2011: 73%

Days Cash on Hand, 2011: 527

Average Retail Rate, 2012: 3.1 cents/kwh

DEBT STATEMENT AS OF December 31, 2012

Rock Island System Revenue Bonds $266 million

Rocky Reach System Revenue Bonds: $18 million

Chelan Hydro Consolidated System Revenue Bonds: $40 million

Consolidated System Revenue Bonds: $521 million

Consolidated System Subordinated Revenue Notes: $29 million

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): (516 3-yr avg) (Aaa)

Sub factor b) Debt Ratio (10% weight): (75% 3-yr avg) (A)

Sub factor c) Adjusted Debt Service Coverage (10% weight): (1.4x 3-yr avg) (Baa)

Grid Indicated Rating: A2

Notching:

Merchant Exposure: -0.5

Scorecard Indicated Rating: A2

RATING METHODOLOGY

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

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

Please see the ratings tab on the issuer/entity page on www.moodys.com for additional regulatory disclosures for each credit rating.

Analysts

Clifford J Kim
Lead Analyst
Public Finance Group
Moody's Investors Service

Chee Mee Hu
MANAGING_DIRECTOR
Public Finance Group
Moody's Investors Service

A.J. Sabatelle
Additional Contact

Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653

Moody's Investors Service, Inc.
250 Greenwich Street
New York, NY 10007
USA