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Ratings

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

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Credit Profile		
Chelan County Public Utility District #1 con sys		
Long Term Rating	AA/Stable	Affirmed

Rationale

S&P Global Ratings affirmed its 'AA' rating on Chelan County Public Utility District No. 1, Wash.'s consolidated system revenue bonds. The district's net revenue pledge secures the bonds. The outlook is stable.

The affirmation reflects our view of Chelan's strong business 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 credit strengths include Chelan's:

- Extremely strong financial flexibility given its extremely low rates, which are among the lowest in the country with residential rates at about one-quarter the national average;
- Very low operating costs which arise from strong hydroelectric generating assets totaling 1,988 megawatts (MW), with an average power cost of just $18 per megawatt hour (MWh) in 2015; and,
- Strong financial policies and risk management techniques;
- Rapidly declining debt burden, with significant debt prepayments during 2011-2015 of more than $200 million;
- Very strong fixed-charge coverage near 2x on a consolidated basis in fiscal 2015; and
- Extremely strong unrestricted cash position, with 456 days' cash in fiscal 2015, projected at no less than 276 days through 2020.

In our view, somewhat offsetting credit factors include a moderate debt burden, an economic base that lacks breadth and depth, and some exposure to variable hydrology, which can affect net wholesale revenues, although the district has significantly reduced this risk in recent years.

Chelan's business profile score is '3' on a scale from '1' to '10', with '1' being the strongest. Its business profile score reflects the district's strong rate-setting ability, extremely low-cost power supply, moderate asset and resource concentration, and low degree of merchant risk-related nonfirm surplus sales. Its low-cost power supply comes from its three hydroelectric plants, which management estimates produced power at an average $18 per megawatt-hour in 2015. District officials project the cost will maintain its competitive advantage in the region, assuming average hydrological conditions. Furthermore, given the size of the district's resources compared to its native load demand, Chelan has surplus power under almost all hydrological conditions. Margins from surplus power sales contribute to the district's very low retail rates.

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, and all senior-lien debt was paid off in 2015.

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. 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 48% of the aggregate output from its Lake Chelan (59 MW), Rocky Reach (1,300 MW), and Rock Island (629 MW) projects and sells 52% of the output from Rocky Reach and Rock Island to three counterparties in the region, Alcoa, Puget Sound Energy and Douglas County Public Utility District No. 1, through long-term, take-or-pay contracts that expire in 2028, 2031, and 2021, respectively. Its distribution system has surplus capacity in nearly all months, even under very low water conditions. The district's long-term financial plan includes hedging a sizable portion of its hydrology risk by annually selling slices of its system by auction to various counterparties for up to five years on a rolling basis. We believe this strategy minimizes the financial risk related to low stream flows.

Actual fixed-charge coverage ratios at the consolidated system have ranged from 1.13x to 1.68x during fiscal years 2011 to 2015. However, when adjusting debt service to remove optional debt prepayments (which totaled $209 million during this period), fixed-charge coverage was much stronger, ranging from 1.57x to 2.68x, most recently 1.90x in fiscal 2015. Likewise, consolidated system unrestricted cash would be at least $209 million higher without such prepayments, but, nonetheless totaled a very strong $236 million or 456 days' cash as of fiscal 2015, including such prepayment (or 860 days had debt not been prepaid).

Consolidated debt service coverage (DSC) is sensitive to wholesale sales, including spot market sales not made under long-term contracts. In fiscal years 2009 and 2010, below-average stream flows, combined with low market power prices, led to the lower DSC levels. Improved hydrology, improved risk management, and budget adjustments to both revenue and expenditures contributed to much stronger coverage in recent years. In addition, with the provisions of two long-term contracts that took effect in 2011 and 2012, and the increased share available for market sales benefiting the consolidated system, a portion of which has been sold via a series of medium-term contracts on a rolling five-year basis, we believe the district has hedged a significant portion of its volume and price risk.

Chelan's capital improvement plan for 2016-2020 averages $78 million in annual spending for a total of $392 million. Capital projects planned include distribution, generation, and fiber-optic systems. Management expects to fund the plan from available funds, without issuing additional debt. Furthermore, with scheduled maturities of $121 million and optional debt accelerations of $161 million over the next five years, management's forecasts indicate a significant reduction of its debt balances, which will drop to about $331 million by fiscal 2020 from $622 million as of the end of fiscal 2015. Debt to capitalization was 47% as of fiscal 2015, and could get as low as 24% by 2020.

Outlook

The stable outlook reflects our assessment of Chelan's extremely low cost power and the financial flexibility that provides, as well as its strong financial position and declining debt burden. The outlook also reflects our expectation that management will continue to enact budget measures to counter any revenue shortfalls that would occur in its wholesale operations, to achieve its targeted liquidity levels.

Upside scenario

We don't expect to raise the rating over the next two years given our view of Chelan's somewhat limited economic base, including the effects related to Alcoa's recent curtailment, and exposure to variable hydrology.

Downside scenario

At the same time, we don't expect to lower the rating during our two-year outlook period given the district's significant rate flexibility and extremely low-cost power supply, and because we believe coverage ratios and liquidity levels will remain very strong.

Debt And Utility Structure

As of Dec. 31, 2015, Chelan had $356 million in hydroelectric consolidated system debt and $247 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 project debt. The rates and charges of the retail utilities, as well as certain intersystem loan payments from the district's three large hydroelectric systems, secure the consolidated system bonds.

Alcoa Curtailment

In November 2015, Alcoa notified Chelan of its intent to idle its Wenatchee Works plant as part of its company-wide plan to shut down smelting operations. But, in 2007, when the contract with Alcoa was created, various provisions were included as incentives for Alcoa to remain in Wenatchee and maintain operations, with increased financial benefits for more production and full employment for plant workers. Keeping good-paying industrial jobs in the local economy was a high priority for the commission at the time and remained so as news of the shutdown was delivered. In December 2015, Alcoa in fact curtailed its Wenatchee Works smelting facility. But, under terms of the power sales agreement, Alcoa must continue to pay its 26% share of the costs and charges regardless of the actual amount of energy produced or the amount of power used to operate Wenatchee Works. Per the contract's provisions addressing a shutdown event, the district is selling unused power in the wholesale market on Alcoa's behalf. After a 90-day threshold of being curtailed, the revenues from unused power sales are first applied to Alcoa's monthly contractual costs and surplus amounts over Alcoa's costs will be retained by the district, while any shortfalls will be paid by Alcoa. As such, the Alcoa shutdown is not expected to weaken the district's or hydro projects' finances.

If the shutdown lasts longer than 90 days, two charges may apply: The first charge is the "Initial Shutdown Amount," which could be as high as $8.6 million if the plant is idle for one year. The second charge is the "Shutdown Settlement Amount," which is the $67 million deferred capacity reservation charge that becomes due if Wenatchee Works remains shutdown for longer than 18 months. The district currently holds $86 million in collateral for protection against default. It has the right to terminate the contract after the 18-month shutdown period is met. According to management, if the district instead sold Alcoa's power at market prices, higher revenues would likely result, but the district maintains its priority for Alcoa to re-start the plant given the economic benefit of the related jobs. About 425 employees were laid off in connection with the shutdown.

Bond Provisions

The resolution has different bond provisions that made some improvements from a credit perspective versus the prior resolution. These improvements 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 for the consolidated system bonds 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 1.25x. The district maintains a debt service reserve for the consolidated system bonds in the amount of maximum annual interest payable in any year.

Related Criteria And Research

Related Criteria

- USPF Criteria: Electric And Gas Utility Ratings, Dec. 16, 2014
- USPF Criteria: Methodology: Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

Ratings Detail (As Of May 20, 2016)		
Chelan Cnty Pub Util Dist #1 rev bnds		
Long Term Rating	AA/A-1/Stable	Affirmed
Chelan Cnty Pub Util Dist #1 (Chelan Hydroelec Cons Sys) jr lien		
Long Term Rating	AA/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.		