

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

Fitch Ratings-New York-23 October 2012: Fitch Ratings has affirmed the following ratings for Chelan County Public Utility District No. 1 (the district), WA:

- \$40.43 million senior consolidated system revenue/refunding bonds;
- \$521.23 million subordinate consolidated system revenue/refunding bonds;
- \$82.67 million third-lien consolidated system notes;
- \$260.76 million Rock Island Hydroelectric project revenue bonds (separately secured by project revenues only);
- \$17.68 million Rocky Reach Hydroelectric project revenue bonds (separately secured by project revenues only).

The Rating Outlook is Negative.

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.

Fitch rates all obligations the same at 'AA+' despite the tiered liens. While the distribution system and the hydro-generating projects are accounted for and can be financed separately, they are managed and operated as an integrated system with the same management team and loans flowing between the systems.

KEY RATING DRIVERS

Low-Cost Power: The strong rating of the district reflects its exceptionally low-cost power resources, which results in very competitive retail and wholesale rates. Average production cost for 2011 was 1.5 cents per kilowatt hour (kWh) and costs are projected to remain low for the foreseeable future.

Favorable Hydro Assets: The district benefits from owning non-carbon-emitting hydroelectric assets and is well positioned to meet the state's renewable energy goals

Ample Liquidity: The district maintains strong unrestricted cash reserves and funds on a consolidated basis, equivalent to 527 days cash on hand at fiscal year-end 2011. Unrestricted funds are expected to increase at fiscal year-end 2012, before decreasing somewhat as the district uses internally generated monies to fund its capital plan and pay down debt, but should remain more than sufficient.

Improving Financial Performance: Consolidated financial metrics are poised to improve considerably, given the district's execution of new wholesale power sales contracts in 2011 and 2012, increased share of output from its hydro assets, and favorable net secondary power sales via an auction process. Fitch-calculated debt service coverage (DSC) for all debt obligations, which had fallen to 1.27x in fiscal 2010, rebounded to 1.62x in fiscal 2011 and is projected to strengthen through fiscal year 2016.

Debt Reduction Plan: Consolidated system leverage is high at 8.0x debt-to-funds available for debt service (FADS) compared to the 'AA+' peer median of 4.7x. However, the district has implemented a debt reduction plan and debt-to-FADS is estimated to decrease to 4.3x by fiscal year-end 2016.

Wholesale Sales and Hydrological Conditions: Sales from the district's excess capacity are subject to variability in hydrological conditions and wholesale electricity prices. The Negative Outlook reflects the challenge of managing these sales during periods of low hydrological conditions and/or depressed wholesale electricity prices.

WHAT COULD TRIGGER A RATING ACTION

INADEQUATE FINANCIAL METRICS: Maintenance of the 'AA+' rating depends upon the district restoring financial coverage and leverage metrics to levels commensurate with the rating category by fiscal year-end 2012 as projected (including 2.0x debt service coverage for all debt obligations). Weak revenue generation and/or the inability to reduce debt as planned may result in negative rating action.

CREDIT PROFILE

OPERATIONS AND POWER SUPPLY

The district is an integrated electricity provider, operating since 1947. The current retail customer base encompasses 48,173 users in central Washington. The district's electric utility operations consist of its retail distribution system (the distribution system) and its hydroelectric projects, which are Rock Island (629 megawatt [MW] generating capability), Rocky Reach (1,300 MW) and Lake Chelan (59 MW). The distribution system includes the district's retail electric system, along with a small water and wastewater utility (2% of fiscal 2011 consolidated revenue), a fiber optics system (2% of revenue) and the Lake Chelan Hydroelectric Project.

The district's retail distribution division currently meets most of its power requirements from its share of the combined output of its three hydroelectric facilities and uses market purchases to smooth load. The average cost of power from the combined hydroelectric projects is very competitive at 1.5 cents per kWh for fiscal year 2011. In comparison, Bonneville Power Administration, a large federal power provider in the region, had average preference power close to 3.5 cents per kWh.

POWER SUPPLY MANAGEMENT

The district manages its hydro project generation capacity of 1,100 average MW through long-term contracts and annual slice/block auctions. New long-term contracts for Rocky Reach and Rock Island went into place on Nov. 1, 2011 and July 1, 2012. The new long-term power sales contracts are more favorable for the district and afford the distribution system a larger share of the projects' output, increasing surplus power by approximately 200 average MW. The contracts now charge on a 'cost plus' basis, versus the previous cost of service, and include adders for capex and debt financing costs.

After long-term contracts and native load, approximately 31% of the district's hydro generation capacity remains to be sold in the wholesale market. The district uses an auction process to lock in medium-term block and slice contracts for approximately 27% of hydro generation capacity. In any given prompt year, only approximately 3% of the district's generation capacity is exposed to current market conditions.

Fitch views the district's power supply management strategy positively, as it materially reduces the district's exposure to price and hydrological risk.

FINANCIAL PERFORMANCE

In fiscal years 2009-2010, a combination of below-average water conditions, slowed retail kWh sales and depressed wholesale market electricity prices reduced the consolidated system's operating margins to their lowest levels of the past five years. Fitch-calculated DSC fell to a low 1.27x in fiscal 2010, versus coverage of above 1.6x since fiscal 2006.

Fiscal 2011 financial results have strengthened, due to above-average water conditions of approximately 125%, coupled with various cost-cutting initiatives. DSC is back in line with historical levels, at 1.6x for the fiscal year. While this level is somewhat below the 'AA+' rating category median of 2.05x, coverage of full obligations is a strong 1.59x, which compares favorably to the median of 1.32x.

Year-to-date financials, as of June 30, 2012, are faring even better despite decreased retail rates, as compared to the prior fiscal year. The district has benefited from more advantageous pricing under its newly executed Rocky Reach power purchase contract, which went into place on Nov. 1, 2011, and from favorable auction pricing on medium-term power purchase contracts.

Fitch's affirmation at 'AA+' reflects the view that the district has taken reasonable actions to moderate net wholesale revenue volatility at the distribution level, and should attain financial performance levels in fiscal 2012 and beyond that are commensurate with historical performance and the 'AA+' rating level.

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Additional information is available at 'www.fitchratings.com'. The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

In addition to the sources of information identified in Fitch's Revenue-Supported Rating Criteria, this action was additionally informed by information from Creditscope.

Applicable Criteria and Related Research:

--'U.S. Public Power Rating Criteria', Jan. 11, 2012;
--'Revenue-Supported Rating Criteria', June 20, 2011;
--'U.S. Public Power Peer Study', June 20, 2011.

Applicable Criteria and Related Research:

2011 U.S. Public Power Peer Study — Excel Addendum
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=638690
U.S. Public Power Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=665815
Revenue-Supported Rating Criteria

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