FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Chelan County PUD, WA's Consolidated Sys and Rock Island Revs at 'AA+'; Outlook Stable

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Related Fitch Ratings Content:
Chelan County Public Utility District No. 1 (WA) - ESG Navigator

Fitch Ratings - Austin - 09 Mar 2022: Fitch Ratings has affirmed the following ratings for Chelan County Public Utility District No. 1 (the district), WA at 'AA+':

--$230.2 million consolidated system revenue bonds (series 2008B bank bond rating, 2011C, 2020A, 2020B, and 2020C);

--$159.2 million Rock Island Hydroelectric project revenue bonds, series 1997A (separately secured by project revenues);

--Long-term Issuer Default Rating (IDR).

The Rating Outlook is Stable.

ANALYTICAL CONCLUSION

The 'AA+' IDR reflects the Chelan County Public Utility District No. 1's sizable portfolio of very inexpensive hydro-generating resources, as well as solid revenue defensibility stemming from the district's independent ability to adjust retail and wholesale rates that are among the lowest in the nation. The district's very low leverage profile is supported by strong cash reserves, which are near historical highs, and the continued accelerated amortization of debt, that together result in a healthy financial profile that Fitch anticipates will remain very strong through its stress scenario.

Fitch views the district and its separately secured hydro projects as a combined, integrated system. 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. As such, Fitch rates all the outstanding bonds in line with the district's 'AA+' IDR.

CREDIT PROFILE

The district provides electric, water, wastewater and wholesale telecommunications service throughout Chelan County, WA (aka, the consolidated system) and wholesale power supply to a variety of regional electric customers. The integrated electric system, which includes the retail electric utility and the hydro-generating projects, accounts for roughly 90% of the combined systems' revenues, and serves as the primary driver of the rating. Additionally, modest revenues are derived from the water and wastewater utility and the fiber telecom network, which combined account for less than 4% of the combined systems' revenues. The district's retail electric system serves approximately 52,850 retail customers in the county.

The integrated electric system consists of its retail distribution system and hydroelectric generation on the Columbia River in central Washington State, namely, the Rocky Reach (1,300 MW), Rock Island (629 MW) and Lake Chelan (59 MW) hydroelectric projects. In aggregate, 49% of the Rocky Reach and Rocky Island generation, and 100% of Lake Chelan's generation is sold to the district for use by its retail distribution system, or sold off-system largely pursuant to medium or long-term contracts. Only a relatively small amount of the district's energy (6% for 2021) remained uncontracted and subject to market price exposure.

KEY RATING DRIVERS

Revenue Defensibility: 'a'

Revenue Defensibility Lead

Significant Wholesale Sales; Largely Contracted

Revenue Defensibility

Revenue defensibility is strong but remains exposed to counterparty risk, which Fitch believes is largely mitigated through contractual provisions, collateral postings and the ability to remarket the very low-cost power upon counterparty default. Of the district's ample 1,988-MW capacity, less than a quarter is necessary to meet the needs of its retail customers. The vast majority of excess power is sold to third parties through long- or medium-term contracts designed to largely insulate the district from price and hydro-variability risks. The reliance on the remaining relatively modest amount of revenue from competitive sources is considered manageable.

Operating Risk: 'aa'

Operating Risk Lead

Exceptionally Low-Cost and Robust Hydro Resources

Operating Risk

The district's operating risk assessment reflects its valuable hydropower generation resources at the Rocky Reach, Rock Island and Lake Chelan projects that provide exceptionally low-cost electric power. Declines in market prices over the past decade narrowed the district's cost advantage relative to market prices through 2020. This trend reversed in 2021, as demand rebounded following the coronavirus pandemic. Regional market prices are projected to remain higher through 2025, improving Chelan's relative cost competitiveness. Additionally, Chelan's hydro assets remain in demand as the need for carbon-free hydropower products remains solid. Fitch's operating cost burden metric is very low at 2.64 cents per KWh. Capital plans are significant but manageable and will largely be funded from cash.

Financial Profile: 'aa'

Financial Profile Lead

Very Strong Financial Profile

Financial Profile

The district's combined financial metrics remain very strong with coverage of full obligations at a healthy 2.5x or better for the fifth consecutive year as of fiscal 2020. The district is prudently using margin from wholesale sales and surplus cash flow to rapidly decrease leverage through optional and scheduled debt payments while preparing for a period of increased capital spending. This has positioned the district well to address the upcoming larger capital plan, limiting new debt requirements. In Fitch's five-year forward look and stress scenario, leverage ratios remain consistent with the rating level, albeit modestly higher (over 3x). Liquidity, which has exceeded 560 days since fiscal 2016, should remain very healthy through the forward look.

Asymmetric Additional Risk Considerations

There are no asymmetric additional risk considerations associated with this rating.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

-- An upgrade to 'AAA' is possible but highly unlikely absent strong government support in the form of guarantees from an equivalently rated entity.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

-- Reduced demand for the district's wholesale products for any reason, including persistently low wholesale market prices, which results in sustained leverage above 4x.

-- A material and sustained increase in the operating cost burden above 5 cents/kwh.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

SECURITY

The consolidated system revenue and refunding bonds are secured by a net revenue pledge of the consolidated system, which includes the electric distribution, water, wastewater and fiber optics systems, and the Lake Chelan hydroelectric project. Various series of consolidated system bonds have been issued with a subordinated lien that is now the senior operating lien. The prior senior lien is closed, and no senior lien bonds are outstanding.

Rock Island and Rocky Reach project-specific bonds are secured by a separate senior lien net revenue pledge for each project. The prior subordinate lien Rock Island and Rocky Reach bonds were fully refunded and the subordinate lien was eliminated with the issuance of the 2020 consolidated system refunding bonds. Only the series 1997A senior lien Rock Island project bonds remain outstanding ($159.2 million as of Dec. 31, 2021), of which the consolidated system is an obligor serving as a credit backstop.

REVENUE DEFENSIBILITY

The district's retail electric customers provide an important base of revenues for bondholders. Fitch views retail electric revenues as a business line that exhibits monopolistic characteristics and provides a high degree of revenue consistency but account for a relatively small portion of the integrated system revenues (19% in FY20). The retail electric load is primarily made up of residential customers, which provide close to half of retail revenues, followed by industrial then commercial customers.

The retail electric load is a growing portion of revenue given both customer growth in the county and annual rate increases currently planned but will remain relatively minor piece of revenues considering the district's sizable capacity and other sales. Other monopolistic revenues include that from the retail water, wastewater, transmission, and below cost fiber telecom services that accounted for roughly 4.3% of the integrated system revenue in FY20. The district's reliance on the sale of excess generation under various contract structures for the majority of its revenue base is considered an asymmetric risk on revenue defensibility described below.

Service Area Characteristics

Chelan County's economic and demographic metrics are generally midrange compared with national and state averages. The county is historically anchored by the agriculture industry with some diversification into manufacturing, healthcare, education, and more recently cryptocurrency mining and other technology as the county has grown and serves as the regional economic hub. Unemployment in the county (8.4% in 2020) was slightly above the national level reflecting some level of volatility in the county due to the seasonal nature of the agricultural portion of the economy. The median household income (MHI) is reflective of these trends and just below the national average. Fitch expects that the county's service area will remain on pace with the national averages.

The district's customer base is stable, and management projects retail load growth of 2.5% through the forecast period, including new large industrial customer contracts. New customers have increased at just over 1% over the past five years, and Fitch expects this trend to produce moderate demand growth over the longer term.

New Advanced Technology Loads

Computing, data processing, and other new technology related businesses looking for large, low-priced energy supply continues to show interest in the district's energy supply products. The district has prudently imposed multiple moratoriums over the past few years on any new, large industrial customers in order to investigate the implication to retail customers. Ultimately, the district's high density load (HDL) rate structures (most recently updated in 2018 to address the growth of cryptocurrency related load requests) ensure these operators carry the full operational and financial risks of providing this power. Going forward, these rates will be updated to reflect market conditions but include market-based pricing and may include the value of the environmental attributes and transmission costs.

New large load customers in recent years include the Diamond Foundry (19MW) and Microsoft (up to 50MW). The district entered into an agreement beginning April 2019 to provide Microsoft carbon free hydroelectric energy to power their Puget Sound region campuses through March 2024. The contract is to supply market rate power, plus environmental and transmission costs, largely offsetting any concentration concerns as the district's cost of power is well-below market. Additionally, the Diamond Foundry, a San Francisco based 2015 startup creating laboratory fabricated diamonds moved to Chelan County and signed a contract to obtain a 19MW carbon-free load that is expected to begin taking power in late 2019.

Coronavirus Considerations on Demand

The district's relatively small portion of capacity used to supply local retail load at discounted prices (generally well below market prices) somewhat insulates revenues from retail demand shocks. Declines in retail loads, such as those related to the coronavirus pandemic, can alternatively be sold off-system through the district's power supply hedging program, similar to other surplus power. The off-system sales were at lower market energy prices in 2020, as the economy abruptly contracted with the business-curtailment response to the coronavirus. Additionally, hydrological, weather and energy market price variations are likely to continue to contribute to revenue volatility for the district, although Fitch believes the district is in a position to hedge a majority of this risk using its varied wholesale products and conservative hedging policies.

Rate Flexibility

Fitch considers the district's retail rate flexibility to be very strong given its independent ability to set rates that are among the most competitive and affordable in the nation. Fitch calculates the average customer bill affordability is very high at 1.2% of MHI with rates at about 40% of the state average, according to the U.S. Energy Information Administration. The inflation-based rate increases planned for retail customers for the next three years will not affect Fitch's assessment of rate flexibility.

Revenue Defensibility Asymmetric

Asymmetric Rating Factor Consideration -- Wholesale and Off-System Revenue

The district manages revenue risk associated with its off-system sales through a combination of contracted and market sales to a level Fitch considers adequate for the 'a' revenue defensibility assessment. The largest source of the district's revenues ($133.5 million or 38% of 2020 combined system revenues) is provided through long-term, take-or-pay contracts priced largely at cost plus margin, which Fitch believes sufficiently addresses hydrological, renewal, and merchant risks.

The three counterparties of these contracts currently are: Alcoa Corporation (Alcoa; BBB-/Stable IDR), contracted for 26% of the combined output of Rocky Reach and Rock Island through 2028; Puget Sound Energy, Inc (PSE; BBB-/Negative IDR), contracted for 25% of the combined output of the combined output of Rocky Reach and Rock Island through 2031; and Douglas County PUD contracted for 5.5% of the output of Rocky Reach through 2031.

A similar contract with Microsoft (AAA/Stable IDR) for up to 50 average megawatts (aMW) or roughly 5% of combined district capacity began in April 2019, is contracted through March 2024, and is estimated to provide about 6% of revenue on average. In December 2021, the district signed a new long-term, cost plus margin supply contract with Avista Corp. (not rated by Fitch), for 5% of the Rocky Reach and Rock Island output for 2026-2030, and increasing to a 10% slice of the hydro projects for 2031-2045.

Another approximately 13% of 2020 combined revenues was derived from market-based "slice of the system" sales under various contracts that expire over the next 5 to 10 years.

The slice contracts are with investment grade counterparties and require posted collateral under one-way margining agreements.

These contracts are monitored and continually updated under a five-year laddered power supply management program. While the majority of these sales are under longer term contracts, the contracts expire on a rolling schedule. As such, a portion of these revenues contracted under shorter terms are continually up for renewal and exposed to market-based pricing that Fitch considers more variable.

Any "remaining surplus" power supply (only 6% of combined revenues for FY20) is largely hedged in the coming year, but adds some level of competitive pricing exposure over any five-year period. Overall, the level of exposure is considered manageable and consistent with the 'a' revenue defensibility assessment. Other revenues from retail water, wastewater, transmission, sale of RECs, and fiber telecom services together make up a small portion of combined revenues.

Counterparty Exposure

The district is protected from its counterparty credit exposure to either Alcoa or Puget Sound Energy through contractual step-ups between the two entities that require either party to step up in the circumstance that the other counterparty defaults. Additionally, in the event of a premature facility closure, as occurred with Alcoa recently, the contracts are designed to provide the district revenue protection. In December 2021, Alcoa announced a permanent closure of its Wenatchee smelter. Under the power sales contract, Alcoa remains responsible for the hydro project slice of the costs regardless of the actual amount of power used through 2028, and the district alone retains the right to terminate the contract. The district also holds $45 million in collateral from Alcoa for protection against default (minimum requirement in contract is $40 million plus three months operating expenses).

For the market-based slice contracts, the district requires that all posting requirements be met with a letter of credit, unless the counterparty holds a senior unsecured credit rating of 'A+' from at least one of the nationally recognized rating agencies.

Fitch believes the credit of the counterparties, the credit management provisions, and guarantees from the distribution system that would ultimately have access to the very low-cost power supply in event of counterparty default, further supports Fitch's 'a' revenue defensibility assessment.

OPERATING RISK

Fitch calculated a very low operating cost burden for the district at 2.6 cents per KWh in fiscal 2020, anchoring the very strong 'aa' operating risk assessment. The district owns and operates three hydroelectric projects, Rocky Reach, Rock Island and Lake Chelan, which have a combined nameplate rating of 1,988 MW. Rock Island Dam was the first hydroelectric facility spanning the Columbia River and was placed into operation in 1933, followed by the larger Rocky Reach Dam in 1961. Lake Chelan is a small hydroelectric facility off the Columbia River and was traditionally part of the distribution system.

The low-cost nature of these generating assets is a significant credit strength. Even with some operational challenges over the past few years and modernization needs, discussed below, the average cost of power from these resources has been extremely competitive.

Operating Cost Flexibility

The operating flexibility is assessed as weaker given the concentration of the district's generation in hydro-electric projects. However, the hydro projects more than meet the power requirements for the district's retail load and allow the district the flexibility to sell a significant amount of excess power. These sales are done under various strategies with prices ranging from cost, to cost-plus-margin and to market prices that are well above the district's costs. While the district's cost advantage relative to the market had diminished in recent years as wholesale power prices in the Northwest declined with the introduction of abundant wind resources and other renewables, the district's stable and low production costs remain attractive to purchasers.

Demand for the district's medium- and long-term slice products has been solid. The district's combined cost of hydropower is roughly $20.3/MWh for 2021, and forecasted to only modestly increase through 2025. The cost at the district's projects remain well below the cost of power in the regional market ($49.3/MWh) or from Bonneville Power Administration (BPA), which provided power to preference customers at an average cost of $40.5/MWh in 2021.

Environmental Initiatives

The district remains in compliance and well positioned to meet additional required state RPS targets. Under Washington State's renewable portfolio standards (RPS), utilities that serve 25,000 customers or more are required to obtain 15% of their load from renewable resources by 2020, or approximately 31 aMW for Chelan PUD. Eligible resources include incremental hydro, wind, solar or renewable energy credits. A portion of Rocky Reach, Rock

Island and Lake Chelan output was affirmed by Washington Department of Commerce as incremental hydro, providing the district with excess supply of renewable resources. Additionally, the district is well positioned, given its carbon-free power supply, to meet the state's Clean Energy Transformation Act (CETA), which requires the state to achieve a power supply free of carbon emissions by 2045.

Capital Planning and Management

Age of plant has increased to 24 years, indicating high lifecycle investment needs, which Fitch believes is being addressed in the updated capital plans. The capital improvement plan (CIP) for 2021-2025 totals roughly $772 million, up moderately by $63 million from prior year's 2020-2025 plan. The largest component of the plan, approximately $285 million, will finance the Rock Island unit modernization.

Modernization and replacement of the generating units at both Rock Island and Rocky Reach are ongoing. At Rock Island, the last of the original generating units were taken out of service in 2016 due to corrosion fatigue on the blades. This work, in addition to the FERC relicensing, is expected to cost the district over $700 million by 2029, including the current repairs that will be credited to relicensing. FERC has determined that over $600 million of investments appear to qualify for early action credit (as of October 2019). These modernizations include environmental work, in partnership with Douglas County PUD that the districts have committed to for salmon and steelhead. The plans contemplate no net impact on fish runs for 50 years.

The new $140 million operations and service center facility, along with modernization at the distribution system, rounds out the majority of the CIP. The CIP will largely be funded through revenues and reserves, with an estimated $103 million of new money financings likely beginning in 2023.

FINANCIAL PROFILE

The district ended fiscal 2020 with a fifth consecutive year of very strong financial performance, producing operating income of $82.6 million which exceeded budget and all financial policy targets. Combined system operating income was over $20 million better than budget for FY20, despite challenges posed by the pandemic. Declines in the district's off-system sales and revenues due to covid-19 restrictions were more than offset by lower than anticipated operating costs and moderate capex delays. Average wholesale market prices weakened in 2020 (below $25/mwh), but retail revenues improved with the ramping up of MSFT sales and the implementation of inflation-level utility rate increases which began in late 2020. COFO marginally weakened to 2.5x in FY20 from 3.0x in FY19, which was an exceptionally favorable financial performance year.

Available cash reserves remained very healthy at 693 days cash on hand in fiscal 2020, with a small draw down of cash for capex. The district's leverage ratio remained very low at 2.0x, supporting the 'aa' financial profile assessment, and cash reserve balances (restricted and unrestricted) more than offset total debt outstanding. With the exception of fiscal 2020, debt has steadily declined in recent years as the district amortized debt rapidly and redeemed it ahead of schedule. Up until FY20, a third of outstanding debt had been retired over the prior five-year period (2015-2019). Debt will return to its downward trend in fiscal 2021. Through the third quarter of FY21, Chelan's financial performance remains very strong, aided by materially higher wholesale market electricity prices boosting off-system revenues and margin; along with a positive pension actuarial adjustment ($26 million)

Fitch Analytical Stress Test (FAST) Base Case and Stress Case

Given the relatively low leverage ratio in fiscal 2020 (2x), neither Fitch's base nor stress case scenarios significantly affect the district's leverage ratio outside of expectations for the high rating level. The base case is informed by the district's proforma financial forecast for its combined systems through 2025, and includes the board-approved annual retail utility system rate increases (3% - 4% per utility each year to 2024), and increased capex that is projected to be funded from a combination of cash, rate increases and modest new money borrowings (13% of capex). Secondary surplus wholesale sales and margins should also improve over the next five years as the northwest market prices are projected to remain elevated.

In Fitch's base case, the leverage ratio is expected to increase to 2.5x through the medium term as capex rises, then trend downward thereafter, as the district continues to accelerate debt paydown and the debt burden declines. Cash balances are anticipated to remain healthy and in line with the district's minimum policy targets of 250 unrestricted days cash on hand and debt service coverage in excess of 2.0x.

Fitch's stress case reflects a significant demand stress in fiscal 2021, with a partial rebound in sales in the outer years. The results of Fitch's stress scenario are not materially weaker primarily due to strategies in place to hedge price and hydro risk on the majority of the district's wholesale sales. The district is currently fully hedged through 2023 with fixed prices mitigating potential price declines. In Fitch's stress case, a significant amount of the district's margin should be preserved due to the wholesale sales that include take-or-pay agreements with costs that include margin stabilization, and the laddering of expiration of shorter-term market-based contracts that secure sales over the next five years. Although leverage initially rises to 4.3x in FY22, it declines thereafter to 3.6x in the latter years, and debt outstanding maintains its descent throughout the forward period.

Debt Profile

The district's integrated system debt profile is neutral to the rating and included a total of $389.4 million in long-term debt outstanding (as of Dec. 31, 2021) that amortizes through 2039. A small portion of currently outstanding debt is variable rate ($40 million, series 2008B consolidated system revenue bonds). A majority of debt is issued on a lien of the consolidated system revenues, which has covenanted net revenues to provide a bond coverage ratio of at least 1.25x annual debt service, together with available funds, or 1.00x without available funds. The remaining debt consists of separately secured Rock Island project revenue bonds. Fitch views the district and its separately secured hydro developments as a single integrated system with the consolidated system as the ultimate obligor.

Sources of Information

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

The ESG Relevance Score of '2' for Environmental Energy Management is changed from a '2' to a '3' to align the score with the U.S. Public Power sector guidance.

The ESG Relevance Score of '2' for GHG Emissions & Air Quality for the district varies from the public power sector guidance score of '3' since hydro-only systems are not significantly exposed to the generation of GHG emissions from operations.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Chelan County Public Utility District No. 1 (WA)	LT IDR	AA+	Affirmed	AA+
Chelan County Public Utility District No. 1 (WA) /Electric System Revenues - Consolidated System/1 LT	LT	AA+	Affirmed	AA+
Chelan County Public Utility District No. 1 (WA) /Electric System Revenues - Rock Island System/1 LT	LT	AA+	Affirmed	AA+
Chelan County Public Utility District No. 1 (WA) /Electric System Revenues - Subordinated/1 LT	LT	AA+	Affirmed	AA+

PREVIOUS Page 1 of 1 10 rows NEXT

VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

APPLICABLE CRITERIA

U.S. Public Power Rating Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 01 Sep 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Chelan County Public Utility District No. 1 (WA)	EU Endorsed, UK Endorsed

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