S&P Global Ratings

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

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

Credit Profile		
US$124.4 mil cons sys rev and rfdg bnds ser 2020A due 07/01/2039		
Long Term Rating	AA+/Stable	New
US$26.2 mil cons sys rfdg bnds ser 2020C due 07/01/2028		
Long Term Rating	AA+/Stable	New
US$14.4 mil cons sys rfdg bnds ser 2020B due 07/01/2034		
Long Term Rating	AA+/Stable	New
Chelan County Public Utility District #1 con sys		
Long Term Rating	AA+/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'AA+' long-term rating to the following proposed consolidated system revenue bonds being issued by Chelan County Public Utility District No. 1, Wash.:

- $124.4 million series 2020A (non-AMT) revenue and refunding bonds,
- $14.4 million series 2020B (non-AMT) refunding bonds, and
- $26.2 million series 2020C (AMT) refunding bonds.

At the same time, we affirmed our 'AA+' long-term rating on the district's various consolidated system revenue bonds outstanding. Finally, we affirmed our 'AA+/A-1' dual rating on the district's series 2008B variable-rate bonds backed by a standby bond purchase agreement with Barclays Bank PLC. The outlook, where applicable, is stable.

Net revenue of the district's consolidated system secures the bonds.

The series 2020A bond proceeds will be used to finance various capital improvements of the consolidated system and refund all or a portion of the district's series 2009D bonds. The series 2020B bond proceeds will be used to refund all or a portion of the district's Rock Island System series 2009A bonds and Rocky Reach System series 2009A bonds outstanding. The series 2020C bond proceeds will be used to refund all or a portion of the district's series 2008B consolidated system bonds outstanding. As a result of these financings and the district's plan to accelerate some future principal payments, the district anticipates no material change in debt outstanding by 2022.

As of Dec. 31, 2019, the district had $265 million in consolidated system debt and $202 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. In addition to direct debt, the district is responsible for approximately $3 million of off-balance-sheet debt attributable to its share of Nine Canyon Wind Phase I and II project debt.

Credit overview

The rating reflects our opinion of the district's very strong enterprise risk profile and extremely strong financial risk profile:

The enterprise risk profile reflects our view of the district's:

- Very strong operational and management assessment, highlighted by extremely strong operational assets, very strong environmental compliance, extremely strong management, policies, and planning, and very strong rate-setting practices;
- Strong service area economic fundamentals, with a largely residential and diverse retail revenue base and slightly above-average income levels, although we note that the majority of district energy sales are to purchasers outside of the direct service territory given its significant surplus sales;
- Extremely strong market position as a result of rates that are among the lowest in the nation at just over 3 cents per kilowatt-hour (kWh) according to our calculations; and
- Extremely strong industry risk assessment relative to other industries and sectors.

The financial risk profile reflects our view of the district's:

- Extremely strong coverage metrics, with fixed-charge coverage (FCC) in unaudited fiscal 2019 of 3.5x on a combined basis, or a still extremely strong 2.7x when including $16 million in accelerated principal payments, forecast at no less than 2.2x through fiscal 2024 under what we consider reasonable assumptions;
- Extremely strong liquidity and reserve position, with $412 million in unrestricted cash, or 680 days' cash, as of unaudited fiscal 2019, with management projecting liquidity to decline somewhat to about $180 million, or about nine months' cash, by 2022 given capital spending plans and avoidance of new debt; and
- Extremely strong debt and liabilities profile, suggested by the district's debt to capitalization of just 30% as of fiscal 2019, with $139 million in additional debt planned in fiscal years 2022 to 2024.

Chelan, established in 1936, 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 (80% in 2019) than to its own retail system (20%). Margins from surplus power sales contribute to the district's very low retail rates and exceptional FCC and liquidity, and provide critical funding for ongoing capital needs, especially renewal and repair projects at Rocky Reach and Rock Island. In fiscal 2019, lower costs more than offset impacts from lower-than-normal (77% of average) stream flows and unit outages, and cash balances continue to exceed debt outstanding.

As of April 7, Chelan County reported 34 cases of COVID-19, but management reports that no district employees have tested positive. The district had an existing outbreak response plan in place as a result of a prior outbreak (bird flu), and is proactively managing the plan to limit the operational and financial impact to the district and its customers. There has been no material operational disruption thus far. We note that the district does not have substantial concentration among customers taking energy, with the leading 10 customers representing just 2.4% of operating revenue and with seven of the 10 representing either health care, agriculture, or electric utility operations, which we view as essential businesses relative to other sectors. In many cases, we have seen commercial and industrial loads decline as a result of requirements for nonessential employees to stay at home, but for Chelan, commercial and industrial revenue account for just 5% of gross revenue. In addition, many loads were expected to increase in 2020, but are now expected to be flat. The district also reports that delinquencies have not yet spiked in light of its policy to not disconnect customers or charge fees for nonpayment during the outbreak, and has already set aside significant money for bad debt. Nevertheless, should the pandemic and economic recession extend and deepen, commercial and industrial loads could decline, as could residential loads, but, in our view, given the district's exceptional financial position, any declines should be manageable.

The district's response to and anticipated manageable impact from COVID-19 helps support the maintenance of the stable outlook. The stable outlook further reflects our assessment of the district's extremely low-cost power supply (substantially below prevailing market prices), significant debt acceleration in recent years and the financial flexibility that that provides, exceptionally strong financial position and declining debt burden. The outlook also reflects our expectation that management will continue to enact budget or hedging measures to counter any revenue shortfalls that would occur in its wholesale operations, to achieve its financial targets.

Environmental, social, and governance

We believe the district's direct environmental risks are very low, based on its power supply almost entirely consisting of non-carbon-emitting resources and its historical efforts and investments in fish and wildlife mitigation. The district faces social risk related to COVID-19, as efforts to protect the health and safety of the community may affect the utility's financial metrics, albeit likely modestly. Finally, we view the utility's governance factors as credit supportive as they include full rate-setting autonomy, strong policies and planning, and a proactive and experienced management team.

Stable Two-Year Outlook

Upside scenario

We don't expect to raise the rating over the next two years given our expectation that FCC and liquidity will likely erode somewhat but nonetheless remain at levels we consider extremely strong. Further constraining upside are Chelan's somewhat limited economic base, asset concentration, large capital plan, exposure to variable hydrology, and uncertainty with regard to the impact of the COVID-19 pandemic and its lingering effects.

Downside scenario

We don't expect to lower the rating during our two-year outlook period given the district's significant rate flexibility given its extremely low-cost power supply, and our view that the utility has considerable headroom for erosion in FCC and liquidity while sustaining extremely strong metrics.

Credit Opinion

Enterprise Risk Profile

Operational Management Assessment: Very strong

In our opinion, the district's operational management is very strong, highlighted by its extremely strong operational assets and management, policies, and planning, and its very strong environmental compliance and rate-setting practices.

We view the district's operational assets as extremely strong. The district's distribution system takes 48% of the aggregate output from its Lake Chelan (59 megawatts, or 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 (although sales to Alcoa are suspended, as discussed below), Puget Sound Energy, and Douglas County Public Utility District No. 1--through long-term, take-or-pay contracts that expire in 2028, 2031, and 2031, respectively. The contract with Douglas is subject to extensions. 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 periodically selling slices of its system by auction or negotiation to various counterparties for up to 10 years (typically five years) on a rolling basis. We believe this strategy effectively minimizes revenue volatility and the financial risk related to low or volatile stream flows. In addition to hydropower, nominal resources come from the district's share of energy from the Nine Canyon Wind Project Phases I and II.

The Rocky Reach Project, with a license extending to 2052, has an extremely low production cost of just 1.2 cents per kWh (2019) and has excellent shaft diversity with 11 turbines. The Rock Island Project likewise has shaft diversity with 19 turbines, with a 2019 production cost of 3.6 cents per kWh. Its license expires in 2028. We believe the projects' low power costs should perpetuate high demand for output beyond the expiration dates of take-or-pay contracts covering about 52% of output. The district's resources also have good geographic dispersion. However, we take a negative view of the consolidated system's concentrated fuel mix in hydropower, which exposes it to streamflow variability, although the quality of the district's assets, including their strong project economics (low power cost), significantly offset these risks. We also view the consolidated system's resource adequacy and wholesale sales hedging strategy as significant credit strengths.

We view the district's environmental regulation and compliance assessment as very strong. The hydro project does not face looming greenhouse gas compliance costs that owners of conventional power plants do. Also, it is in compliance with the state's renewable energy mandate known as I-937. The district expects to meet all future requirements utilizing existing incremental hydro, Nine Canyon Wind Project output, and juvenile fish bypass/spill reductions, which the district reports are well in excess of the renewable portfolio standard requirements under any reasonable scenario. Also significant is that the district's entire resource portfolio is 100% non-carbon-emitting. The district must practice environmental stewardship with regard to actions in response to fish, wildlife, and other environmental regulations, but we view this exposure as minimal given substantial investments in these areas historically.

We view the district's management, policies, and planning as extremely strong. The district has a policy to maintain cash reserves at no less than 250 days, debt service coverage above 2x, debt at less than 35%, and nominal liquidity at more than $175 million, and evaluates its base rates annually as part of the budget process. Updates to the district's financial forecast are completed more frequently than annually. The district also does a monthly budget-to-actual analysis, which it shares with the board on a quarterly basis. Management is especially proactive when it comes to generation, wholesale revenue volatility, and counterparty credit risk. The district's March 2020 updated power supply management program hedges to stressed water scenarios. This is key to mitigating price, stream flow, and operational risk. The district has also made considerable investments in cybersecurity systems.

The district's rate-setting practices are very strong, in our view, reflecting our view of its demonstrated ability and willingness to adjust rates, although no base rate increases have occurred since 2012. The district's board-adopted strategic plan for 2020-2024 does include annual rate actions for the electric system of about 3% per year. Substantially reducing debt and keeping rates low are key district objectives. The district's multilayered comprehensive approach to power supply management offsets the absence of a power cost adjustment mechanism.

Economic fundamentals: Strong

We view the district's economic fundamentals as strong, characterized by median household effective buying income that is slightly above the national average, stability provided by residential revenue accounting for 42% of retail revenue, and a very diverse customer base. The district's leading customer, Douglas County Public Utility District, represents just 1.3% of operating revenue. The district's extremely low-cost power--whereby if the district experienced customer loss and were required to sell the power on the market, it would likely do so at a profit--supports our economic fundamentals assessment.

Chelan County's (population of about 78,000) economic base, historically agricultural, continues to diversify and is generally stable with good employment opportunities, although unemployment could be heightened as a result of the COVID-19 pandemic. We also believe the county lacks the depth and breadth of more urban systems. Unemployment was 4.5% as of 2019, and median household effective buying income was at 104% of the national average as of 2018. The electric utility served 52,146 retail customers in 2019, 76% of which were residential and accounted for 44% of retail energy sales. Retail energy demand from residential, commercial, and industrial customers has been flat since 2017. Electric rates are extremely low with residential rates at just 3.2 cents per kWh in 2019, a figure that has changed very little over the past 15 years. No base rate increases have been implemented for seven years, but increases of approximately 3% annually are included in projections. Given its very low rates, Chelan, as with neighboring utilities in Grant and Douglas counties, has seen increased requests for power to serve high-load cryptocurrency mining operations. The district has put in new rate schedules and has implemented policies to mitigate potential risks (and ensure cost recovery) that come with this increased demand given cryptocurrency mining's potential transient nature, but also given its heavy demands on system infrastructure.

Market position: Extremely strong

We consider the district's market position extremely strong, reflecting weighted average revenue per kWh that is among the lowest in the country at just 3.2 cents per kWh (about one-quarter of the national average), or a very attractive 37% of the state average (2017). This is largely a result of superior project economics from its largest baseload units, the Rock Island and Rocky Reach projects. The district's average power cost was just $20 per MW-hour (MWh) in 2019, well below prevailing market prices (the "average adjusted wholesale" preference rate for Bonneville customers was $42 per MWh in 2019), and in line with previous years.

Industry risk: Extremely strong

Consistent with our criteria "Methodology: Industry Risk," published Nov. 19, 2013 on RatingsDirect, we consider industry risk for municipal retail electric and gas utilities covered under these criteria very low, and therefore extremely strong compared with that of other industries and sectors.

Financial Risk Profile

Coverage metrics: Extremely strong

The district had a record-setting year financially in fiscal 2019, exceeding budgeted net revenue and all financial policy targets. Furthermore, the district reports that the past five fiscal years have yielded the best net revenue in its history. Actual FCC ratios on a combined basis at the consolidated system ranged from 2.2x to 3.4x and averaged 2.9x during fiscal years 2016 to 2019. However, when debt service is adjusted to remove optional debt prepayments (which totaled $44 million during this period), FCC was much stronger, ranging from 3.1x to 3.5x (averaging 3.3x), and was most recently 3.5x in fiscal 2019. Likewise, consolidated system unrestricted cash would be at least $44 million higher without such prepayments. The district's coverage continues to benefit from its recent practice of debt reduction, which has reduced annual debt service requirements. FCC treats off-balance-sheet debt service (e.g., the system's share of the Nine Canyon Wind Project) as debt service rather than as operating expenses. In our view, the district's forecast assumptions are reasonable, especially given the district's recent track record. Forecast FCC (based on scheduled debt service without accelerated principal payments) through 2024 is no less than 2.2x and assumes 3% annual electric rate increases and $139 million in additional debt. We view the district's projections as conservative and realistic, including assumptions on wholesale slice sales activity, expense growth, and market prices.

FCC demonstrated some volatility several years ago, including a decline in FCC to 1.4x in fiscal 2014 from 2.7x the year prior, and these fluctuations typically result from variability in debt service requirements and streamflow or declines in wholesale prices. More recently, management has placed greater emphasis on managing wholesale revenue volatility and counterparty credit risk by entering into five- to 10-year contracts with various counterparties for "slices" of system output. These agreements add stability and predictability to the district wholesale revenue given that the purchasers assume hydro variability risk but also benefit from upside.

Liquidity and reserves: Extremely strong

We consider the district's liquidity and reserves extremely strong, with $412 million in unrestricted cash, or 680 days' cash, as of fiscal 2019. As of fiscal 2019, the district also held $117.5 million in power contract reserves in secondary liquidity that it could utilize, if needed, but that is currently designated for capital projects at the hydroelectric projects. The district's internal policy requires it to maintain no less than 250 days' cash of operating expenses. Based on the district's forecast, it anticipates generating significant cash flow that will significantly bolster liquidity, a portion of which it intends to use for significant capital projects, such as projects at Rock Island or Rocky Reach. Nevertheless, the district projects cash balances to decline to about $180 million, or about nine months' operation expenses, by 2022, and projects liquidity to then post modest increases through 2024.

Debt and liabilities: Extremely strong

In our opinion, the district's debt and liabilities profile is extremely strong, suggested by debt to capitalization of 30%, which we consider very low, as of fiscal 2019. Even despite $139 million in debt issuances planned for the next five years, the district's debt to capitalization is forecast to decline to 22% by 2024 as a result of both scheduled and accelerated debt repayments and refinancing activity. Through fiscal 2024, the district combined has budgeted $695 million in capital spending, with the Rock Island Project budgeting $285 million on its own. Pension and other postemployment benefit liabilities are very manageable, in our view.

Alcoa curtailment

Alcoa Inc., the former parent company of Alcoa Corp., curtailed operations at Wenatchee Works smelter in December 2015, and about 425 employees were laid off in connection with the shutdown. When Alcoa separated from its former parent company, it kept its main aluminum operation, which includes the local Wenatchee Works smelter. The district assigned the existing power contract for the smelter to the new company in November 2016, when the separation occurred, after receiving additional performance assurances including a minimum collateral requirement of $40 million. In May 2017, given Alcoa's and the district's desire to preserve the prospect for a restart (as a benefit to the local economy), the district's commission approved a one-year deferral of what is known as the Shutdown Settlement Amount to June 2018. This contract amendment required that Alcoa pay the district $7.3 million in June 2017. If the plant remained curtailed in June 2018, Alcoa owed a $62 million payment; this indeed was the case and the payment was made. These funds count toward the district's unrestricted cash balance. Even if Alcoa remains shut down, it is contractually obligated to pay its share of monthly operating costs and debt service, although any revenue from the sale of its share of power would be netted against such payments. In addition, the district continues to hold $49 million in collateral for protection against default. The Alcoa plant remains idle as of this report.

Bond provisions

The rate covenant for the consolidated system bonds requires Chelan to collect revenue that provides annual revenue sufficient to pay operating expenses of the consolidated system and cover debt service by 1x, or by 1.25x in combination with other unencumbered funds. The district maintains a debt service reserve for the consolidated system bonds in the amount of maximum annual interest payable in any year. 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.

Ratings Detail (As Of April 9, 2020)		
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