Moody's Investors Service

Global Credit Research
New Issue
15 MAY 2009

New Issue: **Chelan County Public Util. Dist 1, WA**

MOODY'S ASSIGNS Aa2 TO CHELAN COUNTY PUBLIC UTILITY DISTRICT'S DEBT ISSUANCES; OUTLOOK HAS BEEN CHANGED TO NEGATIVE

CHELAN COUNTY PUBLIC UTILITY DISTRICT HAS APPROXIMATELY $1 BILLION OF OUTSTANDING REVENUE BONDS

Electric Utilities
WA

Moody's Rating

ISSUE		RATING
Consolidated System Revenue Bonds, Series 2009A (Non-AMT)		Aa2
Sale Amount	$34,100,000	
Expected Sale Date	06/15/09	
Rating Description	Revenue	
Consolidated System Revenue Bonds, Series 2009A (AMT)		Aa2
Sale Amount	$21,900,000	
Expected Sale Date	06/15/09	
Rating Description	Revenue	
Consolidated System Revenue Bonds, Series 2009B (AMT)		Aa2
Sale Amount	$8,500,000	
Expected Sale Date	06/15/09	
Rating Description	Revenue	
Rock Island Hydro Electric System Revenue Bonds, Series 2009A (Non-AMT)		Aa2
Sale Amount	$14,300,000	
Expected Sale Date	06/15/09	
Rating Description	Revenue	
Rocky Reach Hydro-Electric System Revenue Bonds, Series 2009A (Non-AMT)		Aa2
Sale Amount	$18,100,000	
Expected Sale Date	06/15/09	
Rating Description	Revenue	

Moody's Outlook Negative

Opinion

NEW YORK, May 15, 2009 -- Moody's Investors Service has assigned a Aa2 long-term rating to Chelan County Public Utility District (District or Chelan PUD) No. 1's $30.4 million Consolidated System Subordinate Revenue Notes, Refunding Series 2009A/B, $34 million of Consolidated System Revenue Bonds, Series 2009A , $14.3 million Rock Island Revenue Bonds, Series 2009A, $18.1 million Rocky Reach Revenue Bonds, Series 2009A, and $92.88 million Consolidated System Revenue Bonds, Refunding Series 2008B (Non-AMT).

The Consolidated System Revenue Bonds, Refunding Series 2008B (Non-AMT) are a remarketing of existing Consolidated System Revenue Bonds, Refunding Series 2008B (AMT). The Consolidated System Revenue Bonds will be subject to mandatory tender and will be remarketed as bonds no longer subject to the AMT. The tender and remarketing is expected to be completed in early June. The short-term, VMIG 1, rating on the Consolidated System Revenue Bonds, Refunding Series 2008B (Non-AMT) will not be adversely impacted by the amendment to the Fourth Supplemental Resolution. This amendment provides for: (i) conversion of the Consolidated System Revenue Bonds, Refunding Series 2008B from AMT to Non-AMT; and (ii) the incorporation of provisions for an additional rate mode called the 10 Month Rate Mode. The Consolidated System Revenue Bonds, Refunding Series 2008B following the tender and remarketing will continue to bear interest in the weekly rate mode. Additionally, the SBPA provided by US Bank N.A. will continue to remain in place and is not being amended.

Moody's also affirmed the District's $1 billion of outstanding bonds including $278.8 million of Rock Island Hydroelectric Project revenue bonds, $7.4 million of Rocky Reach Hydroelectric Project revenue bonds, $486.3 million of Chelan Hydro Consolidated System revenue bonds, $173.3 million of Consolidated System revenue bonds, and $53.7 million of Consolidated System subordinated revenue bonds.

The current Aa2 rating reflects Chelan PUD's highly competitive hydro generation, strong liquidity position, low retail rates, and take or pay contracts for a large portion of Rocky Reach and Rock Island's output with investment grade offtakers.

The rating also incorporates the District's significant reliance on large wholesale power sales to meet cash flow needs, large but manageable capital spending and improvements to the hydro system over the next several years and PPA offtakers that are rated lower than Chelan PUD.

The negative outlook on the District's Aa2 rating considers the likely lower than originally expected wholesale revenues over the next several years, the limited rate increase taken by Chelan PUD to offset lower merchant cash flows, and negligible hedges for 2010 and onward to minimize the volatility of wholesale revenues. The negative outlook also considers the likely decline in Chelan PUD's credit metrics and significant reserves over the next several years.

USE OF PROCEEDS:

The Consolidated System Revenue Bonds Refunding Series 2008B (Non-AMT) are a conversion of existing Consolidated System Revenue Bonds Refunding Series 2008B (AMT) from AMT to Non-AMT.

Proceeds from the Consolidated Revenue Notes Refunding Series 2009A and 2009B bonds are expected to refund Chelan Hydro Consolidated System Series 1999A and 1999B bonds.

Proceeds from the Rock Island Revenue Bonds Series 2009A, Consolidated System Revenue Bonds Series 2009A, and Rocky Reach Revenue Bonds, Series 2009A are expected to fund various capital improvements at each respective system.

LEGAL SECURITY:

The current offering of Rock Island revenue bonds is governed under a master resolution and secured by a pledge of net Rock Island system revenues subordinate to the lien on the senior and prior lien Rock Island Revenue bonds. The senior or prior liens have been closed to new debt issuances and approximately $271 million of prior lien Rock Island bonds were outstanding at year-end 2008, which are now considered the senior lien. 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 there is a weak debt service reserve requirement, which is equal 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, which have been refunded. 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 there is a weak debt service reserve requirement of maximum annual interest.

The Consolidated System Subordinate notes and Consolidated System bonds are secured by a third lien and second lien, respectively, and on the revenues of the consolidated system. The Chelan Hydro Consolidated System bonds are senior and Chelan PUD has covenanted not to issue additional senior bonds. The consolidated system includes the net revenues of the District's electric distribution enterprise, the Lake Chelan Hydroelectric Project, the water system, the wastewater system, and the fiber optic system. The rate covenant 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 additional bonds test is 1.25/1.00 times. The debt service reserve requirement is equal to maximum annual interest. While the District's obligations are all currently rated the same, a weakening of Chelan PUD's overall credit quality could also result in rating distinctions between the different revenue liens.

INTEREST RATE DERIVATIVES:

The District has five interest rate swaps with a total notional value of $231,034,000 and agreements with highly rated counterparties. The swaps are floating to fixed rate with two of the swaps related to the 2008B Consolidated System refunding bonds, one forward-starting swap that is expected to take affect in June 2009, and the two other forward-starting swaps that will take effect upon issuance of other refunding bonds. The current termination value of the swaps, while negative, could be adequately managed by the District's current strong liquidity position.

STRENGTHS

* The Rocky Reach and Rock Island Projects are two of the lowest cost power resources in the US and the hydroelectric facilities have had high availability levels.

* The District's retail rate of 3.1 cents/kwh (prior to temporary surcharge starting May 1, 2009) is among the lowest in the U.S.

* Take-or-pay power sales agreements cover a large portion of the Rocky Reach and Rock Island projects.

* In 2009, Rocky Reach was awarded a new 43-year license expiring in 2052 and Rock Island's license does not expire until 2028.

* District's strong internal financial liquidity serves to reduce the impact of low water or volatility of the regional wholesale power market.

*The District is expected to retain significantly more power generation from Rocky Reach and Rock Island after 2011 that should allow Chelan PUD to generate significantly more wholesale cash flows after 2011.

* The District is expected to comfortably meet rising state mandated renewable energy requirement over time due to incremental hydro resources and wind power from the Nine Canyon Wind Project.

*To reduce the impact of lower wholesale revenue, Chelan PUD has implemented cuts in operations and maintenance costs estimated at $8.5 million in 2009 and various delays in its capital program totaling at least $18.8 million.

CHALLENGES

*Chelan PUD's significant reliance on wholesale revenues exposes the District to volatility in hydro levels of the Columbia River and the market price of electricity. The District's wholesale market sales are currently unhedged for 2010 and onward.

* Currently, the District's cash flows have been negatively impacted by lower hydro levels and power prices and are likely to remain negatively pressured for the next few years.

*The District's willingness to raise rates appears to be limited especially in the near term given the recession and weakens an important risk mitigation measure.

*The District's decision to escrow funds equal to debt service on certain Chelan Hydro Consolidate System bonds for 2009 and 2010 weakens the intent of the rate covenant associated with those bonds.

*Currently, the District's retail electric and fiber optic businesses do not generate sufficient revenues to pay for their respective costs.

*Major third party PPA offtakers for Rocky Reach and Rock Island are rated significantly lower than Chelan PUD.

* The District could encounter difficulties in properly marketing surplus energy sales after the 2011 in addition to placing appropriate risk mitigation measures to insulate the District against operating cash flow volatility.

*Debt service coverage for the Consolidated System is expected to drop to 1.4 times on average from 2009 to 2011 compared to almost 1.9 times over the last three years.

*The rate covenants and additional bonds tests are relatively modest.

*Uncertainties remain on the ultimate resolution of weakened monoline insurers and the related interest rate swaps.

MARKET/COMPETITIVE POSITION: LOW COST HYDRO SYSTEM AND TAKE OR PAY PPAS

A key fundamental credit support factor for the District is Chelan PUD's low cost hydro system and the District's easy access to transmission of the energy to retail and wholesale customers. The low cost is significantly due to the major capital investments that were made to the hydro facilities 30 to 40 years ago. The District owns and operates two major hydroelectric projects and one smaller project with 1,972 MW of combined generation capacity. Rocky Reach (1,300 MW) and Rock Island (624MW) are on the Columbia River, and Lake Chelan (48 MW) is nearby. In 2008, almost 8.7 million MWh of power was delivered by the District's facilities at a weighted average cost of $18/MWh. Rock Island's five year (2004-2008) average cost of production was $25/MWh; at Rocky Reach it was almost $13/MWh; and Lake Chelan, $13/MWh. The District's cost of power has historically been well-below regional and national averages. By contrast, the Bonneville Power Administration's (BPA) Priority Firm rate in 2008 averaged $31.00/MWh. Under almost all conditions, such as during 2000-2001 energy crises, the three hydroelectric projects are sufficient for the District to meet its retail load requirements.

The District has several large wholesale customers, including investor-owned utilities and a subsidiary of Alcoa, which purchases electricity pursuant to firm power sale take-or-pay contracts some of which have been extended past 2011.

Moody's believes the very competitive prices charged for the capacity and energy ensures wholesale customer retention. Approximately seventy percent of the power output from the District's hydro-generation facilities is sold under take-or-pay contract to Puget Sound Energy (PSE, 41% of allocated capacity), Alcoa (15%), Portland General Electric (8%), PacifiCorp (3%), Douglas County Public Utility District (2%), and Avista (2%), with the balance sold by the District's distribution system to retail customers (30%).

The new power sales contracts which become effective in 2011 and 2012 shift more of the available power to the District with the District managing 47.8% of total capacity versus the existing 30%, which will require the District to soundly manage its wholesale energy sales activity and implement appropriate risk mitigation measures.

An important consideration regarding these take-or-pay contracts is that any loss of any take-or-pay contracted load or of industrial load would allow the District to remarket that low cost power in the regional wholesale energy marketplace, earning the margin between the low cost of the generation and market prices. Power purchasers also do not have the right of first refusal for any capacity that might become available upon expiration of the existing contracts. Under the Rocky Reach Power Sales Contracts, the non-defaulting parties have an obligation to take up to an additional 25% of their original share upon default by one of the purchasers. Any remainder above that amount would be available to the District and could be sold at market prices.

In February 2006, the District executed a new long-term power sales contract with PSE. Deliveries under the new contract will commence upon the expiration of the existing power sales contracts for the Rocky Reach and Rock Island Projects on November 1, 2011 and July 1, 2012, respectively. The contract is scheduled to terminate in 2031. Under the contract, PSE will purchase an amount equal to 25% of the combined energy and capacity from both the Rocky Reach and Rock Island Projects in exchange for payment by PSE of its proportionate share of operation and maintenance, debt service and other costs. The contract was approved by FERC in March 2006. Alcoa signed a new take-or-pay contract with the District representing 26% of the output of both Rocky Reach and Rock Island that expires in 2028.

MODEST WILLINGLESS TO RAISE RATES IN THE CURRENT ENVIRONMENT AND EFFECTIVE WEAKENING OF A RATE COVENANT ARE VIEWED AS CREDIT NEGATIVES

Chelan PUD's decision to escrow debt service for 2009 and 2010 associated with the Distribution Division's bonds weakens one of the District's rate covenants. Escrowed amounts totaling approximately $10.6 million will zero out debt service for certain of Chelan Hydro Consolidated System bonds and negates the rate covenant. While the escrow provision is allowed per the bond resolution according to Chelan PUD, Moody's views such actions negatively since the purpose of a rate covenant is to ensure sufficient net revenues to meet debt service.

While the District's rate process is not regulated by the state regulatory board, the District has recently shown a limited willingness to use its authority to raise retail rates to maintain its financial condition. In April 2009, Chelan PUD 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. On April 1, 2009, water and wastewater rates increased an average of 6.9 percent and 6.5 percent, respectively.

The modest rate increase also raises significant concerns regarding Chelan PUD's reliance on temporary surcharges as an important tool to mitigate potential shortfalls in cash flow especially given their reliance on wholesale revenue.

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 customer are likely to consider increases relative to their current rates in addition to the absolute rate.

To reduce the impact of lower merchant revenue, Chelan PUD has implemented cuts in operations and maintenance estimated at $8.5 million in 2009 and various delays in its capital program totaling at least $18.8 million.

THE DISTRICT HAS SIGNIFICANT RELIANCE ON PROFITS FROM VOLATILE WHOLESALE MARKET REVENUES

Chelan PUD's reliance on merchant cash flow has grown over time and represents a material portion of Chelan's aggregate cash flow. Merchant power sales as a portion of total operating revenues have averaged 24% of total operating revenues and is considered a credit weakness.

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 hedge. For example, in 2001, Chelan's wholesale revenues increased significantly compared to 2000 even though Grand Coulee flow levels were 59% of normal compared to 97% in 2000. However, the District currently faces both lower market prices due to the recession lowering demand and natural gas prices and lower hydro levels. Currently, the District has price hedges or forward sales representing approximately 24% of forecasted wholesale revenue for the remaining 2009 period while sales for 2010 and onward remain fully exposed to the market. To the extent hydro levels and market prices do not improve meaningful in 2010, Chelan PUD could draw down greater than expected amounts from existing liquidity if the District does not implement potentially large additional rate increases and renew the temporary surcharge.

After 2011, the amount of merchant power generation sold into the market are expected to double and is expected to strongly boost Chelan PUD's cash flows. However, Chelan PUD's reliance on wholesale revenues to subsidize their other operations could grow further. Ultimately, high levels of wholesale revenue could expose Chelan PUD to risk that are not commensurate with the existing rating if the District does not implement appropriate risk mitigation measures to fully insulate the District from severe reductions in power prices and hydro levels.

LARGE LIQUIDITY POSITION REDUCES THE IMPACT OF LOWER WHOLESALE MARGINS

An important credit strength is the District's strong liquidity position. Cash and investments totaled almost $422 million at year-end 2008 and total reserves were $256 million. Days cash on hand was very high at 602 at year-end 2008 though below the four year average of 717. Approximately $112 million of the cash were due to advance payments received from PSE and Alcoa when their new PPAs were executed in 2006 and 2008, respectively.

Moody's believes that the District's strong financial liquidity reduces the short to medium term revenue risks associated with low wholesale revenues; however, the magnitude of the reserves do not serve to fully mitigate this merchant power risk. Under the District's base case, they expect to utilize approximately $75 million in reserves through 2011. In severe downsides scenarios, the District is expected to maintain sufficient liquidity even without large rate increases though reserve levels could drop below the District's target of maintaining at least $130 million in available funds.

CREDIT METRICS UNDER PRESSURE OVER NEXT SEVERAL YEARS

Debt service coverage for the Consolidated System is expected to drop to 1.4 times on average from 2009 to 2011 compared to almost 1.9 times over the last three years. Chelan PUD's weakening cash flow credit metrics are due to lower expected wholesale revenue and the forecast remains sensitive to the market price of power and hydro levels. Starting in 2011, the District's cash flows are expected to significantly improve due to the greater amount of generation available for market sales and increases in the market price of power from the current recession lows.

Moody's notes the District's debt ratio of 79% at year end 2008 is above the median for U.S. public power utilities that own generation and is likely to continue to remain high for at least the medium term.

CAPITAL PROGRAM: MAJOR CAPITAL NEEDS ARE LARGE BUT MANAGEABLE

The District's capital program remains substantial though manageable. The District's capital plan is projected to cost $329 million from 2009 to 2013 with a significant amount of the funding for the Rock Island modernization. The District anticipates new bond issues of approximately $18 million in 2011 and $8 million in 2012, primarily for the Rock Island modernization. Additionally, the District currently anticipates additional spending in the $225 to $275 million range on a net present value basis over the next forty-three years as part of the re-licensing of Rocky Reach. To support the District's large capital program, Chelan PUD allocated almost $160 million of cash and investments at year-end 2008 for construction.

Outlook

Outlook

The negative outlook on the District's Aa2 rating considers the likely lower than originally expected wholesale revenues over the next several years, the limited rate increase taken by Chelan PUD to offset lower merchant cash flows, and limited hedges for 2010 and onward to minimize the volatility of wholesale revenues. The negative outlook also considers the likely decline in Chelan PUD's credit metrics and significant reserves over the next several years.

What Could Change the Rating - DOWN

Factors that could result in a downgrade include continued limited willingness to implement rate increases to maintain a sound financial position based on operating revenues, a decline in reserves greater than currently expected, lack of meaningful hedging of wholesale revenue over time to minimize cash flow volatility or weaker than expected credit metrics. A weakening of Chelan PUD's overall credit quality could also result in rating distinctions between the different revenue liens.

What Could Change the Rating - UP

The ratings are unlikely to be upgraded given the negative outlook. The District's rating could stabilize if Chelan PUD strongly demonstrates a willingness to increase rates to maintain a sound financial position, Chelan PUD's reserves are maintained near current levels and the District implements risk mitigation measures which will ensure that the District is fully insulated from severe reductions in power prices and hydro levels.

KEY STATISTICS:

Total Cash and Investments, 12/31/08: $422 million

Total MWh delivered, 2008: 8.7 million

Aggregate Hydro Capacity (Nameplate): 1,972 MW

Senior Consolidated System-(Distribution/Non Hydro) 2008 Debt Service Coverage: 4.2 times

Subordinate Consolidated System 2008 Debt Service Coverage: 1.7 times

Rock Island System 2008 Debt Service Coverage: 1.11 times

Ricky Reach System 2008 Debt Service Coverage: 1.52 times

Debt Ratio, 2008: 79%

Days Cash on Hand: 602

Average Residential Retail Rate, 2008: 3.1 cents/kwh, prior to the 9% temporary surcharge implemented May 1, 2009

DEBT STATEMENT AS OF December 31, 2008

Rock Island System Revenue Bonds $278.8 million

Rocky Reach System Revenue Bonds: $7.4 million

Chelan Hydro Consolidated System Revenue Bonds: $486.3 million

Consolidated System Revenue Bonds: $173.3 million

Consolidated System Subordinated Revenue Notes: $53.7 million

The last rating action occurred on October 27, 2008, when Moody's assigned Aa2 ratings to the District's multiple bond issues and affirmed the District's Aa2 rating on the then existing debt.

The principal methodology used in rating the current offering was the U.S. Public Power Utilities Methodology, published April 2008 which can be found at www.moodys.com in the Credit Policy & Methodologies directory, in the Rating Methodologies subdirectory. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Credit Policy & Methodologies directory.

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