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Ratings

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Summary:

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

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Long Term Rating	AA+/Stable	Affirmed
Chelan Cnty Pub Util Dist #1 rev bnds		
Long Term Rating	AA+/A-1/Stable	Affirmed

Credit Highlights

- S&P Global Ratings affirmed its 'AA+' long-term rating on Chelan County Public Utility District No. 1, Wash.'s consolidated system revenue bonds outstanding.
- At the same time, 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.

Security

Net revenue of the district's consolidated system secures the bonds. More specifically, the rates and charges of the retail utilities and Lake Chelan system, as well as certain intersystem loan payments from the district's two large hydroelectric systems, secure the consolidated system bonds. 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.

As of Dec. 31, 2021, the district had $232 million in consolidated system debt and $159 million in project debt at its Rock Island hydroelectric project, although hydroelectric project off-takers under take-or-pay, cost-of-service contracts service 51% of project debt. In addition to direct debt, the district is responsible for approximately $810,000 of off-balance-sheet debt attributable to its share of Nine Canyon Wind Phases I and II project debt.

Credit overview

The rating reflects our opinion of the district's very strong enterprise risk profile given its extremely low rates and extremely low-cost, non-carbon-emitting hydroelectric resources, and its extremely strong financial risk profile given exceptional financial metrics.

The rating further reflects our view of the district's:

- Very robust coverage metrics, with S&P Global Ratings-calculated fixed-charge coverage (FCC) at no less than 3x since and including 2016, forecast at 3x to 5x through fiscal 2026 under what we consider reasonable assumptions;
- Extremely strong liquidity and reserve position, with $322 million in unrestricted cash, or 414 days' cash, as of fiscal 2021, with management projecting liquidity to decline somewhat to about $228 million, or almost nine months' cash, by 2025 given capital spending plans and limited additional new debt;
- Extremely competitive and non-carbon-emitting generating assets, as well as management, policies, and planning practices that we view as proactive and conservative;
- Rates that are among the lowest in the nation at slightly more than 3 cents per kilowatt-hour (kWh), which provides the district with substantial financial flexibility; and
- Very low debt to capitalization of just 24% as of fiscal 2021, down from 31% the year prior as the district continues to accelerate principal repayment with surplus revenue.

Partly offsetting the above strengths, in our view, is the district's heavy reliance on hydroelectric power resources for load, although the district has partly mitigated volumetric risks associated with variable or volatile hydrology conditions with various "slice of system" sales. The district is also exposed to compliance requirements and costs related to fish and wildlife mitigation by virtue of its hydroelectric project operations.

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 (75% in 2021) than to its own retail system (25%). 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. We note that the district does not have substantial concentration among customers taking energy, with the leading 10 customers representing just 3.6% of operating revenue and with seven of the 10 representing either education, health care, agriculture, or electric utility operations, which we view as essential, stable businesses relative to other sectors.

Environmental, social, and governance

We believe the district's climate transition risks have a limited effect on our credit rating analysis based on its power supply almost entirely consisting of non-carbon-emitting resources, and although the district is also exposed to costs related to fish and wildlife mitigation, its historical efforts and investments associated with these risks alleviate such risks. We also believe the district has mostly hedged its hydrology risk. Social risks are also credit neutral given extremely low rates and because the ongoing pandemic has not materially affected the district operationally or financially. Finally, we view the utility's governance factors as credit neutral as they include full rate-setting autonomy, strong policies and planning, and a proactive and experienced management team.

Outlook

The stable outlook reflects our assessment of the district's extremely low-cost power supply (substantially below prevailing market prices), significant debt retirement 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.

Downside scenario

We don't expect to lower the rating during our two-year outlook period given the district's significant rate flexibility on account of 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.

Upside scenario

We don't expect to raise the rating over the next two years given Chelan's somewhat limited economic base, asset concentration, large capital plan, and exposure to variable hydrology and perpetual fish mitigation costs.

Credit Opinion

The district's distribution system takes about 51% of the aggregate output from its combined Lake Chelan (59 megawatts, or MW), Rocky Reach (1,300 MW), and Rock Island (629 MW) projects, and sells 49% of the output from the combined projects 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 15 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 1.5 cents per kWh (2021) and has excellent shaft diversity with 11 turbines. The Rock Island Project likewise has shaft diversity with 19 turbines, with a 2021 production cost of 3.8 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 half 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. In addition, the district does not face looming greenhouse gas compliance costs that owners of conventional power plants do. The district expects to meet all future renewable energy requirements utilizing existing incremental hydro, Nine Canyon Wind Project output, and juvenile fish bypass/spill reductions, and the district must practice environmental stewardship with regard 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. Management is especially proactive when it comes to generation, wholesale revenue volatility, and counterparty credit risk. The district has also made considerable investments in cybersecurity practices and 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, with 3% base rate increases in each of 2020, 2021, and 2022, and planned for 2023 and 2024. Key district objectives include substantially reducing debt and keeping rates low. The district's multilayered comprehensive approach to power supply management offsets the absence of a power cost adjustment mechanism.

We view the district's economic fundamentals as credit supportive, characterized by median household effective buying income that is near the national average, modest unemployment, and a very diverse customer base. The district's leading customer, Douglas County Public Utility District, represents just 1.6% of operating revenue. While we believe the county lacks the depth and breadth of more urban systems, the district sells more power outside its boundaries than it does to core retail customers. Also, 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 better margin--also supports our economic fundamentals assessment. The electric utility served 47,074 core retail customers in 2021, 86% of which were residential and accounted for 43% of retail energy sales. Retail energy demand from residential, commercial, and industrial customers has been flat since 2017.

The district has an extremely competitive market position, reflecting a weighted average revenue per kWh that is among the lowest in the country at just 3.3 cents per kWh (about one-quarter of the national average), or a very attractive 38% of the state average (2021). 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 $22 per MW-hour (MWh) in 2021, well below prevailing market prices (the "average adjusted wholesale" preference rate for Bonneville customers was $41 per MWh in 2021) and in line with previous years. Residential rates in 2021 were just 3.4 cents per kWh, a figure that has changed very little over the past 15 years. 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.

The district has achieved exceptional financial results for several years running, exceeding budgeted net revenue and all financial policy targets. FCC based on scheduled debt service has ranged from 3x to 4x since 2019, but when debt service is adjusted to include optional debt prepayments (which totaled $176 million over fiscal years 2019 to 2021), FCC averaged a still very robust 1.6x. Likewise, consolidated system unrestricted cash would be at least $176 million higher without such prepayments. The district's coverage continues to benefit from its recent practice of debt reduction, which has reduced future annual debt service requirements. FCC treats off-balance-sheet debt service (e.g., the system's share of the Rock Island, Rocky Reach, and Nine Canyon wind projects) 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 2026 is no less than 3.9x and assumes 3% annual electric rate increases in 2023 and 2024 and only $11 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.

We consider the district's liquidity and reserves ample at $322 million in unrestricted cash, or 414 days' cash, as of fiscal 2021, not including $93 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. Based on the district's forecast, it anticipates generating significant cash flow, but will use a sizable portion of it for significant capital projects, such as projects at Rock Island or Rocky Reach. The district projects cash balances to decline to about $228 million, or 251 days' operation expenses, by 2025, and projects liquidity to then modestly increase in 2026.

In our opinion, the district's debt and liabilities are very low, suggested by debt to capitalization of 24%, forecast to decline to 10% by 2026 as a result of both scheduled and accelerated debt repayments and minimal debt issuance. Through fiscal 2026, the district combined has budgeted $843 million in capital spending, with the Rock Island Project budgeting $333 million on its own. Pension and other postemployment benefit liabilities are very manageable, in our view.

Alcoa closure

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. But Alcoa remains contractually obligated to pay its share of monthly operating costs and debt service, although any revenue from the sale of its share of power by the district is netted against such payments. The district has retained $122 million in net revenue from the sale of unused Alcoa power since the contractual provisions were established. These funds count toward the district's unrestricted cash balance. This does not include an additional $62 million contractual charge collected from Alcoa in 2018, and the district also holds $45 million in collateral from Alcoa for protection against default. The district has the sole right to terminate the contract, and the Alcoa plant remains idle as of this report.

Related Research

Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022