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Ratings

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Summary:

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

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Chelan County Public Utility District #1 con sys		
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, 2023, the district had $201 million in consolidated system debt and $131 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 Rock Island project debt.

Credit overview

The rating reflects our opinion of the district's extremely low-cost power resources that contribute to retail rates being among the lowest in the U.S., combined with proactive and comprehensive risk management and financial planning that has resulted in exceptional, sustained financial metrics.

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

- Extremely strong liquidity and reserve position, with $359 million in unrestricted cash, or 363 days of operating expenses, as of fiscal 2023, projected to remain near these levels through at least fiscal 2028;

- Very robust coverage metrics, with S&P Global Ratings-calculated fixed-charge coverage (FCC) of 4x in fiscal 2023, projected at 3x to 6x through fiscal 2028 under what we consider conservative assumptions;
- Very low debt to capitalization of just 17% as of fiscal 2023, down from 31% in 2020 as the district continues to voluntarily accelerate principal repayment with surplus revenue;
- Very competitive and noncarbon-emitting generating assets that produce energy well in excess of the district's local demand, allowing for a solid revenue stream from sales of surplus energy; and,
- Exceedingly low and affordable rates that are among the lowest in the nation with residential rates averaging just 3.53 cents per kilowatt-hour (kWh) in 2023, which provides the district with significant financial flexibility.

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. It is also exposed to compliance requirements and costs related to fish and wildlife mitigation by virtue of its hydroelectric project operations, but given significant liquidity, we view both of these exposures as manageable.

The district owns and operates an electric distribution system, three major hydroelectric power generating projects (Rocky Reach, Rock Island, and Lake Chelan), a telecommunications system, and a small water and wastewater system. Chelan sells far more power to contractual off-takers and the wholesale market (67% in 2023) than to retail customers (33%), and these nonretail 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. The district lacks leading customer concentration, which reduces potential revenue volatility risk from customers who may exit the service territory.

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 noncarbon-emitting resources, and although the district is also exposed to costs related to fish and wildlife mitigation, its historical and ongoing efforts and investments associated with these risks alleviate such risks. We also believe it has mostly hedged its hydrology risk.

Social risks are also credit neutral given extremely low rates. Nonetheless, we continue to monitor the strength and stability of electric utilities' revenue streams for evidence of delinquent payments or other revenue erosion. Along with a national rate of inflation, as measured by the Consumer Price Index (CPI), that has persisted above 2% for longer than anticipated, Bureau of Labor Statistics data shows that national electricity price inflation continued to outpace the broader CPI by 100 basis points (bps) to more than 200 bps during March-October 2024. The increases in delinquency rates and debt balances among household, credit card, and auto loan debt, along with household savings rates that are tracking below pre-pandemic levels, compound the financial pressures electricity consumers face as utilities invest in the hardening of existing assets to withstand more frequent and severe climate events while also investing in emissions reductions. Potentially exacerbating issues of energy affordability are S&P Global Economics' forecast of weakening gross domestic product (GDP), and the uncertainty surrounding whether and when the president-elect will implement economic initiatives he proposed as a candidate, including imposing tariffs. The potential for the president-elect's proposals to add to inflation and weaken GDP growth might add to the economic headwinds facing utility customers, which can negatively influence customer capacity to make timely utility bill payments. (See "Economic Outlook U.S. Q1 2025: Steady Growth, Significant Policy Uncertainty," published Nov. 26, 2024, on RatingsDirect).

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. In addition, the district has a strong cybersecurity risk management program, and a comprehensive wildfire mitigation program that includes risk modeling, enhanced data analytics, weather forecasting, and prudent vegetation management.

Outlook

The stable outlook reflects our view that, over the next two years, given the district's financial flexibility as a result of its low rates and substantial margins from surplus energy, financial metrics will remain consistent with recent robust levels.

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 and related operating risks, and large capital plan.

Credit Opinion

The district's distribution system currently takes about 43% of the aggregate output from its combined Rocky Reach (1,349 MW) and Rock Island (629 MW) hydro projects (and all of Lake Chelan, 59 MW), and sells 57% of the output from Rocky Reach and Rock Island to the following three counterparties in the region through long-term, take-or-pay contracts:

- Alcoa ('BB/Stable'; although sales to Alcoa are suspended, as discussed below), 26% of Rocky Reach and Rock Island, expiring in 2028;
- Puget Sound Energy (PSE; 'BBB/Stable/A-2'), 25% of Rocky Reach and Rock Island, expiring in 2031, and
- Douglas County Public Utility District No. 1, 5.54% of Rocky Reach only, expiring in 2031, subject to extensions.

The agreements with Alcoa and PSE are "cost plus," meaning, purchasers are charged actual costs plus charges related to debt reduction and capital recovery, plus other charges related to purchaser credit quality. The district also has a power supply agreement with Microsoft through December 2025 for up to 50 aMW of carbon-free power to its Puget Sound campuses; pricing is market-based and revenue supports reinvestments in Chelan's hydropower assets.

The district recently signed new cost-plus, long-term contracts, with mandatory step-ups (in the event one or more purchases defaults) with the following:

- Avista (BBB/Negative/A-2), 5% of Rocky Reach and Rock Island, 2026-2030;
- Avista, 10% of Rocky Reach and Rock Island, 2031-2045; and
- PSE, 25% of Rocky Reach and Rock Island, 2031-2051.

In addition to hydropower, nominal resources come from the district's share of energy from the Nine Canyon Wind Project Phases I and II. Overall district generating capacity is 2,037 MW versus its peak demand in 2023 of 483 MW.

The district's retail distribution system has surplus capacity in nearly all months, even under very low water conditions. Its long-term financial plan includes hedging a sizable portion of its hydrology risk related to its output net of contracted sales 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. The district currently has six slice agreements with three counterparties (Avista, Puget Sound Energy, and Powerex) with terms ranging from one to ten years. The goal of these laddered hedges is to bring value and cost certainty to the district's retail customers; the strategy minimizes revenue volatility and the financial risk related to low or volatile stream flows.

The Rocky Reach Project, with a license extending to 2052, has an extremely low production cost of just 1.9 cents per kWh (2023) and has excellent shaft diversity with 11 turbines. The Rock Island Project has even greater shaft diversity with 19 turbines, with a 2023 production cost of 5.0 cents per kWh. Its license expires in 2028. Per unit costs at both projects increased in 2023 largely due to lower stream flows. Nonetheless, 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 somewhat 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. It expects to meet most future renewable energy requirements using 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 favorably the district's management, policies, and planning. Key objectives include debt reduction and maintaining low rates, and the district's multilayered comprehensive approach to power supply management offsets the absence of a power cost adjustment mechanism. The district has a policy to maintain cash reserves at no less than 150 days, debt service coverage above 2x, debt at less than 35%, and nominal liquidity at more than $225 million, and evaluates its base rates annually as part of the budget process. Management is especially proactive when it comes to risk management related to generation, wholesale revenue volatility, and counterparty credit. The district has also made considerable investments in cybersecurity practices and systems. Its 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 annually during fiscal years 2020-2024, and planned for fiscal years 2025-2026.

While the local economic base lacks significant depth that is typical with more urban systems, median household effective buying income is near the national average and the customer base exhibits diversity. Also, the district sells more power outside its boundaries than it does to its native retail customers. If it experienced customer loss and was required to sell the surplus power on the market, given its low cost, it would likely do so at a better margin. The electric utility served about 48,400 core retail customers in 2023, 86% of which were residential and accounted for 42% of retail energy sales. Retail energy demand from residential, commercial, and industrial customers has increased about 3% annually since 2019.

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 3.6 cents per kWh (about one-quarter of the national average), or a very attractive 39% of the state average (2023). This is largely a result of superior project economics from its largest baseload units. The district's all-in production cost was just $29 per MW-hour (MWh) in 2023, well below prevailing market prices (the "average adjusted wholesale" preference rate for Bonneville customers was $41 per MWh in 2023) and in line with previous years. Residential rates in 2023 were just 3.5 cents per kWh, a figure that has changed very little over the past several years.

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 2.5x to 4.2x since and including 2020, but when debt service is adjusted to include optional debt prepayments (which totaled $172 million over fiscal years 2019 to 2022), FCC averaged a still very robust 2.5x. Likewise, consolidated system unrestricted cash would be at least $172 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, its forecast assumptions are reasonable, especially given its recent track record. Forecast FCC (based on scheduled debt service without accelerated principal payments) through 2028 is no less than 2.9x and assumes no additional debt. We view the district's projections as reasonable, including assumptions on wholesale slice sales activity and expense growth.

We consider the district's liquidity and reserves ample at $359 million in unrestricted cash, or 363 days' of operating expenses, as of fiscal 2023, not including $65 million in power contract reserves in secondary liquidity that it could use, if needed, but that are 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. It projects cash balances to range between $305 million and $405 million through fiscal 2028.

The district's debt burden is very low, with debt to capitalization of 17%, and forecast to decline to 6% by 2028. Through fiscal 2028, the district combined has budgeted $921 million in capital spending, $534 million of which relates to its three hydro projects. 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 $278 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 $42 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.

Chelan County Public Utility District No. 1, Washington--Key credit metrics

	--Fiscal year ended Dec. 31--		
	2023	**2022**	**2021**
Operational metrics			
Electric customer accounts	51,284	50,770	49,943
% of electric retail revenues from residential customers	31	32	36
Top 10 electric customers' revenues as % of total electric operating revenue	4	3	3
Service area median household effective buying income as % of U.S.	95	97	95
Weighted average retail electric rate as % of state	39	40	38
Financial metrics			
Gross revenues ($000s)	568,088	601,362	456,888
Total operating expenses less depreciation and amortization ($000s)	361,484	339,717	282,870
Debt service ($000s)	42,824	53,386	51,611
Debt service coverage (x)	4.8	4.9	3.4
Fixed-charge coverage (x)	4.0	4.2	2.9
Total available liquidity ($000s)*	359,129	389,295	322,063
Days' liquidity	363	418	416
Total on-balance-sheet debt ($000s)	352,080	381,826	417,150
Debt-to-capitalization (%)	17	20	24

*Total available liquidity includes available committed credit line balances, where applicable. Debt service coverage--Revenues minus expenses divided by debt service. Fixed-charge coverage--Sum of revenues minus expenses minus total net transfers out plus capacity payments (or their proxy), divided by the sum of debt service plus capacity payments (or their proxy). N.A.--Not available.