Research Update:

Chelan County Public Utility District No.1, WA 'AA+', 'AA+/A-1' Debt Ratings Affirmed

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Overview

- 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 in effect through July 1, 2027.
- The rating action reflects our re-evaluation of the district’s consolidated system following our correction of an analytical error relating to the application of our wholesale criteria.
- The outlook, where applicable, is stable.

Rationale

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.

The rating reflects the application of our "Wholesale Utilities" criteria, published May 24, 2005, correcting a previously identified error where we incorrectly applied our "U.S. Municipal Retail Electric and Gas Utilities: Methodology And Assumptions," criteria, published Sept. 27, 2018. (See "S&P Global Ratings Identifies Error In Criteria Application To Three U.S. Wholesale Utilities'

Bonds, March 25, 2025," published March 25, 2025, on RatingsDirect.) We rate the district's consolidated system under our wholesale criteria to reflect the dominance of revenue from its wholesale customers and other wholesale activity; wholesale revenue made up 71% of audited fiscal 2023 operating revenue.

In our analysis, we take a holistic approach and consider the projects' superior economics and noncarbon-emitting nature, which make market participation a viable response to a wholesale customer default. Additionally, we consider the district's financial and operational risks, as relating to both its direct serve retail customers (approximately 48,000) and to its various wholesale customers (that in turn serve more than 1.6 million end-use customers).

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 highlights

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:

- Long-term, cost-plus wholesale contracts representing almost 50% of the district's power portfolio with various counterparties that promote revenue certainty and cost recovery and require additional payments for debt reduction, recovery of capital costs and other charges, and future similar, newly signed contracts beginning as early as 2026;
- Supplemental fixed-price, market-base, medium-term slice sales representing 15%-25% of the district's power portfolio that hedge price, stream flow, and operational risks;
- Exceedingly low and affordable retail 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;
- 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;
- 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 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 and fund capital projects with surplus revenue; and
- 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.

Partly offsetting the above strengths, in our view, is the district's heavy reliance on hydroelectric power resources for load, although it 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. While the district is also exposed to counterparty credit risk, various protections are in place such as collateral thresholds and diligent monitoring of counterparty credit. Regardless, if counterparties do not honor their obligations, we believe that the district would likely be able to promptly remarket the surplus hydropower (and likely at relatively more favorable market prices) given its low cost, noncarbon-emitting nature.

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's consolidated system sells far more energy to contractual off-takers and the wholesale market (67% in 2023; not including direct energy sales from the Rocky Reach and Rock Island projects to long-term purchasers) 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, wildlife, and wildfire 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 given ongoing inflationary pressures on electricity prices (which have outpaced the broader Consumer Price Index inflation rate), coupled with higher operating and debt costs due to investments in emissions reductions, load growth, and climate resilience. S&P Global Ratings believes the administration's imposition of tariffs could exacerbate inflation by 50-70 basis points but observes that forecasting the duration and impact of tariffs is complicated by the high degree of unpredictability around policy implementation (see ""Liberation Day" Tariff Announcements: First Take On What It Means For U.S. And Global Outlook, April 3, 2025," on Ratings Direct). The economy's stressors and the associated financial pressures consumers face might make it more difficult for rate-setting bodies to harmonize the interests of utilities, their customers, and their investors, which in turn could weaken utilities' financial metrics.

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. 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. The outlook also reflects our view that, despite having operating risks, various hedges and protections are in place that, combined with superior project economics, increase the likelihood of continued sound financial metrics.

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, moderate exposure to hydrological volatility, asset concentration and related operating risks, and large capital plan.

Credit Opinion

The district's distribution system currently takes about 45% 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 55% of the output from Rocky Reach and Rock Island to the following three counterparties in the region through long-term, take-or-pay contracts with mandatory step-ups (if one or more purchasers defaults):

- 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, also with mandatory step-ups, 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, providing significant opportunity for lucrative surplus energy sales.

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 five slice agreements with two counterparties (Avista and Puget Sound Energy) 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, with a license expiring in 2028, has even greater shaft diversity with 19 turbines, and a 2023 production cost of 5.0 cents per kWh. 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 protections. 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. Although the district must practice environmental stewardship with regard to fish, wildlife, and other environmental regulations, we view this exposure as minimal given its 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. (Based on unaudited results for fiscal year ended Dec. 31, 2024, FCC remained near these robust levels.) 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.

Ratings List	
Ratings Affirmed	
Public Power	
Chelan Cnty Pub Util Dist #1, WA Wholesale Electric System 2nd Lien	AA+/Stable

The ratings appearing below the new issues represent an aggregation of debt issues (ASID) associated with related maturities. The maturities similarly reflect our opinion about the creditworthiness of the U.S. Public Finance obligor's legal pledge for payment of the financial obligation. Nevertheless, these maturities may have different credit ratings than the rating presented next to the ASID depending on whether or not additional legal pledge(s) support the specific maturity's payment obligation, such as credit enhancement, as a result of defeasance, or other factors.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at https://disclosure.spglobal.com/ratings/en/regulatory/ratings-criteria for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceId/504352. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings referenced herein can be found on S&P Global Ratings' public website at www.spglobal.com/ratings.