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Ratings

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Summary:

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

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Table Of Contents

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Credit Profile		
Chelan Cnty Pub Util Dist #1 WHLELC (Rock Island) (MBIA) (National)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Many issues are enhanced by bond insurance.		

Credit Highlights

- S&P Global Ratings affirmed its 'AA' long-term rating and underlying rating (SPUR) on Chelan County Public Utility District No. 1 (Chelan, or the district), Wash.'s series 1997A senior-lien Rock Island hydroelectric system revenue bonds.
- The outlook is stable.

Security

Securing the bonds are project net revenue from long-term contracts with contracted off-takers as well as payments by project owner Chelan ('AA+/Stable' consolidated system bonds rating; see our summary analysis on the Chelan consolidated system, published Dec. 23, 2024, on RatingsDirect) on behalf of its electric distribution system. Project costs, including debt service, are passed through to Chelan and to the off-takers. Bond provisions under the master bond resolution are permissive, in our view, and include a 1x debt service coverage (DSC) additional bonds test based on operating revenue and a 1x DSC rate covenant based on net revenue adjusted for contingency funds withdrawals and deposits. The district is required to fund a debt service reserve at maximum annual interest.

The Rock Island hydroelectric project had approximately $131 million in direct debt outstanding as of Dec. 31, 2023 (maturing in 2029), not including interfund loans due to the consolidated system totaling an additional $217 million.

Credit overview

The rating reflects our view of the project's exceptional economics and efficiency, along with its operational flexibility and high availability given its 19 turbine generators.

Other factors in support of the rating include the project's:

- Extremely low historical production costs at 5.0 cents per kilowatt-hour (kWh) that we expect will remain highly competitive, even in the event of below-average hydrological conditions;
- Strong operating performance from its multiple turbines, which together partly mitigate single-asset risk;
- Ability to pass through 100% of costs to off-takers, which have signed take-or-pay contracts; and
- Ability to reassign or remarket surplus energy in the event of payment default by a contractual off-taker.

The Rock Island project is a "run-of-the-river" hydroelectric project on the Columbia River and has a capacity of 629 megawatts. The district operates the facility under a long-term license from the Federal Energy Regulatory Commission that extends to Dec. 31, 2028. The Rock Island project's strong project economics provide strong assurance of cost recovery from the project's direct off-takers. The average cost of production remains low but rose to 5.0 cents per kWh in 2023 from 3.4 cents per kWh in 2022, primarily as a result of reduced stream flows in the region but also because of higher operating costs. Project availability has ranged from 55% to 69% since 2020; availability can vary from year to year depending on the number of units out of service for repair or turbine replacement. The project's units operate independently, allowing continued operations even in the event of forced outage at one or multiple units. The project's capacity factor was 40% in fiscal 2023. The project's license expires Dec. 31, 2028, and the district has already spent several years preparing for the relicensing process; it plans to submit its application by Dec. 31, 2026.

Rock Island currently has power sales contracts with purchasers as follows:

- Puget Sound Energy Inc. (PSE; 'BBB/Stable/A-2'; 25% share through 2031); and
- Alcoa ('BB/Stable'; 26% share through 2028).

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.

Chelan uses the remaining output in its own retail electric system or sells it into the market, including "slice" sales out up to 10 years with various counterparties that are designed to reduce wholesale revenue volatility and uncertainty and to provide retail customers with greater cost (rate) certainty.

The contracts with Puget Sound Energy and Alcoa are cost-plus, take-or-pay contracts that recoup operating and debt costs. This provides the district financing flexibility and full operational control. There is a mandatory step-up by purchasers if another defaults. Regardless, should one or more of the power purchasers default, the low-cost, carbon-free power can readily be resold into the wholesale power markets, ensuring adequate funds for debt service. The "plus" components of the contracts include various charges for debt reduction and pay-as-you-go capital.

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.

The project's financial profile is solid, in our opinion. DSC treating interfund loans as deductions to net revenue, was 1.9x in fiscal 2023, and DSC for all debt and loans was 1.4x. Although project-specific unrestricted cash was just $3.2 million, or 14 days' of operations, as of 2023, the project has access to the consolidated system's ample liquidity balances (which exceed one year's cash operating expenses), if needed, and also engages in intersystem loans from the consolidated system.

Debt to capitalization remains moderate at 53% in fiscal 2023 but has improved over the years, from 98% in 2014 and 66% in 2020. Chelan's capital improvement plan indicates a total of $427 million in total spending at the project during fiscal years 2024 to 2028 as a result of turbine modernization and rehabilitation. The district will fund project capital needs largely from available and recurring net revenue. No additional debt is planned over the next five years.

Environmental, social, and governance

We see the district's climate transition risks as having a limited effect on our credit rating analysis based on the power supply almost entirely consisting of noncarbon-emitting resources. Nevertheless, the district, by virtue of operating the project, is subject to fish mitigation regulations that add to costs and modestly reduce net generation.

Given the extremely low-cost power produced by the project, social risks are negligible. 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).

We view the utility's governance factors as credit supportive, as they include full rate-setting autonomy, liquidity targets, a long-term capital plan and cybersecurity procedures, as well as long-term financial forecasting. The district also has 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 of the project's strong operating performance and low production costs. Long-term contracts provide a stable revenue stream, and strong project economics provide credit stability and mitigate credit risks regarding regulation, environmental mandates, and off-taker credit quality. We anticipate that the project will remain competitive with other generators or resource options in the region, even with high capital investments required over the next five years.

Downside scenario

We do not anticipate lowering the rating over the next two years given the competitive cost of power, but we could do so in the unlikely event that costs become uncompetitive on a sustained basis, such as if market prices in the region continue their decline and materially disrupt project competitiveness.

Upside scenario

Given significant capital needs, or the potential for sustained below average stream flows and generation, which could push up per unit power costs, we do not anticipate raising the rating during the next two years. Also limiting rating upside is our expectation that DSC is unlikely to materially improve.