

Summary:

Mason County Public Utility District No. 3, Washington; Retail Electric

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Credit Profile		
US\$53.39 mil elec rev bnds (taxable BABs) ser 2010B due 12/01/2042		
<i>Long Term Rating</i>	A+/Stable	New
US\$9.82 mil elec rev & rfdg bnds ser 2010A due 12/01/2042		
<i>Long Term Rating</i>	A+/Stable	New
Mason Cnty Pub Util Dist #3 elec rev bnds ser 2001 dtd 03/01/2001 due 12/01/2005-2021		
<i>Unenhanced Rating</i>	A+(SPUR)/Stable	Upgraded
Mason Cnty Pub Util Dist #3 elec rev bnds ser 2002 dtd 01/15/2002 due 12/01/2010-2018 2021		
<i>Unenhanced Rating</i>	A+(SPUR)/Stable	Upgraded
Mason Cnty Pub Util Dist #3 elec rev rfdg bnds ser 1998 dtd 02/15/1998 due 12/1/1998-2012		
<i>Unenhanced Rating</i>	A+(SPUR)/Stable	Upgraded

Many issues are enhanced by bond insurance.

Rationale

Standard & Poor's Ratings Services raised its rating and underlying rating (SPUR) two notches to 'A+' from 'A-' on Mason County Public Utility District No. 3, Wash.'s outstanding electric revenue bonds. The raised ratings reflect the district's consistently strong financial performance and maintenance of very low debt. In addition, Standard & Poor's assigned its 'A+' rating to the district's \$9.82 million series 2010A electric revenue and refunding bonds and \$53.39 million series 2010B electric revenue bonds (taxable Build America Bonds, or BABs -- direct payment).

The ratings reflect the following credit strengths:

- The district's low-cost power supply due to its status as a full-requirements customer of Bonneville Power Administration (BPA) with a contract that extends through September 2011, at which time it will be replaced by a new load following contract with Bonneville through September 2028;
- A demonstrated willingness to adjust rates if necessary, including rate increases in four of the last five fiscal years and a plan to raise rates by 7.5% in both 2011 and 2012;
- Very strong senior-lien debt service coverage (DSC) in 2009 of 3.9x, or 3.1x including subordinate-lien obligations, with all-in fixed charge coverage also very strong at 2.9x;
- A low debt burden, with the district's debt to capitalization as of 2009 at just 18%, although set to rise \$63.2 million to 30% debt-to-capitalization with the issuance of the 2010 bonds; and
- Very strong liquidity, with \$31.2 million, or 310 days' cash on hand, as of fiscal 2009, representing the highest level for the district in at least 10 years, with projections indicating cash balances of no less than 165 days for fiscals 2010-2014.

These strengths are offset, in part, by:

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- Rates that are above average for the region, combined with income levels that are good, but below average for the state;
- A relatively large five-year capital plan totaling \$67 million;
- Reliance on BPA for almost 100% of power resources, although mitigated somewhat by BPA's low cost;
- Renewable energy requirements per the state's Initiation 937 that could be challenging for the district and necessitate higher rate increases; and
- Industry and customer concentration within the forest products industry, although some diversification continues to occur.

The district's business profile score of '4' on Standard & Poor's Ratings Services' 10-point scale, where '1' is the strongest, reflects its industry concentration, reliance on BPA for almost all power resources, and competitive rates.

The bonds are secured by a first lien on gross revenues of the district's electric system, subject to the prior payment of operating expenses. The bonds are being issued to refund various outstanding bonds and to fund the costs associated with a new operations center and various capital improvements. We understand that the district may issue all the series 2010B bonds as BABs. If issued as BABs, the bonds will be taxable, and the district expects to receive annual cash subsidy payments from the U.S. Treasury equal to 35% of the interest payable on the bonds, with the subsidy included under the definition of revenues as defined in the resolution. The cash payment does not constitute a full faith and credit guarantee of the U.S., but is required to be paid by the Treasury under the Recovery Act. The district's plans to fund the entire debt service payments without regard to receipt of the subsidy.

Headquartered in Shelton and located about 70 miles southwest of Seattle, the district serves approximately 32,600 customers within 567 square miles. The district is considered a bedroom community to Olympia, 20 miles to the south, and to a nearby Naval base and shipyard to the north. The district's service territory actually extends into three nearby counties: Kitsap, Grays Harbor, and Pierce. The county's employment base is dominated by timber production, although the leading employer is Little Creek Casino (720 employees), followed by Shelton School District (675) and Washington Corrections Center (657). Income levels are good but below average for the state, while unemployment is above average at 10.3% versus 8.7% for the state as of April 2010. As of July 2010, the district reports that the median home price is approximately \$150,000.

The district's customer base is primarily residential, and energy sales for its native load totaled 671 megawatt-hours in 2009, virtually unchanged since 2007. Forecasted annual growth for fiscals 2010-2014 is 0.5%. The district receives the bulk of its power from BPA as a full-requirements customer. The contract, originally signed Oct. 1, 2001, helped insulate the district from exposure to the western power crisis and was due to expire Oct. 1, 2006; however, the district negotiated an extension of this contract until 2011. The district receives approximately 99% of its power from BPA, with the remainder coming from a share of the Nine Canyon Wind Project, a 10% share of Packwood Lake generation, and a 5.2-MW owned generator station. Given the cost, the district's gas-fired generation did not operate in 2009.

Beginning in 2011, BPA has indicated its preference for customers to either assume the role of meeting their own load growth above actual 2010 net power requirements or pay a higher "tier 2" rate to assist BPA in recovering its own costs to meet such increased loads. The district's reliance on BPA for power and its exposure to potentially higher tier 2 rates represent a moderate credit concern, but this is somewhat mitigated by competitive rates should the district be required to pass on higher rates to customers. The district signed a new load following contract with BPA effective October 2011 that will extend until 2028.

The district is considering additional renewable energy resources such as wind and solar, as it is subject to the provisions of I-937 because it serves more than 25,000 customers. This initiative, passed by the state in 2006, requires that utilities with more than 25,000 customers achieve a renewable portfolio standard that includes 3% of the portfolio from renewables by 2012, 9% by 2016, and 15% by 2020. As of 2009, the district's portfolio was 1% renewable because of its Nine Canyon Wind resources. The district projects renewable energy to account for 3.5% of resources by 2012 (including wind from the White Creek project) and 5.8% by 2016. The district is in discussions with the owners of two proposed biomass facilities for potential output contracts in order to meet the 9% requirement in 2016.

Although there is stability in having BPA as the main provider for the district's power, the district is also subject to BPA rate adjustments, as are most public utility districts in the region that receive BPA hydro power. Since 2001, the district raised rates by 3% in June 2005, followed by two 3% rate increases implemented in 2006 (April and October). No rate increases was made in 2007, but the district increased rates 5% in 2008 and 3% in 2009. The district plans to implement 7.5% rate increases in both 2011 and 2012. Despite the increases, rates remain competitive but are nevertheless above average for the region among all customer classes.

The district's customer base is very diverse, and any concerns with regard to top ratepayer concentration is partially offset by the flexibility afforded by BPA to its full-requirement customers in the event of substantial load loss; there are no fixed charges related to the BPA contract. The district's leading customer, Simpson Timber Co., accounted for just 4.3% of revenues in 2009 (down from 9% in 2006 due to a sluggish economy); the next nine largest customers account for an additional 7.5%. The district has indicated that, if top customer Simpson Timber were to exit the district or shut down, it would need to raise rates by only 2% to recover the lost margin. Residential accounts comprise 93% of total accounts but about two-thirds of revenues and energy usage.

The district's financial performance has been consistently very strong, with DSC at 3.9x in 2009 and coverage of senior- and junior-lien debt at about 3.1x. Coverage of all fixed obligations was a very strong 2.9x in 2009, although down from 3.8x in 2008. Forecasted all-in fixed charge coverage for 2010-2014 is no less than 1.8x, including the 2010 bonds being issued, or no less than 1.7x when not including the BAB subsidy. Forecasted senior DSC is no less than 1.9x, or no less than 1.8x without the BAB subsidy. Unrestricted cash reserves continue to strengthen, reaching their highest level in at least 10 years at approximately \$31 million, or 310 days' cash, in 2009. The district has an informal policy of maintaining cash reserves of no less than 120 days. While the district's debt burden has grown nearly ninefold since 2000, it is still manageable, as reflected in an equity-to-assets ratio of 30% as of pro forma 2010. Current district capital plans total what we consider a relatively high approximately \$67 million over the next five years, although we understand that management has no plans to issue additional debt.

Bond provisions are adequate and feature a 1.25x rate covenant, a fully funded reserve fund funded at average annual debt service, and an additional bonds test of 1.25x coverage on parity debt service.

Outlook

The stable outlook reflects our expectation that the district will maintain its currently healthy financial performance including strong DSC and adequate levels of liquidity despite its somewhat concentrated economy, reliance on BPA, and exposure to rate increases. The outlook also reflects our expectation that the district will continue to implement rate increases as needed to avoid a material decline in coverage or liquidity.

Related Criteria And Research

USPF Criteria: Electric Utility Ratings, June 15, 2007

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