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Ratings

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Grant County Public Utility District No. 2, Washington; Retail Electric

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Grant County Public Utility District No. 2, Washington; Retail Electric

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US$75.625 mil elec sys rev rfdg bnds taxable ser 2020Q due 01/01/2041		
Long Term Rating	AA+/Stable	New
Grant Cnty Pub Util Dist #2 elec sys revenue and rfdg bnds		
Long Term Rating	AA+/Stable	Affirmed

Rationale

S&P Global Ratings assigned its 'AA+' long-term rating to Grant County Public Utility District No. 2 (Grant PUD, or the district), Wash.'s proposed $75.6 million series 2020-Q (taxable) electric system revenue refunding bonds. We also affirmed our 'AA+' long-term rating and underlying rating (SPUR) on the district's previously issued electric system revenue bonds. The outlook is stable.

The bonds are secured by net revenue of the district's electric system and are being issued to refund various parity debt outstanding.

The rating reflects our opinion of the district's very strong enterprise risk profile mainly based on our view of its extremely strong market position and very strong operational management assessment, and our view of the district's extremely strong financial risk profile given the district's extremely strong coverage and liquidity.

The enterprise risk profile reflects our view of the district's:

- Very strong operational and management assessment, highlighted by strong operational assets, very strong environmental compliance, extremely strong management, policies, and planning, and very strong rate-setting practices;
- Strong service area economic fundamentals, with a growing customer base that has generated very strong demand growth in recent years, especially the industrial sector, and average income levels, although we note that a sizable portion of generation is sold to end-users outside of the direct service territory given its significant surplus sales;
- Extremely strong market position as a result of rates that are among the lowest in the nation at slightly more than 4 cents per kilowatt-hour (kWh) according to our calculations; and
- Extremely strong industry risk assessment relative to other industries and sectors.

The financial risk profile reflects our view of the district's:

- Extremely strong coverage metrics, with fixed-charge coverage (FCC) of 2.2x in audited fiscal 2018 and an average of 2.1x over the past five fiscal years, forecast at no less than 1.8x through fiscal 2024 under what we consider reasonable assumptions;
- Extremely strong liquidity and reserve position, with $260 million in available reserves, or 588 days' cash, as of fiscal

2018, projected at no less than $142 million, or 277 days' cash, through fiscal 2024; and

- Very strong debt and liabilities profile, suggested by the district's debt to capitalization of just 25% as of fiscal 2018 but a higher 54% when including debt and equity related to the district's share of the Priest Rapids Project (PRP), with no additional electric system debt planned through fiscal 2024.

As of Dec. 31, 2018, the district had $282 million in electric system debt and $1.2 billion in project debt at PRP, including internal loans to the electric system; the district's share of PRP debt is about $1 billion. The PRP consists of the Wanapum and Priest Rapids developments, and PRP off-takers, including the district itself, under take-or-pay, cost-of-service contracts service a large portion of project debt. In addition to direct electric system debt and PRP debt, the district is responsible for approximately $5.6 million of off-balance-sheet debt attributable to its share of Nine Canyon Wind Phase I project debt. Our rating on the electric system's debt is one notch higher than that on the Priest Rapids Project's debt for various reasons, including the significantly higher fixed-charge coverage generated by the electric system and our view that the electric system has relatively stronger ratemaking flexibility. The electric system's capital and debt needs are also less than those of the PRP, although, given that the electric system is the largest PRP off-taker, it is indirectly funding a large portion of the PRP's capital needs.

Utility Description And Credit Overview

Grant PUD, a vertically integrated public utility located in central Washington, serves about 41,000 customers and about 50,700 active meters. It operates its electric system independently of its two hydroelectric developments, the Priest Rapids development and the Wanapum development, together known as PRP.

Outlook

The stable outlook reflects our assessment of the district's extremely low-cost power supply resulting in market prices that are substantially below the prevailing market. The outlook also reflects our view of the absence of additional debt needs, the district's exceptionally strong financial position, and our expectation that management will continue to implement budget adjustments or enter into hedging agreements that promote revenue predictability and stability.

Upside scenario

We don't expect to raise the rating over the next two years given Grant's moderate concentration in leading customers and industrial sales, relatively high unemployment, asset concentration, and exposure to variable hydrology.

Downside scenario

We don't expect to lower the rating during our two-year outlook period given the district's significant rate flexibility resulting from its extremely low-cost power supply, and our view that the utility has considerable cushion for erosion in FCC and liquidity while sustaining extremely strong metrics.

Enterprise Risk Profile: Very Strong

Operational Management Assessment: Very strong

In our opinion, the district's operational management is very strong, highlighted by its extremely strong management, policies, and planning, and its very strong operational assets, environmental compliance, and rate-setting practices.

We view the district's operational assets as strong. The district's primary competitive strength is its preferential access to abundant low-cost hydroelectric power, most of it from owned PRP hydro generation. In addition, the district has minimal reliance on Bonneville Power Administration (BPA) power compared with most electric utilities in the region, purchasing only 2% of its power from BPA to serve loads in the Grand Coulee area because this region is not easily served from district resources. Each PRP development has 10 turbines, giving it shaft diversity, but, in our view, reliance on hydrology for a significant portion of supply is a moderate credit risk, even if the supply is partly hedged. Given that the electric system is the largest PRP off-taker, it is indirectly funding a large portion of the PRP's capital needs, which remain high as a result of turbine-related projects.

We view the district's environmental regulation and compliance assessment as very strong. The district does not face looming greenhouse gas compliance costs that owners of conventional power plants do. Also, it is in compliance with the state's renewable energy mandate known as I-937. The district expects to meet all future requirements utilizing existing incremental hydro and Nine Canyon Wind Project output. Subject to the final official rule-making process, the district also anticipates being compliant through 2045 under the Washington Clean Energy Act, which requires 100% clean (carbon-free) energy by 2045. Although not subject to external rate oversight, the district's hydroelectric dam operations are subject to federal and state regulation. Such regulation includes relicensing and operating requirements that the Federal Energy Regulatory Commission has imposed to achieve compliance with the Endangered Species Act, which protects several local fish species that the projects have been shown to affect adversely. As the operator and an off-taker of the projects, the district is exposed to noncompliance-related regulatory and legal risks, which primarily manifest as increased production costs. The district projects that regulatory compliance requirements are likely to result in increased production costs at its projects, but we believe these costs will remain competitive.

We view the district's management, policies, and planning as extremely strong. Management is especially proactive when it comes to management of generation, wholesale revenue volatility, and counterparty credit risk. This is key to mitigating price, stream flow, and operational risk. District financial policies include an internal goal of no less than 1.8x debt service coverage on a consolidated basis, $100 million in the reserve and contingency fund, and $5 million in the electric revenue fund, which the district has achieved. As of fiscal 2018, the fund held $124 million in cash. In our view, strong financial reserves are essential for stabilizing the district's financial position during unanticipated events or for other financial exposures, but power supply volatility over the next few years has largely been contained as a result of the district's expanded slice strategy (discussed below). Other significant financial policies and parameters include a minimum working capital balance of $35 million and funding of no less than 50% of capital from current revenue, excluding generation projects.

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 annual base rate increases in fiscal years 2010 to 2018 of 2% to 8%. No rate increase was made in fiscal 2019, and none is anticipated in fiscal 2020. The district's multilayered comprehensive approach to power supply management offsets the absence of a power cost adjustment mechanism. The district's elected five-member commission establishes rates, with full rate autonomy. Management plans additional base rate increases

of less than 1% annually in fiscal years 2021 to 2024 effective April 1 of each year. These rate increases are designed to fund electric system capital needs, maintain or increase reserves, and address increasing generation costs at PRP, but also to allow the district to meet its financial planning parameters. In our view, these rate increases will serve to provide the district with continued strong margins and liquidity, consistent with a 'AA+' rated municipal electric system rating.

Economic fundamentals: Strong

We view the district's economic fundamentals as strong, characterized by an economic base that continues to produce strong load growth, and median household effective buying income that is on par with the national average. 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 profit--also supports our economic fundamentals assessment.

Grant PUD's overall retail load growth was robust at about 17% in fiscal years 2014 to 2018, especially with regard to industrial customers (large individual and manufacturing growth of 32% during the same period). The local economic base, though historically based on agriculture and food processing, now has large industrial users representing a diverse mix of sectors, including a growing number of high-tech firms and data centers, chemical manufacturers, manufacturing, and silicon/silane gas production. While we view this growth as favorable, we do note that growing reliance on inherently more volatile industrial loads poses a credit risk. Demographic indicators are average-to-below-average, with 2018 median household effective buying income on par with the national average and unemployment at 6.2% versus 3.9% for the state. Residential customers constituted just 21% of total retail operating revenue, versus industrial customers at 46%, irrigation customers at 13%, and commercial customers at 19%. Off-system sales accounted for 25% of all operating revenue, the lowest level in at least 10 years, despite above-average (11% of normal) runoff, because of relatively low market prices but also because of the district's expanded slice strategy.

The largest 10 customers, which accounted for 35% of retail revenue in 2018 compared with 36% in 2013, are primarily in the food processing and materials/chemicals industries and in the rapidly expanding technology sector (data centers). Retail loads grew 7% in both 2017 and 2018; load growth has averaged a very healthy 7% annually since 2009. Given additional load from the industrial base, including data centers, agricultural processors, chemical manufacturers, silicon/gas producers, and other major manufacturing firms, management anticipates that industrial retail sales will continue to grow. Grant PUD will meet additional load growth with an increased portion of output from PRP (physical and financial), incremental hydroelectric resources and efficiency upgrades, conservation, and other resources to be determined. The district does not anticipate needing to purchase additional resources for several years. The district anticipates overall load growth of 27% to 35% over the next five to seven years.

Market position: Extremely strong

We consider the district's market position extremely strong, reflecting weighted average revenue per kWh that is among the lowest in the country at just 4.1 cents, or a very economical 67% of the state average (2018). This is largely a result of superior project economics from its baseload units, the Priest Rapids and Wanapum Hydroelectric Developments. The district's average power cost was just $18 per megawatt-hour in 2018, well below prevailing market prices and in line with previous years. The district's competitive position is also extremely strong because of the absence of retail competition. The very low industrial rate that the district offers reduces competitive pressure from

investor-owned utilities, but the district does compete with neighboring municipally owned utilities in whose service areas several of the district's large industrial customers operate. In our view, rates will remain very low during the next five years, especially given minimal, if any, rate increases.

Industry risk: Extremely strong

Consistent with our criteria "Methodology: Industry Risk," published Nov. 19, 2013 on RatingsDirect, we consider industry risk for municipal retail electric and gas utilities covered under these criteria very low, and therefore extremely strong compared with that of other industries and sectors.

Financial Risk Profile: Extremely Strong

Coverage metrics: Extremely strong

The district has demonstrated consistently robust financial performance for several years running, including in fiscal 2018. Actual FCC in fiscal 2018 was 2.2x and has averaged 2.1x over the past five years. FCC treats off-balance-sheet debt service (e.g., the system's share of the PRP and Nine Canyon Wind projects) as debt service rather than as operating expenses. The district estimates better-than-budgeted financial results for fiscal year ending Dec. 31, 2019 given strong wholesale sales and underspending on its capital plan, and despite run-off at 85% of average. In our view, the district's forecast assumptions are reasonable, especially given the district's recent track record. Forecast FCC through 2024 is no less than 1.8x and assumes minimal rate increases and no additional debt. We view the district's projections as reasonable, including assumptions on wholesale slice sales activity, customer growth, expense growth, and market prices.

Wholesale operations have historically represented a significant business segment, as the district is typically a net seller into the market. But as retail sales grow, wholesale opportunities decrease. Market prices also heavily influence wholesale sales, being generally lower in above-average water years, but volatility in hydrological conditions is also a factor. The district's wholesale revenue fell to $63 million in fiscal 2016 from an average of $81 million the previous five years, and was about $40 million in fiscal 2018. Management forecasts wholesale sales in the range of $24 million to $65 million annually during fiscal years 2019 to 2024, reflecting the district's strategy to manage hydro volatility, whereby wholesale sales will be lower in some years but more predictable, largely removing upside and downside potential from year to year. This strategy is known as the district's expanded slice strategy) and is discussed below.

The district, aiming to improve revenue predictability (and reduced volatility) from wholesale sales, engages in wholesale sales hedging by selling its own slice product (not to be confused with BPA's Slice product), or energy from the electric system's share of surplus PRP generation. Slice contracts are sold over market and are packaged with simultaneous position buybacks. Nonetheless, in our view, the district's hydrology risk and revenue volatility risks require the district to maintain a strong liquidity position. The district limits its commodity, market, and credit risks by adhering to conservative risk management guidelines. In forecasting its long-term resource needs, the district budget may use a "critical water" level of production assumption at its hydroelectric projects, to the extent a slice program is not in place. The district entered into a contract to sell a 10% portion, or slice, of its 63.3% physical share of PRP power to Avangrid Renewables Inc. in December 2018. The contract runs from Jan. 1, 2019 through Dec. 31, 2021. Avangrid receives 10% of actual PRP output and the district, in return, enters into positional, firm fixed-price energy

buybacks, with the aim of hedging water volume and operational risks through greater portfolio diversification.

The district took its net revenue stability strategy an extra step in September 2015 and entered into a pooling agreement with Shell Energy of North America (SENA) whereby it provided SENA with 43.3% of the capacity and energy of PRP through June 30, 2016, stepping up to 53.3% from July 1, 2016 through Sept. 29, 2020. Under the contract, SENA receives the right to the actual PRP variable generation, and in return the district receives firm power (from a mix of resources) sufficient to meet its load. The firm power is without regard to actual generation or streamflow conditions. Not only is the contract designed to improve the district's net revenue stability, but it enables the district (and SENA) to satisfy variable peak load demands, diversify supply, and enhance reliability. Once the SENA contract expires, the district anticipates replacing it with similar contracts, likely with more than one counterparty, in smaller slices.

These agreements add stability and predictability to the district wholesale revenue given that the purchasers assume hydro variability risk, but the purchasers also benefit from upside. At the same time, the district avoids downside risk to wholesale sales revenue during low run-off years but cannot take advantage of above-average run-off. Management reports that the SENA pooling agreement has worked as planned in terms of minimizing risk in the district's load resource portfolio. In addition, thus far there have been no instances when SENA was unable to serve the district's load, including this past year.

Liquidity and reserves: Extremely strong

We consider the district's liquidity and reserves extremely strong, with $260 million in available reserves, or 588 days' cash, as of fiscal 2018 (cash balances plus balances in the district's renewal and contingency fund). The district's internal policy requires it to maintain no less than 250 days' cash of operating expenses. Based on the district's forecast, it anticipates generating significant cash flow that will significantly bolster liquidity, a portion of which it intends to use for significant capital projects. The district projects total liquidity sources to remain at no less than about $142 million, or over nine months' worth of operating expenses, through 2024. The district expects its excess liquidity to decline somewhat over the next year as a result of the defeasance of approximately $80 million to $90 million in debt. According to the district, unrestricted cash at PRP could also be used for electric system debt service if needed, but this is an unlikely scenario. In our view, strong financial reserves are essential for stabilizing the district's financial position during unanticipated events or for other financial exposures, but power supply volatility over the next few years has largely been contained as a result of the district's expanded slice strategy.

Debt and liabilities: Very strong

In our opinion, the district's debt and liabilities profile is very strong, suggested by debt to capitalization of 25%, which we consider very low, as of fiscal 2018. Inclusive of the district's share of PRP debt and equity, we calculate an adjusted debt-to-capitalization ratio of about 54% for fiscal 2018. But with no debt issuances planned for the foreseeable future for the electric system, we anticipate that debt balances will continue to decline. For fiscal years 2020 to 2024, the electric system has budgeted $312 million in capital spending, largely related to transmission, distribution, and fiber/broadband investments. This does not include the potential for an estimated $100 million in seismic-related projects if that work is deemed necessary. We view the district's pension benefit obligations as manageable, with a funded ratio of 96% in fiscal 2018.

Bond provisions

A rate covenant requires net revenue sufficient to provide 1.25x annual debt service coverage, and the district may issue additional bonds if net revenue for any 12 consecutive months of the previous 24 months provides 1.25x coverage of maximum annual debt service. Net revenue may be adjusted for adopted rate increases, system improvements, and new customers. Management may use transfers from the reserve and contingency fund to meet the rate covenant, but not to meet the additional bonds test.

Separately, with regard to the PRP bonds outstanding, the electric system is obligated, whether or not the PRP is producing power or capable of doing so, to pay all project costs, including its share of debt service, not otherwise paid by other purchasers, and this obligation is payable as an operating expense prior to electric system direct debt service. The electric system covenants to set rates as it deems necessary to make such payments, to the extent required payments are not otherwise made.

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