FitchRatings

Public Finance
Public Power
United States

Grant County Public Utility District No. 2, Washington

Ratings

Long-Term Issuer Default Rating	AA

New Issues

$75,600,000 (Priest Rapids Hydroelectric Project) Revenue and Refunding Bonds Series 2020 A (Taxable)	AA
$105,500,000 Electric System Revenue Refunding Bonds Series 2020 Q (Taxable)	AA

Outstanding Debt Details on Page 3.

Rating Outlook

Stable

Applicable Criteria

Public Sector, Revenue-Supported Entities Rating Criteria (November 2019)

U.S. Public Power Rating Criteria (April 2019)

New Issue Summary

Sale Date: Jan. 21, 2020.

Series: Electric System revenue refunding bonds series 2020 Q (taxable), Priest Rapids Hydroelectric Project revenue refunding bonds series 2020 A (taxable).

Purpose: The bonds are being issued to defease and refund various outstanding Electric System and Priest Rapids Project bonds for present value debt service savings and to pay the costs of issuance.

Security: The Electric System bonds are payable from the electric system revenue bond fund after payment of distribution system operating expenses, inclusive of Priest Rapids Project resource costs. The Priest Rapids Hydroelectric Project bonds are payable from net revenue of the Priest Rapids Project.

Grant County Public Utility District No. 2, WA's Issuer Default Rating of 'AA' and bond ratings of 'AA' reflect the district's continued strong financial performance, very healthy liquidity and strong coverage. The utility benefits from sizable hydroelectric generating resources, collectively the Priest Rapids Project (PRP), producing exceptionally inexpensive power used to meet retail needs.

Fitch Ratings' assessment of revenue defensibility takes into account the amount of surplus energy sold into the wholesale energy market under short- and medium-term contracts and a concentrated industrial customer base. The rating considers the various strategies to mitigate these risks, which successfully produced stable and healthy financial performance in recent years.

Key Rating Drivers

Revenue Defensibility: 'a'; Significant Wholesale Sales Supported by Various Contracts: A majority of the district's ample capacity is used to meet domestic retail customer needs, with the remainder being sold under a mix of contracted sales and market-priced auctions.

The utility manages wholesale contracts and hedging agreements to insulate itself from price and hydro-variability risks, although margins remain exposed to a level of merchant risk, constraining Fitch's assessment of revenue defensibility. The utility remains exposed to revenue concentration and counterparty risks, which is partially mitigated through collateral postings and the ability to remarket very low-cost power upon counterparty default.

Operating Risk: 'aa'; Ample, Very Low-Cost Hydro Resources: The district's rating reflects its valuable hydropower generation resources providing exceptionally low-cost electric power, calculated by Fitch at a very low 3.5 cents/kWh in fiscal 2018. The utility's capital plans continue to increase, as modernization investments are made and the full amount of future capex required, due to Federal Energy Regulatory Commission (FERC) relicensing, is determined.

Financial Profile: 'aa'; Strong: Liquidity remains strong with coverage of full obligations increasing to 2.3x in fiscal 2018. Days cash on hand (DCOH) is very healthy at 474. Capital spending and borrowing increased in recent years and, as of FYE 2018, debt was more than $1.3 billion. Leverage remains adequate for the risk profile at 6.2x in fiscal 2018. Fitch's forward looking analysis includes financial performance remaining supportive of the rating through 2023.

Rating Sensitivities

Revenue Defensibility: The district's ability to effectively manage its operations, including the various hedging agreements, will be critical to maintaining a strong revenue defensibility assessment. Changes in revenue source characteristics and increased exposure to competitive pressures could put downward pressure on the rating.

Increased Leverage: Unexpected sizable increases for capital spending, or higher borrowing requirements reducing financial margins and raising leverage, could place negative pressure on the rating.

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Credit Profile

The district is a vertically integrated electric utility serving retail customers throughout Grant County, WA with a retail customer base of approximately 50,688. The utility maintains and accounts for two operating systems: the electric distribution system, comprised of roughly 4,351 miles of transmission and distribution lines, and the generating assets. The Priest Rapids and the Wanapum hydroelectric development generating assets, collectively the PRP, have a nameplate generating capacity of 2,157MW.

The district historically issued separate debt, payable from each respective development's net revenue, but in 2010 the utility consolidated the developments into one system called the PRP. The utility now issues PRP debt payable from the combined developments. The PRP hydro developments were combined under a new power sales contract, effective Nov. 1, 2009, extending through the life of the FERC license, expiring on April 1, 2052. Under the FERC license, the district's distribution system is entitled to 63.3% of the total physical output of the PRP and is required to sell 30% of the output within the region based on market prices.

Fitch rates the electric distribution system and the separately secured hydro developments as a single, integrated system; given the project debt is legally bound to the distribution system, making it the ultimate obligor. Development-specific debt is still outstanding but is on parity with the combined system debt.

Revenue Defensibility

A majority of the district's total revenue, 65% in 2018, is generated from domestic retail load, which Fitch views as exhibiting monopolistic demand characteristics. A meaningful portion of revenue, roughly 24% in fiscal 2018, is from competitive revenue sources. The remainder of revenue is from power sold under long-term contracts at cost or derived from transmission and other miscellaneous sources.

About 30% of PRP's Output Is Sold Competitively

The competitive portion of sales are driven both by the district's outsized generating resources, relative to domestic retail energy needs, and the federal requirements to sell fixed portions at market-based prices. The federal requirement stems from federal legislation adopted in 1954, Public Law 83-544, requiring the utility to sell a reasonable portion of energy, deemed by FERC at 30% of PRP output, within the region under market rates. An annual auction is held to sell at least 3% of PRP output on a slice basis, establishing the price for the full 30% reasonable portion.

The utility's competitive market sales over the past decade declined significantly to just under a quarter of revenue in 2018 from roughly half of revenue as recently as 2007. Drivers of this reduction are the continued decline in the market price of energy over the last decade, a strategy to increase retail rates, while attracting new industrial load growth, and contracts put in place hedging against variable hydro conditions. Further declines are not expected due to the FERC requirement ensuring a significant portion of the district's revenue base will remain exposed to competition.

This portion of PRP output is sold to 17 power purchasers under take-or-pay contracts expiring in 2052 requiring purchasers to pay their proportionate share of all costs of the PRP. This is regardless of the revenue produced from the reasonable portion auction or whether or not the PRP is producing power. While these payments are contracted to cover, at a minimum, operating expenses and debt service, there is volatility in the level of sales and budgeted margin, depending on the annual auction setting the annual price.

Distribution System's 63.3% of PRP Output Is Largely Hedged

About 63.3% of PRP's output is dedicated to the electric distribution system. This portion is currently hedged against hydro-volatility under two short-term hedging agreements. An energy pooling agreement signed by Shell Energy North America L.P. (SENA) on Oct. 1, 2015 requires the district to provide SENA with 53.3% of the distribution system's entitlement to PRP output.

In exchange, SENA provides the distribution system with firm power sufficient to satisfy 100% of the unmet retail load forecast through the life of the contract, expiring in September 2020, regardless of the actual energy output of the project. A second hedging agreement for the remaining 10% slice of the PRP output is hedged under an agreement with Avangrid Renewables through December 2021.

Rating History (IDR)

Rating	Action	Outlook/ Watch	Date
AA	Affirmed	Stable	12/23/19
AA	Upgraded	Stable	11/11/05
AA–	Affirmed	Positive	1/4/05
AA–	Affirmed	Stable	9/17/04
AA–	Affirmed	RWE	6/8/04
AA–	Assigned	—	1/29/93

IDR – Issuer Default Rating. RWE – Rating Watch Evolving.
Source: Fitch Ratings.

Outstanding Debt

Priest Rapids Hydroelectric Development Revenue and Refunding Bonds	AA
Wanapum Hydroelectric Development Revenue and Refunding Bonds	AA
Electric System Revenue and Refunding Bonds	AA

Fitch views the agreements as trading hydrological risk for counterparty risk. However, the SENA contract cannot be terminated by either party prior to contract maturity, except in the event of default. The district and SENA both have collateral posting requirements if their ratings fall below investment grade. The collateral posting is based on 12-month forward-looking, rolling mark-to-market, not balance of contract. While recalling the power in the event of a default by the counterparties would be financially beneficial to the district in good water years, it would reintroduce hydro-variability risk.

Fitch expects the utility to continue to pursue its hedging strategy using slice sales similar to the SENA and Avangrid agreements to mitigate water volume and market price risk on a rolling basis. Management described the potential to enter into several smaller 10% slice-of-the-system hedging agreements in the future. The shorter-term nature of the hedging, which performed well for margins, exposes the district to some level of renewal risk and potentially counterparty risk.

Mixed Service Area Characteristics

Grant County encompasses a sizable 2,681 square miles in central Washington State along the Columbia River. The county's economy is historically agriculturally based, although a relatively recent influx of technology companies, such as data centers, and energy intensive industrial manufacturing firms, such as chemical and aluminum processors, helped to diversify the economy and bring additional jobs into the area. Very low retail power costs, supportive policies for economic growth, and easy access to transportation and highways create a strong environment for industrial growth.

Favorable demand characteristics including customer growth at 1.5% per year over the prior five years, and electric load growth, near 5% per year, are strengths of the public utility district's (PUD) service area. Fitch expects this to continue in the medium term, as the district expects continued strong industrial load growth approximating 30% over the next five to seven years. The largest increase in loads stemmed from data centers, as Microsoft Corporation (AA+/Stable) and Yahoo! were early operators in the area. These firms continue to show interest in locating in the county and the district is actively recruiting.

Other service area characteristics, such as economics and demographics in the county, are not as strong. Median household income and unemployment reflect the agriculture base of the job market, with midrange incomes and weaker unemployment rates relative to the national level.

Low Retail Rates; Increasing Industrial Load

The exceptionally low cost of power from PRP allows the system to keep retail electric rates exceptionally low, with retail rates among the lowest in the country. Within Washington State, only Douglas County and Chelan County PUDs have lower retail rates. Commercial and industrial rates are comparatively low.

The distribution system's retail electric rates and charges are not subject to state or federal regulation, providing independent ability to adjust rates as necessary, which the district increased since 2010 from 0% to 8% annually. Rates remain just 50% of the state average.

The utility's retail sales are concentrated in several large industrial customers. The 10 largest retail customers accounted for roughly 35% of retail revenue in 2018, which makes up a much smaller portion of total operating revenue. These large customers are somewhat diversified in agriculture and manufacturing but also include several large data centers.

Fitch does not constrain revenue defensibility at this time, largely due to the district's below-market cost of power, providing the option to readily sell excess power into the wholesale markets, reducing the potential effects from unexpectedly losing a larger customer. Industrial rates are currently below market pricing.

As management recruits energy intensive industrial loads, the load growth benefits the system that is long-power associated with the estimate unmet district load portion of PRP available to the district. This could help diversify the historically economically narrow service territory.

Operating Risk

A major credit strength of the utility is the exceptionally low-cost hydropower production at the PRP. Fitch calculates a very low operating cost burden for the district at 3.5 cents/kWh, anchoring the 'aa' operating risk assessment.

The utility calculates PRP power production in 2018 at a combined average cost of $18.60/MWh. PRP's power cost continues to compare favorably with the region's largest power supplier, Bonneville Power Administration, OR (AA–/Stable), which provided power to preferred customers an average cost of $35.60/MWh in 2019.

PRP's operational flexibility provides significant additional value beyond the low-cost of the power produced. Management stated about half of the project's capacity is available for peaking needs at any time, providing significant value in its ability to integrate renewables or act as power storage. The cost of the project's hydropower is expected to remain competitive, despite large capital needs for turbine replacement, licensing and powerhouse improvements. The utility's estimated cost of power in 2022 is $19.97/MWh, which is less than current market prices.

Fitch assesses the utility's operating cost flexibility as weaker due to the lack of resource diversity outside of hydropower and susceptibility to variable water conditions; however, this risk is largely offset by the above discussed benefits of inexpensive and more than ample resources. The distribution system is entitled to 63.3% of the physical output of the PRP and up to an additional 30% of the output of the PRP that is available for the electric distribution system to purchase to meet estimated load requirements. This is sufficient to meet current and anticipated retail customer loads through the 2025–2026 timeframe.

Renewable Portfolio Standards

Under the state's renewable portfolio standards (RPS), utilities serving 25,000 customers or more are required to obtain 15% of their load from renewable resources by 2020. Eligible resources include incremental hydroelectric, wind, solar or renewable energy credits (RECs). The district's existing resources are sufficient to meet compliance for 2020, as provided from incremental PRP hydro generation, and its share of the Nine Canyon Wind Project.

Under the pooling agreement with SENA, the utility is allowed to take the environmental attributes in an amount sufficient to meet RPS requirements with the remainder of RECs going to SENA. As the district's retail load grows, its requirements under the RPS increase and management is estimating a minimal level of qualifying renewable energy credit purchases may be required beginning in the mid-2020s.

Washington State passed the Clean Energy Transformation Act in 2019 requiring the state to achieve a power supply free of carbon emissions by 2045. The district is well positioned, given its carbon-free power supply.

The age of plant is calculated by Fitch at 14 years and capital management appears adequate. Favorably, capex/depreciation totaled nearly twice depreciation over the last five years and is related to both generating assets and its distribution system. The capital improvement plan for 2020–2024 totals $725 million with a majority dedicated to investments at PRP with the remainder going to the electric distribution system. The capital improvement plan includes $153 million in new borrowing over the life of the plan, or less than the significant amount of debt expected to be amortized, signaling room for new debt in financial plans.

The generating system work includes the full replacement of all the turbines and generators at Wanapum expected to be completed in June 2020. The 10 generators are being upgraded for $150 million. A similar investment is ongoing at Priest Rapids Dam including replacing the remaining turbines and generator upgrades. Costs are currently estimated at $307.4 million, including labor, for 2019–2028. Ongoing discussion with FERC will determine the amounts applicable to the upcoming relicensing of the project. The electric distribution system investments include substation work and the completion of its advanced metering rollout in 2019.

Seismic and Other Remediation

The Wanapum and Priest Rapids dams have ongoing remediation work regarding potential exposure to seismic risk. Currently, only the Priest Rapids Dam is being modified at an estimated cost of just under $50 million. The Wanapum Dam potentially needs remediation at an estimated cost of $100 million that is not currently included in capital budgets due to the low likelihood it is required. The fracture discovered in the Wanapum Dam in 2014 was repaired for roughly $62 million with a portion being covered by insurance. The dam was back to full operation in 2015.

Financial Profile

The utility's consolidated financial profile remains strong. Liquidity levels are robust with cash balances well above the 250 day target at 474 DCOH in fiscal 2018 and coverage of full obligations improving to 2.3x in fiscal 2018. The hedging agreements in place with SENA and Avangrid hedged volatility associated with both hydrology and market prices of energy.

Fitch views the reduced reliance on wholesale revenue positively, as it helps reduce variability and uncertainty in financial performance. The poor water conditions in 2019 are not expected to significantly affect financial performance. The contract with SENA follows a netting mechanism eliminating the need to occasionally make market purchases for the distribution system. The utility's purchased power cost in fiscal 2015 was $27.6 million and $0 since.

Fitch Analytical Stress Test (FAST): Base Case and Rating Case

While debt issuance increased slightly over the prior five years to just more than $1.3 billion, as of fiscal 2018, largely to fund capital at the PRP, margins improved and produced a lower leverage ratio of 6.2x. In Fitch's base case scenario, leverage is expected to continue a slow deleveraging trend. The district expects only minimal increases to rates at this time, when budgeting to average water conditions, and the continued increase in the retail load. Capex remains similar to recent years and planned debt issuance to fund the plan trails the debt amortized over this period. Leverage in Fitch's base case declines slightly to just below 5.5x.

Our stress case scenario, a two-year decline in retail and wholesale sales, followed by recovery in years three to five, produces more variable margins affecting the leverage ratio. In this scenario, leverage increases to slightly more than 7.0x before recovering. A modest 3% rate increase in the retail system in the stress years is estimated to reduce leverage back to the base case level.

The district had a total of roughly $1.3 billion in long-term debt outstanding at FYE 2018 with $282 million in the electric system and $1.01 billion in the PRP. Debt is almost entirely fixed rate, outside of two smaller $50 million subordinated Electric System bonds series 2017 M and 2019 P, which were privately placed and include more restrictive covenants. Roughly $125 million of subordinated PRP bonds were issued by the utility since 2014 and purchased by the district's electric distribution system as an investment.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of Environmental, Social and Governance (ESG) credit relevance is a score of '3' — ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed.

For more information on our ESG Relevance Scores, visit www.fitchratings.com/esg.

Appendix: Key Definitions

Key Definitions

Terms	Definition	Significance
Issuer Default Rating (IDR)	An expression of overall enterprise risk and relative vulnerability to default.	Provides an opinion of the relative ability of an entity to meet financial commitments, expressed as an ordinal measure of credit risk.
Net Adjusted Debt	Adjusted debt – unrestricted cash – funds restricted for debt service	Provides an inclusive evaluation of long-term liabilities offset by funds available for debt service.
Adjusted FADS	EBITDA + interest income + 30% of purchase power expense + operating lease expense – transfers/distributions + pension expense	Provides an indication of cash flow available for the payment of debt service, adjusting for purchased power, operating lease and pension obligations.
Net Adjusted Debt to Adjusted FADS	Net adjusted debt / adjusted FADS	Provides an indication of net total leverage position against available operating cash flow.
Full Obligations	Cash interest paid + scheduled long-term principal payments + 30% of purchase power expense	Provides an indication of inclusive fixed and debt service obligations.
Coverage of Full Obligations	(EBITDA + interest income + 30% of purchase power expense + operating lease expense – transfers/distributions) / full obligations	Provides an indication of the relative cushion of operating cash flow to fixed charges.
Base Case	The expected forward-looking case in the current macro-economic environment.	Provides the analytical starting point in the forward-looking analysis, and also informs the rating case.
Rating Case	The potential performance under a common set of assumptions.	Illustrates how cycles affect individual issuers differently, and informs the level of rating stability and credit resiliency.

Source: Fitch Ratings.

Appendix: Financial Summary

Financial Summary — Grant County Public Utility District No. 2, Washington

($000, as of Dec. 31)	2014	2015	2016	2017	2018
Net Adjusted Debt/Adjusted Funds Available for Debt Service (x)	**7.48**	**7.60**	**6.42**	**6.72**	**6.18**
Net Adjusted Debt Calculation					
Total Short-Term Debt	0	0	0	0	0
Total Current Maturities of Long-Term Debt	29,470	30,915	32,075	31,635	29,240
Total Long-Term Debt	1,267,883	1,321,778	1,333,458	1,340,124	1,306,064
– Restricted Funds (Cushion of Credit)	0	0	0	0	0
Total Debt	**1,297,353**	**1,352,693**	**1,365,533**	**1,371,759**	**1,335,304**
+ Capitalized Fixed Charge (Purchased Power)	126,391	66,322	0	0	0
+ Capitalized Fixed Charge (Operating Leases)	0	0	0	0	0
+ Total Pension Obligation (GASB Fitch-Adjusted NPL + FASB PBO)	0	136,535	102,918	113,574	95,006
– Total Unrestricted Cash	190,408	208,141	276,960	225,756	168,036
– Restricted Funds for Debt Service	0	0	0	0	0
Net Adjusted Debt	**1,233,336**	**1,347,409**	**1,191,491**	**1,259,577**	**1,262,274**
Adjusted Funds Available for Debt Service for Leverage Calculation					
Total Operating Revenue	308,665	313,169	286,316	293,909	311,270
Total Operating Expense	228,648	217,077	187,574	198,812	202,707
Operating Income	**80,017**	**96,092**	**98,742**	**95,097**	**108,563**
+ Adjustment for Deferred and Subsidy Revenue	7,770	8,214	10,545	10,556	10,552
+ Depreciation and Amortization	53,896	56,985	61,956	66,206	73,234
+ Interest Income	7,432	4,600	10,008	12,833	11,391
+ Other Non-Cash Charges	0	0	0	0	0
Funds Available for Debt Service	**149,115**	**165,891**	**181,251**	**184,692**	**203,740**
+ Operating Lease Payments	0	0	0	0	0
+ Adjustment for Purchased Power	15,799	8,290	0	0	0
– Total Transfers/Distributions	0	0	0	0	0
+ Pension Expense	0	2,993	4,325	2,850	423
Adjusted Funds Available for Debt Service for Leverage	**164,914**	**177,174**	**185,576**	**187,542**	**204,163**
Coverage of Full Obligations (x)	**1.68**	**2.08**	**2.13**	**2.02**	**2.34**
Funds Available for Debt Service	149,115	165,891	181,251	184,692	203,740
+ Adjustment for Purchased Power	15,799	8,290	0	0	0
– Total Transfers/Distributions	0	0	0	0	0
Adjusted Funds Available for Debt Service for Coverage	**164,914**	**174,181**	**181,251**	**184,692**	**203,740**
Full Obligations Calculation					
Cash Interest Paid	47,211	45,819	54,276	59,349	55,503
Prior Year Current Maturities	35,290	29,470	30,915	32,075	31,635
Total Annual Debt Service	**82,501**	**75,289**	**85,191**	**91,424**	**87,138**
+ Adjustment for Purchased Power	15,799	8,290	0	0	0
Total Fixed Obligations	98,300	83,579	85,191	91,424	87,138
Liquidity Cushion (Days)	**398**	**475**	**805**	**621**	**474**
Unrestricted Cash (Days)	**398**	**475**	**805**	**621**	**474**
Liquidity Calculation					
+ Total Unrestricted Cash	190,408	208,141	276,960	225,756	168,036
+ Total Borrowing Capacity	0	0	0	0	0
– Amounts Unavailable	0	0	0	0	0
Total Liquidity	**190,408**	**208,141**	**276,960**	**225,756**	**168,036**
Cash Operating Expense Calculation					
Total Operating Expense	228,648	217,077	187,574	198,812	202,707
– Depreciation and Amortization	53,896	56,985	61,956	66,206	73,234
– Other Non-Cash Charges	0	0	0	0	0
Cash Operating Expense	**174,752**	**160,092**	**125,618**	**132,606**	**129,473**

GASB – Governmental Accounting Standards Board. NPL – Non-performing loans. FASB – Financial Accounting Standards Board. PBO – Pension benefit obligation.
Source: Fitch Ratings, Fitch Solutions, Grant County Public Utility District No. 2, Washington.

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