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Ratings

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Summary:

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

Primary Credit Analyst:
Paul J Dyson, San Francisco (1) 415-371-5079; paul.dyson@spglobal.com

Secondary Contact:
Doug Snider, Centennial 303-721-4709; doug.snider@spglobal.com

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Credit Profile		
US$49.68 mil elec sys rev rfdg bnds ser 2017-N due 01/01/2044		
Long Term Rating	AA/Stable	New
Grant Cnty Pub Util Dist #2 elec sys rev & rfdg bnds ser 2001-H dtd 11/15/2001 due 01/01/2022		
Unenhanced Rating	AA(SPUR)/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 $50 million electric system revenue refunding bonds (mandatory put bonds). At the same time, we 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 ratings reflect our view of Grant PUD's:

- Very strong fixed-charge coverage of 2.15x in fiscal years 2015 and 2016, improving from 1.70x in 2014, and forecast at an average of 1.85x for fiscal years 2017 to 2021 under assumptions we believe are reasonable;
- Very strong and improved electric system liquidity, with unrestricted cash reserves of $230 million, or 529 days' operating expenditures, as of 2016, and forecast at an average of $175 million, or 333 days, through 2021;
- Favorable Priest Rapids Project (PRP) power sales contracts that allow for the district's allocation of very low-cost, firm hydro project power, which is sufficient on its own to serve the district's native load even at critical water levels (68% of average stream flows);
- Generally good operating performance at PRP, including an availability factor of 85% and capacity factor of 66% in 2016, with an average cost of power of a very low $16.14 megawatt-hour (MWh);
- Very low retail rates of approximately $40 per MWh, with residential rates of about $83 per month, the third-lowest in the state;
- Potential for improved wholesale revenue stability through at least 2020 given the district's practice of selling portions, or "slices," of its share of PRP power and entering into positional buybacks, and its more recent pooling agreement with Shell Energy North America (SENA),as a way to improve the predictability of wholesale revenue, which is often volatile given variable hydrological conditions; and
- Insulation from retail competition as well as willingness and ability to adjust rates, as demonstrated in 2010 through 2017 with eight consecutive rate increases of 2% to 8%, with plans to increase rates by 2% annually during fiscal years 2018 through 2023 and 0.5% thereafter until at least 2027.

Partly offsetting the above strengths, in our view, are Grant PUD's:

- Moderate and growing reliance on industrial loads, which are inherently more volatile than residential loads;
- Moderately high debt burden when including both the district's direct debt and its off-balance-sheet debt related to

PRP and other contracted generation, although the district has demonstrated an ability to pay down debt early in recent years and plans to reduce its reliance on debt for future capital projects;
- High resource concentration in hydroelectric power, the production of which depends on Columbia River stream flow and spill requirements as well as moderate asset concentration, with the district's two major hydroelectric projects accounting for approximately 95% of energy resources in 2016; and
- Moderate but declining reliance on off-system surplus hydroelectric power sales, which depend on Columbia River stream flow, spill requirements, and market prices, although such revenue as a percentage of total operating revenues fell to its lowest level (25%) in over a decade in 2016, partly as a result of the district's expanded slice strategy (ESS).

We have assigned the district a business profile of '3' on our 10-point scale, with '1' being the strongest. The business profile reflects our view of the district's extremely competitive rates, full rate-making authority, good service territory albeit with below-average income levels, strong management practices and policies, and generally strong and stable operations, including a carbon-free resource portfolio.

The bonds are being issued to redeem the district's series 2014-K electric system revenue bonds and are secured by net revenue of the district's electric system. A rate covenant requires net revenue sufficient to provide 1.25x annual debt service coverage (DSC), 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.

The bonds will initially bear interest at a fixed term interest rate for the initial term rate period ending on Dec. 2, 2020, subject to prior optional redemption or conversion to a new term rate. At the end of the initial term rate period, the bonds are subject to mandatory purchase and conversion to a new term rate. While no credit facility secures the purchase price, the failure to pay the purchase price on the mandatory tender date is not an event of default; in case of insufficient funds, the bonds will bear interest at a stepped interest rate of 6% for the first 89 days and 8% thereafter.

Grant PUD, a vertically integrated public utility located in central Washington, serves about 46,000 retail customers. It operates its electric system independently of its two hydroelectric developments, the Priest Rapids development and the Wanapum development, together known as PRP. Grant PUD's retail system continues to experience strong load growth, especially with regard to industrial customers. 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 below average, with 2016 median household effective buying income at 88% of the national average and 2016 unemployment at 7.4% versus 5.4% for the state and 4.9% for the U.S.. Residential customers constituted 25% of total retail operating revenue in 2016, versus industrial customers at 50%, irrigation customers at 14%, and commercial customers at 13%. Off-system sales accounted for 25% of all operating revenue, the lowest level in at least 10 years, despite near-average (98% of normal) runoff, because of relatively low market prices but also because of the district's ESS, discussed below.

The largest 10 customers, which accounted for 34% of retail revenue in 2016 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 load increased by an annual average of 2.4% in 2010 through 2016, but grew 7.1% in 2014 and 8.5% in 2015. In 2016, retail demand fell 2.1% as a result of milder weather patterns. 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 grow by 43% to 55% over the next five to seven years and that overall district load will grow by 27% to 35%. 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 until at least 2025.

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 1% of its power from BPA to serve loads in the Grand Coulee area because this region is not easily served from district resources. As such, BPA accounted for just 1% of power in 2016, down from 25% in 2010. The replacement of BPA power with PRP power is also significant in terms of power supply costs, with the PRP average production cost at a very low $16.14 per MWh in 2016 versus the BPA preference rate of $33.75, a 50% cost advantage.

Hydropower from PRP represented 95% of total power resources in 2016 after having declined in 2014 to 75% from 83%. This decline was mainly the result of a dam fracture repair in which water levels were lowered behind the Wanapum development. Although the cost of PRP power increased to about $22 per MWh in 2014, it was still extremely low cost, in our view--among the lowest in the nation and competitive even with the costs of other Mid-Columbia River dams. As a comparison, in 2014, the Rocky Reach and Rock Island hydro projects, owned by Chelan County PUD, had production costs of $12 and $30 per MWh, respectively, with the Wells project, owned by Douglas County PUD, at $13 per MWh.

Gross generation from PRP was 10.1 million MWh in 2016, up 5% from 2015, and hydro runoff was 98% of normal, up slightly from 96% of normal in 2015. Disposition of net PRP energy to the district in 2016 was 5.6 million MWh, versus its retail load of approximately 4.4 million MWh, still resulting in substantial wholesale sales. The district projects that power costs at PRP will increase to a range of $17 to $19 per MWh through 2022, mainly because of regulatory and capital requirements (turbine and generator replacements) and the related debt service, but the cost of power should remain very competitive relative to forward market wholesale prices and even relative to BPA's forecast firm priority rate of near $37.

The district's power sales contracts enable the electric system to meet all load requirements under critical water with the low-cost power from the PRP. With a term of 44 years, the power sales contracts extend to the expiration of the district's long-term license for the project in 2052. Grant PUD's allocation of project power under the new contracts includes a maximum of 63.3% of firm power (at critical water), with the district selling the surplus to the power purchasers. The district also dedicates 30.0% of project output, the "reasonable portion," for sales within its region, and the remaining 6.7% to various power purchasers. The district meets the electric system's unmet load through cash proceeds resulting from the auction of power. In some years, such as 2007 and 2008, revenue from these auctions exceeded the amount necessary for power purchases. Given this, PRP provides a combined physical and financial benefit to the district of as much as 93.3% of total generation capability (about 695 average MW).

Other than PRP hydropower, the balance of power resources for the district consists of various small hydro projects and wind. The district anticipates comfortably meeting the state's renewable energy requirement with wind and turbine efficiency upgrades. The district estimates that its renewable energy portfolio will exceed 9% through 2019, and 15% for 2020 and beyond.

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 will decrease. Market prices heavily influence wholesale sales, being generally lower in above-average water years, but volatility in hydrological conditions are the main culprit. The district's wholesale revenue fell to $63 million in fiscal 2016 from an average of $81 million the previous five years. Management forecasts wholesale sales in the range of $32 million to $51 million annually during fiscal years 2017 to 2021, reflecting a change in the district's strategy to manage hydro volatility, whereby wholesale sales will be lower but more predictable, largely removing upside and downside potential from year to year. This strategy is known as the district's ESS and is discussed below.

Although the district benefits from remarketing surplus power from the low-cost PRP, wholesale activity and participation in the projects present additional operational and risk management challenges in the event that wholesale sales fall short of forecast levels. 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 contacts 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 budgets "critical water" levels of production at its hydroelectric projects. Purchases to meet firm load requirements may not occur more than 18 months out or for more than 12 consecutive months. The district limits the variance between system load and resources on a monthly and a trailing-12-month basis.

The district entered into a contracts to sell a 10% portion, or slice, of its 63.3% physical share of PRP power to Avangrid Renewables Inc.in January 2015. The contract runs from July 1, 2015 through June 30, 2018. Avangrid receives 10% of actual PRP output and the district, in return, enters into positional, firm fixed-price energy buy backs, 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 SENA where it provides 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. and the SENA contract is a 53.3% slice 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 SENA 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 also enables the district (and SENA) to satisfy variable peak load demands, diversify supply and enhance reliability.

The district's elected five-member commission establishes rates, with full rate autonomy. The district adopted a 4% general rate increase in April 2010, the first since 2003, and has raised rates an additional 2% to 6% annually since, including in fiscal 2017 to provide revenue to fund capital projects and rising operating costs. Management plans additional rate increases of 2% annually on April 1 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.

The district's competitive position is extremely strong because of the absence of retail competition and very low production costs. The district's heavy reliance on its two low-cost hydroelectric projects enables it to offer very competitive rates to its retail customers. The district's rates are the third-lowest in the Pacific Northwest (behind those of the neighboring Douglas and Chelan PUDs) and far below the national average. Residential rates are approximately $83 per month, which is 35% below the state municipal average and 45% below the state investor-owned utility (IOU) average. The very low industrial rate offered by the district, $33.20 per MWh in 2017, reduces competitive pressure from IOUs, 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 low during the next five years, even with annual 2% planned rate increases during 2018 through 2021.

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.

The district's financial performance, already strong, improved further in fiscal years 2015 and 2016 as a result of lower purchased power costs of $133 million in fiscal 2015 and $108 million in fiscal 2016 versus the fiscal 2014 level of $159 million. Power costs were higher than normal in fiscal 2014 largely as a result of the reduced Wanapum development generation stemming from the dam fracture. Direct DSC (including unrated junior-lien debt) improved to 12.89x in 2016 from 5.0x in 2014 and 10.7x in 2015. Fixed-charge coverage, which measures coverage of combined electric system and PRP debt service as well as other fixed costs for Nine Canyon Wind power, was 2.15x in fiscal years 2015 and 2016, up from 1.70x in fiscal 2014. Given additional annual 2% retail rate increases and forecast load growth as indicated above, among other assumptions, the district projects DSC of no less than 5.5x through 2021, and we calculate fixed-charge coverage in a range of 1.6x to 2.1x. In our view, the forecast relies on what we consider reasonable assumptions.

Liquidity improved to what we consider an exceptionally strong $230 million, or 529 days' cash, in fiscal 2016 from $211 million, or 363 days' cash, in fiscal 2014. 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. Total cash on a consolidated system basis is

$248 million, or 570 days, when including operating expenses on a consolidated basis. For the electric system, the district's forecast indicates that total unrestricted cash will remain at very strong levels averaging $333 million, or 333 days of operating expenses. District financial policies include an internal goal of no less than 2x DSC and $120 million in the reserve and contingency (R&C) fund, which the district has achieved. As of fiscal 2016, the R&C fund held $126 million in cash. In our view, strong financial reserves are essential for stabilizing the district's financial position during periods of 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 ESS (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 electric system's debt leverage as of fiscal 2016 is low on a direct debt basis at just 25% debt to capitalization but is a more moderate 52% (a high $22,635 per customer) for both direct and indirect debt. The district's five-year capital budget for 2017 through 2021 anticipates about $234 million in electric system capital requirements. About 29% of capital needs will be debt financed, and management anticipates a reduction in borrowing costs at PRP given that it will fund a sizable portion of the PRP capital improvement plan with equity contributions directly from the electric system.

As of Dec. 31, 2016, the district had an additional $1.18 billion in bonds that had been issued for the district's PRP, either on a consolidated basis or separately, for the Priest Rapids development or the Wanapum development. Located along the Columbia River, the developments consist of two hydroelectric projects. The district has pledged to pay PRP operations-and-maintenance costs as well as related debt service that is not otherwise paid from revenue that the project generates from sales to purchasers other than the district. Electric system payments for the district's share of generation of the project are paid as a district operating expense.

By entering into these contracts, the district avoids downside risk to wholesale sales revenue during low runoff years but cannot take advantage of above-average runoff, thereby generating more predictable margins. The value of SENA's rights to hydro project capacity and associated energy is based on the assumption of average water conditions, and is approximately equal to the value of the firm power requirements that SENA must provide to the district. 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, when the district set new winter and summer peaks.

Outlook

The stable outlook reflects our view of the district's willingness to adjust rates, strong operations and financial performance, and exceptional liquidity position. The outlook further reflects our view of the district's stable customer base and very low rates, which help ensure continued strong demand and load growth.

Upside scenario

Although we are unlikely to do so over the next two years, we could raise the rating if the local economic base strengthens and diversifies, capital needs subside, and fixed-charge coverage remains near current levels, all assuming the district maintains very strong liquidity and strong competitiveness.

Downside scenario

We do not anticipate lowering the rating during the next two years given the district's strong margins and financial flexibility provided by its low rates. But in the unlikely event that the district's cost of power rises significantly and key financial metrics weaken materially, the rating could come under pressure.

Ratings Detail (As Of November 7, 2017)		
Grant Cnty Pub Util Dist No. 2 RETELEC		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Grant Cnty Pub Util Dist #2 elec sys revenue and rfdg bnds		
Long Term Rating	AA/Stable	Affirmed
Many issues are enhanced by bond insurance.		

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 www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.