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Ratings

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Summary:
Grant County Public Utility District No. 2, Washington; Wholesale Electric

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Rationale

S&P Global Ratings affirmed its 'AA' long-term rating and underlying rating (SPUR) on Grant County Public Utility District No. 2 (Grant PUD), Wash.'s previously issued revenue bonds issued for the Priest Rapids Project, and on Grant PUD's revenue bonds issued prior to 2010 separately for the Priest Rapids and Wanapum hydroelectric developments. The outlook is stable.

The ratings reflect our view of the PRP's:

- Unconditional power sales contracts between project owner Grant County PUD and multiple power purchasers for 100% of combined project output;
- Very low production costs at the consolidated PRP of $16.14 per megawatt-hour (MWh) in 2016, which the district anticipates will remain less than $19 per MWh through 2021;
- Continued successful replacement of fish-friendly turbines and other measures that have resulted in reduced spill, enhanced project economics, and compliance with environmental regulations, with additional improvements ongoing;
- Generally good operating performance, including a plant availability factor of 85% in 2016; and
- Continued adequate financial performance, with power purchasers paying their share of project costs plus 15%, such that debt service coverage (DSC) is consistently about 1.15x.

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

- High capital requirements associated mostly with turbine and generator restoration and powerhouse improvements, but also with regulatory compliance and license implementation, which puts pressure on the long-term competitiveness of the project's production costs, although management projects that costs will remain less than $19 per MWh through 2022, about half of Bonneville's firm priority rate; and
- High project debt burden, with debt to plant of 89% and debt to capitalization of 82%, although management anticipates a reduction in borrowing costs given that it will fund a sizable 72% of the five-year capital improvement plan (CIP) with equity contributions directly from the electric system.

The business profile score is '3' on a 10-point scale, with '1' being the strongest. The business profile reflects our view of the project's extremely competitive cost of power, moderate operating risks, good economics of service territories, and strong management practices and policies.

Bonds issued in 2010 or later are secured by a lien on the net revenue of the consolidated PRP project. Bond provisions include a 1.15x rate covenant on both parity and junior-lien debt, a 1.15x additional bonds test, and a debt service reserve fund capitalized at maximum annual interest. Parity bonds issued prior to 2010 for each of the two hydro developments are also payable from net revenue of the combined PRP, pursuant to the resolution and prior resolutions. In 2010, the district consolidated the two developments into one system, PRP. This consolidation had been planned since the late 1990s and simplifies administration and financing, provides cost savings, and signifies that power purchasers consider the combined developments a single project. In addition, the Federal Energy Regulatory Commission (FERC) provided a single license that covers both projects.

Pursuant to the bond resolution, the revenue of both developments has been pledged for debt service on the bonds and all parity bonds; the revenue of the combined developments has been pledged for operations and maintenance, capital, and other obligations of both developments. Revenue consists of all revenue received from the PRP, including that received under power sales contracts and payments from the electric system. The electric system (AA/Stable) 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.

PRP consists of two hydroelectric generating facilities. The Priest Rapids development is a hydroelectric generating facility located downstream from the Wanapum project on the Columbia River in Grant and Yakima counties. The generating plant has a nameplate capacity of 956 MW and began operations in 1961. The Wanapum development is a hydroelectric generating facility located approximately 18 miles upstream of the Priest Rapids development on the Columbia River in Washington. The generating plant has a nameplate capacity of 1,169 MW and began commercial operation in 1963. The project is owned and operated by Grant PUD, a vertically integrated public utility that operates its two utility systems as independent business units: the electric system and PRP.

All power purchasers are either public or investor-owned utilities in the Pacific Northwest, and we believe that they are extremely unlikely to default on their payment obligations to the project given that the project represents one of the lowest-cost power resources in any of their supply portfolios. New power sales contracts took effect in 2005 and 2009 for the Priest Rapids and Wanapum developments, respectively, and will extend to the expiration of the recently renewed 44-year license for the project (April 1, 2052). The new contracts are similar to the prior contracts in that they are take-or-pay. Grant PUD's allocation of project power from PRP has been modified under the new contracts so that Grant PUD has the ability to take a maximum of 93.3% of firm PRP power to meet its load (63.3% physical and 30.0% financial through the reasonable portion/estimated unmet district load). The Grant PUD electric system's share of project costs in 2016 was 73%.

Prior to 2010, the bonds whose proceeds secured each development relied on the net revenue from a single asset, but under the consolidated project this concentration risk is reduced. Even prior to consolidation, single-asset risk was mitigated in several ways. Each development has 10 turbines that have typically achieved availability factors of around 80% to 90%, with a maximum of one turbine or generator undergoing replacement or maintenance at any given time. Also, the supply contracts require power purchasers to satisfy the cost of power production, irrespective of the amount of power produced, thus producing consistent annual DSC of 1.15x (when including excess funds available in the supplemental repair and renewal fund). Under average water assumptions, the district could have as many as four of 20 units out of service without any material effect on generation. We do note, however, that net PRP generation did decline 13% in 2014 mostly as a result of the dam fracture, as hydro runoff was similar to 2013 levels. Production rebounded to normal levels once the repair was complete.

The project exhibits very strong credit fundamentals primarily because of its very low cost of production (essentially cost-free fuel) and its ability to reassign or remarket power from any defaulting power purchaser. It sells power through newly revised power sales contracts to 18 public and private utilities in the Pacific Northwest, including the district's electric system. Even with a 36% spike in the cost of power per MWh to $21.61 in 2014 from $15.89 in 2013 given the reduction of generation related to the fracture, the project's cost of power was still 31% below the comparable Bonneville Power Administration (BPA) preference rate at the time. The production cost has since declined to $16.14 in 2016, giving PRP a 50% cost advantage. Thus, we assume the district would likely easily remarket any available power in the event of a default by a power purchaser, mitigating the lack of step-up provisions. This favorable cost differential of PRP versus market-based power has been stable since about 2008, although the cost of power from PRP was even more competitive prior to 2008 (at just one-third of prevailing market prices in 2006, for example).

Production costs per unit are more favorable in very wet years. The cost of power was $18.97 during a dry calendar 2008, when stream flows were 81% of normal, but fell to near $15 per MWh in 2011 and 2012, when stream flows were about 20% above average. Stream flows can also vary considerably from year to year based on spill requirements and events such as the recent discovery of a fracture at the Wanapum Dam, which forced Grant PUD to lower the water elevation behind the dam. Stream flows were 103% of average in both 2013 and 2014, 96% of average in fiscal 2015, and 98% of average in 2016.

Other regulatory and environmental risks and uncertainties persist, but are dramatically reduced given the 44-year renewal of the district's FERC license for the project in 2008. Nevertheless, the district must comply with state and federal regulations regarding dam operations and protection of endangered fish species. The district projects that production costs will remain competitive for the foreseeable future at less than $19 per MWh through 2022 under average water conditions because of regulatory and capital requirements. Fish habitat mitigation requirements, which include dam spill requirements, result in additional operating costs and loss of revenue.

Capital requirements remain relatively high at the PRP: The five-year capital budget calls for $429 million in capital expenditures from 2017 to 2021 for generator restorations, license implementation, powerhouse and general facility improvements, and miscellaneous projects. Approximately 28% of capital needs are anticipated to be funded by debt, with 72% from equity. The Wanapum development turbine replacement work has been completed with generators to be completed by 2020; eight of 10 have been replaced thus far. In 2014, the Priest Rapids development also began replacing its turbines with more efficient and more fish-friendly advanced turbines. The district projects that the replacement of all Priest Rapids development turbines and generators will be complete by 2026 and anticipates that the useful life of the new equipment will be 50 years. The new generators will also have a nameplate rating of 128.6 megavolt-amperes, an increase of 18%. Management anticipates that the overall PRP capital program will begin to decline in the next five years or so, as the majority of significant projects will be completed by then. Contrary to historical patterns, capital investments will be mostly equity financed given strong operating margins and reserves within the retail electric system. These will be treated as internal loans.

Power purchasers are billed monthly for their respective shares of project operating costs plus 115% of debt service, resulting in consistent DSC of 1.15x. The project's financial performance is generally stable, and margins are slim because the project operates on a cost basis. Debt leverage at the project level is high, in our view, at approximately 82% debt to total capital as of Dec. 31, 2016, but should begin to decrease with most of the five-year CIP funded by equity rather than debt. Combined annual debt service requirements for the project have more than doubled to $95 million in 2016 from $41 million in 2006.

Liquidity has historically been good at the PRP because of the PRP's ability to bill power purchasers monthly for their respective shares of project operating costs plus 115% of debt service. Most operating cash is held at the electric system level. PRP cash and investments totaled $17.8 million (87 days' cash) in 2016. According to the district, unrestricted cash at PRP can fluctuate as a result of the timing of the power sales contracts. For example, in 2014, the ending balance before the true-up at year-end (which reconciles the difference between actual and budgeted results) reflected higher operating costs associated with the fracture compared with both the budget and prior year.

Outlook

The stable outlook reflects our anticipation that long-term contracts through 2052 will continue to provide a stable revenue stream. Strong project economics provide credit stability and override credit risks regarding regulation, environmental mandates, and member credit quality. We anticipate that the project will remain competitive with other generators or resource options in the region despite the high capital investment required to comply with fish species protection requirements and other improvements.

Upside scenario

Given high project debt and capital needs as well as management's projection of rising per unit power costs, even absent the dam fracture's impact, we do not anticipate raising the ratings during the next two years.

Downside scenario

We do not anticipate lowering the ratings over the next two years given the competitive cost of power, but could do so in the unlikely event that costs are no longer competitive on a sustained basis, or if other operating risks arise.

Ratings Detail (As Of November 8, 2017)		
Grant Cnty Pub Util Dist No. 2 WHLELC		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Grant Cnty Pub Util Dist No. 2 WHLELC		
Long Term Rating	AA/Stable	Affirmed
Grant Cnty Pub Util Dist No. 2 WHLELC		
Long Term Rating	AA/Stable	Affirmed

Ratings Detail (As Of November 8, 2017) (cont.)		
Grant Cnty Pub Util Dist #2 rev rfdg bnds (Non-Amt)		
Long Term Rating	AA/Stable	Affirmed
Grant Cnty Pub Util Dist #2 rev rfdg bnds (Direct Payment)		
Long Term Rating	AA/Stable	Affirmed
Grant Cnty Pub Util Dist #2 rev & rev rfdg bnds (Priest Rapids Hydroelectric Proj)		
Long Term Rating	AA/Stable	Affirmed
Grant Cnty Pub Util Dist #2 Priest Rapids Hydroelec Proj rev bnds (Priest Rapids Proj)		
Long Term Rating	AA/Stable	Affirmed
Grant Cnty Pub Util Dist #2 second series (Priest Rapids Hydroelec Dev) ser 1999B		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Grant Cnty Pub Util Dist #2 second series (Wanapum Hydroelec Dev) ser 1998A		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Grant Cnty Pub Util Dist #2 (Priest Rapids Hydroelectric Dev)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Grant Cnty Pub Util Dist #2 (Wanapum Hydroelectric Dev)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Grant Cnty Pub Util Dist #2 2nd ser 2003 (Priest Rapids Hydroelec Dev)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.