FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Grant County PUD, WA at 'AA'; Outlook Stable

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Fitch Ratings - New York - 28 Jul 2021: Fitch Ratings has affirmed the following ratings of the Public Utility District No. 2 of Grant County, WA (the district) at 'AA':

--$233.8 million Electric System senior lien revenue and refunding bonds;

--$761.7 million Priest Rapids Hydroelectric Project revenue and refunding bonds;

--$43.5 million Priest Rapids Development revenue and refunding bonds;

--$76.5 million Wanapum Hydroelectric Development revenue and refunding bonds;

--The district's Issuer Default Rating (IDR):

The Rating Outlook is Stable.

ANALYTICAL CONCLUSION

The affirmation of the 'AA' IDR and revenue bond ratings reflects maintenance of the district's very strong financial profile assessment and robust operating performance throughout the poor hydro conditions in 2019 and pandemic concerns in 2020. Retail electric sales in 2020 declined marginally (-1%), but the decline was more than offset by strong wholesale sales. The district continues to maintain healthy liquidity, very low rates, and reduced leverage in 2020 to 4.2x, which Fitch considers very low leverage relative to its revenue defensibility and operating risk profiles of 'a' and 'aa', respectively. The leverage profile remains adequate for the rating throughout Fitch's base and stress scenarios.

The district benefits from its sizable hydroelectric generating resources which produce very low-cost power sufficient to meet the district's retail needs and provide the opportunity to sell additional energy wholesale. While the district's risk management strategies largely hedge revenue from hydrology-based volume risk, the portion of wholesale energy sold under market-based pricing exposes the district to somewhat elevated revenue volatility on a meaningful portion of revenues (roughly 28% in fiscal 2020), which Fitch believes constrains the district's revenue defensibility at 'a'.

Coronavirus Not a Material Pressure

While Washington State's moratorium on electric customer disconnect is extended through September 2021, the district has not observed a material increase in its uncollected receivables and has seen very limited use of the customer assistance programs. The district did not adjust retail rates in 2020 to address the very minimal decline in the retail revenue in 2020, and no rate increases are planned going forward.

CREDIT PROFILE

The district is a vertically integrated electric utility serving retail customers throughout Grant County, WA, with a retail customer base of approximately 52,200. The district maintains and accounts for two operating systems: the electric distribution system comprising 4,381 miles of transmission and distribution lines, and the generating assets. The Priest Rapids and the Wanapum hydroelectric development generating assets, collectively the Priest Rapids Project (PRP), have a nameplate generating capacity of 2,157MW.

The district historically issued separate debt payable from the electric system and each of the two generating projects net revenues. However, in 2010, the district consolidated the developments into one system called the PRP, and 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, that extends through the life of the FERC license expiring April 1, 2052.

Fitch's rates the district and its debt as a single, integrated system, which includes the debt of the electric distribution system, PRP, and the separately financed hydro development debt issued prior to 2010. PRP debt is secured entirely by unconditional payments from the electric distribution system, reduced by any revenues the PRP collects from other wholesale counterparties, making the electric distribution system the ultimate obligor on the PRP bonds. The electric system makes payments to the PRP as an operating expense, therefore prior to payments on the electric system debt. However, if the PRP were to become inoperable or not provide any energy, the electric system payments to the PRP would become subordinate to the electric system bonds.

KEY RATING DRIVERS

Revenue Defensibility: 'a'

Significant Wholesale Sales Supported by Various Contracts; Very Low Retail Rates

The 'a' assessment factors in the revenue risks and benefits of a growing but concentrated retail load, and significant surplus wholesale energy sales that are exposed to market-based price risk. The rating also considers the district's strategy to hedge these risks including the slice contracts that largely mitigate hydrology-based volume risk. Retail rates are independently set by the district without oversight, very competitive to the state level, and rate affordability is considered very strong.

Operating Risk: 'aa'

Ample, Very Low Cost Hydro Resources

The operating risk assessment reflects the district's valuable hydropower generation resources that provide exceptionally low-cost electric power that consistently produces power below 3.0 cents/KWh. Operating costs are not expected to experience material upward pressure, though the district's capital spending has increased as modernization investments are made and Federal Energy Regulatory Commission (FERC)-required relicensing requirements are determined.

Operating cost flexibility is considered weaker given the concentration in hydro assets, but in Fitch's opinion, the assets provide significant benefits with the risk not rising to a level that constrains the operating risk assessment.

Financial Profile: 'aa'

Very Strong Financial Profile

The district's financial profile is very strong with robust liquidity and coverage of full obligations consistently above 1.5x. Leverage remains very low for the risk profile at 4.2x in FY20. Despite an increased period of capital spending, leverage is expected to remain adequate for the rating at below 6.0x throughout Fitch's forward-looking stress scenarios. The district's cash reserves offset outstanding fixed obligations included in Fitch's leverage ratio.

ASYMMETRIC ADDITIONAL RISK CONSIDERATIONS

There are no asymmetric additional risk considerations affecting this rating.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Consistently higher funding in rates to support capex that produces a materially lower leverage profile could result in upward rating movement.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Inability to effectively manage the various hedging agreements while maintaining a strong revenue defensibility assessment could negatively affect the rating.

--Unexpected sizable increases for capital spending or higher borrowing requirements that reduce financial margins and raise leverage consistently above 6.0x.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

SECURITY

The Electric System bonds are payable from the revenues of the electric system after payment of distribution system operating expenses, inclusive of PRP resource costs.

The Priest Rapids Hydroelectric Project bonds are payable from revenues of the PRP, received under unconditional power sales contracts that extend through 2052, coterminous with the expiration of the FERC (Federal Energy Regulatory Commission) license for the PRP.

REVENUE DEFENSIBILITY

The district's revenue sources are a mix of very stable monopolistic retail electric sales (63% of total revenue in 2020), long-term contracted off-system sales with investment grade counterparties (8%), but also a meaningful portion (25%) derived from more variable wholesale sales exposed to pricing risk from auction sales. Fitch considers this mix of revenues to have meaningful exposure to competitive revenue sources and a degree of concentration in off-system counterparties that are factored into the midrange assessment for revenue source characteristics. A less significant portion (3%) of competitive revenue came from the district's fiber optic services, which the district continues to build out.

Retail System's 63.3% Rights to PRP Hedged to Remove Hydrology-Based Volume Risk

By law, the district is entitled to a 63.3% portion of PRP output to provide retail service in its territory. The district has proactively hedged this portion of PRP output against hydrological variability through various hedging agreements. Under the agreements, the counterparty receives rights to the actual output of the slice the PRP, which will vary with water conditions.

In a low water year, such as occurred in 2019, the hedging arrangements provided more energy to the district's retail load than was produced by that slice of the PRP. Conversely, the agreements provide the upside financial potential associated with above average water conditions to the counterparties. Since 2015 when the agreements began, the hedging along with the growing retail load has acted to stabilize revenues. Counterparties to the agreements (Morgan Stanley [A/Stable] and Avangrid [BBB+/Stable]) have collateral posting requirements if their ratings fall below investment grade.

Remaining 36.7% of PRP Sold Under Various Contracts, Further Hedging Hydro Risk

FERC license requirements stemming from federal legislation adopted in 1954 - Public Law 83-544 - requires the district to sell a "Reasonable Portion" (deemed 30%) of PRP energy output under market-based principles, which the district meets through an annual auction. Selling the PRP output as a slice transfers the hyrdo risk for the upcoming year to the offtaker, and in exchange the district takes on market price risk on this meaningful portion of revenues.

The remaining 6.7% slice of PRP is the minimum slice sold to 17 long-term off-system utilities in the region served under take-or-pay contracts expiring in 2052. This portion of revenues is considered less variable given the energy is sold at cost with the purchaser taking on the hydro volatility for their slice of PRP output. In 2020, sales to these long-term purchasers produced roughly 8% of revenue. Counterparty credit risk is considered factored into Fitch's revenue assessment. The top three purchasers are among the largest investor-owned utilities in the region; PacifiCorp, Portland General Electric, and Puget Sound Energy.

SERVICE AREA CHARACTERISTICS

Grant County encompasses a sizable 2,681 square miles along the Columbia River in central Washington. The county's economy is historically agricultural based. However, a relatively recent influx of tech companies (data centers) and energy-intensive industrial manufacturing firms (chemical and aluminum processors) helped diversify the economy and bring additional jobs into the area. Very low retail power costs create a strong environment for industrial growth.

Favorable demand characteristics, including retail customer growth of 1.9% per year over the prior five years and retail electric load growth near 4% per year, are strengths of the PUD's service area. Fitch expects this to continue in the medium term as the district expects continued strong load growth approximating 24% over the next five years, driven primarily by industrial growth. It is unknown how the ongoing coronavirus pandemic may impact the future growth plans of existing and potential industrial customers, although a number of the new entrants in the region have been data centers. The district continues to actively recruit data centers to its service area given its very low cost of power.

Other service area characteristics in the county, such as economic and demographic characteristics, are not as strong. Median household income and unemployment still reflect the agricultural base of the job market, with midrange income levels at 91% of the national average and weaker unemployment at 186% of the national level in 2019.

RATE FLEXIBILITY

The district is governed by an elected five-member board of commissioners, serving four and six-year staggered terms. The board of commissioners has the exclusive authority to set rates and charges for the district's services. No outside regulatory approval is required.

The exceptionally low cost of power from PRP allows the system to keep retail electric rates similarly exceptionally low, with retail rates among the lowest in the country. The district average retail revenue/KWh as reported by the U.S. Energy Information Administration in 2019 was just 51% of the state average. Rate affordability is very high as measured by average annual residential energy costs in relation to median household income, with an affordability ratio of 2.1%. The district increased retail rates by a modest 2% annually between 2014 and 2018 with no rate increases since or planned going forward.

Asymmetric Rating Factor Consideration - Retail Customer Concentration

The district's retail customer base is concentrated with several large industrial customers. The top ten customers are largely manufacturers and data centers that account for a somewhat elevated 37% of retail revenue, though only 24% of total revenues. Fitch's revenue defensibility assessment is not further constrained by this concentration considering that the district's below-market cost of power provides the option to readily sell excess power into the wholesale markets reducing the potential financial impact from the departure of a large customer. Fitch will monitor the growing industrial concentration as the district promotes its very low cost industrial rates and expects to attract new large customers over the medium-term.

OPERATING RISK

A key credit strength of the district is the PRP's exceptionally low-cost and sizable hydropower production. Fitch calculates a very low operating cost burden for the district at roughly $0.024/KWh, anchoring the very strong 'aa' operating risk assessment. Even in adverse water conditions like in 2019, the district's cost burden increased only minimally to $0.027/KWh. PRP's power cost continues to compare favorably with the region's largest power supplier, Bonneville Power Administration, which reported $0.036/MWh rates for their priority firm power during that year. The district's operating cost burden has very slowly increased over time, but remains among the lowest operating cost burdens in Fitch's retail public power portfolio.

OPERATING COST FLEXIBILITY

Fitch assesses the district's operating cost flexibility as weaker due to the lack of resource diversity outside hydropower. However, the risk of hydro variability is largely offset by the significant benefits of inexpensive power, size of the owned resources, partial hedging of volume risks discussed above, and the district's proficiency in using advantageous hydro years to financially prepare for adverse conditions. In Fitch's opinion, the risk does not rise to a level that currently constrains the 'aa' operating risk assessment.

The PRP largely consists of the Wanapum and the Priest Rapids hydroelectric developments that entered service in 1961 and 1963 and have operated extremely efficiently for decades until the fracture at Wanapum in 2014 (discussed below), which has since been repaired and is back to full operations. The PRP's operational flexibility provides significant additional value beyond the low energy cost of the power produced; value that is monetized both in the pooling and slice contracts the district uses for its rights to 63.3% of the PRP project to meet its retail load, and in the wholesale revenues realized for its remaining access to PRP output. Despite large capital needs for turbine replacement, licensing and powerhouse improvements, Fitch expects the cost of the project's hydropower to remain competitive.

Resource Adequacy

As discussed above, the district's distribution system can use up to 63.3% of the output of the PRP to serve its retail load, which was sufficient to meet its retail customer load through 2020. The district is analyzing various strategies for additional resources, both owned or purchased, to meet increasing load needs. The district in currently engaged in various smaller purchased power contracts used as economically effective to balance load, meet power needs in remote areas of its large geographic service territory, and make renewables investments.

Environmental Considerations

Under the state's renewable portfolio standards (RPS), utilities serving 25,000 customers or more, such as the district, are required to obtain 15% of their load from renewable resources including incremental hydro, wind, solar or renewable energy credits (RECs). The district's existing resources meet compliance of the RPS from investments in PRP incremental generation and ownership shares of the Nine Canyon Wind Project. The district is allowed to take the environmental attributes in an amount sufficient to meet RPS requirements under the distribution system's pooling agreement, with the remaining RECs going to Morgan Stanley.

Washington also passed the Clean Energy Transformation Act in 2019, which requires the state to achieve a power supply free of carbon emissions by 2045. The district is similarly well positioned to meet this mandate given its carbon-free power supply. Management estimates it is in a position to meet all RPS and carbon free requirements through roughly 2025 when retail load growth will increase the district's RPS requirements. These environmental considerations are an important aspect of the district's resource planning as it evaluates additional resources.

CAPITAL PLANNING AND MANAGEMENT

Fitch calculates the average age of plant at 15 years with capital management appearing adequate. Favorably, capex to depreciation totaled nearly twice depreciation over the last five years, related to both its generating assets and its distribution system. The 2021-2025 capital improvement plan (CIP) totals $739 million, with a majority dedicated to investment in the PRP and the remainder going toward the electric distribution system. The CIP will be funded largely from ongoing revenues with an estimated roughly 20% debt funding.

Replacement and investment in the generating assets has been sizable and ongoing. At the Wanapum dam all 10 turbines were replaced by 2013 and all ten generators completed by 2020. The incremental additional capacity gained through such investment is considered renewable under the state's RPS. Importantly the new turbine design satisfies FERC license requirements to provide greater protection of healthy fish passage through the dams. A majority of remaining work includes similar investment at Priest Rapids asset to replace turbines and generator upgrades with estimated costs of $307.4 million, including labor, for 2019-2028.

Additionally, both the Wanapum and Priest Rapids Dams need work to remedy potential exposure to seismic risk. Only the Priest Rapids Dam is being modified, at an estimated cost of just under $50 million. The Wanapum Dam potentially needs remediation and is the subject of an engineering analysis that is in progress. The analysis is scheduled to be complete by early 2022. A fracture discovered in the Wanapum Dam in 2014 was repaired for roughly $62 million, with a portion covered by insurance. The dam was back to full operation in 2015.

FINANCIAL PROFILE

The district's consolidated financial profile is very strong producing operating margins of 30% or better each year since 2015. Recent financial performance remained healthy in spite of both the poor hydro conditions in 2019 and pandemic during 2020, demonstrating the benefit of the district proactively insulating financial performance from volume risk.

The remaining price risk produces some fluctuation in margins and leverage, but leverage continued to trend lower in recent years. Factors in the declining leverage includes the district's increasing retail load and retail rate increases has shifted revenue to the more stable retail base, hedging hydro risk, and limited debt funding needs despite the higher capex environment. Leverage in 2020 declined to a five-year best 4.2x, which is considered very low relative to the revenue defensibility and operating risk assessments. Fitch's net leverage calculation includes cash balances in bond sinking funds and debt service reserve funds. The district has sizable balances in these funds ($221 million in 2020), which Fitch nets against the district's fixed obligations including outstanding debt and pension obligations.

Liquidity is not a concern and considered neutral to the rating given the district's 471 DCOH available in 2020. Unrestricted cash balances of $197 million includes the electric system reserve and contingency fund. Cash levels remain well above the district's liquidity targets of $105 million, or 250 DCOH, for the electric system. Fitch calculated coverage of full obligations (COFO) was consistently over 2.0x through 2019, with a slight decline to a still healthy 1.6x in 2020 when a $50 million private placement maturity (2017-M) came due, which the district paid in cash. Another $50 million private placement (2019-P) payment due in 2021 is expected to be paid in cash and affect COFO similarly.

Fitch Analytical Stress Test (FAST) -- Base and Stress Cases

The FAST model considers the district's base case financial forecast as a starting point, which assumes continued strong growth in retail energy sales, no rate increases, and wholesale revenue from average water condition market prices. The district assumes continued retail sales growth driven by new industrial loads, which Fitch considers reasonable given the new customers added in recent years and advantageous industrial rates the district can offer to attract new customers. The increase in retail load should contribute to stability, and the district will need to add new purchased power to continue to grow retail load.

In both Fitch's base and stress cases, key financial ratios remain supportive of the rating. In the stress case (a two-year decline in both retail and wholesale revenues followed by recovery), leverage increases to close to 6.0x as margins are squeezed, but leverage and liquidity remain supportive of the 'AA' rating. The diversity of revenues helps alleviate a single stress like a retail load decline, where the district would be able to profitably sell excess capacity given the very low cost resources. Limited new debt is expected given the district's plans to continue to revenue fund 75% of capital plans that total roughly $712 million for 2021-2025.

DEBT PROFILE

Fitch considers the debt profile neutral to the rating. The district's consolidated debt outstanding was approximately $1.2 billion at FYE 2020. The majority of debt is outstanding for the PRP system. The consolidated PRP revenue bonds issued since 2010 account for $761 million of total debt. The separately financed (prior to 2010) Wanapum Development and Priest Rapids Development debt specific to each project accounts for a total of roughly $120 million in outstanding debt, though this debt will roll off as it is paid down and no additional debt will be issued on a project-specific basis. The large majority of the district's debt is fixed rate debt with only roughly $50 million in variable rate debt left outstanding.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means 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 by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Grant County Public Utility District No. 2 (WA)	LT IDR	AA Rating Outlook Stable	Affirmed	AA Rating Outlook Stable
• Grant County Public Utility District No. 2 (WA) /Electric System Revenues/1 LT	LT	AA Rating Outlook Stable	Affirmed	AA Rating Outlook Stable
• Grant	LT	AA Rating Outlook Stable	Affirmed	AA Rating

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 23 Feb 2021) (including rating assumption sensitivity)

U.S. Public Power Rating Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Grant County Public Utility District No. 2 (WA)	EU Endorsed, UK Endorsed

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Utilities and Power   US Public Finance   North America   United States

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