



RATING ACTION COMMENTARY

Fitch Rates Grant County PUD, WA's Elec Sys Rev Bonds 'AA'; Outlook Stable

Tue 11 Aug, 2020 - 5:27 PM ET

Fitch Ratings - Austin - 11 Aug 2020: Fitch Ratings has assigned a 'AA' rating to the following bonds issued by the Public Utility District (PUD) No. 2 of Grant County, WA (the district):

--Approximately \$50.0 million Electric System revenue refunding bonds series 2020-R (mandatory put bonds);

--Approximately \$50.0 million Electric System revenue refunding bonds series 2020-S (SIFMA Index bonds).

The bonds are being issued to refinance two existing series of short-term debt, series 2017-M (subordinate lien debt; privately placed) and series 2017-N. The bonds are expected to price via negotiated sale on Aug. 19, 2020. The series 2020-R bonds will be structured as fixed rate debt until the initial mandatory tender, expected to be structured in 2025. The series 2020-S bonds will be variable rate bonds with a mandatory tender, expected to be structured in 2023. Both series will

be secured by a senior lien on electric revenues and neither series will have a debt service reserve fund.

In addition, Fitch affirmed the district's Issuer Default Rating (IDR) and following bond ratings at 'AA':

--\$189.4 million Electric System senior lien revenue and refunding bonds;

--\$787.6 million Priest Rapids Hydroelectric Project revenue and refunding bonds;

--\$48.2 million Priest Rapids Development revenue and refunding bonds;

--\$80.2 million Wanapum Hydroelectric Development revenue and refunding bonds.

The Rating Outlook on all bonds is Stable.

Fitch has withdrawn the 'AA' rating on the Priest Rapids Hydroelectric Project revenue and refunding bonds (taxable) series 2014-Z. The 'AA' rating has been withdrawn because the bonds did not sell.

ANALYTICAL CONCLUSION

The 'AA' IDR and bond ratings reflect Grant County Public Utility District No. 2's very strong financial performance and exceptionally robust liquidity. The district benefits from its sizable hydroelectric generating resources, collectively the PRP, which produce very low-cost power in excess of the district's retail needs. The excess capacity and energy is sold in the wholesale market.

The ratings factor in the risks and benefits of surplus energy sold into the wholesale energy market under short- and medium-term contracts and a concentrated industrial customer base. The rating also considers the district's various strategies to mitigate these risks. As tremendous growth has occurred in the district's retail system (peak load increased to 813 MW in 2019, up 22% from 2013), the financial risk of wholesale sales has decreased, both through the electric system's growing use of the excess capacity for retail load and through the district's hedging strategy that produces strong and consistent financial results.

Coronavirus Considerations

The recent outbreak of the coronavirus and the related government containment measures creates an uncertain environment in the near term. Washington's governor enacted a stay at home, stay healthy order in mid-March and the state is reopening slowly. The district implemented an array of operational and safety precautions at the hydroelectric plants and district facilities. Financial impacts to date at the district have been limited and do not indicate credit impairment. While retail energy sales to date in 2020 are lower than budget, consolidated revenue performance is less impacted since reductions to retail energy sales have been partially mitigated through higher wholesale energy sales. The district has revised its future load forecast downward as a result of lower retail demand and a slower pace of industrial load growth.

The district enacted a moratorium on residential disconnections for nonpayment in March 2020. Residential customers account for only approximately 21% of electric system revenues and the district has not observed any increase in its uncollected receivables. The district is considering the implementation of customer assistance programs for certain residential customers impacted by the effects of the coronavirus but the district has robust liquidity reserves in place for contingencies. The district did not raise retail rates in 2020 and no increases are planned in 2021.

While credit impacts have been limited to date, material changes in revenue and cost profiles are occurring across the public power sector and may worsen in the coming months as economic activity suffers and government restrictions are potentially maintained or expanded. Fitch's ratings are forward looking, and Fitch will monitor developments related to the severity and duration of the virus outbreak, and incorporate revised expectations for future performance and assessment of key rating drivers.

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. 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, PRP debt and the remaining amount of debt issued prior to 2010 and secured individually by the hydro developments as a single, integrated system. 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.

Revenue Defensibility: 'a'

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

A majority of the district's ample hydroelectric generation capacity is used to meet its domestic retail energy needs, with the remainder being sold under a mix of take-or-pay contracted sales at cost, market priced auctions, and pooling and slice agreements. The district manages wholesale contracts and hedging agreements to insulate the district from price and hydrological variability, but the district's margins remain exposed to a level of wholesale sales risk that, combined with the service area characteristics, constrains Fitch's assessment of revenue defensibility to 'a'. Retail rates are very competitive and rate affordability is considered high.

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, calculated at approximately 3.0 cents/kWh in 2019. Operating costs are not expected to experience upward pressure. The district's capital plans continue to increase as modernization investments are made and the full amount of future capex due to Federal Energy Regulatory Commission (FERC)-required relicensing is determined.

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 2.0x. Capital spending and borrowing increased in recent years, and outstanding debt is \$1.2 billion. Leverage nonetheless remains low for the risk profile at around 4.0x and is expected to remain below 6.0x through Fitch's 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:

--While considered unlikely in the current recessionary environment, 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:

--The district's ability to effectively manage its operations, including the various hedging agreements, will be key to maintaining a strong revenue defensibility assessment.

--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 Development 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

A majority of the district's total operating revenue (65% in 2019) is generated from domestic retail sales that Fitch considers exhibiting monopolistic demand characteristics, but a meaningful portion (25% in 2019) is from competitive revenue sources, both wholesale energy sales (22%) and fiber optic network sales (3%). Grant continues to gradually build out its fiber optic network availability across the service area at a measured pace, although recent working from home trends have increased the take rate (the number of customers opting for service from the district where the infrastructure is available) to 60%. The remainder of district revenues is sales under long-term contracts at cost, or derived from transmission and other miscellaneous sources.

The Distribution System's Physical Rights to 63.3% of PRP Hedged to Remove Hydrology Risk

The district is entitled to a 63.3% portion of PRP output to provide retail service to the electric distribution system. The district has proactively hedged their share of the output against hydrological variability through two short-term hedging agreements. A five-year energy pooling agreement with Shell Energy North America L.P. (SENA) provides SENA with 53.3% of the distribution system's entitlement to the output from PRP. In exchange, SENA provides firm power sufficient to satisfy 100% of the district's unmet retail load forecast through the life of the contract expiring September 2020, regardless of the project's actual energy output. In a low water year, such as occurred in 2019, SENA provided more energy to the district's retail load than was produced by the 53.3% share of the PRP. Conversely, the agreement provides the upside financial potential associated with above average water conditions to SENA, which has reduced the district's overall wholesale revenues from levels exhibited prior to 2015 when the contract began. A second hedging agreement for the remaining 10% slice of the district's PRP output is hedged under an agreement with Avangrid Renewables, LLC through December 2021.

The hedging strategy effectively limits the district's hydrological risk and protects revenue stability although the district does have increased counterparty risk. The

district and SENA both have collateral posting requirements if their ratings fall below investment grade, and the collateral posting is based on 12-month forward-looking rolling mark-to-market, not balance of contract. The district has negotiated a similar pooling agreement for 33.3% of the PRP to take effect once the SENA contract expires for another five years period. The remaining 20% is expected to be replaced with agreements similar to that with Avangrid as part of a proposal process initiated in April. Fitch expects the district to continue pursuing its hedging strategy using pooling agreements and slice sales similar to the SENA and Avangrid agreements to mitigate water volume and market price risk on a rolling basis.

Rights to Remaining 36.7% of PRP sold through Take-or-Pay Power Sales Contracts

The competitive portion of the district's consolidated revenues is generated by the district's excess generating resources relative to its domestic retail energy needs and the FERC license requirements to sell 6.7% of the PRP at cost and 30% at market-based prices. The FERC license requirement stems from federal legislation adopted in 1954 - Public Law 83-544 - requiring the district to sell a FERC-established 'reasonable portion' (30%) of the region's PRP energy output under market rates. An annual auction is held to sell at least 3% of PRP output on a slice basis that establishes the price for the full 30% reasonable portion.

This 36.7% of PRP output is sold to 17 power purchasers under take-or-pay contracts expiring in 2052 that require the purchasers to pay their proportionate share of all costs of the PRP, regardless of the revenues 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. The 6.7% portion is a physical share of the asset at cost.

The other 30% is priced at market rates but importantly, as the district's retail load grows, retail load can be served from this 30% reasonable portion, or specifically, the financial benefits from these market sales can be used by the district to purchase energy for retail needs. This ability allows the district to access PRP energy at cost-based rates from this 30% portion. If district load declines, this share of the 30% being used by the district is purchased by the power purchasers at cost. The district's significant growth in new industrial customers has been served from this share given the very low cost of the energy. The district's share of the overall PRP output increased to 82.6% in 2019, up from 61% in 2013. At the pace the district's retail load is growing, management expects the district may consume the financial

benefits related to the full 'reasonable portion' within the next five years, although 3% would still be required to be sold at auction to establish the value of the financial benefit.

Mixed 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.

Very Low Retail Rates

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 2018 was well below the state average at 51% of the 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. Rates were not increased in 2019 and 2020 and no increases are anticipated over the next four years.

Asymmetric Rating Factor Consideration - Customer Concentration

The district's retail sales are concentrated with several large industrial customers. The 10 largest retail customers accounted for 38% of retail revenue in 2019 and the two largest accounted for 22% of electric system revenues. However, these revenues are a smaller portion of the district's overall combined operating revenues, including wholesale. The largest customers are somewhat diversified in agriculture and manufacturing, but also include several large data centers. Fitch does not constrain the revenue defensibility assessment as a result of this concentration, largely due to the district's below-market cost of power, which provides the option to readily sell excess power into the wholesale markets and reduces the potential financial impact from the departure of a large customer. Industrial rates are below market pricing.

OPERATING RISK

One of the district's key credit strengths is the PRP's exceptionally low-cost hydropower production. Fitch calculates a very low operating cost burden for the district at or below 3 cents/kWh over the past five years, anchoring the 'aa' operating risk assessment. The district calculated the PRP power production at a combined average cost of \$18.6/MWh in 2018 and \$22.80/MWh in 2019. The higher cost in 2019 reflected the below average water years; costs remain relatively consistent from year to year but lower water results in lower energy production and a higher per MWh cost. Even in low water conditions, PRP's power cost continues to compare favorably with the region's largest power supplier, Bonneville Power

Administration (BPA), which provided wholesale power to preference customers an average cost of \$35.6/MWh in 2019.

Operating Cost Flexibility

Fitch assesses the district's operating cost flexibility as weaker due to the lack of resource diversity outside hydropower and susceptibility to variable water conditions. However, this risk is largely offset by the benefits of inexpensive power and the more than ample resources. The weaker assessment does not constrain the operating risk assessment from 'aa'. The distribution system is entitled to physical rights to 63.3% of the PRP's physical output and financial rights up to an additional 30% of the PRP's output available for purchase by the electric distribution system to meet its estimated load requirements, which is sufficient to meet its current and anticipated retail customer load through 2028.

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 physical share of the project and in the auction prices realized for the 30% share. Despite large capital needs for turbine replacement, licensing and powerhouse improvements, Fitch expects the cost of the project's hydropower to remain competitive.

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 by 2020. Eligible resources include incremental hydro, 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 district is allowed to take the environmental attributes in an amount sufficient to meet RPS requirements, with the remaining RECs going to SENA. The replacement contract is expected to have similar terms. The district's RPS requirements increase as its retail load grows, and management estimates a minimal level of qualifying REC purchases may be required beginning in the mid-2020s.

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 well positioned given its carbon-free power supply. Once the PRP is no longer sufficient to meet the full retail load, the district anticipates using solar or other non-carbon resources.

Capital Planning and Management

Fitch calculates the average age of plant at 15 years and capital management appears 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 PRP investments and the remainder going toward the electric distribution system. The CIP will be funded at an estimated 25% from additional debt, with the remaining amounts funded from ongoing revenues.

Generating system replacement and investment has been sizable and ongoing. Work completed to date includes the full replacement of all turbines and generators at Wanapum. All 10 turbines were replaced by 2013 and in 2020, the district completed the process of replacing and upgrading all ten generators. The incremental additional capacity gained through such investment is considered renewable under Washington's RPS. Importantly the new turbine design satisfies FERC license requirements to provide greater protection of healthy fish passage through the dams. A similar investment at Priest Rapids Dam that includes replacing the remaining turbines and generator upgrades is ongoing, with estimated costs of \$307.4 million, including labor, for 2019-2028. The electric distribution system investments include substation work and the completion of its advanced metering rollout in 2019.

Seismic and Other Remediation

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. Fitch calculated coverage of full obligations (COFO) was consistently over 2x over the past five years, including 2019, which included below average water conditions to the region, which is a stress scenario for many electric utilities in the northwest. As noted previously, the district has insulated its financial performance from hydrology risk through the terms of the power supply contracts for the reasonable portion of the PRP project and the slice and pooling arrangements in place for Grant's physical share. The operating margin in 2019 continued to be strong at over 30% in 2019, as it had been the four years prior.

Liquidity levels are robust with unrestricted cash balances above \$245 million in 2018 and 2019, which amounts to over 600 days cash on hand, given the district's relatively low operating expenses. Fitch's calculation of unrestricted cash balances includes the electric system reserve and contingency fund, which totaled \$128.8 million at the end of 2019. Cash levels are well above the district's targets of \$105 million and 250 days cash on hand for the electric system. Approximately \$28 million in reserves were used in January 2020 to defease debt.

The district's leverage profile is considered very low, given its revenue defensibility and operating risk assessments and has remained relatively consistent over the past four years between 4.4x and 5.8x. 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, \$218 million at the end of 2019, which helps offset fixed obligations including outstanding debt and pension obligations.

Fitch Analytical Stress Test (FAST)

Fitch's analysis considered the district's financial forecast as a starting point for the FAST. The district's forecast assumes continued strong growth in retail energy sales. Although following Q12020 results, the load forecast has been revised downward from prior levels to include a slight decline in retail sales in 2020 and 5% growth in the subsequent years. The forecast assumes no retail rate increases and consolidated capex of \$739 million over the next five years, funded 25% from debt

proceeds. The forecast includes wholesale revenues in line with prior years since, as noted previously, the district has reduced its financial exposure to market price and hydrology fluctuations.

In Fitch's standard base case FAST, key financial ratios remain supportive of the rating. Leverage remains consistently around 4.0x and COFO and liquidity closely track 2019 levels, with a potential slight decline in liquidity but continued at robust levels. Fitch's stress case assumes 7.0% decline in retail sales in Year 1 and further 3.9% decrease in Year 2 before resumed growth and recovery in the remaining three years. In this stress scenario, leverage remains solidly below 6.0x and COFO and liquidity remain supportive of the rating.

Fitch also considered a coronavirus-sensitized downside case in our analysis that modeled a 9% decline in retail sales in Year 1 with a recovery occurring over the following four years. While this demand decline is well above what the district is experiencing, the downside case is designed to evaluate the potential credit impact of major setbacks in containing the virus and the possibility of the extension of re-imposition of societal lockdowns. Key ratios in this downside scenario appear similar to the stress case results noted above and all key ratios remain supportive of the rating.

Debt Profile

The district has total consolidated debt outstanding of approximately \$1.2 billion. The majority of debt is outstanding for the PRP system. PRP revenue bonds issued in 2010 and later account for \$787.6 million of total debt and Wanapum Development and Priest Rapids Development debt specific to each project, issued prior to 2010, account for a total of \$128.4 million in remaining debt. No additional debt will be issued on a project-specific basis. All debt related to the generation projects is paid as an operating expense of the electric system, or from proceeds under the power supply contracts with 17 power purchasers. The purchasers are obligated to pay the full cost of project, including 115% of the debt service each year.

Remaining debt consists of senior and subordinate debt secured by electric system revenues, including the new series 2020-R and series 2020-S bonds that will refunding outstanding debt in like amounts. Following the refunding, the district will

only have \$50 million in subordinate lien electric system debt. The majority of the district's consolidated debt is fixed rate debt, except for approximately \$150 million.

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

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING
Grant County Public Utility District No. 2 (WA)	

ENTITY/DEBT RATING[VIEW ADDITIONAL RATING DETAILS](#)**FITCH RATINGS ANALYSTS****Kathy Masterson**

Senior Director

Primary Rating Analyst

+1 512 215 3730

Fitch Ratings, Inc. 111 Congress Avenue Suite 2010 Austin 78701

Parker Montgomery

Associate Director

Secondary Rating Analyst

+1 212 908 0356

Joanne Ferrigan

Senior Director

Committee Chairperson

+1 212 908 0723

MEDIA CONTACTS**Sandro Scenga**

New York

+1 212 908 0278

sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com**APPLICABLE CRITERIA**[Public Sector, Revenue-Supported Entities Rating Criteria \(pub. 27 Mar 2020\)
\(including rating assumption sensitivity\)](#)[U.S. Public Power Rating Criteria \(pub. 30 Mar 2020\) \(including rating assumption
sensitivity\)](#)**APPLICABLE MODELS**

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

FAST Public Power - Fitch Analytical Stress Test Model, v1.1.3 (1)

ADDITIONAL DISCLOSURES

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ENDORSEMENT STATUS

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

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