S&P Global Ratings

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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 + 1 (303) 721 4709; doug.snider@spglobal.com

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US$50.3 mil elec sys rev rfdg bnds (Sifma Index) ser 2020-S due 01/01/2044		
Long Term Rating	AA+/Stable	New
US$41.025 mil elec sys rev rfdg bnds (Mandatory Put Bnds) ser 2020-R due 01/01/2044		
Long Term Rating	AA+/Stable	New
Grant Cnty Pub Util Dist #2 elec sys revenue and rfdg bnds		
Long Term Rating	AA+/Stable	Affirmed

Rating Action

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 proposed $41.0 million series 2020-R (mandatory put bonds) and $50.3 million series 2020-S (SIFMA index) electric system revenue refunding bonds. At the same time, we affirmed our 'AA+' long-term rating on the district's previously issued electric system revenue bonds. The outlook is stable.

The bonds are secured by net revenue of the district's electric system, and proceeds will refund the district's series 2017-M and 2017-N bonds.

The series 2020-R bonds will be issued in a fixed-term rate until the mandatory tender date of Dec. 1, 2025, at which point they are subject to mandatory tender for purchase and conversion to a new term rate or to a daily, weekly or index floating rate. No liquidity facility is in place as security for the purchase price of the bonds; in the event that funds are insufficient to meet the mandatory tender, the bonds will bear interest at a stepped interest rate (determined at final pricing) until successfully remarketed. A failure to pay the purchase price on the mandatory tender date is not an event of default.

The 2020-S bonds will bear interest at the adjusted SIFMA rate not to exceed a maximum rate of 12% for the initial index floating rate period ending on Dec. 1, 2023, subject to prior optional redemption or conversion to a new index floating rate or to another interest rate mode, as described herein. The adjusted SIFMA rate is the SIFMA index plus the index floating-rate spread. At the end of the initial index floating-rate period, the 2020-S bonds are subject to mandatory purchase, and the bonds may be redeemed or converted to a new index floating rate or another interest rate mode. As with the series 2020-R bonds, the series 2020-S bonds have no liquidity facility in place as security of the purchase price of the bonds; in the event that funds are insufficient to meet the mandatory tender, the bonds will bear interest at a stepped interest rate (determined at final pricing) until successfully remarketed. A failure to pay the purchase price on the mandatory tender date is not an event of default.

As of Dec. 31, 2019, the district had $232 million in electric system debt and $1.3 billion in project debt at its Priest Rapids Project (PRP), including subordinate intersystem loans from the electric system; the district's approximate share of PRP debt is about $1.1 billion. The PRP consists of the Wanapum and Priest Rapids developments, and PRP off-takers, including the district itself, under take-or-pay, cost-of-service contracts, service a large portion of project debt. In addition to direct electric system debt and PRP debt, the district is responsible for approximately $4.6 million of off-balance-sheet debt attributable to its share of Nine Canyon Wind Phase I project debt.

A rate covenant requires net revenue sufficient to provide 1.25x annual debt service coverage, and the district may issue additional bonds if net revenue for any 12 consecutive months of the previous 24 months provide 1.25x maximum annual debt service coverage. 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.

Separately, with regard to the PRP bonds outstanding, the electric system 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, in the event that required payments are not otherwise made.

Credit overview

Grant PUD, a vertically integrated public utility located in central Washington, serves about 41,000 electric customers and about 51,600 active meters. It operates its electric system independently of its two hydroelectric developments, the Priest Rapids development and the Wanapum development, together known as PRP.

Thus far, the COVID-19 pandemic's overall effect on the district has been relatively minor and we believe the district's key financial metrics will remain near historically robust levels for the near future. The district initiated its already-established Incident Command System in formal response to the pandemic on Mar. 4; the system is designed to guide the district through an emergency by adjusting operations quickly while managing risk, and the district has implemented safe working practices as well as continuity of operations plans. The district also has an employee sequestration plan that it can implement, if needed.

On March 23, the governor of Washington issued Proclamation 20-23, which prohibits electric utilities from disconnecting or refusing to reconnect residential customers who may be affected by COVID-19 and cannot pay their utility bills. It also prohibits utilities from charging late or reconnection fees, and encourages utilities to set up flexible payment plans for delinquent accounts. Despite this, the district reports no material change in aged receivables, and estimated unbillable late fees for 2020 of $620,000 are just 0.2% of total forecast revenue. According to management, there has been no indication as to when Proclamation 20-23 might be lifted. While energy sales in March 2020 were down 14% on the year, temperatures were milder; energy sales in April and May 2020 were up 2% and 9% year over year, respectively, with June energy sales down 8%. Overall through June, energy sales in 2020 were down just 2% from 2019 levels. The district reports no significant business closures or large-scale layoffs in its service territory, and the increase in residential usage has helped offset declines in commercial and industrial loads. Nonetheless, in our view, the ongoing pandemic and related recessionary pressures could weigh more heavily on the rating as time passes, especially to the extent to which the crisis deepens or extends. For more information, see our report "COVID-19's Potential Effects In U.S. Public Finance Vary By Sector," published March 5, 2020, on RatingsDirect.

The rating reflects our opinion of the district's very strong enterprise risk profile mainly based on our view of its exceptional market position and very strong operational management assessment, and our view of the district's extremely strong financial risk profile given the district's track record of maintaining very robust fixed-charge coverage (FCC) and liquidity.

The very strong enterprise risk profile further reflects our view of the district's:

- Very strong operational and management assessment, highlighted by strong, non-carbon-emitting operational assets, very strong environmental compliance, extremely strong management, policies, and planning, and very strong rate-setting practices;
- Adequate service area economic fundamentals, with a growing customer base that has generated very strong demand growth in recent years, especially the industrial sector, but with unemployment rates exceeding the national rate; and
- Extremely strong market position as a result of rates that are among the lowest in the nation at slightly more than 4 cents per kilowatt-hour according to our calculations.

The financial risk profile reflects our view of the district's:

- Extremely strong coverage metrics, with FCC of 2.1x in audited fiscal 2019;
- Extremely strong liquidity and reserve position, with $203 million in available reserves, or 414 days' cash, as of fiscal 2019, projected at no less than $150 million, or 263 days' cash, through fiscal 2024; and
- Very strong debt and liabilities profile, suggested by the district's debt to capitalization of just 20% as of fiscal 2019 but a higher 53% when including debt and equity related to the district's share of the PRP.

The stable outlook reflects our assessment of the district's extremely low-cost power supply resulting in market prices that are substantially below the prevailing market. The outlook also reflects our view of the absence of significant additional debt needs, the district's exceptionally strong financial position, and our expectation that management will continue to implement budget adjustments or enter into hedging agreements that promote revenue predictability and stability.

Environmental, social, and governance factors

The district sources almost 100% of its power through non-carbon-emitting hydroelectric, nuclear, and wind resources, significantly shielding the district from the uncertainty, costs, and operational challenges of legislative and regulatory initiatives to reduce greenhouse gas emissions. Management has taken several measures to minimize the impact of the ongoing COVID-19 pandemic on staff and operations. Nevertheless, we believe the electric system faces social risk related to COVID-19, as efforts to protect the health and safety of the community may affect the system's financial metrics. We believe the district's exceptional coverage and liquidity metrics combined with its significant rate competitiveness offset these risks. We view the utility's governance factors as credit supportive, as they include full rate-setting autonomy as well as strong policies, forecasting, and planning practices.

Stable Outlook

Downside scenario

We don't expect to lower the rating during our two-year outlook period given the district's significant rate flexibility resulting from its extremely low-cost power supply, and our view that the utility has considerable cushion for erosion in FCC and liquidity while sustaining extremely strong metrics.

Upside scenario

We don't expect to raise the rating over the next two years given Grant's moderate concentration in leading customers and industrial sales, relatively high unemployment, asset concentration, and exposure to variable hydrology.

Credit Opinion

Enterprise Risk Profile: Very Strong

Operational Management Assessment: Very strong

In our opinion, the district's operational management is very strong, highlighted by its strong operational assets, extremely strong management, policies, and planning, very strong environmental compliance, and very strong rate-setting practices.

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. Each PRP development has 10 turbines, giving it shaft diversity, but we believe that reliance on hydrology for a significant portion of supply is a moderate credit risk, even if the supply is partly hedged. Given that the electric system is the largest PRP off-taker at 82.6% of project output (physical and financial) as of 2019, it is also indirectly funding a large portion of the PRP's capital needs, which remain high as a result of turbine-related projects.

We view the district's environmental regulation and compliance assessment as very strong. The district does not face looming greenhouse gas compliance costs that owners of conventional power plants do. Also, it is in compliance with the state's renewable energy mandate known as I-937. The district expects to meet all future requirements, utilizing existing incremental hydro and Nine Canyon Wind Project output. Subject to the final official rule-making process, the district also anticipates being compliant through 2045 under the Washington Clean Energy Act, which requires 100% clean (carbon-free) energy by 2045. 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.

We view the district's management, policies, and planning as extremely strong. Management is especially proactive when it comes to management of generation, wholesale revenue volatility, and counterparty credit risk. This is key to mitigating price, stream flow, and operational risk. District financial policies include an internal goal of no less than 1.8x debt service coverage on a consolidated basis, $100 million in the reserve and contingency fund, and $5 million in the electric revenue fund, which the district has achieved. As of fiscal 2019, the fund held $130 million in cash. In our view, strong financial reserves are essential for stabilizing the district's financial position during 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 expanded slice strategy (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 district's rate-setting practices are very strong, in our view, reflecting our view of its demonstrated ability and willingness to adjust rates, with annual base rate increases in fiscal years 2010 to 2018 of 2% to 8%. No rate increase was made in fiscal 2019, and none is anticipated in fiscal 2020. The district's multilayered comprehensive approach to power supply management offsets the absence of a power cost adjustment mechanism. The district's elected five-member commission establishes rates, with full rate autonomy. Management plans additional base rate increases of 0.1% annually in fiscal years 2021 to 2024 effective April 1 of each year. These rate increases are designed 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 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.

Economic fundamentals: Adequate

We view the district's economic fundamentals as adequate, characterized by an economic base that continues to produce strong load growth, especially from commercial and industrial customers, but with relatively high unemployment and median household effective buying income that is below the national average. The district's extremely low-cost power--whereby if the district experienced customer loss and were required to sell the power on the market, it would likely do so at a profit--also supports our economic fundamentals assessment.

Grant PUD's retail load growth was robust at about 20% on a gross basis during fiscal years 2014 to 2019. While the district anticipates additional 24% load growth over the next five years, mainly as a result of the industrial sector, we believe the ongoing COVID-19 pandemic could limit load growth, especially during 2020 and 2021. 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 average-to-below-average, with 2019 median household effective buying income 91% of the national average and unemployment at 7.2% versus 3.6% for the U.S. We believe the ongoing COVID-19 pandemic's recessionary pressures introduce economic uncertainty for the district. See the report "U.S. Faces A Longer And Slower Climb From The Bottom," published June 25, 2020.

Residential customers constituted just 22% of total retail operating revenue, versus industrial customers at 48%, irrigation customers at 12%, and commercial customers at 17%. Off-system sales accounted for 16% of all operating revenue in 2019, the lowest level in at least 10 years, partly as a result of below-average (84% of normal) runoff, but also because of the district's expanded slice strategy. The leading 10 retail customers, which accounted for 38% of retail revenue in 2019, remain primarily in the materials/chemicals and food processing industries, and in the rapidly expanding technology sector (three data centers). Retail loads grew 4% in 2019 following 7% growth in both 2017 and 2018; load growth has averaged a moderately high 6% annually since 2009. Grant PUD will continue to meet additional load growth with an increased portion of output from PRP (physical and financial up to 93.3%), incremental hydroelectric resources and efficiency upgrades, conservation, and other resources to be determined. The district's share of PRP generation grew to almost 83% as of fiscal 2019 from 60% in 2010. The district does not anticipate needing to purchase additional resources for the next few years; Grant will likely exhaust its owned hydroelectric resources by 2025.

Market position: Extremely strong

We consider the district's market position extremely strong, reflecting weighted average revenue per kilowatt-hour that is among the lowest in the country at just 4.2 cents, or a very economical 67% of the state average (weighted; according to Energy Information Administration data as of 2018). This is largely a result of superior project economics from its baseload units, the Priest Rapids and Wanapum Hydroelectric Developments. The district's average power cost was just $21 per megawatt-hour in 2019, well below the Bonneville preference rate of $36 per megawatt-hour and prevailing market prices and in line with previous years. The very low industrial rate that the district offers reduces competitive pressure from investor-owned utilities, 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 very low during the next five years with planned rate increases of no more than 0.1% annually.

Financial Risk Profile: Extremely Strong

Coverage metrics: Extremely strong

The district has demonstrated robust financial performance for several years running, including in fiscal 2019. Actual FCC was 2.1x in fiscal 2019 and has averaged 2.2x over the past five years. FCC treats off-balance-sheet debt service (e.g., the system's share of the PRP and Nine Canyon Wind projects) as debt service rather than as operating expenses. In our view, the district's forecast assumptions are reasonable, especially given the district's recent track record. Forecast FCC through 2024 is no less than 2.2x and assumes minimal rate increases and minimal additional debt. We view the district's projections as reasonable, including assumptions on wholesale slice sales activity, customer growth, expense growth, and market prices.

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 decrease. Market prices also heavily influence wholesale sales, being generally lower in above-average water years, but volatility in hydrological conditions is also a major factor. The district's wholesale revenue was $41 million, or 16% of operating revenue, in 2019, and is forecast to represent about 25% of operating revenue over the next five years. As has been the case in 2018 and 2019, the district's wholesale sales will be remain relatively lower than historical levels but more predictable, largely removing the upside and downside potential from year to year that can result from volatile hydrology. This strategy is known as the district's expanded slice strategy.

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 contracts 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 budget may use a "critical water" level of production assumption at its hydroelectric projects, to the extent a slice program is not in place. The district entered into a contract to sell a 10.0% portion, or slice, of its 63.3% physical share of PRP power to Avangrid Renewables Inc. in December 2018. The contract runs from Jan. 1, 2019 through Dec. 31, 2021. Avangrid receives 10% of actual PRP output, and the district, in return, enters into positional, firm fixed-price energy buybacks, 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 Shell Energy of North America (SENA) whereby it provided 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. Under the contract, SENA receives the right to the actual PRP variable generation, and in return the district receives firm power (from a mix of resources) 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 enables the district (and SENA) to satisfy variable peak load demands, diversify supply, and enhance reliability. Once the SENA contract expires this fall, the district anticipates replacing it with two smaller, similar contracts with slices of 33.3% for five-year terms and 20% for three-year terms.

In our view, these agreements add stability and predictability to the district's wholesale revenue given that the purchasers assume hydro variability risk, but the purchasers also benefit from upside. At the same time, the district avoids downside risk to wholesale sales revenue during low runoff years but cannot take advantage of above-average runoff. 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.

Liquidity and reserves: Extremely strong

We consider the district's liquidity and reserves extremely strong, with $203 million in available reserves, or 414 days' cash, as of fiscal 2019 (cash balances plus balances in the district's renewal and contingency fund). The district's internal policy requires it to maintain no less than 250 days' cash of operating expenses. Based on the district's forecast, it anticipates generating significant cash flow that will significantly bolster liquidity, a portion of which it intends to use for significant capital projects. The district projects total liquidity sources to remain at no less than about $150 million, or no less than about nine months' worth of operating expenses, through 2024. In January 2019, the district used excess operating and bond reserves available to pay down $91 million in debt; nonetheless, liquidity remains at levels we believe are commensurate with the rating. 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. In our view, strong financial reserves are essential for stabilizing the district's financial position during 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 expanded slice strategy.

Debt and liabilities: Very strong

In our opinion, the district's debt and liabilities profile is very strong, suggested by debt to capitalization of 20%, which we consider very low, as of fiscal 2019. Inclusive of the district's share of PRP debt and equity, we calculate an adjusted debt-to-capitalization ratio of about 53% for fiscal 2019. Given minimal additional debt issuances planned over the next several years for the electric system, we anticipate that debt balances will continue to decline. For fiscal years 2020 to 2024, the electric system has budgeted $321 million in capital spending, largely related to transmission, distribution, and fiber/broadband investments. Separately, capital spending at PRP over the next five years is budgeted at $417 million (funded mostly by the district), consisting largely of turbine and generator rehabilitation and other powerhouse projects.

Related Research

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020