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# Mason County Public Utility District No. 3, Washington; Retail Electric


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# Mason County Public Utility District No. 3, Washington; Retail Electric

| Credit Profile | | |
|---|---|---|
| Mason Cnty Pub Util Dist #3 elec rev & rfdg bnds | | |
| *Long Term Rating* | A+/Stable | Affirmed |
| **Mason Cnty Pub Util Dist #3 elec rev bnds ser 2001 dtd 03/01/2001 due 12/01/2005-2021** | | |
| *Unenhanced Rating* | A+(SPUR)/Stable | Affirmed |

Many issues are enhanced by bond insurance.

## Rationale

S&P Global Ratings affirmed its 'A+' long-term rating and underlying rating (SPUR) on Mason County Public Utility District (PUD) No. 3, Wash.'s electric revenue bonds. The outlook is stable.

The rating reflects the application of the U.S. Municipal Retail Electric And Gas Utilities: Methodology And Assumptions, published Sept. 27, 2018 on RatingsDirect, and our opinion the PUD's strong enterprise risk profile and very strong financial risk profile.

The enterprise risk profile reflects our view of the PUD's:

- Very strong operational management assessment. We view favorably the district's operational assets, environmental regulation and compliance position, and proactive rate-setting practices supported by a power cost-adjustment mechanism tempered by potential volatility in hydrological conditions;
- Adequate service area economic fundamentals, reflecting a stable, predominantly residential customer base limited by a shallow economic base and high unemployment rates;
- Strong market position, due to average revenue per kilowatt hour (kWh) slightly above the state average; and
- Extremely strong industry risk relative to other industries and sectors.

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

- Sound financial metrics, evidenced by fixed-cost coverage (FCC) levels that have averaged 1.62x over the past three years, coupled with projections that indicate at least very strong coverage will be maintained despite expected rate increases from the Bonneville Power Administration (BPA);
- Very strong liquidity and reserves, reflecting available reserves measuring 131 days' of operating expenses in 2017; and
- Strong debt and liabilities capacity, indicated by a debt-to-capitalization ratio of 42% in 2017, which we expect will continue to improve as debt amortizes more rapidly than it is added.

A first-lien pledge of the electric system's net revenue secures the bonds.

Headquartered in Shelton and about 70 miles southwest of Seattle, the PUD provides service to approximately 33,512 customers within 567 square miles. It serves as a bedroom community to Olympia, 20 miles to the south, and to a nearby Naval base and shipyard to the north. The district's service territory extends into the nearby counties of Kitsap, Grays Harbor, and Pierce. The county's employment base, historically dominated by timber production, however, the aquaculture industry, particularly shellfish, has been expanding, helping diversify the economy somewhat.

## Outlook

The stable outlook reflects our expectation that the PUD will maintain FCC and cash reserves at or near current levels, consistent with the rating. The outlook also reflects our view of the utility's stable customer base coupled with weak economic indicators. We believe rating stability will rely on the extent to which the PUD is able to manage its power costs and fulfill increasing renewable-energy requirements over time, while consistently meeting or exceeding projections of FCC and liquidity.

### Upside scenario

Given the rural nature of the customer base and limited nature of the economy, we do not anticipate raising the rating. Although not anticipated, a positive rating action could be taken if there is a material improvement in the PUD's market position.

### Downside scenario

While also unexpected, should the PUD fail to make timely rate adjustments in the face of rising power cost requirements, or should financial performance weaken materially because of a failure to respond to the effects of poor hydrological conditions, we could lower the rating.

## Enterprise Risk

### Operational management assessment: Very strong

We believe the PUD is subject to limited operational risk as a distribution-only system. The utility purchases almost 96% of their power from the Bonneville Power Administration (BPA) through a long-term purchase power contract that extends from October 2011 through September 2028. The remainder of its supply comes from its share of the Nine Canyon and White Creek Wind Projects, a 10% share of Packwood Lake generation, and a 5.2 MW owned peaking generating station. We view supply as diverse given that the BPA system is very large, and comprises electricity generated at 31 federal hydroelectric projects, Energy Northwest's nonfederal nuclear Columbia Generating Station, and several nonfederal small power plants. Moreover, BPA's non-carbon emitting and relatively low-cost portfolio warrants a positive consideration for quality of assets.

We believe the district is adequately positioned to meet environmental regulations and compliance requirements, notably Initiative-937, which requires large utilities in Washington to obtain 15% of their electricity from eligible renewable resources by 2020. Although only 8.11% of electricity sold in 2017 was from renewable sources, we understand the district has secured renewable energy certificates to meet the 2020 milestone with modest impact to its power supply costs, especially as the utility experiences generally flat load growth. Therefore, we anticipate the PUD's credit quality will not be unduly exposed to future regulatory measures.

We also view positively the district's policies and planning practices, which include comprehensive long-term financial and capital planning processes. In our opinion, rate-setting practices are strong. The PUD has full rate-setting autonomy, and in November 2017 authorized an automatic cost-adjustment mechanism to pass through changes in BPA purchased power.

### Market position: Adequate

Though the PUD has very strong history of frequent rate increases, average revenue per kWh was 8.9% above the state average in 2017, the most recent year of available comparative information, which we view to be a limiting rating factor, given the adequate income levels in the service area. Although having BPA as its main provider offers some stability, the district is also subject to BPA rate adjustments, as is the case with most public utility districts in the region that receive BPA hydro power.

We have historically viewed BPA's electric rates for municipal customers to be competitive (most recently established at $35.57 per megawatt-hour for fiscals 2018 and 2019) however, we understand the effects of low natural gas prices, an abundance of output from regional wind resources, and flat energy demand, are depressing power prices in the region, which has eroded the relative competitiveness of BPA resources. In our view, the supply certainty that BPA's round-the-clock resources provides to the PUD mitigates some of the competitive disadvantages relative to the low prices of intermittent low-cost renewable resources.

The PUD has a history of frequent base rate increases, most recently of 4% on Oct. 1, 2016 and 2017, respectively, following a 3% base rate increase on Feb. 1, 2015. The district has a plan to increase base rate rates annually by 2% on Oct. 1 2021, 2022, and 2023. On an average basis per KWh, the PUD projects a total rate increase of 1% in fiscal 2019 and 2.5% thereafter for next three years.

### Economic fundamentals: Adequate

We consider economic fundaments to be adequate given that the PUD has a stable, residential and diverse customer base, which contribute to revenue stability and predictability. Residential accounts about 72% of revenue and 68% of energy usage in 2017, which we believe contributes to revenue stream predictability and stability. The PUD's has good revenue stream diversity, with the top 1 customer accounting for 2% total revenue and the top 10 customers accounting for 8% of revenue in 2017.

Restraining a higher assessment is the district's shallow economic base characterized by adequate income levels and high unemployment rates. Mason County had median household effective buying income of 94% of the national average but only 80% of the state average in 2017. Moreover, the county's 2018 unemployment was 6.4 %, well above the U.S. average of 3.9%.

### Industry risk: Extremely strong

Consistent with "Methodology: Industry Risk," published Nov. 19, 2013, we consider industry risk for municipal retail electric and gas utilities covered under these criteria very low, and therefore extremely strong compared with other industries and sectors.

## Financial Risk

### Coverage metrics: Very strong

The PUD's coverage of fixed costs, which include principal and interest on debt, and contractual obligations, as well as an estimate of the debt service obligation embedded in BPA power costs averaged 1.62x over the past three years (at 1.77x in 2017, 1.58x in 2016, and 1.52x in 2015). However, we view 2017 as an outlier with FCC recorded above the prior two years and financial forecasts do not indicate this level of coverage going forward. Incorporating our adjustments, we expect FCC to be very strong at or above 1.5x over management's five-year forecast period.

### Liquidity and reserves: Very strong

Total liquidity equaled 131 days' worth of operating expenses, or $18.4 million as of Dec. 31, 2017, which we view as strong. Management anticipates cash reserves declining slightly to about $15.7 million upon paying an extraordinary capital expenditure in 2018.

### Debt and liabilities: Strong

We consider the PUD a distribution utility under our rating methodology as they purchase the majority of their power needs from BPA. The district's debt measures just over 40% of total capitalization and we expect this ratio will improve over the next several years as debt amortizes more rapidly than it is issued due to the lack of additional borrowing plans. The PUD's five-year capital improvement plan totals $43 million and will be entirely funded from rate revenue.