S&P Global Ratings

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Summary:

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

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Credit Profile		
US$145.5 mil rev and rfdg bnds ser 2023 due 10/01/2053		
Long Term Rating	AA/Stable	New

Credit Highlights

- S&P Global Ratings assigned its 'AA' long-term rating to Grant County Public Utility District No. 2 (Grant PUD), Wash.'s proposed $145.5 million series 2023A Priest Rapids Hydroelectric Project revenue and refunding bonds.
- We also affirmed our 'AA' long-term rating and underlying rating (SPUR) on the district's previously issued revenue bonds for the Priest Rapids Project (PRP), and on Grant PUD's revenue bonds issued prior to 2010 separately for the Priest Rapids and Wanapum hydroelectric developments.
- The outlook is stable.

Security

A lien on net revenue of the consolidated PRP project secures the series 2023A bonds and bonds issued in 2010 or later. Bond provisions include a 1.15x rate covenant on both parity and junior-lien debt, and a 1.15x additional bonds test. Parity bonds issued prior to 2010 for each of the two hydro developments are also payable from net revenue of the combined PRP, pursuant to the resolution and prior resolutions. In 2010, the district consolidated the two developments into one system, the PRP. Revenue consists of all revenue received from the PRP, including that received under power sales contracts and payments from the electric system.

The electric system (AA+/Stable) is obligated, whether or not the PRP is producing power or capable of doing so, to pay all project costs, including its share of debt service, not otherwise paid by other purchasers, and this obligation is payable as an operating expense prior to electric system direct debt service. The electric system covenants to set rates as it deems necessary to make such payments, to the extent that required payments are not otherwise made. Our rating on the electric system's debt is one notch higher than that on the PRP's debt for various reasons, including the electric system's significantly higher fixed-charge coverage, higher liquidity, and stronger ratemaking flexibility. We also note that the electric system and PRP are rated under different rating methodology (retail electric criteria versus wholesale criteria).

The bond proceeds will be used to refund the PRP's various debt outstanding and to fund the PRP's capital improvements. As of Dec. 31, 2022, the PRP had $1.4 billion in debt outstanding.

Credit overview

The ratings reflect our view of:

- Very low production costs of $19.44 per megawatt-hour (MWh) in 2022, and the PRP's non-carbon-emitting nature;
- Unconditional power sales contracts between project owner Grant County PUD and multiple power purchasers for 100% of combined project output;
- Continued successful replacement of fish-friendly turbines and other measures that have resulted in reduced spill, enhanced project economics, and compliance with environmental regulations, with additional improvements ongoing;
- Generally solid operating performance, including a plant availability factor of 90% in 2022; and
- Continued adequate financial performance, with power purchasers, including the district, paying their share of project costs plus 15%, such that debt service coverage (DSC) is consistently about 1.15x.

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

- High capital requirements associated mostly with turbine and generator restoration and powerhouse improvements, but also with regulatory compliance and license implementation, which could put pressure on the long-term competitiveness of the project's production costs, although per unit costs will likely remain well below Bonneville's firm priority rate over the next several years; and
- High project debt burden, with debt to capitalization of 79%, although low borrowing costs should continue given that the PRP will fund a portion of the five-year PRP capital improvement plan of $327 million with equity contributions directly from the electric system.

Environmental, social, and governance

Physical environmental risks include exposure to variability in hydrology but, from an energy transition risk standpoint, risks are limited as the project is non-carbon-emitting. The district and PRP do face considerable and seemingly perpetual costs of remediating fish and wildlife habitats surrounding their hydroelectric facilities, along with the costs of related litigation and regulatory proceedings.

Social risks are neutral given the project's very low operating costs, which make the PRP one of the lowest-cost resources of the power purchasers' resource portfolios. S&P Global Ratings believes that unsustainably strong business and consumer economic activity that are fueling inflation will likely lead to further interest rate increases and ultimately produce an economic slowdown. Although S&P Global Ratings sees an economic weakening on the horizon, it no longer foresees imminent recession risk. (See "Economic Outlook U.S. Q3 2023: A Sticky Slowdown Means Higher For Longer," published June 26, 2023, on RatingsDirect.) Consequently, we monitor the strength and stability of public power utilities' revenue streams for evidence of delinquent payments or other revenue erosion because elevated consumer prices and interest rates will likely continue whittling discretionary incomes.

We view the utility's governance factors as credit supportive, as they include full rate-setting autonomy as well as strong policies, forecasting, cyber security, physical security, and planning practices.

Outlook

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

Downside scenario

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

Upside scenario

Given high project debt and moderate capital needs, we do not anticipate raising the ratings during the next two years. Also limiting rating upside is our expectation that DSC is unlikely to materially improve.

Credit Opinion

The PRP consists of two hydroelectric generating facilities. The Priest Rapids development is a hydroelectric generating facility located downstream from the Wanapum project on the Columbia River in Grant and Yakima counties. The generating plant has a nameplate capacity of 950 MW and began operations in 1961. The Wanapum development is a hydroelectric generating facility located approximately 18 miles upstream of the Priest Rapids development on the Columbia River in Washington. The generating plant has a nameplate capacity of 1,222 MW and began commercial operation in 1963. The project owner and operator is Grant PUD, a vertically integrated public utility that operates its two utility systems as independent business units: the electric system and the PRP.

All power purchasers are either public or investor-owned utilities in the Pacific Northwest, and we believe that they are extremely unlikely to default on their payment obligations to the project given that the project represents one of the lowest-cost power resources in any of their supply portfolios and is a non-carbon-emitting resource. New power sales contracts took effect in 2005 and 2009 for the Priest Rapids and Wanapum developments, respectively, and will extend to the expiration (April 1, 2052) of the project's recently renewed 44-year license. The new contracts are similar to the prior contracts in that they are take-or-pay. Grant PUD's allocation of project power from the PRP has been modified under the new contracts so that Grant PUD has the ability to take a maximum of 93.3% of firm PRP power to meet its load (63.3% physical and 30.0% financial through the reasonable portion/estimated unmet district load). The Grant PUD electric system's share of project costs in 2022 was 86%.

Prior to 2010 the bonds whose proceeds secured each development relied on the net revenue from a single asset, but under the consolidated project this concentration risk is reduced. Furthermore, each development has 10 turbines that have typically achieved availability factors of around 80% to 90%, with generally a maximum of one turbine or generator undergoing replacement or maintenance at any given time, reducing production risks. Also, the supply contracts require power purchasers to satisfy the cost of power production, irrespective of the amount of power produced, thus producing consistent annual DSC of around 1.15x (with the inclusion of excess funds available in the supplemental repair and renewal fund).

The project exhibits very strong credit fundamentals primarily because of its very low cost of production (with hydro essentially being cost-free fuel) and its ability to reassign or remarket power from any defaulting power purchaser. It sells power through newly revised power sales contracts to 18 public and private utilities in the Pacific Northwest, including the district's electric system. The PRP production cost declined to $19.44 in 2022 from $21.61 in 2021, giving the PRP a 46% cost advantage versus the comparable Bonneville Power Administration preference rate of $34.93. Despite some fluctuations in per unit costs from $15 to $23 over the past 12 years, we believe the district would likely be able to remarket any available power in the event of a default by a power purchaser, mitigating the lack of step-up provisions

Production costs per unit are more favorable in very wet years. Streamflow can also vary considerably from year to year based on spill requirements and weather patterns. Streamflow was 111% of average in 2022, up from just 87% of average in 2021, leading to an 8% increase in gross PRP generation.

Other regulatory and environmental risks and uncertainties persist, but are dramatically reduced given the 44-year renewal of the district's Federal Energy Regulatory Commission license for the project in 2008. Nevertheless, the district must comply with state and federal regulations regarding dam operations and protection of endangered fish species. Fish habitat mitigation requirements, which include dam spill requirements, result in additional operating costs and loss of revenue.

Capital requirements remain relatively high at the PRP: The five-year capital budget calls for $327 million in capital expenditures from 2023 to 2027 for generator restorations, and powerhouse and general facility improvements. Management expects to debt-fund approximately 30% of capital needs. The Wanapum development turbine replacement work has been completed, and the Priest Rapids development is also replacing its turbines with more efficient and fish-friendly advanced turbines. The district projects that the replacement of all Priest Rapids development turbines and generators will be complete by 2028, and anticipates that the useful life of the new equipment will be 50 years. Management anticipates that the overall PRP capital program will begin to decline in the next five years or so, as the majority of significant projects will be completed by then.

Power purchasers are billed monthly for their respective shares of project operating costs plus 115% of debt service, resulting in consistent DSC of around 1.15x. The project's financial performance is generally stable, and margins are slim because the project operates on a cost basis. Debt leverage at the project level was high, in our view, at approximately 79% debt to total capital as of Dec. 31, 2022. Combined annual debt service requirements for the project more than doubled to $95 million in 2022 from $41 million in 2006.

Liquidity has historically been only adequate or marginal at the PRP because of the PRP's ability to bill power purchasers monthly for their respective shares of project operating costs plus 115% of debt service. Most operating cash is held at the electric system level. According to the district, unrestricted cash at the PRP can fluctuate as a result of the timing of the power sales contracts' cash flows.

Related Research

Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022

Ratings Detail (As Of June 30, 2023)		
Grant Cnty Pub Util Dist No. 2 priest rapids hydroelec proj rev rfdg bnds taxable		
Long Term Rating	AA/Stable	Affirmed
Grant Cnty Pub Util Dist No. 2 WHLELC		
Long Term Rating	AA/Stable	Affirmed
Grant Cnty Pub Util Dist No. 2 WHLELC		
Long Term Rating	AA/Stable	Affirmed
Grant Cnty Pub Util Dist #2 rev rfdg bnds (Direct Payment)		
Long Term Rating	AA/Stable	Affirmed
Grant Cnty Pub Util Dist #2 rev & rev rfdg bnds (Priest Rapids Hydroelectric Proj)		
Long Term Rating	AA/Stable	Affirmed
Grant Cnty Pub Util Dist #2 Priest Rapids Hydroelec Proj rev bnds (Priest Rapids Proj)		
Long Term Rating	AA/Stable	Affirmed
Grant Cnty Pub Util Dist #2 (Priest Rapids Hydroelectric Dev) (MBIA) (MBIA of Illinois)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Grant Cnty Pub Util Dist #2 (Priest Rapids Hydroelec Dev) elec (MBIA) (MBIA of Illinois)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Grant Cnty Pub Util Dist #2 (Wanapum Hydroelectric Dev) (MBIA) (MBIA of Illinois)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.