FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Benton County PUD No. 1, WA's Electric Rev Bonds at 'AA-'; Outlook Stable

Thu 07 May, 2020 - 11:45 AM ET

Fitch Ratings - Austin - 07 May 2020: Fitch Ratings affirms the 'AA-' rating on the following bonds issued by Benton County Public Utility District No. 1, WA:

--Approximately $49.6 million electric revenue and refunding bonds, series 2010, 2011, and 2016.

Fitch also affirms the 'AA-' Issuer Default Rating (IDR) to Benton PUD.

The Rating Outlook is Stable.

ANALYTICAL CONCLUSION

The rating reflects Benton PUD's strong financial profile, the district's very low operating cost burden and ample rate flexibility. The district's low net leverage is

expected to persist at levels adequate for the rating despite cash funding of relatively heightened short-term capital needs, partially due to an expected structural decline in costs beginning in 2022.

CREDIT PROFILE

Benton PUD provides retail electric and broadband services in a 939 square-mile service area of Benton County, WA, with the majority of its customer base located within the cities of Kennewick, Prosser, and Benton. The county is located in south central Washington, along the border of Oregon. The district does not serve certain other areas within Benton County including the cities of West Richland and Richland; it also does not serve the significant operations by the U.S. Department of Energy on the Hanford Reservation or the rural areas in the county, which are served by the Benton Rural Electric Association.

Energy needs are predominately met with power purchased from the Bonneville Power Administration (BPA) and remaining requirements are met through power purchased contracts and market purchases. Contractual rights to purchase power under long-term agreements exceed the district's power needs under average water conditions.

Coronavirus Considerations:

The recent outbreak of coronavirus and related government containment measures creates an uncertain environment for the public power sector in the near term. While the district's most recently available data has not indicated credit impairment, material changes in revenue and cost profile are occurring across the sector and are likely to worsen in the coming weeks and months as economic activity suffers and government restrictions are maintained or expanded. Fitch's ratings are forward-looking in nature, 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.

KEY RATING DRIVERS

Revenue Defensibility: 'a'

Variable Wholesale Revenues; Mixed Service Area Attributes

Benton PUD's revenue defensibility is driven by the district's continued exposure to wholesale revenue variability combined with its very strong rate flexibility. The district serves a diverse, growing customer base in Benton County, although service area characteristics are mixed with unemployment well above the national average.

Customer concentration exists but does not constrain the Revenue Defensibility assessment. Residential revenues at 48% of total retail revenues and fixed-charge components of the rate structure should help buffer the revenue impacts of any demand declines precipitated by the coronavirus and the related economic shock.

Operating Risk: 'aa'

Low Operating Cost, Primarily Hydroelectric Power Supply

Benton PUD's operating risk is driven by its very low operating cost burden, averaging 6.7 cents per kWh over the last three years. The district's power supply should be supportive of similarly low levels going forward. Relatively heightened short-term capital spending related to reliability and growth objectives is viewed as manageable.

Financial Profile: 'aa'

Strong Financial Profile; Resilient Under Fitch Sensitized Base Case

Benton PUD's financial profile is strong, even with a tightening in 2019. Coverage of full obligations declined to 1.16x in 2019 (unaudited) from 1.41x in 2018. However, financial projections indicate improved results over the low water year in 2019. The

financial profile appears resilient even under Fitch's coronavirus sensitized downside scenario that models large demand declines in 2020 with recovery over the following three years. In such a scenario, modest pressure on liquidity levels may prompt the use of debt funding for a portion of capex or additional rate increases beyond the increase assumed in 2021. Leverage is expected to remain below 6.4x.

ASYMMETRIC ADDITIONAL RISK CONSIDERATIONS

No asymmetric additional risk considerations affected the final rating.

RATING SENSITIVITIES

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

--An acute decline in liquidity.

--A potential dilution of revenue defensibility over the medium term could reduce the district's ability to support existing leverage at the current rating. The potential for dilution could occur from a material weakening of the service area characteristics, such as an abrupt end to customer growth and/or a sustained increase in unemployment.

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

--While considered unlikely in the current recessionary environment, a sustained and material decline in leverage could improve credit quality over time.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Public Finance 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

Bonds are payable from the net revenues of the electric system.

REVENUE DEFENSIBILITY

Benton PUD derives a significant portion, approximately 85%, of its total revenues from the sale of retail electricity throughout its exclusive service territory in the county. Fitch considers this to be a business line that exhibits monopoly characteristics and strong revenue reliability. However, the remaining portion of district revenues is provided by the wholesale sale or surplus energy, which is typical for a hydroelectric-dominant utility. Hydrological variability and energy supply shaping throughout the year, required to match retail load requirements, result in revenue reliance on the sale and purchase of energy in each year.

The district has shifted towards a greater reliance on retail revenues, evidenced by regular retail rate increases over the last decade. While efforts have been successful, wholesale sales of surplus power still influence in the district's financial performance, comprising a sizable 14% of total operating revenues in 2019. Broadband revenues account for another 1%.

Service Area Characteristics

Benton PUD's service area characteristics are viewed as midrange with modest but healthy customer growth just over 1% per year and mixed service area indicators. The area has seen employment growth in a broad range of industries as well as greater agriculture and wine production activity, which has contributed to the rise in irrigation load.

Demographic and economic indicators for Benton County include 2018 median household income of $65,650 finishing at 109% of the national average. However, Benton County's unemployment rate remains structurally higher than national levels (133% of the national average) reflecting the economy of the service area which includes a large portion of agricultural and irrigation activity.

Energy Sales Fluctuations and Expected Coronavirus Demand

Retail sales have been flat, on average, over the last five years due to conservation efforts and energy efficiency improvements across the industry. However, weather fluctuations occur, resulting in a large 5.4% increase in retail sales in 2017 and a 1.5% decline more recently in 2019. Wholesale sales are more volatile, depending on weather conditions. Below average water conditions in 2019 resulted in a 10% reduction in the volume of wholesale sales that year.

Fitch believes that utilities may experience a sharp decline in demand for part of 2020 as a result of the severe economic contraction occurring in response to the coronavirus and responsive shutdowns. However, to date the district has experienced very high irrigation load demand in April 2020, which has more than made up for the decreased demand in the commercial customer class, estimated to be around a 10% decline in that sector. The district is prudently planning for the potential for load demand declines to continue through the balance of 2020 and beyond, given the economic uncertainty.

Rate Flexibility

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 district is governed by a three member commission, elected to serve six-year terms with one member elected every two years.

Benton's average retail revenue per kilowatt hour as reported by the EIA in 2018, is 88% of the state average. Rate affordability is similarly strong, with an affordability ratio (a measure of annual energy cost against median household income) of 2.0%. Collectively, these factors suggest very strong rate flexibility, which is expected to be preserved despite the most recent 2.9% rate increase implemented in October 2019. The increase was designed to meet system capital needs and to match rising

BPA costs. Bonneville's ultimate power system base rate increase implemented in October 2019 was only 1.5%. The district does not treat Bonneville's power supply cost increases as an automatic pass-through in rates but considers the bi-annual power and transmission rate increases as part of its own retail rate setting process.

The district has implemented multiple rate increases since 2009 and increased the portion of rates collected in the fixed charge component in order to offset diminished revenues from wholesale sales and to address rising costs from BPA, renewable requirements, and conservation mandates. In addition to the 2.9% rate increase in October 2019, another 2.9% rate increase is assumed in April 2021.

Asymmetric Rating Factor Consideration - Customer Concentration

The district's customer base exhibits some sector concentration in the top 10 customers that represents an asymmetric rating factor consideration but does not currently constrain the overall Revenue Defensibility assessment from the 'a' assessment. The district's top 10 customers account for 22.5% of revenues and the single largest customer accounts for 7.5%. The concentration exists from a large degree of irrigation demand. Six of the district's largest customers are irrigation-related electrical load, accounting for approximately 17% of total revenues and 22% of retail energy sales. Irrigation demand fluctuates annually, based on weather conditions, resulting in revenue variability from year to year.

OPERATING RISK

Benton PUD has a very low operating cost burden, with a Fitch-calculated cost of power averaging 6.7 cents per kilowatt hour (kWh) over the last three years. The cost burden incorporates wholesale power costs from Bonneville, which provides the majority of the district's power supply. Despite expected Bonneville power rate increases in future years, upward pressure to the district's costs is expected to be moderate.

However, the cost burden also reflects a purchase power contract for 50 MW of the 249 MW Frederickson combined cycle natural-gas plant. The contract was entered into in 2002, just after the Western energy crisis and expires on Aug. 31, 2022. While the fixed-price contract was competitive at the time it was entered into, the

abundance of renewables in the Northwest has brought energy prices down since that time.

Operating Cost Flexibility

The district's power supply is predominately met with the low-cost hydroelectric purchased as a statutory preference customer of Bonneville. The reliance on a single fuel type (hydroelectric power) for over 80% of power supply reflects a weak operating cost flexibility, but does not constrain Fitch's overall operating risk assessment.

The Bonneville contract is in a 'block and slice' power sales agreement effective through September 2028. The block product is a firm amount of power regardless of water conditions that differs in monthly amounts ranging from 70 average MW to 156 average MW. The slice product gives the district the right to 1.37% of Bonneville's overall system production, which is heavily dependent on hydrology conditions.

Remaining requirements met through power purchase contracts and market purchases. The district is fully resourced to meet its power supply needs through 2022 under critical water conditions and through 2032 under average water conditions. However, the district still needs to purchase and sell energy during various months to balance the timing of hydroelectric supply with load demands. The Energy Authority (TEA) is responsible for shaping and balancing Benton's power supply resources with load requirements.

Environmental Considerations

The district is fully resourced to meet the state's renewable portfolio standard (RPS) via contracted renewable resources and renewable energy credit (RECs) purchase agreements. The district expects to meet the 15% requirement in 2020 with contracted REC purchases with a contract term of 2019 to 2028.

Washington also passed the Clean Energy Transformation Act in 2019 that requires the state to achieve a power supply free of carbon emissions by 2045. The district is well positioned given the predominantly carbon-free power supply provided by

Bonneville (hydroelectric and nuclear generation) in addition to its own wind power purchase agreements.

Capital Planning and Management

Benton PUD's age of plant is 20 years, which may indicate high capital requirements. The district is engaged in a level of higher capex spending that began in 2018. Capex spending to depreciation increased to over 150% in the past two years from prior levels around 100% or below. The district has an elevated capital improvement plan (CIP) relative to historical levels, driven by reliability and growth objectives requiring greater substation and transmission investment. The estimated $80.4 million spend from 2020 to 2024 is expected to be primarily funded from cash reserves and operating cash flow. The district may consider additional debt issuance in the near term to finance of a portion of the CIP.

FINANCIAL PROFILE

The district's financial performance was strong in 2017 and 2018 but performance tightened in 2019. Fitch-calculated coverage of full obligations remained adequate at 1.16x in 2019. While the financial profile remains supportive of the rating, the rating also incorporates a degree of financial variability that occurs at the district. Variability results from attributes associated with a hydroelectric system and revenue and expenditure exposure to wholesale market energy prices. The district's financial policies, including maintenance of cash reserves over 90 days cash on hand, help to mitigate the variations.

A confluence of extreme weather conditions and below average hydroelectric production reduced operating margin from 5% in 2017 and 2018 to 0% in 2019 (based on unaudited financials). Very cold winter weather in February and March 2019 coincided with below average hydrology. Below average water resulted in low energy available from the slice purchased power agreement. The district had to purchase power at higher market prices, which drove the district's net power costs above budgeted levels. A 2.9% rate increase was implemented on Oct. 1, 2019, which covered the 1.5% power base rate increase and 3.6% transmission rate increase from Bonneville that occurred at the same time.

Liquidity levels remain solid and the liquidity profile is considered neutral to the rating. Unrestricted cash reserves declined from $57.3 million at the end of 2018 to $42.5 million at the end of 2019 (unaudited), but days cash on hand was still 103 days, as calculated by Fitch. The inclusion of the district's $10 million line of credit with Bank of America results in 127 days liquidity cushion. While financial policies allow for a minimum of 90 days cash on hand, the district has a proven track record of managing to its reserve target range of 108 to 132 days.

Fitch Analytical Stress Test (FAST) - Sensitized Base Case for Coronavirus

Fitch analysis considered the district's financial forecast as a starting point for the FAST. The district's financial forecast prior to April 2020 included modest growth in energy sales of less than 1% annually, an assumed 2.9% rate increase in 2021 and capex of $80.4 million over the next five years funded from ongoing revenues with no planned debt issuance.

In Fitch's standard base case FAST, key financial ratios remain supportive of the rating although liquidity tightens even further during the next couple of years. Fitch's standard stress imposes a 4.8% demand decline in 2020 and a 2.2% decline in 2021 before recovery in the final three years. In the stress scenario, leverage remains in the 6.0x range (similar to 6.3x at the end of 2019; unaudited) as a result of no assumed debt issuance, but days cash levels would fall below the district's minimum 90 day target, signaling the need for revenue increases, lower capex or debt funding of a portion of the CIP. Fitch assumes the district would take one of these steps to remain in compliance with its financial policies.

Fitch also considered a coronavirus sensitized downside case in our analysis that models a 9% decline in energy sales in 2020 with a recovery occurring over the following three years. While this level of demand decline is well above what the district is currently experiencing, the downside case is designed to evaluate the impact of major setbacks in containing the virus and the potential for the extension or re-imposition of lockdowns. In the downside scenario, key ratio pressure appears similar to the stress case results noted above. Pressure on liquidity appears to necessitate some debt funding of the CIP, additional rate increases beyond 2021, or both. Leverage normalizes back to around 6x during the recovery in the second year and Fitch assumes that liquidity will remain above 90 days cash on hand.

Debt Profile

The district's debt profile is neutral to the rating. The district had $49.6 million in debt outstanding at the end of 2019 on one lien. Outstanding debt is entirely fixed-rate, with final maturity in 2041. Debt service is scheduled to decline from approximately $6.5 million in 2020 and 2021 to $5.5 million in 2022 and $4.5 million in 2023, assuming no additional debt issuance, which may occur. Debt amortization is slower with the new money portion of the series 2016 bonds structured with no principal repayment until 2023.

ASYMMETRIC ADDITIONAL RISK CONSIDERATIONS

No asymmetric additional risk considerations were applied in this rating determination.

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

ENTITY/DEBT	RATING		
Benton County Public Utility District No. 1 (WA)	LT IDR	AA-	Affirmed
• Benton County Public Utility District No. 1 (WA) /Electric System Revenues/1 LT	LT	AA-	Affirmed

VIEW ADDITIONAL RATING DETAILS

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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, v1.1.2 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Benton County Public Utility District No. 1 (WA)	EU Endorsed

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