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Ratings

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Central Coast Community Energy, California; Retail Electric

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Rating Action

S&P Global Ratings assigned its 'A' issuer credit rating (ICR) to Central Coast Community Energy (3CE), Calif. The outlook is stable.

Credit overview

3CE is a joint powers agency (JPA) originally formed in 2017, and expanded in 2019 and 2020, to procure retail electric commodity on behalf of about 439,000 electric customers across 33 member cities, counties, and towns throughout California's Central Coast. The incumbent investor-owned utilities (IOUs) deliver the electricity across their existing infrastructure.

While 3CE operates as a JPA with many member cities, it simultaneously provides direct retail service to all of its customers (albeit through the billing systems and physical assets of the incumbent IOU.) Given this direct retail service, S&P Global Ratings views 3CE's creditworthiness under the scope of our retail electric criteria.

3CE provides service as a community choice aggregator (CCA) under the California Public Utilities Code section 366.2. Under the code, all of the incumbent IOUs' customers automatically become 3CE customers, but have the option to opt out and return service to the previous providers, Pacific Gas and Electric Co. (PG&E; BB-/Negative/NR) and Southern California Edison (SCE; BBB/Negative/A-2). Importantly, 3CE does not own, operate, or maintain any of the generation, transmission, or distribution infrastructure used to serve its customers, which we believe distances it from wildfire liability under California's inverse condemnation laws. However, management must procure electricity supply and balance the obligation to enter into contracts for long-term power supply volumes and a potentially fluid customer base that could migrate during the tenure of the CCA's commitments to purchase power.

3CE was formed to provide clean and renewable power to its member at a competitive cost, while also generally reducing greenhouse gas emissions and stimulating the local economy. The CCA has the rights and powers to set rates for the services it provides, incur indebtedness, and issue bonds or other obligations. 3CE has no debt outstanding, nor does it plan to issue any debt in the near term.

The rating reflects our opinion of 3CE's strong enterprise and financial risk profiles.

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

- Large customer base with robust income levels;
- Solid, albeit brief, track record of customer retention;

- Protective JPA member agreements with municipalities, compared with retail customers who retain the right to depart the CCA;
- Diverse power supply and low cost of power;
- Credit-supportive policies and procedures including fundamentally robust JPA contracts, robust long-term financial forecasting, and a balanced approach to power supply management and contract procurement;
- Limited direct exposure to wildfires through California's strict liability standard and inverse condemnation due to the absence of ownership of transmission and distribution assets; and
- Core mandate to provide renewable power, which positions 3CE well for California's renewable portfolio standard (RPS.)

Offsetting these factors are 3CE's direct retail competition with the investor owned utilities, which constrains the CCA to maintain rates comparable with those of the incumbent IOUs. The CCA also faces power-procurement constraints, as the utility must balance its obligation to enter into long-term contracts with a potentially volatile load profile (and must balance its renewable mandates with the need for reliable baseload energy), and the risk of members exiting the CCA.

The strong financial risk profile reflects 3CE's robust liquidity, debt-free balance sheet, and the expectation that fixed cost coverage (FCC) will trend down as the utility shifts to a cost-of-service rate-setting model.

The stable outlook reflects our assessment of 3CE's record of customer retention since its 2017 inception. In addition, after it builds up cash reserves, 3CE plans to further reduce rates relative to those of PG&E, which should further incentivize retail customers to remain with the CCA. The outlook further reflects the utility's robust cash reserves, providing ample cushion in the face of a potentially volatile load profile.

Environmental, social, and governance factors

We believe the CCA's direct environmental risks are low, based on its plans to service 100% of its energy needs through long-term, fixed-price renewable purchase power agreements (PPAs) by 2030. Yet, as a practical matter, the intermittency of renewable resources might frustrate the CCA from achieving those goals in the absence of storage technology breakthroughs. The CCA faces social risk related to COVID-19, as efforts to protect the health and safety of the community may affect the utility's financial metrics if customers continue to be unable to pay utility bills in a timely fashion. We note the CCA deferred 50% of its retail generation charges in May and June 2020 to provide customers with financial relief. Plans to recoup the majority of that lost revenue over the next year will depend on the strength of the local, state, and national economic recovery. Finally, we view the utility's governance factors as generally credit supportive, as they include robust JPA member agreements, full rate-setting autonomy, strong policies and planning, and a proactive and experienced management team. However, the potential for retail customer opt-out tempers our view of the CCA's governance factors somewhat.

Stable Outlook

Downside scenario

We could lower the rating if customers continue to struggle to make timely bill payments. While unexpected, if 3CE were to experience significant retail customer opt-out or lose one or more of its member cities or counties, it could be forced to sell surplus contracted power to the market. In the event market prices were significantly below those of 3CE's portfolio, the utility could face significant financial pressure, which, in turn, could lead us to lower the rating.

Upside scenario

We do not expect to raise the rating in the next two years given 3CE's inherent risks posed by the direct competition for its entire retail customer base; the recessionary pressures that are having an observable effect on collections; and the utility's projections that include reducing rates after building up liquidity, which will lower fixed charge coverage metrics.

Credit Opinion

Enterprise Profile: Strong

Economic fundamentals--Very strong

3CE's 296,000 customers provide revenue diversity and economies of scale--and management expects to continue adding members over the next several years. The 10 largest member cities' median household effective buying incomes were 111% of the U.S. average in 2019, on a weighted-average basis. No single retail customer accounted for more than 1.6% of energy sales in 2019, providing further revenue stability. These factors are offset by 3CE's commercial, agricultural, and industrial concentration--together these customers accounted for about 60% of fiscal 2019 revenues. In our view, these customer classes represent a less predictable revenue stream for the CCA.

3CE's 10 largest municipal and county members accounted for 90% of total load in fiscal year 2019, with the largest (Monterey County) accounting for 27%. A municipal or county member can depart the CCA with six months' notice; however, the JPA contracts stipulate that a departing member must make the CCA whole for any PPAs signed prior to its departure. (Ratepayers are not subject to this clause, lowering the barrier for individual customers switching providers.) Although this remains untested in court, each member knowingly agreed to this stipulation before joining the CCA, and we believe the exit fee serves as a disincentive to member cities and counties to terminate their contracts with 3CE.

Market position--Adequate

3CE sets rates at a slight discount compared with those of the incumbent investor-owned utility (IOU), PG&E, whose rates were 124% of the state average in 2018 according to the U.S. Energy Information Administration. 3CE plans to hold rates 2% below PG&E's rates while it builds reserves and recoups revenue lost during its two-month COVID-19 rate-relief program. Whether due to 3CE's desirable product or a dissatisfaction with PG&E, just 6.5% of CCA customers have opted out, choosing to return to PG&E. We believe this level of customer retention is sustainable given 3CE's plans to align its wholesale and retail prices while ensuring rates remain competitive with the IOU's as it transitions to a cost-of-service rate-setting model in October 2021. Due to the direct competition with PG&E, however, we believe 3CE's rate-raising flexibility is constrained, as any significant rate increase could result in a dramatic

increase in the opt-out rate during the period that 3CE is building up reserves. Furthermore, the above-average rates relative to the state could result in commercial and industrial customers departing member cities in favor of cheaper power elsewhere. 3CE's low cost of power (approximately $56/megawatt-hour for fiscal year 2020-2021) mitigates this risk, as the CCA could absorb a short-term cost escalation in its margins. The CCA also has approximately $119 million in its rate stabilization account, which could be called upon in lieu of a rate increase. We could positively revise our assessment if 3CE's rates are sustainably maintained at a level materially lower than PG&E's, as the decreased rates would both improve 3CE's rate-raising flexibility as well as lower the opt-out risk, especially in light of likely higher rates at PG&E in the near- to mid-term.

CCA's customers are obligated to directly reimburse the incumbent IOU in the form of an exit fee, known as a power charge indifference adjustment (PCIA). The PCIA was established to ensure the IOU's remaining bundled customers do not disproportionally shoulder above-market generation costs that had been procured for the departing customers. According to the California Public Utilities Commission (CPUC), the PCIA is calculated by taking the different between the actual portfolio cost and the market value of the IOU's portfolio, as calculated using CPUC methodology. The total magnitude and method of capture are still being refined by the CPUC. Currently, the PCIA is limited to 0.5 cent/kilowatt annual increases, although a Power Charge Indifference Adjustment Undercollection Balancing Account (PUBA) was also added to capture potential under-collection caused by this cap. If this account balance reaches 7% of forecast unbundled customer PCIA revenues and will reach 10% by year-end, the incumbent IOU must file a request to over-collect on the PCIA. The annual cap does limit short-term risk; however, a significant over-collection of the PCIA by the incumbent IOU, a material change to the underlying formula, or a protracted period of 0.5 cent annual increases could gradually erode 3CE's competitiveness.

Operational Management Assessment--Adequate

3CE's power portfolio is diverse, in our view, with no single contract accounting for more than 9% of total load. Similarly, the CCA's fuel mix is diversified among a number of clean and renewable resources. In 2019, 3CE sourced 69% of its energy from large hydro, 9.5% geothermal, 7.7% wind, 8.1% solar, 3.3% RPS eligible hydro, and 2.4% biomass. This diversity is offset, in our view, by a lack of purchasing flexibility. Under state mandate, 3CE must secure 65% of its RPS-compliant power supply under 10-year or longer contracts by 2021. While we generally view positively the long-term price certainty these contracts provide, the possibility of customer dislocation, coupled with this mandate, could result in 3CE holding a great deal of surplus power. Management reported the CCA can sell its excess energy position into the wholesale market, with no end-use restrictions attached to any of its PPAs; however, in a scenario where one or more larger members departed or there is a retail customer base dislocation and contract prices exceed market prices for an extended period of time, 3CE could face significant financial pressure. As previously mentioned, each member has agreed to make the CCA whole following its departure, mitigating this risk at the wholesale level, but not at the retail level. 3CE staggers its PPAs to temper the exposure of retail or wholesale customer departures.

3CE's environmental regulation and compliance is extremely strong--its core business function is to procure clean and renewable resources, subject to availability, and per state mandate it must source a portion of its energy from eligible renewables.

The CCA's management, policies, and planning are also robust. 3CE maintains a long-term financial forecast, risk

management strategy, and a comprehensive integrated resource plan. In these documents management clearly addresses the risks associated with the CCA business model and provides mitigating steps, as noted above.

Financial Profile: Strong

Coverage--Adequate

3CE has no debt outstanding. However, S&P Global Ratings calculates a FCC ratio, which treats a portion of power purchases as fixed to reflect the provider's pass-through of its fixed costs incurred. The CCA's FCC was an extremely strong 2.05x in fiscal 2019. However, as mentioned previously, management intends to lower rates in the near term--resulting in FCC dropping to about 1.1x after 2023, a level we consider adequate. We believe the long-term forecast is reasonable, and that 3CE has significant leeway to lower rates, given its cost advantage compared with PG&E.

Liquidity--Very strong

3CE had approximately $119.4 million in cash and reserves, including over $112 million in rate stabilization reserves, in fiscal 2019. Management projects liquidity will levelize at about $210 million by 2024, or about 250 days--a level we consider very strong. Although distribution-only utilities generally require less cash than their vertically integrated counterparts, we believe 3CE's inherent risks associated with customer retention, rate setting, and power supply procurement necessitate an enhanced level of reserves.

Debt and liabilities--Extremely strong

3CE has no debt outstanding, and no plans to issue debt in the near term. Given the CCA's minimal physical plant, we believe this is reasonable.

Related Research

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

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