

# RatingsDirect®

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## Summary:

# Central Coast Community Energy, California; Retail Electric

### Primary Credit Analyst:

Doug Snider, Centennial + 1 (303) 721 4709; [doug.snider@spglobal.com](mailto:doug.snider@spglobal.com)

### Secondary Contact:

Alexandra Rozgonyi, Centennial + 1 (303) 721 4824; [alexandra.rozgonyi@spglobal.com](mailto:alexandra.rozgonyi@spglobal.com)

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## Summary:

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### Credit Profile

Central Coast Comnty Energy ICR

*Long Term Rating*

A/Stable

Affirmed

## Rating Action

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

### Credit overview

The ICR reflects the benefits of a diverse, generally affluent customer base; robust liquidity; the absence of debt; and an overwhelmingly clean energy portfolio. Tempering these strengths are the ease with which customers can transition back to the incumbent utility and retail electric rates that are elevated relative to state averages but advantageous relative to the incumbent investor-owned utilities (IOUs). Additional risks include a power portfolio that is exposed to volatile market prices via short-term market purchases coupled with contracted power supply counterparties that include several companies that either exhibit weak credit quality or that we do not rate.

3CE is a joint powers authority and community choice aggregator (CCA). Originally formed in 2017, 3CE has been procuring electricity for retail electric customers along California's central coast. The CCA provides service within 30 incorporated and unincorporated areas historically served by Pacific Gas & Electric Co. (PG&E), and three areas historically served by Southern California Edison (SCE).

3CE serves 229,000 retail customers and derives 36% of its revenues from residential customers, 48% from commercial customers, and 16% from agricultural customers. We believe the residential customers provide revenue stability; however, this is offset somewhat by the concentration in commercial and agricultural customers.

PG&E and SCE, on behalf of 3CE, each perform monthly retail electric meter readings, bill 3CE's customers, collect customer payments, and convey over their transmission and distribution systems the electricity 3CE procures. The IOUs segregate and remit to 3CE the revenues they collect for 3CE; we understand these revenues are insulated from an IOU bankruptcy.

Retail electricity customers who migrated to 3CE at the introduction of 3CE service in their area may return to their respective incumbent IOU upon 60 days' notice. 3CE does not impose fees on departing customers. We consider the relative ease with which 3CE customers can return to their previous electric utility as a potential risk to 3CE's revenue stream. However, there have been few departures, with less than 6% of total customers opting out since 3CE's inception.

Representatives of 3CE's member jurisdictions comprise the CCA's board. The board sets the retail rates for the power it procures. In addition to 3CE's energy charges, the major components of the customer bills that PG&E and SCE respectively prepare also include charges for energy delivery, 3CE and administrative expenses, and the power charge indifference adjustment (PCIA). The PCIA is a legislatively created vehicle. It provides for the IOUs' recovery of those portions of pre-existing generation investments and energy-procurement costs that market sales of energy surpluses created by customer migrations to CCAs do not financially support. The PCIA shields IOUs' non-CCA customers from the cost shifting that might otherwise occur due to the migration of retail customers to CCAs. The PCIA varies by customer class and is about 1.8 cents on a weighted-average basis for 3CE, which diminishes its ratemaking flexibility somewhat.

3CE transitioned from a rate structure that was pegged to PG&E rates to a cost-of-service model for its customers within its PG&E-contested service territory (altogether accounting for about 90% of retail load) on March 1. Rather than following PG&E's rates up and down, which could result in uneven financial performance, rates are now set relative to 3CE's expense profile. We believe this shift provides the utility with greater ratemaking flexibility and ultimately allows 3CE to more predictably and reliably cover costs in a wider array of market conditions. Management indicated 3CE will similarly transition its customers within its SCE-contested territory in 2023.

The stable outlook reflects our assessment of strong customer retention rates; robust incomes across the service territory that mitigate high rates; robust liquidity that reduces but does not eliminate counterparty and customer migration risks; and a resource portfolio, which although currently exposed to potentially volatile wholesale market prices due to a short position, limits the utility's exposure to increasingly stringent emissions regulations and competitive and potentially volatile wholesale markets.

### **Environmental, social, and governance**

We believe that 3CE faces limited environmental risks. Purchases of wind, solar, geothermal, and hydroelectric generation resources that are free of greenhouse gas emissions covered almost 90% of 2021's load. Over the longer term, 3CE has committed to a 100% clean and renewable energy portfolio by 2030. Yet, as a practical matter, the intermittency of renewable resources might frustrate the CCA from achieving those goals, especially given the rising costs of battery storage technology inputs.

Although direct wildfire liability risk is low because 3CE outsourced transmission and distribution functions, public safety power shutoffs by the owners of the transmission and distribution systems serving 3CE's customers could nevertheless adversely affect the reliability of customers' electric service. Management has indicated it is exploring the possibility of asset ownership in the future, which could create direct exposure to wildfires and related liability claims.

We believe 3CE faces slightly elevated social risk. Although residential rates are about 20% below those of PG&E, we note that PG&E's are elevated (124% of California's average retail system rate in 2020), which could weigh on financial flexibility. However, this is mitigated somewhat by above-average effective buying incomes across 3CE's territory.

Finally, we view the utility's governance factors as generally credit supportive, as they include robust Joint Power Authority member agreements, full rate-setting autonomy, strong policies and planning, and a proactive and experienced management team. We note that management has undertaken a comprehensive approach to mitigating the many challenges California CCAs face. However, the potential for retail customer opt-out is beyond management's

control, and tempers our view of the CCA's governance factors somewhat.

## **Stable Outlook**

### **Downside scenario**

We could lower the rating if 3CE experiences customer defections at levels that leave it with meaningful surplus energy purchase commitments whose cost must be recovered either through liquidation into competitive wholesale markets or rate increases. We could also lower the rating if the cost of future power purchase arrangements negatively affects competitiveness, if 3CE faces significant power supply counterparty nonperformance that erodes the CCA's competitive position as a result of cost passthroughs while simultaneously increasing dependence on wholesale market prices, or if financial metrics otherwise fall materially short of projected levels.

### **Upside scenario**

We could raise the rating in the next two years if 3CE is able to successfully secure a greater portion of its portfolio under reliable and competitive power longer-term contracts without material erosion of customer retention, rate competitiveness, fixed cost coverage (FCC), or liquidity. We will reassess financial metrics and wildfire exposure if 3CE were to issue debt.

## **Credit Opinion**

### **Enterprise profile**

3CE benefits from serving a growing and diverse little exposure to industrial customers and no meaningful customer concentration. In addition, much of the residential segment of the service territory exhibits above-average income levels, indicating the affordability of electric rates that are high relative to state averages. However, residential past-due balances have increased by \$4 million since the end of 2019, representing a little under 3% of 3CE revenues. While nominally low, in our opinion, this suggests affordability issues might be present within lower-income portions of the service territory.

We believe that a power supply portfolio that is diverse and highlighted by a mix of resources that do not produce greenhouse gas emissions positions the utility to meet increasingly stringent legislative and regulatory environmental initiatives.

Several factors temper 3CE's enterprise strengths. Among them is the ease with which customers can revert to PG&E as their electric provider, especially if 3CE's relative competitiveness vis-a-vis PG&E declines. Additional exposures include the short tenor of many power supply arrangements, the risks inherent in counterparties that include suppliers that we believe exhibit weak credit attributes, and a currently volatile energy market that could pressure short-term purchases as well as future long-term contract pricing.

### **Financial profile**

3CE does not have any debt; however, S&P Global Ratings calculates FCC to reflect our view that 3CE is funding its contracted power suppliers' recovery of investments in generation capacity. Power purchase and energy program expenses represent about 94% of operating expenses, net of depreciation and amortization.

When calculating FCC, our proxy for suppliers' recovery of capital investment from their purchasers reduces operating expenses and imputes debt service by a matching amount. Applying that adjustment, we calculated FCC of 1.26x in 2021. Our calculations based on 3CE's projections suggest FCC will average 1.17x over the next five years. We note there is some uncertainty surrounding projected expenses costs given continued volatility in market prices for both energy and storage; however, management indicated it is considering extending a temporary rate adjustment to account for these pressures. Nevertheless, we believe a protracted higher-priced energy environment could frustrate 3CE's ability to produce metrics in line with forecast levels.

We consider the \$159 million of unrestricted cash and investments and rate stabilization funds that 3CE reported at fiscal year-end Sept. 30, 2021 as providing a robust cushion for tempering exposures to potential customer departures or supplier disruptions. With the rate stabilization fund, as of Sept. 30, 2021, liquidity represented 226 days' worth of operating expenses. Moreover, liquidity is projected to continually rise through the forecast period as 3CE builds its rate stabilization account, providing additional cushion in the event of above-budget power costs or other expenses.

3CE indicated it is exploring the possibility of direct asset ownership through debt issuances. Management indicated it would pursue asset ownership to achieve greater project control while eliminating the need to rely on intermediaries for project scheduling and equipment deliveries. In addition, 3CE believes it would be able to better monetize directly owned assets while simultaneously being able to enhance local reliability. We would revisit our assessment of 3CE's debt and liabilities if the CCA added concrete plans to issue debt.

## **Related Research**

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

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