FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Snohomish County (WA) PUD No. 1's $100MM Elec Sys Revs 'AA-'; Outlook Stable

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Fitch Ratings - New York - 02 Jun 2021: Fitch Ratings has assigned a 'AA-' rating to the following Snohomish County (WA) Public Utility District No. 1 (the district) bonds:

--$100 million Electric System Revenue Bonds, Series 2021A (Tax-Exempt).

Bond proceeds will be used to fund a portion of the district's capital plans. Bonds are scheduled to price the week of June 07, 2021 via negotiated sale.

In addition, Fitch has affirmed the following ratings of the district at 'AA-':

--$356.9 million electric system revenue bonds series 2010A, 2011, 2012, 2015, and 2020A;

--$72.5 million generation system revenue bonds series 2010B, 2015 and 2020A;

--Long-Term Issuer Default Rating (IDR).

The Rating Outlook is Stable.

ANALYTICAL CONCLUSION

The 'AA-' rating reflects the district's very strong financial profile in relation to the very low operating cost burden, and stronger revenue defensibility due to the independent ability to adjust retail electric rates as necessary in its exclusive service territory. Financial performance in 2020 was healthy with leverage (measured by net adjusted debt to funds available for debt service) remaining consistent at 4.8x on steady cash flows. Retail electric sales in 2020 declined slightly (-1.2% yoy), but the associated revenue decline was more than offset by the year's strong wholesale sales.

The rating incorporates a degree of financial variability resulting from attributes associated with a hydroelectric system exposed to market sales that may vary significantly based on hydrology and market energy prices. The district purchases the majority of its energy supply from the Bonneville Power Administration (Bonneville, IDR AA-/Stable), which while very favorably priced, is the basis for the district's exposure to hydrology risk and a variable energy supply that delivers excess energy in some months.

CREDIT PROFILE

The district is the largest public utility district in the state of Washington by number of customers, serving just over 350,000 electric customers and 20,000 water customers across 2,000sq miles coterminous with Snohomish County (the county). The district is headquartered in Everett, WA, which is home to The Boeing Company's (Boeing, BBB-/Negative) Everett Factory -- the county's largest employer and the district's largest customer.

The district is composed of an electric distribution system, a generation system and a much smaller water system that accounts for less than 2% of system revenues. The three utilities are accounted for individually and issue separately secured debt. However, Fitch views the three systems as a consolidated utility, as presented in the combined fund in the district's financial audit, and does not distinguish the district's ratings based on security. Fitch's financial analysis and calculated metrics are based on the combined fund.

Coronavirus Impact Limited

Pandemic-related declines in commercial and industrial electric sales in 2020 (-6.9%) was largely offset by the increase in residential energy sales (3.4%) that make up a larger portion of energy sales. After strong wholesale energy sales in 2020 given the healthy water conditions, revenues and operating income both increased compared to 2019. Liquidity was not pressured given the minimal size of customer relief relative to budget, which included an increase in writing off bad debt, aging of past due bills, and the district providing customer relief of roughly $3.1 million during 2020.

KEY RATING DRIVERS

Revenue Defensibility: 'a'

Very Favorable Service Area; Wholesale Revenue Exposure

A large majority of revenue comes from the district's monopolistic sale of electricity to retail customers anchoring the strong assessment for revenue defensibility. A significant but manageable portion of operating revenue comes from more volatile wholesale sales into the competitive electric markets.

The 'a' assessment also considers the district's independent ability to adjust rates in a strong and exclusive service territory. Electric rates are expected to increase moderately in the next several years, largely to offset revenue declines from the expected load reduction at Boeing's Everett Factory. Electric bill affordability is very high given the county's above-average income levels, and this will remain the case through the considered rate increases.

Operating Risk: 'aa'

Very Low-Cost Hydroelectric Power Supply

The district's very low electric operating cost burden -- a Fitch-calculated 7.5 cents/kWh in fiscal 2020 -- benefits from power supplied largely through a favorably priced long-term contract with Bonneville. Bonneville's energy portfolio is highly concentrated in hydro-based assets exposing the district to hydrology risk and a variable energy supply. As such, operating flexibility is assessed as weaker but does not constrain the operating risk assessment at this time. The nearly entirely carbon free energy portfolio positions the district well to comply with the state's clean energy requirements. Renewable mandates in the state require the district to purchase a minimal level of renewable energy credits (RECs) given the restrictions on large hydro assets. Capital spending appears manageable and is primarily cash funded.

Financial Profile: 'aa'

Very Strong Financial Profile; Consistent Leverage

Leverage of 4.8x in 2020 is consistent with the past four years and remains supportive of the rating. Liquidity has declined since 2016-2018 but remains healthy with coverage of full obligations (COFO) of 1.65x and days cash on hand (DCOH) increasing to 167 days including the $119 million rate stabilization fund. Fitch's base case expects leverage to remain in the 5.0x-6.0x range given the upcoming period of larger capital plans and associated debt funding. Leverage could increase towards 7.0x in a stress scenario, which remains adequate for the rating. Liquidity is expected to remain consistent with current levels and above the district's minimum operating reserve policy of 120 days.

ASYMMETRIC ADDITIONAL RISK CONSIDERATIONS

There are no asymmetric additional risk considerations associated with this rating.

RATING SENSITIVITIES

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

--Sustained very low leverage settling below 5.0x in Fitch's base and stress scenarios;

--Improved revenue defensibility assessment due to increased importance of retail (non-competitive) revenues compared to competitive wholesale sales while maintaining financial performance.

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

--Leverage consistently over 8.0x in Fitch's base and stress scenarios;

--Inability to maintain financial performance and leverage the district's ability to manage the financial impact from variable wholesale sales, and retail electric revenues in a manner that maintains stable financial performance.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure 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

The electric system revenue bonds are secured by electric system revenues, subject to the prior payments of operating expenses of the electric system (including generation system power costs).

The generation system revenue bonds are payable from and secured solely by generation system revenue, which consist almost entirely of payments made by the electric system.

REVENUE DEFENSIBILITY

Fitch considers the district's revenue source characteristics strong with the large majority of revenue obtained from monopolistic retail electric sales. Reliance on revenue from more variable sources (market sales) are manageable, but expected to continue to vary. Market sales have accounted for between 5% and 10% of revenue over the previous six years. The nature of the district's long-term power supply contract with Bonneville, which serves the district with a slice of the Bonneville system, provides the district with an energy surplus in some months depending on regional water conditions. Surplus energy is sold into the competitive market.

SERVICE AREA CHARACTERISTICS

Fitch considers the district's service area very strong considering economic and demographic metrics and continued solid customer growth. Median household has trended higher in recent years to $86,691, or a stronger 138% of the national level, as of the most recent Census data available for 2019. Unemployment continues to approximate the national level through 2021 figures. The number of electric customers has shown 1.4% average annual growth over the previous five years.

Declining Load

Nevertheless, load is expected to decline over the medium term. Management reports significant conservation efforts in the district and continued load reduction forecasts for the Boeing Everett Factory, who accounts for a moderate 4% of the district's operating revenue. Boeing is also the county's largest employer, with about 35,000 workers, which presents a modest level of economic concentration risk in the county. The pandemic affected the aerospace industry disproportionally and was considered in Fitch's multiple downgrades of Boeing to 'BBB-'/Negative in 2020.

Boeing continues to reorganize its manufacturing plans for the factory including finalizing moving the 787 production out of the state and pushing back the production of the new 777X aircraft past 2025. The district reduced Boeing's forecast load roughly 10% from 2021 to 2025 -- a roughly $2 million revenue decline on $24 million in annual gross revenue from the company. Operations and electricity usage at the Everett plant resumed normal levels after a brief three-week shutdown during the initial stages of the pandemic.

Notably, the 737 MAX grounding problems did not affect district's performance as that aircraft is manufactured in the company's facility located outside the district's service area, about 40 miles south in neighboring King County. Fitch will continue to monitor the county's employment and economic metrics, which remain stronger despite the volatility.

RATE FLEXIBILITY

Rate flexibility is very strong. Retail rates for the electric system are established solely by resolution of the district commission and are not subject to any outside jurisdiction. The strong flexibility also benefits from the very affordable customer bills that average 1.3% of MHI. Residential electric rates, which provide over half revenue, are competitive at 105% of the residential state average according to U.S. Energy Information Administration data.

OPERATING RISK

The district's operating profile benefits from a long-term low-cost wholesale power contract with Bonneville, the largest power provider in the Northwest. Bonneville provides roughly 85% of the district's energy portfolio, most of which is supplied by hydroelectric resources, with a small portion from nuclear generation and balancing market purchases.

The district's energy resources are rounded out by ownership of several smaller hydro facilities in the district, purchase power agreements (PPAs) for renewables, and seasonal market purchases depending on hydro conditions. Fitch calculated the district's overall operating cost burden at a very low 7.5 cents/kWh in fiscal 2020.

OPERATING COST FLEXIBILITY

As with most Pacific Northwest public power providers Fitch rates, operating cost flexibility is assessed as weaker due to the hydroelectric concentration of the generating mix. The reliance on hydroelectric power supply creates the potential for future operating challenges or cost impacts, although no specific challenges are identified at this time and Fitch's operating cost assessment is not currently constrained by this asymmetric risk factor. The low-cost power supply portfolio is predominately carbon free, which positions the utility well for greenhouse gas emission-reduction efforts.

Bonneville Contract

The Bonneville purchased power contract, which includes both block and slice components, went into effect in October 2011 and extends through 2028. Bonneville's average cost to the preference customers was around 3.6 cents/kWh in 2019. The block product provides a monthly guaranteed energy amount, and the slice product provides the district with a specific percentage (5.45%) of Bonneville's actual output, causing the district to bear additional hydro-volatility risk depending on Bonneville's performance. The district also benefits directly when water conditions are favorable. The slice portion annually accounts for the larger percentage of the power purchases from Bonneville.

Management's forecast for power supply, assuming the extension of a Bonneville contract, is roughly sufficient to meet the district's retail needs through 2039 under relatively conservative water conditions. However, due to seasonal water conditions and the winter peaking nature of the retail customer base when hydro conditions can be at their worst, the district has considered various new small hydro projects to add to their generation system though none are including in the current integrated resource plan.

Generation System

The district-owned generation is composed of the Henry M. Jackson Hydroelectric Project (112MW, supplying about 5% of the district's energy needs) and four smaller hydroelectric projects (totaling about 20MW). The district's electric fund is the sole off-taker of the generation system, which passes operating expenses and debt service to the electric system through a purchased power agreement.

Environmental Considerations

In recent years Washington state passed a mix of renewable energy and carbon emission policies. The district's nearly entirely (roughly 97%) carbon free power supply positions it well to manage through carbon free mandates including the state's Clean Energy Transformation Act (CETA), which requires the state to achieve 100% carbon emission-free power supply by 2045, and the new carbon caps passed in 2021.

Additionally, the state's renewables targets (I-937) allows the district to meet a portion of the target through wind contracts and incremental hydro projects, but does not include large hydro projects as renewable. The district has purchased RECs to remain compliant with the targets since 2018. A new integrated resource plan expected in late 2021 will consider the need for additional generation and REC purchases depending on projections for long-term load. The cost of RECs included in current resource plans over the medium-term are not expected to affect Fitch's 'aa' assessment of the district's operating risk given the minimal costs to achieve the policy targets over the medium-term.

CAPITAL PLANNING AND MANAGEMENT

The district's age of plant of 15 years signals elevated lifecycle investment needs, which the district appears to be adequately addressing. The capital improvement plan (CIP) for the electric system totals $602 million for fiscal years 2021-2025. The majority of the electric system CIP is investment in the electric distribution system including $80 million for advanced metering infrastructure, followed by rebuilding community facilities for about $35 million, which drive the increased capex. Customer-requested capital investment of about $170 million is almost entirely offset by customer reimbursements.

The district estimates 70% of capex needs in the CIP will be cash funded, with the current $100 million debt issuance in 2021 and a $60 million debt issuance in 2022 or 2023 expected to fund the remainder of the plan. Additional generating and water system capital spending is more modest at a combined $45 million over the next five years.

FINANCIAL PROFILE

Financial performance in the district varies due to the district's hydroelectric-based resources. Financial performance over the five years through fiscal 2020 was stable with operating margins of 6% to 10% each year and a very low leverage ratio trending around 5.0x. The district continued to rapidly amortize debt over this period to about $417 million outstanding in 2020 from $611 million in fiscal 2015, making room for the current $100 million issuance and also a $60 million issuance planned for 2022 or 2023.

In 2020, liquidity remained healthy with COFO improving to 1.65x on declining debt service requirements. The district's customer-relief programs for 2020 cost $3.1 million, with limited additional relief expected for 2021. The district expects late fees and customer disconnects to be slowly reimplemented as the economy improves, which should improve outstanding bad debt expense.

Bad debt expense increased, but remains a very small portion of the budget. It was originally 1% of budget, and was adjusted to 1.4%, or roughly $6 million. Cash balances are in excess of the district's policy of maintaining an electric system operating reserve equal to 120 days of budgeted expenses, excluding power supply. The district similarly continues to exceed other financial policies designed to achieve DSC of at least 1.75x on the electric fund.

Fitch Analytical Stress Test (FAST) -- Base and Stress Cases

Fitch's FAST analysis considers the district's financial forecast as a starting point for the base case. Key ratios in the base case remain supportive of the rating, with leverage increasing slightly towards 6.0x as the district issues debt to fund increased capital plans before trended back towards 5.0x. Other base case assumptions include increasing purchase power costs from Bonneville with the district budgeting to fairly conservative P35 hydrology.

Additionally, the district forecasts a declining retail load given efficiency-driven declines in the service territory and projected load declines at the Boeing Everett Plant due to the postponed 777X program (a roughly 10% decline at the plant from 2020 through 2025). The district is forecasting general rate increases beginning in fiscal 2022 designed to make up for expected revenue declines. The district's rates were last increased in 2017.

Fitch's stress case includes a two-year decline in sales followed by recovery. In this scenario the district's leverage remains healthy for the rating, increasing towards 7.0x before trending back below 6.0x as sales recover in years three to five. Fitch, assuming management would intervene as necessary through revenue adjustments given both the historical practice and flexibility in rates, includes a minimal 1% retail rate increase in year one of the stress.

While Fitch's standard two-year demand decline stress may not be the most likely stress for a hydro-based system like the district, Fitch finds the significant level of reserves provide significant additional flexibility to address an alternative potential stress while remaining at the current rating level.

DEBT PROFILE

Fitch considers the district's debt profile neutral to the rating. Outstanding debt consists entirely of fixed-rate, amortizing debt structures. Long-term debt totaled approximately $309 million in the electric system, $73 million in the generation system and $12 million in the water system as of 2020.

Utility employees participate in the state's defined benefit pension plan, and Fitch includes the net pension liability (NPL) adjusted to Fitch's more conservative investment return assumption of 6% (compared with the plan's 7.4% assumption) in the leverage metric. The Fitch adjusted-NPL of $119 million is a moderate portion of the system's $917 million net adjusted debt as of fiscal 2020. A majority of net adjusted debt is the capitalized purchase power of $694 million that accounts for debt associated with long-term power purchase agreements with Bonneville.

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 ESG Relevance Score for Energy Management has been revised to a '3' from '2' to align with the public power portfolio. Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Snohomish County Public Utility District No. 1 (WA)	LT IDR	AA- Rating Outlook Stable	Affirmed	AA- Rating Outlook Stable
• Snohomish County Public Utility District No. 1 (WA) /Electric System Revenues/1 LT	LT	AA- Rating Outlook Stable	Affirmed	AA- Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 23 Feb 2021) (including rating assumption sensitivity)

U.S. Public Power Rating Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Snohomish County Public Utility District No. 1 (WA)	EU Endorsed, UK Endorsed

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