

# RatingsDirect®

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## Summary:

# Peninsula Clean Energy, California; Retail Electric

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## Summary:

# Peninsula Clean Energy, California; Retail Electric

### Credit Profile

ICR

*Long Term Rating*

A-/Stable

New

## Credit Highlights

- S&P Global Ratings assigned its 'A-' issuer credit rating (ICR) to Peninsula Clean Energy (PCE), Calif.
- The outlook is stable.

## Security

The ICR represents our view of the PCE's capacity and willingness to meet its financial commitments as they come due and does not apply to any specific financial obligation. PCE has no debt outstanding, nor does it plan to issue any debt in the near term.

## Credit overview

PCE is a joint powers agency (JPA) formed in 2016 to procure retail electric commodity on behalf of about 310,000 electric customers across 22 members that include 20 cities and towns in San Mateo County, San Mateo County, and Los Banos, in Merced County.

Although PCE operates as a JPA with many member communities, it simultaneously provides direct retail service to all of its customers (albeit through the billing systems and physical assets of the incumbent investor-owned utility [IOU].) Given this direct retail service, S&P Global Ratings views PCE's creditworthiness under the scope of our retail electric criteria.

The rating reflects our view of PCE's protective JPA agreements with 22 members (the agreement includes a six-month termination notice and the continued financial obligation of any departing member), the strong overall participation rate of 97%, and a portfolio of contracted low- and no-carbon-emitting resources through various long-term power purchase agreements (PPAs). Because of high power costs and an unfavorable power charge indifference adjustment (PCIA) payable by PCE customers to the incumbent IOU, Pacific Gas & Electric Co. (PG&E; BB-/Stable/NR), for legacy PPAs pre-dating PCE's creation that contemplated retaining the customers who migrated to PCE, reserves declined and fixed-charge coverage (FCC) fell below 1.0x in both fiscal 2021 and 2022. We believe the PCIA charge can reduce rate-making flexibility. Management built up cash to use in lieu of increasing rates, consistent with PCE's strategy to maintain a 5% rate discount relative to PG&E. Nevertheless, year-to-date 2023 results and management's financial forecast indicate FCC will improve because of a decline in the PCIA and an increase in PG&E's generation rate in fiscal in 2022. PCE expanded to Los Banos in 2022 and is analyzing the feasibility of further expansion in Merced County, though management notes any expansion would not occur until 2026 or 2027 at the earliest. Further expansion could add risk related to participation rates, power procurement,

electric rate competitiveness, and costs.

The rating further reflects PCE's credit strengths including:

- A large customer base with robust income levels;
- A track record of solid customer retention since 2016;
- Protective JPA member agreements with municipalities that create economic barriers to exiting PCE, but tempered by the relative ease with which retail customers can return to PG&E;
- A diverse power supply through 16 PPAs, of which 90% expire in greater than five years, although we note there is concentration in solar and wind, which can present intermittency issues that we believe geographic diversity and performance parameters temper;
- Long-term financial forecasting, an investment policy, and an internal financial reserve policy;
- 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; however it could affect reliability and PCE customers could face higher transmission and distribution costs charged by PG&E for wildfire costs, which we also believe could limit PCE's rate-making flexibility; and
- Core mandate to provide renewable power, which positions PCE well for California's renewable portfolio standard (RPS).

Offsetting these strengths include PCE's:

- Direct competition with PG&E, which we believe constrains PCE's rate-setting flexibility. PCE targets to maintain rates 5% below PG&E's, which has resulted in stressed financial performance including FCC below 1.0x and use of reserves. Although management has a strategy of using reserves to maintain a steady 5% discount, it has resulted in volatile and uneven FCC, which we view as a credit weakness;
- Sufficient reserves when including medium-term investments (one- to five-year tenure) at \$135 million (inclusive of \$107 million in investments), equivalent to over 200 days of operating expenses; however, in our opinion frequent use of reserves to defray higher costs is a credit pressure. Moreover, the inherent risks associated with customer retention, rate-setting, and power supply procurement necessitate an enhanced level of reserves; and
- Power-procurement challenge 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 community choice aggregator (CCA) and retail customers migrating back to the incumbent PG&E. No members have exited to date, and management does not believe a departure is likely given the financial penalty for doing so. PCE's members' aggregate retail customer opt-out rate has been 3% since inception in 2016; and
- Power supply that is largely concentrated in solar and wind, which are intermittent resources, although we believe diverse counterparties and performance standards mitigate this risk somewhat. Lastly, we consider PCE's large commercial load a less stable revenue source than a primarily residential customer base.

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

We believe that PCE faces limited environmental risks. Purchases of low- and no-carbon resources make up almost all PCE's 2022 energy needs (including geothermal, hydroelectric, wind, and solar), ECOplus service is over 50%

renewable, and PCE's ECO100 is 100% renewable. We believe PCE's current and projected energy portfolio positions the utility favorably relative to California's stringent and continually evolving regulatory landscape. Although direct wildfire liability risk is low because PG&E continues to own and operate the transmission and distribution functions, public safety power shutoffs by the owners of the transmission and distribution systems serving PCE's customers could nevertheless adversely affect the reliability of customers' electric service, and it is likely that PG&E would socialize the costs of wildfire liability claims across all users of its transmission network.

We believe PCE faces slightly elevated social risk. Although residential rates are below those of PG&E, we note that PG&E's rates are elevated (124% of California's average retail system rate in 2021), which could weigh on financial flexibility. However, this is mitigated somewhat by well-above-average effective buying incomes across PCE's territory. Adding to social pressures, S&P Global Ratings projects that the U.S. economy will likely fall into a shallow recession in 2023, tempered by generally strong labor demand. (See "Economic Outlook U.S. Q2 2023: Still Resilient, Downside Risks Rise," published March 27, 2023, on RatingsDirect.) Consequently, we continue to monitor the strength and stability of power utilities' revenue streams for evidence of delinquent payments or other revenue erosion because rising consumer prices and interest rates are whittling discretionary incomes.

Finally, we view the PCE's governance factors as generally credit neutral, as they include robust JPA member agreements that limit both the ability and incentive for member departure, long-range planning, and policies. Nevertheless, it is our opinion that management's current strategy of maintaining a 5% competitive position compared to PG&E has resulted in an ephemeral financial deterioration in 2021-2022, and that the potential for retail customer opt-out is beyond management's control and tempers our view of the CCA's governance factors somewhat. We note that this opt-out rate has remained low--with overall participation rates at or above 97%.

## Outlook

The stable outlook reflects our anticipation of a significant rebound in FCC due to the large reduction in PCIA and the increase in PG&E's generation rate in 2023, an increase in reserves, management's plan to undergo a rate study, and a resource portfolio that limits the utility's exposure to increasingly stringent emissions regulations and competitive and potentially volatile wholesale markets.

### Downside scenario

We could lower the rating if opt-outs increase throughout the service area, PCE faces significant power supply counterparty nonperformance, or cost recovery is insufficient, resulting in deterioration in PCE's FCC, reserves, and/or competitive position. We could also lower the rating if the inherent risks of setting rates below those PG&E should translate to continued unevenness in financial performance or if future expansion efforts result in material financial deterioration due to overprocurement and/or high opt-out rates.

### Upside scenario

Although unlikely during our two-year outlook horizon, given recent weak financial performance in fiscal 2021 and 2022, we could raise the rating if we see a track record of consistently robust FCC with only modest dependence on reserves.

## Credit Opinion

PCE was formed to provide clean and renewable power to its members at a competitive cost, while also generally reducing greenhouse gas emissions and stimulating the local economy. PCE provides service as a CCA under the California Public Utilities Code Section 366.2. Under the code, all of the incumbent IOUs' customers automatically become PCE customers, but have the option to opt out and return service to the previous provider, PG&E.

Importantly, PCE does not own, operate, or maintain any of the generation, transmission, or distribution infrastructure used to serve its customers. 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.

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 agreed to this stipulation before joining the CCA, and we believe the exit fee serves as a disincentive to member communities to terminate their contracts with PCE.

### Enterprise risk

Most customers reside in San Mateo County, where income metrics are robust and the median household effective buying income of the top five members was 178% of the U.S. average in 2021, based on a weighted-average basis. No single retail customer accounted for more than 3% of energy sales in 2022, providing further revenue stability. These factors are somewhat offset by PCE's commercial concentration, which accounts for about 60% of energy sales. In our view, this customer mix translates to a less predictable revenue stream for the CCA. As noted, PCE started serving Los Banos in 2022 and the current participation rate is about 89%, above the estimated 85% (based on historical initial participation rates). PCE is analyzing the potential expansion to Merced County; influencing future expansion are renewable energy projects near the new customer base, a complementary load, and the prospect of bringing benefits of cleaner energy throughout these communities.

CCA customers are obligated to directly reimburse the incumbent IOU in the form of an exit fee, the PCIA. The PCIA was established to ensure the IOU's remaining bundled customers do not disproportionately 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 difference between the actual portfolio cost and the market value of the IOU's portfolio, as calculated using CPUC methodology.

PCE sets rates at a discount (about 5%, since launch) compared with those of the incumbent IOU, PG&E. PG&E's rates were 124% of the state average in 2021, according to the U.S. Energy Information Administration. We understand PCE has been willing to increase rates but has continued with its strategy of maintaining a 5% discount to PG&E. The strategy has been to use reserves to maintain the 5% discount when the PCIA change is unfavorable, resulting in expenses that exceed revenues.

PCE customers have energy choice from PCE including the ECOplus, which is the default option and is 50% renewable and 100% clean energy, and ECO100, which is 100% renewable and carbon-free. An ECOplus residential pays a total

bill of about \$141 (\$57.27 for electric generation, \$1.84 PG&E added fees, and \$81.89 PG&E electric delivery). PCE is undergoing a formal rate study later in 2023 and will continue to review rates frequently.

Whether due to PCE's desirable product or a dissatisfaction with PG&E, just 3% of PCE customers have opted out, choosing to return to PG&E. We believe the maintenance of rates below those of PG&E helps support this participation rate. Due to the direct competition with PG&E, we believe PCE's rate-raising flexibility is constrained, as any significant rate increase could result in an increase in the opt-out rate, which, if substantial, could have negative rating implications. 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.

PCE's power portfolio consists of 16 current PPAs with no single contract accounting for more than 15% of total load, and with nine contracted PPAs with start dates between 2024 and 2026, some of which include solar plus storage. PCE's contracts consist of geothermal, hydro, solar, and wind. In our opinion, there is some lack of purchasing flexibility given that under state mandate, PCE must secure 65% of its RPS-compliant power supply under 10-year or longer contracts as of 2021. Although we generally view positively the long-term price certainty these contracts provide, the possibility of customer dislocation, coupled with this mandate, could result in PCE 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, PCE 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. PCE staggers its PPAs to temper the exposure of retail or wholesale customer departures.

Furthermore, PCE has met its resource adequacy procurement compliance, but we note there could be financial penalties if PCE does not comply and note California's increasingly stringent procurement mandates.

### **Financial risk**

PCE has no debt outstanding and no debt plans. However, S&P Global Ratings calculates an FCC ratio, which treats a portion of power purchases as fixed to reflect the provider's pass-through of its fixed costs incurred. PCE's FCC during fiscal years 2019-2022 was 0.9x, 0.9x, 1.5x, and 1.6x, respectively. Forecasts suggest FCC will improve significantly in fiscal 2023 and 2024 to above 1.8x and taper off to between 1.2x and 1.3x afterward. Forecasts assumes the forward price curve, 100% renewable procurement by 2025, Resource Adequacy purchases at market prices in all months, and maintenance of favorable PCIA's.

In fiscal 2022, total reserves equaled \$135 million, equivalent to about 200 days of operating expenses. Of this amount, \$107 million is comprised of medium-term investments with an overall tenure of approximately 2.5 years. We understand these investments are unrestricted and can be used for operating expenses, but we note that depending on interest rates, the mark-to-market could result in a realized loss if they are drawn upon. Management projects total reserves will continue to rise in fiscal year 2023 to \$244 million (inclusive of investments). It has been PCE's strategy to build up cash and draw it down during times when power costs are high or PCIA fluctuations are unfavorable in order to maintain the 5% discount to PG&E's rates, which occurred in 2021 and 2020. We would view as a credit negative a reliance on significant ongoing use of reserves. Additionally, although distribution-only utilities generally require less

cash than their vertically integrated counterparts, we believe PCE's inherent risks associated with customer retention, rate setting, and power supply procurement necessitate an enhanced level of reserves.

## **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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