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Ratings

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Summary:

Chugach Electric Assn., Alaska; CP; Rural Electric Coop

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Credit Profile		
Chugach Elec Assoc cml pap due 10/10/2041		
Short Term Rating	A-1	Affirmed
Chugach Elec Assoc ICR		
Long Term Rating	A/Stable	Upgraded

Rationale

S&P Global Ratings raised its issuer credit rating (ICR) to 'A' from 'A-' on Chugach Electric Assn., Alaska. We also affirmed our 'A-1' short-term rating on Chugach's commercial paper (CP) program. The outlook, where applicable, is stable.

The rating action reflects our view of Chugach's consistently good financial performance, declining leverage, continued strong competitive position, and successful management of its transition to a mostly retail utility over the past three years. The rating action also reflects our view of Chugach's positive and supportive relationship with the Regulatory Commission of Alaska (RCA), which regulates rates.

The rating further reflects our view of Chugach's:

- Consistently good fixed-charge coverage (direct amortizing debt plus off-balance-sheet capacity payments related to purchased power) of about 1.4x over the past four fiscal years (2013 to 2016), which is projected to remain near these levels under what we believe are conservative assumptions on load growth and rate increases;
- Declining leverage, with debt balances totaling $535 million as of Sept. 30, 2017, down from $604 million in 2011with management forecasting further declines, and with debt to capitalization of 74%, down from 79% in 2011.
- Good competitive position, with rates 18% below the state average according to 2015 data from the Energy Information Administration (EIA) and among the lowest in the railbelt, and given the absence of direct retail competition;
- Relatively diverse, semi-urban retail service territory near Anchorage, the state's most populous city and center of economic activity;
- Ability to use the simplified rate filing (SRF) process for adjustments to base demand and energy rates, which provides for timely cost recovery, and ability to pass through fuel costs each quarter through a fuel-cost adjustment charge, which helps offset Chugach's dependence on gas-fired generation; and
- Reduced capital spending requirements, with total planned capital spending of $172 million for fiscal years 2017 to 2021 versus a much higher $299 million during fiscal years 2012 to 2016.

Partly offsetting the above strengths, in our view, are Chugach's:

- Inherent risks related to its remote location with no outside transmission access to other regional power grids,

which requires Chugach to maintain ample system capacity;
- Regulatory environment whereby the Regulatory Commission of Alaska (RCA) limits Chugach's interest coverage target for setting wholesale and retail rates; and
- Natural gas supply challenges, partly as a result of expected declines in production in Cook Inlet, which supplies Chugach the bulk of its fuel requirement (however, recent investments in gas drilling in the region and other acquisition strategies have helped diversify and increase the cooperative's supply prospects).

As of Sept. 30, 2017, Chugach had approximately $457 million in debt outstanding, consisting mainly of first mortgage bonds. In addition, it reported $51 million of CP outstanding.

Anchorage-based Chugach is Alaska's largest vertically integrated electric utility, with 68,215 retail members (but 83,855 meters) and significant total generating capacity in a region with no outside transmission access. Chugach serves a moderately urban and growing service territory, mainly around Anchorage. Whereas in 2013 sales were almost evenly divided between Chugach's retail system and contract wholesale sales (composed of two distribution cooperatives and a single municipal electric utility), these sales declined to 18% of revenue in fiscal 2015 and just 3% in 2016 as a result of the expiration of cooperative contracts. Management's forecast through 2021 indicates that about 3% of total operating revenue will come from energy sold to the City of Seward, as was the case in 2016. Chugach's own service territory is semi-urban with modest growth rates, moderate wealth indicators (median household effective buying income is 49% above the U.S. average), and no significant customer concentration. According to September 2017 data, Anchorage's unemployment rate was 5.8%, lower than the state's rate of 7.2% but well above the national rate of 4.2%.

In terms of retail sales revenue, residential and commercial were evenly split in 2016 but commercial customers represented 55% of retail sales and 51% of total energy sales. Retail sales have declined about 1% per year since 2006, and management's forecast assumes additional slight declines of 1.2% annually through 2020 tapering off to annual declines of 0.3% in 2021 to 2027. Management attributes slow economic growth, energy efficiency, and conservation to the declines. Wholesale sales, after averaging 1% annual growth in 2006 to 2014, have declined significantly, as indicated above. Chugach's contract with Homer Electric Assn. (HEA) ended at the end of 2013, and its contract to serve Matunaska Electric Assn. (MEA) expired on April 30, 2015. Chugach also sold non-firm energy to Golden Valley Electric Assn. (GVEA) from 1989 to March 31, 2015. These losses have been incorporated into management's long-term forecasts and have been part of Chugach's rate filings. In our view, Chugach has demonstrated the ability to withstand the lower sales levels, as financial metrics remained stable and good in fiscal 2016. Chugach continues to supply most of the power requirements of Seward, and the agreement includes automatic five-year extensions unless written notice is provided a year in advance. Wholesale energy sales to Seward are forecast to decline at the same annual rates as retail energy sales, indicated earlier, but the forecast includes no other non-member sales. Overall system (mostly retail) peak demand was 200 megawatts (MW) in 2016, down from 475 MW in 2012 and 358 MW in 2014.

Chugach's owned power resources as of 2016 consisted of 531.2 MW of installed generating capacity provided by 16 units at five of its owned power plants, with 87% fueled by natural gas and 13% hydroelectric. On an actual energy basis for 2016, 77% stemmed from natural-gas-fired generation, mostly from Chugach's key baseload resource, the Southcentral Power Project (SPP) three-on-one combined cycle power plant. Chugach had a 70% stake (140 MW) in the SPP, which became commercially operational on Feb. 1, 2013. SPP, currently one of the most efficient power plants in the state, was built to replace older, less efficient generation and to reduce emissions. Availability factors for SPP's four units averaged 94% in 2016. With SPP in operation, Chugach's other key natural-gas-fired resource, the six-unit Beluga Power Plant (BPP), is largely used for peaking. The BPP has a combined capacity of 332 MW and had an average availability factor of 90% in 2016. Chugach also has a small amount (28.2 MW) of peaking capacity from its International Station Power Plant (IGT), but IGT rarely operated in 2016. Balancing out Chugach's resource portfolio is hydroelectric energy from its owned Cooper Lake (19.2 MW) and Eklutna (11.7 MW) hydroelectric plants. Chugach also participates in the Alaska Energy Authority-owned Bradley Lake Hydroelectric Project, where it has a 27.4 MW, or 30.4%, share of the output in exchange for a take-or-pay obligation of 30.4% of annual project costs, regardless of output. Wind energy from Chugach's 17.6 MW share of the Fire Island Wind Project accounted for a minor 3% of energy in 2016.

Challenging Chugach's operating profile are its heavy reliance on gas-fired generation and the need for high reserve margins in a transmission-remote region. The utility's fuel adjustment mechanism, which mitigates fuel price volatility significantly, remains critical to consistent and good financial performance. Another challenge is managing gas supply from the Beluga and other gas fields. However, Chugach's recent acquisition of a share of the Beluga River Unit from Conoco Philips Alaska Inc. includes additional gas reserves, and the installation of more efficient gas generation in 2013 is a positive development for Chugach's long-term fuel supply situation.

Competitive pressures are limited, given the absence of direct retail competition in Alaska. Its only meaningful competitor is Anchorage Municipal Light & Power (MLP), whose retail system is adjacent to Chugach's. Although neither utility is subject to direct retail competition, MLP and Chugach compete to attract and retain large commercial and industrial loads, and thus have similar commercial and industrial retail rates. In contrast, Chugach's wholesale business is subject to competition, and wholesale sales have declined significantly in recent years as some utilities seek other options. However, reductions in sales and capacity needs will allow the utility to retire some of its older, less efficient generating assets. Chugach's all-in system rates on a weighted average basis were a competitive 82% of the state average in 2015, and, according to other data provided by management, Chugach's residential rates are one of the lowest in the railbelt.

The RCA regulates retail and wholesale rates, and has approved several Chugach rate filings in the past few years. The commission has allowed the utility's quarterly-reset fuel cost adjustment surcharge, which has insulated it from fuel price volatility since its implementation in the early 1990s. Significantly, Chugach has obtained approval from the RCA to reestablish a simplified rate filing process that permits quicker rate filings based on revised cost estimates, subject to annual limits of 8% and a cumulative three-year limit of 20%. Neither the existing quarterly gas cost adjustment nor rate cases based on allowed rate of return are eligible for the simplified process. We believe that the simplified process, as approved, reduces regulatory risk.

Management reports that Chugach's 140.1 MW share of the gas-fired Southcentral Power Project has significantly reduced fuel expenditures since commercial operation began in 2013, as a result of the more efficient combined cycle units, and expects the savings to largely offset the debt service costs. The addition of this asset to Chugach's portfolio enabled Chugach to replace older simple-cycle units. Chugach issued $250 million of long-term first mortgage bonds to fund its 70% stake in the plant.

In our view, Chugach has maintained good, consistent financial metrics at levels commensurate with the raised rating. For fiscal 2016, we calculate fixed-charge coverage, which inputs purchased power debt or capacity payments as debt service rather than as an operating expense, at 1.4x, consistent with the prior three years. According to management's forecast, we calculate fixed-charge coverage of about 1.3x during fiscal years 2017 to 2021, although we believe the forecast is conservative given its load forecast, the lack of economy sales being budgeted, and Chugach's rate flexibility. While debt service requirements increase to $51 million in 2020 from $45.5 million in 2016, they decline in 2021 by about $8 million; this is expected to improve fixed-charge coverage to more than 1.4x. We would view a significant departure from recent actual fixed-charge coverage ratios as a key source of rating pressure.

Unrestricted cash and investments totaled $15.1 million, equal to an adequate 41 days of operating expenses, as of Dec. 31, 2016. Chugach also has access to $50 million in a committed line of credit expiring in 2022, for combined liquidity of $65.1 million, or 148 days of operating expenditures, which we view as good. The credit lines above exclude those supporting the utility's $150 million CP program. The program was established to provide access to capital to refinance large bullet maturities, which no longer exist, and remains in place to provide interim financing for capital projects.

Capital spending is declining, as are debt balances, and these trends bode well for credit quality, in our view. Capital spending over the fiscal 2012-2016 period was $299 million, but is forecast at a much lower $172 million over fiscal years 2017 to 2021. Debt balances totaled $535 million as of Sept. 30, 2017, down from $604 million in 2011, with management forecasting further declines to $421 million by 2027. Debt to capitalization as of Sept. 30, 2017 was 74%, down from 79% in 2011, and is projected at 71% by 2021 and 65% by 2027.

In October 2008, Chugach's board authorized the issuance of as much as $300 million of CP as unsecured obligations. The current authorized amount is $150 million, with liquidity provided by several financial institutions under a credit agreement that runs through June 13, 2021. The credit agreement provides for $150 million of liquidity support, corresponding to the authorized CP. While the agreement does not bar Chugach from issuing CP in amounts beyond the commitments under or maturing beyond the agreement's expiration, the CP rating reflects our view of the utility's plan to issue CP that benefits liquidity support. The issuing and paying agent agreement, however, limits CP issuance if the amount outstanding will exceed the sum of bank commitments. The banks can terminate liquidity support if prescribed events of default occur, but in the absence of a Chugach insolvency the banks cannot terminate their commitments to cover CP outstanding. Because their obligations to provide liquidity support could terminate before the agreement's termination, the short-term CP rating reflects Chugach's capacity to service short-term obligations, rather than the banks' credit quality. In the event of a Chugach insolvency proceeding, the liquidity facility will terminate automatically. As of Sept. 30, 2017, the CP program had $51 million outstanding.

Outlook

The stable outlook reflects our assessment of Chugach's good financial metrics and good total liquidity. We also expect that, over the next two years, Chugach will continue to obtain adequate rate relief and regulatory support for cost recovery needs, enabling it to achieve satisfactory margins as it continues to serve a mostly retail customer base.

Upside scenario

We do not expect to raise the rating in the next two years given that we don't expect fixed-charge coverage or liquidity to improve materially, and given its operating risks. However, if the utility's equity and fixed-charge coverage strengthen materially to levels we believe will be sustained, we could raise the rating.

Downside scenario

Rating downside is unlikely over the next two years given Chugach's reduced capital needs, declining debt burden, and strong track record of cost recovery from RCA rate filings. But if coverage metrics decline, liquidity materially erodes, or leverage significantly increases, we could lower the rating.