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Summary:

Merced Irrigation District, California; Retail Electric

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Summary:

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US$62.375 mil elec sys rfdg rev bnds ser 2015A due 09/01/2036		
Long Term Rating	A-/Stable	New

Rationale

Standard & Poor's Ratings Services assigned its 'A-' long-term rating to Merced Irrigation District, Calif.'s $62.4 million series 2015A electric system refunding revenue bonds. The outlook is stable.

The rating reflects our view of the district's:

- Very strong fixed-charge coverage estimated at 1.9x in fiscal 2014 and 2.0x in fiscal years 2013 and 2012, with forecast fixed-charge coverage generally consistent with these metrics;
- Very strong and improved liquidity position, with $34.5 million, or 330 days' cash, as of audited fiscal 2014, estimated at $36.7 million, or 324 days' cash, in fiscal 2015 ended March 31, 2015 and forecast to improve to as much as 450 days' cash by 2020;
- Competitive rates versus those of local investor-owned utility and direct competitor Pacific Gas & Electric (PG&E), with residential, commercial, and industrial rates 15%, 29%, and 29% lower, respectively, reducing competitive pressures such as the risk of customers switching;
- Expanding and diversifying service area economy that retains a strong core of agricultural employers; and
- Prudent management policies that support strong financial metrics and power purchase decision making.

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

- Limited rate-making flexibility despite below-average rates as a result of below-average income levels and competitive pressures related to the presence of a direct retail electric competitor, PG&E, in the district's service area, which is highly unusual for a public power entity;
- High debt burden at 74% debt to capitalization, or $10,369 per customer, with debt set to almost double if the district moves forward with a large $65 million transmission project;
- Limited control over power supply costs given that the district's supply consists entirely of purchased power contracts that must be renewed from time to time, although we recognize that this also reduces plant operating risks; and
- Somewhat shallow economic base with top customer concentration and significant (88%) concentration of load in nonresidential customers.

The 2015A bonds are secured by net revenue of the electric system.

The district had $82.6 million in balance-sheet debt as of fiscal 2014. Proceeds of the 2015A bonds will refund the district's series 2005 bonds and 2013 loan agreement, as well as fund a debt service reserve fund funded at $4.6 million

and pay costs of issuance. Once issued, the bonds will be on parity with the district's series 2012 electric revenue refunding bonds, outstanding in the amount of $10.2 million.

Merced Irrigation District covers 154,000 acres in the central San Joaquin Valley of California, centered around the City of Merced (population: near 81,000). The district was organized in 1919 under the provisions of the Irrigation District Law and, among other business lines (water and hydroelectric; net revenue not pledged to the bonds), owns and operates a retail electric system that serves portions of the district. The local economy is concentrated in the agriculture sector, with the leading employer Foster Farms (3,710 employees), followed by University of California, Merced (1,879), the county (1,821), Mercy Medical Center (1,255), and Merced County Office of Education (1,254). Also among the top 10 employers are Dole Packaged Foods and Liberty Packing Co. LLC. County unemployment is high at 13.5% as of February 2015, well above the state's 6.8% and nation's 5.5%. Merced County median household effective buying income is 88% of the national median, which we consider adequate. The leading 10 customers represented a concentrated 49% of operating revenue in fiscal 2014, with the leading two customers representing 24% on their own, although this is a decline from 29% in fiscal 2009. Energy sales are highly concentrated in commercial and industrial customer segments, representing 37% of energy sales each, with residential at 12% and the balance consisting of municipal and other customers totaling 14% (nonresidential loads account for 88% of energy sales).

In 1990, the district was asked to buy and distribute electric power to customers concerned about the high cost of power obtained from local investor-owned electric utility PG&E. In response, in 1996 the district signed an interconnection agreement with Turlock Irrigation District (TID), whose electric service area is immediately north of the district. The district subsequently constructed the Merced-Turlock 115-kilovolt Intertie, which provides an interconnection to TID's system. Later that year, a substation was added, and the district began delivering 10 MW of power to Foster Farms. Foster Farms has recorded substantial cost savings as a result of switching from PG&E, as have other customers.

Since beginning service in 1996, the district has focused on serving commercial, industrial, agricultural, and residential customers in the area, primarily in the cities of Merced, Livingston, and Atwater. Unlike PG&E, which is obligated to serve customers who request electric service, the district is not obligated to provide service and has chosen to serve customers only where it is economical to do so. (The district typically desires a payback period of five years or less.) To this day, the district is not the sole provider of retail electric service within the district, a structure that is unusual for public power credits. The district serves about 8,200 customers within the district, while PG&E serves the remaining customers. The total number of accounts served by PG&E in the district is not known, but the district estimates that PG&E's load served is about 200 MW, which is about twice as large as the district's load served.

The district reports that since the creation of the system, approximately 770 commercial and industrial customers have switched from PG&E to the district's electric system, while only one commercial and industrial customer has done the reverse. Residential customers generally can't switch; when new homes are built, if the developer of a subdivision decided to go with Merced (most cases), deciding to later switch to PG&E generally isn't an option. For existing residential customers served by PG&E, very few, if any, were converted, given that many were remote and far apart. Merced focuses on new subdivisions of residential growth, and commercial and industrial customers. The district reports that for PG&E to take away customers from the district, PG&E would either need to buy the district's

infrastructure or build its own; this makes competition for existing residential customers cost prohibitive such that competition for such small loads is highly impractical. For many case in which nonresidential customers switch back to PG&E, the district and PG&E have some infrastructure in place already. However, new substations and transformers would need to be placed into service at the cost of the new provider of electric service, which may also be costly, for either PG&E or the district, although for greater load. Generally, most commercial and industrial customers have a choice of electric provider, and although the district currently has a substantial 29% cost advantage, there is no guarantee this advantage will be maintained or that customers won't switch for other reasons.

Growth in accounts was relatively slow from 1996 to 2003, as the district focused on infrastructure construction. Total accounts grew to about 2,500 by 2003, but tripled to more than 7,500 by 2007. From 2009 to 2014, account growth was slower at about 1% to 2% annually, as the majority of targeted customers had been converted. Energy sales during the same period grew at a rate of about 1.85% per year, while revenue was generally flat. Management has budgeted account growth at about 1% annually through 2010, with energy sales growing at 2% to 3% annually.

The district is a distribution-and-transmission-only system, with no owned generation. About 97% of the district's power supply is provided through a full-requirements power sales agreement with TID, expiring on April 30, 2017. This agreement provided the district with 464,816 MW-hours (MWh) of energy in fiscal 2014, 3% above the district's native demand. The fuel mix for this power source is unidentified; TID can source the power from any of its own resource or buy the power on the market. The balance of power (3%) is provided by a power sales agreement with Western Area Power Authority (WAPA) for hydroelectric power expiring on Dec. 31, 2024. The WAPA contract is the district's least costly resource. Both contracts are being negotiated for an extension, but the district is also considering other power supply alternatives, including a possible connection to the California Independent System Operator grid. We note that there is no guarantee that the terms of the contracts will carry over to future agreements. The district also has a 25-year power purchase agreement with Iberdrola renewables for as much as 5 MW of wind energy, terminating in October 2028. All power purchased under this agreement is sold back to Iberdrola at a small loss each year, but the district receives the renewable energy credits. Although California law requires the district to comply with renewable portfolio standards (RPS), including serving no less than 33% of loads with eligible renewable resources by 2020, the district is attempting to convince regulators that RPS requirements for the district are not in the best interest of its residents and customers as a result of the service area's economic limitations. In the event the district must comply, we anticipate that the impact of the cost of acquiring more expensive renewable energy would be manageable given that this cost is already being collected on customer bills through an environmental charge, which includes a component to cover the cost of emissions credits under Assembly Bill 32 and RPS costs.

The district has full rate-making autonomy, which PG&E lacks, and, in our view, the district's board has demonstrated a willingness to raise rates to meet financial targets. Since 2009, no base rate adjustments have been made, given that the cost of power has declined from about $78 per MWh to about $60 per MWh. The district is undergoing a rate study that should be complete in fiscal 2016, but no rate increases are assumed in the district long-term financial forecast through 2020 (although rate increases are likely). The environmental cost adders on residential customer bills amount to about $5 per month for an average customer. The district also has a power cost adjustment (PCA) mechanism used to capture cost fluctuations of purchased power; the PCA is adjusted every six months. Residential rates are 15% below those charged by PG&E, while commercial and industrial rate are even more competitive at a 29% discount to

PG&E's. Management anticipates that its rate advantage will continue, but we note that, given the ability of some customers to switch, this direct competition is a credit weakness. With PG&E in direct competition, several scenarios could occur in which PG&E's rate could become more competitive with the district's to the point that customers switch (or that reliability concerns alone, if any, could lead to switching), even in cases in which switching would be onerous.

As power costs have declined and revenue has remained flat, financial margins have improved and resulted in very strong debt service coverage and fixed-charge coverage during fiscal years 2009 to 2014. This has also allowed the district to bolster its cash reserves substantially. Debt service coverage in fiscal 2014 was 2.18x, and, when considering fixed-capacity payments paid to TID (the planning reserve charge component of TID purchased power) as debt rather than as an operating expense, we calculate fixed-charge coverage at 1.9x for fiscal 2014. The district's financial forecast indicates debt service coverage will range from 1.8x to 3.2x during fiscal years 2015 to 2020, and we estimate fixed-charge coverage at a range of 1.8x to 2.5x, or an average of 1.91x. The financial forecast assumes the district will issue an additional $65 million later in fiscal 2016 to fund a transmission project, and debt service is forecast to increase 74% in fiscal 2017 as a result of this. Nonetheless, financial metrics will remain, in our view, very strong.

The district's liquidity position has grown substantially in the past several years despite a lack of base rate increases and the use of power cost adjustments and environment costs adders on bills, and because of a decline in the cost of power to about $60 per MWh as of fiscal 2015 from about $78 per MWh in 2009. Based on audited fiscal 2014 figures, unrestricted cash (recorded on the balance sheet under the account due from other funds) was $34.5 million, or 330 days' cash, up substantially from $26 million, or 227 days' cash, in fiscal 2013, $18.7 million, or 189 days' cash, in fiscal 2011, $13.9 million, or 125 days' cash, in fiscal 2010, and just $8.2 million, or 66 days' cash, in fiscal 2009. The district's cash projections indicate that balances will continue to improve, reaching $42.2 million, or 383 days' cash, in fiscal 2017 and $55.3 million, or 450 days' cash, by fiscal 2020. Current cash reserves are well above the district's reserve policy, which requires the maintenance of no less than 25% of power costs, 1% of net capital assets, 45 days of operating costs, $1.1 million for new customer growth, and $5 million for capital system support and growth. Under these policy targets, minimum reserves estimated for March 31, 2015 are $15.8 million. The district also has formalized financial management policies with regard to debt issuance, risk management, and investments that we deem strong.

The district's debt burden is high given the relatively young age of the system, with debt per customer of $10,369 and 74% debt to capitalization. The district has no off-balance-sheet debt, but did enter into two direct purchase agreements (bank loans), one of which, series 2012, will remain outstanding upon the issuance of the series 2015A bonds. Based on our analysis of the 2012 loan agreement with Rabobank N.A., its events of default, and the remedies therefor, we view contingent liquidity risks as manageable. In our view, the risk of triggering any of the various events of default are either already factored into the current rating or viewed as less likely than a two-notch lowering of the rating. Following this issuance, about $72 million in debt will be outstanding, but total debt outstanding could almost double to about $140 million if the district decides to finance in full its $65 million Southern Transmission Project. No other debt is planned.

Outlook

The stable outlook reflects our anticipation that, during the next two years, financial margins will remain strong and capital needs will be manageable. In our view, the district's high debt burden and plans to issue additional debt, as well as its unique competitive position and concentrated customer base, make a higher rating unlikely during the next two years. But, at the same time, we don't anticipate lowering the rating during the next two years given the district's very strong financial metrics.

Related Criteria And Research

Related Criteria

- USPF Criteria: Electric And Gas Utility Ratings, Dec. 16, 2014
- USPF Criteria: Contingent Liquidity Risks, March 5, 2012
- USPF Criteria: Methodology: Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011

Related Research

- U.S. State And Local Government Credit Conditions Forecast, April 2, 2015
- U.S. Public Power 2015 Outlook: Despite Several Looming Issues, Credit Quality Should Remain Stable, Jan. 9, 2015

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