FITCH DOWNGRADES SANTEE COOPER TO 'A-'; REMOVES FROM RATING WATCH NEGATIVE; ASSIGNS NEGATIVE OUTLOOK

Fitch Ratings-Austin-14 November 2018: Fitch Ratings has downgraded the long-term rating to 'A-' from 'A+' on approximately $7.0 billion in outstanding revenue obligations issued by the South Carolina Public Service Authority, SC (Santee Cooper). The rating has been removed from Rating Watch Negative.

The Rating Outlook is Negative.

SECURITY

Outstanding revenue obligations are payable from net revenues from the operation of Santee Cooper's electric system.

KEY RATING DRIVERS

PRONOUNCED LEGAL AND POLITICAL RISK: The downgrade to 'A-' reflects risk stemming from the legal claim presented by Central Electric Cooperative, while the legal process may take months or years before a final determination is made. However, the nature of the pending claim by such a large customer (approximately 60% of Santee Cooper's revenues) fundamentally diminishes Santee Cooper's revenue flexibility in Fitch's view. The downgrade further incorporates ongoing concerns related to governance dysfunction brought on by political uncertainty.

WHOLESALE AND RETAIL UTILITY: Santee Cooper is a large wholesale and retail system, serving a population of approximately 2 million. Central Electric Cooperative Inc. (Central) is the largest of Santee Cooper's six wholesale customers with a long-term (2058) all requirements power sales agreement.

LOWER FINANCIAL PERFORMANCE ASSUMED: Debt service coverage (DSC) is projected to fall slightly below Santee Cooper's 1.4x target in fiscals 2019 and 2020. Higher coverage in the following years is projected by Santee Cooper, but this improvement is predicated on assumed rate increases in fiscals 2021 through 2024. If there are no increases, Fitch expects coverage would likely remain slightly below 1.4x, but adequate for the rating.

HIGH LEVERAGE: Leverage is high, with net debt to funds available for debt service (FADS) at 10.8x in fiscal 2017, although substantially lower than 13.1x in fiscal 2016 following receipt of the Toshiba settlement funds (Fitch's calculation nets available cash against outstanding debt). Leverage should slowly trend lower over the next five years as a result of scheduled debt amortization and no additional debt plans but will remain elevated for the rating category.

SUFFICIENT POWER SUPPLY: Load growth is projected to average less than 1% annually, following the loss of sizable industrial load in 2016 and Century Aluminum's contracted load only assumed through 2020. Current generation resources appear ample with the return of the Cross 2 plant to service in 2019 and no additional capacity needed through 2032.

RATING SENSITIVITIES

UNFAVORABLE DECISION REGARDING COST RECOVERY: The removal from Negative Watch and the assignment of a Negative Outlook reflects potential for further downward movement in the rating, possibly multiple notches, if Santee Cooper is legally or legislatively unable to collect costs related to the approximately $4 billion in outstanding debt related to nuclear costs at Summer Units 3&4. This could occur if Central Electric Cooperative ceases making payments during the ongoing legal dispute or in the event of a final legal determination or settlement in favor of Central's claim. Santee Cooper currently has the legal authority to recover costs from remaining customers; however, in the event that Central is not obligated to make payments, the resulting operating and financial profile would be uncharacteristic of the 'A' rating category.

CREDIT PROFILE

Santee Cooper is a state agency that provides electric service to a population of approximately two million spanning parts much of the state of South Carolina. Santee Cooper is governed by a 12 member Board of Directors appointed by the Governor and confirmed by the State Senate. Santee Cooper's enabling legislation gives its Board the power to set rates sufficient to provide for all expenses, including principal and interest on indebtedness.

Santee Cooper currently provides retail electric service directly to approximately 180,000 retail customer accounts and 27 large industrial customers. Wholesale service provided 63% of total revenue in fiscal 2017. Central remains by far the largest of five all-requirements wholesale customers and accounts for 60% of total revenues.

Santee Cooper's Board of Directors voted on July 31, 2017 to suspend construction at Summer Units 2 and 3. By that time, Santee Cooper had spent $4.3 billion and construction of the nuclear plant expansion was 36% complete with the engineering and procurement efforts both over 90% complete. The decision to suspend construction reflects revised cost and timeline estimates considered in the context of developments since the original decision to proceed. Specifically, Santee Cooper's load profile has decreased such that, even with the suspension of nuclear construction, existing generation resources are expected to be sufficient through 2025. Next generation options considered as part of Santee Cooper's analysis are projected to be less expensive than completion of the nuclear unit.

RATING DOWNGRADE ON CENTRAL LEGAL CLAIM AND POLITICAL UNCERTAINTY

On March 7, 2018, Fitch placed Santee Cooper's long-term rating on Rating Watch Negative. The action reflected the heightened credit risk posed by the legal cross claim filed by Central Electric that disputes Santee Cooper's authority to bill Central for certain costs. Central's claim asserts that Santee Cooper does not have the statutory authority or the ability under the Coordination Agreement (the long-term contract between Santee Cooper and Central) to recover costs related to the abandoned nuclear construction at Summer Units 2 and 3. The legal claim was filed as a cross claim to the litigation filed in state court by one of Central's cooperative members that challenges its obligation to pay Central for the nuclear-related costs.

Prior to the legal claim, Central had been an active participant in project-related decision making in coordination with Santee Cooper. In 2017, Central expressed support for Santee Cooper's decision to abandon nuclear construction and, by implication, the understanding that nuclear construction costs incurred would still need to be paid. Central's legal claim that it is not obligated to pay those costs was a material departure from its prior position regarding the project.

Actions to date regarding the legal claim include the state trial court's rejection of Central's request to deposit the portion of its monthly payments to Santee Cooper with the court that relate to nuclear costs. The court rejected Santee Cooper's request to stay the case, pending the South Carolina

Supreme Court's determination of Santee Cooper's petition for original jurisdiction. And most recently, last week the court denied Santee Cooper's request to dismiss the cross claim.

Fitch does not presume the outcome of the legal claim and anticipates that final resolution may take months or even years or could potentially take the form of a settlement. Importantly, Central continues to pay its monthly invoices to Santee Cooper as the legal cases proceed. If Central ceases making payments during the legal dispute, a multiple notch downgrade and below investment grade rating would be likely.

However, given the material risk presented by Central's legal claim based on the magnitude of the disputed amounts in relation to total revenues, Fitch believes that Santee Cooper's overall financial flexibility is reduced. The legal claim is a manifestation of the overarching issue stemming from the substantial amount of debt that was incurred but offers no corresponding asset or energy supply. Santee Cooper's reduced financial flexibility, in conjunction with other credit characteristics such as Santee Cooper's elevated leverage and ongoing political and legislative discord, is factored into the current rating action.

POTENTIAL SALE OF SANTEE COOPER

The decision to suspend nuclear construction in 2017 ignited controversy across the state and drew the scrutiny of legislators and regulators. Since that time, the Governor of South Carolina has been clear in his pursuit and preference for a sale of Santee Cooper. A sale of Santee Cooper, or a portion of its assets, will require approval by the South Carolina Legislature. The bond resolution also requires that all of Santee Cooper's outstanding debt be retired or defeased, such that the potential for the sale of Santee Cooper in its entirety should be credit neutral. It is unclear what the credit implications may be of a partial sale of assets. Notably, the sale of Santee Cooper would give Central the option to terminate its long-term power purchase contract with Santee Cooper.

In 2018, the Legislature established an Evaluation and Recommendation Committee to study the issue of selling Santee Cooper. The committee's objectives include determining the best course of action for ratepayers, taxpayers and the state's electric cooperatives, deciding whether Santee Cooper should be sold whole or in parts, development of a public and transparent process to consider and conduct a potential sale and determine how natural resources owned by Santee Cooper would be protected. The committee is working towards providing a recommendation to the legislature for the 2019 session that begins in January.

Fitch's rating action reflects the ongoing political and regulatory uncertainty that continues 18 months after the decision to abandon nuclear construction at Summer Units 2 and 3. Potential legislation was introduced in 2018 that would have affected Santee's governance structure and rate regulatory construct. While the legislation didn't pass in 2018, it may re-emerge in the 2019 session. The by-product of the unfavorable political environment could pressure Santee Cooper to keep rates as low as possible at the expense of financial margins.

BOARD LEVEL DYSFUNCTION AND POLITICAL DISCORD

Governor McMaster has called for the sale of Santee Cooper, as noted above. In addition, the Governor has been critical of the state agency on multiple occasions over the past year. The Governor has regulatory authority over Santee Cooper in his appointment of the 12-member Board. The Governor's continued criticism of Santee Cooper, including its operational preparedness during Hurricane Florence in September, is a credit concern, given his position of regulatory oversight of the utility. Furthermore, there are direct implications to Santee Cooper's Board of Directors stemming from the Governor's and state senate's inability to reach consensus.

Santee Cooper has not held a Board meeting since June 2018 as a result of a procedural dispute between the Governor and the state senate about who holds the position of Santee Cooper's Board Chairman. The senate has sued the Governor in the South Carolina Supreme Court seeking resolution to the issue. The Governor asserts that he has the authority to appoint the Board Chairman (without Senate approval) when the senate is in recess. The dysfunction resulting from the political climate of mistrust is a credit concern that is factored into the current rating downgrade.

Santee Cooper continues to operate, guided by previously established Board direction. If no Board meeting is held in December to approve the fiscal 2019 budget, Santee Cooper management believes it could continue to operate in accordance with the planning budgets for fiscals 2019 and 2020 that were included in the fiscal 2018 budget when it was approved.

SETTLEMENT FUNDS OFFSET DEBT SERVICE PAYMENTS

Santee Cooper used a portion of the $895 million in Toshiba settlement funds in fiscal 2018 to repay short- and long-term debt. At the end of fiscal 2018, approximately $270 million is expected to remain of the settlement funds, the majority of which is expected to be used to avoid new debt and the remaining amount will pay a portion of debt service during fiscals 2019 through 2021. This use of funds allows Santee Cooper to mitigate higher debt service payments structured in the existing debt service schedule and removed the need for rate increases in fiscals 2018 and 2019. The timing of the next rate increase has not been determined but may be needed in fiscal 2020. Base rate changes are only possible through Board action, which will require a Board meeting.

FINANCIAL MARGINS DECLINE SLIGHTLY

Fitch-calculated DSC was 1.4x in fiscal 2016 and 1.39x in fiscal 2017. Coverage of full obligations after incorporating an annual distribution made to the state and payments in lieu of taxes to local governments was satisfactory at over 1.3x in both years. Payments to the state and local governments accounted Santee Cooper's financial forecast projects debt service coverage will decline slightly below the authority's 1.4x target in the fiscals 2018-2020 even with the assumed use of settlement funds and reserves.

Days cash on hand and days liquidity, including unused capacity available under revolving credit agreements, were robust at the end of fiscal 2017, at 182 days and 273 days, respectively. Liquidity is expected to remain around these levels, which is considered adequate for the rating.

LEVERAGE TO REMAIN HIGH

Santee Cooper's leverage ratios steadily increased since beginning construction of the nuclear units in 2008. The issuance of more than $4.3 billion to fund nuclear construction costs increased the authority's total debt outstanding by more than 50%, weakening the ratios of net adjusted debt to adjusted FADS and debt as a percentage of capitalization to 13.1x and 81%, respectively, at fiscal year-end 2016.

This upward trend in leverage, as measured by net adjusted debt/adjusted FADS reversed with Santee Cooper's decision to abandon nuclear construction, although leverage levels will remain high for the foreseeable future. Following the receipt of the Toshiba settlement proceeds in 2017, net adjusted debt to adjusted FADS exhibited a large decline to 10.8x in fiscal 2017, reflecting the high cash balances at the end of 2017.

Santee Cooper's current capital improvement plan estimates capital spending will total $1.2 billion over the next five years with limited debt financing expected given the planned use of Toshiba settlement funds to offset capital spending and pay a portion of existing debt. Net adjusted debt to adjusted FADS is projected to decline but remain elevated at over 9.0x. Fitch's median for the 'A-' rating category is 7.2x.

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In addition to the sources of information identified in Fitch's Revenue-Supported Rating Criteria, this action was additionally informed by information from Lumesis.

A January 2018 district court ruling that dismissed claims regarding payment of Puerto Rico Highways and Transportation Authority debt has raised questions about the scope of protections provided by Chapter 9 of the U.S. bankruptcy code to bonds secured by pledged special revenues. Fitch's rating criteria treat special revenue obligations as independent from the related municipality's general credit quality. The outcome of the litigation could result in modifications to Fitch's approach. For more information, see "What Investors Want to Know: The Impact of the Puerto Rico Ruling on Special Revenue Debt" available at www.fitchratings.com.

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Additional information is available on www.fitchratings.com

Applicable Criteria
Rating Criteria for Public-Sector, Revenue-Supported Debt (pub. 26 Feb 2018)
https://www.fitchratings.com/site/re/10020113
U.S. Public Power Rating Criteria (pub. 18 May 2015)
https://www.fitchratings.com/site/re/864007