FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Santee Cooper Series 2022 C, D, E & F Revenue Bonds 'A-'; Outlook Negative

Mon 31 Oct, 2022 - 5:36 PM ET

Fitch Ratings - New York - 31 Oct 2022: Fitch Ratings has assigned an 'A-' rating to the following South Carolina Public Service Authority (Santee Cooper, or the authority) revenue obligations consisting of:

--$37,645,000 2022 tax-exempt refunding series C;

--$137,355,000 2022 taxable refunding series D;

--$390,000,000 2022 tax-exempt improvement series E;

--$60,000,000 2022 taxable improvement series F.

In addition, Fitch has affirmed the following Santee Cooper obligations and ratings at 'A-':

--Approximately $6.6 billion tax-exempt and taxable revenue obligations;

--Issuer Default Rating (IDR).

The Rating Outlook has been revised to Negative from Stable.

The 2022 series C, D, E & F bonds are expected to price the week of Nov. 7, 2022. Proceeds from the bonds will be used primarily to refinance existing debt and finance the costs of capital improvements to the system.

ANALYTICAL CONCLUSION

The 'A-' rating reflects the authority's financial profile and leverage ratio, measured as net adjusted debt to adjusted funds available for debt service (FADS), which rose above 11x in 2021 as expected, and remains elevated for the current rating. Santee Cooper made steady progress in reducing its debt burden and leverage from 2017 through 2020, but weaker than expected operating performance in 2021 reversed the improving trend. The revision of the Outlook to Negative from Stable reflects uncertainties related to accumulating costs that the authority is currently unable to recover following its agreement to lock rates through January 2025 as part of a legal settlement. While the authority will seek to recover a large portion of these costs once the agreement expires, these efforts are being challenged in court and the recovery provision is untested.

Unanticipated challenges related to coal supply, higher natural gas consumption and rising gas prices are expected to pressure performance through 2024. The authority plans to defer roughly $550 million of costs currently excluded by the rate lock for future recovery. While the deferrals will buoy financial metrics somewhat, stabilized performance consistent with the rating is not expected to occur until the expiration of the rate lock in 2025, and will be contingent upon the authority's ability to recover the deferred costs.

The authority's leverage and financial profile are supported by strong contractual underpinnings that support revenue collections, as well as by the strong credit quality of Central Electric Power Cooperative (Central), Santee Cooper's largest wholesale customer. Very low operating risk, including very low operating costs and moderate capital spending requirements, also support the authority's profile.

The authority's agreement to lock its rates and the related risks had already been factored into Fitch's analysis and rate flexibility assessment, but the uncertainty of its ability to recover its increasing deferred cost burden in full is now weighing on the current Outlook. While the full recovery of the deferred costs could stabilize the authority's Outlook, the inability to do so would likely result in a downgrade.

CREDIT PROFILE

Santee Cooper is a state agency that provides wholesale power supply, as well as direct retail electric service to approximately 200,000 retail customer accounts and 27 large industrial customers. Including the retail base of Central, the largest of its all-requirements wholesale customers, Santee Cooper supplies electricity to a population of approximately two million spanning much of the state of South Carolina. The authority also owns the Lake Moultrie and Lake Marion regional water systems, two drinking water treatment systems serving over 210,000 people.

Cancelled Nuclear Construction Strains Credit Profile

Santee Cooper's decision to suspend construction of the Summer nuclear units 2 and 3 on July 31, 2017 following the bankruptcy of the project's lead contractor, Westinghouse Electric Company LLC, triggered a number of legal, political and financial challenges for the authority. At the time of the decision, 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.

Fervent customer and political opposition to the recovery of stranded costs related to the project led the governor to sign Act 95, which allowed the state to consider options to sell, manage or reform the authority. In early-2020, committees in the state senate and house of representatives rejected all three of the final proposals considered pursuant to Act 95, including the authority's own reform plan.

Legal and Legislative Resolution

In early-2020, Santee Cooper took a major step forward toward stabilizing its operating profile by agreeing to resolve significant litigation challenging the authority's ability to recover costs related to the Summer project. The agreement -- the Cook Settlement -- provided for the release of major claims against the authority in exchange for payments for the benefit of utility customers totaling $200 million over three years, and an agreement by Santee Cooper to hold rates at levels consistent with its reform plan through Jan. 15, 2025 (the "rate lock").

During June 2021, the general assembly unanimously passed, and the governor signed, Act 90 of 2021, which amended certain provisions related to the authority. Act 90 provided for manageable changes related to the authority's governance, broader state oversight over certain debt issuance, real estate transactions and resource planning, and establishment of a process for challenging rate adjustments approved by the board. Importantly, Act 90 does not include any provision to sell the authority, or undermine the board's sole rate-making authority.

Fuel Supply Issues and Deferred Cost

The authority began experiencing a reduction in contracted coal supplies during 2021 as a result of production and transportation challenges caused by the pandemic, and a fire at and resulting closure of the coal mine operated by the authority's largest supplier. Since then, the authority has had to rely on higher cost natural gas and purchased power to meet the needs of its customers, triggering operating costs that are much higher than budgeted figures and cannot be recovered as a result of the rate lock. The board of directors recently authorized the authority to create a regulatory asset and begin deferring costs related to its fuel supply issues and other exceptions that it expects to recover after the rate lock. The authority deferred a total of $251 million as of Sept. 30, 2022, but continuing cost pressures are expected to result in up to $550 million of deferred costs through 2024. The amounts deferred will be financed through a combination of commercial paper issuance and draws under the authority's revolving credit agreements.

The Cook Settlement authorizes the authority to defer certain just and reasonable costs incurred during the rate lock, but Central, among others, has challenged the exceptions noted in the 2021 annual compliance report. A September 2022 court ruling denied a motion to have the current exceptions reviewed at this time. A ruling on the applicability of the exceptions, as well as the request for an independent auditor, is expected to be made closer to the rate lock's expiration date.

KEY RATING DRIVERS

Revenue Defensibility: 'a'

Statewide Wholesale and Retail Electric Provider

Santee Cooper's revenue defensibility assessment reflects the strong contractual underpinnings supporting revenue collections from both retail (37% of total revenue) and wholesale customers (62% of total revenue), but is constrained by its agreement to lock rates through January 2025 and Central's credit quality.

Operating Risk: 'aa'

Very Low Operating Costs; Unlikely to Experience Upward Movement

Operating costs have averaged approximately six cents per kilowatt hour (kWh) over the past five years, which are considered low for its wholesale business line, but very low for the retail business line. The operating cost burden reflects a diverse mix of generation resources with energy supplied predominately by coal-fired resources. Costs are expected to rise going forward, but should remain in line with the assessment. Capital requirements for current and new generation are lower than historical levels and appear very manageable.

Financial Profile: 'a'

Leverage Remains Elevated

Santee Cooper's leverage ratio exceeded 11x in 2021, as expected, reflecting higher debt balances and weaker operating performance. Metrics are likely to remain weak through 2024, but rebound in 2025 when the authority's rate lock ends and the recovery of previously deferred costs begins. Coverage excluding deferrals will fall below 1.0x in 2022, but should recover in 2023. Liquidity should be adequate at approximately 190 days over the next five years.

Asymmetric Additional Risk Considerations

There are no asymmetric risk considerations factored in the rating.

RATING SENSITIVITIES

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

--Aggregate cost deferrals in line with the authority's estimates and adequate recovery of previously deferred costs;

--Leverage ratios approximating 10.0x in Fitch's scenario analysis would likely stabilize the Outlook;

--Improved revenue defensibility, supported by the expiration of the current rate lock and/or improved credit quality of Central.

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

--Evidence that previously deferred costs may not be recovered in full or on a timely basis;

--Aggregate cost deferrals that are meaningfully higher than anticipated by the authority;

--Failure to reduce leverage ratios to levels approximating 10.0x in Fitch's base and stress scenarios.

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 revenue obligations are payable from, and secured by a lien on, the net revenues of the authority.

REVENUE DEFENSIBILITY

Santee Cooper's very strong revenue source characteristics are rooted in the strong contractual underpinnings supporting revenue collections from both retail and wholesale customers. Wholesale revenues account for roughly 62% of Santee Cooper's electric revenue, and are largely derived pursuant to an all-requirements coordination agreement with Central. Santee Cooper provides approximately 75% of the total power and energy requirements of Central and its member cooperatives under the agreement, which cannot be terminated until 2058.

Amendments to the agreement in 2013 extended the earliest termination dates from 2030 to 2058 to facilitate longer-term debt issuance to finance the Summer nuclear project and provided Central with greater flexibility as to participation in new generating resources constructed by the authority. Earlier revisions to the agreement allowed Central to transition roughly 900MWs of load from Santee Cooper to Duke Energy Carolinas, but no further load transitions are anticipated.

Nearly all of Santee Cooper's remaining wholesale revenues are similarly derived under long-term contracts that terminate between 2023 and 2033. These include all-requirements contracts with the cities of Georgetown, Bamberg, Waynesville and Seneca, as well as agreements for capacity and energy with Piedmont Municipal Power Agency and Alabama Municipal Electric Authority.

The authority also provides direct service to over 200,000 retail customers throughout the Berkeley, Georgetown and Horry Counties of South Carolina, and an additional 27 large industrial customers located throughout the state. These customer classes provide roughly 21% and 16% of Santee Cooper's total electric revenue, respectively. The agency has the exclusive right under state law to provide retail electric service to its assigned service territory and to serve the existing industrial customers outside its assigned territory.

Demand throughout the areas served by the authority has been supported by very strong customer growth (10.5% since 2017) and regional demographics for income and unemployment that are consistent with, or narrowly below, national averages. All of the authority's large industrial customers are supplied under contract, including Nucor Corporation (5.5% of revenue) and Century Aluminum. Contract durations are relatively short, but Nucor and Century have been customers of the authority since 1996 and 1977, respectively. Recent expansions by Century contributed to a meaningful increase in retail sales and revenue in 2021.

Santee Cooper's water operations account for less than 1% of total revenue.

Rate Flexibility

Santee Cooper's enabling legislation gives its board the autonomous power to set electric rates. Moreover, the terms of its revenue obligation resolution require that the authority set rates to provide revenue to meet all obligations, including principal and interest on indebtedness. These factors, together with the competitiveness of its rates and historically timely cost recovery, support very strong rate flexibility. However, rate flexibility is constrained through January 2025 as a result of the Cook Settlement Agreement. The authority's ability to defer for later recovery a wide range of expenses including those related to changes in law, storm events, fire, floods and acts of God, as well as cyberattacks and certain changes in Central's load is favorable, but the extent of this flexibility is untested.

Rate-setting authority rests solely with the Santee Cooper board, which has historically exercised its authority to achieve financial targets of 1.4x debt service coverage and 90 days cash on hand. However, under the terms of the Cook Settlement, the board agreed to impose a rate lock effective for all service beginning in August 2020. The agreement applies to the vast majority of the authority's customers, suspending the rate adjustment mechanisms in place and locking rates at levels accepted by the authority.

The authority began deferring higher fuel and purchased power costs that exceed amounts recoverable under the current rate lock in 2021, and expects to begin recovering these costs along with its then-current operating costs in 2025. While future operating costs are expected to be recovered in full and in a timely manner, the authority is likely to recover deferred costs over a multi-year period.

Purchaser Credit Quality

Purchaser credit quality is midrange, largely based on the credit quality of the authority's dominant purchaser, Central, as assessed by Fitch using publicly available information. Fitch's assessment reflects the cooperative's leverage ratio, measured as net adjusted debt to adjusted FADS, of roughly 8.0x and weaker liquidity as evidenced by historical cash on hand of roughly three days. Central's credit quality is supported by revenue derived pursuant to a very strong contractual framework that includes all-requirements wholesale power contracts with each of its 20 members, and legal authority to set rates to members.

Central's members, in turn, provide electric service to approximately 850,000 customers throughout South Carolina. The areas served by Central's largest members generally exhibit midrange demand characteristics including customer growth rates above 1.5% per annum, unemployment metrics consistent with the national average and income metrics that are weaker than the national average. Additionally, Central's operating risk profile and cost burden are low, reflecting the cost, terms and characteristics of its power supply arrangement with Santee Cooper.

Although the wholesale purchaser cities of Georgetown, Bamberg, Seneca, SC, and Waynesville, NC are not rated by Fitch, the credit quality of purchasers Piedmont Municipal Power Agency (A-/Stable) and Alabama Municipal Electric Authority (AA-/Stable) further support overall revenue defensibility.

OPERATING RISK

Santee Cooper's operating cost burden is assessed as very low, factoring its role as both a wholesale and retail supplier. While the authority's Fitch-calculated cost of power of 5.9 cents per kilowatt hour (kWh) over the past five years suggests a cost burden assessment of 'a' for wholesale systems, the burden is consistent with the 'aa' assessment for retail systems. The relative stability of the cost burden reflects the efficient operation of the authority's generating resources, and factors annual payments in lieu of taxes and distributions to the state totaling $22 million. The current challenges related to coal deliveries have pushed operating costs higher, but even excluding the deferral of certain fuel and purchased power costs, the burden remains below 7.6 cents/kWh.

Operating Cost Flexibility

The authority's operating cost flexibility is neutral to the rating and driven by a power supply portfolio that is well diversified in terms of fuel sources and unit capacity. Summer peak capability, which includes a mix of owned (5,075MW) and purchased resources, remains generally sufficient to meet peak demand, which totaled 4,634MW in 2021 and has declined from 5,869MW in 2015 due in part to lower Century load and declines in Central's purchases.

Coal-fired generation dominates the agency's portfolio of resources, accounting for nearly 62% of existing capacity, and supplied only 37% of energy needs. Natural gas-fired and nuclear generation account for about 24% and 11% of energy needs. Going forward, the diversity of the authority's portfolio should improve further. Additionally, although the authority is not subject to a state renewable portfolio requirement, its reliance on coal-fired capacity should decline. Current resource plans call for the retirement of roughly 860MW of capacity at the Winyah generating station by 2028 in an effort to right-size resources against lower peak demand, and eliminate costly and inefficient generation.

Environmental Considerations and Clean Energy Transition

The authority is not subject to a renewable portfolio standard or clean energy target, but has executed contracts for 425MW of new solar capacity across five projects, all of which are scheduled to be operational by the end of 2023. Pursuant to the authority's 2020 Integrated Resource Plan, up to 1,000 MW of solar capacity and 200MW of phased battery energy storage may be implemented by the mid-2020s and reliance on coal-fired generation will decline to only 19% from the current levels. Santee Cooper expects to file its next Integrated Resource Plan in May 2023.

Capital Planning and Management

Despite historical challenges related to the Summer nuclear project, Santee Cooper's capital planning and management is assessed as strong, factoring in the authority's age of plant (16 years) and continued reinvestment in its system. Capex to deprecation ratios have averaged a lofty 181% over the past five years, reflecting very high capex in 2017 related to the Summer expansion. The ratio totaled only 74% in 2021, but expenditures should approximate or exceed depreciation over the next five years.

The authority's capital planning continues to evolve following the decision to halt nuclear construction in 2017. Whereas spending approximated $3.39 billion over 2015-2019 and included substantial investment in the Summer project, Santee Cooper's current five-year plan contemplates total spending of roughly $1.6 billion through 2025 and will focus on general improvements, environmental compliance and transmission.

The majority of planned expenditures are expected to be funded with internal funds and modest amounts of additional debt.

FINANCIAL PROFILE

Santee Cooper's leverage ratio rose in 2021 after trending downward from 2016 to 2020. Debt balances rose steadily beginning in 2008 when construction of the Summer nuclear project began, but have declined since peaking in 2016 at $8.7 billion to reach roughly $7.2 billion at YE 2021. Similarly, the authority's leverage ratio trended down from a peak of 13.2x to 10.7x over the same period. Scheduled amortization and the use of funds from the authority's settlement with Westinghouse and its parent Toshiba to defease debt, together with improved FADS, contributed to the stronger metrics.

Weaker performance in 2021, however, drove leverage higher as challenges related to coal supply, higher natural gas consumption and rising gas prices all combined to reduce operating income to $269 million from $363 million in 2020. While total debt was only modestly higher, the authority's lower operating income and FADS pushed leverage higher to 11.9x.

Lingering challenges related to fuel supply and high fuel and purchased power costs continue to weigh on operating results in 2022. Based on operating results through September 2022, and after factoring the deferral of $350 million of costs, the authority now projects operating income to total roughly $312 million. Excluding the cost deferral, operating losses approximate ($38 million).

Notwithstanding weaker operating performance, liquidity remains neutral to the rating. Cash balances have remained consistently strong ranging between 160 and 225 days over the past five years. At Sept. 30, 2022, unrestricted cash balances and reserves totaled approximately $603 million. The authority recently increased short-term borrowing capacity under revolving credit agreements and CP program from $700 million to $1 billion, which should further support liquidity over the near term. Fitch-calculated coverage of full obligations has been healthy, but will fall below 1.0x, excluding deferrals.

Fitch Base Case and Stress Case Scenario Analysis

Fitch's base scenario analysis indicates that the authority's leverage ratio will increase to over 12.0x in 2024, even after factoring planned cost deferrals. Leverage is then expected to improve to 10.1x in 2025 when the authority's rate lock expires and deferred costs begin to be recovered, before trending even lower. Liquidity through the scenario analysis is also expected to remain adequate and neutral to the rating. Fitch's base case assumptions are informed by Santee Cooper's own financial forecast and include a modest increase in energy sales (2023-2026), the deferral of $550 million of operating costs in 2022 and 2023, an 17% increase in electric revenue in 2025 upon expiration of the rate lock, the recovery of deferred costs beginning in 2025 and capital spending of roughly $325 million per annum through 2026.

Fitch has also considered an alternative stress wherein the authority is unable to recover its deferred costs. In this stress scenario, leverage is expected to remain above 10.0x for an extended period of time, even after excluding any required non-cash write-offs. To the extent that the authority is unable to offset the effect of these losses and forgone collections, the financial profile assessment would likely be lowered and the rating downgraded.

Debt Profile

Santee Cooper's debt profile is neutral to the rating. Nearly all of the authority's approximately $7.0 billion of outstanding revenue obligations are fixed rate and scheduled amortization is manageable through final maturity. At Sept. 30, 2022, variable-rate debt was limited to 6% of total debt, or approximately $392 million including outstanding CP ($119 million), borrowings under revolving credit agreements ($129 million) and a single series of variable-rate revenue obligations ($143 million). The authority's $300 million CP program is supported by an irrevocable direct-pay LOCs with Barclays Bank PLC, and additional borrowing capacity is available through separate revolving credit agreements with each of Bank of America, TD Bank, N.A., Wells Fargo and J.P Morgan Chase bank, N.A totaling $700 million. The agreements expire at various dates in 2024 through 2026.

Total debt as calculated by Fitch further includes capitalized fixed charges related to purchased power ($729 million in 2021) and unfunded pension obligations as adjusted pursuant to Fitch's methodology ($382 million). Santee Cooper is a participant in the South Carolina Retirement System and contributes to the state's pension plan on behalf of its roughly 1,700 employees. Annual contributions are minimal, equal to less than 1% of total revenue.

ASYMMETRIC ADDITIONAL RISK CONSIDERATIONS

No asymmetric additional risk considerations were factored in the rating.

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

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
South Carolina Public Service Authority (Santee Cooper) (SC)	LT IDR	A- Rating Outlook Negative Affirmed	A- Rating Outlook Stable
South Carolina Public Service Authority (Santee Cooper) (SC) /Electric System Revenues/1 LT	LT	A- Rating Outlook Negative Affirmed	A- Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer’s available public disclosure.

APPLICABLE CRITERIA

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

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 01 Sep 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

South Carolina Public Service Authority (Santee Cooper) (SC)	EU Endorsed, UK Endorsed

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Utilities and Power US Public Finance North America United States

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