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South Carolina Public Service Authority

Update to credit factors after downgrade

Summary

The credit profile of Santee Cooper takes into consideration the continued unstable governance with uncertainty about future rate setting. Santee Cooper operated in 2018 without a permanent board chairman. The recent weakening in credit position reflects the very high leverage that will persist for many years following the termination of the Summer Nuclear project which introduces cost recovery challenges to Santee Cooper, particularly in the near-to-medium term. Another consideration is the continued uncertainty about the ultimate outcome of the litigation brought by Central Power Electric Cooperative, Santee Cooper's major wholesale customer that provides more than 60% of its revenues. While the credit profile factors in our belief that the terms of the contract between Santee Cooper and Central will remain intact, the litigation, if it ends up with an adverse outcome, could affect Santee Cooper's financial strength and would lead to a further credit deterioration.

Despite the weakened credit profile, there are some important mitigating factors including the fact that there was no legislation enacted in the 2018 South Carolina legislative session which curtails Santee Cooper board's unregulated authority to establish rates and charges to meet bond covenants in a timely manner. We believe that this is supported by an existing state statute that prohibits the state from doing anything including enacting new laws that would impact bond covenant compliance. The existence of this state statute is a credit positive feature for Santee Cooper's bondholders. We also observe that notwithstanding the governance challenges at Santee Cooper, the utility has implemented its financial recovery plan based upon management's schedule including using the Toshiba funds to mitigate any rate increases through 2020, while maintaining a targeted debt service coverage in the 1.40x range.

Santee Cooper's internal liquidity days on hand strengthens its credit position as it remains very strong and the utility continues to have access to ample internal resources and low cost external liquidity through letter of credit backed commercial paper and several revolving credit facilities. Moreover, the fact that Santee Cooper does not have the need for new borrowing in the intermediate term enables Santee Cooper's debt levels to moderate as Santee Cooper's debt ratio is one of the highest among US public power electric utilities. Implementation of its debt moderation plan through expenditure reductions, debt refinancing initiatives, and internal funding of capital improvements are expected to be future mitigating factors.

Santee Cooper remains a competitive and reliable electric utility, even after an expected rate increase in 2020, that continues to provide services to a major portion of the state. The utility has an important and well established state role in economic development, flood

control and water supply, and remains an important asset for the State of South Carolina (Aaa stable).

Credit strengths

» Competitive rates now for wholesale and retail customers

» Major customers including the Central customers currently bear fuel cost risk with a monthly fuel cost adjustment mechanism. Over 75% of Santee Cooper revenues are pass through costs

» Broad service area and Santee Cooper has several key state roles such as water supply and economic development

» Below-average power production costs and strong generation performance of existing generation portfolio

» Lower coal-fired generation as part of carbon mitigation strategy

» Authority is owned by the Aaa-rated state of South Carolina; authority, is fiscally separate from state; economic trends indicate a continued broad recovery with employment and income gains all positive for customer sales growth

Credit challenges

» Unstable governance with no permanent board chairman and contentious relationship with Governor

» High leverage with nuclear-related debt and no performing asset for several decades

» Customer concentration, with a significant amount of sales under long-term contract to 2058 to the Central, an association of 20 electric distribution cooperatives

» Challenge by Central to Santee Cooper's ability to collect from Central nuclear-related costs

» Exposure to environmental regulatory uncertainty since a significant amount of energy is still from coal-fired generation

» Significant large industrial load that may be more susceptible to retail competition or customer relocation

» Potential for customer push back to higher customer rates to recover costs associated with Summer 2 and 3

Rating outlook

The rating outlook is negative owing to the uncertainty relating to the Central litigation along with the political risks that Santee Cooper faces as it manages its plan to maintain targeted debt service coverage ratio.

Factors that could lead to an upgrade

» Governance that provides certainty to cost recovery is reestablished

» South Carolina Supreme Court affirms Santee Cooper's rate setting authority to meet bond covenants

» Further mitigation steps to moderate further nuclear debt leverage through combination of expenditure reductions; new revenues and customer growth

Factors that could lead to a downgrade

» No carbon mitigation plan in 2019

» Adverse plan produced by the state study committee formed to evaluate Santee Cooper

» Three year average debt service coverage below 1.40x

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

» Adverse outcome of Central litigation that impacts cost recovery and financial metrics

» Lack of governance certainty and further political influence on Santee Cooper operations

Profile

South Carolina Public Service Authority (Santee Cooper) is a component unit of the State of South Carolina (GO bonds rated Aaa) and was created by the State Legislature in 1934. It is governed by a 12 member board of directors, 7 year staggered terms, appointed by the Governor with the advice and consent of the Senate. One board member has to come from each congressional district in the state. The authority provides electric service, retail and wholesale, and wholesale water supply in several regions of state. It also serves in other capacities including flood control; real estate management; park management and economic development assistance for local communities.

The authority's rates are not regulated by the state Public Utilities Commission and are set by the Santee Cooper board of directors. Rates can be established on an emergency basis but typically there is a process which includes public hearings.

Over 75% of Santee Cooper revenues are derived from cost recovery that is automatically passed through to customers since they are set by pass through cost of service wholesale charges or direct fuel pass through to large industrial customers.

Santee Cooper presently serves over one-third of population of the state and serves in all 46 counties. Santee Cooper has aggressively used its economic development rate to attract new commercial and industrial customers.

Santee Cooper provides power on a wholesale basis to Central Cooperative which is a transmission cooperative that has 20 distribution cooperative members. The contract expires in 2058. Santee Cooper has 166,809 retail customers; major growth is Myrtle Beach area.

Recent developments

» **Governor's sale proposal** - A study committee was formed as an item in the state's FY 2019 budget that includes the Governor and members of the legislature to evaluate 37 items related to Santee Cooper. The items range from the sale of Santee Cooper to regulating Santee Cooper's rates by the state regulatory board. A plan is expected to be presented in the next legislative session in January 2019.

» The master bond resolution states the Santee Cooper board can sell Santee Cooper and its assets but it has to comply with the bond covenants in the resolution. See Moody's FAQ on the political and legislative risks to Santee Cooper's credit profile following the Summer Nuclear suspension, February 28, 2018 in appendix on questions about sale economics.

» **Central litigation**

» Central urged the court to hold any of Central's payments on their power purchase contract with Santee Cooper; Judge Hayes ruled there was no authority to do that and Santee Cooper had the legal authority to charge Central for the services rendered.

» Santee Cooper intervened in Central litigation and asked the Supreme Court to take original jurisdiction to provide an opinion that stipulates Santee Cooper board has full authority to charge Central for the nuclear related costs. In our view, the statute is quite clear that Santee Cooper has that authority. Should the Supreme Court rule on behalf of Santee Cooper, the Central litigation would be less meaningful.

» **Santee Cooper cost recovery financial plan.** Santee Cooper used surplus funds to defease debt so no rate increase was needed in 2018. Santee Cooper has moved forward on $40 million of expenditure reductions and established its forecast with debt defeasement in each of next two years and use of the Toshiba settlement funds to mitigate rate increase with a goal to maintain 1.40x debt service coverage.

» **Governor's interim Santee Cooper board chair appointmen**t This has been challenged by the State Senate in court. The Senate believes interim appointments made during a recess are not valid.

Detailed credit considerations

Revenue Generating Base

Santee Cooper serves approximately 2 million customers in all 46 counties of the state either through wholesale power sales to Central Power Electric Cooperative (64% of sales) and its 20 distribution cooperatives or retail (180,000 customers) (17%) to areas such as Myrtle Beach or to direct sales to some of the largest industrial firms in the state (19%) and to military installations. The power sales contract between Santee Cooper and Central is incorporated in the Coordination Agreement that Santee Cooper serves Central exclusively.

In 1973, Santee Cooper was granted statutorily (SC Code 58-31-320) that Santee Cooper had the express right to serve Central and its members who had to receive and pay for the bulk of Central's energy and power requirements. The retail customers are served on a monopoly basis.

The state statute (58-31-30) establishes Santee Cooper board as regulatory power over cost recovery. Over 75% of Santee Cooper's revenues are pass-through to customers without separate public hearings but are cost of service- cost recovery.

The state's economy is stronger than it has been historically since it has diversified beyond heavy manufacturing including previously being dependent on textiles. While the state encourages large manufacturing to locate, including autos, some growth in other sectors have been a positive development since last recession.

Santee Cooper has a more diverse generation mix than in past with manageable demand growth in the 0.4% range; strong availability of existing generation units; less than 40% energy from coal; a developing carbon mitigation plan after the nuclear suspension; and has managed procurement well including as equity partner of The Energy Authority. Santee Cooper's reserve margin is manageable in the 15% range after the nuclear suspension.

Coal as an energy source has dropped to below 40%, partly accomplished by the idling of coal-fired Cross Station 2. Santee Cooper's carbon mitigation strategy is not as robust as with the Summer nuclear project. Mitigation approaches include the development of a combined cycle facility possibly in 2024 depending on demand growth. Santee Cooper's power supply still has an emphasis on base load availability with its nuclear, gas and coal units maintaining a strong availability factor. This remains important given the state's continued focus to attract large industrial developments such as Volvo that recently sited a major facility.

An important change in the Santee Cooper power supply mix going forward is additional purchased power contracts (in place of new nuclear if needed); and a slow pace of solar development. There is no renewable energy requirement in South Carolina.

Financial operations and position

Prior to the Summer nuclear construction debt service coverage averaged 1.70x. Between 2015-2017 debt service coverage (including CP, after transfers to state) was 1.41x; and forecasted debt service coverage in 2018-2024 is 1.40x. Santee Cooper has had a record of strong liquidity.

As part of management's financial plan for the next several years, Santee Cooper will be defeasing debt principal with part of the $896 million Toshiba settlement funds so that the forecasted scheduled debt service will be lower and is paid from revenues. The defeasement will be accomplished by using Toshiba settlement funds of about $150 to $180 million annually. Without this approach and with no new rate revenue, debt service coverage would be 1.1x on average. In 2021, the combination of expenditure cuts; a rate increase of an estimated 7% spread over three years, results in projected coverage at the 1.4-1.5x coverage range. This assumes a rate increase in 2020 to be implemented in 2021. Should the litigation with Central result in a refund to Central a more significant rate increase would be required potentially having significant impact on Santee Cooper's financial health.

Liquidity

Santee Cooper's external and internal liquidity is significant considering it now has a more limited borrowing program and less construction risk to manage.

The utility transitioned from a sizable self-liquidity commercial paper program of $700 million to establishment of revolving credit agreements with several banks with various termination dates. In addition, Santee Cooper has an estimated $250 million in letter of credit backed commercial paper program rated P-1. The internal liquidity including the Toshiba guarantee settlement amounted to 600 days liquidity at year-end 2017. Over the next several years, Santee Cooper will continue to draw this down as it mitigates any new rate increase. Also, with less long-term borrowing requirements there may be a reduction in external liquidity sources. But we estimate the days liquidity will remain sound particularly for an operating utility with significant owned generation.

Debt and other liabilities

DEBT STRUCTURE

Santee Cooper's outstanding revenue bonds are all fixed rate obligations. Level debt service from 2018 to 2056; a bullet maturity will be managed with prior to debt service payment date by defeasement of the principal with funds on hand. No derivative or variable rate bonds.

Bond Security

The bond resolution includes a sum-sufficient rate covenant and no debt service reserve account or additional bonds test but Santee Cooper must deposit annually into the Capital Improvement Fund an amount which, together with amounts deposited during the prior two years, equals 8% of required revenues (average $180 million) in the preceding three fiscal years. These funds are required to be used for debt service or for capital. The amount Santee Cooper is required to transfer to the state is restricted to a maximum of 1% of Santee Cooper's projected operating revenues. There is no external rate regulation except for federal regulation on transmission rates.

PENSIONS AND OPEB

Moody's adjusted net pension liability for 2017 is $641 million. Measured against net fixed assets and net working capital it increases the utility's debt ratio. Measured against the present value of future cash flow from rates the burden is less meaningful. However, with the uncertainty about the utility's rate setting capability, the pension burden may become more of an overhang.

Management and Governance

Santee Cooper is governed by a 12 member board of directors, 7 year staggered terms, appointed by the Governor with the advice and consent of the Senate. One board member has to come from each congressional district in the state.

Other considerations: mapping to the grid

The grid is a reference tool that can be used to approximate credit profiles in the public power electric utility sector. The grid indicated rating of A3 is one notch lower than Santee Cooper's current rating of A2 reflecting the dominance of the Central wholesale contract and incorporating many of the challenges outlined above following the termination of the Summer nuclear project. The grid is a summary that does not include every rating consideration. Please see Methodology on U.S. Public Power Electric Utilities with Generation Ownership Exposure for more information about the limitations inherent to grids.

Exhibit Methodology Grid for South Carolina Public Service Authority 1

Factor	Subfactor	Score	Metric
1. Cost Recovery Framework Within Service Territory		Aa	
2. Wllingness and Ability to Recover Costs with Sound Financial Metrics		A	
3. Generation and Power Procurement Risk Exposure		A	
4. Competitiveness	Rate Competitiveness	A	
5. Financial Strength and Liquidity	a) Adjusted days liquidity on hand (3-year avg) (days)	Aaa	412
	b) Debt ratio (3-year avg) (%)	B	114%
	c) Adjusted Debt Service Coverage (3-year avg) (x)	Baa	1.41x
Preliminary Grid Indicated rating from Grid factors 1-5		**A2**	
		Notch	
6. Operational Considerations			
7. Debt Structure and Reserves			
8. Revenue Stability and Diversity		-1	
Grid Indicated Rating:		**A3**	

Source: Moody's Investors Service

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