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Ratings

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Summary:
South Carolina Public Service Authority; Retail Electric

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Rating Action

S&P Global Ratings lowered its rating on the South Carolina Public Service Authority's (Santee Cooper, or the authority) revenue debt to 'A-' from 'A'. The outlook is negative.

The downgrade reflects our expectation of weakened coverage metrics in fiscal 2022, stemming from the authority's current inability to pass through to wholesale and retail customers the vast majority of about $520 million in 2022 unbudgeted fuel and purchased power costs due to a rate freeze that will continue through 2024, (imposed under terms of a litigation settlement agreement [the "Cook settlement"]), and at a time when coal supply from its largest and lowest cost coal supplier has been cut in half.

With the authority operating under the rate freeze, we believe that Santee Cooper has limited flexibility to absorb additional unbudgeted cost increases, and so we are maintaining our negative outlook on the authority, assigned earlier this year. We do note that gas and coal commodity costs are now fully hedged for the remainder of 2022, so there is substantial protection, but also continuing exposure, with 13% of total commodity costs remaining unhedged, primarily attributable to projected power purchases.

We understand that the authority has identified substantial costs that it believes are exceptions to the rate freeze, as provided for in the Cook settlement, but these would not be recoverable until after the rate freeze ends, beginning in 2025. Furthermore, we understand that these exceptions could be subject to an audit if requested by a party and granted by the court. However, it is unclear whether an adverse ruling would subject the exceptions to disallowance.

Santee Cooper is accounting for a portion of the exceptions as regulatory assets, which will result in projected 1.3x accrual-based debt service coverage (DSC) for 2022 based on current projections. However, the establishment of a regulatory asset is a non-cash accounting treatment that defers recognition of the costs, but not the obligation to fund them. Consequently, our rating is more reflective of Santee Cooper's 0.59x cash-basis coverage of debt service requirements projected for 2022. We anticipate that in addition to expenditure reductions and deferral of planned defeasances, Santee Cooper will use approximately $219 million of available liquidity in 2022 to bridge the remaining portion of the gap between the cash-basis coverage and debt service sufficiency. However, we believe that despite the planned use of liquidity, Santee Cooper will maintain ample unrestricted cash and available lines to support credit quality at the lower rating.

The bonds are secured by net revenue of Santee Cooper's electric and water systems. The authority had $6.8 billion in debt outstanding as of Dec. 31, 2021.

Credit overview

The authority's financial metrics are being adversely affected by coal supply and delivery disruption; rising gas and power costs; and an inability to pass through higher costs on a timely basis to ratepayers due to a rate freeze agreed upon in settlement of litigation (the Cook Settlement), associated with the cancelled V.C. Summer nuclear units 2&3 (VCS2&3) project.

DSC was down sharply in 2021, declining to 1.24x from the three-year average of 1.36x over fiscal years 2018-2020, with fixed cost coverage (FCC) about two basis points lower.

A fire at the Sugar Camp Mine (located in Illinois and owned by Foresight Energy, the authority's largest and lowest-cost coal supplier) has cut Santee Cooper's expected coal deliveries from that complex in half. The fire occurred at a time when there has been a rapid shift in demand and newfound price competitiveness for the commodity relative to natural gas--the price of which has more than doubled year over year. The disruption has prompted the authority to dispatch its higher-cost gas units and rely on more expensive power purchases to conserve its coal pile, which stands at about 26 days of average burn, about half of the minimum inventory that the utility uses for planning purposes. The authority has assumed that the mine does not return to production until the end of 2023. Santee Cooper has contracted with alternate coal suppliers for a portion of this at substantially higher prices than had been previously contracted and budgeted.

Rising gas prices have driven up day-ahead and real-time power purchases, only a small percentage of which the authority has hedged. Although Santee Cooper has hedged all of its expected gas demand, the authority is unable to recover the higher fuel costs associated with above-budgeted demand, or largely unhedged and elevated power purchase costs, due to the Cook settlement-imposed rate freeze.

Based on management's April 2022 estimate of $196 million in higher fuel costs (reflecting gas prices of about $5.50 per million British thermal units [mmBtu] with power purchases trending similarly, and plans for $100 million in cost reductions), we expected that DSC would be 1.16x in 2022, and this was reflected in our outlook revision earlier this year.

Subsequent volatility pushed gas prices over $8.50/mmBtu, but we note that the authority has fully hedged its gas needs at levels well below this. Purchased power prices have not fully followed the recent drop in gas prices; the authority remains exposed to the heightened (and unhedged) power purchase prices in excess of $100/megawatt-hour.

As a result, management now projects about $520 million in above-budget fuel and power purchase expense for 2022.

Under terms of the Cook settlement, Santee Cooper can defer to rates charged in years after the rate freeze period just and reasonable costs and expenses incurred during the rate freeze period directly resulting from certain circumstances, referred to as permitted exceptions, or Cook exceptions, which generally include force majeure type events, changes in law, and deviations in Central's load +/- 4%. The authority has identified $91 million of costs covering the period of August 2020 through December 2021, including $44 million in force majeure type events--primarily related to a fire at the mine, and to an equipment failure and fire at the authority's V.C. Summer nuclear unit 1--and $29 million in Central Electric load deviation. (We understand that the authority has also estimated about $291 million of additional costs related to the mine fire exception that would apply to 2022 costs, with additional costs related to this exception possible for 2023).

The $520 million in above budget fuel and power costs are mitigated by about $90 million in higher revenue. The authority has identified about $100 million in budget reductions, and about $65 million in savings from the deferral of planned debt defeasance and a 2022 refinancing of a $175 million bullet maturity due in 2023.

Management expects to use a combination of unrestricted cash and draws on liquidity facilities to cover $219 million of the above-budget costs ($170 million in lines of credit and $49 million in cash), until it can collect these from ratepayers (as exceptions) after the rate freeze expires. The ultimate recovery of these exceptions are subject to audit and in our view remains uncertain.

Santee Cooper's board expects to account for $321 million of the projected Cook exceptions as regulatory assets in 2022, and on the strength of the regulatory asset accounting, the authority projects 1.30x DSC on an accrual basis in 2022. With the expected refinancing of a $175 million bullet maturity due in 2023 and defeasance of $85 million of additional 2023 maturities, debt service costs are expected to decline, and the authority projects even higher accrual-based DSC in 2023 and 2024.

However, the authority expects 0.59x DSC on a cash basis for 2022, with cash-basis DSC improving closer to historical averages in 2023 and 2024. In our view, the projected improvement to both accrual- and cash-based DSC is uncertain, given that power costs are not fully hedged and the rate freeze remains in place.

The authority, which had $1.2 billion in available liquidity, representing 355 days of operating expenses at fiscal year-end 2021, now projects that it will have 215 days of liquidity at fiscal year-end 2022--with 62 days attributable to unrestricted cash (excluding collateral), and the remainder attributable to available capacity on revolving lines of credit and commercial paper that can be used for any operating purpose. Out-year projections suggest similar levels of liquidity.

However, we believe that the cost pressures might extend into 2023, presenting a continuing challenge to metrics until the rate freeze expires.

The 'A-' rating reflects our opinion of the interplay of the following:

- A deep and diverse service area and customer base spans much of South Carolina. Santee Cooper serves about 1 million end-use customers--approximately 20% directly, and 80% indirectly--through its sales to Central.
- Rates are competitive, but the authority's rate-raising ability is limited while Santee Cooper operates under the Cook settlement-imposed rate freeze, which in our view constrains financial flexibility.
- In the wake of the stranded investment in the cancelled nuclear project, Santee Cooper's power supply plans are

designed to maintain system reliability while transitioning its coal-dependent power supply to a cleaner, more efficient, more flexible, and more diverse resource portfolio. We generally view these plans as credit supportive, but we also believe that there is a degree of execution risk in pursuing them, and we view them as a key to Santee Cooper's effort to control costs.

- FCC averaged 1.28x during fiscal years 2019-2021, and based on management's projections, we estimate that FCC will be 0.61x in fiscal 2022, which would put the three-year average at 1.04x, a level that no longer supports the previous rating, and only nominally continues to support the new rating.
- In our view, actions to mitigate the impact of the cost pressures are projected to help preserve $971 million in liquidity at fiscal year-end 2022--about $281 million in unrestricted cash and $690 million in undrawn capacity on $1 billion in credit lines and revolving credit agreements--covering about 215 days of operating expenses, a level that we consider solid at the new rating.
- Santee Cooper is a moderately leveraged utility, with debt measuring 76% of total capitalization. We expect this ratio will improve to about 74% by 2026, despite about $1.3 billion in additional debt in support of the authority's $2.3 billion capital plan over fiscal years 2022-2028.

In our view, projected liquidity levels, which while declining, are supportive of the revised rating based on peer comparisons.

Environmental, social, and governance

We believe that Santee Cooper faces environmental risks that are moderately credit negative. The authority anticipates closure of the coal ash ponds at its Cross and Winyah stations will cost $350 million. Santee Cooper also faces environmental risks related to potential future regulation of carbon emissions from its stakes in the coal-fired units (41% of generation production in 2021) and natural gas plants (20% of energy). About 27% of energy comes from purchased power. Nuclear (9% of energy), hydro (2%), and renewables (1%) provide a modest amount of zero-emission energy, but the authority's effort to reduce its carbon footprint was complicated by the cancellation of the VCS2&3 nuclear project. We note that the authority's current power supply plan envisions the addition of renewables (18% of energy by 2030) and the closure of its Winyah coal units by 2028--reducing energy from coal-fired units to 20% but increasing natural gas (31%). Therefore, we anticipate that Santee Cooper will be able to lower carbon intensity over the next decade.

Social risks are credit neutral, primarily related to the financial and operational effects of the COVID-19 pandemic and attendant downturn as customers grapple with health and safety concerns, a situation exacerbated by below-average incomes. In our view, however, the pandemic and attendant downturn have had a limited impact on Santee Cooper. Weather-adjusted sales are back to levels forecast before the pandemic. Disconnections resumed in June 2020, after a three-month moratorium, and delinquencies have not been meaningful from a credit perspective. Nevertheless, we believe that Santee Cooper has limited financial flexibility to absorb future pressures, as the authority will be operating under the rate freeze through 2024.

We believe that governance risk is a credit negative relative to that of peers, given significant turnover of executive management, the constraints of operating under a rate freeze, and the need to jointly conduct resource planning with Central--with such plans subject to public service commission approval.

Negative Outlook

Downside scenario

We could lower the rating if a constrained coal supply and elevated natural gas and power prices persist during the rate freeze, challenging the authority's ability to effectively respond to further pressures to financial margins, coverage ratios, and liquidity, beyond levels currently estimated. We could also lower the rating if the authority is unable to execute on its plans to remake its power supply (which we view as key to controlling costs and flexibility), whether because of deferred capital spending, or the requirement that the authority obtain legislative approval as a precondition to accessing capital markets.

Return to stable scenario

Given the authority's limited financial flexibility while operating under the rate freeze, we do not anticipate revising the outlook to stable during the next two years.

Related Research

- Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022

Ratings Detail (As Of July 21, 2022)		
South Carolina Pub Svc Auth retail elec (AGM)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
South Carolina Pub Svc Auth retail elec (AGM) (SECMKT)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
South Carolina Pub Svc Auth retail elec (AGM) (SECMKT)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
South Carolina Pub Svc Auth retail elec (AGM) (SECMKT)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
South Carolina Pub Svc Auth retail elec (AGM) (SECMKT)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
South Carolina Pub Svc Auth retail elec (AMBAC)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
South Carolina Pub Svc Auth retail elec (ASSURED GTY)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
South Carolina Pub Svc Auth retail elec (BAM) (SECMKT)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
South Carolina Pub Svc Auth retail elec (BAM) (SECMKT)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
South Carolina Pub Svc Auth retail elec (BAM) (SECMKT)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded

Ratings Detail (As Of July 21, 2022) (cont.)		
South Carolina Pub Svc Auth retail elec (BAM) (SECMKT)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
South Carolina Pub Svc Auth retail elec (BAM) (SECMKT)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
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South Carolina Pub Svc Auth retail elec (BAM) (SECMKT)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
South Carolina Pub Svc Auth retail elec (BAM) (SECMKT)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
South Carolina Pub Svc Auth retail elec (BAM) (SECMKT)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
South Carolina Pub Svc Auth retail elec (BHAC) (SECMKT)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
South Carolina Pub Svc Auth retail elec (MBIA) (National)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
South Carolina Pub Svc Auth retail elec (National)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
South Carolina Pub Svc Auth retail elec (National)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
South Carolina Pub Svc Auth retail elec (National)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
South Carolina Pub Svc Auth retail Elec (BAM) (SECMKT)		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded
South Carolina Pub Svc Auth rev oblig bnds ser 2015A-D due 12/01/2055		
Unenhanced Rating	A-(SPUR)/Negative	Downgraded

Many issues are enhanced by bond insurance.