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South Carolina Public Service Authority; Retail Electric

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Long Term Rating	A/Stable	Affirmed

Rating Action

S&P Global Ratings affirmed its 'A' rating on South Carolina Public Service Authority's (Santee Cooper, or the authority) revenue bonds. The outlook is stable.

We recently revised our outlook on Santee Cooper's debt to stable from negative (see our article published Aug, 12, 2021, on RatingsDirect). That rating action reflected our view that:

- The settlement of outstanding litigation related to the cancelled V.C. Summer units 2 and 3 nuclear project (VCS2&3) resolves cost-recovery risk, under terms that are manageable within the context of the authority's financial profile, and that have led to improved relations and coordination between the authority and Central Electric Cooperative (Central), which accounts for 60% of Santee Cooper's electric revenue;
- Budgetary savings associated with renegotiated coal and rail contracts, fully hedged gas needs, and debt reduction provide the authority with financial headroom to operate under the settlement-imposed rate freeze through 2024;
- The expiration of Act 95 of 2019 (effectively ending the South Carolina Legislature's pursuit of a sale of, or third-party operator for, Santee Cooper) and the adoption of Act 135 enable the authority to continue to pursue strategies that enhance the flexibility and diversity of its power supply, reduce carbon intensity, reduce operating costs, and deleverage its balance sheet; and
- The adoption of South Carolina's Act 90 of 2021, which enhances governance oversight, preserves the authority's rate-setting autonomy, and does not unduly constrain operational and financial flexibility.

The authority had $6.9 billion in debt outstanding at Sept. 30, 2021.

Credit overview

Despite the positive developments that led to our revision of the outlook to stable in August 2021, the authority is facing challenges related to disruptions to coal deliveries and an outage at V.C. Summer nuclear unit 1 (VCS1), both of which are expected to result in increased power costs and lower coverage metrics for fiscal 2021, and possibly 2022, as Santee Cooper's ability to pass through these costs to ratepayers is constrained by the Cook settlement-imposed rate freeze. Nevertheless, we believe that the impact will be manageable at the current rating level.

Santee Cooper is facing higher-than-budgeted electric demand and fuel and purchased power expense. Coal suppliers and coal transportation companies have been unable to keep pace with a rapid shift in demand and the new-found price competitiveness for their commodity relative to natural gas--which has increased by 50% year over year. The disrupted coal deliveries have prompted the authority to dispatch its higher-cost gas units and rely on more expensive power purchases to conserve its coal pile, which currently stands at about 34 days of projected burn, or about 70% of the minimum inventory that the utility uses for planning purposes. Although there has been a slight improvement in deliveries in recent weeks, the authority is now projecting that the disruption may last through the first quarter of 2022. Although Santee Cooper has hedged its budgeted gas demand, the authority is unable to recover the higher fuel costs associated with above-budgeted demand, due to the Cook settlement-imposed rate freeze. As a result, management now projects $45 million in higher fuel and power costs associated with the disrupted coal deliveries.

On Nov. 15, 2021, VCS1 experienced a forced reactor shutdown due to the failure of the main step-up transformer (external to the nuclear reactor), which we understand has been preliminarily attributed to bushing insulation on the transformer. A brief fire was extinguished, but not before oil from the faulted main transformer entered Lake Monticello. A replacement transformer is on site, and majority owner Dominion estimates the transformer replacement will be completed on Dec. 6, 2021, but Santee has needed to purchase replacement power during the outage. Based on the preliminary schedule, the authority estimates fuel cost increases of approximately $10 million.

As a result of the heightened power costs associated with the coal supply disruption ($45 million) and the VCS1 outage ($10 million), management now projects 1.25x debt service coverage (DSC), (and we calculate fixed cost coverage [FCC] would be 1.19x) for fiscal 2021. This would represent weakened metrics from historical levels, but in our view this is a near-term event, mitigated by the authority's robust liquidity.

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% served directly, and 80% served indirectly, through its sales to Central Electric Power Cooperative (Central).
- Rates are competitive, but the authority's rate-raising flexibility is limited while Santee Cooper operates under the Cook settlement-imposed rate freeze.
- 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, while also reducing operating costs to create headroom under the Cook settlement-imposed rate freeze. We generally view these plans as credit supportive, but we also believe that there is a degree of execution risk in pursuing them.
- DSC has averaged a solid 1.42x over fiscal years 2018-2020, and FCC has averaged 1.33x.
- We understand that higher-than-anticipated demand (associated with improving economic conditions), coupled with disrupted coal deliveries and a forced outage at the authority's VCS1, have forced the authority to increase power purchases and dispatch of higher cost gas units, boosting power costs above fiscal 2021 budgeted levels. Therefore, we anticipate lower DSC and FCC for fiscal 2021, 1.25x and 1.19x, respectively. Furthermore, we believe that the rate freeze, power supply execution risk, and challenges regarding the return-to-service date for VCS1 and coal supply deliveries make uncertain management's forecast of 1.35x-1.52x DSC (with FCC at about six basis points lower) over fiscal years 2022-2024. Nevertheless, and despite the revision, we believe these levels will continue to support the current rating.
- Liquidity and reserves, which measured $984 million at fiscal year-end 2020 (353 days of operating expenses), are robust although more than half is in the form of available lines of credit and revolving credit agreements supporting

commercial paper that can be issued for either capital or operating purposes.

- Santee Cooper is a moderately leveraged utility, with debt measuring 76% of total capitalization. We expect this ratio will improve to about 70% 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.

The stable outlook incorporates our view that the legal and political headwinds stemming from the cancellation of the VCS2&3 nuclear project have been largely resolved, without further significant sacrifice (beyond the rate freeze) of operational and financial flexibility, enabling the authority to pursue strategies to remake its power supply. Uncertainties resolved include the settlement of litigation that threatened cost recovery on the nuclear project; legislation that enhanced governance oversight but did not result in a change in authority ownership (under consideration prior to expiration of Act 95); and cost-cutting measures that have created headroom for the authority to operate under a rate freeze through 2024. In our view, recent increases in fuel and power costs, and the expected fiscal 2021 decline in DSC and FCC are manageable within the context of the authority's overall credit profile, but we acknowledge that further cost pressures are a risk due to constraints of the rate freeze.

Environmental, social, and governance (ESG) factors

We believe that Santee Cooper faces heightened environmental risk. The authority anticipates closure of its 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 (37% of generation production in 2020) and natural gas plants (24% of energy). Nuclear (12% of energy), hydro (3%), and renewables (3%) 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 primarily relate to the financial and operational effects of the COVID-19 pandemic and attendant recession as customers grapple with health and safety concerns, a situation exacerbated by below-average incomes. In our view, however, the pandemic and attendant recession have had a limited impact on Santee Cooper. Weather-adjusted sales were down about 5% in 2020, primarily among industrial and commercial customers, but are back to levels forecast prior to 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 a rate freeze through 2024.

We believe that governance risk has lessened with the expiration of Act 95 and the adoption of Act 90, which followed the cancellation of the VCS2&3 nuclear project. Nevertheless, we continue to believe that governance risk is elevated relative to that of peers, given significant turnover of its board and executive management, a current search for a new chief executive (the current CEO's contract expires in January 2022 and cannot be renewed), 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 (PSC) approval.

Stable Outlook

Downside scenario

We could lower the rating if the authority's inability to recover rising fuel costs due the rate-freeze further pressures financial margins and coverage ratios beyond levels currently projected. We could also lower the rating if the requirement that the authority obtain legislative approval as a precondition to accessing capital markets frustrates its ability remake its power supply, which we view as key to controlling costs and providing flexibility to operate under the rate-freeze.

Upside scenario

We do not anticipate raising the rating over the next two years given the financial constraints imposed by the rate freeze, higher-than-budgeted fuel costs in 2021 (and projected for 2022), and the execution risk in pursuing an aggressive plan to remake its power supply.

Credit Opinion

Santee Cooper, based in Moncks Corner, S.C., is a state-owned electric and water utility. The electric system, which accounts for about 99% of revenue, derives 36% of its revenue from retail sales, and 64% from wholesale sales. The electric system directly serves about 194,000 retail customers. Direct sales to residential, commercial, and industrial customers measure 11%, 13%, and 12% of total operating revenue, respectively. The utility indirectly serves another 800,000 electric customers, primarily through its largest wholesale customer, Central, under a coordination agreement that expires in 2058. Central serves 20 member-distribution cooperatives, and accounts for about 60% of Santee Cooper's total operating revenue.

V.C. Summer units 2&3 nuclear project abandonment: Litigation, political backlash, and legislation

In mid-2017, Santee Cooper cancelled the construction of the V.C. Summer nuclear units 2 and 3, after investing $4.5 billion. The utility cited the project's significant delays, substantial cost overruns, and uncertain completion costs in support of its abandonment decision. Although we view these positions as compelling, we believe that the project nevertheless contributed to almost doubling the utility's debt over a decade without delivering prospects for producing project revenues to defray the added debt burden. Cancelling the project also removed prospects for replacing carbon-laden coal-fired generation with zero-emission nuclear generation.

Cost overruns and project cancellation triggered customer and political backlash, contentious board and management changes, and litigation and legislation targeting the utility. However, a court-approved settlement was reached in the most significant of the litigation, Cook, et al. v. Santee Cooper, et al., which had sought to preclude Santee Cooper from recovering investments in the abandoned project. Under the settlement, Santee Cooper is cash-funding $200 million in payments (spread over fiscal years 2020-2022), and has agreed to freeze rates through 2024. Importantly, the settlement allows Santee Cooper to include the debt costs associated with the nuclear project in its rates, irrespective of the rate freeze.

The project cancellation also resulted in political backlash and passage of Act 95 (2019), which directed exploration of a sale or restructuring of Santee Cooper. But after receiving bids and evaluating what it deemed to be the best sale and third-party operator proposals, the legislature rejected the proposals, and adopted Act 135 (2020), enabling the authority to proceed with its plans to remake its power supply, consistent with its previously submitted reform budget.

Act 95 expired in May 2021, effectively ending the legislature's effort to sell or find a third-party operator for Santee Cooper; we understand that after unanimously passing Act 90 in June 2021, the legislature has no plans to revisit the matter in the near future.

Key Act 90 provisions address governance reforms touching on the following areas:

- Board composition--including size, representation, terms, and qualifications;
- Debt reforms--creates a process whereby Santee Cooper must seek state Joint Bond Review Committee (JBRC) approval for new money, long-term debt, or refundings that do not achieve savings;
- Resource oversight--requires PSC approval for generating facilities larger than 75 megawatts (MW), transmission facilities of 125 kV or greater, and power purchase agreements greater than 10 years for non-renewable resources; and
- Rate-making oversight--provides a process whereby intervenors may challenge proposed rate increases, and requires that proposed rate increases be submitted to the state Office of Regulatory Services (ORS).

In our view, Act 90 enhances oversight and provides clearer processes for rates, debt issuance, and resource planning. While it may limit nimbleness of action, it does not create extraordinary constraints relative to other issuers or states. In our view, it preserves Santee Cooper's rate-setting autonomy and should not unduly constrain operational and financial flexibility as long as the authority maintains good communication with the JBRC, the ORS, and the PSC.

Enterprise Risk

Economic fundamentals

The utility serves a broad footprint across South Carolina, with almost 1 million direct and indirect customers. Santee Cooper directly serves 198,000 residential, commercial, and industrial customers (36% of total electric revenue), with each class accounting for near-equal shares. About 60% of the authority's revenue is derived from sales to Central, which has 20 distribution cooperative members, serving about 800,000 end-use customers. Central's distribution members have largely residential bases, and it is a significant contributor to Santee Cooper's revenue stream; we believe that this contributes to stable demand patterns.

In our view, direct-serve industrial customers do not represent a significant percentage of authority revenue. Nevertheless, we note that Santee Cooper recently extended its contract to serve its second-largest direct-serve customer, Century Aluminum (1.3% of revenue), through 2023. We understand that the authority earns small margins on sales to Century, but we also note that these sales serve to support Santee Cooper's fixed costs. Although South Carolina's unemployment rate is elevated (4.5% in June 2021) due to the pandemic and economic downturn, it is below the national rate. Incomes are below average at 88% of the nation, which we believe contributed to the backlash regarding the nuclear project and the imposition of the rate freeze. In our view, this serves to constrain our assessment of Santee Cooper's economic fundamentals.

Market position

According to the U.S. Department of Energy's Energy Information Administration (EIA), Santee Cooper's weighted-average rate was 88% of the state's average system rate in 2020, the most recent year of available comparative information. As Santee Cooper is a hybrid retail/wholesale entity, we believe that the EIA comparative is somewhat misleading because it includes wholesale rates to Central (but not distribution costs) as well as fully bundled rates to direct-serve retail customers. We also note that Santee Cooper's rates are below those of SCE&G/Dominion and Duke Carolinas across all customer classes, but slightly above Progress Energy's rates.

The authority's most recent base-rate increase, 2.1%, was in 2017. Proposed rate increases for 2018 and 2019 were withdrawn, as the authority cancelled plans to issue $2.5 billion in additional debt to complete financing of the V.C. Summer project. As part of the Cook litigation settlement, rates are frozen through 2024. During the rate freeze, Santee Cooper will not be able to pass along changes in its fuel and purchased power costs beyond what the authority projected in its reform plan. The settlement established monthly fuel-adjustment rates, for both retail customers and Central that will be used during the rate freeze in lieu of calculating monthly rates, as had been the practice.

While we believe the rate freeze places a potential constraint on Santee Cooper's financial flexibility, we nevertheless note that there are carve-outs allowing for rate increases in certain limited circumstances, including named storm events, cyberattacks, and plus or minus 4% deviations in Central's load.

We also understand that since development of the reform plan, coal and coal transportation contracts have been renegotiated and the authority has largely hedged gas costs for projected demand through 2026, at prices below those contemplated under the reform plan. In our view, this has created headroom to operate under the rate freeze without compromising financial metrics or constraining power supply plans. Supporting this view is Santee Cooper's plan to adopt a modest rate increase in 2027, its first in a decade, which is well after the expiration of the rate freeze.

After the rate freeze, the authority's fuel and power cost recovery mechanisms will revert to the pre-existing formula that we view as credit supportive: for retail sales, an automatic fuel-cost adjustor based on three-month rolling average, and an automatic adjustor for variance in the demand component of non-firm sales and off-system sales; together, the cost tracker covers about 75% of costs and minimizes budget variance. After the freeze, sales to Central will be adjusted monthly for fuel and annually for non-fuel variances.

Operational Management Assessment (OMA)

Although the authority has a diverse fleet of generation assets and fuels, it still has $3.6 billion of debt outstanding (and a $3.7 billion regulatory asset) related to the cancelled nuclear project, and this is captured in our assessment, despite the ameliorative effect of the Cook settlement. Also reflected in the OMA is our view of Santee Cooper's power supply plans, which are designed to preserve system reliability while transitioning its coal-dependent portfolio to a cleaner, more efficient, more flexible, and more diverse generating resource portfolio. Santee Cooper's 4,830 MW of owned generation (and its allocation of hydroelectric energy from the Southeastern Power Administration) supplies about 80% of the utility's energy requirement, with the remainder coming from market economy purchases and long-term power purchase contracts. Santee Cooper has modest excess capacity, but this is expected to be largely eliminated over the intermediate term, as the authority's power supply plan envisions closure of its Winyah coal units by 2028.

Coal-fired generation accounts for about 37% of the authority's energy, down from about 60% several years ago, as natural gas (24%) has economically displaced coal as the fuel of choice.

Despite a challenging legal and political environment, we believe that management has successfully reduced operating costs and leverage, while driving toward settlement of the Cook litigation and improved relations with Central. We also believe that management has put together a credible plan to remake Santee Cooper's power supply, focusing on carbon reduction, fuel diversification, and reduced fuel costs. Key elements of Santee Cooper's power supply plan (which are subject to change as the authority's load forecast is revised) include:

- The retirement of 1,150 MW of coal-fired generating capacity at Winyah by 2028, with the phase-out beginning in 2025;
- The installation of up to 200 MW dual-fuel (natural gas and oil) for reliability purposes;
- The purchase of 1,500 MW of solar capacity by 2031 (a greater than 800% increase over current levels);
- The addition of about 950 MW of natural gas-fired generating capacity, including approximately 550 MW to be built in the mid-2020s and approximately 450 MW to be purchased under tolling agreements during the 2030s;
- The addition of approximately 200 MW of battery storage, which may be purchased from the market by 2028; and
- In conjunction with partners, 150 MW of demand-side conservation by 2027, with an additional 50 MW to be achieved by 2037.

In our view, Santee Cooper's power supply plans, if executed, could help the utility achieve further carbon reduction. Management projects coal will account for 20% of energy by 2030 (down from 37% in 2020), largely supplanted by natural gas (31%, up from 24%) and renewables (18%, up from 3% in 2020). Nevertheless, we expect that Santee Cooper will still have a sizable carbon footprint that exposes it to a wide set of environmental regulations.

It is important to note that the costs associated with these plans were built into Santee Cooper's reform budget, upon which the rate freeze was predicated. We also note that Central is not bound to these plans and has certain opt-out rights on future projects, which effectively forces Santee Cooper to give significant consideration to Central's needs and desires in formulating its power supply plans. Nevertheless, any decision by Central to opt out of future projects would have no bearing on its obligation to serve then-existing load from Santee Cooper's then-existing resources. And from a practical standpoint, we also believe that there is minimal potential for the opt-out to affect Santee Cooper's power supply plans prior to 2030, when Central's contract with Duke Carolinas expires.

Financial Risk

Coverage metrics

The authority achieved DSC averaging 1.48x over fiscal years 2018-2020. However, we calculate FCC at an average of 1.33x (including 1.29x in 2020). Our calculation of FCC treats payments to the state as an operating expense and a portion of payments to other energy suppliers as debt service rather than operating expenses because we view these payments as vehicles for funding the suppliers' recovery of their investments in generation assets serving the utility.

Operating revenue for 2020 were down 6% year over year, due to lower fuel rate revenue, energy sales, and demand usage. About 45% of the decrease was driven by milder-than anticipated weather, with the remainder attributed to the COVID-19 pandemic. Operating expenses for 2020 were down 4% year over year, due largely to lower fuel and power expenses associated with the lower energy sales and lower commodity costs.

Operating revenue for fiscal 2021 year to date (nine months) are tracking above the same period in 2020 and the 2021 budget, as energy sales and demand usage have increased significantly from the height of the pandemic, and secondarily as a result of a new agreement with Century Aluminum that expands facility capacity and higher production at Nucor--among the authority's largest direct-serve industrial customers.

However, the outage at VCS1 and disrupted coal deliveries are driving operating expenses even higher, as the authority has needed to preserve its coal stockpile, replacing owned coal-fired generation with owned gas generation and power purchases, at elevated prices spurred by rising natural gas prices.

Assuming the coal delivery disruptions extend through April 2022, the authority projects 2021 DSC at 1.25x (down from 1.38x projected at the time of budget adoption), and we calculate FCC of about 1.19x. Based on Santee Cooper's projections, we calculate FCC 1.29x-1.46x over fiscal years 2022-2024, but note that remains contingent on VCS1 returning to service by year end 2021, and improved coal deliveries by April 2022.

Liquidity and reserves

We view Santee Cooper's liquidity as robust in both absolute and relative terms. The utility recorded $442 million of unrestricted cash and investments at Dec. 31, 2020. In addition, the authority had $542 million of capacity available under revolving credit facilities and lines, which bolstered its liquidity position to 353 days of operating expenses.

While these levels are down from previous years, the decline was anticipated, as the authority used Toshiba settlement money (related to the failed V.C. Summer nuclear project) to pay down debt and fund debt service requirements over fiscal years 2018 and 2019. We expect liquidity will remain above 237 days of operating expenses through 2025 and continue to support the current rating.

Debt and liabilities

S&P Global Ratings' leverage ratio calculation yielded a 76% debt-to-capitalization ratio for 2020, which we consider moderately leveraged for a vertically integrated utility. Santee Cooper's $2.3 billion capital plan for 2021-2028 calls for $1.3 billion in additional debt; nevertheless, the authority's debt-to-capitalization ratio is expected to decline to about 70%, as amortization and cash from operations offset the new money issuance.

The authority's debt service schedule is relatively flat, with the exception of a $175 million bullet maturity due in 2023. We understand that the authority has designated $85 million in reserves toward the repayment of the bullet, which would have the effect of levelizing debt service requirements from operations and reducing funding risk.

Related Research

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

Ratings Detail (As Of December 6, 2021)

Ratings Detail (As Of December 6, 2021) (cont.)		
South Carolina Pub Svc Auth retail elec		
Long Term Rating	A/Stable	Affirmed
South Carolina Pub Svc Auth retail elec (AGM)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
South Carolina Pub Svc Auth retail elec (AGM) (SEC MKT)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
South Carolina Pub Svc Auth retail elec (AGM) (SEC MKT)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
South Carolina Pub Svc Auth retail elec (AGM) (SEC MKT)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
South Carolina Pub Svc Auth retail elec (AGM) (SEC MKT)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
South Carolina Pub Svc Auth retail elec (AMBAC)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
South Carolina Pub Svc Auth retail elec (ASSURED GTY)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
South Carolina Pub Svc Auth retail elec (BHAC) (SEC MKT)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
South Carolina Pub Svc Auth retail elec (MBIA) (National)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
South Carolina Pub Svc Auth retail elec (National)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
South Carolina Pub Svc Auth retail elec (National)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
South Carolina Pub Svc Auth retail elec (National)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
South Carolina Pub Svc Auth rev oblig (Taxable) ser 2016D due 12/01/2056		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
South Carolina Pub Svc Auth (AGM) (SEC MKT)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.