FitchRatings

Public Finance
Public Power
United States

Peninsula Clean Energy, California

Rating

Long-Term Issuer Default Rating	BBB+

Rating Outlook

Stable

Applicable Criteria

Public Sector, Revenue-Supported Entities Rating Criteria (March 2020)

Related Research

Global Economic Outlook: Crisis Update Late April 2020 – Coronavirus Recession Unparalleled (April 2020)

U.S. Public Finance and Infrastructure: Coronavirus Response So Far (April 2020)

USPF Changes Model Assumptions Due to Coronavirus (April 2020)

Fitch Ratings Updates 2020 Sector Outlooks to Reflect Coronavirus Impact (March 2020)

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The 'BBB+' Issuer Default Rating (IDR) primarily reflects Peninsula Clean Energy's limited operational role as the default provider of generation services as a Community Choice Aggregator (CCA). The IDR is heavily influenced by the inherent credit weakness in the CCA business model, which include a non-exclusive customer base that can select service from one other generation provider, Pacific Gas & Electric (PG&E). The IDR is supported by the financial flexibility conveyed by PCE's current headroom in rates and its strong financial profile, which includes strong operating margins and robust liquidity levels.

The recent outbreak of the coronavirus and related government containment measures create an uncertain environment for the public power sector in the near term. While PCE's performance through most recently available data has not indicated credit impairment, overall demand declined by 6% initially after California's shelter-in-place order. Material changes in revenue and cost profile are occurring across the sector and are likely to worsen in the coming weeks and months as economic activity suffers and government restrictions are maintained or expanded.

Fitch's ratings are forward looking, and Fitch Ratings will monitor developments related to the severity and duration of the coronavirus outbreak, and incorporate revised expectations for future performance and assessment of key rating drivers.

PCE is a California joint-powers authority (JPA) created in 2016 for the purposes of implementing a CCA program. PCE's service area includes all of San Mateo County, CA. Within its service area, PCE provides generation-only services directly to all retail customers of PG&E, unless those customers opt out and elect PG&E as their provider. PG&E still delivers the energy to customers over PG&E transmission and distribution lines, and provides metering and billing services as PCE's collection agent.

Key Rating Drivers

Revenue Defensibility — Weaker: The weaker revenue defensibility assessment primarily reflects a customer base that can opt out of service from PCE, and competitive pressure on PCE not to exceed PG&E's rates, given expected customer sensitivity to rates. Fitch does not believe these weaknesses are mitigated by PCE's independent authority to set and adjust rates or PCE's legal ability to impose an exit fee on departing customers.

The weaker revenue defensibility assessment also reflects PCE's lack of control over the Power Cost Indifference Adjustment (PCIA), which is set by the California Public Utility Commission (CPUC) and charged to PCE customers.

Operating Risk — Midrange: PCE's operating risk is limited given its role as an energy supplier. Power supply resources consist entirely of contracts with varying counterparties, geographic locations, terms and fuel types. The operating risk assessment also incorporates the long-term financial risk associated with securing power supply for a potentially variable customer base, given state legislation that requires 65% of the state renewable portfolio standard (RPS) be secured under 10-year or longer contracts by 2021.

Financial Profile — Stronger: PCE's stronger financial profile reflects robust liquidity (over 200 days' cash on hand) that is steadily increasing. Operating margin was exceptionally strong at 20% in fiscal 2019, and quarterly results YTD for fiscal 2020 indicate similar margins. Fitch expects headwinds from the spread of the coronavirus and resulting impacts on the economy to result in a sharp contraction of energy sales for the balance of fiscal 2020, with a recovery to or near-prior levels in fiscal 2021. Purchased power costs can be reduced to account for lower demand, which should partially mitigate the impact.

Fitch expects PCE's financial profile to continue to be stronger, even under Fitch's revised coronavirus assumptions.

Asymmetric Risk Additive Considerations: No material asymmetric risk factors affected the overall rating.

Rating Sensitivities

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade:

- Sustained strong levels of cash reserves that provide meaningful protection against a multiyear customer opt-out trend, given long-term contractual commitments for energy purchases.
- Continued very strong operating margins and containment of operating expenses related to programs other than resource acquisition.
- Cessation of competition from alternative generation provider.

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade:

- A prolonged economic slowdown triggered by the coronavirus pandemic and a reduction in operating margins or reserve levels in response to the economic effects of the virus.
- Significant adverse change in the regulatory or competitive landscape within which PCE operates.
- An increase in PCE's leverage ratio above 0.0x, or a decline in liquidity below its reserve policy of 180 days.
- Reversal in the declining renewable cost trend that erodes PCE's cost advantage to PG&E.

Rating History (IDR)

Rating	Action	Outlook/ Watch	Date
BBB+	Assigned	Stable	4/8/20

IDR – Issuer Default Rating.
Source: Fitch Ratings.

Credit Profile

Revenue Defensibility

Default Generation Provider in San Mateo County

PCE is the default provider of power generation to all residents located in San Mateo County, as required by the 2002 California legislation enabling CCAs. The legally required default to PCE service is a strong credit feature. Customers are presumed to be price sensitive, but also relatively non-action oriented. Consumer behavior tends to strongly favor the default assignment when automatic enrollment occurs. Fitch views the default to PCE service and rates slightly below PG&E as supportive elements of demand and the final rating.

The 20 cities located in the county and the county itself elected to sign a JPA in 2016 to create PCE. The decision by the 20 city councils and the San Mateo county supervisors was unanimous in support of PCE's creation. The regional unanimity between the 21 entities in the creation and need for PCE as an alternative to PG&E is also considered a strong credit factor.

Participating cities and counties are required to remain part of the JPA or pay the costs incurred on their behalf prior to their departure. Any municipality seeking to leave the JPA must also provide six months' notice. While this requirement could act as a potential restriction on communities seeking to exit the JPA, it provides no constraint on whether residents of the member city can opt out of service from PCE. PCE has the ability to consider the addition of new members to the JPA outside San Mateo County in the future, but it would require a vote of the board.

Customer Opt-Out Ability Is Key Risk

PCE became the default generation provider for all retail customers within the entire county between October 2016 and April 2017. New customers in the county are automatically enrolled as PCE customers. However, all customers retain the ability to opt out of service and revert to being a generation customer of PG&E at any time, potentially undermining the long-term stability of demand. This characteristic limits Fitch's assessment of revenue defensibility to weaker, despite the credit strengths noted above. Operating history is limited to three years, but customer opt-out rates to date are minimal at approximately 2.8%. Given PCE's rates are below those of PG&E, Fitch expects the opt-out rate to remain low.

CCAs are permitted to charge departing customers an exit fee, and PCE charges a $5 administrative fee to residential customers and a $25 fee to commercial customers that leave after the first year of service. The current administrative fee is minimal. Fitch expects any effort by PCE to impose a more sizable exit fee would be met with some level of political backlash. Fitch views the legal ability to implement an exit fee as insufficient on its own to provide financial protection against PCE's fixed costs in the event of a meaningful trend of customer departures.

Very Strong Service Area Characteristics

San Mateo County exhibits very strong service area characteristics, supporting ongoing demand. The county is located in the San Francisco Bay Area, equidistant from the cities of San Francisco to the north and San Jose to the south. The very strong service area characteristics indicate customers in the county may be less sensitive to price and more motivated by product differentiation offered by PCE compared with PG&E. The county's median household income was $113,776 in 2018, or 189% of the national average. Unemployment in the county was very low at 2.1% as of January 2020, or approximately half the national average. Median home value in the county was $1.5 million in 2018.

PCE serves approximately 296,000 customers within the county, residing in 21 cities and unincorporated parts of the county. Residential customers account for around 36% of revenues. Customer concentration is not a concern, with the 10 largest customers accounting for only 11.3% of energy sales.

Coronavirus Considerations on Demand

Retail electric demand in the service area appears strong, albeit on a limited operating history. Retail electric sales increased by 1.6% in fiscal 2019, which is driven by ongoing commercial development within a relatively built out and geographically constrained service territory. Fitch believes electrical demand will decline through fiscal 2020 and potentially 2021 as a result of California's shelter-in-place order announced by Governor Newsom on March 19. PCE's initial indication is a 6% decline in load, with increased residential demand not quite offsetting declines in commercial demand. PCE's operating expenditures are approximately 90% purchased power, which provides some ability to reduce operating expenditures. The board took action in late March to provide a $100 bill credit to low-income customers for a total estimated cost of $3 million.

Product Differentiation

PCE offers two products to customers, both in support of its overall mission to provide the county's power supply from 100% greenhouse gas (GHG)-free sources by 2021 and achieve a 100% renewable power supply by 2025. The differentiation offers customers a greener generation supply than is currently available from PG&E (86% GHG free and 39% renewable in 2018).

PCE's default product is ECOplus, which provides a power supply at or above 50% renewable and 95% GHG free. PCE also offers, at the customers' choice, ECO100, which provides a 100% renewable power supply. ECOplus is priced at a 5% discount to PG&E's comparable generation rate. ECOPLUS charges a $0.01/kWh premium above the ECOplus rate, which results in a rate approximately 5% above PG&E's comparable generation rate.

Product differentiation and cost savings provided the motivation for the cities and county to create and join PCE and define the agency's mission. However, it appears less of a motivation for individual customer decisions given the limited election by customers for PCE's greener alternative at a higher price. Fitch does not view PCE's product differentiation as sufficient to offset the risk of customers' opt-out flexibility; consumers are presumed to be price sensitive. PG&E and all California utilities are legally mandated to continue raising their GHG-free and renewable content over time, reducing PCE's current competitive advantage provided by its higher renewable content.

PG&E Risks

PG&E delivers the energy purchased from PCE to the retail customers over PG&E's transmission and distribution lines, and bills the retail customer on a combined bill in the role of PCE's billing agent. The flow of PCE revenues collected by PG&E is protected following the PG&E bankruptcy filing in early 2019. One of the first actions the bankruptcy court took was to maintain the existing collection arrangements between PG&E and CCAs, including PCE. PG&E remits the funds daily to PCE.

PG&E engages in public safety power shutoffs to reduce its exposure to wildfires during certain weather conditions in high-risk areas. The result of the shut-offs affects PCE's sales because its customers receive power delivered via PG&E's transmission and distribution lines. PCE has no ability to deliver power to its customers during a PG&E public safety power shutoff. PG&E declared 12 public safety power shutoffs in 2019, three of which affected parts of San Mateo County to varying degrees.

Independent Rate Setting, but Competition and PCIA Place Practical Constraints on Pricing

PCE has the independent and legal authority to adjust rates to fully recover costs. The 22-member board of directors makes rate decisions not subject to external review. While all participating municipalities and the county each have a representative on the PCE board, PCE is not considered a related entity of any one participating member or government entity.

In practice, PCE sets its rates for the ECOplus product at 5% less than PG&E cost of service for the comparable customer class. PCE adjusts its rates as often as practical after PG&E implements a rate change. PCE has a good amount of rate flexibility given its rates are 5% under PG&E's rates for its primary product, and rates provide a very strong operating margin. Increases in rates, if implemented, are unlikely to affect demand.

This rate-setting philosophy is likely to remain in place unless PG&E exits the retail generation business or rates are lowered to a point that they do not recover PCE's full costs. Fitch considers this last scenario unlikely given the current differential and no indication PG&E's rates will decline in the near term. PG&E has a three-year general rate case pending at the CPUC that requests rate increase in 2020, 2021 and 2022. To be conservative, PCE has not included any rate increases in its financial forecast, but if PG&E increases its generation rates, PCE expects the board will act to adjust rates to preserve the 5% differential.

Power Cost Indifference Adjustment

PCE does not have ultimate control over one component of its rates, limiting its practical rate flexibility. Customers are charged a PCIA determined by the CPUC. PCE does not have direct recourse to alter the PCIA charged to its customers, but it elects to reduce the amount of its bill to each customer by the same amount of the PCIA charged to that customer to preserve the 5% rate differential to PG&E rates. If the CPUC raises the PCIA, this reduces PCE's revenues, and consequently operating margin.

The PCIA is charged per kWh and is intended to reflect the difference in the cost of PG&E's portfolio developed to serve the departing customer, less the market value of the portfolio, leaving PG&E indifferent to the loss of that customer's generation load. PCIA charges increased over the past few years as market prices decreased, widening the gap between PG&E's portfolio cost and the market value for that power. The PCIA will gradually become less relevant for PCE's customers as PG&E's legacy contracts mature over time.

Operating Risk

PCE's role is limited to power supply procurement. The distribution, delivery and transmission of power, as well as billing and collections, remain obligations of PG&E. Cost drivers are well identified and power supply volatility is manageable given PCE's hedging practices. Capital needs are negligible because PCE does not own any generation; all power supply resources are contracted. Positively, this means PCE generally does not bear the development, construction, operating or system risks experienced by generation resource owners, integrated utilities or distribution utilities.

Operating Cost Flexibility

Operating costs consist of the cost of power, marketing, and general administration and operating expenses. PCE's cost of power is relatively stable within the budget year, as power supply is contracted at or above 90% for each upcoming 1-month period, primarily through fixed-price — or moderately escalating price — multiyear contracts. While the cost of power per MWh is generally known, the volumes necessary to serve load along with potential fluctuations in energy received under each contract, particularly for intermittent renewables, creates some uncertainty regarding the actual price at any point in time and increases the need to maintain adequate liquidity. The risk of intermittent renewable supplies are partially mitigated by requirements for load-serving entities in California, such as PCE, to demonstrate a 15% reserve margin above its projected peak demand and the use of flexible capacity.

Robust power supplies are generally available with good transmission infrastructure in place. PCE's location within the California Independent System Operator, the prevalence of renewable generation in surrounding areas, the diversity of potential suppliers and the geographical dispersion of contracted resources position PCE well in terms of securing sufficient and adequately priced power to meet its needs.

Power supply is met by over 30 contracts with various suppliers incorporating multiple technologies and fuel types, including renewable, conventional and GHG free. Contracted resources are geographically diverse, although all are located within California. No single contract accounts for over 15% of the total generation supply.

Fitch views the key resource risk to be the balance of contracted power supplies against the potentially variable demand, given lack of the exclusive right to provide generation service. PCE adopted a formal risk-management plan intended to limit the potential risk of being either short or long power supply in any particular year, or being vulnerable to unexpected price movement. PCE's practices call for it to have between approximately 90% and 100% of its energy needs under fixed-price contracts during the upcoming year and successively lower amounts in each of the following years. PCE's policy is to be 100% hedged in each upcoming quarter, even those periods of the year that do not typically, but can, experience price variability. This was an enhancement the board implemented following an unusual pricing event in spring 2019.

Balancing supply and demand is further complicated by certain legislative mandates. Utilities, including CCAs, must secure at least 65% of the RPS-compliant power under contracts that extend 10 years or longer by 2021. While California's RPS compliance targets are below the actual renewable content of PCE's power supply (33% in 2020, compared with PCE's 50%), the long-lived nature of the contracts pose challenges to adjusting power supply costs if significant load departure occurs. PCE's contracts result in over 70% of the power supply being contracted through 2021, declining to just over 40% through 2023. PCE could withstand a pronounced customer departure rate over that period as the contract terms mature, but not an event that precipitated a widespread and abrupt departure of most of the customer base.

PCE's capital needs are limited and do not include plans to build self-owned generation. Fitch has not included any debt financing of capital needs in its analysis.

Financial Profile

PCE's leverage profile is supportive of the rating, but less of a consideration than the revenue defensibility and operating risk assessments. Fitch's leverage metric includes fixed obligations, such as debt and pension liabilities (of which PCE has neither) minus cash reserves, compared with cash flow. Given the absence of fixed obligations, Fitch's net leverage calculation for PCE is negative.

Strong operating margins and liquidity support PCE's financial profile and the final rating. PCE's most recent financial forecast for fiscals 2021–2024 was completed in 2019 and indicates a potential tightening of financial margins over the next five years. The tightening is primarily the result of conservative revenue assumptions — no rate increases, although rates were increased in fiscal 2020 following PG&E's rate increase — and operating expenses based on higher prices experienced in spring 2019. Fitch's analysis relied on PCE's financial forecast, adjusted to reflect what Fitch expects to be declines in electric demand in fiscals 2020 and 2021 due to the coronavirus impact and weaker economic growth.

Liquidity is robust and has grown steadily since operations began. Liquidity is additionally enhanced by the use of a $12 million line of credit. Cash balances at the end of fiscal 2019 (June 30) totaled $114 million, or 201 days' cash on hand. Including the line of credit, PCE's total days' liquidity was 222. Unaudited interim results show unrestricted cash balances grew to $162 million by Dec. 31, 2019. Management adopted a revised liquidity policy in February 2020 that targets building cash reserves to 180 days' cash. Fitch expects cash reserves to remain strong, in excess of the board policy.

Asymmetric Risk-Additive Considerations

PCE is governed by a 22-member board of directors. Board members are elected city council members or supervisors from each of the member cities and counties PCE serves. While they are not elected to the PCE board, the representatives are elected to represent their respective communities.

The legal and regulatory environment for CCAs continues to evolve. Fitch does not view the legal and regulatory regime as an asymmetric additive risk factor that affects the overall rating, but changes could present a rating risk in the future.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of Environmental, Social and Governance (ESG) credit relevance is a score of '3' – 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 our ESG Relevance Scores, visit www.fitchratings.com/esg.

Financial Summary — Peninsula Clean Energy, California

($000, Fiscal Years Ended June 30)	2017	2018	2019
Net Adjusted Debt to Adjusted FADS (x)[a]	**(0.56)**	**(1.04)**	**(2.07)**
Net Adjusted Debt Calculation			
Total Short-Term Debt	0	0	0
Total Current Maturities of Long-Term Debt	1,500	0	0
Total Long-Term Debt	5,981	0	0
- Restricted Funds – Cushion of Credit	0	0	0
Total Debt	**7,481**	**0**	**0**
+ Capitalized Fixed Charge – Purchased Power	0	0	0
+ Capitalized Fixed Charge – Operating Leases	0	0	0
+ Total Pension Obligation (GASB Fitch-Adjusted NPL + FASB PBO)	0	0	0
- Total Unrestricted Cash	18,882	66,689	114,069
- Restricted Funds for Debt Service	1,500	0	0
Net Adjusted Debt	**(12,901)**	**(66,689)**	**(114,069)**
Adjusted FADS for Leverage Calculation			
Total Operating Revenue	93,129	244,738	259,782
Total Operating Expenses	70,104	180,970	206,912
Operating Income	**23,025**	**63,767**	**52,870**
+ Adjustment for Deferred and Subsidy Revenue	0	0	0
+ D&A	4	56	74
+ Interest Income	9	150	2,039
+ Other Noncash Charges	0	0	0
FADS	**23,038**	**63,973**	**54,983**
+ Operating Lease Payments	0	0	0
+ Adjustment for Purchased Power	0	0	0
- Total Transfers/Distributions	0	0	0
+ Pension Expense	0	0	0
Adjusted FADS for Leverage	**23,038**	**63,973**	**54,983**
Coverage of Full Obligations (x)	**92.54**	**35.60**	**322.80**
FADS	**23,038**	**63,973**	**54,983**
+ Adjustment for Purchased Power	0	0	0
- Total Transfers/Distributions	0	0	0
Adjusted FADS for Coverage	**23,038**	**63,973**	**54,983**
Full Obligations Calculation			
Cash Interest Paid	249	297	170
Prior-Year Current Maturities	0	1,500	0
Total Annual Debt Service	**249**	**1,797**	**170**
+ Adjustment for Purchased Power	0	0	0
Total Fixed Obligations	**249**	**1,797**	**170**
Liquidity Cushion (Days)	**161**	**159**	**222**
Unrestricted Cash (Days)	**98**	**135**	**201**
Liquidity Calculation			
+ Total Unrestricted Cash	18,882	66,689	114,069
+ Total Borrowing Capacity	12,000	12,000	12,000
- Amounts Unavailable	0	0	0
Total Liquidity	**30,882**	**78,689**	**126,069**
Cash Operating Expense Calculation			
Total Operating Expense	70,104	180,970	206,912
- D&A	4	56	74
- Other Noncash Charges	0	0	0
Cash Operating Expenses	**70,100**	**180,915**	**206,838**

[a]Calculated as defined in Fitch's Revenue Master Criteria. PBO – Pension benefit obligation. FADS – Funds available for debt service. D&A – Depreciation and amortization.
Sources: Fitch Ratings; Fitch Solutions; Lumesis; EIA; Peninsula Clean Energy, California.

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.