S&P Global Ratings

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Silicon Valley Clean Energy, California; Retail Electric

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ICR		
Long Term Rating	A/Stable	New

Rating Action

S&P Global Ratings assigned its 'A' issuer credit rating (ICR) to Silicon Valley Clean Energy (SVCE), Calif. The outlook is stable.

Credit overview

SVCE is a joint powers agency (JPA) originally formed in 2016 to procure retail electric commodity on behalf of about 274,000 electric customers across 13 members that include cities, unincorporated Santa Clara county, and towns in the Silicon Valley.

Although SVCE operates as a JPA with many member communities, it simultaneously provides direct retail service to all of its customers (albeit through the billing systems and physical assets of the incumbent investor-owned utility [IOU].) Given this direct retail service, S&P Global Ratings views SVCE's creditworthiness under the scope of our retail electric criteria.

SVCE provides service as a community choice aggregator (CCA) under the California Public Utilities Code section 366.2. Under the code, all of the incumbent IOUs' customers automatically become SVCE customers, but have the option to opt out and return service to the previous provider, Pacific Gas and Electric Co. (PG&E; BB-/Negative/--). Importantly, SVCE does not own, operate, or maintain any of the generation, transmission, or distribution infrastructure used to serve its customers, which we believe distances it from wildfire liability under California's inverse condemnation laws. However, management must procure electricity supply and balance the obligation to enter into contracts for long-term power supply volumes and a potentially fluid customer base that could migrate during the tenure of the CCA's commitments to purchase power. Management does not anticipate member growth within the CCA, which limits this risk somewhat, as it will not need to procure additional load for prospective new members.

SVCE was formed to provide clean and renewable power to its members at a competitive cost, while also generally reducing greenhouse gas emissions and stimulating the local economy. The CCA has the rights and powers to set rates for the services it provides, incur indebtedness, and issue bonds or other obligations. SVCE has no debt outstanding, nor does it plan to issue any debt in the near term.

The rating reflects our opinion of SVCE's strong enterprise and financial risk profiles.

The strong enterprise risk profile reflects our view of the CCA's:

- Large customer base with robust income levels;

- Solid, albeit brief, track record of customer retention;
- Protective JPA member agreements with municipalities, compared with retail customers who retain the right to depart from SVCE;
- Diverse power supply and low cost of power;
- Credit-supportive policies and procedures including fundamentally robust JPA contracts, comprehensive long-term financial forecasting, and a balanced approach to power supply management and contract procurement;
- Limited direct exposure to wildfires through California's strict liability standard and inverse condemnation due to the absence of ownership of transmission and distribution assets; and
- Core mandate to provide renewable power, which positions SVCE well for California's renewable portfolio standard (RPS).

Offsetting these factors are SVCE's direct retail competition with the IOUs, which constrains the CCA to maintain rates comparable with those of the incumbent IOUs. The CCA also faces power-procurement constraints, as the utility must balance its obligation to enter into long-term contracts with a potentially volatile load profile (and must balance its renewable mandates with the need for reliable baseload energy), and the risk of members exiting the CCA. No members have exited to date, and management does not believe a departure is likely given the financial penalty for doing so.

The strong financial risk profile reflects SVCE's robust liquidity and coverage of fixed costs, coupled with its debt-free balance sheet. This is tempered, in our view, by potential erosion of margins due to uncertainty surrounding the power cost indifference adjustment (PCIA). We could revise our assessment positively if SVCE maintains fixed-cost coverage (FCC) in line with current levels while liquidity and leverage remain stable.

The stable outlook reflects our assessment of SVCE's record of customer retention since its 2017 service launch, as well as the utility's robust cash reserves, providing ample cushion in the face of a potentially volatile load profile.

Environmental, social, and governance factors

We believe the CCA's direct environmental risks are low, based on its carbon-free power portfolio coupled with its plans to achieve a 50% RPS portfolio by 2026, and increasing to 60% by 2030. The CCA faces social risk related to COVID-19, as efforts to protect the health and safety of the community could affect the utility's financial metrics if customers are unable to pay utility bills in a timely fashion. Management approved up to $12 million in spending in the spring of 2020 to provide customer relief, workforce relief, and community resiliency programs to members. Finally, we view the utility's governance factors as generally credit supportive, as they include robust JPA member agreements, full rate-setting autonomy, strong policies and planning, and a proactive and experienced management team. However, the potential for retail customer opt-out tempers our view of the CCA's governance factors somewhat.

Stable Outlook

Downside scenario

While unexpected, if SVCE were to experience significant retail customer opt-out or lose one or more of its member communities, it could be forced to sell surplus contracted power to the market. In the event market prices were significantly below those of SVCE's portfolio, the utility could face significant financial pressure, which, in turn, could lead us to lower the rating.

Upside scenario

We could raise the rating in the next two years if SVCE's customer base remains stable, and if the CCA maintains FCC in line with historical levels while simultaneously preserving or building cash reserves and maintaining minimal to no leverage, in the face of potential uncertainty surrounding PG&E's generation rate and the PCIA, coupled with current recessionary pressures.

Credit Opinion

Enterprise Profile: Strong

Economic fundamentals--Very strong

SVCE's 270,000 customers provide revenue diversity and economies of scale. Member median household effective buying incomes were 197% of the U.S. average in 2019, on a weighted-average basis. No single retail customer accounted for more than 4.0% of energy sales in 2019, providing further revenue stability. These factors are offset by SVCE's commercial, agricultural, and industrial concentration--together these customers account for about 65% of energy sales. (However, this data was sourced before the COVID-19 pandemic, which management reports has resulted in a meaningful shift toward residential sales.) Nevertheless, in our view, this customer mix translates to a less predictable revenue stream for the CCA.

A municipal or county member can depart the CCA with six months' notice; however, the JPA contracts stipulate that a departing member must make the CCA whole for any power purchase agreements (PPAs) signed prior to its departure. (Ratepayers are not subject to this clause, lowering the barrier for individual customers switching providers.) Although this remains untested in court, each member agreed to this stipulation before joining the CCA, and we believe the exit fee serves as a disincentive to member communities to terminate their contracts with SVCE.

Market position--Vulnerable

SVCE sets rates at a slight discount (about 4.5%, on average, since launch) compared with those of the incumbent IOU, PG&E, whose rates were 131% of the state average in 2019, according to the U.S. Energy Information Administration. SVCE plans to hold rates at least 1% below PG&E's rates. Management expects this will provide the CCA robust margins given its favorable power supply costs; however, this could be pressured by the PCIA.

CCA customers are obligated to directly reimburse the incumbent IOU in the form of an exit fee, the PCIA. The PCIA was established to ensure the IOU's remaining bundled customers do not disproportionally shoulder above-market generation costs that had been procured for the departing customers. According to the California Public Utilities Commission (CPUC), the PCIA is calculated by taking the difference between the actual portfolio cost and the market value of the IOU's portfolio, as calculated using CPUC methodology. The CPUC is still refining the total magnitude and method of capture. Currently, the PCIA is limited to 0.5 cent/kilowatt annual increases, although a power charge indifference adjustment undercollection balancing account (PUBA) was also added to capture potential under-collection caused by this cap. If this account balance reaches 7% of forecast unbundled customer PCIA revenues and will reach 10% by year-end, the incumbent IOU must file a request to over-collect on the PCIA. A significant over-collection of the PCIA by the incumbent IOU, a material change to the underlying formula, or a protracted period of 0.5-cent annual increases could gradually erode SVCE's competitiveness, resulting in lower margins as the CCA maintains its 1% flat rate discount (inclusive of the PCIA.)

Whether due to SVCE's desirable product or a dissatisfaction with PG&E, just 4% of SVCE customers have opted out, choosing to return to PG&E. We believe the maintenance of rates below those of PG&E is a crucial factor in supporting similar metrics. Due to the direct competition with PG&E, we believe SVCE's rate-raising flexibility is constrained, as any significant rate increase could result in a dramatic increase in the opt-out rate (although management indicated a rate increase would be the last measure to be taken in the event of a revenue shortfall). Furthermore, the above-average rates relative to the state could result in commercial and industrial customers departing member cities in favor of cheaper power elsewhere. SVCE's low cost of power (approximately $65.30/megawatt-hour for fiscal 2020) mitigates this risk, as the CCA could absorb a short-term cost escalation in its margins. The CCA also has approximately $160 million in liquid reserves, which could be called upon in lieu of a rate increase. We could positively revise our assessment if SVCE's rates are lowered and maintained at a level materially below PG&E's, as the decreased rates would both improve SVCE's rate-raising flexibility as well as lower the opt-out risk, especially in light of likely higher rates at PG&E in the near- to mid-term.

Operational Management Assessment--Adequate

SVCE's power portfolio is diverse, in our view, with no single contract accounting for more than 10% of total load. Similarly, the CCA's fuel mix is diversified among a number of clean and renewable resources. In 2019, SVCE sourced 53.5% of its energy from large hydro, 3.9% geothermal, 15.6% wind, 17.6% solar, 8.3% RPS-eligible hydro, and 1% biomass. This diversity is offset, in our view, by a lack of purchasing flexibility. Under state mandate, SVCE must secure 65% of its RPS-compliant power supply under 10-year or longer contracts by 2021. Although we generally view positively the long-term price certainty these contracts provide, the possibility of customer dislocation, coupled with this mandate, could result in SVCE holding a great deal of surplus power. Management reported the CCA can sell its excess energy position into the wholesale market, with no end-use restrictions attached to any of its PPAs; however, in a scenario where one or more larger members departed or there is a retail customer base dislocation and contract prices exceed market prices for an extended period of time, SVCE could face significant financial pressure. As previously mentioned, each member has agreed to make the CCA whole following its departure, mitigating this risk at the wholesale level, but not at the retail level. SVCE staggers its PPAs to temper the exposure of retail or wholesale customer departures.

SVCE's environmental regulation and compliance is extremely strong--its core business function is to procure clean and renewable resources, subject to availability, and per state mandate it must source a portion of its energy from eligible renewables.

The CCA's management, policies, and planning are also robust. SVCE maintains a regularly updated risk management plan, integrated resource plan, and long-term financial forecasts. In these documents management clearly addresses the risks associated with the CCA business model and provides mitigating measures, as noted above.

Financial Profile: Strong

Coverage--Adequate

SVCE has no debt outstanding. However, S&P Global Ratings calculates an FCC ratio, which treats a portion of power purchases as fixed to reflect the provider's pass-through of its fixed costs incurred. The CCA's unaudited 2020 FCC was a strong 1.31x. Forecast FCC averages about 1.05x through 2024; however, this figure includes almost $100 million in potential contingencies for an unanticipated shift in the PCIA, PG&E's generation rate, or power supply costs. We believe this assumption is conservative, and actual coverage should exceed 1.1x. We could revise our assessment positively if coverage is sustained at or above levels we consider strong. Conversely, if coverage approximates levels closer to 1.0x, we could lower our assessment.

Liquidity--Very strong

SVCE had approximately $160 million in cash and reserves in fiscal 2020. Management project liquidity will increase to about $200 million by 2024. Although distribution-only utilities generally require less cash than their vertically integrated counterparts, we believe SVCE's inherent risks associated with customer retention, rate setting, and power supply procurement necessitate an enhanced level of reserves.

Debt and liabilities--Extremely strong

SVCE has no debt outstanding, and no plans to issue debt in the near term. Given the CCA's minimal physical plant, we believe this is reasonable.

Related Research

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