

Washington, Indiana; Retail Electric

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US\$2.13 mil elec util rev bnds ser 2018 due 07/01/2024

Long Term Rating

BBB+/Stable

New

Rationale

S&P Global Ratings assigned its 'BBB+' long-term rating to Washington, Ind.'s series 2018 electric utility revenue bonds. The outlook is stable.

The rating reflects the application of our "U.S. Municipal Retail Electric And Gas Utilities: Methodology And Assumptions" criteria, published Sept. 27, 2018, on RatingsDirect.

The city owns and operates the electric utility (d/b/a Washington Power & Light). The city's first-lien electric net revenue pledge secures the series 2018 bonds. Officials intend to use series 2018 bond proceeds to fund certain capital upgrades and system expansions to support future commercial development. Following the series 2018 debt issue, the system will have \$2.1 million in total debt.

The rating reflects our opinion of the electric distribution system's strong enterprise risk profile and adequate financial risk profile.

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

- Adequate service area economic fundamentals, as evidenced by its primarily residential revenue base which provides revenue predictability, although the customer base is small with below-average income levels, which we believe limits its revenue-raising flexibility;
- Extremely strong industry risk relative to other industries and sectors;
- Very strong market position, due to its weighted average electric system rate that is 10% below the state average and use of its automatic power cost adjustment mechanism that dynamically passes along changes in power costs to its customers on a quarterly basis; and
- Very strong operational and management assessment, reflecting its role as a distributor of Indiana Municipal Power Agency (IMPA) power through its long-term all-requirements power supply contract, which reduces financial and operational risk to Washington; the full rate-setting autonomy of the city's common council not subject to rate regulation by the Indiana Utility Regulatory Commission (IURC); and its adequate long-term capital and financial forecasting practices.

The financial risk profile reflects our view of the system's:

- Strong coverage metrics, which we note is on a cash basis of accounting, as evidenced by management's financial projections that suggest maintaining fixed-charge coverage ranging between 1.2x and 1.4x over the next three years, following an already adopted 19.4% base rate increase effective in April 2019;

- Adequate liquidity and reserves for a distribution system, with 42 days of total liquidity on hand in fiscal 2017, including its available improvement fund; and,
- Extremely strong debt and liabilities profile, suggested by a projected debt-to-capitalization ratio below 20% that we expect to remain low.

Financial results are based on unaudited statements from the utility's financial advisor, unaudited annual reports (Indiana Gateway Reports) from the city, and examination reports from the Indiana State Board of Accounts, the last of which we view as audit-equivalent. Nevertheless, the financial profile assessment reflects the fact that Washington's financial statements are on a cash basis, which we view as a weaker reporting methodology versus GAAP.

Outlook

The stable outlook reflects our view of the electric utility's stable and primarily residential customer base and its recently adopted base rate increase that we believe will likely preserve strong financial metrics in the near term given the system's low debt burden and lack of additional debt needs.

Upside scenario

Due to the electric utility's small scale, below-average income levels within the service area, and cash basis of accounting practices which weaken its financial profile, we do not anticipate raising the rating.

Downside scenario

Although unlikely, if the recently adopted rate increase proves insufficient, resulting in weaker-than-projected fixed-charge coverage and/or a material decline in liquidity, we could lower the rating.

Utility Description

Washington Power & Light (WP&L) serves 7,542 customers in Washington and customers in the town of Montgomery. WP&L is a distribution utility that purchases all of its power from IMPA according to its long-term all-requirements power supply contract which extends through 2042. The utility's all-requirements power supply contract ensures Washington's load growth will adequately be served and reduces operational and financial risk to Washington.

Enterprise Risk

Economic fundamentals – Adequate

Washington (estimated population: 11,940) is in southwestern Indiana in Daviess County. The city limits extend just east of Interstate 69, which is being extended to connect Evansville and will likely spur commercial development. The city's economy is stable, and officials expect growth in eastern Washington over the next few years. We consider city incomes levels to be below average with a 2017 median household effective buying income that is 80% of the national average. Perdue Farms Inc., the leading employer, employs 825, followed by Daviess County Hospital (573) and Wal-Mart Stores Inc. (300). As of 2017, county unemployment was 2.8%, below the nation's 4.4%.

The electric utility's customer base is primarily residential, accounting for 43% of total revenues in fiscal 2017, which provides a more predictable revenue stream, followed by industrial (34%) and commercial (22%) customers. The customer base is somewhat diverse with the 10 leading customers accounting for 28% of total revenues, although its leading customer, Perdue Farms, accounted for a concentrated 11% of total revenues in fiscal 2017. This large turkey producer has operated in the city since the mid-1980's, and it is our understanding that it is a low-margin customer for WP&L. We believe if there is load loss from this customer, WP&L's revenue structure will not be materially affected.

Industry risk – Extremely strong

Consistent with "Methodology: Industry Risk" (published Nov. 19, 2013), we consider industry risk for municipal retail electric and gas utilities covered under these criteria very low, and therefore extremely strong as compared with other industries and sectors.

Market position – Very strong

We consider the electric system's rates competitive and based on the U.S. Energy Information Administration's latest available data from 2017, the system's weighted average system rate competitiveness (based on relative customer classes' revenue contributions) is 90.4% of the state average. While the utility has recently adopted a 19.4% base rate increase that will likely be effective April 2019, we believe its rate competitiveness will remain very strong in the near term. The system's last base rate increase occurred in 2009. Given IMPA's wholesale power annual rate decreases from 2017 through 2019, officials believe its rate increase will be an overall 6.1% for 2019.

Operational Management Assessment (OMA) – Very strong

We believe IMPA's fuel resources are diverse but it remains coal dependent. IMPA owns approximately 1,070 megawatts (MW) of generating capacity (including 419 MW of gas-fired generation) and obtains another 296 MW of capacity through power purchase agreements (PPAs). As of 2017, IMPA's fuel mix was 67% coal resources, 21% nuclear, 4% natural gas, and 6% renewables. We note that although IMPA has some coal exposure, potential environmental regulation costs don't directly affect Washington. WP&L opted out of the IURC in April 2006, so the utility is not rate regulated. The city's common council has rate-setting autonomy, and it maintains a strong automatic purchase power cost adjustment mechanism which dynamically passes along changes in purchase power costs. We consider management's financial oversight to be sufficient as evidenced by monthly reviewing actual-to-budgeted financial performance, identifying revenue sources for its capital needs over the next five years, but multiyear financial forecasting is not completed on a regular basis.

Financial Risk

Coverage metrics – Strong

The utility currently does not have any debt outstanding. However, following the series 2018 debt issue, we believe its fixed-charge coverage will range between a strong 1.2x and 1.4x over the next five years. S&P Global Ratings' fixed-charge coverage metric reflects the utility system's ability to cover its share of IMPA debt service (2.8%) included in purchased power costs in addition to direct debt service. Based on management's financial projections, we believe the recently approved base rate increase will raise total revenues 4.7% in fiscal 2019 and 1.6% in fiscal 2020 and provide strong fixed-charge coverage of around 1.4x in those years.

Liquidity and reserves – Adequate

We consider the utility's liquidity position to be adequate for a distribution system. The system maintained \$1.8 million in unrestricted cash and available reserves or an adequate 42 days' cash on hand. In addition, over the financial forecast period, management projects to maintain roughly 50 days' cash on hand, including its available improvement fund.

Debt and liabilities – Extremely strong

Following the series 2018 debt issue, WP&L will support \$2.1 million in total debt or just \$280 per customer. Debt amortization is extremely rapid with 100% of debt principal scheduled to be paid by July 1, 2024. We believe the utility's debt burden will remain extremely low with its debt-to-capitalization ratio below 20%. Officials identified \$1.8 million in additional capital needs through 2023, which it intends to cash fund from operations.

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