S&P Global Ratings

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Summary:

Northern California Transmission Agency, California; Wholesale Electric

Primary Credit Analyst:
Timothy P Meernik, Englewood + 1 (303) 721 4786; timothy.meernik@spglobal.com

Secondary Contact:
Doug Snider, Englewood + 1 (303) 721 4709; doug.snider@spglobal.com

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Credit Profile		
Northern California Transmission Agy rev rfdg bnds (California-Oregon Transmission Proj) ser 2016A due 05/01/2039		
Long Term Rating	A+/Stable	Affirmed

Credit Highlights

- S&P Global Ratings affirmed its 'A+' long-term rating on the Transmission Agency of Northern California's (TANC, or the agency) series 2016A California-Oregon Transmission Project (COTP) revenue refunding revenue bonds.
- The outlook is stable.

Security

TANC's revenue, primarily consisting of transmission service payments from its 13 member-participants in the COTP, secures the bonds. The member-participants have take-or-pay obligations with the agency via Project Agreement No. 3 (PA3), which also includes an explicit 25% step-up provision in the event of default by a member-participant. As of June 30, 2022, TANC had $168 million of debt principal outstanding.

Credit overview

Our rating on TANC reflects our assessment of the creditworthiness of the member-participants, whereby we examine the credit profile of the strongest, which make up at least 80% of the agency's entitlement share in the COTP, with the weakest among these having significant influence on the rating. With the 25% step-up provision in PA3, the strongest project members making up at least 80% of the agency's entitlement share would be obligated, if need be, to cover 100% of TANC's project costs, including debt service. In our view, the city of Santa Clara's electric system and the Modesto Irrigation District are the member-participants with the lowest credit quality, each with an 'A+' rating, within a subset of the strongest participants making up at least 80% of the agency's entitlement share. (For more information on the Santa Clara electric utility and Modesto Irrigation District's creditworthiness, see our reports published Nov. 18, 2022 and March 28, 2023, respectively, on RatingsDirect.)

The rating further reflects our view of:

- The PA3 contract between TANC and the member-participants that requires unconditional payment from the member-participants regardless of COTP performance and a step-up provision;
- The importance of the COTP transmission asset to the member-participants, allowing them to obtain less expensive power from the Pacific Northwest, much of which is from non-carbon dioxide emitting resources; and
- TANC's healthy financial performance, with the agency's fixed-charge coverage (FCC) exceeding 3.0x and liquidity at more than 800 days in fiscal year 2022.

Partially offsetting the above strengths, in our view, is the presence of TANC assets in regions that are vulnerable to wildfires; California courts' approach to the doctrine of inverse condemnation, particularly as it would be applied for assigning liability for wildfire damage; and contractual provisions that might frustrate the agency's efforts to allocate liability costs among its member-participants if TANC were found negligent in its wildfire mitigation measures.

Environmental, social, and governance

We believe TANC has minimal climate transition risk given its role as a transmission-only provider, particularly since much of the energy the agency is transmitting is from non-carbon dioxide emitting resources, which will help the member-participants meet California environmental regulations. However, TANC has significant physical risk exposure to wildfires: 34% of the COTP's line miles are in the California Public Utility Commission's Tier 2 elevated fire threat zone, while about 1% falls within the Tier 3 extreme fire threat zone. A wildfire caused by TANC could result in considerable expense for the agency.

From a social perspective, we believe the COTP enables the member-participants to access inexpensive power. TANC estimates that its member-participants overall annually save $50 million to $100 million on power purchase costs because of the project. However, S&P Global Ratings believes that unsustainably strong business and consumer economic activity that are driving inflation around the country will likely lead to further interest rate increases and will ultimately produce an economic slowdown. Yet, although S&P Global Ratings sees an economic weakening on the horizon, it no longer foresees imminent recession risk. (For more information, please see "Economic Outlook U.S. Q3 2023: A Sticky Slowdown Means Higher For Longer," published June 26, 2023, on RatingsDirect.) Consequently, we are monitoring the strength and stability of utilities' revenue streams for evidence of delinquent payments or other revenue erosion because elevated consumer prices and interest rates will likely continue whittling discretionary incomes.

In our view, TANC's governance practices are credit supportive. The agency has implemented vigorous wildfire mitigation practices and annually updates its wildfire mitigation plan, which focuses on minimizing sources of wildfire ignitions and wildfire spread rates while maintaining the resiliency of the electric grid. We believe TANC's management takes a long-term view in the operation of the COTP, maximizing the value of the asset.

Outlook

The stable outlook reflects our view of the overall credit quality strength of the member-participants and TANC's healthy financial performance that we expect the agency to maintain due to the COTP's importance to the member-participants. In addition, we believe TANC continues to take steps to reduce its exposure to wildfires and we expect this work to continue.

Downside scenario

We could lower the rating if TANC's wildfire liability exposure materially increases or if the agency faces wildfire claims that could deplete or exhaust its financial reserves and insurance. We could also lower the rating if the credit quality of the key member-participants erodes.

Upside scenario

We could raise the rating if the credit quality of the key member-participants improves while TANC sustains its robust operational and financial performance.

Credit Opinion

The COTP is a 339-mile, 1,600-megawatt, 500-kilovolt alternating current transmission line between southern Oregon and central California that went into service in 1993 at a cost of $430 million. TANC owns 87% of the COTP with the remaining 13% owned by the Western Area Power Administration, PG&E, the city of Redding, San Juan Water District, and Carmichael Water District. The project is interconnected with the transmission systems of the Bonneville Power Administration, Portland General Electric, and PacifiCorp.

We view the PA3 contract between TANC and the 13 member-participants as having several credit-supporting provisions:

- Each member-participant is unconditionally obligated to pay its share of the COTP's operating expenses and debt service prior to the month of service, regardless of project operation. These payments by the member-participants are considered operating expenses of the member-participants and are senior to their direct debt payments, if any.
- Second, the PA3 contract stipulates that the member-participants covenant to set rates to meet all expenses for operating their electric systems.
- Third, each member-participant is also responsible for as much as 25% more than its entitlement percentage of TANC's project costs in the event of a default by another participant. Should member-participants have to make a step-up payment, we believe the payment would constitute an insignificant portion of their overall operating expenditures.

The five member-participants with the largest entitlement shares, collectively more than 90%, are the:

- Sacramento Municipal Utility District (27.6% entitlement share; AA/Stable);
- Modesto Irrigation District (21.3%; A+/Stable);
- Santa Clara (20.5%; A+/Positive);
- Turlock Irrigation District (12.5%; AA-/Stable); and
- Redding (8.4%; not rated).

In our opinion, the COTP's importance to each member-participant's overall resource portfolio is a key credit strength. The project is critical for the member-participants obtaining less expensive power for their ratepayers, translating into more affordable retail rates. According to 2021 data from the U.S. Energy Information Administration, most of the member-participants' weighted average rate is below the state average. In addition, the COTP enables the member-participants to earn revenue by allowing other utilities to use the transmission line and through the transmission of excess wholesale power generated by the member-participants. We understand that TANC intends to operate the COTP beyond the existing debt's final maturity in 2039.

We believe TANC has had healthy financial performance in recent years. During the past three years, the agency's FCC averaged 3.0x, demonstrating sound cost recovery. While it likely that TANC's FCC declines in the coming years as debt service increases, we believe the agency will maintain credit-supporting FCC. TANC has also built up its available reserves, reaching nearly $60 million at the end of fiscal 2022, corresponding to 830 days' of operating expenses. We understand that the agency's available reserves will likely decline in the coming years as TANC cash funds some of its capital plans. The agency plans to maintain available reserves equivalent to at least 120 days of all expenses (including operating, capital, and debt service). TANC's debt-to-capitalization ratio was a manageable 70% at the end of fiscal 2022, a decline from 90% at the end of fiscal 2018.

In our view, TANC's most significant operational exposure is wildfires: About 34% of the COTP's line miles are in the Tier 2 elevated fire threat zone, while about 1% falls within the Tier 3 extreme fire threat zone. If there is a wildfire claim related to the project that exceeds TANC's internal resources and wildfire insurance coverage, the agency might be able to pass through the associated costs to its member-participants. However, there are conflicting provisions in the PA3 in that member-participants are simultaneously required to support all COTP costs, yet also absolves them of financial liability, in the event of TANC's negligence, if project assets cause property or personal damage, including from wildfires. Consequently, the agency could be precluded from looking to its member-participants to fund liability claims.

We believe TANC's wildfire risk is somewhat mitigated by the agency's continuous efforts to minimize sources of wildfire ignitions and wildfire spread rates while maintaining the resiliency of the COTP. TANC undertakes regular vegetation management and ground inspections and monitoring of lines, equipment, and structures; conducts periodic aerial inspections including with the use of infrared and light detection and ranging imaging; has a program for limiting crop and vegetation height in orchard areas; and coordinates with federal, state, and local agencies. As required by law, TANC annually updates its wildfire mitigation plan, which in our opinion is detailed. We also view favorably that the agency maintains $50 million in wildfire insurance, although the net insurer payment amount is $37.5 million after coinsurance. There are a limited number of structures along the length of the COTP, but we note wildfire can result in various other damages, such as lost timber value. There have not been any wildfires associated with the COTP in recent 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