FitchRatings

Fitch Assigns 'BBB' IDR to Marin Clean Energy, CA; Outlook Stable

Fitch Ratings-Austin-29 August 2019: Fitch Ratings has assigned a 'BBB' Issuer Default Rating (IDR) to Marin Clean Energy, CA's (MCE). The IDR generally reflects the ability of MCE to meet its financial obligations. MCE has no direct debt outstanding.

The Rating Outlook is Stable.

SECURITY
Fitch's rating considers payment of all the financial obligations of MCE from its combined net revenues.

ANALYTICAL CONCLUSION

The 'BBB' IDR reflects MCE's role of providing default generation service as a Community Choice Aggregator (CCA) and the inherent credit weaknesses in the CCA business model, which include a customer base that can elect service from another generation provider (Pacific Gas & Electric; PG&E) and the resulting pressure to retain rates competitive with PG&E. To date, MCE has successfully retained over 85% of the customers in its service area that are eligible to opt out. Positively, the restricted scope of MCE's business, which is limited to the procurement of power and energy efficiency services, largely eliminates any material capex needs given current practices in securing power supply. MCE's rating is further supported by a solid financial profile that reflects adequate liquidity levels and partially offset the competitive pressures. However, MCE's strong leverage profile is less of a consideration in the rating given the absence of direct debt obligations.

Fitch views management's implementation in July 2019 of increased rates to near PG&E levels in order to bolster reserves and increase financial margins as a positive credit development. The rating incorporates higher reserves anticipated by year end fiscal 2020 equal to MCE's financial target of 140 days cash and liquidity. MCE's increasing liquidity position should serve as a temporary buffer against the potential risk of volatile operating costs in the future.

KEY RATING DRIVERS

Revenue Defensibility: Weaker
MCE's weaker revenue defensibility assessment reflects a customer base that can opt out from MCE at any time and at minimal cost, and competitive pressure on MCE not to exceed PG&E's rates as the rival supplier given customers' expected sensitivity to rates. These weaknesses are not fully mitigated by MCE's independent authority to set and adjust rates, MCE's product differentiation or MCE's legal ability to impose an exit fee on departing customers. The assessment also reflects MCE's lack of control over the Power Cost Indifference Adjustment (PCIA) charged to its customers and established by the California Public Utilities Commission.

Operating Risk: Midrange
MCE's operating risk assessment reflects the narrowly defined scope of MCE's business objectives, a contracted and predominately fixed-price power supply, and minimal capital needs. The assessment also incorporates the long-term financial risk associated with right-sizing a power supply for a potentially variable

customer base, given the state requirement established by Senate Bill 350 that requires 65% of total power supply by CCAs to be secured under 10 year or longer contracts by 2021.

Financial Profile: Stronger
MCE's midrange financial profile reflects the power supplier's liquidity levels that are expected to increase over the next few years following recent rate increases and very low leverage metrics. Cash flow improved substantially in fiscal 2019 with the addition of Contra Costa County to the service area, based on unaudited financial results. Strong levels of cash flow are projected to continue over the next few years, which will strengthen cash balances.

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

RATING SENSITIVITIES
Leverage Above Expectations: MCE has a very limited capacity for financial leverage given its revenue defensibility and operating risk profile. A material increase in MCE's net leverage profile, either through a reduction in available cash or the issuance of debt, could result in negative rating action.

Liquidity Below Reserve Policy: The current rating incorporates Fitch's expectation that MCE will achieve and maintain its stated reserve target of 140 days cash. Maintenance of sub-target liquidity could result in negative rating pressure.

Competitive Landscape: A significant change in the competitive landscape for MCE, particularly given the potential for changes that may be brought on by PG&E's bankruptcy filing, could enhance or detract from the business prospects of MCE, which may warrant consideration of a rating change.

CREDIT PROFILE

MCE is a California joint powers authority (JPA) that was created on Dec. 19, 2008 for the purposes of implementing a community choice aggregation (CCA) program. Since then, the JPA has grown from its initial eight members located within Marin County to include all of the following (as of March 31, 2019): Marin and Napa Counties (including all cities and towns), unincorporated Contra Costa County, and the cities and towns of Benicia, Concord, Danville, El Cerrito, Lafayette, Martinez, Moraga, Oakley, Pinole, Pittsburg, Richmond, San Pablo, San Ramon, and Walnut Creek. Unincorporated Solano County will join MCE beginning April 1, 2020 (fiscal 2021).

Within its service area, MCE provides generation-only services directly to all retail customers of Pacific Gas & Electric (PG&E), unless those customers opt out and elect PG&E as their provider. PG&E still delivers the energy to the customers of MCE over PG&E transmission and distribution lines and provides metering and billing services as MCE's collection agent. The flow of MCE revenues collected by PG&E has been protected following the PG&E bankruptcy filing in early 2019. One of the first actions of the bankruptcy court maintained the existing collection arrangements between PG&E and CCAs, including MCE. PG&E remits the funds daily to MCE.

REVENUE DEFENSIBILITY

MCE's weak revenue defensibility is rooted in the ability for retail customers to opt-out of purchasing services from MCE.

MEMBERSHIP REQUIREMENTS

New members (i.e. counties, cities and towns) may elect, by a vote of their City Council or County Board of Supervisors, to join MCE. Once part of the JPA, participating cities and counties are required under the agreement establishing MCE to remain part of MCE or pay the costs incurred on their behalf prior to their departure. In addition, any municipality seeking to leave the JPA must provide one year's notice. Although legally untested, Fitch believes this requirement could act as a potential restriction on communities seeking to exit the JPA.

DEFAULT PROVIDER; CUSTOMERS CAN OPT OUT

Upon joining the CCA, MCE becomes the default option for all retail customers within the member's service area. MCE provides generation-only services directly to retail customers. The customers are automatically switched to MCE as the generation provider when the city or county (unincorporated areas) joins MCE. However, retail customers retain the ability to opt out of service from MCE and revert to being a generation customer of PG&E at any time, potentially undermining the long-term stability of demand, and weakening Fitch's assessment of revenue defensibility as a whole. Customers who opt out of MCE within the initial 60 days of being enrolled as an MCE customer are able to opt back into MCE at any time. Customers who opt out of MCE after the initial 60-day period are required to remain a PG&E customer for one year prior to being eligible to opt back to MCE.

PG&E RISK AS COLLECTION AGENT IS LIMITED

PG&E delivers the energy purchased from MCE 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 MCE's billing agent. The flow of MCE revenues collected by PG&E is protected following the PG&E bankruptcy filing in early 2019. One of the first actions of the bankruptcy court maintained the existing collection arrangements between PG&E and CCAs, including MCE. PG&E remits the funds daily to MCE.

EXIT FEE

If a customer opts out after 60 days of service, MCE charges a one-time $5 (residential) or $25 (commercial) administrative fee. No administrative fee is charged if the customer opts out within the first 60 days of service. MCE is legally able to impose an exit fee on customers switching back to PG&E, but this rate has been set to $0. The exit fee could be increased to either stem departures or capture the costs incurred to serve departing load. While legally permissible, this mechanism has not been used extensively and Fitch expects that any effort by MCE to sharply raise its exit fee could be met with some level of political backlash. Fitch views the legal ability to implement an exit fee as a potentially important tool, but insufficient on its own to raise MCE's overall demand characteristics.

GROWING CUSTOMER BASE

MCE reports that it serves approximately 86% of the customers within its service territory, implying that approximately 14% of the customer base has selected PG&E as their power provider. MCE's IRP notes that participation rates have varied by area served, with the initial communities (2010-2011) at approximately 78% and the more recent communities (2016-2018) ranging from 89%-91%.

MCE's customers are viewed as non-concentrated. Demand growth is expected to track economic trends in the region due to MCE's position as the default electric provider in the service area. Electric sales to the existing customer base are expected to remain relatively flat on a per customer basis, given industry advancements in energy efficiency and conservation, but usage will fluctuate with weather and economic conditions in-line with typical electric utility customer usage.

MCE's current customer count is approximately 470,000, following an approximately 80% increase in April 2018 (fiscal 2019) as service was expanded into Contra Costa county. The customer base will continue increasing if additional communities elect to join. Unincorporated Solano County will be served by MCE beginning on April 1, 2020. The addition is expected to provide approximately 11,000 additional customers and 186,000 MWh sales (about 3.5% of current annual sales). Solano County may increase MCE's sales to industrial customers due to several large customers and irrigation loads in the area, but should not create meaningful concentration in the overall customer base.

PRIMARY PRODUCTS

MCE offers customers three products: 1) default 60% renewable "light green" option; 2) 100% renewable "deep green" option; and 3) 100% local solar option. Customers also have the option to enroll in MCE's programs, such as residential load shifting, energy efficiency, electrical vehicle incentives and net energy metering. Customers will be able to participate in MCE's forthcoming demand response services and programs. The vast majority of customers participate in the light green program. MCE's integrated resource plan outlines the goal to increase the light green renewable content to 70% by 2030, subject to product availability and cost.

The higher renewable content of the power supply appears to be the consideration that has garnered political and customer support for MCE (and other CCAs). However, Fitch does not view MCE's product differentiation as sufficient to offset the otherwise weaker demand characteristic, as customers are assumed to be rate sensitive. In addition, PG&E (along with other California IOUs) are legally mandated to continue raising their power supply's renewable content over time, reducing MCE's current competitive advantage of having a higher renewable content.

INDEPENDENT RATE SETTING

MCE has independent ability to adjust rates to fully recover costs. The board makes rates decisions that are not subject to external review. While all participating municipalities have a representative on the MCE board, MCE is not under the local authority of participating member city and town councils.

COMPETITIVE PRESSURES ON PRICING

Fitch assumes that customers are rate sensitive over time due to the competitive pressure presented by PG&E as a potential alternate electricity provider and the lack of switching costs for customers, which together impose a practical limitation rate setting. However, as long as MCE's rates remain below or equal to those of PG&E, Fitch expects the vast majority of customers will decide not to opt out given the economic incentives to remain with MCE and the community support for the current product offerings. In a situation where MCE's costs were persistently higher than PG&E's, Fitch expects some level of load departure from customer opt outs. There have been short periods (less than one year) since MCE's inception when PG&E rates were lower than MCE, but MCE responded with a rate reduction to bring their rates in line with PG&E.

JULY 2019 RATE ACTION

MCE's board recently adopted rate increases effective July 1, 2019. The increases were designed to absorb nearly all of the headroom between PG&E's rising rates and MCE customer rates, while preserving MCE's cost advantage at approximately 0.3% on average for each customer class. This pricing advantage is based on the highest PCIA vintage charged to MCE customers. The result was an average increase in monthly electric charges of approximately 6.5% across all customer classes. The rate increases are designed to use the increased revenues to increase MCE's financial margins and bolster reserves according to recently adopted financial policies.

POWER COST INDIFFERENCE ADJUSTMENT LIMITS COMPETITIVE PRICING

MCE does not have ultimate control over one component of its rates further limiting rate flexibility. MCE's customers are charged a PCIA that is determined by the California PUC. The PCIA is adjusted annually and varies by the year and date that the customer joined the CCA, as well as the customer's rate class. For example, a residential customer that began being served by MCE in 2015 would have the same '2015 vintage PCIA' charged to all other 2015 vintage residential customers. The PCIA is charged on a per kWh basis 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 have increased over the past few years as market prices have decreased, widening the gap between PG&E's portfolio cost and the market value for that power. MCE and the statewide CCA trade association have challenged the methodology used in calculating the PCIA. However, MCE does not have direct recourse to alter the PCIA charged to its customers. The PCIA will gradually become less relevant for MCE's customers as PG&E's legacy contracts mature (or are potentially terminated through PG&E's bankruptcy).

OPERATING RISK

LIMITED BUSINESS SCOPE REDUCES COST VARIABILITY

MCE's role in serving its customer base is essentially restricted to power supply procurement; the distribution, delivery and transmission of power remain an obligation of PG&E as well as billing and collections. As such, MCE's capex needs are negligible as MCE does not own any generation; all power supply resources are contracted. Positively, this means MCE generally does not bear the development, construction, operating or system risks experienced by generation resource owners, integrated utilities, or distribution utilities. A change in MCE's operating risk profile through the development and/or ownership of generation resources could lead to a revision of the assessment.

OPERATING COST FLEXIBILITY

Operating costs are largely restricted to the cost of power, marketing, and general administration and operating expenses. MCE's cost of power is largely known as power supply is contracted primarily through fixed price (or moderately escalating price), multi-year contracts. MCE's power procurement guidelines, as outlined by its 2019 integrated resource plan (IRP), target the procurement of between 70% and 100% of the current year power supply under fixed-price contract, between 60% and 95% of power supply in the following year and up to 70% in the third year and beyond. The practice is designed to reduce exposure to market price risk and allow for annual rate setting.

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 MCE, to demonstrate a 15% reserve margin above its projected peak demand and the use of flexible capacity.

CCAs are subject to several legal and regulatory mandates that could increase costs and potentially raise operational risks, if not well managed. These include mandates to procure energy storage equivalent to 1% of projected 2020 peak load, fully comply with the CPUC's resource adequacy requirements and submit the IRP to the CPUC for certification. Proposed legislation to adopt a centralized procurement agency, which has been deferred to the 2020 legislative session, and consideration of breaking up PG&E, could negatively affect MCE's rating if the changes are expected to result in significantly higher operating costs.

RESOURCE MANAGEMENT RISK

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

DIVERSIFIED, CONTRACTED POWER SUPPLY

MCE's power supply is currently met by over 60 PPAs with various suppliers incorporating multiple technologies and fuel types, including renewable, conventional and GHG-free. Contracted resources are geographically diverse. System energy is projected to be greater than 60% renewable in calendar year 2019, which is well above state mandates and the renewable content available in PG&E's power supply.

MCE's IRP notes that an additional 25 MW of new renewable resources are expected within its service area by 2021. MCE states that it may consider direct investment or ownership of generation resources. The development of owned generation would change MCE's operating profile and increase MCE's exposure to risks that are currently immaterial, including operating and construction risks.

BALANCING LOAD BIGGEST RISK GIVEN REQUIREMENT FOR LONG-TERM CONTRACTS

MCE's largest resource risk is balancing its power supply with a potentially variable customer base, given MCE's lack of the exclusive right to provide generation. MCE has adopted a formal risk management plan that seeks to limit the potential risk of being either short or long power supply in any particular year. MCE's practice is to contract to fill short positions at years 1-5 to prevent significant pricing risks to emerge. MCE's practices call for it to have between approximately 90%-115% of its energy needs under fixed price contract during the current calendar year and successively lower amounts in each of the following four years.

Balancing supply and demand is further complicated by certain legislative mandates. 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 well below the actual renewable content of MCE's power supply, the long-lived nature of the contracts pose challenges to adjusting power supply costs if significant load departure occurs. This risk is mitigated by MCE's demonstrated trend to date of maintaining customers through periods when PG&E rates were lower than MCE and the ability to maintain the other 35% of supply from short-term contracts.

MCE's capital needs are limited and do not include plans to build self-owned generation in the next five years, although it remains a possibility. Fitch has not included any debt financing of capital needs in this analysis.

FINANCIAL PROFILE

MCE's leverage profile is supportive of the rating but is 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 MCE has neither) minus cash reserves as compared to cash flow. Given the absence of fixed obligations, Fitch's net leverage calculation for MCE is negative.

MCE's liquidity profile is neutral to the rating but the planned increases in cash reserves in fiscal 2020 will directly improve MCE's net leverage profile and financial profile in general. The system's available cash balance at the end of fiscal 2018 was modest at approximately $34.4 million or 63 days. Available cash increased to $60.8 million by the end of fiscal 2019 (unaudited), or 69 days. The increase in expenditures in fiscal 2019 coincided with the approximately 80% increase in customers as the service territory was expanded to include

Contra Costa county in fiscal 2019.

Liquidity levels are enhanced by the use of lines of credit. The most recent line of credit was amended to a revolving credit agreement in July 2017 and at the time was increased to $25 million from $20 million. Cash balances increased in fiscal 2019 (unaudited actuals), increasing days cash on hand to 83 days. Additional increases are expected in fiscal 2020.

Management adopted a revised liquidity policy that targets building cash reserves to 40% of operating costs, or 140 days cash, including available lines of credit. MCE expects to reach its liquidity target by the end of fiscal 2020 with an estimated $113 million in cash reserves and the $25 million line of credit.

GOVERNANCE AND MANAGMENT

MCE is governed by a 28-member Board of Directors. The board members are elected city council members or supervisors from each of the member cities and counties served by MCE. While they are not elected to the MCE board, the representatives have been elected to represent their respective communities. The board has appointed experienced, executive leadership to run daily operations of MCE. MCE has approximately 60 employees.

The legal and regulatory environment for CCAs continues to evolve. Fitch does not currently 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.

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Additional information is available on www.fitchratings.com
Applicable Criteria

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 28 May 2019)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
Solicitation Status
Endorsement Policy

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