KBRA KROLL BOND RATING AGENCY

A Better Way: The Emergence of Community Choice Aggregation in California

Corporates Research

Kroll Bond Rating Agency (KBRA) has continued to monitor the proliferation of community choice aggregation (CCA) incorporations in California and believes that the burgeoning industry presents a compelling alternative to traditional utility generation services.

Key Takeaways

- KBRA believes that well-run CCAs with favorable characteristics in California can achieve strong investment-grade ratings through an asset-light and community-centric business model that provides clean, competitively priced power to residents.
- As stakeholders increasingly prioritize environmental, social, and governance (ESG) considerations, CCAs in California are uniquely positioned to ride the coattails of this movement, helped by social dissatisfaction with traditional vertically integrated utilities.
- KBRA sees a window of opportunity for CCAs in California, given the higher-cost electricity supply and legacy governance issues that burden existing utilities.
- Although KBRA's outlook for CCAs in California is positive, we do see some challenges ahead including regulatory rulings regarding the calculation of the Power Charge Indifference Adjustment (PCIA), and the ability of CCAs to continue to offer discounted electricity to customers compared to traditional vertically integrated utilities.

You Have Heard About CCAs Before, But What Exactly Are They?

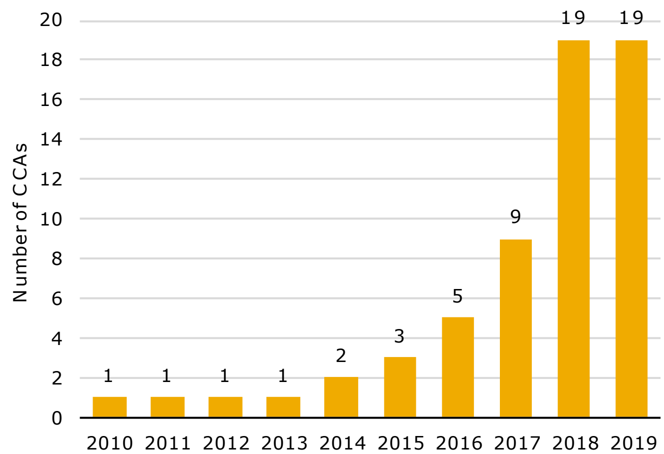
CCAs are not-for-profit entities formed by coalitions of cities and counties to aggregate the buying power of retail customers within their jurisdictions and secure electricity supply on a community-wide basis. All customers in a CCA's service territory are automatically enrolled in the program and must opt out to avoid participation. This allows the CCA to replace the incumbent utility (typically investor-owned) as the generation service provider in the jurisdiction. The program empowers counties and cities to take back control of their power supplies and allows the CCA full authority to set the rates and charges for the electricity and services they furnish, providing them autonomy to adjust rates. The default enrollment of all customers and the CCA's ability to flexibly adjust rates are two important credit strengths.

In contrast to a traditional investor-owned utility, which has an extensive portfolio of transmission and distribution infrastructure assets, as well as generation assets, CCAs typically do not own or operate physical power assets. Accordingly, they operate an asset-light business model, which KBRA views favorably. Instead of owning transmission and distribution assets, CCAs deliver electricity to residents using existing physical infrastructure managed by the California Independent System Operator and the traditional utility. Once a CCA is in service, the existing utility must bill customers for all utility services and remit payments for generation services back to the CCA.

A Clear and Compelling Value Proposition

At a time when ESG considerations are arguably more important than ever, the CCA value proposition in California is clear and compelling. The program offers communities control over their electricity, the opportunity to transition to cleaner energy sources, and the ability to invest back into their communities—all key features to bolster demand. CCAs also typically reduce power bills in their incorporated area by entering into low-cost contracts and operating an asset-light business model not burdened with stranded costs across other parts of the organization as a vertically integrated utility would be. These savings are usually passed on to the community instead of utility shareholders. KBRA believes the value proposition is unique and compelling, as CCAs tend to be established in areas that have favorable demographics and allow CCAs to offer power at competitive prices compared to the existing provider.

Figure 1: Rapid Acceleration - Total Number of CCAs in California



Source: CalCCA

Hardly a Novel Concept, But an Increasingly Popular Alternative in California

The accelerated growth of CCAs in California and increasing media attention might lead one to believe that the concept is novel; however, similar legislation has existed for a while in other states including Illinois, Massachusetts, New Jersey, New York, Ohio, Rhode Island, and Virginia. The National Renewable Laboratory (NREL), a U.S. Department of Energy research laboratory, estimates that 750 CCAs procured 42 million megawatt-hours of electricity on behalf of their customers in 2017 (according to the latest available data).

The regulatory framework for CCAs in California was created in 2002, but the first CCA application was not approved by the California Public Utility Commission until 2007 and the concept is only now starting to take off. The California Community Choice Association (CalCCA) lists 19 active CCAs in California, more than half of which initiated service in 2018 or later. Together, they have contracted 3,600 megawatts of clean generation capacity and currently serve more than 10 million customers (see Appendix 1 for operating statistics of the major California CCAs).

Not a Bulletproof Solution, But One Positioned for Success in California

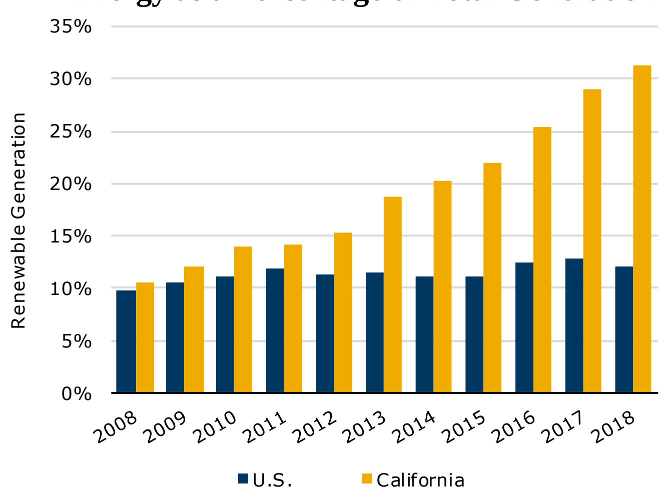
Although longer-running CCA programs in other states have experienced some success, they have also encountered issues. These problems have caused certain CCAs to disband due to customer opt-outs. In these instances, CCAs were often unable to maintain competitively priced power compared to the existing provider. Additionally, several developing issues in California present risks for CCAs, including ongoing debate regarding the calculation of the PCIA formula, which is used to calculate an exit fee that CCAs must pay to existing service providers for customers who switch to the CCA's generation services. Nevertheless, KBRA has a positive view of the supportive regulatory construct in California, which has allowed for rapid approval of new CCAs. Due to the asset-light, cash flow-generating business model, conservative financial risk profiles, and growing reserves, we believe they can attain solid investment-grade ratings.

California is the only state with active CCAs to have a regulated electricity market, as opposed to a restructured one. Both have different implications for a CCA, but most notably, a CCA in a restructured market simply acts as a retail customer, picking the most competitive supplier for its community. In a regulated market, a CCA actually supplants the existing provider and can contract directly with electricity generators. KBRA views this construct favorably as the CCA receives more support from the regulators, due to the need to ensure resource adequacy through long-term power purchase agreements executed directly with generators.

CCAs in California usually have a customer base with favorable demographics, including high-income (well over the U.S. median income and often more than double) residents who support the development of renewable energy and prioritize community-focused action. The high participation rate so far in California provides evidence of this. According to CalCCA, an average 94% of people residing in a CCA's service territory participate in the program. This is at the upper limit of the broader U.S. CCA range of 85%-95% reported by NREL. The high level of disposable income could also lead customers to remain with a CCA if its electricity plans become less competitive due to the positive externalities the CCA creates, which KBRA believes is a credit strength.

Finally, CCAs in California are positioned to capitalize on an increasing stakeholder focus on ESG considerations. California has long been at the forefront of the renewable energy movement (renewable sources in California accounted for 31% of the total electric generation in 2018, compared to just 11% for the U.S. as a whole), and CCAs represent an opportunity to further promote renewable generation. As mentioned previously, CCAs also empower communities to take back control of their electricity supply, at a time when traditional investor-owned utilities in the state are wrangling with high-cost legacy renewable contracts, increasing social dissatisfaction, and in the case of one utility, ongoing bankruptcy proceedings.

Figure 2: Historical California and U.S. Renewable Energy as a Percentage of Total Generation



Source: U.S. Energy Information Administration & California Energy Commission

Where Do We Go from Here?

Looking forward, KBRA expects to see continued CCA development in California, through the incorporation of additional CCAs and the addition of new communities to existing ones. As younger CCAs mature, we expect their credit profiles to improve as they reach their target reserve position and increase liquidity to guard against short-term dislocations.

KBRA will continue to monitor the developments in the CCA industry in California. We expect that strong CCAs will manage financial and operational risks appropriately to ensure long-term resiliency. We believe that well-run, fundamentally sound CCAs can achieve solid investment-grade ratings due to the supportive regulatory construct in California, asset-light, cash flow-generating business model, conservative financial risk profiles (including a target reserve position), and prosperous, active communities.

Appendix 1:

CalCCA Members	Customer Accounts	Estimated Peak Load (MW)	Participation Rate
Apple Valley Choice Energy	25,000	100	89%
CleanPower SF	376,000	510	97%
Clean Power Alliance	972,500	3,600	95%
East Bay Community Energy	533,000	984	97%
Lancaster Choice Energy	50,000	200	93%
MCE	470,000	1,050	86%
Monterey Bay Community Power	277,000	505	97%
Peninusla Clean Energy	293,000	644	97%
Pico Rivera Innovative Municipal Energy	17,600	60	96%
Pioneer Community Energy	79,500	250	89%
Rancho Mirage Energy Authority	14,500	100	99%
Redwood Coast Energy	62,000	125	93%
San Jacinto Power	14,500	65	92%
San Jose Clean Energy	332,500	1,081	99%
Silicon Valley Clean Energy	270,000	800	97%
Solana Energy Alliance	7,300	13	91%
Sonoma Clean Power	225,000	450	87%
Valley Clean Energy	54,200	219	93%
CalCCA Member Totals	**4,073,600**	**10,756**	**94%**

Source: CalCCA

Contacts

Corinne Hill, Senior Director, CFA
+1 (646) 731-3331
chill@kbra.com

Adam Gracely, Associate
+1 (646) 731-3329
agracely@@kbra.com

Andrew Giudici, Senior Managing Director
+1 (646) 731-2372
agiudici@kbra.com

Related Reports

Access for free at www.kbra.com

- U.S. Corporates 2020 Outlook: How Long Will This Go On?