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Middleton Municipal Electric Department, Massachusetts; Retail Electric

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Long Term Rating

A+/Stable

Upgraded

Rationale

S&P Global Ratings raised its issuer credit rating (ICR) on Middleton Municipal Electric Department (MELD), Mass. to 'A+' from 'A.' The outlook is stable.

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

The MELD provides electric service as a distribution-only system that supports a total of \$305,000 in off-balance-sheet system debt as of Dec. 31, 2018 scheduled to be paid by the end of fiscal 2019.

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

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

- Strong service area economic fundamentals, as evidenced by its role as a small distribution system that serves a primarily residential customer base with extremely strong income levels and access to Boston's deep employment base, although its customer base is highly concentrated, with the largest customer, a large manufacturer, accounting for 10.5% of electric revenues in fiscal 2017, which we believe leaves the utility at risk for load loss;
- Extremely strong industry risk relative to other industries and sectors;
- Very strong market position, due to its weighted average system rate that was 3.9% below the state average in 2017 combined with very strong income levels within the service area, which provides further revenue-raising flexibility; and
- Adequate operational management assessment (OMA), reflecting its participation in the Massachusetts Municipal Wholesale Electric Co.'s (MMWEC) Seabrook and Millstone nuclear power projects that accounted for 36% of its energy in fiscal 2017 and contributed to the system's competitive rates, although management does not perform multiyear financial forecasts or capital plans.

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

- Strong coverage metrics, evidenced by fixed-charge coverage ranging between about 1.3x-1.5x over the past three years, which we believe is sustainable because Middleton's cost of power from MMWEC should be more favorable in fiscal 2020 after project debt service has been paid;
- Extremely liquidity and reserves for a distribution system, with about 350 days of total liquidity on hand in fiscal

2017, which the system intends to maintain; and,

- Extremely strong debt and liabilities profile, suggested by the absence of on-balance-sheet debt.

Outlook

The stable outlook reflects an improving cost structure with the reduction of fixed costs associated with participation in the MMWEC projects. We believe this gives the utility financial flexibility allowing the system to maintain strong coverage metrics and address unforeseen needs.

Upside scenario

Although the system's obligation to support MMWEC debt will be rolling off in fiscal 2019, we believe its revenue concentration among its top customers and limited service area population preclude a higher rating.

Downside scenario

The rating could be lowered if demand associated with its leading customer declines and results in significantly lower coverage metrics.

Utility Description And Credit Overview

The MELD serves just 3,745 electric customers throughout its primarily residential customer base that remains concentrated among its leading customers. Middleton (population 10,059) is in Essex County, 19 miles north of Boston in northern Massachusetts. Middleton participates in several MMWEC nuclear projects, providing it with about 36% of its power needs, but also requiring it to share in operation and maintenance costs as well as debt service of the generation projects. However, its power cost structure will likely improve in the near term because its off-system MMWEC project debt service will be paid off by the end of fiscal 2019. The system's significant revenue concentration and limited customer base inherently limit its financial and operational flexibility.

Enterprise Risk

Economic fundamentals: Strong

The system's service area benefits from convenient access to Boston's deep employment base, as evidenced by its affluent primarily residential customer base. Customer growth has been modest, with 3.3% customer growth since 2013. Residential revenues account for 38% of utility revenue in 2017, which we believe contributes to stability and predictability in the customer base. Commercial and industrial customers account for 22% and 39% of 2017 revenue, respectively. We consider the town's income levels extremely strong with 2017 median household effective buying income equal to 195% of the national average.

Though we believe the customer base is stable, there is concentration, with the 10 largest users accounting for 35% of utility revenues, which we believe leaves the utility at risk for load loss. The top customer, Bostik, is a large manufacturer and supplier of adhesives and sealants, which is headquartered in Middleton, and represented 10.5% of system revenues in fiscal 2017.

Industry risk: Extremely strong

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

Market position: Very strong

We believe the system's rate competitiveness provides financial flexibility despite its small size. 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 96.1% of the state average. The system does not have plans to raise base rates in the near term and reviews its discretionary purchased power adjustment clause (PPAC) on a quarterly basis. In addition, we believe the system's extremely strong income levels provide revenue-raising flexibility to ensure revenues and expenditures are properly aligned.

Operational management assessment: Adequate

We believe the system's power supply cost structure will likely improve in the near term after the system's off-system MMWEC project debt service obligations roll off by the end of fiscal 2019.

MELD participates in the Millstone Unit 3 and Seabrook Unit No. 1 nuclear facilities, as well as Stonybrook intermediate and peaking facilities. The remaining energy comes primarily from several bilateral agreements and purchases at Independent System Operator (ISO) New England on the spot market, which accounted for nearly 23% of purchased power in fiscal 2017. We consider the system's fuel mix relatively diverse and centered on nuclear (36%) and unidentified (44%) purchased power, followed by natural gas (6%), hydro (6%), and renewable resources (6%). The system is not exposed to coal generation or any related future environmental regulation. In our view, the system's financial management practices are not comprehensive. While the system identified its capital needs over a five-year period, multiyear financial projections beyond the budget year and formal capital plans are not completed.

Financial Risk

Coverage metrics: Strong

In our view, fixed-cost coverage, which includes Middleton's portion of total MMWEC debt service and actual demand costs from power purchases, has been historically strong. Fixed-cost coverage has ranged from 1.3x-1.5x for the past three years, and ended fiscal 2017 at 1.5x due to a one-time cash refund from MMWEC for overpaying into a project bond reserve account. We believe coverage levels are sufficient to support the current rating. We use fixed-charge coverage that treats capacity charges Middleton pays to power suppliers as debt service rather than operating expenses. We view this portion of operating expenses as funding the suppliers' recovery of capital investments in generation assets. While we think the system's fixed-charge coverage metrics are likely sustainable as the system's MMWEC capacity costs will decline in fiscal 2020, officials have not produced financial projections.

Liquidity and reserves: Extremely strong

MELD ended fiscal 2017 with a combined \$11.3 million of unrestricted cash and investments, or an extremely strong 351 days' cash on hand, which the system has maintained since fiscal 2015. In addition, officials project to increase total liquidity to \$12 million by the end of fiscal 2020.

Given that the system is exposed to limited operational risks as a distribution utility, we consider these liquidity levels robust for a system this size.

Debt and liabilities: Extremely strong

Middleton expects to finance its \$4.5 million in capital needs internally over the next five years. There is no direct bonded debt outstanding, but the utility is responsible for servicing a small portion of off-balance-sheet debt related to its MMWEC entitlement in fiscal 2019. We expect the system's debt profile to remain at extremely strong levels.

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