S&P Global Ratings

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Summary:

Merrimac Municipal Light Dept, Massachusetts; Retail Electric

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Credit Profile		
Merrimac Mun Light Dept ICR		
Long Term Rating	A+/Stable	Affirmed

Credit Highlights

- S&P Global Ratings affirmed its 'A+' issuer credit rating (ICR) on Merrimac Municipal Light Department (Merrimac, MMLD, or the light department), Mass.
- The outlook is stable.

Security

The ICR represents our view of the electric utility's capacity and willingness to meet its financial commitments as they come due and does not apply to any specific financial obligation. Nevertheless, Merrimac's general fund issued debt on behalf of the electric utility. As of FY 2021 the electric utility supported about $525,000 of general obligation debt.

Credit overview

Merrimac has a credit-supportive customer base, as most of the light department's revenue comes from residential customers, which we view as having consistent demand for power. We expect that Merrimac's fixed-cost coverage (FCC), which we calculate using a proxy for capacity charges to assess the capacity to fund suppliers' recovery of capital investments in generation serving Merrimac and which has averaged 1.57x in the three most recent years, will decline significantly when the utility reports fiscal 2022 financial results due to significantly higher operating costs associated with the Mystic Reliability must-run cost-of-service agreement that were not addressed by a rate adjustment until near the end of the year. As a member of New England Power Pool and ISO-NE, Merrimac does not have the option of whether or not to participate in the contract, as all members must pay their share of costs associated with the Mystic Reliability contract. Nevertheless, we expect FCC to rebound given the double-digit rate increase to offset these higher costs. The utility used its rate stabilization fund to account for costs until the rate increase went into effect. The contract is set to expire in 2024. We view Merrimac's infrequent use of rate stabilizations as credit supportive.

The rating further reflects our view of Merrimac's:

- Service area with median household effective buying income (MHHEBI) 31% above the national level, which supports the light department's rate-setting capabilities;
- Competitive rates below the state average, resulting in rate-raising flexibility for the light department, particularly in combination with the high income levels; and

- Sixty percent of load requirement locked in through purchased power agreements (PPAs) through 2034.

Partly offsetting the above strengths, in our view, are Merrimac's:

- ISO New England market purchases for about 10% of the light department's electric demand, which could translate into significant expense if market prices spike (we recognize that the light department has a discretionary PPA clause; however, it has not used it consistently for cost recovery);
- Extensive reliance on short-term contracts for conventional generation in preparation for migration to resources that will comply with Massachusetts' renewable energy mandates, which exposes it to recontracting risk and potential market price volatility; and
- Small number of accounts, limiting the light department's economies of scale.

Environmental, social, and governance

We believe the light department's governance credit factors are neutral in our credit analysis. Merrimac produces multiyear financial forecasts and capital improvement plans, and we believe these planning documents can identify problems and provide guidance to management. To facilitate migration to renewable resources, management relies extensively on short-term contracts for thermal generation. It has also used a combination of rate-stabilization balances and rate adjustments to address extraordinary power purchase expenses associated with a reliability must-run generation unit that is contracted through 2024. Merrimac also introduced a new general manager in 2022. Mary Usovicz arrives at MMLD with an extensive background with experience working within Massachusetts in the energy sector.

In our view Merrimac's environmental factors are credit neutral. Merrimac receives electricity from a wide variety of fuels. In 2022, about 44% of the utility's electricity tied to specific generating sources came from hydroelectric (15%), nuclear (13.69%), wind (8%) and solar resources (7.5%), and the utility does not rely on any coal-fired generation; the remainder of its fuel comes from natural gas. Merrimac plans to follow all Massachusetts regulations by 2030.

We believe Merrimac's social capital factors are neutral within our credit rating analysis. The utility serves a mostly residential community and, according to management, demand decline has been marginal and none of the utility's major customers have shut down. Management has also indicated that there have been no significant cutbacks by any of the utility's top 10 customers. The utility will continue to watch for other leading economic indicators in the coming months and plans to make appropriate changes to its balance of resources if necessary. In our view, if rates needed to be increased to account for ramifications related to inflationary pressures, we view the ratepayers as being able to afford higher rates. The utility maintains affordable rates in the context of current income levels, which help to insulate the utility from operational and financial challenges. Adding to social pressures, S&P Global Ratings projects that the U.S. economy will likely fall into a shallow recession in 2023, tempered by generally strong labor demand. (See "Economic Outlook U.S. Q2 2023: Still Resilient, Downside Risks Rise," published Mar. 27, 2023, on RatingsDirect.) Consequently, we continue to monitor the strength and stability of the revenue streams of public power utilities for evidence of delinquent payments or other revenue erosion because rising consumer prices and interest rates are whittling discretionary incomes.

Outlook

The stable outlook reflects that, although the utility responded to high power costs associated with the Mystic Reliability must-run costs of service agreement with rate-stabilization draws and a significant rate increase in November, we expect that FCC will return to its historically strong levels in the next two years as the agreement with Mystic Reliability will expire in 2024. In addition, we view the utility's high liquidity as providing a material financial cushion.

Downside scenario

We could lower the rating if Merrimac's recent rate increase is insufficient for recovering power costs or if replacing expiring short-term power supply contracts exposes the utility to higher costs that it does not recovery in a timely manner.

Upside scenario

We do not expect to raise the rating in the next two years given the department's recontracting risk and small size, which limits its operational and financial flexibility.

Credit Opinion

Enterprise risk

We view MMLD's largely residential customer base as providing stability to the light department. Residential customers provided 77% of MMLD's revenue in fiscal year 2021. Residential customers have more predictable demand compared to commercial and industrial customers. Moreover, MHHEBI is 131% of the national level, which we view as a credit positive. We note that the light department has 3,000 customer accounts, limiting economies of scale.

The department is a distribution-only system, relying on purchased power supply from a diverse mix of assets. It obtained about 43% of its 2021 energy needs from natural gas systems. An additional portion of energy came from low-cost allocations of hydropower from New York Power Authority and Brown Bear II Hydro Inc., which accounted for approximately 10% of hydro power for the system, and solar power from Merrimac Solar LLC. Merrimac's power supply also includes 14% nuclear, 8% wind, and 7.5% solar power supply. Approximately 9% of power came from the spot market, which is below Merrimac's 10% to 15% spot market exposure target. In 2023, the utility finalized a 25-year Patriot Wind Project. With this contract, Merrimac has more than 60% of its load requirement locked in until 2034. We view Merrimac's power supply diversity positively, but note that the recontracting risk associated with the short-term nature of the contracts mitigates this strength somewhat. Merrimac's power supply suggests a controllable carbon footprint, so environmental costs should be manageable, borne by power suppliers, and passed through to the utility via cost of purchased power.

The department produces formal five-year financial and capital forecasting, which we view positively. It also maintains full rate-setting autonomy, as evidenced by the rate increases of 15% across the board that were implemented in November 2022. This marks the first rate increase since 2009 for the utility.

Financial risk

In our view, FCC has been historically robust. Merrimac's FCC has averaged 1.57x over the past three fiscal years (2019-2021), although coverage declined to 1.37x in 2021 as a result of expenses incurred through the Mystic contract. Although FCC has declined, we believe that cost recovery by the utility is still strong given the rate-raising flexibility and income levels and the base rate increase in November 2022 that should reflect higher revenues beyond 2024 as the Mystic cost-of-service agreement expires at the end of 2024.

In our view, liquidity and reserves have been robust, as the utility built up a rate stabilization fund to apply to extraordinary costs; however, we anticipate that liquidity will decline slightly due to small capital projects that the utility plans to undertake and as the utility uses its rate stabilization fund to cover the cost of fluctuating natural gas prices associated with the Mystic Reliability contract. At fiscal year-end 2021, unreserved cash and investments totaled $11.3 million, measuring 870 days of operating expenses. As a distribution-only operation, the light department's liquidity provides a substantial cushion. 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.

Electric light departments in Massachusetts are unable to issue revenue-backed debt. They tend to internally finance capital improvements and rely on their towns to issue general obligation (GO) debt when external financing of capital improvements is necessary. Merrimac's electric department supports minimal GO debt issued for the electric utility, reflected by its 4.4% debt-to-capitalization ratio as of Dec. 31, 2021. Merrimac maintains a manageable capital plan, which includes minor improvements to transformers and substations. These improvements will be funded from available money and revenues, continuing to support its extremely strong debt and liabilities profile.

Merrimac Municipal Light Department, Massachusetts -- Key credit metrics			
	--Fiscal year ended Dec. 31--		
	2021	2020	2019
Operational metrics			
Electric customer accounts	3,076	3,046	2,982
% of electric retail revenues from residential customers	77.7	77.6	78.1
Top 10 electric customers' revenues as % of total electric operating revenue	10.9	11.0	10.0
Service area median household effective buying income as % of U.S.	131.0	134.0	143.0
Weighted average retail electric rate as % of state	N.A	N.A.	95.4
Financial metrics			
Gross revenues ($000s)	5,424	5,669	5,521
Total operating expenses less depreciation & amortization ($000s)	4,774	4,716	4,146
Debt service ($000s)	98	97	103
Debt service coverage	6.6	9.8	13.4
Fixed-charge coverage	1.4	1.5	1.8
Total available liquidity ($000s)*	11,376	7,427	5,123
Days' liquidity	870	575	451
Total on-balance sheet debt ($000s)	450	525	600

Merrimac Municipal Light Department, Massachusetts -- Key credit metrics (cont.)

	--Fiscal year ended Dec. 31--		
	2021	**2020**	**2019**
Debt-to-capitalization (%)	4.4	5.2	6.3

*Total available liquidity includes available committed credit line balances, where applicable. Debt service coverage--Revenues minus expenses divided by debt service. Fixed-charge coverage--Sum of revenues minus expenses minus total net transfers out plus capacity payments (or their proxy), divided by the sum of debt service plus capacity payments (or their proxy). N.A.--Not available.

Related Research

Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022

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