S&P Global
Ratings

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Summary:

Gainesville, Florida
Gainesville Regional Utilities; CP; Combined Utility

Primary Credit Analyst:
Jeffrey M Panger, New York (1) 212-438-2076; jeff.panger@spglobal.com

Secondary Contact:
Doug Snider, Centennial 303-721-4709; doug.snider@spglobal.com

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Credit Profile		
US$415.9 mil util sys rev bnds ser 2017 A due 10/01/2047		
Long Term Rating	AA-/Stable	New

Rationale

S&P Global Ratings has assigned its 'AA-' rating to Gainesville, Fla.'s series 2017A combined system revenue bonds issued for Gainesville Regional Utilities (GRU). The outlook is stable.

At the same time, S&P Global Ratings affirmed its ratings on parity obligations and its 'AA-/A-1' ratings on GRU's variable-rate demand bonds (VRDBs), series 2005C and 2006A. In addition, S&P Global Ratings affirmed its 'AA-/A-1+' ratings on the utility's series 2007A VRDBs. The ratings on GRU's variable-rate debt reflect our long- and short-term ratings on the utility's respective liquidity facility providers. In addition, S&P Global Ratings withdrew its short term rating on the utility's 2008B and 2012B VRDBs, which we now rate 'AA-/NR'. Finally, S&P Global Ratings affirmed its 'A-1+' short-term rating on Gainesville's commercial paper (CP) program issued for the utility.

The 'AA-' long-term rating reflects our assessment of GRU's following strengths:

- A stable customer base and economy, which the University of Florida anchors;
- Good coverage of fixed costs at the current rating; and,
- Robust liquidity.

We believe the following represent credit weaknesses:

- An unfavorable power-supply portfolio, highlighted by the Gainesville Renewable Energy Center (GREC), an uneconomical biomass plant, and a solar feed in tariff, both of which we believe have contributed to very high rates, limiting financial flexibility and weakening fixed-cost coverage. In addition, the utility faces shaft risk and exposure to environmental regulation related to its coal-fired Deerhaven 2 unit, which was out of service for about eight months in 2016; and
- Rates that are among the highest in the state, resulting in reduced financial flexibility and lower coverage of fixed costs.

The business profile score is '5' (on a scale of '1' to '10', with '1' being the strongest), which reflects our assessment of the risks associated with GRU's generation portfolio and above-average rates, offset by a primarily residential service area with no significant concentration and an economic base that benefits from the University of Florida's stabilizing presence. The Gainesville City Commission governs the system.

The 2017A bonds are being issued to finance a portion of the $750 million cost to purchase GREC--a 102.5-megawatt (MW) merchant biomass plant. Additional financing includes $115 million of unrated variable-rate debt, and $150 million of unrated synthetically fixed variable-rate debt, both of which are expected to be privately placed. We have reviewed the private placement documents and swaps, and we believe they do not, at this time, impose events of default and acceleration risks that would challenge liquidity or credit quality. While not presently a risk, we note that there is a latent risk that future debt issues could contain provisions that would trigger the immediate acceleration on these bonds. This risk is not currently knowable and as such has not been factored into the ratings on GRU's outstanding debt. Should this risk materialize in the future, it would likely have an impact on the ratings for all of GRU's outstanding debt.

To reduce reliance on fossil fuels and enhance fuel-source diversity, GRU had previously made a significant commitment in signing a power purchase agreement (PPA) for energy and capacity from GREC. However, low natural gas prices rendered the biomass plant uneconomical, and GREC has been largely idled in favor of other resources (owned and purchased), whose energy costs are more attractive. Under the PPA, as long as the unit is available, GRU makes substantial fixed payments to GREC (about $74 million per year), regardless of whether the plant dispatches energy. This has raised pressure on GRU's rates, which are among the highest in Florida--47% above the state average in 2015 (the most recent year of available comparative information). In our opinion, the utility's rates are especially burdensome given median household income levels that are just 77% of the national average.

In purchasing GREC, GRU expects to significantly lower annual fixed costs (the net present value of future payments is about $1.2 billion) and provide rate relief. GRU anticipates it will convert the $74 million annual fixed payment associated with the PPA (an operating expense) into an expected $41 million annual debt service expense. Subject to city commission approval, GRU expects to lower rates 8% -10% in 2018, serving to slow the growth in rates to 2% annually over the next five years. Debt payments would be extended five years beyond the current term of the PPA. GRU would take on an estimated $5 million per year of operations and maintenance costs associated with placing GREC on "strategic standby"--available for reliability purposes, and if gas and electric prices rise. However, given current pricing, management does not expect to dispatch GREC more than occasionally; these figures are based on the assumption that the plant never dispatches, which we believe is highly likely. If it does, it would do so only when "in the money," producing additional savings. Management also believes it will be able to dispatch the plant at lower levels than it currently can under the terms of the PPA, potentially fitting in better as an intermediate resource in GRU's dispatch stack.

GREC's original construction cost was about $500 million, making GRU's $750 million purchase price a bitter pill to swallow, in our opinion. Nevertheless, in light of the benefits, we believe the purchase was prudent.

GRU provides electric, natural gas, water, wastewater, and telecommunication services to customers in the Gainesville metropolitan statistical area. The electric utility accounts for 74% of combined revenue, with the other four systems each accounting for 10% or less.

We view GRU's service area as a credit strength. The University of Florida serves as a stabilizing presence for the area's economy. More than 40% of electric revenue comes from residential customers, and no single customer accounts for a significant share of the utility's operating revenue, both of which provide credit stability. While median household income levels are weak, in our opinion, they are somewhat reflective of the area's large student population (50,000).

We consider GRU's operating profile a credit weakness. The utility's owned capacity is largely derived from a single coal unit--Deerhaven 2--exposing it to shaft risk, whose effect was experienced during an eight-month outage in 2016 that necessitated the spot-market purchase of replacement power. Fortunately, the outage's effect was mitigated by low power prices driven by low natural gas prices. Coal-fired generation accounted for just 21% of GRU's energy needs in 2016, (down significantly from previous years) as the utility relied to a greater extent on gas units (55% of energy) and market purchases (22%). Although, Deerhaven 2 complies with existing regulations, the plant is subject to future regulations in an increasingly carbon-constrained environment. In addition to the uneconomic GREC PPA (which will become an owned asset), GRU's adoption of a feed-in-tariff for solar energy has put upward pressure on energy costs.

The situation with GREC has saddled GRU with a substantial fixed cost related to the investment, which is passed through to ratepayers, putting upward pressure on rates, which on a weighted average basis was 47% above the state average in 2015 (the most recent year of available comparative information) and among the highest in Florida. Meanwhile, GRU's management expects the cost of delivered coal will increase when its transportation contract with CSX Corp. expires at the end of 2019. Given the backlash over already high rates, absorbing these cost pressures creates additional credit risk. The utility held base rates steady in 2015 and 2016 in an effort to control already high rates, and with lower gas prices, was able to pass through fuel cost savings. We expect the transaction to generate savings that will mitigate the growth in rates, but management anticipates 2%-3% annual rate increases over the next five years. While GRU's gas rates are low relative to those of competitors, the utility's combined water and sewer rates are above average and expected rise, with projected moderate 3%-5% annual rate increases.

Gainesville's Utility Advisory Board, established in November 2015, has no rate-setting authority, but provides policy and governance counsel to the City Commission. Given a lack of formal oversight powers, we view the board's creation-- the product of ratepayer dissatisfaction--as credit neutral. However, given high rates and current cost pressures, we are wary that the board's role could be expanded in such a ways as to limit GRU's rate-setting autonomy, which we would view as having negative implications for the utility's credit quality.

We believe that these circumstances constrain GRU's revenue-raising flexibility. GRU's coverage of fixed costs ranged from 1.30x-1.35x over fiscal years 2014-2016, and is estimated to be 1.30x in 2017. Fixed-cost coverage treats the GREC payments as a debt rather than an operating expense, and transfers to the city's general fund ($35 million in 2016, a sizable 9% of utility revenue and about one-third of the general fund budget) as an operating expense. Fixed-cost coverage levels are projected to be in the 1.40x range over the next five years.

GRU maintains what we consider to be robust liquidity, with unrestricted cash and investments, plus restricted (but available) rate-stabilization and utility plant improvement funds measuring 254 days of operating expenses in fiscal 2016. GRU has two CP programs that provide $110 million of short-term funding. Bank of America Corp. provides an $85 million credit facility for the utility system that expires Nov. 30, 2018, and State Street Corp provides a $25 million credit facility for the system that expires August 2020.

GRU is highly leveraged, with $1.9 billion in debt (long-term, short-term, and capital-lease obligations) representing

80% of total capitalization. With the debt-financed buyout of GREC's capital-lease obligation, debt levels are expected to decline moderately to $1.6 billion. With about 40% of the $393 million five-year capital improvement plan expected to be debt financed, we anticipate debt levels will decline.

About half of planned expenditures will be for the electric system. GRU expects the water and wastewater system treatment capacity to be adequate for at least the next 10 years. During the next five years, the utility will invest about $65 million in the water system, and $115 million in the wastewater system for expansion, maintenance, and system improvements. The system expects the telecommunications business to require about $17 million to continue expanding its fiber-optic system.

Outlook

The stable outlook reflects our view that the GREC transaction will allow GRU to mitigate further rate pressure and enable the utility to maintain fixed-cost coverage at roughly current levels, which are consistent with the rating.

Upside scenario

We do not expect to raise the rating over the next two years. In our view, while the utility's financial forecast suggests modest strengthening of fixed cost coverage levels, they are not significant enough to offset other credit weaknesses, including: GRU's high rates, which constrain revenue-raising flexibility; the reliance on a single coal-fired generating unit, which exposes the utility to disruption and environmental regulations; and high debt levels, which limit financial flexibility.

Downside scenario

We could lower the rating if fixed-cost coverage falls meaningfully short of projected levels, or if rate pressures exceed what is contemplated in the forecast, or if constraints to rate-setting autonomy are imposed.

Ratings Detail (As Of October 11, 2017)		
Gainesville, Florida		
Gainesville Regl Utils, Florida		
Gainesville (Gainesville Regl Utils) VRDBs - 2008B		
Long Term Rating	AA-/NR/Stable	Outlook Revised
Gainesville (Gainesville Regl Utils) util sys		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
Long Term Rating	AA-/Stable	Affirmed
Gainesville (Gainesville Regl Utils) CP ser C		
Short Term Rating	A-1+	Affirmed
Gainesville (Gainesville Regl Utils) CP ser D		
Short Term Rating	A-1+	Affirmed
Gainesville (Gainesville Regl Utils) VRDBs - 2005C		
Long Term Rating	AA-/A-1/Stable	Affirmed
Gainesville (Gainesville Regl Utils) VRDBs - 2006A		

Ratings Detail (As Of October 11, 2017) (cont.)		
Long Term Rating	AA-/A-1/Stable	Affirmed
Gainesville (Gainesville Regl Utils) VRDBs - 2007A		
Long Term Rating	AA-/A-1+/Stable	Affirmed
Gainesville (Gainesville Regl Utils) VRDBs - 2012B		
Long Term Rating	AA-/NR/Stable	Outlook Revised

Many issues are enhanced by bond insurance.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.