FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Gainesville Regional Utilities, FL's Revs 'A+' and CP 'F1+'; Outlook Stable

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Fitch Ratings - New York - 09 Jul 2021: Fitch Ratings has assigned an 'A+' rating to the following bonds issued by the city of Gainesville, FL on behalf of Gainesville Regional Utilities (GRU):

--Approximately $97million utility system revenue bonds 2021 series A.

The 2021 series A bonds are expected to price the week of July 19 via negotiation. Bond proceeds will be used to pay the costs of the acquisition, construction and equipping of certain capital improvements to the system, capitalizing of interest during the construction period, and paying the costs of issuance of the bonds.

In addition, Fitch has affirmed the following ratings:

--Approximately $1.7 billion in outstanding utility system revenue bonds at 'A+'.

--Up to $125 million of series C tax-exempt commercial paper program notes at 'F1+' ($0 notes currently outstanding).

Fitch has assessed the system's standalone credit profile (SCP) at 'a+'. The SCP represents the credit profile of the utility on a standalone basis, irrespective of its relationship with and the credit quality of the city of Gainesville, FL (Issuer Default Rating [IDR] 'AA'/Stable).

The Rating Outlook is Stable.

ANALYTICAL CONCLUSION

The 'A+' bond ratings and 'a+' SCP reflect the combined utility system's very strong revenue defensibility, supported by its independent rate raising ability and stable demographic trends, as well as its strong operating risk profile, which includes a low operating cost burden through ownership of a diverse, mainly-utility owned resource base. The customer base is diverse and growing, and rates are generally affordable.

GRU's leverage is high for the rating, but Fitch expects a trend of improvement driven by already approved base rate increases and an expected rise in financial margin. The utility's leverage ratio, calculated as net adjusted debt to adjusted funds available for debt service (FADS), declined in 2020 to 9.9x despite a slight decline in energy demand and gas sales as margins were higher for the year due in part to lower fuel costs and other expenses. While Fitch's scenario analysis indicates leverage will increase over the next two years, ratios should decline below 10x over the last three years of the analysis. The current ratings and Stable Outlook remain tied to expectations of lower future leverage, which hinges on GRU's ability to carry out its financial plan.

The 'F1+' rating on the series C commercial paper note program is driven by GRU's long-term rating and further reflects the utility's very strong revenue defensibility and robust liquidity resources, which provide coverage of its liquidity requirements in excess of 1.25x.

CREDIT PROFILE

GRU provides retail electric, gas, water, wastewater and telecommunications services to approximately 281,000 total customers across the five utility systems. The combined system serves the city and a large proportion of the surrounding areas. GRU's vertically integrated electric utility is the largest system, accounting for over two-thirds of total system revenues.

The water (9% of total revenues), wastewater (10%) and gas systems serve territories similar to (and overlapping) the electric system, while the telecom utility, known as GRUCom, serves only a few thousand customers and comprises just 3% of total revenues. Each of the systems is self-supporting and stable and exhibits no customer concentration. Retail rates remain above average for the electric system but are more competitive for the other utilities.

Fitch considers GRU to be a related entity to the city of Gainesville for rating purposes as GRU is a utility enterprise fund of the city, makes annual transfer payments to the city's general fund, and is ultimately governed by the city commission. The commission's duties include approving rates for GRU. The city is the issuer of GRU's bonds. The credit quality of the city does not currently constrain the bond rating. However, as a result of being a related entity, the issue ratings could become constrained by a material decline in the general credit quality of the city.

KEY RATING DRIVERS

Revenue Defensibility: 'aa'

Very Strong Revenue Defensibility

GRU's revenue defensibility assessment reflects the system's very strong revenue framework through the provision of monopolistic services to a growing service area, a strong local economy and independent ability to adjust rates (city commission approval). Customer growth trends have been solid and the city's unemployment rate remains below the national average. The service territory extends into the county with roughly 40% of the customer base residing outside the city of Gainesville's city limits.

Residential electric rates remain slightly above the state average (EIA data not available yet for 2020), but are affordable especially when compared to the broader service territory's somewhat higher median household income (MHI). Rates will rise after the recent approval of a five-year rate plan, which could lower affordability over time.

Operating Risk: 'a'

Low Cost Burden, Diverse Resources

The operating cost burden has been below 13 cents/kWh since GRU's purchase of the 102 MW Deerhaven Renewable (DHR) biomass generating station in 2018. A combination of direct operating control of DHR and lower natural gas prices have led to a decline in operating expenses and to a cost burden that fully supports the strong assessment. Expected capital needs are manageable and will be funded with a combination of 2021 bond proceeds, excess cash flows and some additional borrowings.

Financial Profile: 'a'

High Leverage Expected to Decline

GRU's financial profile is assessed as strong despite currently high leverage based on Fitch's view that a combined utility with sizable water and sewer operations can maintain slightly higher financial leverage relative to electric-only service-providers. In addition, Fitch anticipates the leverage ratio will decline to below 10x in the near term based on GRU's financial forecast.

ASYMMETRIC ADDITIONAL RISK CONSIDERATIONS

There are no additional asymmetric risks affecting the rating.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Further deleveraging that leads to a leverage ratio consistently below 8.0x in Fitch's base and stress cases;

--Sustained decline in the operating cost burden to below 10 cents / kWh could lead to an improved operating risk profile, which in Fitch's view allows for a greater threshold for financial leverage.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Failure to reduce leverage to near or below 10.0x on a sustained basis in Fitch's base and stress cases;

--For the short-term rating, if GRU's long-term rating falls to 'A' or below, or if there is weakening in the utility's revenue defensibility assessment or currently robust internal liquidity support for the commercial paper program.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

SECURITY

The bonds are secured by a first lien on the net revenues of GRU, which includes the combined electric, gas, water, wastewater and telecom systems (collectively, the system). The series C note program is secured by a pledge of system net revenues, subordinate to the prior payment of GRU's long-term debt. There are currently no series C notes outstanding.

REVENUE DEFENSIBILITY

GRU has very strong revenue source characteristics. The system provides monopolistic utility services to a diverse and growing retail customer base, providing resilient and secure revenue sources for the system. While GRU continues to provide telecommunications services that are subject to competition, the service is provided to a small segment of its customer base totaling just 6,500 (fiber optic) and comprises less than 3% of total combined system revenues.

GRU also provides a small amount of contracted wholesale electric sales to the city of Alachua that is set to expire in a couple of years. Spot market sales are de minimis and do not pose a risk of volatility to overall revenue defensibility. Fitch expects non-contracted market sales and revenues from its GRUCom business line to remain limited in GRU's operating profile going forward.

SERVICE AREA CHARACTERISTICS

With an estimated 40% of GRU's customer base residing outside of the Gainesville, and stable overall customer growth, Fitch assesses the overall service area characteristics as strong. The electric system covers approximately 125 square miles and serves roughly 75% of the county's total population. The customer base is predominantly residential (comprising 89% of the total electric system customers) with 46% of total electric sales and 45% of revenues derived from this class.

The strong assessment is supported by GRU's growing customer base, averaging around 1% annually over the past five years, and the strong local economy anchored by the University of Florida (UF), which does not receive retail electric service from GRU. In addition, the local unemployment rate remains below the national average despite a temporary decline in total employment due to pandemic-related stay at home orders through portions of 2020. Double digit employment growth has helped lower the unemployment rate in Alachua County to 4.0% in April 2021.

UF's enrollment of 56,500 comprises over 40% of the city's population base, a noteworthy factor in the city's low median household income (MHI) in Fitch's view. Given the uniqueness of Gainesville's proportionally high student population, coupled with a sizable percentage of customers living outside of the city, Fitch considers the county's stronger MHI (at 82% of the US average in 2019) when assessing the service area's income levels as support for the strong assessment.

The university remains the largest employer in the county, with more than 27,500 employees. Separately, employment is well diversified among the healthcare, higher education, and light industrial and commercial sectors and Alachua County's unemployment rate is almost two full points below the national rate. Other county economic indicators, such as population growth and gross domestic production growth, also compare favorably with state and national averages.

RATE FLEXIBILITY

The electric utility has very strong rate flexibility that is reinforced by its unconstrained legal ability to set rates; GRU's rate-setting authority is subject only to city commission approval. Retail electric rates remain slightly above average despite being lowered in fiscal 2018 following the purchase of DHR. Lower expenses led to a further decline in residential customer bills in 2021, although base rates are set to begin rising in 2022 following city commission approval of a five-year rate plan.

Fitch attributes the slightly elevated rates to GRU's pursuit of higher fixed-cost renewable resources (beginning with the power contract, then eventual purchase of DHR) and the utilities' above-average GF transfer payment, which compensates the city for the high proportion of property tax-exempt customers. Rates charged by GRU for its other utility services are slightly more competitive. A resolution to lower the GF payment by $2 million annually over the next five years is expected to be voted on by the city commission this summer.

The rate flexibility assessment is further supported by electric service that is affordable for a large proportion of GRU's customers. In assessing overall affordability, Fitch takes into consideration the large student population within the city, which leads to somewhat lower income levels, as well as a relatively high proportion of the customer base residing in Alachua County, which demonstrates MHI levels that are roughly one-third higher than the city's. For customers living in the city of Gainesville, the affordability ratio (which measures the annual electric bill for the system to MHI) is strong but at 3.4% just below the threshold for a midrange assessment. However, for the roughly 40% of the customer base living outside of the city, the affordability ratio is closer to 2.5%.

The 2019 residential electric rate, as reported by the U.S. Energy Information Authority (EIA), was 13.18 cents per kWh, which at 113% reasonably approximates the state average. Revenues from residential customers comprised a solid 45% of GRU's total electric revenues, making GRU's residential rate particularly relevant in our analysis. EIA data for 2020 is not yet available.

Rates for water and sewer service are affordable totaling roughly $80 for monthly residential service assuming 7,500 gallons of water use (and 6,000 gallons of sewer).

Rate Structure and Future Rate Adjustments

Electric rates include a fuel and purchased power adjustment component that facilitates the recovery of more volatile operating costs. Adjustments are typically made monthly and may be implemented at management's discretion without commission approval, ensuring timely recovery. Rate structures for GRU's other utility services include similar provisions for enhanced and timely cost recovery, and are designed to allow each system to operate independently, without subsidization. The city commission recently approved a six-year rate plan that will increase base rates for the electric utility by 7% in 2022 and 3% annually for the following five years, and the sewer utility by 5% annually in 2022-2027. Rates for the water and gas systems are not expected to be increased.

OPERATING RISK

The system's strong operating risk assessment reflects a low electric operating cost burden, driven by a diverse resource base and full operating control of DHR since acquiring the plant in 2018. Operating costs, measured by Fitch as total operating expenses including transfers out, divided by total energy sales, declined from an average of just over 16 cents/kWh in 2015-2017 to 12.47 cents in 2020.

Since gaining full control of the operations of DHR, GRU has been able to operate the plant on a more economically advantageous basis than under the previous purchased power arrangement. In addition, with direct ownership, management has more control over scheduled outages and can cycle down the plant to lower levels than previously allowed under the PPA when economically appropriate, and can decide to limit the output from the plant when market prices are low. In 2021, the biomass facility comprises 16% of total resource capacity and 22% of GRU's net energy requirements. In comparison, the biomass plant comprised 12% of total energy dispatched in 2017, the year prior to GRU's direct ownership.

General Fund Transfer

GRU makes annual transfer payments to the city of Gainesville. Fitch includes the transfer payment, which has equaled an agreed upon fixed amount for the past several years, in its analysis of the system's operating cost burden given the city's historical reliance on this payment. The previously agreed upon transfer ($38 million) as well as the formula for deriving it expired in 2019. After negotiations and discussions with the city, the city commission is set to vote on a resolution to lower the transfers by $2 million annually over the next five years. If approved, the lower transfer would provide additional excess cash flow to be used for cash-funding of capex or maintaining cash balances. The leverage ratio would also improve from the increased FADS.

OPERATING COST FLEXIBILITY

Fitch assigns a neutral operating cost flexibility assessment reflecting GRU's well-diversified portfolio of power supply resources led by its ownership of seven distinct natural gas units, totaling 255 MW of capacity, followed by a 228 MW coal plant, Deerhaven Generating Station unit 2, and the 103 MW DHR biomass plant. In total, GRU has over 630 MW's of total generation capacity, which is well in excess of peak demand (425 MW).

GRU's resource mix is diversified by number of units and by fuel type. Some of GRU's steam and combustion turbine units are of older vintage, including the steam combustion unit at Kelly Station which is in the process of being upgraded/replaced. In addition, GRU is expected to retire Deerhaven Unit 1 (75MW, natural gas-fired steam unit), which began commercial operation in 1982 and is mainly used for reserve capacity. GRU is also in the process of converting Deerhaven 2, which is a 228MW coal-fired steam unit, to a natural gas facility with the ability to burn coal or natural gas.

Environmental Considerations

While there are no renewable portfolio standards in the state of Florida, GRU's purchase of the Deerhaven biomass plant (and through purchase of the energy from the plant prior to ownership) coupled with the re-powering of several of its older units demonstrates a longstanding desire to become less fossil-fuel dependent and lower CO2 emissions. With the acquisition of the biomass plant, GRU is able to dispatch at its discretion, which has led to lower use of coal and natural gas units. In 2020, biomass accounted for roughly 25% of total energy dispatched, providing a dual benefit of lower total operating costs and carbon dioxide emissions. The plant utilizes waste wood from around the region, which is processed into small chips and hauled to the facility.

The city commission recently established a goal of reaching 100% renewable energy by 2045, codifying the initial goals to significantly increase renewable generation over the next two decades. Since 2010, GRU reduced total CO2 emissions by nearly 800,000 metric tons, or a 45% overall reduction. Similarly, energy from coal-fired resources is down by over 80% over that time. The process to lowering emissions further will continue over the next few years through unit retirement and repowering and the expected addition of solar capacity. As GRU's resource portfolio evolves, Fitch will continue to analyze any impact these changes have on total costs and portfolio flexibility as well as long-term system leverage, if any.

CAPITAL PLANNING AND MANAGEMENT

Capital planning and management are assessed as very strong with strong historical capex resulting in a low average age of plant of just 11 years. Capex to depreciation has averaged just over 200% over the past six years, but this average reflects spending related to the purchase of the biomass plant.

Management's five-year capital spending plan totals $440 million through 2025, or roughly $88 million annually and just below expected annual depreciation rates. The electric system's expected capex comprises almost half of total capital spending and remains the largest proportion of total expected spending. Funding sources are expected to come from a combination of 2021 bond proceeds, internally generated funds, and some additional debt.

Fuel Diversity/Hedges

GRU's fuel-procurement and management strategy includes diversification of fuel mix and sources, physical and financial hedging activities, and short-term contract procurement, among others. Natural gas supply is transported by long-term contracts for both the electric and natural gas systems by Florida Gas Transmission Company, LLC. Supplies are transported from the Gulf Coast region under firm (daily) contracts priced under tariffs filed with the Federal Energy Regulatory Commission. TEA provides energy trading and strategies to GRU and is responsible for daily natural gas procurement and fuel hedging transactions.

The Natural Gas System

GRU owns and operates a natural gas distribution system consisting of 818 miles of gas distribution mains. Natural gas is purchased by TEA and delivered to GRU from six delivery points interconnected with Florida Gas Transmission Co. TEA provides fuel and risk management services. The average cost of gas delivered to the system in 2020 was $3.94 per million British thermal units. The gas system currently serves approximately 36,000 predominantly residential customers.

The Telecommunications System (GRUCom)

GRU provides telecommunication services, internet access services communication tower antenna space leasing and public safety radio services primarily in the Gainesville downtown area. GRUCom has provided telecommunication services since 1995. Services provided include high-speed internet access, data transport to other local businesses (high-bandwidth circuits), tower leasing for wireless telephone providers and public safety radio services for local government. GRUCom serves approximately 6,500 end-use customers. The fiber-optic network is an important draw for new customers deciding to locate in Gainesville, but remains a small component of operating revenues.

The Water and Wastewater Systems

GRU provides water service to 73,700 customers located within the city limits and the immediate surrounding unincorporated areas of the county. UF and a small residential development in Alachua County are the only wholesale customers of the water system.

Raw water for customer use is obtained from 16 wells in the Floridan Aquifer. Groundwater is treated before distribution at GRU's Murphree Water Treatment Plant. The plant's peak day rated treatment capacity is 54 million gallons per day (MGD), expandable up to 60MGD. GRU's current well supply is expected to yield a minimum of 60MGD, consistent with the capacity of the Murphree plant, and well in excess of actual peak day demand.

The wastewater system serves approximately 65,800 primarily residential customers throughout essentially the same area served by the water system, and also serves roughly 1,000 reclaimed water customers. GRU owns and operates two wastewater treatment plants with a combined average daily capacity of

22.4MGD, which remains comfortably above average daily flows. Wastewater is treated to tertiary standards and effluent is disposed of by discharge and deep well injection. The system is aggressively expanding its water reuse system to conserve groundwater resources and preserve effluent disposal capacity.

FINANCIAL PROFILE

GRU's operating income has been stable over the past several years leading to slightly improved financial metrics and lower leverage. Fitch-calculated coverage of full obligations (COFO) in fiscal 2020 was 1.7x, which is slightly better than levels recorded in the previous four years. Liquidity also improved and remains neutral to the assessment. GRU had a total of $149 million in unrestricted cash and investments on hand, including board designated amounts available in the rate stabilization and utility plant improvement funds, equivalent to 258 days cash on hand at YE 2020.

The leverage ratio remains high at 9.9x in 2020 despite a decline in the ratio from over 11.0x in 2018 and 2019.

Fitch Analytical Stress Test (FAST) - Base and Rating Case Analysis

Fitch's base case is informed by GRU's financial pro forma for fiscals 2021-2025, which incorporates modest overall growth in demand, approved electric and wastewater system rate adjustments, amortization and early redemption of about $200 million of outstanding bonds, capex totaling $440 million, issuance of series 2021 bonds, and an expected approval of smaller general fund transfers. With these assumptions, which Fitch believes to be reasonable, the base case indicates that leverage will increase slightly in 2021 but trend lower in fiscal 2022-2025 as approved base rate increases beginning in 2022 (through 2027) are implemented. The rate adjustments are expected to increase margins and allow GRU to retire some debt earlier than scheduled reducing leverage to closer to 9.0x by years three (2023) and four (2024) of the forward-look.

In the stress case, the FAST incorporates a stress in electric demand and gas sales in the first two years before a return to demand/sales growth in years three through five. The previously mentioned base case assumptions are also applied along with a modest 2% decline in other operating expenses in 2022 to partially offset the revenue decline. No additional base rate increases are applied to the stress even though base rates could be adjusted higher, if needed. The rating case also results in a slight increase in 2021 leverage to 11.1x before a steady decline to below 10x by 2023 and to sub 9.0x by 2025. Overall through the stress case, the leverage ratio follows a similar trend as the base case with leverage below the 10.0x level by fiscal 2023. The resulting ratios should support the current ratings as Fitch believes GRU, as a combined system with significant water and sewer operations, can maintain a slightly larger amount of financial leverage relative to its solely electric-service-providing peers.

DEBT PROFILE

GRU's debt profile is neutral to the assessment. GRU's capital structure utilizes a combination of fixed- and variable-rate debt, as well as long- and short-term financings to match assets and liabilities and achieve the lowest possible interest rate costs. GRU is authorized to issue both senior and subordinate lien debt under existing resolutions.

GRU had $1.7 billion of total debt outstanding at YE 2020 with over 90% of the bonds issued as fixed-rate or synthetically fixed-rate, which is slightly higher than historical levels. GRU continues to actively and prudently manage its hedging instruments, including interest rate swaps, caps and collars, to manage interest rate risk. GRU has seven swap agreements currently outstanding with six different highly rated counterparties.

The mark-to-market valuation on the swaps totaled a negative $123 million as of YE 2020. Swap termination triggers include minimum rating thresholds, although GRU has sufficient liquidity and access to short-term capital to make a termination payment in the unlikely event swap termination is triggered. If owed, swap termination payments would be paid subordinate to the bonds. Fitch believes the challenges of monitoring a sizable variable rate debt portfolio, including swap, liquidity and counterparty exposures remains a risk, but overall has been well managed to date by GRU.

Ample Liquid Resources for CP Program

In addition to the outstanding bonds, GRU has authority to issue up to $150 million in commercial paper notes (series C and series D), which would be subject to a subordinate lien on system revenues. The series C notes ($125 million authorized) are backed by a credit agreement with Bank of America, N.A. through November 2021, while the series D notes have liquidity support from State Street Bank and Trust through June 2025.

The 'F1+' rating on the series C note program is supported by the system's long-term credit quality, very strong revenue defensibility, neutral debt structure and the adequacy of available liquid resources. Fitch's rating incorporates all potential draws on system liquidity, including the smaller taxable series D notes ($25 million authorized, $0 outstanding). Total available cash as of Sept. 30, 2020 combined with the revolving credit facilities, provided approximately 1.7x coverage of the maximum borrowable amount of CP, which is more than adequate to support the higher 'F1+' rating.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

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FITCH RATINGS ANALYSTS

Andrew DeStefano
Director
Primary Rating Analyst
+1 212 908 0284
andrew.destefano@fitchratings.com
Fitch Ratings, Inc.
Hearst Tower 300 W. 57th Street New York, NY 10019

Parker Montgomery
Director
Secondary Rating Analyst
+1 212 908 0356
parker.montgomery@fitchratings.com

Dennis Pidherny
Managing Director
Committee Chairperson
+1 212 908 0738
dennis.pidherny@fitchratings.com

MEDIA CONTACTS

Sandro Scenga
New York

+1 212 908 0278
sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 23 Feb 2021) (including rating assumption sensitivity)

U.S. Public Power Rating Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

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