S&P Global Ratings

Standard & Poor's Credit Research

Gainesville, Florida; Combined Utility; Joint Criteria

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Long Term Rating	A/Stable	Affirmed

Rating Action

S&P Global Ratings affirmed its 'A' rating on Gainesville, Fla.'s senior-lien utility system revenue bonds, issued for Gainesville Regional Utilities (GRU).

At the same time, we have affirmed the 'AA+/A-1' rating on the variable-rate demand obligation series 2019C, which has joint support provided by Bank of America N.A., and reflects the application of our criteria, "Methodology and Assumptions For Rating Jointly Supported Financial Obligations" (published May 23, 2016); and

The outlook on the long-term ratings is stable. The bonds are secured by a pledge of the net revenues of the combined utility, which includes electric (66% of net operating revenue), water (11%), wastewater (14%), gas (7%), and telecommunication (2%) services. At fiscal year-end 2021, the utility, which does business as the Gainesville Regional Utilities (GRU), had about $1.7 billion of debt outstanding, secured by a pledge of the net revenues of the combined utility system.

The combined utility recently privately placed $234 million of fixed-rate senior-lien debt to refund series 2007A and 2008B variable-rate debt outstanding and terminate related swaps, achieving about $4 million in net present value savings. S&P Global Ratings did not rate the privately placed bonds, but we have determined that the termination events are consistent with those applying to GRU's capital market debt, and that there are no acceleration provisions that would result in repayment of the privately placed debt ahead of the capital market debt.

Credit overview

In our view, the depth of GRU's service area, solid management and planning, and robust coverage and liquidity support the current rating, although high rates and a substantial debt burden are a drag on credit quality.

We previously lowered the rating on Gainesville's senior-lien debt to 'A' from 'AA-' in May 2021. That rating action reflected GRU's very high rates and leverage, the product of investment in renewable resources that have proven to be uncompetitive. To maintain financial metrics and ensure full cost recovery, additional rate increases for the electric and wastewater systems are expected over the next several years, which we believe will exacerbate GRU's already limited financial flexibility. Presenting additional challenges are inflationary pressures and rising natural gas prices (with only a portion of fuel requirements hedged), as well as a goal of reaching 100% renewable generation by 2045 (which could entail additional rate increases or debt), possibly resulting in ratepayer backlash.

The current rating reflects our view of the following credit strengths:

- An economy anchored by the stabilizing presence of the University of Florida and several hospitals; and a diverse, residential customer base that provides additional stability to financial operations;
- Fixed cost coverage (FCC), averaging 1.45x over the past three years, that provides operating cushion in the event of declining sales or increasing costs, while also supporting current spending on capital needs, which we view as important given the utility's high debt levels. Based on the utility's financial projections, we expect FCC will be in line with historical results over the next five years, although this is dependent on additional rate increases, the adoption of which could prove challenging given the utility's already high rates; and
- Liquidity that provides flexibility in the event of cash flow volatility. At fiscal year-end 2021, GRU had $263 million in cash and available lines of credit, representing 417 days of operating expenses.

The rating also reflects the following credit risks:

- Although GRU's power supply is diverse, with a significant level of renewables, it is the product of investment in uncompetitive resources, including biomass and solar feed-in tariff (FIT).
- The combination of investment in these uncompetitive resources, the associated high level of leverage and fixed costs, and significant general fund transfers to support the city's general fund, contribute to electric rates that are among the highest in Florida.
- High rates and plans for additional rate increases, coupled with below-average incomes, could result in ratepayer backlash, which could frustrate GRU's strategic goals and cost recovery.
- High rates, coupled with very high debt levels, place a significant constraint on GRU's ability to fund future capital improvements.
- The utility is exposed to natural gas price volatility.

Although we believe that its high rates challenge GRU's financial flexibility, the stable outlook anticipates that financial metrics will continue to support the current ratings. In our view, credit quality is stabilized by recent actions taken by the city commission, including:

- The adoption of electric and wastewater rate increases (7% and 5%, respectively) for fiscal 2022, and annual $2 million reductions in GRU's transfer to the city's general fund for fiscal years 2022-2027 (down from $38 million in 2021); and
- Although yet to be formally adopted, the direction that GRU adopt a rate ordinance for additional annual rate increases (3% for electric and 5% for wastewater) over the next five years.

We believe that at the current rating level, credit quality would be maintained even if GRU's financial metrics fall modestly short of projected levels, whether because of insufficient cost recovery, or lower-than-projected coverage of fixed costs, liquidity, or higher debt levels.

Environmental, social, and governance

On balance, we believe that Gainesville's environmental risks are credit neutral. On the one hand, the utility has a diverse power supply, primarily centered on natural gas, a sizable amount of renewable generation (relative to the region), and only a modest amount of coal-fired generation. On the other hand, achieving its goal of 100% renewable energy by 2045 will likely be challenged by GRU's very high rates and debt levels, as well as inflationary pressures and fuel costs. In consideration of existing high rates, plans for additional rate increases, and below-average income levels, we believe that both social risks are moderately negative. We also view governance risks are moderately negative, as rate raising flexibility will continue to challenge the utility in addressing strategic goals.

Stable Outlook

Downside scenario

Although we believe that credit quality would be maintained at the current rating level even if GRU's financial metrics fall modestly short of projected levels, it could be compromised if metrics suffer more substantial erosion, whether because of failure to pass through rising fuel costs, or if ratepayer backlash against rate increases frustrates the utility's ability to meet its strategic goals and objectives.

Upside scenario

We do not expect to raise the rating over the next two years, as we believe that GRU's substantial debt burden and high rates constrain improvement in credit quality.

Credit Opinion

Enterprise Risk

Enterprise fundamentals

Gainesville is home to the University of Florida, one of the largest universities in the U.S., with an enrollment of about 57,000; and Santa Fe College, with about 15,000 students. These institutions, along with several major hospitals, stabilize the service area economy.

However, as a large portion of Gainesville is tax-exempt, the city's general fund is dependent on transfers from GRU to support about 30% of its municipal operations. Although the city modestly reduced the amount to be transferred in 2022, this nevertheless represents a substantial burden on the utility, and in our view, partially contributes to GRU's high rates.

GRU has a stable customer base and serves a primarily residential area of 99,000 electric customers and 279,000 combined system customers. In our view, this affords the utility scale efficiencies that benefit credit quality. Residential customers account for a significant 47% of retail electric sales; in our opinion, these exhibit more stable demand patterns across economic cycles than do industrial customers, supporting credit quality. Gainesville's customer base is diverse, and customer concentration is not a credit risk, as the leading customer accounts for just 3% of combined system revenue.

Median household effective buying incomes are just 61% of the U.S. average, which is down from 68% in recent years. However, while low income levels signal a limitation to GRU's rate-raising flexibility, the extent to which the large student population contributes to the low metric mitigates the risk. In our opinion, this cohort both skews the income levels of actual ratepayers (that is, on-campus students are not ratepayers) and understates demand elasticity for off-campus students that receive financial support.

Operational Management Assessment

GRU is a department of the city of Gainesville, and is governed by a seven-member commission; the utility operates a vertically integrated electric system, with virtually all energy needs met through owned generation. Although GRU has excess capacity, it is highly dependent on two units for the bulk of its energy--the 228 MW dual fuel (coal and natural gas) Deerhaven unit 2, and the 103 MW Deerhaven Renewable Biomass Plant--representing a credit risk should these units suffer an unplanned outage.

In our view, two power supply decisions made more than a decade ago--a solar FIT paid to behind-the-meter generators and a power purchase agreement (PPA) for a biomass plant--are the source of GRU's uncompetitive rates and high debt levels.

The FIT obligates GRU to make fixed payments at well-above market prices for solar energy for 20 years. And to reduce its reliance on fossil fuels and enhance fuel-source diversity, GRU made a significant commitment in signing a PPA in 2009 for energy and capacity from the Gainesville Renewable Energy Center (GREC), which entered service in 2013. Operational restrictions built into the PPA, coupled with low natural gas prices, rendered the biomass plant uneconomical, with substantial fixed costs that negatively affected rates.

In 2017, GRU purchased GREC for $750 million, renaming it Deerhaven Renewables (DHR). The price was significantly higher than the cost to construct, but ownership enabled GRU to significantly reduce associated fixed costs relative to those under the PPA, producing more than $500 million in net present value savings), while eliminating the operational restrictions, making it a better fit as an intermediate resource in GRU's dispatch stack. Yet despite this, DHR accounted for just 23% of the utility's energy needs in 2020, down from 31% in 2019, suggesting that this key asset remains uncompetitive.

GRU's fuel mix is diverse, with 55% of energy coming from natural gas units, 17% from coal-fired generation, and 26% from renewable resources--primarily from DHR--in 2021. The utility's 634 megawatts (MW) of capacity is more than enough to meet the 448 MW in demand projected over the next five years. GRU does not anticipate needing to add resources through at least 2027. In our opinion, the surplus capacity gives the utility some dispatch flexibility. However, despite the positive attributes, GRU's high all-in cost of power, which is largely attributable to the significant amount of debt associated with DHR, tempers our view of operations. So, despite the excess capacity, the utility's ability to recover fixed costs through surplus sales is very limited.

In our opinion, GRU is exposed to natural gas price volatility, both through its power generation and gas utility operations. Natural gas prices at the Henry Hub were more than $6.60/mmBtu as of June 28, 2022, (up from about $4/mmBtu in August 2021), and the NYMEX forward curve is at approximately the current level through March 2023. We understand that as of June, 6, 2022, GRU's gas requirements were only 60% hedged for the remainder of fiscal 2022 (ended Sept. 30), 20% hedged for the remainder of the calendar year, and 30% hedged for calendar 2023. Therefore, we believe that GRU faces the potential for higher-than-budgeted gas costs, which could exacerbate the utility's market position given its already high rates.

The utility's renewables constitute 28% of energy requirements, which well exceeds the average for Florida and the

Southeast region. With additional rate increases expected, and an uncertain approach to achieving a stated goal of 100% of energy from renewables by 2045, there is a risk that this goal could become an unfunded mandate, which could have further implications for GRU's creditworthiness.

In our view, financial policies and planning are supportive. GRU has a formal policy that governs transfers between the utility and the city's general fund, transferring $38 million in 2020, the bulk of it from the electric system. We understand that the transfer has been reduced to $36 million for 2022, and that the city commission has approved reducing the transfer by $2 million per year through fiscal 2027. GRU produces annual, multiyear financial projections; an annual budget; and a five-year capital improvement plan, all of which we believe support creditworthiness. The utility's cash balance study identified prudent liquidity levels relative to a risk matrix. Despite the utility's high rates, we consider GRU has exhibited a record of setting rates--both base rates and fuel costs--to achieve full cost recovery and provide solid and stable financial metrics.

Market position

Saddled with substantial debt associated with DHR, GRU's rates are among the highest in Florida. Although overall customer bills were lowered by about 8% in 2018 when GRU converted DHR from a PPA to an owned resource, it was only a temporary respite. And while a November 2018 voter referendum to create a utility authority with rate-setting control over GRU was defeated 60%-40%, we note a vocal minority of ratepayers in opposition to GRU's high rates.

In our view, GRU's market position is highly vulnerable, and its current rate trajectory unsustainable. Moreover, we believe that there is a risk that the vocal minority will become a majority, leading to ratepayer pushback that could challenge cost recovery as GRU pursues its operational and financial goals. The weighted-average system rate was a very high 139% of the state average in 2020, the most recent year of available comparative information. Electric base rates have been raised 7% for 2022; GRU's financial forecast incorporates a 3% annual electric base rate increase over the ensuing five years. (Meanwhile, moderate annual wastewater rate increases are also expected, further pressuring utility bills.)

Financial Risk

FCC averaged 1.45x over fiscal years 2019-2021, including 1.53x in fiscal 2021, as GRU's financial results were not materially affected by the COVID-19 pandemic. Our calculation of FCC treats capacity payments and a portion of purchased power expense related to renewables as "debt like" while treating transfers to the city's general fund as an operating expense.

In 2020 and 2021, GRU transferred $38 million to the city's general fund. The transfer for 2022 has been reduced to about $36 million, and future transfers will be reduced by $2 million per year through fiscal 2027. In our view, this should help stabilize FCC in the 1.4x-1.5x range, assuming the revised transfer levels and previously mentioned rate increases are adopted over the ensuing four fiscal years.

In our opinion, liquidity and reserves are robust. At fiscal year-end 2021, internal liquidity totaled $164 million, including operating cash, rate-stabilization reserves, and unrestricted funds designated for capital improvements.

At fiscal year-end 2021, external liquidity measured $100 million, including undrawn capacity on taxable and tax-exempt lines of credit, and taxable CP. Total liquidity and available reserves measured 417 days of operating expenses. In April 2022, GRU replaced its taxable and tax-exempt CP lines with a $150 million line of credit, which can be drawn on a taxable or tax-exempt basis, supplementing a $50 million line previously (and still) in place. GRU projects days' liquidity in excess of 440 days over the next five years.

GRU is highly leveraged, with about $1.7 billion in long- and short-term debt, representing more than 80% of total capitalization. GRU projects debt levels will be largely flat through 2023, as debt issuance offsets amortization. In 2017, GRU privately placed $115 million of variable-rate debt and $150 million of synthetically fixed variable-rate debt, which together with the 2017A capital market bonds, financed the purchase of GREC.I In 2022, GRU privately placed $234 million of fixed-rate refunding debt. The 2022 bonds were not rated by S&P Global Ratings. We do not believe they impose events of default or acceleration risks that would negatively affect liquidity or credit quality. However, there is a latent risk that future debt issues could contain provisions that could trigger the immediate acceleration on certain of these bonds. We have not factored the risk into the rating. However, should this risk materialize, it would likely have negative rating implications.

Related Research

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

Ratings Detail (As Of June 30, 2022)		
Gainesville		
Long Term Rating	A/Stable	Affirmed
Gainesville		
Long Term Rating	A/Stable	Affirmed
Gainesville util sys rev bnds		
Long Term Rating	AA+/A-1	Affirmed
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Gainesville util sys rev bnds ser 2019A due 10/01/2047		
Long Term Rating	A/Stable	Affirmed
Gainesville util sys rev bnds ser 2019B due 10/01/2047		
Long Term Rating	A/Stable	Affirmed