



RATING ACTION COMMENTARY

Fitch Affirms Gainesville Regional Utilities, FL's Revs at 'A+'; Outlook Stable

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Fitch Ratings - New York - 23 Jun 2022: Fitch Ratings has affirmed the ratings on the following bonds issued by the city of Gainesville, FL on behalf of Gainesville Regional Utilities (GRU):

--Approximately \$1.8 billion in outstanding utility system revenue bonds at 'A+'.

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 authority 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 owned resource base. The customer base is diverse and growing, and rates are generally affordable.

GRU's leverage is high for the rating. Fitch expects a trend of improvement in leverage as a result of approved base rate increases, lower general fund transfers, the recovery of actual fuel costs, and an expected rise in financial margins. The utility's leverage ratio, calculated as net adjusted debt to adjusted funds available for debt service (FADS), increased slightly in 2021 to 10.3x. Fitch anticipated the increase in leverage following GRU's issuance of 2021 bonds during the last rating review, and Fitch's base case scenario analysis indicates leverage should decline steadily in subsequent years to around 9.0x by 2025. The current ratings and Stable Outlook remain tied to expectations of lower future leverage, below 10.0x in the near term, which hinges on GRU's ability to carry out its financial plan.

CREDIT PROFILE

GRU provides retail electric, gas, water, wastewater and telecommunications services to approximately 288,000 total customers across the five utility systems. 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 (11%) and gas systems serve territories similar to (and overlapping) the electric system. Each utility is self-supporting and exhibits no customer concentration.

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 GRU's ratings. However, as a result of being a related entity, GRU's 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 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 limits.

Residential electric rates remain slightly above the state average (EIA data not available yet for 2021) but are affordable especially when compared to the broader service territory's somewhat higher median household income (MHI). Rates will rise with approved increases over the next several years, which could pressure affordability over time. Retail rates for the other utilities are competitive.

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 generally lower fuel and natural gas prices have led to a decline in operating expenses, even as resource investments are being made towards the long-term system goal of 100% renewable energy by 2045. Operating costs are rising with increased fuel costs, but Fitch expects the operating cost burden to remain supportive of the 'a' assessment in the near term.

GRU's estimated capital needs of \$560 million through 2026 are manageable and will be funded with a combination of remaining 2021 bond proceeds, excess cash flows and some additional borrowings.

Financial Profile: 'a'

Strong Financial Profile; High Leverage to Decline

GRU's financial profile is assessed as strong despite currently high leverage at 10.3x in fiscal 2021, based on Fitch's view that a combined utility with 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 in the Fitch base and stress scenarios, aided by a 7% electric base rate increase in fiscal 2022. Coverage of full obligations is robust and stable, above 1.6x over the last three years and liquidity was 259 days cash on hand at the end of fiscal 2021.

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.

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;

--Sustained increase in the operating cost burden to above 15 cents / kWh that leads to a lower operating risk profile assessment.

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).

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 and comprises less than 3% of total combined system revenues.

Spot market electric 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 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, at 3.7% the county's unemployment rate remained below the national average in 2021 and tracked even lower in April 2022.

UF's enrollment of roughly 56,000 comprises over 40% of the city's population base, a noteworthy factor in the city's low median household income (MHI). 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 77% of the US average in 2020) 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 reinforced by its 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 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.

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-quarter 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 3.3% is just below the threshold for a midrange assessment (which is 3.6%). However, for the roughly 40% of the customer base living outside of the city, the affordability ratio is closer to 2.5%.

The 2020 residential electric rate, as reported by the U.S. Energy Information Authority (EIA), was 13.02 cents per kWh, which at 116% reasonably approximates the state average. Revenues from residential customers comprised a solid 47% of GRU's total electric revenues, making GRU's residential rate particularly relevant in our analysis. EIA data for 2021 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 Approved Multi-Year Rate Increases

Electric rates include a fuel and purchased power adjustment component that facilitates the recovery of more variable operating costs, which is key in the current rising cost environment. Adjustments are typically made monthly and may be implemented at management's discretion without commission approval, ensuring timely cost 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 approved a multi-year rate plan that increased base rates for the electric utility by 7% in 2022 and will be followed by 3% annual increases for the following

five years. The sewer utility's rates will be increased by 5% annually in 2022-2027. Rates for the water and gas systems were not increased as part of this rate package, and base rate increases are not expected.

OPERATING RISK

The system's strong operating risk assessment reflects a low electric operating cost burden, driven by a diverse resource base by number of units and fuel type. Operating cost burden, 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. The cost burden increased to 13.5 cents/kWh in 2021 and costs are expected to rise further in 2022 with higher projected fuel costs for the year. The cost burden is anticipated to remain below 15 cents over the near term, although a sustained increase above this level could lead to a lower operating risk assessment.

General Fund Transfer

GRU makes annual transfer payments to the city of Gainesville, which totaled approximately 9% of total system revenue in 2021. Fitch includes the transfer payment in its analysis of the system's operating cost burden given the city's historical reliance on this payment. The city commission recently approved a resolution to lower the transfers by \$2 million annually from 2022-2027, which will improve GRU's FADS and excess cash flow to fund capex or maintain cash balances.

Operating Cost Flexibility

Fitch has assigned a neutral operating cost flexibility assessment, reflecting GRU's predominantly natural gas-fired portfolio of power supply resources led by its ownership of seven natural gas units, totaling 264 MW of capacity, followed by Deerhaven Generating Station unit 2 (Deerhaven 2; 228 MW), recently converted to burn natural gas as well as coal, and the 103 MW DHR biomass plant. In total, GRU has over 630 MW's of total available generation capacity, which is well in excess of peak demand (422 MW) in 2021. Following the conversion of Deerhaven 2, from an energy standpoint, natural gas comprises about 64% of total energy delivered, followed by biomass (DHR), and coal.

Environmental Considerations and Clean Energy Transition

The Deerhaven 2 conversion to a natural gas facility in 2022 (ability to burn coal or natural gas), provides flexibility as a physical hedge to rising gas costs but also allows GRU to lower overall carbon emissions. GRU expects to retire Deerhaven Unit 1, a 76 MW, natural gas-

fired steam unit that began commercial operation in 1982 and is mainly used for reserve capacity. The retirement of this unit is anticipated in 2027.

While there are no renewable portfolio standards in the state of Florida, the Gainesville city commission established a goal of reaching 100% renewable energy by 2045, which codifies initial goals to significantly increase renewable generation and lower carbon emissions over the next two decades. Since 2010, GRU reduced total CO2 emissions by 800,000 metric tons, or a roughly 45% overall reduction. Similarly, energy from coal-fired resources is down by over 80% over that time. The process of lowering emissions continues through unit retirements and repowering, as well as the expected addition of solar capacity.

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 12 years in 2021. Capex to depreciation has averaged just over 200% over the past five years, but this average includes the purchase of the biomass plant in 2018.

Management's five-year capital spending plan totals \$560 million through 2026, or roughly \$112 million annually, which is slightly higher than the previous five-year plan but above 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 remaining 2021 bond proceeds, internally generated funds, and 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 2021 was up slightly to \$4.07 per million British thermal units but is closer to \$7.00 thus far in 2022. 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 75,000 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 68,600 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) was 1.7x in fiscals 2020 and 2021, which is slightly better than levels recorded in the previous four years. The leverage ratio remains high at 10.3x in 2021 despite a decline in the ratio from over 11.0x in 2018 and 2019.

Fitch includes revenues in key ratios collected but not recognized and transferred into the rate stabilization fund. Liquidity is robust and remains neutral to the assessment. GRU had a total of \$163 million in unrestricted cash and investments on hand, equivalent to 259 days cash on hand at YE 2021. The balance includes board designated amounts available in the rate stabilization (\$70.6 million) and utility plant improvement funds (\$66 million).

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

Fitch's base case is informed by GRU's updated financial pro forma, which incorporates modest overall growth in demand, approved electric and wastewater system rate increases, the scheduled amortization and early redemption of about \$190 million of outstanding bonds, capex totaling \$560 million, and lower general fund transfers. Additionally, the capital plan will be funded by a combination of existing bond proceeds, internally generated funds and some additional debt.

With these assumptions, which Fitch believes to be reasonable, the base case indicates that leverage will decrease slightly in 2022 to 9.9x and continue to trend lower in the remainder of the forward-look as approved base rate increases are implemented. The rate adjustments are expected to increase margins and allow GRU to retire some debt earlier than scheduled reducing leverage to roughly 9.0x by year four (2025) of the forward-look analysis.

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 1.5% decline in other operating expenses in 2022 and 2023 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 stress case results in a slight increase in 2022 leverage to 10.4x and 10.5x in 2023, before a steady decline to 9.5x by 2025.

The current rating can be maintained if the trend of lower leverage to below 10.0x is achieved 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 rating. At YE 2021, GRU had approximately \$1.8 billion of total debt outstanding with over 90% of the bonds issued as fixed-rate or synthetically fixed-rate, long-term obligations. GRU continues to actively and prudently manage its variable rate portfolio in the current rising interest rate environment, with a combination of liquidity agreements (standby bond purchase agreements) and various hedging instruments, including interest rate swaps, caps and collars, to manage interest rate risk. In addition, GRU recently refinanced outstanding variable rate bonds with a fixed-rate, direct purchase transaction, further lowering its exposure to variable rate debt.

GRU has several swap agreements currently outstanding with several different highly rated counterparties. The mark-to-market valuation on the swaps was a negative \$69 million at YE 2021. The 2022 direct purchase financing totaled approximately \$230 million, and refinanced the series 2007A and 2008B variable rate bonds and the related swaps, as well as related liquidity facilities. Following the issuance, the valuation of all outstanding swaps is now positive.

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. Fitch believes the challenges of monitoring a sizable variable rate debt portfolio, including swap, liquidity and counterparty exposures remains a risk but has improved with the 2022 issuance and has been well managed overall by GRU.

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

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

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| ENTITY / DEBT ↕ | RATING ↕ | PRIOR ↕ |
|--|----------|--------------------------------------|
| Gainesville (FL) [Utilities] | | |
| Gainesville (FL) /Utility System Revenues/1 LT | LT | A+ Rating Outlook Stable Affirmed |
| | | A+ Rating Outlook Stable |

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APPLICABLE CRITERIA

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

[Public Sector, Revenue-Supported Entities Rating Criteria \(pub. 01 Sep 2021\) \(including rating assumption sensitivity\)](#)

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 \(1\)](#)

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