S&P Global Ratings

RatingsDirect®

Gainesville, Florida; Combined Utility; Joint Criteria

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Long Term Rating	A/Stable	Affirmed

Credit Highlights

- S&P Global Ratings affirmed its 'A' long-term rating on Gainesville, Fla.'s senior lien utility system revenue bonds, issued for Gainesville Regional Utilities (GRU).
- At the same time, we affirmed our 'AA+/A-1' rating on the utility's variable-rate demand obligation, 2019 series C.
- The outlook, where applicable, is stable.

Security

The bonds are secured by a pledge of the net revenues of the combined utility, which provides electric (67% of net operating revenue), water (10%), wastewater (15%), gas (6%), and telecommunication (1%) services. The 2019 series C bonds are also supported by Bank of America N.A., and reflect the application of our criteria, "Methodology and Assumptions For Rating Jointly Supported Financial Obligations," published May 23, 2016, on RatingsDirect.

At fiscal year-end 2022, the utility, which does business as the Gainesville Regional Utilities (GRU), had about $1.7 billion of debt outstanding.

Credit overview

Gainesville's combined utility--GRU--serves the city of Gainesville (60% of customers) and unincorporated areas of Alachua County (40%).

Despite robust liquidity and coverage of fixed costs, GRU's combination of high rates, sizable transfers to support the city's general fund, and high debt levels were factored into S&P Global Ratings' 2021 downgrade of GRU to 'A' from 'AA-'.

In light of these credit risks, and in response to mounting pressure from customers and other stakeholders, the city commission developed a plan to reduce leverage by $315 million and bring its debt-to-capitalization ratio down from 82% in 2022 to 70% by 2030. The plan centered on reducing the general fund transfer, which had been $38 million in 2021, to $15 million in 2024, and using the savings, along with expense-side reductions and a portion of adopted rate increases (3% for electric, 5% for wastewater, annually through 2027), to reduce debt. In addition, GRU has previously entered into other transaction, such as a cost-saving pension obligation bond transaction, where the savings will be used by GRU to defease debt as those savings are realized.

Nevertheless, state legislation (HB1645) removes governance of the GRU from the Gainesville city commission and vests it in a five-member board that will include one member (or potentially two, based on customer distribution) from outside of the city limits, to be appointed by the governor and seated by Oct. 1, 2023.

In our view, the strategic direction that the new board will take, and whether it will continue to implement credit-supportive policies, is currently unclear, particularly as it pertains to the general fund transfer (since renamed the government services contribution), the adopted rate increases, the planned debt reduction, and the city commission's plan to achieve net zero carbon emissions by 2045.

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;
- Gainesville's virtual elimination of coal-fired generation; while natural gas accounts for about two-thirds of energy, renewables (primarily biomass) account for nearly 30%, the highest in the state and among the highest in the Southeast;
- Robust fixed cost coverage (FCC), averaging 1.5x over the past three years, including 1.6x in 2022. In our view, the coverage of fixed costs 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 GRU's high debt levels. Based on the utility's financial projections, we expect that FCC will continue in this range, although we believe this is uncertain and could be influenced by the new board's strategic direction on rates; and
- Robust liquidity that provides flexibility in the event of cash flow volatility, which we view as important given GRU's exposure to gas price volatility. At fiscal year-end 2022, Gainesville had $136 million in cash and investments and $200 million in undrawn capacity on lines of credit, together representing 392 days of operating expenses.

The rating also reflects the following credit risks:

- Although GRU has a significant level of renewables, this is the product of legacy investment in uncompetitive resources, including biomass and solar feed-in tariff (FIT);
- The combination of investment in these uncompetitive resources, the associated high leverage and fixed costs, and the historically significant transfers to support the city's general fund contribute to electric rates that are among the highest in Florida (132% of the state average in 2021, the most recent year of comparative data). We anticipate that competitive positioning will weaken further based on the adoption of 3% annual electric rate increases over fiscals 2022-2027 and also note the wastewater rate increases of 5% annually over the same timeframe;
- High rates, coupled with below-average incomes (73% of the state average), have resulted in ratepayer backlash and prompted recently enacted governance legislation that could frustrate Gainesville's strategic goals and cost recovery; and
- High rates, coupled with very high debt levels (82% debt-to-capitalization), place a constraint on Gainesville's ability to fund future capital improvements.

Environmental, social, and governance

On balance, we believe that GRU's environmental risks are credit neutral. On the one hand, GRU has a diverse power supply, primarily centered on natural gas, a sizable amount of renewable generation (relative to the region), and a very modest amount of coal-fired generation. On the other, achieving its goal of 100% renewable energy by 2045 will likely be challenged by very high rates and debt levels, inflationary pressures and fuel costs, Florida's constrained transmission system, and directives of the yet-to-be appointed board. We also believe Gainesville's location in Florida exposes it to hurricane risk. In consideration of the current high rates, recently adopted rate increases, and below-average income levels, we believe that social risks are negative. S&P Global Ratings believes that unsustainably strong business and consumer economic activity that are driving inflation will likely lead to higher interest rates and will ultimately produce an economic slowdown. Yet, although S&P Global Ratings sees an economic weakening on the horizon, it no longer foresees imminent recession risk. (See "Economic Outlook U.S. Q3 2023: A Sticky Slowdown Means Higher For Longer," published June 26, 2023, on RatingsDirect.). Consequently, we continue to monitor the strength and stability of public power/cooperative electric utilities' revenue streams for evidence of delinquent payments or other revenue erosion because elevated consumer prices and interest rates will likely continue whittling discretionary incomes. Given recently enacted governance legislation and a lack of clarity on the direction that the new board will take, we view governance risks as moderately negative, as rate-raising flexibility will continue to challenge the utility in addressing strategic goals.

Outlook

Although we believe that GRU's high rates challenge its financial flexibility, the stable outlook anticipates that financial metrics will continue to support the current ratings. In our view, financial metrics are stabilized by the adoption of electric and wastewater rate increases, the reduction in the transfer to the city's general fund, and the plan to reduce leverage. Unknown at this time is the strategic direction that will be taken by the new board and the extent to which it implements credit-supportive policies.

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 the new board imposes a strategic direction that may result in more substantial erosion, whether because of failure to pass through rising fuel costs or to adopt credit-supportive base rate increases. However, the rating could also be pressured 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

Deep and diverse service area, anchored by the University of Florida

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 its utility to support about 30% of its municipal operations. Although the city modestly reduced the amount to be transferred in 2022 and 2023, this nevertheless represents a substantial burden on the utility and, in our view, partially contributes to its high rates. A more substantial reduction in the transfer is planned for 2024, but it remains to be seen what level of transfers the new board will support. (It also remains to be seen what actions the city of Gainesville will take in response to the diminished general fund support from GRU.)

GRU has a stable customer base and serves a primarily residential area of about 100,000 electric customers and 280,000 combined system customers. In our view, this affords the utility with scale efficiencies that benefit credit quality. Residential customers account for almost half of retail electric sales; in our opinion, these exhibit more stable demand patterns across economic cycles than do industrial customers, supporting credit quality. GRU'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 73% of the U.S. average. 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.

Debt-laden resources contribute to high power costs and rates

The utility operates a vertically integrated electric system, with virtually all energy needs met through owned generation. GRU has excess capacity, giving it operational flexibility, and relies on three units for the bulk of its power needs--the 228 megawatt (MW) dual fuel (natural gas/coal) Deerhaven unit 2, the 103 MW Deerhaven Renewable Biomass Plant, and the 41 MW J.R. Kelly combined cycle unit.

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 (the Gainesville Renewable Energy Center, or GREC)--are the source of GRU's high rates. The solar FIT required GRU to make fixed payments at well above market prices for solar energy for 20 years to participating customers. Although the GREC PPA was intended to reduce GRU's reliance on fossil fuels and enhance fuel-source diversity, the 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 Gainesville's dispatch stack. Yet despite this, DHR accounted for just 28% of the utility's energy needs in 2022, down from 31% in 2019, suggesting that this key asset remains uncompetitive.

GRU's fuel mix is diverse, with 65% of energy coming from natural gas units, 28% from renewable resources, primarily from DHR, and 5% from coal-fired generation. The utility's 644 MW of capacity is more than enough to meet the 408 MW peak load. 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.

FCC and liquidity underpin credit quality, but leverage remains a weakness

FCC averaged 1.50x over fiscal years 2020-2022, including 1.62x in fiscal 2022. 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 2021, GRU transferred $38 million to the city's general fund. The transfer was reduced by $2 million in 2022 and again in 2023. Prior to the change in governance, the city commission adopted a plan to reduce the transfer to $15 million in 2024, using the savings to achieve $315 million in debt reduction. Coupled with the adopted rate increases, GRU projects FCC in the 1.5x to 1.6x range. However, we note that achieving these coverage levels will be dependent on the new board's retention of the city commission's adopted rate increases, which currently is uncertain.

In our opinion, liquidity and reserves are solid. At fiscal year-end 2022, internal liquidity totaled $136 million, including operating cash, rate-stabilization reserves, and unrestricted funds designated for capital improvements. At fiscal year-end 2022, external liquidity (undrawn capacity on lines of credit) measured $200 million. Total liquidity and available reserves measured 392 days of operating expenses.

GRU is highly leveraged, with about $1.7 billion in long- and short-term debt, representing more than 82% of total capitalization. The utility's current plan is to use savings from the reduction in transfers to the general fund, combined with current funds and expense-side savings, to reduce outstanding debt by $315 million, to 70%, by 2033. It is unclear whether the new board will continue to support this plan, reduce debt retirement to effectuate rate reduction, or increase debt retirement.

The combined utility has about $790 million of privately placed debt including $150 million of direct placement debt issued at the end of June 2023. S&P Global Ratings does not rate the privately placed bonds. However, we understand 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.

Gainesville, Florida--key credit metrics			
	--Fiscal year ended Sept. 30--		
	2022	**2021**	**2020**
Operational metrics			
Electric customer accounts	101,573	101,000	99,202
% of electric retail revenues from residential customers	47	47	47
Top 10 electric customers' revenues as % of total electric operating revenue	15	17	17
Service area median household effective buying income as % of U.S.	73	N.A	N.A.
Weighted average retail electric rate as % of state	133	133	139
Financial metrics			
Gross revenues ($000s)	527,238	413,319	380,208
Total operating expenses less depreciation and amortization ($000s)	313,542	230,997	210,926
Debt service ($000s)	107,118	92,207	96,710

Gainesville, Florida--key credit metrics (cont.)			
	--Fiscal year ended Sept. 30--		
	2022	2021	2020
Debt service coverage (x)	2.0	2.0	1.8
Fixed-charge coverage (x)	1.6	1.5	1.3
Total available liquidity ($000s)*	336,288	263,736	249,113
Days' liquidity	392	417	431
Total on-balance-sheet debt ($000s)	1,933,647	1,978,114	1,871,438
Debt-to-capitalization (%)	82	83	82

*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

Ratings Detail (As Of June 30, 2023)		
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