STANDARD & POOR'S RATINGS SERVICES

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Summary:

Gainesville, Florida Gainesville Regional Utilities; CP; Combined Utility

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Credit Profile		
US$43.185 mil util sys rev bnds (Gainesville Regl Utils) ser 2012A due 10/01/2025		
Long Term Rating	AA/Negative	New
Gainesville, Florida		
Gainesville Regl Utils, Florida		
Gainesville (Gainesville Regl Utils) util sys		
Long Term Rating	AA/A-2/Negative	Outlook Revised
Gainesville (Gainesville Regl Utils) var rate util sys		
Long Term Rating	AA/A-1+/Negative	Outlook Revised

Rationale

Standard & Poor's Ratings Services has revised its outlook on Gainesville, Fla.'s system revenue bonds issued for Gainesville Regional Utilities (GRU) to negative from stable. At the same time, Standard & Poor's assigned its 'AA' rating to Gainesville's utilities system revenue bonds, 2012 series A, issued for the system. Standard & Poor's also affirmed its 'AA' long-term rating on the system revenue bonds issued for GRU and its 'A-1+' short-term rating on the utility's commercial paper program.

The negative outlook reflects our view of the potentially weaker financial metrics if GRU is unable to sell a 25% share of its biomass plant, scheduled to begin commercial operation in late 2013 or early 2014, which could result in a lower rating.

The pledged revenue of the electric, gas, water, wastewater, and telecommunications systems secures the debt, of which $994 million is outstanding.

While the absorption of the costs associated with the biomass could weaken debt service coverage (DSC), we see other factors that contribute to GRU's overall credit strength:

- The utilities' solid operational profile and combined average rates;
- A solid financial position, moderate debt per customer, and strong liquidity;
- Commission support for rate increases to maintain a strong financial profile;
- An experienced and proactive management team; and
- A stable economy with an increasing customer base.

Proceeds will provide a portion of the funds required to refund series 2003A and 2005A bonds.

GRU provides electric, natural gas, water, wastewater, and telecommunication services to customers in the Gainesville metropolitan area. The city commission governs the system.

The utility system's overall business risk profile is '4' on our scale of '1' (excellent) to '10' (vulnerable). The system provides reliable services at competitive rates to a customer base that has increased steadily. Gainesville owns and operates the utility's assets, except its 1.4% interest in the Crystal River 3 nuclear plant, which Progress Energy Florida Inc. (PEF) operates. GRU has an agreement to purchase power from the 100 megawatt (MW) biomass unit the Gainesville Renewable Energy Center (GREC) owns, which will begin operating by early 2014. GRU depends primarily on the Deerhaven Unit 2 coal-fired plant, which supplies about 70% of the system's power. Power from the biomass unit will replace a contract for electricity from PEF that expires at the end of 2013.

GRU's retail customers, most of whom support the construction of the of the 100 MW wood-burning facility, expect an 8% rate increase to support 75% of the $70 million of additional fixed cost. Residential customers expect a rate increase in 2014 of $10.56 per month, based on 1,000 kilowatt-hours (kWh) of use. Management projects rate increases in subsequent years of $3.50 or less. GRU expected to sell at least 25% of the output under a 20-year contract, which would have supplemented the rate increase retail customers shouldered. However, the decline in gas prices and slow demand growth has reduced the biomass plant's attractiveness for potential customers. The cost of the plant's electricity is about 13 cents per kWh. GRU has responded by initiating cost-saving alternatives, including debt refinancing that will lower annual debt costs by about$10 million per year. Combined with the expiration of the purchased power contract with PEF, the $70 million of annual fixed costs from the biomass unit will be offset by about $22 million. GRU is looking at other options that could further reduce the impact of the biomass plant's annual cost. The forecast includes an estimated $10 million from off-system sales of power and cost-cutting strategies.

Overall, management expects combined residential utility rates to increase $12.65 per month in 2014, and subsequent year increases to be $5-$6 per month, based on 1,000 megawatt-hours of electricity, 25 therms of natural gas, 7,000 gallons of water, and 7,000 gallons of wastewater. In 2011, GRU's residential rates for all utility services, based on average usage, was about in the middle of rates charged by comparable combined utilities in Florida.

We have cited as a risk GRU's dependence on a single coal-fired generating unit, Deerhaven unit 2, for about 70% of its electricity as is a risk. However, the unit's strong operating record and the agreement with surrounding utilities to provide backup power in the event of an unplanned, long-term outage reduce the risk, in our view. The replacement power's cost would be based on gas prices, which we project will remain low for many years. In 2009, the utility completed the Deerhaven emissions reduction retrofit to assure that the system will operate well within the limits of the Clean Air Interstate Rule and the Clean Air Mercury Rule, and management expects to be able to meet standards proposed to date by the EPA under the Cross-State Air Pollution Rule and Utility Maximum Achievement Control Technology Act rules. Additional investment will primarily be for steam turbine and coal handling improvements, boiler component replacements, line extensions, and distribution improvements.

Management estimates capital spending through 2019 will be about $635 million; about 54% of that is for the electric system. The gas system will spend about $44 million for main and residential extensions. GRU expects the water system to be adequate at least through 2030, and the wastewater system through 2029. During the next seven years, the utility will invest about $80 million in the water system and about $100 million in the wastewater system for expansion, maintenance, and system improvements. The system expects the telecommunications business to require about $59 million to continue expanding its fiber-optic system throughout the metropolitan area.

In our opinion, GRU's financial metrics are appropriate for 'AA' category. We believe this is due to management's oversight of its risk profile, budgeting to assure an adequate cushion of cash flow and liquidity, and to the willingness of Gainesville's commissioners to approve utility rate increases needed to achieve the budget goals. In 2011, DSC, including commercial paper, was 2.2x, which is in line with the five-year average. Fixed charge coverage, which compares cash operating income after transfers to the city's general fund to the combined utilities' debt service, was 1.7x. The general fund transfers from each utility were based on formulae, which resulted in a reduction to about 9% of revenue in recent years from more than 12% of revenue in 2002.

GRU maintains what we consider strong liquidity. Average cash on hand at the end of fiscal years 2007-2011 (Dec. 31) equaled more than 100 days of operating expenses. In addition, the system has two commercial paper programs that provide $110 million of short-term funding. Bank liquidity facilities back the program: Bayerische Landesbank Gironzentrale provides an $85 million credit facility for the electric utility that expires Nov. 30, 2015; and SunTrust Bank provides a $25 million credit facility for GRUCom, the telecommunications system, that expires Sept. 11, 2014.

In addition, management is building a working capital reserve, which it expects will increase to the goal of $25 million by fiscal 2014. That fuel costs are passed through to customers monthly helps limit working capital requirements. In its annual budget approval process, the city commission adopts GRU's specified cash reserve requirements based on risk metrics that are updated annually. The rate-stabilization fund (RSF) and the utility plant improvement fund (UPIF) also provide liquidity. The RSF, which is about $56 million, will help limit rate increases. Management uses the UPIF primarily to fund the equity portion of capital investment, but it can also repay debt. In the 2012-2019 forecast, management expects the UPIF to fund almost 30% of capital investment and about 10% of debt service.

Gas price risk is managed through gas purchase contracts brokered by The Energy Authority (TEA), a Georgia-based nonprofit corporation that municipal utilities founded in 1997 to maximize the value of generation and energy resources in a wholesale market. The required balance in the margin account historically has averaged $2.3 million. In addition, GRU's share of guarantees for letters of credit issued by TEA's bank to cover purchase-and-sale contracts for electricity, natural gas, and related transmission has averaged $30.5 million.

The utility's use of interest-rate swaps also limits liquidity needs. Only 8% of interest expense is variable-rate, and interest on reserves largely hedges that risk. About 57% of interest expense is fixed-rate and 35% is synthetic fixed-rate. Overall interest expense is less than 4.11%. We rate the counterparties on these interest rate swaps 'AA-' or 'A'. The 2005C and 2006A swaps have a small degree of basis risk, in our opinion, since GRU will receive a floating rate based on LIBOR, whereas the bond floating rate is based on the Securities Industry and Financial Markets Association. The swaps terminate if the rating on the utility's debt falls to less than 'BBB-'.

Our primary concern relates to GRU's to sell a portion of the electricity from the biomass plant to off-system customers or to find savings within its own operations to offset at least part of the charges owed under the 30-year contract GRU has signed with GREC. We believe GRU has adequate liquidity built up in the RSF and UPIF to provide reasonably strong DSC through the initial years of the biomass plant's operations, but we are concerned that the plant's high cost will eventually erode the utility's financial risk profile if it is obliged to absorb the high operating cost of the plant without supplemental off-system power sales.

Based on our calculation of financial metrics, we see a significant deterioration in GRU's forecast DSC. Including the beneficial impact of the expiration of the purchased power contract with PEF, the cost reduction associated with this debt refinancing and assuming $10 million savings or cost reimbursement from power sales or assignments, DSC is projected to decline from the 2011 level of over 2.0x to about 1.8x over the five-year forecast period. DSC after the transfer to the Gainesville general fund and net of transfers from or to the rate-stabilization fund is forecast to be about 1.3x, compared with 1.5x-1.7x in 2011 and before. If we also take into account the $70 million of fixed costs associated with the 30-year purchased power agreement with the owners of the biomass plant (adding $70 million to both the numerator and denominator of the coverage ratio), coverage declines to about 1.13x in 2014, gradually increasing to 1.20x in 2020.

The decision to not lower the rating immediately also reflects our view of GRU management's policies that are intended to maintain a strong level of liquidity. Management expects liquidity to remain strong, exceeding policy target levels by as much as $170 million in the next five years. We expect this strong level will help cushion the impact of absorbing the biomass plant's high cost.

Outlook

The negative outlook, which covers a two-year horizon, reflects Standard & Poor's view that we could lower the rating if management's efforts to strengthen financial metrics when the biomass plant begins operating in 2014 are not successful. Gainesville's city commission is willing to support GRU's need for rate increases to maintain strong DSC, but management and the council had expected to sell a portion of the power under a long-term contract. Lower demand and gas prices make this option less probable. Management is exploring other options for lowering costs, one of which is the current refinancing. We do not expect to raise the rating during our outlook horizon.

Related Criteria And Research

- USPF Criteria: Key Water And Sewer Utility Credit Ratio Ranges, Sept. 15, 2008
- USPF Criteria: Standard & Poor’s Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds, Sept. 15, 2008
- USPF Criteria: Electric Utility Ratings, June 15, 2007

Ratings Detail (As Of June 27, 2012)		
Gainesville, Florida		
Gainesville Regl Utils, Florida		
Gainesville (Gainesville Regl Utils) cml pap		
Short Term Rating	A-1+	Affirmed
Gainesville (Gainesville Regl Utils) util sys		
Unenhanced Rating	AA(SPUR)/Negative	Affirmed

Ratings Detail (As Of June 27, 2012) (cont.)		
Long Term Rating	AA/Negative	Affirmed

Many issues are enhanced by bond insurance.

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