S&P Global Ratings

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Gainesville, Florida; CP; Combined Utility; Joint Criteria

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Credit Profile		
Gainesville		
Long Term Rating	AA-/Stable	Affirmed

Rating Action

S&P Global Ratings affirmed its 'AA-' long-term rating and underlying rating (SPUR) on Gainesville, Fla.'s combined utility revenue debt. The combined utility, which does business as the Gainesville Regional Utilities (GRU), includes electric, water, wastewater, gas, and telecommunication services.

At the same time, we affirmed the following ratings:

- The 'AA-/A-1+' rating on the variable-rate demand obligation series 2007A, with liquidity support from State Street Bank and Trust; and
- The 'A-1+' rating on GRU's commercial paper.

We also 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).

The outlook on the long-term ratings, where applicable, is stable. At fiscal year-end 2019, GRU had about $1.6 billion of debt outstanding. A pledge of the net revenues of the combined utility secures the bonds.

Credit overview

GRU operates a combined utility system that includes electric (72% of operating revenue), water (9%), sewer (12%), gas (5%), and telecommunication (2%) services. The utility serves the city of Gainesville and unincorporated parts of Alachua County.

In our view, GRU has enterprise and financial risk profiles that are very strong. We believe that the depth of the service area, solid management and planning, and very strong coverage and liquidity support the rating, while high rates from a substantial debt burden are a drag on credit quality.

The enterprise risk profile reflects our view of GRU's:

- Extremely strong service area economic fundamentals, reflecting a large and diverse residential customer base, anchored by the University of Florida and several hospitals;
- Very strong operational and management assessment, highlighted by diverse generating assets and fuel mix, a favorable environmental profile, credit-protective policies and planning practices, and a power cost adjustment mechanism that maintains robust financial metrics despite uncompetitive rates;

- Highly vulnerable market position, with rates that are 131% of the state average, following substantial fixed costs associated with a biomass plant; and
- Extremely strong industry risk relative to that of other industries and sectors.

The financial risk profile reflects our view of the utility's:

- Very strong coverage metrics, as evidenced by fixed cost coverage (FCC) that averaged 1.40x from fiscal years 2017-2019 (after transfers in from its rate stabilization fund; 1.34x before such transfers). Projections suggest replenishment of the reserve in fiscal years 2021-2024, with FCC of about 1.4x after the transfers, and 1.6x before the transfers). However, in our view, further strengthening- could be frustrated by a decline in demand as a result of the COVID-19 pandemic and recession. Nevertheless, we anticipate coverage metrics will remain at very strong levels;
- Very strong liquidity and reserves, reflecting $162 million in available cash and reserves, measuring 255 days of operating expenses in fiscal 2019; and
- Adequate debt and liabilities, suggested by a debt-to-capitalization ratio of just less than 80% in 2019, and the expectation of improvement as GRU builds equity.

To date, the impact of the COVID-19 pandemic and recession has been modest. In fact, electric and water sales increased during the month of March, as weather-driven demand more than offset lower sales related to diminished economic activity. Although Gainesville is home to the University of Florida, GRU does not serve the campus, shielding it from direct impact related to the school's operation. That more than 40% of sales are to residential customers, and the leading customer accounts for just 2.3% of revenue provides additional insulation from the economic downturn.

GRU is operating under a self-imposed moratorium on service shut-offs and is waiving late fees on delinquent bills. We understand that there has not been a significant increase in delinquent payments to date, but note that this could become more of an issue as the recession deepens. GRU has already implemented hiring, travel, and training freezes to reduce operating expenses, and the utility has identified other potential operational and financial levers, including deferral of non-essential capital spending, should financial pressures materialize.

The utility, which had $298 million in available liquidity at Feb. 29, 2020, recently received city commission approval for an increase to its line of credit by an additional $50 million. In our view, this would provide further operating cushion to absorb even a stress-case scenario, where the pandemic and recession peak in December and then gradually recover through March 2021. Under this scenario, management conservatively estimates a 12.3% reduction in revenue (about $21 million). We also note that financial forecasts produced prior to the pandemic showed improving coverage levels and increasing deposits to the utility's rate-stabilization reserve, and in our view, this suggests additional financial flexibility.

The stable outlook reflects our view that the acquisition of Gainesville Renewable Energy Center (GREC; now known as Deerhaven Renewable Energy Center), with which GRU had a costly power purchase agreement (PPA), has allowed the utility to mitigate further rate stress and enables it to achieve organic FCC levels--without recurring rate-stabilization transfers--that we consider very strong and necessary to support the rating.

Environmental, social, and governance

Gainesville's environmental risks relate chiefly to its relative high coal usage, compared to the Southeast and Florida regions. However, in our view, this has gone down substantially in recent years and is closer to the Southeast region's levels (27.5% 2019 dispatch from Gainesville versus 23.8% 2019 dispatch in the Southeast). Coal usage is expected to increase, but not up to prior levels, as Deerhaven Renewables (DHR) biomass is now dispatching more frequently. Renewables are also significantly higher in Gainesville compared to other utilities in the Southeast and Florida.

S&P Global Ratings recently revised the outlook for the public utilities sector to negative from stable due to the COVID-19 pandemic (see "All U.S. Public Finance Sector Outlooks Are Now Negative," published April 1, 2020, on RatingsDirect). However, in our view, Gainesville has applied adequate measures to stem the spread of COVID-19 and protect the population's health and safety, which we view as a social risk under our environmental, social, and governance (ESG) factors. We see the utility's high rates (especially to commercial customers) as a social risk, especially when looking at them in tandem with COVID-19 risk, as stay-at-home orders are affecting both the supply and demand side of local economies. Nevertheless, we believe that the utility's demand profile and robust financial metrics limit the budgetary challenges, and the risk to cash flows and liquidity.

We do not believe that governance risk is significantly different from that of Gainesville's peers, as the utility has rate-setting autonomy (contingent on approval from the city commission) and is proactive by updating a five-year financial forecast and capital plan annually.

Stable Outlook

Downside scenario

Although we expect GRU will maintain very strong coverage and liquidity despite the initial estimates of demand and revenue loss associated with the pandemic, operating stress may grow and demand may decline (or delinquencies increase) as the recession deepens. Should the University of Florida fail to re-open substantial on-campus education, the rating could be pressured. In our view, a modest decline in FCC, a significant decline in liquidity, or modest increase in debt levels could pressure the current rating.

Upside scenario

We do not expect to raise the rating over the next two years given the uncertainty related to the COVID-19 pandemic and related recession. In addition, we believe that GRU's substantial debt burden and high rates further constrain credit improvement. In our view, while the utility's financial forecast suggests modest strengthening of FCC levels, this is not significant enough to offset other weaknesses, including high rates (which constrain revenue-raising flexibility) and high debt levels (which limit financial flexibility).

Credit Opinion

Enterprise Risk

Economic fundamentals: Extremely strong

GRU has a stable customer base and serves primarily a residential area of 98,000 electric customers and 273,500 combined system customers. In our view, this affords the utility scale efficiencies that benefit credit quality. Residential customers account for a significant 42% share 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, because the leading customer accounts for just 2.3% of combined system revenue.

Gainesville is home to the University of Florida, one of the largest in the U.S., with about 56,000 enrolled students; and Santa Fe College, with about 15,000 students. These institutions, along with several major hospitals, stabilize the service area economy. Median household effective buying incomes are just 68% of the U.S. average. While this generally would signal 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. In response to the COVID-19 pandemic, the university has been conducting classes online. Should the university fail to substantially re-open on-campus education in the fall, this could have a negative impact on our evaluation of the utility's economic fundamentals, and the rating on GRU.

Operational management assessment: Very strong

GRU operates a vertically integrated electric system, with about 97% of energy coming from owned generation and 3% from spot or day-ahead market purchases. The utility operates a diverse set of generating assets running on different fuels. In our opinion, this gives GRU operational flexibility, further enhanced by a capacity surplus that gives dispatch optionality. However, tempering our view is significant leverage associated with the assets that creates an uncompetitive cost structure for its power, as very high rates indicate.

To reduce 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 GREC, which entered service in 2013. Operational restrictions built into the PPA, coupled with low natural gas prices, rendered the biomass plant uneconomical, and GREC was largely idled in favor of other resources (owned and purchased), whose energy costs were more attractive. Nevertheless, GRU was obligated to make substantial fixed payments to GREC (about $74 million per year), regardless of whether the plant dispatched energy, which negatively affected rates.

In 2017, GRU purchased GREC for $750 million, renaming it Deerhaven Renewables (DHR). As the original construction cost was $500 million, the purchase price was, in our opinion, a bitter (but prudent) pill for GRU to swallow. It allowed the utility to significantly lower its annual fixed costs, converting the $74 million annual fixed payment associated with the PPA (an operating expense) into a $41 million annual debt service expense. It also eliminated the operational restrictions, allowing the plant to operate at lower levels, making it a better fit as an intermediate resource in GRU's dispatch stack. DHR accounted for about 31% of the utility's energy needs in 2019.

Other generating assets include the John R. Kelly Station (one combined cycle combustion turbine; 108 megawatts

[MW]) and the Deerhaven Generating Station (two steam turbines and three combustion turbines, for a cumulative 409 MW). Management expects to decommission Deerhaven unit 1, a 75 MW steam unit, in 2022.

GRU's fuel mix is diverse, with 44% of energy coming from natural gas units, 20% from coal-fired generation, and 33% from renewable resources--primarily from DHR. The utility's 634 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. Yet 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.

GRU fully complies with existing environmental regulations. The utility's renewables constitute 33% of energy requirements, which well exceeds the average for Florida and the Southeast region. We believe that, combined with excess capacity, this profile positions GRU well to respond to environmental challenges, even if the utility still has modest coal-fired exposure. GRU is a department of the city of Gainesville, and is governed by a seven-member commission. There is also a utility advisory board. The utility's experience with DHR and the resulting high rates prompted a November 2018 voter referendum to create a utility authority with rate-setting control over GRU. The measure was defeated in a 60%-40% vote, preserving the commission's rate-setting autonomy.

In our view, financial policies and planning support creditworthiness. GRU has a formal policy that governs transfers between the utility and the city's general fund. The policy was set at the fiscal 2014 level, then increased by 1.5% per year through 2019. The policy is under renegotiation. We note that Florida's HB653, which would have barred municipalities from transferring money from their electric utilities to fund other municipal operations, was recently withdrawn from consideration by the state senate. GRU transferred $38 million (the bulk of which came from the electric system) to the city's general fund in 2019.

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 conducted a cash balance study to identify prudent liquidity levels relative to a risk matrix. The policy was approved in March 2019.

Despite its high rates, we consider GRU's rate-setting practices as supporting creditworthiness. The utility has a strong record of adopting regular rate increases--both base and fuel cost adjustments--although the fuel cost adjustment is not automatic. In our view, responsive rate setting has enabled GRU to maintain solid financial metrics.

Market position: Highly vulnerable

Saddled with substantial debt associated with DHR, GRU's rates are among the highest in Florida. The weighted-average system rate was 131% of the state average in 2018, the most recent year of available comparative information, down from 140.7% of the state average in 2017, as an 8.4% rate reduction in February 2018 enabled GRU to lower fixed costs from converting DHR from a PPA to an owned resource. However, we view this as a temporary respite. Management expects 2% average annual rate increases over the next five years, so we believe that GRU's market position will remain highly vulnerable for the foreseeable future. Water and wastewater rates are also above average (with moderate wastewater rate increases expected), but gas rates relative to other Florida utilities are low.

Industry risk: Extremely strong

Consistent with "Methodology: Industry Risk", published Nov. 19, 2013, we consider industry risk for municipal retail electric and gas utilities covered under these criteria as very low, and therefore extremely strong compared with other industries and sectors.

Financial Risk

Coverage metrics: Very strong

FCC averaged 1.4x over fiscal years 2017-2019, including 1.5x in 2019, which we view as robust. FCC is S&P Global Ratings' coverage metric that treats transfers to the city's general fund as an operating expense, and a portion of power purchase payments (representing fixed capacity and demand payments) as debt-like. However, in our view, recurring transfers from the rate-stabilization reserve to the revenue fund inflated FCC over the past three years. In our view, the transfers created rolling coverage and overstated organic operations. Absent these transfers, FCC would have averaged 1.34x over fiscal years 2017-2019 (including 1.44x in 2019). Projections suggest FCC in the 1.4x-1.6x range over the next five years, before expected transfers to the rate-stabilization reserve (and 1.4x-1.5x after transfers to the rate-stabilization reserve). The improved fiscal 2019 and projected FCC were due to lower fixed costs after the purchase of the DHR plant.

GRU's projections do not include the impact of the COVID-19 pandemic and recession; however, we anticipate that FCC will remain at a level we consider very strong, based on GRU's ability to scale back expected transfers to its rate-stabilization reserve, as well as other levers at management's disposal--including a potential deferral of non-essential capital spending.

Liquidity and reserves: Very strong

In our opinion, liquidity and reserves are very strong. Total liquidity and available reserves were $162 million (excluding $125 million in authorized but unissued commercial paper) at fiscal year-end 2019, including $28 million in unrestricted cash and investments, a $57 million rate-stabilization reserve, $28 million utility plant improvement funds, a $25 million line of credit, and $25 million of undrawn capacity under GRU's taxable commercial paper program. Total liquidity and available reserves measured 255 days of operating expenses. GRU projects increasing liquidity over the next five years, but in our view, this could be frustrated by a decline in revenue stemming from the pandemic and recession. Nevertheless, we anticipate that liquidity will remain at a level that we consider very strong.

Debt and liabilities: Adequate

GRU is highly leveraged, with about $1.6 billion in long- and short-term debt, representing just less than 80% of total capitalization. GRU projects debt levels to be largely flat through 2023, as debt issuance offsets debt amortization.

The 2017 financing of the purchase of GREC included privately placed debt--$115 million of unrated variable-rate debt and $150 million of unrated synthetically fixed variable-rate debt. We have reviewed the private placement documents and swaps, and do not believe they impose events of default and acceleration risks that would negatively affect liquidity or credit quality. However, there is a latent risk that future debt issues could contain provisions that would trigger the immediate acceleration on these bonds. We have not factored the risk into the ratings. However, should this risk materialize, it would likely have negative rating implications.

Ratings Detail (As Of May 19, 2020)		
Gainesville		
Long Term Rating	AA-/Stable	Affirmed
Gainesville		
Long Term Rating	AA-/Stable	Affirmed
Gainesville util sys rev bnds		
Long Term Rating	AA+/A-1	Affirmed
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
Gainesville util sys rev bnds ser 2019A due 10/01/2047		
Long Term Rating	AA-/Stable	Affirmed
Gainesville util sys rev bnds ser 2019B due 10/01/2047		
Long Term Rating	AA-/Stable	Affirmed
Gainesville CP		
Short Term Rating	A-1+	Affirmed
Gainesville CP		
Short Term Rating	A-1+	Affirmed
Gainesville VRDBs - 2007A		
Long Term Rating	AA-/A-1+/Stable	Affirmed
Gainesville (AGM)		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.