S&P Global Ratings

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Gainesville, Florida; CP; Combined Utility; Joint Criteria

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Credit Profile		
US$96.64 mil util sys rev bnds 2021 ser A due 10/01/2051		
Long Term Rating	A/Stable	New
Gainesville		
Long Term Rating	A/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'A' rating to Gainesville, Fla.'s approximately $97 million utility system revenue bonds, 2021 series A. At the same time, S&P Global Ratings affirmed the following:

- The 'A' rating on parity senior-lien obligations;
- The 'A/A-1' rating on variable-rate demand obligation series 2007A (with liquidity support from State Street Bank and Trust);
- 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 'A-1' rating on Gainesville's commercial paper program.

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 (72% of operating revenue), water (9%), wastewater (12%), gas (5%), and telecommunication (2%) services. At fiscal year-end 2020, the utility, which does business as the Gainesville Regional Utilities (GRU), had about $1.66 billion of debt outstanding, secured by a pledge of the net revenues of the combined utility system.

The combined utility will also be privately placing $66.075 million series 2022A senior lien debt, priced in June 2021 for delivery in August 2022. The privately placed bonds will not be rated by S&P Global Ratings, 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.

The 2021 bonds are being issued to fund capital projects of the electric, water, and wastewater systems. As of Oct. 1, 2020, GRU had $1.6 billion in debt.

Credit overview

In our view, the depth of GRU's service area, solid management and planning, and very strong coverage and liquidity support the rating, although high rates from 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-' (see report published May 3, 2021, on RatingsDirect). 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 are expected over the next several years, which we believe will exacerbate GRU's already limited financial flexibility. Presenting additional challenges is the recently adopted goal of reaching 100% renewable generation by 2045. In our view, there is heightened risk that achieving this goal will entail additional rate increases or debt. Furthermore, there is heightened risk of ratepayer backlash--which could turn what is now a vocal minority in opposition, into a vocal majority--with implications for financial metrics and strategic planning.

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), which has averaged 1.4x 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 modest strengthening in FCC 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 2020, GRU had $224 million in cash and available lines of credit, representing 388 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.

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 a $2 million reduction in GRU's transfer to the city's general fund for fiscal 2022 (down from $38 million in 2021);
- 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, and
- Although yet to be formally adopted, conceptual approval for additional reductions in GRU's transfer to the city's

general fund by $2 million per year through fiscal 2027.

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 (ESG) factors

On balance, we believe that Gainesville faces average environmental risks. 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. In consideration of existing high rates, plans for additional rate increases, and below-average income levels, we believe that both social and governance risks are elevated, creating fertile ground for ratepayer discord, which could frustrate achievement of GRU's 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 they suffer more substantial erosion, or if ratepayer backlash to 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 further constrain credit improvement.

Credit Opinion

Enterprise Risk

Enterprise fundamentals

Gainesville is home to the University of Florida, one of the largest in the U.S., with an enrollment of about 57,000; and Santa Fe College, with about 15,000 students. We understand that the university expects a mix of on-campus and remote learning this fall. 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 fund 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 primarily a residential area of 99,000 electric customers and 276,000 combined system customers. In our view, this affords the utility scale efficiencies that benefit credit quality. Residential customers account for a significant 47% 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, as the leading customer accounts for just 3% of combined system revenue.

Median household effective buying incomes are just 63% 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; it operates a vertically integrated electric system, with virtually all energy needs met through owned generation.

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 reduce associated fixed costs relative to those under the PPA, 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 61% of energy coming from natural gas units, 11% from coal-fired generation, and 24% from renewable resources--primarily from DHR--in 2020. 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. 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.

The utility's renewables constitute 33% 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 requested a proposal to further reduce 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 134% of the state average in 2019, 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 1.4x over fiscal years 2018-2020, including 1.35x in fiscal 2020, 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", and treats transfers to the city's general fund as an operating expense.

In 2019 and 2020, GRU transferred $38 million to the city's general fund. The transfer for 2022 has been reduced to about $36 million, and the city commission has given conceptual approval (pending final approval in September 2021) to reduce future transfers 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 very strong. At fiscal year-end 2020, internal liquidity totaled $149 million, including operating cash, rate-stabilization reserves, and unrestricted funds designated for capital improvements. External liquidity measured $100 million, and included undrawn capacity on taxable and tax-exempt lines of credit, and taxable commercial paper. Total liquidity and available reserves measured 431 days of operating expenses. GRU projects days' liquidity in the 11-12-month range over the next five years, but in our view, this could be frustrated should the adoption of planned rate increases fail to materialize.

GRU is highly leveraged, with about $1.6 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 debt amortization. The 2017 financing of the purchase of GREC included privately placed debt--$115 million of variable-rate debt (not rated) and $150 million of synthetically fixed variable-rate debt (not rated). 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.

Related Research

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

Ratings Detail (As Of July 9, 2021)		
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
Gainesville CP		
Short Term Rating	A-1	Affirmed
Gainesville CP		
Short Term Rating	A-1	Affirmed
Gainesville VRDBs - 2007A		
Long Term Rating	A/A-1/Stable	Affirmed
Gainesville (AGM)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.