Fitch Rates Lakeland, FL's Energy System Rev Bonds 'AA-'; Outlook Remains Positive

Fitch Ratings-New York-24 August 2018: Fitch Ratings has assigned a 'AA-' rating to the following Lakeland, FL (the city) revenue bonds:

--$50 million energy system revenue bonds, series 2018.

The bonds are being sold via negotiation the week of Sept. 10. Proceeds will fund capital improvements and pay debt issuance costs.

In addition, Fitch affirms the 'AA-' rating on the following bonds:

--$266.5 million electric system revenue and refunding bonds, series 2010 and 2016.

The Rating Outlook is Positive.

SECURITY

The bonds are payable by the net revenues of the city's electric utility (the system).

KEY RATING DRIVERS

SUSTAINABLE COST RECOVERY: The system's financial profile is characterized by a continued trend of strong cost recovery despite temporary weather- and natural-disaster related expenses and natural gas price variability. Combined Fitch-calculated coverage of full obligations (COFO) was 1.5x in fiscal 2017, and liquidity approximated 200 days' cash on hand (DCOH). Management's forecast for continued healthy financial margins seems reasonable.

DECLINING LEVERAGE; MANAGEABLE CAPEX: Leverage is expected to decline with rapid amortization of existing debt and 80% revenue funding of planned capex. The 2018 bonds is the only planned debt issuance. Capital needs through fiscal 2022 focus mainly on system maintenance, renewal and replacement in addition to the purchase of the gas peaking unit.

SIZEABLE RETAIL ELECTRIC UTILITY: Lakeland, FL owns and operates a vertically integrated retail system serving a primarily residential customer base throughout a stable service territory. Situated between the Tampa and Orlando metro areas, unemployment aligns with the state average although median household income continues to lag that of the state. Revenue collection has remained strong.

LOW RATES: Electric rates continue to rank among the lowest in the state, providing the system with significant flexibility and capacity for additional debt, if necessary. In addition, a city ordinance requiring timely adjustments in the system's fuel rate limits the under-recovery of fuel costs to a very low threshold.

AMPLE POWER SUPPLY: Existing power supply resources are sufficient for the long term. The system's
owned generating capacity and fuel mix are weighted towards natural gas-fired resources. However, no single generating asset accounts for more than 36% of total capacity and the ability to purchase power from the Florida Municipal Power Pool (FMPP) allows for access to additional energy supplies.

RATING SENSITIVITIES

SUSTAINED IMPROVED FINANCES, LOWER DEBT: Lakeland Electric's ability to continue to yield positive financial outcomes while decreasing its leverage position could result in positive rating action.

CREDIT PROFILE

Lakeland Electric provides generation, transmission, and distribution services to a largely stable service area that includes the incorporated area of the city (Issuer Default Rating [IDR] AA/Stable) as well as neighboring unincorporated areas of Polk County, FL (IDR AA/Stable).

FURTHER FINANCIAL IMPROVEMENT EXPECTED

The utility continues to generate solid DSC margins and liquidity levels relative to peers within the 'AA' rating category. In fiscal 2017, Fitch-calculated DSC was a strong 2.3x and liquidity equated to a solid 193 DCOH. Fiscal 2017 results would have been stronger if not for a one-time $10.4 million expense item related to damage sustained during Hurricane Irma in late fiscal 2017, as well as higher natural gas prices compared to the prior fiscal year that reduced the DCOH calculation. Excluding the unanticipated hurricane costs, fiscal 2017 DSC would have been closer to 2.6x, out-performing budgetary expectations of 2.4x DSC.

Fiscal 2017 coverage of full obligations (COFO), including a relatively sizeable annual transfer made to the city's general fund (equating to 12.2% of utility revenues), was also a strong 1.5x, similar to prior years but also lower considering the unexpected hurricane costs. General fund transfers are based on a consumption-driven formula and have been relatively stable over time.

Preliminary fiscal 2018 results provided by management include 4% revenue growth driven by a $2 increase in the fuel rate in April 2018, and an only modest 2.2% expense increase. The resulting projected DSC is 2.6x, or a Fitch-calculated 1.9x COFO. Fitch views management's forecast for fiscal 2019 - 2022 as reasonable. Continued solid DSC and COFO levels are supported by a fiscal 2019 3% rate increase, modest ongoing expense growth and a steadily declining debt amortization schedule. The fiscal 2019 forecast also includes an expected reimbursement for the majority of hurricane expenses (close to $7 million) from the Federal Emergency Management Agency. Fitch calculates COFO to approximate a solid 2.1x or better through fiscal 2023.

Liquidity is also forecast to remain strong (at or above 200 DCOH) by management, despite the use of cash to fund nearly 80% of future capex. Liquidity is bolstered by a fuel cost reserve policy (equal to 15% of subsequent 12-month fuel cost projections), which provides a baseline of policy-driven unrestricted cash. Moreover, the utility has access to the citywide pooled investment portfolio totaling $450 million as of August 2018.

DECLINING LEVERAGE

Debt levels have steadily improved due to intermittent debt refundings and management's use of cash to primarily fund capex. Leverage ratios approximate Fitch's 'AA-' rating category medians, and should decline given the system's only minimal additional borrowing needs (the current $50 million issuance) and ongoing debt amortization.
The system's fiscal 2017 net adjusted debt to adjusted funds available for debt service (FADS) of 4.5x is in line with Fitch's 'AA-' median of 4.6x. Annual debt service carrying costs consume a low 14% of gross revenues, which should further reduce as debt continues to amortize and revenues steadily improve. The system's equity position has improved from 34.5% of capitalization in fiscal 2009 to a healthier 45% at the close of fiscal 2017 (gradually approaching the 60% 'AA-' median).

The system's current exposure to variable rate debt of 27% marks a significant decline from prior reviews (48% in 2016) following the refunding of the $100 million series 2014 variable rate bonds by the fixed rate series 2016 bonds. The remaining variable rate debt is a five-year, synthetically fixed floating rate note with Bank of America (IDR A/Stable). Barring future opportunities to fix the variable rate notes and eliminate swaps, management expects to continue to roll its variable rate debt.

MANAGABLE CAPITAL NEEDS

The utility's five-year, fiscal 2018-2022 capital improvement program (CIP) is estimated at $234.6 million and will be funded primarily (79%) from excess cash flow. The current $50 million issuance (21% of capex spending) will fund the purchase of a 125-megawatt Calpine combustion turbine unit (total cost is approximately $36.1 million) as well as other energy supply and delivery projects.

Remaining expenditures appear manageable and address ongoing maintenance, distribution system renewal and replacement, perfunctory regulatory compliance measures, and decisions related to the operations at the coal-fired McIntosh Unit 3. The utility is currently compliant with all existing environmental regulations following recent modifications made to Unit No. 3's selective catalytic reduction system needed to meet existing mercury and air toxic standards (MATS).

LOW RATES

Lakeland's electric rates currently rank among the lowest in the state, providing the system with ample financial and operating flexibility. The average residential rate totaled 10.34 cents/kWh in 2018, lower than statewide and national averages. Future base rate increases included in the current financial forecast are limited to a 3% adjustment in fiscal 2019, which should ensure that the system's rates remain competitive.

Rate setting requires only the approval of the city commission, which has been generally supportive over the years of requested adjustments. The system's cost structure consists of a base rate, fuel rate, and an environmental rider that recovers costs related to environmental projects. Management prudently conducts cost-of-service studies approximately every three years, and quarterly adjustments to the fuel rate are required by city ordinance to ensure full recovery of fuel costs. Management reports that fuel charges have been adjusted consistently as required by ordinance with no political interference.

SOLID ASSET, GENERATION MIX

The system's owned and partially-owned generating assets are sufficiently diversified by fuel mix and number of assets, and provide ample capacity needed to meet intermediate-term load growth. Natural gas-fired capacity represents the system's largest asset and fuel mix, a somewhat high concentration that is offset in part by the diverse number of available generating units owned by Lakeland. The system's second largest energy source comes from the utility's lone coal-fired unit, McIntosh Unit 3 (co-owned with the Orlando Utilities Commission, rated AA/Stable), which makes up about 23% of owned capacity and accounts for a similar proportion of the system's energy mix.
Any remaining energy requirements are typically satisfied through capacity purchases from the FMPP. As one of 20 municipalities participating in and contributing power-generating resources to FMPP, Lakeland is able to purchase power at a price that represents the direct fuel and variable operating and maintenance cost of the next most efficient unit that is available for dispatch. The FMPP operates under a three-year agreement that automatically renews each year unless all members elect to terminate.

STABLE SERVICE AREA

The service territory consists of 246 square miles, including the city and several unincorporated communities lying within a 15-mile radius. Lakeland is bisected by Interstate 4 and is roughly the midpoint between Tampa and Orlando. During fiscal year 2017, the system served 128,535 electric accounts. Retail customers grew by 1.4% (consistent with the five-year CAGR) however total megawatt hour sales declined by 1.5% (compared to the five-year sales CAGR of 1.7%).

The customer base is well diversified. Residential accounts represent 83% of the customer base and over half of aggregate energy sales. The balance of customers are commercial and industrial accounts, making up 42% of retail sales revenue. Customer concentration is limited, as the system's 10 largest customers typically compose less than 15% of total revenue and 20% of combined sales. The system's largest customers represent a varied mix of industries and appear sufficiently rooted to the service territory.

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In addition to the sources of information identified in Fitch's Revenue-Supported Rating Criteria, this action was additionally informed by information from Lumesis.

A January 2018 district court ruling that dismissed claims regarding payment of Puerto Rico Highways and Transportation Authority debt has raised questions about the scope of protections provided by Chapter 9 of the U.S. bankruptcy code to bonds secured by pledged special revenues. Fitch's rating criteria treat special revenue obligations as independent from the related municipality's general credit quality. The outcome of the litigation could result in modifications to Fitch's approach. For more information, see "What Investors Want to Know: The Impact of the Puerto Rico Ruling on Special

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