Summary:
Lakeland, Florida; Retail Electric

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Table Of Contents

Rationale
Outlook
Summary:
Lakeland, Florida; Retail Electric

Credit Profile

<table>
<thead>
<tr>
<th></th>
<th>Long Term Rating</th>
<th>Unenhanced Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>US$50.0 mil energy sys rev bnds ser 2018 due 10/01/2037</td>
<td>AA/Stable</td>
<td>New</td>
</tr>
<tr>
<td>Lakeland elec</td>
<td>AA/Stable</td>
<td>Affirmed</td>
</tr>
<tr>
<td>Lakeland energy sys (AGM)</td>
<td>AA(SPUR)/Stable</td>
<td>Affirmed</td>
</tr>
</tbody>
</table>

Rationale

S&P Global Ratings assigned its 'AA' long-term rating to Lakeland, Fla.'s $50 million (estimated) series 2018 energy system revenue bonds issued for Lakeland Electric, the city's electric utility. At the same time, S&P Global Ratings affirmed its 'AA' rating on the utility's outstanding electric system revenue bonds. The outlook is stable.

Proceeds from the series 2018 bonds will fund the acquisition of a combustion turbine to replace the steam turbine (unit 2) at the utility's McIntosh plant. The steam turbine, used for peaking purposes, suffered a catastrophic failure in 2017, though the failure did not materially affect the utility's operational stability or its financial metrics.

The rating reflects our view of the following credit strengths:

- Competitive rates that are below the state average and support the utility's financial flexibility;
- A stable and diverse service area, with residential customers providing the majority of system revenues and sustained moderate customer growth;
- Very strong financial performance with debt service coverage (DSC) of 2.3x-2.9x and fixed charge coverage between 1.6x and 2.1x over the past three fiscal years, and with DSC projected to be sustained no lower than 2.6x and FCC no lower than 1.8x over the next five fiscal years; and
- Robust liquidity levels that support the utility's financial flexibility. Lakeland's $124 million in cash and cash equivalents at fiscal year-end 2017 equated to approximately 210 days' cash on hand.

Offsetting factors include:

- The service area's relatively weak demographics as evidenced by city-level median household effective buying income levels (MHHEBI) 23% below state medians, and county-level MHHEBI at 16% below state medians. The utility's consistently competitive rates somewhat mitigate the credit risk associated with the relatively weak income levels of its service territory; and
- A recent history of significant unplanned outages at three of the utility's owned generating units, in addition to relatively low capacity factors at the plant's baseload units.
Significantly mitigating the related credit risk, however, is the utility's access to affordable power through its membership in the Florida Municipal Power Pool (FMPP).

The utility's net revenue secure the bonds. Following the issuance of the series 2018 bonds, the utility will have approximately $414 million in debt outstanding.

Lakeland is on U.S. Route 4, between Tampa and Orlando. The city-owned electric utility has approximately 129,000 customers, and has experienced approximately 1.0%-1.5% annual customer growth during the past several years. The utility serves a large service area, with about 60% of customers residing outside of the city limits. The electric system's customer base is roughly 60% residential by revenue, which we view as a credit positive in that it enhances revenue stream stability for the utility. The local economy largely comprises trade, warehousing, and distribution facilities and operations, which we consider reflective of the city's location in central Florida and along a major interstate highway. The utility's customer base, however, is not concentrated by revenue of any large customer. Customer base diversity is a credit positive, and is reflected by the current rating.

Lakeland's McIntosh Plant, units 3 and 5, serve as its primary baseload generating units. Unit 3 is a coal-fired unit that began operating in 1982, while unit 5 is a combined cycle generating turbine (CCGT) that began operations in 2002. Each of those units experienced significant extended or unplanned outages in 2014, and unit 5 had additional unplanned and extended outages in 2017. From 2015-2017, plant capacity factors ranged from 38%-50% for unit three and from 47%-63% for unit 5.

In addition to the operational challenges at units 3 and 5, McIntosh unit 2, a steam turbine unit used for peaking, experienced a catastrophic failure in 2017, leading the utility to move to acquire a replacement combustion turbine, which is being financed with proceeds from the series 2018 bonds. In our view, the utility's assets have somewhat underperformed in recent years, and demonstrated operational failures that are at least in part related to maintenance issues. We understand that management is working to improve plant maintenance to mitigate the risk of further unplanned outages. We further note that Lakeland's membership in FMPP has consistently enabled the utility to purchase replacement power and/or capacity during plant outages, and that Lakeland's financial metrics have remained very strong on a consistent basis.

The city's generating plants burned mostly natural gas each year from 2010-2016, though coal represented a majority (56%) of total energy in 2017, with the greater percentage of coal-fired generation a result of lower coal prices. Lakeland's fuel mix largely correlates with market prices and the availability of energy within FMPP. Lakeland Electric's owned generating units are currently in compliance with existing environmental regulations.

Lakeland's rate setting practices are credit positive, in our view. Management implements a fuel cost adjuster quarterly, passing through fluctuations in fuel costs (forecasted 12 months forward) to its customers, promoting cost recovery and margin stability. The utility has imbedded within base rates additional mechanisms to adjust rates to recover costs related to environmental regulatory requirements and energy conservation efforts. Though base rates were flat in 2017, positive or negative adjustments typically occur each year. We understand that management actively monitors rates of utilities across the state, and that it prioritizes rate competitiveness. We note that the utility's ability to maintain competitive rates has not resulted in any material erosion of financial metrics. According to the most
recent available data from the Energy Information Administration (EIA), Lakeland's overall system rates were about 6% below the state average.

Lakeland Electric's financial metrics are strong and, in our view, adequate for the current rating level. Lakeland's DSC was no lower than 2.2x each year since fiscal 2014, hitting 2.9x in fiscal 2016 and 2.3x in fiscal 2017. Lakeland's FCC has also been strong, ranging from 1.6x-2.1x over the past four fiscal years. FCC fell from 2.1x in fiscal 2016 to 1.6x in fiscal 2017. FCC is an S&P Global Ratings-calculated metric that imputes capacity costs as debt-like obligations and treats recurring payments from the utility to the city general fund as operating expenses. The utility's annual transfers to the city's general fund are governed by a formula and thus are stable from year to year.

The declines in DSC and FCC in fiscal 2017 primarily resulted from the one-time $10.4 million expense related to Hurricane Irma. Absent this one-time expense, which the city expects to be reimbursed for in fiscal 2019, DSC would have been 2.6x and 1.8x, respectively. Our calculations, based on management's financial forecast, which we believe is based on reasonable assumptions, indicate DSC and FCC will remain supportive of the current rating, improving modestly with DSC expected to range from 2.9x-3.1x and FCC from 2.0x-2.1x for fiscal years 2019-2020. In addition to low positive customer growth, modest expense growth, and a 3% base rate increase effective October 1, 2019, we expect that 3%-5% annual declines in annual debt service obligations will support coverage metrics over the next five fiscal years.

We view Lakeland Electric's liquidity position as credit supportive, of which the utility retains an apportioned share. The utility's unrestricted cash and cash equivalents totaled $124.3 million at fiscal year-end 2017, an amount equivalent to approximately 210 days' cash on hand. Management's financial forecast indicates liquidity levels will remain sufficient to cover about 200-210 days' expenses over each of the next five fiscal years. In addition to the liquidity on its balance sheet, the utility benefits from access to the city's pooled investment fund. If the utility faced a liquidity crunch, the city commissioners could apportion additional funds to the utility to cover a shortfall. The utility has only utilized this option one time, in 2008 in relation to the auction rate securities market disruption. We believe the additional liquidity made available on a contingent basis to the utility provides additional cushion that supports Lakeland Electric's overall credit quality.

Following issuance of the series 2018 bonds, Lakeland Electric's debt load will be about 75% fixed rate, 23% variable rate that has been synthetically fixed via interest rate swaps, and 2% unhedged variable rate. The utility's debt-to-capitalization ratio of 53% in fiscal 2017 is moderate for a vertically integrated utility that owns most of its capacity. Lakeland's five-year capital improvement plan (CIP) calls for $234 million in expenditures, 15% of which will be funded with proceeds from the series 2018 bonds. The utility does not have any additional new money borrowing plans at this time, and the current CIP will be primarily funded through system revenue.

The utility's unhedged variable rate debt does not constitute a credit risk, in our view, given its small magnitude relative to the utility's liquidity. Furthermore, the unhedged variable rate debt matures Oct. 1, 2019. The synthetically fixed debt is swapped with two counterparties Citibank N.A. and the Goldman Sachs Mitsui Marine Derivative Products L.P. Termination events of the swaps include a downgrade of either counterparty to speculative grade, a failure to post collateral when required to do so, or a default on debt service payments. We do not believe the swaps pose material credit risk to the utility, given that the mark-to-markets on the swaps are not currently proximate to the
collateral posting thresholds, and the gap between the utility's rating and the rating trigger.

The utility has one series of debt privately held by a bank. We have reviewed the terms of this private placement and, although the terms include the remedy of an immediate tender option by the bank, we do not view the security as posing material credit risk, given the standard and benign nature of the events of default that could lead to an acceleration of debt repayment. Furthermore, if the bank were to tender the debt, payment would be subordinate to the utility's capital markets debt, and the utility has the option to refinance the private placement before maturity, at no penalty.

Bond legal provisions are set per the utility's bond ordinance dating to 2010, bond provisions are credit neutral. A rate covenant requires coverage levels equal to at least 1.25x of debt service requirements, which we view as standard for the industry. The requirement for the issuance of additional debt requires 1.25x coverage of existing and additional debt service, while the utility is not required to maintain a debt service reserve fund unless debt service coverage falls below 1.5x for a given fiscal year.

Outlook

The stable outlook reflects our view of Lakeland's strong coverage metrics and robust liquidity, which we expect the utility will sustain, supported by the utility's rate setting practices and adjustment mechanisms.

Upside scenario
As the utility's strong financial performance and other positive credit factors are already incorporated into the current rating, we do not anticipate that the rating would improve, at least during the two-year outlook period.

Downside scenario
We do not expect to lower the rating given the utility's consistent history of adjusting rates to maintain strong financial metrics while maintaining competitive retail rates. If the utility's rate practices change, or if it experiences further material operational challenges with its owned assets that lead to materially higher purchased power costs or additional debt requirements, we could lower the rating.

<table>
<thead>
<tr>
<th>Ratings Detail (As Of August 29, 2018)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lakeland energy sys</td>
</tr>
<tr>
<td><strong>Long Term Rating</strong></td>
</tr>
</tbody>
</table>

Many issues are enhanced by bond insurance.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.
August 28, 2018

City of Lakeland
228 South Massachusetts Avenue
Lakeland, FL 33801
Attention: Mr. Michael Brossart, Finance Director

Re: US$50,000,000 City of Lakeland, Florida, Energy System Revenue Bonds, Series 2018, dated: Date of delivery, due: October 01, 2037

Dear Mr. Brossart:

Pursuant to your request for an S&P Global Ratings rating on the above-referenced obligations, S&P Global Ratings has assigned a rating of "AA". S&P Global Ratings views the outlook for this rating as stable. A copy of the rationale supporting the rating is enclosed.

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S&P Global Ratings
Public Finance Department
55 Water Street
New York, NY 10041-0003

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