Fitch Ratings-New York-15 July 2019: Fitch Ratings has upgraded the following ratings of the city of Lakeland, FL's electric system (Lakeland Electric or the system) to 'AA' from 'AA-':

--$244.2 million energy system revenue and refunding bonds, series 2010 and 2016;
--$43.9 million energy system revenue bonds, series 2018;
--Long-term Issuer Default Rating (IDR).

The Rating Outlook is revised to Stable from Positive.

ANALYTICAL CONCLUSION

The upgrade is based on Lakeland Electric's improved financial performance and continued deleveraging. The ratings reflect the system's midrange revenue defensibility assessment given the strengths of the revenue sources and improving rate flexibility, but also weaker economic and demographics of the service area.

The rating also takes into account the system's very strong operating risk profile, which reflects its low cost burden associated with owned-generating assets that are predominantly natural gas and also the resources available in the Florida Municipal Power Pool (FMPP). Operating costs are expected to remain low as capacity is in excess of current demand and, despite the potential for asset retirements over the intermediate term, capital needs are manageable. Finally, the system's low fiscal 2018 net leverage of 4.7x and healthy liquidity are expected to remain stable and appropriate for the rating throughout Fitch's moderate stress scenario.

CREDIT PROFILE

The city of Lakeland, FL (tax-supported IDR AA/Stable) owns and operates a vertically integrated retail electric system doing business as Lakeland Electric. The electric system serves a primarily residential customer base throughout a stable, though weak, service territory. Customers are roughly split between the city and surrounding Polk County (tax-supported IDR AA/Stable).

KEY RATING DRIVERS

Revenue Defensibility: 'a'; Lack of Competition and Low Rates, but Weaker Service Area

The revenue source characteristics of this monopolistic retail electric municipal system and its independent rate flexibility support this assessment. While the trends in the diversified customer base and load growth appear favorable, the service area's demographics are otherwise mixed and limit the revenue defensibility assessment. MHI in the city and county are materially weaker than the national average at 73% and 80% of the national level, respectively. Affordability has historically been weaker, but has improved as rates have trended down in the last couple years.

Operating Risk: 'aa'; Diverse Vertically Integrated System Producing a Low Cost Operating Environment

The system is vertically integrated and generates consistently very low cost electricity that decreased to 8.6 cents per KWh in fiscal 2018. The system continues to move towards greater natural gas capacity and benefits from the fuel's current economic environment. Operating
flexibility is neutral to the operating risk assessment despite uncertainty around the changing pool of generating resources. The age of plant has increased to 19 years due to capital spending that has lagged depreciation. However, capex could increase going forward given the system's plans to address the aging system and retire assets.

Financial Profile: 'aa'; Low Leverage,

The system's financial profile is strong with healthy margins providing solid coverage and low leverage. Net leverage of 4.6x in fiscal 2018 falls in line with the rating category and remains so throughout Fitch's stress case scenario. Liquidity is robust at 200 DCOH.

Asymmetric Additional Risk Considerations

There are no asymmetric additional risk considerations affecting this rating.

RATING SENSITIVITIES

Navigating Asset Transition: The rating is sensitive to the system's ability to sustain both a very low operating cost burden (under 10 cents KWh) and very low leverage position, as the utility transitions its asset and resource mix.

SECURITY

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

Revenue Defensibility
The system operates under a very healthy revenue source environment with revenues derived almost entirely from retail electric customers. Lakeland's utility operations are a monopolistic business line; it does not compete in its state mandated service area. The small percent of revenues considered wholesale (less than 3% in fiscal 2018) are a byproduct of the system's participation in the Florida Municipal Power Pool (FMPP or power pool). Fitch does not consider potential volatility in these sales to hold back the assessment of revenue source characteristics.

Service Area Characteristics

The system's sizable service territory consists of 246 square miles including the city and several unincorporated communities just outside the city limits. Lakeland is bisected by Interstate 4 and is roughly the midpoint between Tampa and Orlando. The system serves just over 130,000 retail electric customers and has seen midrange customer growth at a CAGR of 1.2% over the last five years. Management forecasts continued customer growth in line with the five year CAGR, which appears reasonable to Fitch as the city continues to bring in residents and businesses. Population is up over 10% since the 2010 census to about 108,000 residents.

While the trends in customer and load growth appear more favorable, the service area's demographics are otherwise mixed and hold back the assessment of the service area. Customer incomes are considered weaker. A slight majority of the system's meters are located outside of the city where the county MHI figures are better than the city levels, but still just 80% of the national average. The unemployment rate is midrange with both the city and county rates somewhat elevated, but generally in line with the national level.

Rate Flexibility

Rate setting requires only the approval of the city commission, which has been generally supportive over the years of requested adjustments, providing independent legal ability for the city
to adjust rates as necessary. Rates consist 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.

The system's electric rates are average to lower than the rest of the state. As of the EIA's most recent data, the electric system's average total retail rate of 9.42 cents per kWh was 90% of the state average. Residential revenue is just over half of the system's total revenue, and rates are similar relative to the state average. Fitch's residential affordability metric at 3.4% of MHI falls into a midrange assessment, signaling higher affordability than previous years.

Diversified Customer Base

The customer base is well diversified. Residential accounts represent a large majority of the customer base and over half of aggregate energy sales and revenue. The balance of customers is in commercial and industrial accounts and the concentration of large customers is limited. The system's 10 largest customers consistently account for less under 15% of total revenue and represent a varied mix of industries.

Operating Risk
Diverse Vertically Integrated System Producing a Low Cost Operating Environment

The system's operating cost burden is very low at 8.6 cents per KWh in fiscal 2018. Fitch's cost burden metric includes the relatively large annual transfer to the city's general fund. The system transferred $29.7 million in fiscal 2018, or just over 9% of operating revenue, which has been relatively steady under the city's consumption-driven formula.

The system's operating cost burden continues to trend lower, benefitting from an increasing exposure to natural gas-fired capacity and participation in the pooled power program of the FMPP. Gas represents a majority of the system's 2018 capacity at 70% and Fitch expects this figure to increase going forward under the current resource plan (see the coal plant closure discussion below). Currently, the level of natural gas concentration in capacity remains below what Fitch identifies as a credit concern.

Fitch's operating cost flexibility assessment is neutral as the system's generating assets sufficiently cover peak demand, and are diversified by fuel mix and number of assets. The majority of assets are duel fueled -- gas and oil. Outside of the system's capacity resources, nearly half of the system's fiscal 2018 generation was from the system's lone coal-fired baseload plant, McIntosh Unit 3. Fitch expects this will remain the case for the next three to five years as Lakeland and Orlando Utility Commission (OUC, rated AA/Stable) consider replacements to the jointly owned coal plant.

Lakeland's participation in the power pool of the FMPP is another driver of the low cost burden. The FMPP includes considerable generating assets from FMPA's all requirement project (rated A+/Positive), and OUC. In fiscal 2018, Lakeland's purchases from the power pool accounted for roughly 20% of energy generation, though this figure has ranged between 7%-to-30% in recent years. As one of roughly 20 municipalities contributing power-generating resources to the 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.

Impending Retirement of McIntosh Unit 3
The 354MW coal-fired McIntosh Unit 3, co-owned with the Orlando Utilities Commission, makes up about 23% of capacity and generally accounts for a higher proportion of the system's energy mix. The unit has operated since 1982 with a 60/40 operating cost split between Lakeland and OUC (including fuel and administrative costs), respectively. Increasing costs have caused the utilities to decide to retire the unit by the fall of 2024, although an earlier retirement is possible. A decision on replacement capacity for Lakeland's estimated 136MW deficit in 2024 is under evaluation. Potential alternatives include a new owned asset, PPA contracts, and short-term market contracts. Additional natural gas units are the most likely option; however, the system will issue an RFP in late 2020 that could result in a PPA for other fuel sources or renewables. While not held to any renewables requirements under Florida state regulation, management expects to add up to 30MW of solar in the next five years; however, this figure could change as usable land may turn out to be a restricting consideration in Lakeland.

Meanwhile, the coal plant continues to perform as necessary and Lakeland's coal fuel supply contracts extend through the unit's lifecycle. The previously retired McIntosh Unit 1 peaking units were replaced by a 125MW natural gas peaking unit that was purchased with the series 2018 bond proceeds. The new unit is on schedule to be ready for operation in 2020.

Capital Planning and Management

Age of plant has slowly ticked up in recent years to the currently estimated 19 years as the system made capital investment that trailed depreciation. Capital spending increased in fiscal 2018 after the issuance of the series 2018 bonds bringing the five year average of capital spending to an adequate level at 93% of depreciation and amortization.

While capital needs are considered elevated, spending appears manageable. The first five years of the utility's fiscal 2019-2028 capital improvement program (CIP) total $197.2 million and will be funded from excess cash flow and capital reserves. The plan largely addresses ongoing maintenance of the McIntosh coal-fired plan and is therefore subject to change based on the outcome of the resource planning mentioned above, but significant capital spending is also devoted to distribution system renewal and replacement and other regulatory compliance measures.

The utility is currently compliant with all existing environmental regulations following modifications made to Unit No. 3's selective catalytic reduction system needed to meet existing mercury and air toxic standards (MATS).

Financial Profile

A strong sales year in fiscal 2018 and a decline in operating expenses generated solid net income of $58 million on $315 million in sales. The system's fiscal 2018 net adjusted debt to adjusted funds available for debt service (FADS) declined to a very healthy 4.7x. The Fitch-calculated coverage of full obligations (COFO) improved to 1.9x in fiscal 2018 and DCOH improved to 200. 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. Additionally, Fitch expects Lakeland Electric's access to the city-wide investment pool ($435 million as of fiscal 2018) could provide additional liquidity as a line of credit as it has done in the past.

Improved Financial Position; Declining Leverage

Fitch's base case scenario is informed by management's forecast for fiscal 2019 - 2023, which is viewed as reasonable. Continued solid COFO levels are supported by rate increases of 3% in fiscals 2021 and 2023, modest ongoing expense growth, and steadily declining debt service costs. Rates will ultimately be determined by a rate case study being prepared currently. The base case also includes an expected reimbursement for roughly 65% of hurricane expenses (or $6 million) from the Federal Emergency Management Agency. Leverage declines as debt continues to
amortize and rates increase. In the next five years the system is scheduled to amortize roughly $98 million or 23% of its debt.

While capital plans currently include no additional debt, management expects up to $200 million in bond financing could be used as part of the plan to replace the McIntosh Unit 3, as discussed above. Ultimately a decision to build or contract the replacement will be factored into the system's future capital plans and therefore Fitch includes this amount in the out years of its forward look. Management estimates net savings from mothballing the aging coal plant at $9 million annually, which will help to offset potential borrowing costs.

Fitch's Stress Case

Fitch's stress case was developed by using base case assumptions and applying stresses to both retail and wholesale electric sales. Fitch's stress case includes a moderate -2.4% year one shock to retail electric sales followed by a -1.0% decline in year two before returning to growth more in line with historical figures. Management highlighted several potential resources available to absorb changes in energy demand including reasonable potential rate increases already intended over the coming five year period, the capacity for the consumption-based transfer formula to relieve the system's transfer to the city in a period of declining sales, expectations for portions of Hurricane Irma related FEMA reimbursements to come through, and annual cost savings from the eventual mothballing of Unit 3.

Under the stress case assumptions, the utility's net leverage approaches 5.0x in year two and remains below that level in years three to five even when Fitch includes borrowing in the out years to finance a potential replacement unit.

Debt Profile

The debt profile is otherwise neutral to the rating. The system's current exposure to variable rate debt at 27% marks a significant decline from 48% exposure in 2016 following the refunding of variable rate bonds in recent years. The remaining variable rate debt is a five-year, synthetically fixed floating rate notes with Goldman and Citigroup. Barring future opportunities to fix the variable rate notes and eliminate swaps, management expects to continue to roll its variable rate debt.

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Applicable Criteria
Public Sector, Revenue-Supported Entities Rating Criteria (pub. 28 May 2019)
https://www.fitchratings.com/site/re/10064680
U.S. Public Power Rating Criteria (pub. 03 Apr 2019)
https://www.fitchratings.com/site/re/10066654

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