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CREDIT OPINION
5 August 2021

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Lubbock (City of) TX Electric Enterprise

Update to credit analysis

Summary

Lubbock (City of), TX Electric Enterprise's (LP&L; A1 stable) credit profile is supported by a large service area and stable customer base anchored by the institutional presence of Texas Tech University (Texas Tech University System, TX; Aa1 stable). The profile is additionally supported by strong management and planning practices, demonstrated by the successful transition of 70% of its customer load to the Electric Reliability Council of Texas, Inc. (ERCOT; A1 negative) market on May 30, 2021 and the timely regulatory approval of transmission cost of service (TCOS) revenue by the Public Utility Commission of Texas (PUCT). This new revenue stream, coupled with lower purchased power costs should keep debt service coverage steady. Liquidity is expected to decline in fiscal year 2021 after a hold-harmless payment to the Southwestern Public Service Company (SPS; Baa2 stable), but will stabilize in fiscal 2022. These characteristics are balanced by the ongoing execution risk associated with the full integration of system's customer load to ERCOT by June 1, 2023. Leverage has increased significantly and is poised to grow further in the next few years to finance the remaining distribution-related capital projects necessary to integrate the remaining customer load to ERCOT. However, the debt profile should be manageable given the stable and reliable TCOS revenue stream supporting the Series 2021 bonds and elimination of capacity and purchased power costs in fiscal 2023. Legal provisions are adequate to moderately weak and include a sum sufficient rate covenant, additional bonds test (ABT) of 1.10 times maximum annual debt service, and debt service reserve equal to average annual debt service.

Credit strengths

» Large service area and stable customer base

» Additional customer base stability from the institutional presence from Texas Tech University

» Strong and proactive management team

» Stable financial metrics

» Below average rates compared to the statewide average

Credit challenges

» Execution risk of transitioning remaining load to ERCOT in 2023

» Leveraged debt profile with plans for additional borrowing to facilitate full integration to ERCOT

Rating outlook

The stable outlook reflects our expectation that the system's strong management and planning practices will provide for a successful and timely transition of the system's remaining customer load to ERCOT. The stable outlook also reflects our expectation that management will continue to secure timely regulatory approval of TCOS rate adjustments to ensure debt service coverage and liquidity metrics remain in line with the peer group.

Factors that could lead to an upgrade

» Substantial reduction of operating risk from the full integration with ERCOT

» Materially stronger debt service coverage ratios and liquidity

Factors that could lead to a downgrade

» Mismanagement of transitioning the remaining customer load to ERCOT, resulting in elevated costs that are not fully recovered on a timely basis and weaken the system's financial profile

» Significant additional borrowing that outpaces operating revenue growth, resulting in higher leverage and weaker debt service coverage ratio

» Failure to secure PUCT-approved rates that provide Lubbock with a debt service coverage ratio that is consistent with the current peer group

Key indicators

Lubbock (City of) TX Electric Enterprise					
System Characteristics					
Asset Condition (Net Fixed Assets / Annual Depreciation)	26 years				
System Size - O&M (in $000s)	$161,319				
Service Area Wealth: MFI % of US median	86.2%				
Legal Provisions					
Rate Covenant (x)	1.00				
Debt Service Reserve Requirement	DSRF funded at less than 3-prong test OR springing DSRF (A)				
Management					
Rate Management	Aa				
Regulatory Compliance and Capital Planning	Aa				
Financial Strength					
	2016	2017	2018	2019	2020
Operating Revenue ($000)	$222,952	$243,928	$239,179	$211,189	$213,061
System Size - O&M ($000)	$176,381	$195,200	$187,785	$161,441	$161,319
Net Revenues ($000)	$30,719	$31,944	$36,942	$41,933	$40,318
Net Funded Debt ($000)	$105,120	$107,320	$146,718	$133,805	$121,399
Annual Debt Service ($000)	$18,325	$18,016	$20,089	$24,081	$24,368
Annual Debt Service Coverage (x)	1.7x	1.8x	1.8x	1.7x	1.7x
Cash on Hand	133 days	125 days	170 days	261 days	283 days
Debt to Operating Revenues (x)	0.5x	0.4x	0.6x	0.6x	0.6x

Profile

Lubbock (City of), TX Electric Enterprise was established in 1916 and primarily provides electric transmission and distribution to customers within the City of Lubbock (Aa2 stable). The system successfully integrated 70% of its customer load to ERCOT on May 30, 2021 and will fully integrate into the ERCOT market by June 1, 2023. The system's service area is coterminous with the City of Lubbock. As of 2019, the city's estimated population was 254,000.

Detailed credit considerations

Service area and system characteristics: stable service area anchored by Texas Tech University; evolving system on track to fully integrate with ERCOT grid 2023

The system's service area will remain stable in the near term, benefiting from a steady customer base that includes Texas Tech University and modest customer growth. Lubbock is the 10th largest city in the State of Texas (Aaa stable) and exhibits a diverse economic base that consists of higher education, health care, hospitality, and retail trade.

The area's strong economy has resulted in a dynamic employment base with a June 2021 unemployment rate of 5.7% compared to 6.6% for the state and 6.1% for the nation. In fiscal 2020, total metered accounts increased by 0.6% from the prior year to 107,899 accounts. The customer base is primarily residential (86% of total meters) though the top 10 customers accounted for 19% of total megawatt hours billed and 14% of fiscal 2020 operating revenue. Texas Tech University is among the system's largest customers and the institutional presence associated with the university is important to the credit profile by providing additional stability to the customer base through a steady base demand profile and also accounts for the relatively lower service area wealth, with median family income (MFI) of 86.2% of the US.

On May 30, 2021 the system successfully transferred 70% of its customer load to the ERCOT market and is on track to fully integrate with ERCOT by June 1, 2023. Once fully integrated with the ERCOT grid, the system plans to opt-in to retail competition and exit its role as a retail electric provider (REP) for the service area. The integration with ERCOT and subsequent opt-in to retail choice, would virtually eliminate the system's generation exposure and will eliminate capacity costs and the need for purchased power agreements (PPA) for its long term power supply needs. Self-generation assets, which are minimal, will be idled in June 2023, but could be used in merchant power generation if economically advantageous.

Upon full integration to ERCOT, the system's operating risks will be significantly lower because its business model will be dedicated exclusively to the transmission of high voltage electricity. The system's assets will be long-lived, possess low operating risk, enjoy no exposure to commodity prices and will be granted strong regulatory approved cost recovery. The system will be fully regulated by the Public Utility Commission of Texas (PUCT) and will be one of 48 transmission service providers (TSP) operating in the ERCOT transmission grid. Transmission rates in ERCOT are determined pursuant to a 100% "postage stamp" rate that spreads the cost of electric transmission services among the Distribution Service Providers (DSP) operating in ERCOT according to their electrical loads. Charges to DSPs are calculated by multiplying a DSP's share of total electrical load by the statewide postage stamp rate of each TSP.

TSP transmission costs are determined pursuant to Transmission Cost of Service or TCOS rate cases required to be filed with the PUCT by all TSPs. In addition to TCOS filings, which may take six to eight months to be decided, LP&L can also file Interim Capital Addition (ICA) rate case proceedings twice annually to request adjustments to its transmission rate for recovery of costs of new facilities placed into service since its last TCOS rate case. ICA rate cases do not incorporate increases in operating expenses and usually take up to two months to obtain approval. LP&L filed a TCOS application in August 2020 to earn a rate of return on its transmission assets. The new revenue stream commenced upon the integration of the relevant portion of LP&L's load with ERCOT (May 30). The resulting rates will be based on the commission-approved 2020 four coincident peak calculation (4CP). LP&L will submit an ICA rate case in September 2021. The interim filing will include the majority of ERCOT integration-related transmission and distribution assets. After the February 2022 change, future TCOS revenues will grow in line with overall system load growth.

The asset condition is strong, supported by significant capital investment in transmission and distribution infrastructure, and should continue to improve over the next couple of years as additional distribution infrastructure is completed to facilitate full integration with ERCOT. At fiscal year-end 2020 (September 30), net fixed assets increased by 43% from the prior year to $418.4 million, reflecting a remaining useful life of 26 years. With integration of 70% of the customer load in May 2021, LP&L became the owner and operator of three 345 kilovolt (kV) transmission lines, totaling 69 miles in length. Additionally, the assets associated with the

integration include 81 miles of 115kV transmission lines; 20 miles of 69kV transmission lines; and numerous switching stations and substations needed to step down the voltage for residential and commercial use. Unaudited results as of May 31, 2021 reflect $566.2 million of net fixed assets, which is a 35% increase from fiscal 2020 and yields an estimated remaining useful life of 56 years.

We expect LP&L will continue to maintain healthy financial metrics through the more frequent use of ICA rate filings. Any signals that the PUCT might be less credit supportive in future ICAs expected over the next several years could negatively pressure our view of the credit, though we expect LP&L's management will continue to prudently evaluate projects and assess future PUCT approvals well in advance.

Debt service coverage and liquidity: solid debt service coverage

The system's strong management and planning practices are expected to provide stable financial ratios that are on par with A1 peers over the near term, including conservative budgeting practices, multi-year financial and capital forecasts, as well as the timely approval and implementation of transmission cost of service (TCOS) rate cases.

In fiscal 2020 (September 30 year-end), net revenues (after transfers and payment-in-lieu-of-taxes) decreased slightly from the prior year to $40.3 million, but still provided a satisfactory 1.65 times coverage of total debt service, which includes principal and interest on the system's parity revenue bonds and a portion of the city's general obligation limited tax (GOLT) bonds that funded improvements to the electric system, but legally secured by the city's limited property tax pledge.

Fiscal 2021 projected net revenues of $45 million are expected to provide a strong 2.54 times coverage of debt service, as annual debt service requirements decline nearly 32% from the prior year to $17.7 million. Fiscal 2022 budgeted net revenues of $54.8 million, due to higher TCOS revenues and steady purchased power pass through revenue (power cost recovery revenue) coupled with lower O&M expenses due to smaller capacity charges are projected to provide 1.61 times coverage of total debt service of $34 million.

Although the last base rate increase occurred in fiscal 2018, new TCOS revenue combined with a reduction of purchased power, fuel costs, and capacity charges are expected to offset hold harmless payments to ERCOT of $22 million per year from fiscal 2023 through fiscal 2026, while also maintaining debt service coverage ratios that are in line with A1 peers.

Liquidity

At fiscal year-end 2020, unrestricted cash and investments totaled $125 million and represented a strong 283 days cash on hand. As of May 2021, unrestricted liquidity totaled $87 million, or a 30% reduction from the prior year, after a one-time hold harmless payment to Southwestern Public Service Company ("SPS"; Baa2 stable) and still reflects an ample estimated 128 days cash on hand.

Debt and legal covenants: increased, but manageable leverage

The system's leverage has increased, but should remain manageable and favorable relative to peers given our expectation management will continue to implement timely rate adjustments to accommodate additional debt. Including the Series 2021 bonds, the system's has $393 million of total debt outstanding (including $22 million of general obligation limited tax bonds) representing 1.9 times fiscal 2020 operating revenues.

The system's multi-year capital plan includes $246 million of annual capital expenditures from fiscal 2022 to fiscal 2027, of which $119 million will be debt-financed. This includes an estimated $41.3 million of long term debt from fiscal 2022 to fiscal 2023 to finance distribution and capacity upgrades along with minor transmission line rebuilds to facilitate the integration of the remaining load into ERCOT. Additionally, the system plans to issue long term debt to finance a $77.5 million payment to SPS to terminate a partial requirements (PR) agreement with SPS. Under the agreement, LP&L pays roughly $17 million per year for capacity in the Southwest Power Pool (SPP) market. With the termination of the PR agreement, LP&L essentially exchanges an annual capacity charge of $17 million with an estimated debt service expenditure of $5 million, which yields an annual savings of $12 million per year.

Legal provisions are adequate to moderately weak and include a sum sufficient rate covenant (weak) and an additional bonds test (ABT) of 1.10 times maximum annual debt service. The bond ordinance also requires a debt service reserve fund equal to average annual debt service and currently cash-funded.

Legal security

The bonds are secured by a first lien pledge on the net revenues of the electric system.

Debt structure

All of the system's debt is fixed rate and will amortize over the long term after taking out the short-term revolving notes with the Series 2021 bonds. Annual debt service increases to $35 million in fiscal 2023 then descends through final maturity in fiscal 2051.

Debt-related derivatives

There are no debt-related derivatives.

Pensions and OPEB

The system participates in the Texas Municipal Retirement System (TMRS), a multi-employer defined benefit retirement plan administered by the State of Texas. The system contributed $3.6 million to the plan in fiscal 2020, a manageable 1.7% of operating revenue.

ESG considerations

Environmental

LP&L's exposure to environmental risks is low-to-moderate and primarily relate to natural and man-made hazards. Risk related to carbon dioxide regulations is low, as well, because self-generation assets are seldom utilized. After June 1, 2023, the self-generation assets will be idled and activated for merchant power generation when ERCOT energy prices are higher than the utility's production costs.

Social

Social considerations are key influencers of all local economies, financial and leverage trends and governance stability. Social factors are incorporated into the system's profile by way of service area wealth (median family income).

Governance

The system is governed by a 10-member board, consisting of nine voting members and the mayor in an ex officio capacity. The voting members are appointed by the city council and serve a maximum of three, two-year terms. The board has the full authority and power to govern, manage, and operate the electric enterprise system. The city council approves the system's budget, establishes rates, exercises eminent domain on the system's behalf and authorizes the issuance of debt.

The system exhibits good governance by adherence to formal financial policies and multi-year capital planning and financial forecasts. By ordinance, the system must maintain a general reserve equal to three months of gross revenue from all retail electric sales. At fiscal year-end 2020, the general reserve totaled $72.8 million which was $15.2 million above the formal policy. The estimated reserve for fiscal 2021 is $73.6 million. Also, as codified by a local ordinance, the system is required to transfer to the city's general fund a franchise fee equivalent to 5% of gross electric sales revenue (franchise fee) and PILOT equal to 1% of gross electric sales revenue. However, these payments may only occur after all legal covenants in the bond resolution are satisfied. The last base rate adjustment occurred in fiscal 2018. Though the system's benefits from strong management and planning practices, execution risk remains until the entire customer load is integrated with ERCOT.

REPORT NUMBER 1298340

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