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Fitch Rates Lubbock Power & Light, TX's Power System Rev Bonds at 'A+'; Outlook Stable

Fitch Ratings - Austin - 03 Aug 2021: Fitch Ratings has assigned an 'A+' rating on the following bonds issued by the city of Lubbock, TX, on behalf of its municipally owned electric utility system known as Lubbock Power & Light (LP&L):

--\$246.885 million electric light and power system revenue bonds, series 2021.

Bond proceeds will fund certain capital projects, refund outstanding amounts on the utility's revolving note program, fund the series 2021 bond reserve requirement and pay costs of issuance. Bonds are expected to price during the week of Aug. 12 via a negotiated sale.

Additionally, Fitch has affirmed the following outstanding bonds:

--\$136.125 million outstanding electric light and power system revenue bonds, series 2013, 2014, 2015, 2016, 2017 and 2018.

Fitch has assessed LP&L's standalone credit profile (SCP) at 'a+'. The SCP represents the credit profile of the utility on a standalone basis irrespective of its relationship with and the credit quality of the city of Lubbock (Issuer Default Rating AA+).

The Rating Outlook is Stable.

ANALYTICAL CONCLUSION

The rating continues to reflect LP&L's very strong revenue sources and low leverage profile, as well as the risks related to LP&L's recent transition into the Electric Reliability Council of Texas (ERCOT) organized market. LP&L's issuance of long-term debt with this transaction is part of LP&L's plan to refinance outstanding amounts on its revolving note program, the proceeds from which were used to finance LP&L's ERCOT integration and transmission upgrade projects during the past two years.

LP&L's financial performance has been very strong and relatively stable in recent years, and its leverage ratio, measured as net adjusted debt to adjusted funds available for debt service, totaled only 6.0x at fiscal YE 2020. However, leverage is expected to increase near term and medium-term hurdles remain in LP&L's ERCOT integration plan, including the utility's vote to opt in to retail competition, the selection of the provider of last resort (POLR) and the completion of an expanded capital plan that incorporates significant distribution investments. As a result, Fitch views the planned transition as a

limiting factor to the rating over the medium term, given the significant uncertainty around the costs, operational changes and potential system impacts.

Fitch believes the transition also increases the utility's overall operating risks over the longer term given the inherent pricing and resiliency weaknesses in the ERCOT market exposed by the recent Texas winter storm event. However, these risks should be alleviated as LP&L plans to cease power supply services following the utility's plan to opt in to retail competition by June 2023 and operate solely as a transmission and distribution utility.

CREDIT PROFILE

LP&L is the largest municipal electric utility in the West Texas region, serving approximately 107,000 meters in Lubbock and limited surrounding areas. LP&L's acquisition of Southwestern Public Service Company's (SPS) local distribution system in 2010 removed its largest competitor and transformed most of LP&L's service territory into a single-certified area. The utility successfully interconnected to the ERCOT marketplace on May 30, 2021, and plans to opt in to retail competition by June 1, 2023.

Fitch considers the system to be a related entity to the city for rating purposes given the city's oversight of the system, including the authority to establish rates. The credit quality of the city does not currently constrain the bond rating. However, as a result of being a related entity, the issue ratings could become constrained by a material decline in the general credit quality of the city.

Winter Storm Uri

LP&L's net purchased power costs during February 2021 increased to \$23.5 million from a pre-storm projection of \$11.3 million for the month due primarily to the surge in natural gas prices. The price spikes were prompted by unprecedented and prolonged below freezing temperatures across the state of Texas and much of the south-central U.S. region. At the time of the event, LP&L had not yet interconnected to ERCOT, but the utility still experienced exorbitant power and fuel costs. However, LP&L benefited from certain energy purchase hedges (heat rate call option), which mitigated the vast majority of the storm-related costs. LP&L's generation assets remained operational during most of the winter storm event, with only its Massengale and Cooke GT2 units experiencing short outages due gas curtailments.

While the storm costs are meaningful, Fitch believes costs remain manageable. LP&L used excess funds in its power cost recovery factor (PCRf) account to mitigate much of the costs. The PCRf, which was in an over-recovered position prior to the storm, is used by LP&L to match pass-through revenues with purchased power costs and provide an offset to seasonal fluctuations in load and power prices.

Additionally, LP&L does not expect to be affected by any potential ERCOT uplift charges related to the winter storm event. According to House Bill 4492, which was adopted by Texas Legislature during its most recent session, any utility interconnecting to the ERCOT market from May 29, 2021 through Dec. 30, 2021 will not be responsible for any uplift or default charges related to the February winter weather event. LP&L interconnected to the ERCOT market on May 30, 2021.

Coronavirus Impact Limited

The overall impact of the recent coronavirus outbreak on Lubbock remains limited. While the utility experienced material declines in the spring of 2020, energy sales rebounded through the summer and consumption levels remained in line with 2020 budget expectations for the six-month period ending September 2020. Initial measures put in place to reduce costs and delay capital projects have since been lifted as energy sales have returned to pre-pandemic levels.

KEY RATING DRIVERS

Revenue Defensibility: 'aa'

Very Strong Revenue Defensibility

LP&L's revenue defensibility assessment is supported by the system's independent rate-setting authority and strong service area characteristics, as well as the utility's competitive rates. Rate affordability metrics remain strong despite generally median household income metrics that trail the national average.

Operating Risk: 'a'

Very Low Operating Costs

Fitch's assessment of Lubbock's operating risk profile at 'a' reflects LP&L's very low operating costs, in addition to Fitch's view of the utility's weakened operational flexibility in the ERCOT organized market. The winter weather event during the week of Feb. 14, 2021 exposed structural weaknesses in the ERCOT market, which led to the market's failure to provide consistent energy supplies. The systematic failure of the regional organized market to supply sufficient energy, albeit during an unprecedented series of winter storms and cold weather, resulted in widespread blackouts across the region. The weaknesses of the ERCOT organized market exposed by this event include market dislocation and acute energy shortages.

LP&L's historically maintained very low operating costs, averaging 7 cents/kWh during the past three fiscal years. The utility projects significant capex in fiscal 2021 associated with the ERCOT integration.

Financial Profile: 'a'

Relatively Low Net Leverage

LP&L's financial profile is strong. Leverage increased to 6.0x in fiscal 2020 from 5.2x in fiscal 2019 as the utility increased draws on its \$300 million revolving program to fund the ERCOT integration and transmission upgrade projects. Additional draws in fiscal 2021 were predominantly used to fund the remaining ERCOT integration projects, and capex is expected to return to more moderate levels through fiscal 2025.

The proposed long-term financing will refinance all outstanding principal and interest amounts on its revolving credit facility. LP&L intends to maintain the revolving note program, albeit at a lower maximum draw amount of \$75 million, for interim financing for any remaining ERCOT integration capital projects. Fitch expects leverage will continue to remain supportive the financial profile assessment.

Asymmetric Additional Risk Considerations

Fitch views LP&L's ERCOT integration plan as a potential longer term credit positive as the plan assumes LP&L would only provide transmission and distribution services and no longer provide generation services. However, there are hurdles over the near to medium term, including LP&L's planned opt-in vote by the end of 2021, in addition to completion of an expanded capex plan and the selection of a POLR, all of which would need to occur before LP&L opts in to retail competition before June 2023. These factors represent an asymmetric risk that constrains the overall rating to the 'A' category.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--LP&L's completion of its planned transition into ERCOT and a sustained record of successfully managing retail competition could lead to positive rating action;

--Sustained leverage below 8.0x in Fitch's base and stress cases.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Higher than expected capex leading to increased debt issuances and higher leverage;

--The inability to manage its ERCOT integration due to ratepayer or political pushback, or direct transition-related issues;

--A weakening in revenue source characteristics caused by a competitive supplier market if LP&L continues to provide power to the affected load following a transition to the retail choice market;

--Legislative or regulatory changes that impose material new capex or operating costs for utilities.

Best/Worst Case Rating Scenario

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

SECURITY

Bonds are payable from the net revenue of the electric system.

Revenue Defensibility

LP&L's revenue source characteristics remain very strong with electric revenues provided almost entirely from the sale of retail electric service to a predominately single-certified service area. LP&L remains in competition with South Plains Electric Cooperative and SPS in two relatively small overlapping service areas in which LP&L does not have a significant presence. Fitch does not view the remaining competition as a significant credit concern, as the overlapping service areas are defined, limited in geographical size and customer base, and represent less than 5% of LP&L's revenue. Fitch expects the revenue source characteristics to remain very strong following the opt-in vote, as LP&L would remain the sole provider of transmission and distribution services.

Service Area Characteristics

LP&L's service area demand characteristics are consistent with the 'a' assessment, indicating strong electric demand and capacity for revenue generation to support the repayment of utility obligations. Customers have increased at a CAGR of 0.8% over the past five years, while socioeconomic indicators point to modestly below average income levels and a better than average unemployment rate. Residential sales account for a high 49% of electric revenues, providing strong stable demand and support for additional revenue generation.

LP&L maintains a moderately concentrated customer base, with the utility's top 10 customers accounting for 19.3% and 13.7% of fiscal 2020 energy sales and revenues, respectively. However, Fitch does not believe this rises to a level that would indicate an asymmetric risk. The stability of LP&L's two largest customers, Texas Tech University and the city of Lubbock, offset any rating concern.

Rate Flexibility

Fitch views LP&L's rate flexibility as very strong. The Lubbock city council maintains the authority to approve rates as recommended by LP&L's electric utility board, but no outside regulatory approval is needed to adjust rates.

The system's rates drifted lower in fiscal 2019 as the utility customers continued to benefit from lower natural gas prices. Retail rates were in line with the state average in 2019 and residential rates were slightly more competitive at 91% of the state average, according to the U.S. Energy Information Administration. Affordability metrics for LP&L are very high, with the average monthly bill averaging only 2.4% of median household income.

LP&L's rate structure consists of a base rate and a PCRf that is reset semiannually and seasonally based. LP&L used the PCRf in fiscals 2018 and 2019 to collect funds required for a \$24 million SPS hold harmless payment, which was negotiated as part of LP&L's transition into ERCOT. An additional \$10.8 million over-recovery remained in the PCRf fund as of Sept. 30, 2020, which was primarily due to lower than expected commodity prices. LP&L used excess funds in the PCRf fund to mitigate the increased purchased power costs from the Texas winter weather event in February 2021. No base rate increases are budgeted in LP&L's five-year forecast, although the utility conservatively projects pass-through power costs will increase as a result of rising natural gas prices.

Operating Risk

Very Low Operating Cost Burden

LP&L continues to benefit from a very low operating cost burden, with operating costs averaging 7.1 cents/kWh in fiscals 2019 and 2020. LP&L's operating expenses, which averaged 8.3 cents/kWh in the three-year period ending 2018, decreased in more recent years primarily due to lower commodity prices. Costs are expected to rise in coming years due to higher transmission and distribution system costs and higher commodity prices, but should not weigh on Fitch's assessment.

Costs directly related to the transition, in addition to increased purchased power costs related to the recent Texas winter weather event, are expected to temporarily increase operating costs in fiscal 2021. LP&L already reserved \$24 million for the hold harmless payment through its PCRf rate adjustment in fiscals 2018 and 2019. An over-recovered PCRf balance at fiscal YE 2020 will partially mitigate the additional storm-related costs. LP&L also benefited from certain energy purchase hedges (heat rate call option), which effectively provided a ceiling on the utility's power costs during the winter storm event.

LP&L also approved a settlement agreement on May 27, 2021 to terminate its Partial Requirements Agreement (PR agreement) with SPS following the full integration of LP&L's load into ERCOT. As part of the agreement, LP&L will pay \$77.5 million to compensate SPS for power and transmission incremental costs resulting from the early termination of the agreement. LP&L expects to use long-term debt to finance the payment, and management expects the incremental annual debt service costs related to the financing will be more than offset by the termination of its annual capacity charge paid to SPS. The agreement will not become effective unless approved by both the Texas Public Utilities Commission

and the Federal Energy Regulatory Commission. The agreement identified May 31, 2023 as the termination date, which coincides with LP&L's projected date of full integration into ERCOT.

Operating Cost Flexibility

Transition to ERCOT Elevates Operating Risk Over Near Term

LP&L's operating cost flexibility is assessed at weaker and reflects Fitch's view of LP&L's increased operating risk following the utility's integration into the ERCOT market for the majority of its customer load on May 30, 2021. The February winter event in Texas exposed weaknesses in the ERCOT market that precipitated in the form of acute energy shortages and market dislocation. Fitch remains concerned about material pricing and reliability risks that remain in the ERCOT marketplace.

As part of the transition into ERCOT, LP&L expects the utility will opt in, and thereby allow for retail competition. LP&L anticipates remaining as the transmission and distribution utility, while ceasing to act as the power provider. Customers would contract directly with power suppliers and LP&L would provide access to their distribution and transmission system on a nondiscriminatory basis to qualified power providers. Fitch views the potential elimination of LP&L's power supply responsibilities for the majority of its load as a credit positive over the longer term, reducing the system's overall operating risk profile following the transition. The reduced operating risk would be notable -- particularly given the recent winter weather event -- but hurdles remain in the short to medium term as the planned opt-in vote is not expected to occur until the end of 2021 and LP&L has not yet determined the POLR, which would need to occur before LP&L plans to opt in (expected prior to fiscal YE 2023).

The Lubbock City Council and LP&L board engaged a consultant to study the feasibility of opting into retail choice. The study is expected to provide guidance for the operational transition into ERCOT and provide customers with additional information on participating in the retail choice market.

Capital Planning and Management

LP&L's average age of plant of approximately 17 years indicates elevated investment needs. Overall system needs remain high in fiscal 2021, with capex expected to approximate \$186 million as the system continues the buildout of the utility's transmission, advanced metering and distribution assets necessary to make the integration with ERCOT possible. LP&L's capex through 2021 has been financed through a combination of borrowings under a \$300 million revolving credit agreement and cash from operations. Amounts borrowed under the revolving credit facility will be refinanced with the proposed series 2021 bonds.

LP&L's capital needs decline significantly following the buildout to support the ERCOT integration. Annual capex is expected to average approximately \$41 million during fiscals 2022-2025 as management expects to focus on less capital-intensive system maintenance.

Financial Profile

LP&L's financial profile assessment has been revised to 'a' from 'aa', reflecting expectations for higher leverage. The utility reported very low leverage at 6.0x and very healthy liquidity levels at 281 days cash on hand at fiscal YE 2020. Liquidity metrics trended higher over the past couple of years as efforts have been made to increase the financial flexibility of the system to meet expected and potentially unexpected costs related to the ERCOT transition. Leverage increased in fiscal 2020 as the utility drew funds from its revolving note program to fund capex, but remained in line with Fitch's prior expectations.

Fitch Analytical Stress Test (FAST) Scenarios

The FAST base case scenario represents Fitch's expectation of LP&L's financial performance through the five-year forecast ending in 2025. Fitch's scenario analysis focuses on LP&L's financial resiliency through the expected ERCOT transition in fiscal 2021, when debt issuance is expected to peak and costs are expected to be at their highest point due to temporary cost pressures from the transition.

LP&L's leverage is expected to rise in fiscal 2021, as debt is issued to support the buildout of the transmission and distribution infrastructure to allow for the ERCOT transition. However, under LP&L's 2021 budget assumptions, which consider a conservative 0.12% annual load growth, leverage is expected to moderate to between 7.0x and 8.0x through fiscal 2025. Liquidity levels are expected to remain adequate and neutral to the rating over the same time period.

LP&L also made a \$24 million hold harmless payment to SPS on June 1, 2021 as part of an agreement to indemnify SPS and its customers for LP&L's integration into ERCOT. LP&L previously collected for hold harmless payment in fiscals 2018 and 2019, and amounts remain in restricted reserves. LP&L will also pay SPS \$77.5 million for any power or transmission shifted costs following the termination of its PR agreement expected in May 2023. Management expects to use long-term debt to finance the payment. LP&L will also be responsible to pay \$22 million annually through fiscal 2026 to mitigate future ERCOT integration costs. All payments have been incorporated in LP&L's five-year forecast.

Fitch's stress case scenario applies a demand stress to management's energy sales projections using the FAST model demand stress outputs, which are based on the utility's historical demand volatility. Under the stress assumptions, leverage increases, and remains modestly above 8.0x.

Debt Profile

LP&L's debt profile is neutral to the rating. Debt totals \$295.6 million and includes \$136.1 million in revenue bonds, \$120.6 million in short-term notes payable, \$21.9 million in certificates of obligation and \$17.0 million in bond premiums. All debt is amortizing and fixed-rate.

Asymmetric Additional Risk Considerations

Fitch views LP&L's plan to integrate its load into ERCOT as a potential long-term credit positive, but one that presents significant uncertainty in the short term and is therefore considered an asymmetric risk that constrains the overall rating to the 'A' category. The plan involves a significant buildout of infrastructure, changes in operations, most notably through the expected opt in to retail competition, and the involvement of yet to be determined retail electric providers as service providers and billing and collection agents. Completion of the transition on time and on budget along with a proven record of successfully implementing retail competition would likely lead to the elimination of this asymmetric rating factor.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

Lubbock Power & Light (TX) has an ESG Relevance Score of '4' for Exposure to Environmental Impacts due to the effects of recent severe winter weather, which has a negative impact on the credit profile, and is relevant to the rating in conjunction with other factors.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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Applicable Criteria

[Public Sector, Revenue-Supported Entities Rating Criteria \(pub.23 Feb 2021\) \(including rating assumption sensitivity\)](#)

[U.S. Public Power Rating Criteria \(pub.09 Apr 2021\) \(including rating assumption sensitivity\)](#)

Applicable Models

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 [\(1\)](#)

Additional Disclosures

[Solicitation Status](#)

Endorsement Status

Lubbock EU Endorsed, UK Endorsed

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