S&P Global
Ratings

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Lubbock, Texas; Retail Electric

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Rating Action

S&P Global Ratings revised the outlook to negative from stable and affirmed its 'A+' long-term rating on Lubbock, Texas' electric light and power system revenue debt. The system does business as Lubbock Power & Light (LP&L).

The negative outlook reflects our view that, although management plans to exit the power supply business by 2023, which we believe will diminish the utility's exposures to the Electric Reliability Council of Texas (ERCOT) market risks, the utility will likely have a short-energy position during the summer months and possibly for other months in the capacity-constrained ERCOT market during the interim period. Its potential need for day-ahead market purchases to supplement its firm contracts and dispatchable generation could result in increased power costs during extreme weather when price spikes occur. Tempering the utility's ERCOT market exposure is management's plan to add additional firm bi-lateral contracts.

The negative outlook is also based on our view of the utility's exposure to the ERCOT market's potential volatility of power prices and energy supply, particularly during extreme weather or peak summer months, which could affect financial and operational performance. Effective June 1, 70% of LP&L's load was integrated into the ERCOT market from Southwest Power Pool (SPP), and we believe LP&L could face challenges associated with the market's relatively higher price volatility, heightened reliability risks, extreme temperature and demand fluctuations, and weaker grid interconnectivity as compared with other states. Based on the utility's increased operating risk serving the majority of its load in the ERCOT market that is more susceptible to power price spikes, and its increased debt burden as it funds major transmission projects in support of its integration into the ERCOT market, there is a one-in-three chance we could lower the rating over the next two years.

The bonds are secured by a first-lien pledge on the net revenues of LP&L's electric system. LP&L had $295 million in total debt outstanding, including $120 million in short-term debt as of Sept. 30, 2020. We believe debt levels will increase roughly 70% over the next two years and pressure the current rating. However, the majority of the system's future debt burden will be transmission related and transmission rates are based on a cost-of-service filing that includes a return on investment. LP&L intends to refinance its direct-purchase revolving notes with roughly $245 million in long-term fixed-rate senior-lien bonds prior to the expiration of the program later in 2021.

Credit overview

LP&L management plans to exit the energy supply business by migrating all of its customers to competitive alternative energy providers by June 2023. LP&L will continue to provide transmission and distribution (T&D) services to its customers. Management indicated it has completed its transmission buildout and expects the ERCOT return on investment for transmissions assets, currently at 8.27%, will cover the cost of additional transmission asset debt and

provide a margin. Unless the utility's board and city council relieve LP&L of provider of last resort obligations, the utility could face market volatility and business risk if it retains power procurement responsibilities for portions of the customer base. In furtherance of the utility's plans to exit the power supply business, LP&L plans to terminate its power purchase agreement (PPA) with Southwestern Public Service Co. (SPS), a subsidiary of Xcel Energy, effective May 31, 2023. If the board and city council do not vote to migrate customers to alternative providers, the utility will need to secure new supply arrangements. Similarly, any provider of last resort responsibilities will require new supply arrangements.

The rating further reflects our view of the utility's:

- Strong regional economy centered on higher education that provides a stabilizing presence, and steadily growing and diverse electric customer base. We believe its below-average income levels in part, reflect a large student population;
- Competitive retail rates which provide financial flexibility even after a power cost recovery factor adjustment in March 2021, as evidenced by its 2019 weighted average electric system rate that was 7.7% below the state average, and the presence of a power cost recovery mechanism that automatically passes along changes in power costs at least semi-annually;
- Based on our view of management's financial forecast assumptions, including that the city council will vote to opt into retail competition, we believe coverage metrics will remain stable around 1.3x, even as debt service requirements rise without base rate increases; and,
- Planned build-up in liquidity and reserves allowed the utility to make a one-time payment to SPS in fiscal 2021, and we believe lower levels of liquidity will be maintained between $60 million and $73 million over the next three years, with days' cash potentially increasing to 150 days in fiscal 2023.

Partially offsetting factors include our view of the utility's:

- Increased operating risk with 70% of its load integrated into the ERCOT market, reflecting its exposure to the market's potential volatility of power prices and energy supply, although, in our view, its power supply does not rely on intermittent resources to meet its ERCOT peak demand mitigating its exposure to potential ERCOT price spikes. We also consider financial management practices to be very strong as evidenced by its scenario-based multiyear financial projections that are updated annually, along with its multiyear capital plan; and,
- Increased leverage, as suggested by its 56% debt-to-capitalization ratio in fiscal 2020, which we believe will rapidly increase near 70% by fiscal 2023 given the system's additional debt needs as an approved transmission owner in the ERCOT market.

We have applied a one-notch positive adjustment from the initial indicative rating to arrive at the final rating based on peer comparisons, including the utility's competitive retail rates which provides financial flexibility, higher percentage of its power supply from firm energy resources, and projected liquidity levels we consider to be supportive of the 'A+' rating.

Environmental, social, and governance factors

The severe winter event in February 2021 has brought into sharper focus a spectrum of environmental, social, and governance (ESG)-related risks that could inform our credit analyses and ratings over the long term. In our view, the

specter of climate change could weigh more heavily as a credit risk factor for Texas utilities in U.S. public finance. In particular, we expect to consider the adequacy of management's counterbalancing measures to plan for, mitigate, or adapt to risks associated with extreme weather conditions that have the potential to disrupt its power supply and cause a short energy position. Among these considerations are exposures related to the limits of power supply planning and hedging strategies. In our opinion, LP&L and many other Texas utilities face greater environmental risk than do most of their peers nationally. Given wide fluctuations in temperatures in LP&L's territory, the utility, along with many of its Texas-based peers, faces heightened risk related to climate change. The utility's exploration of reducing its energy supply function role will help reduce emissions and exposure to regulatory directives. Nevertheless, it will continue to operate gas-fired generation through May 2023, which we view as creating environmental exposures.

We believe LP&L's exposure to social factors (including health and safety issues related to COVID-19) are in line with those of other rated utilities. While commercial sales declined 3% in 2020, residential sales increased by almost 6% and, in our view, the economic effects of the pandemic have not affected its financial position, as evidenced by its strong 1.3x fixed-charge coverage in fiscal 2020.

In our view, governance risk is heightened given that the environment in which LP&L operates increasingly requires stronger liquidity, proactive planning, hedging, and financial flexibility, which could be costly, versus most utilities in other regions where these risks are lower.

Negative Outlook

Downside scenario

Based on the utility's increased operating risk serving the majority of its load in the ERCOT market that is more susceptible to power price spikes, and its increased debt burden as it funded major transmission projects in support of its integration into the ERCOT market, there is a one-in-three chance we could lower the rating over the next two years. We could lower our long-term rating if our view of the utility's operations and the risks to LP&L associated with its participation in the ERCOT market remain elevated or affect the utility's operational and/or financial performance.

Upside scenario

We could revise the outlook to stable over the next two years if our view of the utility's operational risk profile improves, as evidenced by its plans to outsource its power supply function and operate as a T&D utility in June of 2023, or by other means.

Credit Opinion

ERCOT integrated 70% of LP&L's load into the ERCOT market at the end of May, and LP&L will continue to serve the 30% of its load that will remain in the Southwest Power Pool (SPP), through its partial requirements long-term agreement with SPS for 170 MW.

LP&L entered ERCOT as a nonopt-in entity and has contracted with a third-party power marketing company to enter into bilateral contracts for firm block power to serve its ERCOT customers, combined with the utility's 112 MW in peaking natural gas-fired generation and market purchases. The utility's power supply hedging strategy is used to

manage its market price exposure and it intends to cover 100% of its projected load from June through September while during non-summer months, its block power purchases will cover less than 100% of projected load to benefit from potentially more competitive day-ahead market prices. However, we believe its reliance on day-ahead market purchases to meet a portion of its peak load could result in increased power costs during extreme weather when price spikes occur. Management believes its peaking generation assets will account for less than 5% of its energy. In addition, LP&L entered into a PPA with NextEra Energy Inc. for 90 MW of energy through May 2032 which is available to meet its SPP load.

Prior to June 1, 2021 LP&L was in the SPP, and purchased most of its energy needs from SPS, a subsidiary of Xcel Energy. The utility's generation performance during the severe Feb. 13-17, 2021 North American winter storm and its heat rate call option, which mitigates its exposure to power price spikes, limited its unbudgeted costs to a net $23 million. Management indicated higher day-ahead market purchases, ancillary charges, and lower bilateral real-time sales contributed to the utility's total costs from the winter storm. LP&L absorbed these unbudgeted costs without a rate increase because it drew down liquidity and had over-recovered power costs prior to the winter storm.

We understand LP&L currently intends to seek approval to transfer the remaining 30% of its load from SPP to ERCOT by June 1, 2023. In anticipation of LP&L's full integration into ERCOT, LP&L and SPS have agreed to terminate their long-term PPA, with an estimated termination date of May 31, 2023. Under the terms of the settlement agreement, LP&L will pay $77.5 million to SPS, which we believe will be debt-financed. For comparison, LP&L projects maintaining $73 million or 114 days' cash on hand at the end of fiscal 2021. By terminating its PPA with SPS and its related settlement payment, LP&L projects reducing annual fixed costs by $12.9 million annually equal to roughly 10% in power cost savings to the customer. On May 27, the electric utility board, city council, and SPS approved the settlement agreement, which also requires approval by the Federal Energy Regulatory Commission (FERC) and the Public Commission of Texas (PUCT).

The city has not voted on whether to opt into retail competition, but management anticipates a vote could be held by the end of 2021. Following the board's feasibility study, if the city decides to opt in, we understand that LP&L plans to revise its business model and operate as a T&D utility for the ERCOT portion of its system. LP&L would continue to serve the 30% of its load that will remain in the SPP through May 2023, but competitive energy providers could begin to meet the needs of all of its customers in the retail competition area by June 2023. There is not a retail choice market in the SPP footprint for the balance of the customers that will remain in the SPP. In an opt-in scenario, officials believe LP&L and the city will not choose to be the provider of last resort. We expect limited potential for outstanding generation debt costs totaling an estimated $451,000 by fiscal 2023 because of LP&L's modest generation assets.

LP&L's transmission revenue stream beginning in fiscal 2021 totals an estimated $34 million by fiscal 2022 and will provide additional revenue diversity and predictability because all of the ERCOT area's transmission system users will essentially be LP&L's transmission customers. Transmission rates are approved by the PUC and are based on a transmission cost-of-service filing that includes a return on investment. Also, the regulatory framework socializes the transmission system's costs and the return across the nearly statewide system.

LP&L's six-year capital improvement plan (CIP) has identified about $247 million in total projects through fiscal 2026, the bulk of which are distribution-related. LP&L intends to debt-finance 65% of its current CIP. In June 2019, it entered

into a $300 million direct-purchase revolving note program with Bank of America N.A. that expires Dec. 31, 2021. The system's subordinate-lien net revenue pledge secures the direct-purchase variable-rate notes, and the utility has drawn on the note program to fund its CIP, including major transmission projects supporting its integration into the ERCOT market. Following our review of the direct-purchase documents, we do not believe contingent liquidity risks exist. LP&L intends to execute a new direct-purchase note program with Bank of America that it will use to interim finance its capital needs.

Related Research

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

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