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Fitch Rates Brownsville Public Utilities Board, TX's Utilities System Revs 'A+'; Outlook Negative

Fitch Ratings - Austin - 12 May 2022: Fitch Ratings has assigned an 'A+' rating on the following bonds issued by the city of Brownsville, TX on behalf of Brownsville Public Utilities Board (TX) (BPUB):

--Approximately $16.735 million utility system revenue refunding bonds, series 2022 (tax-exempt);

--Approximately $35.365 million utility system revenue refunding bonds, series 2022A (taxable).

Fitch also affirmed the following ratings at 'A+':

-- Approximately $199.345 million utility system revenue bonds, series 2005A, 2008, 2013A, 2016, 2018, 2020 and 2020A;

--Approximately $6.98 million water supply contract revenue bonds, series 2012 issued by the Southmost Regional Water Authority (TX) (SRWA).

Fitch also assessed BPUB's standalone credit profile at 'a+'.

The Rating Outlook on all obligations above is Negative.

Bond proceeds will be used to refund certain outstanding CP notes and pay costs of issuance. The bonds are expected to price via negotiation the week of May 23.

ANALYTICAL CONCLUSION

The affirmation of the 'A+' rating reflects BPUB's historically strong financial profile, as well as Fitch's expectation that the utility's operating cash flow and leverage metrics will recover to historical levels after the utility's fiscal 2021 financials were negatively affected by the extraordinary power supply costs during the February 2021 Texas winter storm. Despite extremely high purchased power and fuel costs during the week of the storm, the solid operating performance of its power supply resources together with its unrestricted cash balances and access to its available commercial paper program, provided sufficient liquidity to meet its near-term financial obligations.

The Negative Outlook reflects BPUB's weaker leverage profile beyond fiscal 2021 relative to prior projections, in addition to BPUB's increased reliance on the ERCOT market over the near to medium term. Future events that result in heightened market prices would likely result in an increased operating cost burden at the utility, to the extent rising market prices are not sufficiently mitigated. Rising costs that result in narrowed operating margins, or the need to issue additional debt to finance such costs, would put downward pressure on the utility's rating.

The SRWA rating is linked to BPUB's rating, given its 92.9% ownership share in SRWA, and the unconditional take-or-pay contract provision with an unlimited step-up requirement in the event that other participants are unable to meet their respective obligations.

CREDIT PROFILE

BPUB is a component unit of the city of Brownsville, TX (AA-/Stable). BPUB operates a combined utility system that provides electric, water and wastewater services to residential and commercial customers within the city and in certain areas of Cameron County outside of the city limits. BPUB serves a customer base of approximately 54,000 accounts. Utility system assets are owned by the city but operated, maintained and managed by BPUB.

Combined system total revenues historically comprised approximately 78% electric revenues, 12% water revenues and 10% wastewater revenues, but electric revenues surged in fiscal 2021 due to the February 2021 winter storm causing electric revenues to account for nearly 90% of total BPUB's operating revenues. Each of the utilities included in the combined system is financially self-supporting and not reliant on transfers from other funds.

BPUB maintains a 92.91% ownership share in SRWA's assets. The five participants in SRWA, including BPUB, have an unconditional obligation to fund SRWA's operating and maintenance costs and debt service obligations on outstanding contract revenue bonds. An unlimited step-up provision in the event of nonpayment by another participant effectively links SRWA's credit quality directly to that of BPUB.

Fitch considers the combined utility to be a related entity of the City of Brownsville, given the organization of those operations as enterprise funds of the city and the city's oversight, including rate setting. The rating on the utility revenue bonds is not constrained by the credit quality of the city. However, as a result of being a related entity, the rating could become constrained in the event of a very material decline in the general credit quality of the city.

Winter Storm Uri

BPUB experienced net costs related to Winter Storm Uri of approximately $35 million. The net storm costs were incurred during the week of Feb. 14-19, 2021 as a result of exponentially high market energy costs and natural gas prices. The price spikes were prompted by unprecedented and prolonged below freezing temperatures across the state and the resulting regional energy market dislocation within ERCOT, when over 40,000 MW of various fuel-type generation failed to deliver in the extreme conditions.

BPUB's generation assets remained operational during most of the winter storm event. BPUB's Silas Ray Power Plant and Hidalgo Energy Center -- both gas-fired plants -- generally performed during the multi-day event with outage times limited to four hours at the Silas Ray facility due to frozen control lines. Additionally, BPUB management maintained uninterrupted operations at its water and wastewater facilities by strategically limiting power outages at the plants during the event.

While the storm costs are meaningful, Fitch believes costs remain manageable. BPUB remained long power at several points during the event, allowing the utility to partially mitigate expensive fuel and energy purchases with off-system sales. The off-system sales, which contributed a net gain of approximately $90 million during the storm event, offset much of the higher power supply costs that otherwise would have been borne by BPUB's retail customers.

BPUB's city commission approved the use of its commercial paper program to finance storm-related costs in the immediate aftermath of the storm. Funds from the series 2022 bond issuance will refund all of the outstanding commercial paper allowing BPUB to recover the financial shortfall from the storm over a multi-year period. BPUB's financial statements recognized all power supply costs (and associated revenues) from the winter storm event in fiscal 2021, which contributed to the significant tightening of BPUB's operating margins. Weaker operating cash flows in fiscal 2021 also drove a substantial increase in BPUB's leverage in fiscal 2021, but Fitch expects the metric to moderate over the medium term.

KEY RATING DRIVERS

Revenue Defensibility: 'a'

Strong Revenue Defensibility

Demand for utility services remains stable, driven by continued customer growth, but income levels and unemployment rates remain much weaker than the national average, constraining the revenue defensibility assessment to 'a'. The utility has the independent ability to raise rates, which are competitive in relation to the state average.

Operating Risk: 'a'

Low Operating Costs, but ERCOT Operating Risks Remain Elevated

Fitch assesses BPUB's operating risk assessment at 'a' reflecting the utility's historically low operating cost burden. BPUB's electric utility operating cost burden increased to 14.9 cents per kilowatt hour (kwh) in fiscal 2021 from 13.2 cents per kWh in fiscal 2020, due to the energy purchases related to the Texas winter storm, but Fitch expects costs will moderate over the medium term and continue to support the 'a' assessment.

Operating cost flexibility is considered weaker given the ongoing ERCOT market risks, including natural gas delivery and counterparty risk, and price volatility. BPUB's operating risks are further heightened by the utility's increased reliance on ERCOT market energy purchases following the closure of the Oklaunion facility in October 2020.

BPUB maintains adequate water supply, and treatment capacity remains sufficient at the utility's water and wastewater facilities.

Financial Profile: 'a'

Weakened 2021 Financial Profile Expected to Improve

BPUB's coverage of full obligations declined to below 1.0x in in fiscal 2021, although all financial obligations were paid, due to the utility's exorbitant power supply costs as well as the utility's elevated transfer to the city fund, both of which were negatively affected by the February 2021 winter storm event. Weakened operating cash flow was the primary driver for BPUB's elevated leverage ratio, which increased to 19.7x after declining below 5.5x in the two years preceding fiscal 2021. Issuance of an additional $35 million in commercial paper to finance the net winter storm costs over the near-term contributed to BPUB's elevated leverage but had less of an impact on the metric.

Fitch expects the stress on BPUB's financial profile in fiscal 2021 to be a one-time occurrence and leverage to moderate over the medium term as operating costs cash flows improve and as the utility's capex, which remains elevated through fiscal 2022, returns to historical levels. However, BPUB's leverage is expected to remain elevated, relative to prior projections, and could put pressure on the rating to the extent current projections are not achieved.

RATING SENSITIVITIES

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

-- Stabilization of the Negative Outlook will depend on the timely recovery of power supply costs and a sustained decline in leverage below 7.0x in Fitch's base and stress cases;

--Stabilization of the Negative Outlook will depend on the utility's ability to maintain a low electric operating cost burden that is sufficiently insulated from a rise in ERCOT market prices.

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

-- An inability or unwillingness to increase utility system rates following an increase in power supply or other operating costs;

-- A sustained increase in leverage above 7.5x in Fitch's base and stress case scenarios;

--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

The BPUB bonds are payable from net revenues of the utility's combined utilities system, which includes electric, water and wastewater services. BPUB has a small amount of junior-lien bonds outstanding that are payable from net revenues of the combined system after satisfying senior-lien debt service. The CP notes are payable from a third lien on net revenues.

SRWA bonds are secured by water supply contract payments with five participating customers, of which BPUB is the largest, with a 92.9% share of the desalination project financed by SRWA and operated by BPUB. The contract payments to SRWA are unconditional obligations and paid as an operating expense, senior to BPUB's debt service.

Revenue Defensibility

BPUB's operating revenues have historically been derived from its retail utility services with wholesale electric revenues accounting for 4% to 10% of total operating revenue in the four years preceding fiscal 2021. However, wholesale electric sales surged in fiscal 2021 due to the winter storm increasing BPUB's wholesale electric revenues to nearly 30% of BPUB's 2021 operating revenues.

Fitch expects BPUB's electric wholesale revenues to revert back to historical levels, or potentially lower following the closure of one of BPUB's generating facilities, Oklaunion, in 2020. BPUB's projections conservatively assume wholesale sales will account for approximately 4% of total revenues over the next five years. Sales are opportunistic, and the utility's long power supply position has allowed it to benefit from the narrowing ERCOT reserves over the past several years.

The utility also sells wholesale water to three water distribution systems under contract that accounted for 6% of its total fiscal 2021 water revenues.

The electric system operates in both a single and multi-certified service territory. The water system has been certified to provide service within the city's boundaries and has dual certification for an area immediately adjacent to the city. The water supply is drawn from the Rio Grande River, with two reservoirs with 187 million gallons total capacity and a raw water transport system. Additional water is provided by BPUB's share of SRWA.

BPUB has authority to provide wastewater service both inside and outside the city limits. The system includes two treatment plants with a combined capacity of 27.3 million gallons per day (MGD).

Service Area Characteristics

Fitch assesses BPUB's service area characteristics at midrange, reflecting stable customer growth across each of the utility systems but historically weaker economic metrics. The most recent median household income and unemployment levels for the city represent 63% and 132% of the national averages, respectively.

The city of Brownsville serves as a trade center for the lower Rio Grande Valley, with its location as the only port of entry from Mexico with highway, air, rail and shipping transportation modes. The Port of Brownsville is home to hundreds of companies performing offshore oil rig construction, ship repair and construction, rail car rehabilitation, waste oil recovery, steel production, and petroleum transportation services. Three international bridges also provide the city with a link to Matamoros, Mexico. Fitch believes that given Brownsville's strong economic ties to Mexico, notable changes related to U.S. border security or trade policies could adversely city's economic metrics.

The customer base at each of the utility systems remains diversified, with the top-10 customers accounting for less than 15% of each respective utility system revenue. Residential sales account for approximately half of BPUB's total electric revenue.

Rate Flexibility

The City Commission of Brownsville maintains the independent ability to set its electric, water and wastewater rates. Electric rates remain competitive, as evidenced by residential rates that represent approximately 94% of the state average. However, rate flexibility is limited by the service area's weaker income levels. Residential electric costs have averaged 3.6% of the service territory's median household income levels during the past four years, although affordability has improved in more recent years.

Recently Approved Rate Adjustments

BPUB's City Commission approved rate adjustments for each of its utility systems on May 3, 2022. BPUB's electric utility base rates will decline by 22%, in aggregate, in a phased approach that will be fully effective on June 1, 2023. The reduction in electric base rates were the result of BPUB's decision not to move forward with an electric generation project.

While the electric base rate decrease is substantial, the retail electric utility bill decrease is not expected to decline as precipitously for two reasons. First, BPUB had been using revenues earned through the previously elevated base rates to subsidize customers' fuel and purchased energy charges through a program that will be phased out following the implementation of the electric base rate reduction. Secondly, recent rises in fuel and purchased power costs, which BPUB passes through to its retail customers, are expected to offset the base rate reduction. Fitch views the continued pass-through of fuel and purchased power costs as integral to the full and timely recovery of BPUB's power supply costs.

BPUB's City Commission also approved a five-year water and wastewater rate plan that will result in annual rate increases for each system in the range of 4.0% to 9.0% starting June 1, 2022. The rate increases were based on BPUB's recently completed rate study, which aimed to ensure rates fully recovered the cost of services provided. Cash flow from the rate increases will also partially fund BPUB's expanded capital improvement plan. Concurrent with the rate increases, BPUB will also begin charging a monthly fee to all water customers to partially fund the Resaca Restoration Project, a dredging project aimed at restoring the utility's waterways. Funds received from the Resaca fee are expected to be matched with federal funding.

While the rate increases are substantial, BPUB has not increased rates in several years with the prior water and wastewater rate adjustments occurring in 2016 and 2014, respectively. Management anticipates that BPUB's rate will remain very competitive with the average rates in the state, even after implementing the proposed rate increases.

Operating Risk

BPUB's electric system operating cost burden remains strong despite a steady increase in operating costs in recent years. BPUB attributes the trend to higher benefit and pension costs, as well as higher maintenance expenses in fiscals 2018 and 2019. Additionally, fiscals 2019 and 2020 include increased depreciation expenses related to the early closure of the Oklaunion Power Station. Declining depreciation costs in fiscal 2021 following the Oklaunion plant closure in October 2020 were offset by the elevated power supply costs resulting from the February 2021 winter storm event. Average operating costs increased to 14.9 cents/kWh in fiscal 2021 from 13.2 cents/kWh in fiscal 2020, but still support Fitch's assessment of BPUB's operating cost burden at 'a'.

The operating cost burden also includes BPUB's annual transfer to the city general fund. The transfer fluctuates with the utility's operating revenues, as it represents 10% of the utility's annual gross revenues, less purchased power, fuel and SRWA costs, in addition to any amounts owed by the City of Brownsville for utility services. BPUB's operating cost burden was negatively impacted by BPUB's elevated transfer amount, which nearly doubled to approximately $21 million in fiscal 2021 as revenues were inflated due to the February winter weather event, requiring a higher transfer.

Operating Cost Flexibility

BPUB's operating cost flexibility assessment is weaker reflecting BPUB's exposure to ongoing risks associated with the ERCOT market operating structure, including natural gas delivery and counterparty risk, and remaining price volatility.

Fitch believes BPUB's operating cost flexibility weaknesses are further elevated due to the utility's reliance on market purchases to meet its projected peak system demand. BPUB's owned generation and power purchase agreements provide the utility with 311MW of capacity over the next five years, which remains below BPUB's baseline projections for peak demand. BPUB's peak demand, which hit a five-year historical high of 300MW in fiscal 2018, is projected to rise to over 350MW over the next five years under management's baseline scenario.

The utility has issued additional requests for proposal for up to 90MW of additional capacity that would be layered in over the next five years, but BPUB has yet to make a formal decision on the additions.

BPUB's under-resourced position is largely the result of the early closure of the coal-fired Oklaunion facility and BPUB management's strategic decision to use market purchases in the near to medium term to satisfy customer demand. Oklaunion provided nearly a third of BPUB's total resource capacity fiscal 2020.

Economic market purchases accounted for more than quarter of BPUB's energy requirements in fiscals 2020 and 2021, a significant increase from 14% in fiscal 2019. While Fitch notes that BPUB has benefited over recent years from lower cost energy through the ERCOT market given the influx of low-cost renewables and lower natural gas prices, BPUB's increased reliance on market purchases exposes the utility to price risk.

BPUB conservatively projects economic market purchases will provide 5% or less of BPUB's energy requirements over the next year. Instead, BPUB expects to rely more heavily on two power purchase agreements (PPAs) with American Electric Power (AEP) to meet projected demand. The two contracts, which BPUB executed with AEP in October 2020, are projected to provide 37% of BPUB's energy requirements, on average, over the next five years. Both contracts expire in December 2029.

BPUB's under-resourced position is somewhat exacerbated by the ERCOT market, which experienced narrow reserve margins in 2019, at 8.3% during the summer of 2019. Favorably, ERCOT has taken a more conservative approach on summer reserve margins in subsequent planning years. ERCOT's 2022 summer reserve margin is expected to grow to 24% in 2022 and remain above 39% through 2026 as planned generation comes on line. However, Fitch believes BPUB remains exposed to short-term price risks remain.

BPUB's other power supply resources include a wholly owned gas-fired Silas Ray unit (115MW), and BPUB's share (105MW) in Calpine's Hidalgo gas-fired combined cycle project. BPUB also maintains a power purchase agreement with Sendero Wind Energy, entitling the utility to purchase up to 78MW of renewable energy (34MW capacity). The two purchased power contracts with AEP that are expected to provide 57MW, in aggregate, of additional rated capacity.

Water and Wastewater Systems

BPUB's water system includes two reservoirs, with 187 million gallons total capacity and a raw water transport system. Surface water is treated by two water treatment plants providing 40 million gallons of total capacity, 20MGD treatment each. Two clear wells provide 6.85 million gallons storage capacity and three elevated storage tanks provide 5 million gallons of elevated storage capacity. The SRWA desalination plant provides some degree of supply diversity and is an important component of BPUB's water supply. The SRWA plant, which was upgraded to 10MGD capacity in 2015, treats brackish groundwater through a reverse osmosis process and has a 7.5MGD storage capacity. The wastewater system consists of collection and treatment facilities, including gravity wastewater collection lines, lift stations and two treatment plants.

Capital Planning and Management

Fitch considers lifecycle investment needs as elevated, based on a Fitch-calculated average age of plant of 19 years. BPUB's ratio of capex/depreciation drifted lower in fiscals 2019 and 2020 due to the accelerated depreciation of the Oklaunion facility, but the ratio increased to 128% in fiscal 2021 as depreciation returned to historical levels.

BPUB's capex is expected to remain elevated over the next five years as the utility undergoes several electric, water and wastewater system rehabilitation projects. Approved combined system five-year capital improvements through fiscal YE 2026 are expected to average $54 million annually, well above the five-year historical annual spend of $30 million. Operating cash flow historically accounted for approximately 50% of BPUB's capex, although recent water and wastewater rate adjustments are expected to increase cash funding of capex to 55% over the next five years. BPUB also plans to use state loans, grants and contributions to supplement its capital improvement plan funding sources.

Financial Profile

BPUB's financial metrics were significantly affected by the winter storm event in fiscal 2021. Purchased power and fuel costs surged in fiscal 2021 to $209 million from $66 million in fiscal 2020. While operating revenues also increased primarily due to the utility's increased wholesale sales, operating margins were compressed, resulting in Fitch-calculated coverage of full obligations that fell well below 1.0x. Despite the weakened operating cash flow, liquidity levels remained strong at approximately $74 million, in line with the five-year historical levels of $78 million. Fiscal 2021 liquidity levels were aided by BPUB's use of its commercial paper program to finance approximately $35 million in costs due to the winter storm event.

Fitch Analytical Stress Test (FAST) - Base and Stress Scenarios

The Fitch Analytical Stress Test (FAST) base case scenario represents Fitch's expectation of BPUB's financial performance through the five-year forward look through fiscal 2026. The scenario is informed by BPUB's latest financial projections and assumes 1% annual energy sales growth, and operating revenues reflect the recent rate adjustments to BPUB's electric, water, or wastewater systems. The base case also considers BPUB's expanded capital improvement plan, which amounts to $270 million over the next five years. Additionally, the FAST base scenario layers in BPUB's planned refunding of certain outstanding commercial paper with the proceeds from the series 2022 and series 2022A bond issuances.

Fitch expects that BPUB's operating cash flow and leverage metrics will improve in fiscal 2022 as overall fuel and purchased power costs decline relative to fiscal 2021. Fitch also expects BPUB's continued pass-through of fuel and purchased power costs will mute the financial impact further increases in commodity prices. Fitch views the recently approved water and wastewater rate increases favorably and expects the additional revenues provided will offset the impact of the utility's expanded capex plan. BPUB's leverage metric is expected to range between 6.5x and 7.0x over the next two years.

The FAST also considers a stress scenario which applies a demand stress case on BPUB's projected 2022 and 2023 energy sales followed by recoveries in fiscals 2024 through 2025. In the stress case, leverage would be expected to rise as operating margins narrow and liquidity metrics weaken. In response to the stress, Fitch would expect BPUB would implement rate increases to ensure operating cash flow metrics and coverage ratios were maintained, and leverage ratios return to historical levels. Absent rate increases in a stress scenario, leverage metrics could pressure BPUB's current rating. Additionally, inflationary pressures that impact BPUB's other operating expenses or capex would likely pressure BPUB's financial profile, to the extent that rates are not adjusted to fully recover costs.

Debt Profile

BPUB's debt profile is neutral to the rating. The $314 million outstanding long-term debt as of Sept. 30, 2021 consists almost entirely of fixed rate revenue bonds. Fitch's fiscal 2021 leverage calculation also included approximately $103 million in other obligations, including pension obligations and capitalized fixed charges for purchased power obligations.

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

BPUB has an Environmental Social and Governance (ESG) Relevance Score of '4' for Exposure to Environmental Impacts due to the effects of the February 2021 severe winter weather event, which weakens the operating flexibility assessment. The weather event exposed deficiencies in ERCOT's market design and ability to keep the grid functioning well in the face of an extreme weather event, which exposes BPUB to price volatility and counterparty risk outside of its control, which has a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

SRWA's ESG Relevance Score has been revised to '3' from '4' given its limited Exposure to Environmental Impacts from the winter weather event. SWRA does not have direct exposure to the ERCOT market.

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.01 Sep 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

Brownsville (TX)	EU Endorsed, UK Endorsed
Southmost Regional Water Authority (TX)	EU Endorsed, UK Endorsed

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