



RATING ACTION COMMENTARY

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

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Fitch Ratings - Austin - 22 Jul 2020: 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 \$52.255 million utility system revenue refunding bonds, 2020 (tax-exempt);

--Approximately \$62.590 million utility system revenue refunding bonds, 2020A (taxable).

In addition, Fitch Ratings has affirmed the 'A+' rating on the BPUB's series 2005A, 2008, 2012, 2013A, 2016 and 2018 revenue bonds issued by the city of Brownsville, TX on behalf of BPUB.

Fitch also affirmed the rating of approximately \$8.9 million water supply contract revenue bonds, series 2012 issued by the Southmost Regional Water Authority (TX) (SRWA) at 'A+'.

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

The Outlook is Stable.

Bond proceeds will be used to refund certain outstanding CP notes, refund certain outstanding utility system series 2012 and series 2013A bonds, and pay costs of issuance. The bonds are expected to price via negotiation on July 29, 2020.

ANALYTICAL CONCLUSION

The 'A+' rating reflects BPUB's continued strong financial profile, which is supported by the utility's strong operating cash flow, low leverage and healthy liquidity, all of which improved in fiscal 2019. The rating is also supported by the utility's strong revenue defensibility, as evidenced by its consistent customer growth and its independent ability to raise rates. Low electric operating costs reflect the utility's power supply dominated by economic fossil fuel-fired generation, although future reliance on the Electric Reliability Council of Texas (ERCOT) market could weaken Fitch's assessment of the utility's operating risk assessment to the extent rising market prices are not sufficiently mitigated.

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.

The outbreak of the coronavirus has created an uncertain environment for the public power and water and sewer sectors. While BPUB's performance through most recently available data has not indicated significant declines in overall system demand, material changes in revenue and costs could occur or worsen if economic activity suffers further and government restrictions are maintained or expanded. Fitch's ratings are forward-looking in nature, and Fitch will monitor developments

related to the severity and duration of the virus outbreak, and incorporate revised expectations for future performance and assessment of key rating drivers.

CREDIT PROFILE

BPUB is a component unit of the city of Brownsville, TX (AA-/Stable). Located on the north bank of the Rio Grande, about 25 miles inland from the Gulf of Mexico, the city is the county seat of Cameron County and a significant component of the robust Rio Grande Valley economy.

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 50,000 accounts. Utility system assets are owned by the city but operated, maintained and managed by BPUB. Total fiscal 2019 revenues of the combined system comprise approximately 79% electric revenues, 11% water revenues and 10% wastewater revenues. Each of the utilities included in the combined system is financially self-supporting and not reliant on transfers from other funds.

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 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.

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).

Revenue Defensibility: 'a'

Combined Utility with Mixed Demographic Trends

BPUB's revenue defensibility is assessed as strong. Demand for utility services is stable, driven by continued customer growth, but income levels and unemployment rates remain much weaker than the national average. Wholesale electric revenues accounted for 9.7% of BPUB's total 2019 revenues, up from the prior four-year average of 5.7%. However, wholesale sales are considered opportunistic, and Fitch does not view this as a limitation on BPUB's revenue defensibility assessment. The utility has the independent ability to raise rates, which are competitive in relation to the state average.

Operating Risk: 'a'

Low Operating Cost Burden

Operating costs remain low, reflecting a power supply dominated by economic coal and gas-fired resources. Fitch assesses BPUB's operating cost flexibility as neutral, based on the current power supply, but operating flexibility could weaken in the future to the extent that BPUB's increased reliance on ERCOT resources is not sufficiently mitigated against market prices. BPUB maintains adequate water supply, and treatment capacity remains sufficient at the utility's water and wastewater facilities.

Financial Profile: 'a'

Financial Profile Remains Strong

BPUB's fiscal 2019 leverage ratio, as measured by net adjusted debt to adjusted funds available for debt service, strengthened in fiscal 2019, as the utility's operating cash flow improved and debt continued to amortize. Leverage is expected to rise slightly in the near term as the utility partially debt finances its expanded capital improvement plan, but Fitch expects the leverage ratio will remain supportive of the financial profile assessment.

ASYMMETRIC ADDITIONAL RISK CONSIDERATIONS

No asymmetric additional risk considerations affected this rating action.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade:

--Given weaker service territory metrics, sustained declines in leverage well below 6.0x;

--Declines in electric operating costs below 10 cents/kWh that are 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 costs;

--An increase in leverage above 8.0x.

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 BPUB's combined utilities system, which includes electric, water and wastewater services. BPUB has 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 are unconditional obligations and senior to BPUB's debt service.

REVENUE DEFENSIBILITY

Nearly all of BPUB's revenues are derived from provision of its retail utility services. Wholesale electric sales represent close to 9.7% of total fiscal 2019 operating revenue, but do not constrain revenue defensibility. 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. BPUB's projections conservatively assume wholesale sales will account for approximately 4% of total revenues. The utility sells wholesale water to three water distribution systems under contract that accounted for 5.4% of its total fiscal 2019 water revenues.

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 61% and 157% of the national averages, respectively. However, Fitch notes the weaker measures are somewhat offset - with respect to their effect on demand for utility services - by a lower cost of living in the service area.

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 affect 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.

Strong Rate Flexibility

The City Commission of Brownsville maintains the independent ability to set its electric, water and wastewater rates, which Fitch views favorably. Electric rates remain very competitive, as evidenced by residential rates that represent approximately 92% of the state average. However, rate flexibility is limited by the service area's weaker income levels. Residential electric costs account for approximately 3.8% of the service territory's median household income levels, which Fitch assesses at midrange affordability.

Historical Rate Adjustments and Rate Relief

BPUB's base rates have remained unchanged over the past three years, with the most recent electric and water rate increases implemented in fiscal 2017, and the most recent wastewater rate increases implemented in fiscal 2015. This period of

unchanged rates follows a five-year period of rate adjustments that commenced in fiscal 2013 that included multiple rate increases for each of the three utilities.

While no rate adjustments have occurred or been approved since that time, BPUB implemented its rate mitigation plan in fiscal 2016, which provided rate relief to electric customers using the mechanism of the monthly fuel and purchased power charge. The decision to offer rate relief through this mechanism could be reversed at BPUB's discretion.

BPUB is in the midst of completing a water and wastewater rate study, which is expected to outline rates for the next five years. Management expects to complete the rate study in 2020, with any recommended rate changes implemented starting in 2021.

OPERATING RISK

BPUB's electric system operating cost burden remains low, at 13.9 cents/kWh in fiscal 2019, despite increasing in recent years. The utility's unit operating costs have steadily increased over the past five years, from 9.6 cents/kWh in fiscal 2015. BPUB attributes the trend to higher benefit and pension costs, as well as higher maintenance expenses in fiscals 2018 and 2019. Additionally, fiscal 2019 includes increased depreciation expenses related to the early closure of the Oklaunion Power Station. Fitch expects these costs to decline substantially following the planned closure of the plant in October 2020.

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 flexibility is considered neutral. BPUB's 378MW power supply is sufficient to meet its peak load of 294MW in fiscal 2019, with 318MW expected in fiscal 2020. The utility's power supply is diversified across coal, gas and wind resources and is supplemented with market purchases. Owned facilities include BPUB's 18.0% share (124MW) in the coal-fired Oklaunion Units No. 1 and 2, BPUB's 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 Oklaunion facility will be retired in October 2020, pursuant to a Sept. 19, 2018 motion passed by the vote of two owners with a greater than 60% combined share of the plant. The City Commission of Brownsville authorized BPUB to dispose of its ownership interest in September 2018, pursuant to a third-party analysis of the effect on its electric system. In prior years, Oklaunion provided around 40% of BPUB's energy supply, but given the influx of low-cost renewables and lower natural gas prices in recent years, BPUB has purchased lower cost energy through the ERCOT-organized energy market. BPUB plans to replace the retiring coal units with market purchases sufficient to meet its peak load.

BPUB operates in the ERCOT market, which experienced historically narrow reserve margins in 2019, at 8.3% during the summer of 2019. While ERCOT's reserve margin is expected to grow to 12.6% in 2020 and remain above 14% through 2025, Fitch believes BPUB's increased reliance on market purchases could expose it to price risk, if not otherwise mitigated. Market purchases accounted for approximately 14% of BPUB's energy requirements in fiscal 2019, but BPUB projects market purchases will account for approximately a quarter of BPUB's energy requirements following the closure of the Oklaunion facility.

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 9.3MGD 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 moderate, based on a Fitch-calculated average age of plant of 12 years. BPUB's ratio of capex/depreciation drifted lower in fiscal 2019 due to the accelerated depreciation of the Oklaunion facility, which will be retired October 2020.

BPUB's capex is expected to remain elevated over the next three years as the utility completes the construction of its administration building annex, in addition to other electric, water and wastewater system improvements. Approved combined system five-year capital improvements through fiscal YE 2024 total \$227 million. Operating cash flow historically accounted for approximately 50% of BPUB's capex, although the utility is currently reviewing its water and wastewater rates, which may affect future budgeting and funding source allocation for its capital improvement plan. BPUB also plans to use state loans, grants and contributions to supplement its capital improvement plan funding sources.

FINANCIAL PROFILE

BPUB's financial profile continued to improve in fiscal 2019. Leverage declined to 5.0x in fiscal 2019, from 6.2x and 6.4x in fiscals 2017 and 2018, respectively. The decline resulted from improved operating cash flow in fiscal 2019 and continued amortization of the utility's debt. Coverage of full obligations in fiscal 2019 improved to 1.8x, up from the prior three-year average of 1.5x, as wholesale energy sales increased. BPUB's liquidity profile has remained strong, at 177 days at YE 2019, and is neutral to Fitch's assessment of BPUB's profile.

FAST 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 2024. BPUB's projections assume 1% annual energy sales growth, and operating revenues assume no rate increases at any of BPUB's utility systems. The base case indicates some weakening of net leverage over the near term due to an expanded capital improvement plan over the next three years. Funds for the capital improvement plan will come from operating cash flow and planned debt issuances, in addition to state loans and grants. Management anticipates using its CP program to provide short-term interim financing for its capital improvement plan.

While the recent coronavirus pandemic has not resulted in a significant decline in BPUB's overall system demand, Fitch applied additional sensitivities to BPUB's budgeted results to consider a more sustained slowdown resulting from pandemic-related economic slowdown. Fitch assumed a stress of 9% decline in energy sales in fiscal 2021, followed by recoveries of 5%, 3% and 1% in fiscals 2022, 2023 and 2024, respectively. Fitch also assumed a stress of a 4% decline in water and wastewater sales in fiscal 2021, followed by annual recoveries of 2%, 1% and 1% in fiscals 2022, 2023 and 2024, respectively. The stress was overlaid on BPUB's projected utility system sales starting in fiscal 2021. Under the sensitized base case, BPUB's leverage rises to 7.4x in fiscal 2021 due to the decline in energy sales and increased capital spending, but is expected to decline in subsequent years as energy sales recover and capex returns to historical levels.

BPUB's debt profile is neutral to the rating. The \$332.8 million outstanding as of Sept. 30, 2019 consists primarily of fixed rate revenue bonds and \$37.5 million CP. Fitch's fiscal 2019 leverage calculation also included approximately \$73.3 million in other obligations, including pension obligations and capitalized fixed charges for purchased power obligations.

ASYMMETRIC ADDITIONAL RISK CONSIDERATIONS

There are no asymmetric additional risk considerations that affected the rating outcome.

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

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies).

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APPLICABLE CRITERIA

[Public Sector, Revenue-Supported Entities Rating Criteria \(pub. 27 Mar 2020\)](#)
(including rating assumption sensitivity)

[U.S. Public Power Rating Criteria \(pub. 30 Mar 2020\) \(including rating assumption sensitivity\)](#)

APPLICABLE MODELS

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

FAST Public Power - Fitch Analytical Stress Test Model, v1.1.3 (1)

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Utilities and Power US Public Finance North America United States

