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CREDIT OPINION
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Brownsville Public Utility Board, TX

Update to credit analysis

Summary

Brownsville Public Utility Board's (A2 stable) credit profile benefits from ample liquidity and strong financial ratios yet is constrained by a service area with an above average poverty rate and structurally high unemployment. The ramp up in cash flow in recent years follows a series of rate increases for the utility's planned acquisition of a 25% ownership interest in a 800 MW natural gas combined cycle power plant being developed by Tenaska. However, the project has been put on hold due to unfavorable market conditions for constructing this type of facility. The enterprise's debt ratio is below average at 33%, but if the project proceeds, management expects to issue about $225 million to finance Brownsville's share. This represents an 85% increase over currently outstanding debt. How the potential new debt is structured; the retail rate impact of the project and how it fits into the competitive energy marketplace are future rating considerations.

Credit strengths

» BPUB has demonstrated a willingness to adequately raise rates in anticipation of future capital projects while outperforming financial forecasts

» Recent rate increases resulted in the accumulation of a robust 556 days cash on hand

» The utility benefits from ERCOT's nodal pricing due to BPUB's facilities located in the congested north while its users are in the south, resulting in additional revenue

» The $100 million commercial paper program provides low cost initial funding for capital projects and could be used for working capital

Credit challenges

» Leverage will significantly increase due to a planned natural gas generation project if the project moves forward, accompanied by possible construction risk and wholesale power market risk

» Possible increased reliance on market based revenues to meet budget may lead to lower credit metrics in the future if market based margins are not realized

» Rates for the commercial customers in the electric system are very high compared to the state average and could discourage commercial development

Rating outlook

The stable outlook is based on our expectation that BPUB will maintain strong liquidity and coverage levels that provide a key mitigant to the ongoing capital projects necessary to ensure system capacity is maintained to accommodate projected growth.

Factors that could lead to an upgrade

» Sustained economic expansion and median income growth

» Maintenance of strong financial margins exclusive of off-system sales after completion of the Tenaska project

Factors that could lead to a downgrade

» Significant increase in wholesale power market exposure

» Assumption of unmitigated construction risk through the Tenaska project

» Deterioration of financial performance, such that fixed obligation charge coverage (FOCC) ratio and days cash on hand fall below 1.5x and 300 days on a sustained basis

Key indicators

Exhibit 1

Brownsville Public Utility Board, TX

	2013	2014	2015	2016	2017
Total Sales (mWh)	1,279,496	1,300,589	1,276,414	1,300,029	1,320,697
Debt Outstanding ($'000)	307,585	306,483	293,832	278,564	279,650
Debt Ratio (%)	39.4%	38.1%	35.7%	33.0%	33.1%
Total Days Cash on Hand (days)	512	447	479	525	556
Adjusted Debt Service Coverage (x) (Post Transfers/PILOTs - All Debt)	1.87	2.01	2.58	2.30	1.87
Fixed Obligation Charge Coverage (if applicable)(x)	1.79	1.93	2.45	2.20	1.80

Source: BPUB annual financial statements; Moody's Investors Service

Profile

BPUB is wholly owned by the City of Brownsville (GO rated Aa3) and provides electric, water, and wastewater utility services to the City of Brownsville and surrounding areas. The system operates a fully integrated electric generation, transmission, and distribution system, and approximately 96% of the city and all of the developed areas of the Port of Brownsville are within its singly certified area.

Detailed credit considerations

Revenue generating base: Improving economy; relatively low income customer base

Although improving down from double digits as recently as 2013, Brownsville's unemployment rate remains above average at 6.7% as of March 2018, compared with the state rate of 4.1% for the same period. According to Moody's Economy.com, secular trends such as a favorable age structure and high birth rate will support the Brownsville-Harlingen economy over the long-term. The metro area's fast growing healthcare sector in particular will benefit due to demand for medical services. Additionally, rising oil prices are good for rig production, which represents the largest share of factory jobs. Still, median family income is 58% and 56% of the state and nation, respectively, and relatively low educational attainment and a large base of immigrant labor will prevent meaningful gains in closing the gap.

BPUB's peak electric demand was at about 284 MW in fiscal 2017. Electric sales rose 2% in fiscal 2017, mostly due to rising residential demand, and represented 77% of total operating revenue. Water and wastewater sales were 12% and 11% of revenues, respectively.

Electric, water and waste water sales are not overly reliant on the top ten customers, who account for 15%, 13% and 8%, respectively, of the revenues for each utility. The introduction of wind is diversifying the enterprise's resource profile. The board recently entered into a power purchase agreement (PPA) for a wind project with a 78 MW nameplate capacity and began selling energy from the project in fiscal 2016. The board's generation capacity as of fiscal 2017 stood at 58% gas, 33% coal and 9% wind. Its energy mix is 32% gas, 24% coal, 20% wind and 24% market purchases.

Operational and financial performance: Coverage and liquidity bolstered by rate increases

BPUB's FOCC moderated to 1.80x in fiscal 2017 compared with a recent 2.45x peak in fiscal 2015 mainly because of fluctuations in revenues from off-system sales and rate stabilization expenses associated with a bill reduction plan that was initiated in fiscal 2016. Fiscal 2018 is projected to end with FOCC of 2.92x. New bonds for the Tenaska Brownsville project will likely dilute coverage.

Moody's calculation of FOCC is based on net revenues of the combined electric, water and wastewater system. The annual net transfer to the city is treated as an operating expense. In addition, the annual debt related payment to the Southmost Regional Water Authority (A2 stable) is adjusted as a debt service payment rather than an operating expense. This adjustment is due to the take-or-pay nature of the contract, along with the fact that the board is required to purchase any other defaulting minority member's share of the plant should they not pay. The board also operates the plant and has a 92.91% ownership interest.

During fiscal 2017, the board implemented the last of the five approved annual rate increases in order to fund the purchase of 200 MW capacity from the Tenaska Brownsville project. Electric base rates were increased by 7% in fiscal 2017. A 6% water rate increase was also implemented. No rate increases were approved for the fiscal 2018 budget.

The Tenaska Brownsville project has been delayed due to unfavorable market conditions stemming from low natural gas prices and increasing wind generation that have hindered subscription progress on Tenaska's 600 MW share of the facility. Starting in fiscal 2016, the board implemented the bill reduction plan to set the fuel and purchased energy charge (FPEC) at a rate that maintains an average residential electric bill of $102 based on 1,000 kWh of electric consumption. The board reviews and adjusts the FPEC on a monthly basis. To supplement FPEC collections for the bill reduction plan, the board used $24.2 million in fiscal 2017 and $10.5 million in fiscal 2016 from excess cash flows generated by the rate increases.

Tenaska manages BPUB's wholesale energy market interactions. Cash flow and margins from wholesale activities resulted in moderate FOCC fluctuations in recent years. About 8% of total operating revenues for the combined utility were derived from off-system electric sales in fiscal 2016 followed by 4% in fiscal 2017. The board budgeted for off-system sales revenue to provide 3.4% of total revenue in fiscal 2018. This revenue stream benefits from the nodal market. BPUB's generation assets are located in the northern ERCOT zone which is more congested, whereas the actual service territory is in the southern zone near the Texas-Mexico border.

LIQUIDITY

Liquidity improved for the third consecutive year in fiscal 2017 to 556 days cash on hand and $202.3 million unrestricted and discretionary reserves, up from 525 days in fiscal 2016. Liquidity is projected to increase modestly at the end of fiscal 2018 as well. BPUB has a $100 million commercial paper program backed by a letter of credit (LOC) provided by MUFG Union Bank, N.A. (Issuer A2 stable/P-1). Access to this additional source of liquidity benefits the enterprise because it provides low cost initial funding for capital projects. However, we did not adjust days cash on hand to incorporate the commercial paper program because the LOC contains a material adverse change clause related to financial conditions.

BPUB's liquidity profile is well above the 200 days cash median for similarly rated utilities. The stronger liquidity partially mitigates the expected increase in leverage should the Tenaska Brownsville project go forward.

Debt and other liabilities: Planned natural gas project will result in significant additional leverage if approved

Debt outstanding totaled $279.7 million as of fiscal 2017, including $1 million in junior lien bonds as well as a $14 million commercial paper balance. This represents a low debt ratio of 33.1%.

Debt will significantly increase if the Tenaska Brownsville project moves forward. Management anticipates $225 million of debt will be needed to fund the utility's share of the project and ancillary infrastructure including a gas pipeline. Management has already set aside $29 million for BPUB's equity contribution. Construction has been delayed due to unfavorable market conditions for this type of plant.

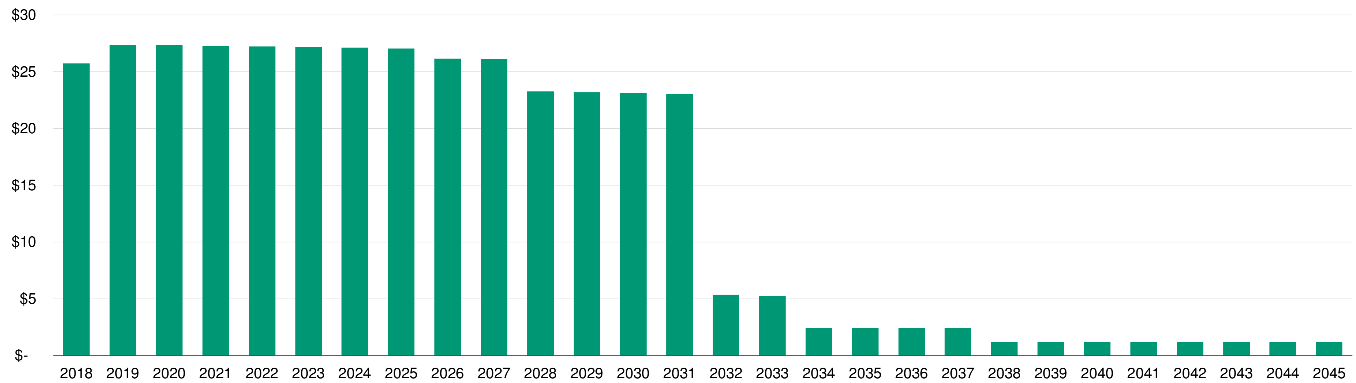
Exclusive of the Tenaska Brownsville project, the enterprise's five-year capital improvement plan identifies $160.2 million needed for projects through 2022 including $49.2 million for the electric system, $51 million for water and $60 million for wastewater. Of the total $160.2 million, approximately $93.3 million (58%) is expected to be debt financed.

DEBT STRUCTURE

All of the debt is fixed rate. Apart from a 6% increase to $27 million in fiscal 2019, annual debt service requirements are declining through final maturity in 2045.

Exhibit 2

Declining debt service structure mitigates impact of potential debt for Tenaska Brownsville project



Source: Moody's Investors Service; BPUB

DEBT-RELATED DERIVATIVES

None.

PENSIONS AND OPEB

BPUB participates in the nontraditional, joint contributory, hybrid defined benefit pension plan administered by the Texas Municipal Retirement System (TMRS). Moody's adjusted net pension liability (ANPL) for the system, under our methodology for adjusting reported pension data, is $106.4 million. This is higher than the reported net pension liability of $34.6 million. The adjusted debt ratio, which includes the ANPL, is 46.3% which is in line with similarly rated peers.

Moody's ANPL reflects certain adjustments we make to improve comparability of reported pension liabilities. The adjustments are not intended to replace BPUB's reported contribution information, or the reported liability information of the plans, but to improve comparability with other rated entities.

Management and governance

BPUB was formed in 1960 to provide electric, water, and wastewater services to its customers in the Brownsville area. The City's charter provides that the management, operation, and control of the City's combined water, wastewater, and electric utilities system be delegated to BPUB. The Board is comprised of seven members, six of whom are appointed by the City Commission for four-year terms, and the seventh member being the City's Mayor serving Ex-officio.

Rating methodology and scorecard factors

The grid is a reference tool that can be used to approximate credit profiles in the industry in most cases. However, the grid is a summary that does not include every rating consideration. Please see US Public Power Electric Utilities With Generation Ownership Exposure for information about the limitations inherent to the grid.

Exhibit 3

Methodology Scorecard

Factor	Subfactor	Score	Metric
1. Cost Recovery Framework Within Service Territory		Baa	
2. Willingness and Ability to Recover Costs with Sound Financial Metrics		A	
3. Generation and Power Procurement Risk Exposure		A	
4. Competitiveness	Rate Competitiveness	Baa	
5. Financial Strength and Liquidity	a) Adjusted days liquidity on hand (3-year avg) (days)	Aaa	520
	b) Debt ratio (3-year avg) (%)	Aaa	34%
	c) Adjusted Debt Service Coverage or Fixed Obligation Charge Coverage (3-year avg) (x)	Aa	2.15
Preliminary Grid Indicated Rating from Grid Factors 1-5		**A2**	
		Notch	
6. Operational Considerations			
7. Debt Structure and Reserves			
8. Revenue Stability and Diversity			
Grid Indicated Rating		**A2**	

Source: Moody's Investors Service

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