FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Brownsville PUB, TX's Utilities System Bonds and Bank Notes at 'A-'; Outlook Positive

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Fitch Ratings - Austin - 06 Nov 2024: Fitch Ratings has affirmed the rating on the following bonds issued by the city of Brownsville, TX on behalf of the Public Utilities Board (BPUB) at 'A-':

--Approximately $222.745 million utility system revenue bonds, series 2005A, 2008, 2013A, 2016, 2018, 2020, 2020A, 2022, and 2022A.

Fitch has also affirmed the $100 million bank note rating for the subordinate lien commercial paper program, series A, issued by the city of Brownsville, TX on behalf of the BPUB at 'A-.

Fitch has additionally affirmed the approximately $4.865 million water supply contract revenue bonds, series 2012 issued by the Southmost Regional Water Authority (SRWA) at 'A-'.

Fitch assess BPUB's standalone credit profile (SCP) at 'a-'.

The Rating Outlook is revised to Positive from Stable.

RATING ACTIONS

ENTITY / DEBT	RATING	PRIOR
Southmost Regional Water Authority (TX)		

Southmost Regional Water Authority (TX) /Water Supply Contract Revenues/1 LT	LT	A- Rating Outlook Positive	Affirmed	A- Rating Outlook Stable
Brownsville Public Utilities Board (TX)				
Brownsville Public Utilities Board (TX) /Electric System Revenues - 3rd Lien/3 LT	LT	A- Rating Outlook Positive	Affirmed	A- Rating Outlook Stable
Brownsville Public Utilities Board (TX) /Electric System Revenues/1 LT	LT	A- Rating Outlook Positive	Affirmed	A- Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

The 'A-' rating and 'a-' SCP reflect the utility's solid financial profile and Fitch's improved view of the operating risk profile for all utilities participating in the Electric Reliability Council of Texas (ERCOT) regional market. BPUB produced robust operating cash flows during the past two years, with coverage of full obligations approximating 2.0x in fiscals 2022 and 2023.

The strong operating margins are primarily due to substantial water and wastewater rate increases implemented during the past two years. The rate increases are part of the utility's broader five-year rate plans approved by BPUB's city commission for the water and wastewater systems, which commenced in June 2022. The rating considers the continued implementation of approved water and wastewater rate increases during the next two years, in addition to the electric utility's ability and willingness to fully recover its fuel and purchased power costs on a timely basis.

BPUB's operating risk profile remains strong, reflecting the utility's low operating cost burden and Fitch's improved view of the ERCOT regional market. Fitch had previously constrained the operating risk assessment for all Fitch-rated ERCOT-based electric utilities. This action was due to certain ERCOT operating risks — including natural gas delivery concerns, counterparty risk and price volatility — all of which were exposed during the Winter Storm Uri in February 2021.

However, the PUCT and ERCOT officials have taken steps to limit future potential operational and financial risks to utilities through additional winterization requirements, a robust inspection program, increased attention on the timing of scheduled plant outages, large-load demand response incentives, protocols to strengthen grid operations and reserve availability, improved communication regarding conservation during tight conditions, and a reduction in the market price cap (from $9,000/MWh to $5,000/MWh).

Fitch's ratings further consider the lower operating risk of the water and wastewater operations which allows the utility to accommodate slightly higher leverage levels than electric utility peers that operate solely with generation and retail electric service business lines.

The Positive Outlook reflects the Fitch's expectation that the BPUB's leverage profile, which was 4.6x at FYE 2023, will remain below 8.5x in Fitch's rating case over the next five years. While BPUB's capital spending is expected to increase over the near- to medium-term, Fitch believes the utility maintains ample headroom on its leverage metric at the current rating. Sustained outperformance of the utility's budget, driven by further improvement in operating income, would likely result in positive rating action.

The SRWA rating is linked to BPUB's rating, given its 92.91% 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.

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.

KEY RATING DRIVERS

Revenue Defensibility - 'a'

Demand for utility services remains strong and stable, driven by continued customer growth, but income levels and unemployment rates across the service area remain much weaker than the national average, constraining Fitch's revenue defensibility assessment to 'a'.

The utility has the independent ability to raise rates, which Fitch views favorably. While rates are competitive in relation to the state average, weaker income levels challenge the utility's affordability metrics. BPUB is currently undergoing an electric cost of service study and management anticipates it will present its board with an electric rate plan in mid-2025 based on the forthcoming results of the study.

BPUB is also in the midst of implementing a five-year water and wastewater rate plan, which commenced on June 1, 2022. The rate increases were based on BPUB's previous rate study, which aimed to ensure rates fully recovered the cost of services provided. Cash flow from the rate increases -- which range from 4% to 9% annually -- partially fund BPUB's expanded capital improvement plan. Concurrent with the rate increases, BPUB also began 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 matched with federal funding,

Operating Risk - 'a'

Fitch assesses BPUB's operating risk profile at 'a', reflecting the utility's low operating cost burden which have approximated 13.3 cents per kilowatt hour (kwh) during the past two years.

The operating cost flexibility assessment is revised to neutral from weaker, reflecting Fitch's improved view of the ERCOT marketplace. The ERCOT marketplace experienced a significant market disruption following Winter Storm Uri, including natural gas non-deliveries, and electric price volatility, in addition to counterparty risk.

Since then, the Texas Legislature passed multiple bills during its 2023 legislative session aimed at improving ERCOT system reliability and resiliency, most notably authorizing the use of $10 billion in state budget surplus to support a loan program for dispatchable generation projects. While ERCOT may still face tight supply or even outages during shortterm extreme weather periods, the risk of market dislocation and financial impacts of the magnitude experienced in 2021 appear to be materially reduced.

Fitch believes BPUB's neutral operating cost flexibility is somewhat tempered by the utility's reliance on market purchases to meet its projected peak system demand. BPUB's owned generation and power purchase agreements provided the utility with 311MW of capacity in fiscal 2023, which is slightly above its 2023 peak load of 308MW. However, demand is projected to rise to close to 314MW over the next five years under management's baseline scenario and BPUB's current resource plan does not include resource additions through fiscal 2026. The utility is in the process of updating their integrated resource plan, which they expect to complete in April 2025.

Economic market purchases accounted for more than a quarter of BPUB's energy requirements in fiscals 2020 and 2021, but declined to 13% in fiscals 2022 and 2023 as the utility's owned generation and power supply agreement were more heavily relied upon. BPUB projects economic market purchases will provide 6% of energy requirements over the next five years, as the utility relies more heavily on two power purchase agreements (PPAs) with American Electric Power (AEP) to meet projected demand. 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, reliance on market purchases exposes the utility to price risk.

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. Projects include electric substation and transformer improvements and advanced metering infrastructure for the electric and water utility system, as well as general maintenance and rehabilitation projects. Approved combined system capital improvements through fiscal YE 2028 are expected to average $53 million annually over the next five years, well above the five-year historical annual spend of $31 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 70% over the next five years as the utility continues to implement its five-year water and wastewater rate plan. BPUB also plans to use state loans, grants and contributions to supplement its capital improvement plan funding sources.

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

Financial Profile - 'a'

BPUB's financial metrics were very strong in fiscal 2023 as operating cash flows remained robust. Financial metrics have consistently outperformed the utility's budget in each of the past two years as BPUB's wholesale sales exceeded projections and actual capex remained substantially lower than budgeted.

Water and wastewater operating revenues have grown at a compound annual growth rate of 15% and 10%, respectively during the past two fiscal years, as the utility continued to implement its five-year water and wastewater rate plan. Fitch-calculated coverage of full obligations (COFO) remained at 2.0x in fiscal 2023, in line with the utility's COFO during fiscal 2022.

BPUB's improved operating cash flows partially funded the utility's capital plan. The utility also used its cash reserves to finance its capital expenditures, which has contributed to the utility's declining liquidity levels. BPUB's days cash on hand declined to 92 days at FYE 2023 from 118 days at FYE 2022, but is still considered neutral to the assessment.

Fitch expects BPUB's financial metrics could weaken slightly over the next five years as the utility's projected operating cash flows decline, but Fitch believes the utility's leverage profile will likely remain below 7.0x in a baseline scenario. Management conservatively projects weaker operating cash flows over the next five years due to assumed inflationary pressures on the utility's operating and maintenance costs. Fitch applied a haircut to BPUB's capital plan in the scenario analyses, given budgeted expenditures have historically outpaced the utility's actual spending.

Fitch believes leverage could peak above 8.5x under a demand stress scenario, but Fitch expects BPUB would likely implement timely rate increases to ensure operating cash flows improved and leverage metrics returned lower over the medium- to long-term. However, additional capital expenditures, absent rate increases in a stress scenario, could pressure BPUB's leverage metrics.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--A sustained increase in leverage above 10.0x in Fitch's rating case scenario;

-- An inability or unwillingness to increase utility system rates following an increase in power supply or other operating costs, or an expansion of the utility's capital plan;

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

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

--A sustained decline in leverage below 8.5x in Fitch's rating case;

--Consistent outperformance of BPUB's budgeted and forecasted operating cash flows;

--Maintenance of a low electric operating cost burden that is sufficiently insulated from a rise in ERCOT market prices.

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 revenues were comprised of approximately 77% electric revenues, 13% water revenues and 10% wastewater revenues during fiscal 2023. 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.

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 is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

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APPLICABLE CRITERIA

U.S. Public Sector, Revenue-Supported Entities Rating Criteria (pub. 12 Jan 2024) (including rating assumption sensitivity)

U.S. Public Power Rating Criteria (pub. 08 Mar 2024) (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, v3.1.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

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

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