Bryan Utilities Rural Electric System, Texas

Revenue Bonds

New Issue Report

Ratings

New Issues

$19,145,000 Rural Electric System Revenue Improvement Bonds, Series 2018	AA–

Outstanding Debt

$1,005,000 Rural Electric System Revenue Bonds, Series 2011	AA–
$14,945,000 Rural Electric System Revenue Refunding and Improvement Bonds, Series 2016	AA–

Rating Outlook

Stable

Key Utility Statistics

Fiscal Year Ended 9/30/17	
System Type	Retail Electric
NERC Region	ERCOT
Annual Revenues ($ Mil.)	44.2
Debt Service Coverage (x)	3.43
Days Operating Cash	63
Equity/Capitalization (%)	71.2

NERC – North American Electric Reliability Corporation. ERCOT – Electric Reliability Council of Texas.

Related Criteria

U.S. Public Power Rating Criteria (May 2015)

Rating Criteria for Public-Sector Revenue-Supported Debt (February 2018)

Related Research

Fitch Rates Bryan Texas Utilities, TX's Rural Electric System Revs 'AA–'; Outlook Revised to Stable (November 2018)

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New Issue Details

Sale Information: $19,145,000 Rural Electric System Revenue Improvement Bonds, Series 2018 via negotiated sale the week of Nov. 12, 2018.

Security: The bonds are secured by net revenues of the rural electric system.

Purpose: Proceeds will finance distribution and transmission projects and related facilities, fund the debt service reserve and pay the costs of issuance.

Final Maturity: July 1, 2043.

Key Rating Drivers

Rural Electric System: The city of Bryan, TX's Rural Electric System (rural system) is a retail distribution system serving a largely residential customer base in a quickly growing service area. The rural system is an all-requirements customer of Bryan's city electric system (AA–/ Stable). The two systems are separately financed but share the same senior management and all administrative functions.

Expected Improvement in Financial Metrics: The upgrade to 'AA–' from 'A+' reflects the rural system's expected improvement in financial metrics and leverage over the near term. The significant reduction in operating costs that began in October 2018 will improve funds available for debt service (FADS), increase coverage and decrease leverage. Liquidity is also expected to increase over the near term to levels supportive of a 'AA–' rating.

Flexible Rate Structure: The system's rate structure includes two adjustable mechanisms tied to fuel costs and regulatory costs, including transmission charges. Fitch views the flexibility provided by the adjustable rate structure positively.

Load Growth: Fitch expects the area's significant development to continue driving load growth over the next several years. Electricity sales increased by 12.3% and 3.2% in fiscals 2018 and 2017, respectively. Customer concentration is not a significant rating concern.

Manageable Capital Needs: Planned issuances through fiscal 2022 are manageable and expected to be offset by growth in FADS, which should keep the system's leverage on a declining trend.

Rating Sensitivities

Weaker than Expected Financial Performance: Bryan rural system's inability to achieve the expected improvement in financial performance, including the expected increase in liquidity, could result in negative rating action.

Rating History

Rating	Action	Outlook/ Watch	Date
AA–	Upgrade	Stable	11/6/18
A+	Affirmed	Positive	6/6/18
A+	Affirmed	Stable	7/1/16
A+	Affirmed	Stable	5/22/15
A+	Affirmed	Stable	5/30/13
A+	Upgrade	Stable	6/14/11
A	Affirmed	Stable	10/22/09
A	Assigned	Stable	4/16/08

Credit Profile

Bryan is located approximately 90 miles west of Houston in Brazos County, and is considered a twin city of College Station. Bryan owns and operates two electric systems: the City Electric System (city system), which serves customers within city boundaries; and the rural system, which serves areas outside the city's borders. The combined systems are referred to as Bryan Texas Utilities (BTU). Each system, while operated by a common staff, is maintained separately for accounting and reporting purposes.

The rural system began operations in 1937 and provides electric service to approximately 21,100 customers. The rural system's service territory includes most of Brazos County, excluding the cities of Bryan and College Station, and parts of Burleson and Robertson counties in a radius of about 20 miles from Bryan.

The rural system is an all-requirements customer of the city system. The city system has sufficient capacity to meets its power needs, including those of the rural system, through its own natural gas-fired resources and long-term purchase power contracts.

Bryan reserves the right, but has no current plans, to merge the city and rural electric systems. The net revenues from the city electric system are not pledged as a repayment source for the bonds.

Governance and Management Strategy

BTU is managed by the Bryan Texas Utilities Board, which was established by the city council in 2001. The board is charged with managing the city and rural electric systems and making recommendations to the city council regarding budgets, rates and rate changes, and employing a manager for BTU, among other responsibilities. The board consists of seven members appointed to staggered three-year terms. Board members are drawn from diverse backgrounds and include customer representatives from the residential and commercial segments. The city council retains final authority in setting rates, issuing bonds and approving annual budgets.

Mr. Gary Miller became the permanent BTU general manager in February 2013 after serving as the interim manager since 2012. Mr. Miller has worked for BTU since 2005 and in the Electric Reliability Council of Texas (ERCOT) market for more than 20 years. Mr. Joe Hegwood, the CFO for both BTU and the city, started at BTU in 2006 and has extensive experience in the industry, both within and outside BTU.

Assets and Operations

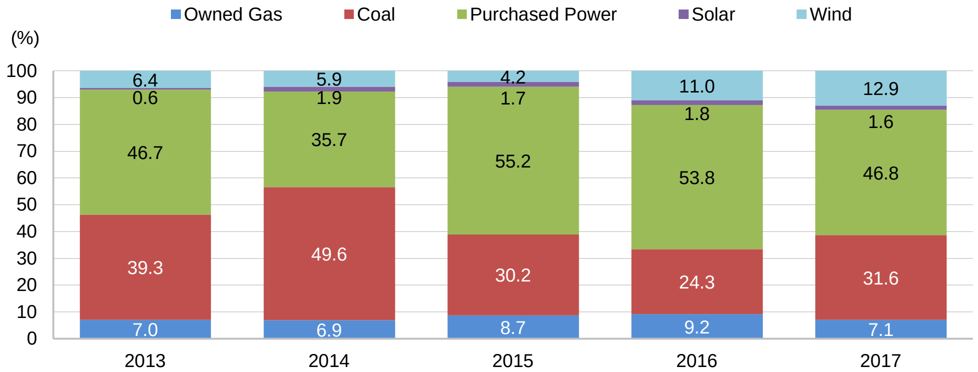
The rural system does not own any generation assets; all its power and energy needs are supplied by the city system. The city system recently completed its transition away from its partial ownership of a coal-fired power plant and diversified its power supply. Its current power supply mix consists of owned gas-fired resources and purchased power contracts.

TMPA — Gibbons Creek

Bryan, along with the cities of Denton, Garland and Greenville, created the join power agency Texas Municipal Power Agency (TMPA) in 1975. Through TMPA, the cities developed Gibbons Creek in Grimes County. The single-unit, coal-fired plant has a net capacity of 470MW and burns Powder River Basin coal. The city system has a 21.7%, or 102-MW, interest in Gibbons Creek.

The city's reliance on Gibbons Creek to meet its annual energy needs decreased as low natural gas prices and increased renewable generation in the ERCOT market made running the plant increasingly uneconomic. As shown in the chart below, Gibbons Creek provided approximately 32% of the system's energy — including Bryan's rural system — in fiscal 2017, compared with nearly 50% in fiscal 2014.

Bryan Texas Utilities Retail Power Supply
(Fiscals 2013–2017)



Note: Numbers may not add due to rounding.
Source: Bryan.

TMPA owns the coal plant and provided power to its four members under identical court-validated, take-or-pay power sales contracts (PSCs) that expired in September 2018. The PSCs financially obligated the members to pay certain expenses to TMPA, including its debt service costs, regardless of actual plant operations. These costs are paid as operating expenses, and therefore have priority over debt service payments. Bryan opted not to renew its PSC following its expiration in September 2018.

The four members approved a joint operating agreement (JOA) that became effective in September 2016. The JOA establishes the framework for the how TMPA and its assets and liabilities are to be managed following the expiration of the PSCs. TMPA's assets and operations are divided into three business lines under the JOA: generation, transmission and mining.

The JOA allocates costs, ownership interests, decommissioning and remediation responsibilities to members based on their participation share. Garland is the largest TMPA participant at 47.0%, followed by Bryan (21.7%), Denton (21.3%) and Greenville (10.0%).

TMPA is currently exploring the possibility of selling Gibbons Creek. If a sale were to occur, it would likely be viewed as credit neutral to positive for Bryan, as it would likely reduce the city's decommissioning liability. BTU replaced the portion of its power supply previously provided by Gibbons Creek at a lower cost through purchase power contracts.

Roland Dansby

BTU's primary natural gas-fired resource is the Roland C. Dansby Power Plant. The Dansby power plant is a three-unit power plant consisting of a 110-MW gas-fired steam turbine and two 48-MW simple-cycle gas turbines with a total capacity of 206MW. The power plant acts as a physical hedge for BTU's power supply and is used as a peaking to intermediate resource.

Management reports Dansby's operations were not affected by the August 2015 discovery of a crack in the Lake Bryan Dam, from which Dansby draws cooling water. The crack was stabilized in fiscal 2017 and management reports that no additional degradation was found.

Natural gas for the Dansby facility is procured by BTU in the spot and forward markets. BTU follows a gas-hedging strategy, whereby approximately 50% of the anticipated gas needs for the coming year are hedged as of Jan. 1. The relatively limited hedging of BTU's gas supply exposes the utility to additional commodity pricing risk. However, the exposure is somewhat offset by BTU's sound liquidity levels and the relatively limited role of BTU's natural gas resources in meeting its power supply needs.

PPAs

BTU entered into several purchase power agreements (PPAs) and forward market power purchases to meet the system's power needs. The forward market power purchases are with four separate counterparties for 2018– 2022 and largely replace the output previously received from Gibbons Creek. The 2018 purchases were shaped to match the time periods when Gibbons Creek was not actively being run. The city also executed forward market purchases for projected power needs from 2023 to 2027.

BTU will also receive power from PPAs that include a 15-year agreement signed in January 2011 for 30MW of wind energy from the Penascal 2 wind project and a 25-year agreement for 10MW of solar. BTU also receives 33% of the output from the 110MW from Los Vientos V under a 25-year PPA that began in December 2015. BTU most recently signed a 15-year solar PPA that begins in 2022.

Cost Structure

The rural system's rate structure mirrors that of the city system and consists of a base rate and two adjustable charges: a fuel-adjustment charge and a regulatory charge. Both of the adjustable charges can be modified at any time at the discretion of the board, without council approval. The regulatory charge is intended to capture Competitive Renewable Energy Zone-driven transmission costs plus any regulatory fines or fees imposed by agencies other than the city.

BTU completed a cost-of-service study in 2018 that showed no need for rate increases over the next several years. The main finding from the study is an approximately 38% rate reduction for the rural system implemented on Oct. 1, 2018. The significant rate reduction reflects the city system's much lower cost of power following the TMPA's cost reduction.

The rural system's rates are generally higher than those of the city system, but remain competitive with nearby electric utilities, including those of the neighboring city of College Station.

Financial Performance

The rural system's financial performance remained solid in fiscal 2017, with Fitch-calculated debt service coverage and coverage of full obligations at 3.43x and 1.37x, respectively. While coverage levels are viewed as sound for the rating, the rural system's liquidity levels are comparatively low at just 63 days cash on hand. However, as a distribution retail system with an all-requirements contract, the rural system's liquidity needs are more predictable relative to vertically integrated utilities with generation responsibilities or purchasing utilities that may have collateral posting requirements.

Financial performance in fiscal 2018, based on unaudited actuals, was generally in line with expectations. Net operating income came in modestly higher than budgetary expectations by approximately $360,000. Available cash balances at the end of the year were approximately $9.1 million, or about 78 days cash on hand.

Management's financial projections through fiscal 2023 reflect an expected improvement in financial performance, as purchased power costs declined significantly at the beginning of fiscal 2019 due to the 38% rate reduction. Cash balances, which ended fiscal 2018 higher than previously projected, are expected to generally continue building through fiscal 2023.

The rural system expects to issue $19.4 million in additional debt in fiscal 2022. Fitch expects leverage metrics will continue to decrease, even with the additional issuance due to the projected improvement in FADS stemming from operating cost reduction.

No Direct Transfers

The rural system does not make any general fund transfers. The city system makes a monthly transfer to the city's general fund in lieu of paying taxes.

Moderate Leverage

The rural system's leverage is manageable for the rating, with net adjusted debt to adjusted FADS of 5.9x at the end of fiscal 2017. Fitch expects leverage metrics to decrease beginning in fiscal 2019 as the lower purchased power costs result in higher operating margins and increased FADS.

The rural system's debt portfolio is relatively conservative, consisting entirely of fixed-rate parity revenue bonds and certificates of participation issued by the city of Bryan but repaid by the rural system.

Customer Profile and Service Area

The rural system provides electric services to a quickly growing, largely residential customer base of approximately 21,637 primarily located in Brazos County, excluding the cities of Bryan (served by the city system) and College Station. The service territory is dominated by residential and commercial customers, which make up 80% and 20% of total customers, respectively.

Although the system started as a rural system, the service territory is transitioning due to its proximity to College Station and the significant development activity taking place in Bryan. Annual customer growth averaged 5% from fiscal 2011 to fiscal 2017. Customer concentration is not a significant concern and residential customers accounted for the majority — 67% — of MWh sales in fiscal 2017.

MWh sales growth is significant, with increases averaging 5.6% from 2014 to 2017. Plans for further development in and around the city of Bryan and College Station are expected to generate additional growth in the area despite uncertainty regarding development activity at nearby oil and gas production projects. The expansion of Texas A&M University's RELLIS campus, which is in the rural system's service territory, could lead to a significant amount of load growth in excess of current expectations, depending on the timing of the development.

Financial Summary — Bryan Utilities Rural Electric System, Texas

($000, Audited Years Ended Sept. 30)	2013	2014	2015	2016	2017
DSC (x)					
DSC	6.06	4.40	4.95	4.52	3.43
Coverage of Full Obligations (PP as D/S and Transfer/PILOT/Dividend as O&M Expense)	1.48	1.38	1.42	1.37	1.37
Liquidity Metrics					
Days Cash and Investments on Hand	74	84	64	63	63
Days Liquidity on Hand	74	84	64	63	63
Leverage Metrics (x)					
Debt/FADS	2.7	2.5	2.0	4.4	3.7
Adjusted Debt (Including PP Adjusted)/Adjusted FADS (Including PP Adjusted)	6.0	6.0	5.8	6.8	6.4
Net Debt/Net Capital Assets (%)	5.5	5.5	8.2	11.8	14.0
Equity/Capitalization (%)	77.2	78.9	80.8	69.2	71.2
Other Financial and Operating Metrics (%)					
Operating Margin	9.4	8.2	9.1	6.5	7.5
Retail Electric Revenue/kWh (Cents/kWh)	9.1	9.3	9.7	10.6	10.9
Capex/D&A	322.8	235.1	289.2	280.2	266.7
Debt Service/Cash Operating Expenses	3.0	3.8	3.6	3.2	4.6
Income Statement					
Total Operating Revenue	32,257	35,728	39,287	41,931	44,225
Total Operating Expense	29,219	32,788	35,717	39,189	40,931
Operating Income	3,039	2,941	3,570	2,742	3,294
Adjustment to Operating Income	2,035	2,358	2,528	2,682	2,945
FADS	5,074	5,299	6,098	5,423	6,239
Total Annual Debt Service	837	1,203	1,231	1,201	1,817
Balance Sheet					
Unrestricted Funds (Cash and Liquid Investments)	5,547	7,047	5,859	6,277	6,589
Restricted Funds	9,759	4,988	2,312	10,901	9,125
Total Net Assets/Members' Equity	46,759	49,247	52,396	54,204	56,836
Total Debt	13,848	13,160	12,457	24,103	22,973
Cash Flow Statement					
FCF (FADS – Transfer and PILOT – Total Annual Debt Service)	4,236	4,096	4,867	4,222	4,422
Capex	6,416	5,371	7,092	7,399	7,665
FCF Less Capex	(2,180)	(1,275)	(2,225)	(3,176)	(3,243)

DSC – Debt service coverage. PP – Purchased power. D/S – Debt service. PILOT – Payment in lieu of taxes. FADS – Funds available for debt service.
D&A – Depreciation and amortization.
Source: Bryan, Fitch Ratings.

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.