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Ratings

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Loveland, Colorado; Retail Electric

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Credit Profile		
US$60.9 mil tax- exempt rev bnds ser 2019A due 12/01/2049		
Long Term Rating	A+/Stable	New
US$28.785 mil taxable rev bnds ser 2019B dtd 04/24/2019 due 12/01/2035		
Long Term Rating	A+/Stable	New

Rationale

S&P Global Ratings assigned its 'A+' long-term rating to the City of Loveland, Colo.'s electric and communications enterprise tax-exempt revenue bonds series 2019A and taxable revenue bonds series 2019B. The outlook is stable.

Loveland is issuing the bonds to construct a fiber-optic telecommunications system that will provide high-speed internet and phone services. The net revenue of both the electric and telecommunications system secures the bonds.

The rating reflects the application of our criteria "U.S. Municipal Retail Electric And Gas Utilities: Methodology And Assumptions," published Sept. 27, 2018 on RatingsDirect.

Loveland Water and Power (LW&P) serves Loveland and certain areas outside the city. The rating reflects our opinion of LW&P's strong enterprise risk profile and very strong financial risk profile. The strong enterprise risk profile reflects a predominantly residential customer base, competitive rates, a diverse resource portfolio, and a management team that annually produces financial projections and long-term capital improvement plans. The very strong financial risk profile reflects robust fixed-charge coverage (FCC), moderate liquidity, and a manageable debt-to-capitalization ratio. The rating also considers the uncertainties associated with the telecommunications system.

The enterprise risk profile reflects our view of LW&P's:

- Strong operational management assessment, highlighted by the purchase of electricity from the Platte River Power Authority's (PRPA) under an all-requirements, long-term contract (moreover, LW&P has an experienced management team that produces 10-year financial projections and a 10-year capital plan);
- Strong service area economic fundamentals, reflected by LW&P's collecting more than 40% of its revenue from residential customers, consistent growth in customer numbers year over year, incomes above the country's median, and low unemployment;
- Strong market position, with the weighted-average rate about 92% of the state average; and
- Extremely strong industry risk relative to other industries and sectors.

The financial risk profile reflects our view of LW&P's:

- Extremely strong coverage, with FCC that has averaged 1.96x over the past three audited fiscal years;
- Adequate liquidity and reserves, reflecting LW&P's ability to meet operating expenses for 98 days with more than $15 million in unrestricted cash and investments in fiscal 2017; and

- Strong debt and liabilities profile, evidenced by no direct debt in fiscal 2017, although with the issuance of debt in 2019 the debt-to-capitalization ratio will be around 30%.

The telecommunications system plans to connect its first customers in 2020. A number of uncertainties exist, including construction of the system itself, take rates, and competitive responses by commercial entities that offer internet, phone, and video services. In comparison with the general stability of public power electric utilities, the operating environment for telecommunications services is much more dynamic. If construction hits a roadblock, take rates are low, competitors aggressively counter LW&P's telecommunication offerings, or other problems arise, LW&P's overall financial performance could suffer.

Outlook

The stable outlook reflects our view of LW&P's residential customer base that provides a consistent and steady source of revenue, low rates that afford rate-raising flexibility if needed, and an all-requirements, long-term power supply. These factors offset the risks of providing telecommunications services that will compete against other providers in a dynamic marketplace.

Upside scenario

We do not expect to raise the rating over the next two years as LW&P undertakes a significant shift in its service offering. In 2020, LW&P will begin selling telecommunications services, and uncertainty surrounds how potential customers, as well as competitors, will respond to these new offerings, and what the financial impact might be. This uncertainty, which has implications for the electric system, constrains the rating.

Downside scenario

Although we are unlikely to do so, we could lower the rating if LW&P's financial projections for the combined electric and broadband enterprises result in substantially lower coverage than forecast. Moreover, significant unanticipated problems with the telecommunication system, such as cost overruns or unexpected capital needs, could also negatively affect the rating. Should these risks materialize, negative changes with the electric system could result, such as increased rates. The development of the telecommunications system carries a number of uncertainties whose outcomes are unlikely to be known for several years.

Utility Description And Credit Overview

LW&P is a distribution utility that has served the City of Loveland since 1925. The city is approximately 50 miles north of Denver and had a population of 79,188 in 2017. While 87% of LW&P's customers are residential, the utility receives significant revenue from commercial and industrial customers, including health care facilities.

In 2015, voters in Loveland approved a measure to give the city the option of providing broadband services; the city council provided final approval in 2018. With this bond issue, LW&P issues almost $90 million in debt to construct a telecommunications system that will enable the utility to sell high-speed internet and phone services. Loveland will offer symmetric upload and download speeds of as much as 1 gigabit per second. The system is expected to be entirely constructed by the end of 2022, with the potential to reach all homes and businesses within the city's boundaries.

While LW&P intends to pay the $90 million in debt with revenue generated from customers who sign up for the telecommunication services, the net revenue of the electric system is pledged to pay the bonds. Thus, the rating considers the potential impact on the electric system if the telecommunications system fails and the electric system must generate revenue to cover debt service and operating expenditures for the telecommunications system. In the worst-case scenario in which all $90 million is spent but the system fails (so no revenue is generated from selling internet or phone services), each electric customer would be charged an estimated $13 per month for 25 years, or roughly $3,900.

Enterprise Risk

Operational Management Assessment: Strong

LW&P obtains almost all of its electricity from PRPA, a wholesale electricity provider that also serves the cities of Estes Park, Fort Collins, and Longmont along the Front Range of the Rocky Mountains. LW&P has contracted for its electric energy supply from PRPA through Dec. 31, 2050. PRPA owns (or partly owns) the following generation units: 151-megawatt (MW) Craig Units 1 and 2 (coal), 280 MW Rawhide Unit 1 (coal), and 388 MW Rawhide Units A, B, C, D, F (natural gas). PRPA also has power purchase agreements (PPAs) with the following projects: 90 MW Western Area Power Administration (hydro), 6 MW Medicine Bow Wind Project, 60 MW Spring Canyon Wind Energy Center, 12 MW Silver Sage Windpower Project, and 30 MW Rawhide Flats Solar. The PPAs with the wind providers run for the next 10 to 20 years. The number and variety of PRPA-owned generation sources and PPAs provide LW&P a diverse power supply.

LW&P receives electricity from a variety of fuels. In 2017, LW&P's fuel mix was 73% coal, 15% hydro, 7% wind, 2% solar, 1% natural gas, and 3% unidentified. PRPA's 2019 projected deliveries are 65% coal, 18% hydropower, 8% wind, 6% purchases/other, 2% solar, and 1% natural gas. LW&P is fully compliant with environmental regulations. However, the amount of LW&P's electricity that is produced from coal exposes the utility to future carbon dioxide emission regulations. PRPA does intend to significantly increase the amount of renewables on its system over the next decade.

LW&P annually produces 10-year financial forecasts and a 10-year capital improvement plan; the utility undertook a cost-of-service study in 2017 and will conduct another one this year. We view these regularly completed plans favorably. Since 2016 LW&P has been required to keep 23% of electric operating expenses as a minimum fund balance; there is a city council directive to increase the minimum fund balance to 33% of electric operating expenses by 2029.

LW&P has produced 30-year financial projections for the telecommunications system under three different scenarios: a base case assuming a take rate of 42% for residential customers and 27% for businesses, a low case assuming a take rate of 32% for residential customers and 27% for businesses, and a high case assuming a take rate of 55% for residential customers and 27% for businesses. All of these scenarios implicitly assume that LW&P will succeed with its construction of the telecommunications system. Moreover, LW&P's base case take rate estimates are higher than the initial estimates of nearby communities that have developed or are developing similar telecommunication systems as

LW&P. While LW&P's base case take rate estimates were developed by two separate studies conducted by outside experts, it remains to be seen what percentage of customers will subscribe to LW&P's service offerings.

LW&P intends to begin offering internet and phone services in 2020, competing with Comcast and CenturyLink. LW&P plans to have 15 broadband employees in the first year of operation, 26 in year two, and 32 in year three; these employees will report to the fiber division manager. Given the take rate of 42% for residential customers and 27% for businesses, the broadband enterprise is projected to have positive net operating income in year five and net cash exceeding liabilities in year 21. However, the competitive decisions of LW&P, Comcast, CenturyLink, and possibly other companies offering substitutes will shape the marketplace. These decisions, as well as LW&P's ability to solve construction, managerial, and administrative problems, will determine when LW&P achieves positive net operating income and net cash exceeding liabilities. It will likely take several years before there is a well-informed sense of LW&P's equilibrium market share.

Economic fundamentals: Strong

In fiscal 2017, LW&P served 36,577 customers, with the vast majority residential. The utility has seen consistent growth in customer numbers over the past 10 years, averaging about 1.5% growth each year. Meanwhile, the number of kilowatt-hours sold each year has decreased slightly over the past five years. Residential customers account for about 42% of LW&P's revenue and 36% of sales, providing stability. Commercial customers account for 18% of revenue and 16% of sales, while industrial customers account for 40% of revenue and 49% of sales.

Income levels are slightly above the country's median. Moreover, the unemployment rate at 2.7% is considerably below the national rate. There is no customer concentration in the service area. LW&P's top 10 customers provide 17% of LW&P's revenue, while the top four customers provide 11%. Overall, the economic fundamentals of LW&P's service area are solid, in our view.

Market position: Strong

In 2017, LW&P's average electricity rate was 92% of that of other electricity providers in Colorado. Residential rates were 85% of the state's average, commercial rates were 100%, and industrial were 96%. The competitive rates provide LW&P with rate-raising flexibility. LW&P has been proactive in raising rates, doing so by 6.3% in 2015, 7.9% in 2016, 5.5% in 2017, and 3.6% in 2018. Management plans to raise rates by 5% in 2019 and 2020, after which annual rate increases will be in the 2%-3% range.

As part of LW&P's rate structure for all its customer classes, the utility collects a per-kilowatt-hour payment in lieu of taxes (PILOT). The PILOT is set at 7% of power sales. The explicit collection of the PILOT is a positive credit factor because LW&P should always collect the appropriate amount to transfer to the City of Loveland. On the other hand, LW&P does not have a production cost adjustment mechanism, and we view this negatively because the city is able to recover changes in fuel costs only through more drawn-out processes.

Industry risk: Extremely strong

Consistent with our "Methodology: Industry Risk" criteria (published Nov. 19, 2013), we consider industry risk for municipal retail electric and gas utilities covered under these criteria very low, and therefore extremely strong compared with that of other industries and sectors.

Financial Risk

Coverage metrics: Extremely strong

LW&P's FCC, which treats transfers to the city as an operating expense and a portion of PRPA's debt service as fixed costs, was 2.21x in fiscal 2017, 1.88x in fiscal 2016, and 1.78x in fiscal 2015. Coverage jumped in 2017 as net revenue after transfers increased. Over the three years, coverage averaged 1.96x. These coverage levels indicate that LW&P's net revenue after transfers, while accounting for fixed costs, is sufficient to cover debt service.

With the issuance of the 2019 bonds, LW&P will have its own debt service expenses that it has not had in the recent past. In particular, annual debt service will be $1.7 million in 2019, $3.6 million in 2020 and 2021, $5.2 million in 2022, and $6.9 million for years 2023 through 2042. Using LW&P's projected revenue and expenses for both electric and broadband operations (base case), we calculate FCC to range from 1.83x to 2.55x over the next five years. Even in a scenario in which no customers sign up for LW&P's telecommunication services, we still calculate FCC to exceed 1.6x. This indicates that the revenue from the combined electric and telecommunications systems should continue to provide sufficient coverage even under an extreme scenario.

Liquidity and reserves: Adequate

LW&P's unrestricted cash and investments totaled more than $15 million in unrestricted reserves, or 98 days' worth of operating expenses, in fiscal 2017. As a distribution-only operation, LW&P has sufficient liquidity to provide a moderate cushion to meet financial obligations, in our view. LW&P's reserves have steadily decreased from more than $21 million in 2015. Reserves are projected to remain around 100 days' worth of operating expenses over the next five years. The telecommunications system will have an additional $4 million rate stabilization fund that can be used for debt service or improvement of the telecommunications system.

Debt and liabilities profile: Strong

In 2017, LW&P had no direct debt. With the issuance of debt in 2019 we calculate that LW&P's debt-to-capitalization ratio, which measures debt as a percentage of the total debt and equity of the utility, will increase to roughly 30%. We believe this leverage is manageable for a distribution-only utility.

As an owner community of PRPA, LW&P is responsible for its portion of PRPA's debt service. In 2017, PRPA's total debt service was $27 million. LW&P is responsible for a 22% share of the debt service, or about $5.9 million in fiscal 2017. In our view, LW&P's share of PRPA's debt does not pose a risk to LW&P.

LW&P's employees participate in a defined contribution pension plan; LW&P has no unfunded pension liability.