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Lafayette (City of) LA Combined Util. Ent.

Update following subordinate lien upgrade to A2 and A1 assigned to senior Series 2019 revenue bonds

Summary

The Lafayette, LA Combined Utilities Enterprise (LUS; A1 stable) consistently maintains healthy financial metrics aided by timely rate increases. We expect the combined utilities system, which includes power, water and wastewater services, will maintain fixed obligation charge coverage ratios (FOCC) averaging around 1.9x and liquidity averaging above 250 days cash on hand. The service area economy is relatively stable, despite concentration in a still weak local oil and gas sector, and is anchored by the institutional presence of the University of Louisiana at Lafayette. These factors combine to keep system demand growth very modest. LUS' strengths are counterbalanced by reliance on coal-fired generation and the potential for increased leverage to fund MISO required capacity additions. Given the system's currently low debt burden, we think LUS can manage the estimated investment costs without significantly impairing credit quality.

The communications system's (LUS Fiber; A2 stable) operating record is improving and is generating good cash flow. LUS Fiber is moving further away from initial startup status and continues to acquire market share which has bolstered the credit profile. LUS Fiber has a much higher business risk profile which, unlike the combined utilities' monopoly service, has direct competition with other telecom providers. The higher risk factors are offset by a backstop of net revenues from LUS that is subordinate to the combined utilities' revenue bond debt service.

Credit strengths

» Unregulated rate-setting ability for the combined utility and automatic fuel cost adjustments allow for timely and adequate cost recovery

» Strong track record of base rate adjustments to accommodate higher costs

» Strong liquidity

Credit challenges

» Need for increased leverage and future construction risk associated with building of the new capacity to replace Doc Bonin power plant

» Exposure of the communication system business to competitive pressures

» Local economy is still concentrated in large part in the oil industry with potential economic volatility caused by industry changes

Rating outlook

The stable outlook reflects stable demand within the service territory and Moody's expectation that LUS will maintain strong financial metrics as it manages its capital plan. The outlook also reflects Moody's expectation that LUS Fiber will maintain self-sufficiency with healthy debt service coverage ratios.

Factors that could lead to an upgrade

» Sustained economic expansion and diversification with growth in higher-wage, non-energy segments

» Successful implementation of investments to address long-term capacity needs while the combined utilities system maintains FOCC and days cash on hand in excess of 2.0x and 250 days, respectively

Factors that could lead to a downgrade

» Deterioration of financial performance resulting in FOCC falling below 1.75x on a three-year average basis

» Communication system operations weaken resulting in diminished self-sufficiency

Key indicators

Exhibit 1

LAFAYETTE (CITY OF) LA COMBINED UTILITIES ENTERPRISE

LAFAYETTE (CITY OF) LA COMBINED UTILITIES ENTERPRISE	2014	2015	2016	2017	2018
Total Sales (mWh)	2,027,115	2,050,434	2,027,945	1,980,653	2,031,847
Debt Outstanding ($'000)	237,865	226,365	214,410	195,915	184,110
Debt Ratio (%)	30.6	28.9	27.3	25.4	23.5
Adjusted Days Liquidity on Hand (incl. Bank Lines)(days)	238	282	277	263	278
Fixed Obligation Charge Coverage (if applicable)(x)	1.80	1.81	1.55	1.70	1.96
LUS Fiber - Adjusted Debt Service Coverage (x) (Post Transfers/PILOTs - All Debt)	1.46	1.29	2.08	1.51	1.65

Source: Moody's Investors Service

Profile

The City of Lafayette, LA is located in southern Louisiana approximately 30 miles from the Gulf of Mexico and has an estimated population of 126,848. The City is the owner of the Lafayette Combined Utility System, which includes the LUS Electric System, the Water System, the Wastewater System as well as the Communications System. The electric, water and wastewater systems primarily serve within the city but also on a limited basis to some areas outside city limits. LUS served approximately 70,000 accounts in 2018. The communications system offers fiber leases, wholesale broadband and retail customer services. On the retail side, the communications system offers “triple play” services: Cable television, internet and telephone.

Detailed credit considerations

Revenue generating base: Utility service demand is stable while fiber market share expands

Lafayette's service territory demonstrates a good degree of resiliency, but the economy took a hit from the oil and gas downturn that began in 2014. Anecdotally, some energy firms are hiring again but the area will probably not recover all of the energy related jobs lost. Many of these higher paid workers left to pursue opportunities in Lake Charles and Houston. The metro area unemployment rate tracked below the nation prior to the oil price collapse and now hovers between 4.6%-5% compared with the national rate of 3.8%.

Meanwhile, the “eds and meds” segment of the economy is a stabilizing force. The University of Louisiana at Lafayette is the second largest university in the state and currently enrolls approximately 19,000. Lafayette General Health is the largest employer with 4,245 workers and is the largest health system in the south-central Louisiana region including Baton Rouge. It staffs 475 beds and recently became one of only four Level II trauma centers in the state. The university and Lafayette General are the two largest LUS electric customers. LUS' customer base composition is diversified with the top ten customers representing at most about 10% of retail revenues and no single customer represents more than 5%. We expect these factors and the underlying economic trend will keep system demand growth flat to very modestly positive. Indeed, LUS' capital planning forecast includes a compound annual growth rate of less than 1% for retail sales over the next ten years.

ELECTRIC

The electric system represents the largest share of LUS operations at about 77% of revenues. LUS has been a full market participant in the Midcontinent Independent System Operator (MISO) since 2013. The market is buy-all/sell-all, meaning that LUS purchases all of its energy needs from MISO and dispatches generation into the market as power sales. The system consists of generation, transmission, substation, distribution and customer facilities within and outside of the service territory. The generation fleet includes two natural-gas fired plants: Hargis Herbert and TJ Labbe for a combined operating capacity of 171 MW. The largest source of generation however is the 225 MW Rodemacher Unit 2 (RPS2) coal-fired power plant. RPS2 is owned by the Lafayette Public Power Authority (LPPA; A1 stable), a joint action agency for which LUS is the sole take-or-pay participant. LPPA has a 50% ownership interest in RPS2. The other co-owners are CLECO and LEPA. LUS also has a PPA for 6 MW of hydro.

LUS does not have enough long-term capacity to meet MISO requirements. While options for additional capacity are being explored, LUS entered into four short-term capacity contracts expiring in 2019 and 2020 to remain in compliance with MISO. One option identified in a 2016 integrated resource plan (IRP) is to install natural gas fired reciprocating engines at the the retired Doc Bonin plant site. The estimated cost would be about $120 million. LUS is planning another IRP that will compare this with other long-term capacity options. We expect LUS to make the necessary capacity investments within the next couple of years.

The joint owners of RPS2 are evaluating the plant's long-term operation. The plant was originally designed with the capability for conversion from coal to natural gas. While the conversion is assumed to occur at some point within the plant's useful life, current operations and performance do not require it in the near term. Since LUS became a MISO participant, RPS2 became less competitive as natural gas prices declined. The annual plant capacity factor averaged 46.4% over the last four years. However, recent cost savings on coal transportation improved the plant's underlying economics. As a result, RPS2 was dispatched more during fiscal 2018, further delaying the need for conversion.

WATER AND WASTEWATER

Water and wastewater represent 9% and 14%, respectively, of LUS revenues. LUS provides water services on a retail and wholesale basis. All of its raw water supply needs are sourced from the Chicot aquifer. The system includes two water treatment plants each capable of treating over 20 MGD, 20 underground wells, elevated and ground treated-water storage and 1,170 miles of distribution piping. During 2018, the system average day demand was 23.1 MGD and peak demand was 33.8 MGD. The wastewater system is comprised of a wastewater collection system, four wastewater treatment plants at various locations throughout the city, and waste sludge management and disposal facilities. Total combined permitted treatment capacity for the four plants is 18.5 MGD. Collection volumes vary based on weather events. Average daily collection in fiscal 2018 was 14.6 MGD.

COMMUNICATIONS SYSTEM

Despite a very competitive landscape, LUS Fiber has become more established since initially offering retail services in 2009, and we expect expansion progress will continue. The system provides fiber leases, wholesale broadband and retail customer services to over 27,000 individual premise locations over 70 mile fiber backbone system with direct connections to national Tier 1 broadband providers, 145 miles of distribution fiber, and 539 miles of access fiber. On the retail side, LUS Fiber offers the “triple play” of cable television (CATV), internet and telephone services.

The system continues to acquire market share. LUS Fiber attained franchise status in November 2017, allowing it to offer communications service outside the city and unincorporated areas in the parish. LUS Fiber recently expanded to offer services in the Cities of Broussard, Youngsville and Carencro. Between fiscal 2013 and 2017, the LUS Fiber target market share grew from 31.9% to 38.4%.

Financial operations and position: Consistently strong finances while maintaining competitive rates

We expect LUS to maintain healthy financial metrics including FOCC ratios averaging 1.9x over the near term. Management has a good track record of implementing timely rate increases while keeping rates competitive with regional peers. Fiscal 2018 ended with an FOCC ratio of 1.96x, according to unaudited results, representing an improvement over fiscal 2017 which ended at 1.70x. Moody's FOCC calculation includes General Fund transfers ("ILOT" payments to the city) as operating expenses. Debt service on LUS' take-or-pay obligation payment to LPPA is netted from operating expenses and added to direct debt service.

LUS benefits from rate-setting authority that is not subject to external regulation. Residential and commercial rates are competitive and are about 6%-7% below the state average. Following a 2016 rate study, the Lafayette Public Utilities Authority (LPUA), consisting of City-Parish Council members whose districts represent 60% or more of citizens residing within city limits, approved rate increases over the last couple of years ahead of the current sale. The ten-year planning period assumes no base electric rate increases. However, we think that will likely change once the city makes a formal decision on long-term capacity investment. Water and wastewater rates will increase 2% annually between fiscal years 2021 and 2028. Wholesale water rate increases of 8% will go into effect bi-annually between fiscal years 2021 and 2027. Another rate study will be performed within the next year which will analyze cost of service and the potential addition of an industrial rate class.

Moody's stressed FOCC by adding the communication system's debt service, which has a subordinate lien on combined utility net revenues, to LUS debt service, resulting in still satisfactory ratios of 1.28x and 1.48x for fiscal 2017 and 2018 (unaudited), respectively. This stress does not include revenues from the communications system nor does it include amounts held in the LUS Capital Additions Account which would be drawn first in the waterfall if a "credit event" occurs and triggers the subordinate lien pledge. The Capital Additions Account balance in the utility system fund totaled $96 million in fiscal 2017.

LUS Fiber is self-supporting and generates good debt service coverage ratios. We calculate the system's ratios at 1.51x and 1.65x in fiscal 2017 and 2018, respectively. This includes imputed tax payments (ILOTs going forward) as operating expenses and payments on interfund loans as debt service. These loan payments are subordinate to debt service and represent reimbursements to LUS for the transfer of its fiber optic network assets to the Communications System Enterprise Fund as well as funds advanced for start-up costs and an operating loan. The balance of these loans was $27 million as of fiscal 2017 and will be fully repaid in 2033.

Unlike the combined utilities system, which benefits from monopolistic service, LUS Fiber has direct competition with other providers including Cox Communications, Dish, AT&T, kaptel, REACH4, and HughesNet. LUS Fiber offers favorable rates and has won awards for speed and price savings.

LIQUIDITY

The combined utilities system has good liquidity with an average days cash on hand of 274 over the last three years including unaudited fiscal 2018 results. LUS will continue to build liquidity over the next few years, although this could change if management decides to use cash to fund investments in long-term capacity. We expect the capital improvement plan will be updated in the next year or so to reflect City Council's decision on recommendations in the next IRP. The communications system ended fiscal 2017 with an estimated 215 days cash on hand. Going forward, we expect the communications system will maintain satisfactory liquidity between 150 and 200 days cash on hand over the next few years based on projected cash flows and capital spending plans.

Debt and other liabilities: Potential for additional leverage to finance capacity needs

Post sale, the system will have approximately $244.3 million of revenue bonds outstanding, representing a still low debt ratio of about 32%. The communications system's revenue bonds currently total $96.8 million. LPPA has $78.5 million of revenue bonds outstanding.

DEBT STRUCTURE

All of the debt is fixed rate. LUS debt service will increase from $21.4 million in fiscal 2018 to $25.5 million in 2020. Thereafter, annual requirements are relatively flat before falling by more than half in 2030 when the Series 2012 bonds mature. Final maturity of all debt is in 2045.

Communication debt will average around $9.4 million over the next few years before increasing to $10.6 million in fiscal 2022 and staying flat through maturity. All of the communications system revenue bonds mature by 2031 and interfund loans will be repaid by 2033. Management currently does not foresee any new money issuance plans for LUS Fiber over the next several years as cash flows are currently sufficient to fund capital needs while maintaining satisfactory reserve balances.

The waterfall structure places LPPA's debt as the first priority given that the take-or-pay obligation is made as an operating expense ahead of LUS debt service. Debt of the combined utilities system is structurally superior to the communications system. The communications system's revenues are not pledged to the combined utility system's debt.

DEBT-RELATED DERIVATIVES

None.

PENSIONS AND OPEB

Moody's adjusted net pension liability (ANPL) for LUS as of fiscal 2017 was $85 million compared with a reported net pension liability of $32 million. Employees participate in the Municipal Employees' Retirement System of Louisiana-Plan A and Parochial Employees' Retirement System of Louisiana-Plan A, both of which are multi-employer cost sharing plans. The main difference between the reported net pension liability and Moody's ANPL is the discount rate applied. The reported net pension liability is based on 7.4% for MERS and 7% for PERS. Moody's ANPL reflects discount rates of 3.87% and 4.14% for the systems, respectively.

Management and governance: Governing authority for consolidated government to split in 2020

While LUS manages the combined utility, The Lafayette Public Utilities Authority (LPUA) and the Lafayette City-Parish Council are the legislative governing bodies of the combined utility system. City-Parish Council members whose districts include 60% or more of citizens residing within city boundaries also serve as LPUA members. In December 2018, voters approved amendments to the home rule charter, most notably the separation of the legislative body into a separate City Council and Parish Council effective January 2020. The newly formed City Council will replace the LPUA as the governing authority for LUS and LPPA.

LUS regularly makes in lieu of tax (ILOT) payments to the City's general fund. The amount is capped by bond ordinance at 12% of the previous fiscal year's gross revenues, and the transfer can only be made if 7.5% of non-fuel revenues have been set aside for capital additions and improvements. Historically, ILOT payments have averaged around 10% of revenues.

Other considerations: Mapping to the grid

The senior lien reference rating maps to the grid indicated outcome. The grid is a reference tool that can be used to approximate credit profiles in the government owned toll road sector in most cases. However, the grid is a summary that does not include every rating consideration. Please see the methodology on US Public Power Electric Utilities with Generation Ownership Exposure published in November 2017 for more information about the limitations inherent to grids.

Exhibit 2

US Public Power Electric Utilities with Generation Ownership Exposure Rating Methodology Factors

Factor	Subfactor	Score	Metric
1. Cost Recovery Framework Within Service Territory		A	
2. WIlingness and Ability to Recover Costs with Sound Financial Metrics		Aa	
3. Generation and Power Procurement Risk Exposure		Baa	
4. Competitiveness	Rate Competitiveness	A	
5. Financial Strength and Liquidity	a) Adjusted days liquidity on hand (3-year avg) (days)	Aaa	274
	b) Debt ratio (3-year avg) (%)	Aaa	27.20%
	c) Adjusted Debt Service Coverage or Fixed Obligation Charge Coverage (3-year avg) (x)	A	1.69x
Preliminary Grid Indicated rating from Grid factors 1-5		**A1**	
		Notch	
6. Operational Considerations		0.0	
7. Debt Structure and Reserves		0.0	
8. Revenue Stability and Diversity		0.0	
Grid Indicated Outcome:		**A1**	

Source: Moody's Investors Service

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