

FITCH UPGRADES LOWER COLORADO RIVER AUTHORITY, TX'S RATING TO 'A+' ON CRITERIA CHANGE

Fitch Ratings-Austin-09 July 2019: Fitch Ratings has upgraded the rating on Lower Colorado River Authority's (LCRA) refunding revenue bonds and bank note rating (CP series B) to 'A+' from 'A'. The upgrade reflects LCRA's favorable operating risk assessment and leverage profile in the context of Fitch's revised rating criteria 'U.S. Public Power Rating Criteria' released April 3, 2019.

Fitch had designated the rating as 'Under Criteria Observation', or UCO on April 9, 2019, following the publication of Fitch's revised rating criteria. The UCO designation has been removed and resolved.

Fitch has also assigned an 'A+' Issuer Default Rating (IDR) to Lower Colorado River Authority.

The Rating Outlook is Stable.

ANALYTICAL CONCLUSION

The rating upgrade is based on the application of Fitch's new criteria and reflects LCRA's very strong revenue defensibility, low operating risks and Fitch's view of the authority's financial profile under new criteria. Strong revenue defensibility is derived from wholesale power supply contracts that extend through 2041, albeit with sizable load-release provisions, and the independent legal ability of LCRA and its 33 wholesale customers to raise electric rates.

Fitch considers the purchaser credit quality of LCRA's largest three wholesale customers as very strong based on their customer growth levels, robust service area characteristics, retail rates that are competitive and affordable, and adequate financial profiles. LCRA's largest customer, the Pedernales Electric Cooperative, is rated 'AA-/Stable and accounts for just over half of LCRA's wholesale power revenues.

Operating costs are very low, reflecting both the costs of LCRA's generation fleet, accompanied by low available energy prices with the regional ERCOT (Electric Reliability Council of Texas) market in recent years that can be used to replace the variable costs of LCRA's own resources, when economic. LCRA's financial profile improved in fiscal 2017 with the scheduled decline in debt service that coincided with the termination of certain customer contracts. LCRA's financial profile is expected to remain stable through Fitch's forward base and rating case scenarios with leverage increasing slightly with planned transmission capital additions, and liquidity and coverage levels in the range of fiscal 2018 levels.

CREDIT PROFILE

LCRA is the largest public power wholesale provider in Texas and provides energy services in a 44 county service area. LCRA provides wholesale power to 33 municipal electric utilities and electric distribution cooperatives in central and west Texas. The authority also manages and distributes water supply and controls flooding along the lower Colorado River in Texas. LCRA's consolidated revenue consists primarily of wholesale electric revenue, which provided approximately 55% of total combined revenue in fiscal 2018. Transmission revenue provided 40% of consolidated revenue but is separately pledged to transmission revenue bondholders. Water and irrigation services provided the remaining revenue. LCRA maintains a public service fund fulfilling the authority's statutory obligations such as parks and natural resource protection. The public service fund is supported by the three business lines of wholesale power, transmission and water.

KEY RATING DRIVERS

Revenue Defensibility: 'aa'; Wholesale Power Contracts with Load Release; Strong Purchaser Credit Quality

Revenue defensibility is very strong in that revenues are predominantly provided by wholesale power sales to customers in service areas that have not provided retail customers the option for retail choice. Wholesale power contracts that extend through 2041 and the legal ability to raise rates provide LCRA with a reliable revenue base. The purchaser credit quality of LCRA's wholesale customers is very strong with financial profiles supportive of the 'A+' rating.

Operating Risk: 'a'; Very Low Operating Costs; Tightening Regional Reserve Margin

LCRA has maintained very low operating costs of around 4.5 cents per kilowatt hour (kWh) over the past five years, as calculated by Fitch. The cost profile has benefited from declining gas prices and the increasing availability of inexpensive renewable energy in ERCOT. Fitch views operating flexibility as weaker based on the low reserve margin in the ERCOT market, which constrains the operating risk assessment to 'a'.

Financial Profile: 'a'; Stable Leverage; Robust Liquidity

LCRA's consolidated financial profile improved in fiscal 2017, reflecting a scheduled decline in generation debt service. Coverage of full obligations was over 1.3x in fiscals 2017 and 2018 and liquidity is robust. Leverage, measured by net adjusted debt to adjusted funds available for debt service (FADS) has been declining slowly to 7.4x at the end of fiscal 2018, even with additional debt issuance for transmission construction. Fitch's rating case indicates that leverage will range between 7.4x-8.8x through a moderate stress scenario.

Asymmetric Additional Risk Considerations: None

RATING SENSITIVITIES

Operating Costs and Flexibility: Positive rating action could result from an improvement in LCRA's operating risk profile as evidenced by consistent operating costs coupled with a return to higher ERCOT reserve margins.

Decline in Leverage: LCRA's generation debt, secured under the Master Resolution, should continue to decline. Deleveraging over time could also result in upward rating movement.

SECURITY

LCRA's revenue refunding bonds, issued pursuant to a master resolution, are secured by all lawfully available funds of LCRA, including but not limited to funds received from LCRA Transmission Services Corporation (LCRA TSC) for its contractual commitment. Generation-related debt matures in 2040, although there is a small amount of parity debt related to the water business line maturing in 2045.

Around \$126 million at the end of fiscal 2018 are paid through a contractual commitment by LCRA TSC. LCRA TSC is a wholly owned subsidiary of LCRA and issues separately secured debt.

Revenue Defensibility

LCRA's strong revenue source characteristics reflect its wholesale power contracts with 33 customers, none of whom have opted in to retail competition as permitted in ERCOT at the option of municipal and cooperative electric utilities. The contracts were renegotiated with customer from the original termination date of 2016 and extended to 2041. Not all of LCRA's original 43 customers extended their contracts.

Wholesale Power Agreement Load Release Provision

Contractual load release provisions in the renegotiated contracts allow customers to reduce purchases from LCRA over time by up to 35% of the total load. In fiscal 2019, twelve of LCRA's customers exercised this option, and approximately 15% of LCRA's customer load is being served by other suppliers as permitted. This provision has the potential to impact LCRA's rate, but LCRA's ability to recover its full costs remains undiminished, albeit on a potentially lower amount of sales to each of its customers.

As customers have exercised this option of the past five years, LCRA's revenue recovery has remained intact as rate setting allocates fixed costs over the total amount of kWh being sold, even as it may become smaller with the load release. In 2019, one of LCRA's customers exercising load release began to bring load back to LCRA, which Fitch views as an indication of improvement in the competitiveness of LCRA's rates relative to other market alternatives within ERCOT.

Rate Flexibility

LCRA charges a consistent rate to all electric customers, which is reestablished each year. The statutory rate covenant in the LCRA Act requires the authority to set rates sufficient to cover all expenses, including debt service and maintain reserves. LCRA's board established financial policies requiring rates set to recover 1.25x of debt service.

LCRA's wholesale rate consists of the fuel and purchased power component and the nonfuel component. Operation within the ERCOT market requires the purchase of all energy through the market to meet the authority's long-term contractual load obligations. LCRA may dispatch energy and ancillary services from owned and contracted generation resources into the market, based on market price signals. The wholesale revenue provided by this activity acts as an offset to the purchase power costs incurred to purchase energy for wholesale customers. The remaining net amount, either excess revenue or balance due, is billed or credited to the wholesale customers on a monthly basis through the fuel rate. Improved wholesale sales will directly benefit contract customers by offsetting the non-fuel rate. The fuel rate recovers commodity price volatility and variable costs related to generation assets not offset through market sales of excess energy. The fuel component of LCRA's rates has enjoyed a decline in the last five years, as has been the case across ERCOT, due to very low natural gas prices and increased availability of low cost energy.

The nonfuel rate component includes fixed costs, such as labor costs not related to fuel procurement, operation and maintenance costs, debt service and generation system contributions to the public service fund equal to 3% of non-fuel costs. The nonfuel rate is typically established annually as part of the budget process but the nonfuel rate component can be changed according to the terms of the wholesale power agreements with a 60-day notice to customers. The fuel rate component can be changed with 30 days notice.

Purchaser Credit Quality

LCRA's very strong purchaser credit quality is represented by the credit quality of its three largest customers, which Fitch evaluates as having a purchaser credit index of '1.35'. Pedernales Electric Cooperative (AA-/Stable), Bluebonnet Electric Cooperative and Bandera Electric Cooperative account for 78%, in aggregate, of wholesale power sales in 2018. The three largest members

exhibit strong abilities to absorb rate increases, primarily through their independent ability to set distribution rates. Service area characteristics include strong annual customer growth of over 6% for Pedernales, and between 2%-3% for Bluebonnet and Bandera. Pedernales in particular, has strong income and unemployment characteristics given the portions of its service area in Williamson and Hays counties that include suburban growth on the west side of Austin and San Antonio. These two counties account for over half of Pedernales' customers even though it services 24 counties across Texas.

Operating Risk

LCRA's operating cost burden (total operating costs in relation to kWh sales) averaged a very low 4.5 cents per kilowatt hour over the past five years ending in fiscal 2018, although the trend has edged upwards over the last two years from a low point of 3.8 cents in 2016 to 4.2 cents in 2018 (all cents per kilowatt hour metrics calculated by Fitch). This low cost includes LCRA's legacy generation assets and contracts which include coal and gas-fired generation and six hydroelectric plants providing electric generation and flood control along the Lower Colorado River. The authority's total owned resources, and approximately 104MW purchased power agreement (PPA) for capacity at the Sandy Creek Energy Station, provide a net dependable capacity of around 3,400 MW. This compares with a winter peak demand of 3,069MW in 2018, providing a 12% reserve margin, in comparison with the 13.5% reserve margin targeted by ERCOT and the 8.6% reserve margin projected by ERCOT system-wide in summer 2019.

Fitch views operating cost flexibility as weaker given the ERCOT market's slight 8.6% reserve margin in 2019, short of ERCOT's own minimum target of 13.5%. LCRA's physical generation provides a degree of price protection against price spikes that may occur as a result of shortages during peak times.

Capital Planning and Management

Fitch views LCRA's capital requirements as moderate based on Fitch's estimate of its age of plant and its capital investment in relation to depreciation. LCRA's \$2 billion consolidated five-year capital plan (2019-2023) will be largely used to fund transmission projects (\$1.3 billion of the total), the majority of which will be debt funded. Transmission investment costs are recovered through LCRA's approved transmission rate from the PUCT and collected from transmission users across the entire ERCOT system. Wholesale power needs are modest and will be funded entirely from cash flow.

Financial Profile

The authority exhibits adequate consolidated coverage metrics with Fitch-calculated coverage of full obligations of over 1.3x in fiscals 2017 and 2018. However, these consolidated coverage ratios include the LCRA TSC affiliate, which is not pledged to bondholders, and has healthier margins improving consolidated coverage levels. Coverage levels are in compliance with LCRA's board policy of achieving 1.25x DSC on a consolidated basis. Coverage levels were aided by the scheduled debt service decline to \$102 million in fiscal 2017 from around \$160 million in fiscal 2016. Financial margins returned to levels consistent in the years prior to fiscal 2014, when the effect of customer departures placed pressure on financial margins.

Consolidated liquidity remained robust during the past five years. Consolidated cash and investments increased to \$637.2 million in fiscal 2018 from \$330 million in fiscal 2014. Days cash on hand increased to 372 days from 169 days in fiscals 2018 and 2014, respectively. The cash balances include \$200 million that LCRA has designated for the defeasance of master resolution debt in fiscals 2019 and 2020. LCRA maintains liquidity facilities and CP programs providing additional liquidity for construction and market trading activities.

Leverage has improved incrementally with the addition of cash reserves offset by additional transmission debt. Consolidated net adjusted debt/adjusted FADS was 7.4x in fiscal 2018. The authority's consolidated debt burden is increasingly weighted toward transmission debt (58% of outstanding debt in fiscal 2018 up from 45% ten years prior) as generation debt amortizes and LCRA TSC continues to finance new projects with debt.

Fitch Base Case and Rating Case

Fitch's analysis indicates the expectation for a modest increase in leverage in the base case, and rating case stress scenario leverage that ranges between 8.0x and 9.0x through 2023. Additional transmission capital projects are anticipated to drive the leverage trends.

Fitch's base case analysis assumes average future load growth of 2% per annum. Fitch assumes cost of power to grow at the same rate. Electric operating revenues assume no non-fuel rate increases, but allow for additional transmission revenues assumed to occur with a transmission rate case in 2023. Base case capital spending and debt issuances mirror LCRA's own business plan projections, which Fitch considers reasonable.

Fitch's rating case applies stress by imposing reductions to energy sales for two years, followed by a three-year recovery based on historical energy sales trends. The rating case holds other expense growth to the base case level. The rating case indicates that LCRA's financial profile remains stable through the rating case, with leverage rising as a result of the imposed stress in the initial years prior to recovering in the outer years.

Contact:

Primary Analyst
Kathryn Masterson
Senior Director
+1-512-215-3730
Fitch Ratings, Inc.
111 Congress Avenue
Austin, TX 78701

Secondary Analyst
Tim Morilla
Director
+1-512-813-5702

Committee Chairperson
Dennis Pidherny
Managing Director
+1-212-908-0738

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

Media Relations: Sandro Scenga, New York, Tel: +1 212 908 0278, Email: sandro.scenga@thefitchgroup.com.

Additional information is available on www.fitchratings.com

Applicable Criteria

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 28 May 2019)

<https://www.fitchratings.com/site/re/10064680>

U.S. Public Power Rating Criteria (pub. 03 Apr 2019)

<https://www.fitchratings.com/site/re/10066654>

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: [HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](https://www.fitchratings.com/understandingcreditratings). IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. DIRECTORS AND SHAREHOLDERS RELEVANT INTERESTS ARE AVAILABLE AT [HTTPS://WWW.FITCHRATINGS.COM/SITE/REGULATORY](https://www.fitchratings.com/site/regulatory). FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

Copyright © 2019 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001

Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the "NRSRO"). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see <https://www.fitchratings.com/site/regulatory>), other credit rating subsidiaries are not listed on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.