New Issue: Moody's assigns Baa1 to LIPA's planned Series 2015 direct placement bonds; outlook stable

Global Credit Research - 26 May 2015

Approximately $200 million of revenue bonds rated

LONG ISLAND POWER AUTHORITY
Electric Distribution and Generation
NY

Moody's Rating

<table>
<thead>
<tr>
<th>ISSUE</th>
<th>RATING</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electric System General Revenue Bonds, Series 2015 A-2</td>
<td>Baa1</td>
</tr>
<tr>
<td>Sale Amount</td>
<td>$149,000,000</td>
</tr>
<tr>
<td>Expected Sale Date</td>
<td>06/05/15</td>
</tr>
<tr>
<td>Rating Description</td>
<td>Revenue: Government Enterprise</td>
</tr>
</tbody>
</table>

| Electric System General Revenue Bonds, Series 2015 A-1 | Baa1 |
| Sale Amount | $51,000,000 |
| Expected Sale Date | 06/05/15 |
| Rating Description | Revenue: Government Enterprise |

Moody's Outlook STA

NEW YORK, May 26, 2015 --Moody's Investors Service assigned a rating of Baa1 to the Long Island Power Authority's (LIPA) planned direct placement of approximately $200 million Electric System General Revenue Bonds Series 2015A (MMD FRN Rate). Proceeds will be used to refund a like amount of variable rate debt. Concurrently, Moody's affirmed the Baa1 rating on approximately $5 billion of parity senior revenue bonds outstanding, and the Baa2 rating on approximately $200 million of subordinate lien bonds outstanding along with the Baa1 and Baa2 ratings of its like parity bank bonds. The rating outlook for LIPA is stable.

SUMMARY RATING RATIONALE

The Baa1 rating for LIPA’s senior revenue bonds reflects its smooth transition to operations under PSEG Long Island (PSEG-LI), and our assumption that this relationship will continue to provide benefits as PSEG-LI has taken the lead in areas such as resource planning, fuel procurement, and rate case filings. The rating considers LIPA’s improved liquidity position and our expectation that cash flow credit metrics will remain near their current levels as LIPA and PSEG-LI work through their first multi-year rate review cycle with the Long Island Office of the New York Department of Public Service (DPS).

The ratings and stable outlook recognize the benefit of commitments LIPA has received at both federal and state levels to assist with continuing storm hardening investment, to limit increases in payments in lieu of taxes, and to provide for a potential lowering of interest cost through another securitization. These efforts have helped to limit the size of the rate increases LIPA and PSEG-LI have proposed as necessary to provide for continued investment in operational and systems improvements while maintaining or potentially improving financial metrics. The economic strength and size of LIPA’s service territories in the Long Island counties of Nassau and Suffolk continue to be a primary positive factor underpinning the rating.

OUTLOOK

The stable outlook incorporates our expectation customer satisfaction with PSEG-LI will continue to increase, that
the proceedings for the three year rate plan filed on January 30, 2015 will proceed relatively smoothly and in a timely fashion, and that LIPA will be successful in implementing various cost recovery and revenue decoupling mechanisms that will increase the predictability of its cash flows.

WHAT COULD MAKE THE RATING GO UP

- The rating is well-positioned and not expected to move upward over the near term.

- Longer term, a sustainable improvement in credit metrics. For example, if the fixed obligation charge coverage were to remain above 1.20 and its days of liquidity on hand (including CP availability) were to be maintained at or over 120 days.

- Establishment of a meaningful debt service reserve for the revenue bonds.

WHAT COULD MAKE THE RATING GO DOWN

- An increase in operating costs or capital expenditures incurred or undertaken without a commensurate increase in revenue resulting in a weakening of credit metrics, for example if coverage of fixed obligation charges was expected to remain below 1.10x on a sustained basis could result in downward pressure on the rating.

- A board approved budget or rate case outcome that is not consistent with maintaining or improving financial metrics, a protracted rate case process or the establishment of final rates that are not consistent with maintaining or improving financial metrics

- Liquidity strain, caused perhaps by delays in the receipt of anticipated state or federal grant income, a decline in cash receipts or a spike in operating costs such that days of liquidity on hand were to decline sustainably below 50.

STRENGTHS

- Economic strength and size of the service territory
- Ability to obtain federal funding for storm related expenditures
- Potential for improved operating efficiency and customer service under operations by PSEG-LI

CHALLENGES

- Relatively weak liquidity and financial credit metrics
- Required rate case filings with New York DPS
- Need to implement system improvements while rates remain under political scrutiny

RECENT DEVELOPMENTS

On May 14, 2015 the (DPS) Staff filed testimony on LIPA’s proposed three-year (2016-2018) rate plan. As discussed later in this report, although the Staff is recommending a rate increase that is only about a quarter of the amount proposed by LIPA and PSEG-LI, the vast majority of the adjustments pertain to items that would be subject to automatic true-ups in the event actual expenses deviate from assumptions. Importantly, Staff was generally supportive of LIPA and PSEG-LI’s proposed methods of establishing rates, including the use of numerous automatic adjustment mechanisms and targeted fixed obligation coverage levels.

In April 2015, John McMahon, LIPA’s chief executive, announced his resignation after two years of service. McMahon came to LIPA in the wake of Hurricane Sandy after more than thirty-five years at Consolidated Edison, Inc. He shepherded the utility through several major transitions, including its ongoing recovery from the storm, the passage of the LIPA Reform Act, and the Authority’s first three-year rate filing. His resignation was not unexpected and becomes effective August 31st. The Authority is currently in the process of seeking a replacement.

For additional information please see our:

- 3 February Issuer Comment - Three year rate plan proposal is consistent with our expectations and supportive of credit quality;
DETAILED RATING RATIONALE

REVENUE GENERATING BASE

Strength and size of Service Territory

LIPA and PSEG-LI deliver electricity to approximately 1.1 million customers in the New York counties of Nassau and Suffolk and a small portion of Queens known as the Rockaways. With median household incomes well above the national average and low unemployment rates, the area economy is arguably one of the strongest in the country and continues to be a primary positive factor underpinning the rating.

First rate plan submitted for DPS review

The LIPA board maintains the authority to approve budgets and to establish rates to be charged for the sale and delivery of electricity within LIPA's service territory. However, the 2013 LIPA Reform Act (the Act) created the Long Island Office of the DPS to also review LIPA's rates and budgets and make recommendations to LIPA's board. On January 30, LIPA filed its first three-year (2016-2018) rate plan, and on May 14, DPS Staff filed their recommendations in the proceeding. LIPA and PSEG-LI are reviewing the recommendations and have the opportunity to file a response by June 4th. After this filing, a two Administrative Law Judges assigned to the case will begin evidentiary hearings on June 23rd to review submitted testimony. DPS final recommendation is due to the LIPA board by September 27th. This will allow time for board review of the filing and DPS' recommendations and additional public hearings in the case of disagreement prior to a final determination by the LIPA board and implementation of new rates on January 1st of each of the next three years. Beyond the 2016-2018 rate plan rates must also be reviewed in any year thereafter where proposed rates would increase aggregate LIPA revenues by more than 2.5%.

LIPA and PSEG-LI's three year rate plan proposed annual revenue increase of about $221 million over the 2016-2018 periods - approximately 2% of total revenues per year. The rate plan also proposed to gradually improve LIPA's credit profile by removing some of the variability in its cash flow through the use of automatic cost recovery and revenue decoupling mechanisms and by targeting gradually improving cash flow based fixed charge coverage ratios. Due in large part to differing views on sales growth, future interest rates and the timing of certain expenditures, the DPS Staff has recommended a base rate increase of only about $48 million over the period. Importantly however, the Staff's recommendations are supportive of LIPA's proposed revenue and cost adjustment mechanisms, including a true-up for actual debt service costs, as well as its intention to target certain fixed obligation coverage ratios.

Of the approximately $178 million of proposed Staff reductions, about $120 million relate to assumed lower debt service (lower interest rates and deferral of some capital projects), which would be subject to true-up if actual costs are different than those assumed. About $30 million is due to differing views on growth, which would also be subject to true-up. There were no recommended changes to LIPA's proposed targeted cash based fixed obligation (including securitization debt) coverage ratios of 1.15x in 2016; 1.20x in 2017; and 1.25x in 2018 which remain in line with our expectations and supportive of LIPA's objective of gradually improving its credit quality.

OPERATIONAL AND FINANCIAL PERFORMANCE

Operational

The transition of operations to PSEG-LI has gone well. LIPA staff and administrative expenses have been reduced as planned, operational enhancements are under way and customer satisfaction seems to be on the road to recovery.

Although the utility still has the lowest score of the large electric utilities included in J.D. Power's recent surveys of both residential customers (covering performance between July 2013 and May 2014), and business customers (April - November 2014), scores are improving. For the residential survey, PSEG-LI reported substantial improvement from January through May 2014, during which they were the operator. In the business customer survey, PSEG-LI's score increased 70 points, to 595 out of a possible 1,000. Increased communications with customers and a new outage management system are factors that likely contributed to the improved score. Under the terms of the operating agreement, PSEG-LI is required to achieve top-quartile performance on specific
components of this survey by year five of its operations. According to LIPA, early results are ahead of their baseline expectations.

Beginning January 2015, PSEG-LI is now also responsible for fuel and power procurement, and has expanded its involvement in long-term resource planning, budgeting and rate-case preparation, an arrangement that, given the experience and track record of PSEG, we view as supportive to credit quality. As a point of comparison, Public Service Electric and Gas, PSEG's New Jersey-based utility subsidiary, received a score of 685 on the J.D. Power survey of electric business customers, the highest of large utilities in the east region.

Federal support expected to continue

In February 2014, FEMA and LIPA signed a letter of understanding under which FEMA pledged to reimburse 90% of a $730 million four-year program to reduce storm exposure. The improvements are to be made to assets that were damaged by Hurricane Sandy and must reduce the chance of future losses from storms by a minimum of 20%. This federal funding gives LIPA a unique competitive advantage as it provides the ability to harden the utility's system without the need to recover these particular costs from Long Island rate payers.

Financial

LIPA's financial performance has also improved. In 2013 and 2014, a combination of relatively mild weather (average storm activity), reduced debt service, increased grant income and a lower introductory rate on the PSEG-LI operating contract (additional compensation for services required by the Act begin in 2016) resulted in net revenue based (calculated from the income statement) fixed charge coverage ratios above 1.15x. The three year average is approximately 1.09x, which is in contrast to an average of about 1.05x for 2010 to 2012. This improvement was a consideration in our revision of LIPA's outlook to stable from negative in 2013.

Based on LIPA's 2015 budget, which was prepared in accordance with the Authority's historical practice of targeting $75 million of net income assuming average weather and with a goal of rate stability, we estimate the net revenue based fixed charge coverage ratio for 2015 to also be above 1.15x.

LIPA's three year 2016-2018 rate plan that was filed for DPS review has features intended to improve LIPA's credit quality by the use of automatic cost recovery mechanisms for items that are outside of LIPA and PSEG-LI's control. The mechanisms, which are intended to reduce cash flow uncertainty should allow for more timely recovery of normal (non-disaster) storm costs, operating expenses at generating facilities (including property taxes) and debt service costs. The rate plan also focuses on achieving specific cash flow based fixed charge coverage ratios that LIPA proposed to increase over time. LIPA's initial plan projected cash flow based fixed charge coverage ratios, inclusive of Utility Debt Securitization Authority debt service and assumed savings from a second securitization, of 1.15x in 2016, 1.20x in 2017 and 1.25x in 2018. As noted above, the DPS Staff made no recommended changes to these target coverage levels.

Liquidity has improved

Through 2012, the utility generally ended its fiscal year with less than 60 days of operating cash on hand, and available external liquidity was limited to $100 million of commercial paper availability (approximately 10 days). As of December 2012, in the wake of Hurricane Sandy and prior to the receipt of funds due from the Federal Energy Management Agency (FEMA), the utility had only 37 days of cash on hand (48 including CP availability).

More recently, there has been meaningful improvement in LIPA's internal liquidity owing in part to the fact that since December 2013 the Authority has been required to pre-fund 90 days of operating and maintenance expenses into an account for use by PSEG-LI. In 2014 internal liquidity was also bolstered by the receipt of the remaining $159 million of expense reimbursement from FEMA as well as an additional $447 million to pre-fund FEMA eligible storm hardening projects. As of year-end 2014, excluding the FEMA fund, days cash on hand increased to about 121 - a significant improvement from 37 at the end of 2012. If the FEMA funds are included, days cash increases to almost 180.

LIPA has also made a concerted effort to enhance its external liquidity arrangements. In March 2013, the Authority obtained a $500 million multi-year (March 2016 maturity) credit facility intended primarily to assure the availability of cash to pre-fund the PSEG-LI accounts. LIPA has also increased commercial paper capacity. In December 2014 LIPA put in place $300 million of subordinate commercial paper capacity to replace programs scheduled to terminate in January. In March the Authority closed on $125 million of additional senior commercial paper facilities and $200 million of additional senior facilities are expected to close in June. In accordance with its August 2014 board resolution, the amount of commercial paper notes and revolving credit outstanding may not exceed $1
As of year-end 2014, the combination of LIPA’s unrestricted cash balances and commercial paper availability resulted in 132 days of liquidity on hand, a dramatic improvement from 48 in 2012. The average for these past three years is 101 days, which falls within the range 90-149 indicated for an “A” score on this metric in our rating methodology for U.S. Public Power Electric Utilities with Generation Ownership Exposure. LIPA’s revolving credit facility matures in less than one year, and it requires various representations, including those of no material adverse change for draws. In addition, the utility’s external sources comprise an unusually large percentage of its overall liquidity; as such, we do not include the revolver directly in our calculation of days liquidity on hand. We do however recognize there is additional liquidity cushion created by this facility.

The rating recognizes the lack of a dedicated debt service reserve fund which remains a comparative weakness in LIPA’s liquidity profile. However as we anticipate LIPA’s days of liquidity on hand will remain above 100, and considering the additional cushion provided by the revolving credit facility, we have reduced the level of notching applied for this factor in our methodology grid to -0.5 from -1.0.

DEBT AND OTHER LIABILITIES

Debt Structure

As of year-end 2014, LIPA had approximately $10 billion of total debt outstanding including about $5 billion of senior lien debt, $2 billion of securitized debt issued by Utility Debt Securitization Authority (UDSA), $2.5 billion of capital leases, $350 million of subordinate bonds and about $215 million of commercial paper and $65 million of revolving credit loans outstanding.

During 2014, LIPA issued approximately $550 million of new (non-refunding) debt, primarily to fund capital spending in 2014 and 2015. As 2015 capital spending is expected to be primarily funded with proceeds of LIPA’s 2014 bond offerings along with FEMA advanced funding, we expect total debt will remain around this level in 2015. A bill enacted as part of the governor’s 2015-16 budget also allows LIPA to refinance an additional $2.5 billion of its debt with lower cost securitized debt.

Going forward, we expect LIPA’s absolute level of debt will likely continue to grow as it funds needed capital investments. Although the absolute debt level is likely to remain elevated, we expect the declining trend in LIPA’s debt ratio (from over 200% in 2005 to about 130% currently) will continue, particularly as FEMA has committed to fund 90% of a four-year $730 million capital program for storm hardening.

Debt-Related Derivatives

As of December 31, 2014, LIPA had approximately $700 million notional floating to fixed swaps covering about $1.2 billion of variable rate debt, including approximately $215 million of commercial paper and $65 million of revolver usage. In addition, LIPA had approximately $1 billion of notional basis swaps (LIPA pays SIFMA and receives 70.5% of 1-month LIBOR) which adds basis risk to its variable rate exposure. LIPA estimates its total floating rate exposure (including basis swaps and adjusted for unrestricted cash) at about $550 million or approximately 9.45% of its total bonds issued. The estimated mark-to-market on the swap position was approximately negative $285 million. The majority of the negative position relates to one insured floating-to fixed swap which may be terminated if the rating of the insurer, Assured Guaranty Municipal Corp. (AGM) falls below A2/A by both rating agencies and LIPA has not maintained one rating of at least A3/A- or provided a replacement enhancement or negotiated other credit support. AGM’s current rating is A2 stable. If the swap were to be terminated, LIPA would be required to make annual payments to the swap counter party for up to five years to cover the mark-to-market at the time of termination. To the extent LIPA were to incur additional debt to fund this potential liability, we expect the associated debt service costs would be recoverable in rates.

Pensions and OPEB

The Authority participates in the New York State and Local Retirement System, which is a cost sharing, multiple employer and public employee retirement system. The plan benefits are provided under the provisions of the New York State Retirement and Social Security Law that are guaranteed by the state constitution and may be amended only by the State Legislature. Under this plan, the Authority’s contributions, which were equal to 100% of its required contributions, were $0.9 million, $2 million and $1.9 million for 2014, 2013 and 2012 respectively.

In addition, the cost of pensions and other post-retirement health and life insurance benefits (OPEBs) for the LIPA-serving workforce of its service provider are a contractual obligation of LIPA. In December 2013, at the conclusion of its Master Services Agreement with National Grid, LIPA settled a dispute for the service of such National Grid
employees through December 2013 for $216 million. The offsetting regulatory asset will be amortized over 10 years beginning in 2016.

Following the transition to management by PSEG-LI in January 2014, the cost of pension and OPEB benefits for the LIPA-serving workforce of PSEG-LI are a contractual liability under the Operating Services Agreement. As of January 1, 2014, the Authority and PSEG-LI estimated its liability for pensions to be approximately $126 million for which the Authority made payment of about $70 million in 2014 and expects to make a payment of $30 million in 2015. The corresponding regulatory asset will be amortized over the remaining term of the PSEG-LI contract, which is also approximately the expected remaining time to retirement of the workforce, or about 12 years. As of December 31, 2014, primarily as a result of a change in prevailing interest rates and resulting actuarial loss, the estimated pension liability had increased to about $190 million.

The PSEG-LI OPEB liability was estimated at about $316 million as of January 1, 2014, and due primarily to actuarial losses resulting primarily from a change in prevailing interest rates, was estimated at about $450 million as of December 31, 2014. These OPEB liabilities remain legal obligations of PSEG-LI, but the costs of the benefits are passed through to LIPA. To meet these obligations, and similar obligations for its own employees which are paid through the New York State Health Insurance Program, the LIPA board in 2014 authorized the funding of a separate OPEB account which is held by LIPA. As of December 31, 2014, the Authority had deposited approximately $22 million into the OPEB reserve account, of which about $20 million is related to PSEG-LI employees and about $2 million is related to LIPA employees. Beginning in 2016, LIPA plans to fund approximately $50 million per year into the reserve account to cover its future liability (LIPA estimates it will be fully funded in about 9 years.) The reserve is funded after debt service, and as currently structured, would be available if needed to pay operating expenses or debt service.

MANAGEMENT AND GOVERNANCE

In accordance with the LIPA Reform Act, LIPA's board was reconstituted with nine members, five of which are appointed by the governor and two by each of the leaders of the state senate and assembly. The authority to set rates and budgets resides with the board but beginning with the 2016 fiscal year, the DPS reviews and provides recommendation to the board.

As of January 2014, PSEG-LI, a subsidiary of New Jersey-based Public Service Enterprise Group Incorporated (PSEG, Baa2 stable) took over the operations and maintenance of LIPA's T&D system under an amended Operating Services Agreement which placed responsibility for customer relations and satisfaction, strategy, policy making, capital planning, budgets, emergency response, and rate case filings with PSEG-LI.

KEY STATISTICS

-Debt Service Coverage 2014 (3-yr avg): 1.16x (1.09x)
-Days liquidity on hand 2014 (3-yr avg): 132 (101)
-Debt ratio 2014 (3-yr avg): 126% (129%)

METHODOLOGY SCORECARD FACTORS

Moody's evaluates LIPA's financial performance relative to the U.S. Public Power Electric Utilities with Generation Ownership Exposure methodology and, as depicted below, the grid indicated rating for LIPA is Baa1, the same as LIPA's current Baa1 senior rating.

Factor 1 - Cost Recovery Framework within Service Territory: Aa
Factor 2 - Willingness to Recover Costs with Sound Financial Metrics: Baa
Factor 3 - Management of Generation Risks: A
Factor 4 - Competitiveness: A
Factor 5 Scores are assigned on the basis of a three year historical average
Factor 5 - Financial Strength - Debt Service Coverage (3 year average - 1.09x; 2014 - 1.16x): - Ba
Factor 5 - Financial Strength - Days liquidity on hand (3 year average - 80; 2014 - 121): days - A
Factor 5 - Financial Strength - Debt Ratio (3 year average - 129%; 2014 - 126%): - Ba

Notching Factors - Financial (Covenant/DSR): - 0.5

Scorecard Indicated Rating: Baa1

OBLIGOR PROFILE

LIPA was established in 1986 as a corporate municipal instrumentality of the State of New York under the Long Island Power Authority Act (the LIPA Act). In 1998, the Authority became the retail supplier of electric service in most of Nassau and Suffolk Counties and the Rockaway Peninsula of Queens by acquiring the Long Island Lighting Company (LILCO) as a wholly owned subsidiary which does business as LIPA. LIPA’s assets currently consist of a transmission and distribution system that is used to serve approximately 1.1 million customers in an approximately 1,230 square mile service territory (911 miles in Suffolk, 287 in Nassau and 32 in Rockaway), as well as an 18% (234 MW) interest in the Nine Mile Point Unit 2 nuclear facility. Peak load in 2013 was reported at 5,602 MW versus available capacity, including purchased capacity, of 6,014 MW.

LEGAL SECURITY

LIPA’s senior revenue bonds are secured by a pledge of net revenues generated by LIPA’s transmission and distribution system. Security for the bonds excludes the non by-passable restructuring charge established for the repayment of approximately $2 billion of 2013 Utility Debt Securitization Authority bonds. There is a sum-sufficient rate covenant - which is relatively weak as it allows the use of rate stabilization funds and expected bond proceeds in revenues. There is no debt service reserve or additional bonds test, which is also weak compared to industry norms.

USE OF PROCEEDS

Proceeds of the private placement notes will be used to refund a like amount of variable rate debt.

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was U.S. Public Power Electric Utilities with Generation Ownership Exposure published in November 2011. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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Analysts

Laura Schumacher
Lead Analyst
Public Finance Group
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