Board Policy:	**Debt and Access to the Credit Markets**
Policy Type:	**Operating Policies**
Monitored by:	**Finance and Audit Committee**
Board Resolution:	**#1319, approved September 21, 2016** **#1354, amended March 29, 2017**

Board Policy on Debt and Access to the Credit Markets

It is the policy of the Board of Trustees of the Long Island Power Authority to serve the long-term interests of the Authority's customers by adopting sound financial plans in each year. Sound financial plans ensure the ready access to borrowing on reasonable terms necessary to fund the infrastructure investments that maintain the reliability and resiliency of the Long Island electric system. Such financial plans contemplate prudent levels of borrowing that will accommodate efficient access to the capital markets and thereby minimize the long-term cost of providing electric service to our customer-owners.

The Board will achieve these objectives by adopting annual budgets and financial plans that support bond ratings of at least A2/A from the several rating agencies by the end of 2021. Such budgets and financial plans include:

- fixed obligation coverage ratios on Authority-issued debt and on the combination of Authority-issued and Utility Debt Securitization Authority-issued debt of no less than:

	2016	2017	2018	2019
LIPA	1.20x	1.30x	1.40x	1.45x
LIPA and UDSA	1.15x	1.20x	1.25x	1.25x

- generating sufficient cash flow from current revenues to maintain the issuance of new debt as a percentage of capital spending at 64% or lower throughout the planning period;
- maintaining cash on hand of at least $100 million in the Operating Fund and $150 million in the Rate Stabilization Fund and overall cash on hand and available credit of at least 120 days of operating expenses;
- Pre-funding of Pension Fund Obligations, Other Post-Employment Benefits and Nuclear Decommissioning Trust Fund Obligations in a fiscally sound manner, as measured no less than every third year by an actuarial services firm.

--

Appendix: Methodology to Calculate Financial Metrics

Exhibit C

Board Policy on Debt and Access to the Credit Markets
Appendix: Methodology to Calculate Financial Metrics

The Board Policy on Debt and Access to the Credit Markets references three quantitative financial ratios: Fixed Obligation Coverage; Days Cash on Hand; and the Percentage of Capital Spending Funded by Debt. This Appendix describes the calculation of each of these ratios as used in the Board Policy.

Fixed Obligation Coverage is the ratio of funds available to pay LIPA's fixed obligations (annual debt service plus capital lease payments) as compared to those obligations. This ratio therefore measures the resources available from operations to make fixed scheduled payments. If a utility has a fixed obligation coverage ratio of 1.0x, they have exactly enough funds from ongoing operations to pay all operating expenses and make such fixed payments, leaving no such funds available for capital investments. Even a small disruption to operations such as higher than anticipated expenses or a storm may therefore endanger debt service and other fixed payments. A coverage ratio of 1.25x means the utility has enough funds to pay operating expenses and fixed obligation costs, plus a margin of 25% over and above the fixed obligation costs. Higher coverage ratios reflect a greater likelihood that such fixed payments will be paid and therefore represents less financial risk to bond holders. As such, higher coverage ratios typically merit higher bond ratings and correspondingly lower borrowing costs on debt and letters of credit.

Coverage is different from most financial statistics, however, in that coverage is not actually paid to bond holders or other outside parties. The funds in excess of those actually required to pay operating expenses and fixed payments remain available to LIPA to fund new infrastructure investments in lieu of issuing debt. As a result, higher coverage provides a double benefit to LIPA's customer-owners: it lowers both the cost of interest on bonds and the amount of bonds LIPA issues to build infrastructure.

LIPA's fixed obligation coverage calculation, detailed below, is intended to be similar to the way that rating agencies and investors calculate coverage and differs from the coverage formula used in LIPA's bond covenants[1]. The approach simplifies the review of sources and uses of cash flow and adopts most of the GAAP[2] conventions for measuring revenues and expenses, except in a few key areas highlighted below where GAAP figures are materially different than cash flow.

[1] LIPA's bond covenants calculate coverage by treating tax payments and capital lease obligations as funds available to pay debt service obligations.
[2] Generally Accepted Accounting Principles, as established by the Government Accounting Standards Board (GASB).

The table below summarizes LIPA's fixed obligation coverage calculation:

+	Operating Revenue	Note 1
+	Grant Income	Note 2
+	Investment and Miscellaneous Income (Net)	Note 3
+	Suffolk Property Tax Settlement Charges	Note 4
+	Visual Benefits Assessment Charges	Note 4
=	**Total Revenue and Income**	Subtotal 1
+	Total Operating Expenses	Note 5
−	Depreciation and Amortization	Note 6
−	OPEB GAAP Operating Expense	Note 7
+	Other Interest Expense	Note 8
=	**Total Deductions from Revenue and Income**	Subtotal 2
+	Total Revenue and Income	Subtotal 1
−	Total Deductions	Subtotal 2
+	Annual Capital Lease Payments	Note 9
=	**Funds Available for LIPA + UDSA Coverage**	Subtotal 3
+	Funds Available for LIPA + UDSA Coverage	Subtotal 3
−	UDSA Debt Service	Note 10
=	**Funds Available for LIPA Fixed Obligations**	Subtotal 4
+	LIPA Debt Service	Note 10
+	Annual Capital Lease Payments	Note 9
=	**LIPA Fixed Obligations**	Subtotal 5
+	LIPA Fixed Obligations	Subtotal 5
+	UDSA Debt Service	Note 10
=	**LIPA + UDSA Fixed Obligations**	Subtotal 6
+	Funds Available for LIPA Fixed Obligations	Subtotal 4
/	LIPA Fixed Obligations	Subtotal 5
=	**LIPA Coverage Ratio**	
+	Funds Available for LIPA + UDSA Obligation	Subtotal 3
/	LIPA + UDSA Fixed Obligations	Subtotal 6
=	**LIPA + UDSA Coverage Ratio**	

The funds available to pay fixed obligations are roughly calculated as revenue plus other sources of income minus operating expenses, excluding non-cash expenses such as depreciation and amortization and OPEBs, minus other interest expense. The actual results for each year are included in the footnotes to the Authority's audited financial statements. The below notes describe each line item in the fixed obligation coverage calculation.

1. *Operating Revenue* can be found on the Authority's Income Statement.

2. *Grant Income* includes money received from state and federal agencies to cover specified program expenditures, such as the Regional Greenhouse Gas Initiative (RGGI) and FEMA reimbursements for storm recovery. Grant income is generally recognized in the period it is received, except for the FEMA storm hardening grant, which is being recognized over the expected life of the assets being constructed in amounts equal to depreciation expense in each year. The amount of Grant Income is reported on the Authority's Income Statement.

3. *Investment Income and Other Miscellaneous Income (Net)* includes the amounts reflected on the Income Statement for investment income and the net amount of the miscellaneous other income and deductions as reported on the Income Statement.

4. *Suffolk Property Tax Settlement and Visual Benefits Assessment* are two large regulatory assets that are being repaid by certain customers in their electric bills over time. The customers repay both principal and interest on related debt obligations. For GAAP purposes, the interest payments are included in Investment Income while the repayment of principal is not reflected in Operating Revenue in the year received (it was previously recognized when the regulatory assets were established). For coverage purposes, the cash receipts related to principal payments shown on the Authority's Cash Flow Statement are available to pay the related debt payments.

5. *Total Operating Expenses* can be found on the Authority's Income Statement and conform to GAAP.

6. *Depreciation and Amortization* are deducted from Operating Expenses for the coverage calculation. Instead of using accounting allocations for the recovery of capital investments and regulatory assets, the coverage calculation recognizes that these costs are to be repaid to bondholders through the scheduled repayment of principal on bonds. Therefore, these amounts are reflected in Debt Service in the coverage calculation. Depreciation and Amortization can be found on the Authority's Income Statement. LIPA's key components of Depreciation and Amortization include:
    a. Depreciation of Utility Plant and Equipment
    b. Amortization of the Acquisition Adjustment paid for the purchase of the Long Island Lighting Company in 1998
    c. Amortization of regulatory assets established by the Board for specific obligations to be funded by ratepayers, which are primarily the long-term obligation to fund pensions and benefits for employees who provided services to LIPA under the

expired Management Services Agreement (MSA) between LIPA and National Grid (the former service provider).

7. *OPEB GAAP Operating Expense.* Due to the transition to a new service provider in 2014, LIPA has few active retirees collecting Other Post-Employment Benefits (OPEBs). The cash pay-as-you-go expense for such benefits is therefore small relative to the GAAP expense for accruing a liability to make such payments to retirees in the future. The difference between these two amounts can be found on the Authority's Cash Flow Statement. In 2014, LIPA adopted a funding plan consistent with actuarially sound principles to pre-fund future OPEB benefit expenses for employees currently working for the Authority and PSEG Long Island (the service provider). This pre-funding is deposited into a separately segregated OPEB Account. As the accrual GAAP Operating Expense for OPEBs in any year is significantly higher than cash pay-as-you-go expense, the difference between the GAAP and cash expense is available if needed to pay fixed obligations in the year. Furthermore, from a legal perspective the Authority's annual pre-funding deposits into the OPEB Account to fund future benefits are also first available to make fixed obligation payments. Additionally, the Board authorized that, should the need arise, the OPEB Account balance is available to make fixed obligation payments, acting in effect as a reserve fund. LIPA's ratemaking model therefore recognizes the availability of these funds to make fixed obligation payments.[3]

8. *Other Interest Expense* represents costs that are reported as interest expense on the income statement but are not part of Debt Service. The largest component of Other Interest Expense is interest rate swap payments, which are generally subordinate to bond payments. Additional such expense includes interest on customer deposits and bank fees. Other Interest Expense is not Debt Service, does not require coverage, and is therefore treated the same as Operating Expenses in the calculation of Funds Available for Debt Service. The amount of Other Interest Expense is shown on the Authority's Cash Flow Statement.

9. *Annual Capital Lease Payments.* Rating agencies treat capital lease payments as a fixed obligation that operates like debt. LIPA has substantial capital leases related to its procurement of power supplies for generating facilities and transmission cables. According to GASB, long-term leases that meet certain criteria must be recorded on the Authority's financial statements as capitalized leases. To recognize capital lease obligations in the calculation of coverage, the rating agencies add the annual capital lease obligation (imputed repayment of principal and interest) to both the numerator and the denominator of the fixed obligation coverage ratio. LIPA's Annual Capital Lease Payments are shown in the footnotes to its audited financial statements.

[3] LIPA originally contemplated a similar adjustment for the pension expense related to PSEG Long Island employees. The difference between GAAP expense and ERISA cash funding for pensions has narrowed and so this is no longer a material adjustment to the funds available to pay fixed obligations.

10. *Debt Service* consists of the payment of principal and interest on LIPA's long term and short term bonds. The debt service payment schedule on long term bonds is established when the bonds are issued and typically includes semi-annual payment of interest. Short term debt typically includes monthly or quarterly payments of interest. Repayment of principal on bonds can occur under a number of circumstances that are relevant to the determination of debt service obligations in any given year.

    Debt that is retired per schedule is considered a debt service obligation and is included in the debt service payments on that scheduled date. Debt is sometimes refinanced through the issuance of new debt, typically to obtain a lower cost. Debt which is refinanced before its scheduled date is excluded from debt service requirements, and the scheduled repayments of the new debt takes the place of the scheduled repayment of the retired debt. Short term debt can also be refunded or rolled over through the issuance of new debt. This happens most frequently when an existing short term arrangement expires or is replaced by a new line of credit on more favorable terms. In such cases, the roll-over of principal is not considered to be a debt service obligation at that time, as this debt was always expected to be paid by the proceeds of the roll-over and not by revenues. The amount of Debt Service payments can be found on the Authority's Cash Flow Statement.

Minimum Days Cash on Hand must be at least 120 days

Days Cash on Hand is the ratio of the total cash and credit available divided by the Authority's average daily operating expenses. Days Cash on Hand measures the Authority's ability to sustain its operations if revenues are delayed, reduced or interrupted for any reason. Available cash consists of cash reported on the balance sheet and includes both unrestricted cash and funds that are held in a restricted account dedicated to pre-funding PSEG Long Island's operating and capital expenditures, in accordance with the terms of the Amended and Restated Operations Services Agreement. Available credit includes multiple sources such as commercial paper, letters and lines of credit, and general revenue notes. Average daily expenditure is calculated by taking LIPA's annual approved budgeted revenues minus depreciation, amortization, and interest expense and dividing the net value by 365 days.

Percent of Capital Spending Funded by Debt not to exceed 64%

Percent of Capital Spending Funded by Debt is calculated as the ratio of new money debt issued in the year divided by total approved capital spending. It is typically calculated both including and excluding funding derived from grants, such as FEMA. The capital spending in any year is directly observable from LIPA's financial documents and represents the net increase in fixed assets (plant in service plus investments in related utility assets like circuits or transformers). Similarly, LIPA's debt issuances are categorized as either refinancing of existing debt or new money debt and are clearly identified as to the general usage of the funds. Capital expenditures financed using short term debt or available cash that is later replenished by long term bonds are excluded from the calculation. Given the variability in capital expense from year to year, it is prudent to target a revenue funding percentage over a multi-year planning period as opposed to implementing a strict year-by-year percentage target.