FitchRatings

Fitch Rates LIPA Electric System Rev Bonds 'A'; Outlook Stable

Fitch Ratings-New York-05 September 2019: Fitch Ratings has assigned an 'A' rating to the following Long Island Power Authority (LIPA or the authority) bonds:

--Approximately $235 million electric system general revenue bonds series 2019A;
--Approximately $250 million electric system general revenue bonds series 2019B (Mandatory Tender Bonds).

In addition, Fitch has upgraded the following LIPA ratings and obligations to 'A' from 'A-'.

--Issuer Default Rating;
--$3.4 billion senior lien electric system revenue and refunding bonds.

The Rating Outlook on all ratings is Stable.

The bond proceeds will be used to fund system capital improvements and pay issuance costs. The series 2019A bonds will be sold with a fixed interest rate through final maturity of Sept. 1, 2039. The series 2019B bonds will be issued as multi-modal bonds and will initially bear interest at a fixed rate through the mandatory tender date of Sept. 1, 2024. The final maturity of the series 2019B bonds will be Sept. 1, 2049.

ANALYTICAL CONCLUSION

The rating upgrade reflects LIPA's improving leverage ratio and Fitch's expectation that the deleveraging trend that began in 2015 will result in a sustained ratio of below 9.0x. The reduction in leverage is largely attributable to more robust operating cash flow, driven by series of rate increases and improved cost recovery, as well as debt balances that remain nearly unchanged. LIPA's very strong service area and its more disciplined approach to rate setting should sustain the authority's very strong revenue defensibility and overall performance even through a period of moderate stress, further supporting its financial profile and the final rating. The authority's operating cost burden remains comparatively high within the sector. Ongoing efforts to moderate costs and overall operating risk have been reasonably successful in recent years, and have been factored in the rating.

CREDIT PROFILE

LIPA owns one of the largest municipal electric distribution systems in the U.S., serving a population of about 3.1 million located throughout New York's Nassau and Suffolk counties and the Rockaways section of New York City. LIPA has provided electric service throughout the area since May 28, 1998, when it acquired the investor owned utility, the Long Island Lighting Company (LILCO) as its wholly owned subsidiary. Since the acquisition, the LILCO subsidiary does business under the name of "LIPA".

LIPA's business model is unique. The authority owns the electric transmission and distribution (T&D) system located throughout its service territory. However, operation and maintenance of the T&D system and significant responsibilities for power supply have been contracted for with external service providers. Currently, T&D system services are provided by PSEG Long Island (PSEGLI; a subsidiary of Public Service Enterprise Group [PSEG; IDR BBB+/Stable Outlook], pursuant to an amended and restated operating services agreement (OSA) that took effect on Jan. 1, 2014, and extends to Dec. 31, 2025. Modifications in 2013 greatly expanded the responsibilities of PSEGLI and were adopted largely in response to the LIPA Reform Act, which sought to restructure LIPA's operations following criticism from customers, local politicians, and the governor's office that LIPA's response and timeliness in restoring power following superstorm Sandy was inadequate. The OSA is extendable contingent upon PSEGLI meeting certain performance criteria.

The majority of LIPA's power supply has historically been purchased pursuant to a power supply agreement (PSA) with National Grid plc (IDR BBB/Stable Outlook). The current contract commenced in May 2013 and replaced an earlier contract that was executed concurrent with the formation of LIPA in 1998. The PSA provides LIPA with access to approximately 3,700 MW of legacy on-island generating capacity currently owned by National Grid. The current PSA extends to May 2028.

The remainder of LIPA's energy supply needs is met through a portfolio of purchased power agreements and its ownership in the Nine Mile Point 2 (NMP2) nuclear facility. Power supply and fuel management services are provided by PSEG Energy Resources & Trade LLC, a PSEG affiliate.

KEY RATING DRIVERS

Revenue Defensibility: 'aa'; Very Strong and Mature Service Area

LIPA's revenue defensibility assessment reflects the utility's primary role as a transmission and distribution utility and its extraordinarily strong service area profile. The assessment also factors very strong rate flexibility, rooted in LIPA's legal ability to determine rates and its affordable cost of electric service.

Operating Risk: 'bbb'; Above Average Operating Costs

Operating risk is assessed as midrange given LIPA's relatively high operating cost burden driven by legacy acquisition costs, challenges related to serving LIPA's island geography and high payments in lieu of taxes (PILOTs).

Financial Profile: 'a'; Improving Cash Flow Supports Declining Leverage

Declining leverage, driven by a series of base rate increases and the resulting improvement in funds available for debt service (FADS), together with increasing cash on hand support LIPA's financial profile assessment.

Asymmetric Additional Risk Considerations

None

RATING SENSITIVITIES

Reversal of Deleveraging Trend: A reversal in LIPA's trend toward deleveraging, whether as a result of a failure to implement planned rate increases or higher than anticipated capital expenditures, and a resulting leverage ratio that fails to consistently remain below 9.0x would likely result in downward rating pressure.

SECURITY

The series 2019 A & B bonds are senior lien obligations of LIPA secured by the net revenues of the electric system, after payment of operating and maintenance expenses.

Revenue Defensibility

LIPA's utility operations exhibit very strong revenue source characteristics, anchored by the authority's electric transmission and distribution services. While current New York State laws that allow for energy purchases from third party providers apply to LIPA, the authority's existing tariff structure provides that alternate energy service providers would be required to pay LIPA the full value of power supply charges that would otherwise be recovered from non-participating customers, mitigating much of the related credit risk. According to LIPA, less than 2,500 customers are supplied by alternate suppliers.

Very Strong and Mature Service Area

LIPA provides electric service throughout a territory that exhibits exceptionally strong demographics and very stable demand characteristics. The territory includes most of Nassau and Suffolk counties in Long Island, and a small portion of Queens, NY. As of year-end 2018, the authority served approximately 1.1 million customers and a population of approximately 3.1 million. Both Nassau and Suffolk counties benefit from a broad, diverse economy, a well-educated workforce, and close proximity to New York City. Median household income ratios in both Nassau ($105,744) and Suffolk ($92,388) counties remain well above the national average and among the highest in the nation, while unemployment throughout the counties is below state and national averages. Fitch rates Suffolk County's general obligation debt at 'A-'/Negative, and Nassau County debt at 'A'/Stable.

Despite the service area's strong demographics profile, energy sales at LIPA have declined modestly over the past five years, reflecting efficiency gains, weather patterns and modest customer growth that is constrained somewhat by the mature and well developed nature of large portions of the service area.

LIPA's customer base is well-diversified, exhibits no customer concentration and is heavily weighted toward residential users, which account for approximately 56% of revenues. Commercial users account for approximately 42% of revenue. LIPA does not serve any large-energy intensive customers, more typical of the industrial service class. LIPA's ten largest customers typically account for approximately 6% of retail revenues, with the largest user (the Long Island Railroad) representing less than 2% of electric sales and revenues.

Legal Ability to Set Rates

LIPA's rate flexibility is assessed as very strong despite retail rates that have ranked among the highest in the nation and a history of pressure to moderate rate increases from ratepayers and local constituents alike. Fitch's assessment focuses on LIPA's legal ability to determine rates which, while influenced by recent reforms, has not been undermined; it also factors in the authority's improving rate competitiveness and affordability.

LIPA's rates for electric service are legally determined by the Authority's board of trustees and are not subject to the approval of the New York Public Service Commission (NYPSC) or any other regulatory authority. However, following passage of the LIPA Reform Act in July 2013, a new office within the New York Department of Public Service (DPS), which is the staff arm of the NYPSC, was established to make recommendations with regard to LIPA's rates, operations and programs. The Act further required that the DPS review for recommendation LIPA's mandated three-year rate plan for the 2016-2018 period, and all future rate increases exceeding 2.5%.

The DPS concluded its initial review of LIPA's three-year rate plan in Sept. 2015, and LIPA's board approved the rate plan in Dec. 2015. Overall, Fitch viewed the DPS's recommendations as constructive. Although the recommendations reduced LIPA's original three-year revenue request by 26.4%, the DPS positively endorsed several rate adjustment mechanisms to offset variability in some of LIPA's largest expense items, including debt service, storm damage, energy efficiency, PILOTs, and fuel and purchased power costs.

The authority has not proposed a rate increase of more than 2.5% since the initial rate plan concluded, and does not expect to do so through 2021, obviating the need for DPS review. To the extent that increases exceeding 2.5% are necessary to support credit quality, and the DPS review process and LIPA board approvals constrain revenue over time, Fitch's assessment of rate flexibility could be lowered.

LIPA's rate flexibility is further supported by the regional competitiveness of its retail rates and the very high affordability of electric service. While LIPA's residential rates of roughly 20 cents/kWh remain 12% above the New York state average, comparisons against neighboring systems, including Consolidated Edison Company of New York and United Illuminating, are more favorable. Moreover, despite the absolute level of rates, the affordability of LIPA electric service remains very high. The retail cost of electricity for LIPA's residential customers represents less than 2% of median household income, lower than the national average.

LIPA's revenue defensibility assessment is further supported by its electric rate structure that includes recovery mechanisms for more than 80% of its revenue requirements and a revenue decoupling mechanism that will annually adjust for the difference in actual revenues versus DPS recommended revenues. Electric rates incorporate a base delivery service charge, as well as a series of charges and riders designed to automatically recover fuel and purchased power expenditures, required PILOT payments, and costs related to energy efficiency and renewable resources. Most of the recovery mechanisms are adjusted at least annually, including the authority's power supply charge which is adjusted monthly. LIPA's largest adjustment factor remains the fuel and purchased power adjustment charge, which recovers 50% of total revenue. Together, these mechanisms should stabilize margins even during periods of higher demand and cost volatility.

No asymmetric rating factors were considered in the rating.

Operating Risk

Above Average Operating Costs

LIPA's operating cost burden is assessed as midrange, reflecting operating costs that are well above the national average and have consistently exceeded 15 cents/kWh over the last five years. LIPA's comparatively high cost burden reflects, among other factors, the high cost structure and debt burden of the original acquisition, the inherent challenges of serving the island geography and PILOT payment requirements that are more than double the average of the Fitch-rated portfolio.

LIPA relies heavily on purchased resources to meet its energy demand and capacity requirements. Declining wholesale market prices and expanded access to regional energy markets have moderated the cost of LIPA's energy supply in recent years by allowing the authority to displace more expensive generation from its PSA resources in favor of more economic energy purchases from independent power producers and short-term purchases in the regional electricity markets.

Most of the authority's available capacity remains rooted in its legacy PSA with National Grid. Although available capacity under the agreement has declined slightly in recent years as a result of unit retirements, the agreement still provides important access to 3,700 MW of on-island gas/oil-fired resources - approximately 65% of the authority's total capacity requirements. Power is supplied under the PSA at rates and charges approved by the Federal Energy Regulatory Commission.

The addition of several new system interconnections over the last decade, however, has significantly increased LIPA's access to a broad range of off-island resources and has improved LIPA's power supply diversity. The interconnections, which include several underwater cables, now provide in aggregate more than 2,125 MWs of import capacity that is partially owned or contracted and capable of supplying up to 40% of LIPA's peak energy requirements. Purchases pursuant to the PSA have steadily declined from 51% of requirements in 2005 to 21% in 2018, whereas purchases from other suppliers, including short-term purchases, now account for 58% of requirements.

Current requirements for PILOT payments by LIPA remain another meaningful contributor to the authority's cost burden. PILOT payments totaled 9.3 % of total revenue in 2018, well above the 4.6% average for the Fitch-rated portfolio. Recent efforts to address the burden, including provisions of the LIPA Reform Act that limit annual increases to no more than 2% and a settlement to reduce payments related to the Port Jefferson Power Station, should moderate payments. But more meaningful reductions will hinge on the outcome of settlement discussions with Nassau County and litigation with the Town of Huntington.

LIPA's operating cost flexibility is assessed as neutral. As noted above, the authority has worked to diversify its power supply mix, adding up to 1,900 MW of purchased capacity from independent generating units located on Long Island and elsewhere. LIPA's current portfolio of contracts includes over 25 individual agreements with expiration dates and capacity ranging from 2019 to 2042 and from 2 MW to 685 MW, respectively. Natural gas is the predominant fuel source for the vast majority of the contracted capacity, supplemented by smaller amounts of nuclear, solar, hydro, oil-fired and refuse capacity. Additional contracts for renewable energy, particularly off-shore wind, are expected to diversify resources going forward.

LIPA's minority 18% ownership interest in the Nine Mile Point 2 nuclear generating station (224 MW share) facility located in Oswego, NY and operated by Constellation Energy Nuclear Group, LLC, accounts for roughly 4% of LIPA's capacity and 9% of its energy supply, broadening the authority's fuel mix and operating cost flexibility even further.

The authority's available capacity has remained comfortably above peak demand (5,206 MWs in 2018) in recent years, due to cooler than average summer temperatures and energy efficiency initiatives, resulting in reserve margins ranging from 11% to 21%. In 2018, total capacity of 5,762 MWs was roughly 11% above peak demand (5,206 MWs).

LIPA's capital investment needs are assessed as moderate, evidenced by a low age of plant (10 years) and the robust capital investment program that the authority has undertaken in recent years, and which is expected to continue. Since 2014, capital expenditures have averaged 150% of depreciation.

PSEGLI conducted an integrated resource plan in mid-2017 that affirmed that LIPA does not need to add baseload generating capacity through at least 2035 due, in part, to the greater adoption of energy efficiency and rooftop solar. Given LIPA's commitment to the goals outlined in New York State's Climate Leadership and Community Protection Act, resource planning will likely involve the addition of new renewable energy generation to cover incremental needs, as well as replace existing capacity earmarked for retirement.

Despite limited generation needs, LIPA's five-year capital budget includes $3.26 billion of capital expenditures, which remains elevated. The increased investment in the electric system reflects LIPA's remaining FEMA-funded initiatives related to strengthening system resiliency, reliability and storm hardening, as well as major transmission and distribution projects necessary for load growth and reliability. Favorably, LIPA expects to debt finance less than 64% of the planned expenditures. FEMA grants and cash from operations will provide the remainder of funding.

Financial Profile

Improving Cash Flow Supports Declining Leverage

LIPA's financial profile assessment reflects the authority's improving leverage ratio, cash flow and coverage metrics. Cash flow and coverage metrics have improved steadily since 2014 as improving FADS, driven by rate increases and improved cost recovery have outpaced slightly higher debt service. The improvement in LIPA's FADS, despite variable operating income, reflects the effect of certain non-cash charges and funds received to offset certain debt obligations, as well as higher revenue requirements approved as part of LIPA's 2016 rate plan and subsequent rate increases. Overall, FADS grew from $1.21 billion in 2014 to $1.39 billion in 2018. Coverage of LIPA's full obligations, which conservatively incorporates the authority's sizable PILOT payments and a portion of purchased power expense as fixed obligation, improved from 1.06x in 2014 to 1.21x in 2018.

Leverage, as measured by the ratio of net adjusted debt to adjusted FADS, has also steadily improved from over 10.5x in 2014 to 8.79x at year-end 2018, due to the authority's improved cash flow and its accumulation of cash reserves. Fitch calculates LIPA's net adjusted debt burden for 2018 at roughly $11.6 billion, which is relatively unchanged from year end 2014. The calculation incorporates LIPA's long- and short-term borrowings ($10.6 billion; including Utility Debt Securitization Authority [UDSA] borrowings), capitalized purchased power obligations pursuant to Fitch's criteria ($2.1 billion) and modest net pension obligations ($2.3 million), offset by cash and investments that are unrestricted and/or available for debt service ($952 million) and debt service reserve funds ($125 million).

LIPA's liquidity profile has also improved supporting a neutral assessment. Total liquidity, including borrowing capacity under its revolving credit agreement and commercial paper program, improved from 195 days in 2014 to 258 days in 2018. LIPA intends to maintain solid liquidity levels of at least $250 million in cash and available credit of at least 120 days of operating expenses.

Overall performance continues to improve through Fitch's scenario analysis, supporting the authority's financial profile assessment. Fitch's base case reflects assumptions consistent with LIPA's 2019 budget including declining energy sales, annual base rate increases of 2.5% and capital expenditures consistent with its current plan. The base case results indicate that while higher than normal capital expenditures of roughly $730 to $740 million will stall further improvement in leverage in 2019 and 2020, lower expenditures together with stronger cash should drive leverage lower in 2021 (8.3x) and beyond. Total borrowings are expected to rise modestly through 2021 to fund planned capital expenditures, but are then expected to decline below current levels by 2023 as funding requirements decline and scheduled debt and capital lease principal payments are made. Coverage of full obligations is expected to remain relatively stable at 1.2x over the scenario.

The results of Fitch's rating case do not deviate meaningfully from the base case as LIPA's regulatory-approved revenue decoupling mechanism allows for tariff changes to recover lost revenues attributable to changes in demand. Therefore, the analytical impact of Fitch's rating case demand stress is expected to be addressed through annual revenue adjustments of roughly 1.7% and 1.1% in years 2020 and 2021 of the rating case, leaving leverage and coverage unchanged.

Finally, Fitch's assessment recognizes that LIPA's leverage ratio is modestly overstated given the terms of the unique UDSA-issued debt, which provides for mandated debt service coverage and related revenue collection that are lower than the authority's remaining indebtedness.

LIPA's debt profile has remained relatively unchanged and is neutral in Fitch's assessment. Total debt obligations have stabilized in recent years and totaled $10.6 billion at year end 2018, including the authority's electric system revenue bonds, capitalized lease obligations and securitized restructuring bonds issued by the UDSA (a special purpose corporate municipal instrumentality of the State of New York).

Part of the LIPA Reform Act created the UDSA and authorized the issuance of restructuring bonds to retire a portion of the authority's outstanding debt, lowering debt costs. The securitization law permits the UDSA to create and collect separate irrevocable and non-bypassable restructuring charges from LIPA's distribution customers that are sufficient to meet its restructuring bond obligations. Moreover, the legislation provides that restructuring charges must be adjusted at least annually to ensure that aggregate collections are sufficient to meet scheduled restructuring bond payments. The restructuring charges are not subject to the lien of LIPA's master or subordinate general resolution supporting its electric system revenue bonds.

The UDSA-issued restructuring bonds (rated AAAsf by Fitch) benefit from the strength and stability of the underlying legislatively-approved restructuring charges and defined property rights in the restructuring property which, together with the characteristics of LIPA's service area, provide bondholders with enhanced protections and repayment expectations that have lowered financing costs. Although Fitch recognizes the benefits of the separately secured restructuring bonds, which are not direct obligations of the authority, the required restructuring charges remain an obligation and burden of current ratepayers limiting the benefits attributable to the initiative in Fitch's view.

LIPA has issued $4.5 billion in securitized restructuring bonds pursuant the initial securitization law and subsequent amendments. All of the proceeds have been used to repay or defease outstanding LIPA debt of matching maturity dates, as required. LIPA estimates that the restructuring debt has resulted in present value savings of $492 million and lowered revenue requirements by a like amount, which Fitch views favorably. LIPA has completed all legislatively approved securitizations.

In aggregate, approximately 10% of LIPA's debt was variable rate, and the remainder was fixed rate, including the securitization bonds at year-end 2017. Overall, interest rate and liquidity risk is limited as a portion of the authority's variable rate debt is hedged through a floating-to-fixed interest rate swaps, and exposure to failed remarketings or mandatory redemptions is mitigated by the terms of the floating rate note agreements. Line of credit expirations are comfortably staggered through 2022.

Asymmetric Additional Risk Considerations

Management and Governance

Fitch views LIPA's governance and management as neutral at this time. LIPA's governing board was reduced from 15 members to nine, effective Jan. 1, 2014. Five members of the board are appointed by the Governor, two by the state Senate majority leader and two by the state assembly speaker. The chairperson is appointed by the Governor. Each Trustee serves for a four-year term. The Act requires that all board members have relevant utility, corporate board or financial experience. However, despite maintaining an independent, albeit appointed, governing board, Fitch remains concerned with the influence legislators and local consumer groups can exert on governance, as exhibited in the passage of the LIPA Reform Act.

Day-to-day utility operations are managed by PSEGLI, with oversight by LIPA senior management team. PSEGLI maintains a staff of 2,350 employees dedicated to providing LIPA's electricity service. Positively, LIPA and PSEGLI's management team appear to have established a constructive relationship with the DPS, as demonstrated by the effective completion of the utility's first DPS rate review in the fall of 2015.

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Additional information is available on www.fitchratings.com
Applicable Criteria
Public Sector, Revenue-Supported Entities Rating Criteria (pub. 28 May 2019)
U.S. Public Power Rating Criteria (pub. 03 Apr 2019)

Additional Disclosures
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