



# **Board Policy on Debt and Access to the Credit Markets**

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December 16, 2020

# OVERVIEW: DEBT AND ACCESS TO CREDIT MARKETS

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As presented to the Board in the PFM Financial Policy Report at the November 2020 meeting:

- Increase Fixed Obligation Coverage ratio – 1.40x in 2022
- Transition funding Other Post Employment Benefits to operating expense
- Funding capital expenditures from new debt will exceed 64% for 2021 and 2022 due impacts from COVID-19 pandemic and Tropical Storm Isaias. Return to target in 2023
- Continue cost recovery mechanisms to ensure collectability of costs that could fluctuate materially

## **BOARD AGENDA SUMMARY SHEET**

<b>Committee or Board:</b> Finance and Audit	<b>Date:</b> December 11, 2020	<b>Board Meeting Date:</b> December 16, 2020
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**For All Board Voting Items:**

**Title of Agenda Item:** Recommendation to Approve Amendments to the Board Policy on Debt and Access to the Credit Markets

**Consent Agenda:** ☒Yes ☐No

**Accompanying Presentation:** ☐Yes ☒No

**LIPA Presenter:** Tamela Monroe

**PSEG Long Island Presenter:** N/A

<b>Requested Action:</b>	The Committee is requested to adopt a resolution recommending amendment to the Board Policy on Debt and Access to the Credit Markets (the “Policy”).
<b>Summary:</b> <b>(include proposed amendments to Board Policies, if applicable)</b>	<p>In 2015 PFM Financial Advisors issued its 2015 Report with recommendations to LIPA for the development of the Policy. PFM has updated its review to ensure the Policy allows LIPA to continue to reduce debt over time to prudent industry levels, ensures LIPA’s consistent access to the capital markets on reasonable terms, and lowers LIPA’s long-term cost of electricity for its customers. The 2020 Report: (1) evaluated LIPA’s performance against the established targets, (2) discussed the credit rating agencies’ reactions to LIPA’s financial performance, and (3) evaluated potential adjustments to the prior targets to maintain LIPA’s recent favorable financial trajectory.</p> <p>PFM recommended the following updates to the Board Policy: increase the fixed obligation coverage ratio target to 1.40x in 2022; transition funding of the OPEB Account with funding sourced and categorized as an operating expense in LIPA’s consolidated budget; and continue to fund the Service Provider’s Pension Trust from operating expense; allow the percentage of Capital Expenditure Funded from New Debt to exceed 64% target on a forward-looking three-year rolling average in 2021 and 2022 as LIPA responds to the effects of the COVID-19 pandemic and Tropical Storm Isaias. Afterward the target percentage should return to 64% or below on a forward-looking basis for 2024 and beyond; and continue to use cost recovery mechanisms to ensure collectability of costs that could fluctuate materially.</p> <p>Additionally, LIPA Staff recommends removing the Appendix, Methodology to Calculate Financial Metrics, and include that in a LIPA internal Policy.</p>

## **FOR CONSIDERATION**

December 16, 2020

**TO:** The Finance and Audit Committee

**FROM:** Thomas Falcone

**SUBJECT:** Recommendation to Approve Amendments to the Board Policy on Debt and Access to the Credit Markets

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### **Requested Action**

The Finance and Audit Committee (the “Committee”) Board of Trustees (the “Board”) of the Long Island Power Authority (“LIPA”) is requested to adopt a resolution recommending amendments to the Board Policy on Debt and Access to the Credit Markets (the “Policy”), which resolution is attached hereto as **Exhibit “A”**.

### **Background**

By Resolution No. 1319, dated September 21, 2016, the Board adopted the Policy with the purpose of serving the long-term interests of LIPA’s customer-owners by adopting sound financial plans in each year. The Policy was amended by the Board by Resolution No. 1354, dated March 29, 2017, Resolution No. 1473 dated March 20, 2019 and last updated by Resolution No. 1498, dated December 18, 2019.

In 2015 PFM Financial Advisors issued its 2015 Report with recommendations to LIPA for the development of the Policy. PFM has updated its review to ensure the Policy allows LIPA to continue to reduce debt over time to prudent industry levels, ensures LIPA’s consistent access to the capital markets on reasonable terms, and lowers LIPA’s long-term cost of electricity for its customers.

The 2020 Report: (1) evaluated LIPA’s performance against the established targets, (2) discussed the credit rating agencies’ reactions to LIPA’s financial performance, and (3) evaluated potential adjustments to the prior targets to maintain LIPA’s recent favorable financial trajectory.

PFM recommended the following updates to the Board Policy:

- Increase the fixed obligation coverage ratio target to 1.40x in 2022;
- Transition funding of the OPEB Account with funding sourced and categorized as an operating expense in LIPA’s consolidated budget; and continue to fund the Service Provider’s Pension Trust from operating expense;
- Allow the percentage of Capital Expenditure Funded from New Debt to exceed 64% target on a forward-looking three-year rolling average in 2021 and 2022 as LIPA responds to the effects of the COVID-19 pandemic and Tropical Storm Isaias. Afterward the target percentage should return to 64% or below on a forward-looking basis for 2024 and beyond; and
- Continue to use cost recovery mechanisms to ensure collectability of costs that could fluctuate

materially.

Changes to the Policy are more specifically detailed in PFM Report as set forth in **Exhibit “D”**.

Additionally, LIPA Staff recommends removing the Appendix, *Methodology to Calculate Financial Metrics*, and include that level of detail in an internal LIPA Policy.

### **Recommendation**

Based upon the foregoing, I recommend approval of the above requested action by adoption of a resolution in the form attached hereto.

### **Attachments**

<b><u>Exhibit “A”</u></b>	Resolution
<b><u>Exhibit “B”</u></b>	Policy (redline)
<b><u>Exhibit “C”</u></b>	Policy (clean)
<b><u>Exhibit “D”</u></b>	Financial Policy Report prepared by PFM

**RESOLUTION RECOMMENDING APPROVAL OF AMENDMENTS TO THE BOARD  
POLICY ON DEBT AND ACCESS TO THE CREDIT MARKETS**

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**WHEREAS**, the Board Policy on Debt and Access to the Credit Markets (the “Policy”) was originally approved by the Board of Trustees (the “Board”) by Resolution No. 1319, dated September 21, 2016; and amended by Resolution No. 1354, dated March 29, 2017, Resolution No. 1473, dated March 20, 2019; and Resolution No. 1498, dated December 18, 2019.

**WHEREAS**, the Finance and Audit Committee (the “Committee”) of the Board of Trustees affirms that the changes to the Policy described herein are due and proper.

**NOW, THEREFORE, BE IT RESOLVED**, that consistent with the accompanying memorandum, the Committee hereby recommends approval of the amendments to the Policy as set forth in **Exhibit “B”**.

Dated: December 16, 2020

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**  
**#1473, amended March 20, 2019**  
**#1498, amended December 18, 2019**  
**#XXXX, amended December 18, 2020**



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### **Board Policy on Debt and Access to the Credit Markets**

It is the policy of the Long Island Power Authority to serve the long-term interests of LIPA's customer-owners. The Long Island electric grid requires substantial investments each year to maintain its reliability and resiliency. By adopting sound fiscal metrics and sustainable financial plans, LIPA ensures prudent levels of borrowing, ready access to funds on reasonable terms for infrastructure investment, and the lowest long-term cost to our customer-owners.

LIPA will achieve the lowest long-term cost to our customer-owners by adopting budgets and financial plans that meet the following objectives:

- Support credit ratings of at least A2/A;
- For 2020 and 2021, Achieve fixed-obligation coverage ratios of no less than (i) 1.35x on the combination of LIPA-issued debt and lease payments; and (ii) 1.15x on the combination of LIPA-issued debt, Utility Debt Securitization Authority ("UDSA")-issued debt, and lease payments<sup>1</sup>;
- Beginning in 2022, LIPA shall increase the fixed-obligation coverage ratios to no less than (i) 1.40x on the combination of LIPA-issued debt and lease payments; and (ii) 1.20x on the combination of LIPA-issued debt, UDSA-issued debt, and lease payments;<sup>1</sup>
- Generate sufficient cash flow from revenues to maintain the issuance of new debt as a percentage of capital spending at 64 percent or less as measured on a three-year rolling average; however, allow this percentage to exceed 64 percent% target on a forward-looking three-year rolling average in 2021 and 2022 as LIPA responds to the effects of the COVID-19 pandemic and Tropical Storm Isaias;
- Maintain (i) cash on hand at each month end of at least \$100 million in the Operating Fund and \$150 million in the Rate Stabilization Fund, and (ii) cash on hand and available credit of at least 120 days of operating expenses;
- Annually, Pre-fund obligations to LIPA's Service Provider for pension costs from operating expenses in a fiscally sound manner, as measured by an actuarial services firm no less than

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<sup>1</sup> Lease payments are defined in Governmental Accounting Standard Board Statement No. 87

every other year; and

- Annually Pre-fund obligations to LIPA's Service Provider for Other Post-Employment Benefits ("OPEBs") to a dedicated OPEB Account in a fiscally sound manner, as measured by an actuarial services firm no less than every other year<sup>2</sup>;
- Transition to a phase-in approach for annual pre-funding OPEB obligations from operating expenses beginning in 2023;
- Pre-fund LIPA's OPEB Trust in a fiscally sound manner, as measured by an actuarial services firm no less than every other year; and
- Pre-fund LIPA's Nuclear Decommissioning Trust Fund in a fiscally sound manner, as measured by an actuarial services firm no less than every other year.

The Chief Executive Officer shall report annually to the Board on compliance with the key provisions of this Policy.

#### Appendix: Methodology to Calculate Financial Metrics

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<sup>2</sup> After notifying the Finance and Audit Committee, LIPA's Chief Executive Officer or Chief Financial Officer are authorized to withdraw funds from the OPEB Account if there are insufficient revenues to pay reasonable and necessary Operating Expenses or to make payments on bonds or parity obligations. The OPEB Account is therefore deemed available to make such payments, acting as a reserve fund. Any withdraws for such purposes will be repaid within twelve months.



## **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 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 ratio.

**Fixed Obligation Coverage** is the ratio of funds available to pay LIPA's fixed obligations (annual debt service plus lease payments) as compared to those obligations. This ratio therefore measures the resources available from operations to make fixed scheduled payments. A fixed obligation coverage ratio of 1.0x, provides for exactly enough funds from ongoing operations to pay all operating expenses and make such fixed payments, leaving no excess funds available for capital investments. Even a small disruption to operations therefore could endanger payment of debt service and other fixed payments. A coverage ratio of 1.35x means the utility has enough funds to pay operating expenses and fixed obligation costs, plus a margin of 35 percent. Higher coverage ratios reflect a greater likelihood that such fixed payments will be paid and therefore represent less financial risk to bondholders and lease holders. As such, higher coverage ratios typically merit higher bond ratings and correspondingly lower borrowing costs.

Coverage differs from most financial statistics; in that it is not paid to bond and lease holders or 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 rating agencies and investors calculate coverage. This differs from the coverage formula used in LIPA's bond covenants<sup>1</sup>. The approach simplifies the review of sources and uses of cash flow and adopts most GAAP<sup>2</sup> conventions for measuring revenues and expenses, except in a few key areas highlighted below where GAAP figures are materially different than cash flow.

UDSA bonds are paid by an irrevocable, nonbypassable restructuring charge recovered from consumers set at an amount sufficient to pay the principal and interest payable on the bonds and other ongoing financing costs.

<sup>1</sup> LIPA's bond covenants calculate coverage by treating tax payments and lease obligations as funds available to pay debt service obligations.

<sup>2</sup> Generally Accepted Accounting Principles, as established by the Government Accounting Standards Board.

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
<b>= Total Revenue and Income</b>	<b>Subtotal 1</b>
+ Total Operating Expenses	Note 5
+ Other Interest Costs	Note 6
Less Non-Cash Adjustments:	
= Depreciation and Amortization	Note 7
= OPEB-GAAP Operating Expense	Note 8
<b>= Total Deductions from Revenue and Income</b>	<b>Subtotal 2</b>
+ Total Revenue and Income	Subtotal 1
= Total Deductions	Subtotal 2
+ Annual Long-Term Lease Payments	Note 9
<b>= Funds Available for LIPA + UDSA Coverage</b>	<b>Subtotal 3</b>
+ Funds Available for LIPA + UDSA Coverage	Subtotal 3
= UDSA Debt Service	Note 10
<b>= Funds Available for LIPA Fixed Obligations</b>	<b>Subtotal 4</b>
+ LIPA Debt Service	Note 10
+ Annual Long-Term Lease Payments	Note 9
<b>= LIPA Fixed Obligations</b>	<b>Subtotal 5</b>
+ LIPA Fixed Obligations	Subtotal 5
+ UDSA Debt Service	Note 10
<b>= LIPA + UDSA Fixed Obligations</b>	<b>Subtotal 6</b>
+ Funds Available for LIPA Fixed Obligations	Subtotal 4
/ LIPA Fixed Obligations	Subtotal 5
<b>= LIPA Coverage Ratio</b>	
+ Funds Available for LIPA + UDSA Obligations	Subtotal 3
/ LIPA + UDSA Fixed Obligations	Subtotal 6
<b>= LIPA + UDSA Coverage Ratio</b>	

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

1. ~~*Operating Revenue*~~ is reported on LIPA's Income Statement of Revenue, Expenses and Changes in Net Position.
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 Federal Emergency Management Agency (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 recognized over the expected life of the assets being constructed in amounts equal to depreciation expense on those assets in each year. The amount of Grant Income is reported on LIPA's Statement of Revenue, Expenses and Changes in Net Position.
3. ~~*Investment Income and Other Miscellaneous Income (Net)*~~ includes the amounts reflected on the Statement of Revenue, Expenses and Changes in Net Position for investment income, excluding income earned on LIPA's Nuclear Decommissioning Trust, and the net amount of the miscellaneous other income and deductions as reported on LIPA's Statement of Revenue, Expenses and Changes in Net Position.
4. ~~*Suffolk Property Tax Settlement and Visual Benefits Assessment*~~ are two regulatory assets that are being repaid by impacted customers through their electric bills over a specified period of time. Such customers repay principal and interest on related debt obligations. For GAAP purposes, the interest component is included in Other 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 as shown on LIPA's Cash Flow Statement are available to pay the related debt payments.
5. ~~*Total Operating Expenses*~~ are reported on LIPA's Statement of Revenue, Expenses and Change in Net Position and conform to GAAP.
6. ~~*Other Interest Costs*~~ represent costs that are reported as other interest expense on the Statement of Cash Flows Revenue, Expenses and Changes in Net Position but are not part of Debt Service. The largest component of Other Interest Cost Expe are ense is interest rate swap payments, which are generally subordinate to bond payments. Additional costs include interest on customer deposits and bank fees. Other Interest Costs 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 Expenses is shown on the LIPA's Statement of Revenue, Expenses and Changes in Net Position.

~~7. *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 recovered through debt service and are eliminated from the coverage calculation. Depreciation and Amortization are reported on LIPA's Statement of Revenue, Expenses, and Changes in Net Position. LIPA's key components of Depreciation and Amortization include:~~

- ~~• Depreciation of Utility Plant and Equipment;~~
- ~~• Amortization of the Acquisition Adjustment (purchase adjustment related to purchase of the Long Island Lighting Company in 1998); and~~
- ~~• Amortization of certain regulatory assets established by the Board for specific obligations related to 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).~~

~~8. *OPEB GAAP Operating Expense.* With the transition to a new service provider in 2014, there was a limited number of employees eligible for retirement and the cash pay-as-you-go costs for Other Post Employment Benefits (OPEBs) was relatively small compared to the GAAP accrual expense. 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 service provider. This pre-funding is deposited into a separately segregated OPEB Account that is available to make fixed obligation payments. LIPA's ratemaking model therefore recognizes the availability of these funds to make fixed obligation payments.<sup>3</sup> The non-cash OPEB expense is reported on LIPA's Statement of Cash Flow. Beginning Starting in 2023, the non-cash adjustment for OPEB GAAP Operating Expense will be phased out of the fixed obligation coverage calculation over three years, which is intended to result in higher revenue requirements and more cash available from coverage to fund capital expenditures.~~

~~9. *Annual Long Term Lease Payments.* Rating agencies consider lease payments as a fixed obligation that operates like debt. LIPA has substantial leases related to its procurement of power supplies for generating facilities and transmission cables. In Accordance with ing to GASB, leases are must be recorded on LIPA's financial statements as long term assets and obligations. To recognize long term lease obligations in the calculation of coverage, the rating agencies add the annual lease obligation (imputed repayment of principal and interest) to both the numerator and the denominator of the fixed obligation coverage ratio. LIPA's Annual Long Term Lease Payments are shown in the footnotes to its audited financial statements.~~

~~10. *Debt Service* consists of the payment of principal and interest on LIPA's long-term and~~

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<sup>3</sup> LIPA originally employed 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. Over time, the difference between GAAP expense and cash expense for OPEBs will also narrow and LIPA expects that this adjustment may be eliminated.

~~short-term bonds. The debt service payment schedule for long-term bonds is established when the bonds are issued and typically includes semi-annual interest payments. Short-term debt typically includes monthly or quarterly interest payments. 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. Scheduled debt maturities are considered debt service obligations and are included in the debt service payments. Debt is sometimes refunded with new debt, typically to obtain lower interest costs. Debt refunded before its scheduled date is excluded from debt service requirements, and the scheduled repayments of the new debt replaces the scheduled repayment of the refunded debt. Debt may also be called for early retirement should cash on hand be sufficient for such purposes. Such early redemption or defeasance of debt is excluded from debt service requirements. Short-term debt can also be refunded or rolled over through issuing 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 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. Debt Service payments are reported on LIPA's Cash Flow Statement.~~

~~**Days Cash on Hand** is the ratio of the total cash and credit available divided by LIPA's budgeted average daily operating expenses.~~

**Minimum Days Cash on Hand  
must be at least 120 days**

~~Days Cash on Hand measures LIPA's ability to sustain its operations if revenues are delayed, reduced or interrupted for any reason. Available cash consists of cash reported on the Statement of Net Position and includes both unrestricted cash and funds 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, letters and lines of credit, and general revenue notes, including a revolving credit agreement. The average daily expenditure is calculated by taking LIPA's annual approved budgeted revenues minus depreciation, amortization, and interest expense (budgeted operating expenses) and dividing the net value by 365 days.~~

**Percent of Capital Spending Funded By Debt**

~~is calculated as the ratio of new money debt budgeted to be issued divided by 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 statements and represents the net increase in utility plant and property (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 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.~~

**Percent of Capital Spending Funded by Debt not to exceed 64% measured over a three-year period**

~~Given the variability in capital spending from year to year, as well as the variability in timing of bond issuance, it is prudent to target a revenue funding percentage over a multi-year planning period as opposed to implementing a strict year-by-year target. LIPA measures the 64 percent target on a rolling three-year average basis.~~

~~In certain circumstances, LIPA may choose to exercise an early redemption of existing debt with available cash on hand. These transactions reduce outstanding debt obligations that could have been used to cash fund capital spending and effectively reduce the amount of new capital spending funded by debt. Such early redemptions are incorporated into the ratio in the year that the redemption occurs and represent an offset to the new debt that was issued in the year.~~

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**  
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### **Board Policy on Debt and Access to the Credit Markets**

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LIPA will achieve the lowest long-term cost to our customer-owners by adopting budgets and financial plans that meet the following objectives:

- Support credit ratings of at least A2/A;
- For 2020 and 2021, achieve fixed-obligation coverage ratios of no less than (i) 1.35x on the combination of LIPA-issued debt and lease payments; and (ii) 1.15x on the combination of LIPA-issued debt, Utility Debt Securitization Authority ("UDSA")-issued debt, and lease payments<sup>1</sup>;
- Beginning in 2022, LIPA shall increase the fixed-obligation coverage ratios to no less than (i) 1.40x on the combination of LIPA-issued debt and lease payments; and (ii) 1.20x on the combination of LIPA-issued debt, UDSA-issued debt, and lease payments;<sup>1</sup>
- Generate sufficient cash flow from revenues to maintain the issuance of new debt as a percentage of capital spending at 64 percent or less as measured on a three-year rolling average; however, allow this percentage to exceed 64 percent target on a forward-looking three-year rolling average in 2021 and 2022 as LIPA responds to the effects of the COVID-19 pandemic and Tropical Storm Isaias;
- Maintain (i) cash on hand at each month end of at least \$100 million in the Operating Fund and \$150 million in the Rate Stabilization Fund, and (ii) cash on hand and available credit of at least 120 days of operating expenses;
- Annually, pre-fund obligations to LIPA's Service Provider for pension costs from operating expenses in a fiscally sound manner, as measured by an actuarial services firm no less than every other year; and

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- Annually pre-fund obligations to LIPA's Service Provider for Other Post-Employment Benefits ("OPEBs") to a dedicated OPEB Account in a fiscally sound manner, as measured by an actuarial services firm no less than every other year<sup>2</sup>;
- Transition to a phase-in approach for annual pre-funding OPEB obligations from operating expenses beginning in 2023;
- Pre-fund LIPA's OPEB Trust in a fiscally sound manner, as measured by an actuarial services firm no less than every other year; and
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The Chief Executive Officer shall report annually to the Board on compliance with the key provisions of this Policy.

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<sup>2</sup> After notifying the Finance and Audit Committee, LIPA's Chief Executive Officer or Chief Financial Officer are authorized to withdraw funds from the OPEB Account if there are insufficient revenues to pay reasonable and necessary Operating Expenses or to make payments on bonds or parity obligations. The OPEB Account is therefore deemed available to make such payments, acting as a reserve fund. Any withdraws for such purposes will be repaid within twelve months.





# **Long Island Power Authority**

## **Summary of the 2020 Financial Policy Report**

**Mike Mace**  
**Managing Director**

November 18, 2020

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PFM Financial Advisors

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[www.pfm.com](http://www.pfm.com)



## 2020 Financial Policy Report

### Discussion Topics

Recap of 2015 Report Recommendations and Results

2020 Recommended Revisions to the Financial Policy

Impacts of the Recommendations

Summary



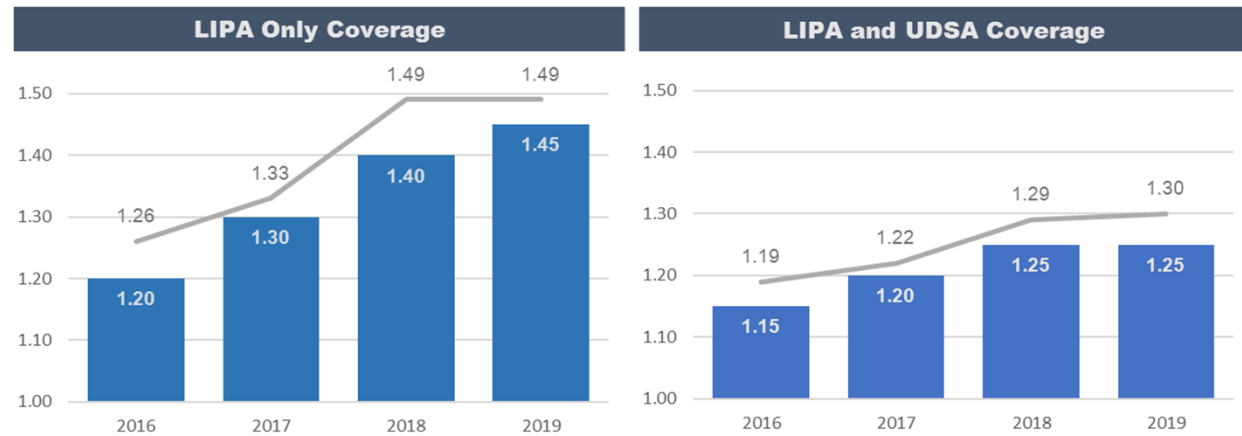
## Recap of the 2015 Report

- Prior to 2015, LIPA's financial strength, metrics, and credit ratings positioned LIPA as the “low outlier” among its peer group of major public power utilities
- LIPA was paying materially higher interest rates and bank credit costs than its peers
- The higher financing costs had a direct impact on customer costs, and put LIPA at risk to unexpected and adverse events in its operating environment and the financial markets
- The 2015 Report contained recommendations designed to elevate LIPA's financial condition from “at risk” to “viable”, and achieve credit rating upgrades to the mid-A level:
  - Gradually improving fixed obligation coverage (cash flow for debt service and cap ex)
  - Use of “automatic” Cost Recovery Mechanisms for timely recovery of highly variable or uncertain costs
  - Monitoring/improving other financial metrics (liquidity/leverage)
- LIPA's success in establishing and achieving targets led to credit rating upgrades and materially reduced financing costs; directly benefiting customers.



## Recap of the 2015 Report

- ◆ LIPA achieves and exceeds financial objectives



- ◆ Improvement drives bond rating upgrades



(September 6, 2019) Fitch Ratings, Moody's and Standard & Poor's cited LIPA's improved financial metrics and controls, including a policy of keeping more cash on hand to fund operations... ...in upgrading the Authority's debt, which had traditionally been among the lowest-rated among national public utilities. All three rated LIPA's outlook as "stable."



## 2020 Recommended Revisions to the Financial Policy

- ◆ LIPA is on a sound path to continued, gradual financial improvement
  - LIPA is a solid A credit
  - Any policy changes should balance near term affordability and long-term benefit
- ◆ However, LIPA remains the most highly leveraged of its large public power peer group

Public Power Peer Group Utility	Sr Bond Rating	Debt Ratio (%)
Long Island Power Authority, NY	A2	97.5
Salt River Project, AZ	Aa1	42.3
Orlando Utilities Commission, FL	Aa2	47.4
Austin Electric Enterprise, TX	Aa3	48.1
Seattle Electric Enterprise, WA	Aa2	54.6
Sacramento Muni Utility Dist, CA	Aa3	57.4
San Antonio Combined Utility Enterprise, TX	Aa1	58.1
Omaha Public Power District, NE	Aa2	63.7
Los Angeles Dept of Water & Power (LADWP), CA	Aa2	65.1
Average of Other Peer Group Members		54.6

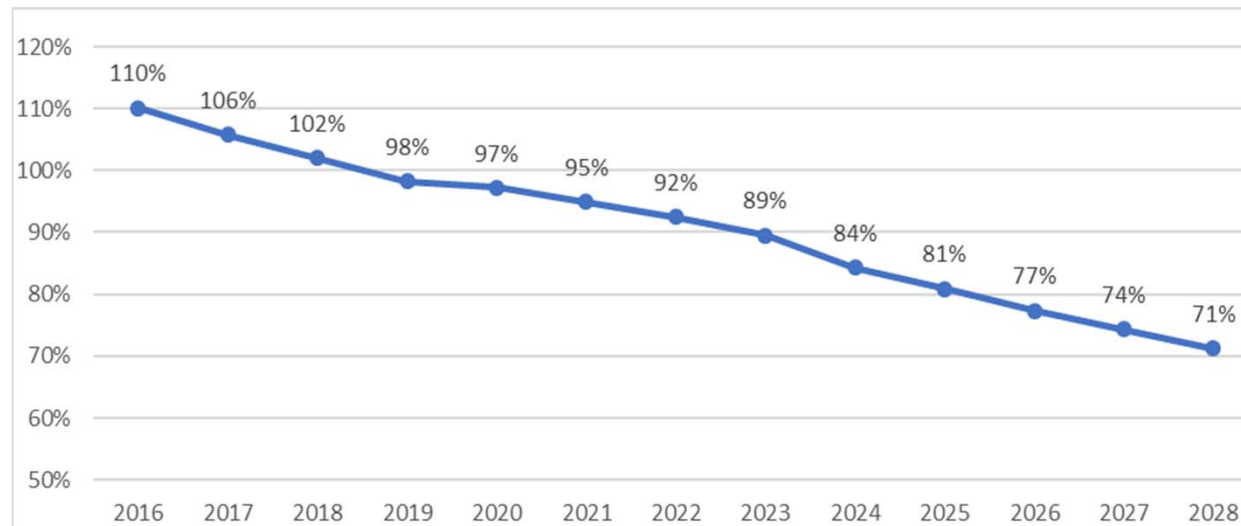
- ◆ And more exposed to financial impacts of external events (storms, COVID, market disruption)
- ◆ PFM recommends a phased-in increase of the LIPA-Only coverage target up to 1.40x



## Impacts of the Recommendations

- ◆ Additional, measured improvement in LIPA's Debt-to-Assets ratio is warranted
  - Achievable with a slight increase in the LIPA-Only coverage target from 1.35X to 1.40X
  - This will also achieve LIPA's long-term objective of limiting debt reliance to 64% of cap ex
  - COVID-19, Storm Costs and OPEB funding argue for a phase-in of the 1.40X target in 2022
  - The higher target can be achieved with modest rate impacts due to significant potential refinancing savings on LIPA and UDSA debt
- ◆ Reasonable targets and consistent achievement will deliver results

**LIPA Historical and Projected Debt-to-Assets Ratio**





## Summary

- ◆ LIPA's financial and credit ratings improvement to date will translate to over \$1 Billion in cost savings over the long-run, through:
  - lower new money borrowing costs
  - enhanced debt refunding savings
  - lower bank credit costs
  - greater access to low-cost, variable-rate debt
- ◆ Further affordable, achievable improvement will “de-risk” LIPA's balance sheet and reduce exposure to external disruptions, while lowering the long-term cost of electricity for customers
- ◆ This should improve LIPA's bank credit capacity and costs, and create the potential for further credit rating upgrades
- ◆ Investors will recognize and reward adherence to prudent objectives
- ◆ Questions and Comments

# **FINANCIAL POLICY REPORT FOR THE BOARD**

PREPARED BY PFM FINANCIAL ADVISORS

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## EXECUTIVE SUMMARY

In 2015, the LIPA Board of Trustees requested that PFM Financial Advisors (“PFM”) provide a report (the “2015 Report”) containing financial policy recommendations that would reduce LIPA’s debt over time to prudent industry levels, ensure consistent access to the capital markets on reasonable terms, and lower the long-term cost of electricity for LIPA’s customers.

The 2015 Report’s recommendations were adopted by the Board of Trustees at the December 2015 meeting and reflected in the Board Policy on Debt and Access to the Credit Markets (the “Financial Policy”).

After five years of experience with the Financial Policy, the LIPA Board of Trustees requested that PFM undertake a review of the Policy.

As a result of the Board’s Policy, **LIPA has received four credit rating upgrades since 2013 and achieved the stated Policy goal of mid-A ratings in 2019**, which were affirmed by all three rating agencies in 2020. The rating agencies, Moody’s Investor Services, Fitch, and Standard & Poor’s, cited the following key factors for such upgrades:

- Improved Coverage Ratios
- De-Leveraged Debt-to-Assets Ratio
- Adequate Liquidity
- Robust Cost Recovery Mechanisms

**The Board’s Financial Policy has resulted in a steady decline in the cost of borrowing, which has directly benefited LIPA’s customers.** This improvement reflects the bond market’s assessment that LIPA has become a more credit-worthy borrower, meriting a lower cost of debt, which translates into customer savings.

**LIPA continues to have elevated levels of debt compared to peer utilities.** However, the Board’s Policy, if followed, will result in continued de-leveraging of LIPA over time, achieving the Board’s goal of prudent industry standard levels of debt by 2028.

**PFM recommends that LIPA continue its present course with a few Policy modifications.** The Board’s current Financial Policy calls for fixed-obligation coverage of 1.35x of LIPA debt service and lease payments. The Policy also calls for borrowing 64% or less of capital expenditures. The 1.35x fixed obligation coverage ratio is projected to be insufficient to meet the 64% or less borrowing threshold. To reduce borrowing, PFM recommends:

- Increasing the fixed-obligation coverage ratio target to 1.40x in 2022;
- Phasing in the funding of Other Post Employment Benefit (“OPEB”) benefits from Operating Expenses rather than from fixed-obligation coverage;
- Continuing to use CRMs for costs that are outside the utility’s control and could fluctuate materially, resulting in greater than anticipated borrowing (or alternatively, to budget for a level of fixed obligation coverage in excess of the Board’s target ratio); and
- Maintaining the target for cash and available credit at 120 days of operating expense.

**These recommendations should enable LIPA to achieve a Debt-to-Assets ratio of 70% by 2028.** A 70% Debt-to-Assets ratio would still leave LIPA at the upper end of its municipal utility industry peer group for leverage.

It is important to note there are near-term issues such as the COVID-19 pandemic; and long-term challenges, including meeting the Board’s clean energy and service improvement objectives. These near- and long-term challenges may affect LIPA’s year-to-year ability to achieve certain financial objectives. Based on projections, these could result in a lengthening of the period to achieve a 70% Debt-to-Assets ratio. However, the long-range goal should be one of continued de-leveraging and gradual improvement in LIPA’s financial condition.

LIPA's improved financial performance, improved credit ratings, and lower borrowing costs represent the benefits of establishing and following prudent financial objectives. LIPA's customers have benefited from the financing cost savings resulting from the Board's prudent Financial Policy.

## BACKGROUND ON PUBLIC POWER FINANCIAL POLICIES

In 2015, PFM issued its 2015 Report and recommendations to LIPA. As the Board reviews its Financial Policy, PFM has been requested to provide an update to continue to reduce LIPA's debt over time to prudent industry levels, ensure consistent access to the capital markets on reasonable terms, and lower the long-term cost of electricity for LIPA's customers.

The 2020 Report: (1) evaluates LIPA's performance against the established targets, (2) discusses the credit rating agencies' reactions to LIPA's financial performance, and (3) evaluates potential adjustments to the Financial Policy to maintain LIPA's recent favorable financial trajectory.

There are several factors public power utilities consider in establishing financial policies. Listed below are the major financial metric categories credit analysts examine in order to determine relative credit strength in the public power industry.

### i. Coverage Ratios

Debt service coverage is the amount of funds available, after payment of operating costs, to pay debt service; divided by the principal and interest due in the year. Considerations specific to LIPA's approach to coverage include:

- LIPA, like many utilities, has debt-like features in certain long-term power purchase agreements. In calculating coverage, such costs are excluded from operating expenses and considered debt service in the calculation of a utility's total "Fixed Obligation Coverage." The rating agencies and credit analysts focus intently on this broader measure of cash flow coverage.
- LIPA's utilization of Utility Debt Securitization Authority ("UDSA") securitization debt as a low-cost financing alternative is unique among public power utilities. Some rating agencies consider the fixed obligation coverage ratio on only LIPA debt, while others combine the LIPA and UDSA coverage requirements into a single composite ratio.

### ii. Debt Ratios and Leverage

Credit analysts are also concerned with the amount of debt a utility owes in comparison to its assets. Leverage is the relationship between debt and other sources of capital and the degree to which an entity uses debt to finance its assets.

**In 1998, LIPA borrowed over \$7.0 billion to acquire the Long Island Lighting Company (LILCO).** At the time, the transaction was the largest municipal debt financing ever issued in the nation.

To reduce the cost of LIPA's debt, in 2013, the LIPA Reform Act created the Securitization Law and established the UDSA. The Securitization Law allowed the UDSA to issue restructuring bonds totaling approximately \$4.5 billion, the proceeds of which refunded LIPA bonds and generated total net present value debt service savings of \$492 million for LIPA's customers.

In addition, PFM recommended LIPA reduce its leverage by achieving a lower Debt-to-Assets ratio. As with coverage ratios, there are multiple methods to calculate leverage and debt ratios. LIPA uses the Debt-to-Assets ratio outlined by Moody's Investors Services described below:

**(Gross debt – debt service funds – interest payable – debt service reserve funds)**

**Divided by**

**(Gross fixed plant assets – accumulated depreciation + net working capital)**

*(Net working capital is defined as cash and investments plus receivables expected to be collected minus current liabilities unrelated to debt.)*

This calculation provides a good indication of overall financial strength by comparing “net debt” to “net assets.” With the adoption of the Board's Financial Policy in 2015, and reduced reliance on debt funding for the capital program, **LIPA was able to generate considerable cash flow for capital funding, thereby improving its Debt-to-Assets ratio from 110% in 2015 to roughly 98% in 2020.**

### iii. Liquidity and Days Cash on Hand

Most municipal and investor-owned utility financial policies include liquidity targets. The targets often specify which funds can be drawn upon to meet liquidity needs. The targets may also establish the timeframe for rebuilding cash balances if they are drawn down below targeted reserve levels. **LIPA targeted to maintain liquidity levels equal to roughly 120 days of average cash expenditures.** This level is consistent with other large public power utilities and within the range viewed by rating agencies as prudent and reasonable.

### iv. Cost Recovery Mechanisms

The existence of effective CRMs for volatile or hard-to-predict costs is an important, positive consideration for credit analysts who follow public power utilities. CRMs reduce the chance unexpected cost increases could reduce debt service coverage and liquidity metrics. The resulting stability in financial performance enables a utility with CRMs to function with less coverage and lower liquidity than a utility that is unable to make these timely adjustments to reflect actual costs (and thus defers these costs for future collection).

## RECOMMENDATIONS FROM THE 2015 REPORT

PFM's 2015 Report provided three general recommendations:

**Recommendation #1:** Establish Fixed Obligation Coverage Ratio Targets That Support Mid-Single-A (A2/A/A) Credit Ratings Within Five Years by achieving the following key financial metric targets:

- “LIPA-only” Fixed Obligation Coverage of 1.45x over the next four years.<sup>1</sup>
- “Combined LIPA/UDSA” Fixed Obligation Coverage of 1.25x over the next four years.

**Recommendation #2:** Implement Cost Recovery Mechanisms to Enhance Financial Stability and Allow for Lower Overall Electric Rate Levels.

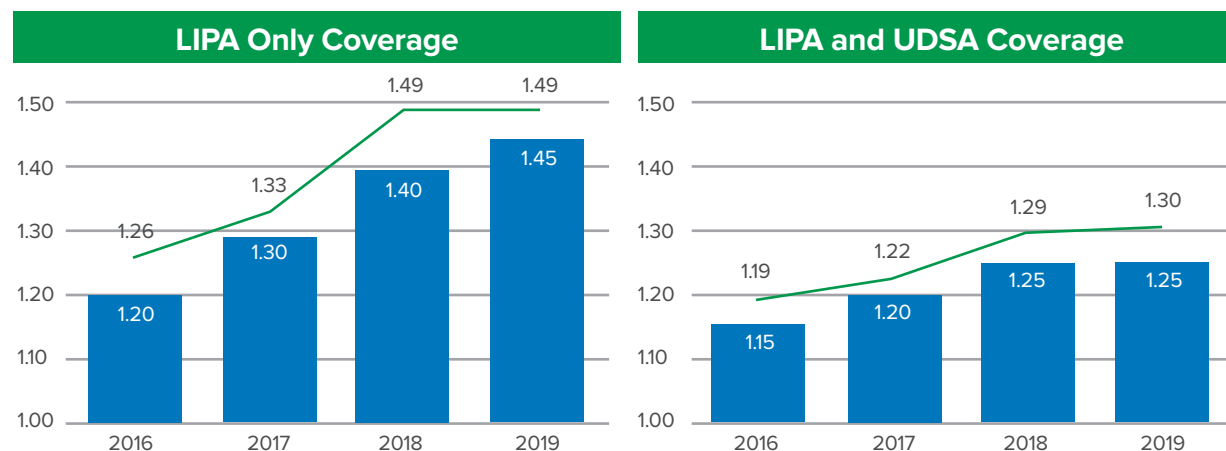
**Recommendation #3:** Monitor Other Financial Metrics (i.e., debt ratios) Affected by Coverage and which are Important to Credit Analysts.

<sup>1</sup>Due to a subsequent change in accounting rules related to the capitalization of leases, PFM's original 1.45x fixed obligation coverage ratio is equivalent to 1.35x today.

## LIPA'S FINANCIAL TARGETS AND RECENT BOND RATING UPGRADES

PFM's recommendations in the 2015 Report were designed to achieve mid-A level credit ratings within five years. PFM advised LIPA to: (1) develop sound financial policies; and (2) implement the policies consistently over three to five years. PFM believed LIPA would attain mid-A credit ratings by achieving a "LIPA-Only" Fixed Obligation Coverage ratio of 1.45x and a "Combined LIPA/UDSA" Fixed Obligation Coverage ratio of 1.25x over the three to five-year period. LIPA's Board of Trustees adopted these goals in the Board's Financial Policy.

As the following charts demonstrate, **LIPA has met or exceeded the Board's Financial Policy targets in each year.**



**The Board's Financial Policy, which targeted the above fixed obligation coverage ratios, was intended to provide adequate cash flow to limit borrowing to no more than 64% of capital spending.** LIPA exceeded its coverage target in every year and was able to fund less than 64% of its capital expenditures from new debt.

As a result of achieving (and exceeding) its financial targets, **LIPA achieved its objective of improved credit ratings in the mid-A range in 2019.** The excerpts from the rating agency reports contained in Appendix 1 provide a summary of the rationale for the upgrades, which relate primarily to LIPA's financial policy. PFM also recommends that readers examine each of the referenced reports in their entirety.

## BENEFITS OF THE FINANCIAL POLICIES TO CUSTOMERS

Beyond achieving its target financial metrics and credit ratings, **LIPA accomplished its overall goal of reducing interest rates on its debt and delivering lower costs to its customers.** Most public power bond issuers compare their new issue borrowing costs over time to the Municipal Market Daily Index ("MMD Index"). The MMD Index contains a collection of independent market-based data with daily general market rates for the highest-rated (AAA) municipal market borrows. The municipal market describes interest rates on individual municipal bonds in terms of their "Spread to MMD." This is the amount by which the market rate on a particular bond exceeds the rate on the highest quality AAA-rated bonds. This differential is typically expressed in "basis points" – with 1 basis point equaling 0.01%, or 100 basis points equaling one full percentage point in interest rate. LIPA's new issue MMD spreads declined by roughly 75 basis points (or 3/4s of 1%) between 2012 and 2019.

This reduction in borrowing cost may not seem like a large amount. However, when this interest rate reduction is applied to a \$500 million 30-year bond issuance, which is approximately the size of LIPA's annual borrowings, the annual interest savings is \$3.8 million, and the interest savings total to about \$75 million over 30 years.

In addition to the interest savings on the funds LIPA **does** borrow each year, **customers also realize the benefits of avoided principal and interest on the reduced amount of borrowing LIPA will require over time.** For example, if LIPA's prudent Financial Policy decreases annual borrowings by roughly \$60 million each year, the avoided long-term debt service savings applicable to the \$60 million debt avoidance is roughly another \$100 million. LIPA's Financial Policy provides long-term savings on both borrowing and avoided borrowing. It is these savings, which will accrue to LIPA's customers, that are the primary objective of LIPA's Financial Policy.

Recent events related to the COVID-19 pandemic have caused concerns within the overall bond markets. New issue trading spreads relative to the AAA MMD Index have increased across the municipal market. While MMD spreads on LIPA's recent 2020 bond issue increased slightly relative to 2019 levels, the spreads were materially less than if LIPA had not achieved its recent credit rating upgrades. It should be noted that the interest rates on LIPA's recent 2020 bonds sale were the lowest in its history – attributable to LIPA's improved financial performance combined with lower interest rates in general.

## RECOMMENDED REVISIONS TO THE FINANCIAL TARGETS

**The Board's well-designed Financial Policy and CRMs have earned LIPA a high level of investor confidence,** as exhibited by its improved credit ratings and lower borrowing costs. PFM believes LIPA is well positioned from the standpoint of its current financial direction and credit ratings. PFM's recommendation for LIPA's future financial targets are to continue with its current path with minor adjustments.

PFM's 2015 recommendations were designed to improve LIPA's credit ratings to the mid-A level within five years. PFM believes LIPA's adoption of the Policy revisions will keep LIPA on the path of continued improved financial strength based on reduced reliance on debt and an improving Debt-to-Assets ratio. Consistent achievement of the objectives will translate to further improvements in LIPA's credit ratings, likely within five years.

## COVERAGE AND DEBT FUNDING STRATEGIES

The fixed obligation coverage ratio targets in the 2015 Report were designed to: (1) provide coverage metrics that were expected to achieve LIPA's mid-A credit rating objective, and (2) reduce LIPA's Debt-to-Assets ratio by providing sufficient cash flow to fund at least 36% of LIPA's capital expenditures.

LIPA is currently on a path to continually reduce its Debt-to-Assets ratio over time. Actions LIPA can take to impact this trend involve the amount of funds generated from coverage relative to the level of capital spending.

**LIPA continues to be the most highly leveraged of its peer group of large public power utilities.** While LIPA has made tremendous improvement to credit strength, its greater reliance on debt than its peer group translates to higher interest rates, higher debt-related costs, and more risk than its public power utility peer group.

Following is a listing of the Debt-to-Assets ratios of what PFM considers to be LIPA's most applicable peer group of large, vertically-integrated public power utilities. The Debt-to-Assets ratios were obtained from Moody's Financial Ratio Analysis data listing the most recently recorded Debt-to-Assets ratios in their database. The ratios calculated by Moody's may vary from those calculated by the utilities themselves, or by other third parties. We utilize the Moody's data for its calculation consistency across the group – as all of them are rated by Moody's.

Public Power Peer Group Utility	Sr Bond Rating	Debt Ratio (%)
Long Island Power Authority, NY	A2	97.5
Salt River Project, AZ	Aa1	42.3
Orlando Utilities Commission, FL	Aa2	47.4
Austin Electric Enterprise, TX	Aa3	48.1
Seattle Electric Enterprise, WA	Aa2	54.6
Sacramento Muni Utility Dist, CA	Aa3	57.4
San Antonio Combined Utility Enterprise, TX	Aa1	58.1
Omaha Public Power District, NE	Aa2	63.7
Los Angeles Dept of Water & Power (LADWP), CA	Aa2	65.1
Average of Other Peer Group Members		54.6

**The average debt ratio of the other peer group members is roughly 55%, which compares to 97.5% for LIPA.** The average Moody's rating of the other peer group members is close to Aa2. While it would certainly benefit LIPA to have a roughly 50% debt ratio and an Aa2 credit rating, it would simply be unaffordable for LIPA's customers to increase electric rates to achieve these metrics in the next 3-5 years.

**LIPA cannot change the history behind its currently high Debt-to-Assets ratio. Nor can it burden customers by targeting an unachievable goal of getting to its peer group average over a few years. But it can stay on the current path of continued improvement.** This is a path that has allowed LIPA to borrow at very competitive interest rates and gain the confidence of investors and rating agencies.

**PFM recommends the LIPA Board consider two changes to ensure LIPA achieves a prudent balancing of its capital program from both debt and cash flow coverage for the next five years:** (1) implement a slight increase to the fixed obligation coverage target beginning in 2022; and (2) phase in collection of OPEB expense as a component of operating expense, so that coverage dollars can be used predominately to lower borrowing needs for capital expenditures, thereby further improving LIPA's Debt-to-Assets ratio.

PFM's 2015 Report recommended a LIPA-only fixed-obligation coverage ratio of 1.45x beginning in 2019 and thereafter. The 1.45x coverage ratio target was adjusted by LIPA to reflect a new accounting definition of lease payments issued by the Government Accounting Standards Board (Statement no. 87 – Leases). The revised ratio of 1.35x coverage, combined with the new lease definition, provides the same level of cash flow available for capital improvement funding as the prior 1.45x coverage target.

**PFM believes LIPA should increase its LIPA-only fixed obligation coverage ratio from 1.35x to 1.40x beginning in 2022 to reduce future borrowing.** Transitioning from a 1.35x to a 1.40x coverage ratio will reduce LIPA's annual borrowings by approximately \$33 million per year.

## **PRE-FUND LIPA'S FUTURE OBLIGATIONS FOR OTHER POST-EMPLOYMENT BENEFITS**

LIPA "pre-funds" future obligations for Service Provider pension and employee OPEB benefits by contributing to a pension trust and a dedicated OPEB Account. Pre-funding involves contributing to reserves for these future obligations each year, rather than waiting until the obligations come due in the future.

Due to the high level of OPEB obligations upon transitioning to its new Service Provider, LIPA was not able to immediately collect such costs in rates derived from operating costs without causing undue burden on customer bills. Rather, the dedicated OPEB Account was built up over time based on a forecast of actuarially determined funding using funds generated from the coverage ratio (i.e. in lieu of reducing borrowing).

Given LIPA's actuarially determined OPEB expense has levelized, LIPA should change its source of annual OPEB Account funding to an operating expense, as opposed to the current approach of funding with coverage dollars. The new policy should be phased in over three years (2023 – 2025) to avoid a substantial increase in the revenue requirement for OPEB costs in one year.

**A sound, consistent OPEB funding mechanism will allow LIPA to appropriately fund this material future financial obligation as it is incurred.** This will more clearly align the timing and nature of the OPEB cost as a current year operating expense, and designate dollars collected and labeled as fixed obligation coverage to reduce borrowing needs for capital expenditures. Moving funding of OPEBs to operating expenses will reduce LIPA borrowing by approximately \$30 million per year when fully implemented.



## NEAR TERM IMPACTS OF COVID-19 AND TROPICAL STORM ISAIAS

LIPA's coverage ratio targets were designed to reduce LIPA's debt ratio by providing sufficient cash flow to fund at least 36% of LIPA's capital expenditures on an ongoing basis. Recent events have impacted financial results and the borrowing levels in LIPA's financial plan.

The financial impacts from the COVID-19 pandemic include loss of commercial revenues, waiver of various miscellaneous revenues, and higher operating expenses. LIPA is forecasting it will fall below its revenue and coverage targets for 2020. However, LIPA's strong cash position and access to the credit markets, which were a direct result of its strong financial policies, ensured these operating impacts were properly managed without imposing significant rate impacts on customers. In the midst of the COVID-19 crisis, the rating agencies maintained LIPA's credit ratings, with the caveat that potential further COVID-19 impacts were not yet known.

LIPA's finances were also affected by Tropical Storm Isaias, which devastated the North-East Atlantic coastal region in August of 2020. Damage on Long Island reached levels not seen since Superstorm Sandy, making it one of the most damaging storms ever to hit Long Island's electric grid, with estimated repair costs in the range of \$300 million. LIPA expects FEMA to reimburse roughly 75% of the cost of restoration. However, typical FEMA reimbursements lag actual expenses considerably. LIPA has the financial responsibility to fund the restoration costs prior to the anticipated reimbursement. LIPA will also be responsible for any amounts that are not reimbursed by FEMA; and as such LIPA expects to use interim borrowing for storm costs. This will temporarily increase LIPA's debt levels.

**With LIPA's strong financial policies in place, LIPA was able to manage both COVID-19 and Tropical Storm Isaias in 2020.** However, their costs have led to temporary deterioration in certain of LIPA's financial metrics. PFM sees this as a temporary impact, and believes LIPA is positioned to meet its overall target of reducing its debt-levels over the longer term.

## LIQUIDITY LEVELS

Liquidity levels and targets are designed to ensure a utility has sufficient cash on hand to meet ongoing cash flow needs – even in the event of revenue disruption or unexpected costs. LIPA's Board has established a goal of approximately \$250 million of available cash on hand at all times, and a combination of cash and available borrowing lines equal to 120 days of operating expense. The rating agencies are generally comfortable with 90 to 150 days liquidity for A rated utilities, and LIPA's 120 days target is in the middle of this range. **PFM believes LIPA should maintain the current liquidity target as it falls in the midrange for what credit rating agencies and investors expect of a mid-A rated utility.**

## COST RECOVERY MECHANISMS

**Rating agencies and investors place considerable emphasis on LIPA's CRMs to enhance LIPA's ability to consistently deliver upon its financial objectives.** The value of these CRMs is clear in the language of the credit rating report excerpts listed previously in this report, and further highlighted below.

### Moody's Investors Service – September 06, 2019

While LIPA's fixed charge coverage ratio is somewhat weak for a mid-A rated public power utility, its cash flow stream is more stable than certain comparable utilities due to the strong suite of cost recovery mechanisms. For example, these mechanisms provide recovery should a shortfall from budgeted revenue and expense items occur due to external factors, including weather, storms and economic conditions.



## Fitch Ratings – September 5, 2019

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. 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.

## S&P Global Ratings – September 5, 2019

... the operational and management assessment reflects the benefits of a basket of financial tools that facilitate passing along to customers the changes it could experience in a wide range of variable costs, including a decoupling mechanism that tempers the exposure of energy sales and revenue to energy-efficiency programs, distributed generation, and weather.

The stable outlook reflects expectations of strengthening fixed charge coverage, the availability of robust pass-through mechanisms for recovering rising costs...

Beyond base rates, retail rates include monthly and other periodic adjustment mechanisms for recovering changes in sales, purchased power costs, delivery costs, debt service, storm costs, payments in lieu of taxes, and other adjustments. We consider these mechanisms as supporting revenue-stream stability. Among these is a revenue-decoupling mechanism that provides for the collection of revenues deemed to have been lost to energy-efficiency programs, distributed generation, weather, and changes in economic conditions.

The rating analysts' excerpts clearly support LIPA's CRMs as positive credit features. **PFM recommends LIPA continue to use CRMs to manage major variable cost components largely outside of the utility's control.** PFM is confident LIPA's customers will be well served by maintaining LIPA's CRMs and its financial objectives – along with potential future modifications to these policies as needed to reflect changing credit rating agency methodologies and emerging industry trends.

**In the absence of a CRM for a significant variable cost component, LIPA should consider budgeting for a fixed obligation coverage ratio in excess of the minimum called for in the Board's Financial Policy. LIPA will only achieve its financial objectives by meeting its minimum financial ratios in each year.**

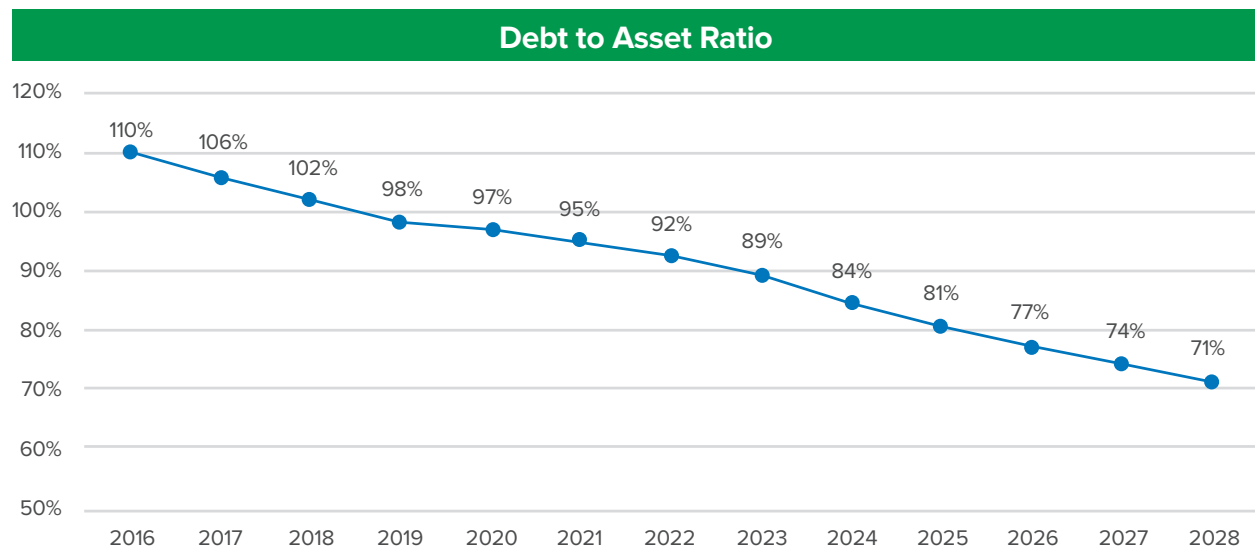
## IMPACT OF RECOMMENDATIONS ON LIPA'S METRICS

The Board's Financial Policy targets roughly 36% of the capital program to be funded with coverage dollars. Based on projections provided by LIPA, it appears a LIPA-only fixed-obligation coverage ratio of 1.40x, combined with phasing in funding of OPEBs from operating expenses, will provide this level of coverage dollars for capital beginning in 2025, and gradually reduce LIPA's Debt-to-Assets ratio to a level of roughly 70% by 2028. These projections were based on a capital budget of approximately \$850 million per year.

PERCENT OF CAPITAL FUNDED FROM DEBT	2021	2022	2023	2024	2025	2026	2027	2028
With Report Recommendations	72.0%	67.6%	66.2%	65.7%	62.6%	61.4%	58.4%	58.8%
No Change to Coverage Ratio and OPEB Policy	72.0%	71.8%	71.8%	72.3%	70.7%	69.3%	66.7%	66.9%

**Without these adjustments, LIPA would fail to meet its upper threshold of 64% of debt funding of the capital program.** Implementing the 1.40x coverage target will reduce LIPA's debt burden by approximately \$500 million by 2028.

The following graph demonstrates LIPA's improvement since the inception of the Board's Financial Policy in 2016 and the path toward achieving a 70% ratio by 2028.



## SUMMARY

**PFM has reviewed LIPA's financial performance since the 2015 Report and believes:**

- LIPA's adherence to the recommendations made in the 2015 Report as reflected in the Board's Financial Policy has produced significantly improved financial performance and has directly contributed to the upgrades to single-A credit ratings in 2019 by all three rating agencies.
- LIPA's financial projections demonstrate that major changes to LIPA's Financial Policy are not necessary to achieve LIPA's overall goal of maintaining coverage and cash flow to ensure financial strength and to reduced reliance on debt.

**PFM recommends LIPA:**

### Coverage Ratios

- Increase the fixed obligation coverage ratio target to 1.40x in 2022 and maintain that level, subject to two qualifications:
  - The ratio may need reconsideration for 2024 and beyond if higher than expected capital spending is required;
  - Changes in accounting standards impacting LIPA's long-term lease obligations may require downward or upward adjustments to the coverage ratio in order to maintain the appropriate amount of coverage dollars to fund future capital expenditures.

### Pension & Other Post-Employment Benefit Funding

- Transition to funding the OPEB Account with monies sourced and categorized as an operating expense in LIPA's consolidated budget. This will eventually lead to a prefunded plan that appropriately meets future obligations and allow coverage dollars to be used predominately to fund capital expenditures (thereby reducing debt);
- Continue to fund the Service Provider's Pension Trust from operating expenses.

### Debt Funding Capital Ratios and Leverage

- Allow the percentage of Capital Expenditure Funded from New Debt to exceed 64% target on a forward-looking three-year rolling average in 2021 and 2022 as LIPA responds to the effects of the COVID-19 pandemic and Tropical Storm Isaias. Afterward the target percentage should return to 64% or below on a forward-looking basis;
- Adhere to a goal of achieving a Debt-to-Assets ratio of 70% by 2028, with continued improvement beyond that date. This metric will be managed through interim adjustments as needed to the annual targets for the fixed obligation coverage ratio.

### Liquidity, Days Cash on Hand, and CRMs

- Maintain the cash and available credit target of 120 days which has successfully provided a suitable cushion for unanticipated events.
- Continue to use its CRMs to ensure collectability of costs that could fluctuate materially and are largely outside of the utility's control (or alternatively budget for a coverage ratio in excess of the minimum stated in the Board's Financial Policy).

## APPENDIX 1 – 2019 RATING AGENCY REPORTS

### MOODY'S INVESTORS SERVICE – SEPTEMBER 6, 2019

#### RATINGS RATIONALE

The upgrade and rating assignment reflect the economic strength of LIPA's service territory along with the continued improvement in LIPA's financial performance. Moreover, it considers our expectation for execution on the company's strategic goal focused on continual improvement on the company's financial position and operating performance. LIPA's key financial metrics in 2018 continue to improve. Specifically, the company's fixed charge coverage, as calculated by Moody's, improved to 1.27x in 2018 from 1.16x in 2017 and 1.11x in 2016, while its debt ratio declined to less than 100% from 110% during the same timeframe.

Going forward, we expect LIPA to maintain a fixed charge coverage in excess of 1.2x and its debt ratio to continue to trend downward. LIPA's capital spending in 2019 and 2020 are expected to exceed historical levels and approximate \$1.6 billion over this timeframe. LIPA intends on funding approximately 65% of its capital expenditures with new debt, resulting in approximately \$1 billion of incremental general revenue debt over this period. LIPA's debt ratio over this timeframe is expected to decline, however, driven by the sizeable increase in plant property and equipment combined with operating cash flow, scheduled amortization, and the use of remaining FEMA grant funds as a funding source.

While LIPA's fixed charge coverage ratio is somewhat weak for a mid-A rated public power utility, its cash flow stream is more stable than certain comparable utilities due to the strong suite of cost recovery mechanisms. For example, these mechanisms provide recovery should a shortfall from budgeted revenue and expense items occur due to external factors, including weather, storms and economic conditions. Moreover, its rate setting capacity is premised around an ability to meet a target debt service coverage ratio, which we view as a credit supportive feature.

#### RATING OUTLOOK

The stable outlook assumes LIPA maintains a sound operating track record while maintaining at least 140 days cash on hand for liquidity support. LIPA's days cash on hand in 2018 was approximately 160 days.

#### FACTORS THAT COULD LEAD TO AN UPGRADE

LIPA's rating is well-positioned at the mid-A category and is not expected to move upward in the foreseeable future. Longer term, a sustainable improvement in credit metrics could give rise to a higher rating. For example, consideration of a higher rating could occur if the fixed obligation charge coverage were to reach 1.50 times on a sustained basis while its debt ratio fell below 80%.

## APPENDIX 1 – 2019 RATING AGENCY REPORTS

### FITCH RATINGS – SEPTEMBER 5, 2019

#### 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.

#### 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.

#### Legal Ability to Set Rates

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. 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.

#### 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. Despite limited generation needs, LIPA's five-year capital budget includes \$3.26 billion of capital expenditures, which remains elevated. 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. 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.

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.

## APPENDIX 1 – 2019 RATING AGENCY REPORTS

### S&P GLOBAL RATINGS – SEPTEMBER 5, 2019

S&P Global Ratings raised its rating on the Long Island Power Authority (LIPA), N.Y.'s \$4.07 billion unsecured revenue bonds to 'A' from 'A-'. The outlook is stable. The upgrade reflects expectations of strong fixed charge coverage (FCC) metrics that require moderate rate increases. In addition, the operational and management assessment reflects the benefits of a basket of financial tools that facilitate passing along to customers the changes it could experience in a wide range of variable costs, including a decoupling mechanism that tempers the exposure of energy sales and revenue to energy-efficiency programs, distributed generation, and weather.

Our FCC calculation treats capacity charges paid to other generation owners as debt service rather than as operating expenses, because we view these payments as funding the suppliers' recovery of their investments in generation assets that they dedicate to LIPA. FCC was unusually robust at 1.5x in 2018 because of the year's low principal amortization. We consider liquidity to be very strong based on \$952 million of unrestricted cash and investments at year-end 2018.

Outlook – The stable outlook reflects expectations of strengthening FCC, the availability of robust pass-through mechanisms for recovering rising costs, and favorable service area demographics that can support the utility's high rates.

#### **Enterprise Risk Profile: Very Strong**

In our opinion, the rate oversight distinguishes the utility from most other public power utilities. However, the several available pass-through and decoupling mechanisms could diminish the need for base-rate adjustments that exceed the threshold. Beyond base rates, retail rates include monthly and other periodic adjustment mechanisms for recovering changes in sales, purchased power costs, delivery costs, debt service, storm costs, payments in lieu of taxes, and other adjustments. We consider these mechanisms as supporting revenue-stream stability. Among these is a revenue-decoupling mechanism that provides for the collection of revenues deemed to have been lost to energy-efficiency programs, distributed generation, weather, and changes in economic conditions.

#### **Financial Risk Profile: Strong**

##### **Debt and liabilities: Highly vulnerable**

As of Dec. 31, 2018, the utility reported \$3.8 billion of unsecuritized long-term debt, and \$235 million of short-term debt. By comparison, its 2018 net position was only \$495 million, translating into what we consider an extremely high debt-to-capitalization ratio of 89%. The utility has identified \$3.1 billion of 2019-2023 capital needs, requiring almost \$2 billion of new debt.

##### **Coverage metrics: Strong**

Securitization transactions produced multi-billion-dollar debt reductions and improved DSC of unsecuritized debt, which reached 1.8x in 2018 on the year's uncharacteristically low principal obligations. The minimum lease payments LIPA projects in the notes to its financial statements indicate that FCC could be at least 1.2x through 2023, which we consider strong.

##### **Liquidity and reserves: Very strong**

The utility recorded \$952 million of unrestricted cash and investments on its balance sheet as of Dec. 31, 2018, which we view as representing a strong four-months' operating expenses. Undrawn capacity available under credit facilities brings this ratio up to about five-months' operating expenses.

